**The Impact of the U.S. Financial Crisis on Mexico: Saved by the Float?**

David M. Kemme
University of Memphis

Kayhan Koleyni[1]
University of Memphis

## Abstract

We simulate the impact of the U.S. financial crisis on Mexico, a major trading partner with close financial linkages, with the Gali and Monacelli (2005) small open economy DSGE model under two exchange rate regimes: fixed and floating. We assume the financial crisis generates a supply side shock (a productivity shock) and a demand side shock (a preference shock), which are the driving forces of the model. For the fixed exchange rate regime the impulse responses of the productivity shock indicate the effects of the U.S. financial crisis on most of Mexico's macroeconomic variables dissipate in less than thirteen quarters with inflationary effects on price variables and permanent effects on CPI and Mexico's home prices. Under the flexible exchange rate regime the effects of this shock are much smaller, and there is a deflationary effect on price variables and negative permanent effects on nominal exchange rate, CPI and Mexico's home prices. For the demand side preference shock, the floating exchange rate again ameliorates much of the impact on the Mexican economy. For both exchange rate regimes there is a negative permanent effect on the CPI and Mexico's home prices, and they are greater under the fixed rate. The period by period differences in the responses under the two regimes is the "buffer" that the floating exchange rate provides in limiting the foreign shocks. We then consider interest rate adjustments initiated in response by both the U.S. and Mexico's monetary authorities and found a permanent positive effect on the CPI level, the effective nominal exchange rate and Mexico's home prices. The variance decompositions indicate that the effects on real variables are larger under the fixed exchange rate regime and the external linkages are tighter. Welfare losses under the float are also less vis-a-vis the fixed exchange rate regime.

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