



Highlights of Chile

2007-2008

PRICEWATERHOUSECOOPERS 

Synopsis

- Economic growth slowed in the second half of 2007 with an unexpected rise in inflation and a severe energy crisis.
- A Free Trade Agreement signed with Japan and a limited Free Trade Agreement signed with India came into force during the second half of 2007.
- The Central Bank of Chile raised interest rates in September and December in an effort to contain inflation.

Political environment

According to the statistics of the Centro de Estudios Públicos, the second year of Mrs. Michelle Bachelet's government began with a 52% approval rating and ended with 39%. The cause of this drop in the polls is mainly associated with a poor implementation of the new public transport system in Santiago.

The current composition of the Lower Chamber is of 53 representatives from the center right coalition (Alianza por Chile), 57 from the center left coalition (Concertación), and 10 independents.

The Senate is made up of 16 senators from the center right coalition, 18 from the center left coalition, and 4 independents.



Economic Performance, Tax and Labor Legislation

1 GDP

During 2007, GDP grew by an estimated 5.1%. However, growth in the second half of the year was less than the Central Bank of Chile and private analysts had forecasted.

The low level of growth was partly the result of a drop in the added value of the electric sector, caused by the domestic energy crisis. Moreover, energy generation costs rose and were passed onto consumers (homes and businesses).

Chile's per capita income is approximately US\$ 9,810, though if expressed at purchasing power parity it is, according to the IMF, nearly US\$ 14,000, the highest in Latin America.

2 Trade Balance and Balance of Payments

The trade balance for 2007 showed a surplus of approximately US\$ 24,000 million. This is explained by an increase in exports, fueled by a record average copper price of approximately US\$ 3.2 per pound.

This is the ninth consecutive year of surplus.

Foreign exchange reserves were US\$ 16,910 million at the end of the year, compared to US\$ 19,428 million in 2006, US\$ 16,963 million in 2005, US\$ 16,016 million in 2004, and US\$ 15,851 million in 2003.

3 Double Taxation Agreements

Chile has double taxation agreements (DTAs) in force with Argentina, Brazil, Canada, Croatia, Denmark, Ecuador, France, Mexico, New Zealand, Norway, Spain, Peru, Poland, South Korea, Sweden, and the United Kingdom.

DTAs with Belgium, Colombia, Ireland, Malaysia, Paraguay, Portugal, Russia, Switzerland and Thailand have been already signed and are currently pending ratification by Congress.

DTAs are being negotiated with Australia, China, Cuba, Czech Republic, Finland, Hungary, India, Italy, Kuwait, The Netherlands, the United States, and Venezuela.

DTA negotiations with South Africa have concluded and the treaty is awaiting signature by both countries.

4 Trade agreements

At present, there are Free Trade Agreements (FTAs) in force with the United States, China, Canada, Mexico, South Korea, E.F.T.A. (Iceland, Liechtenstein, Norway, and Switzerland), and Central America. The latest agreement, with Japan, was enacted on September 3, 2007.

Agreements of Economic Association were signed with the members of the EU and of the P4. The P4 is formed by New Zealand, Singapore, Brunei Darussalam, and Chile.

Also, a limited FTA with India was enacted on August 17, 2007. This agreement will benefit 98% of Chilean exports to that country (which include minerals, wood pulp, timber, and salmon).

At present, FTAs are being negotiated with Australia, Ecuador, Malaysia, and Turkey.

5 Foreign debt

Foreign debt has been increasing at a yearly rate of approximately 15% in US Dollars, and reached a gross amount of approximately US\$ 54,748 million at the end of 2007. This increase is due to a mix of higher long-term indebtedness by local banks and an accumulation of short-term loans by local companies.

A large share of the foreign debt has fixed interest rates and 80% is long-term. Furthermore, 74% of the external debt corresponds to private company debts, of which 43% corresponds to debt between Chilean subsidiaries and their foreign parent companies, mostly Spanish.

Main banking creditors are from the United States (21%), Germany (7%), and Spain (6%). A liquidity shock in any of these economies may trigger a further shock in Chile and its neighboring countries.

6 Foreign investment

During 2007, total foreign direct investment (FDI) amounted to US\$ 15,300 million, an increase of 100% in relation to the previous year. Of this total investment, 8.9% was channeled through DL 600 and 91.1% through Chapter XIV.

Between January and July 2007, the main sectors receiving DL 600 FDI were Mining (50.8%), Services (21.2%), Electricity, Gas & Water (15.7%), and Forestry (5.5%).

The breakdown by sector information is not yet available for chapter XIV FDI.

7 Outbound investment

Outbound investment was approximately US\$ 4,700 million, duplicating the 2006 amount. 2007 outbound investment represents the largest capital injection by Chilean companies into foreign countries of the past 10 years. Of this amount, the main destinations were Peru, Brazil, Argentina, and Colombia. On the other hand, the most important sectors for investment were retail, industry, and the real estate sector.

8 Sector performance

In comparison with 2006, industrial production grew 3.9% in 2007. This growth is lower than expected due to the appreciation of the exchange rate, gas supply cutoffs by Argentina, rising energy prices, weather conditions, and labor conflicts in the production plants of certain industries.

To highlight the situation, half of the industrial growth is explained by the startup of operations by two new wood pulp projects. Without taking these into consideration, industrial production growth would be only 1.7%.

The mining sector grew only 3.2%, showing a worse development than expected, caused largely by a 1.5% fall in copper production output in November, 2007.

9 Country risk

On December 18, 2007, Standard & Poor's upgraded Chile's credit risk rating in foreign currency from "A" to "A+". The credit risk rating in local currency and its transfer and convertibility evaluation was confirmed at "AA". This consolidates the position of Chile as the Latin American country with the lowest credit risk rating. This classification reflects the growing resilience of the Chilean economy to external impacts, despite its dependence on raw materials exports.

Furthermore and according to the Fiscal Liability Law, on March 6 2007 the Chilean government incorporated the Economic and Social Stabilization Fund (Fondo de Estabilización Económica y Social). This fund is formed by the effective fiscal surplus and its purpose is to insure fiscal budget financing in years of deficit. The Treasury manages the fund according to the faculties granted by the abovementioned law. These funds are accumulated offshore to reduce the impact on the exchange rate. Based on the latest information available, the fund had accumulated more than US\$ 10,000 million at the end of September 2007.

10 Labor

During 2007, unemployment steadily increased from 6.4% at the beginning of the year to 7.2% at the end of the year. A possible reason may be associated to the strong rise in the labor force of 2.7%, caused by the incorporation of more women to the employment market, and only moderate job creation. Despite this, the 2007 average annual rate of 7.1% still represents the lowest average rate in the past 9 years.

11 Inflation

During 2007, annual inflation measured by the Consumer Price Index was nearly 8%, which significantly exceeds the annual rate of 2006 (2.6%). This important rise was caused by a number of shocks related to supply factors, such as the sustained increase in food prices globally, especially corn and wheat; the effects caused by frost on the price of fruit and vegetables; and the unexpected rise of oil prices and oil-based products.

Inflation was 3.7% in 2005, 2.4% in 2004, 1.1% in 2003 (the lowest in decades), and 2.8% in 2002.

12 Exchange rates

The observed exchange rate, which is the average of buying and selling rates for transactions in the Formal Market, closed at year end at Ch\$ 496.89 per US dollar, compared to Ch\$ 532.39 at the previous year end.

The exchange rate reached its highest value for the year on February 8 at Ch\$ 548.67 and its lowest value on November 2 at Ch\$ 493.14. The Chilean peso appreciation reached 6.44% during 2007 and continued strongly in early 2008.

13 Interest rates

The Central Bank raised interest rates 5 times during 2007. The benchmark lending rate stood at 5.09 % at the beginning of the year and reached 5.88 % at the year end. In January 2008, the Central Bank increased its benchmark rate to 6.17% in response to the inflation scenario.

14 Foreign exchange regulations

Since 2002, foreign exchange operations fall into 3 categories: (i) operations that must be performed through the formal exchange market (i.e. a commercial bank) and informed to the Central Bank; (ii) operations that must be performed through the formal exchange market; or (iii) operations that need only be informed to the Central Bank. Thus, there are no transactions that require prior approval by the Central Bank.

15 Labor legislation

The most important change to labor legislation in 2007 was the issuance of **Law No. 20,194** that interprets Article 162 of the Labor Code. This Article sets forth that the dismissal of an employee is void if the employer has not paid the social security remuneration of the dismissed employee. Consequently, the employer would be liable to pay compensation until effectively paying all outstanding social security contributions.

The Supreme Court, however, had limited the extension of this article, declaring that the employer is liable to pay remuneration for a maximum of 6 months after a void dismissal, since this is the statutory term of limitation for the action to claim forced payment of unpaid social security contributions.

Law 20,194 made a legal interpretation of Article 162 of the Labor Code stating that remuneration must be paid from the date of the dismissal until full payment of outstanding social security contributions has been made, despite the statute of limitations to claim forced payment of unpaid social security contributions.

16 Tax legislation

Law No. 20,190 in force since June 2007 introduced amendments to the Capital Markets Law and modified some provisions of the Income Tax Law.

This law clarified the tax treatment applicable to capital gains from investments in mutual funds. In this regard, the law sets forth that the liquidation of the investment will not trigger capital gains taxation if the funds received are immediately reinvested in other mutual funds. For this purpose, the mutual fund managing company will have to carry out the liquidation and transfer of the funds to the other entity.

On the other hand, Law No. 20.190 incorporates a concept of venture capital and an allowance applicable to the capital gain made from the sale of the shares of the recipient business. This capital gain will be treated as Non-taxable Income if the necessary conditions set forth by the law are met.

Law No. 20,241 was published in January 2007, to create a tax incentive applicable to Research and Development.

In order to use the tax incentive, local companies must engage in research or development tasks with a Research Center, under the terms of the law. These contracts will have to be certified by CORFO, the governmental agency in charge of the promotion of production.

Taxpayers that fulfill all legal requirements will have a 35% credit against their corporate tax liability. This credit may not exceed 15% of their gross income or the equivalent of 5,000 Monthly Tax Units (approximately US\$ 450,000).

17 Prospects for 2008

The Central Bank of Chile forecasts a GDP growth of 4.5% to 5.5% with the risk balance biased downward. Domestic demand forecasts are not too optimistic, although it is expected that demand will continue to outpace output growth.

The Central Bank's long term projections for inflation consider that it will remain anchored around 3% per annum. However, annual Consumer Price inflation for 2008 will continue above the tolerance range for the whole year.

Local thinktanks expect that unemployment will increase to 7.3% during 2008, due to a slowdown in growth.

Exchange rate projections for 2008 hovered around Ch\$ 505 per US dollar at the end of the first quarter but they have proven to be inaccurate given the strong downward trend observed during the same period.

The Central Bank forecasts for copper prices during 2008 are US\$ 2.95/lb as compared to US\$ 3.23/lb for 2007 and US\$ 3.05/lb for 2006.

18 PricewaterhouseCoopers in Chile

PricewaterhouseCoopers (www.pwc.cl) has been present in Chile since 1914. During these 94 years we have served the most prestigious local and foreign entities operating in Chile. We are the leading firm in the auditing business, with a staff of approximately 850 persons distributed in the cities of Antofagasta, Santiago, Viña del Mar, Concepción, Valdivia, and Puerto Montt.

Our services include auditing, management consulting, executive recruitment, fixed asset valuation, due diligences, technology and software selection, performance improvement, enterprise risk management, tax and legal services, foreign investment registration and structuring, bookkeeping, confidential payroll and corporate finance services. In general, we provide information and advice on how to operate in Chile.

Our main objective is to help our clients be successful and we welcome any questions you may have related to either our services in general or to the information above.

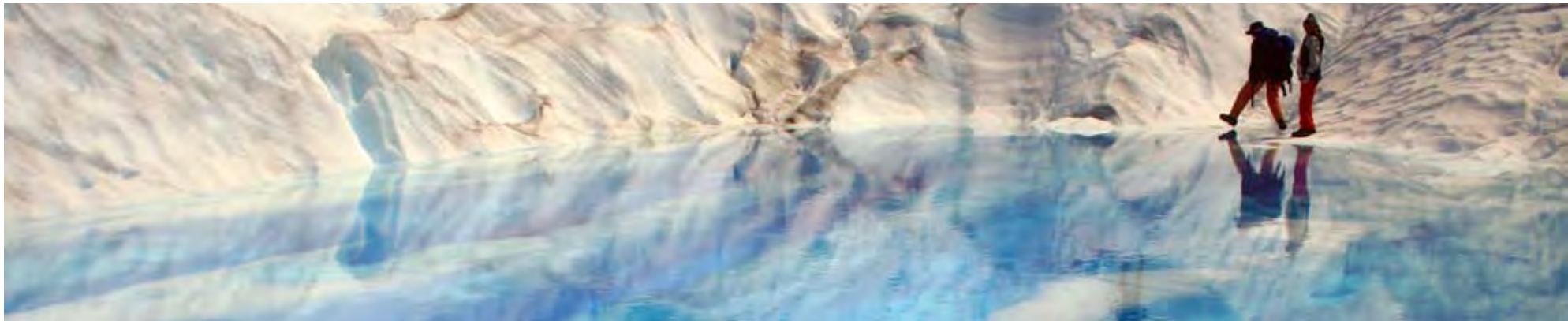


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