BOX 2: RECENT DEVELOPMENTS IN PROFITS AND FORECAST IMPLICATIONS[1]

The steep increase in underlying inflation in Malta was in large part driven by very high import price pressures, although re-opening effects after the pandemic may also have contributed. Since Malta is a small, open economy, these high import price pressures are a major cost to Maltese businesses. Businesses may either absorb such costs, compressing profit margins, or may pass them on to consumers. The pass-through to consumer price inflation depends on firms' ability to pass on higher costs to retail prices – which would be reflected in profit margins.

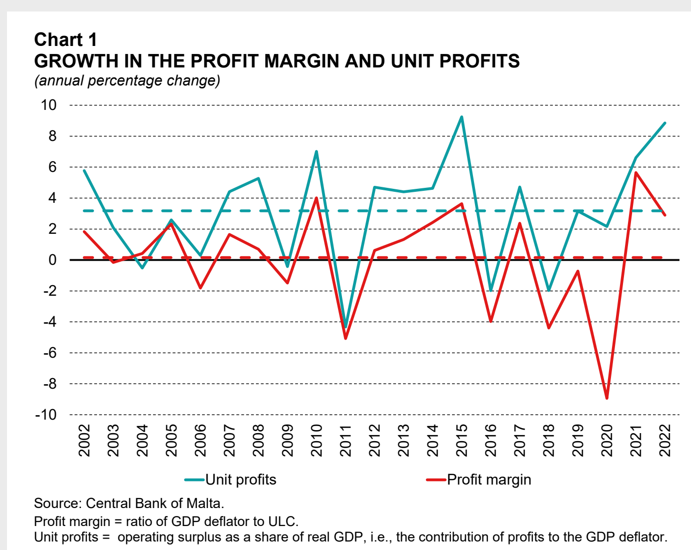
There are two main indicators of profits that emerge from the national accounts: unit profits and profit margins. Unit profits measure domestic price pressures and are defined as gross operating surplus and mixed income per unit of real GDP. The second indicator is profit margins which is defined as the ratio of the GDP deflator to unit labour costs (ULCs).[2] The latter shows the degree to which profits grow with respect to the change in labour costs.[3]

This box outlines recent developments in both indicators and expands on profit growth projections.

Recent developments in unit profits and profit margins

Chart 1 plots the growth in profit margins and unit profits since 2002 and compares them to their historical average (dashed line). On average, unit profits have grown at an annual rate of around 3.2% since 2001, while the profit margin historical growth rate stands at around 0.2%. Both indicators have picked up strongly since 2021 and have markedly exceeded their historical averages. This

Chart 1
GROWTH IN THE PROFIT MARGIN AND UNIT PROFITS
(annual percentage change)



Source: Central Bank of Malta.
Profit margin = ratio of GDP deflator to ULC.
Unit profits = operating surplus as a share of real GDP, i.e., the contribution of profits to the GDP deflator.

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[1] Prepared by Ian Borg, Manager within the Economic Projections and Conjunctural Analysis office.

[2] See https://www.ecb.europa.eu/pub/economic-bulletin/focus/2023/html/ecb.ebbox202304_03~705befadac.en.html#:~:text=Overall%2C%20unit%20profits%20have%20grown,through%20of%20increased%20labour%20costs for an extensive treatment of such measures.

[3] These measures must be interpreted with cautions in view of measurement difficulties in deflators as well as the evolution of hours worked on unit labour costs. Another measure of profits is the profit markup, which is expressed as profit as a percentage to total costs. See https://maltabusinessweekly.com/insight-averting-a-wage-price-spiral/23594/ for the latter.

suggests that firms have generally been able to pass on recent increases in costs to consumer prices.

Developments in profits need to be interpreted with caution, however, especially in view of the statistical impact of the pandemic on these measures. Firstly, while unit profit growth slowed down slightly in 2020, it remained quite robust (and close to its historical average). This reflects the statistical impact of the wage supplement scheme on unit taxes and unit labour costs. The wage supplement scheme was generally very successful at avoiding layoffs through subsidies to firms. By contrast, profit margins declined sharply in 2020 in view of the sharp increase in ULCs, though this was partly financed by the wage supplement scheme.

The strong increase in unit profits and profit margins in 2021 and 2022 can thus partly be interepreted as a normalisation from the pandemic. Indeed, profit margins rose sharply in 2021 and 2022 in view of the strong decline in unit labour costs, which was in turn driven by a sharp improvement in productivity as activity levels rebounded. Meanwhile, unit profits continued to accelerate in 2022, as the positive contribution of unit taxes decreased.

Chart 2 shows the evolution of profit margins in the industrial and services sectors, excluding the public administration, education, and health. Profit margins have improved in both the industrial and services sectors in 2021 and 2022.[4] Profit margins in the industrial sector have reached historical highs, which suggests that, the manufacturing industry was able to pass on higher non-energy input costs to customers. In part, though, this might also reflect the fact that Maltese businesses have generally been shielded from higher energy costs due to the government's freezing of energy prices, which thus limited the increase in their overall production costs. This enabled local firms to increase their profit margins without compromising competitiveness.

In the services sector, the increase in profit margins in 2021 and 2022 may reflect a normalisation in profit margins following the sharp declines experienced in 2020 as a result of the COVID-19 pandemic. However, profit margins in this sector exceeded those in 2019. We observe a broad improvement in profit margins across all sub-sectors of the services sector, which

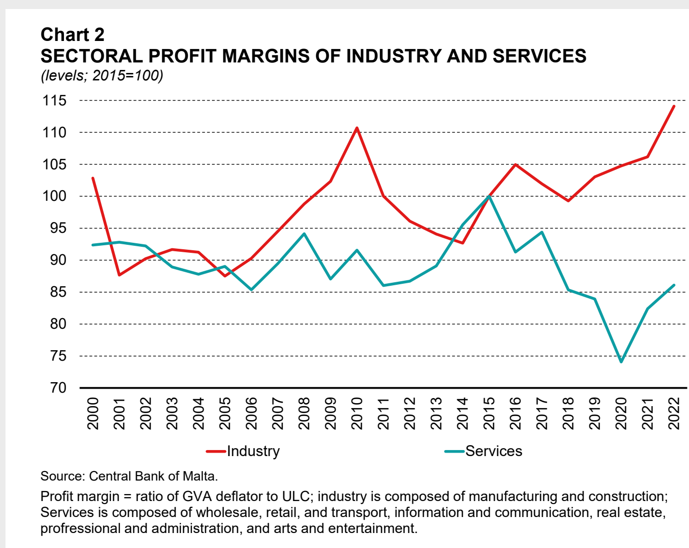


Chart 2
SECTORAL PROFIT MARGINS OF INDUSTRY AND SERVICES
(levels; 2015=100)

Source: Central Bank of Malta.
Profit margin = ratio of GVA deflator to ULC; industry is composed of manufacturing and construction; Services is composed of wholesale, retail, and transport, information and communication, real estate, professional and administration, and arts and entertainment.

[4] The industrial sector is composed of manufacturing and construction. Services is composed of the wholesale, retail and transport, information and communication, real estate, professional and administration, and arts and entertainment.

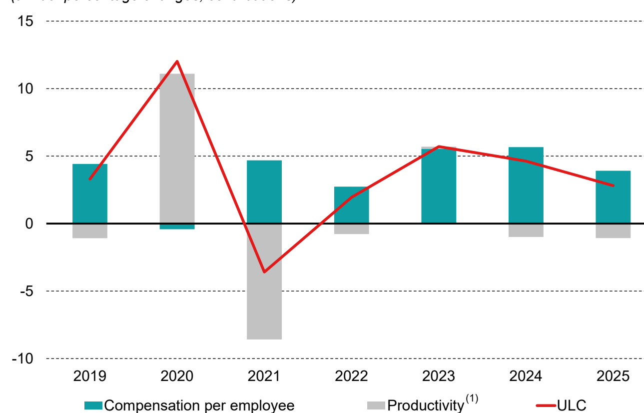
reverses the trend decline in profit margins that occurred between 2015 and 2019. In particular, sectors that are more domestically-oriented – such as the wholesale, retail, and transport sector – have regained their 2019 profit margins after the strong decline experienced in 2020. Meanwhile, export-oriented sectors such as the professional and administration sector, as well as the arts and entertainment sectors, have increased their profit margins beyond those in 2019.

Profitability is expected to moderate significantly in the projection horizon

The latest CBM business dialogue[5] suggests that firms this year are increasingly worried about their ability to maintain strong profitability levels. In part this reflects very high wage pressures due to inflation compensation and high labour market tightness.

During the projection horizon, we expect unit labour costs to increase markedly, and exceed their historical growth (see Chart 3). This is projected to be driven by a sharp rise in nominal wage growth, which reflects the prevailing high wage pressures. Meanwhile, productivity growth is expected to remain subdued over the projection horizon, as demand for employees is still expected to remain strong.

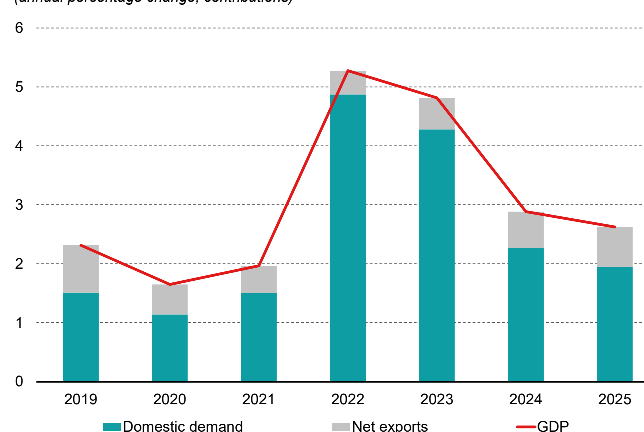
Chart 3
UNIT LABOUR COSTS PROJECTIONS
(annual percentage changes; contributions)



Source: Central Bank of Malta.
(1) A rise (drop) in productivity contributes negatively (positively) to ULC growth.

As regards prices, we expect that growth in the GDP deflator will remain persistently high in 2023. It is projected to grow by 4.8% in 2023, slightly down from 5.3% in 2022 (see Chart 4). This reflects our projection that consumption prices will remain quite high this year in view of very high inflation persistence (see Box 1). Meanwhile,

Chart 4
GDP DEFLATOR PROJECTIONS
(annual percentage change; contributions)



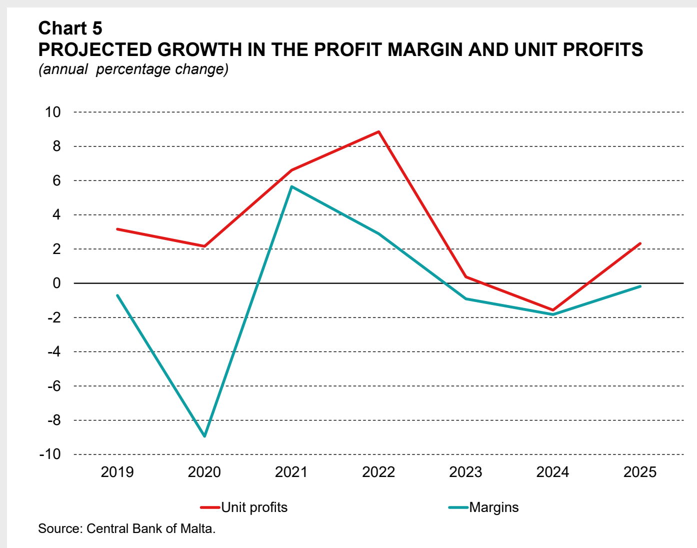
Source: Central Bank of Malta.

[5] See Business Dialogue Vol. 3 No. 3.

investment prices are expected to moderate somewhat this year in view of lower import price pressures. On the other hand, the terms of trade are projected to contribute positively to the growth in the GDP deflator as import price pressures normalise. Over the period 2024 and 2025, we expect growth in the GDP deflator to ease considerably. This is driven almost entirely by the envisaged slowdown in consumer prices.

In view of the expected sharp increase in labour costs over the projection horizon, as well as the projected moderation in price pressures, we expect profitability to be weak (see Chart 5). This implies that over the projection horizon, the rise in costs will be distributed between both labour and businesses. In particular, profit margins are projected to decline throughout the projection horizon. Meanwhile, growth in unit profits is expected to remain slightly positive this year, supported in part by energy-related subsidies, before they decline in 2024 and increase again in 2025.

Chart 5
PROJECTED GROWTH IN THE PROFIT MARGIN AND UNIT PROFITS
(annual percentage change)



Source: Central Bank of Malta.