In July 2001, the Central Bank of Chile decided to change the way that it performs monetary policy, leaving behind the scheme of defining a real interest rate level and welcoming one in which the bank signals via a nominal rate. This change in the monetary policy procedure meant the abandonment of a practice held by the issuing bank for over a decade.

The supporters of the scheme used before the so called “nominalization” of the monetary policy argue that the previous system gave out clear signals regarding the Central Bank’s intentions. Accordingly, a higher real interest rate was a most certain sign of a more restrictive monetary policy and vice-versa. This “fluent communication” between the Central Bank and the rest of the economy could get confusing, they say, if the real interest rate started to waver as a consequence of specifying a nominal interest rate.

The critics of the former procedure state that specifying the real interest rate as the main tool of monetary policy contributes to the maintenance of a wide use of indexation mechanisms. These could eventually affect the Central Bank’s inflation targets, in case of aggregate demand or supply shocks. The presence of frequent fluctuations in the monthly inflation rate, would then imply alterations in the short term interests rates.

An essential matter in the debate about the costs and benefits of each of these policy strategies regards the effects they have on the variability of other macroeconomic indicators. When the real interest rate is defined, one might expect a greater short term instability in the nominal rates and in the money supply. On the other hand, fixing the nominal rates would imply a bigger variation in the short term real interest rates. The danger could be that the monetary authority didn’t adjust the policy promptly enough, when perceiving a change in expected inflation. In this case, the economy would be exposed to longer inflation –and possibly also business– cycles.

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The following papers reflect the opinion of two distinguished Chilean specialists in monetary policy matters. First, Felipe Morandé explains the reasons why the Central Bank of Chile decided to change the way it conducts monetary policy. The author was at that time Director of Research of the issuing institution, having therefore a leading role in this decision.

The second paper, written by Juan Andrés Fontaine, shows a critical position towards the “nominalization” of the monetary policy. Fontaine was the Central Bank’s Director of Research between 1985 and 1990.