THE HYPERINFLATION SURVIVAL GUIDE

Strategies for American Businesses

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Preface

By
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Imagine that a customer has just placed the largest order you have ever received, and he is prepared to pay cash for immediate delivery.

Your response? You thank him and explain that you can't afford to fill the order, in spite of the fact that you have enough inventory.

You explain further that you gave your employees a 10 percent pay hike last week, and they will be demanding another within the month.

The price of your most important raw material went up 12 percent yesterday, and to purchase more you will need a loan, with interest rates currently running at 6 percent *monthly.*

In spite of your increased wage and supply costs, you can't raise your own prices because the government refused your latest price increase request.

If you fill your customer's order, you will actually lose money.

This scenario, in one form or another, is not uncommon in economies with soaring inflation rates, and has become practically routine in countries like Brazil, Argentina and Bolivia.

But I am not asking you to imagine what it would be like to run a business in South America, where the situation is often worse than the one I just described.

I am asking you to imagine what it might one day be like in the United States.

If the U.S. fails to rein in its debt — the largest in world history and more than double the debt of the entire Third World — American businesses might find themselves facing South America's inflationary nightmare.

The United States has destroyed its economic flexibility, and the longer we wait to confront our problems, the more impossible they will be to overcome.

Between 1982 and 1987, the U.S. debt more than doubled, climbing from just over $1 trillion to almost $2.4 trillion. Projections suggest that, if current trends are allowed to continue, that debt could reach $13 trillion by the year 2000. At that point, our annual deficit would be as much as $2 trillion, and *$1.6 trillion* of that would simply be interest on the debt!

American industry is in similar straits. As of mid-1988, corporate debt had reached $1.8 trillion, and U.S. non-financial industry had a debt-to-equity ratio of 0.9 to 1, the highest in history. The pre-tax earnings coverage of interest had fallen from 26 times to only two.

I am basically a businessman, and I don't consider myself an alarmist. However, as part of our corporate planning process, Figgie International has been forced to face the strong possibility that we will be thrust into a high inflationary climate by the middle of the 1990s.

We decided a couple of years ago to prepare for that prospect, and began looking for information on how companies operate during hyperinflation. Unfortunately, we found that very little had been written on that subject in the United States.

As a result, we initiated research of our own, and chose as our target South America — specifically Bolivia, Brazil and Argentina — as the best available example of economies suffering high inflation rates.

We put together a three-person team headed by Dr. Gerald Swanson, a University of Arizona economist and director of the Academy for Economic Education.

The team went to South America four times over a two-year period to study the development of inflation and its impact on businesses, individuals and governments. They interviewed 80 leading bankers and industrialists and a considerable number of ordinary citizens throughout Argentina, Brazil and Bolivia.

The team's findings were quite frightening.

subsidies, control the money supply, and privatize government businesses to the maximum extent.

Obviously, only the government can do what is necessary to avoid or curb high inflation. All industry or individuals can do — other than pressing for government action — is to cope with the results. This manual is designed to help managers do just that. It offers an extensive list of insights into how American businesses can best survive high inflation, covering the areas of financial management, marketing, manufacturing and industrial relations. The strategies discussed are based on the experiences of South American business leaders who have battled long and successfully with some of the highest inflation rates in recent world history.

Though this manual focuses on inflation's impact on businesses, we are also planning a companion volume that will discuss inflation's development and its effects on individuals and governments. The picture in those areas is no brighter: Pensions, savings, bonds and insurance policies become absolutely worthless. Credit is virtually nonexistent, and people must pay cash for everything — including houses. Wages never keep step with prices, which rise continually. In an Argentine supermarket, it was common to take a loaf of bread from the shelf, only to find that the price had increased by the time it reached the checkout counter.

It is my fervent hope that this manual will turn out to be interesting, but unnecessary. However, to ignore South America's lessons — and warnings — is to hide one's head in the sand. At Figgie International, we plan to prepare ourselves for the very real possibility that the U.S. inflation rate will soon take off, and we offer this manual to other American businesses in the hopes that all of us can survive whatever curves the U.S. economy may throw.

WHAT EXACTLY IS HYPERINFLATION?

The classic definition of hyperinflation, as described in 1956 by economist Phillip Cagan, is a 50 percent average monthly price rise, translating into an annual inflation rate of 12,875 percent compounded. While Bolivia met that criterion in 1985, Argentina's and Brazil's inflation peaked at 20 to 25 percent monthly, or 800 to 1,400 percent annualized. Still, this was sufficient to wreak havoc on all three economies. For the purposes of this report, "hyperinflation" is used to signify rapid, debilitating inflation that leads to a major devaluation of a country's currency, which happened in all three countries.

Introduction

"The problem with hyperinflation is that it happens so fast. We never realized what was happening until it was too late."
— South American bank director

"Sometimes I wonder how the United States holds together. Your investments in productive assets are down, growth in non-productive sectors is up, and you purchase more than you produce."
— South American bank director

"In South America, taking a cab is cheaper than a bus because you pay for the cab at the end of the ride. By then, the money is worth less."
— Common saying

Once the chief scourge of every respectable U.S. economist, inflation has become the forgotten bandit of the eighties. Though occasionally discussed in the back pages of the press, inflation has been supplanted in the public consciousness by issues like America's dwindling global competitiveness, recessionary trends, and foreign trade imbalance.

The primary reason inflationary concerns have abated is that, contrary to traditional economic theory, the huge U.S. budget deficits of the past few years have not translated into spiraling prices.

The continuing failure of our deficits to trigger inflation has confounded many economists, because the postwar years, until this decade, have demonstrated a direct correlation between the two. When deficits rose, increases in prices and interest rates were sure to follow. Since 1980, however, the annual deficit has tripled and the national debt has doubled, yet nominal interest rates have actually fallen.

Many economists believe the U.S. has avoided inflation only because the other developed nations of the world have been willing to finance our excesses. Whatever the reason for this aberration, we can consider ourselves fortunate. However, most economists would argue that the trend is simply not sustainable.

South America: A Frightening Lesson

Observers of the South American economic scene may feel a special horror as the U.S. government continues to add to its mountain of debt. Countries such as Brazil, Argentina and Bolivia have for years demonstrated similar deficit-spending habits, each with the same result — runaway inflation. All three nations have suffered triple- or quadruple-digit inflation in recent years. As a matter of fact, in the case of Bolivia, the inflation rate has climbed as high as 25,000 percent, topping out at a monthly annualized rate of 50,000 percent during the spring of 1985. Not only is this among the highest inflation rates in world history, but it is believed to be the highest ever for a peacetime economy. (Exhibit 1 on the next page gives an illustration of the tremendous impact inflation has had on the cost of living in each country.)

To learn more about functioning in a severely inflationary environment, a three-person research team spent a total of eight weeks in these three countries on four separate trips: May 1986, January 1987, May 1987 and January 1988. Personal, in-depth interviews were conducted with 80 of the leading bankers, economists and businessmen in Argentina, Bolivia and Brazil. Interviewees included top executives of large, publicly and privately held companies, banks and accounting firms, some of them South American-owned and others South American branches of major U.S.-based companies.

There is widespread agreement among these South American economists, bankers and business executives that the principal

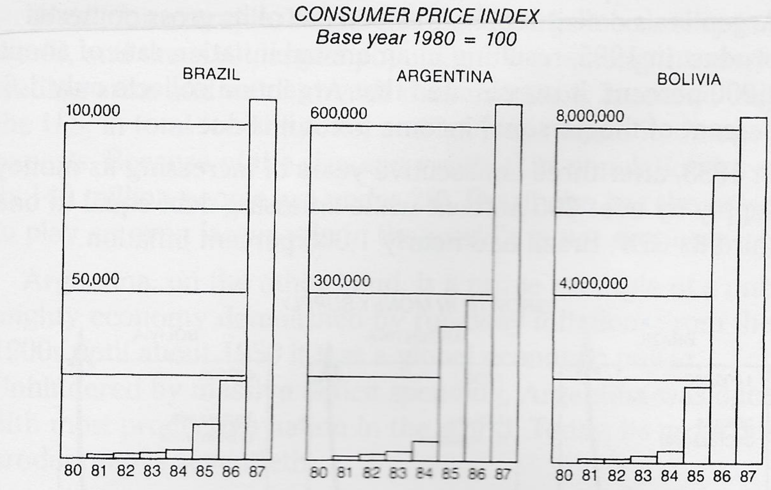

Exhibit 1: *These charts show the massive increases in prices experienced in all three countries during the 1980s. In Bolivia, for example, an item valued at 100 pesos in 1980 cost the equivalent of over eight million pesos by 1987.*

source of inflation in all three countries is deficit spending. They consider the logic of cause and effect to be indisputable: Paying off debt by increasing the amount of currency circulating in an economy, without increasing production, inevitably leads to higher prices.

"Inflation is always and everywhere a monetary phenomenon."
— *Milton Friedman, 1970*

Growth in a nation's money supply allows prices to go up, fueling inflation as a result. As Exhibit 2 shows, the quantity of currency in Brazil, Argentina and Bolivia has skyrocketed since 1980, the same period when inflation shot through the roof in all three countries.

As currency supplies grew in these South American countries, deficit spending reached mammoth proportions:

- In 1985, just before Bolivia reached record inflation levels of 50,000 percent annualized, its tax revenues covered just 15 percent of government expenditures. Total government revenues were only 1.3 percent of the gross domestic product for the first half of 1985.

- Argentina's deficit reached 11 percent of its gross domestic product in 1985, resulting in an annual inflation rate of about 1,000 percent. It is estimated that Argentina collects only 1.6 percent of the personal income taxes it is due.
- In 1988, after three consecutive years of increasing its money supply by over 300 percent while amassing debt equal to one-third its GDP, Brazil had nearly 1,000 percent inflation.

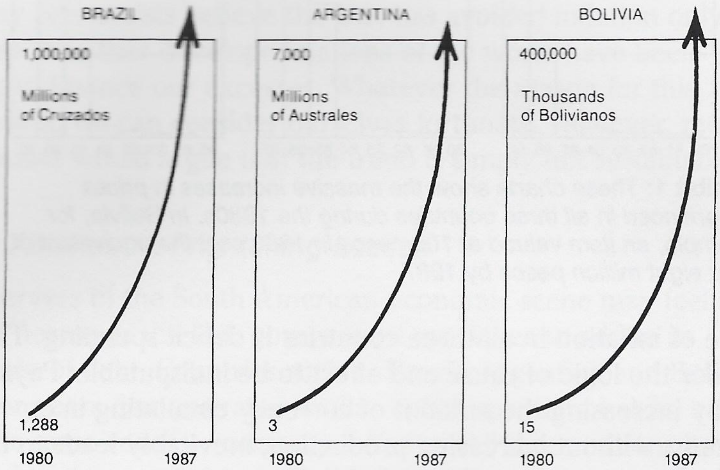

Exhibit 2: *Brazil, Argentina and Bolivia drove their economies toward hyperinflation by printing huge quantities of money since 1980. Brazil, for example, had the equivalent of only 1.288 billion cruzados in 1980, but increased that almost 100-fold to over one trillion cruzados by 1987. (All three countries have adopted new currencies since 1985. Both Brazil and Argentina lopped three zeros off their currencies, renaming them the cruzado and the austral, respectively. Bolivia took the extreme step of lopping off six zeros in renaming its currency the boliviano. Money supply figures for 1980 are the equivalent in today's currency of the currency used in 1980.)*

Brazil and Argentina are still struggling with intolerably high inflation rates, finishing 1988 at 934 percent in Brazil and 376 percent in Argentina. Though Bolivia has temporarily reduced its inflation to about 20 percent, it has done so at tremendous cost: its economy is now operating far below capacity, with extremely high rates of unemployment.

It is easy to dismiss the relevance of South American economic experiences because of the relative weakness of these nations, but to do so is to underestimate both the economies in question and the devastating impact of severe inflation.

Brazil, for example, boasts the eighth largest economy in the world, and the sixth largest population. It is among the world's leading arms and small aircraft manufacturers, is second only to the U.S. in total food exports, and leads the world in orange juice exports. Because of the size and youth of its population (over half its 140 million people are under 20), Brazil also has the potential to play an even larger role in the world's future economy.

Argentina, on the other hand, is a prime example of a once mighty economy demolished by runaway inflation. From the early 1900s until about 1950 it was a global economic power. Unhindered by massive deficit spending, Argentina was once the fifth most productive nation in the world. Today, its gross domestic product ranks seventieth.

Inflation has devastated the currencies of all three countries in the world market. As Exhibit 3 illustrates, the value of Brazilian, Argentine and Bolivian currencies has plummeted on the international exchange market.

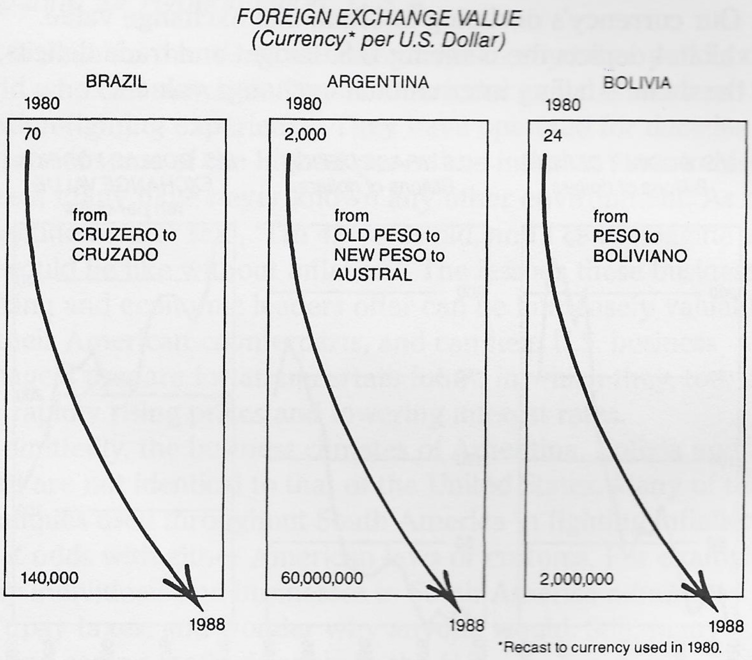

Exhibit 3: *These charts show the rapid deterioration in value of South American currencies — specifically in relation to the U.S. dollar — as a result of hyperinflation. For example, in Bolivia, it took only 24 pesos to buy a dollar in 1980. In 1985, the near-worthless peso was replaced by the boliviano, and by 1988 it took the equivalent of over two million pesos to buy a single dollar.*

The U.S. Follows South America's Path to Hyperinflation

South American executives warn that, just as it is a mistake to dismiss the lessons offered by their crumbling economies, it is extremely dangerous to underestimate America's vulnerability to inflation.

Among economists, business executives and banking officials in Argentina, Brazil and Bolivia, there is widespread agreement that the United States government is following the same path their governments followed, plunging head-on toward runaway inflation.

There is also considerable surprise that Americans do not seem to see the disastrous possibility they face. As evidence that America is well along the road to high inflation rates, South Americans point to several factors the U.S. has in common with their pre-hyperinflationary economies:

- Large deficits.
- Deterioration in our international balance of payments.
- Calls for protectionism.
- Eroded confidence in our national currency.
- Our currency's declining international exchange value.

Exhibit 4 depicts the climbing U.S. budget and trade deficits, and the dollar's falling international exchange value.

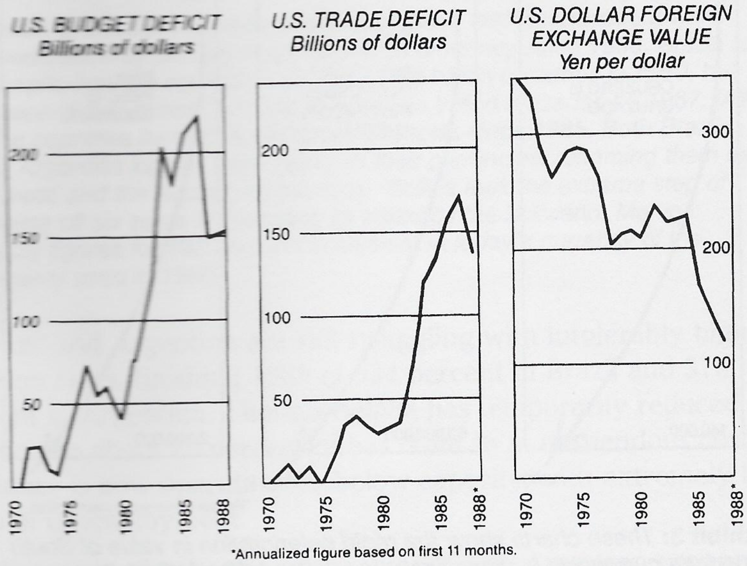

Exhibit 4: *The steady increase in U.S. budget and trade deficits has corresponded with a precipitous drop in the dollar's international exchange value. This situation is similar to that found in Brazil, Argentina and Bolivia over the past decade.*

Of course, this does not mean the United States will inevitably face the triple-digit inflation experienced by Argentina, Bolivia and Brazil. However, it certainly suggests a strong prospect of rising inflation rates, and South American executives warn it would not take triple-digit inflation to devastate the American economy. Even a diluted version of South America's inflationary experience would have terrible repercussions here, because, according to many South Americans, it is not so much the level of inflation that is difficult to live with as it is the fluctuation in rates.

Argentina, for example, learned to cope with 100 percent annual inflation, but a fivefold increase to 500 percent plunged the country into chaos.

Likewise, 5 percent may be tolerable in the United States, but a sudden fivefold increase to 25 percent would profoundly change our economic realities. As a matter of fact, when President Nixon took the extraordinary step of instituting wage and price controls in 1971, inflation was *only 4.7 percent.*

Preparing for Hyperinflation, U.S.A.

It is doubtful that there are executives in any other part of the world who can match the South Americans as far as modern inflation-fighting experience. They have operated for decades in the face of some of the highest peacetime inflation rates in history. Indeed, many have never known any other environment. As one Argentine banker said, "I'm 42 years old, and I can't imagine what life would be like without inflation." The lessons these business, banking and economic leaders offer can be immensely valuable for their American counterparts, and can help U.S. business managers prepare for an uncertain future in which they, too, may face rapidly rising prices and towering interest rates.

Admittedly, the business climates of Argentina, Bolivia and Brazil are not identical to that of the United States. Many of the techniques used throughout South America in fighting inflation are at odds with either American laws or customs. For example, many individuals and businesses in South America admit they don't pay taxes, and wonder why anyone would. Still, many inflation-coping methods apply to the U.S.

Hyperinflation Requires Hypermanagement

While many of the management practices undertaken during hyperinflation are also common in stable economic environments, during hyperinflation they become much more critical. Whereas American managers currently have time to consider, plan and discuss their responses to problems and opportunities, the constant change and instability of high inflation creates an ongoing crisis that demands immediate and continual reaction by management. Under such circumstances, the impact of small errors can be greatly magnified.

Should the United States enter a period of high inflation, those companies not prepared to make drastic adjustments will probably not exist for long.

Operating a company in a hyperinflationary environment can be a nightmare. There is absolutely no stability, and the cost of doing business is mercurial. Salaries escalate almost daily, the price of key raw materials can skyrocket from one day to the next, and supplies often dry up overnight.

While good management skills are a prerequisite for success in any business climate, during hyperinflation they are an absolute requirement for survival. Well-managed companies can maintain stability under chaotic conditions, and many even earn healthy profits. Conversely, bad management practices are magnified during hyperinflation, both because of the continual need for instant decisions and the thin line between survival and disaster. Hyperinflation has driven many poorly managed companies to an early grave, some plummeting from solvency to bankruptcy in a period of weeks.

Because events occur so rapidly during hyperinflation, those companies that can maintain their flexibility are best off. New information must be absorbed quickly, and today's political or monetary event can negate yesterday's wise business decision, requiring an immediate change of course. In many instances, a one-day delay in making or implementing a decision can be devastating. At some point, though, flexibility itself can create additional chaos, so it is necessary to implement a wide range of checks and balances, and at all times bear in mind that a single error can be fatal.

The key to operating in a hyperinflationary economy is to stay ever mindful that the real value of money erodes significantly over very short periods of time. Any aspect of management that involves cash transactions takes on added urgency, which gives the chief financial officer a major role in almost all day-to-day decisions. Cash management becomes the most critical component of business operation, and the difference between profitability and bankruptcy is often simply a matter of how well a firm handles its cash.

In any sale, the payment price begins to lose its value before the ink on the invoice is dry, and any delay in collecting payment will result in a lower real price. At 20 percent monthly inflation — Brazil's 1988 average — a 30-day delay can wipe out the better part of a product's profit margin, and two months can make the sale a money-loser.

Prices are increased rapidly during high inflation, and payment is collected as soon as possible and invested immediately upon receipt. Cash is never left idle — investments are made overnight and renewed daily, because the value of money can trickle to nothing if it fails to earn sufficient interest to keep step with inflation.

Likewise, any delay in purchasing supplies will result in higher costs, and South Americans routinely stockpile huge amounts of inventory to avoid price increases.

Production Plays a Smaller Role in Survival

High inflation changes the fundamental texture of business operation, and can even alter the focus of individual businesses. Operating an efficient company often takes a back seat to money management, and some companies allow their manufacturing operations to grind to a virtual halt. Product lines that may once have been a staple of business can suddenly become unprofitable, and have to be abandoned.

Managers turn from production and long-term planning to financial arbitrage, surviving by speculating in the currency and commodities markets. Many South American companies invest their money in other countries, or at least place their assets in a more stable currency, most often the U.S. dollar. South American companies also commonly stockpile large inventories as a speculative device, with expectations of selling them later at substantially higher prices.

Other South American companies cope with hyperinflation through a strategy of vertical integration. By acquiring raw materials and production and distribution facilities, some corporations have been able to minimize the impact of price fluctuations and government regulations.

There are no long-term, fixed-price contracts. At Bolivia's 1985 inflationary peak, all payments had to be in cash at the prevailing black market rate. If not in cash, all payments are indexed, so that the bill goes up over time according to an inflationary index, to ensure that the value of the payment does not decrease in real terms.

INDEX BILLS

The Great Credit Drought

During hyperinflation, loans are available only for short periods, and at extremely high interest rates. Cash becomes the nearly universal medium of exchange, and capital expenditures are often sacrificed for the sake of survival.

Because credit is so tight and interest rates so high, the relationship between a business and its bankers and investors often changes. Companies are forced to widen their circle of creditors to improve the availability of capital.

Businesses cannot afford to be heavily leveraged since interest rates are so unpredictable. Imagine those Brazilian firms that made an investment decision based on the 70 percent annual interest rates prevailing in November 1986, and then found themselves faced with an actual interest rate of 550 percent only 90 days later. Such instability is enough to ruin even the best laid plans.

Personnel needs often change during hyperinflation, requiring larger accounting and data-processing staffs. The labor/management relationship also tends to become more adversarial, because of the constant demand for wage hikes and the ever-present threat of layoffs. In addition, the relationship between management layers can become more tense, as middle management is generally hardest hit by inflation.

Filling supply needs is a much more complex process during hyperinflation. The number of sources for any given product tends to dwindle, so competition is often nonexistent. Suppliers frequently sit on their goods in anticipation of price increases, and in some cases demand immediate payment in cash. There is much less tolerance for overdue debts. At the same time, companies may attempt to stockpile inventories, both to ensure future supplies and as a speculative device.

A consistent, reliable source of raw materials and parts is of course critical to all companies, but particularly those operating in a hyperinflationary economy, since they tend to be mired in regulations and controls which can cause local supply sources to disappear.

High inflation can also affect the relative affordability and availability of foreign supplies and sales, especially when protectionist legislation is enacted, as it often is. Manufacturers who rely on imported parts may have an especially difficult time obtaining or affording those parts.

Fluid Management Style a Must

Reporting structures and managerial authority also undergo transformations as inflation rises. Because decisions have to be made quickly, there is no time for red tape or chain-of-command approval processes. Managers on every level must understand financial management, corporate objectives and rules, and must be given the authority to act quickly and independently. Likewise, they must communicate verbally, because the time involved in communicating via written messages is simply too valuable to waste.

Information, always important, is absolutely critical during hyperinflation. It is crucial not only that a company understand the true impact inflation is having on its costs and operations, but also that it develop the ability to gather and use information to predict future costs. This requires that businesses monitor the government, competitors, financial markets, the foreign exchange, and even black markets, and that they attempt, whenever possible, to anticipate changes in any of these spheres.

Governments also tend to play a larger role when inflation rises, as regulations — especially wage and price controls — are routinely introduced in an attempt to keep inflation down. And, as regulations are introduced, the temptation to circumvent them builds, especially when companies aren't allowed to pass on higher costs in the form of price increases. Inevitably, price controls lead to shortages, which in turn lead to black markets.

During hyperinflation, companies become extremely vulnerable to corruption. Some of the smaller South American companies have gone so far as to put family members in key positions inside the company to protect themselves from employee theft. Short-cutting regulations becomes all-pervasive, and everyone plays the black market.

The immediate need to survive begins to dominate all business decisions and behavior, making long-term planning a rare and generally futile exercise. Events simply change too fast and too unpredictably. During hyperinflation, the outlook of a long-term plan may be reduced to a few weeks, whereas short-term may cover only a few days.

Hyperinflation Is Immune to Politics

History has shown again and again that once hyperinflation becomes a reality, politicians inevitably succumb to the temptation of trying to legislate it out of existence, and just as inevitably fail. This was the case after both World War I and World War II in Europe, and more recently in Argentina, Bolivia and Brazil, each of which has imposed wage and price controls in the past decade.

These controls succeeded only in disrupting natural market forces of supply and demand, and usually led to shortages of basic commodities, hoarding, black markets and devious wage and pricing practices.

We must also remember that, as recently as 1971, the U.S. government imposed wage and price controls, and these measures proved to be as unsuccessful in the United States as they have been in South America.

In South America, government restrictions resulted in an increase in white collar crime, as a never-ending cycle developed in which the government implemented a maze of regulations, and citizens and companies just as quickly found some way to evade them.

Hyperinflation is by no means a certainty for the United States, but we have managed to create conditions conducive to its development, not the least of which is our widespread refusal to believe that it can happen here. According to several South American executives, not only can runaway inflation happen in the U.S., but it can easily catch the nation off guard, plodding along unnoticed before heading upward suddenly and without warning into the region of ruinous rates.

Granted that the U.S. economy and political structure are much more stable and powerful — and much less prone to chaos — than those of any South American country, but the parallels remain. And, more importantly, no country anywhere, during any time in world history, has been able to survive over a prolonged period by spending money at a faster clip than it takes it in.

"Do not accustom yourself to consider debt as only an inconvenience. You will find it a calamity."
— Samuel Johnson, 1758

The intention of this manual is not to predict future U.S. inflationary trends. Rather, it is meant to provide information that will allow American businesses to fare as well as possible should inflation begin to rise in America, as so many world business and political leaders fear it will.

If inflation does take off here, the lessons of South Americans who have successfully battled its ravages can help ensure that American business will land on its feet.