Liquidity Management and Firm Survival During a Hyperinflation: Business As Usual?

Lyndon Moore[a]
(Monash University)

Stefan Petry[b]
(University of Manchester

ABSTRACT

Large cash balances are important for a firm to survive a financial crisis. Starting with Froot et al. (1993), the literature highlights the importance of having sufficient internal funds to take advantage of attractive investment opportunities. Cash seems to be particularly useful for financially constrained firms in a crisis (see e.g., Denis and Sibilkov (2010) and Campello, Graham, and Harvey (2010)). Fresard (2010) finds that firms with larger cash reserves gain market share at the expense of industry rivals.

But is cash useful for firms during a hyperinflationary crisis when prices are rising by more than 50% per month? Holding firm wealth in nominal assets such as cash is worse than having wealth in real assets, all else equal. However, all else is unlikely to be equal. Holding a high proportion of cash before hyperinflation could be associated with unobservable firm or managerial characteristics. If firms with a large share of nominal assets to total assets outperform other firms during hyperinflation, we can conclude that cash balances must act as proxies for unobserved firm or managerial characteristics. Cash itself may be unimportant.

To discriminate between these hypotheses, we manually assemble a dataset of all German non-financial firms listed in Berlin during the period 1919—1926. This era spans the German hyperinflation period of 1922—1923. We observe the stock and bond prices

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[a] Monash Business School, Monash University, Wellington Road, Clayton 3800, Australia. +61 (0)3 9903 1400. Lyndon.Moore@monash.edu.

[b] Alliance Manchester Business School, University of Manchester, Booth Street West, Manchester M15 6PB, United Kingdom. +44 (0)161 306 2069. stefan.petry@manchester.ac.uk.

the balance sheets and income statements of 1,202 firms or 7,119 firm-years. We convert all German currency variables into U.S. Dollars and group firms by SIC codes.

We find that cash is not a major determinant of post-hyperinflation firm performance. Firms with the fastest sales growth over the hyperinflation period are those with the highest starting fraction of property, plant, and equipment (PPE) on their balance sheet. Interestingly, firms with the highest PPE share are significantly smaller than other firms. If we were to use asset size as our proxy for financial constraints, (a standard assumption in the literature), our findings would suggest that financially constrained firms better survive the German hyperinflation. However, what drives our results is not the financial constraints per se, but the proportion of PPE. Our findings have important implications for corporate finance policies, showing that the beneficial effects of precautionary holdings of cash during financial crises or recessions, do not apply to hyperinflation periods.

JEL classification: G3.
Key words: Liquidity Management, Cash, Working Capital, Hyperinflation; Germany.