January 13, 2021

Chile | CLP could rise above $750 in the very short-run

Central Bank announces a program to increase international reserves by USD 12 bn

On Wednesday morning, the Central Bank of Chile decided to initiate a gradual program of replenishment and expansion of international reserves to strengthen the country's international liquidity position, in preparation for the end of the IMF Flexible Credit Line in 2022. The goal of this initiative is to increase the level of international reserves up to around 18% of GDP. Thus, the CB will buy around USD 12 bn.

In 2020, the Board of the CB considered it necessary to strengthen its international liquidity position, in order to mitigate the effects of the potential materialization of financial risks for the country. Therefore, the Central Bank of Chile obtained in May last year a flexible credit line (FCL) from the International Monetary Fund for almost USD 24 billion, available for 24 months.

Considering that the FCL is a precautionary and temporary facility, which expires in May 2022, and that the prevailing international financial conditions are appropriate, the Board has considered it is prudent to start now a process that will allow the CB to fulfill the role of the FCL through gradual accumulation of international reserves.

Starting on Monday, January 18, the Central Bank will implement a gradual foreign exchange purchase program for USD 12 bn. Of these, USD 2.55 bn correspond to the replacement of the reserves used in the intervention plan that was executed between December 2019 and January 2020, following the social outbreak, and the remaining balance to the amount necessary to increase its size to around 18% of GDP. **This program will materialize in a period of 15 months, in order to coincide with the end of the FCL, through regular purchases of foreign currency for USD 40 mn per day through competitive auctions.**

Our economic view

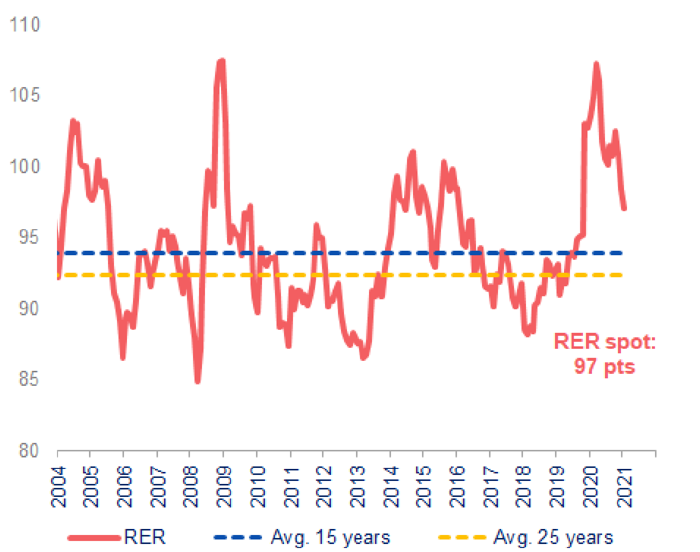
- **Our estimates indicate that for each USD 1 bn the CB purchases, the exchange rate depreciates $2 to $3 CLP *(ceteris paribus)***. Therefore, the CLP could rise transitory to $750, and much of that depreciation happening few days after the announcement. We don’t rule out higher levels if there are some global corrections to the USD or a change in carry trade positions by foreign investors (below we talk about it).
- **With this, the Central Bank will intervene the FX market when the real exchange rate is at 97 (index 1986=100), around 3% higher than its historical average, which in our view is an appreciated level** given that the Chilean economy is going through a severe adjustment process and there are still wide output gaps coming from the crisis caused by the pandemic (Fig 1). A

couple months ago the Central Bank expressed that the equilibrium real exchange rate had increased as a result of the latest crisis.

- **This announcement reveals that the Central Bank is not worried about medium-term inflation. On the contrary, they don’t consider the inflationary pressures we have experienced in the past months as permanent, pressures that have been fueled by the two withdrawals of pension assets by almost USD 30 bn.** The announcement could even reveal some disinflationary concerns stemming from the recent appreciation of the peso, in a context where the labour market remains deteriorated and the economic, sanitary and political uncertainty is still high.
- **The CB has also announced that they will not completely sterilize this intervention (sell CB´s bonds).** The exact amount of the sterilization is unknown, but it indicates that the financial conditions to completely sterilize this intervention are not met, given also that the CB has expressed a dovish bias in recent minutes. **Therefore, the impact on interest rates should be contained.**
- **Off-shore positions have increased their exposure to CLP in recent months. High risk of unwinding which would fuel depreciation.** We will have to wait and see if this announcement will cause a sell-off of non-residents´ positions, further depreciating the CLP. In fact, the non-resident position on derivates/forwards reached -USD 6.2 bn yesterday, after reaching -USD 16 bn in early November. Therefore, foreign investors bet in favor of the CLP by USD 10 bn in just a couple of months (Fig 2 and 3).
- **Worth mentioning that this accumulation of reserves of USD12 bn comes when the Treasury will liquidate USD3 bn of the sovereign funds and USD6 bn of foreign bond issued abroad in foreign currency, according to the fiscal budget, to finance government expenditure during 2021.** It may be that the announcement of USD liquidation by the Treasury has already been internalized by the market (already priced in the CLP), although we doubt this is the case since not the entire market was aware of the historic bond issuance abroad (USD6 bn).

Figure 1

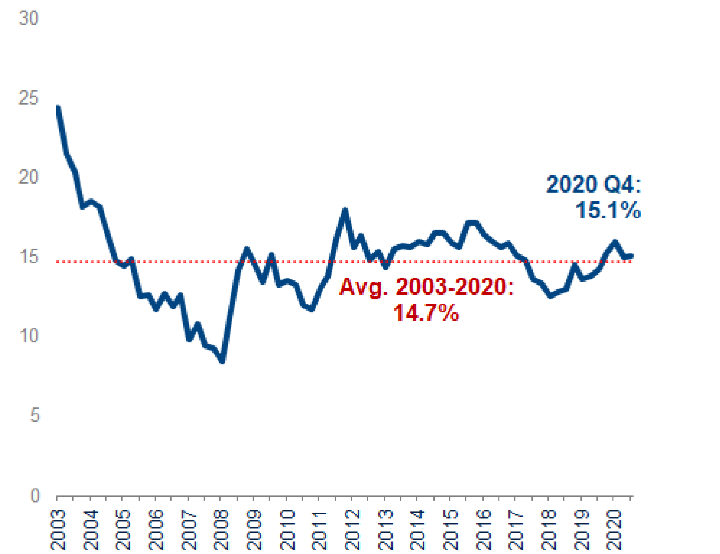
Real exchange rate: just 3% above historical average
(index 1986=100)



Source: Central Bank, Scotiabank Economics

Figure 2

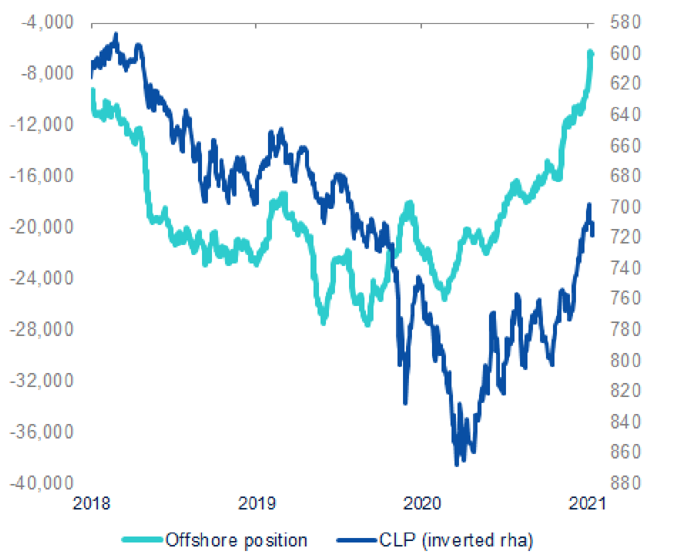
Foreign exchange reserves: not high enough for the current economic and political situation
(percentage of GDP, last 12 months)



Source: Central Bank, Scotiabank Economics

Figure 3

Offshore position and spot exchange rate
(mill. of USD, $/USD)



Source: Central Bank, Scotiabank Economics

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