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Article

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What Profit-Price Spirals Are Telling Us About Post-Pandemic Inflation

It is an empirical fact that sharply rising profit margins account for a historically large share of the spike in prices that occurred in 2021 and early 2022. For example, between the official beginning of the recovery from the COVID-19 recession (the second quarter of 2020) until the end of 2021, rising profits could account for roughly 55% of inflation in the non-financial corporate sector of the economy. In normal times, profits account for about 13% of prices.

What this fact means about *why* inflation spiked in 2021 and has remained abnormally high since is less clear. The debate over “profit-price” spirals – the role of elevated profits in driving inflation – has had many different facets, but we will just focus on one: does the profit spike support or undermine claims that recent years’ inflation was driven by macroeconomic overheating?

By macroeconomic overheating, I mean an excess of economy-wide spending relative to the economy’s productive capacity. Imagine that in 2021 households, businesses and governments demanded \$20 trillion in goods and services at prevailing prices. But say that factories and other workplaces in the U.S. economy could not muster the labor, capital and other inputs needed to produce enough to satisfy this volume of demand. This would lead to macroeconomic overheating – prices would rise as large segments of goods and services would see demand in excess of the economy’s ability to supply them. This macroeconomic overheating view of recent years’ inflation has become conventional wisdom. But there are plenty of reasons to be skeptical of it.

The most persuasive reason for skepticism is the global nature of inflation – it appeared across every single advanced economy in the world regardless of what macroeconomic policy path they took after the pandemic. Further, the empirical proxies for economy-wide demand and productive capacity just do not look stressed enough to account for an inflationary spike like the one we have seen in recent years. Essentially, the gap between economy-wide spending demands and the economy’s potential output looks unremarkably small.

Somewhat strangely, proponents of the macroeconomic overheating view have claimed that the profit-price spiral seen in recent years unambiguously supports their interpretation of inflation. Take just one example, a May 2022 column by *Washington Post* writer Catherine Rampell:¹

The greedflationists argue that something fishy is afoot because companies are not merely “passing along” their higher costs; their profit margins are expanding, too. But this is exactly what you’d expect when flush customers are buying more stuff and willing to pay whatever’s necessary to get what they want. Prices *and* profits rise.

The last sentence is a clear assertion that macroeconomic overheating generally leads to both price increases and profit margin spikes. But in fact, every single economic expansion in U.S. history since World War II has actually been associated with the opposite pattern: when the economy heats up (i.e. unemployment falls to low levels after recessionary shocks), the share of the economy’s income claimed by profits instead of wages begin falling, not rising.

¹ <https://www.washingtonpost.com/opinions/2022/05/12/democratic-conspiracy-theory-on-inflation-makes-things-worse/>

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It is true that the profit share hits its lowest levels during recessions. Further, early in recoveries when unemployment is still elevated from the recession, it tends to rise rapidly. But when the economy is running hot – not in recession and well into a subsequent expansion with low unemployment – the profit share is essentially always low and falling, not high and rising.

Take the clearest example of a hot economy spurring inflationary pressures in the post-World War II era – the late 1960s. Driven in part by a desire to avoid paying for the Vietnam military build-up with new taxes, fiscal policy became expansionary. The unemployment rate sat below 4% in every year between 1966 and 1969, and core inflation accelerated from roughly 1.5% to almost 5% in those same years.

But the profit share fell like a stone in those same years, decreasing by 5.8 percentage points between the beginning of 1966 and the end of 1969 (roughly \$700 billion today). In short, the archetypal episode of macroeconomic overheating leading to stubborn inflation saw profit shares decline sharply. It is simply not the case that “when flush customers are buying more stuff and willing to pay whatever’s necessary to get what they want” that “prices and profits rise”.

This fact that profit shares universally fell as the post-war U.S. economy heats up is important but under-recognized in the context of recent debates over inflation. Soaring profits are not evidence in favor of the macroeconomic overheating explanation. They are instead a strong signal against this interpretation of recent years’ inflation. The contribution of high and rising profit margins to price growth in recent years holds the promise that as margins normalize, this will constitute an important source of disinflation.

We end with an example of how important this profit margin compression could be in generating a slowdown of inflation without causing a marked deterioration in the labor market – the “soft landing” that everybody is hoping for in coming months. Currently, hourly wage growth is roughly 4% in the U.S. This is a bit faster than the sum of the Fed’s 2% price inflation target and the long-run 1.5% trend growth in economy-wide productivity. If wage growth exceeds the sum of productivity growth and price inflation, the labor share of total income must rise while the profit share falls.

But we have been highlighting throughout that this profit share has reached historic highs recently, so, some reduction would be both expected and good. This raises an obvious question: if wage growth continued at today’s 4% pace and inflation dropped to 2%, how long would the resulting shift from profit shares to wages be sustainable? If we define the 2019 peak as normal, we could have 4% wage growth and 2% inflation for three years. If we define the 2007 peak as normal, we could have this combination for six years. And if we allow the 2000 peak to be our benchmark, it would take 13 years before this target profit share was hit. Given this analysis, it is hard to see why policymakers should be targeting significantly higher unemployment or substantial labor market cooling in the next year in the name of fighting inflation – the labor market has clearly cooled enough for now.

We should add an important data caveat to this analysis – when measuring the profit share of the U.S. corporate sector, one needs to remove the profits of the Federal Reserve. As the Fed’s policy swung from large-scale asset purchases to keep interest rates low in recent decades to the sharp increase in rates over the past year, its profits have swung from \$140 billion to minus \$60 billion. This \$200 billion swing has sharply pulled down measures of the profit share that do not account for this. Once this important data adjustment is made, today’s profit share still looks historically high, and the prospect of it falling to normal levels in coming years provides ample room for inflation to decelerate without any need to slam the brakes on today’s labor market growth.

The debate over the recent profit-price spiral got sidetracked in disputes about what this spiral told us about corporate greed. We should have been paying more attention to what it told us about the state of macroeconomic slack and the prospects for a soft landing in coming months.