

2023: Domestic Demand Perseverance 2024: Reaction To Fed Policy

Emerging Markets Chief Economist Elijah Oliveros-Rosen's Year-End Blog

December 13, 2023

This report does not constitute a rating action

For the final 2023 edition of our Essential Economics Newsletter, we asked each S&P Global Ratings chief economist to share their insights on following questions:

- *What was the biggest surprise for you in 2023 and what are the takeaways?*
- *What will you be watching most closely in 2024, and why?*

2023: Domestic Demand Perseverance

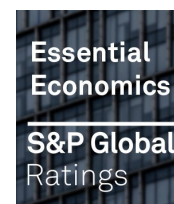
In 2023, domestic demand across most emerging markets (EMs) surprised to the upside, which meant that most of our revisions to GDP growth throughout the year were upward. Our 2023 aggregate GDP growth forecast for major EMs (excluding China) started the year at 3.3%; it's now at 3.7%. High inflation, interest rates, and economic uncertainty (including the impact of two major conflicts) didn't stop domestic demand from expanding across most of EMs this year (see chart 1). Four factors, in our view, explain this.

First, the economic resilience of major advanced economies, especially the U.S., kept demand for key EM exports stronger than anticipated, maintaining robust labor market dynamics in export-oriented sectors. Second, the transmission of tight monetary policy to domestic demand in EMs is weaker than in most advanced economies (and the lags of transmission could also be longer). This is because financial intermediation is still relatively low in most EMs. Third, fiscal stimulus remained abundant in most EMs. In some cases, stimulus measures introduced during the COVID-19 downturn were, to a degree, extended. In other cases, new measures were introduced in anticipation of weaker growth prospects, which in most cases didn't materialize. Fourth, consumption patterns in several EMs are in the process of returning to pre-pandemic trends, especially in EM Asia, where COVID-19 restrictions were among the harshest, giving an extra boost to domestic demand throughout 2023.

Takeaways The lag of monetary policy transmission in EMs can be particularly long, and its impact on domestic demand is smaller than in advanced economies due to lower levels of financial intermediation. Conversely, the impact of fiscal policy can be considerable in EMs, as it proved to be the case throughout 2023. Furthermore, we're still learning what the "new post-pandemic normal" will look like in most EMs, as sectors adapt to the changes brought upon by COVID-19.

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2024: Reaction To Fed Policy

It has been an active year for EM central banks (see chart 2), and 2024 is likely to be so as well. Most consensus projections (including ours) expect EM central banks that have started reducing interest rates to continue doing so into next year, and those that haven't done so yet, to start easing policy by the end of 2024. An important factor that will play a role in determining the magnitude and timing interest-rate cuts will be expectations around the Federal Reserve's (Fed) monetary policy. This is because the spread between central bank policy rates in EMs and the Fed's funds rate has important implications for capital flows, financing costs, exchange rates, and consequently, for inflation (pass-through effects from exchange-rate movements).

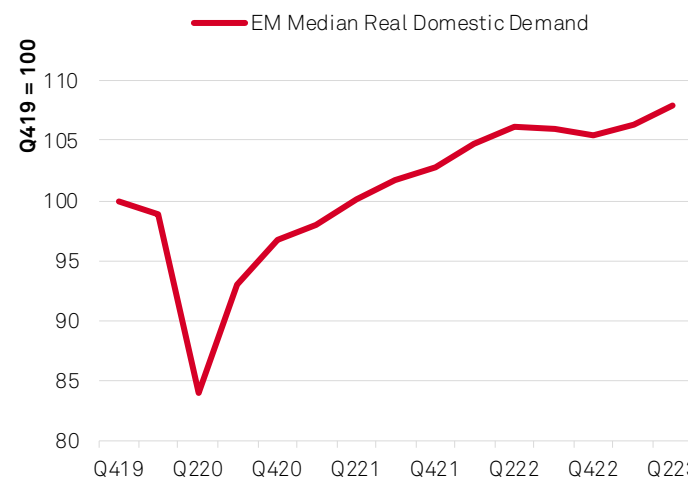
The good news is that after the sharp surge in prices that started in 2022, the process of disinflation is well underway in most EMs. The median inflation in EMs, which peaked above 8% year over year in August 2022, is now about half of that. This has allowed several EM central banks to start cutting interest rates ahead of the Fed. The bad news is that interest rates are still very high, even in EMs that have started lowering them. Unless nominal interest rates fall at least as much as inflation does, rates will get higher in real terms as inflation continues to slow. Therefore, what the Fed does (and what markets expect it to do) will influence how much EM central banks are able to lower real interest rates without risking disorderly currency adjustments.

What to watch Market-implied interest-rate expectations and forward guidance by the central banks. More specifically, how central banks manage potential swings in market expectations for interest rates, given the impact that market expectations typically have on financial conditions.

Chart 1

Domestic demand held up better than expected

EMs' median real domestic demand

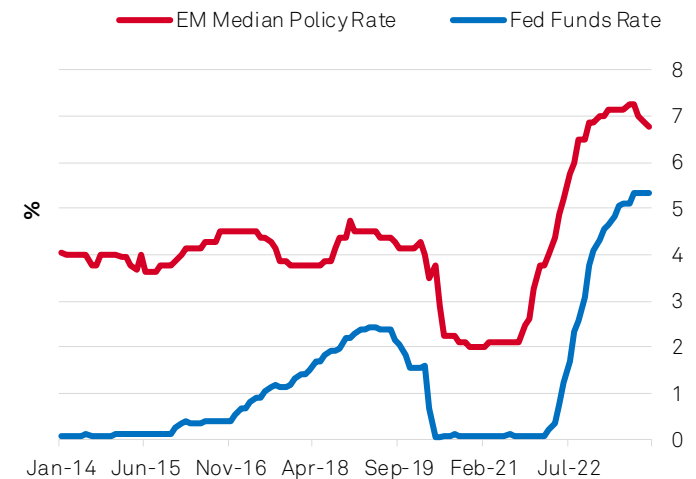


Note: Median calculation includes major EMs, excluding China. Sources: Haver Analytics and S&P Global Ratings.

Chart 2

Fed expectations will play a role in EM policy rates

EM and Fed policy rates



Note: Median calculation includes major EMs, excluding China and Argentina. Sources: Haver Analytics and S&P Global Ratings.

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