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Hanke uncovers Iranian currency hyperinflation

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Steve H. Hanke, Professor of Applied Economics and Co-Director of the Institute for Applied Economics, Global Health, and the Study of Business Enterprise, and his team of 10 undergraduates, known as the bullpen, were the first ones to come to the realization that Iran was undergoing hyperinflation after studying the black market exchange rate in the country.

The rial has been decreasing since President Barack Obama signed the Comprehensive Iran Sanctions, Accountability, and Divestment Act, in July of 2010. In July of that year the official exchange rate of Iranian rials for U.S. dollars was very close to the black-market rate. However, the two rates have been diverging ever since. The sanctions represent an attempt to convince Iran to comply with all of its nuclear obligations and engage in negotiations on the future of its nuclear program.

KELLY STANDART/ PHOTOGRAPHY EDITOR

“There are several licensed dealers in Iran where you can trade at 28,000 rials to the dollar but even that is a rate that overvalues the rial. In fact the black market rate is closer to 35,000 rials,” Hanke said.

“It took Prof. Hanke and I about a month of searching to find the dataset that we were looking for. I had to make use of Professor Hanke’s vast network of contacts to have any success in finding the data. There was a lot of corresponding until someone was able to locate a currency trader in Iran who I was able to get in contact with briefly. He pointed us to a website that currency traders were using,” research assistant, senior Hassan Yasin wrote in an email to *The News-Letter*.

Once the monthly inflation rate of a country exceeds 50 percent, it is officially undergoing hyperinflation. Hanke estimates that Iran is experiencing a rate of about 69.6 percent inflation at the moment. He, having studied currencies for 45 years and been responsible for stopping 10 of the world’s 57 hyperinflations, was able to uncover the disparity between the Iranian government’s official exchange rate and the black-market exchange rate.

“With Iran the signal to noise ratio is almost zero,” Hanke said. “Even if you are there, you don’t know what’s going on. It is a very murky, kind of unstable equilibrium at all times, at least at the political level. But I knew what the black market rate was because I had a source that was telling me every week what the aggregate amount of black market activity was and what the rates were. The official exchange rate is just a fiction, however the black market rate is about the only free market in Iran.”

Wyatt Larkin, a senior and Hanke’s Chief of Staff, is responsible for ensuring that the office and the bullpen are functioning in an efficient manner so that Hanke has everything he needs to write articles, conduct research and make recommendations to the world leaders who rely on him for advice. Larkin is in charge of the administrative aspects and handles a lot of the student research as well.

“When the Iran story began to break, Prof. Hanke knew we needed to hit the story with a full-court press. He understood that, particularly with a hotspot like Iran, people would be coming out of the woodwork with their opinion on the situation. Since he was the only person with data on what was actually occurring in Iran, it was important to have the whole bullpen working on preserving Prof. Hanke’s competitive advantage —reliable economic analysis, based on objective data,” Larkin wrote in an email to *The News-Letter*.

The bullpen, which has been responsible for working with and conducting research for Hanke, includes Chris Skoff, Wyatt Larkin, Prof. Steve Hanke, Nick Krus, Jason Harary, Daniel Corbett, Andrew Gelston, Yury Yakubchyk, Hassan Yasin, Charlie Weintraub and Wes Panek.

“The bullpen is, by far, the best group project I’ve been a part of at Hopkins. It’s very much a team environment, where we all work together to support the important work Prof. Hanke does every day. We learn from each other, keep each other accountable, and the end result is a much better experience —and generally a better final product —than if we were all off doing our own thing,” Larkin wrote.

While the sanctions levied by the United States have been an effort to coerce Iran into further discussing their nuclear capability, some of the potential outcomes of the current situation could pose drastic problems for the rest of the world.

“Sanctions are typically very counter-productive, in the sense that they just strengthen the hand of the existing government that they are being imposed on. They can be quite popular for populous political purposes, but they are kind of a dumb man’s game,” Hanke said.

About 25 percent of Iran's Gross Domestic Product (GDP) comes from oil, and while high oil prices in recent years have allowed Iran to accumulate well over $100 billion in foreign exchange reserves, unemployment and inflation have remained problematic, as shown in Hanke's misery index. However, Iran may be forced to act if the sanctions continue to tighten, and essentially shut down their exportation of oil.

"If the sanctions tighten too much further, and Iran isn't really exporting too much in the way of oil, Iranians really hold the ace up their sleeve; and that is to close the Strait of Hormuz. That would be the end of this game. About 35 percent of all oil comes out of the strait, and 20 percent of all liquefied natural gas as well. It would have a catastrophic effect on the rest of the world," Hanke said.

Hanke modified what is known as the Misery Index, originally developed by economist Arthur Okun, in application to countries beyond the United States. Hanke's misery index summed interest, inflation and unemployment rates, subtracting annual percent change in per capita GDP. The misery index in Iran has risen from about 30 in 2011 to around 225 in 2012, all under Mahmoud Ahmadinejad. The index effectively shows how dire the situation is in Iran, much of which is caused by the strict military regime and lack of action to resolve this.

"Iran is already acting exactly how I predicted they would act. They are not enacting any type of real currency reform, but they are using police to enforce many trading regulations, essentially making it illegal to trade the rial," Hanke said.

Hanke, who is also a Senior Fellow at the Cato Institute in Washington, D.C., has written over 20 books on currency reform, along with his former Hopkins post doctorate Kurt Schuler. Hanke offered up advice for how Iran could stop its currency crisis.

"The way you stop hyperinflation, if the government is proactive and wants to stop them, is to do what I did in Bulgaria when I was advising President Stoyanov, and that is you put in a currency board, which we did on July 1, 1997. The currency board issues a local currency that is backed up with reserves of an anchor currency, and you allow full convertibility and the ability to freely trade one for the other. Inflation has been running around 242 percent for a month in Bulgaria, which was much more severe than what is starting to rear its ugly head in Iran," Hanke said.

Within a month, due to the actions of the currency board regime in Bulgaria, inflation rates and interest rates were back in the single digits. However, Hanke is skeptical about the prospects of Iran adopting a currency board.

"I think there is a very small chance that Iran would ever adopt a currency board, because it is a very free market mechanism and Iran is basically a police state.

The idea that the government wouldn't have control over a monetary policy and that they would just be exchanging rial for dollars, wouldn't suit the Iranian government," Hanke said.

Professor Hanke and Alex Kwok, a recent graduate and Hanke's former chief of staff, are responsible for estimating hyperinflation in Zimbabwe, which peaked in mid-November of 2008. In Zimbabwe, inflation was so extreme that the government stopped surveying for price changes because prices were rising so quickly— doubling roughly every 24 hours. In the case of Zimbabwe, there was no proactive government policy that ended hyperinflation.

"The people just stopped using the Zimbabwe dollar, and the economy dollarized rapidly. They forced the government's hand, and the government had to officially embrace the dollar and change the budget to dollars. The inflation stopped immediately," Hanke said.

Hanke is skeptical of this process occurring in Iran due to the extensive reach of the Iranian police, and their ability to limit the trading of currencies.

"If American sanctions squeeze Iran out of the oil business all together, then you would wind up with a higher probability of a situation similar to Zimbabwe where the Iranian government would have to finance things with a printing press, only resulting in higher inflation," Hanke said.

Success with short sale policy in Dubai shows strength of bullpen

Professor Hanke has been conducting currency research at Hopkins for 30 years, and worked with a plethora of undergraduates. During the Reagan Administration, Hanke was a Senior Economist on the President's Council of Economic Advisers, and later served as a Senior Adviser to the Joint Economic Committee of the U.S. Congress. During his time serving Reagan, Hanke became friendly with Chief of Staff James Baker III who always advised his team: "Remember the five P's…prior preparation prevents poor performance." This has been the mentality that Hanke has guided his students with over the years.

"The undergraduates are learning not through some class, but they are experiencing the real world. Our research is very thinking-oriented, and the five P's are always stressed," Hanke said.

"Prof. Hanke demands precise, high-quality work on every assignment, stressing replicability, as well as the importance of including our own analysis on every memo. Every day in the office is like a test, and he fully expects a 'perfect score' from every student, every day," Larkin said.

The prior preparation of the undergraduate team became very evident when Hanke went to Dubai two weeks ago for a Financial Advisory Council meeting in

Dubai. Hanke had been researching the fact that that the short sale of stocks has always been illegal in the United Arab Emirates. There are three stock markets— the Abu Dhabi Securities Exchange, the Dubai Financial Market and the Dubai Gold and Commodities Market— but it is not legal to sell a stock short.

Hanke, who disagreed with this policy, went to Dubai with the intention of lifting this ban, and he was successfully able to do so.

“Some of the undergraduates were in a state of semi-shock, when I told them that we had won, and the ban was lifted. I had to go deliver the case, make the argument, and remember the five P’s, but the basic work was that I had three detailed briefing books that were done for me by the bullpen, as part of my course, Problems in Applied Economics. The undergraduates are learning how to function in the real world, and write memos that they know will actually be used,” Hanke said.

The undergraduate team led by Professor Hanke is exposed to problems in the real world, and expected to come up with solutions for them.

“Working with Professor Hanke is a unique experience. You have the opportunity to work on projects that have a tangible impact somewhere in the world, such as the project that was presented to the economic council of Dubai. Having a professor call you when you did something improperly or didn’t turn in something requires a time commitment that most students aren’t willing to give, but hearing praise from him is a incredibly rewarding,” Yasin said.

Hanke, who also taught economics at the Colorado School of Mines and the University of California, Berkeley, has a set of expectations pertaining to what the atmosphere of a university needs to be like in order to achieve success.

“There are three things you need at a university. Students should learn how to think. The professor should be helping them to think and apply their knowledge to real situations. The second thing is learning how to conduct research and actually do something with that research. Thirdly, you need to have an environment where you get people fired up about something, so you have some sizzle,” Hanke said.

Nick Krus, research associate for Hanke, who graduated from Hopkins last year, and has worked for Hanke for three years, recently co-authored a paper with Hanke entitled, “World Hyperinflations.” Most of the work for the paper was completed when he was an undergraduate at Hopkins, and was finished the summer after his graduation.

“My main focus of research is on currency boards and hyperinflation. The energy the group has keeps everyone energized and enthusiastic. The level of dedication is really quite amazing,” Krus said.

Hanke stresses the fact that the learning and research done by his students is applied to real economic problems, and whether or not they have done their job right is determined by quantitative figures or various world leaders.

“First and foremost, Prof. Hanke teaches you how to do real economic research, something he’s been doing his whole adult life. But, he isn’t just a casual academic observer — on many important issues, he is very much on the ‘front line’ and the ‘front page.’ In Problems in Applied Economics, the questions are real, the data are real, and often the results are measured more on Bloomberg or in the Financial Times than on ISIS,” Larkin said.