The root causes of hyperinflation.

Root causes of hyperinflation

From http://en.wikipedia.org/wiki/Hyperinflation

The main cause of hyperinflation is a massive and rapid increase in the amount of money, which is not supported by growth in the output of goods and services. This results in an imbalance between the supply and demand for the money (including currency and bank deposits), accompanied by a complete loss of confidence in the money, similar to a bank run. Enactment of legal tender laws and price controls to prevent discounting the value of paper money relative to gold, silver, hard currency, or commodities, fails to force acceptance of a paper money which lacks intrinsic value. If the entity responsible for printing a currency promotes excessive money printing, with other factors contributing a reinforcing effect, hyperinflation usually continues. Often the body responsible for printing the currency cannot physically print paper currency faster than the rate at which it is devaluing, thus neutralizing their attempts to stimulate the economy.[7][dead link]

Hyperinflation is generally associated with paper money because this can easily be used to increase the money supply: add more zeros to the plates and print, or even stamp old notes with new numbers. Historically there have been numerous episodes of hyperinflation in various countries, followed by a return to "hard money". Older economies would revert to hard currency and barter when the circulating medium became excessively devalued, generally following a "run" on the store of value.

Hyperinflation effectively wipes out the purchasing power of private and public savings, distorts the economy in favor of extreme consumption and hoarding of real assets, causes the monetary base, whether specie or hard currency, to flee the country, and makes the afflicted area anathema to investment. Hyperinflation is met with drastic remedies, such as imposing the shock therapy of slashing government expenditures or altering the currency basis. An example of the latter occurred in Bosnia-Herzegovina in 2005, when the central bank was only allowed to print as much money as it had in foreign currency reserves. Another example was the dollarization in Ecuador, initiated in September 2000 in response to a massive 75% loss of value of the Sucre currency in early January 2000. Dollarization is the use of a foreign currency (not necessarily the U.S. dollar) as a national unit of currency.

The aftermath of hyperinflation is equally complex. As hyperinflation has always been a traumatic experience for the area which suffers it, the next policy regime almost always enacts policies to prevent its recurrence. Often this means making the central bank very aggressive about maintaining price stability, as was the case with the German Bundesbank, or moving to some hard basis of currency such as a currency board. Many governments have enacted extremely stiff wage and price controls in the wake of hyperinflation, which is, in effect, a form of forced savings, but does not prevent further inflating of the *money supply by its central bank, and always leads to widespread shortages of consumer goods if the controls are rigidly enforced.*

A 500 billion Yugoslav dinar banknote circa 1993, the largest nominal value ever officially printed in Yugoslavia, the final result of hyperinflation. Photo courtesy of National Bank of Serbia (www.nbs.rs)

As it allows a government to devalue their spending and displace (or avoid) a tax increase, governments have sometimes resorted to excessively loose monetary policy to meet their expenses. Inflation is considered by some another tax on citizens but less overt and is therefore harder to understand by ordinary citizens. Inflation can obscure quantitative assessments of the true cost of living, as published price indices only look at data in retrospect, so may increase only months or years later. Monetary inflation can become hyperinflation if monetary authorities fail to fund increasing government expenses from taxes, government debt, cost cutting, or by other means, because:

(1) during the time between recording or levying taxable transactions and collecting the taxes due, the value of the taxes collected falls in real value to a small fraction of the original taxes receivable;

(2) government debt issues fail to find buyers except at very deep discounts

Theories of hyperinflation generally look for a relationship between seigniorage and the inflation tax. In both Cagan's model and the neo-classical models, a crucial point is when the increase in money supply or the drop in basic money stock makes it impossible for a government to improve its financial position. Thus when fiat money is printed, government obligations that are not denominated in money increase in cost by more than the value of the money created.

From this, it might be wondered why any rational government would engage in actions that cause or continue hyperinflation. One reason for such actions is that often the alternative to hyperinflation is either depression or military defeat. The root cause is a matter of more dispute. In both classical economics and monetarism, it is always the result of the monetary authority irresponsibly borrowing money to pay all its expenses. These models focus on the unrestrained seigniorage of the monetary authority, and the gains from the inflation tax. In Neoliberalism, hyperinflation is considered to be the result of a crisis of confidence. The monetary base of the country flees, producing widespread fear that individuals will not be able to convert local currency to some more transportable form, such as gold or an internationally recognized hard currency. This is a quantity theory of hyperinflation.[citation needed]

In neo-classical economic theory, hyperinflation is rooted in a deterioration of the monetary base, that is the confidence that there is a store of value which the currency will be able to command later. In this model, the perceived risk of holding currency rises dramatically, and sellers demand increasingly high premiums to accept the currency. This in turn leads to a greater fear that the currency will collapse, causing even higher premiums. One example of this is during periods of warfare, *civil war, or intense internal conflict of other kinds: governments need to do whatever is necessary to continue fighting, since the alternative is defeat. Expenses cannot be cut significantly since the main outlay is armaments. Further, a civil war may make it difficult to raise taxes or to collect existing taxes. While in peacetime the deficit is financed by selling bonds, during a war it is typically difficult and expensive to borrow, especially if the war is going poorly for the government in question. The banking authorities, whether central or not, "monetize" the deficit, printing money to pay for the government's efforts to survive. The hyperinflation under the Chinese Nationalists from 1939-1945 is a classic example of a government printing money to pay civil war costs. By the end, currency was flown in over the Himalaya, and then old currency was flown out to be destroyed.*

Hyperinflation is regarded as a complex phenomenon and one explanation may not be applicable to all cases. However, in both of these models, whether loss of confidence comes first, or central bank seigniorage, the other phase is ignited. In the case of rapid expansion of the money supply, prices rise rapidly in response to the increased supply of money relative to the supply of goods and services, and in the case of loss of confidence, the monetary authority responds to the risk premiums it has to pay by "running the printing presses."

In the United States of America, hyperinflation was seen during the Revolutionary War and during the Civil War, especially on the Confederate side. Many other cases of extreme social conflict encouraging hyperinflation can be seen, as in Germany after World War I, Hungary at the end of World War II and in Yugoslavia in the late 1980s just before break up of the country.

Less commonly, inflation may occur when there is debasement of the coinage — wherein coins are consistently shaved of some of their silver and gold, increasing the circulating medium and reducing the value of the currency. The "shaved" specie is then often restruck into coins with lower weight of gold or silver. Historical examples include Ancient Rome, China during the Song Dynasty, and the United States beginning in 1933. When "token" coins begin circulating, it is possible for the minting authority to engage in fiat creation of currency.

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