Pricing Through High Inflation

by Slobodan Farago

In an environment of entrenched inflation, those companies that can execute fast on price adjustments/increases will become the fittest to overcome the challenge. Reacting means already losing margins, and potentially even business and competitiveness. Managing in anticipation and swift execution are key to coping with an inflationary business environment. That said, price adjustments need to be fair, evidence-based, and transparent, and they need to be tuned to that level which allows for good competitiveness. This demands a high level of business agility, as the author explains. Slobodan Farago, Ph.D., MScM, CPP is Pricing Director at Sol-Millennium Medical Group in EMEA and can be reached at farago@bluewin.ch.

Before the recent inflation in 21/22 hit the global economy, most of the industrial world had enjoyed almost two decades of decent costs and price stability. This has created a whole generation of pricing folks that have excelled in dealing with many different aspects of pricing except the one that we are facing just now – adjusting prices to account for overly and broadly increasing costs.

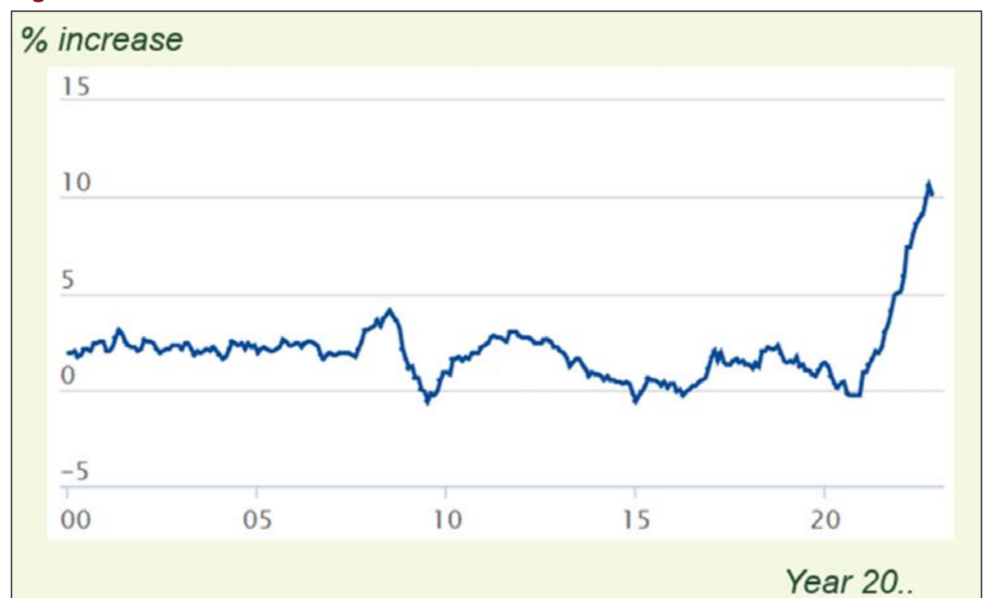
So, how will inflation change the markets and business, and what does it mean for pricing? The following article discusses some of the potential implications.

Different types of inflation

We all know that in a free-market economy, demand and supply will determine the price. This fundamental rule of pricing applies also during a period of inflation, and in fact, even defines price inflation when supply is disrupted or limited. See Figure 1.

Before the crisis in 2021/22, inflation in the industrial world was indeed very moderate, oscillating between 0-3%. This made planning and pricing quite reliable. As a result, in many situations costs of goods have often even decreased due to higher efficiencies achieved in sourcing, manufacturing, and transportation and due to higher volume demand/economies of scale - allowing for a regular supply of ever more affordable materials and goods at stable or even lower prices, cycle on cycle. At the same time, wages have gone up, unobtrusively, but constantly. Such moderate labor cost increases were often traded off with the economies of scale and through other optimizations related to volume manufacturing and supply, such as, for example, automation and digitalization. This positive balance of savings achieved gave room for even further price decreases which eventually occurred also as a result of the competitive dynamics. In sum, suppliers were still growing their businesses with good margins while at the same time benefitting customers and consumers with somewhat lower prices. In return, price stability allowed many businesses to further grow along with a higher willingness and ability to spend on value products. This positive development suddenly changed when a higher inflation hit, first in 2021, and then when it accelerated through 2022.

Figure 1



Inflation can have different root causes (Quantum Theory of Money - equation 1), and thus it may need to be addressed differently depending on the specific situation.

1) Temporary and limited inflation

Eventually, even over the past 20 years, we have seen here and there some short-term hikes in costs, quite limited in scope (e.g., affecting only a part of an industry or some specific materials), and often very temporary in nature.

In a competitive market, such temporary cost increases would usually not affect the prices as suppliers would not want to lose their market position based on a temporary cost development which may force them to

reverse prices when costs soon after get back to previous levels. Often, sellers will swallow and absorb such short-term cost hikes to maintain their market and price position. When such cost hikes become irreversible, and if competitors are also affected, then this might be the opportunity for a market price adjustment. The profit requirements behind the affected products and services will usually define the need for and magnitude of such efforts. Further, the sellers' need to maintain a competitive position will also determine price adjustments. Usually, such price adjustments would be initiated and led by the market leader. See Figure 2.

Figure 2: Quantity Theory of Money (mainstream) – Inflation as a consequence of money supply and velocity

$$\text{Aggregated Price Level} = \frac{\text{Money Supply x Velocity of Money}}{\text{Aggregated Volume of Transactions}}$$

2) Entrenched inflation

Different from temporary inflation is entrenched and broad high inflation. For it to occur across economies, a trigger of a broader spatiotemporal significance is needed. Such can be a regional or a global crisis, like the recent COVID-19 pandemic, a natural disaster of broader significance, a financial crisis that shakes the global economy, a war that impacts or disrupts global supply, or political (e.g. sanctions) and economic tensions (e.g. trade embargoes), which may also affect the overall global supply of critical goods.

Indeed, the COVID pandemic has shifted the equation of supply and demand significantly and in several ways. First, supply chains were massively disrupted, leading to a shortage of products and services. Secondly, governments had to provide financial support during the various lockdowns to cope with the spread of the disease, and in consequence, they expanded their monetary base.

Expansion of money alone would not have forcibly led to inflation, as debt can be reduced over a longer period of time. But in combination with limited goods, the two factors together caused a surge in prices. Prices will usually go up when customers begin to compete for limited supply. Conversely, they tend to go down when supply competes for the customers. Hence, in a market where demand has not changed significantly from before, but money became more abundant (and hence the value of money became cheaper), and where supply became limited, prices went up.

In such a sensitive economic environment, not much more is needed to entrench the problem. For example, the crisis in Ukraine has had a significant impact on the energy markets. Energy affects almost every part of our lives as well as almost every part of the economy, such as extraction, transportation, manufacturing, etc. With this added strain, eventually, a broad range of goods and services will be also affected. Their costs will go up.

A persistent surge in costs will at some point have to be passed on to customers should suppliers be able to continue to operate profitably. And that means mostly higher prices for the broad consumer population. In consequence, wages and pensions will eventually need to be raised to allow workers, pensioners, and low-income households to cope with the higher cost of living.

The adjustment of wages and pensions to account for some of the inflation indeed marks a turning point from temporary to entrenched inflation. Because labor costs constitute a significant part of the equation in any process of an economy, it can be expected that an increase in labor costs will add to further and future increases in costs across a broad range of products and services. And so, the wages-price spiral will continue to fuel more cycles of inflation.

Besides that, once wages and pensions have been raised, the new prices will become the accepted benchmarks, as it cannot be assumed that wages and pensions will ever come down again, even not once a crisis is over. A new equilibrium will eventually settle in. For entrenched inflation to ebb away, it usually takes a few cycles (years) of hiking costs and prices combined with rising wages.

The new equilibrium with zero or moderate inflation (0-3%) will not come by itself. Central banks need to carefully manage and balance money supply. Much of it depends on whether or not the underlying crisis that caused the problem in first place will go away and if more problems arise that may hamper the effort.

There are different ways to manage inflation, but the possibilities are limited and always painful. They depend mostly on the very specific economic situation of a country. In the UK, for example, the government has refused to raise wages for public services with the consequence that workers have taken industrial actions. The US has raised interest rates making borrowing more expensive, etc.

Is the 21/22 inflation over?

The impacts of COVID-19 on global economies are easing. Supply is coming back to normal. Transportation costs have fallen back to pre-inflation levels, and the energy crisis – an additional impact of the Ukraine conflict – is turning out to be less expressive than originally anticipated.

Further, central banks have taken measures to fight inflation. All this may indicate that inflation will ebb away at some point, and it probably will. The question of how long it will take for it to reach acceptable levels will mostly depend on the third factor, which is labor costs.

An inflation rate of 10% means that consumers are left 10% poorer if their wages are not adjusted. For pensioners and those already at the edge with their living costs, an increase in pensions or salaries could be unavoidable. Moreover, in a labor-drained market, as we observe it in many industrial economies today, and under inflationary pressure, it is difficult to believe that the amount on the paycheck will not make a difference to attract or retain talent. Employers may have to compete for workers by providing even more competitive salaries. As outlined above, a wage-price spiral might be the consequence. Hence, the answer is, we should hope inflation will ebb away soon, but we should not take it for granted that it will be very

soon. See Figure 3.

The Impact of an Entrenched Inflation on the Market

Going through a period of entrenched inflation, one of the main questions is, how is that impacting the markets and how can we expect those markets to respond?

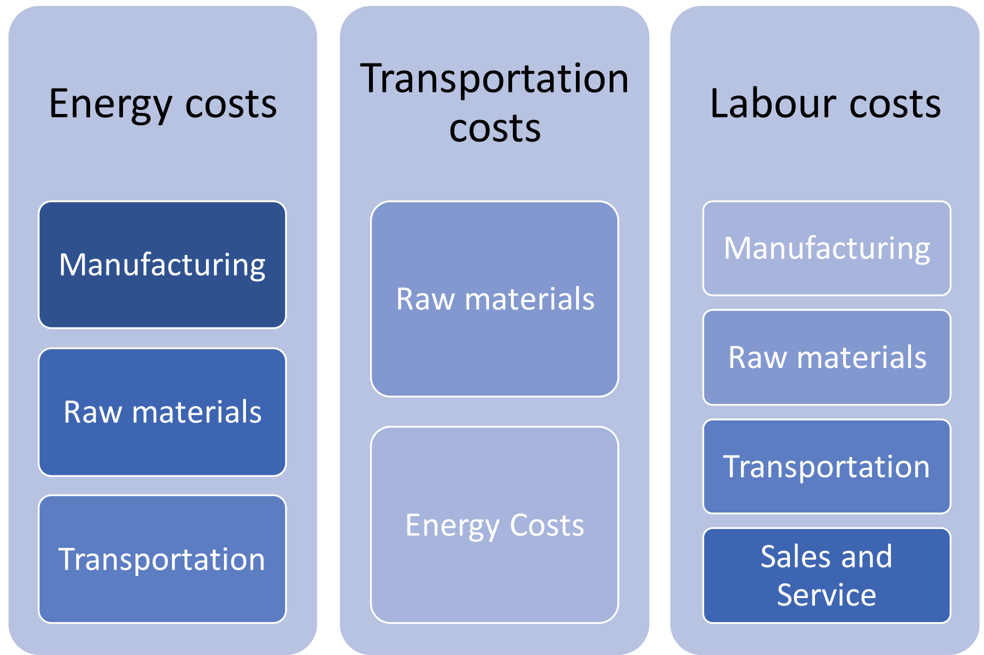
One answer is that there will be a shift towards essential needs as the purchasing power of consumers will become smaller. This is usually expected even if wages and budgets are increased as they will rarely be increased to fully account for inflation.

Essential products and services that cannot be deleted from the shopping list will be the ones where price increases will be easiest to implement. Nice-to-haves and value-adding products may still be purchased if budgets can accommodate for those, but with reduced purchasing power overall, it is likely that they won't enjoy focus and priority for the majority of customers. In other words, there might be less eating out and more home cooking. What applies to private households will apply to businesses as well.

Further, as necessities are often commoditized goods, and their margins are usually low, the impact of energy, transportation, and labor on their costs may also turn disproportionally higher than for higher-value products which often better absorb cost increases. Hence, prices of commoditized products may experience higher hikes. That may disrupt the value propositions of value-adding products. Unless they provide immediate economic benefits and savings, value-adding products may be indeed parked or de-prioritized at large. That said, purchasing of some high-value or value-preserving goods might be less affected than others, or even experience temporarily higher sales as those consumers who can afford them may even see them as an investment (buy cheaper now as tomorrow it may cost more). This may apply to high-end niche products such as expensive watches and jewelry, luxury cars, real estate, or art.

If the supply of essential goods is also becoming limited, the market may shift its focus from price to supply reliability, even if a product gets more and more expensive.

Figure 3: The major drivers of inflation



By this, price and supply reliability, the two major focus areas of procurement, may change priorities. If supply is abundant, the primary focus is on getting a good price. If supply is, however, limited and not guaranteed, pricing will come second. That opens room for higher pricing in re-negotiations of essential goods, where customers may accept a price premium for a more reliable supply in return.

For example, a limited supply may cause customers to stick with their current suppliers, because having a long-run relationship with a supplier can make a difference in getting access to the necessary goods and services. Switching to a new supplier in a supply-drained environment will mean the customer potentially queuing up at the end of a new line. Such an action bears significant risks. Even if prices might be more favorable with a different supplier than the one who has been supplying to date, customers may choose not to switch.

Another issue for businesses is cash flow. Where customers will also need to reprice their goods and services and pass cost increases to their customers, they first will need to swallow higher prices from their suppliers. The time between paying more before charging more will affect the cash flow. If cost increases are significant, margins are small, and the time to realize price increases is long, these factors may have a potentially negative impact on solvency. In such a situation, plenty of anticipation and risk adjustment is needed. Building a case for price increases on retrospective and past evidence may not work any longer. One may need to start thinking in scenarios of how to get ahead of the game, eventually also taking their suppliers and customers along on that journey of thought. Strategic partnerships will be crucial for overcoming such a difficult situation. Overall, anticipation and risk management, while necessary, may further fuel inflation as additional premiums might need to be baked into the price.

How will Inflation Affect Sales Activities?

Market focus shifting means a change in sales activities. It is likely that there will be less push for new products and innovations. Instead, more focus will be given to the existing business, managing difficult supply situations, negotiating price adjustments, documenting the justifications for price increases and communicating these changes to customers, shaping agreements to account for price adjustments and other terms to reduce business risks, etc. The focus of sales on introducing new products and driving adoption of value with customers will yield some ground to those activities.

In a business environment where supply is

potentially limited, uncertain, or at risk to become unprofitable, management focus will need to shift from top to bottom line. Such re-shifting of priorities will also affect the incentives provided to sales. Growing on volume is only seen as good when the required profitability can be maintained. An increase in costs will eventually erode profits, and a significant increase in costs may even make a business unprofitable. Selling more unprofitable products may accelerate the problem dramatically. Hence, in an inflationary environment, the primary growth in revenues will have to come first from price and only secondarily from volume. Volume growth can be pursued, but only if margins can be maintained. That new focus and mindset need to be set by the management with new sales incentive plans with profitability and price in focus.

Another important refocusing of sales facing an inflationary business environment is on initiating and managing strategic relationships with customers. First, by engaging with customers to understand the situation, second, by implementing new terms and conditions for sustainable supply as well as for price adjustments, and third, by changing procurement focus from price to supply reliability, establishing processes to share important information early on, such as forecasts.

Such refocusing of sales activities can become a substantial change management task as different sales skills from those usually needed in regular, non-inflationary times are required. Reinforcing sales teams with such new skills might be needed.

The New Role for Pricing

Any company that maintains a pricing department and that has been applying an annual price adjustment process knows that this is one of the heaviest processes an organization can have. The reason is that price adjustment decisions affect almost every part of a business, starting with sales teams that need to source relevant pricing information, and also ending with sales by implementing new prices with the customers. In the middle of the process, marketing needs to ensure value structures are maintained and product strategies can be executed. Procurement and operations need to provide price adjustment evidence and communication details to support case-building and negotiations. Finance will have to make sure profitability and transfer pricing requirements are provided for and balanced accordingly, and that the new prices are reflected in budgets and projections. Customer service will need to change the new prices in the systems for execution, etc.

Businesses with a price adjustment process will usually start such an initiative 6-9 months before new prices are implemented beginning with the underlying analysis and proposals, often undertaken by pricing, which may also be leading the process by coordinating and mediating between the marketing, sales, and finance functions.

and digestible. For example, a flat inflationary price increase might be easy to communicate, but it may make certain products look disproportionally expensive compared to the competition or to other benchmarks of the portfolio. This could cause unnecessary losses. Further, certain markets may get a higher price increase than others, which may change the price structure in a region and induce parallel imports, etc. There are many aspects that have to be taken into consideration in order to bring an organization behind price adjustments.

Another complexity is with multiyear contracts. Occasionally, such contracts will not account for price adjustments, or if they do, they will be often capped or tied to certain indicators. They may only allow

> **For organizations that already maintain a price adjustment process, things may play out easier these days than over the years before because they have already gone through cycles of optimizations and adoptions.**

For organizations that already maintain a price adjustment process, things may play out easier these days than over the years before because they have already gone through cycles of optimizations and adoptions. Others may have even software in place that would support such activities through simulations and systemic alignment. These types of platforms are most helpful if supplying companies distribute thousands of line items and services in multiple markets on a global scale.

Price adjustments will need to be implemented by market and eventually also by product group or even at the line-item level. Not every market has the same inflation nor the same competition dynamics, and not every product group will experience the same cost increases. The differences can be significant, and so need to be the price adjustments applied.

A balance needs to be pursued between the complexity of communicating price increases to customers and the level of necessary distinctions that need to be made. Any evidence provided needs to be solid for price increases at defined times of the calendar. Companies that maintain a contract management system that allows for retrieving information according to such terms and conditions may benefit enormously these days from such an investment. Those without a system in place might be overstretched by reading through hundreds, if not thousands, of contracts just to identify the actionable ones.

Where it is discussed that price adjustments in a high inflation environment may have to occur more frequently than just annually, quarterly, or even monthly, it becomes obvious that for many suppliers without proper systems and processes in place, such adjustments could be an overwhelming and unmanageable task.

Thus, the role of pricing will also need to shift towards supporting the organization more on the establishment and execution of the price adjustment process. Where companies had maintained pricing before as part of marketing (strategic pricing), in supporting, for example, new product pricing, or as part of sales by supporting deal

desk activities, or as part of the finance function in price setting or price governance activities (operational pricing), the new role of pricing may transition more to a project or process management role of continuous price adjustment support across the whole organization. This would also ask for new skills such as project management, process engineering, system implementation, advanced analytics, and last but not least, change management skills.

Conclusions

In an environment of entrenched inflation, those companies that can execute fast on price adjustments/increases will become the fittest to overcome the challenge. Reacting means already losing margins, and potentially even business and competitiveness. Managing in anticipation and swift execution are key to coping with an inflationary business environment. That said, price adjustments need to be fair, evidence-based, and transparent, and they need to be tuned to that level which allows for good competitiveness. This demands a high level of business agility.

In support of this business agility, efficient systems and processes will be needed to quickly respond to changes in costs and the overall business environment. Terms and conditions of contracts need to account for regular price adjustments, and customers need to be convinced to accept those and refocus their attention from pricing to supply reliability. For all this, customers need to be engaged in strategic partnerships. Transparency, exchange of information between supplier and customer (and vice versa), and efficient communication links need to be established in support.

In times of entrenched inflation, where agility is needed, there is a good chance for pricing to emerge as an own, independent function and discipline within an organization whose activities would go beyond the usual marketing, finance, and sales support. Such a new role would be put in charge of driving and owning the continuous price adjustment process, including the execution of the related pricing strategy, pricing analytics, assembling supporting documentation and data, leading negotiations and communications, and mediating between the functions. Further tasks would be maintaining prices in the various systems as well as providing pricing performance monitoring and price impact simulations.

Such a new pricing department would need to be initiated and established high up within an organization with a strong mandate from the board to lead and direct the pricing process across the businesses and different functions. ❖