Discussion Paper on Inflation

Prepared for the National Competitiveness Council

by
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1. What is the issue?

Inflation is an increase in the price of goods and services in the economy. Measured in terms of movement in the consumer price index in Ireland, inflation is now running at an annual rate of 6.8 per cent. This is a significant rate of inflation, far above that of other European countries. The average rate in the EU is only 2.5 per cent.

Inflation at this level represents a marked departure from the kinds of inflation rates seen in Ireland in recent years. The period of macroeconomic stability leading into Ireland's entry to Economic and Monetary Union (EMU) had seen rates at low levels of around 2 per cent, well within the range needed to qualify for EMU membership and to provide a stable basis for growth in the economy. Only by looking back to the 1980s, to the periods of high unemployment and mounting national debt, can inflation rates higher than the current ones be found.

2. Why is it important for competitiveness?

Inflation is important for competitiveness for the following reasons:

- Increases in the price of goods and services in Ireland relative to other countries in the EU reduce the ability of Irish companies to compete in export and domestic markets
- Increases in prices also reduce the relative attractiveness of Ireland as an investment location for foreign companies, and foreign direct investment has been the principal driver of growth in Ireland's economy
- Accelerating inflation reduces the certainty for businesses in their investment and operational decisions, thus reducing confidence and diminishing prospects for innovation growth in the future
- Inflation may disguise inefficiencies and thus reduce pressures for productivity improvements
- Inflation also complicates and can undermine Government economic strategy, both in the fiscal field and with regard to investment
- Inflation reduces the purchasing power and the relative living standards of those on fixed incomes or those dependent on state benefits, further disadvantaging those already in lower income categories, since their incomes will not be adjusted or will be increased only in retrospect
- Inflation creates upward pressure on wages and salaries to compensate for the loss in purchasing power, further adding to business costs
- Inflation in Ireland has begun to militate against the achievements of social partnership, which has been up till now a key component of Ireland's competitiveness

Causes of Inflation

The present increases in inflation have a number of causes, both short-term and structural.

The *short-term causes* include the following:

- Strength of the US dollar: the sustained appreciation of the dollar relative to the euro has increased many import costs, feeding into the overall inflation
- Strength of sterling: appreciation with respect to the euro has also contributed to inflation because of our high import dependency on the UK
- Oil price increases: the present levels of world oil prices have affected business costs and consumer costs directly
- Increases in taxation: one-off increases in tobacco duties in the March budget have fed into the consumer price index and, because of their size, had a significant effect initially

The *structural causes* include the following

- **Labour and skills shortages**: with economic success, unemployment has fallen dramatically, from 12.8 per cent as recently as 1996 to as little as 4.3 per cent currently. This has resulted in labour and skills shortages across all sectors, pushing up wages and salaries, resulting both in higher business costs and in higher consumer demand for non-traded goods
- **Housing shortages**: Because of shortages of serviced building land, planning delays, and a growing concentration of economic activity in the Eastern region, house prices have increased rapidly, putting upward pressure on wages and downward pressure on labour supply. These in turn result in increases in rents and in mortgage costs, which are reflected in the consumer price index.
- **Traffic congestion**: this is adding especially to business costs by reducing delivery possibilities and productivity, and also because of the lower frequency of deliveries, leading to higher inventories and militating against efficient production management
- **Public transport inadequacies**: these lead to increased traffic congestion, increased dependence on private cars, increased oil imports, intensified housing shortages, and reduced labour market flexibility,
- Inadequate **competition in some sectors**: especially in the non-traded sector, there is inadequate competition in some activities that can play a role in keeping prices higher than they should be. Barriers to entry, such as in pubs and pharmacies, result in higher prices.
- Undiversified **imports structure**: Ireland has not yet begun to take full advantage of the euro zone both as a destination for exports and as a source of imports. Heavy dependence on the UK as a source of goods and services means that an increase in the value of sterling feeds directly into inflation. Moreover, lack of choice of sources may result in higher prices.

3. Recent Trends in Inflation

Inflation in Ireland, as measured by the Consumer Price Index, is now growing at an annual rate of 6.8 per cent (October 2000 compared to October 1999). The annual rate has not fallen in any month since July 1999, when it was 1.2 per cent compared with 1.3 per cent in June 1999.

Table 1: Consumer Price Index January-October percentage changes

	All Items	Food	Tobacco	Housing	Transport	Services & Related Expenditure
January	4.0	3.0	17.2	-4.9	7.8	5.8
February	4.3	2.6	17.2	-3.3	7.8	5.8
March	4.6	2.5	17.2	-1.5	9.1	5.8
April	4.9	2.4	15.9	0.0	9.8	6.5
May	5.2	3.1	17.1	4.2	8.4	6.4
June	5.5	3.1	17.5	6.1	9.3	6.7
July	6.2	4.1	17.4	10.6	9.0	6.2
August	6.2	4.3	17.5	11.1	8.1	6.2
September	6.2	4.6	17.4	16.6	7.1	6.2
October	6.8	4.8	17.4	22	8.1	6.8

October 2000 saw increases in the rate of inflation in all categories except alcoholic drink. The largest price increases are seen in the housing sector, where costs are 22 per cent above those in October 1999 (this is illustrated in Table 1 above), reflecting continual difficulties in the housing market. It should be noted however that housing costs had been showing negative inflation in 1999, reflecting falls in mortgage interest rates as a result of the introduction of the euro. Housing in the CPI does not measure the costs of houses directly. The 17.4 per cent in tobacco reflects the increase in duties in the last Budget. It should be noted that if the duties were not further increased in the December Budget, this item would show much lower increases thereafter. The other well above average increase is fuel and light, where the rate of inflation is 12.4 per cent, compared with an annual rate of 9.1 per cent in September.

Of the 6.8 per cent increase, the biggest contribution is made by housing (1.46 percentage points). Housing accounts, therefore, for between a fifth and a quarter of the total inflation. The next largest components are transport and food, each of which contributes 1.14 percentage points.

4. Issues for Competitiveness

The Role of the US dollar

Over the last year, since the launch of the euro, it has been in steady decline against the US dollar, as a consequence of

- scepticism in the markets about the management and direction of the new European single currency
- Continued US export success, especially in high-growth sectors, giving strong growth in the US economy, and increasing its attraction for foreign investment.

The dollar denominates much of world trade and commodity prices, including oil

Use of the United States dollar is by no means confined to trade and investment transactions with the United States. It is widely used for trade between many other regions. For instance, much trade between Europe and Asia is denominated in dollars. Moreover, commodities are usually priced in dollars, so any increases in the dollar relative to the euro brings about an increase in the cost to Ireland of a number of essential raw materials, including oil, minerals and agricultural products that are traded internationally.

Foreign owned companies in Ireland import intermediate goods as inputs

Most business activity in Ireland needs imports. Ireland has one of the highest shares of imports as a percentage of GNP. Even if an individual enterprise does not use imports in its activities directly, it certainly does so indirectly. Imports from the United States and other non-euro areas, such as the sterling area are an important requirement for economic activity. The foreign owned sector in Ireland imports 65 per cent of its turnover. These imports included components, basic chemicals, and other raw materials that are needed for production in Ireland. The foreign-owned sector is in fact more dependent on imports than the Irish-owned sector, which imports only 23 per cent of its turnover. The origin of the imports of the foreign-owned sector has not been measured precisely, but it is safe to assume that a significant proportion of it comes from outside the euro area. In view of the connections of many-foreign owned companies with other worldwide operations of their companies, much of imports come from the United States or Asia.

Euro decline may reduce rate of return on US investment

Increases in the value of the dollar lead to increases in input costs and particularly for foreign-owned companies. This reduces their profitability and thus the rate of return on investment. Up to now, Ireland has been a highly successful location for foreign direct investment. The United States Department of Commerce has consistently reported that the highest returns on US investment abroad are found in Ireland. But such investments are denominated in dollars and the rates of return on them are therefore reduced by a euro decline relative to the dollar. Thus from two points of view the attractiveness of Ireland as an investment location is reduced, both because of inflation itself and because of one of its short-term causes.

Table 2. Exchange rates for the euro 1999-2000

		US dollar	Percentage change	Pound sterling	Percentage change
1999	Quarter 1	1.12		0.69	
	Quarter 2	1.06	-5.8	0.66	-4.2
	Quarter 3	1.05	-0.8	0.65	-0.4
	Quarter 4	1.04	-1.0	0.64	-2.8
2000	Quarter 1	0.99	-5.0	0.61	-3.4
	Quarter 2	0.93	-5.3	0.61	-0.1

Sterling

Because of the weakness of the euro, but also because of good macroeconomic performance in the UK and other factors, sterling has also performed well on international markets. While a much smaller currency than either the dollar or the euro, the close economic ties between Ireland and the UK mean that the strength of sterling has particular importance for Ireland’s economy. On the one hand, Irish exporters, particularly Irish-owned companies are oriented to the UK market, and the decline in the euro has given them significant price advantages, leading to sustained growth and profitability for many. On the other hand, imports from the UK have increased in price, thus contributing to inflation in Ireland. The two effects do not cancel one another out because they are different in nature. Inflation, if left unchecked, will eventually erode any competitive advantage of Irish exporters on the UK market, and leave them badly exposed when the euro recovers and sterling declines. At present sterling is still 22 per cent above its value relative to the euro from a year ago, although it has begun to weaken relative to the dollar.

The euro zone

The significance of the introduction of the euro goes far beyond the currency markets. Although the performance of the euro has been poor against other countries, this should not distract attention from the fact that its introduction represents the completion of the European Single Market. The only remaining barriers for Irish enterprises doing business across the euro zone are language barriers. The euro zone, now including with the addition of Greece a total of twelve countries represents an economy where the proportion of trade to total economic activity is low, and thus the significance of exchange rate fluctuations as they affect the external value of the euro is small. Ireland's position is different because of our openness to international trade and also because the structure of exports is different geographically to that of imports.

Table 3. Trade with the euro zone as percentage of total

	Exports	Imports
Austria	55.6	70.6
Netherlands	64.6	45.6
Italy	43.7	51.0
Belgium/Luxembourg	61.9	59.5
Finland	29.2	35.5
Spain	57.8	56.1
France	48.7	54.5
Germany	42.2	47.3
Ireland	40.0	20.8

Table 3 shows that Ireland's trade relations with other euro zone countries are not typical. Ireland has the second lowest share of exports going to the euro zone, and it has the lowest share of imports coming from the euro zone. Moreover, it has the largest gap between the two shares. Ireland is therefore less cushioned against fluctuations in the external value of the euro than other countries.

Many factors account for this skewed pattern of trade, most notably the closeness of UK markets and suppliers and the pattern of imports of foreign companies located in Ireland. Again, policy has up to now focused on exports, with imports receiving little attention.

The effect of oil price increases

The increase in the price of oil on world markets has had a significant effect on business and on consumer costs. Recent trade figures show growth in all categories of imports in the first eight months of 2000, compared to the same period in 1999. Total merchandise imports grew by 27.6 per cent. However, petroleum and petroleum products grew by 82.8 per cent. This major increase is due mainly to oil price rises, and amounts to an additional cost of about £600 million on an annualised basis.

Table 4. Merchandise Imports (in £'000, current prices)

Imports Increase	Jan-Aug 1999	Jan -Aug 2000	% Growth
Food and live animals	1251.7	1374.9	9.8%
Beverages and tobacco	236.1	250	5.9%
Crude material, inedible, except fuels	344	423.1	23.0%
Mineral fuels, lubricants and related	635.9	1069.9	68.2%
(Petroleum, petroleum products)	492.2	899.8	82.8%
Animal and vegetable oils	72	65.9	-8.5%
Chemicals	2525.2	3245.1	28.5%
Manufactured goods	1941.2	2198.3	13.2%
Machinery and transport equipment	11208.4	14342.4	28.0%

Source: CSO External Trade Nov 2000

Car registration increases

A continuing trend in the Irish economy in recent years has been of steady increases in the numbers of registered private cars. The number grew by fifty per cent between 1991 and 1998. The total consumption of petrol also increased by about the same proportion. However, there is evidence to suggest that lately petrol consumption per registered car is showing significant growth. In 1998, the figure rose by 5.8 per cent, having previously been static or declining for every year since 1992 (as is clearly demonstrated in Table 5 below). While this could be partly explained by more journeys, the likelihood is that traffic congestion is increasing average consumption, thus reversing trends seen earlier in the decade, where a combination of the scrappage scheme as well as high taxation on larger cars had brought about a shift towards more modern fuel-efficient vehicles in the car population. Such trends, unless addressed, mean that the economy will become more directly vulnerable to increases in the world price of oil and thus more likely to undergo inflationary pressures.

Table 5: Petrol consumption and private car registrations

	Total Petrol (litres '000)	Private cars	Petrol per car (litres '000)	Change
1990	1168602	796408	1.47	
1991	1170341	836583	1.40	-4.7%
1992	1239817	858498	1.44	3.2%
1993	1268151	891027	1.42	-1.4%
1994	1327459	939022	1.41	-0.7%
1995	1382766	990384	1.40	-1.2%
1996	1454134	1057383	1.38	-1.5%
1997	1563431	1134429	1.38	0.2%
1998	1745588	1196901	1.46	5.8%
1999	1893726			

Source: Dept of the Environment and Local Government Irish Bulletin of Vehicle and Driver Statistics 1998 and Revenue Commissioners Statistical Report 1999

5. What has been done?

The short-term causes of inflation outlined above (dollar and sterling strength, oil price rises) are essentially exogenous to the Irish economy and not readily amenable to policy action, given their uncertain evolution. Until recently, for instance, it was the weakness of sterling that was regarded as creating difficulties for the enterprise sector. Addressing structural weaknesses in the Irish economy will however go a long way to diminishing the impact of external shocks of this kind.

With respect to the structural causes of inflation, however, a number of policy actions have been taken by Government in recent years in order to address them. The actions include the following:

- **Labour and skills shortages**: Incentives to participate in the labour market were increased in the last Budget, childcare provision is being addressed, additional training and education facilities are being provided, and restrictions on work permits for those from outside the European Economic Area have been eased.
- **Housing shortages**: A series of Government initiatives have been taken following the various Bacon reports in order to curb speculative activity in the housing market, to increase the availability of building land and of affordable housing, and to simplify the planning process and reduce delays in it. As a result there are now some indications that the rate of increase of house prices is falling.

- Traffic **congestion**: Significant investment in road and rail infrastructure is scheduled in the National Development Plan, directed towards easing traffic congestion and encouraging regional development and industrial re-location
- **Public transport inadequacies**: Again, significant investment in public transport is being implemented as part of the National Development Plan, including a comprehensive expansion of the Luas and rail networks in the Dublin region. The taxi market has now been opened to full competition with the removal of barriers to entry.
- **Inadequate competition in some sectors**: Resources for the Competition Authority have been increased and the recommendations of the Competition and Mergers Review Group are being implemented. New oversight bodies for the accountancy profession and to regulate financial services are being established. At the request of the Government, the OECD is undertaking a study of regulatory reform requirements in Ireland
- **Undiversified imports structure**: The expansion of e-business, the target of a number of Government initiatives, will help to diversify both imports and exports. The EMU Business Awareness Campaign, managed by Forfás, has continually emphasized the strategic opportunities for importers as a result of the introduction of the euro.

6. What needs to be done?

The Council has recently made recommendations in a number of areas that affect the structural weaknesses identified that are encouraging inflation. Most recently, the Council has issued a *Statement on Small Business* that highlighted a number of ways in which business costs could be reduced, including in the areas of enhanced competition, regulatory reform, infrastructure, and regional development. In September 2000 the Council also issued a *Statement on Labour Markets and Skills*, which pointed to a range of measures to improve the functioning of the labour market, to increase incentives to women and to older people to re-enter the work force, and to increase the supply of skills from outside the EEA. The Council's *Statement on Regulatory Reform*, issued in July 2000, listed measures to be taken to improve competition in the economy generally, as well as in the transport industries and in business services. Such enhanced competition will lower costs, as has been seen in the telecommunications and in the air transport sectors.

The Council believes that consideration of any changes in taxation should take a broad view of competitiveness and all possible implications should be closely examined. Changes in taxation taken in isolation from other measures might result in an outcome totally at variance with that intended. For instance, if excise duties on petrol were reduced to compensate for an increase in the oil price, there would be no incentive to consumers to alter their pattern of consumption. Similarly, reductions in VAT may reduce the CPI on a once-off basis, but would encourage further consumer spending that would again accelerate inflation, unless the supply constraints were instantly removed.

The structural problems therefore should be the principal areas of concentration. Apart from implementation of the recommendations in these documents, the Council also believes that action in a number of other areas is needed to allay inflation, including the following:

Energy and Transport

1. Energy conservation and the encouragement of alternative energy sources must be given higher priority. As well as helping to meet Ireland's commitments under the Kyoto protocol this will also reduce costs and reduce vulnerability to increases in world oil costs. Incentives to encourage conservation, including the use of new taxes to discourage waste of energy, should be investigated.
2. Improvements in public transport, including its availability, its scale and its quality are urgently needed in order to arrest and reduce the dependence on private cars. Greater numbers using public transport would reduce overall petrol consumption and also reduce congestion, with consequent reductions in business costs.
3. More incentives are needed to encourage people to use public transport, including the introduction of integrated ticketing and discounts, together with road pricing and other forms of taxation to discourage use of private cars.
4. Accelerated improvements are needed in road and rail infrastructure, including the use of turnkey contractors to implement essential projects rapidly.

Competition and Regulation

5. More competition should be encouraged in non-traded sectors, since they also constitute a significant component of the economy as a whole and contribute to costs for both businesses and consumers. Any barriers to entry should be removed and assessment of the degree of competition in individual sub-sectors should be undertaken.

Imports

6. Ireland's imports should be a specific focus of policy, and measures to encourage wider sourcing of imports should be taken. These could include specific support services to encourage imports from the euro zone in co-operation with the export promotion agencies of other euro zone countries
7. The government should support efforts at EU level to encourage the provision of lower cost and easier payments systems for doing business across the euro zone
8. Increasing productivity in enterprises and in the economy as a whole is the best defence against inflationary pressures. Measures to encourage improved productivity should be applied to all sectors. In particular, a new focus on the productivity of the non-traded sector is required.