Latam Economic Update

- **Argentina: Ninth default prompts government to improve debt offer**
- **Mexico: Inflation unexpectedly high in May's first half, while both retail sales and wholesale figures worsened in March**
- **Peru: Home isolation extended until June 30, but with greater flexibility; details on first quarter national accounts**

ARGENTINA: NINTH DEFAULT PROMPTS GOVERNMENT TO IMPROVE DEBT OFFER

As expected, Argentina allowed the 30-day grace period on USD 500 mn in coupon payments on external law bonds to lapse at the end of Friday, May 22, which pushed the country into its ninth sovereign default. Economy Minister Guzman said on Friday night that the government would continue discussions with bondholders and revise its offer terms, but provided no indications on the shape new terms would likely take. Given the authorities' interest in minimizing upfront cash-flow needs, Argentina is likely to focus on reducing the principal haircut in any debt exchange, while preserving the longest grace period and lowest initial coupon rates possible. There has been some talk of additional contingent sweeteners, such as GDP warrants, but it is unclear whether these possibilities have gotten any traction in the talks.

The government has set June 2 as a new negotiation deadline. Creditors are said to have indicated that they will not accelerate their bond holdings so long as productive discussions continue. All sides are keen to avoid the extended legal wrangling that surrounded the 2005 and 2010 debt exchanges.

—Brett House

MEXICO: INFLATION UNEXPECTEDLY HIGH IN MAY'S FIRST HALF, WHILE BOTH RETAIL SALES AND WHOLESALE FIGURES WORSENED IN MARCH

According to figures published on Friday, May 22, headline inflation was 0.30% 2w/2w in the first half (H1) of May, significantly above the market consensus of -0.13% 2w/2w. This was the highest rate for the first half of May since 1998 (chart 1)—and well above the series low of -0.78% 2w/2w hit in the second half of March.

- Core inflation increased 0.24% 2w/2w, versus 0.09% in H1-May 2019.
- Meanwhile non-core inflation accelerated to 0.46% 2w/2w in the fortnight (versus -1.49% a year ago) because its agricultural component increased 2.43% biweekly versus 0.21% a year earlier, which outweighed the -2.04% 2w/2w drop in energy versus -3.87% 2w/2w a year earlier, which was associated with the summer electricity rate program in some cities of the country.

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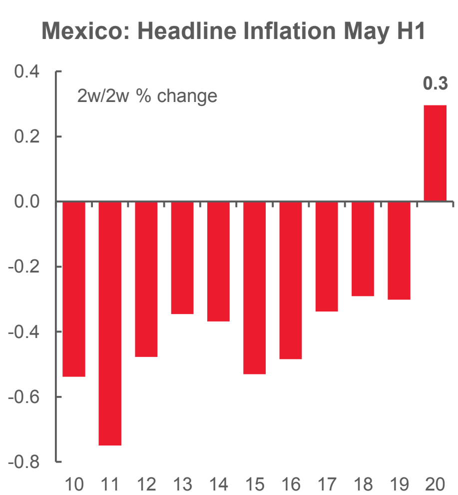
Chart 1



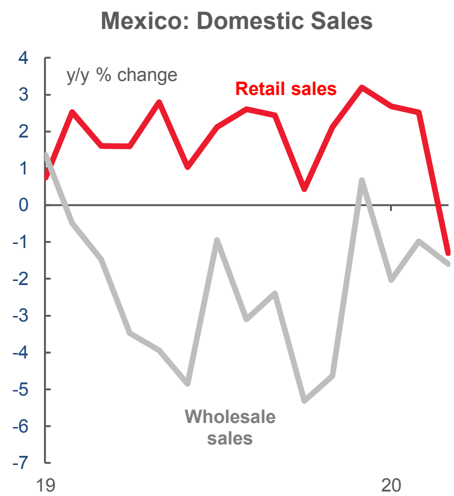
Sources: Scotiabank Economics, INEGI.

- Annual headline inflation accelerated from 2.21% y/y in the second half of April to 2.83% y/y in H1 of May compared with 4.43% y/y a year earlier. Its core component rose from 3.61% y/y to 3.76% y/y, versus 3.77% y/y a year ago, and non-core softened its decline from -2.00% y/y in H2 April to -0.06% y/y in H1 May, still much weaker than the 6.41% y/y we saw in the same period of 2019.

Retail sales data for March, also released on Friday, May 22, showed a contraction for the first time in 14 months. Growth fell from 2.5% y/y in February to -1.3% y/y in real terms, a greater deceleration than the market consensus of -1.0% y/y and a big turnaround from the 1.6% y/y growth we saw a year earlier (chart 2). The drop reflected early effects of the imposition of lockdown measures in the last week of March.

Meanwhile wholesale growth also slid further, from -1.0% y/y in February to a -1.6 % y/y contraction in March, marginally worse than the -1.5% y/y in March 2019 (chart 2, again).

Chart 2



Sources: Scotiabank Economics, INEGI.

The softness in the retail and wholesale data had significant breadth. March's contraction in retail sales was due to declines in five out of nine components, even though items such as self-service stores and internet sales accelerated their pace of growth. Amongst wholesalers, five out of seven subsectors saw contractions, which together outweighed growth in the grocery, food, and beverages sectors.

In quarterly terms, retail sales were up 1.3% y/y in Q1-2020 and wholesale activity fell by -1.6% y/y in the quarter. This performance contrasts with a 1.6% y/y expansion for retail sales in Q1-2019 and a -0.2% y/y decline in wholesale activity in Q1 last year.

March's weak domestic sales numbers lead us to reaffirm our negative outlook for private consumption as the health crisis generated by COVID-19 continues. The April figures are likely to be even worse owing to a sharp decrease in employment and what are likely to be further declines in remittances.

—Daniel Mendoza

PERU: HOME ISOLATION EXTENDED UNTIL JUNE 30, BUT WITH GREATER FLEXIBILITY; DETAILS ON FIRST QUARTER NATIONAL ACCOUNTS

On Friday May 22, President Vizcarra extended the State of Emergency, in a mildly lighter version, for another five weeks until the end-June. Mandatory home isolation will continue, as will the curfew, which will now start at 9pm, rather than at 8pm. E-commerce and delivery will be allowed on a wider scale, including clothing, appliances, books, school supplies, etc. Certain activities such as hair-dressing and plumbing will be allowed. Soccer sports and non-contact professional sports will be enabled, albeit in empty venues.

The State of Emergency will not alter the four-phased schedule to reopen the economy. In essence, and unlike the lockdown, the extension of the Emergency will have a greater impact on demand than on supply. There was some expectation that the State of Emergency would be extended until June 11, but the stretch to June 30 was a surprise. The decision comes as the tide of opinion is turning against the home isolation measures, and in favour of unlocking more quickly. Thus, Pres. Vizcarra risks generating political fallout, and perhaps social unrest. With more activities opening, the government will have even greater difficulty in ensuring compliance with the Emergency.

The BCRP also published details on the first quarter's national accounts on Friday, May 22.

I. First quarter external accounts

- **The current account deficit came in at 2.8% of GDP for the quarter, and 1.4% of GDP on a rolling four-quarter basis (table 1).** This compares with a 1.5% of GDP deficit for full-year 2019. The quarterly 2.8% deficit figure gives the impression that the deficit trend is intensifying, but the widening in the deficit in Q1 is partly seasonal: the figure actually represents an improvement over a 3.1% deficit in Q1-2019.

- **The trade balance was a positive, but small, surplus of USD 529 mn. Exports, down -13.6% y/y, were hit harder than imports, off -9.4% y/y, mostly because COVID-19 affected metal prices and exports to China before it became a domestic demand issue.** However, both will fall significantly going forward, with imports likely to decline more strongly than exports.

- **In contrast with past shocks, the decline in trade will be felt more in terms of volumes than values,** as Peru's terms of trade have actually been fairly stable.

Table 1

Peru: Balance of payments, USD mn

	Q1-2019	FY2019	Q1-2020
Current Account	**-1,386**	**-3,531**	**-1,444**
% of GDP	***-3.1***	***-1.5***	***-2.8***
Trade balance	1,284	6,614	529
Exports	11,253	47,668	9,717
Imports	-9,969	-41,074	-9,188
Services balance	-667	-3,114	-741
Investment income	-3,239	-10,749	-1,837
Transfers	960	3,718	606
Financial Account	**2,987**	**10,548**	**910**
% of GDP	***5.6***	***4.6***	***1.8***
Private sector	376	5,512	-842
Public sector	3,782	4,417	616
Short-term capital	-1,170	618	1,135
TOTAL	2,682	6,906	-884

Sources: Scotiabank Economics, BCRP, SBP.

- **In the current account balance, the lower trade surplus was compensated for by a decrease in the outflow of investment income from foreign (mainly mining) companies in the country.** This is likely to continue throughout 2020, thereby bolstering the current account balance. In BoP accounting, foreign company profits are registered as a current account outflow, with retained profits then registered as a financial account inflow. When mining exports decline, as will occur in 2020, both the current account outflow and the financial account inflow, decline in line with lower mining profits. Thus, lower metal exports frequently help the current account balance, rather than hurt it. This, and a greater decline in imports than exports going forward, is what is behind our forecast of a 1.1% of GDP current account deficit in full-year 2020. In the end the main factor increasing the current account deficit as a percent of GDP in 2020 may well be the sharp decline in GDP that we will experience this year; and

- **The financial accounts balance in Q1 showed a surplus equivalent to 1.8% of GDP.** This, actually, represented a significant decline from a 4.6% of GDP surplus in full-year 2019 and a 5.6% of GDP surplus in Q1-2019. Net direct investment, at USD 518 mn, was a fraction of its normal quarterly average of USD 2 bn throughout 2019. However, the financial accounts balance will soar in Q2 when inflows from newly issued government bonds, including USD 3.4 bn in global bonds, will be reflected. This inflow is already evident in net foreign reserves, which increased from USD 68 bn at the end of March, to USD 74 bn currently in May.

II. First Quarter GDP Growth by Demand Components

- **GDP fell -3.4% y/y in Q1-2020 (table 2), as previously released, together with growth by sectors.** The BCRP has now published the breakdown by demand components.

- **Most components moved within expectations, but a few surprised.** Perhaps the greatest disappointment was the -1.7% y/y, decline in consumption. This was large, considering that the lockdown did not begin until March 16, very late in the quarter, and points to the risk of a very sharp decline in consumption in Q2, when consumers will feel the full brunt of the quarantine measures.

Table 2

Peru: GDP growth, % y/y change

	FY2019	Q1-2020
GDP	2.2	-3.4
Domestic demand	2.3	-1.2
Domestic demand, excl. inventories	2.9	-3.3
Gov't goods & services	2.1	6.5
Private investment	4.0	-16.8
Public investment	-1.4	15.7
Exports	0.8	-13.6
Imports	1.2	-6.4

Sources: Scotiabank Economics, BCRP, SBP.

- **Domestic demand only declined -1.2% y/y, on the face of it, much better the decline in GDP, but there were problems in the details.** If you dig deeper, inventories accounted for much of the difference. If inventories were excluded, then domestic demand would be down -3.3% y/y, much more aligned with GDP. In fact, inventories make up a large part of the difference between -3.4% y/y actual Q1 GDP growth and our original forecast of -6% y/y.

- **The 15.7% increase in public sector investment reflects the pre-COVID-19 trend.** According to Ministry of Finance (MoF) figures, public investment was up 59% in January–February (MoF figures tend to exceed BCRP figures because they involve disbursements rather than execution). The impact of the lockdown on public investment will be felt fully in Q2; by Q3, we hope the government will be investing in full force once again.

- **Private investment was lacklustre since well before the lockdown, so the -16.8% y/y decline in Q1, which reflects not only the lockdown, but also a pre-existing concern regarding global COVID-19 developments, was not a surprise.** Mining investment was down -12.1% y/y, while non-mining investment fell -17.5% y/y.

- **Government spending on goods and services rose 6.5% y/y, but note that this was off a low base, as it had declined -3.6% y/y in Q1-2019.** Once again, due to timing, Q1 picked up relatively little of the increase in government spending that we expect to see in 2020.

- **The BCRP provided one key additional data point.** Seasonally adjusted GDP growth was -19.9% in q/q annualized terms.

III. First Quarter Fiscal Accounts

The fiscal deficit, in the 12-months cumulative to March, rose to 2.6% of GDP. This is the largest figure since Q1-2018, as expected, and represents a hefty increase from 1.6% at the end of 2019. However, this increase is just the beginning of a trend that we expect will lead to a 9% of GDP deficit by year-end. The first quarter just saw the beginning of the impact of the lockdown in terms of lower tax revenue (-5.5% y/y in Q1-2020; -21% y/y in March); and on higher government spending (9.9% in Q1-2020).

—Guillermo Arbe