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PREPARED BY

Alfredo Coutiño
alfredo.coutino@moodys.com
Director of Latin American
Economic Research

CONTACT US

help@economy.com

U.S./Canada
+1.866.275.3266

EMEA
+44.20.7772.5454 (London)
+420.224.222.929 (Prague)

Asia/Pacific
+852.3551.3077

All Others
+1.610.235.5299

economy.com
moodysanalytics.com

Mexico Under a Severe Economic Scenario

"If the U.S. economy declined, Mexico's would sink more profoundly"

A severely adverse economic scenario in the U.S. will cause severe damage to Mexico's economy. If the Federal Reserve's severe scenario to test the strength and resilience of banking institutions materializes, Mexico's economy would suffer profoundly. The negative consequences will surpass in magnitude and duration those faced by the Mexican economy during the global recession in 2008-2009.

Mexico Under a Severe Economic Scenario

- *Mexico's economy would suffer profoundly if the U.S. were to fall into a severe recession and financial dislocation.*
- *Such a recession would be amplified due to Mexico's dependence on the U.S. cycle and policy restrictions.*
- *The subsequent rebound would also be amplified in Mexico's economy, as happened after the 2009 recession.*

METHODOLOGY

Based on the Federal Reserve's supervisory scenarios to test the strength and resilience of banking institutions —and using our quarterly econometric model that replicates the structure of the Mexican economy and includes linkages with the U.S.—we generated the corresponding baseline and severely adverse scenarios for Mexico. The severe scenario represents a realistic illustration of Mexico's high synchronicity with the U.S. business cycle: The country strongly benefits from U.S. economic booms but also suffers severely from U.S. downturns. The scenario is also consistent with Mexico's response during past economic crises.

A MODERATE EXPANSION

The Fed's baseline scenario for Mexico reports a moderate economic expansion and is built as a combination of the projections of the International Monetary Fund's World Economic Outlook and the Moody's Analytics baseline scenario for the medium- and long-term horizon. Real GDP growth is higher in 2019 and 2020 and then moderates thereafter, going from rates between 2.5% and 3% in the first five years to rates around Mexico's potential growth of 3% for the rest of the forecast horizon.

However, in 2019 the economy is functioning under tight monetary policy, which, together with a volatile external environment, is limiting its performance. Financial markets remain nervous regarding the normalization of U.S. monetary conditions and the threats of additional tariffs by the U.S. government. Uncertainty regarding policymaking under Mexico's new leftist government and weaker investor sentiment due to the cancellation of infrastructure projects could also affect the economy's performance in 2019.

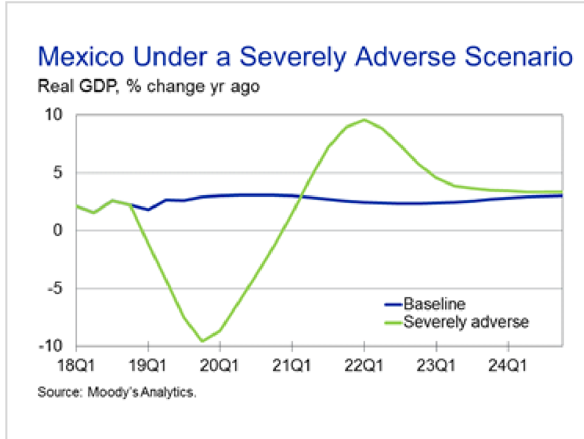
Unemployment is fully determined by the model based on the economy's performance, gradually moving from a rate of around 3.3% in 2018 to 3% in 2020, then increasing in the medium and long term to more natural rates when the economy converges to potential growth. Mexico's economy continues to benefit from the steady advance of the U.S. economy, its main trade partner.

Financial variables and prices are, in general, similar to the Moody's Analytics baseline projections. Monetary conditions stay in restrictive territory in 2019 in order to reduce the above-target inflation, with the policy rate staying above 8% in the first half of the year before gradually decreasing toward its neutral rate of around 4.5% in the medium term. As a result of the policy response, inflation starts to trend downward in the second half of 2019, then hovers around 4% in the medium term and converges to the 3% target in the long term.

The foreign exchange market remains under pressures in 2019, mainly affected by external factors and some uncertainty related to Mexico's new leftist government. In 2020, the peso stabilizes and then depreciates gradually in order to neutralize the differential of inflations between Mexico and the U.S. The stock market reports an adjustment in the short term given the external and domestic uncertainties, and then advances according to the economy's performance and the influence of the U.S. market.

Mexico's reforms will benefit the economy's potential capacity in the medium term. However, the size of the economic impact depends on the magnitude of the structural changes produced by the main reforms implemented. The key is not the quantity of reforms, but rather the quality. The country has moved in the right direction by strengthening the fundamental sources of permanent growth, but it will take some time for the economy to increase its production capacity and consequently its potential growth.

A SEVERELY ADVERSE SCENARIO



One of the Fed's test scenarios is built with a set of unfavorable economic and financial conditions that create a severely adverse environment for the U.S. economy and generate significant stress for financial markets. As a result, the global economy experiences a deep recession and prolonged financial dislocation.

In this severely adverse scenario, Mexico also suffers a deep recession as a result of the severe contraction in the U.S. The negative consequences surpass in magnitude and duration those faced by the Mexican economy during the global recession in 2008-2009. Mexico is severely affected by the external shock and particularly because of the magnitude of the U.S. downturn.

For the U.S., the severely adverse scenario presents a deep economic contraction accompanied by a severe global recession. The U.S. has a recession that is deeper and longer than that in 2008-2009, with a contraction of 8% for seven consecutive quarters (2019Q1-2020Q3). Financial markets are stressed severely, global risk aversion increases, asset prices experience a significant correction, and unemployment accelerates quickly. Given the magnitude of the world economic recession and global risk, the U.S. dollar reinforces its role as a safe-haven currency.

Given Mexico's high dependence on the U.S. business cycle, the Mexican economy also enters a severe recession, with real GDP contracting almost 6% in 2019, around 5% in 2020, and 11.4% cumulatively from the prerecession peak in the fourth quarter of 2018 to the recession trough in the third quarter of 2020. Mexico's recession cycle coincides with the U.S. cycle, with the economy falling through seven consecutive quarters. This is accompanied by a rise in the unemployment rate to a peak of 7.8% in the third quarter of 2020, more than 2 percentage points above the average rate of 5.5% reached during the 2009 recession. Unemployment then starts to trend downward to gradually approach the baseline's trend in the long term. The economy begins to recover at the end of 2020 and strongly rebounds afterward, coinciding with the U.S. expansion cycle.

As has been typical in past crises, Mexican financial markets suffer a period of strong volatility and stress generated by risk aversion and uncertainty. The peso reacts immediately with a strong overshoot, depreciating almost 20% in the first two quarters of the shock and generating a quick pass-through to inflation. Inflation initially overshoots to around 9% in the first two quarters and then declines as the economy falls into a severe contraction. Inflation converges to more consistent rates when the foreign exchange rate stabilizes and approaches its long-term parity.

The policy response to the increasing financial instability is—as shown in past crises—through a reinforcement of fiscal and monetary discipline. In this sense, the central bank acts by tightening monetary conditions to control the inflation spike and the peso depreciation. Thus, the policy rate rises by around 3 percentage points during the first two quarters of aggressive instability and surpasses the peak of 8.25% reached during the 2008-2009 recession. The 10-year government bonds respond even more aggressively given the increasing risk aversion, with the widening credit spreads raising the funding cost for government debt and imposing additional pressure on fiscal accounts. However, as economic conditions in Mexico continue to worsen, the central bank starts to reverse the monetary tightening, lowering the policy rate in synchrony with the cycle of global monetary relaxation.

Hence, in this scenario of adverse economic and financial conditions, Mexico's economy reproduces the typical overshooting cycle in the exchange rate, inflation, and interest rates accompanied by a deep correction in the stock market. Equity prices in Mexico are mainly driven by worsening economic conditions and the fall in U.S. stocks. Mexico's stock prices fall around 45%, less than the contraction of 50% in the U.S. stock market.

Mexico's more aggressive policy response produces a deeper depression of domestic absorption, sending the economy into a more severe recession compared with the contraction in the U.S. After markets return to stability and the U.S. begins to recover, Mexico's economy strongly rebounds in the medium term, thus amplifying the U.S. expansion.

MEXICO'S BUSINESS CYCLE

The Mexican economy is subject to two shocks in this severely adverse scenario: One is externally generated by the U.S. economic contraction, and another is produced by the depression of domestic demand caused by the necessary policy adjustment.

Given the lack of fiscal space and the limitation imposed by the single-objective monetary mandate of price stability, in an environment of increasing financial instability and high inflation, domestic economic policy has no option other than to move procyclically. This policy procyclicality is the main reason for Mexico's internal amplification of the U.S. economic contraction.

However, the same way that Mexico's economy internally amplifies the U.S. contraction, it also amplifies the rebound. This way, the U.S. recovery propels a rebound of Mexico's economy. Similar to what happened after the 2009 recession, Mexican economic growth rebounds to above 7% in 2022 and surpasses 6% in 2023, thus amplifying the U.S. expansion cycle.

This scenario simulation replicates Mexico's economic history: If the U.S. economy falls, Mexico's economy sinks; but if the U.S. recovers, Mexico rebounds. Therefore, a severely adverse economic scenario in the U.S. will cause severe damage to Mexico's economy.

ABOUT THE AUTHOR

Alfredo Coutiño is a Director with Moody's Analytics, responsible for analysis, modeling and forecasting for Latin America as well as real-time coverage of the macro economies. He is frequently quoted in media and industry publications and has been a speaker at United Nations conferences and at the American Economic Association. Alfredo has published papers on applied econometrics with Nobel laureate Lawrence Klein. Dr. Coutiño received his PhD in economics from the University of Madrid after completing doctoral studies at Temple University.