

Beyond Volcker: Developing Country Disinflations and the Fed's Two- Percent Target

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Question: Can advanced economy central bank officials, **quickly**, and at a **low cost** to employment and output reduce inflation to the 2-percent target?

Two opposing schools of thought

Sacrifice Ratio (SR) School: as during Volcker, the journey back to stable prices will be painful and protracted; it requires fall in output in accordance with Phillips Curve (Ball 1994; Fischer 1986; Gordon 1982; Okun 1978).

This Time is Different (TTID) School: disinflation need not be protracted and costly; Fed will soon pause or start cutting rates. **TTID School** might look for comfort in Sargent (1982); in the aftermath of World War I, credible shifts in monetary and fiscal policy regimes: (a) rapidly stabilized prices, and (b) inflicted little cost on employment and output.

Two opposing schools of thought

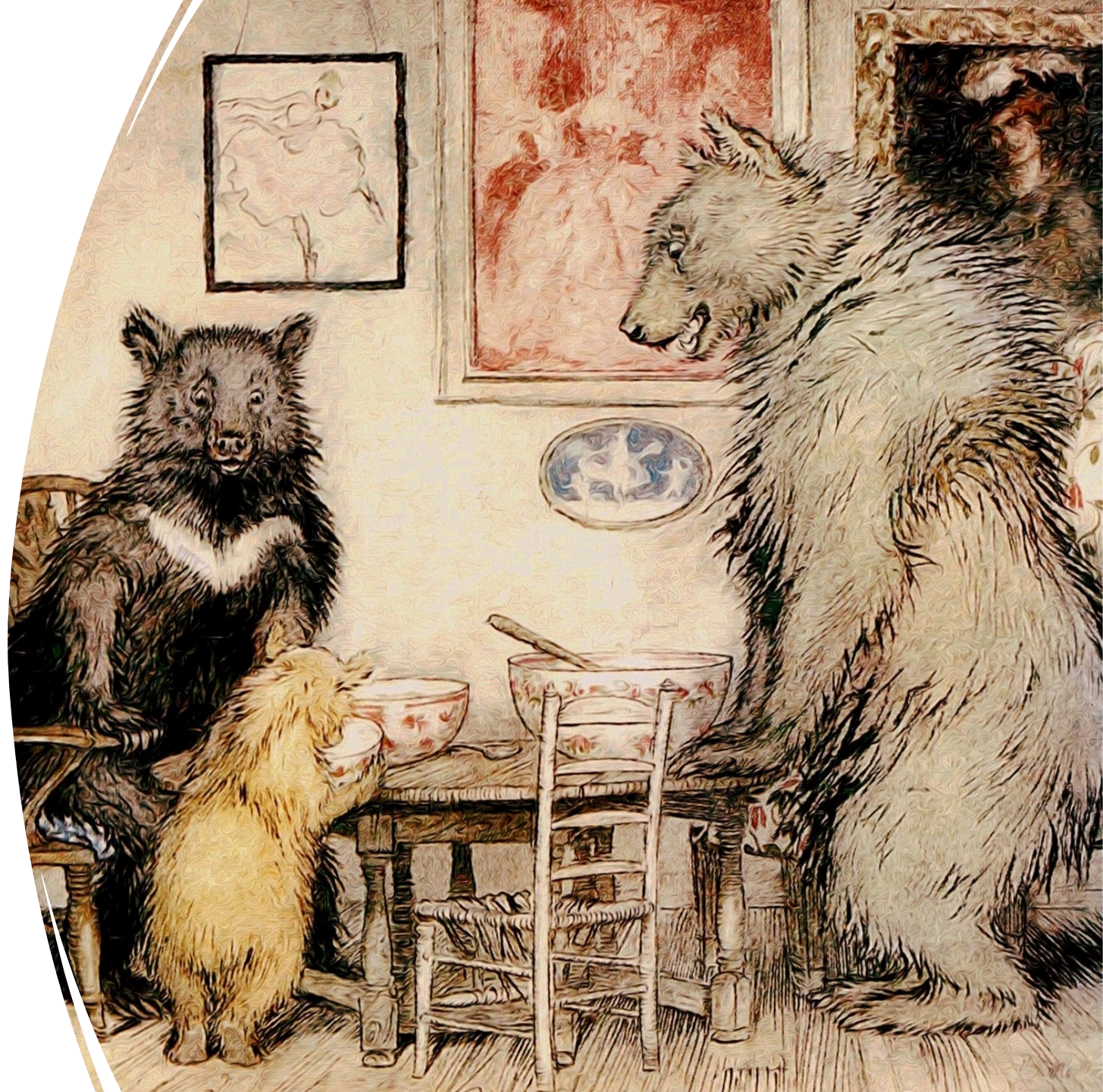
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“...the countries that successfully disinflated to low inflation—...Ireland and Spain—did so at a significant cost to output.” (Dornbusch & Fischer, 1993)

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- Austria, Germany, Hungary, Poland (Sargent, 1982)

Immaculate Disinflation: The Goldilocks Soft-Landing?



Trouble with the TTID view:

(1) There has been no change in US fiscal policy—federal deficit was 5.4 percent of GDP in 2022, will be 5.3 percent in 2023, and is forecast to climb, on average, through 2033 (Congressional Budget Office, 2023)

(2) After raising Federal Funds Rate at a record-setting pace, monetary policymakers are gaining credibility;

however, having let the inflation genie out of the bottle in the first place, the Fed is having to fight very hard to maintain credibility.

(3) Not clear whether we have met the Sargent (1982) standard of a jointly credible regime shift.



Both SR and TTID view suffer from a small sample problem

Hard to infer how long and costly current US disinflation path will be by comparing it to the only previous attempt to actively engineer a US disinflation this order of magnitude.

And can advanced economy central banks learn from the experience of emerging markets?

In contrast to singular focus on Volcker, this paper...

Uses historical experience of developing countries' attempts to actively engineer disinflation as a set of quasi-laboratory experiments to ask:

Will advanced economy central banks be able to achieve a rapid (✗), low-cost return to 2-percent inflation?

Conclusion: No soft landing in Europe or the UK. A soft landing by the Fed remains an open question in the context of the signaled higher for longer.

In the process of drawing this conclusion, the paper makes two contributions.

First Contribution: More Power

81 disinflation programs; 21 developing countries between 1973 and 1994

56 programs directed at reducing Dornbusch and Fischer (1993)
“moderate” inflations

25 programs directed at reducing Bruno and Easterly (1996) “high”
inflations

Figure 2. During successful disinflations, the transition from high inflation to moderate inflation is swifter than the transition from moderate to low.

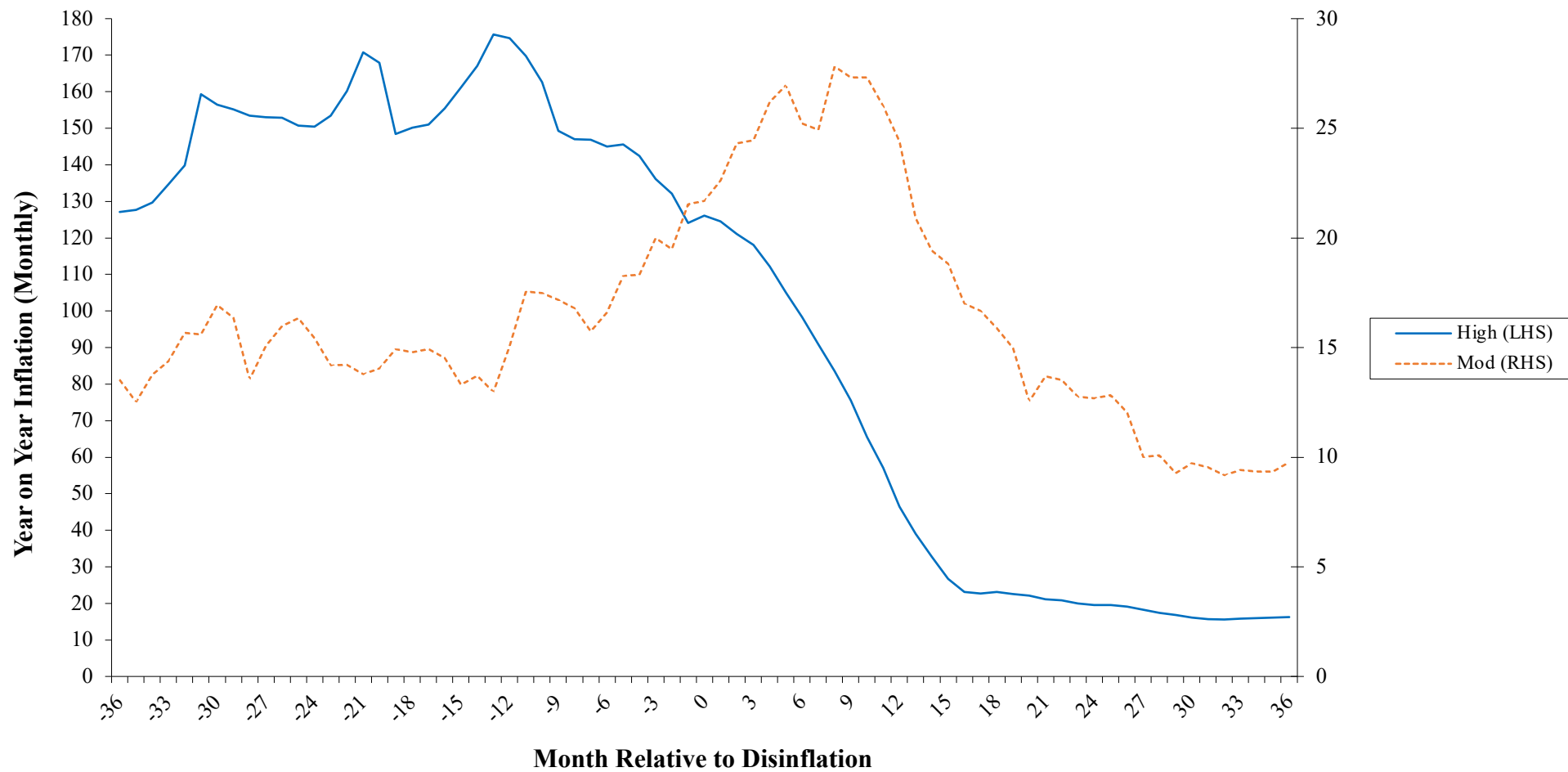
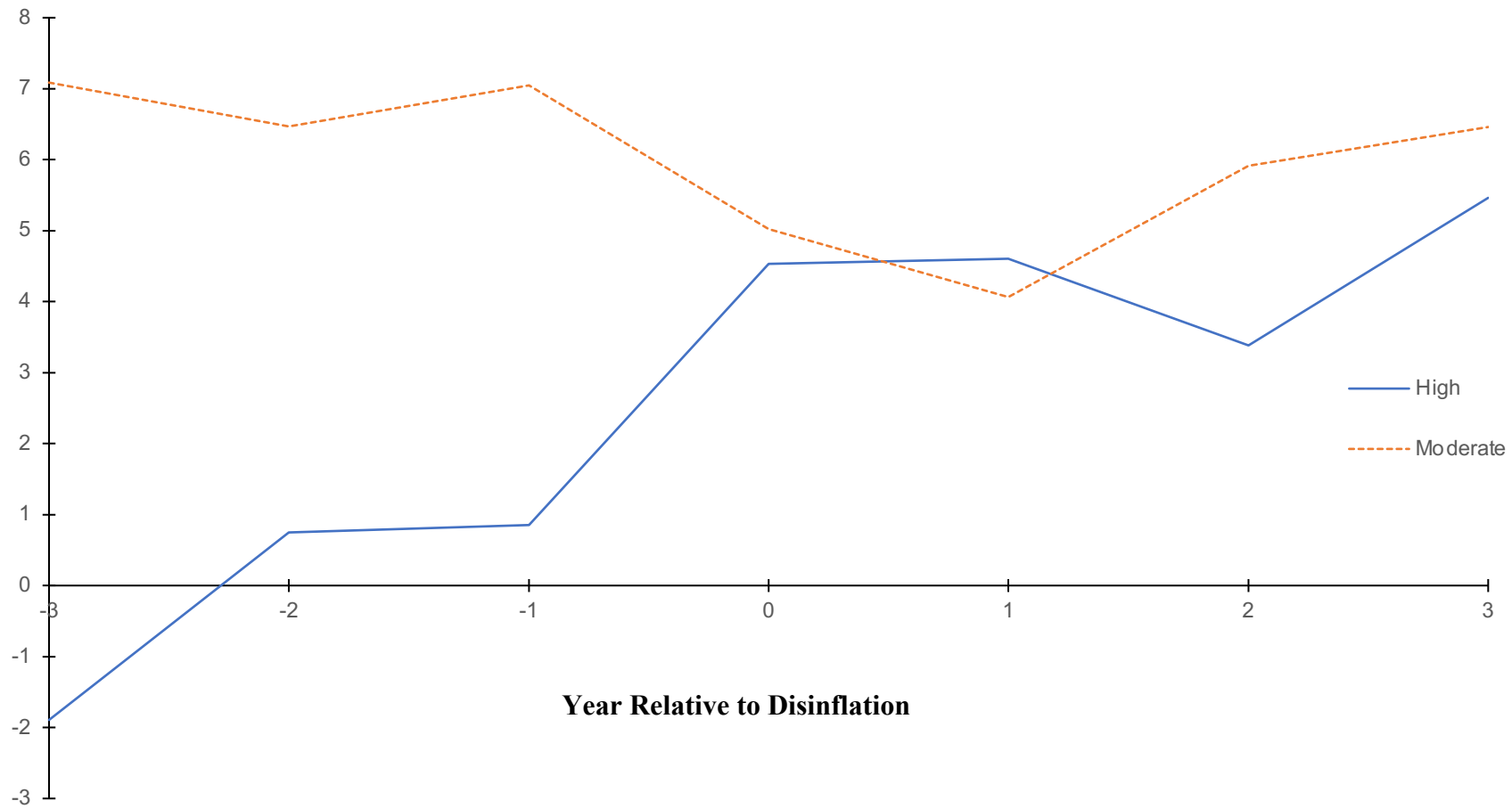


Figure 3. Growth slows during successful disinflations from moderate inflation to low inflation, but rises during disinflations from high to moderate.



Second contribution: New Methodology

Use stock market data from the 21 developing countries to provide a cost-benefit analysis of disinflation.

The central issue about disinflation is not how costly it is in the short run but whether the costs, if any, are outweighed by the longer-run benefits (Henry 2002).

In contrast to the exclusive previous emphasis on costs, by accounting for benefits, our stock market analysis of disinflation highlights the fundamental issue of net present value.

Announcement returns accompanying disinflation programs collapse the entire expected future stream of disinflation costs and benefits into a single summary statistic: the present value of the expected net benefits of the program.

Figure 1. The stock market responds positively to disinflation programs directed at high inflation, negatively to those directed at moderate inflation.

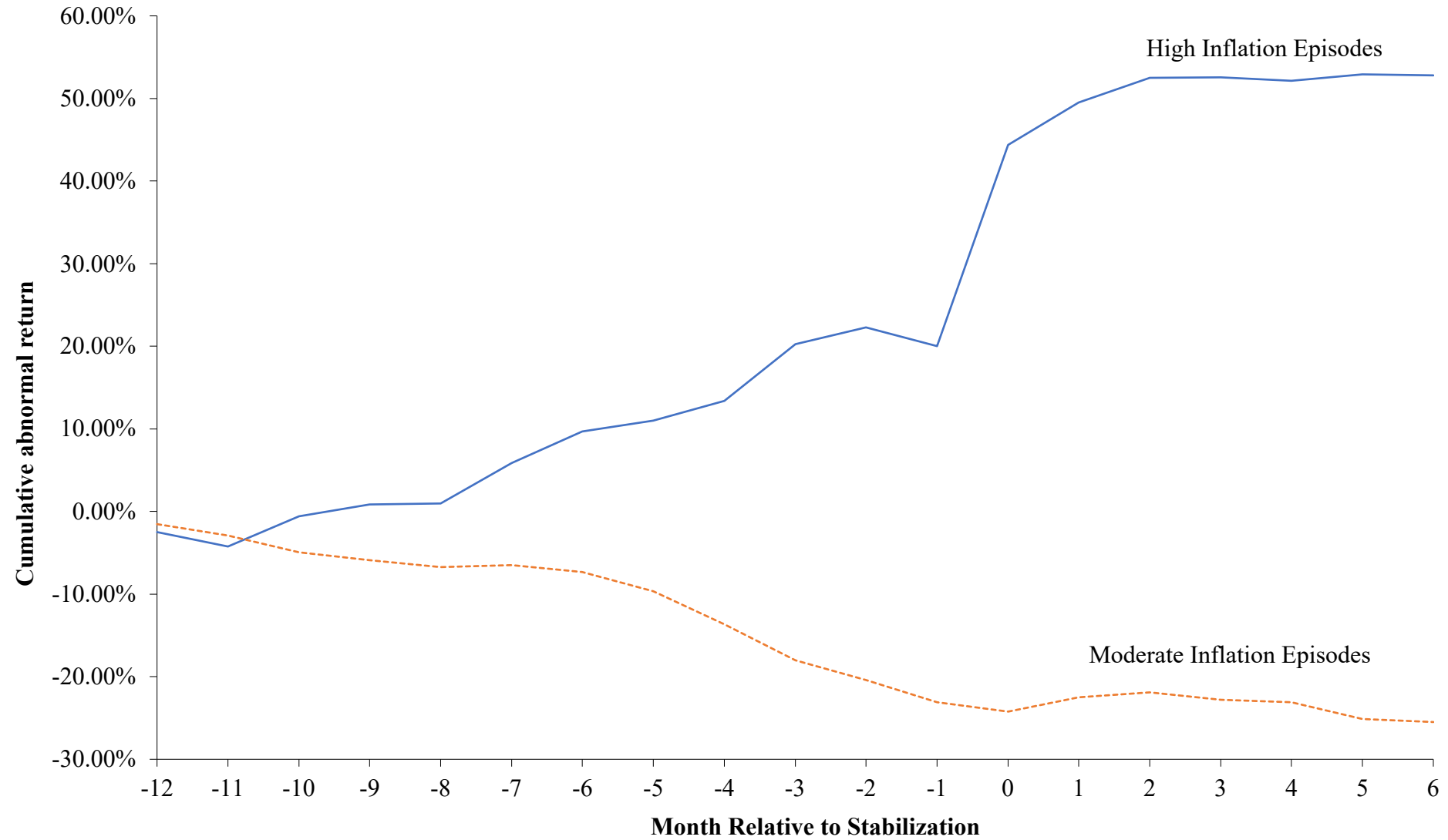



Table 2. The stock market responds positively to disinflations directed at high Inflation and negatively to disinflations directed at moderate inflation.

	Panel A: Real Dollar Returns			Panel B: Real Local Currency Returns		
	(1a)	(2a)	(3a)	(1b)	(2b)	(3b)
HIGH	0.040*** (0.016)	0.040*** (0.016)	0.042*** (0.016)	0.040*** (0.016)	0.040*** (0.016)	0.040*** (0.016)
MOD	-0.015*** (0.005)	-0.015*** (0.005)	-0.017*** (0.005)	-0.010** (0.004)	-0.010** (0.004)	-0.011*** (0.004)
HIGH>MOD?	Yes***	Yes***	Yes***	Yes***	Yes***	Yes***
OECD		-0.022 (0.026)	-0.022 (0.026)		-0.044* (0.024)	-0.044* (0.024)
LIBOR		-0.002*** (0.008)	-0.002*** (0.008)		-0.000 (0.001)	-0.001 (0.001)
SML			0.039 (0.026)			0.031 (0.027)
TRADE			-0.014 (0.024)			-0.015 (0.024)
PRIV			-0.039 (0.047)			-0.030 (0.046)
DEBT			0.000 (0.011)			0.008 (0.010)
ELECTION			0.035* (0.021)			0.029 (0.021)



Conclusion: Whether in advanced economies or the developing world, no team of policymakers has ever executed an immaculate reduction of inflation from moderate to low akin to what we have seen in the vanquishing of high inflations past.

How quickly and costlessly we return to the 2% target remains to be seen. The data so far are more consistent with the historical evidence of disinflating from moderate to low inflation than the TTID view. Whether there will ultimately be output costs remains an open question.