



INSTITUTIONAL FRAMEWORK AND MONETARY POLICY: THE CASE OF CHILE

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Outline

- I. Institutional framework
- II. Monetary policy
- III. Monetary Policy Meeting
- IV. 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 over time.



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 statutory 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:
 - Conduct 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;



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 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.

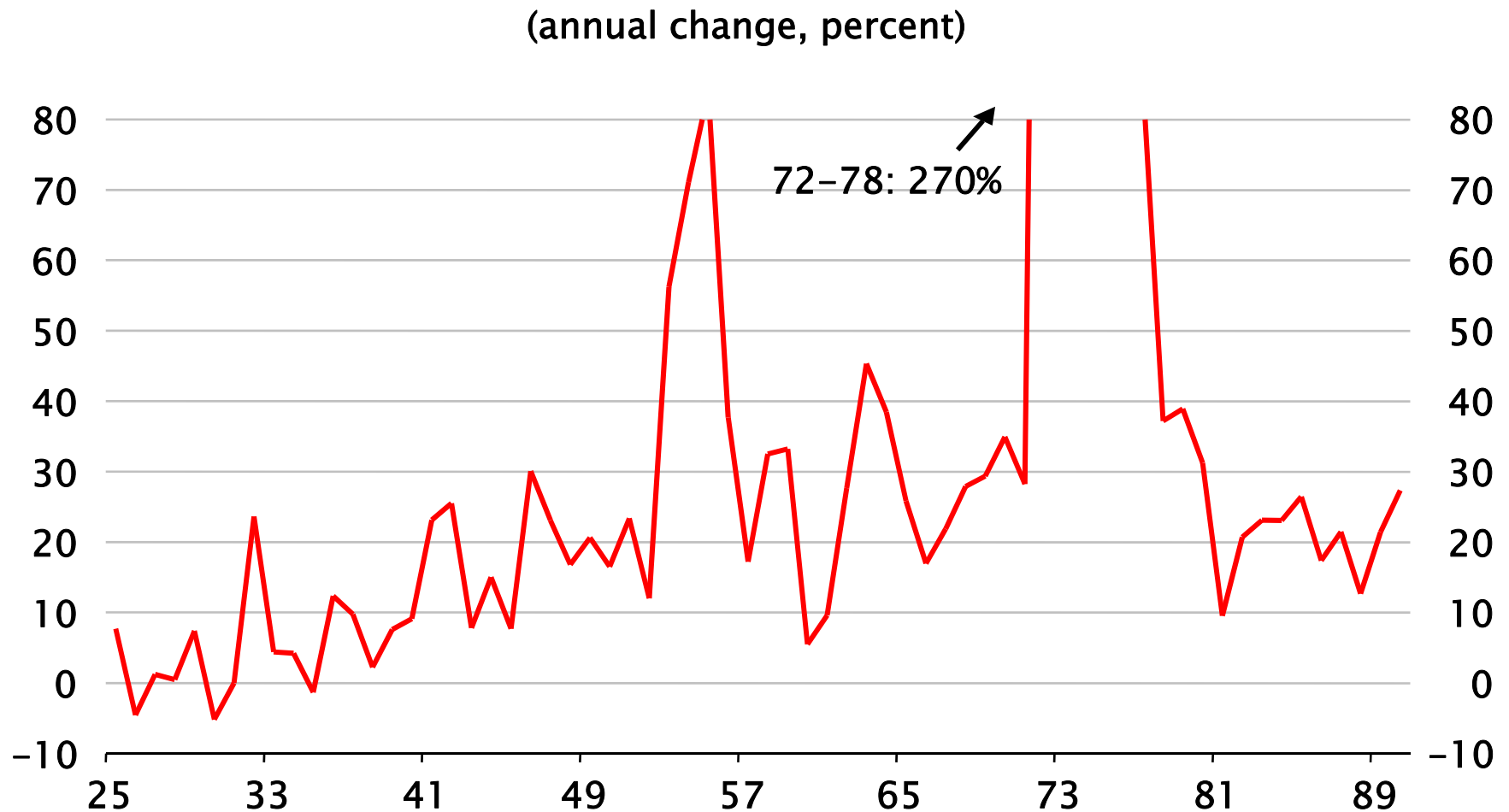


Institutional Framework

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



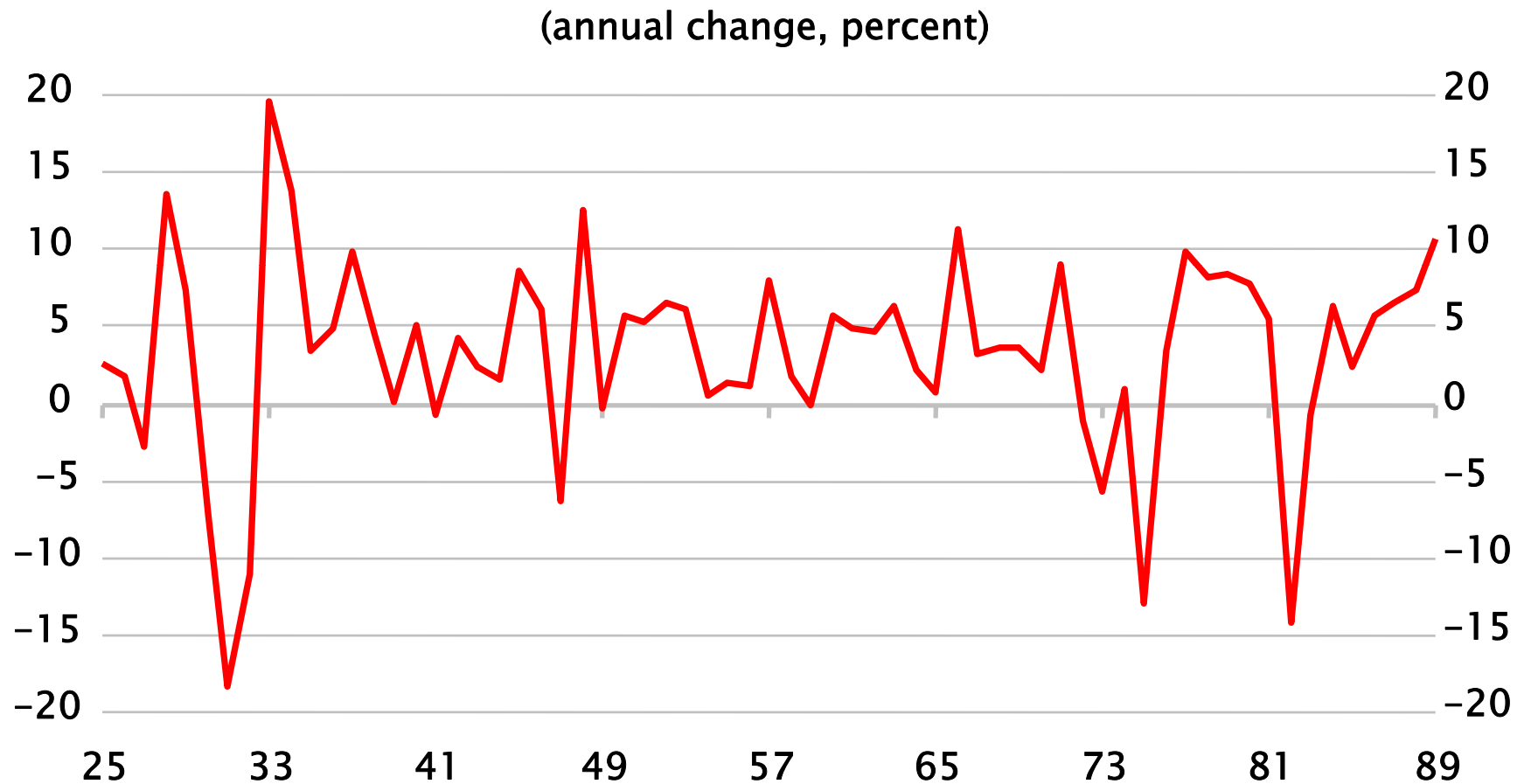
Inflation Rates, 1925–89



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



Growth Rates, 1925–1989



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

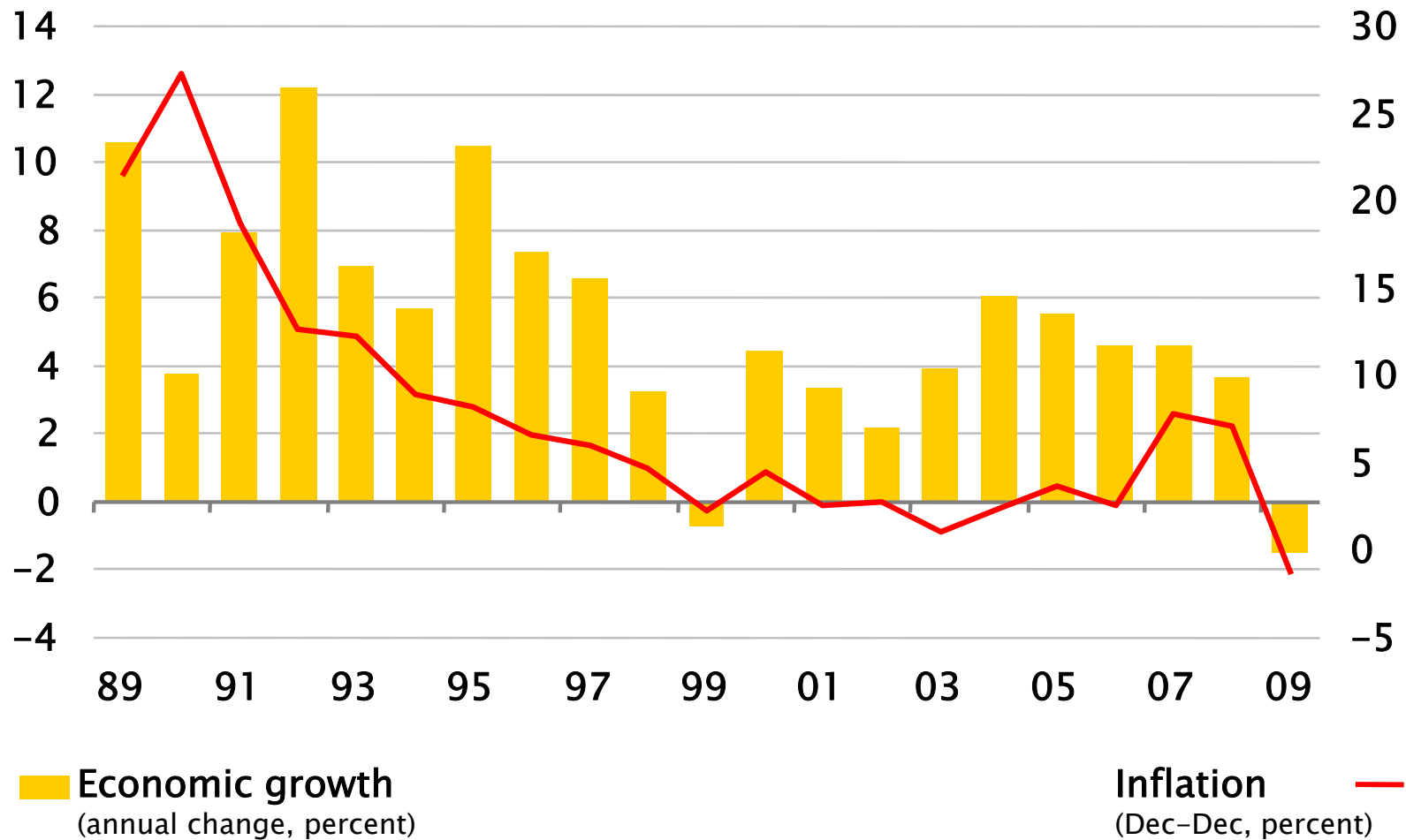


Institutional Framework

- 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, 1989–2009



Source: 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.



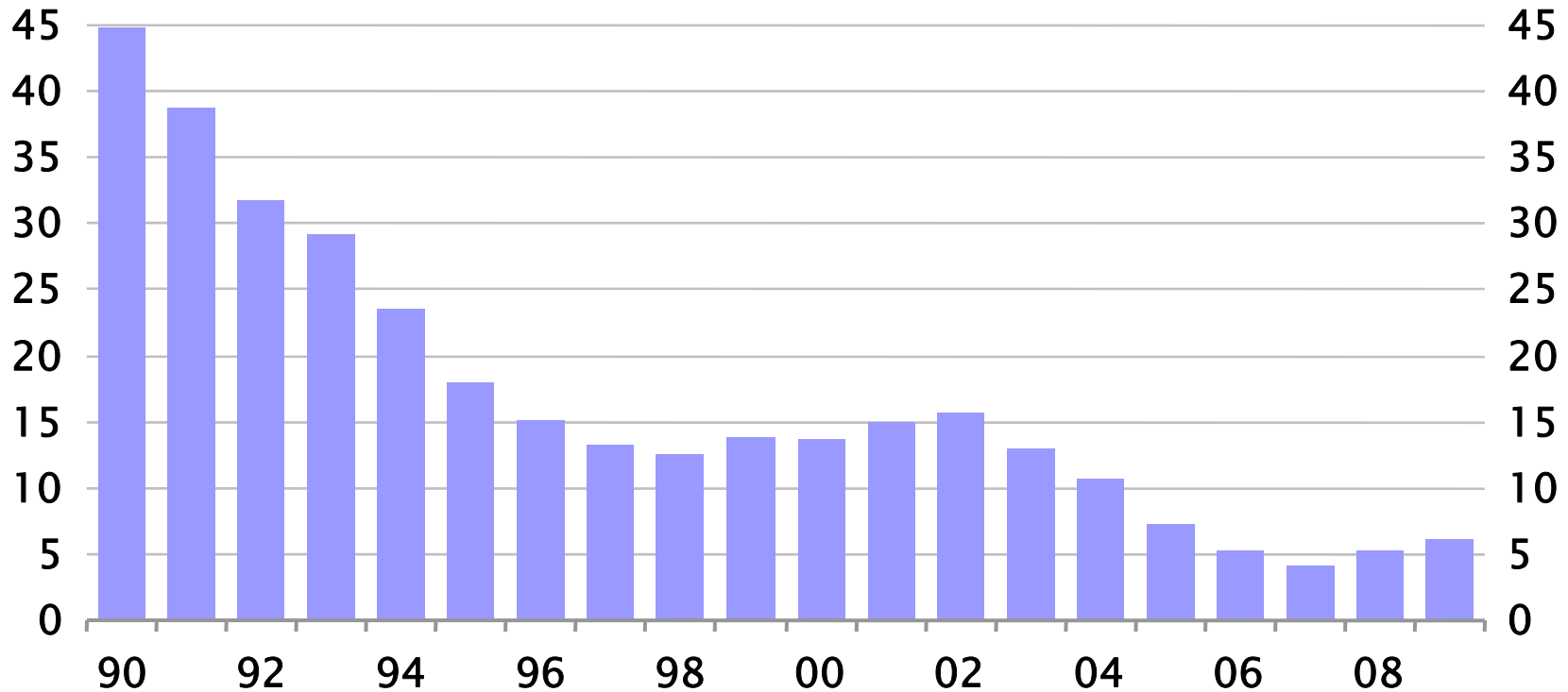
Institutional Framework

- In addition to the autonomy and clear mandate assigned to the Central Bank, these pillars include:
 - A responsible and predictable fiscal policy.
 - A solid banking system that is well regulated and supervised.
 - A relatively deep capital market that provides an alternative source of finance, mainly for medium and long-term horizons.
 - A floating exchange rate regime which has been in force since September 1999, permitting flexible adjustments to external shocks.
 - Increasing commercial and financial integration with international markets.



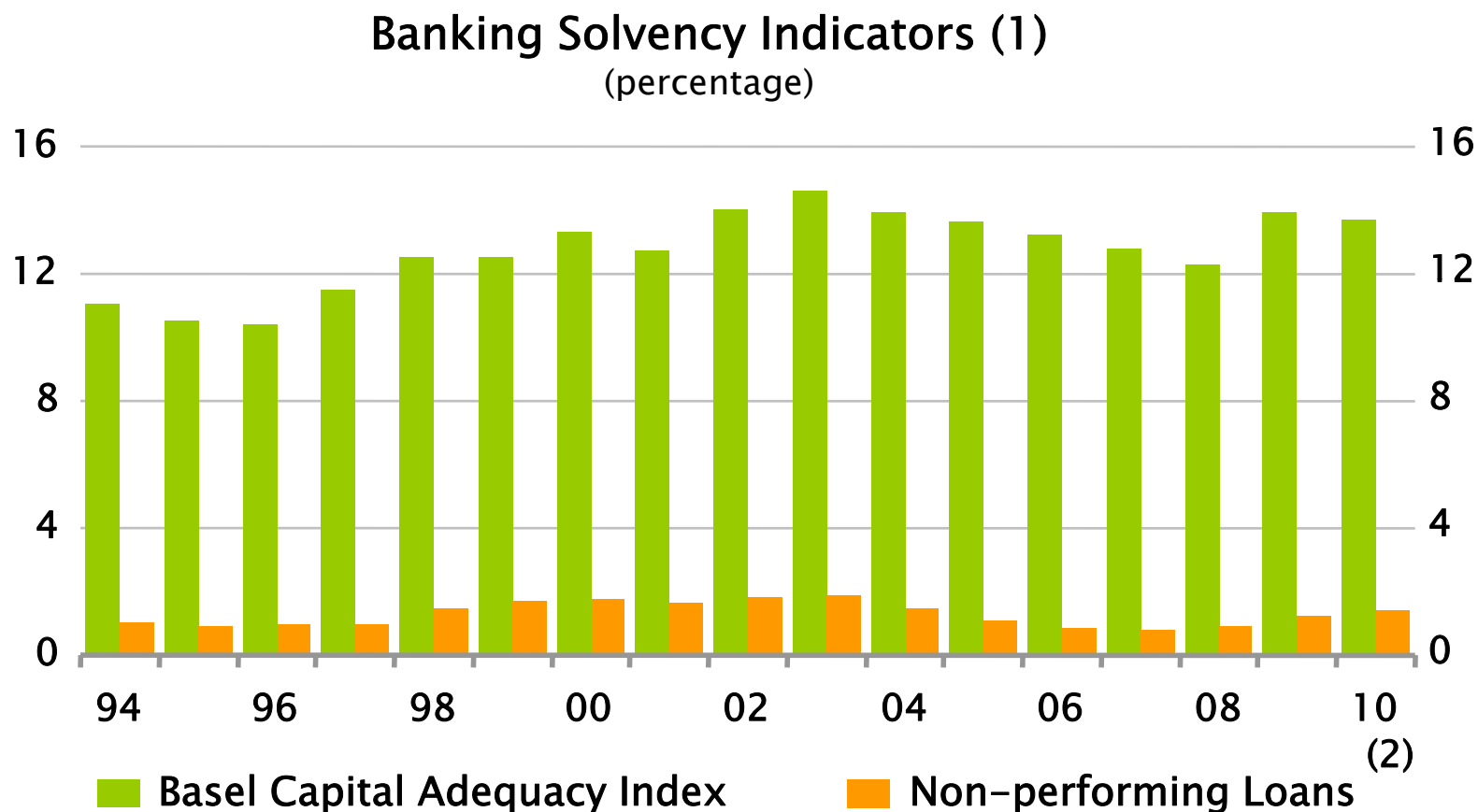
Fiscal responsibility has led to a significant reduction of public debt

Government Debt
(percentage of GDP)





At present, the banking system appears fundamentally safe and sound as confirmed by solvency and performance indicators



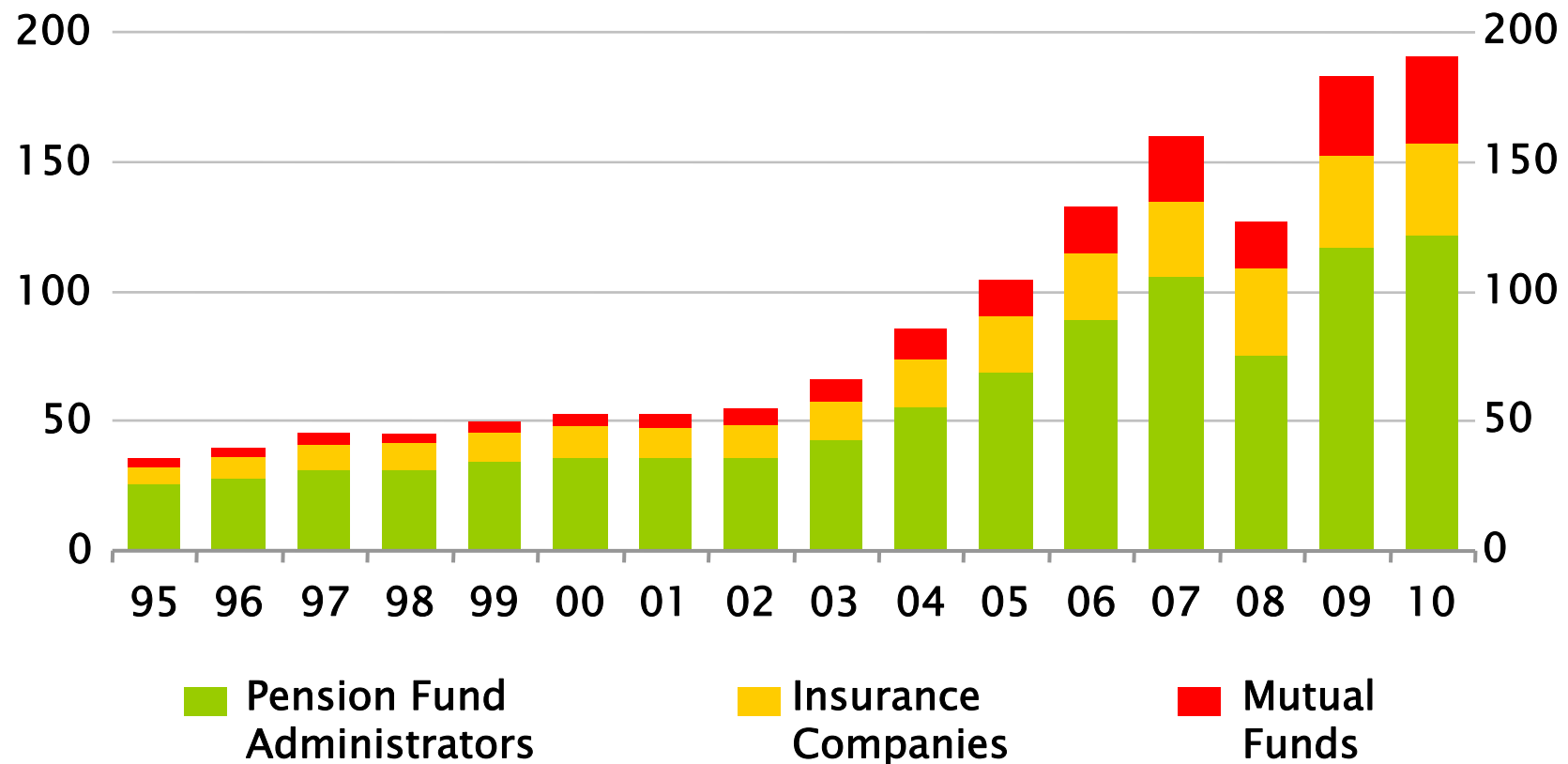
(1) As of January 2008, data of past-due loans is not strictly comparable with earlier data, since as part of the convergence plan to International Financial Reporting Standards (IFRS), banks changed the format of their financial statements. (2) March figures.

Sources: Central Bank of Chile and Superintendence of Banks and Financial Institutions (SBFI).



Institutional investors and, particularly, pension funds, have played a key role in developing capital markets.

Financial Savings by Institutional Investors
(USD billions)



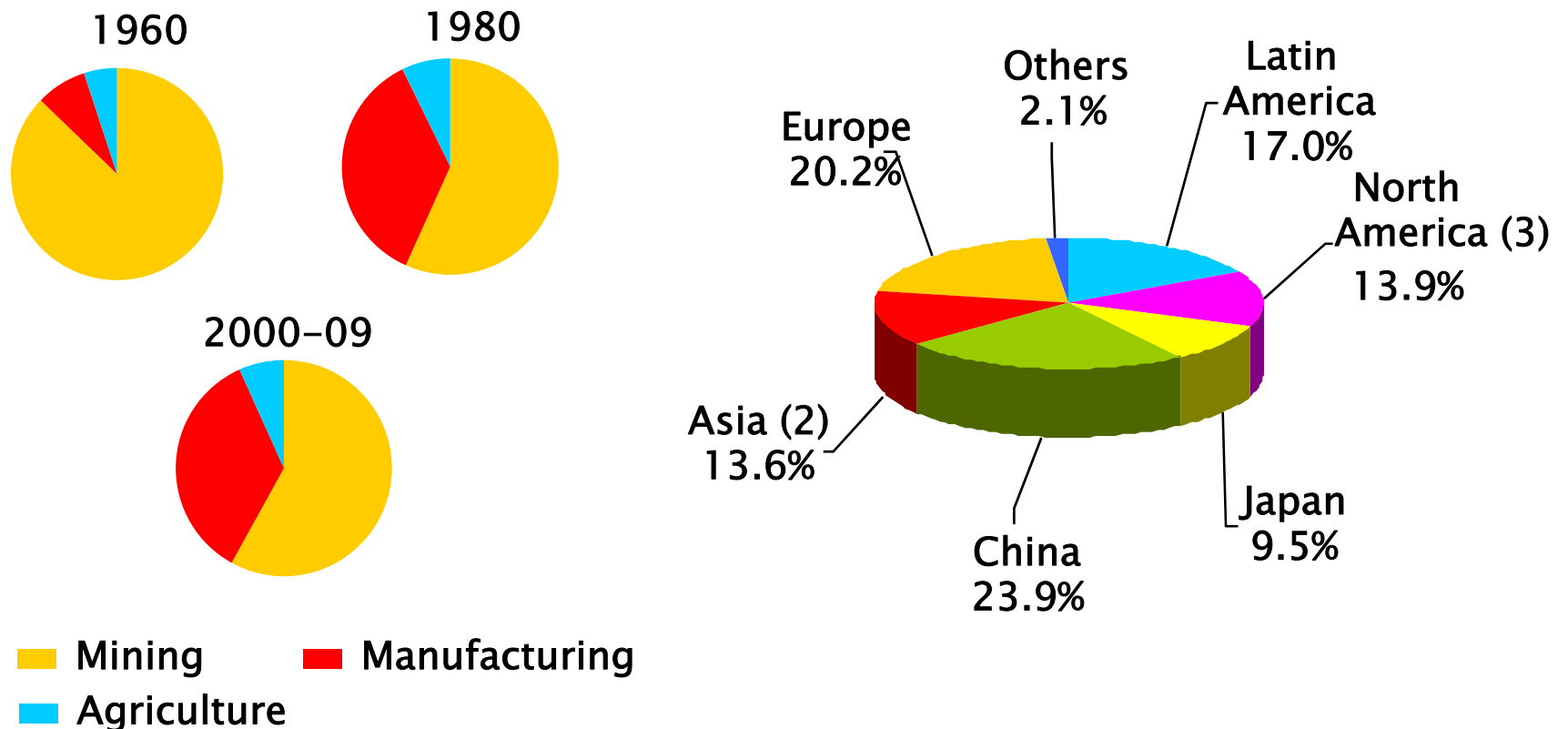
(*) Information for April 2010, except insurance companies (March 2010).

Sources: Superintendence of Securities and Insurance and Superintendence of Pensions Funds.



Exports are mainly based on natural products, but they are well diversified by country of destiny.

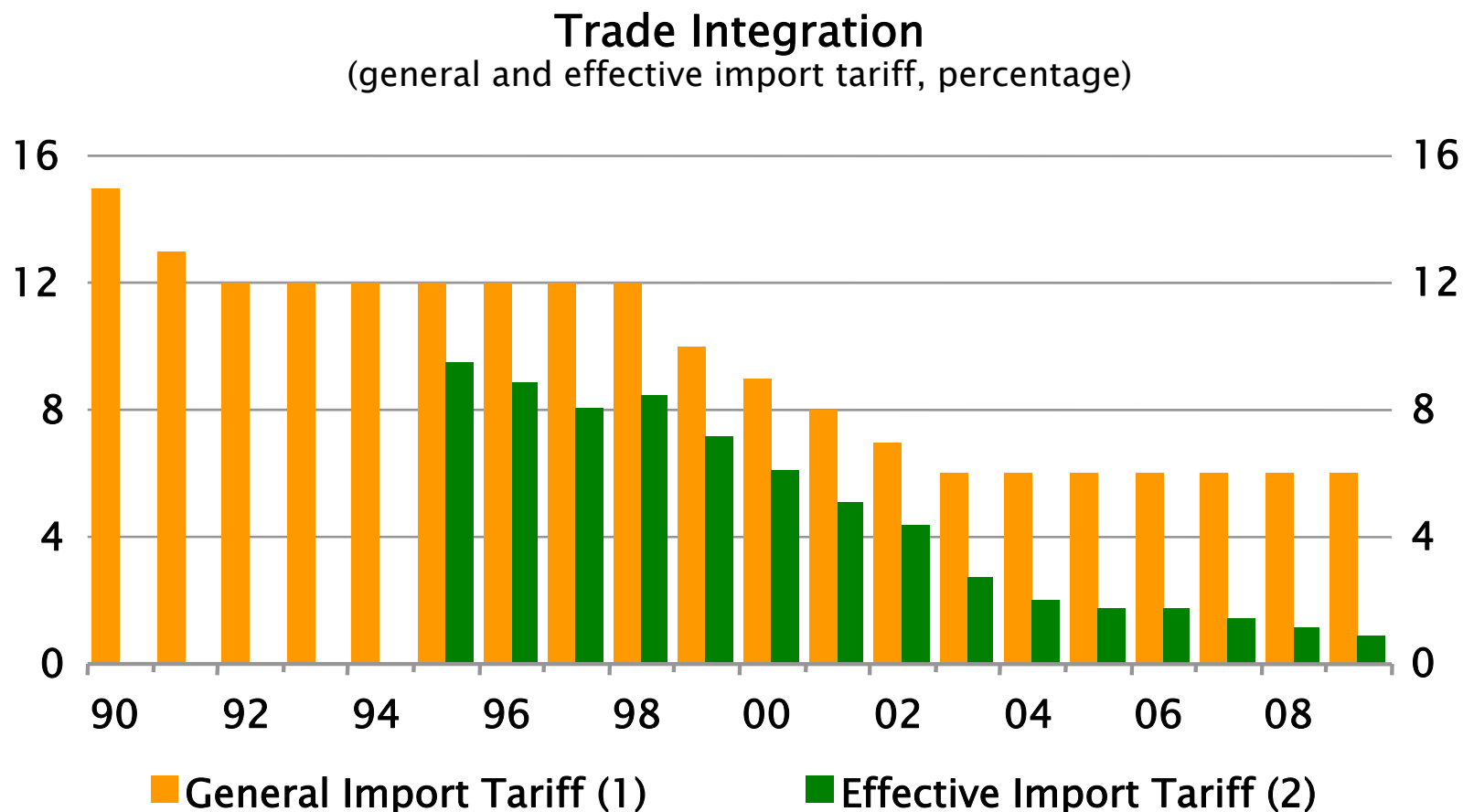
Chilean Exports by Economic Sector and Destination (1)
(share of total exports, percentage)



(1) Export destination data as of 4Q09. (2) Asia excludes China and Japan. (3) North America includes USA and Canada.
Source: Central Bank of Chile.



Import tariffs have declined over time and currently stand at low levels.

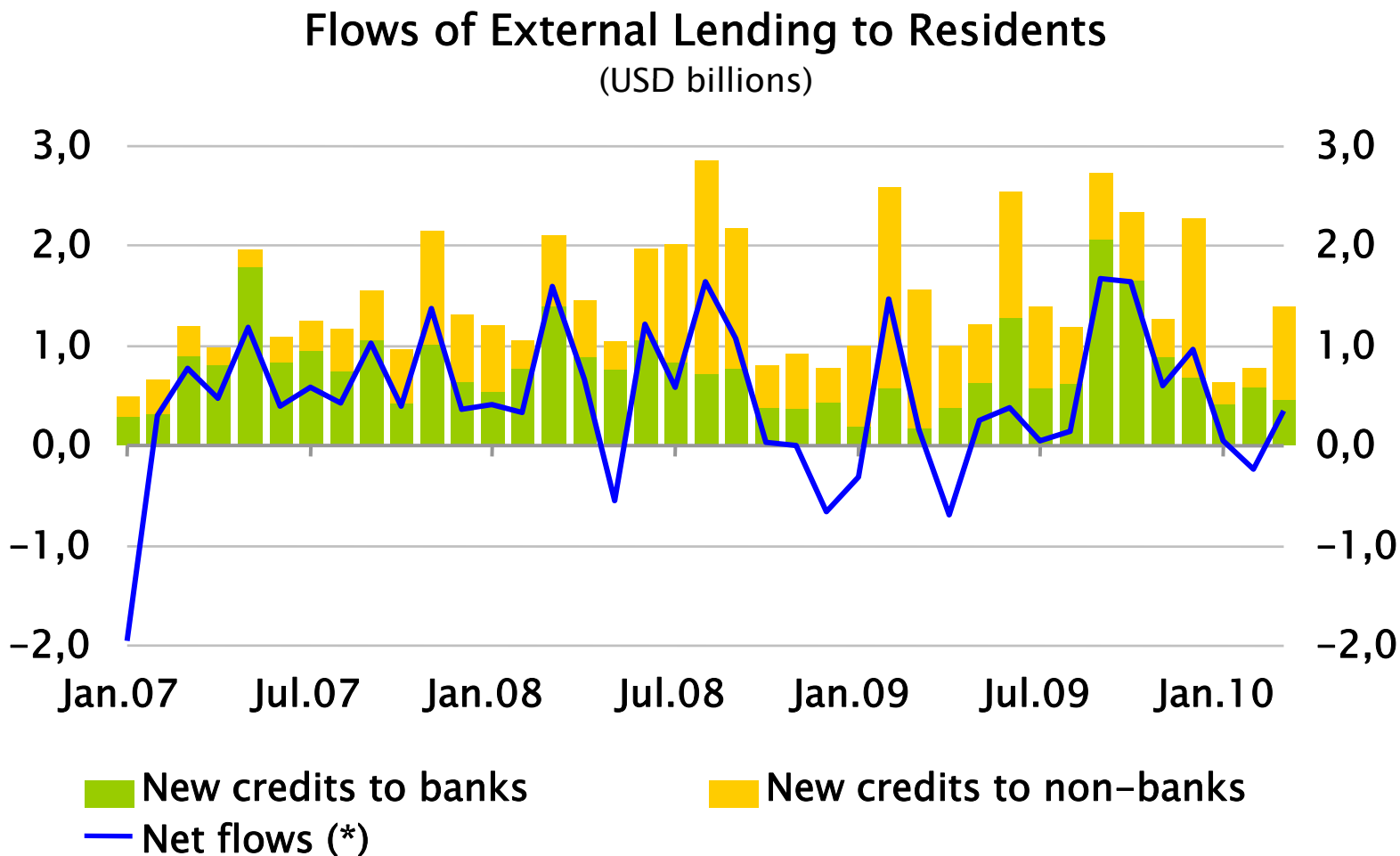


(1) Includes every product of General Agreement and excludes those of Free Trade Agreements. (2) Becerra, G. (2005), Statistical Economic Studies 50. Posterior data is estimated as the ratio of Foreign Trade Tariffs to imports. Figures until 1Q09.

Source: Central Bank of Chile.



Access to external funding by banks and corporations has been opened for years and has remained so with no interruption during the financial crisis.



(*) Total new lending amount discounted by amortization made by banks and non-banks.
Source: Central Bank of Chile.



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. Monetary Policy



Monetary Policy

- Monetary policy comprises the measures and decisions adopted by the CBC in order to achieve and maintain price stability.
- But why is price stability so important? It is because Inflation has adverse effects and significant economic costs.



Monetary Policy

- On the one hand, inflation has a negative impact on the allocation of resources and investment decisions. It also 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 a wage or a pension.



Monetary Policy

- For these reasons, it can be argued that low and stable inflation contributes to the welfare of a country's inhabitants.
- However, regarding monetary policy, concepts have changed significantly in the past three to four decades.



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.
- Today, the widespread view among economists is that there is not a permanent trade-off between growth and inflation.



Monetary Policy

- Experience has shown us that attempts to reduce unemployment below its normal level or to raise output above its potential level lead to an acceleration of inflation.
- As a result, monetary policy is now normally associated with the goals of macroeconomic stability and is not seen as a tool for resolving structural problems of unemployment or low potential growth.



Monetary Policy

- The design of monetary policy now differs from the past when it focused on monetary aggregates or the exchange rate.
- Today, the design that has gained increasing acceptance is that the Central Bank sets the monetary-policy interest rate (MPR) in order to achieve an explicit inflation target over a certain time horizon.



Monetary Policy

- In Chile, an inflation–targeting regime has been fully in place since 2001.
- This regime is complemented by a floating exchange rate system that facilitates the economy's adjustment to external shocks.



Monetary Policy

- 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 target is set in terms of headline inflation, measured using the CPI, which is the price index most commonly used in Chile.



Monetary Policy

- 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.
- An above-zero target is fully justified because it allows room for smooth adjustments in relative prices, thereby facilitating the implementation of monetary policy.



Monetary Policy

- The focus of monetary policy is on projected inflation over a 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

- This forward-looking approach requires to visualize the economic outlook that will prevail in the future.
- For this purpose, the CBC carries out forecasting exercises using economic models and statistics.



Monetary Policy

- These exercises have limitations due to imperfect knowledge, incomplete information and uncertainty about future developments.
- For this reason, the technical judgment of the board of directors is always essential when making forecasts and policy decisions.



Monetary Policy

- Monetary policy operates primarily through modifications to the MPR, but also through the communications that the CBC issues to the market.
- Changes in MPR have a first effect on interbank interest rates.

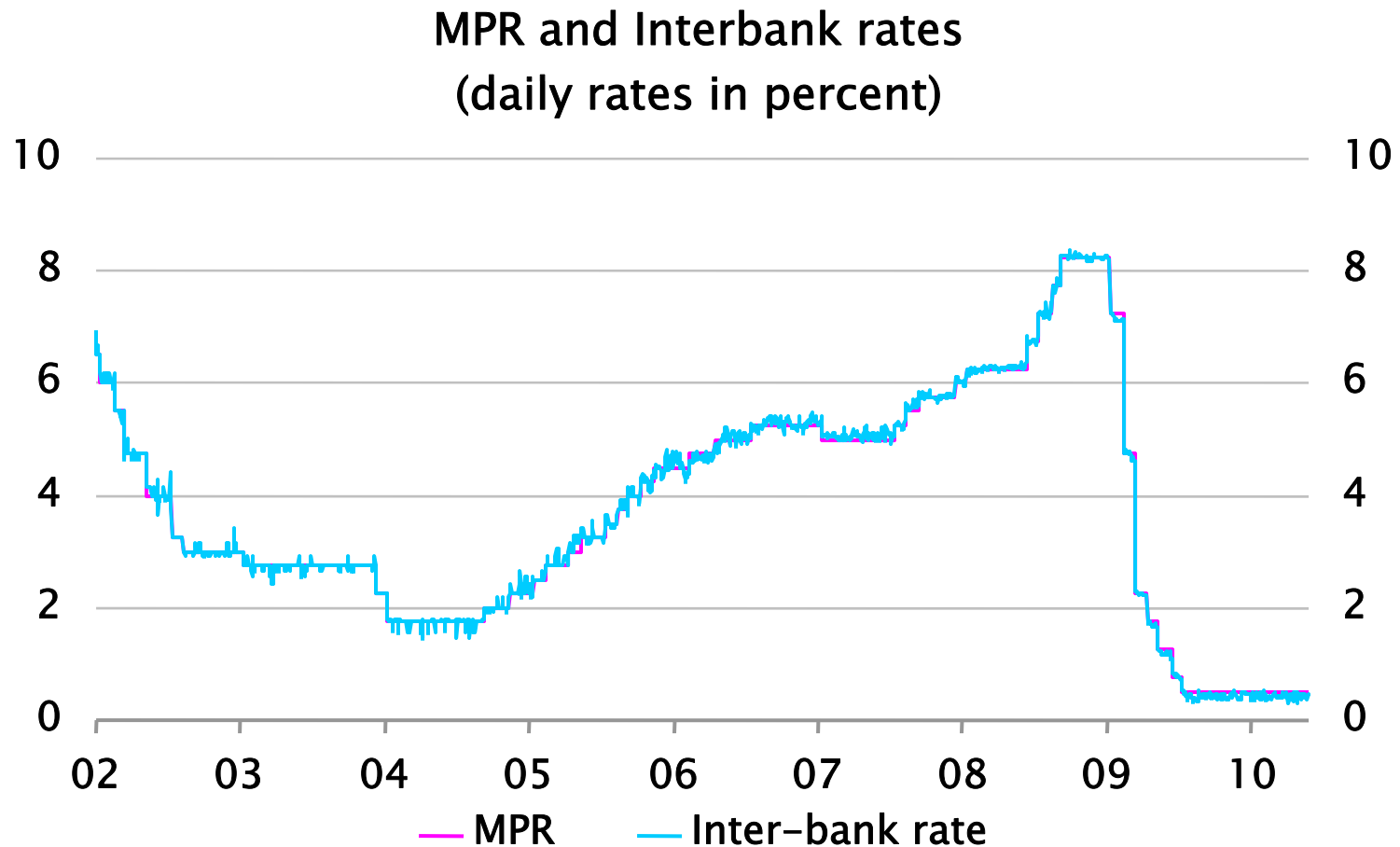


Monetary Policy

- Then they affect the whole set of interest rates, the price of financial assets, the exchange rate, and monetary and credit aggregates.
- They also influence expectations and confidence.
- Finally, all these movements have then an impact on economic activity and inflation.



The current stance of monetary policy



Source: Central Bank of Chile.



III. 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.



The media coverage is usually extensive

ECONOMISTAS PLANTEAN QUE FACTOR EXTERNO FUE CLAVE EN DEJAR LA TPM EN 0,5%

Banco Central anticipa pronta alza de tasas y la mirada del mercado se vuelca a junio o julio

“El Consejo considera que se acerca el momento de iniciar el proceso de normalización de la política monetaria”.

ISABEL ÁLVAREZ H.

El Banco Central nuevamente decidió ayer mantener la tasa de interés de referencia en su nivel mínimo de 0,5%. Esta vez, sin embargo, dio una señal concreta de que la fecha de inicio del alza del tipo de interés se producirá en el corto plazo.

“El Consejo considera que se acerca el momento de iniciar el proceso de normalización”.

AYER LA MANTUVO EN 0,50%

Central: Se Acerca el Momento de Normalizar la Tasa de Interés

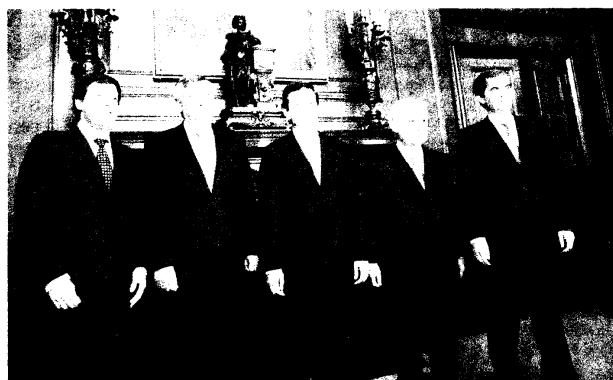
La autoridad monetaria optó por la cautela ante la incertidumbre generada a partir de la crisis fiscal en naciones de la zona euro.

Al como lo anticipaba el mercado, el Banco Central resolvió mantener la tasa de interés en su mínimo histórico de 0,50% anual en su reunión de política

las apuestas de los economistas están por debajo del 3% en que se debería situar la TPM al término del año, según lo implícito en los precios de los activos de mercado.

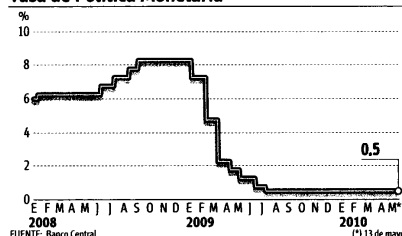
Para el economista de Inversiones Security, Aldo Lema, la tasa debería cerrar en 2%. Explica que la proyección de mercado “es algo exagerada y, probablemente, se va a moderar en los próximos días después de este comunicado”.

Algo más arriba está la proyección del economista de Forecast, Ángel Cabrera, quien pronostica que el Banco Central subirá la tasa a razón de 25 puntos base por reunión llegando a 2,25% a fines de 2010.



En el comunicado, el Consejo también afirma que “los efectos del terremoto fueron menores a lo que se esperaba”.

Tasa de Política Monetaria



2,5% y 2,75%. Agrega que la decisión de mantener la tasa implicará que en el segundo semestre se produzca un incremento de 50 puntos base, lo que para él no es lo más conveniente, ya que “es algo que sólo debería ser usada de forma excepcional”.

Factor externo

Los economistas también coinciden en que el escenario externo fue clave a la hora de tomar la decisión.

“Si no hubiese sido por el empeoramiento del ambiente global, probablemente el inicio del ciclo monetario

contractivo se habría iniciado este mes”, afirma el gerente de economía y renta fija de LarraínVial, Dalibor Eterovic.

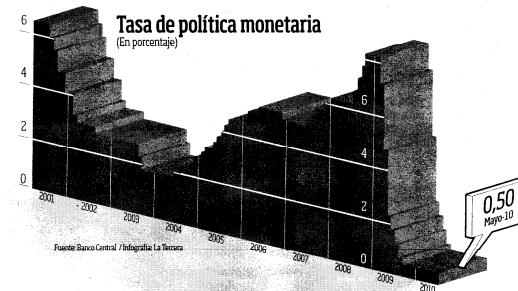
Una opinión similar tiene Cabrera, quien añade que “dada la volatilidad provocada por la situación europea parece conveniente esperar un poco, pero claramente la inclinación del Banco Central es mover la tasa pronto”.

Y, de hecho, la autoridad monetaria hizo alusión a la crisis que está afectando a las economías del Viejo Continente. “Los efectos de las turbulencias financieras recientes sobre la actividad mundial son aún inciertos”, sostiene el comunicado.

Al respecto Selaive, señala que el Banco Central debió haber “explicitado esta situación como un riesgo en el Informe de Estabilidad Financiera (IEF) o en el último Informe de Política Monetaria (IPOM) y que está marcando la pauta de la normalización”.

Algo más matizados fueron para Lema los factores que determinaron la decisión del Central. “Se ponderaron -dice- elementos externos como mayor volatilidad e incertidumbre sobre la recuperación global y factores domésticos donde la actividad y la inflación estuvieron bajo lo previsto”.

LA TERCERA Viernes 14 de mayo de 2010



BC anticipa fin a ciclo histórico de bajas tasas y alzas partirían en junio

El instituto emisor mantuvo ayer la tasa rectora en 0,5%, nivel que conserva desde julio de 2009. Sin embargo, el consejo del Central adelantó que pronto iniciará el proceso de normalización. Economistas apuestan a que la tasa llegará hasta 0,75% en junio.

La decisión se extiende por diez meses consecutivos

Banco Central mantiene tasa de interés en 0,5%



La decisión del Consejo del Banco Central de mantener la tasa ayudará a incentivar al consumo de las personas y además la inversión de las empresas.

Larraín, afirmó que la decisión es “una adecuada la medida que se va a ver en la práctica”.

“Chile comienza de reducción del tipo de interés que va a ver en la práctica”.



Participants in the MPM

- 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





Outcome of the MPM

- The monetary–policy decision, which may be to maintain, raise or lower the MPR.
- A press release announcing the decision and its reasons, which is made available immediately after the meeting.
- Minutes which are published two weeks after the MPM, including:
 - The policy options that were considered;
 - The main arguments behind the decision;
 - The vote of the Board Members.



Example of a press release

Press Release*

Santiago, 13 March 2010

In its monthly monetary policy meeting, the Board of the Central Bank of Chile decided to maintain the monetary policy interest rate at 0.50% (annual).

Internationally, the high volatility of the markets has been mitigated by fiscal announcements and financial support measures in Europe. Global growth prospects continue to be favorable, but the effects of recent financial turbulences on world output are still uncertain. The prices of copper and oil have declined, but are still at historic highs.

Domestically, available information on economic activity suggests that the immediate effects of the earthquake exceeded earlier estimates. Demand indicators, meanwhile, show more dynamism than expected in the March Monetary Policy Report. Lending conditions have continued normalizing. Unemployment has kept on falling.

In April, the CPI posted a somewhat smaller increase than had been forecast by the market, while longer term private inflation expectations are consistent with the last Report's baseline scenario.

The Board considers that the time to begin the process of monetary policy normalization is approaching. At the same time, it reiterates that it will continue to use its policies with flexibility so that projected inflation stands at 3% over the policy horizon.



IV. 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 structure 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

- 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.
- Although very significant progress has been achieved as regards to inflation, this cannot be taken for granted and discipline and perseverance are necessary.



Final remarks

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



Appendices



The Central Bank of Chile and the Federal Reserve System: a comparative view.

	Chile	USA
Mandate (single or dual)	single (inflation)	dual (inflation and growth)
Independence	yes	yes
Financial stability powers	yes	yes
Highest decision-making body	Board	Board
Monetary Policy Committee	Board	FOMC *
Board members	5	7
Tenure of board members (years)	10	14
Appointment of board members	President	President
Senate approval for board members	yes	yes
Federal or regional structure	no	yes
Regulatory powers	yes	yes
Supervisory functions	no	yes, but limited to certain areas or aspects **
Inflation targeting	yes	no

(*) FOMC is composed of the seven members of the Board of Governors and five of the twelve Reserve Bank presidents.

(**) The main objective of the supervisory process is to evaluate the overall safety and soundness of the banking organization.



Snapshot of the Chilean Economy

	2006	2007	2008	2009
Gross Domestic Product (billions of USD)	146.8	164.5	174.0	164.6
Real GDP growth (%)	4.6	4.6	3.7	-1.5
Consumer prices (annual % change Dec/Dec)	2.6	7.8	7.1	-1.4
Population (millions of inhabitants)	16.4	16.6	16.8	16.9
Exports of goods FOB (millions of USD)	58,680	67,972	66,465	56,735
Imports of goods FOB (millions of USD)	35,900	44,031	57,617	39,754
Current account balance (% of GDP)	4.9	4.5	-1.5	2.6
Foreign exchange reserves excl. gold (millions of USD, as of 31 Dec. of each year)	19,429	16,910	23,162	25,373
Foreign debt (% of GDP)	33,7	33,9	37,7	45,2
Average exchange rate (Chilean pesos per dollar)	530.3	522.7	521.8	559.7

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



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