COMPANIES' PRICING POWER AND THE INFLATION OUTLOOK

The question of the persistence of high inflation matters because it will determine the extent of monetary tightening necessary to bring inflation under control. Key factors are growth of unit labour costs, the price elasticity of demand and its mirror image, the pricing power of companies. The latter two are conditioned, at least in part, by the cyclical environment: when growth is very strong, price elasticity of demand will be lower and pricing power higher than normal. A regression analysis between the PMI output prices index and the PMI input prices index (explanatory variable) shows that recently in the US and the euro area, pricing power has increased quite significantly. Rising input prices force companies to consider increasing their output prices and strong demand enables them to do so. In the latest surveys, input and output prices have started to ease, so fewer companies than before face price increases or are raising their sales prices. This should slow down inflation. Eventually, slower demand growth should contribute to this development by reducing pricing power.

Until some months ago, the Federal Reserve and the ECB considered the elevated level of inflation as transitory, but since then their thinking has evolved and they see it now as more lasting. This change in view has influenced their guidance with respect to the outlook for monetary policy, causing an upward shift of the yield curve in the US and the euro area.

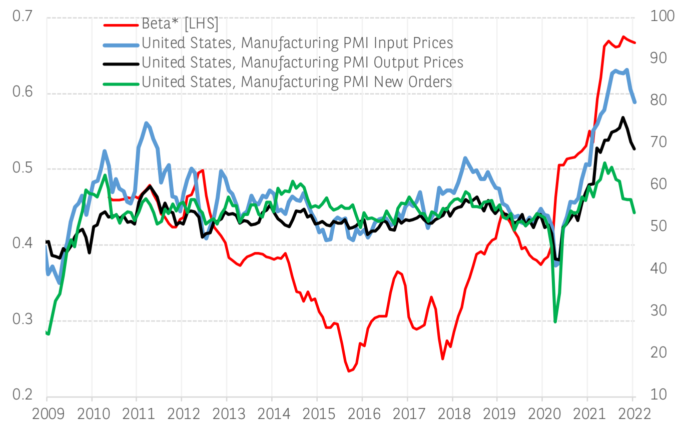
The question of the persistence of high inflation matters because it will determine the extent of monetary tightening that will be necessary to bring inflation under control. Moreover, the bigger the expected cumulative rate increases, the higher the risk that eventually fears about a significant hit to growth start to build. When analyzing the dynamics of inflation, it is useful to make a distinction between the initial inflation shock and second-round effects. Concerning the former, the inflation jump that started last year was the result of a positive demand shock, a shift in demand from services to consumer goods – a phenomenon that was particularly strong in the US – and a supply shock. The latter was caused by bottlenecks, whereby supply, due to its short-term inelasticity, could not keep pace with strong demand growth. Supply chain disruptions also played a role.

Second-round effects refer to the interaction between wages and prices and, more broadly, to the pass-through of higher input costs into the prices of more and more products and services. Key factors are the growth in wages compared to the change in productivity – considering that for the profitability of a company, it is the change in unit labour costs that matters –, the price elasticity of demand and its mirror image, the pricing power of companies[1]. The latter two are conditioned, at least in part, by the cyclical environment. When household income growth is strong (weak), one should expect price elasticity to be low (high) and pricing power to be high (low).

1 These three factors are in turn influenced by inflation expectations, the growth outlook, etc.

This cyclicality is important for the analysis of the second-round effects. When growth is strong, the transmission of the initial inflation shock to wages and a broad range of goods and services should be high whereas it should weaken when growth is slowing. Less dynamic growth should lead to lower inflation because it will reduce the imbalance between demand and supply but also because the negotiation power of the labour force weakens – causing wage growth to slow – and households spend more time on comparing prices before making purchases. The latter implies a decline of corporate pricing power.

UNITED STATES: INPUT PRICES, OUTPUT PRICES AND PRICING POWER



*Beta coefficient of rolling regressions (3-year window) of Manufacturing PMI Output Prices as a function Manufacturing PMI Input Prices

CHART 1

SOURCE: MARKIT, BNP PARIBAS

> In the latest surveys, input and output prices have started to ease, so fewer companies than before face price increases or are raising their sales prices. This should slow down inflation. Eventually, slower demand growth should contribute to this development by reducing pricing power.

The purchasing managers' surveys (PMI) allow to shed light on this by comparing the evolution of input prices and output prices for the manufacturing sector. Unsurprisingly, both are highly correlated and very cyclical (chart 1 and 2)[2]. In order to check whether pricing power fluctuates over time, a rolling regression has been run between the PMI output prices index (dependent variable) and the PMI input price index (explanatory variable). A rising beta means that when an increasing number of companies report higher input prices, more companies than before report they are raising their sales prices. As shown in the charts, in the US the beta coefficient has increased very significantly as of late, reaching record levels[3]. The same applies in the euro area, although the beta is smaller than in the US. The results suggest that recently, pricing power has increased quite significantly against a background of intense pressure from input prices and strong demand, as shown by the high level of the new orders PMI. Rising input prices force companies to consider increasing their output prices and strong demand enables them to do so. In the latest surveys, input and output prices have started to ease, so fewer companies than before face price increases or are raising their sales prices. This should slow down inflation. Eventually, slower demand growth should contribute to this development by reducing pricing power.

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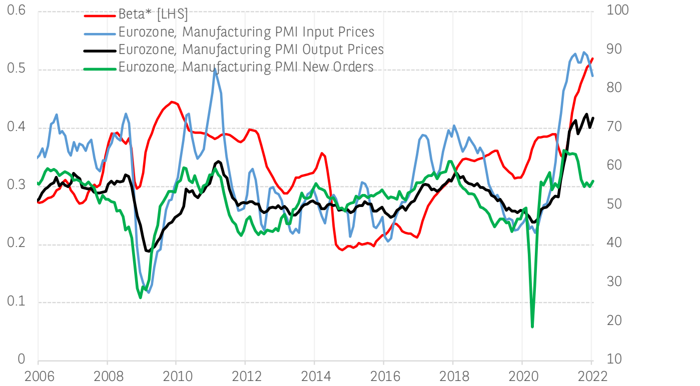

*Beta coefficient of rolling regressions (3-year window) of Manufacturing PMI Output Prices as a function of Manufacturing PMI Input Prices

CHART 2

SOURCE: MARKIT, BNP PARIBAS

2 The PMI indices are diffusion indices so an index value of 100 means that all companies respond their input (output) prices are rising compared to the previous month and a value of 50 means there is no change or that an equal number of companies report higher or lower prices. Source: Markit PMI website.

3 Because the beta is calculated for a moving window of 3 years, there is a lag between its evolution and that of the PMI input and output prices.