Chile Flash

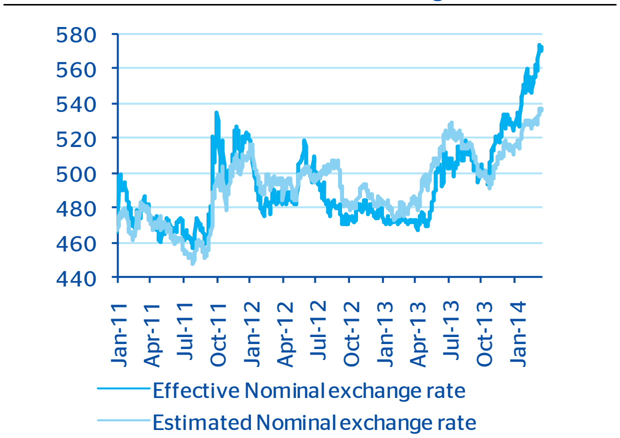
Exchange rate: beware of short-term reversals

The exchange rate is trading well above its fundamentals at present, incorporating *flow* and *carry trade* factors. This misalignment has nothing to do with copper price, USD appreciation, international asset prices or the USD9.0bn of NDF transactions between October 2013 and March 2014.

We alert about a possible short-term appreciation within the medium-term depreciation trend, which would have a short-lived deflationary impact. If a transitory appreciation towards USDCLP 550 occurs the coming weeks, the negative impact on domestic gasoline prices will be felt during April, with CPI monthly inflation temporarily migrating towards zero or negative ground.

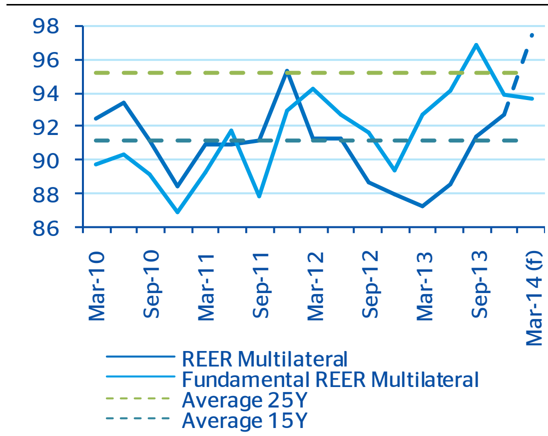
All our different exchange-rate models indicate that the current value of parity is located above levels that can be explained by its fundamentals. In effect, a short-term model that most of the time provides a reasonable explanation of exchange-rate fluctuations, is not explaining the severe peso depreciation in the present circumstances. Even though if we include in the model the net position in the foreign derivatives market – an indicator of carry trade – the explanatory power of the model improves to close to 90%, there is an increasing error in the margin and there is no explanation for levels above USDCPL 540 (Figure 1). A model of the drivers of the real exchange rate confirms our view that the exchange rate is beyond levels that can be explained by its fundamentals, and only explains peso depreciation down to levels around USDCPL 545-550 (Figure 2).

Figure 1
Nominal effective and estimated exchange rate (USDCPL)



Source: Central Bank of Chile, BBVA Research

Figure 2
Real effective and estimated exchange rate (index 1986=100)

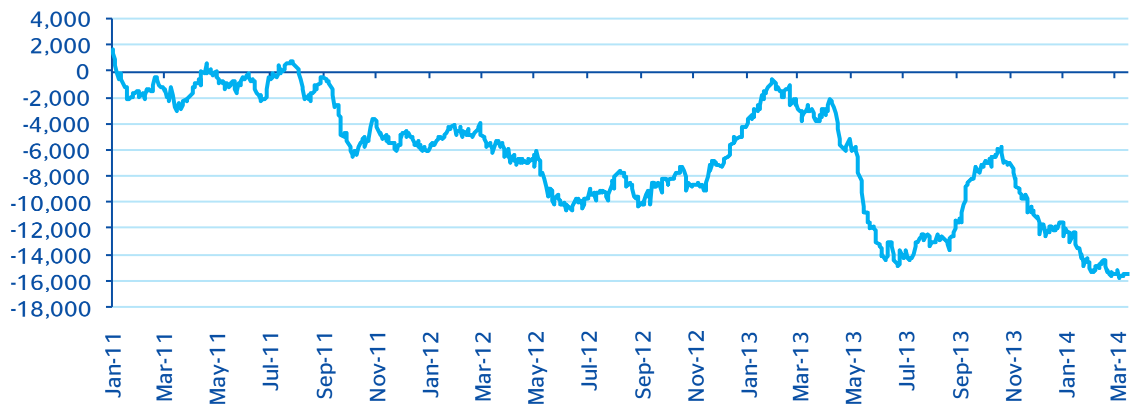


Source: Central Bank of Chile, BBVA Research

We estimate that the RER will reach the 99 level in March 2014 (index 1986=100), assuming CPI at around 0.7% and nominal rates at similar levels to the close on 18 March for the rest of the month. This level would be located 9% above its average from 1996-2013 and 6% above its average from 1999-2013. If this level were 9% below the historical average, and the Central Bank were symmetrical in its evaluation of the exchange-rate misalignment, it would be seriously considering an intervention. **We rule out an exchange-rate intervention, but this misalignment indicates at least two things: i) we see little room for peso depreciation in the short term; and ii) we would have the Central Bank maintaining its monetary policy rate at 4% until the exchange rate returned to levels closer to fundamentals as a first alignment barrier.**

What are we likely to see in the short term regarding carry trade? We estimate that if CPI comes in at high levels for March, this will be neutral for monetary policy. This could lead to positions being reinforced, or at least a stop in the unwinding seen in recent months (Figure 3). Bear in mind that both the fall in the price of copper as well as the expansiveness of local monetary policy and tapering have contributed to peso depreciation. Given expectations that local monetary policy would not continue to inject stimulus (an error that could increase after the CPI in March), one of the reasons for foreigners to continue betting against the peso would disappear.

Figure 3
Net foreign derivatives positions (USD bn)



Source: Central Bank of Chile, BBVA Research

One direct consequence of the above is that we could see short-term reversals in the exchange rate to levels of USDCPL 550, and one indirect effect is that we could see CPI monthly inflation towards a flat or negative figure, during one or even more months.

Beyond the short-term fluctuations and our short-term trading viewpoint, we continue to see the exchange rate closing the year at around USDCPL 590, driven by a gradual deterioration in local fundamentals and a more robust external scenario for the USD, and with copper still at its long-term level (which is not the consensus view). In effect, we are forecasting that after a pause in the process of cutting the monetary policy rate that could last for one or two months, the Central Bank will continue injecting monetary stimuli to the economy, taking the MPR to around 3.25%, coherent with real interest rates close to zero. This level of monetary policy rate is not incorporated into either economic agents' expectations or financial asset prices. When it is incorporated, we could see a return to a phase of CLP depreciation, although this time more in line with the fundamentals.

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