# BOX 1. PROFIT MARGINS AND THE CYCLICAL CONDITION OF THE ECONOMY

Following the dissipation of inflationary pressures stemming from the COVID-19 pandemic, the Russia-Ukraine war, and supply chain disruptions, prices quickly stabilized from 2023 onwards. This stabilization was aided, among other factors, by timely and strict monetary policy responses. Currently, alongside high economic activity, inflation remains low. This is a result of several factors. On the one hand, high economic growth has been driven by structural changes to the economy that have accelerated potential GDP growth and reduced the output gap. On the other hand, based on observations of various trends and analysis using structural models, the low inflationary pressure can partly be explained by the trend of decreasing profit margins in the economy.

It is thus interesting to explore how profit margins change with the economic cycle and to analyze the compatibility of a reduction of profit margins with strong demand (high economic growth). In Georgia, as in developing economies more generally, a tendency for profit margins to decrease has been observed (see Figure 1.6.4).

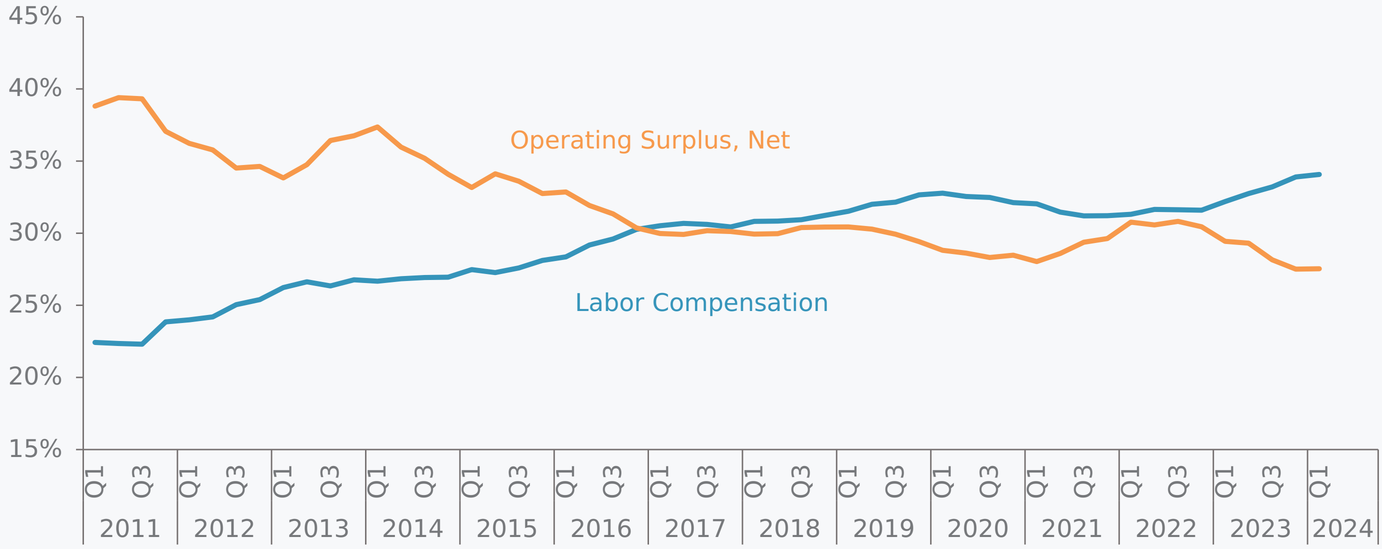


Figure 1.6.4. GDP decomposition according to the generation of income account

Source: GeoStat

This can be explained by ongoing long-term structural processes in the economy, where returns on capital decrease and competition improves. This latter trend has emerged in recent years and has been aided by, among other things, increased market entry by new enterprises (see Figure 1.6.5). However, it should be noted that post-pandemic margins cyclically increased, and thus recent changes likely reflect a cyclical reduction in margins along with a return to trend.

Generally, profit margins are procyclical and increase when demand is strong. However, three factors influence the determination and cyclical dynamics of profit margins: the rigidity of prices and wages and the so-called desired margin level of firms. Considering economic theory as well as empirical facts, we can say that wages are more rigid than prices. As a result, a reduction in profit margins may occur during the winding down of the economic cycle, when wage adjustments happen intensively against the backdrop of high economic activity; meanwhile, price adjustments occur earlier in the cycle, increasing margins. Also, profit margins may decrease due to a reduction of a firm's desired margin, which typically happens during a slowdown in economic activity, when firms lower prices to retain or attract customers.

Another measure by which the dynamics of profit margins can be assessed is presented in Figure 1.6.6, which evaluates the dynamics based on the profit and loss indicators of business entities as a ratio to their value added. As we can see, this measure is characterized by pronounced procyclicality.

Therefore, if we accept the notion that margins are procyclical and the discussed measures accurately reflect the state of firms, this may indicate—even given the recent wage increases—the winding down and

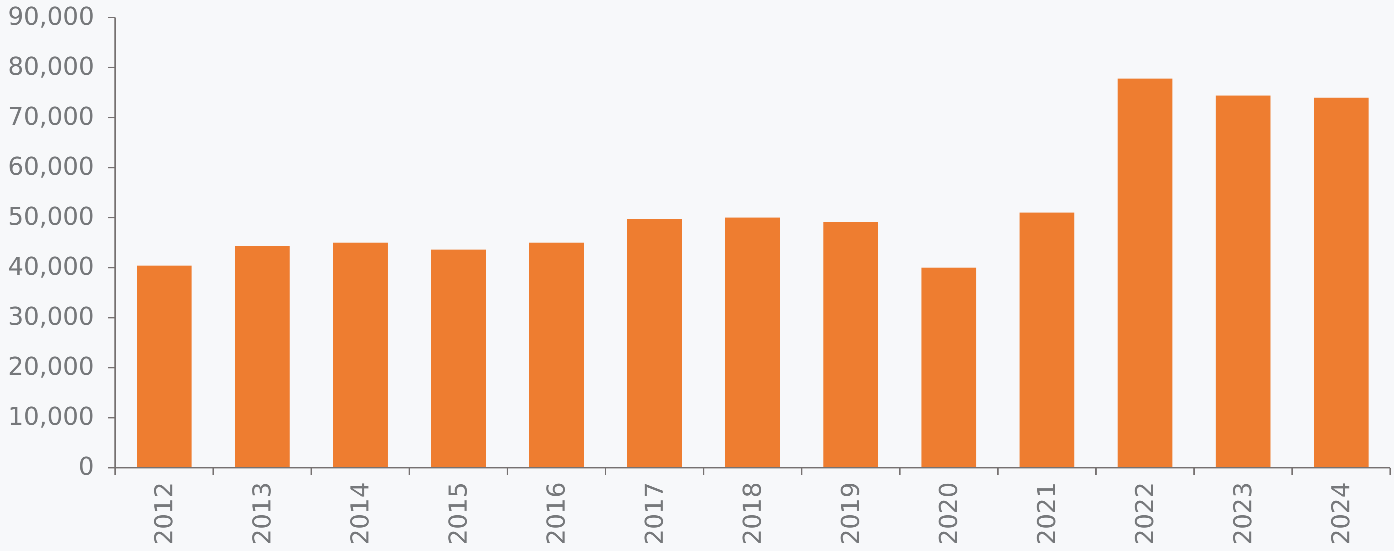

Figure 1.6.5. Number of newly registered enterprises (units)

Source: GeoStat

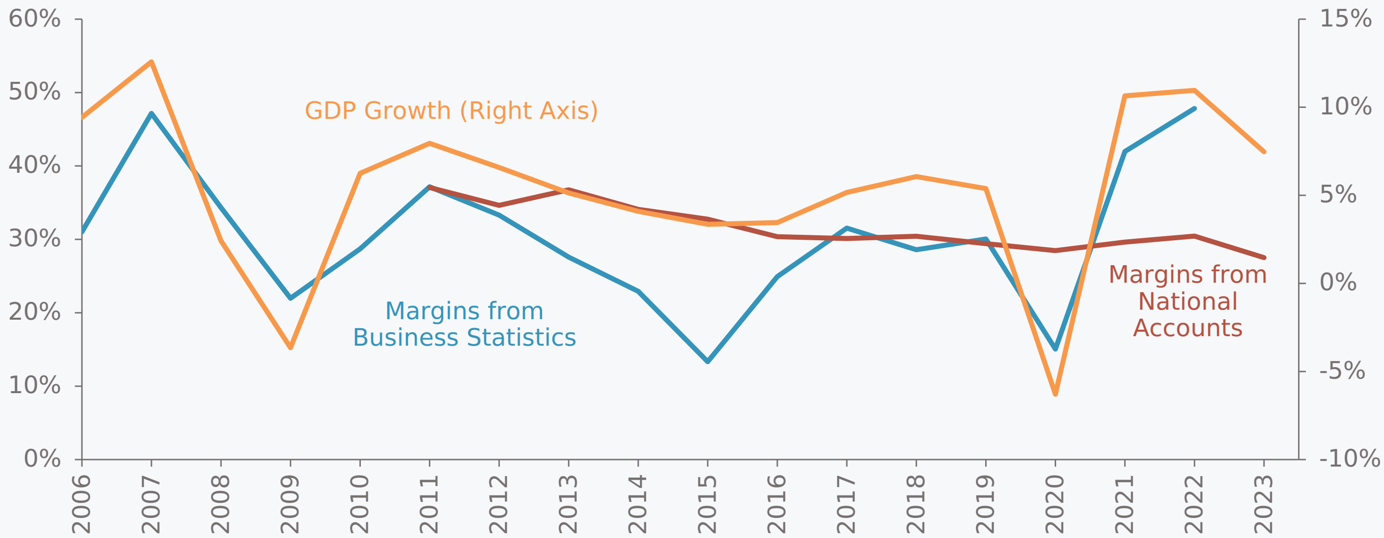


Figure 1.6.6. Profit margins and GDP growth

Source: GeoStat

stabilization of the economic cycle. However, this does not necessarily imply low economic growth in the future. As seen in Figure 1.6.7, post-pandemic growth has been concentrated in two sectors: transportation and storage, and information and communication. If this represents a structural change, then long-term economic growth is expected to be maintained, although the additional contribution from demand will dissipate. It is also possible that the profit margin calculated from national accounts is an imperfect measure for discussing the economic cycle (since it does not show a strong correlation). The updated 2023 data on profit indicators taken from business statistics might provide a different picture. If their dynamics remain strong, talking about the end of the cycle would be premature.

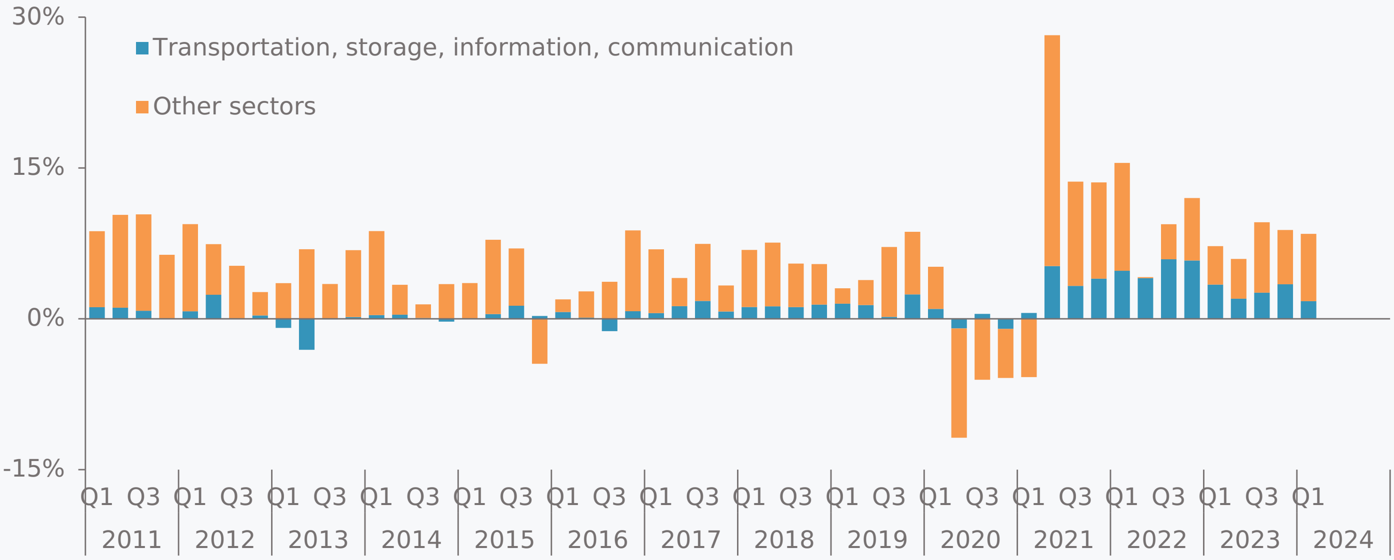


Figure 1.6.7. Real GDP growth by sector

Source: GeoStat

In summary, the reduction in profit margins, which had sharply increased in the post-pandemic period amidst the growth of prices and a return to the long-term trend, reflects the gradual correction of those prices distinguished by greater rigidity. It also explains why the recent sharp wage increases have not been passed on to prices. It should be noted that the stabilization of margins reduces the ability to use profits as a buffer to absorb shocks, which increases the risk of shocks being passed to final prices in the case of intensified inflationary pressure in the economy. This underlines the need for active monitoring and caution regarding current economic trends by monetary policy makers.