A HYPERINFLATIONARY ENVIRONMENT CAUSES DEVIATION FROM AND DISMANTLING OF CORPORATE GOVERNANCE TRENDS: CASE OF ZIMBABWE

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Abstract

Proper hyperinflation detection is a clear prerequisite for effective contracting and corporate governance modeling if stakeholder value is to be preserved even in deflated terms. This paper examines how inflation, linked to other macroeconomic variables, such as interest or currency rates, can affect the company's operating margins and cash flows, so modifying the equilibriums among different stakeholders. The paper will also demonstrate that inflation may not always be a zero sum game, with compensating winners and losers. Literature review will show that inflation has a deep impact on operating leverage and cash flows, affecting, with its volatility, the risky cost of collected capital. Inflation risk stands out as a powerful, albeit often unperceived, stakeholder wealth redistributors. The impact of inflation on economic margins and financial flows, which represent the company's strategic key parameters, is originally presented in an intuitive way with the conclusion that inflation and corporate governance are considered linked issues. Recommendations are proffered in that prompt monitoring and resilient contractual design ease inflation risk detection and mitigation, together with proper and flexible financial modeling

Key words

Corporate Governance, Hyperinflation, Stakeholder value, Operating margins, Wealth redistributors, Economic margins, financial flows

1. INTRODUCTION

1.1 Problem Statement

Zimbabwe was the first country to experience a hyperinflationary episode in the 21st century. Hyperinflation is rare and often associated with wars, regime change and unstable political and economic environments where revenues are insufficient to cover government expenditures and printing more currency becomes a solution. Excess money supply not backed by economic growth leads to a loss of confidence in the currency, which ultimately can result in abandonment of the local currency in favor of foreign ones. The economic crisis with particular reference to a hyperinflationary environment has a negative impact on corporate governance. The post crisis transformation of corporate governance will be driven by risk assessment and management. Top management will spend more of their time as stewards of risk while senior executives will have to articulate, both internally and externally, the implications of such risks in order to satisfy an increased demand for transparency and the need to benchmark against other companies Management will also need to challenge their assumptions and decisions and cultivate an environment where challenging assumptions is acceptable to promote the long term betterment of the company. While there is need for changes in corporate governance, there is also worry that the government will limit and control compensation of senior management and otherwise regulate corporate governance, which could be detrimental to businesses and the public.

This paper was motivated by the desire to detect how inflation impacts on economic margins and cash flows, so modifying the relationship among different stakeholders and the nexus of their explicit or implicit contracts. Proper inflation detection is a prerequisite for effective contracting and corporate governance modeling; so as to preserve stakeholder value even in real (deflated) terms. The conceptual point of departure is the problematic question of whether the political and socio-economic processes that were prevailing in the Zimbabwe hyperinflationary period amount to a consolidation of democratic governance. In short, to what extent did the country conform to or deviate from the broad governance trends during the hyperinflationary environment.

1.2 Justification of study

The research will show how hyperinflation can dismantle the corporate governance framework and how this can simultaneously impinge upon the development of equity markets, research and development, innovative activity, entrepreneurship, and the development of an active SME sector, and thus ultimately derail or retard economic growth. The lessons learnt from Zimbabwe will be an addition to the scholarly research repository and may help countries who could experience same scenario in future.

1.3 Objective of the study

Hyperinflation makes a mockery of traditionally sound business practices and makes day to day decision making an impossible choice between short term survival and long term suicide. Davis et al. (2014) concurred with the same sentiments when he laments that decision windows become shorter and long term control becomes impossible. Products without substantial profit margins will disappear from the shelves and production will be increasingly ignored in favour of speculation as the later comes to play a greater role in corporate profit making (Swanson, 2007). Inflation and corporate governance are seldom considered as linked issues; and yet the impact of inflation on economic margins and financial flows, represents the company’s strategic key parameters.

1.3.1 Objectives

- Investigate the awareness of the importance of corporate governance principles during the hyperinflationary environment.
- Analyze the relationship between corporate governance and a hyperinflationary environment.
- Ascertain the issues of principles, processes, implementation, and challenges of corporate governance issues during the hyperinflationary period.
- Qualitatively assess the impact of governance processes on enterprise performance during hyperinflationary period.

1.3.2 Hypothesis

Implementation of good corporate governance practices in a hyperinflationary environment could have an impact on the increase of accountability and transparency and in whole improve better enterprise performance.

1.4 Theoretical Framework

Contemporary inflation oriented research is split between empirical works concerned with short run effects on income, and theoretical contributions with long term considerations (Nordhaus, 1973). Inflation is broadly defined as the increase in the cost of living, generally measured in terms of a consumer price index (CPI) (Siklos, 2000). There are different explanations of hyperinflation to be found in academic literature. Definitions include rising prices by more than 50 percent per month (Cagan, 2005) or when price rises reach an annual rate of 100 percent in any one year (Capie, 1986; Fischer et al., 2002). When hyperinflations first became a topic of academic and political discussion after the end of the First World War (and the five great hyperinflations that followed it in Germany, Austria, Poland, Hungary and the Soviet Union), the discussion centered on the question of whether hyperinflation was caused by monetary expansion, or by an imbalance in the balance of payments (Fischer et al., 2002). The balance of payments view put particular emphasis on the assumed exogenous behavior of the exchange rate: a view held throughout the German hyperinflation by the Reichsbank, bankers, industrialists, much of the press, and most German economists (Bresciani-Turroni, 1986). Another branch of the literature views inflation as a tax on the public, shifting the emphasis from monetary to fiscal factors as being the root cause of hyperinflations. Once prices begin to rise, they become, in effect, “a tax on holding money” (Lerner, 2011). Due to lags in tax collection, high inflation causes the real value of government tax revenues to be eroded (Keynes-Tanzi effect). Inflation also has strong effects on wealth distribution. David Hume (2011), while exclusively focusing on the units change aspect of money stock inflation in his quantity theory, saw no widening wealth gap, as the inflation tax would deplete everybody’s money in the same way

2. Methodology

The aim of the research is to investigate the awareness of the importance of corporate governance principles in a hyperinflationary environment and the way this could affect enterprises performance. The study will consist of desk research. The research will probe into issues of representation and accountability, citizen participation, local governance, economic management and corporate governance. In order to meet that, descriptive analysis and statistics will be applied. To conduct the survey two kinds of data sources are needed. First source is data from official published information for companies. The second source is additional data concerning implementation of some corporate indicators and performance measurement.

For analyzing governance contribution to enterprises performance three main variables were used:

- Environment of hyperinflationary economy (process and law requirements, social, political and economic development)
- Board attributes (size, structure, composition and board role etc.)
- Disclosure level (financial information, remuneration, code of ethics)

3. LITERATURE REVIEW

Hyperinflation is defined as inflation that is out of control, a condition in which prices increase rapidly as a currency loses its value (Makochekanwa, 2007). We can further describe hyperinflation as an inflation cycle without any tendency toward equilibrium. Cagan (2005) described hyperinflation as the general increase in prices of goods and services exceeding 50% per month translating into an annual inflation rate of 12,875 percent compounded. Stanlake (1976) states that hyperinflation is an extreme form of inflation were prices rise at a high rate daily. In 1923 Germany experienced this kind of inflation and by the end of that year prices were one million times greater than their pre-war level. Towards the end of 1923, paper money was losing half or more of its value in one hour, and wages were fixed and paid daily. In 1924 the currency was withdrawn and new marks were issued at the rate of 1 Reichsmark = 1 000 000 000 000 old marks. All the scenarios of daily increases in prices were experienced in Zimbabwe including the issues of the zeros. The main cause of this hyperinflationary environment in Zimbabwe was the massive increase in money supply which was not supported by growth in the output of goods and services (Makochekanwa, 2007). This showed hyperinflation as it was experienced by other countries where money supply causes hyperinflation. In Zimbabwe hyperinflation is explained by the use of money printing as one of the major source for financing government deficits. The parallel foreign exchange market was found to play a significant role in the hyperinflation function for Zimbabwe. The challenges that were faced by the companies during the hyperinflation included foreign currency shortages, raw material shortages, brain drain, price controls, and lack of credit lines and cash shortages.

With inflation, countries must be warned against the long term battle with cynical insurgents and suicide in the form of price distortions, reduced productivity and negative growth. Inflation may also remain high owing to high money supply growth and weakening parallel market exchange rates. When hyperinflation takes over and foreign exchange crisis disrupt the price system, shortening the economic horizon to a week or a month, normal economic development is suspended. The difficulty to reverse capital flight puts savings outside the economy and companies may also find it difficult to remain profitable. In hyperinflationary conditions, any analyst will advise you to buy tangible assets such as real estate, commodities or precious metals. Stocks can safely be added to that list, depending on the counters you buy.

Corporate governance has traditionally been associated with the “principal agent” or “agency” problem. A “principal agent” relationship arises when the person who owns a firm is not the same as the person who manages or controls it. For example, investors or financiers (principals) hire managers (agents) to run the firm on their behalf. Investors need managers’ specialized human capital to generate returns on their investments, and managers may need the investors' funds since they may not have enough capital of their own to invest. In this case there is a separation between the financing and the management of the firm, *i.e.* there is a separation between ownership and control, see Berle and Means (2012).

Agency problems may undermine the reputation of agents acting on their own self interest and from the other side, reputation-building, so useful for managers seeking employment, but also for shareholders attempting to collect debt, is a common explanation for why people respect their commitments even if they cannot (always) be forced to do so (Kreps, 1990). Other considerations may concern executive remuneration (with stock option plans and their sensitivity to inflation), debt covenants and dividend payout policies and proper debt monitoring, or other classical corporate governance issues, such as relationship governance and the "optimal" contracts between the firm and its strategic suppliers or customers

When Zimbabwe was struck by hyperinflation, the effects for the country and the wealth of its inhabitants were devastating, in the same the many episodes of hyperinflation that happened before. Corporate governance is the key driver of business performance and a major factor when it comes to attracting investors. During the hyperinflationary period that Zimbabwe went through, many aspects of good corporate governance were abandoned, with black market foreign currency activities', being condoned as unavoidable if an organization was to survive. Despite attempts to control inflation by legislation, and three redenomination (in 2006, 2008 and 2009), use of the Zimbabwean dollar as an official currency was effectively abandoned on 12 April 2009. This was a result of the Reserve Bank of Zimbabwe legalizing use of foreign currencies for transactions in January 2009. Currencies such as the South African rand, Botswana pula, pound sterling, euro, and the United States dollar are now used for all transactions. In Zimbabwe; the policy of the government of Zimbabwe has insisted that any attempts to reintroduce Zimbabwean currency should be considered only if industrial output improves.

Practical implications are that inflation may not always be a zero sum game, with compensating winners and losers. What is critical is prompt monitoring and resilient contractual design which ease inflation risk detection and mitigation, together with proper and flexible financial modeling. As for originality or value, inflation and corporate governance are seldom considered as linked issues. This is because the impact of inflation on economic margins and financial flows represent the company's strategic key parameters. A monetarist view is that a general increase in the prices of things is less a commentary on the worth of those things than on the worth of the money. This has objective and subjective components: Objectively in that the money has no firm basis to give it a value. Subjectively in that the people holding the money lack confidence in its ability to retain its value. Crucial to both components is discipline over the creation of additional money.

Note that the other motive for excessive money creation in Zimbabwe was due to self dealing. At this point in time, Transparency International ranked Zimbabwe's government 134th of 176 in terms of institutionalized corruption. The parallel market premium, which had narrowed in early 2004, widened from 45 percent in January 2005 to about 100 percent by early July (IMF Staff Report, 2005). This reflected the loosening of monetary policy in early 2005, as well as the declining availability of foreign exchange in the auction system. There were substantial abuses within the RBZ with regard to surrender requirements. Coltart (2008, p. 4) states that "members of the ruling regime and their associates became rich buying up foreign currency at the official exchange rate and then selling it at the black-market rate, pocketing the difference. The resulting lack of confidence in government undermines confidence in the future and faith in the currency". This in turn has got serious negative corrupt governance issues with people and institutions operating on a get rich quick scheme. Bankers for instance were under immense pressure everywhere due to management failures and other things like paying themselves hefty bonuses even in the middle of serious financial problems and widespread suffering by their clients. The bottom-line was that bankers were sometimes irresponsible and insensitive. They carelessly handled depositors' funds, enriching themselves at the expense of their clients and even running down their institutions through mismanagement, poor corporate governance and greed.

There was closure of some banks and some placed under recuperative curatorship which brought into sharp focus the debate around ownership structures and corporate governance issues within the banking sector. Analysts said while bank and company collapses occur everywhere, the common thread in Zimbabwean corporate failures then, were acts of impropriety on the part of shareholders and managers. Some analysts blamed bank failures more on structural problems within the economy such as the chronic liquidity crunch that had dogged the sector since the advent of multicurrency, while others saw this as symptomatic of poor corporate governance.
Zimbabwe experienced a chain of bank collapses in 2004 at the height of the economic meltdown and hyperinflation. Economic analyst Eric Bloch had a different view. He believed that the single biggest cause of bank failures was the irresponsibility of senior management in banks, who had been lending excessive amounts to a few companies on the basis of personal relationships without paying due regard to collateral and their capacity to pay back. Bloch also argued that the legislative framework was not necessarily weak as some analysts said, but the trouble was that laws were being violated. Erich Bloch said, quote "The laws that we have are more than adequate, but the problem lies in that they are being ignored. Regulatory authorities also need to be more proactive rather than reactive. As things stand, their actions are akin to closing the stable door when the horse has bolted," end of quote.

James Msipa, Quest Financial Services MD, was of the opinion that the corporate governance problems faced by the local banking sector were partly caused by the tendency for bankers to pursue other interests beside their core business. Msipa was quoted saying "The critical challenge for the country's banking sector is that a lot of our bankers, shareholders and managers, have become industrialists in one form or other'. He was implying that this had created the temptation for insider lending, as the bankers wanted to promote their interests outside banking. Therefore there was need to revisit corporate governance ethics and structures. In the end, banks failed due to a combination of structural, corporate governance factors and greed which authorities had a duty to stem out in order to save the ailing sector from plunging into turmoil.

Living with hyperinflation was a challenge for Zimbabweans. Prices in shops and restaurants were still quoted in Zimbabwean dollars, but were adjusted several times a day. Any Zimbabwean dollars acquired needed to be exchanged for foreign currency on the parallel market immediately, or the holder would suffer a significant loss of value. Such business venues constituted a black market, an arena explicitly outside the law. Transactors could evade the price freezes and the mandate to use Zimbabwean dollars. But black-market transactions are not enforceable under law. When the Zimbabwean government announced that price controls are the appropriate means to tackle inflation, each citizen faced an ethical dilemma: either to comply in the hope that all will follow suit, or break the price control in order to reap the profits that the otherwise compliant have sacrificed. When the governor of the Zimbabwean Reserve Bank suggested that the only solution to the crisis was a firm social contract, the public largely remained unconvinced. Such a contract would require each and every player to commit to a common rule. When the proponents of this contract have preceded their announcement with mismanagement and corruption, it is almost inevitable that the public will choose to break with price controls, causing everyone to lose when the inflation returns worse than before.

4. ANALYSIS

Hyperinflation produces adverse impacts where wealth and savings are wiped out within months, and prices of basic commodities become out of reach to many, especially those on fixed incomes. Governments often implement price controls in an attempt to control inflation. This frequently leads to shortages, as producers opt for alternative markets to avoid the mandated price ceilings that don't cover production costs. A thriving black market ensues, where basic goods and foreign currencies are traded at premium prices. Economies also resort to barter and trade in foreign currencies when the home currency has lost its value.

Shareholders are people who sink their capital and need to be assured that they get back the return on this capital. The corporate governance mechanisms provide this assurance. What matters when inflation peaks or is enduring are real deflated returns, which accrue to different stakeholders, respecting their purchasing power. If devaluated money is paid back, its real value may be substantially reduced, so exacerbating governance problems. A core issue of corporate governance is concerned with the agency problem, sometimes referred to as separation of ownership from control. Since these relationships are not necessarily harmonious, conflicts of interests may easily arise and so agency theory is primarily concerned with the binding mechanisms and incentives that principals may use with agents to get their money back, possibly with a fair and risk adjusted gain. Inflation therefore can distort agency problems, with an asymmetric and somewhat surreptitious transfer of risk among different stakeholders. According to agency theory, in imperfect labor and capital markets, managers will inevitably seek to maximize their own utility at the expense of shareholders. Hence inflation may well be considered a major source of imperfection. Agents-managers have the ability to operate in their own conflicting self-interest rather than in the best interests of the firm. This happens as a consequence of asymmetric inside information (since they know better than shareholders whether they are capable of meeting the shareholders' objectives) and physiological uncertainty. Since myriad factors contribute to final outcomes, it may so not be evident whether the agent directly caused a given outcome, positive or negative.

Unless properly treated and foreseen, inflation can exacerbate conflicts among stakeholders, surreptitiously acting as a wealth redistributor, distorting previously agreed rules of the game. Compensating winners and losers may end up to a disrupting disequilibrium, causing a game over scenario. Inflation may so distort and hamper the search for "optimal" corporate governance, where equilibrium and fairness among stakeholders prevails over disorder.
Another typical conflict of interests between managers and investors is concerned with managerial discretionary investment decisions, which may typically reflect the personal interests of the former.

In terms of the banking sector this discussion paper suggests that there was persuasive evidence to the fact that these problems experienced in Zimbabwe had their roots primarily in deficient or ineffective supervision by the central bank. Other factors such as legal compliancy and operational pressure, opportunities to commit fraud presented by weak controls and a possible case of regulatory capture all contributed to weaknesses found in Zimbabwe's banking sector. Stringent operational and compulsory compliance pressures on bankers could also have been responsible for the recurrent problems that beset the banking sector in Zimbabwe. Banks are required to comply with the provisions Banking Act (1999). The country has experienced unprecedented loss of capital in the past decade due to the hyperinflation and the concurrent political turmoil. To date most banks' balance sheets are still very weak. All this leads banks to create schemes and transactions that are meant to circumvent central bank regulations and directives in order to satisfy their operational needs and capital adequacy requirements.

However this discussion paper notes that financial innovation by financial institutions to exploit profit opportunities or to mask the real nature of transactions was increasing rapidly and posed huge challenges for effective oversight by the central bank's financial service supervisors and other compliance officers. Of major concern in financial markets globally, was the development of inter-company relationships due to cross shareholding, investment in other companies as a way to mask the true nature of transactions. This has serious implications for good corporate governance. This is because regulation and supervision of such financial interrelated companies becomes complex, due to collusion between the shareholders, directors as well as executive management to evade the ambits of the law. This poses huge potential systemic risk for the whole financial system.

5. Conclusions/Recommendations/Policy Implications

The main findings are basically applicable to corporate governance issues, since they may deeply concern the relationships among different stakeholders, who may benefit or be penalized by inflation, especially if unexpected.. Unless properly treated and foreseen, inflation can exacerbate conflicts among stakeholders, surreptitiously acting as a wealth re-distributor, distorting previously agreed rules of the game. Compensating winners and losers may end up to a disrupting disequilibrium, causing a game over scenario. Inflation may so distort and hamper the search for "optimal" corporate governance, where equilibrium and fairness among stakeholders prevails over disorder. Another typical conflict of interests between managers and investors is concerned with managerial discretionary investment decisions, which may typically reflect the personal interests of the former The impact of inflation on the asset and liability structure, the profit and loss account and the cost of collected capital has a subsequent repercussion on delicate corporate governance equilibriums and subsequent contracting among the different stakeholders.

Contractual provisions of inflation scenarios may greatly affect stakeholders and their real returns, with strong implications for corporate governance practice and models. Inflation has an impact on economic margins and related cash flows, so modifying the economic and financial relationships among stakeholders, with an often unperceived but nevertheless enduring impact on corporate governance issues, especially if protracted for a long time. Asymmetric sensitivity to inflation may exacerbate conflicts of interest and so any rise in the general level of prices affects core corporate governance issues. While the problem is of general interest, little attention has been paid to the relationship between inflation risk and “real” corporate governance, after having discounted this factor. Sustainable corporate governance models should properly consider the changing nature of the relationship of the firm towards its stakeholders, including the impact of external macroeconomic factors, such as inflation. This should enable board members to develop inflation-proof professional standards and long lasting strategies, where external distortions with their expropriating and redistributing effects are properly considered and hopefully minimized.

To manage inflationary pressures, financial regulation and supervision need to evolve by creating incentives for prudent risk taking by those entrusted with the public’s wealth, while adapting and adopting international standards and best practices. This will assist financial institutions to remain compliant at all times, thus fostering confidence in the financial system’s stability and the ability to weather external shocks. Strengthening the institutions charged with the responsibility to regulate and supervise financial institutions such as the central bank and treasury; getting rid of moral hazards through clear exit rules for non compliant and financially weak institutions, limited and credible deposit insurance, and better contingency planning will strengthen the institutional ability of the central bank to discharge its responsibilities in terms of supervision and regulation of the financial system

This paper identified three key factors contributing to the weaknesses in the financial sector of Zimbabwe. These are identified as: pressure to meet operational and regulatory needs, lack of and integrated financial system which gives opportunities to executives to conduct illegal activities undetected as well as a weak institutional framework to enforce good corporate governance and customer protection. The paper has shown that lack of effective supervision and regulatory enforcement as well as a possible case of regulatory capture seems to be at the root of the financial problems. In conclusion, it can be argued that most of financial sector problems in Zimbabwe can be traced to weaknesses at the central bank through its lack of capacity, lack of vigilance and slow speed to act in cases of identified violations by financial institutions.

Decentralized decision making is important to take care of sudden changes in the environment. During hyperinflation functional managers must be given enough room to make decisions without a lot of reference to Head Office. This decentralized decision making process is key especially in procurement where verbal orders were allowed..There is need for innovation if an organization is to survive the effects of hyperinflation. Innovation comes from a motivated work force. The recommended strategies under human resources of shorter pay periods and paying in vouchers, fuel coupons and hard currency were essential to ensure that the objective of keeping employees motivated was achieved.

With respect to enforcement, a major challenge arises from the general lack of effective enforcement of existing laws and regulations. Meeting this challenge requires recognition that the structure and capacity of regulatory and judicial frameworks are integral parts of the corporate governance environment. The challenge is to narrow the gap between ‘formal’ provisions and actual implementation. This is critical because adherence to corporate formalities constitute the bedrock of corporate law and corporate accountability. Corporations in most jurisdictions are mandated to adhere strictly to statutorily stated formalities. Adherence to these can be very time consuming and financially costly. One always hopes that aggressive, voluntary self regulation by businesses will help avoid government intervention in this area.

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