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Irish Experience – Inflation under the Conditions of a Single European Currency

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Irish inflation is faster than that in the average of the Euro-zone, and may still be accelerating. On this basis, the European Commission made critical remarks to the Irish government, and formally proposed the Council of Ministers to follow suit. The Irish economy is certainly overheated, and may tend to become more so. However, it would be difficult to argue that this hurts anybody else than the Irish themselves. Dampening inflation is a rather complicated task if monetary policy measures are not available.

Sensitive EC reaction to an Irish internal problem

The faster Irish inflation does not violate any inflation-restricting agreement – there is no such agreement within the European Union. The "Stability and Growth Pact", which substitutes for the Maastricht accession criteria with respect to behavioural rules for Euroland countries' macroeconomic policies, does not include any such commitment. However, member countries themselves have to elaborate their own economic policy programmes, and submit them to the community. Regulation 1466/97, which entered into force on 1 July 1998, outlines the necessary provisions for reinforcing multilateral surveillance as outlined by Article 103 of the Treaty. Euro-zone countries must produce a Stability Programme, which has to be reviewed on an annual basis. Ireland's Programme foresaw a price increase in HICP (harmonised index of consumer prices) of 3.1%, with the actual outcome (average for 2000) being 5.6% (but the end-year rate was 7%). The Commission has to make a formal Recommendation to the Council on the details of each programme. The Council of Ministers must adopt an official Opinion on how countries intend to meet the objectives of the programme (instead of just general Conclusions). If the Council considers that the contents of the programme are unsuitable, it can ask the country in question to make a number of amendments.

It is questionable on several counts whether the Commission or the Council had, any real reason to criticise Ireland or another similarly small country possibly facing such developments in the future.

Cautious analysis may suggest that first glance inflation differences hide quite various things. In the given case, the difference between headline inflation rates (eurozone total – Ireland) is 3 ¼ %, which – following the argument of Mr Padraig McGowan, Director General of the Central Bank of Ireland – may be decomposed as follows.

HICP - Ireland	6%
HICP - euro area	2¾%
Inflation Differential	3¼%
of which:	
Price Level Convergence	1%
Larger Effective Exchange Rate Effect	½%
Indirect Tax Effect	¾%
Excess Domestic Inflation	1%

"Indirect tax effect" refers to the price raising impact of the increase of indirect taxes in Ireland, which entailed an inflation surplus of ¾%. "Larger effective exchange rate effect" means that the greater exposure of the Irish economy (via extra-Euroland trade, mainly with the UK and the US) to non-euro currencies accounts for around ½ of a percentage point of the inflation difference. „Price level convergence" refers to the Balassa-Samuelson effect: productivity increases are faster in the internationally traded sector relative to the non-traded sector (mainly services), but wages increase in parallel in both, pushing up prices in the non-traded sector. (Of course, the latter mechanism works everywhere, not only in Ireland. It can and does result in surplus inflation in Ireland as against Euroland average because GNP and thus productivity growth in the Republic of Ireland is extremely fast (see Table 1)).

In principle, only the remaining one percentage point inflation difference is the Irish government's "sin", the consequence of inflationary pressure in Ireland – this is suggested by McGowan's analysis. Let me remark that this is to some extent debatable. It can be argued, e. g., that under less expansionary economic policies the increases of indirect taxes could only partly be passed on to consumer prices: partly they should reduce enterprise profits. This implies that the government's "sin" is bigger. What remains doubtful, however, is whether that actually is a sin with respect to the euro, or Euroland.

If inflation happened to accelerate in a big country within Euroland, representing a significant share of Euroland's economy, that would clearly be a problem also for the others, not only for that country. Let us imagine, e. g., that inflation accelerates in France. Let us also suppose that the EUR/USD nominal exchange rate does not change (and, for the sake of simplicity, that there is no other currency in the world, or all of them are pegged to, or otherwise move together with the USD). Then the Euro would appreciate in the real sense relatively significantly. This (real) appreciation is only another expression of accelerated inflation in a rather large part of the Euroland economy. And this appreciation would also tend to further increase relatively rapidly (because France's share in intra-Euroland trade is big, and this share of the trade would push prices upward in other, otherwise low-inflation parts of Euroland). Thus, France's accelerated inflation would exert upward pressure on inflation and generate devaluation expectations in Euroland, with all the well-known consequences of these phenomena (most importantly, an upward pressure on interest rates).

Now, if inflation accelerates only in the tiny Irish Republic, rather than in France, consequences for Euroland will be the same – with one important difference: that their size will be negligible. In other words, the Irish Republic's inflation harms nobody.

Except for Ireland itself. The trouble for that country is bigger than would be, ceteris paribus, for a country having a separate currency, since the weapon of devaluation is not available for the Irish government now. It cannot eliminate the real exchange rate consequences (appreciation) of the faster inflation with devaluation. Whether the availability of the devaluation weapon (and thus the possession of a separate currency) is good or bad is a hotly debated question between Keynesians and monetarists. The lack of this weapon in principle deters governments from maintaining inflationary policies – this is good to the extent to which it is true. However, if once the inflation is there then it is not extremely Keynesian to say – even economist moderately leaning towards monetarist views will agree - that devaluation is a less bad accommodation than deflation.

On the other hand, for other countries of Euroland the faster Iris inflation is good, rather than bad. It is, with fast increasing nominal wages (in the same currency), the way towards the reduction of the extraordinary Irish competitiveness.

Thus, as The Economist remarks in explaining the Commission's criticism addressed to Ireland, "Some officials argue that if Ireland's sins are ignored, then it will not be possible to chase bigger countries' sins when they really matter."

A further interesting particularity of the accelerated Irish inflation is the very strong growth of real estate prices and rents, see Table II. This is not surprising. Immigration pushes up the population, income growth pushes up per capita demand for real estate. The reduction of interest rates that took place before and with the introduction of the euro also pushed up real estate demand and prices. At the same time, the supply side reaction to the demand upsurge has been rather sluggish. Of course, these trends on the Irish real estate markets are again problems for the Irish themselves, not really bothering others in Euroland.

Fiscal policies, politics and inflation

One way of dampening inflation, unavailable now in the Republic of Ireland, is restrictive monetary policy. Alternatives to that might in principle include structural measures – e. g., the reduction of labour market rigidities. Not really now in Ireland, where unemployment has dropped to an "American" 4% level. It is hard to imagine any other way of dampening inflation than increased budgetary austerity that – in accordance with McGowan's view – may also be complemented by incomes policy.

However, budgetary austerity is not an easy way to take. In 2000, Ireland had a fiscal surplus of approximately 3.7% of GDP. And should this be further tightened!? Next year's budget does not foresee that. On the contrary, the surplus will be reduced, although not very significantly: to 3.3%). This means some further tax reductions, following expenditure increases and tax cuts a year earlier. The latter tax cuts were introduced in the framework of the country's Programme for Prosperity and Fairness, meant to repeat a successful formula, pioneered in 1987, by which tax cuts were traded for low nominal increases in pay, both to maintain competitiveness and to bolster workers' real take-home pay. But in 2000, quite unexpectedly, it did not work: tax reductions were followed by wage increases.

Rapid growth and rapidly improving standards of living did not lead to general satisfaction and social quietness (they seldom do, think, e. g., of Poland in the last decade). The government's relations with public sector trade unions are tense, and it may be rather difficult to "sell" them a budget, which – instead of the 3 percent of GDP deficit, as allowed by the Growth and Stability Pact – contains a surplus even bigger than that. Obviously, if Ireland had a monetary policy at its disposal, it should use that against the danger of overheating in its economy.

In the final analysis, the lack of availability of monetary instruments causes rigidity in macroeconomic policy – a deficient control over inflation.

Let me remark that the difficulty might be worse. Conditions in Ireland are particular since, after a long period of rapid growth, the problem for the government – and for the political process – is how to spend (or maybe not spend) the new increments of budgetary revenues. If, after less bright years, expenditure cuts and/or incremental taxes had to be "distributed", that might be even more difficult politically, and might also meet legal difficulties: entitlements are often set for longer periods. Euroland countries may face such situations in the future.

Of course, in the future the macroeconomic puzzle may also appear in one or another (or several) Euroland country(ies) the other way around. Namely, the need for loosening, rather than tightening, may emerge. Then governments, not possessing the tools of monetary policy, will only be able to loosen their fiscal policies. That may seem a rather attractive necessity. However, even that is not so simple. Rapid action in this field is hardly possible. Fiscal measures usually require lengthy preparations, including negotiations and decisions that are submitted to complicated rules (consultation with social partners, decisions at different levels of government, parliamentary approval) – a nightmare of time lost, as compared to the simplicity and fastness of taking measures of monetary policy. And as time passes, the macroeconomic situation usually changes. Thus sooner or later – sometimes not much later than when it is finally introduced – the fiscal loosening may have to be withdrawn. I. e., the agreeable measures may lead to the need of difficult and disagreeable measures.

Sources

Ireland's risky budget, The Economist, December 16 2000.

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Padraig McGowan, Ireland - Experiences in EMU, http://www.bis.org/, Bank for International Settlements, Basel, 2001.

Ireland: Commission Says 2001 Budget Plans Are out of Step With Stability Pact, European Report, Jan 27, 2001 p225

Table 1. Recent Indicators of Ireland's Economic Performance

Recent Indicators of Economic Performance[a]

	1994	1995	1996	1997	1998	1999	2000 (f)[c]
GNP	6.3	8.2	7.4	9.3	7.8	7.8	8 1/2
GNP per capita	6.0	7.7	6.6	8.3	6.6	6.7	7 1/4
Employment[b]	3.2	5.0	3.6	3.9	6.8	6.3	4 3/4
Unemployment[b]	14.7	12.2	11.9	10.3	7.8	5.6	4 1/2
Inflation (CPI)	2.4	2.5	1.6	1.5	2.4	1.6	5 1/2
Exports/GNP	78.8	86.3	87.6	90.7	98.9	102.4	107.0
General Gov. Balance	- 2.0	- 2.2	- 0.2	0.7	2.1	1.9	3.7
Revenue/GDP	40.1	37.4	37.8	36.9	36.0	36.2	35.2
Expenditure/GDP	42.1	39.7	38.0	36.2	33.9	34.3	31.5

(a) Growth rates, except unemployment (rate) and Government balance (percentage of GDP).
(b) As at April of each year, except for 1999 and 2000 which are averages of quarterly data.
(c) Central Bank of Ireland forecasts (Autumn 2000)

Table 2. Irish property prices and rents

Property Prices: Annual Percentage Increases

	Residential[a]	Commercial[b]	Rents[c]
1994	4.1	7.6	2.3
1995	7.2	4.2	1.8
1996	11.8	11.1	8.2
1997	17.2	17.0	10.6
1998	22.6	32.1	14.6
1999	18.5	23.8	16.1
2000[d]	13.9	21.6	16.2

(a) Department of Environment and Local Government, National New House Prices.
(b) Jones Lang LaSalle, Capital Values.
(c) Jones Lang LaSalle, Rental Value for Irish Commercial Property.
(d) Jan. – Sept. 2000, year-on-year.

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