Latam Economic Update

- **Argentina: Q2 GDP data confirm impact of the lockdown**
- **Brazil: September 16 Copom minutes show reliance on forward guidance rather than additional rate cuts, at least for now**
- **Peru: The Ministry of Finance aims for October 1 start to Phase 4 of re-opening as it pushes for greater and faster public investment**

ARGENTINA: Q2 GDP DATA CONFIRM IMPACT OF THE LOCKDOWN

Argentina is the last of the Latam-6 major economies to report its official Q2 GDP data on Tuesday, September 22, and the numbers confirmed the historic depth of the pandemic-driven economic shutdown. Real GDP fell by -16.2% q/q, which put the level of real economic activity down by -19.1% y/y, back to levels from a decade ago in both quarterly and rolling annual terms. This was close to consensus expectations, but a bit worse than our -17.9% y/y forecast in the September 20 *Latam Weekly*.

On the demand side, private consumption (-22.3% y/y) and total investment (-38.4% y/y) drove the worst quarter since the current GDP data series began in 2005, but government spending also exerted a drag on activity despite growing deficits (chart 1). Net exports were the sole major positive contributor to growth, but their impact was down from a year ago on decreased international demand.

The cut in economic activity was broadly spread across the supply side of the Argentine economy. Every one of 17 major production sectors saw reduced activity compared with Q2-2019. As in most countries, the hospitality sector was hit hardest (down -73.4% y/y), with a similar decline in private services of -67.7% y/y. Sectors relatively lightly touched by physical distancing, such as financial services (-1.2% y/y) and utilities (-3.3% y/y), experienced the smallest hits.

Early data for Q3 imply that rebound has started, but the pace of growth has lost some steam in the most recent indicators. With quarantine measures now extended into October, there are downside risks to our projected -10.0% y/y contraction for 2020 as a whole.

—Brett House

BRAZIL: SEPTEMBER 16 COPOM MINUTES SHOW RELIANCE ON FORWARD GUIDANCE RATHER THAN ADDITIONAL RATE CUTS, AT LEAST FOR NOW

On Tuesday, September 22, the BCB released the minutes for its Wednesday, September 16 Copom meeting where it left the Selic rate at 2.00%, but introduced forward guidance to its set of tools to provide further stimulus.

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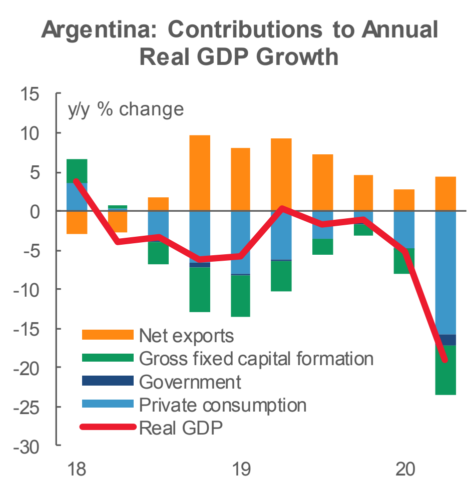
Chart 1



Sources: Scotiabank Economics, INDEC.

In the minutes, the Copom noted the relatively fast rebound in the Brazilian economy, which to an important degree was supported by aggressive government stimulus that is scheduled to end by 2021. In addition, the re-opening of other major global economies has also proven supportive. However, we'd add that news out of Europe and the US, where the pandemic seems to be once again gaining strength due to re-opening, adds a degree of risk—particularly as we head into the Northern Hemisphere's winter.

Table 1

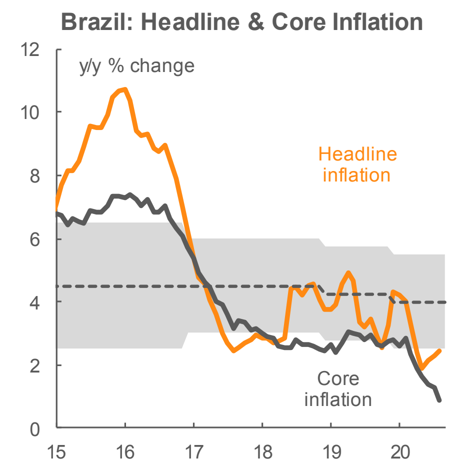
Copom's updated baseline scenarios

I. Baseline scenario with Selic constant at 2.00%				
Year-End	USDBRL	Selic, %	IPCA inflation, %	BCB target, %
2020	5.30	2.00	2.10	4.00
2021	5.30	2.00	3.00	3.75
2022	5.30	2.00	3.80	3.50
II. Hybrid scenario with interest-rate path from Focus Survey				
Year-End	USDBRL	Selic, %	IPCA inflation, %	BCB target, %
2020	5.30	2.00	2.10	4.00
2021	5.30	2.50	2.90	3.75
2022	5.30	4.50	3.30	3.50

Sources: Scotiabank Economics, BCB Focus Survey.

On the inflation front, the BCB acknowledged that we are likely to see continued upward pressure in the short term, but the BCB assumes that this will be temporary and driven primarily by food prices, as well as some price hikes derived from the recovery in economic activity as capacity utilization rates rise. However, the BCB does not seem overly concerned with inflationary pressures, which is consistent with anchored inflation expectations in the BCB's *Focus Survey* (Mean expectations: 2020 IPCA at 1.99% y/y, 2021 IPCA 3.01% y/y, and 2022 IPCA at 3.50% y/y—versus a BCB inflation target of 3.75% y/y for 2021 and 3.50% y/y for 2022).

Chart 2

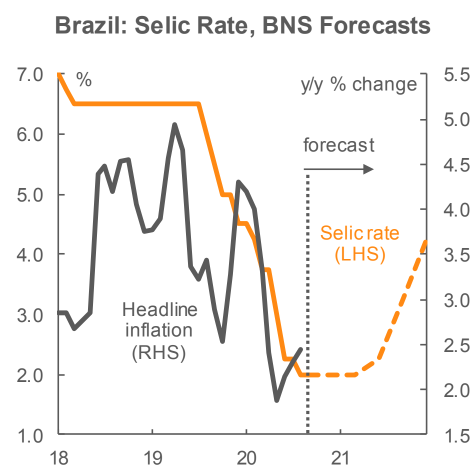


Sources: Scotiabank Economics, IBGE.

The minutes outline two possible scenarios for the Brazilian economy (table 1) in an effort to guide expectations. The first scenario assumes that the Selic is held constant at 2.00% over the forecast horizon; in the alternative hybrid scenario, the Copom assumes that the Selic rises in line with *Focus Survey*-consensus to 4.50% by end-2022. Reading between the scenarios' lines, the BCB appears to be attempting to provide an implicit sign that it sees its inflation target being hit via a path for the Selic somewhere between the two scenarios' projections. By laying out the two scenarios, the BCB is now relying on forward guidance to provide stimulus by anchoring expectations that the Selic rate will remain low for long.

As has been the case for several months, the Copom's hand appears to have been stayed from further easing by fiscal concerns and their impact on risk premiums. In particular, the minutes stated "*This premium is dynamic and tends to be larger in Brazil, given the country's relative fiscal fragility and the uncertainties regarding its prospective fiscal path. In this context, we would already be close to the level from which further interest rate reductions could be accompanied by asset price instability*". The worry is that unprecedented low rates could create unnecessary asset price volatility and affect financial system profitability. To get further rate cuts, we think we would need to see one of two things: (1) the political system and the government delivering on fiscal adjustment (which looks tough); or (2) another bout of economic weakness—which we think is probable, especially if forward guidance is not sufficient to stimulate activity.

Chart 3



Sources: Scotiabank Economics, BCB, IBGE.

The BCB noted a high degree of uncertainty about the outlook for economic activity, with the minutes stating that, "*several service sector activities, especially those more directly affected by social distancing measures, remain significantly depressed. Looking forward, the poor predictability associated with the evolution of the pandemic and the necessary decline in emergency aid by the end of 2020 increase uncertainty about the speed of the economic recovery*". At this point, we see the main risks to the downside for growth.

Bottom line: we think that the BCB has room to add stimulus to the economy given that inflation is low (chart 2) and expectations are anchored, but the Copom minutes confirm the revised call in our recent *Latam Weekly* for a hold at 2.00% followed by a gradual lift-off from Q2-2021 (chart 3). We think the economy faces risks of another deceleration as the current domestic stimulus is unwound over the next five months; at the same time, the virus is once again spiking in a large share of the world's major economies, creating the possibility of additional shut-downs. However, the Copom will likely adjust only gradually to changing circumstances, even if it does cut rates further: the minutes noted that, "*the Committee concluded that possible new interest rates reductions would demand caution and additional gradualism. To this end, if necessary, further interest rate cuts would require greater clarity about prospective inflation and activity and could be spaced over time*".

Brazil has limited room for further fiscal stimulus and another deceleration in economic activity would present a big problem for the BCB. We see binary outcomes ahead: if the coming months develop in line with the Copom's scenarios in table 1, the hold at 2.00% will look prescient; if, instead, the economy stumbles further, future stimulus may need to be even greater than it would be if further cuts were implemented now. At this point in time, the BCB seems to be relying on forward guidance to anchor current stimulus measures and to try to flatten the yield curve, but we see real risks that the BCB could be forced into making further cuts.

—Eduardo Suárez

PERU: THE MINISTRY OF FINANCE AIMS FOR OCTOBER 1 START TO PHASE 4 OF RE-OPENING AS IT PUSHES FOR GREATER AND FASTER PUBLIC INVESTMENT

Finance Minister María Alva was interviewed on a local news program on Monday, September 21 and stated that Phase 4 of the re-opening of the economy would begin on October 1. She cautioned, however, that Phase 4 would be implemented very gradually over time, and must first be approved by the Cabinet. The Cabinet will be meeting today, Wednesday, September 23, to consider a proposal by the Finance Minister on a timeline and conditions for Phase 4. The proposal would include new activities and would also consider allowing businesses to operate at 70% capacity, rather than the 40% currently allowed in some sectors. Recently, another Cabinet member noted that a re-opening of international flights from October 15 was additionally under consideration.

Min. Alva also stated that public sector investment should have increased in September compared with the same month last year. This would be the first sign of positive annual growth since February. This is important, as public sector investment has been underperforming the rest of the economy and positive year-on-year growth would shift government investment from being a drag on the economy to becoming a stimulus to growth. In this spirit, Min. Alva also said that Arranca Peru—the government employment and infrastructure program—would be expanded by PEN 2 bn to PEN 8 bn, with "Fastrack" execution already beginning.

—Guillermo Arbe