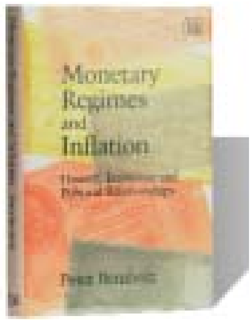
The Horrors of Hyperinflation



Peter Bernholz

Monetary Regimes and Inflation
History, Economic and Political Relationships
Edward Elgar, Surrey, United Kingdom/Northampton, Massachusetts, 2003, 224 pp., £55/$85 (cloth).

PETER BERNHOLZ, one of the leading European monetary economists, takes readers on a journey of exploration in time and space, sharing with them a lifetime's professional experience. His journey ranges from ancient Egypt to contemporary Bolivia. An excellent guide, Bernholz leads readers to the most significant inflation episodes in recorded history, of which 29 qualify as hyperinflation (when the general price level soars by 50 percent or more each month). This is not a tour of the Louvre, but rather of Madame Tussaud's Chamber of Horrors. In detailing these horrors, his purpose is a moral one. Only a small minority of the people alive today have experienced the social and political devastation that hyperinflations wreak. For example, while the Weimar hyperinflation was only one of the catastrophes that contributed to Hitler's election victory, the economic devastation of much of Germany's urban middle class, especially teachers and other public servants, undoubtedly helped the National Socialist party to win.

The causes of inflation are cast in a public choice framework. Bernholz shows how ruling politicians are all too easily tempted to unleash forces that bring about high inflation because they believe, often rightly, that such a course of action will help them retain power. Anyone who doubts that politics can play havoc with the economic fortunes of millions of people need only look at what has happened in Argentina over the past 15 years. Nor are dictatorships immune from inflationary temptations. The root question about inflation is how to tie the government's hands. The classic analogy of Ulysses tied to the mast to resist the sirens' enchanting song comes to mind. Bernholz takes us on a search for monetary regimes that might tie governments' hands. Ultimately, of course, there is no permanent solution. Governments can always decide to untie their hands.

Bernholz considers, in turn, metallic monetary regimes and paper money. His analyses and policy conclusions are grounded in the examination of historical inflation episodes, distinguishing mild inflation from hyperinflation. The reason for this distinction becomes clear as Bernholz offers policy recommendations. The medicines needed to end mild inflation are different from those for hyperinflation. For the former, efforts have to be made to reduce the stock of money, while for the latter, demand for money having collapsed, currency reform must bring about an increase in the stock. The IMF is chided for having at times failed to make the distinction. The historical episodes include extreme cases that occurred in the course of the French Revolution and the American War of Independence and Civil War; the German and Hungarian hyperinflations; and several examples of hyperinflation in developing and former communist countries, some quite recent.

Some common threads emerge quite clearly from these episodes. Gresham's Law is seen at work over and over, as "bad money" (debased coins or paper money) drives out "good money" (usually foreign currency). At some stage in the inflation cycle, the reverse may happen. The author calls this Thier's Law, when currency substitution occurs because the public distrusts paper money so much that no one accepts it in payment anymore (despite the threat of draconian penalties—during the French Revolution, anyone who so much as *asked* in what currency they should pay was sentenced to long years in the galleys). Bernholz also shows how the real exchange rate tends to behave during and after inflation, and how successive episodes of under- and overvaluation play an important role in shifting political support for and against inflationary and anti-inflationary policies. Governments that ended high inflation or hyperinflation episodes were often brought to power by coalitions of exporters and import-competitors and their employees.

Bernholz's conclusion is uncompromisingly liberal (in the nineteenth-century European sense). The gold standard emerges as the most effective way of tying the hands of government. In a somewhat brief passage, he refutes arguments to the effect that recessions were worse under the gold standard than under other monetary regimes.

I would have liked the book to have included an additional chapter about the impact of globalization on inflation. It is remarkable how, during the past 10–15 years, the frequency of pathological inflation episodes has diminished. In Latin America, for example, a continent plagued with inflation for most of its postcolonial history, average inflation has come down to low levels. Few would have predicted this. One of the main reasons for improvement is, I believe, a kind of "virtuous contagion." First, the euro-zone countries made low inflation one of their main economic policy objectives and, thanks to a supranational institutional framework, succeeded in achieving it. Next, the United States (historically far less allergic to inflation than Germany) followed suit, as did a number of other governments, many of which strengthened their central banks' autonomy and some of which subordinated monetary policy to inflation targeting. Perhaps trade liberalization—which is almost worldwide—is bringing about beneficial competition between regimes. Eventually, the developing countries also realized that stamping out inflation would enhance their competitiveness.

Indeed, in most developing and transition countries it has become almost impossible for advocates of higher inflation to win elections. This is a welcome change.

In brief, Bernholz takes his readers on a rewarding journey. His book is addressed to professional economists as well as to the general public, who can skip the more technical passages without losing the thread. Last, but not least, the book offers vivid "real-time" citations by Ernest Hemingway, Stefan Zweig, and other writers that bring home some surreal and tragic personal experiences of hyperinflation.

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To Float or Not to Float

W. Max Corden

Too Sensational

On the Choice of Exchange Rate Regimes

MIT Press, Cambridge, Massachusetts, 2002, 288 pp., $29.95/£19.95 (cloth).

THE BOOK opens with a quote from Oscar Wilde, in which the Irish writer characterizes the sharp depreciation of the Indian rupee in the 1870s as "somewhat too sensational." Sharp exchange rate movements do, indeed, arouse wild sentiments in policymakers and the public alike, often eliciting equally sensational proposals for solutions. Rather than yield to that temptation, Professor Corden offers a sober discourse on the inevitable trade-offs involved in countries' choice of exchange rate regime.

The very first task for policymakers, he suggests, is to decide what to expect of an exchange rate regime. This is a superb starting point: if one expects too much of it, disappointment is guaranteed. Corden proposes organizing expectations around three objectives. A high-inflation economy seeking a credible anchor for its disinflation policy would typically opt for the nominal anchor approach. An economy that is primarily concerned about employment and output but not about inflation might adopt a real target approach. When irrational market forces are seen to wreak havoc with the exchange rate, the exchange rate stability approach gains strength.

Having anchored expectations at three corners, Corden proposes to group the available options around three polar regimes: the pure floating regime, the absolutely fixed regime (dollarization or monetary union), and the fixed-but-adjustable exchange rate regime. This last regime is regarded as a polar regime on its own, because it has the distinct problem of being vulnerable to speculative attack. Convex combinations of these polar regimes can produce all the exchange rate regimes that have ever been put in place.

Armed with this basic structure, Corden engages in intelligent storytelling, a goal that he set for himself in this book and at which he succeeded admirably. The story ranges from the importance of fiscal discipline through liability dollarization to a guided tour of the world's exchange rate regimes in recent decades. Throughout, he adopts a tone of balanced moderation. For example, he argues that the emphasis on the fixed-but-adjustable exchange rate regime as a significant cause of the Asian crisis was probably misplaced. Corden argues that all the crisis countries were forced to give up their fixed-but-adjustable regimes as a result of the crisis but suggests that the crisis may or may not have been caused by those regimes. The moral is that in the choice of exchange regime, trade-offs are always involved.

Maintaining a safe distance from polemics while discussing all major issues relating to exchange rate regimes, Corden succeeds in recounting a well-deliberated but plainly spoken story of the key policy question in open macroeconomics. It is a soothing book for those agitated by too sensational coverage of exchange rate stories.

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Restarting America's Economic Engines

Jeff Madrick

Why Economies Grow

The Forces That Shape Prosperity and How to Get Them Working Again

Basic Books (for the Century Foundation), New York, 2002, xiv + 242 pp., $26.00 (cloth).

IN THIS well-written and highly accessible book, *New York Times* columnist Jeff Madrick reminds us all—general readers and policymakers alike—that, beyond all the hype surrounding the widespread advent of information technology (IT), there was very little that was truly *new* about America's so-called new economy of the 1990s. From an economic history perspective, U.S. growth in 1995–2001, although unquestionably strong, did not surpass earlier periods of expansion, such as the last quarter of the nineteenth century or the post–World War II boom of 1945–72. Moreover, 1995–2001 followed a 22-year period of declining average incomes and sluggish economic growth, if not economic stagnation.

By the mid-1990s, as the U.S. economy began to surge, there was a common sense of surprise among economists, policymakers, and the public. Human nature dislikes change, especially when it seems sudden, and Madrick's chief argument is that the widely held perception of a radical reversal of fortune for the American economy created a strong need for plausible explanations. For the media and, later, Wall Street and Capitol Hill, the desire was for a simple yet powerful reason, and a "new" economy, based on growth in technology-driven sectors, both provided a viable immediate explanation and laid the groundwork for the policy of technological determinism that was to follow. As Madrick repeatedly points out, however, these kinds of single-faceted policy responses, which can frequently start out as nothing more than intellectual conveniences, present a real concern to academics and a potential danger to public policy because, as in the case of the "new" economy, they often become ensconced in rhetoric and political doctrine leading to their general and unquestioning acceptance as fact.

Madrick's book is undeniably controversial, but then breaking down common beliefs, however inaccurate or blinding, is always fraught with controversy. It is easy for Americans to believe that technology is the font of all goodness when it comes to their economy, but Madrick wants them to look beyond one-sided and narrow explanations to gain a stronger understanding of how the U.S. economy really works. Technology—its development, acceptance, use, and improvement—is but one force for economic growth. Open markets, rule of law, entrepreneurial innovation, and responsible governance are all far more important drivers of sustained economic vitality, especially taken in combination.

The greatest contribution Jeff Madrick makes in his new book—in addition to some practical long-term policy advice and despite the overly pessimistic concluding chapter—is to present an in-depth discussion of the other side of the debate surrounding America's policy of technological determinism. This book is directed at those involved in creating and setting domestic public policy, as well as the general public. While some academics may consider certain aspects of Madrick's discussion overly simplified, his book takes a significant step forward in expanding the public's awareness of the depth, complexity, and resilience of the U.S. economy and, more generally, in elucidating the theories and empirical realities of economic growth.

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