

Inflation and the Small Business

Fighting Inflation

By

Kimberly Robinson

Presented to Dr. Suhansa Rodchua

in partial fulfillment of Graduate degree requirements for a Masters of Science in

Industrial Management

At

The University of Central Missouri

April 2007

## Abstract

Inflation is usually deemed a “bad” word in the business world. Small business owners begin with many obstacles. When small business owners hear that inflation is on the rise, they cringe. But, what is inflation, really? How does it impact small business owners? This paper seeks to define inflation. It will also examine the causes of inflation, seek to identify economic indicators of increasing inflation rates and identify its impacts on small businesses.

## TABLE OF CONTENTS

INFLATION DEFINED .....	
MEASURING INFLATION .....	9
FORECASTING INFLATION.....	9-10
REDUCING THE IMPACTS OF INFLATION .....	
CONCLUSION.....	23 - 24
REFERENCES .....	24 - 27

## INFLATION DEFINED

What exactly is inflation? A persistent increase in the level of consumer prices or a persistent decline in the purchasing power of money, caused by an increase in available currency and credit beyond the proportion of available goods and services.

Inflation occurs when the price level rises from one period to the next. The rate of inflation expresses the increase in percentage terms. Over time, as the cost of goods and services increase, this causes the value of a dollar to fall because one won't be able to purchase as much with that dollar as before. While the annual rate of inflation has fluctuated greatly over the last half century, ranging from nearly zero inflation to 23% inflation, the Federal Reserve actively tries to maintain a specific rate of inflation. The goal is to keep inflation at about 2-3%. Of course it does vary depending on different circumstances. The definition of inflation and price level are one and the same.

Economists measure the price level by computing a weighted average of consumer prices. The value of the average is arbitrarily set equal to one (or one hundred) in a base year, and the index in any other year is expressed relative to the base year. The value of the consumer price index in 1999 was 167, relative to a value of 100 in 1982 (the base year). That is, prices in 1999 were 67 percent higher on average than in 1982.

## MEASURING INFLATION

The measurement of the price level is a difficult task and, therefore, so is the measurement of the inflation rate. The general upward price of goods and services in an economy are measured by the Consumer Price Index and the Producer Price Index. The

Consumer Price Index produces data which provide information about or predicts the health of the economy or the financial markets. While the Producer Price Index “measures the average change over time in the selling prices received by domestic producers for their output. The prices included in the PPI are from the first commercial transaction for many products and some services”.<sup>1</sup>

It is important to recognize that a positive rate of inflation, as measured by a price index, does not mean that all prices have increased by the same proportion. Some prices may rise relative to others. Some might even fall in absolute terms, and yet, on average, inflation is still positive. For example, many economists believe that the consumer price index has overstated the rate of inflation in recent decades because improvements in the quality of goods and services are not adequately reflected in the index. An index that held quality constant, according to this view, would show a smaller rate of price increase from year to year, and thus a smaller average rate of inflation.

The distinction between absolute and relative price change is important in understanding the theory behind the effects of inflation on economic activity.

### ECONOMIC INDICATORS OF INFLATION

Economic indicators are among the most closely watched pieces of news in the investment world. Practically every week there is some announcement that affects investors' predictions about the future of the economy. Leading indicators are those which are believed to change in advance of changes in the economy, giving you a preview of what is going to happen before the change actually. Generally speaking, economic indicators of inflation are statistical data showing general trends in the

economy. Those with predictive value are leading indicators; those occurring at the same time as the related economic activity are coincident indicators; and those that only become apparent after the activity are lagging indicators.

The most important indicator is the Gross Domestic Product (GDP) report. Basically, the GDP is the widest measure of the state of the economy. The figure is released at 8:30 am EST on the last day of each quarter and reflects the previous quarter. The GDP is the monetary value of all the goods and services produced by the entire U.S. economy during the quarter. This figure does not include international activity. The key number to look for is the growth rate of GDP. The U.S. economy grows at around 2.5-3% per year. If there is a major shift in the GDP growth rate, it can severely impact the economy. If there is significant growth higher than the range, it is predicted that there will be a high inflation rate. A significant amount of growth below this range means that the economy is running slowly. This can result in reduced spending and even prompt companies to cut work forces.

#### REDUCING THE IMPACTS OF INFLATION

Inflation has many disadvantages; it creates uncertainty, in that people do not know what the money they earn today will buy tomorrow. This uncertainty discourages productive activity, saving and investing. Inflation reduces the competitiveness of the country in international trade. If inflation is not offset by a nation with a less valuable currency, the U.S.'s exports become more expensive and less attractive. This makes other countries' imports more attractive. This forms an economy of unbalanced trade which results in a much more reduced U.S. economy.

As the purchasing power of the monetary unit becomes less predictable, people resort to other means to carry out their business. The main concern for business owners, consumers and investors is the bottom-line rate of return. There are many investments which can compensate for an increased inflationary period. There are several investments which offset inflation. Inflation-protected securities (IPs) can work as a hedge against the loss in purchasing power that fixed-income investments like bonds and annuities may experience during high inflation periods. IPs are available in different forms, each of which we review below.

1. Treasury inflation-protected securities (TIPS) offer the safety of the U.S. government, ensuring you'll get your money back. The interest rate on TIPS is lower than what's offered on standard Treasury notes, but TIPS pay interest on the inflation-adjust principal rather than the nominal principal. This spread represents what the market expects the annual inflation rate will be over the next 10 years. You won't receive income from your TIPS until you sell it or it matures. You will, however, have to pay income taxes each year on the increased value of the principal. But you can avoid this tax by holding the TIPS in a tax-deferred account, such as an IRA.

2. Municipal inflation-linked securities are issued by various government entities. The semi-annual interest payments are less than you might receive from similar term Treasury bonds, but these payments change with the consumer price index. Plus the income tax treatment is the same as that for regular municipal bonds. Therefore, with inflation-linked securities, depending on your tax bracket, you could possibly come out ahead when compared to fully taxable bonds including TIPS.

3. You can purchase corporate inflation-linked securities with as little as \$1,000 through your broker. The yields on these securities adjust monthly for inflation increases. As these securities are issued by companies and carry more risk, the yields are usually higher than comparable Treasuries. But remember, there is no government backing, so there is the chance that the company might not meet its obligations.

### IMPACT OF INFLATION ON SMALL BUSINESS

Just hearing talk of inflation has the Federal Reserve taking swift action and has sent the stock markets tumbling. Many entrepreneurs have never had to do business in an age of inflation. In fact, the last bad inflationary period was almost thirty years ago. Since then, careful control of the economy with interest rate policy has helped to keep things in check.

Recently, many small business owners have begun to feel the pinch of inflation. Health care costs, fuel costs, and many raw material costs due to the many hurricanes of last season are pushing up prices on almost everything. Add to that labor shortages in key areas, and you have the recipe for inflation.

During times of inflation in the past we were still in the old economy and big companies could pass along the increased prices to consumers, who due to stronger unions in those days were able to push wages higher to keep up. If their ability to raise prices fell behind, they had lots of cash reserves and knew that they could soon catch up. They just laid people off, shrunk inventories, and tight supplies then pushed up prices.

All of this would continue until the economy ran out of gas. We then had a recession to cool things off.

But, we are now in an entrepreneurial economy. Small businesses are always tight on cash flow. And if their inputs of raw materials and other direct operating expenses go up, they may not be able to pass along these costs quickly enough to keep their cash flow positive. Managing cash flow is only one issue for small business owners. Raising prices is a difficult process for many small businesses. But, every increase potentially makes them less competitive, and raises the possibility that customers might go elsewhere.

Since everyone will be experiencing inflation if it happens, small businesses will have a little more room to raise prices than they are used to. But, if we have a period of inflation in our near future, it will be different that we've seen in the past.

First, some of the major causes of inflationary pressures right now are not within the ability of the Fed to control. Many of the top oil producers in the world are not the most reliable governments right now. Issues like oil production and export are controlled by other countries.

And secondly, we are in a much more open, global economy than we have been in the past. When we had inflation in the mid-1900s, everyone was faced with the same pressures and all could raise prices in relative harmony. Inflation is quite variable around the world, and therefore foreign competitors might not face the same inflation rates that we do in the US. That would put us at a huge price disadvantage.

Here are some important tips for small business owners to do to combat inflation:

- Keep overhead low.
- Build cash reserves to buffer short term price increases
- Watch your margins carefully. Worry about growing profits, not sales.
- Don't lock into long-term contracts that have narrow margins with large customers.
- If you notice an increase in inflation, begin making small price increases instead of large increases all at once.
- Eliminate or pay down any variable interest loan. These payments will increase with inflation

### CONCLUSION

Even when the economy seems hopeless, there are many things that we can do to combat its effects. Knowing how to predict economic changes is a very important financial tool. We can use investment tools and business strategies to combat the impact of inflation and keep our personal financial portfolios and small businesses intact.

REFERENCES:

- Elder, J. (2004). Another Perspective on the Effects of Inflation Uncertainty. *Journal of Money, Credit & Banking*, 36(5), 911+. Retrieved April 29, 2007
- Evans, D. R. (2001, Winter). No Sale: Effects of the Government Sector's Decline in Employment. *Business Perspectives*, 14, 20+. Retrieved April 29, 2007.
- Hansen, B. (1951). *A Study in the Theory of Inflation*. New York: Rinehart. Retrieved April 29, 2007.
- Holland, A. S. (1993). Uncertain Effects of Money and the Link Between the Inflation Rate and Inflation Uncertainty. *Economic Inquiry*, 31(1), 39-51.
- Kemmerer, E. W. (1942). *The B C of Inflation, with Particular Reference to Present-Day Conditions in the United States*. New York: Whittlesey House, McGraw-Hill. Retrieved April 29, 2007.
- Paarlberg, D. (1993). *An Analysis and History of Inflation*. Westport, CT: Praeger Publishers.
- (1985). *The Politics of Inflation and Economic Stagnation: Theoretical Approaches and International Case Studies* (L. N. Lindberg & C. S. Maier, Ed.). Washington, DC: Brookings Institution.
- Skene, G. L. (1992). *Cycles of Inflation and Deflation: Money, Debt, and the 1990s*. Westport, CT: Praeger Publishers. Retrieved April 29, 2007.
- Thoma, M. A. (1994). The Effects of Money Growth on Inflation and Interest Rates across Spectral Frequency Bands. *Journal of Money, Credit & Banking*, 26(2), 218+.

