

Latin

Economic Watch

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Economic Analysis

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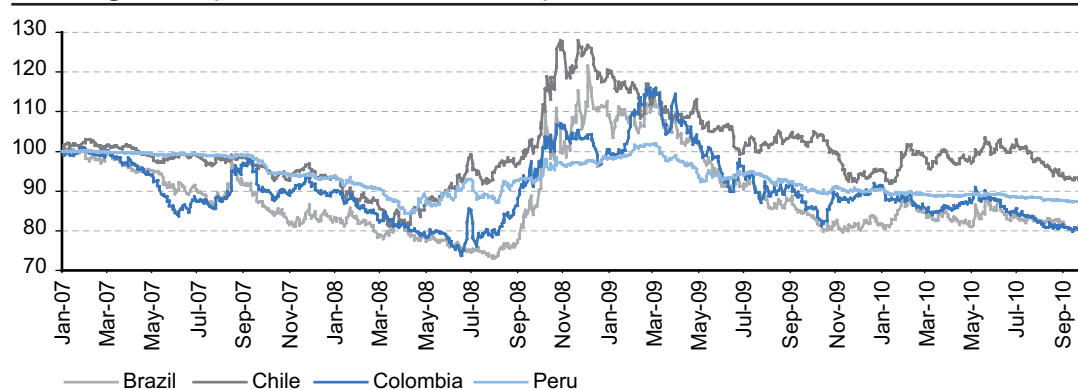
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The “Exchange Rate Wars”: report from the South American front

- **The Brazilian government announced an increase of the IOF tax on fixed-income investments from 2% to 4%**
In addition, the Treasury was allowed to expand dollar purchases to pay external debt. These are the latest in a series of moves by economic authorities in the region to limit appreciation.
- **FX intervention have reached very high levels in Peru and Brazil**
but there is room for further action in Colombia, and Chile might start intervening too in that market.
- **The pace and extent of monetary tightening is being limited**
due to appreciation pressures.
- **Peru might introduce similar taxes to those just announced for Brazil**
due to active purchases by foreigners of public debt in the local market.
- **We see some risks of mounting inflationary pressures in these countries**
unless other policy measures are taken to contain the expansion in domestic demand.

Chart 1

Exchange Rate (vs. US\$, Index Jan07=100)



Source: Datastream and BBVA Research

In the last few weeks we have witnessed significant pressures for appreciations of LATAM currencies vis a vis the USD. Authorities in the different countries have voiced concern about losses of competitiveness and stepped up interventions in FX markets, using both traditional instruments (purchases of FX reserves by central banks) as well as non-traditional ones, such as increases in reserve requirements, etc.

On Monday, the Minister of the Economy of Brazil, Guido Mantega, announced that the IOF tax on foreign inflows into fixed-income and into investment funds would be raised from 2% to 4%. This follows the introduction of an IOF tax of 2% on fixed and variable income one year ago and the recent authorization for the Sovereign Wealth Fund to use the resources of the Treasury to intervene in FX markets. Two days after the announcement of the IOF measure, the National Monetary Council authorized the Treasury to buy dollars in advance to pay the external debt scheduled to mature within four years instead of only two years. In addition to these measures, Central Bank's dollar purchases increased from USD 5.3 Bn. in the first quarter of the year to more than USD 14 Bn in the third quarter.

Although some were expecting these announcements to be delayed until after the second round of presidential elections on October 31st, the measures did not surprise markets. Moreover, this suggests that other announcements could be made right after the final round of Brazilian elections at the end of this month. Both presidential candidates, Dilma Rousseff and Jose Serra have signalled their concerns about excessive appreciation of the real.

Brazil is not alone in this process: Colombia and Peru have taken action to dampen currency appreciation in last months. Colombia restarted FX intervention, at a pace of USD 400millions per month, while Peru has increased reserved requirements for FX deposits as well as on general bank deposits (to discourage credit expansion), while at the same time stepping up intervention in FX markets, from USD 2.3 Bn. in the first quarter of the year to USD 5.5 Bn in the third quarter. In Chile the government voiced concerns and has asked for better coordination with the Central Bank, and we see this as a prelude to intervention in FX markets.

All these developments come on the back of a fast recovery in these economies that prompted the Central Banks of Brazil, Peru and Chile to raise their official interest rates. In the case of Brazil the SELIC rose to 10.75%, in Peru the official rate has gone up to 3.0% and in Chile it stands at 2.5%. Colombia did not cut interest rates as aggressively as her neighbours, stopping at 3%, and domestic demand growth has been more subdued there, so they have not raised interest rates yet.

Brazil decided to call an early end to the monetary tightening and now it seems that Peru and Chile might follow the same route, by slowing down the pace of increase in interest rates and stopping earlier than expected. In Colombia, the start of the monetary tightening was expected to begin at the end of this year, but now we expect that monetary tightening will not begin earlier than in the second quarter of 2011.

What can we expect now?

In the case of Brazil we expect further action in addition to those described above to stem capital inflows, and the government could at any moment (but more likely after October 31st), take other measures such as dollar purchases by the Sovereign Wealth Fund, introductions of limits to short USD-positions by the banking system, or even new increases of the IOF tax.

For Colombia we attach a very high probability of a sudden increase in the amount of the FX purchases. In addition they could introduce reserve requirements (non-remunerated deposits in the Central Bank) to foreign loans (as done in 2007).

In Peru the relative size of the FX interventions is by far the largest and they could begin causing problems for monetary policy, so we attach a significant probability (50% perhaps) to the introduction of some form of tax to foreign purchases of public debt in the local market, in addition to the increases in reserve requirements already in place.

In Chile we see a rising probability of a re-introduction of a USD purchases program by the Central Bank to accumulate reserves, as done in 2008.

In all cases, we see also a slowdown or a delay in the pace of interest rates increases. Brazil already stopped short from market expectations. For Peru, Colombia and to a lesser extent in Chile, we have revised down our projections for official interest rates, as shown in the graphs below. In the case of Chile we attach a very high probability for such a slowdown to start in the coming meeting of the Central Bank (next week).

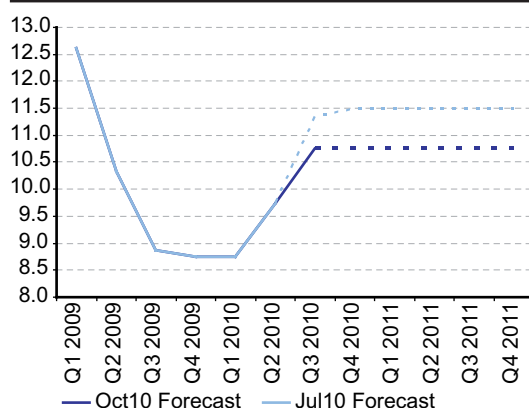
Will these measures be effective?

Given the depth and connectedness of Brazilian financial markets, the direct impact of the recent measures is expected to be short-lived and limited. The prospects of additional interventions in the future might scare markets and could help to set a floor for the exchange rate. Something similar can be said about the other 3 countries.

What should come as no surprise, though, is that stability of the exchange rate - instead of appreciation - combined with a dynamic expansion of domestic demand could begin stoking inflationary pressures for 2011. If so, governments might consider some sort of fiscal adjustment to alleviate the burden of Central Banks.

Chart 2

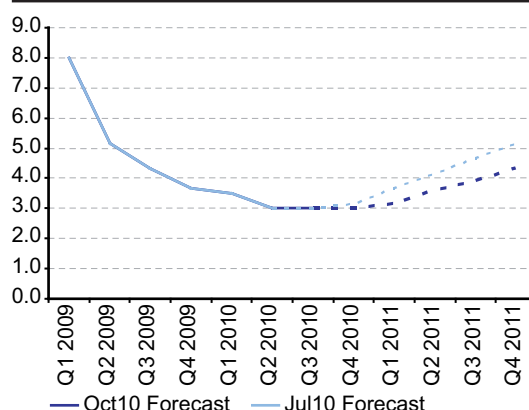
Brazil: Official Interest Rate (% , average)



Source: BBVA Research

Chart 3

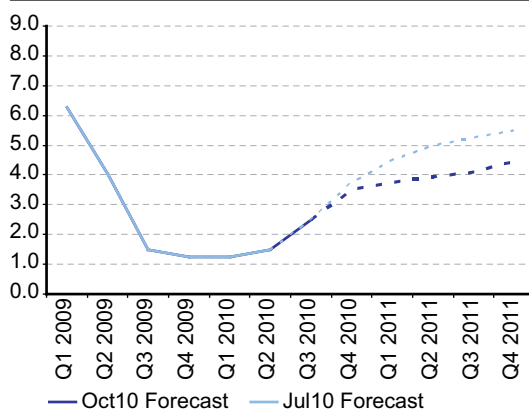
Colombia: Official Interest Rate (% , average)



Source: BBVA Research

Chart 4

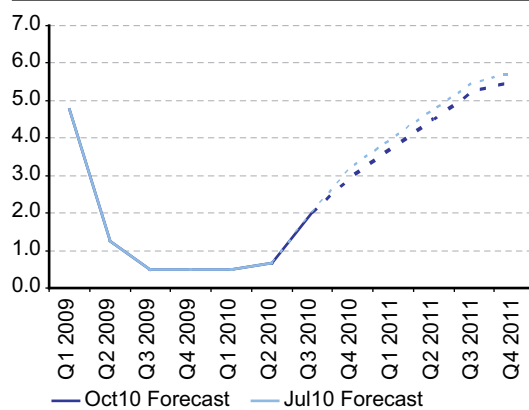
Peru: Official Interest Rate (% , average)



Source: BBVA Research

Chart 5

Chile: Official Interest Rate (% , average)



Source: BBVA Research

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