Economic Analysis

# GDP contraction is inevitable; the decisions that are currently being made will determine how severe it will be and how quickly it could recover

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## We are anticipating an economic contraction of 4.5% in 2020, with a strong downward bias if measures are not taken quickly to stem the spread of the virus

The outbreak of Covid-19 will have a significant negative impact on economies at a global level. In an environment of generalized shocks on global supply and demand as a result of Covid-19, with disruptions to value chains, and in which whole countries (Italy, Spain) or regions (California, New York) have already taken drastic yet necessary measures to stem contagions of the virus that are causing an abrupt drop in demand. A global recession, including the United States, is now the most probable scenario, with a high level of uncertainty with regard to its magnitude and duration, but with the certainty that the simultaneous adverse shocks to supply and demand will imply significant drops in economic activity. **Mexico is not isolated from the disruptions to value chains and will be severely affected by the foreseeable collapse in production and demand in the United States.** It will also be affected by the expected fall in remittances. Moreover, the impact will be greater than in other countries due to the drop in the price of oil, which will even mean more problems for the Pemex balance, which will consequently affect public finances.

Furthermore, Mexico is not the exception and is already being affected by this invisible enemy. Until now, the number of confirmed infections has been low; it is expected that, if we assume that the spread of the virus will be similar to that observed in other countries, such as Italy and Spain, there will be many more cases that have not yet been confirmed and that **if the necessary measures are not taken quickly (social distancing and isolation, which have been proven to be the most effective, as demonstrated in the cases of Korea, Taiwan and Singapore), the virus will spread rapidly.** There are moments of truth, crucial for the fate of countries. **This fate does not have to be inevitable, but a moment of truth like the current one means that this is an important time in which decisions must be made quickly, and during which what is decided upon will have significant consequences for the future.** A deep recession is inevitable, the uncontrollable spread of the virus is not. **The moment to make decisions has arrived, and these decisions will determine whether the drop in economic activity is short or long term but, far more importantly, they will indicate whether it has been possible to eventually contain the spread of the virus (i.e. that "the infection curve is flattening off") or they will translate into an unnecessary exponential growth. The decisive measures that other countries are taking are necessary. They will be undoubtedly taken in Mexico too, and the sooner the better.** The main body responsible in this moment of truth is the federal government, but local governments, companies and individuals must also act and bring out the best in dealing with this crisis (we are all in this together), and assume the responsibility and immediacy that the challenge warrants**. Not taking social distancing and isolation measures for fear of the economic impact will not only result in a public health problem, but it may also result in an even greater impact on the economy**: the higher the infection rate is, the greater the overall economic impact will be.

**At the moment, we are revising our GDP growth forecast downward to -4.5%.** It goes without saying that making economic forecasts is always a process that needs to be carried out with considerable uncertainty and that, in this case in particular, the uncertainty is even greater. Nobody can accurately predict how long the epidemic is going to last or whether there are factors, climate, for example, that may mean that infection rates are going to vary between different geographical areas. **If the epidemic is not under control before the summer, the contraction will be even greater.** Disruptions to global value chains are already having an effect on national manufacturing output, especially in sectors intensive in the use of capital, such as the automotive and electronic goods industries. With regard to the tertiary sector, services related to tourism, especially air transport, food preparation and temporary accommodation, are being significantly affected, whilst the demand for other services will drastically fall in the days to come as a result of the prevention measures that should be implemented by the federal government, local governments, companies and individuals. Over the coming months, private consumption will witness a deterioration due to the lower disposable income that companies and households will have resulting from the negative impact on production and employment, whilst investment will further deepen its slump.

The extent and duration of the outbreak across the world, in the United States and Mexico will determine the ultimate effect on internal supply and demand. **Total isolation is the worst scenario for economic activity in the short term, yet the best in order to curb the spread of the virus and, therefore, the greatest ally to ensure that the drop in economic activity is as short as possible, and that it rebounds as soon and as strongly as possible. This isolation is becoming more and more probable.** We anticipate that the supply and demand shocks will affect economic activity more profoundly in the second quarter of 2020, for which we expect a 5.6% contraction QoQ. The negative effect of the pandemic will extend into the third quarter of 2020, with a quarterly drop of 0.6% in GDP. During the fourth quarter of 2020, the economy will start to recover, but without any significant impetus until the first quarter of 2021. **Our scenario assumes that decisions be made quickly. Otherwise, the fall will be greater and will last longer. Moving forward, Mexico is in a good position to make a strong recovery with ratification of the USMCA and the benefits for value chains established in Mexico due to a possible redirection of production from China to Mexico which would increase FDI over the coming years.** The sooner we get through this public health crisis, the sooner Mexico will be able to take advantage of this new comparative advantage which can be expected to acquire its full force once the current situation comes to an end on a global basis.

Together with the above, and in the context of a collapse of energy prices and a rapid widening of the negative output gap, downward pressures on inflation will offset the potential negative effects of the depreciation of the peso and the contraction of aggregate supply. The overall risk of inflation is now declining. As a result, **a foreseeable lower rate of inflation in the coming months and the deep economic downturn will call for a monetary stance that is suited to the context. There is a need to show greater flexibility and to adjust monetary policy quickly, especially considering its potential delayed effects.** We therefore expect Banco de México to reduce the reference rate to 5.0% by August (i.e., four consecutive cuts of 50 bp). In our opinion a cut of 100 bp is required at the next meeting, (in fact we believe that Banco de México should have taken this decision ahead of its next scheduled meeting), but the central bank’s recent announcement leads us to think that there is little likelihood that this will be the case. We consider that there is still a margin for a greater degree of flexibility in monetary policy (i.e., so that the rate will end up lower than 5.0%), but, to our great surprise, there have been recent signs that doubts still continue within the Board of Governors at Banco de México as to whether a fall in rates is appropriate, judging from recent interviews given by the central bank’s Governor. **We believe that the depreciation of the exchange rate should not be a factor that could prevent the Central Bank from reducing the reference rate** for two reasons: i) at the present time the link between short-term rates and the exchange rate is broken; the reason why the exchange rate has risen so much is the global risk aversion, so that the rate differentials between countries are not important. Many global funds are liquidating positions to face this situation with the highest possible degree of liquidity; ii) the transfer rate of exchange rate to prices in a contracting economy is practically zero. If Banxico changes the tone of its announcement, we will incorporate greater rate reductions into our base scenario. We also think that Banxico should follow the lead of various countries’ central banks by taking more aggressive measures to inject liquidity into the financial system to prevent financial conditions from becoming even tighter. Credit crunch scenarios can be expected at a global level: firstly because global risk aversion will lead to an increase in interest rates for companies and sectors facing problems (airlines, for example), and will therefore increase the risk that they default on their payment commitments. This is why it is desirable to introduce programs of regulatory facilities to provide solvent and viable borrowers with extensions on their credit obligations before the start of the health emergency.

The Mexican Chamber of Deputies has authorized an emergency fund of 180.7 billion pesos (0.7% of GDP) that the Federal Government could use in the event of health emergencies or economic crises. The law initiative was sent to the Senate for final approval. The resources for this new fund will come from federal budget appropriations to political parties that have not yet been tapped. It is highly likely that considerable public resources will need to be allocated in order to counter the negative economic effects of the Covid-19 outbreak, so that it will be necessary to give up the target of 0.7% of GDP for the 2020 primary balance. **In economic contexts such as the present one, fiscal objectives have to take second place; in our opinion, the most urgent and important requirement is to underpin health systems and provide them with support, especially for workers in the service sector and the informal economy,** who will undergo a drastic fall in their income. So that financial markets will be able to better digest a higher deficit, announcements should also be made about a tax reform that will increase public revenues, together with the cancellation of infrastructure projects such as the Dos Bocas refinery, which are not profitable, and will be even less so in this context of low oil prices.

## Conclusions

Global economic growth faces its greatest challenge since the Great Recession of 2009. On this occasion, both advanced and emerging economies are simultaneously facing both supply and demand shocks. Supply shocks are taking the form of disruptions to production chains in a globalized economy with a relatively high degree of vertical integration in such chains. Demand shocks are a result both of the decisions of those participating in the economy and of the restrictions imposed by the governments of many countries to favor social distancing to try to flatten out the curve of Covid-19 contagions. Even though many central banks have introduced loose monetary policies and allowed conditions of greater liquidity in their economies, and many governments are also giving significant tax breaks, the great uncertainty about the geographical extension and duration of the economic paralysis that is already affecting the world’s major economies make us anticipate a severe economic recession at a global level for the second quarter of 2020. In this international context, the Mexican economy will also experience a strong contraction in the same quarter, and it can be foreseen that the decline in economic activity will continue, although to a lesser extent, in the third quarter of the year, with the road to economic recovery beginning in the last quarter of the year. As a result, we expect an annual fall of 4.5% in real GDP in 2020.