The Chilean Inflation Targeting Experience and the Challenges Ahead

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Agenda

1. The Development of the Framework
2. The Results of the IT Framework
3. Recent Challenges to IT-Regimes

1. The Development of the Monetary Framework

Monetary policy framework

- ✓ Chile had a long history of high and variable inflation that extended from the early 1930s to the end of the 1980s.
- ✓ This was put to an end with the creation in October of 1989 of an autonomous Central Bank with a constitutional mandate to pursue price stability.
- ✓ Early on the Bank Board decided to fulfill its mandate using a combination of active monetary policy and an adjustable exchange rate band.

Monetary policy framework

- ✓ This monetary policy framework converged later on to a full-fledged flexible inflation targeting regime with a two year policy horizon.
- ✓ As the annual inflation rate at the time was close to 30%, inflation targeting was early on a strategy to reduce inflation from high levels.
- ✓ Furthermore, to minimize output loses, price stability was to be pursued gradually.

2. The Performance of the IT Framework

The performance of the IT regime

- ✓ Achieving price stability has been a difficult objective. However, the current monetary policy regime has made a great improvement in reducing and stabilizing inflation, while decreasing its inertia. ⇨
- ✓ Together with bringing down inflation, a reduction in the volatility of both inflation and output growth was achieved. ⇨
- ✓ To isolate the contribution of the monetary regime from other reforms and shocks is a difficult task, but there is evidence that IT regimes have made an important contribution.
  - ✓ MP efficiency is still higher for IT countries in control group comprised by NITers and IT countries (Mishkin and Schmidt-Hebbel (2007)).

3. Recent Challenges to IT-Regimes

Recent Challenges to the IT regimes

- ✓ IT regimes had been put under great stress by two recent phenomena: The sharp rise in commodity prices of 2007-2008 and the financial crisis.
  - ✓ **"The ability to deal with demand shocks and financial crises can be enhanced by a commitment to an explicit (inflation) target"** Walsh (2009)
- ✓ For the first shock, the appropriate response calls for making an assessment of the durability of the shock, to monitor its effects on inflation expectations and to design an appropriate monetary response.
- ✓ This boils down to an estimation of the implications of the shock for inflation expectations and trend inflation.

Recent Challenges to the IT regime

- ✓ In forward looking and highly credible IT regimes the challenge is to calibrate a monetary response that will not put the credibility of the regime in jeopardy.
- ✓ In the process inflation will exceed the target for a (transitory) period.
  - ✓ But the authority must respond with clear MP actions when expectations start to diverge from the target in a more persistent way.
- ✓ Chile managed this challenge quite well.

Recent Challenges to the IT regime

- Much has been discussed with respect to the role that monetary policy should play to promote financial stability.
  - There is no question that asset prices will play a larger role in monetary policy rules than what e have seen thus far.
  - Here there is a trade-off between errors in identifying bubbles in asset prices and errors resulting from allowing a bubble to develop, which later on may generate a heavy cost when it bursts.

Recent Challenges to the IT regime

  - ✓ But the use of interest rates will have to be complemented with a counter-cyclical regulation (an additional policy instrument is required to accomplish two policy objectives).
  - ✓ Also a closer collaboration with the regulatory and supervisory authority has to be in place.
- ✓ Central Banks will have to work also on:
  - ✓ Preparing crisis management manuals with rules that contribute to reduce moral hazard risk and limit the role of power groups.
    - ✓ This will provide more transparency to their role as lenders of last resort.

Recent Challenges to the IT regime

- ✓ Widening the traditional instruments and channels to provide liquidity to the economy in times of stress.
- ✓ Developing specific mechanisms for international coordination.
- ✓ Avoiding the creation of implicit insurance for financial institutions with potentially large systemic effects.
- ✓ Strengthening pre-financed deposit insurances schemes.
- ✓ With monetary policy rates close to zero, the distinction between monetary and fiscal policy tends to disappear, which represents a major challenge for the monetary authorities.

Recent Challenges to the IT regime

- Theorist and central bank practitioners will have also to focus and decide on the following issues:
  - The appropriateness of interest smoothing rules when risks are heavily biased in one direction.
  - The use of a higher inflation targets to minimize likelihood of hitting the interest rate zero bound
  - The extension of standard policy horizons (Mishkin)
  - The complementary use of conventional IR and unconventional MP instruments (quantitative and credit easing) when the IR is close to the zero bound.

Recent Challenges to the IT regime

- The inclusion of more argument(s) in MP objective and policy functions: credit growth and/or asset price gaps
- The use of a larger weight on output gap in objective function.

- The financial crisis has raised another issue, the capacity to use counter-cyclical macro policies to deal with the external shock arising from the Great Recession.
  - Countries with a credible IT regime, strong fiscal fundamentals and a sound financial system have been able to pursue aggressive counter cyclical policies.
  - Again, Chile has used this opportunity quite well.

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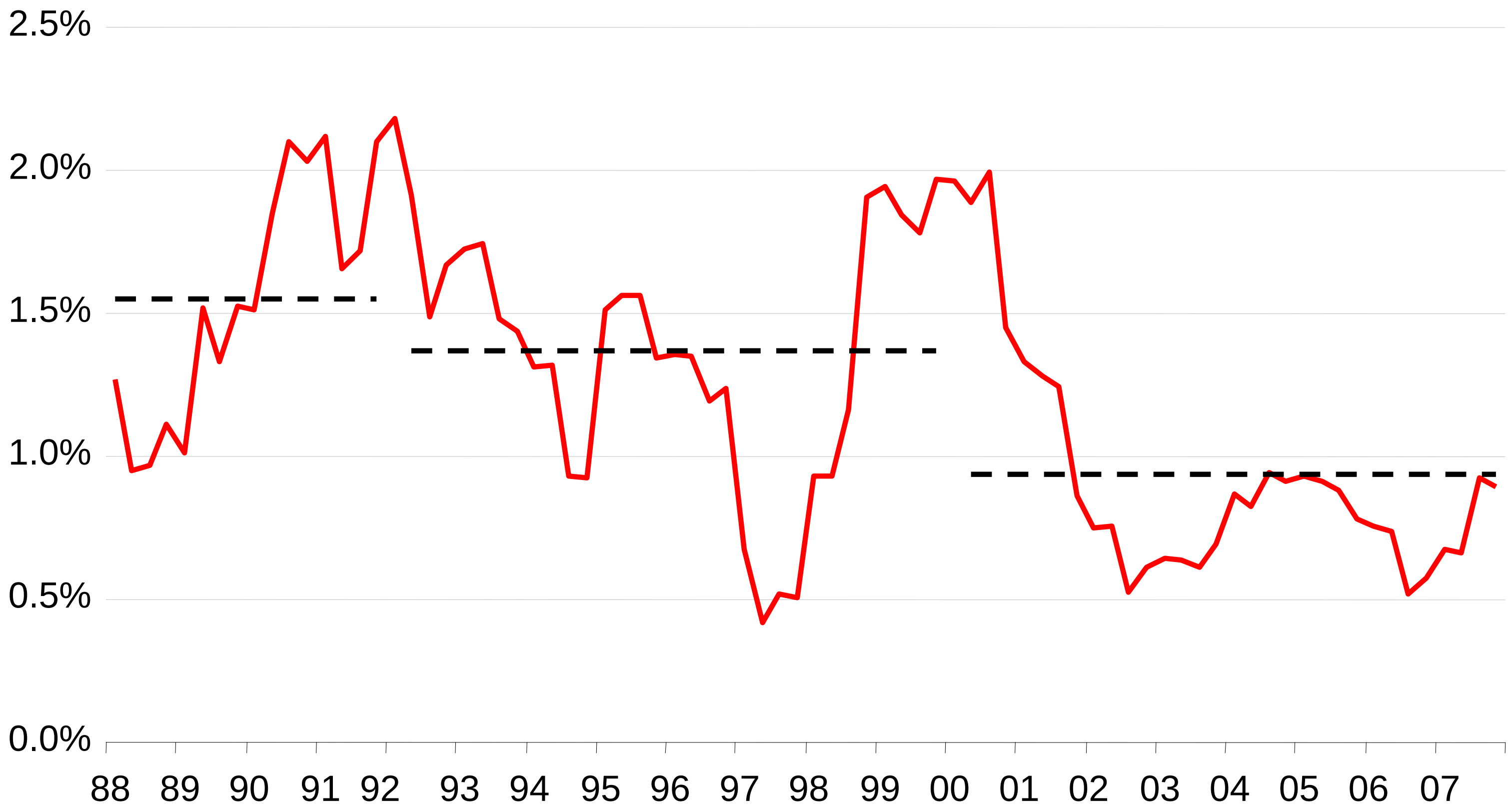
Inflation dynamics
(Annual average based on quarterly data, percent)

	1960-1989	1990-1999	2000-2007
Average	76.1	11.8	3.1
Standard Deviation	135.2	7.3	1.3
Persistency I (1)	0.957	0.982	0.944
	1986-1989	**1990-1999**	**2000-2007**
Persistency II (2)	1.047	1.078	0.755
	1985-1989	**1990-1999**	**2000-2007**
Average inflation expectations (3)	20.0	13.4	3.1

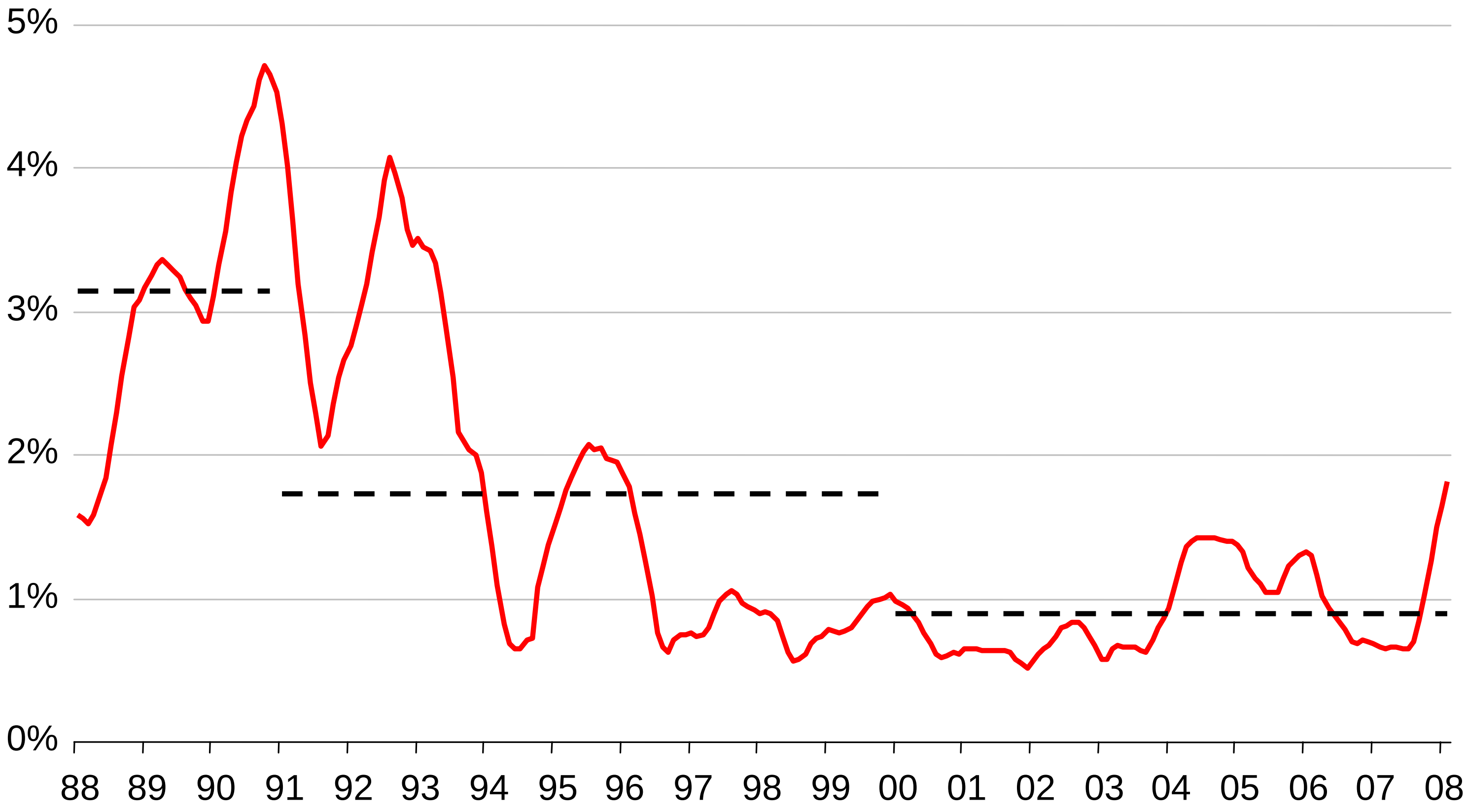
(1) Persistency I considers the coefficient of lagged inflation in the regression inflation = a + b inflation (-1).
(2) Persistency II considers the coefficient of lagged inflation in the regression inflation = a + b inflation (-1) + c output gap.
(3) The difference between the nominal deposit rate and the CPI indexed deposit rate for operations of one to three years.
Source: Central Bank of Chile.

Growth Volatility



Note: Standard deviation of rolling – eight quarters window.

Inflation volatility



Note: Standard deviation of rolling (annual variation) – 24 months window.