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Manufacturing Decisions

"In New York City you know the prices and value, so you shop around. In Argentina you don't care about the prices, just that you can buy."
— *Argentine banking executive*

During periods of high inflation, manufacturing operations are particularly hard hit. In fact, in some extreme cases in South America, corporate attempts to survive have led some companies to shut down their manufacturing operations in favor of speculation, which can be a more profitable use of capital.

Purchasing efforts become increasingly difficult as inflation climbs, growing in importance at the same time. According to the South American experience, supplies and supply sources dwindle, government regulation increases, capital markets dry up, and costs change rapidly, often without notice.

High inflation tends to force changes in inventory policies and relations with foreign and domestic supply sources, making cost control efforts extremely difficult to manage. While conditions demand that the purchasing department be given greater authority and independence, they also increase opportunities for corruption.

■ ***Anticipate that your purchasing department will assume a more dominant role in the long-run survival of your firm.***

Materials constitute the single largest portion of total costs and, because the supply and cost of materials can fluctuate so wildly during hyperinflation, effective purchasing practices become absolutely critical to business survival. An inefficient purchasing department can easily lead a company into bankruptcy.

In the United States, there are typically many sources of supply for any particular item. As far as a purchasing department is concerned, competition is the name of the game. Efficient, creative purchasers can save a company substantial amounts of money through the proper sourcing of material.

In South America, however, a purchasing department often finds itself in a situation with only one or two suppliers, thereby limiting the degree of price competitiveness.

There is a good possibility that similar circumstances will prevail in the United States should wage and price controls be instituted — as they were in 1971 — because shortages are the natural result of such controls.

In some South American markets, the situation has grown even worse. Because there is a limited number of suppliers, there is a tendency for some of them to form associations that operate as cartels. These cartels establish a market price, and often a company's only choice is to pay that price or shut down.

In Brazil, these supplier associations exercise additional market power by prohibiting their customers from producing parts that could be supplied by any member of the association.

Though cartels are illegal in the United States, it is safe to assume that, in the event of anti-inflationary regulations, shortages and other supply problems will develop here, making the purchasing function much more difficult to carry out, and the department's performance even more critical to any business's success.

■ *Purchasing agents should be prepared to deal with price controls.*

As mentioned earlier, price controls are a natural government reaction to inflation. Though this does not guarantee that price controls will be instituted in the United States, purchasing departments would be best off to anticipate controls and thereby avoid being blindsided should they be introduced. (See the Appendix for a description of the 1971 U.S. wage and price regulations.)

Perhaps the greatest impact of price controls upon the purchasing function is that they result in shortages and change the expectations of suppliers. The situation is exacerbated by the frequent desire of both customers and suppliers to use inventory as an inflation hedge. While buyers want to obtain inventory before price increases are granted, suppliers often attempt to hold inventory until they are able to raise prices.

Some South American manufacturers purchase raw materials ahead of time based on the anticipation of receiving an order. Though this is not the normal purchasing practice in the United States, it can be crucial in a hyperinflationary economy, where a company cannot depend on having its purchase orders filled at a moment's notice. Purchasing managers in South America always try to keep one step ahead of suppliers, because suppliers who have information about upcoming government-approved price increases will often delay accepting orders.

During periods of wage and price controls, companies have to engage in anticipating governmental action. When controls are in effect, if a company's information suggests that a controlled price will be increased shortly, purchasing activity should be increased immediately.

In Brazil, for example, one producer of machine parts found out that the government was about to grant a 60 percent increase on stainless steel, and instantly placed an order for $300,000 worth — though he had no immediate use for the steel — in an effort to avoid the $180,000 increase.

■ ***Be prepared to examine foreign supply sources and shift the balance of your purchases toward domestic suppliers.***

Another by-product of hyperinflation that complicates purchasing activities is the decreased availability and affordability of imported goods. Hyperinflation is often characterized by changes in exchange rates and protectionist regulations that make foreign supplies both expensive and hard to get, so those businesses that depend most heavily on imports can expect to be particularly hard-hit by high inflation.

In Argentina and Brazil, foreign suppliers are at a particular disadvantage because the government subjects them to tight quotas and high taxes. Argentine firms are reluctant to buy from U.S. suppliers, for example, because the government imposes a 180-day delay in payment in order to improve, at least in the short term, the country's international balance of payments. The risk the company faces from this delay is that a currency devaluation could greatly increase the dollar cost of the imported goods.

Should inflation begin to rise in the United States, American companies with a major reliance on foreign suppliers should anticipate especially high prices and increased difficulties obtaining imported supplies, and whenever possible should develop domestic alternatives as a contingency.

■ ***The director of purchasing should be given the authority to move quickly and independently to take advantage of opportunities.***

During hyperinflation, events occur so rapidly that a company's executives must be given the responsibility and authority to act quickly and decisively. In particular, inventory decisions must be made promptly, or immense additional costs may be incurred. Under these circumstances, there is often no time for the red tape and chain-of-command approvals common in the United States.

"I DON'T WANT TO INTERRUPT, MYRTLE, BUT SHOULDN'T WE GET ON WITH OUR SHOPPING BEFORE THE PRICES GO UP AGAIN?"

For example, in January 1987, the general manager of a Brazilian equipment firm learned of an impending price increase. He instantly picked up the phone and placed an order for a large quantity of raw material for immediate delivery. This practice in the United States might entail filing a request to corporate superiors, which would probably take weeks for approval. In a hyperinflationary economy, however, the opportunity would have disappeared long before such approval was granted, since the new prices would have already gone into effect, costing the firm what could have been a substantial savings.

South American businesses cannot afford to delay decision-making, and for that reason there is much less red tape and more delegation of responsibility and authority than is common in the United States. Capable, assertive managers are crucial in this type of inflationary environment.

Though current purchasing policies in the U.S. do not require such immediacy, if the nation's inflation increases significantly, American companies should be prepared to shorten channels of approval so purchasing decisions can be made rapidly.

■ *Allow the director of purchasing to commit to suppliers with verbal purchase orders.*

Verbal purchase orders are typical in a hyperinflationary environment, because the time consumed to prepare even a minimal amount of paperwork can be extremely costly. However, verbal purchase orders are only practical when the company or division president has complete confidence in his purchasing manager and has given him or her a high degree of responsibility and authority.

In Argentina, companies have another reason for using verbal, rather than written, communications. The government imposes a 1 percent tax on the face value of any written purchase order. Verbal purchase orders and internal records are often used to offset the formal process and avoid paying the tax.

■ *Be aware that hyperinflation creates increased opportunities for corruption.*

Because of the fluctuation in costs and the rapid pace of change, it is very difficult to adequately monitor cash transactions when inflation is high. Increased vigilance, audits and crosschecks must be capable of picking up undue variance in prices that may point to employee corruption.

Unfortunately, in all countries, because the bulk of the sales dollar revolves around the purchasing department, and because buyers need freedom to negotiate if they are expected to reduce costs, the purchasing area is particularly susceptible to corruption. This is especially true if purchasing departments are given wide leeway as to when and with whom they place large orders. For this reason, in many privately held South American companies, someone from the owner's family is placed on the purchasing department staff in order to prevent corruption.

Whether a family member or not, it is vital that every person in a company's purchasing department be beyond reproach. This is particularly important in hyperinflationary economies, where the maze of regulations and rapidly fluctuating prices creates a situation in which dishonesty can easily go undetected.

■ ***Change inventory policies if necessary to permit the accumulation of large inventories during times of hyperinflation.***

In high inflationary economies, inventory becomes not only a source for production, but also a speculative device, because its value frequently increases faster than the value of other investments.

Depending on current prices, cash is often used to purchase large amounts of inventory, usually in the form of raw materials. A standard manufacturing tenet in the United States is that inventory should be kept as low as possible. But in a hyperinflationary economy, there are two strong incentives for stockpiling inventory. It can protect profit margins that might otherwise be eroded by sudden price increases from suppliers, and it can protect the company from shortages, which often arise when wage and price controls are used to combat inflation.

In South America, when price controls are not in effect, it is normal practice to convert cash to inventory as quickly as possible. (When controls are in effect, inventory does not gain value as rapidly, and therefore loses some of its speculative value.)

In fact, when the inflation rate is greater than the interest rate — negative interest — it is common for companies to borrow money in order to purchase inventory and/or merchandise. This is an important way to maximize future profits. A company would gladly borrow money at 18 percent monthly interest if that inventory was going to soon experience a 60 percent price increase.

Another reason for keeping large inventories is to ensure a steady production schedule. Under hyperinflation, suppliers also use inventory as a speculative device, and, during periods when prices are controlled, often sit on their inventory in anticipation of the government approving a new price increase.

While the stockpiling of inventory can be instrumental to a company's survival, it is by no means always appropriate. In trying to decide whether to increase or decrease inventory, a company has to consider both the earning potential of that inventory relative to other investments, and the necessity of having inventory available to maintain a steady production flow.

■ *Effective cost control requires that you develop methods for estimating your internal rate of inflation.*

One of the primary goals of every company in every country is to reduce costs. Smart managers recognize that cost reduction is the most effective way to positively affect a company's bottom line. A dollar saved through cost reduction is literally a dollar earned, while a comparable dollar increase in sales volume may or may not translate into additional profits. It certainly will not increase profits by one dollar, since additional sales volume will mean corresponding increases in a variety of costs.

In the United States, a number of techniques are used to reduce and control manufacturing costs. The objective is to produce a product for the lowest possible cost, enabling a company to realize the greatest profit and/or to reduce its price and maintain or increase market share.

During hyperinflation, however, it is difficult to track the true costs of production, and consequently price increases tend to be substituted for cost-reduction efforts, which can lead to less efficient production techniques.

(For more information on cost reduction, see *The Harry Figgie Guide to Cost Reduction and Profit Improvement.)*

In order to effectively monitor true costs during a hyperinflationary period, it is necessary for companies to develop methods of estimating their own internal inflation rates. One large Brazilian manufacturer developed an index to track its internal rate, and found that, in 1987, the company's own inflation was 525 percent, while the country's official rate was 365 percent. In other words, it was forced to sell its product at a loss for several months until its next round of price increases was approved. Had the company failed to monitor its own inflation rate, it would not have known it was operating at a loss, and would not have had the evidence necessary to gain government approval for the price increase that covered its true production costs.

American companies will generally have an advantage over their South American counterparts in tracking their internal inflation rates, because the former have more fully integrated computerized data analysis into everyday management. This is another reason that companies in the United States should make sure their computer capabilities are up to date. At most companies in Argentina, Bolivia and Brazil, cost-reduction techniques are in limited use. Work sampling, organizational and ratio analyses, and other inexpensive yet effective cost-reduction measures, so critical to U.S. operations, are in the infant stages. A large part of this failure to stress cost reduction is related to the wide price fluctuations found in hyperinflationary economies. One can imagine the frustrations of a president intent on cost control but facing almost daily increases in his labor, material and burden costs.

ROTHCO ORIGINAL

"I'M AFRAID I MAY HAVE TO LET SOME OF YOU GO!"

Other impediments to cost control are the strong unions and heavy government regulation typically found in South America. In all three countries studied, it remains very difficult and expensive to lay off employees, making it especially hard to reduce labor costs. Similar circumstances may develop in the United States, because it is not unlikely that both union strength and government regulation will increase here should inflation rise significantly.

■ ***Large corporations and multinationals should expect to have greater need for cost reduction.***

The fact that it is difficult to control costs during hyperinflation is self-evident. This does not mean, however, that cost reduction should be ignored. In the vast majority of small South American companies, cost reduction is not emphasized, but at large corporations — especially multinationals — ignoring cost reduction can be suicidal.

Under wage and price controls, multinationals and larger companies are frequently used to set an example. Their requests for price increases are more likely to be constrained than those of local companies. Small local suppliers are frequently permitted to raise prices without being subject to normal government review. This creates a problem for large companies, since they often incur cost increases which they cannot pass on in the form of price increases of their own.

Extra scrutiny of these companies was common in all three South American countries, as well as in the United States during the 1971 wage and price controls. Cost-reduction measures may therefore be the only way large companies can maintain profit margins when government price controls are in effect.

Also, it is often only the large multinationals that have the ability to implement sophisticated control measures and computerized systems, which can be a tremendous asset in identifying cost-reduction opportunities. For example, a top executive of one large multinational stationed in Sao Paulo, Brazil — unable to afford new equipment — developed a computerized control system that enabled the company to more economically utilize existing machinery, resulting in greatly improved operating results.

■ ***Though cost reduction remains a key to improving profits, companies must always be prepared for opportunities to raise prices.***

Regardless of its importance, cost reduction can in no way offset the effects of inflation on a company's profit margin during hyperinflation. A firm must be prepared to react almost instantaneously any time there is an opportunity to increase prices.

In Brazil, for example, at the end of 1987 the government suddenly lifted price controls, presenting companies with a long-awaited opportunity to raise their prices. Forty-five days later controls were once again imposed. Those companies that failed to take advantage of this window of opportunity lost out on a chance to recoup their own higher costs. One lost opportunity can easily put a company out of business.

Ironically, when price controls are introduced, inefficient firms can in some cases actually benefit. The inefficient firm has more opportunity to reduce costs, since the operation has so much fat that can be eliminated easily. In fact, price controls can be a catalyst toward reducing costs in all companies, since that may be the only way to maintain profits.

■ *Anticipate difficulty in maintaining capital expenditure programs.*

As inflation rises, access to funds shrinks and long-term investment projects become harder to finance. Though the extent of capital expenditures differs widely in Argentina, Bolivia and Brazil, the instability caused by hyperinflation has resulted in a serious flight of resources from all three countries. This problem has been particularly severe in Argentina and Bolivia because of the relatively easy access to dollars as an alternative form of investment.

In Argentina, Bolivia and Brazil, local banks are a limited source of investment capital. Reserve requirements are extremely high — 75 percent in Argentina, for example, compared to 12 percent in the United States. Furthermore, a bank's available funds are usually lent to the government to support its fiscal budget.

While South American companies might occasionally borrow in local currency for short-term investments, they have to borrow in U.S. dollars from an international source when looking for a long-term or sizable loan. Multinational corporations, of course, have the possibility of obtaining needed capital from their parent company.

American companies should expect domestic banks to play a decreasing role in the financing of long-term projects. There is already a trend among American companies to rely increasingly on foreign capital, and this trend can be expected to accelerate in the face of any inflation-triggered flight of capital from the United

States. However, foreign investors are likely to be more hesitant to invest in American companies as inflationary instability increases. The probable result will be a credit squeeze, with long-term funding especially difficult to obtain.

■ *Be aware that speculation in commodities and currencies may provide a better rate of return than capital projects.*

American firms may also need to alter their thinking regarding capital expenditures because, in severe inflation, the rate of return from capital projects may fall far short of the rate of return on speculation in commodities and other currencies. Under such conditions, capital development is often sacrificed because profitability and even survival may depend on speculation.

SUMMARY

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- Purchasing agents should be prepared to deal with price controls.
- Be prepared to examine foreign supply sources and shift the balance of your purchases toward domestic suppliers.
- The director of purchasing should be given the authority to move quickly and independently to take advantage of opportunities.
- Allow the director of purchasing to commit to suppliers with verbal purchase orders.
- Be aware that hyperinflation creates increased opportunities for corruption.
- Change inventory policies if necessary to permit the accumulation of large inventories during times of hyperinflation.
- Effective cost control requires that you develop methods for estimating your internal rate of inflation.
- Large corporations and multinationals should expect to have greater need for cost reduction.

- Though cost reduction remains a key to improving profits, companies must always be prepared for opportunities to raise prices.
- Anticipate difficulty in maintaining capital expenditure programs.
- Be aware that speculation in commodities and currencies may provide a better rate of return than capital projects.