BOX I.2:

Financial risks in the external scenario

High inflationary pressures have raised the outlook for global policy rates, constituting the main factor behind the deterioration in international financial conditions since the March Report. In particular, the Fed has begun the withdrawal of conventional and unconventional monetary stimulus, and the systematic inflationary surprises and the evolution of its fundamentals suggest that this could intensify going forward (box I.1). In the past, these events have caused significant capital outflows from emerging economies. Thus, the withdrawal of stimulus by the Fed, the uncertainty about the intensity with which this process will continue, and the potential consequences it would have on emerging economies, have considerably increased risk aversion, especially for emerging economy assets. Additional vulnerability factors include the still high level of some asset prices, particularly for housing; the high level of sovereign and corporate leverage; the increase in global uncertainty due to the conflict between Russia and Ukraine; and signs of weakness in the Chinese economy.

International stock markets have recently experienced sharp declines, and a deepening of these trends cannot be ruled out, especially in developed economies. There, although the level of stock prices already looks somewhat more consistent with the earnings outlook, they are expected to continue to fall as the global monetary policy tightening cycle intensifies, risk aversion continues to mount, and the growth outlook worsens. Following the onset of the pandemic, housing prices rose sharply in developed economies, driven by changes in preferences and the rapid growth of mortgage credit (figure I.19). However, recent increases in long-term interest rates and reduced global liquidity have been passed on to the cost of these loans, raising the probability of a reversal in property prices, which the European Central Bank highlighted as an important risk in its latest financial stability report. The deterioration in asset prices could also affect the global economy via a fall in consumption due to reduced households' wealth and disposable income[1]/.

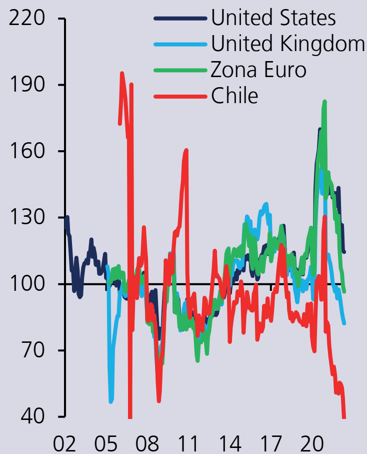
The high levels of sovereign and corporate indebtedness also presage potential complications, especially in combination with higher interest rates and lower global liquidity. These factors have led to a significant increase in the cost of financing for governments and businesses in both developed and emerging economies. Although they are still not far from historical averages, the increase in debt after Covid-19 and the poorer growth outlook paint a weak picture that could trigger sustainability problems (figure I.20). In China, the situation also looks delicate, given the imbalances accumulated in recent years in the housing sector. Furthermore, several emerging economies show current-account deficits larger than their historical averages.

The current context raises the likelihood that financial conditions for Latin America and Chile will worsen further[2]/. The central scenario of this Report anticipates a faster pace of monetary normalization by the Fed than implicit in market prices, and also considers a sensitivity scenario where higher inflationary pressures could accelerate the process even more. In the past, these episodes have triggered significant capital outflows from the region, causing debt sustainability problems and economic recessions[3]/. In addition, several international mitigating factors for other episodes would be absent: the dollar has appreciated, long-term interest rates are on the rise, the business cycle is entering a phase of slower expansion, the outlook for China has worsened, and there are risks that the prices of some commodities, such as copper, may fall due to greater global weakness[4]/. In Chile, monetary and fiscal policy buffers have tightened given the current inflationary context, while the withdrawals from pension funds have reduced their capacity to mitigate a potential outflow of capital from non-residents[5]/.

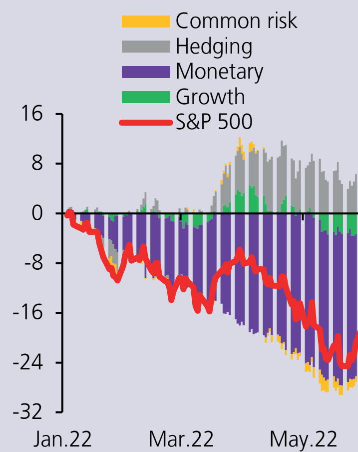
[1]/ Case, Quigley and Shiller (2013); Sousa (2009); Alfaro and Sagner (2021).
[2]/ This was recognized as one of the key elements shaping the external scenario in the recently published Financial Stability Report, first half 2022
[3]/ See Rey and Miranda Agrippino (2022); Miranda-Agrippino and Nenova (2022).
[4]/ Box I.1 in March 2017 Report.
[5]/ Financial Stability Report, first half 2022.

FIGURE I.19 PRICE TO EARNINGS RATIO, S&P DECOMPOSITION, AND HOUSING PRICES

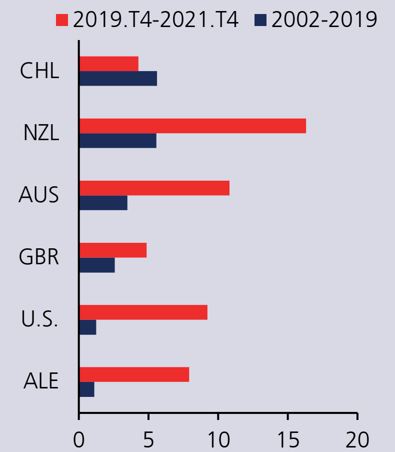
a. Price/earnings ratio expected 12 months out (2006-2019 average =100)



b. Decomposition of cumulative changes in S&P 500 (*) (percentage points)



c. Average growth real housing prices (percentage points)

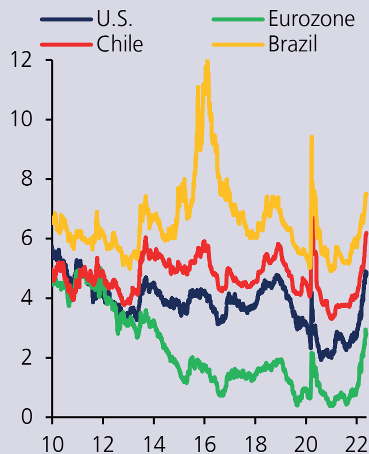


(*) The model decomposes the common movements of the 2-, 5- and 10-year rates and the stock index, by identifying the different effects according to the coefficients' relative sizes and signs (Cieslak and Pang, 2019). The rates used are from the zero-coupon swaps.

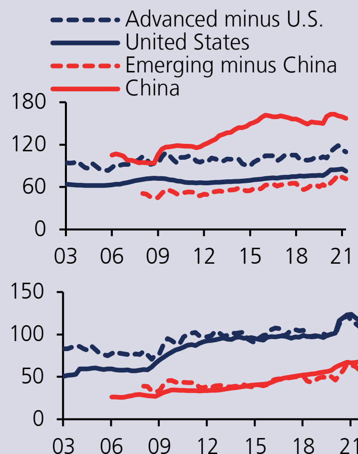
Sources: Central Bank of Chile, Bank for International Settlements, and Bloomberg.

FIGURE I.20 SOVEREIGN AND CORPORATE BOND RATES AND DEBT LEVELS

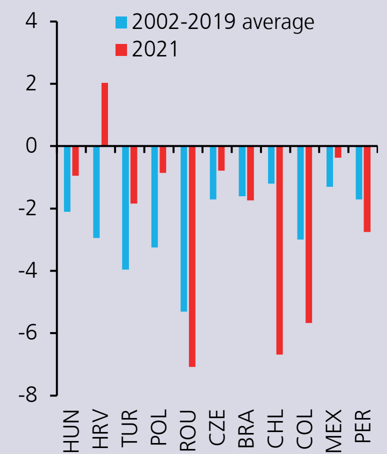
a. Corporate bond rates (U.S. and Eurozone; BBB rating; Chile and Brazil; Cembi indexes; percentage points)



b. Non-financial corporate debt (upper panel) and sovereing debt (lower panel) (percent of GDP)



c. Current account as percent of GDP (*) (percentage points)



(*) The 2021 figure for Hungary, Croatia, Romania, Czech Republic and Brazil is obtained from the IMF estimate for that year.
Sources: Bank for International Settlements, Bloomberg, and International Monetary Fund.