

Summary

Chile remains a country characterized by good macroeconomic policies and high quality institutions. The country was hit by a heavy earthquake in early 2010, but the impact of this event on country risk has been fairly limited. Nonetheless, reconstruction will add to growth in the coming years. The popularity of the right-wing Piñera government has gone down recently, and Piñera has reacted with a reshuffle of his team. Strong upward pressure on the peso, and the resulting loss of competitiveness of some Chilean industries (such as the wine industry), has induced the government to announce the purchase of USD 12bn in foreign reserves during 2011. As a result, the peso will no longer be a totally free floating currency. Overall, country risk remains low.

Things to watch:

- Copper prices, as copper exports account for 50% of total exports.
- Popularity of government, as the approval ratings of the Piñera administration have been hit by a conflict over higher fuel prices.

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Chile			
National facts		Social and governance indicators	
Type of government	Republic	Human Development Index (rank)	rank / total 45 / 169
Capital	Santiago	Ease of doing business (rank)	43 / 183
Surface area (thousand sq km)	756	Economic freedom index (rank)	11 / 179
Population (millions)	16.9	Corruption perceptions index (rank)	21 / 178
Main languages	Spanish	Press freedom index (rank)	33 / 178
Main religions	Roman Catholic (70%) Evangelical (15%) Jehova's Witness (1%)	Gini index (income distribution)	52
Head of State (president)	Sebastian Pinera	Population below \$1 per day (PPP)	0.5%
Monetary unit	Peso (CLP)	Foreign trade	
Economy		2010	
Economic size		Main export partners (%)	
	<i>bn USD</i>	<i>Main import partners (%)</i>	
Nominal GDP	199	Canada	16
Nominal GDP at PPP	257	Mexico	11
Export value of goods and services	77	China	9
IMF quatum (in mln SDR)	856	Japan	7
Economic structure		2010	
	<i>2010</i>	<i>5-year av.</i>	
Real GDP growth	5.1	3.4	
Agriculture (% of GDP)	6	6	
Industry (% of GDP)	33	36	
Services (% of GDP)	53	50	
Standards of living		Main export products (%)	
	<i>USD</i>	<i>% world av.</i>	
Nominal GDP per head	11644	119	
Nominal GDP per head at PPP	15044	129	
Real GDP per head	8122	101	
		Openness of the economy	
		Export value of G&S (% of GDP)	39
		Import value of G&S (% of GDP)	33
		Inward FDI (% of GDP)	8.3

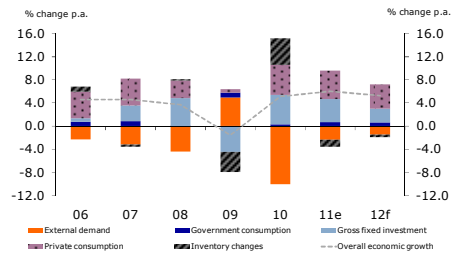
Source: EIU, CIA World Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

Economic structure and growth

Chile has arguably been Latin America's most successful economy. The country has a track record of implementing sound economic policies, and its institutions are strong. Among all the South American countries, Chile has the highest level of level of human development and economic freedom, coupled with the lowest level of corruption. The effectiveness of its government is high (see chart 3). The country has considerable natural resources, in particular large copper deposits. As a result, Chile is the world's biggest copper exporter with a market share of 40%, while it has enough copper reserves to continue producing at the existing level for 60 years. However, with copper exports accounting for 50% of total exports in 2010, the importance of the copper sector also implies that the economy has a rather narrow economic base. At the same time, the strong macroeconomic policies of the government do provide some cover, as they enable the government to implement countercyclical policies. The quality of the financial sector in Chile is high. In contrast to some other Latin American countries, the dollarization level of the sector is low, which means that the vulnerability to sharp exchange rate moves is low. Moreover, capitalization levels are high and as 85% of bank funding comes from domestic sources, reliance on external borrowing is low. In February 2010 Chile was hit by a heavy earthquake. The earthquake (8.8 on the Richter's scale) killed about 800 people in Chile and made about 2 million people homeless. According to government estimates, the economic damage totaled USD 29.7bn, or roughly 15% of GDP. Despite this sizeable damage, Chile is well equipped to deal with the natural disaster, thanks to its large fiscal buffers and its strong institutions. Reconstruction is likely to add to growth in the coming

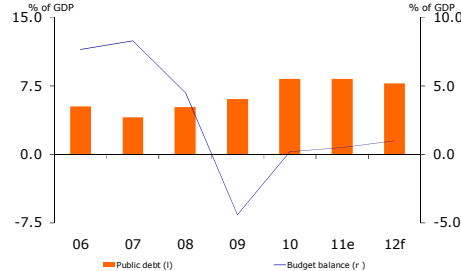
years. As a result, strong growth is expected in 2011 and 2012, with the economy likely to grow with 5% to 7% in both years.

Chart 1: Growth performance



Source: EIU

Chart 2: Public finances



Source: EIU

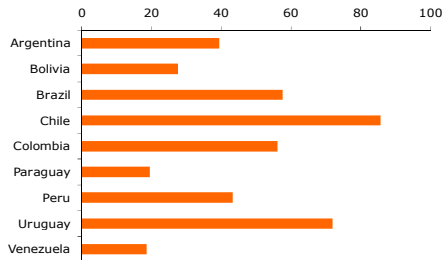
Political and social situation

In January 2010, Sebastián Piñera of the centre-right Coalición por el Cambio (Coalition for Change) won the presidential elections. After twenty years of center-left Concertación rule, it was the first time that the right obtained power since the country returned to democracy in 1990. The ruling coalition lacks a majority in the senate, but the two party blocks are both pragmatic and well prepared to co-operate, and the transition of power has been rather smooth. The successful rescue of trapped miners, and the global media hype this created, boosted the popularity of the Piñera administration in the second half of 2010. However, in particular due to a conflict in the southern province of Magallanes over higher fuel prices, the popularity of the government has dipped afterwards. A poll released on 1 February showed that Piñera's approval rating had fallen to 41%, against a disapproval rate of 46%. Support for his administration has also dipped below 50%. Piñera reshuffled his government in January 2011, after four ministers had resigned. One of the ministers to resign was Defense Minister Jaime Ravinet of the right wing Democratic Independent Union, a party that had links with the Pinochet dictatorship. Ravinet had declared that the army would not help the country to deal with natural catastrophes if the government forced the armed forces to reveal details of arms purchases. Ravinet's resignation may have increased the tension within the ruling coalition. Newly inaugurated Defense Minister Andrés Allamand fired the Chief of the General Staff, after accusations of corruption, and also a number of other high army officials. Furthermore, the Piñera government has approved a proposal by the former Bachelet administration to revoke the so called copper law, which decreed that 10% of the revenue of the National Copper Cooperation of Chile (Codelco) should be spent on the armed forces. These measures will further check the power of the military. Chile remains one of the most politically stable countries in the region. It is also one of the strongest democracies in Latin America. Compared with other democracies though, political participation is low. Furthermore, just like in other Latin American countries, inequality remains high in Chile. However, Chile's recent track record of political stability, coupled with the slow downward trend in inequality, imply that the risk of social upheaval is fairly low.

Old border conflicts with Bolivia and Peru have not yet been resolved, and Chile formally does still not have diplomatic relations with both countries. However, relations with Bolivia have improved recently, while relations with Peru have been normalized after a spying incident in late 2009. Thus, Chile faces no real external political threats. In the past years, cooperation with Argentina has increased. Chile is not very much engaged in regional political cooperation, but has been very active in the international economic arena by signing free trade agreements with many important

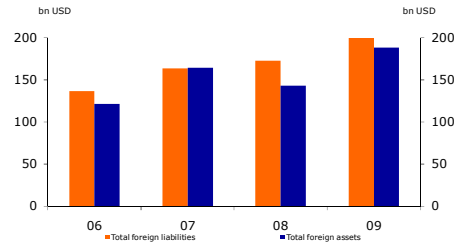
export markets, such as the United States, China, Canada and Mexico. Chile joined the Organization for Economic Cooperation and Development (OECD) in 2010.

Chart 3: Government effectiveness high



Source: World Bank

Chart 4: International investment position



Source: IMF IFS

Economic policy

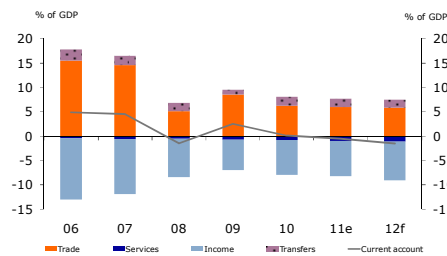
The agenda of the new government is dominated by a number of microeconomic reforms and the reconstruction after the February 2010 earthquake. The Piñera administration stands a good chance of implementing reforms to improve healthcare and competitiveness. However, it will be much harder to change Chile’s labor laws, which are rather inflexible. Attempts by the government to enact labor reform could be met by strong opposition from workers. Reconstruction is of course much less contentious and has been supported by the opposition. Reconstruction will also be easy to finance, as Chile has a very low level of public debt. Since 2001, Chile’s fiscal policy has been based on strict rules. These rules were formalized in the Fiscal Responsibility Law in 2006. Under this law, fiscal policy is designed on a structural long-term basis, which increases fiscal and economic stability. When the economy is performing strongly, fiscal expansion is subdued by mandatory saving of part of the windfall revenue. Moreover, the fiscal position also benefited from high copper exports, with fiscal revenues from copper production accounting for almost 5% of GDP between 2001 and 2009. This has resulted in significant public savings in boom years, and has allowed the government to run a countercyclical fiscal policy. Thus, Chile has been able to increase public spending after the global financial crisis and the 2010 earthquake had hit the country. The fiscal performance in 2010 is estimated to have been better than expected. The growth of expenditures remained below budget in the first 11 months of 2010, while the fiscal revenues were higher than expected, partially thanks to a higher copper price. Chile also has strong monetary policies. The Central Bank introduced an inflation targeting regime in 2000, and has been able to keep inflation low at an average rate of 3%. To counter the effects of the financial crisis, the central bank reduced its policy rate to 0.5% in 2009. As the recovery gathered momentum, Chile has implemented seven hikes since mid-2010, but the central bank decided to maintain the rates at the existing rate of 3.25% in January. In light of the inflationary pressures and rapid closing of the output gap, the central bank can be expected to raise the interest rate in the coming months. However, this may complicate Chile’s exchange rate policy. Just like many other emerging markets, Chile has recently been confronted with strong upward pressure on its currency. The driving forces in the case of Chile are the strong increase of the copper price and a growing interest differential between western countries and Chile. Traditionally, the Chilean peso has floated freely. However, faced by the loss of competitiveness, with the wine industry in particular being affected, the government changed its course. In January 2011, Chile earmarked USD 12bn for the purchase of foreign currency on the spot market. This has lowered the pressure on the peso. However, some

tension between monetary policy and exchange rate policy is likely to persist. We do expect the government to adhere to market friendly policies though.

Balance of Payments

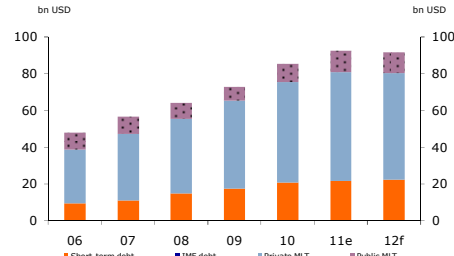
Chile traditionally couples a surplus on the trade account with a large deficit on the income account and a small deficit on the services account. As repatriations of profits by foreign direct investors are expected to increase, the deficit on the income account is likely to rise in the coming years, which will lead to a deterioration of the current account. Nonetheless, the current account deficit is likely to grow only modestly to about 0.5% of GDP in 2011 and roughly 1.5% of GDP in 2012. Moreover, this deficit is dwarfed by large foreign direct investment inflows. On the back of heavy investment in mining projects, inward direct investment surpassed 8% of GDP in 2010, and is likely to stay at least at that level in the coming years. At the same time, outward foreign direct flows have been strongly up recently. Chilean firms are investing in other Latin American countries, in particular in Brazil, Colombia and Peru. The growth of the outward investments may lead to a lower deficit on the income account in the longer run. For now though, outward direct flows are still much smaller than inward flows, which results in a net inflow of FDI. The lack of diversification of Chile’s exports, with copper exports accounting for 50% of total exports, is the main vulnerability of Chile’s balance of payment. However, this is partially mitigated by the strong macroeconomic policies of the government, which allow the country to absorb sharp shocks of the copper price.

Chart 5: Current account



Source: EIU

Chart 6: Decomposition of foreign debt



Source: EIU

External position

China has foreign reserves equal to five months of imports, which does not look overly comfortable at first sight. However, we note that the exchange rate regime is (still) rather flexible, with a low level of dollarization of the financial system. Furthermore, the government also owns substantial foreign assets through the two sovereign wealth funds, which together are holding about USD 17bn. Furthermore, the private sector pension funds are also holding sizeable external assets. On a net basis the government is a creditor, while the net investment position of Chile as a whole was close to balance in 2009 (see chart 4). However, the private sector has a relatively large external debt burden. The government is now working to improve the infrastructure of the capital markets, which may help to reduce the reliance of the private sector on external loans.

Chile							
Selection of economic indicators	2006	2007	2008	2009	2010e	2011f	2012f
<i>Key country risk indicators</i>							
GDP (% real change pa)	4.6	4.6	3.7	-1.5	5.1	6.0	5.3
Consumer prices (average % change pa)	3.4	4.4	8.7	1.5	1.5	3.6	3.6
Current account balance (% of GDP)	4.9	4.5	-1.5	2.6	0.2	-0.5	-1.5
Total foreign exchange reserves (mln USD)	19392	16837	23072	25284	27527	29910	32000
<i>Economic growth</i>							
GDP (% real change pa)	4.6	4.6	3.7	-1.5	5.1	6.0	5.3
Gross fixed investment (% real change pa)	2.3	11.2	18.6	-15.3	20.2	13.8	7.8
Private consumption (% real change pa)	7.1	7.0	4.6	0.9	7.4	6.8	5.9
Government consumption (% real change pa)	6.4	7.1	0.5	6.8	2.1	5.4	4.6
Exports of G&S (% real change pa)	5.1	7.6	3.1	-5.6	2.2	5.3	6.6
Imports of G&S (% real change pa)	10.6	14.5	12.2	-14.3	24.8	8.3	7.5
<i>Economic policy</i>							
Budget balance (% of GDP)	7.7	8.3	4.5	-4.4	0.2	0.5	1.0
Public debt (% of GDP)	5	4	5	6	8	8	8
Money market interest rate (%)	5.3	6.0	8.3	0.5	1.8	4.3	5.5
M2 growth (% change pa)	17	21	19	-5	7	16	13
Consumer prices (average % change pa)	3.4	4.4	8.7	1.5	1.5	3.6	3.6
Exchange rate LCU to USD (average)	530.3	522.5	522.5	560.9	510.7	486.2	498.0
Recorded unemployment (%)	8.0	7.0	7.8	9.6	8.3	7.8	7.6
<i>Balance of payments (mln USD)</i>							
Current account balance	7154	7458	-2513	4217	313	-1220	-3740
Trade balance	22780	23941	8848	13982	12481	13710	14510
Export value of goods	58680	67972	66464	53735	67532	74630	81620
Import value of goods	35900	44031	57617	39754	55050	60920	67110
Services balance	-632	-987	-871	-1074	-1523	-2240	-2680
Income balance	-18401	-18625	-13423	-10306	-14307	-16690	-19540
Transfer balance	3406	3123	2924	1616	3661	4010	3970
Net direct investment flows	4556	9961	7194	4719	7345	9740	14110
Net portfolio investment flows	-9819	-15599	-7154	-12407	-8226	-6040	-8560
Net debt flows	2296	5713	7253	8380	12726	7050	-1070
Other capital flows (negative is flight)	-1723	-10087	1456	-2695	-9913	-7150	1340
Change in international reserves	2464	-2554	6236	2214	2244	2380	2090
<i>External position (mln USD)</i>							
Total foreign debt	48052	56542	64277	72763	85562	92700	91630
Short-term debt	9318	11056	14910	17476	20738	21630	22370
Total debt service due, incl. short-term debt	21635	20820	26244	27854	31777	37650	40520
Total foreign exchange reserves	19392	16837	23072	25284	27527	29910	32000
International investment position	-15157	727	-30178	-19551	n.a.	n.a.	n.a.
Total assets	121528	164585	142917	188699	n.a.	n.a.	n.a.
Total liabilities	136685	163858	173095	208250	n.a.	n.a.	n.a.
<i>Key ratios for balance of payments, external solvency and external liquidity</i>							
Trade balance (% of GDP)	15.5	14.6	5.2	8.6	6.3	5.9	5.9
Current account balance (% of GDP)	4.9	4.5	-1.5	2.6	0.2	-0.5	-1.5
Inward FDI (% of GDP)	5.0	7.6	8.9	7.8	8.3	8.0	8.3
Foreign debt (% of GDP)	33	34	38	45	43	40	37
Foreign debt (% of XGSIT)	65	65	74	104	96	95	86
International investment position (% of GDP)	-10.3	0.4	-17.7	-12.0	n.a.	n.a.	n.a.
Debt service ratio (% of XGSIT)	29	24	30	40	36	39	38
Interest service ratio incl. arrears (% of XGSIT)	3	3	2	1	1	1	1
FX-reserves import cover (months)	5.2	3.7	4.0	6.1	5.0	4.9	4.7
FX-reserves debt service cover (%)	90	81	88	91	87	79	79
Liquidity ratio	114	116	103	115	107	102	100

Source: EIU

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