Abstract

The paper studies the design of efficient disinflation programmes in open economies using the sacrifice ratio, that is, the cumulative additional unemployment or cumulative lost output required to achieve a one percent sustained reduction in the rate of inflation, as the metric of efficiency. The 'new Keynesian' Phillips curve first proposed by Calvo has a zero sacrifice ratio: costless disinflation is possible, because the inflation process is purely forward-looking. There is inertia or rigidity in the price level but not in the rate of inflation.

More interesting inflation kernels for which current inflation is partly forward-looking and partly backward-looking have a positive sacrifice ratio. Real exchange rate appreciation early in the disinflation process may raise the sacrifice ratio relative to a policy that keeps the real exchange rate constant. The sacrifice ratio is lower under gradualism than under 'cold turkey'. Efficient disinflation policies may, however, be time-inconsistent and therefore not credible.

Key words: sacrifice ratio; disinflation; new Keynesian Phillips curve.

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