



Challenges in Implementing an Inflation Targeting Regime

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Outline

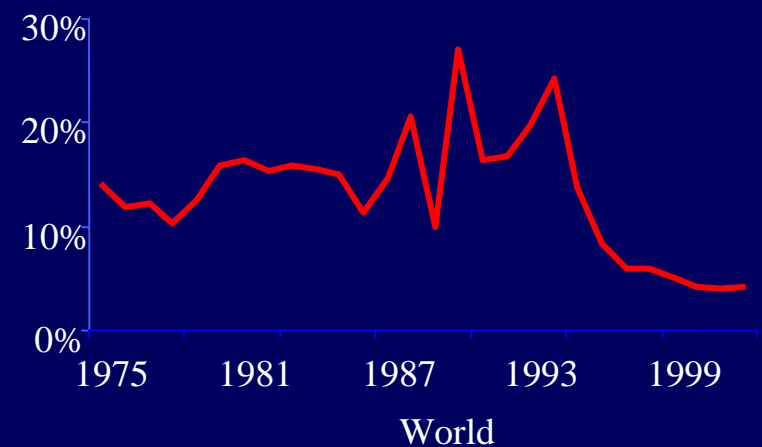
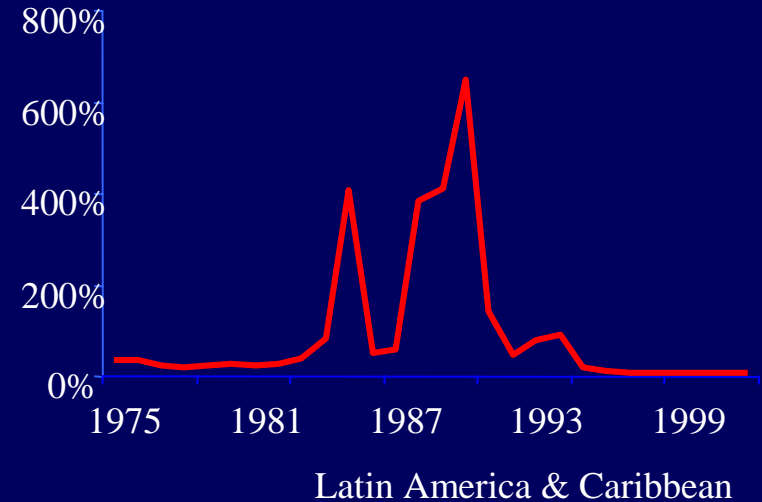
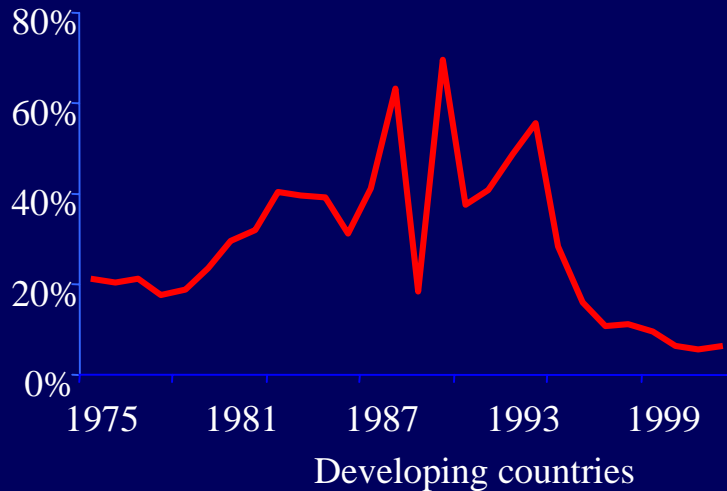
- I. Benefits of low inflation and inflation targeting (IT).
- II. Looking backward: Chile's gradual price stabilization under IT, 1991-2004.
- III. Looking forward: Challenges of monetary policy under IT.
- IV. Conclusions.

I. Benefits of Low Inflation and Inflation Targeting

Benefits of low inflation

- Low inflation is associated to:
 - ✓ Reduced relative price variability.
 - ✓ Less distortionary inflation taxation.
 - ✓ Enhanced financial development.
 - ✓ Less arbitrary redistribution.
 - ✓ Lower “shoe leather” and menu costs.
- And: sustained low inflation fosters long-term growth.
- Thus, worldwide inflation reduction in recent years comes as no surprise.

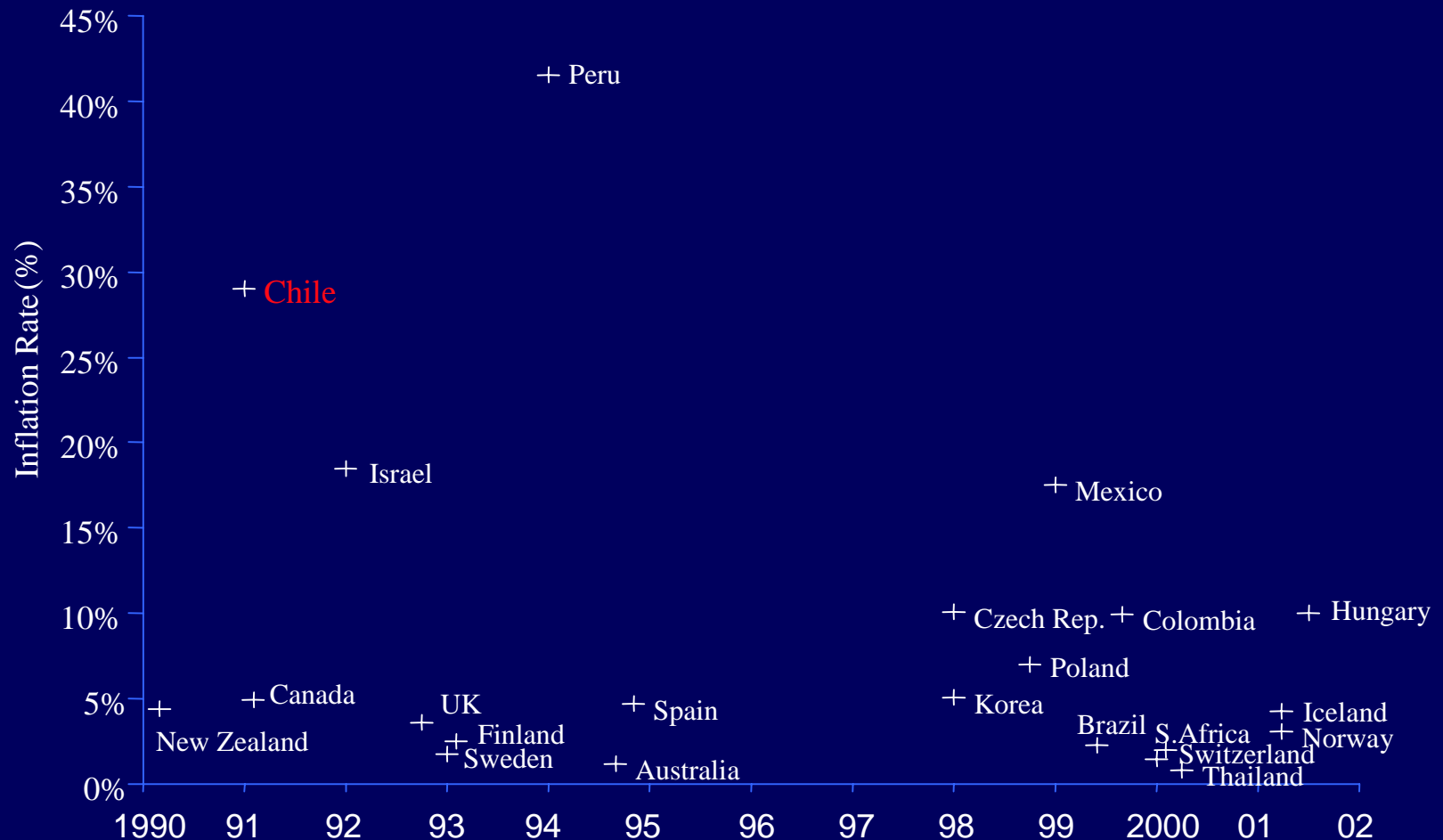
World trend toward lower inflation



Advantages of inflation targeting

- IT is consistent with modern view on the power and limits of monetary policy.
- Provides better nominal anchor for monetary policy (MP) and inflation expectations.
- Addresses squarely the need to determine long-run inflation objective.
- Increases MP transparency and accountability.
- Takes care of time-inconsistency → forces authorities to take into account long-term consequences of short-term actions.

World sample of ITers: Starting dates and initial inflation rates



Empirical benefits of inflation targeting

- Evidence from Bernanke et al. (1999) and from Corbo et al. (2002):
 - ✓ IT has helped in reducing inflation and inflation expectations, without raising output volatility.
 - ✓ IT has improved the ability to predict inflation.
 - Lower inflation-forecast errors.
 - ✓ IT has contributed to maintaining price stability, preventing one-time shocks to inflation from affecting permanently inflation.

2. Looking Backward: Chile's Gradual Price Stabilization under Inflation Targeting, 1991-2004

The road toward IT

- Chile's current macroeconomic and monetary policy (MP) framework is the result of gradual evolution:
 - ✓ MP was subordinated to fiscal policy for many decades until the mid-1970s.
 - ✓ MP lacked an anchor in 1975-1978.
 - ✓ MP was subordinated to the resolution of the banking crisis during 1982-1988.
 - ✓ MP was subordinated to a fixed exchange-rate anchor during 1979-1982, and limited by a crawling exchange-rate band in 1984-1999.
 - ✓ MP was strengthened in 1989 with CBCh's independence law and first independent CBCh Board.

The road toward IT

- Monetary policy by the Central Bank of Chile is part of the country's overall macroeconomic framework, which sits on a “stool of three strong legs”:
 - ✓ Full-fledged inflation targeting, complemented by floating exchange rate.
 - ✓ A fiscal policy rule anchored to a 1%-of-GDP structural fiscal surplus.
 - ✓ Strong financial system with appropriate regulation and supervision.

How IT was strengthened during 1990-2004

- Highlights of CBCh's path toward full-fledged IT:
 - ✓ 1991 Adoption of first annual inflation target.
 - ✓ 1995 Change in the operational MP target from the 90 days interest rate to the overnight rate.
 - ✓ 1999 Elimination of exchange-rate band and adoption of floating exchange-rate regime.
 - ✓ 2001 After successful convergence to low inflation, adoption of 2% - 4% inflation-target range, focused on 3% inflation.
- CBCh's record in attaining inflation targets is good, reflected by Chile's 1991-2004 inflation performance and compared to other inflation-targeting countries.

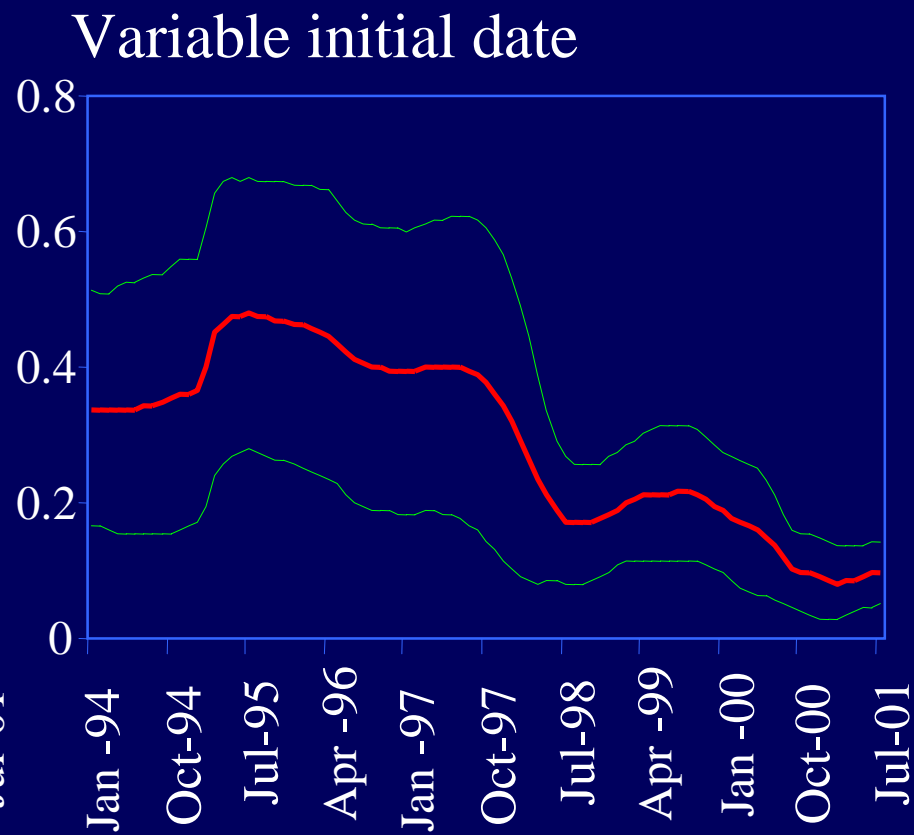
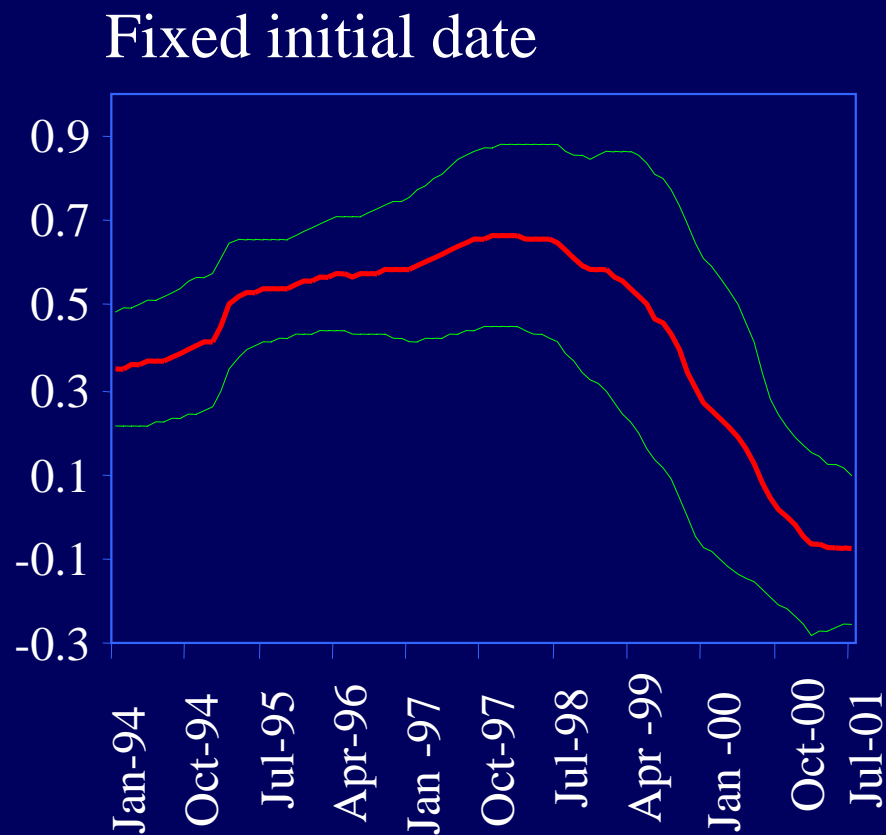
Inflation targets and inflation rates, 1990-2005



Chile's gradual disinflation

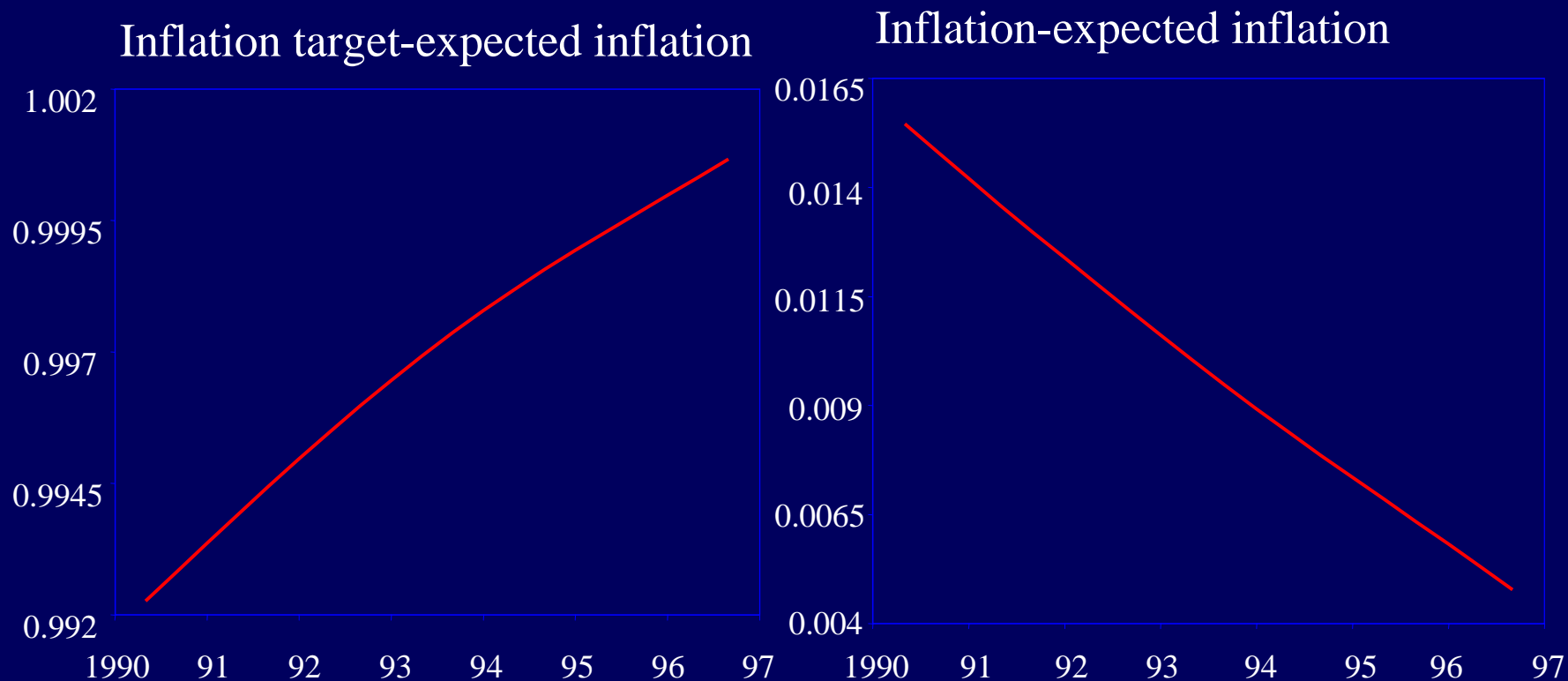
- Gradual disinflation was key in Chile's experience because of need to build up credibility of private sector in IT and due to widespread indexation to past inflation.
- This was reflected by:
 - ✓ (1) Steady reduction in pass-through from inflation to devaluation.
 - ✓ (2) Gradual rise in influence of inflation targets on inflation expectations.
 - ✓ (3) Continuing rise in influence of inflation targets on core inflation.

(1) Steady reduction in pass-through coefficients (rolling coefficients)



Source: García & Restrepo (2003)

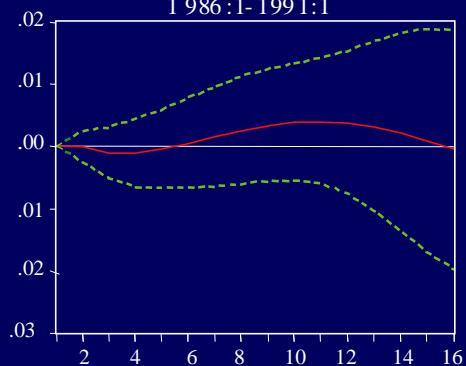
(2) Rising role of inflation targets and declining role of inflation shocks on inflation expectations



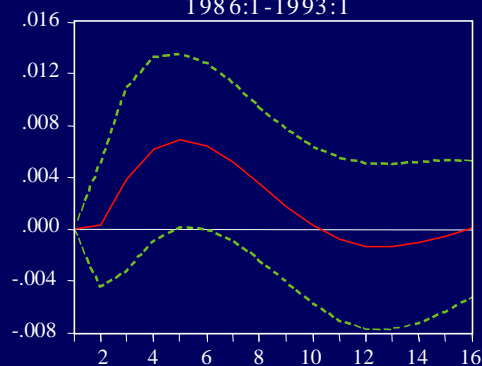
Source: Schmidt-Hebbel & Werner (2002)

(3) Continuing rise in role of inflation targets on core inflation

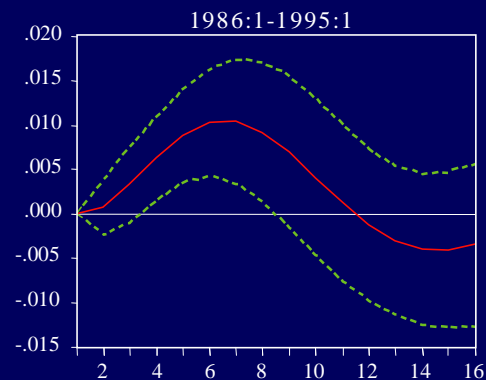
Response of Core Inflation to Cholesky
One S.D. Inflation Target Innovation
1986:1-1991:1



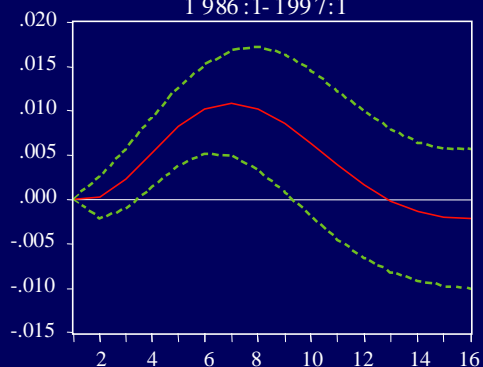
Response of Core Inflation to Cholesky
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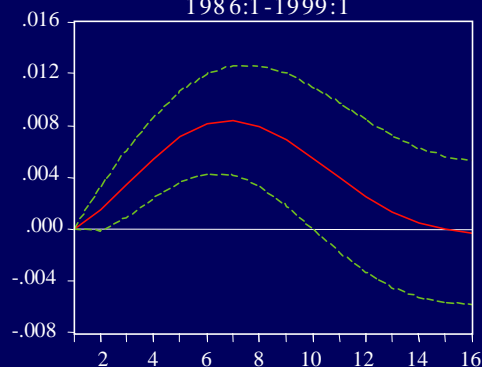
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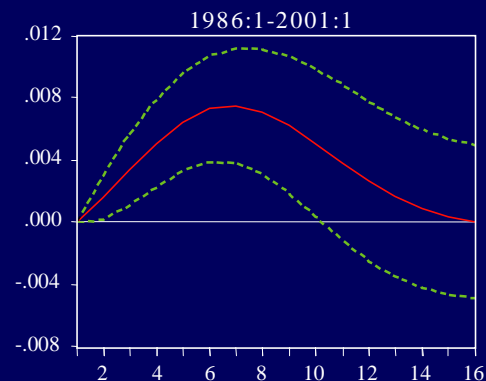
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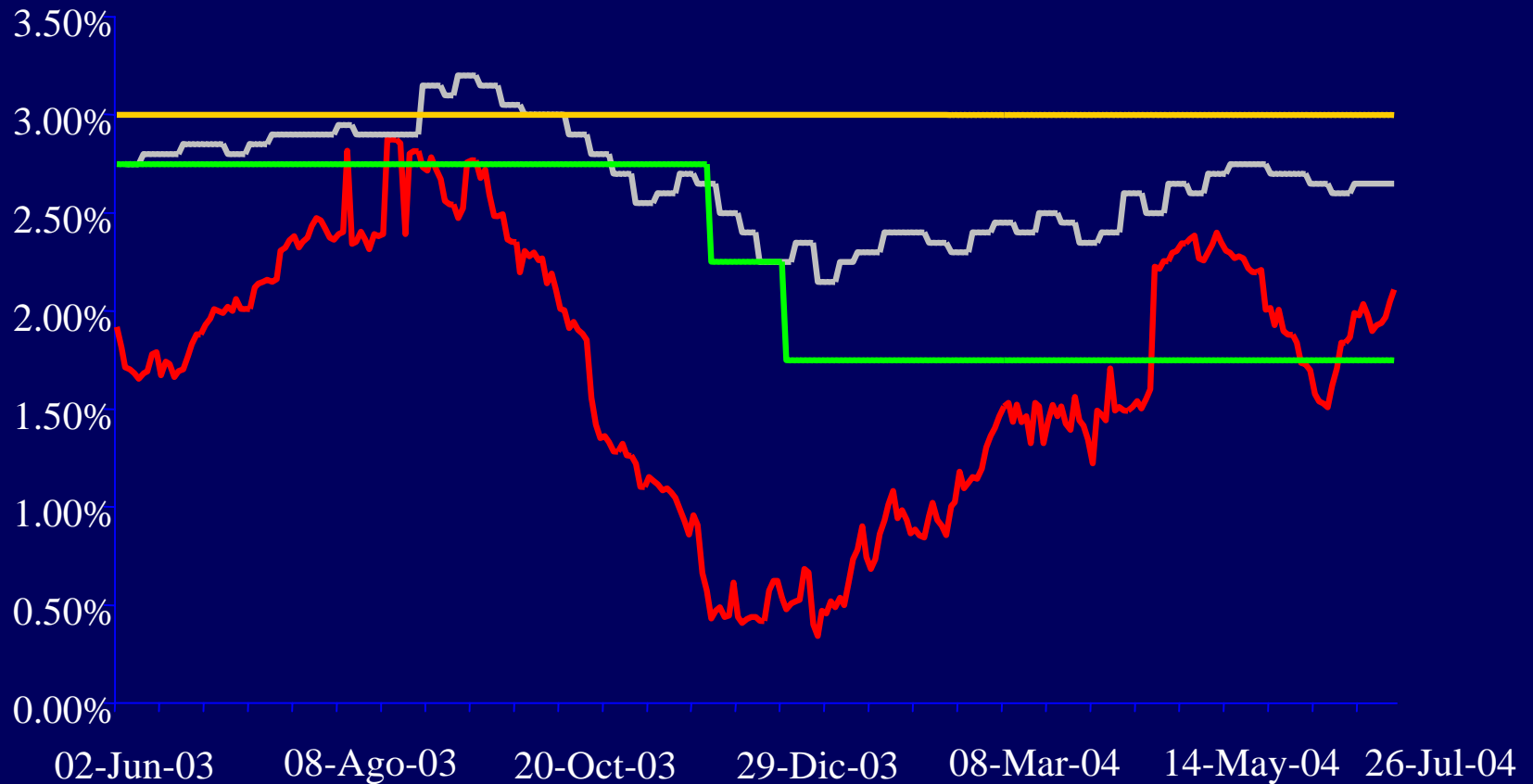


III. Looking Forward: Challenges of Monetary Policy under IT

IT Challenge 1: Responding to inflation-expectation shocks

- Private inflation expectations are crucial gauge of IT credibility, with important bearing on MP decisions.
- Chile experienced episode of strong reduction in inflation expectations in late 2003, in conjunction with negative inflation shock.
- Some analysts called for downward revision of Chile's 3% inflation target center.
- CBCh reinforced its target by adopting an expansionary monetary stance, lowering the MP rate by 50bp in December 2003 and again in January 2004.

Inflation forecasts, inflation target, and MP rate



— Inflation forecast from indexed bonds — Inflation Poll — Inflation target — Monetary Policy Rate

IT Challenge 2: Holding steady the ship's helm

- In response to major inflation shocks that imply significant and persistent deviations from target, IT central banks face two options:
 - ✓ (1) Accommodating shocks by changing IT framework parameters (target center and width, policy horizon), or
 - ✓ (2) responding to shocks and providing candid explanation for the inflation deviation.
- Most IT central banks have followed second alternative, minimizing cost of eroding IT credibility and widening gap between inflation expectations and the target.

IT Challenge 3: Improving transparency and communication

- Benefits of better transparency, accountability, and communications:
 - ✓ Strengthen IT framework credibility, align inflation expectations closer to IT, improve effectiveness of MP, and ultimately reduce sacrifice ratio.
 - ✓ Provide democratic legitimacy to independent central banks.
 - ✓ Increase accuracy in meeting inflation targets.
 - ✓ Enable adoption of counter-cyclical monetary policy.

Chile's progress in improving transparency and communication

- Since 2000, CBCh has made progress in several areas, by publishing:
 - ✓ Regular MP reports.
 - ✓ Schedule of MP meetings six months in advance.
 - ✓ Press release or communiqué of MP meetings within 30 minutes.
 - ✓ MP meeting minutes with three-week lag.
 - ✓ CBCh's macroeconomic projection models.

Chile's progress in improving transparency and communication

- Further progress at the CBCh:
 - ✓ Significant upgrade in coverage and timeliness of data publication.
 - ✓ Large output of research papers, meeting high demand (third central bank in working-paper downloads).
 - ✓ Creation of a communications department.

IV. Conclusions

Conclusions

1. Low inflation has large benefits for stability and growth.
2. Inflation targeting - the newest kid on the block of monetary regimes - has been tested as an effective policy framework that dominates competing nominal anchors.
3. Chile's gradual disinflation strategy was justified by widespread initial backward indexation and imperfect credibility.

Conclusions

4. Maintaining the ship's helm in the face of adverse inflation shocks pays off, strengthening the IT framework.
5. However, the art and science of prudent monetary policy is continuously tested by inflation shocks that require central banks to carefully assess optimal policy response.

