

Chapter 3

Inflation targeting in Chile: Experience and selected issues

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This chapter discusses the Chilean experience with inflation targeting (IT). Emphasis is placed on a number of institutional characteristics of the Chilean IT regime that have contributed to, or acted as a pre-requisite for, a good track record of inflation control. The chapter also sheds light on particular macroeconomic outcomes, including changes in the dynamics of inflation, as well as on selected practical issues in the conduct of monetary policymaking under IT, including the role of inflation expectations and the exchange rate.

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Introduction

Chile's macroeconomic performance over the last couple of decades, and particularly its macroeconomic framework during the 2000s, has been very well evaluated in different economic policy circles. The OECD country reports on Chile and the International Monetary Fund's Article IV consultation documents have usually praised the Chilean macroeconomic framework and management track record. One particular exceptional achievement in the past eighteen years has been the successful implementation of inflation targeting (IT), first partially during the 1990s and then fully during the 2000s. Indeed, the conduct of monetary policy under IT has resulted in the introduction of a strong, credible nominal anchor in a country that had endured high, unstable inflation for many decades (Table 3.1). Failed exchange rate-based stabilisation efforts in 1962 and 1982 contrast with the sustained decline in inflation in 1990-99 and its rather stable behaviour since then.

Of course, not only IT but also many other factors have helped to control inflation in Chile, including global developments. Internally, a number of institutional characteristics have favoured or even been a prerequisite for this outcome, including the independence of the Central Bank of Chile (CBC), a responsible fiscal policy stance and a strong financial system. This paper revisits the Chilean experience with IT, with a focus on some of these institutional characteristics, particular macroeconomic outcomes, and a few selected practical issues.

Table 3.1. **Chile: Inflation outturns, 1925-2006**

	Mean (in %)	Standard deviation (in %)	Coefficient of variation
1925-2006	39.2	89.7	2.3
1925-1989	47.5	99.1	2.1
1925-1989 ¹	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

1. Excludes 1972-75 and refers to December-December inflation.

Source: Díaz and Wagner (2003) and National Statistics Bureau.

IT in Chile

IT was implemented partially in Chile in 1990 and fully in 1999. In this section I revisit the key institutional developments that underpinned the adoption and functioning of this policy framework, as well as its implementation in the two phases and important macroeconomic outcomes.

Institutional background

The CBC implemented IT within a particularly well suited institutional framework. To begin with, the central bank's Constitutional Organic Law provides the institution with a large degree of independence in terms of both objectives and instruments. It explicitly forbids any form of central bank financing of the government, sets a clear mandate with the sole objective of price stability and the normal functioning of the internal and external payments system, and contains strict provisions under which board members can be dismissed.¹

The independence of the CBC can be further assessed by comparing it with other central banks around the world. Following Cukierman (1992), Cukierman and Lippi (1999) and Jácome and Vázquez (2005), it is possible to compute Chile's scores and percentile ranking in different criteria of independence in both 1980 and 1990. By the same token, following Fry *et al.* (2000), it is possible to evaluate Chile in a cross-section of countries in 1998. Tables 3.2 and 3.3 show the results. It is clear that the CBC's independence increased between 1980 and 1990 and, in terms of the Cukierman index, it achieved a very high ranking (percentile 97 among 37 countries) in 1990. According to Fry *et al.* (2000), the CBC's independence score was in the 93rd percentile in a sample of 93 cases.

Table 3.2. **Chile: CBC independence from an international perspective, 1980 and 1990**

Indicator	1980			1990		
	Chile	All countries (72)	Ranking (percentile)	Chile	All countries (37)	Ranking (percentile)
CB governor	0.46	0.47	46	0.71	0.57	82
CB's primary objective	0.80	0.38	94	0.60	0.50	61
Policy formulation	0.27	0.21	72	0.75	0.53	78
CB lending	0.50	0.33	88	1.00	0.60	96
Cukierman index	0.51	0.34	92	0.88	0.58	97

Source: Céspedes and Valdés (2006), based on Cukierman (1992), Cukierman and Lippi (1999), and Jácome and Vázquez (2005).

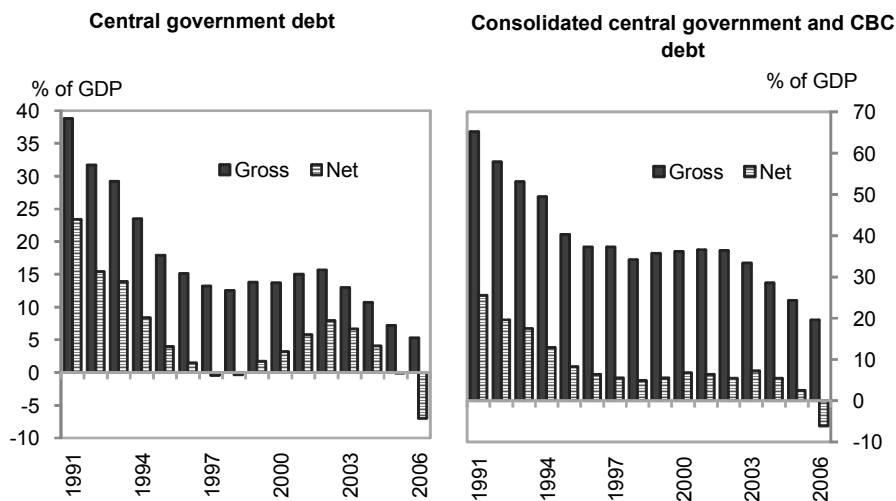
Table 3.3. **Chile: CBC independence from an international perspective, 1998**

	Chile	All countries (93)	Ranking (percentile)
Fry <i>et al.</i> Index (1998)	0.93	0.74	93

Source: Fry *et al.* (2000).

Aside from legal provisions, the CBC has not had to endure any form of fiscal dominance. In fact, it can be argued that the contrary has happened: while the central government's accounts have improved considerably and consistently during the past 15 years, the CBC's net worth has declined and, in accounting terms, turned negative. This negative CBC capital has not been an issue, in part because of the strength of fiscal policy. The central government's gross debt declined from 39 to 5% of GDP during 1991-2006 (Figure 3.1). Net debt, in turn, declined from 23 to -7% of GDP. Net consolidated debt has also declined substantially, to less than -6% in 2006.

Figure 3.1. **Chile: Gross and net public indebtedness, 1991-2006**



Source: Central Bank of Chile.

Financial dominance has not been an issue either for the conduct of monetary policy in Chile in the last decade and a half. After a severe banking crisis in 1982, the financial system's regulation was strengthened considerably

and supervision practices were upgraded. In this environment, banks have had low non-performing loan ratios and have been quite profitable, while capital ratios have been maintained well above minimum standards (Table 3.4). Furthermore, the issuance of CBC debt instruments to finance both a portion of the 1982 crisis cost still in its balance sheets and the accumulation of international reserves has found strong market appetite because of both the overall fiscal strength and a growing pool of institutional investors, especially pension funds.

Table 3.4. **Chile: Banking system indicators, 1995-2006**

	Non-performing loans (in % of total loans)	Capital (in % of risk-weighted assets)	Profits/capital (ROE, in %)
1995	0.9	10.5	12.9
1996	1.0	10.5	15.5
1997	1.0	11.5	13.7
1998	1.5	12.5	11.5
1999	1.7	13.5	9.4
2000	1.7	13.3	12.7
2001	1.6	12.7	17.7
2002	1.8	14.0	14.4
2003	1.6	14.1	16.7
2004	1.2	13.6	16.7
2005	0.9	13.0	17.9
2006	0.8	12.7	18.6

Source: Superintendencia de Bancos e Instituciones Financieras.

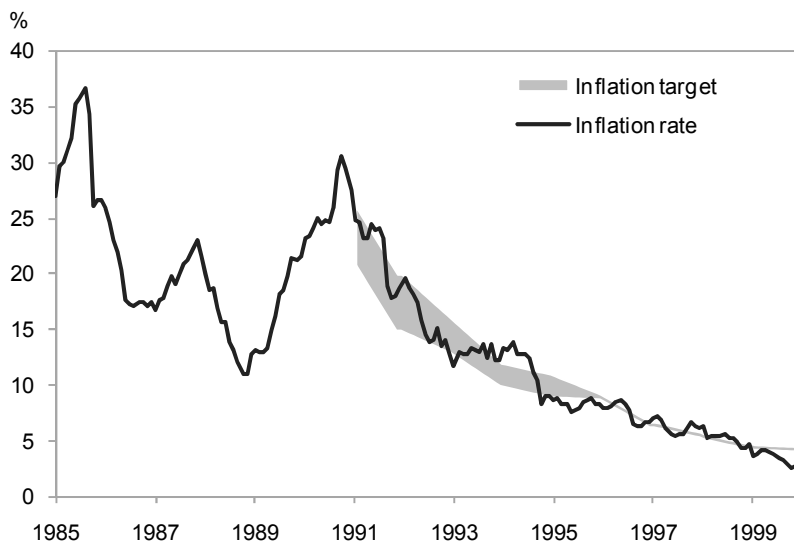
Against this backdrop of effective independence, the CBC meets all the pre-requisites for IT. This has not precluded due co-ordination with the government, particularly during the convergence phase, when targets were set after consultations with the minister of finance. The CBC charter has a special provision establishing that, when making decisions, the board of the CBC should take into consideration the economic policy of government.

Convergence phase: 1990-99²

During the IT convergence phase the CBC managed to reduce annual inflation from almost 30% in the early 1990 to less than 3% in late 1999, after

major fluctuations in previous years (Figure 3.2). Target achievements were impressive.

Figure 3.2. Chile: Inflation outturns and targets, 1985-99



Source: National Statistics Bureau and Central Bank of Chile.

The system had a few IT characteristics, in particular the announcement of an annual quantitative inflation target and the predominance of these targets as the nominal anchor of the economy. These targets eventually came into conflict with other nominal commitments, particularly the exchange rate, which was used as the main anchor. Other typical features of an IT regime were absent, however. For instance, both the transparency and the communication devices fell short of what is regarded today as a prerequisite for effective IT.

Annual targets for the December-December inflation rate for the following year were announced each September in the central bank's annual report to Congress, a mandatory information dissemination document in the CBC's charter. In communicating its ultimate inflation stabilisation objective, the central bank first considered the goal of converging to single-digit inflation and, once that objective had been accomplished, the final goal was to achieve the level of inflation prevailing in developed countries, a level that was not defined precisely.

The announcement process explicitly included the notion of slow convergence to lower inflation because of the prevalence of widespread backward-looking indexation in the Chilean economy. Rapid convergence to low inflation was considered risky, because the key price misalignments that were likely to emerge would have negative effects on the real economy and jeopardise the sustainability of the disinflation programme. Only once in eleven years was the inflation target revised in the course of the year: in 1995 the target was lowered from 9 to 8%. The initial inflation targets were defined as a range, and point targets were set after 1995.

Given the date of announcements and the focus of the inflation target on the rate prevailing in December of the coming year, the average duration of the targets was only seven and a half months in the 1990s, which is hardly long enough for monetary policy to have strong effects on inflation through the conventional transmission mechanisms. Rather, the announcements were a compromise between current inflation forecasts, and the need to lower inflation and to develop an effective communication strategy.

There is no consensus on the precise reasons for the remarkable reduction in inflation. Some authors (*e.g.* de Gregorio, 2003; García, 2003) identify the positive productivity shocks that hit the economy throughout the 1990s as a key driving force of the inflation dynamics. In their view, unit labour costs decreased, despite indexation and declining inflation, thanks to the economy's unexpectedly high growth performance. Others (*e.g.* Corbo, 1998; Morandé, 2001) underscore the existence of the inflation target as a key co-ordinating device for expectations. They show that the inflation dynamics changed substantially in the 1990s.

In addition to these annual inflation targets, the CBC managed a target band for the exchange rate. The band was perceived as the key instrument for ensuring the normal functioning of the external payments system, which in turn became the effective target (cap) for the current-account deficit. The exchange-rate band was based on a purchasing power parity rule, corrected in some periods for productivity differentials between Chile and its trading partners. It underwent a number of modifications over the 1990s, including changes in its width and once-and-for-all realignments. The CBC intervened not only at the edges of the band, but also actively within it. The CBC maintained important regulations on the capital account throughout the 1990s, including a non-remunerated reserve requirement for capital inflows (which was increasingly broadened until 1997) and a minimum stay for some inflows. These regulations were based on the desire to retain the possibility of managing the exchange rate within monetary policy autonomy and to manage inflows to keep total expenditures under control.

Finally, monetary policy implementation improved progressively over the 1990s. From a rather rough management of interest rates on a variety of instruments in 1990, the CBC converged to managing liquidity by targeting an overnight interest rate in the interbank market. In turn, foreign-exchange interventions were carried out in different ways: directly, through foreign-exchange purchases by public enterprises (mainly Codelco, the state-owned copper corporation), and indirectly, through open-market operations. Publicly available information did not specify the exact magnitude and timing of interventions, given that interventions and other international reserve movements were reported in a consolidated manner, although interventions were clearly aimed at countering real exchange-rate appreciations. The effort to sterilise inflows between 1990 and 1997 was a large one: during that period the CBC increased its foreign-exchange reserves from USD 2.5 billion to USD 17.8 billion. Its foreign-exchange position switched from a deficit of 5.1% of GDP to a surplus of around 25% of GDP. In 1998, the central bank also intervened in the foreign-exchange market by issuing dollar-linked debt and, briefly, using options.

Steady-state phase: Since September 1999

Although the macroeconomic policy framework generated remarkable results from 1990 to 1997, by the beginning of 1997 the Chilean economy had experienced unprecedented strong growth with signs of overheating. The Asian and Russian crises of 1997-98 had strong effects on the Chilean economy through both real and financial transmission mechanisms. Valdés (2007) revisits this episode and the policy responses at the time. Beyond the immediate response, the policy framework suffered large transformations in the years that followed. The implicit evaluation was that Chile suffered more than it should have, including a recession in 1999.

In the second half of 1999, the authorities began to implement a number of changes in the macroeconomic policy framework, including the adoption of fully-fledged IT in September 1999. Other key changes included: *i*) the introduction of a free-floating exchange-rate regime, *ii*) the deepening of foreign-exchange derivatives (forward) markets, *iii*) the total opening of the capital account, and *iv*) the “nominalisation” of monetary policy in 2001 (*i.e.* the CBC switched from using a CPI-indexed or UF-referenced interest rate – a real rate – to a nominal interest rate). The central bank explained these changes as improvements that were in line with the following considerations: inflation had already converged to low levels, greater exchange-rate flexibility was possible given the development of hedging mechanisms and lower exchange-rate mismatches, and the need to accommodate transitory inflationary

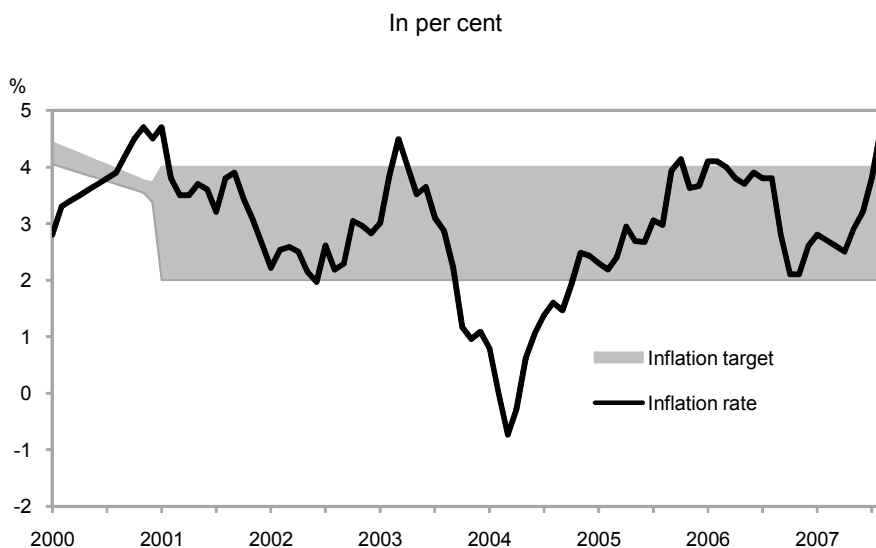
shocks and a longer time span for monetary policy to affect inflation (and thus prevent unnecessary output volatility).

The gradual transition to a floating exchange-rate system was pursued with the adoption of a widening exchange-rate band in December 1998. After ten months in which the band's width was increased from 7 to 16% of the central parity, the CBC announced in September 1999 that the band was no longer part of the policy framework. The central bank officially retained the authority to intervene, but it announced that it would do so only in special circumstances, and it would inform the public about those decisions. In parallel to this "slow" transition to a floating-rate regime, the CBC made the necessary regulatory adjustments to foster the development of foreign-exchange hedging. In particular, it eased regulations to allow banks to participate more actively in the forward market. Volumes increased rapidly: between 1998 and 2003 total turnover in the derivatives market increased by 60%, while the spot market more than doubled in size. The CBC intervened in the foreign-exchange market only twice (each episode with duration of about three months) in 2001 and 2002.

In September 1999, an open-ended band of 2-4% was announced for the new inflation target starting in 2001 (the interim target for December 2000 was 3.5%). This 2-4% target was maintained until late 2006. In early 2007, the target was reformulated as being most of the time around 3%, with a tolerance interval of ± 1 percentage point. The monetary policy horizon (*i.e.* the maximum period in which the CBC is expected to bring back inflation to target) was 12 to 24 months between 2000 and 2006. In January 2007 it was defined as around two years (more about these changes below). Between 2001 and September 2007 annual inflation averaged 2.8%, it was between 2-4% during 73% of the time, above 4% during 10% of the time and below 2% during 17% of the time (Figure 3.3).

During this phase the IT framework had several of the characteristics of this type of monetary regime. In addition to a floating exchange rate, the CBC began to publish an inflation report three times a year (the first issue was released in May 2000), to announce the dates of monthly monetary policy meetings six months in advance, and to disclose monetary policy meeting minutes with a three-month lag, which was subsequently shortened to three weeks. Overall, it improved markedly the disclosure of information, including detailed forecasts and views about transmission mechanisms. Procedural changes were enacted in a new central bank board ruling.

Figure 3.3. Chile: Inflation and inflation target, 2000-01



Source: National Statistics Bureau and Central Bank of Chile.

Two key additional elements during this phase were fiscal policy and the CBC's anti-inflationary credentials earned in 1998. With regard to fiscal policy, the structural balance rule announced in 2000 facilitated macroeconomic policy co-ordination and improved the counter-cyclicality and credibility of the policy regime. The rule, based on a target for a structural surplus equivalent to 1% of GDP, consists of a cyclical adjustment of tax and copper revenues and limits the likelihood of sudden changes in expenditure.³ The strong commitment by the CBC to controlling inflation, as evidenced by an extremely tight monetary policy in 1998, made it clear that the mandate of price stability would be fulfilled. This probably had a significant influence on the inflation process (Table 3.5). Particularly striking is the decline in inflation persistence for both headline and core measures after 1998 (García and Valdés, 2005). Other explanations include global factors and an update of the CPI reference basket in 1998.

Table 3.5. Chile: Inflation persistence and volatility¹

	1991.1-1998.12			1999.1-2005.4		
	Model 1	Model 2	Model 3	Model 1	Model 2	Model 3
Sum of coefficients	0.80	0.72	0.78	-0.15	-0.03	0.06
P-value	0.00	0.00	0.00	0.02	0.91	0.03
Residual SE	0.37%	0.36%	0.33%	0.25%	0.26%	0.24%
Volatility	0.82%	0.68%	0.71%	0.23%	0.26%	0.25%
Coeff. of variation	1.1	0.8	0.9	1.0	1.1	1.1

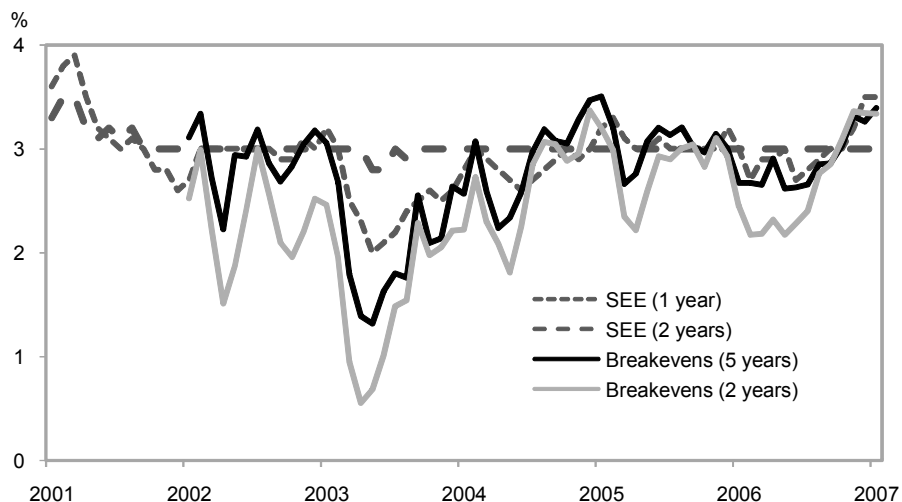
1. The three models consider $\Delta p_t = \alpha + \sum_k \beta_k \Delta p_{t-k} + \varepsilon_t$, where Δp_t is the monthly change in the log of the price level. All models are estimated using OLS. In Model 1, $k = 1, 2, 3, 6$ and 12 ; in Model 2, $k = 1$ to 12 and β is constant for all k ; and, in Model 3, $k = 1$ to 12 .

Source: García and Valdés (2005).

Macroeconomic performance under IT

Overall, the most important achievement of IT in Chile has been the reduction and control of inflation. Having a clear mandate and an unambiguous inflation target has provided an effective nominal anchor for the economy. An obvious way to assess this achievement is through the behaviour of market inflation expectations (Figure 3.4). The Survey of Economic Expectations (SEE) conducted monthly by the CBC shows that the 3% target acts as a strong magnet for one- and two-year-ahead expectations. In fact, the median of two-year-ahead inflation expectations has been 3% for several years. The same pattern emerges with inflation breakeven estimates (*i.e.* the difference between nominal and CPI-indexed bonds issued by the CBC with similar maturities). Although these measures are more volatile, they clearly converge to 3%.

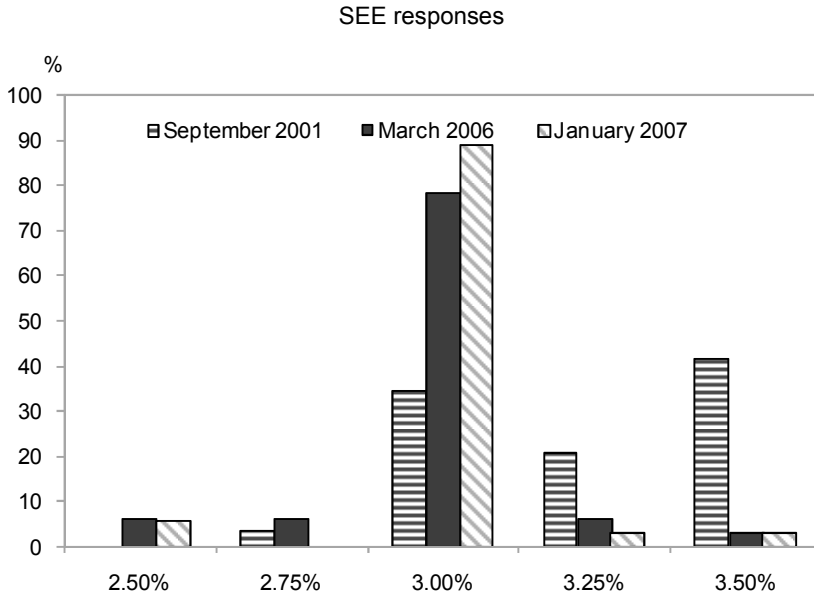
Figure 3.4. Chile: One- and two-year-ahead expected inflation, 2001-07



Source: Central Bank of Chile.

The gained credibility of the anchor can also be gauged by the distribution of inflation expectations among SEE respondents. Whereas in 2001 a large portion of analysts expected inflation two years ahead to differ from 3%, in early 2007 a solid 90% of responses was 3% (Figure 3.5). Macroeconomic performance in terms of output and inflation volatility, as well as inflation persistence, has also improved over the last decade and a half. Of course, it is virtually impossible to determine how much responsibility monetary policy has had for this outcome, since shocks may have been different, including those of foreign origin, and other policies also mattered, but it is still worthwhile to compare simple statistics.⁴

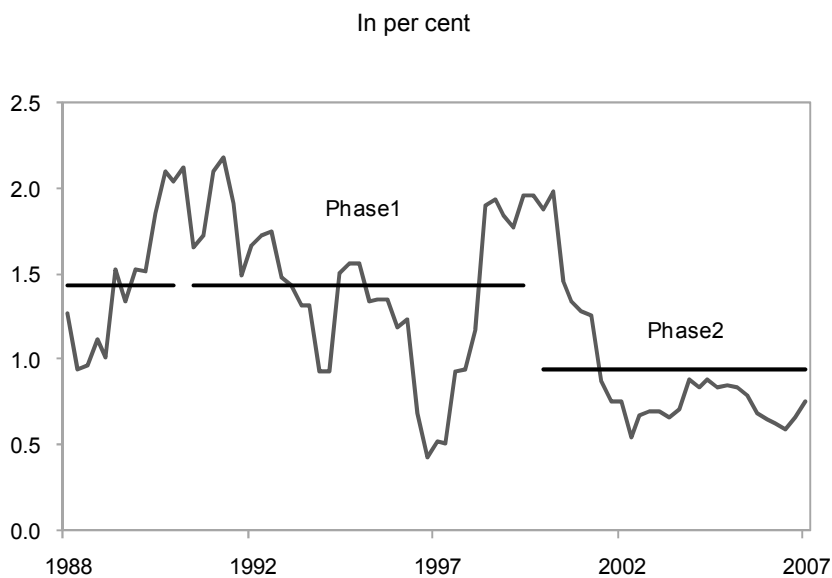
Figure 3.5. Chile: Distribution of two-year-ahead expected inflation, 2001, 2006 and 2007



Source: Central Bank of Chile.

Output volatility has had ups and downs in the past few years, but on average it has clearly declined. During the current steady-state phase of IT, the standard deviation of the seasonally-adjusted quarterly growth rate of GDP over two-year windows has been close to 1%, around two-thirds of the level prevailing in the late 1980s (Figure 3.6). Inflation volatility has declined even more markedly and is about one-quarter of its pre-IT level (Figure 3.7). The two results are in line with what has been observed in developed countries: the “great moderation” phenomenon.

Figure 3.6. Chile: GDP growth volatility, 1988-2007¹

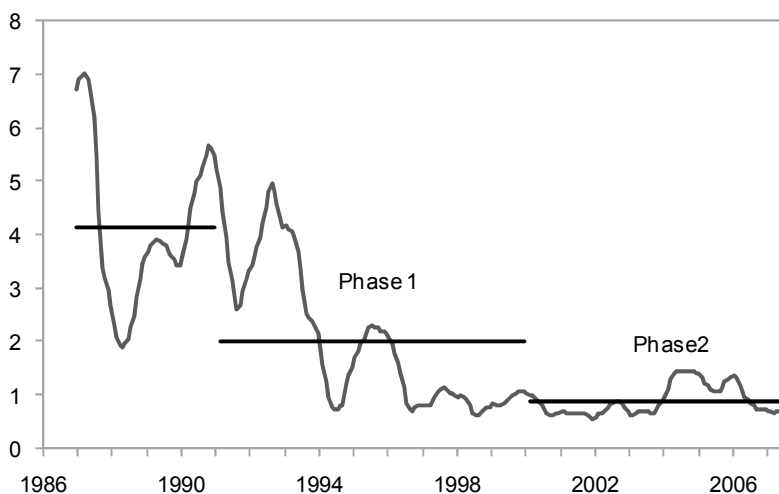


1. Two-year rolling-sample standard deviation of quarterly GDP growth (seasonally adjusted).

Source: Author's calculation based on Central Bank of Chile.

Figure 3.7. **Chile: Inflation volatility, 1986-2007**¹

In per cent

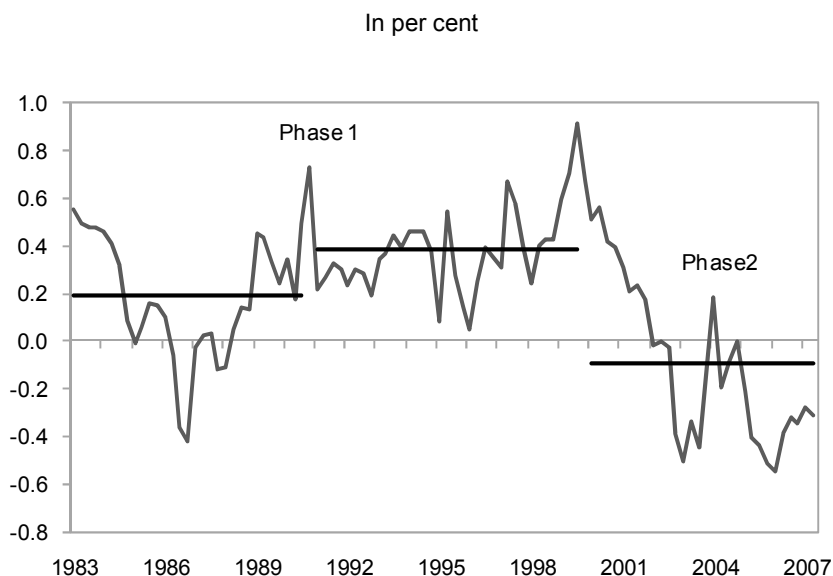


1. Two-year rolling-sample standard deviation of monthly year-on-year CPI inflation.

Source: Author's calculation based on National Statistics Bureau.

Finally, inflation persistence (measured as the sum of the autoregressive terms of quarterly inflation in rolling two-year samples) has not been different from zero on average during the steady-state phase of IT, which is clearly below the level observed during the convergence phase (Figure 3.8). This result is qualitatively similar to that shown in Table 3.5.

Figure 3.8. **Chile: Inflation persistence, 1983-2007**



1. Sum of autoregressive coefficients in a linear model for quarterly inflation (rolling estimations).

Source: Author's calculation based on National Statistics Bureau.

Selected monetary policy issues under IT

The CBC's experience with IT has involved analysis, discussion and decisions on multiple policy issues. I analyse here four policy topics that have evolved in the last several years: the setting of the inflation target and the central bank's operational objective, the assumptions on future monetary policy stance included in forecasts and communications, the role that inflation expectations may have in the conduct of monetary policy under IT, and the exchange-rate regime and its interaction with monetary policymaking.

Target setting and operational instrument

There are three distinctive periods in the Chilean experience with setting the inflation target and the operational objective: the convergence phase (1990-99), 1999-2006 and 2007 onwards. As mentioned before, during the convergence phase, annual targets were announced in September of each year for the following December-December period's inflation rate.⁵ During this

phase, the target and the operational objective were indistinguishable. Monetary policy decisions were in principle guided by the need to bring inflation to the December target. The operational objective, in this sense, was a fixed-moment mark. Furthermore, the official inflation forecast and the target were equal. Therefore, the precise inflation target set every year was a combination of what was considered achievable and a new step towards low inflation. Both range and point targets were announced at different moments. The target was announced strategically in the month before Congress began debating next year's budget. The government used the same target in the preparation of the budget submitted to Congress in September and when setting public-sector wages in November. Interestingly, for many years there was also a GDP growth target in the authorities' presentations.

In the steady-state phase of IT (after 1999), the first target was 2-4% for every month, not only December. Speeches and documents also considered that this target range "was centred at 3%". To achieve its goal, the CBC had an operational target to maintain projected inflation around 3% in a policy horizon of 12 to 24 months. In 2000, early in the steady-state phase, the CBC released a document explaining the rationale for these numbers.⁶ Monetary policy lags were considered to be in line with the policy horizon. The document also explained why the chosen target was headline CPI (because alternative definitions would not have been as effective as an anchor, given the difficulty to communicate them to economic agents) and the role of a basic core inflation measure as an indicator of persistent inflation pressures. In this new target definition forecasts were not always equal to 3%, although published forecasts were always very close to this number over 24-month horizons.

As time passed, the long end of the 12-to-24-month horizon became more important in the CBC communication and decision-making process. For instance, in a few official monetary policy communiqués, the central bank plainly referred to the "24-month policy horizon". In the monetary policy report, the 12-month forecast was often quite different from 3%, whereas it was rarely different from 3% within the 24-month horizon.⁷ The two-year horizon was the focal point of policy discussions and the assessment of market inflation expectations.

In early 2007, in an effort to make the entire monetary policy framework more transparent, the CBC released a new official document describing the objective, conduct, transmission mechanism, implementation and communication of monetary policy. This document emphasised both the subtle but important redefinition of the target and the change in the policy horizon. The target was redefined as keeping annual CPI inflation most of the time close to 3%, with a tolerance interval of ± 1 percentage point, rather than a target

range. The change entailed two important elements. *First*, it aimed at strengthening 3% as the nominal anchor of the economy. *Second*, it recognised that, as had been the case, inflation could be transitorily outside the 2-4% range. The new target definition also made it clear that there were no discontinuities for the conduct of monetary policy at the edges of the target range. In addition, the document revisited the arguments for why a 3% target seemed appropriate for the Chilean economy.

The official policy horizon was extended and made a little less precise with the new definition of “around two years” instead of “12 to 24 months.” To a large extent, this was nothing but a recognition of what had actually been done during the last few years. The definition also made it clear that the policy horizon was part of the operational target, which also included the maintenance of inflation forecasts at 3%. Furthermore, the document clarified that the policy horizon was the maximum period of time at which the CBC would try to bring inflation back to 3% under normal circumstances.

Monetary policy path and forecasts

When the CBC started to present its Monetary Policy Report, it implemented the standard practice at the time of assuming a fixed policy rate during the policy horizon (12 to 24 months at the time) and evaluating the inflation forecasts that emerged in that setting.⁸ If the forecast was incompatible with the target, rates had to be adjusted. The communication of the forecast was quite open with respect to this procedure and explicit regarding the interest rate assumption.⁹ By definition, board members did not need to agree on a future assumed path for monetary policy. Technically, however, as has been discussed extensively elsewhere, fixing the policy interest rate path entails several problems, particularly in forward-looking models. For instance, one implication of a fixed-rate assumption is that monetary policy has to jump after the policy horizon to anchor inflation, especially if inflation were to deviate significantly from the target without this jump. Another is that such monetary policy is assumed to be extremely persistent, and therefore to have quite powerful effects. Implicitly, therefore, the assumption restricted how far monetary policy could deviate from neutral and, therefore, it hindered the degree of activism that could be achieved.

During 2002, at times of aggressive rate cuts, which proved to be necessary with the benefit of hindsight, the CBC changed its internal procedures and communication strategy to accommodate monetary policy adjustments that did not need to last two full years. In other words, they were cuts expected to be reversed, at least partially, in less than two years’ time. From a technical point of view, the staff implemented an “imperfect credibility assumption”, whereby

agents were assumed to form monetary policy expectations according to a simple Taylor-type rule, despite the fact that the CBC announced a fixed monetary policy rate for two years. Thus, the yield curve and the exchange rate (and other relevant asset prices) would react to “shadow” future moving interest rates. Because the policy interest rate exerts by itself some effect on domestic demand, the fixed-rate assumption did retain a transmission mechanism to output and inflation and, thus, had some direct effect on forecasts. The communication of the forecasts was adapted to include an explicit statement that the policy rate was assumed constant for two years, but that all relevant asset prices would follow a path similar to the expected implicit one in current market prices.

The 2002 solution was a step forward in terms of freedom for monetary policy and some internal consistency, but a step back in terms of transparency and easiness of communication. Moreover, this solution implied rather implausible monetary policy shock responses in the core model used for forecasting and analysis. In particular, a policy shock in the form of an increase in the policy rate would depreciate the local currency, because the shadow interest rate from which expectations are formed would move in the opposite direction as an attempt to reverse the original shock. The same happened with the long-term interest rate. In September 2004, after internal discussions, the CBC decided to move to a full monetary policy rule to close its official forecast. A special document on CBC models explains some of the details, although it does not include the exact rule parameters, which have varied from time to time. The rule is based on the output gap and forecast of inflation deviations in the following few quarters.

Two caveats are in order on this subject. *First*, using policy rules in forecast discussions does not substitute for the rich and necessary discussion surrounding policy decisions. Policy rules are too blunt to answer the questions of when and by how much policy should be adjusted. They just provide benchmarks. Moreover, they cannot incorporate tactic considerations that are quite important in actual decision making, particularly with regard to timing. *Second*, the use of policy rules has to do with the temptation of postponing necessary decisions, just because future actions may appear to do the job. Discipline in keeping track of the exact assumptions becomes even more necessary.

Communication was also adjusted. Since 2004, the Monetary Policy Report has described the broad contours of the assumed policy path, using as a way of comparison the policy path implicit in the yield curve that is available on average two weeks prior to the statistical closing date. Usually, the assumption and the market-implied monetary policy paths are similar, and the

communication simply says so. On a few occasions, however, the paths have been different and the Report has indicated so, with mild effects on the yield curve at the time of disclosure.

One issue that has been somewhat problematic in a few cases has to do with the question of what to communicate regarding the implicit longer-term monetary policy rate. If one considers model-based forecasts, this rate depends critically on the assumed level of the neutral interest rate. Market-implied rates, in turn, also have an implicit neutral rate and most probably important risk premium terms. Given the uncertainty surrounding both elements, the CBC has described the behaviour of the “next few quarters” in cases where the implicit longer-term policy rates differ too much from assumed rates. Another issue that could arise is the risk of excess precision when the implied path considers a long pause. It is clear that a path with rate hikes or cuts is uncertain in terms of both timing and the magnitude of rate changes. However, when a central bank communicates a pause, it is much more explicit, maybe more so than desirable. Finally, it is worth noting that the CBC has been clear in its communications explaining that assuming a path for monetary policy rates in its forecasts is by no means a commitment. Policy actions are decided on a monthly basis and are always data-contingent.

Role of inflation expectations

It is now standard in any IT regime to follow private-sector expected inflation indicators as an intermediate variable. The CBC is no exception. The group of indicators includes breakeven inflation, both average and forward at different maturities, estimated from CBC nominal and CPI-indexed bonds; a CBC monthly survey including 35-40 analysts of the Chilean economy; a weekly CBC survey of banks and institutional investors’ trading desks; and surveys of both households and firms. These indicators have played at least three different roles in the conduct of monetary policy. *First*, they are a very useful benchmark against which to compare internal inflation forecasts. Because of well-known technical reasons, it is not possible to simply target these expectations, so that the central bank’s own forecasts are necessary. However, internal forecasts are also subject to error, so that benchmarks are particularly useful. That said, it should be mentioned that medium- and long-term inflation expectations have converged to the inflation target with increased credibility and are almost invariant to news, which increases the need for internal forecasts.

Second, by themselves, expected inflation indicators are measures of inflation. Particularly important are household and firm surveys, which are a source of information regarding whether or not inflation is perceived to be a problem. There is the presumption that second-round effects from supply

shocks may develop with more intensity if inflation is perceived to be high. *Third*, on technical grounds, expected inflation measures are useful to evaluate the real impulse of monetary policy. *Ex ante* real rates are easily computed on the basis of expected inflation, which in turn enriches the discussion of monetary policy (although it is not an issue that can be easily communicated).

Finally, expected inflation indicators allow central banks to evaluate their credibility at any point in time. Within an IT framework this is particularly important, because ultimately the nominal anchor reflects the public's confidence that the central bank will take action to ensure that inflation converges to the target. Medium- and long-term expected inflation precisely measures this confidence. Although it is not clear how these expectations are formed, they do influence the inflation dynamics in so far as they are a benchmark for actual price-setting behaviour.

The CBC faced a particularly challenging episode regarding the credibility of the target in late 2003 and early 2004. In the midst of an unprecedented low-inflation cycle, with negative year-on-year readings for a few months explained mainly by increased competition in the retail market, long-term inflation expectations started to decline appreciably below the target. In parallel, an incipient discussion emerged in the media regarding the convenience of lowering the target from the 2-4% range to one centred in 2% or even 1%. With the evaluation that these low inflation expectations posed the risk of having a protracted period of low inflation, the CBC decided to cut interest rates in two consecutive monetary policy meetings by 50 basis points each to 2.25%. In principle, the standard determinants of inflation regularly analysed in monetary policy discussions did not justify such a bold policy action (*i.e.* there was no major news about how much slack there was in the economy, wage pressures, exchange movements, etc.). However, the behaviour of expectations was particularly worrisome, and the CBC decided to defend the target.

In principle, the CBC could have also validated a new lower target. Two types of considerations made this option problematic. *First*, there are several reasons to have a 3% target in Chile.¹⁰ Besides standard measurement problems, the zero bound restriction appeared particularly obvious in that juncture. Had the target been 2%, inflation would have been 1% or less, restricting the possibilities of monetary policy to achieve the needed stance. *Second*, it would have been an opportunistic adjustment, which would have risked future credibility if a shock with the opposite sign had to be confronted. Once the target starts to be adjusted after particular shocks, it becomes very difficult to discriminate under which conditions they are appropriate or not. Once a permanent target has been set, new adjustments should be carefully analysed and communicated, possibly with considerable time in advance. This is

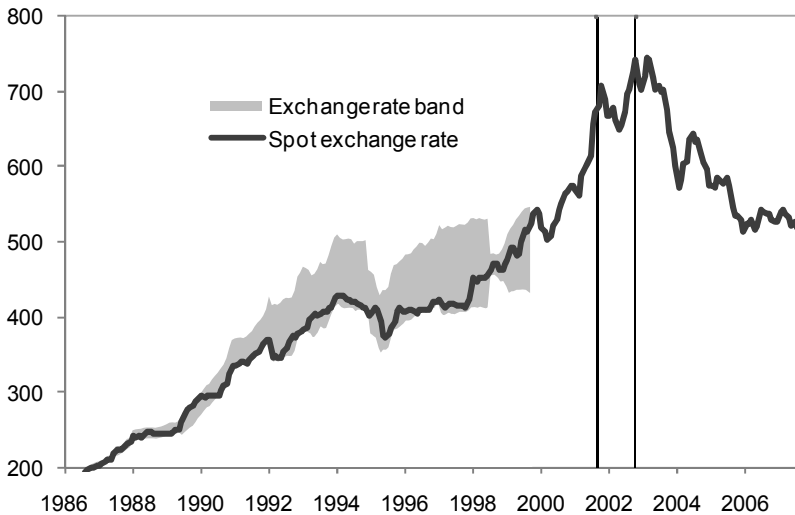
particularly important for economies that have, like Chile, a relevant portion of CPI-indexed instruments in the financial system.

The exchange rate

The exchange rate regime differed markedly between the two phases of IT. As mentioned above, the CBC maintained a target range during the 1990s and a floating-rate regime after 1999 (Figure 3.9). Their assessment and the transition between these regimes are fascinating topics by themselves and go beyond the scope of this chapter.¹¹ However, during the fully-fledged IT period there are at least three issues regarding the interactions of monetary and exchange-rate policies that deserve a few words: market interventions, the relevance of the exchange rate for inflation forecasts, including how to incorporate exchange-rate assumptions and views of its likely path within the formulation and communication of forecasts, and changes in the sensitivity of monetary policy to exchange-rate shocks.

Figure 3.9. Chile: Exchange rate and target band, 1986-2007

CLP per USD, the vertical lines show interventions during the floating regime



Source: Central Bank of Chile.

Together with letting the peso float, the CBC reserves the right to intervene in “exceptional circumstances”: when there is an overreaction of the exchange

rate that could be damaging to the economy. Furthermore, when it intervenes, the CBC has to be comfortable that this action will have a good chance of moderating the overreaction.¹² An overreaction of the exchange rate could require movements in the policy interest rate in the opposite direction to that suggested by fluctuations in the output gap and their implied inflationary pressures. Therefore, interventions can be seen as a first line of defense during periods of inflationary (deflationary) pressures before adjusting monetary policy. The CBC has explicitly recognised that detecting an exchange-rate overreaction or overshooting is quite difficult. In the end, determining exceptional circumstances or whether the exchange rate is overreacting is a judgment call by the central bank's board. However, it is an informed call grounded on a thorough analysis based on different perspectives (see Caputo and Valdés, 2007, for a review of methodologies used in practice).

Between 2000 and 2007, the CBC intervened on two occasions: August 2001 and October 2002. The episodes coincided with financial turmoil stemming from the convertibility crisis in Argentina in 2001, further enhanced by the economic effects of the 11 September attacks and turbulence in Brazil around the presidential election of 2002. Interventions were implemented through a pre-announced package with a fixed four-month terms and maximum amounts to be used in spot transactions and the issuance of US dollar-indexed bonds. According to Tapia and Tokman (2004), the announcement itself had a relevant effect on the exchange rate.

On the issue of how to incorporate the exchange rate on inflation forecasting exercises, the CBC has used standard estimates from open-economy Phillips-curve equations. As has been the case elsewhere, different statistical approximations show that the pass-through coefficient has declined substantially during the past 10 to 15 years. Currently, the central forecasting model has an implicit pass-through coefficient of between 20% and 30% in a two-year horizon. More interestingly, perhaps, is the incorporation of assumptions about the path of the exchange rate in forecasting exercises. The nominal path has been completely endogenous, which is consistent with price setting. By contrast, the long-run real exchange rate is defined as an external input, after intense scrutiny. In particular, a variety of real exchange-rate models informs the decision on whether the current real exchange rate can be considered to be very different from fundamentals. If not, that same exchange rate is considered as the long-run one. The dynamic path, in turn, is determined through an uncovered interest parity relationship, with some degree of inertia. If the current real exchange rate differs from long-run estimates, then the long-run real exchange rate assumption incorporates an add-factor adjustment.

As regards the communication of the exchange-rate assumption, the CBC's Monetary Policy Report has presented the broad contours of the exercise described above. For example, in cases in which there has been no expected real exchange-rate adjustment, the Report has stated that, as a technical assumption, the real exchange rate would not change significantly and would therefore not affect the forecast. It has also reminded readers that in a floating-rate regime it is very likely that the exchange rate would move. In the few cases where the assumption has included a certain degree of real exchange-rate adjustment, the Report has incorporated it explicitly, albeit with little market reaction.

Finally, concerning the monetary policy reaction to exchange-rate innovations, the evidence shows that during this decade there has been very little interest rate reaction beyond the effects of the exchange rate on inflation and the output gap. Specifically, policy rule estimates show no reactions to the exchange rate, either real or nominal, once inflation and slack are taken into account. This contrasts with the experience of the 1990s, for which rule estimates show a statistically significant policy reaction to the exchange rate, albeit economically modest. For instance, Caputo *et al.* (2006) estimate on the basis of Bayesian methods a Stochastic Dynamic General Equilibrium model for the Chilean economy allowing for different monetary policy rules in 1990-99 and 2000-05. The results indicate that, although monetary policy reacted somewhat to real exchange-rate innovations in the second sample period, this effect was one-half the size of the one estimated for first sample period.¹³ These findings are consistent with CBC statements. The Monetary Policy Report justifies interest-rate adjustments precisely as a reaction to inflation-forecast deviations from the target. The monetary policy communiqués and the Reports have also been consistent with this premise. This again contrasts with the experience of the 1990s, when there was an explicit (ceiling) target for a current-account deficit, which in turn translated into a target for the real exchange rate.

Conclusions

It is difficult to dispute the claim that IT has served Chile well. Key institutional developments and IT have together allowed the country to achieve sustainably low inflation. Furthermore, the 3% target has become an effective nominal anchor and monetary policy enjoys considerable credibility. Despite this success, it is difficult to know how much of the “great moderation” observed in Chile is due to IT. However, at the moment this paper is being written (October 2007), inflation increased substantially to around 6% (year on year), mainly due to a series of supply shocks. In this challenging environment, long-run nominal and break-even interest-rate differentials have not increased materially, demonstrating the importance of the anchor.

The Chilean experience also shows that IT is a monetary policy framework that is far from being rigid. On the contrary, it raises the possibility of self discovery, improvements and learning. We have discussed here four particular areas and issues in which the CBC has innovated. There have been others and most probably many others will come.

Notes

1. Céspedes and Valdés (2006) revisit the CBC's experience with autonomy.
2. This section draws from Céspedes *et al.* (2006).
3. See Marcel *et al.* (2001) for more information on the fiscal rule.
4. Ochoa (2008) estimates efficient frontiers for monetary policy in Chile and shows that both the frontiers and actual efficiency improved with IT.
5. The December reference became so entrenched that even today, after eight years of a rolling target, the press and some analysts evaluate the CBC's performance on the basis of the December (year-on-year) inflation rate.
6. See Central Bank of Chile (2000). The document had many features in common with that of the Bank of England describing the monetary policy regime in the United Kingdom.
7. Gredig *et al.* (2007) discuss from different angles the definition of the policy horizon and its rationale and evaluate these forecasts.
8. Before the Monetary Policy Reports, during Phase 1, the CBC used to publish the annual target in September but did not release a clear path for future monetary policy.
9. In contrast with the exchange-rate path assumption, that was not made explicit.
10. See Central Bank of Chile (1997) for more information.

11. See Morandé and Tapia (2002) for a description of the exchange-rate regime at the time of the target band and De Gregorio *et al.* (2005) for a description of the floating period.
12. See Box II.4 in the January 2003 *Monetary Policy Report* and Central Bank of Chile (2007).
13. They also find that in the second period a larger fraction of wages were adjusted following a passive rule based on the IT target.

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List of acronyms

ADF	Augmented Dickey-Fuller Test
AR	Autoregressive Model
BCB	Central Bank of Brazil (<i>Banco Central do Brasil</i>)
BER	Bureau for Economic Research
BI	Bank Indonesia
BIS	Bank for International Settlements
BRSA	Banking Regulatory and Supervisory Agency
CBC	Central Bank of Chile
CBT	Central Bank of Turkey
CDT	Colombian Interest Rate (<i>Certificado de Depósito a Término</i>)
CETES	Mexican Interest Rate (<i>Certificados de la Tesorería de la Federación</i>)
CMN	Brazilian National Monetary Council (<i>Conselho Monetário Nacional</i>)
CNB	Czech National Bank
COPOM	Brazilian Monetary Policy Committee (<i>Comitê de Política Monetária</i>)
CPI	Consumer Price Index
CPIX	Consumer Price Index (excluding mortgage interest costs)
DSGE	Dynamic Stochastic General Equilibrium
EMBI	Emerging Market Bond Index
FAVAR	Factor-Augmented Vector Autoregressive Model
FDI	Foreign Direct Investment
FIML	Full Information Maximum Likelihood
FPAS	Forecasting and Policy Analysis System
FTO	Fine-Tuning Operations
GDP	Gross Domestic Product
GNP	Gross National Product
IGP-DI	Brazilian General Price Index (<i>Índice Geral de Preços - Disponibilidade Interna</i>)

IMACEC	Chilean Monthly Economic Activity Index (<i>Indicador Mensual de Actividad Económica</i>)
IMF	International Monetary Fund
IMT	Inflation Management Team
INPC	Mexican Consumer Price Index (<i>Índice Nacional de Precios al Consumidor</i>)
IPC	Chilean and Colombian Consumer Price Indices (<i>Índice de Precios al Consumidor</i>)
IPCA	Brazilian Consumer Price Index (<i>Índice Nacional de Preços ao Consumidor</i>)
IRF	Impulse Response Functions
IT	Inflation Targeting
M-GARCH	Multivariate Generalised Autoregressive Conditional Heteroskedasticity Model
MPC	Monetary Policy Committee
MPR	Monetary Policy Report
OMO	Open-Market Operations
PP	Phillips-Perron Test
QPM	Quarterly Projection Model
SADC	Southern African Development Community
SARB	South African Reserve Bank
SBI	Bank Indonesia Certificates (<i>Sertifikat Bank Indonesia</i>)
SDIF	Savings Deposit Insurance Fund
SEE	Survey of Economic Expectations
SELIC	Brazilian Policy Interest Rate
SIC	Schwarz Information Criterion
TJLP	Brazilian Long-Term Interest Rate (<i>Taxa de Juros de Longo Prazo</i>)
TPM	Chilean Policy Interest Rate (<i>Tasa de Política Monetaria</i>)
TR	Brazilian Reference Interest Rate (<i>Taxa Referencial de Juros</i>)
UF	Chilean <i>Unidad de Fomento</i>
VAR	Vector Autoregressive Model
VMA	Vector Moving Average

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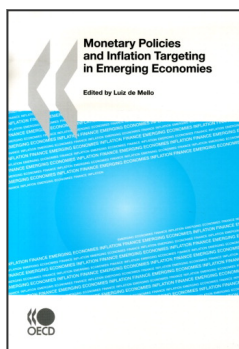
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