

FX Report

CLP appreciation: too much, too soon



Scotiabank Economics Chile

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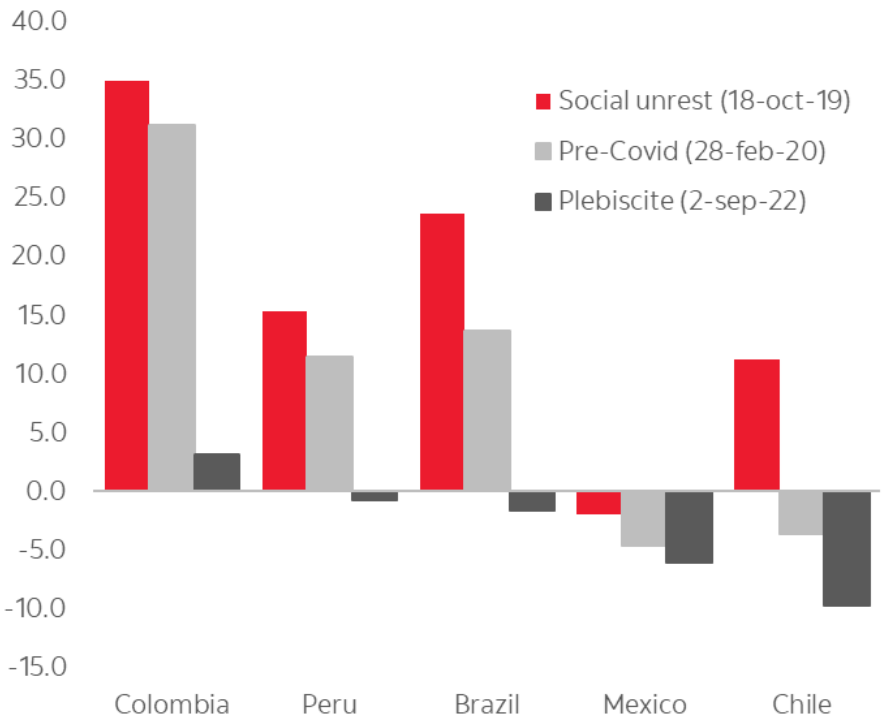
Key messages

- **Strong appreciation of the Chilean peso is explained by better external financial conditions, resilient domestic activity and an improvement in terms of trade.** Although, it is also driven by short-term capital inflows, selling of USD to accelerate fiscal spending, forward dollar sales by the BCCh and an underestimation of the political and economic risks that lie ahead.
- **Real Effective Exchange Rate is on its historical average and the USDCLP is appreciated with respect to its fundamental value. Although we observe a better political environment after Sept. 4, the tax and pension reforms can be a source of domestic financial volatility.** The risk of a not market-friendly constitutional assembly is low, but not insignificant.
- **We see more risks of negative than positive surprises in inflation over the next few months despite one-time and second-round effects (VAT on services, educational services and pending rises in utilities and public transportation, among others).** High level of inventories, negative output gap, weak labor market and multilateral appreciation of the Chilean peso will impact goods' inflation, food prices and some volatile items.
- **A faster inflationary break will lead the BCCh to modify its monetary policy stance earlier than anticipated in its baseline scenario which should unwind part of the short-term capital inflows behind the CLP appreciation.** We do not rule out lower levels in the short-run, but we maintain our forecast of USDCLP850 during the second half of 2023.

- **CLP has appreciated almost 15% during the last 3 months, outperforming peers.**
- **Most of the multilateral appreciation has occurred since the rejection of the new constitution.**

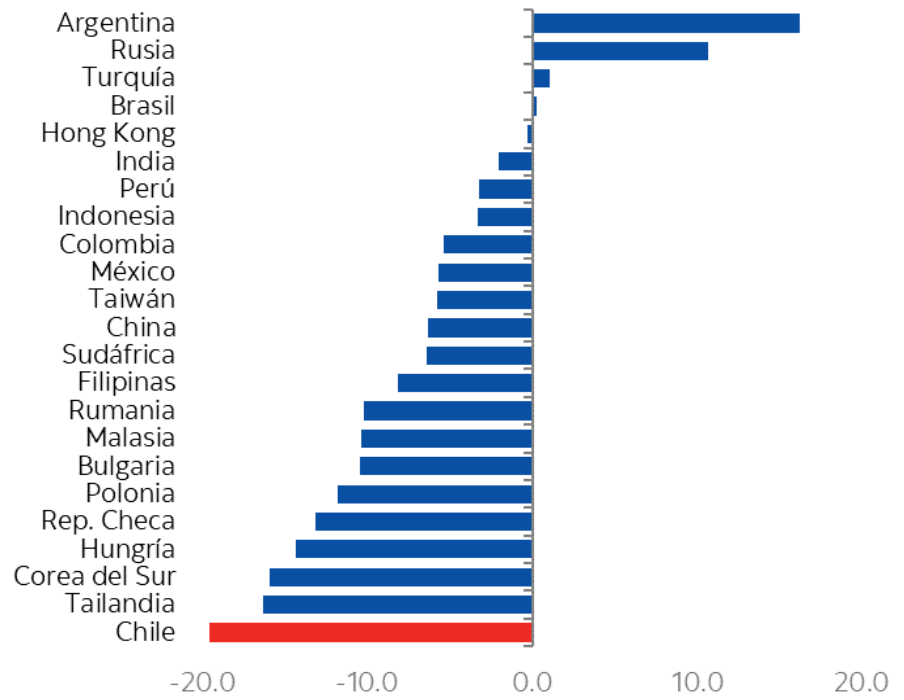
Latam exchange rates*

(% depreciation (+)/appreciation (-) w/r to key Chilean dates)



Emerging market exchange rates*

(percentage, change in the last 3 months)

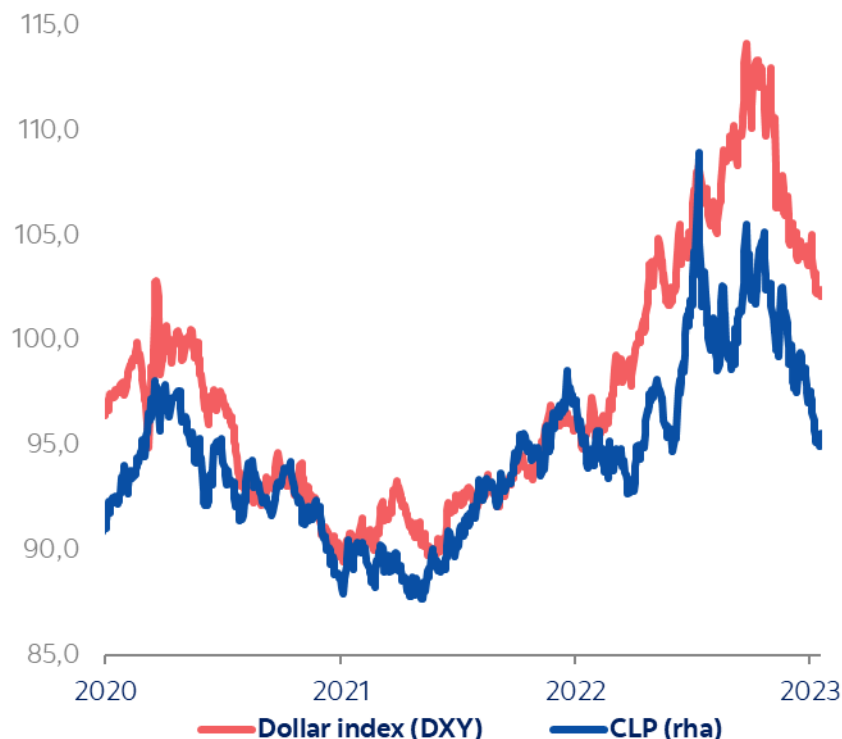


* Positive values indicate depreciation against US dollar.
Source: Bloomberg, Scotiabank Economics

- CLP has responded strongly to the US dollar depreciation.
- Recovery in USDCLP relation with GDP growth differential after a relevant interruption triggered by the 3rd withdrawal of pension funds. Even though, CLP is appreciating contrary to growth differentials at the margin, another symptom of excessive appreciation.

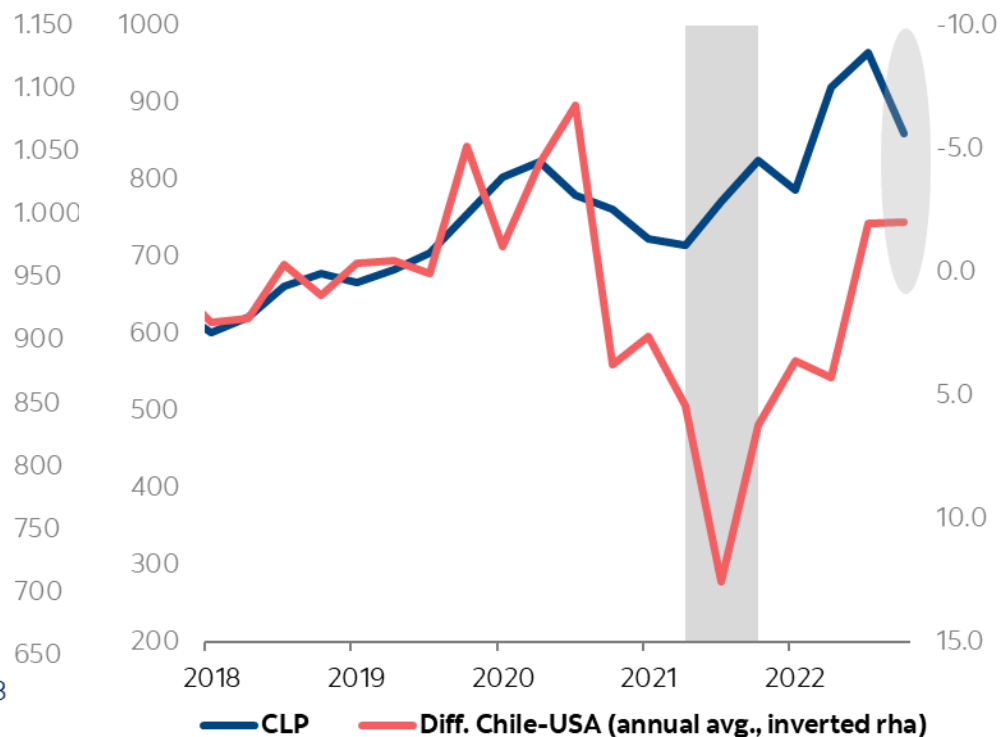
Dollar index and CLP

(index DXY, \$ per US dollar)



GDP growth differential: Chile vs US

(\$/US\$, percentage points, QoQ saar)

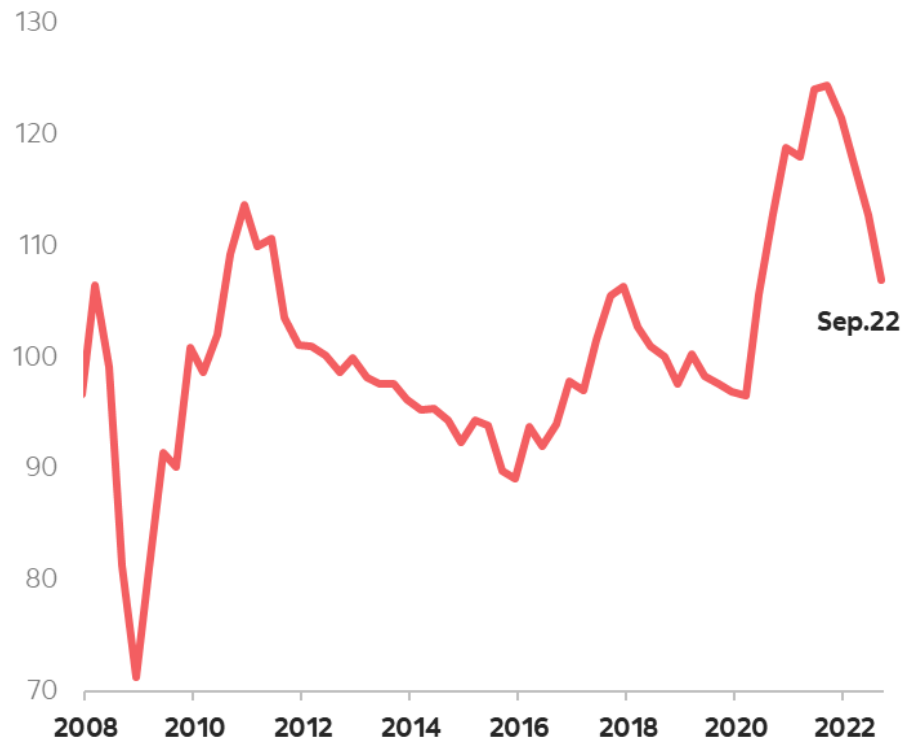


Source: Bloomberg, Central Bank, Scotiabank Economics

- **Terms of trade were decreasing until Sept. 2022.**
- **Since the last quarter of 2022, the price of copper increased sharply due to global market optimism. This coincided with the triumph of the rejection of the new constitution.**

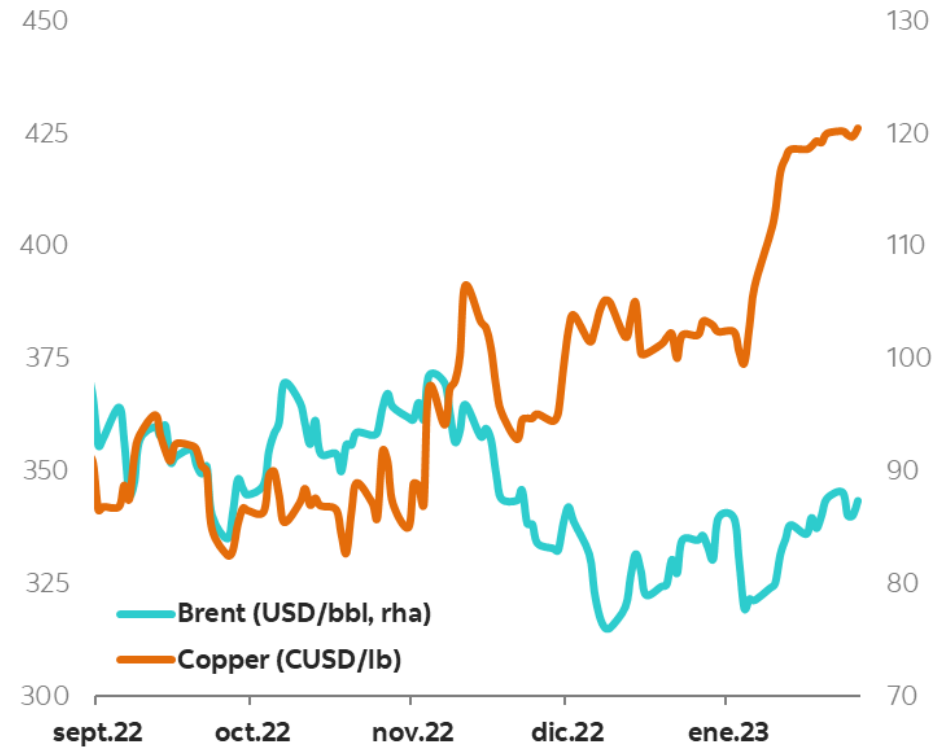
Terms of trade of the Central Bank

(index, base 2018=100)



Oil and copper prices

(cUSD/bl., USD/bbl.)

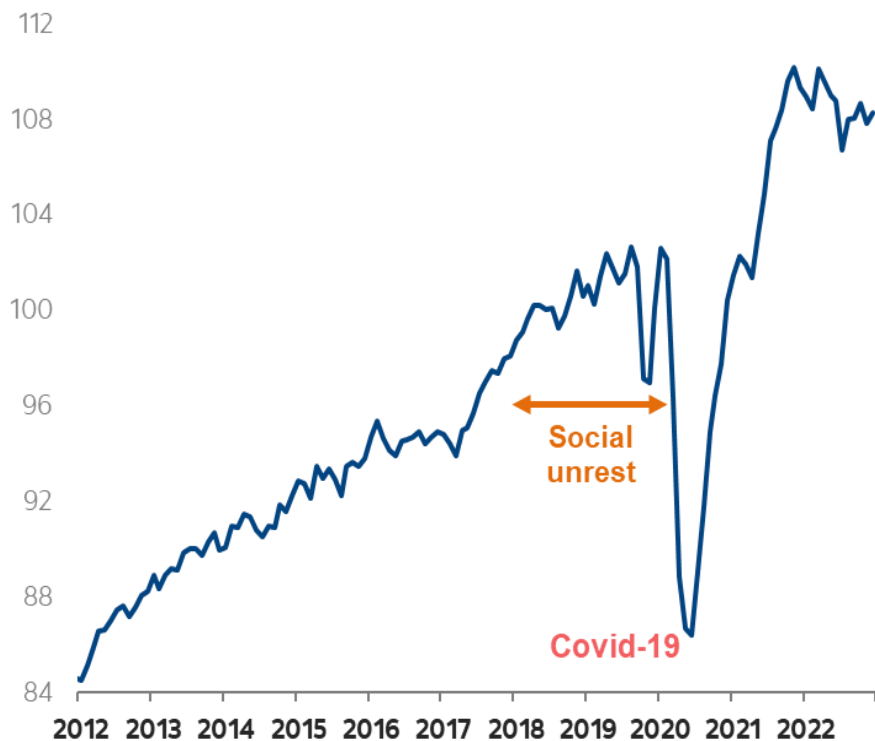


Source: Bloomberg, Central Bank, Scotiabank Economics

The gradual closing of macroeconomic imbalances has helped to consolidate a better view on the CLP.

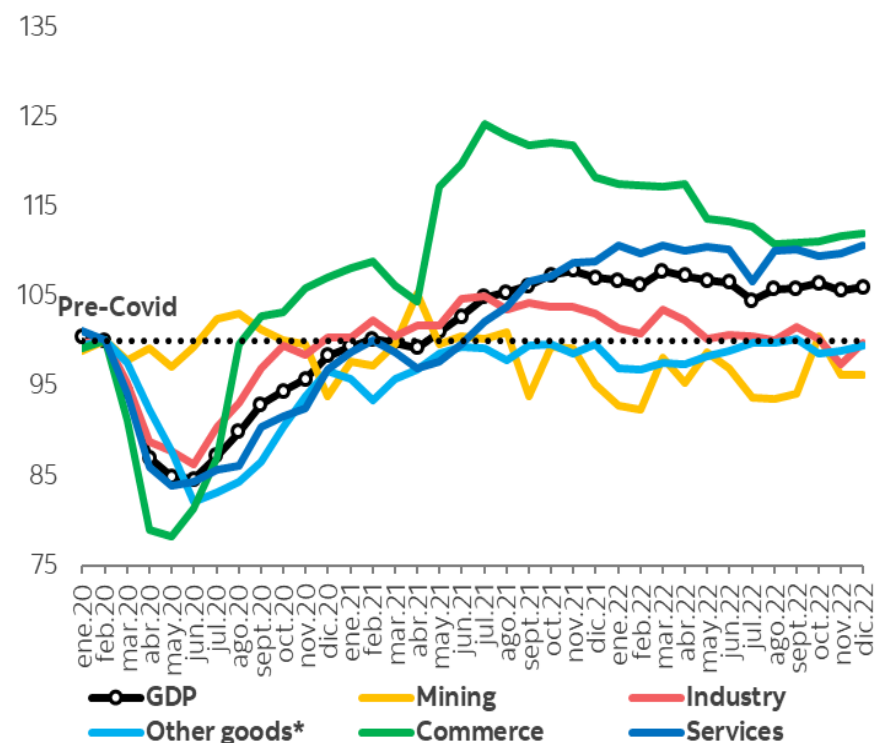
GDP level

(level, 2018=100, seasonally adjusted, monthly data)



GDP level by sector

(index, February 2020=100, monthly data)

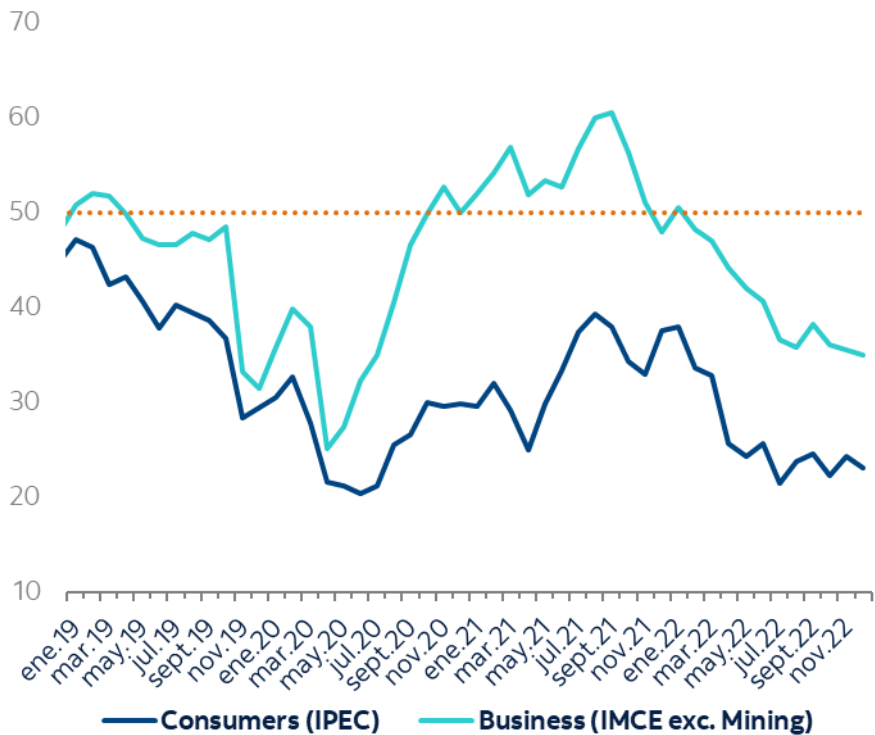


* Includes Construction, Agro-forestry, Fishing and EGW.
Source: Central Bank, Scotiabank Economics

- **Pessimism in confidence and decline in economic expectations are part of the adjustment process after being overheated for almost 2 years.**
- **Therefore, the reading of confidence indicators is positive for the CLP.**

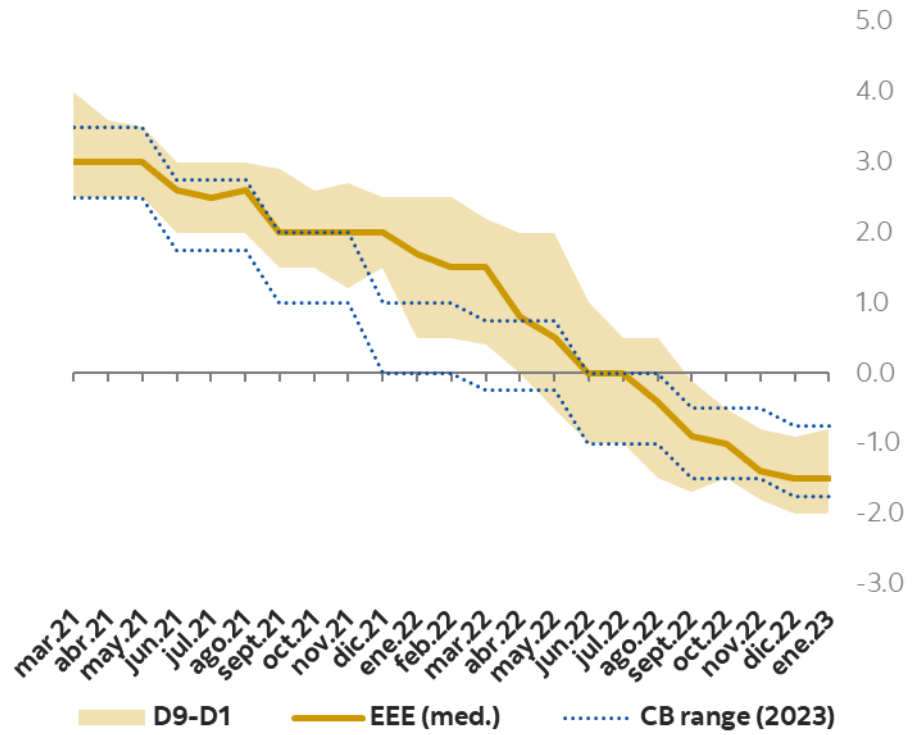
Business confidence: optimistic levels

(level, 50=neutral)



GDP expectations for 2023

(%, y/y, EES*)



* EES: Economic Expectations Survey (EEE in spanish).
Source: Central Bank, Scotiabank Economics

- **Private consumption landing to a sustainable levels thanks to restrictive monetary policy and no additional support to internal demand.**
- **Positive response from foreign investors.**

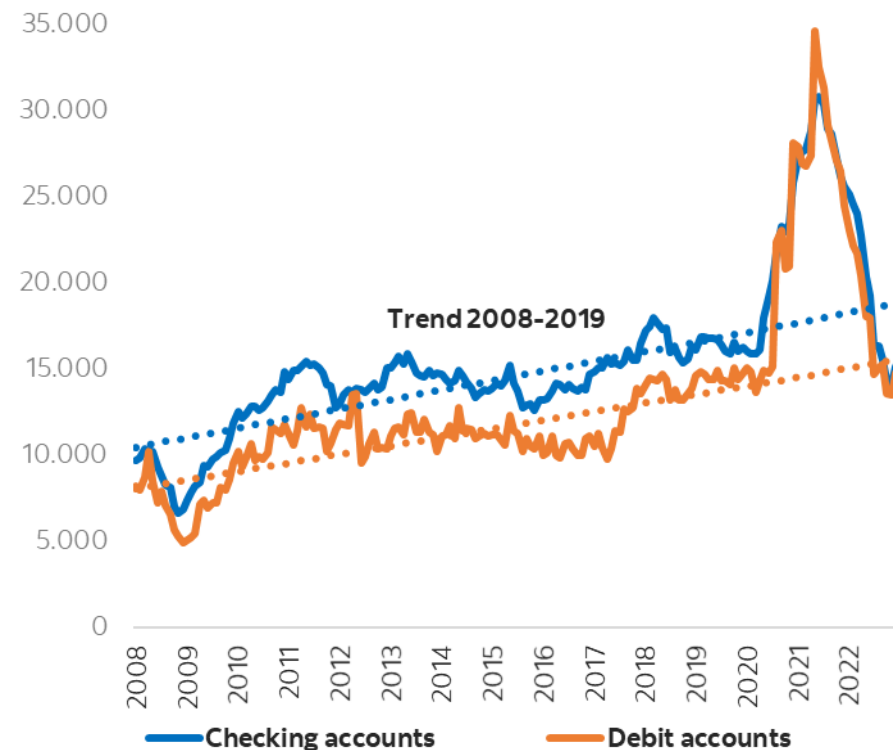
Level of purchases with debit cards

(level*, real, index 1-Jan-2020=100, 30-day moving sum, up to Jan. 28)



Liquidity in non-remunerated accounts

(millions of USD, natural persons, as of December 2022)

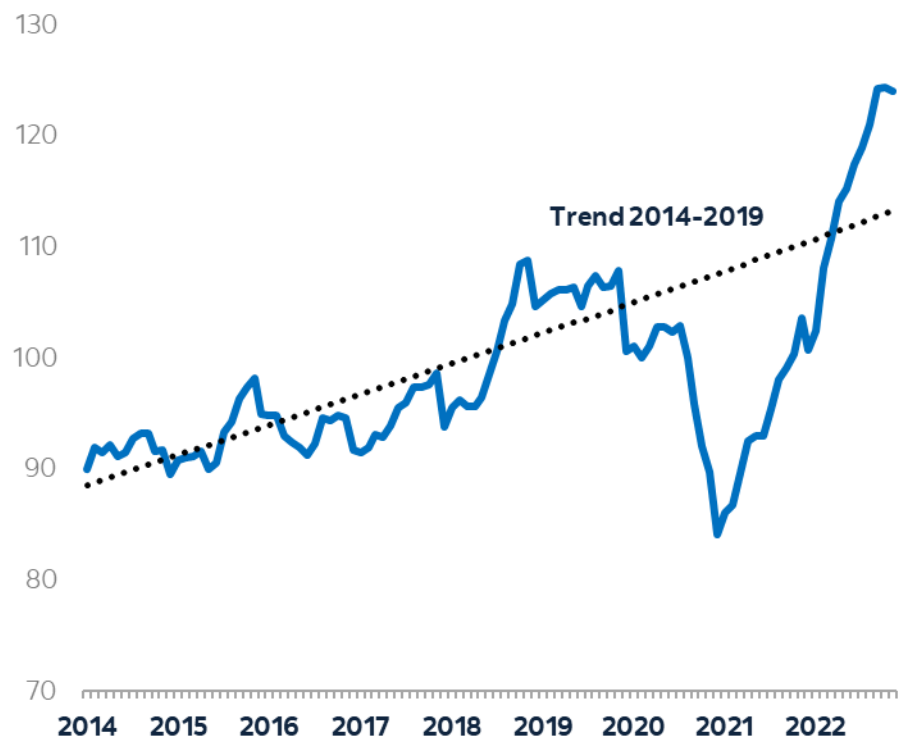


* Data show purchases with Scotiabank's credit and debit cards. The level of purchases is shown as an inflation-adjusted index.
Source: Central Bank, Scotiabank Economics

- **Quick inventory recovery with positive implications for tradable goods inflation in 2023.**
- **Central Bank will only deal with second round effects of a 2-digits inflation (30% of the CPI basket is directly indexed to past inflation).**

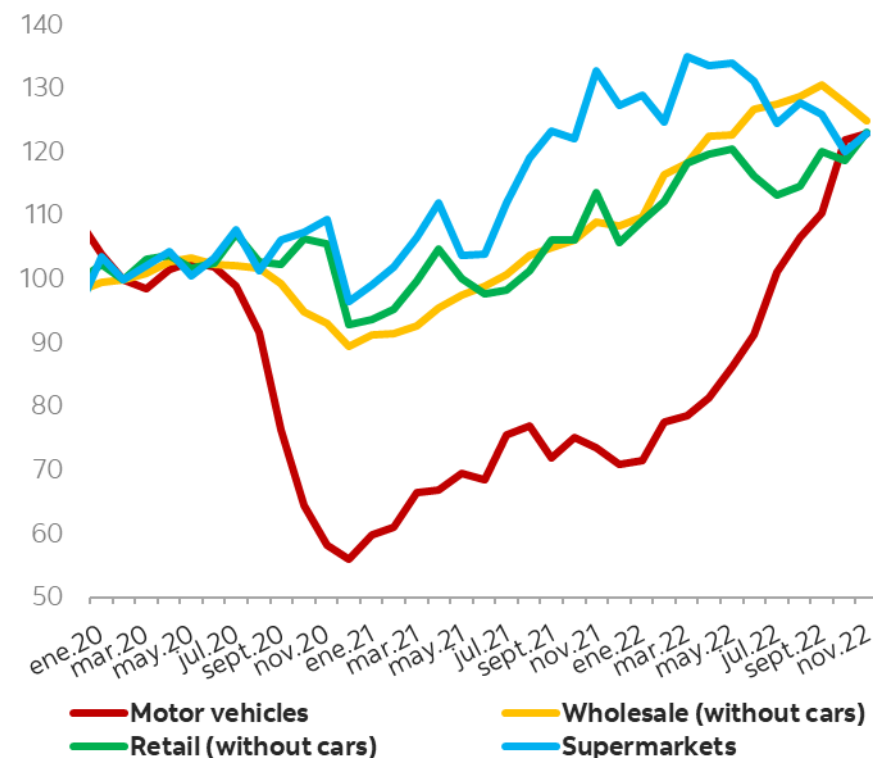
Level of inventories in Commerce (IICOM)

(inflation adjusted index, Feb.2020=100)



Level of inventories by segment

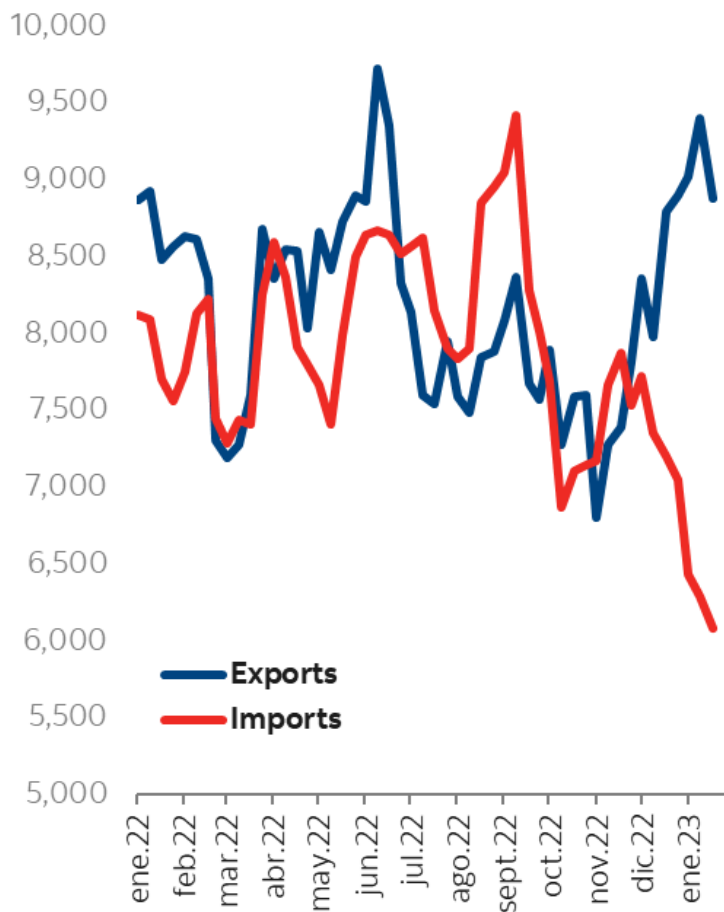
(inflation adjusted index, Feb.2020=100)



- **Convergence of the current account towards a sustainable level sooner than later. Resilient exports and imports fading out.**
- **Freight cost normalization is favoring a reduction in trade balance of services.**

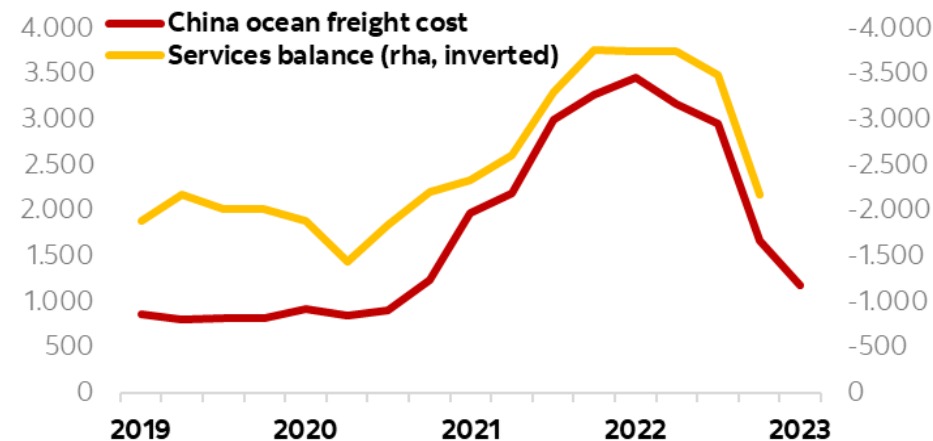
Exports and Imports of goods

(level, USD millions, 1-month accum.)



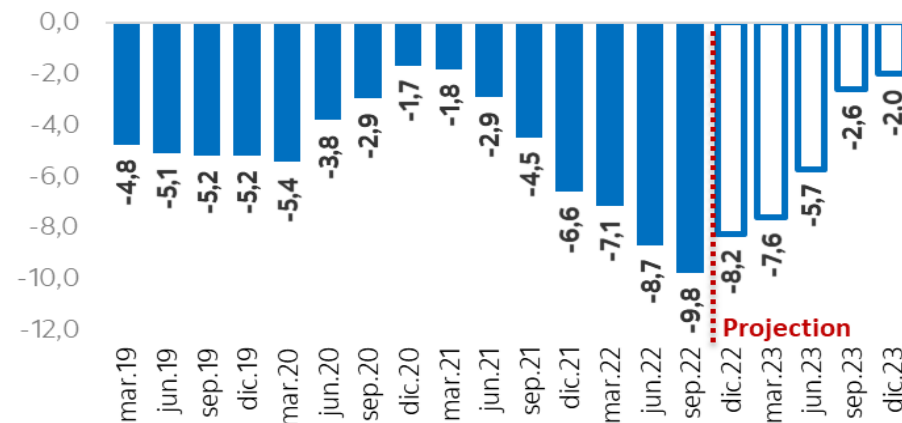
Freight cost and Balance of services

(USD million & index in USD)



Current Account deficit

(% of GDP, accum. last 12 months)

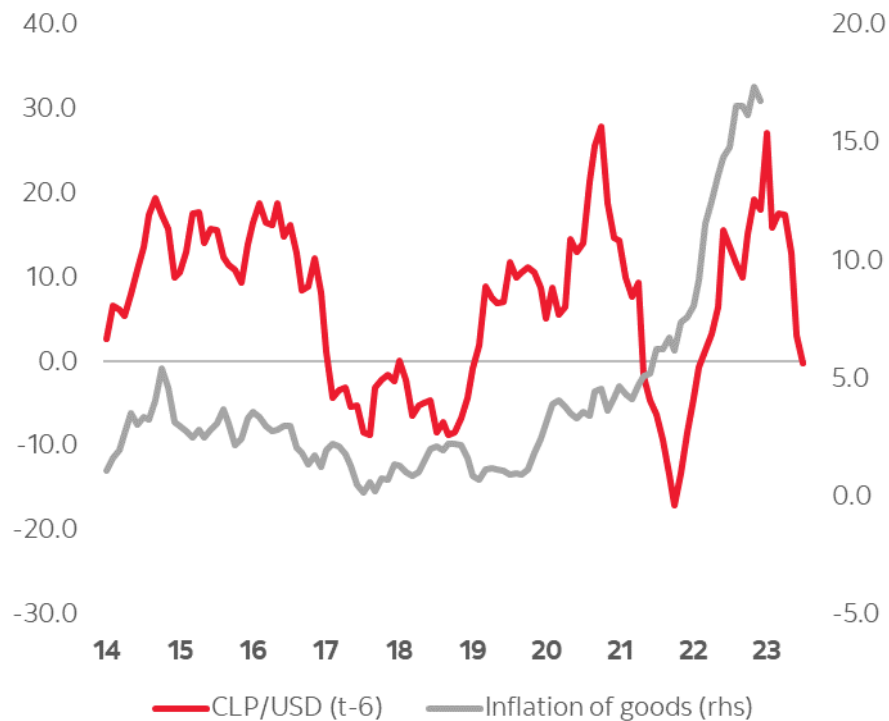


Source: Central Bank, Scotiabank Economics

- **Appreciation of the CLP ensures drop in goods inflation (51% of the CPI basket).**
- **Therefore, second round effects in services should be the main concern of the Central Bank.**

USDCLP & CPI of goods

(var. %, y/y)

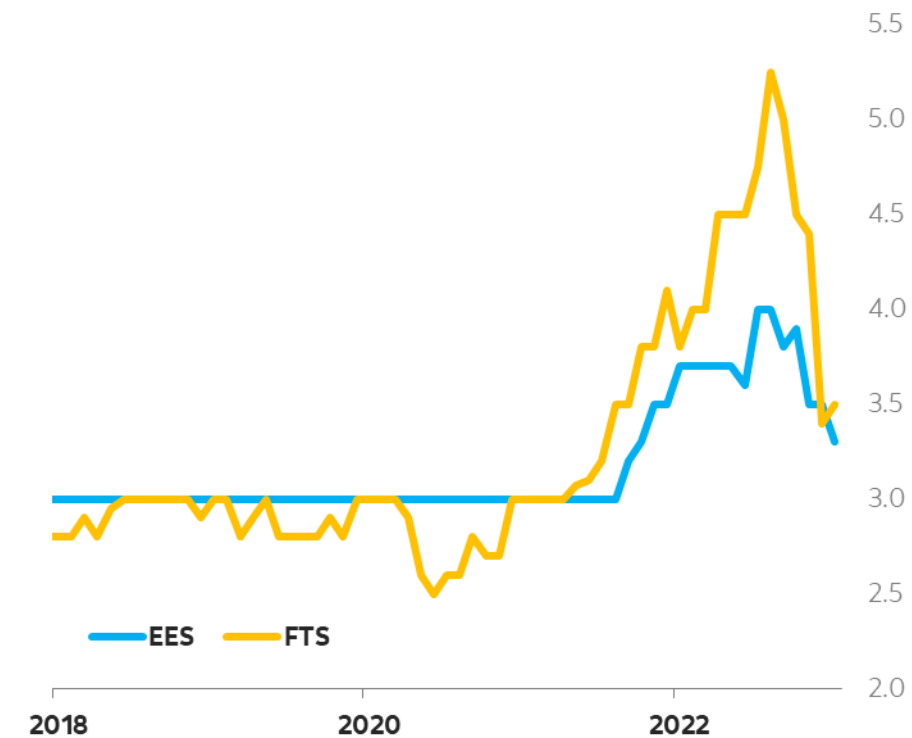


"The macroeconomic implications of the recent appreciation of the peso will be assessed in the next Monetary Policy Report"

Central Bank, Monetary Policy Meeting, January 26th.

- Inflation expectations have fallen sharply, standing close to 3%.
- Just one negative surprise in the monthly CPI will be enough to anchor long-term inflation expectations triggering the cutting of the benchmark rate. That should give some support to the USDCLP.

Inflation expectations 2y: surveys
(%, 2 years ahead)



Inflation expectations 1y & 10y: breakevens
(%, implicit in swap rates)

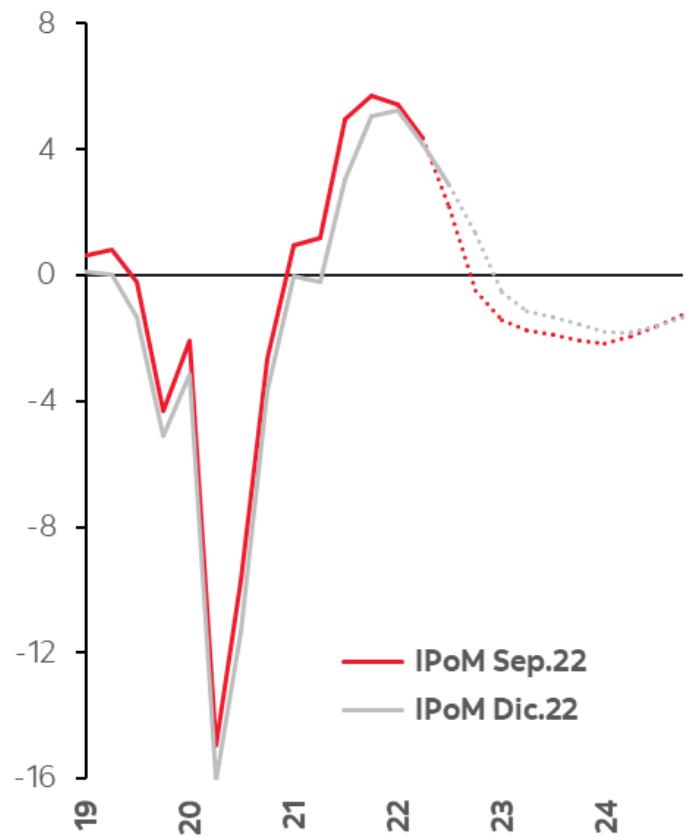


EES: Economic Expectations Survey. FTS: Financial Traders Survey.
Source: Central Bank, Scotiabank Economics.

- A negative output gap will consolidate during 1Q23. Resilient activity in 4Q22 was explained by public spending and delayed investment in energy and mining.
- April's meeting is still open for the first cut as a better activity/demand will not compensate the disinflationary pressure coming from the appreciation of the CLP.

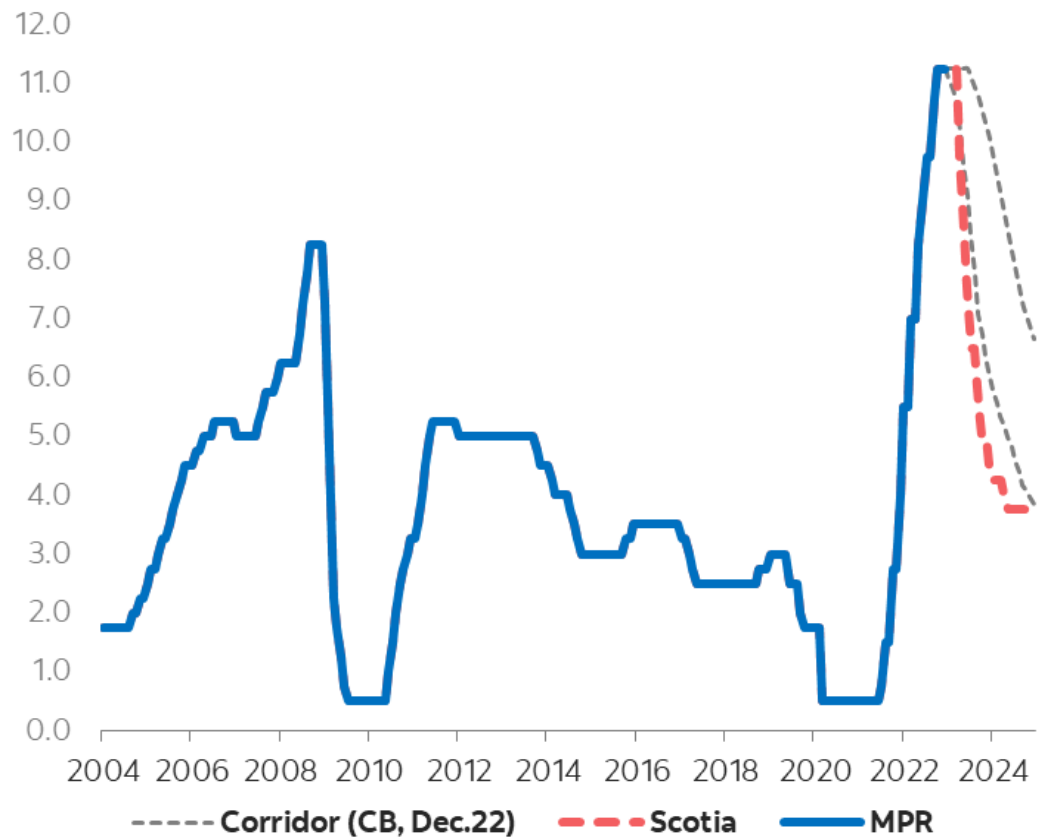
Output gap

(%, Central Bank estimation)



MPR expectations and CB corridor

(percentage, nominal)

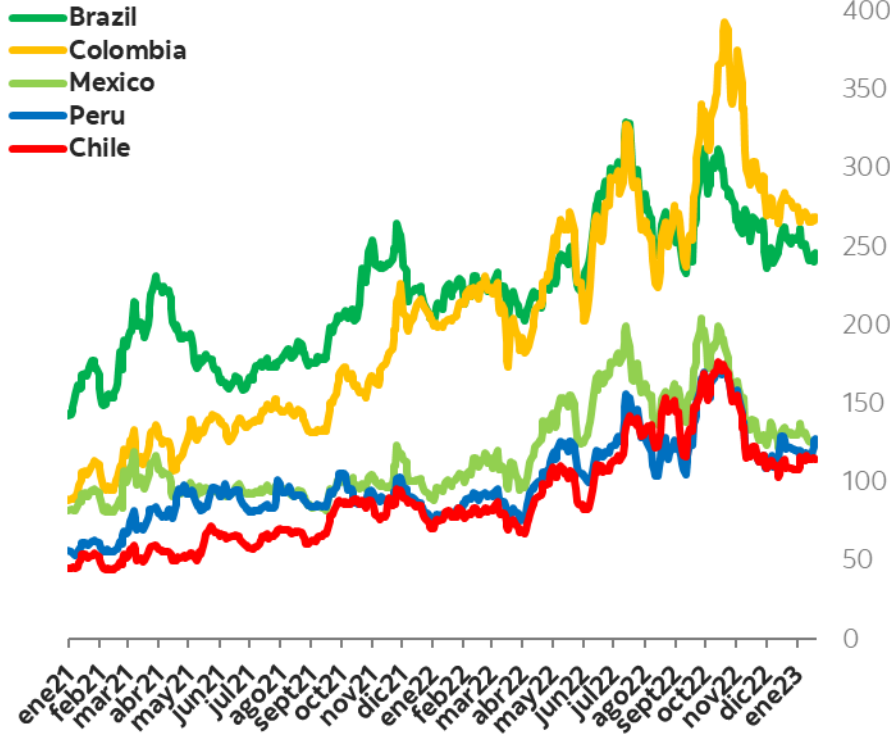


Source: Central Bank, Scotiabank Economics.

- Drop in country risk has given support to the appreciation of the CLP.
- Strong appetite for domestic fixed income along with a normalization in term premium.

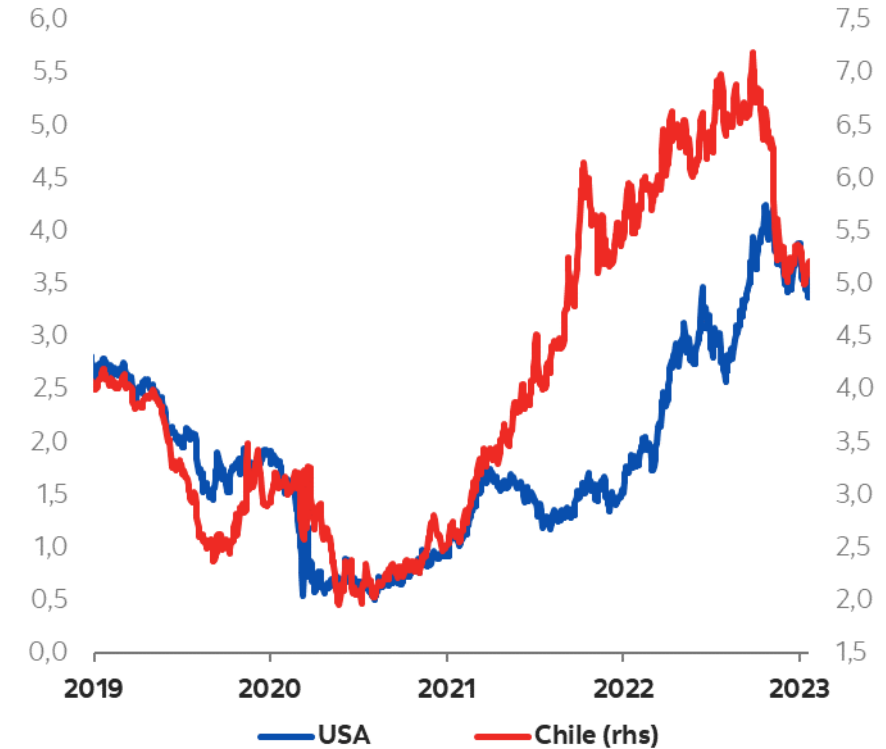
5Y Sovereign Credit Default Swap (CDS)

(basis points)



10Y interest rate: Chile & USA

(%)



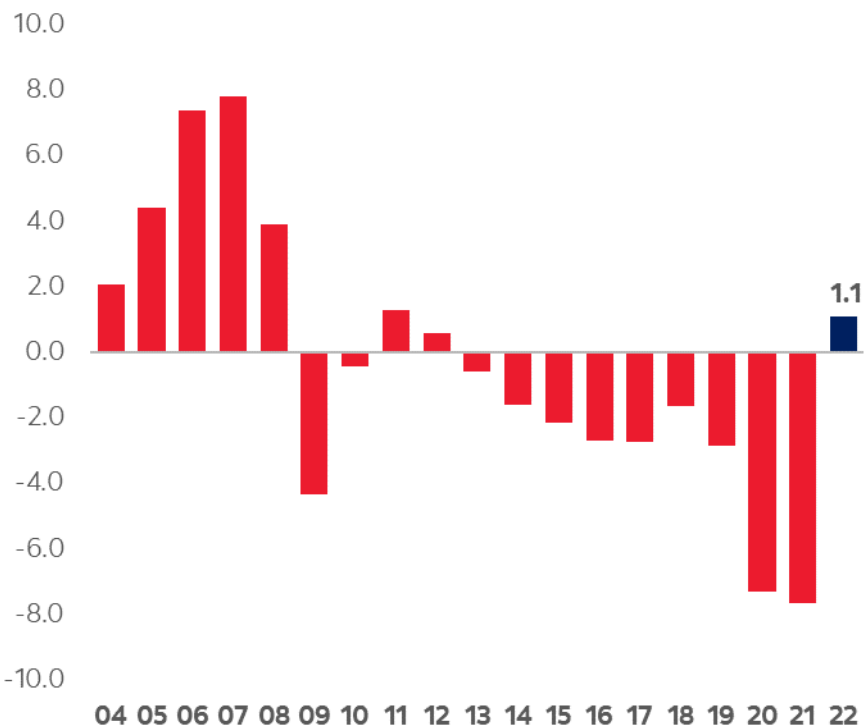
	Rating	Outlook
Moody's	A2	Stable
Fitch	A-	Stable
S&P	A	Stable

Source: Bloomberg, Ministry of Finance, Scotiabank Economics

- **Fiscal sustainability is the game of the Minister of Finance, very well received by foreign investors.**
- **Stability in debt/GDP is also welcomed by credit rating agencies, giving some support to a lower premium on the CLP.**

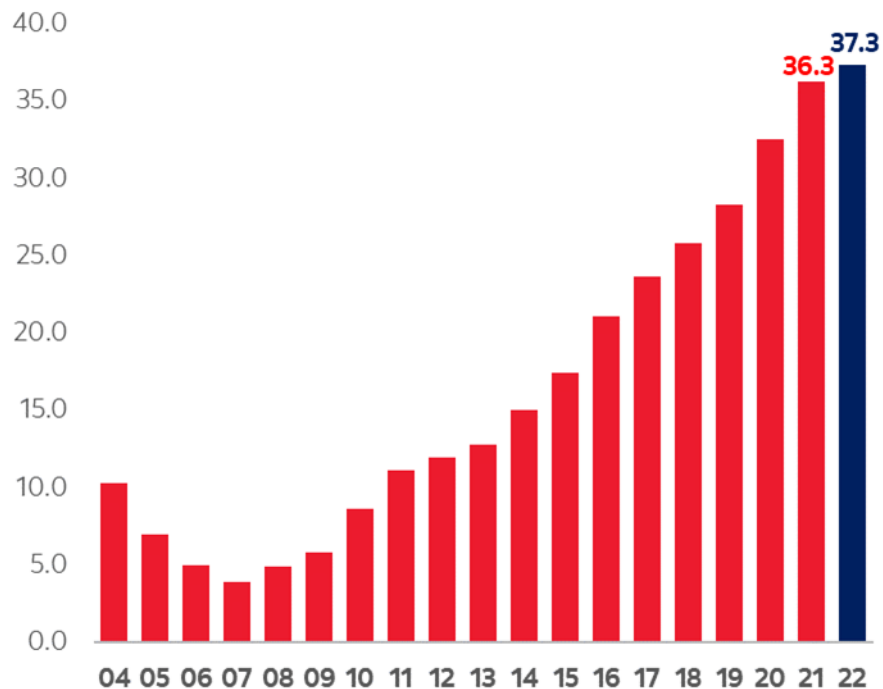
Effective Fiscal Balance

(% of GDP)



Gross fiscal debt

(% of GDP)

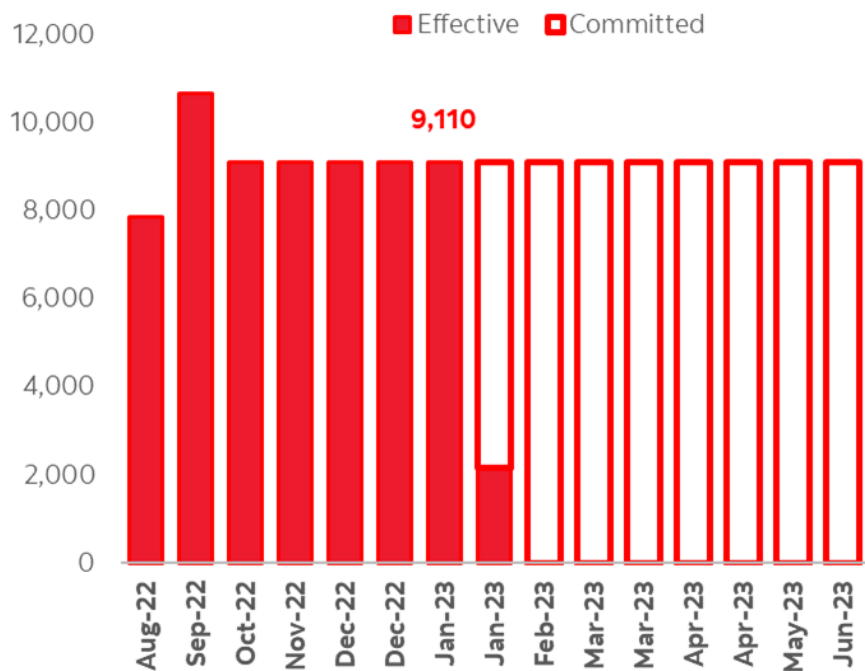


Source: Ministry of Finance, Scotiabank Economics

- **Central Bank extends forward USD sales operations program to June. We do not rule out an early ending.**
- **Government selling USD adds "short-term" fuel to CLP appreciation.**
- **Treasury: USD-denominated assets close to USD 1.4 bn. after the recent announcements of selling.**

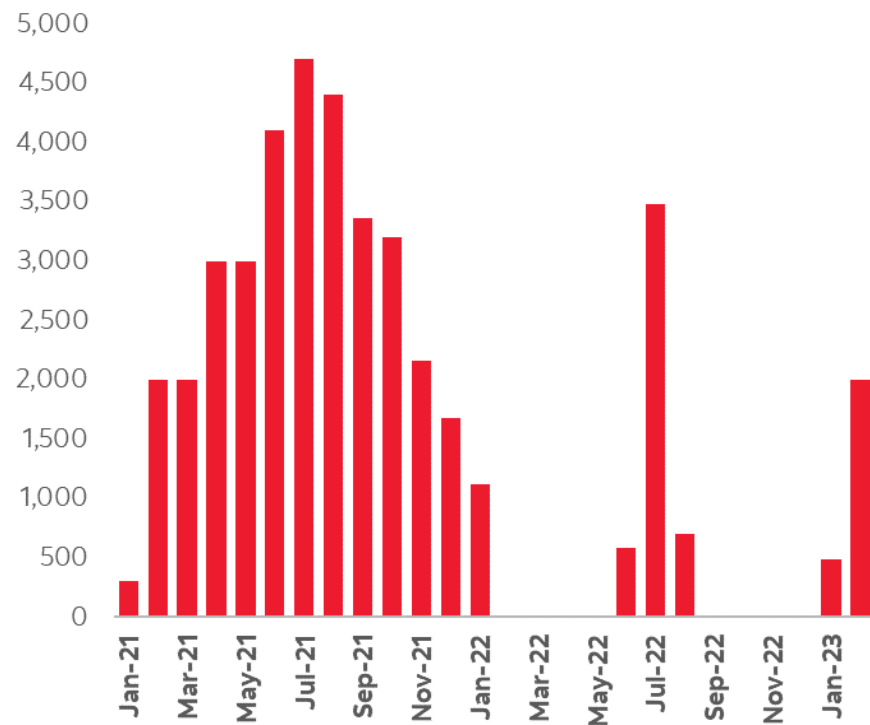
Forward USD sales by the Central Bank

(mn US\$)



Sales of US dollars by the Ministry of Finance

(mn US\$)

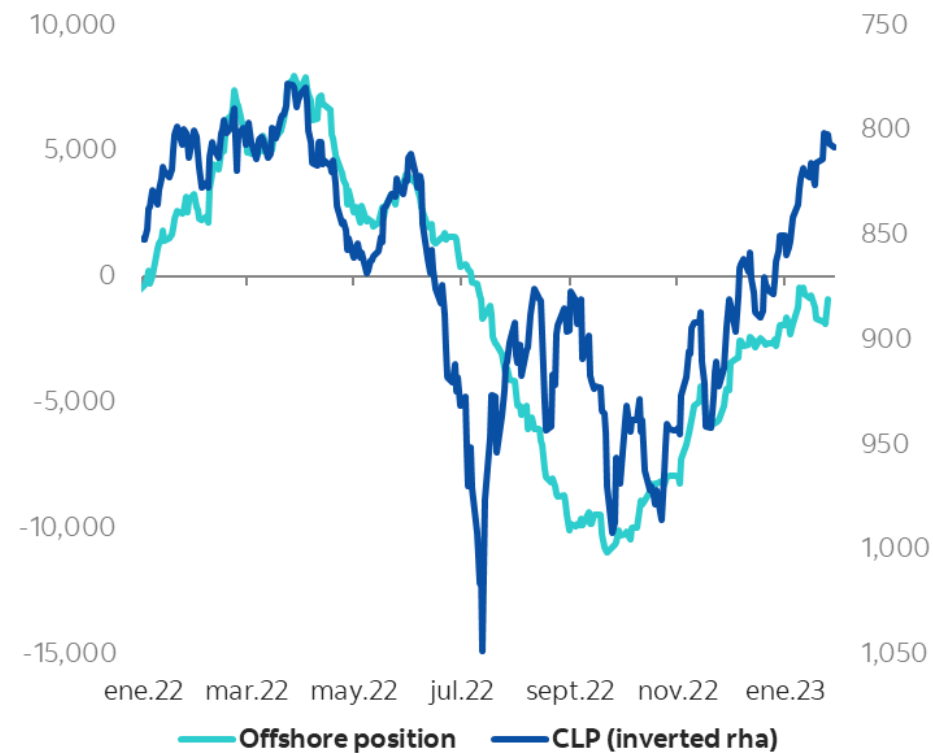


Source: Ministry of Finance, Central Bank, Scotiabank Economics

- **Strong appetite for carry trade by foreign investors has explained part of the CLP outperformance. Warning: concerning increase in spread on shore.**
- **Ingredients of recent carry trade: high benchmark rate, perception of more political negotiation on the structural reforms and moderate political route to re-write the constitution.**

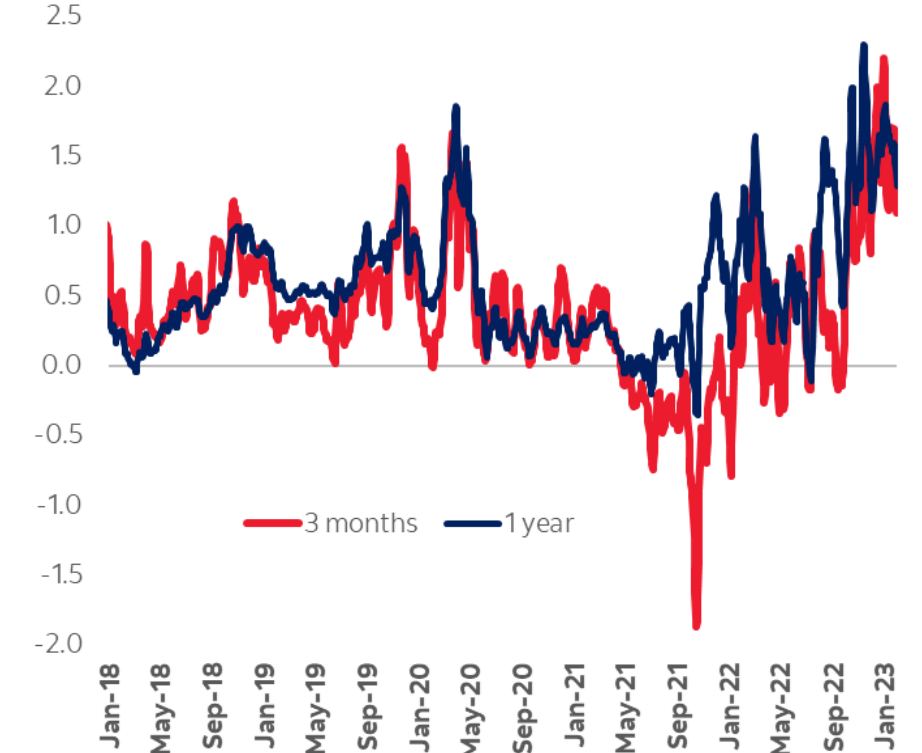
Net offshore position CLP/USD*

(millions of dollars, \$ per US dollar)



Spread on-shore over Libor: 3 months & 1 year

(%)

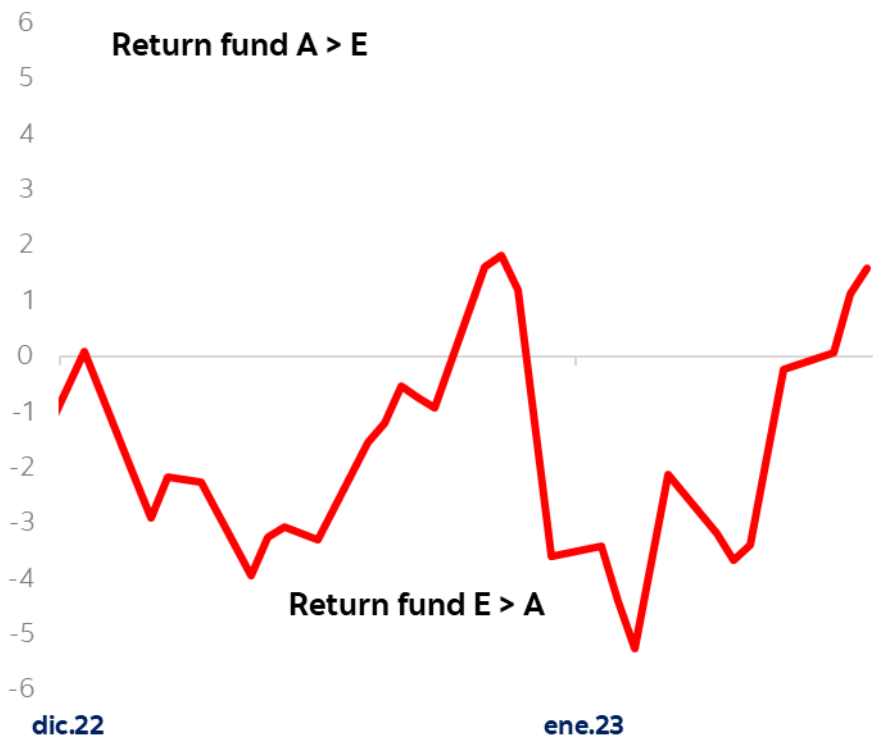


* Net NDF position (Non-deliverable forward) of local banks with non-residents.
Source: Bloomberg, Central Bank, Scotiabank Economics

- **Pension funds: better performance of risky funds and net inflow of contributors to conservative funds.**
- **PFs have been net sellers of USD (contributing to the appreciation of the CLP) and net buyers of domestic fixed income (contributing to the drop in long-term interest rates).**

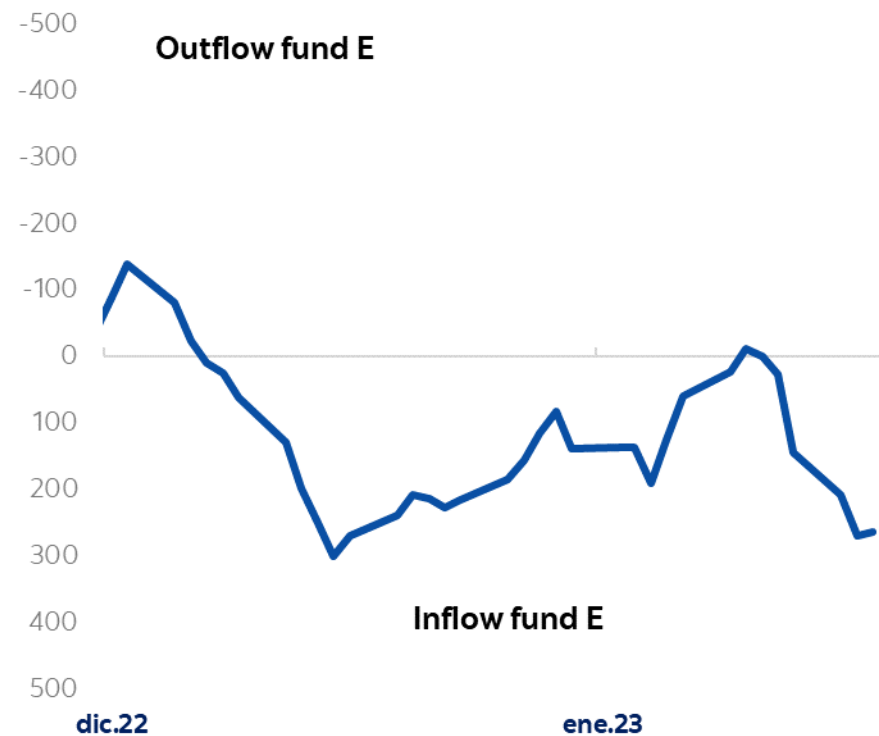
Relative return: Fund A vs Fund E

(%, return of fund A minus E, 10-day accum.)



Contributors' flow to Fund A+B*

(millions of dollars, daily flow of contributors to fund E, 10-day accum.)

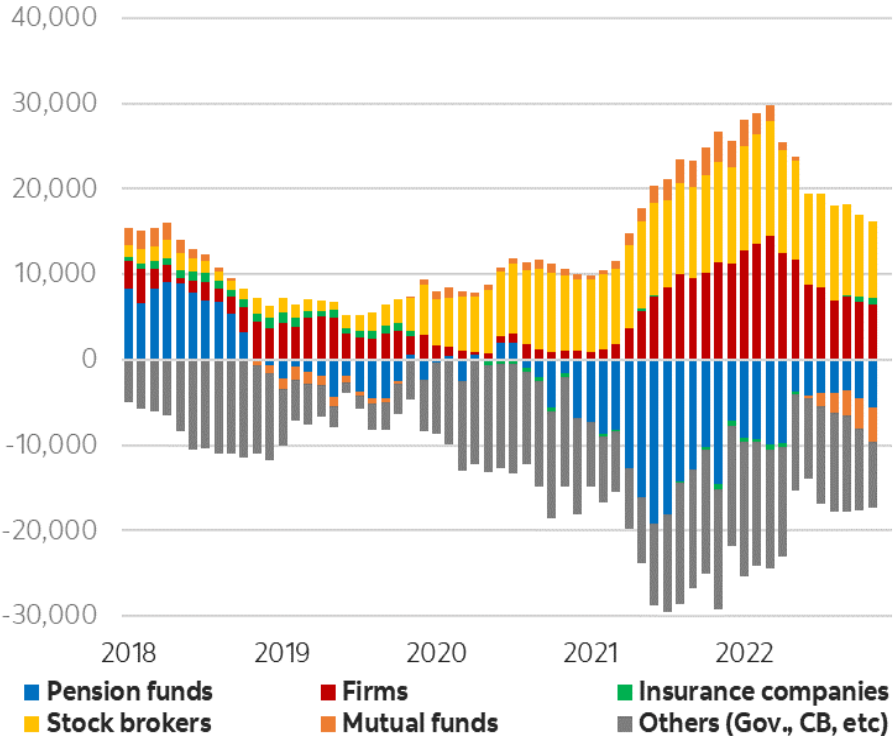


* **Relative return:** weekly return of fund A minus fund E. **Contributors' flow:** flow to fund A+B (in millions of US\$).
Source: Bloomberg, Scotiabank Economics

- In the FX spot market, selling pressures coming from the government and Institutional investors.
- Less buying pressure from corporations.

Net purchases of foreign currency in local market: Spot*

(millions of USD, accum. 12 months)

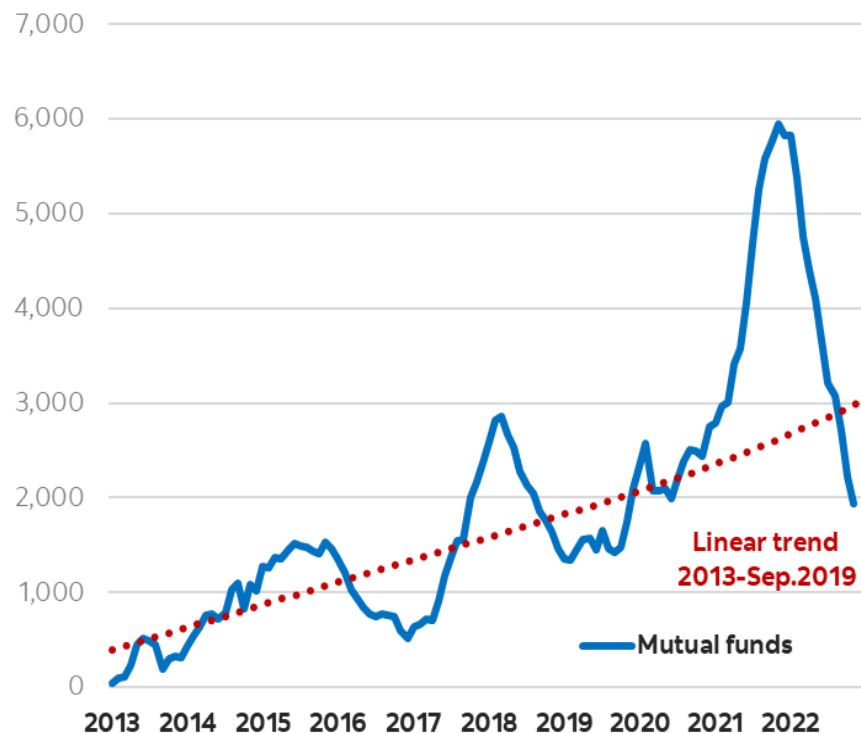


Note: Net purchases of foreign currency (purchases – sales).
 * Other include: households, government, the Central Bank of Chile and any other financial company not considered among the classifications already disclosed.
 Source: Central Bank, Scotiabank Economics

- **Less dollarization along with a stronger Chilean peso.**
- **A lower appetite for assets in US dollars is observed already in November.**

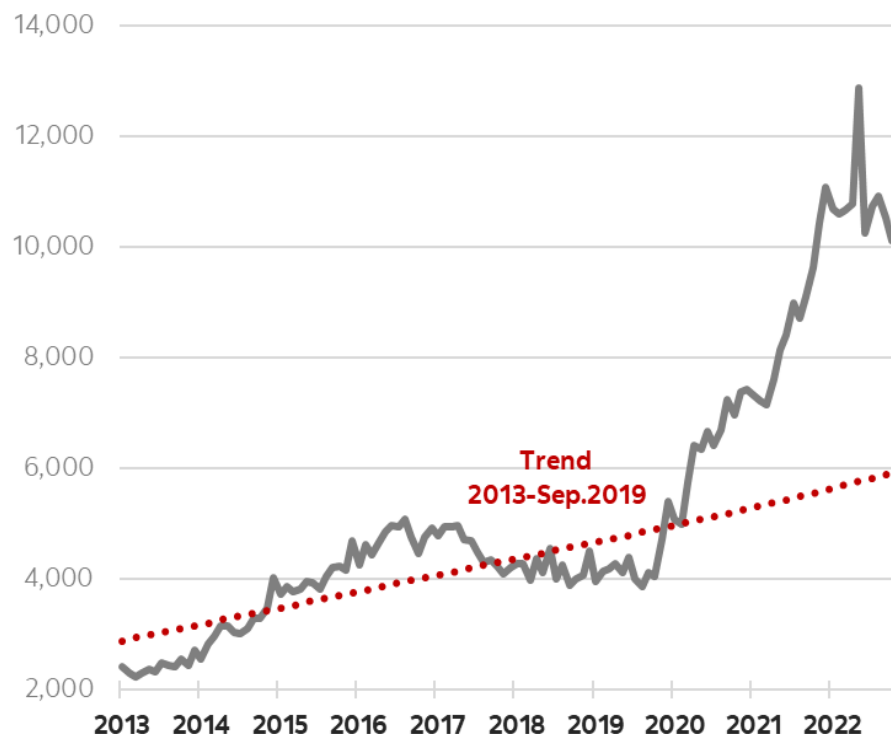
Net purchases of foreign currency: Mutual funds

(millions of USD, accum. since 2013, as of Nov.22)



Balances in checking accounts in foreign currency

(millions of USD, as of Oct.22, constant exchange rate)



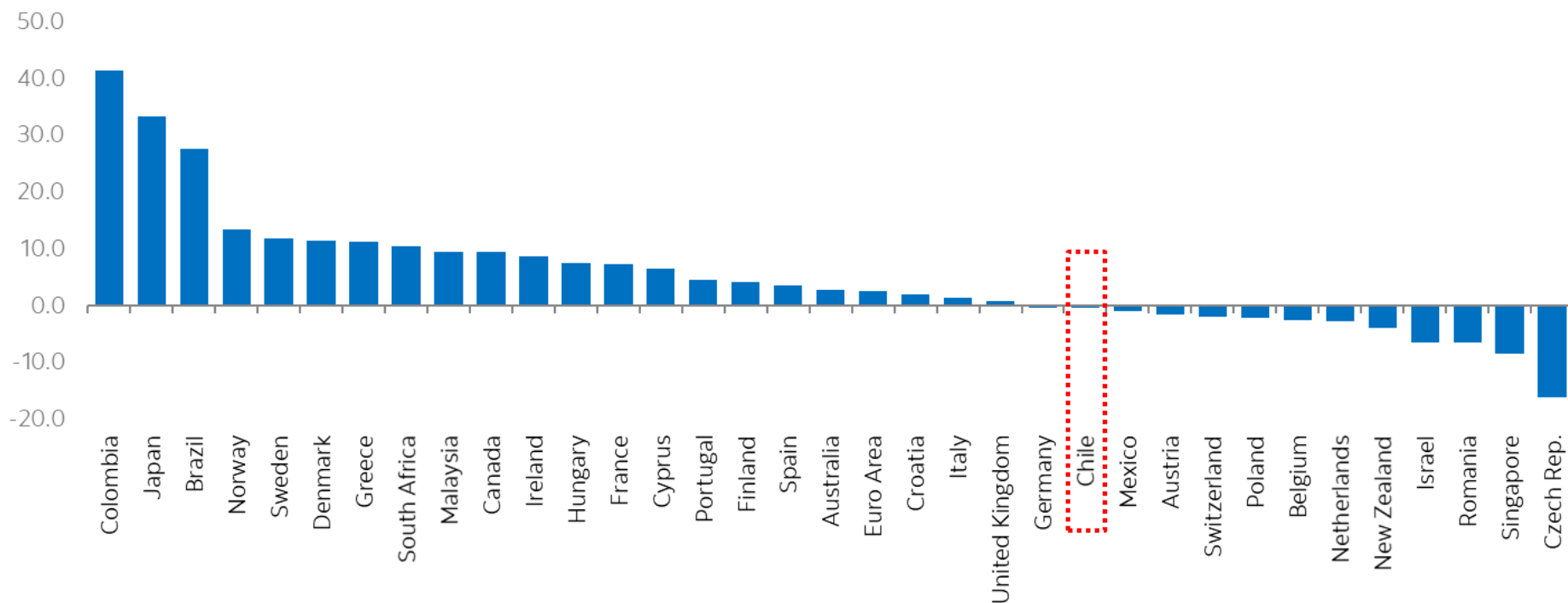
Note: Net purchases of foreign currency (purchases – sales).

Source: Central Bank, Commission for the Financial Market, Scotiabank Economics

- In a cross-country comparison, Chilean peso is among the most appreciated currencies (12 out of 35).
- Chilean peso is as appreciated as the Mexican peso.
- Chile is the only country negotiating two structural reforms and in the middle of a constitutional process.

Misalignment of the REER for a large group of countries

(percentage appreciation (+)/depreciation (-) with respect to 15-year average)*



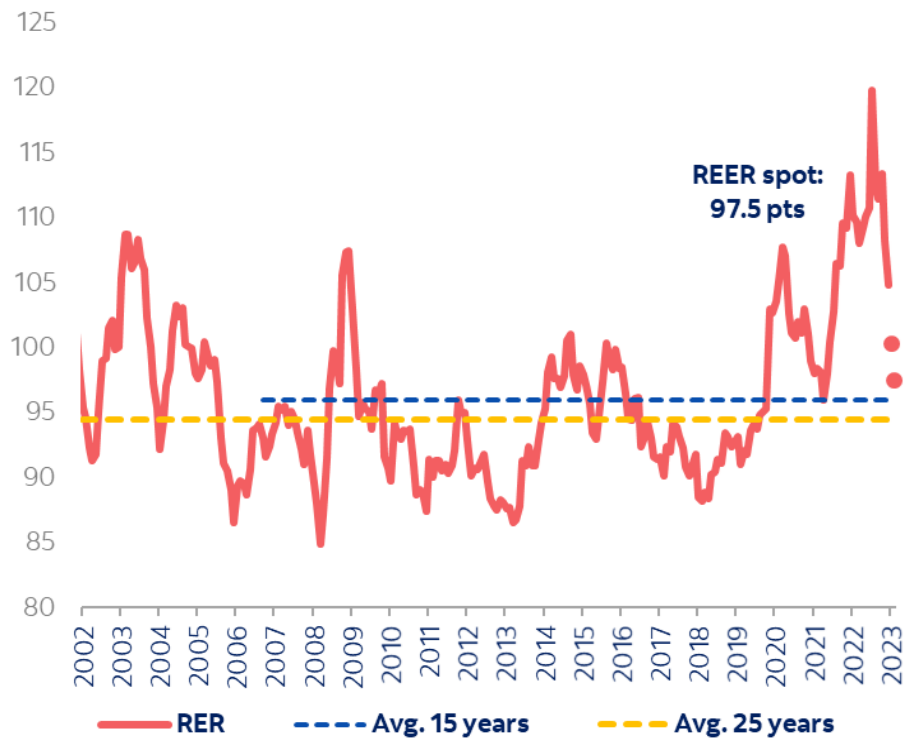
* Positive values denotes depreciation with respect to its 15-year average (2008-2022). For Chile, the REER corresponds to the REER of December 2022 plus the variation of the nominal exchange rate from December to date (January 31, 2023).

Source: Central Bank, IMF, Scotiabank Economics

- REER is too close to its historical average denying the challenging economic and political environment. Is Chile the same country it was 20 years ago?
- Alternative models point in the same direction. Too close to normality in currency.

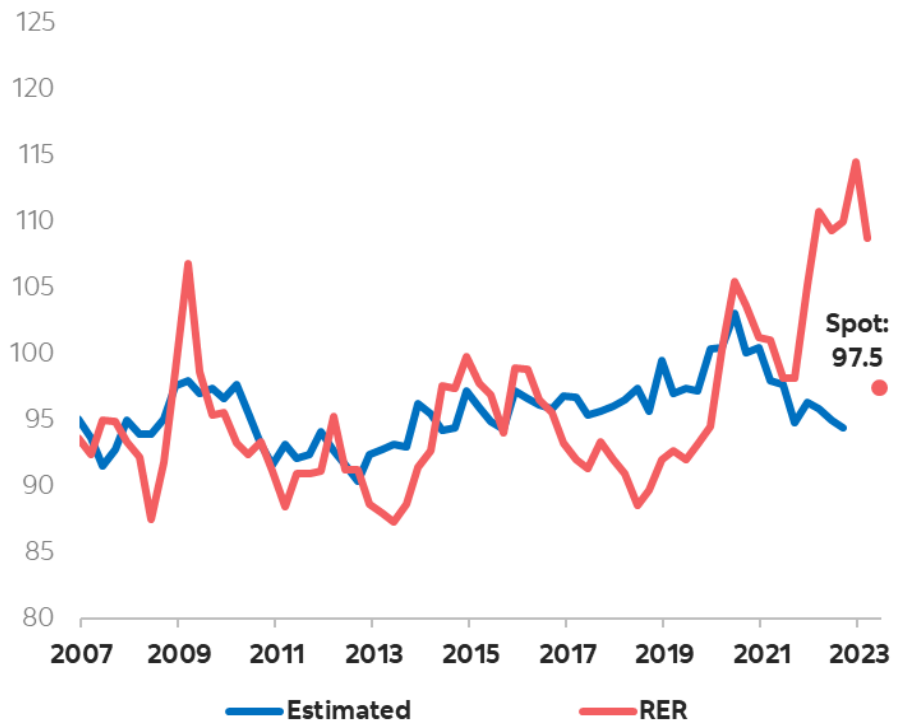
Real effective exchange rate (REER)

(index 1986=100; up to Dec.22)



REER based on fundamentals (*Behavior effective exchange rate model**)

(index 1986=100, quarterly estimation until 3Q22)



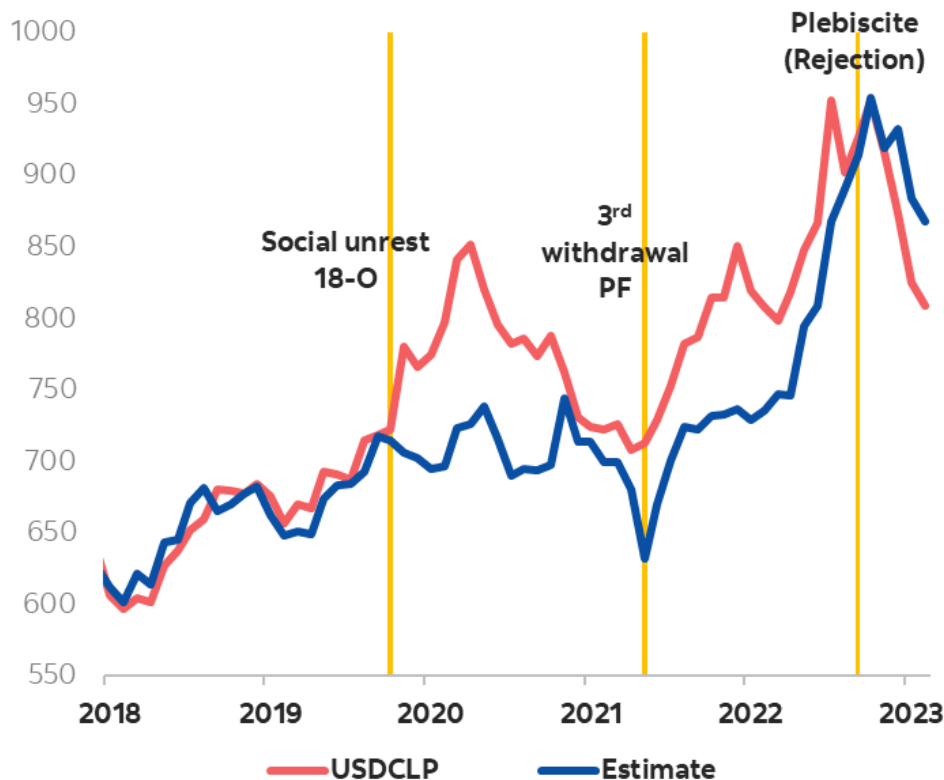
• Purchasing Power Parity assumes mean reversion. Therefore, the misalignment of the REER is estimated as the distance to a representative historical average. Source: Central Bank, Scotiabank Economics

• BEER models link real exchange rates to a set of economic fundamentals. This approximation could be seen as an extension to the PPP model as it seeks to explain long-term changes in purchasing power parity. Source: Central Bank, Scotiabank Economics

- Political moderation and preliminary signs of fiscal consolidation have allowed for less misalignment, but fundamentals cannot fully explain the strong appreciation of the CLP.
- Too much and too fast appreciation of the Chilean peso. The stronger the appreciation, the sooner the Central Bank will cut the rate.

USDCLP vs Model of fundamentals*

(\$/USD)



Misalignment explained by:

- Social unrest
- 3rd withdrawal of pension funds
- Rejection of the new constitution

* Based on a short-term fundamentals' model, including copper price, broad dollar (DXY), swap spread (Chile-USA), business confidence, among others.
Source: Scotiabank Economics

Risks ahead in the USDCLP

Depreciation of the CLP

- Leftist composition of the Constitutional Council. Less than 20 councilors from the center-right parties.
- Political negotiations that reduce the expected collection of the Tax Reform along with keeping the increase in structural spending of the Pension Reform.
- Pressures to increase government expenditures beyond the budget law approved for 2023.
- New pension fund withdrawals.
- Tighter financial conditions for emerging economies.

Appreciation of the CLP

- Moderate composition of the Constitutional Council. More than 20 councilors of the center-right parties.
- Delay in the normalization of the benchmark rate in Chile.
- Better financial conditions for emerging economies.
- Surprising recovery in China with positive implications for copper prices.

Economic Outlook

Forecast	2018	2019	2020	2021	2022	2023
GDP (% yoy)	4.0	0.8	-6.0	11.7	2.7	-1.7
Inflation (% yoy, eop)	2.1	3.0	3.0	7.2	12.8	3.7
Exchange rate (vs. USD, eop)	695	753	711	852	860	850
Monetary policy rate (% , eop)	2.75	1.75	0.5	4.0	11.25	4.5
Copper price (US\$/lb, eop)	2.7	2.8	3.5	4.4	3.8	3.7
Total consumption (% yoy)	3.6	0.7	-7.2	18.2	3.4	-4.8
Investment (% yoy)	6.5	4.7	-9.3	17,6	3.0	-6.0
Fiscal balance (% GDP)	-1.7	-2.9	-7.3	-7.7	1.1	-3.0
Current account (% GDP)	-4.6	-5.2	-1.7	-6.6	-8.2	-2.0

Source: Scotiabank Economics.

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