ABSTRACT

Inflation after the pandemic: what drove it and how is policy responding?

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Supply chain disruptions, a rapid and strong post-pandemic rebound in demand, and war-related energy and food price shocks are contributing to unacceptably high levels of inflation in Ireland and the euro area. Inflation is far in excess of most Central Bank’s targets, which are typically around 2%. In November 2022, headline inflation was 9% in Ireland and 10% in the euro area. Some euro area countries are experiencing inflation above 20%, in part because of a greater exposure to Russian energy imports. High inflation is eroding real incomes, threatening resilience and economic stability. Central Banks have raised interest rates at an unprecedented pace in order to bring supply and demand back into balance, and return inflation sustainably back to our 2% target. The main ECB policy rate has increased from -0.5% in June to 1.5% in October, with further increases likely.

This paper looks at the drivers of inflation during 2022, highlighting the role of pandemic-related supply bottlenecks, imported energy and food prices – which together constitute a large terms of trade shock that is almost impossible to fully offset in the short- to medium-term – and very strong demand coming out of the pandemic. Recent data points to an ease of pandemic-related supply bottlenecks, but a high degree of uncertainty about both the pass-through of current commodity shocks, and the future patch for energy and food prices. Thus far, wages have lagged inflation, leading to a large fall in real wages, which, in turn, is contracting demand.

Focusing on the monetary policy response, I show that the pace of globally coordinated interest rate rises is unprecedented. In the eurozone, changes in the policy rate have passed through rapidly to new lending rates for most countries. In Ireland, pass through to lending rates for firms is very similar to the rest of the euro area; whilst for households, Ireland stands out as being very different: there has been almost no pass through to mortgage lending rates (for new lending) in Ireland. I discuss the reasons for this, relating to the structure of the market, including the historical legacy of tracker mortages on banks’ books, and the imminent exit of two incumbents from the market.

The paper concludes by looking at the distributional aspects of the current environment. Drawing on data from the Household Finance and Consumption Survey, I highlight who is exposed to interest increases and what this means for household resilience. The emerging literature on heterogenous agents in macro models shows that monetary policy transmission tends to be stronger when there are more households in society whose consumption is very sensitive to income changes – typically those with limited access to credit, or fewer savings. Drawing on a recent Central Bank Quarterly Bulletin article on “Household Economic Resilience”, which quantifies for the first time the joint distribution of income and wealth across Irish households, I show that between 6 and 15 per cent of Irish households could be considered to be in a precarious position in relation to income risk from higher inflation and interest rates, while also holding little – if any – in the way of savings buffers.

Keywords: Inflation, Eurozone, Ireland, transmission, interest rates, resilience and financial buffers.