Economic Impact of Rising Inflation and Savings Expectations on German SMEs and Ways Forward

Whitepaper by The Procurement Initiative

In association with

University of St.Gallen
Institute of Supply Chain Management

H&Z

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EXECUTIVE SUMMARY

Background and challenges:
Reasons for higher demand or lower supply are versatile. On the supply side, the COVID-19 crisis, the Russia-Ukraine war, and supply bottlenecks like the Suez Canal obstruction created manifold challenges including soaring energy prices, shortage of materials, and supply bottlenecks. In the wake of these severe disruptions, the general price level rises as a higher demand in terms of purchasing power meets lower supply of goods and services. In this inflationary environment, suppliers request surcharges in anticipation of the given effects within their supply chain. Therefore, business organizations determine Procurement's performance by its ability to prevent price increases sought by suppliers, enforce savings, and assess the extent of price increases suppliers require to compensate for inflation risks.

Cost levers:
Besides energy and raw material shortages leading to soaring commodity prices, the two primary cost sources businesses face are continuous high savings expectations by large companies (especially OEMs) and a stagnant economy due to export sanctions and unemployment, squeezing business revenues and incurring significant economic impact.

Approach:
To illustrate the business ramifications of the current economic situation, we project the identified cost levers on German SMEs (below 250 employees & 50M € annual turnover), representing 99.3% of companies in Germany by number and 32.9% by revenue.

Calculation:
To demonstrate the economic impact on German SMEs, we create a reference business case based on the identified cost levers. We evaluate and compare three scenarios for this purpose: a best-case scenario (lower savings expectations and inflation), a base-case scenario (medium savings expectations and steady inflation), and a worst-case scenario (rising inflation and stagnant GDP) for 2022.

Results:
Our calculations indicate that German SMEs face a three-digit billion-euro additional financial burden per year due to soaring inflation rates, persistent savings expectations, and opportunity costs due to lower GDP growth. The bandwidth of costs ranges from 113 to 228 billion euros.

Outlook and recommendations:
SMEs must increase efficiency, which negatively leads to a danger that investments to transform our economies fall under the cracks.

Politics must support SMEs in maintaining their supply function and implementing transformation projects to keep technology leaps in Europe and mitigate emerging hegemonic powers.

Large companies (especially OEMs) must withhold savings expectations and demonstrate solidarity with the supply base to build a competitive ecosystem in Europe. Collaborative approaches should include seeing SMEs not as scapegoats and passing the buck to them, as the boomerang may fly back.

INFLATION IS ENDEMIC AND FORCES PROCUREMENT ORGANIZATIONS TO MAINLY PURSUE FIREFIGHTING STRATEGIES

Today's supply chains are suffering significant levels of uncertainty since supply chain disruptions increase in frequency and intensity of shocks.[1] Based on the Stanford University World Uncertainty Index[2], Figure 1 depicts the rising magnitude of global uncertainty. Yet, the COVID-19 crisis, the Russia-Ukraine war, and the Suez Canal obstruction have not only contributed to global uncertainty but hampered the supply function of Procurement organizations. In addition to this supply shock, an expansive monetary policy and national economic stimulus programs further hit the global economy, reinforced the demand-supply imbalance, and created the perfect storm for soaring price inflation.

152%
Increase in global uncertainty compared to the average value between 2006 and 2020

- Businesses face unpredictable challenges in a "VUCA" world (volatility, uncertainty, complexity, and ambiguity)[3]
- Continued market uncertainty and associated risks shape the 'business-not-as-usual' Procurement agenda[4]

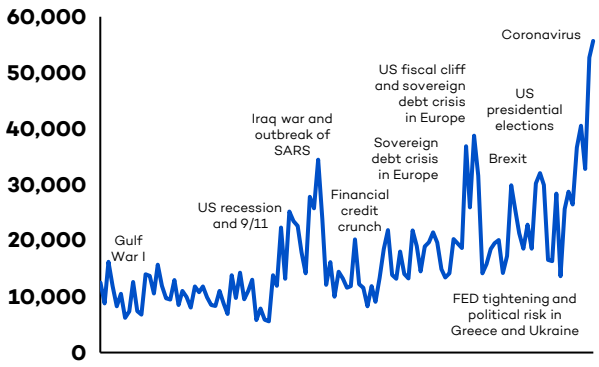
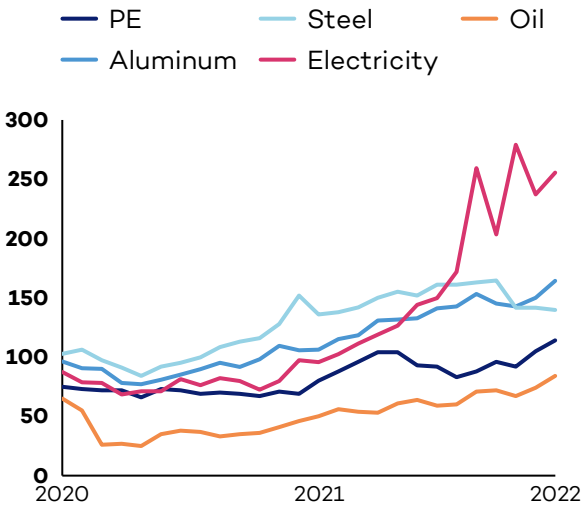


Exhibit 1
World Uncertainty Index[2]

Energy, the 'Achilles' heel' of Europe

- Strongest inflationary environment since 1990[5]
- Suppliers shorten the supply of goods and sell to the highest bidders
- Difficult to assess whether current market developments justify a price increase
- Buyers often have no time or the right tools to counteract the price increases and the supply shortages successfully



53.2%
YoY (04/21-04/22) price increase of aluminium

Exhibit 2
Key commodity price trends[6]

Procurement and Supply Chain ramifications

Besides energy and raw material shortages leading to soaring commodity prices, the two primary cost sources business organizations face are continuous high savings expectations by large companies (especially OEMs) and a stagnant economy due to export sanctions and unemployment, further squeezing business revenues.

Commodity prices

High savings expectations

Stagnating economy

40%
Share of Russian natural gas supply to total European consumption[7]

DETERMINING THE FINANCIAL BURDEN OF THE IDENTIFIED COST LEVERS

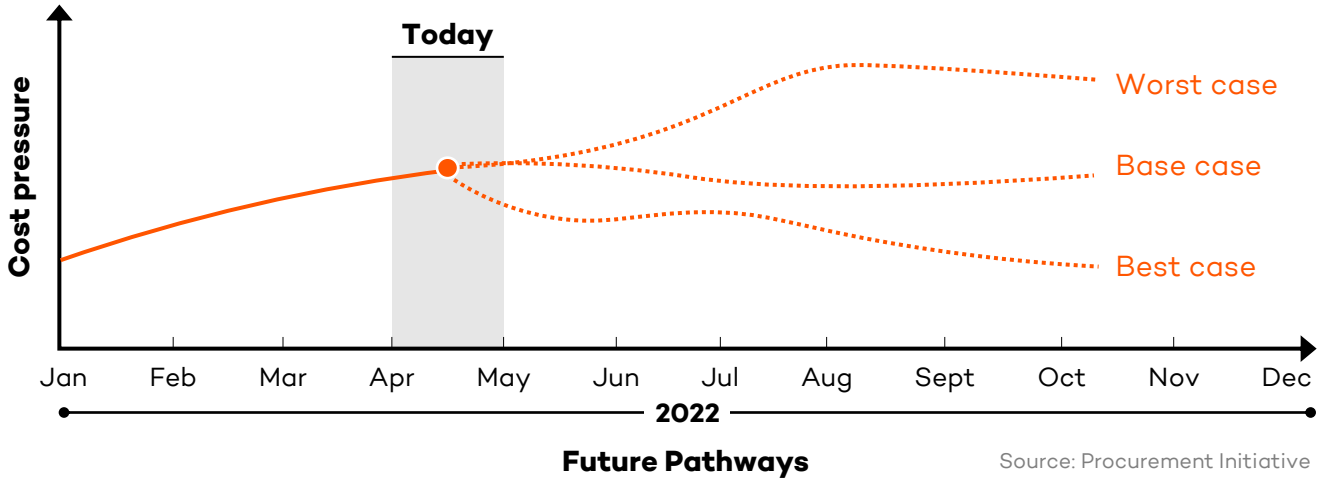
What lies ahead for German SMEs

By calculations of the Procurement Initiative, German SMEs face a three-digit billion-euro additional financial burden per year due to soaring inflation rates, persistent savings expectations by large companies (especially OEMs), and lower GDP growth.

Overview of our scenario analysis

German SMEs need to prepare for three possible scenarios that could unfold depending on crisis progression and economic development.

Scenario analysis
Cost pressure (bn. €) in 2022 for German SMEs

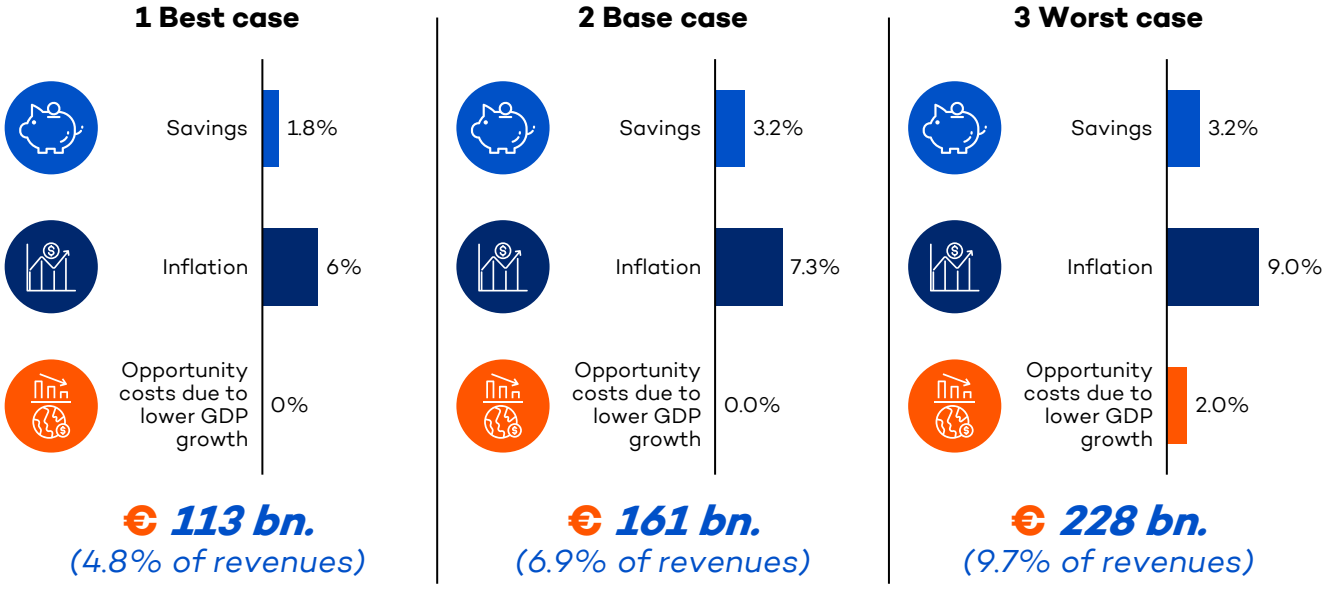


Source: Procurement Initiative

Assessment of crisis progression and impact on SMEs in Germany in terms of costs

The cost impact on German SMEs varies due to the different assumptions regarding inflation, savings, and general economic development. Therefore, while our base-scenario represents the most probable cost case that German SMEs will face in 2022, other scenarios should be continuously monitored.

Breakdown of incremental cost drivers and total cost for German SMEs in 2022

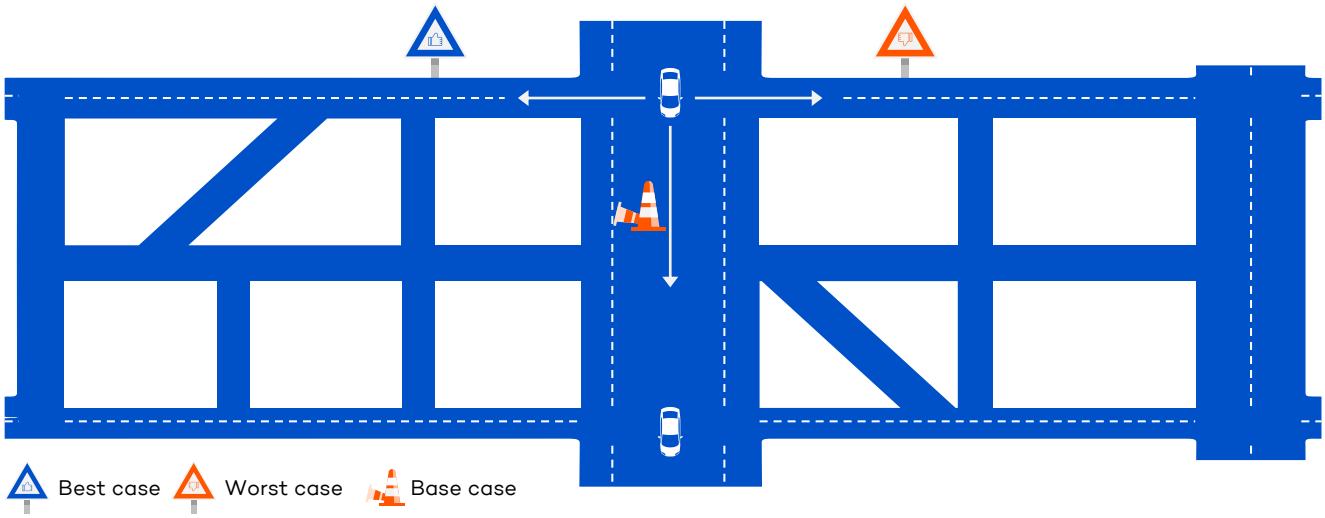


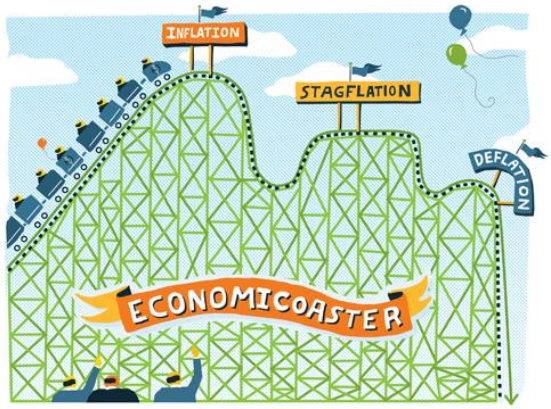
Source: Procurement Initiative

THE "ECONOMICOASTER" WILL CONTINUE – FROM INFLATION TO STAGFLATION TO DEFLATION?

Assessment

Modeling future cost scenarios enables Procurement organizations to develop and implement practical strategies. To do this, Procurement organizations must continuously monitor commodity prices and economic indicators presented in this paper to interpret when distinct scenarios are at crossroads to better understand when to pursue alternative strategies.





This could be coming our way

What history teaches us: The Great Inflation during the 1970s triggered by two oil shocks and comprehensive fiscal policy resulted in overall economic stagflation with inflation above 8% and a general economic recession with stagnant or negative GDP growth. The "Economicoaster" illustrates these possible economic developments:[8] Inflation rises slowly, suddenly turns into stagflation, and after everything settles, turns deflationary.

Worst-case impact

- **The stagflationary headwinds** calculated in our worst-case scenario would hit the German economy and SMEs even harder with calculated costs of € 228 bn. As Germany has a significant exposure by procuring 40% of its natural gas from Russia, ongoing sanctions could lead to a worst-case scenario
- **In our worst-case scenario**, we assume that further sanctions and trade disputes between Russia and Germany will at least reach a decline in GDP growth of 2 percentage points

GETTING STARTED: OVERVIEW OF MITIGATION STRATEGIES

Our research indicates that especially for those actors with little bargaining power along the supply chain, who are thus unable to pass on their inflation costs (or only to a limited extent) will face major challenges. Therefore, large companies need to consider very carefully how they treat suppliers, as tough price negotiations and savings expectations can backfire like a boomerang during and after a crisis. Since our calculations are solely based on German SMEs, we estimate that the overall cost impact would be significantly higher when considering large companies (below 1.000 employees). To deal with such numbers, we recommend addressing the underlying conditions, not just treat the symptoms (by solely passing inflation to customers).



1. **Cooperation Programs** between buyers and suppliers to create cost transparency for high runner products
2. **Should Costing**, jointly identifying optimization areas for products and the supply network, and sharing benefits among buyers and suppliers
3. **Raw material index forecasting** based on supply chain dependencies, time-series modeling, and brute-force machine learning

Outlook: Our research suggests it is well worth taking the collaboration plunge

Companies and policymakers have realized that resilience is an urgent concern as supply chains face disruptions once again, exacerbating already soaring inflation rates. However, the far-reaching consequences for SMEs cannot be foreseen just yet, making it even more important…

1. for OEMs to **remove complexity from the supply chain**, thereby removing costs and creating more sustainability (e.g., reducing model complexity in the automotive industry)
2. for SMEs to **increase efficiency and productivity**, which on an opposing side leads to a danger that critical investments in future technologies to transform our economies fall under the cracks (e.g., electrification, circular economy)
3. for politics to **support SMEs to maintain their supply function** and further implement transformation projects to keep technology leaps in Europe and mitigate emerging hegemonic powers (e.g., Gaia-X)
4. for large companies (especially OEMs) to **withhold savings expectations and demonstrate solidarity with the supply base**. This includes not seeing SMEs as scapegoats and passing the buck to them, as the boomerang may fly back (e.g., monitoring the financial health to mitigate supplier bankruptcies)

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ABOUT THE PROCUREMENT INITIATIVE

The Procurement Initiative is a modern think tank and a platform for people who want to shape the future of Procurement. We live in a world where uncertainty and crises are the new normal. And that is exactly why we believe in a new purpose of Procurement: to take full responsibility for creating and orchestrating global supply chains that positively impact the needs for viable and sustainable businesses, a prosperous society, and a healthy planet alike.



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