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ESTIMATING GAPS AND TRENDS FOR THE CHILEAN ECONOMY

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Resumen

Los componentes de tendencia y de brecha del PIB constituyen piezas claves para la evaluación y proyección de modelos estándar de política monetaria. Sin embargo, la medición de estas variables está plagada de dificultades. En este trabajo se proponen dos enfoques diferentes. El primero consiste en un análisis basado en los datos, que tras hacer las estimaciones primal y dual del crecimiento de la productividad total de los factores (PTF), ocupa una variedad de procedimientos para filtrar sus insumos. El segundo estima simultáneamente las dinámicas macroeconómicas y las tendencias subyacentes en la economía a través de un enfoque consistente con los modelos de crecimiento. Finalmente, se comparan las dificultades de usar cada metodología de construcción de medidas de brecha productiva y de crecimiento potencial para Chile.

Abstract

Trend GDP and the output gap are key inputs for policy evaluation and forecasting in standard models of monetary policy. However, the measurement of these variables is plagued with difficulties. In this paper we propose two different approaches. First, a data-based approach, that starts with the primal and dual estimates of total factor productivity (TFP) growth, and then uses a variety of procedures to filter the inputs. Second, a model-consistent framework that simultaneously estimates the macroeconomic dynamics and the underlying trends of the economy. We compare the difficulties in using each methodology, and we use them to construct measures of the output gap and potential growth for Chile

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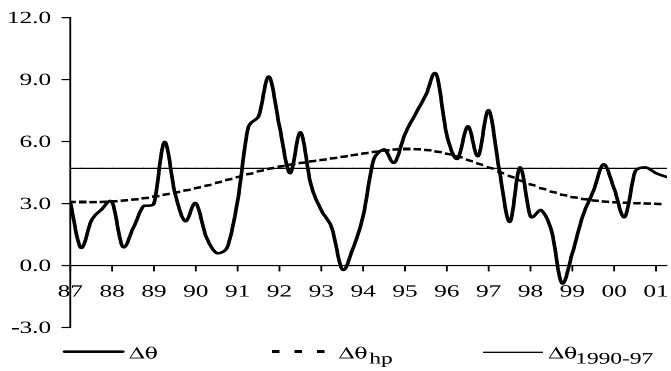
1 Motivation

Over the last few years the Chilean economy has experienced a marked deceleration in economic growth. Labor productivity growth averaged more that to 6% annually over 1994 to 1997, but since 2000 it reaches between 3% and 4%. Moreover, the time span since the outbreak of the Asian and Russian crises in 1997 and 1998 seems to indicate that more than purely cyclical factors are at play in determining the expansion of productivity and the recent rates of aggregate growth: monetary policy has shifted to a clearly more expansionary stance, and long term interest rates have declined sharply in real terms since 1999.

Figure 1: **Growth Rate of Aggregate Labor Productivity**



1.1 Why do we need output gap measures?

The debate on whether the current and forecasted rates of growth of the Chilean economy in the short terms reflect a shift in the underlying expansion of productivity or are only a symptom of weak aggregate demand reflects the difficulties in separating trends from cycle. The same can be said about the different opinions regarding the size of current slack in capacity utilization. This is unfortunate though, because these two variables are key inputs in the formulation of monetary and fiscal policy. On the one hand, the current slack in factor and goods markets determines the present underlying inflationary tendencies, through their impact on wages and markups. On the other hand, the expansion of capacity utilization over the next quarters or years affects the trends in these inflationary pressures.

Given that since 1999 monetary policy in Chile is guided by what has been called "forecast inflation targeting", in which the current stance of monetary policy is endogenous to the expected or forecasted path of prices, erring on one side or the other of the side of the output gap or trend growth can affect the achievement of the inflation target. Moreover, unlike supply shocks or relative price shocks such as oil prices and the exchange rate, which are immediately observed, the uncertainty about the true extent of underlying price and wage pressures is only lifted when it is too late to act with monetary policy. The transmission mechanism of monetary policy to inflation through the labor market is the one that is likely to have the longest lags.

On the fiscal policy side, difficulties are similar. The current framework in Chile aims at the achievement of a structural surplus of 1% of GDP over the cycle. Therefore, the yearly discussion of the budget requires an actual quantification of the size of the output gap, to fix the path of real expenditure. Again, using assumptions about the gap or trend growth over the short run can introduce a bias in fiscal policy, inducing too much or too little aggregate demand impulse, relative to what is deemed convenient.

Unfortunately, the construction of output gap measures is plagued with difficulties. A first approach, that we tackle on the second section of this paper and call data-based, relies on a two-step procedure. First, using traditional growth accounting exercises, a measure of total factor productivity (TFP) is obtained. Then, potential output is defined as the result of assuming that inputs (labor and capital) are at their normal or trend utilization rates. It is apparent then that this procedure is sensitive to assumptions in both steps. First, an accurate measurement of *actual* inputs used in the production process includes issues such as shifting quality and composition of both labor and capital, as well as time varying utilization rates that should not be accounted for as TFP fluctuations. Then, in the second step assumptions about the *trend* or *normal* use of inputs must be made, to go backwards and then estimate potential output.

In simple terms, and leaving aside the measurement issues related to quality trends, the data-based approach actually requires identifying a-priori the cyclical and trends component in the data. A typical case is the capital utilization rate, usually associated with the unemployment rate since Solow's classic exercise. Then, to construct potential output (an exercise that Solow did not pursue), the production function is evaluated at a "normal" utilization rate (i.e. the "natural" unemployment rate, defined in a particular way). Thus, it is paradoxical that the key identification assumption corresponds closely to the result of the calculation. By going through the two steps mentioned above we do not pretend to circumvent these difficulties, but hope that we will highlight the type of assumptions needed for this approach.

To complement the data-based estimates, the third section uses a simple empirical methodology to directly estimate the output gap from aggregate demand and aggregate supply macro models. Given that the output gap measures are typically used as inputs of a macro model such as the one we use, the simultaneous estimation through state-space techniques of the macroeconomic variables and the underlying unobserved level of the output gap provides an interesting alternative to the data-based approach.

This model-consistent estimate still requires some identification assumptions. The first one is the actual specification of the macroeconomic model, particularly the functional form and the excluded variables. This is unavoidable though, given that the output gap measures themselves are used in the context of specific models of the macroeconomy. The other main identification assumptions relates to the assumed volatility of output trend.

1.2 Related work

The interest in potential growth is not novel in Chile. However, most of the research refers to the period previous to 1997, and in general does not acknowledge the importance of the specific identification issues that surround the estimation.

Combining two different analysis - growth accounting and regression analysis - Roldós (1997) examine economic growth determinants and the relation between economic growth and inflation pressures. He estimates an aggregate production function using a cointegrating vector, that relates total GDP and production factors - capital and labor - adjusted by quality indexes. These indexes measure changes in composition of the production factors that make aggregate factors more productive. The factor shares obtained from the estimation of the production function allow to calculate the Solow's residual or the TFP (Total Factor Productivity). Through a Hodrick-Prescott (HP) filter the cyclical components of the TFP and employment are removed for estimating the potential output.

Roldós however did not find a positive correlation between output gap and inflation, but rather a small negative one. He interprets these results as a product of the high average inflation over the nineties. However, he does not control for movements in the exchange rate.

Rojas et al. (1997), make a similar exercise of a growth accounting model, considering not only capital and labor as production factors, but also the contribution of international trade to growth. They try to estimate the contribution of the increasing commercial integration of Chile in the last decades to effective and potential growth. The study calculates the potential output of the Chilean economy during 1960-1996.

Using a cointegration focus, this paper estimates a production function that considers capital and labor - corrected by grade of utilization and by quality indexes - and a variable of terms of trade that controls for fluctuations of international prices faced by the economy. To calculate the potential output it is used a cointegration vector with the series of labor, capital, terms of trade and comercial integration, all filtered by HP.

As we see, it is typical to filter the series to obtain a measure of the gap. It is questionable however how much this differs from directly filtering the GDP data. (Figure 1)

Other studies, that do not use filtering methods, still imply strong identification assumptions. Marfán and Artiagoitía (1989) use linear programming techniques to obtain a measure of the gap. However, they in fact impose a production function that is linear in capital. García (1995) uses an indirect approach: he estimates a labor demand function to identify the parameters of the production function. Potential output is then defined as output at full employment. Hence, the gap is the mirror image of the unemployment rate. Jadresic and Sanhueza (1992) also identify the output gap in a similar way, by assuming an increase in the natural rate of unemployment by the late seventies and early eighties.

Coeymans (1999) does not estimate a measure of potential output, rather focusing on a sources of growth approach to measure trends in GDP. He estimates a production function, which growth determinants are centered in the aggregate supply factors: capital accumulation, hiring of new workers, TFP factor.[1] Assuming constant scale returns, this analysis shows an important cyclical component in productivity. The high correlation between productivity and external shocks (terms of trade, impact of international interest rate over financial services and external crisis index) reveals the importance of this shocks as principal determinants of productivity cycles and output.

A related effort is Nadal-de-Simone (2001), who estimates a small macroeconometric model using state-space techniques similar to the ones used here. The main difference with his work is that, while he uses an approach based uniquely on unobserved trends in GDP, we incorporate more structure on the main macroeconomic relations, including aggregate demand and price determination.

As is evident, we will not dwell too far from previous efforts. However, we think it is important to acknowledge the importance of the assumptions behind the estimates of trends and gaps. That explains why we use two very different approaches.

The results of these two methodologies are different, as expected, and also are quantitatively different from simple filtering techniques such as Hodrick-Prescott (HP). This reveals that, not unlike many of the other aspects surrounding monetary policy under Inflation Targeting, quite an amount of judgement must be used to evaluate what are the underlying inflationary pressures in the economy. The use of a unique mechanical procedure to estimate trends and gaps is therefore dangerous, in that it is very likely to introduce biases in the conduct of monetary policy.

[1] It includes changes in the level of utilization of capital and labor, reallocation of resources from low to high productivity activities, and technical advance.

The rest of the paper is structured as follows. The next section details the construction of data-based estimates of the gap. Section 3 uses the model-consistent approach. Section 4 concludes.

2 Data-based estimates of potential output and the output gap

In this section we construct estimates of total factor productivity (TFP) growth, and assess its contribution to the slowdown of aggregate growth over the last few years.

2.1 Dual and primal estimates of TFP: Notation

There are two possible strategies for the estimation of TFP, the primal and dual approaches. They differ in the data required, and in general are viewed as complementary. The primal approach relies on the calculation of "Solow's residual", through the use of aggregate GDP data, along with estimates for the capital stock and labor employment. The dual estimate instead focuses on the path of relative prices: wages and the cost of capital. The relationship between these two approaches can be easily seen by assuming a production function for value-added and using the income identity of national accounts, both in real terms.

$$Y = F(A, K, N) = C_k K + C_n N \tag{1}$$

The only assumption underlying Equation **??** is that output equals payments before direct taxation to the factors of production: labor ($C_n N$) and capital ($C_k K$). These include depreciation and eventually rents due to imperfect competition in labor or capital markets. Note that Y is cost-based value added, not including indirect taxes. No assumption is made about the shape of the production function, in particular the way technological change A affects the relative demands for capital and labor.

First order differentiation with respect to time, using the normalization $(\partial F/\partial K) = 1$, leads to:

$$\Delta Y = \Delta A + (\partial F/\partial K)\Delta K + (\partial F/\partial N)\Delta N = K\Delta C_k + C_k\Delta K + N\Delta C_n + C_n\Delta N \tag{2}$$

Dividing both sides of equation by Y, one obtains

$$\Delta y = \Delta a + \frac{\partial F}{\partial K}\frac{K}{Y}\Delta k + \frac{\partial F}{\partial N}\frac{N}{Y}\Delta n = \frac{C_k K}{Y}(\Delta c_k + \Delta k) + \frac{C_n N}{Y}(\Delta c_n + \Delta n) \tag{3}$$

Defining $\alpha = (C_k K/Y)$ as the share of capital in total costs, it is the case that

$$\Delta y = \Delta a + \alpha\Delta k + (1-\alpha)\Delta n = \alpha(\Delta c_k + \Delta k) + (1-\alpha)(\Delta c_n + \Delta n) \tag{4}$$

This formulation is correct under both perfect and imperfect competition, as long as markups enter as a wedge between marginal factor productivity and the reservation wage and cost of capital: $C_k = \overline{C_k}(1+\mu_k) = \partial F/\partial K$ and $C_n = \overline{C_n}(1+\mu_k) = \partial F/\partial N$. This means that both approaches should have the same measurement error.

Now, its possible to define the primal (Δa^{primal}) and dual (Δa^{dual}) estimates of TFP growth.

$$\underbrace{\Delta y - \alpha\Delta k - (1-\alpha)\Delta n}_{\Delta a^{primal}} \equiv \underbrace{\alpha\Delta c_k + (1-\alpha)\Delta c_n}_{\Delta a^{dual}}$$

The intuition for this identity is simple: TFP grows if real wages or the real return on capital are growing too, because in the steady state these relative prices (not adjusted for quality) should be constant.

Before moving to the primal and dual estimates of TFP growth, some measurement issues must be highlighted. These revolve around two main aspects: the changing quality of the inputs in production and their varying utilization over the business cycle.

2.2 Dealing with quality trends

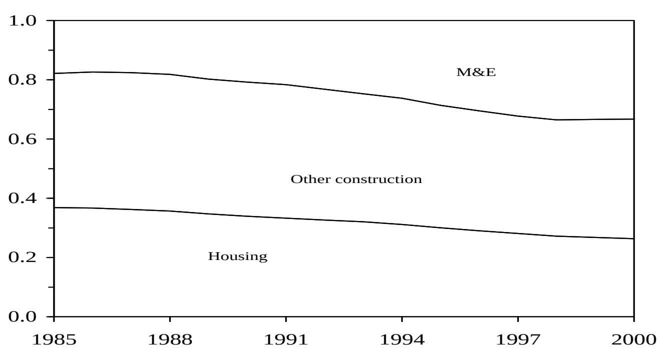
Capital

Over the last decade and a half, there has been a dramatic shift in the composition of gross fixed investment. In 1986, machinery and equipment (M&E) composed 43% of gross capital formation (in constant 1986 prices), while from 1995 onwards its share had stabilized around 60%. In nominal terms, the share of M&E first increased from close to 40% in the mid-eighties up to 50% in the early to mid-nineties, to then decline to slightly over 40% in recent years.[2]

Also, within M&E there have been fairly large shifts over time. The imported component increased from 80% in the mid nineties, reached close to 90% in 1998, and then experienced a steep decline in 1999 and 2000, reaching 76%.[3]

Accounting for these large shifts in the composition of investment is important. They have been substantial enough to matter in the composition of the capital stock over the last decade and a half. Recent estimates by Aguilar and Collinao (2000) show that the share of the capital stock accounted for by M&E increased from 18% in 1985 to 33% in 1997, having remained stable since. (Figure 2)

Figure 2: **Composition of the capital stock**



From Jorgenson's definition of the cost of capital, one sees that these shifts have potentially large effects on the dual estimate of TFP growth. Let $C_{k,i}$ represent the capital cost of brand i of capital, measured relative to the GDP deflator P, while R_i is the net return on capital, D_i the depreciation rate, P_i own deflator, and τ_i any tax-induced wedge:

$$C_{k,i} = \tau_i \left(R_i + D_i\right) \frac{P_i}{P} \tag{5}$$

[2]Official data on nominal investment reaches 1998, so we used estimates for investment deflators for 1999 and 2000.

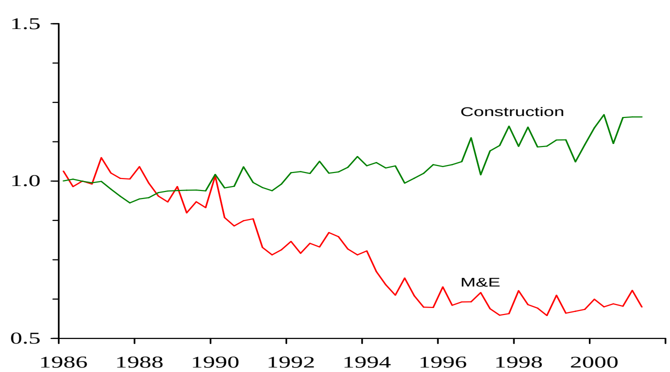
[3]Again, the later data are estimates based on the path of capital imports quantum, which fell close to 35% in 1999. 2000 and 2001 have seen a modest recovery: third quarter data are only 11% higher than the 2000 average.

Abstracting from the importance of different tax treatments, τ_i, and if by arbitrage $R_i = \overline{R}$ for all i, still different rates of depreciation as well as different relative prices P_i/P for each brand of capital will have an important incidence in the cost of capital. M&E in particular, by having a high relative rate of depreciation, and an important imported component, must be treated differently that construction. Moreover, these facts affect not only the estimated path of the cost of capital for the dual estimate of TFP, but also the share of M&E in total costs, an input for primal growth accounting.

How important quantitatively are these factors in determining the path of the cost of capital? Figure 3 show quarterly M&E and construction deflators, normalized by the GDP deflator for the period 1986 to 2001. They display a very different evolution. The increase of the construction deflator has been fairly stable, increasing by a little over 1% over the increase in the GDP deflator. Meanwhile, the appreciation of the real exchange rate had a large impact on the relative price of M&E, that fell around 40% between 1990 and 1996. Since then, it has remained stable: the depreciation of the nominal exchange rate has been compensated by not only a decrease in the dollar unit import value of capital goods, of close to 15% since its peak in early 1996, but also a reduction in the average tariff rate of 3 percentage points.

Thus, since the mid-eighties, the relative price of M&E *vis-a-vis* construction has declined 50%, although all this reduction occurred prior to 1997.

Figure 3: **Investment deflators (relative to the GDP deflator)**



Labor

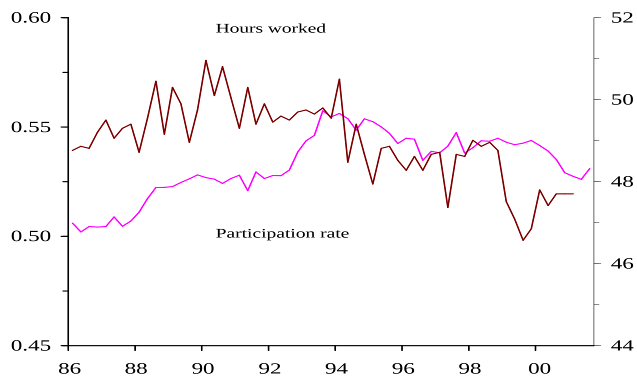
On the other hand, the quantity and quality of labor inputs changes over time, due to the increase in educational attainment, the sectoral reallocation of labor and secular trends in labor participation and hours worked. In simple terms, the actual labor input that enters the production function is a combination of the participation rate p, the employment rate $(1-u)$

(defining u as the unemployment rate), hours worked H, effort E and educational attainment S.

$$N = P \cdot (1 - p) \cdot (1 - u) \cdot H \cdot E \cdot S \tag{6}$$

All these factor have some importance in the case of Chile over the last decade and a half. Since the mid-eighties, the average years of schooling of the labor force have increased by over 10%. On the other hand, participation rates also shifted up, specially among women and in the early part of the nineties. Since 1999 though participation has declined by a couple of percentage points. Hours worked on the other hand show a downward trend since 1986. (Figure 4)

Figure 4: **Hours worked and average participation rate**



2.3 Dealing with utilization over the cycle

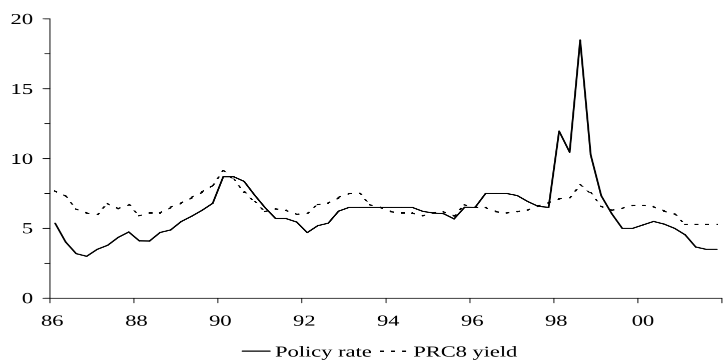
Over and above the changing quality of the inputs, their utilization over the cycle can introduce "false" movements in TFP. It must be assumed that some frictions exists that prevent the full utilization of the existing stock of capital or the labor force. We will not dwell on the reasons why this might be so, purely stating that this is a fact that must be taken into account to prevent a spurious relationship between TFP and the business cycle.

For the case of labor input, unemployment figures allow at least a partial disentangling of the labor utilization effect. However, three other factors, mentioned above, add to the complication: participation rates themselves are not exogenous, and do have a relationship with the business cycle due to the combination of "added-worker" and "discouraged-worker" effects. These two effects actually show interesting empirical dynamics over the cycle, depending on the persistence of the path of unemployment. García and Contreras (2001) show that an increase in unemployment initially increases participation ("added-worker" effect). However, if this increase persists over time, participation start to drop below its initial level ("discouraged-worker" effect). Moreover, physical labor can be employed in varied intensity over the cycle, because of changes in hours worked and effort.

Above it was shown how these factors could affect labor input trends. They also have a quantitative impact over the cycle, particularly labor force participation.

The issues above are relevant for a correct interpretation of the primal TFP estimation. They also come into play for the case of the dual estimate. Real wages, once one controls for inflation fluctuations, move along with unemployment fluctuations in a significant way.[4] Even more so, the real return on long-term bonds, which because of arbitrage is the variable used to construct the cost of capital, are sensitive to monetary policy shifts, that themselves react to perceived output deviations from trend and inflationary pressures. Therefore, the dual estimate of TFP growth will be polluted by the cyclical behavior of the cost of capital and wages. (Figure 5)

Figure 5: **Interest rates**



2.4 Identifying assumptions

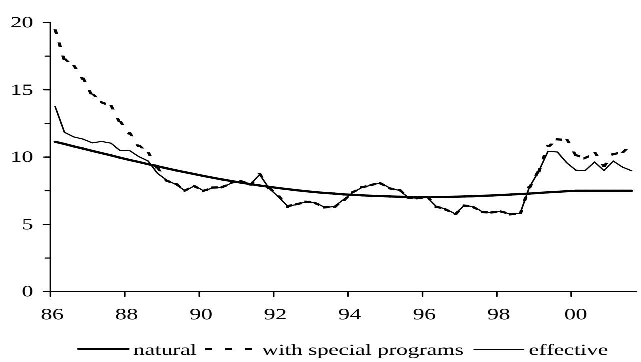
As we have seen, to construct the primal and dual measures of TFP one needs to identify separately the cyclical vs. the trend components of each of the stock (for the primal) or price (for the dual) estimates. The key identification assumption we will make here is the estimation

[4]See Restrepo and García (2001) and Coeymans (1999).

of the natural rate of unemployment, that as we will see plays an important role in all the corrections for the estimation of TFP.

To obtain the natural rate of unemployment we filter the unemployment rate with the Hodrick-Prescott filter, setting $\lambda = 20000$ and restricting the sample up to the first quarter of 2000. The HP filter has a well known problem in dealing with end points, thus we exclude the last six quarters, fixing instead the natural rate of unemployment at 7,5% from then on (Figure 6).

Figure 6: **Effective and natural rates of unemployment**



We define the unemployment gap as $u - u_n$.

Capital

We assume that the effective use of capital over the cycle in a similar way to the gap between the effective unemployment rate and the natural rate[5]. That way in a boom utilization is over 100% and in a slump it falls below 100%. We further assume that both the utilization of M&E and construction move in tandem. These effective measures of the capital stock are defined as:

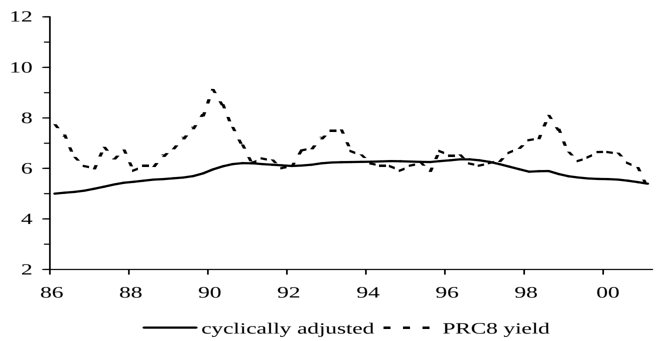
$$\widetilde{K_i} = K_i \cdot (1 + u_n - u) \tag{7}$$

Long term interest rates

[5]This is the same assumption used traditionally in the literature since Solow's (1957) classic article. It does not imply that the labor/capital ratio is constant. Rather, then this ratio does not move mechanically with the employment rate.

Long term interest rates in Chile have been highly volatile in the past, reflecting in part the impact of monetary policy decisions. However, for the dual calculation of TFP we are interested in more persistent factors that affect the demand for long term bonds, such as, precisely, growth prospects. Thus, we need to disentangle from the path of interest rates the movements associated with short term interest rates.

Figure 7: **Long Term Interest Rate Cyclically Adjusted**



To do this we proceed in two steps. First, we use the Kalman filter to estimate a policy rule for short term interest rates, that includes the unemployment gap, the difference between inflation and the target and an autoregressive term.[6] We interpret the state variable that results as an indicator of the unobserved neutral stance for monetary policy. Second, we input the resulting neutral policy rate into an estimated equation for long term interest rates, that includes leads and lags of itself. In this manner we recover a path for long term interest rates that, hopefully, is unrelated to the cyclical situation of the economy. (Figure 7)

[6]Details can be found in the Appendix.

Labor

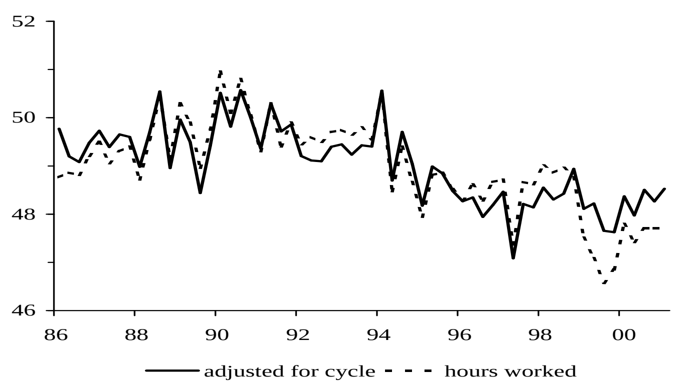
A similar correction needs to be performed for hours worked. We estimate a simple specification, regressing average hours worked with the unemployment gap, and a quadratic trend. The resulting equation, with Newey-West standard errors below coefficients, is:

$$ln\,H = \underset{(0.01)}{3.88} + \underset{(0.009)}{0.03}\,ln\,trend - \underset{(0.001)}{0.008}(ln\,trend)^2 - \underset{(0.155)}{0,778}(u - u_n)$$

$$\overline{R^2} = 0,63,\ SE = 0,01,\ DW = 1,59$$

This shows that hours tend to be quite procyclical: a 1.3 percentage point increase in the rate of unemployment leads to a fall of 1 hour worked. (Figure 8)

Figure 8: **Cyclical correction of hours worked**



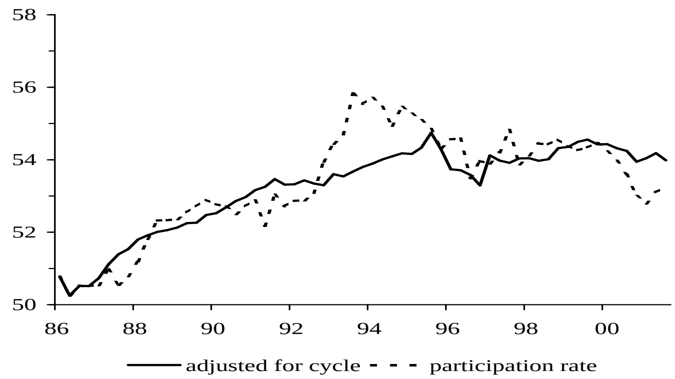
For the case of participation rates, García and Contreras estimate that the long run elasticity of the participation rate to unemployment is close to 1.[7] The short run dynamics however play an important role, but still the cyclical correction, using their estimates, shows a large procyclical component in the participation rate.

2.5 Estimation results

Below are the results of dual and primal estimates of TFP growth, including forecasts for 2001 and 2002.[8] The results are not radically different from what is obtained in other studies. The

[7]Central Bank of Chile (2001).

Figure 9: **Cyclical correction of the participation rate**



period of high average GDP growth (1986 to 1997) can actually be decomposed in several subperiods, according to the relative importance of the different growth determinants.

- Mid to late eighties

  This period of high average growth was sustained by a sharp increase in the labor input, after the recession of 1982-1983. This was manifest not only in the increases in employment, but also in more hours worked and schooling. Capital accumulation had a lesser importance. The utilization rate though rose sharply. This factor is key in explaining the flat behaviour of TFP over the period: by not controlling for utilization, one would attribute a larger role to TFP growth over this period. In terms of the dual, slow real wage growth and declining real interest rates confirm this panorama.

- First half of the nineties

  In the years from 1990 to 1994 some of the features of the previous years were apparent, mostly in the high rate of employment growth that, although less that over the eighties, still reached 3% annual terms on average. Capital accumulation picked up significantly, and utilization rates reached a 100%. This period also saw real wage gains, that themselves seem to have led to increased female labor participation. TFP growth increased, reaching around 2% annual average (3% in the dual).

- Boom

  The years between the Mexican and Asian crisis saw an unprecedented acceleration of economic growth. This was accompanied by a swift accumulation of capital and a further increase in primal TFP growth measures. A slowdown of employment growth,

[8]These forecasts are not to be taken as official proyections by the Central Bank of Chile.

to rates similar to the increase in the working-age population, and real wages growing at close to 6% annual, show that the economy was clearly at full employment. The dual estimates for TFP show still high rates of growth, although lower that earlier in the decade.

- Bust

  A dramatic slowdown in growth followed the combination of the Asian and Russian crises with a tightening in monetary policy. However, the reduction in growth was mostly reflected in a sharp stop to the almost continuous expansion of employment over the last decade, as well as a sharp reduction in TFP growth and the utilization of the capital stock. Capital accumulation however proceeded at a high rate, reflecting relatively important rates of investment still after the sharp fall in 1999.

- Recovery

  The aftermath of the crisis years have witnessed a resumption of growth, to rates higher than the ones seen in 1998 and 1999 but lower than the ones seen in the nineties. This new situation is consistent with increases in the capital output ratio, and a flat TFP.

These different periods can be seen in the path of TFP over the last decade and a half. First, in the late eighties TFP growth was modest. This is a result of controlling for a varying utilization of capital, which incorrectly can be measured as TFP growth. A second period last over the nineties, from 1991 to 1995 for the case of the primal estimates, and 1989 to 1994 for the dual estimates. This was a period of high TFP growth. The third period is the last one, when TFP growth, although still positive, has slowed down. (Table 1)

We also constructed an additional measure of the primal TFP estimate, excluding inventory accumulation to reduce the cyclicality of output.

The variety of adjustments mentioned in previous sections do matter. For example, for the primal measure of TFP, an additional cumulative growth of 10% results if no adjustments are done. This is close to half the growth of adjusted TFP. However, the cyclical behavior of TFP is still an issue.

This matters for the estimation of the gap. Indeed, if one directly uses TFP for the calculation of potential output, the gap over the mid eighties is close to zero, and the current slack is also small, specially the unadjusted series. As other authors have done, the filtering of TFP then appears as a reasonable option. Here we applied the HP filter, but with $\lambda = 10000$. The gap appears more procyclical.[9]

[9] The correlations between the three gaps presented and quarterly growth of seasonally adjusted GDP are -0.03, 0.01 and 0.40.

Table 1: Sources of Growth

Primal estimates of TFP

	GDP		Capital				Labor			TFP	
	total	w/o stock accum.	total	M&E	Construc-tion	Utilization rate	Physical	Hours	Schooling	with stocks	w/o stocks
$87-89$	8.2	8.0	4.5	6.2	3.9	98.8	7.2	0.6	1.2	0.3	0.1
$90-94$	7.3	7.4	6.9	10.9	5.3	100.3	3.0	-0.2	0.9	2.2	2.3
$95-97$	8.5	7.6	9.1	14.8	6.3	100.5	1.6	-0.6	0.6	3.0	2.1
$98-99$	1.5	3.5	7.8	10.8	6.1	98.9	-0.6	-1.4	0.5	-0.4	1.7
$00-02(f)$	4.3	3.9	5.1	5.5	4.8	97.5	0.5	1.2	0.5	0.8	0.3

Dual estimates of TFP

	Labor Cost	User Cost of Capital			TFP
		KC	KM	KT	
$87-89$	0.9	-3.9	-6.3	-5.1	-1.8
$90-94$	5.4	2.6	-3.5	0.6	3.2
$95-97$	5.7	1.9	-4.9	-1.7	2.4
$98-99$	4.9	1.0	-1.8	0.5	2.9
$00-02(f)$	0.5	3.9	-0.8	0.4	0.1

This exercise shows a last point that we want to highlight before moving to the model-consistent estimates. The filtering approach not only is required for the inputs, but also for the TFP measures that are finally obtained. This is a difficulty that should not be underestimated.

3 Model-consistent estimates

Given the difficulties surrounding the direct estimation of trend GDP starting from the data, in this section we propose the joint estimation of the output gap and the macroeconomic dynamics embedded in small macroeconometric models for the Chilean economy. This strategy still requires imposing some identification restrictions, which will be described below.

We use two models for the estimation, based on the aggregate demand and price blocks of a more complete model discussed in more detail elsewhere.[10] They center on empirically based equations that are not explicitly derived from first principles. Each model will have a similar structure. First, an equation that describes the short run macroeconomic dynamics. Second, an equation for the unobserved state variable that captures underlying productivity. Third, a definition of trend GDP growth and/or the output gap.

[10]See García, Herrera and Valdés (2002).

Figure 10: **Primal and Dual TFP**

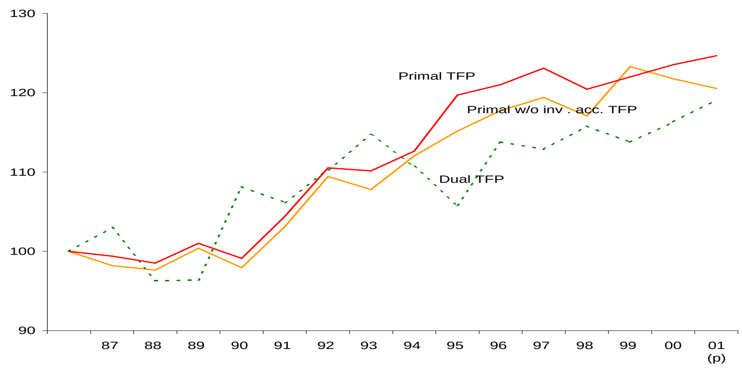
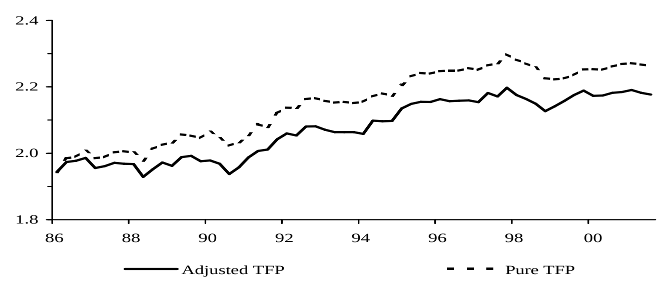


Figure 11: **Primal TFP**

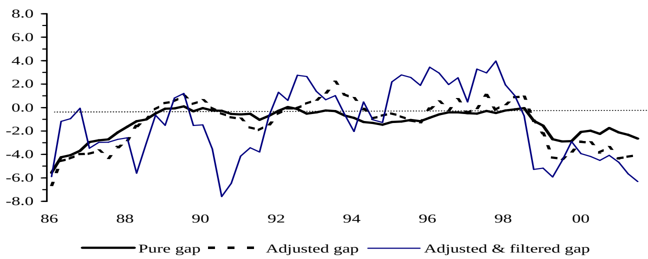


3.1 Structure of the models

Aggregate demand model

Our first model (AD, or aggregate demand model) consists of an aggregate output growth equation, that relates the first difference of seasonally adjusted log output to its unobserved trend component γ and the deviations from steady state of a set of domestic and external variables. Among the former, it includes the stance of monetary policy given by the slope of the yield curve $r - rl$, long term interest rates rl. External conditions are identified here with international interest rates rx and the log price of copper $\ln P_{cu}$. Two lags are included to capture the dynamics. A disturbance term ϵ_y is also added to account for short-term fluctuations.

Figure 12: **Primal Output Gap**



$$\Delta y = \gamma + \phi_r((r - rl)_{-1} - (\overline{r} - \overline{rl})) + \phi_{rl}(rl_{-2} - \overline{rl}) + \phi_{rx}(rx_{-2} - \overline{rx}) + \phi_{cu}(\ln P_{cu} - \ln \overline{P_{cu}}) + \phi_{y1}(\Delta y_{-1} - \gamma_{-1}) + \phi_{y2}(\Delta y_{-2} - \gamma_{-2}) + \epsilon_y \quad (8)$$

We think of the state variable γ as capturing underlying trends in output growth. Although the *level* of productivity should be smooth, we do not have any priors about the process that drives the growth rate of productivity. Thus we impose an autoregressive functional form.

$$\gamma = \rho\gamma_{-1} + \epsilon_\gamma \quad (9)$$

After estimating this small model, we cannot recover trend GDP, but we can infer its rate of change through time. We define trend growth when every variable of the AD model reaches its equilibrium level[11]:

$$\Delta\overline{y} = \gamma \quad (10)$$

A identification assumption behind this definition is that external conditions do not affect the unobserved underlying productivity component. This view differs from other studies that consider the inclusion of external conditions[12].

[11] For simplicity we imposed the average levels as equilibrium values for each variable.

[12] Beechey et al. (2000) use it for the estimation of Australian trend growth, as do Rojas et al. (1997), with a focus on terms of trade, for the Chilean economy. Although Coeymans' (1999) adjudicate to the external conditions a role in trend growth.

Aggregate supply models

Our second model focuses on the determination of prices. It determines core CPI inflation through an accelerationist Phillips curve (AS, aggregate supply).[13] Core inflation is related to its own lags and leads, and imported inflation, given by the sum of nominal exchange rate depreciation and foreign (dollar) inflation. The equation is homogeneous to the first degree in these determinants, reflecting long-term neutrality. An other factor influence core CPI inflation: the output gap. This is obviously a reduced form, whereas a more general framework would include wage setting and unemployment as determinants. A positive output gap tend to accelerate inflation.

The first, restricted, version of the model imposes dynamic homogeneity on the inflationary process, to guarantee neutrality and a vertical Phillips curve in the long run. This implies adding-up restrictions on some of the right hand side regressors as well as the restriction of a zero constant. As this model is very simple, and there is evidence that inflation in Chile follows more complex dynamics[14], we also estimate an unrestricted version of the model. However, we cannot reject the null hypothesis of homogeneity and a zero constant.[15]

Thus, our AS model is as follows:

$$\begin{aligned}\Delta\pi = \xi_l \sum_{i=2}^{4} \frac{\pi_{-i} - \pi_{-1}}{3} + \xi_f \sum_{i=1}^{2} \frac{\pi_{+i} - \pi_{-1}}{2} \\ + \xi_e \sum_{i=1}^{2} \frac{\widehat{e}_{-i} + \pi^*_{-i} - \pi_{-1}}{2} \xi_{vat} \Delta \ln VAT + \xi_y \sum_{i=2}^{4} \frac{y_{-i} - \overline{y}_{-i}}{3} \qquad (11)\end{aligned}$$

The definition of trend GDP in this case is straightforward, as it is directly specified as the unobserved state variable:

$$\overline{y} = \rho \overline{y}_{-1} + \epsilon_{\overline{y}} \qquad (12)$$

[13] Noncore CPI inflation items include products such as fuels, regulates services and perishables, which follow simple price-setting rules.

[14] See García and Restrepo (2002).

[15] The p-value of a χ^2 test of the joint hypothesis of a zero constant and adding-up constraint is 0.756.

3.2 Estimation results

The models above are estimated using state-space techniques, imposing identification restrictions with respect to the volatility of the trend components of GDP ($\overline{y}$). We assume throughout that trend output is smoother than actual output. Our choice for the dependent variable is total GDP minus mining, fishing and energy. These sectors are linked to natural resources, and their expansion over time responds more to exogenous factors.

Aggregate demand model

The results of the estimation are broadly consistent with single-equation estimates by least-squares. As expected, the results show the sensitiveness of GDP growth to interest rates, both due to monetary policy actions and the shifts in the cost of external finance.[16] Also, the price of copper affects significantly GDP growth. The state-space estimates are similar to the OLS estimates, both in terms of their size and statistical significance.

However both models exhibit a considerable difference in the estimates of trend output growth (γ), because OLS estimation do not distinguish between the volatility of the trend and cycle components.

The state-space estimation also deliver some interesting results. First, the autocorrelation in the growth rate of the state variable (measured by ρ), although large, are not statistically different from zero. This implies that, at least in the context of the AD model, shocks to the underlying productivity growth show little persistence over time.

As a matter of fact, the state space estimation of the AD model differs very little from the OLS estimation, in that only a small fraction of the variation in the data can be attributed to the state variable. Figure 13 shows the path of actual output growth, the thick line, the trend growth rate that result from the state-space model, and the results from a HP filter.

Aggregate supply model

From the results in the last section it is apparent that little information about trends is gained from direct observation of the path of output. With the AS models however, the inference about the size of the output gap and the growth rate of trend GDP depends on the informativeness of the path of inflation.

As before, some identification assumptions must be made, now related to the magnitude

[16] rx was constructed using the 10 year T-bond as benchmark, deflated by US core inflation and adjusted for a measure of the sovereign spread and the incidence of capital controls over the nineties.

Table 2: Estimation results - AD models

	OLS[a]		State-Space[b]	
γ	0.013	*0.038*	0.016[c]	
ϕ_r	-0.404	*0.067*	-0.404	*0.087*
ϕ_{rl}	-1.501	*0.288*	-1.461	*0.314*
ϕ_{rx}	-0.564	*0.281*	-0.553	*0.233*
ϕ_{cu}	0.029	*0.011*	0.028	*0.010*
ϕ_{y1}	-0.288	*0.107*	-0.226	*0.179*
ϕ_{y2}	-0.282	*0.068*	-0.331	*0.252*
ρ			-0.494	*1.174*
$\sigma(\epsilon_y)$	1.25%		1.05%	
$\sigma(\epsilon_\gamma)$			0.47%	
$\overline{R}^2$	0.477			
Log-Likelihood	175.44		175.52	

[a] Newey-West standard errors in italics

[b] Standard errors in italics.

[c] Average of the sample period.

Figure 13: **Actual and Trend Output Growth in AD model**

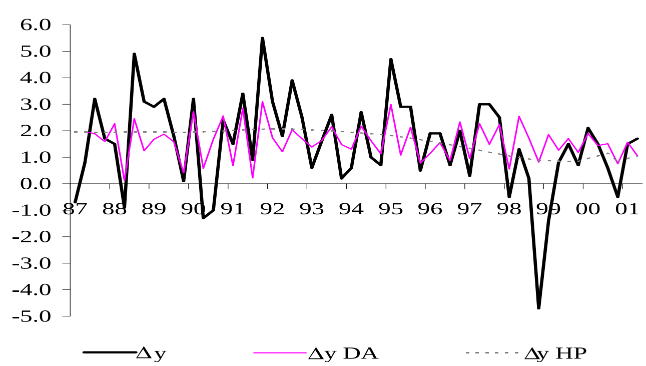


Table 3: Estimation results - AS models

	IV[a]		State-Space[b]					
			$\sigma(\epsilon_{\overline{y}}) = 1.0\%$		$\sigma(\epsilon_{\overline{y}}) = 3.95\%$		unrestricted $\sigma(\epsilon_{\overline{y}})$	
ξ_l	0.462	*0.122*	0.410	*0.127*	0.322	*0.116*	0.305	*0.124*
ξ_f	0.332	*0.113*	0.195	*0.117*	0.406	*0.106*	0.442	*0.141*
ξ_e	0.085	*0.037*	0.094	*0.050*	0.055	*0.051*	0.048	*0.054*
ξ_{vat}	0.700	*0.206*	0.663	*0.264*	0.650	*0.258*	0.641	*0.260*
ξ_y	0.048	*0.036*	0.054	*0.037*	0.038	*0.036*	0.025	*0.045*
ρ			0.982	*0.062*	0.974	*0.066*	0.972	*0.065*
$\sigma(\pi)$	0.73%		0.66%		0.56%		0.58%	
$\sigma(\overline{y})$			1.00%		3.95%		6.90%	
$\overline{R}^2$	0.477							
Log-Likelihood			208.52		211.62		211.73	

[a] Instrumental variables estimation. Instruments used for π_{+i} include lags of inflation, interest rates and the unemployment rate, among others. An HP trend is used as proxy for the gap.

[b] Standard errors in italics.

of the volatility of trend GDP $\sigma(\epsilon_{\overline{y}})$. We estimate the AS model with a variety of assumptions about this volatility. Table 3 shows the resulting estimates.

The growth rates of trend output differ, but tend to be stable over time. However, some evidence of a slowdown in trend growth appears on some of the estimations. The measures of the gap too differ, in general show a positive gap over most of the nineties and a negative one since 1999. The magnitudes are important: over to 10% in recent quarters. This is probably related to the low pass-through from exchange rate depreciation up until now, that the state-space estimation interprets as a large, negative output gap.

AD-AS model

The disadvantage of estimating AD and AS model separately is that one obtains two unrelated measures of trend growth. To resolve this problem we estimated both models together, in an equation system, using the state-space method. This allows to have a consistent measure of the output trend (shown in Figure 16). For this purpose however we imposed the

Figure 14: **Trend Output Growth - AS model -** $\sigma_{\epsilon\overline{y}} \in [0.1\% - 1\%]$

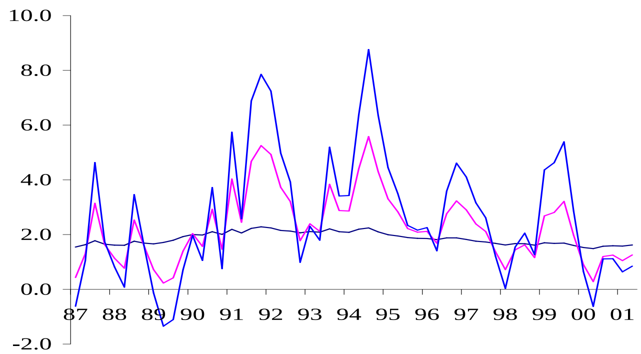
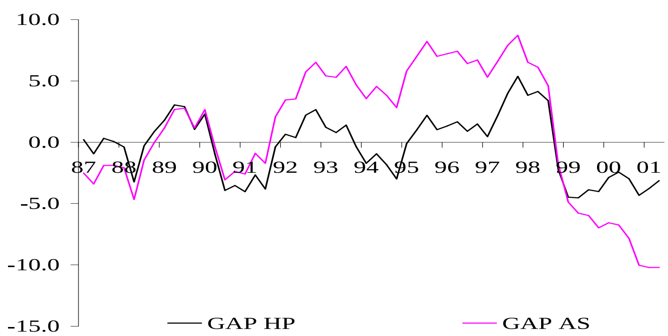


Figure 15: **Output Gap - AS model** ($\sigma_{\epsilon\overline{y}} = 0.5\%$) **and HP filter**



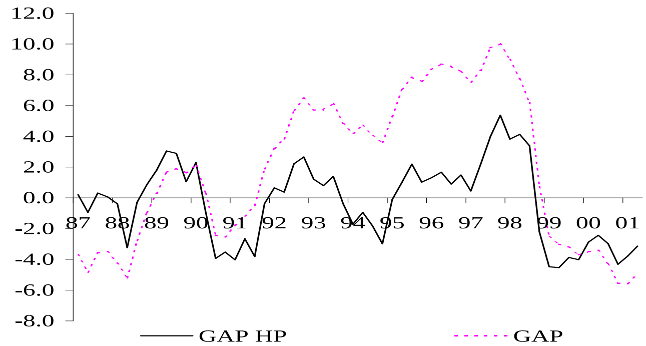
coefficients on the right hand side variables obtained from single equation estimates, given the difficulties in obtaining convergence.

4 Concluding remarks

What have we learned from the estimates presented in this work? We think four lessons are important.

The first thing that is readily apparent is the wide dispersion in both the magnitude and the trends of the different estimates of the output gap. The following figure displays several

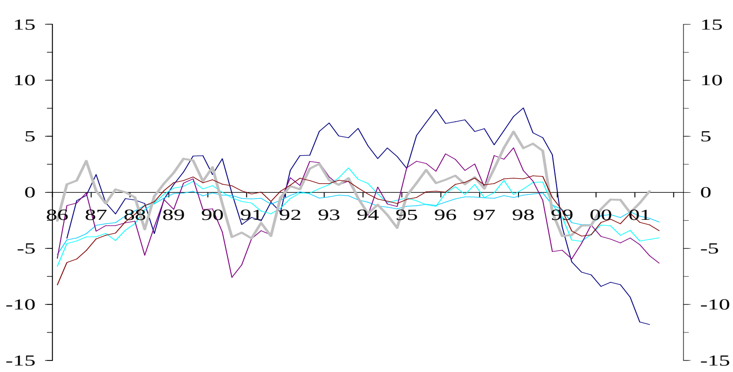
Figure 16: **Output Gap: AD-AS model and HP filter**



measures of the output gap that have been presented along this work. Some of them rely on growth accounting exercises, while another results of assuming a particular natural rate of unemployment. A third is the product of a state space estimation of a simple Phillips curve. As a benchmark, the thick gray line results from a simple HP filter.

While some seem very procyclical, others are smoother. While some show a stable gap over the last quarters, others indicate an increasing slack. While some of them are not very correlated with each other, others are extremely so. This in particular is the case with the filtered primal TFP estimate and the unemployment gap, showing the importance of particular identification assumptions.

Figure 17: **Output Gaps**



Secondly, all these measures indicate that current slack lies between 2% and 11% and, more importantly, that it has been mostly stable since 1999. The notable exception is the simple,

Table 4: Correlations between gaps

	HP $\lambda = 1600$	AS model	Primal adjusted	Primal n/adjusted	Primal filtered	Unemployment gap
HP	1.00	0.53	0.41	0.29	0.76	0.36
AS		1.00	0.77	0.59	0.75	0.66
Pr.adj.			1.00	0.90	0.57	0.92
Pr.n/adj.				1.00	0.40	0.99
Pr.filt.					1.00	0.49
Unemp						1.00

$\lambda = 1600$, HP filter, that indicates actually a positive output gap for the second quarter of this year. The well-known sensitivity of this filter to end-points is the culprit for this somewhat counterintuitive result. [17]

Third, a careful treatment of growth accounting is key for two reasons. It is the first step for the estimation of potential output, although the dual approach is not useful for estimating the gap, as it leads to the growth rate of TFP, not its level. Moreover, no matter what alternative statistical method is used for in-sample estimation, for forecasting purposes there is no easy substitute for a sources-of-growth approach.

Finally, this is a warning to the mechanical application of statistical methods, loosely related to economic theory, for the measurement of trends and gaps. Some structure is needed to infer economically sensible conclusions about the measurement, through a particular method, of the output gap. A judgemental approach seems best: using a variety of methods provides a wider perspective on an issue that is key to the efficient conduct of monetary policy. This reflects the fact that potential output and the output gap are conditional statistics, and thus are sensitive to the particular identifying assumptions chosen.

Regarding our first motivation, we find that most output gap measures derived in the paper are either stable or increasingly negative over the last few years. This, coupled with the results from the aggregate demand models and TFP estimates, imply that trend GDP growth has probably stayed above actual growth but below levels during the nineties. Therefore, we discard the alternative that the recent slowdown in growth is due mainly to supply side factors. However, the prospects for longer term growth depend critically on these factors. Understanding their importance is beyond the scope of this work.

[17] See Chumacero and Gallego (2001) for evidence on the sensitivity of this filter to new information.

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Appendix: Policy Rule and the Yield Curve

To obtain the dual estimation of TFP we want to consider only those factors that affect the long run demand for long term bonds, such as growth prospects. Thus, we correct for the volatility of long term interest rates caused by the impact of movements of monetary policy decisions (associated with short term interest rates).

We start estimating the neutral stance for monetary policy using a Kalman filter in a policy rule for short term interest rates. This regression includes the unemployment gap, the difference between inflation and the target, an autoregressive term and a unobserved state variable. This variable, which we interpret as the neutral policy rate, is used as input into an estimated equation for long term interest rates, that includes leads and lags of itself. In this manner we recover the cyclically adjusted long term interest rates.

First we model the policy rule:

$$r = rn + \alpha_\pi(\pi - \pi_{target}) + \alpha_u(u - u_n) + \alpha_r r_{-1} + \epsilon_r$$

The construction of the natural rate of unemployment u_n is explained in the text. We use a dummy variable (D_{98}) for the year 1998, when interest rates were allowed to float, and the *de-facto* exchange rate arrangement was closer to a fixed than a floating exchange rate.

We impose an autoregressive functional form for the neutral policy rate, restricting the disturbance term ϵ_{rn} to take a standard deviation of 0.22:

$$rn = \rho\, rn_{-1} + \epsilon_{rn}$$

The last two equations conform the state-space model, that is resolved with the Kalman filter, which results appear in Table 5. The initial condition needed for rn is taken from the OLS estimates. With the neutral policy rate one can obtain the equilibrium short rate interest rate ($\overline{r}$), when inflation reached target inflation and employment gap is null:

Table 5: Estimation results - Policy Rule Model

	OLS[a]		State-Space[b]	
α_π	0.063	*0.026*	0.085	*0.095*
α_u	0.243	*0.053*	0.192	*0.364*
α_r	0.502	*0.042*	0.396	*0.091*
α_{98}	7.574	*0.507*	5.902	*0.587*
ρ			0.994	*0.015*
$\sigma(\epsilon_r)$	0.69%		0.92%	
$\overline{R^2}$	0.92			
$Log - Likelihood$	-59.97		-86.621	

[a] Newey-West, standard errors in italics.

[b] Standard errors in italics. OLS estimates used as initial conditions.

$$\overline{r} = \frac{rn}{1 - \alpha_r}$$

Finally the cyclically adjusted long term interest rate is obtained replacing $\overline{r}$ instead of r in the already estimated equation for rl.[18] This construction needs values for the initial and final conditions of the long term interest rate, which are assumed as 5.5 (1986:1) and 5.2 (2002:1).

$$rl = \underset{(0.387)}{0.31} + \underset{(0.053)}{0.36}\, rl_{-1} + \underset{(0.035)}{0.54}\, rl_{+1} + \underset{(0.008)}{0,05}\, r$$

$$\overline{R^2} = 0,83,\ SE = 0,29,\ DW = 2,34$$

[18]This model uses instrumental variables for the lead of the long term interest rate, that include the exchange rate, lags of interest rates and the difference between inflation and the target, the band among others.

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