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The Case For Currency Substitution In Venezuela

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Venezuela lopped off three zeros when it replaced its old currency in January 2008. The arrival of new banknotes on December 18 shows the government is committed to putting those zeros back on. The newest denomination, 500 bolívares, will soon be joined by 1,000, 2,000, 5,000, 10,000, and 20,000 bolívares notes. Higher denominations are supposed to help Venezuelans deal with rising prices. But it isn't new notes that hard-working Venezuelans need; it's a new money.

Destroying a currency in less than a decade is no small task. And, yet, that is exactly what Venezuela has done. A 100 bolívares note—the largest denomination in circulation before the new notes arrived last month—could be used to purchase more than 50 liters of milk in 2008. Today, with black market exchange rates at more than 1,500 bolívares/USD, it takes roughly 18 of those notes to buy a single liter. The new 500 bolívares note will not even buy a cup of coffee in Caracas. Indeed, the value of notes in circulation is so low that shopkeepers weigh out piles of cash rather than trying to count it.

Steve Hanke, an economist at The Johns Hopkins University and director of the Troubled Currencies Project at the Cato Institute, estimates Venezuela's monthly inflation rate at 131% in December. That makes it the 57th official case of hyperinflation.

The proximate cause of inflation is well known. As the late Nobel-prize winning economist Milton Friedman argued, "Inflation is always and everywhere a monetary phenomenon." When the supply of money increases, consumers use the new money to bid up prices of goods and services in the economy. And, in Venezuela, there is a lot of new money floating around: The money supply has increased by roughly 127% in the last year.

Whereas the proximate cause of inflation is clear, the fundamental cause might vary from one episode of inflation to another. In cases of hyperinflation, however, rising prices are almost always preceded by fiscal imbalance. Unable to pay the bills, big spending governments turn to the printing press in a desperate attempt to preserve the status quo. Or, in expectation that the government will turn to the printing press, speculators attack the currency. In either case, it is an all-too-familiar pattern of deficits, debt and debasement.

That seems to be the case in Venezuela. Declining oil prices have caused government revenues to plummet. There have been no corresponding cuts in spending. The International Monetary Fund estimates Venezuela's fiscal deficit at 25.70% of GDP in 2016, up from 16.85% two years earlier. The average fiscal deficit as a share of GDP across Latin American and Caribbean countries this year is just 4.14%.

In order to get inflation under control, Venezuela must prevent the fiscal authority from determining monetary policy. Economists in rich countries usually stress the importance of an independent central bank. By delegating monetary policy to the central bank, and pledging not to interfere, the fiscal authority commits to getting its affairs in order. Unfortunately, such a policy is unlikely to be adopted in Venezuela, where all existing institutions are effectively controlled by the executive branch. And, even if such a policy were adopted, it is hard to believe the commitment would be credible. Consider that, when the opposition party won control of the National Assembly in 2015, President Nicolás Maduro promptly curtailed its power to make central bank appointments.

If an independent central bank is off the table, Venezuela might opt, instead, for a currency board. A currency board is required, by law, to exchange local currency—in this case, the bolívar—for some foreign currency at a fixed rate and to hold 100% foreign currency reserves to meet that requirement. Under a currency board, Venezuela would continue to earn seigniorage revenue from circulating bolívares—though it would be limited to the interest generated by its foreign currency assets—and its reserve holdings, so long as they are sufficient, would protect it from speculative attacks.

There are a couple problems with a currency board, though. First, the fixed rate a currency board could support might be much higher than the administration is willing to admit. Venezuela has experienced a massive reserve drain since 2008, with international reserves falling from around $43 billion to just $10.9 billion today. Second, although the currency board is *legally* required to hold 100% reserves, nothing *technically* limits it from over-issuing. And, as with other laws in Venezuela, the legal requirement to hold reserves might be abandoned when it becomes inconvenient.

Venezuela's last option is outright currency substitution. The Kobayashi Maru of monetary policy, currency substitution recognizes that the only way to win the game is not to play at all. Abandon all hope of preserving the bolívar. Let Venezuelans use some other money.

Currency substitution is, without a doubt, the most credible solution. One need not worry that Venezuela might over-issue bolívares if it no longer issues any currency at all. Sure, Venezuela would lose seigniorage revenues. But that is a small price to pay to eliminate the costs of a crummy currency.

Many countries engaging in currency substitution, like Ecuador in 2000, have opted for the dollar. But dollarization is almost certainly a non-starter in Venezuela, where the ruling administration is decidedly anti-American. The Chinese renminbi is, perhaps, a more palatable alternative. Moreover, since China would earn seigniorage on yuan circulating in Venezuela, adopting the renminbi might also serve as an unusual but convenient means of repaying one of its biggest creditors.

There is no denying the problems of transacting with legacy bolívar notes in hyperinflation Venezuela. But rolling out higher denomination notes is a temporary fix at best. To eliminate the problem, Venezuelans need a new money—one that cannot be mismanaged by the fiscal authority.

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