

# What is profit-led inflation?

## Chief economist's comment

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- Developed economies have had three waves of inflation since the pandemic: transitory inflation for durable goods; commodity inflation; and finally profit margin-led inflation.
- Profit margin-led inflation is not caused by a supply-demand imbalance. Profit margin-led inflation is when some companies spin a story that convinces customers that price increases are "fair," when in fact they disguise profit margin expansion.
- Technically, companies are able to use stories to reduce their customer's price elasticity of demand.
- Raising rates to reduce demand will eventually squeeze profit margin-led inflation, but it is a crude and unnecessarily destructive policy approach. Convincing consumers not to passively accept the price increases is a potentially faster and less destructive way of reversing profit margin-led inflation. Social media might have a role to play in this process.



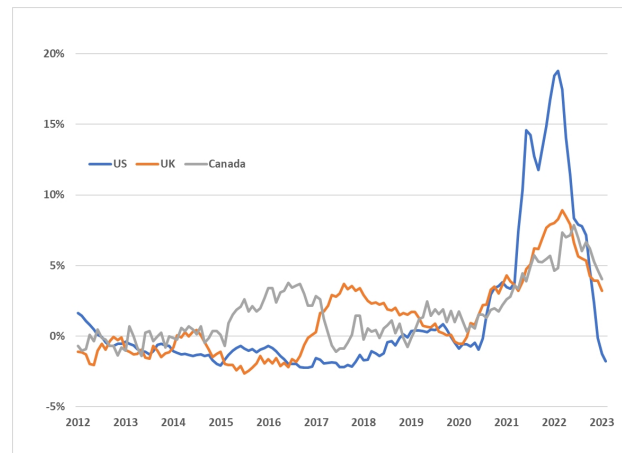
Source: Getty

Since the pandemic, there have been three waves of inflation in most developed economies.

First, there was the transitory inflation of consumer durable goods. This was a fiscally fueled, demand-led inflation. As economies reopened, supply of manufacturing goods surged—but demand surged even more as people spent the money they had received during the pandemic. The result was a temporary and dramatic spike in durable goods price inflation. As demand returned to normal, inflation came crashing down in a truly spectacular fashion (particularly in the Anglo-Saxon world).

Fig. 1: Transitory inflation – durable goods

Durable goods prices, % y/y

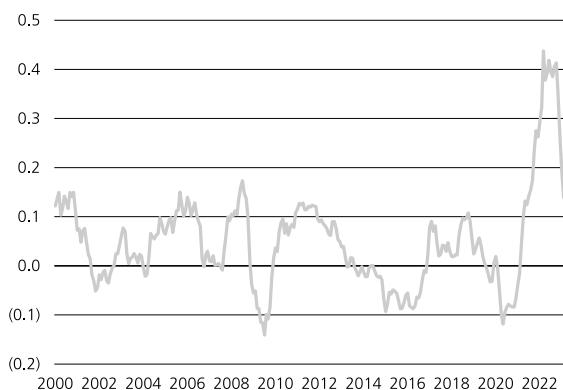


Source: Haver, UBS

The peak of US transitory inflation came in February 2022, just as war in Europe accelerated the second wave of inflation. Energy prices had been rising as economic growth recovered from the pandemic, and were then given an additional boost as the war hit. This second wave of inflation was completely independent of the transitory inflation.

Fig. 2: European energy price inflation

Consumer energy prices, % y/y



Source: Haver, UBS

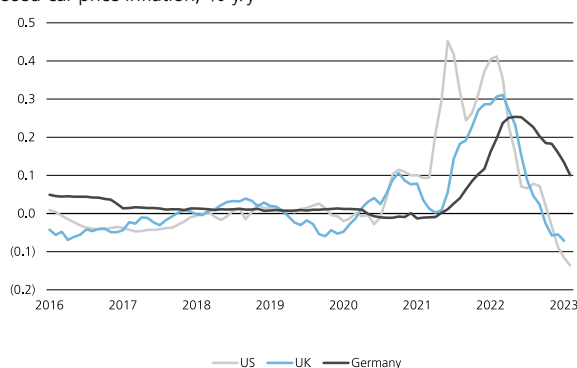
Recent inflation has been driven by an unusual expansion of profit margins. Profit margin-led inflation occurs when companies tell their customers a convincing story that lets them raise prices without significantly reducing demand. It is inflation driven by spin, not substance.

## A tale of two types of companies

Simplistically, there are two sorts of companies in the world. Some companies tend to have strong, cyclical pricing power—higher demand means higher prices and higher profit margins. Companies with strong cyclical pricing power generally depend less on repeat business or customer loyalty. If you do not care whether the customer comes back, you will take every opportunity to get as much money from any customer who wants to buy from you.

Fig. 3: Procyclical profits / pricing

Used-car price inflation, % y/y



Source: Haver, UBS

Used-car prices are a classic example. Buying a used car is generally a one-off purchase. The seller will get the buyer to pay as much as possible for the car. When used-car demand surged in 2021, profit margins on used cars exploded and prices soared. In 2022, as demand eased, the pricing power and profit margin fell back.

This first group of companies will therefore raise and lower profit margins (and potentially prices) as demand fluctuates. Inflation is demand-driven. This is normal, and it is not what is creating unusual inflation at the moment.

The second group of companies normally have weaker pricing power. They have strong brand values and need customers to keep coming back. Any company that issues a customer loyalty card is in this category. Ordinarily, these companies pass on cost increases, but they will not expand profit margins. The reason is simple. If consumers feel that prices are rising unfairly, they will desert the company. Consumers who have defected to a rival brand are very hard to win back—loyalty is an expense commodity, which is exactly why loyalty cards offer the rewards that they do.

Very occasionally, this second group of companies find a way to spin a story that lets them expand their profit margins without creating a consumer rebellion. For some companies (though not all), this is one of those occasions. If a company can use some external shock to justify a price increase, they may also be able to expand profit margin. The result is that inflation today is being driven by an unusual degree of profit margin expansion.

Companies can expand profit margins if they can convince their customers that the price increases are fair. For this to work, there are two necessary conditions.

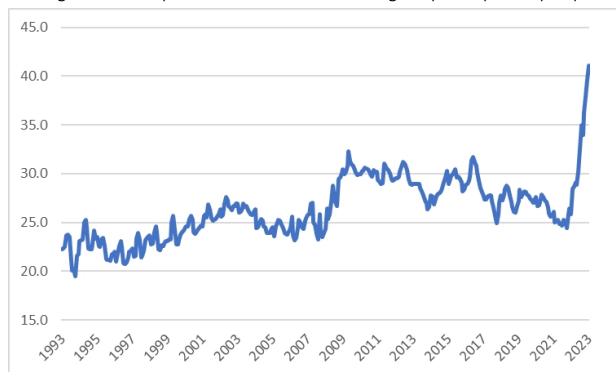
- Something has happened which companies can present as being “outside of their control.”
- Customer do not understand the companies’ true costs.

For example, widespread reports of rising agricultural prices allow supermarkets and restaurants to raise the price of food. Years of careful advertising by food producers and retailers have convinced consumers that we live in some kind of rural idyll, where the cost of food is mainly about the farmer. In fact, the farmer gets a tiny share of the price we pay as consumers. Labor after the farm gate is a far more significant cost.

The consumer hears worrying stories about rising agricultural prices, climate change, and so forth, and feels a food price increase is “fair.” The fact that most of the price of food is labor costs, and labor costs have not been rising so much, means that the seller is able to raise food prices faster than their costs—expanding their profit margins.

Fig. 4: The UK milk *markup*

Average UK retail price of milk less the farm gate price, pence per pint



Source: ONS, AHDB, UBS

The UK milk market shows this in action. Farmers get less than half the consumer price of a pint of milk (in price terms, milk is not, in fact, milk). For almost two decades, the UK retail price for milk added a markup of around 25 pence to 30 pence to the farm-gate price. Today, the retail price is adding 41 pence, with all of this abnormal markup increase taking place in the last few months.

Other stories that are being spun to present price increases as “fair” include supply chain disruption (in fact global trade is at a record high), labor shortages (in fact wage costs are rising far less than prices), and in the most circular of arguments “general inflation.”

While large companies are often (rightly) criticized for this profit-led inflation, it can just as easily be small businesses. The family-run shop is just as capable of ramping up its profit margin as is the national chain. It is also more likely to be retail customers that are convinced to accept higher price increases. Higher up the supply chain, corporate purchasers are more likely to be aware when price increases are not fair.

Fig. 5: Retail profits spike higher

US retail profits as a % US retail GDP



Source: Haver, UBS

The leap up in US retailers’ profits as a share of GDP is exactly what is expected in a profit-margin inflation episode. For over a decade, pricing power was moderate, and the amount of profit retailers took was fairly steady. But in the second quarter of 2021, as the economy reopened, US retailers were able to persuade consumers to accept far higher prices. At the same time, retailers were able to keep down wage costs, and so profit margins exploded.

## How to tackle profit-led inflation?

There are two ways to defeat profit-led inflation. As with most other forms of inflation, a general attempt to reduce consumer demand will ultimately weaken profit-led inflation. This is an inefficient tool to use. Profit-led inflation is not driven by rising demand. Rather, it is a relative stability of demand as consumers are made to believe that it is only fair they pay the higher prices that generate the increase in margins. (Technically, the story being told reduces the price elasticity of demand of consumers). The risk in profit-led inflation episodes is that central banks focus too much on demand reduction, tighten policy too much, and create unnecessary unemployment.

The alternative remedy for profit-led inflation is when consumers stop believing that price increases are fair (restoring the previous price elasticity of demand). This threatens the customer loyalty for a profiteering company. If consumers believe the price increase is not fair, they will stop buying the product by either delaying their purchase or switching to an alternative supplier. Loyalty card points will not prevent customers moving to another store if they feel they are being “ripped off” by profit-led price increases. Consumers may already be starting to question whether price rises are really fair, in particular in the wake of the traditional start-of-year price increases.

Aligned with consumer rebellion is the threat of political involvement. If consumers are upset, politicians are likely to notice. This may then lead to threats of regulation, or a competition inquiry. Political concerns about profit-led

inflation have been gradually increasing in volume on both sides of the Atlantic.

Finally, it is worth considering what social media may do to profit-margin led inflation. It is certainly possible that companies have found it easier to spin stories justifying price increases in the modern social media world. Lurid tales of shortages and delays are just the sort of sensationalism that serve as clickbait—the media has effectively boosted the stories that companies want to tell. But it is also true that social media can increase the power of consumers to fight back against price increases that are perceived as unfair. After enough one-star comments criticizing poor value for money on a review website, the family-run restaurant may reconsider its margin expansion. On a larger scale, if a company is trending on Twitter alongside #boycott, it is time to review its pricing policy.

A real-world example of this is the Great Cottage Cheese Boycott of Israel in 2011. An increase in cottage cheese prices led to a social-media-orchestrated boycott, which was very effective (cottage cheese sales fell most aggressively where internet access was greatest). Politicians started to take notice, and within weeks the price increases were reversed.

## Profit-led inflation

Many developed economies are experiencing a profit-led inflation episode in specific sectors of the economy. This is not about profits rising on the back of strong demand. Profit-led inflation occurs with more or less stable demand, but in circumstances where consumers are persuaded that the price increase is “fair” or “justified.” Companies pass on costs and an increase in margin. Raising interest rates is a less effective way of dealing with this sort of problem—but once consumers rebel against the price increases (especially if backed by political angst), the margins are likely to be squeezed quickly. This potentially reduces inflation more quickly than would occur in a demand- or wage-driven inflation episode.

## Appendix

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