Meeting of the Budget Oversight Committee, RE:*Cost of Living*,

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Opening Statement of Mr Brendan O'Connor,

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Introduction

I would like to start by thanking the Chairperson and the Committee for the opportunity to be here today to discuss the measures introduced since Budget 2022 in response to cost of living increases. I am joined by colleagues Joe Cullen and Cathal Sheridan from the Department of Finance, as well as colleagues from the Department of Public Expenditure.

We are, of course, meeting at a time of unprecedented uncertainty and economic volatility. As well as the ongoing humanitarian crisis, Russia's invasion of Ukraine has created a large 'supply-side' shock which has shaken the global economy, with European economies at the epicentre.

Given Russia's outsized role in global energy supply, oil and gas prices have risen sharply over the last few months. As Ireland is a global price taker, this has fed through to higher energy prices for both businesses and households.

Deflationary impact of Covid-19 pandemic in 2020

It is important that we put the current inflationary environment into context. The emergence of inflationary pressures contrasts markedly with the relatively low inflation that has been a feature of advanced economies in recent decades.

In Ireland, inflation averaged ½ per cent between 2010 and 2019, with euro area inflation of around 1½ per cent over the same period.

The Covid-19 pandemic exacerbated the low inflation environment. As the decline in demand outstripped the fall in supply, Ireland's inflation turned negative.

Increase in inflation in 2021

However while consumer price inflation remained subdued in Ireland in the first quarter of 2021, the annual rate of inflation picked up sharply thereafter, with both domestic and global factors behind the increase. These included a recovery in energy prices, global supply chain disruptions, supply side bottlenecks and pent-up demand.

To address this, Budget 2022 contained an income tax package to the value of €520 million. This involved increases in the standard rate band and key personal tax credits. On the expenditure side, a social welfare package worth almost €560 million was introduced. A range of other measures, including health and childcare supports, were also aimed at mitigating the cost of living.

At the time of Budget 2022 last October, inflationary pressures were expected to ease over the course of the winter and throughout this year. However higher than anticipated energy prices last winter resulted in higher than expected inflation throughout the winter and into early spring.

Impact of the war in Ukraine

The war in Ukraine has served to further exacerbate inflationary pressures. Inflation stood at 7¼ per cent in April - the highest rate since the HICP series began in 1997.

This is a trend that is seen across most advanced economies. In the euro area, inflation reached a record 7½ per cent in April, while multi-decade high inflation rates were recorded in the US (8½ per cent) and UK (7 per cent) in March.

Inflation outlook

Looking ahead, higher energy and commodity prices are expected to continue to feed into higher inflation over the coming months.

As set out in the Stability Programme update, based on market prices at the time, inflation is expected to remain elevated in the near term, peaking in the second quarter and averaging 6¼ per cent for the year as a whole.

Pass-through price effects are also expected in other sectors such as food (via higher fuel and fertiliser costs) and consumer goods and services (due to higher energy inputs), with 'core' inflation of just under 4 per cent projected for this year.

A significant easing is anticipated next year, with the headline rate projected to average 3 per cent for 2023 as a whole. Indeed energy prices are expected to fall next year, though the price level is expected to remain high.

Higher energy and commodity prices will erode real incomes of households while also denting the margins of firms. This, alongside heightened uncertainty will dampen consumer spending and private sector investment in the near term. In this manner, higher inflation will act as a headwind on output growth this year.

As a result, we have revised down our forecast for modified domestic demand growth this year by 2¼ percentage points, with growth of around 4¼ per cent now projected for this year.

Risks to the outlook

However, these projections were produced against a backdrop of exceptional uncertainty. As such, risks to the forecast are considerable and firmly tilted to the downside.

In light of this, we also published a scenario analysis in the SPU, in which wholesale oil and gas prices return to their early-March levels and remain elevated relative to baseline throughout this year and next.

In this scenario, inflation would be 2 percentage points higher this year at 8¼ per cent– peaking at 9¼ per cent in the third quarter - and 1¼ percentage points higher next year at 4¼ per cent.

Of course, the energy price shock would not only affect inflation, but would also have broader macroeconomic implications; output in the domestic economy would be around 2 per cent lower over the medium term while the projected surplus for next year would be wiped out.

Policy Response

I will now outline the Government's more recent response to the increase in energy prices from a taxation perspective.

In early-March, the Government approved a VAT inclusive reduction in excise duty of 20 cent per litre in respect of petrol, 15 cent per litre in respect of diesel and 2 cent per litre in respect of Marked Gas Oil (MGO) amounting to **€320 million**

Further measures were announced in mid-April, including a reduction in the VAT rate for electricity and gas to 9 per cent from 1 May until end-October which should result in estimated annual savings of €49 on gas and €69 on electricity bills for households. The cost of this measure is estimated at €46m.

There was also a further VAT inclusive reduction of 3 cent per litre on MGO from 1 May and an extension of the reduction in excise duties on MGO, auto diesel and petrol to mid-October with a combined cost of just shy of €100 million.

Including expenditure measures that colleagues from the Department of Public Expenditure will shortly outline, cost of living measures announced since the Budget amount to just over €1 billion, on top of roughly €1.1 billion announced in Budget 2022 itself.