BBVA

Chile Watch

Economic Research Department

First Semester 2009

Economic Activity: A negative start to 2009, but with expectations of recovery

Interest rate at historical lows and inflation in free fall

Financial conditions return to levels similar to those observed before the tensions in international markets began

Index

Closing date: june 16th, 2009.

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Editorial

The scope and severity of the adverse situation that the Chilean economy, along with most of the world's economies, has been facing since the end of 2008 have far surpassed all expectations. In this context, we have been able to evaluate the 'insurances' on which Chile's macroeconomic policy is based and which enable us to anticipate recovery toward the end of 2009.

The first of these 'insurances' is the rule of the structural surplus, which aims to smooth the economic cycle and its effects. In March 2008, the rule was relaxed and the new objective of a structural result of 0.5% (previously 1%) of GDP was established. However, in view of the economic crisis and in response to the resulting anticipated increase in the need for financing, the rule was relaxed even further, introducing the objective of a zero structural balance. This latest change is a transitory one and the rule is therefore set to return to 0.5% of GDP in 2010. Spending is therefore also set to be aligned with this objective. In any event, it is our opinion that its reimplementation should be postponed by another year.

The government-designed stimulus package announced in January 2009 includes a series of measures for reactivating domestic demand, while also improving productivity and increasing the economy's potential output. In this regard, both the original plan and the supplementary plans (pro-credit plan launched in March and the pro-employment plan launched in May) have successfully created a balance between the stabilization objectives and the social protection objectives by appropriately focusing resources (in particular by limiting welfare expenditure) not only to reduce the volatility of economic activity but also help increase productivity.

The scale of the fiscal effort is another point to bear in mind. The resources involved are equivalent to 3% of the GDP in 2009. Other than China, no other economy has been able to match this effort. What is remarkable about this situation is that it does not significantly affect the government's future ability to react, as the fiscal plan is completely financed by sovereign wealth funds. Furthermore, as this edition was going to print, the government announced the withdrawal of an additional US$4 billion on top of the amount announced in January. Even with this, the Economic and Social Stabilization Fund still has 65% of the resources accumulated as of December 2008.

The Chilean economy's other 'insurance' is based on its monetary policy of inflation targeting and a flexible exchange rate. In this respect, it is necessary to highlight the intensity of the BCCh's expansionary monetary policy, which is one of the world's most aggressive policies. This has been possible thanks to the confidence in the Chilean institutions and the existence of a solid financial system that makes it possible to overcome the 'fear of floating'.

The combination of the economic policies implemented before and during the crisis has therefore been a key factor in recuperating shareholders' trust. This has become evident, for example, in the development of Chile's risk levels, which are currently lower than they were last September before the collapse of Lehman Brothers. Once the crisis is over, the strengths of the Chilean economic policy will help to reduce the cost of capital and make the country more attractive to foreign investment, thus supporting a higher economic growth rate in 2010 - above 2%- after registering a negative result in 2009.

Executive Summary

The slowing global economy and the increased level of uncertainty greatly impacted upon the forecasts for the Chilean economy made by agents over the last six months. Both consumers and entrepreneurs put their consumption, production and investment decisions on hold, thus explaining the severe decline in domestic demand. Prices have fallen over several consecutive months, following a high of 9.9% annual inflation in October last year. The current level has now reached 3%, which is precisely in the middle of the Central Bank's target range. Meanwhile, the financial system has remained solvent and even though there was a period of credit crunch at the end of last year (decline in supply and demand at the same time as rates rose considerably), this was quickly overcome.

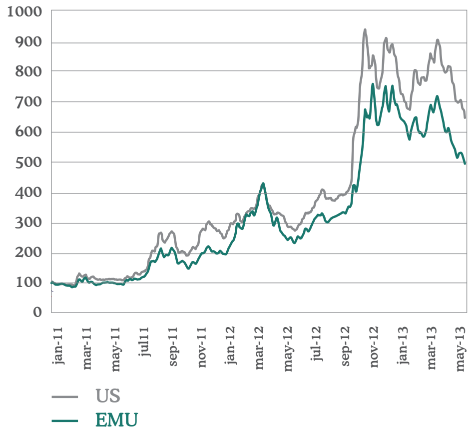
In this scenario, the estimates of GDP growth in 2009 have been revised downward several times, with a current level of -1.2% yoy, along with a 0.2% annual inflation by year end, the lowest since the beginning of 2004. Although job losses have been moderate to date, there is no doubt that the labor market situation is set to decline over the coming months due to the delayed impact of the decline in activity in the Chilean labor market.

The levels of globalization and synchronicity of the crisis have no precedent and the Chilean economy has not been immune from it. However, there are few, if any, economies that have been able to combine a monetary and fiscal stimulus package of the proportions of that successfully implemented by the Central Bank of Chile and the Chilean Government without risking the stability of the financial system or the health of the fiscal accounts. We are referring to a reduction of the monetary policy rate of 750 bps in 6 months to a level of 0.75% and a fiscal package of US$4.3 billion (3% of GDP), completely financed by resources saved in times of plenty. Towards the end of the year, we expect the policy rate to remain at this level over a long period. If necessary, and without putting the ex-ante fiscal rule at risk, the government could implement an additional stimulus package specifically designed to enable the continuity of the fiscal stimulus in 2010 and to reduce the impact of the crisis on employment.

The Chilean foreign sector has been deeply affected and is still not showing any signs of recovery, especially imports. On the other hand, following major depreciation at the end of the year, the peso has once again appreciated to a level of $560 per dollar. We expect this to be the level by year end. This situation is based on the recovered confidence in the country's solvency, the improvement in the price of copper to levels of just over US$2 per pound (a situation that we do not expect to last), and the repatriation of government savings abroad to finance its deficit, increased by the aforementioned stimulus package. Despite the above, foreign demand will take a while to recover, which is bad news for an economy that is as open as Chile's. In fact, the main risk facing the Chilean economy in 2010 is that it takes a long time for trading partners to recover, or even that this situation become worse.

The main domestic factors behind our forecast are the major decline in investment and private consumption expenditure. As expectations improve, consumption expenditure, especially in relation to durable goods, will start to recover. On the other hand, investment will take longer to recover. The increase of real wages will certainly be one factor that will help improve private consumption expenditure and somewhat offset the negative effects of the high unemployment rate.

Indicator of Financial Tension



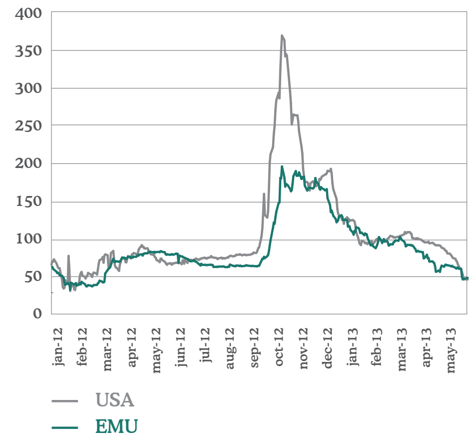
Source: Research Department.
The first standardized principal component of the OIS spread series, implicit stock market volatility, bank, corporate and sovereing (in the case of Europe) CDSs.

Banks: CDS debt Senior 5 Years
(bp)

Source: Bloomberg

* Banks included: Barclays, RBS, Lloyds, HSBC, Alliance & Bingley, Standard Chartered, Allied Irish Bank, BNP, Deutsche Bank, ING, Unicredito, UBS, Credit Suisse, Credit Agricole, Societe Generale, Intesa, BBVA, Santander.

Interbank Markets: 3-Month OIS Spread
(3M LIBOR - 3M OIS)



Source: Bloomberg

1. International Outlook

Following a complex start at the beginning of the year, with high financial tensions and strong declines in activity, the second quarter has seen the pressures starting to ease

Since the beginning of the year, the global environment continued to be characterized by high levels of tension in the financial markets, even though several indicators have shown considerable improvements over the last month. Thus in May, US bank CDs reached the lowest level since the collapse of Lehman Brothers, while European CDs –which have remained below their American equivalents- fell to their lowest level since November 2008. In addition, significant corrections have also taken place in the interbank markets, with the 3-month OIS spread in the US and the EMU reaching its lowest point since the beginning of 2008.

In the first months of the year, the contraction of the global economy was a fundamental element in maintaining these high rates of risk aversion. The data for 1Q09 showed a strong drop in activity in the US (-1.6% quarterly rate), with a rate of decline very similar to that of 4Q08. In Europe, the indicators maintained an extraordinarily negative tone, with a quarterly GDP drop of 2.5% in 1Q09, higher than the 1.6% fall in 4Q08. However, the general tone of the economic activity indicators on the basis of the April and May data is less negative. This means that the rate of contraction on activity may be slowing, although negative growth will still be observed in the short term. The markets reacted very positively to this likely turning point, although because of the uncertainty surrounding the duration of the crisis, this move may have vulnerable foundations.

New public measures to stabilize the situation

In this context, governments have bolstered measures to tackle the global financial crisis. The US remains the economy that has made most progress in the adoption of these policies, with a new package of measures aimed at stabilizing the financial system. One key element of this program was the conducting of stress tests on the balance sheets of the major banking institutions, which revealed the system's capital needs. As a result, 10 of the 19 largest American financial institutions must raise $75 billion of additional capital within 6 months. These results were well received by the market, generating a large part of the recent reduction in financial pressure. A second pillar is the Public-Private Investment Program, which seeks to attract private investors to buy toxic assets from banks through funds where the capital will be supplied jointly by the private and public sectors, with a highly significant level of leveraging. Finally, the Obama administration has implemented a plan to ease access to housing, which includes greater facilities to refinance mortgages and subsidies for those financial institutions that change the terms of the mortgages of families facing default risk. Our assessment of the banking stabilization strategy is positive, even though the implementation of the approved plans seems highly complex, and their impact could be limited unless all the elements are combined properly.

In its turn the Federal Reserve has also played a crucial role in the financial stabilization process and is tackling deflationary risk mainly through asset acquisition. Thus, the Federal Reserve has implemented a program to purchase $1,250 billion in mortgage bonds, and up to $300 billion in public debt. The Federal Reserve also plans to participate actively in funding the Public-Private Investment Program through the Term Asset-Backed Securities Loan Facility (TALF) program, which could reach around $1,000 billion.

In Europe, the financial stabilization efforts have been mainly at national level, with very different initiatives in each country. Thus, Germany and Ireland are putting the final touches to a "bad bank" which will buy other banks' most toxic assets. The ECB continued lowering the interest rate, which was at 1% at the time this report was written. The European monetary authority has decided to continue with its weekly liquidity auctions through the fixed rate fullallotment system for as long as necessary, and in any case beyond 2009, and the term for ECB loans has been extended to 12 months. Apart from this, in May it was announced that ¤60 billion of bank bonds would be purchased, although details of this plan are not yet known.

The adoption of these measures is justified, as in the short term the key risk is that the persistence of a very weak economic situation results in negative inflation rates being maintained for too long. In addition, although the balance sheets of the central banks continue experiencing strong expansion, especially as regards the Federal Reserve, the central banks should not have any difficulties in draining liquidity quickly when the time comes, as the Bank of Japan did at the end of their non-conventional monetary policy program.

Despite stabilization and the measures taken, recovery continues to be uncertain

The effectiveness of the policies aimed at streamlining the financial systems on the one hand, and the fiscal policies designed to boost demand on the other hand, will be the focus of attention in coming months. Their success will depend to a great extent on the answers to three questions: when the recovery will begin, how fast the recovery will be, and which economies will prove most dynamic.

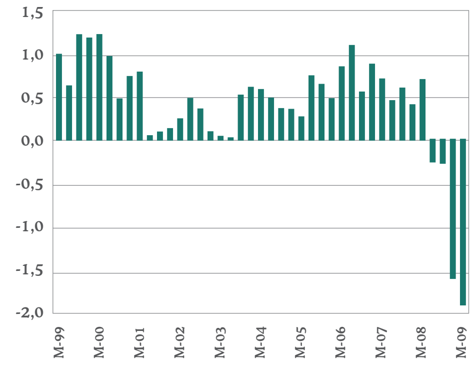
Despite these measures having a favorable impact on the economy, the details of possible recovery in 2010 are still uncertain. Recent data seem to suggest that the recession has bottomed out, so it is foreseeable that falls in GDP will be lower in the next few quarters. However, our perception is that if the recession ends in 2010, growth rates will still be very moderate and below the potential growth rate. Besides, it is probable that it will occur later in Europe, given the slowness of the adoption of both financial stabilization and monetary policy measures. These uncertainties will force central banks to keep the official rates low for an extended period of time.

The emerging countries are feeling the effects of the global situation, but they are receiving considerable support

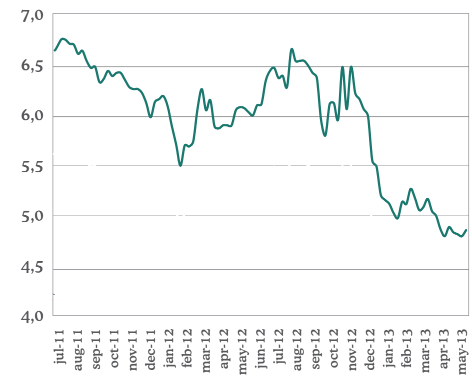
The financial indicators show a very favorable evolution in the last month, following a sharp deterioration of the financial indicators in the last quarter of last year and the first quarter of this year. Sovereign risk spreads have undergone strong adjustment, depreciatory pressures on currencies have reversed, and even the inflows in emerging countries have returned to positive territory, leading to significant rises in the stock exchange indexes.

There is no doubt that one of the factors that have contributed to this move has been the moderation of global risk aversion. But at least two additional factors should also be mentioned. On the one hand, the support that the G20 summit has given emerging markets through the increase in the provision of resources made available to the IMF. This was complemented by the creation of a new IMF credit line that can be used by economies with solid fundamentals, but which might undergo temporary funding problems. It is an instrument designed to prevent, rather than end a possible crisis in emerging markets. The success of this new formula has already been confirmed after applications from some countries such as Mexico, Poland and Colombia, and the positive reaction from the markets. Finally, but no less important, are the measures adopted on the domestic front to cushion the impact of the crisis. We find that, to a varying degree, a large number of emerging economies have adopted demand, fiscal and monetary policies whose impact on activity will be

EMU: GDP Growth
(quarter-on-quarter)

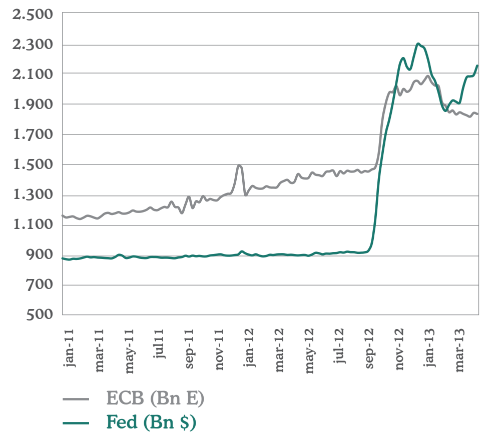


Interest Rate of an Average 30-year Mortgage in the US



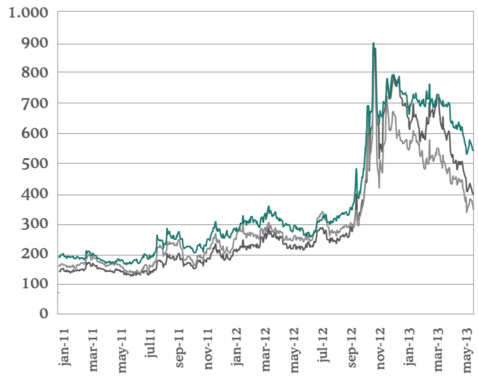
Source: Bloomberg

Central Banks: Total Assets



Source: Datastream

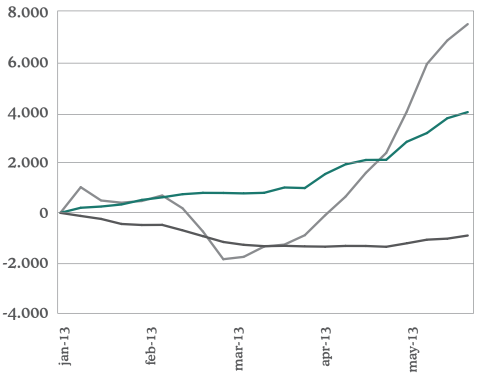
EMBI Spreads



— Asia
— Emerging Europe
— Latam

Source: Datastream and JP Morgan.

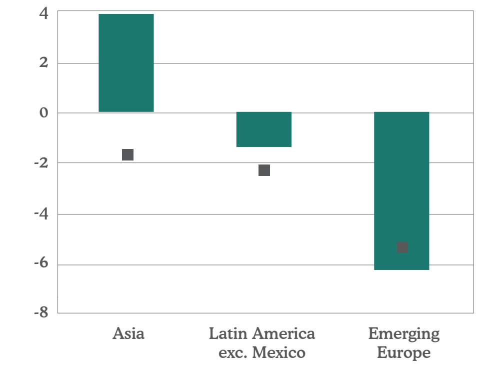
2009: Net Entry of Stock Income (cummulative, $Mm)



— Latin America
— Emerging Europe
— Asia

Source: BBVA and EPFR

Emerging Economies: Growth Forecast for 2009 and Variation in Forecast Since January



— Growth forecast 2009
— Forecast variation: may09 vs jan09

Source: EBRD and BBVA

felt during the second half of the year, and in some economies already in 2Q09. China is clearly the most noteworthy example within the emerging world, following the approval of a substantial fiscal stimulus package (16% of GDP over two years) and the exceptional relaxation of monetary conditions, which has encouraged a reactivation of credit to the private sector. Latin America is also noteworthy, since for the first time in this crisis it has found itself with leeway to apply countercyclical policies.

Nevertheless, the impact of the crisis on the activity in emerging countries has been significant. GDP adjustment in 4Q08 was extremely sudden, basically as a result of the collapse of international trade, which led to a downward adjustment of forecasts in the first months of the year. In this respect, it is important to emphasize the high degree of heterogeneity within the emerging world. The well-known vulnerabilities of emerging Europe – bulky fiscal and external imbalances, strong credit growth accompanied by high currency mismatch, and high dependence on external financing - will bring about very intense adjustments. Thus, it is estimated that the region's GDP will fall around 6%, with some economies falling up to twice this figure, which entails an element of risk for western European economies. Overall, it is expected that emerging markets, led by Asia and with very moderate GDP drops in Latin America, will grow at higher rates than the developed economies in coming years.

Despite weak global demand, commodity prices rose above the historical averages in the first quarter of 2009. More recently, commodity prices once again rose considerably due to the significant production cuts and the perception in the financial markets that the worst of the crisis may be behind us. Recent supply cuts and the dollar's valuation prospects should limit the current upward trend in commodities, but the prices should keep supporting the countries that export commodities, including Latin American countries.

2. Macroeconomic Outlook: A negative start to 2009 but with expectations of recovery

Since the last edition of this publication, the world has experienced a level of uncertainty not seen since the depression in the 1930s. The economic deceleration of the economies in different regions has reached a level os synchronicity never before seen[1], affecting both developed (first) and developing economies. The Chilean economy did not remain immune from the negative impact of this financially-based crisis. In the final quarter of 2008, a surprising growth rate of barely 0.2% yoy was recorded - far below the forecast by analysts- resulting in an average growth rate of 3.2% in 2008.

The external shock was compounded by the expectations shock that led to the collapse of consumption and domestic investment, and thus to the collapse of production

The turning point of the Chilean economy is marked, as the majority of the world's economies, by the events of September 2008. Export and imports (in dollars) dropped by around 50% over several consecutive months. In the case of exports, most of the losses can be attributed to the mining sector, and in particular to the copper sector, following the abrupt fall in the price of this metal and the decline in foreign demand. On the other hand, the loss in value of imports is predominantly attributable to a fall in volume rather than a fall in price, with the exception of fuel and lubricant imports. In line with the global trend, the consumption imports that have suffered most from the shock are durable goods, which are not yet showing any signs of recovery. This is a clear indication that there is still not yet an upturn in expectations. In contrast, the marginal value in the export sector does seem to be recovering.

The weak international situation had a major impact on domestic expectations: Both consumers and businesses put a hold on their consumption, investment and production decisions. Therefore, following the highest ever investment rates since the end of 2007, investment in machinery and equipment is rapidly declining, both in volume terms and in terms of the product size.

Inventories slumped, which may seem counterintuitive but is a reflection of the fact that companies substantially reduced production (especially in the mining sector) due to the anticipation of a future reduction in demand.

The greatest surprise, therefore, did not come from beyond our borders but from domestic demand.

The industrial sector has been hardest hit by the crisis…

Without a doubt, it is the industrial sector that has been most affected by the crisis. The negative variation rates far exceed those recorded during the Asian crisis. On that occasion, the most drastic decline was recorded in July 1999 at -9.8% yoy, but since then and until August 2008, the average industrial growth rate was 4%. Now, in contrast, the average growth in the sector since November has been 8%, with a low of -11.5%. With regard to the margin, the industrial sector is showing no signs of having touched bottom.

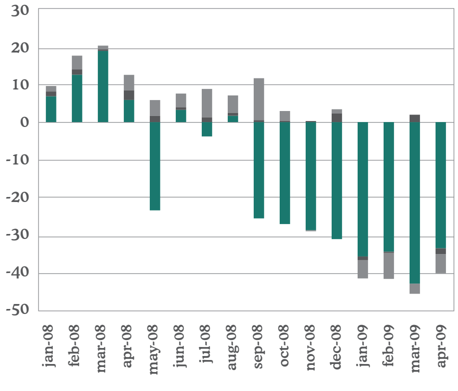
1 When looking at a sample of 29 developed and emerging economies, the Central Bank of Chile found that around 90% had recorded a decline in economic growth in the fourth quarter of 2008 (BCCh, MPR May 2009).

Aggregate Demand in Chile
(% var. yoy)

	2007	2008		2009	
		4th qtr	Year	1st qtr	Year(p)
Domestic Demand	7,8	-0,2	7,4	-7,6	-0,4
Consumption	7,1	1,1	4,2	-0,6	1,4
Investment	12,0	10,4	19,5	-9,3	-7,6
Exports	7,6	3,4	3,1	-2,7	-15,1
Imports	14,9	1,8	12,9	-14,8	-10,7
GDP	4,7	0,2	3,2	-2,1	-1,2

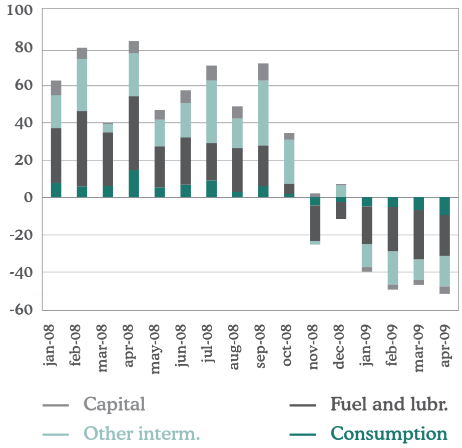
Source: BCCh and BBVA

Total Export Growth Contribution by Areas
(%)



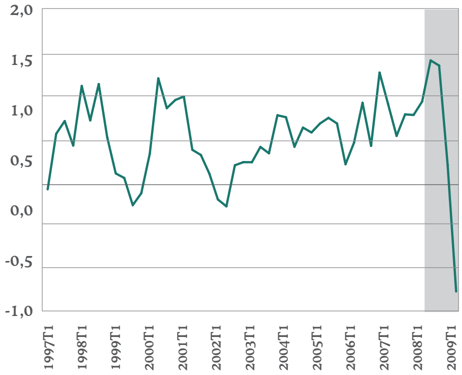
Source: BCCh and BBVA

Total Import Growth Contribution by Areas
(%)



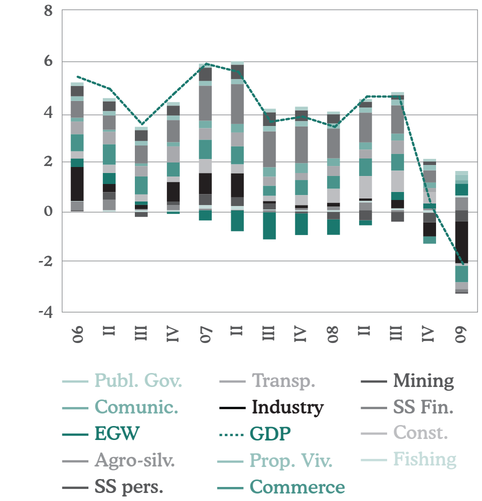
Source: BCCh and BBVA

Variation in Inventories
(% GDP, rolling year)



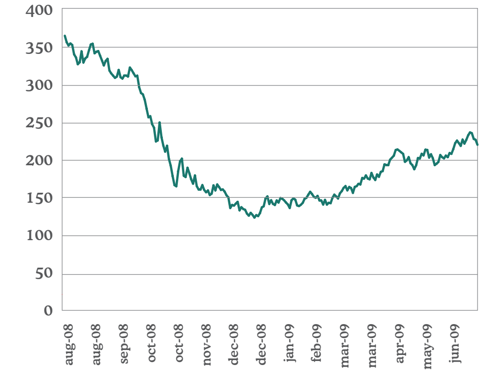
Source: BCCh and BBVA

Contribution by Sector to Quarterly GDP Growth
(%)



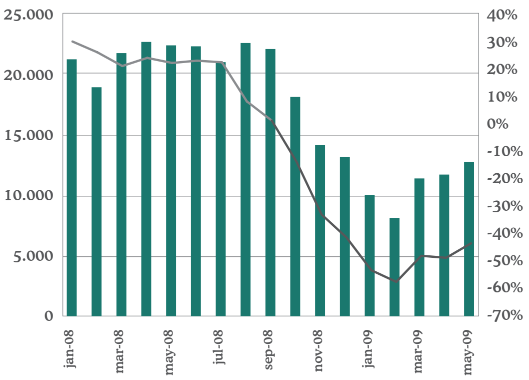
Source: BCCh

Copper
(US$cent / pound)



Source: Cochilco

Car Sales
(units / month and % var. yoy)



Source: ANAC and BBVA

There are several reasons for the crisis having such a negative impact on the industrial sector and its slow recovery. Firstly, some sectors have suffered from drastic supply effects, such as the salmon (ISA virus) and methanol industries (lower availability of gas from Argentina). Secondly, several industrial activities linked to export activities were negatively affected by the international real estate cycle. One clear example of this is the Chilean forestry sector, a high percentage of whose produce is sold on the North American market. Thirdly, major changes were made to production in the mining sector following price slumps (steel and copper refining). Finally, the sudden fall in domestic demand affected the production of durable goods, construction materials, and other items.

…followed by the mining sector…

The reduction in the price of red metal is one of the explanations given for the actions taken by the mining sector, which has been forced to postpone projects. It is worth remembering that 2008 was a year of major contrasts, in which the price of copper reached an all time high of US$4.1/lb in the middle of the year but then fell to a mere US$1.2/lb, the lowest price since September 2004 (see Second Quarter Report, Cochilco). The mineral grade also fell considerably, increasing the duration of extraction processes and the production unit costs (see Monthly Reports, National Institute of Statistics). This is further compounded by production losses due to technical faults (SAG mill at Escondida's Laguna Seca concentrator plant and problems with the stability of the pit walls that slowed the production rate at Codelco), as well as the production, employment, and investment changes made by several companies in response to the major price slump.

With regard to the rest of the year, an upturn can be seen in the price of copper, which currently costs over US$2/pound. If this price remains stable, it could possibly lead to the reactivation of several postponed investment projects. However, we believe that it is unlikely that the price will remain at the current level, although there are enough supporting factors to indicate that it may maintain a level of around US$1.78/lb. Over the remainder of the year, upturns in production are expected due to the launch of the second phase of the Gabriela Mistral project, the first stage of the Collahuasi expansion, capacity increases at Andina, Escondida, El Teniente, Los Pelambres, and Candelaria, and finally, the launch of the Andacollo Sulfuros project. The downtime at Escondida and Codelco Norte caused by operational problems will continue to have repercussions during the first half of this year, but these will gradually disappear in the second half of the year.

… and the trade sector, especially in relation to durable goods

The trade sector has been one of the sectors most affected by the expectations shock, which has curbed durable goods purchases, in line with the global trend. The automotive sector has been one of the hardest hit. According to information issued by the National Automotive Association of Chile, average monthly new car sales fell from 20,000 in 2007-2008 to a low of 8,000 in February this year. It is worth noting that the sales figures in the years directly preceding the crisis were exceptionally high, but even so the recently recorded falls of around 50% are sharper than those recorded during the Asian crisis.

Furthermore, both retail and supermarket sales have plummeted. As we mentioned above, the expectations have been key to this situation. The downward trend in the inflation outlook together with the heightened purchasing power of wages and the improvement in consumers' economic expectations enable us to predict an improvement in consumption around the middle of the year, as already being implied by recent retail sales indicators.

The construction sector was not particularly affected and the expectations of the entrepreneurs in this sector are the most optimistic

In real aggregate terms, the construction sector recently (during the first quarter of this year) recorded its first decline since the second quarter of 2004. Despite this, the number of building permits has been falling since mid2008. This became more evident at the end of 2008 and the start of 2009, and even if the twelve month rolling average shows a slight slowdown in the decline rate, it is still not yet possible to talk about a trend reversal.

Past power supply problems should not resurface in 2009

During 2007 and even until mid-2009, the utilities sector recorded negative variation rates. Despite this, it is still one of the few sectors currently making a positive contribution to GDP growth (27.7% yoy growth), although this may change if there is a lack of winter rainfall. The high energy costs due to the rise in oil prices, the low precipitation levels and the restricted supply of natural gas from Argentina not only caused major inflationary pressures but also declines in productivity that placed pressure on the low potential growth of the economy.

With regard to the remainder of the year, the country's power supplies should be guaranteed. This particularly applies to the supply of natural gas as the start-up of Quintero's LNG plant in the second quarter of the year will make it possible to meet the domestic consumption demands in the center of the country without having to depend on the volatile supply from Argentina.

Double digit unemployment rate on the cards…

The social costs of the crisis are reflected in a major rise in the unemployment rate, which hit 9.8% in the February-April quarter and is therefore likely to reach double digits in the next mobile quarter. This reflects a high number of job losses. In fact, job creation was negative in March for the first time since 2001, and again in April, with negative payroll employment contributions in both months. In contrast, the self-employment rate fell in March but recovered in April, which is a natural development due to people starting to look for selfemployment alternatives when they are unable to find employment.

One specific feature of the current situation is the increase in the workforce participation rates, which were extremely procyclic in previous crises. The current participation rate (workforce as a percentage of the economically active population) is the highest rate recorded for the month of April during the period from 1986-2009.

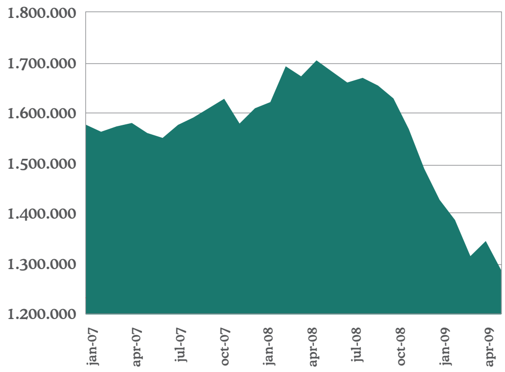
…in a context of rising real wages

The development of wages indicates a high level of inertia as they are adjusted on the basis of past inflation rates. The general slowing in price rises has helped to increase real wages significantly. Given the current economic climate, the increased purchasing power of wages is a factor that will somewhat help to revive private consumption expenditure, thereby partly counteracting the negative impact of growing unemployment.

Inflation in free fall

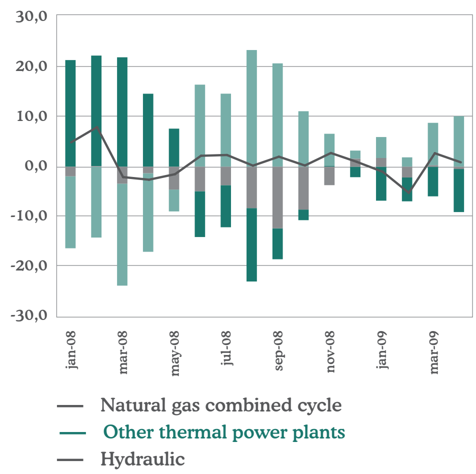
The disinflation rates forecast on the basis of the reduced oil and food prices since mid2008 and the slowing of domestic demand have been far surpassed by the actual rates. In but a few months, the highest inflation rate (in 12 months) fell from 9.9% in October 2008 to 3.0% in May 2009, placing it right in the middle of the Central Bank's target range.

Construction Permits
(12-month rolling average)



Source: National Institute of Statistics and BBVA

Electricity Output by Plant Type Contribution to Growth
(%)

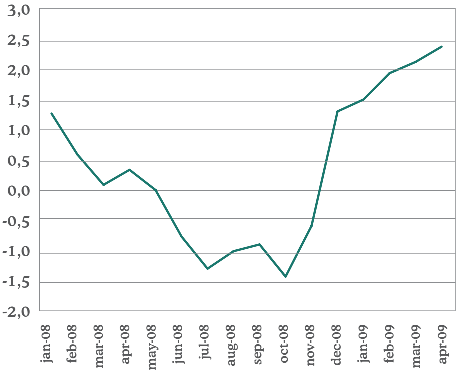


Source: National Institute of Statistics and BBVA.

Unemployment Rate
(%)

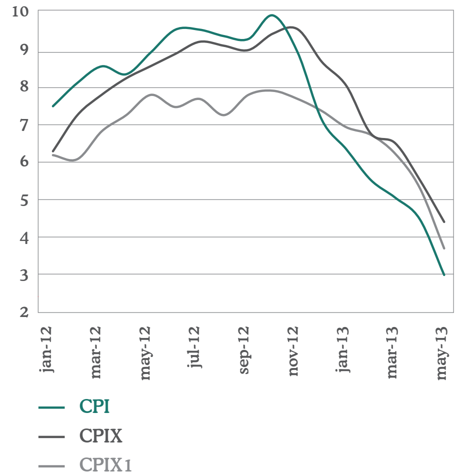
Source: National Institute of Statistics and BBVA.

Real Wage Index
(annual %)



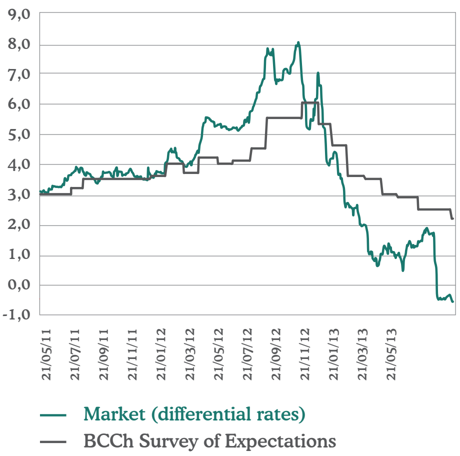
Source: National Institute of Statistics.

Inflation Dynamic
(real annual percentage variation)



Source: National Institute of Statistics.

Inflation Expectations Over 11 Months



Source: BCCh

The aforementioned factors were also compounded by several surprises: In January, the CPI recorded a 0.8% decline, which was sharper than the market expectations and at the time was attributed to the clothing and footwear clearance sales being more aggressive than in previous years due to the reduction in demand. In the following month of February, the surprise was the methodological innovation of applying the entire reduction in stamp tax to the price of financial services, which thus fell by 40%. All subsequent surprises have been linked to fluctuations in domestic demand.

One factor that has affected the surprises is the changes to the CPI calculation method, which accompanied the base change in December 2008[2]. These include eliminating the previous process of smoothing the seasonal fluctuations in clothing and non-processed food prices. This change seems to have affected the results in January, April, and, to a slightly lesser extent, May.

With regard to the causes of the disinflation, the most notable is the significant fall in oil prices (-54%). The effect of international fuel prices has been even greater in relation to other petroleum-derivatives such as diesel and kerosene despite the Fuel Price Stabilization Fund attenuating the price fluctuations in the domestic market. The decline in international food prices has also had a significant effect. In fact, the index variation in the food and non-alcoholic beverage sector was the greatest seen in 12 months, falling from 16.7% in January of this year to 6% in May, accruing a variation of -2.3% from January to May.

In general, commodity price changes seem to be having a major impact on domestic inflation. Nevertheless, the changes to the upturn in the exchange rate, mainly in the final quarter of 2008 and the first quarter of 2009, have not affected the price of other internationally tradable goods.

In contrast, the appreciation of the exchange rate over the last three months (approximately 6%) seems to have contributed to the sharp decline in the clothing and footwear and miscellaneous goods and services sectors, which reflects the asymmetrical behavior of the effect of the exchange rate in an adverse economic context.

In the case of the services sector, the reaction to the worsening of the general economic climate seems to depend on the elasticity of demand for the service in general as education and health have recorded zero and positive variations (8.8%) respectively over the year so far, whereas the leisure, culture, and transportation sectors have accumulated negative variations over the first five months of the year.

In relation to core inflation, the CPIX, which excludes fuel and nonprocessed food, accrued a change of -0.5% over the year and the yearonyear inflation rate fell from a high of 9.5% in November 2008 to just 4.4% in May 2009.

The inflation dynamics over the recent months have caused rapid changes to inflation expectations

The Economic Expectations Survey anticipated inflation of 2.2% over a year while the expectation indicated by the rates is -0.5%. We believe that the market is possibly overreacting to the price changes seen in recent months and does not anticipate the statistical effect that should come from the low basis for comparison at the end of 2008. Nevertheless,

2 For an analysis of the CPI base change, please see Chile Watch, second half of 2008.

we are set to experience a rapid decline in year-on-year inflation over the next few months as we are predicting monthly inflation at a level that is below the Central Bank's long-term objective (3%), as well as due to the increased basis for comparison related to the average monthly inflation of 1.1%, recorded between June and October 2008.

This forecast is supported by the relative stability in both fuel prices and the exchange rate, as well as demand that will not alter the positive gap between supply and demand despite being affected by the expansionary stimulus of the fiscal and monetary policies.

On the other hand, our forecast shows that yearonyear inflation will fall below zero between September and November and will remain below or at around the lower limit of the Central Bank's target range throughout 2010. The recovery of economic activity, the partial reinstatement of the stamp tax, and the development of wages will help prevent deflation. With regard to the development of wages, we expect a real yearonyear increase in 2009 due to the increased popularity of adjusting wages to above the previous inflation base rate.

On the whole, we expect 2009 to close with an inflation rate of 0.2% and 2010 to close with an increase of 1.8%. These forecasts are lower than those presented in the latest Monetary Policy Report by the Central Bank, although the Bank's forecast was made under consideration of the complete reinstatement of the tax on fuel and did not include the negative inflation rate (-0.25%) recorded in May.

The government has reacted to the crisis with a highly expansionary fiscal policy that has been well-managed and quickly implemented, as well as supported by a pro-employment plan

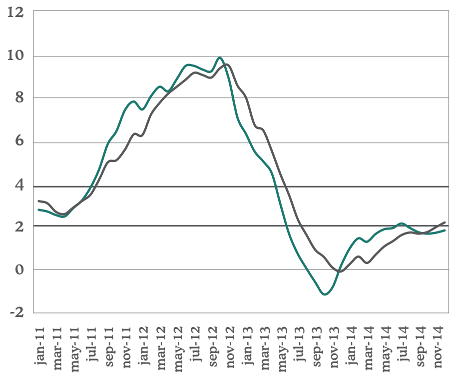
Unlike in previous periods of crisis, this time the government has not only prevented reduced spending due to falling income, but has also been able to use the savings stored in Sovereign Funds (US$22.717 billion as at 31 December 2008) to finance a notably countercyclical policy of considerable dimensions, not only in relation to the size of Chile's economy but also in comparison with the stimulus plans introduced around the rest of the world.

In January 2009, the government announced the most well-founded package of measures, which is the pillar of the stimulus package. It considers the injection of US$4 billion (equivalent to 2.8% of the GDP) into spending and investment. It then complimented the injection with a number of pro-credit measures, the effect of which was unfortunately rather limited, followed by a pro-employment plan agreed upon by the government, businesses and workers. This plan aimed to prevent job losses by encouraging approaches such as training as an alternative to dismissal. More recently, new measures were announced during President Bachelet's annual budget. These have an equivalent value of 0.2% of the GDP and are mainly aimed at relaxing the restrictions on household cash flow.

Budget execution during the first four months of 2009 has been higher than that recorded in previous years

Tax revenue has been notably lower than in previous years. This year is distinguished by expenditure being at the forefront of the execution of the current budget. By April 2009, 33.53% of the expenditure items included in the Budget Act had been executed. This indicates a concentrated use of the fiscal stimulus in the early part of the year, which seems apt, considering that economic growth is expected to rise this year. In other words, the most public spending is to be carried out in the months in which private spending seems to be the lowest, thereby reinforcing the treasury's current countercyclical stimulus.

Development of Inflation
(% var. yoy)



— CPI
— CPIX

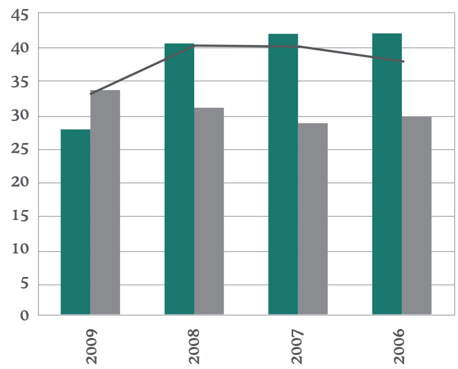
Source: BCCh and BBVA

Inflation Forecasts
(% var.)

	2009		2010	
	MPR	BBVA	MPR	BBVA
CPI December	0,6	0,2	2,3	1,8
Average CPI	2,3	2,0	1,5	1,7
CPIX December	0,5	-0,1	1,1	2,2
CPIX December	3,7	3,3	2,2	1,3

Source: BCCh and BBVA.

Fiscal Execution: % Over Law Approved in April



— Income
— Non-copper income
— Spending

Source: Budget Office.

The revenue collected by the budgetary central government only amounts to 27.6% of the budgeted amount – a somewhat low figure compared to previous years when by April, the treasury had received over 40% of the revenues contemplated by law. With regard to the State revenues from sources other than copper, we can see that a low proportion of the budgeted revenues has been received to date. However the decline is less severe than if revenues from copper are included. This is consistent with the current macroeconomic climate. The lower level of domestic demand explains the fall in tax revenue, but the changes in consumer spending cannot be as dramatic as the fall in the price of copper.

It should be noted that we expect the budget execution to become less intense as the year progresses and thus to fulfill the fiscal rule and reduce the stimulus around the middle of 2009, when we expect domestic demand to start showing signs of recovery. (See Chart with an assessment of the fiscal policy rule and 2009 fiscal projections).

The expansionary fiscal policy has been complemented by monetary easing, which in practice has meant reducing the monetary policy rate from 8.25% to 0.75% over the year to date

The combination of policies (see Monetary and Exchange Outlook for a discussion on the monetary policy) has been successful in terms of containing domestic demand on the one hand and keeping the credit channel open on the other.

The economy may have bottomed out

All in all, we believe that the most pronounced fall in GDP may have been recorded between the fourth quarter of 2008 and the first quarter of 2009 as according to the margin (in other words, when compared with the previous quarter) the economy recorded its worst slump. Looking to the future, declines in the range of -3,5% and 4% yoy in the second quarter would mark a trend reversal, as the GDP would not fall in the margin. The return of positive growth rates is expected in the third quarter, although this is more likely in the fourth quarter. But is this trajectory believable?

Signs of a trend reversal seem to be evident in some sectors, such as the mining sector and part of the trade sector (supermarkets). The expectations of businesses, and especially consumers, have improved considerably. Similar behavior has also been evident on the stock market. However, the industrial sector remains very depressed and is showing no sign of having bottomed out. Likewise, consumer goods imports, a leading indicator of domestic consumption, slumped again in May.

The forecasts for the remainder of the year reflect a recovery in the second half of the year, even if the annual growth rate is negative

In light of the above, we expect the year to close at -1.2% compared to 2008. This figure is close to the average figure projected by analysts (-1%) according to the most recent survey (see BCCh Economic Expectations Survey, June 2009), and below the range of -0.75 to 0.25% indicated by the Central Bank in its most recent report (see Monetary Policy Report, May 2009). This projection has a neutral bias, given the available information, as even if it does not rule out a more benign foreign situation, domestic demand may maintain the expected baseline rhythm, with the effects therefore canceling each other out. The quarterly profile anticipates that the margin will start to recover in the second half of the year, more pronouncedly in the fourth quarter.

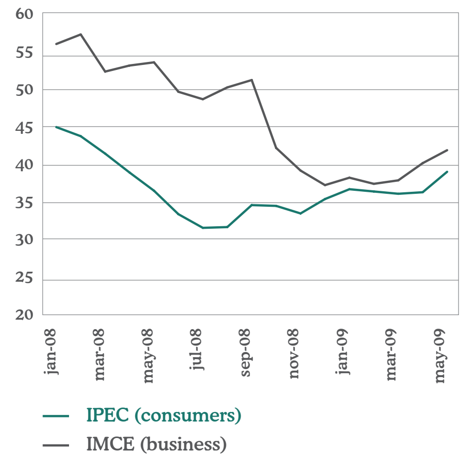
The main element of doubt continues to be the evolution of the foreign sector

We already mentioned this in the introduction: the level of economic uncertainty that we have experienced since the end of last year has

Evolution of Seasonally-Adjusted IMACEC in Two Recessions

Source: BCCh and BBVA

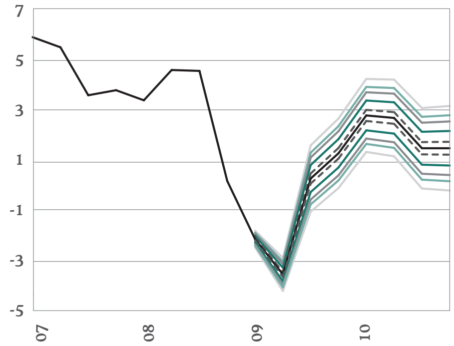
Consumer and Business Confidence



Source: UAI - Icare and Adimark

been unprecedented. Although we expect the situation to start to return to normal toward the end of the year, and especially over 2010, the projections for Chile depend on the development of economies such as the United States, Europe and China, which are still subject to a high level of uncertainty. We expect baseline recovery in the United States to start in the third quarter of 2009 and China to experience around 8% growth. Deviations (more negative scenarios) in these two economies alone will have a major impact on our projection due to the effects on the exchange rate, the price of copper, direct foreign investment, and the demand for exports, to name but a few variables. When compounded with the fact that another international downturn would have disastrous consequences for consumer and business confidence, the slowdown would be reflected on the domestic market by a slower-than-expected

Quarterly GDP Growth Scenarios (*)



Source: BCCh and BBVA
* Confidence intervals of 20,50, 70,80 and 90% are shown around the baseline.

Box 1: Fiscal Policy Rule: ex-ante or ex-post assessment?

On January 5, the dramatic downturn in economic conditions led the government to announce a fiscal stimulus package of US$4 billion, equivalent to 2.8% of the 2009 GDP forecast at the time. On that occasion, the government corrected its income projections, and predicted that 2009 would close with a deficit of 2.9% instead of the surplus previously expected; it also announced a temporary reduction in the target for structural surplus of 0.5% of GDP to 0% of annual GDP. More recently, the government has once again had to modify its public finance estimates for 2009 in order to adjust its calculation of the revenue to the new economic situation. Fiscal revenue is now predicted to be 24.3% lower than contemplated in the Budget Act, while public spending will rise by 14.5% in real terms instead of the 5.7% –also in real terms– established in the act. With these estimates we can expect an effective deficit of 4.1% of the GDP for the current year.

Our own estimates point to a fiscal deficit in 2009 that is slightly higher than the -4.2% of GDP predicted in the last report from the Ministry of the Treasury, which can be explained by differences in the economic growth projections for 2009.

There has been a recent debate regarding the fulfillment of the fiscal rule, which was adjusted in order to achieve a balanced fiscal result for 2009, as the effective structural revenue will be lower than that calculated when the budget was drawn up. This is because the decline in revenue has been greater than the result of applying the elasticity-revenue to the effective fall in GNP. This is the reason we estimate that although total government spending will be consistent with the amounts planned, there will be a structural deficit of 0.4% by the year's end.

Those who criticize the government for failing to fulfill the fiscal rule are saying that it should be used both to define the level of spending during the budgetary process (ex – ante), and to assess its fulfillment at the end of the year (ex - post). The government, however, maintains that this rule defines an ex – ante spending limit which would not be subject to subsequent changes if in fact the original assumptions (growth, elasticities, etc.) are not fulfilled.

This is an important point, as what is at stake is whether fiscal expenditure should be adjusted within the year as conditions change, or whether current spending should be maintained and a greater structural deficit assumed ex - post. This is a legitimate debate which has not yet been addressed in Chile. Although it is true that there have been significant ex – post deviations in the past, they have never been as dramatic as at the current time. There is no obvious answer, and to find one we must assess the objective of the establishment of the fiscal rule.

Macroeconomic Assumptions from the Ministry

	Ley de Presupuestos 2009	enero 2009	junio 2009
GDP			
Real Variation Rate	4.0%	2%-3%	-0.75%-0.25%
Growth in trend GDP	4.9%	4.9%	4.9%
Domestic Demand			
Real variation rate	4.3%	4.3%	-4.0%
CPI			
December to December variation	6.2%	5.2%	2.3%
$/US$ Exchange Rate			
In $ 2009	538	538	580
Copper price Usc/lb			
BML	290		192
Long-term	199	199	199

Source: Budget Office.

The fiscal rule aims to give a medium-term outlook to public finances by providing a buffer for positive and negative shocks. This is done by projecting the structural fiscal revenue, adjusting it by the price of copper and molybdenum and the level of production, eliminating any changes in revenue produced by the economic cycle. This revenue is used to determine the level of actual expenditure compatible with the rule, thereby providing stability for aggregate fiscal expenditure and for public sector policies, programs and projects.

From this perspective, it seems reasonable to say that the fiscal rule only makes perfect sense when it is applied ex - ante, that is to say, to define the maximum spending limit in the budgetary year. Otherwise, continual adjustments would be required throughout the year as new factors emerge, most of which arrive with a substantial time lag, making them impractical to incorporate. In years of major deviation from the trend, calculation errors may well be far greater, which adds the problem that requiring ex – post fulfillment could go against the very aims of the economic policy.

What does seem necessary is to clearly establish that the fiscal rule in Chile is a rule that is applied ex - ante to define the spending limits and prevent future confusion.

Public spending in 2010

If the structural parameters that sustain the projection of structural fiscal revenue are maintained, and assuming that the long-term price of copper stays at US$1.99 per lb and the trend growth rate at 4.9%, we will have a situation where the lower structural revenue basis derived from the fall in GDP in 2009 will lead to lower structural revenue for 2010. This will mean that with a targeted structural surplus of 0.5% of the GDP, nominal government spending could only grow by 3.9%. Although we expect low inflation for the next year, we believe that this figure would be too low to sustain a solid economic recovery. However, if the (temporary) 2009 target is maintained (structural fiscal balance), this would permit an expansion of a nominal 6.1% in 2010, a modest figure in comparison with recent years, but consistent with maintaining the proportion of public spending with regard to the GDP.

BBVA Macroeconomic Assumptions

	2009	2009
GDP		
Real Variation Rate	-1.20%	2.10%
Domestic Demand		
Real Variation Rate	-1.40%	5%
CPI		
Annual Average	2.0%	1.7%
$/US$ Exchange Rate		
In $ 2009	576	563
Copper Price Usc/lb		
BML	1.78	1.57

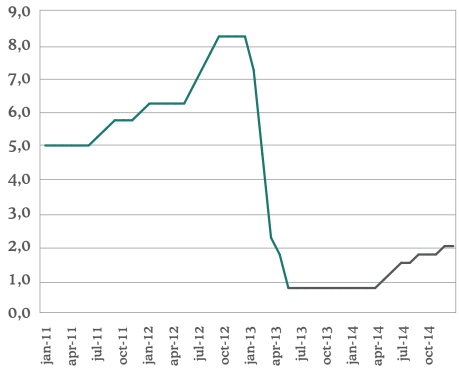
Source: BBVA

Fiscal Projection
(% of GDP)

	2009
Total Revenue	19.3%
Total Expenditure	23.6%
Primary Budget Surplus	-4.1%
Net Lending / Net Indebtedness	-4.2%

Source: BBVA

Monetary Policy Rate
(%)



Source: BCCh, BBVA forecasts.

3. Monetary and Exchange Rate Outlook

In the first six months of the year, the Central Bank moved from a contractionary monetary policy to a strong expansionary one, cutting the monetary policy rate (MPR) from 8.25% to 0.75%.

Despite multiple indications of a decline in the macroeconomic environment, in its January meeting, the BCCh Board acted with extreme caution and only cut the monetary policy rate by 100 bps. The Board's report recognized that inflation expectations were clearly deteriorating due to both the downturn in global growth and the slowdown in domestic activity and demand. In relation to the international environment, it recognized that the slowdown of growth was reflected in tighter credit conditions and falls in commodity prices. On the domestic front, it took into account that the information available for the fourth quarter of 2008 indicated a significant slowdown in economic activity and the continued existence of restrictive credit conditions.

All in all, the Board considered that the inflation risks were balanced and that the level of growth-related uncertainty had increased despite there being a downward bias in the balance of risks for activity. Although the report announced an easing of monetary policy, its dependency on the development of inflation gave no grounds for anticipating the actions required in the subsequent two months.

In February, the Board had to admit that both the domestic and international situations were far worse than projected in January's Monetary Policy Report, and that the activity-related risk situation was materializing with a widening gap between supply and demand. A downward bias therefore became evident in the balance of risks for both growth and inflation, and monetary policy rate cuts of between 200 and 300 bps were considered, as the real MPR was at an extremely high level following the sharp slump in inflation expectations. In the end, the Board decided on a 250 bp cut, which took the MPR to 4.75%, commenting in the report that the most likely scenario was that the MPR would follow a path below that deduced in the baseline of the Monetary Policy Report and similar to the one that can be inferred from financial asset prices for the middle of the year. It acknowledged that the adjustment to below the expectations was a risk but also that it would be quickly assimilated by the fact that the market anticipated new cuts. What the market did not anticipate, however, was the further 250 bp cut in March.

The March cut reduced the MPR to 2.25%, barely 50 bps above the record low since the introduction of a nominal monetary policy rate.

The 600 pb cut during the first three months of the year was quickly reflected in the rate structure, especially in 'typical' long-term rates, and was transmitted to the rates of several loan types, as detailed in the Financial Outlook

Finally, the 50 pb cuts in April, May and June were based on the deterioration of the economic expectations and their impact on domestic demand, the speed of disinflation, and the expectations that yoy inflation would hit negative figures in the third quarter of the year. The June cut marks the end of the cycle of cuts.

The long-term indexed rates curve has reassumed its normal, positive trajectory with levels that reflect the expectations of the normalization of the activity and inflation situation for long-term rates. In fact, the curve is showing an upward trend.

The short-term rates in pesos have fallen marginally since the figures reached in April, and the slope of short-term indexed rates has once again reversed, following the market expectation that negative variations in the CPI could be repeated.

The forward curve of May 8th indicates that the monetary policy rate should reach a minimum of 1% between June and July, start to gradually rise between the end of 2009 and the start of 2010, and be over 3% by the end of 2010. Together with the May inflation data, the April activity data, and our medium-term growth expectation, this leads us to forecast that the MPR will remain at 0.75% until the first quarter of 2010, when it will start a gradual ascent to 2% by the end of the next year.

The limit reached by the MPR cut policy has led to expectations that the BCCh will start to use different monetary policy instruments such as quantitative measures that induce a reduction in the long-term rate structure. To be specific, the Central Bank may revise its issues policy, which could include changing the term structure, favoring shorter terms, and possibly determining an excess in demand for long-term bonds. Although authorities have not explicitly said so, this action remains relatively unlikely in view of the monthly schedule of public instrument issues published at the start of June. In all events, when announcing its tax financing policy, the Ministry of Finance indicated that it would coordinate the issues schedule with the BCCh to leave room for treasury issues.

This strategy should lead to increased issues by foreign corporations, the use of international reserves and the depreciation of the peso, as shown under the Macroeconomic implications of the introduction of ‘Huaso Bonds’.

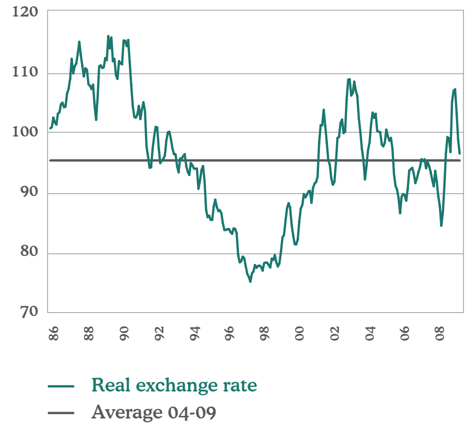
As the financial tensions have started to ease, the Chilean peso has become stronger, appreciating by more than 10% between the end of 2008 and the beginning of June

This development has been supported by reduced risk aversion at an international level and the recovery of currencies in relation to the dollar. However, the peso's recovery is not only restricted to its value against the dollar, and it has in fact appreciated by 11.6% this year in multilateral terms (using the BCCh’s multilateral exchange rate). This appreciation has also been influenced by idiosyncratic factors such as the recovery of the price of copper and the weekly tenders for US$50 million (until the sum of US$3 billion is reached) from the Economic and Social Stabilization Fund for financing the fiscal deficit. Furthermore, the Ministry of the Treasury recently announced that the timeframe for tenders is to be extended, as effective from 1 July 2009 – the date on which the sale of dollars ends – it will start to liquidate US$4 billion at a rate of US$40 million per day.

With regard to the possible future development of the exchange rate, it is important to remember that the BCCh does not have a target, and that the inflation targeting policy requires a flexible exchange rate. In this respect, in its latest Monetary Policy Report, the BCCh indicates that the exchange rate will be at a level that is in line with its long-term fundamentals, and that as a working assumption it is estimated that the exchange rate for the long term would be "at similar levels to those prevailing in the two weeks prior to this Report’s statistical closing”.

Our projection for the future development of the exchange rate also assumes a gradual convergence to an equilibrium level similar to that used by the BCCh, which leads us to expect a closing exchange rate for 2009 of around $560 per dollar.

Real Exchange Rate



Source: BCCh

Box 2: Macroeconomic Implications of the Introduction of "Huaso Bonds"

Last April, the multinational company América Móvil issued Chilean bonds with a value of UF4 million (equivalent to US$144.5 million).[4] In doing so, it became the first foreign company to issue national currency bonds on the Chilean market to finance operations outside Chile, hence the name given to this type of bond issue: 'Huaso Bonds'. But the story does not end there, as various participants in the Chilean stock market have indicated that major corporations, mainly from the region, may be interested in issuing new Huaso Bonds. In this respect, Banco de Crédito de Perú (BCP) is planning to issue bonds amounting to the equivalent of US$300 million and CAF is looking into issuing national currency bonds in Chile amounting to the equivalent of between US$100 million and US$200 million. Other multinationals from Mexico and Brazil could also be mentioned.

Therefore, a number of questions arise in relation to this novel financial tool. The first is in relation to the factors that explain how a developing country such as Chile is able to use its currency to structure and issue corporate debt. The second is in relation to the extent to which the Chilean financial market has the depth to conduct other operations like those being proposed. Finally, there is the question of the macroeconomic implications of the operations that are carried out.

Starting with the factors that made it possible for América Móvil to issue bonds, the first factor is undoubtedly the existence of both investors with a high level of capital that they are prepared to lend and companies that are thirsty for this capital.

In Chile, the first part of this requirement is mainly met by the developments acquired by institutional investors and more specifically the AFPs, which accumulated US$92.982 billion in May (exchange rate US$564.64 on 29 May 2009), equivalent to 59.3% of the 2008 GDP.

In relation to the above, these corporations will be incurring debt in national currency, which makes other requirements necessary for this kind of operation. One such requirement is the existence of a derivatives market that will protect the corporations against the possible devaluation of the Chilean peso. Although this market exists, the existence of the macroeconomic conditions that give stability to the value of the national currency is equally important. In this regard, there is an independent Central Bank that uses an inflation target monetary rule, as well as the structural surplus fiscal rule, to help fulfill this requirement. These Chilean macroeconomic strengths also maintain low risks and hedging costs.

All in all, one question that arises is in relation to the limits for these kinds of operations in a small, open economy like Chile's. The answer is linked to the macroeconomic implications of these developments.

It is clear that extremely large operations such as those anticipated, can significantly affect the behavior of variable fundamentals such as the exchange and interest rates.

In brief, from a theoretical perspective, it is possible to infer that the impact of capital movements (or even the expectation of these movements) on the exchange and interest rates should have a stabilizing effect and moderate the size of the operations and, specifically, the effect on the variables indicated above.

With regard to the exchange rate, a currency depreciation trend is to be expected in the short term. It is clear that while this pressure is stronger and discernable, issues in Chile will be less attractive as hedging operations will be more expensive. Furthermore, in the case of an open economy with no restrictions on the movement of capital, the increase in the depreciation expectations should lead to a rise in interest rates, reinforcing the above effect.

Depending on the intensity of the exchange and interest rate movements, these will affect the GDP structure, favoring net exports rather than shortterm investment and the tradable sectors rather than the non-tradable ones. Nevertheless, as the Chilean capital market is relatively profound (in comparison to other countries in the region), it is our opinion that the combination of the aforementioned stabilizing effects and a limited demand for foreign securities will make it unlikely for the materialization of numerous operations on such a large scale to substantially affect the Chilean GDP structure.

4 The UF is a unit of account that can be continually adjusted to inflation. It was originally created on 20 January 1967 for the purpose of indexing mortgage loans but its use has subsequently been extended to all kinds of financial operations.

4. Financial Outlook

In general terms, the Chilean financial market can be described by international standards as one of the best regulated markets, with banking institutions with consistently high solvency levels and no credit restrictions. Aside from the period of great tension between September and October 2008, during which the foreign financing lines were practically closed, these lines have remained open, although at higher costs. In the domestic market over the same period, the banks recorded substantial liquidity demands as companies started monopolizing their credit facilities for fear of not being able to finance labor capital in the near future. Both the Ministry of the Treasury and the Central Bank of Chile injected dollars into the system and the situation had almost returned to normal by the end of the year.

In fact, the Central Bank of Chile's Financial Stability Report published in January 2009 portrays a relatively positive image of the Chilean financial system, even if it does ‘invite’ the banks to increase their capital as a preventive measure. It is worth noting that around 80% of the bank still has an AA and AAA rating, as well as direct credit and financial risk exposure controls, thereby restricting any losses in this regard.

As we commented in this edition’s Monetary and Exchange Outlook, the monetary policy has been strongly expansionary with the objectives of i) increasing liquidity, ii) encouraging higher expenditure and iii) combating disinflation.

The transmission of the monetary policy rate cuts to the market rates has been relatively fast

In various sectors, such as the mortgage lending sector and the commercial loans sector, the current rates are below the pre-crisis levels, indicating not only a reversion to the upward cycle, but also that conditions are more favorable. Without dismissing the fact that this means per se that the liquidity restrictions have eased, it is necessary to take into account that these are the average nominal rates of successfully granted loans.

With regard to the consumption loan rates, their development is mixed, because though a significant downturn is observed in certain segments (rates higher than last year), including to pre-crisis levels, this is not evident in other segments.

This transmission of rates has neither become widespread nor has it been clearly evident in relation to the longer-term rates of the Central Bank of Chile bonds, such as the BCU5. In order to accelerate the transmission to the long-term part of the curve, the Central Bank’s Board has indicated that it will maintain the low interest rates for an extended period.

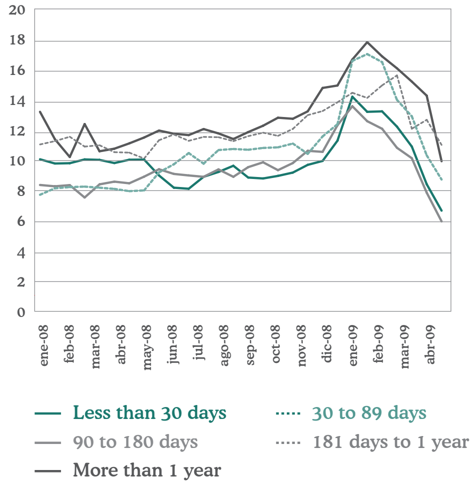
Credit flows improve or become stable in all sectors...

The information obtained from the credit flows, or in other words, from the change in the stock of credit between one month and the previous month, is important to understand what is happening to the margin. Following the necessary seasonal adjustments, what we observe is that after several consecutive months of decline in credit flows, some segments are starting to show signs of recovery.[3]

In particular, Chilean companies, which generally registered positive development during the volatile exchange rate period at the end of the

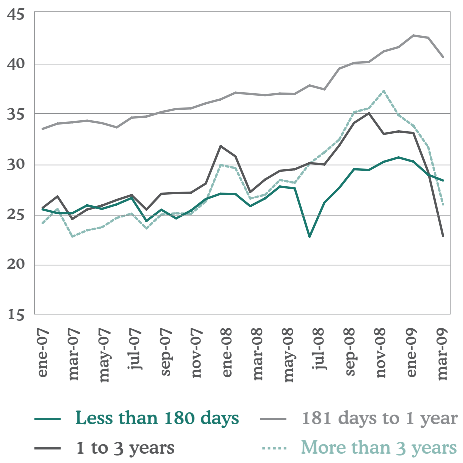
3 A comparison with historical records is difficult from January 2008 onwards, as accounting changes were made in order to comply with international standards (IFRS). Further changes were also introduced in January 2009, although this time the comparison with 2008 is possible (see table).

Commercial Credit Rate
(nominal rates)



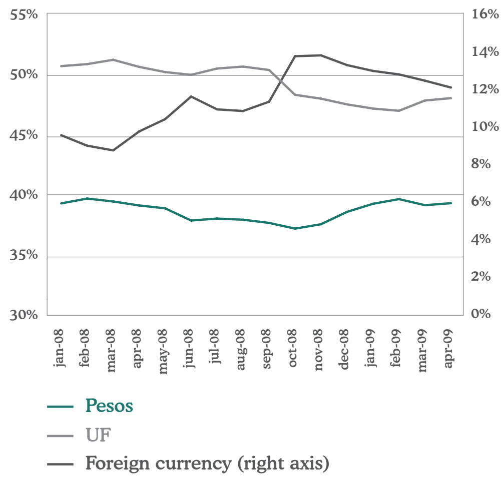
Source: BCCh

Consumption Loan Rate
(nominal rates)



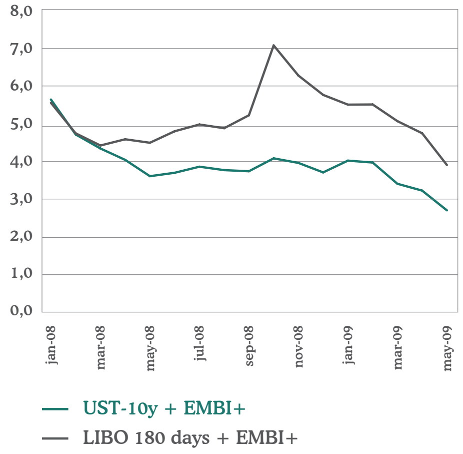
Source: BCCh

Bank Placements Distribution, by Currency
(jan. 08 - apr. 09)



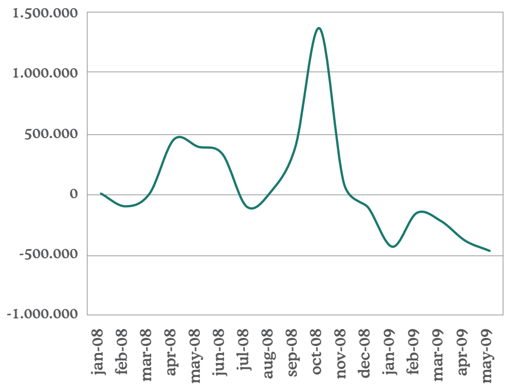
Source: SBIF and BBVA

Cost of Foreign Funding
(%)



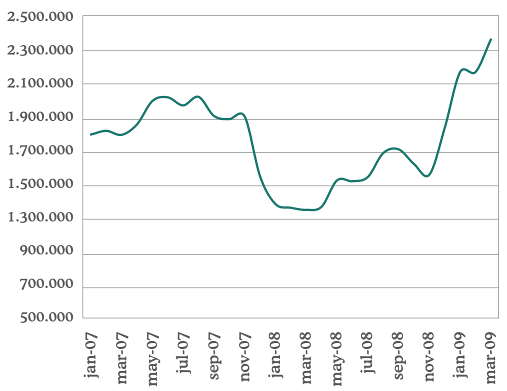
Source: BCCh

Credit Flow Comex Nominal
(millions of $ seasonally adjusted)



Source: SBIF and BBVA

Placement of Corporate Bonds
(millions of pesos, last 12 months)



Source: SVS and BBVA

year and had low exposure to the exchange risk and favorable levels of cover for these risks, returned to the local financial market by financing labor capital both through banks and private debt issues. Hence, a significant upturn was recorded in commercial loans and loans for foreign trade.

…except for the foreign trade loan segment, which has recorded negative flows since the boom in the final quarter of 2008

Taking seasonal adjustment into account, the increase in credit flows for foreign trade in October 2008 reflects this effect. The same graph also shows that the trend has reversed, especially since February 2009 when the cost of foreign financing (but also foreign trade flows) started to fall faster. In other words, fewer loans are required as the volume of imports (for example) is falling significantly. However, the credit flows are falling faster than the trade flows as the ratio between them has been falling drastically since November 2008.

Foreign financing requirements are not very important to the bank, which is currently undertaking the divestment of the pension funds in foreign markets and increasing the availability of funding in the local market.

With regard to the possible discrepancies between local and foreign currency, it should be noted that a low proportion of the Central Bank of Chile's credit portfolio is in foreign currency – which has been on the downturn since October 2008. The bank also has a regulatory control that reduces the level of exposure to this and other financial risks. On the other hand, risk exposure in derivatives is a source of base capital consumption, although the total balance owed by the opposing party is considered rather than the net position. Consequently, increased exposure in turn increases capital requirements.

However, the standards for approving new loans have increased and the demand for bank financing has weakened

The paradox is that having seen that the rates have returned to pre-crisis levels and the credit flows have started to recover, it should be possible to conclude that there are no restrictions in the credit market. However, the latest bank loan survey conducted by the Central Bank of Chile (March 2009) indicates that even though the proportion of the banks that report restrictive conditions has fallen since the previous survey, loan conditions are more restrictive. In other words, there are greater spreads across the cost of commercial loan funds, higher premiums are demanded for higher risk loans, increased guarantee requirements have been introduced, and the amounts and terms of the credit lines approved have been reduced. According to the Central Bank, credit demand also seems to have fallen.

The corporate bond market has become attractive even to foreign issuers, instruments which have been called "Huaso Bonds"

The corporate bond market became a protagonist in the Chilean capital markets during the first quarter of the year, even if the equity market was in close competition with it. Issues have significantly increased, reaching levels that far exceed the average levels recorded in the last two years. The bond spreads reflect an improvement in the financial conditions and are extremely competitive and difficult for bank loans to match.

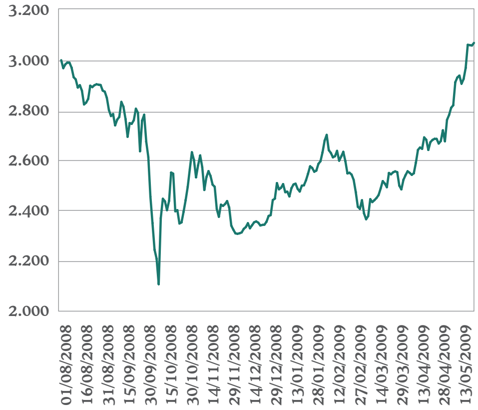
The attractive issue conditions have captured the attention of companies beyond our borders. (See table).

Following losses of around 40% in 2008, the stock market is recovering and even reversing many of its losses

Improvements in growth estimates, the monetary policy rate at an all time low, and an increased price of copper are just some of the factors that could explain the upturn of the stock exchange index. With a general upturn in global stock markets recorded in recent months, this is not just a local occurrence.

In any case, the downturn in 2008 will be remembered with regret as it involved considerable losses in pension fund portfolios, and therefore losses to the pensions of those approaching retirement. Nevertheless, the law dictates that these people cannot manage their assets in the riskier funds (A and B). The default option is then the fund with the lowest risk (known as 'fund E'), although even this one was not immune to the losses. The Pension Fund Administrators (Administradoras de Fondos de Pensiones – AFP) and the sector's tax auditing authority launched a joint awareness and education campaign for affiliates to prevent a mid-crisis exodus towards lower risk funds and encourage decision taking based on long term objectives.

IPSA, Stock Index



Source: Bloomberg

Box 3: Transition to the New International Financial Reporting Standards (IFRS)[5]

The banking sector has been preparing the implementation of the international accounting regulations and procedures known as the IFRS since 2005. This process is now in its final stages. The agreed roadmap has been followed as planned. In the first stage, which began in 2006, changes were introduced to the recognition and measurement of financial instruments (IAS 39). It is particularly worth noting that as the bank retains a significant portion of the risk, the securitized issues should be reintegrated into the balance sheet (underlying assets) without allowing any release of capital. In a second stage, effective from January 2008, a new format for Financial Statements was introduced. These are now consolidated rather than individual. The consistent application of the IFRS was achieved in January 2009, thereby completing the third and final stage.

As a result of the implementation of IFRS criteria, it is not possible to compare past placements (up to December 2007) with those made effective from January 2008. Recently, it has also become impossible to compare placements made from January 2009 onward with those made in 2008 (even though comparison would be feasible in practice as these changes had a lesser impact).

In relation to a bank's results, the new standards will have implications for institutions' equity (due to the first implementation) as well as for the results, with the main implication being the elimination of monetary correction. In the latter case, the profits gained from not recognizing the losses due to monetary correction (with positive inflation) could amount to between 20% and 30% of the pre-tax profits.

With regard to the impacts on equity, it is worth noting:

(1) MTM adjustment of property assets: Negative impact on equity as the appraised value of some physical assets (fixed assets) at market value falls as a result of the real estate situation.

(2) Monetary correction: As Chile is not an inflationary country according to IAS standards, the monetary correction of its balance sheet totals is not carried out. This mainly affects fixed assets, capital and reserves (the latter especially, as monetary correction usually causes a loss in results). The effect of the monetary correction of fixed assets is adjusted against equity, affecting it negatively.

(3) Changes to provisions: Provisions must be constituted for contingent credit and the amounts approved for open lines of overdraft and card credits for client companies and individuals. This has a negative impact on equity.

(4) Freedom from suspensions: With regard to any loans for which the accrual of interest has been suspended, the accrual shall basically be considered in the results through a change to the suspension principle, by considering the debt/surety ratio of the loans to recognize the losses. This has a positive effect on equity.

(5) Acceleration of write-offs: According to the new standard, write-offs will be made more quickly. This mainly affects the commercial portfolio but also, to a lesser extent, the mortgage portfolio. This has a negative effect on equity.

Another important change is in relation to the way in which the overdue portfolio is accounted. Until the end of 2008, only the credit amounts (payments) that were overdue by more than 90 days and entire credit amounts the collection of which had been brought forward were recorded as delinquent. Under the new reporting standards, once any of the credit amounts are delinquent, the entire loan balance is recorded in the delinquent portfolio. The immediate consequence is that the new indicators reflect a far more drastic unraveling of the debt portfolio than that reflected by the previous indicator. For the purpose of conducting comparisons with historical records, the SBIF has continued publishing the former amount under the name 'overdue portfolio' and the new amount as a portfolio with delinquency of 90 days or more. By way of comparison, in April 2009 the overdue portfolio amounted to 1.19% of the total placements while the portfolio with delinquency of 90 days of more amounted to 2.86% of this total.

Along the same lines, the IFRS recommend the introduction of an impaired portfolio. This is a portfolio that is still valid but that has a poor projection in the sense that it may become classified as a delinquent portfolio in the near future. One reason for a portfolio becoming impaired, for example, would be that once a client has defaulted on an obligation, rather than only the amount in default being considered delinquent, the total of the remaining placements held by the client with the bank are included as 'impaired', regardless of whether or not the debtor is up to date on its commitments. Other

5 We are grateful for the comments from Leonel Segovia, Head of Planning and Valuation Office, Financial Division, BBVA Chile.

reasons for classifying a portfolio as impaired include financial difficulties on the part of the debtor, imminent bankruptcy, forced restructuring, or exceeding the predefined limits on credit lines or overdrafts, among others (see Financial Stability Report, second half 2008, BCCh). The implementation of this idea was postponed mainly due to a lack of standardization across the criteria used by banks to classify their debtors, as some banks have stricter standards than others. Our estimates indicate that the impaired portfolio could amount to around 3.5% of the total placements, far above the 1.19% of the overdue portfolio as of April 2009.

Main Economic Indicators

	2007	2008	2009(e)	2010(e)
Activity				
Nominal GDP ($, billion)	85,621	88,535	84,196	88,083
Nominal GDP (USD billion)	163.9	169.5	146.2	156.5
Real GDP (% variation)	4.7%	3.2%	-1.2%	2.1%
Inflation. end of period				
CPI (%)	7.8%	7.1%	0.2%	1.6%
Interest and Exchange Rates, end of period				
TPM	6.00%	8.25%	0.75%	2.00%
Exchange Rate	499.28	649.00	560.00	566.00
Public Accounts				
Fiscal Surplus/Deficit (% GDP)	8.8%	4.9%	-4.2%	-3.8%
External Sector				
Exports (USD billion)	67.7	66.5	46.0	49.2
Imports (USD billion)	44.0	57.6	45.1	50.1
Trade Balance (USD billion)	23.6	8.8	0.9	-0.9
Current Account (% GDP)	4.4%	-2.0%	-3.1%	-4.6%
International Reserves (USD billion)	17	23	23	23

International Context

Commodities (end of period)	2007	2008	2009		2007	2008	2009
Brent (USD/barrel)	93,9	45,6	56,3	Soybean (USD/t.)	423,2	343,2	370,0
Copper (USD/t)	6.675,0	3.070,0	3.638,0	Corn (USD/t.)	160,8	143,7	170,0
Gold (USD/troyoz.)	833,9	882,1	875,0	Wheat (USD/t.)	312,4	215,6	210,0

	Real GDP (%)				Inflation (%, end of period)*			
	2007	2008	2009	2010	2007	2008	2009	2010
USA	2,0	1,1	-2,0	1,1	2,9	3,8	-0,3	1,5
EU	2,6	0,6	-3,3	-0,1	2,1	3,3	0,3	1,0
Japan	2,4	-0,7	-6,0	-0,4	0,7	0,0	-0,8	0,4
China	13,0	9,0	8,1	8,4	6,5	2,0	0,0	2,0
Latin America								
Argentina	8,7	7,0	-1,8	0,7	8,5	7,2	7,5	10,0
Brazil	3,8	5,1	-2,1	3,0	4,5	5,9	4,2	4,4
Chile	4,7	3,2	-1,2	2,1	7,8	7,1	0,2	1,8
Colombia	7,5	2,5	-0,5	1,1	5,7	7,7	4,3	3,8
Mexico	3,3	1,4	-6,3	1,7	3,8	6,5	3,8	3,9
Peru	8,9	9,8	2,4	3,6	3,9	6,7	2,1	2,0
Venezuela	8,4	4,8	-0,5	-2,9	22,5	31,9	42,3	49,2
LATAM [1]	4,9	4,1	-2,9	1,9	6,0	8,1	6,6	7,5
LATAM Ex-México	5,7	5,1	-1,4	1,8	7,1	8,7	7,5	8,7

[1] Average of the 7 mentioned countries. * USA and EU Inflation: Average of period.

	Public Sector Balance (% GDP)				Current Account Balance (% GDP)			
	2007	2008	2009	2010	2007	2008	2009	2010
USA	-1,2	-4,6	-12,7	-8,4	-5,3	-4,8	-3,0	-2,9
EU	-0,6	-1,9	-5,4	-6,0	0,5	-0,1	-0,3	-0,4
Japan	-5,4	-4,9	-8,0	-9,0	4,8	3,2	3,0	3,0
China	0,7	-0,4	-2,9	-1,4	11,0	9,8	9,5	10,0
Latin America								
Argentina [2]	3,2	1,4	0,1	0,8	2,7	2,3	1,9	2,0
Brazil	-2,3	-1,7	-2,3	-1,4	0,1	-1,8	-1,3	-1,4
Chile [2]	9,9	4,9	-4,2	-3,8	4,4	-2,0	-3,1	-4,6
Colombia	-2,7	-2,3	-4,2	-3,5	-2,8	-2,8	-4,0	-2,7
Mexico	0,0	-0,1	-1,8	-1,8	-0,8	-1,4	-1,9	-2,1
Peru	3,1	2,1	-1,2	-1,1	1,1	-3,3	-3,3	-3,2
Venezuela [2]	3,0	-0,2	-6,0	-6,6	8,7	13,1	0,7	2,4
LATAM [1]	0,1	-0,4	-2,3	-1,8	0,7	-0,4	-1,3	-1,3
LATAM Ex-Mexico	0,4	-0,4	-2,6	-1,9	1,3	-0,1	-1,2	-1,1

[1] Average of the 7 mentioned countries. [2] Central Government.

	Exchange Rate (vs $, end of period)				Official Rate (%, end of period)			
	2007	2008	2009	2010	2007	2008	2009	2010
USA					4,25	0,25	0,00	0,00
EU ($/euro)	1,5	1,3	1,2	1,1	4,00	2,50	0,75	0,50
Japan (yenes/$)	112	93	93	101	0,50	0,10	0,10	0,10
China (cny/$)	7,3	6,8	6,8	6,6	7,47	5,31	4,50	3,96
Latin America								
Argentina	3,1	3,4	4,1	4,5	13,50	19,08	17,00	15,03
Brazil	1,8	2,3	2,1	2,1	11,25	13,75	8,50	8,50
Chile	499	649	560	566	5,90	8,25	0,75	2,00
Colombia	2.015	2.244	2.343	2.586	9,50	9,50	5,00	5,00
Mexico	10,9	13,7	13,0	12,4	7,50	8,25	4,50	4,50
Peru	3,0	3,1	3,15	3,20	5,00	6,50	2,00	2,00
Venezuela	2,2	2,2	2,7	3,5	11,70	17,60	16,00	14,50

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