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Country Risk Indicator DB2*b*

For Country Risk Indicator definition see page 51

Regional Risk Indicators

US	DB1*b*
Canada	DB1*c*
Chile	**DB2*b***
Trin. & Tob.	DB3*a*
Mexico	DB3*b*
Costa Rica	DB3*c*
Brazil	DB4*a*
Panama	DB4*a*
Uruguay	DB4*a*
Dom. Rep.	DB4*b*
Colombia	DB4*c*
El Salvador	DB4*c*
Jamaica	DB4*c*
Peru	DB4*d*
Argentina	DB5*a*
Bolivia	DB5*a*
Guatemala	DB5*a*
Venezuela	DB5*b*
Honduras	DB5*d*
Ecuador	DB6*a*
Paraguay	DB6*a*
Nicaragua	DB6*c*
Cuba	DB6*d*

Comparative Risk Indicators

Mauritius	DB2*b*
Greece	DB2*b*

Indicator Summary

- Chile's propitious DB2*b* risk indicator is underpinned by the government's sound macroeconomic management, which it adhered to even during the difficult financial climate during 1998-2000.
- The risk indicator is supported by strong fundamentals, not least a good fiscal policy record and healthy domestic savings, which have bolstered the economic growth outlook.
- On the downside, growth in output in 2001 is being hampered by lacklustre domestic consumption and declines in investment spending. Domestic confidence remains weak. Moreover, Chile is heavily exposed to deteriorating trends in copper prices. These swings place pressure on the current account and, to a lesser degree, the fiscal account.

Positive Risk Factors

+ Congressional elections due to take place in December are unlikely to see major changes in the composition of Chile's upper and lower houses. The government will continue to be supported in its restrictive monetary policy stance.

+ Negotiations on trading agreements with the EU, the US, South Korea, as well as within the region, will reduce Chile's dependence on one region for a major share of its exports and therefore its exposure to adverse developments in that region.

+ Chile's record of healthy budget balances will stand the authorities in good stead should they need to raise funds on the international capital markets. The authorities' recent successful bond launch proves that Chile has access and to international capital at reasonable interest rates.

Negative Risk Factors

– In comparison with the period 1985-97, GDP growth at an estimated 5.9% in 2000 (after recession in 1999) was moderate. With growth forecast at 3.5% in 2001, the economic recovery failed to take-off, dampened by weak domestic consumer and business sector confidence and the deteriorating global economic climate.

– Both the fundamentals and demand trends dictate that copper prices are likely to continue to fall through the remainder of this year and into the first half of 2002 at least. This will damage the outlook for government revenues, export earnings and the strength of the peso.

– While unemployment fell during the second half of 1999, by mid 2000 it had begun to trend upwards again, reaching 10.1% in the third quarter of 2001. It is unlikely that private domestic consumption will improve while unemployment remains this high.

	1998	*1999*	*2000*	*2001f*	*2002f*
GDP growth, %	3.9	-15.3	8.1	3.1	2.3
Inflation, year end %	4.7	2.6	3.8	3.5	3.4
Government balance, % GDP	0.4	-1.5	0.2	0.0	0.0
Interest rate, year end %[1]	15.7	10.5	12.5	13.5	11.7
C/A balance, % GDP	-5.1	-5.8	-0.1	-1.4	-1.0

Note: [1]Commercial bank lending rate.
Sources: International Monetary Fund, *International Financial Statistics*; http://www.bcentral.cl; Dun & Bradstreet

Background Data

Head of state
Ricardo Lagos Escobar

Government
Multiparty democracy

Next elections

Presidential:	Dec. '06
House of Deputies:	Dec. '02
Senate:	Dec. '02

Capital (pop., m)

Santiago	4.8

Major cities (pop., 000s)

Vina del Mar	297.3
Concepcion	294.4
Vaiparaiso	278.8
Puente Alto	231.5

Official language
Spanish

Currency
Chilean peso (denoted CLP)=100 centavos

Religion
Roman Catholic

Timezone
GMT -4 hours

Telephone code
256

	1997	***1998***	***1999***	***2000***
GDP				
CLP billion	31,774	33,578	34,423	37,775
US$ billion	72.24	70.87	64.94	69.24
Breakdown of GDP				
Agriculture (%)	7.2	n/a	n/a	n/a
Industry (%)	40.1	n/a	n/a	n/a
Services (%)	52.6	n/a	n/a	n/a
National accounts (CLP billion)				
Private consumption	20,511	22,312	22,068	23,917
Gross investment	8,051	8,551	7,522	8,430
Government consumption	3,320	3,698	4,127	4,602
National accounts (% of GDP)				
Private consumption	64.6	66.4	64.1	63.3
Gross investment	25.3	25.5	21.9	22.3
Government consumption	10.4	11.0	12.0	12.2
External data (US$ billion)				
Merchandise exports	16.8	15.0	15.5	18.0
Merchandise imports	-19.7	-18.8	-15.1	-18.1
Trade balance	-2.8	-3.8	0.3	-0.1
Current account balance	-3.7	-4.1	-0.1	-1.0
Total reserves	17.0	15.1	14.4	14.1
External data (% of GDP)				
Merchandise exports	23.3	21.1	23.8	26.0
Merchandise imports	-27.2	-26.5	-23.3	-26.2
Trade balance	-3.9	-5.4	0.5	-0.2
Current account balance	-5.1	-5.8	-0.1	-1.4

Source: http://www.bcentral.cl

	Population (million)	*Land area ('000 sq. kms)*	*GNP per capita (US$)*	*GNP per capita (US$ PPP)1*	*Life expectancy (years)*	*Adult literacy (%)*
US	270.6	9,159	29,080	29,080	76.4	99.0
Mexico	100.2	1,909	3,700	8,110	72.0	90.1
Chile	**15.0**	**749**	**4,820**	**12,240**	**75.0**	**95.2**
Brazil	161.8	8,457	4,790	6,350	67.0	84.0
Argentina	36.1	2,737	8,950	10,100	73.0	96.5

Note: [1]GNP adjusted for relative cost of living between countries.
Sources: World Bank, *World Development Report*; United Nations, *Human Development Report*

Executive Summary

Political Risk

In January 2000, Ricardo Lagos Escobar was elected president, winning by a narrow majority over right-wing opponent Joaquin Lavin of the UPC alliance. As leader of the Partido por la Democracia (PPD), Lagos' win assured another six years in power for the centre-left Concertacion alliance.

Congressional elections are due in December, allowing Chileans to cast votes on the entire composition of the lower house and half the Senate. The run up to elections has seen fierce competition both within the two main coalitions and between the government and opposition. Given the difficult economic climate, including a poor outlook for copper export revenues and high unemployment the opposition is likely to gain seats at the government's expense. The governing coalition will probably retain its 50% standing in the upper house. However, the coalition is at greater risk in the lower house where it now hold 70 of the 120 seats.

Despite the expected losses to the Concertacion, Dun & Bradstreet does not expect the government to lose its majority in the lower house. Even if this were to happen, a hung parliament would not pose a serious risk to the stability of Lagos' government. The president is politically astute, with an obvious understanding of the need for consensus and a wide support base. For example, following the January 2000 presidential election, the balance of power within the alliance shifted - Lagos is the fist Concertación president from outside the PDC. With PDC members determined to compensate for this loss by increasing their control at ground level, a dispute emerged over which of the two parties (PDC or PPD) should field the most candidates in the upcoming elections. Rather than see Concertación candidates stand against each other, Lagos decided that the PDC should field more candidates than the PPD.

Nevertheless, the president will face difficulties during the next parliamentary session. It is significant that the government pushed labour reform through Congress before the elections: the bill would not have been supported by the opposition, and may therefore have been defeated in an altered Congress. The reform, approved by the Senate in September, will cut the official working week by three hours to 45 hours, and will make it more costly for employers to dismiss workers. It also encourages collective bargaining and offers greater protection to part-time and seasonal workers.

Macroeconomic Risk

The Chilean economy grew a lacklustre 3.4% in 1998 (the lowest rate in 1986-1998) and fell into recession in 1999. Arguably, the economy posted respectable growth in 2000, increasing by 5.9%. Exports performed particularly well, benefiting from a rebound in copper prices. Industrial output also grew, fuelled by steady activity in the hydroelectric energy, transport and communications sectors. However, this growth was sedentary when the recession of the year before it taken into account.

In 2001, a lack of confidence has damaged Chile's economic performance. Overseas, the combination of deteriorating sentiment towards the emerging markets as well as increased risk aversion in the US has cut foreign investment into Chile. At home, high unemployment continues to stifle consumer confidence, while the government's prolonged indecision over labour reform, and well as the weaker global economic environment has hurt domestic business confidence.

Nevertheless, Dun & Bradstreet believes that Chile's sound macroeconomic management and structural reform programme of the past two decades have created a fundamentally sound economy. The scaling back of the state's role in the economy has helped to foster private initiative. The liberal investment regime has also encouraged foreign participation in the economy. The characteristics bode well for the longer-term prospects for the economy.

External Economic Risk

Although Chile's fundamental external economic position is the envy of the other countries in the region, Dun & Bradstreet is bearish on the short- to medium-term outlook for the country. This pessimism reflects continued weak sentiment. Chile's exposure to terms of trade shocks regarding copper, highlighted in the wake of the Asian crisis, remains a concern. While exports of copper (which account for 40% of Chile's external revenues) improved in the second quarter of 2001, they fell back again in the third quarter as a result of the seasonal slowdown in sales and have yet to recover. The weaker economic outlook in the US market and to a lesser degree in Asia will mean that copper exports are unlikely to rebound in 2001 into 2002, placing downward pressure on the peso.

Another area that may pose a cause for concern centres around the capital account. This account recorded a structural surplus through the 1990s, helping to offset the effects of deficits on the visible trade account on the balance of payments. However, in 1999, the capital account registered a deficit for the first time. Inflows of capital continued to grow in the year, but the outflow of domestic capital was higher (boosted by the softening of controls on overseas financial interests). We believe that this capital outflow is likely to increase over the medium term, while foreign investment in Chile will remain steady. Growing imbalance on the capital account will damage Chile's ability to secure a sustainable balance of payments.

Commercial Risk

Credit risks deteriorated significantly during 1998-1999 as the global trading environment worsened. The export-oriented sectors were badly hit by the decline in global commodities prices and demand in Asian markets, which led to cash flow problems. Importantly, the banking system was shielded from the downturn. Although bank profits were squeezed and non-performing loans increased, the solvency of the banking system has not been in doubt. Capital adequacy ratios remain high and provisioning adequate. In addition, although non-performing loans have risen, the reserves-to-past due loans ratio remains healthy.

Conditions began to improve in 2000, with Chile attracting US$0.7 billion in fresh credit in the first quarter of the year alone. Part of this improvement resulted from healthier macroeconomic conditions. However, the uneven pace of recovery meant that conditions varied across the economy. Notably, liquidity started to improve more significantly in the external sector (including agriculture, agro-processing and mining), reflecting the rebound in export volumes and improving terms of trade. Dun & Bradstreet expects that the recovery will continue to be uneven over the short to medium term. Bearish sentiment dominates the outlook and therefore prospects for credit recovery, where earlier this year, the external sector had looked like it would drive credit growth. However, looser monetary policy should encourage credit growth. More fundamentally, the restructuring, mergers and acquisitions that (most notably featuring the Spanish banks has strengthened the system. Additionally, the absence official ceiling on how much of the loans market a single entity can control, will encourage consolidation, and improve profitability.

Political Risk

Key Point: Congressional elections due to take place in December are likely to result in losses for President Ricardo Lagos' Concertación alliance. However, Dun & Bradstreet does not foresee a change to Chile's current successful system of consensus politics. We expect opposition support for the government's financial liberation and fiscal austerity programme. Although Lagos comes from the more left-leaning wing of the Concertación, commitment to a broadly free-market policy agenda remains secure.

Background

In September 1973 Chile's armed forces led by General Augusto Pinochet Ugarte took power from the country's democratically elected Marxist President Salvador Allende. After 16 years of General Pinochet's military regime, Chile returned to democracy in December 1989.

Chile has now transformed itself decisively, and has established a competitive, consensus-based party political system. Democratic institutions continue to be consolidated, respect for civil liberties is being strengthened and political participation is being promoted. The more extreme parties of both the left and the right have largely been isolated, with the major parties often fighting for the middle ground.

Some of the vestiges of the authoritarian regime still persist (not least the ongoing influence of the military) and the populace is far from fully recovered from the psychological traumas caused by repressive military rule. Nonetheless, Chile is decisively set on a path to full, strong democracy.

The centre-left Concertación coalition has dominated Chilean politics since the transfer to democracy in 1990 overseeing the process of entrenching political pluralism. The collective memory and continued popular resentment of almost 17 years of bloody military rule under General Pinochet have helped to maintain political stability.

Recent Developments

In January 2000, Ricardo Lagos Escobar was elected president, winning by a narrow majority over right wing opponent Joaquin Lavin of the Alianza por Chile (APC) alliance. As leader of the Partido por la Democracia (PPD), his win assured another 6 years in power for the centre-left Concertación alliance. Given the narrow majority of his win, Lagos is keen to reassure the cohesion of the coalition. Stamping an inclusive mark on his presidency from the start, Lagos immediately assigned 13 of the 16 available cabinet posts to members of the Partido Demócratico Cristiano (PDC), Partido Socialista (PS) and the Partido Radical Socialista Demócratico (PRSD) within the coalition, with only three posts going to other members of the PPD.

Government Stability

Congressional elections are due in December, allowing Chileans to cast votes on the entire make-up of the lower house and half the Senate. The run up to elections has seen fierce competition both within the two main coalitions and between the government and opposition. Given the difficult economic climate, including a poor outlook for copper export revenues and high unemployment the opposition is likely to gain seats at the government's expense. Lagos' government was widely popular when he took office in March 2000. However, by July 2001 the president's disapproval rating was at 44%. The governing coalition will probably retain its 50% standing in the upper house. But the coalition is at greater risk in the lower house where it now hold 70 of the 120 seats.

In spite of the expected losses to the Concertacion, Dun & Bradstreet does not expect the government to lose its majority in the lower house. Even if the government were to lose its majority, a hung parliament would not pose a serious risk to the stability of President Lagos' government. The president is politically astute, with an understanding of the need for consensus and a wide support base. For example, following the January 2000 presidential elections, the balance of power within the alliance shifted - Lagos is the fist Concertación president from outside the PDC. With PDC members determined to compensate for this loss by increasing their control at ground level, a dispute emerged over which of the two parties (PDC or PPD) should field the most candidates in the upcoming elections. Rather than see Concertación candidates stand against each other, Lagos decided that the PDC should field more candidates than the PPD.

Table 1

Party Standings November 2001

Party	*Chamber of Deputies (seats)*	*Senate (seats)*
Concertacion Coalicion	**70**	**11**
Christian Democratic Party (CPD-PDC)	39	10
Party for Democracy (CPD-PPD)	16	-
Socialist Party (CPD-PS)	11	1
Radical Social Democrats (CPD-PRSD)	4	-
Alianza por Chile Coalicion	**46**	
National Renovation (UPC-RN)	23	2
Independent Democratic Union (UPC UDI)	17	7
UPC Independents (UPC-Ind)	6	-
Centre-Centre Progressive Union (UCCP)	1	-
Party of the South (UPC-P.del S)	1	-
Non-partisans	**2**	-
Other	0	-
Total	**120**	**20 of 47**

Source: Ministry of the Interior, http://www.elecciones.gov.cl

Political System

Chile is bound by the 1980 constitution, which came into force in March 1981. Successive attempts to amend it to reduce the role of the military in favour of elected representatives have largely been stifled by the continued presence of pro-military elements within the legislature, particularly in the Senate where non-elected officials still sit.

The Republic of Chile is headed at the executive level by the president, who is responsible for the appointment of a cabinet team. Legislative power lies in a bicameral Congress, comprising an upper house or Senate (with 38 members), and a lower house or Chamber of Deputies (which contains 120 nationally elected members, who are elected for a four-year term). Voting is compulsory.

Legislature

Legislative power lies in a bicameral Congress, comprising a lower house or Chamber of Deputies (which contains 120 nationally elected members, who are elected for a four-year term) and an upper house or Senate consisting of 38 elected and nine appointed members. Senators are elected for a maximum term in office of eight years; one half of the Senate is re-elected every four years.

Some of the vestiges of authoritarian rule have yet to be removed, not least provisions within the 1980 constitution which limit the power of Congress. The president can call a plebiscite on constitutional amendments rejected by Congress; budgets proposed by the presidency must be voted on within 60 days or they automatically go into effect. Furthermore, the constitutional tribunal has the final word on important legislation.

Executive

The Republic of Chile is headed at the executive level by the president, who is responsible for the appointment of a cabinet team. A traditionally important office under Pinochet, the transition to democracy has meant that the president is now subject to more scrutiny.

The role of the central government was significantly diluted under Pinochet who decentralised a lot of budgeting and decision-making to local government and municipalities (who have taxing power).

Judiciary

The judiciary was once subservient to the military junta, bowing to the will of the executive. Judicial reform was therefore an important policy priority for the Frei administration as part of overall efforts to democratise the country’s political institutions. Consequently, the power of the Supreme Court has been strengthened and the Court itself expanded to take on its new role as a branch of government responsible for ensuring that the executive and legislature are accountable.

Government Coalition Parties
Concertación (*de los Partidos de la Democracia*), created in 1989:

Party for Democracy (Partido por la Democracia, PPD): The PPD embraces several moderate socialist groupings. The PPD has wide-scale and rising popular appeal (especially among younger voters) for its centre-left agenda of modernising public services through market forces and streamlining the state sector to fund social programmes.

Christian Democrat Party (Partido Democrático Cristiano, PDC): The PDC is Chile’s largest single political force dominating the centre ground. Its policies are guided by the belief in Catholicism as an agent of social justice and change. It built up support in the 1960s when, led by Eduardo Frei Montalva, it appealed to conservatives fearful of a Marxist victory. At that time, it was partly aided by US government funding. The lack of conservative support in the 1970s elections effectively opened the way for the Marxist Allende. The PDC lent its support to the Pinochet-led coup, expecting democracy to be restored. Its philosophy continues to centre on encouraging a mixed economy and defending human rights, which appeals to the middle class, women, labour groups and urban shantytown dwellers

Socialist Party (Partido Socialista, PS): The PS is a left-wing party which remains in favour of more widespread state intervention, particularly in firms such as the state-owned copper giant, Codelco. Originally made up of moderate socialists (most of whom left to form the PPD), it also has a more communist wing.

Radical Social Democratic Party (Partido Radical Social Democrático, PRSD): The PRSD is an old centrist party which has been weakened by internal splits and has limited support in rural areas and provincial towns.

Opposition Parties
Alianza por Chile UPC Alliance:

National Renovation (Renovacion Nacional, RN): The RN is a rightist party which supported many of the economic reforms undertaken under Pinochet. It focuses on the importance of private initiative and a minimal state role in the economy.

Independent Democratic Union (Unión Democrático Independente, UDI): The UDI has often sought to protect the Pinochet legacy. It wields considerable power when it votes with the RN and designated senators in the Senate.

Centre-Centre Union (Unión de Centro-Centro, UCC): The UCC is a small right-wing party based around businessman and leader Francisco Javier Errázuriz.

Other parties include: *Communist Party (Partido Communista, PC).*

Policy Agenda

Economic Reform

The government opted for fiscal austerity when it pledged to lift public spending only in line with growth in 2002 and maintain a structural surplus of 1.0% of GDP.

Public spending will focus on health and education, and these departments will see their budgets rise by 10%. This budget increase over and above growth, will partly be financed from an ongoing efficiency drive in state departments. The proposals will be debated in Congress over the next two months and are likely to be supported by the opposition. Indeed, there may even be calls for greater spending on employment creation and poverty reduction programmes. Sebastian Pinera, president of the centre-right Renovacion Nacional Party called for a total restructuring of social spending to combat poverty and inequality.

There is also likely to be widespread support for a major financial liberalisation bill that will help to deepen Chile’s capital and credit markets.

Political Reform

Since 1989, the political reform agenda has concentrated on restoring Chile’s democratic credentials and enhancing political pluralism. Radical change has been constrained by the military’s continued high profile and public demands for consensus-style government.

The least extreme elements of Chile’s right wing seem resigned to the fact that further constitutional reform to eliminate the authoritarian enclaves left by the Pinochet dictatorship is at the top of president Lagos’ political agenda. Soon after taking power, Lagos announced that an all-party commission would be set up to seek agreement on a package of reforms. The core elements include:

- doing away with unelected senators (designated and senators for life);
- reinstating the president’s power to remove the top commanders of the military; and
- modifying the composition of the national security council and the constitutional tribunal, so as to eliminate the dominant position now held by the military.

The more militant members of the right wing are opposed to the plan. The Renovacion Nacional party for example, interpreted the plan as a rebuff of its proposed ‘Great National Agreement’, which constitutional reform dependent on an end to the human rights trials and a dignified withdrawal for Pinochet from the political scene. In spite of this opposition, Lagos has set out his stall as a reformer early on in his administration. Dun & Bradstreet therefore believes that the prospects for the completion of reforms are better now than they have ever been.

Socio-Political Risk

Interest Groups

Military: The military has played a major role in shaping the country’s recent history. The military take-over in 1973 was traumatic, with significant loss of life, the exile of thousands, and the complete rupture of the long-standing constitutional system. The coup was aided by opposition party agitation which led to waves of strike action causing economic and political chaos; a US blockade and finance for the military also severely undermined the Socialist administration.

The military junta retained power through surveillance and repression by the National Intelligence Service (DINA), even on foreign soil; the 1978 Amnesty Law subsequently protected the perpetrators from prosecution (excluding those who committed illegal acts abroad). Free-market economic policies which delivered good growth also consolidated support by conservatives. The re-charging of the economy drew widespread support from the upper and middle classes; the lower classes were largely left out of the new-found wealth. However, in its misguided attempts to ensure complete political order, the police state took away the citizenry’s political rights, killing, jailing or exiling opponents. Politically, while left-wing parties were outlawed, a dialogue was maintained with opposition groupings of all persuasions (right, centre and centre-left) for a transition to democracy. A new constitution to develop an organised democracy was passed in 1980 (although the lack of a voting roll meant this could not be verified) as Pinochet sought to legitimate his power with provisions for him to remain in power until 1990.

Ultimately, the deterioration in economic conditions in the early 1980s weakened the government’s authority and resulted in a resurgence of violence by left-wing groups and, in turn, the use of counter-repression tactics by the armed forces. This continued until 1986 with Pinochet clinging to power by negotiating with non-violent opposition forces for a return to democratic government. But the October 1988 national plebiscite did not give the results Pinochet expected. His alarmist pronouncements reminding the electorate of the chaos of the Allende administration were not shared by the majority. Following a concerted No campaign from the centre and leftist parties and a huge Church-organised voter registration drive, the referendum resulted in a clear rejection of military rule.

President Lagos has effectively speeded up the erosion of the military’s power by announcing in August that it will have to work within a reduced budget. At a meeting with the commanders of the three services, he told them that they would only receive the assured portion of the state’s copper sales. Thus there will be no extraordinary budget supplement to help them carry out the rearmament plans that military chiefs had claimed were essential.

Catholic Church: As in many Latin American countries, the Catholic Church is an important player on the political scene. Indeed, Pinochet actively and unsuccessfully sought Church support during his period in office. In fact, during military rule, the Church, guided by an ethos of Christian social justice, sought to defend human rights, providing shelter for some of the persecuted, and it continues to represent the underprivileged. It also plays an important role in education (through important Catholic universities).

Business Groups: The main business groups are the Society for the Promotion of Manufacturing (SOFOFA is its Spanish acronym) and the Confederation for Production and Commerce. SOFOFA is generally supportive of government policy and at times has an input into policy-making. However, the association is critical of the government's labour reform policy, which it claims will add 2.4% to employment costs and actually slow down the reduction in unemployment.

Labour Relations

Industrial strife is minimal in Chile which is partly a symptom of the repression of the unions during the military era; union membership is still quite limited and most wage bargaining is conducted at the company level. Nevertheless, as democracy became more entrenched in the late 1990s, the public-sector labour unions (allied to the ruling Concertación) have increasingly been flexing their muscles, seeking concessions from the government in terms of welfare spending and labour legislation; Chile's ports have intermittently been hit by disruptive strike action ahead of privatisation. recent changes to labour law (see Policy Agenda will restore some of the bargaining power lost by the unions during the period of repression under Pinochet.

Internal Stability

Following the transition to democracy in 1990, the rule of law has once more been established and the government has reinstated widespread respect for human rights as an important policy objective. The government has sought to reconcile the families of the victims of the 1973-1990 dictatorship (represented by the Group of Families of the Detained-Disappeared, AFDD) and alleged perpetrators, but pressure to deal with cases of human rights violations remains considerable.

Since 1990, there have been eight attempts at reaching a political or legislative solution to the trials pending over the nearly 1,200 forced disappearances; the government continues to seek measures to encourage former officers to provide information to help locate the disappeared. Prosecutors have managed to exploit loopholes in the 1978 amnesty law and are currently charging several retired officers for kidnapping.

Overall, there are no major internal security concerns, with interest groups seeking to lobby parliament and corral support through democratic means. Notably, the government has sought to improve relations with the indigenous Indian minority, signing a landmark deal in August 1999 to clamp down on discrimination and improve social services for the Mapuches, who account for around 10% of the population.

However, high rates of common crime continue to undermine domestic stability; money laundering is present but not as widespread as in some other Latin American nations.

External Political Risk

The democratic governments of the 1990s have worked hard to reintegrate Chile into the world after it became an international pariah because of the repressive regime. Chilean foreign relations have become increasingly entwined with the government's desire to develop trading relations. The country joined the Asia-Pacific Economic Co-operation (APEC) forum in November 1994. In 1995, it became an associate member of Mercosur, the trade group that links Argentina, Brazil, Paraguay and Uruguay (Bolivia is also now an associate member.) In particular, with growing regional co-operation, relations with Argentina (a country with which Chile has historically had a number of border disputes) have also substantially improved in recent years.

Chile’s outward-looking trade and economic policies remain unconstrained by the country’s natural geographical borders or by its regional location. It is actively seeking to conclude bilateral or multilateral free-trade deals with a plethora of countries and regions throughout the world. Talks with the US are expected to yield a free trade agreement by the close of this year. This deal is ultimately aimed at incorporating Chile in to the North America Free Trade Agreement (NAFTA).

Political Risk Outlook

The government is expected to suffer losses in upcoming congressional elections. However, we are not forecasting a loss of the government’s majority in Congress. Even in the unlikely event of this occurring, we do not anticipate any significant challenge to the stability of Lagos’ government or changes to the policy stance. Consensus government will continue.

Nevertheless, the president will not have an easy ride during the next parliamentary session. It is significant that the government pushed labour reform through Congress before the elections: the bill would not have been supported by the opposition, and may therefore have been defeated in an altered Congress. The reform approved by the Senate in September will cut the official working week by three hours to 45 hours, and will make it more costly for employers to dismiss workers. It also encourages collective bargaining and offers greater protection to part-time and seasonal workers.

Macroeconomic Risk

Short-Term Economic Performance

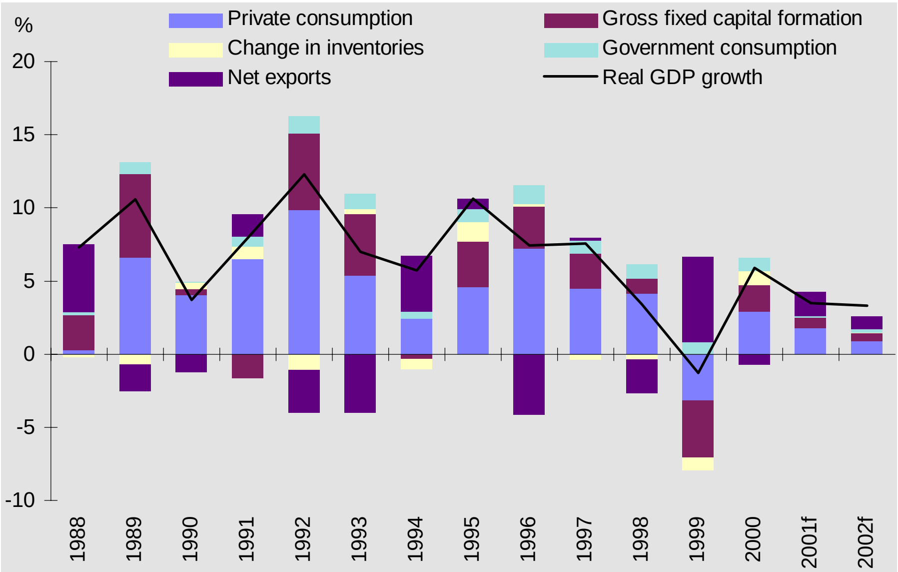
Key Point: With GDP expected to grow by 3.5% in 2001, Chile's economy will be the best performer of the region's big four. However, this rate of growth is significantly below the average for the 1990s, with output hampered by weak prospects in the copper industry. This weakness suggests moderate real GDP growth in 2002, with the stronger rebound postponed to 2003.

Chile's economy fell into recession in 1999. The contraction was a product of various factors, but significantly, the downturn highlighted the fact that the economy's fortunes still remain closely tied to the copper industry. The Asian crisis and weak Japanese economy severely curtailed demand for copper and exerted sharp downward pressure on prices.

Important though the copper industry may be the Chilean economy, it was the decline in investment and private consumption which in effect dragged the economy into recession. Net exports made a positive contribution to GDP in 1999. True, exports did decline, but imports fell faster on the back of weak domestic demand. Private consumption and investment were both negative in 1999.

Chart 1

Yearly GDP Growth Contribution by Demand



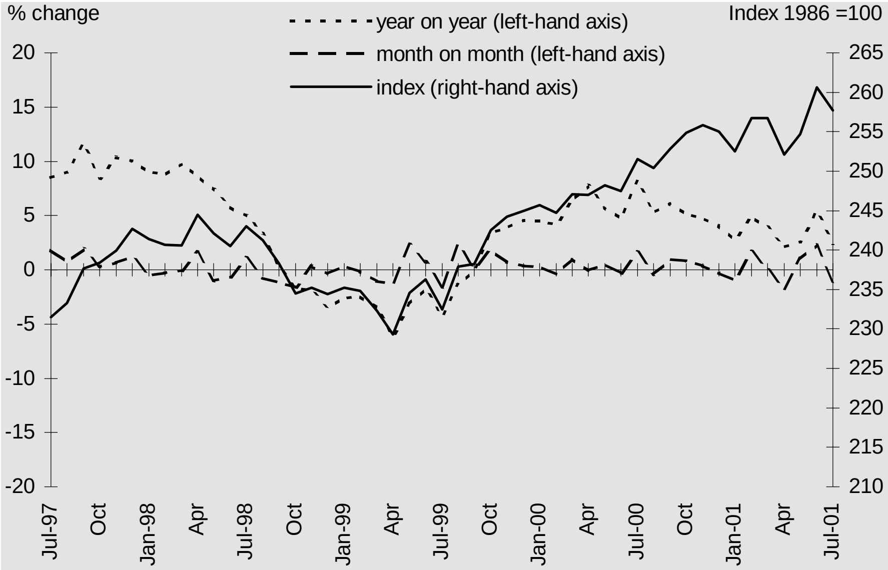
Sources: Banco Central de Chile, *Boletin Mensual*; Dun & Bradstreet

Arguably, the economy posted respectable growth in 2000, increasing by 5.6%. Exports performed particularly well, on the back of a rebound in copper prices. Industrial output also grew, fuelled by steady activity in the hydroelectric energy, transport and communications sectors. However, this growth was sedentary when we take into account the recession of the year before.

In 2001, confidence (or rather the lack thereof) has damaged Chile's economic performance. Overseas, the combination of deteriorating sentiment towards the emerging markets as well as increased risk aversion in the US has cut foreign investment into Chile. At home, high unemployment continues to stifle consumer confidence, while the government's prolonged indecision over labour reform, and well as the weaker global economic environment has hurt domestic business confidence.

Chart 2

Economic Activity Indicator (IMACEC)



Source: Banco Central de Chile, *Boletin Mensual*

Components of Growth

Table 2

Contribution to Growth

	1998	1999	2000
Real growth rate (%):			
Private consumption	6.4	-4.8	4.6
Gross fixed capital formation	3.9	-15.3	8.1
Government consumption	9.0	7.4	7.6
Exports	-7.6	11.2	16.2
Imports	0.3	-9.8	19.9
Real GDP	**3.4**	**-1.3**	**5.9**
Share of GDP (%):			
Private consumption	66.4	64.1	63.3
Gross fixed capital formation	25.5	21.9	22.3
Government consumption	11.0	12.0	12.2
Exports	25.8	29.0	31.8
Imports	29.8	27.2	30.8
Contribution to real GDP growth (percentage point):			
Private consumption	4.2	-3.2	2.9
Gross fixed capital formation	1.0	-3.9	1.8
Government consumption	0.9	0.8	0.9
Exports	-2.2	2.9	4.7
Imports	0.1	-2.9	5.4

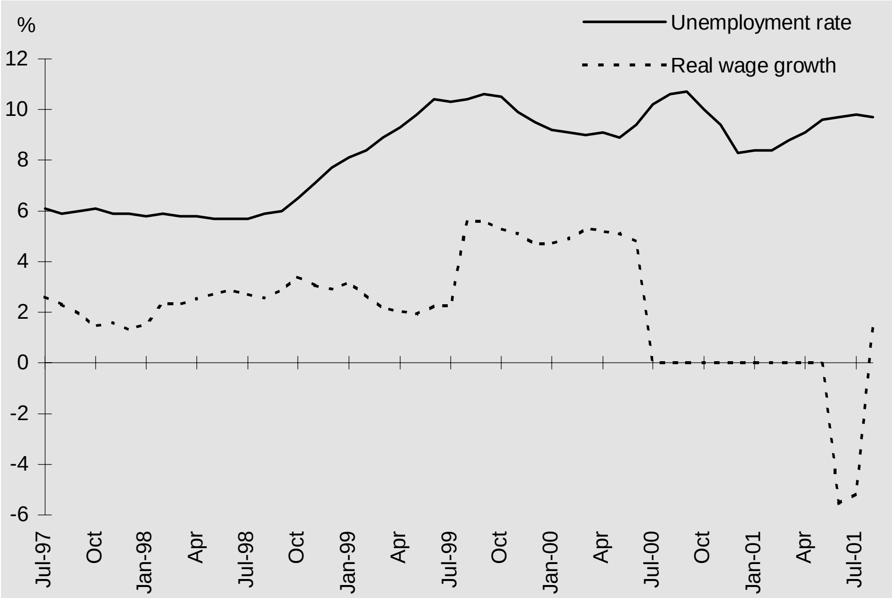
Source: Banco Central de Chile, *Boletin Mensual*

Private Consumption

Real consumption growth began to slow in 1998, reaching just 3.9% in the year compared with 8.3% in 1997. The following year, consumption fell by 4.8% as unemployment rose to 9.2% at year-end. Although consumption spending grew by 4.1% in 2000, the size of the rebound was hampered by the resurgence in unemployment in the year.

Chart 3

Wage Growth and Unemployment



Source: Banco Central de Chile, *Boletin Mensual*

A seasonal downturn aside (due to extra employment opportunities during the December to February summer months), Chile's unemployment rate has continued its stubborn rise throughout 2001, reaching 10.1% in the third quarter. This steady increase in the unemployment rate has seriously weakened consumer confidence and explains why consumption has been slow to recover this year, despite the aggressive cuts in interest rates over the first half. Extra fiscal spending on infrastructure (see **Government Consumption**) designed to create jobs, may go some way to reviving consumer confidence. However, Dun & Bradstreet remains bearish on the outlook for consumer spending. With the outlook for copper prices weak, copper producers are expected to reduce their workforces. In addition, recent changes to employment law (see **Government Stability**) will make hiring new employees more costly, so that when prospects do pick up, employers are likely to offer overtime rather than hire new workers.

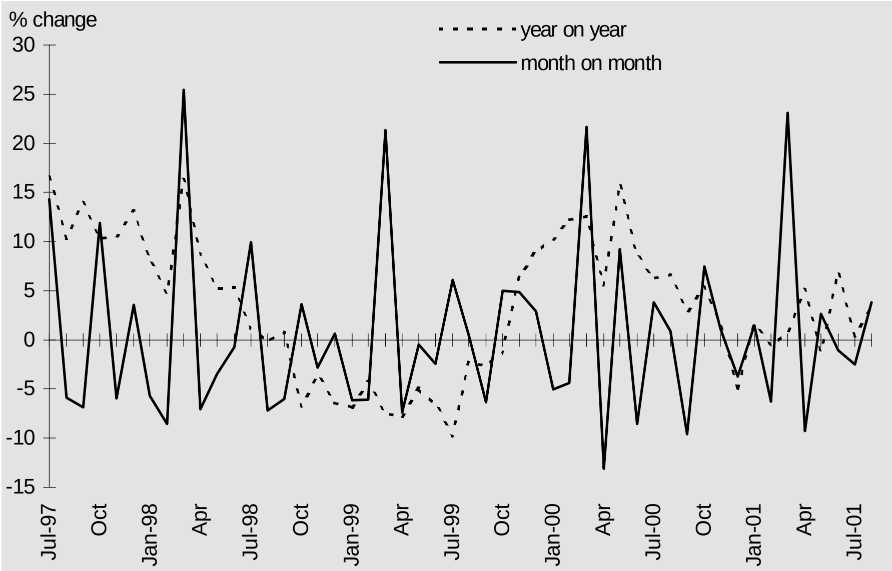
Gross Fixed Capital Formation

The slowdown in investment growth which began in 1998 continued into 2000, and made a significant contribution to the deceleration in real GDP. Fiscal cuts in 1999 - particularly in the investment budget which saw projects in the copper sector delayed - also had adverse effects for the private sector. In 2000, weak domestic business sector confidence lay at the root of poor investment spending. The government's indecision over reforms to investment and labour laws also caused businesses to postpone their investment plans.

Nevertheless, some areas of the economy prospered, with private investment directed towards the dynamic transport, communications and utilities sectors. The government's investment plan 'Todo Chile' encouraged US$1 billion in investment spending in 2001 in the outlying regions of the country rather than in the capital (compared with the US$260m invested in 2000). This investment bodes well for growth in the medium term by improving infrastructure for industry and trade.

Chart 4

Production Trends



Source: Manufacturing Development Association (SOFOFA)

Government Consumption

Chile's fiscal policy record has generally been cautious. Strong GDP growth contributed to the underlying strength of the fiscal accounts which remained firmly in surplus for most of the 1990s. The state copper company Codelco is an important source of revenue but, with an economy reliant on one commodity export, running fiscal surpluses is essential to smoothing out fluctuations in revenue. The Copper Stabilisation Fund, established in 1986, is an important mechanism through which the fiscal impact of falls in the copper price are dampened. When the copper price is above 96 cents per pound excess earnings are transferred to the fund, but when the price falls below 96 cents transfers are channelled from the Fund to the Treasury.

Table 3

Government Balance

CLP million	*1997*	*1998*	*1999*	*2000*
Total revenue	**7,525.4**	**7,909.0**	**7,909.9**	**9,114.5**
Current revenue	7,334.4	7,707.7	7,730.6	8960.1
Capital revenue	191.1	199.4	179.4	154.4
Total expenditure	**6,902.1**	**7,775.2**	**8,412.4**	**9,058.1**
Current expenditure	5,575.8	6,324.6	6,882.2	7,555.9
Capital expenditure	1,326.3	1,450.6	1,530.2	1,502.2
General government balance	**623.3**	**133.8**	**-502.5**	**56.4**
General government balance, % of GDP	2.3	0.4	-1.5	0.2

Note: General government balance includes the central bank.
Source: Ministry of Finance, http://www.minhda.cl

The budget for 1999 assumed an average copper price of 73 cents per pound and GDP growth of 2-3%. The economy actually contracted by 1.1% in 1999. Thus the government was forced to increase spending on social benefits by CLP0.3 billion while its revenues only increased by CLP0.1 billion. At the same time, the Frei government had committed itself to a launching fiscal stimulus packages to assist economic recovery. As a result, the government recorded its first budget deficit in a decade, the size of the deficit reaching 0.8% of GDP. In 2000, president Lagos' government announced that fiscal spending for the year would increase by 3.3%. The extra spending would go to the recovery effort including:

- a US$400 million public-sector investment programme focused mainly on education and transport;
- the speeding up of the construction of phase 2 of the Radomiro Tomic copper mine by Codelco;
- a US$90 million job creation initiative including subsidies for the employment of technical and university students; and
- tax breaks including rebates on housing purchases and help for small- and medium-sized companies with their debts.

The extra spending did not to have a detrimental effect on the size of the budget deficit in 2000. Indeed the government recorded a moderate surplus of 0.1% of GDP. Higher tax receipts and the privatisation of public utilities last year added US$1.7bn to the public purse.

The 2001 budget included a 7% increase in spending on programmes for health education and public housing, based on official GDP growth forecasts of 6.2%. The government also forecast a 1.0% surplus in 2001. We expect that the budget will record a moderate deficit of 0.5% of GDP. We believe that official growth forecasts are over-ambitious. Additionally, there will be less possible revenue gains from privatisations, since the highest yielding sell-offs have already taken place.

The 2002 budget sees government spending rising by 4.9% (in line with the official GDP growth forecast) with employment creation and health programmes set to receive around 10% of the funding. The government hopes to create 90,000 jobs in 2002. The government also wants to maintain the structural surplus of 1.0%. However, the continued weakness of copper prices and external demand is more likely to see a balanced budget in 2002.

Public Debt

The profile of the small government debt stock is propitious. The bulk of the debt is in the form of domestic debt owed to the central bank, accumulated as part of open market operations in the conduct of monetary policy. Only a small proportion is foreign debt. Although the decline in government tax revenue (due to lower GDP growth and reductions in tariffs) did hurt debt servicing capacity in 1999, the existence of the Copper Stabilisation Fund acted as a short-term source of liquidity. In 2000, the government bought back debt, thus improving the country’s debt position. Over the medium term, the up-tick in the economic cycle should help ease fiscal pressures.

Net Exports

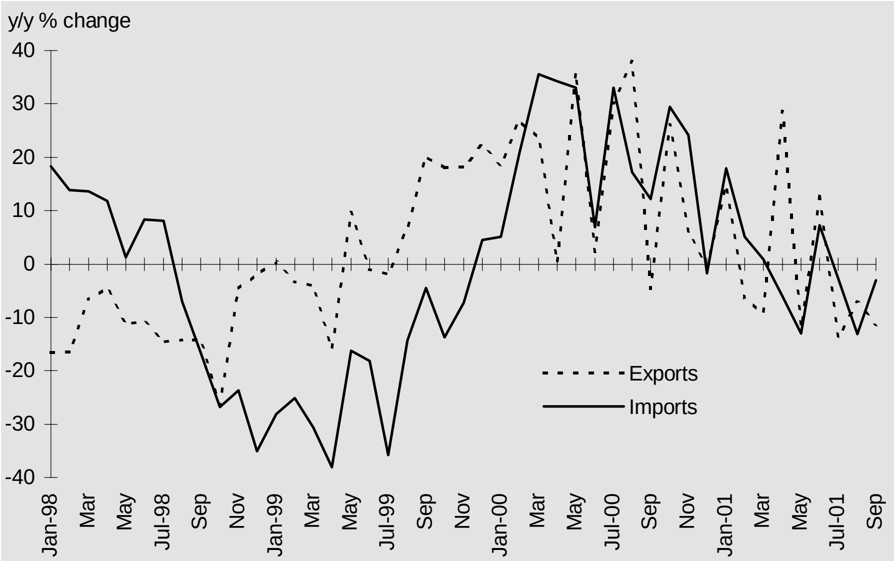
Exports have been an important source of GDP growth. Net exports actually made a positive contribution to growth in 1999, even though the value of Chile’s major commodity exports declined through the year. Export volumes continued to grow during the year as strong demand from the USA and Europe picked up the slack left by weaker sales in Asia. At the same time, the value of imports fell faster than that of exports, as domestic demand contracted.

In 2000 net exports made a negative contribution to GDP growth. While export volumes continued to grow, copper prices languished at historical lows throughout the year, dampening receipts from Chile’s single most important foreign exchange earner. Meanwhile, import demand staged a moderate rise as domestic demand rebounded from recession to growth. Chile reported a trade surplus of US$1.3 billion in the first eight months of this year, up US$0.2 billion on the previous year.

We expect a trade surplus of US$1.1 billion for the year as a whole. Import costs have declined through the year as prices for energy imports have come down from recent highs. However, underlying demand has remained weak and is the main factor in driving down the cost of imports. Meanwhile exports grew well in the first half. Dun & Bradstreet therefore expects that net exports will make a positive contribution to GDP growth for 2001.

Chart 5

Export and Import Growth



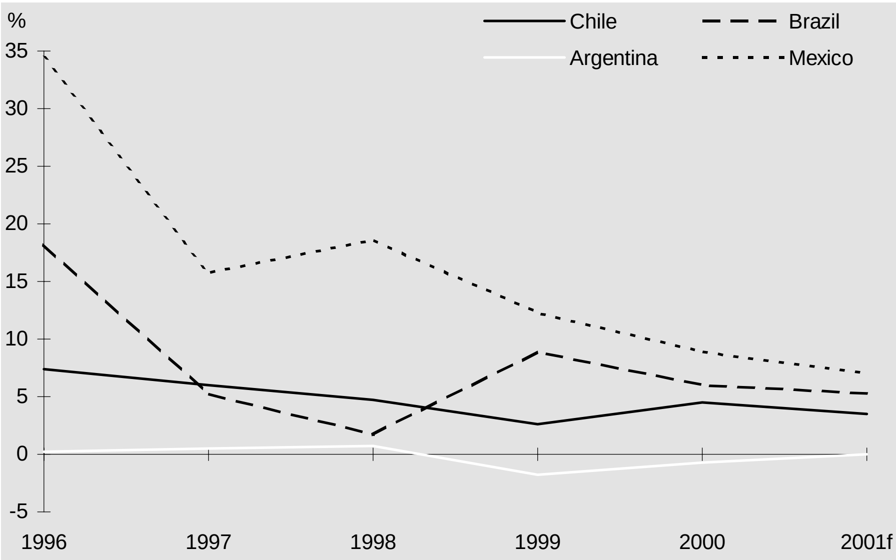
Source: Banco Central de Chile, *Boletin Mensual*

Inflation

The monetary authorities have sought to reduce inflation and in this they have largely been successful. The inflation performance compares favourably with regional counterparts, and the rate fell through the 1990s. Average annual inflation fell to 5.1% in 1998 from 26.6% in 1990.

Chart 6

Consumer Price Inflation

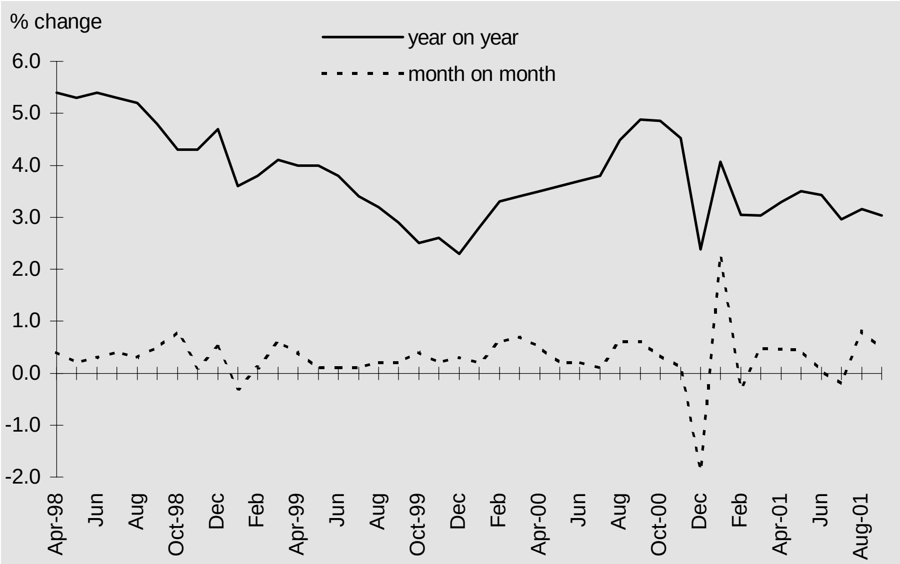


Source: Inter-American Development Bank, http://www.iadb.org

Interest rates have see-sawed during the course of 2001, with central bank cutting rates early in the year in order to boost domestic activity, and then increasing rates in order to protect the peso. At their last meeting in November, the authorities agreed to leave rates unchanged at 6.5%, since shoring up the value of the peso remains a priority. However, lower interest rates have not encouraged inflationary pressures. On the contrary, weak domestic demand and lower prices for fuel imports have outweighed the inflationary effect of the depreciating peso/dollar rate, and inflation has been through the year, reaching 3.0% year on year in September.

Chart 7

Inflation Trends



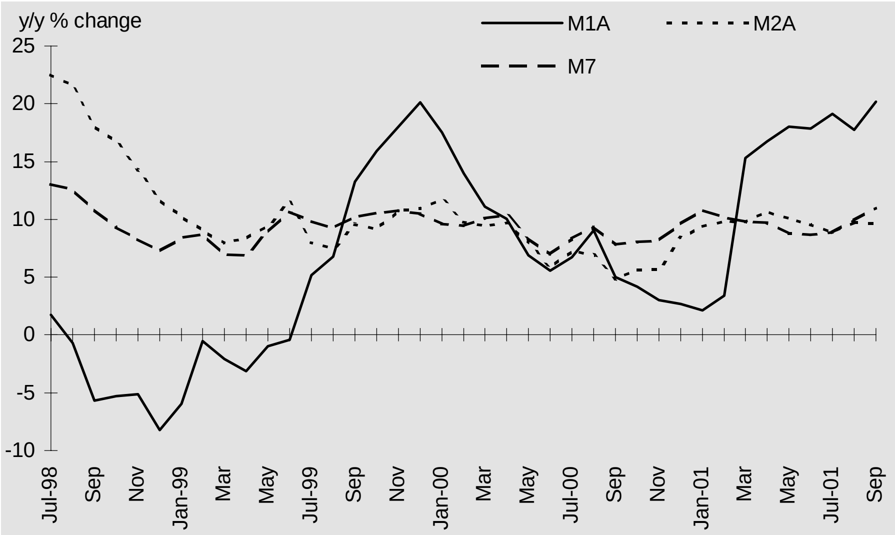
Source: Banco Central de Chile, *Boletin Mensual*

Monetary Environment

Money Supply

Interest rates have generally been adjusted in response to GDP trends while money supply has tended to act passively (although some credit limits are used). The central bank sets an offer rate, which is effectively the target for the daily inter-bank rate, in real terms (as a premium over the Unidad de Fomento, an inflation index).

Chart 8
Money Supply

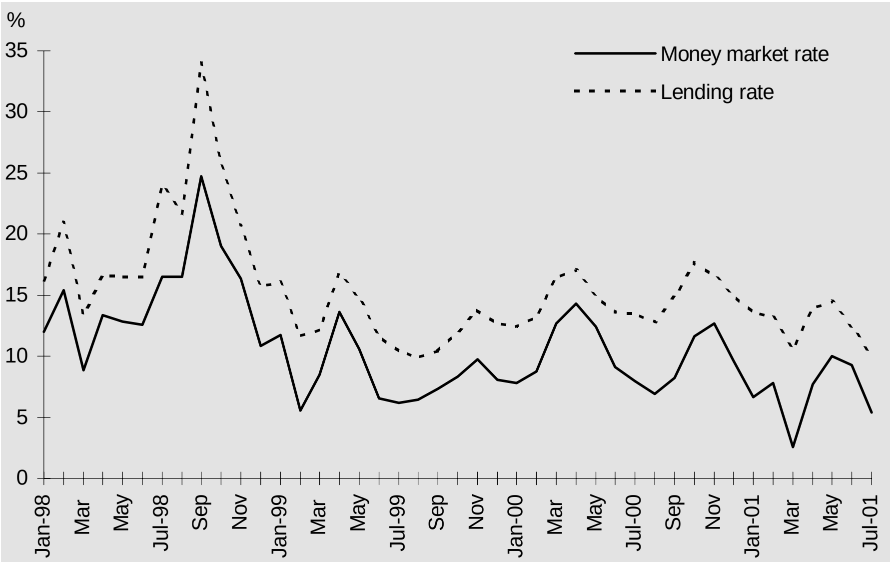


Source: Banco Central de Chile, http://www.bcentral.cl/indicadores

Interest Rates

Dun & Bradstreet believes the central bank will hold the benchmark rate steady over the first half of 2002, in order to encourage a resumption in investment and consumer spending. Any rise in rates will be slower, given the dramatic shift in external conditions sparked by the events of 11 September.

Chart 9
Interest Rates



Source: International Monetary Fund, *International Financial Statistics*

Short-Term Growth Forecast

Chile's economy grew by a moderate 3.7% year on year in the first half of 2001, but growth is likely to slow in the second half, taking the expansion in real GDP for the year as a whole to just 3.5%.

Domestic confidence has remained stubbornly in the doldrums since the economic contraction in 1999. Uncertainty over investment and employment laws discouraged businesses from investing in employment creating initiatives, while high and rising unemployment saw consumers rein in their spending. While overseas demand provided a engine for growth in 2000, weaker prospects and a downturn in confidence in the US and Japan in particular hamper the outlook for an export-led GDP growth drive. Furthermore, while Chile's fundamentals remain sound, its regional association with Argentina's woes has served to reinforce bearish sentiment surrounding the emerging markets.

Table 4

Key Short-Term Economic Forecasts

Forecast	***2001f***	***2002f***
Real growth rate (%):		
Private consumption	2.8	1.4
Gross fixed capital formation	3.1	2.3
Government consumption	1.2	1.8
Exports	24.0	4.0
Imports	19.4	1.8
Real GDP	**3.5**	**3.3**
Contribution to real GDP growth (percentage point):		
Private consumption	1.8	0.9
Gross fixed capital formation	0.7	0.5
Government consumption	0.1	0.2
Exports	7.6	1.5
Imports	6.0	0.6
Inflation, year end (%)	3.5	3.4
Interest rate, lending (%)	10.7	9.2
Interest rate, deposit (%)	6.1	5.5

Source: Dun & Bradstreet

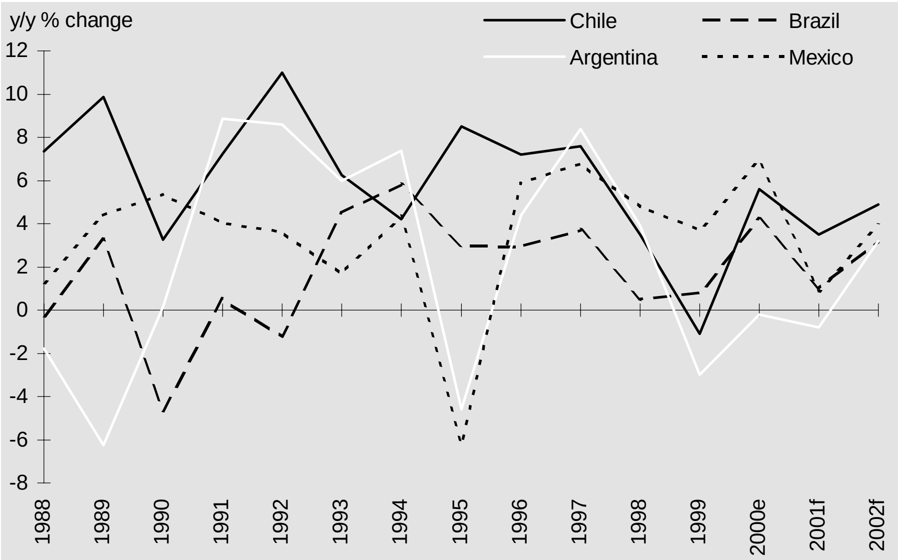
While successive governments have been successful in diversifying the Chilean economy, Copper still accounts for 8.0% of GDP. Weak copper prices are forcing the worlds biggest producers to consider mine closures or delay expansion plans in Chile. Copper prices have plummeted by more than 25% this year to US$0.64 per pound. The rapid expansion of copper mining in Chile during the 1990s is partly blamed for this year's price weakness. Although copper prices had begun to recover last year from historic lows (brought on by Asia's crisis) growing stocks and declining demand threaten to establish a new floor this year. The shut down of Chile's highest cost mine in Antofagsta would involve the loss of 500 jobs. A clutch of other mines may have become unprofitable over the second half and may close if low prices persist in to the middle months of 2002.

Long-Term Economic Potential

Key Point: Despite the much-vaunted pension reforms, current domestic savings will be insufficient to sustain investment, and risk limiting real GDP growth over the next decade to 6.0%, below the 7.5% annual average registered in 1989-98.

The Chilean growth story has been impressive, with healthy growth during 1983-1998. The country is now the most developed in the region. Growth has been stimulated by numerous factors, not least sound macroeconomic management and structural reforms initiated by the Pinochet regime.

Chart 10
Annual Real GDP Growth Rates



Sources: World Bank, *World Development Indicators*; Dun & Bradstreet

Trade liberalisation, privatisation and social security reforms date back to the 1970s and early 1980s. These reforms have helped to promote private initiative, with the public-sector playing a relatively small role. On the downside, the economy remains vulnerable to structural imbalances, especially its exposure to developments in commodities markets. Moreover, gains from development have not been evenly distributed with a significant part of the population still living in poverty.

Structural Factors

Chile's relatively long history of structural reform has helped to create a modern industrial base and infrastructure. The country thus has a well-developed and dynamic services sector and a flexible, albeit small, manufacturing sector, dominated by processed primary goods particularly, food and drink products, cellulose and paper products and chemicals.

Yet efforts to diversify the economy have yielded mixed results and Chile continues to rely on a relatively large primary sector with agriculture, forestry and fisheries, and mining and quarrying. Consequently, the economy is vulnerable to changes in prices and demand for commodity goods. This exposure can have additional effects on the economy given the importance of the primary sector as a source of employment; it also has significant linkages with the rest of the economy, not least the processing industries.

The agricultural sector produces a whole range of goods. Traditional crops include wheat, oats, maize, potatoes, sugar-beet and rice, and there are also new market gardening crops of vegetables. Moreover, since the early 1970s Chile has been a major exporter of a wide range of fruit, taking advantage of the country's diverse topography (for example, the grape season is unusually long, spanning from November to April). A well-developed agro-processing industry also adds value to the production of these agricultural goods. Nevertheless, some restructuring will prove necessary in the medium term, particularly as world agricultural trade flows rise; the amalgamation of small producers into larger operations would allow exploitation of economies of scale and productivity gains.

Copper

Chile has the world's largest known copper deposits and is regarded as the most efficient producer. Copper production was boosted in the 1990s by the opening of new facilities, including La Escondida, the world's third-largest copper mine. But dependence on the metal has been a mixed blessing given the historically erratic movement of copper prices, which has often undermined fiscal and external accounts. In the past 30 years, the price of copper has fluctuated between 24 and 160 US cents per pound, often doubling and halving over two- or three-year periods, with severe consequences for macroeconomic stability.

The copper price was volatile in the late 1990s, strengthening in 1995 and 1997 but weakening in 1996 and 1998-1999. Yet the sector's long-term position appears somewhat stronger. On the supply side, output will continue to rise on the back of strong foreign (and domestic) investment in mining. This will be assisted by the development of the foreign-financed US$1.8 billion Collahuasi mine, expected to be one of the world's largest copper mines, with annual output expected to surpass 330,000 tonnes. But output from Collahuasi will still be dwarfed by production at the state copper giant Codelco, the world's largest producer, and the vast foreign-owned Escondida project. However, this upturn in production risks leading to oversupply, given still weak demand in the crucial Japanese market..

Long-Term Growth Factors

The Elements of Growth

The 1980s witnessed a reawakening of interest among economists as to why some economies grow faster than others over the long term (ironically, spurred in part by the spectacular growth witnessed in developing Asia). While much of the 'new growth theory' has increased our understanding of the relative performance between economies, the key growth elements are the same as those identified back in the 1950, principally:

- population;
- investment; and
- technological progress.

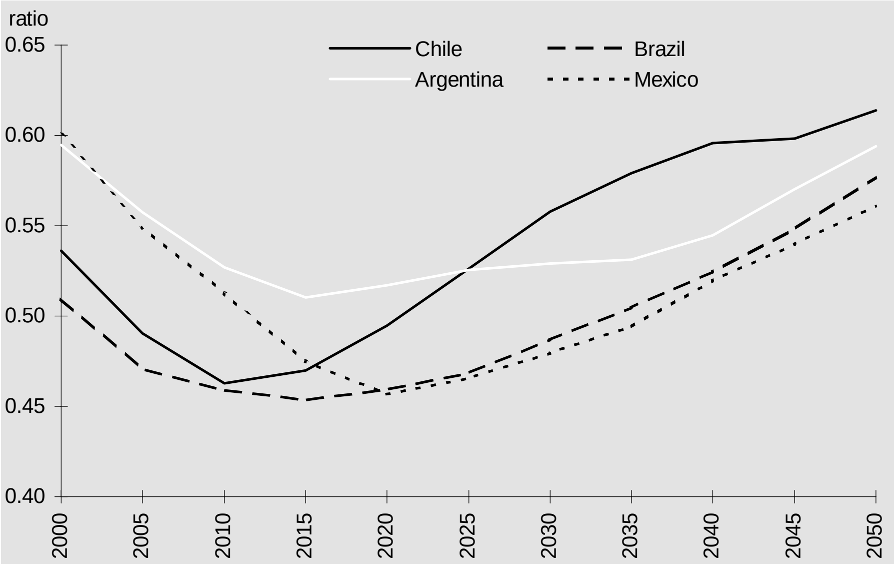
Each element is not in itself sufficient to secure growth. Bangladesh, for example, has a poor growth record as it is not able to equip its burgeoning population with the skills or capital to increase output on a sustainable basis. Accordingly, each element is needed in order to bolster output and, potentially, transform living standards within a generation.

Demographics

Quantity of Human Capital

Chile's population was 15.0 million in 1999. Average annual population growth has been a stable 1.4% in 1990 to 1999, unchanged from the previous two decades. The population is also relatively young; 29.5% of the 1995 population were under 14 years of age (albeit below the regional average of 33.8%).

Chart 11
Dependency Ratio

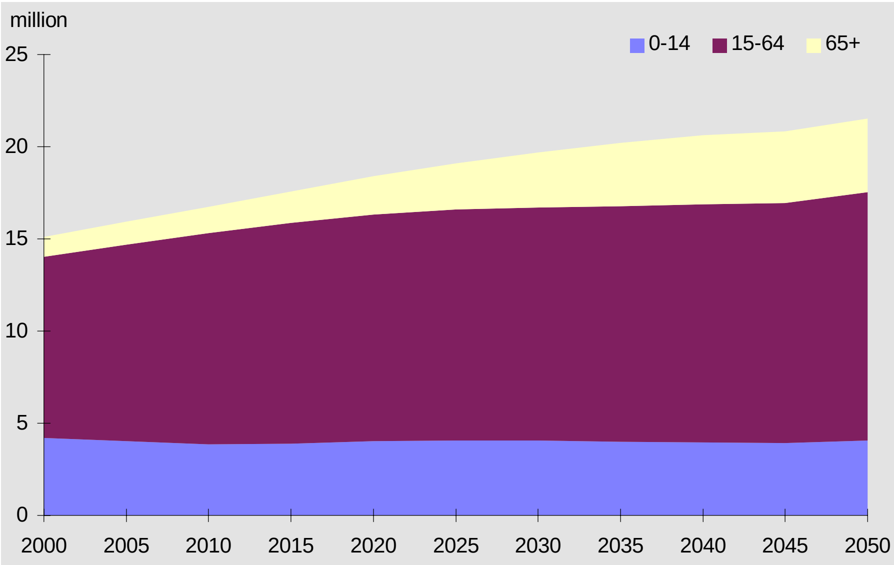


Source: World Bank, *World Development Indicators*

The UN forecasts population growth to slow from an annual average 1.4% in 1995-2000 to 0.7% in 2020-2025. This trend is predicated on a fall in the crude birth rate and reproduction rate given increased participation of women in the labour market and improving health care provision (which will also engender a fall in the infant mortality rate).

Slower population growth will lead to a reduction in the dependency ratio for the first decade of the 21st century; according to the UN, the ratio will fall to a low of 0.46 in 2010. This favourable demographic trend will reduce the burden on scarce fiscal resources such as housing, education and health. The swelling of the workforce will raise pressure for accelerated job creation. Clearly, this trend calls for more effort to reduce structural unemployment and initiatives to improve labour market flexibility. After 2010, a rise in the number of people over 65 years of age (as well as improved basic health) will raise the dependency ratio once more.

Chart 12
Chile's Population Projection by Age Group



Source: World Bank, *World Development Indicators*

Quality of Human Capital

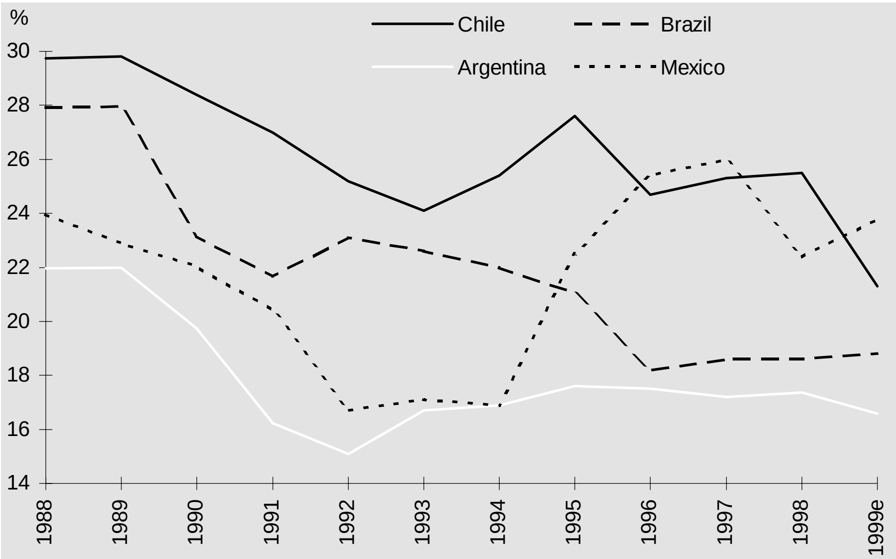
The quality of human capital is relatively high in Chile, reflecting the country's good level of economic development and the government's continued emphasis on improving social provision. The UN Human Development Index places Chile in the 'high human development' category, ranking it number 34 out of 174 countries; Chile enjoys a similar ranking (33rd) in the UN's gender-related development index, reflecting policies to narrow differentials in the living standards of the nation's male and female population.

Notably, increased government spending on health care provision, rising incomes, and improved diet and sanitation have extended life expectancy to the level of many developed countries. At the same time, education has been a policy priority reflected in a sustained rise in education spending over the past decade. Consequently, enrolment rates are quite high, particularly at the primary and secondary levels and the literacy rate is a high 95.2%. However, large disparities in the distribution of education across different income groups persist with poorer children in some of the more backward regions having reduced access to education.

Savings and Investment

The domestic savings rate is relatively high by regional standards. This is partly due to entrenched macroeconomic stability since the 1982 recession, rising incomes, successive budget surpluses and the strengthening of the banking system since the crisis in the early 1980s. Significantly, Chile's high savings rate is often considered a consequence of pension reforms introduced in 1980 which introduced a private pension system. Recent assessments have dampened the enthusiasm for the reforms particularly given a decline in the savings rate in the mid-1990s. Nevertheless, the pensions reforms have contributed to a deepening of the financial markets as well as reducing potential fiscal liabilities in the long term (in the medium term, the government must pay out the contributions made to the old state system) and raising a general awareness of the need to save.

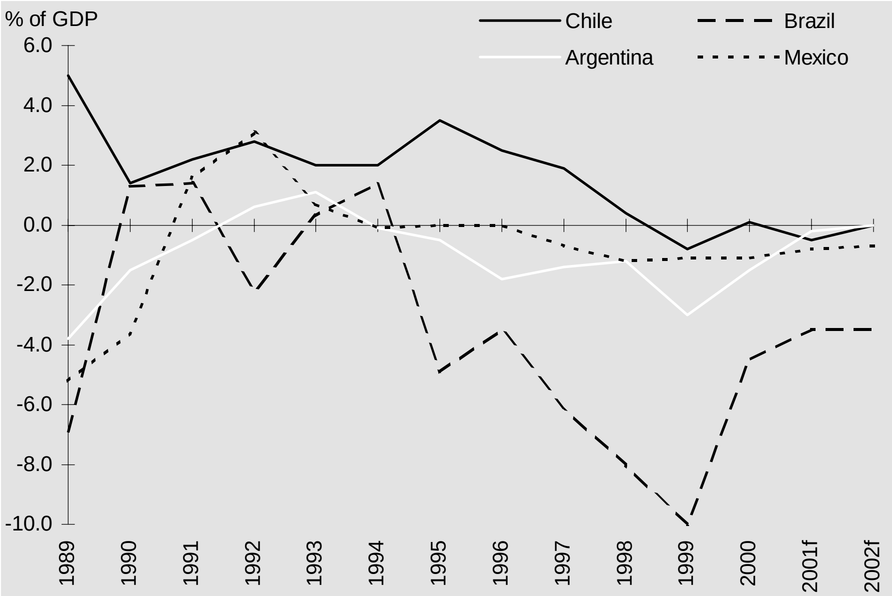
Chart 13
Gross Domestic Savings Rates



Source: World Bank, *World Development Indicators*

In the meantime, several factors point to an increase in savings in the medium to long term. Demographic shifts will also result in a rise in savings over the next five years, although as the dependency ratio increases in the 21st century, domestic savings will come under pressure. In addition, government success at reducing inflation to below 5.0% will also stimulate savings.

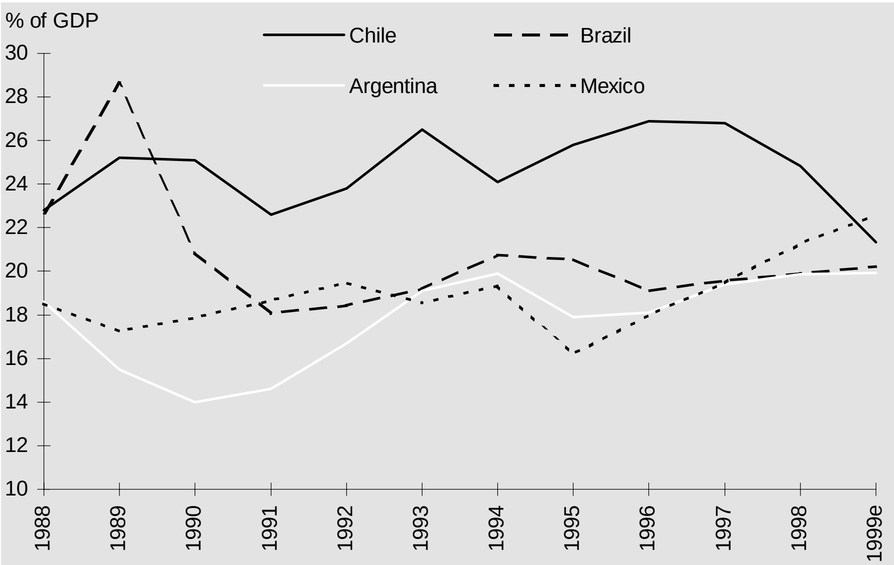
Chart 14
Government Balance



Source: Inter-American Development Bank, http://www.iadb.org

Chile's usually high domestic investment rate is not fully financed by domestic savings. Hence, domestic investment financing needs are met using foreign capital, underpinning the current account deficit (see **External Economic Risk**). This has been recognised by the government which enacted various new incentives in 1998 (including a 15% tax credit on savings and a reduction on capital gains tax for active participants in the stock market) to promote personal savings.

Chart 15
Gross Domestic Fixed Investment Rates



Source: World Bank, *World Development Indicators*

Productivity

Chile's relatively long history of trade liberalisation, deregulation and privatisation has helped to modernise the economy and promote competitive pressures.

Privatisation has encouraged restructuring and investment in new, more efficient, (mainly imported) technology as well as introducing modern managerial and organisational practices. This has produced a modern economic infrastructure and an efficient primary sector, albeit still exposed to weather patterns.

New technology has helped to boost productivity. This has outstripped wage growth (which has been quite high by regional standards) with real wages growing an annual average 3.2% in 1987-1999 compared to an annual average 4.3% productivity growth, a trend which has become more marked in the 1990s.

Long-Term Economic Outlook

Dun & Bradstreet expects Chile's annual real GDP growth to average 6.0% over the next ten years. Macroeconomic stability and a strong spirit of free enterprise will help to underpin growth. Growth potential will be constrained by a lack of domestic savings, given the bullishness of investment. Like many Latin American nations, Chilean demographic trends will be favourable in the early part of the 21st century; however, the window of opportunity created by a decline in the dependency ratio (which will have a positive effect on savings) is relatively small. Moreover, additional investment in skills and vocational training will be necessary to ensure further productivity gains.

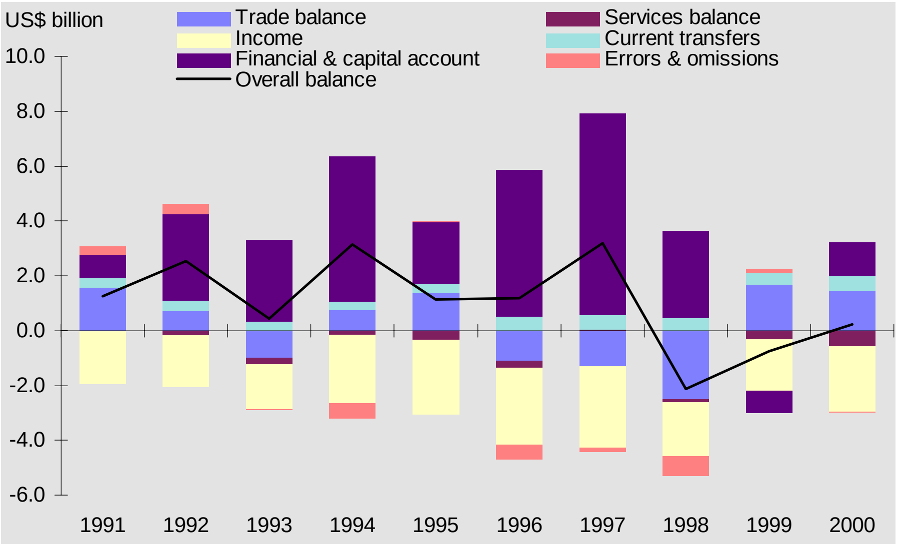
External Economic Risk

> ***Key Point:*** Two years of deficits on Chile's external payments were replaced with a moderate surplus in 2000. However, Dun & Bradstreet is forecasting a return to deficit this year, driven by the weak performance of Chile's visible exports in 2001 to date. Despite export diversification, Chile remains exposed to the vagaries of commodity price trends.

Balance of Payments Performance

Chile's balance of payments has recorded a surplus in nine of the past 11 years. In 1998 a sharp deterioration in the deficit on the trade balance pushed Chile's current account deficit, at US$4.1 billion, to 5.7% of GDP. The meagre surplus on the financial and capital account that year wasn't enough to counter balance the current account deficit. The size of the balance of payments deficit decreased in 1999 and returned to surplus in 2000, on the back of improvements in the trade balance. In the first half of 2001 both the current and financial and capital accounts recorded deficits of US$168 million and US$142 million respectively, producing a six-month balance of payments deficit of US$137 million.

Chart 16
Balance of Payments Performance

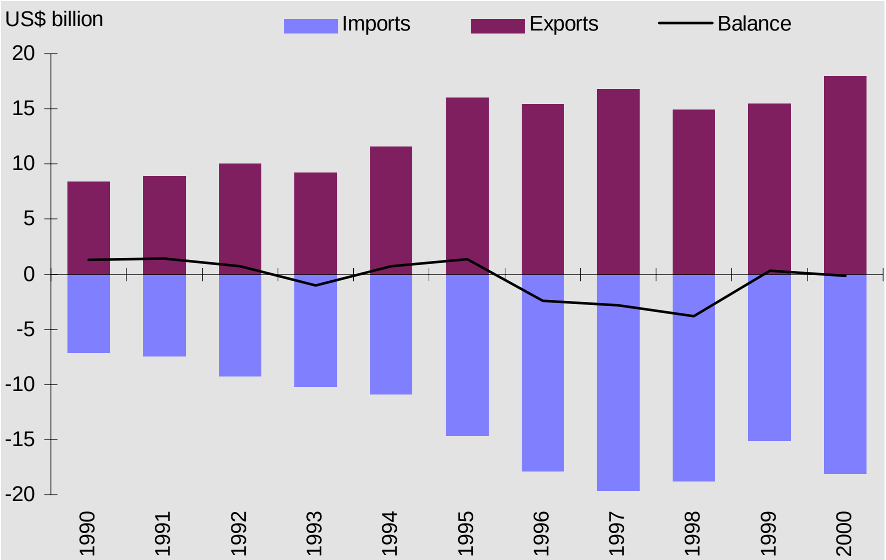


Source: International Monetary Fund, *International Financial Statistics*

Trade Balance

Chile's visible trade account registered successive deficits from 1995 to 1998. This trend, was characterised by strong import demand - underpinned by a strong peso and buoyant capital inflows as the economy expanded - which outstripped export growth. The pattern was reversed during 1999, when the balance registered a $1.7 billion surplus. As the economy fell into recession, the value of imports contracted by 20%, while export sales grew by 5%. The growth in the contribution made by export revenues came from the 8% increase in the volume of sales rather than the recovery in prices for the country's key exports. The balance recorded a moderate US$100 million deficit in 2000. Growth in import demand was moderate, hampered by subdued consumer and business confidence, while the recovery in export revenues was dampened by continued weakness in copper prices (copper accounts for around 40% of Chilean export revenues). In the first half of 2001, the balance recorded a US$1.2 billion surplus, an increase of US$213 million on the same period of 2000. Exports grew by 3.1%, while import growth was more moderate at 0.9%. Although export prices remained weak through the first half (falling by 5.4% in January to June year on year), export volumes were up by 2.4%. Copper export revenues from sales to the US grew particularly rapidly in the second quarter following the closure of a US production plant favouring Chile's more efficient production.

Chart 17
Trade Balance



Source: International Monetary Fund, *International Financial Statistics*

Export Profile

Chile's export profile is more varied than many of its regional counterparts - both in terms of export products and the geographical distribution of trade. In the late 1970s the export diversification process began, when forestry and fishing resources began to be exploited to supplement more traditional goods such as copper. Several non-traditional exports have risen strongly in the past decade with notable examples including the fresh fruit industry and even the industrial sector (mainly food and drink, processed fishmeal, and forestry products). Nevertheless, despite export diversification efforts, copper continues to be the single most important source of foreign exchange.

Table 5
Principal Exports

Category	*1999*		*2000*		*Jan-Jul 2001*	
	US$bn	*% of total*	*US$bn*	*% of total*	*US$bn*	*% of total*
Manufacturing	7,152	45.8	8,172	45.0	4,894	45.3
Mining	6,934	44.4	8,430	46.4	4,755	44.0
Agriculture, forestry and fishing	1,530	9.8	1,556	8.6	1,158	10.7
Total	**15,616**	**100.0**	**18,158**	**100.0**	**10,807**	**100.0**
Non-copper	9,727	62.3	10,811	59.5	6,650	61.5
Copper	5,889	37.7	7,347	40.5	4,156	38.5
Total	**15,616**	**100.0**	**18,158**	**100.0**	**10,807**	**100.0**

Source: Banco Central de Chile, *Boletin Mensual*

Diverse trade relations reduce the potential for adverse natural or economic conditions in any given location to undermine Chile's overall economic performance. Thus, in 2000, flat sales to the US (Chile's single most important export market) were counterbalanced with growing sales to all of Chile's other export markets.

Table 6
Export Share by Region and Country

US$ million	*1997*	*1998*	*1999*	*2000*	*% change 1999-2000*
US	2,711	2,593	3,096	3,094	-0.1
Japan	2,676	2,109	2,199	2,556	16.2
Other industrialised countries	4,465	4,416	4,424	5,033	13.8
Latin America	3,483	3,448	3,295	3,953	20.0
Asia	3,105	2,035	2,194	2,817	28.4
Middle East	156	177	152	305	100.7
Other	225	177	116	227	95.7
Total	**16,820**	**14,955**	**15,476**	**17,985**	**16.2**

Source: International Monetary Fund, *Direction of Trade Statistics*

Similarly in 2001, sales to Asia fell by 12% in the first half compared with the first six months of 2000 mainly because of weak growth in Japan, Korea, and Taiwan. Moderate increases in sales to Peru, Mexico, Ecuador, and Venezuela partly counterbalanced the slow down in Asia. Surprisingly exports to Argentina grew by 7.1% in the first half, and exports to the US rebounded from a 2.4% fall in the first quarter, to grow by 7.9% in the April-June quarter, due mainly to an increase in copper sales.

Import Profile

Chile imports a lot of consumer, intermediate, and capital goods which are not produced domestically. Capital goods import growth has been driven by substantial investment in infrastructure, often associated with the privatisation programme, and mining.

Table 7
Principal Imports

	1999		*2000*		*Jan- Jul 2001*	
	US$m	*% of total*	*US$m*	*% of total*	*US$m*	*% of total*
Intermediate goods	9,008	59.5	11,007	60.8	10,551	72.1
Capital goods	3,297	21.8	3,702	20.5	2,200	15.0
Consumer goods	2,833	18.7	3,381	18.7	1,878	12.8
Total	**15,137**	**100.0**	**18,089**	**100.0**	**14,628**	**100.0**

Source: Banco Central de Chile, *Boletin Mensual*

The gradual reduction in tariffs and, to a lesser extent, non-tariff barriers in the 1990s encouraged a steady rise in imports, until economic slowdown in 1998 saw a fall in imports for the first time in fifteen years. Imports declined further in 1999, as the economy fell into recession. Economic rebound in 2000 encouraged another year of import growth. The first half of 2001 has seen a moderate increase in import demand: with consumer confidence languishing in the doldrums for the period, consumer goods imports fell. Meanwhile capital and intermediate goods imports rose in the first half.

This respective pattern of decline and growth in consumer and capital/intermediate goods, was also reflected in the demand for imports by region. Imports from Argentina (mainly energy) grew most, followed by Brazil (mainly intermediate goods). There was a decrease in imports from the US where consumer goods dominate. Indeed, imports from Latin America have grown faster than imports from any other region with which Chilean importers do business, indicating Chile's growing importance within the Mercosur bloc. Nevertheless, Chile sources its imports from a range of countries particularly industrialised nations (including the US and Japan), which are reliable sources of import needs. Indeed, the high profile of the US in Chile's trade accounts has prompted negotiations aimed at reaching a free trade agreement between the two nations, and ultimately, Chile's its accession into an expanded North American Free Trade Agreement (NAFTA).

Table 8
Import Share by Region and Country

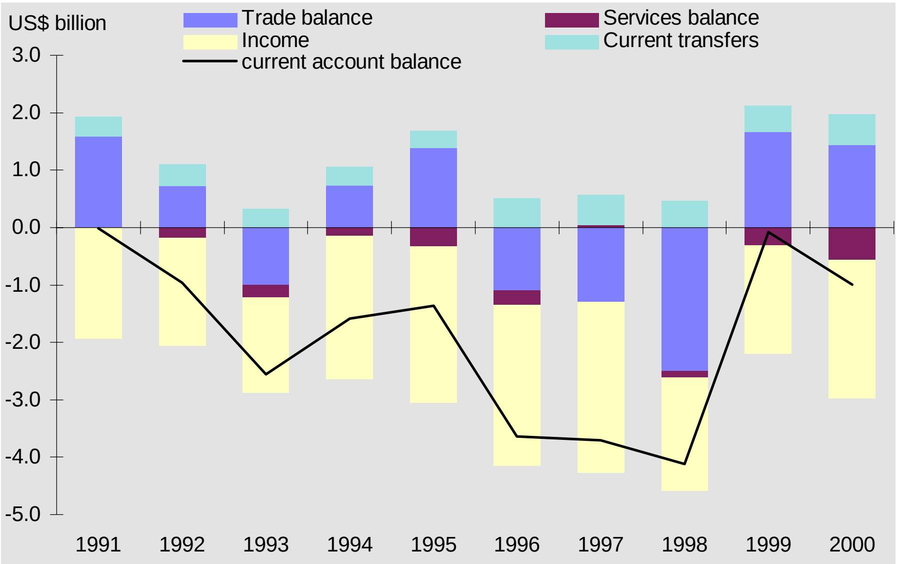
US$ million	*1997*	*1998*	*1999*	*2000*	*% change 1999-2000*
US	4,333	4,161	3,167	3,339	5.4
Japan	1,054	1,012	643	710	10.4
Other industrialised countries	4,746	4,636	3,583	3,696	3.2
Latin America	5,325	1,984	4,447	6,020	35.4
Asia	1,993	2,376	1,694	2,152	27.0
Middle East	85	100	75	87	16.0
Other	468	524	373	676	81.2
Total	**18,003**	**14,793**	**13,982**	**16,680**	**19.3**

Source: International Monetary Fund, *Direction of Trade Statistics*

Current Account

The deficit Chile's current account was moderate during the early part of the 1990s, averaging -1.3% of GDP. However the size of the deficit swelled during 1995-1998, on the back of the deterioration of the trade balance in those years.

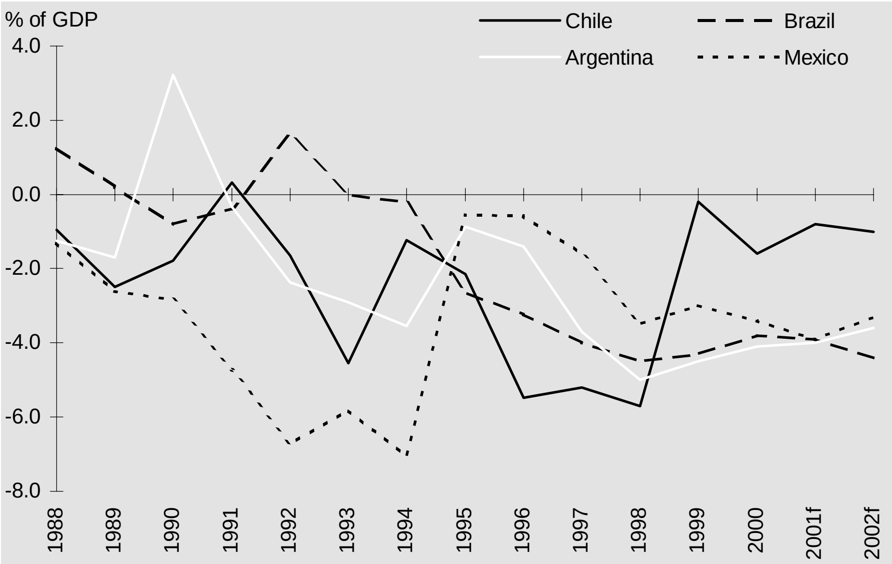
Chart 18
Current Account



Source: International Monetary Fund, *International Financial Statistics*

Even though the deficit on the trade balance was replaced by surplus in 1999 and 2000, the current account remained in deficit in those years, weighed down by the sizeable deficits on the income and services balances. Deficit on these balances represent the repatriation of profits and other payment for investment.

Chart 19
Current Account Balance



Source: World Bank, *World Development Indicators*

Financial and Capital Account

Healthy net FDI and portfolio inflows sustained the financial account surplus during the 1990s, securing balance of payments sustainability. However, in 1999, the capital account registered a US$746 million deficit. This account deficit reflects the fact that investment by Chilean entities overseas doubled in 1999. In fact, the outflow of foreign capital increased significantly through the 1990s with the Chilean private sectors investing in neighbouring Argentina and in the US. Moreover, Chilean pension funds have been encouraged to invest abroad as limits to their foreign interests have been eased. Additionally, short-term bank debt was bought back to the tune of US$3 billion.

Table 9
Financial and Capital Account Balance[1]

US$ million	*1995*	*1996*	*1997*	*1998*	*1999*	*2000*
FDI	2,205	3,445	3,353	1,842	4,366	-1,103
Portfolio flows	36	1,100	2,365	-829	130	-261
Other capital	38	797	1,663	2,242	-5,260	2,563
Financial & capital account	**2,279**	**5,342**	**7,381**	**3,255**	**-764**	**1,199**

Note: [1]Data are net flows.
Source: Banco Central de Chile Boletin Mensual

The surplus on the financial and capital account was restored in 2000. Chilean direct investment abroad was US$4.7 billion and portfolio investment abroad was US$148 million. Significantly, net flows of other capital was positive. Deficit of US$142 million in the first half of this year. Again outflows of FDI and portfolio capital were greater than inflows. The central bank lifted the last remaining controls on international capital flows in mid-April. The changes mean that investors no longer need to secure central bank authorisation for capital inflows related to loans, portfolio investment and FDI, authorisation is no longer needed for capital outflows related to capital gains, dividends and other benefits, and the reserve requirement obliging investors to deposit a portion of their investment with the central bank for up to a year is eliminated.

Risk Elements

Foreign Debt and Default Risk

Strong capital account surpluses met the bulk of Chile's external financing of current account deficits during the 1990s. These surpluses were been underpinned by buoyant foreign direct investment inflows. Indeed, net capital inflows more than fully covered current account deficits allowing an accumulation of foreign reserves, until 1998. At this time, capital inflows were insufficient to meet current account needs, leading to the first balance of payments deficit in the 1990s, totalling US$2.1 billion (or 2.1% of GDP) and financed by a draw down of foreign reserves. The reserves were again drawn down in 1999, even though the size of the balance of payments deficit had shrunk to a third of the previous year's total.

Table 10

Debt Indicators[1]

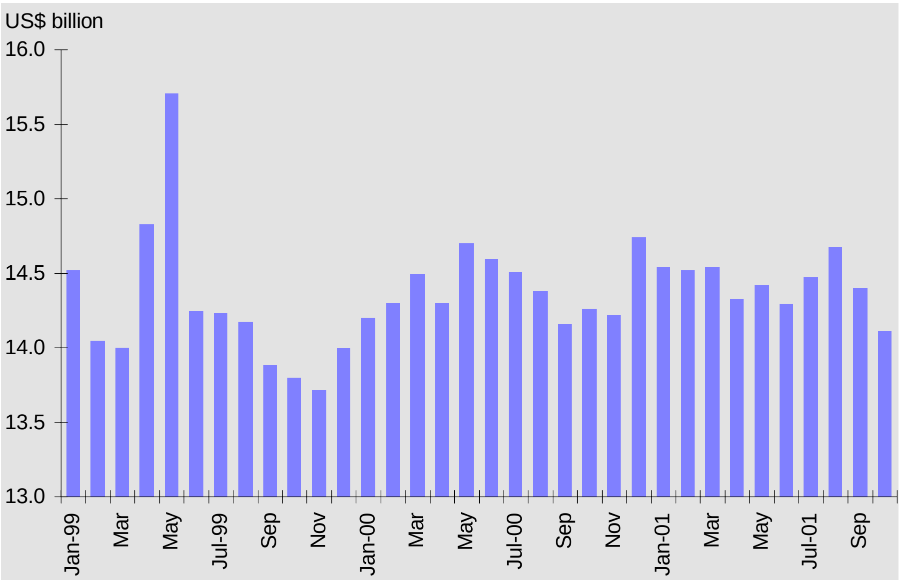
US$ billion	*1997*	*1998*	*1999*	*2000*	*2001*
Short-term debt	3.6	4.2	4.0	6.4	6.5
Medium & long-term debt	23.1	27.5	30.2	30.4	30.3
Of which: public sector	4.0	4.7	5.0	3.9	3.7
private sector	19.1	22.8	25.2	26.5	26.6
Total external debt	**26.7**	**31.7**	**34.2**	**36.8**	**36.8**
Short-term debt (% of exports)	21.6	28.0	25.6	35.3	34.1
Short-term debt (% of total debt)	13.5	13.1	11.7	17.4	17.8

Note: [1]Data for 2001 are to October.
Source: Banco Central de Chile, *Boletin Mensual*

With the size of the current account deficit much reduced in 1999 (and in all likelihood tiny in 2000), that the capital account registered a deficit in 1999 (and is likely to do so again in 2000) does not pose immediate cause for concern. However, structural deficits on the current account are likely to return from 2001. Growing outflows on the capital account will begin to damage Chile's ability to secure balance of payments sustainability.

Chart 20

Foreign Exchange Reserves



Sources: International Monetary Fund, *International Financial Statistics*; Banco Central de Chile, *Boletin Mensual*

Exchange Rate Risk

Exchange Rate Policy

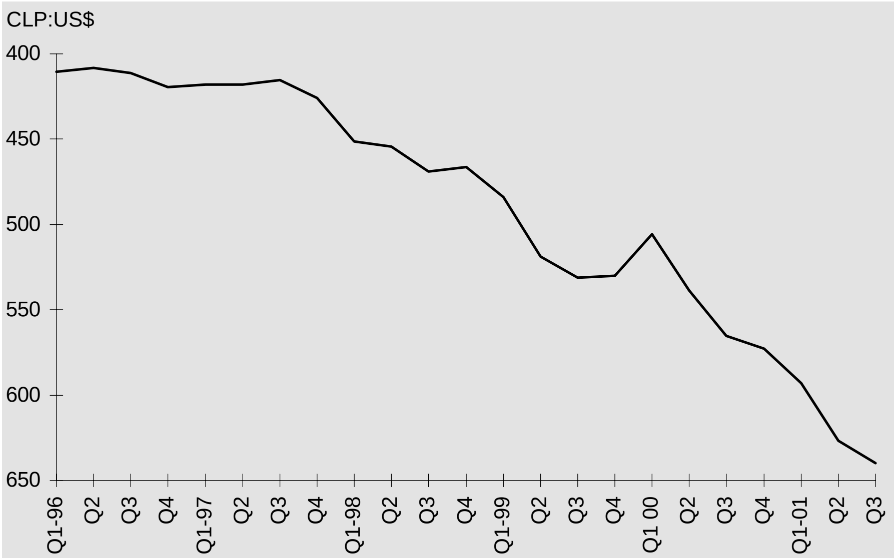
Chile abandoned a short-lived fixed peg to the US dollar in 1981 which proved unsustainable as the current account deficit widened. Following devaluation in 1982, exchange rate policy is conducted through a crawling peg in which a central reference rate of the peso (the Dolar Acuerdo) is gradually devalued against the US dollar.

Since 1992, the reference rate has been set against a basket of currencies, now the US dollar, Japanese yen and euro. The reference rate is also adjusted by 2% to take account of productivity differentials.

This policy has largely been successful in maintaining export competitiveness while acting as an intermediate target in helping anti-inflation policy. Nevertheless, in an effort to boost exports and make policy more flexible, the authorities floated the peso on 2 September 1999. This means that the central bank will only intervene in the foreign exchange markets only in exceptional circumstances.

Chart 21

Chilean Peso:US Dollar Exchange Rate (Inverted Scale)[1]



Note: [1]Rates are average per quarter.
Source: International Monetary Fund, *International Financial Statistics*

A moderate strengthening in the first quarter of 2000, Chile's nominal exchange rate has depreciated almost continuously since 1996. However, the peso's loss of value has been most dramatic this year. The dollar rate came off the rails this year breaking Cp700/US$ mark in late October.

The central bank has acted decisively to defend the currency through this year. Most recently, the authorities announced an 80% increase in this year's offerings of dollar denominated bonds (from US$2.5billion to US$4.5 billion). In addition, the government sold US$600m (a third of the budgeted total) in order to prop up the peso. The peso did gain strength on the back of this announcement. However, the overwhelming combination of a weak outlook for copper demand and prices, deteriorating sentiment towards the emerging markets (on the back of potential debt default in Argentina) and a sharp slowdown in the growth prospects in Brazil and Mexico, has seen Chile's currency back on the slide.

External Economic Risk Outlook

Although Chile's fundamental external economic position is the envy of other countries in the region, Dun & Bradstreet is bearish on the short- to medium-term outlook for the country. Continued weak sentiment informs this forecast. While exports of copper (which account for 40% of Chile's external revenues) improved in the second quarter of 2001 they fell back again in the third quarter, reflecting the seasonal slowdown in sales, and have yet to recover. The weaker economic outlook in the large US market and to a lesser degree in Asia will mean that copper exports are unlikely to rebound in the short term placing downward pressure on the peso.

Table 11

External Economic Outlook

% of GDP	*2001f*	*2002f*
Current account balance	-1.4	-1.0
Capital account balance	7.7	8.2
Overall balance of payments	6.3	7.2
Import cover (months)	8.9	8.7

Source: Dun & Bradstreet

At the same time, while Argentina remains perched on the edge of debt default, Chile's peso is likely to suffer by association. As the regional situation worsens, we expect further depreciations in the value of Chile's peso. While the authorities will continue to support the currency, the central bank will want to avoid stifling the nascent recovery and will therefore want to avoid raising interest rates. Consequently, more debt issuance is likely.

Trade Environment

Key Point: Chile remains committed to its liberal trade regime. Ongoing annual reductions are set to reduce the average tariff rate to just 6% in 2003. The authorities are also in negotiation aimed at creating free-trade agreements with the US (by December 2001) and the EU.

Trade Overview

Successive Chilean governments have sought to forge ties with other nations and trade blocs. This opening up of the foreign trade regime has bolstered trade and investment flows markedly during the 1990s, and bodes well for the development of new trading and investment relations over the medium to long term.

The EU

In August 2000, the Chilean authorities held talks with EU trade officials aimed at developing a free trade agreement (FTA) by 2002. Chile is granting a high priority to talks with the EU, since at the moment the European market is Chile’s second largest export market (ahead of Mercosur). In 1998, the EU included in its mandate to negotiate FTA with Chile and Mercosur the proviso that both would be simultaneous and conclude at the same time. However, at the August meeting with EU officials, Chile’s foreign minister Soledad Alvear announced that Chile would not link its own FTA with the EU to any arrangement between the EU and Mercosur. The requirement for separate negotiations stem from the different tariffs that Mercosur and Chile impose on imports. The main obstacle to negotiations is likely to be the issue of agricultural tariffs, since the sector is highly protected from imports in both Chile and the EU.

The US

The Chilean government began free trade talks with US authorities in December 2000, aimed at wining entry to the North American Free Trade Area (NAFTA) for Chilean exports. Talks are expected to conclude this year, for a 2002 start date.

Mercosur

Chile became an associate member of Mercosur in 1995. (Argentina, Brazil, Paraguay and Uruguay are the full members, Bolivia is the other associate member). President Lagos announced that Chile would apply for full membership in December 2000, however, given Chile’s desire to become a NAFTA member, full membership of Mercosur is now unlikely. The bone of contention between Chile’s accession to NAFTA and its membership of Mercosur concerns plans for the creation of a Free Trade Area of the Americas (FTAA), and the timetable for the reduction in tariff barriers of the pact members. The US would like to see barriers come down from 2003, while the Brazilians favour the later date of 2005. Brazil believes that its bargaining power in the matter will be weakened if Chile achieves membership of NAFTA.

Chile’s previous reluctance to take full membership stems from the variance in tariff structures between the bloc and Chile. While Mercosur’s average CET is around 14% (but is as high as 35% on auto imports), Chile’s import tariff averages 9% (and is scheduled to fall to 6% by 2003). The government has made it clear that Chile’s import tariff will not be raised to meet that of the other Mercosur members. Instead it will seek membership on the understanding that tariff convergence be made a longer term requirement. The full members of Mercosur would have to amend their statutes in order to grant Chile this special status (in a similar fashion to the special concession granted to the UK by the EU).

Within Mercosur, the Brazilian authorities have taken the initiative in pushing for a wider South American Free Trade Agreement (SAFTA) by 2003. The ultimate goal of the SAFTA would be to strengthen the region's bargaining position in the broader negotiations with the USA, Canada, and Mexico, on the creation of Free Trade Area of the Americas (FTAA) two years later. Chile had aspired to the membership of the North American Free Trade Area (NAFTA) during the 1990s but growing opposition to the idea within the US sent the project backstage. The attainment of free trade access to the US market via a FTAA would resolve this issue for Chile.

South Korea

Chile is actively pursuing the development of its relations with economies in the Far East. Chile became a member of the Asia-Pacific Economic Co-operation (APEC) forum in 1994, and the authorities are in the process of negotiating a FTA with South Korean officials. If the negotiations are successful, this will be the first such agreement between an Asian and Latin American economy. South Korea will use the FTA as a spring-board to increasing investment and trade with the whole region. Chile currently runs a trade surplus with South Korea.

Trade Regime

Chile has an open trade regime and liberalised its trade in the 1970s. The government has actively sought to promote trade ties mainly on a bilateral basis but also through associate membership of Mercosur and ultimately as part of the Free-Trade Area of the Americas initiative. The favourable trading environment means that Chile is the most open economy in South America.

Current Account Exchange Regulations

Payment for visible trade through the official foreign exchange market is not permitted unless an *Informe de Importación* (import permit) has been issued. Some liberalisation in foreign exchange controls has taken place and since January 1997 commercial banks have been allowed to undertake foreign exchange and trade operations at branches outside Santiago.

In November 1994, the central bank eased foreign exchange rules for exporters, allowing an extended period of 270 days during which earnings must be converted into pesos (formerly 210 days). This was the second revision in only two months, with the transfer period previously raised from 180 to 210 days in September 1994. In addition, the central bank raised from 20% to 25% the amount of export earnings an exporter can retain (largely for meeting import requirements).

Tariff Barriers

The government has remained committed to reducing tariff barriers, enacting an across-the-board cut in tariffs to 10% in 1999. The tariff should fall by one percentage point per year, to 6% in 2003.

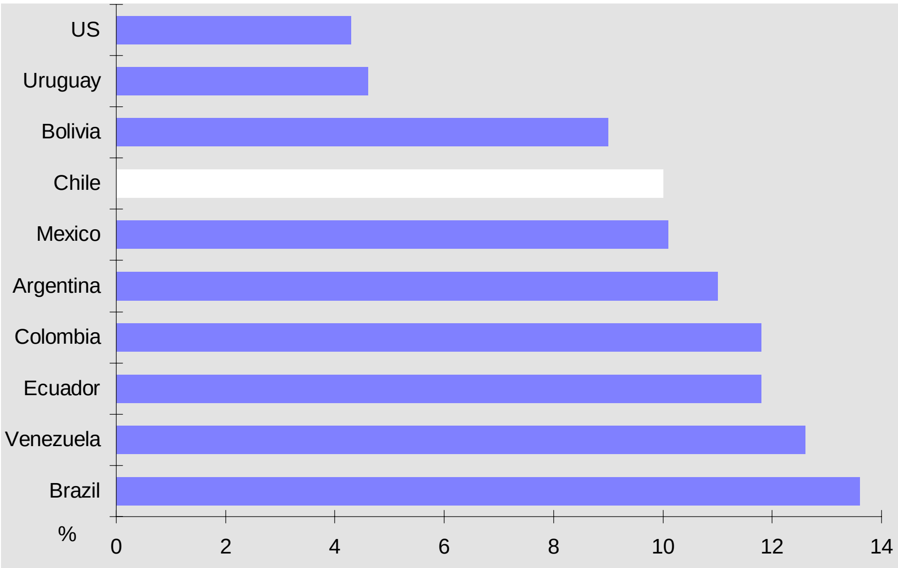
There are some exceptions to this general tariff; used goods have a tariff levied at 16.5% (second-hand cars are not permitted) while computer goods enter duty-free.

The maximum tariff on most goods is 25%. Flour, vegetable oil and wheat have a tariff set at 31.5% in accordance with WTO requirements, and tariff on sugar imports was raised to 98% in July this year (a move backed by the WTO). Nonetheless, tariffs are sometimes subject to change; for example, tariffs on wheat were increased to protect domestic industry from falling international prices. The government also imposes minimum customs valuations on agricultural imports for the same reason.

A few items are exempted from the present tariff regime. Exemptions include tariffs negotiated with Latin American Integration Association (LAIA) countries and under a number of bilateral trade agreements. Chile also has free-trade agreements with Canada, Colombia, Costa Rica, Ecuador, Mexico and Venezuela.

Chart 22

Weighted Mean Tariffs for All Products, 1999



Source: World Bank, *World Development Indicators*

Non-Tariff Barriers

All imports require a licence (largely as a means of registering imports) although these licences are granted as a routine for most goods; pharmaceuticals and weapons are subject to tighter licensing requirements. A registration certificate is also needed for goods over US$3,000.

The import of used passenger and cargo transportation is prohibited. Exceptions are ambulances, armoured cars, public road cleaning vehicles, and cement-making vehicles; these goods pay 11% import duty plus VAT.

Non-tariff barriers are also present in the form of strict animal and phytosanitary requirements, often designed to protect domestic food-producing industries. Nevertheless, numerous controls on agricultural goods (including wheat and various fruits) have been lifted. Similar licensing, registration, phytosanitary and quality controls are imposed on exports.

Documentation

Bills of Lading: Original plus two copies usually required. Should show gross weight of each item, made out to order. ‘To order’ bills of lading are recognised legally in Chile.

Certificates of Origin: Not needed unless specifically required.

Consular Invoices: Not required.

Commercial Invoice: The invoice should be prepared in a minimum of four copies. Those covering automobiles should be the invoices of the manufacturer or of an authorised dealer. The commercial invoice should contain a detailed and specific description of the goods, giving the net, legal and gross weights, the f.o.b. value of the merchandise, unit price of each item, date of insurance covering shipment (if applicable) and other usual particulars of such documents. Notarisation or Chamber of Commerce certification is not required, but a sworn statement of declaration of origin, in English or Spanish, in a prescribed text is required.

Import Licence: Imports valued over US$3000 must be covered by a registration certificate (informe de importacion) issued by the Central Bank.

Insurance Certificate: This should follow the importers instructions.

Marking of Goods: Country of origin must be shown in most cases. The importer's name should also be shown on canned foods and consumer goods.

Packing Lists: This should be issued in accordance with the importers request.

Samples: Samples of negligible value are subject to special duty.

Steamship Company Certificate: No known requirement.

US Shipper's Export Declaration: is required if the value is more than US$2,500.

Consular Fee: Since fees are payable at destination, all original documents should be sent to the importer. Fees are collected on commercial invoices, bills of lading or air waybills.

Counter-Trade

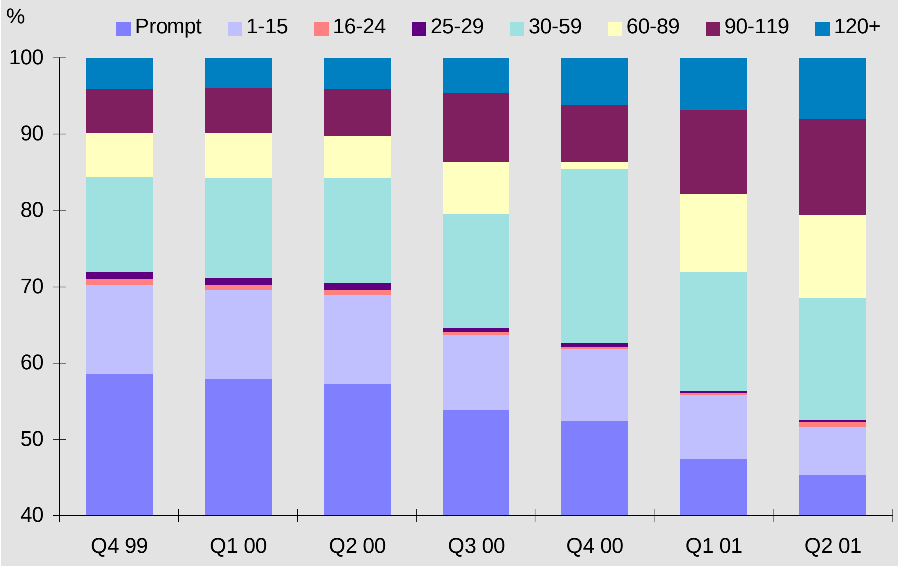
Counter-trade is possible with Chile, although uncommon as a result of a regulatory system which requires exporters to return foreign currency generated abroad within a set period. Debt-for-equity swaps have, however, been used as a counter-trade option.

Risk Management

Payments Performance

The payments performance of Chilean firms has deteriorated significantly over the past seven quarters. In the second quarter of this year, only 51.7% of businesses paid their counter party promptly, compared with 70.3% paying within agreed terms in the final quarter of 1999. Dun & Bradstreet believes that this pattern of worsening payments performance continued through the second half of this year on the back of weaker economic performance. While we expect the rate of decline to moderate, we anticipate further declines in payments performance in to the first half of 2002, as the Chile economy struggles under the weight of with the forecast global slowdown. We are forecasting recovery in the second half.

Chart 23
Chile's Payments Performance



Source: Dun & Bradstreet

Usual Terms

Minimum Terms	Sight Draft (S/D)
Recommended Terms	Letter of Credit (L/C)
Usual Terms	90-120 days

Usual Terms: Recommended and minimum terms for trade with Chile have deteriorated this year. Dun & Bradstreet now recommended letters of credit are used while sight drafts are the recognised minimum trading terms. This development notwithstanding, Chile's terms compare favourably within the region, and are most likely to be upgraded over the coming twelve months.

Transfer Situation

Local Delays	0-3 months
Foreign Exchange/Bank Delays	0-1 month
Import Cover	8-9 months

Transfer Risk: The transfer situation is generally favourable, aided by ample foreign exchange liquidity and limited bank delays (given a sound and competitive banking system). Import cover is steady, underpinned by bullish capital inflows. More dynamic recovery will raise import financing needs and these may not be met by sustained foreign direct investment and portfolio flows.

Export Credit Agencies

US Eximbank	Full cover available
NCM	Short-term unrestricted cover available
ECGD	All facilities generally available; cover may be limited
Euler TI	Full short-term cover available

Commercial Risk

Key Point: Credit risks worsened during 1998-99 as the economy fell into recession. Conditions began to improve (albeit moderately) during 2000 as a result of economic growth and regulatory changes to the sector. However, 2001 has not seen any improvements to date, and we expect credit risk to deteriorate over the short term given weaker economic prospects.

Credit Risk

Credit risk deteriorated significantly during 1998-1999 as the global trading environment worsened. The export-orientated sectors were badly hit by the decline in global commodities prices and demand in Asian markets which led to cash-flow problems. Domestic companies also suffered from limited access to international finance. Chilean blue-chip companies have traditionally sought finance through American Depository Receipts (ADRs). Companies with foreign-currency debt experienced a damaging tightening in liquidity, (although this has not represented an undue risk given that they generally have a favourable track record in the global debt markets and good relations with creditors).

Conditions began to improve in 2000, with Chile attracting \$0.7 billion in fresh credit in the first quarter of the year alone. Part of this improvement came on the back of the healthier macroeconomic conditions. However, there were also some key legislative changes that encouraged credit growth. Where local businesses used to be restricted to ADR listings in the USA, new legislation gives them more freedom in the way they finance themselves. This significantly reduces the borrowing costs, since companies are free to raise equity on the international stock markets. Second tier companies which lacked the capital base to list in New York, internet start-ups and small groups aspiring to public offerings on the Nasdaq will be the main beneficiaries of this change. Larger foreign controlled companies such as Telefónica Chile are now free to raise equity in their home markets.

While these changes encouraged credit growth, the increase in activity was not spectacular in 2000, growing by just 5.4% in the first half. This meagre growth is the result of the industry's plodding progress towards the normalisation of credit operations and the expansion of financial services to under-served sections of the population.

Moves to restructure outstanding debt obligations for small businesses fuelled optimism that market for loans will improve substantially in 2001. There has also been aggressive bank targeting of middle and lower income households as the largest pool of prospective clients who currently fall outside the formal banking system. As a result credit activity has shown signs of a modest revival in particular areas such as foreign trade housing and leasing contracts, but the total loan portfolio increased by just 3.4% in the first half of this year.

Banking Sector Risk

The banking sector has been relatively resilient to the current turmoil in emerging markets. Ironically, this strength largely comes from the restructuring, mergers and acquisitions that occurred after the 1980s debt crisis. Moreover, the banking superintendency also tightly supervises the banking system with extensive disclosure requirements making the system very transparent. Indeed, following the November 1997 banking law, regulations were brought into line with Bank of International Settlements (BIS) recommended capital-risk adequacy and lending guidelines. Since then, Chile's long debated tender law has been signed onto the statute books (in December 2000), setting the framework for some of the most sophisticated governance legislation in the world. The reforms define guidelines on the allowable market share that one bank can acquire following Spanish BSCH's acquisition of Banco Santiago which left it in control of the country's two largest bank (BSCH also controls Banco Santander Chile) and with 28% of the country's US$70 billion loan market. The law requires that any M&A that would leave a single institution with more than 15% of market share meet special approval from the banking superintendency. The institution would also have to demonstrate a capital adequacy ratio of at least 10% compared with the Basel Committee requirement of 8%.

Table 12

Banking Sector Indicators

%	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*	*2000*
Asset quality:							
Past due loans/total loans	1.2	1.1	1.1	1.1	1.7	1.9	2.0
Reserves/past due loans	165.0	145.9	130.0	130.4	119.3	144.6	134.6
Loans:							
Commercial loans/total loans	51.4	48.5	48.5	48.9	49.2	46.1	45.7
Trade finance/toal loans	13.9	13.5	11.3	9.4	9.0	8.5	8.2
Profitability:							
Return on assets	0.9	1.0	1.3	1.2	1.0	0.8	0.9
Return on equity	11.4	12.8	15.9	14.7	11.5	9.1	10.8

Source: Moody's Investors Service

The banking system has also been strengthened by the entry of foreign institutions, particularly Spanish banks, which have taken significant stakes in local banks. In addition a large part of the system is privately run with Banco del Estado the main state bank; its remit is to provide services to those with little access to private bank services including the poorer less developed regions of the country. Chile is still without an official ceiling on how much of the loans market a single entity can control. This should encourage more consolidation, and improve profitability. The rules wont affect BSCH's acquisition of Banco Santiago since the law is not retrospective, but the merger of its two top subsidiaries in Chile will need superintendency approval.

Table 13

Top Ten Chilean Banks by Tier One Capital, December 2000

Bank	*Tier One captial (US$m)*	*Total assets (US$ bn)*	*Pre-tax profit/Loss (US$m)*	*Return on assets (%)*
Banco Santiago	865	10.2	156	1.5
Banco Santander Chile	555	8.9	164	1.8
Banco del Estado de Chile	528	9.3	113	1.2
Banco de Chile	526	9.9	155	1.6
Banco de A. Edwards	391	4.9	4	0.1
Banco de Credito & Inversiones	318	6.2	76	1.2
BBVA Banco BHIF	288	3.4	17	0.5
Corp Banca	214	2.9	20	0.7
Banco Sud Americano	183	2.5	50	2.0
Banco BICE	126	2.1	19	0.9

Source: *The Banker*

This restructuring at the top will likely push small- and medium-sized banks together. In particular it clears the path for the union of Banco de A Edwards and

Banco de Chile. Together these banks account for 19% of the total financial system assets. Capital adequacy ratios at end January reached 10.9% at Edwards and 13.6% at Banco de Chile. The banking superintendency approved the Edward deal with the main condition that the new bank earn profits of US$4.25 billion this year.

The banking sector as a whole has maintained generally strong capitalisation and profitability over the past 12 months in the face of a challenging business environment. Banks have succeeded in building their capital and earnings bases despite virtually flat growth in system deposits and loans over the past year labouring under the weight of a sluggish economy.

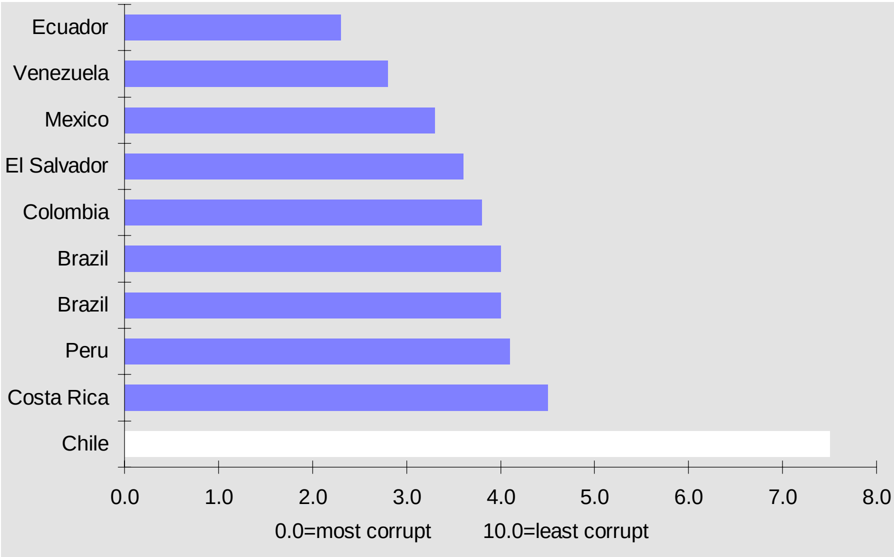
Other Commercial Risks

Corruption

Measuring what is corruption and what is local business culture is a difficult task. The non-profit organisation Transparency International publishes a corruption perceptions index (according to the results of a poll of experts and the general public), which gives some idea of the relative level of corruption between countries. Transparency International's *2001 Corruption Perceptions Index* ranked 91 countries (from Finland at number 1 through to Bangladesh at 91). Each country is rated from 1.0 (most corrupt) to 10 (least corrupt) with Chile ranked well at 18 (a two-rank improvement on last year) and rated at 7.5 (compared with 6.8 in 2000).

Chart 24

Corruption Perceptions for Selected Countries, 2001



Source: Transparency International, *Corruption Perceptions Index*

While Chile was recently ranked the least corrupt nation in the region, the nation is not immune form political scandal (see **Political Risk**). However, corruption is not thought to be pervasive in Chile, in sharp contrast to many other neighbouring nations. While bribery is illegal, anti-corruption legislation is not comprehensive.

Commercial Risk Outlook

Cuts in interest rates are aimed at reviving domestic consumption and lagging production. A steep decline in peso interest rates poses a competitive challenge for the banking industry, sparking renewed interest for fresh loans but also threatening pressure on interest rate margins. This may add impetus to the mergers and acquisitions activity currently taking place.

Investment Environment

Key Point: Chile welcomes foreign investment into large areas of the economy, and the removal of capital controls should serve to boost investment.

Investment Overview

Chile has one of the most liberal and transparent foreign investment regimes in Latin America. Foreign participation in the economy through inward investment is actively encouraged as a means of sustaining economic growth and development in the long term. Such investment enables the more efficient utilisation of existing and potential resources and creates the conditions for structural economic diversification through greater access to new technology. The Chilean foreign investment supervisory authority is the Comite de Inversiones Extranjeras (CIE) which authorises most investments.

Foreign firms are generally treated on a par with local companies. There are no limitations regarding foreign share ownership in a Chilean company, except in the media and hydrocarbon industries. However, there are some restrictions; investments over US$5 million, or those proposed in state-controlled industries, require the approval of the whole committee. For other cases the executive committee of CIE has approval powers. Overall, the liberal trading and investment environment has underpinned a strengthening in foreign investment flows in the 1990s.

Capital Account Exchange Regulations

The Chilean central bank lifted the last remaining controls on international capital flows in mid April 2001. The changes eliminate the following requirements: that investors secure central bank authorisation for capital inflows related to loan, portfolio investment and FDI; that authorisation is sought for capital outflows related to capital gains dividends and other benefits; and the reserve requirement obliging investors to deposit a portion of their investment with the central bank for up to a year. President Lagos has also announced his intention to change the tax rules. Granting domestic and foreign investors equal tax status and providing tax incentives to encourage new outlays will make investment easier and more profitable.

Decree Law 600: provides for a contract to be drawn up between the government and the investor on (mainly productive) investments over US$1 million; free access to foreign exchange for capital and profits remittance is guaranteed. Profits derived from foreign investments made through the more informal Chapter XIV of the country's foreign exchange regulations may be remitted annually.

Chilean residents' access to official markets was improved in 1997:

- residents are now allowed access to markets for investment activity abroad (including the purchase of assets and bank loans);
- the US$15,000 per month per individual ceiling on the purchase of hard currency for travel, medical expenses and subscriptions was lifted on 16 April 1997; and
- residents are no longer subject to reserve requirements on inflows of the proceeds of investments abroad. In addition, companies are not now required to cash 30% of profits or capital earned from investments abroad, and the share of

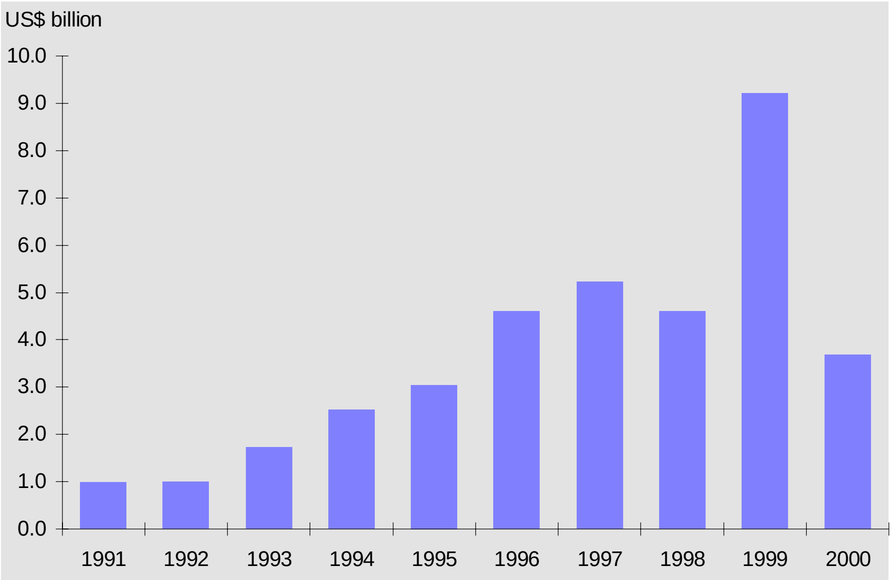
private pension funds which could be invested abroad was raised from 9% to 12%. Rules governing transactions involving derivatives have also been simplified.

Foreign Direct Investment

Net inflows of foreign direct investment (FDI) accelerated sharply in the mid-1990s, rising to US$4.6 billion in 1998. According to Foreign Investment Committee data, realised FDI under Decree Law 600 (DL600) equalled US$4.7 billion in 1998, an increase of US$0.4 billion on 1997. Significantly, DL600 investments remained strong in 1999 despite the economic downturn. Indeed, the 1999 figure was almost double that if the previous year at US$8.6 billion. Most of this fixed investment was in the utilities and service sectors and came from Spanish and US investors in the main.

Chart 25

Foreign Direct Investment Flows



Source: Banco Central de Chile, *Boletin Mensual*

In 2000, FDI was relatively weak at US$3.7 billion (but above the average for the 1990s). However, the first half of this year saw a return to rapid FDI growth. FDI rose by 143.2% in the first half to reach US$3.6 billion. The transport and telecoms sectors were the main beneficiaries of this rise, together accounting for 37% of the total. The USA remained Chile's major source of FDI with 36% of the total followed by Italy, Spain, and Australia. Changes to capital account regulations served to boost the already rising trend in overseas investment in Chile.

Authorisation was granted to eight foreign investment projects in the first half of 2001 reaching a total of US$4.7 billion, each were directed at the mining industry. The Ministry of Public Works and Transport will also open bidding for a US$23 million concession to build and operate the new Atacama airport by the close of this year. Funds related to these projects are likely to begin showing up on capital account data in the first half of 2002. However, given the deteriorating outlook for the global economy we do not anticipate record investment levels in 2001 or 2002.

Investment Incentives

Various investment incentives are available in certain sectors, including the petroleum and nuclear industries (particularly on imported machinery). There are also investment incentives according to region, which are designed to promote development in some of the less developed areas of the country.

Free-Trade Zones

There are free trade zones at the ports of Arica, Iquique and Punta Arenas. Companies located in a free trade zone are exempt from corporate income tax and VAT, and duties on imported inputs and parts.

Foreign Investment Laws

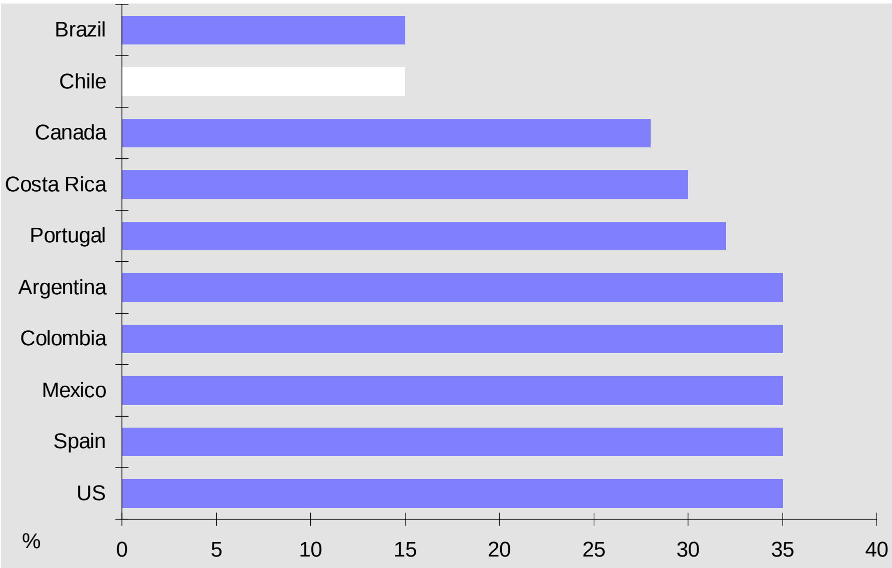
Decree Law 600, introduced in 1974 and since subject to various modifications, specifically encourages foreign direct investment in order to underpin development and technological flows. DL600 specifically prohibits discrimination against FDI.

Under DL600, all applications for investment must be lodged with the Foreign Investment Committee; profits and capital can be repatriated immediately. Following reform in 1997, the minimum investment allowed under DL600 was increased to US$1 million from US$25,000 (technology, machinery and equipment are exempt). Equity now has to be at least 50% of the investment (rather than 30%) with the remainder as debt. Exemptions to reserve requirements were also tightened: investments below US$100,000 (rather than US$200,000) are now exempt.

Taxation

The corporate income tax rate is charged at 15%, the lowest in the region. Capital gains are treated as normal income. Dividends paid by a resident company to resident shareholders are not taxable; those paid to non-resident are subject to a 35% withholding tax (subject to a credit). Interest paid on loans from abroad is also subject to a 35% withholding tax; if the loan is granted by a foreign or international bank or financial institution that rate is 4%. Value-added tax is levied at 18% (exports are exempt). Various municipal and real estate taxes are also levied.

Chart 26
Corporate Tax Rates, 2001



Source: Ernst & Young

Double taxation and tax evasion agreements have been signed with numerous countries including Argentina, Canada and Mexico. Notably, there is no agreement with the US. There have been some encouraging moves with respect to the tax treatment of foreign investors. Capital gains tax on portfolio foreign investment was lowered to 15% from 35% this year. But a reduction in dividend tax which is levied at 35% is unlikely given the government's need to keep a rein on the size of the fiscal deficit this year.

Company Organisation

There are seven basic forms of company organisation in Chile:

- *Sociedad Anónima (S.A.):* Corporation.
- *Sociedad de Responsabilidad Limitada (S.R.L):* Limited liability company.
- *Agencia:* Branch of a foreign corporation.
- *Sociedad Colectiva:* General partnership.
- *Sociedad en Comandita*: Limited partnership.
- *Asociacion o Cuentas en Participacion:* Silent partnership joint venture.
- *Empresario Individua:* Sole proprietorship.

The most common forms of association selected by foreign investors (apart from branches) are corporations and limited partnerships.

Corporations

There are two forms of corporations: open and closed. Open corporations are quoted on the stock exchange. When they have less than 500 shareholders, 100 shareholders or more must hold at least 10 per cent of the capital. Open corporations must publish their financial statement annually. Closed corporations must have a minimum of two shareholders. They are not submitted to any of the above requirements and are used for small ventures.

Limited Partnerships

These are most favoured in cases of association, either of persons or of corporations. The liability of each partner is limited to the amount of his initial investment. The parties are legally bound once a partnership deed has been drawn. Partnerships are under no obligation to publish any financial statements.

Branches

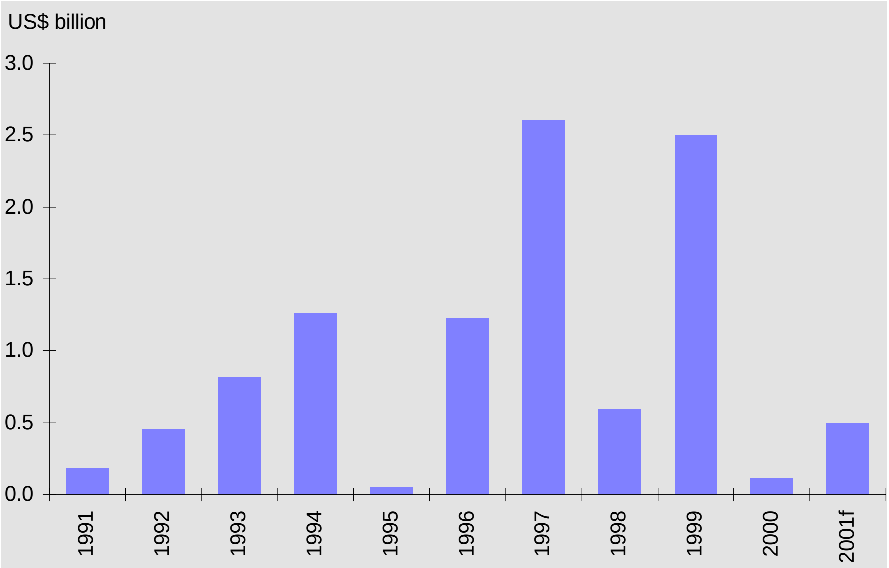
Branches of foreign companies must be registered with a Chilean notary. They must produce documents relative to the legal existence of the company in its country of origin and a copy of its bylaws. Power of attorney must also be given to the agent representing the company in Chile. A copy of the branch's annual accounts must be published in a local newspaper within four months following the end of the financial year.

Portfolio Investment

Foreign portfolio investment into was remarkably robust during 1997 and 1999, reaching US$2.6 billion and US$2.5 billion in each year respectively. While flows to other emerging markets languished under the weight of the emerging markets crisis, Chile's investment market benefited from its 'safe haven' status. In 2000 portfolio flows fell to just US$113 million. However, this was not an indication of weakening confidence in Chile's market, rather, an indication of the market's preference for government debt over Chile's stock and money markets. Given the strength of demand for government debt during this year to date, Dun & Bradstreet is only forecasting a moderate increase in portfolio investment for the year .

Chart 27

Portfolio Flows into Chile



Source: Banco Central de Chile, *Boletin Mensual*

Equities

Having posted a stellar performance in the early 1990s aided by the explosion in pension funds and trading in the major privatised power and utility companies, the Chilean stock market performed dismally during 1996-1998. This disappointing performance was partly a symptom of deteriorating prospects for the mining sector and the impact of Japanese stagnation on Chilean export prospects, particularly copper. Later, the market was also depressed by low commodity prices, rising interest rates and the fallout from the Asian crisis which hit investor confidence and reduced export demand in important Asian markets. Bullish earnings in the energy sector were unable to offset poor performance in the commodities sector, and the pensions funds switched to bonds as interest rates rose.

Table 14

Stock Market Profile

	1997	*1998*	*1999*	*2000*	*2001*
Number of companies	295	277	285	n/a	n/a
Market capitalisation (US$ million)	72,046	51,866	68,228	n/a	n/a
IGPA Chile Index: 1984=100	4,794.4	3,594.8	5,167.7	4,869.5	5,040.0
Change in index, %	-2.2	-25.0	43.8	-5.8	3.5

Note: [1]2001 index figure is for October 2001.

Sources: International Finance Corporation, *Emerging Stock Markets Factbook*; http://www.bolsadesantiago.com

In 1999, multi-billion dollar mergers, interest rate cuts, and an improvement in copper prices helped Chile's equity market to achieve the third best results in the region, behind the markets in Mexico and Brazil. Spain's Endesa acquired a controlling stake Enersis and Empresa de Generacion Electrica. These two transactions boosted Chilean stock market returns in the first half of the year. The effects of recession and the depreciation of the peso halted the market's rise in the third quarter, as expectations of curb profits due to higher dollar debt servicing costs rose. Shares regained momentum in the final months of the year as expectations of an economic rebound developed. In 2000, Chile's market rose during the first half, the rise fuelled by Endesa's bid for a further US$2.1 billion stake in Enersis. However the continued depreciation of the currency (despite rising copper prices) halted the rally, with the index closing the year 5.8% down on 1999.

The market rallied early in 2001, the IPGA index reaching 5121.8 on 18th January. US investor confidence was at record highs, and sentiment towards Latin America was improving on the back of political stability in Mexico and an improving economic outlook for Brazil. While there were fluctuations, Chile's market trended upwards through the first eight months of the year peaking at 5717.9 in August. While sentiment towards the Brazilian and Argentinean markets had begun to deteriorate, Mexico and Chile's markets retained their 'safe-haven' status. By October however, optimism had been replaced with pessimism following the release of poor second quarter data on the prospects for US economy and the confidence shattering events of 11th September. While Chile's index stood 3.5% higher than last years close at the time of writing, Dun & Bradstreet believes that the index will close this year below the 2000, as pessimism continues to dominate investor opinion.

Bonds

The Chilean (mainly corporate) bond market performed well in 1999 on the back of high interest rates. Issues in foreign bond markets also rose in the year with companies emboldened by the government's US$500 million benchmark global bond issued in April. Chilean companies including energy company Enersis and state-owned copper company Codelco have returned to the Yankee and euro bond market. As interest rates were lowered in 1999 and 2000, so private-sector bond market activity picked up as more corporate issuers have entered the market.

Early in 2001, the market for Latin American paper performed well, riding on the wave of optimism that surrounded the outlook for the region. Chile's sovereign bond market benefited accordingly. With copper prices failing to stage a second quarter rally, the Chilean authorities announced a US$1 billion programme of bond sales in July, the proceeds of which were used to support the currency.

In October Chile defied the global unease and faltering investor sentiment towards Latin America and sold the first international sovereign bond from the region since the events of 11th September. Demand for the 10 year bond was almost double the final issue amount of US$650 million, and the bond was sold at the lowest rate of any Latin America country - the yield was 256 basis points above US treasuries compared with Brazil at 1168 over treasuries, and Mexico at 397 over treasuries. Interest in high quality favoured Chile's market. Chile has full cheap access to capital markets in the midst of weakening sentiment towards the region and emerging markets as a whole.

The bond was used to bolster finances after the price of copper continued its decent through the third quarter. The government aimed to sell US$2 billion in debt over the coming months to set a benchmark rate for Chilean companies borrowing abroad. This would bring total bonds issued this year to US$4.5 billion.

Bank Lending

Chile has always had a sustainable international bank balance, compared with other countries in the region, (Argentina for example has bank debt almost three times the size of debt owed by Chile). Short term debt did jump by 35.9% in 1997, on the back of strong growth in the year, but during 1998 and 1999 debt was increasingly scheduled over longer terms, and this pattern continued into 2002.

In line with the trend among the emerging market economies, Chile has moved away from bank debt in favour of issuing debt on the international bond markets, hence the moderate 1.5% increase in bank lending in 2000. With international investors resolutely confident in the fundamentals of Chile's economy despite weaker growth prospects for the remainder of this year and into 2002, Dun &

Bradstreet expects that Chile will continue to successfully finance its needs by issuing debt.

Table 15

Maturity and Sectoral Distribution of Bank Lending to Chile

US$ million	***1996***	***1997***	***1998***	***1999***	***2000***
Maturities:					
Up to and including one year	7,762	10,550	8,794	8,275	9,584
Over one year up to two years	915	1,241	1,614	3,069	3,007
Over two years	6,107	8,778	11,146	10,587	9,697
Unallocated	371	612	631	433	420
Total	**15,155**	**21,181**	**22,185**	**22,364**	**22,708**
Sectors:					
Banks	3,701	3,602	3,810	1,972	1,803
Public sector	1,689	1,847	1,663	1,647	1,527
Non-bank private sector	9,765	15,732	16,711	18,728	19,353
Unallocated	-	-	1	17	25
Total	**15,155**	**21,181**	**22,185**	**22,364**	**22,708**

Source: Bank for International Settlements, *International Banking and Financial Market Developments*

Additional Sources of Information

Banco Central de Chile
Agustinas 1180
Santiago, Chile
Tel: (562) 670.2000
Fax: (562) 670.2231
http://www.bcentral.cl

Chilean-American Chamber of Commerce
Av. Americo Vespucio Sur 80,
9 Piso
82 Correo 34
Santiago, Chile
Tel: (562) 208.4140/3451
Fax: (562) 206.0911
http://www.amchamchile.cl

Corporacion Nacional del Cobre de Chile (Codelco)
Huferfanos 1270, Casilla 150-D
Santiago, Chile
Tel: (562) 698.8801
Telex: 24.06.72
http://www.codelco.com

US Embassy in Chile
2 Bello Avenue, Las Condes
Santiago, Chile
Tel: (562) 232.2600
Fax: (562) 330.3710
http://www.usembassy.cl

ProChile
510 W Sixth Street, Suite 1206
Los Angeles
CA 90014, USA
Tel: (213) 624.6302
Fax: (213) 489.9889
http://www.chileinfo.com

North American-Chilean Chamber of Commerce Inc
220 E 81st Street
New York, NY 10028
USA
Tel: (212) 288.5691

US Department of Commerce
Trade Information Center
International Trade Administration
14th and Constitution Ave, NW
Washington, DC 20230
Tel: 800-USA-TRADE
Fax: (202) 482.4726
http://www.ita.doc.gov

Chilean Trade Bureau
510 W Sixth Street, Suite 1204
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CA 90014, USA
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Credit Information

Dun & Bradstreet provides information relating to over 64 million companies world-wide. Visit www.dnb.com for details. Additional information relevant to Chile can also be found in the following services:

International Risk & Payment Review: Provides timely and concise economic, political and commercial information and analysis on 131 countries. Available as a subscription based internet service and monthly updated journal, the IRPR carries essential information on payment terms and delays. It also includes the unique D&B Country Risk Indicator to help monitor changing market conditions.

D&B International Business Locator: Provides access to information on more than 31 million public and private companies around the globe and can include information such as SIC, number of employees, sales, key executives, address, telephone, identification of ownership, upward linkage, and more.

Exporters' Encyclopaedia: Information on 220 world markets to help customers decide where they can safely and profitably do business. Data provided include key contacts, transportation information, legislation affecting export commerce and tips on foreign business travel.

Country Risk Indicator Definition

Dun & Bradstreet's 'DB' risk indicator provides a comparative, cross-border assessment of the risk of doing business in a country. The indicator seeks to encapsulate the risk that country-wide factors pose to the predictability of export payments and investment returns over a time horizon of two years. The 'DB' risk indicator comprises a composite index of four over-arching country risk categories:

Political risk -	internal and external security situation, policy competency and consistency, and other such factors that determine whether a country fosters an enabling business environment;
Macroeconomic risk -	the inflation rate, government balance, money supply growth and all such macroeconomic factors that determine whether a country is able to deliver sustainable economic growth and a commensurate expansion in business opportunities;
External Economic risk -	the current account balance, capital flows, foreign exchange reserves, size of external debt and all such factors that determine whether a country can generate enough foreign exchange to meet its trade and foreign investment liabilities;
Commercial risk -	the sanctity of contract, judicial competence, regulatory transparency, degree of systemic corruption, and other such factors that determine whether the business environment facilitates the conduct of commercial transactions.

The DB risk indicator is divided into seven bands, ranging from DB1 through DB7. Each band is subdivided into quartiles (*a*-*d*), with an *a* designation representing slightly less risk than a *b* designation and so on. Only the DB7 indicator is not divided into quartiles.

Indicator Meaning Explanation

DB1	Lowest risk	Lowest degree of uncertainty associated with expected returns, such as export payments, and foreign debt and equity servicing.
DB2	Low risk	Low degree of uncertainty associated with expected returns. However, country-wide factors may result in higher volatility of returns at a future date.
DB3	Slight risk	Enough uncertainty over expected returns to warrant close monitoring of country risk. Customers should actively manage their risk exposures.
DB4	Moderate risk	Significant uncertainty over expected returns. Risk-averse customers are advised to protect against potential losses.
DB5	High risk	Considerable uncertainty associated with expected returns. Businesses are advised to limit their exposure and/or select high-return transactions only.
DB6	Very high risk	Expected returns subject to large degree of volatility. A very high expected return is required to compensate for the additional risk or the cost of hedging such risk.
DB7	Highest risk	Returns are almost impossible to predict with any accuracy. Business infrastructure has, in effect, broken down.

