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MANAGING PRICES IN A HIGH-INFLATION ENVIRONMENT
A Guide to Boosting Profits

EXPERT INTERVIEW WITH **DR. DANILO ZATTA**

"Price management is not only the strongest but also the fastest lever for increasing profits. In the current environment with inflation and sharp cost increases, managing pricing well is even more important. In addition, many companies are discovering how innovative pricing models are becoming the new source of competitive advantage."

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Dr. Danilo Zatta is a leading advisor in topline growth. He is an expert in profit improvement on the revenue side, with extensive experience in pricing. As a management consultant, he has led hundreds of projects over the past 25 years in numerous industries, generating substantial profit gains. His interventions typically focus on pricing and sales excellence plans, growth strategies, topline transformations and redesign of business and revenue models.

He has published over 20 books, including the best seller translated into 10+ languages, "The Pricing Model Revolution" (Wiley), as well as hundreds of articles in several languages. He is regularly keynote speaker at universities and conferences.

Dan graduated with honours in economics at Luiss in Rome, Italy and UCD in Dublin, Ireland. He completed an MBA at Insead in Fontainebleau in France, and in Singapore. Finally, he did a PhD in revenue management and pricing at TUM Munich in Germany.

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How do prices affect households today?

Let us start with the good news: inflation is slowing down in several countries. In Italy, for example, it was at 11.6 per cent in December and fell to 10.1 per cent in January. That does not mean consumer prices are falling, just that they are growing less fast. And, still, always in double digits. Imagine going 120 miles per hour on the highway and slowing down to 100 miles per hour. You are not backing up, just speeding up less. This is happening with inflation these months. Unless the prices of goods and services come down in the near future, purchasing power will be lost forever. It can eventually be recovered only from higher incomes, which are currently at the pole. Inflation thus continues to hit households, especially less affluent families that spend most of their income on food and energy. Even in 2023, due to inflation, prices will remain high, and the purchasing power of households will consequently reduce.

Considering that one of the main drivers of growth in 2022 was the increase in consumption in 2023, even with the easing of inflationary pressures, this situation could have a negative impact, substantially reducing consumer spending and, thus, the contribution to the country's overall growth.

Can we make a comparison between European countries?

The lowest European inflation rate is currently in Switzerland, with only 2.9 per cent. In the rest of the European countries, inflation is comparable. However, inflation rates in countries such as Spain, France, and Germany are a few points lower because they import fewer energy resources. That is why we often talk about the effect of imported inflation in countries like Italy. Where it is far higher, however, is in Eastern European countries, particularly the Baltic countries, where inflation is as high as 20 per cent.

How much do salaries and labour costs impact inflation, and what does it mean for price setting?

March 27th 2023, was a special day in Germany: The entire country was paralysed by a strike in favour of higher salaries. Still, the impact of wages and labour costs is limited: energy and commodity costs account for about half of the inflation. Moreover, on the salary front, most countries have no automatic indexation in the private sector. Therefore, you can buy fewer things with the same amount of money in your pocket. Or conversely, the price to be paid in the same currency is higher.

If wages remain fixed, the standard of living decreases as inflation rises. That is why there were systems to match wages to these price increases, as well. However, this indexation of wages has at least two flaws. First, it promotes inflation. Companies forced to raise their wages are tempted to raise their prices to maintain the level of their margins. This is why the European Central Bank is against this kind of measure. After that, indexation penalises struggling businesses, especially small and medium-sized enterprises, which are already struggling to maintain the level of their wages.

Even without an automatic indexation, you can observe rising salary levels

across Europe. Labour-intensive industries shall therefore act to maintain their profitability. Professional services companies, like auditing, consulting, travel & tourism, logistics etc., are, therefore, increasing the prices of their services. The most successful ones, however, do not apply a simple increase on all the services but segment and differentiate the increase by customer groups and regions. Through this, they achieve a reasonable average price increase, which is still sustainable and accepted by customers.

There are many debates about the energy crisis and rising costs in conjunction with the war between Ukraine and Russia. But how much does the geopolitical situation affect our daily economy, and why?

The geopolitical impact on our economy is there and can be felt. Although the long-term consequences of the war in Ukraine depend on its further course and (international) reactions to it, far-reaching economic and social consequences for Europe are already emerging. In addition to rising prices, especially in the energy sector, but also in the food sector (Ukraine being a major grain producer), the influx of refugees from Ukraine will impact the social situation in several European countries.

Even before Russia attacked Ukraine, the price situation in energy markets was tense. Since then, once again, it has come to a head. For example, the price of diesel before the Russian raid was 1.86 euros, and natural gas for delivery in April cost about eight times more in early March than what was predicted in the long run a year ago. These higher energy costs not only increase households' costs for electricity, heating, and mobility but also place higher burdens on energy-intensive industries, affecting the prices of their products.

Since several European countries' dependence on imports is also high in the food sector, and Ukraine and Russia are critical agricultural suppliers, further price increases are expected. For example, Ukraine and Russia account for about 30 per cent of the world market share for wheat, 20 per cent of corn, and more than 80 per cent of sunflower oil.

Rising energy prices (especially for electricity, mobility, and heating) and consumer goods (e.g., food) have reduced household purchasing power. Low- and middle-income households have a high consumption rate and are the most affected. Overall, this implies a negative demand shock. In addition, low-income households are the most socially burdened, as housing, energy, and food costs account for the largest share of disposable income.

On the business side, this implies a lower demand and willingness to pay for companies serving such customers. On the other side, companies are directly affected by rising energy prices as well. As a result, there are supply chain challenges and a reduction of the offer linked to this phenomenon, especially for energy-intensive sectors like steel mills, paper production or machinery.

Short-term solutions are governmental subsidies and fiscal aids. However, in the medium to long range, the development of alternative energy sources like hydrogen, biofuels or wind power are a solution.

A question many companies ask in the current environment of exploding commodity prices and high inflation is whether or not it pays to raise prices and, if so, by how much.

I have a clear view of how to move in the current environment: Companies must raise prices immediately, at least to the level of inflation, preferably higher, if they do not want to reduce their profits. In the current environment, some companies may consider keeping prices lower than competitors to gain market share. However, this is not the ideal way to go because companies are exposed to the same cost increases as their competitors. If cost increases cannot be passed on, profits will clearly suffer. For many years, the problem has been that companies across Europe have had, on average, a limited profit margin. This means that those who cannot pass on cost increases to their customers will most likely end up at a loss.

Then there is a second issue. Even if we could pass on price increases one-for-one in percentage terms, our nominal profit remains the same, but the real inflation-adjusted profit decreases. So, we must think in terms of real gains. This means that prices must be increased more than proportionally so that the same real profit remains in the end after adjusting for inflation. This is, therefore, a highly complex situation.

In that case, it pays to raise prices and increase them more than the inflation rate. Very clear. However, how should one go about it: is it better to wait and then better to make a significant price increase at the end of the year or raise prices several times a year?

I do not think it makes sense to wait to raise prices. Instead, it is better to do the opposite: one must anticipate the cost wave. Therefore, prices must be raised before the cost wave swamps them; otherwise, the annual result is ruined. Moreover, regarding the frequency of price increases: it is better to make several small price increases during the year than to wait until the end of the year.

Otherwise, you will not recover what you have lost. Reacting early enough and moving with inflation is what I advise my clients to do. It does not pay to wait in the hope of having a competitive advantage for a certain period; otherwise, the annual result is offset.

In that case, it is not wise to hesitate but to increase prices quickly. Nevertheless, the most important in the current environment is the way of communicating and justifying the price increases. Can you give us an indication of how to do that successfully?

Communication of price increases is crucial and will find large acceptance if cost increases are justified.

This applies to both industrial and consumer goods: Customers will accept cost increases as an argument. If you say, "The good is scarce, I can afford price increases," or "I have to raise the price to balance supply and demand," customers will not accept it. This is why it is convenient to use the argument of cost increases in price negotiations, and this is almost always true because nearly all costs increase in current times.

So, you propose the alternative of creating a discourse that speaks to the customer's understanding and sense of fairness rather than making them feel taken advantage of by invoking goods scarcity or supply chain issues. From your experience, does that work and has additional benefits, or must you tailor the approach to each customer's profile?

Absolutely: fairness is essential, especially in long-term relationships with customers. Short-term price moves shall not harm long-term customer loyalty. Some companies, therefore, communicate explicitly to their customers the reasons for price changes to be perceived as fair and to increase acceptance of higher prices.

I like to quote the case of the discounter Aldi. They bought an entire page in a newspaper and announced: "Prices of milk products shall increase by 6%" and listed all sorts of reasons. But then they added: "As we care about you, we managed to create synergies and carry ourselves part of the increase. Therefore, the real price increase for you will be just 3%." The reaction of customers was great: they felt Aldi cared about them. So a price increase became a competitive advantage for Aldi!

Especially for the sizable and more critical customers, I always recommend tailoring the approach: assessing the balance of power will also help select the most suitable course and be convincing.

Many people wonder if we might end up in an extreme price spiral. But how long will inflation last?

I believe this inflation will last for at least a few years. If we consider the role of unions, they should demand more to compensate for the loss of purchasing power of their members. This means that it is hard to imagine that the increasing spiral of prices of raw materials, energy, etc., will not also generate wage-side inflationary pushes, thereby sustaining inflation.

Moreover, we have a massive amount of money lying around the world that will not shrink rapidly. Of course, the ECB will further increase interest rates, but money will continue to chase assets. Therefore, I see no reason for a sharp drop in inflation rates in the next few years. However, we must be prepared for that.

What can only be hoped for is that so-called stagflation will not return as it did in the 1970s. That means we have inflation and stagnation, that is, no growth. However, I think this risk is limited in the short run.

ABOUT EPP

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EPP Pulse offers another valuable platform for the Pricing and RGM community by bringing to light successful practices and strategies, enabling expertise exchange, fostering connections among pricing professionals, and engaging the community in dialogue and content sharing. Furthermore, EPP Pulse serves as a tool to identify market needs and interests for topics that could be developed in future EPP forums and events."

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