Are profits driving inflation?

August 2023

Inflation has been above the 2% target since August 2021, averaging 9.3% in the first half of 2023. Inflation was first driven up by pandemic-related supply chain frictions, and then by energy and other commodity prices, exacerbated by the war in Ukraine. The role of external factors in driving UK inflation over the past three years is now fading, but domestic price pressures have strengthened, with core CPI inflation, services price inflation and wage growth close to multi-decade highs. One suggestion is that rising prices are being driven by growth in companies' profit margins, but at the macro level the evidence does not support this. If anything, CBI business surveys suggest that a squeeze on profits has worsened in recent months, which may be prompting some firms to put investment plans on hold.

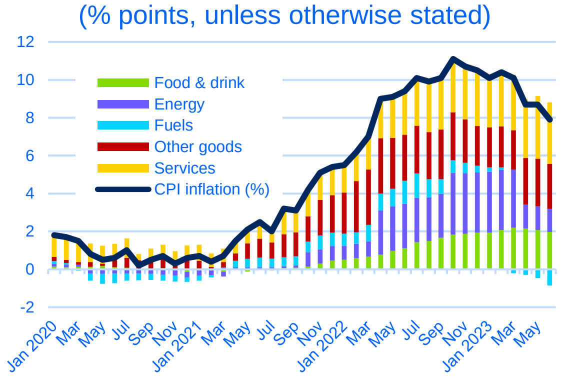
Inflation is increasingly being driven by domestic price pressures

Recent inflation data have underlined the diminishing role of imported inflation, following the twin shocks of pandemic-related disruption (on goods prices) and the war in Ukraine (which caused energy and food prices to spike). Falling fuel prices and slower annual food price inflation helped push the headline rate of CPI inflation down to 7.9% in June, from 8.7% in May and a peak of 10.1% in October 2022 (see Chart 1, below). And headline inflation is expected to slow further in the coming months, partly because lower wholesale energy prices paved the way for a significant cut to household electricity and gas bills from July.

By contrast, the importance of more domestically generated price pressures has grown. While goods inflation (more heavily influenced by global factors) peaked in October 2022 at 14.8% and has since come down sharply to 8.5% in June, core inflation (excluding food and energy) and services inflation continued to rise through much of 2023, from 6.5% and 6.3% last October, respectively, to 6.9% and 7.2% in June. This is clear evidence of “second round effects” at work, as workers seek to restore purchasing power through higher wages and companies try to rebuild their profit margins. The link between strong wage growth and high core and services price inflation is clear from Chart 2 below, but what can we say about the role of profits in driving prices higher?

Chart 1

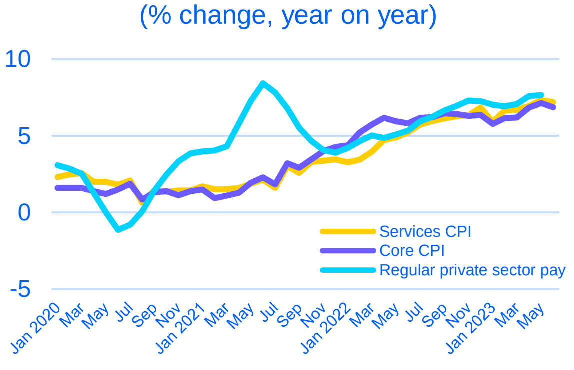
Contributions to CPI inflation
(% points, unless otherwise stated)



Sources: ONS; Bank of England.

Chart 2

Inflation indicators and pay
(% change, year on year)



Sources: ONS; Macrobond; CBI calculations.

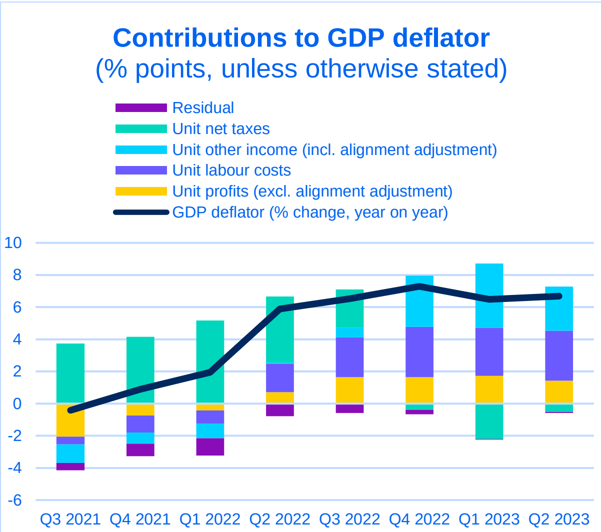
Profits have recovered, but not excessively

One way to assess the impact of profits on prices is by using the GDP deflator, which is a measure of the price of domestically produced output[1]. Changes in the GDP deflator tend to mirror changes in core inflation over time, but because it is derived from the national accounts it can be decomposed to show the contributions from labour costs, profits and net taxes (i.e., taxes minus subsidies).

Chart 3 illustrates the gradual strengthening of domestic price pressures from the middle of 2021 and the role of these different factors, which are expressed in "unit" terms (i.e. the contribution per unit of output of labour, profits, etc,). One striking feature is the large contributions of increasing unit net taxes through to mid-2022, which reflected the scaling back of pandemic-era income support. The contribution of net taxes then turns negative from Q4 2022, reflecting large payments by the government to limit the impact of higher energy prices on households and businesses. As changes in taxes and subsidies correspondingly affect household or business incomes, such large swings highlight the need for some caution in interpreting movements in other factors.

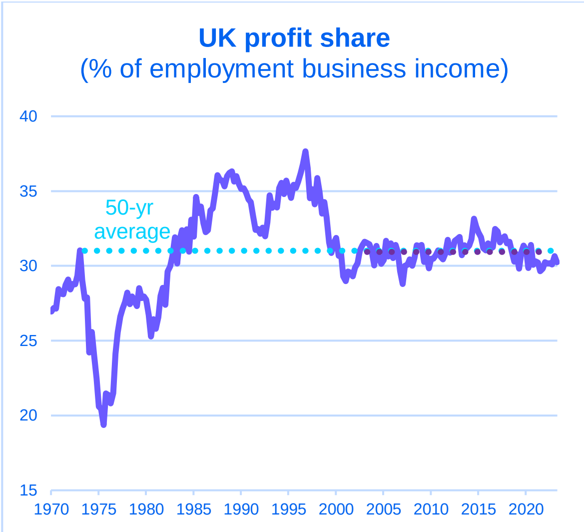
Chart 3 also highlights the significant role of labour costs in driving domestic price increases over the past year or so. Unit labour costs contributed 3.1% points to the 6.7% increase in the GDP deflator over the year to Q2. The contribution of unit profit growth has also recovered over the past year or so, though fell slightly in Q2. Contributing a more moderate 1.4% points in Q2, it's clear that profits have added less to domestic inflation than labour costs. This is partly because labour compensation accounts for the largest share of incomes generated within the economy. However, even taking the recovery of profits in recent quarters into account, their share in total business income (profits plus compensation of workers) remained slightly below the long-run average in Q1, as can be seen in Chart 4.[2]

Chart 3



Sources: ONS; Macrobond; CBI calculations.

Chart 4



Sources: ONS; Macrobond; CBI calculations.

[1] The GDP deflator is calculated as the ratio of the nominal value of goods and services produced domestically to their volume. By definition GDP excludes imports, so the GDP deflator is a good proxy for the price of domestic production.

[2] These conclusions should be regarded with some caution, given the potential for revisions to early estimates of the national accounts, as reflected in large "alignment adjustments" in current data for Q4 2022 and Q1 2023. This is an adjustment made by ONS to balance different measures of GDP, which in this case represents unallocated income. It is typically included with the gross operating surplus of non-financial corporations, the category believed to have the lowest accuracy, but for the purposes of this article the alignment adjustment has been included in the other income category.

Trends in profits have varied across sectors

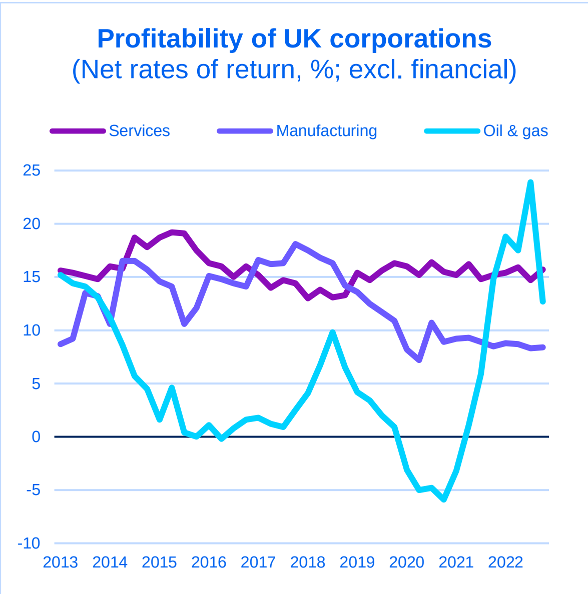
Alternative measures of profitability support a view that higher margins or mark-ups have not contributed significantly to rising prices.[3] One source is the ONS's data on net rates of return for private non-financial corporations operating (defined as the gross operating surplus of corporations, net of depreciation as a share of capital employed in production). Excluding the offshore oil and gas sector, aggregate profitability generally fell over 2021-22 (the latest available data).

As can be seen in Chart 5, manufacturing profitability has been particularly weak, dropping to 8.4% in Q4 2022, well below the average for the previous decade (12.5%). Profitability in the services sector has been more stable (15.7%, in line with its recent average). One sector that has seen an increase is offshore oil and gas, where rates of return are influenced by (often volatile) global energy prices. Net rates of return for companies operating on the UK continental shelf surged to an average 18% in 2022, though this followed a weaker period over the early years of the COVID-19 pandemic (4.7% in 2021 and -4.7% in 2020).

A second source of insight into changes in firms' profit-behaviour comes from business surveys, which also offer a more timely view of trends in margins than official data. The purple bars in Chart 6 show a weighted composite of profitability growth derived from the CBI's services and manufacturing surveys, which suggest that after falling in 2022 profitability deteriorated further during the first half of 2023.

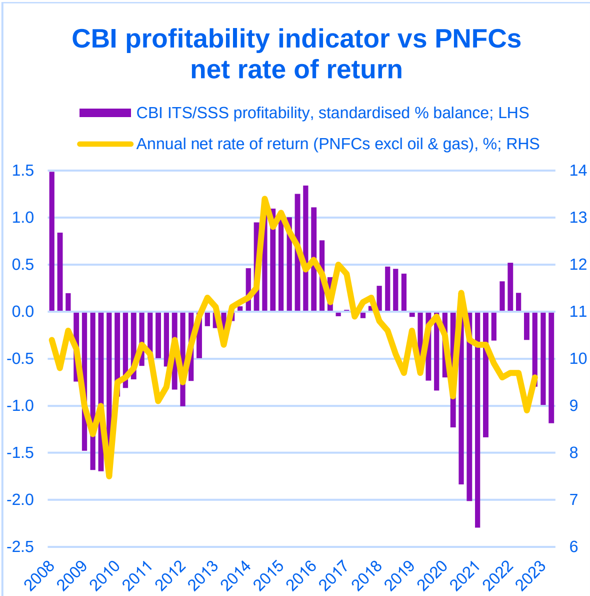
A similar picture emerges from the Bank of England's Agents' scores for profit margins, which point to significant reductions in profit margins between October 2022 and July 2023. Meanwhile, the Bank of England's Decision Makers' Panel for July also found that a net balance of firms reported a fall in profit margins over the past year, but that more firms expect margins to increase in the coming year than expect them to fall. If this proves to be the case, this could slow the descent of inflation.

Chart 5



Sources: ONS; Macrobond; CBI calculations.

Chart 6



Sources: ONS; Macrobond; CBI.

[3] As an indicator of firms' behaviour, the measure of profits derived from the national accounts (the gross operating surplus of corporations, or GOS) has its limitations. Close to half of GOS (45%) is accounted for by depreciation, which should be thought of as a business expense rather than income that could be distributed to shareholders or workers. It also possible for GOS to increase without an increase in profit margins or "mark-ups" if more capital has been used in production. Other profitability measures, such as net rates of return or self-reported profitability from surveys, can correct for this.

Squeezed profits could dampen investment

The outlook for firms' profitability has important implications for economic growth and the direction of interest rates. If high inflation is squeezing profits (as well as wages), firms may respond by cutting back hiring or investment to restore their profit margins, weighing on the level of aggregate demand. For example, CBI members in food manufacturing—a sector that is seeing high rates of cost and price inflation—have reported that badly needed investment in the supply chain is not taking place due to pressures on margins. Our latest Industrial Trends survey for July 2023 also shows a notable softening in investment intentions in the manufacturing sector more broadly, owing to a combination of uncertain demand, inadequate net returns and a rising share reporting a shortage of internal finance, as well as higher finance costs.

By contrast if, as the DMP survey suggests, profit margins are poised to recover, this could slow the descent of inflation, while helping support employment and investment. A higher level of aggregate demand could ultimately require a comparatively tighter monetary policy stance to return inflation to target. While the role of corporate profits has generally not played a significant role in driving inflation to date, it could come under more scrutiny in the year ahead if inflation is slow to come down and interest rates stay higher for longer.

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