



Current Issues in Inflation Targeting in Latin America

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Motivation

- Fact: Inflation targeting (IT) is spreading around Latin America.
 - Among others, Brazil, Chile, Colombia, Mexico and Peru follow this approach to conduct monetary policy.
 - Uruguay is in a transition to IT.
- One key characteristic of IT: allows for a continuous learning process, from own and other's experience.
- This presentation: discusses three specific but relevant issues, with focus on what has been our approach in the CBC.



Agenda

1. Target definition and operational target
2. Assumption and communication of MP and exchange rate paths, and “unobservable variables”
3. Role of market expectations



1. Target Definition



Targets in Chile

- 1991–1999 targets: Dec./Dec. inflation.
 - Gradual reduction of targets given inflation inertia.
 - Poor past experience with sustainability of previous stabilization attempts (1962 and 1982).
 - Rather blurred final objective.
- 2000–2006 target: Maintain inflation in a 2–4% range, centered in 3%.
 - Stable and permanent inflation target.
 - Consistent with MP transmission and lags.



Quite strict in historical perspective

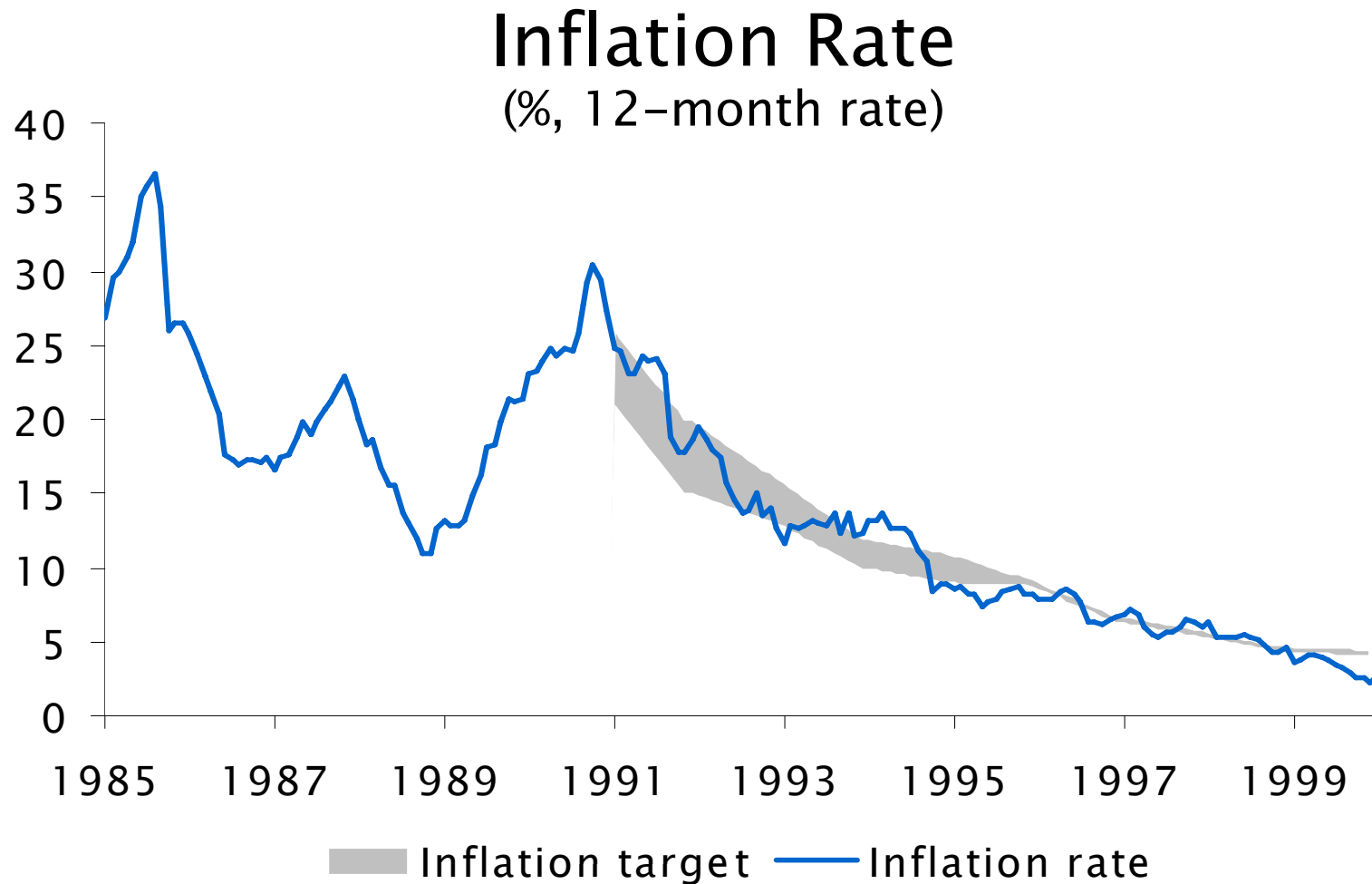
December–December inflation			
Period	Mean	Standard Deviation	Coefficient of variation
1925-2006	39.2%	89.7%	2.3
1925-1989	47.5%	99.1%	2.1
1925-1989*	24.8%	29.3%	1.2
1990-2006	7.5%	6.9%	0.9
1990-1999	10.8%	7.5%	0.7
2000-2006	2.8%	1.1%	0.4

* Excluding 1972–75 period.

Sources: Díaz et al. (2003); National Statistics Bureau.



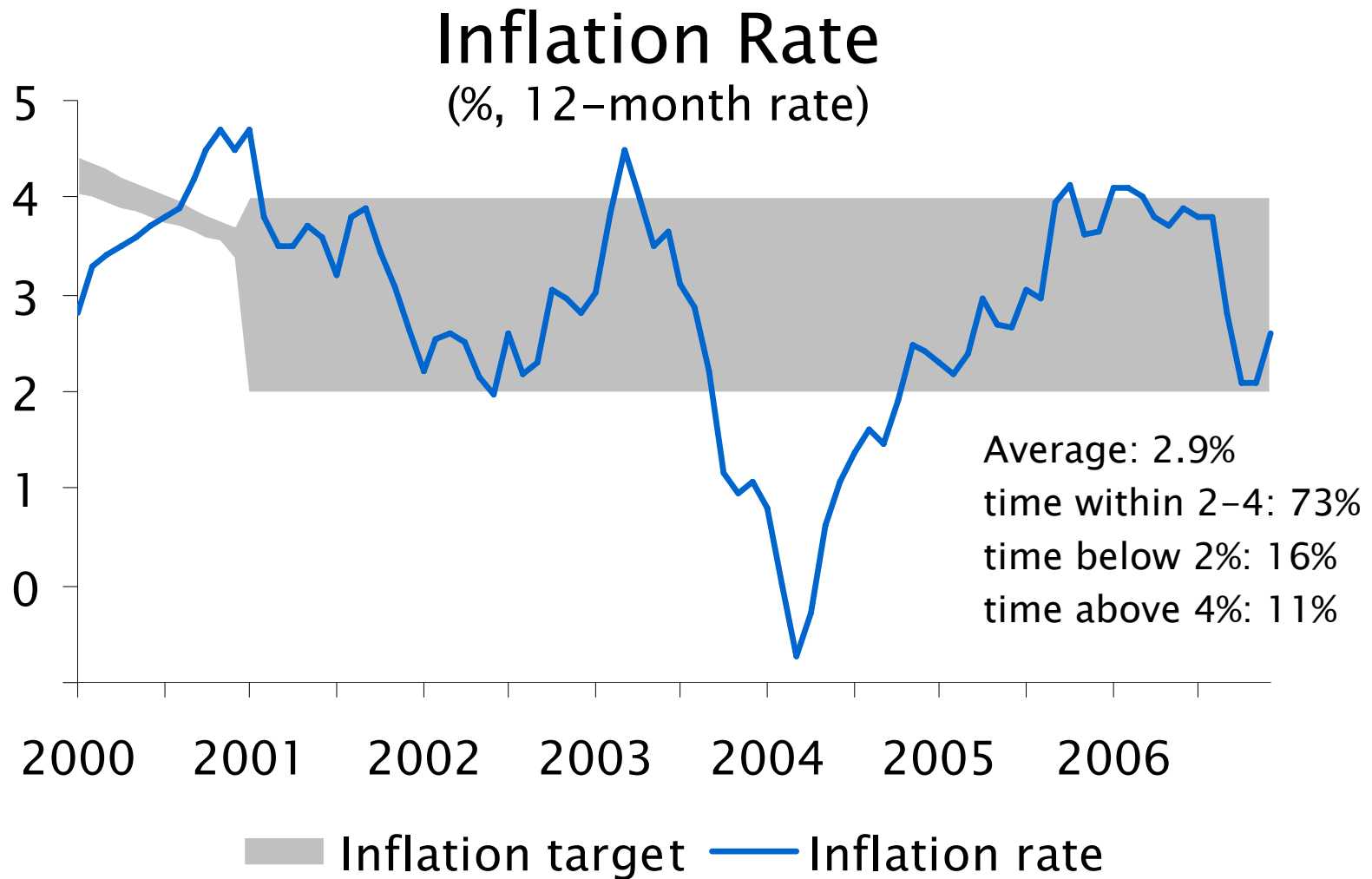
IT: Convergence phase (1990–99)



Sources: National Statistics Bureau and Central Bank of Chile



IT: Steady state (since Sep. 99)



Sources: National Statistics Bureau and Central Bank of Chile.



Targets in Chile

- Since 2007 (special document):
 - Objective: To keep annual CPI inflation most of the time around 3%, within a ± 1 pp tolerance range.
 - Aimed at strengthening 3% as the nominal anchor of the economy.
 - Recognize it can be transitorily out of 3 ± 1 .
 - Operational target: Inflation forecast = 3% in a policy horizon of around 2 years.
 - In line with actual MP implementation in practice.
 - Current trend in CBs – lengthening horizons.



Considerations

- Why 3%?
 - Standard reasons: CPI bias, 0 percent bound for nominal interest rate bound, oil-in-the-wheels.
 - Once fixed, credibility may weaken with changes.
- Why 2-year horizon?
 - On purpose, a bit more blurred – “optimal” horizon is shock contingent.
 - Should help to avoid mechanical responses.
- Why symmetry?
 - Political support.
 - Even if credibility risks are skewed, it is not obvious that asymmetric target is the solution (maybe responses?).



2. Communication of MP rate FX rate paths and “unobservable” variables



Special variables deserve special treatment

- Transparency is particularly important within IT given that, ultimately, credibility in the target is the nominal anchor.
- Both forecasting and publishing forecasts are part of the usual IT practice.
- The future path of MP interest rates is special because they will be determined by the CB.
- The future path of exchange rate matter because it directly affect inflation, is influenced by the CB (even directly with FX interventions), and has had a role as an anchor.
- Both paths have a large impact on the pricing of financial assets.



Special variables deserve special treatment

- There are unobservable variables (parameters), possibly time variant, that play a central role in MP decisions:
 - Slack: Potential or trend GDP and NAIRU.
 - “Long run equilibrium” real exchange rate.
 - Neutral interest rate.
- Some claim that they are useless. But it seems difficult (impossible?) to forecast inflation and evaluate MP without some reference to them.
- How should we assess and communicate them?



Special variables deserve special treatment

- MP rate path publishing practice varies considerably:
 - New Zealand and Norway publish the complete path consistent with the forecasting scenario (a “fan chart” for the interest rate in Norway)
 - BoE and others show a “fixed-rate” forecast and another one considering market implicit rates.
- FX rate forecasts practice and disclosure also varies considerably.
 - Random walk and UIP assumption are common.
- There is no clear standard for “unobservables”.



Special variables deserve special treatment

- Some considerations:
 - It seems difficult to completely separate practice from disclosure.
 - Possibly stronger effect on financial prices (and thus effectiveness) with disclosure.
 - Key risks and problems include:
 - To be understood as commitment – extreme assumptions avoid this.
 - Strong disagreement among board members about paths.
 - Unobservables are unknown and often change (e.g., equilibrium RER, neutral interest rate).



Monetary policy rate path in the CBC

- As other CBs, the CBC initially included an explicit “fixed MPR” during the policy horizon in its forecast.
- In 2002 moved to a “non credible fixed MPR”.
 - A fixed rate implied:
 - Large jumps after the policy horizon
 - Overly restricted activism – time to undo changes?
 - Forecast included a shadow MPR (rule-based) for determining the exchange rate and long-term interest rate.



Monetary policy rate path in the CBC

- In Sept. 2004 we moved to a rule-based assumption.
 - Partial solution implied implausible MP shock responses.
 - Rule parameters have not been published.
 - Internal discussion have separated more clearly the MP strategy from implementation (timing) issues.
 - Model usefulness is limited for the latter.
 - External communication gives broad contours of the assumption.
 - Some comparison with market expectation implied in financial markets
 - Risk of excessive precision when CB communicates a long pause.



FX rate path in the CBC

- Internally, ample discussion for long run equilibrium exchange rate using a suite of models.
- Forecast assumption:
 - If current XR is within certain range, assume UIP with current real exchange rate as the long term equilibrium value.
 - If it is out of bounds, assume convergence at some rate.
- Communication: broad contours in MP report, including assumption of no large changes or “some” appreciation/depreciation.



“Unobservables” in the CBC

- A relevant part of the research agenda in last few years focused on alternative estimation methods.
- No “official” numbers, except for potential GDP growth rate, with updates once or twice a year.
 - Fiscal rule has its own potential output number.
 - Recently, there is growing demand for exact output gap level calculation and forecast.
- Disclosure of ranges and methods of NAIRU and neutral rates within MP report.
 - Ranges show uncertainty involved and avoid excess commitment to particular figures.



3. Role of market expectations



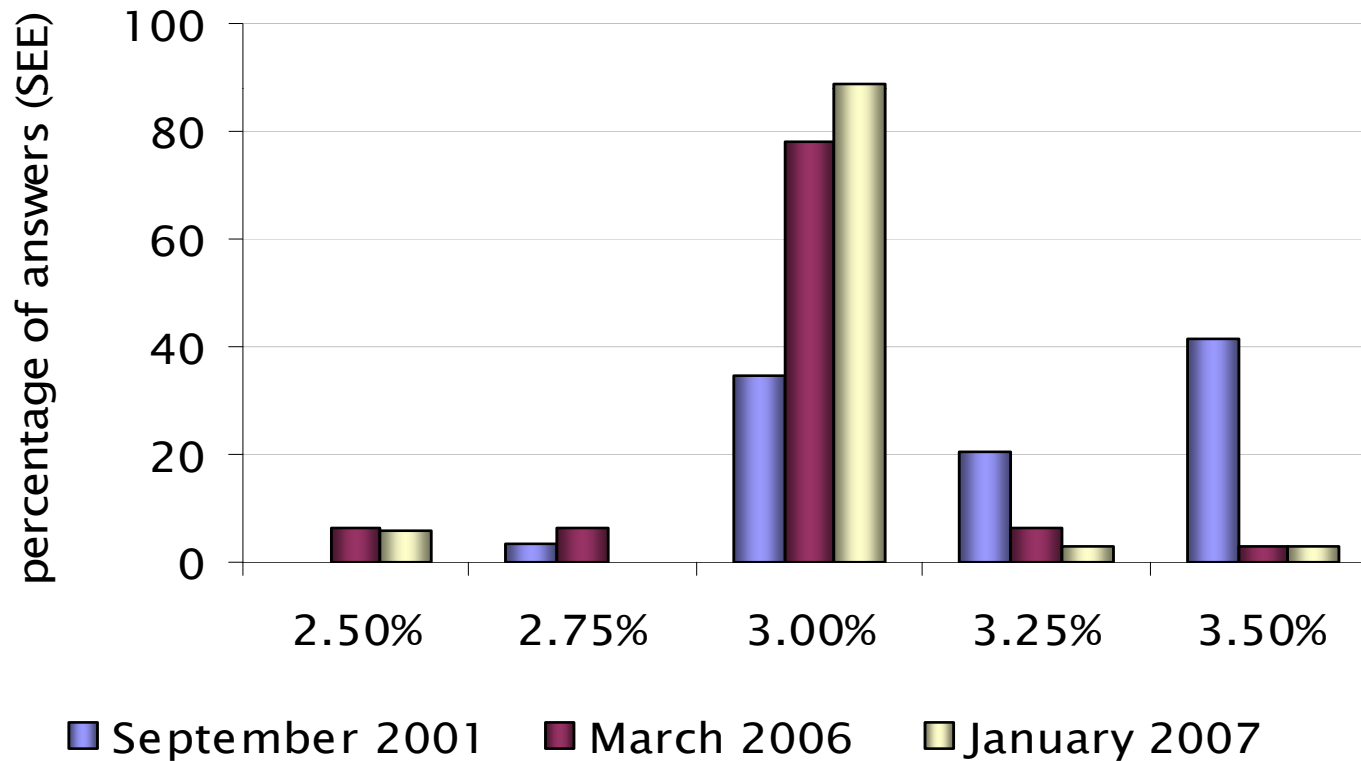
Role of market expectations

- Broad question: How much weight should be given to market expectations?
- Expected inflation:
 - Not 100%, because of “mirror game” danger.
 - Not 0%, because they at least check anchor credibility.
 - Some weight, given that they contain information.
- Problems:
 - Higher credibility implies that private expectations are less informative.
 - In general, what determines inflation expectations is not well known.



Inflation Expectations in Chile

Two-year Expected Inflation Distribution (Survey)

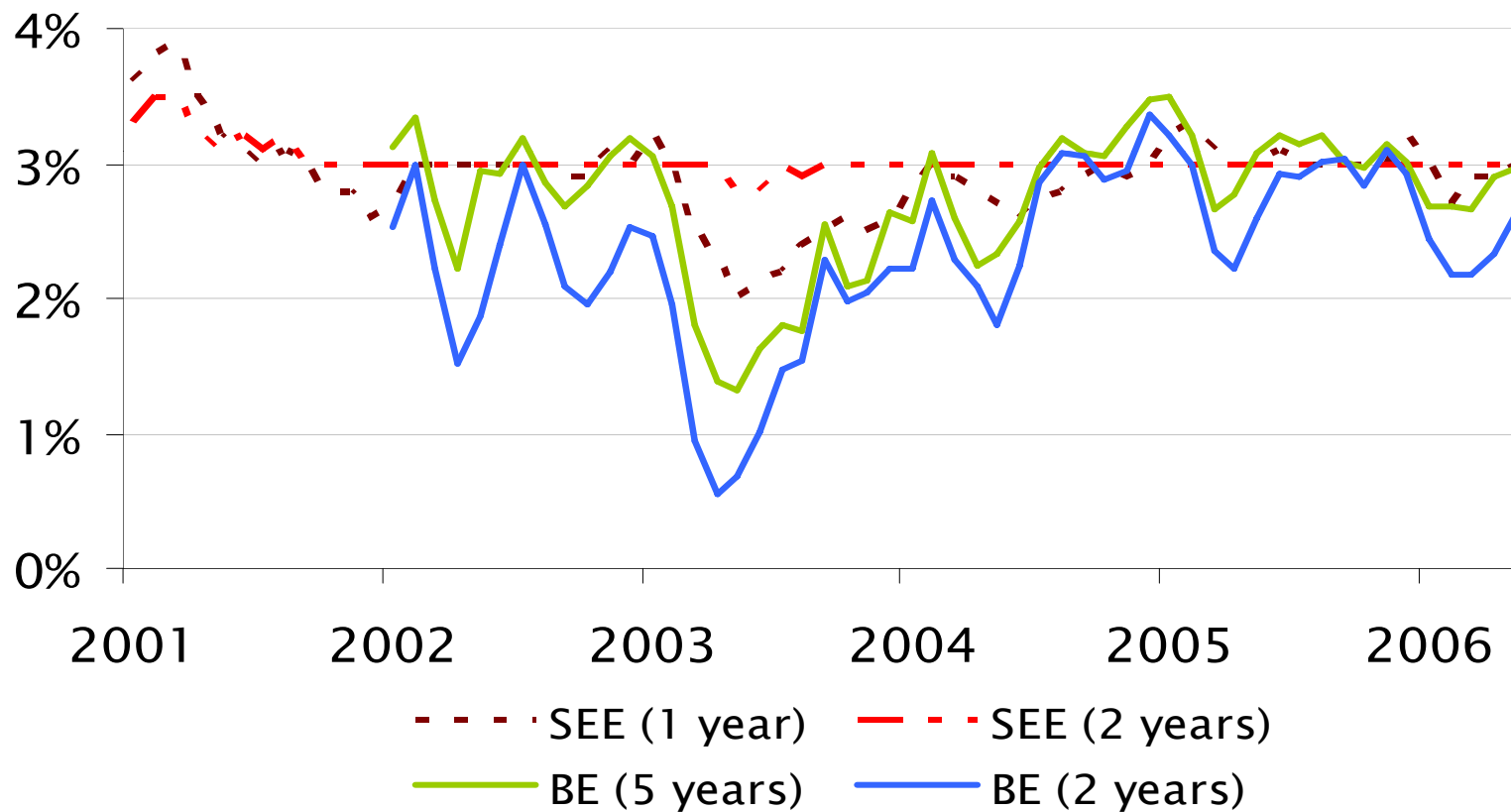


Source: Central Bank of Chile.



Inflation Expectations in Chile

Survey and Break-Even Inflation



Source: Central Bank of Chile.



Role of market expectations

- End–2003 episode:
 - Public discussion included the claim that given the low level of inflation, the CBC should have lowered the inflation target.
 - BE's way below target (survey only marginally so).
 - CBC cut 50bp each time in two consecutive meetings, partly as a reaction to this “discrepancy”.



Role of market expectations

- Interest rate expectations
 - CB strategy needs to be understood – otherwise broad trajectory in financial prices would not reflect MP intentions.
 - But, should MP changes be always anticipated?
 - How much?
 - Frequency of surprises?
 - Time span matters? Precommitment for one meeting eliminates surprises, but it does not mean full understanding of MP strategy.
 - Asymmetries? Interest rate cuts have generally not been anticipated in Chile.



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