SMEs' Exposure to Inflation Risk

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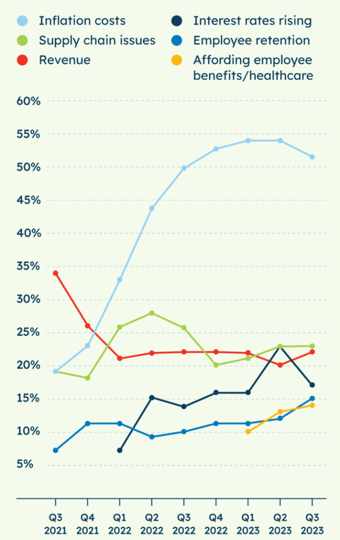
Inflationary pressures and SMEs



Source: U.S. Chamber of Commerce (2023, [5])

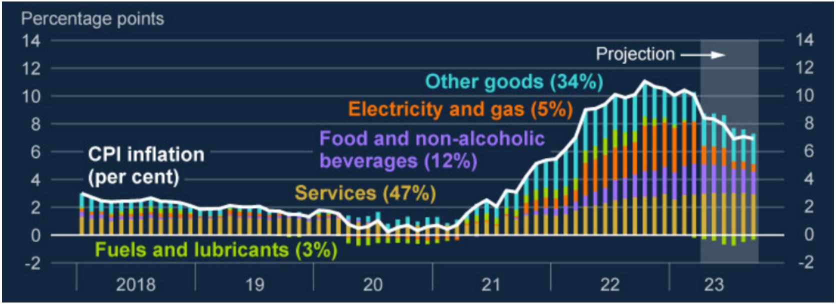
This paper:

(How) does inflation in the UK affect SMEs' profitability at the regional and sectoral levels?

My suggestions are about:

1. Nature of inflation
2. Measure of performance
3. The price effect of inflation

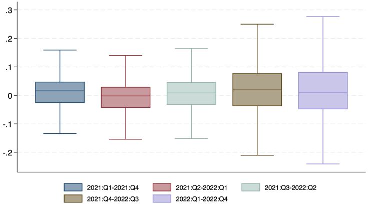
1. Covid pandemic, invasion of Ukraine and UK core inflation



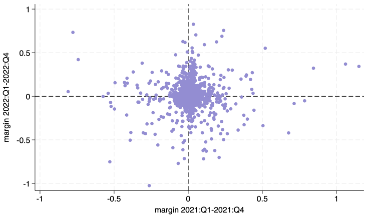
Note: BoE (2023, [1])

1. SMEs' exposure to inflation over time

Gap distribution widens over time



Some winners become losers and v.v.



Identify what drivers of $\Delta\pi$ affect gap distribution

Break down intermediate input I in inflation measure

$$P_{s,t} = \sum_{j=1}^{N_s} (W_j^I \times P_{j,t}^I) + W_s^L \times P_{s,t}^L$$

Identify the effect of each driver of $\Delta\pi$ in a panel analysis

Related points:

- Include region and time FEs in measuring exposure to inflation
- Conduct analyses at firm levels

2. Measuring (operational) performance

"To better capture changes in the **firm's operational performance**, *we subtract any inflows resulting from the firm taking new loans [...]"*

- A cash payment in t associated with an economic transaction happening in $t-1$ increases performance in t?
- New capital increases performance but not new debt?

"Similarly, [...] the expense variable tracks the total amount of outflows from all current accounts that are held by the firm. The outflows encompass various types of expenditures such as labor and non-labor costs, capital expenditures, shareholder payouts as well as debt servicing costs."

- An investment in t reduces performance?
- Dividends are considered as income!?

2. Cash or profit?

- Profitability of a business during a given period is assessed using the income statement, regardless of when cash arrives or leaves the company (cash flow statement)
- The importance of accruals increases the shorter the performance measurement interval (Dechow, 1994 [2])
- Income and expenses are not cash flows and v.v. and unclear how they are correlated (across sectors and over time)
  - E.g., Dechow et al. (1998 [3]) show that earnings better predict future operating cash flows than current operating cash flows

2. Measurement and result interpretation

What do inflows/outflows of funds from firms' current accounts capture?

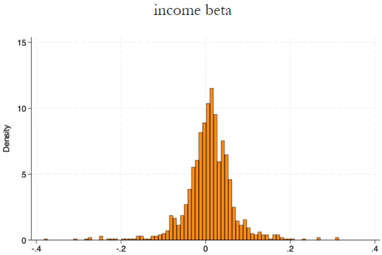
- Movement of cash and cash equivalents with some corrections
- Total (net) cash flows (i.e., operating, investing and financing activities) with some corrections
- Financial health

What is a (better) interpretation of the results?

1. Main result: on average firms manage their cash inflows and outflows to hedge inflation shock
2. Industry/sectoral heterogeneity (winners/losers):
   (a) Operating cash flows: product market competition, bargaining power with key stakeholders, international exposure (exchange rate)
   (b) Investing cash flows: ?
   (c) Financing cash flows: leverage
3. Time variation: cash flow volatility can account for the fact that some winners becomes losers and v.v.

3. Price or quantity?

"The presence of negative values means that, in some industry-regions, firms' nominal income and expenses decline, on average, as inflation increases."



This suggests, interestingly, that inflation affects SMEs' performance by driving quantities (see Nakamura and Steinsson, 2008 [4]) ⇒ further explore as a channel (elasticity of demand curve)

My take

- Super relevant and important study
- Great data and setting (micro to macro aggregation)
- The (preliminary) findings show great promise for an excellent paper
- My suggestions:
  - Examine the drivers of inflation in a panel analysis
  - Clarify what you exactly measure by “income” and “expenses”
  - Explore the channels (efficiency, competition, bargaining power, demand elasticity)
- Looking forward to read the paper ☺ and good luck with it!

Thank You!

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