

Discussion of “Beyond Volcker...” by Chari and Henry

Laurence Ball

Johns Hopkins University

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For moderate inflation rates, are the long run benefits of disinflation worth the short run costs?

What is the effect on the present value of output?

State of knowledge:

Short run costs: studies typically estimate sacrifice ratios of 2-3.

Long run benefits: ???

Feldstein (1997) estimates the effect on the PV of output.

He finds large gains from disinflation.

But result depends on questionable assumptions about effects on investment.

This paper's key idea: Measure the effects of disinflation on the stock market.

This captures the effect on the PV of capital income. If capital's share is roughly constant, it also captures the effect on the PV of output.

No need to figure out why inflation is costly.

For moderate inflation, the paper finds that disinflation hurts the stock market.

A puzzle: Why do central banks choose to disinflate?

The result is provocative, but more work is needed to make it persuasive...

Some suggestions:

Adjust for procyclical behavior of capital's share (implies overstatement of short run output loss).

**Study disinflation episodes → be more careful about dating when markets learn about the policy shift.

Examine disinflations in advanced economies (Spain, Ireland, etc etc). (Many start at inflation rates below 10%.)

Distinguish between successful disinflations and unsuccessful disinflations (most of them).

Another possible exercise suggested by the paper:

In the recent U.S. inflation episode, the stock market "yearns for signs" of easing by the Fed.

Might examine the effects of Fed statements on the stock market more rigorously.

A key issue: Does a hawkish statement by a Fed official reveal the Fed's preferences, or bad news about the tradeoff it faces?

Summary: An innovative approach to measuring the costs and benefits of disinflation.

I question the application to the current U.S. situation. There is a big difference between this episode and past disinflations: long-term inflation expectations are anchored at a level near the Fed's target.