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The Great Transition.

Global Opportunities

Introduction

June 2016

The Great Transition argued the global economy was transitioning towards a higher level of productivity. This productivity surge is deflationary. It lowers prices and, in turn, it should lower profitability. In particular, it argued that corporate capital is challenged by the consequences of technology, competition, easily accessible information and shifting consumer patterns.

At the heart of this change is the rise of the market in decision-making. Market-based decisions are fundamentally changing the global economy and making redundant historical decision-making structures; most obviously the global corporation. The Great Transition identified a number of factors in making information more accessible and valuable. These include falling decision-making costs, the cheaper acquisition of trust, the ability of smaller businesses to access the benefits of scale and a shift in consumption patterns from the homogenous to the heterogeneous.

In the coming decade, these substantial changes are likely to impact the profits flowing to corporations. They may also be to the benefit of labour providers. This second edition of the Great Transition will aim to explore in more detail the level of profitability globally and attempt to identify some of the changes likely to occur in coming years.

But as the inestimable Yogi Berra[1] put it "In theory there is no difference between theory and practice. In practice, there is."

James White
Senior Analyst, Economic and Market Research

Profits

What is profit?

Profits should not exist; not for long anyway and not in a competitive economy. At least that is the theory.

Profit, defined by economists, is the difference between total revenues and both explicit costs (the costs associated with supplying a good or service) and implicit costs (the opportunity cost of allocating capital to this opportunity). Economic profit exists when no other allocation could offer the same level of risk-adjusted return.

In a competitive economy, the existence of such profits is presumed impossible. Profits act as a signal for other entrepreneurs to allocate capital to the opportunity and so compete away the excess return.

What service does profit provide to an economy?

Above all, profit is a signal to entrepreneurs. High profits should provide an incentive to entrepreneurs to invest capital in order to capture some of the return themselves. In doing so, entrepreneurs will provide the conditions for high profits to be competed away. This is a useful service to the economy in itself; such an outcome optimises levels of goods production or service provision and should help ensure a stable price environment.

Does the level of profit matter?

Not particularly. Indeed, persistent high profits run two risks. Most obviously, economic profits are often followed by losses as new capital rushes in to claim an excess return, pushing returns rapidly lower. In the course of the last two decades, three such major 'boom to bust' cycles have been observed; the 'Asia Crisis', the 'Tech Wreck' and the 'Sub-Prime Crisis'. Alternatively, persistent high profits are often associated with natural monopolies. In these cases, government will often regulate the industry or asset to ensure that these natural monopolies do not exploit their position with consumers.

1 http://www.brainyquote.com/quotes/quotes/y/yogiberra141506.html

A persistent, low profitability economy presents some advantages. It should be more stable. The absence of an economic profit is likely to result in shallower business cycles; less of a boom and less of a bust. The achievement of such an economic outcome will be determined by competitive conditions; a regulatory environment that encourages competition and access to shared infrastructure to lower the capital costs associated with competition.

A higher profitability economy may not necessarily present as many advantages. In recent years, there has been considerable focus on the profit share of modern economies. This focus has examined the consequences of high profits on inequality of income. It has also begged the question: if profits are high, why are they not reinvested into the national economy?

The Data

As a starting point, an examination of the data highlights many of the key points.

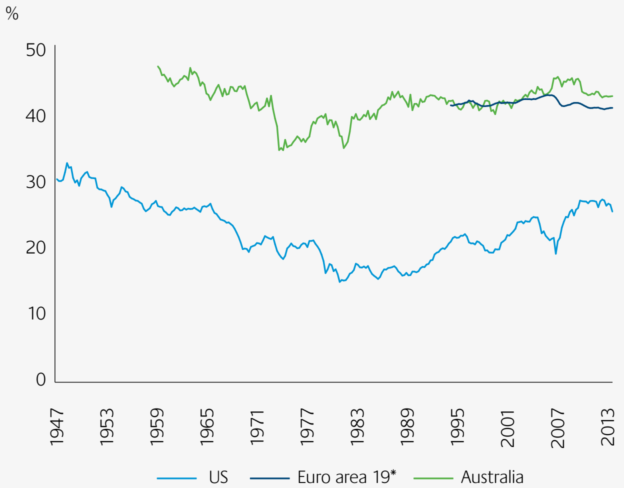
The data, looking at national income, varies across jurisdictions. In the United States (US) the data goes back to 1947 and Australia to 1959, while in the Euro area it goes back to just 1995. The data is often also classified in different ways, making cross-country comparison more difficult. But at a broad level, it is possible to highlight some important trends.

Profits as a share of National Income

In Australia and the Euro area, profit data includes the profits of companies, but also the profits from the investments of individuals. As a consequence, the data for the US has been similarly adjusted, though it is likely the adjustment is imperfect.

The data show profits have grown as a share of national income in both Australia and the US from the 1980s, though there has been some divergence in the post financial crisis era. Importantly, the impact of the decline in oil prices is beginning to emerge in the US profit data.

Chart 1: Gross Operating Surplus & Mixed Income as % of GNI (to Dec 2015)



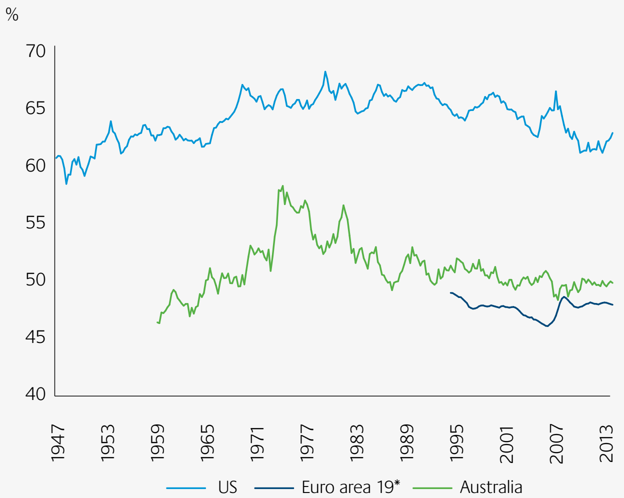
* The euro area 19 series represents Gross Operating Surplus and Mixed Income as a % of GDP and is a four-quarter trailing moving average.

Source: CEIC, US Bureau of Economic Analysis, Federal Reserve Bank of St. Louis, Eurostat, ECB, Australian Bureau of Statistics.

Employee Compensation

The lower level of employee compensation in Australia and the Euro area, likely explains the lower operating surplus in the US. That is, for instance, in Australia household investment income is included as corporate profit, whilst in the US, investment income from corporate activity is accounted for as household income. The obvious conclusion to draw from this data is the decline in employee compensation, as a share of national income, from the beginning of the new millennium. Though again, recent developments seem to be more supportive for wages.

Chart 2: Employee Compensation as % of GNI (to Dec 2015)



* The euro area 19 series represents Employee Compensation as a % of GDP and is a four-quarter trailing moving average.

Source: CEIC, US Bureau of Economic Analysis, Federal Reserve Bank of St. Louis, Eurostat, ECB, Australian Bureau of Statistics.

The aim of this series

The aim of this series is to shine a greater level of light on global profitability. Is global profitability likely to remain at record highs? Are wages likely to enjoy a larger share of income?

In order to answer these questions, the following areas will be examined:

- Profits in the US.
- Global profits.
- The profitability of the listed sector: what are the benefits to being listed?
- The experience in emerging economies: is information transforming profits?
- The impact of the services sector on profitability, particularly in Australia.
- The role technology, information and competition are directly impacting profits.

The research is likely to provide an insight to the future direction of global profitability and the consequences for the economy and financial markets.