Chile All Ways Surprising

Chile INVESTMENT REVIEW

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CHILE'S BACHELET VOWS MORE SPENDING TO FIGHT ECONOMIC DOWNTURN

Chile will use public spending on 2009 to offset the effects of the global economic slowdown and to help fight unemployment, President Michelle Bachelet said.

The country can afford to spend on stabilizing the economy because it saved as copper soared, Bachelet said. The government had US$22 billion in offshore funds at the end of November.

Chile's Central Bank last month revised its forecast for growth on 2009 to less than 3 percent from as much as 4.5 percent as the price of copper, the country's principal export, slumped 68 percent from its July record. The worst financial crisis since the Great Depression will slow Latin American growth to its lowest in five years next year, increasing the threat of social unrest, the United Nations's economic research unit for the region said this month.

"My government will use all the tools available to mitigate the consequences of the crisis and, above all, to moderate the effects on employment," Bachelet wrote in an article on the government's Web site.

Chile's economy will grow modestly in 2009, she said. Industrial output shrank 5.7 percent in November, the National Statistics Institute said yesterday, its steepest decline since Chile's 1999 recession.

"When unemployment becomes a threat and the country is affected by declining external demand, public investment becomes enormously important to inject dynamism into the economy. That is what we will do in 2009," she said.

Bachelet promised improvements in education, health and public transport.

Bloomberg, January 2

CHILE UNVEILS US$4 BILLION ANTI-CRISIS STIMULUS PACKAGE

Chilean President Michelle Bachelet announced a US$4 billion stimulus package aimed at fending off global financial crisis by beefing up public spending on infrastructure and providing subsidies and tax rebates.

Bachelet said the plan aimed to underpin growth of 2.0 percent to 3.0 percent this year, adding public spending would rise 10.7 percent in 2009 in real terms and translate into an implied effective fiscal deficit of 2.9 percent of gross domestic product.

"Facing this crisis will be the number one priority of my government this year," Bachelet said in a televised national address, just hours after data showed Chile's economic growth fell to its slowest monthly pace in nearly 7 years in November as the global crisis bit.

She said the plan also included a US$1 billion capitalization for state copper giant Codelco, the world's No.1 producer, to help shore up its investment plans. The stimulus package will be funded from copper windfall earnings saved in sovereign wealth funds as well as via bond issuance, she said.

Bachelet said the plan aimed to create 100,000 jobs, would increase public spending by nearly US$1.5 billion, with US$700 million of that destined for public works projects and would include handouts for the most vulnerable families as well as a temporary cancellation of stamp duty.

The package also would lower employer contributions for small- and medium-sized companies, include income tax rebates and would deprive the government of around US$1.5 billion in fiscal income, Bachelet said.

The stimulus package comes after the government unveiled a separate US$1.15 billion package of measures in November 2008 to spur lending to middle income families and small and medium-sized businesses to help shield them from global financial turmoil.

But while Chile is seen better placed than most of its Latin American neighbors to cope with the crisis because of its debt profile, a cushion of around US$21 billion worth of copper boom savings in sovereign wealth funds and a similar amount of

Central Bank reserves, it is not immune. Chile's economic activity index, the IMACEC, rose a slower-than-expected 0.1 percent in November compared with a year earlier, when it climbed 4.4 percent, reinforcing expectations of a cut in official interest rates this week as the global crisis spreads.

Industrial production sank a bigger-than-expected 5.7 percent in November from a year earlier to its lowest level in nearly a decade. Copper output tumbled in November for a third consecutive month, falling 6.4 percent.

In November the Central Bank cut its 2009 growth estimate to between 2.0 percent and 3.0 percent, compared with a forecast in September for growth between 3.5 percent and 4.5 percent, citing the spiraling global financial crisis and plunging prices for copper.

Reuters, January 5

CHILE FINMIN SAYS NO RECESSION SEEN IN 2009-REPORT

Chile's Finance Minister said the economy should not enter in a recession in 2009 thanks to government moves to ease the impact of a global downturn, an interview published in daily El Mercurio.

Minister Andrés Velasco told the newspaper he did not expect gross domestic product to fall in two consecutive quarters of this year, which would technically constitute a recession.

"We do not have data that suggests the Chilean economy will be in that situation," Velasco was quoted as saying.

Earlier this week, the government announced a US$4 billion economic stimulus plan to spur employment and growth despite the global financial crisis, aiming for an expansion of between 2 percent and 3 percent of GDP this year. The country's Central Bank also moved this week to jump-start the economy by slashing its target overnight lending rate by 100 basis points to 7.25 percent, making its biggest interest rate cut in more than 10 years.

Nonetheless, analysts are less optimistic than the government, forecasting 2009 economic growth at a median of 1.5 percent, down from a previous estimate of 2.0 percent.

Analysts have predicted 2008 growth of around 4 percent.

Reuters, January 10

CHILE'S FALABELLA PARTNERS WITH RIVAL RIPLEY

Falabella, one of Latin America's top diversified retailers, said it has agreed to develop new shopping malls with smaller rival Ripley Corp in the increasingly competitive Chilean market.

The agreement will see Falabella associate with Ripley through the former's Mall Plaza chain of shopping malls -- the nation's largest -- and its smaller unit, Nuevos Desarrollos.

Ripley is to take a 22.5 percent stake in Nuevos Desarrollos, controlled by Falabella, for about US$28 million.

"Falabella, Ripley Corp. and Nuevos Desarrollos have signed an association agreement to develop together the business of building, acquiring, administering, developing and running new commercial centers in Chile, as well as those that are already operating," Falabella said in a statement.

The two retailers have already worked together under a similar association in the less developed Peruvian market since 2007.

Other major Chilean mall operators include Parque Arauco and retailer Cencosud. The agreement comes three weeks after No. 1 global retailer Wal-Mart Stores Inc started a tender offer for Chile's largest supermarket chain D&S, marking what markets are touting as the next era in Chilean retail.

The merger, which followed a failed bid by Falabella to acquire D&S, is seen maturing the local market and driving retail competition in the Southern Cone.

Retailers have been among the biggest winners of Chile's booming economic growth in recent years that helped them turn into regional giants in the southern South America.

Ripley has operations in Chile and Peru and plans to enter the Mexican market with partner Palacio de Hierro this year.

Falabella chains include department stores, home improvement stores, supermarkets and consumer banks.

Reuters, January 10

LESSONS FROM AMERICA FOR THE US FINANCIAL CRISIS?: THE CASE OF CHILE

By Daniel Kaufmann, Director Global Programs and Governance, World Bank Institute

Forbes Magazine invited me to write an article on corruption. Among others, I argue that the US financial crisis is a major and overdue wake-up call to the dormant anticorruption field, which for too long has focused on conventional second-order issues. I also suggest that some humility could help: for a change, lessons from an emerging economy could be useful to the current situation in the US. We know that the experience of Sweden in addressing their past financial crisis offers some insights.

But it is also important to draw on the lessons from other countries. Let us focus on Chile, another country in the Americas (the era of equating the US with America should be over anyway). I am getting questions about the parallels and insights from Chile for the US crisis. Let me bring up a few points here, with some more detail than in Forbes.

To address the US financial crisis, two huge financial rescue packages are currently proceeding in parallel: the bailout of the financial system, and the fiscal stimulus package. They may soon reach close to a trillion dollars each. In the case of the bailout, Chile offers insights on both how the financial crisis was addressed. For the fiscal stimulus, Chile also provides lessons on how to improve the efficiency and probity of public investment programs. And there are also common challenges in terms of how to address capture by private vested interests (also addressed in the Forbes article]. The focus here is on the first set of lessons (financial); possible insights related to the fiscal stimulus for infrastructure, as well as the politics of capture, will be addressed in future entries.

Almost twenty years ago, Chile experienced a major banking crisis, covering the period between 1981 and 1984. The short-term costs of resolving the financial crisis at the time were very high. Studying how the US may strive to end up with lower costs may be warranted, although it is already apparent that the costs in the US are likely to be very high as well.

High costs in resolving the crisis is one likely common characteristic, but far from the only one. Another one is in some of the causes of the crisis. In particular in the following: i) dogmatic and reckless financial deregulation for years prior to the crisis; ii) macro-economic mismanagement (in the Chilean case through a subpar exchange rate regime, in the US case with macro-imbalances, fiscal irresponsibility); iii) incentive structure favoring a highly risky over-reliance on debt by corporate, and, iv) private vested interests unduly influencing the regulatory and policy regime.

In spite of all the negatives that contributed to the crisis in Chile, the shock spurred concerted action, mostly carried out rather effectively. In brief, the positive lessons from Chile in addressing the financial crisis include the following:

First, the sounder short and medium term macro-economic management. This included sounder exchange rate management, prudent fiscal policies to limit deficits, and tax reforms that provided incentives to increasingly rely on equity rather than debt.

Second, the quick and effective micro-interventions of the Central Bank in the banking sector to restore confidence in the financial markets. This included a decisive restructuring of corporate and household loans, the sale or liquidation of insolvent financial institutions, the temporary purchase of non-performing loans from troubled yet viable banks and the provision of secured loans by the public sector to such troubled banks.

Indeed, troubled yet viable banks sold their toxic loans to the Central Bank. They were required to repurchase these nonperforming loans once loss provisions could be made. These banks were banned from distribution of profits until these loans were retired and they returned to financial health. And in providing secured loans to troubled financial institutions, so to help them recapitalize, the Chilean government used the bank's own assets as collateral. The government was a subordinated creditor, which facilitated attracting fresh private capital into the banks.

Third, revamp of the institutional prudential supervision and regulatory institutional framework. Actually, perhaps more apt would be to depiction what Chile did as the creation of a prudential supervision and regulatory institutional infrastructure, since prior to the crisis such infrastructure had become largely inexistent. De facto, Chile did not even have a Securities and Exchange Commission (SEC in the US). It is from the ashes of such a financial debacle that a serious regulatory institution emerges (Superintendencia de Valores y Seguros, or SVS), one which to this day is very effective and highly respected. Further, the major overhaul in the oversight, disclosure and prudential regulatory requirements undertaken by Chile are also worth study for the current case of the US.

Much is being debated in the US today as to whether it is essential to create a 'bad bank' or not. Chile did create one. This does not imply that the US shouldn't, since despite similarities there are also differences between both cases (e.g. the absolute magnitude and global scope of the financial crisis, and the diversity, sophistication and obscurity of financial products and institutions). The point is that beyond very specific questions about what to do regarding one institution, such as the 'bad bank', the focus on an integrated strategy with broad-based policies (such as the macro and institutional stance with major implications for the Fed, Treasury, SEC and others), is paramount. If those broader fundamentals are not addressed correctly, no amount of fine-tuning of a 'bad bank' will do.

Having derived the lessons from the financial crisis of the early 1980s, and subsequent prudent macro-economic and financial management, Chile's financial sector does not need a 'bailout' today. Yet a stimulus package for the real economy is warranted, given that the effects of the global economy slowdown. Such stimulus package has been prepared already; there are insights to be derived from it for other countries as well.

Further, there are also important lessons, relevant for the US, as to how to improve the effectiveness and transparency in infrastructure projects. I will discuss these in another blog entry, including the political dimension as well: how to reduce the likelihood of capture by vested interests (privates, lobbyists) of the proceeds from the bailout and stimulus package, or unduly benefiting by differential treatment from the regulatory framework.

Governance Matters, February 5

CHILE CENBANK SLICES RATE BY 250 BPS TO 4.75 PCT

Chile's Central Bank slashed its benchmark interest rate by a much bigger-than-expected 250 basis points to 4.75 percent on Thursday, and signaled further cuts as it fights the specter of recession amid global crisis.

The bank said it was the deepest cut since comparative records began in 1995 and that it would likely continue to relax monetary policy.

"This really points to, I believe, a deep fear of deflation and recession and the need to coordinate this with fiscal stimulus as soon as possible," said David Duarte, an analyst at 4CAST in New York.

"I think the biggest challenge for them is that by doing 250, they have to be willing to do 250 again, or something nearly as aggressive, and in that scenario then we are looking at definitely a sub-three percent scenario as early as March," he added.

One hundred basis points equals one percentage point.

Fourteen of 26 traders and economists polled by Reuters this week had predicted the bank would cut the rate by 100 basis points, while six had expected a 150 basis-point cut. Forecasts ranged from a 75 basis-point cut to a 200 basis-point reduction.

"This decision is based within the framework of a significant fall in inflation, and heralds the monetary policy rate converging in line with the current macroeconomic environment and its risks," the Central Bank said in a statement.

Reuters, February 13

CHILE WITH WORLD BANK SUPPORT TURNS TO WIND ENERGY

The Totoral Wind Farm, situated 300 kilometers north of Santiago, will consist of 23 two-megawatt Vestas wind turbines. The project is expected to generate an average of 110 gigawatt hours per year of electricity for the Chilean central grid, relieving the significant supply constraints the country is experiencing.

The WB International Finance Corporation will invest US$30.75 million for its own account and syndicate US$30.75 million, to be funded by DnB NOR, the leading Norwegian financial services firm. The project developer is Norvind S.A., a special-purpose vehicle set up by the project sponsors, Statkraft Norfund Power Invest A.S, the Norwegian power developer, and its Chilean partner, Centinela. Centinela, controlled by the Pavez family, is an investment company with interests in a wide range of industries.

The Totoral Wind Farm is expected to be one of the largest operating wind farms in Chile when it is completed in 2009. It will also be the first renewable energy project to be financed under Chile's new "Non-Conventional Renewable Energy Law," which was passed in March 2008.

IFC is supporting the government of Chile's objectives of rapidly increasing and diversifying its energy supply. In the past five years, IFC has invested over US$290 million in five projects with a focus on supporting the expansion of the country's traditional energy sources such as hydro, as well as less traditional energy sources such as wind.

Merco Press, February 16

ENDESA CHILE TO INVEST US$24 MLN IN SMALL HYDRO PLANT

Endesa Chile, the nation's leading electricity generator, said on Tuesday it planned to build a small hydroelectric plant in the south at a cost of some US$24 million.

Endesa said it had submitted its environmental plan to authorities for the plant, to be known as Piruquina and with installed capacity of 7.6 megawatts.

The plant will be located in the province of Chiloe, some 1,100 km (684 miles) south of the capital Santiago.

Endesa Chile is a unit of Chile-based regional energy group Enersis, in turn the Latin America investment arm of Spain's Endesa.

The following are excerpts from Wall Street Investment banks' reports on Chile:

From Santander Investment, Inside Latin America 1Q09 - Hostage to Global Growth, January 2,, 2009.

RAZOR'S EDGE

POSITIVES

· Chile's solid financial position should allow the Ministry of Finance and the Central Bank to implement measures to deal with the direct effects of low liquidity and limited access to international credit. In addition, the government has room to implement a countercyclical fiscal impulse, supporting private consumption and investment.

· Inflation may no longer be a problem for the Chilean economy, as the international scenario and wider capacity gaps could imply a rapid curbing of the annual CPI inflation in 2009. We expect annual inflation to decrease to 3.4% in December 2009 after finishing 2008 near 8.0%.

NEGATIVES

· We expect both the export sector and internal demand to be significantly affected by the financial crisis. We highlight several negative effects for the Chilean economy: (1) lower demand for Chilean export goods and services, (2) a rise in financing costs, (3) a negative impact on both investor and consumer confidence, (4) a rise in unemployment, and (5) a current account deficit around 3.0% of GDP in 2009.

· We expect GDP growth to decelerate in 2009, when we see GDP growing at 1.5%. Moreover, we see downward risks to our output estimate as a result of the worst international scenario in the last several years. We expect flat internal demand in 2009 as a result of a sharp adjustment of investment and a modest growth of private consumption.

PROSPECTS

Economic growth - Our base scenario considers GDP growth of 1.5% in 2009, reflecting the impact of the international crisis on internal demand and the export sector. Moreover, we see downward risks to our output estimate owing to further developments in the international scenario.

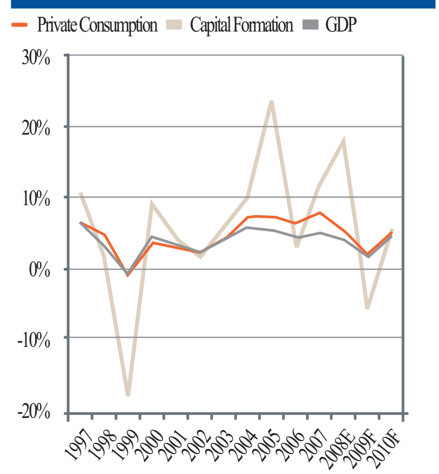
While the impact and the full extent of the current crisis are undetermined, and bearing in mind Chile's very solid financial position, we note three clearly negative effects for the Chilean economy owing to the worst external scenario in several years: (1) lower demand for Chilean export goods and services, (2) a rise in financing costs, and (3) a negative impact on both investor and consumer confidence.

Therefore, our base scenario includes average GDP growth of 1.7% in 2009 in a range from 1.2%-1.8%. Thus, we see some downside risks to our output estimate from the international scenario, which could add pressure to the dynamism of Chilean export volumes and to internal demand. We expect internal expenditures to grow less than GDP for the first time since 2003, approaching 0% and implying a capacity gap that could help to curb inflation in 2009.

Concerning the impact of the financial crisis on internal demand, our first impression is that it will enhance the Central Bank monetary tightening process in effect in the second half of 2008, as the international crisis has meant lower supply and demand for credit. We expect some tightening of credit access for both consumers and companies as financial institutions restrict risk exposure, in addition to lower demand for credit because of the deterioration of economic expectations.

We estimate the impact of the monetary tightening has a lagged effect of about two to three quarters over internal demand, so we anticipate negative pressure on the local economy in the first half of 2009. Nevertheless, we expect the Central Bank to reverse the monetary policy rapidly in 2009, which could imply Inside Latin America - January 2, 2009 that the interest rate would finish the year at 5.5% or even lower. Thus, we expect the monetary impulse to support an upturn of internal demand in late 2009 and mid-2010.

We expect national accounts to worsen in 2009 due to the international crisis



Source: Central Bank and Santander estimates.

On the expenditures side, we expect private consumption to remain relatively healthy, but decelerating strongly compared with 2008. Although private consumption has been one of the most stable variables in the Chilean economy since 2004, reflecting the transition toward a high-middle income country, we expect it to decelerate in 2009, growing at 2.0% compared with the average of 6.8% between 2004 and 2008, mostly owing to the negative impact of (1) lower real disposable income due to high inflation in 2008, (2) restrictive financial conditions due to the increase in interest rates and stricter risk management, (3) lower consumer confidence as a result of the deceleration of economic growth and the news coming from the international crisis, (4) a flat labor creation rate and an increase in unemployment due to the slowdown of activity.

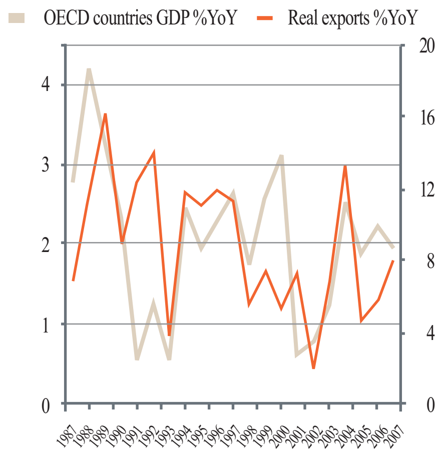
Among the factors that could offset these negative issues, we highlight a decrease in inflation, which could allow a recovery in real salaries in 2009, implying that real payroll could show positive growth rates despite flat employment creation. In addition, we expect consumption to be supported by a rise in permanent income, explained by an increase in so-called "top quality" employment (top quality because it is linked to a formal employment contract). The wage-earning component of employment grew at 5.7% in 2008. Nevertheless, in 2009 we expect up to 200,000 fewer formal job positions as a result of the diminished dynamism of the economy.

In addition, the fiscal sector should play a role in supporting private consumption, mostly through transfers and subsidies to consumers. In this regard, the 2009 government budget assumes a 5.7% real spending increase, and about 70% of the fiscal budget is social spending, which ends up as consumption spending in the private sector.

We expect investment to decrease 5.7% in 2009 compared with its strong performance in 2008, when we estimate capital formation grew 18%, mainly explained by investment in electricity and mining projects. This year we see a strong decrease in spending on machinery, as important mining and electricity projects ended their building phase, which contributed to a strong comparison base (this variable grew nearly 25% in 2008). In addition, investment is the macroeconomic variable that is most sensitive to the increase in interest rates, and the international crisis has negatively affected the confidence of investors and businesses. Thus, we expect the delay of some investment projects in addition to a weak performance by the real estate sector.

The export sector could be the most affected by the international slowdown. At current prices copper exports represent about 60% of the total, but volume growth has been driven by non-commodities items such as wine, processed food, salmon, wood products, etc. In fact, while mining production has grown by 0.7% annually since 2005, real exports have increased by 5.1%. Therefore, as most of these non-commodities products are sold in high-income countries (50% of Chilean exports go to the U.S., Europe, or Japan), a recession in the industrialized economies could prompt a significant impact on demand for Chilean exports. Thus, we expect exports to decrease by 3.5% in real terms in 2009. However, we also expect imports to decrease in real terms (-5.1%), as the local demand for machinery and durable goods, which are mainly imported, could decrease strongly this year, as we anticipate that both components will be strongly affected by the decline in investment and the slowdown of private consumption.

Exports growth in real terms shows a high correlation with GDP growth in developed countries



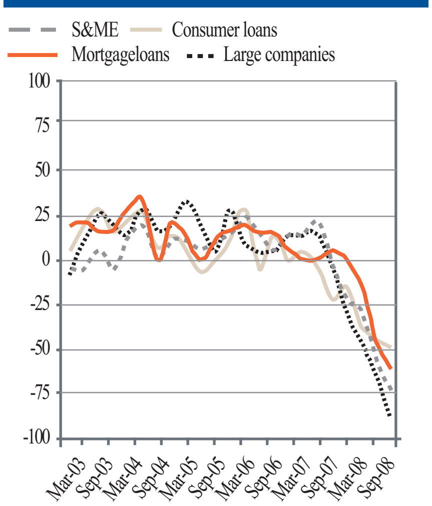
Source: OECD, Central Bank and Santander.

Internal financing - We expect the international credit crisis to affect the local financial system indirectly, mainly through a rise in funding cost and an increase in risk aversion. In addition, although we anticipate a loosening of monetary policy in 2009, we expect restrictive financial conditions for the Chilean economy next year.

Even though no Chilean financial institution has exposure to toxic assets, we expect the financial crisis to indirectly affect local financial conditions. The Central Bank's quarterly survey of credit conditions points to an acceleration in the slowdown of loan growth in Chile. The last three surveys published have shown consistently lower rates of credit approval (as a percentage of loan applications). Moreover, credit approval conditions have deteriorated across the board, affecting virtually all sectors of the economy with higher rates and/or tighter covenants but also shorter loan terms, smaller credit lines, and higher spreads related to the increase in risk perception. We believe that the international credit crunch, explained by an increase in risk aversion, is leading to a significant deceleration in credit supply, and we now expect slower volume growth for the system. In addition, there could be an increase in the funding cost of banks, as about 8.5% of the system's funding was obtained internationally. Thus, we expect this source of funding to see an increase in costs or limited availability.

We also expect lower demand for credit, as the worsening of economic expectations could prompt a delay of investment projects, and consumers could want to reduce their personal debt owing to the deterioration of the economic scenario, which affects the employment outlook.

The Central Bank's survey of credit conditions points to restrictive credit supply



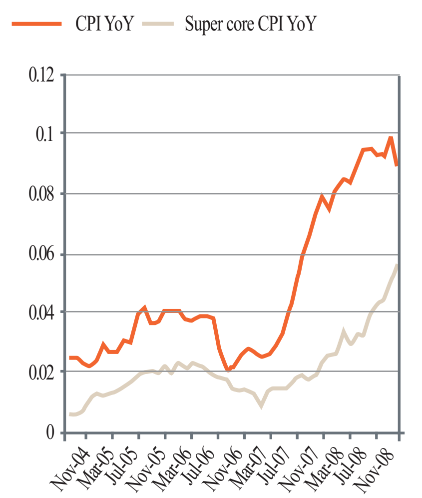
Source: OECD, Central Bank and Santander.

Monetary policy and inflation - We expect inflation to decrease rapidly in 2009 owing to lower inflation pressures from the international scenario, with wider capacity gaps driving inflation down to 3.4% annually in December 2009. In line with this trend, we expect the Central Bank to decrease the reference interest rate 275 bps in 2009, finishing the year at 5.5%, if not lower.

If we want to find any positive news coming from the international crisis, we should look to inflation. The international scenario has prompted a precipitous fall in commodities prices relevant to local inflation (especially oil and food-related commodities). In addition, the slowdown of internal demand could imply wider capacity gaps, meaning lower inflation pressures in the mid-term.

Given the worsening of the international scenario, which could prompt a sharp slowdown of internal demand, we expect inflation to be curbed in 2009, making it no longer the main problem of the Chilean economy, as it was in most of 2008.

Yearly inflation could decrease rapidly due the fall of oil and other external prices



Source: National Institute of Statistics and Santander.

We expect zero inflation pressures from the international scenario, owing to the slide in commodities prices relevant to local inflation (especially oil and food-related commodities), partly offset by the depreciation of the Chilean peso. The new CPI basket in effect starting February 2009 enhances the relevance of imported goods for the CPI. Thus, even though we expect lower international prices, fluctuations of the Chilean peso could imply added volatility in the CPI. Meanwhile, the slowdown of economic activity could imply a wider capacity gap that should help curb inflation in 2009 by controlling second-round effects. The propagation of inflation can be controlled by worsening credit conditions, as it directly affects the possibility of passing high costs or increasing margins through to prices, due to the slowdown of demand. In fact, we expect internal demand to remain flat in 2009, implying a growth rate lower than that of GDP for the first time since 2003. In addition, we expect the slowdown of the activity to moderate labor market pressures, as the increase in unemployment could limit the expected rise in salaries owing to indexation to past inflation. Thus, we expect a sharp reduction in annual inflation starting in April, which could imply that annual inflation in the CPI will reach close to 6% in that month, after finishing 2008 around 8%. We expect a year -end figure well below 4%, the top end of the Central Bank comfort zone, at 3.4%.

Among the risks to our base scenario, we highlight the following:

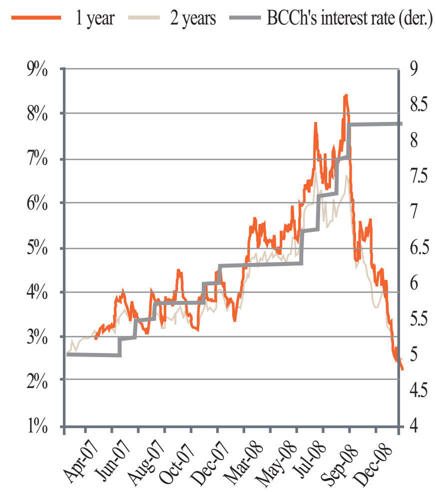
· **Weak economic activity.** Our base scenario assumes that the slowdown will help to curb inflation. Nevertheless, as the full impact of the international crisis is unclear, we do not rule out different scenarios that could imply wider-than-expected capacity gaps.

· **Oil and food prices.** The volatility in commodities prices could persist in the next few months. However, our base scenario considers an average oil price of US$53 per barrel in 2009. Therefore, if current prices of around US$40-45 per barrel persist, there could be a downward risk to our estimates. We expect food prices to be flat in 2009 owing to the decline in international food prices, after increasing by 10% in 2008.

Movements of the Chilean peso. The new CPI basket could show less resilience to changes in the exchange rate, because it increases the weight of imported goods in the basket. As a consequence, the new CPI basket shows a lower level of indexation to past inflation. In addition, the main indexed items (particularly basic services) have a reduced weight as a consequence of their "primary good" nature. In other words, the 2007 basket for the CPI represents a higher income basket compared to the old 1998 basket, as imported goods gained importance.

Inflation expectations in the medium term have decreased significantly in the last month, reaching levels below 3% in the 12- to 24-month horizon. In our view, the disappearance of second-round effects in late 2009 and wider capacity gaps could imply yearly CPI inflation rates lower than 3% in some periods of 2010. Thus, in addition to the uncertainty of the impact on the local economy of the international scenario, we expect the Central Bank to reduce the reference interest rate strongly in 2009, as its inflation target is 3.0%. Therefore, the monetary authority could act to prevent a scenario of low inflation, low economic dynamism, and high interest rates. Consequently, we expect the BCCh to reduce the reference interest rate by 275 bps in 2009, reaching 5.5% in December. We expect this process to start in January, as we believe the Central Bank could anticipate a further downward correction in inflation expectations due to the low activity level and the strong deceleration of inflation we expect for the first half of 2008.

Inflation expectations have decreased in recent months



Source: Bloomberg and Santander.

Fiscal policy - The proper execution of the 2009 fiscal budget plays an important role in our expectations for GDP growth. We see government spending supporting private consumption and investment, in addition to limiting unemployment through labor programs.

The government's sound cash position (sovereign wealth funds could rise to US$30 billion in 2009) allows the government to implement a countercyclical fiscal impulse, supporting private consumption and investment. The budget law considered a real increase of 5.7% in 2009. In our view, the fiscal budget is in line with the commitment of the government to controlling inflation, in addition to providing funding for programs focused on supporting the economy, as about 70% of the fiscal budget is related to social spending. Recall that under the policy of achieving a structural fiscal surplus of 0.5% of GDP, the government calculates its expenditures considering structural revenues, which are related to the "potential" GDP growth, estimated at 4.9%, and the long-term copper price of US$1.99 per pound. Therefore, fiscal expenditures are isolated from fluctuations in copper prices, allowing the government to apply countercyclical policies and diminishing GDP growth volatility.

We expect social spending to increase by 7.8% in 2009. Thus, we see public spending creating a positive demand shock to counter declines in private consumption spending. Note that US$500 million has been set aside to fund new benefits originated by the pension system reform, and the education budget has been increased by US$450 million. Meanwhile, it's worth considering the multiplier effect that certain government expenditures have on the economy, such as those for construction, public works, and infrastructure projects.

Finally, we estimate a fiscal deficit in 2009 of 0.1% of GDP, given that we expect the copper price to be below the US$1.99 estimate used in the fiscal budget, meaning actual copper-related revenues could be below projected levels. In addition, as GDP growth would be below potential, structural tax revenues could also be below the estimates used in the fiscal law. Nevertheless, government financial needs are zero, given the strong financial position of the Chilean government. Therefore, we expect the government to finance its deficit through withdrawals from the sovereign wealth funds.

Trade balance and current account - We expect Chilean external accounts to deteriorate because of the international scenario. We are forecasting an US$2.0 billion trade surplus in 2009, below our estimate of US$10.0 billion in 2008, due to the deterioration of the terms of trade. The current account should show a deficit in both 2008 and 2009, after four years of being in surplus.

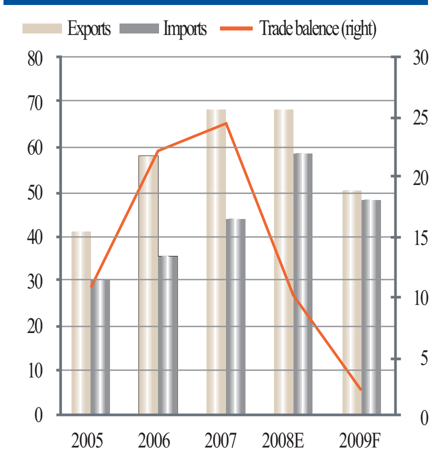
Recall that one of the direct negative effects of the international crisis on the Chilean economy is a lower demand for Chilean export goods and services. Our baseline scenario indicates that the trade balance surplus will narrow sharply in 2009, reaching US$2 billion compared with US$10 billion in 2008. The export sector could be the most affected by the international slowdown. In addition to the expected decrease in the value of copper exports, volume growth has been driven by non-commodities items such as wine, processed food, salmon, wood products, etc. In fact, while mining production has grown by 0.7% yearly since 2005, real exports have increased by 5.1%. Most of these non-commodities products are sold in high-income countries (50% of Chilean exports go to the U.S., Europe, or Japan), so a recession in the industrialized economies could have a significant impact on demand for Chilean exports.

Despite the above mentioned relevance of non-copper exports when analyzing real exports growth, in nominal terms, copper shipments represent about 60% of the total. Therefore, as we estimate a copper price of US$1.70 per pound in 2009, down 45% y/y, we expect mining exports to diminish 43% y/y, reaching US$22.8 billion. We expect industrial exports to reach US$21.2 billion in 2009, roughly flat from the US$21.4 billion estimated for 2008, explained by the positive impact of the weakening of the Chilean peso, in addition to a favorable comparative base. However, this performance looks quite weak considering that industrial exports have been growing by an average of 17% since 2004. Consequently, we estimate exports at US$50.1 billion in 2009, down 26.8% y/y.

We expect imports to decrease in 2009 as a result of the slowdown of internal demand (which could imply lower demand for durable goods and for machinery and equipment) in addition to a lower average oil price, which we estimate at US$53 per barrel, down 46% yearly. By components, we expect intermediate goods imports (which include oil and its derivatives) to reach US$29 billion, down 23% y/y. In addition, we expect capital goods imports to decrease 25%, after rising close to 32% in 2008, due to the sharp deceleration of investment. Finally, we expect consumer goods imports to be flat in 2009, which represents a significant slowdown from the 25% growth we estimate for 2008, due to the deceleration of private consumption, most likely led by durable goods, which are mainly imported. We see imports at US$48.1 billion this year, down 18% y/y owing to the deceleration of international demand.

We expect the current account to show a deficit in 2008 and 2009, after four years of surplus. The deterioration of the trade balance could also imply a current account deficit in 2008 and 2009, reaching levels of 3.0% and 3.7% of GDP, respectively. In this regard, we expect the narrowing of the trade balance surplus to be offset by a fall of 36% in remittances in 2009, as a result of lower remittances by foreign-owned copper companies.

Trade balance could narrow sharply in 2009



Source: Central Bank and Santander estimates. In billions of USD.

External financing - Despite the expected deterioration of external accounts, Chile's financial position is very solid, with the sum of international reserves and the sovereign wealth funds at about US$48 billion (26% of GDP) as of October 2008. The consolidated public sector has no net financial needs, and has a consolidated creditor position of 14.4% of GDP as of 2008. In this scenario, we think it is very unlikely that we will see any external issuance of central government debt in 2009. Nevertheless, we expect the international financial crisis to limit external issuance by Chilean companies.

At first glance, the consolidated public sector appears to have no financial needs despite an expected fiscal deficit in 2009. Sovereign wealth funds amounted to about US$30 billion as of 2008, and the central government and the Central Bank have a consolidated creditor position of 14.4% of GDP as of 2008. We expect the government to finance any fiscal deficit in 2009 by using the resources allocated in the sovereign funds. Moreover, we believe the minister of Finance could add liquidity in dollars to the local market by allocating some of these resources internally.

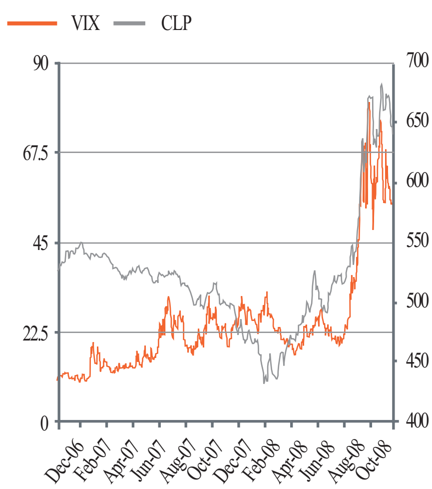
Looking to the medium and long term it is also unlikely that we will see any external debt issuance due to the strong fiscal assets accumulation. In this regard, the fiscal structural surplus rule supports the idea that Chile will have no financial needs in the long term.

With regard to corporate issuance, we expect credit conditions for issuance overseas to worsen as a direct result of the financial crisis. Therefore, we could see Chilean companies financing their dollar needs locally instead of issuing bonds internationally.

Currency - The recent strong depreciation is explained by the deterioration of both fundamentals and financial conditions. We believe in the medium term the Chilean peso could strengthen owing to the trend of the U.S. dollar internationally, the attractive interest rate differential between Chile and the U.S., and expectations of an upturn in the internal activity in late 2009.

Like other currencies (both emerging and developed), the Chilean peso has depreciated in recent weeks as a result of the lack of liquidity, lower flows due to increasing risk aversion, and the fact that the U.S. currency is still seen as a safe haven. However, setting aside the recent volatility, we expect the Chilean currency to strengthen in the medium term.

The Chilean peso has depreciated, pushed by worsening financial conditions



Source: Bloomberg and Santander.

We believe the U.S. dollar could lose some value internationally in 2009. Based on fundamentals, we expect both the zero interest rate policy and the rescue programs to generate increasing inflation prospects for the U.S. economy in late 2009 and 2010. Therefore, the U.S. dollar could depreciate in real terms in 2009, anticipating this scenario. This picture could also help the U.S economy by increasing the competitiveness of its exports and reducing the net debt in real terms.

In addition, although we expect the Central Bank to cut the reference interest rate at least 275 bps in 2009, consensus points to a zero interest rate policy for the U.S., implying an interest rate differential of 550 bps by the end of 2009. We expect positive flows as a result of this situation.

Finally, we expect these factors to be partly offset by the deterioration of Chile's external accounts. We expect lower demand for Chilean goods and the sharp fall in commodities prices (especially copper and pulp) to imply a narrowing of the trade balance, despite the adjustment of imports on the back of the deceleration of internal demand. We believe this scenario will result in a current account deficit at 3% and 4% of GDP in 2008 and 2009, respectively. Although we believe this current account deficit does not affect Chile's strong financial position, this clearly implies some depreciation pressure on the peso.

Employment and labor market trends - We expect the labor market to be less positive in 2009 after posting a sound performance in 2008. Fiscal employment programs and a moderation of labor force growth could imply an unemployment rate of 9.8% in 2009.

In 2008 the labor market posted sound numbers. We estimate that the labor creation rate averaged 3.0%, with the labor force expanding 4%. However, we expect the slowdown of local activity to imply a flat job creation rate in 2009. Two of the main economic sectors that are responsible for job creation (construction and financial services) could decelerate strongly owing to the fall in investment and a lower supply of credit. In addition, we expect a flat labor force growth rate owing to its high expansion in 2008. Therefore, we expect an unemployment rate of 9.8% in 2009. We believe higher unemployment rates could drive higher intervention by the public sector through employment programs and hiring subsidies.

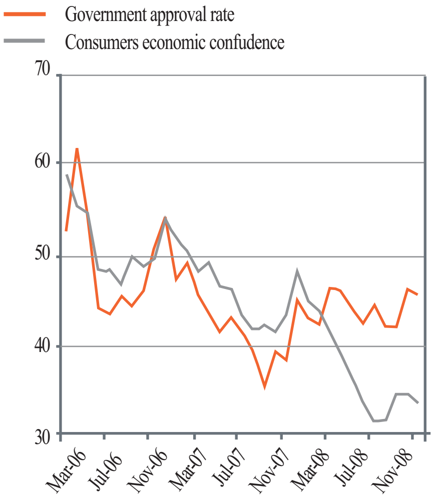
By sectors, we expect construction and commerce to be hit by the slowdown of internal demand, implying fewer job positions in both areas. In contrast, we expect fiscal programs to double participants, partly offsetting the impact on unemployment.

Nevertheless, because some wages are indexed to past inflation, together with its expected fall in 2009, we expect real wages to increase in a significant way in 2009, reaching 2.9%, despite the rise in unemployment, pushing a positive growth rate of real payroll, which could expand at 3.5%. However, we do not rule out lower growth rates due to the slowdown of internal demand.

Politics - Although there will be a presidential election in 2009, we believe the economic agenda could increase its importance, as economic concerns, especially related to the employment outlook, remain a very important focus of popular attention.

There will be a presidential election in December 2009, but economic news has gained importance on the political agenda. President Bachelet has stated that one of the main challenges of her last year in office is to support the Chilean economy amid the worst international scenario in several years. We expect the government to support the labor market by maintaining employment programs and to implement programs in order to help small and medium-sized companies (SMEs) face worsening credit conditions and lower demand for their

Government support is correlated with economic perceptions



Source: Adimark and Santander.

The Ministry of Finance has already announced several measures intended to support economic dynamism:

· **An US$850 million package to help finance exporters and SMEs.** The government aims to channel these funds to the financial sector. The programs include the allocation of US$500 million to SMEs for investment projects, US$200 million for working capital lines of credit to SMEs, US$100 million for loans directed to SMEs, and the remainder to exporters. Other measures to strengthen the financial sector were taken by eliminating (1) the capital gain tax for foreign insurance companies, endowments, and sovereign wealth funds, and (2) tax reporting requirements for the nonresident/nondomiciled foreign investors in the real estate, FX, and other financial markets.

· **An economic stimulus plan to support the real estate sector.** This package is valued at US$1,150 million, and is aimed at helping finance home ownership by increasing demand for new homes. The measures include (1) a temporary increase in existing home subsidies; (2) the creation of additional home subsidies; and (3) an increase in mortgage insurance and guarantees.

In addition, if the Chilean economy experiences worse conditions, we expect the government to enhance its countercyclical measures, not ruling out temporary tax reductions, especially for the VAT.

However, we still believe the presidential election could prompt the government to send some populist measures to Congress in order to force the opposition into taking stands on several sensitive topics such as labor regulation and the election system. Although these initiatives could add some noise to the economic environment, we do not believe macroeconomic fundamentals will become a part of the political discussion.