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## Greenspan's Enigma Variations: variable pricing power:

> To better understand recent developments, it is helpful to view prices from the perspective of consolidated costs and profit margins. From the first quarter of 2003 to the first quarter of 2004, consolidated unit costs for the nonfinancial corporate business sector declined. Hence, at least from an accounting perspective, all of the 1.1 percent increase in the prices of final goods and services produced in that sector during that period was the consequence of a rise in profit margins. The 6.4 percent increase in nonfinancial corporate business productivity over those four quarters accounts for much of the decline in unit costs. The remainder of the decline is accounted for by the effects of accelerating output in reducing non labor fixed costs per unit of output. (**Greenspan June 8, 2004 to the London International Monetary Conference)**

**Why is this statement so interesting?** Earlier in this speech Greenspan claims to answer why for three years business managers "**sought every avenue to forestall new hiring despite rising business sales**." Unfortunately, even though the Chairman always tries a new 'theory' to explain what he is unable to conventionally explain, we have to conclude after reading this speech: hmmnn…maybe…Where's the beef? More enigma variations! It truly explains very little.

**Think about it:** How was it that non-financial business was able to increase prices and retain the excess for the bottom line? What happened to competition along the way? It died? Well, Greenspan is much too clever to fall into that trap. Instead, he throws us the caveat, "**Hence, at least from an accounting perspective, all of the 1.1 percent increase in the prices of final goods and services produced in that sector during that period was the consequence of a rise in profit margins**." He is explaining by means of an "accounting" perspective. Time to change auditors!

Doesn't it seem strange that during the post-bubble period (2000/2001/2002) business lost pricing power but suddenly regained it in 2003 after very aggressive monetary policy had been applied for three years? A conventional, monetarist interpretation is that money is beginning to work its magic and we are seeing both output and price increases. (This raises some interesting questions about "slack," but let's leave that for now).

What do we know about the bubble and post bubble periods? We know during the bubble at least some firms focused on volume (almost at any cost) and forgot about profits. We've seen that before in earlier bubbles (Japan). P/E multiples soared and the rewards from stock options made for a lot of overpaid managers. The Corporate Governance Scandals, to which Greenspan attributes much of the reluctance of managers to spend on labor or capital, had two phases: Dereliction and Discovery. Dereliction was the combination of GAAP (growth at any price!) and soaring compensations standards, both of which meant that Shareholders got screwed. Managers could point to other managers who were doing better, and no Board wanted to lose any human capital during the bubble! But, it was a bubble because soaring equity prices were clearly not accompanied proportionally by soaring earning. (We ignore the obvious cases of cooked books, although there were many cases of that). As we said at the time, given the right incentives (and should have added, given the lack of governance), earnings can get manufactured. In some sense, then, a focus on earnings was badly needed and perhaps some of that focus should have included whether there was scope to raise prices, and not worry so much about market share. But if managers were overpaid, how about the analysts? Next!

Let's tentatively accept the new Greenspan variation, namely that since QI2003, corporations have regained 'pricing power.' Combined with growing productivity that is not compensated by rapidly inflating wages, this means more of the price change drops to the bottom line. That's arithmetic. Where's the economics? The puzzle for me is that the absence of pricing power and then its sudden return doesn't make a lot of sense from an industrial organization point of view. Pricing power must either come from an 'innovation' that yields temporary competitive advantage and is not quickly replicated by competitors or from a deviation from competitive behavior in the industry in question. Otherwise, it is a ***deus ex machina.***

Given growing globalization, input costs could be reduced by outsourcing, but that says very little about how the excess of revenues over declining unit costs will be distributed. And why should more outsourcing show up in rising prices and not falling costs? Furthermore, how come at raised prices, competitors couldn't take back some market share by not raising the price, ultimately forcing the initiator of the price rise to rescind? You don't think that happens? Ask an airline pricing manager.

Greenspan refers to historical data to show that "profits of nonfinancial corporations as a share of sector output…rebounded to 12 percent in the first quarter of 2004" and attributes this to a diminishment of "price discounting." That might explain the present, but it leaves unexplained what happened in the past. That is why we have tried to fill out the Greenspan theorem…but it is an untested hypothesis and he surely knows it!

**Getting Immersed:** Greenspan relates recent rises in core consumer prices and the absence of commensurate rises in unit labor costs to the growth in profit margins. So far, we have only an accounting identity, but we can now see the real nubbin that needs explication. How is it that firms can raise prices and not be faced with higher wages? Slack in the labor market provides part of the explanation, but it fails to account for a sudden ability to raise prices against competitors or against producers of close substitutes? Moreover, why now but not before? Certainly, slack would tend to repress nominal wage growth and thereby improve profit margins, but that could happen even if firms could not raise prices. Then, to keep up with evidently growing demand and still not raise prices, firms are driven to employ more capital and drive productivity upwards in order to produce larger profits. That couldn't be done during the "full employment" period of the bubble without driving up wages, but in the bust, with the fears of outsourcing, clearly, nominal wage growth was slowed. Yet, it fails to explain margin growth that would arise from the ability of firms to raise prices now, but not in an earlier period.

## Going Forward

All of this would be suitable fodder for academics but not very essential for market watchers. What counts is what's ahead and the issue of the day is whether profit margins are going to shrink under advancing wages. Right now, to raise profits, business hires more labor (suddenly beginning to lose the "ability" to keep raising prices) because labor productivity being high, extra output will increase profits as long as wages don't move to fully exhaust the additional product that productivity growth supplies. Now, out with the magic wand, Chairman G. Profit margins are now high enough to shrink a bit to accommodate labor that is seeking higher wages!

Do you get the sense that the variable ability to raise and lower profit margins by means of price increases is kind of a magic elixir or a near tautology? When you're famous and powerful, you can get by with a lot. The relevance of this seemingly arcane debate is obvious. If it isn't 'variable pricing power,' then rising prices are not just profit margin adjustment…they are something else…Shush. Don't tell the bond market!