

# Latin America Monitor

## Southern Cone

Vol 22 Issue 2 February 2005

Business Monitor International's monthly regional report on political risk and macroeconomic prospects

### CHILE

## Mining royalty back on the agenda

Government proposals to apply a royalty tax on Chile's mining companies stalled in congress for the second time in December. **BMI View:** Given the favourable benefits they have enjoyed for many years, the mining companies may eventually have to accept that the government's proposals recommend no more than bringing the industry into line with international standards.

Plans to resubmit a revised mining royalty bill to congress stalled in the early stages in December. Mining companies generated record profits last year, and the deal would increase government revenue by approximately US\$220mn a year. However, speaking to reporters after a meeting with cabinet ministers, Finance Minister Nicolas Eyzaguirre said that the bill would only be sent once the government had forged a consensus.

Chile is the world's principal copper producer, and estimates put total copper revenues for 2004 at US\$16.5bn, up

from US\$8.8bn in 2003. Chinese demand has fuelled a massive rally in prices, which hit a 15-year high in 2004. Furthermore, copper demand looks set to continue in 2005, according to Chile's Sociedad Nacional de Minería (SONAMI), and Chilean output is expected to rise 3.5% in conjunction.

The government's stance is clear. It believes that after some 50 years of stable and solid growth, it is reasonable for Chile's mining industry to make a small extra tax contribution. The 1974 investment law (Law 600) granted very favourable

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### PARAGUAY

## IMF lets Paraguay off the hook

The IMF has decided to approve Paraguay's third stand-by loan agreement despite its failure to meet key structural reform criteria. **BMI View:** President Nicanor Duarte Frutos has made significant economic progress since coming to office in 2003. However, the government's failure to pass these essential reforms has highlighted growing divisions between the cabinet and the opposition-dominated congress.

On December 21 2004, the International Monetary Fund (IMF) announced that it had approved its third review of Paraguay's US\$76.2mn

stand-by loan agreement. It also extended by six months, to September 30 2005, the original 15-month arrange-

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### THIS MONTH'S TOP STORIES

#### Argentina: Debt deal prospects improve

Matters finally appear to be coming to a head in the protracted and embittered struggle over Argentina's US\$100bn of defaulted debt. **BMI View:** The prospect for a resolution of the issue are improving. The authorities' divide and conquer tactics and indefatigable bargaining position finally appear to be bearing fruit as the first signs of investor fatigue become apparent. The fight is not over by any means, yet we are increasingly hopeful that the issue may be drawing to a close.

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#### Uruguay: Good times ahead

The outlook for 2005 is extremely positive, and the prospect of a new administration has inspired new-found confidence among investors and creditors alike. **BMI View:** The economy should continue to grow in 2005, albeit at a slower pace than last year. That said, we remain concerned about the government's considerable debt servicing burden, but are reassured by Vasquez' commitment to market-friendly policies.

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#### Argentina: 2004 surprises on the upside

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#### Chile: An immaculate record

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### REGIONAL INDICATORS

	2003	2004e	2005f	2006f
<b>Real GDP Growth, % y-o-y</b>				
Argentina	8.7	8.0	4.7	3.5
Brazil	-0.2	5.1	3.7	3.5
Chile	3.3	5.8	5.5	4.7
Mexico	1.3	4.0	3.8	4.0
Paraguay	2.6	2.4	3.0	3.2
Uruguay	2.2	10.0	4.0	5.0
<b>Inflation, % y-o-y eop</b>				
Argentina	3.7	6.1	6.8	7.2
Brazil	9.3	7.2	5.5	3.5
Chile	1.1	2.4	3.0	3.3
Mexico	4.0	5.2	4.2	3.5
Paraguay	9.3	3.0	5.0	4.0
Uruguay	10.2	7.6	7.0	6.0
<b>Current Account Balance, % GDP</b>				
Argentina	6.1	2.8	2.7	1.6
Brazil	0.9	2.3	0.5	0.3
Chile	-0.8	0.6	0.2	0.1
Mexico	-1.5	-1.1	-1.2	-1.3
Paraguay	2.6	3.0	3.6	4.1
Uruguay	0.7	0.9	1.2	0.7

*e/f = BMI estimate/forecast. Source: IMF/National Statistics Bureaux/Central Banks/BMI.*

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**RISK SUMMARY****POLITICAL RISK****Positive Political Polls**

An **Ipsos-Maura y Araujo** survey published in January showed that 79% of people approved of President Néstor Kirchner while 73% supported his policies. This sounding was taken before the December night-club fire in which 190 people died; nevertheless, a **CEOP** poll published in *El Clarín* suggests that nearly 60% of people approved of the president's handling of the disaster, so the political fall-out may be limited where Kirchner is concerned. Moreover, an **Equis** poll suggested that 56% of Argentines would vote for Kirchner in a presidential election.

Our short-term political risk rating remained stable this month at 71.

**ECONOMIC RISK****Pre-emptive Price Plea**

In January President Kirchner appealed to businessmen to hold down prices, to avoid increasing prices 'either of construction materials or of daily goods'. His plea followed news that prices in December rose 0.8% m-o-m, the highest such rise since April 2004. While end-year inflation stood at 6.1%, below the budgetary ceiling of 11%, there were concerns that inflation could be picking up once more. Kirchner's vague allusion to price controls was not helpful; **BMI** does not believe that such measures are effective in the medium term, as they tackle the symptoms rather than the cause of the problem. We expect capacity constraints brought on by insufficient investment and pressure on public utility prices to push inflation to at least 6.5% y-o-y in 2005.

Primarily due to the recalibration and rebasing of data for 2005, our short-term economic risk rating slipped to 71.

**BUSINESS ENVIRONMENT****Power Problems Persist**

Following a threat by Bolivia to curtail its gas exports to Argentina, the country has agreed to pay a higher price for Bolivia's natural gas this year. The price for natural gas will be raised from last year's US\$1.60 per million British Thermal Units (BTUs) to a new US\$2.08/mn BTUs. Given the deficiencies of the Argentine energy sector, it is crucial that the country maintains its supplies.

Our business environment risk rating slipped fractionally to 65.1, while our composite risk rating dropped slightly to 70.5.

**ECONOMIC OUTLOOK**

# 2004 surprises on the upside

After a raft of positive Q304 data, Argentina looks set to realise real GDP growth in excess of 8.0% y-o-y in 2004. **BMI View:** This will exceed our initial forecast of 6.5%. The bounce-back from the energy crisis was faster than we expected; and the output gap, while narrowing, allowed for higher-than-anticipated levels of non-inflationary growth. We forecast a relatively strong Q105, but a tail-off in economic activity set to begin in Q205 and a much more muted H205.

It is now apparent that the slowdown we expected following the rebound from recession has been far less pronounced, and the economy has made a rapid recovery from a brief blip in Q204 caused by the energy crisis. Argentina recorded growth of 8.3% year-on-year (y-o-y) in the third quarter of 2004, compared with rates of 8.2% over the same period in 2003. The economy continues to display evidence of a gradual slowdown but real GDP y-o-y growth for 2004 should still weigh in at an impressive 8.0%. Even this is a conservative assessment; the authorities have raised their projections from 8.2% to 8.5% full-year growth for 2004. This will represent the second successive year of rapid economic expansion. However, these results were from a low base of comparison and must be placed in the context of the shrinkage of the economy in 2002 of 10.9% of GDP along with three previous years of economic stagnation.

Construction and manufacturing drove third-quarter expansion, registering growth of 26.1% y-o-y and 9.5% y-o-y respectively. In the aggregate, the goods sector expanded 9.2% y-o-y to the end of Q304, while the service sector grew 6.6% y-o-y. Although the goods sector, in particular manufacturing, is still the prime contributor to economic growth, we expect the service sector to play an increasingly important role through 2005. Indeed, in November 2004, according to **Estudio Orlando Ferres y Asociados**, the finance sector exhibited its first positive y-o-y growth for two years (12% y-o-y).

Industrial production grew 8.3% y-o-y in November, with output registering a 10.8% increase in the first 11 months of 2004 against the same period in 2003. This brings manufacturing production levels to within 3 percentage points of the high registered in 1998. However, according to **FIEL**, the private research foundation, on a seasonally adjusted basis industrial production fell 1.7% month-on-month (m-o-m), setting the

scene for a more modest y-o-y expansion of 5.2%. These figures should be treated with caution due to a slightly irregular month in which a period of refitting heavily impacted the oil sector. We expect industrial production to continue to expand through at least the first half of 2005, though at a more moderate rate as capacity constraints begin to make their presence felt.

Utilisation of installed capacity actually fell marginally in November for the second consecutive month, to 70.4%. Nevertheless, capacity utilisation has increased from a level of 68.0% in November 2003 and has expanded fairly steadily from a yearly low of 65% in January 2004. Much of the rapid economic growth that Argentina has experienced over the past two years has stemmed from this relatively 'easy' process of soaking up excess capacity left from the 2002 crash. These productivity gains have kept unit labour costs relatively low, despite several wage hikes, which have consequently had a rather muted impact on inflation. The challenge for 2005 and 2006 is to ensure that growth rates can be maintained in the face of a narrowing output gap as capacity constraints begin to tell. Indeed, some sectors are already working at very high levels of capacity utilisation. The basic metals, paper and packaging and petroleum refining industries all exhibit levels of utilisation above 80%. Political pressure for further wage increases in an election year, with reduced scope to exploit spare capacity, lends weight to our view of building inflationary pressures in the latter half of 2005.

For non-inflationary growth to continue, high levels of investment in the expansion of industrial capacity must be maintained. According to provisional data, gross fixed investment in Q304 expanded 33.1% y-o-y. This follows a similar expansion of 36.8% y-o-y in Q204. Nevertheless, **BMI** is concerned that the investment horizons of many businesses are fairly limited. While business

confidence is buoyant for the short term, long-run expectations are less positive and could negatively impact on crucial long-term investment decisions.

The **University of Torcuato di Tella's** ICC consumer confidence rating reflects the improving picture, increasing 9.5% (m-o-m) in November. Moreover, domestic demand continued to be supported by developments in the labour market. Unemployment fell in Q304 to 13.2%, down 1.6% quarter-on-quarter (q-o-q) from 14.8% in the second quarter of 2004. The latest figure also compares favourably with the level of 16.3% recorded in Q303. It leaves the unemployment rate at its lowest level for five years, having declined steadily since its May 2002 peak of 21.5%. In absolute numbers, there were 469,000 fewer people out of work and 866,000 more people employed in the private sector than in 2003. The sectors that registered the fastest rates of job creation over the year were hotels & restaurants, with a 51% y-o-y increase; and construction, with employment growth of 24% y-o-y. The industrial sector produced slower job growth of 6.5% y-o-y.

Despite the apparently positive employ-

ment data, it should be noted that the authorities do not include beneficiaries of the 'Heads of Household' scheme in the jobless tally. When these 1.6 million people are accounted for, the jobless rate stood at 17.6%, a more accurate reflection of the true picture. Another underlying structural weakness in the labour market is that around 2.3 million workers are technically 'underemployed'. Nevertheless, under the adjusted figures, unemployment still registered a marked decline from a level of 21.4% recorded at the same point in 2003.

The international economic environment remains, on balance, favourable to continued Argentine economic growth. Despite significant falls in commodity prices (especially for soya, a crucial export crop), they remain at relatively high levels. Going forward, demand from Argentina's main export markets (including Brazil and China) looks healthy.

Through 2005 we expect commodity prices to remain well bid. However, these price levels cannot be sustained indefinitely, and economic projections that make unrealistic assumptions based on elevated commodity prices will fall short in the medium

term. Downside risks remain from the indirect effect of high international oil prices and the current tightening cycle under way with international interest rates. However, **BMI** expects oil prices to moderate through 2005 and forecasts relatively steady and moderate increases in the Federal Funds rate. Thus, we do not believe these factors will be determinative.

**BMI** continues to predict growth through 2005, albeit at a more moderate pace of 4.7% y-o-y. It is important to disaggregate this figure: we see at least a 2-2.5 percentage points of 2005 growth resulting from 'carry over' from 2004. Thus, the actual growth recorded in 2005 will be rather less impressive than may appear at first glance. Moreover, we must emphasise that we forecast much of this growth to manifest itself in H105; we expect a significant slowdown in the latter half of 2005. We also have concerns over the sustainability of economic growth over the mid to long term. For sustained and sustainable economic growth, the structural reform process must be extended and deepened, and the authorities need to secure a satisfactory resolution to the issue of restructuring US\$100bn of defaulted debt.

## DEBT OUTLOOK

# Debt deal prospects improve

Matters finally appear to be coming to a head in the protracted and embittered struggle over Argentina's US\$100bn of defaulted debt. **BMI View:** The prospects for a resolution of the issue are improving. The authorities' divide and conquer tactics and indefatigable bargaining position finally appear to be bearing fruit as the first signs of investor fatigue become apparent. The fight is not over by any means, yet we are increasingly hopeful that the issue may be drawing to a close.

In January, the IMF cautioned the Argentine government over its current debt restructuring process, in which it proposes to swap US\$100bn in defaulted instruments for around US\$40bn in new bonds, saying that an acceptance rate of less than 75% would not be regarded as a suitable resolution to its debt problem. The government, on the other hand, sees 50% as the critical level. The Fund has criticised the way in which the administration of President Néstor Kirchner has acted unilaterally in its restructuring deliberations, and argues that it has not acted with the required 'good faith'. The government has maintained that this offer is the only opportunity for creditors to swap their bonds, in an effort to dissuade those

who are holding out for a better deal in the future. It warns that those who keep their old bonds risk seeing their investments remain in indefinite default.

However, the likelihood of a successful swap seems increasingly strong. The IMF has admitted policy errors in the run-up to the Argentine economic crisis in 2000, which is likely to influence the Fund's position on the restructuring and subsequent loan programme negotiations, despite the tough stance it has taken. The fact that all foreign regulators, apart from Japan, have given the go-ahead for the swap has certainly weakened the prospects of a successful legal challenge. Moreover, local pension funds, which hold 17% of the debt, have also agreed to

the restructuring terms, thereby lending domestic support to the proposal. Furthermore, President Kirchner has courted domestic popular support by not bowing to international pressure, so calls for an improvement of the offer have thus far been ignored. Nevertheless, many foreign investor groups, which claim to hold up to US\$40bn in bad debt, have argued that the 75% hair cut is simply too punitive and have urged creditors not to accept the current terms.

**BMI** is doubtful whether the government is currently in a position to satisfy the Fund's demand of 75% acceptance: the 50% threshold is, we believe, eminently achievable. The implications of this process, which would be the largest debt write-off in history, are immense, and likely to set standards for future international lending. There are real concerns that such a favourable settlement for Argentina could set a worrying precedent and increase the temptation for other sovereign debtors to follow suit and default on loans in the future.

In spite of this, a recent IMF report has questioned the degree to which defaulters, in the long run, are punished by the credit markets. Perhaps the Argentine authorities' uncompromising stance has been a rational strategy after all.



**POLITICAL OUTLOOK**

# PJ's internal struggles continue

A complex political *ménage à trois* has been developing between President Néstor Kirchner, Buenos Aires Governor Felipe Solá, and former president Eduardo Duhalde. **BMI View:** Expect the latest realignments within the Peronist party to generate significant internal conflict; the festering Kirchner-Duhalde pact is likely to reassert itself if the two principals do nothing to avert it.

The Buenos Aires Partido Justicialista (PJ or Peronist Party) entered a particularly fractious period of power politics when the tensions between Felipe Solá, the governor of the province of Buenos Aires, and Eduardo Duhalde, one-time president, finally bubbled over into the public domain. Apart from President Néstor Kirchner, the two powerbrokers are the most significant individuals in the provincial, and indeed national, party hierarchy.

The Peronist party has always been a remarkably diffuse entity, almost continually riven by intense ideological and, more commonly, regional factionalism. Buenos Aires is the most important province in national politics and has long been the power base of Eduardo Duhalde, a former governor of the province, who also represents the most significant obstacle to Kirchner's re-election in 2007.

The Solá-Duhalde conflict was almost inevitable: Duhalde has consistently frustrated his former political protégé's attempts to construct a power base independent from that of his mentor. In a December reshuffle of the PJ's provincial leadership council, Duhalde ensured that a close ally, José María Díaz Balcázar, took the top job, Solá's supporters were largely excluded from the process. In response, Solá instituted an anti-Duhalde faction of his own (*Felipismo*) within the PJ to contest party positions. The congressional elections, scheduled for the end of 2005, now will have an added edge to them.

Meanwhile, by appearing alongside Solá at a political ceremony in mid-January, President Kirchner appeared to lend his support to the governor. Kirchner is playing a high stakes game. After this provocative act, the hitherto dormant Kirchner-Duhalde rivalry is unlikely to remain that way for long.

**DATA & FORECASTS**

**BMI View:** Our adjusted 2004 forecast of ARS2.94/US\$, proved to be slightly on the bullish side of the unit weighed in at ARS2.97/US\$ at year-end. Nevertheless, we continue to forecast a strengthening peso, with a year-end 2005 destination of ARS2.80/US\$. The recent dollar bounce back somewhat relieved the appreciation pressure that had been building in the latter part of 2004. This will please Argentine exporters, who were beginning to worry that they might lose their competitive price advantage. In spite of recent central bank (BCRA) moves to lean against appreciation, we continue to forecast a strengthening of the unit. We are not convinced that the current dollar rally is sustainable, with the double-deficit weighing heavy on investor consciousness and little prospect of this situation improving. Moreover, as the debt issue appears to be reaching a conclusion of sorts, the markets should look on Argentina as a more reliable prospect in 2005.

	2003e	2004e	2004-2005 latest period		2005f	2006f
Nominal GDP (current US\$bn) <sup>1,5</sup>	129.74	<b>144.60</b>	-	-	<b>163.65</b>	<b>189.66</b>
Population (mn) <sup>3,5</sup>	<b>38.46</b>	<b>38.94</b>	-	-	<b>39.44</b>	<b>39.93</b>
GDP per capita (current US\$) <sup>1,5</sup>	<b>3373</b>	<b>3713</b>	-	-	<b>4150</b>	4749
Real GDP growth (%) <sup>1</sup>	8.7	<b>8.0</b>	8.3	Jul-Sep	4.7	3.5
Industrial prodn. (EMI, y-o-y, %) <sup>3</sup>	16.0	<b>10.5</b>	8.3	Nov	5.0	4.0
Unemployment (%) <sup>3</sup>	14.5	<b>13.5</b>	13.2	Jul-Sep	<b>12.8</b>	12.0
Fiscal balance (% of GDP) <sup>2,5</sup>	1.4	<b>3.5</b>	-	-	<b>2.4</b>	<b>1.43</b>
Inflation (y-o-y, eop, %) <sup>3</sup>	3.7	6.1	6.1	Dec	<b>6.8</b>	<b>7.2</b>
Short-term lending rate (ARS, % avg) <sup>3</sup>	19.5	<b>8.00</b>	5.9	Oct	<b>10.00</b>	<b>10.00</b>
Exchange rate (ARS/US\$) <sup>4</sup>	2.91	2.97	2.97	07-Jan	<b>2.80</b>	<b>2.75</b>
Exports* (fob, US\$bn) <sup>3</sup>	29.57	<b>33.50</b>	31.49	Jan-Nov	<b>36.00</b>	<b>40.00</b>
Imports* (cif, US\$bn) <sup>3</sup>	13.81	<b>20.00</b>	20.21	Jan-Nov	<b>24.00</b>	<b>29.00</b>
Trade balance (US\$bn) <sup>3,5</sup>	15.76	<b>13.50</b>	11.28	Jan-Nov	<b>12.00</b>	<b>11.00</b>
Current account balance (US\$bn) <sup>2</sup>	7.94	<b>4.00</b>	0.37	Jan-Mar	<b>4.50</b>	<b>3.00</b>
- % of GDP <sup>2,5</sup>	6.1	<b>2.8</b>	-	-	<b>2.7</b>	<b>1.6</b>
Reserves (eop, US\$bn) <sup>1</sup>	14.18	19.65	19.80	11-Jan	<b>20.00</b>	<b>24.00</b>
Total external debt (US\$bn) <sup>2</sup>	146.95	<b>148.00</b>	-	-	<b>145.00</b>	<b>139</b>
Total external debt/GDP (%) <sup>2,5</sup>	113.3	<b>102.4</b>	-	-	<b>88.6</b>	<b>73.3</b>
Total external debt/exports* (%) <sup>2,5</sup>	<b>497.0</b>	<b>441.8</b>	-	-	<b>402.8</b>	<b>347.5</b>

eop = end of period e/f = BMI estimate/forecast (bold) \* of goods and services. Source: <sup>1</sup>Banco Central de la República Argentina (BCRA), <sup>2</sup>Ministerio de Economía (MECON), <sup>3</sup>El Instituto Nacional de Estadística y Censos (INDEC), <sup>4</sup>Reuters, <sup>5</sup>BMI calculation.



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able conditions to foreign mining companies, including a promise of tax stability for 10 years for any new venture. In addition, accelerated capital depreciation allowances mean that many companies pay little or no taxes in their first years of operation. Over the past three decades this favourable environment has successfully attracted massive investment inflows. Nearly US\$16bn worth of foreign direct investment (FDI) has poured into mining projects in the country since the late 1980s. The copper boom of 2004 only served to harden the government's conviction that the industry should be paying more.

This was the second time in 2004 that the government had attempted to introduce a tax on mining. The earlier bill, submitted in August, proposed imposing a 3% royalty on ferrous metals and a 1% tax on non-ferrous metals in order to fund investment in new technologies, but this was rejected by congress. Under the proposed bill, which would come into force in 2006, there would be a 4-5% tax on operating profits for firms that do not operate under DL600. Those who are allied to DL600 would have the option to abandon that regime and be taxed at a rate of 4% on operating profits for 15 years. Small miners would be exempt from the new proposals.

## ECONOMIC OUTLOOK

# An austere approach to debt

Chile has managed to keep tight control of its debt levels, and is now using higher-than-expected copper revenues to make early payments on outstanding debts. **BMI View:** In maintaining austerity despite record growth, the government is not only protecting the economy from its vulnerability to commodity price shocks but also increasing confidence in its reputation as a stable investment environment.

Chile's foreign debt climbed to US\$44.8bn at the end of October 2004, US\$1.4bn more than in December 2003. Of that sum, public-sector debt totalled US\$9.8bn, while private-sector debt accounted for US\$34.9bn. Breaking this figure down, Chile's foreign debt is split into US\$35.7bn long-term debt and US\$9.0bn short-term debt. Meanwhile, the central bank's international reserves reached US\$16.0bn in November.

Given its strong fiscal position in 2004, the government decided to pay back early about US\$0.6bn of its debt to multilateral creditors in a bid to reduce its debt-servicing bill. By September 30, the central bank had already used its Copper Stabilisation Fund to pay back US\$0.5bn of foreign debt. The government is accelerating debt pay-

ments at its fastest rate since the mid-1990s. However, many in the mining industry argue that by changing the tax rules the perception of stability offered by the DL600 regime would be eroded, thereby undermining the investment climate. Opponents of the tax include **Barrick Gold Corp** and **Placer Dome Inc**, the world's third- and fifth-largest gold producers respectively. William Hayes, chief executive of the Chilean subsidiary of Placer Dome, has already indicated that plans to invest US\$1.6bn in a project in northern Chile may be reconsidered if the firm's cost margins increase. Meanwhile, Barrick also hinted that it would think twice about its plans to build a US\$1.5bn mine on the Argentinian border.

However, with an A credit rating from ratings agency **Standard & Poor's**, Chile has established a strong reputation as the most stable and reliable investment destination in Latin America, and this is not solely due to DL600. The country has some of the world's richest copper deposits, and demand is riding high. As such, we do not anticipate the mining royalty presenting a huge disincentive to investment. Despite vigorous opposition, the mining companies may eventually have to accept that the government's proposals recommend no more than bringing the industry into line with international standards.

## RISK SUMMARY

### POLITICAL RISK

#### Lagos Approval Ratings Strengthen

According to a recent survey by the **Centre for Public Studies (CPS)**, the approval rating for President Lagos' centre-left administration has reached 60%, the highest level ever recorded since the country returned to democratic governance in 1990. When respondents were asked who they wanted to see as the next president, Michelle Bachelet received 31% of the votes, up from 29% six months ago. In contrast, right-wing Juan Luis Lavín, the second most popular candidate – received 27% of the votes, which signified a decline of four percentage points since the last poll.

The short-term political rating remains the highest in the region, coming in at an impressive 85.0.

### ECONOMIC RISK

#### Interest Rate Rise

The central bank hiked its benchmark interest rates at its monthly monetary policy meeting by 25 basis points (bps), bringing it to 2.5%. The bank cited dynamic growth and inflationary pressures as the prime reasons behind the move. The bank also stated that it would continue to gradually tighten rates towards 3.0%. Elsewhere, the growth outlook remains firm; in a statement released by the monetary policy board, it confirmed that investment and exports are still strong. After rebasing our ratings for the new forecast period, the short-term economic rating came in at a strong 75.0.

### BUSINESS ENVIRONMENT

#### Natural Gas Supply Cut

Energy stocks have sold off in January, following statements from the national energy commission that Argentina had limited natural gas exports to Chile by 4.18mn cubic metres a day, which amounts to 20% of daily needs during the summer. Argentina stated that this move was made as a result of high domestic demand during a heat wave. As a result, Chile's largest generator, **Endesa**, saw its shares decline by 0.6%, while larger losses were seen in the second- and third-largest generating companies, **AES Gener** and **Colbun**.

Our business environment and short-term composite ratings came in at 74.8 and 77.9 respectively.

**ECONOMIC OUTLOOK**

# An immaculate record

**BMI View:** The economic outlook for Chile is very positive, on the back of a stable political environment, strong macroeconomic fundamentals and still-high copper prices. Furthermore, a successful policy mix allows the economy to absorb the natural volatility caused by its dependence on commodity exports.

The Chilean economy is in good shape as it goes into 2005, and the short-term outlook is extremely favourable. Several factors have combined to produce this optimistic picture. First, as the world's biggest copper producer, Chile was able to take advantage of a 52% rise in copper prices in 2004, aided by the fact that the government did not take on too much debt when copper prices were lower. This not only boosted real GDP growth and trade figures, but also increased the flow of funds into the public purse, improving the fiscal situation and contributing to the rapid accumulation of foreign reserves. Indeed, copper revenues are now being used to make early payments on some of Chile's external debt. Second, an austere approach to macroeconomic policy has improved Chile's creditworthiness in the eyes of the international investment community. Lagos has maintained a strong pace of economic

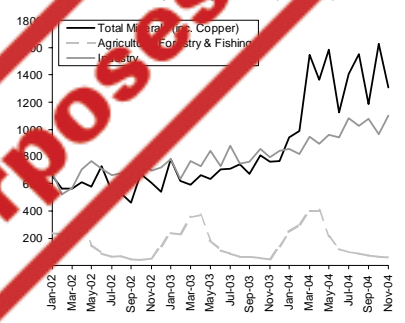
growth throughout his tenure, and is now benefiting from tight control of inflation levels, following the central bank's gradual tightening of monetary policy in Q404. Such measures make Chile far less vulnerable in the case of a copper slump.

On the downside, the copper boom has not translated into stellar employment gains, due to the capital-intensive nature of the mining industry. But as the economic benefits have filtered through to the domestic economy, unemployment has started to retreat from its high of 9.9% of the labour force in August to 8.6% in November. Still, this remains above the unemployment rate of the same period in 2003, when it stood at 5.1%, but we expect a continued improvement in job prospects as the non-copper economy continues to flourish.

Looking ahead to 2005, the government will be focusing its efforts on international

trade and the promotion of Chile as a bridge between Asia and South America. However, in prioritising extra-regional economic ties, the government would be wise not to overlook both economic and political relations with its closer neighbours. That said, Chile sets a standard for its South American neighbours to follow; and while it is still a long way to go until it reaches the levels of

**Mighty Minerals - Copper's Contribution**  
Value of Exports by Sector (US\$ bn)



Source: Central bank

the world's more advanced economies, it is already firmly on the right track. Indeed, we see a robust 5.5% expansion this year, with exports remaining strong as the copper industry continues to experience firm demand from China and the US.

**DATA & FORECASTS**

**BMI View:** Chile registered a trade surplus of US\$9.04bn in 2004, its highest-ever annual figure. Foreign sales last year totalled US\$32.00bn, a yearly rise of 52%. Imports rose a slower 27% y-o-y to reach US\$22.96bn. In December alone, Chile recorded its highest-ever monthly export value, of US\$3.32bn, a y-o-y rise of 77%. Imports rose by 47% y-o-y, their highest y-o-y increase since 1995, to register US\$2.21bn. The main driver of the healthy surplus was a boom in copper prices last year. In the first three weeks of December, foreign sales of the metal, which accounted for 40% of the country's total exports last year, reached US\$1.363bn.

**Government View:** On the back of these healthy trade statistics, the government expects the economy to have expanded by 6.0% in 2004, which, if achieved, would be the highest rate of growth in seven years. Although we expect economic expansion to slow slightly this year in line with the global economy, Chile is still expected to fare well, and as such we see robust real GDP growth of 5.5%.

	2003e	2004e	2004-2005 latest period		2005f	2006f
Nominal GDP (current US\$bn) <sup>1,7</sup>	74.38	<b>86.77</b>	69.70	Jan-Sep	<b>92.91</b>	<b>99.00</b>
Population (mn) <sup>6,7</sup>	15.8	<b>16.0</b>	-	-	<b>16.2</b>	<b>16.40</b>
GDP per capita (US\$) <sup>1,7</sup>	4714	<b>5428</b>	-	-	<b>5738</b>	<b>6036</b>
Real GDP growth (%) <sup>1</sup>	3.3	<b>5.8</b>	6.8	Jul-Sep	<b>5.5</b>	<b>4.7</b>
IMACEC index (y-o-y, % eop) <sup>1</sup>	3.2	-	7.5	Nov	-	-
Industrial prodn. (SOFOFA, y-o-y, %) <sup>1</sup>	1.9	<b>10.0</b>	11.8	Nov	<b>4.0</b>	<b>5.0</b>
Unemployment (INE, average, %) <sup>3</sup>	8.6	<b>8.8</b>	8.6	Nov	<b>8.0</b>	<b>7.6</b>
Fiscal balance (% of GDP) <sup>4,7</sup>	-0.8	<b>1.0</b>	1.5	Jan-Oct	<b>0.5</b>	<b>1.0</b>
Inflation (m-o-m, %) <sup>3</sup>	-	-	-0.38	Dec	<b>2.9</b>	<b>3.5</b>
Inflation (y-o-y, eop, %) <sup>3</sup>	1.07	<b>2.43</b>	2.48	Dec	<b>3.00</b>	<b>3.3</b>
Short-term lending rates (% pa avg) <sup>1</sup>	6.01	<b>5.16</b>	5.16	Dec	<b>6.00</b>	<b>7.5</b>
Exchange rate (CLP/US\$, eop) <sup>5</sup>	592.9	<b>610.5</b>	571.3	07-Jan	<b>600.0</b>	<b>630.0</b>
Exports* (FOB, US\$bn) <sup>1</sup>	21.05	<b>32.00</b>	32.00	Jan-Dec	<b>34.00</b>	<b>30.00</b>
Imports* (FOB, US\$bn) <sup>1</sup>	18.03	<b>22.96</b>	22.96	Jan-Dec	<b>25.00</b>	<b>27.60</b>
Trade balance (FOB-FOB, US\$bn) <sup>1,7</sup>	3.02	<b>9.04</b>	9.04	Jan-Dec	<b>9.00</b>	<b>2.40</b>
Current account balance (US\$bn) <sup>1</sup>	-0.59	<b>0.50</b>	0.21	Jul-Sept	<b>0.20</b>	<b>0.10</b>
- % of GDP <sup>2,7</sup>	-0.80	<b>0.58</b>	-	-	<b>0.22</b>	<b>0.10</b>
Reserves (eop US\$bn) <sup>1</sup>	15.91	<b>16.10</b>	16.01	Nov	<b>16.50</b>	<b>16.8</b>
Total external debt (US\$bn) <sup>1</sup>	41.18	<b>42.00</b>	44.8	Oct	<b>43.00</b>	<b>45</b>
Total external debt/GDP (%) <sup>1,7</sup>	<b>55.4</b>	<b>48.4</b>	-	-	<b>46.3</b>	<b>45.5</b>
Total external debt/exports† (%) <sup>1,7</sup>	158.2	<b>152.2</b>	-	-	<b>110.5</b>	<b>128.6</b>

eop = end of period \* of goods and services e/f = BMI estimate/forecast (bold) Source: <sup>1</sup>Banco Central de Chile (BCC), <sup>2</sup>IMF, <sup>3</sup>Instituto Nacional de Estadísticas (INE), <sup>4</sup>Ministerio de Hacienda (MINDHA), <sup>5</sup>Reuters, <sup>6</sup>IDB, <sup>7</sup>BMI calculation.



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ment approved on December 15 2003.

Even though Paraguay has not drawn down any of the available funds so far, instead treating the agreement as precautionary, the decision must nevertheless have come as a relief to legislators who feared that the government's failure to approve key reforms might threaten the entire agreement. This, in turn would have done little to improve confidence about the state of the domestic economy. However, on this occasion, the IMF decided to give Paraguay the benefit of the doubt. Indeed, in a statement issued after the review, the multilateral said that it had waived the non-observance of certain quantitative and structural performance criteria, which would allow the government more time to pass the reforms.

Despite its waivers, the Fund's representative, Takatoshi Kato, praised the government for its sound economic management, under which the economy had grown, inflation had been reduced, international reserves increased and the exchange rate stabilised. Having praised the economic side, Kato went on to broach structural issues, citing key pieces of economic legislation that had been passed, such as the fiscal adjustment law, the customs code, the bank resolution law and public pension reform. However, he criticised the government's delay in enacting essential reforms such as the pub-

lic banking law necessary to combat consistently high unemployment and poverty.

While the IMF accepted the government's wavier request, it warned that it would not allow any more delays or changes to the reform schedule. Of the reforms in question, the 2005 budget law is perhaps the most contentious. The law, approved by the Senate in December, increased government spending to almost 2% of GDP. Not only does the government consider this level unfeasible, but it is also above the limit agreed with the IMF. As such, President Duarte Frutos and his economic team decided partially to veto the reform.

This strained relations between the cabinet and congress, and may explain why the Senate decided to delay discussion on the matter until February. However, in doing so, it put the IMF loan at risk as the multilateral had indicated that the reform needed to be passed by the end of 2004.

On this occasion the government's fiscal and monetary progress appear to have saved the day. Nevertheless, cracks are emerging within Duarte Frutos's government; and, given that the opposition Partido Liberal Radical Auténtico (PLRA) retains a majority in congress, the president may face increasing barriers to policymaking. Furthermore, while the economy has escaped on this occasion, politicians from all parties should be wary of placing their relations with the IMF at such risk in future.

**RISK SUMMARY**

**POLITICAL RISK**

**Landless Dispute Escalates**

The landless dispute escalated further at the end of 2004. Despite mediation efforts by the president of the senate, the government has failed to reach a compromise with the most radical of the peasant groups, the Federación Nacional Campesina (FNC). The FNC has now threatened to escalate its actions unless the government begins to fulfill its promise of land distribution. President Duarte Frutos has been criticised for his failure to resolve the issue, but he faces a difficult task of striking a delicate balance between the demands of the landless groups and those of powerful agricultural interests.

Following a comparative exercise of rebasing and recalibration of data for 2005, our short-term political risk rating fell to 61.0 this month.

**ECONOMIC RISK**

**Government Fails To Pass Banking Reform**

The government has been given extra time by the IMF for the crucial reform of its banking system. The reform was one of several that made up part of Paraguay's US\$73mn loan agreement with the multilateral. It is aimed at increasing the efficiency of public bank loans to small businesses through the creation of a wholesale state bank. The IMF agreed to the stand-by loan despite the government's failure to complete the reform. Finance Minister Dionisio Borda said that the government wanted the law to be approved, but that it needed to be a good law that had the approval of creditors.

Our rebasing exercise pushed Paraguay's short-term economic rating to 58.0.

**BUSINESS ENVIRONMENT**

**Hydroelectric Project Should Be Completed By 2008**

The governments of Argentina and Paraguay have signed an agreement to complete the 3,200MW Yacyreta hydroelectric project by 2008. This will increase the generation capacity of the plant by 58%. The Yacyreta project has been blighted by corruption scandals since it began operating in 1991, and has cost Argentina and Paraguay a combined US\$10bn thus far, five times original estimates when construction began in 1973.

Revision of our ratings for 2005 nudged our business environment rating up to 47.0 but pulled our composite rating down slightly to 59.5.

**DATA & FORECASTS**

**BMI View:** In November 2004, the accumulated trade balance showed a US\$0.87bn deficit, 64% larger than November 2003's US\$0.53bn shortfall. This was largely due to the fact that imports accelerated at a faster rate than exports during the month. Indeed, exports reached US\$1.5bn year to date (ytd), an increase of 28% y-o-y. This was primarily due to an increase in exports of soya derivatives. Meanwhile, higher fuel prices pushed accumulated imports up by 39.1% y-o-y to reach US\$2.4bn on a ytd basis. We expect fuel prices to moderate slightly but to remain high throughout 2005, and as such see the trade deficit remaining at around US\$0.6bn at year-end.

	2003e	2004e	2003-2004 latest period		2005f	2006f
Nominal GDP (US\$bn) <sup>1,5</sup>	5.65	<b>6.64</b>	-	-	<b>6.96</b>	<b>7.39</b>
Population <sup>3</sup>	5.67	<b>5.82</b>	-	-	<b>5.96</b>	<b>6.11</b>
GDP per capita (US\$) <sup>2,5</sup>	996	<b>1142</b>	-	-	<b>1167</b>	<b>1210</b>
Real GDP growth (%) <sup>2</sup>	2.6	<b>2.4</b>	-	-	<b>3.0</b>	<b>3.2</b>
Inflation (m-o-m) <sup>2</sup>	-	-	1.6	Dec	-	-
Inflation (y-o-y, eop, %) <sup>2</sup>	9.3	<b>3.0</b>	2.8	Dec	<b>5.0</b>	<b>4</b>
Exchange rate (eop, PYG/US\$) <sup>4</sup>	6115	<b>6090</b>	6200	7-Jan	<b>6500</b>	<b>6350</b>
Exports (US\$bn) <sup>2</sup>	2.26	<b>1.65</b>	1.52	Jan - Nov	<b>1.70</b>	<b>2.3</b>
Imports (US\$bn) <sup>2</sup>	2.52	<b>2.50</b>	2.39	Jan - Nov	<b>2.30</b>	<b>2.5</b>
Trade balance (US\$bn) <sup>2,5</sup>	-0.26	<b>-0.85</b>	-0.87	Jan - Nov	<b>-0.60</b>	<b>-0.20</b>
Current account balance (US\$bn) <sup>2</sup>	0.15	<b>0.20</b>	0.09	Jan - Mar	<b>0.25</b>	<b>0.3</b>
- % of GDP <sup>2,5</sup>	2.6	<b>3.0</b>	-	-	<b>3.6</b>	<b>4.1</b>
Total Reserves (US\$bn) <sup>4,1</sup>	0.97	<b>0.85</b>	1.19	Oct	<b>0.88</b>	<b>0.95</b>
Total External debt (US\$bn) <sup>3</sup>	<b>3.40</b>	<b>3.45</b>	2.35	Oct	<b>3.50</b>	<b>3.75</b>

<sup>1</sup> excluding gold <sup>2</sup> eop = end of period <sup>3</sup> e/f = BMI estimate/forecast (bold). Source: <sup>1</sup>IMF, <sup>2</sup>Banco Central del Paraguay, <sup>3</sup>IDB, <sup>4</sup>Reuters, <sup>5</sup>BMI calculation.



## RISK SUMMARY

## POLITICAL RISK

## New Cabinet

President-elect Tabaré Vázquez named his full cabinet in early December. While some independents were allocated posts, the majority of the positions were apportioned to different factions of the ruling coalition Encuentro Progresista-Frente Amplio. Three posts were allocated to the Vázquez' Partido Socialista (PS), two to the Movimiento de Participación Popular, two to the Vertiente Artiguista and one each to the Alianza Progresista and Asamblea Uruguay. Meanwhile, Walter Cancela, director of economics at the Universidad de la República and member of the Partido Demócrata Cristiano, has been named as Uruguay's new central bank president.

Following a comparative exercise involving the rebasing and recalibration of our risk ratings, the short-term political risk rating for Uruguay was 82.0 this month.

## ECONOMIC RISK

## Mercosur: Uncertain Future

Danilo Astori, Uruguay's finance minister designate, has questioned the future viability of the Mercosur agreement. He cited the larger economies' lack of commitment towards the 'free trade spirit' of the treaty, together with the absence of coordination of economic policies. He did, however, recognise the fact that the Mercosur members had managed to follow similar monetary policies. The future minister sees solving the issues within Mercosur as among his top priorities when he takes up his post in March.

Our rebasing exercise brought the short-term economic rating to 69.0.

## BUSINESS ENVIRONMENT

## High Season For Tourism

It is high season for tourism in Uruguay: an estimated 350,000 visitors have flocked to the country's beach resorts since mid-December, according to government figures. This represents an 8% increase on visitor numbers for the same period last year. Statistics show that the largest group of visitors hails from Argentina.

After recalibrating our risk ratings, the business environment rating was 65.9, while our composite indicator was 70.1.

## ECONOMIC RISK

## Good times ahead

The outlook for 2005 is extremely positive, and the prospect of a new administration has inspired new-found confidence among investors and creditors alike. **BMI View:** The economy should continue to grow in 2005, albeit at a slower pace than last year. That said, we remain concerned about the considerable debt servicing burden, but are reassured by Vázquez' commitment to market-friendly policies.

Uruguay has experienced a surge of investor confidence, thanks to optimism over the advent of a new administration and an economic recovery that was well under way at the time of the election. Although Tabaré Vázquez does not take office until March, the peso has appreciated by 7% since the presidential election in October 2004, to reach UYU25.05/US\$ on January 7, its highest level since August 2002. In early December 2004, Vazquez named his cabinet, which is predominantly drawn from his left-wing Encuentro Progresista-Frente Amplio coalition. With a majority in both houses of Congress, Vazquez' first months in office should be relatively smooth, although his professed commitment to market-friendly policies could be challenged by the weight of the reform agenda and public debt. He ought to be well supported in this mission, however,

by the capable Danilo Astori, who has asserted his desire to prove, as economy minister, that left-wing governments can successfully reform and manage the economy.

For Astori, debt management will be the most pressing issue in 2005, with US\$2.6bn of maturing debts needing to be paid off or refinanced just this year. The government can count on the support of the IMF, which recently approved a US\$212.3mn disbursement following its sixth review of the country's US\$3.02bn stand-by arrangement. The economy is steadily improving, with the industrial sector leading the way. We estimate that the economy grew by an exceptional 10% in 2004 but expect a more moderate expansion of 4.0% this year, given the high base of comparison and our outlook for somewhat sluggish global growth.

## DATA &amp; FORECASTS

**BMI View:** Trade continues to play an important role in Uruguay's growth trajectory. Exports were US\$276mn in November, up 37% y-o-y. On an accumulated basis, exports reached US\$2.8bn in the same month. This represents an increase of 38% compared with the same period in the previous year. Meanwhile, imports were also up, by 49% y-o-y, bringing the monthly total to US\$334mn. This pushed year-to-date (ytd) imports up to US\$2.8bn, an increase of 40% y-o-y. As of November, the accumulated trade deficit for 2004 was US\$0.02bn.

	2003e	2004e	2004-2005 latest period		2005f	2006f
Nominal GDP (US\$bn) <sup>1,3,7</sup>	11.29	12.67	-	-	13.04	14.28
Population (mn) <sup>5,6</sup>	3.41	3.43	-	-	3.46	3.47
GDP per capita (US\$) <sup>1,3,7</sup>	3311	3692	-	-	3775	4109
Real GDP growth (% change) <sup>3</sup>	2.2	10.0	12.5	Jul-Sep	4.0	5.0
Unemployment (national urban, % pa) <sup>4</sup>	16.9	13.0	12.1	Sep-Nov	14.0	13.50
Fiscal balance, nominal (% of GDP) <sup>3,7</sup>	-3.1	-3.3	-	-	-2.5	-0.5
Inflation (m-o-m, %) <sup>4</sup>	-	-	0.09	Dec	-	-
Inflation (y-o-y, eop, %) <sup>4</sup>	10.2	7.59	7.59	Dec	7.0	6.0
Exchange rate (eop, UYU/US\$) <sup>6</sup>	28.70	30.50	25.05	7-Jan	32.00	34.00
Exports (FOB, US\$bn) <sup>3</sup>	2.20	2.85	2.77	Jan-Nov	2.60	2.55
Imports (CIF, US\$bn) <sup>3</sup>	2.19	2.90	2.80	Jan-Nov	2.35	2.40
Trade balance (FOB-CIF, US\$bn) <sup>3,7</sup>	0.01	-0.05	-0.02	Jan-Nov	0.05	0.15
Current account balance (US\$bn) <sup>3</sup>	0.08	0.12	-	-	0.15	0.10
- % of GDP <sup>3,7</sup>	0.7	0.9	-	-	1.2	0.7
Reserves (US\$bn) <sup>*1</sup>	2.09	2.50	2.35	Oct	2.75	2.85
Total external debt (US\$bn) <sup>2</sup>	11.01	11.15	11.34	Jul-Sep	11.80	11.50
Total external debt /GDP % <sup>2,7</sup>	97.58	88.00	-	-	90.47	80.54

\* excluding gold. e/f = BMI estimate/forecast (bold). Sources: <sup>1</sup>IMF, <sup>2</sup>World Bank, <sup>3</sup>Banco Central del Uruguay (BCU), <sup>4</sup>INE, <sup>5</sup>IDB, <sup>6</sup>Reuters, <sup>7</sup>BMI calculation.



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Publishers: Richard Londesborough/Jonathan Feroze

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