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Inflation targeting in Chile

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Abstract

Chile was the second country in the world to adopt inflation targeting (IT), setting its first annual target in September 1990. IT was used as a device to bring inflation gradually down to a stationary 3% level. This paper analyzes four main questions, exploiting Chile's long IT experience. Is Chile's experience different from that of other countries that have adopted IT during the 1990s? Has IT contributed to monetary policy credibility in Chile? Does the monetary authority exhibit fear of floating? Is the Central Bank's monetary policy function consistent with the goals of IT? The evidence reported in this paper shows that credibility grew as inflation targets were attained, that there is little "fear of floating," and that monetary policy has evolved according to the strengthening of IT and attainment of stationary inflation.

JEL classification: E31; E52; E61

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1. Introduction

When the Reserve Bank of New Zealand announced in 1989 for the first time an explicit inflation objective for the following year, its authorities were probably unaware of the world-wide implications of the project they were starting. More than 10 years later, inflation targeting (IT) is an increasingly popular monetary framework, currently in use by 20 countries around the world.

Chile was the second country in adopting IT, setting its first annual target in September 1990 for the following year. Since then, Chile's Central Bank has used IT to bring inflation down from 27% in 1990 to low, stationary levels that are consistent with the current indefinite

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target range of 2–4% per year. Chile's experience with IT-based price stabilization provides a case study that highlights the strengths and limitations of IT.

What are the similarities and differences of Chile's experience relative to other countries that have adopted IT during the 1990s, countries like Sweden, Israel or the United Kingdom? Does IT contribute to monetary policy credibility in Chile? Does the Chilean monetary authority exhibit fear of floating? Is monetary policy consistent with the goals of IT?

This paper addresses these questions in the following way. Section 2 briefly reviews the international experience with IT, focusing on its main features and results. This discussion is followed by a narrative description of the Chilean experience, highlighting Chile's transition to low inflation in a context of high GDP growth and describing the evolution of Chile's policy framework during the last decade. The role of inflation targets in building up credibility is examined in Section 4. Here the direct role of IT in shaping policy credibility is viewed through the effect of inflation targets on inflation expectations and on actual inflation. The effects of inflation targets on regime credibility are examined in terms of the response of inflation to shocks from non-core goods prices and the exchange rate.

Section 5 addresses the question of "fear of floating" in Chile by measuring exchange rate devaluation-to-inflation pass-through and its determinants, examining relative exchange rate volatility, and assessing Central Bank intervention and foreign exchange markets. Section 6 examines the Central Bank's policy rule and the evolution of the role of specific policy determinants in the transition to low and stationary inflation. Section 7 concludes.

2. IT—a developing chronicle

More than a decade after the pioneering introduction of IT by New Zealand, Chile, Australia, and Canada, the monetary regime has become an increasingly popular choice among developing and industrialized economies. Currently 20 countries—8 industrial and 12 developing nations—have explicit quantitative inflation targets in place (Fig. 1). Spain and Finland are the only two countries that have abandoned IT as they joined the Euro area in 1999. The worldwide trend toward IT is likely to continue in the future. IT's rising popularity is reflected by having been proposed—for different reasons—for the two largest economies in the world: the U.S. (Meyer, 2002) and Japan (Svensson, 2001).

The regime developed as a result of policy intuition and trial-and-error approaches in search of price stability under monetary policy independence.[1] Even the precise definition of IT and which countries to classify as inflation targeters is still open to discussion. For example, while most authors consider Chile to have been an inflation targeter since 1991, others (Schaechter, Stone, & Zelmer, 2000) mark dates as late as 1999, when Chile adopted some features considered mandatory by these authors.

Despite this ambiguity, there is broad agreement on the main features of IT. They comprise (i) an explicit quantitative target for the rate of increase of a specified consumer price index; (ii) dominance of the inflation target over other nominal targets or absence of other targets;[2] (iii) absence of fiscal policy dominance over monetary policy; (iv) instrument independence of the monetary authority to target its goal; and (v) high degrees of monetary transparency and accountability in the conduct of monetary policy and the achievement of the target.