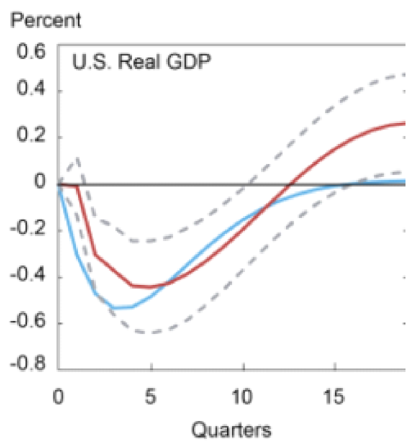
Real-time insight from DuPont Capital Management's Global Equity Team (December 2021)

US monetary policy is known to have a sizable spillover impact on Emerging Market Economies (EME's) through both trade and financial channels. The latter manifest themselves through declines in risk asset prices, tighter financial conditions and capital outflows. A 100 basis point increase in the Fed Funds rate is estimated to have a similar impact on real economic growth in EME's (0.45%) than in the US (0.50%). Economists at the New York Fed have recently tried to model and disentangle the empirical findings (*).

The red line in the 3 charts below shows the estimated real impact and the blue line shows the economist's model. Chart 1 and 2 show the impact and persistency of a 100 basis point hike in Fed Funds on real economic growth in the US and Emerging Markets, while chart 3 shows the relative importance and persistency of the trade and financial transmission channels in Emerging Market Economies.

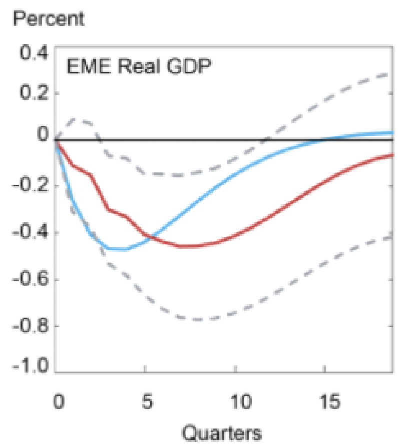
Impact on Real Economic Growth of 100 basis point increase in US Fed Funds Rate

Chart 1



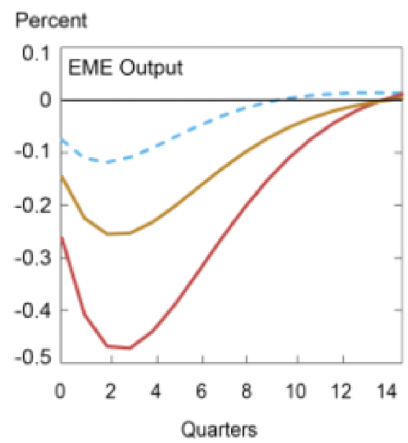
Blue: Model
Red: SVAR impulse Response (real est.)
Grey: 95% confidence Interval

Chart 2



Blue: Model
Red: SVAR impulse Response (real est.)
Grey: 95% confidence Interval

Chart 3



Blue: Trade Channel
Yellow: Fin. Channel without Dollar Debt
Red: Financial Channel with Dollar debt

(*) Source: Liberty Street Economics, Ozge Akinci & Albert Queralto, "How does US Monetary Policy Affect Emerging Market Economies?", 05/17/2021

It is noteworthy that the effect of US monetary policy reverberates much longer in EME's that it does in the US (I.e. it takes many more quarters to recover).

The trade impact, estimated to be 0.10% of growth, is muted as the impact of lower US imports is partly mitigated by lower exchange rates.

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A drop in EME asset prices (the first financial impact) leads to a deterioration of the borrower's balance sheet, which in turn leads to higher credit spreads and a higher EME risk premium. This is called a "financial accelerator effect" and causes the EME economic output to fall by another 0.15%. The presence of US Dollar debt on EME balance sheets (the second financial impact) ultimately serves as an additional and significant financial amplifier with an estimated drag on real economic output of 0.25%.

Despite poor relative performance year to date, expected tighter monetary policy in the US, in addition to a more onerous regulatory environment in China, may very well put emerging market economies at a disadvantage relative to Europe and the US.