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An Roghchoiste um Fhormhaoirsiú Buiséid

Ar Tuairisc Boilsciú

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Select Committee on Budgetary Oversight

Report on Inflation

March 2022

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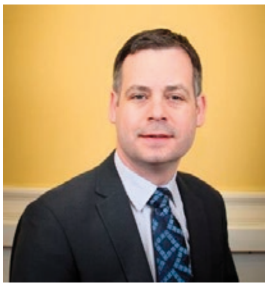

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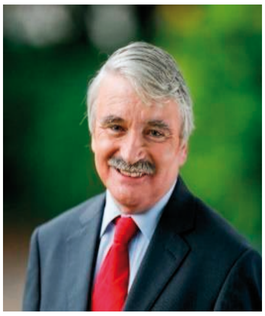

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Chair's Foreword

For the first time since the financial crisis, higher inflation has become an issue of significant concern for individuals and households. The Committee met with stakeholders in November 2021 to discuss the drivers and impact of inflation. The Committee heard that the inflation was driven by three main factors: energy costs, supply chain issues and base effects. Due to the source of the inflationary pressures, those on lower and fixed incomes are most impacted (particularly due to energy cost rises) and are the least able to absorb the additional costs. The Committee is very aware that global developments since the Committee held these meetings will exacerbate issues around energy costs and supply chain pressures.

The Committee discussed whether inflation would be temporary or whether there was potential for more prolonged inflation and heard how policy decisions from central banks could impact on future inflation.

The report also examines potential policy responses to higher inflation and how inflation needs to be considered across budgetary decisions and some potential inflationary risks.

The invasion of Ukraine by Russia will likely have significant impact on future inflationary developments, the observations and recommendations outlined in this report are intended to inform how the budgetary process must take into account and respond to inflationary pressures. The Committee will continue to monitor inflationary developments throughout the year.

On behalf of the Committee, I would like to thank the witnesses, Dr Ella Kavanagh, Professor Karl Whelan, representatives from the ESRI Dr Karina Doorley, Dr Niall Farrell and Professor Kieran McQuinn, and from the Central Bank of Ireland, Governor Gabriel Makhlouf and Dr Mark Cassidy for appearing before the Committee. Their insight and discussions with the Committee have allowed us to gain a deeper understanding of the issues around inflation.

Finally, I would like to thank the Members of the Committee for their work in examining this area and their input into this report.

Neasa Hourigan T.D.

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Summary of Committee Observations and Recommendations

Observations and Recommendations

1. The Committee wishes to note that the following report and related sessions were undertaken prior to the commencement of the current invasion of Ukraine by Russia. It is probable that this event will have consequences on inflation levels within the EU and globally, though the extent and timeframe of these impacts remains unclear.

2. The Committee notes that the current drivers of inflation are primarily global in nature and some are outside Ireland’s control.

3. The Committee notes that base effects have impacted on inflation figures over 2021 (the disruption to date due to Covid-19 would self-correct over the following quarters regardless of other inflationary pressures), however this will not, in of itself, slow the current high levels of inflation.

4. The Committee notes that many of the factors that have contributed to inflation have been global in nature and require international policy measures to mitigate their impact. However, the Committee is concerned that housing inflation, and some other sectors are due, in part, to domestic factors and has potential to continue in the medium-term, even if external inflationary pressures ease.

5. The Committee is concerned that the geo-political situation and high international demand could have a significant negative impact on future energy prices and that this may place a corresponding pressure on households and individuals. As such the Committee is of the view that the State needs to make considerable investments in state owned renewable sources to protect future energy security.

6. The Committee notes that inflation impacts differently on different parts of society depending on the particular inflationary drivers. Therefore, the

Committee recommends that the impact of inflation on lower-income or fixed income households should be considered, even in periods where overall inflation is lower.

7. The Committee notes that as current inflation is driven in part by energy price increases, lower-income households are more likely to be significantly impacted which could lead to an overall increase in rates of fuel poverty during this period of inflation. Therefore, targeted measures which are progressive in nature should be considered.

8. The Committee notes that Budget 2022 proposed to offset the impact of inflation as forecast at Budget time. However, the Committee also notes that inflation has exceed these forecasts meaning lower income groups have suffered more in real terms.

9. The Committee notes that the high inflation could lead to pressure on Government expenditure. However, the Committee notes that some revenue sources will also rise with inflation, this could offset those cost pressures, meaning a potentially cost neutral effect.

10. The Committee notes that further measures will likely be required in Budget 2023, if not before, to mitigate against an increase in the cost of living due to inflation.

11. The Committee recommends that future measures take into account how inflation developments impact on different sections of the income distribution and that this work must be adopted as part of the budgetary cycle and that it should include regional adaptations, equality and gender budgeting strategies.

12. The Committee notes that targeted fiscal policy can be used to offset some of the impacts of inflation.

13. The Committee recommends that the fuel allowance and other targeted welfare supports are kept under review throughout each budgetary cycle to ensure it is providing sufficient support.
14. The Committee notes capital investment will have to be tightly managed to ensure it does not add to inflationary pressures.
15. The Committee notes that inflationary pressures, particularly in the construction sector, may impact on the ability to deliver capital projects.
16. The Committee notes that all fiscal policy measures in response to inflation will have to take into account the potential to contribute to overheating the economy and driving further inflation.
17. The Committee notes that inflationary developments will have to be closely monitored and inform publications such as the Stability Programme Update and the Summer Economic Statement, including assessing the risk and potential scenarios of more prolonged inflation.
18. The Committee highlights that it has begun an examination of the Indexation of the Taxation and Social Protection System and will publish a report with its findings.
19. The Committee will continue to consider the impact of inflation as it carries out its work programme in advance of Budget 2023.

Introduction

Following Budget 2022, the Committee on Budgetary Oversight ("the Committee") decided to examine the issue of inflation and the impact it could have on both society and on Ireland's fiscal policy.

After a sustained period of low inflation since the financial crisis, there has been an increase in inflationary pressures in the last number of months.

Inflation is the broad increase in prices of goods and services. Inflation, which has been very low for the last decade, has begun to increase, in part, as the global economy begins to adjust to re-opening following the pandemic.

The Committee stated in its Pre-Stability Programme Update Report, 2021 that inflationary pressures should be monitored, particularly in relation to the construction sector. In its Interim Pre-Budget Report 2022, the Committee outlined that inflation presented a greater risk than in the last number of years.

The Committee held three meetings in November 2021 to discuss the issue of how inflation could impact on Ireland. The meeting transcripts and witnesses' opening statements are available on the Committee's webpage[1].

Meeting Date	Witnesses
Wednesday 10 November	Dr Ella Kavanagh, UCC Professor Karl Whelan, UCD
Wednesday 17 November	Economic and Social Research Institute (ESRI) • Dr Karina Doorley, Research Officer • Dr Niall Farrell, Research Officer • Professor Kieran McQuinn, Research Professor
Wednesday 24 November	Central Bank of Ireland • Mr Gabriel Makhlouf, Governor

[1] https://www.oireachtas.ie/en/committees/33/budgetary-oversight/

- Dr Mark Cassidy, Director, Economics and Statistics

The meetings and preparation of this report took place prior to the invasion of Ukraine by Russia and therefore do not take into account the consequences on inflation.

Observations and Recommendations

1. The Committee wishes to note that the following report and related sessions were undertaken prior to the commencement of the current invasion of Ukraine by Russia. It is probable that this event will have consequences on inflation levels within the EU and globally, though the extent and timeframe of these impacts remains unclear.

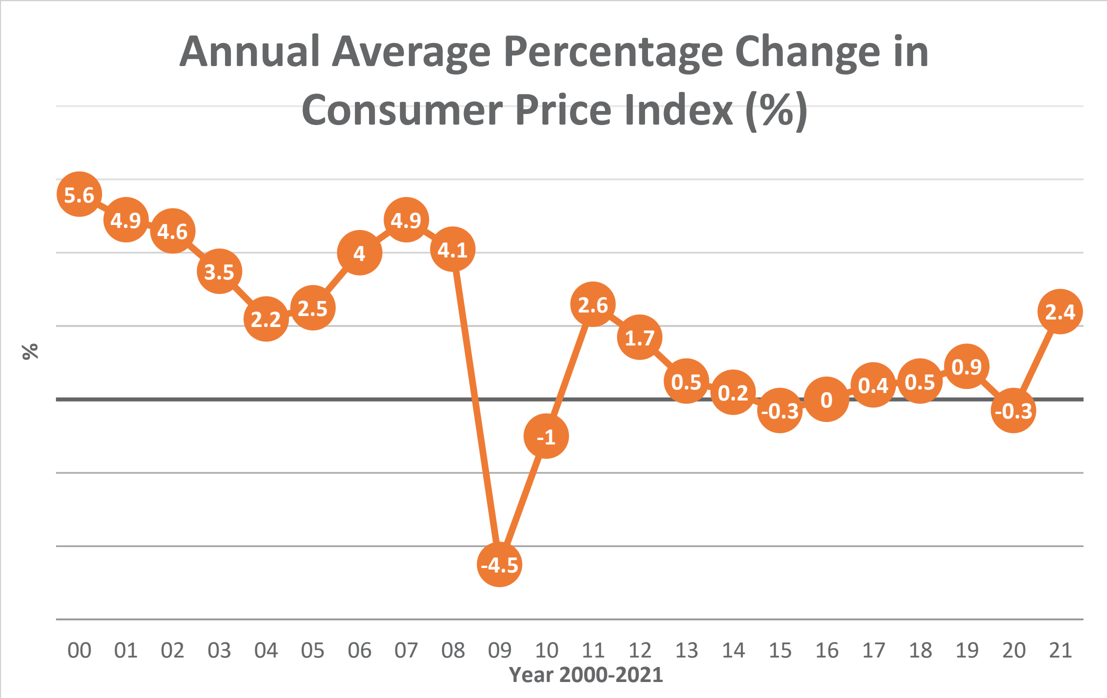
Inflation Levels

Mr Makhlouf outlined that the ECB's (and most other central bank's) target of 2% inflation is based on the assessment that it is the right rate to encourage investment, promoting stable and sustainable growth. Zero or negative inflation would distort incentives to spend. However, the eurozone inflation rate has been below this target for most of the last decade.

Inflation prior to the financial crash was much higher than in the last decade (see figure 1). Prof Whelan outlined to the Committee that inflation was around 5% in the years before 2008 but that it did not appear to be a major issue at the time as wages were growing far ahead of inflation.

Figure 1 shows inflation had been very low and steady since the financial crisis, with current inflation levels not seen since the immediate aftermath of the crisis. However, inflation prior to the financial crisis was notably higher.

Figure 1: Annual Inflation 2000-2021



Source: From CSO data, CPA01

Inflation figures are presented in two broad forms, the monthly changes, and the annual change. The monthly change refers to price change in the month, while the annual change refers to the same month the previous year (see Table 1).

The average annual rate of inflation provides the rate of inflation across the year. The annual average rate of inflation in 2021 was 2.4%, compares to a fall of 0.3% for 2020 (see figure 1).

Table 1: CPI & HICP January 2022[2]

CPI and HICP

	CPI		HICP	
	% monthly change	% annual change	% monthly change	% annual change
Sep 2021	0.5	3.7	0.4	3.8
Oct 2021	0.7	5.1	0.8	5.1
Nov 2021	0.6	5.3	0.6	5.4
Dec 2021	0.5	5.5	0.5	5.7
Jan 2022	-0.4	5.0	-0.4	5.0

Source: CSO, Consumer Price Index January 2022 - CSO - Central Statistics Office

Inflationary Pressures

The Committee heard current inflationary pressures are primarily driven by three factors, energy costs, supply issues and base effects. These, along with some other factors, will be outlined in this report. Some households and in particular lower income households are more heavily impacted as they tend to spend larger shares of their income on energy.

These inflation pressures are largely externally generated, and Ireland has little control or ability to act against these drivers of inflation as it is a small open economy. There are a number of policy options to mitigate the impact of inflation on society. Some of these options are examined in the report. However, there are certain areas, such as housing, where domestic factors are also contributing to inflation and may require additional consideration.

[2] For an explanation of the differences between CPI and HICP see Comparison between CPI and HI... (cso.ie)

Drivers of Inflation

The various stakeholders before Committee outlined a number drivers of the current inflationary pressures.

The current inflationary pressures are largely from external sources and as a result of the recovery from pandemic. Prof Whelan stated that it is external in the sense that it is coming from abroad or is global in nature. He also noted that these are beyond the control of the Government.

Dr McQuinn outlined that increased energy prices is an international issue while the supply chain difficulties are global issues due to the pandemic. Mr Makhlouf told the Committee the inflationary pressures are global as everyone was impacted by the pandemic and responded in similar ways.

Observations and Recommendations

2. The Committee notes that the current drivers of inflation are primarily global in nature and some are outside Ireland's control.

Base Effects

Prof Whelan noted that base effects due to the falling prices over the first months of the pandemic are a component of the increased inflation. As a result, price increases are currently being compared to prices that had fallen due to the pandemic. Prof Whelan stated that in September 2021 prices were at the level they would have been at had there been 2% inflation from the start of the pandemic.

Giving the ESRI's opening statement, Dr Doorley outlined that to understand the current inflationary pressures it is important to note the deflationary pressures of the pandemic. The public health restrictions in the first months of the pandemic led to a sharp reduction in demand for goods and services, resulting in prices falling in 2020 and early 2021. These falls are an important part of explaining the magnitude of current inflation.

As inflation focuses on the growth rate of prices, Dr Doorley outlined that due to the fall in prices in the first stages of the pandemic even with a strong increase in prices the price level may not be far from where the long-term level would be. A small increase in the price compared to pre-pandemic can therefore result in significant increase in inflation.

Mr Makhlouf also outlined these base effects were larger in Ireland than some other euro countries as prices fell more in Ireland. For example, Mr Makhlouf noted that the rise in energy prices followed a drop in prices in 2020.

However, a number of stakeholders emphasised that base effects do not account for the totality of current inflation rates. Mr Makhlouf stated that the base effects are now playing a smaller role with energy prices exceeding pre-pandemic levels.

Observations and Recommendations

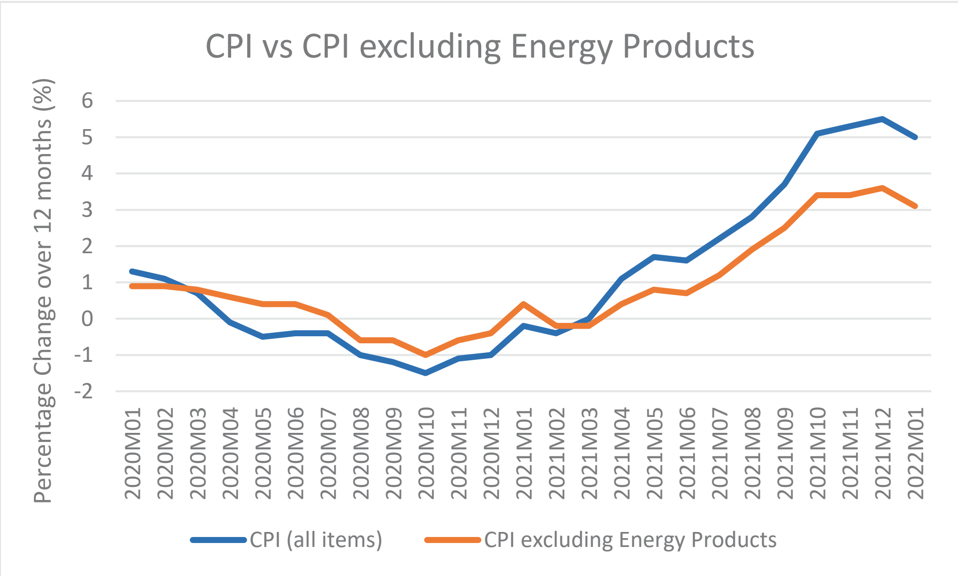
3. The Committee notes that base effects have impacted on inflation figures over 2021 (the disruption to date due to Covid-19 would self-correct over the following quarters regardless of other inflationary pressures), however this will not, in of itself, slow the current high levels of inflation.

Energy Costs

Mr Makhlouf stated that global energy prices have been a major driver of inflation. Prof Whelan outlined that the rise in energy prices has been the single biggest contributor to the increase in inflation. He also noted that at the beginning of the pandemic energy prices fell with the reduction in travel due to lockdowns. Dr Kavanagh outlined that geopolitical factors are a factor in the increased energy prices. In the time since the Committee’s public meetings in November, the geopolitical situation has become more volatile, which may have significant knock-on effects on gas, and other energy, prices.

Dr Doorley outlined that energy products are a significant contributor to current inflation, noting that in October 2021 the annual change in the CPI excluding energy products was 3.4% whereas it was 5.1% for overall CPI. This has remained similar for the remainder of the year (see figure 2).

Figure 2: CPI vs CPI excluding Energy Products



Source: From CSO data.

Dr Doorley also stated that between April and October 2021 gas prices rose by 400%. This has been driven by the growth in demand due to the economic recovery and supply constraints. There are a number of factors for these supply constraints. These include the reduction in international investments in oil and gas following previous price falls, maintenance work has been delayed from 2020 to 2021 and the cold 2020-2021 winter depleted European stocks. International demand for gas imports has also compounded price rises.

Dr Kavanagh outlined that demand for gas has increased as it is considered a bridging fuel between other fossil fuels and renewable energy, and has resulted in rising prices. For Dr Kavanagh, moving away from dependence on fossil fuels is a key way to reduce exposure to the volatility of energy markets.

Dr Farrell outlined that as much of our electricity and heating comes from gas, we are exposed to international price of gas. Reducing reliance on fossil fuels and accelerating the use of renewables is perhaps the longer-term solution to avoiding the volatility of fossil fuel prices.

Prof Whelan noted that Ireland has long been dependent on external energy supplies and subject to price changes, such as during the OPEC shocks.

Mr Makhlouf outlined that increased energy prices impact both directly and indirectly on household costs. Direct costs through increased electricity, heating and personal transport fuels pass quickly to consumer. Indirect costs through the increase in business costs are often passed on more slowly or only partly to consumers.

Dr Cassidy noted that the current energy price increases were somewhat unusual as price rises are equally significant amounts across all energy types, reflecting developments in international energy markets.

Dr Doorley noted that, based on the information at the time, rising energy prices was expected to persist over the winter and potentially fall in spring. Dr Farrell outlined that it was forecasted that gas prices were projected to fall back to more normal levels by spring.

Dr Cassidy outlined that futures markets indicated the expectation that oil and gas prices will decline in the first quarter of 2022 and then gradually reduce to pre-pandemic levels. However, Dr Cassidy noted the high uncertainty around future energy prices.

It should be noted that the witnesses were speaking in November 2021 and therefore were referring to the expectations and forecasts at that time. Some forecasts, such as the European Commission, now expect energy prices to stay higher for longer. Political tensions have also grown in recent weeks increasing uncertainty on future prices.

Prof Whelan and Dr Kavanagh addressed the impact of carbon tax on increasing prices. Prof Whelan noted that the carbon tax introduced in the last budget increases the cost of a 60-litre fill by around €1.50 and that the carbon tax is a relatively small contributor to the cost-of-living increases. Dr Kavanagh notes that reducing reliance on fossil fuels would help reduce the impact of the volatility of prices on the cost of living.

Dr Farrell stated that the vast majority of energy price increases are driven by increases to international prices, emphasising that on a litre of fuel carbon tax accounts for around 10 cents.

Supply Chain Issues

The pandemic has had a major impact on global supply chains. Dr McQuinn cited work carried out by the Bank for International Settlements[3] showing that difficulties with the supply chain are a significant factor in inflation rates in both the USA and the eurozone.

In terms of impact on supply, Prof Whelan noted that factory shutdowns were common early in the pandemic and Covid outbreaks continue to cause issues for manufacturing.

Dr Kavanagh outlined that the supply chain disruptions are a global issue and directly or indirectly a result of the pandemic. However, it remains uncertain how long these disruptions will continue and the impact on costs. Mr Makhlouf told the Committee there is a consensus that supply issues are blockages, not structural changes.

Prof Whelan stated that the pandemic had led to unexpected changes in global spending patterns. The surge in demand for certain goods has resulted in manufacturers and transporters being unable to meet the demand.

Dr Doorley noted that global shipping has been significantly impacted by the pandemic, with firms reducing capacity at the onset of the pandemic and therefore unprepared to meet the surge in global demand.

The supply issues have not been mirrored by falls in demand. Prof Whelan told the Committee that global demand has remained surprisingly strong and, while many households have lost income due to the pandemic, the average household balance sheet is stronger than before the pandemic. Mr Makhlouf also noted that following

[3] Bottlenecks: causes and macroeconomic implications (bis.org)

the early stages of the pandemic there was a surge in demand combined with reduced supply due to shutdowns.

Dr Kavanagh also noted that the extent to which companies are willing to continue to pass on the additional costs to customers is not clear.

Questioned on the potential impact of reshoring/onshoring, Dr Kavanagh stated that companies may react to supply chain disruptions by building more security into their supply chains and ensuring component parts are in closer proximity and readily available. Prof Whelan noted that companies will have to face a trade-off between cheap, but not necessarily secure supply, or source parts in Ireland or Europe to increase supply security. However, this could increase costs which would ultimately get passed on to consumers. This could lead to higher future inflation as the costs rise. Prof Whelan noted that the low cost of sourcing goods from China was a component of the low inflation over the last decade.

The impact of changes to supply chains, such reshoring or shortening of supply chains was also raised with Mr Makhlouf. He stated he was not worried at the concept of supply chain changes and would need to understand the changes before assessing if they were positive.

Mr Makhlouf outlined that once there is evidence that the blockages are being fixed, it will not be as important if it takes four months or a year. However, Mr Makhlouf told the Committee he would be concerned if there is evidence that the blockages were not being repaired.

Other Issues

A number of other issues that will have an impact on the inflationary trends were also discussed during the Committee's engagements. Dr Doorley noted that the Irish economy's strength throughout the pandemic has left Ireland vulnerable to inflation as demand grows quickly increasing pressures on prices.

Mr Makhlouf outlined three additional components of inflation in Ireland to consider, food, non-energy industrial goods and services. Increases in food and goods prices are due to the energy and supply chains issues. These pass-through costs from energy and inputs are likely to continue for several months.

Mr Makhlouf outlined that the price of services rose throughout the second half of 2021, in particular rents and restaurants and hotels. Base effects have impacted on these inflation rates, but Mr Makhlouf stated that these were both 4.2% higher compared to pre-pandemic levels.

Dr Kavanagh outlined wages and slack in the labour market are another source of uncertainty. There may be pressure for wage increases if spending reorients towards services, there's a reduction in the size of the labour force, or if higher inflation becomes a feature of wage negotiations. However, there could also be some downward pressure on wages as a result of the unwinding of pandemic supports.

Housing

Inflation in the housing/property sector was discussed with a number of witnesses. Dr Doorley outlined that the property sector is particularly impacted by inflationary pressures. Demand has remained strong and was largely unaffected by the pandemic but there was a slowdown in supply. Dr McQuinn noted that the housing sector has been one of the most affected areas by the pandemic, notably because demand has remained strong, if not stronger, and supply was restricted due to the public health restrictions. As a result, Dr McQuinn expects housing to be the one area with lingering inflation in the medium term.

Dr Doorley noted that the build-up of savings may have increased demand in the property market, further impacting prices with house price inflation in August 2021 of around 11%. Dr McQuinn stated that the preliminary evidence suggests that build-up in household savings during the pandemic are being used in the housing market.

Dr McQuinn stated that ultimately the solution to high housing costs is increasing supply and Mr Makhlouf noted that supply is the fundamental issue for housing, not the availability of finance. Mr Makhlouf also outlined the supply challenges in the housing market and stated that demand-side policies can create an inflationary effect.

Prof Whelan outlined that the increases in the cost of housing contributes to inflation as it can lead to increased pressure for higher wages. Dr McQuinn highlighted housing as an example of Covid compounding issues that were already there.

Mr Makhlouf outlined that in terms of inflation figures, the impact of rents is included in the calculation but not the purchase of housing. However, he also informed the Committee that work is ongoing at European level to include the cost of owner-occupied housing in the calculations.

Observations and Recommendations

4. The Committee notes that many of the factors that have contributed to inflation have been global in nature and require international policy measures to mitigate their impact. However, the Committee is concerned that housing inflation, and some other sectors are due, in part, to domestic factors and has potential to continue in the medium-term, even if external inflationary pressures ease.

Inflationary Trends

How inflation develops over the coming months will have a significant impact on both the response required to combat inflation and to ensure purchasing power is maintained.

Mr Makhlouf outlined the expectation that inflation will recede gradually in 2022 as base effects come out of the calculation and, hopefully, the supply bottlenecks ease. However, it should be noted that the most recent forecasts from the Central Bank[4] predict inflation of 4.5% for 2022, before slowing to 2.4% in 2023.

Dr Kavanagh told the Committee that the general consensus is that the current increase in inflation is temporary and will fall back towards the ECB's 2% target in the medium term. This is due to the expectation that energy prices will probably stabilise or fall in 2022 and that supply disruptions will ease. Base effects will also drop out of the inflation figures. However, Dr Kavanagh also noted that uncertainty around this is high and imbalances could lead to spikes in energy prices. Dr McQuinn noted that while the degree of confidence amongst experts has reduced, the core drivers of inflation should resolve within six to nine months (from November 2021).

In a speech to the European Parliament on 14 February, Christine Lagarde outlined that "while the outlook for inflation is uncertain, it is likely to remain elevated for longer than previously expected, but to decline in the course of this year".[5]

Prof Whelan noted that the ECB have been confident that inflation would return to the 2% target. However, Dr Kavanagh also stated that financial markets were of the view that inflation would be higher than central banks predictions.

Dr McQuinn outlined that the supply chain issues are expected to ease considerably over the following six to nine months. As previously outlined, Dr McQuinn also noted the pressures on energy costs are expected to ease in the next six to nine months.

[4] Quarterly Bulletin Q1 2022 | Central Bank of Ireland
[5] European Parliament plenary debate on the ECB Annual Report (europa.eu)

Dr McQuinn told the Committee that inflationary pressures in the housing market could linger for longer.

Potential for Prolonged Inflation

Prof Whelan stated that wholesale energy costs continuing to rise is a significant risk. The European natural gas market is, in particular, under strain and is likely to depend on a number of factors such as the severity of the winter and Russia's willingness to increase supply.

The pace at which supply bottlenecks will be resolved is also unclear according to Prof Whelan and will impact on the inflationary pressures.

Prof Whelan also pointed to the risk of current inflation figures fuelling expectations of what inflation will be. This could result in demands for pay increases, which could then lead to a high inflationary wage-price spiral. Prof Whelan emphasised that this was not seen as likely by economists and financial markets but that it should be pointed out.

Responding to how long inflation would have to continue at higher levels before getting worried, Mr Makhlouf told the Committee he was already worried but the longer it persists the more likely it will feed into second-round impact effects.

Observations and Recommendations

5. The Committee is concerned that the geo-political situation and high international demand could have a significant negative impact on future energy prices and that this may place a corresponding pressure on households and individuals. As such the Committee is of the view that the State needs to make considerable investments in state owned renewable sources to protect future energy security.

Future Inflation

While the witnesses were agreed that inflation was likely to be temporary, a number of areas that would require monitoring were discussed. Mr Makhlouf outlined to the

Committee that forecasting future developments is always challenging and that there is a remarkable level of additional uncertainty in the current economic context.

Wages

Dr Kavanagh noted that as inflation increases there will be greater pressure for wage increases, which in turn will increase prices and outlined that as inflation becomes embedded in people's thinking, it impacts on further decisions. Shortages in some sections of the labour market, such as the construction sector, may also lead to wage pressures.

Dr Cassidy outlined that there have been modest developments in wage increases since the financial crisis. Dr Cassidy stated that wage increases are a good thing, noting that the concern arises where wages across the economy are rising faster than productivity, which was not the case.

Mr Makhlouf noted that as of November 2021 data for the eurozone did not show inflation feeding into broad-based higher wage demands. However, he also noted that the upheaval in labour markets due to the pandemic make it difficult to accurately analyse the data.

Dr Cassidy noted that wages are increasing significantly in some sectors, those with the tightest labour market and difficulty attracting workers, but increases had not become generalised across the economy.

Impact of Inflation

If wages rise broadly in line with inflation, the impact on working households is limited. As outlined by Prof Whelan, prior to the financial crash inflation was high but wages were rising more.

Mr Makhlouf outlined the measurement of inflation is designed to represent an average consumption basket, but people will be impacted differently based on their exposure to certain price changes. Lower-income households, older people and rural households are more exposed to energy prices, while higher-income households, younger people and urban households spend a larger proportion on services.

Prof Whelan outlined those on fixed incomes (for example those on social welfare or pensions) that do not increase in line with inflation are negatively affected by rising inflation. Mr Makhlouf stressed that the Central Bank and the ECB take the impact of high inflation on purchasing power very seriously.

Observations and Recommendations

6. The Committee notes that inflation impacts differently on different parts of society depending on the particular inflationary drivers. Therefore, the Committee recommends that the impact of inflation on lower-income or fixed income households should be considered, even in periods where overall inflation is lower.
7. The Committee notes that as current inflation is driven in part by energy price increases, lower-income households are more likely to be significantly impacted which could lead to an overall increase in rates of fuel poverty during this period of inflation. Therefore, targeted measures which are progressive in nature should be considered.

Central Bank Response

Monetary policy for the eurozone is set by the ECB. Dr McQuinn noted that as monetary policy is made at eurozone level, the Central Bank of Ireland capacity to respond is limited. As outlined by Dr McQuinn that this can sometimes lead to a disconnect between the Irish economy's performance and monetary policy that is based on the eurozone as a whole.

The impact of monetary policy on inflation was discussed with the stakeholders. Mr Makhlouf outlined that monetary policy primarily affects the demand side of the economy. As the recovery from the pandemic is incomplete and remains uncertain, the wrong monetary policy action could have more negative effects than the current inflationary spike and slow economic growth over the medium term.

Mr Makhlouf outlined that monetary policymakers have to consider two things in deciding the response to inflationary pressures. First, what is the source of inflation and how long it is expected to last. Second, what is the potential for more broad-based and persistent inflation above 2% over the medium term.

Increasing interest rates was, in Mr Makhlouf's assessment, "absolutely not warranted"[6] as the drivers of inflation are temporary and that "increases in interest rates today would have a very negative effect on economies".

Mr Makhlouf argued against early monetary policy changes, but also recognised the risks to the inflation outlook, stressed the need to remain vigilant and stated that if inflation trends persist the case for monetary policy action will become stronger. If the evidence changes, particularly second round effects, such as inflation feeding into wages, Mr Makhlouf stated his view would change.

Questioned on how other central banks were responding (for example, in February the Bank of England raised interest rates for the second time in three months), Mr Makhlouf outlined there were some differences in responses from central banks, but it was important to consider the different circumstance each is operating in. For example, while there were significant fiscal responses in both the EU and the US,

[6] Committee on Budgetary Oversight debate - Wednesday, 24 Nov 2021 (oireachtas.ie) p5

the US's significant fiscal action is contributing to their inflationary pressures. Mr Makhlouf also noted that while the ECB and Federal Reserve both have price stability mandates, the Federal Reserve also has a mandate to achieve maximum sustainable employment.

The ECB has a number of tools available according to Mr Makhlouf. Interest rates are the preferred tool, but it also uses asset purchases and forward guidance to influence inflation and economic activity. Mr Makhlouf stated that is likely that asset purchases would be reduced before increasing interest rates. Mr Makhlouf also noted that monetary policy has a lag and therefore takes time for decisions to feed through.

Speaking to the European Parliament on 14 February[7], Christine Lagarde confirmed that the ECB would be reducing the pace of its asset purchases over the coming quarters and that interest rates would not increase until the asset purchases finish.

Dr McQuinn noted that the ECB commentary (around November 2021) was clear that interest rates would not rise for at least six to nine months. Prof Whelan was of the view that the ECB would wind down its purchasing programmes before increasing interest rates and that interest rates won't rise until the summer at the earliest. Prof Whelan outlined that the ECB had been clear that interest rates would not be rising over the coming months.

Mr Makhlouf outlined to the Committee that while lower income households are most impacted by the rise in energy prices, they are also more exposed to a contraction in demand (as a result of the increase in interest rates) that would reduce employment.

Risks

Prof Whelan stated that one of the biggest risks comes from the potential responses of central banks. Raising interest rates would increase the cost of Government debt, however, Prof Whelan notes that Ireland is somewhat protected as much of the debt is long-term and at fixed interest rates.

[7] European Parliament plenary debate on the ECB Annual Report (europa.eu)

The greater concern outlined by Prof Whelan is that the reaction from the ECB and Federal Reserve could lead to a global recession, as seen in the 1980s and 90s, as they restrain the economy to bring inflation down.

Dr Doorley also cautioned against hasty reactions from central banks raising interest rates as it could threaten the economic recovery from the pandemic. An increase in interest rates could be a shock for those relying on the cheap finance conditions. Dr Kavanagh noted that by the time interest rate increases have an impact over the medium term, the energy price pressures may have receded. By not reacting Dr Kavanagh stated that central banks would at least not aggravate the problem.

Dr McQuinn also outlined that increasing interest rates could set back the economic recovery, noting that the ECB and European Institutions have probably learned from the mistakes of the response to the financial crisis, where there was an emphasis on cutting expenditure and raising interest rates, impacted on economic recovery. Dr McQuinn believed that the ECB was cognisant that increasing interest rates could have a knock-on effect on Members States' borrowing rates.

Prof Whelan outlined that neither the central banks nor academic economists have a very good theory of the determinants of inflation. It is important that decisions are made taking into account the specifics of the current inflationary pressures. Previous experience has shown that increasing interest rates to lower inflation can result in significant increases in unemployment. Prof Whelan told the Committee there were many examples of raising interest rates to combat inflation resulting in a recession.

Policy Responses to Inflation

While the Committee heard from a number of witnesses that Ireland does not have much control over inflation, there are a number of options available to attempt to mitigate the effects of inflation.

The level of desired inflation also needs to be considered. Dr Kavanagh emphasised that inflation around 2% would not be a major concern.

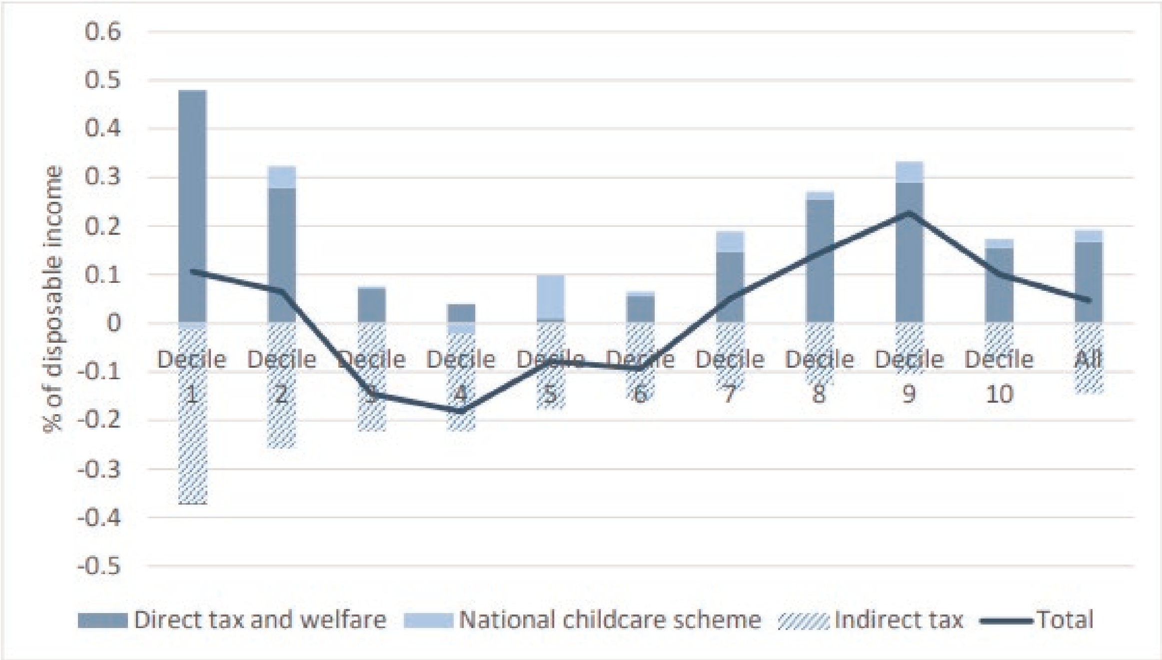
Prof Whelan outlined that as Ireland imports a high proportion of consumer goods, we are subject to price developments in the global economy.

Budget 2022

Prof Whelan noted that there were not many budgetary tools available to the Government to offset the externally driven inflation. However, the adjustment of tax bands and increases in fuel allowances in Budget 2022 partially offset the impact of increased inflation on people, based on forecast inflation at the time of the Budget.

Similarly, Dr Doorley noted a number of measures in Budget 2022 that aimed to maintain household's standard of living. Tax credits and bands were increased by more than the level of inflation forecast at budget time. However, the thresholds for USC and PRSI were fixed in nominal terms. As a result, the middle-income declines benefited less than other both lower and higher deciles from the budgetary changes (see figure 3). This is due to middle deciles not benefitting as much from changes to social welfare and not earning enough to benefit from the increase in the standard rate band. Increasing the USC and PRSI bands along with the income tax bands would helped benefit the medium deciles. However, Dr Doorley did note that the magnitude of these effects across deciles are small, ranging from -0.2% of disposable income to 0.2%.

Figure 3: Distributional effect of Budget 2022 compared to a price-indexed Budget



Source: 1 ESRI, Opening Statement to the Committee[8]

Dr Doorley also noted most social welfare payments were increased in Budget 2022, with some payments rising quicker than the forecast inflation (such as the fuel allowance, for those living alone) at the time.

Overall, Dr Doorley told the Committee Budget 2022 would compensate most households for the projected increases in inflation (around 2% or 3%). If inflation exceeded forecasts, Dr Doorley stated that targeted measures (like the fuel allowance or living alone allowance) may not be sufficient to protect low-income households.

Dr Doorley recommended that the impact of the Budget 2022 decisions be considered in Budget 2023 with a view to ascertaining if further changes should be made.

8 https://data.oireachtas.ie/ie/oireachtas/committee/dail/33/committee_on_budgetary_oversight/submissions/2021/2021-11-17_opening-statement-dr-karina-doorley-et-al-senior-research-officer-esri_en.pdf

Observations and Recommendations

8. The Committee notes that Budget 2022 proposed to offset the impact of inflation as forecast at Budget time. However, the Committee also notes that inflation has exceed these forecasts meaning lower income groups have suffered more in real terms.

European Commission Toolbox

The European Commission has published a toolbox outlining possible measures to support consumers face temporary increases in energy prices, including deferral of bill payments, adjustments to VAT and temporary social welfare changes. Dr Doorley noted that for Ireland changes to social welfare payments and bill deferrals would likely be the most effective policies as taxes represent a smaller proportion of total costs than in many EU countries. However, the Commission is not advocating rolling back on carbon taxes as it is a long-term policy.

Impact on Budgetary Sustainability

Increased inflation can create a number of demands on Government spending. Prof Whelan outlined wage increases for public workers and increases to welfare rates as two examples.

However, the increased inflation also generally increases tax revenue. Prof Whelan noted VAT and Corporation Tax receipts will rise with higher inflation.

Prof Whelan outlined that, on balance, while it depends on the decisions taken by Government, the overall impact on the budget and deficit to GDP ratio is likely to be neutral.

Observations and Recommendations

9. The Committee notes that the high inflation could lead to pressure on Government expenditure. However, the Committee notes that some revenue

sources will also rise with inflation, this could offset those cost pressures, meaning a potentially cost neutral effect.

Cost-of-Living Measures

The Government announced a €505 million package of measures on 10 February[9] to mitigate the cost of living. The following measures are being rolled out:

- energy credit increased to €200 including VAT
- fuel allowance lump sum payment of €125
- drug payment scheme reduction to €80
- front-loading of the working family payment
- 20% reduction in public transport fees from end of April until the end of the year
- reduction in caps for school transport fees

The bulk of the cost, €378 million is taken up by the energy credit. This includes both the previously announced credit of €100 (excluding VAT) and the increase to €200 (including VAT). This measure will be directly applied to electricity bills in April.

There has been some criticism of this payment as it does not target those most impacted by the current inflationary pressures. However, it has also been noted that the social welfare and tax measures in Budget 2022 did not impact on middle income households. The universal payment ensures that all households will benefit.

The additional fuel allowance payment of €125 is due in mid-March, with an additional cost of €49 million.

Observations and Recommendations

10. The Committee notes that further measures will likely be required in Budget 2023, if not before, to mitigate against an increase in the cost of living due to inflation.

[9] gov.ie - Ministers McGrath and Donohoe announce €505 million package in measures to mitigate the cost of living (www.gov.ie)

11. The Committee recommends that future measures take into account how inflation developments impact on different sections of the income distribution and that this work must be adopted as part of the budgetary cycle and that it should include regional adaptations, equality and gender budgeting strategies.

Possible Policy Responses

Dr Kavanagh and Prof Whelan noted that as a small open economy Ireland does not set prices. In particular, Prof Whelan noted that there is no “magic formula” for reducing oil and gas prices.

Dr Kavanagh outlined some policies that could reduce the impact of supply side shock, such as infrastructure investment, education, and training to reduce the labour mismatch.

Prof Whelan outlined that prudent management of fiscal policy will be required and to avoid over-stimulating the economy.

Fiscal Policy

Mr Makhlouf outlined that Government’s fiscal policy can have an important impact on inflation, along with the broader economy. Mr Makhlouf noted the importance of capital investment but stressed the need for it to be carefully managed and accompanied, where necessary, by structural reforms to ensure that it does not result in excessive inflationary pressures. Mr Makhlouf summarised by stating “put simply, the economy as a whole does not need, nor would benefit from, expansionary fiscal policy in the coming years” but was also clear that this does not preclude targeted measures to offset the negative impact of inflation on the most vulnerable.

One option outlined to the Committee by Prof Whelan is to temporarily reduce VAT rates on certain goods and services to reduce the cost of purchases. However, on balance, Prof Whelan stated he would argue against such a proposal as it is politically difficult, noting that temporary cuts often last beyond the intended period.

It should be noted that the current VAT rate on energy bills benefits from an historic derogation under the EU VAT directive. The Minister for Finance outlined in a recent Parliamentary Question[10], that if the VAT rate were to be temporarily reduced below 12% it would not be able to return to the current 13.5% but would have to move to the standard rate (23%).

Prof Whelan was of the view that carbon taxes should not be rolled back, however, the distributional impact should be examined, for example through increases to the fuel allowance. Dr Kavanagh also called for fuel allowance to be revisited due to the increasing energy costs.

Dr Doorley and Dr Farrell told the Committee a carbon tax is the most efficient way to incentivise reducing emissions, while also having the lowest cost to society's welfare. However, Dr Doorley also noted that carbon tax can have a disproportionate impact on lower income households as they spend a higher share of their incomes on heat and fuel. Carbon taxes should therefore be in included in wider changes to the taxation and welfare system. Dr Doorley outlined that carbon taxes should be accompanied by measures that ensure that households that are unable to switch are left no worse off.

Prof Whelan stated that all carbon taxes and energy-related policies should include a distributional analysis on how it impacts lower income households and how funds raised could be used to offset such impacts. Dr Doorley stated that temporarily reducing the taxes on fuel could be considered, as could increasing the fuel allowance, though she noted that the fuel allowance only targets those receiving social welfare.

Dr Doorley stated carbon taxes should be viewed from a long-term perspective and with the goal of behavioural change. Dr Doorley also noted that carbon taxes need to be applied across the board to achieve behavioural change. Dr Farrell outlined that carbon taxes should be considered as part of a suite of measures related to environmental policy.

[10] https://www.oireachtas.ie/en/debates/question/2022-02-10/256/

Observations and Recommendations

12. The Committee notes that targeted fiscal policy can be used to offset some of the impacts of inflation.
13. The Committee recommends that the fuel allowance and other targeted welfare supports are kept under review throughout each budgetary cycle to ensure it is providing sufficient support.

Price Controls

The possibility of introducing price controls was raised with some of the witnesses. Dr Kavanagh would not recommend price or wage controls, noting that price controls can reduce supply. Prof Whelan outlined that while price controls are a natural response to high inflation the historical evidence is that price controls do not really work.

Rent controls, in particular, were discussed. Dr Kavanagh was of the view that increasing supply was the main avenue of alleviating the cost of housing.

Inflationary Risks

The Committee also heard that Government spending could contribute to inflationary pressures.

Capital Spending Programme

Prof Whelan noted that consideration will have to be given to the economy's capacity to deliver the ambitious capital spending plan, as if inflationary pressures continue, overheating the domestic economy could make the situation considerably worse.

Dr Cassidy noted that there are inflationary pressures in the construction sector and the challenge will be to ensure value for money. Dr Cassidy outlined a number of areas that will require careful monitoring, including the need for significant additional labour, the low level of productivity in the sector compared to some other countries and the need to manage delivery and limit cost overruns.

Dr Cassidy told the Committee that if there are excess inflationary pressures or private sector construction being squeezed out by the increased public sector activity the timing of delivery of some capital projects may need to be re-examined. The Committee recognises that although total employment in the construction sector is higher today than in the year 2000, the delivery of new home dwellings is below this period, because a higher proportion of the workforce is employed in commercial activity (offices, hotels, etc), and efforts should be made to prioritise housing.

Prof Whelan outlined that the capital spending programme was a potential risk. While no individual project is a concern, the scale of the plan raises questions on the sufficient supply of labour and whether the economy could overheat. Prof Whelan cautioned that the capacity to deliver projects without overheating the economy will have to be considered. Dr Kavanagh outlined that demand for materials and labour in the construction sector drives up costs. Mr Makhlouf noted that both the size of the capital spend and how it is spent are causes of concern.

However, Dr Kavanagh also outlined that capital investment in infrastructure can have long term benefits on inflation by reducing inefficiencies and improving the supply side of the economy.

Observations and Recommendations

14. The Committee notes capital investment will have to be tightly managed to ensure it does not add to inflationary pressures.
15. The Committee notes that inflationary pressures, particularly in the construction sector, may impact on the ability to deliver capital projects.

Current Expenditure

Dr McQuinn outlined the importance of being relatively disciplined in terms to current expenditure to avoid overheating the economy. In particular, Dr McQuinn noted tax cuts would be difficult to justify and that some discipline around public sector pay would be required.

Observations and Recommendations

16. The Committee notes that all fiscal policy measures in response to inflation will have to take into account the potential to contribute to overheating the economy and driving further inflation.

Committee Conclusion

The impact of inflation on the cost of living over the coming year will be a significant issue for households, businesses, and State spending. Should inflation persist longer than currently anticipated, it could have a significant impact on budgetary decisions over the medium-term.

It is vital that preparations for Budget 2023 and Government finances more generally, take into account the potential impact of inflation across the tax and welfare system.

The Committee discussed a number of options for mitigating the impact of inflation. As part of its work programme in advance of Budget 2023, the Committee is examining the indexation of the taxation and social protection system. An indexation system is one option for ensuring that tax bands and social welfare payments increase in line with inflation.

Observations and Recommendations

17. The Committee notes that inflationary developments will have to be closely monitored and inform publications such as the Stability Programme Update and the Summer Economic Statement, including assessing the risk and potential scenarios of more prolonged inflation.
18. The Committee highlights that it has begun an examination of the Indexation of the Taxation and Social Protection System and will publish a report with its findings.
19. The Committee will continue to consider the impact of inflation as it carries out its work programme in advance of Budget 2023.

Appendix – Orders of Reference

Committee on Budgetary Oversight.

219. (1) There shall stand established as soon as may be, following the reassembly of the Dáil subsequent to a General Election, a Standing Committee, to be known as the Committee on Budgetary Oversight, to examine and, where it considers it appropriate, report to the Dáil on—

(a) the overall fiscal position, including—

(i) the aggregated position on revenue and expenditure and the General Government Balance, including structural targets;

(ii) medium-term projections for the public finances;

(iii) macro-economic forecasts and developments;

(iv) general fiscal governance including the application of fiscal rules and risks to the fiscal position; and

(v) matters arising from the introduction of a supplementary Estimate or Estimates that, in its opinion, have or may have significant budgetary implications: Provided that the Committee shall advise the appropriate Committee or Committees of any decision on its part to undertake such consideration and the reason or reasons therefor;

(b) public expenditure policy, including— 109

(i) the expenditure position having regard to the Government Expenditure Ceiling and the expenditure benchmark under the Stability and Growth Pact;

(ii) Ministerial Expenditure Ceilings applying to individual Estimates or groups of Estimates for the Public Services where significant variations from the expenditure profile could potentially impact on the overall fiscal position; and

(iii) the adequacy of planned and actual aggregate levels of capital expenditure and the policies and practices in relation to capital expenditure, including public procurement policy and public private partnership policy, intended to ensure the achievement of value for money.

(c) Exchequer receipts policy.

(2) The Committee may consider a matter of public policy with significant impact on the budgetary position or on the overall fiscal position: Provided that prior to the commencement of such consideration, the Cathaoirleach of the Committee shall consult with the relevant sectoral Committee established pursuant to Standing Order 95.

(3) The Committee may also consider the overall framework for parliamentary engagement throughout the course of the budgetary cycle and may make recommendations thereon to the Committee on Standing Orders and Dáil Reform for that Committee's consideration under Standing Order 119(1)(b): Provided that, in so doing, the Committee shall consult with—

(a) the Committees established pursuant to Standing Order 95 on any recommendations which, in the opinion of the Committee, impact on their role or remit; and

(b) the relevant Minister or Ministers on any recommendations which, in the opinion of the Committee, impact on the role or remit of a Department or Departments,

and shall notify the results of such consultations to Committee on Standing Orders and Dáil Reform.

(4) The Committee shall have the following powers:

(a) power to send for persons, papers and records as defined in Standing Orders 96(3) and 99;

(b) power to take oral and written evidence and submissions as defined in Standing Order 96(1) and (2);

(c) power to appoint sub-Committees as defined in Standing Order 96(4); (d) power to engage consultants as defined in Standing Order 96(14);

(e) power to travel as defined in Standing Order 96(15).

(5) Every report which the Committee proposes to make shall, on adoption by the Committee, be laid before the Dáil forthwith, whereupon the Committee shall be empowered to print and publish such report, together with such related documents it thinks fit. 110

(6) The Committee shall consist of fifteen members, none of whom shall be a member of the Government or a Minister of State, and four of whom shall constitute a quorum: Provided that—

(a) the Committee and any sub-Committees which it may appoint shall be constituted so as to be impartially representative of the Dáil; and

(b) the provisions of Standing Order 106 shall apply to the Committee.

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