Welfare Gains from Disinflation in an Economy with Currency Substitution

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PRELIMINARY AND INCOMPLETE, PLEASE DO NOT CITE OR CIRCULATE

November 13, 2009

Abstract

This paper builds a general equilibrium model with working capital and currency substitution and uses this model to assess welfare gains from disinflation. It is found that welfare gains from disinflation are higher when the baseline inflation rate and the elasticity of substitution between foreign currency and domestic deposits are higher. Indeed the gains from disinflation can be quite large compared previous studies especially for moderate rates of inflation if the two assets are highly substitutable under the baseline scenario. After the benchmark economy is specified, the model is used to assess welfare gains from disinflation for a given level of financial development. The model implies that, higher currency substitution is welfare enhancing for high inflation rates but not for moderate and low inflation rates. In other words, currency substitution is not necessarily welfare enhancing.