Senate Economics Legislation Committee

ANSWERS TO QUESTIONS ON NOTICE

Treasury Portfolio

Budget Estimates 2022 - 2023

Agency: Department of the Treasury
Question No: SBE134
Topic: Profits and inflation
Reference: Written (18 November 2022)
Senator: Nick McKim

Question:

1. What work has Treasury undertaken to understand the role that company profits are having in driving recent high inflation?
a. Has Treasury examined the contribution of changes in labour costs and profits to the GDP deflator during the recent period of high inflation?

2. Profits share of national income has risen structurally since the 1970's, and relatively sharply since 2016: Does Treasury attribute either this long-term trend or the more short-term trend to high commodity prices?

Answer:

1. Treasury's approach to understanding and forecasting inflation incorporates a wide array of factors. This includes monitoring relevant macroeconomic measures, such as the unemployment rate, wage growth, import prices and utilisation of capital. We also take into account feedback from business liaison and monitoring of international economic conditions, events and trends.

Inflation has recently increased in many countries, driven by factors such as the balance of global goods demand and supply, the impact of Russia's invasion of Ukraine and international supply chain disruptions. While inflation in Australia has been driven by these global factors, domestic weather events and supply constraints, combined with strong demand in residential construction and consumer goods, have also contributed to price growth.

Supply constraints during COVID have resulted in higher input costs. Ordinarily, businesses would at least partially absorb relatively small and temporary cost increases, as was observed earlier during the pandemic. As supply cost increases have compounded over time, somewhat fuller and earlier passthrough of cost increases has been reported through liaison. While not a primary driver of inflation, price setting behaviour of firms can respond to short-term economic conditions.

Recent changes in the profit share of income have been driven by large movements in commodity prices. Sectors with a higher capital intensity, including the mining sector, would typically have a larger share of income flowing to capital. Outside of the mining industry, the capital and labour shares of income have remained steady over recent decades (see response to Question 2 below). In the 2021-22 financial year, gross operating surplus contributed 3.9 percentage points to nominal GPD growth, compensation of employees contributed 2.8 percentage points to nominal GDP growth and gross mixed income contributed 0.6 percentage points to nominal GDP growth.

Treasury will continue to monitor measures of profit and business conditions. Gross operating surplus represents a return on capital invested and risk, which attracts further investment and puts downward pressure on inflation over time. Investment in capital supports capital deepening and productivity growth, which drive real wages growth.

2. The profit share of income has varied over time. In Australia, the rise in the profits share of income since the 1970s has been attributed to higher returns accruing to owners of housing and financial institutions. Over the past 20 years the expansion of the mining sector has played a larger role.

The increase in the profits share of income since 2016 was driven by higher mining profits supported by high commodity prices.

Commodity price increases typically flow to higher mining profits. This reflects the capital-intensive nature of the sector and the significant lead times required to increase output in response to price changes. As a result, a rise in commodity prices increases total income in the economy but also increases the share going to capital.

Higher commodity prices are also expected to increase consumer’s real purchasing power through an appreciation in the exchange rate, all else equal, which increases in government revenue.

The non-mining labour share of income has remained steady at around its 20-year average during this period.

sProfits and inflation

Question: *Are profits driving inflation?*

I'm aware of recent analysis suggesting that profits are a major driver of inflation. This is an important issue, but the analysis is flawed and significantly overstates the role of profits.

- It uses an incorrect measure of prices and profits.
- It fails to account for the major role played by elevated commodity prices.

Global cost increases have played a far more substantial role in driving inflation.

- The cost of imports for firms, shipping, petrol and construction materials. Floods also pushed up fruit and vegetable prices. These supply constraints are now easing.

Increasingly, wages will drive inflation, but this is consistent with a return to the target range, and the risk of a wage-price cycle remains low.

s22 [redacted]

Key points

The Australia Institute's paper on profits as a driver of inflation tackles an important question for Australians but its analysis is flawed.

- The analysis fails to account for the overwhelming influence of mining profits. If mining profits were properly accounted for in the analysis, returns to workers would not have fallen.
- The analysis also relies on a misleading measure of prices, the GDP deflator, which measures the prices received by firms rather than prices paid by consumers.

Rather than profits, global price shocks and compounding supply constraints have defined the current inflation episode to date. s22 [redacted]

s22 [redacted]

It would be difficult to assert that profits did not grow temporarily in some pockets of the economy. However, aggregate data does not support profits as a material or ongoing driver of inflation.

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[redacted]

National accounts data

- The factor shares of income are heavily impacted by the mining sector. In Treasury's view a more useful analysis of factor shares should exclude mining (see chart 1 below).
  - The profit share of factor income (including mining) increased from 31.4% to 31.8% in the December quarter however, the change this quarter (and over the last ten years) is a result of mining industry profits on the back of persistently high commodity prices.
  - The profit share of factor income excluding mining is now 0.1 per cent lower than December 2019, the quarter preceding the pandemic (Chart 1).
  - While not a precise guide to firm profits, this measure provides an indication of the distribution of income between factors of production.

Pages 3-5 are outside the scope of the request and have been deleted