# Continental shifts

THE SURGE OF INWARD INVESTMENT INTO LATIN AMERICA HAS INCREASED THE LIQUIDITY OF THE REGION'S CURRENCIES. **KAREN BOXALL** AND **CLAUDIA CEJA GONZÁLEZ** EXPLAIN THE KEY FACTORS AFFECTING EACH CURRENCY'S VALUE.

Investment funds have joined the carnival, with flows to Latin America having grown by 477% since 2004. Sovereign and structural risks have diminished while local economies continue to grow and local rates offer attractive carry trade opportunities.

These trends have stimulated the appetite for LatAm currencies, which, in turn, has increased liquidity, like mojitos flowing on a Thursday night in the City. According to the 2010 tri-annual FX survey from the Bank of International Settlements, daily FX turnover in the Brazilian real, Chilean peso and Mexican peso rose by 155%, 138% and 98% respectively since 2001. The Colombian peso and the Peruvian nuevo sol rose 604% and 491% respectively, although these markets were smaller to begin with. Conversely, turnover of the Argentine peso has decreased over the last six years as a result of active FX controls.

The Mexican peso claims the top spot as the most liquid LatAm currency, having the 14th largest global turnover, followed by the Brazilian real in 21st place. However, with 4.4% of global FX volumes as of 2010, LatAm remains a relatively small FX area.

**TEQUILA SUNRISE** Most liquid LatAm currencies have appreciated over this tenor and may currently appear overvalued, with the exception of the Mexican peso, which is exposed to the US economic cycle. That said, we do not expect an imminent reversal in other LatAm pairs. The Chilean peso, Peruvian nuevo sol, Brazilian real and Colombian peso are linked to commodity prices and we are not expecting a material fall in near-term commodity prices.

Chile and Peru have increased their exposure to China's economy while Brazil has an attractive real interest rate attracting carry trades. Foreign direct investment (FDI) is expected to grow in Colombia, partially due to new oilfield discoveries. Conversely, domestic inflation pressures are likely to push the Argentine peso lower, but in an orderly fashion, thanks to local central bank intervention.

**CLIMBING THE ANDES** Although most LatAm countries have free-floating FX regimes, the majority of their central banks intervene when market conditions require and, in some cases, capital controls are used as an intervention tool. Historically, regulation was used to tackle foreign outflows but now some LatAm countries resort to capital controls to manage inflows. Either way, the target is generally to reduce FX volatility or perceived overvaluation.

The region's current intervention policies can be divided into three

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categories: those with few measures (Mexico and Chile), those that use measures to contain capital outflows (Argentina and Venezuela), and those that use measures to contain capital inflows and general appreciation (Peru, Colombia and Brazil).

Brazil is the clearest example of a country using different interventionist measures involving capital controls. Colombia and Peru have no capital controls per se, but they both have a tax on financial operations. Additionally, the Peruvian central bank intervenes directly in the spot FX market while Colombia's central bank purchases $20m a day as well as making discretionary purchases of up to $1.2bn.

Mexico and Chile have been more conservative; the former has a monthly reserve accumulation plan that represents less than 2% of the Mexican peso's daily turnover and Chile's central bank operates via spot in small amounts. Finally, Argentina's central bank buys and sells dollars almost daily, with the objective of reducing its currency's volatility in order to maintain a gradual depreciation trend.

In the near future, we expect Brazil, Argentina and Peru to continue to take more aggressive FX interventionist policies while the others remain more conservative.

These capital control measures have an impact on how corporates need to approach their liquidity and risk management needs. On the one hand, open market central bank interventions tend to be seen as more benign and even corporate-friendly since they are relatively ineffective over the medium term and are aimed at reducing market volatility and/or speculative positioning. On the other hand, capital controls implemented via fiscal or regulatory measures are corporate-damaging since they can create friction and entry costs into local markets. Climbing the Andes is possible but needs planning and determination.

As a consequence of these barriers to entry, a divergence between the onshore market (forwards with physical delivery) and offshore market (non-deliverable forwards) has developed in some currencies. Corporates should always consider which market is more appropriate for their hedging requirements and strategy. Implementing the optimal FX strategy often requires the participation of banks that have both on and offshore FX capabilities, such as BBVA.

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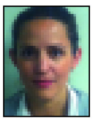

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