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Chilean Corporates Well Equipped for a Crunch

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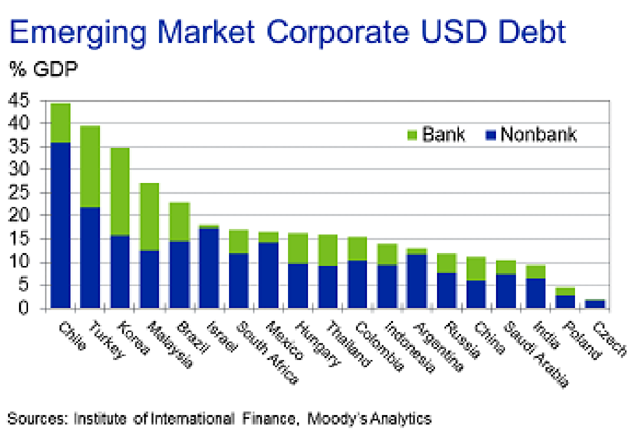
- As a small, open economy, Chile remains vulnerable to a broader global downturn.
- Chile's dollar-denominated corporate debt ranks among the highest of emerging markets.
- The sharp decline in copper prices this year could squeeze the corporate sector, even if firms' ability to meet debt payments is not in question.

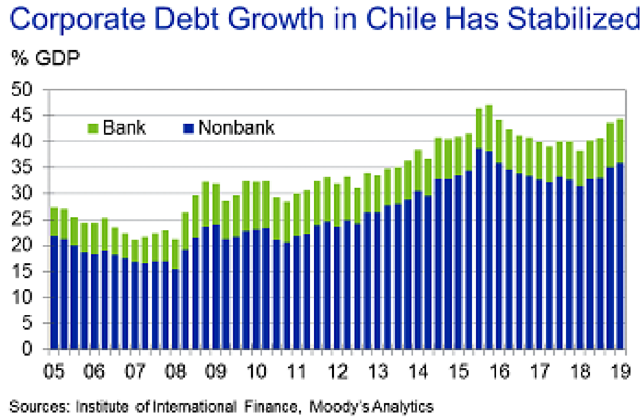
Debt-thirsty Chilean corporates could face higher borrowing costs as global headwinds swirl, but currency hedges and robust inflows of foreign direct investment will make for good insulation. Economic growth in Chile has slowed substantially this year amid supply disruptions in mining and falling copper revenues. Despite an increase in the volume of copper exported to China and other copper-importing powers in emerging Asia, export revenues from copper have fallen 8% in the first eight months of this year.

Like their peers in other emerging markets, Chilean corporates borrowed aggressively in the past five years even as copper prices fell and domestic demand weakened. Much of this debt is denominated in dollars. Indeed, as a share of GDP, Chile's dollar-denominated corporate debt ranks among the highest of emerging markets.



Mining firms are not alone among the highly levered. Consumer-facing industries such as retail chains and transportation firms have piled on debt to drive expansions. Mining firms are well poised to weather a weakened peso given that export earnings are in dollars. Weaker global growth and a weaker peso pose a greater risk to retailing and telecommunication giants given their reliance on peso revenues and large debts, but high inflows of foreign direct investment and currency hedges limit the risk of large exposures.

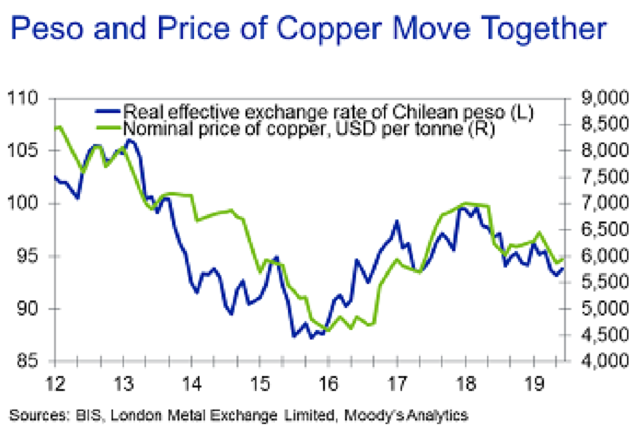
With capital markets in retreat, corporate bond issuance has slowed this year. Still, the gross debt burden of the corporate sector has edged up because of Chile's slowing economy.



An exchange rate depreciation does remain a risk for some corporates. However, while global growth has weakened substantially this year, Chilean firms faced a far greater test in the aftermath of the late-2014 commodities bust.

At that time, the sharp deceleration in China pummeled global demand for copper—the source of almost half of Chile's export earnings—when the peso weakened and capital flows reversed. The value of the Chilean peso, measured against the dollar and against a broader basket of currencies and adjusted for differences in price levels, fell nearly one-fifth from 2015 to 2016.

This latter measure, known as the real effective exchange rate, is tightly correlated with the price of copper. Despite efforts to diversify exports, Chile's economy remains highly reliant on copper mining and other extractive industries, and its competitiveness ebbs and flows with the effective exchange rate. In the wake of the commodities bust, price effects—namely, the cheapening of Chilean exports—were unable to counter the hit to demand from China's slowing economy.



As the commodities rout deepened, export revenues declined sharply and profit margins thinned. However, strong financial institutions and stable inflows of foreign direct investment kept the corporate sector insulated. Over half of Chile's corporate debt is backed by foreign direct investment, the consequence of a tax incentive that has channeled foreign lending into long-term debt rather than short-term equity investments.

Still, the sharp decline in copper prices this year—while short of that experienced during the commodities bust—could squeeze the corporate sector, even if firms' ability to meet debt payments is not in question. While copper mining accounts for just 10% of Chile's GDP, lower copper prices flow through to the rest of the economy via the exchange rate and imported inflation. This translates into less spending power for consumers and less tax revenue for the government—one of the reasons behind the slowdown in public investment this year.

As a small, open economy, Chile remains vulnerable to a broader global downturn. But high levels of financial sector development, strong institutions, and ample buffers, including a large stockpile of foreign exchange reserves, make the financial sector unlikely to be the first domino to fall. If the global economy falls into recession—a possibility with growing likelihood given the escalation of the trade war, weakness in Europe, and financial market ructions—Chile’s economy will ultimately fold. But the felling blow will likely be dealt by pressures from the real economy rather than a corporate credit crunch.

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CONTACT US

For further information contact us at a location below:

U.S./CANADA
+1.866.275.3266

EMEA
+44.20.7772.5454

ASIA/PACIFIC
+852.3551.3077

OTHER LOCATIONS
+1.610.235.5299

Email us: help@economy.com
Or visit us: www.economy.com

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