



REPUBLIC OF CHILE
Ministry of Finance

ECONOMIC AND SOCIAL STABILIZATION FUND

Second Quarter, 2008

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I. INTRODUCTION

As of June 30, 2008, the Economic and Social Stabilization Fund (ESSF) had a market value of US\$18,770.38 million. During the second quarter, contributions of US\$1,900 million were paid into the fund. However, it showed a net drop of US\$321.61 million in capital and interest income, representing an Internal Rate of Return (IRR) in US dollars¹ of -1.81% for the quarter.²

The fund's value evolution during the second quarter is explained by the rise of almost 90 bps in sovereign bonds yields –in spite of the 25 bps cut in the Federal funds rate in the US- and by the impact of the exchange rate movements in the currencies held in the portfolio. The ESSF's IRR in local currency was -1.04% for the quarter.

The present report is divided into two parts. The first section provides information about the ESSF's performance during the second quarter and the composition of its portfolio by currency and type of risk while the second part contains an explanation, prepared by the Fiscal Agent, of the behavior of the markets that affected the ESSF's investments during the period.

¹ Henceforth, referred to simply as dollars.

² Unless otherwise indicated, the rate given is the non-annualized rate for the period in question.

II. MARKET VALUE AND PERFORMANCE OF THE ESSF

The Economic and Social Stabilization Fund (ESSF) was established on March 6, 2007 and its management was entrusted to the Central Bank of Chile (CBC) which acts as Fiscal Agent. However, formal monitoring of its performance did not begin until April 1, 2007, after the implementation of its investment policy. The starting date for all comparisons with the benchmark is, therefore, March 31, 2007.

II.1. Market Value of the ESSF

As of June 30, the ESSF held assets worth US\$18,770.38 million. The variations in its market value are set out in the table below:

Table 1: Market Value of ESSF

Market value (US\$ million)	2007	Q1 2008	Q2 2008			Total
			April	May	June	
Starting value	-	14,032.61	17,191.98	17,251.33	17,132.33	
Contributions	13,100.00	2,100.00	400.00	-	1,500.00	17,100.00
Change in value	932.61	1,059.38	-340.66	-119.00	138.05	1,670.38
Final value	14,032.61	17,191.98	17,251.33	17,132.33	18,770.38	

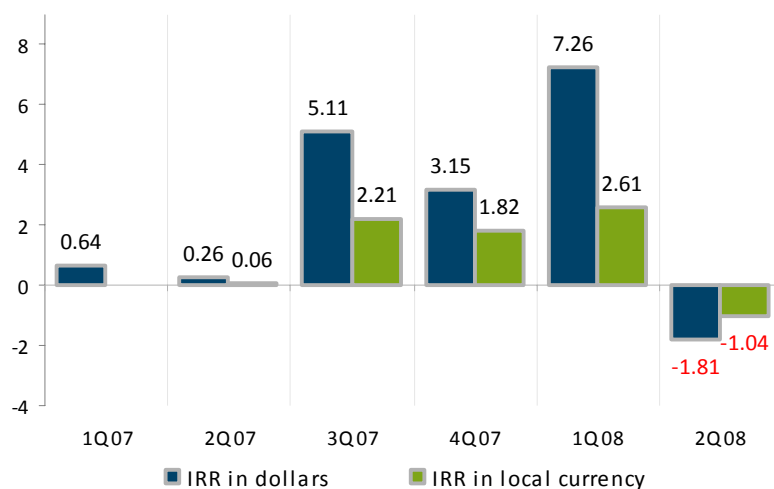
Source: JP Morgan

During the second quarter of 2008, the ESSF's market value decreased by US\$321.61 million, representing an IRR for the period of -1.81%.

Since its inception, the value of the ESSF at market prices has shown a net increase in capital and interest income of US\$1,670.38 million, equivalent to an annualized IRR in dollars of 11.15%.

The figure below shows the fund's quarterly IRR in dollars and in local currency.

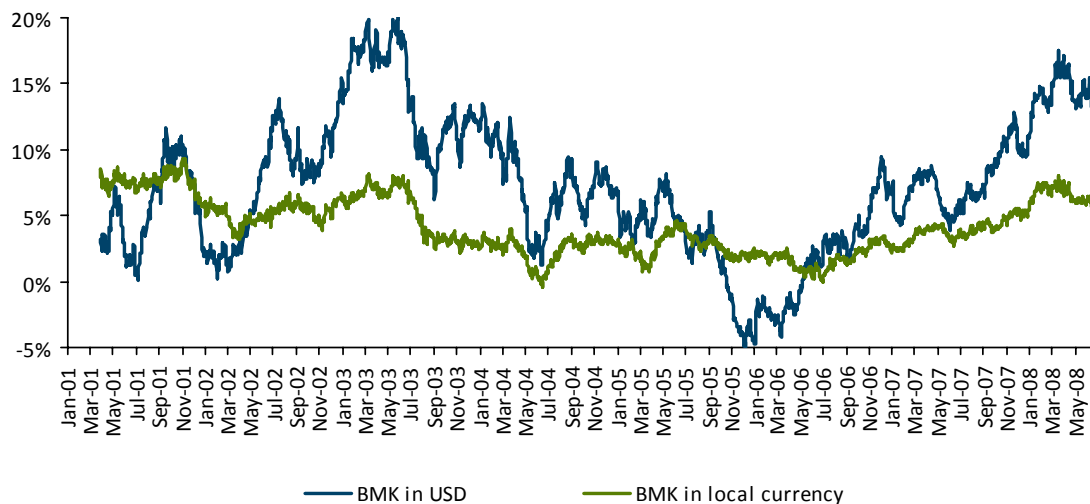
Figure 1: Quarterly IRR in Dollars and Local Currency³
(percentage points)



Source: Dipres based on data provided by JP Morgan and Bloomberg

Analysis of the historic performance of the benchmark portfolio shows that the return in dollars during the first quarter of 2008 and subsequent adjustments in the second quarter are similar to those seen between 2001 and mid-2004 during the US Federal Reserve's last expansive monetary-policy cycle. As shown in Figure 2, the benchmark registered higher annual returns - measured in dollars - for almost two years as from mid-2002 before entering a two-year cycle of decreasing returns.

³ Annualized compound rate. The fund started regular operations on April 1, 2007.

Figure 2: Moving Annual Return on the Benchmark in Dollars and in Local Currency

Source: Dipres based on data provided by JP Morgan and Bloomberg.

In the second quarter, the composition of the ESSF by type of risk and currency, expressed in dollars,⁴ was as follows:

Table 2: Composition of the ESSF by Asset Class, Currency and Duration

Assets	Original currency	2 nd quarter 2008 (US\$ million)		
		April	May	June
Sovereign	USD	6,126.30	5,772.91	6,622.90
	EUR	4,939.45	4,895.99	5,356.97
	JPY	1,138.71	1,152.89	1,269.45
Agencies	USD	-	-	-
	EUR	-	-	-
	JPY	-	-	-
Bank	USD	2,562.47	2,870.67	2,692.60
	EUR	1,944.08	1,936.21	2,220.43
	JPY	540.31	503.65	608.03
Total		17,251.33	17,132.33	18,770.38
Duration	(years)	2.48	2.34	2.30

Source: JP Morgan

⁴ According to JP Morgan, the exchange rates used at the close of the month were:

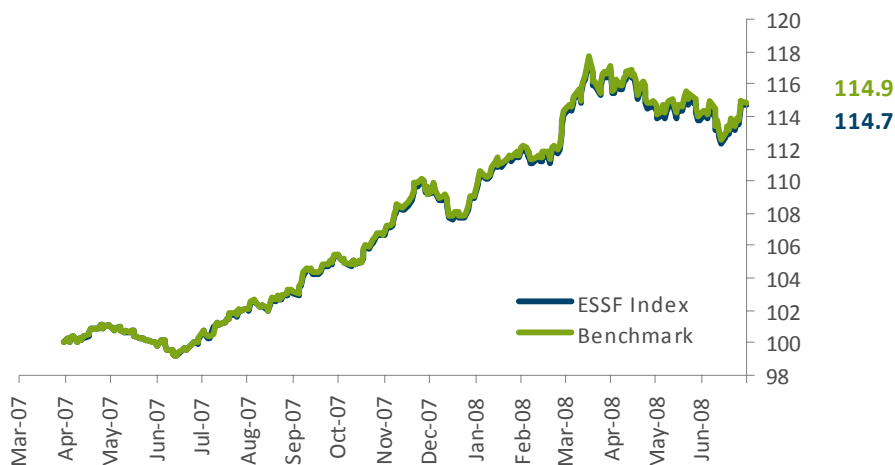
April 30 : 1.5569 USD/EUR and 104.510 JPY/USD
 May 29 : 1.5540 USD/EUR and 105.565 JPY/USD
 June 30 : 1.5755 USD/EUR and 106.005 JPY/USD

II.2. Performance of the ESSF

II.2.1 Performance of Financial Investments

Figure 3 sets out the performance of the ESSF measured using an index⁵ that shows daily variations in the market value of its portfolio expressed in dollars. The base value is 100 as of March 31, 2007.

Figure 3: ESSF Index vs. Benchmark
(March 31, 2007 = 100)



Source: Dipres based on data provided by JP Morgan, CBC and Bloomberg

In the second quarter of 2008, the index showed a return of -1.87% in comparison to -1.88% for the benchmark. As from March 31, 2007, the index registered an annualized return of 11.71% while the equivalent figure for the benchmark was 11.89%.

⁵ Unlike the IRR, this indicator excludes the effect of net cash flows (contributions minus withdrawals) on the fund's return.

The table below provides a summary of the return of both the index and the benchmark in dollars and in local currency:

Table 3: Returns on the ESSF
(In dollars and local currency)

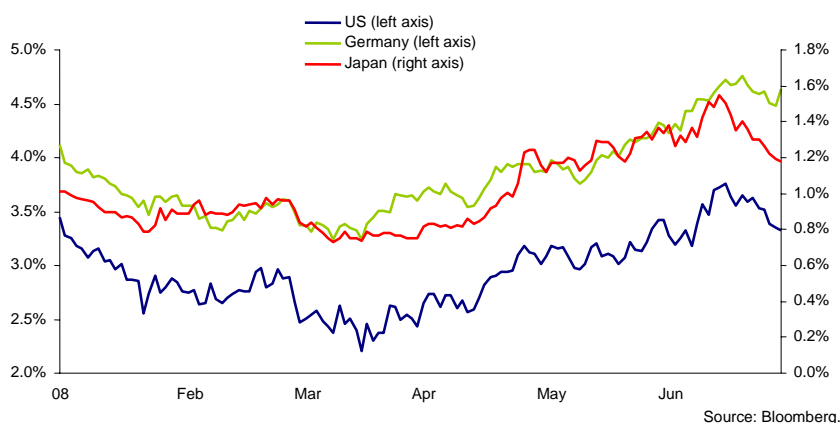
	Return	Q2	Accumulated since March 31, 2007 (annualized)
Dollars	ESSF Index	-1.87%	11.71%
	Benchmark	-1.88%	11.89%
	Return differential	0.01%	-0.18%
Local Currency	ESSF Index	-1.07%	4.70%
	Benchmark	-1.08%	4.87%
	Return differential	0.01%	-0.17%

Source: Dipres

III. BEHAVIOR OF RELEVANT MARKETS IN THE SECOND QUARTER

In the second quarter of 2008, the yield on sovereign bonds rose as a result of an increase in the risk of inflation which was, in turn, explained by the behavior of oil prices.

Figure 3: Interest Rates on 5-Year Bonds



III.1. Main Economic Trends

In the **United States**, the Federal Open Market Committee (FOMC) decided to reduce the monetary-policy interest rate by 25 basis points to 2%. This decision, which was anticipated by the market, was a response to a deterioration in the outlook for the US economy and occurred in a context in which the consumer price index closed the quarter with an annual increase of 4.2%. Unemployment reached 5.5%, up from 5.1% at the close of the previous quarter. Consumer and business confidence continued to weaken over the quarter.

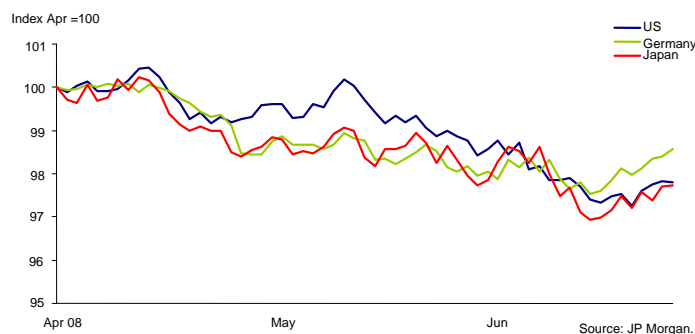
In the **Euro Zone**, inflation remained high, closing the quarter at an annual rate of 3.7%, while core inflation closed at 1.7%. Nonetheless, the European Central Bank held its monetary-policy interest rate at 4.0%. The labor market remained dynamic, with the unemployment rate reaching 7.3%. The main indicators of activity as well as consumer and business expectations weakened during the quarter.

In **Japan**, the monetary authority held the policy rate at 0.5%. In June, the consumer price index showed an annual increase of 1.3% while core inflation, at -0.1%, remained negative. Unemployment rose marginally from 3.8% to 4.0% at the close of the quarter.

III.2. Fixed-Income Market

In the second quarter, the increase in interest rates meant that fixed-income sovereign instruments performed negatively as regards total returns (**Figure 4**).

Figure 4: Index of Total Returns, 1-10 Year Sovereign Bonds⁶



III.3. Main Spreads on Portfolio Securities

The agencies spread⁷ closed the quarter at the same level as at the beginning of the quarter (**Figure 5**). However, as regards total returns, 5-year agency bonds performed slightly better than the equivalent Treasury bills.

An increase in adjustment for inflation meant that the yield on US Inflation-Linked Bonds (TIPS)⁸ was higher than on nominal US Treasury bills. This resulted in an increase in the TIPS spread⁹ during the quarter.

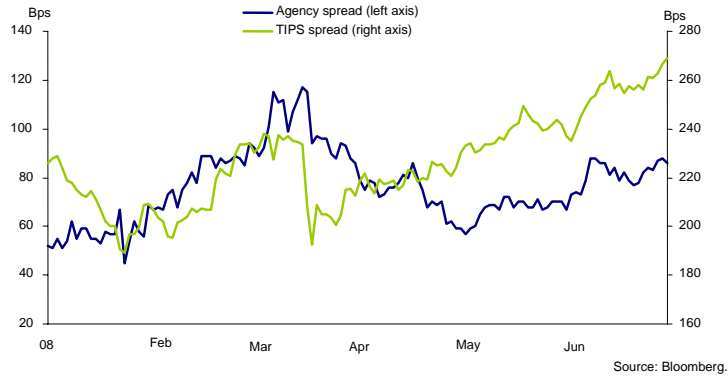
⁶ Total return expressed in the original currency.

⁷ Agency Spread: Yield on an agency bond minus the yield on a US Treasury bill of an equivalent maturity.

⁸ TIPS: Treasury Inflation-Protected Securities.

⁹ TIPS Spread: Yield on a US Treasury bill minus the yield on TIPS of an equivalent maturity.

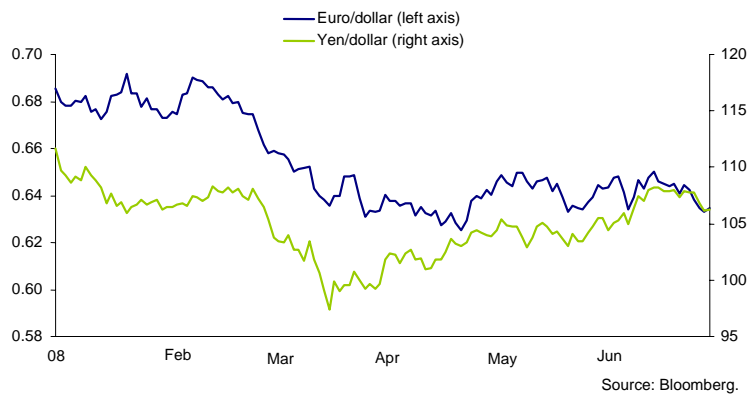
Figure 5: Agency and TIPS Spread on 5-Year Bonds



III.4. Exchange Rates

Despite an increase in the yield differential in favor of Europe, the euro/dollar exchange rate appreciated by 0.57% in the second quarter while the yen/dollar rate increased by 6.50% (Figure 6). As a result, the appreciation of the euro against the yen reached 5.9%.

Figure 6: Euro/Dollar and Yen/Dollar Exchange Rates



IV. APPENDIX 1: POSITIONS WITH SOVEREIGN ISSUERS AND FINANCIAL INSTITUTIONS

The Fiscal Agency has investments in **Sovereign Bonds** of the United States, Germany, France and Japan.

ESSF and PRF Banks with Deposits, June 30, 2008

- 1 ABN AMRO BANK NV, AMSTERDAM
- 2 ALLIANCE AND LEICESTER PLC, LEICESTER
- 3 ALLIED IRISH BANKS, DUBLIN
- 4 BANCO BILBAO VIZCAYA ARG, SA, MADRID
- 5 BANCO BILBAO VIZCAYA ARG, SA, N. YORK
- 6 BANCO ESPIRITO SANTO SA, LONDON
- 7 BANCO SANTANDER CENTRAL HISPANO SA, N. YORK
- 8 BANK AUSTRIA CREDITANSTALT AG, VIENNA
- 9 BANK OF MONTREAL, LONDON
- 10 BARCLAYS BANK PLC, LONDON
- 11 BAYERISCHE HYPO-UND VEREINSBANK AG, MUNICH
- 12 CAIXA GERAL DE DEPOSITOS SA, N. YORK
- 13 CAJA DE AHORROS Y PENSIONES DE BARCELONA, BARCELONA
- 14 CALYON CORPORATE AND INVESTMENT BANK, LONDON
- 15 CREDIT INDUSTRIEL ET COMMERCIAL (CIC), LONDON
- 16 DEKABANK DEUTSCHE GIROZENTRALE, FRANKFURT
- 17 DEPFA BANK PLC, DUBLIN
- 18 DEXIA BANK BELGIUM SA, BRUSSELS
- 19 DEXIA CREDIT LOCAL SA, PARIS
- 20 DZ BANK AG DEUTSCHE ZENTRAL-GENOSS., FRANKFURT
- 21 FORTIS BANK SA/NV, BRUSSELS
- 22 HSBC FRANCE, PARIS
- 23 HSH NORDBANK AG, KIEL
- 24 ING BANK NV, AMSTERDAM
- 25 INTESA SANPAOLO SPA, N. YORK
- 26 LANDESBANK BADEN-WÜRTTEMBERG, STUTTGART
- 27 MIZUHO CORPORATE BANK LTD., LONDON
- 28 NATIXIS, PARIS
- 29 NORDDEUTSCHE LANDESBANK GIROZENTRALE, LONDON
- 30 NORDEA BANK FINLAND PLC, HELSINKI
- 31 SVENSKA HANDELSBANKEN AB (PUBL), STOCKHOLM
- 32 THE ROYAL BANK OF SCOTLAND PLC TCM, LONDON
- 33 UBS AG, ZURICH
- 34 UNICREDITO ITALIANO SPA, LONDON

V. APPENDIX 2: FINANCIAL INTERMEDIARIES USED BY THE FISCAL AGENT**ESSF and PRF****Intermediaries used between January and June 2008**

- 1 BANK OF AMERICA SEC. LLC, USA
- 2 BARCLAYS CAPITAL INC., USA
- 3 BAYERISCHE HYPO-UND VEREINSBANK AG, MUNICH
- 4 BNP PARIBAS SECURITIES CORP., USA
- 5 CALYON CORPORATE AND INVESTMENT BANK, NY.
- 6 COMMERZBANK AG, FRANKFURT
- 7 DEUTSCHE BANK AG, FRANKFURT
- 8 DRESDNER BANK AG, FRANKFURT
- 9 DZ BANK AG DEUTSCHE ZENTRAL-GENOSS., FRANKFURT
- 10 GOLDMAN, SACHS & CO., USA
- 11 GREENWICH CAPITAL MARKETS, INC., USA
- 12 HSBC SECURITIES (USA) INC., USA
- 13 J.P. MORGAN SEC. LTD., U.KINGDOM
- 14 J.P. MORGAN SECURITIES, INC., USA
- 15 LANDESBANK BADEN-WÜRTTEMBERG, STUTTGART
- 16 LEHMAN BROTHERS INC., USA
- 17 MERRILL LYNCH GOV. SEC. INC., USA
- 18 MERRILL LYNCH INTL., U.KINGDOM
- 19 MIZUHO SECURITIES USA INC., USA
- 20 MORGAN STANLEY & CO. INC., USA
- 21 NATIXIS, FRANCE
- 22 SOCIÉTÉ GÉNÉRALE, FRANCE
- 23 THE ROYAL BANK OF SCOTLAND PLC TCM, LONDON
- 24 THE ROYAL BANK OF SCOTLAND PLC, LONDON
- 25 UBS LIMITED, U. KINGDOM
- 26 UBS SECURITIES LLC, USA

VI. INVESTMENT LIMITS

A. Credit Risk

The ESSF's investments must fulfill the following credit-risk conditions and requirements:

The eligible issuers are:

Asset Class (Risk)	Upper Limit
Sovereigns	100%
Multilaterals	60%
Banks	50%
Agencies	30%

A.1 Sovereign Risk

The eligible countries are those, other than Chile, that over the previous 24 months have held a long-term risk classification equivalent to **A-** or higher issued at least by two of the following international credit rating agencies: Fitch, Moody's and Standard & Poor's.

Investment limits for eligible sovereign risk (between **AAA** and **A-**) are:

Risk Classification	Upper Limit
AAA	100%
AA+	90%
AA	
AA-	
A+	30%
A	
A-	

A.2 Supranational or Multilateral Risk

The eligible international organizations are those with a long-term risk classification equivalent to **AA-** or higher issued at least by two of the following international credit rating agencies: Fitch, Moody's and Standard & Poor's.

Investment limits for eligible multilateral risk (between **AAA** and **AA-**) are:

Risk Classification	Upper Limit (US\$ million)
AAA Aaa	800
AA+ Aa1	
AA Aa2	600
AA- Aa3	

A.3 Bank Risk

The methodology for selecting banking institutions and assigning limits is based on international risk classifications and the size of the institutions.

Eligible institutions are those that have a long-term risk classification of **A-** or higher issued at least by two of the following international credit rating agencies: Fitch, Moody's and Standard & Poor's, and a minimum shareholders' equity equivalent to **US\$1,000 million**.

Investment limits by institution are expressed in discrete intervals according to the table below:

Risk Classification	Upper Limit (US\$ million)
AAA Aaa	600
AA+ Aa1	
AA Aa2	400
AA- Aa3	
A+ A1	
A A2	300
A- A3	

A.4 Agency Risk

The eligible agencies are those in the United States with a long-term risk classification equivalent to **AAA** issued at least by two of the following international credit rating agencies: Fitch, Moody's and Standard & Poor's, and a minimum shareholders' equity equivalent to **US\$1,000 million**. Investment in any one agency may not exceed **US\$800 million**.