

ECONOMIC ANALYSIS

February 2019

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South America Under Hypothetical Stress Scenarios

Applying the Fed's latest CCAR parameters, the region's recessions would be deeper than in the U.S.

The Federal Reserve's Comprehensive Capital Analysis and Review scenarios, designed to stress test banks, portray hypothetical global recessions. Under this year's CCAR parameters, South America would be particularly vulnerable due to the collapse of commodity prices and global financial volatility. Our narrative based on the scenarios suggests that the region is poorly prepared for a new global recession.

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The Board of Governors of the Federal Reserve System conducts a required annual supervisory stress test of banks—the Comprehensive Capital Analysis and Review. In early February, the board released the parameters for this year's CCAR exercise, which includes three supervisory scenarios—baseline, adverse and severely adverse. Banks must use these economic scenarios when conducting their annual company-run stress tests and estimate projected revenues, losses, reserves and capital levels as part of their 2019 capital plan submissions. It is important to note that these are hypothetical scenarios designed to assess the strength of banking organizations and their resilience to adverse economic conditions. The scenarios do not represent forecasts by the Federal Reserve.

CCAR SCENARIOS

The board's scenarios include six measures of economic activity and prices for the U.S. as well as four aggregate measures of asset prices or financial conditions and six measures of interest rates. When it comes to the global economy, the board only provides projections for GDP, inflation, and foreign exchange rates for the U.K, the euro zone, Japan, and developing Asia. The board does not provide specific projections for other developing economies such as South America. Yet it notes that “economic conditions in developing Asia should be assumed to be representative of conditions across emerging market economies.”

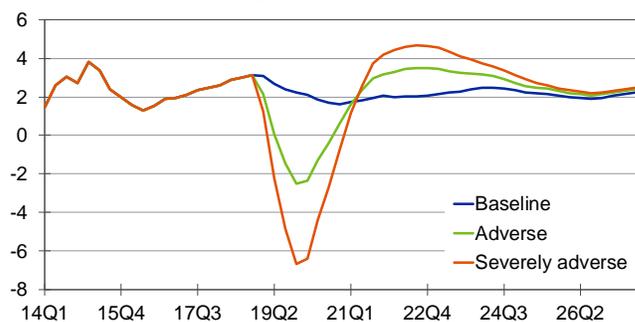
The baseline outlook for U.S. real activity, inflation, and interest rates is similar to the January 2019 consensus projections from Blue Chip Economic Indicators. The baseline scenario for the U.S. is a moderate expansion through the projection period. Real GDP growth averages 2.25% in 2019, drops slightly to 1.5% in 2020, and then rises to 2% in 2021. The unemployment rate falls to about 3.5% during 2019, and then increases to about 4% by the first half of 2021. CPI inflation averages about 2.25% each year.

In the adverse scenario, the U.S. economy experiences a recession, with real GDP falling slightly more than 2.75% from peak to trough. Reflecting weak economic conditions, short-term interest rates and longer-term Treasury yields fall. In addition, financial conditions tighten and asset prices decline, but less intensely compared to the severely adverse scenario. Following the recession, U.S. real activity picks up slowly at first and then gains momentum. The growth rate of U.S. real GDP increases from about 0.75% in 2020 to about 3.25% in 2021.

The severely adverse scenario is characterized by a severe global recession accompanied by a period of heightened stress in commercial real estate markets and corporate debt markets. In the U.S. real GDP falls about 8% from its pre-recession peak, reaching a trough in the third quarter of 2020. As a result of the severe decline in real activity, the interest rate for three-month Treasury bills falls 2.25 percentage points and remains near zero through the end of the scenario. The 10-year Treasury yield falls by a somewhat smaller amount, resulting in a mildly steeper yield curve. The 10-year Treasury yield reaches a trough of about 0.75% in the first quarter of 2019 and rises gradually thereafter to 1.5% by the first quarter of

CCAR Includes Two Recession Scenarios

U.S. GDP, % change yr ago



Sources: Federal Reserve, Moody's Analytics

2021 and 1.75% by the first quarter of 2022.

SOUTH AMERICA UNDER CCAR SCENARIOS

Moody's Analytics has used the parameters provided by the Fed to develop a specific narrative for South America. The narrative is based on the region's history when it comes to global recessions, and the current state of South American economies. One key assumption of the Federal Reserve's recession scenarios is the collapse of commodity prices due to plummeting global demand. This represents a key factor when building a particular narrative for South America that deviates from the parameters specified by the Federal Reserve for Developing Asia. Lower commodity prices normally create deflation pressures in Developing Asia—a net commodity importer. By contrast, lower commodity prices tend to create temporary inflation pressures in South America, even in the face of a deep recession.

Lower commodity prices not only create inflation pressures in South America—due to a widening external imbalance—but also tend to deepen economic recessions, since they hit fiscal revenues and prevent the use of countercyclical economic policies.

RECESSION SCENARIOS

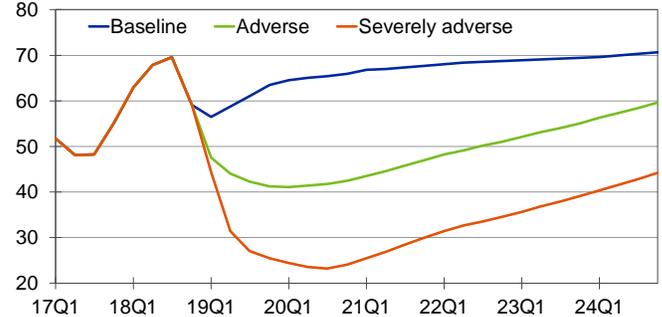
The global recessions described in the adverse and severely adverse scenarios hit South American economies with dislocation in domestic financial markets and extreme volatility in the foreign exchange market. Commodity prices slump as a result of the global recession, worsening the region's fiscal and external balance. Financial turbulence deals a particularly hard blow to those countries with more globally integrated markets such as Brazil, Chile and Colombia. Global demand for South American exports declines significantly, particularly for primary goods, accelerating the external imbalance. Oil exporters like Venezuela, Ecuador and Colombia face a more severe external imbalance.

South American governments are left with no other option than a severe fiscal adjustment combined with a more aggressive monetary intervention. The policy response is more pronounced in the severely adverse scenario given the larger negative external shock. Regional currencies depreciate significantly amid massive capital flight, with the negative consequence of accelerating inflation. The region's central banks tighten monetary conditions initially to stabilize their currencies and prevent an inflationary spiral. The fiscal adjustment includes not only budget cuts but also increases in taxes and public prices in an effort to avoid the explosion of fiscal imbalances. Policymakers quickly reverse such tightening by late 2019 once global financial markets stabilize, and declines in commodity prices ease. As South American currencies stabilize, or in some cases appreciate, inflation decelerates and converges with the baseline scenario in the medium term.

In the adverse scenario, the region's economy falls into recession in early 2019 with real GDP contracting 2.1% for the year. The economy starts to recover by mid-2020 as external conditions improve and inflation decelerates. GDP contracts 0.6% in 2019. Real GDP falls 3.5%

Commodity Prices Slump Under CCAR

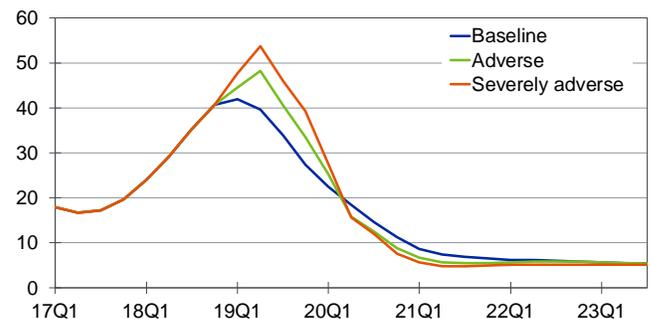
Price of West Texas Intermediate, \$ per bbl



Source: Moody's Analytics

LatAm Suffers Inflation Spike Under CCAR

South America annual inflation rate, %



Source: Moody's Analytics

from the prerecession peak to the recession trough in the first quarter of 2020. Slumping commodity prices and the need to implement procyclical economic policies make the economic recession in South America deeper than in the U.S. in the adverse scenario.

In the severely adverse scenario, domestic demand is depressed further by the effects of the larger policy adjustment implemented to restore stability and contain deepening imbalances, turning the economy's downturn into a deep and long recession that lasts until late 2020. The region's GDP contracts 5.3% in 2019 and a further 4.5% in 2020. Real GDP falls 9.9% from the prerecession peak in the fourth quarter of 2018 to the recession trough in the third quarter of 2020, compared with 8% for the U.S. South America's economy begins a

solid recovery by early 2021, and growth accelerates measurably through 2022, as the global economy rebounds and the region takes full advantage of rebounding commodity prices and renewed capital flows. The region's unemployment rate falls steadily after 2020 and reaches its long-term equilibrium level by the early 2030s.

South America would face deeper recessions under the described CCAR scenarios than other regions of the world due to the lack of fiscal space and its long-standing dependency on commodity prices. Macroeconomic fundamentals—including debt measures—deteriorated following the 2008 global crisis and have yet to improve in a meaningful way.

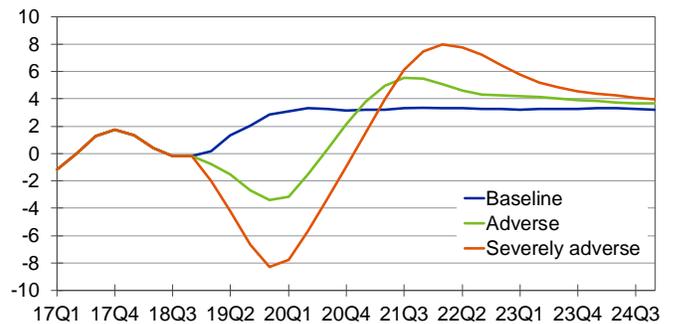
ABOUT THE AUTHOR

Juan Pablo Fuentes is an economist at Moody's Analytics. He is a regular contributor to the Economy.com/Latin America web site and produces forecasts and alternative scenarios for a number of Latin American countries. Juan Pablo also writes about energy-related issues. Before joining Moody's Analytics, Juan Pablo analyzed Latin American economies for IHS Global Insight. He received his master's degree in international economics from Suffolk University and his bachelor's degree in economics from the Andres Bello Catholic University in Caracas, Venezuela.

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Deeper Recession for LatAm Under CCAR

South America GDP, % change yr ago



Source: Moody's Analytics

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