DÁIL ÉIREANN

AN ROGHCHOISTE UM FHORMHAOIRSIÚ BUISÉID

COMMITTEE ON BUDGETARY OVERSIGHT

Dé Céadaoin, 10 Samhain 2021

Wednesday, 10 November 2021

Tháinig an Romhchoiste le chéile ag 6 p.m.

The Select Committee met at 6 p.m.

Comhaltaí a bhí i láthair/Members present:

Teachtaí Dála/Deputies	
Richard Boyd Barrett,	
Seán Canney,	
Bernard J. Durkan,	
Mairéad Farrell,	
Michael Healy-Rae,	
Aindrias Moynihan,	
Patricia Ryan.	

Teachta/Deputy Neasa Hourigan sa Chathaoir/in the Chair.

Inflation: Discussion

Chairman: Good evening. Members and all in attendance are asked to exercise personal responsibility in protecting themselves and others from the risk of contracting Covid-19. They are strongly advised to practise good hand hygiene and to leave at least one vacant seat between themselves and others attending the meeting. They should also always maintain an appropriate level of social distance during and after the meeting. Masks, preferably of medical grade, should be worn at all times during the meeting except when speaking. I ask for everyone's full co-operation in this.

Before we begin, I wish to explain some limitations to parliamentary privilege and the practice of the Houses as regards references witnesses may make to other persons in their evidence. The evidence of witnesses physically present or of those who give evidence from within the parliamentary precincts is protected, pursuant to both the Constitution and statute, by absolute privilege. However, as the witnesses are giving evidence remotely from a place outside the parliamentary precincts, they may not benefit from the same level of immunity from legal proceedings as a witness physically present. Witnesses are reminded of the long-standing parliamentary practice that they should not criticise or make charges against any person or entity by name or in such a way as to make him, her or it identifiable or otherwise engage in speech that might be regarded as damaging to the good name of the person or entity. Therefore, if their statements are potentially defamatory regarding an identifiable person or entity, they will be directed to discontinue their remarks and it is imperative that they comply with any such direction.

Committee members are reminded once again of the long-standing parliamentary practice to the effect that they should not comment on, criticise or make charges against a person outside the Houses or an official, either by name or in such a way as to make him or her identifiable. I remind members of the constitutional requirement that they must be physically present within the confines of the place in which Parliament has chosen to sit, namely, Leinster House or, in some cases, the Convention Centre Dublin in order to participate in public meetings. I will not permit a member to participate where he or she is not adhering to this constitutional requirement. Therefore, any member who attempts to participate from outside the precincts will be asked to leave the meeting.

On behalf of the committee I welcome Dr. Ella Kavanagh from the department of economics in University College Cork, UCC, and Professor Karl Whelan from the economics department in University College Dublin, UCD, and thank them for attending. The purpose of today's meeting is to examine the very current concern and issue of inflation. The committee would also like to discuss drivers of inflation, possible policy responses to the current levels of inflation and budget 2022. I now invite Dr. Kavanagh to deliver her opening statement.

Dr. Ella Kavanagh: I thank the Chairman for the invitation to this meeting. I will extract some key points from the brief that I submitted to the committee and will begin by giving some background to the current situation.

The current global inflation issue is the outcome of a perfect storm. On the demand side, the pandemic resulted in a change in consumer expenditure patterns from services to goods. The current easing of Covid restrictions and accumulated savings have unleashed pent-up demand. At a macro level, unlike in previous recessions there has been a co-ordinated monetary and fiscal policy response to the pandemic. On the supply side, disruptions to supply chains, difficulties in the labour market due to Covid, geopolitical factors and importantly, climate change consequences and responses, have affected the global commodities market, including the energy market and the supply and availability of raw materials, inputs and products. We are seeing the effect of this and during this year we have entered into a period of rising prices and higher inflation rates.

In July 2021, average prices of goods and services in Ireland measured by the consumer price index, CPI, were 2.2% higher than the average a year ago. This rose to 2.8% in August and, more recently, 3.7% in September. This followed a period of deflation during the height of the restrictions. It is also important to note that over the last decade low inflation of less than 1% has been the norm. The categories in the CPI that have experienced the most significant price increases between September 2020 and September 2021 were transport, housing, water, electricity, gas and other fuels, alcohol, beverages and tobacco, restaurants and hotels, and communications. With the exception of the latter, these categories all made the greatest contribution to the rise in inflation. The figures I just quoted refer to headline inflation but core inflation, where we remove both unprocessed food and energy prices, has also risen although by less. It increased by 1.4% in July, 2.1% in August and 2.7% in September. Increases in price inflation across categories seem to suggest more broad-based inflation but I would suggest that we need more observations. On building costs, the wholesale price index for buildings and construction has been consistently increasing year on year since last March. Materials prices have increased from 2.3% in March 2021 to almost 13% in September.

The general consensus is that the current increase in inflation is temporary and that inflation will fall back towards the European Central Bank, ECB, target of 2% or below over the medium term. The Central Bank of Ireland is forecasting headline price inflation for Ireland of 2.1% in 2021 rising to 2.9% in 2022, which is above the ECB inflation target of 2%, but moving back to below that target at 1.9% in 2023. Recently the US Federal Reserve, the ECB and the Bank of England all projected a temporary effect although there are differences between them. The reasons for this temporary effect are various. First, energy prices are expected to stabilise or fall next year. Second, supply is expected to recover as supply disruptions ease and demand is expected to normalise. Third, base effects will drop out of the inflation figures. Underlying this is the view that long-term inflation expectations remain well anchored.

However, there are risks around these projections and the risk are mainly on the upside, that price inflation could be more persistent and therefore, higher than projected for next year and into the medium term. These centre around the restoration of global supply chains, global energy and commodity prices and wages. The recent supply chain disruptions are global in nature and have been directly or indirectly related to Covid. Companies are attempting to offset the effect of increased costs on their margins by increasing prices and generating efficiencies. The key uncertainty here is how long supply chains remain disrupted but even if they remain disrupted for longer, it is expected that impacts will still be transitory as companies and businesses move to re-establish reliable operations and cut costs in the chain, as they have done in the past. The point is made that the pandemic has led to a series of regional supply and transportation disruptions, linked to the spread of Covid and the vaccination programmes, which may have had a more persistent impact than a single large shock. Even if disruptions continue, another uncertainty is to what degree companies will be willing to continue to pass these higher costs on to their customers.

On global energy costs, the projections are that prices for crude oil, gas and solid fuels will reverse in 2022, reducing headline price inflation. However, it is argued that uncertainty remains high and that imbalances could lead to spikes in prices. Oil prices, although high relative to pre-pandemic levels, are still well below their all-time high of 2008 and the subsequent peak in 2013 so they could move higher. Energy prices are also wrapped up in geopolitical issues. In addition, climate change targets are increasing the global demand for the bridging fuel, namely, natural gas. Turning to headline price inflation in Ireland, short-term increases arising from electricity price rises, effective from late October into November 2021, are still in the pipeline.

Another major uncertainty relates to wages and the level of slack in the labour market. On the one hand, we might expect upward pressure on wages if consumers reorient their spending back towards services, if there is a reduction in the size of the labour force or, indeed, in particular sectors and if higher inflation features in wage negotiations or causes an upward revision of inflation expectations. On the other hand, the ending of the pandemic supports could result in some loosening of the labour market which would put downward pressure on wages. There is significant uncertainty around this.

There are also questions regarding demand in 2022. It is expected demand pressures will subside as the pent-up demand unwinds but this will also depend on policy responses.

On policy responses, the appropriate response of a central bank to supply-side shocks is not as straightforward. Supply-side shocks such as energy prices rises may be temporary or transitory. Therefore, if the central bank increases interest rates today in response to this, by the time the impact of the policy change comes over the medium term energy prices may no longer be increasing or indeed may have reversed. By leaving well alone and not stepping on the brake the central bank does not aggravate the problem. Central banks will be concerned about whether these supply-side shocks will persist and will have persistent effects on the economy through second-round effects and then of course whether to act. The situation today is very complex. On the one hand, there has been a significant rebound in demand causing demand-pull inflation where demand has outstripped supply. On the other hand, there are major supply-side shocks around which there is major uncertainty. However, it is important to note that prior to the pandemic, price inflation has been persistently below its inflation target and that returning inflation to its target is the desired aim of central banks.

On fiscal policy, the situation, as stated earlier, is more complicated when supply-side shocks and as we are seeing today, supply chain and labour market disruptions, are the cause of costs and price increases. What governments can do is ensure they are not adding to the disruption. At the same time, governments may be able to reduce the impact of these supply shocks and increase efficiencies through infrastructure investment, for example. They may also be able to reduce labour mismatch through the provision of education and training, reducing both frictional and structural unemployment; in other words, by focusing on supply-side policies. The volatility introduced through dependence on fossil fuels also provides a further reason, in addition to climate change, for governments to focus on investment and incentives to reduce dependence on fossil fuels.

As a final point, it would appear the current increase in inflation is temporary, although there are caveats around this. This raises the question of whether inflation will revert to the inflation rates that existed prior to the pandemic, or to a higher rate of price inflation. The change in the ECB's monetary policy strategy with the restatement of the ECB's target for inflation of 2% may increase expectations of price inflation which will in turn affect actual inflation. Another possibility is the consequence of the recent price increases is price inflation may now re-enter people and workers' decision making processes. Other factors which may also affect the trend inflation rate, that is, the dynamics of inflation and volatility, are of course demographic considerations, globalisation and climate change.

Chairman: I thank Dr. Kavanagh and ask Professor Whelan to give his opening statement.

Professor Karl Whelan: I thank the Chairman. Let me start with some of the facts. I am going to repeat quite a number of the things Dr. Kavanagh said and want to get on with it and not waste too much of the committee's time.

After many years out of the news, inflation has come to the fore again in recent months. We have seen that with a spike in inflation all across Europe. In Ireland, consumer price inflation as measured by year-over-year percentage change in prices in September was 3.7%. That is the highest reading since the period before the global financial crisis. The Central Statistics Office, CSO, has not yet published its figure for the October CPI, but EUROSTAT has a flash release for the harmonised index of consumer prices, HICP, which gives an estimate of what it thinks this number is going to be, or what inflation is going to do, in October. That showed a further of 1.3% rise in inflation in Ireland in October so we appear to be on track for an inflation reading of about 5% for year-over-year inflation to be published by the CSO very soon. This would be strikingly high relative to what we have seen in recent years.

The largest single contributor to the rise in inflation has been the jump in energy prices. The story on this has been relatively simple. The onset of the pandemic saw a collapse in energy prices. Most notably, oil prices fell because lockdowns meant people were not travelling in their cars, on aeroplanes and so on. As the global economy has recovered those initial price declines started to be reversed and with strong global demand for manufacturing we have seen those energy prices go back above the levels they were at prior to the pandemic. Even excluding energy, CPI inflation in Ireland was running at 2.5% as of September. That is very moderate. We know the ECB's target rate of inflation is 2% so there is nothing too scary about 2.5% but that is much higher than we had seen in the years running up to the pandemic.

There are a number of forces contributing to the rise in non-energy inflation. One element is we are seeing year-over-year price rises for services that were restricted in their activities for much of 2020. With the September CPI inflation reading, of that 2.5% for non-energy inflation, about 0.5% of it was things like air fares, hotels and restaurants, which were barely open a year ago. If they were open, they were offering cheap prices. Beyond that, we are seeing rising prices for industrial goods also contributing to inflation. This is basically a global phenomenon. The pandemic produced some quite unusual combinations of supply and demand for various products. On the supply side, we saw factory shutdowns in various parts of the world due to Covid outbreaks and we are still seeing elements of Covid outbreaks causing difficulties for manufacturing in various parts of the world.

The pandemic also produced unexpected changes in global spending patterns. With many service providers closed and limited opportunities for in-person shopping during lockdowns, households in advanced economies switched to purchasing goods online, most notably gadgets of various sorts. Much of that stuff is produced in Asia and especially China. That surge in demand for those products took those manufacturers by surprise and took transportation firms by surprise. If we take shipping for instance, prior to the pandemic there was the outbreak of a trade war between the US and China and that convinced many people global long-distance trade was actually going to decline during these years. We saw the supply of container shipping capacity was not able to cope with this surge in demand. Thus we have seen a big increase in shipping costs around the world and that has added to the cost of the goods we are buying. We are also seeing shortages of parts.

The other element influencing global inflation is surprisingly strong global demand. Some farms and households have been badly affected by losing income because of shutdowns but, on average, the aggressive response from governments has meant that the average household balance sheet is stronger than it was 20 months ago. Consumers have spent less and active fiscal policies like wage subsidy schemes and the pandemic unemployment programme have meant that the direct impact on the average person's disposable income has largely been shielded. In addition, we have seen house prices continue to rise around the world and global stock markets are at an all-time high so people's ability and capacity to spend money on goods is strong.

What will inflation do next? One can provide an optimistic case and a pessimistic one. I will give members both cases and then we can discuss the arguments over questions. The positive case rests on observing that the recent high inflation rates are partly a function of what economists call "base effects". What do we mean by that? We had this period after the pandemic started in which prices were falling fast. Once it was clear that vaccines were going to come into place and that there would be an element of economic recovery, those price drops reversed.

The overall amount of inflation we have seen going back to the start of the pandemic is relatively modest. Prices in Ireland in September were exactly what they would have been if they had grown at an annual rate of 2% from the start of the pandemic, which is the ECB's target. On the path of how they have reached that level, we see there is an issue of sharp decline and now, when we are looking at figures for October 2020 versus October 2021, for which figures will be released next week, we will see that October 2020 was the bottom of the decline. That is the base that goes into the calculation of the inflation rate for that period. The idea is that as we proceed through the following months and into next year, we will not be comparing current prices with that particular artificial lull of the price level. That is the underlying assumption.

That is not to say that October has to be the peak. As Dr. Kavanagh pointed out, there is a process of the pass-through from wholesale to retail energy prices. That will go on over the coming months and continue to add to CPI inflation. It is unclear when the peak will be according to this scenario. The optimistic scenario is that these are just temporary numbers and base effects and we will largely see them go away. That is the scenario one can see in the economic projections accompanying the budget. The Government expects all prices to fall back a bit from their current levels and total and core inflation to be equal to the magic number of 2% in 2022 and beyond.

What are the risks on the high side? One obvious source of risk is that wholesale energy prices do not behave themselves. There are a lot of stories about the natural gas market, in Europe in particular, showing that it is under a lot of strain. What will happen with gas price developments in the coming months is likely to depend on factors such as the severity of the winter weather in Europe. It may depend on Russia's willingness to supply more gas to Europe in the absence of the complex issue of the Nord Stream 2 tunnel and whether it will get approval for quick usage or not. We also do not have a good handle on when the kind of global bottlenecks and mismatches between supply and demand that we are seeing will be resolved. We hope they get resolved quickly. To give one concrete example, we know it takes about three years from ordering a container ship to getting it delivered. There is a shortage and tightness in the shipping market, which will be in place for some time to come.

The argument that it is just base effects and that everything will normalise in the coming months is undermined by the fact that the core CPI, as Dr. Kavanagh has pointed out, has grown at quite a fast pace in recent months. Going beyond the coming months, we then start to get into the risk that in Ireland and beyond, these high inflation rates will start to fuel the public's expectations of what inflation will be. We might start to see trade unions looking for higher wages. Inflation could then get into the system in the way it did in the 1970s and 1980s and we would have a high inflationary wage-price spiral. Neither professional economists nor people in financial markets who have real money at stake are anticipating this high inflation scenario but it is worth pointing out the risks.

Since this is the Committee on Budgetary Oversight, I will talk a little about the budget and possible policy reactions. It is important to stress that Ireland imports a high fraction of the items that consumers purchase and in general Irish Governments have traditionally not had much control over inflation. There were not many tools available to the Government in the most recent budget that could offset this kind of largely externally driven inflation that we are seeing. What we saw in the budget were a number of measures such as adjustment of tax bands and increases in fuel allowances that at least partially offset the impact of the higher inflation on people.

The most obvious fiscal policy response is for the Government to consider temporary reductions in VAT rates on certain types of goods and services. That is a way to reduce the headline inflation rate. On balance, I would argue against that because it is politically difficult. We have seen examples of temporary low tax rates being introduced and they generally remain in place beyond the supposedly temporary period for which they were intended. It is a good thing that the budget did not proceed with various proposals that have been knocking around such as vouchers for the hospitality sector or other measures that would boost domestic demand and fan the flames of what is already an uncomfortably high level of inflation. In the longer term, in managing the demand and supply mix in the economy the Government has an ambitious capital spending plan. However, it will have to think about what the capacity of the economy is to deliver on that. If inflation has already moved up because of various global factors, overheating the domestic economy could just end up making a bad situation considerably worse.

It is easy to think of the negatives of a period of higher inflation on the budgetary position. It places upward pressure on Government spending on wage increases for the public sector and to adjust welfare rates upwards. It also generally brings in extra revenue and the Government will see extra VAT and corporate tax revenue. It will also see extra income tax revenue if people are getting wage increases to compensate them. On balance, the overall effect on the budget and the deficit as a share of GDP depends on decisions the Government takes but is likely to wash out in a neutral way.

A greater risk stems from the potential responses of central banks. A sustained increase in inflation, where it goes above 2% and stays there for a reasonable period of time, would likely see the end of the ECB's accommodative monetary policy and it would be likely to start to raise interest rates. That would have a fiscal effect because it would increase the costs of Ireland's government debt, which is still high when measured in *per capita* terms. That said, the public debt has largely been financed via long-term and fixed-rate bonds and loans. The majority of the public debt does not mature until 2030 and has been locked down at low interest rates. It would take quite a while for those higher interest rates to have a big fiscal effect. More worrying is the possibility that the interest rate hikes that a sustained period of high inflation could produce from the ECB, the US Federal Reserve and possibly the Bank of England could lead to another global recession of the style we saw in the 1980s, 1990s and so on when central banks intervened and deliberately restrained the economy to bring inflation down.

Chairman: With the kind permission of Deputy Mairéad Farrell, I will allow Deputy Michael Healy-Rae, who has strong views on this matter, to contribute at this point.

Deputy Michael Healy-Rae: I will be brief because I respect being given this opportunity. I thank Dr. Kavanagh and Professor Whelan for their very informed, intelligent and thoughtful contribution. Their experience and knowledge are most appreciated by all of us.

We can watch world markets and the global price of oil, as I do because I have been the holder of a high-carbon licence for 32 years. In blunt terms, that means I sell and dispense oil, oil products, diesel and petrol, so I have been closely tuned into the price of a barrel of oil for my entire adult life. I have not seen before what I have seen happen in the past 12 or 18 months. It is unprecedented. The witnesses stated they believed things will start to turn globally next year, but they will not. We have not discussed the attack on "mom's purse" being undertaken by politicians in the Houses of the Oireachtas through the climate budget. I am not a climate change denier. I respect very much every person who has strongly held views on climate action or inaction, as I do personally.

I own land so I am the custodian of land. When I say I own it, I am not carrying it anywhere. When I die, I will not take it any place with me. I have never seen any person taking a field into the ground. People have to leave their land to somebody else. I hope I will give the land I leave after me to other people in better shape than I got it and I hope they will do the same. I am the same as every other farmer in Ireland. Land is not a possession; it is something we use to try to make a couple of pounds of a living or part-time living.

My point is that mom's purse is my economic guide. It is my financial indicator or barometer of how things are going in the country. If mom's purse in Ballymullen or Ballybunion is all right, then it is all right around the rest of the world, in my humble opinion. If it is not, then things are not good. Mom's purse is under attack. The reason is that it seems to be socially acceptable to tax the living daylights out of everything at the moment, all in the name of climate action and preventing people from emitting more carbon.

It is totally insane, crazy, bonkers and bananas for someone with a well maintained diesel car that runs well and which is paid for or on which payments are being made to dispose of that good diesel engine and buy an electric car. First, the electric car is very expensive to buy. To produce that electric car is expensive and harmful to the environment, as has been proven. Then there is the energy to charge that electric car. The Government is telling everyone to go electric and install electric heat pumps in their houses, yet at the same time it is shutting down power stations. The Government is also talking about trying to bring in gas-powered generators and buying fuel next winter from France and England. These countries are talking about conserving the energy they have because it is a finite resource. If it does not suit them, they will not sell it to us and we will potentially have blackouts.

When we talk about budgetary oversight, one of the first things we should do is overseeing ourselves and checking on ourselves and the way we are voting inside in the Dáil when it comes to imposing more taxes on the hard-pressed taxpayers of Ireland and on mom's purse. Mom's purse is a seriously attacked personal possession. We should be taking a more considered view on taxation. I am not someone who will blindly continue to vote for and support increased taxes because someone has to pay for them at the end of the day. What is happening is wrong. We should be like France and Italy. The Government should decide to reduce taxes on fuel because it is taking an awful lot of money away from people in taxes. It should reduce the tax take it is getting from energy costs because people simply cannot afford it any more.

I will keep to my promise. I just wanted to make those points. It would be neglectful for us to have an engagement on budgetary oversight without talking about the elephant in the room, and that elephant is us. Whether we are Fianna Fáil, Fine Gael, Independents or Sinn Féin, we are responsible to the people who elected. There is an onus of responsibility on us. At the moment, all we seem to be doing is attacking, hurting and crippling them with inflation that we are causing. Globally, we can say there are other contributing factors but it is we, the politicians, who are one of the biggest things hitting people at the moment. Every one of us has look in the mirror and ask what way we will vote tonight. What did people say today when they stood up and made lovely speeches? Will they support the motion brought forward by the Rural Independent Group or will they pay us lip service today and vote against us tonight? It is a time for straight talking.

Chairman: Do either of the witnesses wish to respond to those points?

Professor Karl Whelan: Sure. On the specific topic of inflation, it is worth emphasising that the carbon tax, which I think is largely what the Deputy is referring to, will be only a very modest contributor to energy price inflation. The Department of Finance's calculations are that the change in the carbon tax introduced in this budget would add about €1.50 to a 60 l fill at the pumps. Everyone knows how much it costs to fill up but I know that the cost of filling my car has been going up an awful lot more than that in recent months. The major contributor to higher energy prices has been global events. The carbon tax is a relatively small contributor to the current rise in the cost of living.

Dr. Ella Kavanagh: To make a general point, the whole issue with energy prices is that they have been so volatile. They go up and down and there is great volatility in the market. As the Deputy just mentioned, we see the impact that this has on people's lives and their disposable income. Any attempt to reduce that impact, the importance of fossil fuels and those sorts of energy would be fantastic and would, hopefully, help to reduce some of the volatility we have observed over the years. Maybe an opportunity to try to reduce our dependence on fossil fuels would help to reduce the impact they currently have on all our lives.

Deputy Mairéad Farrell: I thank the Chair for suggesting and arranging this meeting. I also thank both speakers. I was very interested in their opening statements. It is refreshing to hear what they have to say. They have taken quite a nuanced approach on the factors driving inflation. Sometimes you would get a bit worried when you hear some of the media commentators as it seems that they are keeping to the old Friedmanite line that "inflation is always and everywhere a monetary phenomenon.". Both Dr. Kavanagh and Professor Whelan in their opening statements stated what the Central Bank has been saying, that it could be temporary and that there are obviously risks. I would like to hear what their views would be if they had to give an opinion on it because they have hedged in their analysis. It makes me think - I do not mean this is an bad way - of President Truman who asked for a one-handed economist because he was annoyed that his economic advisers would often say that on the one hand X could happen but on the other hand Y could happen. We have all been there. I would be interested if they did come down on the one side. My question is, do they agree with the ECB and the recent comments of Professor Philip Lane that this is likely to be temporary or do they think it is an incorrect assessment? That would be my first question.

Chairman: Is that question to somebody in particular?

Deputy Mairéad Farrell: It is for both our guests. Both said that it could be temporary but there are risks. I would be interested to know, if they did have to say, which they would think would happen. If the Chair would prefer me to ask a few questions together, that is no problem. I have a number of questions.

Chairman: I am happy to take them one after the other. Is there one of our speakers who would like to offer to go first?

Professor Karl Whelan: I went first the last time.

Chairman: We will do it like that then. I call Dr. Kavanagh.

Dr. Ella Kavanagh: We are, as economists, very much guilty of what the Deputy outlines. It is a very difficult question to answer. Financial markets have the view that inflation will be higher in the future. They think the central bankers have got it wrong. Let us be honest that there is much uncertainty out there at present about what could happen.

My worry would be that the way we view inflation now is quite different. There is so much talk about inflation now whereas before, prior to the pandemic, it hardly entered any of our thinking. That has definitely changed. I wonder, therefore, if it will become much more a consideration for people in terms of, as Professor Whelan said as well, negotiating wages to ensure that they are able to cover this higher-price inflation they expect will be there in the future. Unfortunately, the danger is that it will lead, as wages go up, to prices going up. That would be a concern for me. It is so much in the news at present and people are so aware of it that I suppose my worry for the future would be that it becomes embedded in people's thinking and, therefore, affects the decisions which they will be making in the future. I am not sure if that covers it; it is still a bit hedgy but it gives the Deputy a sense of where my worries would be.

Deputy Mairéad Farrell: I thank Dr. Kavanagh.

Professor Karl Whelan: I might follow up with a similarly two-handed approach, but try to give a bit more depth than I gave in my opening statement.

In terms of the position that it will go back to inflation being low and below 2%, it is interesting that the ECB's position, as expressed by Professor Philip Lane in the past couple of days, both in a speech and in an interview that he gave, was much stronger that, in Europe at least, the ECB is very confident that inflation is returning to 2%. That statement is much stronger than those being made by central bankers in the UK or at the Federal Reserve. Professor Lane's argument is basically that there is a set of circumstances that have been in place in Europe dating back to 2008-2009 which have together meant systematically low inflation and the ECB has put in place historically unprecedented levels of stimulus from the central bank and still not seen inflation rise that much. They look at the pandemic and they say that after the pandemic, all the forces that were in place that were leading to there being not much pricing power for firms, and perhaps demographic factors that mean that lots of people in Europe are saving rather than spending, are still all in place. The pandemic did not make any of those go away. I think that is their ultimate argument for why it is that these forces will recede and we will end up sometime next year looking around and the economy will look much like it did before the pandemic, and in that era the economy was structurally almost incapable of delivering high inflation. I think that is their argument.

I will give one argument as to why they are somewhat on shaky ground and give the inside baseball on this topic in the profession. Neither the central banking community nor the academic economics community is currently feeling that it has a very good theory of the determinants of inflation. The Federal Reserve for years relied on what we call the "Phillips curve", which is, basically, if the unemployment rate gets low and the economy gets hot, you will see inflation. The Federal Reserve, Fed, more or less walked away from the Phillips curve as a framework in the period prior to the pandemic. Mr. Jerome Powell, the Fed chair, oversaw a review of the monetary policy and their previous cycle where they had raised interest rates was not because they had seen high inflation but only because unemployment was low. Within that framework, you have to come out and say "We actively want to raise unemployment", which, if you think about, means there are people in jobs now when we actively want them to not be in jobs because we think their being in jobs is a threat to inflation. When they went through that, the inflation never appeared. Therefore, even prior to the pandemic, the Federal Reserve had been cutting inflation. A prominent member of the Federal Reserve board, on quitting his seven-year position a couple of years go, Professor Daniel Tarullo, stated it was his assessment that the Federal Reserve did not have a working model of inflation that was useful. There was a recent paper by a very senior Federal Reserve economist, who is an old friend of mine and somebody I wrote a number of academic papers with, Dr. Jerome Rudd, who has been a bit of a *cause célèbre* in the central banking and macroeconomic world where he said that lots of these theories that we have, that everything is driven by inflation expectations and central banks are able to anchor inflation expectations by going out and giving speeches, are all nonsense and nobody listens to central banks.

Dr. Rudd's concern, I guess, is that when people - to follow up on the final point Dr. Kavanagh made - get concerned about inflation it starts to influence their decision-making, and then it really matters. It does not matter until they wake up and it is 5% and then it does matter. The concern is the ECB's confidence and the Government's confidence that when the tides roll out we are just back in the same economy that we were and there just may be a day we wake up and realise that is not the case.

Deputy Mairéad Farrell: I thank Professor Whelan. That is interesting. I used to have a job where I had to listen to everything that the Central Bank did - the Fed, the ECB and the one in Britain - and I used to have to update my team. It is not technically correct that nobody listens because that is what used to be my job. The Minister for Housing, Local Government and Heritage, Deputy Darragh O'Brien, was not necessarily listening to them but we will not go into that.

Dr. Kavanagh and Professor Whelan noted the inflationary problems arising from the extended supply chains but we have also been seeing, even before the onset of Covid, businesses engage in the process of nearshoring and reshoring. In 2019, a Eurofound study pre-Covid found that an upward trend was evident and that the number of reshorings or nearshorings was likely to increase in the short term. It seems, with Covid, and, obviously, with all the growing environmental concerns, that this trend could further increase. Would they agree that could act as a further mitigating factor in the present inflation that we are seeing?

Dr. Ella Kavanagh: There has been the issue of companies, as the Deputy said, reshoring and bringing production of their component parts onto newer sites and away from being dispersed or spread out. They bring them together in a particular centre. That is important. There is a question about security around component parts now because for the first time we have seen the impact of a disruption to the supply chain. It has introduced an uncertainty, as Professor Whelan mentioned, into the supply chain, which we have not been familiar with. Whether companies react to that by building more security and ensuring they have the component parts closer to them and more readily available is a major consideration. That might affect their investment decisions as to where they locate, etc. That would be important.

If costs increase for businesses, one would expect that competition means they would look at the supply chain again and try to minimise costs. They have been doing that over recent decades and it partially explains the really low inflation we have been seeing. It is about how businesses react. If their natural inclination is to try to increase efficiencies as much as possible, we might expect them to return to old patterns of behaviour. For example, we have seen that, since the financial crisis, banks now hold a larger buffer of capital. We might see the same thing with companies wanting to hold a larger buffer of raw materials, semi-finished goods and so on. Over time, we might wonder whether that situation might change and they revert to being more concerned about efficiencies and competition.

Professor Karl Whelan: I think Dr. Kavanagh is correct that, ultimately, firms are facing a trade-off in the future that they may not have thought about before. Having lots of the supply chain in China and far-flung parts is cheap but not necessarily secure. There is a trade-off there. Different businesses will settle on different ways of coping with that but it seems likely some businesses will decide to source parts in Ireland or Europe rather than China because the security of their supply to those they supply and sell to is foremost for them. That means it will not be as cheap and those costs will ultimately get passed on. There is a lot of evidence that supply chains were about as stretched as we could let them be in terms of operating safely. That is another element that is likely to show up in increased costs and possibly higher inflation than we saw in the past. One of the many stories about low inflation over the past decade was sourcing things really cheaply in China. To the extent that firms start to think twice about doing that, that force starts to unwind itself.

Deputy Mairéad Farrell: Thanks, just-----

Chairman: Sorry, the Deputy is out of time.

Deputy Mairéad Farrell: That is most upsetting.

Chairman: We will have a second round of questions if we have time.

Deputy Aindrias Moynihan: I thank Dr. Kavanagh and Professor Whelan for their presentations. I was interested in the conversation and learned a great deal from it. Professor Whelan expressed the view that inflation is largely externally driven. There was another conversation earlier about the carbon tax. What proportion is external and what proportion is internal? Would it be a 60:40 split or is the split closer to 80:20? What level of influence do domestic factors such as the carbon tax, the stay and spend scheme and the capital programme have? We are seeing an ambitious capital programme which will be far bigger than any carbon tax or stay and spend scheme.

Professor Karl Whelan: I would describe as external almost all of what we have seen in Ireland until now. It is external either in the sense of coming from abroad, as in the case of higher energy prices which are a global issue, or higher goods prices, which applies to almost all goods we export, or else it is external in the sense of being beyond the control of the Government, such as some of what we are seeing with the pandemic. Part of this base effect was, for instance, that one could buy an airline ticket in August, September or October last year, but people did not feel it was safe to travel and the right conditions were not in place. Airlines were flying half empty and practically giving tickets away. Now there are more people flying so tickets are more expensive. It is the same with restaurants and hotels. That is a contributing factor. It is completely outside the control of governments in that they have to do what they do with restrictions and do what is best for public health. The inflation we are seeing is largely a result of external developments and the pandemic recovery.

Across the world, there are places which have generated their own internally and policy driven inflation. The most recent number hot off the presses today is that the US consumer price index, CPI, for October is over 6.3% year on year. In addition to the global factors we are talking about, that is clearly driven by a very aggressive fiscal response, which includes multiple rounds of stimulus cheques mailed to people that are burning a hole in their pockets. We have not done anything like that here.

The capital spending programme is something I would flag for the next couple of years. I am not referring to any individual item but if we add it all up, we seen that the Government wants to make public transport infrastructure investment, build roads and make lots of investment in public housing and climate-related energy areas. When one starts adding it up, one wonders where all the builders for this will come from. Once the economy starts to recover, we have to think about whether it could overheat. We can see domestic overheating. I refer to the first figure I provided in my briefing and the wording I used. I indicated inflation was higher than we have seen since prior to 2008. In Ireland, in the couple of years prior to 2008, inflation was running at 5%. It was a bit funny to go back and look at it because I do not remember people talking about it. The times were so good and everybody's wage increases were so far ahead of inflation that I do not remember much talk about it. That was internally driven inflation. It was driven by an overheated economy and, in particular, an overheated construction sector. We can do it but it is not what is happening now.

Deputy Aindrias Moynihan: Do both witnesses feel the increase is a temporary phenomenon? If not, what kind of red flags indicate a longer term problem?

Dr. Ella Kavanagh: I would be watching wages, to go back to that point. I would watch what is happening there and whether wages are increasing. At the moment, we have shortages in parts of the labour market. There is a lot of what we would call frictional unemployment. Whether it is due to that or not, there are many vacancies out there and wages are being driven up by that. I would watch what was happening to wages. We should also determine whether higher inflation is becoming a feature of wage negotiations. In other words, have wage negotiations become more conscious of inflation? That is probably what I would be watching.

Deputy Aindrias Moynihan: The interest rate increase was referred to as a tool that might follow a sustained high. What does "sustained high" mean? Are we looking at some time next summer or the year after if we continue at this rate? What sort of sustained high would drive up interest rates?

There have already been wage increases in some sectors, for example, the technology sector where people are working from home and can now compete for jobs in Dublin, Cork, New York or wherever, allowing them to increase their wages. While this is only happening in some sectors, it is happening nonetheless. There is no talking of inflation driving those wage increases. Rather, it is down to the scarcity of labour.

Will one of the witnesses discuss the sustained high?

Professor Karl Whelan: It is about the timing of the ECB's actions. The ECB will not move quickly. Professor Lane's strongly worded interventions over the past few days can be taken as indicative of the stance of the ECB's president, Ms Christine Lagarde, and the majority of its governing council. The ECB will not start raising interest rates immediately as the first policy reaction. Currently, it is still pursuing its quantitative easing programmes, its purchasing of government and corporate bonds and other measures. All of this is contributing to lower interest rates for government borrowing and so on. The first step the ECB will take is winding those programmes down. It will not shut them down immediately. Rather, it will announce a schedule by which it will slow the pace of purchases and then stop them. After that, it will think about raising interest rates. I suggest that next summer would be the very earliest that we would see an actual interest rate increase in the wild. If I knew, though, then I would run my own bond fund and collect lots of money.

Suffice it to say that for many people who are on variable rate mortgages or relying on the very cheap finance conditions of recent years, an interest rate increase could be a shock. If it comes to pass, we will probably find that many financial institutions that have taken positions that are dependent on interest rates being very low for a long time will be caught on the hop. Relative to what people have expected the ECB to do, it would be a fast turnaround if it was raising interest rates by next summer. Perhaps it can do that and avoid engineering a recession. There are plenty of historical examples of central banks raising interest rates to squeeze inflation out of the system and recession being a by-product. When I was an economist in short pants, that was the stereotypical recession. It was a boom-bust cycle. There was inflation during the boom, a central bank stepped in to take away the punch bowl and then there was a recession. As such, there would be a number of concerns. Knowing that a relatively fast changing of pace in monetary policy could be damaging is one reason the ECB is so reluctant to talk now about doing that.

Dr. Ella Kavanagh: To add to that, this would be the first increase in interest rates in a long time. Therefore, it would generate an expectation that we were on a stepped rise in interest rates into the future, which would affect people's decisions today.

Deputy Aindrias Moynihan: If it was to come about, but there has been no indication of that.

Dr. Ella Kavanagh: Exactly. Hence, the ECB's carefulness about making that decision.

Deputy Bernard J. Durkan: I thank our guests for their interventions. I am a little bit of a pessimist in this regard. I raised this question numerous times in the run up to the financial collapse. Our guests might not have read the Official Report, but I raised this question time and again. We were cautioned not to raise it lest it cause a run on the currency, on investment or on confidence. I felt that we were heading towards a disaster, so I asked whether the fundamentals of the economy were on a safe footing. That was the only way I could get around the scares. I got one good answer that told me "No", and then the whole thing fell down. Everything was denied afterwards and we know what happened.

House prices are a major contributor to inflation and have been for some considerable time. They will ultimately be a contributor to demands for higher wages, at which point the spiral will take off. I am willing to be convinced that current inflation will only last for a short duration and we will see a reduction during the second quarter of 2022, but if it does not happen that way, we could be in for a shock. Some means will have to be found to arrest the trend in inflation.

Professor J. K. Galbraith used to say that, if we stimulated the economy, we would inevitably need to introduce price controls in order not to contribute to inflation. That is laughable to everyone nowadays, but we had price controls in the 1970s and 1980s because we needed to. There was no other mechanism available and inflation took off along a serious tangent. Our guests will remember how bank interest rates eventually increased to 17% or 18%. I remember dealing with people who were charged 25% penalty rates and so forth. At that stage, nothing could happen and the economy was in a downward spiral. I hope that does not happen again.

I will pose a question, but never mind "on the one hand and on the other hand". Let us take both hands out of this, put them up and say what we can do now to arrest this inflation before it gets too serious without permanently damaging the economy and causing a slump. That is my first question. I would be happy for anyone to take it.

Dr. Ella Kavanagh: I will speak about what we can we do at this moment. I would not recommend price and wage controls. I do not believe that system, in particular price controls, works because we would just be trying to keep a lid on prices. Given the fact that prices are externally determined anyway, controls would be difficult to impose. Since we are operating in a market economy, it would be difficult to do.

I will pass over to Professor Whelan and give the Deputy's question a little more thought, if possible.

Professor Karl Whelan: Let us be honest. Ours is a small, open economy and most of the goods we buy are coming in from the rest of the world. We do not set those prices. The Government has no magic formula for getting low gas or oil prices. Being part of the euro means some of the tools we had in the past whereby we could have focused on domestic inflation are gone. We do not set our own monetary policy, we cannot set interest rates high because inflation is high in Ireland and we do not have an exchange rate that we can adjust. There are price and wage controls but, historically, they do not really work, and there is lots of evidence from the 1970s of price and wage controls being introduced and not working. We have a micro-study of our own going on right now with regard to rent controls, which seem to be a bit of a leaky sieve in that rent inflation seems to be proceeding apace, even with the various controls that are in place. That is relatively consistent with what has happened with price and wage controls in the past.

We are left with a sort of boring answer, which is prudent management of fiscal policy and to try to avoid using fiscal policy to have the economy get over-stimulated. When we look back at the period of 2008-09 or prior to that, perhaps a lot of the public expenditure and capital expenditure that was done during that period - all of the motorways that were built and so on - could have been done at a slower pace and we might have had more money left later to smooth things out. That is a major instrument that we have but we are a bit like a golfer with one club.

In terms of the housing market more generally, we have macroprudential policies in place to try to prevent a collapse. Borrowers are not given 100% mortgages anymore and they have much more equity in their homes than they did, so we are less likely to get into a negative equity situation. We are not quite on the verge. I do not think the economy is as unbalanced or on the verge of collapse as it was back then, but, at the same time, if we do see this jump in inflation, I do not want to overstate how much control the Government really has of it.

Dr. Ella Kavanagh: My answer was around that but I could not think of instruments that we could actually use to deal with inflation. There is one point I would like to make. To go back to the fact that inflation was so low for so long prior to the pandemic, if we are talking about an inflation rate around 2%, which Professor Whelan referred to earlier, I want to reiterate the point that it would not be a major concern for us and, in fact, the ECB would like inflation to come back up to 2%. That is one point to make. We are probably thinking more in terms of the actual level of inflation but we do need some inflation in the system. It is the number that we are probably most concerned about.

Deputy Bernard J. Durkan: I am not concerned about one element of inflation so much, having regard to the experiences of the past. It is when there are a number of competing elements, all of which contribute to inflation, that I would get worried, and I mentioned house prices for starters, although there are other issues. However, there are some areas where we could control our own destiny to some extent, for instance, in regard to energy. We could have produced more energy, particularly wind energy, over the last number of years, and while there are those who would say that is linked to international energy prices, that is not necessarily the case. If we are able to buy it from ourselves at a lower rate, it has to make some beneficial contribution in the context of inflation. That is the kind of thing we need to be looking at now because energy is a critical issue. If we do what has to be done in that area and produce energy at a competitive rate, at least it will be of benefit to our own market. If the time comes when we can sell it to others, that will be of benefit to our economy as well.

I do not want to delay the meeting and I have to attend another meeting where I have to ask questions also. I will finish by saying that I believe we need to watch it very carefully. All possibilities need to be examined with the objective in mind of arresting the trend in inflation. If the trend continues for too long, it will create problems and reversing it will be that much harder. We could curtail credit and we could increase taxes, and all of these things have been done before, but all of them will also slow down the economy, of course, so that remains to be seen. I would hope that, from the golf bag we are selecting the club from, we take something out of that bag as soon as possible with a view to achieving at least a target that we can manage in the future, that of inflation.

Deputy Seán Canney: I thank the witnesses for their presentations and their input. What Deputy Durkan said with regard to what we need to do is interesting. One of the issues I would like to ask about is energy costs. Would the witnesses say some of our energy costs are related to the fact we have not put in place bridging measures when trying to get rid of fossil fuels, turf burning and so on? There has been a rush of blood to stop all of that bad stuff without actually having the transitional arrangements in place, so we have left ourselves with a gap and we are now at the mercy of Russia and other places to supply us with gas. The Corrib gas field off the coast of Mayo has been in decline for a number of years yet there has been a reluctance and we have frightened away gas and oil exploration, when I think we have time to run on that yet. It seems that we have had a rush of blood to the head and we have got rid of stuff. By the same token, if someone is buying a new car, whether electric or diesel, as was mentioned earlier, they will not sell their car until the new car is on the forecourt and they can go and collect it. We have created a gap which has created a shortage of energy, and this is also the case internationally, I believe. Now, we are relying on people who hold the strings and who may not be very adept at sharing what they have, or who see potential in it. I would like to get the comments of both witnesses on this philosophy that I hold.

Dr. Ella Kavanagh: That is certainly true globally. We have seen that in terms of the increasing demand for gas as it is considered to be the bridging fuel between the heavy fossil fuels and more renewable energy. China's and India's move towards gas has certainly increased the demand for gas on global markets and has put pressure upwards on the price of gas. That is on the one hand. On the other, what it suggests is that, if prices are increasing like that and if that increases dependency on particular sources of gas, it is all the more important that one begins to move towards removing the dependence on these energy fuels. The argument one could make is that it is really important to start reorienting away from those and to focus in on more renewable energies, and that is a matter of some importance and some urgency if the energy market continues to behave as it is currently.

That is a particular view. I can understand why one would like to temper that move but it is almost giving us a reason or an incentive, to put it that way. The prices are rising as there is increasing demand for gas and other fossil fuels, and that is acting as an incentive to move away from those sources. Unfortunately, what we are seeing is a move back towards fossil fuels and the reopening of stations that use fossil fuels. It suggests to me a greater impetus towards renewables and moving in that direction, and moving away from dependence on fossil fuels and carbon fuels, given these very volatile movements.

Professor Karl Whelan: To be fair, it was always so. We are a small, open economy and as long as I have lived, we have been dependent on external energy supplies and were affected by the first and second OPEC shocks and so on. Whether it is oil or gas, we have always been externally dependent. I am by no means an expert in energy markets, but I continually read about this great opportunity for us to have more energy security coming from offshore wind. However, I also read that developments there seem to be disappointingly slow. A large Norwegian company recently pulled out of being involved in offshore wind in Ireland, disappointed by the slow pace of progress.

Deputy Seán Canney: That is exactly my point. We have the potential to be self-sufficient and an international net supplier. We have the potential on the west coast of Ireland, but we are only now developing our national maritime planning legislation to work out a system by which we do it, which seems should have been done 20 years ago. We did not do it and all of sudden, in a rush of blood to the head to get rid of stuff, two power stations have been closed down and probably rightly so. However, our current shortage of energy does not give us the impetus to do something about it because we are punishing the people as we do that and turning them against the idea of climate action by penalising them. I am not talking about carbon tax, but increasing costs.

The other area I have concern about with inflation is farming. The cost of farmers' inputs is rising. Fertiliser has gone up from €425 per tonne, to more than €800 per tonne. The farming community is not a price giver. It has to take whatever price is there and, therefore, it cannot add the price of fertiliser to the price of the bullock, sheep or pig going to the market. It has to take whatever price the market will give it on the day. That is a significant problem. We will have a reduction in output because people will not buy as much fertiliser as they will not be able to afford it. Consequently, there will be a reduction in food supply and more inflation when the consumer wants to buy over the counter. The farmer will not be dictating the price. It will be dictated in other areas. I have an issue with that.

We have the cost of construction materials and labour, which is going up, but also the cost of our regulation in terms of the way we want our houses built now. The cost of building passive homes, planning permission and connecting to utilities is driving up the costs further and further. Regardless of what we do, people cannot afford a mortgage because of the rules on the mortgage one can have, affordability and one's ability to pay back. We are creating a perfect storm in the construction industry. With construction inflation, public works contracts have been signed as fixed-price contracts for the next three years, which will drive people out of business and drive good people to the UK to seek business, rather than try to do business here, where we have such a system at play.

When one increases wages in line with inflation, everything goes up in price, but so does Government tax take. It comes back to the Government through VAT, PAYE, PRSI and USC. We should not worry too much about inflation, except when it goes at a pace faster than which we can keep pace and we are running to stand still or end up further back in the chain a year later. The idea of increasing interest rates is fine, but people who have mortgages and are meeting them fairly well will find themselves under pressure. There is a positivity. Businesses do not have the same debt levels as they did during the bust of 2007 to 2008. Companies are stronger, but there are many unknowns. Is there a silver bullet the witnesses would throw to the Minister of Finance, Deputy Donohoe, to steady the ship from our perspective and that of the nation?

Professor Karl Whelan: I have given one golf club analogy and unfortunately, it is not a silver-bullet-shaped golf club. I will echo some of what the Deputy has said. Economists sometimes underplay inflation as a problem. They say inflation is 4% to 5%, but if people are, on average, getting wage increases of 4% to 5%, then everybody comes out of it not really worse off and it is an annoyance prices are going up. People get annoyed prices are going up, but think they deserve that 4% wage increase. The problem is no individual or business is the average person or business. As the Deputy pointed out with farming, when one sees inflationary pressures and increased costs, businesses that can pass those costs on will cope fine and those that cannot, will not cope fine.

However, there are analogies beyond business. People on fixed incomes which will not go up with inflation will do badly. Somebody who has an investment portfolio on the stock market will do better because the firms charging these higher prices will end up getting higher profits. The higher levels of inflation we have seen over the past few years unleash a set of distributional questions. Distributional and sectoral questions are not easily dealt with. If the high inflation of the coming years is tough on the farming sector, there may be a European approach with the CAP, farming subsidies and so on. This is another area in which the Government has left Brussels as the major player, as opposed to the Department of agriculture.

Deputy Richard Boyd Barrett: I apologise to our guests. I did not hear their earlier contributions because I was at another committee next door. It was a bit frustrating. I apologise in advance if I repeat questions. What do the witnesses think of what I would favour to deal with energy price rises, rent and house price increases and other forms of inflation which will adversely impact on our economy and society? I favour controls. Controls, in and of themselves, do not solve all the problems. If there is a genuine lack of supply in an area, the controls do not solve the problem because of either genuine shortages or as I expect it is much of the time, bad planning, whether it is a failure to plan or allowing market cycles to determine the supply of certain things. Having said all that, and if we take housing inflation as an example, while I do not think rent controls solve all the problems, as a stopgap until we get planning right on housing and we can deliver the supply that would at least deal with the shortage, it is a legitimate thing to do. The other aspect is if we need to subsidise certain things because they are just too important to allow them get out of the reach of ordinary people then we must subsidise them. We accept that logic in some areas but we often reject it in others. I would argue we must subsidise certain things because we just have to have them. Thus if public transport costs are getting too expensive, one cannot keep letting them get more expensive, especially if one wants to get people out of their cars. One must say we are going to subsidise to make it cheap and affordable and that we are going to do the same with housing. Of course, energy becomes more controversial because there is a climate imperative but also an imperative to ensure ordinary people can heat their homes. I would be interested in the economists' views but I certainly think controlling energy prices at this point is a legitimate thing to do, however it is done. That might be holding off on carbon taxes or just controlling the prices. I would like to hear the economists' thoughts on using price controls, essentially, to deal with these problems. They would not be a silver bullet but a mechanism, until we get the planning side right, to deliver things that can ensure shortages are not generating inflation or bottlenecks, for that matter, in particular areas.

Dr. Ella Kavanagh: One of the issues with controls is they can actually have the effect of reducing supply. If one has a rent control in place, economists would argue this could have the effect of reducing the amount of accommodation actually supplied on to the market, even as is, even at this moment. That would be one of the arguments against using rent controls. At the same time, by having a lower rent one could have, dare I see it, a much greater demand. I personally believe the issue really comes down to increasing the supply, focusing in on that and trying as much as possible to increase the supply of housing accommodation because it clearly is one of the major issues behind this and behind what we are seeing with rents. To reiterate the point about rental costs, in the CPI information is given about rental increases. What we have seen is although rental prices came down somewhat at the start of the pandemic, we now see them accelerating once again. Even if there are controls in place or some measure controlling them, there might be ways of bypassing that. We are definitely seeing rental rates increasing again.

Professor Karl Whelan: To that I add price controls are a natural response when one sees high inflation. Inflation is prices going up so let us go straight for the target and stop the prices going up. I am sure the Deputy and I could have a great debate about the role of prices in the market system and we could talk about Hayek versus Marx and so on, and all that good stuff. Beyond the philosophical issues, the practical point is in general the evidence shows price controls do not work and that people get around them. Businesses get around them and people are willing to pay more for things to get reasonable supplies. Almost every place around the world where one has seen high rates of inflation, eventually they go and implement price controls of some sort and they never really seem to work. I also point out that in this country, some of the background discussion that has been had on the current rent controls concerns the legal limits on the State's ability to intervene with people's businesses and their property rights in terms of what they can actually do, how they run their business and how they use their assets. On widespread price controls, even if one did think there was a man in the Department of Finance who knew the right price for everything - and even the Department would not claim there is such a man or woman - then even if that is something we thought was desirable it is unlikely to be legal.

However, we have to take things like higher energy prices. On energy prices, we cannot on the one hand send people off to COP26 and talk the talk about global climate and then say now is not the time to continue with the carbon tax and that it should now be suspended and so on. Given how poor our performance has been on climate change targets it is the wrong policy approach to roll back carbon taxes at this point and for this reason. That is not to say we do not look at the distributional implications or the effect on people and the cost of people heating their homes. That is why we have fuel allowance. We should keep a very close look at what happens with energy prices in the next couple of months. If the fuel allowance that was provided for in the budget is not big enough then it should be changed and increased. We should always accompany any analysis of carbon taxes or energy-related policies with a distributional analysis of how it affects the poorest and what we can do with the money that has been raised by these taxes to offset that. There are other cases and clear cases where governments should set prices below market level and I fully endorse Deputy Boyd Barrett's call for subsidised public transport. Of course if we want people to use public transport more then it should be an awful lot cheaper than it is.

Deputy Richard Boyd Barrett: Yes. I am glad I agree with Professor Whelan on something there, namely, the last point. I respectfully disagree with the economists on the issue of rents, house prices and so on. I will make the obvious point. I made it to the Taoiseach and have made it several times in this debate as supply, supply, supply is always the answer. Forget about the debate between Marx and Hayek, as interesting as that is. I point to our own recent experience. When we had the greatest supply of housing in the history of the State by a long chalk, that is, during the Celtic tiger period, when between 70,000 and 90,000 houses and apartments were being built every year, prices did not go down at any point. They consistently rose. That is because the market and the people who were providing had no interest whatsoever in prices falling. None. To my mind, they will not, of their own volition, increase supply to the point at which prices drop. Why would they? They would be mad to do that, from their point of view. However, from society's point of view the control they have over something as absolutely critical as housing is just not acceptable. I agree with the economists that controls, in and of themselves, are not the silver bullet. However, where the market has clearly failed, as it has in housing, one must do something to get something as basic as housing to a level that is affordable. At the moment it is simply is not and if one says wait for the supply to come on stream one will be waiting a very long time. I would like to hear the economists' answer to how they riddle that one but it seems to me one has to intervene. To an extent, I take Professor Whelan's point about the constitutional provisions around private property. It is interesting how that defence suddenly collapsed when rent pressure zones, RPZs, were brought in and so on.

I would like to see all this legal advice from the Attorney General. I am less than convinced about that excuse. The Government has promised a referendum on housing. Let us get on with it and have a referendum in which private property rights could be diluted in order to vindicate something as basic as the right to housing.

Regarding energy, it is not an opinion but a fact that the rich are the greatest producers of carbon emissions, so whether geographically or socially, the poor are being punished for the crimes of the rich in destroying our planet. However, we are saying that we should keep loading a self-evidently regressive measure onto the shoulders of the poor. The rich who cause the problems will not be particularly bothered by the carbon tax increases, so there is a real problem with regard to justice, which I believe is central. The climate objectives cannot be delivered if justice is not at the heart of it. It will turn most people off the climate agenda. We cannot afford to do that.

Dr. Ella Kavanagh: One reason for the increase in house prices prior to the crash was the expansion in credit. We would expect today that in light of the sort of regulations that have been put in place by the Central Bank, there should be more control over the expansion of credit. Even though supply would increase, it would not necessarily lead to an increase in house prices. The situation is quite different today compared with before the crisis.

Professor Whelan highlighted fuel prices and their impact on people on fixed incomes, and the associated distribution issues. They are key. Consequently, the fuel allowance should be looked at again in light of the increase in energy prices if they continue to increase. If they continue to be volatile, they might come back down again, and there would therefore not be a long-term effect on individuals. However, if they continue to increase, that would suggest a review of those fuel allowances is necessary.

Professor Karl Whelan: I want to say a word about house prices. They contribute to inflation because expensive housing leads to people having to look for higher wages to be able to afford where they live. That affects costs throughout the economy in many ways. Regarding Government intervention, we clearly have a housing market that is dysfunctional in many ways and many different things could be done. Regarding supply capacity, I note today's Daft.ie report on the number of rental properties available across the country. It is extremely low. There are very few places for people to rent. I see this as an academic. Our students struggle to find places to rent. Colleagues coming from other countries to work with us struggle to find places to live. Availability is not a heap of laughs for people looking to buy their own properties either. We need to start by noting that there is clearly a scarcity of housing in the country relative to what we need. We have not repealed the law of economics which states that when something is scarce, it will be more expensive. One reason that rents are so high is because it is so difficult to get rental properties as a result of their being so scarce. The same applies to house purchase costs. There is a talking point that, although we built many houses in the 2000s and somehow the prices went up, that is somehow irrelevant and the scarcity that we see has nothing to do with the high prices. I strongly disagree with that. It would be great if we had more supply, with much affordable public housing. The only issue that I have with that is that it is expensive.

One should look at the Government's capacity within the dreaded EU fiscal rules. I suspect that in the past, the Deputy might have heard me complaining about the fiscal rules, but they exist. The ESRI gives a figure of 33,000 housing units being needed a year. That is probably an underestimate. The reality is that we will need the private sector to produce units as well as public housing being built. It is not a case of and-or, but rather, as with the girl from the meme emoji, "Why not both?" That is what we need to do.

Deputy Patricia Ryan: I thank the witnesses. I apologise for having been in and out. I was at another meeting. I apologise in advance if I ask a question that somebody else has asked. I have read Professor Whelan's views on helicopter money, in the form of vouchers, to stimulate certain sectors of the economy. Is there any area of the economy where he feels it might work without affected inflation? Is there any way to mitigate the effect on inflation?

Professor Karl Whelan: I am always happy to discuss helicopter money. The ECB will never approve it as a policy. I have thought about this. One of my areas of expertise is trying to figure out what is or is not legal for the ECB to do. If I ever got the chance to brief the governing council on this, I would try to explain that it is probably is legal and can be done. Its considered opinion is that this is fiscal policy. Everybody ends up being sent a cheque. It looks much like a tax cut or tax refund, so the ECB feels that it is a fiscal policy, when it is supposed to be dealing with monetary policy. I do not think that we will ever see it. The ECB has created low financing conditions over the past decade. It has made it not just free for Governments to borrow but instead Governments, including our own, have been able to borrow at negative interest rates. The ECB has created those conditions.

Looking at the pandemic response, we did not need the helicopters because the Government could source money at will. In a sense, the ECB has created almost helicopter money-like conditions by the back door, by making it cheap to borrow. That will probably continue, even if we see an increase in inflation over the next couple of years or higher interest rates. I expect sovereign debt borrowing costs to be low, which raises questions about whether we can borrow more. The recent ESRI paper by Professor McQuinn focused on whether we can just borrow more to spend on public housing, which brings us back to the dreaded fiscal rules. They have not gone away.

Deputy Patricia Ryan: I thank Professor Whelan. I agree with what the witnesses say about the fuel allowance and rising energy prices. As Sinn Féin spokesperson for the elderly, I am concerned that there will be fuel poverty this winter if the prices go any higher. There have been a large number of fuel price rises, which was discussed earlier. Other Deputies spoke on that. I am speaking against the clock and apologies for that. Is inflation targeting the right approach and at what level should we aiming for?

Professor Karl Whelan: Is that question for me? Am I getting fed all my favourite questions?

Deputy Patricia Ryan: Yes, if Professor Whelan would like to answer it.

Professor Karl Whelan: I have never been a fan of strict inflation targeting as it has been practised by central banks. In the European context, what it has always meant is that when inflation is above 2%, the European Central Bank, ECB, has had its hair on fire, so to speak, to try to get inflation down and when it is below 2% it has not always been as worried. The ECB has been more concerned in recent years following many years of being below target to at least be seen to be pursuing expansionary policy to meet its target. That is one of the issues. If people are thinking about what will happen to prices in the next number of years, if the inflation target is 2%, one would think prices will go up by 2% per year and in five years time, they will be up 10% effectively. With the way the ECB has implemented inflation targeting, it has not worked like that. Prices are up less than 10% and then it is hard to forecast how much of a shortfall there will be in that respect.

What we have seen recently with the Federal Reserve is that it has moved to what is called average inflation targeting, which is basically a commitment that if inflation is below its target of 2% for some period of time, it will then accept a period of inflation above 2% so that when it is averaged over, one gets 2%. That is closer to what economists would call price level targeting, making the price level predictable over time. I have always felt that is a better policy.

I would note the ECB's monetary policy strategy review. It spent 18 months reviewing its monetary policy strategy and announced with great fanfare the new strategy during the summer. It explicitly said that it is not its policy. It more or less has the Federal Reserve's old policy of targeting 2% inflation. Perhaps there are more strategy reviews to come and it will get it right the next time.

Deputy Patricia Ryan: I thank Professor Whelan for that response. I have many more questions but I am up against the clock. Perhaps I will get to ask them another time. I thank our guests for their input.

Chairman: I thank Deputy Ryan for that. I will allow members to come back in if they would raise their hands to indicate they would like to do so. I would like to follow up with a question of my own. One of the questions I had related to the fiscal rules, which have already been raised. We discussed to some extent the expectation that inflation will be a relatively short-run thing, that it will not last for a long period. I am mindful the European Commission has just relaunched its review of EU economic governance. First, as a mini question, I am curious as to whether experts like our guests submit to those open call consultations. I am interested to know what is the voice coming from Ireland. Is it simply from Government or do experts like our guests get involved in the fiscal rules discussion at that level? The other question I have is that if this level of inflation is not a short-run thing, if it is still with us when the fiscal rules may click back into place in 2023, what mechanisms would they expect to see, or could we see, within it to address issues of continuing inflation? Dr. Kavanagh might respond to those questions.

Dr. Ella Kavanagh: On the Chairman's second question, given the fact that the ECB is the institution tasked with the responsibility for price stability, I would assume it would be the ECB that would be dealing with that issue of inflation and, consequently, introducing particular instruments, be it increasing rates or whatever, to try to bring inflation back under control.

Clearly, that is its objective, which is all about achieving price stability and, as Professor Whelan said, achieving a 2% inflation target. One would expect monetary policy would be geared towards achieving the inflation target. If do not know if Professor Whelan has anything further to add to that.

Professor Karl Whelan: Yes, a couple of things. I am not aware of any Irish economist who has yet participated in making a submission to this review from the European Commission. In general, we are all busy and it is difficult to find time or to know what impact an individual input from an academic would have. I play a role with the European Parliament engaging with monetary policy in the ECB and making advice and recommendations there. I do that on a more formal level. That is to what I tend to largely restrict myself.

On the issues of what will happen with inflation and what will happen with the debate on the fiscal rules, they will not be totally separate. The ECB sees price stability as its goal but the mood music around the discussion over the next year on the reintroduction of the fiscal rules will be affected by inflation. Clearly, some countries would like to reintroduce the fiscal rules as they have existed previously and to have a quick and fast reintroduction versus quite a number of countries that would like to see a milder version of the rules. If it looks as though inflation is possibly getting out of control European-wide, then, to use economic parlance, the hawks will have a better argument than the doves that fiscal policy needs to be playing its role in constraining the economy.

The greater problem with the fiscal rules is that they are very badly designed. They have those two numbers, the 60% debt-to-GDP ratio and the 3% deficit. Somebody plucked them out of the air in the late 1980s or early 1990s. They might have been appropriate then but they are not now and that is the problem. Ideally, what we would need is some form of treaty change but a treaty change in any controversial area is extremely difficult to executive. In practice, we are seeing proposals around, for example, while the 60% ratio is formally in the treaty the Commission would really only focus on encouraging countries whose debt ratios are above 100% debt-to-GDB ratio. We may see things like that but this will be one of the big European bun fights over the next year or so.

Chairman: I thank Professor Whelan for that response. I read both our guests' submissions with great interest. In fairness, we have covered many of the issues they raised. Could either of them outline in greater detail, as I am a layperson and not from an economics background, the relationship between Government capital spending and inflation? Obviously, I understand as inflation rises, our capital commitments will bear the brunt of inflation just like anybody else's spending commitments. Is there a possibility of the opposite effect whereby capital expenditure can increase the risk of further inflation. Could they outline that for me? Who would like to take that question?

Dr. Ella Kavanagh: Regarding building and construction costs, they are an important part of inflation.

If there is an increase in demand for materials and also then for workers employed in that particular sector, that will drive up those particular costs. They are a part of inflation. Another way of looking at it is a more long-term perspective. If there is an increase in capital expenditure on infrastructural developments, transportation or whatever, it can have more benefits longer term. In other words, it improves efficiencies in the economy. Therefore, it is an important supply side dimension to policy. It improves the supply side, the productive potential of the economy. The latter can help to ameliorate some of the inflationary forces that can be there.

At the same time, there could be a further increase in construction costs because of Government demand for more materials. These capital expenditures can lead to a multiplier effect which, in turn, can lead to an increase in demand that can drive up prices and inflation. There is not only the initial effect of inflation increasing construction costs but there can be a multiplier effect associated with that. It can be quite strong in the domestic economy because if everything is being used domestically that multiplier effect is much stronger in the rest of the economy. If people are spending and buying more that is driving up costs and prices more and that multiplier effect can be much stronger within the domestic economy when all the costs are within the country.

Professor Karl Whelan: I will go back to the analogy of what happened before the 2008 crash. By 2007 we were building 100,000 residential units per year and people who remember that time will recall that kids were dropping out of school to become builders and that there was a song about the breakfast roll. It was very visible throughout the country that the construction industry was dominating. It went to the point where we were importing lots of builders from eastern Europe to help build these units, and then those guys had to live somewhere as well. We ended up with costs and wages going up a lot and the economy was overstimulating. We started to see manufacturing businesses leaving Ireland because costs were too high here as a result of the fact that we were spending loads of money building houses and selling them to each other.

We will not end up with 100,000 residential units being built per year again but we have relatively ambitious public housing plans, we will see a private sector response and we have plans for retrofitting, building wind farms and constructing further motorways, as well as plans for expanding public transport. Builders have to do this work and we could end up with a more varied portfolio of capital spending than there was in the mid-2000s but we will still end up with the economy overheating and we will drive away some of the same types of businesses that were driven away before. When that bubble popped the last time it was a sore point that so many of those businesses left and it was a slow process to win a lot of those jobs back. The economy can get a bit unbalanced at times and setting public capital spending to meet priorities is important, but we have to think about our capacity to deliver those priorities without triggering inflation.

Chairman: I was asking that question in the context of the review of the NDP and the new commitments to retrofitting. I lived through the 2008 and 2009 crash as an architect. There was a hollowing out of the industry and firms collapsed. It is the same kind of people who build all that stuff and do all that work so that is a concern.

This is our first of three sessions on inflation. It has been fascinating. I thank Dr. Kavanagh and Professor Whelan for attending and for their assistance to the committee. We look forward to seeing them again at the committee in the near future.

The select committee adjourned at 8.05 p.m. until 4 p.m. on Wednesday, 17 November 2021.