


economic and financial environment



During 2005, the global economy was noted for its great dynamism, mainly sustained on the growth in the United States and China.

International Outlook

The global economy showed positive growth during 2005 and the United States of America was no exception, producing growth of around 3.6% with private consumption being the main motor. The growth in this component of aggregate demand was mainly supported by low interest rates, especially during the first half of the year.

The Federal Reserve's monetary policy continued with the normalization process begun in July 2004, with consecutive increases in the reference interest rate. However, the rise in short-term interest rates had not been reflected in a significant rise in long-term rates until September 2005, despite being a key factor for the effectiveness of monetary policy. This, together with public spending that continued to expand strongly, generated a current account deficit in excess of 6% of GDP, this being one of the principal imbalances today faced by the global economy.

The Chinese economy, for its part, continued with its significant expansion process that has again enabled it to achieve a growth rate of over 9% despite its government's efforts to moderate the accelerated economic activity. The increase in exports allowed China to produce a record current account surplus. In July, the Chinese government announced a 2.1% revaluation of the yuan which, although marginal with respect to the effects that it could have caused to global trade, constitutes the first step in a process that could lead the Chinese currency to an equilibrium level as well as collaborating in reducing, although partially, the large imbalance with the American economy.

The news was promising in the case of Japan during 2005. The activity figures showed greater dynamism in the weakened domestic demand and positive inflation levels that lead us to expect the end of the deflationary environment that has affected the country for years. Europe, for its part, continued its sluggish growth trend, mainly the result of the inflexibility in the labor market. The European economy expanded by around 1.4% in 2005.

The Latin American economies showed some deceleration compared to the growth in 2004, mainly the consequence of the increase in international interest rates, a slower expansion of the global economy and less favorable external liquidity conditions. However, in general terms, they maintained a growth rate higher than that achieved in the first years of this decade. The principal progress was made in Argentina and Uruguay which, starting from very depressed bases, showed growth rates of 9.1% and 6.2% respectively. Venezuela also recorded growth of 9.4%, benefiting from the high oil prices during the year.

An important factor in the global economy in 2005 was the substantial rise in international oil prices, largely influenced by China's strong demand for commodities and the uncertainty about Middle East production levels. The 36% increase in the average price (WTI) during the year led to an increase in production costs, affecting global economic activity and substantially increasing inflationary pressures in the different countries.

The Chile we all want

Survey	Position of Chile	Higher position	Following position	Number of countries analyzed
Global Competitiveness (World Economic Forum)	27	Estonia	Spain	117
Economic Freedom (The Heritage Foundation)	14	Finland	Switzerland	157
Perception of Corruption (Transparency International)	21	Ireland	Japan	159
Governability (The World Bank)	23	Malta	Cayman Islands	209

Chile's economic environment in 2005

Chile has achieved outstanding global positions in the different measures of desirable attributes, with its solid macroeconomic fundamentals and a history of sustained growth and political and institutional stability. The global competitiveness index prepared by the World Economic Forum, places Chile as number 27 out of a total of 117 countries, notable being its first place in terms of macroeconomic management.

The Economic Freedom Index published by The Heritage Foundation, gives Chile 14th place out of 157 countries, in similar positions as countries like Finland and Switzerland. Transparency International publishes a world indicator of the perception of corruption in which Chile occupies 21st position out of 159 countries, showing ratings similar to countries like Belgium, Ireland, Japan and Spain. The World Bank prepares an indicator of governability where Chile occupies 23rd place out of 209 economies, being specially noted for the quality of its regulation.

In addition, Chile's country credit rating reflected an average of 65 basis points, reaching a record level in August (of 55 basis points). This variable was determined by the excellent economic fundamentals and the high degree of liquidity in the international capital markets.

These considerations, together with serious and consistent management in macroeconomic matters, the high level of institutionality of the country, the quality of supervision and the autonomy of the regulatory authorities, among other factors, have enabled Chile to be rated as investment grade by the principal international credit rating firms for some years now.

During 2005, Standard and Poor's maintained their A rating with stable prospects, while Moody's maintained a rating of Baa1 and up-graded its prospects to positive, noting the solid financial institutions, the stable and high economic growth and the good state of the external accounts. Finally, Fitch Ratings made an upgrade in March 2005, from A- to A, with stable prospects. It should be pointed out that the principal limitation for obtaining even higher ratings is the ratio of foreign debt to GDP, which is higher than other countries with a similar rating. However, a large part of this debt is private sector and includes a high proportion to subsidiaries of multinational companies with investments in Chile.

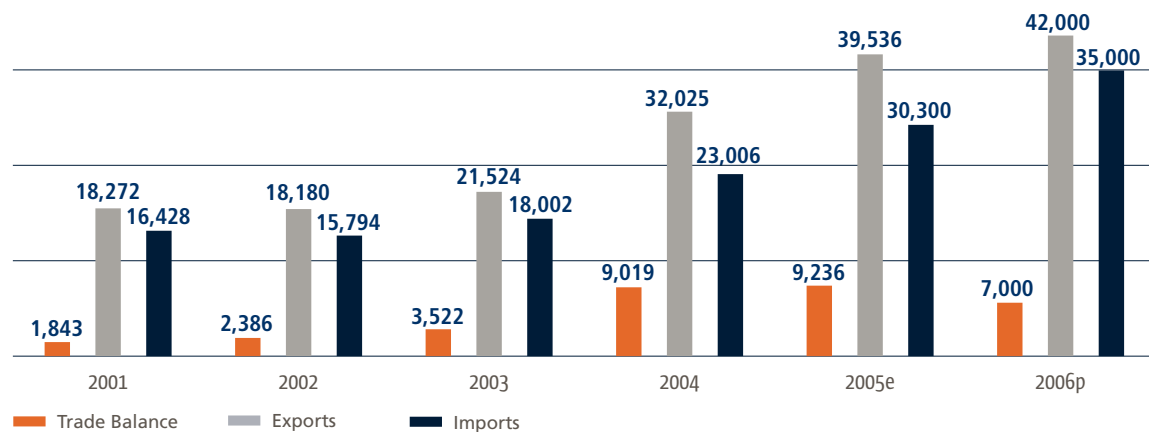
Investment and consumption sustained the good performance of the Chilean economy during 2005

Domestic demand became the principal protagonist in the expansion of the Chilean economy which has again generated GDP growth of over 6%. Investment was the component showing the greatest dynamism, producing growth rates even higher than 26% in the first quarter. This produced a ratio of real investment to GDP of over 29%, similar to the figures recorded in the early 1990s. Investment in machinery and equipment rose by close to 40% which was associated with low interest rates, the appreciation of the peso and the lower costs of imports, especially from China.

economic environment

Trade Balance

(millions of dollars)



Source: Central Bank of Chile

Private consumption also showed a significant acceleration in 2005 with a growth rate of around 7.3%, mainly explained by spending on durable goods.

Sector growth was led by construction and retail which produced real growth rates of over even 10% in the second quarter. The strong impulse for construction investment, especially in the first half of the year, came from the high activity in building permits. The strong growth in spending on durable goods had a positive impact on the retail sector. The sectors showing the weakest dynamism were mining and fishing. In the first case, the mining of areas abundant in by products (molybdenum), a reduction in mine ore yields and production problems caused by the earthquake affecting the north of the country in June, resulted in practically nil growth during 2005.

In the case of fishing, the reduction produced during 2005 was mainly due to the high comparison base and longer fishing ban periods. Finally, the industrial sector showed reduced growth compared to 2004, affected, among other things, by reduced woodpulp and textile production.

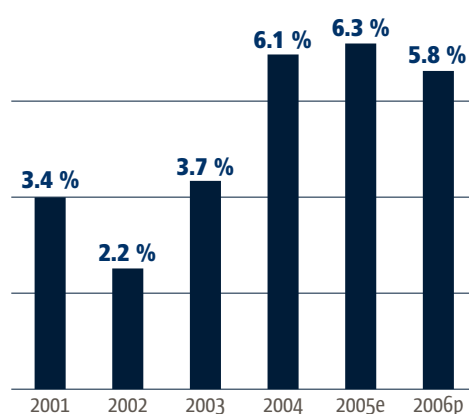
The external sector had a favorable year, benefiting from solid growth in the global economy and an important improvement in the terms of trade. The copper price rose by 28.4% compared to 2004, reaching peak levels of over US\$ 2 a pound. The principal reason for this rise was the huge demand from China, currently the world's largest consumer of copper. Exports totaled close to US\$ 40 billion in 2005, equivalent to growth of 23.5%

compared to 2004. On the other hand, the high level of domestic demand caused total imports to grow by 31.7%, basically explained by imports of capital goods related to the increase in investment.

Shipments from abroad were more than US\$ 30 billion, thus generating a trade surplus of over US\$ 9 billion. Despite this strong trade balance, there was a current account deficit of 0.4% in 2005, principally the result of the heavy remittances of profits by foreign companies, particularly those in the mining sector.

The high copper price and compliance with the structural surplus rule enabled the public sector balance to produce a surplus of 4.8% of GDP. Monetary policy, for its part, accelerated its process of normalizing the reference interest rate toward the end of the year, passing from 2.5% in January to 4.5% in December. The monetary policy interest rate reflected the objective of the Central Bank of Chile to hold inflation within a range of 2% to 4% over a 12-24 month horizon. In the second half of the year, the rise in oil prices was reflected in the economy through a large increase in fuel prices. This caused the inflation rate

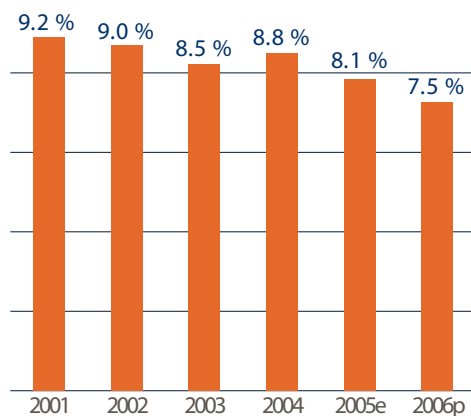
GDP Growth



Source: Central Bank of Chile

Unemployment Rate

(Annual Average)



Source: Central Bank of Chile

in December to be in the upper part of the target range, ending the year at 3.7%. But underlying inflation, which excludes perishable foods and fuels, ended the year at practically the middle of the target range (2.9%). The positive change in the terms of trade led to an important strengthening of the currency in real terms, resulting in an average nominal appreciation of the peso against the dollar of over 8% during 2005.

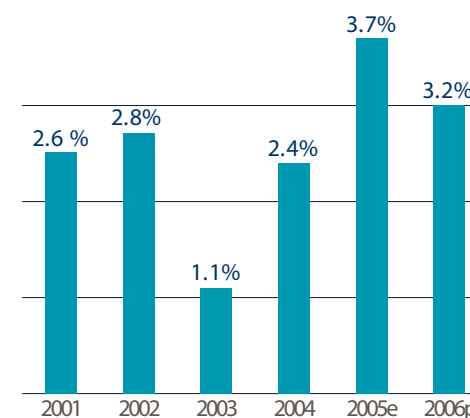
One of the most sluggish variables with respect to the recovery of the economy continues to be unemployment. However, job creation from April onward began to increase significantly, allowing the unemployment rate to decline to 8.1% in 2005, from the 8.8% recorded in 2004.

Expectations about the Chilean Economy for 2006

The strong growth in domestic demand observed toward the end of 2005 should continue during this year but at a slower rate. This would be the result of a less expansive monetary policy and fiscal spending at a higher rate than in 2005. Our projections indicate that the economy should grow at around 5.8% during 2006. Retail and construction will be the sectors leading the economy, led by changes in domestic demand. We also expect an important recovery in the fishing and mining sectors, taking into account in the latter case the higher production and investment projected for 2006.

Annual Inflation Rate

(annual change in CPI)



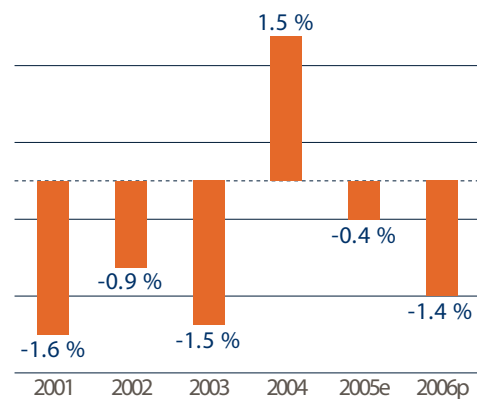
Source: Central Bank of Chile

In the global context, growth in the principal economies will tend to decelerate. It is forecasted that the United States will produce growth of about 3.3% while China will achieve growth of 8.7%.

The above will probably result in a fall in our terms of trade, particularly the copper price which should average at around US\$ 1.7 a pound, while oil should fall to levels of US\$ 60 per barrel to average at US\$ 59.

economic environment

Current Account/GDP



Source: Central Bank of Chile

External liquidity and financing conditions for emerging economies will be no better than in 2005, so sovereign spreads will show a slight rise.

It is expected that domestic long-term interest rates will continue their rising trend that began in the last months of 2005, while the monetary policy rate will continue to increase, but at a slower rate. We estimate that the reference interest rate should end 2006 within a range of 5.5% and 5.75%.

Inflation should end the year at around 3%, within the Central Bank's range, although it is probable that it will exceed 4.0% in the first months of 2006. Unemployment should continue to decline, ending the year with an average rate of 7.5%.

Finally, expectations for the external sector of our economy are mixed. The terms of trade should decline compared to the levels of 2005. However, the coming into effect of the free-trade agreement with China, and the consolidation of the different trade agreements signed earlier, will sustain positive prospects in the external sector. We think, particularly, that the current account balance will be in deficit and at around 1.4% of GDP, in line with the reduction in the trade surplus which we estimate will decline to US\$ 7 billion.

chilean financial system

The Chilean financial system is recognized around the world as the most solid in Latin America, sustained by a very stable political and economic environment and a modern and efficient regulatory framework. This is evident from the high international credit ratings that reputable rating agencies have granted to Chilean financial institutions in recognition of their consistent risk, profitability, solvency and management indicators.

Business volumes

The vigorous economic activity and low real interest rates of 2005 made a positive impact on loan growth. At the end of December 2005, loans, excluding interbank loans, amounted to Ch\$ 44,243,987 million, representing real growth of 14.3% in twelve months. This important increase in business volumes was driven by sustained growth in consumer and mortgage loans to the personal segment, growth that was in turn influenced by the favorable economic conditions, strong competition and low interest rates. Consumer loans increased by 20.6% while housing loans rose by 16.6%, driven mainly by the expansion of endorsable mortgage loans.

Loans to the businesses market were led by commercial loans which made up almost 42% of the system's total net loans, with 14.5% real growth compared to December 2004. This despite the important expansion of the substitutes for bank credit for this market, such as bonds and commercial paper, also driven by favourable stock market conditions and historically-low interest rates.

The expansion in business volumes was mainly financed by time deposits which grew by 22% during 2005 to Ch\$ 28,763,616 million. On the other hand, sight deposits, net of clearing, showed moderate real growth of 5.3%, reducing their proportion on loans (excluding interbank lending) from 19.7% in December 2004 to 18.2% in December 2005.

It is important to note that the expansion in loan volumes has been accompanied by an improvement in credit quality, reflected in lower levels of past due loans and a reduced charge on provisions for doubtful assets.

Financial institutions with the largest share of loans show a considerable dispersion. While the annual growth of the financial system was a real 14.3%, twelve entities achieved growth rates higher than that figure. Of the three entities with the largest shares in the market, two show growth rates higher than the system.

Chilean Financial System: Loans

(millions of real Ch\$ at December 2005, except for %)	Dec. 2004	Dec. 2005	% change
Loans, net of interbank	38,693,871	44,243,987	14.3%
Commercial Loans	16,118,061	18,459,983	14.5%
Other Mortgage Loans	4,149,000	5,709,520	37.6%
Consumer Loans	4,504,650	5,432,683	20.6%
Note-funded Mortgage Loans	5,709,239	5,120,528	-10.3%
Contingent Loans	2,882,356	3,431,391	19.0%
Foreign Trade Financing	2,885,889	2,926,940	1.4%
Leasing Contracts	1,684,880	2,132,706	26.6%
Other Current Loans	288,478	624,364	116.4%
Past Due Loans	471,318	405,872	-13.9%

Source: Superintendency of Banks and Financial Institutions

chilean financial system

Results

The financial system produced a net income for 2005 of Ch\$ 777,842 million which represents real growth of 12.9% compared to the year before. This was due principally to a greater gross margin, associated with the higher business volume and an increase in fee income. In addition, banks' constant efforts to improve their operating efficiency through the control of operating costs, together with a significant reduction in provisions for loan losses, were the main elements behind the increase in net income.

The net income of the financial system produced a return on average capital and reserves of 18.0% at December 2005, comparing positively with the 16.8% obtained the previous year. The efficiency ratio (Operating Expenses to Operating Income) also improved from 55.8% to 54.1%. As already mentioned, one of the outstanding factors behind the increased profit of the financial system was the low Provisions for Loan Losses, which as a percentage of net average loans, fell from 0.83% at December 2004 to 0.58% at December 2005. Similarly, the improvement in the financial system's loan quality is demonstrated by the Past Due Loans to Net Loans ratio, reducing from 1.22% to 0.92% during the same period.

The capital strength of the Chilean financial system is notable. The Basle ratio (Total Capital to Risk-Weighted Assets) was 13.0% at November 2005, substantially higher than the minimum of 8% under current regulations. This equity position constitutes an important strength for the industry in facing future expansion which will mainly come from introducing banking products and services to those segments which are still not served by the industry.

The fierce competition present in the sector, together with low interest and inflation rates, has led to a reduction in financial margins. This has been partly offset by growth in fee income related to new products and services. The share of net fee income in gross margin therefore increased from 15.9% in 2004 to 16.7% in 2005.

Service quality and modernization.

In order to successfully face this growing competition in a context of more flexible regulation and increasingly more demanding customers, the banking industry has placed special emphasis on the quality and coverage of banking services and on increasing efficiency through technological development. Banks have therefore continued to invest in technologies that enable them to reduce costs while expanding their capacity, coverage and the quality of their financial services. In terms of coverage, the increase in the number of branches should be mentioned. This has provided a wider coverage of the country, an effort that is in line with the extension of banking being promoted by both the banks and the regulators. Between September 2004 and September 2005, the number of branches increased from 1,492 to 1,570, with 78 new distribution points being added to the network. The automated teller machine network has equally been expanded, reaching 4,510 machines at September 2005, 509 more than at the end of the year before. This led to a 27% expansion in the number of transactions in annualized terms. There were also 5.2 million debit cards issued at June 2005.

In the virtual banking area, strong competition has been developing among the institutions for innovating and expanding the services offered via the Internet. At June

Chilean Financial System: Results

(millions of real Ch\$ at December 2005, except for %)	2004	2005	Var. Real
Gross Margin	2,396,723	2,570,916	7.3%
Operating Expenses	-1,337,539	-1,391,537	4.0%
Net Margin	1,059,184	1,179,379	11.3%
Provisions for loans losses	-298,803	-235,072	-21.3%
Operating Income	760,380	944,307	24.2%
Non-Operating Income	59,838	-5,042	-108.4%
Other Net Non-Operating Income	-14,857	-35,445	138.6%
Result of Foreign Branches	3,480	-6,723	-293.2%
Minority Investments in Companies	128,126	124,029	-3.2%
Price-Level Restatement	-56,911	-86,903	52.7%
Pre-Tax income	820,219	939,265	14.5%
Provision for Taxes	-131,096	-161,423	23.1%
Net Income for the Year	689,122	777,842	12.9%

Source: Superintendency of Banks and Financial Institutions

The Chile we all want

Chilean Financial System: Indicators		
(annualized when corresponds)	2004	2005
Profitability		
Net income / Average Capital & Reserves	16.8%	18.0%
Net income / Average Equity (ROAE)	15.3%	16.4%
Net income / Average Assets (ROAA)	1.16%	1.25%
Fee Income / Gross Margin	15.9%	16.7%
Efficiency		
Operational Expenses / Gross Margin	55.8%	54.1%
Operational Expenses / Average Productive Assets	2.91%	2.80%
Asset Quality		
Past-Due Loans / Net Loans	1.22%	0.92%
Provision for Loans Losses/ Average Net Loans	0.83%	0.58%
Risk Ratio	1.99%	1.61%
Capital Adequacy		
Total Capital / Risk-Weighted Assets	13.5%	13.0%
Basic Capital / Risk-Weighted Assets	10.5%	10.0%

Source: Superintendency of Banks and Financial Institutions

2005, the banks reported a total of 923 thousand customers who made some kind of transaction by Internet, an increase of 50 thousand over December 2004.

Combanc started to operate in December 2005. This is a payments system operated by a support company in which Banco de Chile has an 11.6% interest. Combanc enables banks, and through them their customers, to make high-value payments with immediately-available funds. The system complements the LBTR (Gross Real-Time Settlement) system promoted by the Central Bank and inaugurated in April. These modernizations are intended to raise efficiency levels and align high-value payment systems to international standards.

Regulations

The Central Bank modified the regulations concerning derivative product transactions, authorizing banks to offer purchase and sale options in currencies, indexation units and interest rates. This initiative is designed to promote the development and depth of the Chilean financial market, expanding the local offer of financial risk hedging instruments. In addition, the Central Bank of Chile and the Superintendency of Banks presented a proposal for regulations concerning the issue and operation of non-bank credit cards, taking into account recent developments in the payments industry.

With respect to the new capital adequacy regulatory framework, known as Basle II, important progress was made during 2005 in the definition of the different stages for its implementation which should be completed by the end of 2007. In May 2005, the Superintendency of Banks published a route map for the implementation of Basle II, which meant that bank boards have to approve their plans for this matter. Rules for the management of market risks

came into effect in the second half of 2005, leading banks to formalize their strategies, measurement methods and limit structures for these risks. Finally, the Superintendency in December published new accounting rules for financial, derivative and hedging instruments that will come into force in 2006.

Prospects for 2006

The prospects for the banking industry in 2006 are seen as favorable given the good macroeconomic scenario expected for the year. It is possible that there will be a tightening of margins during 2006, especially in the companies and large corporations segment, as has occurred in recent years. A substantial development of derivative products is also expected following the opportunities opened up by the regulation. In the market for persons, competition between banks and non-bank entities will drive continuous innovation and efforts to reduce costs. This will undoubtedly mean the incorporation of a large number of new banking customers, principally from those segments that are still not well served by banks.

Efforts in the internationalization area will also help increase business and support customers. The Superintendency of Banks and Financial Institutions has authorized Banco de Chile to operate in Beijing, China, through a representative office, and also authorized Banco BCI to open a representative office in Hong Kong and Banco del Estado to open a branch in New York.

The principal challenges facing local banks in the coming years will be constant competition in a mature financial market, the opening up of banking to segments that still have no access to the financial system, the achievement of greater efficiency, the prudent management of credit risk and market exposures, full compliance with regulatory requirements, principally relating to the application of the Basle II guidelines and the perfecting of internal corporate governance rules.