

Highlights of Chile 2006-2007*

*connectedthinking

Synopsis

- Chilean economic growth slowed towards the end of 2006 due to weakening investment growth, exchange rate effects and an increase in energy costs.
- A Free Trade Agreement signed with China came into force in the second half of 2006.
- Inflation remained low, with the Central Bank steadily increasing interest rates throughout most of the year. No further increases were implemented from November onwards.



Political environment

The newly elected president, Mrs. Michelle Bachelet, a moderate socialist, took office at the beginning of 2006. Her term in office will last 4 years, and is the fourth consecutive government of the Concertación, a center left coalition that has been in office since 1990.

The current composition of the Lower Chamber is made up of 53 deputies from the center right coalition, 63 from the center left coalition, 3 independents and 1 from a regional party.

The Senate composition is made up of 17 senators from the center right coalition, 19 from the center left coalition, 1 independent and 1 senator who recently resigned from a center left coalition party.

Economic Performance, Tax and Labor Legislation

1 GDP

During 2006, GDP grew by an estimated 4.2%, which is less than the Central Bank of Chile and private analysts had forecast.

The lower than expected level of growth was the result of weakening domestic demand throughout 2006, and a fall-off in investment growth, exchange rate effects, and an increase in energy costs, all concentrated in the latter part of the year.

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

2 Trade Balance and Balance of Payments

The trade balance for 2006 showed a surplus of approximately US\$ 23 billion, which is more than twice the result obtained in 2005. This is explained by an increase in exports, fueled by a record copper price of approximately US\$ 3 per pound.

This is the eighth consecutive year of surplus.

Foreign exchange reserves were US\$ 19.4 billion at the end of the year, compared to US\$ 16.5 billion in 2005, US\$16 billion in 2004, US\$ 15.9 billion in 2003 and US\$ 15.4 billion in 2002.

3 Double Taxation Agreements

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

DTAs with Ireland, Portugal, Russia, Malaysia, Thailand and Paraguay were signed during 2006 and are currently pending ratification by Congress.

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

DTA negotiations with South Africa have concluded

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.

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

Negotiations have concluded with India for a limited FTA.

5 Foreign debt

Foreign debt has been increasing at a yearly rate of 7% in US Dollars, and reached approximately US\$ 48 billion at the end of 2006. Of this amount, a significant proportion relates to loans provided by foreign suppliers. 80% of foreign debt is long term. 50% of private companies' foreign debt is owed by Chilean subsidiaries of multinational enterprises.

The overall level of foreign debt is one of the lowest in Latin America, considering its relation to foreign exchange reserves, GDP and exports.

6 Foreign investment

Between January and October of 2006, total foreign direct investment (FDI) amounted to US\$ 4 billion, an increase of 40.5% in relation to the previous year. Of this total investment, 55 % was channeled through DL 600 and 45% through Chapter XIV.

The main sectors receiving DL 600 FDI were Electricity, Gas & Water (53.5%), Mining, (19.9%), Services (11.5%) and Transport & Communications (9.9%).

7 Outbound investment

Outbound investment was approximately US\$ 2.4 billion (59% more than 2005). Of this amount, the main destinations were Argentina (17%), Brazil (11%), Peru (15%), Colombia (23%) and Australia (21%).

8 Sectorial performance

During 2006 most sectors recorded slower growth, compared to 2005.

Growth forecasts for 2007 are optimistic for most sectors, particularly for Mining (6%), Manufacture (4.8%), Construction (8.8%) and Communications (8%).

9 Country risk

Chile has consolidated its position as the Latin American country with the lowest credit risk rating. Standard & Poor's has given Chile a sovereign risk rating of "A" since 2004.

10 Labor

During 2006, unemployment steadily decreased from 8% at the beginning of the year to nearly 6% at the end of the year.

11 Inflation

During 2006, annual inflation was 2.6%, which was significantly below the Central Bank's expectations published in September that year. This was caused by a rapid fall in oil prices towards the end of the year and slower economic growth. 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 on December 30 at Ch\$ 534.4 per US dollar, compared to Ch\$ 514.21 at the previous year end. The exchange rate reached its highest value for the year during June at Ch\$ 549.63. The Chilean peso appreciation is mainly a result of record-high copper prices.

13 Interest rates

The Central Bank raised interest rates 6 times during 2006. The benchmark lending rate stood at 4.5% at the beginning of the year and reached 5.25% at the year end. In January 2007, the Central Bank reduced its benchmark rate to 5% in response to a scenario of lower projected inflation.

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 Savings and investment

No significant changes occurred compared to prior years.

16 Tax legislation

- **Law No. 20,130** was passed in November 2006, to amend the regulations regarding the Stamp Tax levied on documents evidencing money lending operations.

Until December 2006, Stamp Tax was levied at a rate of 0.134% on the amount of the loan for every month, or fraction thereof, from the issuance of the documents until their maturity, capped at 1.608%. If the document referred to an operation payable on demand or without maturity term, the rate was 0.67%.

The new bill established a permanent reduction of the current Stamp Tax rates, as from January 1, 2009. For the interim years of 2007 and 2008 the following reduced rates were established with effect as from January 2007:

For 2007, the respective rates shall be 0.125%, 1.5% and 0.625%.
For 2008, the respective rates shall be 0.1125%, 1.35% and 0.5625%.

This bill also established new regulations to provide a greater Stamp Tax exemption on loans taken to pay other outstanding or matured loans.

- **Law No. 20,154** was passed during January 2007 to change the taxation of outbound remittances for trademarks, patents, and other royalty payments.

While royalties for the use of trademarks, patents, formulas and other similar payments will remain subject to the 30% withholding tax, payments for invention patents, utility models, drawings and industrial designs, royalties for new vegetable varieties and for computer programs will be subject to a 15% withholding tax.

The new bill also reduced the withholding tax levied on outbound payments for engineering services or technical assistance provided in Chile or abroad by non resident or non domiciled individuals or legal entities. The 20% withholding rate that was previously applicable has been reduced to 15% for engineering or technical work, or for professional or technical services provided by an appropriately qualified person and appropriately documented.

However, the reduced 15% withholding tax would not be available in any of these cases if the payment is between related parties, or where the beneficiary of the payment is incorporated, domiciled or resident in a jurisdiction considered by the Chilean authorities to be a tax haven. In such cases, the rate would be 30% or 20%, as applicable.

- **Law No. 20,171** was passed on February 16, 2007, to amend the regulations regarding the Chilean tax credit on foreign source income.

The new law ensures the availability of a tax credit for taxes paid abroad on dividends or profits, without regard to the existence of a Double Tax Agreement with the source country. It also allows the use of the foreign tax credit against both the Chilean corporate tax, and the final taxes payable by Chilean resident or domiciled individuals, and non resident or non domiciled individuals or legal entities.

However, this new bill creates two areas of concern.

Firstly, it stipulates that the credit that may be used against final taxes must be deducted from the tax liability after any credits or deductions authorized by law. Any unused balance will not create a right to a reimbursement, cannot be imputed against other taxes, and may not be carried forward to future periods.

Secondly, the new law limits the foreign tax credit to an amount equivalent to 30% of the yearly Net Foreign Income. This amount is defined as the foreign source profit or loss subject to tax in Chile, after deducting the necessary expenses in the corresponding proportion, plus all the credits for foreign taxes calculated in the manner described in the new provisions.

In order to assess the impact that these new provisions will have on taxpayers, it will be necessary to wait for the Chilean IRS to issue a Circular with the instructions on how to calculate the Net Foreign Income and what expenses must be deducted from it.

This law also increased the income tax credit for investments in fixed tangible assets from 4% to 6% of their value, for assets purchased new, built or acquired via a lease with an option to purchase from January 1, 2007 until December 31, 2009. The yearly maximum credit is approximately US\$ 38,000.

17 Labor legislation

The most important change to labor law in 2006 was the issuance of Law No 20,123, to regulate employee outsourcing and temporary hires.

In addition, Law No. 20,087 was passed to amend court procedures for labor lawsuits that will become enforceable on March 1, 2007. The new bill establishes fast track, oral procedures in public.

18 Prospects for 2007

The Central Bank of Chile has forecast that the output gap recorded at the end of 2006 will persist for several quarters, notwithstanding a projected faster rate of output growth for 2007 based on higher fiscal spending scheduled for this year, favorable external and internal macroeconomic conditions and good prospects for investment.

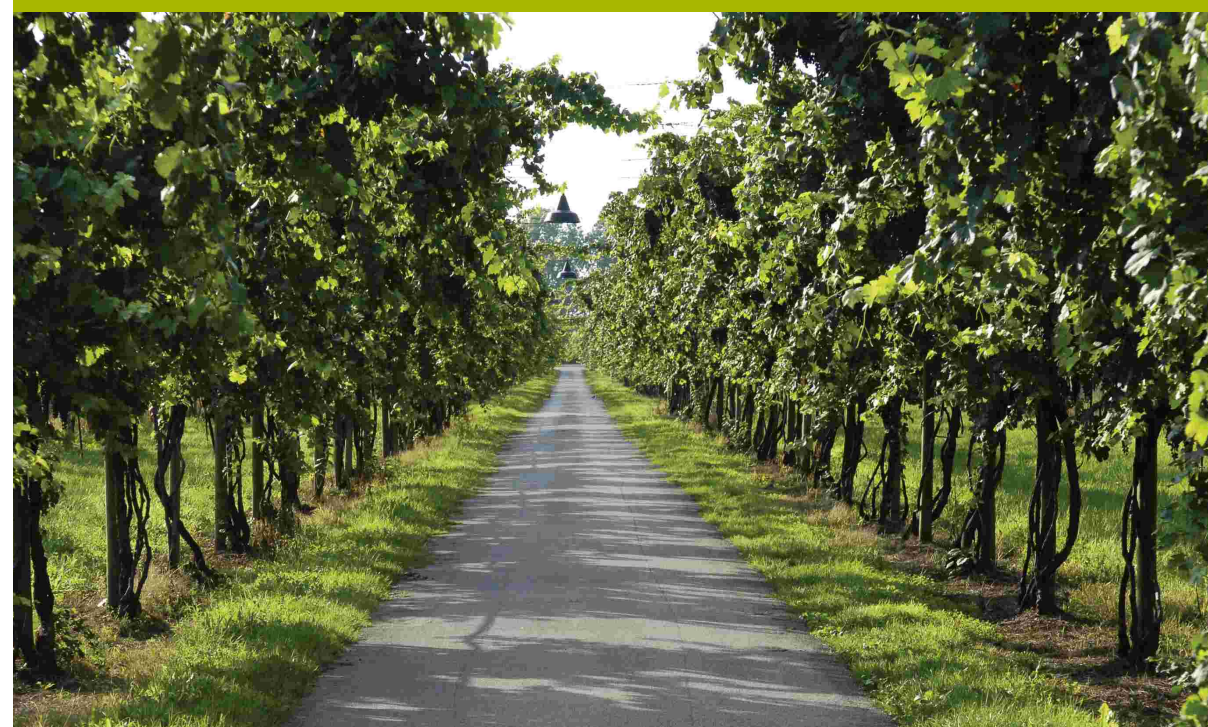
The Central Bank predicts a growth rate for 2007 of between 5% and 6%.

The Central Bank and private sector forecast an inflation of between 2% and 3% for this year.

Unemployment is expected to continue its downward trend which began in 2006, driven both by economic expansion and slow labor force growth.

The exchange rate at the end of 2007 is expected to be between Ch\$ 550 and Ch\$ 560 per US dollar.

The average copper price for 2007 is expected to be approximately US\$ 2.3/lb as compared to US\$ 3.05/lb for 2006 and US\$ 1.67/lb for 2005.



19 PricewaterhouseCoopers in Chile

PricewaterhouseCoopers has been present in Chile since 1914. During these 93 years we have served the most prestigious local and foreign entities operating in Chile. We are the leading firm in our line of business, with a staff of approximately 800 persons 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.

www.pwc.cl