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Global storms blow Chile's central bank off course

Chile's central bank is blaming difficult external conditions for its decision to slow the pace of rate cuts and suspend its FX reserve accumulation programme. This may bring questions for other central banks in the region

Headquarters of the Central Bank of Chile, Banco Central de Chile.

50bp instead of 75bp

Late yesterday, the Central Bank of Chile (CBC) delivered a 50bp rate cut. This brings the overnight target rate down to 9.00%. The move was a surprise in that the CBC had guided over recent meetings for the target rate to end the year in the 7.75-8.00% area. Investors had assumed that with the policy rate at 9.50% before yesterday and two meetings left, two 75bp cuts would be forthcoming.

Chile's central bank was quite explicit in its rationale for the smaller rate cuts. Its domestic macro scenario remained very much on track. The economy was slowing, inflation was falling and longer-term inflation expectations were anchored at 3%. What was not on track was the international scenario, where higher US yields on the back of a hawkish Federal Reserve and fiscal concerns, a strong dollar and high oil prices were all weighing heavily on Chilean asset markets and raising concerns over financial stability.

The CBC statement provided little forward guidance as to the size of future rate cuts, but presumably, the market will continue to reprice the pace and terminal rate of the CBC easing cycle. When the central bank opened its easing cycle in July with a 100bp rate cut (to 10.25%), investors priced in rates being cut to 3.50% next year. The pricing of the low point in the easing cycle has been pared back to just under 5.00% now and could be raised further after yesterday's caution from the CBC.

Weak peso prompts suspension in FX reserve rebuild

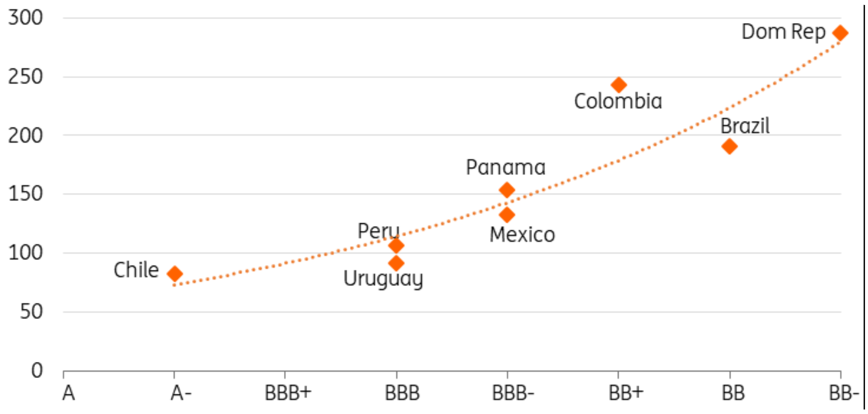
In a sign of just how sensitive the central bank is to recent weakness in Chile's peso, the CBC yesterday announced it was suspending two schemes designed to rebuild FX reserves. One was the suspension of June's plan to add $10bn to its FX reserves over a 12-month window. This plan was suspended yesterday, with only $3.6bn accumulated. The other was to unwind its short dollar position in its Non-Deliverable Forward (NDF) book. Last year, the CBC had sold $9.1bn through the NDF market to protect the peso. In suspending the unwind programme, it leaves a $2.7bn short dollar position to roll over.

This will have been a disappointing announcement for the central bank to have made yesterday. It had been seeking to rebuild FX reserves after losing virtually half of them last year trying to fight peso weakness. Curtailing the reserve rebuild programme sees the CBC stop short of reaching the goals it had set to improve its FX reserve adequacy metrics.

Sovereign credit: Chile stands out among Latin American peers

Chile retains one of the strongest sovereign credit profiles in Latin America with its A2/A/A- ratings, despite some deterioration in recent years over political volatility and fiscal concerns. Chile's sovereign CDS spreads and dollar bond spreads trade at the tight end of the region, and around the middle of its rating tier, with comparables such as Poland and Saudi Arabia. Investor perception, therefore, is of Chile as a more stable investment than regional peers such as Brazil and Mexico, and much more than the extreme example of Argentina.

Chile still boasts a strong sovereign rating (rating versus CDS)



Source: Refinitiv, ING

Market implications

Chile's financial markets are closed today (27 October) for a national holiday. When they re-open – assuming the international conditions have not deteriorated any further – Chile's peso should get a lift. However, with the dollar environment staying strong, we doubt investors would want to chase USD/CLP much below the 900. This remains our year-end target.

Chile's swap market should see some decent re-pricing at the short end of the curve. Traders had assumed that the CBC was on target to take the policy rate to 7.75-8.00% by year-end. These expectations can be pared back by 30bp – perhaps by 50bp.

Chile's moves also raise questions for some other banks in the region. Brazil also started rate cuts this summer and firmly guided for 50bp rate cuts at every meeting this year. Brazil's central bank meets to set rates next week. The market now prices 48bp and 46bp cuts for the 3 November and 14 December meetings respectively. Brazil's real has held its value much better than Chile's peso, and its central bank may therefore be more tempted to push ahead with 50bp cuts this year – but the scale of the 2024 easing cycle could be pared back still further.

Expectations for Banxico's easing cycle were always priced more conservatively than in Chile and Brazil. But Chile's more cautious move stands to cement current pricing that Banxico will not be cutting rates for another six months – unless the pricing of the Fed cycle adjusts sharply lower. And like others in the region, the terminal rate in Banxico's easing cycle has already been re-priced 150bp higher over the last three months.

Like Chile, Banxico also has a forward book unwind programme underway at the moment. As we noted when the plan to unwind its $7.5bn short dollar position was announced in September, the majority of that unwind would be front-loaded into September and October. Mexico's currency has generally performed better than Chile's and given that a decent chunk of the unwind has taken place, we doubt Banxico would follow CBC and scrap its own forward book programme.

In general, high US interest rate volatility has undermined the carry trade and weighed heavily on the Latam high-yielding currencies which had been its beneficiary. Unless the Fed can usher in some more benign conditions, we expect choppy conditions for USD/Latam continuing into year-end.

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