

Abstract

In some inflationary countries, a foreign currency has replaced the domestic currency as a store of value, unit of account, and even means of payment. This paper studies the relationship between this "currency substitution" (CS) phenomenon and the theory of inflationary finance. CS poses several problems to our understanding of inflationary taxation because it implies that some agents choose to evade the inflation tax. The following questions arise: How does CS limit the government power to impose the inflation tax? If some agents can evade the tax, who pays the tax? What are the welfare effects of policies that deal directly with CS?

I answer these questions in the context of a model in which both CS and inflation arise as endogenous equilibrium outcomes. Because of transactions costs, private agents substitute foreign for domestic currency only if the domestic rate of inflation is sufficiently high. Because of heterogeneity, however, the relative cost of substitution differs across agents.

I characterize competitive equilibria given a constant value of the fiscal deficit to be financed by inflation. For small deficits, no CS arises in equilibrium. In another, higher range of deficits, equilibria exist in which some agents engage in CS. For some values of the deficit, both CS and non CS equilibria exist.

The maximal revenue from inflation depends on the willingness of the private sector to engage in CS, which in turn depends on transactions costs. I characterize exactly the distributional effects of inflation. Finally, I analyze the welfare consequences of taxes on holding of foreign exchange and exchange controls. CS is shown to be inefficient for the country as a whole, because seigniorage accrues to foreigners.