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Could a Mini Colombian Peso Currency Crisis be Coming?

Economist(s)

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Summary

We believe conditions are forming where the Colombian peso could experience a mini currency crisis in the near future. Just recently, Colombia's central bank turned less hawkish and President Petro suggested an unorthodox replacement for interest rate hikes, both developments that placed depreciation pressure on the currency. In addition, we have reservations about the sustainability of the recent jump in oil prices, particularly if, as we expect, the "zero-COVID" policy in China remains in place after the country's 20th National Party Congress. We saw an environment build in Chile earlier this year that resulted in a short-lived, but sharp, Chilean peso depreciation, and we believe similar conditions are currently forming in Colombia. In the coming weeks, the peso could breach COP5000, which would represent an all-time low against the U.S. dollar and imply a 7.5%-8% depreciation from current levels.

Tread Carefully Colombia

Over the last few weeks, central banks across the emerging markets have met to assess monetary policy. One of our takeaways from these meetings is that policymakers are turning less hawkish, and that broadly speaking, interest rate hikes are set to be more gradual going forward. Recently, the Brazilian Central Bank (BCB) paused its tightening cycle, while the National Bank of Hungary (NBH) and Central Bank of Poland (NBP) signaled rate hikes are likely over going forward. In our view, slowing (or an end to) tightening cycles at this juncture may be a dangerous game for emerging market central banks to be playing. By ending tightening cycles, emerging market policymakers are placing their respective monetary policies on diverging trajectories from the Fed. To date, most emerging market currencies have faced depreciation pressures as the Fed has led the charge on tightening monetary policy. And, with the Fed unlikely to relent on rate hikes and shrinking its balance sheet just yet, ending rate hike cycles could lead to additional depreciation pressure building on emerging market currencies in the coming months.

In fairness, an argument for pausing or slowing tightening cycles in some emerging economies can certainly be made. Policymakers are likely concerned that over delivering on interest rate hikes could plunge their respective economies into recession. Which is a fair concern; however, by placing interest rates on diverging paths from the Fed, policymakers run the risk of sharp currency selloff's. Those currency depreciations could prompt central bank tightening just to defend the value of respective currencies, while weaker currencies could have effects that lead to recessionary conditions forming anyway. Fed tightening and diverging paths for monetary policy underpin our view for a strong U.S. dollar and weaker emerging market currencies. But, after the last few weeks we believe select currencies associated with less hawkish, or even dovish, central banks could be most at risk in the current environment. In that sense, downside risks exist to our forecasts for currencies such as the Brazilian real, Polish zloty and Hungarian forint. However, we highlight here the Colombian peso as a currency that could experience outsized selling pressure in the near future, and could breach our short-term targets earlier than we expect as the Colombian Central Bank turned significantly less hawkish recently and local political risks tied to the new Petro administration are percolating longer than we initially expected.

In assessing monetary policy and the Colombian Central Bank, our concerns stem from the idea that **real interest rate differentials between Colombia and the United States may move sharply against the peso in the coming weeks**. To that point, at Colombia's recent September monetary policy meeting policymakers lifted the Overnight Lending Rate 100 bps to 10.00% instead of the 10.50% market participants were expecting. In addition to a less robust rate hike, policymakers suggested they were approaching the end of their tightening cycle. The combination of a less robust rate hike and less hawkish forward guidance led to a sharp peso depreciation in the immediate aftermath of the meeting. September inflation data, released a few days later, exacerbated the peso's decline as the CPI came in firmer than expected, climbing to 11.4% year-over-year from 10.8% a month earlier. With inflation still running hot and potentially uncontained, and markets adjusting to a more gradual monetary policy path going forward, real interest rates in Colombia are likely to turn more negative in the coming months. As far as real interest rate differentials against the United States, yes inflation in the U.S. is elevated, but the Fed is responding with aggressive rate hikes. As the Fed continues along a path of outsized rate hikes, real interest rate differentials could swing against the peso and lead to a more pronounced depreciation in the near future.

Adding insult to injury were comments from President Petro that the central bank's tightening cycle should end immediately. While the independence of Colombia's central bank has never been in question, nor are we suggesting there is a risk of the institution losing that independence, commentary from a new administration with an already unorthodox policy agenda hurt sentiment toward the country as well as the currency. To make matters worse, Petro suggested that instead of rate hikes — which according to Petro are designed to prevent capital outflows rather than control inflation — Colombian policymakers should impose a tax on any capital outflows. Essentially, such a proposal would install a form of capital controls to contain any peso depreciation that could stem from prematurely ending the tightening cycle. Details of how a tax on outflows would work are unavailable, but nevertheless the suggestion of capital controls from the Petro administration was taken seriously enough to garner a response from Colombia's finance minister. Finance Minister Ocampo sought to reassure markets that currency controls, in any form, are a policy that will not be implemented by the administration. And while we do not think capital controls will be imposed, the fact Petro is suggesting controls leads us to believe that **political risk and the implementation of a less technocratic policy**

agenda is still a risk hovering over the peso. Historically, widening real interest rate differentials and elevated political risk have led to sharp emerging market currency selloffs.

And finally, we have some reservations over the sustainability of the current rebound in oil prices. We acknowledge that OPEC+ just cut production by 2 million barrels per day, but with OPEC nation production already constrained, the actual supply reduction should be much lower. Also, markets may be hopeful that China will lift the “zero-COVID” policy at the upcoming 20th National Party Congress, which could spark renewed demand for oil from the world's largest consumer of energy. We do not share that view, and **we believe oil prices could drop as National Party Congress meetings are designed to appoint a new leadership structure in China and historically has not been a forum to enact policy change**. As markets adjust to “zero-COVID” remaining policy for an extended period of time, oil prices should decline and currencies associated with energy exporting countries could weaken. Given Colombia is a large oil exporter, we would expect the peso to come under pressure in the aftermath of China's National Party Congress, which begins on October 16.

The entire combination of more negative real interest rate differentials, elevated political risk and a potential oil price decline can lead to a sharp peso depreciation in the near future. We saw similar dynamics unfold in Chile earlier this year, where the Chilean currency experienced a mini currency crisis in an environment of high local inflation, signals of less hawkish Chilean central bank monetary policy adjustments as well as a collapse in copper prices. That scenario seems to be on the brink of forming in Colombia, and we believe the Colombian peso could see its own short-lived, but significant, depreciation in the weeks ahead. Right now, we forecast the USD/COP exchange rate to reach COP4850 by Q1-2023. As the dynamics we describe above materialize, **a move to COP5000 or higher could be in range by the middle of Q4-2022, which would not only imply a 7.5%-8% depreciation from current levels**, but also that the Colombian currency could reach an all-time low earlier than we previously forecast.

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