Deflating Profits

BY KEN COTTRILL

Potential threat from deflation puts pressure on 3PLs, manufacturers to cut more costs from supply chains

With inflation tamed, deflation is the hot economic issue. Will it suppress a recovery and drive the U.S. economy further downhill? Is it real or overrated?

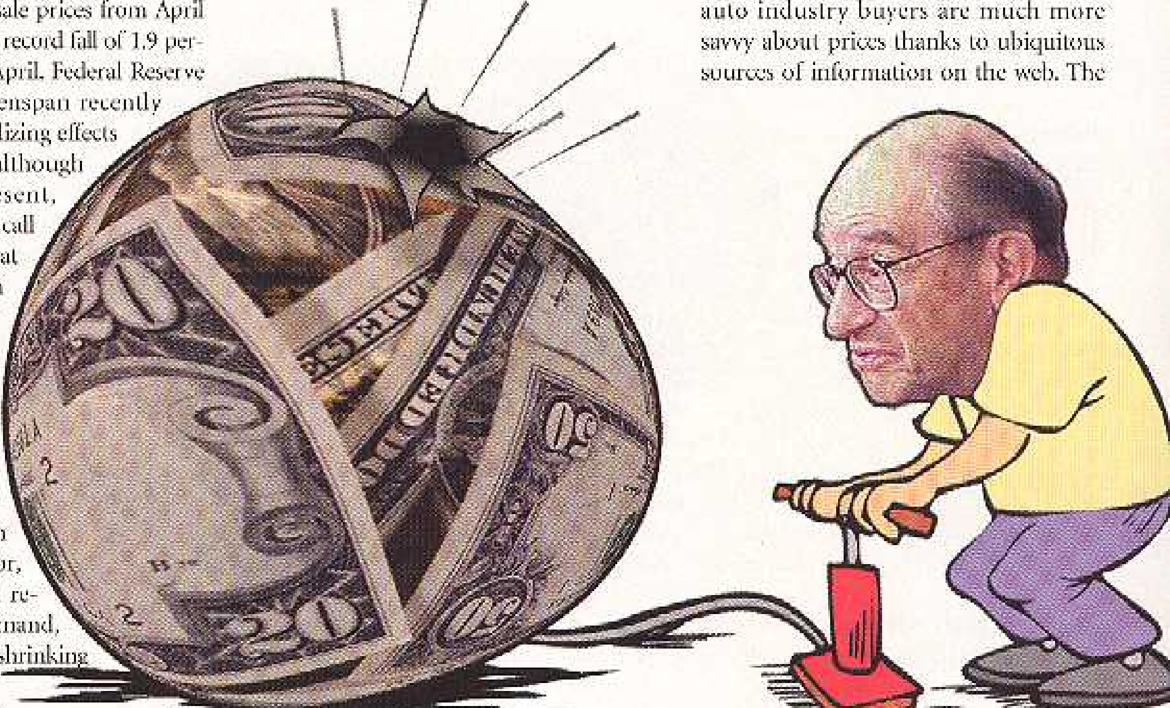
The debate was fueled by the release on June 13 of the Federal Reserve Board's latest Producer Price Index that showed a 0.3 percent decline in wholesale prices from April to May. That follows a record fall of 1.9 percent from March to April. Federal Reserve Chairman Alan Greenspan recently warned of the destabilizing effects of deflation, which although improbable at present, could cause "what we call corrosive deflation that feeds on itself, with falling asset prices," he said.

Deflation is a persistent fall in the general price levels of goods and services. It is much more global than a drop in prices within a sector, and harmful when it reflects a fall-off in demand, excess capacity and a shrinking money supply. It made an infamous appearance during the Great Depression.

As a barometer of economic activity, the logistics business is sensitive to downward price pressures and to deflation. When presenting his latest "State of Logistics Report," Cass Information Systems Senior Vice President Robert V. Delaney said, "I'm unsettled by it," and noted that the U.S. price index for durable goods is back to 1993 levels. "The trend suggests that prices may fall even further," Delaney said.

In addition to being vulnerable to the economic fallout from deflation, the logistics business also is on the front line of efforts to counter it. Cutting supply-chain costs is one of the chief weapons companies use to protect profits in tough markets. "When prices are falling, earnings improvements must come from supply-chain operating efficiencies," Delaney said.

The need to make supply chains more efficient and the impact of deflationary forces can be seen in the retail and distribution sectors. An analysis of industrial distribution companies carried out by Philadelphia-based Pembroke Consulting concludes that deflation may pose a serious threat to the profits of an estimated 25,000 U.S. companies.



Graphic illustration by Jay Sexton/Traffic World

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CASS' DELANEY

According to Pembroke President Adam J. Fein, wholesale prices for industrial products increased a mere 1.4 percent per year over the last decade and were deflating in early 2002. Growing import volumes from Asia also are helping maintain the downward pressure on prices; industrial supplies account for about 25 percent of domestic imports, Fein estimated.

Another factor is the growing influence of the Internet. For example, in the auto industry buyers are much more savvy about prices thanks to ubiquitous sources of information on the web. The markup on a new car at the dealership has dropped from about 19 percent 20 years ago to around 4 percent last year, Fein said. "In other words, car dealers don't really make a lot of money selling new cars because consumers have a lot more information." As a result dealerships have turned to other revenue sources such as car financing and servicing. "This started in the auto industry and has migrated to almost every other category," he said.

At the same time, costs are rising. Pembroke identified personnel costs rising by 4 percent a year for distributors and average health care premium increases of 19 percent in 2002. A continuation of this trend over the next three years could slash the profits of a typical industrial distribution company by 25 percent to 50 percent or even more, Fein said. The reason is painfully obvious: falling prices and increasing costs mean that companies are getting fewer profit dollars from markups. This is what Fein calls "the gross profit dollar squeeze."

Businesses such as distributors "get paid for everything they do in the supply chain in the form of a markup to the customer," Fein said. As the customer is less willing to pay these markups and deflationary forces are keeping a lid on prices, "profits are vanishing unless they figure out a way to get paid for the services they provide."

These companies also have to figure out a way to reduce costs, and that comes back to the supply chain. Fein estimated that 60 to 70 percent of annual operating costs in the wholesale and retail sectors are related to personnel. "That means the biggest elements of productivity improvement are going to come from removing people from the process," Fein said. And supply-chain innovations are a primary vehicle for achieving that, he noted.