Wage Shifts

Labor and material prices seem to be rising for the long-term.

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Iconic motorcycle firm Harley-Davidson saw its return to profit threatened in the second half of 2021 by a substantial runup in its raw material costs, especially for steel and aluminum, which cut margins by five points. “I think dealers and customers understand that we needed to pass on some of the price increases and the price pressures we are seeing in the market,” CEO Jochen Zeitz told analysts July 21, explaining that the firm added a 2% surcharge.

Harley’s experience became an increasingly common complaint for CFOs: Steadily rising material and labor costs are creating an inflationary spiral for many companies for the first time in two decades. For many current executives, such an economic environment is an entirely new experience.

The US inflation rate reached 5.4% in July from the previous year, the biggest jump in prices in 13 years. In Europe, inflation reached 3% in August, the highest level in a decade. Developing Asia was also affected by the price surge. The producer price index in China, which is the workshop to the rest of the world, surged 9.5% in August, according to the National Bureau of Statistics, prompting Beijing to release oil from its national reserves for the first time ever to “alleviate raw material price pressures.”

While the trend of rising prices became obvious to many private sector executives, central bankers and many economists continue to insist that inflation is likely to be “transitory,” and that the higher prices may abate early next year. Fed Chairman Jerome Powell, for example, said in late August that recent inflation numbers are “cause for concern,” but warned that tightening monetary policy in response would be a “damaging mistake.”

But the Fed’s own Beige Book, the central bank’s commentary on the economic outlook, told a more downbeat inflation story. “With pervasive resource shortages, input price pressures continued to be widespread,” according to the Beige Book released September 8. “Most districts noted substantial escalation in the cost of metals and metal-based products, freight and transportation services, and
construction materials, with the notable exception of lumber whose cost has retreated from exceptionally high levels. Even at recently increased prices, many businesses report having trouble

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a year-over-year basis, the PPI was up 8.3%, the biggest annual increase since records began in 2010. The PPI measures the final demand prices producers get for goods and services.

Most business executives have a close-up view of the economy and had seen evidence of the ramp up in prices long before they were reflected in government statistics. Many believe they are seeing a long-term trend rather than a short-term blip.

“Policy makers have a strong incentive to say this is transitory because if it is not transitory then higher prices become a self-fulfilling prophecy,” says Campbell Harvey, the J. Paul Sticht Professor of International Business at Duke University’s Fuqua School of Business, who believes inflation may be around for at least two more years. “Inflation is bad for companies because unless you have market power, you cannot pass on 100% of the cost increases.”

Big manufacturers such as General Motors and General Electric are warning investors that higher prices are cutting into their profit margins. “I see the inflationary pressure very clearly,” said Carlos Tavares, CEO of Stellantis, which was formed by the merger of Fiat Chrysler and France’s PSA Group, speaking on an auto journalists’ webinar in July. “I see inflation coming from many different areas,” he added.

Consumer goods companies are also feeling the heat. “Inflation is impacting us across the full spectrum of input costs, in materials, in packaging and, quite notably, in freight and distribution costs,” Graeme Pitkethly, CFO of British-Dutch giant Unilever, said on the company’s second quarter results conference call. He noted that the price of soybean oil, an ingredient in the company’s dressings, had risen 80% compared with the previous year; while palm oil, which is used to make skin treatments, had increased 70%. “Our best percentage estimate of our input cost inflation for H2 increased to the high teens,” Pitkethly said.

Simon Geale, executive Vice President of Proxima, a British-based procurement firm, says that in addition rising raw material costs, freight prices are soaring for companies that need to import commodities, in some cases reaching 10 times the cost that prevailed 15 months ago.

“It’s a very tough market for businesses, especially those that haven’t been stockpiling a long way in advance,” he says.

Geale says his firm is advising CFO clients to factor higher prices into their strategic planning and to wring savings out of their supply chains by streamlining product specifications and reducing waste. He also recommends what he calls a “new-market focus”—seeking out new sources of supply with whom it is possible to have greater negotiating power than existing vendors. “You have to change the way that you think about buying and the way you think about the market,” he says.

Hardik Sheth, head of the CFO Excellence practice at consultants BCG, notes that the last significant inflation occurred when Ronald Reagan was president in the 1980s. Many CFOs—now in their 40’s—have no experience of how to handle rapidly rising costs.

Sheth points out three ways to cope with rising prices, beginning with the traditional approach of cutting internal costs. Secondly, firms can match higher input costs by raising their prices. A third option is to invest in sales channels to expand the business footprint. “Just simply raising prices might not get you [where you need to go],” he says.

And not all companies face the same elasticity of demand. “Some companies that took quite a hit in the pandemic are not looking for an immediate price increase,” he explains. “They want to attract customers back first.”

Sheth says companies should hedge their input costs, much as Southwest Airlines did in the 1970s by buying oil price contracts. “If you are a manufacturing company and you need to procure certain raw materials to produce your finished product, you lock in the price of that raw material with your
supplier," he says. But he conceded that with supply chains in disarray in the aftermath of the pandemic, reshuffling inventory of raw materials and even finished components like digital chips is

Most firms have a primary supplier, and they should be approached to use the past relationship to begin a discussion about lowering prices, suggesting that it may be necessary to use other suppliers to meet your cost goals if the primary supplier is unyielding on price. Another tactic businesses are using is to take a financial stake directly in suppliers to ensure that they are first in line when supplies do exist.

Another concern for companies is the impact inflation may have on labor demands. The recent runup in the US consumer price index is likely to prompt workers to seek higher wages according to Duke University's Campbell. "If the CPI is running 5.4% and you give an employee a 2% raise, are they going to buy that?" Campbell asks. "They're going to say, 'you cut my wage,' and I need to look elsewhere—and it's really easy for me to jump to another job right now."

He says that with wages increasing, at some point it may become attractive for some companies to move manufacturing to cheaper labor countries, but the shortage of spare parts and hefty shipping costs to the US and Europe may make that alternative less appealing.

Another solution is to increase use of technology like machine learning and artificial intelligence to reduce dependence on workers. The pandemic speeded up adoption of digitization of many job functions because workers couldn't easily get to the office, but that trend is likely to be sticky even when the pandemic ends. For example, the use of contactless digital payments in the US and Europe—which had never taken off-soared because consumers didn't want to touch terminals for fear of catching Covid-19, while businesses had no one in the office to open mail containing checks from customers. Companies are using video technology mounted on the heads of warehouse employees to conduct inventory counts instead of sending auditors to make the legally mandated inventory controls.