

Highlights of Chile 2005-2006*



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Synopsis

- In 2005, the Chilean economy continued with its recovery, receiving a boost from record-high prices for copper and other commodity exports.
- The Free Trade Agreement signed with China came into force in the second half of the year.
- A low level of inflation was maintained, with the Central Bank increasing interest rates several times.
- The governing political coalition won both the presidential and the congressional elections in December.



Political environment

Presidential and congressional elections were held in December. The presidential election was won in a second round by Michelle Bachelet, a moderate socialist. The newly elected president is backed by the Concertación, a center left coalition that has been in office since 1990.

Mrs. Bachelet's term will last 4 years, and will be the fourth consecutive government of the Concertación. During her campaign, she stated that one of her main objectives will be to overhaul the pension system.

After the congressional elections, the composition of the Lower Chamber is the following: 54 deputies from the center right coalition, and 65 from the center left coalition, with one seat won by an independent.

The Senate composition is the following: 17 senators from the center right coalition, 20 from the center left coalition, and one regional independent. This is the first time the governing coalition has had a clear majority in the Senate.

Economic Performance, Tax and Labor Legislation

1 GDP

The economy grew strongly in 2005, with GDP amounting to approximately US\$ 112 billion, a 6.3% increase in relation to 2004.

This is explained mainly by high commodity prices, and an increase in local investment and demand.

Chile's per capita GDP is now approximately US\$ 7,000.

2 Trade Balance and Balance of Payments

The trade balance for 2005 showed a surplus of approximately US\$ 8.5 billion, which is slightly higher than the results obtained for 2004. This is explained by an increase in exports, fueled by a record average copper price of approximately US\$ 1.70 per pound, offset by a increase in imports, mainly caused by sharply higher oil prices and strong domestic demand.

This is the seventh consecutive year of surplus.

International reserves were US\$ 16.5 billion at the end of the year, in comparison with US\$ 16 billion in 2004, US\$ 15.9 billion in 2003 and US\$ 15.4 billion in 2002.

3 Double Taxation Agreements

Until 2004, there were double taxation treaties (DTT) in force with Poland, Spain, Peru, Ecuador, South Korea, Norway, Brazil, Mexico, Canada and Argentina.

DTTs with the United Kingdom, Denmark and Croatia came into force during 2005 and treaties with Ireland, Portugal and Paraguay signed during the year, are currently pending ratification by Congress. Also signed and pending ratification by Congress are treaties with Russia, Malaysia, France and New Zealand. The DTT with Sweden will come into force during 2006.

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

4 Trade agreements

At present, there are Free Trade Agreements (FTA) in force with Canada, Mexico, the United States, the E.U., South Korea, E.F.T.A. (Iceland, Liechtenstein, Norway and Switzerland) and Central America.

In November, Chile signed a FTA with China which is expected to come into force during the second semester of 2006. When in force, 92 per cent of Chile's current exports to China will enter duty free. The same goes for 50 per cent of China's current exports to Chile.

An agreement of Economic Association with the members of P4 was signed. The P4 is formed by New Zealand, Singapore, Brunei Darussalam and Chile. When it will come into force is still being discussed in Congress.

Negotiations with India for a limited FTA are at an advanced stage, and are expected to conclude during 2006.

5 Foreign debt

Foreign debt was approximately US\$ 45 billion at the end of 2005. Of this amount, 79% corresponds to private debt. Public debt has decreased approximately 4% in relation to the previous year. Together with the increase of approximately 6% in private debt, this keeps total foreign debt on its upward trend of recent years. Still, this level of debt is one of the lowest in Latin America, when compared to international reserves, GDP and exports.

6 Foreign investment

During 2005, total foreign direct investment (FDI) reached US\$ 3.7 billion, showing a decrease of 42.3% in relation to the previous figures. Of this total investment 51% was channeled through DL 600 and 49% through Chapter XIV.

7 Outbound investment

Outbound investment was approximately US\$ 1.5 billion. Of this amount, the main destinations were Argentina (27%), Brazil (25%), Peru (11%) and Colombia (9%).

8 Sectorial performance

Sectors recording the highest positive variations on physical production as of November 2005 are Textiles (8%), Pulp & Paper (7%) and Food & Drinks (6.7%).

The two only sectors recording negative variations on physical production as of November 2005 are Metallic Products, Machines & Equipment (-5%) and Chemicals & Oil (-0.8%).

9 Country risk

Chile's country risk hit a new record-low in September as it fell to just 40 basis points above U.S. Treasuries. At present, Standard & Poor's gives Chile's long term foreign currency debt an A rating, and A-1 for its short term foreign currency debt.

The 2005 Global Growth Report, prepared by the World Economic Forum, places Chile 23rd among 117 economies evaluated. Chile is in 1st place among Latin American countries, followed by Uruguay ranked 54th, and Mexico ranked 55th. According to the World Economic Forum, Chile's strengths are based on its open trade and foreign investment regime and the quality of its public institutions.

10 Labor

Unemployment steadily decreased from 8.6% at the beginning of the year to less than 7.9% at the end of the year.

11 Inflation

Inflation was 3.7% for the year, above the target range set by the Chilean Central Bank. The main factor explaining this figure is an increase in local demand and in fuel costs. Inflation was 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 on December 30 at Ch\$ 512.5 per US dollar, compared to Ch\$ 557.4 at the previous year end.

The exchange rate reached its highest value for the year in June at Ch\$ 592.75. The Chilean peso's appreciation is largely a result of record-high copper prices.

13 Interest rates

The Central Bank raised interest rates 9 times during 2005. The benchmark lending rate went from 2.25% at the beginning of the year to 4.5% at the year end.

In February 2006, the Central Bank continued to increase interest rates, raising the rate to 4.75%. This is in response to lower unemployment, higher wages and increased consumer spending.

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 reported to the Central Bank;
- (ii) operations that must be performed through the formal exchange market; or
- (iii) operations that only need to be reported to the Central Bank.

Thus, there are no transactions that require prior approval by the Central Bank.

There is a dispute between the Internal Revenue Service (IRS) and the private banks in relation to a request made by the IRS for banks to report transactions of over US\$ 10,000 to the IRS. A recent Court ruling established that this request violates banking secrecy laws.

15 Savings and investment

No significant changes occurred compared to prior years.

16 Tax legislation

The only significant tax law change was Law No. 20,026, dated June 16, 2005, which establishes a specific tax on the "taxable operational revenue from the mining activity obtained by a mining exploiter". Individuals or legal entities that extract minerals and sell them (property transfer) in any state are subject to this tax.

A progressive rate was established, with a maximum of 5% applicable to taxpayers with operational revenues that exceed a value equivalent to 50,000 metric tons of fine copper. Those taxpayers that obtain operational revenues of less than the value equivalent of 12,000 metric tons of fine copper are exempt from this tax.

To determine the tax rate applicable, the total amount of sales of mining products of all individuals or entities related to the mining exploiter must be taken into account.

It is an annual tax that must be declared and paid in April of every year, with the additional obligation to make provisional monthly payments.

The tax will be applicable to profits generated from January 1, 2006. As a consequence, the obligation to make provisional monthly payments creditable against this tax arises from January, 2006.

The rate of the provisional monthly payments for the first commercial years relative to this specific mining tax will be 0.3% of gross income from the sale of mining products.

17 Labor legislation

The most important issue of 2005 was Law No 20,087, which amends the labor lawsuits procedures, and will come into force on March 1, 2007. This law modifies procedures relating to oral, public and concentrated hearings.

There is a bill pending in Congress to regulate outsourcing of employees and temporary services in order to limit alleged bad labor practices.

18 Prospects for 2006

For 2006, forecasts are optimistic, but they acknowledge that the economy will not keep the same pace of the previous two years. Of special importance is the future behavior of commodity markets, especially copper, a key Chilean export. Record-high copper prices have caused a significant revaluation of the Chilean currency, generating certain tension among non-copper Chilean exporters, although this may be mitigated if the global economy keeps the same pace that it showed during 2005.

The Central Bank predicts a growth rate for 2006 of between 5.25% and 6.25%.

The private sector expects an inflation rate of between 3.0% and 3.2%.

Unemployment is expected to continue its downward trend, ending at 7.6%. This is caused both by the economic expansion and the slowing growth of the labor force, which is expected to grow at only 4.5% compared to 5.7% in the previous year.

The exchange rate at the end of 2006 is forecast to be between Ch\$ 559 and Ch\$ 570 per US\$ 1.

The average copper price for 2006 is projected at approximately US\$ 1.5/lb as compared to US\$ 1.67/lb for 2005 and US\$ 1.3/lb for 2004.

The new government is expected to continue with the economic policies of its predecessors and, therefore, has not been a factor in the above estimates.

19 PricewaterhouseCoopers in Chile

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We are the leading firm in our line of business, with a staff of over 700 distributed in the cities of Antofagasta, Santiago, Viña del Mar, Concepción, Valdivia and Puerto Montt.

Our services include audit, management consulting, executive recruitment, fixed asset valuation, 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 to 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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