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Seller's Inflation

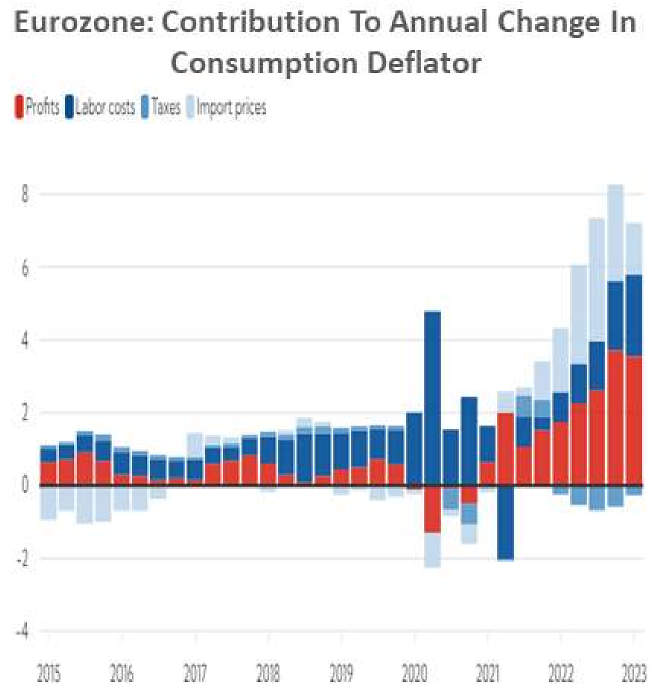
Corporate profits are being challenged by market forces, diminishing pricing power.

Two years ago, many were of the view that price gains would be temporary and would vanish as the pandemic's damage healed. Instead, inflation has turned out to be anything but transitory, spreading to nearly every sector across economies. The search for root causes has been intense.

Central banks and governments are certainly among the main culprits, having implemented pandemic responses that were often too big, too wide and too long-lasting. However, fiscal policy has normalized and central bank leaders have responded with the most aggressive tightening campaign in decades. Pandemic-driven supply chain problems were early contributors to inflation but have largely been solved. Commodity prices are well below their recent peaks. Why, then, are price increases still rampant?

High inflation did not put a dent in corporate profits; higher costs of inputs were passed along to final prices, squeezing household incomes. But some price moves seemed too rapid and disproportionate to be explained by costs alone. Hence, "greedflation," where corporations are seen as gouging consumers and fueling inflation, is no longer a fringe theory.

Businesses always set prices to maximize profits. When changing demand patterns and stimulus make buyers willing to pay higher prices, sellers capitalize. But when prices of goods and services grow more rapidly than input costs, it attracts greater attention. Recent remarks from some central bankers and other prominent observers have reflected some concern that this is the case today.



Sources: Axios, FactSet, BEA, IMF

"Greedflation" claims predate COVID. Former U.S. labor secretary **Robert Reich** has long argued that higher inflation results more from excess corporate power than demand-supply mismatches. One contributor to this trend has been five decades of corporate consolidation, which has reduced competition. According to **researchers** at the Federal Reserve Bank of Boston, monopolistic concentrations made U.S. inflation worse than it would have been otherwise between 2005 and 2018.

Though American industries have become more concentrated, inflation remained contained for most of the last 25 years. Pricing power, the ability to increase selling prices without losing business to a competitor, was non-existent amid increasing globalization (see chart panel below). Shortages during the COVID era provided opportunities for firms to expand their margins.

We have seen this develop in waves. First, with activities restricted, consumers spent primarily on household goods. When public health restrictions receded, consumers were eager to

return to spending on services like travel and dining. The splurges collided with disrupted supply. This created a seller's market, giving businesses more pricing power.
The outcome was a surge in corporate profits, which rose to points well above pre-pandemic levels in the U.S. and the eurozone, relative to gross value added (GVA). Profit margins of U.S. non-financial corporates (NFCs) jumped to a multi-decade high of about 18% in early 2021. Gross profit share of European NFCs as percentage of GVA rose from 39.8% just before COVID to a peak of 41.2% in the second half of 2021.
Energy and contact-intensive sectors were the biggest contributors to aggregate unit profit growth in the eurozone. In a year when consumers faced soaring energy prices, profits of British oil & gas firms surged 170% year over year in the third quarter of 2022 and were 15 times higher than two years earlier.

Sources: Oxford Economics, NFIB

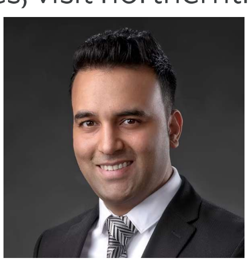
A European Central Bank **blog post** showed that unit profits contributed around one-third to the gross domestic product (GDP) deflator between 1999 and 2022. The contribution doubled to an average of two-thirds last year, as households suffered the greatest cost of living crisis in decades.
Historically, corporate profit growth in the U.S. has accounted for about one-third of inflation. But a **paper** from the Federal Reserve Bank of Kansas City found that about 60% of inflation in 2021 was driven by corporate bottom lines.
Outside of the energy sector, the U.K. appears to have bucked this trend. Corporate profit margins in Britain have been below their historical average in the manufacturing and service sectors. As a share of GDP, NFCs' aggregate profits have fallen to a nearly 25-year low. This is no consolation to Britons enduring the worst cost of living crisis in the developed world. This

suggests that inflation is not solely caused by profits. Brexit-induced red tape and increased costs for businesses likely explain the low margins.

Some governments responded to "greedflation" by either announcing windfall taxes or price controls on essentials. Most recently, the French government reached an agreement with food retailers to set the "lowest possible price" on a range of products. But these measures have not yielded any significant results in the fight against inflation.

Under normal circumstances, market dynamics constrain inflation. High prices turn buyers away, and competitors will steal share with lower prices. After a long pause, these forces are reappearing. Though still elevated by historical standards, profit margins appear to have peaked last year and are on their way down. Profits are being challenged by lower demand and normal supply, diminishing pricing power. The difference between output and input prices in Purchasing Managers' Index surveys suggests that margin growth has peaked and is starting to ease in the eurozone too. This gives hope for a more benign inflation outlook.

Whenever a bad outcome occurs, there is a rush to assign responsibility. Corporate pricing strategy appears to have been a factor in inflation's rise, but it certainly isn't the only one. And it also appears that consumers have regained the upper hand. That provides hope that "greedflation" will fall back to the recesses of our vocabulary.



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