

# WHY GOLDMAN SACHS IS WRONG AND MARX IS RIGHT.

Much attention has been drawn to the jump in profit margins during the pandemic, an unexpected outcome, when the opposite had been expected from slump like conditions. Most margins are limited to larger corporations which have much better price leverage. When all corporations large and small are included the jump in margins is not as pronounced as compared to the margins produced by the likes of Goldman Sachs or FactSet (Graph 9.) Before proceeding the reader will note that all graphs are located at the end. This has been done in order to make comparisons easier to see, so that linkages can be identified spontaneously.

This posting is the result of a report by Goldman Sachs released on the 29<sup>th</sup> November titled: *“Who Pays for Input Cost Increases? Evaluating the Impact on Prices and Profit Margins”* (Briggs) This report notes the recent increase in profit margins, and it seeks both to account for them as well as predicting their movement over the next two years. To do so it assumes four things, firstly that input price rises play a role in setting margins, that wage rises also play a role, that tax rises also play a role, and finally, the ability and agility of corporations to pass on cost increases in the form of sale price increases.

Now it is true that cost price holds tightly onto the arm of profit margin on the left-side, while on the right-side selling price holds firmly onto the other arm, but what does not happen is for cost price and selling price to end up holding hands. The profit margin which separates selling price from cost price does so in a manner inexplicable to capitalism, especially Goldman Sachs. It is not simply a subtraction, where cost price is deducted from selling price. Instead profit margins are set by the rates of profit guiding the movement of capital, forming the parameters of demand and supply which continuously act on selling prices. Thus profit margins arise from the redistribution of the pool of profits via the movement of capital.

Of course included in cost price is wages, its biggest component. Now according to G.S. wage rises will cause price increases. In fact they put a number to it. *“All estimates suggest that a 1pp acceleration in wage growth implies a roughly 0.2-0.4pp acceleration in price inflation after two years, and averaging across estimates suggests around a 35bp cumulative boost,...”* In other words a 1% wage rise yields a 0.35% increase in prices, an effect which can be measured over 2 years no less. They call this phenomenon “the wage-to-price pass-through” (reminds me of how stools are formed).

They come to this conclusion using regression theory which both they and quoted academics have employed. *Investopedia* defines regression theory thus: *“Regression is a statistical method used in finance, investing, and other disciplines that attempts to determine the strength and character of the relationship between one dependent variable (usually denoted by Y) and a series of other variables (known as independent variables).”* I am no mathematician able to take this regression hypothesis head on, but it should be done by a reader or a Marxist academic with sufficient skill. But I know enough to know that if the dependent variable is juxtaposed for an independent variable a different result could emerge.

Now clearly the G.S. postulate flies in the face of what Marx found, namely that wage rises do not lead to price rises, but to profit squeezes instead, everything else being unaltered. Thus we need to repudiate G.S. by doing our own investigation. My strength lies in connecting up data and ensuring I have a full suite of assumptions. Good maths can never compensate, nor rectify, for bad or incomplete assumptions.

One of the problems with G.S. approach is that it includes retail prices in its variable. Now if we take the net import of goods (imports less exports) we find it is equal to one quarter of the value added by US manufacturing. Furthermore according to the Washington Post, imports from say China or Mexico only

accounts for 44% of the end user selling price. Thus much of what is sold in US retail, both in terms of value and volume, does not derive directly from US producers but foreign producers thus confounding any attempt to form associations between the wages paid to US production workers and eventual US retail sales. <https://www.washingtonpost.com/business/2019/01/11/reminder-most-what-you-pay-made-china-product-goes-us-workers-businesses/>

To get around this problem I confined my riposte to the manufacturing sector in the USA. There a direct comparison between wages and prices can be found. For wages FRED Table CIU102300000000I was chosen covering the Employment Cost Index for Manufacturing - all civilian employees. For Prices the Producer Price Index found in FRED Table PCUOMFGOMFG covering Manufacturing was chosen. The P.P.I. is the best index for prices circulating within Manufacturing and between Manufacturing and other sectors.

The result can be seen in Graph 5. It demonstrates convincingly that no correlation exists between prices and wages. There are two periods of interest, post-2008 and post-2014. In the former wage growth fell but prices rose, in the latter wage growth rose marginally but prices fell significantly. Disassociation rather than association is the norm.

The only correlation is with the rate of profit. Post-2008 the slight deceleration in wages coupled to higher prices yielded higher profits. In the post-2014 period when wages accelerated slightly and prices fell, the mass of profits was squeezed. In all cases the movement of wages and prices were independent, when prices rose faster than wages, profits increased, and when they did not, profits fell. When we take Graphs 1 – 4 as a block we see an even stronger correlation between profits and wages. This is strongest in Graph 4 which is the rate of surplus value which is the ratio between profits and variable capital, or what is the same thing, the ratio of annual profits and annual wages where wages are reduced by turnover. It shows how the change in selling prices versus the change in wages results in a change in profit.

Having concluded on the issue of wages and prices, another startling issue arose. G.S. provided a graph depicting profit margins, what it termed its Exhibit 3. This is a curious depiction of profit margins because they were after tax corporate profits divided by GDP. But GDP covers only Final Sales or End User Sales. It does not cover intermediate sales. Together Final and Intermediate Sales make up Total Sales. Normally profit margins are derived from Total Sales, not only Final Sales. Using this peculiar ratio G.S. claimed that profit margins on a GDP basis had reached their second highest level ever in Q3 of this year.

Having already produced profit margins based on Total Sales or Gross Output for non-financial corporations this represented an intriguing variation, one that demanded immediate investigation. The margins I obtained ran counter to G.S. claim that margins were now at their second highest point (only 2013 had a higher peak). The reader can see this variation for themselves by examining Graph 9. In fact Graph 9 shows that Q3 margins have fallen from Q1 and are below levels last seen in 2006. Strip out subsidies, and margins look much worse than before the pandemic, let alone the run up to 2008 and 2014.

But there was more to this picture. Why the discrepancy between total-sales-margins and final-sales-margins? And do they have different trends? Pursuing these questions resulted in a revelation, Graph 1, which by being indexed, shows relative movements. Who says statistics cannot be magical when they reveal that which hitherto has not yet been revealed. What the graph shows is that profit margins in the up-phases of the business cycle overtakes the total-sales-margins because final sale prices are now vigorous. The opposite happens during the down-phase when market conditions depress final sale prices.

Thus what Graph 1 was revealing was the classic crisis of realisation. An unexpected find. To confirm this Graphs 1 – 4 are blocked with a common line dissecting the up-phase from the down-phase. The cross over in margins coincides with a deceleration in the annual rate of turnovers, with a fall in the rate of surplus value and subsequently a fall in the rate of profit itself. (In addition Graph 8 reveals that the higher total-sales-margin was not due to input and/or import prices rising faster than output prices. Note 1.)

Had the cross overs not coincided with a deceleration in the rate of turnover itself, it would have been impossible to confirm the hypothesis lodged in Graph 1, namely that the reason the cross over occurred was due to a relative fall in final prices which can only be caused by the headwind of falling demand. This confirms once again that the realisation crisis is really a crisis of turnover.

When turnovers decelerate it means the period of production and circulation is extended. In the case of Manufacturing, the period of production and circulation was 74 days 2014, but by 2016 it had stretched to 86 days. Not only did capitalists have to wait an additional 12 days for their potential profits to be monetised, the prices they received also tended to be softer than before, thus robbing them of some of their profits. On the other side of the ledger, they had to find 12 extra days of working capital.

Thus any delays in converting already produced surplus value into money delays profit generation while raising capital requirements. Viewed on an annual basis, this results in a contraction in the mass of profits resulting in an absolute fall in the annual rate of profit. Thus it is the deceleration in turnover that converts relative falls in the rate of profit into the absolute fall in the rate of profit, the trigger for recessions.

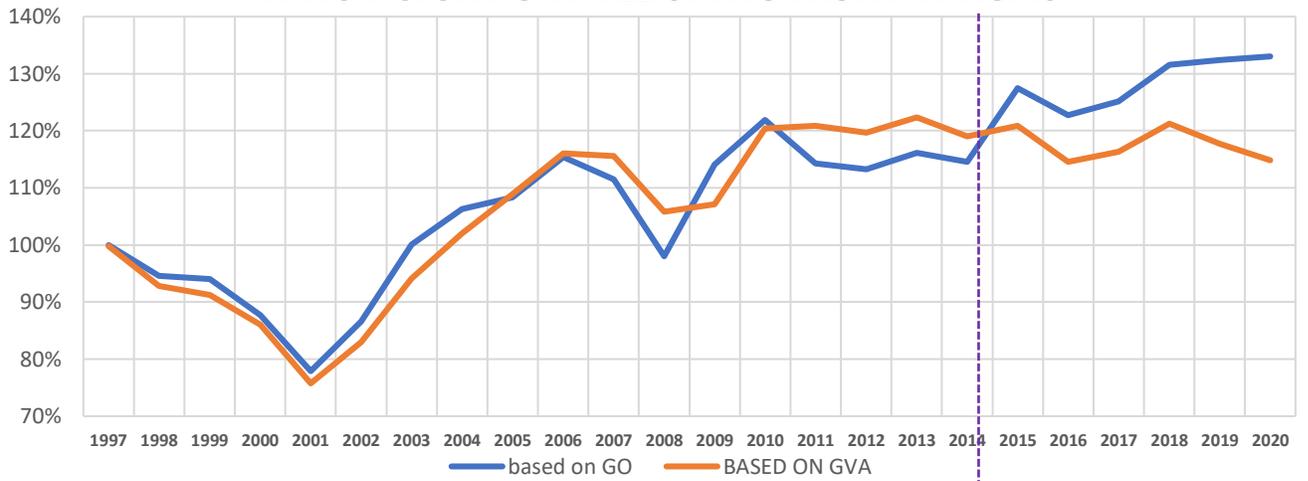
There is no reason to dwell on the rest of this report. Its forecasting is irrelevant. Even if it had some merit before the new Omicron variant it does not have any now. Already there are the first signs of consumer fatigue (items bought in advance because of supply issues) and capitulation (beaten by inflation). According to CNBC, Adobe announced that for the first-time that spending on Cyber Monday fell. The 1.4% fall in \$s translates into a much higher volume fall, not only because of inflation, but because of the lower discounts this time round (27% in 2020 vs 12% in 2021). <https://www.cnn.com/2021/11/30/cyber-monday-online-sales-drop-1point4percent-from-last-year-to-10point7-billion-falling-for-the-first-time-ever.html>

Or take that market bellwether, Apple. Its share price together with that of its suppliers fell sharply on a poorer outlook for its phones. *“The stock fell as much as 4.2% to \$157.80 on Thursday, the most since May 4, after Bloomberg reported that Apple told component makers that demand for its iPhone 13 line-up has weakened. Suppliers including LG Innotek Co. and STMicroelectronics NV declined in Asia and Europe.”* <https://fortune.com/2021/12/02/apple-shares-fall-4-2-percent-i-phone-13-demand-is-down/>

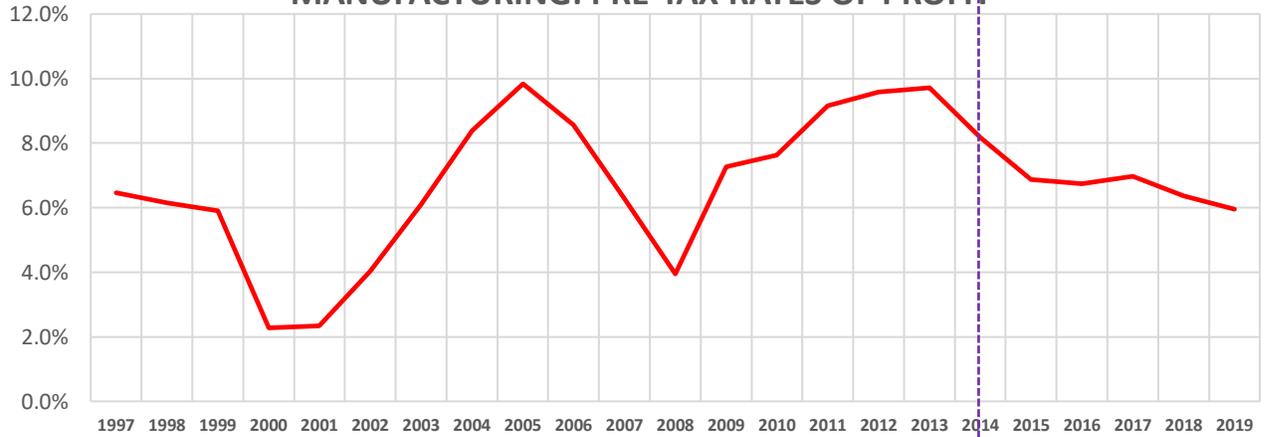
In October the Cass Freight shipment index rose a mere 0.8% from a year ago (Graph 10). <https://www.cassinfo.com/freight-audit-payment/cass-transportation-indexes/cass-freight-index> We have now entered that twilight zone where supply issues are being used to obscure the growing weaknesses on the demand side. This was the same argument used mid-year over the sale of homes. Falling sales were blamed on shortages of housing supply to protect prices even while inventory built. Comparing Oct 21 to Oct 20 the following is found; new home sales fell from 78K to 59K while inventory rose from 284K to 388K. <https://fred.stlouisfed.org/release/tables?rid=97&eid=22712>

Finally Graph 6 is ancillary, it is there to substantiate that it was not the rise in wages which led to the collapse in profits. This graph represents the annual rate of exploitation. Post 2014, the rate of exploitation was relatively stable. Similarly with Graph 7, the same pattern is seen when measuring the share of annual circulating capital occupied by annual wages.

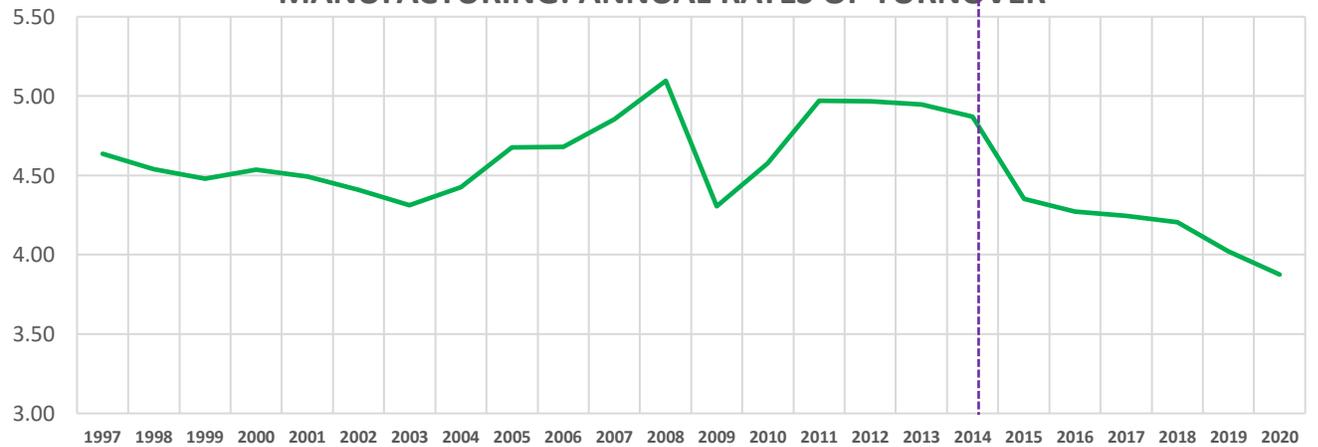
### MANUFACTURING: A TALE of TWO PROFIT MARGINS



### MANUFACTURING: PRE-TAX RATES OF PROFIT

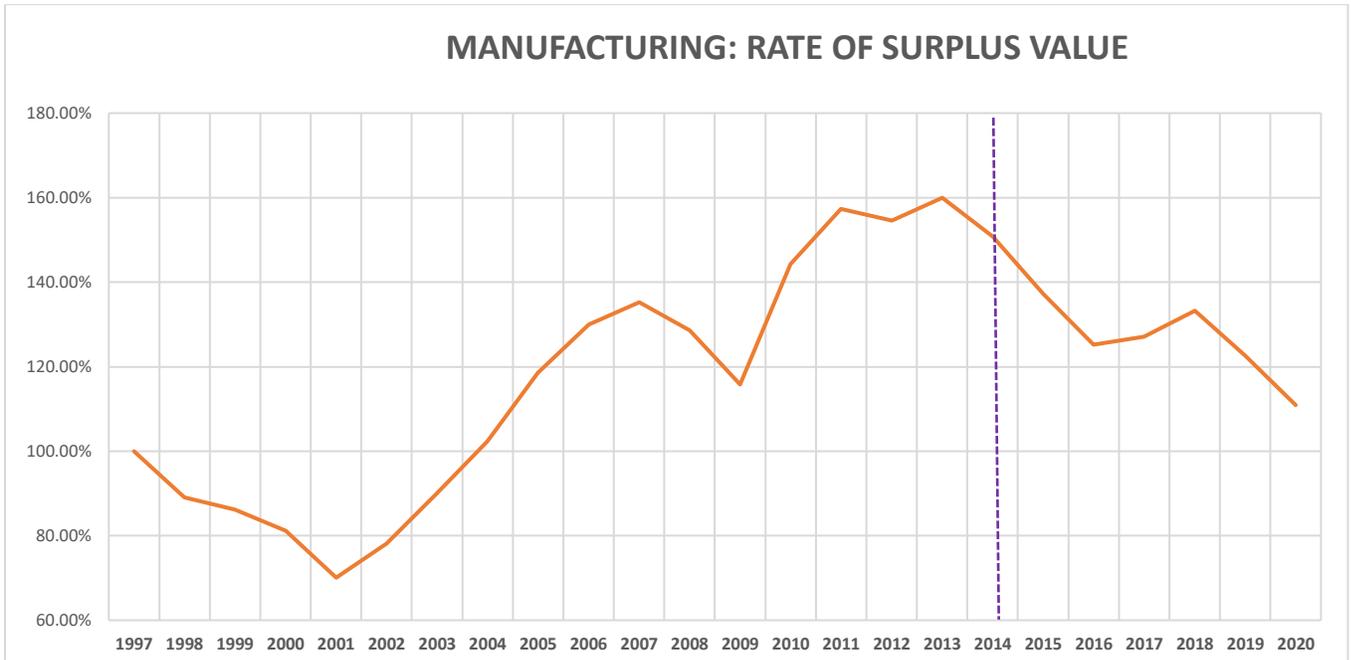


### MANUFACTURING: ANNUAL RATES OF TURNOVER

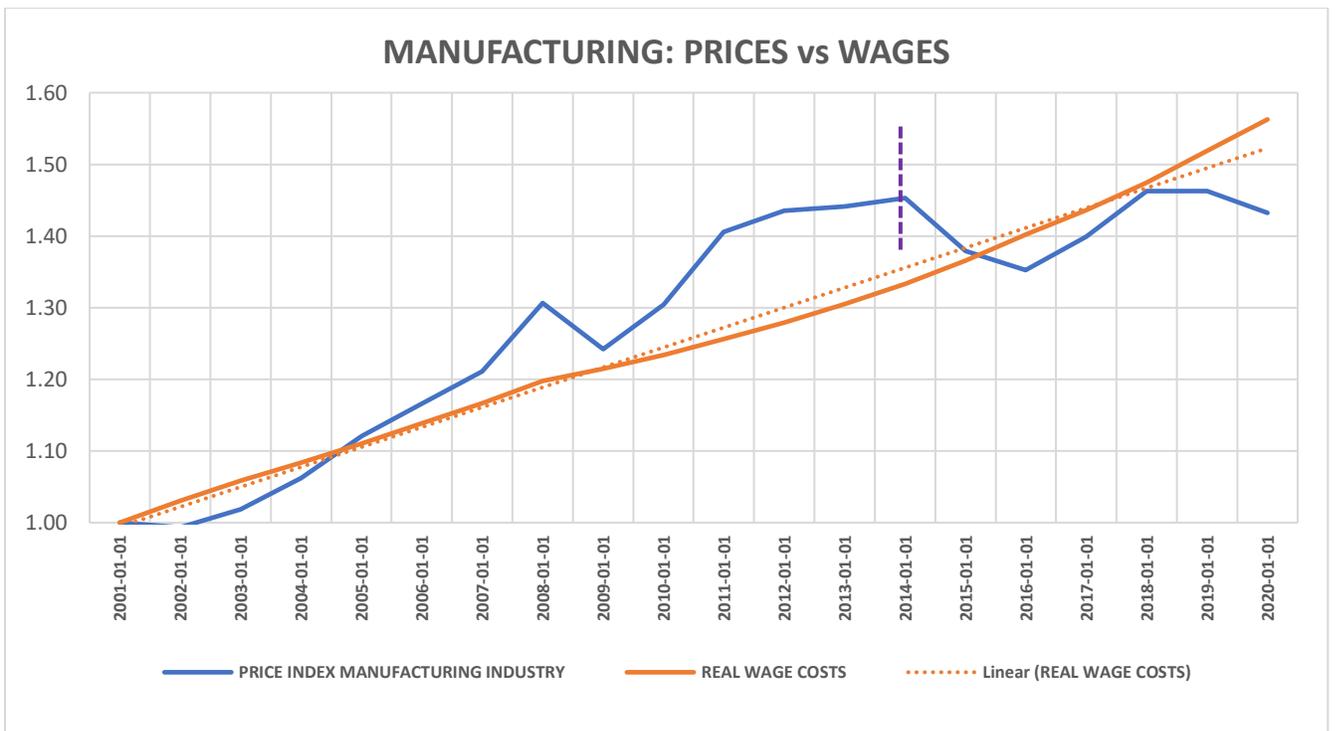


GRAPHS 1-3 

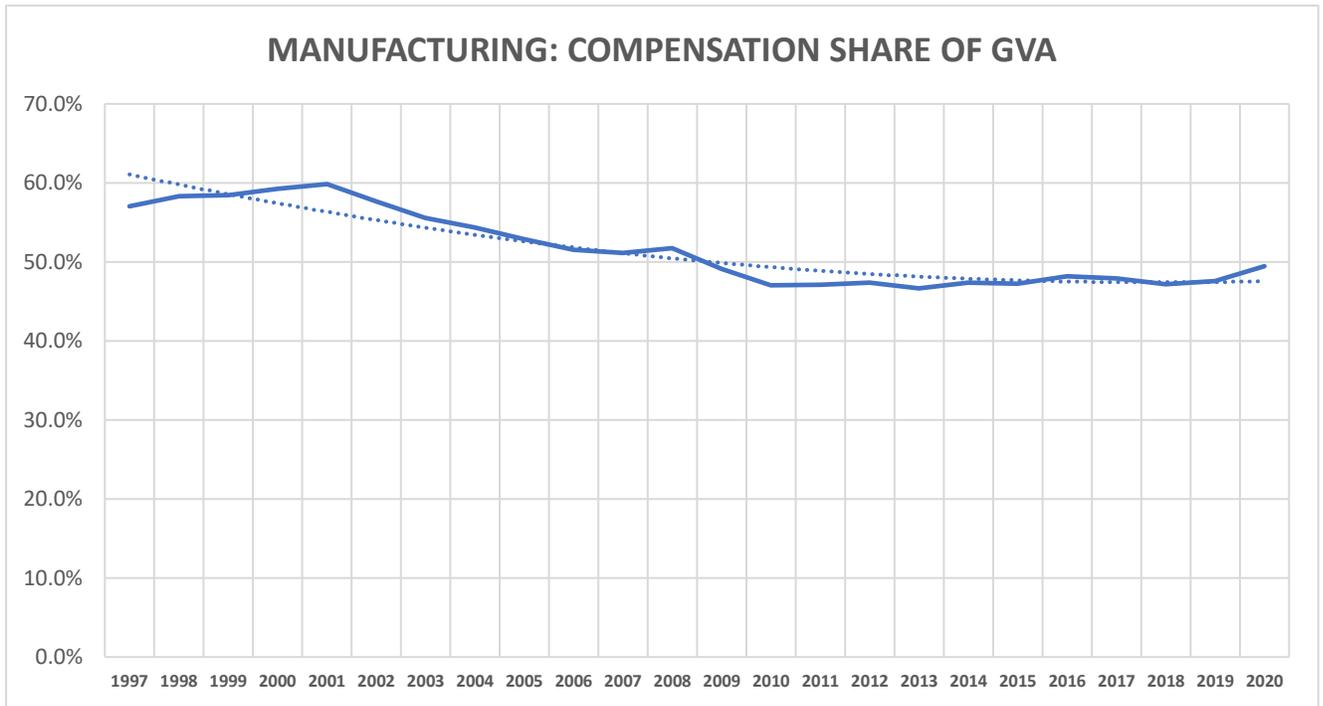
GRAPH 4.



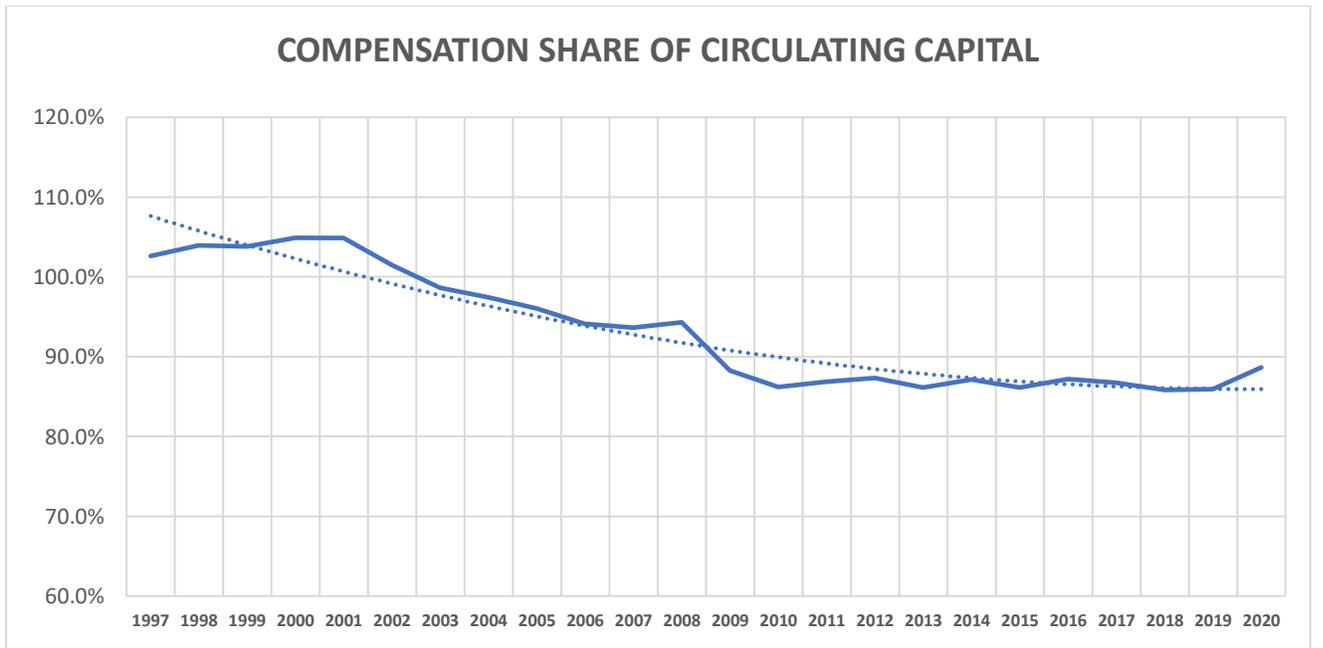
GRAPH 5.



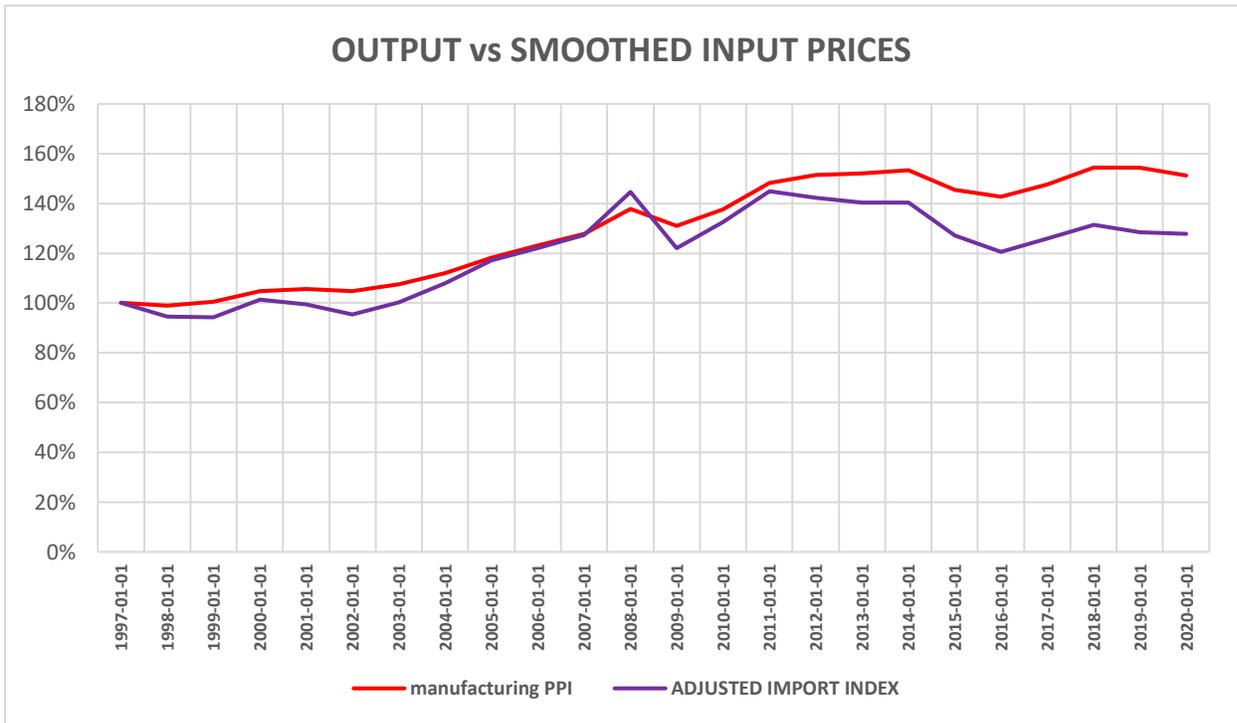
Graph 6.



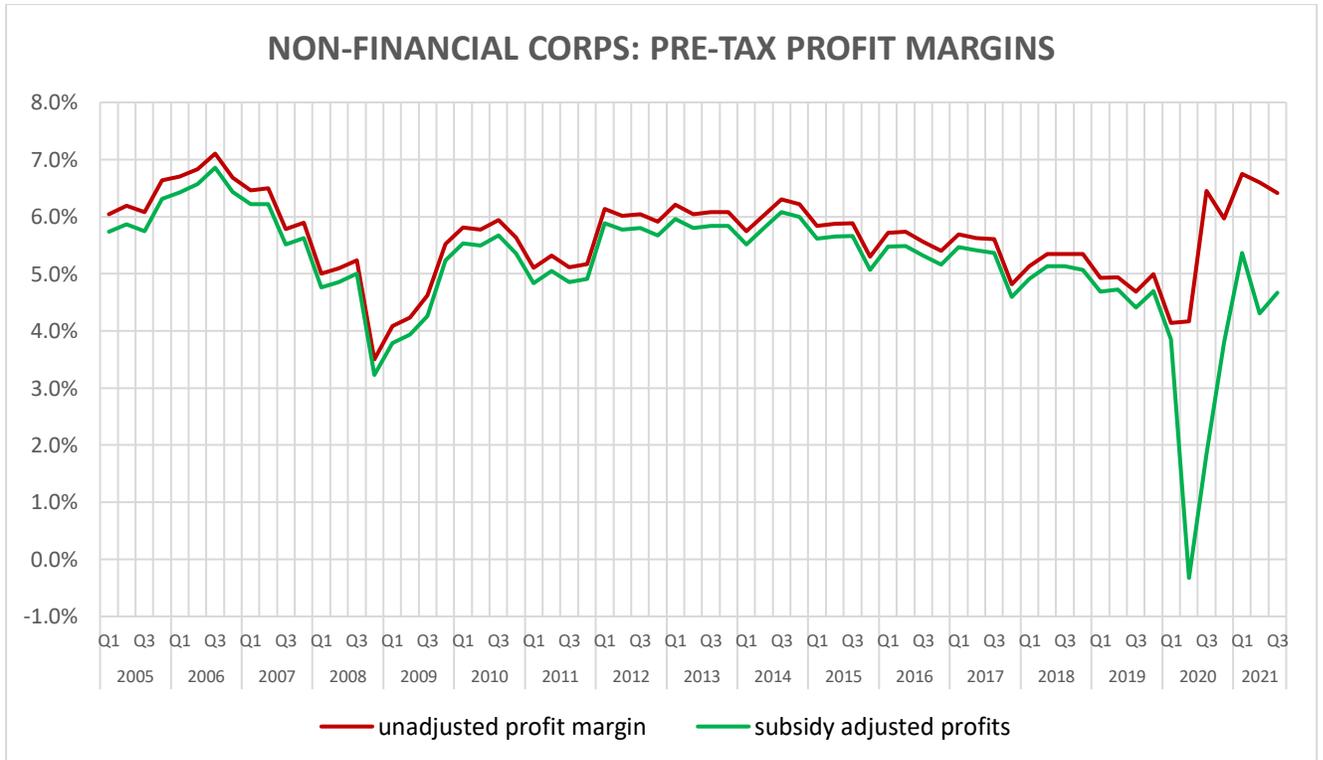
Graph 7.



Graph 8.

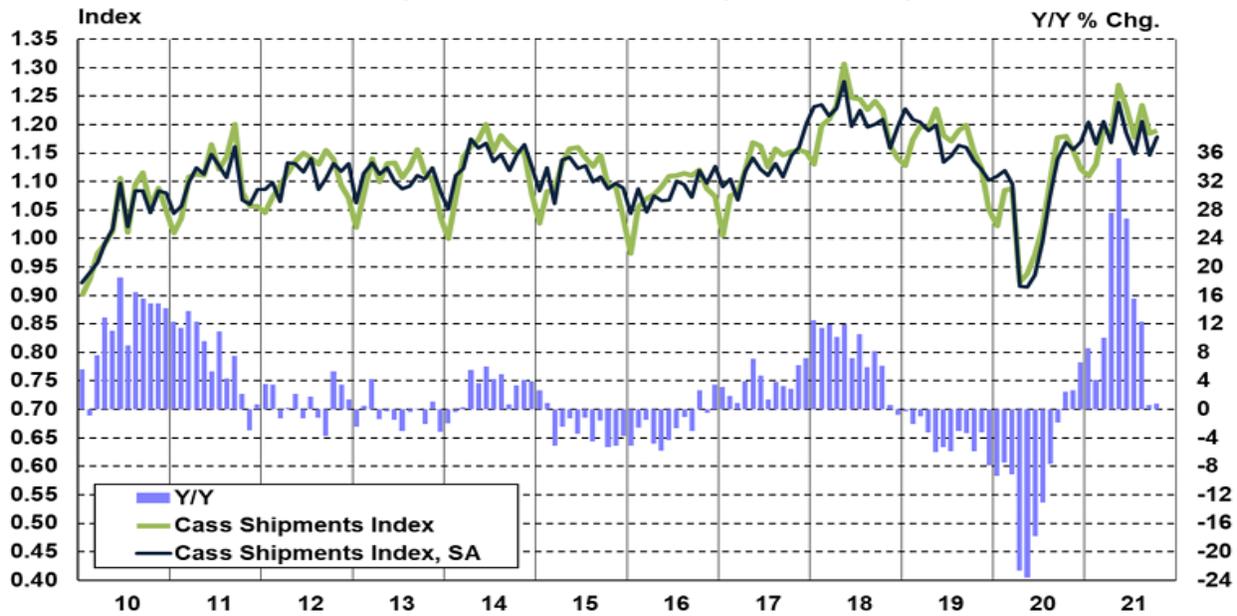


Graph 9.



Graph 10.  
**Cass Freight Index® - Shipments**

January 2010 - October 2021 (01'1990=1.00)



Source: Cass Information Systems, Inc., ACT Research Co., LLC: Copyright 2021

**A quick look at profits, wages and demand.**

The Bank of England recently expressed disquiet about wage-push inflation because they had underestimated how quickly the labour market would “normalize”. Is there such a thing as wage-push inflation? We recognised above that the association is between profits and wages, not prices and wages. Should wages wrestle with profits and score some knockdowns, then clearly there will be a rearrangement in the pattern of demand. If wages rise at the expense of profits, then demand for the articles of consumption bought by workers may rise while demand for the luxury articles bought by the recipients of profit may fall. There will thus be localised disruption to prices but no effect on general price levels as rises in one sphere will tend to be negated by falls in another. Additionally, two things will happen making this effect short lived. Because most of the articles destined for workers consumption are mass produced, the ability of capital to increase their production rapidly is high especially if profit margins are improved as they will be. Secondly, when faced with cost pressures, and rising wages is the dominant pressure, employers tend to increase their investment in labour saving techniques to reduce their wage bill.

In fact all the evidence suggests the opposite is the case. Price rises are outpacing wage rises, meaning that real wages are actually falling, if they were not, then profit margins would not have risen. In the end, wages tend to be the victim of price rises and not the other way around.

**A note on methodology.**

I have relied on the data found in the GDP-by-industry series rather than NIPA Tables. The GDP-by-industry data, as the name implies is confined to wages, prices and profits as they relate solely to US production. I have tested this data against the raw data supplied by the Census Bureau and find them to be robust. I also find BEA Data to be more refined. [https://www.census.gov/econ/qfr/mmws/current/qfr\\_pub.pdf](https://www.census.gov/econ/qfr/mmws/current/qfr_pub.pdf)

**Note 1.** The smoothing of import prices in Graph 8 was achieved by averaging the Total Import Price Index for all goods with the Import Price Index for imported manufactured goods to reduce the impact of the volatility in raw materials prices, including oil. It is possible to provide a weighted average, but this was not done here because it was deemed to be unnecessary as both total and smoothed prices rose more slowly than did output prices. The source data for import prices is BEA Table 4.2.4. *Price Indexes for Exports and Imports of Goods and Services by Type of Product* found under the International Section.

## **Conclusion.**

I believe that Marx's hypothesis concerning the correlation of wages, profits and prices has been defended. What G.S. cannot deal with because of its incomplete suite of assumptions, is the issue of realisation. What current profit margins have revealed, is that courtesy of the Covid Relief Funds, the prolonged period during which some profits were not realised has been interrupted. But it will not last. It seems that Powell of the FED lost his bottle over "transitory inflation", just as inflation markers were turning down, which would tend to indicate that selling prices are about to come under renewed pressure. I intend to return to the question of inflation and money in the near future.

The Markets which survived October will face a new test in January. This time the omens are more ominous.

Brian Green, 6<sup>th</sup> December 2021.

<https://theplanningmotivedotcom.files.wordpress.com/2021/12/goldman-sachs-does-not-understand-profit-margins.pdf>