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# 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

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- The nature of the inflation shock

Expectations and the policy response

Challenging times for Inflation Targeting



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- The nature of the inflation shock

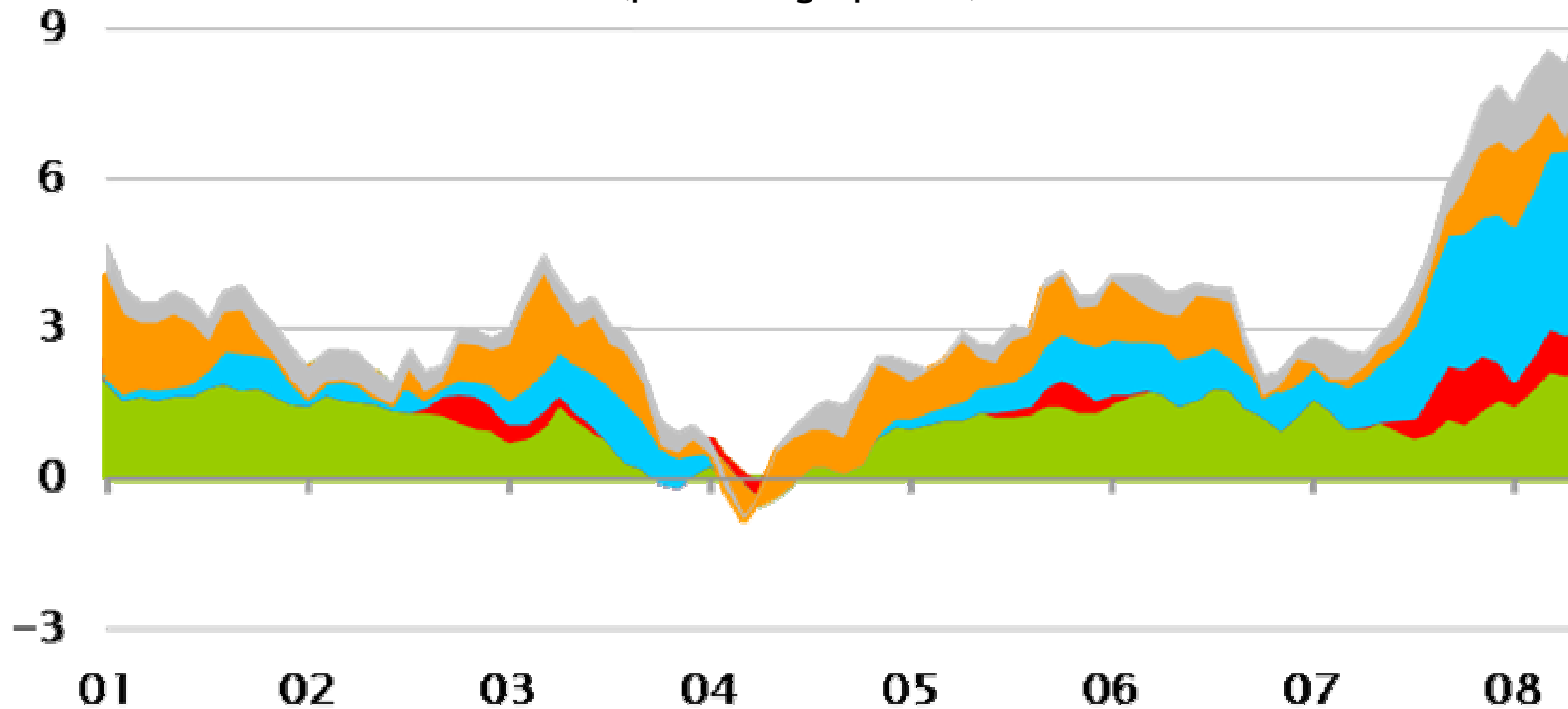
Expectations and the policy response

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)

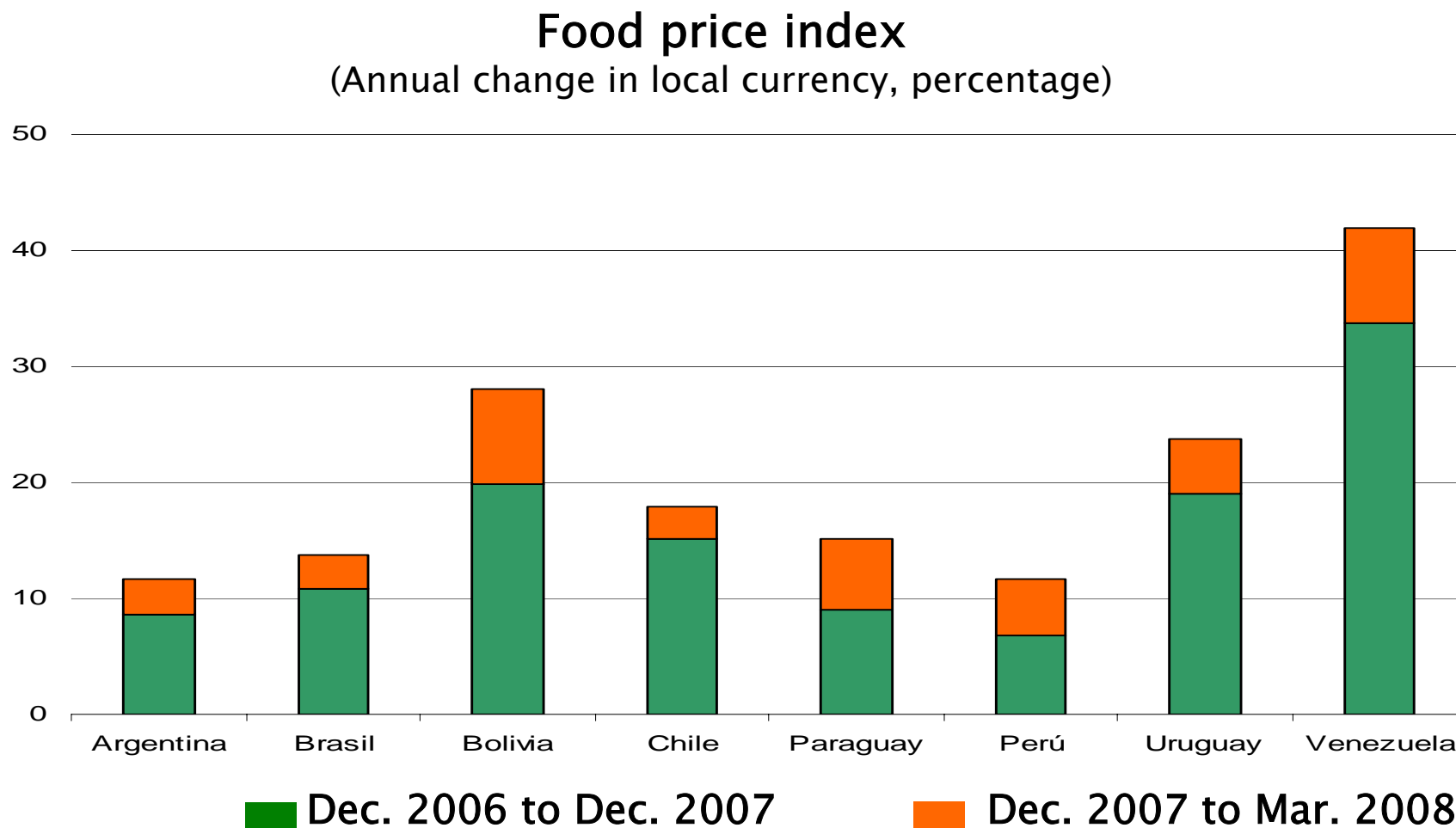


- Fresh fruits and vegetables (3,77%)
- Rest (63,25%)
- Public services (5,51%)
- Fuels (3,97%)
- Food without fresh fruits and vegetables(23,5%)

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



# This is not unique to Chile



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



# Idiosyncratic shocks have occurred in most analyzed countries

## Food prices affected by idiosyncratic shocks

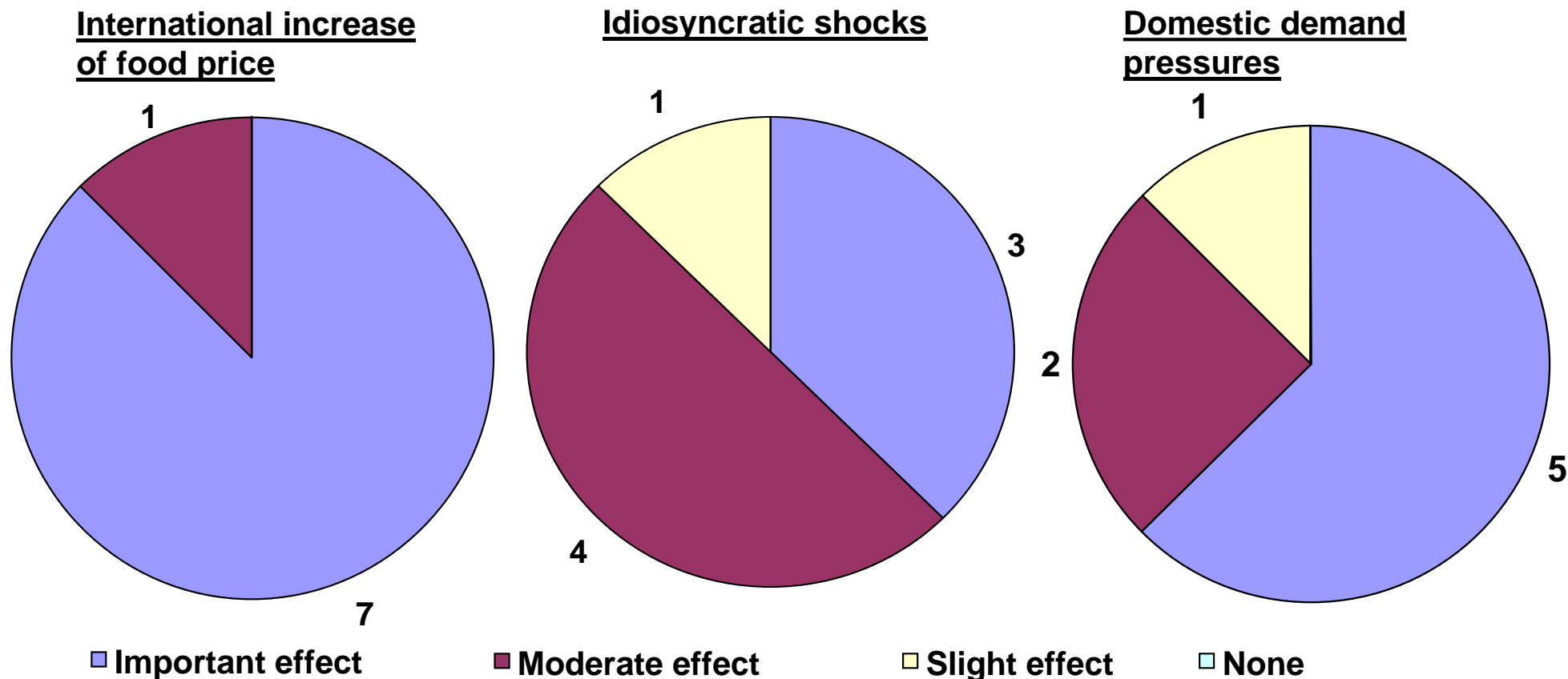
	<u>Argentina</u>	<u>Brazil</u>	<u>Bolivia</u>	<u>Chile</u>	<u>Paraguay</u>	<u>Peru</u>	<u>Uruguay</u>	<u>Venezuela</u>
Important effect:	Vegetables and fruits	Kidney beans	Tomato, beef and pea	Fresh vegetables, fresh fruits and vegetables		Papaya, fresh vegetables, tomatoes and other vegetables	Fruits 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



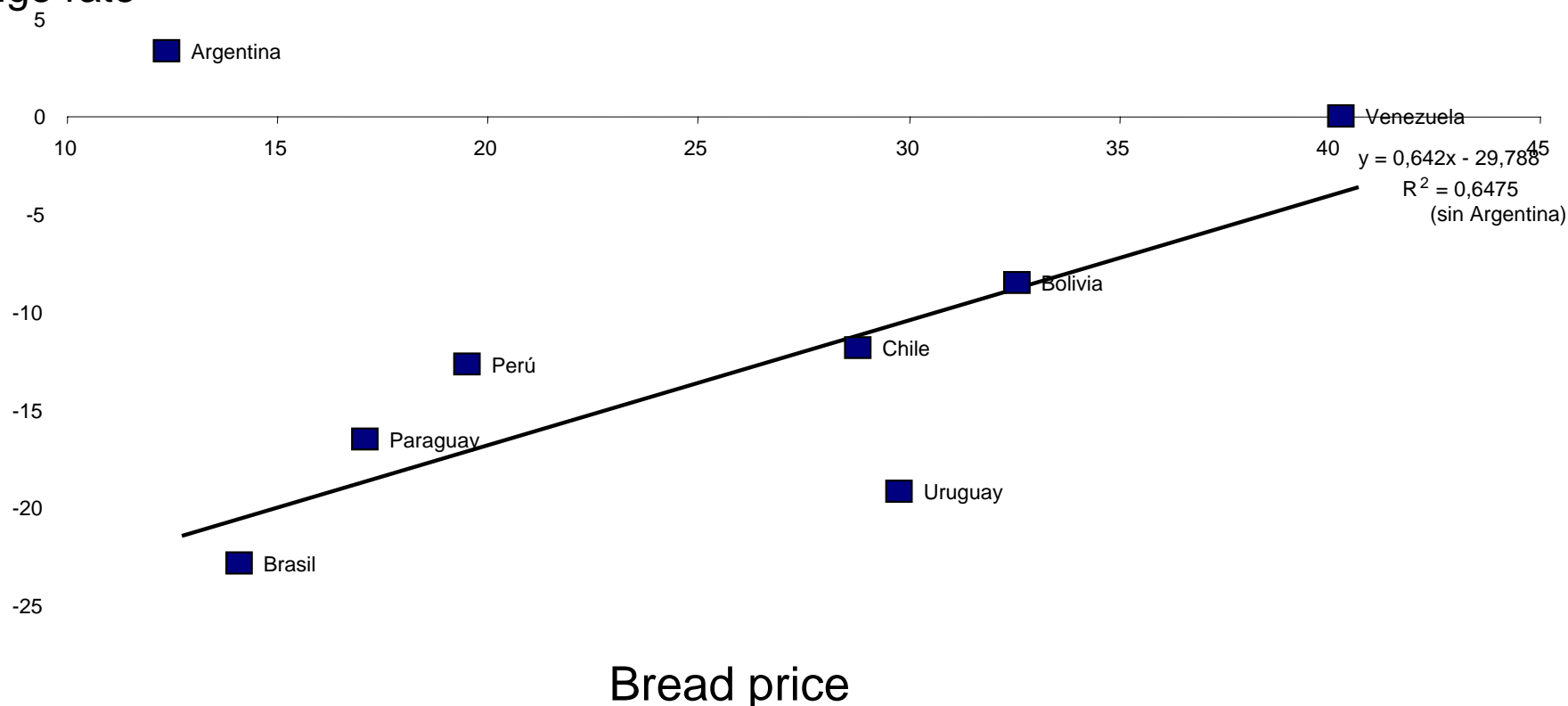
Source: Magendzo (2008) from Survey on increases in food prices,



# 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

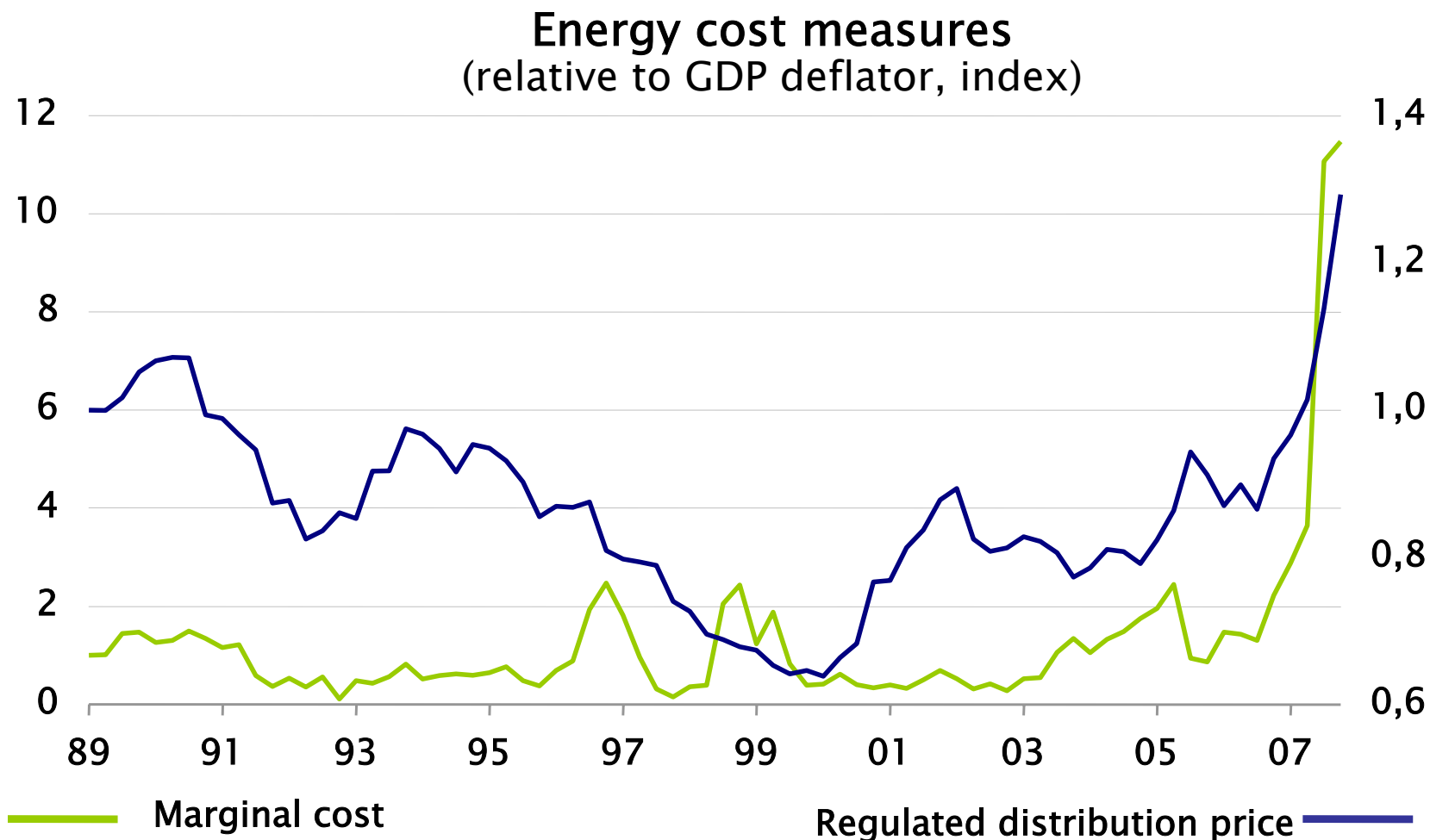


Source: Magendzo (2008) from Survey on increases in food prices,





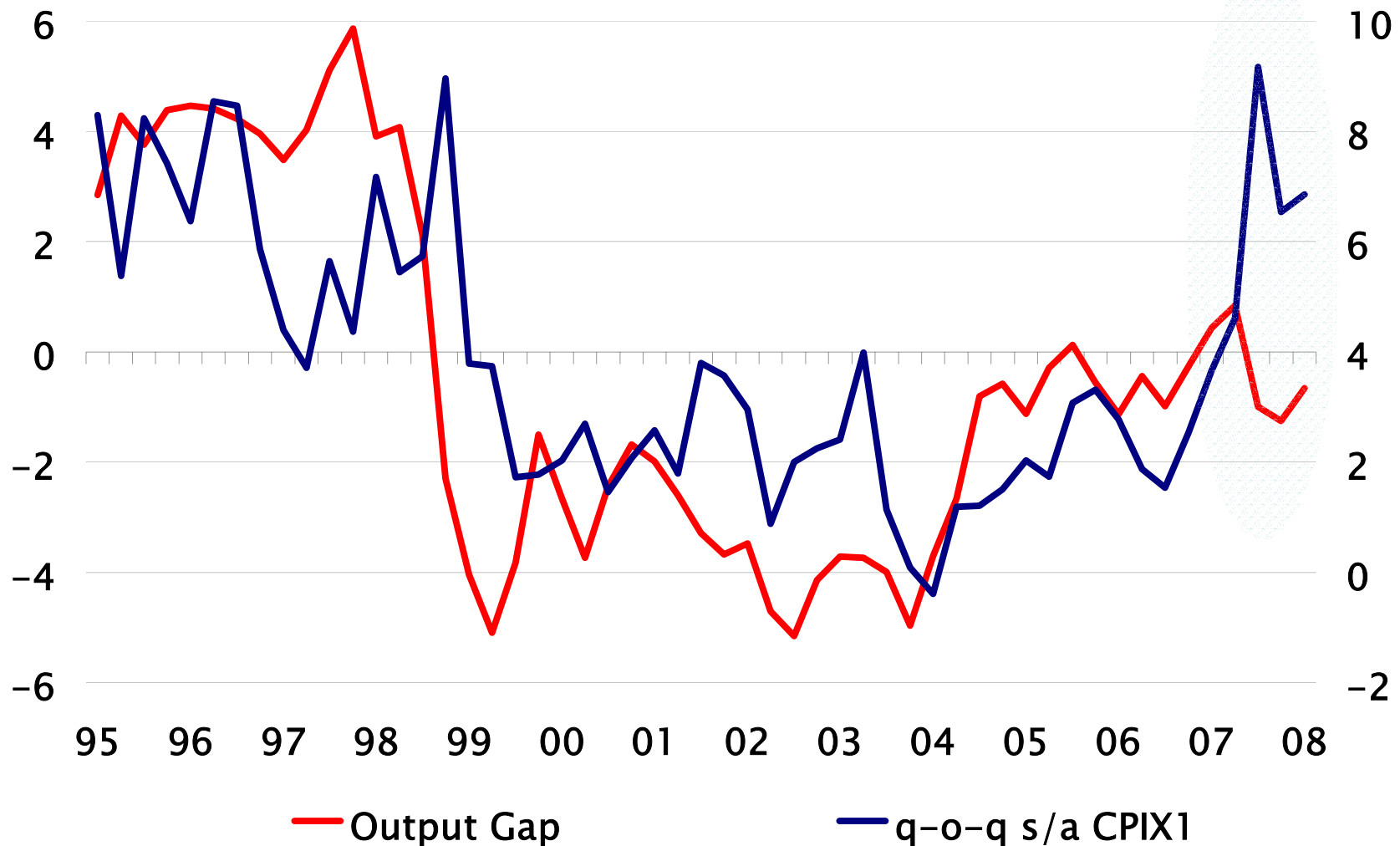
# Shift in generation away from hydro and gas towards diesel, along with hikes in oil prices, have led to sharp increases in energy costs.



Source: Central Bank of Chile



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



Source: Central Bank of Chile



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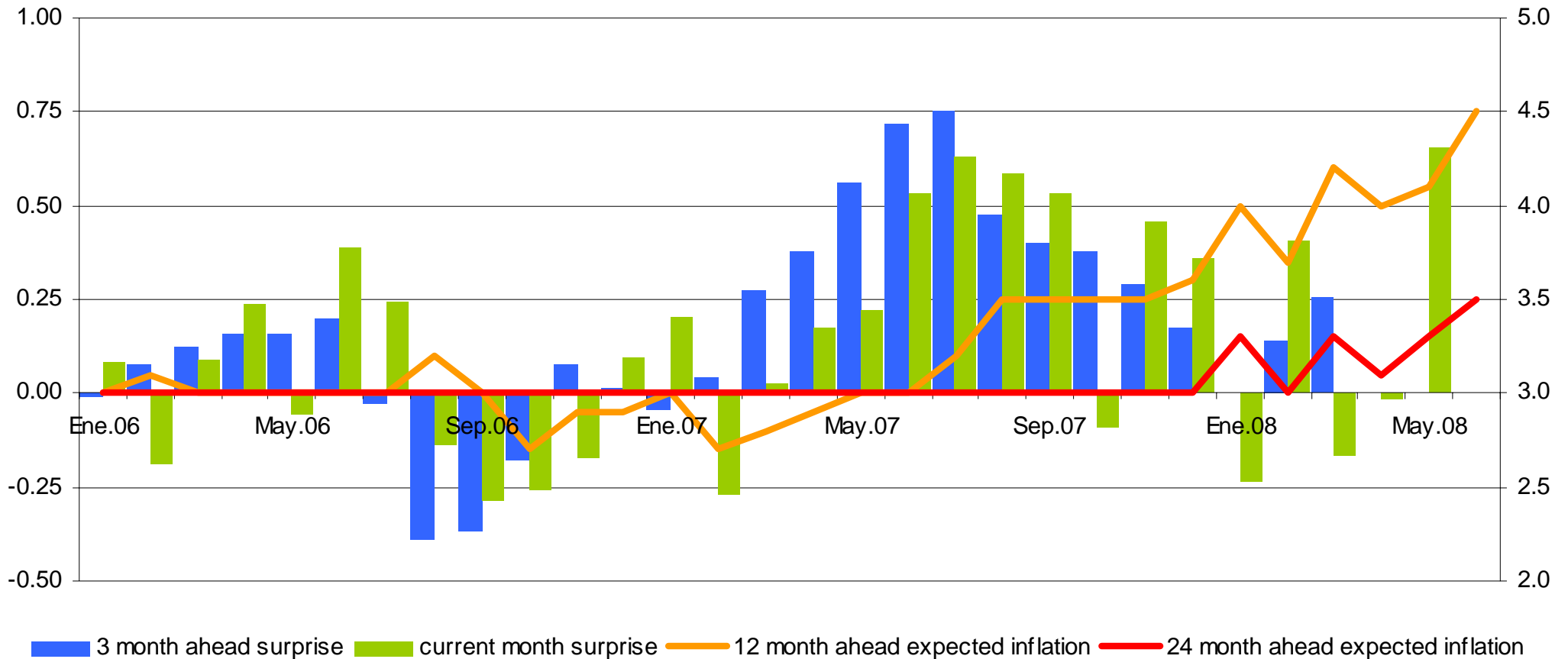
- The nature of the inflation shock

## Expectations and the policy response

## Challenging times for Inflation Targeting



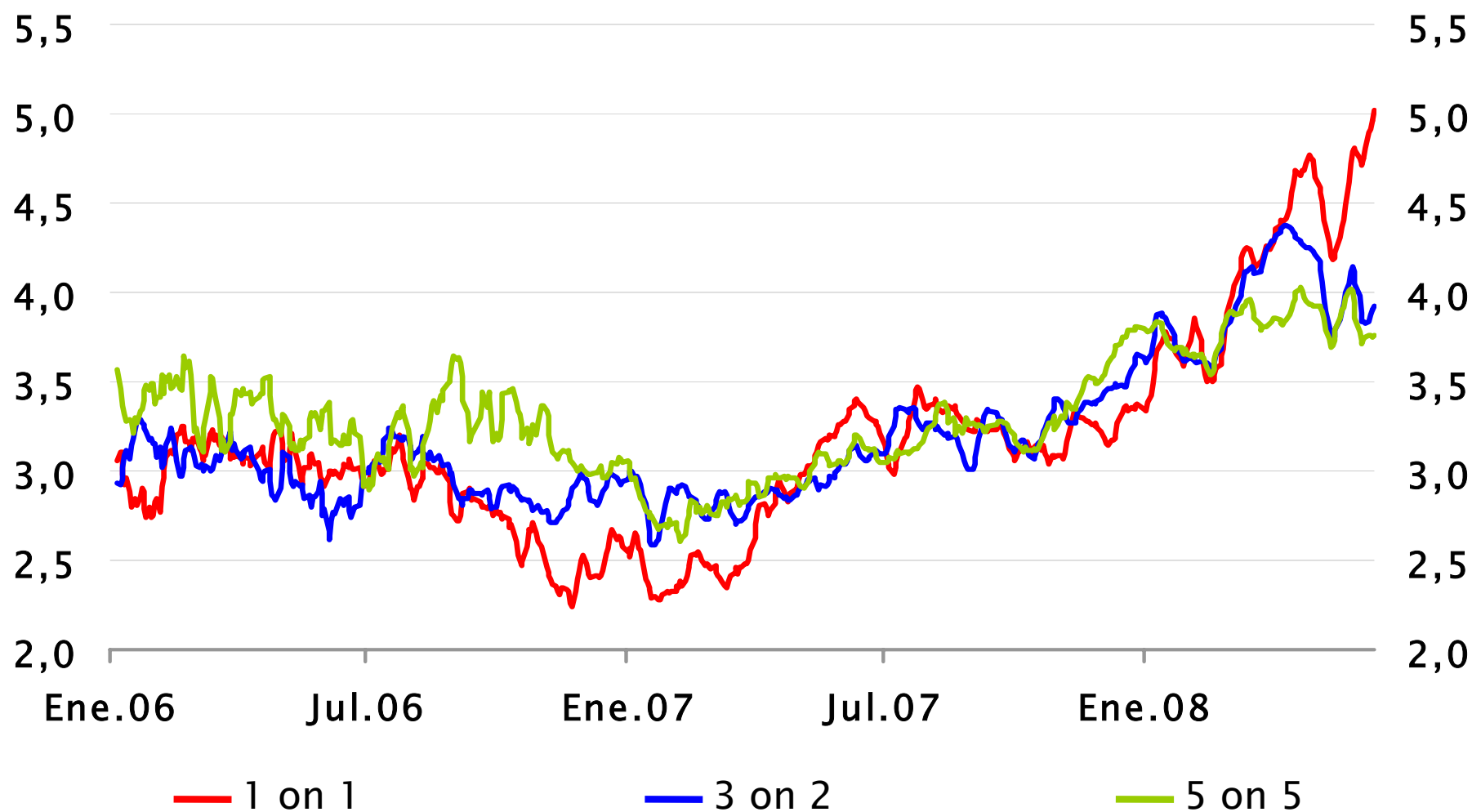
# Inflation surprises led to a gradual shift in expected inflation in monthly survey



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



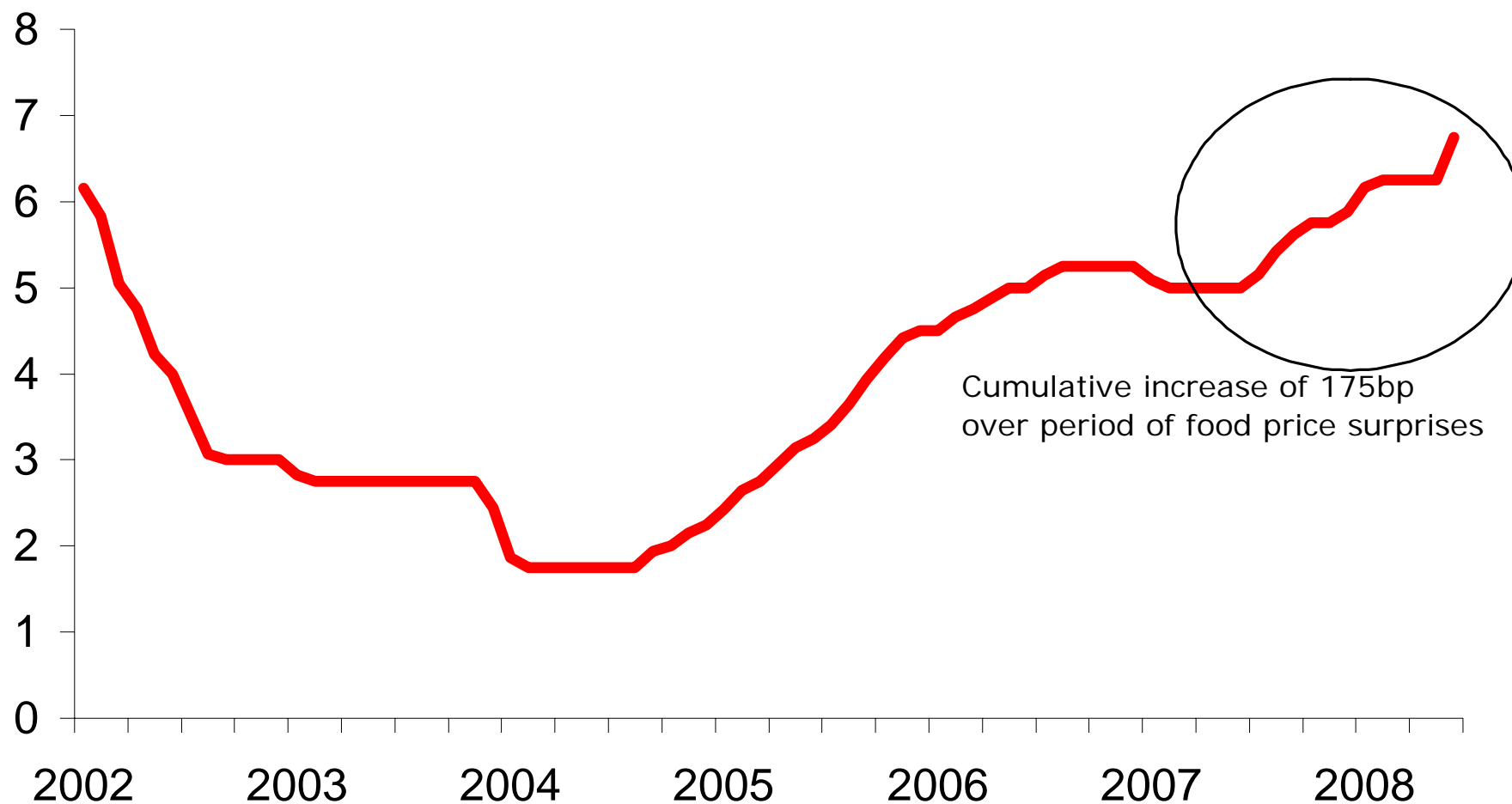
# Break-even inflation tenors have also risen, affected by expectations and significant inflation risk premia



Sources: Central Bank of Chile and Bloomberg.



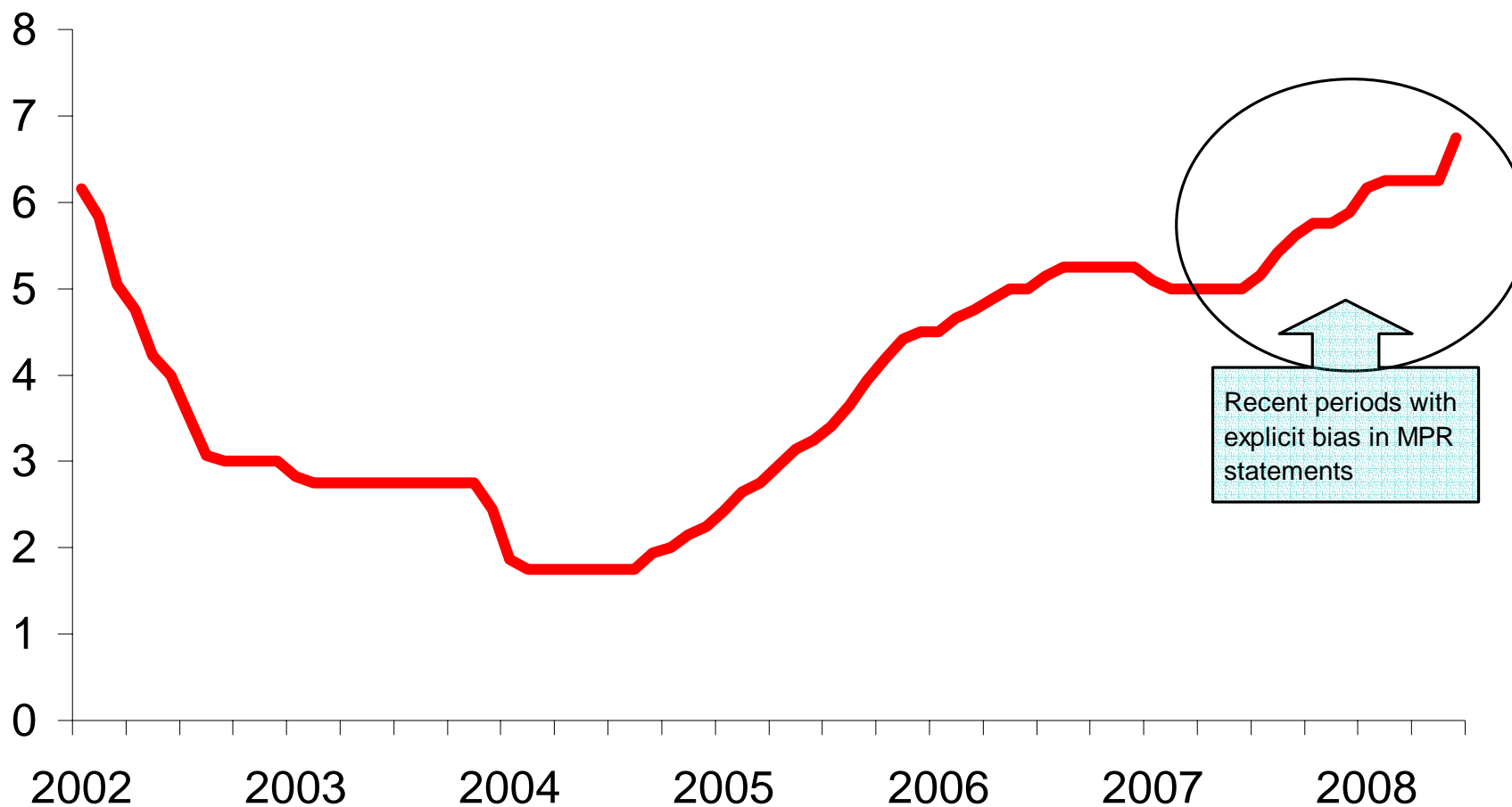
# Monetary policy stance has been shifted by a cumulative 175bp since mid 2007



Source: Central Bank of Chile.



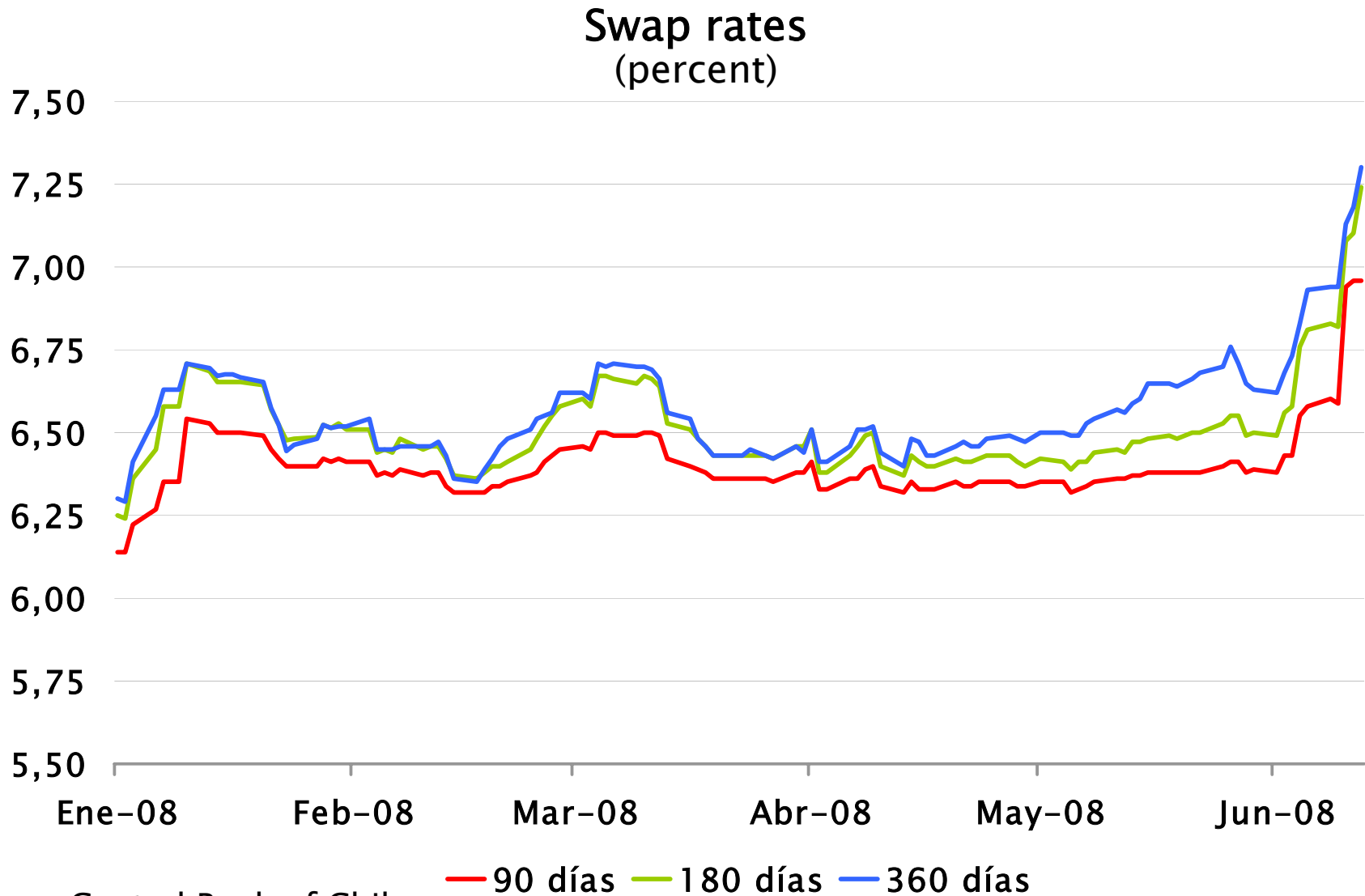
# MPR statements have used explicit biases



Source: Central Bank of Chile.



# The market is pricing further hikes



Source: Central Bank of Chile





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## Challenging times for Inflation Targeting



# Challenges for Inflation Targeting

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- Consistency with intervention policy

Adjusting communication to large deviation from target



# Consistency with intervention policy

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## **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:**

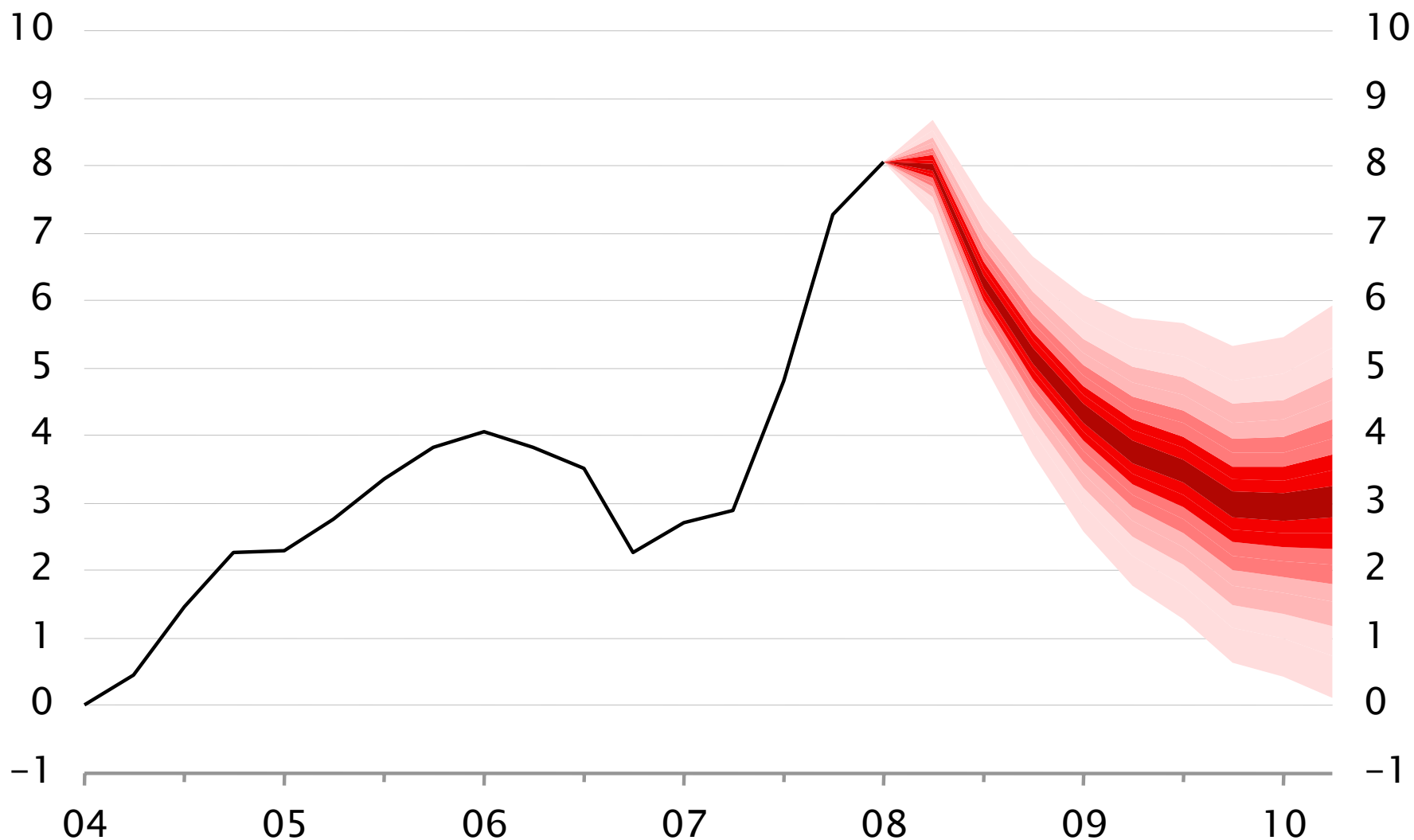
- **Investment in stability**
- **Role of forex liquidity provision with the Central Bank, not the fiscal authority through SWF**
- **Mechanic implementation: USD50 million daily for eight months**
- **No target for the exchange rate**

## **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

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**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

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**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**



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