



Globalization, disinflation and monetary policy

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CENTRAL BANK OF CHILE

4 DECEMBER 2006



1. Introduction

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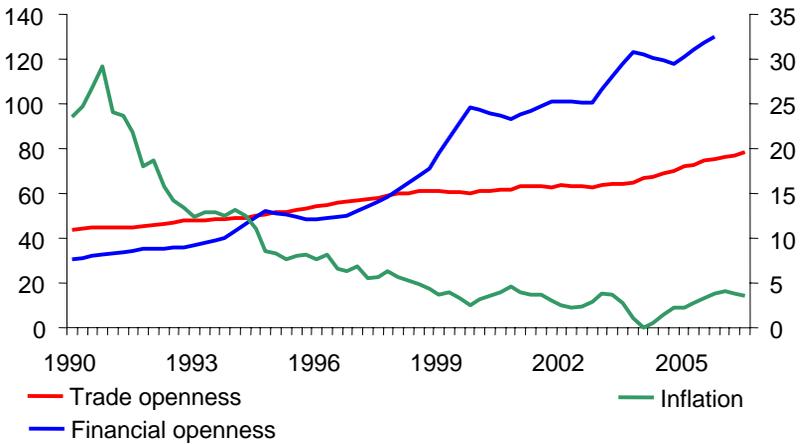
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Inflation and openness in Chile

(quarterly data, percentage)



Note: Trade openness is measured as the sum of exports and imports in percent of GDP. Financial openness is measured as the sum of the stocks of external assets and liabilities of foreign direct investment and portfolio investment in percent of GDP.

Source: Central Bank of Chile.

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1. Introduction

- 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.

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2. Changes in relative prices



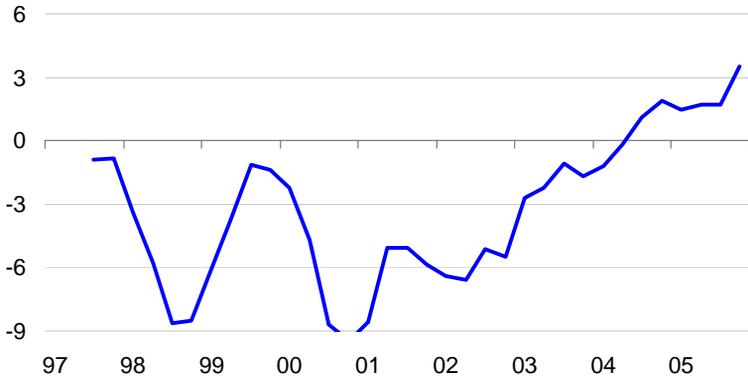
Changes in relative prices

- 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.

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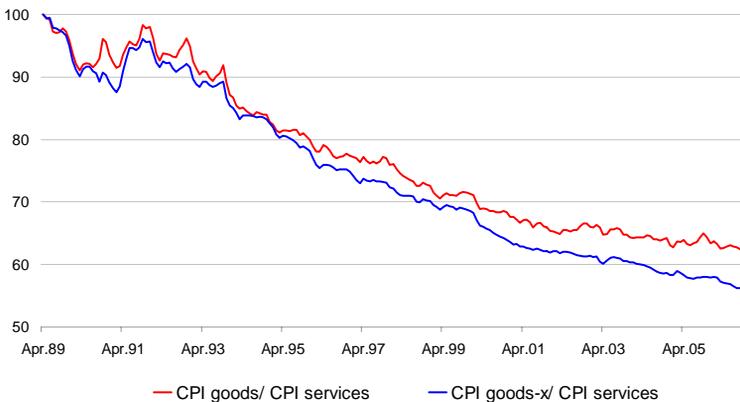
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CPI Inflation for goods and services

(index; April 1989=100, quarterly)



Note: CPI goods-x excludes oil and perishables.

Sources: Central Bank of Chile and National Bureau of Statistics.

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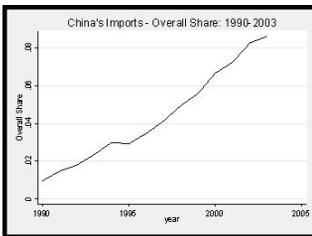
Changes in relative prices

- 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.

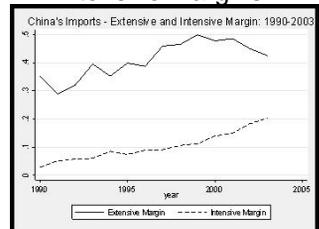


Aggregate margins

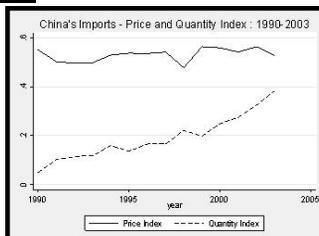
Panel a: Overall share



Panel b: Extensive and intensive margins



Panel c: Price and quantity Index



Source: Alvarez and Claro (2006).



3. Monetary policy transmission channel



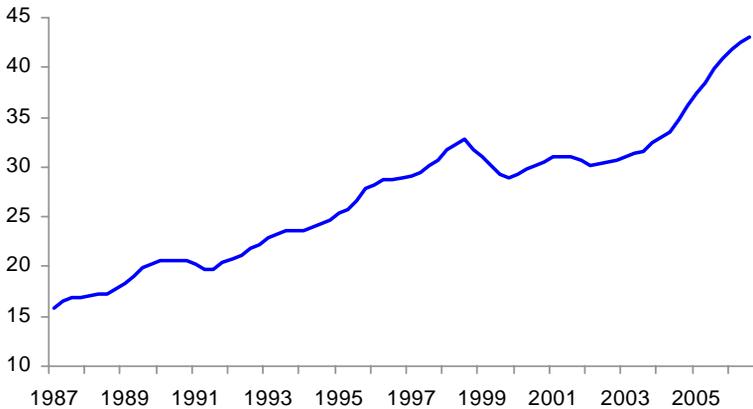
MP transmission channel

- 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.



MP transmission channel

- 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.



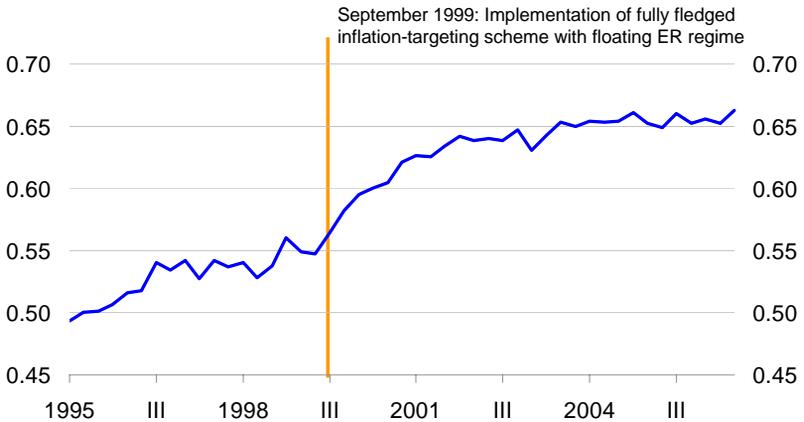
Inflation expectations



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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