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Venezuela's death spiral

Black market signals light at the end of the tunnel

by Steve Hanke in Baltimore

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Since the election of Hugo Chávez in December 1998, Venezuelans have embraced Chavismo, a peculiar form of socialism that has turned Venezuela into, essentially, an organised crime syndicate. Under Chávez's successor, President Nicolás Maduro, the country has entered ever further into an economic death spiral. Evidence of this comes from Venezuela's inflation rate, which, according to my computations, is running at 139,839% per year.

Unlike the exaggerated inflation forecasts broadcast by the International Monetary Fund, the data I calculate are real and accurate measurements of Venezuela's inflation. The IMF erroneously forecasted that Venezuela's annual inflation rate would reach 2,500,000% by the end 2018, when in fact it reached 80,000% per year. Its forecast for this year is even more fantastic: the IMF reports Venezuela's annual inflation will reach 10,000,000% in 2019. Indeed, the IMF has repeatedly forecasted Venezuela's hyperinflation, even though no one has ever been able to predict the magnitude or direction of hyperinflations throughout history.

There have only been 58 episodes of hyperinflation recorded in history, but Venezuela's episode should be noted as special. Its rate of inflation is modest by hyperinflation standards, but its longevity is extended. Venezuela's episode has lasted 27 months to date. Only four other episodes have lasted longer.

The word 'hyperinflation' is thrown around carelessly and misused by the popular press to such lengths that it has almost lost its meaning. The term needs careful definition.

Scientific literature adopts the convention of classifying an inflationary period as a hyperinflation when the monthly inflation rate exceeds 50%. This definition was adopted in 1956, after Phillip Cagan published his seminal analysis of hyperinflation in a book, edited by Milton Friedman, Studies in the Quantity Theory of Money .

Using high-frequency data, I have been able to refine Cagan's 50% per month hyperinflation hurdle. With improved measurement techniques, I define a hyperinflation as a period in which the inflation rate exceeds 50% per month for at least 30 consecutive days.

As evidenced by the tensions of recent news, the US has been using Venezuela's vulnerabilities to engage in a low-grade economic war. Instead of military action, the US has imposed select economic sanctions against certain Venezuelans. These have amounted to slaps on the wrist, with threats of worse to come. But, as of 28 January, the US has declared a full-scale economic assault. It declared an embargo against Petróleos de Venezuela, the country's state-owned oil company that controls the world's largest oil reserves and produces virtually all of Venezuela's foreign exchange.

This move shouldn't surprise us. Economic warfare is nothing more than protectionism, a doctrine close to the heart of President Donald Trump and his administration. The measures taken under the protectionist flag are often precisely the same as those employed under the economic warfare flag. Both fly in the face of free trade and free market capitalism.

At the same time that Washington declared economic war, Caracas announced it was going to devalue its currency, the bolívar, in an attempt to allow its value to align with that in the black market (read: free market). The official bolívar-dollar exchange rate plunged and shot past the black market rate. This realignment of the official and black market exchange rates carries significant implications.

The black market premium is a convenient metric that allows us to understand the importance and relationship between the official and black market exchange rates. Since November 2018, the BMP has registered positive on most days, meaning that Venezuelans were willing to pay a premium for dollars on the black market. This contrasts with those who were lucky (or privileged) enough to obtain them at the official rate.

For the privileged, Maduro's cronies and regime insiders, the premium meant they could buy dollars 'cheap' at the official rate and immediately sell their dollars 'dear' on the black market. In the process, they would pocket the premium. By keeping the official rate set so that the bolívar was artificially overvalued via controls, the Maduro regime could restrict access to Venezuela's foreign exchange reserves and dole them out to friends, guaranteeing massive profits at no risk.

But as of 29 January, the largesse for loyalists has dramatically dried up. Indeed, the BMP has turned negative. This implies that market participants expect the bolívar to appreciate relative to the dollar, and that individuals are willing to pay a premium to obtain bolívars on the black market. This indicates that those engaged in the black market expect an end to Venezuela's death spiral. For observers scanning world headlines for a ray of sunlight at the end of the Venezuelan tunnel, this is the first signal of good news starting to break through.

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