Box 6

TRENDS IN PROFIT MARGINS OF EURO AREA NON-FINANCIAL CORPORATIONS

Profit margins are an important factor in the development of output prices. They are typically seen as a mark-up on costs and their evolution can thus provide a gauge for the capacity or need of firms to pass on or absorb changes in different costs or charges in their output prices. Profit margins or profit developments are also relevant for real economic developments, e.g. investment. At the aggregate level, the role of profit margins in output price developments is often approximated by developments in gross operating surplus per unit of output (in short: gross unit profits) in relation to the growth in the GDP or value added deflators. However, for the different institutional sectors of the economy, the profit measure of gross operating surplus tends to capture rather different economic forces, and it also includes components that may not correspond to the notion of profits in a more narrow sense. Against this background, this box focuses on profit developments in the non-financial corporations (NFCs) sector (which accounts for roughly half of euro area gross operating surplus) and on underlying components of gross operating surplus.[1]

Profit margin developments

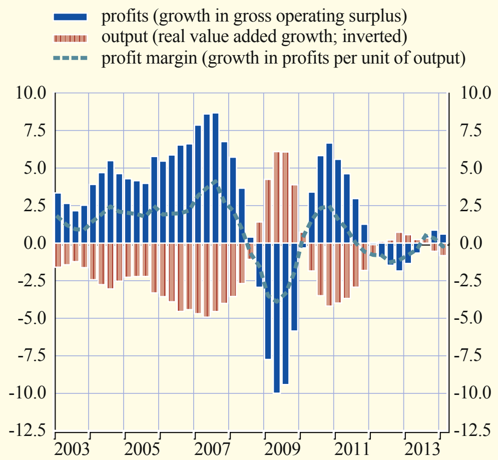
Profit margins of NFCs fell sharply during the 2008/09 recession and declined also over the past two years (see Chart A). Profit margins as measured in terms of gross unit profits are driven by the interplay between developments in gross operating surplus in the numerator and real value added as a measure of output in the denominator. Their declines during the great recession and over the past two years are explained by sharper drops in gross operating surplus than in real value added. In 2014, some improvements in real value added contributed to the decreases in gross unit profits.

Gross and net operating surplus

When activity slumped during the 2008 crisis, gross operating surplus was squeezed and since then has remained below its earlier levels. In an environment of mostly subdued developments in nominal value added, this squeeze reflects the relatively small responsiveness of compensation of employees (see Chart B). As a consequence, the profit share (in value added) moved sharply down to a level below its longer-term average, after trending upwards before the crisis

Chart A Non-financial corporations' gross unit profits and contributions

(annual percentage changes)

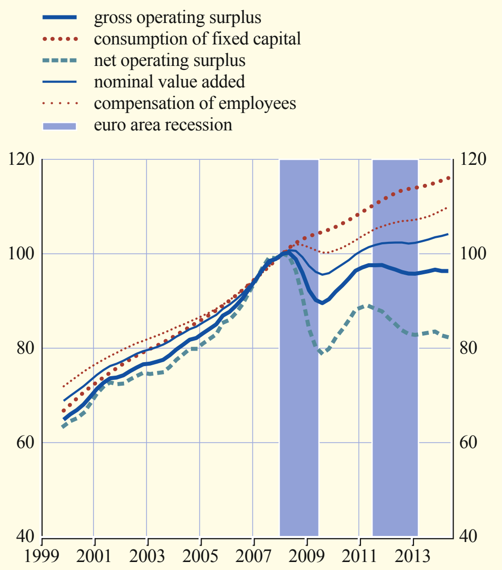


Sources: Eurostat and ECB calculations.
Note: Real value added for non-financial corporations is based on an ECB estimate.

1 For an analysis of profits focusing on the whole economy, see the box entitled "The role of profits in shaping domestic price pressures in the euro area", *Monthly Bulletin*, ECB, March 2013. For developments in profit margins of NFCs split into euro area external deficit and surplus countries, see the box entitled "A sectoral account perspective of imbalances in the euro area", *Monthly Bulletin*, ECB, February 2012. See also the box entitled "Integrated euro area accounts for the second quarter of 2014", *Monthly Bulletin*, ECB, November 2014.

Chart B Gross and net operating surplus of non-financial corporations

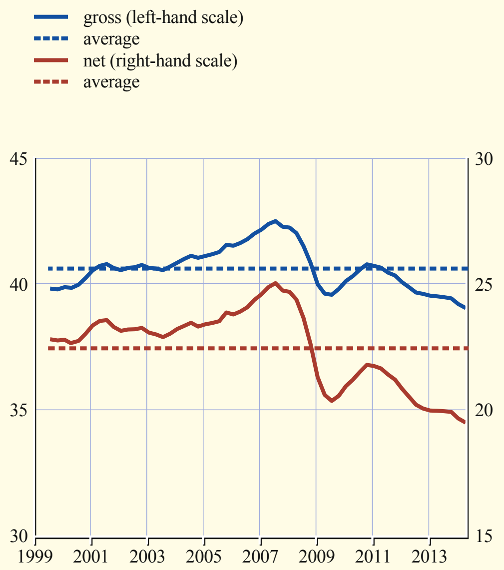
(index: Q1 2008 = 100)



Sources: Eurostat and ECB calculations.

Chart C Gross and net profit shares of non-financial corporations

(percentages of value added; average since 1999)



Sources: Eurostat and ECB calculations.

(see Chart C). Over the past two years, the profit share has continued to weaken. These patterns are more pronounced when looking at net operating surplus, given that consumption of fixed capital and the associated costs of capital services increased unabated during the crisis. The net profit share is thus more visibly below its longer-term average and has more clearly continued to decline in the past two years than the gross profit share.

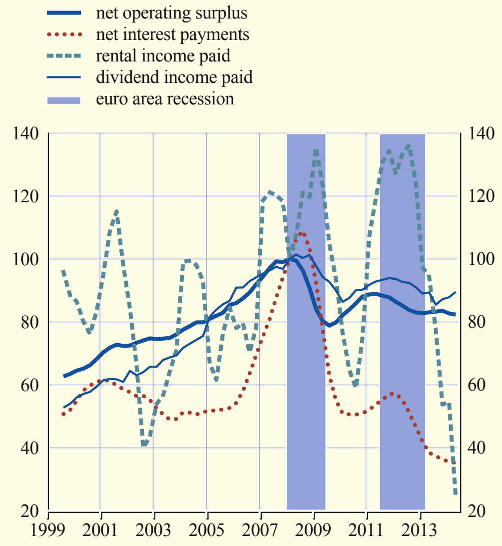
The declines in the profit shares may have different reasons. On the one hand, they reflect the fact that in the weak economic environment prevailing for most of the period since 2008, the additional increases in labour and capital services costs could not be passed on to selling prices. On the other hand, profit shares had increased substantially prior to the 2008 crisis and in this respect, it is difficult to benchmark developments in profit shares as there is no reliable gauge of a truly long-run level of these shares.

Net entrepreneurial income and net retained earnings

Net entrepreneurial income and net retained earnings have developed modestly over the past two years, but remained relatively more robust than net operating surplus. Subtracting from net operating surplus the costs for net interest payments and rental income paid and adding non-interest property income received (such as dividend income received and property income from insurance) provides the profit measure of net entrepreneurial income. Given declines in net interest payments and rental income paid in the past few years, and more recently some improvements in non-interest property income received (see Chart D), net entrepreneurial income has developed better than net operating surplus. From net entrepreneurial income, firms still have to pay, in particular, taxes on income and wealth and dividends; net retained earnings (net savings) – as a measure of the income that firms have ultimately available for additional

Chart D Non-financial corporations' net operating surplus and some components

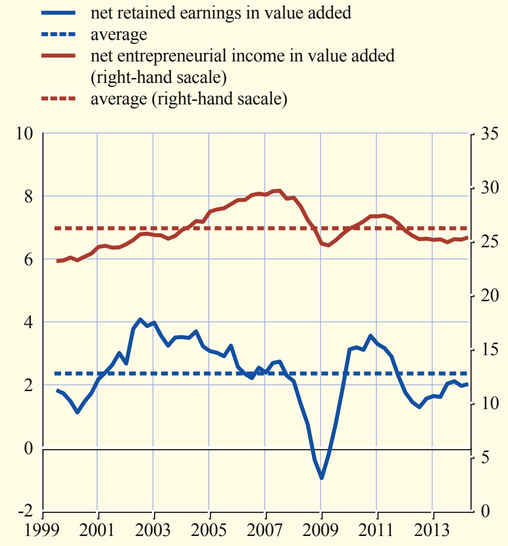
(index: Q1 2008 = 100)



Sources: Eurostat and ECB calculations.

Chart E Share of net entrepreneurial income and net retained earnings in value added for non-financial corporations

(percentages of value added; average since 1999)



Sources: Eurostat and ECB calculations.

financing – is thus smaller than net entrepreneurial income. In contrast to pure cost components such as net interest payments, dividend payments are at the discretion of companies, at least to the extent that they remain in line with shareholder value expectations. Dividend payments, therefore, provide companies with some leeway to influence their net retained earnings.[2] Due to lower dividend payments net retained earnings declined less than entrepreneurial income.

The shares of net entrepreneurial income and net retained earnings in value added have recently stabilised or improved slightly. This contrasts with a continued decline in the corresponding shares for gross and net operating surplus. Moreover, the shares of net entrepreneurial income and retained earnings stand slightly below the longer-term average, but not at unprecedented low levels (see Chart E). The relative movements in the variables imply that downward price pressures from net unit profits on the growth in the value added deflator over the past year do not reflect a further squeeze in unit net retained earnings but rather declines in net interest payments and dividend payments.

Conclusions

Bearing in mind that there is substantial heterogeneity across euro area countries, data for the euro area as a whole indicate that NFCs' profit margins dropped strongly as profits were squeezed by increases in labour and capital services costs in the aftermath of the 2008/2009 recession. This reflects the limited possibilities of companies to pass cost increases on to output prices in an environment of weak demand and needed competitiveness gains. Cost developments themselves have been increasing, at least relative to income, in view of low productivity growth and downward rigidities in wages.

2 In this respect, net retained earnings can also reflect NFCs' choice with regard to generating external or internal financing funds, e.g. at times of constraints in access to external financing, or deleveraging pressures and the need for balance sheet repair.

However, the more narrow profit measure of net entrepreneurial income and companies' net retained earnings remained lately more robust than net profits. This is the case as net entrepreneurial income was propped up by declines in costs such as net interest payments and as net retained earnings was supported by decreases in dividend income paid. Other profitability measures for NFCs confirm these profit developments. Measures of the return on capital, such as the ratio of entrepreneurial income to loans, bonds and equity net of cash, are currently at relatively low levels but showed some tentative signs of improvement in 2014.