Opening Statement – Oireachtas Committee on Budgetary Oversight

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Introduction

Let me begin by thanking the Chair for the invitation to the ESRI to appear before the Committee. I am Prof. Kieran McQuinn, and I am joined by my colleagues Dr. Karina Doorley and Dr. Conor O'Toole. We are grateful for the opportunity to appear before the Committee today to provide our views on inflation.

Price pressures are now more broadly based than when we previously briefed this committee. Higher inflation is not unique to Ireland; growing uncertainty and increases in international prices have led to considerable downward revisions in global output and expectations for slowed growth in the present year. Due to the small, open nature of the Irish economy, developments in global inflationary pressures are likely to feed through into domestic Irish prices. Understanding the global environment allows us to understand the root causes of the rise in the domestic cost of living and to consider the most appropriate response.

Global price pressures

The breakout of war between Russia and Ukraine has disrupted already strained food and energy markets, contributing further upward pressure on international prices. As a result, the IMF have increased their latest global inflation forecast to above 7 per cent for this year and we now anticipate Irish CPI to exceed 7 per cent in 2022, with the impact on basic foodstuffs and energy being particularly acute.

As the pandemic began, supply chains abruptly shut down as public health-related restrictions disrupted production activities. The re-opening of the global economy contributed to a sudden surge in demand which coincided with a sluggishness in international supply. This surge in demand has also been seen in Ireland with the domestic economy recovering rapidly. The strong economic performance domestically, coupled with the international pressures, create an environment with considerable inflationary pressures. As of May 2022, inflation in Ireland and the euro area stood at 7.8 per cent and 8.1 per cent, respectively.

Supply chains have yet to normalise as further disruptions from the invasion of Ukraine by the Russian Federation and ongoing Covid-related lockdowns in China have contributed to further bottlenecks. Altogether, supply chain disruptions have placed considerable upward pressure on international prices.

As a result of these global disruptions to commodity markets, international inflationary pressures have escalated to rates unseen in many years. A further escalation in prices is expected, as indicated by the IMF forecasts for global indices for food, beverages and energy series. In order to understand the pass through of extreme price pressures in the global market to Irish prices, we have linked certain sub-indices of the Irish CPI to comparable global series provided by the IMF World Economic Outlook. Table 1 presents the growth rate in the international index from the IMF forecasts as well as the outturn in the Irish monthly CPI for the period January to April 2022. From the table it is evident that at a global level some of the increases envisaged are substantial. From an Irish perspective, it is clear however that international inflation rates traditionally do not fully pass through to the Irish CPI; therefore, we are unlikely to see all of the current inflation observed in the international series being passed through to Irish prices.

Table 1. IMF Forecast[1] and Annual Growth in Irish CPI YTD

Food and energy	IMF Index Global Forecast	Annual Growth YTD
Food	13.8%	2.8%
Non-alcoholic beverages	6.2%	3.4%
Electricity	87.9%	23.8%
Gas	146.9%	33.5%
Liquid fuels	54.6%	81.6%
Solid fuels	179.3%	15.4%
Petrol	54.6%	29.7%
Diesel	54.6%	37.9%
Motor oil	54.6%	6.6%

Food and Energy

As indicated by the IMF Economic Outlook, the areas experiencing the most acute inflation globally and in Ireland are food and energy. Global food prices experienced a near 30 per cent rate of inflation in 2021 due to the disruption in agriculture caused by extreme weather events associated with climate change and disruptions to food supply chains during the pandemic. In light of Russia and Ukraine's significant share of the global traded wheat supply, forecasts for food prices in 2022 are likely to come with considerable upside risks as the war continues. The IMF forecast for food inflation is expected to increase an additional 14 per cent in 2022.

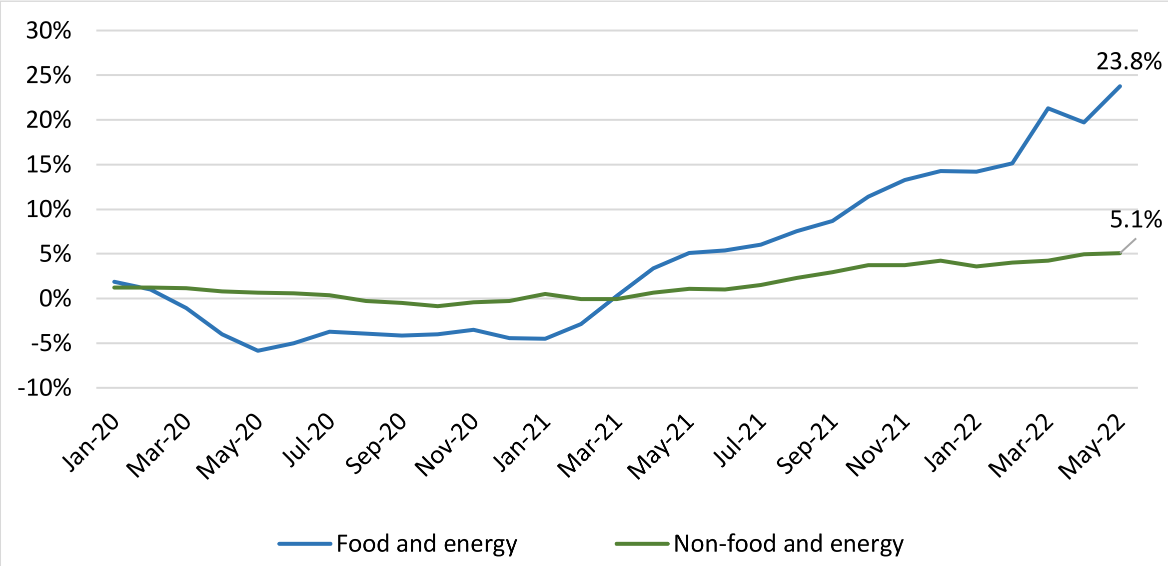
In addition to food, the war has had a significant impact on an already vulnerable global energy market. In 2021, prices of energy products had already begun to accelerate as supplies were not prepared to meet the post-pandemic surge in demand. Sanctions imposed on Russian energy products have contributed to further price increases across the market. The euro area is particularly susceptible to price increases of Russian energy products, as Russia accounts for 20 per cent of oil and 35 per cent of gas supplied to the euro area.

Given these price pressures, we have divided the Irish CPI into two main indices: food and energy related items, and non-food and energy items. Food and energy items have accelerated rapidly over the past year, reaching a high point of 23.8 per cent per annum in May 2022. While the increase in non-food and energy-related goods has been more gradual, price pressures in these items are of real concern. As of May 2022, prices of these items had increased 5.1 per cent on an annual basis. As inflation becomes more broadly based, the likelihood of increased

[1] IMF World Economic Outlook, April 2022.

inflationary expectations amongst the public could result in greater demand for higher wages which in turn can reinforce any inflationary pressures.

Figure 1. Inflation in Food and Energy and Non-food and Energy items (Y-on-Y %)



Distributional effects of Inflation

Due to differences in the composition of household expenditure, households are experiencing different rates of inflation.

Figure 2 shows the diverging inflation rates across income deciles and highlights the disproportionate affect of price increases on lower-income households. Due to sharp increases in energy prices, the aggregate share of household expenditure on energy and transportation is expected to rise significantly. For households in the bottom half of the income distribution, inflation exceeded 7 per cent in March 2022 compared to a rate of just over 6 per cent for households in the top three deciles.

Figure 2. CPI (March 2022) by Household Income

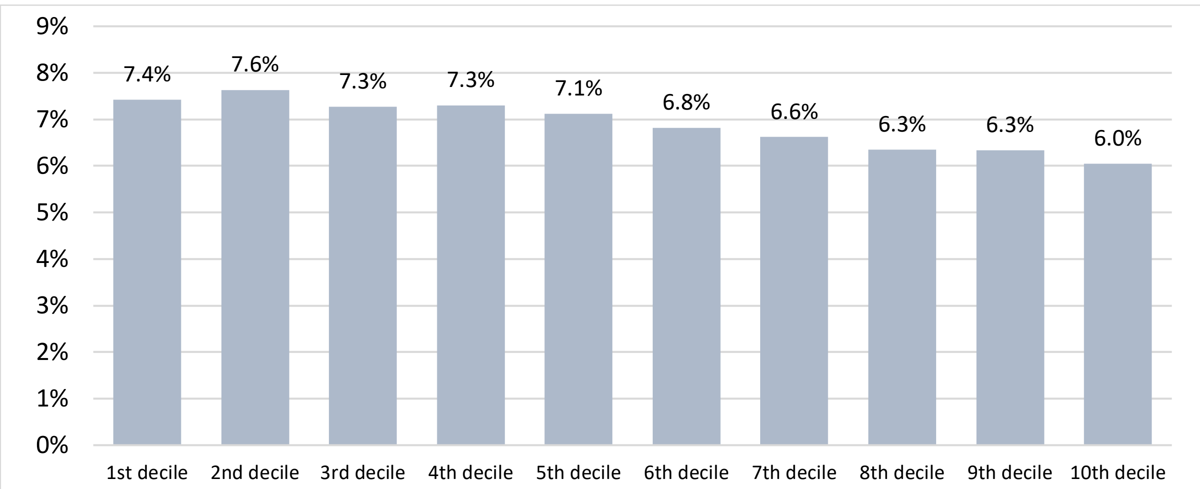
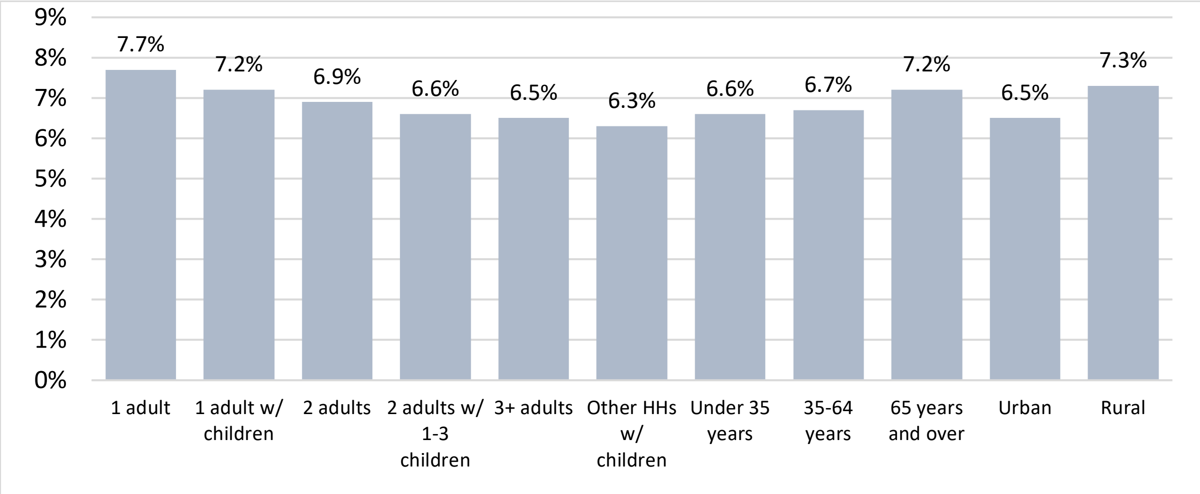


Figure 3 shows the diverging inflation rates across composition, age and location. When considering household composition, single adult households experienced the highest inflation rate in March 2022 (7.7 per cent). Rural households also experienced higher inflation than urban counterparts, and households over age 65 experienced inflation of 7.2 per cent, while inflation remained under 7.0 per cent amongst younger households.

Figure 3. CPI (March 2022) by Composition, age and location



Monetary Policy Response

In order to tackle higher inflation rates across the euro area, the ECB has signalled a tightening of monetary policy, with an expected interest rate rise of 50 basis points in the short-term. The ECB have also signalled a wind down in the non-standard monetary policy asset purchase schemes. From a Euro area perspective, while an increase in policy rates is typically used to counter inflationary pressures, it does pose significant challenges from a sovereign debt perspective and also acts to slow growth in the macroeconomy through adversely impacting consumption and investment.

The risk of a tighter monetary policy response from the ECB has led to the re-emergence of concerns over the management of sovereign debt as member states across the euro area issued significant amounts of new debt in response to the pandemic. While all member states have experienced increasing bond yields in reaction to inflationary pressures, Italian and Greek spreads from the German Bund increased by 58 and 85 basis points, respectively, between 1 May and 1 January 2022. As interest rates rise, high-debt countries such as Italy and Greece could face a higher debt burden and vulnerabilities.

From a domestic perspective, the tightening of monetary policy may temper some of the recent inflationary pressures; this is particularly the case in the housing market. This market has witnessed a significant increase in demand since the pandemic with the increased savings observed across households additionally fuelling housing demand. The supply-side of the housing market was adversely impacted by the public health measures adopted and is currently facing significant inflationary pressures in many crucial inputs in the construction sector.

Therefore, house prices have witnessed a noticeable pick-up in inflation in recent years, with the latest CSO data revealing prices are growing at an annual rate of 14.2 per cent for the year to April. The latest Quarterly Economic Commentary contains analysis which indicates that the 50 basis point increase in the ECB policy rate could, by itself, result in Irish house prices falling by 2 per cent. Therefore, the increase in policy rates should help to temper the demand-side of the housing market and result in a reduced rate of house price appreciation going forward.

Outlook

High food and energy prices weigh heavily on household purchasing power. Increases in the costs of food and fuel prices have a disproportionate effect on lower income and rural households, as they typically spend a higher share of income on these items. Further, wage rates in Ireland for the present year, while strong, are not expected to keep pace with inflation resulting in a decline in real wage rates in 2022. However, we do anticipate wage rates to exceed inflation in 2023[2].

The improvement apparent in the public finances does mean that there is still some scope for the Government to assist those most affected by the recent increases in the cost of living. However, it is imperative that any further such measures would be targeted in nature in order to avoid generating inflationary pressures themselves.

[2] Inflation forecast at 4.0 per cent in 2023, while wage rates forecast at 4.5 per cent.