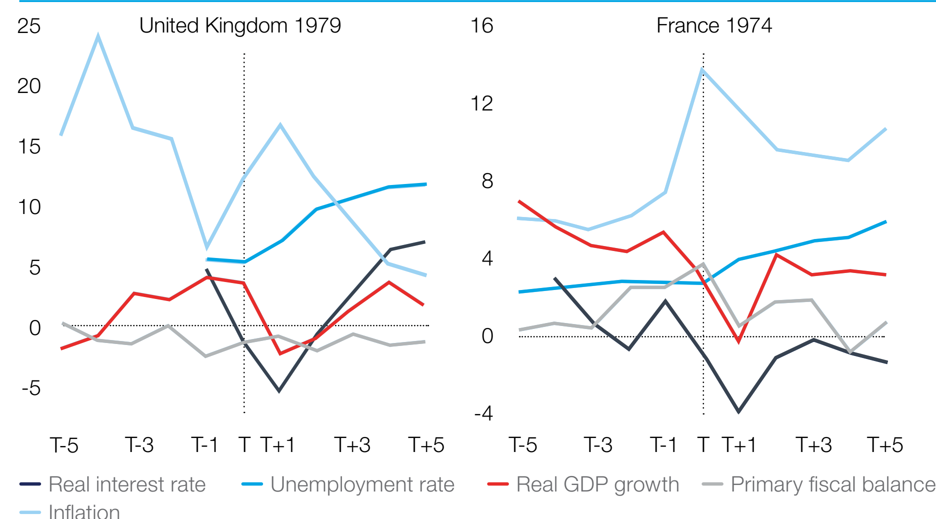
The Economic Brief returns in 2024 with two topics in the spotlight. Continuing a theme from the last edition, we look into inflation and consider how its current development compares with past crises and trends. We move on to examine corporate profits, reviewing in particular forecast against past performance and interpreting how feasible such forecasts may be.

How can we beat inflation? To answer this question, let us take inspiration from the IMF's paper *One Hundred Inflation Shocks: Seven Stylised Facts*, published towards the end of last year. The paper reviews more than 100 inflationary shock episodes over the past half century and draws seven conclusions that can be put to effect in facing inflation now. These seven 'stylised facts' are set out below:

- **Inflation is persistent, especially after a terms-of-trade shock.**
- **Most unresolved inflation episodes involved 'premature celebrations', where inflation declined initially only to plateau at an elevated level or re-accelerate later.**
- **Countries that resolved inflation had tighter monetary policy. There is further, weaker evidence for tighter fiscal policy too.**
- **Countries that resolved inflation implemented restrictive policies more consistently over time.**
- **Countries that resolved inflation contained nominal exchange rate depreciation.**
- **Countries that resolved inflation had lower nominal wage growth. This did not translate into lower real wage growth, as lower nominal wage growth coincided with lower inflation.**
- **Countries that resolved inflation experienced lower growth in the short term but not over the five-year horizon. This potentially indicates that the benefits of macroeconomic stability and policy credibility over time offset the costs of a tighter policy stance.**

Example of policy paths during inflation shocks



Sources: Accuracy, IMF

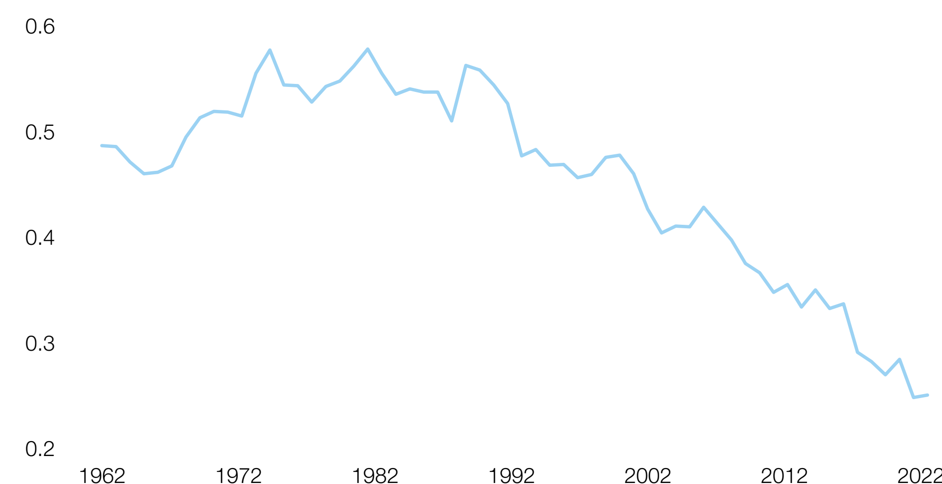
The figure opposite provides concrete examples of the policy paths taken after certain inflationary shocks over the period, namely the paths taken by the UK and French governments during the inflationary episodes of 1979 and 1974 respectively.

The UK example immediately follows the second oil shock that fed into the second inflationary peak of the decade, when inflation grew from 5% to 15% in the country. We can observe that monetary policy tightened considerably, with the real interest rate rising from -5% in 1980, the year after the shock, to +7% in 1984. Despite fiscal policy remaining relatively stable over the period, the significant and consistent tightening of monetary policy was sufficient to resolve the episode. As a consequence of the shock and policies implemented, however, we see GDP growth suffer in the immediate aftermath before recovering to pre-shock growth rates of 3% to 5%; unemployment, by contrast, rose considerably from 5% to 12% in the five years analysed.

The French example shows a typical 'premature celebrations' path. Here, inflation spikes in 1974, and monetary and fiscal policies tighten in the following two to three years in a bid to bring it under control. This started to succeed, with inflation reducing until 1977. However, just as inflation appeared to be coming under control, policies loosened again; real interest rates declined and what was a fiscal balance became a fiscal deficit. Consequently, the disinflation trend foundered.

Let us move on to our second topic: the matter of future corporate profits. Earnings per share are forecast to grow in the US and Europe by around 10% and 5% respectively this year, rates that look set to continue into 2025 and 2026. Two things are worth noting here: (i) the forecast growth is roughly in line with that of the past six years (annual growth of c. 11% and c. 8% respectively) and (ii) there seems to be a proactive element in this growth, given the GDP growth figures of c. 4% in the US and c. 3% in the eurozone for the same forecast period.

Interest & tax expenses as a share of EBIT



Note: Aggregate values for S&P 500 non-financial firms, 1962 to 2022
Sources: Accuracy, Federal Reserve

Reviewing past performance will help us to put these forecasts into perspective and determine how realistic they may be. A study published in June 2023 by the Federal Reserve entitled *End of an era: The coming long-run slowdown in corporate profit growth and stock returns* does just this by examining the past 60 years. It splits the period in two: period 1 covers 1962 to 1989, a time of triumphant Keynesianism where GDP growth (3.6%) outpaced that of corporate profits (2.0%); period 2 covers 1990 to 2019, a time of neoliberalism where corporate profits grew faster than GDP (3.8% vs 2.5%).

What brought about this acceleration of profits in a period of lesser economic growth? According to the study, the answer is reduced tax expenses and interest on debt. The graph above shows just how these expenses decline as a proportion of EBIT over the 60-year period analysed.

But if future corporate profits are projected to continue growing at more or less the same rate as in the past, wouldn't that imply a continuing reduction in interest and tax expenses? That hardly seems likely in the current context of rising/plateauing interest rates and the generally poor shape of public accounts. Another mechanism will therefore have to come into effect. That could be greater productivity, for example, though current figures leave a little to be desired on this front. And if not that, then some other change in public policies in favour of generating corporate wealth would need to occur. Given our elevated cost of living at the moment, whether such policies would be socially or politically acceptable seems uncertain at best. In sum, it might be wise to question where this forecast growth in corporate profits will come from.