

Economic

Credit Rating:

Moody's: A2

S&P: A

Fitch: A

Nominal GDP (2006):

USD 145.8bn

Population (2006):

16.4mn

Total Trade / GDP:

64.5%

Currency:

Chilean Peso

Exchange Regime:

Independently floating

Merchandise Imports from Canada (2006):

CAD 427.7mn

Main Sources of Foreign Exchange (excl. FDI):

Copper

Largest Trading Partners:

United States

Japan

Argentina

Brazil

Main Imports:

Intermediate goods

Capital Goods

Risks to the Outlook:


Sustained high copper prices



Southern Cone energy crisis

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Stuart Bergman
sbergman@edc.ca

Market Spotlight: Consumer prices jumped 1.1% m/m in July, the most in 4 years. ■ Despite global financial market jitters, the peso remained below the 525/USD-mark. ■ Codelco resumed production at the El Teniente mine, as striking workers prepared to vote on whether to end a 5-week dispute. ■ The government posted a budget surplus of 2.9% of GDP in Q2, bringing the surplus for H1 to 5.3% of GDP ■ The trade surplus jumped 32% m/m in July, to US\$2.4bn, on higher copper prices. ■ After data showed growth to have hit 6.1% y/y in June, the BCC lifted its overnight rate to 5.5%.

Real Sector: Chile's economy continues to grow at a rapid clip, as a result of strong domestic demand and a supportive external backdrop. Flexible credit conditions, a favorable financial environment, improved labor conditions, and still-strong foreign revenues from the export of minerals are fueling domestic consumption and investment. After a strong Q1, GDP appears to have expanded 5.8% in Q2 – bringing growth in the first half of the year close to 6%. Further, strong capital accumulation trends portend enhanced capacity going forward. We expect growth of 5.5% this year and 5.1% in 2008, as monetary tightening curbs domestic demand.

Monetary Policy: There are concerns, however, that growth has pushed beyond potential given the intensity and duration of the recovery. Propelled by energy and food prices, inflation pierced the 3% target in June and went even higher in July. Based on this trend, the BCC lifted its overnight lending rate to a 5-year high of 5.5% in August, following a similar hike in July. But we believe that monetary conditions remain in expansionary territory, with interest rates below the neutral level. As such, the Bank still has scope for further tightening before year-end.

External Sector: Elevated copper prices and strong agricultural exports continue to power Chile's external position. While import growth is responding to strong domestic demand, it has so far failed to keep pace, pushing the trade surplus up 21% y/y in the year-to-July. With global demand for commodities remaining strong, we expect the trade surplus to post a new record this year. Even as copper prices boost the profit remittances of foreign companies looking to take advantage of the appreciated peso, the current account still managed a surplus of US\$3.3bn in Q1. FDI will continue to increase as mining companies look to reinvest rising profits, offsetting any increases in resident portfolio investment abroad. The fallout from the US subprime fiasco may deter local mutual funds and insurance companies seeking better returns in international markets.

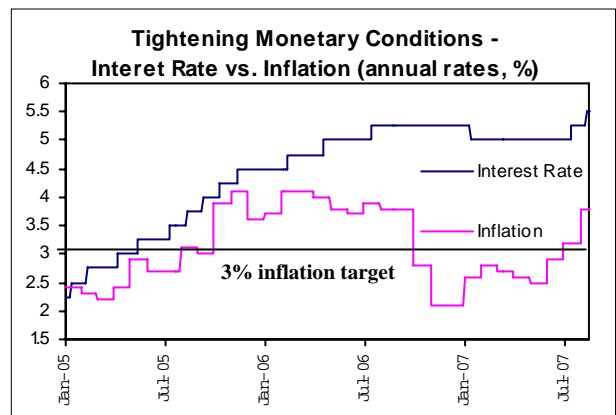
Fiscal Policy: Strong copper prices pushed the fiscal surplus to 7.7% of GDP in 2006, from 2.1% in 2004. As copper prices remain high, we expect a surplus of 6% this year. Authorities will continue to target a structural surplus of 1% of GDP in 2007, before lowering the SSR to 0.5% in 2008. Consistent with the Fiscal Responsibility Law, excess funds will be transferred to the Economic and Social Stabilization Fund (after payments to the Pension Reserve Fund and the recapitalization of the central bank).

Debt: Aside from allowing authorities to increase fiscal spending, the windfall of the last two years enabled the government to repay IFI debt, and boost its net creditor position. Debt-to-GDP fell to 5.3% in 2006, and debt-to-revenues was under 19%. Given those ratios, we believe that the underlying credit quality of the Chilean government is likely to remain strong even under the coming global correction.

Outlook: With benign debt ratios and adequate reserve levels, Chile does not face any significant liquidity risks, even if copper prices erode significantly. Despite strong fundamentals and a sound policy framework, however, the Bachelet administration must address the issue of potential growth by reviving productivity-enhancing reforms. A more immediate risk, however, is the energy shortage that threatens the Southern Cone. Hydroelectric potential and plans for an LNG processing plants near Santiago will only help alleviate the strain in the longer-run.

Economic Indicators

	01-05 avg.	2006(e)	2007(f)	2008(f)
Real GDP (% change)	4.2	4.0	5.5	5.1
Cons. Inflation (% change, eop)	2.6	3.4	3.2	3.0
Fiscal Balance (% of GDP)	0.9	7.7	6.0	3.5
Exports (% change)	16.5	40.7	7.5	-1.0
Imports (%change)	12.3	17.7	12.0	10.0
Current Account (% of GDP)	0.0	3.6	3.1	0.8
Reserves (months of imports)	5.8	3.4	3.6	3.5
External Debt (% of GDP)	52.2	32.8	31.8	30.5
Debt Service Ratio	24.6	12.0	11.4	11.5
Currency (CLP/USD, eop)	608.4	534.4	530.0	540.0



General Political Environment:

The ruling centre-left coalition commonly known as the “Concertación” won its fourth consecutive term in elections held in December 2005; Concertación has been in power since Chile’s transformation from a dictatorship to a democracy in 1990. An alliance of the two principal right-leaning parties, called the Alliance for Chile, constitutes the main opposition. While Concertación includes extreme leftist groupings, and the Alliance includes parties of the far right, both compete vigorously for the crucial centrist vote.

Michelle Bachelet of the Socialist Party is Chile’s first female President. The former Health and Defense Minister is an agnostic divorced mother with children from two separate marriages. Her election reflects the increasingly progressive nature of the Chilean electorate as that the Catholic Church remains an important institution and divorce was only recently legalized.

Bachelet has promised continuity on various fronts and is expected to maintain the country’s orthodox economic policies. Despite her leftist stance, she is expected to be as moderate and pragmatic as her predecessor, Ricardo Lagos. Her key social objectives include pension reform, job creation, labour reform, increasing opportunities for women and the indigenous and an education system upgrade.

Bachelet’s popularity has dropped as a result of various protests against her educational reform proposals and in reaction to the shortcomings of the transit system in Santiago. She is attempting to redress her support levels through cabinet changes and by exploring the possibility of bringing an electoral reform to a national referendum. Although the latter is popular, the opposition is protesting as the plebiscite serves to by-pass Congress.

Chile experienced deep national trauma stemming from the extensive human rights abuses committed under right wing dictator Augusto Pinochet (1973-1990). The Concertación has made great strides in reconciling with the country’s violent past and the Bachelet government is expected to continue these efforts. Pinochet died in late 2006, but the government intends to prosecute those members of his regime and family accused of human rights abuses and fraud.

A series of constitutional amendments adopted in 2005 make a clear break with the country’s authoritarian past. The new constitutional framework increases civilian control over the military, eliminates senatorial appointments and reduces the presidential term from six to four years.

Investment Environment:

Chile has actively sought free trade agreements with several partners including Canada, Japan and the US. These agreements underscore Chile’s status as a free-trading nation.

Chile officially encourages foreign investment and investment legislation has been incrementally liberalized since 1974. Most recently, the Finance Minister introduced a package of fiscal reform measures to encourage investment, including incentives for SMEs. Some reactions from the legislature reinforce the need to balance the ability of the state to generate revenue to be applied to social programs with the need to stimulate economic growth.

There is no waiting period before profits can be repatriated, and investors are guaranteed access to foreign exchange in the inter-bank currency market.

Systemic problems in Argentina’s energy sector have serious implications for Chile. Argentina’s government has repeatedly restricted gas shipments to Chile to ensure adequate domestic supply. The Chilean government and energy regulator have reacted quickly, and are seeking to diversify energy sources and promote energy infrastructure investment to minimize medium-term implications.

Political Violence:

Since Chile’s return to democracy in 1990, there has been very little political violence.

Strikes and demonstrations are commonly used as a means to express grievances, including labour unions and environmental activists. The mining sector is especially vulnerable. Occasionally small bombs are planted by anti-globalization activists or those with political grievances.

Political

Political Structure

Presidential Republic

President

Michelle Bachelet

Legislative Bodies

- Congress (120 seats)
- Senate (38 seats)

Major Parties (seats in Congress; Senate)

- Concertación de Partidos por la Democracia (Concertación) (64; 20)
- Alianza por Chile (Alianza) (52; 17)

Last Elections

- Presidential: January 2006
- Legislative: December 2005

Next Elections

- Presidential: December 2009
- Legislative: December 2009

Press Freedom Survey:

- 2006 Score: 26 Free (0: Free; 100: Not Free)
- freedomhouse.org

Control of Corruption Index:

- 2006 Score: +1.31 (-2.5: Worst; +2.5: Best)
- worldbank.org

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Signi Schneider

sschneider@edc.ca

Political Outlook

Chile’s now-solid foundations in economic management and democratic rule point towards policy stability for the foreseeable future. Despite the fact that Bachelet figures amongst South America’s growing pool of leftist leaders, she is considered moderate and pragmatic. In the coming months, she will have to demonstrate her ability to formulate and execute reforms that convince Chileans that visible improvements on the social front are on the horizon. If her policies and approach do not meet expectations, her approval ratings may fall further and her ability to muster support for legislation may falter.