RESEARCH INSIGHTS

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Inflation

How will inflation come under control?

Amidst the recent crises resulting in inflation in various sectors, the governments and the FED have implemented various measures to combat inflation as they are crucial decision makers in keeping the economy of the world stable. However, how much can these actions help in our current economic downturn?

At a Glance

Inflation is defined as a sustained increase in an economy's general price level, meaning that prices of goods and services are rising over time. There are many causes of inflation, some of which are external factors while some of which are domestic factors. The underlying cause of inflation is driven by decisions of both the government and businesses.

Inflation rate has been high for two reasons. There has been a lot of money injected into the economy in the past two years and there have been severe product shortages caused by supply issues stemming from pandemic lockdowns, trade tensions and the Russia-Ukraine war. Both of these have increased the prices of goods, but it is hard to determine which is having a bigger impact at any given time. Up until recently, the federal reserve bank was primarily pointing the finger at supply chain issues for price spike in certain areas.

Conveniently, this would relieve them of responsibilities for inflation as they only have direct control over cash flows in the economy and they do not involve themselves in neither trade negotiations nor lockdown policies.

Types of inflation

The increase in prices driven by demand-pull inflation or cost-push inflation arises from imbalances on either side of the supply or demand of suppliers and consumers respectively. In such an inflationary environment, we have to identify the types of inflation causing the global inflation to rise.

Demand-pull

Demand-pull inflation is brought about when the supply of goods and services are unable to meet the rising demand. To measure the potential for demand-pull inflation in an economy, economists often study the capacity utilization rate of key industries. High rates of capacity utilization suggest that the economy is producing above potential GDP and may experience inflationary pressure.

Cost-push

Cost-push inflation is brought about by an increase in cost of production to the producers. The most prevalent source of cost-push inflation is the pressures caused by increase in wages.

Analysts have several ways to study wage pressures. The most straightforward way is to look at the unemployment rate where a lower unemployment rate would mean a higher pressure on wages. However, most analysts acknowledge that the unemployment rate may not be the most effective indicator of wage pressures. Factors such as job skills mismatch, cultural patterns that despise certain jobs and inefficiencies in the labour market can mean that the economy is facing labour shortages even though the unemployment rate may not be that low. A better indicator that encompasses these aspects of the labour market is the non-accelerating inflation rate of unemployment or the natural rate of unemployment.

In addition, analysts can use data on labour productivity to identify signs of potential wage pressure as wage increases are not inflationary as long as they remain in line with gains in productivity. An example would be the surge in global prices of commodities and raw materials due to the Russia-Ukraine war, together with an increase in unemployment rate, thus leading to cost-push inflation in these industries.

Shrink-flation

One way that companies are passing on costs to consumers is through "Shrink-flation". "Shrink-flation" is a term used to describe when products get smaller in weight, size or quantity but prices stay the same, or even increase.

An example of a company who has practiced such acts is "Barilla Spaghetti", where the quantity of their spaghetti in a packaging was reduced but they hid this fact from the consumers. When they were asked for the reason as to why they decreased the quantity of their spaghetti rather than increasing the price of it, they feigned ignorance and claimed that it was due to rising costs while still trying to include 4-5 servings in one box without having to increase the price of their spaghetti.

Aqua-flation

Aqua-flation occurs when the key ingredients of a product are being replaced with water, thus allowing the product to be produced at a cheaper rate. For example, the formulation of the ingredients in the E.D smith pie filling had a change whereby the concentration of the vegetable oil significantly decreased and it was replaced with a higher water content. However, E.D smith denied that they did not deliberately hide the change in the formula and that the change happened under the previous ownership.

Inflation in different sectors:

Retail inflation

Retailers rely heavily on the global supply chain, however, due to pandemic-induced supply-side disruption, the supply-and-demand curve between the suppliers and buyers has become largely misaligned. During the pandemic, consumers were mainly attracted towards online shopping as pandemic restrictions took away the opportunities for consumers to have in person experiences. The growing demand for goods such as clothing and electronics further pressurizes suppliers, specifically in China, which was already hampered by pandemic restrictions, including factory shutdowns and a lack of manpower.

As the demand for goods increased, so did the demand for shipping capacity. The availability of empty shipping containers gradually decreased and the average shipping container price quadrupled due to COVID-induced shipping container shortages. This resulted in an increase in shipping costs and significant inventory delays. Thus, retailers then pass on the increase in cost along to the consumers through inflated retail prices.

Housing inflation

Due to the pandemic, most of the construction sector came to a halt for the past two years. Although the sector is currently moving forward, it is tough for operations to return back to pre-covid levels due to disruptions in the supply chain which was worsened by the Russian-Ukraine war as well as China lockdowns. This has resulted in an increase in the costs of resources and prolonged the time needed to complete building homes. Meanwhile, there are buyers who need to get a flat urgently and they would therefore opt for ready resale units , thus driving up its demand and price.

Additionally, with Work From Home (WFH) becoming a norm and with a growing culture of a hybrid workplace concept, most of us are leaning towards having bigger units to have more space for ourselves. However, in Singapore's case, since the 2000s, HDB flat types have generally reduced in size as the average household size reduces. Together with the implementation of Total Debt Servicing Ratio (TDSR), smaller units are built to ensure affordability. Hence, buyers who are opting for units with a larger space would lean towards resale units that were built before the 2000s.

In spite of the uncertainty in the global economic outlook, foreign demand for properties in Singapore continues to grow as they value Singapore as a safe haven to invest in. Thus, in response to the growing demand, the Ministry of National Development has announced a potential supply of about 8000 units (including EC) from Government Land Sale Sites, Confirmed List sites and en-bloc sale sites. This will bring about an estimated of 33,600 units available for sale by the next two years and which has remarkably increase compared to 11,500 units being compared since 2021.

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How has rising inflation impact the stock market?

Although the stock market had a bad year in 2022, it could be a blessing in disguise. Most of the value lost in the headline indexes came from tech companies that were arguably overvalued. The fall in the value of these tech companies had the highest contribution in pulling the value of the total stock market. In fact, many of the biggest, more traditional companies in the world are actually having a great year. Thus, the performance of these traditional companies has allowed them to stand out from the other companies.

Impact of covid & Russian-Ukraine war on inflation

Russia's invasion of Ukraine will likely pose new challenges to the global economic recovery by affecting energy prices and inflation rates. Both short-term and long-term inflation expectations increased as an immediate result of the invasion. This increase can partially be attributed to consumers' fear of soaring energy prices.

The outbreak of the war in Ukraine took the world by surprise. Although many had discussed potential scenarios for such an event, few anticipated its occurrence, or at least the exact day of its onset. This major unanticipated event played a huge role in shaping consumer's sentiment.

With Ukraine and Russia being the major suppliers of raw materials and energy for many crucial supply chains, the Russia-Ukraine war had a huge impact on the prices of numerous essential commodities namely: energy, food, and metals.

Energy :

Before the Russia-Ukraine war, Global gas reserves were already limited due to the pandemic. With gas being a key input to supply chains, even a slight disruption to the Russian gas flow will have widespread economic consequences. During the war, certain countries such as the EU, the United Kingdom, the United States, Canada and Japan halted their energy products from Russia. A number of large oil companies have also ceased their operations in Russia. This will not only have a significant impact on Russia's future energy production but energy prices have been soaring due to the lack of energy supply from Russia.

Food :

Russia and Ukraine are responsible for more than 25% of global wheat exports while Ukraine itself exports close to 50% of sunflower oil. These are essential commodities used in food products. With the war disrupting trading routes, countries that are heavily reliant on Ukraine and Russia for food exports will have to search for alternatives or step up their productions to reduce the impact of interruption to food supplies. However, since Russia is also a main supplier of key ingredients for fertilizers, Russia's suspension of fertilizer exports in March 2022, together with China's suspension of urea and phosphate exports could affect the speed of production of agricultural yields. Thus, it would be tough for other countries to step up their production with a lack of supply of fertilizers. Thus, the disruption to wheat exports has therefore also increased the price of wheat due to a fall in supply.

Metals :

Russia and Ukraine have a significant share in the global production of metals such as nickel, copper and iron. They also export and manufacture key raw materials such as neon, palladium and platinum. Fears of sanction on Russia have increased the price of these metals. For instance, the trading price of palladium doubled to a price of about US$2700 per ounce. This may result in disruptions and potential shortages for such products, leading to a significant increase in price.

Corporate greed

Companies would inevitably want to stay profitable given the supply chain disruption and pandemic closure. Many argue that companies are taking advantage of the current economic situation and increasing prices of goods and services more than necessary. According to the New York Fed, the more inflation an industry saw, the more gross profits increased. For instance, most US companies are recording their largest profit over the last two quarters since 1950. This situation is referred to as the "wage-price spiral".

In the early 1900, businesses believed that in order to be successful, the products that they produce have to be of good quality and are durable enough to last for a long time. When consumers had a good experience with their products, they are certain that consumers would trust their products and spread the word, thus allowing businesses to grow in reputation. However, in today's world, the trick that best-practices seminars educate business executives are that the way to succeed is to produce products which will require authorized repairs by factory-trained and certified technicians to maintain the warranty. Companies would also place critical parts and mechanisms in inaccessible sealed compartments, and build the product with parts and materials designed to fail within days of warranty expiration, if not sooner.

For businesses, this resulted in an increase in product and maintenance sales, eventually having consumers to replace or repurchase their products more. Thus, if consumers have to constantly repair or replace their product, they are basically feeding these greedy companies, while they themselves grow more powerful, earning more and more money, and purely justifying their actions with an increased in profits.

Therefore, companies are making use of this golden opportunity of inflation to increase their prices under the guise of simply keeping up with inflation. However, in reality, most companies have raised their prices too far. They assume that if people are expecting a rise in the price level of their goods and services, they are not going to be surprised when there is a rise in the price level of their goods and services. However, companies are simply eroding consumers' purchasing power by having such greed. The last 6 months of seeing record corporate profits even though many measures are being implemented is because these companies can get away with charging any price they want to.

Current economic downturn VS the Great recession in 2008

Both the International Monetary Fund and the world bank are warning that we are heading towards a global recession, nonetheless, it is complicated to determine if we are in a recession. There is no official definition of recession but the globally recognized definition is that when an economy experiences two consecutive quarters of negative growth, it is in recession. However, the percentage of GDP (Gross Domestic Product) of an economy is not the only factor to consider, the unemployment rate and consumer's confidence are also crucial factors in determining if an economy is in recession.

The general assumption is that global recession refers to bankers being publicly shamed and people possibly losing their homes. They do indeed occur when a large number of major economies are going through an economic slump. Thus, analysts are worried as a recession in one economy might lead to a recession in another.

GDP growth in the global economy has been slowing down and the international monetary fund predicts that a third of the world economy will likely be in a technical recession next year. In essence, the US and Eurozone are facing an especially negative outlook. In the U.S, economic growth is declining to a fifth of its 2021 levels next year while in the Eurozone, growth is almost stagnant.

To understand the current economic downturn better, it would be good to compare it to the financial crisis in 2008. The financial crisis in 20078 pushed the world's banking system towards the edge of collapse and left many people no longer being able to afford their homes. This incident started with a housing bubble in the U.S where a whole industry ballooned around giving people mortgages. It happened when mortgage brokers got greedy and they started giving out loans to people whose financial income were not stable and eventually, they could not afford to pay back their debts. Hence, causing a banking crisis. Therefore, banks had to be rescued by government bailouts and the crisis even spread beyond the United States. Since European banks had bought a lot of bad mortgages from the US, they also collapsed and had to be bailed out by governments. Many European countries ultimately could no longer pay their own debt. Hence, government budgets were squeezed and this resulted in years of austerity and severely impacting the lives of millions of Europeans.

However, the current economic downturn is different in a sense that money is not the main issue. The economy is not facing a capital shortage and in fact, the capital markets and banks are sitting on loads of money but they could not spend it as there is nothing that comes into the economy.

Even though the world is currently not short of cash, it is short of almost everything else. When the pandemic struck, the fragility of supply chains became apparent, factories from Asia to Europe and North America halted production, sending the global economy into a freefall. As countries emerged from lockdowns, demands for goods and services returned faster than supply. Swelling orders have also outstripped availability and businesses across the economy struggled to hire workers. Hence, the measures to alleviate these issues would have to be different from those in the financial crisis in 2008.

Actions to be taken when inflation is high and the economy is headed towards a recession

The federal reserve bank's main goal is to achieve price stability and they normally try to balance this with enabling economic growth. They will choose to maintain a stable price level even if they are left with no choice but to push the economy into a recession. As much as these actions will have negative consequences on millions of regular people around the world, it is the harsh reality of the FED reserve's role.

Even though it is said that it is possible to recover from very severe recessions, however, it would be much harder to recover from hyperinflation. In such a situation, with all of the problems in the world to be worried of, the FED would not consider raising interest rates but due to rising inflation, they have no other option but to do it. However, the response of the government is different because unlike the FED, they do not have a narrow mandate, instead, they exist for the good of the people they represent. For example, the White House has already announced that inflation has become its top economic priority and that it will not interfere with the federal reserve's efforts to cool inflation even though it acknowledges that it could put a damper on the economy's recovery. Instead, the government is trying to implement new stimulus measures to alleviate the effects of both inflation and the potential recession.

On the contrary, although it can be argued that huge government stimulus efforts are part of the reason as to why we are facing rising inflation to begin with, the difference with these new stimulus measures are that they are designed to increase the supply of the goods and services in the economy rather than just the demand of goods and services. Previously, when one of the measures was to give its citizens a cash payouts, it does not necessarily add value to the economy as citizens would only spend it to keep businesses going but if they continue doing so, it will only lead to an inflation problem. However, with the new stimulus proposal, it is aimed at releasing oil reserves and building more housing. These are aimed at increasing the supply of the goods and services in the economy, which should tackle the concern of rising prices and provide a certain level of economic stimulus at the same time.

Writer's Opinions

Even though we are stuck between unreasonably high inflation and recession, instead of focusing on whether we are entering a recession, as individuals, we can focus on managing our wealth strategically. The biggest economic downturn in history such as the ones in 1921, 1937, 2001 and 2008 more or less came as a complete shock. Although this is not an excuse to be complacent, the fact we have been "seeing" this coming for years means that we are less likely to be blindsided by the impacts of either inflation or severe recession.

In the case of US earlier this year, their GDP growth were negative for two consecutive quarters which were recorded at "-1.6%" and "-0.6%" respectively for the first and the second quarter. According to the traditional definition of recession, which states that an economy is in recession if it experiences two quarters of negative GDP growth consecutively, the U.S. economy would have been defined to be in a technical recession. However, the White House and Federal Reserve Chairman Jerome Powell argued that traditional definition of recession does not accurately reflect the state of the US economy as the economy was experiencing a low unemployment rate and the labour market continued to perform well despite the current economic downturn. Hence, the U.S. decided to use a more open definition.

With the National Bureau of Economic Research (NBER) being the official judge on deciding whether the US is in recession. They have now redefined recession to be an event as "a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in production, employment, real income, and other indicators. A recession begins when the economy reaches a peak of activity and ends when the economy reaches its trough." Although it is understandable that an economy would try its best to avoid declaring a recession, we could not ignore the fact that President Biden's solution could possibly be avoiding responsibilities and just denying that the U.S are not in recession.

However, other than the U.S., many countries still adhere to the old definition of recession. Thus, just like national recessions, a consensus on the definition of a global recession has yet to be reached. It can only be said that we are facing a worldwide downturn globally if the economies of numerous major countries are contracting simultaneously, together with other indications of weak global economic growth.

To conclude, even though many economies may try to deny the fact that they are in recession, we should be glad that reserve banks have acknowledged the inflation problem and have now taken decisive steps to alleviate the issue. In addition, employment in the top economies is still strong which means that at least people are still receiving income. Furthermore, if the measures implemented by the governments that were previously mentioned are successful, it could possibly lead to a sustainable economic recovery. By believing that every downturn presents an opportunity, as long as we remain rational, we will be able to highlight the opportunities that we are exposed to.

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