

MONETARY POLICY IN CHILE

IN THE AFTERMATH OF THE ASIAN CRISIS

Klaus Schmidt-Hebbel

Central Bank of Chile

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1. Conduct of Monetary Policy in Chile
2. Channels of Transmission of Monetary Policy
3. Chilean Policy Response to the Asian Crisis



Conduct of Monetary Policy in Chile

Objectives of Monetary and Exchange Rate Policies:

- Price stability
- Domestic financial stability
- Sustainable current account deficit

Explicit Annual Inflation Target (main nominal anchor in highly indexed economy)

Monetary Policy Rate:

- Overnight interbank real (ex-post indexed) rate of interest

Standard Monetary Policy Instruments for conducting Open-Market Operations:

- Pre-announced issue of BCC debt
- Repos and antirepos of BCC debt

Exceptional Monetary Policy:

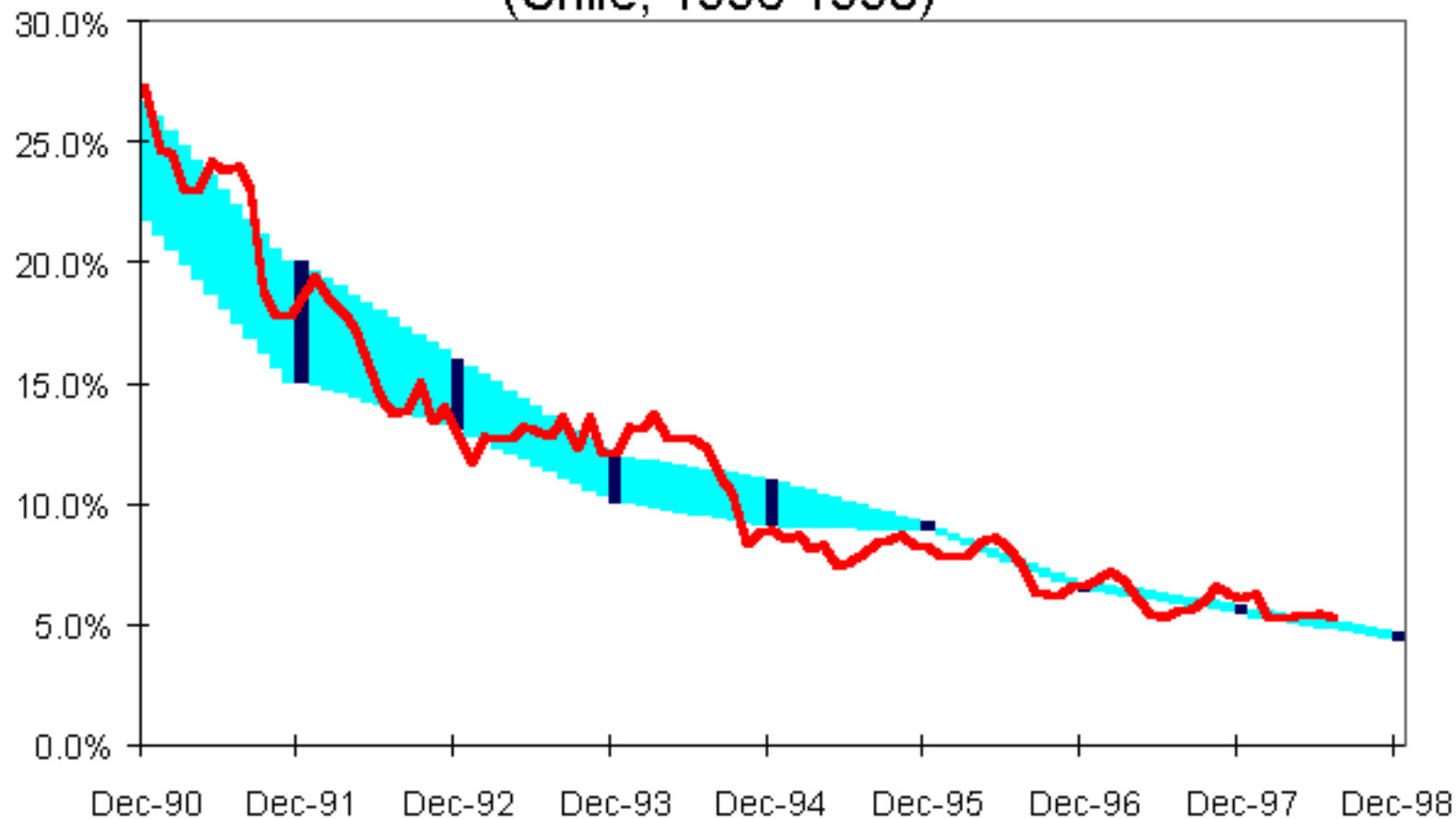
- Non-sterilized forex interventions

Monetary Policy Reaction Function:

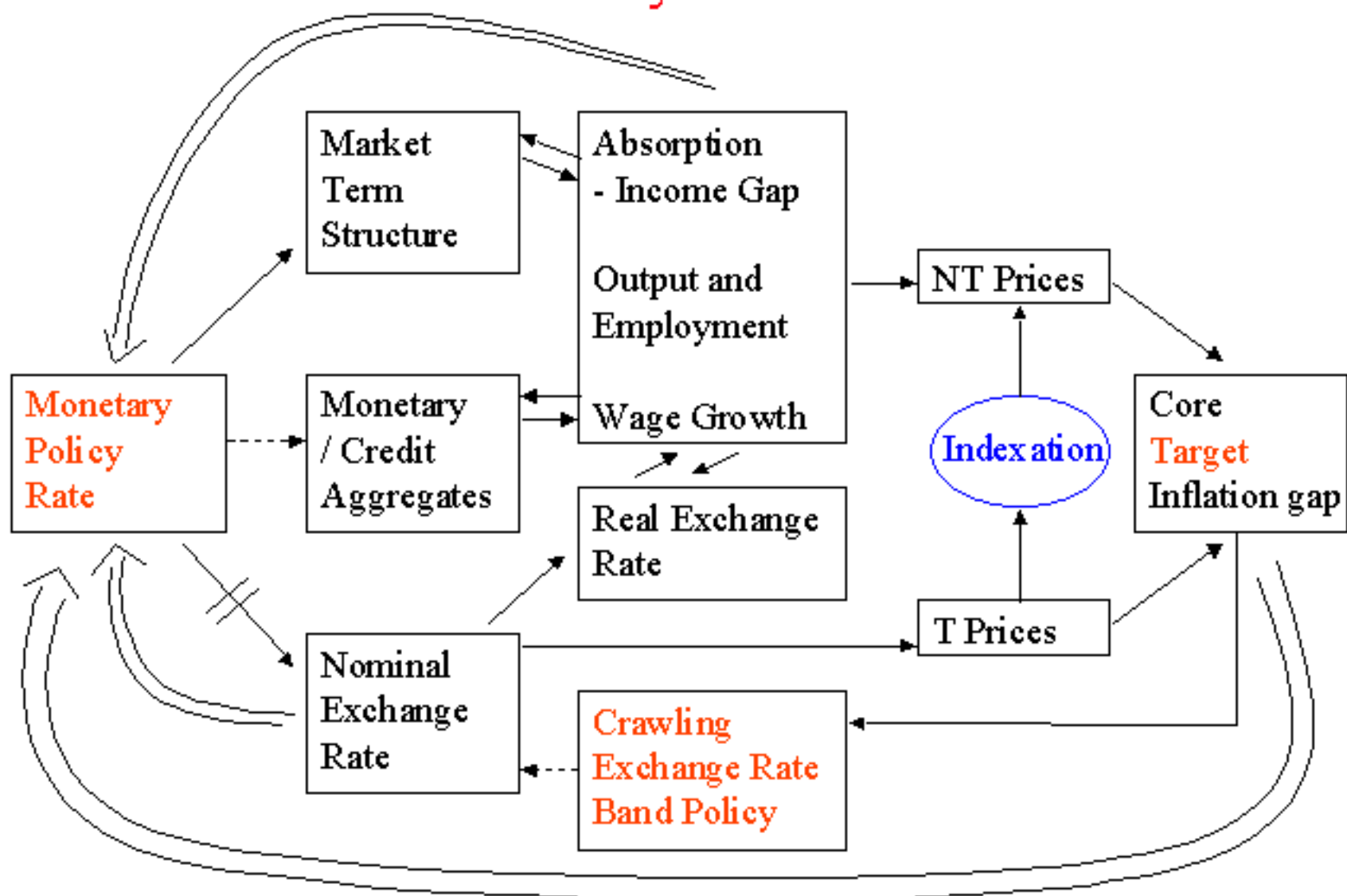
$f(\text{core minus target inflation, absorption-income gap, activity level, unemployment rate, wage growth, growth of monetary aggregates, exchange rate,})$

	Chile	New Zealand	Canada	United Kingdom	Sweden	Australia
Initial target	Start Sep 90 15-20%	Start Mar 90 0%-3%	Start Feb 91 3%-5%	Start Oct 92 1%-4%	Start Sep 90 1%-3%	Start Sep 90 2%-3%
Current target	±4.5%	0%-3%	1%-3%	2.5%±1%	1%-3%	2%-3%
Long-term target and convergence speed	No explicit long-term target	Target is long term	Target lasts for three years (1995-1998)	Target is long term	Target is long term	Target is long term
Target indicators	CPI	CPI excluding interest rate	CPI	MPI excluding mortgage interest	CPI	Core CPI
Target horizon	Annual, December of each year	Long-term target	Triennial	Long-term target	Long-term target	Long-term target
Exclusion clauses	There are no exclusion clauses	If target is missed, a <i>Policy Declaration</i> is issued	Target can be missed for short temporary periods	Target can be missed for short temporary periods

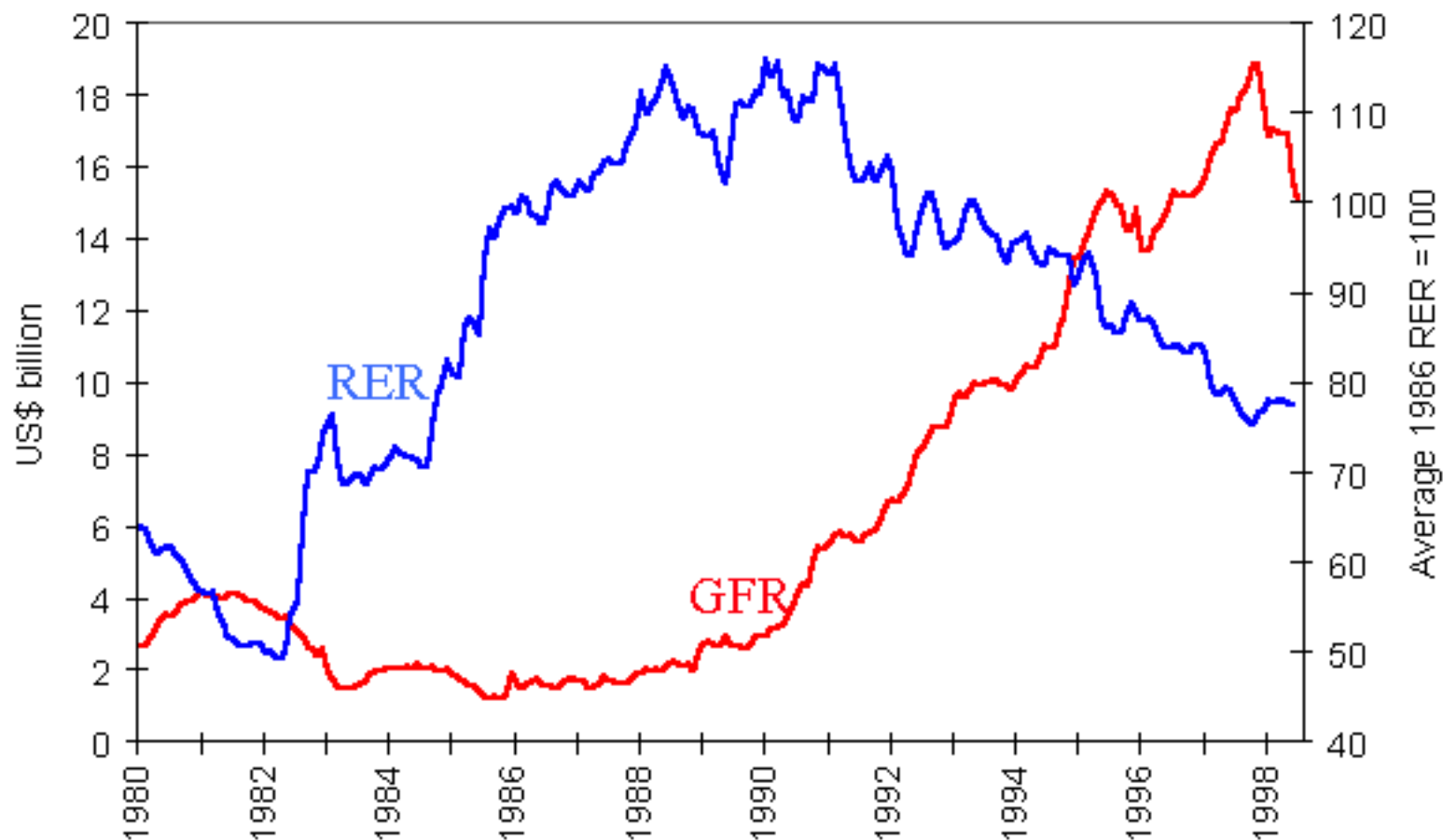
Inflation Target and Actual 12-Month Inflation (Chile, 1990-1998)



Channels of Monetary Transmission in Chile



Real Exchange Rate and Gross Foreign Reserves (Chile, 1980-1998)



How was Inflation brought down in Chile?

Hypothesis #1: Sheer Good luck

→ 1990-97 RER appreciation

Hypothesis #2: Hard work

→ Credible policy anchored on inflation target

The evidence:

1. Semi-structural VARs (Valdés 1998)

An innovation in the monetary policy rate:

- lowers output growth, money growth, and core/target inflation gap
- raises NIR
- does affect neither the RER nor the inflation level

2. Structural econometric model (Corbo 1998)

- Decline in 1992-97 inflation was due to: the credibility of the inflation target, the RER appreciation, and labor productivity growth
- However: “the first effect ... was the most important factor ... in reducing inflation”

3. VARs and structural econometric model (Morandé and Schmidt-Hebbel 1997)

Introduction of inflation target → regime shift for inflation in 1990s as compared to 1980s:

- Inflation target has long-lasting significant effect on inflation
- lower inflation inertia
- lower effect of ER on inflation
- significant negative effect of innovation in monetary policy rate on inflation

How did the Asian Crisis affect the Chilean Economy in 1998?

Estimated Current-Account Effects:

- 5-10% terms-of-trade loss
- decline in export volume to East Asia
- temporary (1998) current account deficit of US\$ 5,000 (6-6.5% of GDP)

Capital Account Effects:

- lower credit and portfolio inflows
- continuation of large foreign direct investment inflows

Related Exchange Rate Effects:

- required RER depreciation
- strong correction of previous appreciation expectations
- portfolio shift away from peso-denominated assets
- actual nominal (and real) exchange rate depreciation

Policy Response to the Asian Crisis

Policy Diagnose:

- Risky process of ER depreciation → nominal depreciation feeds quickly into higher inflation in highly indexed economy, particularly under conditions of full employment
- Gradual medium-term RER correction required, jointly with public / priv. spending cuts
- BUT: short-term nominal ER overshooting to be avoided to maintain the economy's nominal anchor → commitment with pre-announced level of the inflation target

Policy Actions:

- Monetary policy stance is tightened to achieve required RER adjustment by combination of nominal ER depreciation with reduction in absorption to lower NT inflation
- Excessive nominal ER depreciation in the wake of a speculative attack is halted by strong but temporary forex intervention (selling foreign exchange rate by a limited amount) and restricting liquidity
- Overnight bank rate attains high levels, far beyond level of monetary policy rate
- Lower incentive for portfolio adjustment away from pesos and stop to ER overshooting
- Complementary monetary and fiscal measures taken to correct fundamentals
- Forex interventions cease and liquidity is restored
- Overnight interbank rates converge back to policy rate and ER attains new stable level

Two Episodes in 1998

Dec. 1997 - Jan. 1998:

- ER and IR stabilization attained after temporary interventions
- Correction of fundamentals: increase in monetary policy rate by 100 basis points, fiscal adjustment
- 10% nominal ER depreciation

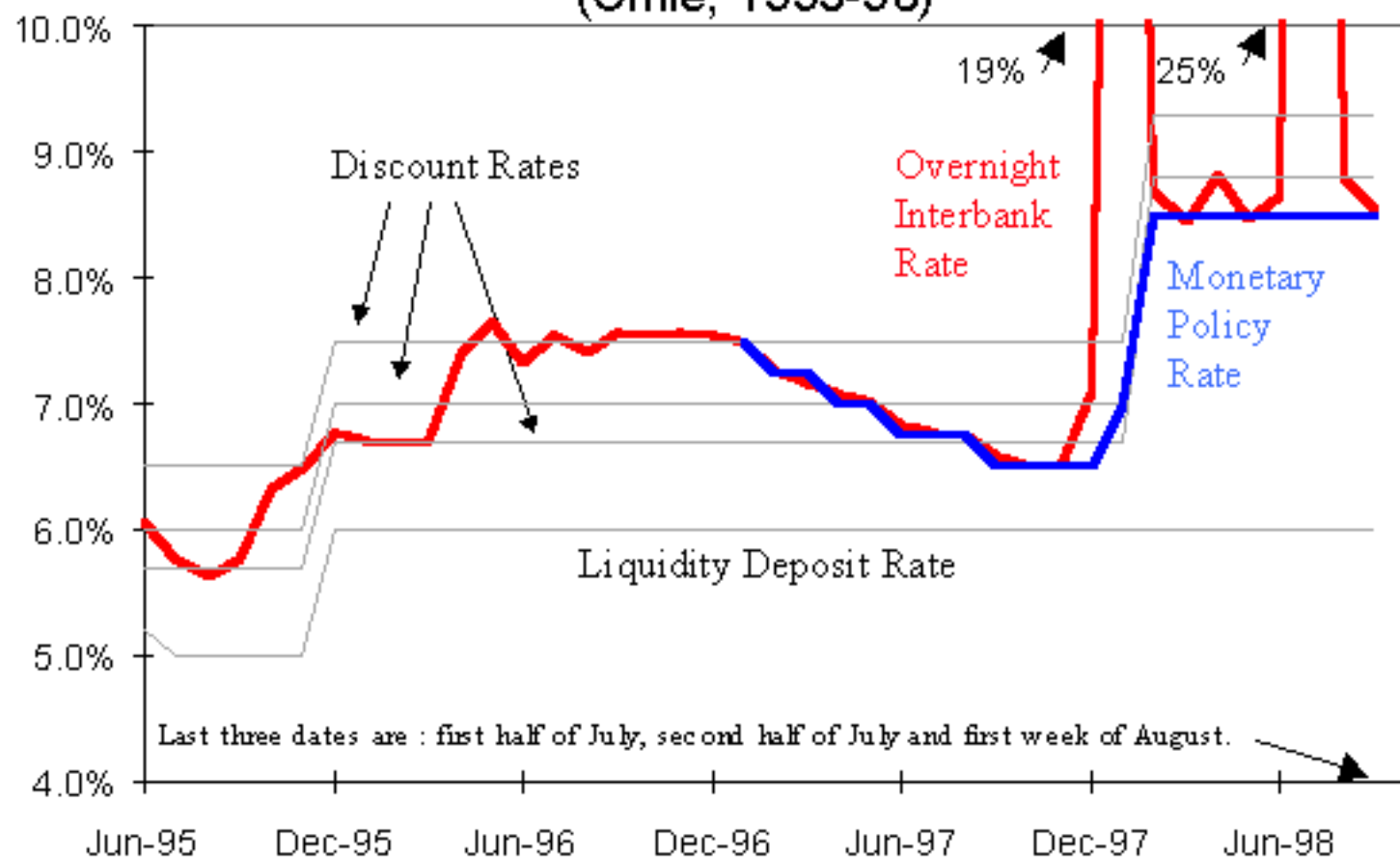
June-July 1998:

- ER and IR stabilization attained after temporary interventions
- Correction of fundamentals: strong reduction in reserve requirement on capital inflows, issuing of long-term dollar-denominated CB debt (by low amounts), further fiscal adjustment
- further 3% nominal ER depreciation

Prospects for 1998:

- Inflation reduction to level close to 1998 inflation target (4.5%)
- 5.5% real GDP growth, full employment
- Significant RER correction
- Declining absorption-income gap leads to ongoing CA correction

Overnight Monetary Policy Rates and Interbank Rate (Chile, 1995-98)



Chile: Future Policy Challenges

1. Medium-term convergence to OECD level of inflation
2. Adoption of multi-annual (long-term) inflation target range
3. Increase in policy transparency (inflation report)
4. Shift from real to nominal monetary policy rate
5. Exchange rate flexibility
6. Full integration into world financial markets