The Chilean Experience with Inflation Targeting

Rodrigo Vergara M.
Governor
Central Bank of Chile

PANEL
Futuro de la Política Monetaria: Lecciones del Esquema de Metas de Inflación
LACEA, November 1st, 2012

Outline

- The two phases of IT in Chile
- Why these choices?
- Outcomes of IT in Chile
- Issues arising from the recent experience

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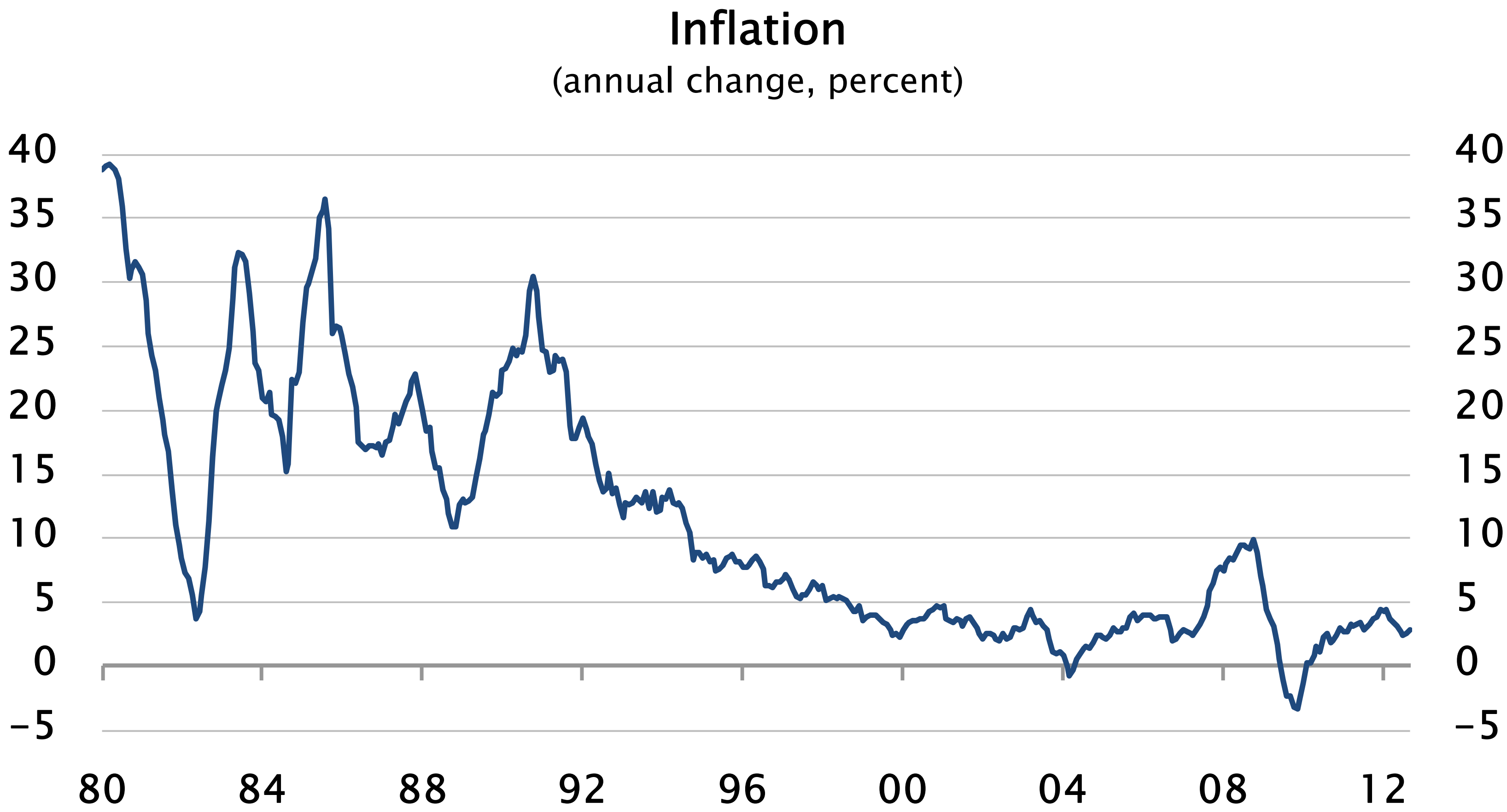
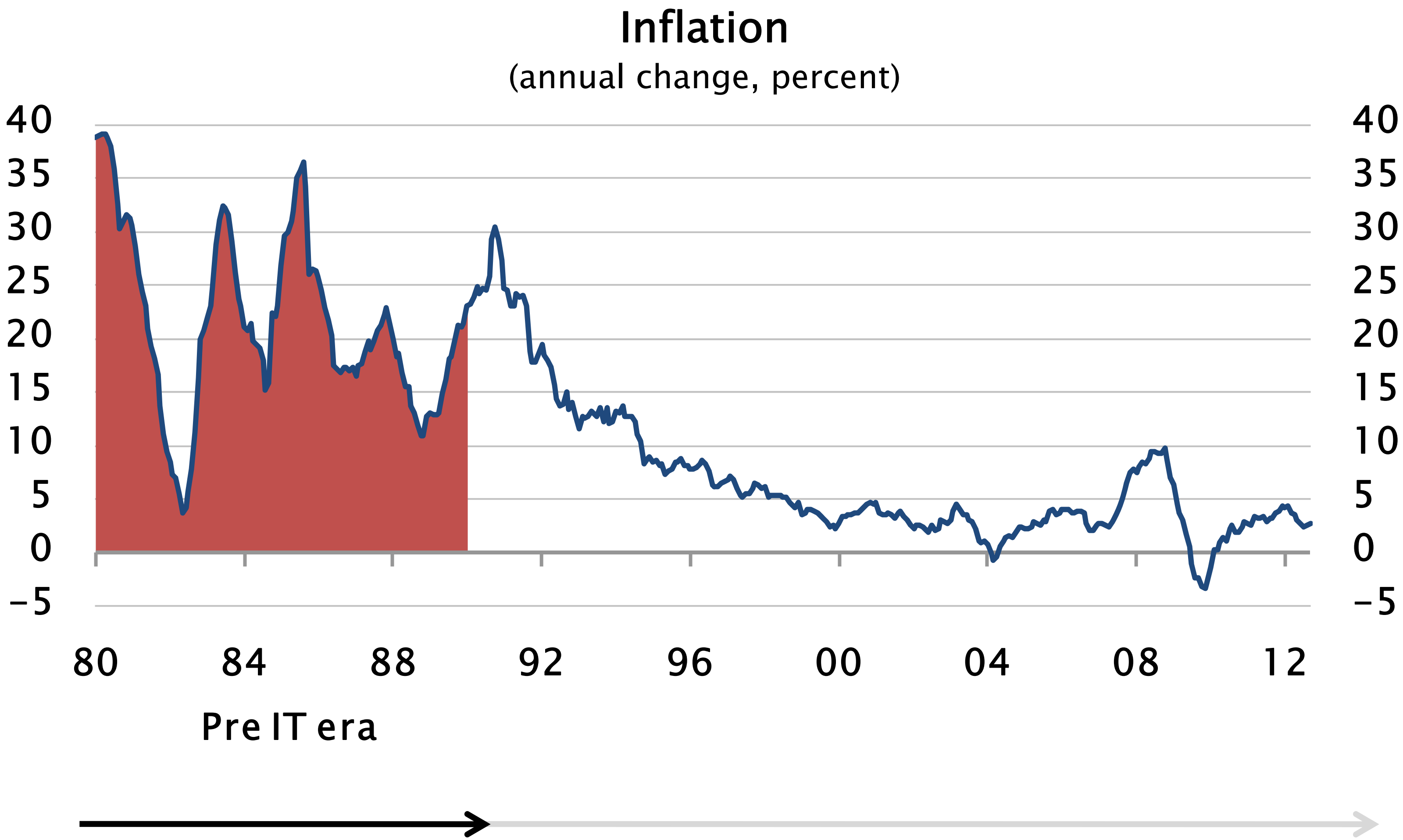
The timeline of inflation in Chile



Source: National Bureau of Statistics.

The timeline of inflation in Chile



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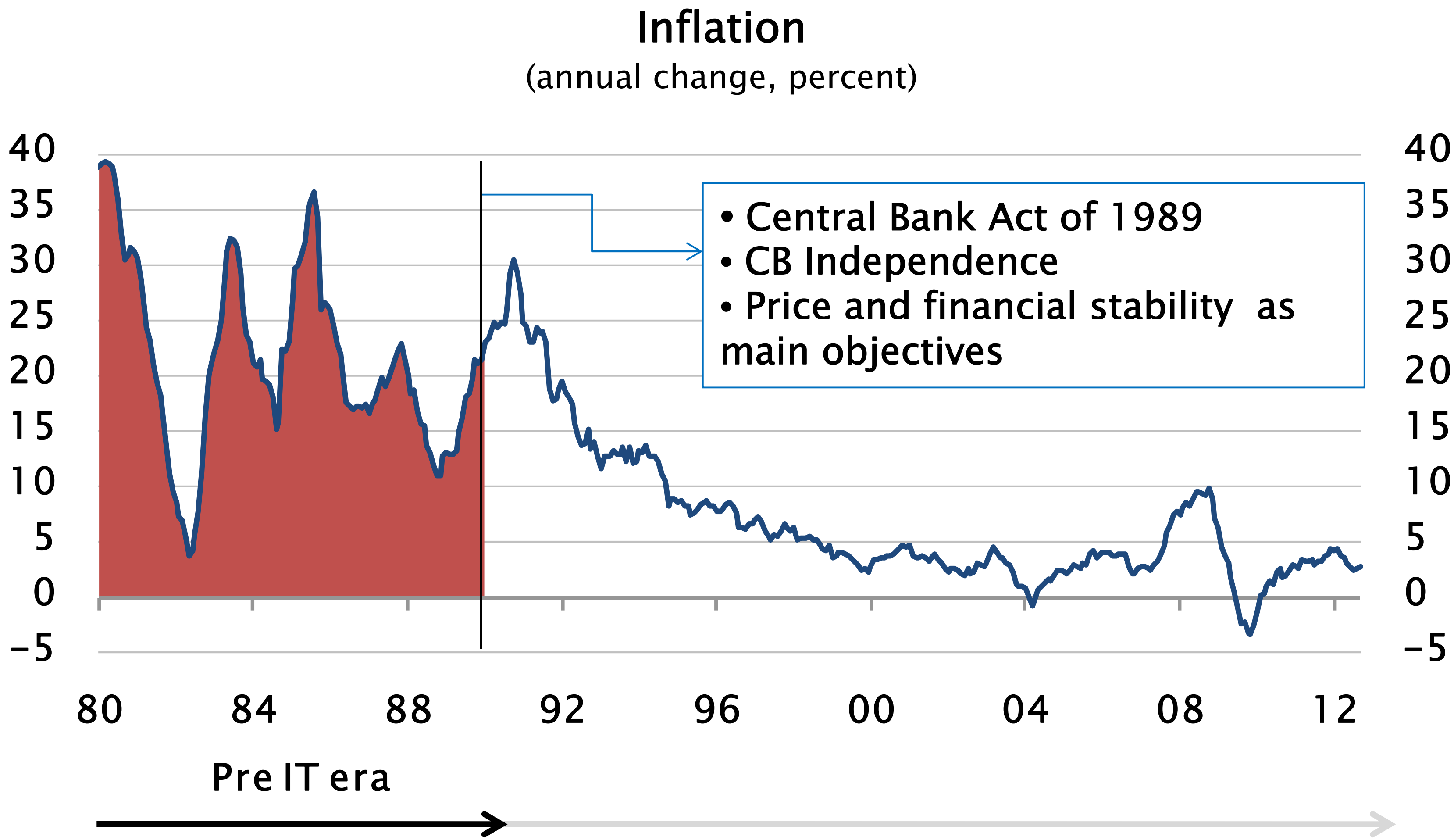

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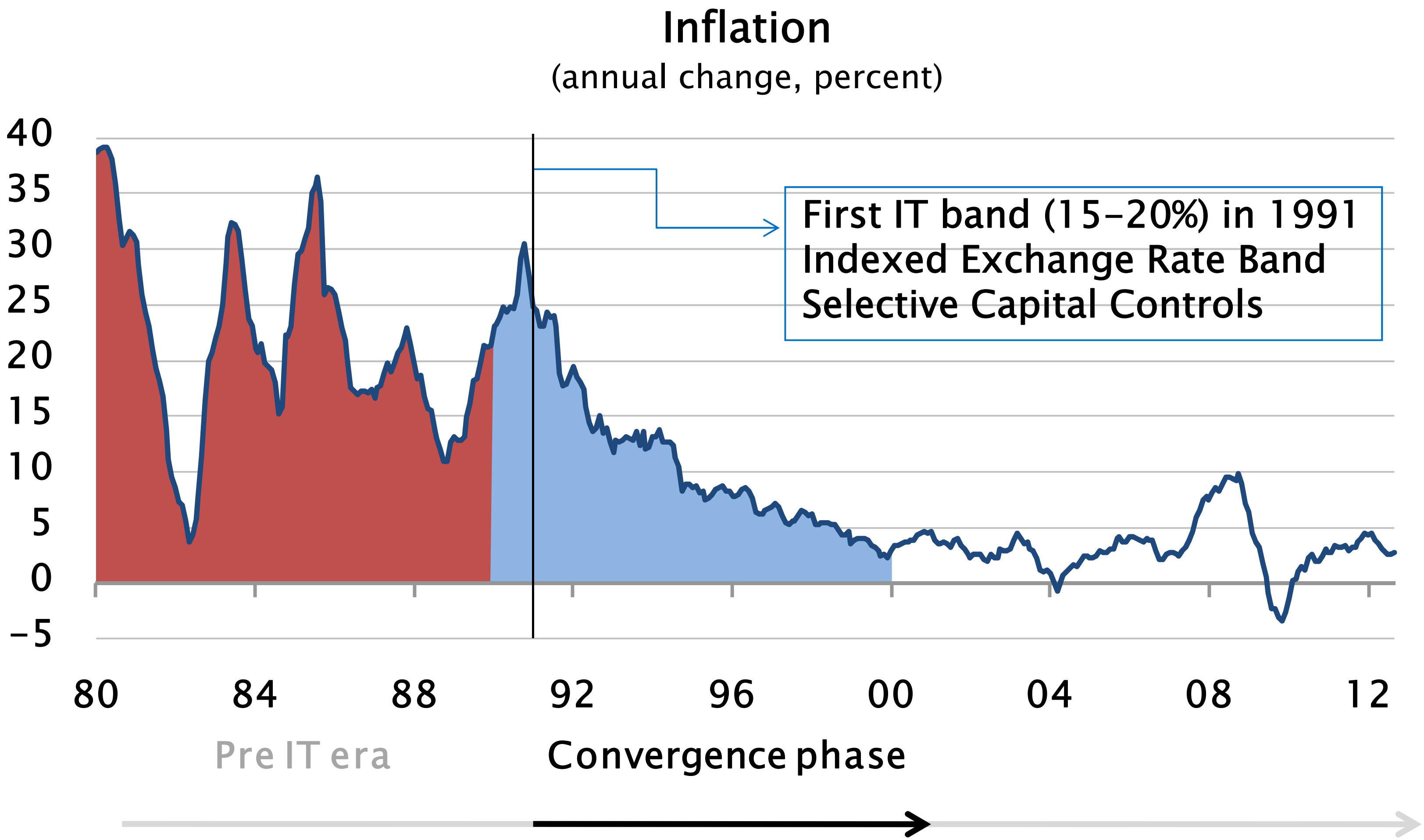

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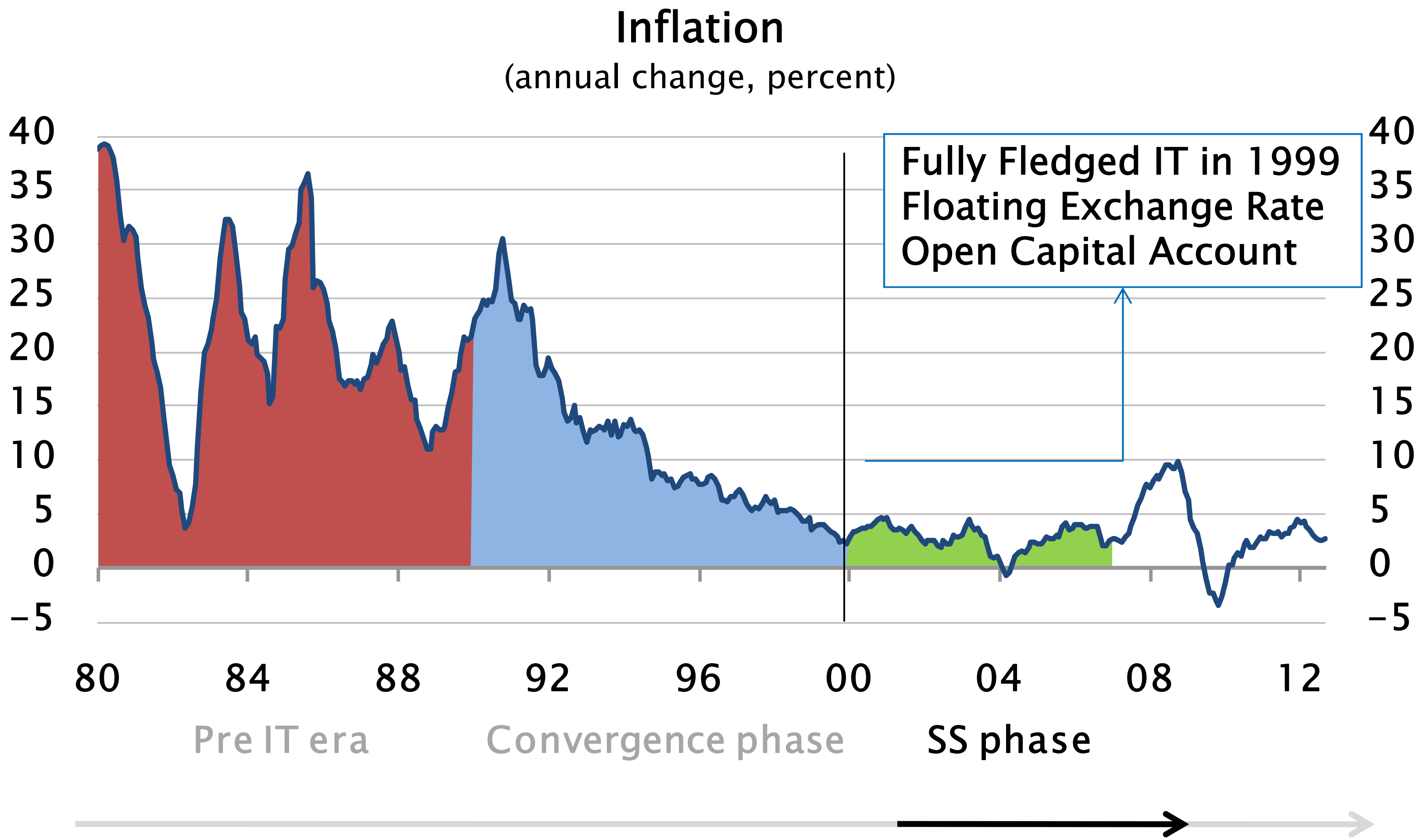

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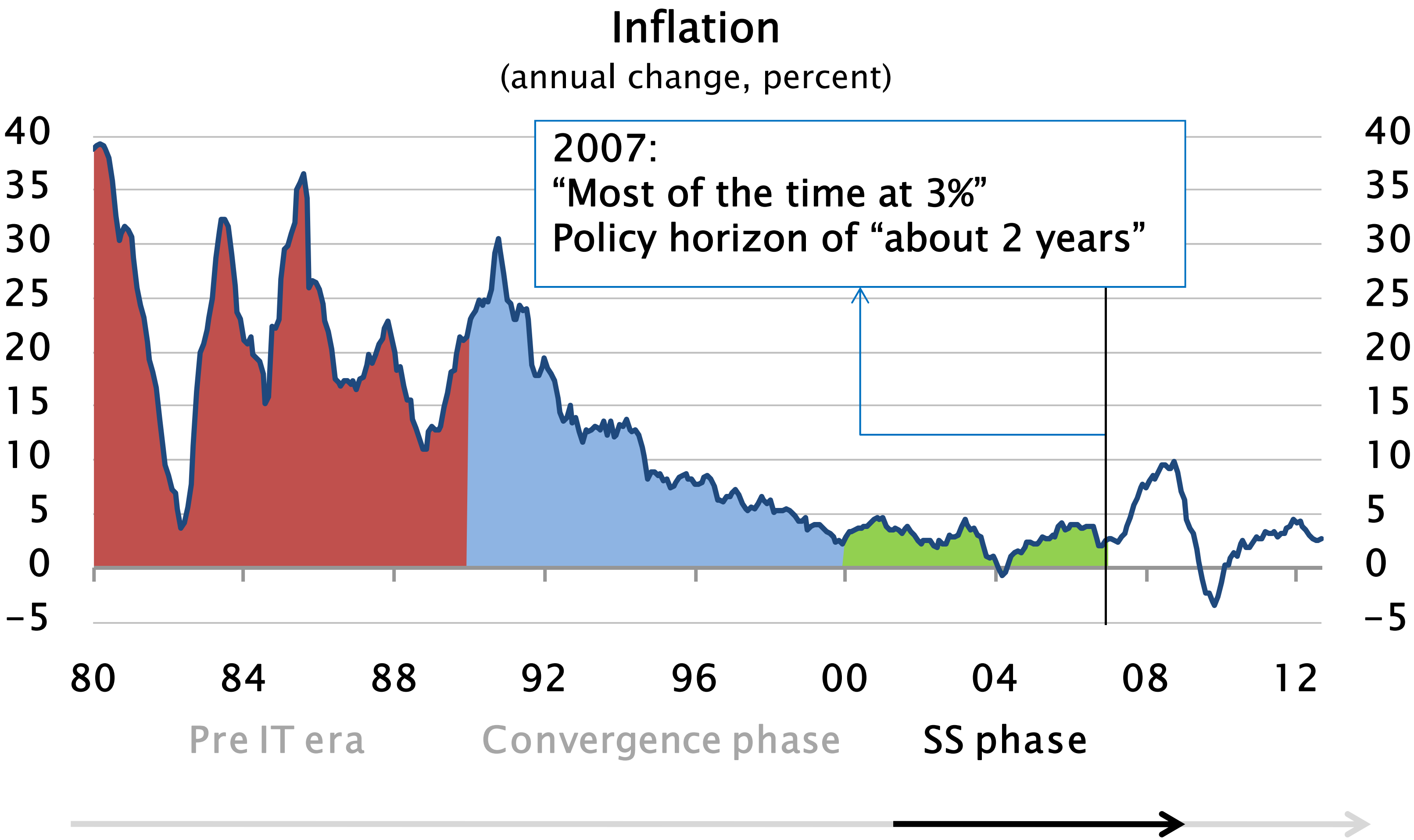

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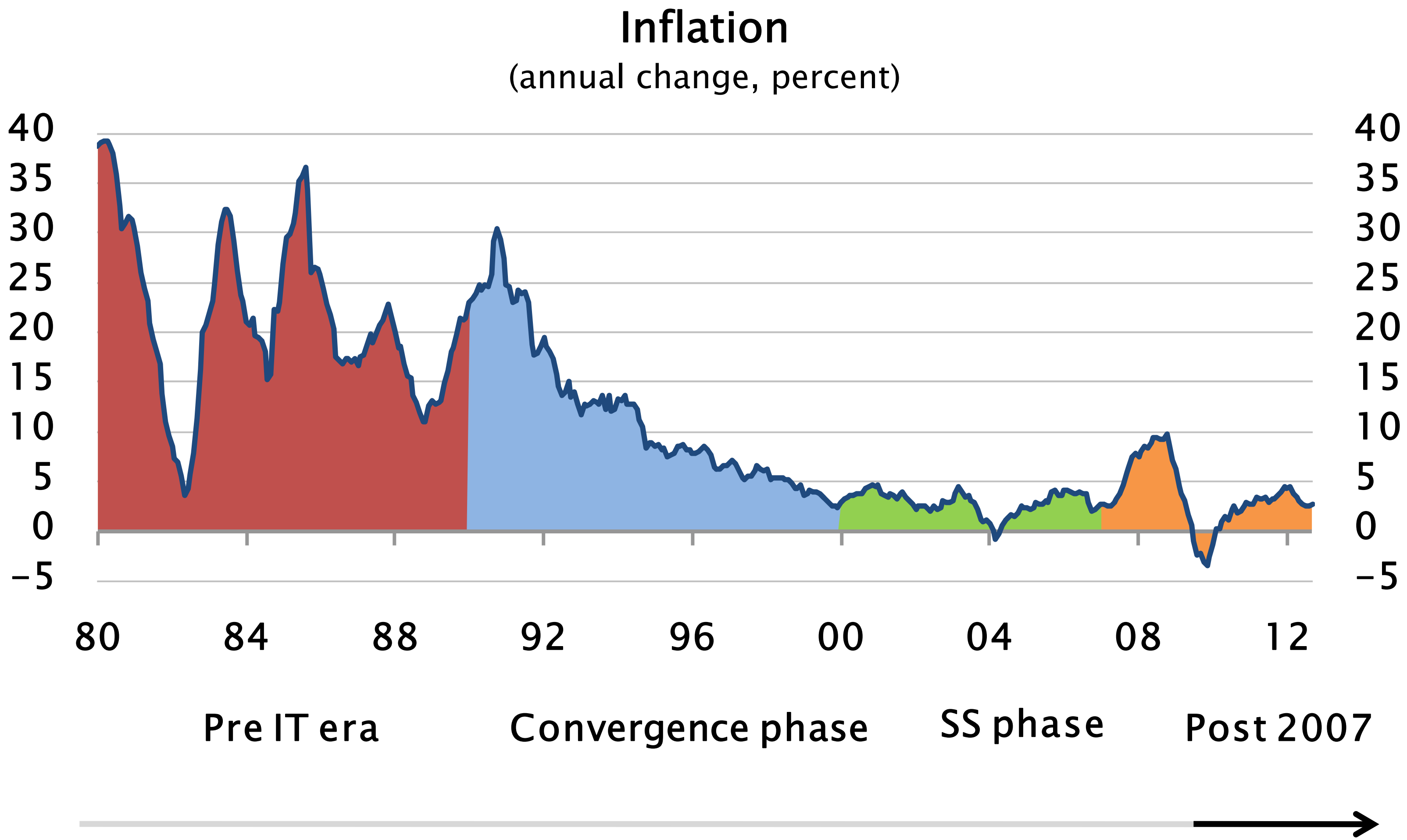

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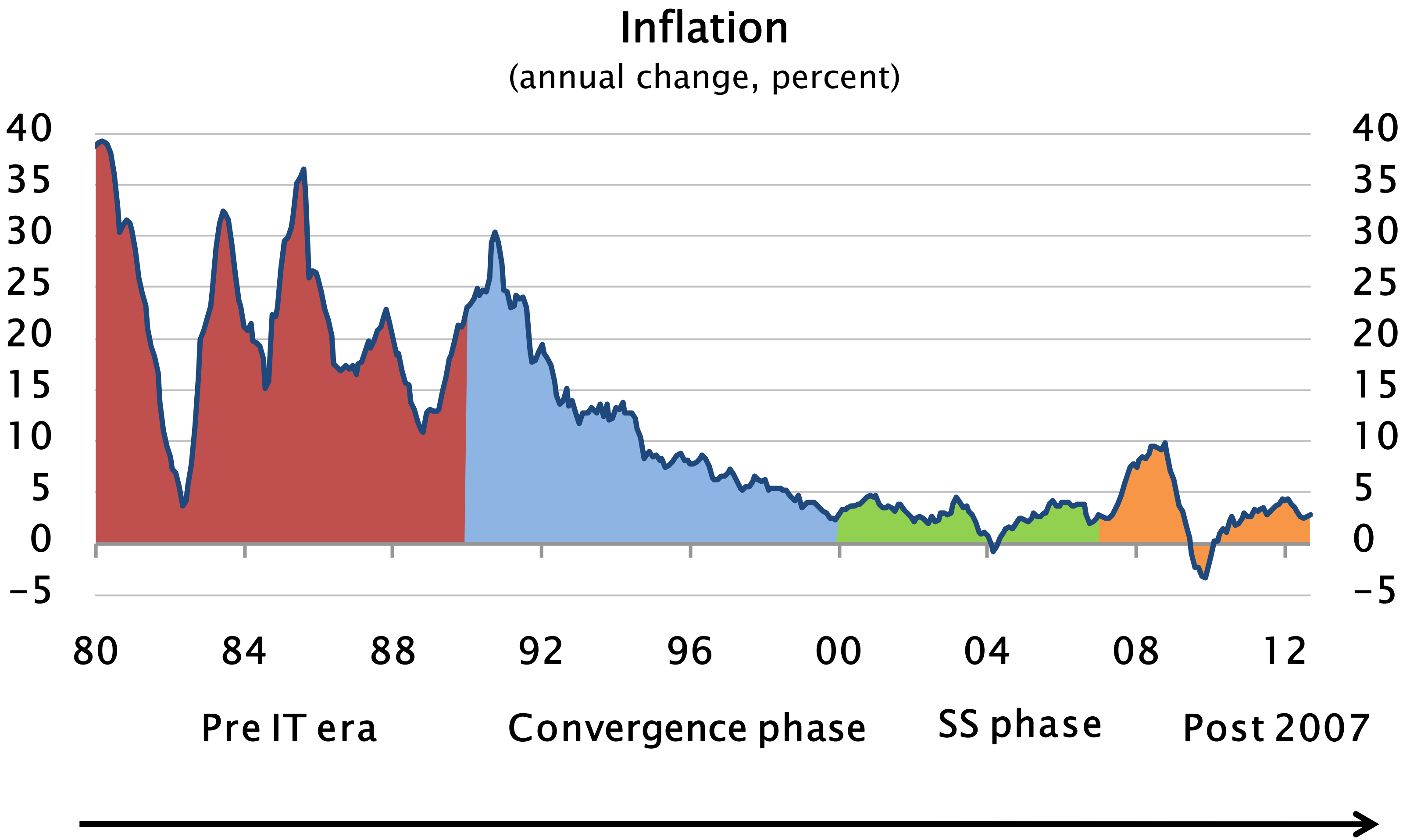

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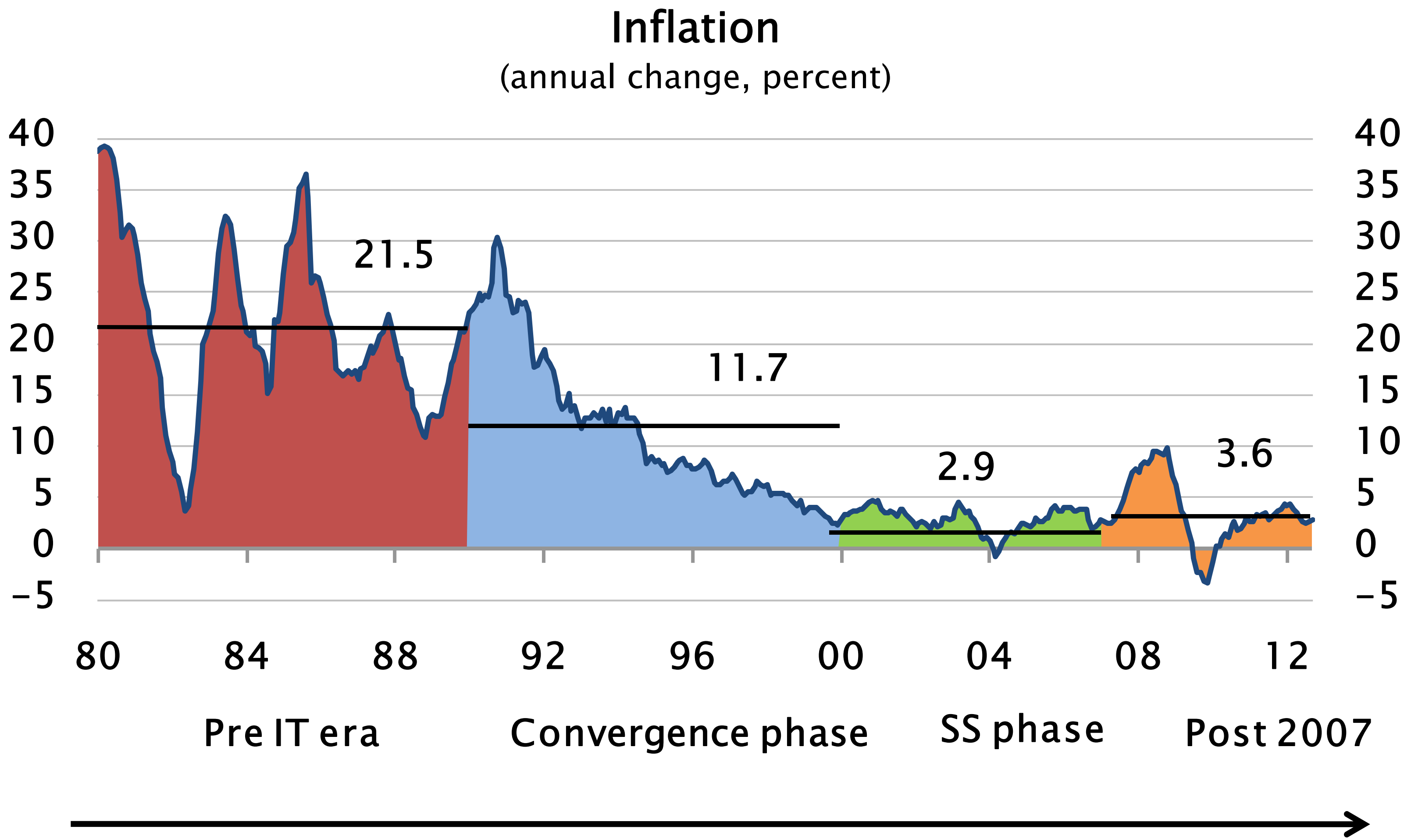

Source: National Bureau of Statistics.

IT in Chile since Sep. 99

- Floating exchange rate regime
- Removal of selective capital controls
- Permanent inflation target (instead of declining)
  - 2000-2006: 2-4% for CPI Headline Inflation
  - Since 2007 : Most of the time 3%, tolerance +/- 1%
- MP horizon over the medium term
  - 12-24 months during 2000-2006
  - Around 2 years since 2007
- Nominalization of the policy rate (2001)

IT in Chile since Sep. 99

- Other standard characteristics
  - Pre-announced monthly MP meetings (6 months in advance)
  - Detailed minutes of MP meetings after 3 weeks
  - Inflation report every 3 (before 4) months

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Why these choices?

- Floating exchange rate
  - Unique nominal anchor
  - Flexible monetary policy
  - Absorb external shocks to terms of trade and capital account
- Headline inflation (CPI)
  - Broadly used as a reference in Chile and easier to communicate
  - Obvious cost of including volatile components
- A 3% level target
  - High level is harder to consider as a signal of “price stability”, may entail risks
  - Low level:
    - Increases the probability of negative adjustment of nominally rigid variables (ie. wages)
    - CPI inflation usually overestimate actual household inflation because of quality and substitution
    - Reduces margin of action of MP because of the ZLB

Why these choices?

- A +/- 1% tolerance band
  - Inflation may deviate from target because of temporary shocks.
    - Smoothing them may be too costly in terms of output and interest rate volatility
  - Monetary policy operates with lags
  - Symmetry signals that the CBC cares equally about inflation and deflation.
  - In Chile there is no explicit list of situations where the band may be breached
- An horizon of about 2 years
  - Gives time for temporary deviations to resolve and for monetary policy to operate
  - Defines the operational goal of CBC:
    - Targeting of inflation projections at that horizon

Why these choices?

- Inflation reports, etc.
  - Power of MP lies in its impact on expected paths of certain variables
    - Clear communication with markets helps to set these expectations
    - Also help explain the rationale for deviations of previous paths
  - Careful to avoid forecasts to be considered as commitments!

Some key companions

- Fiscal responsibility
  - Initially declining levels of debt and converging in first phase
  - Fiscal responsibility since mid 70´s and fiscal rule since 2000
  - Cyclical adjustment for tax and copper revenues, etc.
  - Avoids sudden changes in fiscal expenditures and procyclicality
- Healthy financial system supported by strong institutions
  - Prudential supervision and effective regulation

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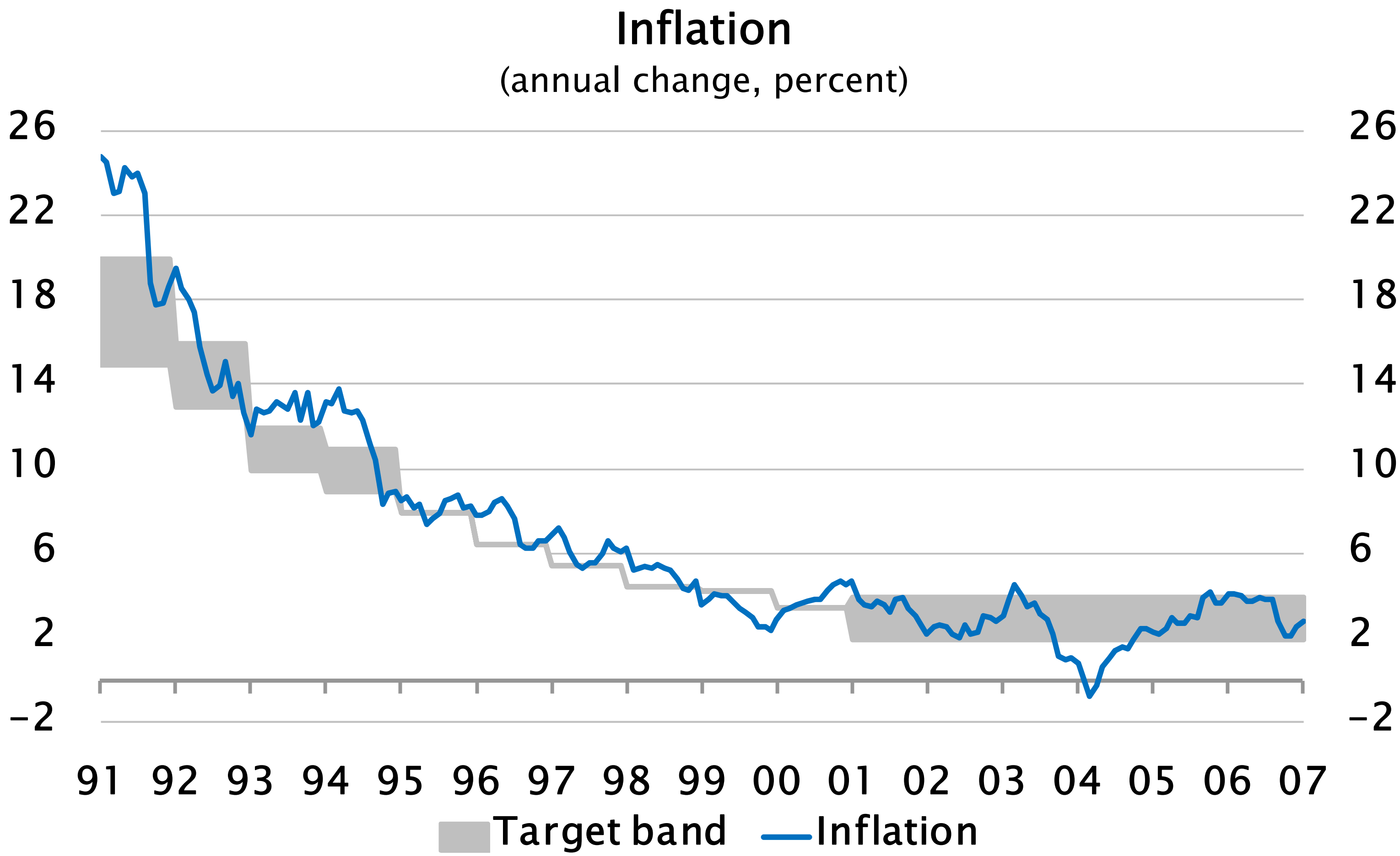
Observed outcomes during the Great Moderation: 2001-2007

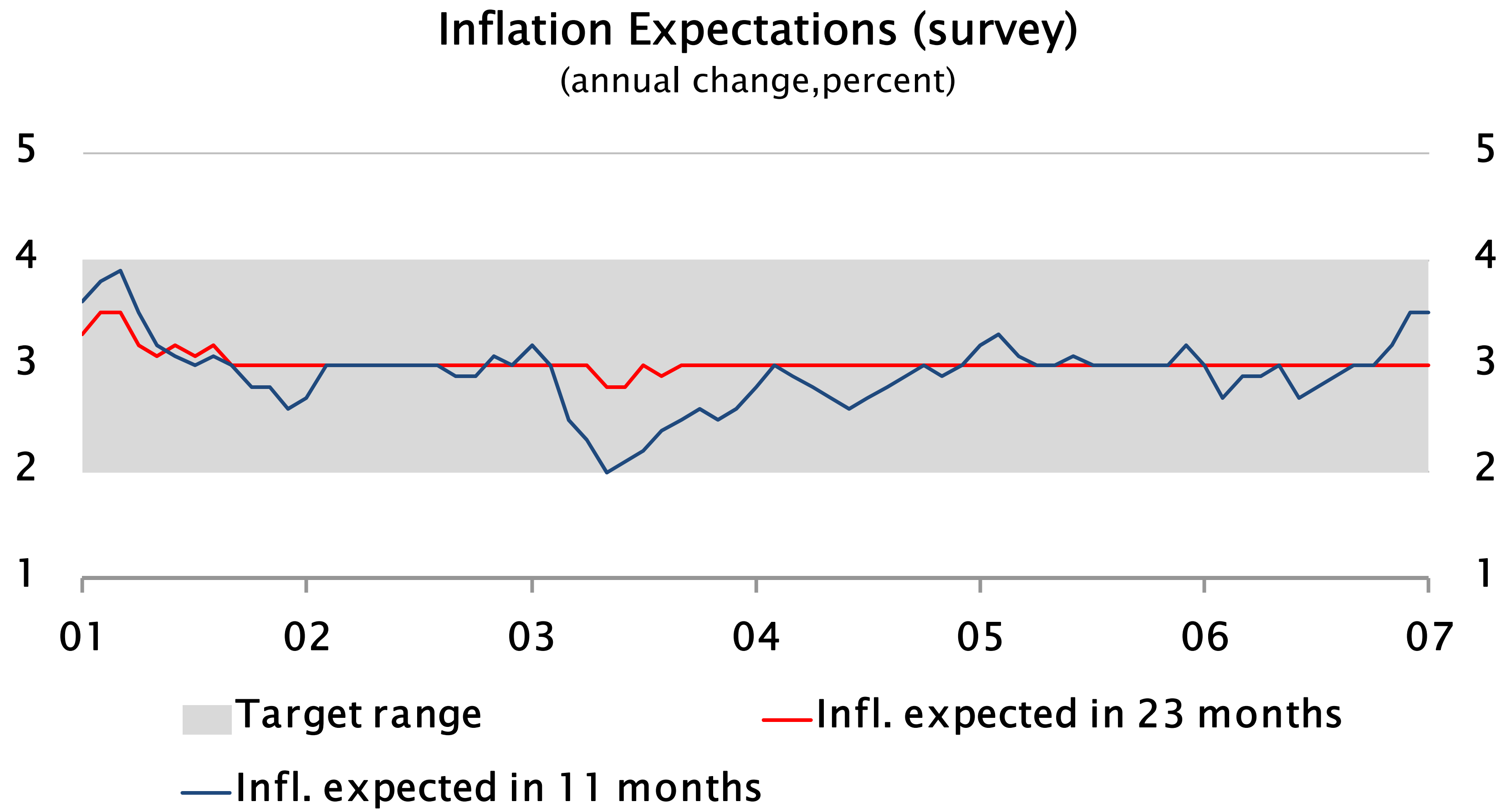
- Convergence of inflation and expectations
- Declining inflation and output volatility
- Less inflationary inertia in prices and wages and smaller exchange rate pass-through

Convergence of Inflation



Source: National Bureau of Statistics.

Expected Inflation and target range



Source: Central Bank of Chile.

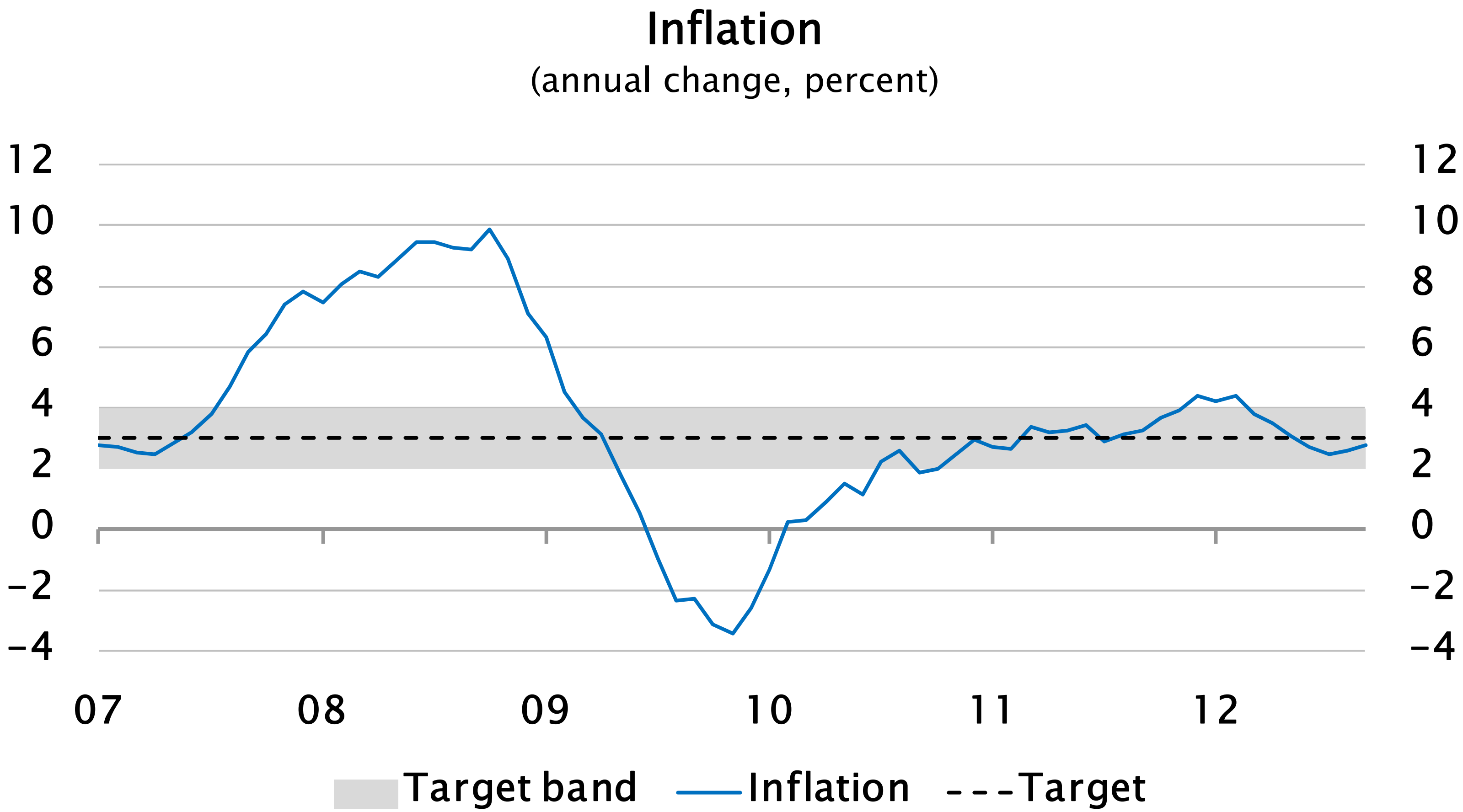
Inflation since 2007

- Food and energy price shocks
- Financial crisis and its aftermath

→ More volatility of headline inflation

→ Some frictions in the monetary transmission mechanism

Inflation in Chile since 2007



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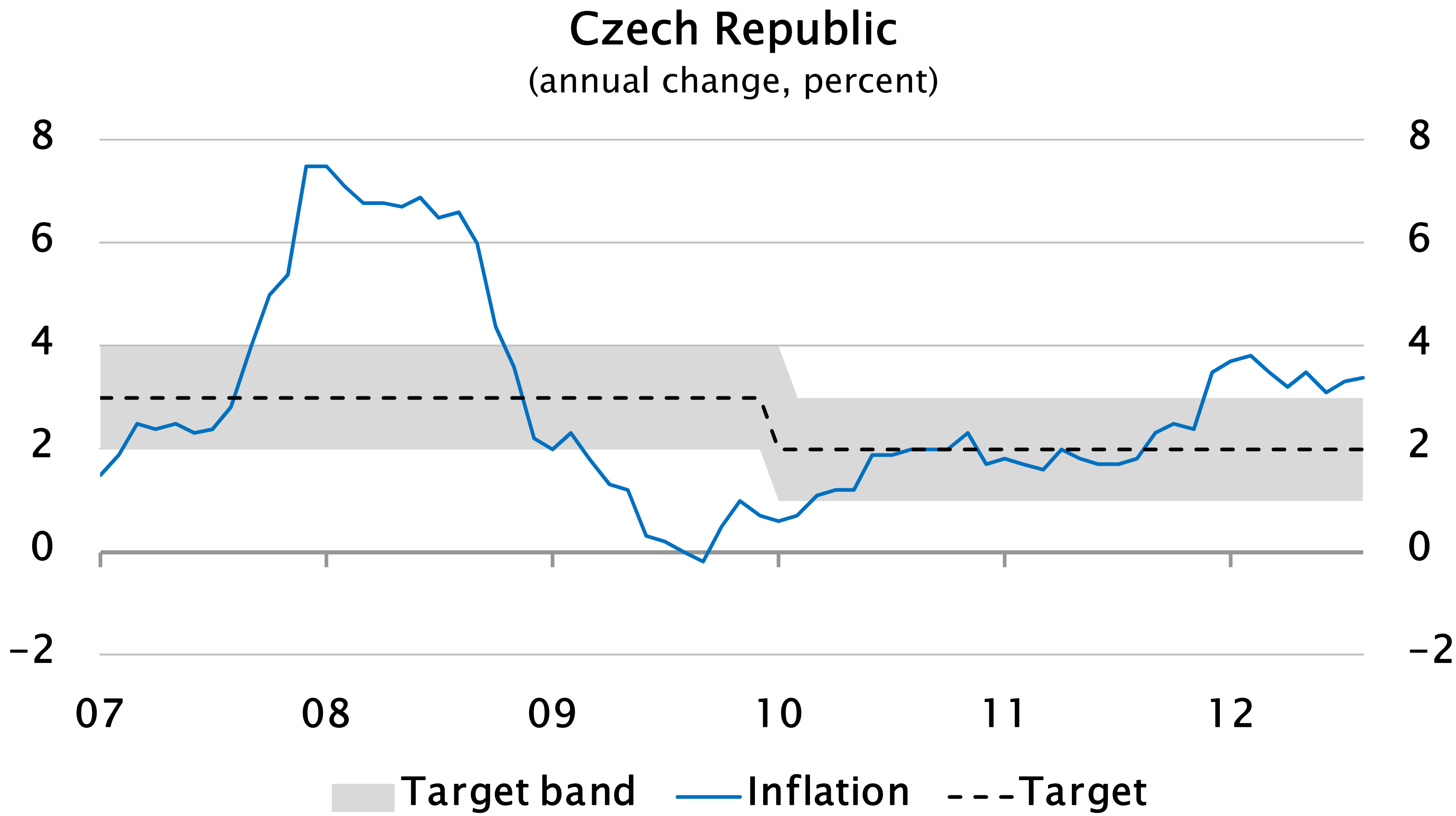
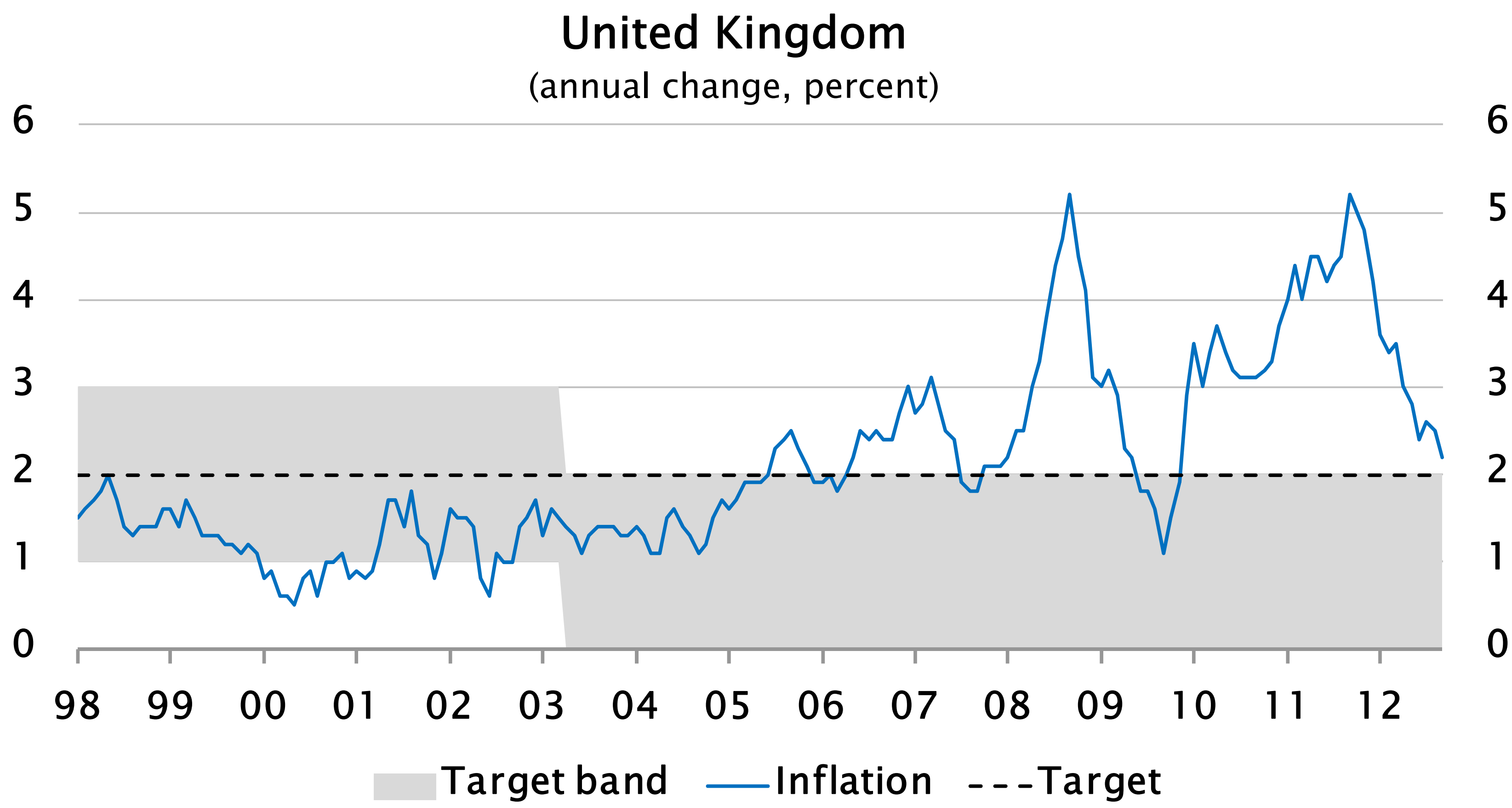
Inflation and target range



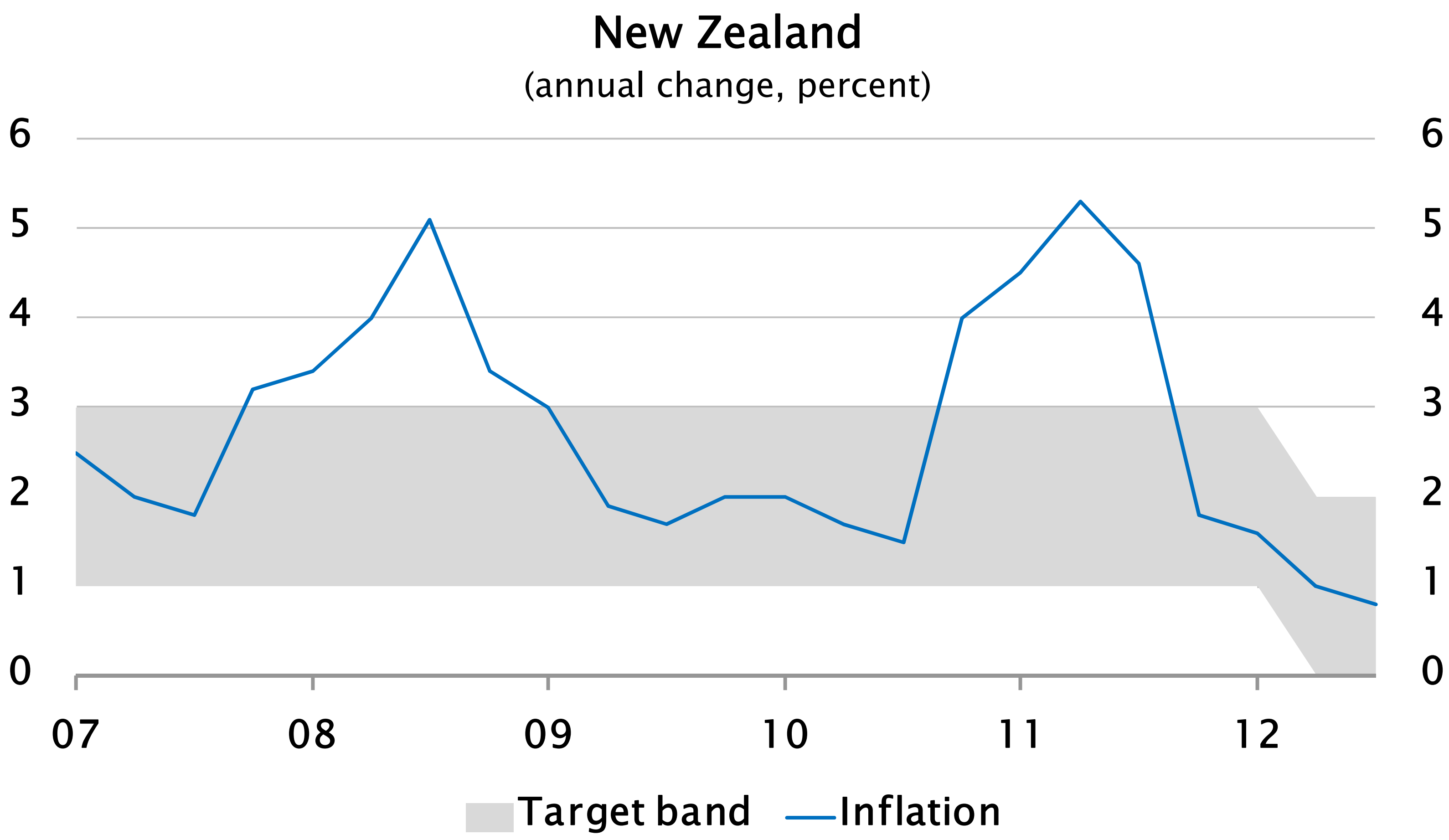
Source: Czech National Bank.

Inflation and target range



Source: Bank of England.

Inflation and target range



Source: Reserve Bank of New Zealand.

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Supply shocks and Flexible IT

- Changes in relative prices are hard to deal with
  - Flexibility in the scheme should allow accommodation and reallocation.
- Several research related questions
  - Is headline inflation the right target? Core inflation? Domestic inflation?
  - How much flexibility should be introduced?
    - Tolerance, horizon, explicit escape clauses.
- BCCh focuses on headline for target and communication but actively follows various core measures of inflation and domestic inflation to asses inflationary pressures and even refers to them in communications

The level of the target

- Countries that found the ZLB binding after the crisis started seriously considering the cost-benefit of higher target levels of inflation
  - A higher target would give more room for maneuvering
  - The proposals to raise these levels from 2% to 3 or 4% have found weak support among academics and policymakers
    - It has costs and there are better tools to deal with the possibility of a ZLB
- Chile already has a target above those of most EME ITers.
  - ZLB was not a big issue during the recent crisis
- More extreme proposals highlight the advantage of a price level target (or even a nominal income target)
  - Good to deal with ZLB
  - Time consistent?

New monetary policy tools to deal with financial turmoil and the ZLB

- The implementation of monetary policy may become severely impaired in a scenario of significant stress in financial and credit markets:
  - Frictions in credit markets impair the transmission of monetary policy and reduce its effectiveness
  - ZLB may become an active restriction to implement a more expansionary monetary policy
- Central Banks need to use other instruments beyond a target for the overnight interest rate to implement their desired monetary stance:
  - Communications policy on interest rates and explicit forward guidance (ie. FED)
  - Medium and long term financing facilities for banks. (ie. Chile in 2009, ECB)
  - Quantitative easing targeted to certain financial markets (ie. FED, BoE)
  - FX intervention and FX targets (ie. SNB)

Asset prices / Financial Stability

- The crisis reignited the debate on whether central banks should take financial stability issues into consideration
- For instance, react to asset price inflation or to strong credit growth
  - Especially if they are “misaligned” (bubble) or growing “too fast”
  - Standard framework responds to these to the extent they affect inflation
  - But if the Phillips curve is very flat due to external competition or credible expectations, then the response of monetary policy may be too little or too late.
- Main issue is the misallocation that can result and the resulting troubles when there are corrections
  - Especially in the crucial financial sector
- Wait and clean or lean against the wind?

Asset prices / Financial Stability

- Debate is open:
  - CB should incorporate measures of froth/stress in financial markets and the risk of financial crises into their policy function. Consistent with flexible IT (Woodford (2012))
  - Monetary policy and financial stability policy are different goals that require different instruments. May or may not be conducted by the same entity.
  - Macroprudential tools are the best instruments to deal with financial stability issues, while monetary policy is a second best tool (Svensson (2011) , Walsh (2009))
- BCCh
  - Monetary policy is too blunt to deal with financial stability issues. We need other tools to address additional goals
  - Using MPR for other targets beyond inflation may confuse its goals and put at risk its credibility
  - In practice, we actively monitor financial conditions, assess likely impact on output and prices, and coordinate with other regulatory agencies to avoid reaching critical conditions (prudential policy).
  - But we remain open to academic and policy developments in the area (macroprudential policies)

Asset prices / Financial Stability

- A related issue for the BCCh and other CBs is whether MP should react to exchange rate fluctuations
  - In Chile there is a flexible regime.
  - But significant deviations of RER from fundamentals may lead to misallocation in the real sector and financial vulnerabilities
  - The CBC can, and has, intervened when it asses there is the possibility of a costly misalignment
  - Crucial to do it in a way such that it does not affect monetary policy credibility
  - For this, the form of intervention matters a lot
    - Through sterilized reserve accumulation (de-accumulation). Consider quasi-fiscal cost. Small if intervention is “correct”
    - Transparency and focused in quantities (not prices)
    - Only in extraordinary situations

High public debt and fiscal dominance

- Public debt in advanced economies has reached unprecedented peace-time levels.
- Under current conditions, uncertainty about future fiscal sustainability may create at some point uncertainty about monetary policy.
  - High public debt makes the public budget dependent on the monetary stance and the level of interest rates.
  - Pressure on Central Banks to implement quasi-fiscal policies (asset purchases) through their balance sheets.

Concluding remarks

- Chile has a long history with IT
- IT has served Chile well
  - Macroeconomic pillars plus IT have allowed the Chilean economy to have sustainable low inflation
  - Today 3% acts as a true inflation anchor, which has survived strong tests in recent years
- Flexible IT raises the possibility of improvement and learning, it is far from a rigid system
  - Chilean system has evolved over time in broad aspects and in details to follow best practice
  - We will continue to do so in the future