An Oifig Buiséid Pharlaiminteach
Parliamentary Budget Office

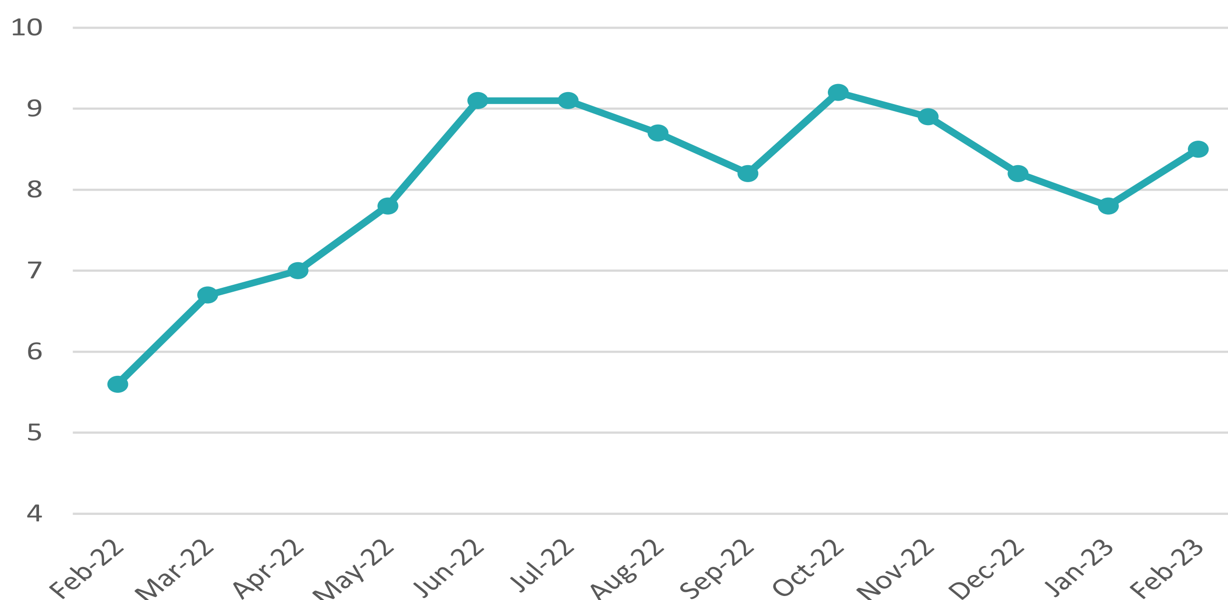
# Introduction to the Irish economy: Inflation

## What is inflation?

**Inflation** is the rise in the price of goods and services over time.

The chart below shows that the annual inflation rate was 8.5%[1] in February 2023.

Chart 1: Inflation rate from February 2022-2023




Source: *CSO, Consumer Price Index*

**What does this mean?** It means that between February 2022 and February 2023, prices rose by 8.5%. If a consumer bought €10 worth of goods in February 2022, they would need €10.85 in February 2023 to buy the same bundle of goods. Put simply, a consumer would need 85c more to buy the same basket of goods a year later i.e., *inflation reduces a consumer's purchasing power*[2].

**Core inflation:** is the change in the costs of goods and services, but it does not include items from the food and energy sectors. It excludes these items because their prices are much more volatile. Core inflation is considered a good indicator of long-term inflation.

## How is it measured?

- The Consumer Price Index (CPI) is Ireland's official inflation measure. The CPI measures the percentage change in the price of a typical basket of household goods and services.

- The Harmonised Index of Consumer Prices (HICP) measures consumer price inflation in the euro area and allows for international inflation rate comparisons between member states.

1 Historically, the European Central Bank (ECB) aims for an inflation rate of 2% over the medium term.

2 **Purchasing power** is the amount of goods and/or services that can be purchased with a unit of currency e.g., €1.

## Causes of inflation:

The main causes of inflation are:

1. Demand-pull – demand for goods exceeds supply
2. Cost-push - higher input costs
3. Inflation expectations – people think prices will continue to rise

Demand-pull - **Low supply when demand is high leads to an increase in prices.** Oil was in high demand after the relaxing of Covid health restrictions. At the same time, the war in Ukraine meant less was available from Russia, putting further pressure on prices.

Cost-push - **A rise in production costs may cause goods to become more expensive.** This cost is passed on to the consumer through higher prices, e.g., if the cost of flour increases, then a baker may charge more for a loaf of bread.

Inflation expectations – **is the rate at which people expect prices to rise in the future**. If everyone expects prices to rise 5% over the next year, businesses will want to raise prices by (at least) 5%, and workers will want similar wage increases. If businesses don't raise their prices, they may make a loss, and if workers don't get a pay raise, their spending power will be reduced.

## How inflation impacts the economy and public finances

Rising prices reduce the purchasing power of consumers. Typically, those with low or fixed incomes are the most badly affected as they are forced to pay a higher portion of their income on goods or services, reducing their ability to save or buy other goods.

If inflation gets too high, the ECB may try to reduce it through tighter monetary policy. This typically comes in the form of higher interest rates. Higher interest rates may cause loan repayments to rise, making it more expensive for borrowers[3] to repay their debt.

High inflation increases the government's tax revenue from indirect taxes like VAT and excise duty. However, higher inflation may lead to lower personal consumption which could eventually reduce tax receipts.

3 Borrowers include individuals, businesses, and governments



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