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INFLATION AND CORPORATE MARKET POWER: LESSONS FROM RECENT CRISES

BENOÎT CŒURÉ*

“**W**hen the facts change, I change my mind, and you Sir?”, John Maynard Keynes is quoted as having said after the 1929 crisis. The inflationary crisis of the early 2020s has now compelled economists to take a fresh look at the causes of inflation.

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In the 2010s, inflation was low or very low in the developed economies, forcing central banks to deploy new instruments – large scale purchases of public and private securities, conditional loans, and negative interest rates. For the most part, economists attributed this weakness essentially to macroeconomic mechanisms, such as the trend decrease of the natural rate of interest, the weakness of mechanisms that transmit economic activity to prices, as well as international factors and, in the eurozone, repeated crises¹.

In contrast, the surge in prices after the double shock of lockdown and the war in Ukraine clearly had microeconomic causes: rising oil and gas prices, a supply of services limited by the lockdowns, and disruption of global production chains. Accustomed to looking at the demand side, macroeconomists had to start turning their eyes towards the supply side. To account for the transmission of price shocks, a sectoral approach was needed that reflected the severity of supply

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This article is based on a presentation given on September 28, 2023, at the invitation of the Breizh Macro Club of the Economics Department of the University of Rennes, and the roundtable of the OECD Competition Committee on November 30, 2022. The author would like to thank Agnès Bénassy-Quéré for her comments. The opinions expressed in this article are his own.

constraints and the nature of the energy mix within each sector of activity, and even within individual companies. And since a good crisis should never be wasted, economists pushed ahead with major research programs aimed at making the theoretical description of the economy more granular when dealing with frictions of all kinds (Baqee and Farhi, 2021) and at integrating real-time observation of the economy into macroeconomic analysis².

One aspect of this research aroused special interest from public opinion and economic decision-makers. It involved the behavior of companies during the twin crises of the Covid-19 pandemic and energy prices and to what extent they shared responsibility for the surge in inflation. By rapidly increasing their prices and boosting their profits during these two crises, companies are said to have contributed to the spread, and even the exacerbation, of the inflation shock. Based on the large profits noted in certain sectors, this debate developed in the United States under the catchwords of greedflation, sellers' inflation or profitflation before spreading to Europe, where it is more commonly referred to as the "profit price spiral", in reference to the wage price spiral of economic textbooks.

In the remainder of this article, I will examine the empirical arguments in favor of this thesis in Europe and the United States before placing it in the more general context of trade-offs between wage workers and owners of capital and then drawing the consequences for the formulation of anti-inflation policies, with particular attention paid to the role of competition policy.

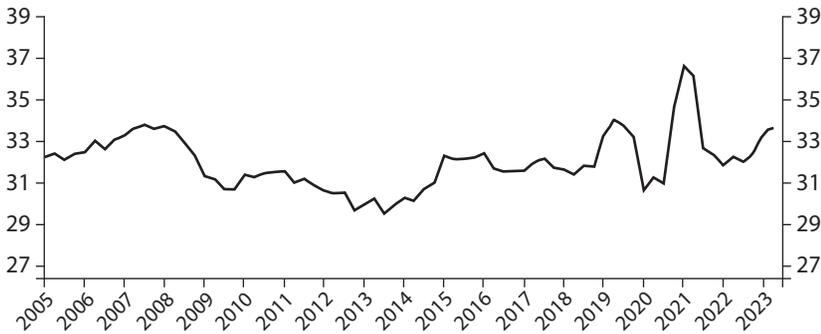
THE RISE IN CORPORATE PROFIT MARGINS AFTER THE PANDEMIC AND THE ENERGY CRISIS

At the macroeconomic level, the profit margin is the ratio of a company's gross operating profit to its value added, and thus measures the proportion of value added that remunerates capital. It should not be confused with the microeconomic definition of a company's margin, which measures its sales price in relation to its marginal cost on a given market and corresponds to markup in theoretical models. According to the Insee, the profit margin of French non-financial companies fell to 31% after the pandemic support measures were introduced. Between early 2021 and mid-2023, it then rose by almost two points to over 33% (see Figure 1 below).

This increase warrants several remarks. First, it needs to be considerably relativized from an historical perspective. As Figure 1 (below) shows, apart from the temporary shocks of the pandemic in 2020-2021 and from the substitution, in 2019, of the tax credit for competitiveness

and employment by a reduction in employers' social security payroll taxes, the profit margin of French non-financial companies has fluctuated within a fairly narrow range over the past twenty years. Secondly, the increase has been quite uneven from one business sector to another. In particular, profits in the agri-food industries rebounded by 50% in 2022. Their profit margin returned to its 2019 level, after having fallen by more than 4 points in 2021 due to the effect of rising input costs (Inspection générale des finances, 2023).

Figure 1
Profit Margin of Non-Financial Companies
(as % of value added)



Source: Insee.

There may have been different reasons for this increase. As the accounting breakdown shows below (for the moment, we remain at the macroeconomic level), an increase in the profit margin can be explained by a rise in labor productivity, by an improvement in terms of trade, by a decline in the real cost of labor, or even by a lowering of production taxes once the subsidies received are subtracted:

$$TM = \frac{P_Y Y - wL - (T + S)}{P_Y Y} = 1 - \frac{L}{Y} \frac{w}{P_C} \frac{P_C}{P_Y} - \frac{T - S}{P_Y Y}$$

Profit margin = 1 - {1/labor productivity} × {real wages} × {terms of trade} - {production taxes net of subsidies/value added}

Notations: Y denotes value added in volume, L employment, w wages, T production taxes in value, S business subsidies in value, P_c and P_Y consumption and value added prices.

Over the period under review, business subsidies more or less declined after pandemic support measures were ended, and the terms of trade were adversely affected by the rise in energy costs. The fact that on the whole companies were able to increase their profit margin in

such an environment shows that wage adjustments lagged and that, at least temporarily, it was possible to pass on higher input costs to sales prices, or even increase them more than costs. It is this behavior that lies at the heart of the “profit price spiral”.

MARKET POWER AND THE TRANSMISSION OF COST SHOCKS: THEORETICAL MECHANISMS

There are several possible explanations for the higher-than-normal elasticity of corporate sales prices. Consumers impatient to make up for lost consumption during the pandemic, and who had built up a cushion of savings during that period, may have been less price-conscious. Multiple factors limited the production of goods and services: sanitary restrictions, then shortages of raw materials, bottlenecks in the ports, and so on. In this context of scarcity, companies that remained active in a market were able to raise their prices more than their costs increased. In the sectors where demand was met by a limited number of companies, those companies benefited from greater market power. Finally, it can't be excluded that high inflation may have facilitated tacit collusion, or even active collusion punishable under competition law – I'll return to that later.

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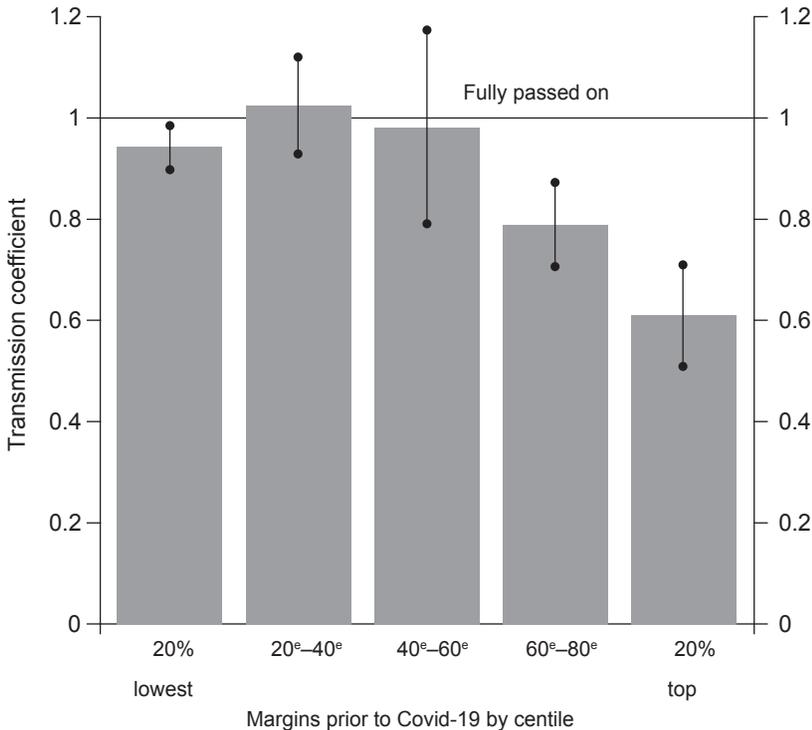
It is worth exploring the link between corporate market power and the transmission of cost shocks. What does theory tell us? Perfect competition is a useful benchmark, even if it doesn't exist in reality. In perfect competition, companies make zero profits, charge their marginal cost, and so transmit any cost shock in full. In monopolistic competition, the sales price is higher because it incorporates a profit margin based on the company's market power. If the margin is stable, shocks are fully transmitted. But the existence of this margin may make it possible for the company to temporarily absorb them. To sum up, companies with market power are expected to charge higher prices on average, but are also expected to have a greater capacity to absorb temporary shocks, such as the shock of 2021-2022.

A study by the International Monetary Fund using data from US companies largely confirms this reasoning (IMF, 2022). The authors point to a generally decreasing relationship between the pre-Covid profit margin and the degree of transmission of the 2019-2021 cost shock, with the notable exception of companies among the top fifth of those with the highest profit margins, for which the transmission coefficient is slightly lower (see Figure 2 below)³.

Bräuning *et al.* (2022) find, however, that the increased concentration of the US economy between 2005 and 2018⁴ led to a more pronounced transmission of costs to sale prices. Similarly, in the French case, Alquié and Thie (2023) find that the increase of energy prices in

2021 was passed on more completely to sales prices in industries with the highest initial margins. In the food industry, companies passed on up to 117% of the initial shock⁵.

Figure 2
Coefficient by Which Production Costs Were Passed Along to Prices
in 2019-2021 [in Function of Corporate Profit Margins; in %]



Source: IMF (2022).

These results seem inconsistent, but economists have good excuses. Profit margins are very uneven both between and within sectors. Alquié and Thie's study, for example, is limited to the manufacturing industry, where the increase in profits was greater in 2022. Generally, the impact of market power on price levels is a long-term relationship, one difficult to distinguish from its impact on price variations. The conceptual and empirical difficulties involved in measuring market power should also be noted. On a macroeconomic or sectoral level, the available indicator is the ratio between gross operating profit and value added (see above), but for individual corporate data, one attempts instead to look directly at the margin that the company applies to its costs⁶.

Secondly, as mentioned above, production capacity that is limited locally (e.g. during the lockdown) or internationally (e.g. due to shipping disruptions) justifies higher prices, all other things being equal. Comin *et al.* (2023) thus attribute half of the rise in inflation in the United States in 2021-2022 to production line disruptions. Other mechanisms may have also come into play, such as companies raising prices to build up a savings cushion in view of prospects that were less predictable.

Finally, the interaction between different markets is more complex than a purely macroeconomic approach would suggest. Take, for example, a company whose bargaining power is high when buying from its suppliers on the upstream market, but low when selling to its customers on the downstream market. The first factor limits the extent of the cost shock it endures, but the second factor limits its ability to pass the cost shock on. Another example: a company can exploit its market power for certain products in order to keep prices low on others. All this argues in favor of understanding developments in 2021-2023 by breaking them down as much as possible and not generalizing the much-publicized examples of a few companies in the energy or shipping sectors whose profits soared.

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THE "PROFIT PRICE SPIRAL": FANTASY OR REALITY?

The impact on prices of an increase in corporate profit margins can be measured simply by inverting the definition of the profit margin given above and by identifying the relative impact to the change in sales prices of profits measured in terms of value, labor costs, and taxes in value terms, after subtracting subsidies, all measured per unit of output:

$$P_Y = P_Y TM + \frac{wL}{Y} + \frac{T-S}{Y}$$

Value-added price = unit profit in value + unit wage cost
+ unit production taxes net of subsidies

What actually happened? In the United States, the findings differ according to the period, the field of activity, and the methodology employed. The recovery in unit profits accounted for 40% of the rise in the US GDP deflator between 2019 and 2021 according to the IMF (2022), but for only a quarter of it between 2021 and 2022, according to Gerinovics and Metelli (2023).

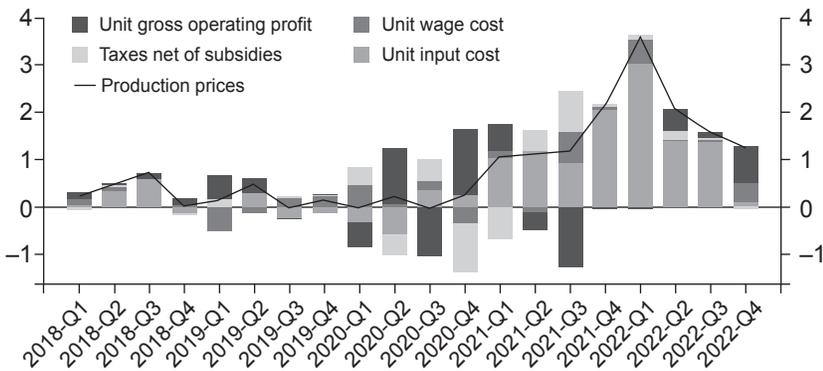
In the eurozone, a study by the European Central Bank created a major stir, fueling public debate on the profit price spiral. According to Arce *et al.* (2023), unit profits contributed to two thirds of the

increase in the price of value added in the eurozone between the end of 2021 and the end of 2022, whereas the historical average had been only one third. Using the same methodology, the European Commission (2023) found wide variations between countries. According to it, in France the contribution of unit profits was lower than the European average and in Spain it was much higher.

In the UK, the contributions of unit profit and unit wage costs appear to have been on the same level (Haskel, 2023). In France, the contribution of unit profit to inflation was even lower than that of unit wage costs in the second half of 2022, whereas it was higher in the eurozone (Bénassy-Quéré, 2023). In fact, with the exception of the agri-food industry, where unit profit recovered sharply in 2022 (see above), Figure 3 (below) shows that the unit gross operating profit of French non-agricultural market sectors did indeed recover beginning with the second quarter of 2022, but that its contribution to the rise in production prices remained limited when compared with the rise in input costs.

Figure 3
Contributions to Production Prices by Non-Agricultural Market Sectors
in France
(quarterly variations in %)

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Source: Insee.

The attentive reader will not failed to have noticed that the focus so far has been on the price of value added and not on consumer prices. Yet consumer prices in Europe were more affected by energy imports than they were in the United States. Other methodological criticisms have been levelled at the approach based on the contribution of unit profits to the price of value added⁷. First of all, this breakdown is an exercise in accounting and says nothing about shock transmission dynamics. Secondly, it can be affected by “cyclical effect” and “com-

position effects”. “Cyclical effect”: the profit margin always recovers during an upturn because employment and wages are slow to react to economic activity. It was therefore to be expected that it would recover in the aftermath of the pandemic, and in fact, although it is too early to draw conclusions, the figures for 2023 and subsequent forecasts show that the balance between profits and wages is beginning to be restored. “Composition effect”: a recovery in the labor market driven by job creation rather than wage growth, as was the case in France in 2022, automatically results in a low contribution from unit wages.

Overall, the “profit price spiral” seems to have been a temporary phenomenon, more European than American, and relatively less pronounced in France than in other European economies. It’s true that the initial macroeconomic situation was very different in the US and Europe – the terms-of-trade shock was positive in the US, a net energy exporter, and the labor market was also much tighter and wages consequently more dynamic. In 2024 and beyond, as energy prices are returning to normal, wages are picking up, and inflation is gradually returning to its 2% mark, it will be important to keep a close eye on whether corporate profit margins return to normal and to avoid any downward rigidities that could contribute to the fueling of high inflation.

*A RELATIONSHIP OF FORCES THAT INCREASINGLY
FAVORS CAPITAL?*

The debate on the “profit price spiral” can be put back in the broader context of the balance of power between labor and capital, concerning, both in the long run and through the macroeconomic cycle. Without disputing the macroeconomic origin of inflation (whether this origin is monetary or non-monetary is not the subject of this article), the conflict of interest between wage earners and holders of capital can lead each of them to try to protect their income – wage earners by increasing salaries and holders of capital by raising prices – with the result being inflation that persists or even increases. Previously, post-Marxist economists analyzed this war of attrition (Kalecki, 1954), as did – albeit with very different theoretical premises – New Keynesians. Doesn’t the WS-PS model, which is taught in all economics curriculums (Cahuc and Zylberberg, 1999), makes equilibrium unemployment the outcome of a Nash bargain between unions and businesses?

The negotiation between labor and capital is part of the background of recent discussions on the profit price spiral, as evidenced by the title of the European Central Bank study mentioned previously: “How tit-for-tat inflation can make everyone poorer”. Lorenzoni and Werning (2023) have proposed a more up to date theoretical model under a blunter title: “Inflation is conflict”.

The question may thus be raised as to whether the recent inflationary episode is different from previous episodes not only because of the nature of the shock, but also because the relative bargaining power of workers and holders of capital has gradually changed. Certain trends point in this direction.

During the entire decade of the 2010s, low inflation was partly attributed to the weakness of wage demands, despite an unemployment rate above its equilibrium level. In both the US and Europe, the Philips curve, which links the unemployment rate (or insufficient demand) to wage fluctuations, was too flat. There were various explanations – a trend towards weaker trade unions; imported disinflation from low-wage emerging countries; substitution by capital and low-skilled labor under the pressure of new technologies; in the eurozone, a current account surplus, and so on. Even if we can't rule out the possibility that the Philips curve is non-linear, and that wage demands will accelerate if unemployment drops below a certain level, the structural causes of the weakness of wage demands are likely to persist, or even deepen – consider the growing debate on the impact of artificial intelligence on employment. Moreover, the link between higher wages and higher prices, which macroeconomists and central bankers take for granted, often turns out to be surprisingly weak empirically (Eser *et al.*, 2020). All these factors may have given more weight to the role of companies (as opposed to wage workers) in the inflation dynamic.

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FROM MACRO TO MICRO: INCREASING CONCENTRATION OF PRODUCTION

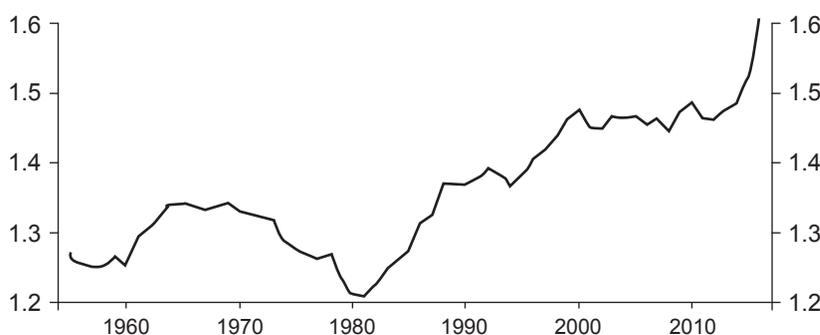
The decade of the 2010s was characterized by an increasing concentration of activity in the developed economies. Philippon (2022) has demonstrated this in the United States, ascribing it to the weakness of competition policies until the arrival of the Biden administration. We also know that, within each sector, the reallocation of market share towards the most productive companies (emergence of corporate “superstars”) has contributed to the decline of the wage share of value added (Autor *et al.*, 2020). The spectacular rise in the individual markup of US companies (from 21% to 61% of their marginal cost between 1980 and 2014, according to De Loecker *et al.*, 2020, see Figure 4 below) is concentrated among the most powerful companies within each sector, with the median markup remaining unchanged.

In Europe, Koltay *et al.* (2023) examined the importance of the four largest companies in each sector and each country. This concentration indicator rose by an average of 7 points between 1998 and 2019, from 36% to 43%. It's in France and the UK that concentration increased the most: +11 and +10 points respectively, versus +5 points

in Germany and Italy. At the end of that period, the most concentrated economy was the UK and the least concentrated was Italy. The sectors with the highest degree of concentration were communications, transport, energy, and finance.

In France, Bauer and Boussard (2020) found that the individual markup was stable between 1984 and 2016, with the same composition effect as in the US, i.e. a redistribution of production towards the larger companies in each sector. However, this was mitigated in France by a general decline in corporate market power, which the authors explain by international competition and the emergence of online platforms and price comparators. More recent estimates do not appear to be available.

Figure 4
Average Markup of US Companies from 1955 to 2016
(expressed as a multiple of marginal cost)



Sources: De Loecker *et al.* (2020); calculated from individual company data.

A MORE DIVERSE TOOLBOX TO FIGHT INFLATION

Let's return to Keynes: "When the facts change, I change my mind, and you Sir?". The autopilot that guided macroeconomic policy during the "great moderation" of the 2000s fell victim to a succession of crises. The global financial crisis reminded us of the necessary role of the state in disciplining private impulses and providing liquidity in times of crisis. The eurozone crisis dispelled the illusion that the single monetary policy could be oblivious to the situations of the economies involved. The pandemic demonstrated the power of a coordinated approach to fiscal and monetary policy when their goals coincide. And along with the war in Ukraine and the energy crisis, it also exposed the microeconomic roots of certain inflationary episodes.

This crisis of a new type saw the use of tools against inflation that ranged from monetary policy (which remains key to stabilizing expec-

tations) to fiscal policy (in order to stabilize household income first amid lockdowns, then against the energy shock)⁸, to tools of a more microeconomic nature, such as competition policy and regulatory policies in the energy, agricultural, and retail sectors. Some have even suggested returning to administered price controls as an instrument of last resort (Weber and Wasner, 2023).

In what follows, we will focus on the role of competition policy⁹. The previous analyses suggest that we should distinguish between the impact of corporate market power on price *levels*, which is a long-term phenomenon, and its impact on price *variations*.

In the long term and all other things being equal, increasing corporate market power leads to higher margins and therefore higher prices. Competition policy, by encouraging competition on the basis of merit as well as the arrival of new players, proves here all its usefulness in reducing monopoly or oligopoly rents. In the short term, as we saw above, the relationship between concentration and price increases or decreases is not clear-cut. On the one hand, powerful companies can pass on higher costs to their customers and/or put pressure on their suppliers. On the other hand, their higher margins may enable them to absorb these cost increases, at least temporarily, thus slowing the spread of inflation. Consequently, antitrust policy can be of only limited help, unless it is shown that anti-competitive behavior is encouraging cost increases. For example, some companies may be tempted to take advantage of a windfall effect to raise their prices excessively while hiding behind the need to pass on increased costs. Others may be tempted to work together with their competitors in a “crisis cartel” to pass on price increases to their customers in a coordinated manner (Combe, 2022). Tacit collusive behavior can also occur.

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In such an environment, price transparency plays an ambiguous role. It helps consumers choose, but can also aggravate competitive risks. Indeed, companies may have an incentive to coordinate their present or future price increases, either explicitly or tacitly. In markets whose structure is likely to encourage anti-competitive coordination, competition authorities need to reinforce their vigilance regarding the exchange of information between companies¹⁰.

Competition authorities are taking action in three areas: detecting and penalizing anti-competitive practices (“antitrust” efforts), controlling mergers and acquisitions, and issuing opinions¹¹.

1– One example of an anti-competitive practice is the cartel, an arrangement by which competitors agree on prices or divvy up markets. Through the higher prices they cause, cartels directly affect buying power. For example, compensation awarded by European courts for

harm caused by cartels reveals prices 12 % higher on average, sometimes as much as 34% higher for the products concerned (Laborde, 2021). In September 2023, the French Autorité de la concurrence levied 31.2 million euros in fines against six companies in the nuclear demolition sector for having conspired together on tenders issued by the French Atomic Energy Commission (CEA). Dawn raids have recently been carried out in the dairy, food and non-food consumer good, graphic card, and air transportation sectors, which may lead to statements of objections and, where appropriate, penalties.

Another anti-competitive practice, abuse of a dominant position, can lead to a company foreclosing its competitors, or charging excessive prices that it would not have been able to charge in a competitive market. In December 2022, the French Autorité de la concurrence took disciplinary action against such practices on the market for safety certification of trucks in the Caribbean islands of Guadeloupe.

2– Merger control aims at preserving the competitive structure of markets by imposing remedies for, or even banning, a merger or acquisition that presents too many risks to competition, particularly in the form of price increases – but also in the form of a problem of diversity or innovation. The French Autorité de la concurrence issued 266 merger decisions in 2023, 4 of which imposed conditions. This is the preferred instrument for preventing the accumulation of excessive market power.

3– Competition authorities are frequently asked to give their opinion on draft regulations or legislation, and to analyze their impact on competition. On their own initiative, they may also investigate the competitive functioning of a sector. In such cases, they seek to identify reforms that will improve households' purchasing power and offset some of the losses caused by inflation. In 2022, the Austrian, German, and Greek competition authorities investigated how hydrocarbon prices are set. In 2023, the French authority published opinions on cloud computing, real estate brokerage, food vouchers, and ground passenger transportation. In 2024, it is working in particular on electric vehicle charging stations and artificial intelligence.

CONCLUSION

Competition and the business cycle do not share the same time horizon, and competition policy cannot be the main weapon against inflation. It can, however, identify reforms that make it possible to improve households' purchasing power, prevent excessive market concentration when there is still time, and punish certain behaviors likely to favor price increases. Even if it takes years to investigate these

practices, meting out disciplinary action for past abuses and dawn raids carried out by the Autorité de la concurrence, which are preparing future disciplinary action, send an important signal to economic players¹². In some cases, the quest for more competitive market structures may require more extensive government intervention, such as the prohibition of certain practices *ex ante*, as provided for in the new European Digital Markets Act, and the tightening of sectoral regulations.

The “profit price spiral” of 2022-2023 is probably behind us, but it has woken up economic leaders to the macroeconomic consequences of the increased concentration of our economies and to the need for an improved dialogue between macroeconomists and industrial organization specialists, as well as between central bankers and regulators.

January 2024

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1. Already at the time some analyses were devoted to the consequences of the growing concentration of the economy for the transmission of monetary policy, see for example Duval *et al.* (2021).
2. See, for example, Chetty *et al.* (2023) for the United States, and the contributions brought together in the special July 2020 issue of the *Revue de l'OFCE* for France.
3. This result is difficult to understand, because companies with the lowest profit margins are generally subject to more intense competition and should pass on cost shocks in full – unless there are possible sector composition biases.
4. Specifically, the authors find an increase from 0.095 to 0.14 in the Herfindahl-Hirschman index in the US economy between 2005 and 2018, excluding public services, network industries, gas stations, postal and financial services.
5. The industries where companies raised their prices more than the increase in their energy bill (transmission coefficient greater than one) are the food industry, textiles, metal products, cars, and lumber.
6. See De Ridder *et al.* (2022) for a methodological discussion and the examples given below.
7. See Bénassy-Quéré (2023) for a discussion.
8. It has been objected that these subsidies, by augmenting household income, may be a source of future inflation. Economists at the International Monetary Fund have shown that this is not the case and that the net effect of these measures has indeed been to moderate inflation (Gourinchas, 2023).
9. For a more detailed discussion, see the OECD Secretariat note (2022).
10. In its opinion 23-A-06, the Autorité de la concurrence thus noted the potential risks to competition of a plan to publish the cost of building materials, since the upstream markets concerned were highly concentrated.
11. See Cœuré (2023) for a more detailed presentation.
12. See my interview in *Le Parisien* (Vérier and Lernoud, 2023).

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