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High real interest rates in the aftermath of disinflation: is it a lack of credibility?

Graciela L. Kaminsky a,*, Leonardo Leiderman b

Board of Governors of the Federal Reserve System, Washington, DC 20551, USA
Berglas School of Economics, Tel-Aviv University, Ramat Aviv 69978, Israel

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Abstract

High real interest rates have been observed in many countries for several months after the adoption of disinflation programs. While they may reflect primarily a liquidity crunch, high ex post real interest rates can also be explained in terms of an ex post error in inflation expectations that reflects a lack of credibility of the low-inflation policy. The latter hypothesis is tested using data for Argentina, Israel, and Mexico during the implementation of the stabilization programs in the mid-1980s. © 1998 Elsevier Science B.V.

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1. Introduction

High real interest rates have been observed in many countries for several months after the adoption of disinflation programs. For example, 6 months after the start of stabilization plans in Argentina, Israel, and Mexico in the mid-1980s, real interest rates were still on the order of 40–50% per year (see Table 1). Much higher real interest rates have been observed in the aftermath of hyperinflations. For example, real interest rates reached about 100% per year 6 months after the Bolivian stabilization program of October 1985 (see Calvo and Guidotti, 1992). Dornbusch (1986) presented similar evidence for the first year after the end of the

^{*} Corresponding author. Tel.: +1-202-736-7644; fax: +1-202-452-2301; e-mail: m1glk99@frb.gov.

Table 1 Inflation, money growth, and government deficits

Year /quarter	Inflation rate ^a	Nominal interest rate ^a	Real interest rate ^a	MI growth rate ^b	Credit to private sector growth rate ^b	Government deficit (in % of GDP)
Argentina						
1982	250.9	201.9	6.2	247.5	224.0	12.6
1983	472.6	738.9	57.1	362.1	400.8	15.7
1984	745.9	868.8	10.9	566.7	554.1	17.2
1985:1	1268.3	1266.2	-4.2	500.0	684.8	
1985:2	1945.4	3143.1	307.8	650.0	1030.6	
1985:3	58.7	139.5	81.7	950.0	676.6	
1985:4	34.6	93.1	37.7	500.0	372.1	12.3
1986	85.9	107.5	10.5	86.7	83.7	8.5
1987	213.4	242.6	21.3	150.0	196.0	10.8
1988	513.8	430.4	-0.2	357.1	355.7	
Israel						
1982	135.7	140.2	5.7	110.3	158.0	10.0
1983	238.9	186.2	-0.4	138.1	198.5	6.0
1984	530.1	823.0	118.6	342.1	526.9	13.0
1985:1	249.6	499.8	17.7	392.7	469.9	
1985:2	421.1	715.3	77.5	342.2	440.3	
1985:3	624.0	599.5	349.7	396.7	358.3	
1985:4	31.2	174.2	168.1	257.2	181.1	2.8
1986	20.8	62.1	31.5	119.9	16.1	-0.7
1987	16.7	62.1	41.2	51.0	20.6	3.3
1988	16.6	46.3	23.0	11.2	22.2	8.1
Mexico						
1984	60.2	48.6	-6.7	60.0	51.3	6.4
1985	66.2	60.2	-2.2	49.5	69.7	8.7
1986	108.2	86.7	-8.2	67.2	101.7	14.8
1987:1	133.6	96.1	-17.4	77.9	94.3	
1987:2	148.0	92.0	-20.4	94.0	74.8	
1987:3	142.1	90.5	-21.4	123.1	74.8	
1987:4	244.5	105.2	-48.5	118.1	104.4	15.0
1988	74.8	69.2	23.2	67.8	66.9	11.3
1989	20.1	45.0	19.6	37.4	45.6	5.4
1990	30.8	35.8	6.4	62.9	41.7	3.6

Sources: Banco Central de la Republica Argentina. Boletin Estadistico; Banco de Mexico, Indicadores Economicos: IMF, International Financial Statistics; IMF, Government Finance Statistics: Dornbusch and de Pablo (1990).

All rates of change and interest rates are expressed in % per year. The real interest rate is computed using the 1-month ahead inflation rate. ^aAnnual (quarterly) average of monthly rates. ^bAnnual rate. The government budget deficits of these countries are defined as follows: for Argentina the deficit series reported is the Cavallo–Pena measure, for Israel the deficit corresponds to deficit of the central government, and for Mexico it reflects the overall public sector deficit.

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