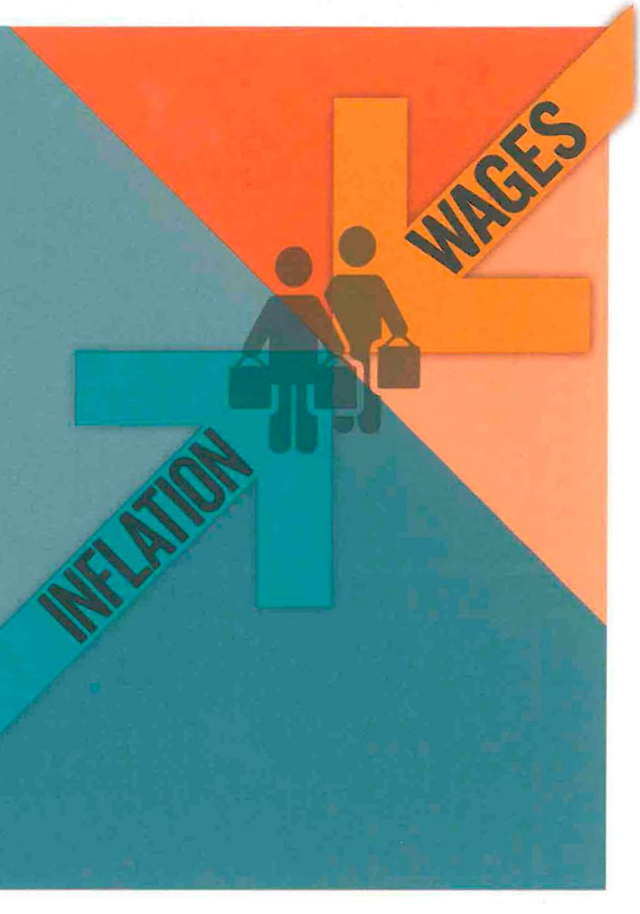
THE BIG STORY

Are retailers running out of options?



Inflation and real wages are creating an untenable environment for retailers trying to shield customers from price increases. Matthew Chapman reports

Inflation spiralling as real wages dwindle is putting retailers in a bind about passing their additional cost on to consumers.

In the month before the Brexit vote inflation stood at only 0.3%, as measured by the Consumer Prices Index. But it has now spiralled to its highest level in five years – 2.9%.

British Retail Consortium (BRC) head of retail insight and analytics Rachel Lund says retail is "running out of options" when it comes to continuing to protect shoppers from significant price increases. "The reality is there's a limit to how much retailers can absorb into their margins," she explains.

While non-food prices have remained deflationary – in part because of hedging contracts, competition and heavy discounting at the start of the year – rising inflation began feeding into food prices back in February. This is due to the shelf life food has and its shorter stock turnaround time, Lund explains.

However, non-food deflation reached its lowest rate in more than four years in August, suggesting it too is about to enter into a period of inflation.

The simplest solution would be to pass on the price increase to consumers. However, inflation is happening at a time when real average weekly earnings have been in decline, year-on-year, for months.

With consumers feeling the pinch, it would take a brave retailer to hike prices and risk shoppers deserting it for of a cheaper rival.

Co-op chief executive Steve Murrells says passing on as little of its additional costs as possible to customers is the "right thing to do as people are becoming more strapped for money because of Brexit".

The pressure on margins is only likely to worsen for retailers in the immediate future.

"Our outlook for the sector generally is quite downbeat," says Richard Lim, chief executive at insights firm Retail Economics.

> **Pricing is clearly the biggest challenge we all face. Inflation and commodity costs and the fall in sterling is a huge challenge**
> **Matthew Barnes, Aldi**

"We think the pressure on disposable incomes for households will be most intense in the final quarter of this year."

Retail Economics forecasts inflation will reach a peak of 3.1% in November, and predicts real earnings will only return to growth in the middle of 2018.

Aldi and Iceland

Aldi this week reported a decline in profits and reduced margins as it seeks to shield consumers from price rises, but even the privately-owned discounter, which prides itself on being lean and nimble, has been forced to raise its prices.

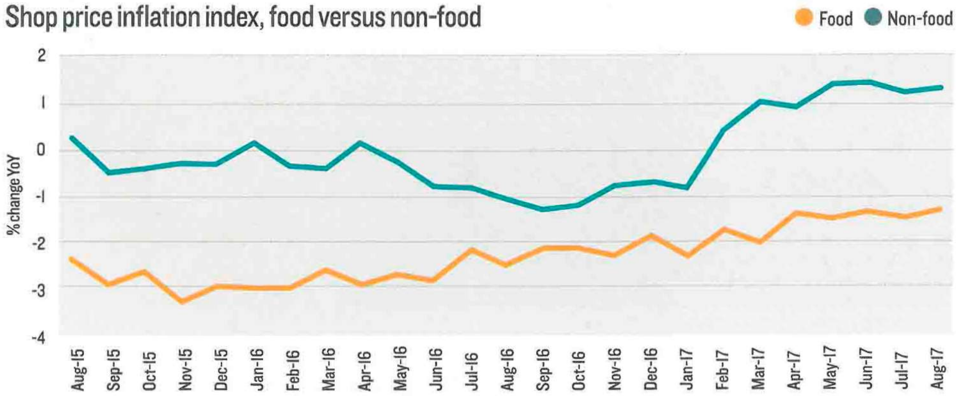
"Pricing is clearly the biggest challenge we all face," says Aldi UK and Ireland chief executive Matthew Barnes. "Inflation and commodity costs and the fall in sterling post-Brexit is a huge challenge for all of us."

Aldi remains defiant though. Barnes thunders that, despite the profit drop, the retailer feels "stronger than ever" and able to maintain its price advantage against the big four.

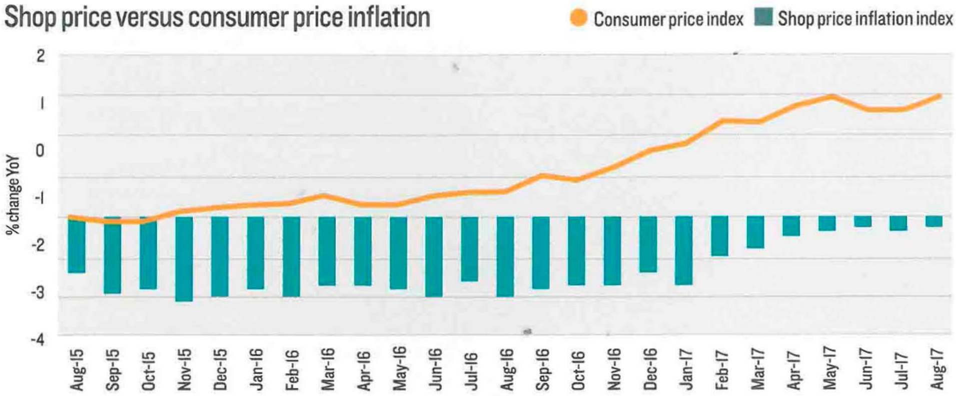
He says that "lots of little things can add up to big differences" such as a focus on efficiencies in the supply chain and lowering energy costs. "We have reduced our cost base by over 5% in 2017,"

Read more on Co-op boss Murrells' vow to hold back inflation
Retail-Week.com/Murrells-inflation

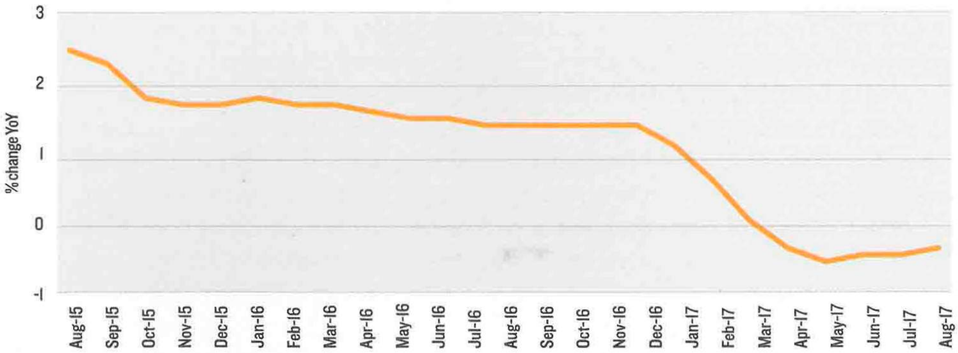
Shop price inflation index, food versus non-food



Shop price versus consumer price inflation



Real average weekly earnings (three month average)



says Barnes. "Aldi is proportionately a cheaper business to run than it was 20 years ago."

Meanwhile, Iceland boss Malcolm Walker says he is keeping a close eye on suppliers to ensure customers get a good deal.

"We want to make sure suppliers are not using inflation as an excuse or an opportunity. If there is a justified price increase we have to take it, but obviously it is eroding the margin because we don't want to pass it on," says Walker.

Shrinkflation and beyond

Lim suggests that retailers work with suppliers to try and mitigate the impact of rising costs and prices. Businesses can "essentially re-engineer their packaging sizes and things like that", he says.

But while shrinkflation is a popular tactic in food, it is not possible across all product categories. Planet Retail macroeconomics specialist and retail analyst Tatjana Wolff points out inflationary pressure in non-food is particularly high because it "mainly has to be imported". And Lim predicts one of the hardest hit sectors could be electricals; price rises within the sector are likely to spark a sharp tail-off in demand because "non-discretionary spending has quite high responsiveness to changes in price".

According to the BRC, the Government will play a pivotal role in the outlook for retailers.

"It is imperative the Government puts the UK's consumers at the top of its agenda in the negotiations on our future trading relationship with the EU," Lund insists.

Things are likely to get worse before they get better for both consumers and retailers. Retailers will have to be at their most creative and nimble to ride out the inflation storm.

Thankfully, inflation is nearing its peak

Paul Hollingsworth
UK economist,
Capital Economics

The resurgence of inflation has been one of the key themes this year, and is the primary driver of the squeeze on households' real incomes that is currently underway.

However, there are some good reasons to think that high inflation is not here to stay.

For starters, the almost 3% rise in consumer prices over the past year has been largely driven by the impact of the drop in the exchange rate that followed the vote for Brexit.

That depreciation in the pound made it more expensive to import raw materials and finished goods from overseas.

Admittedly, some firms decided to absorb some of that impact, allowing their margins to be squeezed, and limiting the final impact on the consumer.

I think inflation is probably not that far away from peaking

Nonetheless, many firms were confident enough to pass on the increase in their costs, meaning that well over half of the increase in consumer prices can be attributed to this drop in the pound.

In the past, it has taken a number of years for this impact to fully work its way through the system. However, this time around, the drop in the pound appears to have had a more immediate impact.

As a result, the rise in inflation has been a bit sharper than most anticipated. But thankfully, that means it should fall back reasonably quickly too.

And there are already signs that this is happening, with firms' input price pressures waning, and the inflation rate of imported goods having faded.

The factors which kept inflation high back around 2011 – notably a series of VAT hikes and commodity price shocks – seem unlikely to be repeated now.

So I think inflation is probably not that far away from peaking. It may inch above 3% briefly in the next few months, but it should start to drop back around the turn of the year.

Admittedly, inflation is likely to remain above the Bank of England's 2% target throughout next year. But if I'm right in thinking that pay growth will see a modest acceleration, then real wages are likely to start rising again around the middle of next year.

So while this winter might be tough for the consumer, the prospects for next year look brighter.