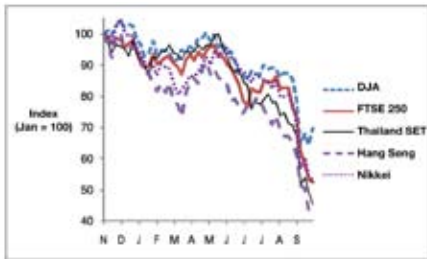


How should the global financial crisis affect your freight strategy?

David Jacoby

Stock markets worldwide have been impacted by the current market crisis, some dropping more than 50%, and it looks like growth will be nonexistent or negative in 2009. The run-up was extraordinary, so we have to expect some overcorrection. Drama aside, the question for supply chain practitioners is: what actions should be taken during this period of dramatic change?

Figure 1: Stock Market Values since November 2007



Freight rates have also fallen substantially. Freight rates are down as much as 40% in some markets, and since the beginning of the year rates on some trades have fallen by 60-80% if you take into account some structural overcapacity problems, such as those existing in some bulk markets. The declines in the prices of oil - which had driven up the cost of fuel - and steel - which increased volume and distance and also drove up the cost of ships - have really brought rates down.

These cost increases are a major factor, but a fundamental softening of demand may be as significant. From a traffic volume standpoint, the main driver of the decrease would be a decline in the demand for low-cost discretionary goods, which represent a large share of the volume. Demand for, and hence trade of, capital goods would

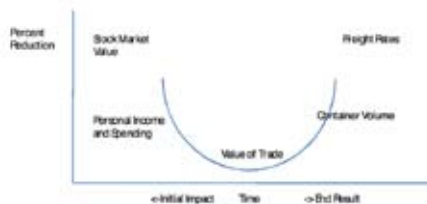
drop by more than consumer discretionary goods, but they don't represent as much of the total volume. Demand for basic food products would not fall as much, and neither would luxury goods, which are relatively price-inelastic.

Figure 2: Effect of a Recession on Consumption



The drop in demand has an indirect effect on freight rates. In an hypothetical incremental scenario, let's say that a 10% drop in the stock market, through its impact on disposable income and home equity, results in a 1% increase in unemployment. That would cut consumption, and by extension the value of trade, by a similar amount. Volume would drop by a little less because some traffic is relatively inelastic (for example, food products). If carriers are aggressive, they reduce freight rates by slightly more than the drop in trade in an effort to recapture lost traffic volume.

Figure 3: Effect of a Reduction in Trade on Freight Rates



But today's times are not incremental. The markets are over-correcting and many people don't expect them to bounce back soon. Both the bullwhip effect of over-correction and the pessimistic outlook are exacerbating the fall and together could result in a downward spiral. The sharp drop in stock values and its associated impact on wealth and disposable income could result in a severe loss of jobs and reduction in consumer and business spending over the medium term, which could result in further reductions in trade, traffic, and rates.

While shippers normally redesign their supply chain network every several years, the sharp reduction in rates and trade volumes make it imperative for shippers and carriers to review their networks now. Shippers should evaluate the economics of every lane, benchmark rates and costs, and renegotiate fuel surcharges. Boston Strategies International just negotiated a 46% reduction for one shipper due to the new rate environment. Carriers and 3PLs should assess current and forecast traffic volumes and margins by lane and type of cargo, reassess their competitive differentiation, and adjust pricing to be competitive while still placing a premium on their unique value-added.

Good times are ahead, but nobody can ignore the immediate and significant changes that have occurred. Due to the magnitude of the changes, both shippers and carriers must review their supply chains and adapt their costs and rates to these new realities.

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