July 16, 2020

Latam Economic Update

- **Argentina: June inflation above expectations**
- **Chile: Pension bill advances to Senate; BCCh held policy rate at 0.5%, as expected**
- **Colombia: May's coincident indicators improved, proving that April was the worst of the lockdown; BanRep survey shows softening inflation expectations**
- **Peru: In a day full of information and events, Wednesday saw the cabinet overhauled and May growth and unemployment figures released**

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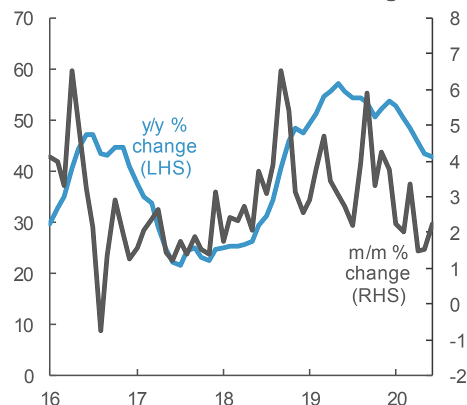
ARGENTINA: JUNE INFLATION ABOVE EXPECTATIONS

June inflation data, released on the afternoon of Wednesday, July 15, came in at 2.2% m/m and 42.8% y/y, compared with 1.5% m/m and 43.4% y/y, respectively, in May (chart 1). June inflation was a bit above consensus, which expected 1.85% m/m, and our own view that price controls, official monitoring, capital controls, and the lockdown would hold official inflation closer to 1.5% m/m for a third month. Goods prices rose 2.9% m/m in June, while services prices lagged at 0.9% m/m. Clothing led the gains amongst sectors at 6.6% m/m, but data collection challenges during the lockdown continue to mean that some services prices are imputed or simply carried over from previous readings. Core inflation came up from 1.6% m/m in May to 2.3% m/m in June, but base effects meant that annual core inflation slowed from 46.2% y/y to 45.6% y/y.

Argentina's macroeconomic environment and policy framework are tipped toward sustained monthly inflation in the months ahead. Base effects imply, however, that annual inflation readings will come down from the low 40-percent range to mid-20-percent rates as 2020 advances, before heading back up again in 2021.

—Brett House

Chart 1



Sources: Scotiabank Economics, Bloomberg.

CHILE: PENSION BILL ADVANCES TO SENATE; BCCh HELD POLICY RATE AT 0.5%, AS EXPECTED

I. Bill to allow withdrawal of 10% of pension funds moves to the Upper House

The House of Deputies confirmed approval of its bill that would allow individuals to withdraw up to 10% of their funds in the AFPs. As in the previous decision, the vote exceeded the minimum necessary by only two members (i.e., 95 votes compared with a threshold of 93). The bill is now up for discussion in the Senate where the review will be much more technical. In this new round, there are several factors that could lead to substantial changes in the bill that could even lead to its rejection. These include:

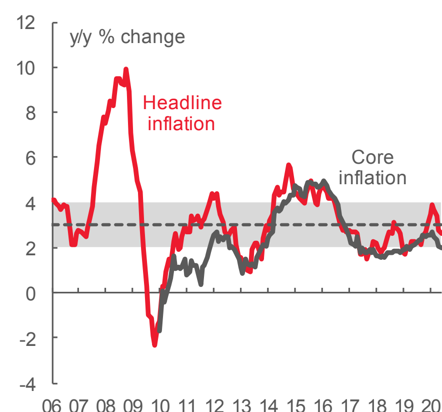
1) **The government could further improve the scope and magnitude of the latest fiscal aid package for the middle class.** This may lead some Senators, particularly from the Christian Democrats who are usually swing voters, to end up voting against the bill; and

2) **The Senate**'s **discussion will highlight the regressive characteristics of the bill.** As the Senate reviews the bill, it is likely to introduce modifications that would limit the conditions under which people can withdraw funds from the AFPs. Our analysis implies that if only the unemployed and/or people who have experienced significant reductions in income are allowed to withdraw funds, the liquidation of holdings by the AFPs would be around USD 3.5 bn, significantly lower than the approximately USD 20 bn contemplated by the current draft of the bill.

II. Central bank highlights the dynamism of external sector as it holds at 0.5%

As widely expected, the BCCh held its monetary policy rate unchanged at 0.5% following a unanimous vote at its Wednesday, July 15 meeting. Forward guidance was unchanged as the statement advised that the Monetary Policy Committee (MPC) intends to keep the policy rate "at its technical minimum over the entire projection horizon" and that "if economic developments so require, it will continue to explore options to intensify the impulse and support financial stability, using unconventional instruments." With headline inflation below target (chart 2), we continue to expect that the policy rate will be held at 0.5% at least until 2022 and that any additional efforts to ease financial conditions will be delivered through liquidity and credit measures, including the BCCh's ongoing asset purchases.

Chart 2



Sources: Scotiabank Economics, INE.

In its statement, the MPC provided some anticipatory insights about the next *Monetary Policy* Report (MPR), due in September, where the central bank intends to publish a review of the "technical minimum" for the policy rate. Economic activity fell by -15.3% y/y in May, which is in the range of the GDP contraction the BCCh expects for 2020 (i.e., a decline between -5.5% y/y and -7.5% y/y). However, the statement highlighted the recovery we have seen in the external sector, particularly in exports, which have performed better than expected. The central bank highlighted that the latest economic data show improvements in an important group of countries, in line with the gradual re-opening of their economies. This has translated into better numbers on industrial production, retail sales, the labour market and expectations, both for households and companies, which in turn has supported the performance of financial markets and commodities. Better prospects for China have helped drive copper prices up to around USD 3/lb., its highest level so far this year. Fiscal and monetary stimulus, including unconventional measures in economies such as the US, the Eurozone, and the United Kingdom have also helped. Risks are rooted in the recent outbreaks in COVID-19 infections, especially in the US, which could mean more confinement measures in some states.

In this context, we expect the BCCh to narrow the forecast range for GDP contraction in 2020 to between -5.5% y/y and -6.5 y/y in its September *MPR*, centering it at -6.0 y/y, as in our baseline scenario. This would be conditional on a gradual lifting of isolation measures during the remainder of July and a gradual re-opening of economic activity in the Santiago Metropolitan Region and in other areas. At its previous meeting, the BCCh had already opened a second stage in its Conditional Facility to Increase Loans, with an objective to expand commercial credit by around 20.7% y/y in nominal terms this year and lift economic activity.

In its forthcoming review of the technical minimum for the policy rate, we expect the Bank to revise its estimates for several key macroeconomic variables. In the September *MPR,* we expect to see the BCCh's estimates of potential GDP and the neutral monetary policy rate brought down significantly. For now, we expect the central bank to reduce potential GDP growth to the 2.5–3.0% y/y range and the nominal neutral monetary policy rate to the 2.75–3.25% range. This would accompany a ratification of the technical minimum for the policy rate at 0.50% or a possible reduction to 0.25%. The latter would depend crucially on the growth of commercial loans as of August, but also on the characteristics of any eventual withdrawals from pension funds, which remain under discussion in Congress.

It is notable that reference to the proposed pension reforms remains absent from the BCCh's communications. The pension discussion's negative stock market impact, its slightly appreciative effect on the CLP, and its upward pressure on interest rates, as well as other financial impacts of the bill, are likely to be mentioned by the central bank in its next *MPR* or alternatively in its next F*inancial Stability Report*. The financial implications of the pensions bill are not minor for the monetary policy and we hope that the central bank will contribute a technical view on the proposed reforms if the bill is still under discussion when the September *MPR* is published.

—Jorge Selaive & Carlos Muñoz

COLOMBIA: MAY'S COINCIDENT INDICATORS IMPROVED, PROVING THAT APRIL WAS THE WORST OF THE LOCKDOWN; BANREP SURVEY SHOWS SOFTENING INFLATION EXPECTATIONS

I. May retail sales and manufacturing data

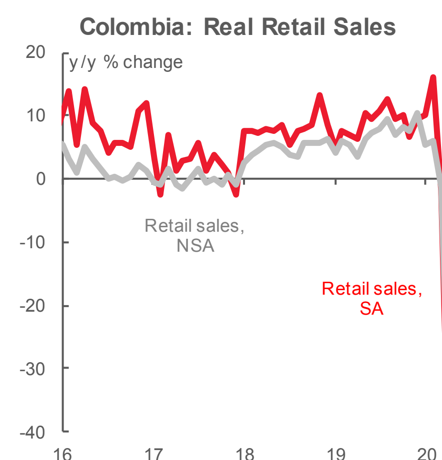
On Wednesday, July 15, DANE released real retail sales and real manufacturing production data for May. Although growth for both remained in negative territory, contractions were significantly smaller than in April's data. Real retail sales declined by -26.8 versus -42.9% y/y in April (chart 3), better than market expectations (-28.7% y/y). Real manufacturing production fell by -26.3% y/y in May versus -35.8% y/y in the previous month (chart 4), meeting market expectations (-26% y/y).

According to our estimates for May, 25% of the economy was shut down, while our estimate for April was 34%. High frequency data showed that the re-opening process continued in June, which implies better numbers in both indicators for this month. However, further recoveries would depend on the severity of new lockdown measures in some cities in response to the recent increases in COVID-19 cases. For now, May's numbers are in line with our expectation that GDP contracted by -10.6% y/y in Q2-2020.

In May, gasoline (-37.7% y/y) and vehicles (-57.1% y/y) accounted for 66% of total contraction in retail sales; a sharply negative performance was also recorded in the clothing sector (-73.1% y/y). These contractions are directly related to mobility restrictions and weaker demand due to the COVID-19 shock. On the positive, side consumer staples continued performing positively, with foodstuffs (up 8.5% y/y), and cleaning products (up 20.2% y/y) both showing gains. In the coming months, leading indicators point to better demand for gasoline and vehicles; other items, such as clothing and household appliances, should also show better behaviour due to the recent VAT holiday.

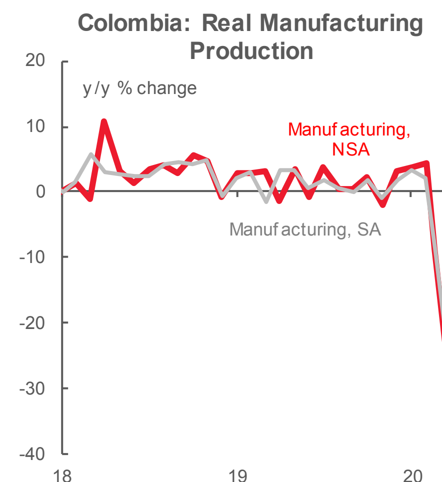
On the manufacturing side, production in 34 out of 39 sub-sectors fell in y/y terms in May. The worst-performing sectors were those related to construction, transport, and commercial activities. Specifically, the contraction in beverages (-32.4% y/y) was led by lower production of the glass bottles usually used for personal consumption and restaurants. Mining-related construction materials fell -45.6% y/y, oil refining dropped -45.6% y/y, and clothing -63.4% y/y —all of which accounted for 40% of the manufacturing contraction. It is worth noting that the manufacturing decline is equivalent to a shutdown of 8.6 business days in the industry, which is smaller than our estimate for the extent of April's closure (12 days). Manufacturing has contracted by -12.9% y/y year-to-date.

Chart 3



Sources: Scotiabank Economics, DANE.

Chart 4

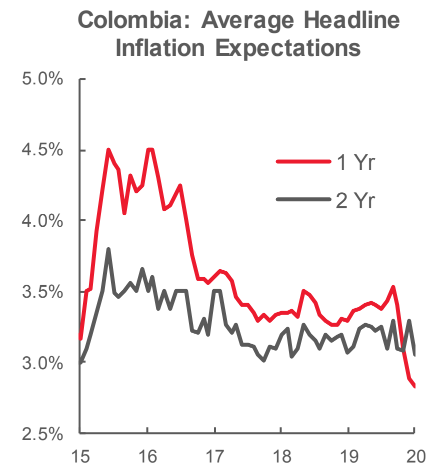


Sources: Scotiabank Economics, DANE.

May's indicators affirmed that the worst of the lockdown's effects on the economy were in April. June's data should come in even better, although, in the coming months, risks of new lockdowns in the country's main cities, such as Bogotá and Medellin, are still a concern for the economic recovery. However, we expect new lockdowns to be less aggressive than April's restrictions. In

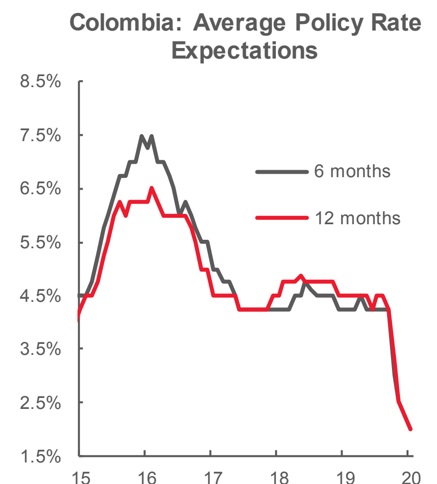
terms of monetary policy, the central bank projects a contraction in Q2-2020 GDP between -10% y/y and -15% y/y, which supports our perspective that gradualism will guide adjustments in the monetary policy rate. We think BanRep will cut the monetary policy rate by -25 bps to 2.25% at the July 31 meeting, followed by another -25 bps cut at the August meeting.

Chart 5



Sources: Scotiabank Economics, BanRep.

Chart 6



Sources: Scotiabank Economics, BanRep.

II. BanRep survey shows softening inflation expectations

- **According to BanRep's just-released July survey of macroeconomic expectations, analysts expect inflation at 1.89% y/y for December 2020, 32 bps lower than last month.** Inflation expectations (IE) for longer tenors also fell. In fact, the 1Y tenor stood at 2.85% y/y (previous: 2.88%), and the 2Y at 3.07% (chart 5). It is worth noting that inflation has fallen mainly due to government support for utility fees and due to a temporary VAT reduction in cell phone plans; however, these effects will reverse as soon as these policies expire, which explains the reversion of inflation expectations toward levels around 3%.
- **On average, July's monthly inflation is expected to come in at -0.13% m/m versus our expectation -0.17% m/m, which would brings annual inflation to 1.84% y/y, 35 bps lower than June's y/y inflation reading.** It is worth noting that in July, utility prices would contribute negatively again and the VAT holiday would also have a negative effect. For the longer term, we believe that the economic downturn will continue to exert negative pressure on core prices, while low headline inflation will be reversed as soon as government supports expire.
- **USDCOP forecasts for end-2020 stood at 3,678, -25 pesos from the previous survey.** For December 2021, respondents think, on average, that the COP will end up at 3,543. We believe that volatility will continue, although our FX models point to an equilibrium level around 3,600 to 3,700.
- **BanRep's repo rate is expected to close 2020 around 2.0% (chart 6), according to the median of the respondents, 50 bps lower than the current level.** The first hike of 25 bps is expected by November-2021 and the monetary policy rate is expected to hit 2.50% by the end of 2021. For July's meeting, analysts' consensus points to a rate cut of -25 bps and no one is expecting a 50 bps cut.
- **GDP contraction is expected to fall between -20% and -0.4% y/y in Q2-2020,** however, consensus expects better numbers in the ensuing quarters.

—Sergio Olarte & Jackeline Piraján

PERU: IN A DAY FULL OF INFORMATION AND EVENTS, WEDNESDAY SAW THE CABINET OVERHAULED AND MAY GROWTH AND UNEMPLOYMENT FIGURES RELEASED

I. Cabinet shuffle

First, we look at changes to the Cabinet, which are more important in that they will guide future events, whereas May economic figures are backward looking. The decision to overhaul the Cabinet was surprising only because of the speed with which it occurred. For weeks, political analysts and opposition figures had been calling for a new Cabinet. However, there didn't seem to be much movement in that direction until the last two days. The argument in the public debate for refreshing ("oxigenación" is the term frequently used) the Cabinet was that it had been showing fatigue, it had been underperforming in its responsibilities, especially in terms of ramping up public investment to spur the economy, and it had not been capable of

establishing a workable relationship with Congress. There is now hope that a new Cabinet will lead to a pause in the tension between the Executive and Congress, if not an outright thaw in their relationship.

The new cabinet is headed by Pedro Cateriano, a centrist who is well-traveled in Peruvian politics. Cateriano presided over the cabinet from April 2015 to July 2016, during the Ollanta Humala regime. He was also Minister of Defense from 2012 to 2015, during the same regime. Cateriano was also a member of Congress in 1990 for the right-wing Movimiento Libertad, until Congress was closed down by the Fujimori regime in 1992. Cateriano is a lawyer, with a specialty in Constitutional Law, which may have influenced his appointment, given the number of initiatives currently in Congress that are questionable on Constitutional grounds. He is viewed favourably by the business community. Having participated credibly and in a non-partisan fashion in both a right-wing movement and a leftist government gives him a veneer of political independence.

The changes in Cabinet were very broad in scope, with 11 of its 19 positions changing hands. There were two particularly significant decisions:

1) **Finance Minister María Alva stayed put.** Thus, economic policy is not at risk. Minister Alva has gained prestige with her handling of the economy in a crisis situation. The fact that she has been maintained is a very positive signal; and

2) **The Minister of Health, Víctor Zamora, has been replaced by Pilar Mazzetti.** Zamora had been under siege by the Opposition in Congress and public opinion due to the continuing surge of COVID-19 despite the government's drastic containment policy. Zamora was the face of the anti-COVID policy in Peru, and, even though COVID-19 has not been contained, under his leadership there was a clear improvement in health infrastructure. Letting him go must not have been an easy decision, given his expertise, and the fact that this could be taken as an admission of failure in dealing with COVID-19. His successor is Pilar Mazzetti, a prestigious medical surgeon-cum-politician, director of the National Institute of Neurological Sciences, and, until her appointment yesterday, the director of the government's COVID-19 Command Force. Her appointment promises continuity in the government's health policy. She was also been Minister of Health in 2004–06, as part of the Alejandro Toledo regime, and, somewhat oddly, Minister of the Interior during 2006–07.

Other new members of the Cabinet are much less well known. A number of them had previously held high positions within the Ministries that they now lead.

The new Cabinet members are:

- Pedro Cateriano – President of the Council of Ministers (cabinet)
- Mario López – Foreign Relations
- Pilar Mazzetti – Health
- Jorge Montoya – Interior
- Ana Neyra – Justice
- Martín Ruggiero – Labour
- José Salardi – Production
- Rafael Belaunde Llosa – MINEM
- Carlos Estremadoyro – Transportation
- Kirla Echegaray – Environment
- Patricia Donayre – Social Development

The Cabinet members that will continue unchanged are those at the Ministries of Finance, Defense, Education, Agriculture, Housing, Women Issues, and Culture.

It would seem that the new Cabinet will be highly dependent on Cateriano to manage a working relationship with Congress. Only Cateriano, and to some degree Mazzetti, seem to have the political ability and experience to carry this off. This expectation will be put to the test fairly soon, as any time that there is a new Cabinet (or, more specifically, any time there is a change in the head of the Cabinet), the new Cabinet must submit a governing plan to Congress. This tends to be a defining moment in the relationship between the two bodies.

II. GDP growth in May was spot on our bleak expectations

In figures released Wednesday, July 15, GDP contracted -32.8% y/y, in May, spot on our forecast of a -33% y/y decline. There were few surprises in the breakdown. Financial services (8% y/y), government services (3.5% y/y), and agriculture (1.6% y/y) were the only sectors to show positive growth (table 1). Telecom growth was nil, and pretty much everything else fell by double digits. Of course, May was a lockdown month: Phase 1 of unlocking began, in principle, in mid-May, but the need to implement health protocols led to delays into June. The decline in hospitality (i.e., restaurants and hotels) was appropriately dramatic, down -90% y/y, but it's weight in GDP is only 2.9%. The three sectors that factor the most heavily in GDP—manufacturing, mining, and commerce—were all down near -50% y/y. Thankfully, these higher-weight sectors will all see improvements in June–July with the unlocking. Hospitality will not, but given it's low weight, this does not matter all that much.

Table 1

Peru: GDP Growth (y/y)

	May-20
Aggregate GDP	**-32.8**
Agriculture	1.6
Fishing	-47.0
Mining	-49.9
Oil & Gas	-20.7
Public Services	-21.7
Manufacturing	-47.5
Resource processing	-28.3
Construction	-66.4
Commerce	-49.6
Transportation	-56.4
Hospitality	-90.1
Telecom	-0.3
Financial Services	8.0
Government Services	3.5

Sources: Scotiabank Economics, INEI.

The important point to make is that the worst is over. Henceforth, GDP should decline less and less in year-on-year terms, and grow in month-on-month terms. May's contraction comes after a -40% y/y decline in April. The April–May results fall within our -9% y/y to -14% y/y range for full-year 2020 GDP contraction, and point more toward the mid-point than either extreme. This forecast range has served us well during the time of lockdown uncertainty. Now, with data points for the March–May lockdown period available, and the economy very nearly fully unlocked, we shall revise our GDP forecast and return to a normal, point projection rather than a range.

Wednesday also saw the release of Q2-2020 labour market data, where the unemployment rate rose to 16.3%, surpassing our forecast of 15.0% for the quarter. This reflects the loss of 2.7 million jobs during the lockdown. Both figures, jobs lost and the unemployment rate, are likely to be the worst prints for both indicators in 2020. We had originally expected that unemployment would peak at 16% in Q3-2020, rather than Q2, owing to a slower unlocking. As it is, the impact of the lockdown on employment has been stronger and more immediate than expected. However, on the positive side, the unlocking of the economy has been faster than originally thought, so unemployment is not likely to continue rising in Q3. There is now downside risk to our 16% unemployment rate forecast for Q3-2020 and to our 14% year-end forecast.

—Guillermo Arbe

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