Title – Economic Turbulence: Volatile Foreign Exchange Markets
Excerpt – Find out how the changes in currency value affect the foreign exchange markets as well as the subsequent economic impacts on the affected countries.
Content –

Exchange rate turbulence refers to a country's exchange rate volatility. A high degree of volatility indicates that a country's exchange rate is subjected to rapid changes over a short span of time. This is a phenomenon that concerns mainly floating exchange rates, as the value of a floating currency is set by the forex market and is easily subjected to change based on its supply and demand relative to other currencies.

Exchange rate turbulence causes negative impacts such as an increase in the exchange rate risk. This refers to the potential to lose money because of a change in the exchange rate. When an investor wants to convert money into another currency to make an investment, he faces the risk of loss in value of the investment due to potential changes in the exchange rate. This increases transaction costs and reduces the gains to international trade. As such, it is more difficult to make international trade and investment decisions and this lowers the level of foreign direct investment (FDI) into the economy.

Exchange rate turbulence can also lead to hyperinflation which can be seen in the case of Venezuela. In Venezuela, currency controls were implemented in 2003 to limit capital flight out of Venezuela. These controls mandated businesses and individuals to buy dollars through the state. However, the official exchange rate sold dollars at a rate which was ten times less than the black market, which provided an incentive for traders to buy dollars at the official rate and then sell them for profit on the black market to make easy money. This drove up the demand for dollars. Due to the government's lack of supply of US dollars, the demand for dollars far surpasses the supply of dollars, pushing up the black market exchange rate. This creates a vicious cycle whereby a rise in black market price drives up the inflation rate, which increases demand for the dollar and again pushes up the price of the dollar.

This is a case for concern as 25 percent of the market imports via the black market and most prices in Venezuela are determined by the black market. Hence, a fluctuation in the black market exchange rate causes a rapid change in Venezuelan prices. Moreover, this imbalance between the amount of US dollars present in the economy and the amount of Venezuelan bolivares is worsening as the government prints more bolivares to finance the broadening fiscal deficit. As such, the bolivar has been losing value rapidly, which has caused the inflation rate to shoot up with unprecedented speed, where the annual inflation rate at the end of 2018 amounted to a massive 80,000 percent.

Hyperinflation has damaged Venezuela's economy drastically. It erodes purchasing power and encourages the hoarding of goods, as people expect further price increases. As a result, the economy has been in deep recession for 5 years, and the poverty rate is 90 percent. There are also shortages of food and medicine across the country. Moreover, these harsh conditions have also prompted mass migration from Venezuela.

The Venezuelan government has tried and failed to solve this problem by implementing policies that set artificially low exchange rates. For example, in August 2018, it introduced a new sovereign bolivar banknote which is pegged to the petro, a state controlled cryptocurrency. The sovereign bolivar had five zeros less than the current, highly inflated bolivar currency. This devaluation of more than 95 percent of the bolivar was introduced to guarantee the country's economic stability. However, this effort was carried out in vain because removing five 0s off the face value of the currency did not help much with the hyperinflation problem.

To solve its hyperinflation problem, Venezuela needs to adopt certain measures. One proposed method would be to adopt another more stable currency such as that of the US dollar or the Euro. Dollarisation (the adoption of the dollar) would give Venezuela the credibility and stability it needs to extinguish hyperinflation. It should also engage in further easing of its currency controls. Only when it unifies the exchange rate and puts an end to the black market, then can it begin on its path to recovery.