Discussion of
“Disinflation and the Stock Market: Third World Lessons for First-World Monetary Policy”
by Chari and Henry

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Getting from Here to There

• Here = moderate inflation
• There = Federal Reserve’s 2% target
• Paper studies disinflations from around the world
  • 21 countries
  • 81 disinflation programs
• Event Study Methodology
  • Event = 12 months prior to announcement of intention to stabilize inflation or engineer disinflation by signing official agreement with IMF
  • Outcome = 12 month stock return, i.e. \([t-12,t-1]\)
  • Sample split: Look at cases where inflation was HIGH >40% in \([t-24,t-1]\) and MOD (10-40%) in \([t-24,t-1]\)
Countries Affected by MOD or HIGH $\pi$
Results

Disinflation from Inflation >40% in [t-1,t-24]
Disinflation from Inflation 10-40% in [t-1,t-24]

Return in 12 Months Prior to Stabilization

-30% -20% -10% 0% 10% 20% 30% 40% 50% 60%

High

Moderate

Real Dollar Returns Real Local Currency Returns
Comment 1: Timing

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

- So during this time, markets see that the high inflation is at least starting to cool...
- ... but they also see that MOD inflation is in fact picking up
- Natural question: what happens to markets after the MOD inflation cools?
Comment 2: Valuation

• Valuation equation, ignoring leverage, think of everything as REAL

\[
Unlevered\ EV_0 = \sum_{t=1}^{\infty} \frac{E_0[FCF_t]}{(1 + r_{A,t})^t}
\]

\[r_{A,t} = r_{f,t} + Risk\ Premium_t\]

• \(r_{f,t}\) is the real risk-free yield curve, Fed increasing parts of it to fight \(\pi\)

• Explaining the results
  • Each \(FCF_t\) is now discounted by higher \(r_{A,t}\)
  • \(E_0[FCF_t]\) may decline as fewer future investment opportunities positive NPV
  • MOD inflation per se not that detrimental REAL FCF
  • HIGH inflation per se might be VERY detrimental to REAL FCF
## Valuation Impact for $Dur=10$

<table>
<thead>
<tr>
<th>10yr Real Yield</th>
<th>$1/(1+r)^{10}$</th>
<th>dEV(0) versus</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>0%</td>
</tr>
<tr>
<td>0%</td>
<td>1.000</td>
<td></td>
</tr>
<tr>
<td>1.5%</td>
<td>0.862</td>
<td>-14%</td>
</tr>
<tr>
<td>3.0%</td>
<td>0.744</td>
<td>-26%</td>
</tr>
<tr>
<td>5.0%</td>
<td>0.614</td>
<td>-39%</td>
</tr>
<tr>
<td>10.0%</td>
<td>0.386</td>
<td>-61%</td>
</tr>
</tbody>
</table>

- How much did sample CBs raise real yields at horizon $Dur$?
- How much does the Fed have to raise real yields at horizon $Dur$ to reduce inflation to 2%?
Comment 3: Are These Countries Valid Comparisons?

• Is US more comparable to a low inflation situation than MOD? We never broke 10%

• Is US history of cooling inflation in 1980s relevant in bringing confidence in the Fed?

• Does US$ not weaken as much during inflationary episodes as emerging market currencies would?
Other Questions for Discussion

• In economic models, costs of expected, moderate inflation not high
• Presumed reason Fed fights moderate inflation: Demonstrate credibility to respond quickly to unexpected inflationary shocks
• But does this value show up in stock prices today?
  • On the one hand: Markets don’t seem to see MOD inflation-fighting as a net positive, given the paper’s headline findings (-18%)
  • On the other hand: Valuation hits might be even larger if market didn’t perceive value of MOD inflation-fighting