One of the indicators for assessing domestic price pressures is the GDP deflator, which reflects the “price” of GDP per unit of output. Movements in the GDP deflator are driven...
by developments in labour costs, profits and net indirect taxes – measured per unit of output. Although the greatest focus is usually placed on developments in unit labour costs, the adjustment in unit profits is also very relevant for domestic price pressures. Against this backdrop, this box reviews the role that unit profits have played in shaping domestic price pressures in the euro area over the past decade, and, in particular, during and after the 2008-09 recession.

**The contribution of unit profits to domestic price pressures**

Unit profits, as measured by gross operating surplus and mixed income, have contributed about one-third to the increase in the euro area GDP deflator over the period since 1999. This compares with a contribution of somewhat more than 50% from unit labour costs and around 12% from unit taxes. Chart A highlights that the contributions from unit profits have tended to buffer developments in unit labour costs. The buffer role of unit profits is clearly visible during a recession, as in the period 2008-09 when it helped to contain price pressures as productivity setbacks drove up unit labour costs.

Unit profits declined significantly during the 2008-09 recession, but recovered notably thereafter. However, they had only just about returned to their pre-recession levels by the third quarter of 2011 (see Chart B). This implies that the recovery of unit profits was more moderate than that of unit labour costs and unit taxes over the same period. From a longer-term perspective, the magnitude of the increase has been broadly similar for all components, as unit profits rose more strongly during the boom years prior to the recession.
Gross versus net unit profits

The measure of gross operating surplus and mixed income at the economy-wide level comprises many elements that may not immediately be associated with profits in a more narrow sense. Examples of such elements are net interest payments, rents and dividends, but also the provisions made for the depreciation and replacement of fixed capital.

Consumption of fixed capital, which, on average, accounted for about 45% of gross operating surplus in the decade prior to the 2008-09 recession, continued to rise during the recession years, resulting in an acceleration in consumption of fixed capital per unit of output (see Chart C). Taking this into account, the downward adjustment in net unit profits (i.e. net of capital consumption) during the 2008-09 recession was, hence, even stronger than that in gross unit profits. Net unit profits recouped only a small share of their losses in the period thereafter and started to drop again in the downturn that set in during 2011, thus deviating significantly and, thus far quite persistently, from any pre-recession benchmark.

Overall, the downward flexibility of unit profits in the euro area was pronounced during the 2008-09 recession, containing price pressures in the wake of rising unit labour costs. This is particularly evident when looking at gross operating surplus measured net of capital consumption.

Chart C Gross unit profits and its components
(index: Q1 2008 = 100)

Sources: Eurostat and ECB calculations.
Notes: Taxes denote taxes less subsidies on production, profits denote gross operating surplus and mixed income. For further information on CEPR dated recessions, see http://www.cepr.org/data/dating/.