Public Issues

Nr 999
January 7th, 2011
www.lyd.org ISSN 0717-1528

Facing the Dollar Problem

We certainly do not know if the current copper price will be transitory or permanent, and if we have already caught the Dutch disease or not; for Chile it is currently wise and advisable to accumulate additional international reserves, recover a positive and significant productivity growth and strongly reduce public spending levels, and at the same time to improve efficiency.

At last, the Central Bank has decided to face the dollar problem. After the market closing on Monday, the first working day of 2011 and after the exchange rate had reached the CLP465 level, the issuing bank announced that in 2011 it will accumulate additional international reserves for an amount of US$12,000 millions, by periodically buying foreign exchange.

This decision, which has been expected by export and import substituting sectors for a long time, produced immediate effects in the market, by increasing, only three days after, the dollar rate to CLP495, CLP29 more or 6.2% over the observed average rate previous to the intervention made on January 3rd, that is, CLP466.

This is a positive measure, since it reduced the uncertainty on this issue which was affecting decisions regarding productive investment and also the creation of new working sources. Besides, it avoided a possible downwards adjustment of the foreign currency producing serious damage to the export sector.

In other words, a signal was given to privilege a higher over a lower dollar rate together with a more gradual curve, at least while the high risk and uncertainty foreign scenario persists.

The question is what level the dollar will reach in the next weeks and months. The answer will depend, among others variables, on what will occur with the copper price.

In this perspective, it is interesting to review the facts occurred since the intervention by the Central Bank on April 10th, 2008. As it may be observed in Table 1, when the dollar was controlled, it closed at CLP434 and in the following two months it raised approximately CLP60, equivalent to 15%. On the other hand, the copper price, as can be appreciated in Chart 2, was at 403 cents per pound when it was controlled, then it reached an average of 383 cents for the next two months, that is, 5% less. From this analysis, it may be concluded that the copper relative rate reduction helped to increase the dollar rate after the intervention of 2008.

Copper price before the intervention was 442 cents, and three days after the announcement it dropped to 435 cents, almost 2% less, which certainly collaborates with the increase.

Chart 1

NOMINAL EXCHANGE RATE (CLP/US$)
DAILY AVERAGE QUOTATION: JANUARY 2nd, 2007 – JANUARY 6th, 2011.

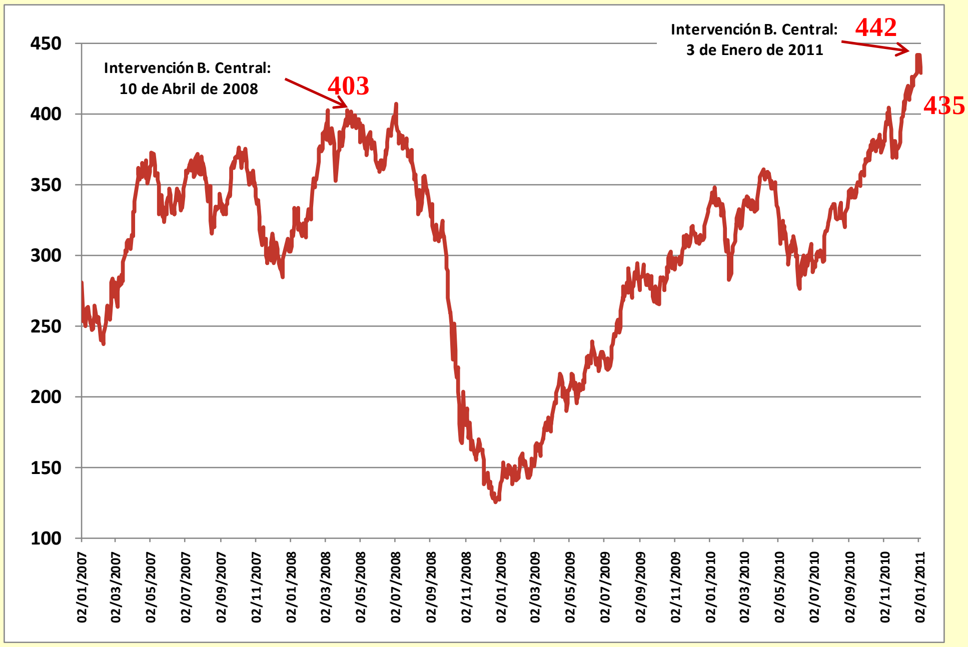
Source: Banco Central de Chile

Henceforward, the dollar should reach CLP500, but the increase celerity and the level at which it could be stabilized in the weeks ahead will depend on the copper price evolution. If copper moderates its price at an average close to 420 cents, the dollar would have some space to rise. Thus the importance of monitoring the copper price's daily level which, as we know, does not only depend on the physical demand and offer conditions but on the financial ones which are related to the investors' greater or lower risk willingness.

Chart 2

COPPER PRICE (US$ cents/pound)

DAILY AVERAGE QUOTATION: JANUARY 2nd, 2007 – JANUARY 6th, 2011.



Source: Cochilco

The present scenario of external fragility has not allowed having a clear idea about the copper price, if it will be transitory or permanent for our main export product. We do not have any certainty if current copper prices –approximately 440 cents per pound- will continue rising and will remain over time or, on the contrary, if they will adjust downwards to a new crisis scenario.

Nobody has an answer for this question and as doubts are considerable we believe that prudence advised the Banco Central's intervention. That is, if these high copper prices are temporary, a greater level of international reserves is welcome to face any international finance impairment.

Actually, and as it can be concluded in Table 1, Chile does not only have a lower reserves level in relation to the average GDP of the Latin American countries but this level is lower than that of some East Europe and Middle East countries and, above all, with respect to the South-East Asian countries which in average quadruplicate the Chilean level.

Table 1

INTERNATIONAL RESERVES AS GDP % FOR SELECTED COUNTRIES

	International Reserves (ThM US$)2010*	GDP (ThM US$)2010*	International Reserves/ GDP
Argentina	51.9	351.0	14.8%
Brazil	285.5	2,023.5	14.1%
Chile	26.5	199.2	13.3%
Colombia	27.5	283.1	9.7%
Ecuador	2.3	61.5	3.7%
Mexico	1,16.3	1,004.0	11.6%
Peru	43.8	153.1	28.6%
Uruguay	7.9	40.7	19.4%
Venezuela	18.4	285.2	6.5%
Latin America Average			13.5%
China	2,650.0	5,745.1	46.1%
Hong Kong	267.1	226.5	117.9%
India	298.0	1,430.0	20.8%
Indonesia	91.8	695.1	13.2%
South Korea	293.3	986.3	29.7%
Malaysia	105.3	219.0	48.1%
Philippines	57.2	189.1	30.3%
Singapore	221.4	217.4	101.9%
Taiwan	387.7	427.0	90.8%
Thailand	171.1	312.6	54.7%
Developing Asia Average			55.4%
Israel	69.6	201.3	34.6%
Turkey	84.0	729.1	11.5%

Russia	497.1	1,476.9	33.7%
Rumania	47.2	158.4	29.8%
Poland	96.6	438.9	22.0%
Hungary	43.4	132.3	32.8%
Czechoslovakia	41.5	165.0	25.2%
Other selected countries average			27.1%

Source: L&D based on estimates from the IMF (October-November 2010).

On the contrary, if we realize that the higher prices of our main export product remain stable over time, materializing once again the so called "super cycle" of copper, we will have enough resources to help small and medium enterprises (Pymes), with a real and aggressive plan cost reduction in labour, tributary and regulatory matters in addition to establish a new concept in the relationship between enterprises and the government.

The preceding should be an important "bridge" for this large enterprise sector which generates the largest number of employments in the country. The efforts made by the government in order to increase productivity and to exercise a greater fiscal austerity, which as we know are a key factor for the economy's long term sustainability, but in the short term they are only a marginal help.

It is precisely this supposed new "super cycle" of copper the reason why we talk again about the so called "Dutch disease" that Chile could suffer – it also occurred at the beginning of 2008, before the Banco Central's foreign exchange intervention- that is, a prolonged period of high incomes, that a country receives for different causes and ends up seriously affecting the competitiveness of its non traditional exporting sector.

Certain symptoms of this disease are starting to show in some degree in Chile, but to categorically affirm that we have just caught the disease is something else.

Classic symptoms are: an increase in the real foreign exchange, a slower increase in the manufacturing sector and, in general, higher salaries.

Nowadays, Chile shows slight symptoms but we must be very careful and not hurry to draw conclusions, since it is extremely difficult to clean the effects on some of the them such as the strong fiscal expansion produced at the end of the first decade of 2000, that negatively influenced the real exchange rate and that of real wages – it is only the real exchange's reverse of the coin - and those derived from the strong earthquake occurred at the beginning of last year which affected the recovery rate of the industrial sector after the international financial crisis.

In any case, as we do not know if the current copper prices will be transitory or permanent and if we have already caught the Dutch disease or not, for Chile it is wise and advisable to:

1) Accumulate additional international reserves;
2) Attain positive and significant productive growth;
3) Strongly reduce the public spending levels, and to improve efficiency.

Considering the Banco Central's decision, point 1) is materializing; point 2) is one of the government's main concern for which many commissions have been created in order to detect specific "bottle necks" for competitiveness, but it is necessary to focus in how we may reduce the costs for the Pymes; and point 3) is no doubt a great challenge since to recover the public spending versus GDP ratio from the current 24.5% to an 18% level approximately, as we had years ago, will not be an easy task, especially due to the expenditures compromised after the earthquake. In relation to the efficiency of this spending, it will be a key issue where we should evidence notable progresses and it will definitely determine the economy's greater productivity which is what we are hoping for.