



Monarch Special Report

Implications of COVID-19 for Mexico

March 17, 2020



Like the rest of the world, Mexico has been hit by two powerful shocks in the past ten days: the explosion of COVID-19 into a global pandemic and the related collapse of international oil prices. Given that many of our clients and followers are not physically in Mexico and might benefit from a more direct sense of what is happening there, we have decided to publish this Special Report for your benefit. We recognize that this is an extremely fast moving situation; facts on the ground are constantly changing. Our goal is to provide timely, well-sourced information from public and private sources. If this medium proves to be helpful, we expect to publish further updates as we are able.

In light of the extensive coverage already available, there is no need to discuss the progression of COVID-19 from its December outbreak in Wuhan, China, into the current global pandemic. But its economic implications are worth noting: the crumbling of global financial markets, a U.S. and global economy speeding toward recession, and the widespread closing of national borders and concurrent collapse of global tourism. At the

same time, a sharp disagreement between Saudi Arabia and Russia over how to respond to the global oil glut that accompanied the coronavirus-generated economic slowdown beginning in China led to a collapse in global oil prices. Together, these global developments have had a marked impact on Mexico, which is just barely at the beginning of the proverbial COVID-19 curve.

The Health Impact: What We Know

The number of confirmed COVID-19 cases in Mexico jumped in the last week, from 7 on March 9 to [82 on March 16](#). However, these numbers have been greeted with some skepticism due to the Mexican government's response to the coronavirus pandemic.

As the Mexican government is following World Health Organization guidelines strictly, it considers itself in "Phase I" of the pandemic, where no communal transmission has yet been observed. [Testing in Mexico has been limited](#) to those who have had direct contact with someone who either traveled to a country with an outbreak or has a confirmed case of COVID-19. Limited testing translates into a likely under reporting of the number of cases in Mexico. Equally significantly, Mexico has only just begun to implement containment efforts, but these are varied at best and contradictory at worst. Last week, the health ministry suggested Mexicans practice social distancing, but President Andrés Manuel López Obrador (AMLO) flaunted this suggestion by hugging supporters over the weekend. Meanwhile, while some state and local officials have instituted more aggressive responses, just this past weekend, March 14-15, the mayor of Mexico City allowed a massive music festival to go forward gathering thousands of Mexican celebrants. In addition, the national sports federation circulated a flyer that made light of the threat posed by COVID-19. The Education Ministry has recently announced it would close schools, but not until March 23. Meanwhile several states and most private schools announced closures beginning Tuesday, March 17. (As we go to press, we have heard from confidential sources that the federal judiciary will close all non-essential operations today; we have not yet been able to confirm this, however.)

We are not aware, as of this writing, of any efforts by Mexican authorities to significantly screen inbound passengers at any ports of entry. There are no reported cases of screenings on the northern border with the U.S., [nor of passenger screenings in](#)

[Mexico's major airports](#). Conversely, Mexico's southern neighbor, [Guatemala, shut down the border with Mexico](#) to protect itself from any vectors coming from Mexico.

To the extent that there is a government strategy, [it seems to be](#) to wait until a real problem emerges before taking action, not unlike what happened in the United States. The flaw in this strategy is that since it takes about a week for COVID-19 symptoms to appear, a government that only responds to symptoms as they appear is actually responding to events a full week behind the actual transmission of the virus.

Worse still, and not unlike President Trump's initial reaction in the United States, AMLO has downplayed the importance of the coronavirus threat since the first case appeared in late February. In [his morning news conferences](#), AMLO has argued that the coronavirus is similar to the flu and that alerts about the virus were "conservative" propaganda. He even mocked the idea of social distancing. It wasn't until March 13 that he accepted the idea that Mexicans should refrain from hugging one another, and yet the very next day he toured villages in Guerrero State where he waded through crowds, hugged supporters, and kissed babies.

Finally, the pathology of the virus suggests that Mexico is just days away from its first case of community transmission of the virus, and the ensuing more widespread outbreak of COVID-19. All of this has convinced the public health community that things will get much worse in Mexico before they get better.

There are also concerns about the capacity of the Mexican healthcare system to deal with the challenge that COVID-19 is likely to present in the coming weeks. The massive changes that the AMLO administration made in the purchasing of drugs and medical supplies [culminated in shortages of cancer and HIV drugs that led to the deaths of some cancer patients](#). Further, Mexican hospitals could be quickly overwhelmed by demand for respirators should large numbers of patients exhibit severe respiratory distress (as is also feared in the United States). The decision to replace the *Seguro Popular* health insurance scheme for lower income Mexicans with universal health care (Insabi) has been equally chaotic, and is still very much in process. The result is a healthcare system in transition, a less than ideal setting to deal with the healthcare emergency that COVID-19 could bring to Mexico.

That being said, some former health officials optimistically point to Mexico's response to the 2009 H1N1 flu epidemic to suggest that Mexico has a blueprint to follow. At that time, Mexico's transparency and cooperation with the United States and Canada were cited as the most important components of its response, which included mass closures of schools and other social distancing measures, especially in Mexico City. As of this writing, testing is being performed free in designated public hospitals and for modest fees in some private ones, and a protocol has been established for further screening beyond that. Whether the system will hold if, and likely when, the pandemic fully hits, time will tell.

There is emerging yet very early data that may suggest the virus is affected by temperature and climate, which may explain the low incidence to date in Mexico and the lack of reported cases thus far in the northern border region. But this is very preliminary information that should not be relied upon. It is possible, however, that the impact on Mexico could be mitigated.

The Economic Impact: A Coming Tsunami?

On the economic front, the coming dramatic slowdown in the U.S. economy and collapse of global tourism will inevitably push the Mexican economy further into recession. With 80% of its exports destined for the United States, a U.S. recession always has an outsized impact on the Mexican economy. If it's true that "when the U.S. economy sneezes Mexico catches a cold," we shudder to contemplate what happens in the world of COVID-19. In addition, Mexico should anticipate a significant drop in tourism, which accounts for about 9% of the Mexican economy. With the U.S. and other key markets in near-lock down, and with the cruise and airline industries in shambles, Mexico is especially vulnerable. It is hard to see how, under these circumstances, the Mexican economy does not fall into a significant recession in the first half of 2020. Indeed, [Barclay's Bank recently lowered its 2020 growth estimate](#) from +0.5% to -2.0%. We expect similar or worse estimates to be put out by others soon.

A recession will reduce tax revenues, at the same time that a collapse in oil prices cuts into the 17.9% of Mexican budgetary funds that come from petroleum sales. Brent crude [prices have fallen over 40% since February 26](#) (including a massive 25% drop on March 9) owing to both [the price war driven by Saudi Arabia and Russia for which there](#)

[appears to be no quick end](#) and fears of a global recession caused by the coronavirus pandemic.

The Mexican finance minister insisted on March 10 that the government has the capacity to resist the budgetary impact of these events. He pointed to the oil price stabilization fund, which could provide up to 158 billion pesos in revenue, but this is small potatoes in a 6.1 trillion peso budget. He also noted that Mexico has hedged a portion of budgeted oil revenue at the equivalent price of \$49 per barrel, although [the percentage that was hedged has not been disclosed](#). Unfortunately, most analysts believe that the type of hedge used – [the type every previous Mexican government has used](#) – has a year-long term, which means its payout will not come until 2021. So it would provide little support during the peak of the crisis in 2020.

In short, falling revenue for the Mexican government poses the question of how the AMLO administration will adapt. *We do not believe this situation will lead either to a tax increase or increased debt in 2020.* In part this is because a tax increase would further reduce demand in the economy, something AMLO and his economic team hope to avoid. But it also reflects AMLO's deep-seated policy preferences. AMLO is completely wedded to a balanced budget, not accumulating debt, and keeping his promise not to raise taxes until 2021. Only time will tell whether COVID-19 affords him the luxury of holding on to these principles.

In the meantime, the government is left with two main options: (1) reduced government spending, which in the near term would likely manifest itself as underspending of budgeted funds (rather than a formal spending cut) in the hopes that the external shock will be short lived; or (2) frontloaded annual budgetary outlays to stimulate growth based on the same hope, [which currently appears to be the government's preferred option](#). There is also the possibility that the government will use the coronavirus-induced budgetary challenge as a justification for cutting back spending on core infrastructure projects of questionable utility, such as the Mayan Train or the Dos Bocas refinery, into which AMLO has invested considerable political capital.

To make matters worse, turbulence in financial markets hit the peso hard, [shaving 15% off its value in a little over a week](#) to close at an all time high on March 16 of 22.9 pesos to the U.S. dollar before [sinking further, to over 23, as we go to press](#). This should not

have a major impact on Mexican debt payments (and thus budgetary spending) since [78% of Mexican government debt is denominated in pesos](#). But it will have a huge impact on Pemex's debt payments, which are mostly denominated in dollars, and the dollar-denominated debts of Mexican private firms.

Between the falling peso and the dramatic drop in oil prices, which pushed prices below the cost of production in about 75% of Pemex's fields (including the fields prioritized by the AMLO administration), it is hard to see how Pemex avoids a downgrade of its bonds to junk by the middle of 2020. This, in turn, is likely to trigger a downgrade of Mexican sovereign debt. Although this would have limited impact on the Mexican budget since [81% of federal government debt is contracted at fixed interest rates](#), it will have a strongly negative impact on both the Mexican stock market, which [has declined over 15% since March 4](#), and the peso.

Apart from these macro-economic considerations, the truth is it is simply too early to know or predict how this will all play out. We are witnessing an economic and public health crisis that may be on an unprecedented global scale. Mexico will not be immune from this, and even the most closely held rules and norms may go out the window. We will be watching this closely.

Final Thoughts...For Now At Least

An outbreak of COVID-19 in Mexico will have obvious negative short-term implications for the Mexican economy, just as similar outbreaks have had everywhere else that the coronavirus has taken hold. This is apt to be magnified by three things. First, while the Mexican government is beginning to focus on the healthcare aspects of the crisis, *it seems quite unconcerned with the economic tsunami that is headed its way*. Second, once it wakes up to the economic challenges ahead, the Mexican government has very little room to fight back, with an economy already in recession, a very tight budget coupled with a hard promise not to increase the debt, and a crumbling peso that will likely restrain coming interest rate cuts. Indeed, AMLO even insisted in his March 16 morning news conference that there was [no need for a fiscal stimulus](#).

Third, should the pandemic take hold in Mexico, the United States could cancel flights and sharply restrict movement across the border to prevent the spread of the virus, not

unlike President Trump's decisions to cut off airline service with China and Europe. While the impact would be felt by border economies in both countries, it is likely to filter more deeply and more negatively into Mexico's economy. Conversely, if the situation in the U.S. rapidly deteriorates, Mexico may have little choice but to severely restrict border crossings from the north to enable adequate passenger screening. Either scenario is a nightmare for the Mexican economy.

But there could be a silver lining for Mexico in the coronavirus pandemic. The initial outbreak in China disrupted global supply chains that are highly dependent on Chinese inputs. It accelerated a process of economic decoupling between China and the United States that was already underway due to rising production costs in China, technological changes that favor regionalization over globalization, and the U.S.-China trade war. This [creates an opportunity for Mexico](#) (subscription required), especially in sectors where Mexico and China share a comparative advantage such as electronics manufacturing. Mexico is also a key source of medical device imports into the United States, creating an opportunity in this sector to respond to current and coming shortages in the U.S. as COVID-19 spreads. Mexico could also market its extensive and well-tested Maquila regime, offering short, intermediate and long-term manufacturing alternatives to a range of companies searching to quickly diversify their supply chain sourcing. We hope to write more about these opportunities in subsequent updates.

To take advantage of these opportunities Mexico, at a minimum, will need to engineer a "confidence shock" – an action that will send a message to investors that Mexico is once again open for business and serious about welcoming foreign investment, reversing the messaging that has emanated from Mexico City in the first year of the AMLO administration. With the Canadian Parliament's recent approval of the USMCA, and the agreement being urged to go into effect on June 1, Mexico could leverage its newly re-affirmed connectivity to the North American economy and position itself as the logical platform for a wide range of investment and manufacturing. The obvious opportunity to send such a message is the energy investment program whose continually postponed announcement date is now supposed to take place in the next 10 days. Regrettably, to date, we have seen little evidence of this type of thinking or messaging. We hope, above all for Mexico's sake, that this changes soon.

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