

# Monetary Policy Process in a Challenging Environment\*

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(\*): The views expressed herein are exclusively those of the authors and do not necessarily reflect the position of the Central Bank of Chile.

# A canonical monetary policy framework for open economies (EMEs)

- Inflation is the main (perhaps the only) target of monetary policy.
- Authorities use the short-term interest rate (both its current setting and announcements about its future course) to achieve their inflation target.
- The exchange rate floats freely.

# Inflation: Chile 1990-2006



# But large shocks can happen...

- Global Financial Crisis 2008-2009.
- Covid Crisis.

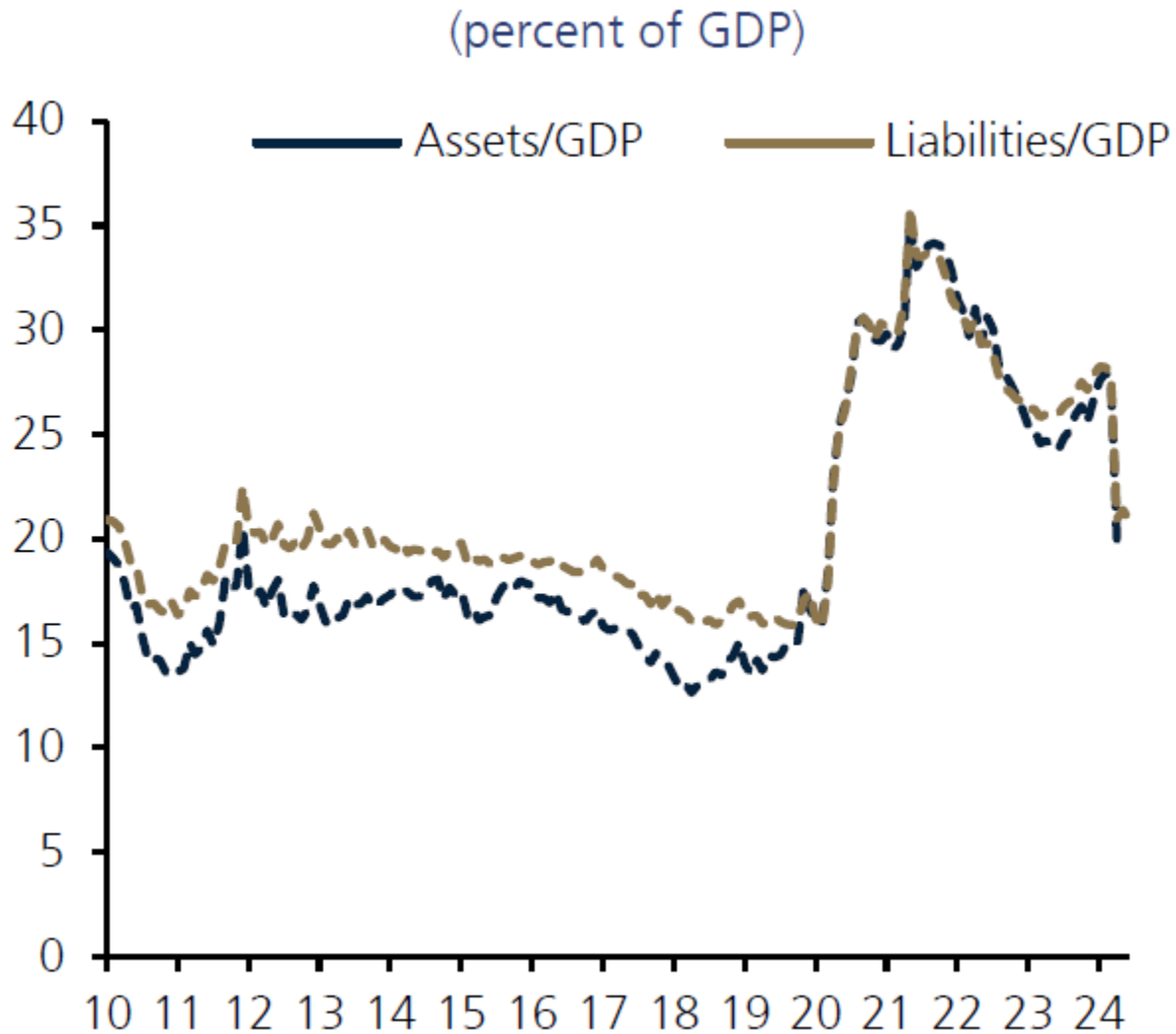
# Policy responses have gone beyond the “traditional” instrument...

- Global Financial Crisis 2008-2009.
  - Increases in maturity of discount loans.
  - International liquidity provision.
  - Domestic liquidity provision.
  - Reductions in reserve requirements.
  - Widening of acceptable collateral.
- Covid Crisis.

# Policy responses have gone beyond the “traditional” instrument...

- Global Financial Crisis 2008-2009.
- Covid Crisis.
  - New funding facility for banks conditional on them increasing credit.
  - Significant broadening of collateral, including corporate bonds, commercial paper and commercial loans.
  - Regulatory liquidity requirements were relaxed.
  - Program for purchase of bank bond.

# CBCH Assets and Liabilities



# Need for a new monetary policy framework?

- It is important to notice that what emerged was not an alternative regime to inflation targeting, but rather an expanded and enriched version.
- Crisis times versus *normal times*...
  - Which restrictions are active...nature of shocks
- Policy responses consistent with monetary policy goals.



# Need for a new monetary policy framework?

- Policy responses consistent with monetary policy goals:

Chile MPR March 2020: “...In this scenario, medium-term inflationary pressures have dropped significantly, so that inflation’s convergence to the 3% target requires monetary policy to remain in a highly expansionary stance for an extended period of time. Consistently with this, in March the Board lowered the MPR by 125 basis points, to 0,5%, its technical minimum. Additionally, the Board has announced that it will continue to implement ***the necessary measures to ensure the proper functioning of financial markets and compliance with the Bank’s inflationary and financial stability objectives.***”

# Need for a new monetary policy framework?

- It is important to notice that what emerged was not an alternative regime to inflation targeting, but rather an expanded and enriched version.
- Crisis times versus *normal times*...
  - Which restrictions are active...nature of shocks
- Policy responses consistent with monetary policy goals.
- Credibility is key for effectiveness of policies and to be prepared for new shocks...

# Potential new shocks...

- Climate change.
- Fiscal risks.
- Demographics.
- Political fragmentation.
- Geopolitical risks.

# A sound macro framework

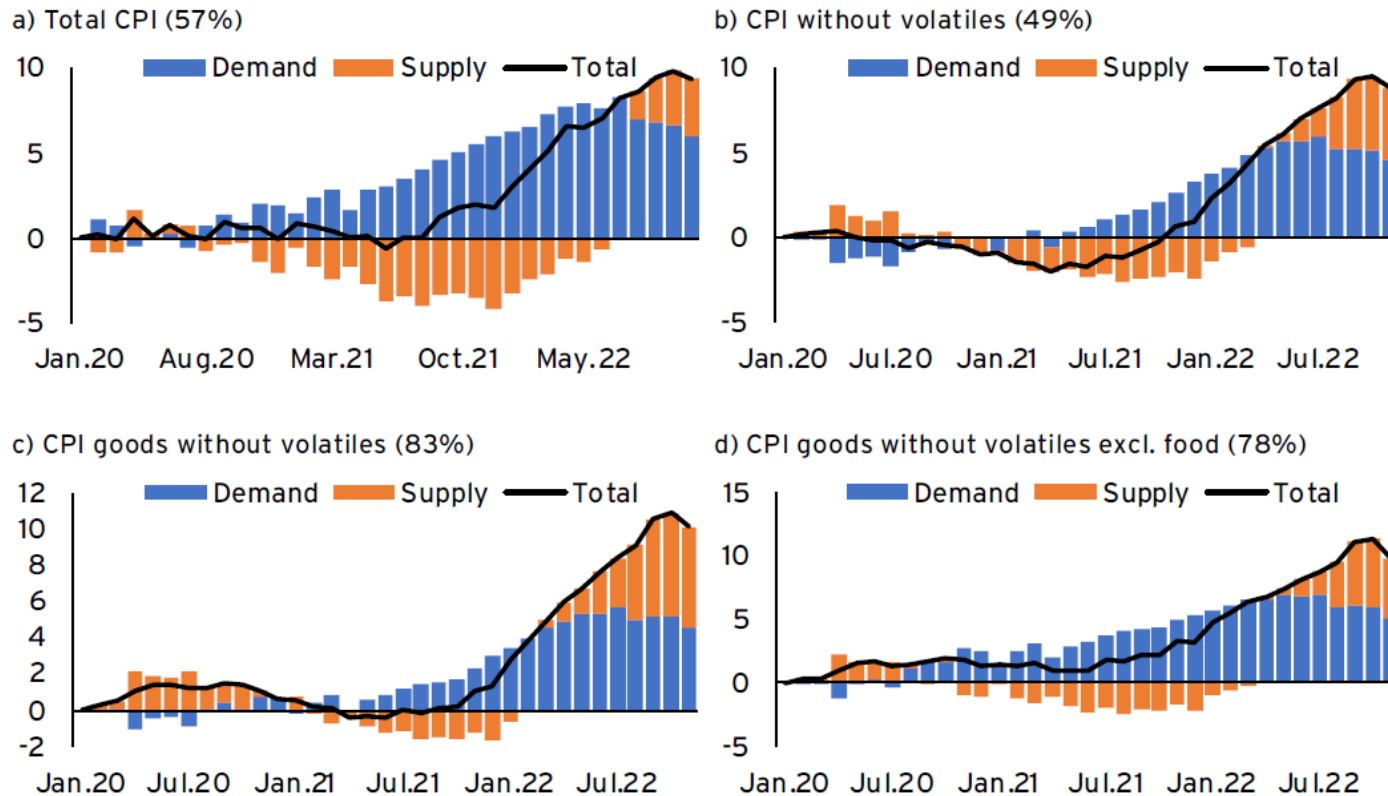
- A credible medium-term monetary policy regime that anchors inflation expectations appropriately, but at the same time allows the central bank to respond flexibly to short-run movements in the inflation rate.
  - Inflation target and monetary policy horizon.
- A sustainable and credible fiscal policy.
- A floating exchange rate that helps to stabilize swings in the economy arising from the external shocks.
- Liquid and well-developed financial markets that allow financial institutions and firms to hedge risks arising from movements in financial prices.

# A new policy process?

- Need for constant understanding of transmission mechanisms and for the impact of new shocks.
  - Significant effort in terms of data availability.

# Chile: Microdata (electronic invoices)

**FIGURE 2 HISTORICAL DECOMPOSITIONS OF MAIN CPI AGGREGATES  
(PERCENTAGE POINTS)**



Source: Albagli and García (2024)

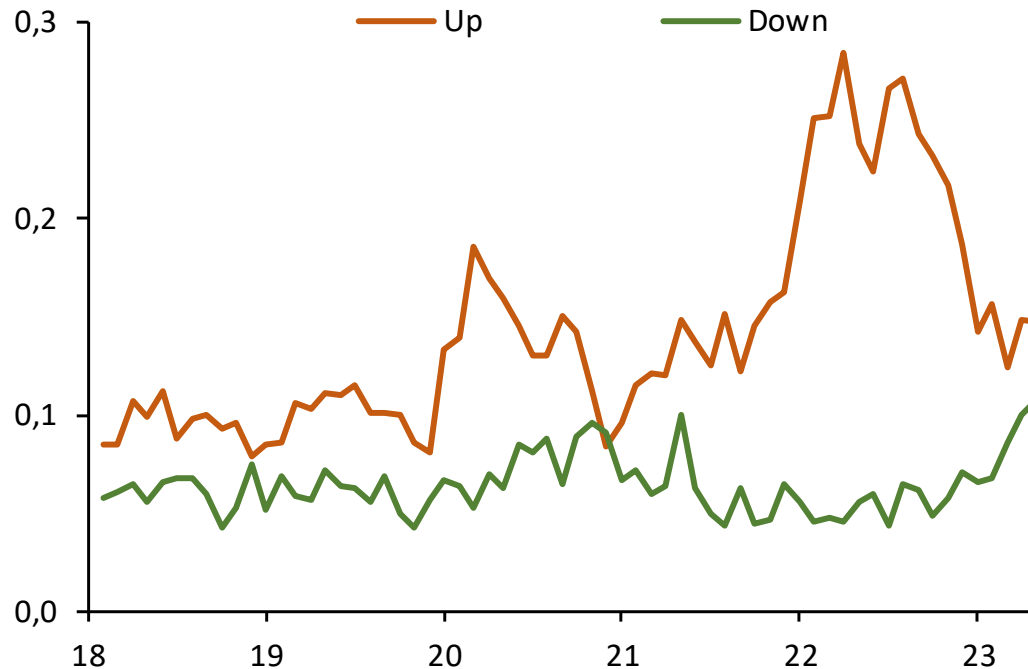
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- Implications for inflation dynamics (state versus time dependent pricing/role of market structure in transmission of shocks)).

# Chile: MP Report June 2023

FREQUENCY OF PRICE CHANGES (\*)

(proportion)



(\*) Blue line shows the median proportion of a firm's products that change prices within a month. Red line shows the median proportion of a firm's products that see their prices go up within a month. Green line shows the median proportion of a firm's products that see their prices go down within a month.

Source: González and Rojas (2023).



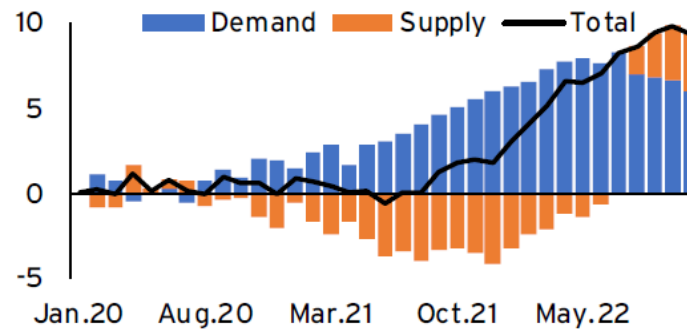
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- Symmetrical policy responses.
  - The nature and size of the shock should not affect the target but the policy response.

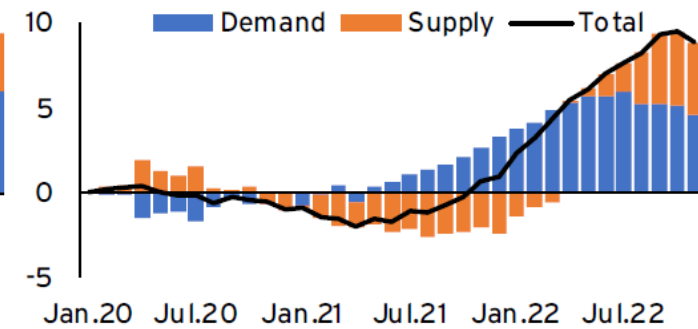
# Chile: CPI inflation

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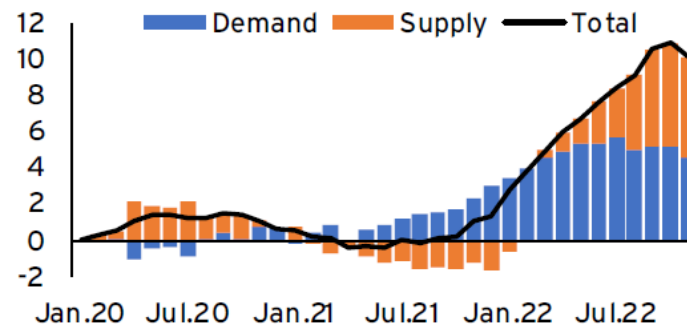
a) Total CPI (57%)



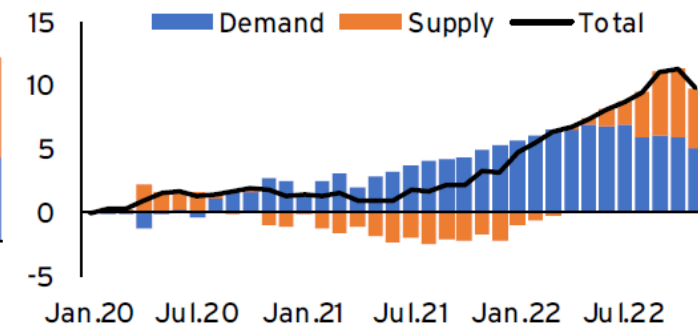
b) CPI without volatiles (49%)



c) CPI goods without volatiles (83%)



d) CPI goods without volatiles excl. food (78%)



# Chile: Monetary Policy Rate



# Chile: CPI inflation

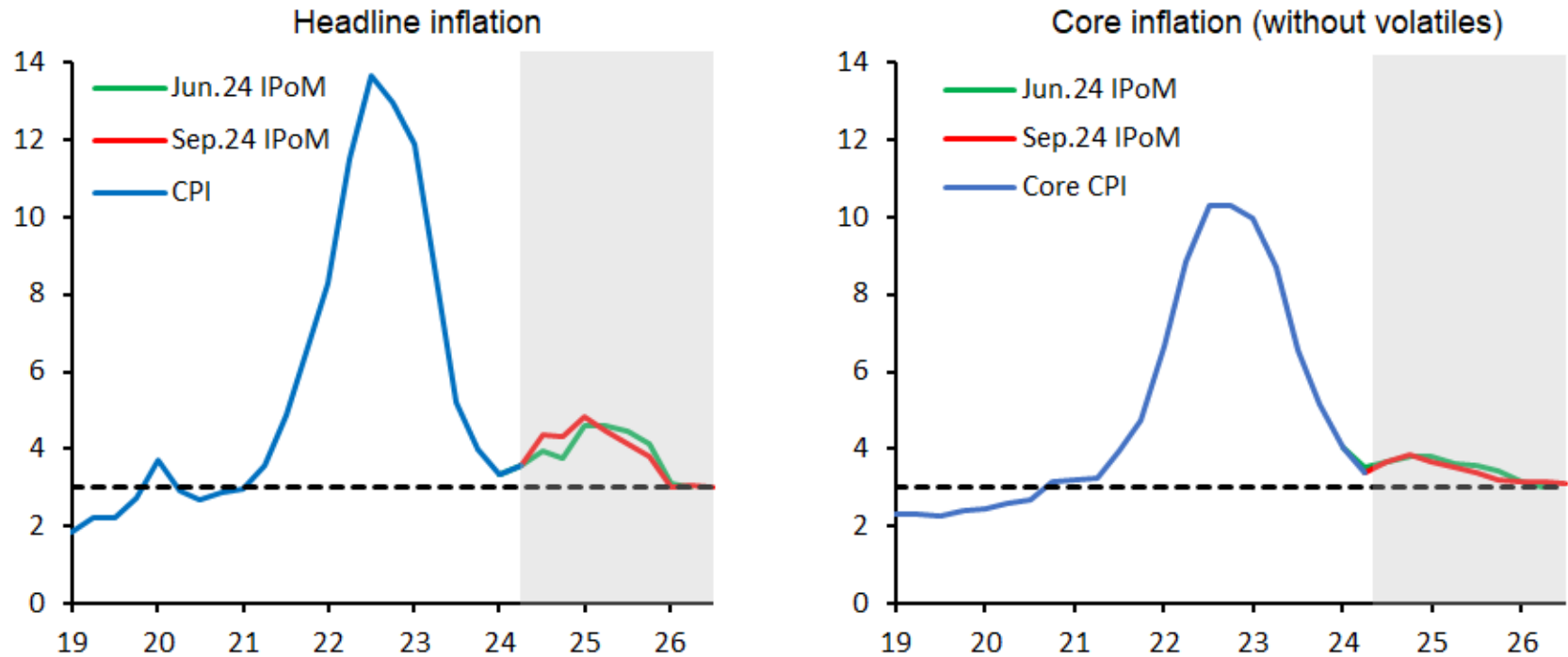


# Chile: CPI inflation forecast

**FIGURE II.9**

INFLATION FORECAST (\*)

(annual change, percent)



(\*) Inflation figures consider 2023 CPI basket using BCCh splicing. Monthly and annual variations of this index do not coincide with official INE variations –useful for indexation purposes– as these use the previous basket series for base year changes. Gray area, as from third quarter 2024, shows forecast.

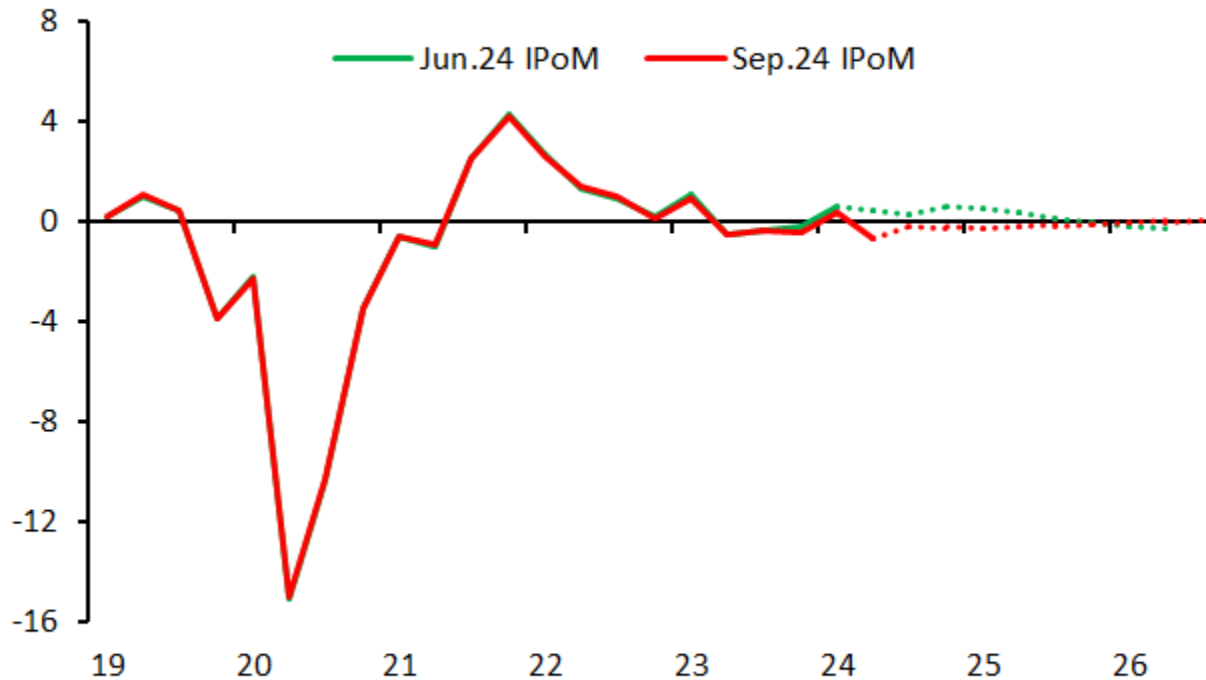
Sources: Central Bank of Chile and National Statistics Institute.

# Chile: Output gap

**FIGURE II.8**

OUTPUT GAP (1) (2)

(level, percentage points)



(1) Dotted lines show forecast.

(2) Forecast assumes structural parameters updated in December 2023 Monetary Policy Report (IPoM) (trend and potential GDP).

Source: Central Bank of Chile.

# A new policy process?

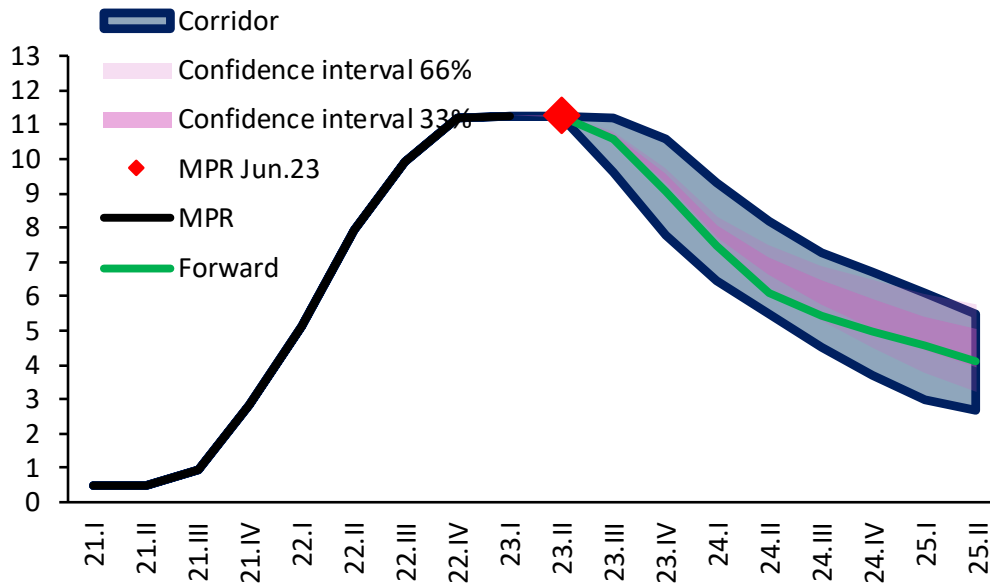
- Need for constant understanding of transmission mechanisms and for the impact of new shocks.
  - Significant effort in terms of data availability.
- Implications for inflation dynamics (state versus time dependent pricing/role of market structure in transmission of shocks)).
- Symmetrical policy responses.
  - The nature and size of the shock should not affect the target but the policy response.
- Effective communication of alternative scenarios.

# Chile: MPR Corridor

**FIGURE II.10**

MPR CORRIDOR (\*)

(quarterly average, percent)



(\*) The corridor is built by following the methodology described in boxes V.1 of March 2020 Report and V.3 of March 2022 Report. Includes June EES, FTS pre-policy-meeting of June and the average smoothed forward curve of quarter to 13 June. This is calculated by extracting the implicit MPR considering the forward curve on the interest rate swap curve up to 2 years, discounting the fixed rates at every maturity at the simple accrual of the ICP. For the current quarter the surveys and the forwards consider the average daily effective and are completed with the respective sources.

Source: Central Bank of Chile.



# A new policy process?

- Need for constant understanding of transmission mechanisms and for the impact of new shocks.
  - Significant effort in terms of data availability.
- Implications for inflation dynamics (state versus time dependent pricing/role of market structure in transmission of shocks)).
- Symmetrical policy responses.
  - The nature and size of the shock should not affect the target but the policy response.
- Effective communication of alternative scenarios.
- Assessment of non-conventional policies implemented.

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