LATAM Market Update

- **Chile: From adjustment to FX hedging regulation for Pension Funds, to delaying additional monetary stimulus**
- **Colombia: N21 Nationwide social protest**

CHILE: FROM ADJUSTMENT TO FX HEDGING REGULATION FOR PENSION FUNDS, TO DELAYING ADDITIONAL MONETARY STIMULUS

The Chilean economy is subject to a portfolio adjustment in the relative holding of pesos and foreign currency. For Pension Funds, this would mean that we should continue seeing a gradual but persistent migration from conservative funds (D&E) to riskier funds (A&B) that are identified by contributors as more exposed to the exchange rate and foreign assets. If we carry out the simple exercise of taking Fund A to recover its historical average level with respect to the rest of the funds, that would lead to an increase of additional AUM between US$10 up to 15 billion during the next weeks/months.

What alternatives do the CB and Minister of Finance have, within the scope of the well-known economic orthodoxy of Chile, to temporarily mitigate the depreciation of the peso?

The first line of defense (after the verbal intervention already done) is to ensure the provision of liquidity in pesos and dollars in order to avoid abrupt adjustments in the relative prices of short-term instruments in pesos and the domestic dollar rate. As we anticipated, we have already seen the implementation of these measures through swap lines in dollars during the last weeks, with a growing demand. Since November 14th, the Central Bank has been auctioning dollar swaps at 30 and 90 days for an amount of up to US$4 billion, with a minimum spread of Libor + 200 bp. These measures have been expanded twice.

Direct foreign exchange intervention—selling foreign currency. The Central Bank can sell dollars from international reserves that amount to US$40 billion (13.8% of GDP). This measure could not be less than US$10 billion so as to partially close the significant exchange rate misalignment. If this exchange intervention occurs, we see that it is more likely (but not certain) that it will be sterilized, that is, it will be accompanied by a paper purchase program by the CB. In any case, we continue to believe that this policy action would leave the level of international reserves too low (around 10% of GDP), which could give a defenseless signal to financial agents, leading eventually to a more aggressive speculative attack or asset reallocation.

Adjustment in the policies and regulations that regulate the exchange coverage policies of the pension funds (PF). The regulations that regulate the PFs in the field of coverage of their investments abroad have been modified several times. Currently, depending on the fund and the underlying exchange rate, there are upper and lower limits for exchange coverage. The exchange coverage regulations, unlike the investment limits, are not defined by the Central Bank but by the regulator of the PFs (Superintendence of Pensions). Consequently, we could have a suggestion from the Financial Stability Board to evaluate these policies, increasing the requirements of exchange hedging and thus generating a greater availability of forward dollars. Recall that, in simple terms, the PFs buy spot currencies to make investments abroad, and for a maximum proportion they take

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exchange coverage (they sell forward currencies). Even though a change in the hedging policy of PFs could affect the on-shore spread, the CB has already a program in place to manage liquidity in foreign currency.

Delay the injection of greater monetary stimulus. Monetary policy has no other way but to increase the monetary stimulus in the policy horizon, and we continue to expect the MPR to be at 1% by mid-2020. Beyond that we observe more inflation generated by the supply shock of the depreciation of the peso, which is certainly in our baseline scenario, this shock must be interpreted as transitory by the Central Bank, and the inflation it generates would also be of that nature. It is the capacity gaps that have opened significantly and will close slower than expected that define the monetary policy action. However, considerations should also be taken regarding the liquidity of the money market in foreign currency in circumstances such as the current ones. Consequently, the CB could deliver a conditional maintenance message to the normalization of monetary conditions at its December meeting that would last the necessary time. In any case, we consider that the strategy at the level of swap rates should be structured considering the short-term risk of delaying the injection of greater monetary stimulus.

Fiscal policy can also play a role containing the depreciation of the peso. The first option is to liquidate dollars from sovereign wealth funds (ESSF: Economic and Social Stabilization Fund) to finance part of the greater expenses that will be incurred in the short term, a fund that currently has a market value around US$14.2 bn. Although this fund is not intended to finance permanent commitments, it can be used, and has been since its foundation, in a discretionary manner to supplement the debt space authorized in the Budget Law. In this regard, the Ministry of Finance has already announced that it will liquidate US$2,400 million in the coming months (US$1,000 mn this year and another US$1,400 mn at the beginning of 2020) for cash needs in pesos. Furthermore, there is the option of using resources from the pension reserve fund (PRF, market value of US$10.5 bn), which can be used to finance spending on higher pensions, which is precisely one of the main demands of the social movement.

Finally, the Government can also adjust its borrowing strategy, intensifying the issuance of dollar denominated debt, and then liquidating the dollars in the local market to finance its cash requirements. The current Budget Law under discussion limits the amount of debt that can be incurred for the year 2020 to US$8 bn, but given the current situation the Ministry of Finance has requested to increase it to US$9 bn. This increase was initially rejected by the Lower House, but today it is under discussion in the Upper House, where we expect it to be approved. However, the final decision on the currency in which the debt will be issued is of the Government, and so the Ministry of Finance may opt to issue a greater portion in dollars, giving a signal of greater availability of foreign exchange in the local market for next year. Although this strategy could push down local interest rates, due to the lower availability of local currency debt, and push towards a greater depreciation of the peso by that channel, the current scenario attenuates this effect due to the lower appetite for local debt by PFs. The main buyers of long-term local sovereign debt are pension funds, but due to the flow of contributors from conservative funds (fixed income) to more risky funds (external equities), the PFs have taken a position selling local debt as we discussed previously.

—Jorge Selaive, Carlos Muñoz & Waldo Riveras

COLOMBIA: N21 NATIONWIDE SOCIAL PROTEST

Yesterday, the November 21st nationwide social protest developed mostly peacefully. Labour union members, pensioners, students, teachers, among other organizations, joined the protest across the country, which was one of the biggest demonstrations in recent years. Although the protest was without significant incidents until late in the afternoon, where the protests spilled out into vandalism and violence against public transport system stations. Protesters rejected vandalism and tried to battle violence acts. At 8:00 pm, another kind of peaceful manifestations started; families joined marches in their neighborhoods. The spontaneous mobilizations extended until 11:00 pm, closing the mass demonstration of widespread dissatisfaction with President Duque's Government.

Today, there are some difficulties in the transport system due to yesterday's unrest. Labour unions have not officially convened new protests, but other groups talked about the possibility of continuing to protest peacefully in the afternoon. We think the protests were much bigger than we initially expected, and discontent with Duque's administration is evident. We think today is crucial. We believe that if there are spontaneous forces that go out on the streets and continue the protests, we believe vandalism will start to rise again, and more importantly, it will show that Duque's administration is in serious trouble, because of governability and possibility to implement key structural reforms in the future.

Bogota's Mayor, Enrique Peñalosa, reported that unrest damages would worth around COP 20 billion to the city. President Duque rejected violent acts but didn't announce any new action for public policy.

—Sergio Olarte & Jackeline Piraján