

## **Congress Briefing Paper**



# **The Big Squeeze: Inflation Up, Wages Stagnate**

**Irish Congress of Trade Unions**

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## Introduction

The strong rise in consumer prices in 2008 shows no sign of abating. It is a particularly pernicious type of inflation - hitting food and energy hard. It is impacting on all, but most especially on those on low incomes and the poor. Thus action must be taken to a) reduce the cost of food and energy and b) immediately and materially help the people most affected.

This is particularly important for workers as wages have fallen by 1.7 percent under the terms of *Towards 2016*. In addition, many workers are enduring a further pay freeze because their deal ran out three months ago and they have been due a rise from the end of March. This week's ESRI report demonstrated that its projected recession for this year is being caused by deficient domestic demand. This is largely caused by the pay freeze over the past two years, accentuated by rising inflation and lower consumer confidence.

Thus calls for a second pay freeze for workers would have a negative impact on the economy by reducing domestic demand by the largest cohort of spenders in the economy - 1.7 million employees. Current calls for a pay pause in the public sector conveniently forget that *Towards 2016* began with a six month pay pause for that sector, following from another in *Sustaining Progress*. Calls for general pay freezes are also hypocritical, when made by, or on behalf of, those at the top who have enjoyed such spectacular remuneration and gains in the course of the 15 year boom.

## Consumer Prices

The sharp rise in consumer prices has come as no surprise to Congress. Most commentators had wrongly forecast that the downward trajectory in consumer prices early in the year would continue. In several comments on monthly inflation and in our *Spring Economic Outlook: Narrowing the Pay Gap*, we forecast that the rising prices would stick, based on international commodity prices and the upward trend in inflation internationally. The ESRI has again revised its CPI forecast upwards for this year from 3.4 to 4.5 percent. We do not accept its forecast that it will fall to 3 percent in 2009.

In recent years, economists had expected that Irish prices would rise at higher rates than in Europe, because Ireland was catching up. Yet the sustained rises in prices, which have pushed Irish price levels to the second highest in the EU27 member states, is now substantially above the average even of the richest 15 states. This has surprised many. Wages have risen too, but are still well below those in most EU15 states.

The European Central Bank (ECB) has an inflation target of less than 2 percent. It can be seen from Table 1 that for every year in the last decade, bar 1999, Ireland's price rises have exceeded that target.

**Table 1      Consumer Prices in Ireland**

1998	2.4
1999	1.6
2000	5.6
2000	4.9
2001	4.6
2002	3.5
2003	2.2
2004	2.5
2005	4.0
2006	4.9
2007	4.6 (to May inclus.)

Source: CSO

Since 1997, Ireland's inflation has been a good deal higher than in Europe (27). But measured by the Harmonised Index of Consumer Prices (the HICP, which excludes the important item, interest rates, and some others too), it is now on a par with the EU27 largely because average EU inflation has increased.

In the Euro area, inflation (measured by the HICP as the Consumer Price Index (CPI) is not available for comparative purposes) is still at 3.7 percent, its highest in 16 years and almost twice the ECB's target. China's inflation rate of 8.5 percent is the highest in 12 years, up from 3 percent a year ago, while the US is at 3.9 and UK at 3 percent. Most countries are enduring very high inflation. It is an international phenomenon which is sticking, driven by high energy and food prices. As economic growth stalls in many countries, price rises should also slow, but this is not happening and the spectre of *Stagflation* looms: high inflation and stagnation in growth.

### Food Prices

Overall, food prices are rising twice as fast as the rise in 'all goods' inflation – 8 percent compared to 4 percent. There is some good news in that the rate of increase in food prices has fallen slightly over recent months. However, of concern to Congress is that food price rises impact disproportionately on the lower paid and families dependent on social welfare.

**Table 2 Food Price Rises in Ireland, Year to May 2008**

<i>CPI Overall</i>	4.7%
Flour	39.1%
Bread	17.0%
Milk Cheese and Eggs	20.7%
Milk	29.9%
Eggs	9.3%
Butter	15.9%
Low Fat Spreads	17.2%
Tea	11.0%
Tinned Veg	7.9%
Rice	14.6%
<b>Food Overall</b>	<b>8.0%</b>
<i>Goods Inflation</i>	4.0%

Source: CSO: *CPI, Detailed Sub Indices, May 2008*

The June 18 survey by the National Consumer Agency (NCA) showed that branded goods cost up to 31 percent more south of the border. The NCA survey looked at Tesco, Dunnes Stores and Lidl and was conducted on both sides of the border. It showed there was a 31 percent difference between a basket of 42 branded goods in Dunnes Stores, north and south of the border. Unfortunately, the NCA's remit does not allow it to take action against excess profit-making by wholesalers or retailers, except in very limited circumstances.

### **Price Rises Will Continue ....**

Commodities - energy, agricultural and materials - rose successively to all time highs in Spring 2008, and many continued to rise as we reach mid-year, driven by rising demand, the weak dollar and low inventories.

In the US, corn prices soared to a record level of over \$7 a bushel, (week ending June 13), tracked by soyabean and wheat. Stocks of all three are low. Australian wheat output is down substantially due to drought.

Oil hit \$139.12 a barrel in June 2008. Our estimate that it would average over \$100 a barrel in 2008 now looks distinctly optimistic. The demand for oil continues to grow, but supply is uncertain. While the *Economist* magazine's index for metals saw a slight fall in the year to June 2008 (of -4.1 per cent) prices for metals remain high.

The price of tea, coffee and cocoa are also reaching record levels in 2008 e.g. cocoa hit a 28 year peak in June. Biofuels are taking more land out of food production all over the world, boosted by taxpayer subsidies. This perverse use of taxpayers' money has got to be ended. High oil prices will continue to feed into high food prices through the cost of fertiliser, for some time. Food and fuel prices may continue to rise at higher rates for years to come, according to some experts.

In the year to May 2008, mortgage interest rose by 17 percent and is likely to rise again to reflect the recent mortgage increases of Irish banks due to the financial crisis and then further again, as the ECB puts up interest rates next month.

The good news from the CSO that electricity prices fell in the year to May 2008 (-5.4 percent) as did natural gas prices (-8.3 percent), was miserably quashed when the news broke that the ESB is looking for a 30 percent increase! This is because of the rise in fuel prices and not all energy prices have yet had their full impact on other goods and services.

If the ESB is granted the increases it seeks by CER, it would add about €45 to the average two-monthly bill and so increase the average bill for a year to more than €1,100. Such an increase, which will be accompanied by increased gas bills, will add to the misery for hundreds of thousands of households, on top of the big food prices rises and that of liquid fuels, which have risen by a massive +47 percent. Fuel poverty impacts on 145,000 Irish households<sup>1</sup>. Petrol rose by 8.2 percent in the year to May and diesel by a more hefty 23.2 percent<sup>2</sup>. Fuels have a weighting of under 4 percent in the CPI makeup.

A recent AA survey found that diesel is rising at an even faster rate than petrol, with the average price of a litre of diesel now at 142.9 cent. This is a rise of 10.5 cent since May and an increase of more than 18 cent a litre since figures were released in April. Since October 2007, the price of petrol has gone up by 13 percent, according to the AA, while the price of diesel has risen by a 30 percent in six months.

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<sup>1</sup> SEI, June 2008.

<sup>2</sup> The AA came out with a higher figure for diesel, but this is the official one from the CSO, based on its regular national survey.

The *Economist's* dollar-based commodity price index rose by 32 percent and its food index by 62 percent, in the year to June 2008. The price of oil rose by 102 percent in the year to June 2008 and it has yet to translate to higher prices in the rest of the economy. These high rises are the main cause of higher inflation across the globe. They are also related, at least in part, to structural changes in the global economy.

Finally, as we have stated before the ECB does not have to take socio-economic factors into account in determining interest rates and does not appear to believe that inflation might be generated, at least partially, by greedy corporations, boosting profits with price hikes and over-paying their top executives. The ECB is very likely to raise interest rates next month to curb European demand but this action will push up Ireland's CPI further.

Food makes up 12 percent of the average consumer basket for Irish people (it is 15 percent in the UK) and energy products 8 percent. Congress believes that both weightings may have to be revised upwards due to the prolonged impact of inflation. Congress has repeatedly stated that both of these essentials comprise a higher proportion of weekly spending for those on lower incomes – as high as 35 percent for some.

Congress has repeatedly stated its opposition to the Orwellian attempt by the Irish Government, a very large employer itself, to underplay inflation by ordering all state agencies not to use the Consumer Price Index (CPI) but instead the HICP, which excludes mortgage interest. While the HICP is a perfectly valid measure and the one used for European comparisons, Congress rejects this attempt to change the rules to suit employers.

## **Consumer Confidence is Falling**

While consumer confidence is falling all over Europe, in Ireland it is very low at -2.4 for April 2008, compared to the EU15 average of -2.1. This lack of confidence is reflected in the three months of falling retail sales. Of course, such sales are a combination of the numbers at work and rising incomes. As average incomes have fallen in the past year and half, workers have had less to spend. This, in turn has hit retailers and other businesses, underlining the case for real wage increases.

## **Price Levels**

Price *levels* are extraordinarily high in Ireland. Irish price levels are 24.9 percent above the average in the EU 27, second only to Denmark. Back in 1995, Irish price levels were the same as average price levels in the 27 states, at 100.7 percent of the average. Then Ireland was the tenth highest of these 27 states, whereas we are now placed second in this troubling table<sup>3</sup>. For consumer goods, Irish prices are 14 percent higher than the average in the 27 states, but for consumer services, they are a staggering 31.2 percent above the average.

## **Government Can Reduce Prices**

While much inflation in Ireland is externally driven, the government still has a major role in creating and in curbing price rises. We have one of the highest rates of consumer spending taxes with VAT at 21 percent, compared to 17.5 percent in the UK<sup>4</sup>. This high tax on spending has boosted Ireland's inflation and accounts for part of our high underlying price levels.

Further, the government induced many hikes in prices as policy under Mr McCreevy shifted taxes (at the end of the economic boom), from incomes and

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<sup>3</sup> Eurostat: Comparative price levels of final consumption by private household including indirect taxes, using Purchasing Power Parities and market exchange rates for each country.

<sup>4</sup> The standard rate of VAT averages 15 per net in the 30 OECD countries, and is lower in Italy, France and many other countries than Ireland.

profits to consumer spending. While there have been few government induced consumer tax rises in recent Budgets, the privatisation of many public services have led to the introduction of user charges.

There is a strong case for a reduction in VAT by 2 percentage points to reduce inflation. This would cost under €1 billion in tax revenue, but would reduce inflation by almost 1 percent i.e. from 4.7 percent today to 3.7 percent. It could be paid for by a rise in income taxes for those earning over €120,000 a year and by ending the many property tax breaks, especially those for private hospitals, clinics and hospices. The cut in VAT would have to be accompanied by a beefing up of a state agency like the National Consumer Agency, to ensure this reduction in VAT is passed on by retailers and wholesalers, to consumers. If the Taoiseach is fearful it might not be passed on, then the powers of the NCA need to be strengthened.<sup>5</sup> Incidentally, his belief that the market is imperfect is refreshing and demands action to protect consumers.

In addition, there is a case for the government not to continue to make major gains from soaring fuel costs. As fuels prices rise, government automatically gains with increased taxes on fuel. Recognising that fuel taxes are environmental taxes and can change behaviour and help reduce climate change, such reductions have to be temporary and only while fuel prices are soaring. Thus, government should eschew any further raise while oil remains at over say, €125 a barrel, for a specified period of time.

### **Wages & Prices**

While inflation in Ireland is externally driven and is not driven by wages, Congress is aware that wage costs are important for labour intensive firms, and member unions are sensitive to market pressures. The answer is to boost these firms' innovation and productivity, but such improvements take time and are also not easy to generate, in some sectors.

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<sup>5</sup> Irish Times 10<sup>th</sup> June 2008

Paul Tansey, Economics Editor of the *Irish Times*, has noted that: “In recent years it has been the strength of the euro, not the pace of domestic price increases or the rate of wage increases, that has been killing Irish competitiveness.” The exchange rate is the major determinant of price competitiveness.

He said “over four-fifths of the loss in real Irish price competitiveness over the past six years has been caused by the strength of the euro and less than one-fifth is due to Ireland's inflationary excesses relative to trade rivals.” And over the past two years, Tansey concluded that “virtually all of the erosion in real price competitiveness has been caused by the slippage of the dollar and sterling against the euro.”

Thus a fall in the Euro would have a major impact on improving our competitiveness, especially as we export 36 percent (in 2007) of all our exports to two economies outside the 15 member Eurozone, the UK and US.

### **Renewal of the Social Market Economy**

Congress has argued that the state rescue of Bear Stearns in the US and Northern Rock in the UK sounded the death knell for the neoliberal model and the myth of a self-regulating market. A *Financial Times/Harris* poll revealed that strong majorities in major European countries believed that the gap between rich and poor had grown too wide.

The level of top executive pay has shocked citizens throughout Europe. Christine Lagard, the French Finance Minister, said it was “scandalous” that some CEOs had received huge pay increases regardless of performance. She called on French bosses to rein themselves in or “under public pressure, rules, laws and European directives we will intervene.” President Sarkozy has criticised rogue directors where there is high pay and poor performance and he called for a “re-moralisation of Capitalism.” The total remuneration of the top 40 CEOs in France leapt by 58 percent in 2007, causing much outrage. Last year, France introduced a new measure, unheard of elsewhere, which makes severance

payments conditional on performance. Usually only bonuses and long-term incentive plans are tied to results.

Jean Claude Juncker, Luxembourg's Prime Minister and also chair of the EU Finance Ministers 'Eurogroup', recently called excessive pay a "social scourge" and demanded action. The European Commission is working on a response to the Eurogroup's complaint.

In the Netherlands, Sweden and Norway, shareholders get a binding vote on compensation packages under law while in Britain, they only get a non-binding vote. Some Spanish and Swiss firms are voluntarily starting to offer shareholders a vote, but of course, major shareholders, such as big fund managers, are tied into the same reward packages and so won't rock the boat.

Banks in particular were responsible for the credit crisis, and some, such as Switzerland's UBS, have admitted that the way in which they rewarded senior employees led them to take greater risks, resulting in huge losses on subprime mortgages.

In Germany, moves are afoot to curb excessive remuneration through two methods. First, is that Supervisory Boards, which include trade union representatives, are to take over responsibility for remuneration committees and secondly, is it proposed to forbid the deduction of excessive remuneration against the company's tax. Both these suggestions have been made in relation to Ireland by Congress earlier this year. Germany's President has also criticised the bizarrely high pay of some executives

In the Netherlands, the Finance minister has drafted legislation to tax excessive pay more heavily, including 30 percent tax to be paid by companies on golden parachutes, where the annual salary is over €500,000 a year. Shareholders in Phillips voted down excessive share options for executives in March.

Only last week, the German Chancellor, the conservative Angela Merkel, rejected the Anglo Saxon model of capitalism, reasserting the superiority of the market system “tempered by consensus-building politics and a generous welfare state.”<sup>6</sup> She is on strong ground because the German social market alternative, once derided by neoliberals as outdated and inefficient is now proving particularly resilient.

“The social market economy was always against the division of society. It is a system that had, and still has, social cohesion and equality at its core. It tries to forge alliances. We will perhaps always insist on a higher degree of equality than in Anglo Saxon societies,” Ms Merkel said. She said the dark side of globalisation was revealed by those bankers who took unacceptable risks and by companies which eschew social responsibility and she also criticised the bribery scandal in Siemens, the corruption in Volkswagen and the spying by Deutsche Telecom.

In Ireland, the Taoiseach Brian Cowen has also criticised – albeit in milder tones – high and excessive executive pay. But so far, neither he nor any private sector bosses have taken action on excessive remuneration and the growing pay gap.

### **Recommendations for Action against Inflation and High Prices:**

1. As food price rises impact disproportionately on the lower paid and families dependent on social welfare, food and fuel poverty programmes must be immediately enhanced.
2. The massive price rises to be sought for electricity and gas must be mitigated action by government and public transport fares and user charges must be frozen for 2009.

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<sup>6</sup> Financial Times, *March to the Middle, Merkel celebrates Germany's Social Market Model*, 11 June 2008

3. The Orwellian attempt by the Irish government to try to underplay inflation by ordering all state agencies not to use the Consumer Price Index (CPI) but the HICP, should cease forthwith.
4. As average incomes have fallen in the past year and half, workers have had less to spend. Combined with slowing employment growth, this, in turn, has hit retailers and other businesses, underlining the case for real wage increases.
5. There has to be official, open recognition by government that Irish consumer price levels are far too high. For consumer goods, Irish prices are 14 percent higher than the average in the 27 states, but for consumer services, they are a staggering 31.2 percent above the average. This must be addressed.
6. An immediate reduction in VAT by 2 percentage points. This would reduce inflation by almost 1 percent i.e. from 4.7 percent today to 3.7 percent. It could be paid for by a rise in income taxes for those earning over say €120,000 a year and ending all the many property and other tax breaks, especially those for private hospitals and clinics.
7. The remit of the National Consumer Agency should be immediately strengthened to enable it to police the passing on of the reduction to all consumers. It needs to a) investigate price fixing and, b) take vigorous action against excess profit-making by wholesalers or retailers, especially for food including groceries and petrol and diesel.
8. The government should not continue to make major gains from soaring fuel costs. It should eschew any further rise in taxes on fuel while oil remains at over say, \$125 a barrel, for a specified period of time.

9. There must be publication of the accounts of all Irish supermarkets and other 'public interest companies' to assist transparency in assessing their prices and profits.
  
10. Move to address the growing pay gap, in both the private and public sectors.

## **Conclusion**

As Ireland enters a recession, some have called for workers to pay for it with a second pay freeze, on top of the small reduction in wages we have endured for the past two years. The effect of another pay freeze would further erode consumer confidence and reduce domestic demand and prolong the recession. The main drivers of the recession are reduced domestic demand and the high euro. Few commentators have focused on the huge fortunes made in the Celtic Tiger years, too often untaxed or lightly taxed and the huge remuneration still enjoyed by many executives and proprietors. Congress will not agree to a further pay freeze in the light of growing inequality, soaring food and petrol prices and rises in heating oil, electricity and gas. Government should rapidly implement the 10 proposals set out in this paper in so far as possible, if it is to show leadership in mitigating the recession through social partnership.

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