

SITUACIÓN CHILE: EXECUTIVE SUMMARY Second Quarter 2008

Starting in the third quarter of last year, the economy has begun to show signs of a slowdown which is largely due to the sharp deterioration in the outlook for the tradable goods sector. Factors such as a reduction in productivity, health problems, labour conflicts, the lack of availability of cheap energy, a less competitive exchange rate, and the decline in demand for Chilean goods in sectors impacted by the slowdown in the US economy, are the reasons for the continuous deterioration in the contribution to growth of the external sector.

However, although export growth has been weak in recent months, the non-tradable goods sector continues to be very dynamic, thanks to the growth of internal demand and in particular of private consumption. We expect private consumption to continue to slow down, as it has since the end of the year, reflecting slightly more restrictive credit conditions, a slowdown in the dynamism of real salaries, and the gradual slowdown in the growth of employment in the industrial sector. But the increase in private spending will be enough to guarantee growth of 4.3% this year, which represents a cut of 0.4 pp from our forecast three months ago. Moving into 2009, we think that the economy will continue to be impacted by the current bottlenecks, which have reduced our estimate for the trend growth level of the economy to close to 4%. However, the significant increase in investment that we have seen from the second half of last year, concentrated in those sectors which have contributed to the reduction in productivity (mining and energy), is opening the way to expectations of higher growth rates in the economy from 2010.

This scenario is not free from risks. As in other emerging countries, Chile is not exempt from the pressures posed by the increase in raw material prices, and in April this year inflation was 8.3% year on year (well above the Central Bank target of 3%). However, the slowdown in consumption, the rise in the exchange rate, and an increase in the labour force, have meant that the shock has been felt less widely than was initially expected. Looking forward, inflationary expectations are subject to high uncertainty, due to the unclear future path of raw material prices. Hence it cannot be ruled out that the Central Bank will have to return to a cycle of interest rate rises. But we expect that a moderate slowdown in oil and food prices, less pressure on the demand side, and the consolidation of expectations, will mean that inflation will converge to the target range in the second quarter of 2009, without a need for additional rises in interest rates. As this outlook becomes clearer, the main concern of the Central Bank will begin to be the slowdown in internal demand, which should lead it into a more expansive monetary policy in 2009, and the likelihood of a more depreciated currency.

In addition, uncertainty at the international level has clearly increased. As well as tensions in liquidity and expectations of lower demand from developed countries, there is now the risk of higher inflation worldwide. The possibility of facing less favourable scenarios in the coming months has led Chilean authorities to take

measures to protect the country's economy. The intervention of the Central Bank in the foreign exchange market, and its target of increasing international reserves by over 40% by the end of the year, have increased its ability to respond in negative scenarios. And regardless of this, the net creditor position of the public sector, the surpluses in the external accounts, and the stability in private sector debt ratios, all suggest that the country is well prepared to meet scenarios of greater global uncertainty.