Irish CONGRESS of Trade Unions

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BRIEFING PAPER

Inflation Outlook 2004-2005

Introduction

It is impossible to forecast the future. Therefore, this inflation outlook is based on an extrapolation of previous performance, assisted by an analysis of the drivers of inflation and judgment calls on these and trends in the economy. There are a number of economic factors driving inflation which give a very clear indication of the level of price movements over the next six to twelve months. Forecasts for longer become less accurate with time. This projection is based on "all things remaining equal", that is, that there are no major changes which will impact on price movements.

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Summary

Ireland has had the highest price rises in the European Union for several years, though it was overtaken by Greece in the last month of 2003. Its rate has exceeded the EU average for more than five years. However, there has been a steady decline in price rises here for a year - since February 2003. It stood at 5.1 per cent and it fell steadily since then. In February 2004, it was down to 1.7 per cent on the CPI. By the HICP measurement, Irish inflation in February was a higher 2.2 per cent. Importantly, Irish price levels are estimated to be 14 per cent above those in the Euro area. They had been at 85 per cent of the Euro average in 1995, according to the European Commission.

It would be good for Irish workers as consumers, if Ireland's overall price levels could be rolled back to the average in the Euro area and sustained at that level. To achieve average EU price levels Ireland's inflation would have to rise at levels much lower than Europe's for some time. This looks very unlikely.

The reasons Irish prices are currently higher than in Europe are because of the rise in the Euro (Ireland's trade is 80 per cent with non-Euro members); convergence of prices with market integration; catching up as a low income country and policy-induced prices changes – high rises in indirect taxes and rises in administered prices. The government's role in prices is crucial in a small open economy and Ireland has seen dramatic rises in indirect taxes and in the prices of goods and services over which government has influence, such as utility charges and other regulated areas. Ireland has low taxes on higher incomes, property and companies but high taxes on consumption, which impacts on inflation and on the price level. As this is a key part of government policy, it is unlikely to change.

Ireland, a small, open economy is a price-taker. The main determinant of Irish prices is the exchange rate. The main factor in Ireland's high prices was the fall in the Euro, which has been reversed against the dollar and to a much lesser extent, against Sterling, in the last year and a half or so. The tightness of the labour market and general catching up with Europe had a large impact on Irish prices in recent years too, but these have diminished. The role of oil prices and soaring house price inflation in Ireland also impacted on prices over time. The introduction of carbon taxes next year will push up prices. The decision to give away emissions trading permits for free to the top 100 companies and not to auction them is regressive and will impact on the lower paid.

The forecasts for inflation from the main agencies, ESRI, Central Bank, OECD, EU Commission and Department of Finance are examined for this year and 2005. The general consensus is that prices are falling and will be between 2 and 2.5 per cent this year and next. However, a leading economic indicator is commodity prices and it is rising. It is also possible that the Dollar may rise and this will both push up the prices of commodities and prices of imports from the US. The role of housing wealth in boosting and maintaining economic demand through

consumption is now well recognised by economists. The rapid rise in house prices in Ireland is unprecedented with a tripling since 1995. A major fall in house prices would have a bigger impact on personal spending than a fall in real disposable incomes. This in turn impacts on economic growth. While a crash in house prices is unlikely, it is not impossible. The threat of deflation is examined, but deemed to be highly unlikely.

The international recovery is well established and will lead to higher economic growth and possibly consequent rises in international prices. It is argued that the ECB focuses too much on controlling inflation and while it does not pursue its policy too rigorously, its mandate should be wider than this. Workers expectations on prices have been conditioned by rises of around 5 per cent in Ireland over the past four years. Workers are also well aware that prices in Ireland are higher than in Europe. They are in fact 14 per cent above the average in Europe. Many are deeply affected by the high prices of houses in Ireland. There is a lag in peoples' perceptions of prices with which Congress will have to deal.

Finally, this briefing concludes that as we enter a lower inflation period, the role of government in altering prices becomes more important. Congress has sought assurances from the Minister for Finance on the future role of government in raising prices directly through indirect taxes and its influence on administered prices. We have not received any assurances on this important area.

Prices are falling and fell to 1.7 per cent in the year to February 2004. Average prices this year will be around 2.0 to 2.5 per cent and it is likely that they will remain at this level in 2005, due to external factors – exchange rates and commodity prices. The high level of prices in Ireland, the high price of houses, lagging expectations and the potential impact of rises in indirect taxes and administered prices means that trade unionists cannot be confident that consumer prices will remain between 2.0 to 2.5 per cent for the period of the next pay round.

Measuring Inflation

Inflation is the rise in prices and it can be measured in many ways and in many sectors. The Consumer Price Index is the key measure and it tracks movements in consumer prices. The CSO in Ireland also measures price movements in wholesale prices, in sectors like agriculture, both outputs and inputs and building and the Department of Environment measures house price movements.

The CSO measures consumer price movements in two slightly different ways, with the Consumer Price Index and the Harmonised Index of Consumer Prices, an EU measure of consumer prices. (HICP is used to compare price movements across Europe on a consistent or harmonised basis for each country). HICP excludes a number of items which are in the CPI including; mortgage interest, building materials, union subs, and car tax. Thus the CPI is a better measure for Irish consumers. No measure can never truly measure all prices, but the samples the CPI uses are very extensive in scope and it covers the whole country very well. We would of course, resist the exclusion of tobacco products from the CPI as its price is a cost to many workers.

Irish Prices Double the EU Since 2000

Irish prices soared to over 20 per cent in 1981, fell progressively and by the middle of the 1990s were rising only by between 1 and 3 per cent a year. Indeed, in the late 1990s, Irish prices were actually rising at slower rates than those of the EU 15 as the following Table 1 shows. In the period 1994 to the end of 1997, in spite of rapid economic and employment growth, Ireland's inflation did not rise because there was high unemployment, a growing labour force, inward migration and spare capacity. However, Irish inflation has been higher than the EU average for the past number of years, with the fall in the euro, with a tight labour market, when wages rose and Ireland began to catch up with Europe. From 1998 Irish inflation was higher than the EU average and from 1999 it rose at double the average rate of European price rises. In 2003, however, Irish price rises began to fall again and are now expected to come close to the EU average movement in prices. Since the Euro was introduced in January 1999, the Irish Central Bank estimated that our competitiveness has been eroded by 12 per cent. While this was more than offset by the weakness of the euro until mid 2002, prices at the beginning of 2004 are still "some 12 per cent above the EU average and even higher in relation to some other OECD countries."[1] With the additional inflation differential in 2003 Irish price levels today are 14 per cent higher than average prices in Europe.

"Irish price levels today are 14 per cent higher than average prices in Europe".

[1] Central Bank Winter 2003, p 6.

Table 1. Ireland and European Average Annual Consumer Prices

(HICP method)

Ireland	EU (15)
1997 1.2	1.9
1998 2.2	1.3
1999 2.5	1.2
2000 5.2	2.1
2001 4.0	2.2
2002 4.7	2.1
2003 4.0	2.0

Sources: CSO, European Commission & ESRI.

An Examination of Why Prices Have Risen Faster Here than in Europe

The difference between Ireland and EU inflation has been a cause of much comment, though the European Commission is of the view that "from a policy perspective, recent inflation dispersion largely reflects the diversity of national economies and is not a major source of concern"[2]. However, it warns that cyclical imbalances "can have lasting effects on inflation differences because of price and wage rigidities".

There are seven reasons for the differences in prices in the European Union. First, are price *shocks*, such as the increase in energy prices in 2000-2001 and in late 2002 with the Iraqi war threat. Another shock was the sharp depreciation in the euro after its introduction which affected some member countries (especially Ireland) and the Foot and Mouth Crisis which impacted on some prices. Secondly, differentials are caused by *market integration*, where studies have shown that prices for similar goods are quite different in differing states. Thirdly, market integration and the Euro are leading to further convergence in price levels and this will continue for some years. In the meantime this will entail some inflation divergence. The *Balassa-Samuelson* (BS) effect is where lower income countries like Ireland have been catching up and this causes higher inflation in these countries. The Commission said that "the BS argument probably explains some of the price pressure registered in Ireland and Finland in recent years". The differences in productivity between traded and non-traded sectors within these economies also has a major impact on prices and Commission data shows how this impacts on Ireland's inflation.

A fourth factor is *structural adjustments* which might have been remedied by exchange rate adjustment prior to the euro, if the asymmetries were large enough. A fifth factor, cyclical differences (which are difficult to differentiate from structural) can also lead to differences in prices. *Policy-induced* price changes are the sixth source of difference and include indirect taxes and regulated or administered prices. These affect price levels and there have been large price rises in this category in Ireland, particularly in late 2002 and early 2003. Finally there are some *statistical differences* in the weights used to aggregate sub-sectors in the Member States, according to consumption patterns.

The Commission paper states that Ireland was particularly adversely affected by the first source of difference, which was the fall in the value of the Euro. This was because we have extensive trade with non-euro countries and this meant an increase in imported inflation. The BS effect has an ongoing impact and in recent times the policy-induced price increases in direct taxes.

The rise in the value of the Euro led to competitiveness problems for the Irish exporter, but it did ease prices. Ireland's trade with non-euro countries is the highest of the eleven Euro Member States, at 80 per cent.

The Euro rose against the Dollar by over 40 per cent between 28th December 2001 and March 2004 and by 10 per cent against Sterling as the Table 2 below shows:

The Euro fell since early January 2004. On the 9th of January it had been 5 per cent higher than in the table (Table 2) and over 44 per cent against the Dollar (at 0.70 and 1.27 respectively, compared to December 2001). In the year 2003, the Euro rose by 6.7 per cent against the Pound

[2] European Commission, Qterly Report on Euro Area, 19th December, 2002:6

Table 2. Changes in Euro (Dollar and Sterling)

28 December 2001	8th March 2004	Percentage Change
Sterling 0.6085	0.67	10%
Dollar 0.8813	1.24	40.9%

Sources: Central Bank Report and Irish Times

Sterling and by 21.7 per cent against the Dollar. The rise in the Euro has helped reduce inflation, but while the movement against the Dollar has been large, it has not been significant against Sterling. Ireland exports more to the US, but imports more from the UK. Thus the rise in the Euro, of smaller magnitude against Sterling, did not impact as much on consumer prices. Further a large proportion of our imports from the US are capital goods and so do not impact on consumer inflation, whereas much of UK imports are consumption goods, such as processed food, which impact on consumer prices. The policy induced impact on prices in Ireland will be examined later in the Briefing.

What Drives Irish Inflation?

Irish inflation has been running at higher rates than in the Eurozone since 2000 because:

- 80 per cent of imports are from non-Euro countries and the Euro fell steadily from its launch for 40 months against the Dollar.[3] This pushed up Irish inflation.
- Domestic factors contributed to Irish inflation too, especially the rise in the prices of services and especially non-traded services. Services contribute to up to 40 per cent of all inflation. The strong demand allowed a widening of profit margins especially in services during the boom years when there was a tight labour market from 1998 to 2000.
- Some non-traded services' prices have risen twice (or more) as fast as overall prices.
- Taxes on spending and price rises in "administered goods and services" (i.e. government sponsored prices changes) have contributed significantly to inflation in recent years.
- Taxes are low on higher incomes, property and companies, but are high on consumption in Ireland and have been raised further in the two of the last three Budgets. High taxes on spending contribute much to high Irish prices.
- The 2003 Budget which raised spending taxes had promised that it would only add 0.9 per cent[4] to the CPI but the Constant Tax Price Index showed that the tax rises added 1.5 per cent to prices in the first three months of 2003. It declined over the year as the tax impact washed out, but its lowest level was 1 per cent in December. This was substantially above the Department of Finance's forecast and together with government influenced administered prices, these taxes on spending, which is part of the government philosophy, have had a substantial negative impact on Ireland's competitiveness (see more below). Over the past five years, government taxes contributed almost 5 cent of the total rise in prices of 22.1 per cent.
- Wage inflation has been a major factor in overall Irish inflation, with the tight labour market and rapid rise in the cost of professional services over the past few years. This eased with the international economic downturn and rising unemployment. Sustaining Progress also had an important positive impact on prices in the year and in 2004 (see reference by European Commission in Table 7).
- Sectors like insurance and "eating out" in pubs and restaurants have contributed to the higher rises in prices in Ireland than in the other Euro zone countries.

In the long run, it is monetary factors which drive inflation. Shocks like oil prices rises or high wage increases do add to inflation, but only in the short run. Unless there is expansion in the money supply, such shocks will not translate into long term inflation. As the money supply is now determined in Europe, this will not occur as Ireland is a region of the Euro area.

In addition we have had convergence between Ireland and the Euro area as we catch up, as we have seen above.

[3] The Euro was launched on 1 January 1999 at £0.70 Sterling and $1.16.

[4] Budget 2002, pg.14

An Examination of the Major Factors which Influence Inflation

Ireland is a price-taker. The main factor influencing Irish prices is the exchange rate. Other external factors also include the price of oil which is a major input into so many areas of the economy. Internal factors also play a part in the short-term and these include the role of government on indirect taxes, on carbon taxes, emission trading, wages, employment and unemployment, and various input prices like wholesale prices, agriculture prices etc.

However, in the long term, prices are determined externally and Irish prices may move within a band within the Euro area, but cannot be sustained over time at a level which is much higher. Irish prices tracked those of the UK when we were linked to Sterling until 1978 and did rise to as much as 3 per cent above the UK level for short periods. The biggest prices differential while in the Euro area has been 2.9 per centage points in 2000. House prices, while not included in the CPI, do impact on trade union members' perception of inflation and of what pay rises they should receive.

The Government's Role in Inflation

The government has a major role in driving inflation in a small open economy. Not alone does it push up (or reduce) inflation with indirect taxes like VAT, excise etc, but it plays a major role in determining price levels in growing areas of the economy, which are being privatised or where charges are being levied. Furthermore, government will play the determining role in meeting the Kyoto Protocol, of which Ireland is a signatory and it will try to meet its obligations with new carbon taxes and by setting the regime on emissions trading.

Indirect Taxes

The policy of the government had been to rely heavily on high indirect taxes as a major source (almost half of all revenue at 45 per cent for 2004 and the Government's own projection for 2005) of revenue as the following chart (Chart 1) shows:

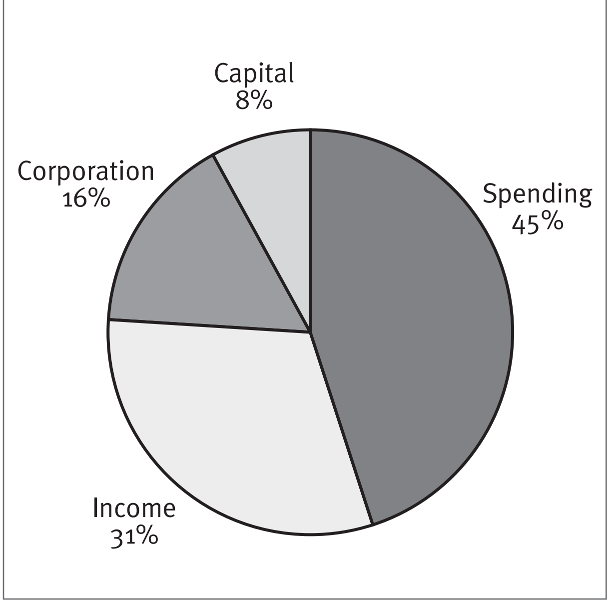
The rise in prices in 2003 would have been considerably lower had the government not contributed substantially, both directly and indirectly. The December 2002 Budget raised Irish prices substantially with many tax rises and price rises of what are termed *administered services.*

Administered Services Prices Soaring

The Administered Services include utilities i.e. gas, electricity, water, waste charges and public transport. The rise in "Utilities and Local Charges" rose by a substantial 10.4 per cent in the year to November 2003, that is almost 5 times the annual rate of inflation. These and "administered services" are "subject to direct or indirect government control" according to the Central Bank.[5] On 1st January 2003 the lower rate of VAT was increased by 1 per cent to 13.5 per cent, tax on some cars rose by 5 per cent and car tax was raised too, as was the cost of diesel. Parking charges were raised in Dublin and electricity bills rose by 13.25 per cent. The price of cigarettes and alcohol had been raised earlier. VHI premia had been allowed to rise by 18 per cent in September and bus and train fares were allowed an increase of 9 per cent in December 2002. TV licence and cable TV charges were also increased by 9 per cent from 1 January 2003. Gas prices also rose in

[5] Central Bank, Quarterly Spring, p 45

Chart 1
Sources of Taxes, 2005



2003. Administered Services' prices soared and will continue to rise because government policy is to make consumers pay for an increasing number of services which had previously been paid from central revenue.

Congress responded positively to IBEC's anti-inflation plan which became part of *Sustaining Progress*. The government did not respond so well and in fact, pushed up prices dramatically in its 2003 Budget both directly and in administered prices. Furthermore, the government, in line with its overriding tax policy of low taxes on corporates and on higher incomes and high taxes on spending, has clearly indicated to public bodies that it generally approves of charging for services which were once free. There is also tacit government approval for the privatisation of many services which will lead to sustained payments over the long term for services which were funded by taxes on income. In short, its approval of stealth taxes is contrary to its stated anti-inflationary policy.

The rise in water, refuse and miscellaneous services in the December CPI was a massive 25.7 per cent in the year, against an overall prices rise of 1.9 per cent. Electricity prices rose by 13.7 per cent (for ideological reasons - to encourage competition – the ESB is making historically high profits) and gas rose by 10.1 per cent – again it is a regulated industry. Once the charges are taken into the annual CPI, they drop out of the figures, though they remain as part of the increase in the price level. Congress wrote to the Minister for Finance seeking assurances that he will keep indirect taxes low for the next two budgets and that he will signal to the independent regulators that the government is serious on its anti-inflationary policy. His reply is covered in the conclusion.

Oil Prices

Oil prices are very important in the CPI as they have a high weighting in total consumer spending and they impact on gas and electricity and other fuel prices. Oil is also an input into all areas of the economy. Its price is therefore extremely important for the CPI and economic growth. The fall in the Dollar did not mean that oil prices fell, but rather rose to compensate for the Dollar's fall. Output hit a record high in December 2003 at 29 million barrels a day, prompting OPEC to cut production by 1.5 million barrels a day from 24.5m immediately, on 11 February 2004. OPEC members were worried about a crash in oil prices when the Spring arrives and so decided on this cut. Oil prices have been above OPEC's preferred range of $22-$28 Dollars a barrel, but this was defined before the Dollar's fall. Some OPEC members believe that oil prices are €2 or €3 below their preferred range. While the White House and Treasury Secretary condemned the decision, most people believe that its impact will be limited as OPEC members are desperate for revenue and are unlikely to adhere to the cuts. One analyst thought the action would stop a crash in oil prices, though China's demand is surging. Thus it appears that oil prices will remain stable, even with rising demand as the world economies recover in 2004. There may be upward pressure on oil prices in 2005, with political uncertainties in producing nations, Venezuela, Russia, Iraq, Nigeria and growth in demand in Asia and particularly China.

It is estimated that oil prices are 10 per cent above the market rate because of speculators, though others hold that the price of oil reflects demand and lack of investment in refineries, pipelines oil tankers and storage.[6]

Carbon Taxes and Emissions Trading

The government, along with the other EU member states is expected to introduce carbon taxes (in addition to taxes on petrol and diesel, which are considered to be environmental taxes) next year. It recently proposed an emissions trading regime for industry which has major tax impacts. This trading regime gives permits to the largest Irish firms for free. The alternative was to auction them off, but it did not do so, because the EU directive set out a free regime in this tranch of permits. The government has the opportunity to auction 5 per cent of them. The free permits will not change firms' behaviour, but will allow them to raise prices which will impose costs on consumers.

[6] Financial Times, 2 March 2004

Table 3. Rise in Overall Earnings

	1999	2000	2001	2002	2003	2004	2005
Davy Stockbrokers	6.5	6.5	8.5	9.3	5.5	5.3	6.0
ESRI (wage growth)			10.1	5.4	5.1	3.6	n/a
Non Agric. Earnings			6.8	7.4	4.7		

Source: Central Bank of Ireland

Table 4. Relative Unit Labour costs (1995=100)

	1997	1998	1999	2000	2001	2002	2003	2004
Ireland	94	78	68	61	58	54	58	59
Major Trading Partners	91	79	72	69	66	60	60	60

Source: Central Bank of Ireland

The carbon taxes and the emissions trading regime will push up the price of many goods. This will have an impact on fuel poverty and all consumers. The introduction of carbon taxes, which by necessity are indirect taxes, must be framed in the context of overall tax reform. The incidence of these taxes must not fall on poorer consumers.

Earnings and Wage Rises

Earnings rose substantially in real terms at the end of the Celtic Tiger boom, when the labour market was tight and as part of the catching-up process. The rise in earnings eased with the slowdown in the economy, a slight rise in unemployment and with the much looser labour market. There were substantial skill deficits in some sectors which assisted in the wage rises in these areas and there would have been spillover into related areas.

As can be seen from Table 3 the aggregate rise on total earnings in the economy was forecast to be around 7.4 per cent in 2002, falling to 4.7 per cent in 2003 according to the ESRI, with a different figure for wage growth.

Table 4 gives unit labour costs in a common currency for Ireland and our main trading partners. It shows the huge gains in productivity made by workers in the Irish economy, with labour costs in 2004 being only 59 per cent of what they were in 1995. Thus on average, Irish companies' labour costs are less than 60 per cent of what they were almost ten years ago in 1995. It is clear therefore that the rapid rise in wages in the intervening years, which were higher than inflation and thus, in gross terms, gave workers real pay increases, were well deserved.

Rapid pay rises would cause a rapid rise in prices in the absence of productivity growth. There is a lag in peoples' perceptions of price rises. At the time of the pay talks, prices were rising rapidly. In February 2003, the annual rise was 5.1 per cent. With a "free for all" there are greater difficulties for firms in budget planning and a greater threat of potential industrial unrest. Over the 18 months of the first phase of *Sustaining Progress* there will be a real increase in pay for employees.

Industrial earnings rose by 4 per cent in the year to September 2003. The rises in hourly earnings for all industrial workers were 3.6 per cent in 2002, 5.8 per cent in 2001 and just 3.5 per cent in 2000 according to the CSO.

Table 5. ESRI Forecast					
	2000	**2001**	**2002**	**2003f**	**2004f**
GNP		3.8	0.1	2.8	3.3
CPI	4.5	5.6	4.6	3.5	2.2
Wages			6.8	7.4	4.7
Employment growth			24K	24K	16K

Source: ESRI f=forecast

The ESRI forecast for economic growth, non agricultural wages, the CPI and jobs growth is as in Table 5.

It forecast a fall in prices to 2.2 per cent this year and has not yet made an estimate for next year. Their estimate for wages is a decrease to 4.7 per cent, but a rise in real terms, with a smaller growth in employment in 2004 on 2003. The Institute will revise its forecast shortly, as will the Central Bank.

The Central Bank forecast[7] can be seen in Table 6.

The Department of Finance (G&SP forecast) (Table 7) forecast inflation at 2.5 per cent for this and for next year and 2.4 in 2006. Their forecast for growth is strong at over 5 per cent by 2006 and a slight fall in employment and a small fall in inflation in that year too.

The European Commission, in its forecast for 2004,[8] said that the "fairly moderate pay provisions for the private sector in the latest national agreement, *Sustaining Progress* and easing price pressures should foster wage moderation and thereby help maintain competitiveness, although the latest data on industrial earnings point to some upward pressure". It said that there was a marked easing of the pay increases per head "given the flexibility of the Irish economy in the face of deteriorating external environment". It set out its forecast for pay and productivity, inflation and growth see Table 8.

The Commission expresses the view that growth will be broad based and will accelerate "towards that commonly thought to be sustainable in the medium term, of some 5 per cent". The rise in prices is in the HICP format and may be a little high for this and next year. It can be seen from the

7 Central Bank of Ireland Winter 2003.

8 European Commission, DG Economy and Financial Affairs, Economic Forecast, Autumn 2003, Brussels.

Table 6. Central Bank Forecast				
	2001	**2002**	**2003f**	**2004f**
GNP	2.0	2.2	2.3	3
CPI		4.6	3.5	2.3
Wages			6.3	5.0

Source: Central Bank

Table 7 . Department of Finance Forecast				
	2003	**2004**	**2005**	**2006**
GNP	2.2	3.3	4.7	5.2
CPI	3.5	2.5	2.5	2.4
Unemployment	4.8	5.0	4.9	4.8

Source: Department of Finance

Table 8. European Commission Forecast

	2000	2001	2002	2003f	2004f	2005f
GDP	10.1	6.2	6.9	1.6	3.7	4.9
HICP	5.3	4.0	4.7	4.1	3.0	2.7
Pay Rise per Head	8.1	9.0	5.2	5.1	5.0	4.8
Real Unit Labour Costs	-1.4	0.6	-5.5	2.8	-1.0	-1.5

Source: EU Commission f=forecast

table that wage rise per head were high in 2000 and 2001, but have been stable since according to this forecast at around 5 per cent. It includes the full payment of the Benchmarking award. Real unit labour costs did rise in 2003 according to this forecast, indicating the loss of competitiveness that employers are citing, but productivity is rising again as unit labour costs fall in 2004 and 2005.

The OECD forecast for Ireland[9] is set out below in Table 9:

Thus it can be seen that the inflation forecasts for 2004 from the main agencies range from 2.2 per cent from the ESRI to as high as 3 per cent from the Commission. The forecast for 2005 from the external bodies is around 3 per cent and it is likely that they would scale these down if making a forecast today.

Employment and Unemployment

In the Celtic Tiger years, particularly from 1996 to 2000, the labour market was tight. The situation had never occurred in Irish economic history before. Since the boom ended in 2000/01, the labour market has held up better than most economists would have expected. Unemployment is still relatively low, industrial production is still growing, albeit only by 1 per cent in year to November 2003, with industrial turnover up by 5.5 per cent. There was a fall of almost 15,000 in industrial employment in the year to September 2003, down to 240,500 jobs. The main fall was in computer and electrical equipment, which fell from its peak of 72,200 in the sector in March 2001 to 53,100 in September 2003, a fall of over one-quarter in two and a half years. There had been a fall in the previous year and in 2001 too. The peak in employment was 272,000 in the sector in March 2001. Industrial employment includes manufacturing as well as mining and electricity, gas and water. Employment in construction grew slightly, by 0.5 per cent, in 2003. It had declined in 2002 by just over 2 per cent, the first fall in several years.

If there was a large rise in unemployment, it would impact on wage demands and may ultimately affect prices, but it has held up. The number of unemployed rose from 71,000 in 2001 to 90,000 in 2003 and the number on the Live Register also rose in these two years from 142,000 to 173,000 (ESRI). These rises, while unwelcome, were accompanied by rises in total employment of 24,000 in 2002 and 2003 and a further rise of at least 16,000 is expected this year. The rises are small compared to the 50,000 plus in the boom

[9] OECD Economic Outlook, No 74, December 2003., Paris.

Table 9. OECD Forecast

	2001	2002	2003f	2004f	2005f
GDP	5.1	5.4	1.7	4.2	3.5
HICP	4.0	4.7	4.1	2.8	3.1

Source: OECD.

years, but with a labour force which is growing at a much slower rate, this is a reasonable performance. Thus the downward pressure on wage demands from unemployment is weak.

Input Prices

Factory gate or wholesale prices in Ireland fell in the year to December 2003 by 9.1 per cent. There had been no rise in wholesale prices in Ireland over the previous three years. A major contributor was a fall of 19 per cent in the price of computers and office machinery, radio, TV and communications equipment (12 per cent) and basic chemicals by 11 per cent. The only real rises were beverages and tobacco where the Government's tax policy of high taxes on goods (and low taxes on corporates and higher incomes) had the main impact. Construction materials rose by under 1 per cent in the year and capital goods rose by 1.4 per cent. Energy products rose by 5.4 per cent but petroleum fuels rose by 3.5 per cent, with a rise of over 5 per cent having taken place in December due to the Budget.

Agricultural output prices fell by 1.7 per cent in the year to November 2003. This is not exceptional as agricultural prices have stagnated for many years. Indeed output prices are 10 per cent below the levels in 1995. This indicates that the cost of many food items are stable and should not impact on the CPI.

The overall fall in factory gate prices and wholesale agricultural prices will help reduce consumer prices, i.e. the CPI over time. There is a time lag and there may be profiteering between the transmission of these prices into the CPI. On the other hand, however, the proportion of the factory gate price in the final consumer goods is often small and so a fall in its price may have little impact on consumer prices.

The prices of commodities internationally are rising in Dollar terms which is good for some industries like mining (Arcon, Tara and Lisheen), but with the fall in the Dollar, the rise in Euro is mitigated.

House Prices and Inflation

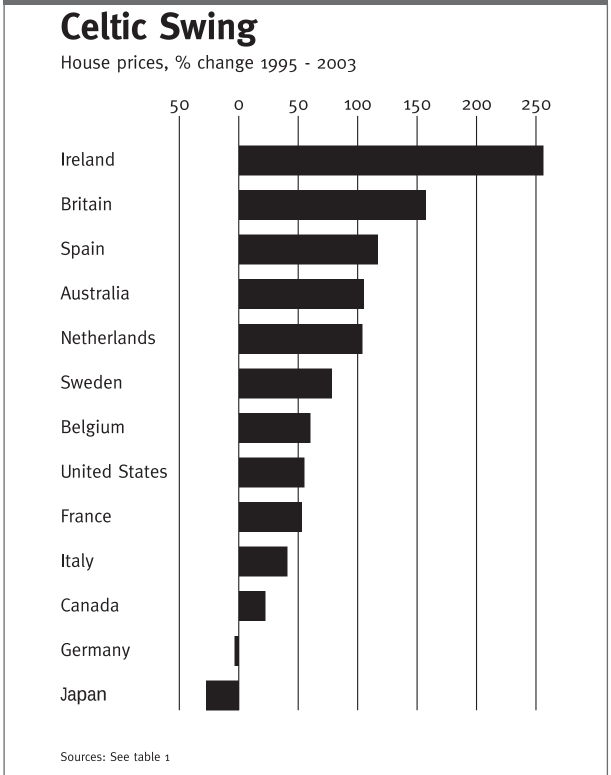
Irish inflation figures do not include the rise in the prices of assets. The high price of houses does however, translate into pressure on consumer prices through demands for wage increases. The CSO's CPI does measure the rise in the price of interest on mortgages, or the fall as it has been in recent times (HICP does not include interest). Many are critical of the exclusion of house prices from the inflation data, but it would greatly distort price measures meant if capital spending as well as current items were included. There has been much debate over this and economists are agreed that it would not be possible to include asset price movement in the Consumer Price Index.

There are many other measurements of price rises in addition to the CPI and HICP, the main measures of consumer prices in Ireland and Europe respectively. These include wholesale prices, agricultural prices, land prices and manufacturing prices as well as movements in earnings in different sectors. It is also valid to measure house price rises (as capital appreciation) and the Department of the Environment has monitored prices nationally, regionally and by type of dwelling for many years. More recently, Permanent TSB had established an index of house prices. The level of asset prices, of house prices in Ireland has risen so rapidly in the past decade that even if there were a slowdown, the prices are already so high that they will continue to be a cause of concern for many people. There is a measure of the relationship between average earnings, interest rates and house prices and the gap between earnings and asset prices has never been as wide as it is at present.

Chart 2 shows (see page 13) that the price of Irish houses has tripled since 1995. Price rises have been far ahead of any other country, including even the UK. While house prices have more than doubled in UK, Spain and Australia and Netherlands since 1995, they have tripled in Ireland. The Economist considered Ireland to be one of 6 countries where house prices are "dangerously overvalued." As almost one-third of new houses built since 1996 have been second homes/investments and as rents are falling, there could be a fall in prices, particularly if interest rates

Chart 2

Ireland - Most Rapid House Price Inflation in the Industrialised World



Source: Economist 3 January 2004

were to rise. If the fall is substantial, it could impact on the rest of the economy.

Housing Wealth and Consumption

There is a strong correlation between consumer spending and housing wealth. The rise in house prices in several countries has been the driving force behind consumer demand. In the US, the collapse in the stock market with the bursting of the technology bubble did not impact adversely on the economy because consumers still continued to spend, confident in their housing wealth. In most developed countries, households have twice as much of their wealth tied up in housing as in shares. The importance of the wealth effect is probably the reason why the Governor of the European Central Bank, M. Tricet called for European consumers "to spend more", in February.

House prices have soared in Ireland as Chart 2 above shows. No country has had such house price inflation. What is certain is that continued rapid rises in house prices will not continue in Ireland, not just because of the extent of Irish house price inflation, but because demand is now meeting supply and rents are falling. Whether there will be a housing crash in Ireland is a matter of opinion. The dominant opinion, of the many involved in real estate and their huge influence on newspaper editorial opinions is that the boom will continue indefinitely. But a crash cannot be ruled out. What is certain is that it would have a profound negative impact on the economy, depending on how far prices fell.

A sustained 10 per cent drop in housing wealth would reduce consumption by over 1 per cent in the UK, according to the OECD.[10] It could have a slightly larger impact in Ireland because of the more rapid prices rises and the ratio of value to disposable income. A UK study found that "changes in real house prices are highly correlated with changes in private consumption, more so in fact than the change in real personal disposable income", in Ireland, the UK and Nordic countries.[11] What this is suggesting is that a major fall in house prices would have bigger impact on personal spending than a fall in real disposable income. In turn this impacts on economic growth. A rapid rise in interest rates would impact on those with large mortgages, but they are a small proportion of the total with borrowings.

A staggering 67,000 new houses were built in Ireland last year, a massive 157 per cent more than ten years ago. For many years the number of new houses was around the early to mid 20,000s. Last year's completion was far higher than most forecasts and while the number will fall somewhat this year, supply is meeting demand and this is reflected in falling rents. Furthermore a high proportion of houses/apartments are investments and the fall in rents and termination of tax breaks to investors (postponed, again), could lead to many sales. Provided it is not a stampede, its impact on the total housing market will be limited. This means that the important housing wealth effect will not materially alter its consequent impact on consumer spending. This is a difficult area to predict, but it is one with which one should be at least familiar.

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[10] OECD, ibid, p19.

[11] OECD, ibid quoting from Housing Consumption and EMU, HM Treasury, June 2003, London.

The Threat of Deflation

Most people expect prices always to rise. A 60 year American has seen prices rise by 1000% in her lifetime.[12] Until the 1940s prices were as likely to fall as to rise, but there has been deflation or falling prices in some economies in recent years. The overall fall in prices internationally to low single figures has led to speculation as to whether there may be deflation. Deflation or rapidly falling prices can lead to economic instability. Worldwide prices have been falling to low single digit figures in the past few years. Even prices in South America have been falling fast, as Appendix 1 shows for a few countries. It has two countries with deflation or falling prices, but a draft a month ago had four countries with falling prices.

A prolonged period of falling prices or deflation is far more detrimental than inflation, though productivity-driven deflation, with prices pushed lower by technology is good for economies and consumers. A sharp fall in demand and excess capacity can be very dangerous. If consumers expect prices to fall, they delay spending, which force prices down further, leading to stagnation. A low rise in prices lubricates an economy.

Deflation has not been a consideration in Ireland where the rise on consumer prices had been double the average in Europe for five years. There has been continuous deflation in Japan for many years. The rate of price decrease had been reduced but prices fell by 0.3 per cent annually, in early 2004. Prices also fell in two other countries – Hong Kong by -1.5 per cent and in Israel by -2.3 per cent in the last year and did not move in Taiwan.

The OECD forecast continuing deflation in Japan for this and next years of 0.2 per cent. The Bank of Japan is pursuing a policy of "quantitative easing". It cannot lower the price of money any further—nominal interest rates are already at zero—so it has boosted the quantity of money in the economy instead. It appears as if Japan is coming out of its long deflationary period and China had a rate of inflation of 3.2 per cent in January, ending five years of price deflation, led by rising domestic food prices and a surge in demand for raw materials. China, which provides half of the coke traded in the world, is curbing exports due to surging demand. This will push up its price. Speculators have moved into commodities, including oil, gold, silver, platinum and even soybean oil.[13]

While it is unlikely that there will be deflation in Ireland, there are two factors which could impact. First is rising oil prices and the second is a collapse in the housing market. Oil prices were low for many years until 2000 and while they have risen in recent times, the fall in the Dollar, in which oil is still priced, cushioned the rise. A rough rule of thumb is that a 10 per cent rise in oil prices pushes up the CPI by one fifth of a per cent. Morgan Stanley[14] believed that a rapid rise on oil prices would spell deflation for Europe, because the Euro would fall by 2-3 cents with each 10 per cent rise in oil. But with the twin deficits in the US, this has not occurred. In fact, the Dollar has fallen substantially. Thus it is unlikely that even if there is a rapid escalation in oil prices, it would trigger deflation, but rather it would boost inflation.

The issue of a house price collapse which was dealt with above, would impact on the economy as a whole, if it were large and could cause many domestic prices to fall, but as Ireland is generally a price-taker, this is unlikely to generate serious deflation. The real threat to deflation, is international and it now appears highly unlikely.

Yet it should be noted that some prices have been falling for some years, masking the rise in other prices, for example, the 11 per cent rise in utilities and local charges in 2003 compared to the overall rise of 1.9 per cent. The price of clothing has fallen by 30 per cent since the end of 1996 (though some economists would question the exact accuracy of this figure). The other big category fall has been in communications which dropped by 20 per cent- while average prices rose by 26.5 per cent in this period.

The threat of deflation is lower because services are a larger proportion of the economy and the prices of services are more resistant to fall than prices of goods because they are more labour-

[12] Economist 18 February, 1999.

[13] Financial Times, 2 March 2004.

[14] Morgan Stanley, 2002, Oil Matter fro Europe, Joachim Fels, morganstanley.com.

intensive and wages seldom fall. The immediate threat is less now than it was a year ago because commodity prices are rising and upward because of the price movements in Japan and China.

The International Recovery

The international recovery is well established and all forecasts for the next year are bullish, holding that the recovery will gain momentum. The OECD Economic Outlook forecasts growth of 3 per cent for the OECD area in 2004, which is almost twice the level achieved in 2000-03. The US, in spite of its twin deficits (on trade and runaway government spending) is performing extremely well, boosted by the fall in the Dollar and will grow by 4 per cent this and next year. The Eurozone will see growth of 1.8 per cent in 2004 and 2.5 per cent in 2005, according to the OECD. The growth in Ireland's main trading partners will help Irish trade.

The OECD predicts growth of Irish GDP of 3.5 per cent, which is similar to the Department of Finance and Central Bank. In the booming 1990s, our trading partners were performing as well as this year but our growth will not match this because of the fall in the dollar, the smaller number of new labour force participants and continuing infrastructural problems etc.

Many economists argue that Europe is bearing the impact of the US twin deficits (the soaring budget deficit, as Bush spends like a drunken sailor and cuts taxes for the rich and the huge trade deficit, as America's imports soared). The Euro floats but many Asian countries, including China, have tied their currency to the Dollar. Asian countries hold most of their foreign currency reserves in Dollars. They are willing to buy both US bonds and Dollars and so prop up the huge borrowing of the US government and households. These are staggering sums amounting to 2.3 per cent of world GDP or 4.5 per cent of US GDP and most are invested in the US. Martin Wolf, the Financial Times conservative, but astute, economic correspondent called this:

> *"the biggest "aid" program of all time relative to global GDP. It has allowed the US to enjoy **both guns and butter**, without choosing between the two."*[15]

This had meant members of the Eurozone, where the currency floats freely, have suffered from weak domestic demand and falling competitiveness. As the US is keen to build its links with China, it is unlikely to take action by printing Dollars or imposing barriers against Asian countries. Europe could help itself to some degree by reducing interest rates, but the ECB's obsession with inflation control make this unlikely. The rise in economic activity generally does feed into prices. The transmission of economic activity into inflation depends on many variables. A rise in the Dollar would increase prices. BMW, one of Europe's biggest currency hedgers, stopped hedging. It believes that the current value of the Dollar is $1.10 against $1.22 on the day it stopped hedging on 17th March 2004.

ECB Focuses Too Much on Inflation

The main focus of the EU is on inflation. It is not interested in the broader economic picture. Its target is to keep inflation in the Euro area below 2 per cent. Many critics have argued that the ECB has been too slow to cut European interest rates. America's Federal Reserve has cut American rates by twice as much as the ECB over the past three years. Many hold that the ceiling of the ECB's inflation target, of less than 2 per cent, is too low. If the ECB had a higher target, in line with most other central banks, it could have cut interest rates by far more. In reality, the ECB has not pursued its policy too rigorously. For example, during the past three years inflation has been below 2 per cent in only five months. Yet the Euro area's slow growth demonstrates that interest rates have been too high. The ECB's mandate should be broadened to include employment and social areas as well as its monetary role.

[15] Martin Wolf, Financial Times, 11 February, 2004.

Table 10. Everybody's Forecast

	2003	2004	2005	2006
ESRI	3.5	2.2	3.2*	
Central Bank	3.5	2.3	n.a	
OECD (HICP)	4.1	2.8	3.1	
EU (HICP)	4.1	3.0	2.7	
Dept Finance Budget (G&SP)	3.5	2.5	2.5	2.4
Davy Stockbrokers (Bank of Ireland)	3.5	1.3	n/a	

*MTR - adjusted forecast.

N.B. Both the ESRI and CB will be making forecasts in the last week in March 2004 which will include 2005.

The outturn for 2003 was an average of 3.5 per cent., down from 4.6, 4.9 and 5.6 in previous years.

The Soothsayer's Forecasts

In summary, the economists' CPI (or HICP) forecasts for inflation average are as above in Table 10.

It appears that an average of forecasters predict that inflation would be around 2.3 per cent this year. If there is a pay agreement for 18 months and for some it begins in mid-year, then the rise in prices in 2004 is important. The consensus from these bodies is that prices are falling and the average CPI will be from an extremely low 1.3 to 3.0 per cent in 2004.

The Outlook for 2004 and 2005

This Year, 2004, the Economy Looks Brighter

The past two years have not been good news for the Irish economy, with near zero economic growth, a rise in unemployment, low private investment, higher prices and a return to Exchequer deficits. However, the prospects for 2004 are much better.

- The US economy is picking up and the recovery is firm
- Asia is recovering strongly
- Japan is also recovering with GDP growth of 2 per cent
- The Euro area is making a tentative recovery
- The UK economy is performing well with strong consumer demand
- Consumer and business confidence is strong in Ireland and in most of Europe (except Germany)
- Government's finances are in good order, with low national debt and a manageable, modest deficit
- Ireland's GNP will be around 3 to 3.5 per cent, up on under 3 per cent last year

Inflation Outlook

The high rate of inflation in Ireland is falling and is now close to the EU average of 2 per cent. It is likely that inflation will fall further this year and will average between 2.0 and 2.5 per cent for the year.

There is a lag between expectations and price movements.

- As workers are used to price rises of close to 5 per cent (the average was 4.7 per cent for the past four years - 2000-2003 inclusive), now that they have fallen to below 2 per cent, has not registered with many people.
- People are afraid that price rises will not continue to be low. They have no guarantee.
- Workers, as consumers, are aware that price levels in Ireland are higher than in other countries and feel that they should be compensated for this.
- Soaring house prices in Ireland dominate the thinking of many.

- Commodity prices, a leading economic indicator, are rising rapidly.

The reasons for lower inflation in 2004 include the rise in the Euro and core services inflation, which only a short time ago, in Q1, 2002 was running at 9 per cent, is now down to just 3 per cent. Services' inflation was a major driver of the high prices. The fall in core services inflation would have been higher had it not been for many rises in administered services. There is actually disinflation or falling prices in some private services, though, on the other hand, administered services (stealth taxes) are rising rapidly as government agencies sanction rapid price rises "to encourage competition,[16]" allow charging where goods or services were "free" that is, mainly paid from direct taxes,[17] and allowing charges to substitute for taxes (again water and refuse charges – to a limited degree). Lower interest rates on mortgages also contributed to the reduced services inflation.

Inflation in the Euro area is expected to be below 2 per cent in the course of 2004 and to remain at levels within price stability thereafter, according to the ECB. Its survey of professional forecasters for Euro area inflation in 2004 and 2005 in the first quarter of 2004 gave a consensus of 1.8 and 1.7 per cent for each year, respectively, with 1.8 per cent in the longer term (to 2008)[18]. But it admits this is "subject to considerable uncertainty". There is even a forecast, by Consensus Economics, of an average rate of 1.8 per cent for the period 2009-13!

High Price Levels and the Government's Role

Price levels in Ireland are estimated to be about 14 per cent higher than in most European countries. The surge in prices in recent years has been boosted by high indirect taxes imposed by government as part of their low direct taxes policy, combined with high administered tax rises. The government policy of privatisation and of encouraging state agencies like local authorities to charge for services will continue to push up prices for many years to come. It has been seen that the rise in these charges was a very high 25.7 per cent in the year to December 2003, compared to an overall rise of 1.9 per cent.

As inflation falls, the government can push up prices very rapidly if it so chooses. While it can also allow prices to rise for administered services, it has less say in this area. While Congress had sought assurances from the Minister for Finance on keeping indirect taxes and prices of administered goods and services down for the duration of the next agreement, his ability to keep the lid on the latter is very limited, particularly in the current environment of raised charges for public and other services. If he were successful in keeping such prices down for the duration of the agreement, it might backfire, if at the end there was an explosion of increases. But if the effort did keep inflation low, then there would be no case for consequent higher prices.

Conclusion

The main determinant of inflation in a small open economy like Ireland is external. In the long run, a small open economy cannot sustain inflation at more than 0.5 per cent above its main trading partners. Therefore, the role of government in maintaining an anti-inflationary environment is vital. It is the government which is the major player in this area. Other factors, including the social partners, can impact on prices, but only in temporary and less significant ways.

A major pressure point on trade unions is that when it comes to inflation, expectations lag behind developments. Members will expect pay rises to compensate them for the higher inflation of recent years when it averaged 4.7 per cent. Yet it fell to under 2 per cent in January 2004. Even if we were to expect inflation to continue to fall, members' expectations lag. There is the uncertainty that the fall in prices may not continue. The role of government in this area is fundamental. It has played a major role in keeping expectations high. It has been a key driver in

16 (for example, in the electricity market – big profits could, attract in competitors to the ESB, though utility experts doubt this simplistic market model)

17 Water, refuse, tolls, street parking, telephone enquiries.

18 ECB Monthly Bulletin February 2004. 22nd Survey of Professional Forecasters.

inflation over the past five years and it continues to benefit from Ireland's high price levels, even after rises in taxes wash out from the figures. Government could reduce inflation substantially by reducing the rate of VAT, from 21 per cent to the rate in the UK, 17.5 per cent. This appears to be unlikely. This reduction would reduce inflation by 1.6 per cent in a year which would eliminate it for the year.

However, it is important for the trade unions that the government gives the social partners a guarantee that over the next two Budgets, for the life of the next pay agreement under Sustaining Progress, it will not push up prices by increases in indirect taxes. Further it must state that it will actively discourage price rises in "stealth taxes" or administered taxes, where government and its agencies do have a major influence, as part of its Anti-Inflation Initiative.

Congress wrote to the Minister for Finance, seeking assurances on government policy on indirect taxes and administered prices over the next two Budgets. As inflation appears to be falling, any rise in indirect taxes and administered taxes will have a more disproportionate impact on prices than when the CPI was high. If inflation does fall further, then the role of government assumes greater importance in determining the level of price rises than in the past. The response was that the government policy is to allow taxpayers keep more of their earnings in their pockets, but when they spend it, indirect taxation would have to be maintained to fund public services. Rises in administered prices were a response to rising costs, including wages and were outside the Minister's area of responsibility, the Minister for Finance stated.

This is an area on which Congress, indeed the social partners, must get greater clarity. The government has signed up to an Anti-Inflationary Strategy yet it is the main contributor to Ireland's high price rises over the past four years. In the long run, Irish price movements have to follow those in the Eurozone closely. We can have a period when prices are somewhat higher, but it cannot be maintained at any more than 0.5 per cent over time. This means that a rapid rise in wages cannot be sustained over time because it would lead to pressure on trading companies which would, in turn, be unable to recoup costs as they escalate.

A leading indicator of future price trends over the long term is the price of commodities. While this is probably less true than in the past because of substitution and the growth of services in the economy, the steady rise in commodity prices over the past few years, in Euro terms, does indicate price pressure in the longer term. The huge demand from the booming Chinese economy is driving much of the rising prices of raw materials.

Consumer prices in Ireland are falling and will average 2.0 to 2.5 per cent in 2004. While most forecasters were predicting a rise or around 2.9 per cent some months ago, it is likely that they will reduce this. Yet, as stated at the beginning, it is impossible to forecast the future. The rise in commodity prices, a further rise in the Dollar (on the past month or so) means that there is no certainty that Irish prices can remain as low in 2004 as they began the year. Further, policy-induced price rises have not been ruled out by government and they could suddenly emerge. With the shift to more user charges and rapidly rising user charges, there will be pressure on consumer prices and these can have a disproportionate impact, as inflation falls. Soaring house price inflation stirs the expectations of many members, regardless of assets not being included in the CPI. Trade union members are supremely aware that Irish price levels are higher than average prices in Europe. Finally, as inflation averaged 4.7 per cent over the past four years, the expectations of trade union members are lagging and the lack of certainty on the future means that most trade union members cannot be confident that inflation will remain as low as 2 to 2.5 per cent for the term of the next agreement.

Paul Sweeney
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Congress
April 2004

Appendix 1

Annual Changes in Consumer Prices Europe and Selected Countries January 2004 (CPI and HICP)

Austria	1.1*
Belgium	1.7
Finland	1.2
France	2.4
Germany	1.1
Greece	3.1
Ireland	2.9*
Italy	2.5
Luxembourg	2.4
Netherlands	1.6
Portugal	2.3
Spain	2.7
Denmark	1.2
Sweden	1.8
UK	1.3
EU 15	1.8
US	1.9
Switzerland	0.1
Poland	1.7
Russia	11.4
Australia	2.4
Japan	-0.3
China	3.2
Hong Kong	-1.5
Taiwan	0.0
India	4.3
Singapore	1.3
South Korea	3.3
Argentina	2.2
Chile	0.8
Venezuela	21.9
Brazil	7.7
Mexico	4.2

Sources: CSO and Economist.

*HICP for December 2003 for EU states.

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