CAPITAL ECONOMICS

LATIN AMERICA ECONOMICS UPDATE

Can Chile's private sector cope with higher interest rates?

- **There's little evidence (so far) that the surge in interest rate is leading to widespread debt servicing problems in Chile's private sector, but there are pockets of vulnerability in the household sector. Although we don't expect a wave of defaults in the coming quarters, high interest rates are likely to dampen consumption and investment, supporting our view that Chile's economy will contract this year.**
- Chile's central bank has delivered one of the most aggressive monetary tightening cycles worldwide, raising the policy rate from a trough of 0.50% to 11.25%. And although the tightening cycle has ended and we expect the central bank to start lowering interest rates in Q3, strong (core) price pressures mean that policy will be loosened only gradually and interest rates will remain historically high this year.
- **Our modelling suggests that the surge in interest rates will lead to a large increase in private sector debt servicing costs this year.** (See Chart 1.) The degree to which this results in debt servicing *problems* depends on the strength of households' and corporates' balance sheets, and hence their ability to offset the hit to incomes from higher interest expenses.
- **Chilean non-financial corporates (NFCs) appear to be relatively well placed to deal with higher debt servicing costs.** Many of Chile's largest corporates are in the mining sector and have benefitted from high copper prices over the past couple of years, which have boosted their revenues. Indeed, NFC's gross entrepreneurial income (i.e. income before taxes, distributed income and reinvested earnings) was more than 25% higher last year than it was before the pandemic in US dollar terms (the number is even higher in peso terms). Our copper price forecast implies that NFCs' incomes will remain elevated over the next couple of years (see Chart 2), putting them in a good position to deal with higher interest expenses.
- A look at the non-performing loan ratio on commercial loans adds to the view that there are limited signs of stress in the corporate sector. While the ratio rose to 1.8% in January 2023, up from 1.4% in December 2021, it remains in line with its historical average. (See Chart 3.)
- **There are some pockets of vulnerability in the household sector though.** While mortgages (which account for more than half of total household debt) generally have relatively long maturities (13-17 years according to central bank's latest Household Finance Survey) and are mostly issued at fixed rates, the average maturity for consumer loans (which account for around a quarter of total household debt) is much shorter, at between 19 months for consumer credit to just over four months for credit card loans. **This raises the risk that these debts need to be rolled over at much higher interest rates.**
- Admittedly, Chilean households sit on a relatively large stock of liquid assets following three rounds of pension withdrawals during the pandemic. That led to a shift in the composition in household assets from (less liquid) pension fund assets to (more liquid) currency and deposits in banks, which now stand at around 30% of GDP, up from 24% before the pandemic. This should help Chilean households service debts, mitigating the risk of a broad-based rise in defaults over the coming quarters.
- **Even so, there are signs of debt servicing problems arising in parts of the household sector.** In particular, lower-income households that tend to have a lower propensity to save and, as the central bank's Financial Stability Report highlighted, rely most heavily on consumer loans at short maturities have been struggling to service their debts. This is reflected in a rise in the NPL ratio on consumer loans over the past 12-18 months, although at 2.7% the ratio is still below its pre-pandemic average. (See Chart 3 again.)
- The good news is that Chile's banking sector is well placed to deal with higher non-performing loans. The ratio of regulatory capital relative to banks' risk-weighted assets stands at around 15%, well above the minimum under Basel III. And our analysis suggests that most major Chilean banks could endure a loan loss rate of around 7-8% before their CET1 capital would fall to the regulatory minimum.
- **But high interest rates will still take their toll on Chile's economy by weighing on consumption and investment. This feeds into our view that Chile's economy will contract by 0.3% this year.** (See Chart 4.) And we expect the economy to operate below its pre-pandemic trend over the next couple of years.

Kimberley Sperrfechter, Latin America Economist, kimberley.sperrfechter@capitaleconomics.com

Chart 1: Private Sector Interest Expense (% of Disposable Incomes)

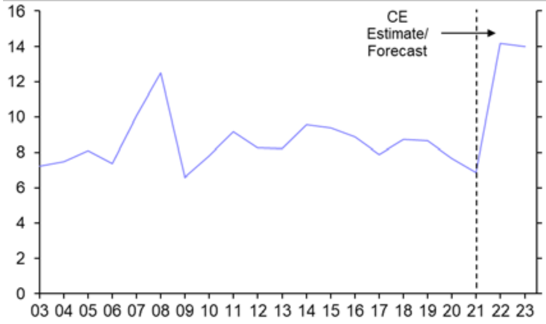


Chart 2: Copper Price & Gross Entrepreneurial Income (US$ Terms, Q3 2019 = 100)

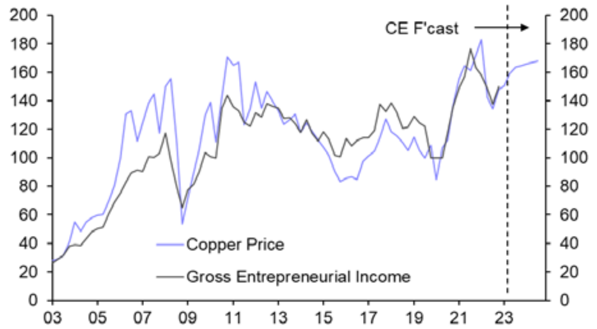


Chart 3: Non-Performing Loan Ratio (%)

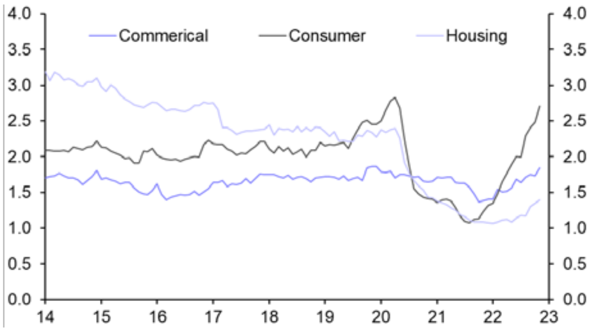
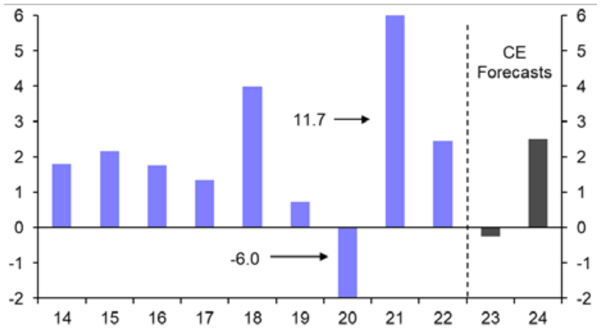


Chart 4: Chile GDP (% y/y)



Sources: Refinitv, BCCh, CMF, Capital Economics

Email **sales@capitaleconomics.com** Visit **www.capitaleconomics.com**