

IRISH INFLATION: APPROPRIATE POLICY RESPONSES



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This article argues that the cost-increasing, supply side approach cannot adequately explain the current Irish inflation. It suggests that the correct model is one that is based on excess demand fuelled by continuing economic growth and demand-side shocks, including nominal exchange rate depreciation and lax budgetary policy. Evidence is presented to suggest that inflationary pressures have been building up in the economy for longer than is generally appreciated. As for appropriate policy responses, these include nominal wage increases above those agreed under the PPF but exclude tax cuts which, at the time of writing, seem likely to emerge in the December 2000 Budget.

INTRODUCTION

Few can doubt that inflation is now present in the Irish economy. The year-on-year change in the Consumer Price Index (CPI), which registered only 1.2% in mid-1999, increased to 3.4% in December 1999 and is now running at nearly 7%. The problem which this poses is not simply that inflation has risen over the last twelve months but that the increase was unanticipated, with the consequence that nominal wage increases agreed under the Programme for Prosperity and Fairness (PPF) have failed to deliver the expected real wage. Hence, trade unions are demanding that the PPF be renegotiated with, of course, strong opposition from both government and employer groupings such as IBEC.

This conflict raises an obvious question: what, if any, is the appropriate policy response to the current inflation? Should employers, including government, agree to compensating wage increases? Should the government deliver on promised income tax reductions and, as suggested in some quarters, cut rates of indirect tax such as excise and VAT? To a large extent the disagreement on policy is reflected in the more

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fundamental question of the causes of our inflationary problems. Those economists who favour tax cuts appear to believe that the cause of inflation is a series of cost increasing, or supply-side, shocks including higher oil prices and a depreciating euro. Alternatively, those who argue that tax cuts should be postponed, but in some cases accept the inevitability of nominal wage increases, tend to see the current inflation as a consequence of excessive demand pressures associated with an undervalued currency, low real interest rates and a loose fiscal policy.

SUPPLY AND DEMAND SHOCKS

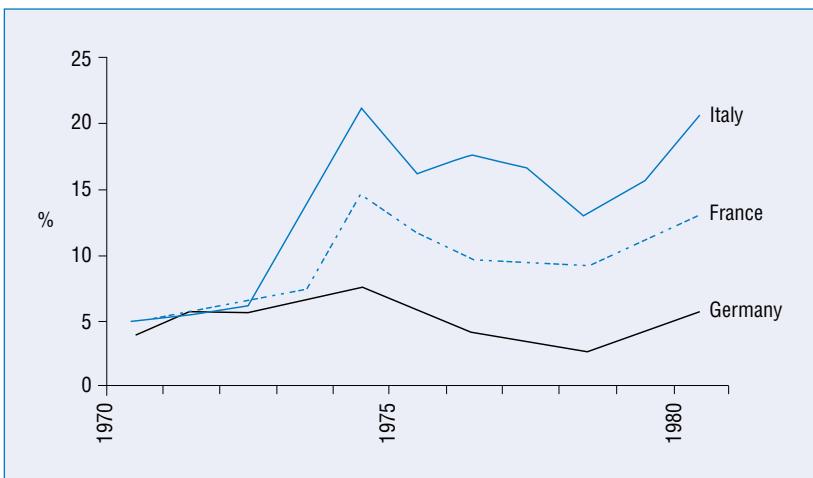
In the context of current Irish inflation the most frequently cited factors causing shifts in aggregate demand and supply are oil prices, exchange rates, interest rates and government budgetary policy. These 'usual suspects' can be categorised into supply shocks and demand shocks. Increases in oil prices can be classified as a supply-side shock while the others (exchange rates, interest rates and government budgetary policy) are usually treated as demand-side shocks.

SUPPLY-SIDE SHOCKS

Recent media analysis has tended to focus on rising oil prices as a significant factor in explaining Irish inflation. Other things being equal, higher oil prices are contractionary in that they imply higher prices, lower real wages and a lower level of economic activity. However, once the economy adjusts to the higher oil price there is no reason why the average price level should continue to rise; that is, unless other factors such as 'compensating' wage increases and/or accommodating policy responses, such as monetary expansion or tax cuts, are used in an attempt to offset the real consequences of the oil price increase. This is well illustrated by Figure 1 which charts German, French and Italian inflation over the period affected by the 1973 rise in the world oil price. If OPEC's actions were responsible for sustained inflation in France and Italy, how come German inflation remained relatively low and stable? Oil prices rose in all three countries, but unlike the others the German Government, anchored by the Bundesbank's commitment to price stability, refused to countenance accommodating monetary and fiscal policies. The result was a rise in the German price level without a sustained inflation.

As the advent of the euro has effectively prevented national governments from engaging in monetary accommodation, and as the ECB appears to be following the Bundesbank's example, there is no reason to expect that recent oil price rises will have a sustained effect on either Irish or euro zone inflation. Hence, while current wage demands may in part reflect recent increases in oil prices, there is no obvious reason why wage increases should attempt to compensate for further oil-induced inflation. Higher oil

FIGURE 1: INFLATION RATES 1970-1980



Source: The European Economy

prices simply imply lower real wages and, *ceteris paribus*, a reduced level of economic activity in oil importing countries. To pretend otherwise is the fast route back to the dark days of the 1970s.

DEMAND-SIDE SHOCKS

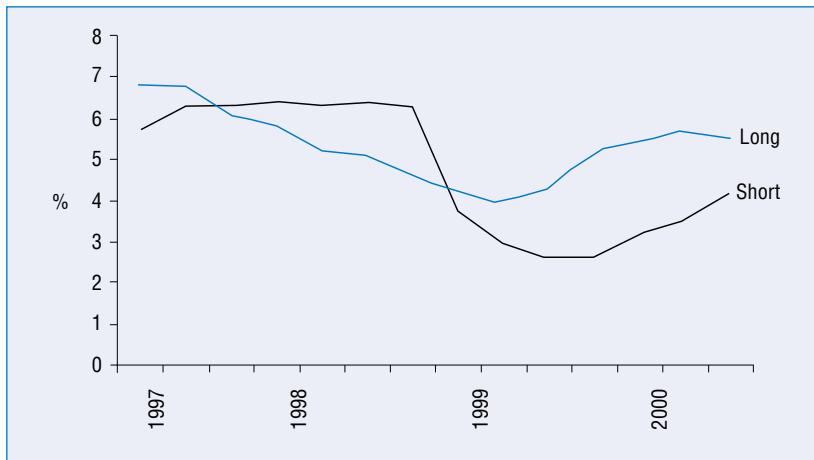
Three factors appear to have exerted a significant influence on aggregate demand – the exchange rate, interest rates and budgetary policy. The first two are now, to our undoubted detriment, exogenous; while the third, given the restrictions imposed by the Stability Pact, is still subject to some national control. Figures 2, 3 and 4 trace the behaviour of the relevant variables over recent years. Figure 2 documents the dramatic depreciation in the effective Irish Pound nominal exchange rate since 1997. Figure 3 illustrates Irish interest rates over 1997 to 2000 and Figure 4 presents recent Central Bank estimates of the Structural Budget Balance.

FIGURE 2: NOMINAL EFFECTIVE EXCHANGE RATE
JANUARY 1999 = 100



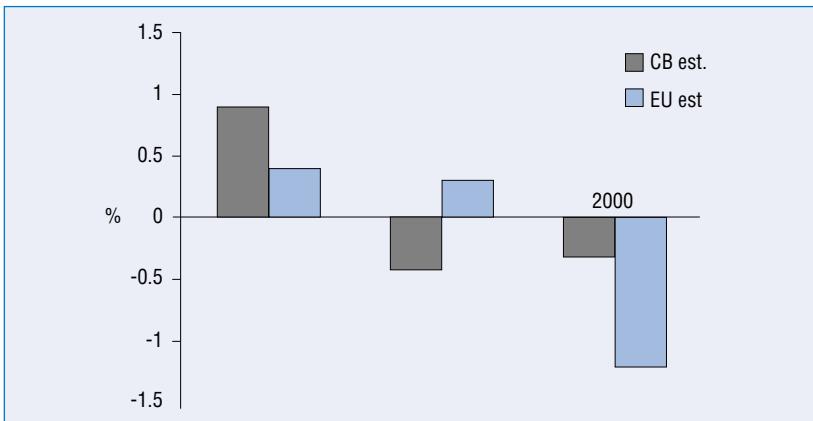
Source: Bank of England

FIGURE 3: IRISH INTEREST RATES



Source: ESRI Quarterly Economic Commentary

FIGURE 4: CHANGE IN STRUCTURAL BUDGET (% GDP)



Source: Cronin & Scally Central Bank Quarterly Bulletin, Autumn 2000

All three Figures point in the same direction – a stimulus to aggregate demand leading to a higher price level and increased economic activity. With respect to fiscal policy it should be noted that, although the actual budget is in surplus, Cronin and Scally (2000) present evidence to suggest that the structural, or full employment, balance (the correct indicator of policy) is in deficit and conclude that the evidence suggests “a significant loosening of fiscal policy in 2000”.^[1] Even though such exercises are fraught with conceptual and practical difficulties – as the authors are at pains to point out – the claim that the last three budgets have been tax-cutting ones is uncontroversial.

SUPPLY SHOCKS, AGGREGATE DEMAND AND INFLATION

Given these shocks it would be surprising if inflation had not picked up by now. However, the claim is frequently made that Ireland's CPI has increased, not because of persistent demand pressure, but because of a series of unconnected shocks – specifically, tax increases, oil price rises and a weakening euro. One-off price shocks only have a temporary effect on the measured inflation rate and in some sense do not constitute inflation at all. If indeed the CPI had increased merely on these grounds, it would be reasonable to expect low inflation in 2001. This argument is not sustainable.

Four pieces of evidence support the contention that Irish inflation is largely the result of demand pressure rather than cost-increasing, supply-side shocks. First, the most

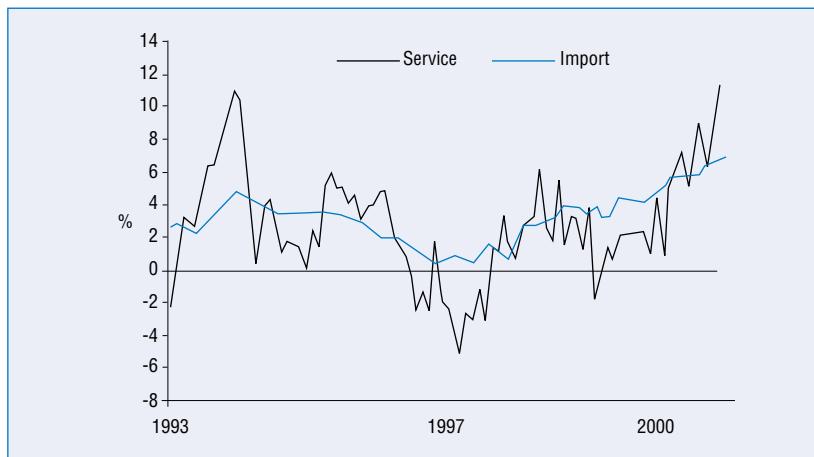
^[1] Cronin and Scally, *Central Bank Quarterly Bulletin*, Autumn 2000, p.76.

recent Central Statistics Office (CSO) inflation release of October 2000 calculates that, of the 6.8% inflation rate then obtaining, just 1.6% was due to higher indirect taxes.

Secondly, in their Summer 2000 *Quarterly Bulletin*, the Central Bank estimated the impact on the CPI of five specific price shocks. The exercise makes a crucial point as follows. While oil and tobacco prices rose in a once-off manner, thereby artificially raising the headline rate of inflation above the underlying rate, there were other once-off price shocks (for example, associated with increased competition in the telecommunications market) that were artificially lowering headline inflation *below* the underlying rate. The five shocks considered in the Central Bank exercise were to the prices of oil, tobacco, unprocessed foods, clothing and footwear, and telecommunications. Together, these five shocks added just 0.4% to the CPI. Underlying inflation thus had to be adjusted downwards from the figure of 4.6% which then applied to 4.2% – a minimal adjustment.

Thirdly, in the same Summer 2000 *Quarterly Bulletin*, the Central Bank estimated that the 3% gap between underlying Irish inflation and average euro inflation, which then existed, could be decomposed as follows: just 0.5% was due to Ireland's greater exposure to non-euro imports (a factor emphasised in the *Bank of England Quarterly Bulletin* for August 2000); 1% was due to higher Irish traded-sector productivity growth; the remaining 1.5% was "mainly attributable to cyclical considerations. This essentially reflects strong domestic demand conditions".^[2]

**FIGURE 5: SERVICE & IMPORT PRICES
% CHANGE**



[2] *Central Bank Quarterly Bulletin*, Summer 2000, p.27.

Fourthly, Figure 5 provides further perspective on the sources of Irish inflation by plotting the inflation rates for services and import prices since 1993. Services are non-traded and their inflation rate reflects domestic demand and supply conditions alone. The graph shows that service inflation started to pick up in mid-1997, was running at or around 4% for much of 1998, and subsequently escalated to 7% before falling back to approximately 5%. If a weakening exchange rate or higher oil prices were the main factors driving up inflation, we would expect to see import prices rising more rapidly than service prices. The opposite was true during 1999, at which stage the euro was already weakening and services inflation was already increasing. The most recent available data (July 2000) show import price inflation running at around 11%, as compared with a services inflation rate for that month of 7%. However, import price inflation only began to clearly exceed services inflation around mid-2000, at which stage inflation was already well established. The balance of evidence clearly indicates that high aggregate demand is playing *at least* as large a role in fuelling inflation as external and other once-off shocks.

DID INFLATION ONLY BEGIN IN 2000?

Figure 5 shows that service inflation was already high and rising by 1998. Yet, inflation as measured by the CPI fell from mid-1998 to mid-1999, at which stage it was at an astonishingly low 1.2%. However, when Irish aggregate demand increases, the impact should be on the price of Irish output or the GDP deflator. Table 1 (based on Irish national accounts) shows that the price of Irish output went up by 4.4% in 1997 and 5.8% in 1998. Alternative *Eurostat* data show slightly lower increases in the Irish GDP deflator, but also indicate that Irish price increases exceeded average euro zone price increases by 1.8% in 1997, 3.9% in 1998, 2.5% in 1999 and 2.5% in 2000. On this most relevant measure for competitiveness Ireland has been losing competitiveness against its euro partners since 1st January 1999.

The discrepancy between the behaviour of the CPI and the GDP deflator can in large part be explained a high Irish propensity to import. Table 1 also suggests that the methods used to construct the CPI may be part of the explanation as well. An alternative measure of consumer prices, the price deflator for personal consumption derived from the national accounts, rose 1% more rapidly than the CPI in 1996, 1.1% more rapidly in 1997, 1.4% more rapidly in 1998, and 1.7% more rapidly in 1999. The statistical uncertainties attached to the estimation of consumption mean that this deflator is ordinarily not the best measure of consumer prices, but in our current climate a large proportion of the gap between the two measures is probably explained by the way in which owner-occupied housing costs are treated.

TABLE 1: ALTERNATIVE INFLATION MEASURES

Ireland	CPI	PCD	GDPD	WPI	PPI
1993	1.5	2.2	5.2	4.8	4.6
1994	2.4	2.8	1.7	1.0	1.1
1995	2.5	2.8	3.0	2.1	2.5
1996	1.6	2.6	2.3	0.5	0.7
1997	1.5	2.6	4.4	-0.4	-0.6
1998	2.4	3.8	5.8	1.6	0.8
1999	1.6	3.3	3.8	0.4	1.0

Source: CSO data

	GDPD	GDPD	PCD	PCD	GDPD	PCD
	IRL	EU-11	IRL	EU-11	DIFF.	DIFF.
1993	5.2	3.4	2.1	4.0	1.8	-1.9
1994	1.7	2.7	2.7	3.3	-1.0	-0.6
1995	2.7	3.0	2.8	3.1	-0.3	-0.3
1996	2.3	2.3	2.5	2.6	0	-0.1
1997	3.5	1.7	2.4	2.0	1.8	0.4
1998	5.6	1.7	3.7	1.5	3.9	2.2
1999	3.9	1.4	3.0	1.3	2.5	1.7
2000	4.2	1.7	3.1	1.6	2.5	1.5

Source: Eurostat data

CPI: consumer price index

PCD: private consumption deflator

GDPD: GDP deflator

WPI: wholesale price index

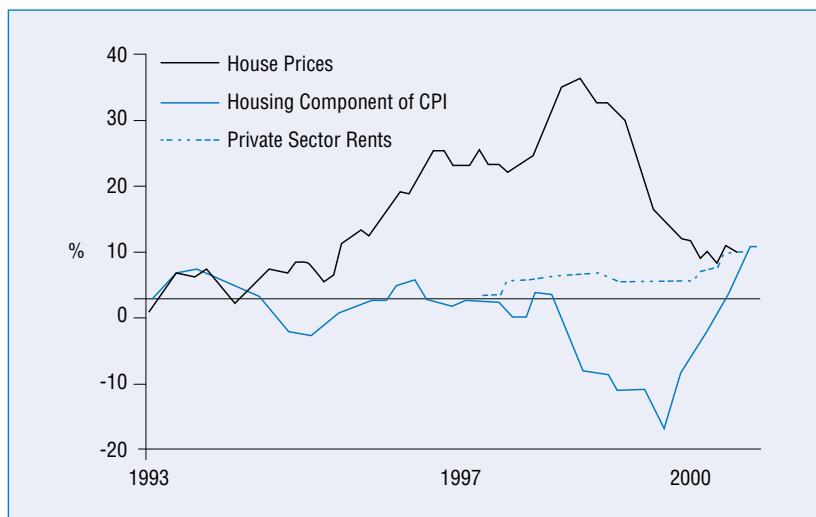
PPI: producer price index for manufacturing

HOUSE PRICE FACTORS

The most obvious symptom of inflation in the Irish economy over the past three or four years has been the rapid increase in house prices. Figure 6 shows that house-price inflation was most rapid during 1998 and 1999 – not coincidentally the years associated with the transition to EMU and the consequent fall in interest rates – when for several months year-on-year inflation rates exceeded 30%. The question is whether and how these developments are reflected in the CPI. As is well known, the Irish CPI adopts the

payment approach to measuring the costs of home ownership; that is, it measures 'the change in mortgage costs actually incurred by house owners to occupy the house' (CSO n.d.). Thus, housing costs for owner-occupiers tend to fall as interest rates fall, even though lower interest rates stimulate house price increases. Figure 6 shows that, indeed, there has been a negative correlation over the past six years between house prices and the housing component of the CPI. During 1999, this component actually became strongly negative (although both house prices and private sector rents continued to rise).

FIGURE 6: HOUSING PRICE INFLATION



There are alternative ways of measuring the costs of home ownership for the purposes of constructing a CPI. In Denmark, Germany, Japan, the Netherlands, Norway, Portugal and the United States, private sector rents are used instead of mortgage repayments, since the owner is paying an opportunity cost of occupying the house rather than renting it out. While this practice is conceptually correct, the implication is that owner occupiers' incomes should also be adjusted upwards to take account of the notional income they derive from occupying their property. Implicitly, this is what happens in the construction of the private consumption deflator, explaining why it was rising more rapidly than the CPI in 1999. In Austria, France, Greece, Italy and Luxembourg, home ownership costs are omitted altogether from the CPI. The Irish practice is adopted in the UK, Australia and New Zealand. The fact that our method implies that interest rate increases, which

are anti-inflationary, will have a short-run positive impact on measured inflation is recognised as a shortcoming of the approach (Turvey 2000).

No single measure is perfect. However, it is important to recognise that the Irish CPI is not strictly comparable with the American CPI, for example. This is why the ILO suggests excluding housing from the CPI when comparing inflation across countries, a practice adopted in the EU's Harmonised Index of Consumer Prices. On the American measure Irish inflation would have been higher in 1999, since housing costs would have increased in line with rents, rather than declined (Figure 6). By comparing the CPI with and without housing costs, it can be seen that declining mortgage repayments imposed quite a drag on the aggregate inflation rate in 1999. For example, in September the CPI was rising at a 12-month rate of 1.5%, while the CPI excluding housing was rising at 3%. On the French measure, the CPI would have been rising more rapidly again, reflecting the rising rents of those living in rented accommodation; on the American measure, it would have been rising even *more* rapidly, since those rising rents would have been applied to all home owners as well.

The point is *not* that the Irish practice is invalid; as the CSO says, it measures the cost of living in a 'publicly acceptable' way and accords with the intuitions of most. The point is that other, equally valid practices would have shown a rise in inflation at an earlier stage. Given the evidence on what was happening to the price of services, the GDP deflator, the personal consumption deflator and house prices – not to mention increased traffic congestion and other symptoms of overheating – it is hard to credit that so many commentators took so long to accept that excess demand was a problem for the Irish economy.

POLICY IMPLICATIONS

Ireland is experiencing inflation rather than a series of one-off price rises and this inflation is largely due to excess demand. Three questions thus arise as follows. Should policy makers be concerned about this? What, if anything, should they do? Is there anything that they *can* do about it?

SHOULD POLICY MAKERS BE CONCERNED?

Some might argue that the fact that Ireland is now an EMU Member State means that inflation is less of a problem. However, the standard costs of inflation are just as important in a state that is a member of a currency union as in a monetarily independent state. These costs include the blurring of the information conveyed by the price system and arbitrary redistributive effects. People on fixed incomes lose. Moreover, with real

interest rates now close to zero, savers are also heavily penalised, while borrowers are benefiting. This latter effect is presumably potentially more severe than in an independent monetary regime, since outside EMU a rise in inflation would bring about a rise in nominal interest rates. No such response can be assumed in our present circumstances.

Thus, inflation is costly even within monetary unions. An argument of greater nuance is that inflation will be self-limiting in any EMU region, since inflation implies a loss in competitiveness. As Irish prices rise relative to those in the rest of Europe, the (now-defunct) Irish pound appreciates in real terms. The standard open-economy IS-LM (Mundell-Fleming) model suggests that this should reduce export demand and raise Irish import demand; a more important channel in the Irish case may be a fall in investment demand, as foreign multinationals scale back on their investments here. Thus, high Irish inflation rates eventually lower aggregate demand and this process will continue until the Irish price level is so high that no further excess aggregate demand exists.

This relatively benign scenario, predicated on there being no further shocks to the Irish economy, implies a soft landing for our runaway economy, with demand falling to just the level consistent with non-inflationary full employment. The mechanism involved (a gradual loss of competitiveness) would presumably not be welcome to those who hope for a further decade of extremely high growth rates; but economic theory, common sense and historical experience all tell us that a growth slowdown will occur regardless, implying that such a loss of competitiveness is in fact no great loss.^[3] Indeed, to a large extent it would reflect higher Irish real wages and better living standards, which is after all supposed to be the reason why we have economic growth in the first place.

While there is clearly much merit in this argument, it would be a mistake to be excessively sanguine about our current inflation rate. In the first place, there are the standard costs of inflation referred to earlier. Secondly, inflation is putting Ireland's social partnership model under considerable strain, a subject that is addressed below. Thirdly, inflation can become self-reinforcing through a number of mechanisms, the most obvious being that, with nominal interest rates fixed in Frankfurt, high inflation lowers real interest rates and further stimulates demand. While this might simply hasten the arrival of a sustainable real exchange rate, it might also make it more likely that the real exchange rate would overshoot, appreciating to the point where unemployment, rather than inflation, would become a possibility. Fourthly, prolonged inflation risks raising inflationary expectations, with implications for the wage setting process. If inflationary

^[3] In the long run (that is, once economies have 'caught up') growth rates of 2% or 3% is about as good as it gets (Ó'Gráda and O'Rourke, 2000).

expectations were to remain high, unemployment could result in the event that actual inflation eventually fell below expectations, as in the benign scenario referred to earlier.

Fifthly, there is always the possibility of an adverse shock occurring at some time in the future, which would lead to unemployment and the need for a real depreciation. In a monetary union such a depreciation would have to come about through lower-than-average Irish inflation rates. If inflation has gathered sufficient momentum and is still ongoing when such a shock hits, then real exchange rates might well move in the wrong direction for some time, increasing the real exchange rate adjustment ultimately required and exacerbating Ireland's adjustment problems. Sixthly, Ireland's very high rates of private credit growth, fuelled by (and fuelling) asset price inflation, could lead to a consumption crunch in the years ahead, if euro interest rates increase by more than is currently expected. On balance, excessive growth and inflation at this stage of the business cycle probably increase the prospects of an eventual hard landing.

WHAT SHOULD THE GOVERNMENT DO?

Our current rate of inflation is a problem on both microeconomic and macroeconomic grounds. Given policy independence, the best option would undoubtedly be to raise interest rates and let the currency appreciate. Not only would this modify demand pressures, but it could also have a dramatic effect on inflationary expectations, reduce the chances of a wage-price spiral and permit the authorities greater flexibility in engineering a soft landing. Although EMU precludes this option, it does not imply that the government is powerless. The Mundell-Fleming model, after all, tells us that in our situation fiscal contraction will be extremely effective.

WHAT CAN THE GOVERNMENT DO?

Given the constraints imposed by euro participation, the textbook remedy for our problems is a combination of tax increases and/or expenditure cuts. However, there are problems with this approach. First, one of the big lessons of the EMU experiment to date has been that this Mundell-Fleming prescription ignores political reality. It was well known that the fiscal Stability Pact, if applied, would make it difficult for governments to use fiscal policy to combat recessions. It is also well known that tax increases are impossibly hard to sell to the electorate (or at least to an electorate not convinced of the merits of textbook economics) at a time when the economy is booming and revenues are buoyant. Interest rate increases would be a much more effective tool in our circumstances.

Furthermore, it is also the case that tax increases would lead to the breakdown of our social partnership arrangements, which are commonly credited with having played an important role in the Irish growth miracle of the 1990s, just as they were important in the European growth miracle of the 1950s and 1960s.^[4] Whether this is a decisive argument against a fiscal contraction depends of course on one's attitude towards social partnership. From the perspective of delivering short-run macroeconomic stability, a flexible American-style labour market would be as efficient as a social partnership model and possibly more so (since it avoids the danger that relative wages become inflexible across sectors, regions, or occupations). If the alternative to social partnership is not such flexibility, but decentralised unions, then experience shows that centralisation is the preferable option.^[5] In such circumstances, a fiscal contraction could do real economic damage. Importantly, the damage would presumably become evident when the next recession hits, not now when wage restraint is not what the economy needs. Between now and then, so the argument would go, it is important to avoid depreciating the stock of social capital that has been built up over the past decade.

What about expenditure cuts? Cuts in public sector pay, or even delays in pay increases, would plausibly have more severe political effects than tax increases and the same consequences for social partnership. Perhaps a more politically palatable alternative would be to delay major public infrastructural projects, preferably until the next recession. While this would make abundant macroeconomic sense from a demand management point of view, it would also involve a supply-side cost, in that major infrastructural improvements are now needed in order to relieve transportation bottlenecks. While neither alternative is particularly attractive, at the very least government should import any construction services which it may require over the next year or two. It should defer indefinitely projects such as the national sports arena, which would have a high opportunity cost and boost aggregate demand without yielding any supply-side benefit.

Economists may be naive, therefore, in calling for a fiscal contraction. However, economists have an obligation to point out that politicians, business and trade union leaders are equally naive in calling for further tax cuts that will clearly fuel inflation (and thus presumably put social partnership under further pressure). Nor is the ESRI's proposal – that the tax cuts promised under the PPF be deferred for a year – a sufficient response to this dilemma. As recognised by the ESRI itself, forward-looking taxpayers are quite capable of spending next year's tax cuts today (just as forward-looking house purchasers in 1997 and 1998 made offers on houses based on the expectation that

^[4] Eichengreen 1996; Ó Gráda and O'Rourke 2000.

^[5] Calmfors and Driffill 1988.

EMU entry would lower Irish interest rates). Indirect tax cuts may cut the headline rate of inflation, but at the cost of increasing the underlying, core inflation rate. These are inescapable economic realities.

In such circumstances, it makes more sense to compensate workers for the unexpected rise in inflation by raising nominal wages. There are several reasons for arguing this. First, while tax cuts clearly fuel aggregate demand, wage increases will be associated with declining profits and the net impact on demand will depend on relative expenditure propensities of wage- and profit-earners, about which little is known. Unfortunately, there is a caveat: public sector wage increases are associated with higher government expenditure and thus add to aggregate demand. While the higher than anticipated government surplus suggests that such increases are affordable in the short run, both longer-run budget constraints and the short-run inflationary situation suggest that public sector wage increases should be paid for by higher taxation and/or fiscal restraint elsewhere.

Secondly, anecdotal evidence suggests that pay restraint has in any event broken down in large segments of the private sector. Thirdly, the whole point of economic growth is to raise real wages. Fourthly, while there is a sound justification for using centralised pay deals to keep wages down in a situation where a union free-for-all would lead to excessive wages and unemployment (as was true in the late 1980s), there is little justification for intervening in the marketplace to keep wages below their equilibrium level in a situation of full employment. To the extent that such interventions are effective (as is true in the public sector, for example) labour shortages will result and this is precisely what is happening, particularly in the Dublin region.^[6]

CONCLUSIONS

EMU membership means that the government has relatively few policy options. Fiscal contraction would be effective but politically unacceptable and would also pose significant threats to social partnership. However, at a minimum government should reconsider its current plans to embark on major infrastructural projects in the immediate future – at least, the less productive ones. Nominal wage increases are less of a problem. The real wages implied by the PPF have not been delivered because the current inflation was unanticipated. However, given the economy's sustained high growth rate, both profits and government revenues are also higher than anticipated.

Wage increases in excess of those agreed under the PPF may also be an effective, and necessary, means of keeping social partnership alive. They also recognise that

^[6] If wages were competitively determined in a US-style labour market, presumably wages in occupations such as nursing would be higher in Dublin than in other regions. It is unclear to what extent our social partnership arrangements are capable of delivering such an outcome.

eventually price and wage inflation will lead to a sufficient loss of competitiveness and that inflation will no longer be a problem. There is nothing heretical about such a stance. In the standard analysis of monetary unions, such upward wage flexibility (and/or immigration) is the recommended solution for a region that has experienced a positive demand shock.

The catch, and it is a crucial one, is that when unemployment once again becomes a problem – either because current wage and price adjustment overshoots equilibrium, or because of an unanticipated negative demand shock – optimal currency area theory calls for nominal wage decline and/or emigration. In the absence of a move to an American-style labour market, the former possibility implies the urgent need to keep social partnership alive, which in practice means delivering tangible gains to workers now, while warning about potential problems in the future. The latter possibility raises the spectre of a significant house price adjustment, with consequent wealth effects. To a certain extent, having tied ourselves to the euro roller coaster, we have no option but to sit back and convince ourselves that we are enjoying the ride. Whether it might make sense to get off the roller coaster at some future date is a matter for another paper.

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