

Box 7

DEVELOPMENTS IN EURO AREA PROFITS

This box presents information on overall profit developments in the euro area, based on national accounts data, up to the end of 2006. In addition to developments in the economy as a whole, those in different branches of activity are also described.¹ The focus is on profit measures calculated using overall gross operating surplus and mixed income in the economy, rather than on the gross operating surplus of non-financial corporations. The former measure captures both operating surplus – the surplus (or deficit) on production activities before account has been taken of the interest, rents or charges paid or received for the use of assets – and mixed income – the remuneration for the work carried out by the owner (or by family members) of an unincorporated enterprise, which is referred to as “mixed income” as it includes the entrepreneurial profit of the owner. Although this measure includes some income that is probably labour income (of the self-employed), it is used in this box since the data are available over a longer time span and are also available by branch of activity.² As shown in Chart A, the profit measure for the whole economy and the measure for non-financial corporations suggest broadly similar developments in aggregate profits since 2002 and capture the pick-up in profits observed since mid-2005.

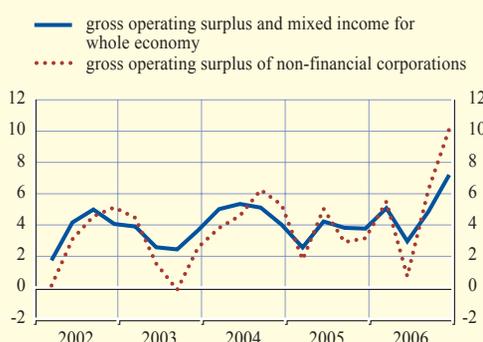
To better understand developments in overall profits, Chart B decomposes the change in profits into two parts: changes in real output (“volume”) and changes in profit per unit of output (“margin”). This decomposition suggests that much of the increase in profit growth observed since mid-2005 is due to the expansion in economic activity, although the rate of growth in profit per unit of output also increased sharply in the second half of 2006. The observed increase in the latter may reflect the combined effects of the decline in oil prices, the gradual passing through of past increases in commodity prices observed at the later stages of the production chain and the reported increased pricing power of firms generally. However, it should be noted that changes in economic activity may also have an impact on developments in profit per unit of output to the extent that unit input costs tend to be counter-cyclical. It should also be borne in mind that, while the decomposition presented in Chart B is a static one and assumes pricing and output are independent, in reality pricing and output outcomes are jointly determined.

1 “Branches of activity” refers to construction, industry, services, etc. “Institutional sectors” refers to households, non-financial corporations, etc.

2 For an overview of macroeconomic profit measures in the euro area, see the article entitled “Measuring and analysing profit developments in the euro area” in the January 2004 issue of the Monthly Bulletin. Since then, data by institutional sector have been released (see the article entitled “Integrated financial and non-financial accounts for the institutional sectors in the euro area” in the October 2006 issue of the Monthly Bulletin and Box 9 in this Monthly Bulletin).

Chart A Gross operating surplus – whole economy and non-financial corporations

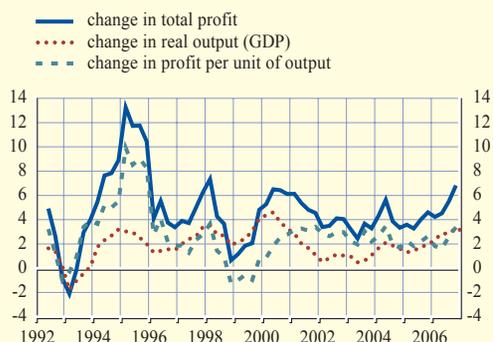
(annual percentage changes; non-seasonally and non-working day-adjusted data)



Sources: Eurostat and ECB.

Chart B Decomposition of change in profits into change in output and change in profit per unit of output

(annual percentage changes; percentage points; seasonally and working day-adjusted data)



Sources: Eurostat and ECB calculations.

The pick-up in profit growth since mid-2005 has occurred notwithstanding the significant rises in oil and non-oil commodity prices over that time period. This resilience in profit developments is primarily due to the upswing in activity, since the rate of change in prices (as measured by the value added deflator) has been easing since 2002 (see the table below). However, it appears that much of the current strength in aggregate profit mark-ups comes from industry, owing mainly to the strong cyclical increase in labour productivity in that branch of activity. In industry, the rate of increase in the value added deflator was moderate on average in 2005 and 2006, reflecting the squeeze on value added from external price pressures. Nonetheless, profit mark-ups in industry expanded, on average, robustly – by over 2 percentage points in both years – on account of the decline in unit labour cost growth. It should, however, be noted that variations in profit developments along the production chain due to differences in the speed of

Profit mark-up developments by branch of activity

(annual percentage changes; percentage points; seasonally and working day-adjusted data)

		1996-2001 ¹⁾	2002	2003	2004	2005	2006
Whole economy	Value added deflator	1.6	2.6	2.2	1.8	1.7	1.5
	Unit labour cost	1.1	2.4	1.8	1.1	0.9	0.8
	Compensation per employee	2.2	2.6	2.1	2.2	1.7	2.2
	Labour productivity	1.1	0.2	0.3	1.1	0.8	1.4
	Profit mark-up indicator	0.5	0.2	0.4	0.7	0.7	0.8
Industry	Value added deflator	0.6	1.3	-0.2	0.9	1.2	0.6
	Unit labour cost	-0.5	0.9	0.2	0.2	-1.2	-1.7
	Compensation per employee	2.0	2.2	2.1	2.7	1.5	2.5
	Labour productivity	2.5	1.3	1.9	2.5	2.7	4.3
	Profit mark-up indicator	1.0	0.4	-0.5	0.7	2.4	2.3
“Mainly services”	Value added deflator	1.6	2.9	2.5	1.9	1.4	1.3
	Unit labour cost	2.1	2.5	1.6	1.0	1.2	1.6
	Compensation per employee	2.1	2.5	2.2	1.7	1.8	2.1
	Labour productivity	0.6	0.2	0.4	0.7	0.9	0.7
	Profit mark-up indicator	-0.4	0.3	0.9	1.0	0.2	-0.2

Sources: Eurostat and ECB calculations.

Notes: The profit mark-up indicator is defined as the difference between the rates of change in the value added deflator and in unit labour cost. In turn, changes in unit labour cost can be decomposed into changes in compensation per employee and labour productivity.

1) Average over the period.

the pass-through of commodity price increases and the rate of growth in activity may be concealed by these aggregate data. Somewhat in contrast, developments in profit mark-ups in the “mainly market” services branches were relatively subdued, being broadly unchanged in 2006, notwithstanding the higher increase in the value added deflator because of the more moderate labour productivity and higher unit labour cost growth in these branches.³ It should be noted, however, that both in the industry and in the “mainly market” services branches the generalised increase in activity (“volume”) has also supported overall profit growth.

All in all, despite ongoing external price pressures, growth in euro area profits has picked up since mid-2005, mainly as a result of a solid expansion in economic activity. This increase in profitability has facilitated investment, which grew by approximately 5% in 2006, and employment creation – euro area employment increased by approximately 2 million persons in 2006. Looking forward, although some moderation in profit growth may occur, these broadly favourable developments may be expected to continue, provided wage developments remain moderate in the context of an ongoing expansion in economic activity.

³ The “mainly market” services branch refers to the NACE branches G-K, i.e. wholesale and retail trade; hotels and restaurants; transport, storage and communications; financial intermediation; and real estate, renting and business activities.