



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

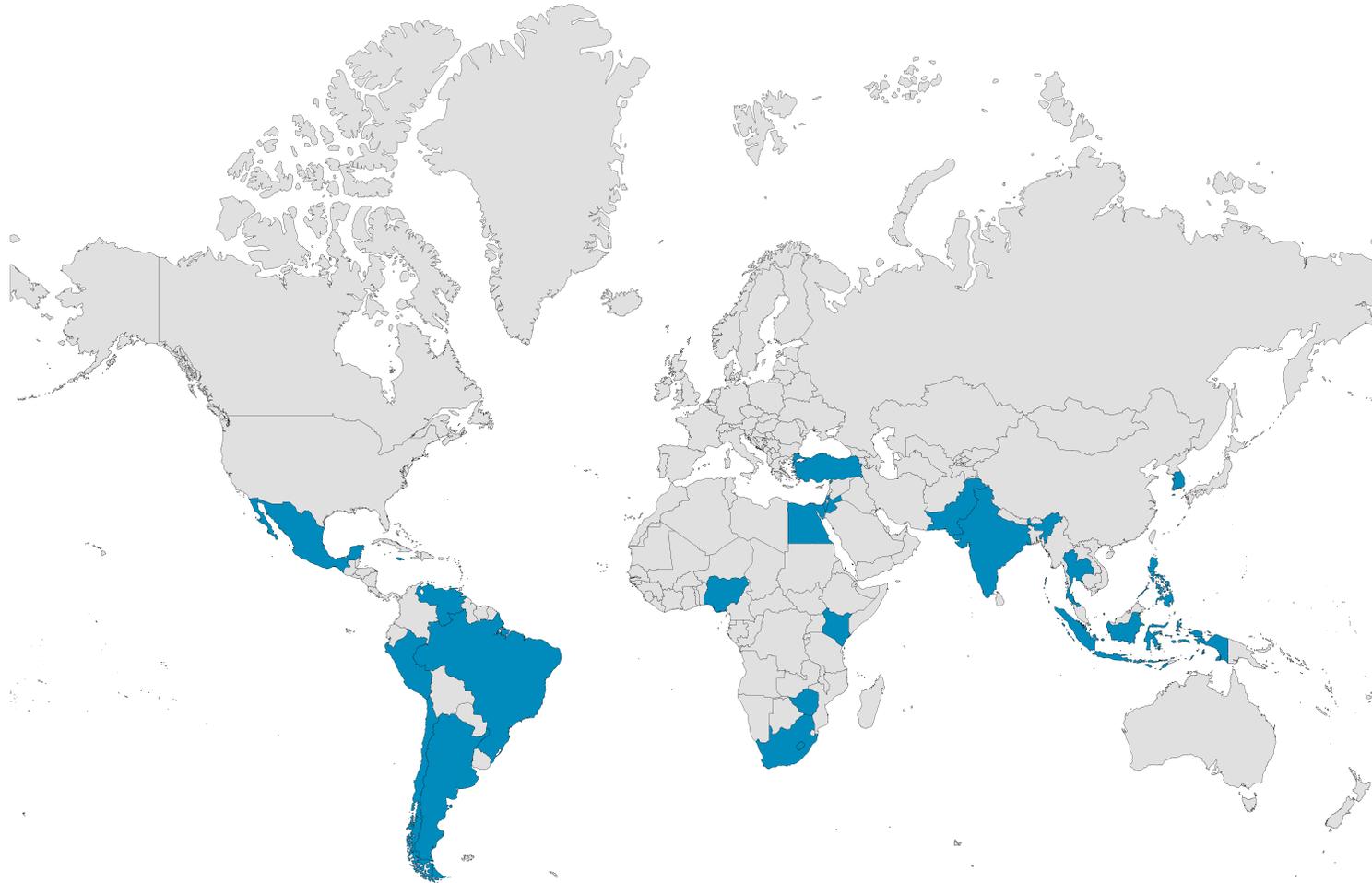
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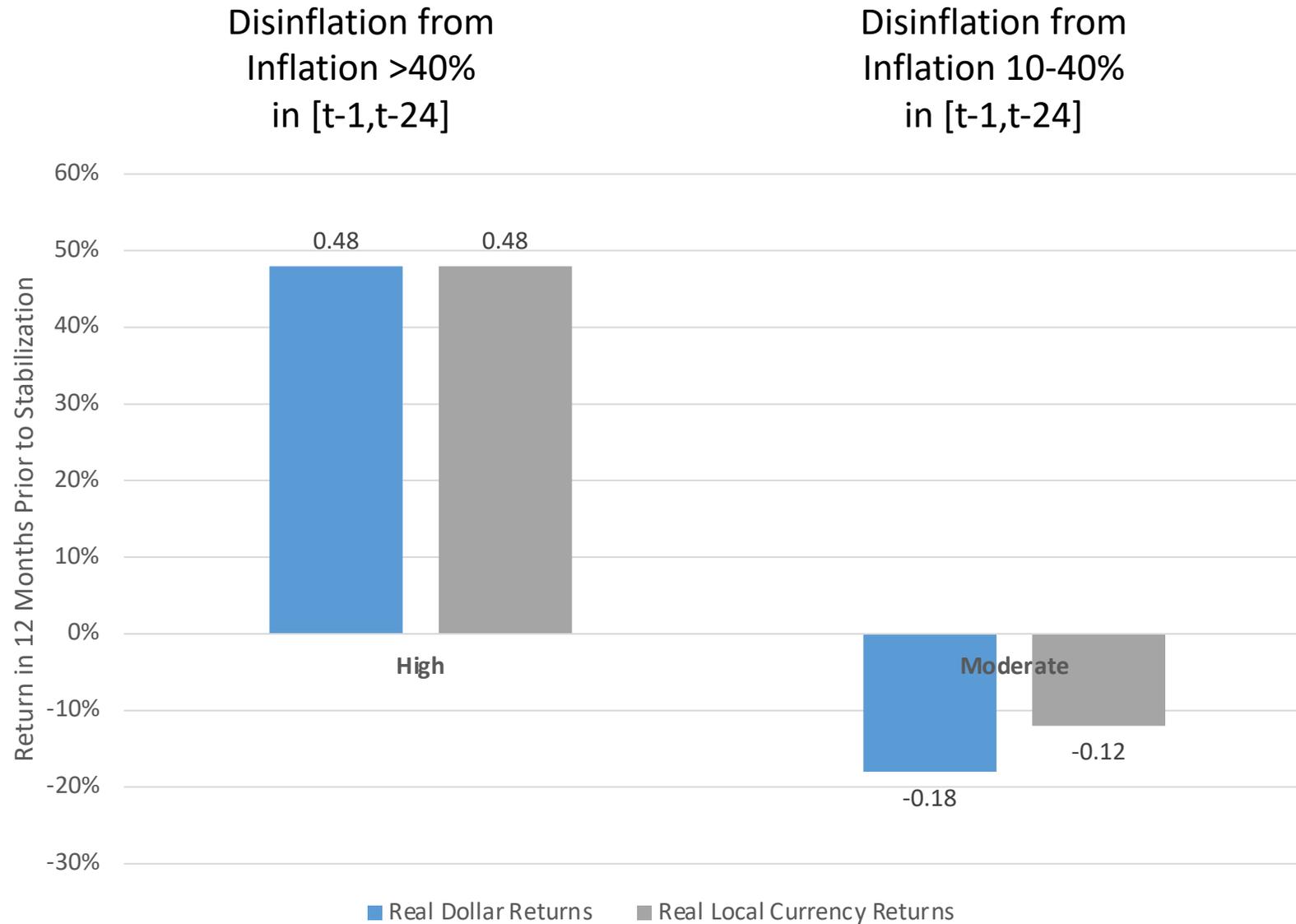
Getting from Here to There

- 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 π

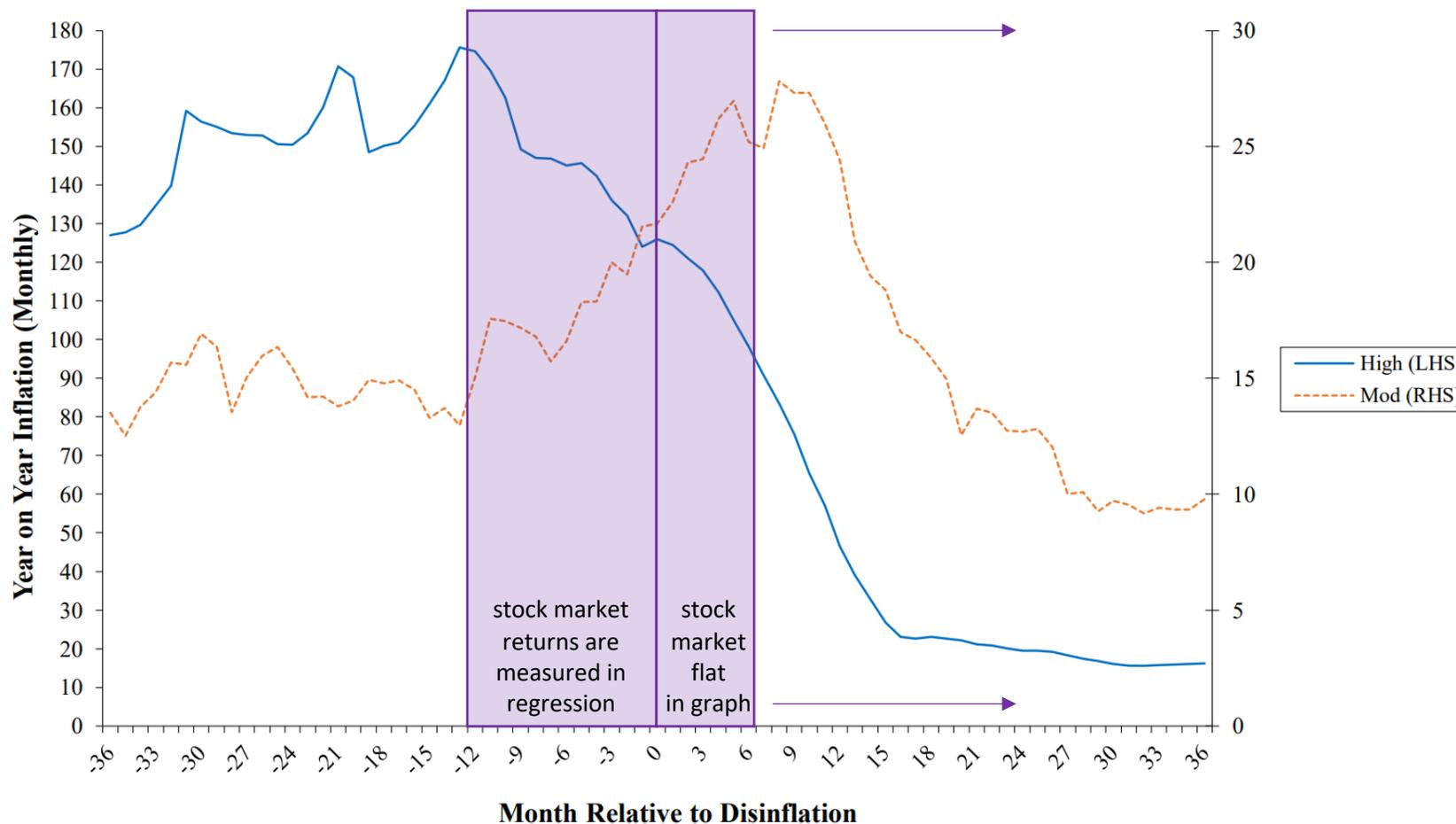


Results



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

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

$$r_{A,t} = r_{f,t} + \text{Risk Premium}_t$$

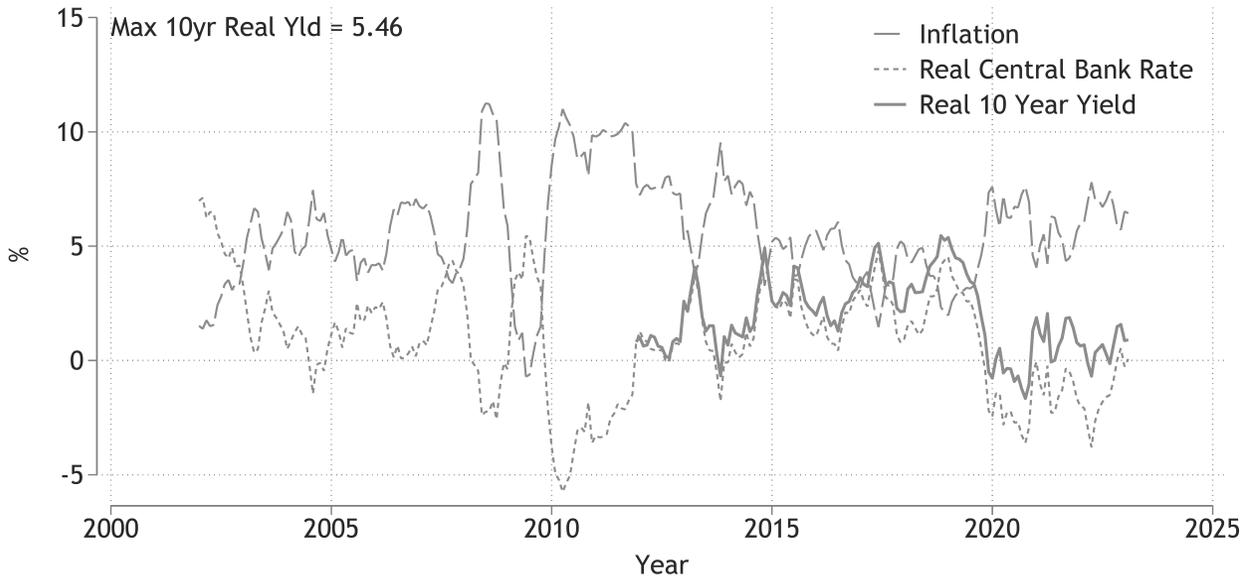
- $r_{f,t}$ is the real risk-free yield curve, Fed increasing parts of it to fight π
- Explaining the results
 - Each FCF_t is now discounted by higher $r_{A,t}$
 - $E_0[FCF_t]$ may decline as fewer future investment opportunities positive NPV
 - MOD inflation per se not that detrimental REAL FCF
 - HIGH inflation per se might be VERY detrimental to REAL FCF

Valuation Impact for $Dur=10$

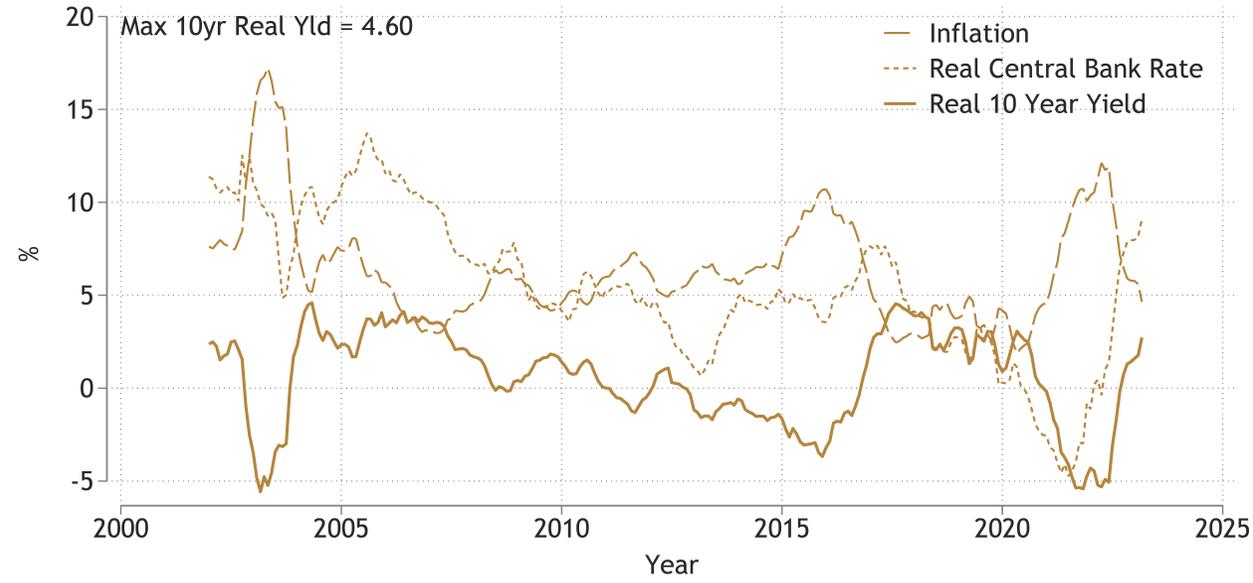
| 10yr Real Yield | $1/(1+r)^{10}$ | dEV(0) versus | | | |
|-----------------|----------------|---------------|------|------|------|
| | | 0% | 1.5% | 3.0% | 5.0% |
| 0% | 1.000 | | | | |
| 1.5% | 0.862 | -14% | | | |
| 3.0% | 0.744 | -26% | -14% | | |
| 5.0% | 0.614 | -39% | -29% | -17% | |
| 10.0% | 0.386 | -61% | -55% | -48% | -37% |

- 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%?

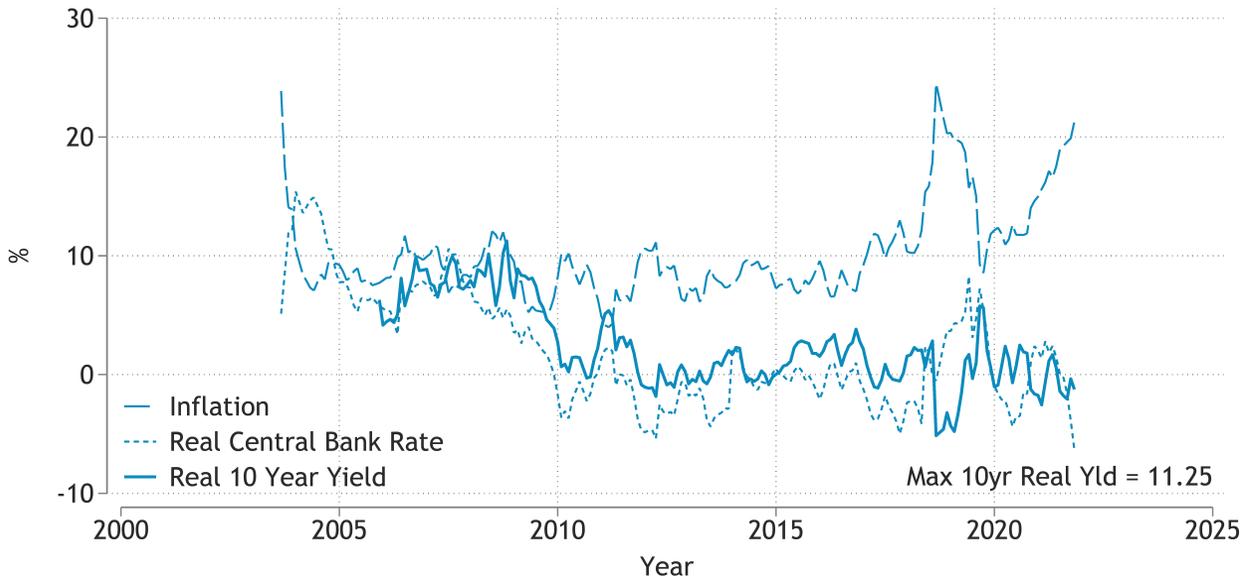
India



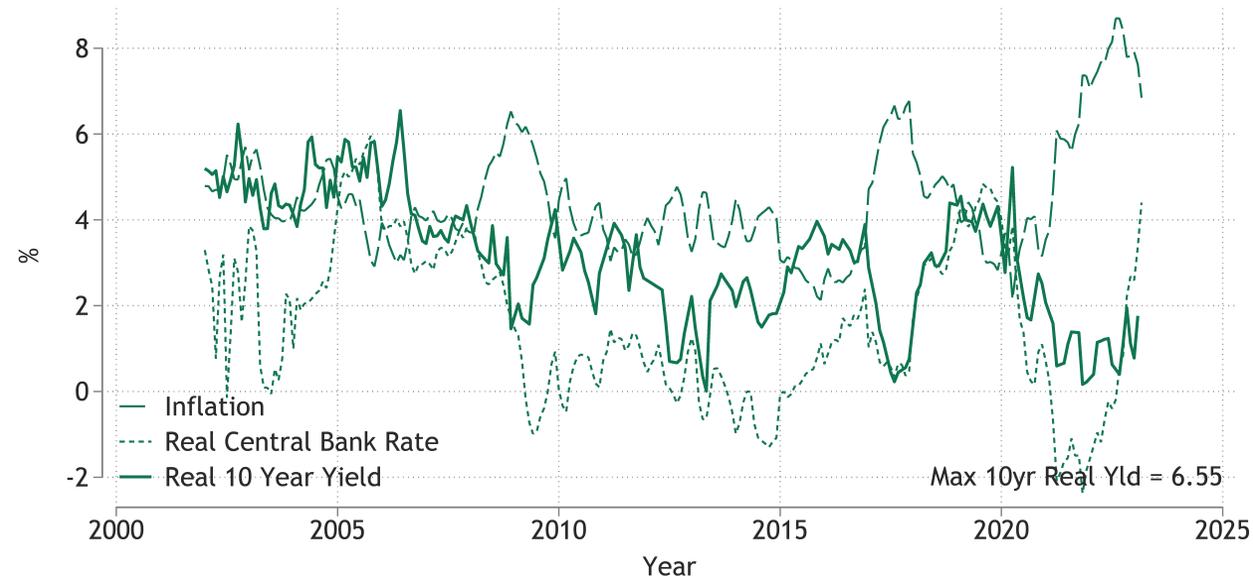
Brazil



Turkey



Mexico



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