Chile Reverses on Monetary Normalization

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- Chile began monetary normalization in 2018 but introduced a pause earlier this year.
- Recently, the central bank suddenly reversed monetary course by implementing a rate cut.
- The probability of a monetary mistake rises when policy decisions are based on an estimation of the output gap.

When monetary policymaking is based on the output gap, which depends on the estimation of potential output—a non-observable variable—then monetary decisions are subject to a high probability of error: Mistakes can be made.

At the beginning of June, the Central Bank of Chile suddenly decided not only to break its monetary pause but also to put in reverse the monetary normalization by implementing a rate cut of 50 basis points. The announcement might have produced no more than simple surprise, but the main argument used to justify the decision has generated negative reactions and raised the probability of a monetary mistake.

Normalization, pause and reversal

After 17 months of keeping the policy rate at 2.5%—May 2017 through September 2018—the central bank began the normalization of monetary conditions after the prolonged money expansion. It hiked the policy rate by 25 basis points in October 2018 followed by another 25-basis point hike in January of this year, putting the rate at 3%. The central bank had also outlined the path of increases for 2019, with the goal of reaching the neutral range of 4% to 4.5% by 2020.

But given the economy's deceleration during the first quarter of 2019, and with an inflation rate stationed below the 3% target, the central bank then signaled a monetary pause through the year. While economic activity was showing signs of converging to potential growth, after the over-expansion in 2018, one part of the market and the central bank were seeing a weakening economy, thus reinforcing the idea of prolonging the pause.

However, during its monetary policy meeting on June 7, the central bank committee made the surprise decision to cut the policy rate by 50 basis points to 2.5% under the argument that the economy's slack had widened as a result of new estimates of potential output. The bank stated that potential growth had increased by 25 basis points, while the neutral interest rate had decreased by 25 basis points. Based on that, the bank concluded a rate cut of 50 basis points was necessary to help the economy close the negative output gap.

Potential issues

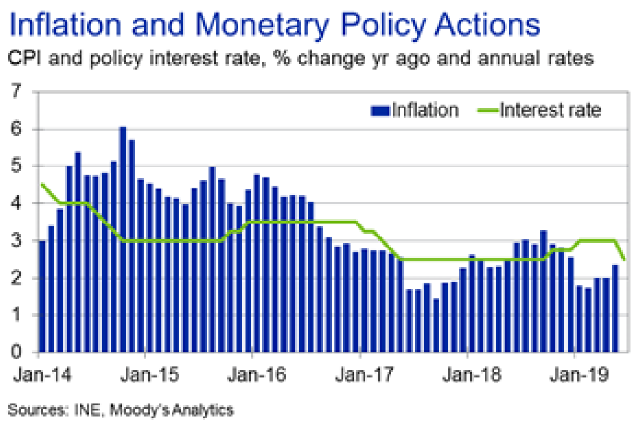
The monetary decision raises two potential issues that introduce doubts about Chile's policymaking. First, central banks generally do not cut the interest rate just at the moment that they get new estimates of potential output, precisely because those estimates are heavily dependent on subjective components. Second, and more important, a monetary policy that highly depends on the estimates of a non-observable variable (potential output) can lead to wrong monetary decisions. This is because the estimates of potential output can vary as new data on economic activity become available or when the assumptions of future variables are modified. In fact, a negative output gap in a particular period can turn positive for the same period as a result of historical data revisions.

A research paper that was published in 2016 in the Journal of Policy Modeling illustrates the cases of Mexico and Chile taking monetary decisions based on underestimates of the output gap. In the case of Mexico, the central bank cut the policy rate based on the argument of a nonexistent output gap in 2013. In Chile, the estimation of potential output in 2013 indicated a zero output gap, but national accounts later reported increasing excess demand. In both countries the policy rate was cut, but new observed data a year later indicated the existence of a positive output gap—the presence of excess demand.

Hence, monetary policy actions based on the estimates of the output gap can lead to wrong decisions, but the worst comes when the monetary measure changes the course of the monetary plan just because policymakers have new estimates of potential output. In this case, either the monetary reversion indicates that monetary actions taken previously were wrong—so there was a need to correct the monetary course—or the near future will prove that the latest monetary decision was wrong. In any case, Chile's monetary decision to cut the policy rate seems to be premature and also poorly justified.

Excess demand

In addition, observed data from aggregate demand show that Chile's economy has been running with increasing excess demand since 2017, reaching 1% of GDP in 2018 from 0.3% in the previous year, and remaining positive in the first quarter of 2019. This excess demand is consistent with the prolonged monetary expansion.



However, inflation has not shown signs of acceleration because of the recent change of methodology that reduced annual inflation by almost 1 percentage point since the beginning of 2019, so that inflation remains around 2%. However, the presence of excess demand raises the risk of demand pressures on prices if the monetary expansion persists.

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