

ECONOMIC ENVIRONMENT AND FINANCIAL

ECONOMIC ENVIRONMENT

GENERAL OUTLOOK

During 2004, the global economy produced a notable performance, marked principally by the excellent results in the United States, an economy that was capable of growing at its potential level of around 4%, mainly as a result of the strength of domestic demand. In contrast, the other two large economies, Japan and the European Union, both with a high degree of external dependence, recorded a mixed performance during the year, expansive in the first half and contractive in the second. Japan practically stagnated in the third quarter compared to an annual rate of growth of 5% in the first half of the year. For its part, the deceleration in the European Union has been more intense than expected after recording growth of only 1.3% in the third quarter of the year.

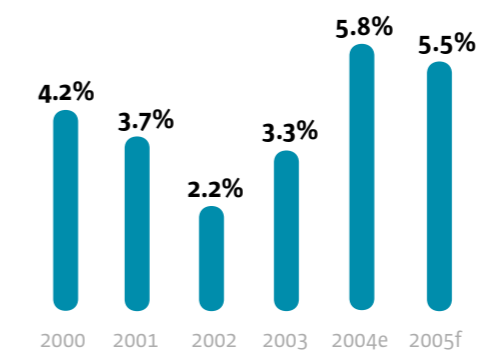
With respect to the emerging countries, the performance seen in 2004 was also quite notable. The combination of global interest rates at minimal levels, raw material prices at a peak and gains in competitiveness explains this improvement in general. Also the extraordinary financial market liquidity has reduced the costs of debt servicing while the high prices of raw materials have driven revenues and the depreciation of the dollar has improved competitiveness, accelerating exports and international trade.

It should be noted however that one of the principal economic challenges for the coming years will be the ability of the American economic authorities to adequately reduce the high current account and fiscal deficits and thus avoid an imbalance in the global economy. China also should show its ability to make smooth adjustments to its economy in the next years in order to avoid greater corrections later that could affect global economic stability.

CHILE'S ECONOMIC ENVIRONMENT IN 2004

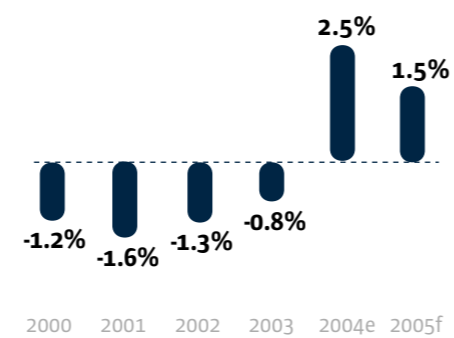
As in the rest of the countries in the region, the Chilean economy in 2004 produced a faster rate of growth, particularly in the second half of the year. In the first half, GDP grew by 5%, high in comparison with the same period of the previous four years. The principal contributor to this growth was the external sector which was driven by the expansion of international trade, in particular by the increasingly influential Chinese economy on the global economy, which is and will be one of the most relevant pillars in the world's future demand for commodities.

GDP GROWTH



(Source: Central Bank of Chile)

CURRENT ACCOUNT/GDP



(Source: Central Bank of Chile)

This favorable scenario was reflected in the Chilean economy especially during this year with the great dynamism in copper sales whose international price rose by 60% compared to 2003, a fact that also benefited the public accounts and partly explains the depreciation of the dollar to levels of Ch\$560, after touching Ch\$649 in June 2004. On the other hand, domestic demand showed a very similar performance to GDP in the first half, with fixed capital investment being the weakest expense item in that period.

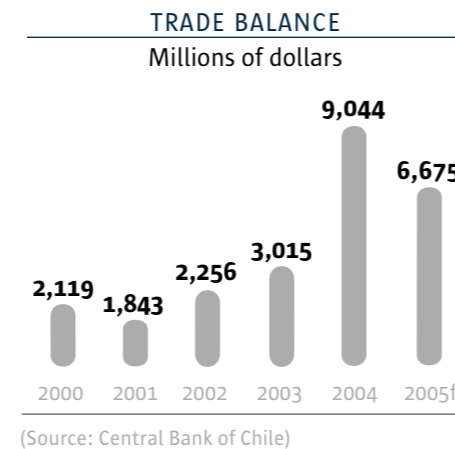
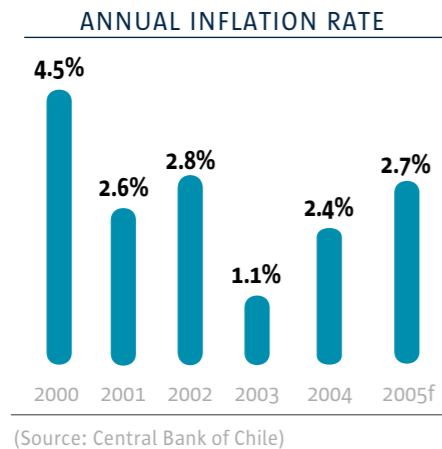
The situation changed radically in the third quarter of 2004, with growth of 6.8% being recorded. In contrast to the previous quarters, expansion in the period was led by growth in domestic demand, particularly the share of investment with a rise of 14%. This item included machinery and equipment which expanded by 25.1% (9.3% in the first quarter and 13.6% in the second) and, to a lesser degree, investment in construction which grew 6.2% in the quarter compared to 1.8% in the first and 2% in the second quarters. The rest of domestic demand, consumption and inventories, with 6.9% growth, showed a moderately better performance than in the first two quarters of the year.

There was great dynamism in Chilean exports which amounted to US\$ 32 billion in the year, representing a record increase of 52% over the year before. On the other hand, imports also grew substantially, consistent with the expansive external front. The total for the year 2004 was almost US\$ 23 billion, which represents an increase of 27% over 2003.

The exceptional growth in Chile's foreign trade enabled the balance of trade for 2004 to reach more than US\$ 9 billion, representing around 9.4% of GDP, the highest level for the last 16 years; the average throughout the 1990s was just 0.9%.

Progress on the inflationary front has also been positive. A slight appreciation of the peso and increasingly more modest wages growths, have been able to offset the effects of increases in fuel prices on the more general measures of inflation. After showing very low levels, inflation for the year reached 2.4%, within the annual target range of 2 to 4% of the Central Bank.

However, the labor market has been the weakest area for the Chilean economy. At November 2004, the unemployment rate reached 8.6%, five decimal points above the level at the same time in 2003. This weakness, even when there are various interpretations, partially dampens the good performance of the domestic economy, a situation about which it is essential for all the country's economic sectors to jointly review the policies and rules governing the present labor market in order to make it more flexible.



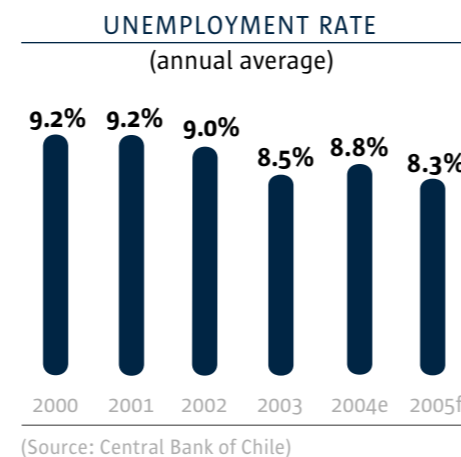
EXPECTATIONS ABOUT THE CHILEAN ECONOMY FOR 2005

The sharp recovery in internal demand in the second half of 2004 has expanded the growth base and thus improved economic expectations for 2005. New forecasts for GDP growth stand between 5 and 6%, a wider range than that estimated during the first half of the year. In a conservative scenario, the projections center on 5.5%, a level that could be corrected upwards during the first quarter of 2005 if the present growth trends continue.

Even when it is expected that the external scenario will continue to show the dynamism of 2004, the rate of expansion will be lower as a consequence of high oil prices and the general reduction in the monetary and fiscal stimuli. This will translate into less vigorous growth in international trade and thus also in our exports. However, the customs-duty tariff reduction processes related to the free-trade agreements with the United States and Europe, the potential benefits deriving from the trade liberalization commitments reached in the APEC meetings held in Chile, and the coming into effect of the free-trade agreements with South Korea and member states of the European Free Trade Association (EFTA), all should contribute to the diversification of Chilean exports and the increase in foreign investment in Chile.

It is expected that copper prices will continue at a high level although the average price will be lower than for 2004 (130 US\$ cents per pound). Overall, it is forecasted that the current account balance as a percentage of GDP will be 2.5% for 2004 and 1.5% in 2006.

Finally, inflation should stand between 2.5% and 3.5% for the year 2005, thus providing space for the Central Bank to adopt a smooth process of normalization of its expansive monetary policy.



FINANCIAL SYSTEM

THE FINANCIAL SYSTEM IN 2004

During 2004, the Chilean financial system continued to progress in its consolidation and modernization process, being recognized locally and internationally for its great strength and stability. According to the most recent financial stability report of the International Monetary Fund (IMF), the Chilean financial system is the leader in Latin America and heads emerging nations in 21st place among 60 countries.

The international credit-rating agency Standard & Poor's has stated that the solvency of the Chilean financial system continues to consolidate in the Latin American context, in contrast to other countries in the region that have been highly affected by different political and economic crises. The positive performance of the Chilean system is based, among other things, on its stable legal framework, fiscal discipline and the lowest-risk loan portfolio in the region.

BUSINESS VOLUMES

The year 2004 was marked by a recovery in the dynamism of economic growth with historically low interest rates that positively affected growth in loans, the incorporation of new customers and the development and expansion of new businesses. However, the year was also noted for the heavy renegotiation of debts of all kinds and segments, encouraged by expectations that the low interest rates could not last for long.

Total loans (net of interbank lending) at December 2004 therefore rose to Ch\$ 37,349,296 million, representing an 11.0% growth in 12 months, the highest rate in the last seven years. This important recovery in business volume was particularly driven by sustained growth in consumer and housing mortgage loans in the retail sector, influenced in turn by the improved economic conditions, fierce competition and the low interest rates. Consumer loans increased by 17.3% during the year while housing loans rose by 18.9%, mainly structured on the expansion of endorsable mortgage loans.

For its part, loan activity for businesses resumed its strong growth rate in the last months of the year in commercial loans and there was a significant recovery in foreign trade financing. These two areas grew by 6.2% and 14.1% respectively during the year.

This business expansion was financed mainly by time deposits which rose by 10.8% to Ch\$ 25,900,719 million, but also by a 10.3% increase in current accounts to Ch\$ 6,127,659 million, based on 82,000 additional accounts and the low interest rates.

This loan growth has been accompanied by an improvement in credit quality, reflected in the lower levels of overdue loans and the proportion of allowances for loan losses to total loans.

RESULTS FOR THE FINANCIAL SYSTEM

The greater economic activity in 2004 not only positively affected business volumes but also the results of the financial sector. Thus, the year 2004 was excellent for banking sector results. Total profits at December were Ch\$ 665,176 million, representing a 5.2% increase over the year before. This implied an improvement in the system's return on equity from 16.6% in 2003 to 16.8% in December 2004. These improved results are mainly explained by a 5.9% increase in operating revenues, the greater contribution of subsidiary companies and expense controls which together contributed to improving operating efficiency from 57.4% in 2003 to 55.8% at December 2004.

Similarly, closely related to the positive change in the Chilean economy and the recovery of the loan portfolio, the sustained downward trend in banks' credit risks during the year also favorably affected the sector's results. The stock of allowances for loan losses compared to loans (net of interbank lending) fell from 2.2% in December 2003 to 2.1% in 2004. The past due loans to total loans ratio also improved from 1.7% to 1.2% in the same period.

FINANCIAL SYSTEM INCOME STATEMENT

(millions of Ch\$ at December 2004)	2003	2004
Gross operating income	2,184,064	2,313,440
Operating expenses	-1,254,586	-1,291,062
Net charge for loan losses	-247,348	-288,420
Foreign subsidiaries and branches	113,634	127,033
Voluntary loan loss provisions	10,740	0
Others*	-174,128	-195,815
Net income	632,376	665,176
Gross operating income / Average interest-earning assets	5.2%	5.2%
Efficiency	57.4%	55.8%
Net charge for loan losses / Net average loans	0.8%	0.8%
Net income / Capital and reserves	16.6%	16.8%

* includes net Other non-operating income, Price-level restatements and Taxes.

The banking system's capital adequacy also showed sustained strength, reaching 12.8% at November 2004.

Despite the good results, fierce competition in the banking business and the low interest and inflation rates in recent years have led to a reduction in financial margins. This has been offset by growth in fee income related to new products and a rise in business volumes as a result of an increase in banking penetration of certain market segments.

With respect to regulations, the year was notable for the introduction of new rules for loan classification and the making of provisions and allowances. Guidelines were also prepared for the transition to the application of the new Basle II agreement which seeks to strengthen the performance and solvency of financial institutions and the stability of the banking system.

Lastly, new rules were introduced covering fees and charges made to customers as part of initiatives for giving greater

PROGRESS AND CHALLENGES FOR THE CHILEAN FINANCIAL SYSTEM

Two new banks opened for business in 2004, strategic alliances were made between different financial institutions and large retail store groups, and the automated teller machine network was expanded with the incorporation of the Banco del Estado network. A non-banking operator was also authorized to issue international brand credit cards and there was in general an increase in competition from other credit providers.

To successfully meet this competition in the context of more flexible regulations and increasingly more demanding customers, banks have placed a special emphasis on the quality and coverage of their banking services and on increased efficiency through technological development. Banks continue to invest in technology that enables them to reduce costs while expanding capacity, coverage and quality of their financial services. In particular, hard work was done on the modernization of the payments system to make it more efficient, secure and fast. The "High Value Payments Clearing System - Combanc" was thus formed under the new regulations covering bank support companies.

Considerable progress was also made during the year in the field of internationalization. Another Chilean bank was introduced to the New York Stock Exchange and the opening of new representative offices and branches abroad was announced, taking advantage of Chile's involvement in international markets through the different trade agreements.

transparency to banks' relations with customers within the framework of improving the self-evaluation performance system.

Banks face large challenges in 2005 including (i) the entry of banks into other businesses, (ii) the application of the new Basle II capital requirements, (iii) the extension of banking to certain sectors that still have no access to the financial system, and (iv) the achievement of higher levels of efficiency.

The Chilean financial system expects a positive year in 2005, with a strengthening of the Chilean economy and greater demand for financing that will enable a consolidation of its results and stabilization of its growth rates. This will require, among other things, additional efforts in risk control, the management of operating costs and innovation in products and services.