



# Disinflations in Latin America and the Caribbean: A free lunch?

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## Abstract

This paper challenges the conventional view according to which disinflations in Latin America – even from low and moderate peaks – have been carried out at no cost to output. After suggesting a new methodology that overcomes some of the shortcomings of the traditional methods used to measure the costs of disinflations, large sacrifice ratios are obtained for the 1970s and 1980s. While the disinflation costs for the 1990s remain negative, it is shown that an unusual combination of circumstances – i.e., factors related to capital inflows, structural reforms, and the peculiar recent inflation history – can explain this fortunate result.

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“The evidence suggests that . . . such [moderate] inflations can be reduced only at a substantial short-term cost to growth” (Dornbusch and Fischer, 1993, p. 1).

“There are little evident output costs of disinflation in the stabilization from moderate inflation” (Burton and Fischer, 1998, p. 18).

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## 1. Introduction

During the 1990s, after almost a quarter of a century enduring high inflation rates, Latin-America and the Caribbean (LAC) countries were finally able to pursue successful disinflationary processes. This disinflation was a remarkable accomplishment. Indeed, in 1990 at the peak of the inflation era, half of the nations had inflation rates above 40%. The average was 1152% and not a single country had annual price increases below 15%. In contrast to that, since 1997, more than half of the nations have had annual inflation rates in single digits, and the average has been below 15%, a combination of events not seen since 1971 (see Fig. 1).

Driven by the infamous inflation history of the LAC countries during the 1970s, 1980s and early 1990s, economists studied the stabilization attempts from *high* inflation rates, as well as the consequences of enduring high inflation. With respect to the latter, the evidence points at a negative relationship between high inflation and growth. In fact, the relationship between inflation and growth loses significance when data from countries with inflation rates above 40% are excluded (e.g., Bruno and Easterly, 1998). As for stabilization attempts from high inflation, the evidence shows that the output performance during stabilization is actually good (Hamann, 2001).

Nevertheless, under the new inflation scenario, the challenges faced by Central Banks in the LAC countries both currently and in the near future, are mainly attached to the handling of low and moderate inflation rates. Unfortunately, very little research has been devoted to studying the experiences of the region when dealing with inflation rates in this range. Furthermore, the few papers analyzing LAC disinflations from low and moderate peaks (e.g., Partow and Yuravlivker, 1998) find the puzzling result that they were costless in terms of output. The LAC countries seem to have enjoyed a free lunch. This outcome challenges the conventional wisdom shared by most economists, i.e., “When economies reduce their rate of inflation, they almost always experience a period of high unemployment and low output” (Mankiw, 2004, p. 523). Indeed, costless disinflations are also inconsistent with the results obtained for OECD countries by Ball (1994), or more recently Zhang (2005) and Boschen and Weise (2001) where substantial output costs are associated with disinflation.

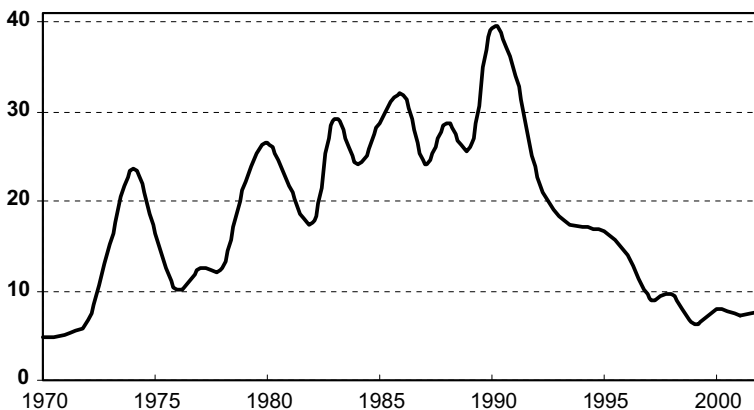


Fig. 1. Median inflation rate in LAC 1970–2002. Source: Author’s calculations based on International Monetary Fund, *International Financial Statistics*, various issues.

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