Macro Research

The labour share, profits and inflation

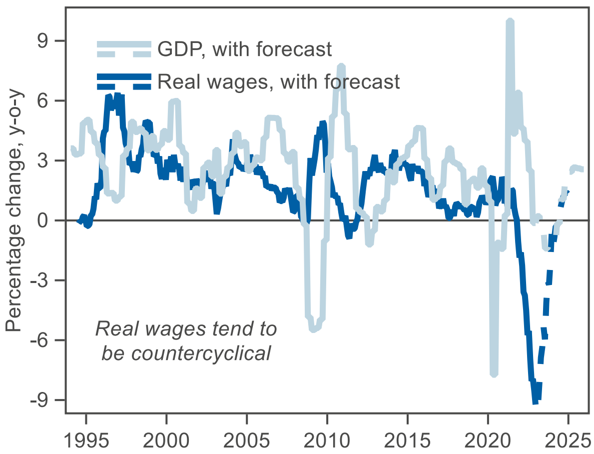
Big loss in real wages, with no quick bounce-back[1]

Despite sharply rising input prices, Swedish businesses managed to maintain and even improve their profit margins in 2021–22. At the same time, employees have been receiving a smaller and smaller percentage of business sector value-added, which is illustrated by the declining labour share and the steep fall in real wages. In our view, corporate profit margins will be squeezed, and we believe that slightly higher wage increases than normal should be anticipated ahead, even after the current two-year wage agreements. Combined with our forecast for gradually cooling inflation, we therefore expect real wages to recover, albeit slowly and not fully.

Inflation higher than wage increases in 2022

The high inflation rate has eroded households' purchasing power, particularly in countries such as Sweden that have more co-ordinated wage agreements. In the past year, real wages have dropped back to 2013 levels, which means that a normal household will get as many goods and services for its salaries as it did a decade ago, despite the fact that companies' production levels are higher. Meanwhile, employment has continued to rise as a result of the economy remaining strong, which means that the household sector's real disposable income has not declined to the same extent as real wages. All in all, the labour share of the economy – i.e. the total wage sum as a percentage of value added – has fallen. In other words, wages have not kept up with profit growth.

Sharp decline in real wages



Sources: Macrobond and Handelsbanken

The question is whether there has been a permanent fall in real wages and the labour share, or whether we should expect a more rapid increase in real wages in the next few years. A common assumption is that, ultimately, the labour share will converge with a long-term trend, but how does this happen, and does the

A closer look at the labour share

The labour share can be defined as follows:

$$Labour\ share = \frac{\text{Wage sum}}{\text{Value added}}$$

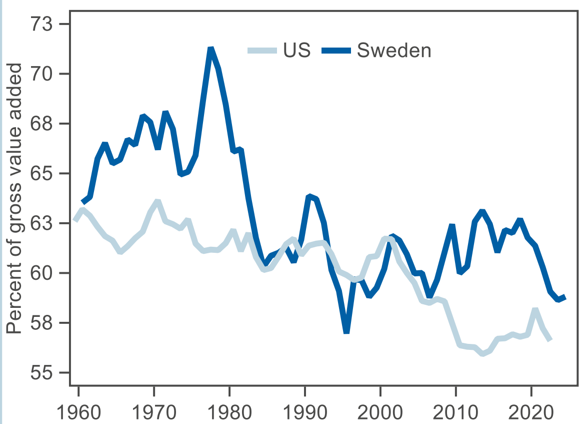
$$= \frac{\text{Hourly wage} * \text{Hours worked}}{\text{Productivity} * \text{Hours worked}}$$

The labour share decreases if hourly wages increase more slowly than prices or productivity. In 2022, the labour share fell, as productivity growth in Sweden was close to zero. At the same time, real wages decreased, i.e. price increases were much higher than the growth in hourly wages.

$$\Delta Labour\ share = \Delta Hourly\ wage - \Delta Price - \Delta Productivity$$

Since the 1960s, we have seen a negative labour-share trend in the US and the eurozone, and this also applies to Sweden. Research in this area is not unanimous, but it links this trend to technological advances, greater global and financial integration, and increased inequality in incomes.

Falling labour share in developed economies



Sources: Macrobond, European Commission (DG ECFIN), U.S. Bureau of Labor Statistics (BLS) and Handelsbanken

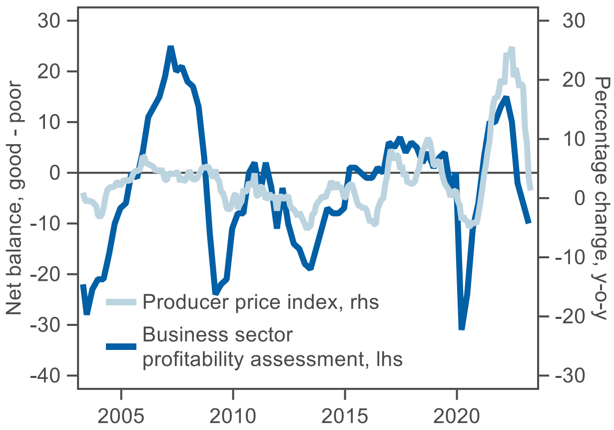
[1] This analysis is a translated version of the theme article published in our Swedish macro forecast report on May 24, 2023.

recent trend entail a permanent change? Among other things, the answer has to do with how future corporate profits are divided between owners and employees.

Companies have increased their profits

Let us start by looking at corporate profits. Despite the high cost pressure from raw materials, shipping and other inputs, companies have increased their profit margins.[2] And, to an unusually large extent, companies have been grading their own profitability as "good" (i.e. more than satisfactory) in 2021-22 (see graph). Instead, households have absorbed the biggest blow from inflation.

Good profitability coming under pressure



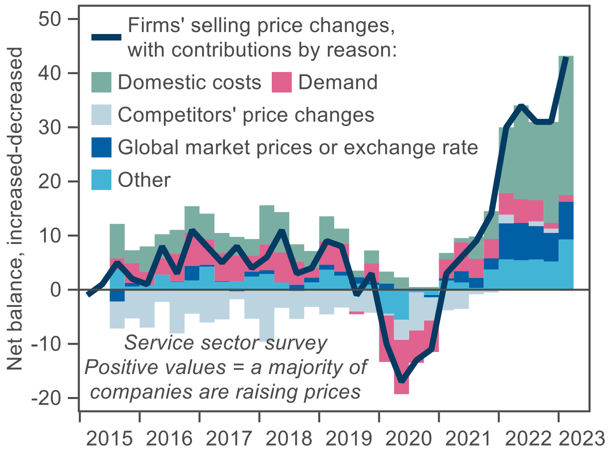
Sources: Macrobond, NIER, Statistics Sweden and Handelsbanken

One factor that suggests that the profit trend will slow down, leading to a recovery of the labour share, is the business cycle dynamic. Recently, companies' profitability assessments have become more subdued, in step with rising funding costs and weaker growth in demand, and this year, we forecast that profits will be squeezed further. Despite this, the proportion of companies that are planning imminent price hikes has started to decrease (albeit from high levels) – a sign that it is becoming more difficult to pass on rising costs to consumers.

Has business pricing behaviour changed in a more persistent way?

On the other hand, the higher corporate profits over the past couple of years have been paired with observed changes in business pricing behaviour, for example prices being raised more often than usual, and, if anything, being driven *up* rather than down by the actions of competitors (see graph). Could business pricing behaviour have been affected in a persistent way, for example leading to a greater focus on high profit margins? New academic research explains how the comprehensive global cost shock of recent years may have acted as an implicit co-ordinating factor behind the changed pricing behaviour.[3] The Riksbank also highlights the changing behaviour as an uncertainty factor in the inflation outlook.

Multiple reasons for higher sales prices



Sources: Macrobond, NIER and Handelsbanken

Standard macroeconomic models cannot explain all of the rise in the inflation rate over the past year. The Riksbank's analysis[4] suggests that its forecast error derives only to a limited extent from the direct effects of rising energy prices and a weak currency. However, the analysis cannot determine with certainty whether this is due to increasing profit margins, or if other factors such as higher inflation expectations or the unusually rapid impact of rising costs also plays a role. The National Institute of Economic Research (NIER) has also analysed the issue of companies' pricing behaviour[5]. The analysis does not give clear indications that consumer prices have risen more than can be justified by rising production costs. Instead, the high business sector profit share is in large part attributable to non-consumer oriented sectors, e.g. ones that have benefited from high world market prices and a weak exchange rate, such as the Pulp and Paper sector, Electronics and Mechanical engineering. At the same time, the NIER emphasises that

[2] Corporate profits in relation to sales.
[3] See Weber, Isabella M. and Wasner, Evan, "Sellers' Inflation, Profits and Conflict: Why can Large Firms Hike Prices in an Emergency?", WP 343, 2023. See also our theme article "What's stopping another high-inflation regime?", p.p. 16f, Global Macro Forecast, September 2022

[4] See the Riksbank's study, Evaluation of the Riksbank's forecasts, March 2023.
[5] See the Swedish National Institute of Economic Research's occasional study "Swedish firms' pricing in 2022" (December 2022).

its conclusions are subject to considerable uncertainty.

We forecast it will become harder for companies to protect their profit margins when demand weakens. In addition, the comprehensive global cost shock is not expected to persist. Thus, all in all, business pricing behaviour is largely set to normalise, although we expect underlying inflationary pressure to be higher than previously, so that higher interest rates than before will be required for the inflation target to be reached. We expect inflation to gradually creep down towards the inflation target, but that price levels will remain high. This expectation is based on the economy not entering a deep recession. At the same time, this means that the labour share is set to increase – but how rapidly?

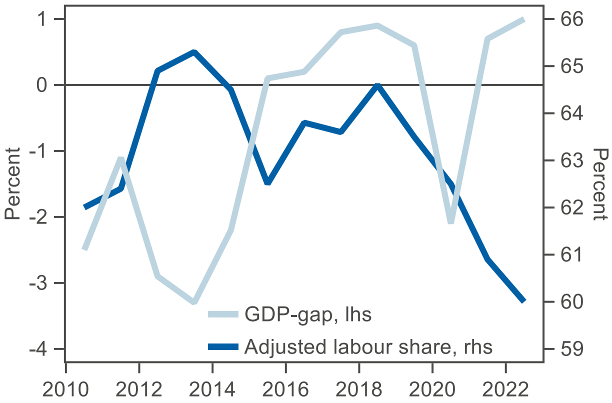
Labour share recovers slowly

Swedish wage formation, with its high degree of coordination, and manufacturing as the key sector, means that wage growth is relatively slow moving. This also means that the effect of wages on employment, etc. is taken into account. At the same time, there is less of a risk that high wages in other countries will pull up wages in Sweden, or that we will have a wage-price spiral.[6] Given our starting-point of high profits for the average business owner, squeezed real wages for employees, and the risk of inflation being further fuelled, the trade-offs for manufacturing employers' and employees' organisations in this year's collective agreement negotiations were particularly difficult. Nonetheless, early this year they managed to strike a two-year wage agreement; the employee side achieved higher wage increases than previously, but the second year's more moderate hourly wage growth clearly indicated that the Riksbank's inflation target is a long-term anchor of the wage formation model. In our view the two-year agreement was a good compromise, but it will take a long time for the labour share to recover.

This year, we expect the business cycle to weaken further and unemployment to rise. However, by the time of the 2025 collective agreement negotiations, we expect prospects to be looking brighter again. Admittedly, companies' actual profit margins will have slimmed down, but the profit share will still be somewhat elevated. This suggests that wages will again increase more rapidly than normal, even though the labour market has cooled.

Normally, the labour share is low (and the profit share high) during an economic boom, and rises (falls) after the business cycle has peaked. Thus, part of the recent fall in the labour share may be a normal cyclical effect. The cyclical fluctuations of the labour share correlate closely with productivity growth varying across the business cycle. At present, productivity growth is non-existent. However, in future we expect it to increase at a more normal rate of around 1.8 percent. Thus, in order for the labour share to recover, real wages will need to rise by around 2 percent per year, which is more quickly than the average rate of increase since 2000 at 1.7 percent.

Labour share to rise when economy has peaked



Note: Adjusted labour share refers to the business sector excluding residential properties.
Sources: Macrobond, NIER and Handelsbanken

If wages do not keep up with the profit trend, there will be a greater risk of conflicts and strikes in the labour market. Weaker demand will also make it more difficult for companies to protect their profit margins. Both the employers' difficulties in finding the right manpower and the employees' strong incentive to regain their purchasing power can also result in higher wages.

All in all, we expect real wages to increase more rapidly than previously. Nonetheless, despite this, we forecast a permanent drop in households' purchasing power, as real wages will recover only slowly, and not to the previous trend level (this is also the case with the outlook for developed economies' trend GDP following the negative global supply shocks of recent years). Thus, in our view, it will take a long time for the labour share to recover completely. Total household incomes will also be supported by, among other things, tax cuts, which would suggest that the recovery in real disposable incomes will take place more rapidly.

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[6] According to the NIER's simulations, wages in Sweden are affected relatively little by a higher rate of wage growth in other countries (see the Wage formation report 2022).

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