Monetary Policy and Central Bank Independence in Emerging Economies: The Case of Chile

NOVEMBER 2005

Vittorio Corbo
Governor

Outline

1. Legal framework
2. The conduct of monetary policy
3. Current monetary policy strategy
4. Cyclical behavior of monetary policy in Chile
5. Open issues

1. Legal framework

Legal framework

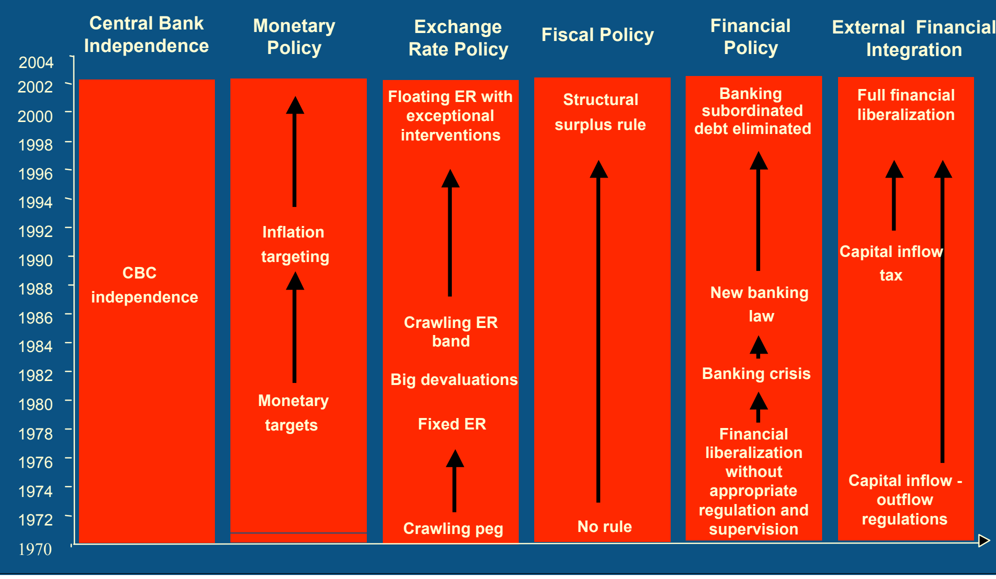
- Central bank autonomy is required for monetary policy to be effective and independent from political cycles.
- Law 18840 gave operational and financial autonomy to the Central Bank of Chile (CBC) in 1989.
- The law defined CBC's policy objectives:
  - Ensure the stability of the value of the national currency, and;
  - Ensure the normal functioning of domestic and foreign payments.

2. The conduct of monetary policy

Chile's overall macro and financial policy framework, 1970s to 2005

- Today, CBC's monetary policy is part of Chile's overall macroeconomic framework, which is based on a "stool of three strong legs":
  - An independent Central Bank with the explicit mandate of achieving price and payments stability, that has successfully introduced a full-fledged inflation targeting framework, complemented by a floating exchange rate;
  - Strong fiscal position: low public debt/GDP ratio and a fiscal policy rule anchored to a 1%-of-GDP structural surplus for the central government;
  - Strong financial system, with a dynamic, competitive, and well capitalized banking industry governed by appropriate regulatory and supervisory standards.

Chile's overall macro and financial policy framework, from the 1970s to 2005



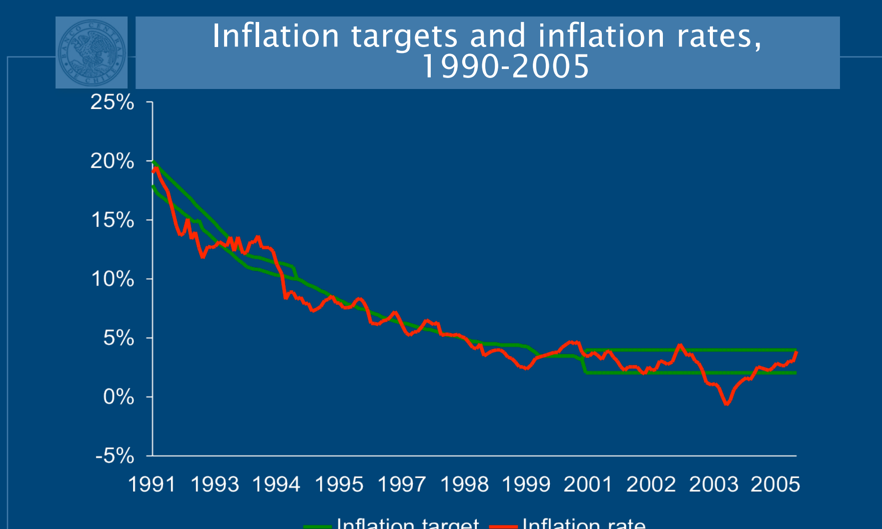
From partial to full-fledged IT in Chile

- 1990-1997:
  - Partial IT regime.
  - Additional nominal anchor: crawling ER band.
  - Good record in achieving inflation targets and high levels of growth and employment.
- 1998 is a particular year: strong defense of the peso.

From partial to full-fledged IT in Chile

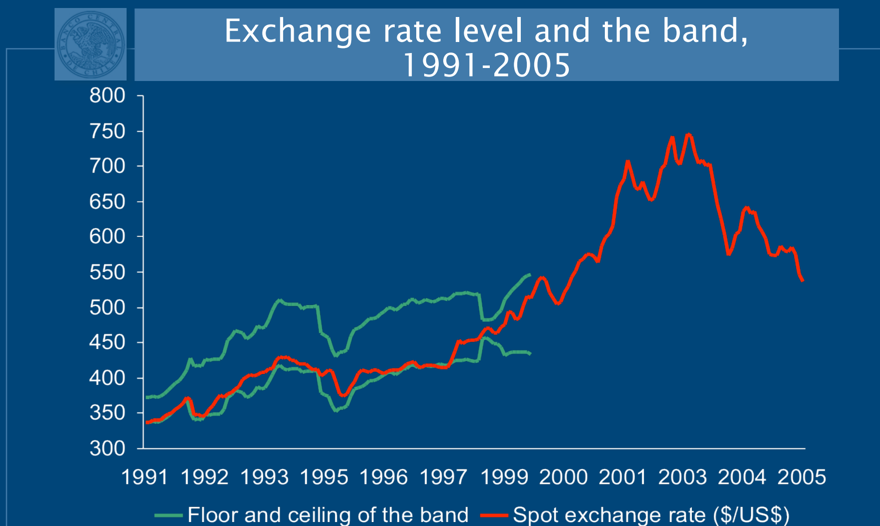
- 1999-2005:
  - Full-fledged IT (1999-2000)
  - Elimination of all controls to capital flows (2001)
  - Replacement of the ER band by a mostly clean float (1999)
    - Higher predictability of monetary policy changes, and
    - stable inflation expectations.

From partial to full-fledged IT in Chile



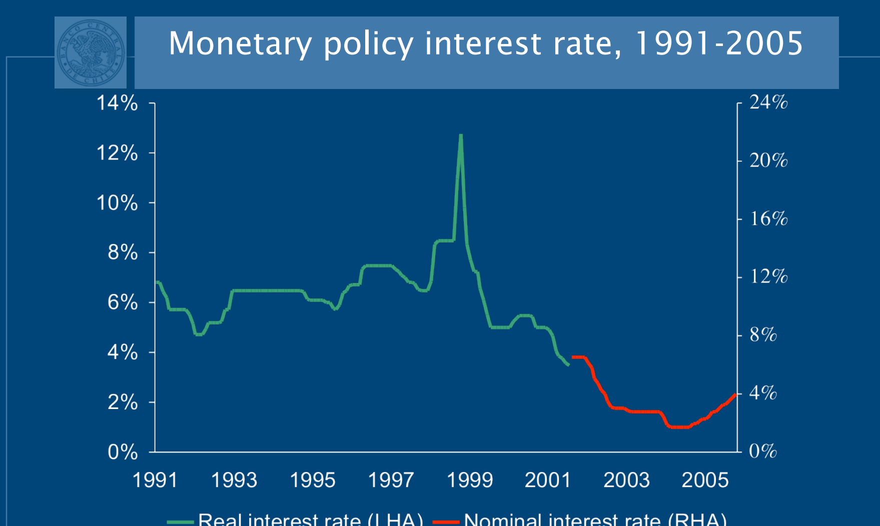
Source: Central Bank of Chile

From partial to full-fledged IT in Chile

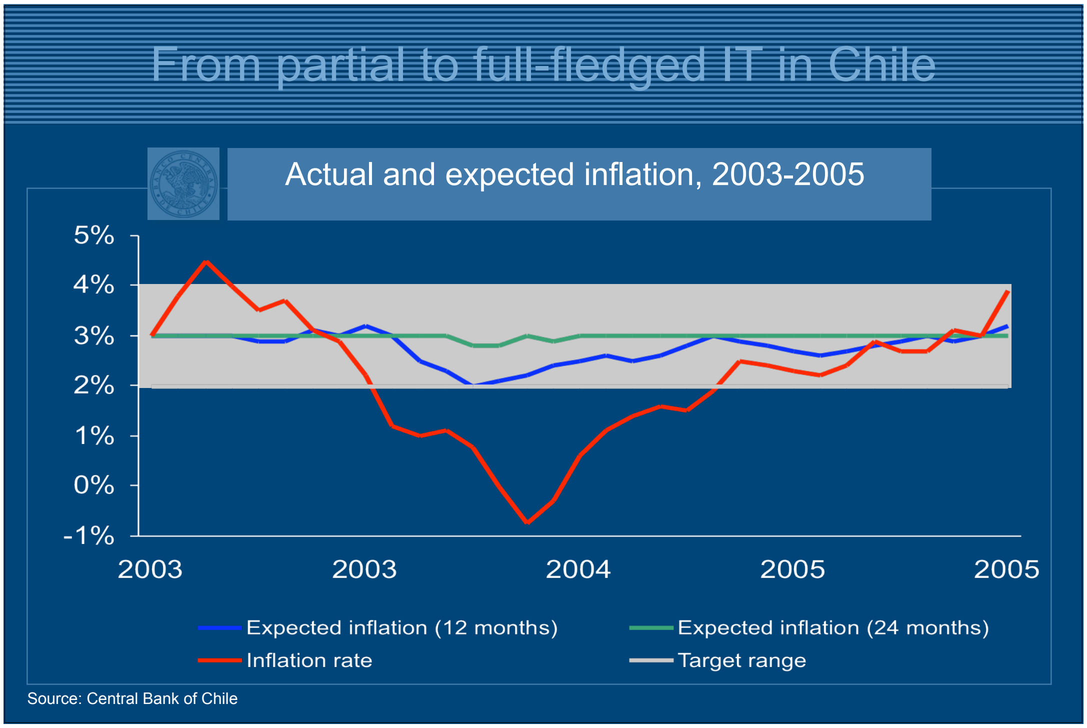


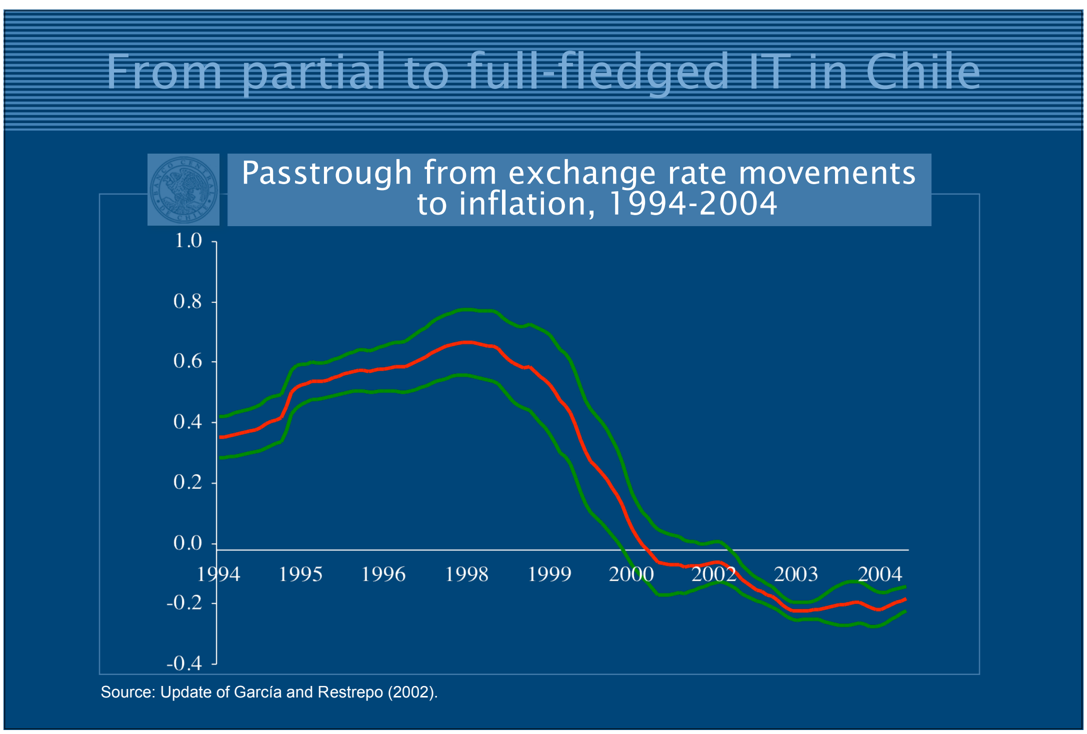
Source: Central Bank of Chile.

From partial to full-fledged IT in Chile

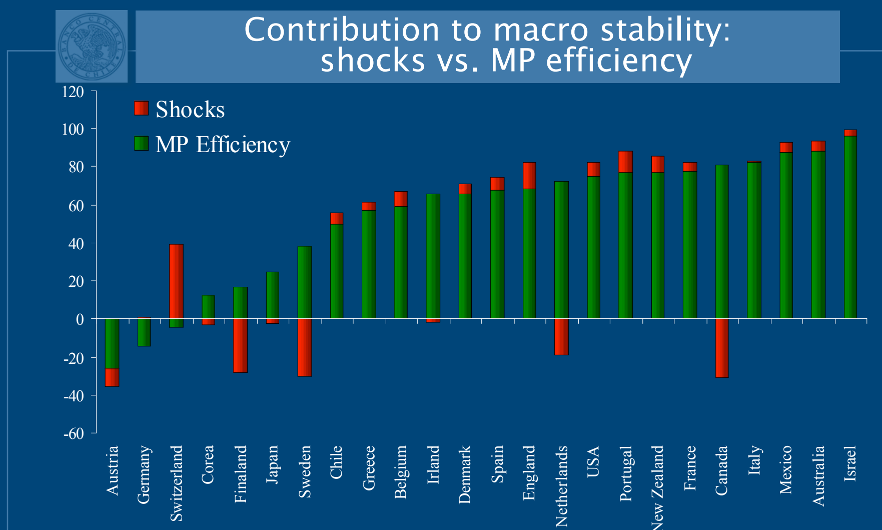


Source: Central Bank of Chile.


From partial to full-fledged IT in Chile
Actual and expected inflation, 2003-2005
5%
4%
3%
2%
1%
0%
-1%
2003
2003
2004
2005
2005
Expected inflation (12 months)
Expected inflation (24 months)
Inflation rate
Target range
Source: Central Bank of Chile


From partial to full-fledged IT in Chile
Passtrough from exchange rate movements to inflation, 1994-2004
1.0
0.8
0.6
0.4
0.2
0.0
-0.2
-0.4
1994
1995
1996
1998
1999
2000
2002
2003
2004
Source: Update of García and Restrepo (2002).

From partial to full-fledged IT in Chile



Source: Albagli and Schmidt-Hebbel (2005).

3. Current monetary policy strategy

Current monetary policy strategy

- Modern macroeconomic thinking and practice during the past 20 years show that the main role for monetary policy (MP) is to achieve and sustain price stability.
- This does not mean that MP has no effects on output:
  - Short run: Phillips curve;
  - Long run: sets the basis for potential output growth; macroeconomic instability lowers long-run growth.
- These are the main principles that guide MP at the Central Bank of Chile (CBC).

Current monetary policy strategy

- MP is aimed at achieving CBC's main policy objective: attaining annual headline inflation of 3% in a policy horizon of 12-24 months.
  - 3% is the mid-point of a 2-4% inflation target range.
- A credible MP policy also contributes to stabilize output in the short term, but this aim is subordinated to attaining the inflation target.
- CBC shows a good record in attaining its inflation targets during 1991-2004, and compares well with other inflation-targeting countries.

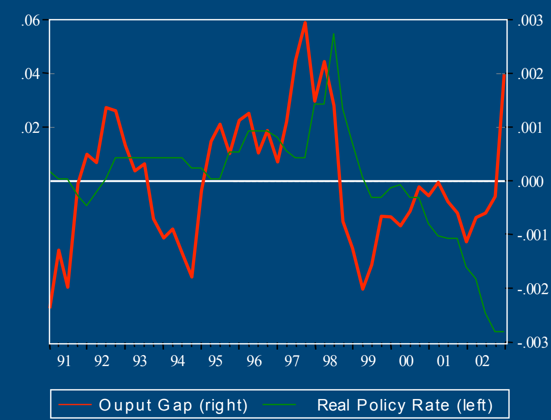
4. Cyclical behavior of monetary policy in Chile

Cyclical behavior of monetary policy in Chile

- Optimal monetary policy should be counter-cyclical, aiming at keeping output close to its potential.
- A principal determinant of the cyclicality of monetary policy is credibility.
- The cyclical behavior of monetary policy in Chile has changed over the last decade.
  - It has been counter-cyclical since 1993, when credibility largely increased (reflected in sharp decline in country risk premium).

Cyclical behavior of monetary policy in Chile

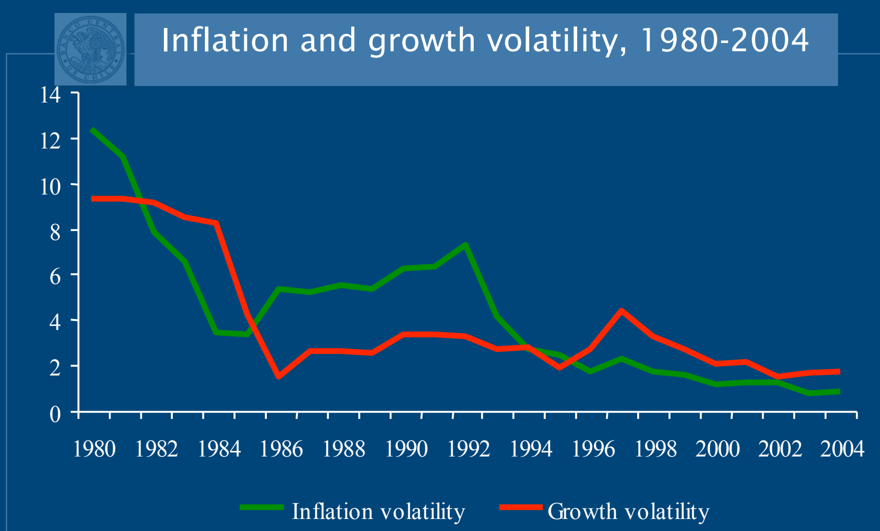
Real policy interest rate deviations from its long-run level and output gap
(Chile: 1991.1-2003.1)



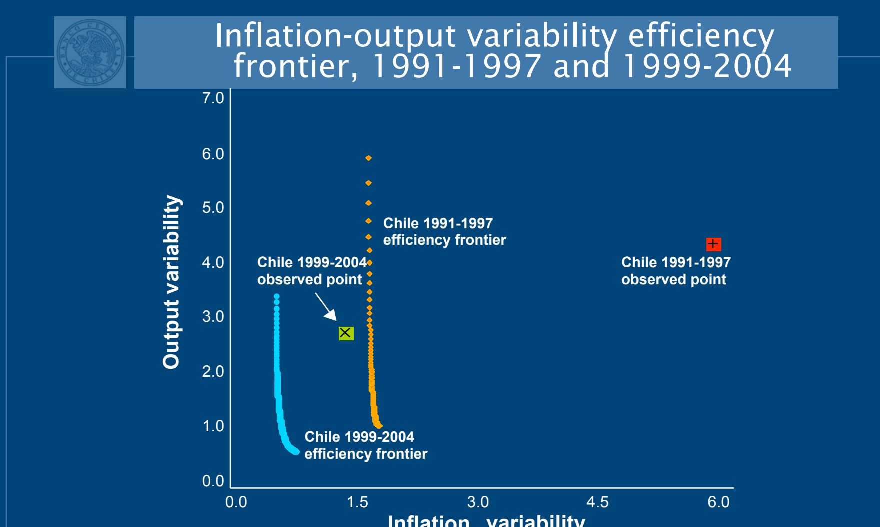
Cyclical behavior of monetary policy in Chile

- Over the last few years, Chile has seen substantial decrease in output and inflation volatility.
- This could be caused by increased monetary policy efficiency or just by living in a calmer world.
- The estimation of an inflation-output variability efficiency frontier allows to disentangle both effects.
- Comparing the 1991-1997 and 1999-2004 periods, we observe that:
  - 76% of the improvement in performance can be attributed to policy efficiency.
  - 24% of the progress is due to smaller shocks.

Cyclical behavior of monetary policy in Chile



Cyclical behavior of monetary policy in Chile



5. Some open issues

Living with exchange rate flexibility

- A flexible exchange rate regime allows MP to attain full independence, responding freely to shocks. Floating allows the nominal ER to absorb shocks.
- But a flexible ER system also implies a high level of ER volatility, as exemplified by Chile since 1999.
- However, larger ER volatility has encouraged development of strong private market of hedging instruments and has helped to avoid excessive foreign exchange imbalances at non-financial corporations.
- Hence, MP independence and effectiveness has been strengthened by ER flexibility, while adverse effects of volatility have been kept at bay.

Challenges: Uncertainty

- Monetary policy is subject to several sources of uncertainty:
  - Doubts about quality of statistical data, imperfect knowledge about the nature and persistence of the shocks hitting the economy, uncertainty about projection models, etc.
- Does this uncertainty justify slower policy reactions to shocks to inflation or GDP?
- These and other questions raise the need to invest heavily in data, models and economic projections and research, a task to which the CBC devotes large efforts.

Range and horizon of the target

- The CBC has a 2-4% target range for annual inflation, with a focus on the center of the range (3%), over a policy horizon defined at 12 to 24 months
- Is the present combination of a 2-4% target range for inflation and a 12-24 month policy horizon optimal?
- Is it advisable to review the length of the policy horizon as a way to consider financial stability concerns in the conduct of monetary policy?

Measurement and implications of inflation expectations

- An inflation targeting scheme is highly sensitive to private-sector expectations of future inflation, because they are a key anchor of the IT regime
- The CBC attaches a large weight to direct measures of expected inflation and inflation compensation
- New concerns:
  - How do we remove the inflation expectation component from inflation compensation measures?
  - Why do inflation expectations and compensation apparently overreact to particular shocks?

Response to supply shocks

- The classical tradeoff in monetary policy response to supply shocks is faced by central banks all over the world during 2005, due to the ongoing oil price shock.
- The CBC does not react to the direct effect of oil price rises on headline CPI.
- But the CBC does react to second-round effects through prices of other goods.
- In practice, this response is tainted by the intense uncertainty regarding the shock's persistence and its consequences.

Response to foreign exchange shocks

- In general, the CBC does not react to exchange rate movements beyond their effects on inflation and output:
  - The passthrough coefficient from exchange rate depreciation to inflation has dropped substantially.
  - Currency mismatch has been reduced in non-financial firms.
- However, it reserves the option to intervene directly in the foreign exchange market if temporary exchange rate volatility or misalignment so warrants.

Asset prices/financial stability concerns

- Central bankers and academics continue debating if monetary policy should react to asset-price shocks or perceived misalignments (bubbles).
  - Some argue that the best way to alleviate the impact of bubbles is to adjust interest rates in response to asset-price misalignments.
  - Others claim that using interest rates to combat the bubbles is difficult due to the problems of identifying imbalances in a timely and precise fashion.
- However, in the absence of central bank information advantages over the private sector, and considering the large uncertainty about future asset prices and their fundamentals, it is hard to justify a proactive MP stance.

Monetary Policy and Central Bank Independence in Emerging Economies: The Case of Chile

NOVEMBER 2005

Vittorio Corbo
Governor