Box 4

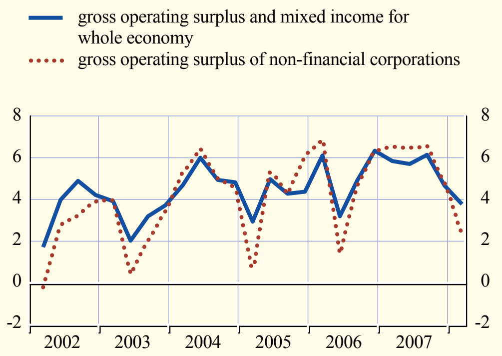
PROFIT DEVELOPMENTS IN THE EURO AREA

This box presents the latest available national accounts data on euro area profit developments. Although these data are only available with some lag – whole economy data for the first quarter of 2008 became available in mid-July and institutional sector account data for the same period were released at the beginning of August – their analysis can shed useful light on the factors that have an impact on profit developments and, importantly, may provide some insight into the evolution of corporate sentiment and investment intentions.[1]

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

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

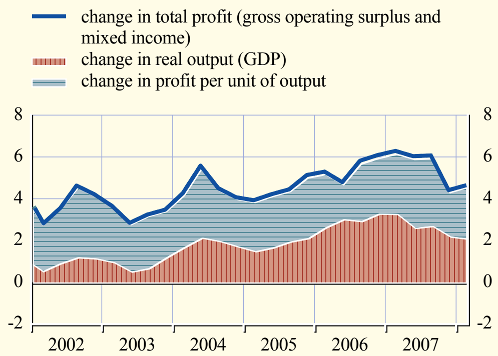
(annual percentage changes; non-seasonally and non-working day adjusted data)



Sources: Eurostat and ECB.

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

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



Sources: Eurostat and ECB calculations.

Chart A shows that the rate of increase in profits has declined in recent quarters from the robust rates observed at the beginning of 2007, although it is still close to its average over the past ten years. This profile is evident from data for both the whole economy and non-financial corporations. Chart B shows the breakdown of changes in profits into changes in real output ("volume") and changes in profit per unit of output ("margin") for the whole economy.[2] It should be borne in mind that this decomposition is static and assumes that pricing and output are independent, whereas in reality they are determined jointly. Nonetheless, it is clear that both volume and margin effects have played a role in the slowdown in profits, although the slowdown in margins has occurred primarily since the third quarter of 2007. Both external and domestic factors had a marked impact on profit margins around the turn of 2008. On the external side, rises in commodity prices (both energy and non-energy) and the relative strength of the euro exchange rate played a role. On the domestic side, unit labour costs increased strongly, reflecting higher wage growth (compensation per employee) and slowing labour productivity growth. As labour constitutes the most significant cost for most firms, these developments in unit labour costs, combined with the moderation in annual GDP growth rates, are key factors behind the decline in profit growth.

An analysis of profit developments by branch of activity (i.e. industry, services, etc.) reveals a broadly similar pattern, albeit with some differences. The table shows an alternative measure of profitability – the profit mark-up indicator – which is calculated as the difference between the rates of change in the value added deflator and unit labour costs. This indicator captures firms' mark-ups relative to their labour costs. The rate of change in the value added deflator increased in both the industry and the "mainly market" services branches from 2006 to the first quarter of 2008.[3] This increase may in part reflect the delayed pass-through of previous commodity price increases. However, in both branches, the rate of change in unit labour costs increased by even more than that of the value added deflator. In the case of industry, unit labour costs actually declined in 2006 and 2007, but rose in year-on-year terms in the first quarter of 2008. In services,

2 Data on real activity by institutional sector are not yet available.
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.

Profit mark-up developments by branch of activity

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

		2005	2006	2007	2007 Q2	2007 Q3	2007 Q4	2008 Q1
whole economy	value added deflator	1.8	1.6	2.0	2.0	2.1	2.1	2.4
	unit labour cost	1.0	0.9	1.5	1.3	1.4	2.4	2.4
	- compensation per employee	*1.8*	*2.2*	*2.4*	*2.2*	*2.2*	*2.8*	*2.9*
	- labour productivity	*0.8*	*1.3*	*0.9*	*0.9*	*0.7*	*0.4*	*0.5*
	profit mark-up indicator	0.8	0.7	0.5	0.8	0.7	-0.3	0.0
industry	value added deflator	1.2	0.8	1.5	1.9	1.5	1.3	1.8
	unit labour cost	-0.8	-0.6	-0.3	0.1	-0.8	0.2	1.0
	- compensation per employee	*1.8*	*3.5*	*2.7*	*3.1*	*2.4*	*3.0*	*3.3*
	- labour productivity	*2.6*	*4.1*	*3.1*	*3.0*	*3.2*	*2.8*	*2.3*
	profit mark-up indicator	1.9	1.3	1.9	1.8	2.4	1.0	0.8
"mainly market" services	value added deflator	1.5	1.3	1.7	1.8	1.8	1.7	2.2
	unit labour cost	1.0	1.3	2.2	2.0	2.1	3.0	3.3
	- compensation per employee	*2.0*	*2.0*	*2.2*	*2.1*	*2.0*	*2.2*	*2.6*
	- labour productivity	*1.1*	*1.0*	*0.4*	*0.5*	*0.2*	*-0.2*	*-0.4*
	profit mark-up indicator	0.5	0.1	-0.4	-0.2	-0.3	-1.3	-1.2

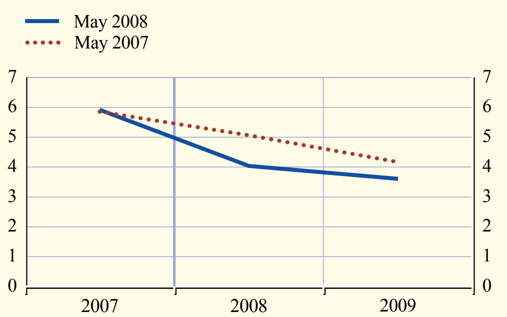
Sources: Eurostat and ECB calculations.
Note: The profit mark-up indicator is defined as the difference between the rates of change in the gross value added deflator and in unit labour cost. In turn, changes in unit labour cost can be broken down into changes in compensation per employee and labour productivity. Due to rounding, these figures may not always add up exactly.

the upward movement in unit labour cost growth was even more pronounced, rising from 1.0% in 2006 to 2.9% at the beginning of 2008. The steeper increase in the latter is the result of a rise in wage growth in services, as labour productivity growth declined in both branches.[4] Thus, notwithstanding some acceleration in the value added deflator, the strong rise in unit labour cost growth has resulted in weaker developments in the profit mark-up indicator in both branches. In addition to weaker unit labour cost developments, the somewhat stronger profit growth in industry over recent years also reflects higher output growth in that sector.

Overall, national account profit data support the information drawn from financial market-based indicators (see Box 4 entitled "Recent developments in the earnings of euro area firms" in the June 2008 issue of the Monthly Bulletin), which have highlighted downward revisions to corporate earnings expectations since summer 2007. Looking ahead, the profit environment is likely to remain challenging for the remainder of 2008. Continuing high commodity prices, slower growth in the world economy and exchange rate developments are all likely to weigh on the profitability of euro area firms exposed to the global economy, either directly or indirectly. Furthermore, weaker economic growth combined with high rates of growth in unit labour costs are also expected to be a drag on company profitability. This assessment is shared by respondents to surveys by Consensus Economics, which in May revised downward

Chart C Consensus Economics corporate profit expectations

(annual percentage changes)



Sources: Consensus Economics and ECB calculations.

4 For more detail on disaggregated wage developments, see Box 6 "Recent developments in sectoral wage and labour costs in the euro area" in the June 2008 issue of the Monthly Bulletin.

euro area corporate profit growth expectations for 2008 and 2009 compared with expectations a year previously – see Chart C.

In the current challenging environment, the main factors that can support profitability are competitive product and labour markets, moderate wage developments and medium-term price stability. Sustained profitability is necessary to support ongoing investment and job creation.