NATIONAL POST

Horror and hyperinflation in Iran

By Steve H. Hanke - 10/23/2012

Iranian crisis could have a horrible end

Since early September, there has been an accelerated slide in the value of the Iranian rial (IRR). This slide has been punctuated by dramatic collapses in the demand for the rial. With each collapse, there has been something akin to a “bank run” on rials — with a sharp rise in the black-market (read: free-market) IRR/USD exchange rate.

Ironically, Iranians are clamouring for U.S. dollars. In a land where the signal-to-noise ratio is very low, the black-market rate represents an important piece of objective information. It says a great deal about the state of the Iranian economy and the populace’s expectations.

On Sept. 8, 2012, the black-market IRR/USD exchange rate was 23,040. In the course of just under a month, after two big sell-offs, the rate settled at 35,000. That is a 34.2% depreciation in the rial. At this 35,000 IRR/USD rate I first calculated the monthly inflation rate implied by the rial’s depreciation — it was 69.6%. Since the hurdle rate to qualify for hyperinflation is 50% per month, Iran registered what appears to be the start of the world’s 58th hyperinflation episode.

With that, the Iranian authorities swung into action and introduced a new multiple-exchange-rate regime. There is an official exchange rate of 12,260 IRR/USD, which is available for Iranians who are importing essential goods, such as grain, sugar, and medicine. In addition, there is a “non-reference” rate, which is available at licensed dealers and can be used by importers of non-essential goods, such as livestock, metals and minerals. This rate is purportedly 2% lower than the black-market rate, though it currently (as of Oct. 10) sits at 25,480 IRR/USD — representing a significant discount relative to the black-market rate. And then, there is the black-market rate that is available to anyone willing and able to avoid the ever-watchful eyes of the police.

Among other things, the multiple-exchange-rate regime generates noise in the Iranian economy. Indeed, more than one price for the same thing creates prices that lie, and lying prices make it difficult for Iranians to determine the true cost of what they are producing and ultimately selling, making the multiple-exchange-rate regime just one more monkey wrench thrown in the wheels of the economy.

So, how does one stop a hyperinflation? In my experience, as someone who has been involved in stopping 10 of the 57 known hyperinflations, there are two sure-fire ways: instituting a currency board or adopting a foreign currency (dollarization). In Bulgaria in 1997, where I was then-president Petar Stoyanov's advisor, hyperinflation peaked at a monthly rate of 242% in February. On July 1, Bulgaria installed a currency board, under which the Bulgarian lev was issued. It was backed 100% by German mark reserves and fully convertible at a fixed rate with the mark. Hyperinflation stopped immediately.

In Zimbabwe, President Robert Mugabe simply looked the other way as the hyperinflation roared ahead. It peaked in mid-November 2008, reaching the second-highest level ever recorded in the world. At that point, the daily inflation rate was 98%, and it took only 24.7 hours for prices to double. Faced with this, Zimbabweans abandoned the Zimbabwe dollar, and the economy spontaneously, and unofficially, dollarized, eventually forcing the government to officially dollarize its accounts. With this, Zimbabwe's hyperinflation abruptly ended.

What course will Iran take? Neither the Bulgarian free-market currency board nor the Zimbabwean spontaneous (and eventually official) dollarization appears to be in the cards. As long as the Iranians can sell some oil, the regime will attempt to muddle through.

But, there is a catch — a dangerous one — what if the sanctions advocates get their way and the screws are tightened so hard that Iranian oil exports dwindle to a trickle? The Supreme Leader might just play the ace he has up his sleeve and order the Strait of Hormuz to be blocked, among other mischiefs. This would cause more havoc than any bomb in the allies' arsenal. After all, 35% of the world's crude oil, and 20% of the world's liquefied natural gas, flow through the Strait of Hormuz.

If a diplomatic solution cannot be found (admittedly a very difficult task), then Iran promises to be one of those situations that produce a "horrible end" or a "horror without end."