

## **The Cost of living crisis**

**Inflation: where it came from and where it is going....**



**Huw Dixon 30<sup>th</sup> March 2022**

# Inflation: where it came from and where it is going....

## I. Inflation: where it came from.



We have been here before....

# **Inflation: where it came from and where it is going....**

**The reasons are different in 2008 and 2011**

**2008: Before the Great financial crisis (GFC) - high demand and growth. commodity prices rising rapidly.**

**Oil prices peaked at almost \$150 a barrel in July 2008....**

**2009-2011: Devaluation against both Euro and USD \$ (about 20%).**

**2007 £1 = \$2      £1 = EUR 1.35**

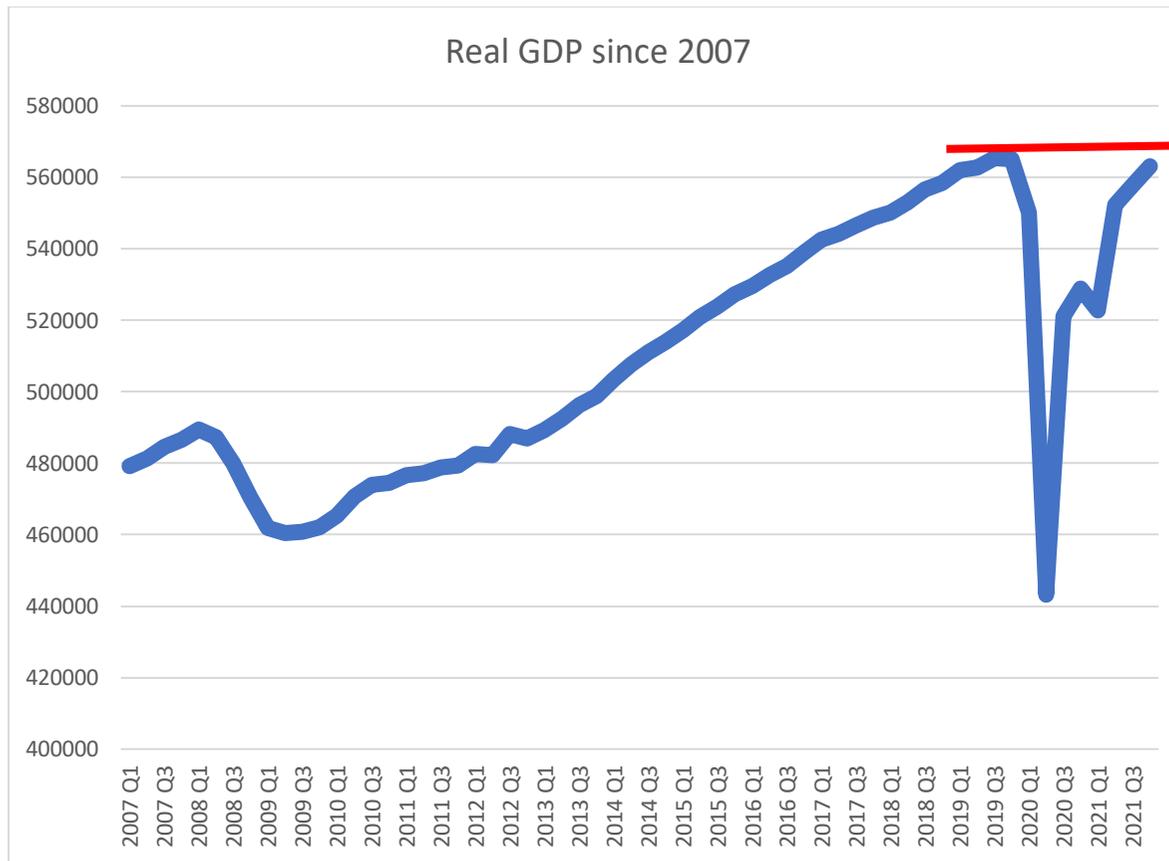
**2009 £1 = \$1.60    £1 = EUR 1.10**

(detail: devalued against \$ first and then Euro).

**2021-2022: some similarities with 2008. but rather different reasons....**

# Inflation: where it came from and where it is going....

Output in 2022 not much less than 2019 Q3. So why the inflation?



# **Inflation: where it came from and where it is going....**

## **1) Big shift in the structure of demand during pandemic that has persisted.**

- More money on things, less on services.
- More online (20% before pandemic rose to over 30% of consumer spending).
  - It takes time to adjust: workers need to move from one sector to another, firms need to adjust.
  - Also new firms come into existence, old firms die off. All has been *Speeded Up*.

**“Adjustment costs” have become larger with the Big Shift in demand. Rapid shift restricts ability of supply to adjust to demand in the short-run.**

## Inflation: where it came from and where it is going....

- This did not happen to the same extent in 2008-2010 (GFC). Post GFC inflation primarily due to devaluation of Sterling. Has not happened this time.

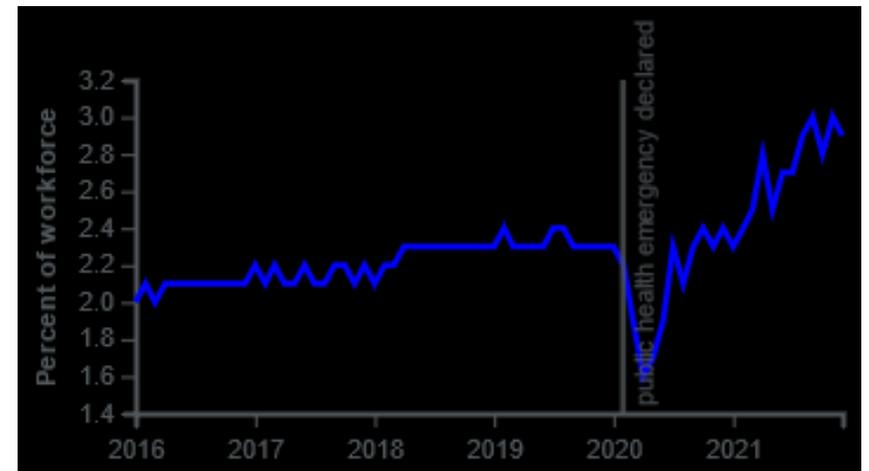
2) Changes in Labour supply. Modern macroeconomics emphasises the importance of “habit formation”. People got used to:

more leisure during lockdowns (Furlough etc.).

Working from home. People do not want to return to commuting.

The **Great resignation**. People leaving jobs, have decided to do something else.

US very stark: resignation rates have soared in 2021.



## **Inflation: where it came from and where it is going....**

In UK 1 in 4 workers “plan” to change jobs in 2022

Early retirement: people have decided to leave workforce.

In UK: Additional factor of Brexit. Missing workers who never came back. 1.3 million left UK during the pandemic, far fewer have returned.

So, putting the pieces together:

- Big switch in demand, takes time for supply to adjust.
- Fall in labour supply



Labour shortages and supply shortages.

Sector specific stories (Lorry drivers, container ships) as well, but this is the general picture.

Less supply, more demand post pandemic has increased inflationary pressures.

**Inflation: where it came from and where it is going....**

**Question: why is there inflation in 2022 despite output being below its 2019 level?**

**Answer: Even though output in 2022 is no higher than 2019, there is a lot of sectoral movement and adjustment going on that was not going on in 2019...**

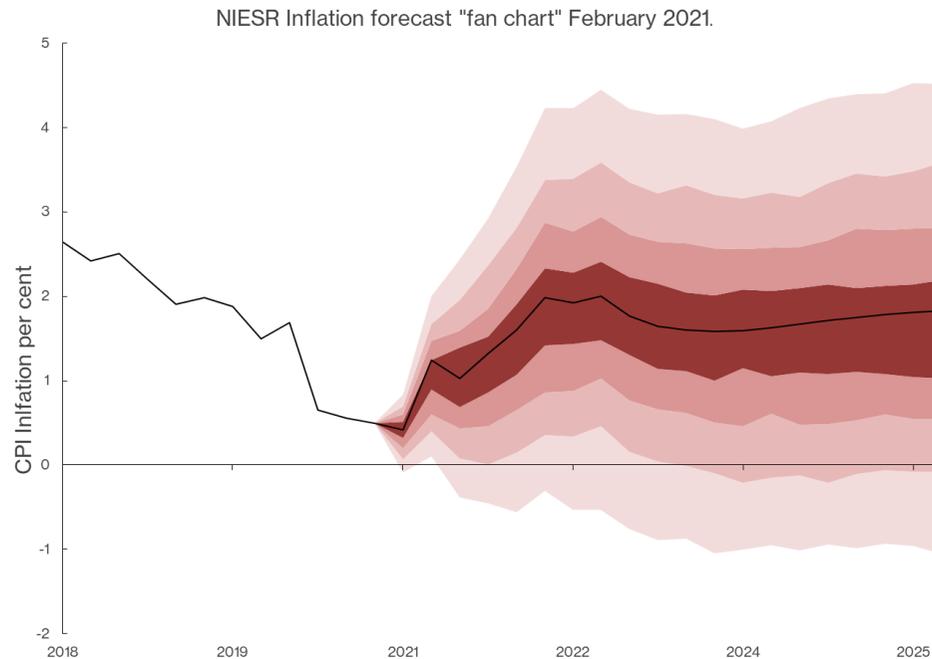
## **Inflation: where it came from and where it is going....**

Was this foreseen?



## Inflation: where it came from and where it is going....

Even in first few months of 2021. Great uncertainty: how would balance of supply and demand work out as pandemic receded. NIESR forecast: 2% remains central forecast, but big Fan chart:

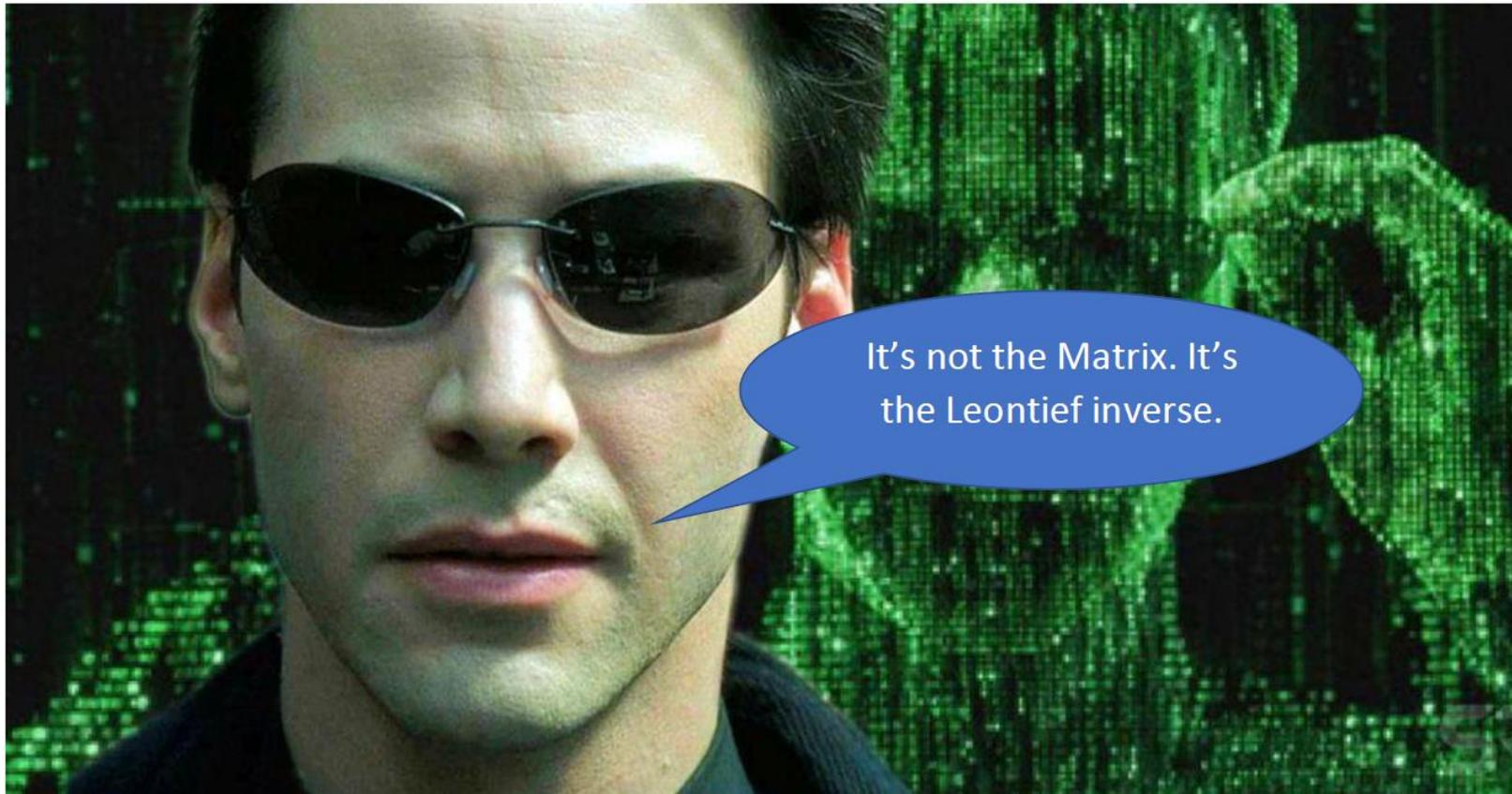


Where did the forecasts go wrong?

## **Inflation: where it came from and where it is going....**

- 1) **The supply chain issues lasted much longer than first thought.** Only just beginning to end in early 2022. Lasted 12 months rather than 6 months.
  - a. Supply chain adjustment dealing not only with the “restart” of the economy post-pandemic, but also the **re-alignment of the economy**. Never seen for a long time in developed nations.
  - b. The labour shortages were greater than expected (Great resignation etc.). **Furlough** kept people “in place” and delayed adjustment (although protected jobs).

## Inflation: where it came from and where it is going....



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2) Transport and Energy Prices. For a variety of reasons, these really took off.

a. Container ships: increase of 300% plus.

b. Oil and gas. Huge increase since low of 2020 Q2, but not much higher than 2019.



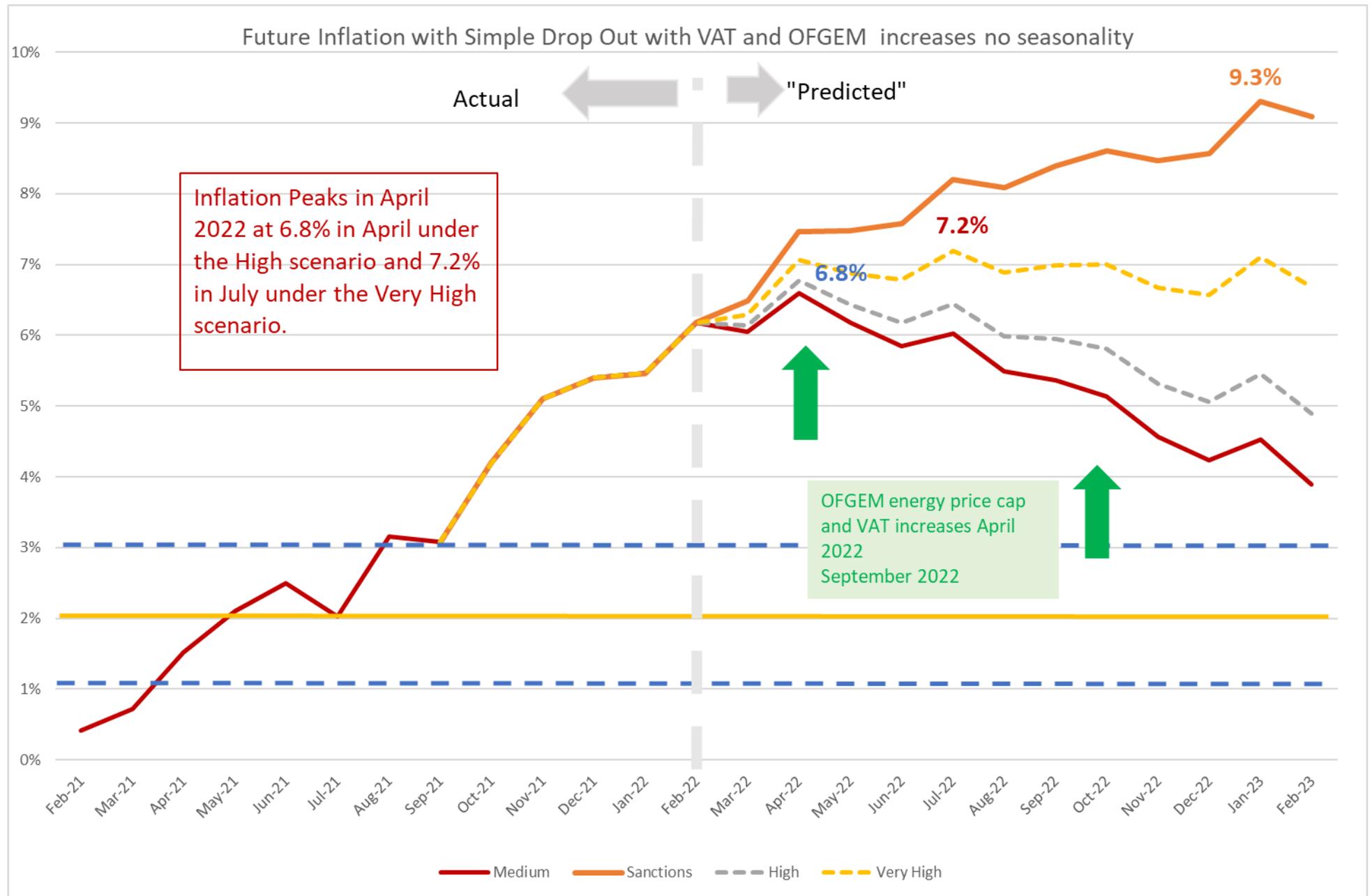
**Inflation: where it came from and where it is going....**

**And then came Ukraine and Sanctions....**



**More inflation as a result (talk at the end if time). Very uncertain future in many dimensions. Current forecast.....**

# Inflation: where it came from and where it is going....



## **Inflation: where it came from and where it is going....**

### **What about the Cost of living?**

the cost of living is rising rapidly.

CPI inflation is divided up into different types of goods and services.

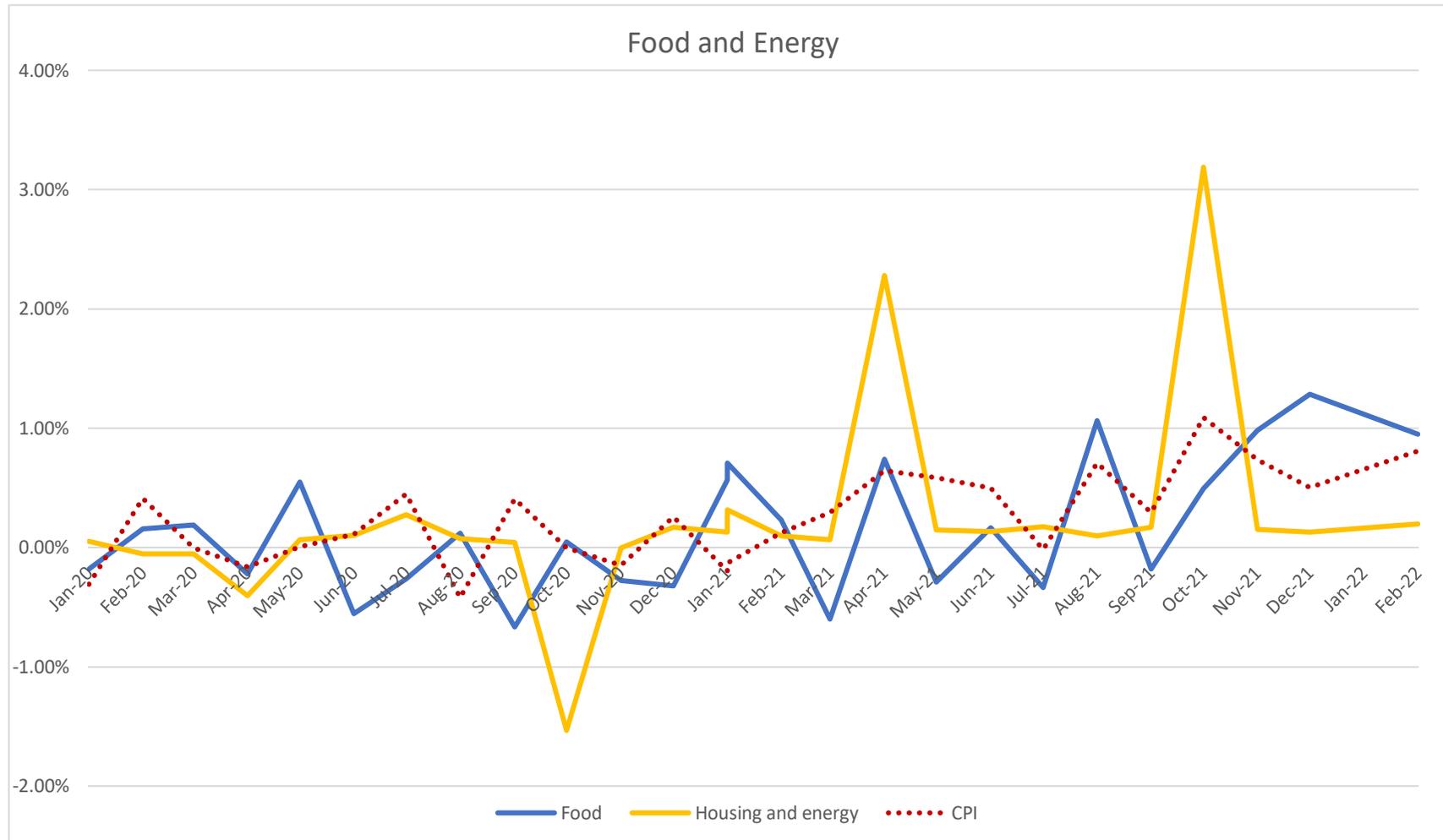
1	2	3	4	5	6	7	8	9	10	11	12
D7BU	D7BV	D7BW	D7BX	D7BY	D7BZ	D7C2	D7C3	D7C4	D7C5	D7C6	D7C7
FOOD AND NON-ALCOHOLIC BEVERAGES	ALCOHOLIC BEVERAGES AND TOBACCO	CLOTHING AND FOOTWEAR	HOUSING, WATER, ELECTRICITY, GAS AND OTHER FUELS	FURNITURE, HOUSEHOLD EQUIPMENT AND MAINTENANCE	HEALTH	TRANSPORT	COMMUNICATION	RECREATION & CULTURE	EDUCATION	RESTAURANTS AND HOTELS	MISCELLANEOUS GOODS AND SERVICES

Each type of expenditure has a weight in the Basket based on the average expenditure of households across UK.



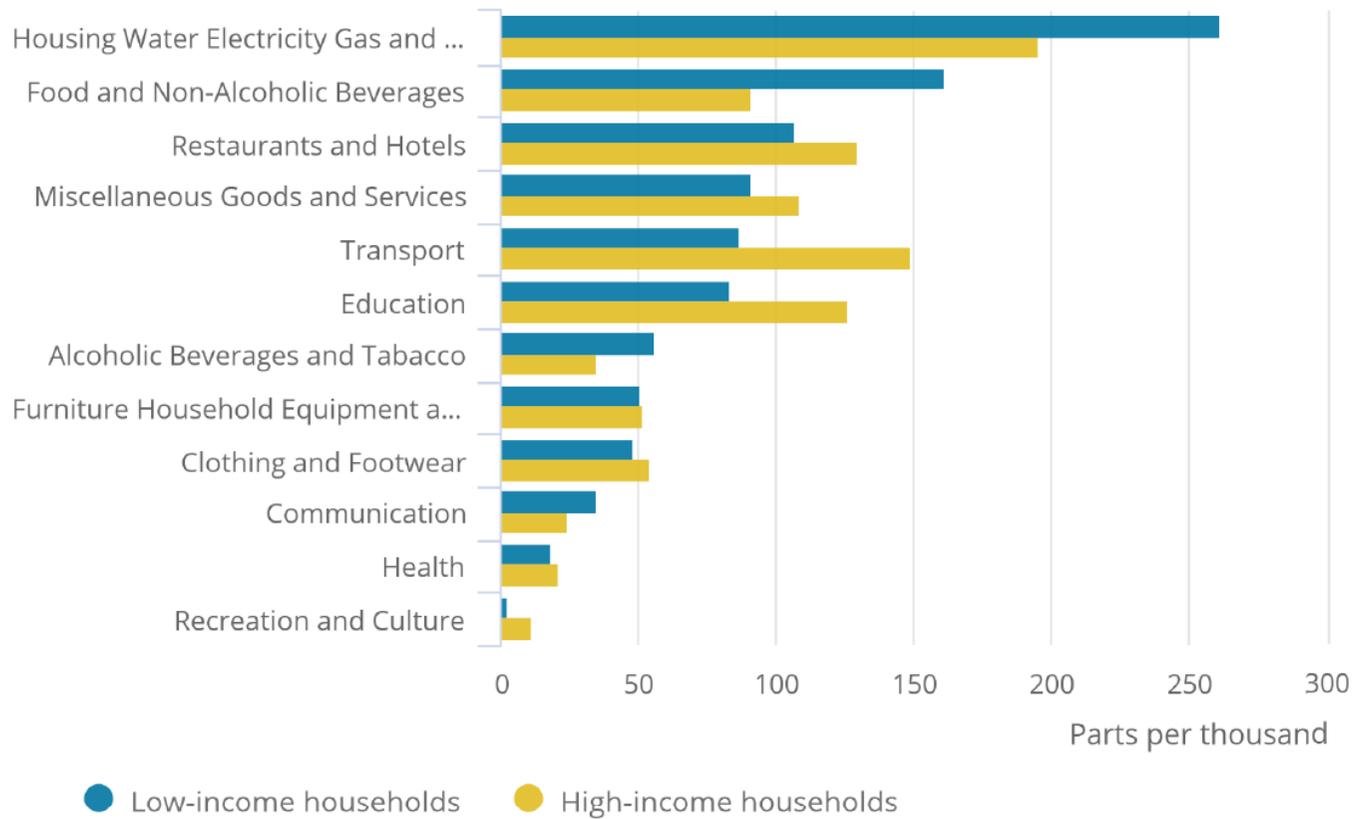
# Inflation: where it came from and where it is going....

Let's look in detail at Food and energy:



# Inflation: where it came from and where it is going....

Expenditure shares differ: high income vs low income.



Food and energy more important for low-income households.

## **Inflation: where it came from and where it is going....**

**Also, Food, housing and heating “Necessities”.** For better-off households, increases in Food and energy expenditure simply mean less “non-essential expenditures”. For the poorest there is no “non-essential” expenditure.

**Increases in food and energy affect poorest the most.**



## Inflation: where it came from and where it is going....

Simple example: 2 person household, after tax income £20k pa (£1666 pcm).

Living costs (£pcm)	Before	Just Energy	Energy plus 10%
Rent	600	Same	660
Rates	100	Same	110
Car	100	Same	110
Food (15%)	250	Same	275
Energy	<b>130</b>	<b>200</b>	<b>200</b>
Phone/internet	50	Same	55
Everything else.	<b>400</b>	<b>330</b>	<b>220</b>

There is a significant fall in *discretionary expenditure*: energy alone reduces it by 18% from £400 to £300: if all other things go up by 10% as well, reduces it by 45% to £220.

## **Inflation: where it came from and where it is going....**

### **Wages: Should I ask for a pay cut?**

Answer NO.

If wages went up with inflation, would there be a cost-of-living crisis?

NO, BUT...

NO: real wages, the purchasing power of wages would “keep up”. In our previous example, if wages went up 10% from £20k to £22k, then the household would be have the extra income to pay for extra costs.

Benefits and Pensions need to keep up as well.

BUT: inflation has other costs...

## **Inflation: where it came from and where it is going....**

### **Are wages keeping up?**

- On average, *almost*, but “it is complicated”.
- The impact of the pandemic was very uneven (affecting lower paid workers more), also the Furlough scheme affected millions, so makes the interpretation of averages much harder.
- Recovery looks good, but actually higher paid workers working more (compositional effect). Manager (£80k) and the waiter (£20k). Average goes from £50k to £80k when waiter loses job.
- *For many, wages are not keeping up with inflation and will not keep up as inflation surges in 2022.*

# Inflation: where it came from and where it is going....



## **Inflation: where it came from and where it is going....**

Many people will see real wages fall -

Particularly the public sector: nurses, Teachers, university lecturers...(Cash planning)

Pay deals are being made at this moment.

- If they do match inflation, then you start to get the dreaded “*wage-price spiral*” of the 70s.
- If not, then living real wages fall.

Mixed story: some will prosper if they can get inflation busting wage increases (those in high demand shortage sectors), some will be impoverished (those on pensions that are not indexed to inflation or subject to public sector pay freezes).

**Only time will tell...**

## **Inflation: where it came from and where it is going....**

### **Ukraine and sanctions.**

War has *direct effects*: the effect on output in the warzone and other affected areas. Mainly disrupting economic activity in Ukraine itself and closing of the Black Sea ports. We can predict these (there have been too many wars).

There are then *indirect effects*: the Sanctions imposed in response. The indirect effects will almost certainly be far bigger than the direct effects. Harder to predict: sanctions have been done to a large economy like Russia since WW2.

How will rest of world react to western sanctions? India, China, Africa, Middle East, Latin America, South-East Asia etc.

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### **Food:**



- Wheat and other grains. Russian and the Ukraine are major exporters of Wheat and prices started to increase even before hostilities started.

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- Fertilizer: the price has already spiked in anticipation of future shortages. Belarus/Russia and Ukraine produce a large amount of it. Russia is 20% of world supplies plus ingredients to make it elsewhere (urea, ammonia, and potash). *This will increase the cost of food across the globe.*

### **Energy**

- Energy. Russia is a major supplier of oil, coal and natural gas. In the short run there is little chance of replacing this, so either get
  - a) inflationary effect if it is removed (bigger the more is removed), or get
  - b) “moving of the chairs”, Russia shifts supply to China, India and elsewhere, EU and US replace it with middle eastern oil (China, India buy less from middle east).

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### Some other effects:

- Neon. About 50% of the world's semiconductor-grade neon, critical for the lasers used to make microchips, smart phones etc, comes from two Ukrainian companies, *Ingas* and *Cryoin*. Ingas is based in Mariupol and Cryonin in Odessa. World stocks will run out in April.
- Metals. Russia is a significant producer of Gold, Nickell, Palladium, Copper and Aluminium. Difficult to estimate effects...

The main point about sanctions is that *the more effective they are, the bigger the supply chain disruption and hence the bigger the effect on inflation in the UK (and everywhere).*

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### **Take Home:**

1. Inflation is here to stay for the next 24 months. Could peak as high as 9% or above late in 2022.
2. Things could get even worse if war or sanctions spread (South China sea etc.)
3. The poor will be hardest hit (since they spend more on Food and energy).
4. There will be a mixed story, but it is unlikely that wages will keep up with prices, meaning that most households will be worse off as a result.

# **Inflation: where it came from and where it is going....**

**Thankyou.**

There are no  
zeros in the  
Leontief  
Inverse.

