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Hyperinflations can end quickly, given the right sort of regime change

For long-suffering Venezuelans, that cannot come too soon

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Banknotes used as toilet paper. Wheelbarrows of cash exchanged for a loaf of bread. Prices in supermarkets revised upwards each hour. These vignettes of hyperinflation would be funny if they did not cause such hardship. This is now Venezuela's situation, in what may be the final days of the ill-starred regime of Nicolás Maduro. An estimate by Steve Hanke of Johns Hopkins University put the country's inflation rate last year at 100,000%, with prices doubling roughly once a month. The IMF reckons that in 2019 it may reach 10,000,000%.

Hyperinflations are not an exclusively modern problem. Rome suffered one under the emperor Diocletian. But the spread of fiat currencies, backed by the credibility of a government rather than a physical commodity such as gold, has made them more common. They came in devastating bursts over the past century: in the aftermath of the first and second world wars, during the post-Soviet transition from communism to capitalism, and more recently in misgoverned poor countries, mostly in Africa and Latin America. They are not cases of garden-variety inflation run amok. Rather, they demonstrate a catastrophic breakdown in a state's capacity to govern. In a narrow sense, they are a monetary phenomenon, with printing presses running nonstop. Yet the important question for economists, and for those trying to end them, is why the presses ran out of control in the first place.

The culprit, nearly always, is a politically unmanageable fiscal burden. Huge budget deficits can erode confidence in a state's fiscal discipline, causing the currency to weaken. Heavy government borrowing and a worsening exchange rate, which raises the cost of imports, fuel inflation. Most governments in such circumstances avert looming crisis by reining in borrowing and money growth. Indeed, periods of high inflation are not that unusual, according to Stanley Fischer, a former vice-chairman of the Federal Reserve, Ratna Sahay of the IMF and Carlos Végh of the World Bank. During the post-war period, they note, a fifth of a sample of 133 countries experienced inflation in excess of 100% at some point. But most avoided hyperinflation. Indeed, a country with annual inflation of 100-200% was more than twice as likely to see inflation decline the following year as it was to see it rise.

But sometimes the situation deteriorates. Politicians may be unable to impose the necessary reforms without losing the backing of the interest groups keeping them in power. Excessive spending continues, increasingly funded by seigniorage—spending power captured by the government thanks to the gap between the face value of new banknotes and the cost of printing them. As the bills mount, so does inflation. Hyperinflation often occurs against the backdrop of war or other social chaos. Germany's Weimar government, beset by political unrest and burdened with war debts and reparations, stumbled into economic oblivion. But it can begin in more prosaic circumstances. In the 1970s Bolivia enjoyed a commodity-driven boom under the rule of a military leader, Hugo Banzer, during which it borrowed heavily from abroad. Banzer was pushed from power in 1978. During the ensuing upheaval, global economic conditions turned; interest rates soared and resource prices tumbled. The left-leaning government that came to power in 1982 inherited annual inflation of 300%, a shrinking economy and the loss of access to foreign creditors. But as Jeffrey Sachs of Columbia University documented in an analysis published in 1987, Bolivia's new leadership had won support by promising to increase social spending. Attempts to limit spending or raise taxes enraged interest groups on which the government depended. The reliance on seigniorage continued, and inflation rose to 60,000%.

Economists once thought that high inflation should prove damnably persistent, as expectations of soaring prices became embedded. Yet in a seminal paper in 1981 Tom Sargent, a Nobel prizewinner, argued otherwise. Rather, expectations of high inflation reflect candid assessments of government policy: people anticipate high inflation when politicians are unserious about reform. A credible policy shift, he notes, can change expectations quickly and at little or no cost. He examined four great inflations in the 1920s and showed that once a credible policy "regime change" occurred, hyperinflation ended in weeks.

Stop the presses

More recent experience confirms that hyperinflation can end quickly under the right conditions. That usually means a sustainable fiscal consolidation, a credible pledge to stop funding the government via seigniorage and a commitment to a new monetary framework, most often via an exchange-rate peg. New political leadership often helps, as does external financial support. A new government took over in Bolivia in 1985, after three years of raging inflation. It raised taxes, slashed public investment, froze public salaries and stopped paying interest on its debt, thus restoring fiscal balance. And it stabilised the exchange rate against the dollar, with help from the IMF. The programme started in earnest late in August 1985; by early September a five-digit inflation rate had flipped to deflation.

Not every case concludes so neatly. Countries with histories of high inflation can stagger on with it, rather than tumbling into hyperinflation. It then proves frustratingly difficult to escape. This was the situation in Argentina and Brazil in the 1980s and 1990s, as repeated attempts at stabilisation failed to solve the problem conclusively. After extended periods of ineffectual leadership, people may become jaded about reform campaigns, and shock and awe may be required if they are to to be taken seriously. Venezuela, despite a long record of double-digit inflation rates, may dodge this fate; inflation there has rocketed only in the past few years amid an impressive display of fiscal incontinence. For its people, the sooner regime change comes, the better.