FX Report

CLP Depreciation Needed to Avoid Sub-2% Inflation

Scotiabank Economics Chile

Aníbal Alarcón

Waldo Riveras

Jorge Selaive

February 2024

Scotiabank

Key messages

- **The Chilean peso (CLP) has shown a relevant multilateral depreciation since June 2023 along with a dovish view of the Central Bank (CB).** The reduced depth of the capital market, the erratic probability of seeing a closure of the structural reforms (tax and pension) in the short term and the low level of international reserves are the main determinants of the higher exchange rate volatility and the preponderant role of carry trade on the exchange rate.
- **Excessive and rapid depreciation of the CLP beyond traditional fundamentals reflects previous FX misalignments amidst external and domestic macroeconomic imbalances along with historical political uncertainty**. More recently, it just seems overshooting to the new stance of monetary policy.
- **It seems guaranteed that we will see a level of $1,000 or something above that in the short-term, but why will the CLP appreciate over the next quarters?**

  (1) In the political arena, Chile will deal with the usual problems in Latin America. Political fragmentation and structural reforms are not peculiar aspects to push for greater depreciation of the peso with respect to peers.

  (2) Current account at sustainable levels. Not a driver for more depreciation of the currency as it was the case during 2022/2023.

Scotiabank

Key messages

(3) There is limited space for additional unwinding of carry trade. The swap rates have almost completely internalized the relevant reduction in the monetary policy rate to its neutral level by mid-2024.

(4) The negative GDP growth differential with respect to the US and peers will close during next quarters giving support to the CLP.

(5) A final political agreement on Pension Fund Reform during the second half of the year (although not guaranteed) would also provide some support to the CLP.

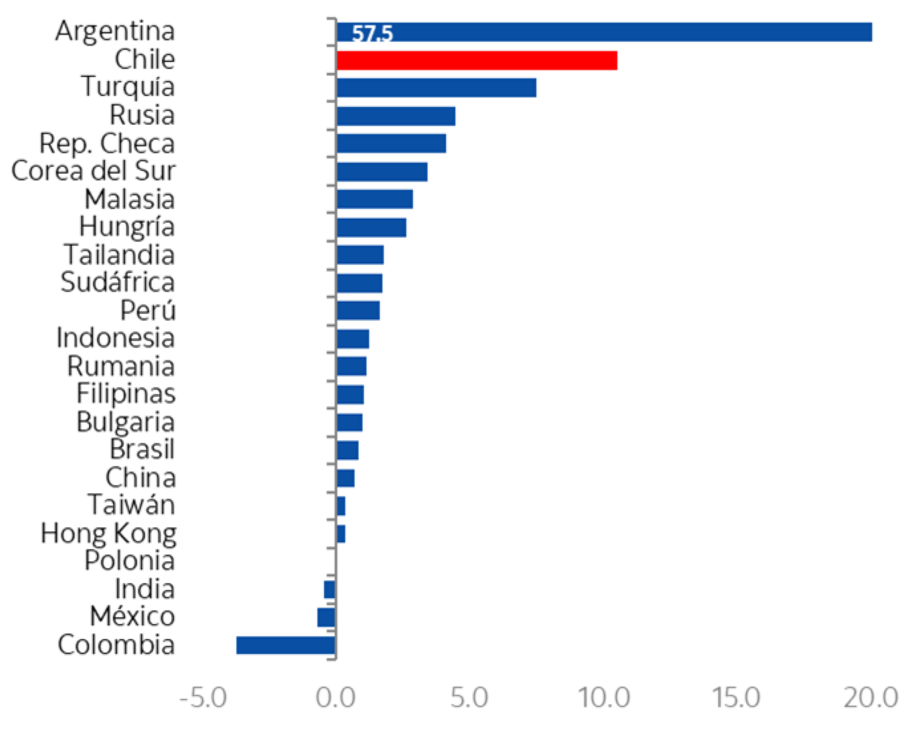
(6) Resilient copper and lithium prices are part of our baseline scenario along with the Fed taking the rate to 4.5% by December 2024 with cuts concentrated the second part of the year.

- **We do not expect an exchange rate intervention, although we might see an exchange rate reflection by the CB confirming the misalignment. The CB can be very talkative about the CLP, but we do not see room for a successful intervention.** The market underestimates the inflationary impact (pass-through) of the recent depreciation. This higher inflation in the first half of the year would be almost the only source to avoid a fall in inflation below 2% and a benchmark rate markedly below the neutral level during the second half of 2024.

The peso has depreciated more than 10% in the last 3 months despite the rejection of the new Constitution and a slightly more friendly political scenario.

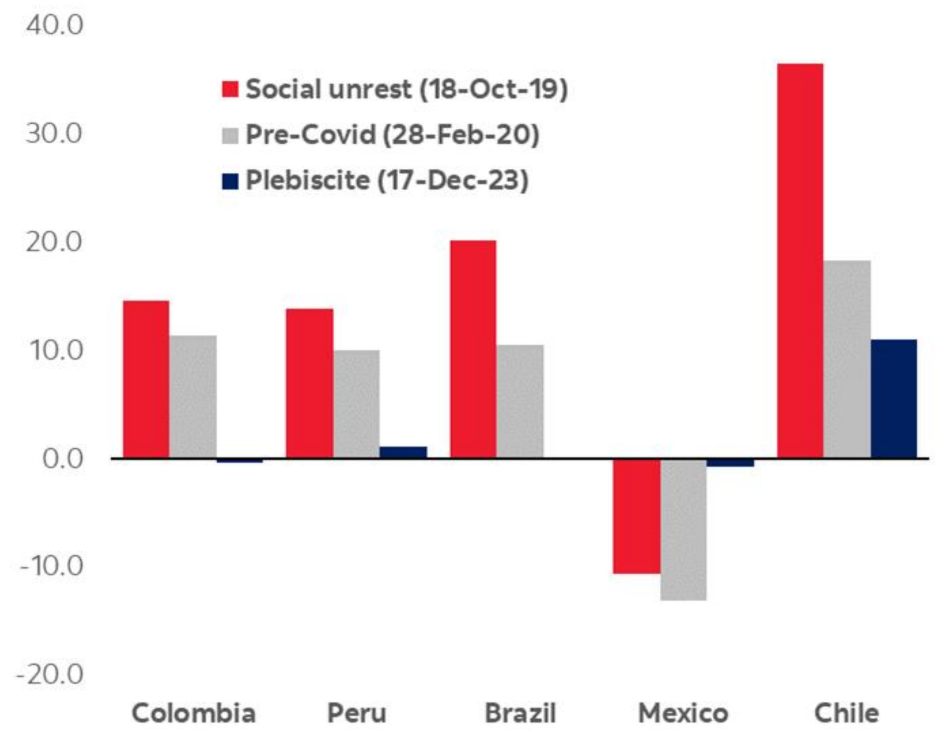
Emerging market exchange rates*

(percentage, change in the last 3 months)



Latam exchange rates*

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

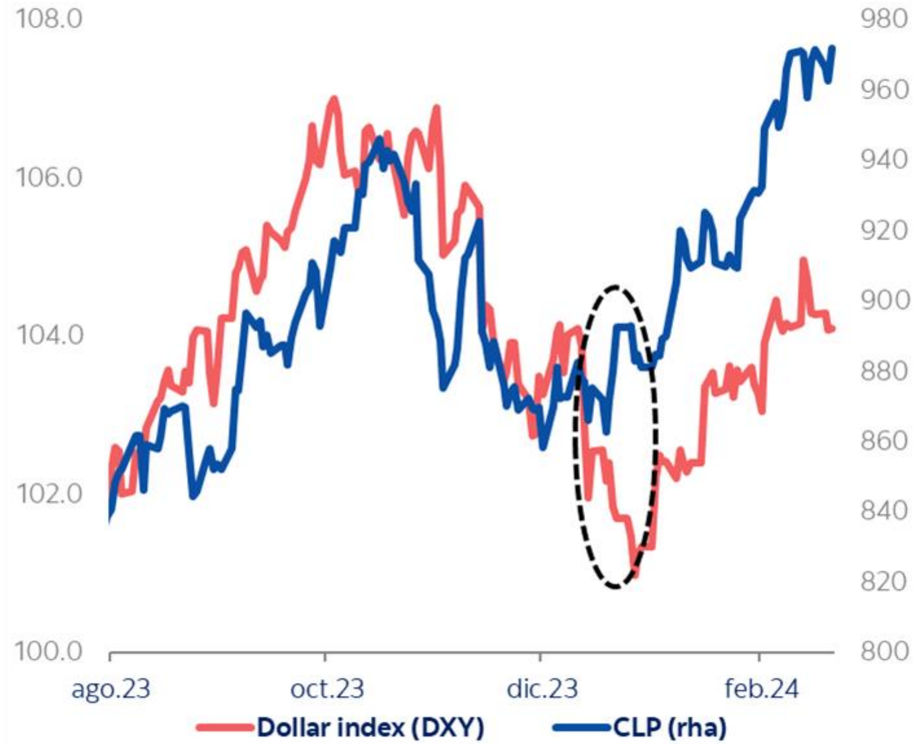


* Positive values indicate depreciation against US dollar.
Source: Bloomberg, Scotiabank Economics

Scotiabank

Misalignment with the DXY is at historic highs.

Dollar index and CLP
(index DXY, $ per US dollar)



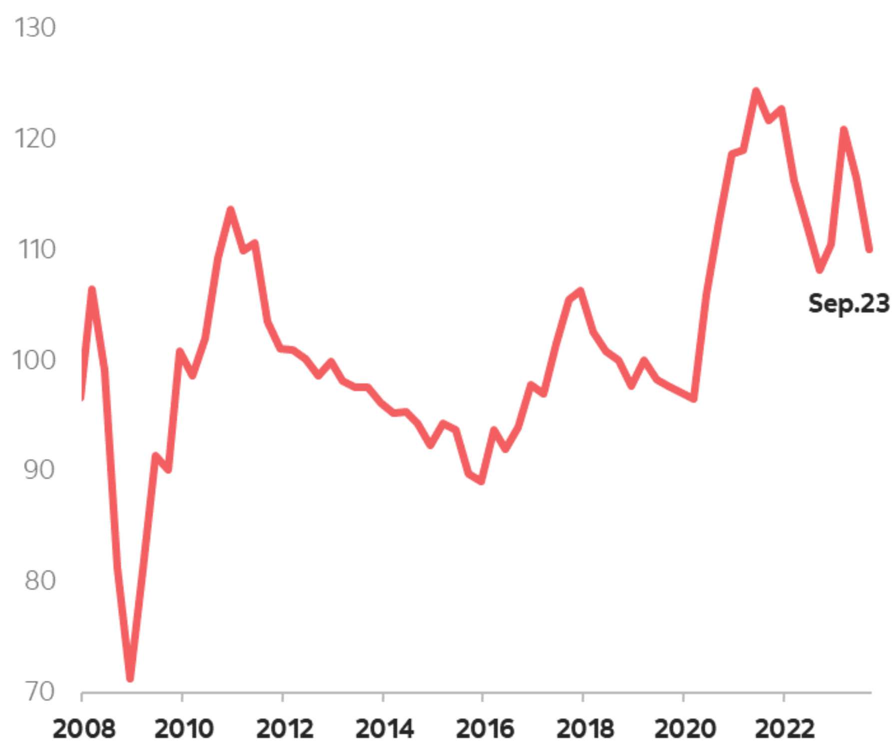
Difference between Dollar index and CLP
(ratio, CLP/DXY)

Source: Bloomberg, Scotiabank Economics

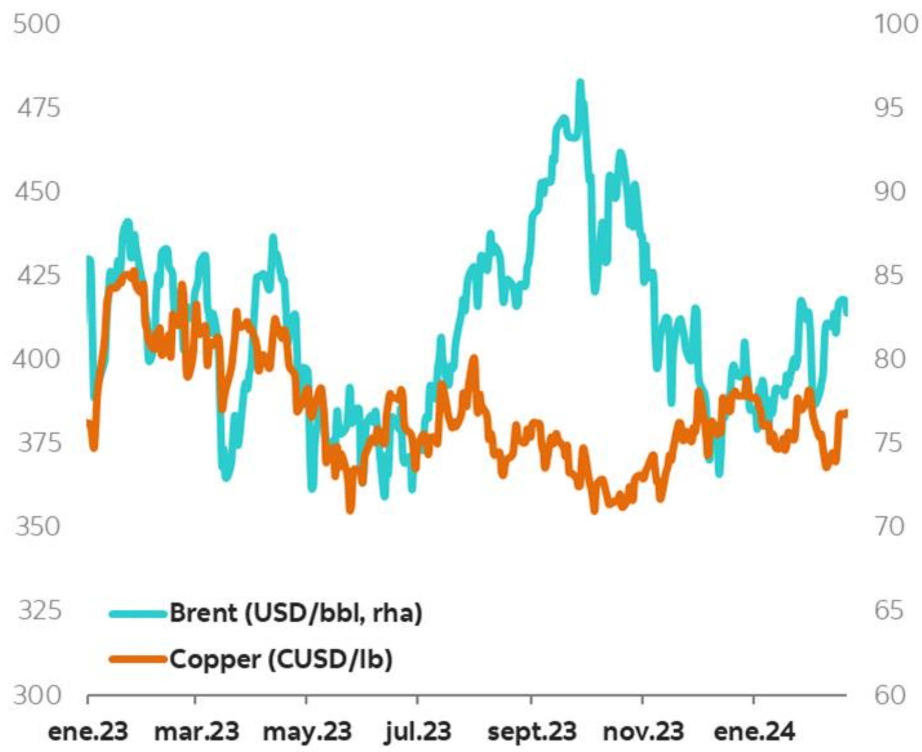
Scotiabank

Improvement of terms of trade after the Q3-23 do not explain the CLP depreciation. The price of oil fell significantly while the price of copper remained stable.

Terms of trade of the Central Bank
(index, base 2018=100)



Oil and copper prices
(cUSD/bl., USD/bbl.)



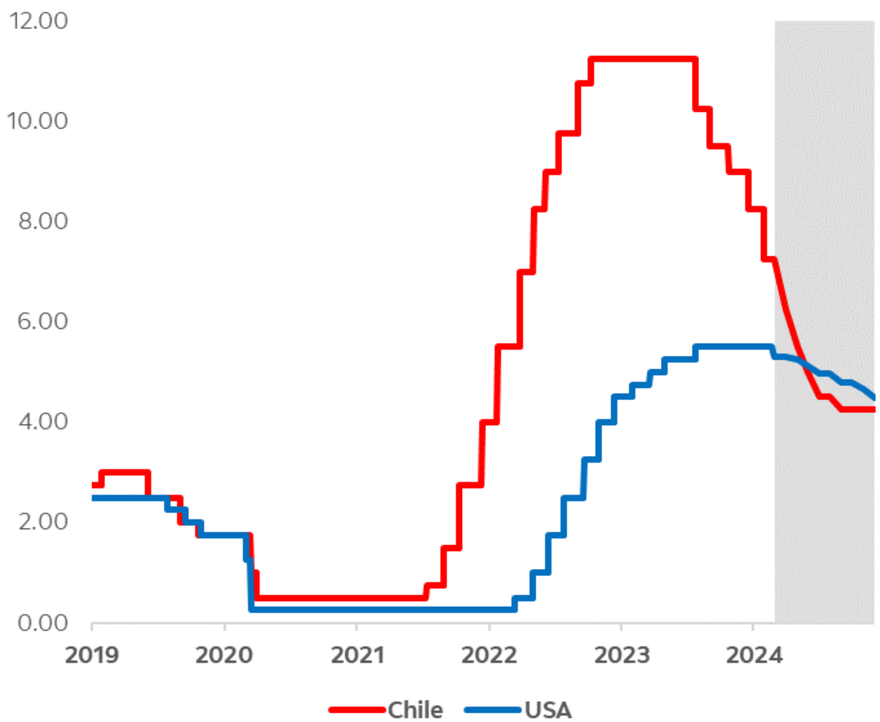
Source: Bloomberg, Central Bank, Scotiabank Economics

Scotiabank

Expectations of aggressive rate cuts by the Central Bank have pushed the swap spread into negative territory, fueling the unwinding of NDF positions in favor of the peso.

MPR expectations: Chile & USA*

(percentage, nominal)



Swap spread 1Y

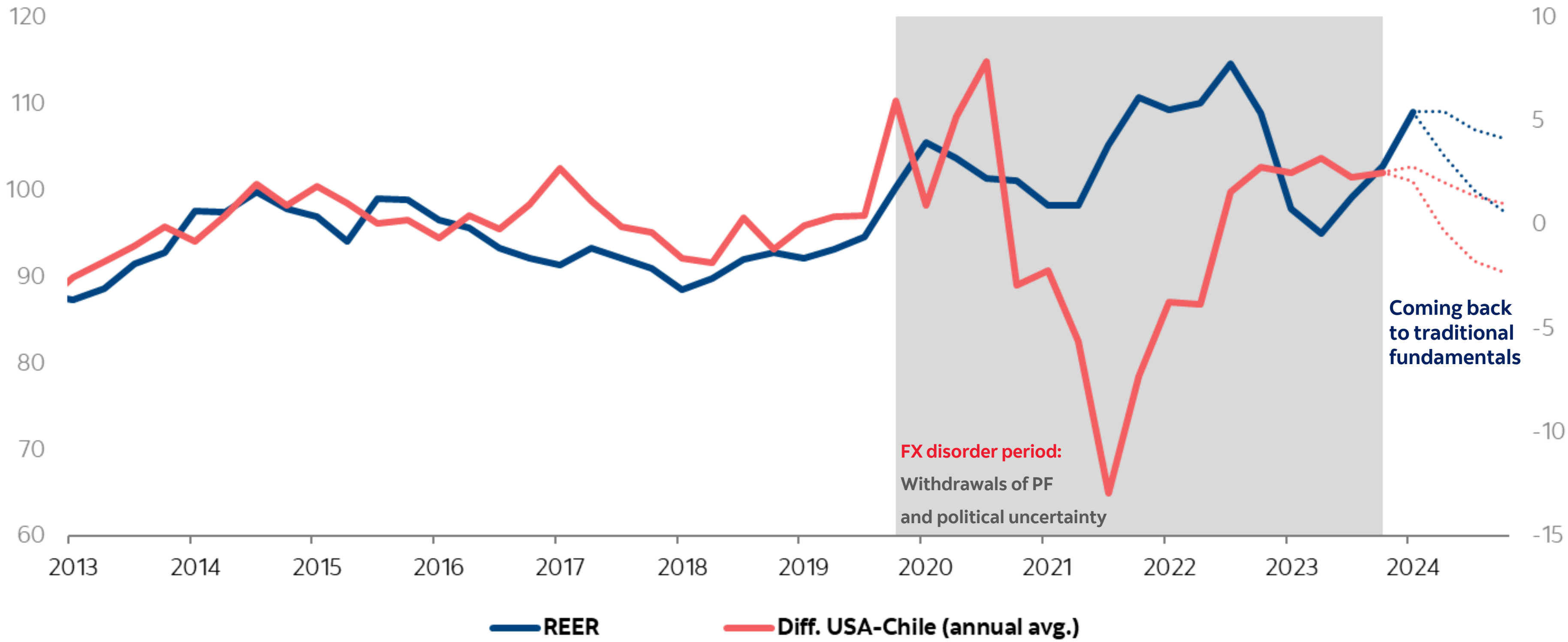
(percentage, 1Y interest rates Chile-USA)

*Scotia estimation for Chile and Bloomberg consensus for the USA.
Source: Bloomberg, Central Bank, Scotiabank Economics

In a stressed GDP growth scenario for Chile in 2024, the appreciation of the CLP seems guaranteed. Neither structural reforms nor political fragmentation are first-order drivers of the exchange rate, as were the withdrawals of PFs and the failed constitutional process in the "FX disorder period."

Real effective exchange rate & GDP growth differential between USA and Chile

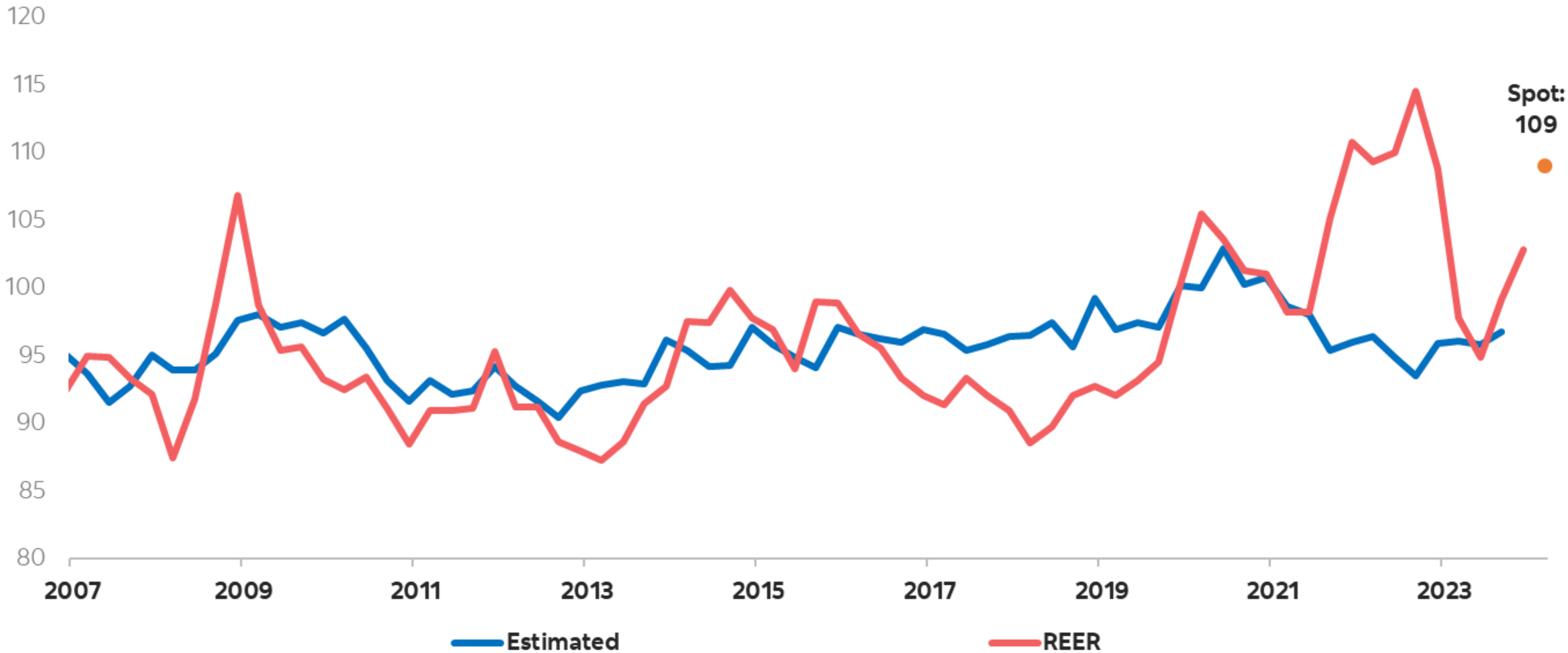
(index 1986=100; percentage points)



Note: GDP growth differential measured as the difference between the seasonally adjusted annual rate (QoQ saar) of the USA and Chile, expressed as an annual moving average. For 2024, we consider the consensus estimation for USA GDP (1.6%), and for Chile we consider scenarios with 70% of confidence around our baseline scenario.
Source: Central Bank, Scotiabank Economics

REER remains misaligned with respect to its fundamentals. Alternative models point in the same direction. Too much depreciation; overshooting above $1,000 opens opportunity for long positions in favor of the peso.

REER based on fundamentals (*Behavior effective exchange rate model**)
(index 1986=100, quarterly estimation until Q3-23)

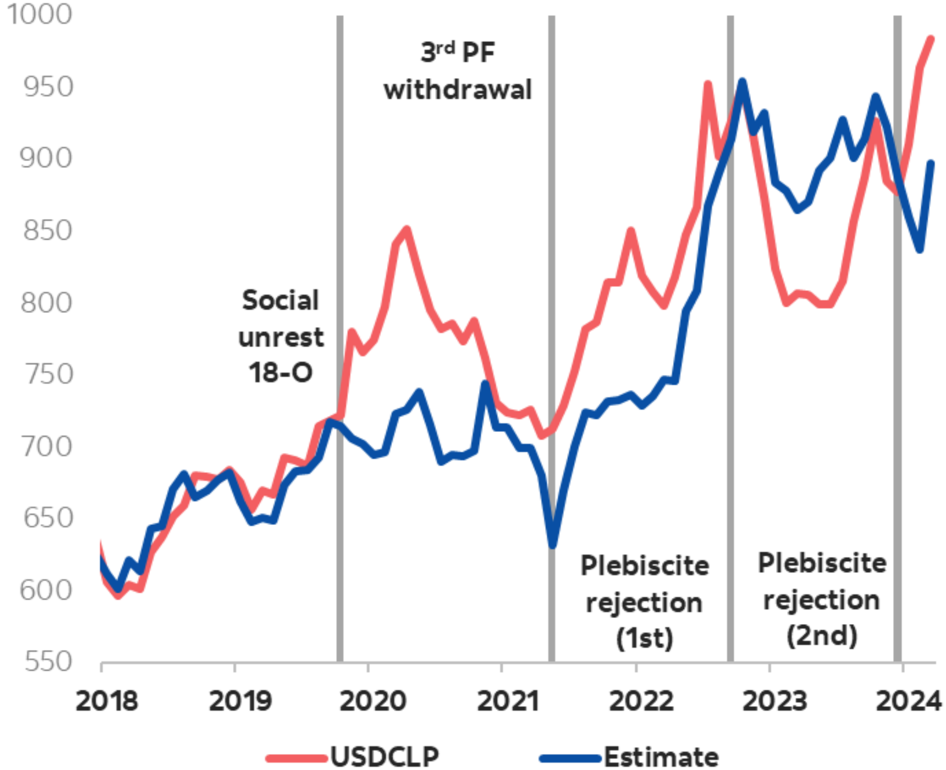


*BEER models link real exchange rates to a set of economic fundamentals. This approximation could be seen as an extension to the PPP model as it seeks to explain long-term changes in purchasing power parity.
Source: Central Bank, Scotiabank Economics

Macroeconomic fundamentals cannot fully explain the strong (and fast) depreciation of the CLP.

USDCLP vs Model of fundamentals*

($/USD)



Misalignment explained by:

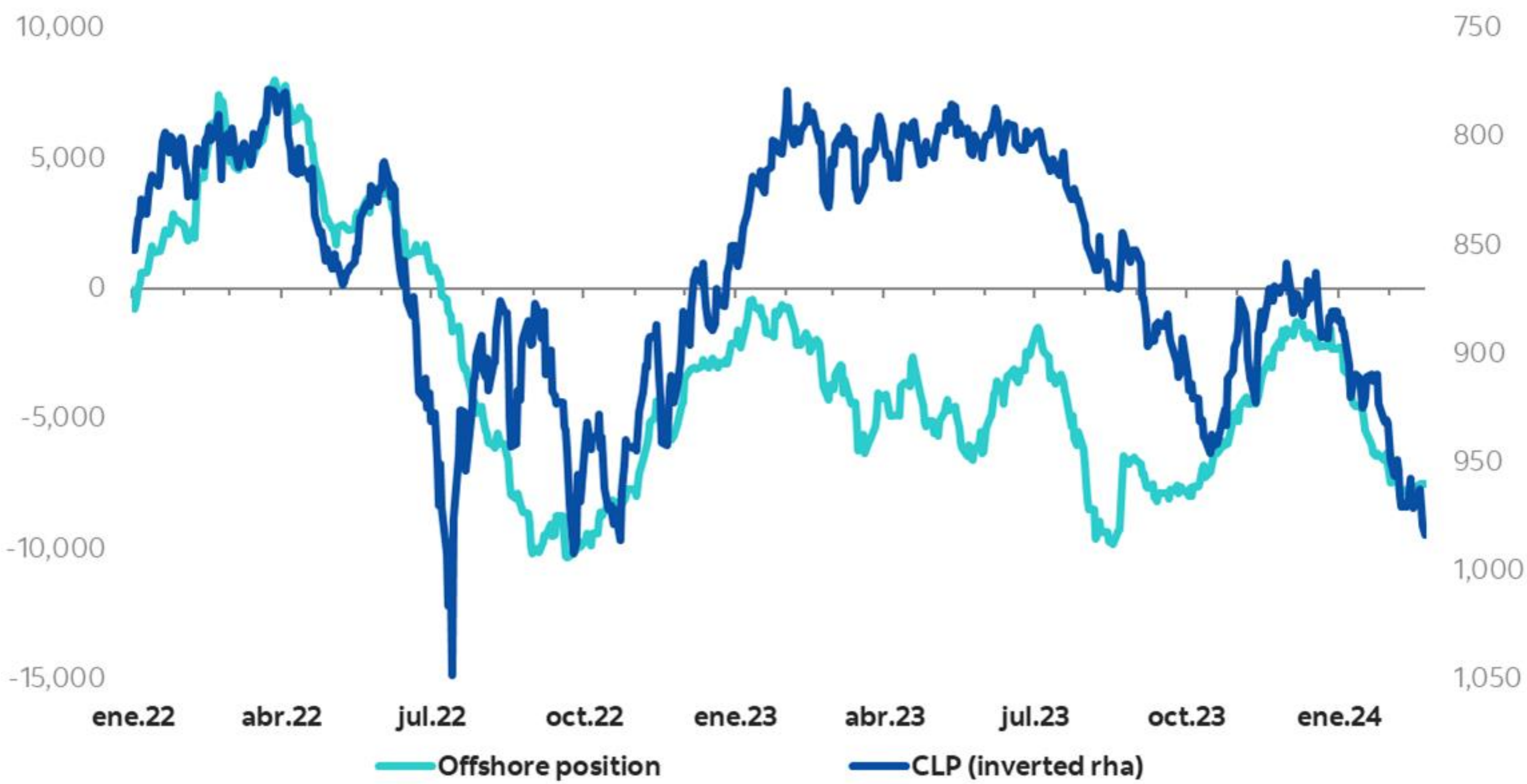
- Short-run divergence in monetary policies (Fed vs BCCh).
- Offshore NDF (unwinding) flow against the Peso.
- High volatility of the Peso due to less financial market depth.

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

Scotiabank

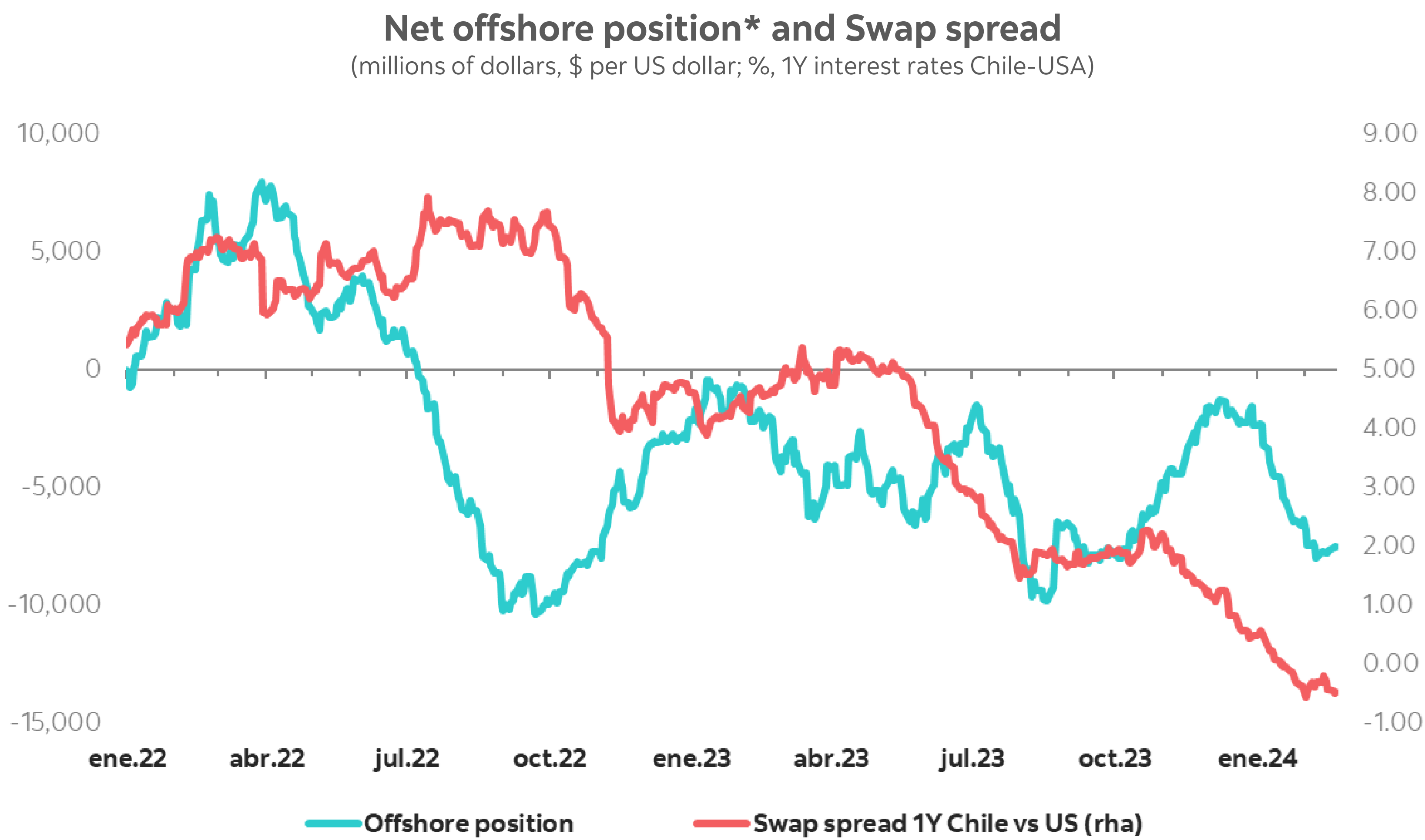
Recent depreciation of the CLP has been driven by an unwinding of positions in favor of the peso: (1) Historically, portfolio effects are transitory; (2) Stock of NDF very close to historical lows.

Net offshore position CLP/USD*
(millions of dollars, $ per US dollar)



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

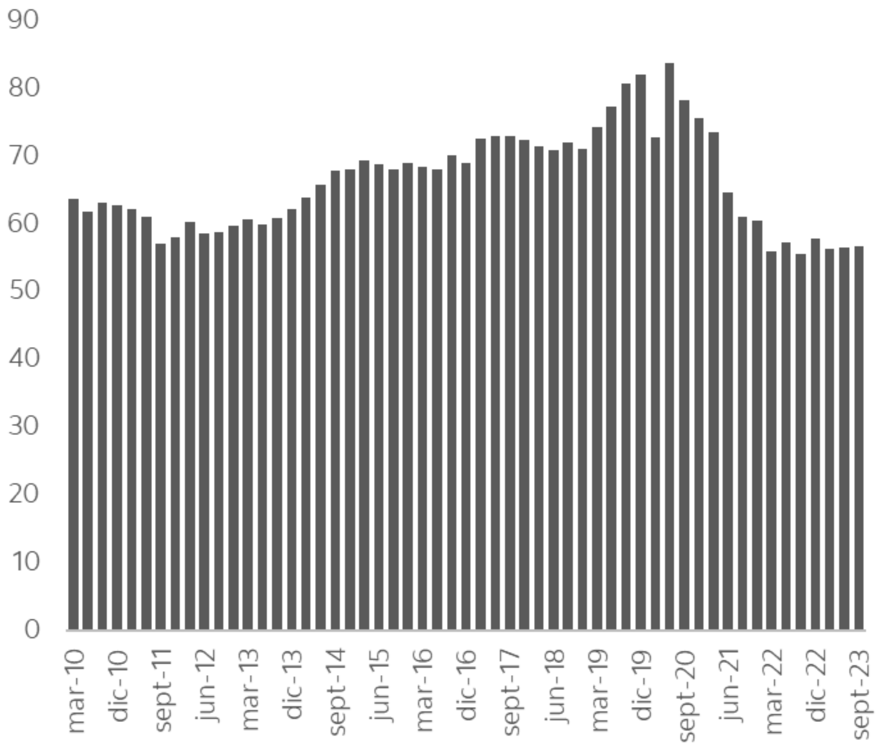
Interest rate differential already in negative territory. Limited additional space for unwinding of carry trade.



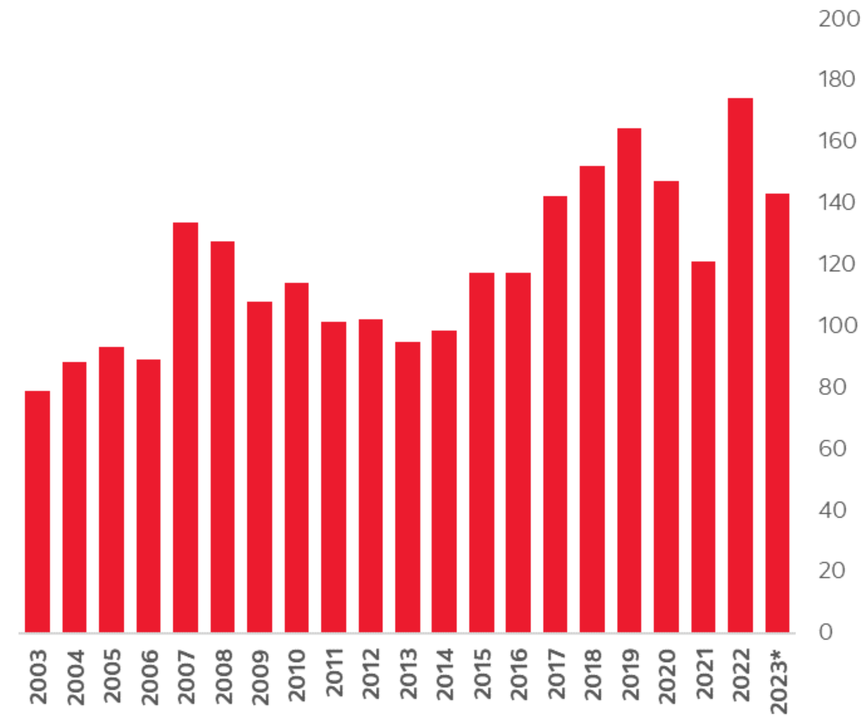
*Net NDF position (Non-deliverable forward) of local banks with non-residents.
Source: Bloomberg, Central Bank, Scotiabank Economics

Why the greater reactivity of the CLP to carry trade? The lower depth of the capital market together with the lower firepower of the Central Bank.

AUM in Pension Funds
(% of GDP)



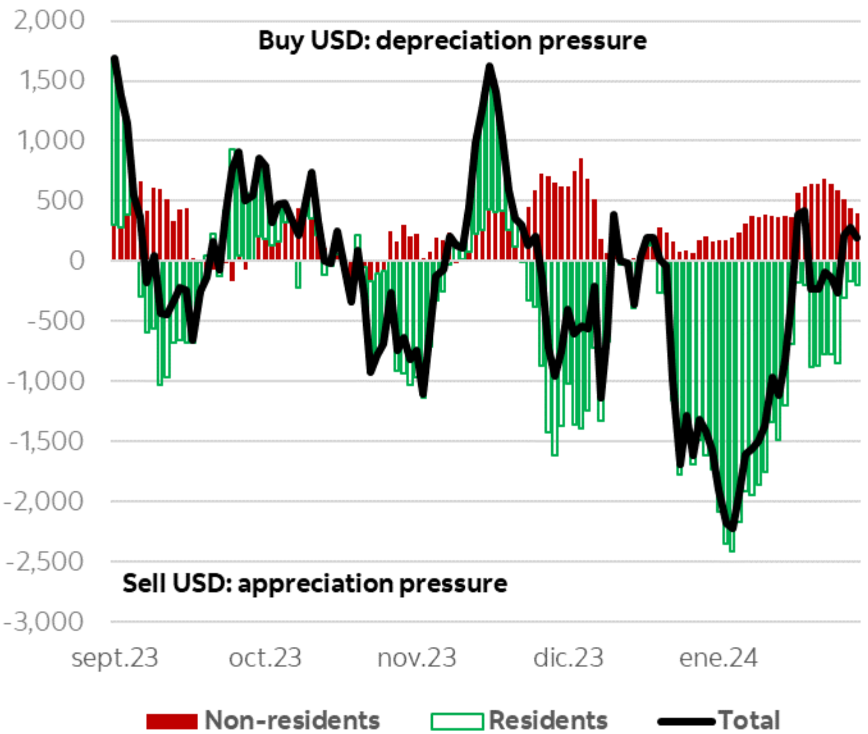
Residual short-term external debt over IR
(% of International Reserves, as of Sept. 23)



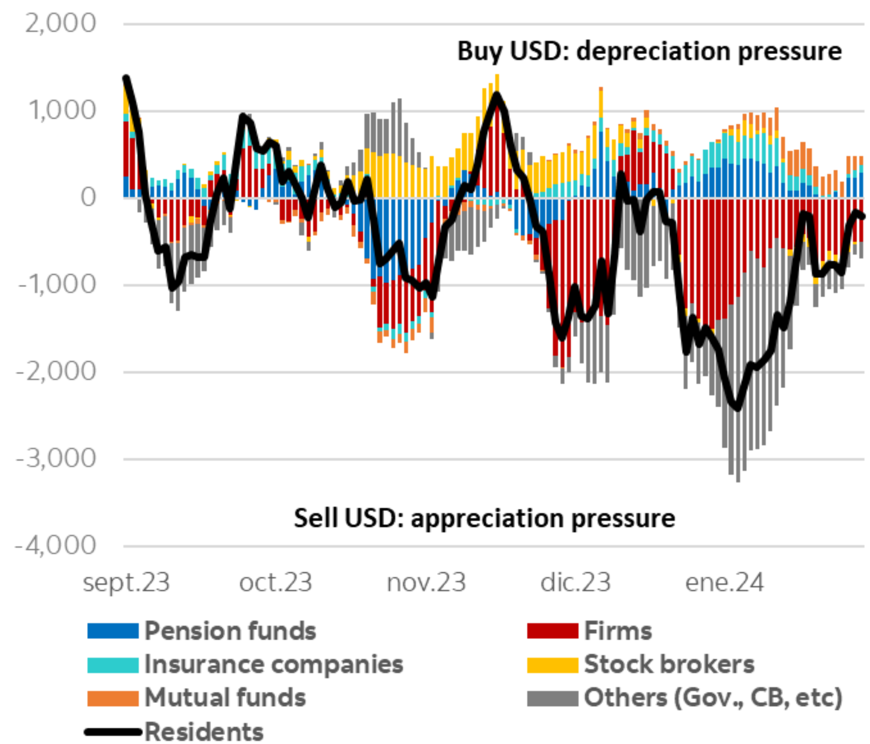
Source: Central Bank, Scotiabank Economics.

Moreover, in the spot market, the depreciative pressure on the CLP is over. Resident and non-resident flows are netting.

Net flow of USD in spot market
(millions of USD, accum. 10 days)



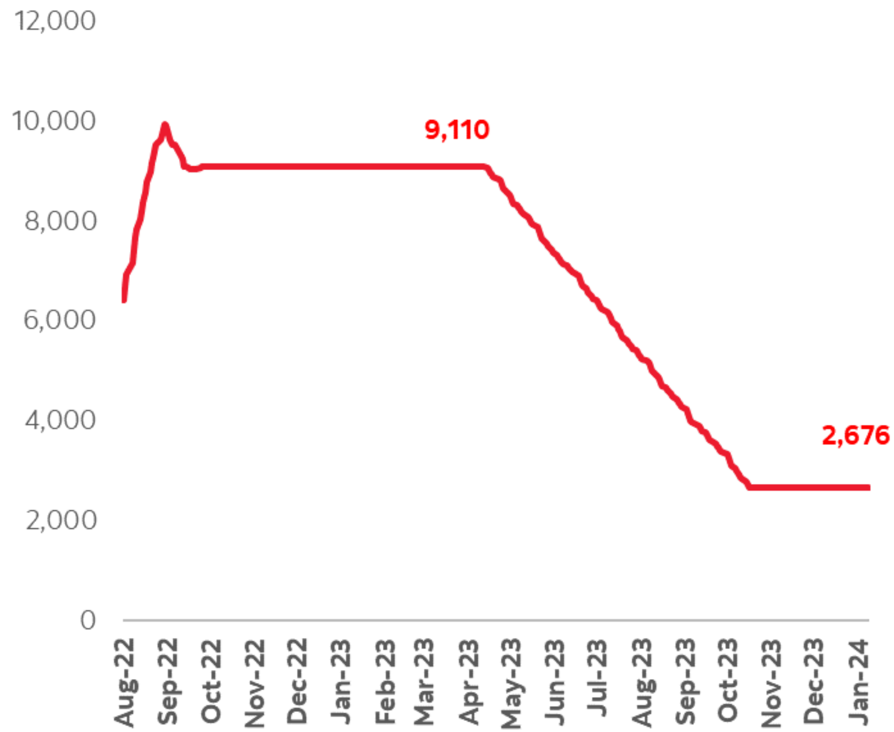
Net flow of USD by residents
(millions of USD, accum. 10 days)



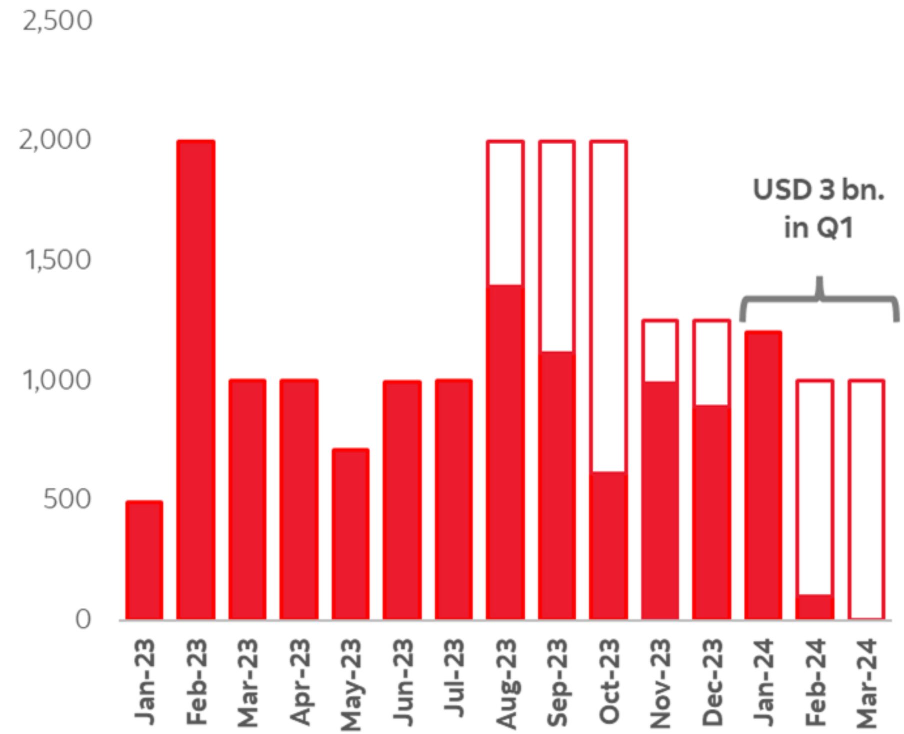
Note: Net purchases of foreign currency (purchases – sales).
Source: Central Bank, Scotiabank Economics

The CB is rolling over outstanding forward FX holdings and we do not expect additional portfolio measures. The Treasury will sell up to USD 3bn from January to March (although the probability of disappointment is high).

Forward USD sales by the Central Bank
(mn US$)



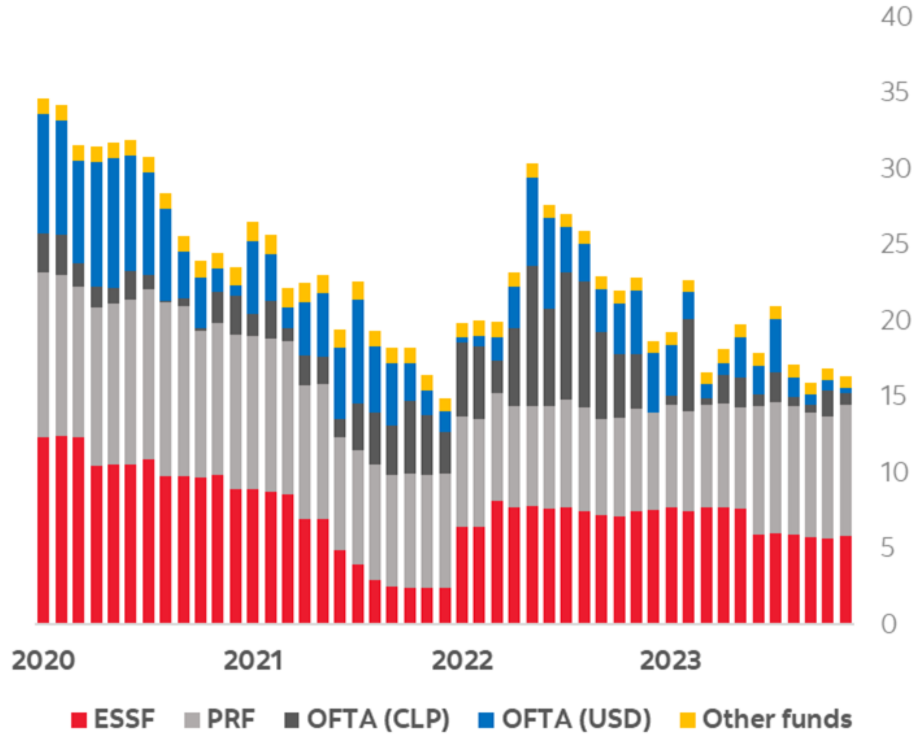
Sales of US dollars by the Ministry of Finance
(mn US$)



Source: Ministry of Finance, Central Bank, Scotiabank Economics

Why do we think that the Treasury may again disappoint us in the sale of US dollars? Low cash in dollars and no more issuances in foreign currency.

Sovereign Wealth Funds and Treasury Assets
(USD bn)

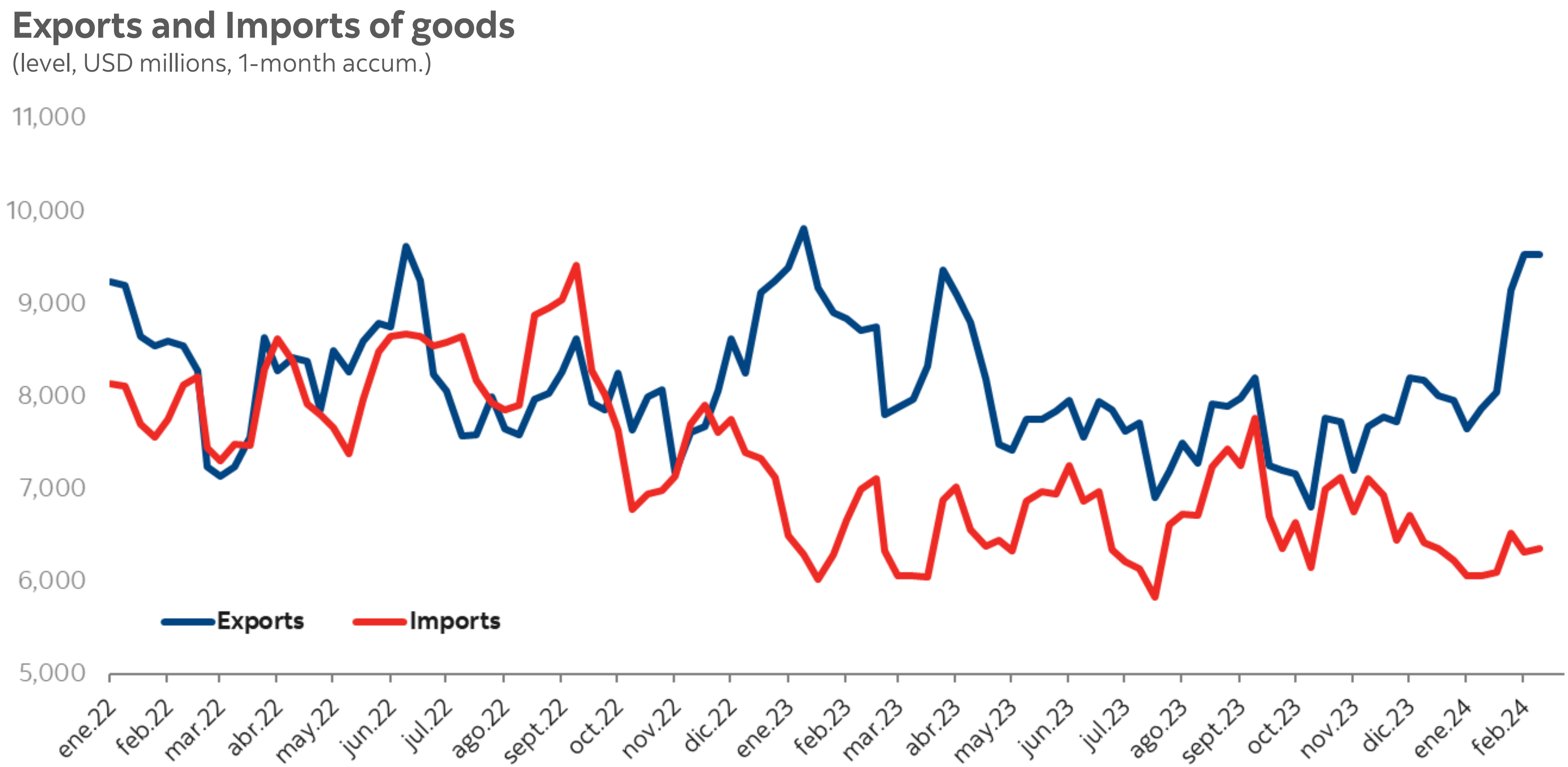


Bond issuance plan
(USD bn)

2024 Issuances	Currency	Amount (USD bn)
Foreign currency	USD	1.7
Local currency	Pesos	7.7
	UF	7.1
Total		16.5

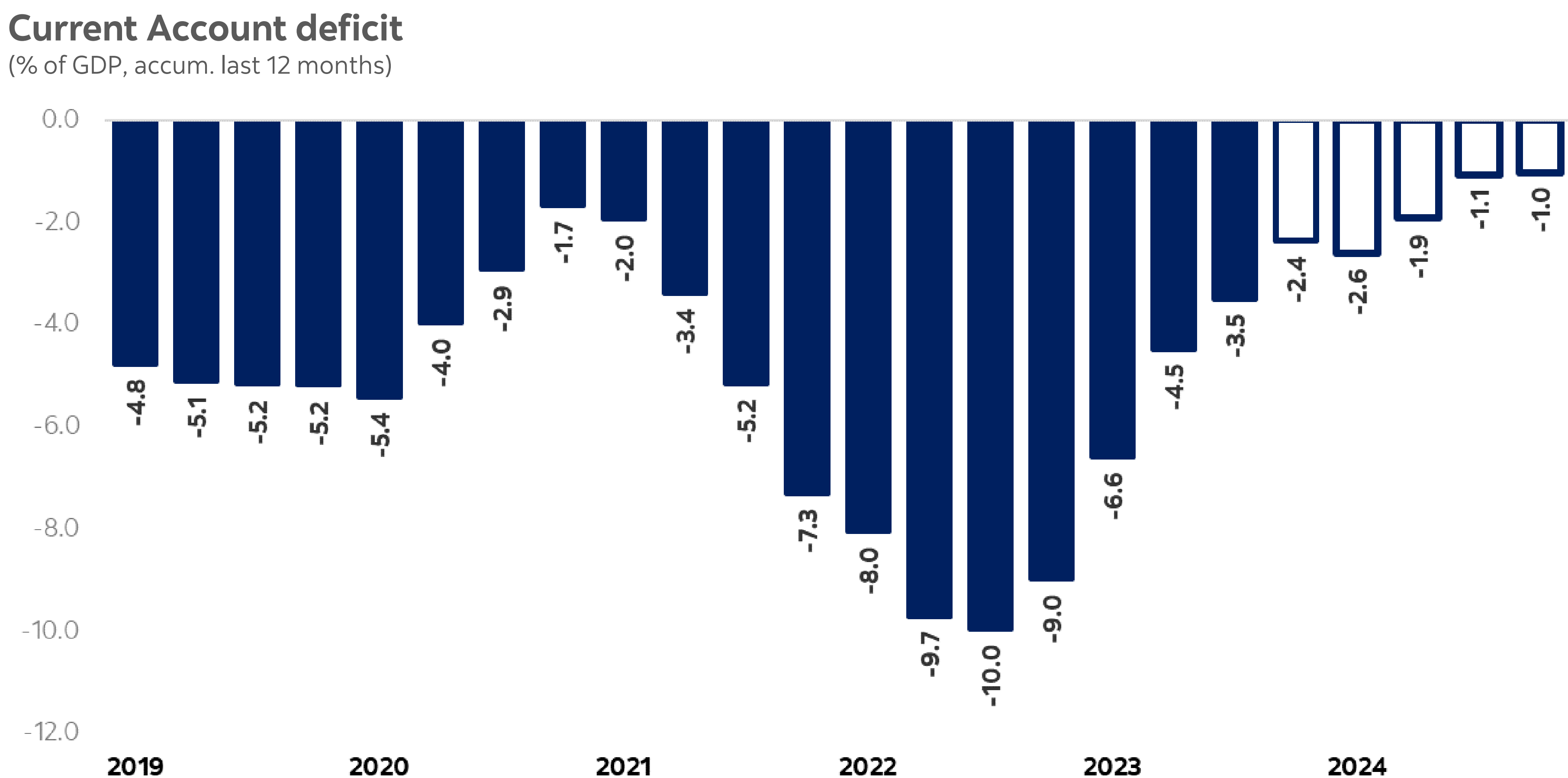
Source: Ministry of Finance, Central Bank, Scotiabank Economics

On the external side, the trade balance is favoring a closing of the large current account deficit thanks to resilient copper prices.



Source: Central Bank, Scotiabank Economics

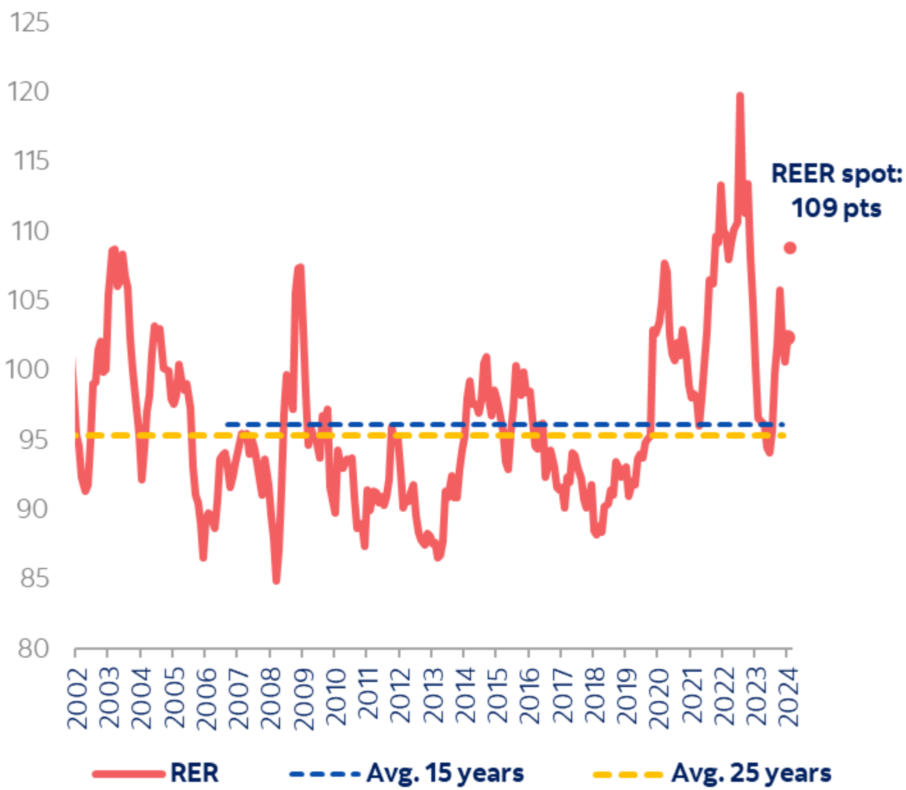
Convergence of the current account deficit towards a sustainable level is occurring sooner than market expectations, very in line with our view (see our Latam Insights).



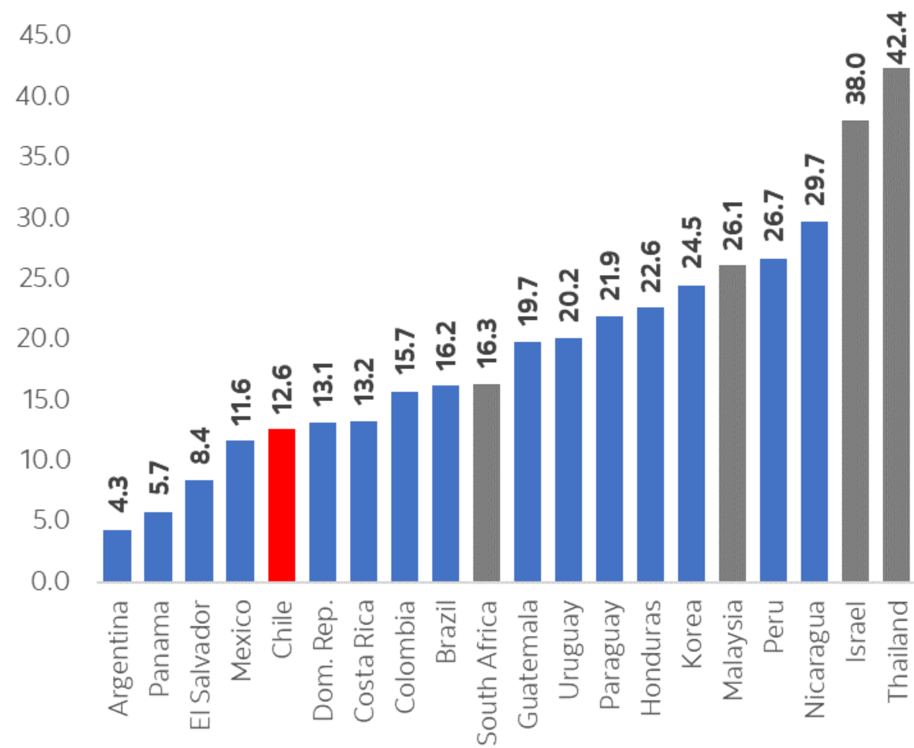
Source: Central Bank, Scotiabank Economics

REER markedly above its long-term equilibrium not needed for closing the current account deficit. Even though, the CB do not have enough fire power to intervene the FX market.

Real effective exchange rate (REER)
(index 1986=100; up to December 2023)*

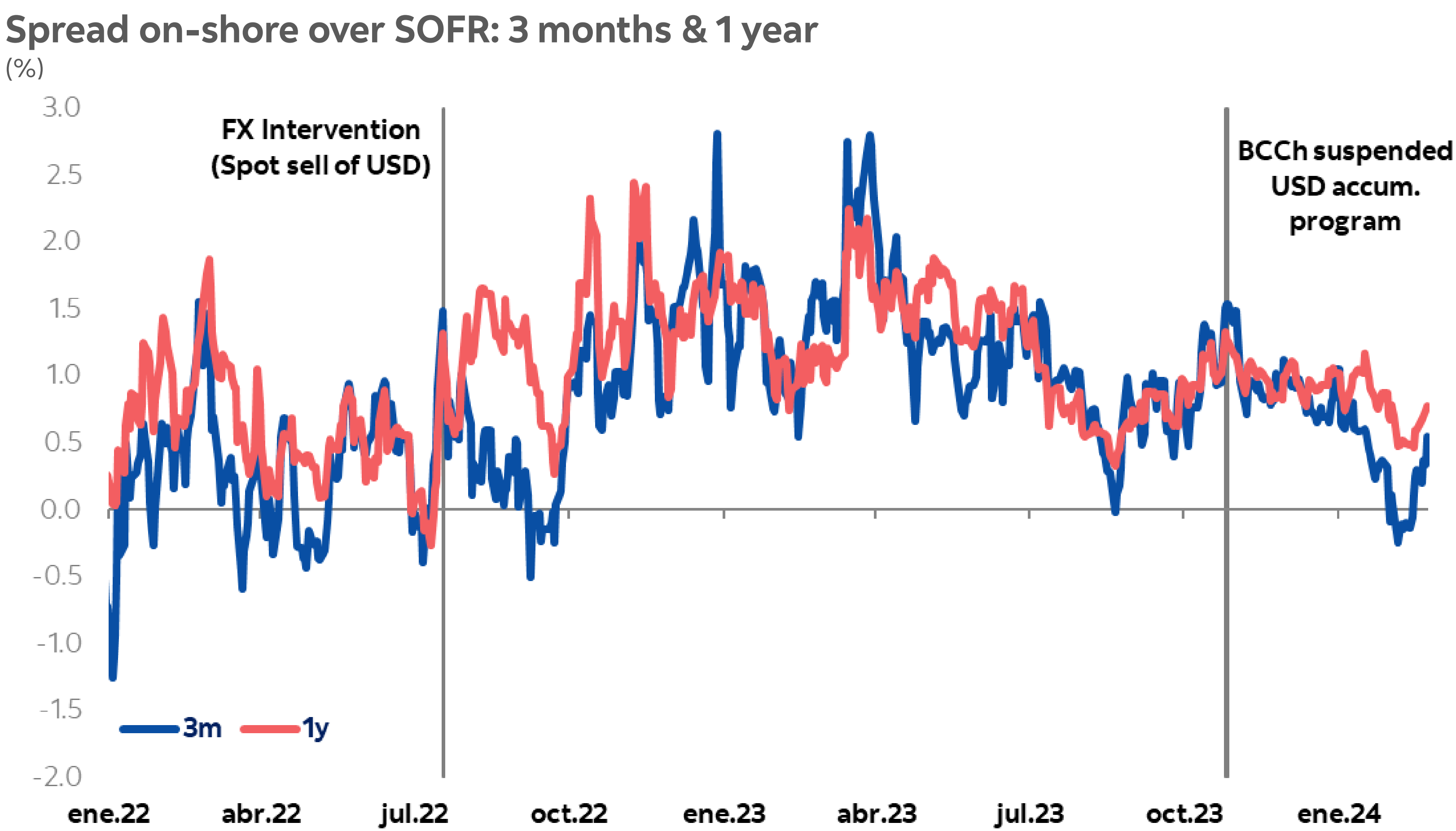


International reserves
(% of GDP, as of Sept. 23)



*Purchasing Power Parity assumes mean reversion. Therefore, the misalignment of the REEE is estimated as the distance to a representative historical average.
Source: Banco Central, IMF, Scotiabank Economics.

There are no signs of tight liquidity in the FX forward market to justify a FX intervention by the Central Bank.



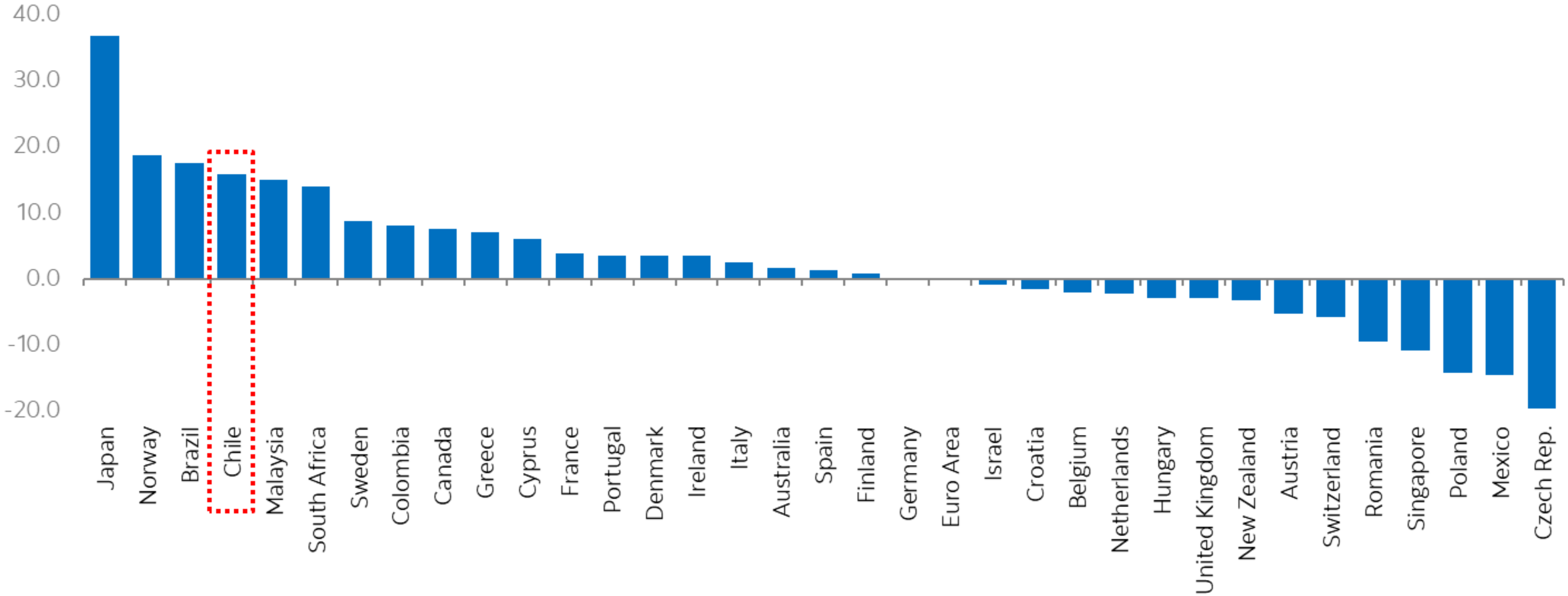
Source: Central Bank, Scotiabank Economics

Scotiabank

Do we need more depreciation of the currency for closing macroeconomic imbalances? No, we do not. In a cross-country comparison, Chilean peso is among the most depreciated currencies.

Misalignment of the REER for a large group of countries

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



*Positive values denotes depreciation with respect to its 15-year average (2009-2023). For Chile, the REER corresponds to the REER of December 2023 plus the variation of the multilateral exchange rate from December to date (February 23, 2024).
Source: Central Bank, IMF, Scotiabank Economics

Economic Outlook

Forecast	2020	2021	2022	2023	2024
GDP (% yoy)	-6.0	11.7	2.4	-0.2	2.0
Inflation (% yoy, eop)	3.0	7.2	12.8	3.9	3.0
Exchange rate (vs. USD, eop)	711	852	860	881	850-900
Monetary policy rate (%, eop)	0.5	4.0	11.25	8.25	4.00-4.25
Copper price (US$/lb, eop)	3.5	4.5	3.8	3.9	3.8
Total consumption (% yoy)	-6.6	19.3	3.1	-3.8	2.2
Investment (% yoy)	-10.8	15.7	2.8	-1.0	1.0
Fiscal balance (% GDP)	-7.3	-7.7	1.1	-2.3	-2.3
Current account (% GDP)	-1.7	-6.6	-9.0	-2.4	-1.0

Source: Scotiabank Economics.

CONTACTS

Jorge Selaive | Chief Economist
jorge.selaive@scotiabank.cl

Waldo Riveras
waldo.riveras@scotiabank.cl

Aníbal Alarcón Astorga
anibal.alarcon@scotiabank.cl

DISCLAIMER