Oireachtas Select Committee on Budgetary Oversight

Pre-Stability Update Scrutiny 23 March 2022

Opening Statement – Central Bank of Ireland

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We welcome the opportunity to discuss the economic and fiscal outlook with the Committee. I am Mark Cassidy, Director of Economics and Statistics at the Central Bank of Ireland. I am joined by Martin O'Brien, Head of the Irish Economic Analysis Division at the Bank. In my opening remarks I will refer to our latest assessment published in the Central Bank Quarterly Bulletin at end-January, but will also reflect on the implications of more recent events. The Russian invasion of Ukraine is shaping current and prospective developments in the European economy, as well as adding risks and uncertainty to the outlook. During the first week of April we will be publishing our next Quarterly Bulletin, including an updated forecast incorporating available information.

Medium-term economic and fiscal outlook

The economy overall has proven resilient through Covid-19 and, prior to the war in Ukraine, robust growth was expected over the coming years. Modified domestic demand (MDD) is estimated to have grown by 6.5 per cent in 2021, bringing the domestic economy broadly back to pre-pandemic levels. Our latest forecast is for MDD growth of 7.1 per cent, 5.2 per cent and 4.8 per cent in 2022, 2023 and 2024, respectively. If these growth rates were to emerge, by 2024 the domestic economy will be back to where it would have been expected to be had the pandemic not taken place. The economy is expected to be operating at its potential level of activity over the course of our forecast horizon.

The extent of the labour market recovery has been encouraging. The standard ILO rate of unemployment is now approximately 5 per cent, with the Covid-adjusted rate approximately 7 per cent. Employment and labour force participation has increased relative to 2019, especially for females and younger workers. We expect the labour market to tighten further, with employment growth continuing but at a slower pace than last year, and the unemployment rate remaining relatively low out to 2024. While the official earnings data are not straight-forward to interpret at the moment and come with a lag, it is reasonably clear that sectors which have experienced consistently high demand for labour have also witnessed strong wage growth. As the labour market tightens, it can be expected that wage growth would become more broad-based.

According to the latest available data, consumer price inflation in Ireland as measured by the Harmonised Index of Consumer Prices (HICP) rose to 5.7 per cent in February 2022. This is the highest rate of inflation since late-2000, and is in stark contrast to the experience over the decade preceding the onset of the pandemic, when inflation averaged 0.5 per cent. The experience in Ireland reflects common global drivers of inflation being witnessed to a similar extent in the euro area as a whole. Specifically, the current rates of inflation are driven by higher global energy prices and supply bottlenecks, with some knock-on implications of the energy price rise for the prices of other consumer goods and services. The energy component of the HICP rose by 30 per cent over the year to February, with the most significant increases recorded in home heating oil (53.8 per cent). Relatedly, the cost of motor fuels rose by 31.3 per cent. Excluding energy, HICP inflation in February was 3.7 per cent. More domestically determined inflation is most evident in rents, which increased by 8.5 per cent over the year to February.

These increases in official consumer prices for energy and fuel are yet to reflect in full the developments of recent weeks and the implications of the conflict in Ukraine. Both the spot and future wholesale price of oil and gas have risen substantially since the Russian invasion began, and have also been volatile on a day-to-day basis. In addition, wholesale prices have increased for products where Russia and Ukraine are prominent suppliers, such as coal, wheat and other cereals, fertilisers and certain metals. The impact has already been seen in reported consumer fuel prices across Ireland, and will eventually also be reflected in higher than previously anticipated consumer prices for gas, electricity and food. Our January forecast envisaged HICP inflation averaging 4.5 per cent in 2022 and 2.4 per cent in 2023. While there is substantial uncertainty as to the actual outturn, inflation will likely be significantly higher in 2022 and could remain elevated for longer than previously expected as a result of the war.

The economic effect of the Russian invasion of Ukraine can be primarily characterised as a supply-side shock, leading to higher prices and lower availability of energy and other commodities generally. Direct trade between Ireland and Russia, as well as that between Ireland and Ukraine is very low overall, but exposure on the import side is relatively important for coal, fertiliser and some cereals. However the two countries are important in the supply of energy, metals and food commodities to the European market generally. This will lead to higher inflation and slower growth in many of Ireland's main trading partners, and affect economic conditions here.

Higher inflation, likely driven by energy and food components, will place increased pressure on household's real incomes and operating costs for businesses in Ireland. Alongside a general increase in uncertainty, this can be expected to dampen domestic consumption and investment growth to a degree.

Regarding the public finances, the pace of recovery given the extent of the Covid shock has been remarkable. We estimate the 2021 General Government deficit to have been €8.7 billion, equivalent to -2.7 per cent of GNI*. The better than expected outturn for 2021 reflected (1) higher than anticipated domestic activity leading to better income tax and VAT receipts, (2) lower than expected Covid-related expenditure, and (3) positive surprises in terms of corporation tax receipts. With the economy performing strongly as the effect of the pandemic eases, our January forecast was for a deficit of €3.8 billion to be recorded this year, and a surplus of €3.4 billion to emerge in 2023 (1.3 per cent of GNI*). The re-emergence of a General Government surplus will contribute to an easing of the debt position. However, almost all of the improvement in the public finances is expected to be achieved through growth in nominal GNI*. Our January forecast envisaged General Government debt to be below 90 per cent of GNI* in 2023, and fall further to 84.9 per cent in 2024, having been 102.2 per cent in 2021. In euro terms, however, debt was only forecast to be 0.4 per cent lower in 2024 relative to 2021, at €231.2 billion.

The war in Ukraine raises many issues for the outlook and conduct of fiscal policy, spanning the immediate humanitarian response for those displaced by the war, mitigating the economic impact on the most vulnerable Irish households, and addressing medium-to-longer term implications. I will briefly discuss some of these in a moment.

Risks to the outlook

Before doing so I will mention some of the main risks to the current economic and fiscal outlook. These can be summarised under three inter-related headings:

1. The escalation or prolongation of the war could worsen global supply conditions and dampen foreign demand.
2. The scope for, and implications of, second-round or cost-push drivers of inflation emerging more forcefully.
3. Structural challenges for the public finances in light of already existing and emerging priorities that raise demands on government resources. Already existing priorities include the need to address infrastructure deficits in housing, climate action, and the long-term costs of an ageing population.

Implications for fiscal policy

This brings me to the overall budgetary stance in light of current circumstances.

The experience of the currently high rates of inflation is not uniform across the economy. Cost of living increases from higher food and energy prices tend to be larger for lower income, older and rural households. This is because food and energy spending is a larger share of the weekly spending for these households. It is appropriate for fiscal policy to reduce the impact of higher inflation on those households less able to cope with current circumstances. Measures introduced in Budget 2022 and afterwards (including temporary cuts in fuel excise taxes, one-off fuel allowance payments and energy rebates) will help to alleviate some of the cost of living increases. The better than expected performance of the public finances last year has provided the Government with some additional space to fund this expenditure. Nevertheless, with the public finances in a deficit position following COVID-19, this additional expenditure will be funded by borrowing. If, for any reason, these measures became quasi-permanent, appropriate funding through current resources would have to be considered to avoid introducing a structural vulnerability in the public finances.

At the same time, pre-existing priorities in housing and climate action need to be addressed over the medium-term, and at a time of inflationary pressures that are mostly externally driven. While uncertainty over the outlook is particularly high, the nature of the economic shock arising from the war means it remains likely that the economy will be reaching capacity constraints. To ensure that the economy and public finances remain on a sustainable path over the medium term, the composition of fiscal policy may have to be adjusted to avoid excessive inflationary pressures domestically, while simultaneously addressing these priorities for the community as a whole. Tax and expenditure measures which more explicitly support supply-side conditions, builds resilience to future shocks across the economy, and over the longer-term enhances the structural budgetary position become a more immediate priority the longer energy and other commodity prices are expected to remain high.

Conclusion

The economy and the public finances have proven resilient through the pandemic. As a result both are overall relatively well positioned to address many of the challenges that may lie ahead. However the degree of uncertainty around the outlook is particularly high. Careful management of the public finances in light of known and emerging priorities and challenges remains necessary.