



# Monetary Policy in Chile

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Governor



# Agenda

1. Monetary policy framework
2. Basic principles of monetary policy
3. Monetary policy at the Central Bank of Chile
4. Communication and transparency
5. International financial turmoil
6. Conclusions



# Monetary policy framework

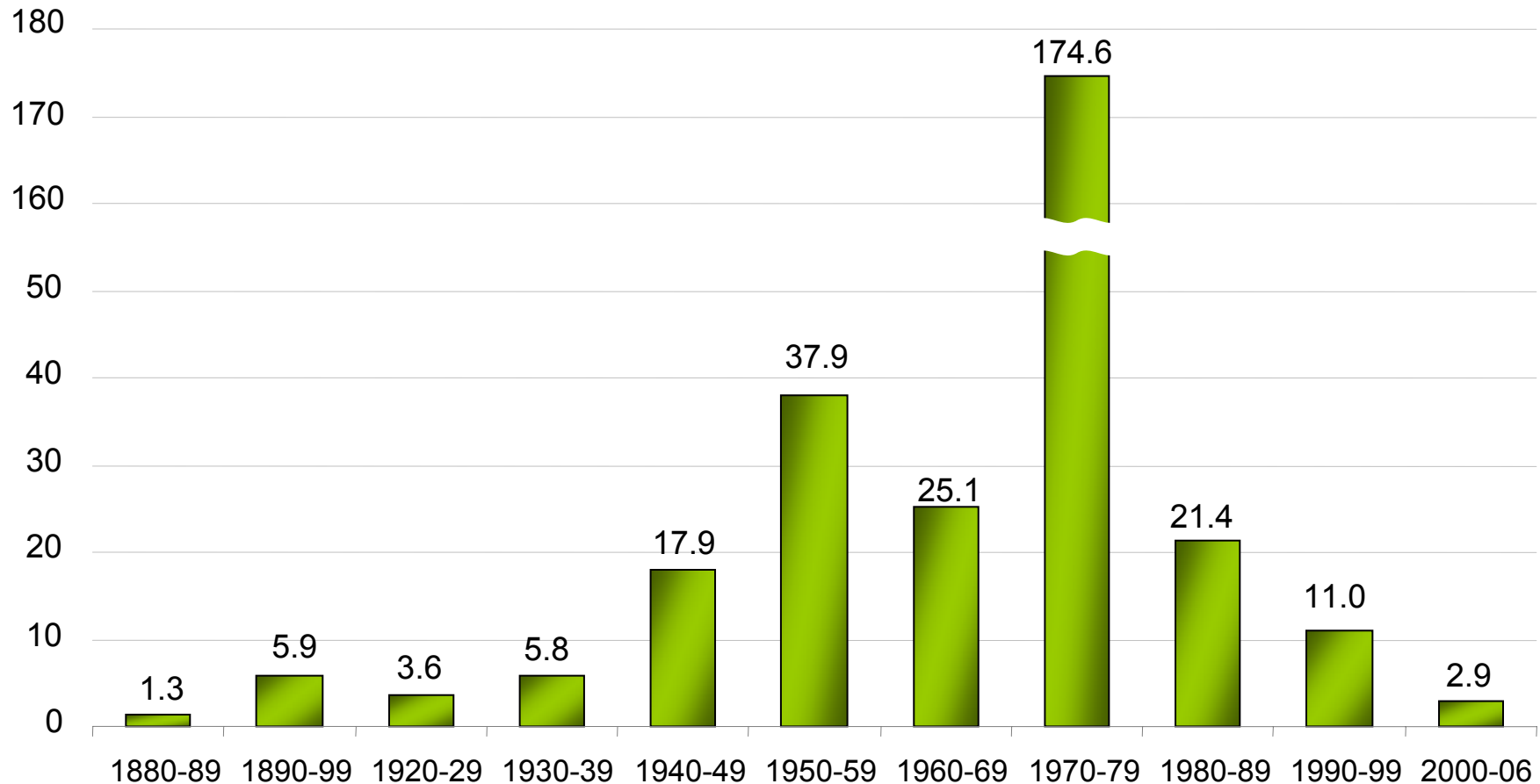


# CBC objective

- The objective of the Central Bank of Chile is "to safeguard the stability of the currency and to ensure the normal functioning of domestic and external payments".
- The actions and decisions related with price stability constitute what is known as Monetary Policy (MP).
- In Chilean history, price stability has been an elusive objective, due to:
  - Lack of clarity with respect to the objective of monetary policy.
  - Incapacity to control fiscal deficit.
  - Inconsistency across foreign exchange, fiscal and monetary policies.



# Annual inflation (average of period, percent)



Sources: Central Bank of Chile; International Financial Statistics, IMF.



# Legal instruments

- The Constitutional Law that governs the CBC since 1990 provides the following instruments to attain its objective:
  - Autonomy to conduct MP.
  - Legal authority (issue of currency, conduct of monetary and foreign exchange operations).
  - Technical and material resources.

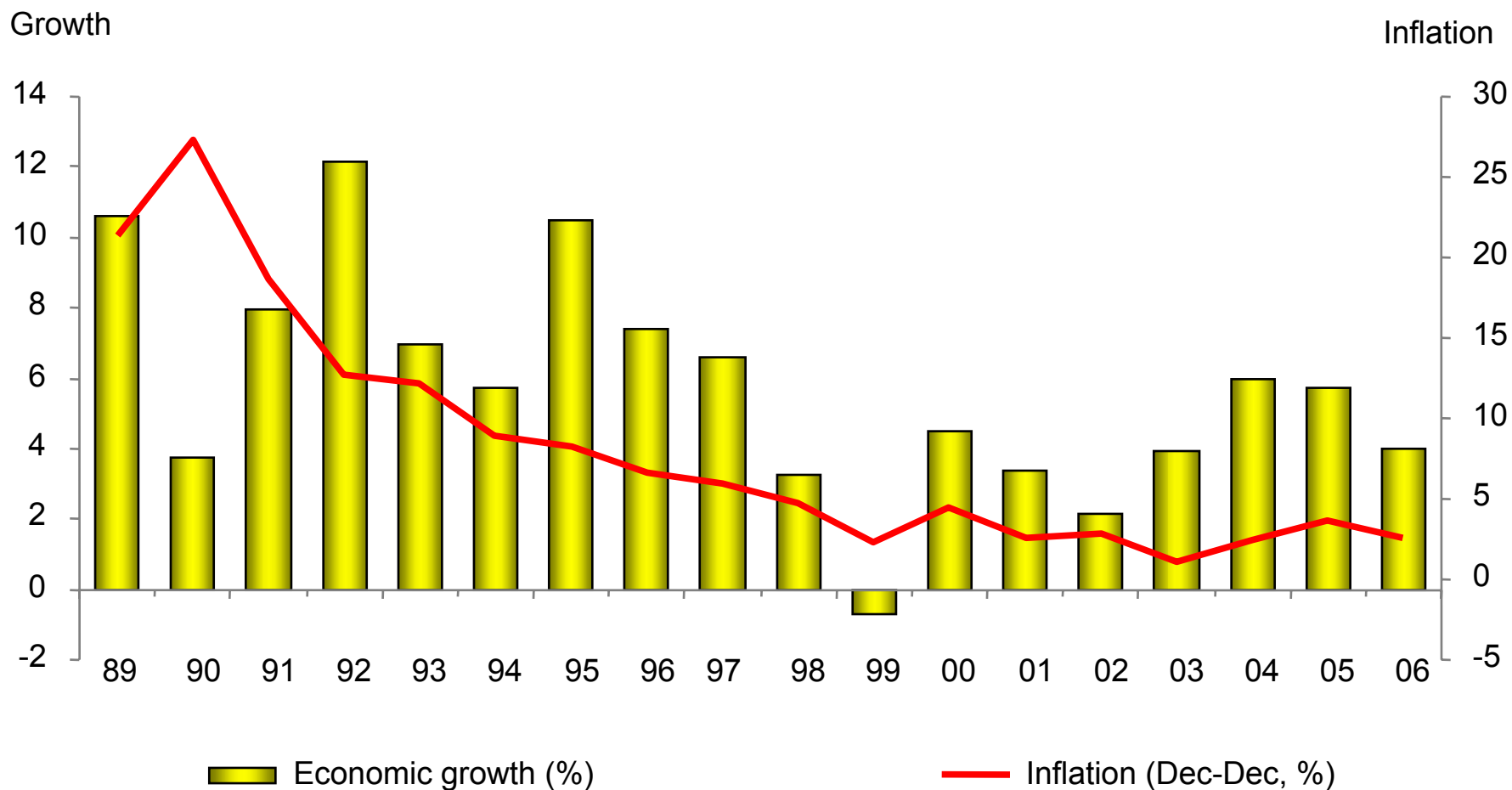


# Monetary policy framework

- From the early nineties, the framework of monetary policy has evolved into one of inflation targeting.
- The inflation-targeting scheme, combined with a floating exchange rate, a solvent fiscal sector and a solid financial system, have allowed Chile to reach macroeconomic stability:
  - Gradual reduction in inflation during the nineties, along with high economic growth.
  - Reduction in both inflation and growth volatility.



# Growth and inflation (1989-2006)



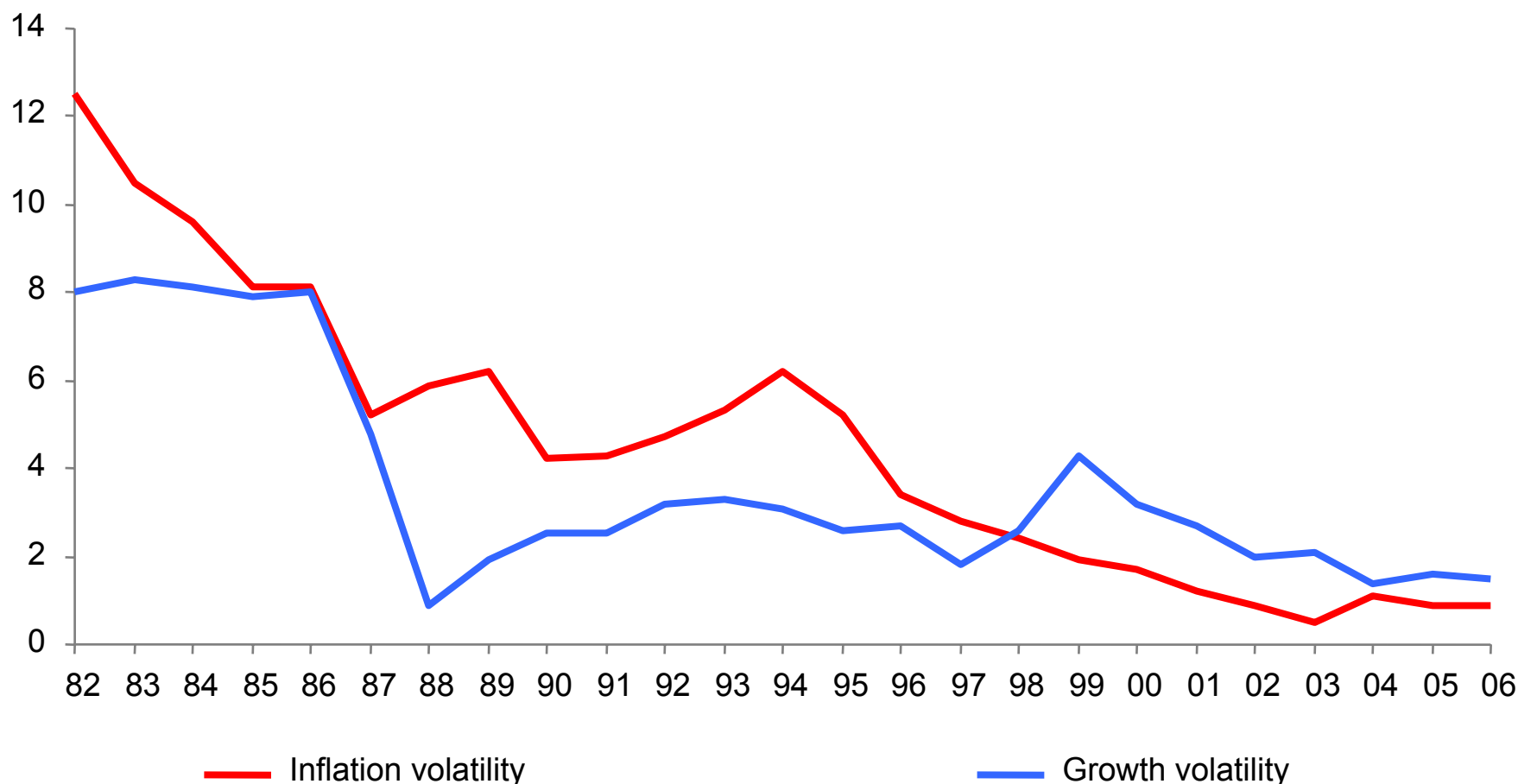
Source: Central Bank of Chile.





# Inflation volatility and growth volatility

(standard deviation of rolling five-year window)



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



# Basic principles of monetary policy



# Major changes in the last 30 years

- Common thought until mid-1970s: inflation can permanently stimulate employment and activity.
- Today: consensus on the inexistence of a long-run tradeoff.
  - Unemployment  $<$  natural U rate  $\Rightarrow$  accelerating inflation.
- Long run: inflation is determined by MP.
- Short run: MP affects output and employment.
  - However, the scope for fine tuning is small.



# Monetary policy design

- To control the price trend, the CBC adjusts the interest rate to achieve the target inflation in the policy horizon.
- Three channels of MP passthrough:
  - Inflation expectations: importance of communication and transparency.
  - Interest rates and financial-asset prices.
  - Monetary aggregates and credit trends.



# Importance of price stability

- Price stability contributes to macroeconomic stability and growth:
  - It improves prices' information content, thus contributing to improve efficiency, financial development and investment.
  - It avoids deterioration of income distribution. Inflation is a regressive tax that damages with particular intensity the ones who have less.



# Why is price stability above zero-CPI-inflation?

- Inflation target 3% with a tolerance range of +/-1pp.
- CPI overestimates true consumer inflation.
- Bigger bias in emerging countries:
  - Larger impact of technological advance.
  - Basket updated less frequently (Chile: every 10 yrs).
- Difficult MP if interest rates are too low (high cost of deflation).



# Inflation targets

(annual percent change, 2007)

Developed economies		Emerging economies	
Switzerland	<2%	Israel	1-3%
United Kingdom	2% (+/-1pp)	Chile	3% (+/-1pp)
Sweden	2% (+/-1pp)	Mexico	3% (+/-1pp)
Iceland	2.5%	Thailand	0-3.5%
Norway	2.5%	Peru	2% (+/-1pp)
Australia	2-3%	Poland	2.5% (+/-1pp)
Canada	1-3%	South Korea	2.5-3.5%
New Zealand	1-3%	Czech Rep.	3% (+/-1pp)
		Hungary	3% (+/-1pp)

Source: Central Bank's website.



# CPI bias in developed economies

	<b>Average (percentage points)</b>	<b>Range (percentage points)</b>
Substitution	0.2 Chile: 0.6*	0.05-0.4
New product and quality	0.4	0.1-0.7
New outlet	0.1	0-0.25

Note: CPI bias on average found in developed economies.

(\*) Le Fort (1998).





# Monetary policy at the Central Bank of Chile

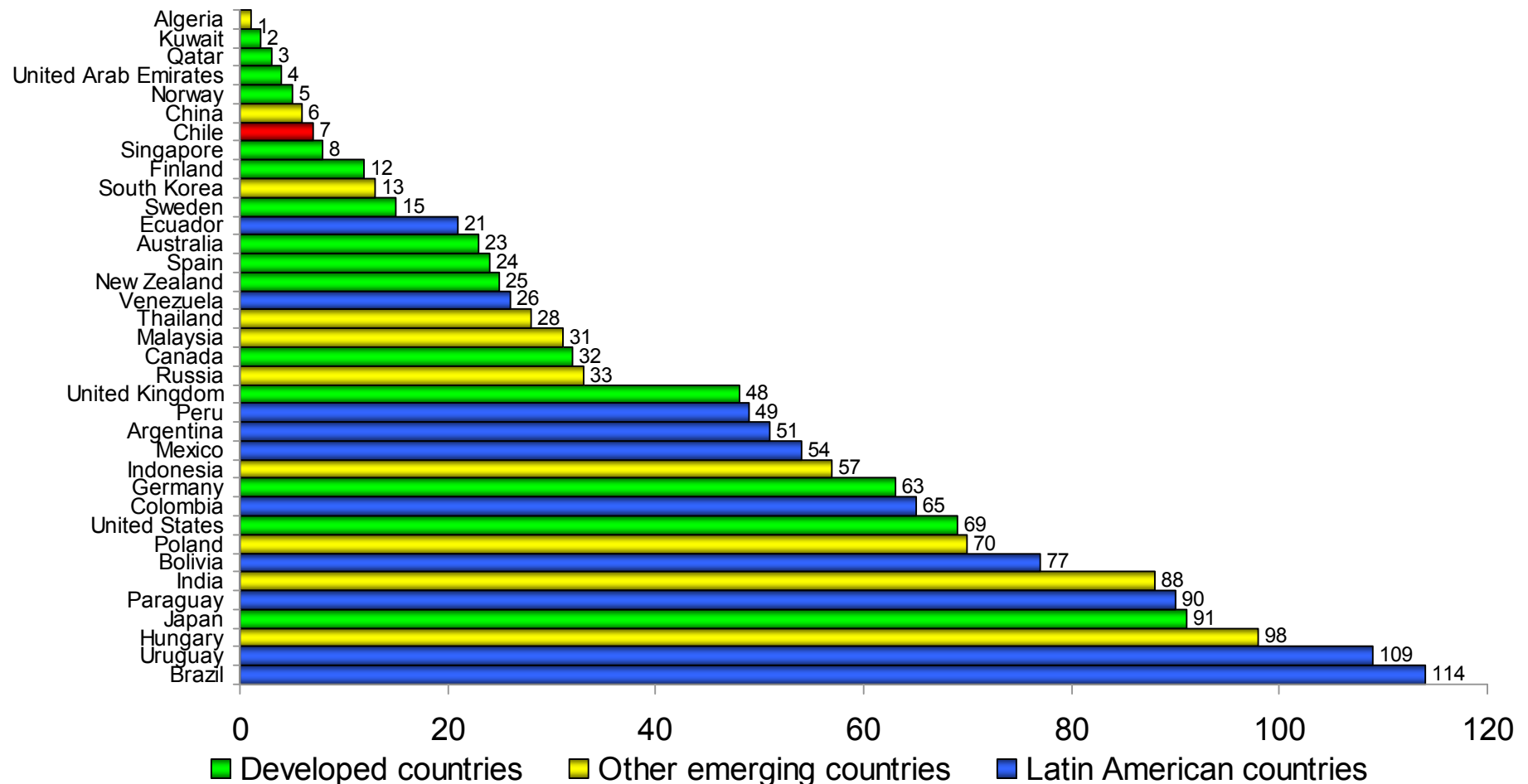


# Macroeconomic policy framework

- Monetary policy is part of Chile's overall macroeconomic framework, which rests on four pillars:
  - An autonomous Central Bank with the explicit mandate of safeguarding stability of prices and payments.
  - A low public-debt-to-GDP ratio and a fiscal policy rule anchored to a structural fiscal surplus.
  - A robust financial system, with competitive and well-capitalized banks, appropriately regulated and supervised.
  - A full-fledged inflation-targeting framework, complemented by a floating exchange rate regime.



# Macroeconomic management (ranking, 2006)



Note: The number beside each bar represents the place in the ranking.

Source: Global Competitiveness Report 2006-2007, World Economic Forum (September 2006).



# Central bank autonomy

Indicator	1980			2003		
	Political autonomy	Economic autonomy	Total	Political autonomy	Economic autonomy	Total
Developed countries (27)	0.36	0.49	0.42	0.69	0.80	0.75
Emerging countries (135)	0.26	0.37	0.31	0.45	0.66	0.55
IT-countries (21)				0.50	0.83	0.66
Chile	0.17	0.20	0.18	0.50	0.88	0.69

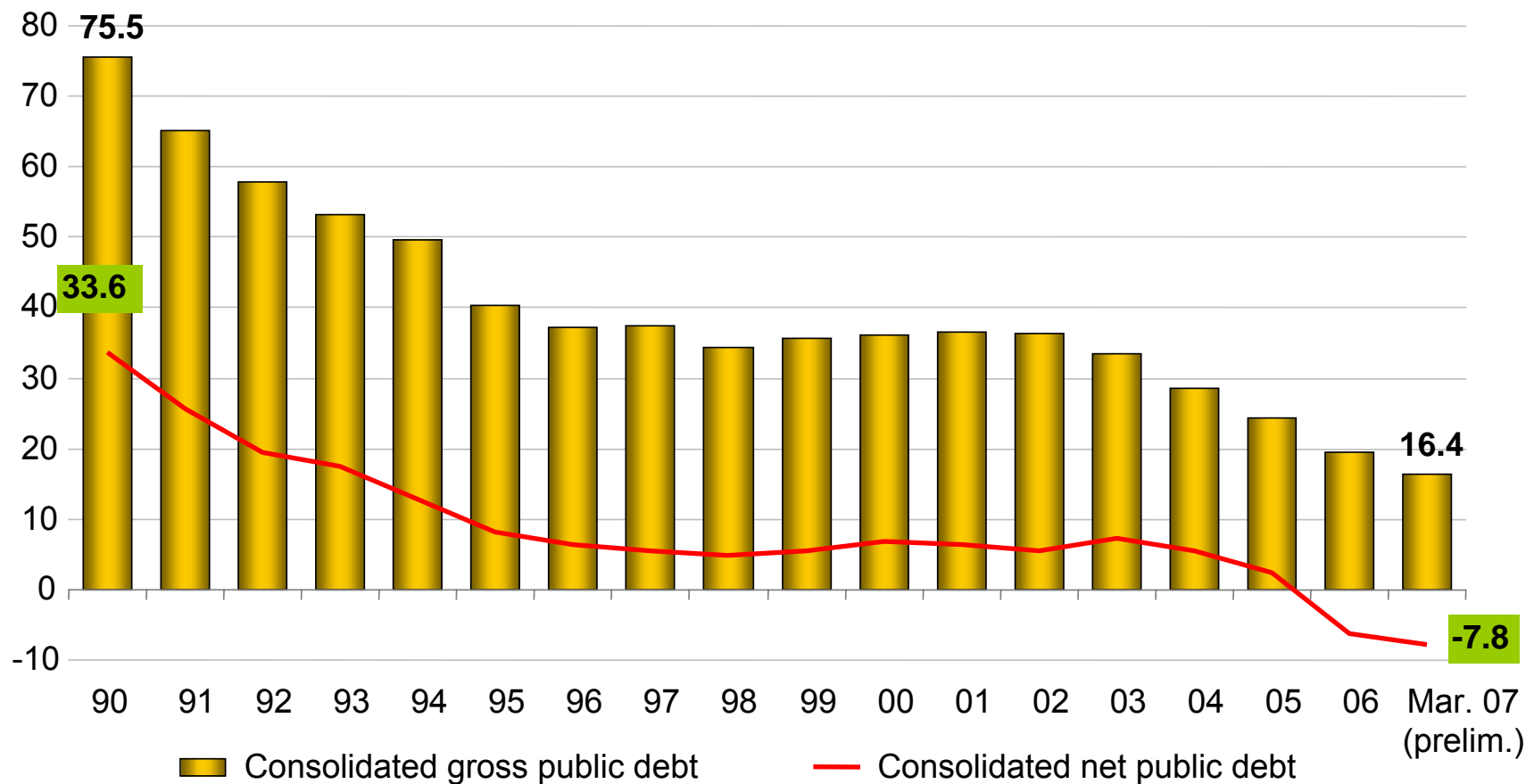
Note: The component of political autonomy measures the degree of independence of the Central Bank's Governor (appointment, duration, replacement and restriction) and the Board members (appointment and duration), and the presence of mandatory participation of a government representative in the Board. In addition, it considers if there is autonomy in the formulation of the monetary policy and if price stability is a primary objective of the central bank. The component of economic autonomy considers if direct credit facilities to the government are carried out by the central bank and, if so, at which market interest rate, amount of the credit and whether it is temporary or not. In addition, the component considers if the central bank has the exclusive responsibility in setting the interest rate and has responsibility in the supervision of the banking system. The total index summarizes all these aspects.

Source: Arnone et al. (2007).



# Government debt in Chile

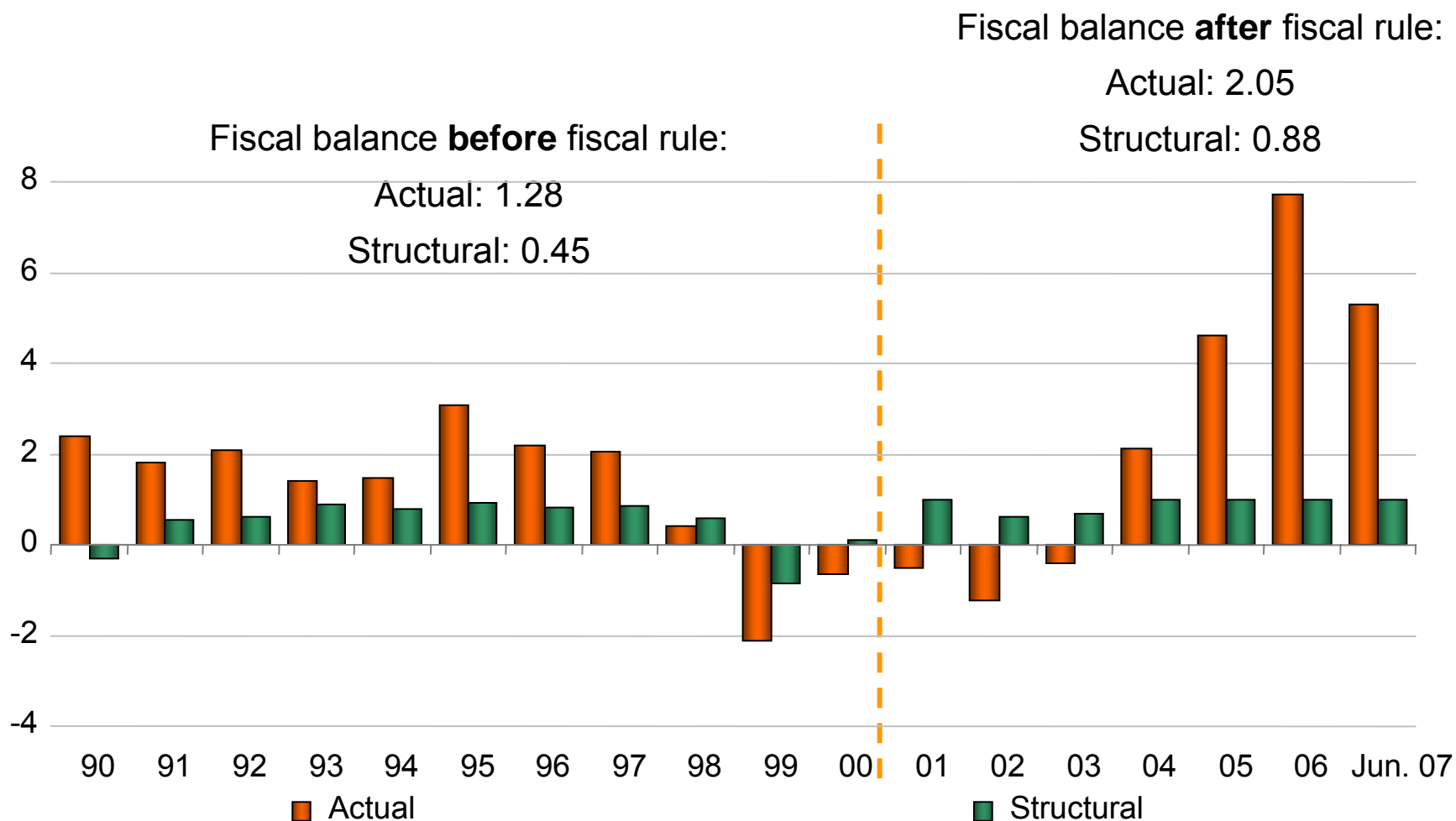
(percent of GDP)



Sources: Chile's Ministry of Finance; Central Bank of Chile.



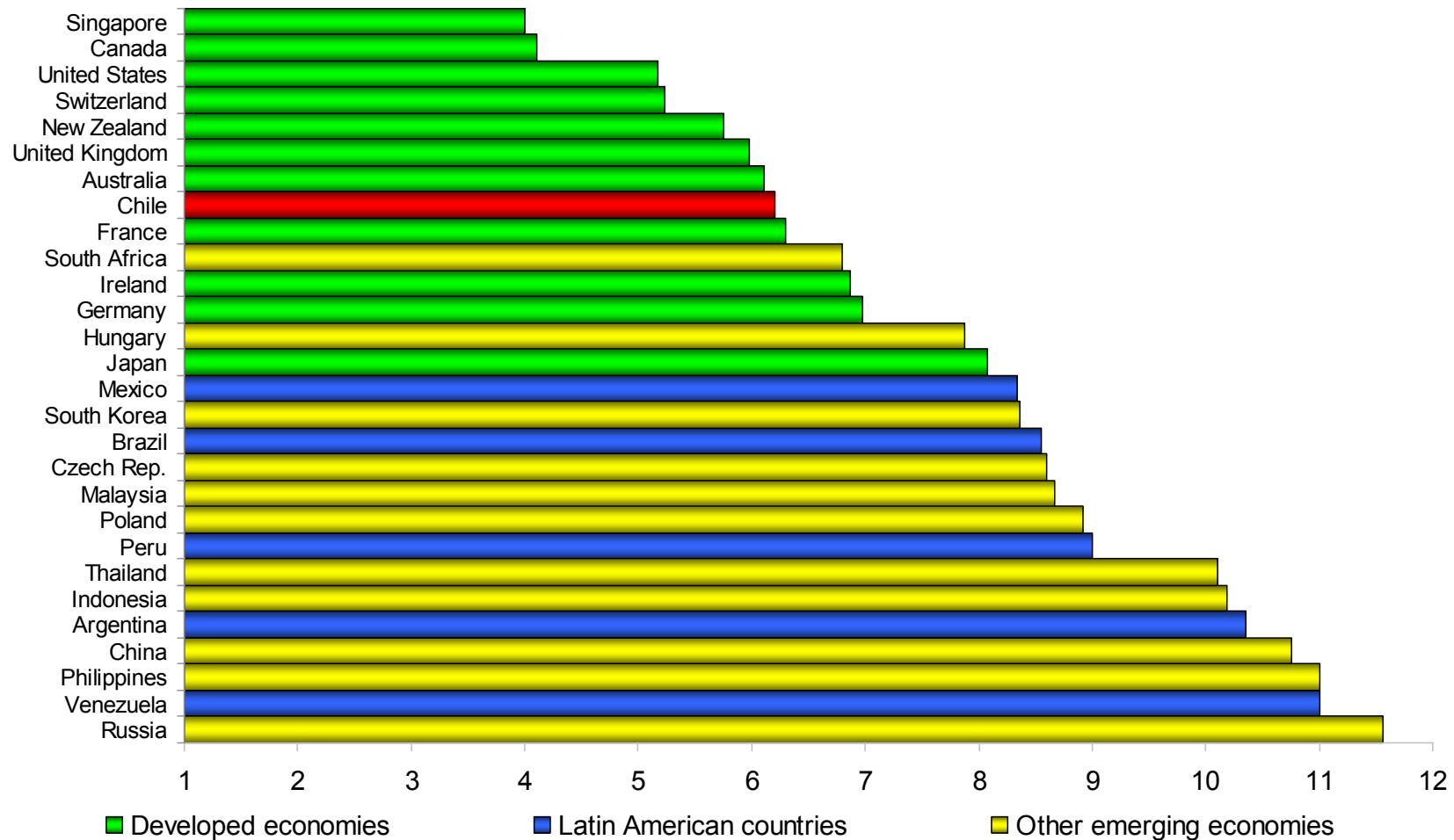
# Central government balance in Chile (percent of GDP)



Source: Chile's Ministry of Finance.



# Banking system strength (index, September 2007)



Note: It is quantified in a scale from 1 to 12. Lower levels of the index indicate stronger banking sectors.

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



# Inflation-targeting regime

- Gradual implementation of the IT regime:
  - 1991-1999: Adoption of firm inflation targets but without full framework (phase one);
  - 2000 to the present: Full-fledged IT regime (phase two).
- Phase one falls short of a full-fledged inflation targeting regime. MP was focused on two targets (inflation and the exchange rate).
- Phase two features a single inflation target and an active communication strategy for MP.



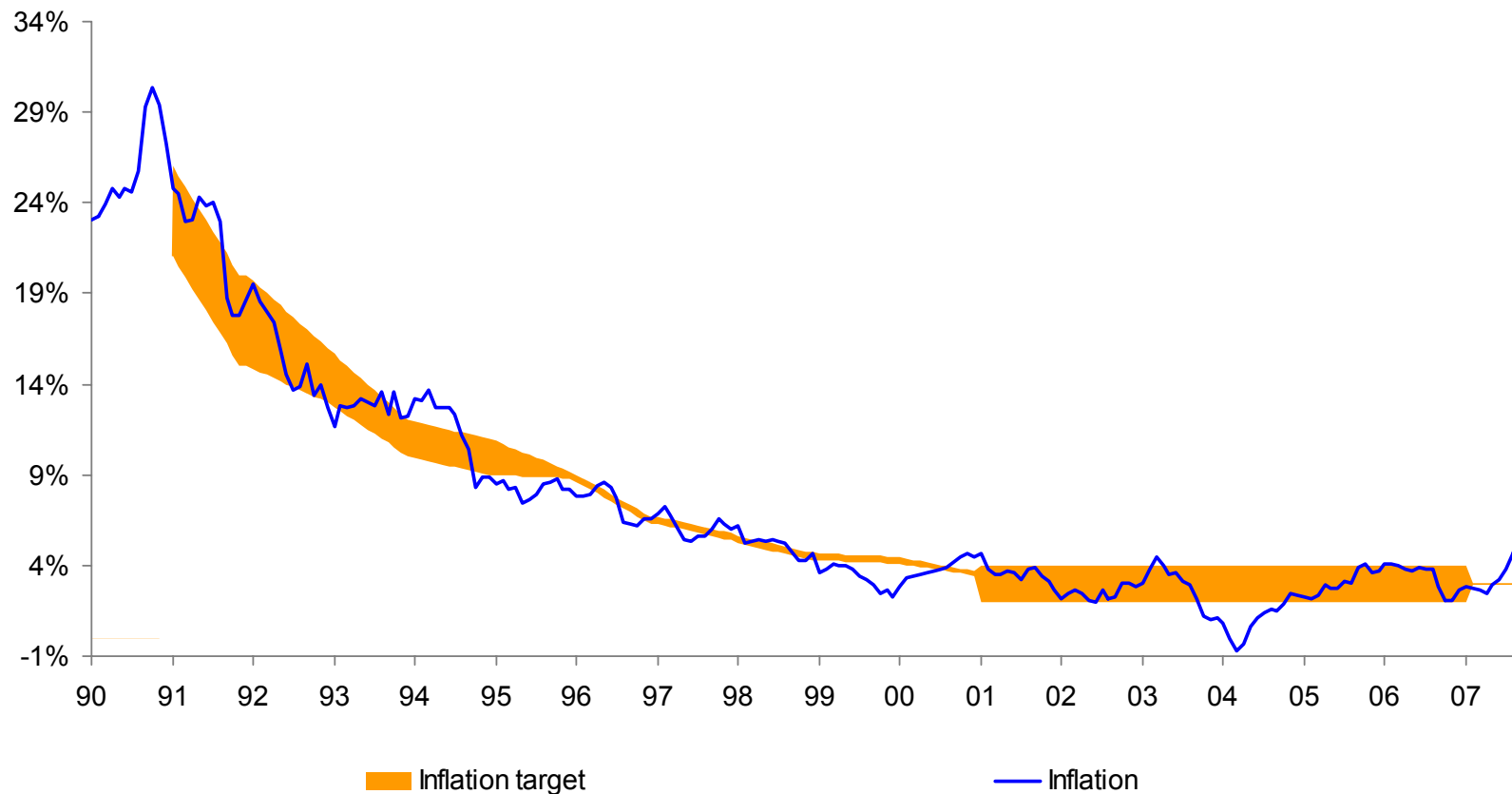


# Features of IT, 1991-1999

- Partial IT was introduced in 1991:
  - Annual announcements of CPI inflation targets: in September of each year for next year's Dec-to-Dec inflation.
    - Announcement of annual target ranges during 1990-1996 and annual point targets during 1997-1999.
  - Annual targets were lowered by 1.5 percentage points per year on average.
- Inflation performance improved strongly during this period: annual inflation fell from 20%-30% to low single-digit levels.
- However, independence and effectiveness of MP were hindered by conflicts between exchange-rate-band commitment, annual inflation targets, and capital controls.



# Inflation target and inflation rate (annual change, percent)



Sources: National Statistics Bureau; Central Bank of Chile.



# Transition to full-fledged IT scheme

- Transition to full-fledged IT was carried out in 2000 with:
  - Inflation rate converging near 3%;
  - MP credibility strengthened by attainment of inflation targets;
  - Adoption of a floating-exchange-rate regime;
  - Abolition of capital controls.



# Full-fledged IT scheme

- Between 2000 and 2006, the inflation target was defined to keep annual inflation most of the time within a range of 2% to 4%, with MP horizon at 12 to 24 months.
- Since 2007, the main MP objective is to keep the annual CPI inflation rate most of the time at around 3%, within a symmetric tolerance range of one percentage point.
  - This target strengthens the 3% mid point as the nominal anchor of the economy, while acknowledging that inflation can temporarily deviate from the 3+/-1pp range to accommodate transitory shocks.
- Monetary policy operates with a policy horizon of around two years.

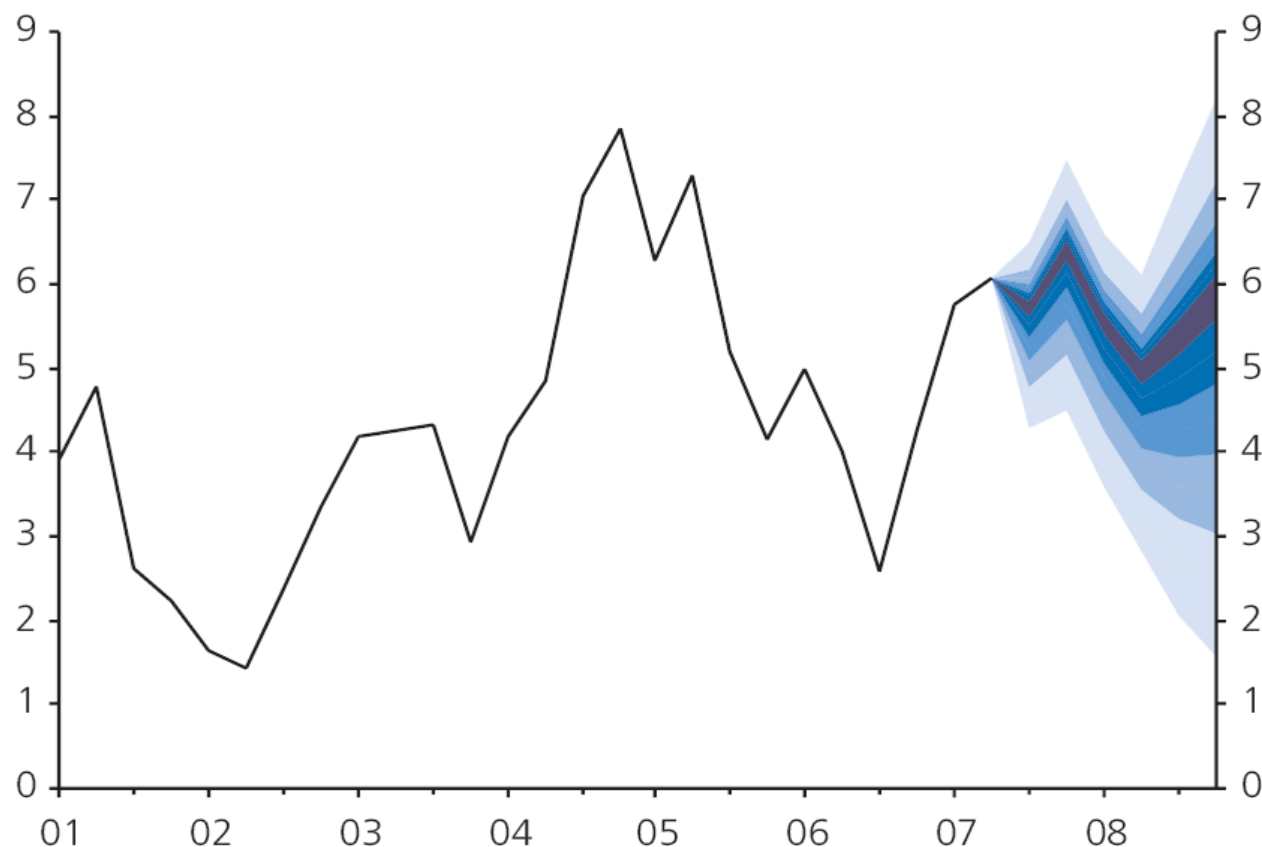


# Full-fledged IT scheme

- Lagged MP effects require that the CBC anticipate price changes.
- The importance of a forward-looking approach (projected inflation) emerges:
  - Great technical capacity and judgment is needed to make projections of price changes.
  - A set of economic and statistical models, in continuous improvement, are used in interaction with the judgment of the Board members.
  - The result of the forward-looking exercise is a baseline or most likely scenario and alternative risk scenarios, that take into account the uncertainty of the process.



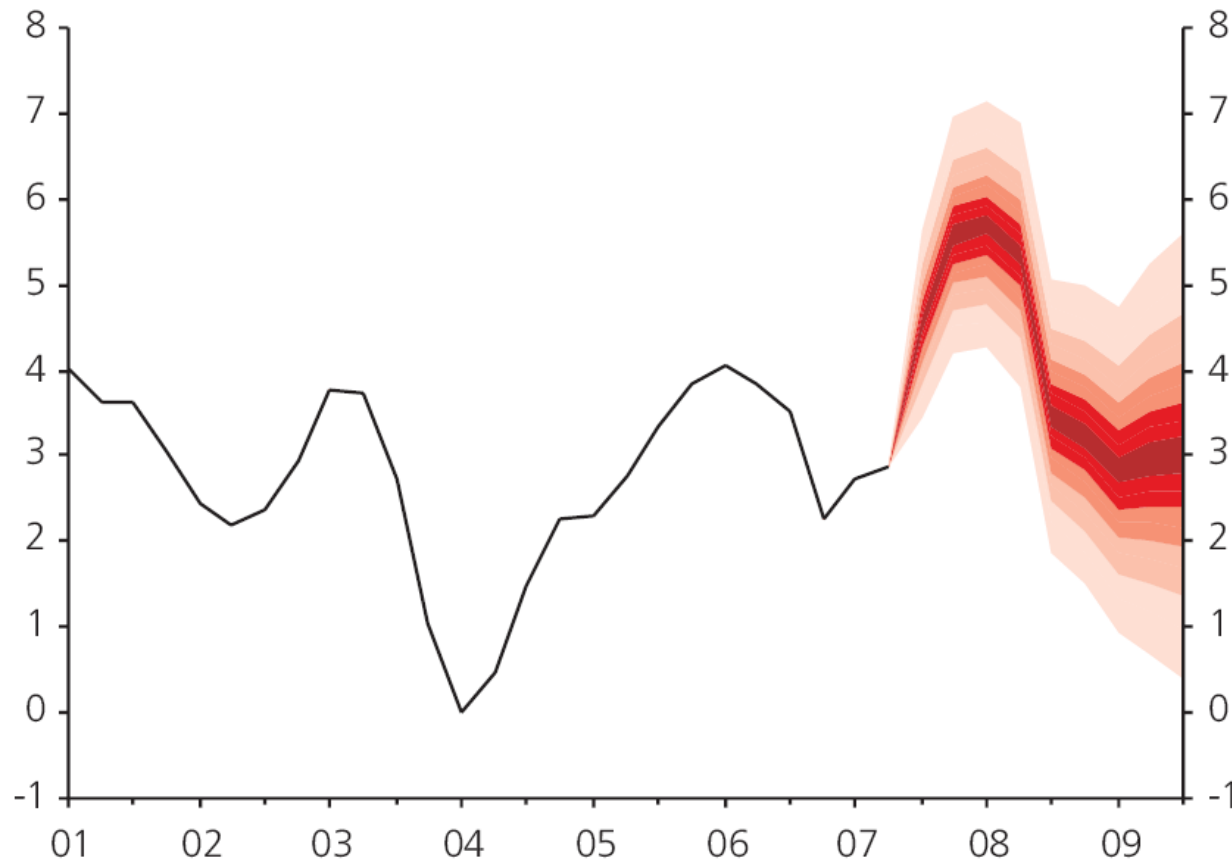
# Quarterly GDP growth scenarios (annual change, percent)



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



# Projected CPI inflation (annual change, percent)



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



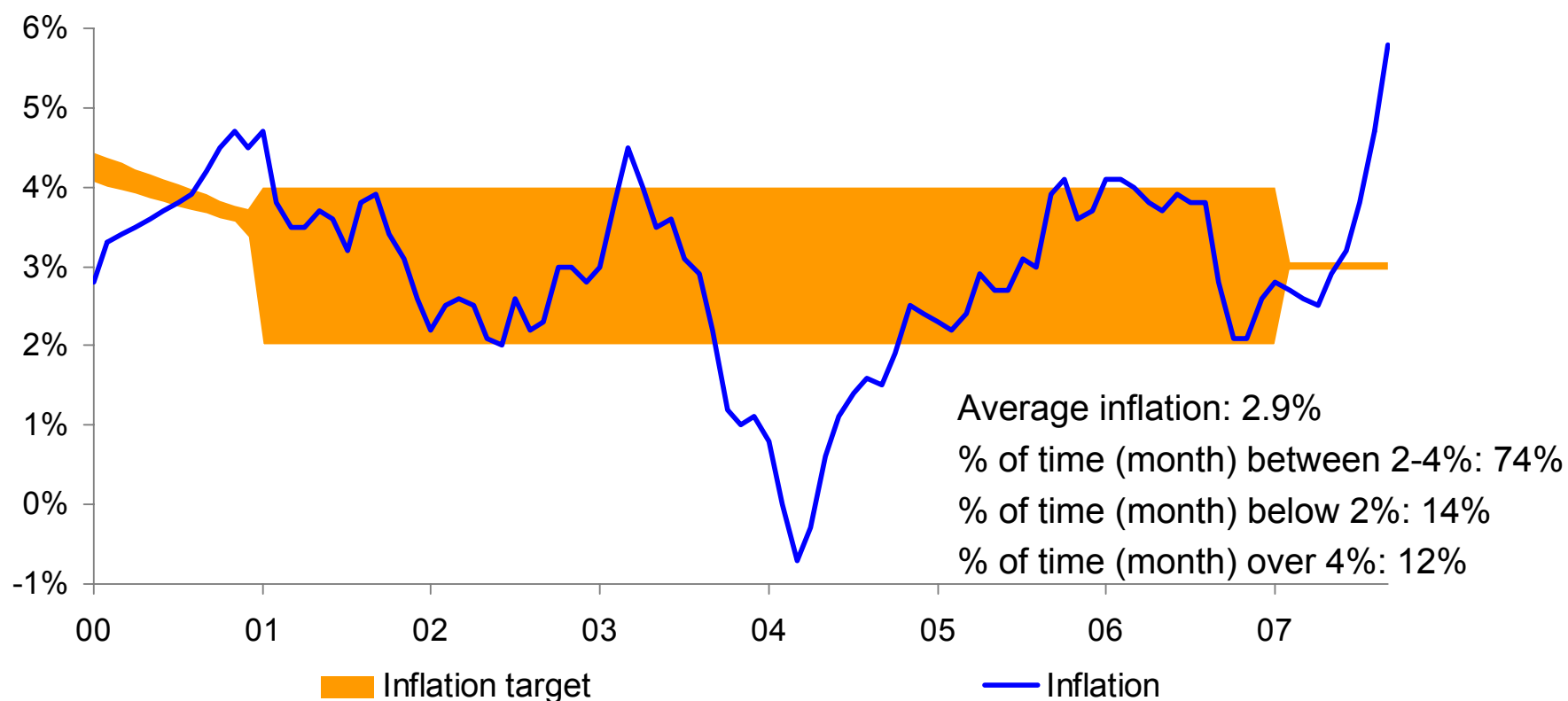
# Successful monetary policy

- The inflation target, maintaining inflation most of the time around 3% with a tolerance range of  $\pm 1$  percentage point, has been reached successfully.
- Among IT-countries, Chile has a good record of reaching the inflation target.
- Inflation expectations have been well anchored around the inflation target.
- Low output and inflation volatility.
- Overall, monetary policy has contributed to macroeconomic stability.
- As a result of the above, MP has been used as a counter-cyclical instrument.





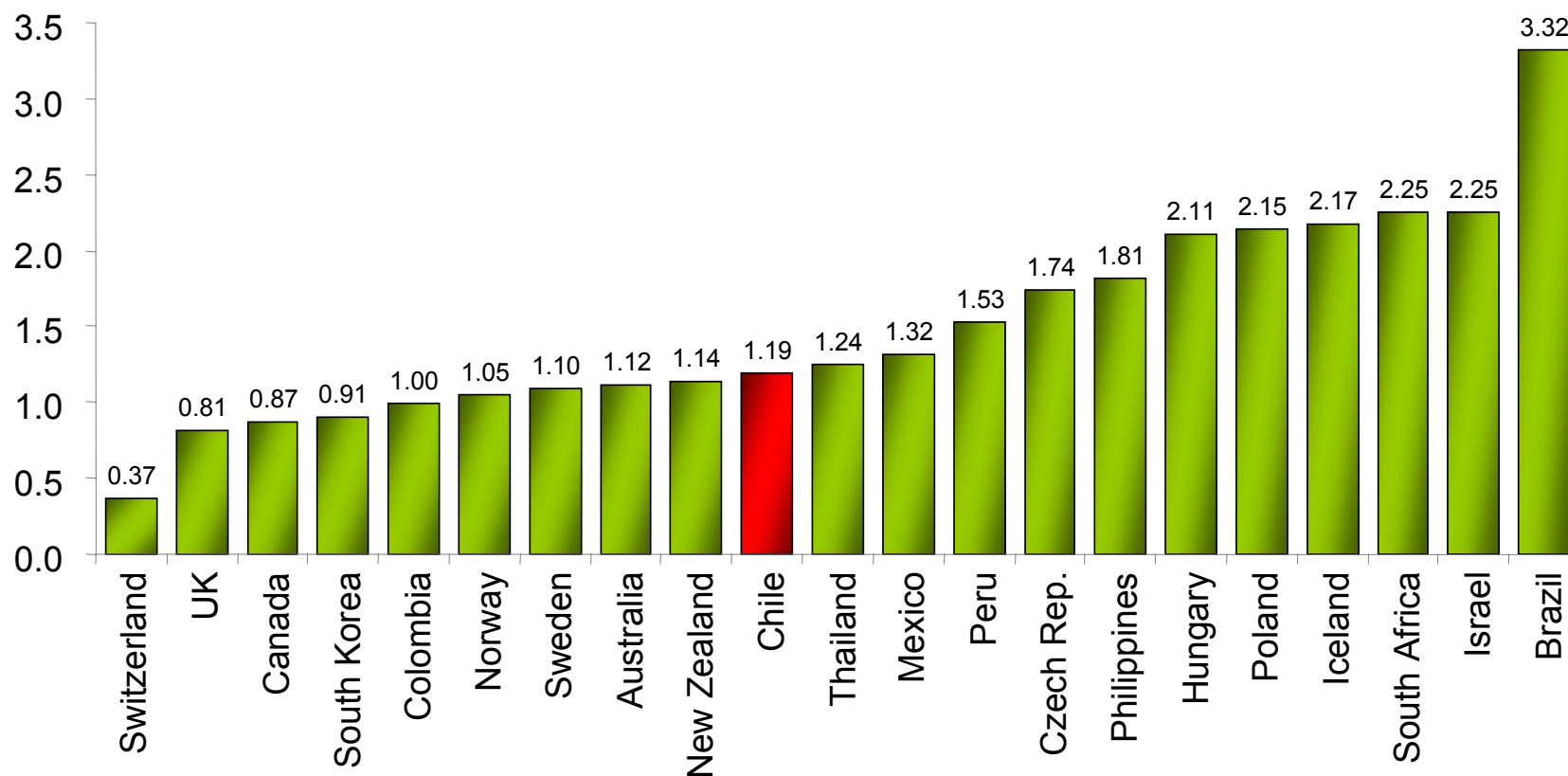
# Deviation of inflation rate from target (January 2000- September 2007, annual percent change)



Sources: National Statistics Bureau; Central Bank of Chile.



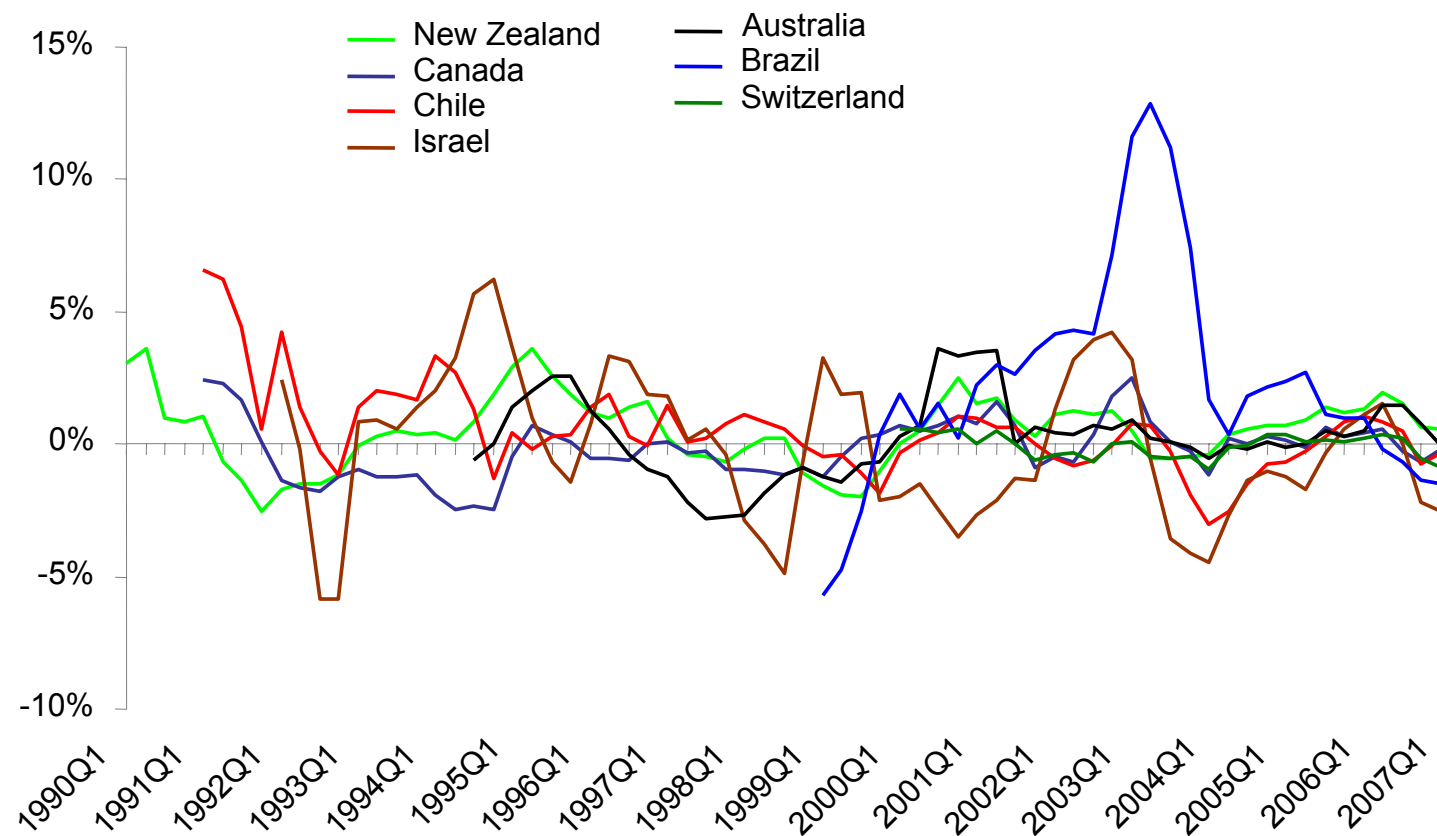
# Absolute deviation of inflation from target



Note: Considers the starting period of an inflation-targeting scheme to March 2007. The initial period of an inflation-targeting scheme varies across countries. Source: Based on Albagli and Schmidt-Hebbel (2005).

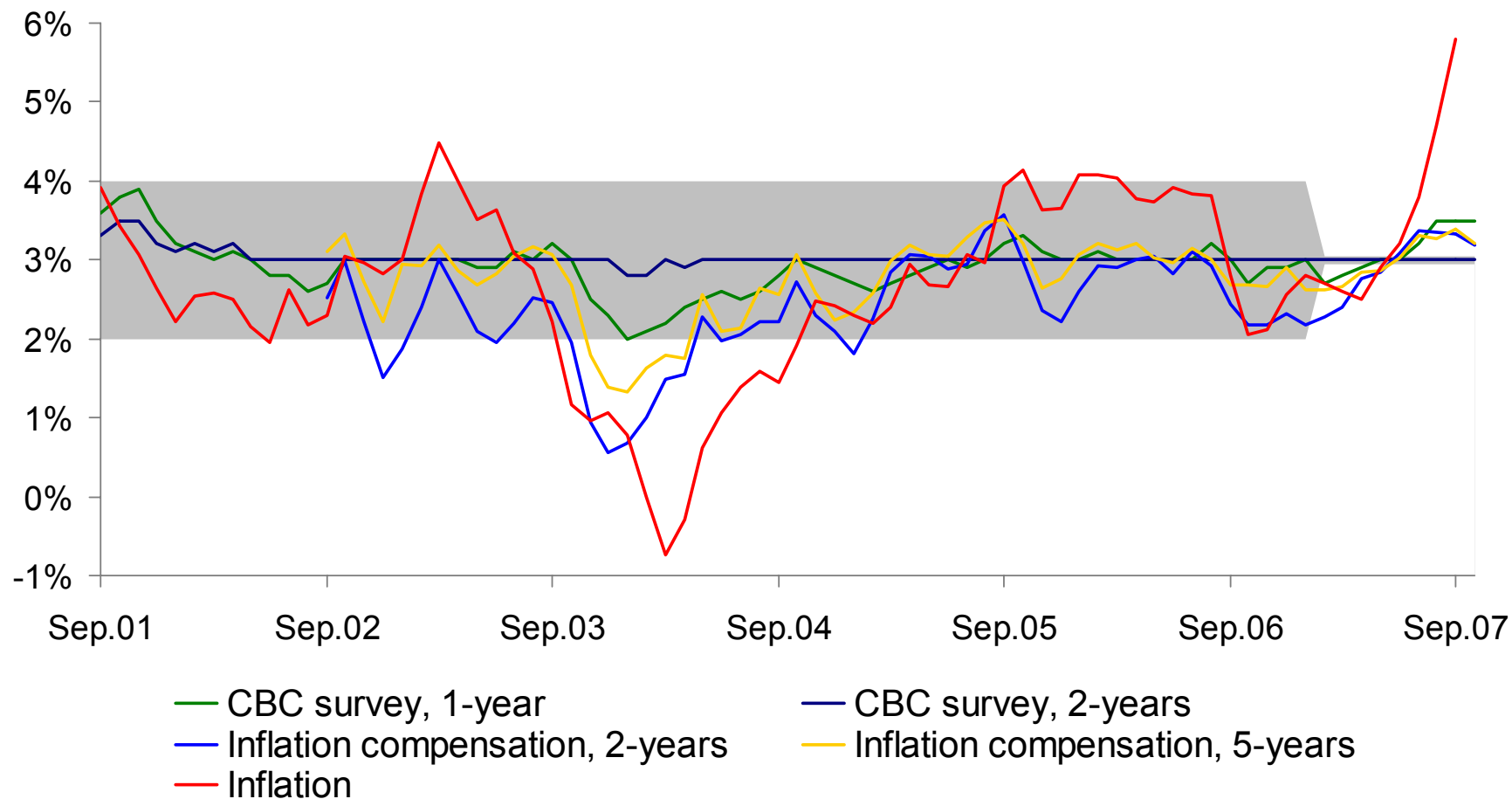


# Deviations of inflation from target





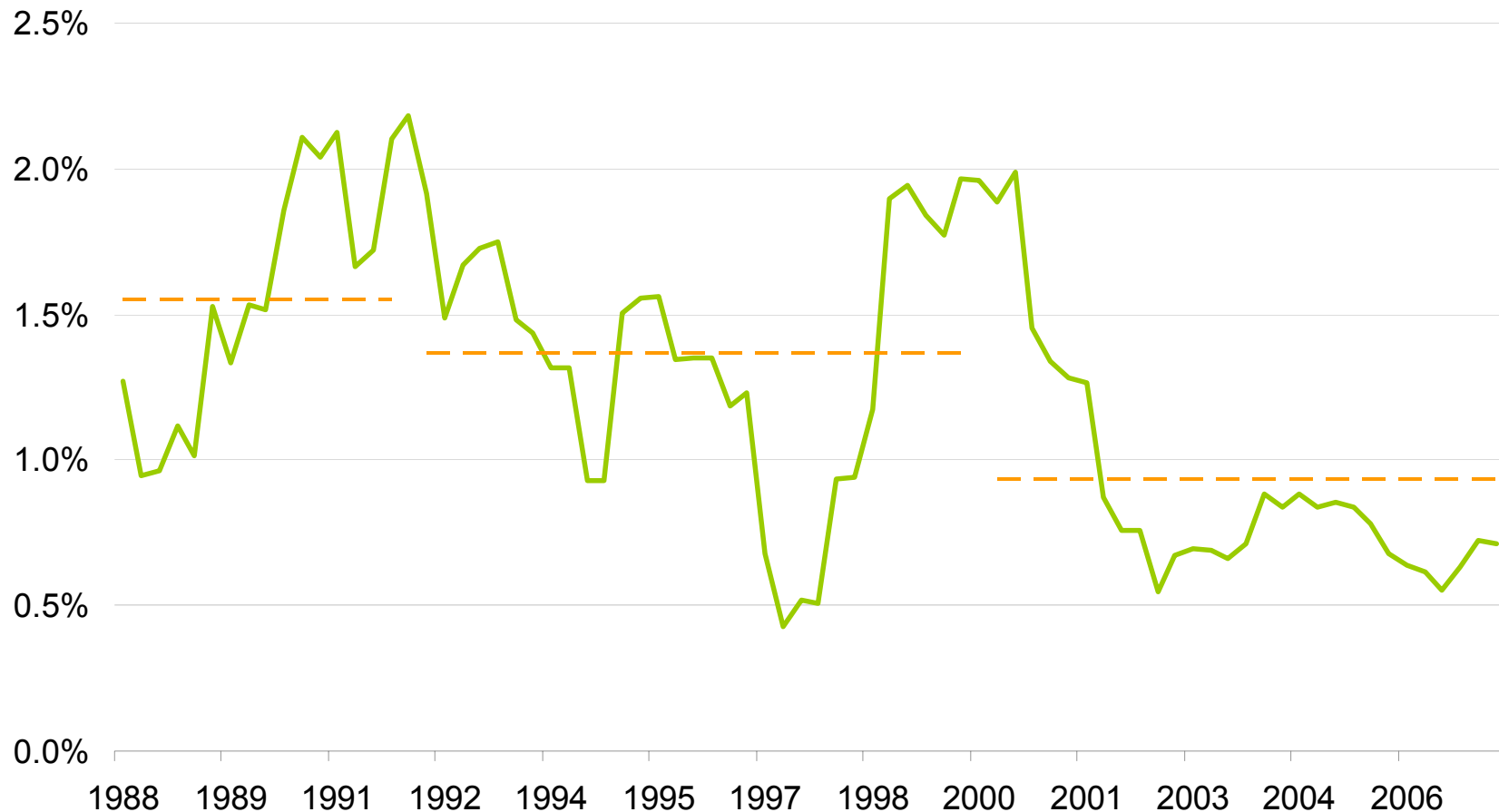
# Expected inflation (annual percent change)



Source: Central Bank of Chile.



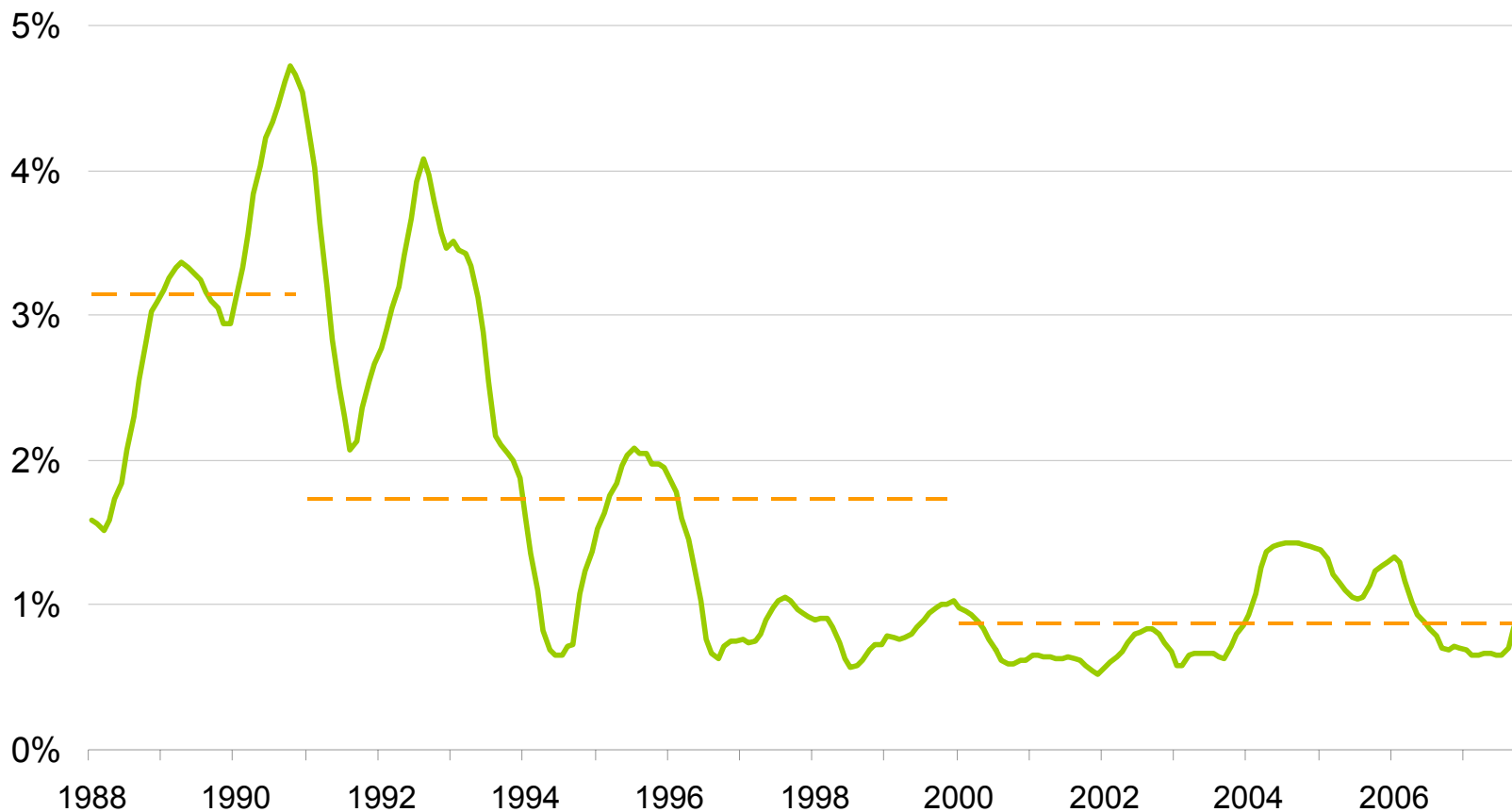
# Growth volatility in Chile



Note: GDP growth standard deviation using two-year moving windows. Source: Central Bank of Chile.



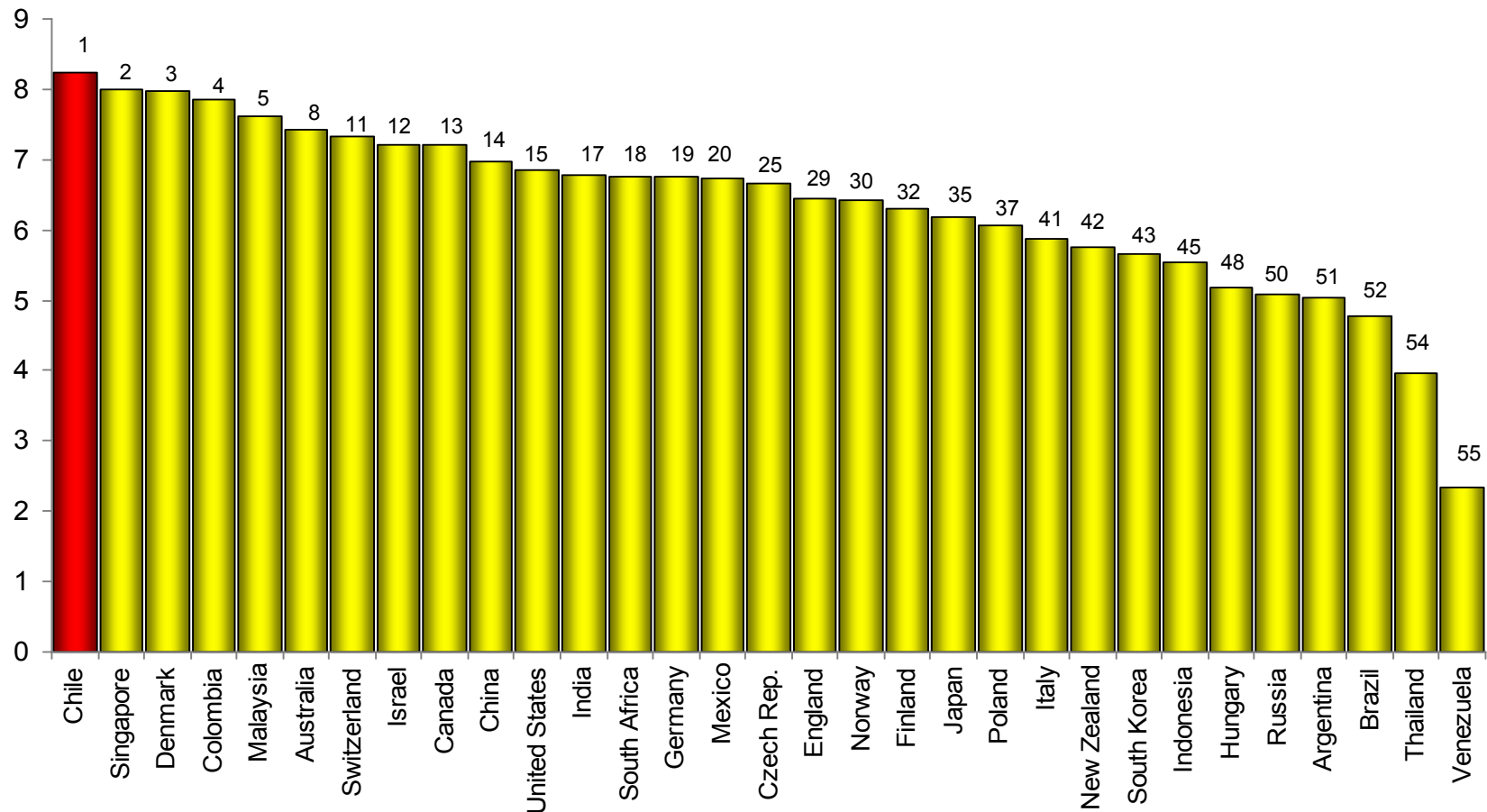
# Inflation volatility in Chile



Note: Annual inflation rate's standard deviation using two-year moving windows. Source: Central Bank of Chile.



# Contribution of monetary policy to macroeconomic performance (ranking, 2007)

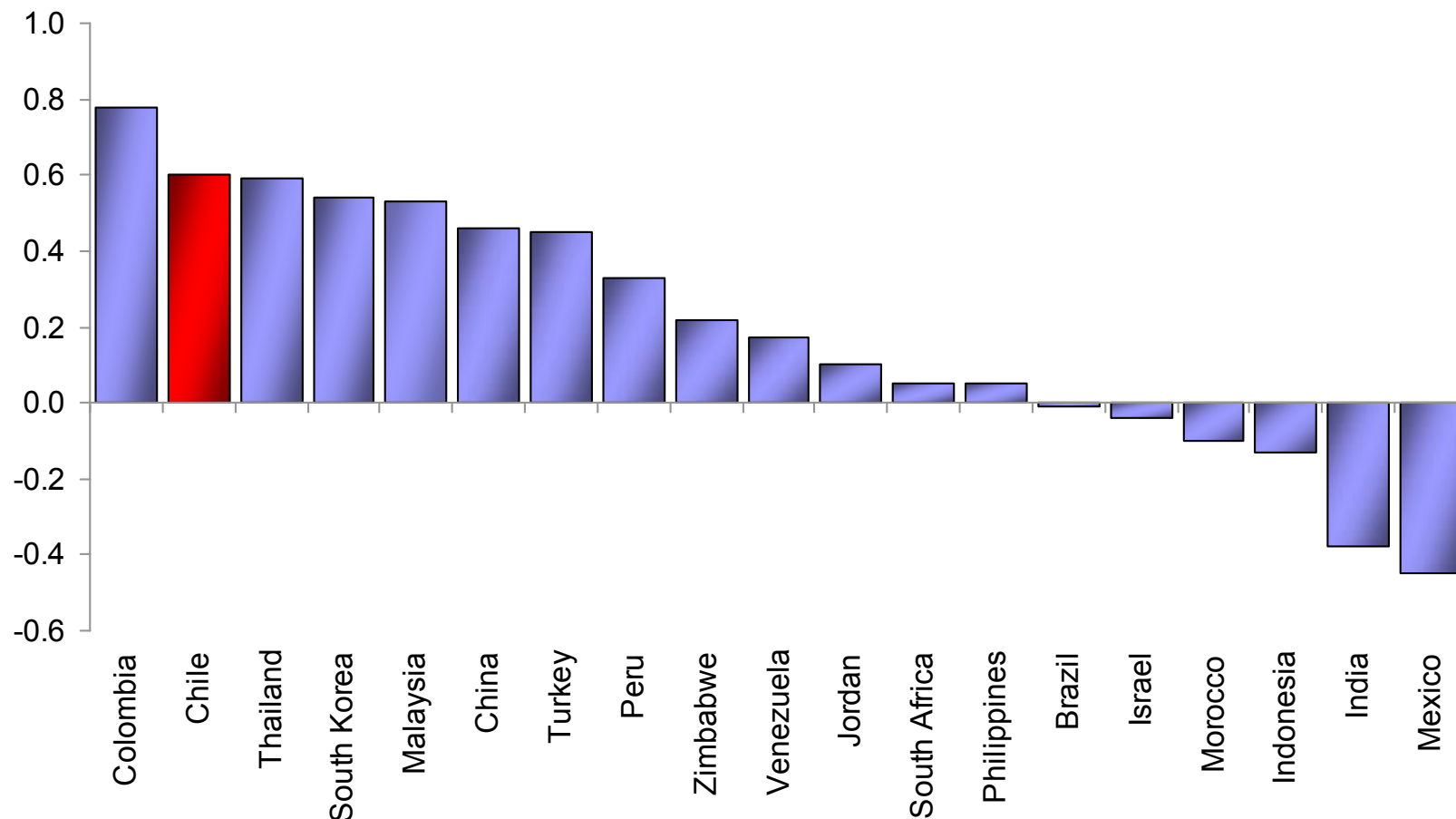


Note: It is quantified in a scale from 1 to 9. The number over each bar represents the place in the ranking.

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



# Countercyclical monetary policy (1990-2003)



Note: Correlation between interest rate and output gap. Source: Calderón, Duncan and Schmidt-Hebbel (2003).





# Communication and transparency



# Communication and transparency

- Communication with the market is essential:
  - Provides institutional legitimacy and substantive accountability;
  - Promotes monetary policy effectiveness, guiding market expectations:
    - The efficacy of MP depends on agents' understanding of how it is formulated and how it operates.
    - MP influences expenditure and prices through the expectations on the future course of monetary policy, rather than by the direct effect of a change in the MPR.

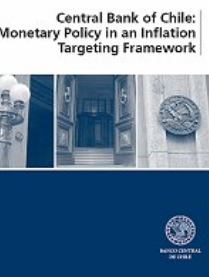


# Communication and transparency

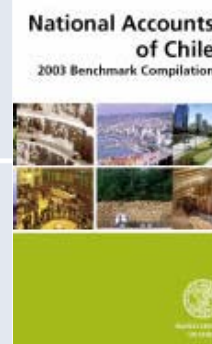
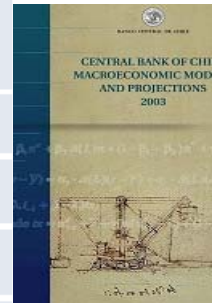
- The CBC has done a great effort to deliver more and better information to the market and to explain how its IT scheme operates:
  - Disclosure of relevant data with minimum delay, calendar and information available on the website and great number of technical publications.
  - Transparency in MP decision at every Monetary Policy Meeting.



# Communication and transparency in practice



Frequency	Bank policies	Studies	Statistics
Daily			Daily report
Monthly	Official Board communiqué Minutes of the monetary policy meeting Background minutes		Statistical preview <i>Monthly Bulletin</i>
Quarterly			<i>Foreign trade indicators</i>
Every four months	<i>Monetary Policy Report (IPOM)</i>		<i>Journal Economía Chilena</i>
Every six months	<i>Financial Stability Report (IEF)</i>		
Annually	<i>Annual Report of the Central Bank of Chile</i>	Book series on Central Banking, Analysis, and Economic Policies	National Accounts Balance of Payments External Debt Monetary and Financial Synthesis
Occasionally	<i>Macroeconomic and projection models</i> <i>Central Bank of Chile Monetary Policy Document</i>	<i>Economic Policy Papers</i>  Working Papers Studies in Economic Statistics	Various. See: <a href="http://www.bcentral.cl/esp/publ/">www.bcentral.cl/esp/publ/</a>



Source: Central Bank of Chile.



# The monetary policy meeting

- Monthly meetings —announced six month in advance— in which the monetary policy rate is set for the next month.
- Normally, it has two parts:
  - 11:30-13:30 hrs. – Review of new developments and their implications on projected inflation.
  - 16:00-18:00 hrs. – Analysis of options, voting, and press release.
- Participants:
  - All five Board members of CBC with a right to vote.
  - Minister of Finance with a right to speak only.
  - Senior CBC staff (several managers, legal counsel, certifying officer, some advisors).



# The monetary policy meeting

- Press release with MPR decision and justification.
- Three weeks after MP meeting, a minute is published that includes:
  - A summary of information reviewed in the meeting and main points analyzed.
  - The policy options considered.
  - The main arguments evaluated by the Board members in the decision.
  - The vote of each Board member.



# Example of 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.



# Good international evaluation

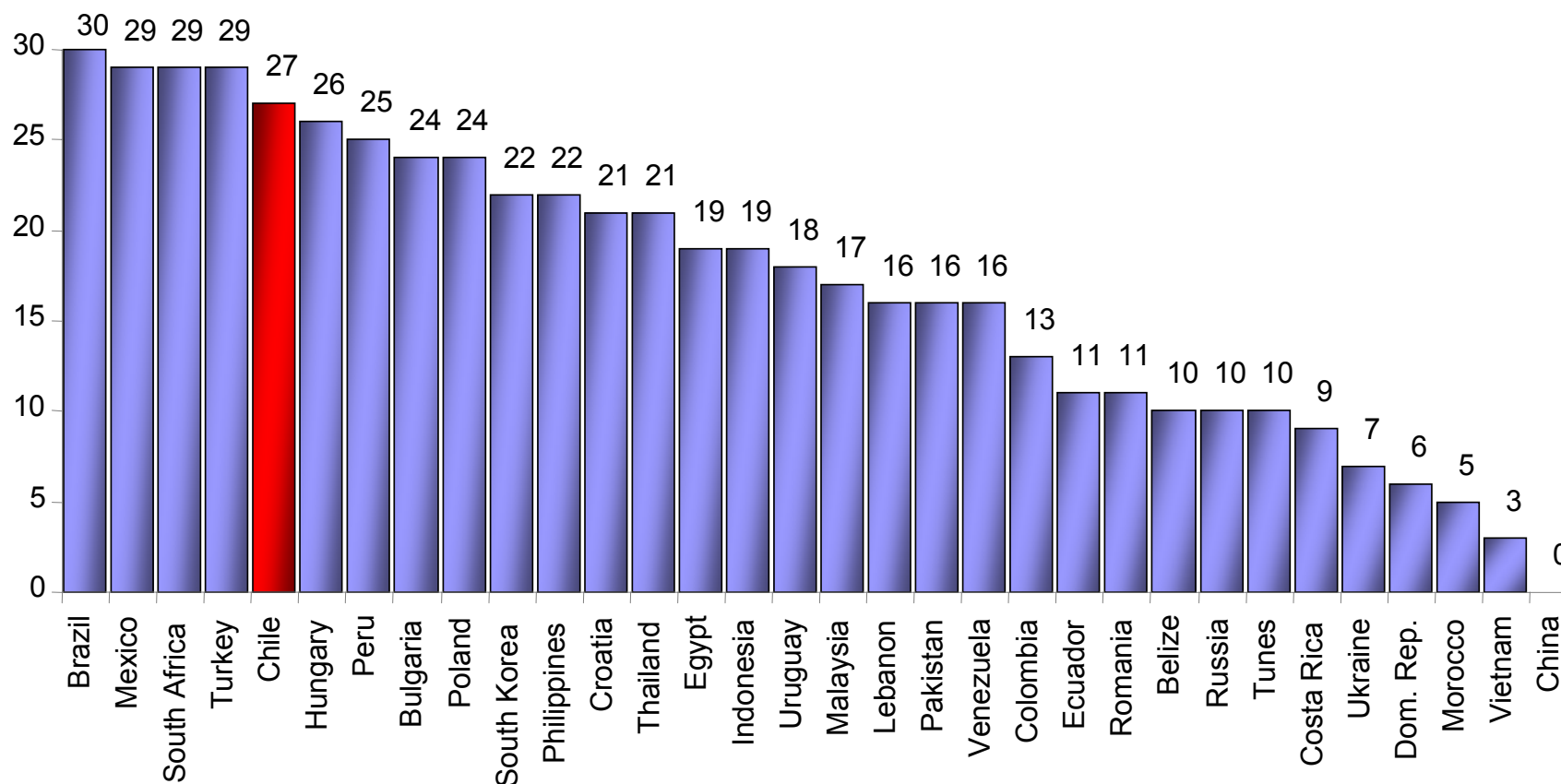
- The efforts made by the CBC places it among the most transparent central banks worldwide.
- CBC's monetary policy report has received good international evaluation.
- Additionally, the CBC is ranked among the central bank with greatest publication of working papers, right after the ECB and the Fed.





# CB transparency in the delivery of information

(2006)

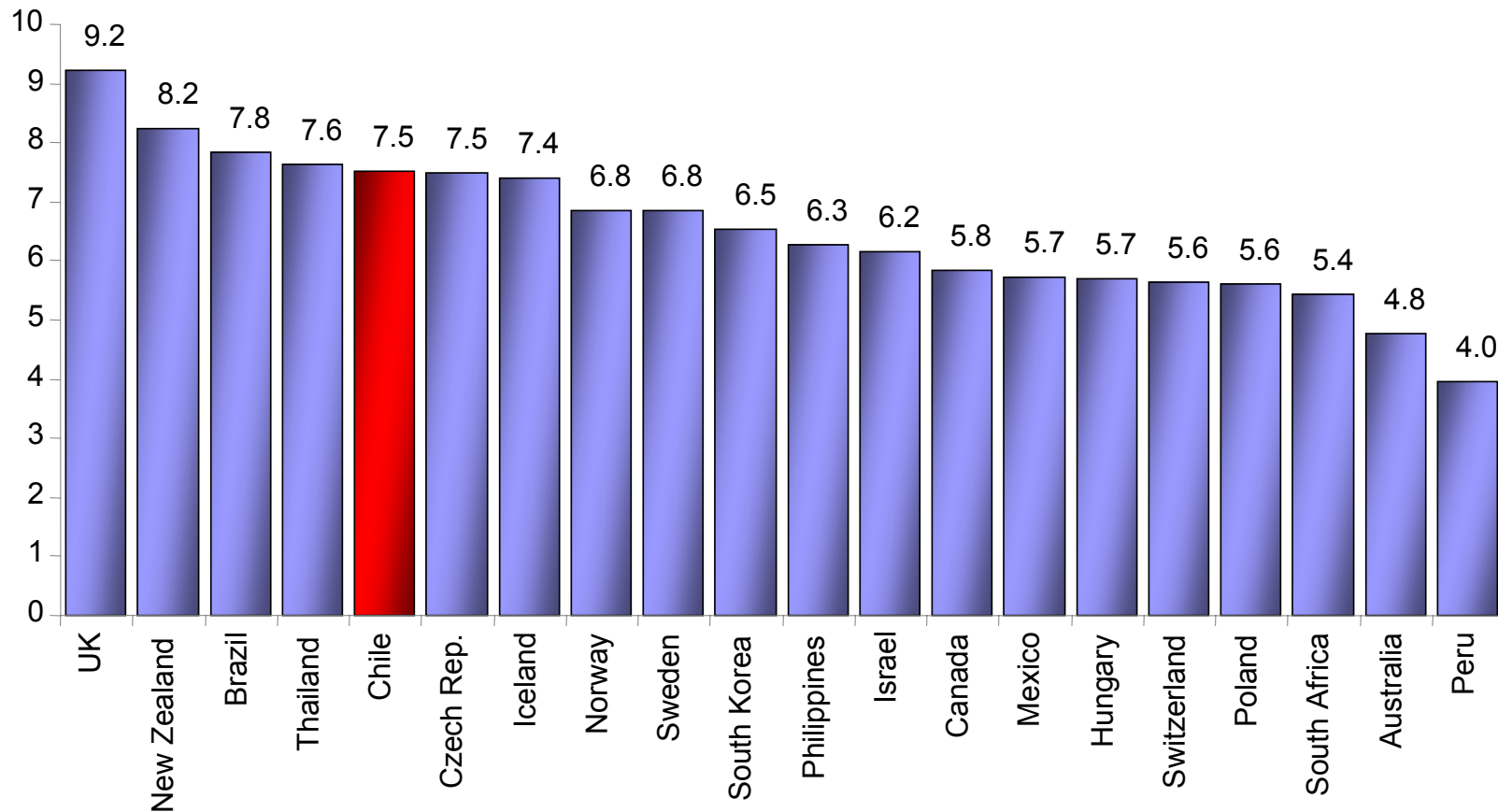


Note: It is quantified in a scale from 0 to 30. The sample considers 32 emerging economies.

Source: Institute of International Finance (2006).



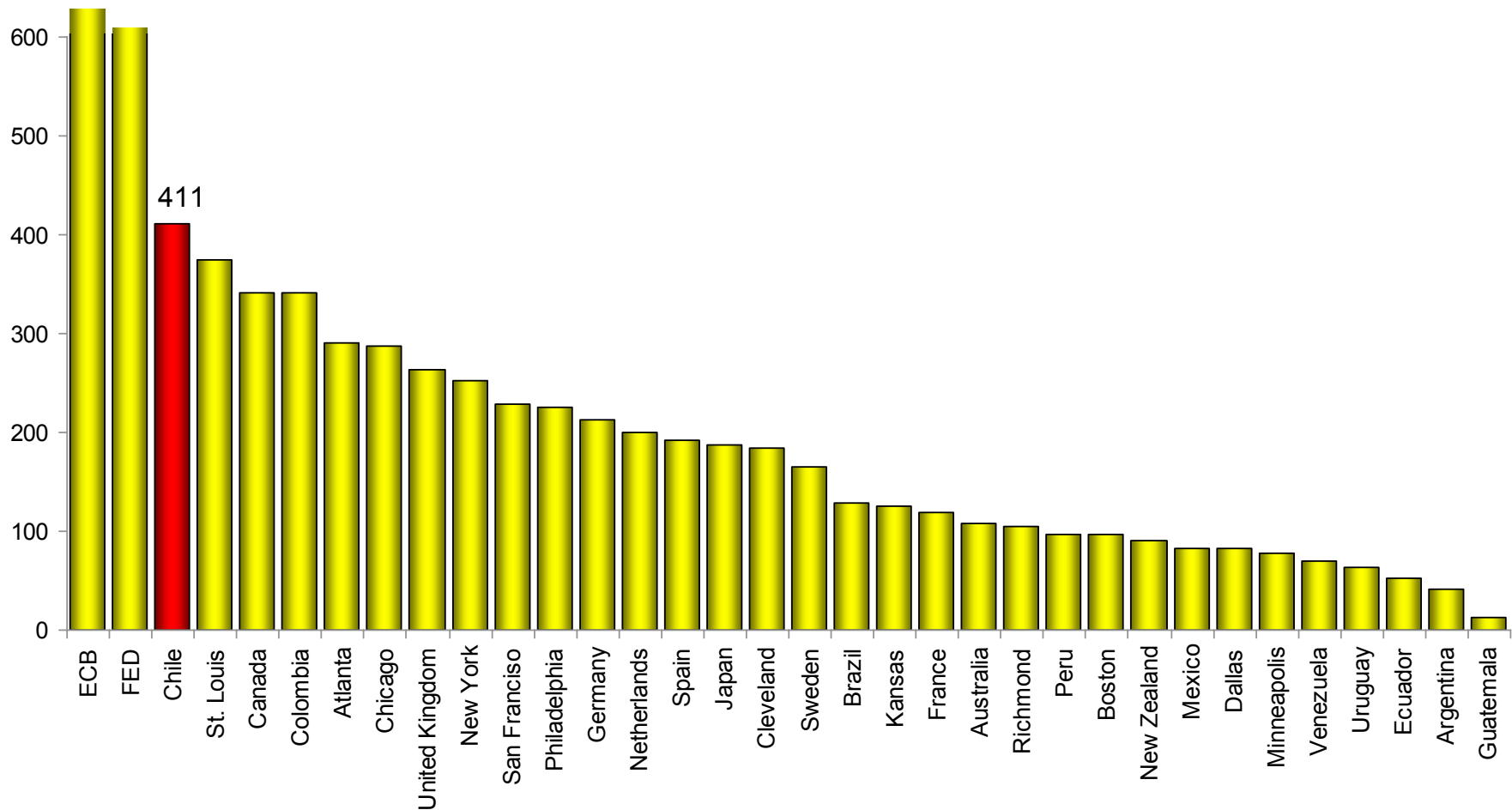
# Quality of monetary policy reports (2002)



Note: It is quantified in a scale from 1 to 10. The authors evaluate the MP reports of 20 central banks with inflation-targeting schemes. Source: Fracasso et. al. (2003).



# Volume of published working papers (1997-2006)



Source: Larraín and Schmidt-Hebbel (2007).



# International financial turmoil



# International financial turmoil

- Beginning in mid-July, international financial markets have experienced important corrections.
- Risk aversion has increased, implying an upward correction in risk premiums and an important fall in interest rates of long-term government bonds of developed economies.
- Adjustments in financial market have also become notorious for emerging economies, especially the most vulnerable, with increases in sovereign spreads, a fall in stock markets and depreciation of their currencies.
- Chile's current framework of macro/financial policies and institutions has favored the way the economy absorbs swings in the international financial scenario.



# The effect on stock markets of the latest episode is comparable to those of May 2006...

## Impact on stock markets

(accumulated change, percent)

	May 2006 (1)	February 2007 (2)	August 2007 (3)	August 2007 (4)
Argentina	-17.3	-11.0	-17.3	2.6
Australia	-11.7	-8.7	-20.0	9.5
Brazil	-24.6	-13.1	-26.9	14.3
Chile	-14.2	-4.1	-14.4	5.2
Euro zone	-11.1	-7.3	-13.3	1.3
Hungary	-29.9	-7.0	-22.9	-6.5
Indonesia	-22.2	-6.4	-20.2	21.4
Japan	-15.0	-4.9	-3.0	-0.3
Malaysia	-9.6	-13.9	-14.5	1.6
Mexico	-22.1	-9.6	-17.7	-0.4
New Zealand	-8.0	-6.3	-21.8	-4.1
Philippines	-22.2	-12.8	-23.7	4.8
Poland	-19.2	-9.4	-17.9	4.2
Russia	-18.8	-12.4	-14.3	6.1
South Africa	-27.1	-13.4	-17.6	7.7
South Korea	-17.2	-7.9	-15.2	6.0
Turkey	-39.9	-13.7	-24.9	14.1
United Kingdom	-9.1	-7.6	-14.6	-0.4
USA	-6.2	-4.6	-8.2	-0.1

(1) Change between 10 May and 27 June 2006.

(2) Change between 26 February and 5 March 2007.

(3) Change between 19 July and 16 August 2007.

(4) Change between 19 July and 15 October 2007.

Source: Bloomberg.



...in the initial phase there was a marked recovery of the dollar against all other currencies, however this was reverted in the last weeks...

### Impact on foreign exchange markets

(local currency/USD, accumulated change, percent)

	May 2006 (1)	February 2007 (2)	August 2007 (3)	August 2007 (4)
Argentina	1.5	0.0	1.8	1.7
Australia	5.8	3.0	11.2	-2.1
Brazil	8.0	2.6	10.3	-2.5
Chile	7.3	1.0	2.3	-3.5
Euro zone	1.6	0.7	2.8	-2.8
Hungary	7.0	0.7	5.4	2.1
Indonesia	6.6	2.0	5.4	0.7
Japan	5.2	-4.2	-6.7	-3.8
Malaysia	2.9	0.7	2.1	-1.7
Mexico	5.4	1.0	4.1	0.6
New Zealand	3.3	5.2	15.2	4.1
Philippines	4.0	1.0	4.6	-1.9
Poland	6.1	0.6	2.0	-1.2
Russia	0.1	0.4	1.4	-2.0
South Africa	20.3	5.9	8.8	-0.3
South Korea	3.2	1.2	3.2	0.4
Turkey	20.3	5.1	9.7	-3.4
United Kingdom	2.3	2.2	3.3	0.3

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Source: Bloomberg.



...while the effect on the Chilean peso has been reduced.

### Impact on foreign exchange markets

(local currency/USD, accumulated change, percent)

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Chile	7.3	1.0	2.3	-3.5
Euro zone	1.6	0.7	2.8	-2.8
Hungary	7.0	0.7	5.4	2.1
Indonesia	6.6	2.0	5.4	0.7
Japan	5.2	-4.2	-6.7	-3.8
Malaysia	2.9	0.7	2.1	-1.7
Mexico	5.4	1.0	4.1	0.6
New Zealand	3.3	5.2	15.2	4.1
Philippines	4.0	1.0	4.6	-1.9
Poland	6.1	0.6	2.0	-1.2
Russia	0.1	0.4	1.4	-2.0
South Africa	20.3	5.9	8.8	-0.3
South Korea	3.2	1.2	3.2	0.4
Turkey	20.3	5.1	9.7	-3.4
United Kingdom	2.3	2.2	3.3	0.3

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Source: Bloomberg.





# Interest rates rise in emerging markets due to the search for safer assets...

## Impact on government bond markets (nominal to 10 years, accumulated change, basis points)

	May 2006 (1)	February 2007 (2)	August 2007 (3)	August 2007 (4)
Argentina	--	--	363	469
Australia	4	-18	-28	9
Brazil	15	35	107	75
Chile	25	-7	-2	-18
Euro zone	11	-8	-30	-12
Hungary	108	6	56	17
Indonesia	118	7	112	7
Japan	-9	-4	-25	-17
Malaysia	30	-3	18	16
Mexico	50	-6	41	17
New Zealand	9	-12	-64	-39
Philippines	--	--	--	--
Poland	72	-5	18	17
Russia	-11	0	21	32
South Africa	122	20	6	-34
South Korea	--	--	--	--
Turkey	679	75	171	-117
United Kingdom	4	-9	-34	-33
USA	8	-13	-36	-34

(1) Change between 10 May and 27 June 2006.

(2) Change between 26 February and 5 March 2007.

(3) Change between 19 July and 16 August 2007.

(4) Change between 19 July and 15 October 2007.

Source: Bloomberg.



... in Chile, on the contrary, they declined.

**Impact on government bond markets**  
(nominal to 10 years, accumulated change, basis points)

	May 2006 (1)	February 2007 (2)	August 2007 (3)	August 2007 (4)
Argentina	--	--	363	469
Australia	4	-18	-28	9
Brazil	15	35	107	75
Chile	25	-7	-2	-18
Euro zone	11	-8	-30	-12
Hungary	108	6	56	17
Indonesia	118	7	112	7
Japan	-9	-4	-25	-17
Malaysia	30	-3	18	16
Mexico	50	-6	41	17
New Zealand	9	-12	-64	-39
Philippines	--	--	--	--
Poland	72	-5	18	17
Russia	-11	0	21	32
South Africa	122	20	6	-34
South Korea	--	--	--	--
Turkey	679	75	171	-117
United Kingdom	4	-9	-34	-33
USA	8	-13	-36	-34

(1) Change between 10 May and 27 June 2006.

(2) Change between 26 February and 5 March 2007.

(3) Change between 19 July and 16 August 2007.

(4) Change between 19 July and 15 October 2007.

Source: Bloomberg.



# Sovereign spreads also increased...

## Impact on sovereign emerging bond markets (accumulated change, basis points)

	May 2006 (1)	February 2007 (2)	August 2007 (3)	August 2007 (4)
Argentina	102	26	186	23
Brazil	50	19	68	-1
Chile	7	6	19	17
Hungary	11	1	22	8
Indonesia	51	30	92	22
Malaysia	13	2	38	20
Mexico	34	13	48	2
Philippines	67	25	75	-2
Poland	10	4	21	6
Russia	29	14	53	13
South Africa	44	-2	52	16
Turkey	147	27	64	9

(1) Change between 10 May and 27 June 2006.

(2) Change between 26 February and 5 March 2007.

(3) Change between 19 July and 16 August 2007.

(4) Change between 19 July and 15 October 2007.

Source: Bloomberg.



# Conclusions



# Conclusions

- Price stability is a prerequisite to achieve high and sustained growth rates.
  - The Constitutional Law of the CBC embodies this principle and the inflation-targeting scheme puts it in practice.
- Chile adopted the IT regime in two distinct phases and implemented a solid macroeconomic framework based on central bank autonomy with a clear focus on price stability. This was supported by a solvent, responsible, and predictable fiscal policy and a solid and well regulated financial system.



# Conclusions

- Low inflation and a credible monetary policy represent an essential macroeconomic achievement.
- Chile's good record of attaining inflation levels close to the target has strengthened private sector confidence in the CBC and raised MP effectiveness and credibility.
- Additionally, by improving its policy framework, supported by strong transparency, accountability, and communication, the CBC has laid a major foundation to Chile's macroeconomic stability.



# Conclusions

- However, conquest and predictability of inflation are not guaranteed. The CBC will remain vigilant, improving its policy framework as needed to continue delivering high levels of macroeconomic stability.
- In particular, the recent inflation shock associated to a jump in food and energy prices imposes important challenges for monetary policy.



# Inflation and monetary policy

- Specifically, the Central Bank will pay attention to the following events:
- Risks of an eventual propagation of the food and energy price shock to inflation dynamism, in a picture with closed capacity gaps and transitory high inflation:
  - Wage inflation.
  - Inflation expectations.
- Financial adjustments in global markets with consequences on world growth and commodities prices in state of flow.
- Some signs of moderation in the dynamism of the Chilean economy, beyond expected.





# Monetary Policy in Chile

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