European Economics Analyst

The Role of Profit Margins in Euro Area Inflation (Schnittker)

- The outlook for profit margins has gained policymakers' attention as a key factor in determining when and how quickly Euro area core inflation will cool from the current high levels. Unit profit growth now accounts for more than half of GDP deflator growth, with compensation per employee growth explaining a little over a third. While unit profit growth has been strong across sectors, contact intensive services following the pandemic re-opening and energy have been the biggest contributors to aggregate unit profit growth.
- Following the sharp decline in gas prices, however, unit profits in the energy industry should decline, too. Surveys also suggest that margin growth is peaking, with room for some margin compression in particular in manufactured goods. Historically, higher wage growth has also led to slower margin growth, as some of the increased labour cost is absorbed into firms' profit.
- We estimate the effect of these factors using a simple statistical model. This suggests that unit margin growth should cool quite rapidly this year, as lower growth makes it harder for firms to raise their prices, while strong wage growth eats into unit margins. The deceleration of activity growth over the last year and our expectation for subdued Euro area growth this year is also likely to weigh on margin growth.
- The outlook for inflation therefore is driven by a combination of two factors: higher wage growth is likely to push up inflation but a more subdued margin outlook is likely to weigh on it. On net, we forecast that stronger wage growth is likely to continue to push up on inflation, but that this will be offset by lower margin growth across goods — where margins are already plateauing — and lower services margin growth due to their sensitivity to wage growth. We therefore look for sequential core inflation to slow from 0.4%mom in March to 0.2%mom in December, implying a year-on-year rate of 3.9%yoy by year-end.

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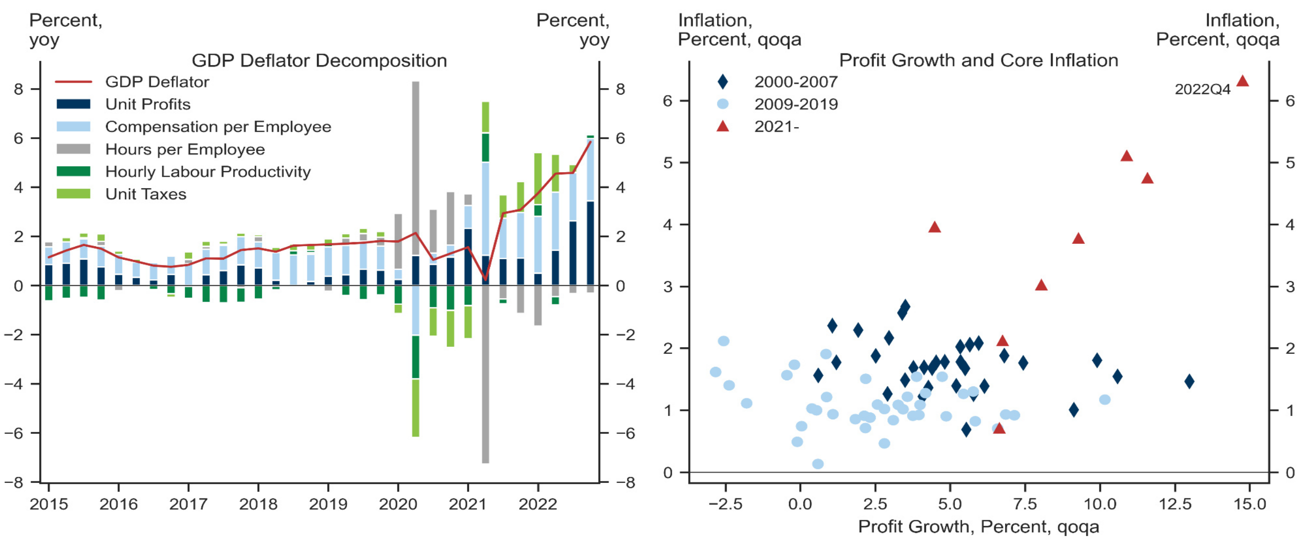
The Role of Profit Margins in Euro Area Inflation

Profit margin pressures have taken centre stage together with the outlook for wage growth for the core inflation outlook. As a recent ECB blog argues, the key question is how to allocate the cost of higher energy prices between firms and workers. If both workers and firms try to offset any real income losses, a spiral could emerge that keeps inflation persistently elevated. In today's Analyst we therefore take a deeper look at Euro area margin growth.

Unit profits now account for over half of the growth in the GDP deflator (3.4pp), followed by compensation per employee (2.5pp, Exhibit 1, left). Historically higher unit profit growth has not always coincided with high core inflation as the economy-wide labour share has shrunk (2000-2007), or moved largely sideways (2009-2019). But since the onset of the energy crisis, both core inflation and unit profits have moved up together (Exhibit 1, right).

Exhibit 1: Significant Contribution of Unit Profits to Price Pressures

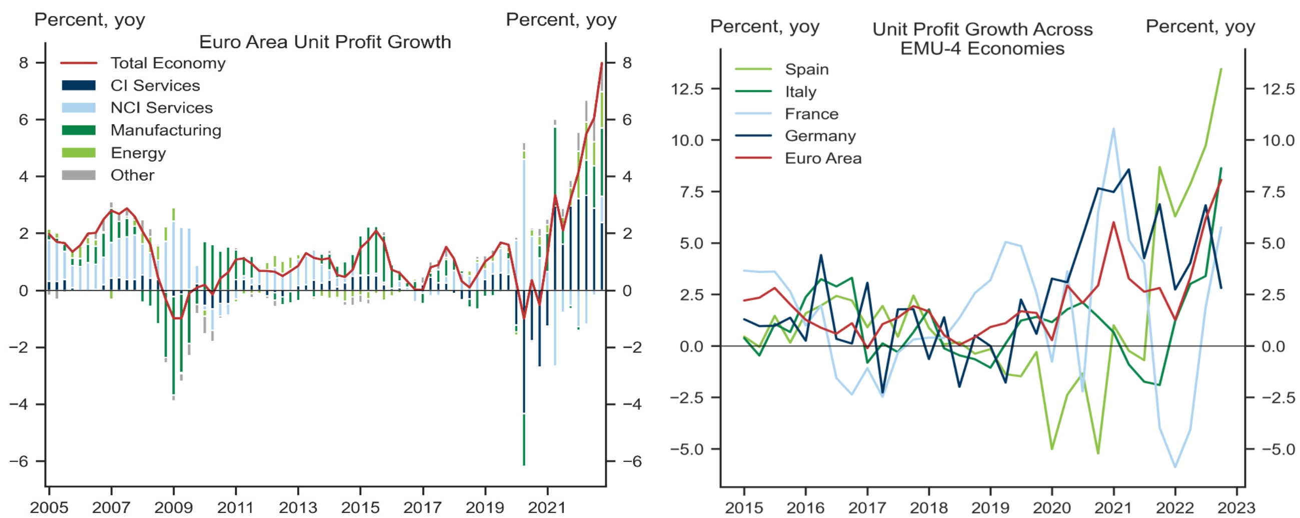


Source: Goldman Sachs Global Investment Research, Haver Analytics

Broad Based Strength in Margin Growth

Importantly for the core inflation outlook, aggregate unit profit growth in the Euro area has been driven by contact intensive services to a significant extent (dark blue bars, Exhibit 2, left). The country dimension shows a similar picture: aggregate unit profit growth is running hottest in the South, which is more reliant on services (Exhibit 2, right). Within this, manufacturing profits — notably in France — have also risen sizably, in particular in Spain contact-intensive services (eg tourism) saw the sharpest unit profit growth.

Exhibit 2: Energy and Contact Intensive Services are Major Drivers of Profit Growth

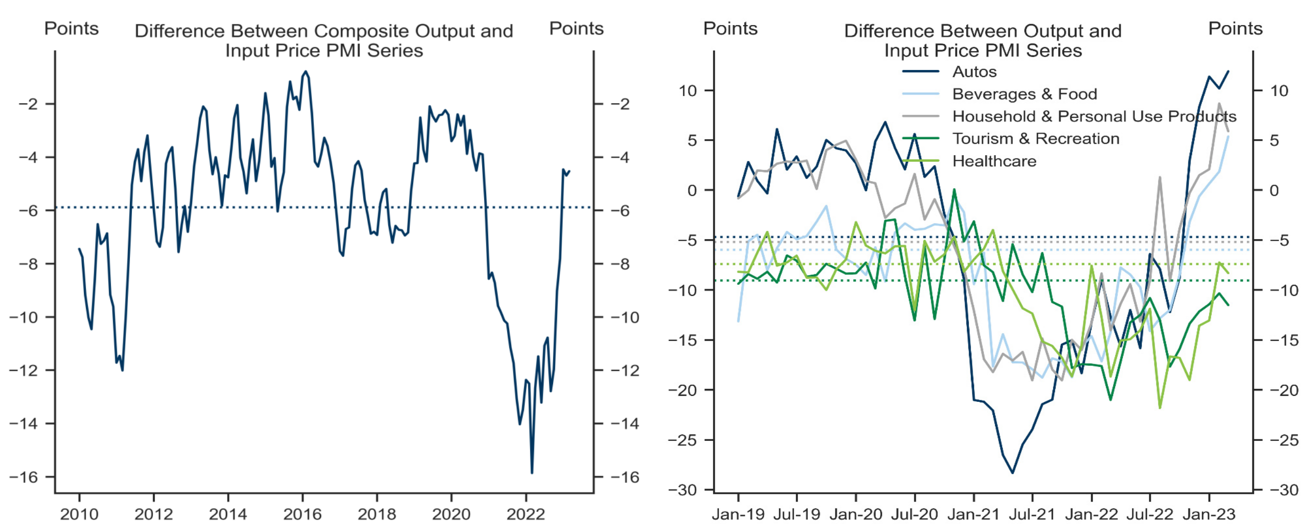


"CI Services" refers to contact-intensive services, and includes wholesale and retail trade, transport, accommodation, and food, and arts, entertainment and recreation, and other service activities.

Source: Goldman Sachs Global Investment Research, Haver Analytics

Euro area gross operating surplus data is only available until end-2022, however, making it hard to gauge whether this trend is continuing. More recent survey data suggests that margin growth has peaked and is starting to ease (Exhibit 3, left). For core goods inflation, the level of the gap between PMI output and input prices remains elevated relative to historical standards for manufactured products, suggesting room for disinflationary pressures going forward. Services margins, meanwhile, still look subdued both at an aggregate and industry level, paving the way for potentially more sequential inflation pressures (Exhibit 3, right).

Exhibit 3: Lower Profits in Services, Somewhat Higher Manufactured Products

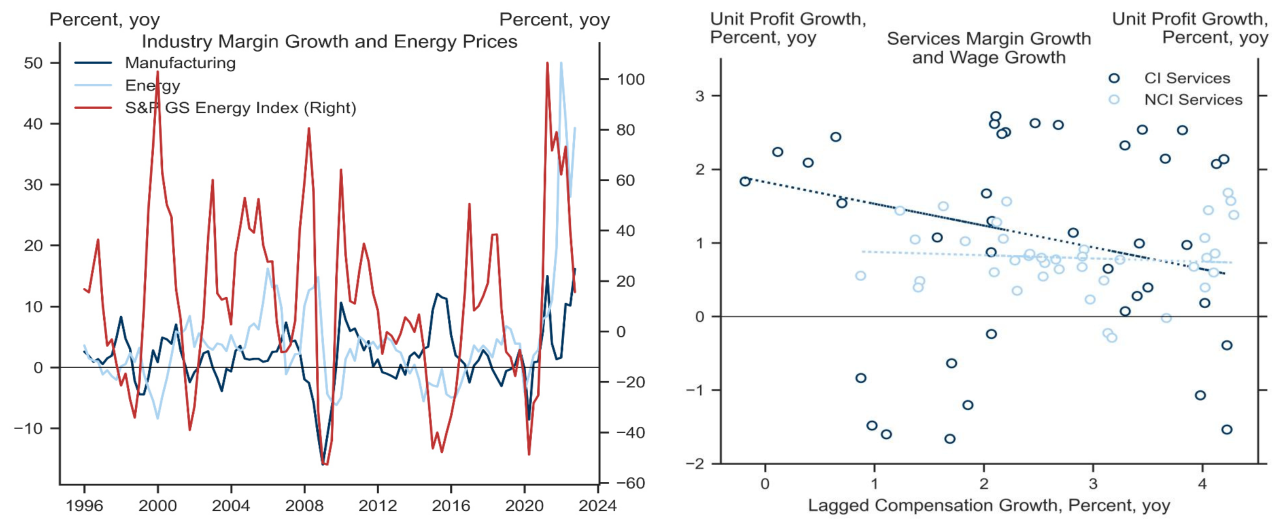


Source: Goldman Sachs Global Investment Research, Haver Analytics, Markit

A Subdued Picture for Margins Supports a More Benign Inflation Outlook

Next we turn to the underlying drivers of margin growth and the implications for the outlook. Economy-wide margins data is only available at a high level and is released with a sizable lag (latest data available is Q4). But historical data suggests a few patterns: first, energy margins tend to increase in line with energy prices (Exhibit 4, left). Given the decline in gas prices since the highs of last year, we would expect energy margins to start to decline over the course of 2023. Second, manufacturing margins historically have tended to rise when energy prices fall, but given the already elevated level of margins, in addition to declines in other manufacturing input costs as supply chain pressures continue to ease, we see limited room for further price increases to prop up margins. Third, services margins tend to move inversely with wage growth, albeit with a lag, and more strongly for contact intensive services (Exhibit 4, right). Historically higher compensation growth has led to lower margins growth, and we would expect the continued strength in pay growth to weigh on services margins going forward.

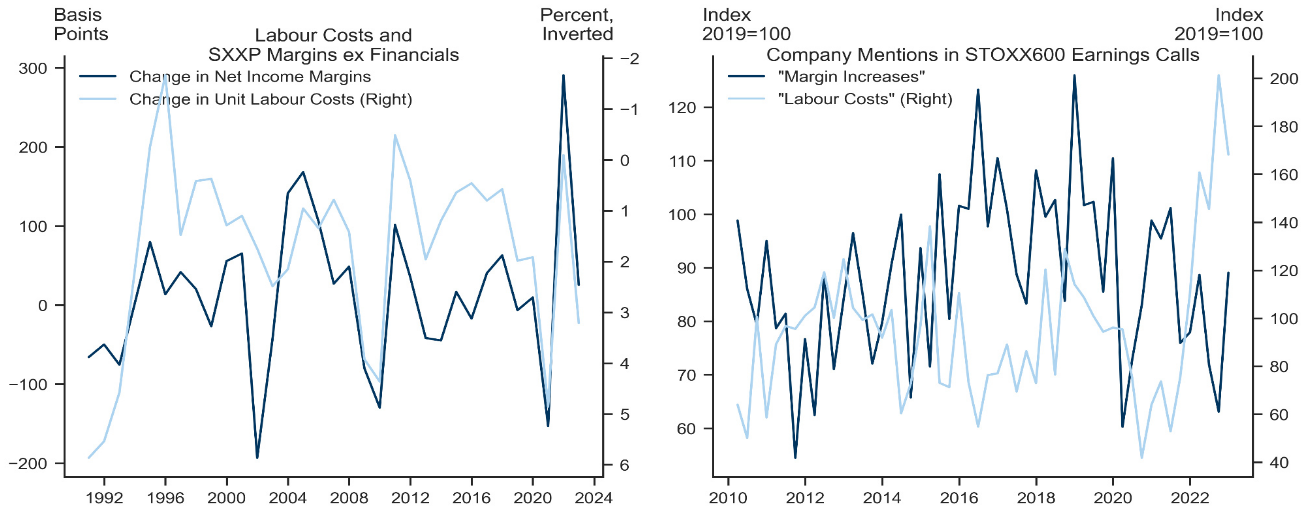
Exhibit 4: Margin Growth Slowing on the Horizon



Source: Goldman Sachs Global Investment Research, Haver Analytics

This pattern of slower margin growth across industries is also broadly corroborated by alternative data sources: listed companies' net income margins tend to decline in periods of high wage growth, which is the key driver behind our portfolio strategists' expectation of weaker margins growth going forward (Exhibit 5, left). And while mentions of "Margin Increases" in earnings calls have picked up again, these remain well below previously highs (eg 2016 and 2019) when aggregate margins growth in the Euro area increased. At the same time, concerns around labour costs in earnings calls remains close to all-time highs, likely weighing on the margin outlook going forward (Exhibit 5, right).

Exhibit 5: A Subdued Earnings Calls Outlook for Margins

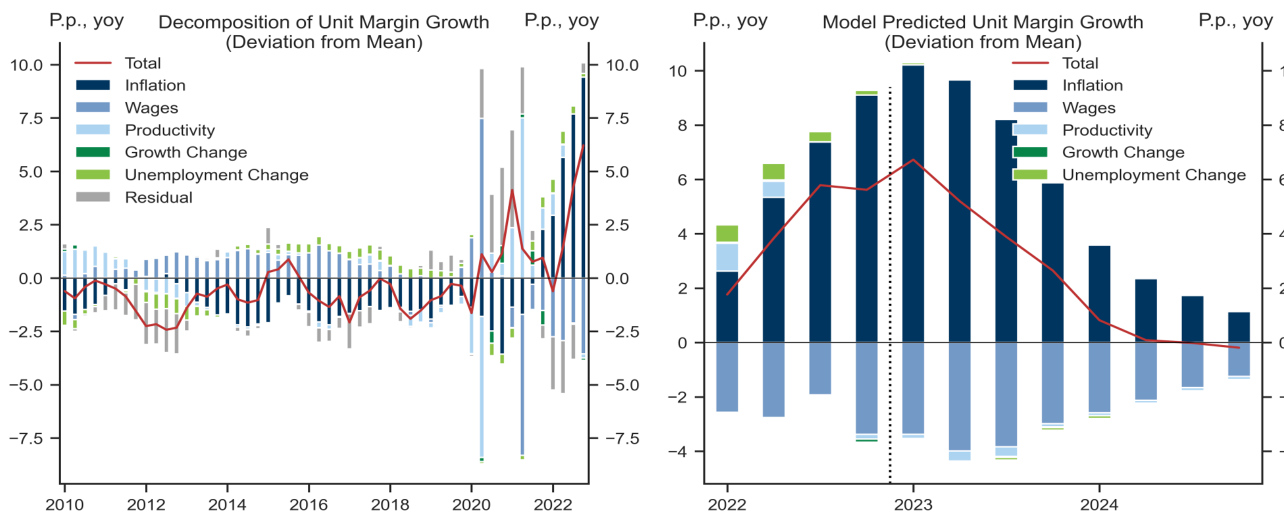


Source: Goldman Sachs Global Investment Research, Haver Analytics

To quantify these effects for the outlook we estimate a simple statistical model. We regress the quarterly growth rate of unit profits on (lagged) core inflation, wage growth, productivity growth, changes in GDP growth (to proxy for an accelerating or decelerating growth environment), and the change in the unemployment rate (to proxy for the general demand level). As expected from economic theory, the model suggests that margin growth tends to increase in a high inflation environment, but contract when wage growth is rising. Productivity enhancements lead to rising margins, while in an accelerating growth environment (the change in the GDP growth rate is positive), margin growth tends to rise, but they tend to fall when unemployment is rising.

The left panel of Exhibit 6 shows the historical decomposition of this model: pre-covid, a low inflation environment weighed on unit margin growth in the Euro area, while subdued wage growth was largely supportive of unit profit growth. During covid, large swings in compensation growth (due to short-term work schemes), and changes in productivity (compositional changes in the economy) were the main factors behind unit margin growth fluctuations. More recently, however, the higher inflationary environment has allowed firms to pass on not just their increased input costs, but also raise unit margins, which was only partially offset by increasing wage growth. Looking ahead, our simple model suggests that unit margin growth should cool rapidly this year, as lower growth makes it harder for firms to raise their prices, while strong wage growth eats into unit margins (Exhibit 6, right).

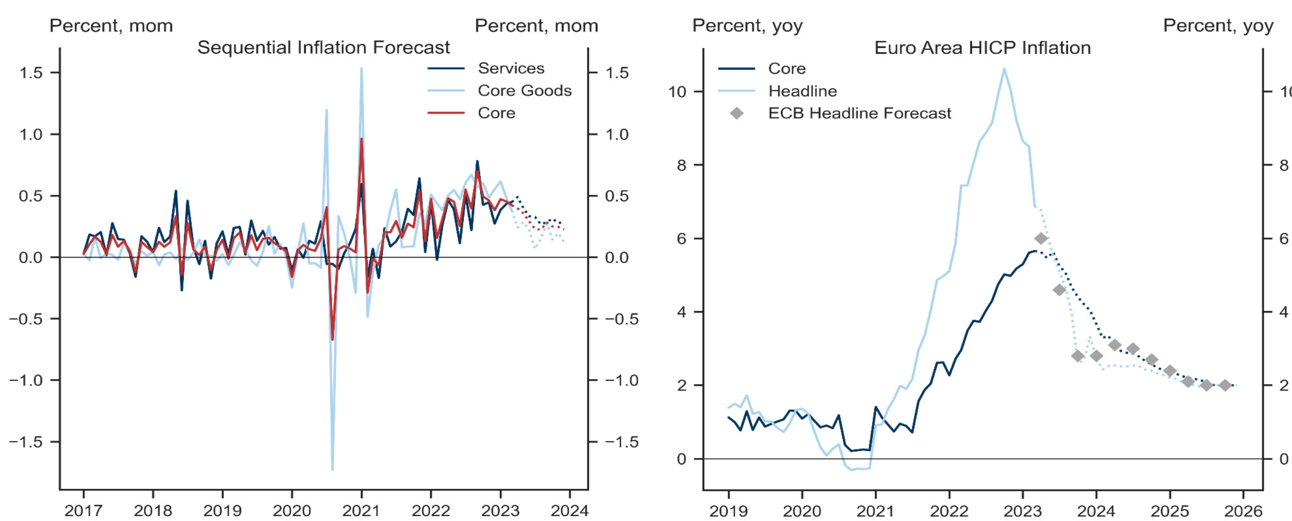
Exhibit 6: Margin Growth to Slow Sharply over the Course of the Year



Source: Goldman Sachs Global Investment Research, Haver Analytics

The outlook for inflation therefore is driven by a combination of two factors: higher wage growth is likely to push up inflation but a more subdued margin outlook is likely to weigh on it. On net, we forecast that stronger wage growth is likely to continue to push up on inflation, but that this will be offset by lower margin growth across goods — where margins are already plateauing — and lower services margin growth due to their sensitivity to wage growth (Exhibit 7, left). We therefore look for sequential core inflation to slow from 0.4%mom in March to 0.2%mom in December, implying a year-on-year rate of 3.9%yoy by year-end (Exhibit 7, right).

Exhibit 7: We Expect Continued Service Price Pressures, but Look for Lower Core Goods Pressures



Source: Goldman Sachs Global Investment Research, Haver Analytics, European Central Bank

We see two main risks to this outlook: first, stronger-than-expected wage growth could keep in particular sequential services inflation elevated for longer, though this could be buffered to some extent by slimmer margins. Second, our commodity strategists expect European gas prices to rise again as storage needs rebuilding ahead of next summer:

this could push energy margins up once more (though consumers will likely be protected from this to a large extent through the introduction of price caps), and could delay the easing in sequential core goods pressures.

Christian Schnittker

Disclosure Appendix

Reg AC

We, Sven Jari Stehn, Christian Schnittker, Filippo Taddei, James Moberly, Alexandre Stott and Ibrahim Quadri, hereby certify that all of the views expressed in this report accurately reflect our personal views, which have not been influenced by considerations of the firm's business or client relationships.

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