Retail Economics 101: Lessons and Strategies of a Recession

September 2008

Introduction

Despite the fact that the economy has yet to hit the official benchmark of a recession, historically defined as two consecutive quarters of declining GDP, the majority of Americans feel the economy is in a recession. At the very least, we know there are sectors of the economy that are exhibiting strong recessionary indicators and the retail industry is at the forefront of those trends. With the rash of recent retail bankruptcies, store closings, and increasingly vacant retail space it is apparent the retail industry is facing tough times. Because retail is the second largest sector in the U.S. in number of businesses and employees and accounts for 8.3% of GDP, the implications of a retail recession are numerous and far reaching. Consumer spending also accounts for two-thirds of the national economy, giving us an indication of the relative strength of our economic times. As we have seen national retailers folding it is natural to wonder what the impacts will be of a slowing economy on Iowa owned retail establishments and our overall retail landscape. This report presents data and analysis for decision makers, retail business owners, and concerned residents to determine the local impacts of tough economic times and offer solutions and means of adapting.

Current Economic Conditions

The current economic picture is represented by a lot of negative headlines and dismal performance of the economy’s leading indicators. Some of the economic ills we are facing are rising prices, lower disposable incomes, lower savings rates, declining consumer spending, a housing slowdown, and rising unemployment. What these indicators tell us about the outlook for retailers is that the record consumer spending expansion is over. Retail is the proverbial end of the road for a good so when its demand weakens the effects will ripple though its supply chain. Now imagine its not just the demand for a single good that is weakening, but demand for most goods. The retailer will struggle but so will the manufacturers, the input suppliers, the truck drivers who transport the goods and so on. This is where the concept of lag time is important in our economic system. The phenomenon that led to a decline in consumer spending and retail demand may have been in progress for months before we notice the slowdown in spending. Thus the impacts on manufacturing, distribution, and employment in other industries may be a year removed from the events that actually triggered the declines. As economic forces slow or stop altogether, retail demand further weakens thus exacerbating the decline. In the end, the retail industry as a whole takes a beating in a recession, with more losers than winners.

Predictions for retail are negative, with the NRF projecting the weakest holiday season in six years. It is not only possible, but probable that the retail sector will not even meet the lowered expectations of this years forecasts. This will mean significant hardship for many Iowa businesses and communities. Understanding what businesses can do to help weather the storm depends on their understanding of the unique attributes of their business and environment.

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The basic economic concept of consumption smoothing can help us understand how the current retail situation has developed and what we can expect next. Consumption smoothing refers to an individual’s preference to maintain a certain standard of living over time. All things constant this means an individual will use savings as a tool to compensate when incomes are low or save more when incomes are high thus “smoothing” their consumption patterns. This doesn’t mean that spending doesn’t increase or decrease as incomes levels change, but rather that the peaks and valleys’ will be less dramatic.

The theory suggests that people won’t spend one less dollar for every one less dollar that they earn, and vice versa. Evidence of this trend can be found in the proliferation of credit cards and their increased use in rough economic patches. Because a certain amount of people’s consumption is fixed and doesn’t vary with income, shortages are made up by dipping into savings or debt to maintain ones standard of living. Financing personal consumption when income is decreasing comes down to a choice between debt and equity, and most recently with the historic rise in housing values we saw this framework altered. As housing prices were increasing, individuals had more paper wealth triggering spending increases as though that paper wealth was a real stream of income. People feeling wealthier, spent more money, fueling the tremendous consumer expansion simultaneous with the growth of the housing market. In the infancy of the recent growth in these two sectors, individuals paid off credit card debt accumulated in the prior recession by refinancing their homes. Unfortunately, real incomes were not rising during this period and many people smoothed their new “wealthier” consumption levels with more credit card debt. Many households refinanced their homes more than once during this expansion, only to be faced with the dismal reality that home prices cannot continue to increase at the current rate and the equity in one’s home does not have the same wealth effect of a liquid asset such as traditional savings.

We are now in a period where many people have exhausted the safety nets that typically sustain a minimal level of consumer spending. In many cases, savings are exhausted and credit cards are maxed out forcing people to accept lower levels of consumption and a reduced standard of living.

While consumption smoothing explains the fundamental choices behind savings and spending for the consumer, it does not explain their specific spending decisions. During a recession, the typical consumer is forced to make difficult decisions and economic tradeoffs. In terms of consumption, we often see these choices manifested as substitution between goods. When budgets are constrained, the typical consumer will substitute down or choose an inferior good. An example of trading down would be substituting ground beef for steak. Other examples might be buying frozen fruit instead of fresh or purchasing the store brand rather than a name brand. This trading down is a type of consumption smoothing allowing the consumer to get the same level of consumption but at a lesser quality per unit. This theory of good substitution holds when there are inferior goods to trade down to and they are reasonably good substitutes for the more expensive good.

Another example of this good substitution at work is in the consumer’s choice of where to shop. While most retailers are experiencing sales declines, discount retailers are thriving as people trade down from expensive specialty and department stores to shop at discount and wholesale stores. These trends have great impacts on a retailer’s strategy to survive a recession or downturn.
Retail Economics 101: Business Choices

Managing Inventories and Costs

The art of maintain the profit maximizing level of inventory is difficult in the best of economic times, during a recession it becomes both more critical to success and more difficult. For small retail businesses and independent stores this task is increasingly complicated due to payment terms and minimum order sizes. It is necessary to reduce inventories for most retail establishments particularly those specialty items that aren’t frequent sellers. Reducing existing inventory is typically done via in store sales and specials allowing the retailer to convert some of their existing assets into cash. Converting inventory to cash is an important first step however, most retailers cannot sustain themselves through a recession on existing inventories and therefore must place orders for new inventory under a great deal of uncertainty. This reduction in demand for new inventory sends ripples throughout the supply chain and coupled with high fuel prices results in larger minimum order sizes and less favorable terms for delayed payment. The wisest retail strategy under these circumstances is to order the minimum necessary to sustain existing demand. This is a difficult balancing act as no retailer wants to take the chance of being out of a mainstay item and sending a shopper to another retailer in a competitive market. A wise strategy is to have ample supply of items that sell daily or frequently, typically these are the items that get people into the store. Another strategy is to vary selection, offering less high end items and more inexpensive to moderately priced items for budget conscious consumers. Additional consideration is in the appearance of the store as minimal inventories can convey a negative impression to customers. Often a well stocked store implies a certain success to customers and encourages a better relationship. One means in which to convey the same message to consumers with reduced inventories is to change the appearance of the store and displays. A restaging of the layout of the store can be done inexpensively and with great results and impact. Optimal merchandising and use of space is one non-pecuniary means retailers have to improve their chances of success.

Suppliers facing their own constraints and recognizing retailers need to pull back on inventory spending will offer deep discounts to retailers who place large orders or pay their invoice quickly. For the majority of small and independent retailers these “deals” are a bad idea and can deepen the pain of a downturn. The discounts are intuitively appealing to retailers, however inventory is only as useful to a retailer as its ability to be converted to cash quickly. So while a 70% discount on a unique item may come along once every five years it will be useless if the item is only sold once a month and many must be ordered.

During tough financial times small retailers must put their liquidity ahead of considerations such as profits and markups per unit. Often retailers are hesitant to liquidate or reduce inventory at a loss per unit in tough times and therefore feel a cash-flow crunch. With no cash safety net or reserves, any additional shock to their demand can make fundamental business expense payments difficult to maintain. During a recession, many retailers wind up in bankruptcy for these reasons. Another common mistake is to not anticipate the downturn or underestimate its severity and duration resulting in changes being made too late to be effective.

To withstand the tough times small retailers must be honest about their sales prospects and make difficult choices. The first step is to analyze the inventory for the must haves or staple items and then actively reduce the stock of non-essential items. Next retailers should set limits for ordering new inventory and plan for its ongoing management, presentation and marketing. Finally, the key is to try and acquire as many months of cash reserves as possible that would pay basic expenses such as rent, utilities, and wages.
Retailers from clothing stores to restaurants are experiencing rapidly rising input and inventory prices. Inflationary pressures coupled with the recession make it even more difficult for retailers to survive. The reason is that these increases cannot simply or universally be passed on to consumers, not when they are dramatically cutting back on spending. Additionally, for many retailers and business owners there is an expense to changing prices and with uncertainty about the duration of the downturn these decisions are more difficult.

The goal for many business owners during a recession is to maintain their current levels of income or profit. Perhaps they don't expect to grow but they certainly don't want to lose money. This motivation is why it seems intuitive to raise prices when costs increase, however this strategy may actually result in less income for the business owner. In principle a good has a price that is so high, the quantity demanded by the consumer will be zero, and for many goods if the price were zero demand would be infinite. What happens in between? The answer depends on the type of good, and its elasticity. The price elasticity of a good describes how strong the response of the consumer is in the quantity demanded of a good when the price changes. An inelastic good exhibits little change in the amount demanded by the consumer when prices change while an elastic good sees more dramatic changes. It is unrealistic to think a retailer will know the exact elasticity of a good, however understanding the nature of demand for a good enhances their decision making ability.

Pricing goods based on their elasticity is a smart retail strategy during a recession. Examples of inelastic goods are gasoline (at least in the short run), water, and goods that typically do not have good substitutes. Elastic goods such as dining out, luxury automobiles, and sugar have many substitutes and therefore price increases result in less quantity demanded. The lesson for a retailer is to not raise prices on those goods that your customer can live without or go down the street and purchase in a less expensive form. A gourmet grocer raising the price on a imported spaghetti sauce by one dollar would be foolhardy when a less expensive substitute is readily available. Conversely, daycare providers may find that in the short run they can increase their fees due to rising costs and not see a decline in revenue.

Another reason some retailers may find changing prices difficult is that the process of changing prices has a real cost. This economic concept is known as menu costs and as the name suggests is based on the cost to restaurant of having menus reprinted to reflect new prices. Without knowing how long input prices will be affected it is difficult for some firms to incur the additional expense to raise prices. This transaction cost theory has truth to it but is less applicable when input prices are rising due to long term economic trends and less in response to shocks. However, this theory does point to an interesting dilemma for restaurants. It is more costly for a restaurant to raise prices due to menus and compounding the problem is that dining out is an elastic good. When the economy moves into a recession, people cut back on dining out and substitute eating at home or at less expensive restaurants such as fast food franchises or the new quick-service types. Raising prices for a restaurant can decrease revenue much more than it would otherwise decrease due to smaller profit margins. In the short run, retailers and restaurant owners may not have the opportunity to change their price structure. However, businesses can prepare for the long run by thinking about the choices consumers will face and adjusting the types of goods they offer and the range of prices they charge. For a restaurant this may mean offering lower price options as specials, using less expensive food items, and offering some self service items.
Employment and Labor Costs

According to National Retail Federation research, retail and food and drinking places employ more workers than all other sectors of the U.S. economy. With one in five workers occupying a job in this sector, the impacts of a retail recession on employment will be significant. During the recent boom in consumer spending, the retail sector added hundreds of thousands of jobs. Data from the BEA and BLS from 1980-2003 illustrates that retail employment exhibited average annual growth of more than 1% despite two recessions and one downturn. The fastest year to year growth occurred in the 1980’s following the recession lasting from 1980-1982 with average annual growth in retail employment gaining 4% between 1983-1985. During the recessions beginning in 1980, 1990 and the slowdown in 2001 the retail industry saw declines in employment. The average annual employment declined during these events at .8%.

BEA data indicates that Iowa’s retail sector employment followed national trends over the long run but has deviated in the timing of adjustments. During the recession 2001-2003 retail employment declined nationally as well as in Iowa. Prior to 2001, Iowa employed a larger percentage of its 2001 retail labor force than the nation did and following the recession, Iowa reemployed its retail labor force at a lower rate than the nation did. Iowa’s retail employment began declining in 2007 while the nation’s retail employment was still increasing indicating Iowa’s adjustment to the recession might be more gradual.

The data illustrates that retail employment responds quickly to economic conditions, and cautions that the individual retailer is currently facing difficult decisions with respect to levels of employment and overall labor costs. With input costs rising and structural rigidities affecting a retailer’s ability to maximize revenue, labor becomes an avenue for retailers to reduce costs. Some options businesses use to avoid laying off employees is reducing hours from full to part time, using less employees per shift, and reducing store hours. None of these are desirable solutions as employees are often family in smaller retail establishments and reducing hours makes it more difficult to compete with discounters. Another option retail businesses often revert to is becoming a non-employee establishment to weather these downturns. Again, the decline in retail employment has ripple effects throughout the economy and forces the individual retailer to make tough decisions to survive.

IOWA’S RETAIL EMPLOYMENT FELL BY NEARLY 3% DURING THE MIDDLE OF THE MOST RECENT DOWNTURN
Retail Economics 101

Tips for Consumers and Retail Shoppers

1. Now is a good time to be a consumer. You might have less money to spend but retailers want your money more than anytime in recent history. Take some time to shop around for the best prices, environment and service.

2. Your dollar is your vote. If you really enjoy shopping at a local retail store don’t expect it will be waiting for you to come back if you switch your shopping habits. Choose where you spend your dollars based on whom you would most like to continue doing business with.

3. Be reasonable about where you travel to shop. Driving an additional ten miles to save $1.00 probably isn’t worthwhile, try and maximize your savings per trip.

4. Limit credit card use. Retailers may be running great specials but stocking up at 70% isn’t saving you money if the balance stays on your credit card for multiple billing periods.

Tips for Retailers and Business Owners:

1. Just like consumers shouldn’t rely on debt to purchase items at a discount neither should you. Financing unnecessary inventory with debt because it is being offered at reduced prices won’t make you money in the long run.

2. Offer consumers lower price substitutes in your store. Lower price point options may keep a consumer in your store from shopping at a discounter.

3. Don’t be afraid to have sales or specials to move inventory. The downturn won’t last forever and getting more people in your store or restaurant is the key to building long lasting customer relationships and repeat business. You might not make the same profit per item or entrée that you were prior to the downturn, but you are making sales and meeting customers.

4. Don’t assume the raising prices will keep your revenue stream stable during a downturn. The price elasticity of the goods you sell will determine whether you can raise prices or not. Do not raise prices on highly elastic goods as this will reduce the quantity demanded dramatically.

5. Know your inventory. This might include keeping detailed records or journals of what you sell the most of and to whom. Pay attention to your competition and their prices. Being in touch with the nature of your inventory can limit lost revenue with respect to price changes and stocking of inventory.

6. Consider low to no cost options to revitalize your space. Changing the layout of your store can add instant appeal with little or no expense.

7. Be prepared to make some sacrifices and tough choices. Plan for the future and think strategically about where you want to be when the down time ends.

8. Listen to your customers, they are your greatest asset.
For more information about retail trends and performance in Iowa’s communities please contact the author or visit the ReCAP website to view online copies of retail reports for all 99 Iowa Counties and over 700 Iowa cities. Data used in this report can be found at the following websites:

www.bls.gov
www.bea.gov
www.census.gov

Additional Websites of Interest:

National Retail Federation, www.nrf.org
Plunkett Research, www.plunkettresearch.com
Market Watch, www.marketwatch.com