

# On Measuring Hyperinflation Venezuela's Episode

*Steve H. Hanke and Charles Bushnell*

## Key Points

- Venezuela now exhibits the 57th historic episode of hyperinflation as measured in the *Hanke–Krus World Hyperinflation Table*.
- Entry to the hyperinflation dataset depends on three qualifying criteria: inflation rates greater than 50% per month; the persistence of this rate for at least 30 consecutive days; and full documentation so that inflation estimates are replicable.
- This paper measures Venezuela's hyperinflation by transforming changes in the US dollar–Venezuelan bolivar exchange rate into implied inflation rates using the purchasing power parity doctrine.
- The purchasing power parity method is accurate during periods of hyperinflation. Venezuela's hyperinflation peaked with a monthly inflation rate of 219.7% on 30 November 2016.

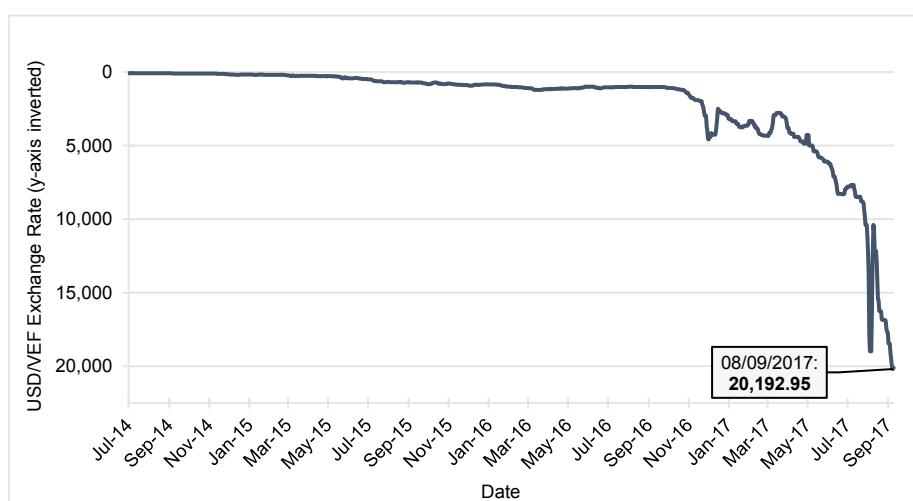
## Introduction

This paper addresses the measurement of hyperinflation. The first 56 verified episodes of hyperinflation are reported, and, for the first time, we report the world's 57th episode of hyperinflation: Venezuela's. We measure Venezuela's hyperinflation, which occurred during November/December 2016, by transforming changes in the US dollar–Venezuelan bolivar (USD/VEF) exchange rate into implied inflation rates using the purchasing power parity doctrine (PPP). During periods of hyperinflation, this method is incredibly accurate. Venezuela's hyperinflation peaked with a monthly inflation rate of 219.7% on 30 November 2016.

## On Error and Deception

The Grim Reaper has taken his scythe to the Venezuelan bolivar. The death of the bolivar is depicted in Figure 1. A bolivar has become virtually worthless, and, with its collapse, Venezuela is witnessing the world's worst inflation. As of 8 September 2017, Venezuela's annual rate of inflation (yr/yr) is a whopping 1,906% (see Figure 2).

**Figure 1: The fall in the value of the Venezuelan Bolívar: the black market USD/ VEF exchange rate**



Sources: *DolarToday*, *Dolar Paralelo*, *Paralelo Venezuela*, *Venezuela Econ*.

Prepared by Professor Steve H. Hanke, The Johns Hopkins University.

Note: For the purpose of illustrating the declining value of the Venezuelan bolívar relative to the US dollar, the y-axis is inverted.

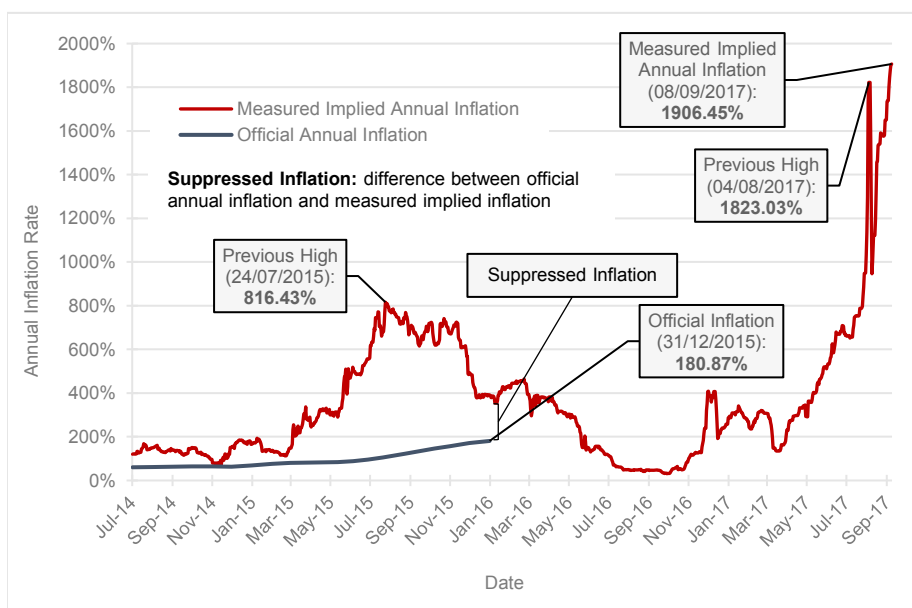
As the bolivar plunged and inflation surged, the Banco Central de Venezuela (BCV) became an unreliable source of inflation data. Indeed, from December 2014 until January 2016, the BCV did not report inflation statistics. Then, in January 2016, the BCV pulled a rabbit out of its hat and reported a fanciful annual inflation rate for the third quarter of 2015. So,

Venezuela's last official inflation data are almost two years old. Clearly, timely reporting is not a priority.

The BCV, like many central banks, has followed a pattern that Oskar Morgenstern elegantly documents in his classic work *On the Accuracy of Economic Observations* (1963). Indeed, the BCV has failed to report data that would reflect poorly on the government, and when it has reported inflation statistics, it has lied and doctored the data. Instead of reporting Venezuela's 'real' open rate of inflation, the BCV has attempted to measure suppressed inflation.

Venezuela imposes a thick blanket of price controls and a maze of subsidies over the economy. List prices are artificially held down. Yet these suppressed prices are the ones that, in principle, the BCV attempts to measure and use to construct a price index for calculating the inflation rate. But this metric misses the mark. Arbitrage opportunities prevail under the Venezuelan regime of price controls and subsidies, because there is a gap between the items under price controls and the prices of those goods and services that are actually exchanged on the black market. And it is in the black market and underground economy that most of Venezuela's economic activity occurs. In consequence, there is a huge gap between the official inflation rate, which is based on artificially suppressed prices, and the 'real' open inflation rate, as shown in Figure 2. (Note: our method for measuring the 'real' open inflation rate is developed in a later section of this paper.)

**Figure 2: Venezuela's annual inflation rate**



Sources: Banco Central de Venezuela, *DolarToday*, *Dolar Paralelo*, *Paralelo Venezuela*, *Venezuela Econ*. Calculations by Professor Steve H. Hanke, The Johns Hopkins University.

Note: These inflation rates are implied by the movements in the black market VEF/USD exchange rate.

So much for the BCV's errors and deceptions. What about the reportage in the financial press? We have been saving bits of misreported statistical strings about Venezuela's inflation, and it has become a giant ball. Most of the bits originate from the International Monetary Fund (IMF).

For one example, the IMF's *World Economic Outlook* (April 2016) forecasted that inflation would rise to 720% by the end of 2016. This number was nothing more than a guesstimate. Never mind. It became carved in stone. The media—from *Bloomberg*, *The New York Times*, the *Washington Post*, the *Wall Street Journal*, *The Financial Times*, *The Economist*, to countless other ostensibly credible sources—have repeated that guesstimate

*ad nauseam*. The financial press has great difficulty distinguishing between a measurement and a forecast. Indeed, they report forecasts as if these were measured values. The performance of the press on Venezuela confirms the 95 percent rule: 95% of what appears in the financial press is either wrong or irrelevant (Hanke, 2016).

So, while everyone agrees that Venezuela's inflation rate is very high, confusion reigns. To lift the shroud and shine a light on what has become the most recent episode of hyperinflation, we delve into the measurement of hyperinflation and Venezuela's episode.

### **On the *Hanke–Krus World Hyperinflation Table***

The *Hanke–Krus World Hyperinflation Table* first appeared in the authoritative *Routledge Handbook of Major Events in Economic History*, which was published in 2013. The table contained every country that had ever experienced an episode of hyperinflation—all 56 of them. On 3 December 2016, Venezuela's inflation met all the criteria required to qualify as hyperinflation. Specifically, Venezuela's monthly inflation rate exceeded 50% per month for 30 consecutive days. Accordingly, the Hanke–Krus Table was amended to include Venezuela as the 57th episode of hyperinflation.

What was the genesis of the *Hanke–Krus World Hyperinflation Table*? What are the criteria for a country to qualify for the hyperinflation designation? What is the standard method for estimating inflation in countries that are experiencing elevated inflation rates, and why is this method superior to others? How is the standard method used to estimate Venezuela's inflation rates, and what are those rates? These are the main questions we address.

In 2010, Hanke was invited to write the survey article on hyperinflation for *The Routledge Handbook of Major Events in Economic History*. He accepted the invitation, thinking it would require routine work on his part and that he could complete the task in short order. He had already surveyed the literature on hyperinflation and had accurately estimated the inflation rates in several countries that had experienced hyperinflation. These included two relatively recent, dramatic episodes of hyperinflation—

Yugoslavia (Hanke, 1999) and Zimbabwe (Hanke and Kwok, 2009). In addition, he had designed and implemented currency reforms that had stopped episodes of hyperinflation, notably Bulgaria's episode (Hanke, 2016).

While reflecting on the existing literature on hyperinflation, Hanke was struck by its lack of uniformity and clarity. The literature was widely scattered in time and space; it had been written by many different researchers, and those researchers had used diverse methods to estimate and analyze the inflation episodes they studied.

So, Hanke concluded that the best way to 'clean up' the subject of hyperinflation was to create a 'World Hyperinflation Table.' In his mind, this table would include all of the world's hyperinflations. The data would be presented in a uniform and clear manner, so that all hyperinflations could be compared. But what criteria would be used for an episode of inflation to qualify as a hyperinflation? Hanke specified the following three qualifying criteria:

1. Following Phillip Cagan's (1956) classic article on hyperinflation, the economics profession adopted the following criterion: to qualify as a hyperinflation, the inflation rate had to be at least 50% per month. Hanke adopted this convention.
2. In addition, Hanke specified that the 50% rate had to persist for at least 30 consecutive days.
3. Lastly, he mandated that the inflation episode had to be fully documented and that inflation estimates had to be replicable.

It turned out that the third criterion was the most difficult one to satisfy. Fortunately, Hanke's chief research assistant at the time, Nicholas Krus, was capable and interested in taking on this research task. Hanke and Krus spent the better part of two years constructing what has come to be known as the *Hanke-Krus World Hyperinflation Table*. They documented and recalculated the inflation rates for all alleged hyperinflations in history. The project required the gathering of primary data for each potential case of hyperinflation. This proved to be very difficult and time-consuming. For

example, primary data for France's episode of hyperinflation from 1795 to 1796—the first verified case of hyperinflation—had to be obtained and analyzed. But, that was not the most difficult set of data to obtain. That 'prize' was awarded to the Republika Srpska, which experienced hyperinflation in the 1992–1994 period. Fortunately, Hanke was able to use his extensive contacts in former Yugoslavia to eventually obtain high-quality inflation data for the Republika Srpska.

After a long and onerous research effort, the *Hanke–Krus World Hyperinflation Table* was published. It is contained in 'World Hyperinflations,' which is a chapter in the *Routledge Handbook of Major Economic Events in History* (2013) co-authored by Hanke and Krus.

The Table (amended to include Venezuela) is reproduced below. The original Table contained 56 hyperinflation episodes. Several things are noteworthy and merit mention. The most famous and well-known hyperinflation episode is the Weimar Republic's hyperinflation. It peaked in October 1923 at 29,500% per month. This rate is well below Zimbabwe's November 2008 peak hyperinflation rate of 79.6 billion%—that is, 80 followed by nine zeros. But Zimbabwe's hyperinflation is only the world's second-highest recorded case. It is minuscule next to Hungary's July 1946 peak monthly rate of 41.9 quadrillion%—that is, 42 followed by fifteen zeros. While the German hyperinflation ranks fifth in the world hyperinflation rankings, its magnitude was much less than the top four inflations.

**Table 1: The Hanke–Krus World Hyperinflation Table (2013, amended 2016)**

| Location                             | Start Date | End Date      | Month With Highest Inflation Rate | Highest Monthly Inflation Rate | Equivalent Daily Inflation Rate | Time Required For Prices To Double | Currency             | Type Of Price Index    |
|--------------------------------------|------------|---------------|-----------------------------------|--------------------------------|---------------------------------|------------------------------------|----------------------|------------------------|
| Hungary <sup>1</sup>                 | Aug. 1945  | Jul. 1946     | Jul. 1946                         | 4.19 x 10 <sup>16</sup> %      | 207%                            | 15.0 hours                         | Pengő                | Consumer               |
| Zimbabwe <sup>2</sup>                | Mar. 2007  | Mid-Nov. 2008 | Mid-Nov. 2008                     | 7.96 x 10 <sup>10</sup> %      | 98.00%                          | 24.7 hours                         | Dollar               | Implied Exchange Rate* |
| Yugoslavia <sup>3</sup>              | Apr. 1992  | Jan. 1994     | Jan. 1994                         | 3.13 x 10 <sup>6</sup> %       | 64.60%                          | 1.41 days                          | Dinar                | Consumer               |
| Republika Srpska† <sup>4</sup>       | Apr. 1992  | Jan. 1994     | Jan. 1994                         | 2.97 x 10 <sup>6</sup> %       | 64.30%                          | 1.41 days                          | Dinar                | Consumer               |
| Germany <sup>5</sup>                 | Aug. 1922  | Dec. 1923     | Oct. 1923                         | 29500%                         | 20.90%                          | 3.70 days                          | Papiermark           | Wholesale              |
| Greece <sup>6</sup>                  | May. 1941  | Dec. 1945     | Oct. 1944                         | 13800%                         | 17.90%                          | 4.27 days                          | Drachma              | Exchange Rate‡         |
| China§ <sup>7</sup>                  | Oct. 1947  | Mid-May 1949  | Apr. 1949                         | 5070%                          | 14.10%                          | 5.34 days                          | Yuan                 | Wholesale for Shanghai |
| Free City of Danzig <sup>8</sup>     | Aug. 1922  | Mid-Oct. 1923 | Sep-23                            | 2440%                          | 11.40%                          | 6.52 days                          | German Papiermark    | Exchange Rate**        |
| Armenia <sup>9</sup>                 | Oct. 1993  | Dec. 1994     | Nov. 1993                         | 438%                           | 5.77%                           | 12.5 days                          | Dram & Russian Ruble | Consumer               |
| Turkmenistan †† <sup>10</sup>        | Jan. 1992  | Nov. 1993     | Nov. 1993                         | 429%                           | 5.71%                           | 12.7 days                          | Manat                | Consumer               |
| Taiwan <sup>11</sup>                 | Aug. 1945  | Sep. 1945     | Aug. 1945                         | 399%                           | 5.50%                           | 13.1 days                          | Yen                  | Wholesale for Taipei   |
| Peru <sup>12</sup>                   | Jul. 1990  | Aug. 1990     | Aug. 1990                         | 397%                           | 5.49%                           | 13.1 days                          | Inti                 | Consumer               |
| Bosnia and Herzegovina <sup>13</sup> | Apr. 1992  | Jun. 1993     | Jun. 1992                         | 322%                           | 4.92%                           | 14.6 days                          | Dinar                | Consumer               |
| France <sup>14</sup>                 | May 1795   | Nov. 1796     | Mid-Aug 1796                      | 304%                           | 4.77%                           | 15.1 days                          | Mandat               | Exchange rate          |
| China <sup>15</sup>                  | Jul. 1943  | Aug. 1945     | Jun. 1945                         | 302%                           | 4.75%                           | 15.2 days                          | Yuan                 | Wholesale for Shanghai |
| Ukraine <sup>16</sup>                | Jan. 1992  | Nov. 1994     | Jan. 1992                         | 285%                           | 4.60%                           | 15.6 days                          | Russian Ruble        | Consumer               |
| Poland <sup>17</sup>                 | Jan. 1923  | Jan. 1924     | Oct. 1923                         | 275%                           | 4.50%                           | 16.0 days                          | Marka                | Wholesale              |
| Nicaragua <sup>18</sup>              | Jun. 1986  | Mar. 1991     | Mar. 1991                         | 261%                           | 4.37%                           | 16.4 days                          | Córdoba              | Consumer               |
| Congo (Zaire) <sup>19</sup>          | Nov. 1993  | Sep. 1994     | Nov. 1993                         | 250%                           | 4.26%                           | 16.8 days                          | Zaire                | Consumer               |
| Russia†† <sup>20</sup>               | Jan. 1992  | Jan. 1992     | Jan. 1992                         | 245%                           | 4.22%                           | 17.0 days                          | Ruble                | Consumer               |
| Bulgaria <sup>21</sup>               | Feb. 1997  | Feb. 1997     | Feb. 1997                         | 242%                           | 4.19%                           | 17.1 days                          | Lev                  | Consumer               |
| Moldova <sup>22</sup>                | Jan. 1992  | Dec. 1993     | Jan. 1992                         | 240%                           | 4.16%                           | 17.2 days                          | Russian Ruble        | Consumer               |
| Venezuela <sup>23</sup>              | Nov. 2016  | Ongoing       | Nov. 2016                         | 219%                           | 3.94%                           | 17.9 days                          | Bolivar              | Exchange Rate***       |
| Russia / USSR <sup>24</sup>          | Jan. 1922  | Feb. 1924     | Feb. 1924                         | 212%                           | 3.86%                           | 18.5 days                          | Ruble                | Consumer               |
| Georgia <sup>25</sup>                | Sep. 1993  | Sep. 1994     | Sep. 1994                         | 211%                           | 3.86%                           | 18.6 days                          | Coupon               | Consumer               |
| Tajikistan†† <sup>26</sup>           | Jan. 1992  | Oct. 1993     | Jan. 1992                         | 201%                           | 3.74%                           | 19.1 days                          | Russian Ruble        | Consumer               |
| Georgia <sup>27</sup>                | Mar. 1992  | Apr. 1992     | Mar. 1992                         | 198%                           | 3.70%                           | 19.3 days                          | Russian Ruble        | Consumer               |
| Argentina <sup>28</sup>              | May-89     | Mar. 1990     | Jul. 1989                         | 197%                           | 3.69%                           | 19.4 days                          | Austral              | Consumer               |
| Bolivia <sup>29</sup>                | Apr. 1984  | Sep. 1985     | Feb. 1985                         | 183%                           | 3.53%                           | 20.3 days                          | Boliviano            | Consumer               |
| Belarus†† <sup>30</sup>              | Jan. 1992  | Feb. 1992     | Jan. 1992                         | 159%                           | 3.22%                           | 22.2 days                          | Russian Ruble        | Consumer               |



Table 1: continued...

| Location                        | Start Date | End Date  | Month With Highest Inflation Rate | Highest Monthly Inflation Rate | Equivalent Daily Inflation Rate | Time Required For Prices To Double | Currency              | Type Of Price Index  |
|---------------------------------|------------|-----------|-----------------------------------|--------------------------------|---------------------------------|------------------------------------|-----------------------|----------------------|
| Kyrgyzstan †† <sup>31</sup>     | Jan. 1992  | Jan. 1992 | Jan. 1992                         | 157%                           | 3.20%                           | 22.3 days                          | Russian Ruble         | Consumer             |
| Kazakhstan †† <sup>32</sup>     | Jan. 1992  | Jan. 1992 | Jan. 1992                         | 141%                           | 2.97%                           | 24.0 days                          | Russian Ruble         | Consumer             |
| Austria <sup>33</sup>           | Oct. 1921  | Sep. 1922 | Aug. 1922                         | 129%                           | 2.80%                           | 25.5 days                          | Crown                 | Consumer             |
| Bulgaria <sup>34</sup>          | Feb. 1991  | Mar. 1991 | Feb. 1991                         | 123%                           | 2.71%                           | 26.3 days                          | Lev                   | Consumer             |
| Uzbekistan †† <sup>35</sup>     | Jan. 1992  | Feb. 1992 | Jan. 1992                         | 118%                           | 2.64%                           | 27.0 days                          | Russian Ruble         | Consumer             |
| Azerbaijan <sup>36</sup>        | Jan. 1992  | Dec. 1994 | Jan. 1992                         | 118%                           | 2.63%                           | 27.0 days                          | Russian Ruble         | Consumer             |
| Congo (Zaire) <sup>37</sup>     | Oct. 1991  | Sep. 1992 | Nov. 1991                         | 114%                           | 2.57%                           | 27.7 days                          | Zaire                 | Consumer             |
| Peru <sup>38</sup>              | Sep. 1988  | Sep. 1988 | Sep. 1988                         | 114%                           | 2.57%                           | 27.7 days                          | Inti                  | Consumer             |
| Taiwan <sup>39</sup>            | Oct. 1948  | May-49    | Oct. 1948                         | 108%                           | 2.46%                           | 28.9 days                          | Taipei                | Wholesale for Taipei |
| Hungary <sup>40</sup>           | Mar. 1923  | Feb. 1924 | Jul. 1923                         | 97.90%                         | 2.30%                           | 30.9 days                          | Crown                 | Consumer             |
| Chile <sup>41</sup>             | Oct. 1973  | Oct. 1973 | Oct. 1973                         | 87.60%                         | 2.12%                           | 33.5 days                          | Escudo                | Consumer             |
| Estonia †† <sup>42</sup>        | Jan. 1992  | Feb. 1992 | Jan. 1992                         | 87.20%                         | 2.11%                           | 33.6 days                          | Russian Ruble         | Consumer             |
| Angola <sup>43</sup>            | Dec. 1994  | Jan. 1997 | May-96                            | 84.10%                         | 2.06%                           | 34.5 days                          | Kwanza                | Consumer             |
| Brazil <sup>44</sup>            | Dec. 1989  | Mar. 1990 | Mar. 1990                         | 82.40%                         | 2.02%                           | 35.1 days                          | Cruzado & Cruzeiro    | Consumer             |
| Republic of Congo <sup>45</sup> | Aug. 1998  | Aug. 1998 | Aug. 1998                         | 78.50%                         | 1.95%                           | 36.4 days                          | Franc                 | Consumer             |
| Poland <sup>46</sup>            | Oct. 1989  | Jan. 1990 | Jan. 1990                         | 77.30%                         | 1.93%                           | 36.8 days                          | Zloty                 | Consumer             |
| Armenia †† <sup>47</sup>        | Jan. 1992  | Feb. 1992 | Jan. 1992                         | 73.10%                         | 1.85%                           | 38.4 days                          | Russian Ruble         | Wholesale            |
| Tajikistan <sup>48</sup>        | Oct. 1995  | Nov. 1995 | Nov. 1995                         | 65.20%                         | 1.69%                           | 42.0 days                          | Tajikistani Ruble     | Wholesale            |
| Latvia <sup>49</sup>            | Jan. 1992  | Jan. 1992 | Jan. 1992                         | 64.40%                         | 1.67%                           | 42.4 days                          | Russian Ruble         | Consumer             |
| Turkmenistan †† <sup>50</sup>   | Nov. 1995  | Jan. 1996 | Jan. 1996                         | 62.50%                         | 1.63%                           | 43.4 days                          | Manat                 | Consumer             |
| Philippines <sup>51</sup>       | Jan. 1944  | Dec. 1944 | Jan. 1944                         | 60.00%                         | 1.58%                           | 44.9 days                          | Japanese War Notes    | Consumer             |
| Yugoslavia <sup>52</sup>        | Sep. 1989  | Dec. 1989 | Dec. 1989                         | 59.70%                         | 1.57%                           | 45.1 days                          | Dinar                 | Consumer             |
| Germany <sup>53</sup>           | Jan. 1920  | Jan. 1920 | Jan. 1920                         | 56.90%                         | 1.51%                           | 46.8 days                          | Papiermark            | Wholesale            |
| Kazakhstan <sup>54</sup>        | Nov. 1993  | Nov. 1993 | Nov. 1993                         | 55.50%                         | 1.48%                           | 47.8 days                          | Tenge & Russian Ruble | Consumer             |
| Lithuania <sup>55</sup>         | Jan. 1992  | Jan. 1992 | Jan. 1992                         | 54.00%                         | 1.45%                           | 48.8 days                          | Russian Ruble         | Consumer             |
| Belarus <sup>55</sup>           | Aug. 1994  | Aug. 1994 | Aug. 1994                         | 53.40%                         | 1.44%                           | 49.3 days                          | Belarusian Ruble      | Consumer             |
| Taiwan <sup>57</sup>            | Feb. 1947  | Feb. 1947 | Feb. 1947                         | 50.80%                         | 1.38%                           | 51.4 days                          | Taipei                | Wholesale for Taipei |

It is striking how few cases of hyperinflation have occurred—only 56 as of 2013, when the Table was first constructed. However, at that time, there was probably a 57th hyperinflation episode. It likely occurred in North Korea during the 2009–2011 period. But North Korea was not included in the Table because the only reliable price data from North Korea were for rice; so the hyperinflation estimates were for rice price inflation, not for a general, broad measure of North Korean price changes.

Another striking feature of the Table is that Latin America, a region burdened with endemic inflation, only accounts for 7 of the original 56 hyperinflations. Those are: Argentina (1989), Bolivia (1984), Brazil (1989), Chile (1973), Nicaragua (1986), and Peru (1988 and 1990).

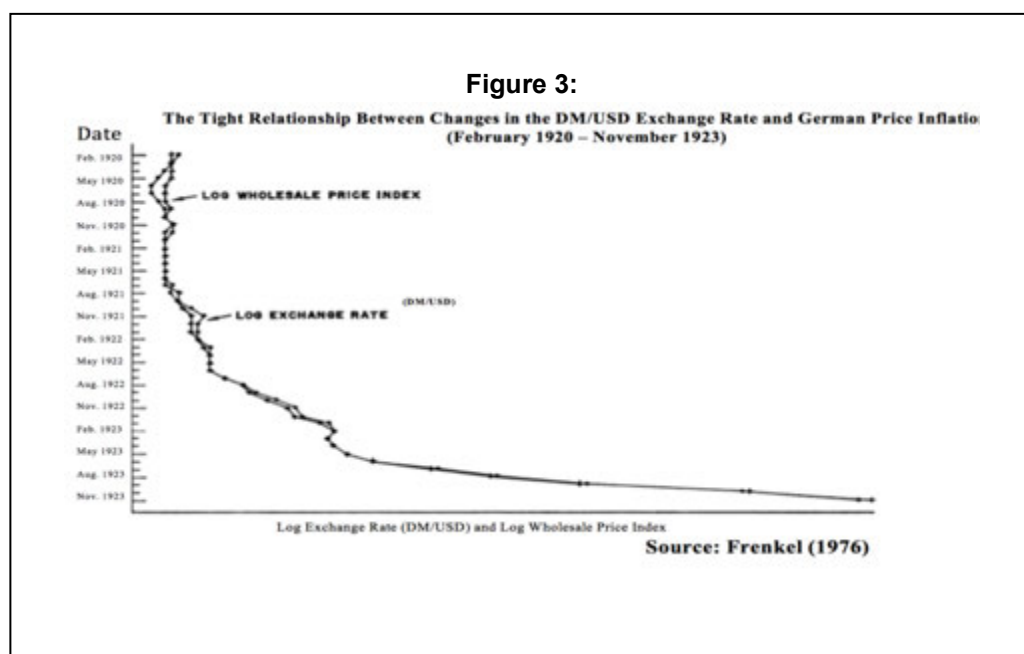
On 3 December 2016, Venezuela's inflation bout became the 57th episode of hyperinflation. Meeting all three criteria, Venezuela now appears in the new, amended *Hanke–Krus World Hyperinflation Table* at the 23rd rank, with a peak monthly inflation rate of 219% recorded in November 2016. This puts Venezuela in between the USSR, which recorded a peak monthly inflation rate of 212% in February 1924, and Moldova, whose peak monthly inflation of 240% occurred in January 1992.

## **On the Method and Use of Purchasing Power Parity to Estimate Venezuela's Inflation Rate**

As previously mentioned, reliable official inflation statistics for Venezuela are not available. Fear not, lack of reliable inflation data is a 'problem' that can be overcome. The most important price in an economy is the exchange rate between the local currency and the world's reserve currency—the US dollar. As long as there is an active black market (read: free market) for currency and the black market data are available, changes in the black market exchange rate can be reliably transformed into accurate estimates of countrywide inflation rates. The economic principle of purchasing power parity (PPP) allows for this transformation and the accurate estimates of countrywide inflation rates.

Jacob Frenkel's (1976) path-breaking work on the German hyperinflation established once and for all why, at high rates of inflation, the use of PPP

yields very accurate inflation estimates (Manzur, 1990). Frenkel ran six regressions of the German mark–US dollar exchange rate on various German price indices (Frenkel, 1976). The results of these regressions confirm the theory of PPP and strongly support its application during episodes of hyperinflation. Indeed, Frenkel found a near one-to-one relationship between changes in exchange rate and price levels during the German hyperinflation. Figure 3 shows that relationship. McNown and Wallace (1989) reinforced Frenkel's findings and confirmed that PPP held for countries that were experiencing elevated rates of inflation, as did Taylor and Taylor (2004).



Venezuela employs a multiple exchange-rate regime, coupled with exchange controls (Crooks, 2015). In consequence, the official exchange rates are not free-market rates. To obtain the free-market exchange rates required for the application of PPP, we use black market exchange rates. Black market rates are efficient processors of information when political and economic circumstances make the official exchange rate unreliable or irrelevant (Arbetman and Kugler, 1997). The course of the Venezuelan

bolivar–US dollar (VEF/USD) black market rate is shown in Figure 1. The value of the bolivar against the dollar has collapsed. PPP suggests that Venezuela is experiencing a dramatic inflation surge.

We can employ PPP to accurately transform changes in the bolivar's black market exchange rate into accurate estimates of Venezuela's inflation. One form is Absolute PPP. It states that the price of a standard market basket of goods, when measured in a common currency, is the same in all countries because of international arbitrage (Manzur, 1993). Formally, this can be written as  $S=P/P^*$ , where  $S$  is the spot market exchange rate,  $P$  is the price of the basket in domestic currency, and  $P^*$  is the price of the basket in foreign currency. With Absolute PPP, the Law of One Price holds. That is, all goods sell at the same price when converted into a common currency. However, three major factors can cause the Law of One Price to not hold in the short run. They are: transportation costs and barriers to trade; different speeds of adjustment in the foreign exchange market and goods markets; and differences in the composition of 'market baskets' (Mahdavi and Zhou, 1994).

The shortcomings of Absolute PPP can be overcome with the use of a second form of PPP: Relative PPP. This accounts for the factors that can cause deviations from Absolute PPP and adjusts for transaction costs and barriers to trade (Manzur, 1993). Relative PPP relates the percentage change in the exchange rate between two currencies to the inflation rate differential between two countries. It holds, even if Absolute PPP does not (Mahdavi and Zhou, 1994). Relative PPP can be written as  $S'=P'-P^*$ , where  $S'$  is the percentage change in the spot market exchange rate,  $P'$  is the percentage change in the price of the basket in domestic currency, and  $P^*$  is the percentage change in the price of the basket in foreign currency (Manzur, 1993).

We apply Relative PPP to calculate inflation in Venezuela. Let

$P_A$  = the Venezuelan price level in bolivars,

$P_B$  = the United States price level in US dollars, and

$S_{A/B}$  = the exchange rate (bolivars/US dollar).

Then, PPP in the absolute form states that:

$$\frac{P_A}{P_B} = S_{A/B}^*$$

We can convert Absolute PPP to Relative PPP:

$$\frac{1 + \frac{\Delta P_A}{P_A}}{1 + \frac{\Delta P_B}{P_B}} = 1 + \frac{\Delta S_{A/B}}{S_{A/B}}$$

We can then rearrange these terms to obtain the following relationship:

$$\frac{\Delta P_A}{P_A} = \left[ \left( 1 + \frac{\Delta P_B}{P_B} \right) \left( 1 + \frac{\Delta S_{A/B}}{S_{A/B}} \right) \right] - 1$$

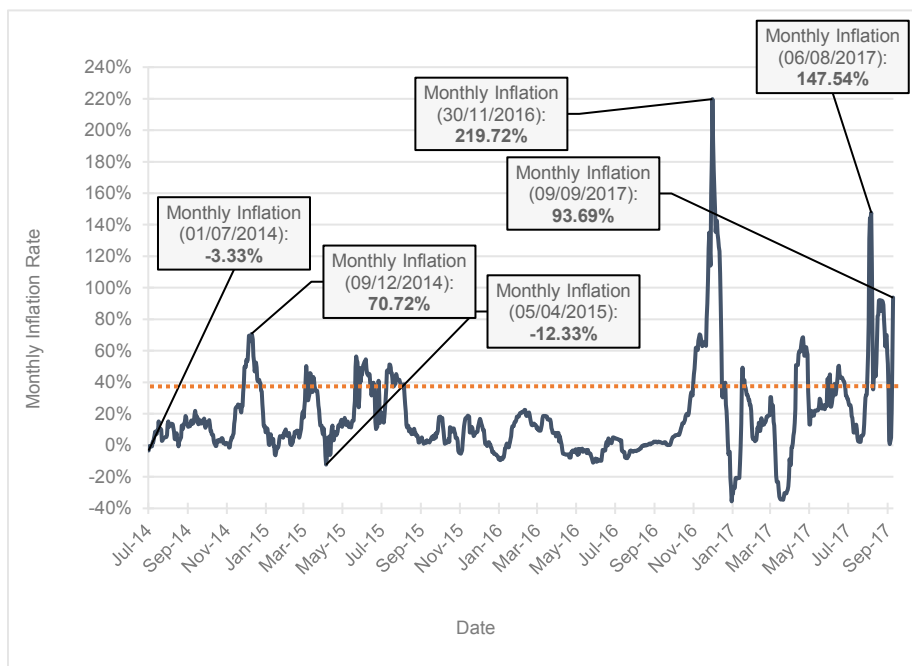
Thus, if we know the US inflation rate and the change in the exchange rate between the bolivar and the dollar over the given period, we can calculate the inflation rate in Venezuela. In order to make the calculations, we use the Consumer Price Index for All Urban Consumers: All Items. This index is reported by the US Bureau of Labor Statistics, and the black market exchange rate for the bolivar against the dollar is reported by *DolarToday*.

Our calculations show that monthly inflation broke through the 50% threshold on 3 November 2016, when the black market exchange rate deteriorated to 1682.12 VEF/USD. At that time, the monthly inflation rate in the USA was 0.16%. On 3 November 2016, Venezuela's monthly inflation was:

$$Inflation_{Venezuela} = \left[ (1 + 0.0016) \left( 1 + \frac{1682.12 - 1084.63}{1084.63} \right) \right] - 1 = 0.548$$

Since inflation is expressed in percentage terms, monthly inflation on 3 November 2016 was 54.8%. The monthly inflation rate, as shown in Figure 4 below, continued to stay above 50% for each day between 3 November 2016 and 14 December 2016.

**Figure 4: Venezuela's monthly inflation rate**



Sources: Banco Central de Venezuela, *DolarToday*, Dolar Paralelo, Paralelo Venezuela, Venezuela Econ. Calculations by Professor Steve H. Hanke, The Johns Hopkins University.

Note: These monthly inflation rates are implied by the black market USD/VEF exchange rate.

## Reflections on Why Purchasing Power Parity is Powerful During Hyperinflation

Versions of purchasing power parity theory date back to the Salamanca School in sixteenth-century Spain and the work of Gerard de Malynes in England in 1601 (Manzur, 1993). The theory was largely neglected until the Swedish economist Gustav Cassel began an extensive investigation of exchange rates and price levels in the early twentieth century (Manzur, 1993). Cassel's conjecture was that movements in exchange rates reflected

movements in relative purchasing power. He plotted monthly changes in prices in different countries and compared those to movements in exchange rates during the same period. Countries with weaker currencies (read: stronger currency depreciations) suffered high rates of inflation. He found that the linkage between an increase in exchange-rate depreciation and increased inflation was tight. Cassel dubbed the theory the Purchasing Power Parity Doctrine (1916 and 1918). In a study of the relationship between the German mark's exchange rate and German inflation, Cassel found that Absolute PPP did not hold, and concluded that PPP is 'one of the most intricate, most actual, and practically most important chapters of economic science' (Cassel, 1919).

Even though Cassel continued to embrace the Absolute Purchasing Power Parity doctrine, his work opened the door for the development of Relative Purchasing Power Parity, which is the form we have used to estimate inflation in Venezuela. It is this form of PPP, as applied to countries with elevated inflation rates, which provides the standard used by the economics profession. The reason is clear: in high-inflation countries, Relative PPP holds and yields very accurate results (for example, see Frenkel, 1976; Mahdavi and Zhou, 1994; Manzur, 1990; McKinnon, 1979; McNown and Wallace, 1989; and Taylor and Taylor, 2004). As Petrović, Bogetić, and Vujošević put it: 'At moderate rates of inflation, prices adjust to past inflation and currency depreciation does not play a prominent role. As inflation accelerates, currency depreciation becomes increasingly important for price adjustments' (Petrović et al., 1999). Ronald McKinnon agrees and pointedly specifies Relative PPP as the standard for high-inflation countries: 'The relative version of PPP performs most impressively, however, when inflation in a single country is extraordinarily high *vis-à-vis* the outside world' (McKinnon, 1979).

In concluding these reflections on Relative PPP, it is worth noting that the empirical evidence shows that it holds in the 'long run,' when arbitrage has time to work its magic. The debates on the topic always swirl around whether it holds in the 'short run.' This debate does not appear when hyperinflation is the order of the day. During an episode of hyperinflation, the currency of the relevant country plunges in value rapidly and prices soar

in lockstep. In these circumstances, a foreign currency becomes the reference unit of account, and the ‘short run’ becomes the ‘long run’ and vice versa. With this equivalence, Relative PPP holds, as it always does in the ‘long run,’ because the ‘long run’ can occur in an hour.

To put this point into perspective, we use an illustration from Yugoslavia, where Hanke served as the adviser to the government of Ante Marković in 1990–91, and where he anticipated the great hyperinflation of 1992–4 (Hanke, 2016). Compared to Venezuela’s episode of hyperinflation, Yugoslavia’s was ‘great.’ The peak monthly rate of inflation in Yugoslavia was 313 million%. This is a daily rate of 64.4%. The comparable figures for Venezuela are only 219% per month and 4.0% per day.

To appreciate how the ‘short run’ and ‘long run’ became one in Yugoslavia, consider how fast prices were changing: literally in front of Yugoslavs’ eyes. A kilogram of potatoes was 4,000 dinars on 10 November 1993. The same kilo of potatoes went for 8 quadrillion dinars two months later (Gordy, 1999). On 16 January 1994, one of Belgrade’s prominent newspapers, *Politika*, reported that ‘yesterday [morning] the price of the [Deutsche] Mark on the black market was 2.0 million dinars, and around 3:00 p.m., it was 2.5 million dinars. Belgrade dealers were reluctant to sell marks, as they expected the exchange rate to reach 5 million dinars (per DM 1) by evening’ (Gordy, 1999). Talk about speed and the compression of time periods.

## Concluding Remarks

Venezuela, welcome to the record books. You have now entered the inglorious sphere of hyperinflation. It is a world of economic chaos, wrenching poverty, and death. Its purveyors should be incarcerated, and the keys should be thrown away.

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