



MONETARY POLICY IN CHILE

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Board Member



Outline

- I. Institutional framework
- II. Principles of monetary policy
- III. Current monetary policy regime
- IV. Assessment of inflation performance
- V. Monetary Policy Meeting
- VI. Final remarks



I. Institutional Framework



Institutional Framework

- The Central Bank of Chile (CBC) was created in 1925.
- In this process, Chile received the assistance of a mission of international experts headed by Walter Kemmerer, professor of economics at Princeton University.
- Although the CBC has remained a key component of Chile's economic and financial architecture for more than 80 years, the original definition of its purpose has been modified significantly over time in response to changing circumstances and needs.



Institutional Framework

- Under its present statutes, which date back to 1989, the CBC is autonomous and has a clear mandate to keep inflation under control and ensure the orderly functioning of the payment system.
- In other words, its goals are very similar to those of Central Banks around the world and can be defined as *price stability* and *financial stability*.



Institutional Framework

- In line with these goals, the CBC's main functions are to:
 - Set monetary policy;
 - Provide liquidity to the banking system in cases of need;
 - Regulate certain banking and financial activities;
 - Regulate foreign exchange operations;
 - Issue coins and bills to meet market needs;
 - Operate the high-value inter-bank payment system;
 - Manage its assets and liabilities (i.e. international reserves).



Institutional Framework

- The CBC is headed by a five-member board of directors, appointed by the President of the Republic subject to ratification by the Senate. One of these directors is appointed as Chairman of the Board and Governor of the Bank.
- The board, among its other responsibilities, takes monetary policy decisions. In this sense, it plays the same role as the FOMC in the USA or the Monetary Policy Committee in the UK.



Institutional Framework

- In the past, the CBC did not always give price stability its present priority.
- In fact, inflation became a very serious problem shortly after the CBC was established.
- This was mainly the result of an expansionary fiscal policy, which left the CBC little room for maneuver to attempt to achieve price stability.

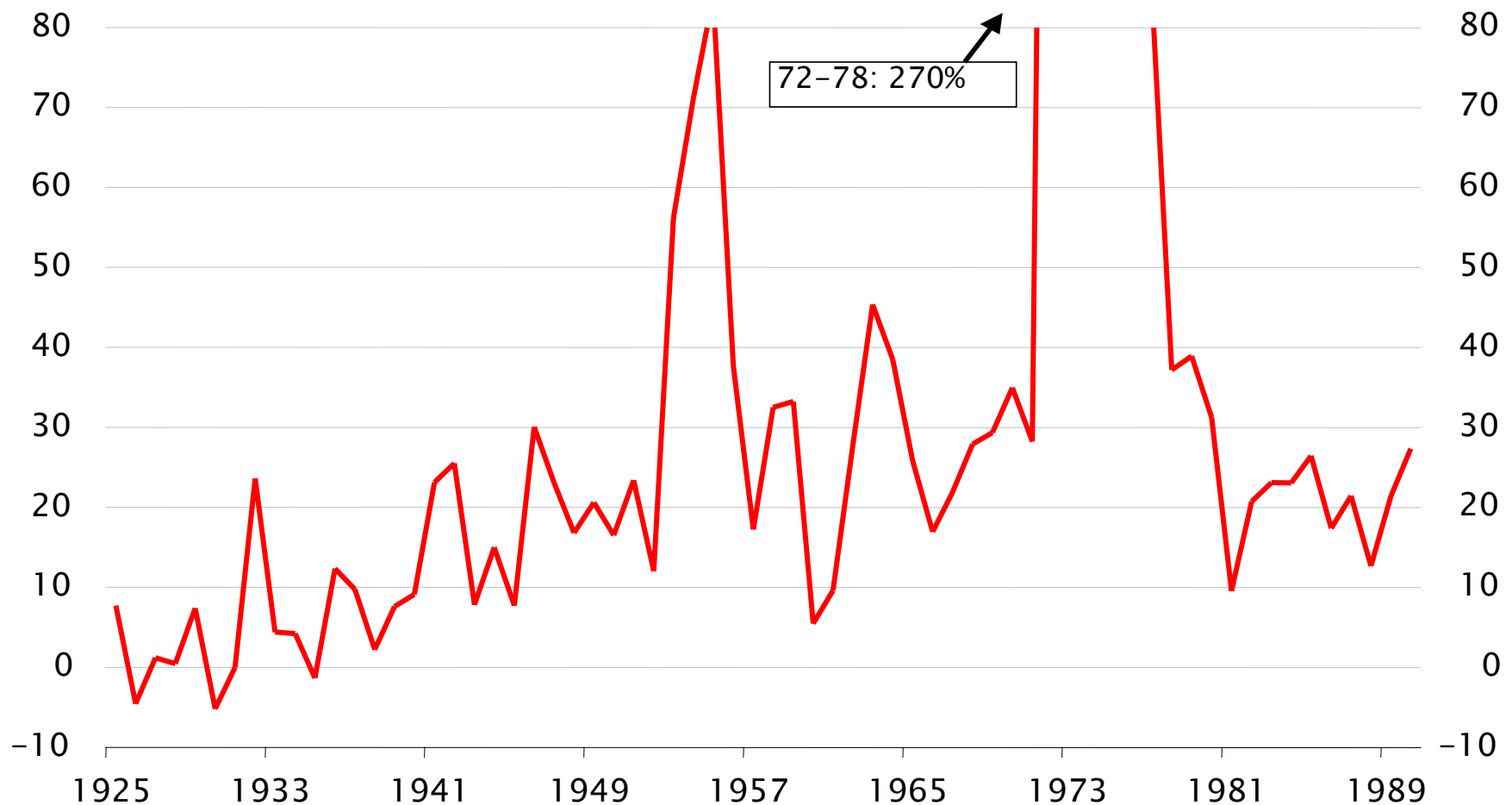


Institutional Framework

- Several stabilization programs were designed and implemented but all failed, due to a lack of consistency with macroeconomic policies.
- As a result, during most of the twentieth century, inflation was high and volatile while growth rates fluctuated sharply.



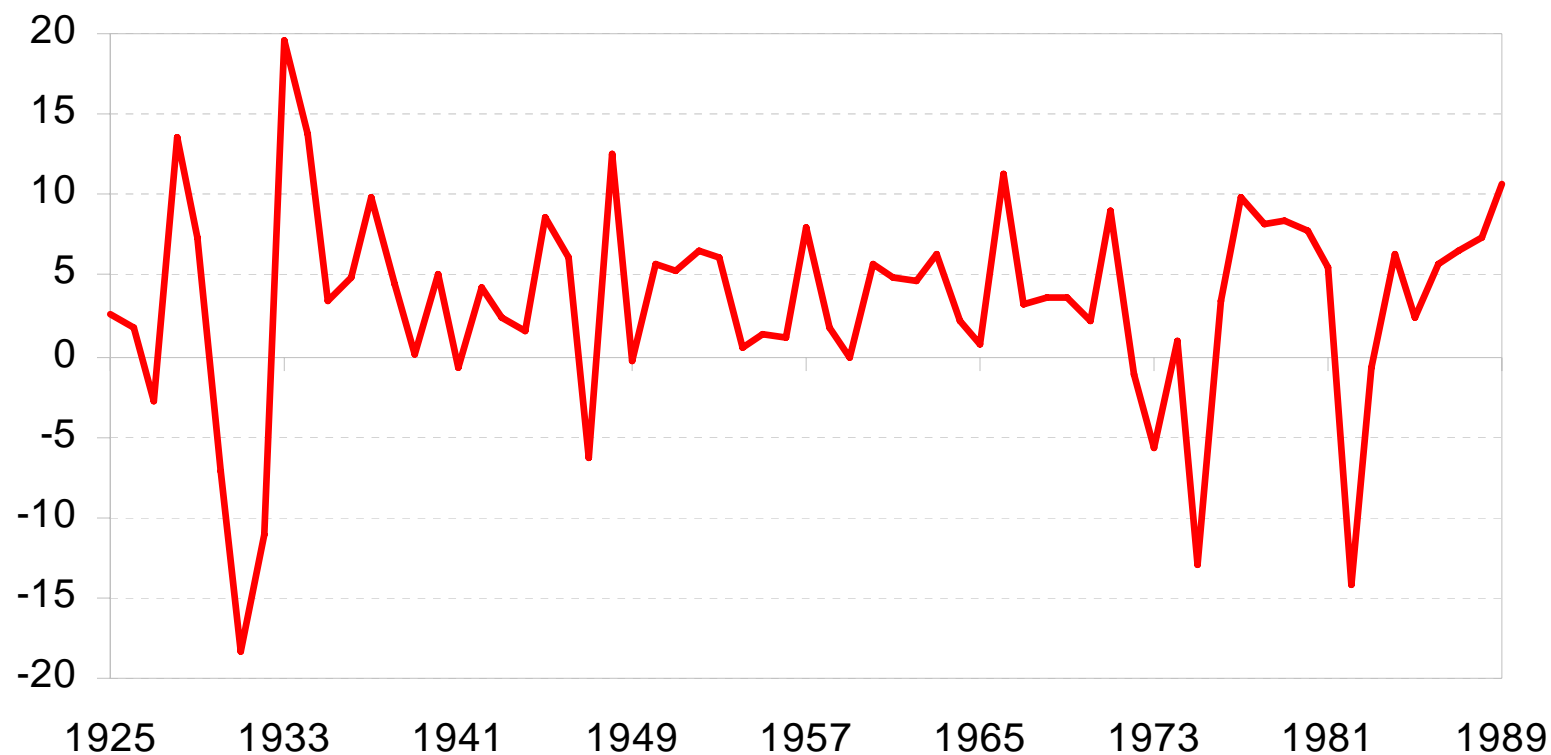
Inflation Rates, 1925–89



Sources: Díaz, et al. (2003) and National Bureau of Statistics.



Growth Rates, 1925–1989



Sources: Central Bank of Chile and Haindl (2006).

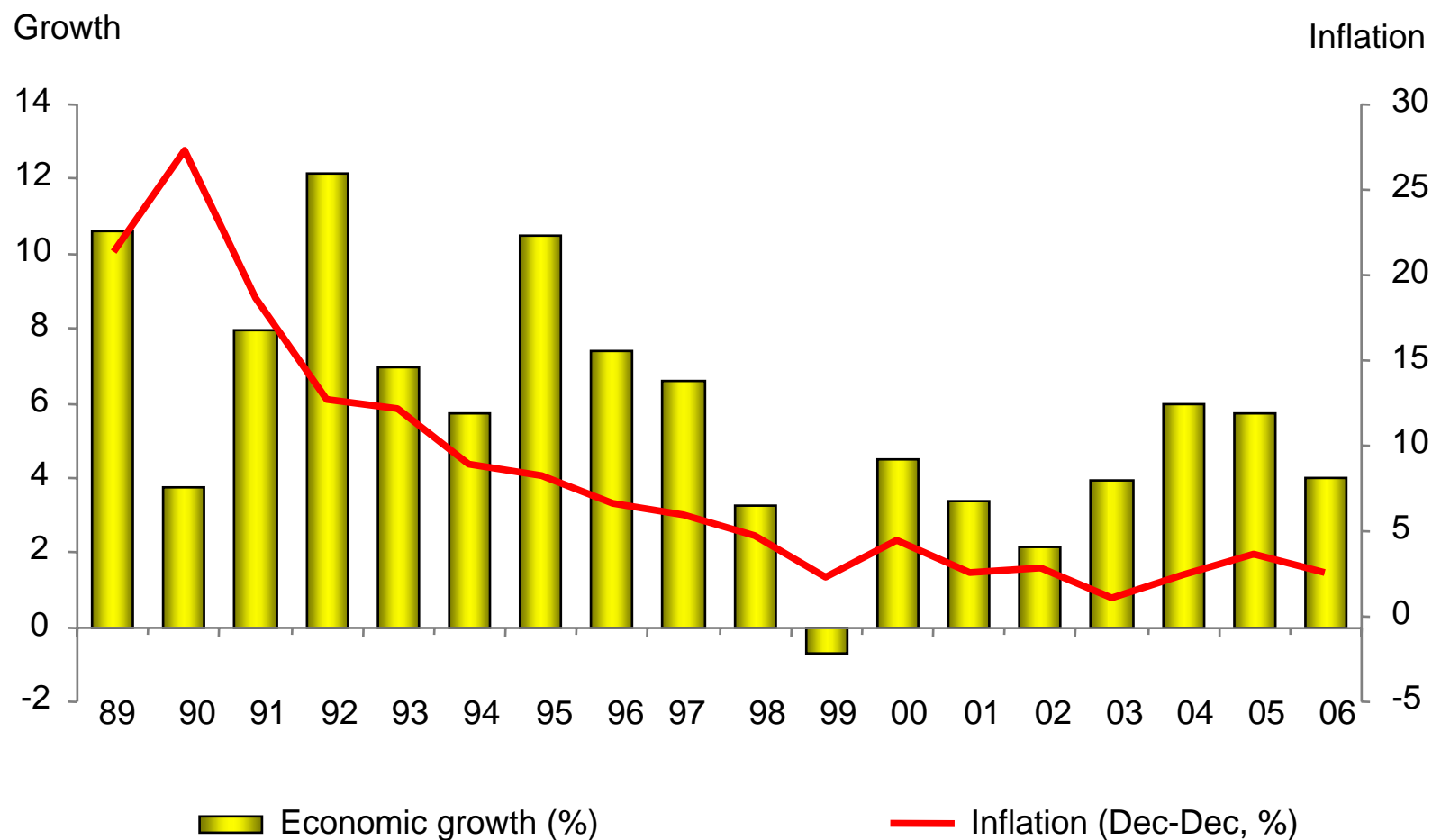


Institutional Framework

- Macroeconomic stability and, particularly, price stability showed a significant improvement after the introduction of the CBC's current statutes in 1989.
- The CBC's clear mandate to bring inflation under control and its autonomy from the government and interest groups made a decisive contribution to this improvement.



Growth and Inflation, 1989–2006

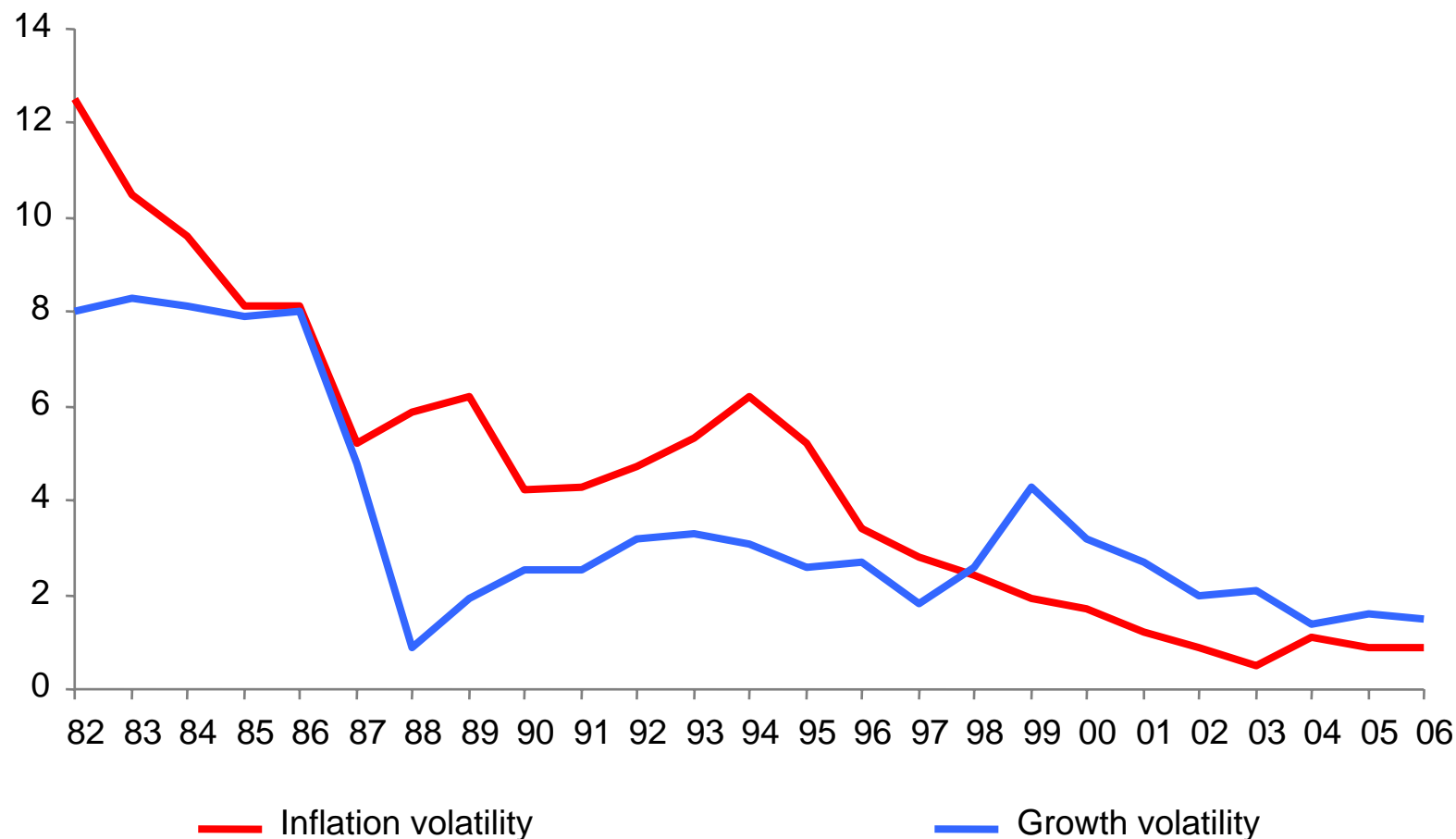


Source: Central Bank of Chile.



Volatility of inflation and growth

(Standard deviation of rolling 5-year window)



Source: Own estimation, based on data of National Statistics Bureau and Central Bank of Chile.



Institutional Framework

- Monetary policy is key for macro stability. However, it does not act in isolation but within a context of institutions and policies that are mutually self-reinforcing.
- It is, therefore, important to take into account all the pillars that have contributed to Chile's macroeconomic stability.



Institutional Framework

- These pillars include:
 - An autonomous Central Bank with a clear mandate to keep inflation under control;
 - A responsible and predictable fiscal policy;
 - A solid financial system that is well supervised and professionally managed;
 - Increasing commercial and financial integration with international markets.



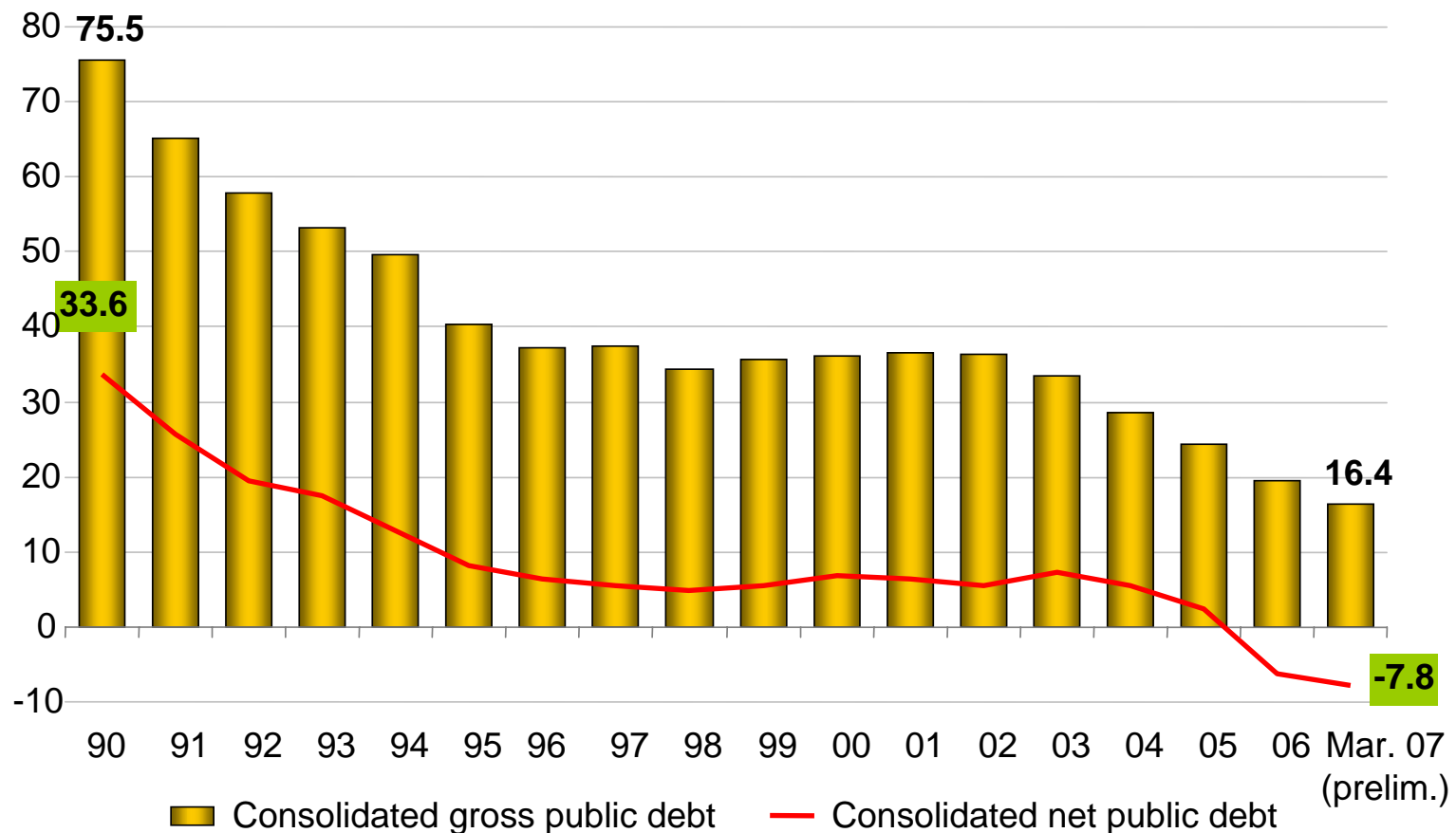
Institutional Framework

- In 2000, the government introduced the so-called “structural fiscal surplus rule” under which the budget must show a structural surplus.
- Originally, the target for the structural surplus was set at 1% of GDP but, as from next year, will drop to 0.5%.
- The word ‘structural’ indicates that the surplus is calculated making adjustment for the economic cycle and using, for example, potential rather than actual GDP growth and a long-term, rather than short-term, copper price.



Chilean Government Debt

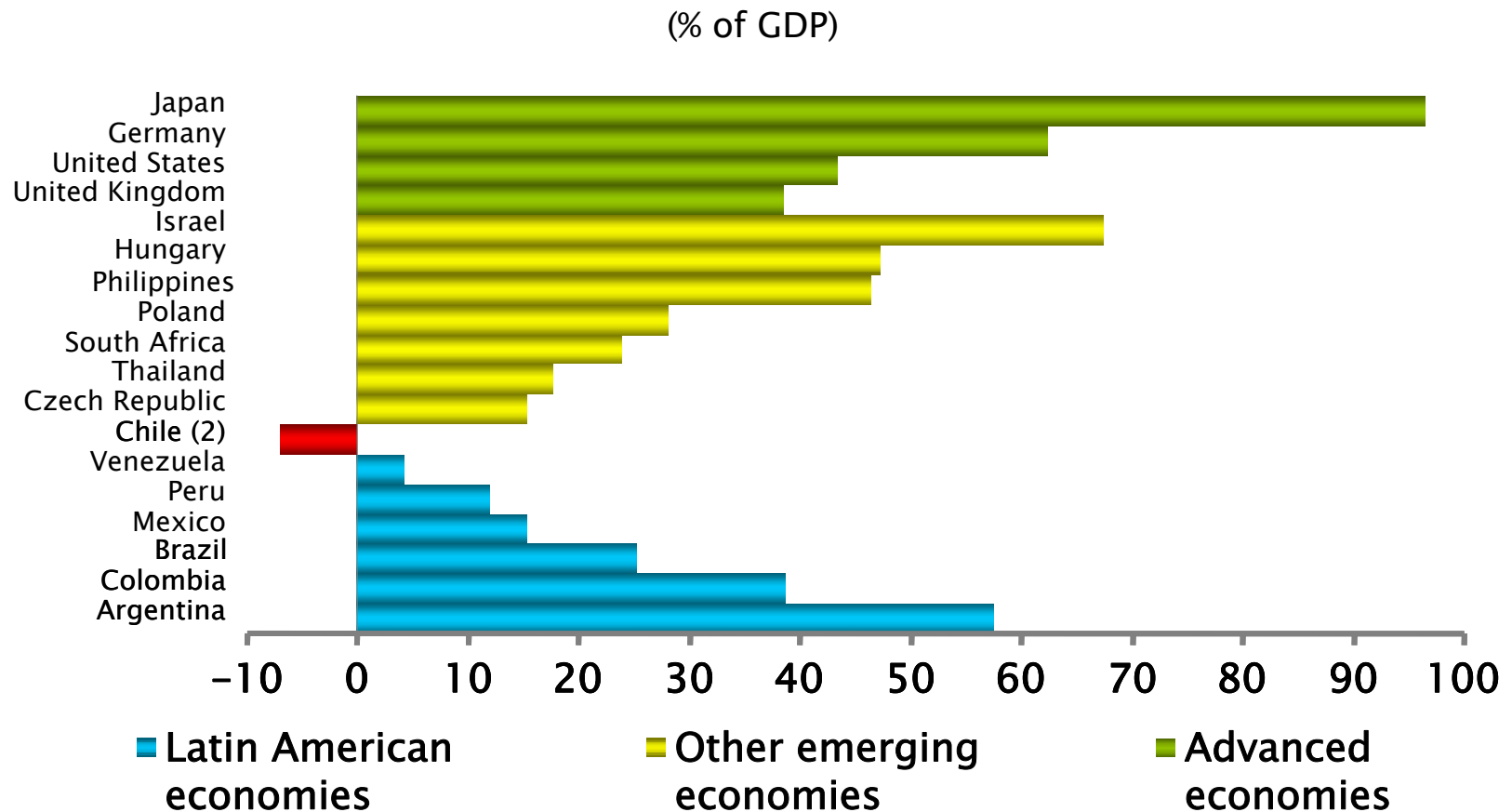
(% of GDP)



Sources: Chilean Ministry of Finance and Central Bank of Chile.



Public Sector Debt, 2006 ⁽¹⁾



(1) General Government Net Debt (excluding reserves, Central Bank debt and social security).

(2) In December 2006, Chile's Central Government Net Debt reached -7% of GDP.

Sources: IMF, JPMorgan Chase, Chilean Ministry of Finance and Moody's.

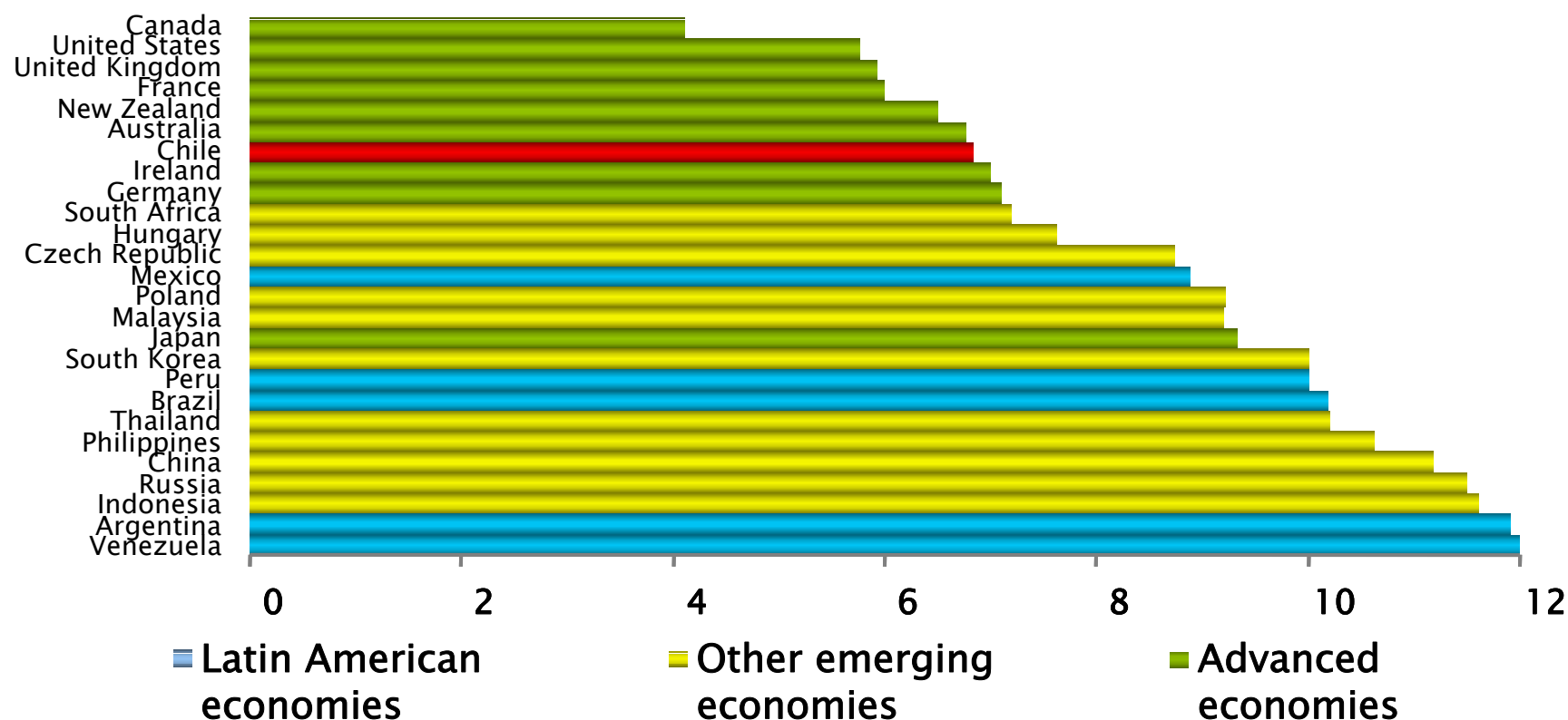


Institutional Framework

- Regulation and supervision in Chile are very much in line with international standards:
 - Bank supervision is exercised by a separate entity, but this coordinates closely with the CBC.
 - Cooperation between financial authorities extends to other sectors: securities, insurance and pension funds.



Banking Sector Financial Strength Index (*)



(*) Lower scores indicate greater banking sector strength.

Source: Central Bank of Chile, based on Moody's Financial Strength Rating, September 2007.



Institutional Framework

- Chile's integration with the rest of the world is characterized by:
 - Low effective tariffs (2% on average);
 - Free Trade and Trade Agreements with major trading partners (USA, EU, Japan, China, Mexico, Canada and Korea);
 - Capital mobility;
 - A floating exchange rate regime which has been in force since 1999, permitting flexible adjustment to external shocks.



Institutional Framework

- In addition, the Chilean economy has been benefited by:
 - The strength of its legal framework and the quality of public institutions, which provide security for investors;
 - Political stability, which is reflected in widespread consensus as to the main thrust of economic policies.



II. Principles of Monetary Policy



Principles of Monetary Policy

- Monetary policy comprises the measures and decisions adopted by the CBC in order to achieve and maintain price stability.
- But why does price stability matter?



Principles of Monetary Policy

- Inflation has adverse effects and significant economic costs.
- On the one hand, inflation has a negative impact on the allocation of resources and investment decisions. It distorts price signals (relative prices) and discourages financial development. As a result, it is a barrier to economic growth.
- In addition, it adversely affects income distribution because it is normally detrimental to those who depend on wages or a pension.



Principles of Monetary Policy

- For these reasons, it can be argued that low and stable inflation contributes to the welfare of the population.
- However, as regards monetary policy, concepts have changed significantly in the past three to four decades.



Principles of Monetary Policy

- Until the 1960s, the prevailing theory indicated that, with slightly higher inflation, it was possible to permanently lower unemployment and increase the real level of economic activity.
- This theory was summed up in the “Phillips Curve” showing a negative and supposedly stable relation between the rate of inflation and the unemployment rate.



Principles of Monetary Policy

- However, economic theory and the empirical evidence subsequently belied this concept.
- Today, the widespread view among economists is that there is not a permanent trade-off between growth and inflation.
- Experience has shown us that attempts to reduce unemployment to below its normal level or to raise output above its potential level lead to an acceleration of inflation.



Principles of Monetary Policy

- It is accepted that, in the long term, monetary policy only has an impact on nominal variables (inflation) and not on real variables (employment and activity).
- However, it is recognized that, in the short term, it can have effects on real variables. With limitations, this opens the possibility of using monetary policy to help stabilize the level of real activity and employment.



III. Current Monetary Policy Regime



Monetary Policy Regime

- In Chile, an inflation–targeting regime has been fully in place since 2001.
- Under this framework, policy decisions are adopted in order to achieve an explicit inflation target.
- This is complemented by a floating exchange rate system that facilitates the economy’s adjustment to external shocks. This means that the exchange rate is determined by the market, although the CBC reserves the right to intervene in exceptional circumstances.



Monetary Policy Regime

- The target set by the CBC is to keep inflation most of the time at around 3% with a tolerance range of $\pm 1\%$.
- The focus of monetary policy is on projected inflation over a time horizon of approximately two years.
- This takes account of the transmission lags of monetary policy while, at the same time, it allows room to accommodate transitory supply shocks.



Monetary Policy Regime

- Chile's 3% target is well in line with those set by most emerging economies, although it is somewhat higher than those seen in developed countries.
- The target is set in terms of headline inflation, measured using the CPI, which is the price index most commonly used in Chile.
- However, since headline inflation includes variations in highly volatile items, such as food and energy prices, different measures of core inflation are also used to assess inflation trends.



Monetary Policy Regime

- As indicated, the approach is essentially forward-looking and focuses on projected inflation over the policy horizon.
- For this purpose, the CBC carries out forecasting exercises using economic models and statistics.
- These exercises have limitations due to imperfect knowledge, incomplete information and uncertainty about future developments.



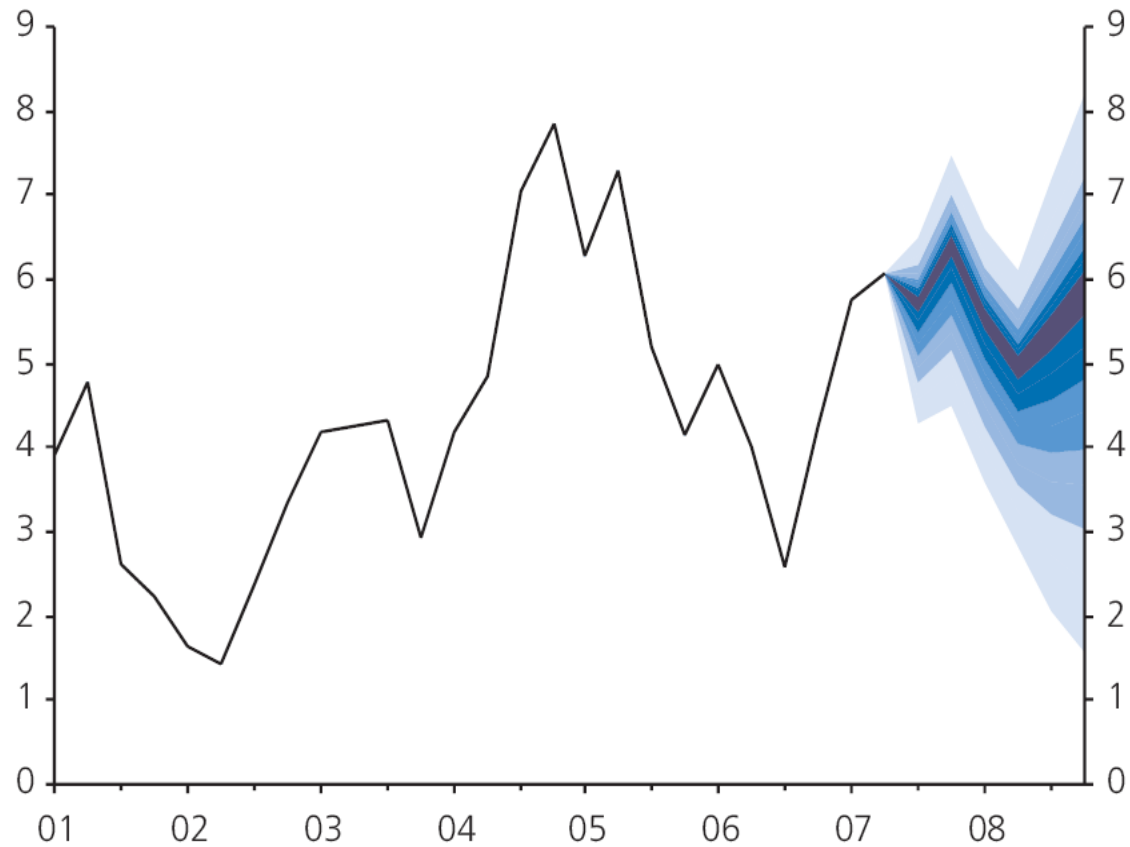
Monetary Policy Regime

- For this reason, the technical judgment of the board of directors is always essential when making forecasts and policy decisions.
- Using these analyses, a base (most likely) scenario is defined as well as alternative or risk scenarios that deviate from the outlook contained in the base scenario.



Projected Growth Scenarios

(Annualized rate, %)

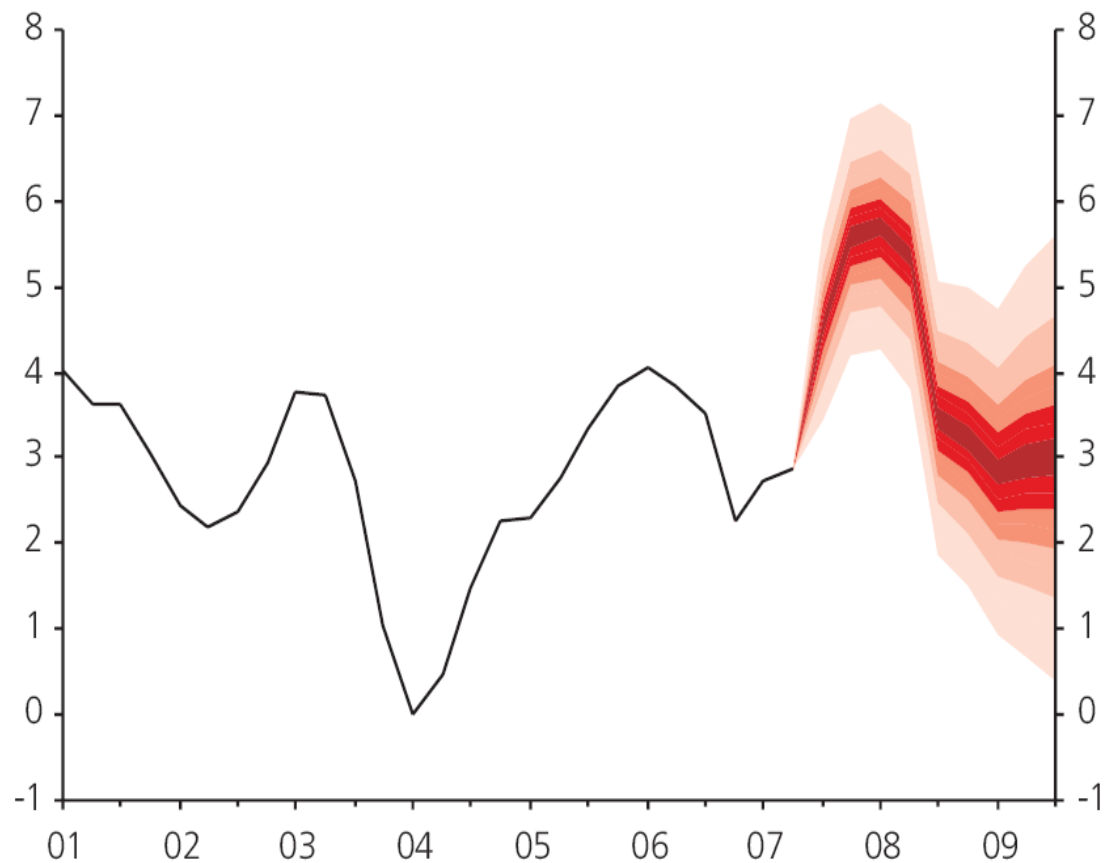


Source: Monetary Policy Report, Central Bank of Chile (September 2007).



Projected Inflation Scenarios

(Annualized rate, %)



Source: Monetary Policy Report, Central Bank of Chile (September 2007).



Monetary Policy Regime

- Monetary policy operates primarily through modifications to the monetary policy rate (MPR), but also through the communications and minutes that indicate the CBC's view of the evolution of the economy.
- An important part of the effects of monetary policy are transmitted via market expectations about the future behavior of inflation and the MPR.



Monetary Policy Regime

- In this context, the credibility of monetary policy is a crucial factor.
- The key lies in the confidence of market agents that the CBC will adjust monetary policy in such a way as to achieve its target.
- For this reason, communication with the market and the transparency of the CBC's decisions are essential.



Monetary Policy Regime

- Monetary policy, therefore, operates through a number of different mechanisms. It has a direct influence on:
 - inflation expectations;
 - interest rates and prices of financial assets;
 - the exchange rate and monetary and credit aggregates.
- All these have a subsequent impact on demand, real activity, costs and, finally, inflation.

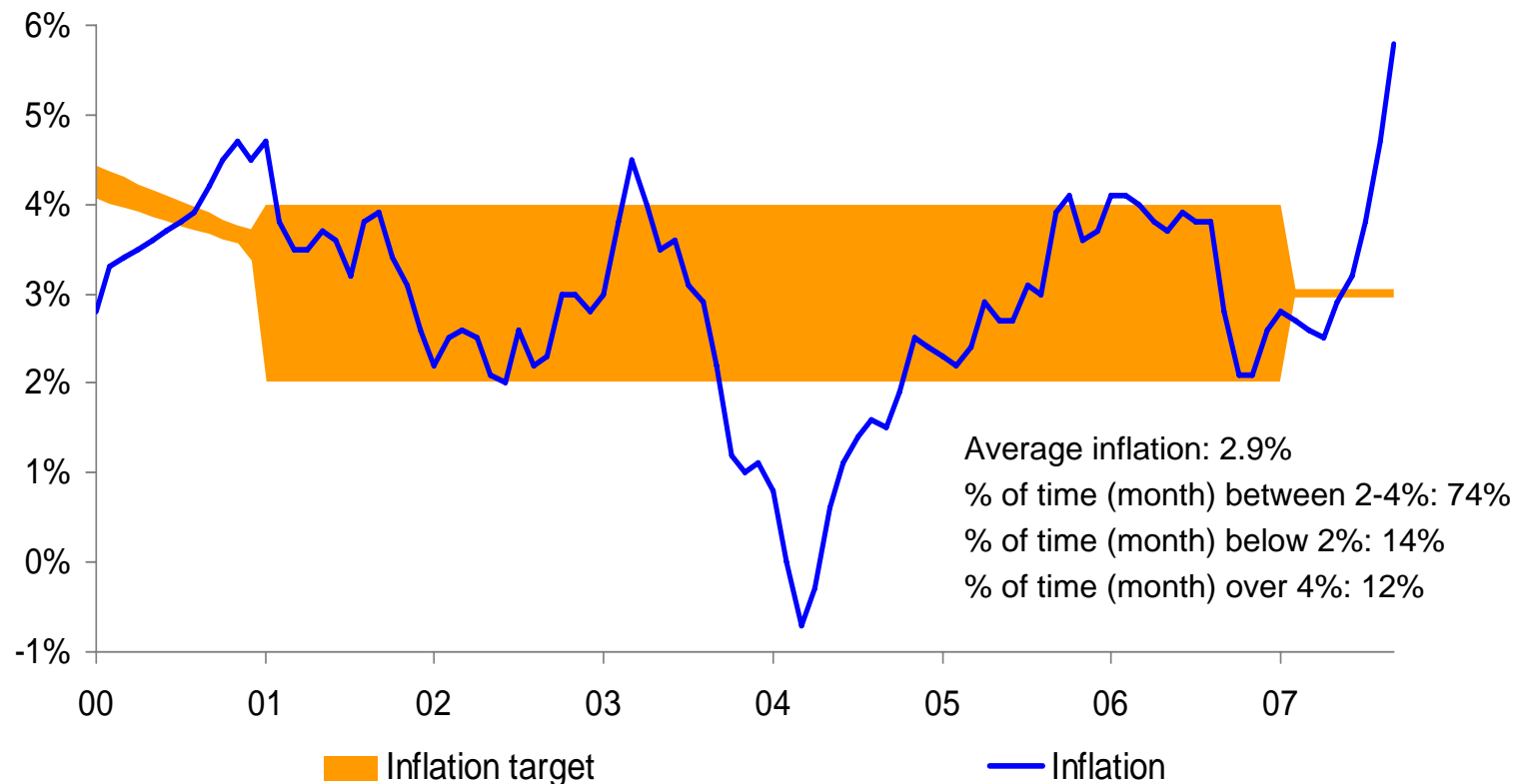


IV. Assessment of Inflation Performance



Inflation has mostly remained at around 3% with a tolerance range of one percentage point

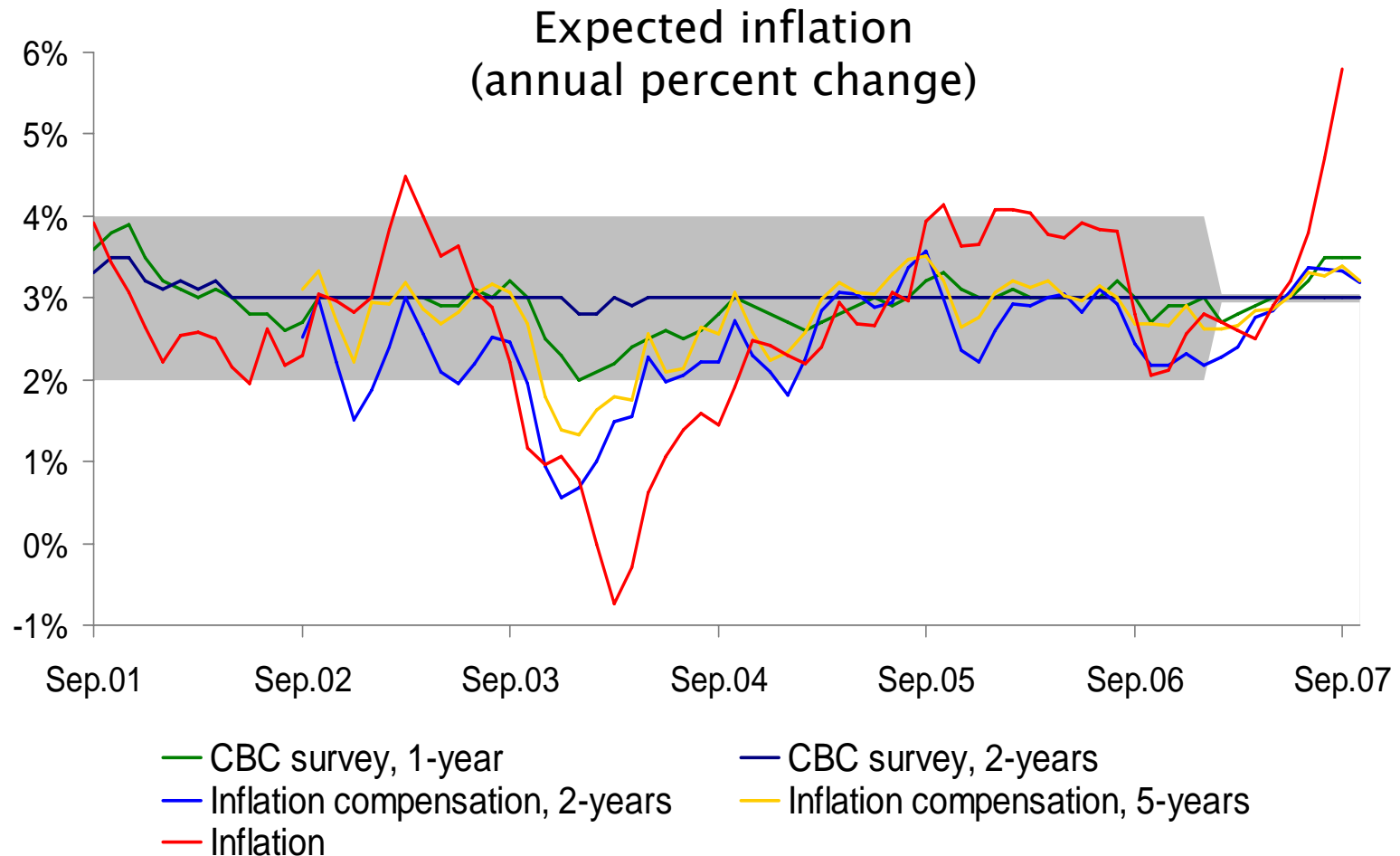
Deviation of inflation rate from target
(January 2000–September 2007, annual percent change)



Sources: National Statistics Bureau and Central Bank of Chile.



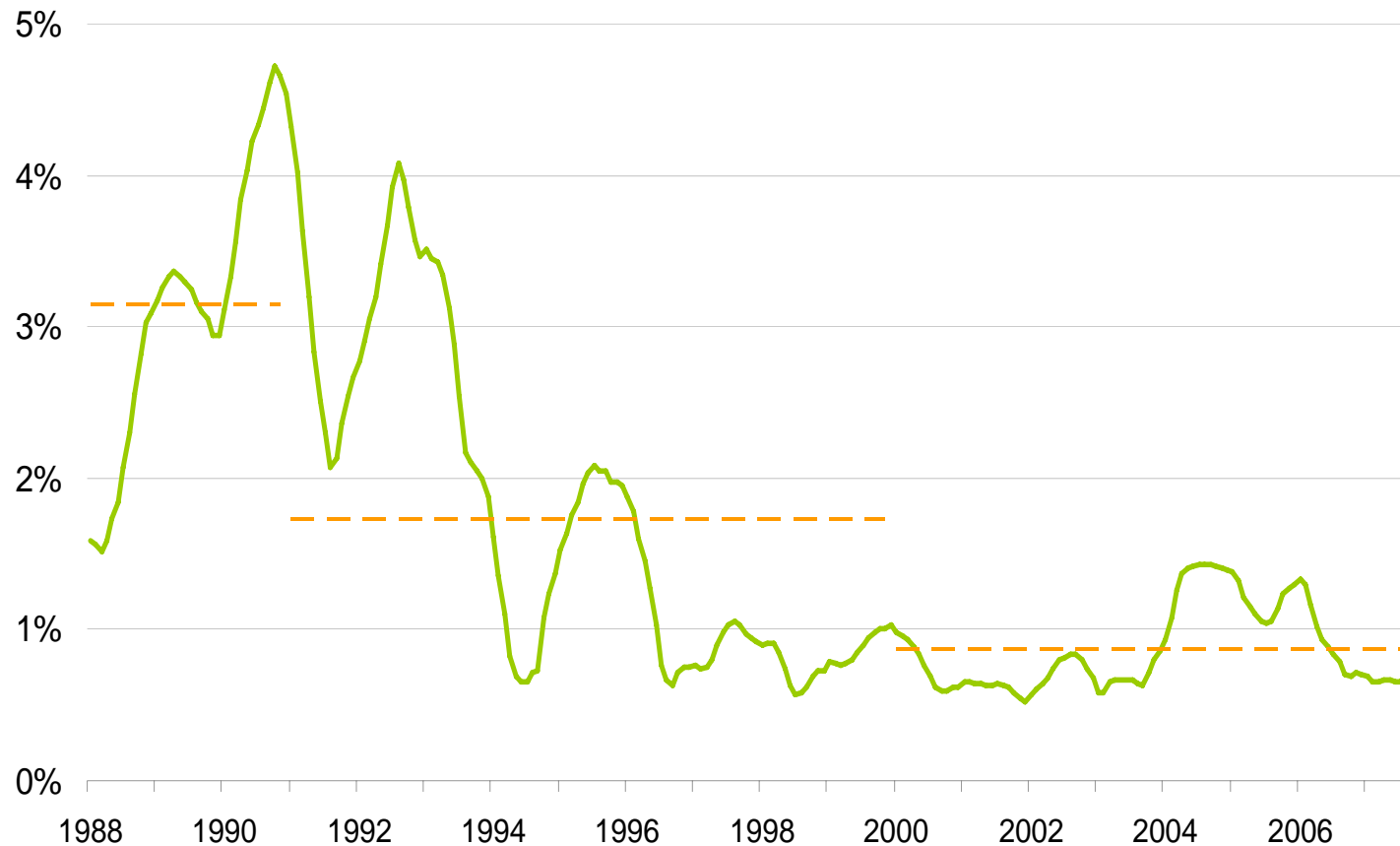
Inflation expectations have remained well anchored around the inflation target.



Source: Central Bank of Chile.



The volatility of inflation has declined.

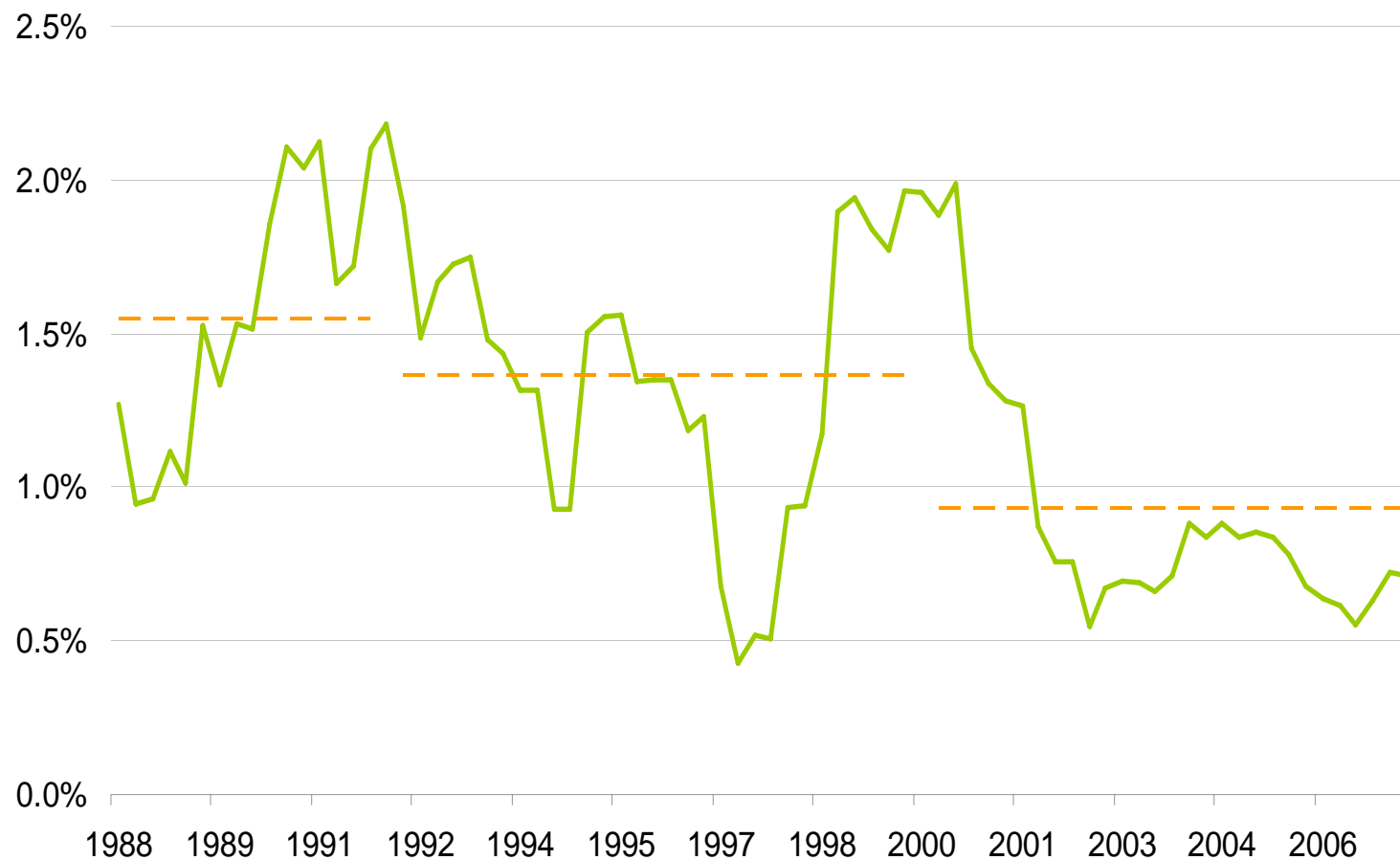


Note: Standard deviation of annual inflation rates using two-year moving windows.

Source: Central Bank of Chile.



The volatility of growth has also declined.



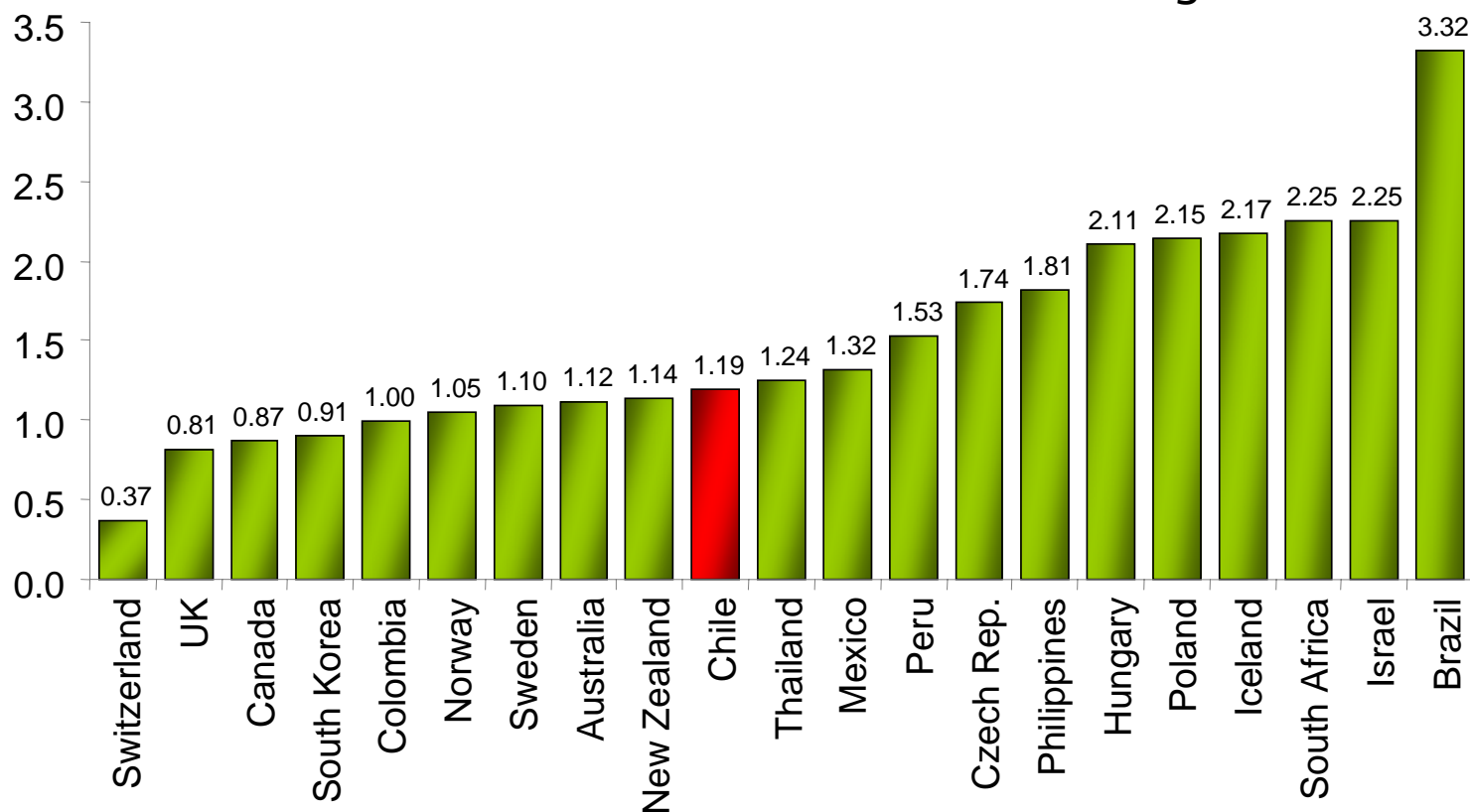
Note: Standard deviation of GDP growth using two-year moving windows.

Source: Central Bank of Chile.



Chile's performance compares favorably with other inflation-targeting countries.

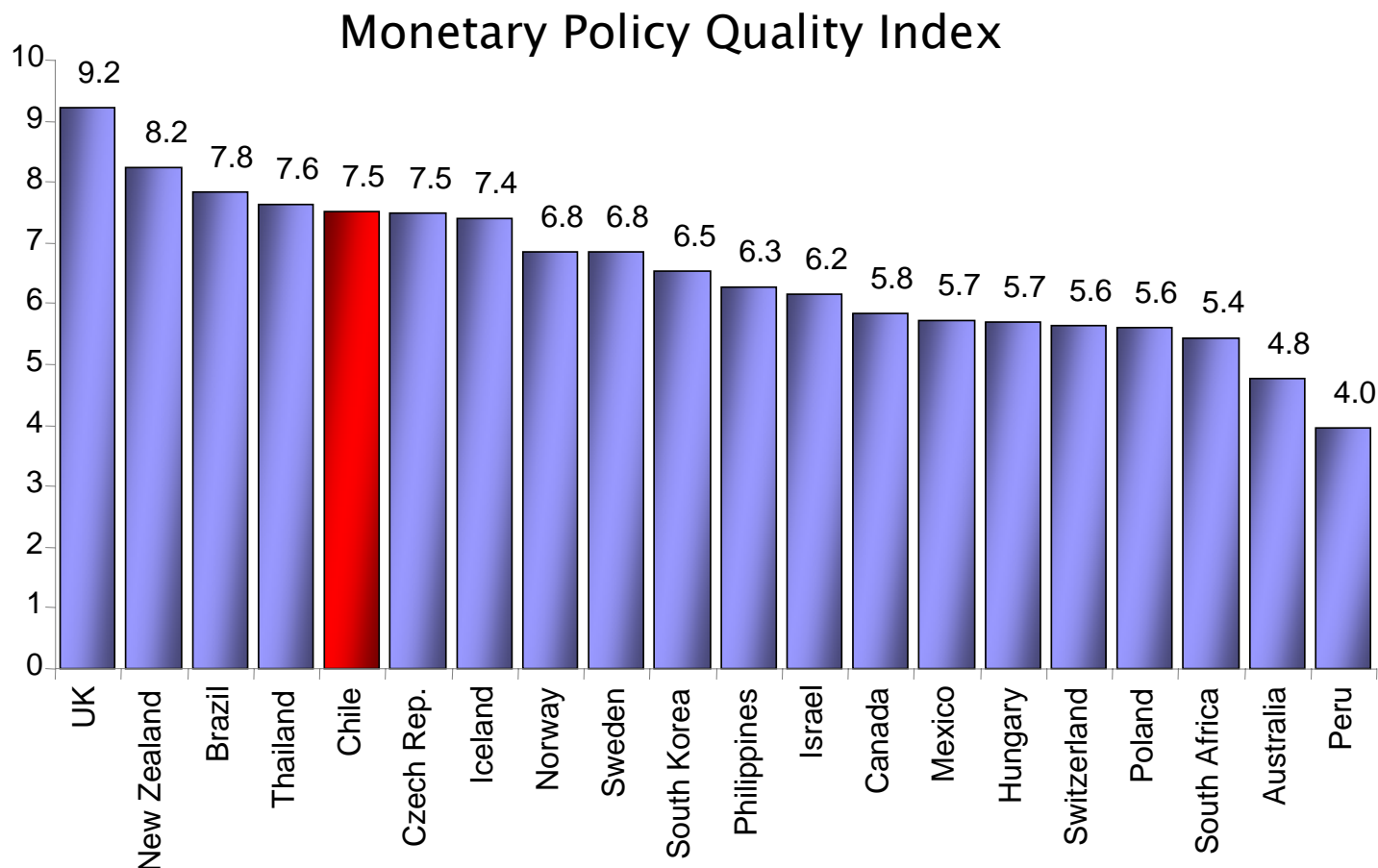
Absolute deviation of inflation from target



Note: Considers the period from the introduction of an inflation-targeting system, which varies from country to country, through March 2007. Source: Based on Albagli and Schmidt-Hebbel (2005).



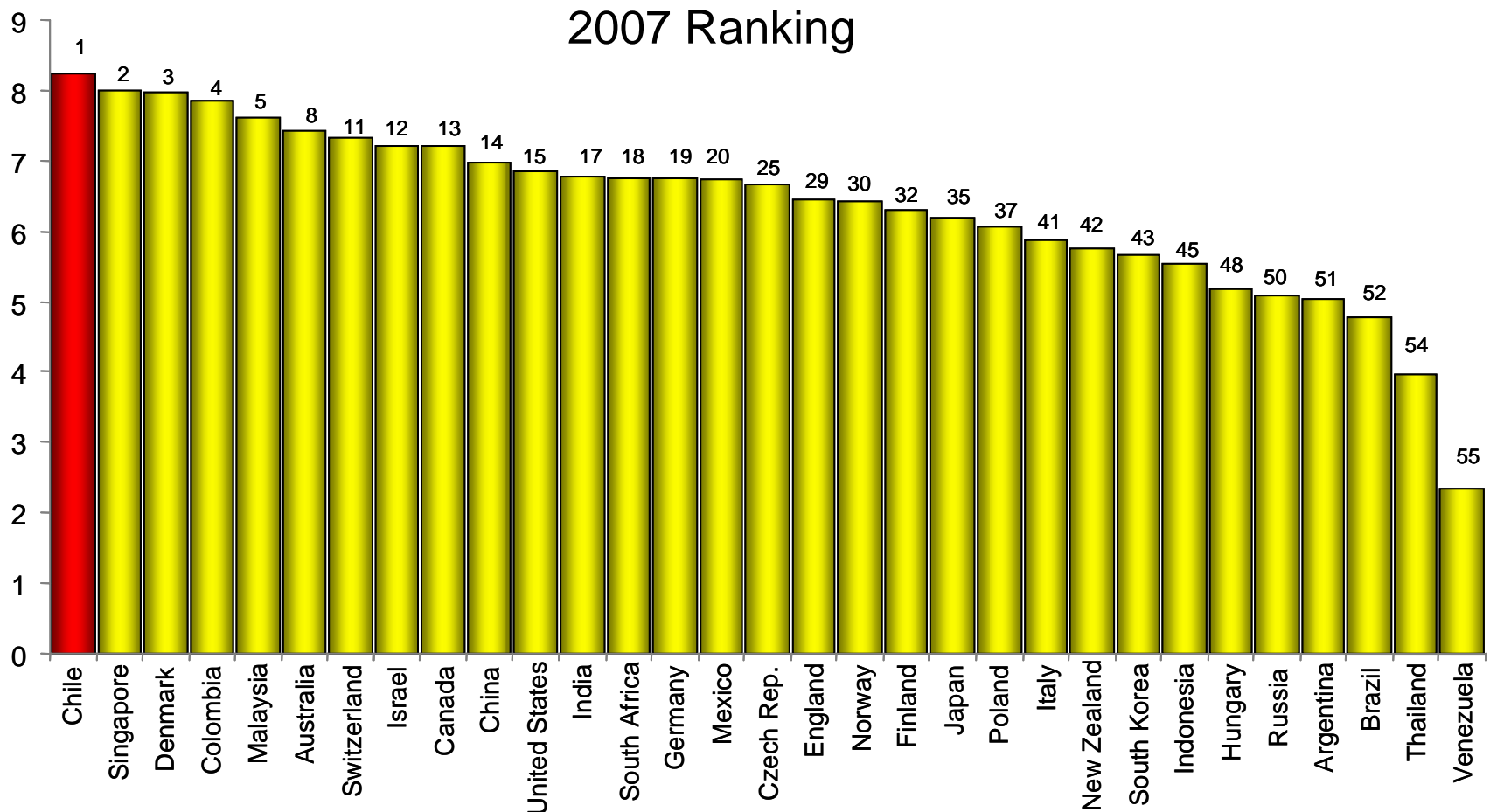
Chile's performance compares favorably with other inflation-targeting countries.



Note: On a scale from 1 to 10; the authors evaluated the monetary policy reports of 20 Central Banks with inflation-targeting systems. Source: Fracasso et. al. (2003).



Chile ranked N°1 for contribution of monetary policy to macroeconomic performance.

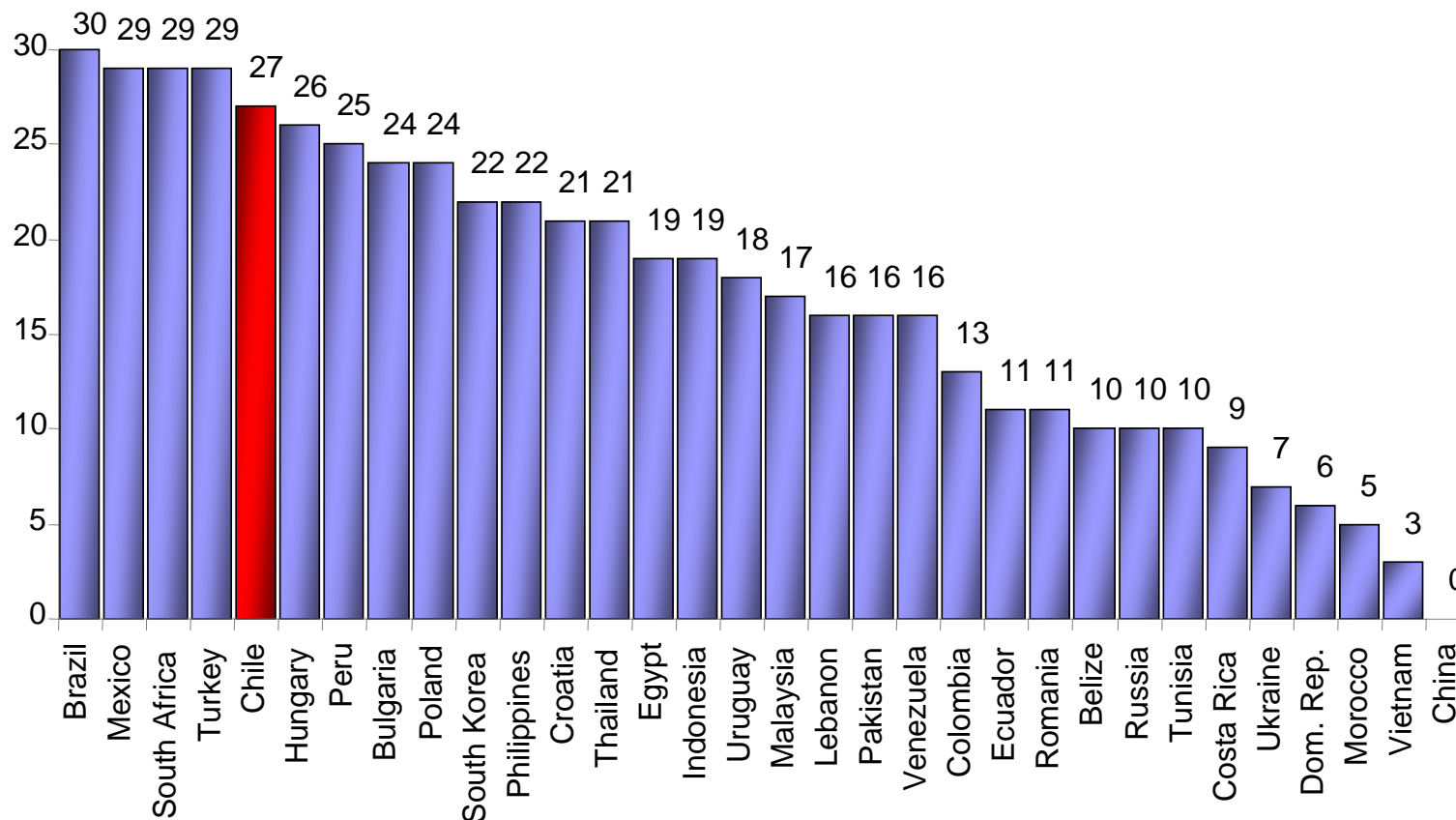


Note: On a scale from 1 to 9; the number over each bar indicates position in the ranking.

Source: World Competitiveness Yearbook 2007, Institute for Management Development.



The CBC's transparency in the delivery of information is also well-ranked among emerging countries.



Note: On a scale from 0 to 30; the sample considers 32 emerging economies.

Source: Institute of International Finance (2006).



V. Monetary Policy Meeting



Importance of the MPM

- The single most important monetary policy decision – the setting of the MPR – is taken in the so-called Monetary Policy Meeting (MPM).
- The MPM takes place monthly and attracts great attention both from the market and the public in general.



Media coverage

EL MERCURIO VIERNES 10 DE AGOSTO DE 2007

Política monetaria:

Banco Central sube tasa a 5,5% y anuncia nuevas alzas para controlar la inflación

Analistas ven una señal más dura para anclar las expectativas de inflación a 3%, manteniendo un ajuste gradual.

LINA CASTAÑEDA

El Banco Central optó por subir la tasa de interés de política monetaria (TPM, desde 5,25 a 5,50% anual), y anticipó que en el escenario más probable seguirá subiendo la tasa en los próximos meses para que la inflación en un horizonte de dos años se mantenga en 3%.

La medida ya había sido internalizada por el mercado, por lo que en opinión de los analistas no debiera incidir en las tasas de interés ni en el precio del dólar.

El comunicado, que fue difundido alrededor de las 18:30 horas de ayer (media hora después de lo acostumbrado), presenta un

énfasis distinto al de meses anteriores. En opinión de algunos analistas, el mensaje esta vez es "más duro y agresivo".

Como es usual, al final del comunicado el banco indica que la evolución de la TPM dependerá de la nueva información que se acumule y de sus implicancias sobre la inflación proyectada.

Pero introduce un nuevo elemento al señalar que, en particular, un cuadro de fuertes shocks de precios específicos requiere especial seguimiento, tanto a la eventual propagación a otros precios como a las expectativas de inflación de mediano y largo plazo.

En opinión de Alejandro Alar-

cón, gerente general de la Asociación de Bancos, el Central reconoce que está siguiendo con cuidado el shock de oferta, por su efecto en las expectativas, y continúa con un ajuste moderado para llegar a una tasa de interés neutral de 6% a fin de año.

Leonardo Suárez, director de Estudios de LarraínVial, califica el mensaje como "bastante duro" al plantear directamente que monitoreará los shocks de precios específicos para anclar las expectativas de inflación.

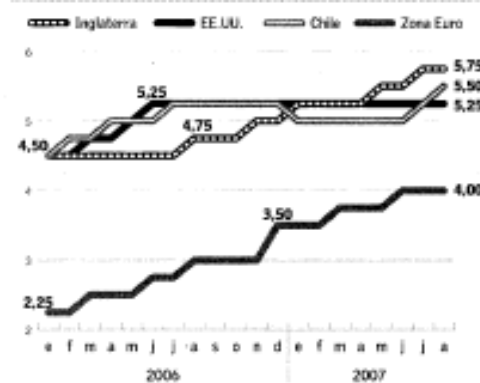
En los últimos dos o tres meses, las expectativas de inflación para bonos a cinco años han subido desde 3 a 3,5% al comparar las tasas nominales con las tasas reales, debido a las fuertes alzas de alimentos y combustibles, que han presionado la inflación.

Aunque el Central mantiene su diagnóstico de que la mayor inflación es por factores externos o exógenos, también está velando por los efectos de segunda vuelta y su impacto en las expectativas, dice Miguel Cardoso, economista jefe del BBVA.

Suárez habría preferido que el banco subiera la tasa en 50 puntos base, pese a lo cual piensa que la señal que entregó el Banco Central es buena y coherente porque reconoce la transferencia

Tasa de Política Monetaria

Evolución del las TPM por país y zona.



• Cifras en porcentaje

Fuente: Bloomberg

EL MERCURIO

de la inflación a otros precios.

La apuesta de Pablo Correa, economista de Santander Investment, era a un alza de 25 puntos base, porque dice que el banco no quería introducir sorpresas a un mercado que ya está bastante volátil. A su juicio, resulta más eficiente aumentar la frecuencia y seguir con alzas de 25 puntos para llegar a 6% en diciembre.

Otro de los elementos distintos fue la argumentación. Cuando subió la tasa de 5 a 5,25% en julio, el instituto emisor dijo que "esta decisión es coherente con holguras de capacidad menores que las previstas en el último Ipom". Esta vez señaló que "esta decisión es necesaria para que la inflación proyectada en torno a dos años se ubique en 3%".

COMUNICADO

"El Consejo del Banco Central de Chile acordó aumentar la tasa de interés de política monetaria en 25 puntos base a 5,5% anual".

"Esta decisión es necesaria para que la inflación proyectada en torno a dos años se ubique en 3%".

"La inflación del IPC se ha elevado hasta casi 4%, muy por encima de la proyectada en el Informe de Política Monetaria de mayo. Se ha profundizado el aumento de los precios de algunos alimentos no perecibles y de los combustibles, a los que se han sumado alzas inusuales en los precios de varios productos perecibles, las que debieran ser en gran medida transitorias".

"En particular, un cuadro de fuertes shocks de precios específicos requiere especial seguimiento tanto a la eventual propagación a otros precios, como a las expectativas de inflación de mediano y largo plazo".

» Lo que pesa en el tipo de cambio

El mercado tenía asumido el aumento de la TPM a 5,5%, pero el precio del dólar subió ayer 2,2 pesos, al incorporar la inestabilidad de los mercados internacionales, dice Alejandro Alarcón.

Esta volatilidad fortalece al dólar en el mundo e impide su caída en Chile, plantea Leonardo Suárez.

Pablo Correa cree que esto puede ayudar al Banco Central, ya que uno de sus problemas es que un alza de tasa muy significativa provoca una fuerte apreciación del peso. Pero con el traslado de los inversionistas desde el mercado subprime hipotecario a otros de menor riesgo, la apreciación del dólar en el mercado externo será útil para ajustar la tasa local. Miguel Cardoso cree posible que el Central no tuviera que incrementar mucho más la tasa de interés.



Formalities and participants

- The date of MPMs is announced six months before they are due to take place.
- The MPM is divided into two sessions:
 - In the morning, economic and financial data is presented and reviewed in detail.
 - In the afternoon, the different policy options are identified and evaluated, board members vote, and a formal short press release is approved.



Formalities and Participants

- Participants:
 - 5 board members with the right to vote;
 - Finance Minister with the right to express opinions, but not vote;
 - Top CBC officials and economists.



MPM in the Board Room





Material prepared for MPM

- A complete set of updated economic and financial data from both domestic and international markets;
- Short and medium-term projections on key macroeconomic variables, i.e. economic activity and inflation, prepared by the CBC's staff;
- Policy options to be considered, including the costs, benefits and risks associated to each.



Economic and financial data presented and reviewed

- Global scenario:
 - Growth trends
 - Inflation and financial markets
 - Commodity prices
- Domestic scenario:
 - Financial markets
 - Aggregate demand, real activity and labor markets
 - Cost factors
 - Market expectations
 - Inflation trends



Examples of charts prepared for the MPM

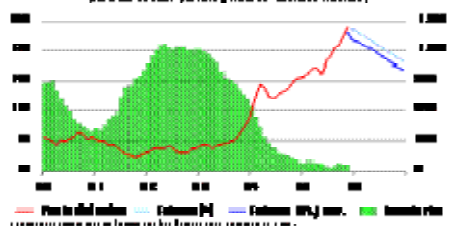
Escenario Internacional

Proyección de Crecimiento
(porcentaje)

	2007	2008	2009	2010	2011	2012	2013	2014	2015
Brasil	5.4	5.4	5.1	5.1	5.4	5.7	5.7	5.4	5.7
Argentina	8.4	8.4	8.4	8.4	8.4	8.4	8.4	8.4	8.4
Chile	5.1	5.4	5.4	5.4	5.4	5.4	5.4	5.4	5.4
Colombia	5.1	5.4	5.4	5.4	5.4	5.4	5.4	5.4	5.4
Costa Rica	5.1	5.4	5.4	5.4	5.4	5.4	5.4	5.4	5.4
Ecuador	5.1	5.4	5.4	5.4	5.4	5.4	5.4	5.4	5.4
El Salvador	5.1	5.4	5.4	5.4	5.4	5.4	5.4	5.4	5.4
Guatemala	5.1	5.4	5.4	5.4	5.4	5.4	5.4	5.4	5.4
Honduras	5.1	5.4	5.4	5.4	5.4	5.4	5.4	5.4	5.4
Paraguay	5.1	5.4	5.4	5.4	5.4	5.4	5.4	5.4	5.4
Panamá	5.1	5.4	5.4	5.4	5.4	5.4	5.4	5.4	5.4
Perú	5.1	5.4	5.4	5.4	5.4	5.4	5.4	5.4	5.4
Uruguay	5.1	5.4	5.4	5.4	5.4	5.4	5.4	5.4	5.4
Venezuela	5.1	5.4	5.4	5.4	5.4	5.4	5.4	5.4	5.4

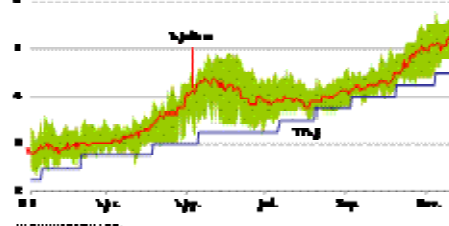
Escenario Internacional

Moneda de Chile
(porcentaje de dólares por libra grande de toneladas métricas)



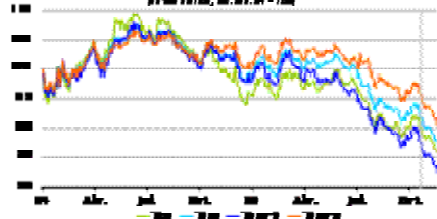
Mercados Financieros

Tasas de Interés de Captación a 90 días, 100 Principales Bancos
(porcentaje)



Mercados Financieros

Tipo de Cambio México
(porcentaje de dólares por libra grande de toneladas métricas)



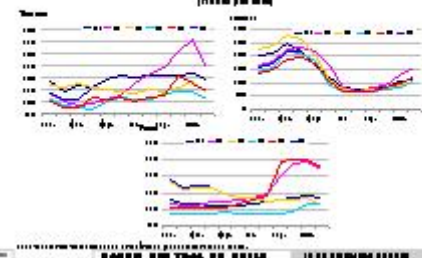
Empleo

Empleo Nacional



Precios y Costos

Precio de Alimentos
(porcentaje por libra)





MPM outcomes

- The monetary–policy decision, which may be to maintain, raise or lower the MPR;
- A press release announcing the decision and its reasons, made available immediately after the meeting;
- Minutes published three weeks after the MPM and including:
 - A summary of the economic and financial information presented and reviewed;
 - The policy options considered and analyzed;
 - The main arguments behind the decision;
 - The vote of each board member.



Example of a press release

Santiago, 11 October 2007

Press Release

In its monthly monetary policy meeting, the Board of the Central Bank of Chile decided to maintain the monetary policy interest rate at 5.75% (annual).

In the last few weeks the liquidity problems in international financial markets have moderated, while the US dollar has depreciated against the majority of global currencies. Meanwhile, a lower dynamism of the industrial economies is foreseen. On another front, the price of copper has increased again, and that of oil and various food products remain high, all above what was forecast. The preceding configures a relevant external scenario for the Chilean economy which continues to be positive, although the risk of adverse international scenarios persists.

Domestically, the available information suggests that output in the third quarter was lower than projected in the last Monetary Policy Report, situation that appears to go beyond the performance of a few specific sectors and whose persistence is still uncertain. Regarding domestic demand, indicators suggest that the dynamism of investment has remained and that of consumption has dropped slightly. Salaried employment keeps rising and domestic financial conditions remain favorable.

Annual CPI inflation has risen over 5% and is foreseen over the coming months to surpass the projections of the last Monetary Policy Report. The unusual increases in some food prices, both perishable and non-perishable, have not only persisted, but have intensified. Non-perishables have also contributed to increasing core CPIX1 inflation (that excludes fuels, perishables and some regulated utilities). Alternative measures of trend inflation stand above 3% annual. Notwithstanding the above, wages have not had an additional acceleration most recently, while the peso dollar parity has dropped over the last several weeks. Inflation expectations for the medium and long term remain anchored around 3% annual, coherent with a transitory increase in inflation.

The future path of the monetary policy interest rate will depend on incoming information and its implications on projected inflation. Of particular importance will be the developments in the international scenario, the propagation of recent inflationary shocks to other prices, especially the path of wages and medium term inflation expectations, as well as the evolution of the output gap.



VI. Final Remarks



Final remarks

- As the literature and experience show, price stability is a prerequisite for high and sustained growth.
- This is properly reflected in Chile's institutional framework which provides the elements needed to achieve this stability.
- From this point of view, the autonomy granted to the CBC to manage monetary policy and maintain a low and stable rate of inflation is particularly important.



Final Remarks

- Over the past two decades, remarkable progress has been achieved on inflation.
- This has strengthened the confidence of economic agents in the CBC and, as a result, the effectiveness of monetary policy has increased.



Final remarks

- Under the present monetary policy regime, the confidence of agents that the CBC will take all the necessary steps to maintain stability is key.
- Monetary policy has also been supported by other components of Chile's institutional and policy framework, particularly its fiscal discipline and the safety and soundness of its financial system.



Final remarks

- Although very significant progress has been achieved as regards inflation, this cannot be taken for granted and discipline and perseverance are necessary.
- That is why the CBC constantly reaffirms its commitment to the goal of price stability and, particularly, to its decision to manage monetary policy in such a way that projected inflation remains at around 3% over its policy horizon.



Final remarks

- By acting in this way, the Central Bank of Chile is fulfilling its legal mandate while, at the same time, making its best contribution to the growth of the country's economy and the welfare of its population.



MONETARY POLICY IN CHILE

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