Hyperinflation: Lessons from South America

by Gerald J. Swanson

How would you like to live in an economy without memory, where you don't know the price of anything day to day or the value of the wage you are paid? That's what it's like under hyperinflation. In Argentina, supermarket prices are increased twice daily. During the two weeks we were in Brazil recently, interest rates rose 100% from 330% to 430%. Bolivia's demand for money is so great that its third largest import is currency.

Inflation, to say nothing of hyperinflation, seems to be the forgotten bandit of the eighties. Inflation was once the chief scourge of every respectable U.S. economist. Today we seem to have other things to worry about: pockets of severe unemployment, a lack of competitiveness internationally, the fear of a recession, even the possibility of disinflation.

The chief reason inflationary concerns have abated is that, contrary to traditional economic theory, the huge U.S. federal deficits of recent years have not yet translated into spiraling prices. Until this decade, the postwar years had demonstrated a direct correlation between deficits and inflation. When deficits rose, price and interest rate increases were sure to follow. During the past six years, however, the annual deficit has almost tripled, with the national debt almost doubling, but nominal interest rates have actually fallen.

Whatever the reason for this aberration, we can consider ourselves fortunate. But for how long? Most economists would argue that the trend is simply not sustainable. South American countries such as Argentina, Bolivia, and Brazil—all of which have suffered annual inflation rates into the triple digits in recent years—offer conclusive proof that no country can indefinitely get away with spending more than it makes. The United States has something to learn by the plight of these countries. It would be a mistake to write them off as hopelessly backward, having no relevancy to such a powerful, sophisticated economy as ours. Argentina as recently as the 1920s was the fifth most productive nation in the world. Now it is 70th, with hyperinflation the major culprit.

At a critical juncture, Argentina, Bolivia, and Brazil were not willing to bite the bullet and take the steps necessary to prevent high inflation. Make no mistake about it, neither is the United States. We all seem to share a love affair with the hot fudge sundae diet; the notion that we can eat as much as we like without getting fat. But eventually the piper has to be paid. Increasing the amount of currency circulating in an economy in order to pay off debt, without increasing production, will inevitably lead to higher prices. In each country we visited, large deficits and high inflation go hand in hand. And when runaway inflation starts, it moves quickly . . . in a matter of months, or even days!

To a certain extent, it is the fluctuation in inflation rates that is difficult to live with, rather than the rates themselves. Argentina learned to cope with 100% annual inflation, but when it rose to 500% the result was virtual

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chaos. In the United States we've become accustomed to 5% inflation, but a sudden increase to 20% would profoundly change our economic realities. In fact, even 5% took some getting used to. When President Nixon imposed wage and price controls in 1971, the national inflation rate was a whopping 4.7%.

The Consequences of Hyperinflation

What would life be like in the United States with an inflation rate of 20% or more? South America offers a number of clues. At one time in Argentina, a pair of shoes cost as much as an entire steer. With hyperinflation, prices cannot be used as benchmarks for decisions, since yesterday's prices do not offer any relevancy for today. In fact, it isn't unusual for South American shoppers to see the price of bread increase between the time they enter a grocery store and the time they leave it. Savings lose their value. The only incentive is to spend. Paychecks are cashed immediately and turned into hard goods like washing machines, refrigerators, and radios. And that's assuming they are available. Consumers are forced to pay cash for everything, including homes. Above all, political and social certainty is lost.

In the United States we are accustomed to stability. We know that if today $300 is a good price for a 19-inch color television set, it will be an equally good price tomorrow. Not so in the South American economies we are studying. Beset by hyperinflation, it is nearly impossible for individuals to judge their status in life, since status is so closely related to the control over what they are able to consume.

As a political problem, inflation is much more illusive than, say, unemployment, which simply provokes a call for more jobs. Citizens don't necessarily demand an end to inflation, only to the personal hardships that result. Once wages are tied to prices so that people can be assured that their purchasing power is not damaged, they are usually satisfied. In that case, another problem actually arises when inflation is temporarily curbed and wage increases are halted. Workers tend to feel they are worse off when their monthly paychecks no longer increase routinely. Governments also become accustomed to inflation, using it as an all-too-easy way to lower their outstanding debt.

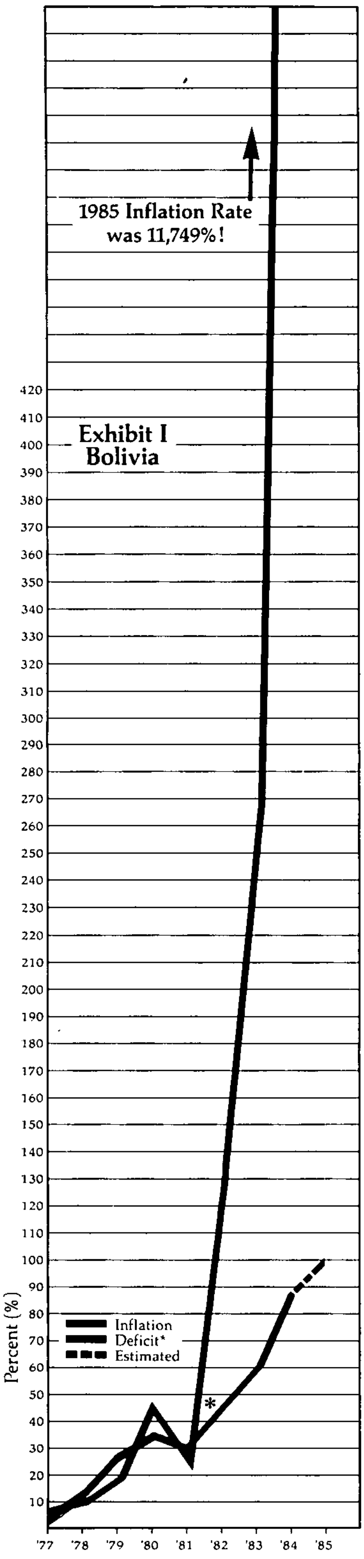
In these three South American countries hyperinflation has created more wrongs than legislators can put right. In order to protect industry, governments have been known to close their borders, which might help domestic companies in the short-term, but makes long-term competitiveness impossible. Unchecked hyperinflation inevitably plays havoc with an entire nation's standard of living. The need to survive begins to dominate individual actions, making long-term planning impossible. During hyperinflation, short-term is considered three days; long-term, two weeks. According to a top executive at Banco Palmares, "The name of the game in terms of planning during periods of high inflation is guessing what ways the government is going to try to correct their bad choices."

For individual businesses, good management is always a crucial ingredient for success. We found that during hyperinflation it becomes even more critical. New information must be absorbed rapidly, because today's political or monetary event can negate yesterday's wise business decision. In Brazil the government recently gave approval to automotive suppliers to increase the price of stainless steel by 60%. Such business decisions are needed to reassess inventory levels and production scheduling. A thorough knowledge of financial and currency markets is vital, since managing a company's money could become more important than increasing sales or even productivity.

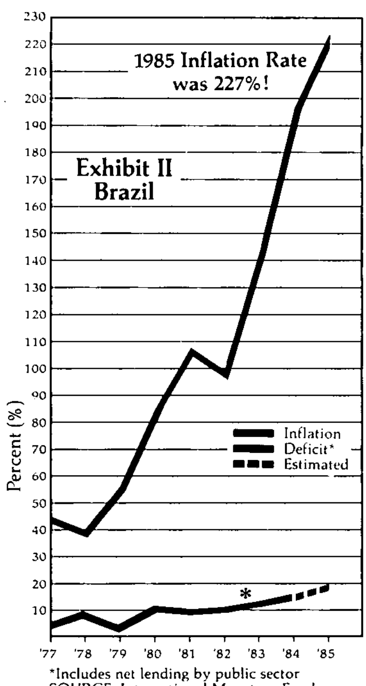
During high inflationary periods, managers turn from production management and long-term planning to financial arbitrage in order to make short-term profits by borrowing dollar denominated funds and lending them in local currency. Many South American companies invest their money in other countries, or at least place their assets in a more stable currency, which in the past has been the U.S. dollar.

Some of the most successful South American companies make collections in seven days, while delaying payment for thirty days or longer. Prices are increased rapidly, and inventories are often built up and warehoused, with expectations of selling them in the future at substantially higher prices. Other South American companies cope with hyperinflation

HYPERINFLATION IN BOLIVIA, BRAZIL, AND ARGENTINA



*Includes net lending by public sector
SOURCE: International Monetary Fund



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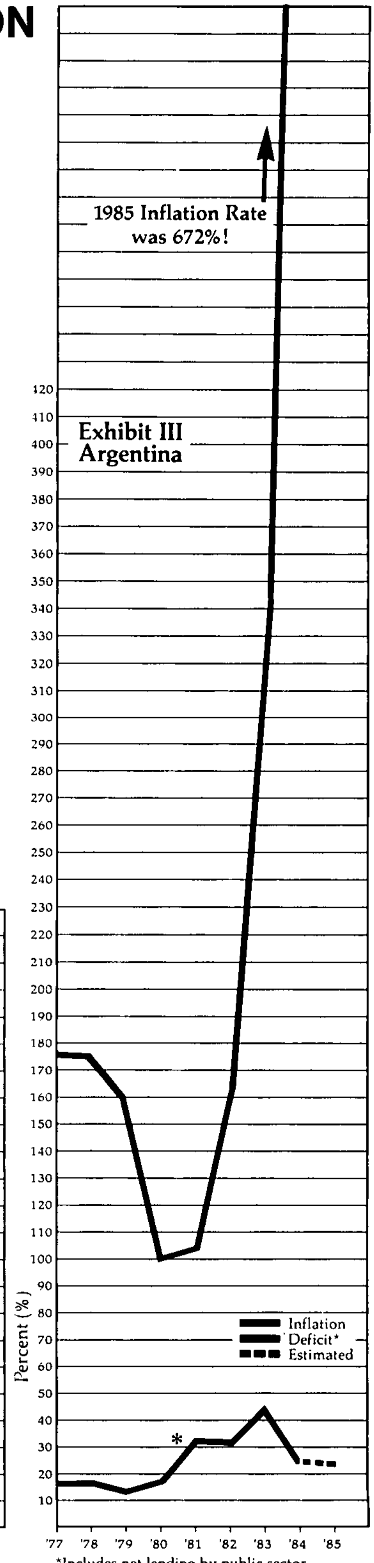

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SOURCE: International Monetary Fund

through a strategy of vertical integration. In other words, by acquiring raw materials and production and distribution facilities, some concerns have been able to minimize the impact of price fluctuations, as well as government regulations.

Because events occur so rapidly under hyperinflation, those companies who can maintain their flexibility are best off. In many instances, a one-day delay in making or implementing a decision can be devastating. Often there isn't time to put orders in writing, so effective oral communications are vital. But at some point flexibility becomes the antonym of stability, and taken to its extreme creates chaos. How is a Brazilian firm, faced with an annual interest rate of 70% in November of 1986, supposed to make a proper investment decision when 90 days later the actual interest rate on loans soars to 550%? Neither individuals nor businesses can be heavily leveraged since interest rates are so unpredictable. It is enough to cause even the best laid plans to fall apart.

Once hyperinflation becomes a reality, politicians inevitably succumb to the lure of legislating it out of existence. During the past decade, Argentina, Bolivia, and Brazil all at one time or another addressed their hyperinflation problem with the simplest of solutions; they outlawed it. While government intervention often has a short-term salutary effect, making it irresistible to politicians, in the end all governments—including our own—have had to conclude that more fundamental solutions are needed to attack the root of the problem, not just the symptoms.

In 1986, President José Sarney of Brazil, in an attempt to do something dramatic about an inflation rate that threatened to soar to 500% or more, instituted an anti-inflation program that froze prices, controlled wages, and lopped three zeroes off the Brazilian currency. The plan succeeded in temporarily curbing inflation, but higher prices were quickly replaced by other problems. Severe shortages of daily necessities such as eggs, meat, and milk developed. Black markets quickly filled the vacuum, resulting in higher prices that didn't show up in official inflation figures.

White-collar crime inevitably increased as well, as a never-ending spiral began, with the government implementing a maze of regulations and citizens just as quickly developing innovative strategies to evade them. One distributor of heavy machinery told us that because used equipment is not subject to wage and price controls, he routinely leases for a month or two, then turns around and sells the equipment at twice its original price. Many companies get around wage controls by giving their employees loans that are not expected to be repaid. In all three South American countries we are studying, this kind of subterfuge, necessary as a means of survival, gives a sense of legitimacy to breaking the law, threatening a nation's moral fiber. "Inflation," a top South American officer of the Bank of Boston told us, "is an immoral tax that leads to immoral values."

Because hyperinflation can so easily become a way of life, the best—some might say the only—foolproof solution is to avoid it in the first place. Once underway, hyperinflation can only be thwarted by a painful reduction in government spending and by a halt to the printing of money not backed by the production of real goods and services. As the noted author Peter Drucker likes to say, "You can't consume what you haven't produced."

Hyperinflation is by no means a certainty for the United States, but we have managed to create conditions conducive for its arrival. In investigating what the lessons from South America can teach us, we have taken a "What if?" approach. As a further caution, however, it is important to note that in coping with hyperinflation, South America has had one weapon at its disposal that would be unavailable to us. At least these countries have a world currency to fall back on. The U.S. dollar provides them with some measure of stability. But in the event of hyperinflation in the United States, what currency could we turn to? ❑

Invasive Government and the Destruction of Certainty

by Ridgway K. Foley, Jr.

Law exists. It exists in the inexorable rules of consequence which govern the universe, including the inescapable rules attendant upon human action. It exists in positive or man-made rules and orders imposed by human beings, acting singly or in concert, upon other men.

Men search for justice as a quality of law in both senses of the term. If a precise and acceptable definition of law has eluded scholars and students, so also have the quality and the essential characteristics of justice proven chimerical. Attempts at definition often produce tautologies; attempts at analysis often bring forth murk. Solutions to such eternal and complicated inquiries sometimes commence with simple beginnings, and this essay addresses one simple element of justice prevalent in the common law tradition, the requirement of predictability.

I. Predictability as an Aspect of Justice

A commonplace tautology equates justice with fairness, without any feint at content or elucidation. Nonetheless, "fairness" in the common law tradition gives birth to the beguiling beauty of equality. Equality, in the guise of Cain, cultivates a leveling egalitarianism, quite apart from sound tradition or good sense. Equality, in the garb of Abel, calls for like treatment in similar situations: it is "fair" or "just" if commoner and king each must keep their uncoerced promises, avoid trespassing upon the next-door neighbor's land, and restore gains secured by deception and malevolence. The grand phrase, "equality under the law," properly conveys no more than this notion.

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Certainty represents an essential component of this sort of fair or just behavior. Occupants of all stations in life start legally equal if each individual understands that similar responses will follow like acts or omissions. The common law participated in a sentiment that every man should know the law and govern his actions accordingly. This presumption—less a fiction in the fifteenth century than in the twentieth—obviated any defense of the unintended consequence; one could not avoid an unpleasant outcome by the subjective assertion that he did not understand his act to be unlawful, or that he did not contemplate a specific binding result. Derided by some modernists as unduly formalistic, the certainty of the common law allowed men to organize their activities and to accommodate their behavior to regular, common, known rules of order, similar in concept to the natural rules of order of the physical and praxeological universe.

II. Two Aspects of Certainty

Each individual participates in a search for certainty. The desire for predictable consequences inheres in each of us. Men cannot function in a random world; a rational aspect compels us to behave in a manner consonant with anticipated results. Hence, if we lived in a