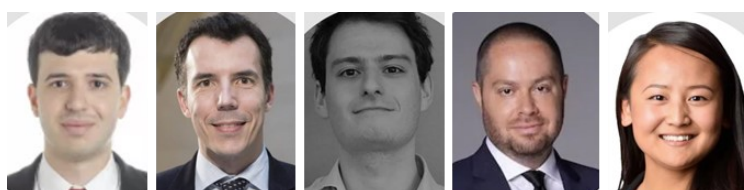


Lessons from 100 inflation shocks*



By Anil Ari, Carlos Mulas-Granados, Victor Mylonas, Lev Ratnovski, and Wei Zhao
International Monetary Fund (IMF)

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Our analysis identifies over 100 inflation shock episodes in 56 countries since the 1970s, including over 60 episodes linked to the 1973–79 oil crises. We document that only in 60 percent of the episodes was inflation brought back down within 5 years, and that even in these “successful” cases disinflation took, on average, over 3 years. Most unresolved inflation episodes involved “premature celebrations”, where inflation declined initially, only to plateau at an elevated level or re-accelerate later. Countries that resolved inflation had tighter monetary policy that was maintained more consistently over time, lower nominal wage growth, and less currency depreciation, compared to unresolved cases. Successful disinflations were associated with short-term output losses, but not with larger output, employment, or real wage losses over a 5-year horizon, indicating the value of policy credibility and macroeconomic stability.

*This policy brief is based on [IMF Working Paper No. 2023/190](#). The views expressed in IMF Working Papers are those of the author(s) and do not necessarily represent the views of the IMF, its Executive Board, or IMF management.

The 1970s oil price shocks left central banks around the world scrambling to control inflation. After a year or so, oil prices stabilized and inflation started to retreat. Policymakers in many countries believed they had restored price stability and loosened policy to revive their recession-hit economies only to see inflation return. Could history repeat?

Inflation reached historic highs in 2022 after Russia's invasion of Ukraine triggered a terms-of-trade shock akin to that of the 1970s. Disruptions to Russian oil and gas supplies added to COVID supply-chain problems to drive prices higher. In advanced economies, prices rose at the fastest pace since 1984. In emerging market and developing economies, inflation was at its highest since the 1990s.

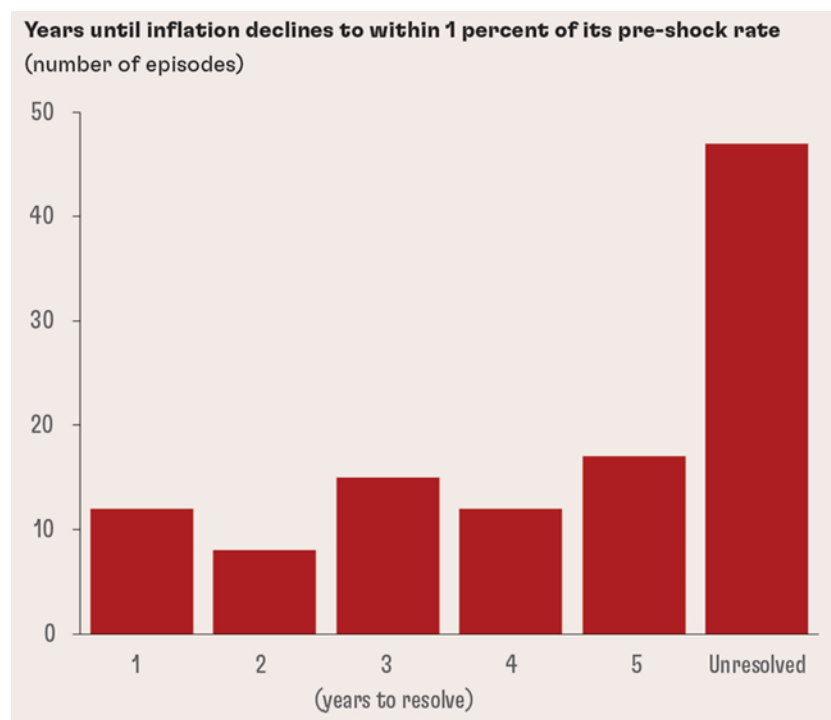
Aided by the sharpest rise in interest rates for a generation, inflation has started to subside at last. Headline inflation in the United States and across much of Europe has halved from about 10 percent last year to less than 5 percent today. The latest conflict in the Middle East has, for now at least, not had a large impact on oil prices.

Still, our analysis suggests that it might be too soon for policymakers to celebrate victory over inflation.

Patterns of inflation

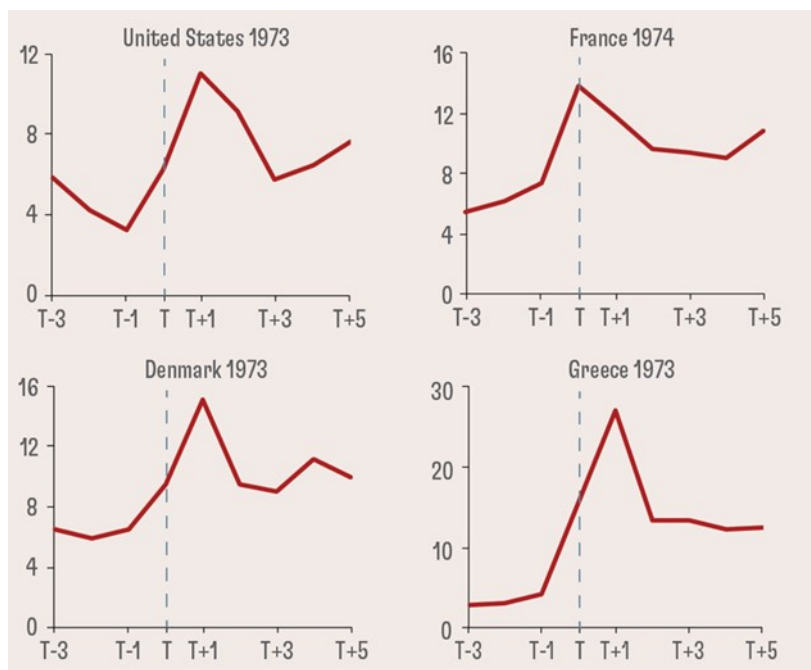
Our [recent study](#) of over 100 inflation shocks since the 1970s provides two reasons for caution. First, history teaches us that inflation is persistent. It takes years to “resolve” inflation by reducing it to the rate that prevailed before the initial shock. Forty percent of countries in our study failed to resolve inflation shocks even after five years. It took the remaining 60 percent an average of three years to return inflation to pre-shock rates (Figure 1).

Figure 1: Persistence of inflation.



Second, countries have historically celebrated victory over inflation prematurely and loosened policy in response to an initial decline in price pressures. When the decline in inflation proved only transitory, such loosening became a costly mistake. Denmark, France, Greece and the United States were among nearly 30 countries in our sample to loosen prematurely after the 1973 oil-price shock (Figure 2). There are many more examples in our data. In fact, almost all countries in our analysis (90 percent) that failed to resolve inflation saw price growth slow sharply in the first few years after an initial shock only for it to accelerate again or become sticky at a faster pace.

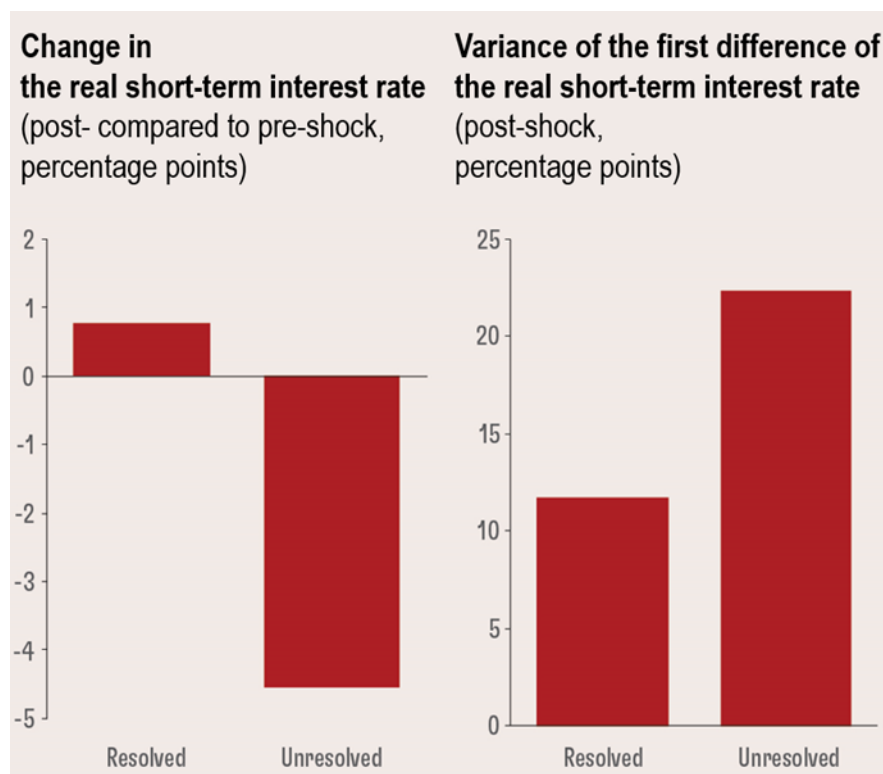
Figure 2: Examples of premature celebrations. (CPI, percent.)



Policy consistency and credibility

How should policymakers respond to persistent inflation? Again, history provides some lessons. The countries in our study that successfully resolved inflation tightened macroeconomic policies more in response to the inflation shock and, crucially, maintained a tight policy stance consistently over a period of several years. Examples here include Italy and Japan, which adopted tighter-for-longer policies after the 1979 oil-price shock. By contrast, countries that did not resolve inflation had a looser policy stance and were more likely to change between tightening and loosening cycles (Figure 3).

Figure 3: Tightness and consistency of the monetary policy stance.



Policy credibility matters, too. We document that countries where inflation expectations were more firmly anchored, or where central banks had more success maintaining low and stable inflation in the past, were more likely to defeat inflation.

Today's policymakers can take some solace from this finding. Central bankers in many countries may find it easier to defeat inflation this time because of the policy credibility that they have built up over several decades of successful macroeconomic management. With the right policies in place, countries could resolve inflationary pressures sooner than in the past.

But it won't be easy. Conditions in the labor market in particular require close attention. In many countries, workers' wages have fallen in inflation-adjusted terms and may need to rise again to catch up with higher prices. Yet wage growth could fuel inflation if it is too high and lead to pernicious wage-price spirals.

Our analysis brings evidence that countries that resolved inflation successfully tended to have lower nominal wage growth. Importantly, this did not translate into lower real wages and a loss of purchasing power because lower nominal wage growth was accompanied by lower price growth. The implication for policymakers here is to focus on real wages, not nominal wages, when responding to developments in the labor market.

Countries that resolved inflation successfully were also better at maintaining external stability. Free-floating currencies were less likely to depreciate sharply, and currency pegs were more likely to survive. This is not a call for currency intervention. Instead, it appears that countries' success in fighting inflation—through tighter monetary policy and greater policy credibility—was instrumental in shoring up exchange rates.

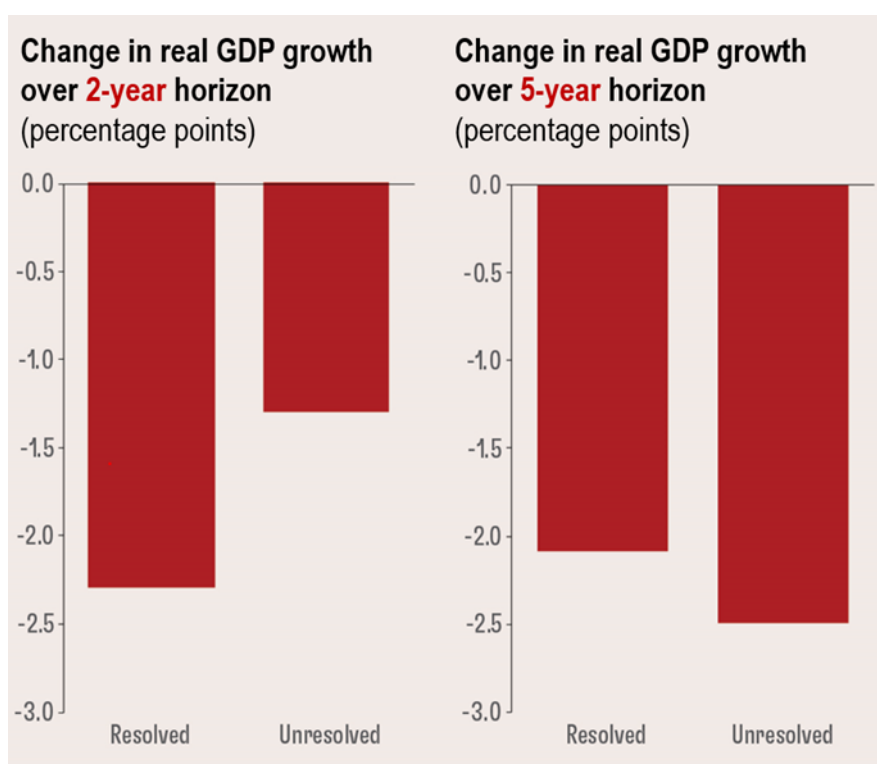
The economic benefits of price stability

Fighting inflation is difficult. But it is important to recognize the benefits of price stability. We document that countries that resolved inflation had lower economic growth in the short term than those that did not. But this relationship reversed over the medium and long term. Five years after the inflation shock, countries that resolved inflation had higher growth and lower unemployment than economies that allowed inflation to linger.

The economics behind this finding are intuitive. There is a trade-off between bringing inflation down on the one hand and achieving higher growth and lower unemployment on the other. But this trade-off is temporary: growth recovers and jobs are created once inflation is brought under control.

By contrast, leaving inflation unresolved comes with its own costs of macroeconomic instability and inefficiency. These costs accumulate for as long as inflation remains high. Consequently, cumulative welfare losses from unresolved or permanently high inflation dominate over the medium to long term (Figure 4). Countries that allow inflation to linger ultimately pay a higher price.

Figure 4: Macroeconomic impact of resolving inflation, in the short-term vs. in the medium term.



The past is never a perfect guide to the future because no two crises are precisely alike. All the same, history offers clear lessons to policymakers today. Fighting inflation is a marathon, not a sprint. Policymakers must persevere, demonstrate policy credibility and consistency, and keep their eye on the prize: macroeconomic stability and stronger growth brought about by returning inflation firmly to target. If history is a guide, inflation's recent decline could be transitory. Policymakers would be wise not to celebrate too soon. ■

References

Ari, Anil, Carlos Mulas-Granados, Victor Mylonas, Lev Ratnovski, and Wei Zhao. 2023. "One Hundred Inflation Shocks: Seven Stylized Facts". [IMF Working Paper 2023/190](https://www.imf.org/en/Publications/Working-Papers/2023/01/190).

About the authors

Anil Ari is an economist in the European Department of the International Monetary Fund, where he works on the United Kingdom. Previously, was as a desk economist for Ukraine and in the IMF Research Department. Mr. Ari has published in the *Journal of Monetary Economics* and the *Journal of Banking & Finance*. Mr. Ari holds a Ph.D. in Economics from the University of Cambridge.

Carlos Mulas-Granados is Deputy Chief of the Strategy Unit at the International Monetary Fund. Previously, he was a Professor at Complutense University and the Deputy Director of the Spanish Prime Minister's Economic Office. Mr. Mulas-Granados has published in *Economic Policy*, the *Journal of International Money and Finance*, and the *British Medical Journal*. He holds a Master's degree from Columbia, a PhD from Cambridge University, and a Doctor degree from Complutense University.

Victor Mylonas is an External Expert at the International Monetary Fund (IMF), affiliated with the Fiscal Affairs Department and the Institute for Capacity Development. He is also a Consultant in the Macroeconomics, Trade and Investment Global Practice of the World Bank. Victor has previously held various other positions at the IMF, the World Bank, and the European Investment Bank.

Lev Ratnovski is Senior Desk for the Euro Area at the International Monetary Fund. Previously, he was Lead Economist at the European Central Bank and Senior Economist at the IMF Research Department. Mr. Ratnovski has published in the *Journal of Monetary Economics* and the *Review of Financial Studies*. Mr. Ratnovski started his career at the Bank of England after receiving Ph.D. from the University of Amsterdam.

Wei Zhao is a Research Analyst for the Euro Area at the International Monetary Fund. Prior to this role, Wei worked as a consultant for the Sector Economics and Development Impact Department at the International Finance Corporation. Wei holds an MA in International Economics and Latin American Studies from the Johns Hopkins University School of Advanced International Studies.

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SUERF Secretariat
c/o OeNB
Otto-Wagner-Platz 3
A-1090 Vienna, Austria
Phone: +43-1-40420-7206
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