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2004: TAKING OFF

Last year was a good one for the economy. GDP growth accelerated over 6% by year end, a figure not seen since 1997, before the Asian crisis. The leading factors were exports that grew more than 50% in nominal terms following an increase of around 60% in the world price of copper, Chile's main export, and substantial growth in the world economy. This, in turn, produced growth of around 13% in export volume. This compares to a 7.8% increase in domestic demand. Among components of domestic demand, gross investment was clearly the most dynamic, showing a rate of growth of 12.6%, well above the 5.6% rise in total consumption. Most of the investment growth was linked to the import of capital goods (up 22.8%), while investment in construction grew much less (5.9%).

Even though growth has been essentially export-led, it is interesting to note that domestic demand has been accelerating, after being somewhat depressed in previous years. Fiscal policy and especially monetary policy have been very expansionary since 2002 in order to boost local spending. The monetary policy interest rate reached an all-time low of 1.75% in January 2004, but investor and consumer sentiment did not improve until there was clear evidence that the world economy was picking up. That did not happen until around the second quarter of last year, and investment was the first sector to speed up. It is not surprising that the investment upsurge has been focused on natural resources activities (mining, pulp, fish factories), in commodities that are exported, like copper, cellulose, and salmon.

Net capital inflows picked up strongly in 2004, although they still remain well below the high level achieved before the Asian crisis. The reappearance of inward foreign investment is reflected in the increase in asset prices and expanded lending by the banking sector. The stock market increased just over 27% during 2004 in nominal terms (after growing over 42.1% in 2003), and its momentum is continuing. Early on, most of the action was in natural resources shares but more recently stocks of retail and inward-oriented services companies have soared, based on the expectation of sustained growth of domestic demand. Private credit to the private sector has increased to approximately 26% of GDP in the fourth quarter of 2004, up from 23% the year before. Meanwhile, FDI flows totaled US$7.148 million last year, an increase of 460% compared with 2003, but still well below the level of the late-1990s.

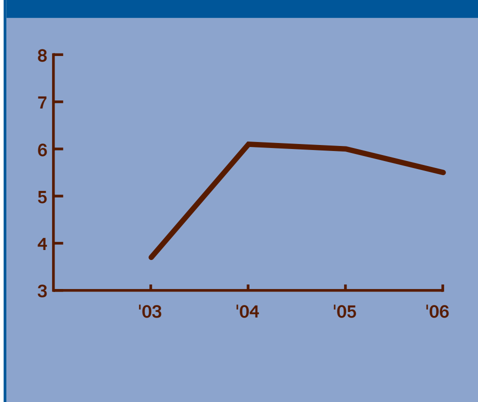
Increased international demand for commodities has led to a sharp rise in prices. This is in general good news for Chile. Terms of trade, though, did not improve as much because Chile imports most of its oil and gas needs and these commodities also rose. Still, terms of trade improved by 20% in 2004. From other perspectives, high copper prices also bring relief to the fiscal accounts, since CODELCO, the state owned copper consortium, accounts for about 30% of Chilean copper output and contributes generously to government coffers when the price of copper is high. Actually, last year the central government had a surplus of 2.2% of GDP, much of it accounted for by the price of copper that reached an average of US$1.30 per pound.

The Chilean peso moved in 2004 very much in tandem with the euro, appreciating 4.4% against the US dollar by the year end compared to December 2003. Some real appreciation was also observed as GDP growth prospects consolidated and as the current account moved into a significant surplus for the first time since 1976 — US$1.4 billion, or a 2.1% of GDP — mostly as a result of the huge increase in the value of exports. The Multilateral Real Exchange Rate index calculated by the Central Bank indicates that competitiveness is comparable to that of 1986, a reduction from higher levels in 2003.

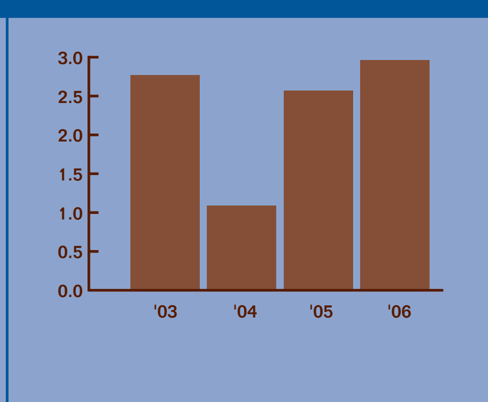
In spite of rapid growth, the unemployment rate remained high at 7.6% as of February. Job creation saw a healthy 3.2% growth yoy by the same date, but the labour force is increasing faster as women and young workers are entering in large numbers. The good news is that much of this job creation is in formal markets (people working under wage contracts, as opposed to self-employed workers). Still, unemployment rates this high when the business cycle is in an expansionary phase is a new phenomenon that many analysts attribute to reforms approved in 2001 that introduced a number of new rigidities in labour hiring and firing.

Inflation remains fairly under control, notwithstanding the fact that it is slowly rising. As of

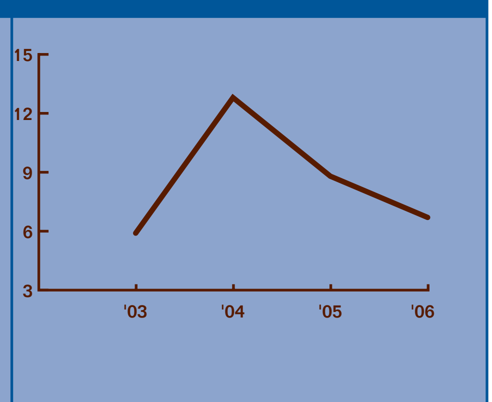
GDP GROWTH (%)



CPI INFLATION (%)



EXPORT GROWTH (%)



February, core inflation was 1.4% yoy, below the Central Bank target range of 2-4%, but up from its lowest level of 0.4% reached in April 2004. The Central Bank initiated in September last year a gradual upward adjustment in its monetary policy interest rate in order to move over time to a more neutral stance. The consolidation of domestic demand growth will eventually close the long-lasting output gap that in turn will push prices upwards in due time. Actually, the increase already seen in domestic prices beyond those caused by external factors (like oil price hikes), albeit slow, is an early sign of inflationary pressures in the near future.

The fiscal surplus of 2.2% of GDP is not a minor outcome. It was the first surplus since 2000 and the favorable conditions in terms of high copper prices and economic recovery pose a challenge to the official policy of achieving a 1% of GDP "structural" surplus. Indeed, between 2001 and 2003 the actual fiscal deficits were justified on the grounds that the copper price was well below its long run value and that the economy was operating below its potential. So, in spite of accounting deficits, the "structural" account implied achieving the 1% of GDP target. In 2004, when the price of copper went well above its long-term value and economic activity accelerated, some skeptics had doubts as to whether the government would honour its commitment. There was political pressure to increase government spending when income increased, but the administration remained firm in its commitment and accepted an increase in spending in line with its "structural" target.

Proof of the government's resolve, added to strong external accounts to explain the drop in sovereign risk. Indeed, EMBI's index for Chile declined to just over 50 basis points by the end of 2004, among the lowest for emerging economies.

2005 AND 2006: GROWTH AGAIN

As usual the Chilean economy will continue to follow closely the fluctuations of the world economy. As the US, Japan and Europe will show slower growth this year than in 2004, the world economy at large is expected to decelerate somewhat, implying less demand for Chile's exports. However, the demand for copper will continue to be strong as China and India will keep growing rapidly. Capital flows will probably go up steadily during the year as foreign investors increase their appetite for risk and look to emerging economies with more enthusiasm.

A consensual growth forecast for 2005 would be 6%, but an increasing number of analysts are revising their projections to slightly higher figures. Although exports will contribute less than in 2004 due to a less dynamic world economy, domestic demand should keep up its momentum and grow by 7%. Investment will go up by 11.5% and interestingly, investment in construction should be a strong pillar with a rate of growth around 8%. The available information on capital formation indicates a number of large investment projects in mining and cellulose production, as well as some others in electricity generation. Private consumption growth, too, will be higher than last year, at 6.3%, based on an improvement in job creation, a slight increase in real wages and an overall optimistic mood.

Inflation should accelerate during the year but stay within the Central Bank's target range although closer to the lower bound of 2%. The market expects the inflation rate to converge to the center of the target range (3%) by 2006, as a consequence of a reduced output gap. The speed of convergence has been an issue though, as inflation has remained below the Central Bank target range for much longer than anyone expected in the past three years.

Job creation should remain strong and unemployment rates should decline through 2005 and 2006 as labour force growth recedes somewhat. The current account of the balance of payments should show a slight surplus in 2005 before turning moderately negative in 2006. This should come as a surprise as terms of trade are likely to deteriorate, although not dramatically, both in 2005 and 2006.

RISKS AND UNCERTAINTIES

The main uncertainties for the Chilean economy come from the external front. On one side, the fiscal and current-account deficits of the US are still pending and threaten to further depreciate the US dollar and/or to press world interest rates upwards. This in turn could harm the world economy, bringing a slowdown and with it, less space for Chile's exports and lower terms of trade. Another risk on the external front comes from China and a sudden stop in its economy or an unexpected revaluation of its currency. Domestically, some risk could be attached to the presidential and legislative elections in December this year, as populist pressures tend to emerge on such occasions. However, none of the leading candidates is proposing any dramatic changes to the economy, all of them value a conservative fiscal policy and macroeconomic stability, and all of them emphasize economic growth as the means to progress and poverty reduction.