

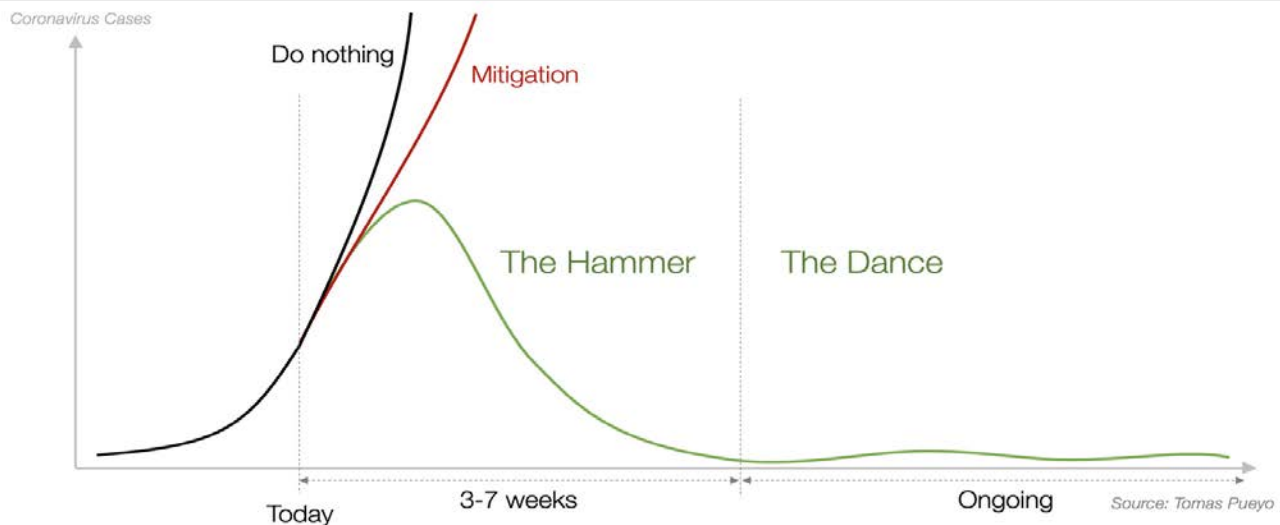
Economic Analysis

Impact of Covid-19 on the Economy: Lack of action is more dangerous than overreaction, both for public health and the economy

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- This is a time when decisions must be made quickly; what is decided will have significant consequences
- Drastic measures to ensure that people isolate are urgent, “desirable” and absolutely necessary
- It is also necessary to allocate fiscal resources to have as many tests as possible, including on people who are not showing symptoms
- Economic measures are needed as never before to limit the economic consequences of the pandemic on people, starting with the most disadvantaged; fiscal objectives must be put on the backseat
- The private sector must also respond to the circumstances

Graph 1. **Coronavirus**



Source: Tomas Pueyo

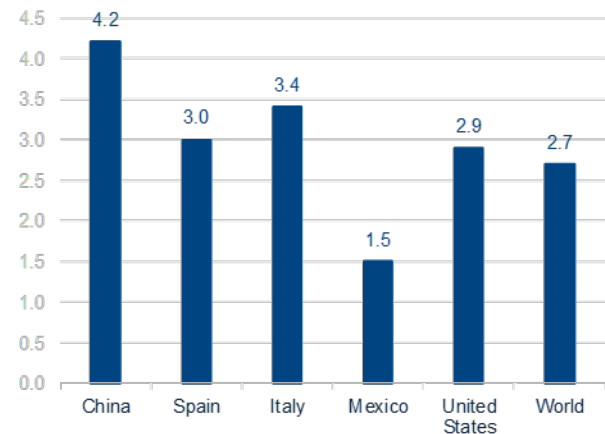
Globally, there are 2.7 hospital beds per 1,000 inhabitants on average

- China (4.2), Italy (3.4) and Spain (3.0) have more hospital beds per 1,000 inhabitants than the world average (2.7).
- Mexico has only 1.5 hospital beds per 1,000 inhabitants.

Globally, there are 1.5 doctors per 1,000 inhabitants on average

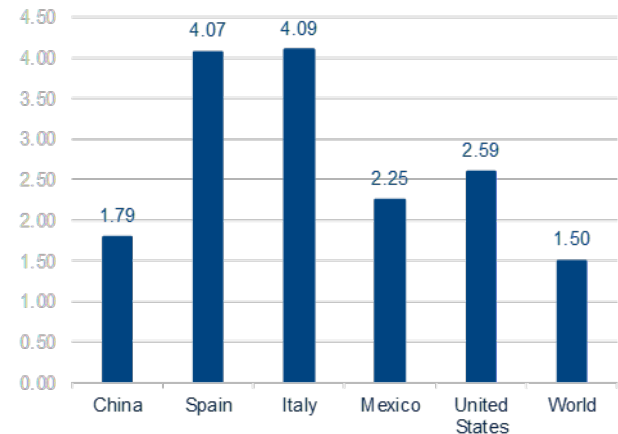
- Spain and Italy have 4 doctors per 1,000 inhabitants, more than double the global average (1.5).
- The United States has 2.59 doctors and Mexico has 2.25 doctors per 1,000, a higher figure than China, which has 1.79 doctors per 1,000 inhabitants.

Graph 2. **Hospital beds per 1,000 people, most recent year**



Source: BBVA Research based on World Bank data, 2020

Graph 3. **Doctors per 1,000 people, most recent year**



Source: BBVA Research based on World Bank data, 2020

Drastic measures to ensure that people isolate are urgent, “desirable” and absolutely necessary

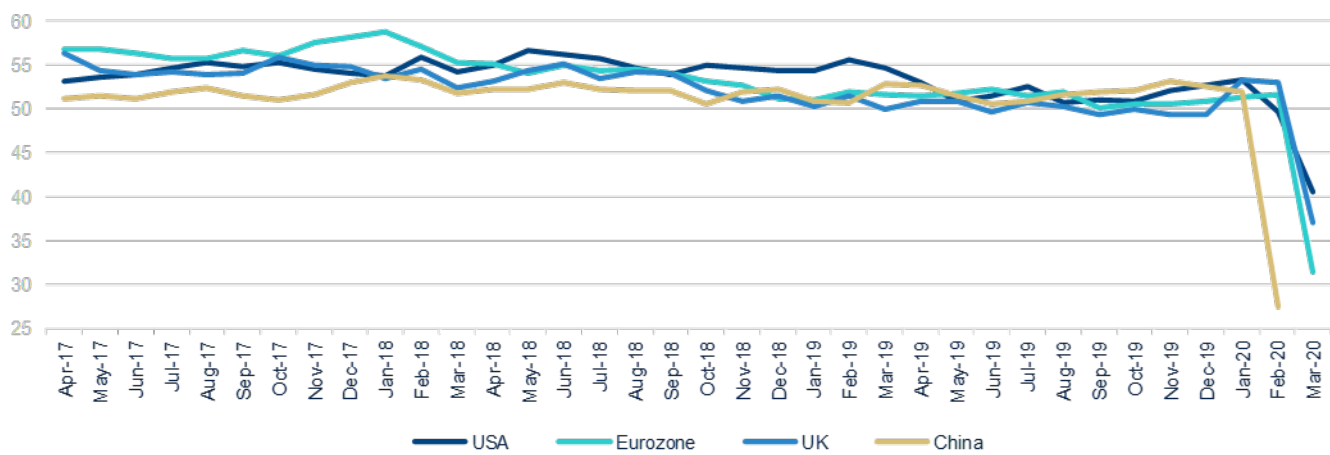
- A contraction in GDP is inevitable; decisions being made now will determine how deep it will be and how soon a recovery might occur.
- Ultimately, sacrificing the economy can be avoided through attempts to curb contagion. In other words, the trade-off between trying to curb contagion and the economic impact is illusory. In fact, the stronger, faster, and more forceful the measures (which can lead to national lockdowns), the smaller the spread of the virus will be, and thus the lesser the economic impacts in the medium term.
 - That is why it is time to “overreact” and implement strong measures that stop the foreseeable exponential growth of the contagion as quickly as possible.
 - The measures and restrictions that other countries have taken are necessary, and experience shows that in most places they were weak and arrived late.
 - The sooner they have been implemented and the more restrictive they have been, the better the results (e.g., Korea, Singapore, Taiwan). The Imperial College study, which, while built on assumptions that are yet to be tested, is the most comprehensive that has been produced by the scientific community to date and its conclusion

is clear. Mitigating measures, such as social distancing of older adults and vulnerable people (for example, those with diabetes), quarantine of infected people is not the right strategy, as health systems could be overrun very soon - the solution is not mitigation but suppression, trying to stop the epidemic as quickly as possible. This requires the implementation of quarantines for most of the population, as early as possible.

- So the question for Mexico is not whether measures should be taken, but when. The answer is that they should already have been implemented. The sooner, the better.
 - Mexico is already very late — according to the WHO, the country is already at the stage of cases of local transmission (i.e. a predictable exponential increase). The more time is lost, the greater the consequences for public health and, therefore, the economy.
 - On February 23 there were only 130 confirmed cases of contagion in Italy. Just a month later, they were at over 60,000 and are continuing to grow at an exponential rate.

The collapse of economic activity at the global level is evident

Figure 4. **Composite PMI (Diffusion Index)**



Source: Bloomberg

Economic measures are needed as never before to limit the economic consequences of the pandemic on people, starting with the most disadvantaged

- Never before has the world economy seen a “closure” as fast as the current one. A global recession is unavoidable, with a high degree of uncertainty over its magnitude and duration, but with the certainty that the simultaneous brake on supply and demand will lead to sharp falls in economic activity. The impact on economic activity worldwide is likely to be greater than that of the global financial crisis of 2008-2009.
- The question is not whether there will be a recession in most economies, but how deep it will be and how long it will last. Uncertainty mainly revolves around: (i) the fact that no one knows how the epidemic will progress, (ii) what containment measures will be taken and how effective they will be, and (iii) how long it will take health systems to find or develop effective medicines and/or find a vaccine against the virus.

- If aggressive containment measures are put in place quickly, the likelihood that inescapable economic effects will last a relatively short time (possibly one or two quarters) will increase. If states choose not to do so, the contagion will grow much more and the measures that will end up being implemented will last longer. We repeat: There is no trade-off.

It's time to overreact. In situations like the current one, if you are going to make a mistake, it would be better to err on the side of overreacting

- While well-aimed fiscal stimuli will be the key to limiting the economic effects of the indispensable measures that will be implemented, the central bank's role will be key.
- GDP - a sharp decline followed by a slow recovery is the most likely scenario.
- Recognizing that uncertainty is greater than usual, we anticipate an economic contraction of 4.5% in 2020 with a strong downward bias if measures to curb contagion are still being delayed.

Expected effects on supply:

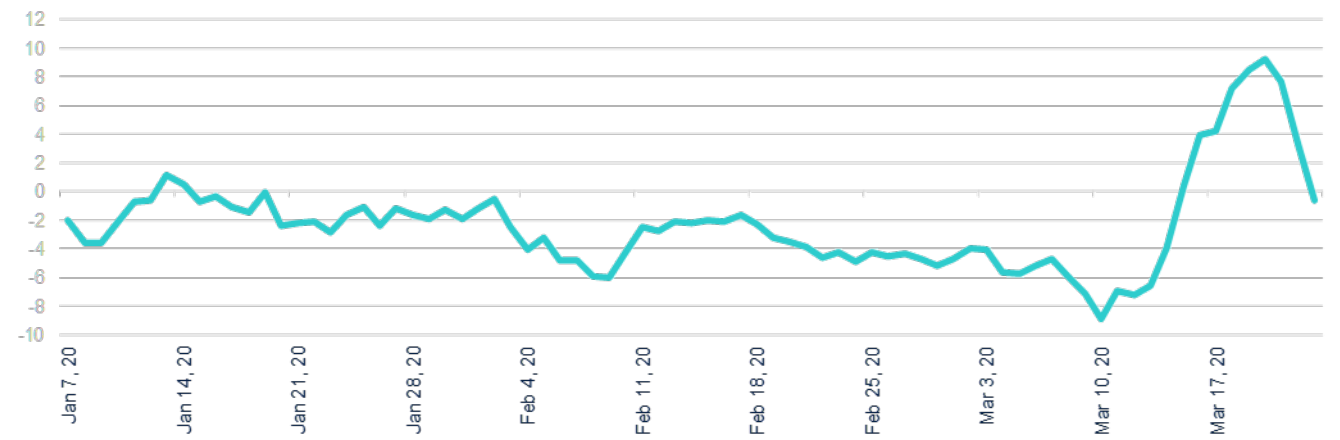
- The collapse of US demand, coupled with disruptions to value chains by economic "closure" in many regions, will cause significant declines in manufacturing output in Mexico.
- This will add to the foreseeable brake on construction by containment measures and the foreseeable negative effects on household finances that will result in a temporary collapse in demand for housing and mortgages. Moreover, public spending should be redirected to the public health system and to supporting families, so public investment will surely fall further than expected, which was already worrying. In short, the construction industry will experience even more weakness.
- Overall, industrial production will see significant declines.
- With the population staying home, the services sector will be severely affected in the short term.

Expected effects on demand:

- A sharp decline in investment in the context of unprecedented uncertainty. The recovery will be slower due to the disappointing consultation decision on Mexicali's brewery. It should be the opposite because of the enviable context of ratification of the T-MEC: Mexico is facing a historic opportunity to attract investment and is wasting it. The consultation, in which only 3% of the population participated, is not a democratic exercise and is a very bad economic decision that will have similar effects on confidence as the cancelation of the Texcoco airport. The message that is being sent is that there is no legal certainty and that the rules can be changed partway through the game (the plant was more than two thirds advanced).
- A brake on consumption due to temporary economic "shut down" and slow recovery due to the profound effects on household finances. The loss of jobs (formal sector) and income (informal sector) will add to the accumulation of debts and the likely collapse in remittances, whose decline could be more intense than in 2009, due to the sharp rise in the US unemployment rate.
- Our daily retail sales indicator already points to an accelerated decline in private consumption in recent days, following the temporary boost that panic buying had caused in recent weeks. The services likely to be impacted

the most will be air transport, food and beverage preparation, hotels and lodging, as well as leisure and entertainment services.

Graph 5. **BBVA Retail Sales Indicator** (YoY% of 7-day cumulative)



Source: BBVA Research

- Job creation is being affected by supply and demand shocks, the effects of which will be most visible from April onward. Depending on the duration of global and domestic economic sudden stops, the loss or destruction of jobs will be greater.
- In the context of widespread social distancing, the sectors most affected initially are trade, restaurants, transport, and tourism, which currently employ 32.7% of the total number of working people.
- We anticipate sharp declines in exports due to the collapse of demand in the US and globally, and disruptions to value chains.
- We expect, and recommend, greater growth in public spending because of the need for countercyclical fiscal policy.

We anticipate lower inflation...

- In a context of falling energy prices and an accelerated widening of the negative output gap, downward forces on inflation will more than offset the possible negative effects of peso depreciation and contraction of aggregate supply. Uncertainty about the balance of risks to inflation is greater, but in our view, the balance sheet is clearly downward.
- Banxico estimates that the convergence of inflation to 3.0% “could be slower.” In contrast, we anticipate that it will be faster, due to the significant contraction in aggregate demand.
- In recession scenarios, the passthrough from the exchange rate to prices is often close to zero.
- We are not ruling out the possibility that inflation may be below the variability range of Banxico's target (2-4%) at some point in the coming quarters.
- In advanced countries, the risk is more of deflation than of inflationary episodes.

...and a more accentuated cycle of decreases

- The severe economic downturn and the possible dominance of downward pressures on prices make a monetary stance in line with this context necessary.
- The monetary stance in Mexico remains highly restrictive even after the 50bp drop in the monetary rate to 6.5% (reaching a real rate of about 3.0%, with a neutral estimated at about 2.0%): Mexico still has one of the highest real monetary policy rates in the world.
- In this sense, monetary policy in Mexico is among the worst-placed in the world to counteract the negative effects on the economy and people.
- There is an urgent need to make monetary policy more flexible and to adjust the monetary rate quickly, especially given its lagging effects. In our view, the recent decline should have been 100 basis points and taken out of schedule, not in place of the planned meeting.
 - Although we now anticipate three declines of more than 50bp to 5.0% in the next three meetings (outside or within the schedule), this level of the monetary rate is neutral when a clearly expansive one is required. The downward cycle ought to have a longer journey than currently expected.

Banxico should adopt an expansive monetary stance as soon as possible so that the economy is better positioned for an eventual recovery

- What makes us conservative in our estimate? The fact that Banxico maintains a hawkish tone in its communications.
- In any case, the monetary rate is likely to end up reaching significantly lower levels than we are currently forecasting. In fact, we do not rule out the possibility that the rate could end up reaching historical minimum levels of 3.5%.
- In addition, a lower interest rate would eventually provide marginal relief to the financial cost of debt and, in particular, to potential new debt issuances in the primary market.
- Expansionary monetary policies around the world will ultimately last a long time. When the pandemic is eventually controlled, risk aversion will decline rapidly, and Banxico will be able to maintain an expansionary monetary policy without concerns about the relative position of monetary policy and even possibly about the exchange rate, which should be moderated after the overreaction that we are now seeing.
- At this juncture, the link between monetary policy rates and exchange rates has weakened considerably. Investors around the world are trying to deal with this episode with the highest degree of liquidity possible and thus liquidate risky assets, in many cases because of their liquidity level, regardless of their returns.

Expansionary monetary policy as soon as possible is not the only action required of the central bank

- Banxico must ensure that the necessary liquidity is granted to the financial system in the event that this is required in the short term.
- Banxico must deepen liquidity measures more decisively to avoid further tightening of financial conditions.
 - Banxico must provide the liquidity that the financial system will end up requiring.

- It must make conditions much more flexible. These are not normal times, resorting to the liquidity discount window should not be stigmatized or punished. The high rates prevailing in an environment with significant liquidity needs, and at a time when “punishment” still prevails in the rate for such needs, further demonstrate the need to rapidly reduce the benchmark rate.
 - Banxico should broaden the catalog of securities that it accepts as collateral.
 - Liquidity should be provided so that banks can bridge loans to companies and that companies, in turn, can continue to pay their operating expenses, including salaries, in a very sluggish sales environment.
 - Restructuring loans must also be granted in such a way that the companies and families affected do not have to make capital and interest payments during the current situation.
 - No company that was viable and solvent before the beginning of this episode should disappear. It would be a policy mistake.

Targeted fiscal stimuli are needed, prioritizing the most affected and disadvantaged groups

- Fiscal objectives must play second fiddle to underpinning the health system and supporting workers.
 - At times like these, primary surpluses and the stability of public debt are not the top priority, and they must temporarily take a backseat. A countercyclical fiscal policy will be indispensable.
 - Moreover, it should be noted that most countries will provide fiscal stimulus, so the deterioration would not be significant in relative terms.
- To avoid a loss of confidence in the anchor of fiscal stability in the medium term, fiscal support measures should be accompanied by clear signals that they will only remain as long as necessary and that they will be accompanied by an upcoming fiscal reform that increases public revenues once the health and economic contingency period goes by. It would also be appropriate to announce the establishment of an Independent Fiscal Council.
- Greater progressiveness is indispensable.
- Effective corporate rates should tend to rise and loopholes that prevent or decrease the payment of taxes should disappear.
- In contrast, a rule of law must be created with accountability and real institutional punishment for corruption.

We suggest that the following fiscal measures be adopted:

- Cash transfers both to people who have lost their jobs (because of the lower consumption derived from public and private social distancing measures) and those who live off their daily income.
 - The priority is to ensure the welfare of workers. In this sense, it is important to note that of the total number of employed people, 11.8 million have no access to medical care and have incomes below the poverty line, of which 2.2 million are over 60 years of age — this is the most vulnerable population group. In a scenario of high-demand for medical services, they would potentially exceed the capabilities of INSABI which is in an incipient stage in its creation.

- There is room for the formalization of employment. 50.6% of informal workers work in formal economic units. Informality in formal enterprises should be punished more in this contingency. Within the public sector, 13.7% of the employed are informal and have no access to health.

Direct fiscal stimulus is needed for citizens, starting with the most affected and vulnerable

- Fiscal stimulus to companies, prioritizing small and medium-sized businesses and those in the most affected sectors. Unlike for people, incentives should be in the form of credits, deferral of some taxes, etc., and not direct transfers. These support mechanisms, mainly for larger companies, should be conditional, primarily to avoid firing employees and to keep the company afloat and not for other purposes.
- Reallocation of budget items to non-profitable investment projects (new refinery, Mayan Train, Santa Lucia airport, etc.), firstly to acquire materials and provision of medical services appropriate to hospital care needs derived from patients with Covid-19, and then for infrastructure improvement.
- This recognizing the weakness of the health system in Mexico.
- Attack Pemex's problem head-on. With the fall in international crude prices, all companies around the world will be affected; several will disappear. Pemex will not escape this reality. Their losses will be much higher than those observed in recent years. To tackle the problem, they must: (i) suspend the entire debt issuance plan that the company had contemplated; the federal government must issue the debt on behalf of Pemex; (ii) stop, as already mentioned, the construction of the refinery; (iii) significantly reduce refining activity and import more gasoline by taking advantage of the current low price and the fact that Pemex loses considerable amounts when refining.

It is the worst time to have initiatives that destroy investor confidence

- Having conducted a questionable public consultation on the Constellation Brands brewing plant in Mexicali is unfortunate. It seems to us a worse sign for investment than the airport cancelation or the pipeline contract disputes because it suggests that these decisions do not represent isolated facts but are central to the current government's decision-making process.
- If the government does not back down, it is to be expected that an indispensable recovery in private investment following the likely severe economic downturn will not take place.
- Damage to confidence has again been caused and can be partially reversed if it a backward step is taken. It is now more necessary than ever to do it backwards.

The private sector must also respond to the circumstances

- Not only are public sector actions and the support of the people required to comply with isolation measures, private sector involvement is also needed in both current and immediate future contingency.
- Never again should there be a deep reflection on the very complicated situation facing the most vulnerable population. It must be recognized that priority should be given to the most disadvantaged, and action must be taken accordingly.
- Government resources will be limited and it will be time to help as never before, supplementing those efforts.
- Soon after, once the worst stage of contingency is over, many will have to stop holding back from creating the conditions to reduce poverty and inequality more quickly.

- For example, the greatest contribution to the increase in pension savings under the current defined contribution system should fall primarily to companies. The issue should be addressed as urgently as possible.

Finally, two reflections:

1. Economic and social fragility will be evident as never before. This juncture must ultimately be used to lay the foundations for a society in which the majority can aspire to live in dignified conditions.
2. Extreme situations get the best or worst out of people and societies. In a country like Mexico, with so much backwardness and so many difficult times, it is necessary to change the social contract to lay the foundations of a fairer society.

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