Abstract

High real interes rates typically accompany successful disinflations. The phenomenon is often attributed to lack of credibility. This first part of this paper derives the conditions under which real rates rise during disinflation even under full credibility. The exchange rate regime matters. Under perfectly flexible exchange rates, the real interest rate is invariant to changes in the rate of money creation. By contrast, the real rate of interest tends to rise when an economy under predetermined exchange rates is disinflated via the type of "exchange rate management" analyzed by Drazen and Helpman (1987). If government deficits are financed with domestic debt, this can be destabilizing. High interest rates can increase debt service costs and contribute to the accumulation of debt, threatening the whole anti-inflation effort. The second part of this paper therefore analyzes the consequences of such interest rate behavior for the "monetarist arithmetic" problem first raised by Sargent and Wallace (1981). Rules for fiscal and/or monetary policies are developed to ensure that the economy reaches a new steady in the aftermath of a disinflation.