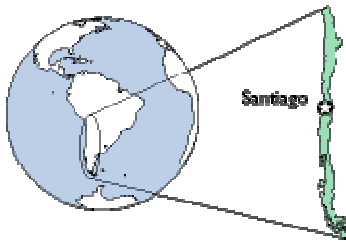


COUNTRY REVIEW

Chile



25 September 2009

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EULER HERMES COUNTRY RISK GRADE: A

Country Risk Grades are on a scale of AA, A, BB, B, C, D
where AA is the lowest and D the highest risk.

Strengths

- Widely accepted democratic framework with peaceful transfers of power
- Natural resource base, especially copper
- Sound fiscal and monetary policy, consensus surrounding liberal orthodoxy
- Adequate external liquidity position
- Flexible exchange rate
- Sound banking sector

Weaknesses

- Commodity dependent—copper accounted for 57% of total export earnings in 2007
- Skewed income distribution

Country Risk Assessment

Ratings	Chile		Median Grade A	Slovenia	Peers Taiwan	Mexico
	Latest	Previous				
Systemic Political Risk:	P1	P1	P2+	P1	P2+	P2+
Systemic Economic Risk:	E2	E2	E2	E2	E2	E3
ME rating:	ME2	ME2	ME2	ME2	ME2	ME3
<i>Structure</i>	4.0	4.0	3.3	1.6	4.0	2.3
<i>Policy</i>	2.8	3.2	2.3	4.2	1.9	4.0
<i>Solvency</i>	1.0	1.0	1.3	1.7	1.0	1.9
<i>External Liquidity</i>	3.8	3.3	2.3	2.8	2.8	3.6
SBE rating:	SBE1	SBE1	SBE2	SBE2	SBE2	SBE3
COUNTRY GRADE:	A	A	A	A	A	BB

Nomenclature:
 Political Risk Ratings are on a scale of P1 (lowest risk), P2+, P2-, P3+, P3-, P4 (highest risk).
 Economic Risk Ratings are on a scale of E1 (lowest risk), E2, E3, E4, E5, E6 (highest risk).
 ME (Macro-Economic) ratings are on a scale of ME1 (lowest risk), ME2, ME3, ME4, ME5, ME6 (highest risk).
 The constituent parts of the ME rating are on a scale of 1.0 (best) to 6.0 (worst).
 SBE (Structural Business Environment) ratings are on a scale of SBE1 (best), SBE2, SBE3, SBE4, SBE5, SBE6 (worst).
 Country Grades are on a scale of AA, A, BB, B, C, D where AA is the lowest and D the highest country risk.

Source: Euler Hermes Country Risk Unit

ECONOMIC STRUCTURE

Country Profile

Capital city:	Santiago
Population:	16.8 mn (2008)
GDP:	USD 169458 mn (2008)
Currency:	Peso (CLP)
Form of state:	Republic
Head of government:	President Michelle Bachelet
Next elections:	2009 December (presidential & legislative)

Major Industries (% of GDP at market prices, 2008)

Agriculture & fishing	3.9%
Mining	18.6%
Manufacturing	16.4%
Utilities & construction	13.5%
Services	52.3%

Global Assumptions

	2009	2010
Real GDP grth (% yr/yr) *	-3.9	0.9
Inflation (% , av) *	-0.1	1.3
Dated Brent (USD/b)	61	72
* Major economies		

Main Exports (% of total, 2008)

Mining	60.4%
Copper	51.8%
Agriculture & fishing	6.2%
Industrial products	33.5%

Main Imports (% of total, 2008)

Consumption goods	20.5%
Intermediate goods	63.1%
Fuels & lubricants	25.6%
Capital goods	16.4%

Lead Export Markets (% of total exports, 2007)

China	14.8%
US	12.5%
Japan	10.5%
Netherlands	5.8%

Lead Import Markets (% of total imports, 2007)

US	16.7%
China	11.2%
Brazil	10.3%
Argentina	9.9%

Basic indicators

Selected economic indicators	2006	2007	2008	2009f	2010f
Nominal GDP (USD mn)	146,773	163,881	169,458	171,586	187,666
Population (mn)	16.47	16.64	16.80	16.96	17.12
GDP per capita (USD)	8,912	9,849	10,087	10,117	10,962
Real GDP growth (% yr/yr)	4.6	4.7	3.2	-1.5	3.0
Inflation (% , eop)	2.6	7.8	7.1	-0.1	2.5
Fiscal balance (% of GDP)	7.5	8.7	5.0	-4.5	-2.0
Current account balance (% of GDP)	4.9	4.4	-2.0	1.3	-0.7
External debt/GDP (%)	34	34	38	38	35
External debt/Exports of goods & services (%)	70	69	80	110	95
Interest payments/Exports of goods & services (%)	2	2	2	3	2
Foreign exchange reserves (USD mn)	19,392	16,837	23,072	25,976	27,300
Import cover (months)	4.5	4.3	2.9	5.9	5.5
Exchange rate assumption, CLP:USD (av)	530.28	522.46	522.46	565.00	545.00
f: CRU central forecast					

Sources: National, IMF, World Bank, Euler Hermes Country Risk Unit

Political Stability

Stable democracy is well established with peaceful transfers of power through widely accepted constitutional elections, notwithstanding an unstable period during the late 1960s and early 1970s followed by a period of dictatorship until 1989 under President (formerly general) Pinochet. The dictatorship ended peacefully, however, as the Pinochet regime respected the outcome of a plebiscite that went against the president. Constitutional reforms in September 2005 resolved most of the remaining legacy issues from the Pinochet era, including the elimination of ten non-elected seats in Senate, although the voting system, which works in favour of large coalitions and against large majorities and small parties, was retained. The presidential term was reduced to four years from six. A Concertacion government—a centre-left coalition—has ruled continuously since 1989.

Elections are due in December 2009 (first round presidential, with a run-off, if necessary, in January 2010, and legislative). President Michelle Bachelet, who retains high levels of public support, is not permitted to stand for a second consecutive term. Yet despite the president's standing and her support for the ruling coalition's candidate, former president Eduardo Frei, local opinion polls currently point to a win in the presidential elections for the opposition Coalicion por el Cambio—a broad based opposition grouping that includes the centre-right Alianza—candidate, Sebastian Pinera. The outcome is not a foregone conclusion, however, and a run-off will probably be necessary. Voting has been complicated also by the emergence of an alternative centre-left candidate, Enriquez-Ominami, who left the Partido Socialista earlier this year to form a breakaway group when he was not allowed to stand in the primaries and is taking votes from both the main contenders. Whatever the outcome, it is unlikely to herald a major departure from the main thrust of current policies, not least because Pinera will probably have to tack to the centre to secure a win. Systemic stability is not under threat.

The liberal economic policy framework established during the Pinochet years has been maintained by successive Concertacion governments and there has been broad continuity under President Bachelet. Although the current government has broadened out the benefits of strong economic growth across all social groups through a wide ranging incremental social reform programme, it was not at the expense of sound fiscal and monetary policy, which paid dividends during the global financial crisis and recession, enabling the government to move robustly to mitigate the worst effects. Government effectiveness generally is good and the central bank is independent.

Internationally, there are long-standing disputes with its neighbours Bolivia and Peru, largely related to maritime boundaries and access to the sea, but these are not serious threats to overall stability. Multilateral relations are good, though Chile has also developed an extensive series of bi-lateral Free Trade Agreements.

Economic Stability

Chile is a well-developed, upper middle income economy (World Bank classifications) with an estimated 2008 GDP per capita of USD10,087. Chile produces around 35% of world copper output and copper accounted for almost 17% of current GDP and 52% of merchandise exports in 2008. Other important sectors are fruit, forestry and value-added industry based on these products. Although the economy is vulnerable to swings in commodity prices, there are in-built policy safeguards and relative growth volatility has been moderate over the past decade. Annual average real growth of per capita GDP was a solid 3.5% in the past ten years.

Annual average growth of real GDP was 5.2% in 2003-07, but weakened to 3.2% in 2008 and GDP contracted in H1 2009 by 3.5% yr/yr. Q2 2009 was the fourth successive qtr/qtr contraction, but the pace of contraction has been slowing and the monthly indicator of activity was positive mo/mo in May-July (latest available). This suggests that the worst may be past and a modest upturn may be evident in H2 and 2010, underpinned by fiscal stimulus, low interest rates and higher copper prices (at least from the lows of Q4 2008 and Q1 2009). We expect GDP to contract by 1.5% in calendar 2009 and to increase by 3% in 2010.

Fiscal policy is based on a structural target that allows fiscal policy to operate counter-cyclically, while providing medium-term credibility and a sustainable public debt framework. Spending is adjusted to trend revenues, which are determined by a trend growth of GDP (set at 4.9%) copper prices (set at USD1.99 per pound) and a structural balance target. This means that if actual growth and copper prices are below these medium-term trend assumptions (as in 2009-10) a deficit will be permitted, but when the reverse is the case (as in 2004-7, the budget will be in surplus and, accordingly, medium-term discipline should be maintained. Part of any actual fiscal surplus goes to a fund to cover

minimum pension liabilities, part to gradually re-capitalise the central bank and the rest into a Fund for Economic and Social Stabilisation (FEES), which is mainly held as financial assets abroad.

In view of the severity of the downturn in 2009, the structural fiscal balance target was reduced from surplus of 0.5% of GDP to balance and the government has announced that this could slip to 0.4% deficit as a result of lower than expected copper revenues. A fiscal stimulus package was put in place earlier in the year. The actual fiscal deficit will be around 4.5%, against a surplus of 5.2% of GDP in 2008. In 2010 the deficit should narrow to around 2% of GDP. The bulk of the government's financing needs in 2009 will be covered by the use of USD8bn from the FEES. In July the FEES stood at USD15.1bn, down from USD20.2bn at end-2008. If it is assumed that the FEES falls by USD8bn for the whole of 2009 the fund would still be the equivalent of 7% of GDP. Public debt will increase as a proportion of GDP in 2010 but will remain low at 20% of GDP and overall the government remains in a net creditor position.

Monetary policy is based on inflation targeting and a floating exchange rate. Monetary policy has been loosened dramatically in 2009. The central bank cut the policy interest rate in stages by 775bps from 8.25% to just 0.5% in July and has announced that this rate will be maintained for at least six months. However, as deflation is now evident (prices fell 1% yr/yr in August) and is only expected to give way to modest inflation, below the 3% +/-1% target for much of 2010. Interest rates will also remain low for some time. The government has also re-capitalised the state-owned Banco del Estado which has allowed it to increase lending.

The banking sector is generally well capitalized and liquid and banks' credit ratings are among the highest in the region, according to the IMF article IV consultation. Nonetheless, foreign borrowing by banks meant that at the height of the global financial crisis there was a sharp tightening of credit conditions, though the authorities acted promptly to maintain liquidity and stabilise the system.

The exchange rate depreciated sharply through 2008 and early 2009, as copper prices slumped, but has since appreciated and, provided copper prices do not fall sharply should remain fairly stable. The real exchange rate is not seriously overvalued.

The current account balance moved into deficit in 2008 (2% of GDP) as copper and other commodity prices fell, while imports remained relatively high for the first nine months of the year, before dropping sharply in Q4. In 2009 H1 exports stabilised and are beginning to pick up, while imports continued to fall sharply on lower domestic demand and, with outward profits remittances also down, the current account balance swung back into small surplus, where we expect it to remain for the full year. As imports recover in line with stronger domestic demand in 2010 a small deficit (0.7% of GDP) could re-emerge. Net foreign direct investment flows are still likely to be around 3% of GDP in 2009-2010 and to more than cover any current account deficit. Foreign exchange (FX) reserves provide 5.5 months import cover at 2009-2010 lower import levels and 95% of external debt falling due in 2009 (short term and principal repayments on M/LT debt), which could rise above 100% in 2010 as scheduled principal repayments fall. The M2/FX reserves ratio is just under 400%. The external debt-GDP has risen but is still a moderate 38% of GDP and 109% of exports of goods and services. It should also be noted, however, that Chile is a net external creditor, as foreign assets exceed liabilities.

Structural Business Environment

The Structural Business Environment is generally very strong, though Closing a Business was below average (based on data and definitions from the World Bank's 2010 Doing Business Survey). The World Bank Institute's Governance Research Indicator puts regulatory quality, the rule of law and control of corruption well above average for the Latin American region and for the upper middle-income group of economies. Transparency International's Corruption Perception Index, 2008, assigns Chile a score of 6.9—on a scale of 1 (bad) to 10 (good)—and a ranking of 23 out of 163. As a broad measure of the pro-business environment The Heritage Foundation 2009 Index of Economic Freedom ranks Chile 11 out of 179.

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Charts

