Working Paper

INTERNATIONAL MONETARY FUND

IMF WORKING PAPER

© 1992 International Monetary Fund

This is a Working Paper and the author would welcome any comments on the present text. Citations should refer to a Working Paper of the International Monetary Fund, mentioning the author, and the date of issuance. The views expressed are those of the author and do not necessarily represent those of the Fund.

WP/92/24

INTERNATIONAL MONETARY FUND

Research Department

Can the Release of a Monetary Overhang Trigger Hyperinflation?

Prepared by Shoukang Lin and Kent Osband*

Authorized for Distribution by Malcolm Knight and Peter Wickham

March 1992

Abstract

It is widely feared that, once prices are decontrolled in the formerly centrally-planned economies, households' release of previously accumulated money will trigger a hyperinflation. This paper finds, instead, that whether a country's fiscal, monetary, and labor market policies are destabilizing typically does not depend on the money stock. However, the release of a monetary overhang can precipitate a large initial real wage shock. To the extent such a shock is not feasible politically, there is a motive for monetary reform, which must be weighed against the cost of reduced public confidence in money.

JEL Classification Numbers:
E31, E63, P22

* Discussions with Michael Gavin and Peter Wickham helped to illuminate the model, while Catherine Fleck provided editorial assistance.

©International Monetary Fund. Not for Redistribution

Contents

	Page
Summary	iii
I. Introduction	1
II. A Savings-Driven Model	3
1. Description	3
2. Solution	5
3. Discussion	7
III. Modifications	10
1. Exogenous Growth	10
2. Revenue Adjustments	11
3. Social Expenditure Adjustments	13
4. Wage Adjustments	14
5. Monetary Adjustments	16
IV. A Special Case when Bond Holdings Are Zero	16
V. Simulation Results	18
VI. Policy Implications	20
Figures	
1. Impact of Initial Wealth on Real Wages in a Savings-Driven Model (k=0.5)	18a
2. Impact of Adjustment Speed on Real Wages in a Savings-Driven Model (A/Y=1)	18b
3. Impact of Velocity of Money on Real Wages in a Transactions-Driven Model	18c
4. Impact of Velocity of Money on Inflation in a Transactions-Driven Model	18d
References	22

©International Monetary Fund. Not for Redistribution

Summary

It is widely feared that, once prices are decontrolled in the formerly centrally-planned economies, the release of financial assets accumulated by households will touch off a hyperinflation. This paper finds, instead, that the money stock typically has little influence over whether a country's fiscal, monetary, and labor market policies are destabilizing. High inflation is fundamentally a flow problem, not a problem of an initial money stock. Admittedly, an initial inflation can elicit more inflation, but the responses tend to be damped rather than explosive.

The money stock does bear directly, however, on the dimensions of the initial price surge and the consequent shock to real wages. The real wage compression must allow consumer markets to absorb over time not only the initial overhang, but also the subsequent rounds of monetary emissions induced by the overhang. To permit recovery of future real wages, as required by labor market pressures, present real wages must bear most of the shock. The shock tends to be greater, the larger the initial holdings of cash and bonds, or the weaker the stabilization policies pursued.

Measures to soften the initial wage shock demand careful scrutiny. Social expenditure measures should be limited to the neediest and/or phased out over time. If this is not politically feasible, a monetary overhang may indeed become "too big to work off," unless other stabilization policies are made more stringent. By spreading the adjustment burden over time, temporary wage controls (or reductions in guaranteed indexation) may be particularly helpful in easing the immediate shock. Another possible remedy is monetary reform, whose merits should be weighed against the likely further diminution of households' confidence in domestic money.

These theoretical findings appear to be borne out by the recent Eastern European experience with price liberalization. The initial price surge quickly gave way to manageable rates of inflation, albeit at the cost of substantial labor unrest. In the former Soviet republics, stabilization appears to be endangered less by the existing monetary stock than by the attempts to peg minimum wages and social benefits at unsustainably high levels.

©International Monetary Fund. Not for Redistribution