



The Global Rise in Food Prices and the U.S. Slowdown: Issues and Challenges in Monetary Policy

The case of Chile

Pablo García Silva
Director of Research, BCCh



Agenda

- The nature of the inflation shock

Expectations and the policy response

Challenging times for Inflation Targeting



Agenda

- The nature of the inflation shock

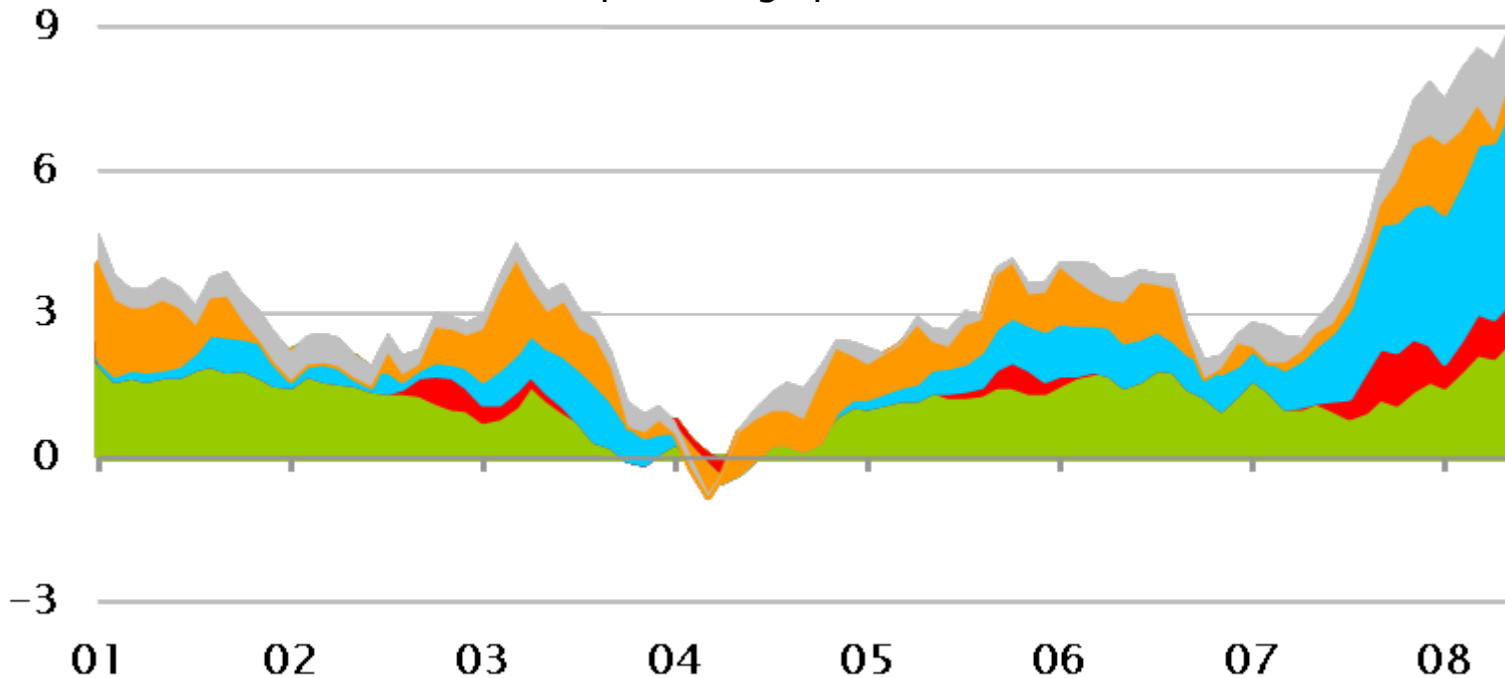
Expectations and the policy response

Challenging times for Inflation Targeting



A highly significant share of current y-o-y inflation has been driven by food prices

Impact on Annual CPI Inflation(*)
(percentage points)



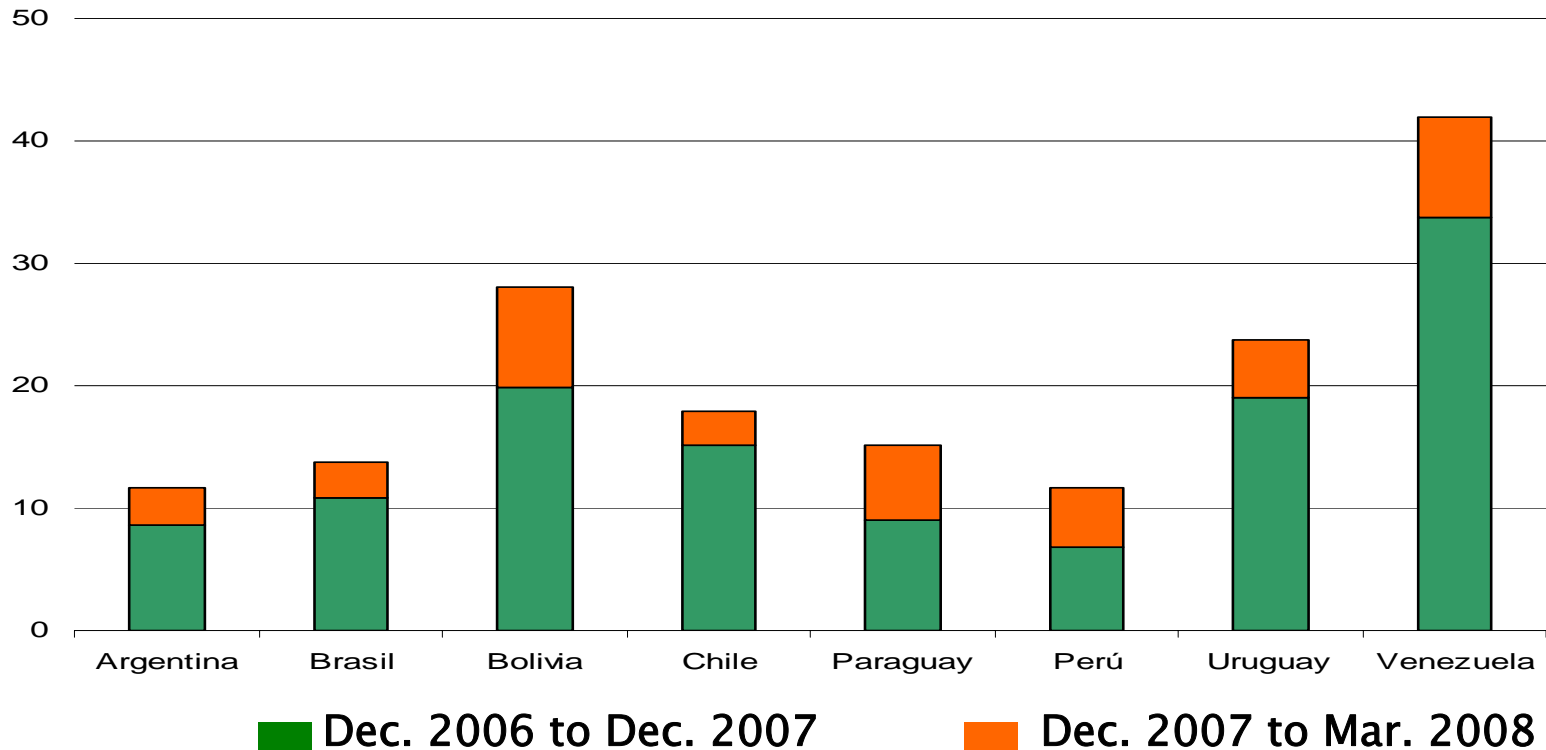
- Fresh fruits and vegetables (3,77%)
- Rest (63,25%)
- Food without fresh fruits and vegetables(23,5%)
- Fuels (3,97%)
- Public services (5,51%)

(*) In brackets, shares in the CPI basket
Sources: Central Bank of Chile and National Statistics Bureau.



This is not unique to Chile

Food price index
(Annual change in local currency, percentage)



Source: Magendzo (2008) from Survey on increases in food prices,



Idiosyncratic shocks have occurred in most analyzed countries

Food prices affected by idiosyncratic shocks

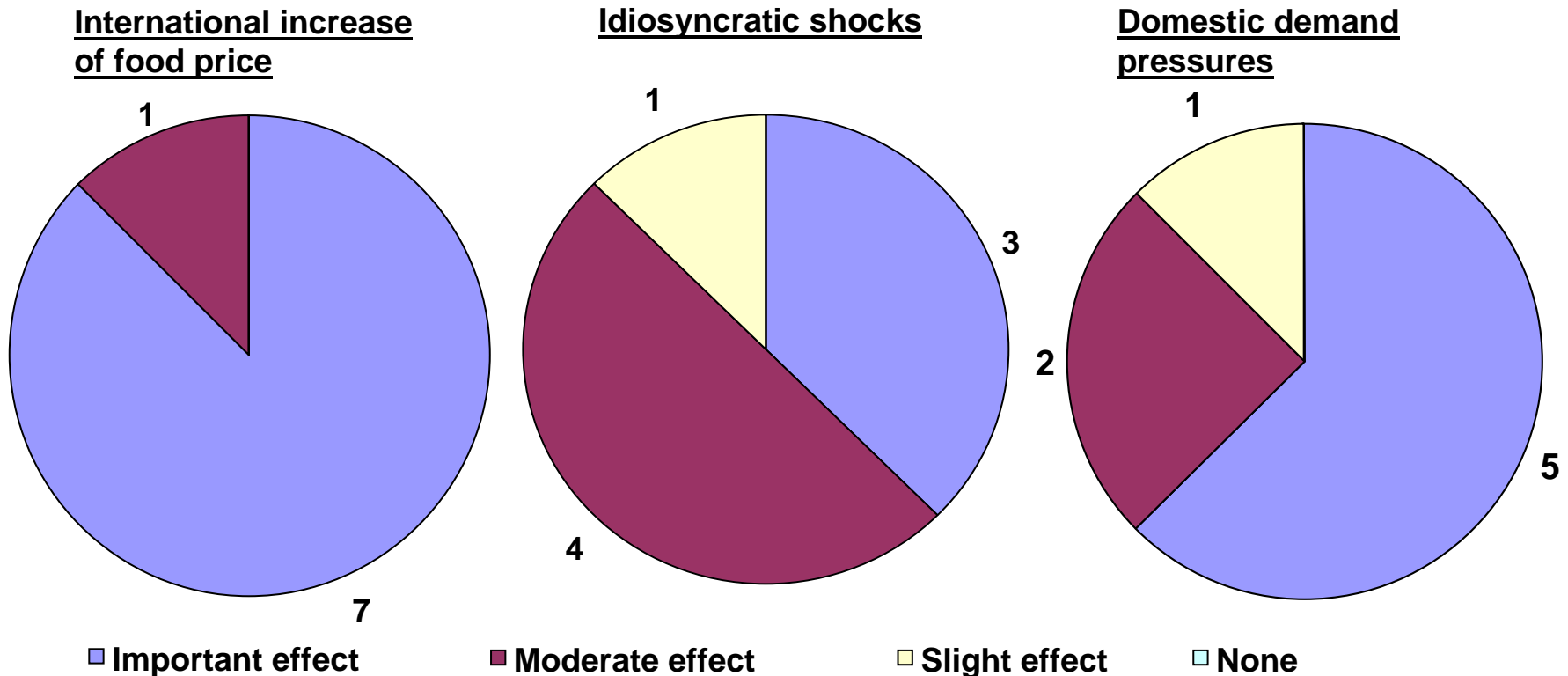
	<u>Argentina</u>	<u>Brazil</u>	<u>Bolivia</u>	<u>Chile</u>	<u>Paraguay</u>	<u>Peru</u>	<u>Uruguay</u>	<u>Venezuela</u>
Important effect:	Vegetables and fruits	Kidney beans	Tomato, beef and pea	Fresh vegetables, fresh fruits and vegetables		Papaya, fresh vegetables, tomatoes and other vegetables	Fruits and vegetables	
Moderate effect:	Meat and dairy		Papayas, bananas, lettuce, carrot, onion, pepper and broad bean	Prepared food, tomato sauce and preserved fruits	Vegetables	Potatoes, tomatoes and citrus	Meat and dairy	

Source: Magendzo (2008) from Survey on increases in food prices,



Demand pressures have also played a role in some economies

How far do the following factors explain the extraordinary rise of food prices since December 2006



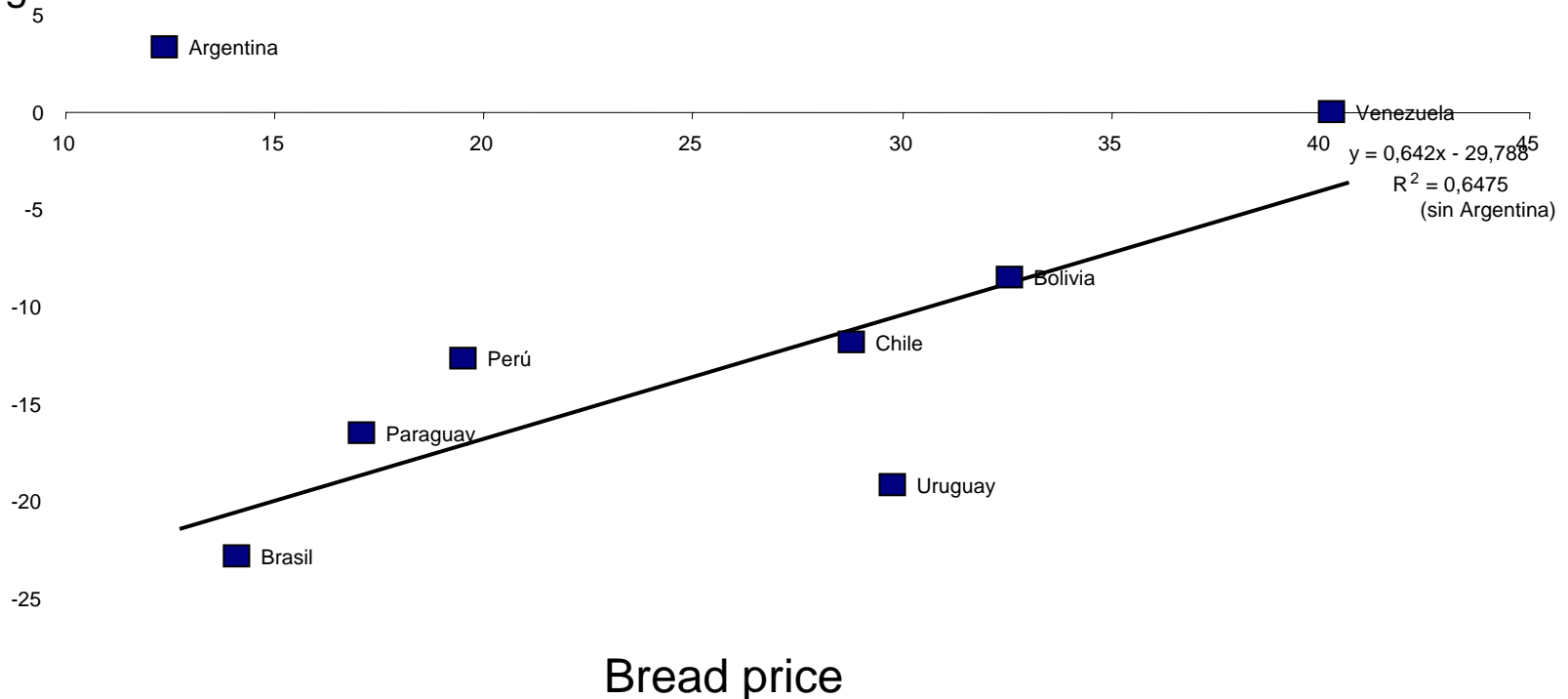
Source: Magendzo (2008) from Survey on increases in food prices,



Bread prices have risen less in countries that have had a greater appreciation of their currency

Change in the price of bread and exchange rate (Dec06 to Mar08 change, percentage)

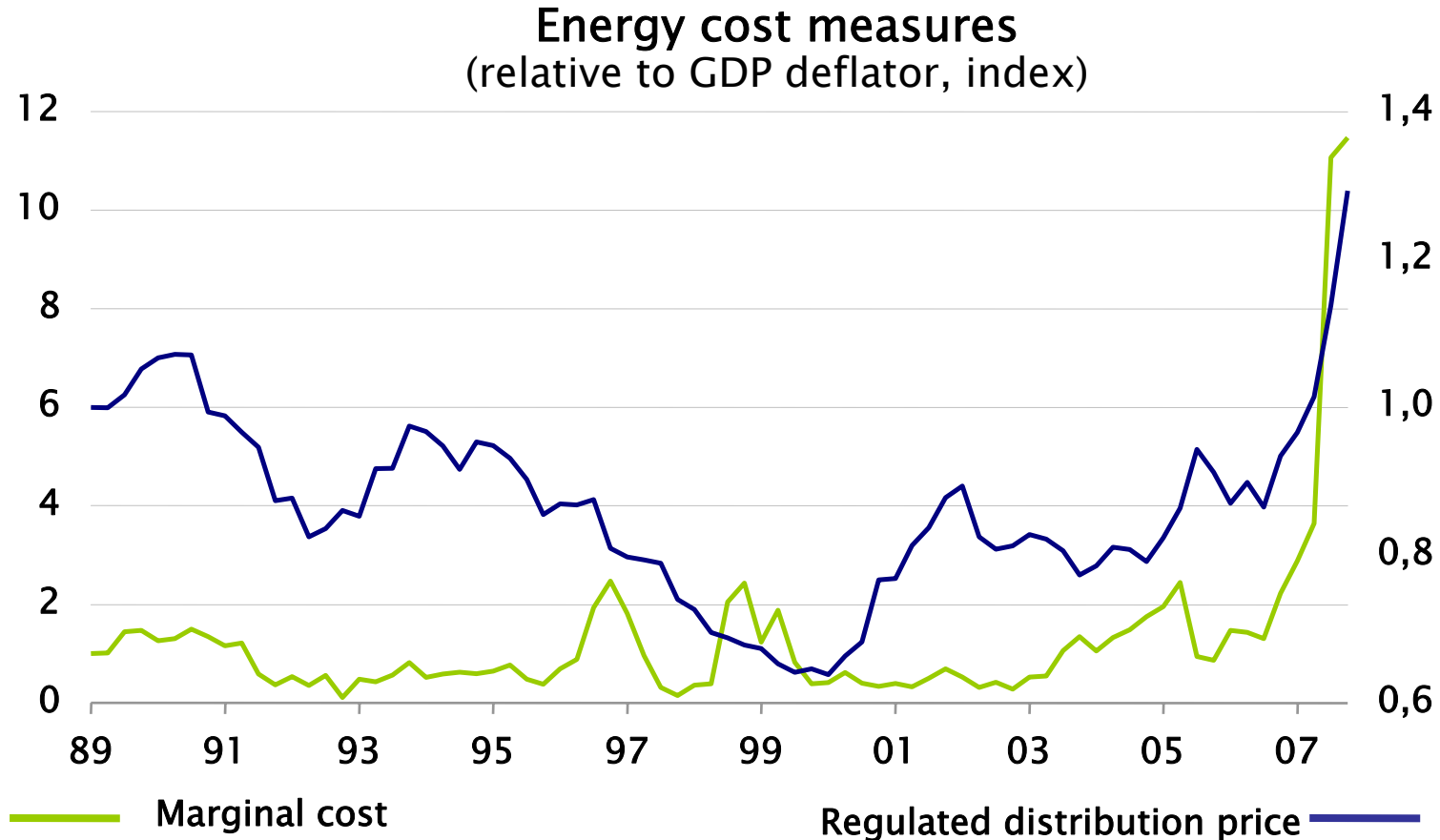
Exchange rate



Source: Magendzo (2008) from Survey on increases in food prices,



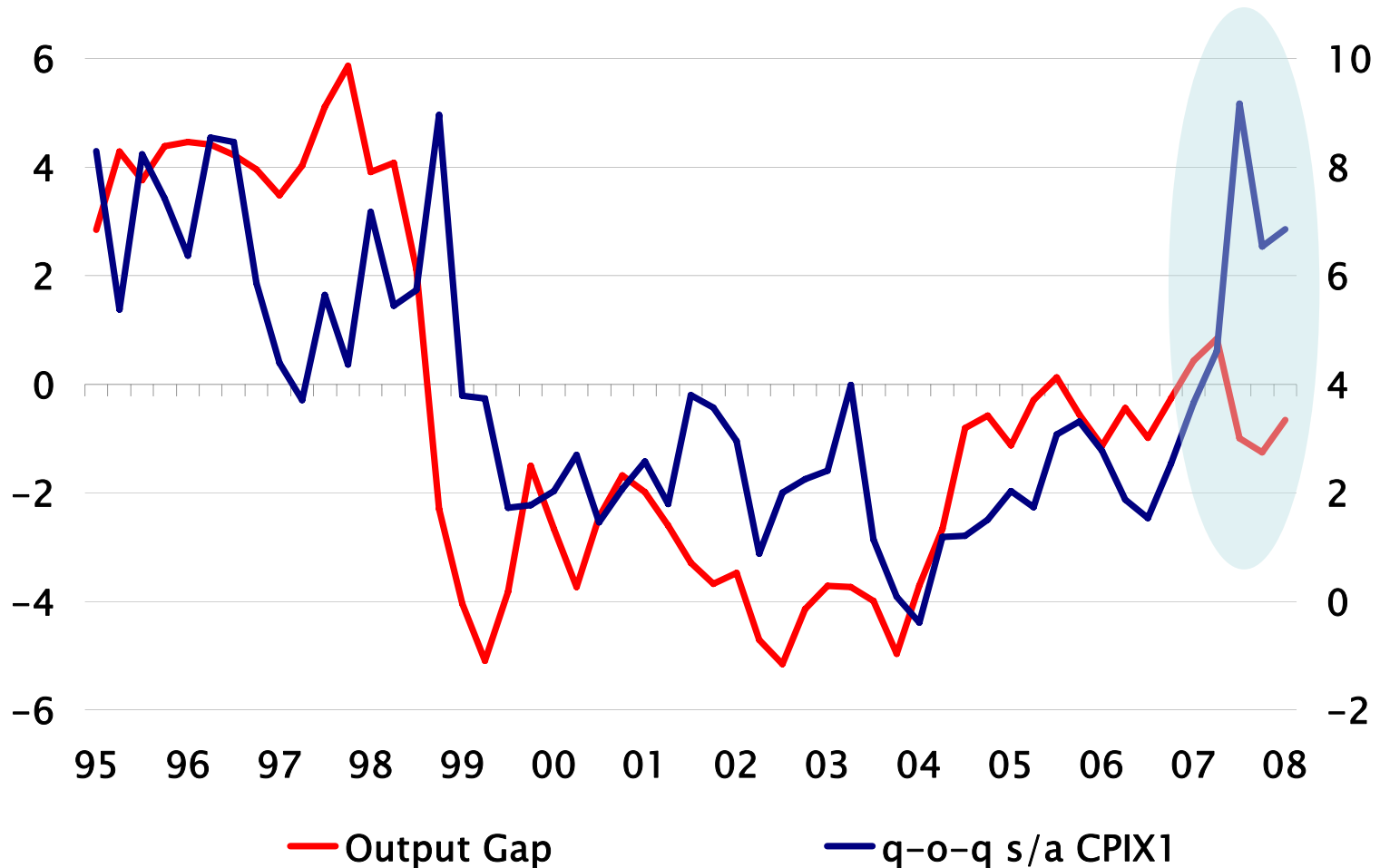
Shift in generation away from hydro and gas towards diesel, along with hikes in oil prices, have led to sharp increases in energy costs.



Source: Central Bank of Chile



Recent acceleration of core inflation related to food and energy costs, not demand pressures.



Source: Central Bank of Chile



Agenda

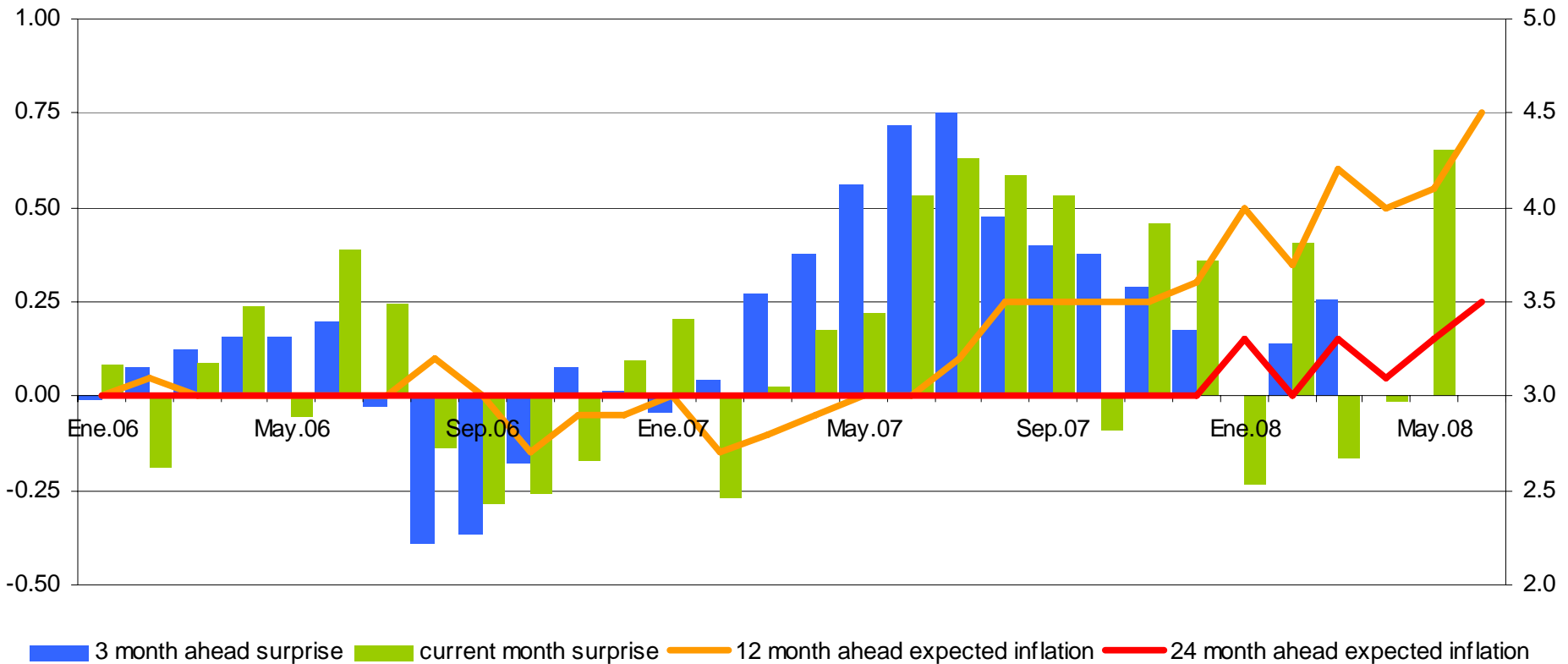
- The nature of the inflation shock

Expectations and the policy response

Challenging times for Inflation Targeting



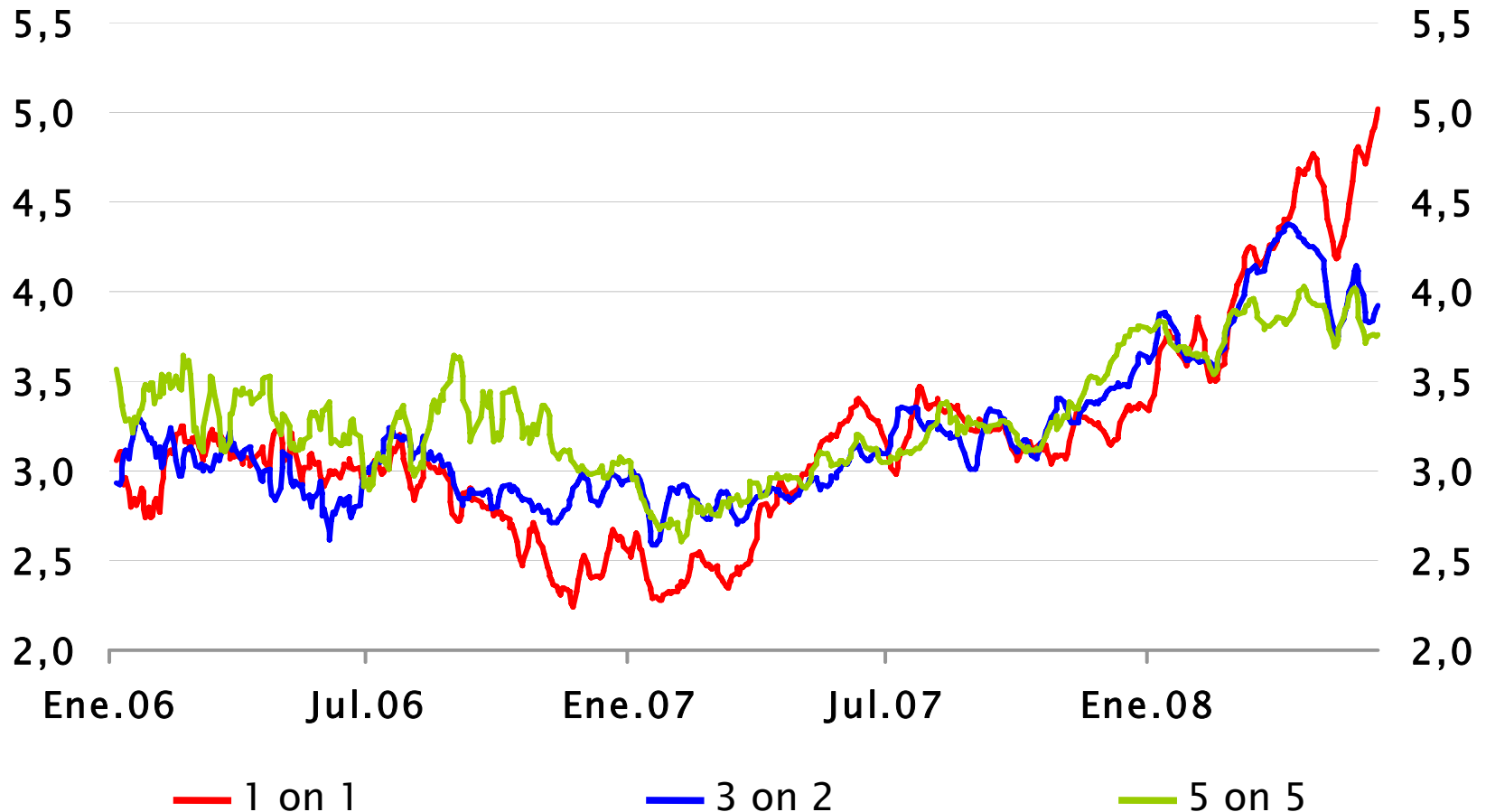
Inflation surprises led to a gradual shift in expected inflation in monthly survey



Sources: Monthly survey of Economic expectations, Central Bank of Chile.



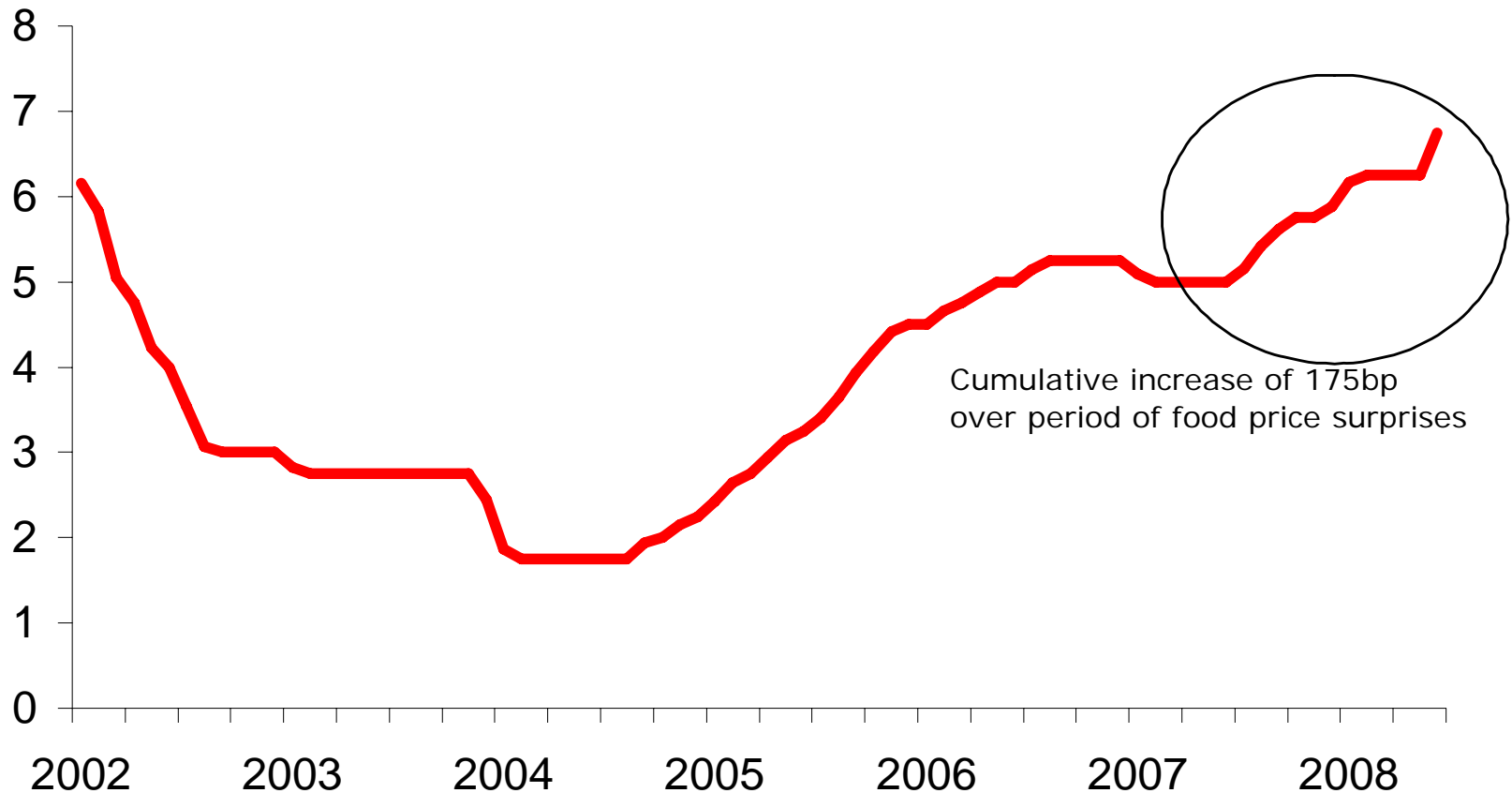
Break-even inflation tenors have also risen, affected by expectations and significant inflation risk premia



Sources: Central Bank of Chile and Bloomberg.



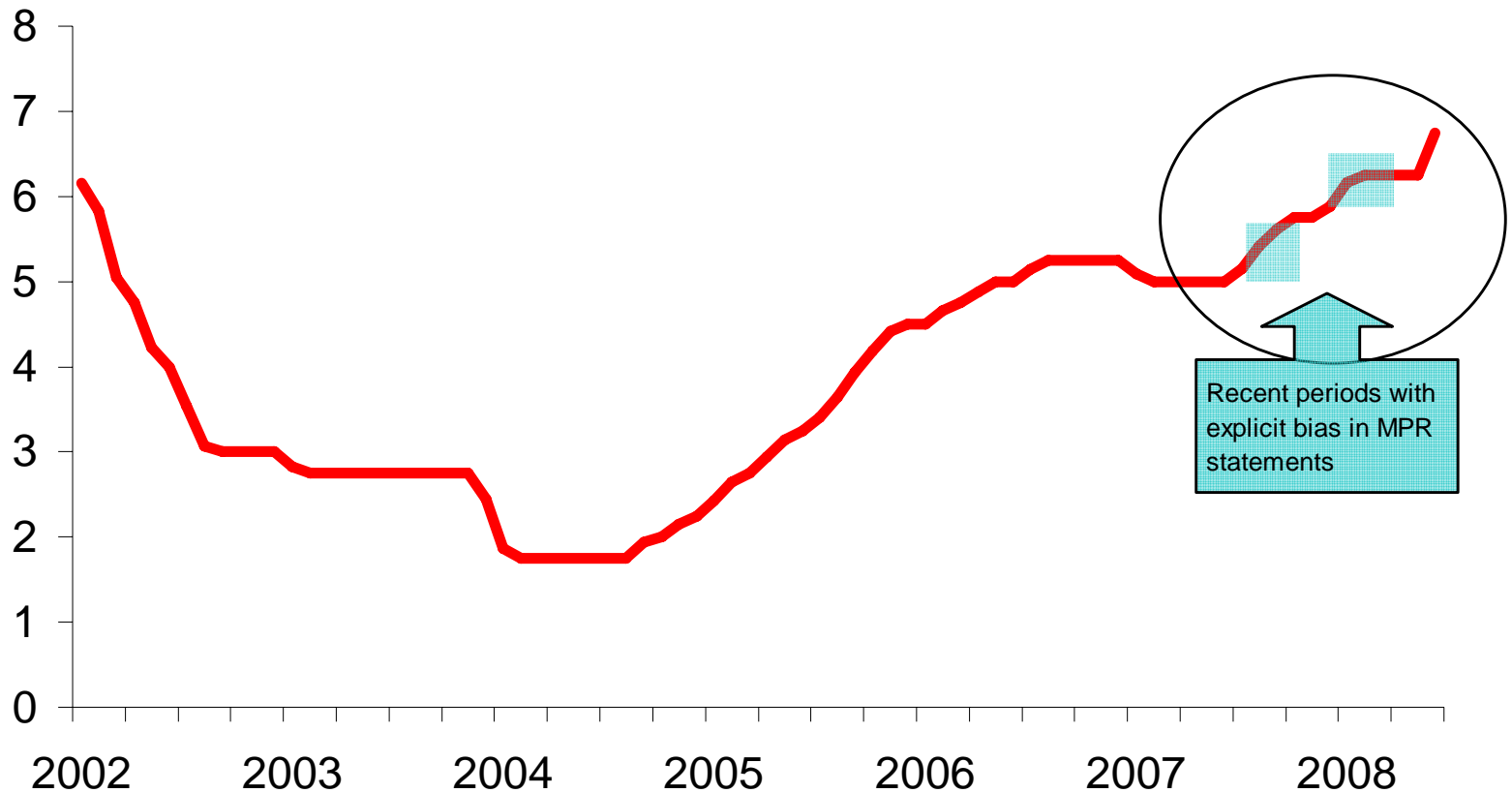
Monetary policy stance has been shifted by a cumulative 175bp since mid 2007



Source: Central Bank of Chile.



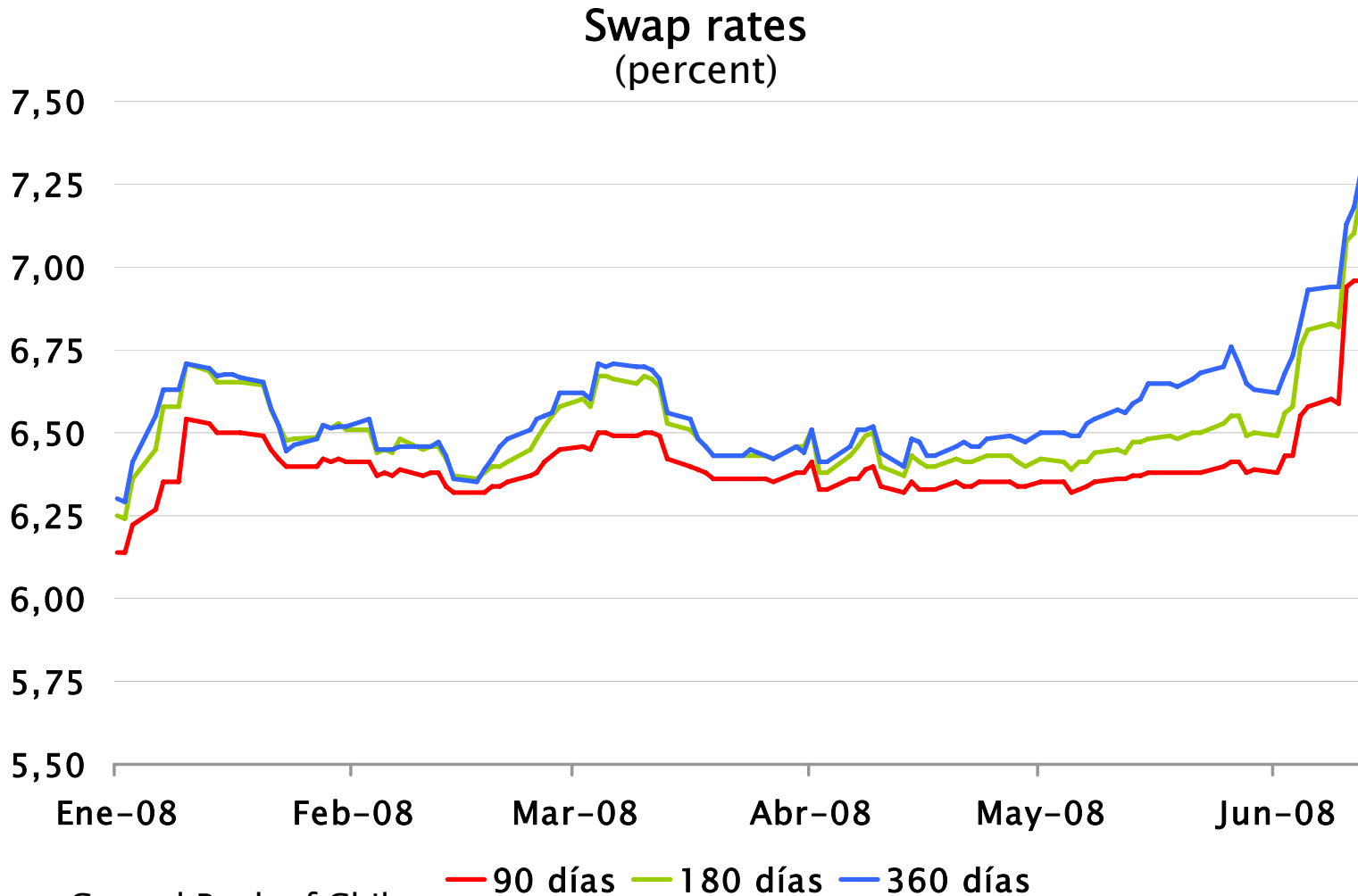
MPR statements have used explicit biases



Source: Central Bank of Chile.



The market is pricing further hikes



Source: Central Bank of Chile



Agenda

- The nature of the inflation shock

Expectations and the policy response

Challenging times for Inflation Targeting



Challenges for Inflation Targeting

- Consistency with intervention policy

Adjusting communication to large deviation from target



Consistency with intervention policy

April 10th intervention package:

Announcement within window of opportunity given by neutral bias in MPR and lack of further inflation surprises during 2008:Q1

Rationale based on high uncertainty in global financial markets:

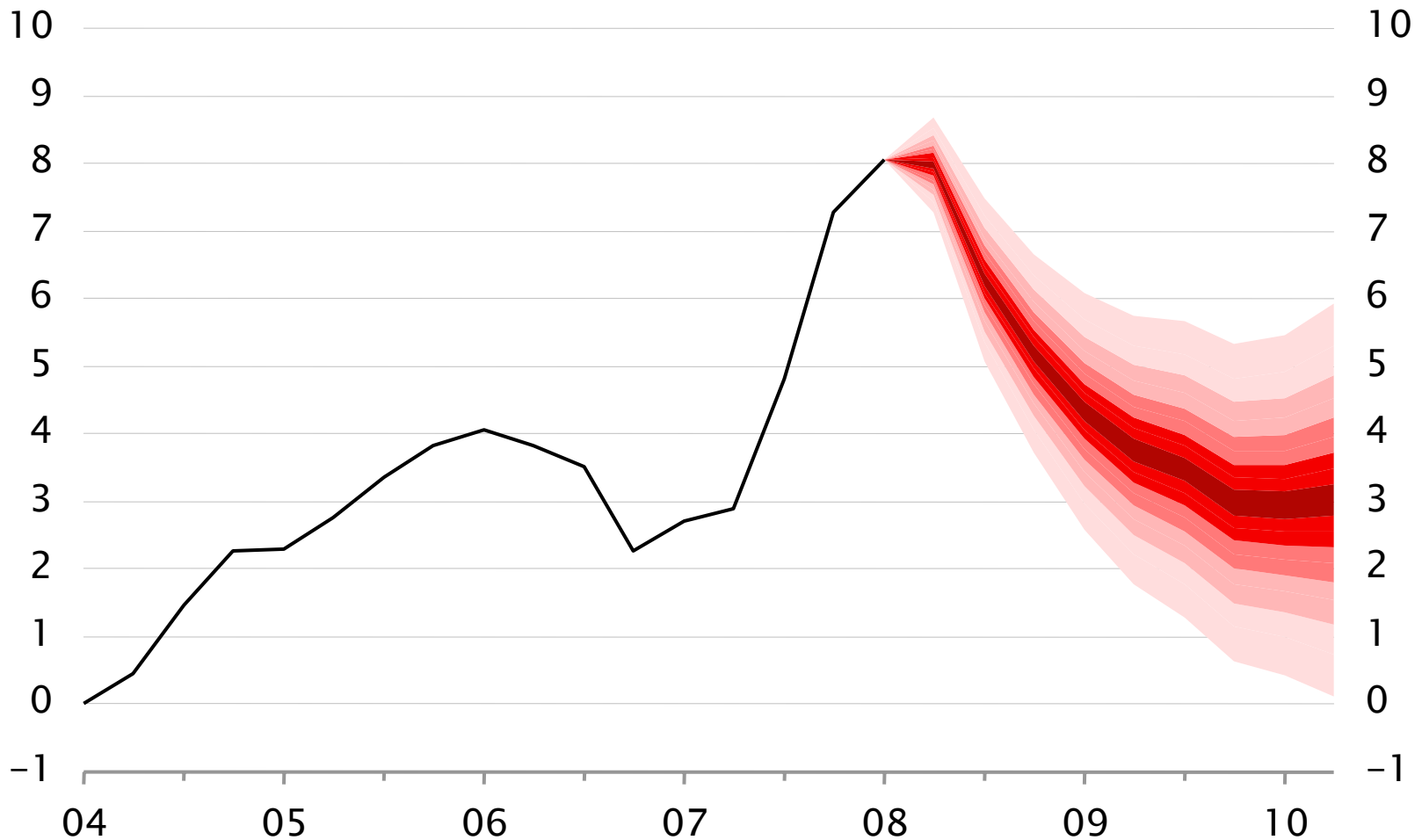
- Investment in stability
- Role of forex liquidity provision with the Central Bank, not the fiscal authority through SWF
- Mechanic implementation: USD50 million daily for eight months
- No target for the exchange rate

Implications for monetary policy:

- Mechanic implementations does not constrain monetary policy
- Mechanic implementation avoids the discretion of using exchange rate policy for disinflation purposes



Adjusting communication to large deviation from target



Source: Central Bank of Chile.



Adjusting communication to large deviation from target

In normal times and under small shocks:

- **IT under full credibility has a rolling policy horizon and is fully forward looking**
- **Supply shocks vs demand shocks distinction critical when tailoring monetary policy responses**

In times under large shocks flexibility is curtailed:

- **Little scope for postponement of disinflation to target**
- **Little tolerance of further inflation surprises regardless of the nature of the shock, difficult distinction between normal and undesired propagation**

Shift in recent MPR statement: 50bp decision based on the need to avoid “undesired postponement” of convergence to target



Concluding remarks

Inflation targeting has served emerging economies well during times of turmoil (2001-2003)

We live in challenging times for Inflation Targeting

- **Shocks at each country level are supply shocks**
- **But worldwide we face a significant demand shock**

It is not the time for tinkering for the framework (eg. increasing flexibility), but rather for simplification of the message and sticking to the basics: avoid the unhinging of inflationary expectations



The Global Rise in Food Prices and the U.S. Slowdown: Issues and Challenges in Monetary Policy

The case of Chile

Pablo García Silva
Director of Research, BCCh