



The perils of lax economic policy: The case of Chile during the COVID-19 pandemic

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Abstract

This paper examines the short- and long-term effects of lax economic policy in Chile during the COVID-19 pandemic and discusses whether they promoted or inhibited sustainable economic growth and development. The case of Chile is worth studying because it straightforwardly describes the effects of passive and active economic policy on the economy. It is argued that the active or lax economic policy generated a short-term boom period and a long-term recessive environment. Lax economic policy in Chile distorted the price system and the intertemporal allocation of resources, stimulating consumption and indebtedness. Investments became less capital intensive, stagnating labor productivity and reducing growth and development. Regardless of external factors, the research shows that the recession of the Chilean economy emerged from lax economic policies and institutional uncertainty. These findings recognize the causes of the recessive environment of emerging economies, offering new insights into promoting sustainable economic growth and development post-crisis.

Keywords Lax fiscal policy · Lax monetary policy · Economic growth · Development · Ethics

JEL classification B53 · E52 · E62 · E63 · O23

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1 Introduction

The threat of recession emerges suddenly after periods of apparent economic prosperity, understood as high economic growth and reduced unemployment in the short term without a prior increase in genuine savings and productivity. Some critical voices indicate that the capitalist system contains the seeds of its destruction (Piketty, 2015, 2020). The problem with capitalism, critics say, is that it works under an anarchic and unstable logic based on selfishness and avarice, which brings business cycles of boom and recession that decrease people's well-being (Palley, 2015). Capitalist logic generates recurring periods of disequilibrium with unemployment, and the leading solution is coercive government interventionism through lax economic policy. The Keynesian promise to save capitalism consists of lax fiscal and monetary policies in times of crisis to increase aggregate demand (e.g., increase consumption, investment, and government spending), boosting full employment and economic growth (Mulligan, 2013; Van Den Hauwe, 2016). Accordingly, Keynesian economists cheerfully conclude that lax economic policy is a powerful tool to counteract the threat of recession caused by free enterprise and the market economy.

In 2020 and 2021, the world's governing bodies applied lax fiscal and monetary policies to increase aggregate demand in response to the gross domestic product (GDP) contraction and rise in unemployment due to the lockdown of the COVID-19 pandemic (Bagus et al., 2021; Huerta de Soto et al., 2021). These Keynesian short-term policies generated high economic growth and reduced unemployment in 2021. They also began a long-term recessionary route founded on indebtedness and inflation by the end of 2022 and 2023 (Boettke & Powell, 2021). The outcomes were a drop in savings, investment, and real wages, the massive bankruptcy of companies, and an increase in unemployment, poverty, and indigence at the hands of a contraction in GDP. In the meantime, there is a debate about the role of lax economic policy in recessions. While some economists indicate that recessions follow capitalist logic and economic policies help save capitalism, others suggest that lax fiscal and monetary policy drives boom-and-bust business cycles. The former fits the Keynesian approach, and the latter fits the Hayek and Friedman approach (Wray, 2015; Huerta de Soto, 2006; Hülsmann, 2008). The underlying question is, what are lax economic policy's short-term and long-term effects? Should the economic policy be active or passive? Should it be left to the authorities' discretion (active) or based on fixed rules (passive)? What are economic policy's theoretical and practical frontiers to achieve its objectives?

This paper examines the short- and long-term effects of economic policy in Chile during the COVID-19 pandemic. The case of Chile is worth studying because it straightforwardly describes the impact of passive and active economic policy on sustainable economic growth and development. It is argued that the lax economic policy generated a short-term boom period and a long-term recessionary route. Other things being equal, the active or lax economic policy encouraged, fueled by institutional uncertainty, higher aggregate demand in the short term versus lower output in the long term, inducing unsustainable economic growth and development defined by an inflationary spiral and a fall in GDP and employment, while poverty and inequality increased. These findings recognize the causes of the recessive environment of

emerging economies, offering new insights into promoting sustainable economic growth and development post-crisis.

The structure of the paper is as follows. Section 2 explains the theoretical debate between the Keynesian approach and that of Hayek and Friedman on the role of short-run and long-run economic policy and its practical boundaries. After Sect. 3 describes the role of lax economic policy in the Chilean economy's boom in 2020 and 2021, Sect. 4 clarifies the bust effects of these policies in 2022 and 2023. Section 5 discusses the role of institutional uncertainty and some policy lessons for emerging economies. Section 6 concludes.

2 Literature review

How should political decision-makers address business cycles? Following John Maynard Keynes's approach, some economists consider the economy inherently unstable because aggregate supply and demand coordination is frequently disrupted (Gordon, 1990; Lavoie, 2022). These shocks intrinsic to the logic of the capitalist system will cause unnecessary and inefficient boom and bust fluctuations in macro-economic variables, such as GDP, unemployment, and inflation. The governing body can use fiscal and monetary policy to stabilize the economy toward a short-run full-employment equilibrium, stimulating economic growth when it is in recession and slowing it down when it is overheated.

Following the approach of Friedrich Hayek and Milton Friedman, other economists believe that the entrepreneurial market process tends to coordinate supply and demand within the institutional framework of secure private property rights, promoting sustained or long-term economic growth and development (Hayek, 1931, 1933, 1941, 1945, 1989; Friedman, 1967, 1971, 1982; Friedman & Schwartz, 1986). The enormous boom-and-bust fluctuations are sometimes seen as the result of flawed economic policy decisions. Knowledge's subjective, proprietary, dispersed, and non-articulate nature makes coordinating society through coercive mandates impossible (Huerta de Soto, 2010; Moreno-Casas et al., 2022). They argue that the governing body cannot coordinate supply and demand because a theory that starts from the assumption that it has the information it cannot get is not scientific (Boettke, 2018; Shleifer, 2009). Those decision-makers for the economic policy must admit their limited capacity and be satisfied with no harm.

Although the debate between these two strongly marked approaches has persisted for decades, a fundamental question remains: should monetary and fiscal policies actively seek to stabilize the economy or stay passive? Keynesian claims to prefer active or lax economic policy are well known (Boettke & Newman, 2017). Yet, Hayek and Friedman's approach suggests three main arguments for opting for passive rather than active economic policy. First, political decision-makers need to catch up on the application and effects of economic policies. Economic policy application and outcomes are not immediate because fiscal and monetary policy intervenes in an open and complex "process structure" of the creation and distribution of knowledge. Following Mankiw's analogy, managing economic policy is like steering a ship in a storm (Mankiw, 2014). Ships change direction long after the pilot has adjusted the

rudder, and once the ship begins to turn, it continues to spin long after the rudder has returned to its normal position. A newbie will probably over-steer the rudder, and when he realizes the mistake, he will overreact by turning it too far in the opposite direction. The outcome can be a perilous route. The newbie will react to earlier mistakes by making larger and larger corrections.

Economists differentiate between internal and external lags in economic policy (Garrison, 1984). The internal lags consist of the time between a shock that affects the economy and the adoption of measures. These lags occur because political decision-makers take time to recognize that a disturbance has occurred and, later, to take the appropriate steps. For example, consider the times and resources used to seek an agreement on a problem that deserves a political solution, first, within the government and, later, in the parliamentary discussion until it is a law. The external lags are the time that elapses between adopting a measure and its short- and long-term impact on the economy. These lags occur because economic policy measures take time to affect GDP, unemployment, and inflation. For example, lax economic policies can increase GDP and reduce unemployment and inflation in the short term, but usually cause a crowding-out effect (lax fiscal policy) and business cycles (lax monetary policy) in the long term (Garrison, 2001; Young, 2015).

Second, quantitative predictions of economic variables are impossible because political decision-makers cannot achieve a full-employment equilibrium even if the economic policy lags do not exist. This statement is Lucas's critique: an optimal coactive government intervention design requires that political decision-makers quantitatively estimate the effects on society. However, they need to know how people's expectations will respond to that change. This pretension of knowledge is epistemologically impossible (Lucas, 1976). If the subjective values of human actions are given, wealth is provided by a permanent social structure, as occurs with the objects of the natural sciences. Any change is included in *a posteriori* and also taken as given. Political decision-makers are unlikely to recognize the causality of economic phenomena because the issues discussed are restricted to the quantitative and experimental operations of the natural sciences. At best, these models can produce an unbiased estimate with little external validity and exclude real-life dynamics. They need to give a scientific explanation about a big question as the essence of sustainable economic growth and development.

Third, historical data cannot predict the future quantitatively. Coordinating market supply and demand requires that the governing body simultaneously know and articulate: (1) the past, present, and future subjective valuations and the intertemporal preference rate of all individuals; (2) changes in asset endowments, capital accumulation, amortization rates, and technology of all present and future companies; and (3) control people's expectations. Again, the pretension of knowledge is impossible. Should an economic policy be based on robust rules or left to the authorities' discretion? Economic policy is based on robust rules if the governing body announces in advance how they will respond to different situations and undertake to comply with what has been reported (Leeson & Subrick, 2006). In contrast, it is based on discretion if those responsible are free to deal with the facts as they arise and choose the measures they deem appropriate as they go on the fly.

Hayek and Friedman's approach further indicates that the temporal inconsistency of economic policy (i.e., the gap between the speech and the action of the governing body) includes the above arguments for preferring a passive political economy under robust fiscal and monetary rules against discretion. For this reason, some countries have implemented robust fiscal rules, such as balanced budgets and restrictions on public debt and taxes, and robust monetary rules, such as an independent central bank focused on inflation targeting. Robust fiscal and monetary rules would tie the hands and feet of political decision-makers, protecting the economy from incompetence and opportunism (Vanberg, 2005, 2020). Alternatively, active or lax fiscal and monetary policy forces an expansion or contraction of the production structure through quantitative models and shallow assumptions, distorting the intertemporal allocation of resources and triggering recurring cycles of boom, financial crisis, and recession.

3 Chile's economic boom (2020–2021)

This section describes the role of lax economic policy in the Chilean economy's boom in 2020 and 2021 based on economic history and the main macroeconomic variables. The first part focuses on lax fiscal policy, the second focuses on lax monetary policy, and the third analyzes the lax economic policy outcomes in the Chilean economy's performance during the COVID-19 pandemic.

3.1 Lax fiscal policy

October 18, 2019, marked a milestone in the history of Chile. That day began what historians call the "social outbreak" (*estallido social*), an explosion of massive protests with unprecedented levels of violence, crime, and destruction of public and private infrastructure in a country internationally recognized for its cultural environment bright to constitutional order and republican traditions (Collier & Sater, 2004). The economic, political, and social reasons for the social outbreak are not the subject of this paper, and the phenomenon's complexity requires another investigation. What is essential here is to stress that these events drove political pressures that led to breaking the fiscal and monetary rules that kept Chile one of the most macroeconomically stable countries in Latin America (Fernandois, 2020). While the Chilean fiscal rule (also called the structural balance or cyclically adjusted rule) conditions fiscal spending to the evolution of structural tax revenues, the monetary rule consists of the independence of the Central Bank of Chile and an inflation target of 3% per year.¹

Remarkably, policymakers signed an "Agreement for Social Peace and the New Constitution" on November 15, 2019, in an atmosphere of institutional uncertainty due to political pressures to break fiscal and monetary rules to increase deficit spending, along with the incompetence of those in power to reduce crime and violence. The

¹ While Chile's fiscal and monetary rules are shared by developed countries such as the United States and the Eurozone, the Chilean political background for breaking them is discussed in detail by Kaiser (2020) and Espinosa (2023, ch. 8).

critical facts of the social outbreak that lasted between October 18, 2019, and March 18, 2020, are the following (Freire, 2020; Oyarzún-Serrano, 2020):

1. The protest movement taken over by extreme leftist groups described the 1980 Constitution as the heart of Chile's misfortunes of inequality and corruption.
2. 3.7 million people attended more than 4 thousand protests.
3. The violence left 34 dead, 30,000 people arrested, and 5,000 police officers injured.
4. The destruction of infrastructure is estimated at \$3.3 billion, with losses of between 100 and 300 thousand jobs.
5. 80% of small businesses reduced their income and productivity.
6. Economic growth was 1% in 2019 (far from the 4% estimated at the beginning of the year).

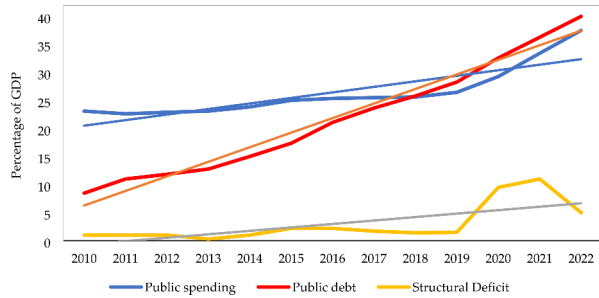
The first case of the COVID-19 pandemic in Chile was on March 3, 2020, until it spread throughout the country, further pressuring the breakdown of fiscal and monetary rules. President Sebastián Piñera decreed the “catastrophe constitutional state of exception” between March 18, 2020, and September 30, 2021, in the form of a lockdown or total quarantine to contain the spread of the virus and also the social outbreak with strict curfews guarded by police and military. The government promoted a series of sectoral measures for lockdown planning, such as health and social planning and the “Step-by-Step Plan” to prevent, contain and reduce the spread of COVID-19 in the country.² While the first big wave was between May and August 2020, with a range of infections from 1,000 to 7,000 new cases of daily infections, the second big wave was between April and August 2021, with everyday infections between 2,000 and 9,000.

The COVID-19 pandemic's statistics show that, between March 18, 2020, and September 30, 2021, infections were 1.65 million (235 million worldwide), with 37 thousand deaths (4.8 million worldwide), in addition to a complete vaccination of 74% of the population (versus 34% of the world population) (University of Oxford, 2022).³ Meanwhile, the lockdown stagnated Chile's economic activity, yielding massive business bankruptcy and indebtedness to households and companies. Following the Superintendence of Insolvency and Re-entrepreneurship (*Superintendencia de Insolvencia y Reemprendimiento*), from January 1, 2020, to July 31, 2021, a total of 11,200 procedures for companies and individuals have been entered and 2,755 liquidations of assets of debtor companies (Diario Financiero, 2022). The Central Bank of Chile estimates that the total debt of families calculated as a percentage of disposable income rose to 76.4% in the second quarter, reaching a historical maximum (Central Bank of Chile, 2022). The world economy's stagnation generated a trade balance surplus of 5.6% in 2020 (far from the deficit of -0.4 in 2019); that is, imports of goods

² The “Step-by-Step Plan” was a five-stage strategy in which progress will be made or will go back in the lockdown concerning the epidemiological situation of each commune or region and to the extent that the established health standards are met.

³ In comparative terms, COVID-19 deaths in Chile were 0.20% of the total population in that period, the same as in countries without lockdowns, such as Sweden (University of Oxford, 2022).

Fig. 1 Chilean government finances (Percentage of GDP). Own elaboration from the Central Bank of Chile (2022) and the World Bank (2022)



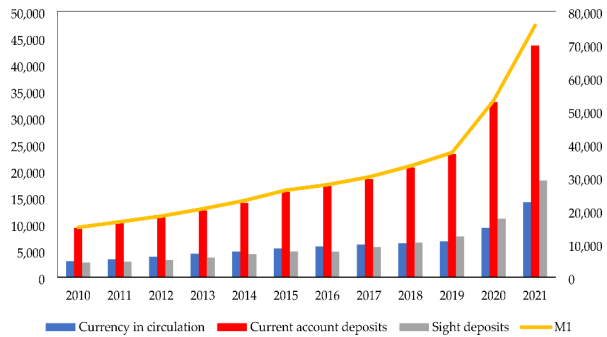
and services (e.g., vehicles, technology, and fuel) decreased more proportionally to exports (for example, copper, fruits, vegetables, cellulose, fish and other meats, wine) (World Bank, 2022).

The Chilean economy stagnation due to the lockdown brought the economic growth of 2020 to -6% (the lowest figure since the socialist government of Salvador Allende in 1973), reducing the total production stock of goods and services (Espinoza, 2021). While unemployment rose from 7% to 2019 to 12.4% in 2020, poverty increased from 10.7 to 14.2%, indigence from 1.4 to 4.5%, and inequality measured in the Gini coefficient from 0.44 to 0.45 (similar data to that of México and higher than that of Argentina, Bolivia, and Peru) (Central Bank of Chile, 2022; World Bank, 2022).

After lengthy internal lags of political debates, the Chilean government adopted the laxest fiscal policies in the country's history as a "public spending carnival". Figure 1 indicates that the government broke the fiscal rule, increasing public spending by 10.4% between 2019 and 2020 and an additional 22.2% in 2021. Public debt increased by 30% between 2019 and 2021, and in the same years, the structural deficit did it by 82%. Between 2010 and 2021, public spending increased by 80% and the structural deficit by 91%. This lax fiscal policy was excessive for two main reasons. First, income from work fell by \$10 billion in 2020 and \$3 billion in 2021, a total loss of \$13 billion compared to 2019. The government implemented a series of household transfers through bonuses and employment subsidies of \$17 billion of fiscal resources delivered between May 2020 and June 2021. Emergency Family Income (IFE) was given to 90% of Chileans at an additional \$16 billion between June and November.

Second, Chileans' liquidity increased by \$50 billion due to the three withdrawals from the private pension funds, meaning a 30% reduction in the amount saved by workers. 74% of the withdrawn funds were injected into the economy through direct purchases from businesses through electronic means. The remaining 26% was used to pay debts or save. In summary, the amount of money injected into consumption, thanks to direct transfers and withdrawals from pension funds, generated changes in the Chilean economy. If the gross domestic product formula is $GDP = C$ (consumption) + I (investment) + G (government spending) + XN (net exports, i.e., exports minus imports), the lax fiscal policy increased GDP due to increases in consumption, public spending and net exports in the short term.

Fig. 2 M1 and its components (annual averages, billions of Chilean pesos). Own elaboration from the Central Bank of Chile (2022)



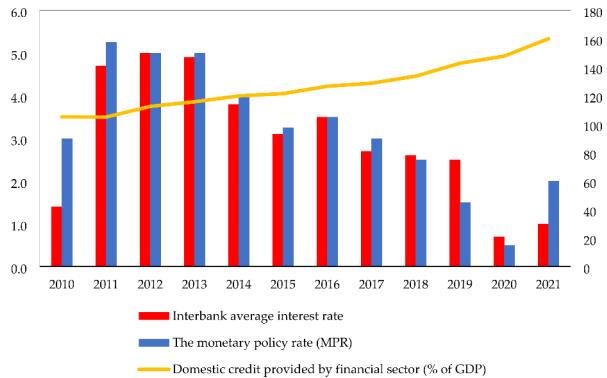
3.2 Lax monetary policy

The governing body has two ways of injecting money into the economy. On the one hand, the Chilean government's lax fiscal policy increased aggregate demand variables financed with present taxes (i.e., current tax structure) and future taxes (i.e., public debt implies that taxes will rise at some point to pay for the fiscal deficit). On the other hand, the Central Bank of Chile can increase the supply of money (M) through a lax monetary policy. The artificial reduction of the interest rate or monetary policy rate (MPR) is a powerful instrument of the Central Bank to increase the money supply through credit expansion (Huerta de Soto, 2006; Hülsmann, 2008). It is an interest rate on loans that a central bank grants to commercial banks. If the central bank lowers its MPR, loans between financial institutions will be cheaper, the supply of credit will increase, and the quantity of money in the economy (loanable funds will increase). Loans to the public will also charge lower interest.

The Fractional Reserve Banking System (FRBS) allows banks and governments to earn additional profits by lending "part" of their customers' deposits, keeping a small "fraction" of these deposits as "reserves" available in the form of cash or highly liquid assets. Although it assumes that depositors will not be a joint demand claiming all their money simultaneously, it assumes that a monetary aggregate greater than the monetary base will not harm economic performance. The function of the fractional reserve is to guarantee the short-term solvency of banks. However, the FRBS's effect is credit expansion at lower interest rates (Garrison, 2001; Huerta de Soto, 2006; Hülsmann, 2008; Young, 2015). If economic growth slows and unemployment rises, the Central Bank can, for example, lower its benchmark interest rate as a counter-cyclical measure. As explained above, this makes it possible to make credit cheaper for individuals, expand loans and family consumption, and boost the gross domestic product (GDP) in the short term. The above can occur in the opposite case. If the economy is growing too fast in an inflationary spiral, central banks can raise interest rates to reduce the money supply in the economy.

Figure 2 illustrates the increase in the money supply in terms of M1, defined as the amount of money circulating in the economy made up of banknotes and coins in the hands of the public, current deposits by citizens, and reserves held by the central banks have cash deposited in the central banks of each country. The Central Bank of Chile used lax monetary policy to control the amount of money in circulation and stimulate economic activity through consumption, spending, and investment. In

Fig. 3 Relationship between the interest rate and credit expansion. Own elaboration from the Central Bank of Chile (2022) and the World Bank (2022)



boom periods, M1 rises as banks are more willing to lend money, and the amount in circulation increases. In contrast, this monetary aggregate declines during bust periods, as banks have trouble lending money. The Chilean case indicates that M1 grew by 126% between 2018 and 2021 and 400% between 2010 and 2021 in an evident boom period. Thus, M1 measures the quantity of money in circulation and the money supply, influencing growth rates, unemployment, and inflation. This aggregate is accounted for differently by country and extends to the monetary aggregates M2, M3, and M4. This definition of money does not include investments made in equities and fixed income.

Figure 3 shows the relationship between the interest rate and credit expansion. According to Huerta de Soto, recent credit expansion is the sole work and creation of the governing body through the central banks (Huerta de Soto et al., 2021). Credit expansion is the primary tool for political decision-makers to intervene in the economy. It allows them to hide the actual scarcity of capital through an artificial reduction in interest rates. All this is done under the illusion of the neutrality of money. Interest is the discount for the substitution of present goods for future goods. Its alteration results in constant booms and busts in all economies because there is no way to avoid the final collapse caused by an artificial credit expansion. In this regard, the Central Bank of Chile reduced the monetary policy rate (MPR) by 90% between 2013 and 2020 and by 80% between 2018 and 2020, stimulating the reduction of the interbank interest rate by 86% between 2013 and 2020 and by 73% between 2018 and 2020. The result was a reduction in the price of domestic credit provided by the financial sector, increasing the credit stock by 50% more as a percentage of GDP between 2010 and 2020.

3.3 The performance of Chile's economy

Implementing the lax economic policy had internal lags between political decision-makers' judgment of the problem and the application of mitigation measures. On the one hand, the lax fiscal policy required a long political debate on the design and scope of the social outbreak, the lockdown, and the monetary transfers to the public (Madeira, 2022). On the other hand, the lax monetary policy required the agreement of the Central Bank of Chile advisors due to the short and long-term effects

Fig. 4 The effects of lax economic policy on GDP (annual percentage), Unemployment (rate of the total active population), and the Chilean Stock Market Index (IPSA). Own elaboration from the Central Bank of Chile (2022) and the World Bank (2022)

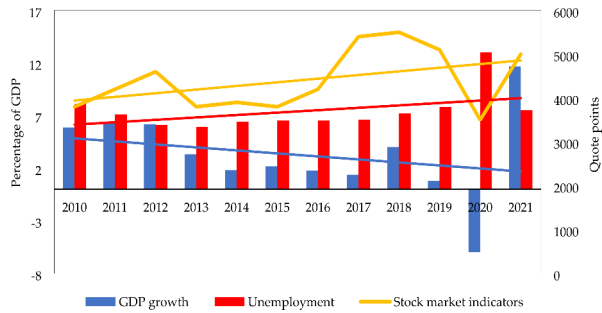
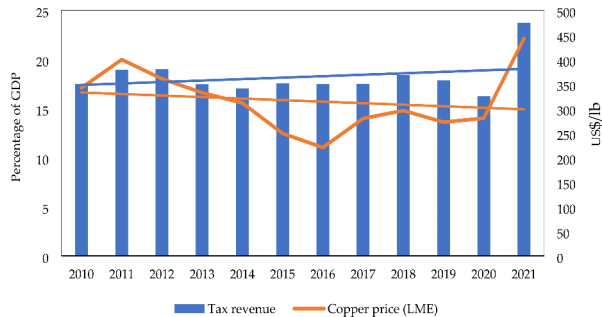


Fig. 5 Tax revenue (percentage of GDP) and LME copper price (US\$/lb). Own elaboration from the World Bank (2022) and Sociedad Nacional de Minería (SONAMI) (2022)

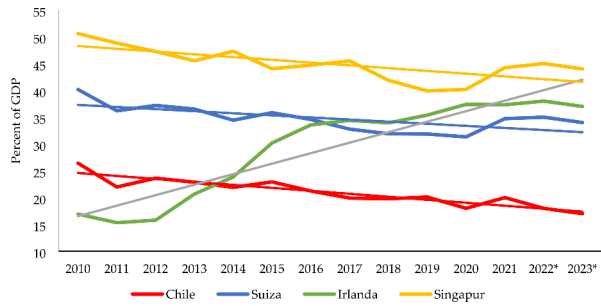


(Long et al., 2022). The governing body applied the lax economic policy to increase the macroeconomic variables that make up aggregate demand, stimulating economic growth and reducing unemployment in the short term. This way of thinking follows the Keynesian aphorism of achieving full employment equilibrium in the short run, saving capitalism from its own theoretical and practical contradictions.

Figure 4 illustrates the effects of the lax economic policy boom on economic growth, unemployment, and the Chilean capital market. While the effects of the social unrest and the lockdown contracted GDP by -6% in 2020, the injection of liquidity from lax fiscal and monetary policy increased GDP growth by 12% in 2021 (unusual for Chile since 1993). Unemployment reached 13% in 2020, dropping 42% to 7.5% in 2021. Finally, the Chilean stock market grouped in the IPSA Index decreased by 31% between 2019 and 2020, increasing by 42% in 2021.

Figure 5 shows the relationship between the price of copper and tax revenue. Tax revenues increased 50% between 2020 and 2021 due to taxes paid for the lax economic policy boom of aggregate demand and high copper prices (an increase close to 60% in a context where the share of copper reached 46% of the export basket). The *Corporación Nacional del Cobre* (CODELCO) has transferred surpluses (dividends) to the Treasury since April 2021, amounting to \$7.4 billion as of December 2021 (40% higher than in 2020). It paid First Category Taxes and 40% of Public Companies (Decree Law 2,398), given the end of the absorption of tax losses accumulated in previous years.

Fig. 6 Chile, Switzerland, Ireland, and Singapore's gross savings (percentage of GDP). Own elaboration from the World Bank (2022). *Estimated data



4 The Bust (2022–2023)

This section may be divided into subheadings. After addressing the effects of lax fiscal policy on savings and productivity, lax monetary policy on inflation, and the increase in the cost of living in Chile, the results of the recession are explained in terms of economic growth (i.e., GDP growth and unemployment and development (i.e., poverty and inequality). The interest rate on Chilean bonds and expectations clarifies the meaning of institutional uncertainty in the recession risks in the Chilean economy. Emphasis is placed on the role of external lags, quantitative prediction problems, and historical data in economic policy design and application.

4.1 Fiscal crisis

The external lags of Chile's lax fiscal policy led to the fiscal crisis. It consists of the insolvency of public finances because tax revenue is unsatisfactory to cover public spending, and there is no reasonable way to collect more taxes. The steady increase in Chile's deficit spending during the COVID-19 pandemic has driven the fiscal deficit and debt to their highest levels in decades. The governing body offered a tax reform to increase tax revenue by 8% of GDP to continue the rise in deficit spending and public debt in "a responsible way" (Libertad y Desarrollo, 2022). However, the external lag of the increase in taxes in an institutional environment of historical indebtedness would increase companies' production costs, reducing private savings and investment. If that is the case, tax revenues would be lower than expected, and, again, the governing body will require more debt and further tax reform to keep deficit spending in a vicious circle.

Figure 6 shows the genuine savings level in Chile compared to Switzerland, Ireland, and Singapore, the most economically free countries worldwide.⁴ The data indicates that the freest countries save between 35 and 45% of GDP in 2022 and 2023. Between 2019 and 2023, Switzerland's genuine savings increased by 6% (fell by 18% between 2010 and 2023), Ireland's fell by 3% (increased by 54% between 2010 and 2023), and Singapore's rose 9% (fell 16% between 2010 and 2023). In contrast, Chile's savings fell by 59% between 2010 and 2023, 18% between 2019 and 2023, and 13 places in the Economic Freedom Index over the last decade (Miller et

⁴ The Economic Freedom Index ranks economies according to their performance on secure private property rights, fiscal burden, fiscal health, and business freedom (Miller et al., 2022).

al., 2022). Chile is one of the ten economies with the lowest productivity and wage growth in the OECD over the last decade (a difference of 50% from the OECD average), and productivity in Switzerland, Ireland, and Singapore is three times that of Chile (Díaz-Bahamonde & Wagner, 2020). Hence, Chile's 12% economic growth in 2021 was unsustainable because it was fueled by a lax fiscal policy in a fiscal crisis route, reducing private savings, investment, productivity, and stagnant wages.

4.2 Monetary crisis

The external lags of Chile's lax monetary policy occurred with an increase in the money supply rather than an increase in saving (Garrison, 2001; Huerta de Soto, 2006; Huerta de Soto et al., 2021). In 1755, Richard Cantillon explained the mercantilist fallacy that increasing the money supply raises prosperity (Cantillon, 1755). The issuance of additional paper money and credit expansion is always intentional. The increase in the money supply is usually limited to the central bank's expansion of bank reserves and the proliferation of bank lending. Credit expansion lowers the interest rate below the natural rate (i.e., the social rate of time preference) and initiates a consumption and investment boom. The first receivers benefit from credit expansion. They spend it according to their preferences, and this causes specific prices to rise. Sellers of those goods benefit from the new money, while others who face only higher prices are hurt. As newly created money spreads in society, consumer goods rise in price, production costs exceed income, and the adjustment process threatens entrepreneurs with bankruptcy (The Cantillon effect) (Hagemann & Trautwein, 1998).

Inflation is the loss of purchasing power of money. When the money supply increases (i.e., an increase in the quantity of money), relative prices tend to rise (i.e., the purchasing power of money decreases). Inflation equals excess money supply (i.e., the stock supplied exceeds the quantity demanded). Suppose people judge that inflation expectations will continue to increase. In that case, everyone will tend to buy as much as possible and keep their cash on hand to a minimum, and therefore the money prices of all goods and services will persist in rising with no possibility of stopping them. The maintenance of cash in such conditions implies not only the costs, usually called interest, but also considerable losses due to the decrease in the purchasing power of money. The advantages of holding cash must be purchased at sacrifices that seem so high that each further restricts their available cash.

Figure 7 shows inflation (12-month percentage change) for Chile, Latin America, and the Caribbean. Chile's inflation has been lower than Latin America's between 2011 and 2023, except for 2014 and 2022. The inflationary spiral in Chile started in 2020 with a lag of 18 and 24 months to fully extend in society, reaching a cumulative inflation rate of 12.8% in 2022 (its highest inflation rate since 1991) and breaking the monetary rule (more than four times the inflation target). As of 2023, a deflationary trend (an excess demand for money) is estimated because the Chilean central bank implemented an intensely restrictive monetary policy. It is a monetary policy rate of 11.25% in the third quarter of 2022 to reduce consumption and, thus, inflation. Still, further increases in the TPM are not ruled out to ensure the convergence of the inflation target to 3% (i.e., the Chilean monetary rule), at least in 2024 (see Fig. 3). The

Fig. 7 Inflation (12-month percentage change) for Chile, Latin America, and the Caribbean. Own elaboration based on the Central Bank of Chile (2022) and Statista (2022). *Estimated data

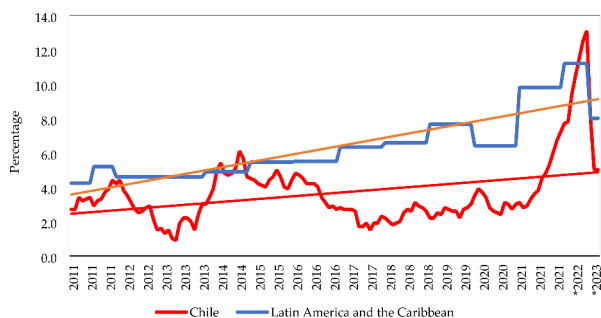


Fig. 8 Index of perception of the economy (IPEC). Own elaboration from the Central Bank of Chile (2022)

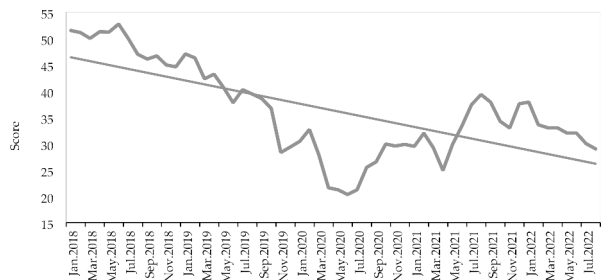
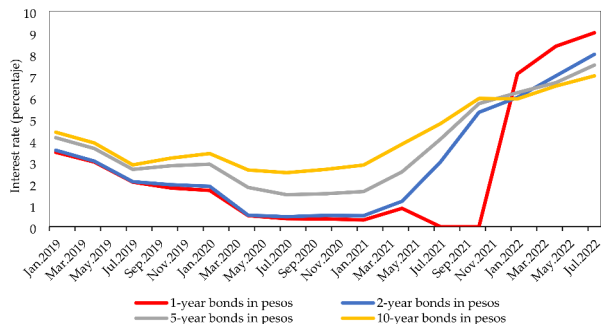


Fig. 9 Chile Bond Yield. Own elaboration from the Central Bank of Chile (2022)



abrupt reduction in autonomous spending is the prelude to a deflationary spiral, for the most part, like those of any other sharp decline in aggregate demand: recession, rising unemployment, and financial stress.

4.3 Recession

The lax economic policy initiated in 2020 fueled a “spending carnival” through money injections orchestrated by the Chilean government and central bank. The rise in aggregate demand fueled a boom, increasing GDP and reducing unemployment in the short term (2021). The unsustainability of the boom lies in the increase in the money supply instead of an increase in genuine savings, driving a spiral of inflation and indebtedness. The historical levels of inflation and indebtedness clarify the 20.6% increase in the prices of the basic food basket and the 18% increase in the

poverty line for a household of four people between 2021 and 2022. These indicators anticipate GDP growth of 2.7% in 2022 and between -1.5 and -1% in 2023.

In contrast, the economy of Latin America and the Caribbean will grow by 3.9% in 2022 and 2% in 2023, and the whole world by 3.4% in 2022 and 2.9% in 2023. While the contraction in Chile's aggregate demand reduces inflationary pressures, underlying inflation (i.e., excluding volatile components such as food and energy) risks remaining close to 8% in 2023 (Central Bank of Chile, 2022; World Bank, 2022; Statista, 2022). A contraction of economic growth in the long term is accompanied by a stagnation of development, where poverty remains at two digits and inequality measured by the Gini coefficient would reach 0.47 (approaching the average of 50 in Latin America).

The difficulties of quantitative predictions and temporal inconsistency became latent in 2022 when political decision-makers realized that the Keynesian guidelines brought a recessive route for the Chilean economy in 2023. Besides, the direct and indirect effects of the Russian invasion of Ukraine on rising prices, especially of fuels and cereals, and capital flight to developed countries led by the United States, aggravated Chile's current account deficit, together with a substantial depreciation of the Chilean peso.

5 Lessons for emerging economies

The case of Chile offers some policy lessons for emerging economies on the theoretical and practical frontiers of economic policy. Active or lax economic policy has insoluble difficulties: internal and external lags, the impossibility of quantitative prediction, and temporal inconsistency. Contrary to the Keynesian approach, this paper found that Chile's lax economic policy yielded a boom-and-bust business cycle. As suggested by Hayek and Friedman, the perils of lax economic policy are that it can promote short-term economic growth at the cost of a fiscal and monetary crisis that can inhibit long-term economic growth and development.

Regardless of external factors, the recessionary environment in the Chilean economy was encouraged by institutional uncertainty (Bylund & Packard, 2022). Uncertainty is inherent to human beings about the internal and external conditions of their natural and social environment as a fog of ignorance (Bylund & McCaffrey, 2017; Kirzner, 2017; Solorza, 2021). The internal conditions are the subjective evaluations of the actor, and the external conditions are the subjective evaluations of others and the events of nature. The actor can control his subjective assessment of himself, not those of his neighbor or the circumstances of nature. People ignore what they ignore, and no computer can solve this concern. Accordingly, the lax economic policy led Chile to break fiscal and monetary rules, shifting people's incentives from entrepreneurship and savings to consumption and indebtedness in an unsustainable route. Figure 8 shows that 70% of the entrepreneurs surveyed judge that the Chilean economy is on the wrong track. Figure 9 shows that domestic uncertainty has increased short-term bond interest rates by almost 20 times between September 2021 and July 2022.

Hayek and Friedman's approach suggests that economic policy should be passive and subject to robust fiscal and monetary rules (Hayek, 1989). The passive economic

policy implies responsibility, defined as the governing body's commitment to facilitate sustained economic growth and development under institutions of private property rights (Espinosa et al., 2021; Espinosa, 2023). The evidence from Chile raises two essential economic policy lessons for emerging countries, which often suffer from fiscal and monetary imbalances. First, a robust fiscal rule aims for fiscal stabilization. It implies that the government should not spend more than its income, so the fiscal deficit and public debt should have a constitutional limit and sanctions for noncompliance. While developed countries usually have a fiscal deficit rule between 0 and 3% per year, the government's indebtedness capacity must be determined in the same way as the rest of society, following the formula:

$$\text{Debt Capacity} = (\text{Annual Income} - \text{Fixed Expenses}) \times 0.35 \quad (1)$$

The annual income depends on the government's budget, the fixed expenses are the public yearly sector's expenses and debts, and 0.35 indicates that the annual indebtedness must be at most 35% of the income available annually. If the government's yearly income is 100 billion pesos, and the fixed expenses are 90 billion pesos, the subtraction of the income and expenses is $100 - 90 = 10$ billion pesos. This result is multiplied by 0.35, giving the exercise year a debt capacity of 3.5 billion pesos. With these game rules, the government budget would be planned differently. Instead of the various ministries announcing their deficit spending demands and trying to impose them in challenging negotiations with the finance minister, the dynamic would be reversed (Rose, 2006). Now the cabinet of ministers would define a framework to which the negotiations with the different portfolios must be adjusted (Fatás & Mihov, 2006; Rose, 2006; Heinemann, 2021).

Second, a robust monetary rule aims for monetary stabilization. It implies that the central bank must be constitutionally independent of political power and subject to inflation targeting (Friedman rule) (Friedman, 1977). On the one hand, the Central Bank is independent when it has freedom of action to define monetary policy, and decision-making by the president and the board of directors is protected from political pressures, particularly from the government and the private sector. On the other hand, inflation targeting must be low enough not to distort the price system. For example, following the gold standard, inflation targeting should be around 0 and 2% per year (Hülsmann, 2008). Evidence shows that countries with independent central banks have the lowest inflation rates globally, and countries with subjugated central banks to political pressures have the highest inflation rates (Bernanke & Mishkin, 1997; Aisen & Veiga, 2008; Taylor, 2019). If the central bank is not independent, it becomes the ATM for the government's current deficit spending.

6 Conclusion

This paper examined the short-term and long-term effects of lax economic policy in Chile during the COVID-19 pandemic to discuss whether lax fiscal and monetary policy should have an active or passive role in economic performance. The results showed that the Chilean governing body embraced the Keynesian approach to reach a

full employment equilibrium. The lax economic policies yielded a boom in economic growth and employment in the short term, but induced a recessive bust in the long term. The boom was fueled by money injection and not by increased genuine savings, substituting people's incentives from entrepreneurship and saving to consumption and debt. Following Hayek and Friedman's approach, the lesson for emerging economies is that economic policy must be passive and subject to robust fiscal and monetary rules to facilitate development and sustained economic growth.

These findings suggest future research directions. Hayek and Friedman's approach can be applied to the case of other countries to strengthen the evidence on the active-passive debate. Also, this paper did not use the Austrian business cycle theory. Still, it left unexplored theoretical and practical developments, especially the double effect of active-passive fiscal and monetary policy in boom-and-bust cycles.

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