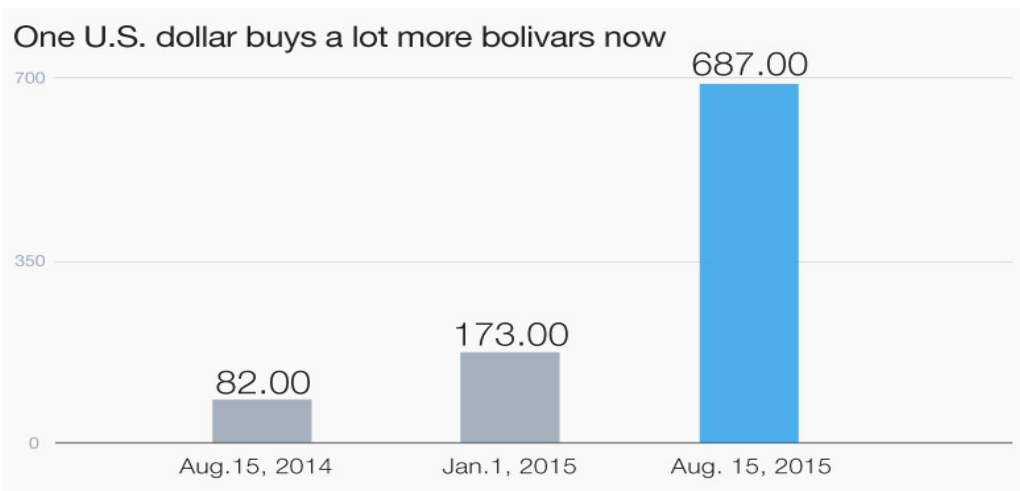
Venezuela's currency is worth less than a napkin

CNNMoney (New York) August 19, 2015: 11:12 AM ET

A photo posted on Reddit Monday has gone viral. It showed a man holding his empanada with a $2 Venezuelan bolivar (VEF) bill as a napkin. The post has already generated over 1,770 comments. The Reddit user, "Victorinox126" has a point. One bolivar is literally worth less than a penny on the popular, unofficial exchange rate market.

Venezuela's economy is in shambles and basic goods like napkins are hard to come by. Earlier this year, officials from Trinidad and Tobago allegedly offered to send tissue paper to Venezuela in exchange for oil. Sugar, milk and flour are not easy to buy either. That's a problem when 70% of consumer goods are imported, according to the Brookings Institution.

Most Venezuelans exchange dollars and bolivars on the unofficial exchange rate, which has skyrocketed over 700% over the past 12 months. One U.S. dollar equaled 82 VEF/USD a year ago. Now a dollar is worth 676 VEF/USD, according to dolartoday.com, a website that tracks the unofficial rate.



Venezuela's economy is suffering from extreme inflation sparked by political instability, a murky economy and the fall in oil prices. Last year, inflation rose 68% in Venezuela. Since December, the Venezuelan government has stopped publishing monthly inflation data. Most economists reckon that the inflation rate is already 120% a year. Some expect it to reach 200% by the end of 2015.That makes it harder for the government to pay for food imports, and harder for ordinary citizens to find things like napkins.

Venezuela's president Nicolas Maduro isn't helping the cause. He's continued massive government welfare programs that his predecessor Hugo Chavez began. The country's lifeline of growth -- oil -- has lost a lot of value this year, forcing Maduro to go to other Organization of Petroleum Exporting Countries (OPEC) members and ask for cash.

Maduro has also arrested political dissidents, created a currency system with three official exchange rates (not including the unofficial one) and blamed outsiders like the U.S. government for the country's economic woes.

Maduro did make one reform that Venezuelans like: they can finally buy dollars -- sort of. Venezuelans can buy up to USD 300 a day, but only USD 200 can be in cash and the other USD 100 must go to a Venezuelan bank account. That exchange can be done under one of the official rates, called SIMADI, and is about 200 VEF/USD, well below the unofficial rate.

The country's economy is highly reliant on oil, which accounts for around 95% of its exports, according to the OPEC, of which Venezuela was a founding member. The broader oil and gas sector constitutes roughly one-quarter of Venezuela gross domestic product (GDP).

Venezuela must pay USD 5 billion in debt payment in October. As its oil profits have dwindled, experts say Venezuela could default on its debt later this year. Both Moody's Investors Service and Standard & Poor's have cut Venezuela's credit rating deeper into speculative territory this year.

Questions

1. Explain why the economic situation in Venezuela is placing pressure on the value of the Venezuelan bolivar (VEF).

2. Does the effect of Venezuelan inflation on the value of the VEF support PPP (assume that last year’s inflation in the U.S. was 2%)? How might the relationship be distorted by political conditions in Venezuela?

3. Does it appear that the prices of Venezuelan goods will be equal to the prices of U.S. goods from the perspective of Venezuelan consumers (after considering exchange rates)? Explain.

4. Given the inflation and the decline in the bolivar, will the effects offset each other for U.S. importers? That is, how will U.S. importers of Venezuelan goods be affected by the conditions?