High Inflation: Uncharted Waters for Supply Management

With a long period of price increases possible, a proactive approach can help procurement professionals weather the storm.
A growing economy. A tight labor market. Two of the biggest telltale signs of inflation have been evident in recent months, and concerns have been further fueled by two factors: tariffs and trade turbulence stemming from the Trump administration’s protectionist policies and supply chain bottlenecks as a result of rising transportation costs and ongoing truck-driver shortages. The US inflation rate for the 12 months ending in July was 2.9 percent—the highest since February 2012.

Prices for many commodities are already on the rise, and the dynamics are in place for a potential long-term inflationary environment that would be new territory for most supply management professionals, especially with trade-war speculation showing no signs of abating.

According to Merriam-Webster, economic inflation is defined as “a continuing rise in the general price level usually attributed to an increase in the volume of money and credit relative to available goods and services.” Historically, price inflation conditions have produced increases in costs for purchased goods and services that negatively impact how much we pay. Long periods of inflation can make it seem as though there’s no limit to price increases. The last time western economies experienced double-digit inflation was more than 40 years ago in the 1970s and early 1980s.

Merriam-Webster goes on to describe the financial definition of inflation as “the rate at which prices rise and purchasing power falls. It is why something that cost $1 in 1980 cost $2.37 in 2005.”

The Institute for Supply Management® (ISM) and A.T. Kearney partnered to study how companies are responding to the current environment of increasing price inflation and likelihood of continued acceleration in inflation, using an online survey of a sample of ISM customers and members from April 5 to May 18. In all, 304 usable responses were collected. (Among respondents, 54 percent were from manufacturing industries, 43 percent were employed by organizations with revenue of $1 billion or more, and 66 percent were managers or higher.)

This inflation study integrates the practitioner network of ISM with the client experiences of A.T. Kearney to identify how companies are reacting and what supply managers can do to mitigate the impact of inflation on the prices they pay to suppliers.

**The Impact on Supply Management**

When supply management professionals evaluate how inflation will make their jobs more difficult, lost purchasing power is their primary concern. A long inflation cycle may be brewing, and many of today’s professionals have never lived through the kind of double-digit inflation that could be coming. In fact, recent decades have provided low price inflation, and many industries (such as automotive and electronics) have seen price declines thanks to improved efficiencies and newer technologies. Pointing to clear bottom-line cost savings may become difficult when procurement success means avoiding price increases that suppliers request—or demand.

Today, inflation is mostly driven by rising commodity prices. The Manufacturing ISM Report On Business® Prices Index has been above 70 percent since January. In 2017, the Index dipped below 60 percent only twice and averaged 65 percent for the year. In May, the Index reached its highest level (79.5 percent) since April 2011 and reflected price increases for 27 straight months.
Notably, the Manufacturing ISM Report On Business showed that, for May, hot-rolled steel prices and aluminum prices rose 18 and 19 straight months, respectively. However, it may not take long for inflation to affect other types of purchases, including labor. We expect to see wages go up as competition for workers intensifies. In 2018, for the first time in many years, the number of unfilled jobs exceeded the number of unemployed workers (see figure 1).

Figure 1

The United States has more unfilled jobs than unemployed workers

Unemployed people


It may be wise to start planning for higher inflation for the next decade or more. In fact, some theories, including the Kondratieff wave, claim that long economic cycles last 40 to 60 years.

The Signs of Inflation

Inflation warnings are in the news, and the impact of rising prices is being felt by companies across many industries. A sampling of current articles highlights the severity of this concern, as there are daily reports on rising commodity prices, growing construction costs, and a tightening labor market. Also, healthcare costs are rising at a faster rate year over year.

Commodity costs are rising, and volatility is growing. Such factors as increasing demand among major and developing economies, geopolitical uncertainty, trade protectionism, and climate change all create supply chain risk, increase costs, and contribute to price volatility. For example, Chinese government shutdowns of factories that do not comply with environmental regulations, combined with US tariffs, create upstream and downstream price pressures on steel and aluminum as supply constraints and import taxes increase. Today’s trade environment is distinctly different from previous ones in breadth alone, and this is the first time companies have to address trade policy as a risk, as added costs cannot simply be passed off to consumers.

Higher prices impact procurement professionals in several ways. Inflationary environments make it difficult for buyers to determine price increases their suppliers need to offset inflation, compared with opportunistic price increases. This is especially true in commodity markets, where commodity producers have endured years of low margins and will try to recover in an inflationary environment.
Year-over-year reductions in prices and purchase price variance are not always possible. In such a situation, controlling price increases and showing value to an organization becomes the focus of procurement activities. Interestingly, at the beginning of long-term inflationary cycles, commodities play a key role. Our study confirms that business leaders’ primary concerns are about price inflation for commodities versus non-commodities (see figure 2).

Uncertainty may come from the US government’s unclear direction on tariffs and other international issues and a lack of experience with inflationary economic environments among many supply management professionals. A selection of headlines provides an overview of recent reporting on these dynamics:

- Mexico’s President-Elect Balks at Including Energy Chapter in New NAFTA
  —The Wall Street Journal, August 21, 2018
- Trump’s Fed Criticism Sends U.S. Dollar Lower
  —Financial Times, August 20, 2018
- Starbucks Boycott? Nike Shutdown? China Holds Trade War Leverage
  —Bloomberg, August 20, 2018
- The World’s Biggest Shipping Company Says Trump’s Trade War Will Hurt America More Than Anyone Else
  —Business Insider, August 20, 2018
- Canada on the Sidelines as U.S. and Mexico Near an Agreement on NAFTA
  —The New York Times, August 17, 2018
- Trump Tariffs Could Reduce U.S. Exports, Says Fed
  —Financial Times, August 13, 2018
The current political and economic environment could threaten what has been a seemingly inexorable march toward more integrated economies and more integrated global supply chains. A company’s flow of goods and services are profoundly global and deeply dependent on a free flow internationally. Businesses are revising sourcing and distribution strategies that they relied on for decades. This diverts resources from other business activities, such as new product development or expansion into new markets. Also, inflation may make it difficult for net cost savings to be seen on a company’s bottom line.

**Additional Insights**

Respondents were also asked about their organizations’ strength in areas necessary to navigate the high seas of inflation.

**Supplier selection.** Being prepared to handle inflation requires a company’s suppliers to control costs. If not, costs are passed on to the company in the form of higher prices, which can result in difficult supplier relationships if the supplier’s profits dwindle.

Most companies say their suppliers are only average or below average at controlling costs (see figure 3).

Most supply managers believe they are merely reactive to increasing prices. In an uncertain world and with insufficient experience (in general) with inflationary times, supply managers need to develop more proactive decision-making for increasing price inflation.

---

**Figure 3**

**Suppliers have a range of abilities to control costs**

Sources: Institute for Supply Management; A.T. Kearney analysis
**Market analysis.** Our study also indicates most companies do not have a formal market analysis program—highlighting a missed opportunity to extract more value from the supply base (see figure 4).

**Internal communication.** Stakeholder identification, engagement, and crucial conversations are essential tools at all times, especially when changes occur. Increasing price inflation will alter the way we define procurement success, as cost saving may morph into cost avoidance.

Most respondents (53 percent) indicate the importance of internal communication and stakeholder management (see figure 5). However, almost half report either no communication or only ad-hoc communication with finance and other stakeholders.

More formal structures for communicating internally will help supply managers during times of uncertainty and change. Supply management practitioners can take the lead in formalizing communication regarding responsibilities—and help provide accountability—as a company navigates unfamiliar waters.

---

**Figure 4**

**Most companies do not have supply market analytics teams**

<table>
<thead>
<tr>
<th>Tools to monitor market changes</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Informal, ad-hoc, or in-house supply market research</td>
<td>57%</td>
</tr>
<tr>
<td>Public exchanges quoting commodity prices (for example, coordinated market economy and liberal market economy)</td>
<td>41%</td>
</tr>
<tr>
<td>Formal in-house supply market analytics team drawing from public and private sources</td>
<td>40%</td>
</tr>
<tr>
<td>Private commodity price trackers and forecasts (for example, Bloomberg terminal, paid reports, and newsletters)</td>
<td>38%</td>
</tr>
<tr>
<td>Other</td>
<td>5%</td>
</tr>
</tbody>
</table>

Sources: Institute for Supply Management; A.T. Kearney analysis

---

**Figure 5**

**Internal communications are essential to managing costs**

<table>
<thead>
<tr>
<th>How cost pressures are communicated</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Regular communications with key stakeholders</td>
<td>43%</td>
</tr>
<tr>
<td>Regular communications with finance only</td>
<td>28%</td>
</tr>
<tr>
<td>Ad-hoc communications with key stakeholders</td>
<td>10%</td>
</tr>
<tr>
<td>Ad-hoc communications with finance only</td>
<td>9%</td>
</tr>
<tr>
<td>Procurement does not communicate inflationary cost pressures to our organizations</td>
<td>10%</td>
</tr>
</tbody>
</table>

Sources: Institute for Supply Management; A.T. Kearney analysis
Internal collaboration. Sixty-two percent of participants partner with finance to assess implications and plan for purchasing negotiations. Finance can be a supportive stakeholder if open and active cooperation exists between it and procurement.

External collaboration. Most respondents (67 percent) report focusing on supplier relationship management to help identify approaches to jointly mitigate cost inflation (see figure 6). Our study also reveals a greater focus on inventory management (by 52 percent of respondents), which can free up cash flow as borrowing becomes more expensive amid higher interest rates.

Figure 6
Supplier relationship management is often used to identify ways to limit cost inflation

Top approaches to managing costs

- Build strong supplier relationships: 67%
- Manage inventory: 52%
- Identify demand forecasts of products and services: 48%
- Identify long-term production strategies: 41%
- Reach out to both upstream and downstream suppliers: 39%
- Hedge indirectly against price pressures, by working with suppliers to lock in prices: 39%
- Logistics planning: 37%
- Collaborate with operations, manufacturing groups, and end users: 35%
- Hedge against price pressures: 28%
- Other: 6%

Sources: Institute for Supply Management; A.T. Kearney analysis

Collaboration and communication are key contributors to stronger supplier relationships. But one is not necessarily tied to the other. A supplier may have a strong collaborative relationship with procurement on new product development but competing in other areas—a scenario that stifles open communication and the opportunity for gainsharing. Or a supplier may have excellent communication throughout the organization, while collaboration opportunities are limited because of differences in strategy or market focus.

Consequently, as supply management professionals focus efforts on strengthening supplier relationships to reduce uncertainty and mitigate risk, they should be attentive to opportunities to improve communication and collaboration.

Inflation-Fighting Strategies

Five battle-tested strategies fuel procurement’s success in inflationary times. The ideal strategy will depend on the situation.
Block. While perhaps the most desirable option, blocking inflationary price increases is limited to scenarios with high demand power and more transactional supplier relationships. In this scenario, buyers refuse to accept the price increases. However, this plan is not ideal when demand power is low.

Transfer. Instead of blocking, a company might transfer or share the risk with suppliers by locking in prices for a longer period than normal and directing suppliers to hedge positions in advance. Don’t use this strategy if price forecasts are trending downward.

Hedge. Sometimes, a supplier is unwilling or has poor or limited hedging experience. If it aligns with your firm’s risk tolerance, you can hedge against future inflation. For example, most large consumer packaged goods companies apply financial hedges to such primary traded commodities as wheat, soy, corn, and sugar. If risk tolerance is low, take a different approach.

Deflect. If you don’t have an oligopolistic end market or high price elasticity, you can deflect the price increases and pass cost increases on to customers. Or if suppliers do not own your specifications and your organization has sufficient internal R&D capabilities, consider creating new specifications that allow you to leverage lower-cost supply sources.

Operate. If sufficient capital and capacity are available, inflationary risk can be managed operationally by building up inventory or making the product in-house.

The best inflation-fighting strategy depends on a company’s overall strategy, risk tolerance, operational constraints, end-product market dynamics, and supplier relationships as well as the category. Indeed, you might employ multiple tactics in a given category with different suppliers. Weigh these internal and external considerations to ensure the right approach for your organization.

If sufficient capital and capacity are available, inflationary risk can be managed by building up inventory or making the product in-house.

To help govern these strategies and gain full transparency and impact of price increases that are the result of inflation, companies are implementing an inflation management council made up of executives from across business units and functions. The council’s objectives are to manage a process for price increases and be an escalation point for decisions that come out of the mitigating strategies.

For specific information about transportation and packaging, see the Market Forecast sidebar on page 8.

Full Steam Ahead

Higher prices are being felt across industry sectors. “Inflation is here. It’s just not sharp inflation, but it’s here,” Anthony Nieves, chair of the ISM Non-Manufacturing Business Survey Committee,
said in June. “Prices are going up. We see it in the Index; we see it in certain commodities.” Add the uncertainty of tariffs and trade turmoil, and it’s an environment that few supply management practitioners—regardless of age and experience—have seen.

However, supply managers can take a proactive approach—comprised of a formal market analysis, improved communication with stakeholders, effective supplier relationship management, and strategies to lock in lower prices, leverage buying power or build inventory. When aligned with a company’s strengths and overall goals, this approach can help power procurement through inflationary times.

### Market Forecast

#### Transportation

Soft transportation markets in 2015 and 2016 left most shippers unprepared for a rapid run-up in the cost of shipping goods in 2017. Short-term supply disruptions, including those from hurricanes in the United States, were compounded by an improving global economy, leaving shippers with double-digit rate increases in road markets. For the rest of 2018, we expect further capacity tightening and higher costs in North America and Europe as carriers face inelasticity in driver availability. Also, we project additional price increases of 4 to 8 percent. With capacity limited in the short term, efficiency will be the biggest resource to combat transportation inflation.

Leading shippers are implementing “shipper of choice” programs to calibrate capacity through better internal collaboration, changing demand, and increased collaboration with shippers. Furthermore, disruptive technologies are on the cusp of viability, allowing forward-thinking shippers to shape, implement, and reset logistics cost structures in their favor.

#### Packaging

Plastic-based packaging prices in 2018 are expected to be in the same range as in 2017. Even if plastic resins such as polyethylene and polypropylene experience a price drop of 4 to 6 percent from the heights achieved in 2017—partly from the impact of Hurricane Harvey on feedstock supply—a potential trade war and other geopolitical factors might lead to an oil price increase, which could push resin prices higher again. Paper-based packaging is likely to experience a 4 to 8 percent price increase because of a widening gap between supply and demand. Demand for paper-based packaging is rising because of regulations that support sustainable packaging, the growth of e-commerce, and demand for innovative packaging, driven by retailers and the food and beverage industry.
Authors

Jane Wanklyn, partner, Chicago  
jane.wanklyn@atkearney.com

Marc Hochman, partner, Chicago  
marc.hochman@atkearney.com

Yves Thill, partner, Atlanta  
yves.thill@atkearney.com

Jim Barnes, managing director,  
Institute for Supply Management

The authors wish to thank Lane Burkitt and Paul Lee for their valuable contributions to this paper.
About A.T. Kearney

A.T. Kearney is a leading global management consulting firm with offices in more than 40 countries. Since 1926, we have been trusted advisors to the world’s foremost organizations. A.T. Kearney is a partner-owned firm, committed to helping clients achieve immediate impact and growing advantage on their most mission-critical issues. For more information, visit www.atkearney.com.

About the Institute for Supply Management®

The Institute for Supply Management (ISM) is the first and leading not-for-profit professional supply management organization worldwide. Its 47,000 members in more than 90 countries around the world manage about $1 trillion in corporate and government supply chain procurement annually. Founded in 1915 by practitioners, ISM is committed to advancing the practice of supply management to drive value and competitive advantage for its members, contributing to a prosperous and sustainable world. ISM empowers and leads the profession through the ISM Report On Business®, its highly regarded certification and training programs, corporate services, events, and the ISM Mastery Model®. The Manufacturing ISM Report On Business and the Non-Manufacturing ISM Report On Business are two of the most reliable economic indicators available, providing guidance to supply management professionals, economists, analysts, and government and business leaders. www.instituteforsupplymanagement.org

For more information, permission to reprint or translate this work, and all other correspondence, please email: insight@atkearney.com.

© 2018, A.T. Kearney, Inc. All rights reserved.