Globalization, disinflation and monetary policy

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1. Introduction
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- Globalization has affected the way monetary policy is conducted at the Central Bank of Chile:
  - The country is facing a large and persistent change in relative prices together with terms of trade gains.
  - The transmission channel of monetary policy to inflation has changed.
  - Stricter and better defined standards for the monetary policy regime and the conduct of macroeconomic policy are imposed by more integrated markets.
2. Changes in relative prices

- The prices of manufactures have fallen continuously in the last fifteen years.
- In Chile, the price of imported consumer goods has dropped by an average of 2.5% each year for the last ten years.
- During 2005 inflation of goods, excluding oil and perishables, was 1.5%, significantly below the target (3%) and total CPI inflation (3.1%).
Consumption: Unit value import index

(annual growth, quarterly moving average, %)

Source: Central Bank of Chile.

CPI Inflation for goods and services

(index; April 1989=100, quarterly)

Note: CPI goods-x excludes oil and perishables.
Sources: Central Bank of Chile and National Bureau of Statistics.
Changes in relative prices

- The relative prices change is likely to continue for a while, as more goods are going to be produced at a lower cost elsewhere.
- That poses a challenge for achieving the inflation target.
  - Reducing the target is dangerous (credibility), not desirable (relative prices distortion) and most likely ineffective (nominal, not real).
  - It is better to lower interest rates, let internal demand speed up and push non-tradable goods inflation above the target.

Aggregate margins

Panel a: Overall share

Panel b: Extensive and intensive margins

Panel c: Price and quantity Index

Source: Alvarez and Claro (2006)
3. Monetary policy transmission channel

- In Chile, as in many other countries, the Phillips Curve has become flatter (Céspedes and Soto, 2006; Caputo, Medina and Soto, 2006).
- Longer-term interest rates seem more linked to international interest rates and less affected by short-term domestic ones.
- A larger part of GDP is tradable and international prices are not determined domestically.
- The above means that it has become more costly to reduce inflation, and larger changes in the MPR could be needed to affect long-term market rates.
Imports to GDP ratio in Chile

(annual moving average, %)

Source: Central Bank of Chile.

The flattening of the Phillips Curve due to globalization implies:

- Increased need to closely monitor international events:
  - Meetings with international institutions e.g., IMF, BIS.
  - Highly specialized unit on global markets.
- Credibility of monetary policy has become a very valuable asset.

MP transmission channel
Inflation expectations

Source: Central Bank of Chile.

Expected inflation coefficient

Note: This chart shows the rolling coefficient of inflation expectations in a standard Phillips curve equation, where the sample begins in 1985 and ends in the indicated date.

Source: Central Bank of Chile.
4. Concluding remarks

Conclusion

- Globalization has brought many challenges upon MP. It has also facilitated:
  - More interaction on policy and technical issues.
  - Better understanding of the do’s and do-not’s.
- Deviations from best practices have economic and political consequences.
- Globalization also encourages macro discipline:
  - Punishment for misbehavior is global.
  - Massive speculative attacks are more likely.
- Standard of IT + floating ER regime has gained broad consensus in Chile.
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