



Hyperinflation, the exchange rate and endogenous money: post-World War I Germany revisited

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We re-examine the interaction of domestic and external factors in the German hyperinflation by extending Frenkel's monetary model of the exchange rate to incorporate: (1) endogeneity of the money supply with respect to government debt, expected inflation and money wages; (2) the direct impact of exchange rate depreciation on the domestic price level; and (3) endogenous wage determination. Four-equation estimates support each extension of the monetary model. It appears that government deficit finance, the collapse of the exchange rate *and* the monetary transmission of the wage–price spiral were *all* crucial contributors to the price explosion. (JEL E31, N14, F41). Copyright © 1996 Elsevier Science Ltd

A crucial issue in analyses of hyperinflation is the respective causal roles assigned to government deficit finance and exchange rate depreciation in the inflation process. The controversy over this question is reflected in alternative perspectives on the post-World War I hyperinflations in Germany and other European countries. On the one hand, the fiscal-monetary approach, as exemplified by Sargent (1982), views the impact of rising (current and prospective) government deficits on expected money supply growth as the primary causal factor in the inflation process. This approach emphasizes the importance of the government's resort to the 'inflation tax' as a means of funding its expenditures,¹ and suggests that successful stabilisation relies upon credible monetary

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reforms that insulate central bank policy from government budgetary pressures.

On the other hand, there is also the question of the exchange rate depreciation that accompanies the monetary acceleration. To the extent that the initial depreciation leads to higher import prices and demands for higher nominal wages, this may then give rise to a 'vicious circle' with successive rounds of price and wage increases that make the exchange rate depreciation *self-sustaining* in the short run. Such a perspective is apparent in Robinson's (1938, p. 508) argument that 'it was the collapse of the exchange which inaugurated the great inflation' in conjunction with an accelerating wage-price spiral that 'precipitated a further fall in the exchange rate' (Robinson, 1938, p. 510).²

As noted by Holtfrerich (1986a, pp. 156ff), this analysis presumes that the inflationary effects of exchange rate depreciation were accommodated by domestic money growth, which, in the German case, occurred via increased discounts of commercial and government bills at the Reichsbank. Indeed, Haberler (1936, p. 60) had earlier stressed 'that, *if* the quantity of money is kept stable, forces are released which bring the movements of prices and of the exchange to a standstill and adjust prices and rates of exchange to one another, as asserted by ... purchasing-power parity' (emphasis in original).³ Nevertheless, under conditions where the money supply reacts passively to any inflationary pressures, it is possible for exchange rate depreciation to play a key role in *sustaining* the inflationary spiral regardless of whether the process is actually *initiated* by internal rather than external factors.⁴

The potential relevance of this vicious circle argument to more recent high inflation episodes is illustrated by Montiel's (1989) analysis of the accelerations in inflation that occurred in Argentina, Brazil and Israel in the early 1980s. Indeed, the prime importance of nominal exchange rate shocks, and associated money wage movements, in accounting for the innovations in inflation that were experienced by these countries seems very much in line with Robinson's (1938) qualitative account of the German experience.

Similarly Franco (1990, p. 185), while conceding that fiscal pressures may have been an important element in the post-World War I European inflations, argues that, particularly in the German case, a 'combination of balance of payments problems and a wage push of very significant proportions ... most likely contributed very significantly, if not decisively, to inflation'. At the same time, 'regarding "fundamentals", the necessary conditions for these stabilisations comprised many problems outside the fiscal sphere' (Franco, 1990, p. 185) such as the stabilisation of the exchange rate and reduction of wage-push pressures (cf. Dornbusch *et al.*, 1990).⁵

More generally, to the extent that fiscal deficits and the wage-price spiral reflect underlying conflicts over distributive shares, a basic condition for stabilisation may be the resolution of such conflicts through the negotiation of a new social consensus among the relevant parties, or the *imposition* of such a consensus by one party over the other parties (Alesina and Drazen, 1991; Casella and Eichengreen, 1994).⁶ Given that the quantitative literature on the German hyperinflation has focused primarily on testing the essential predictions of the quantity theory of money, there has, however, been surprisingly

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