

Hyperinflation
description causes
and effects
economics essay



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The term hyperinflation in economics refers to an inflationary action that has spiraled out of control. The condition makes prices increase rapidly while the currency loses its value. Economists see hyperinflation as an inflationary cycle that lacks any tendency towards equilibrium. The term is subjective and therefore no firm rule to determine when a situation develops from an inflationary state to hyperinflationary state. Declaring hyperinflation is therefore left to financial analysts and political Pundits.

Hyperinflation is believed to be caused mainly by a massive increase in money that is not directly supported by a corresponding increase in supply of goods and services. This will create instability in demand and supply for the money, currency and bank deposits. Hyperinflation theories look for relationship between inflation tax and seigniorage. In Cagan and neo-classical models, tipping point occurs when there is increase in the supply of money or drop in monetary base hence making it impossible for the government to improve its financial status. In this case, it is seen as if the government is causing hyperinflation. However, this is attributed to the fact that hyper inflation is an alternative to a defeat by the military or depression. The basic cause is a matter of dispute. In Monetarism and classical economics, it is as a result of monetary authority borrowing money irresponsibly to pay expenses.

Neoliberalism hyperinflation is seen to come as a result of crisis of confidence through which country's monetary base flees leading to widespread fear that locals may not convert the local currency to a more portable form such as gold or any internationally recognized hard currency.

This brings about hyperinflation quantity theory.

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The theory of neo-classical roots the cause of hyperinflation to the deterioration of monetary base and confidence is built on the basis that the store of value will be later commanded by the currency. This model makes the perceived risk of holding the currency to rise dramatically and make sellers to demand high premiums to accept the prices. This in turn creates greater fear that the currency may collapse and lead to even higher premiums. This situation is likely to occur during the periods of warfare or intense civil conflicts. The government should continue fighting since the alternative is nothing but the defeat.

Explanation to hyperinflation may not be applicable to all cases since inflation is a complex phenomenon. During rapid money expansion, there is a corresponding increase in prices relative to supply of goods and services. In loss of confidence, the responsible authorities respond to risk premiums by paying the printing press.

Hyperinflation in Brazil

The Brazilian bright economy has emerged from decades of turmoil. Currently the country enjoys a booming agricultural production, alternative fuel programs, discovery of very huge off-shore oil deposits as well as a strong currency. All these have elevated Brazil among the most vibrant and important 21st century economies.

The history of inflation in Brazil dates back to 1956 when the then president Juscelino initiated a massive public works project to construct a new capital city in the country's hinterlands. Due to lack of funds to facilitate the project, the country decided to borrow foreign loans. This led to inflation and soared <https://assignbuster.com/hyperinflation-description-causes-and-effects-economics-essay/>

the cost of living. In responding to public pressure over prices, the next government made a disastrous decision to solidify the nation's dependency regarding inflationary policies. The military coup of 1964 created an index that adjusted the salaries and other financial deals in an automatic manner to the rate of inflation. This policy prevented the pain of inflation like anesthesia, but the real cause of economic sickness was not treated, that is overspending and debt. Indexing reduced the pain of inflation to the middle and upper-class citizens with income related to rising costs generally. Hyperinflation pushed the poor whose income was not indexed further into poverty.

Politics and economic expediency motivated the indexation policy but not the moral concern for future generations. The leaders deferred political and economic sacrifices for paying the national debt hence making successive governments responsible in dealing with inflation. The then governments were unwilling to make short-term sacrifices and this made inflation soar to astronomic levels (Harry 19).

Economists at Brazil's largest private bank, Bradesco, estimated that the highest inflation rate occurred in a period of 45 years that is between 1961 and 2006. No one can calculate the suffering that inflation inflicted on the citizens of Brazil, mostly the poor, and no one is to blame but lack of principled leadership and corruption.

Solutions

President Fernando was impeached in December 1992 and was replaced by his Vice President Franco Itamar. Franco was less interested in economics <https://assignbuster.com/hyperinflation-description-causes-and-effects-economics-essay/>

and signed any suggestion by the ministers to depoliticize the process. Also in December 1994, twenty six members of the congress together with 3 state governors were held accountable for the diversion of millions in federal funds to their private and personal accounts and these individuals were left out of the discussion. This provided a window of opportunity since politicians could not interfere (Harry 21).

Gustavo Franco admitted frankly that they empowered central bank and treasury to subvert democracy because politicians and people whom they represented voted to achieve things they could not afford. The ministry of finance with treasury and central bank, utilizing a constitutional amendment which was passed in 1994, never implemented the budget but instead changed the composition of the monetary authority and the CMN to comprise of three members that is the finance minister, central bank minister and the planning minister. The close of off-budget spending, and the treasury cutting back on the implementation of the congressional budget and the previous passing of the budget by the congress at \$800 million on the project was reduced by the treasury to \$200 million.

Lending of money by the bank to their own shareholders was prohibited and crime penalties on such actions were introduced. This was aimed at stopping the flood of bad loans that banks lend to the government to fund various projects. The officials in private banks avoided checking the accounts in their own banks because of the fear that they will be prosecuted if their check cards give them funds to cover an over draft.

However state banks were allowed to lend to the government. The same rules were enforced under the real plan on state banks and threatened their officials' with being jailed if they lend money to the government. A major source of inflation was criminalized especially the frequent buying of government bonds by the regional banks. About 40 banks were bankrupt in mid-1994 as a result of their lending to fund government projects.

Monetary Reform

The spiraling in the private sector was prevented through freezing of wages and leaving the prices free to avoid the previous scenario. Accounting and payment was broken away from the existing currency. This was done by creating financial standards of artificial nature, the Unit of Real Value (URV). Prices were computed in contrary to this standard with an intention of de-indexing the economy (Harry 19).

URV was converted into an actual currency, the real, in July 1994. The policy according to Franco was relevant for what was happening in Argentina then. There was a dramatic drop in price rates from July 1994 onwards. The hyperinflation was over in 1997 when they reached the standard international levels.

Conclusion

The key thing in tackling inflation involves the creation of an impersonal mechanism, not for getting into negotiations with unions and parties or house wife associations. One needs a market mechanism because dialogue will yield nothing in this kind of situation. The assumption is that,

consultations of each constituency causes fighting for particular entitlement and drives the state budget up and also keeps the spiraling of prices virulent.

Work Cited

Harry, Ivan. Economic reform in Latin America. Dryden Press, 1998.