2003

# Statement on Inflation

May 2003

Forfás

National Competitiveness Council

## 1. An Opportune Time to Focus on Inflation

Reducing inflation and restoring Ireland's international cost competitiveness should become the immediate economic priority for the Irish Government and Social Partners. High inflation in recent years has resulted in average price levels significantly above those of our European competitors. While Ireland cannot, and should not, attempt to compete in global markets on the basis of low prices and wages, the widening gap between prices here and elsewhere in Europe is not justified by higher Irish levels of productivity. Further cost escalation will put at risk employment and growth in many internationally trading sectors of industry, and will undermine the efforts of Ireland's development agencies to grow new high technology industries here. This "competitive disequilibrium" threatens to undermine our internationally traded sectors and will, if left unchecked, adversely affect the economic well-being of the entire country.

The expected fall in the rate of Irish inflation over the remainder of 2003, while welcome, should not lead to complacency. Inflation throughout Europe is falling and will remain well below inflation in Ireland, implying further divergence in Ireland's prices and costs from average EU levels and a deterioration in competitiveness.

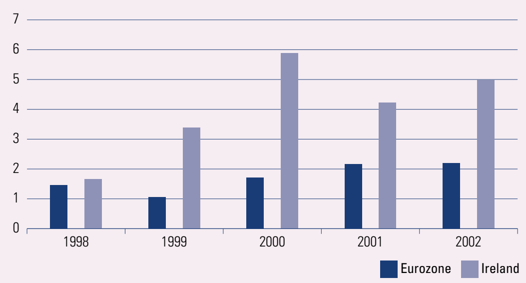
The non-traded services sector has been the primary driver of Ireland's rapid inflation. Price rises in domestic service sectors in recent years were, in part, driven by a benign process of income convergence with other EU states. Of greater impact on prices in the non-traded services sectors however, has been economic overheating, the effects of which have been compounded by restrictions to competition in many service sectors and by expansionary fiscal and monetary policy. Although the recent slowdown in the economy has diminished the underlying drivers of inflation, rapid growth in prices administered by the public sector pushed the headline rate of consumer price inflation to 5.1% in February – a two year high. As a result, high inflation is becoming "embedded" in public expectations, threatening a price-wage spiral which would have damaging consequences for employment and growth. The signing of the new social partnership agreement *Sustaining Progress* was a key first step in minimising some of these risks. Continued efforts to tackle other inflationary pressures will further underpin the objectives of the agreement and put in place the necessary conditions to reinforce Irish competitiveness.

It is difficult for small open economies, particularly those that share a currency with larger regions, to control their rate of price inflation, as this is, to a significant degree, determined by events outside domestic control. Nonetheless, there are domestic solutions to the inflation problem, albeit ones involving difficult choices. Against the backdrop of the anti-inflation initiative announced by Government and the social partners in the latest social partnership agreement, this Statement by the National Competitiveness Council sets out the actions that are required across a range of public policies, in the short, medium and long term, to lower Ireland's inflation rate and reinforce our international competitiveness. The Council recognise that there is no single response to the inflation challenge and attaches equal weight to all of the seven recommendations in the statement. Each must be viewed as part of an all encompassing and over-arching anti-inflationary policy.

## 2. Ireland's Inflation Story

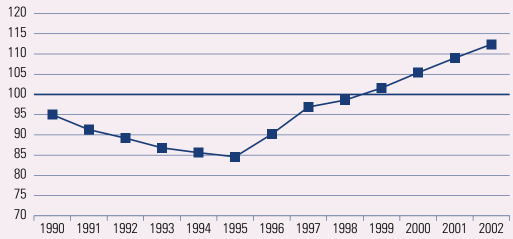
Following a sustained period of low inflation – an annual average of just 2.2% in 1991-98 – Ireland's inflation rate since 1999 has been a multiple of the European average. According to the EU Harmonised Index of Consumer Prices (HICP), prices in Ireland increased by 14.2% compared with an EU-15 increase of 6.6% between December 1999 and December 2002. Despite the recent slowdown in the Irish economy, the inflation differential between Ireland and the rest of the Europe has remained. While average EU consumer price inflation remained subdued at 2.3% in the year to February 2003, inflation in Ireland accelerated to 5.1% over the same period. This year will be the sixth consecutive year in which Irish inflation has exceeded the EU and euro area average.

*Figure 1* **HICP Growth Rates 1998-2002**



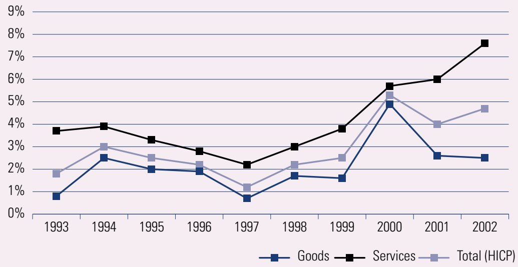

*Source: Ecowin*

*Figure 2* **Irish GDP Price Level relative to euro area average**




*Source: Central Bank of Ireland*

*Figure 3* **Goods and Services Inflation**



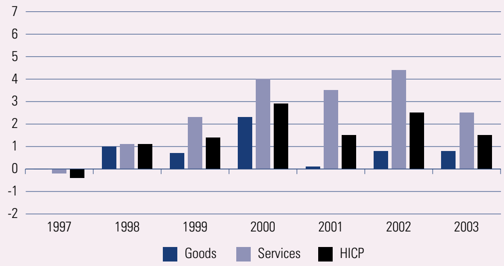

*Source: Central Bank of Ireland*

The cumulative effect of the sustained inflation differential since 1998 has been to increase the general price level in Ireland compared to other European states. According to European Commission estimates, the price level in Ireland, expressed in common currency terms, has increased from under 85 per cent of the euro area average in 1995 to just over 112 per cent in 2002 (see Figure 2). A recent study commissioned by Forfás estimates that Ireland is now the joint most expensive country in the euro area, along with Finland, and the third most expensive in the entire EU, behind only Sweden and Denmark[1]. While the study found Ireland to be relatively cost competitive for clothing, footwear and communications, we are particularly expensive for certain food types (milk, cheese, eggs, fruit, vegetables and potatoes), alcoholic beverages, tobacco, residential rents and restaurants and hotels. Ireland has now joined a cluster of five European countries[2] where prices and costs are well ahead of average EU levels.

## 3. Explaining the Inflation Differential

Understanding the causes of price and cost escalation in Ireland in recent years is important in assessing the implications for competitiveness and growth, and in formulating the right policy response. The gap between Irish inflation and the euro area average, as measured by the HICP, has averaged 2.5% since 1999. As can be seen from Figures 3 and 4, most of this differential is accounted for by higher inflation in the services sector in Ireland. During the period 2000-02, roughly 73% of

*Figure 4* **Inflation Differential Between Ireland and Eurozone**




*Source: Central Bank of Ireland*

total Irish inflation originated in the services sector. Prior to 2000, prices in the services sector were rising at only a slightly higher rate than for traded goods. Since 2000 however, while goods inflation has eased, services sector inflation has continued to accelerate, and has been consistently well above the euro area average.

It has been suggested that the higher rate of services inflation in Ireland relates to the convergence in average Irish and European incomes due to faster productivity growth in Ireland during the 1990s[3]. Services inflation due to this "convergence effect" is not, in itself, a major concern, reflecting as it does a "natural" rise in the cost of domestic services as incomes and living standards improve. According to recent estimates, however, this process accounted for only 1¼ percentage points – or half – of the annual divergence in Irish and euro area inflation in the mid-1990s[4]. Moreover, since the process of convergence

1 *Consumer Pricing Study 2003,* commissioned by Forfás from PwC

2 Ireland, UK, Denmark, Finland and Sweden

3 This is known as the 'Balassa-Samuelson effect'. This concept is based on the fact that in an economy catching up with its richer neighbours, labour productivity tends to rise faster in sectors producing internationally tradeable goods (particularly in capital-intensive manufacturing industry) than in those involved in the more labour-intensive and generally non-traded service sector. Increases in labour productivity growth in traded manufacturing industries are usually followed by wage growth throughout the economy (both manufacturing and services compete for employees in the same labour market). Thus, a combination of wage growth across both traded and non-traded sectors, but lower labour productivity gains in the services sector, leads to more rapid increases in the cost of services. In this way, services inflation is often higher in those regions of a monetary union enjoying the most rapid growth in productivity and incomes.

4 IMF, 1999 Article IV Report (Appendix)

between Irish and euro area average living standards is now largely complete, this effect is likely to have diminished over recent years.

Of greater importance in driving the acceleration in Irish services inflation in recent years has been economic “overheating” (i.e. increases in spending in excess of the growth potential of the economy) caused partly by our extraordinary success in attracting Foreign Direct Investment, increasing employment and incomes levels. The rapid drop in interest rates in the lead-up to Irish participation in Economic and Monetary Union (EMU) in the late 1990s and the competitive exchange rate at which the Irish pound was fixed to the euro combined to stimulate fast growth in investment, consumption and export demand. These policies were not appropriate for Irish economic conditions, given the already rapid growth in Irish incomes and spending over this period. These policies were, however, largely outside the control of Irish policy makers; since 1999, monetary policy (interest rates and exchange rates) in Ireland has been set, or largely controlled, by the European Central Bank to cater for the requirements of economic conditions in the euro area as a whole.

Added to the effects of expansionary monetary policy were large cuts in income and corporate taxes and fast growth in public spending. Such policies were dramatically beneficial in increasing work incentives, promoting employment and improving the country’s infrastructure, but they also resulted in spending increases well in excess of the growth potential of the economy, as reflected in the rapid decline in the rate of unemployment from 10.4% in 1997 to a low of 3.7% in 2000. The tight labour market, allied to infrastructural deficits (particularly with regard to housing shortages) combined to increase upward pressure on prices in domestic services industries and on wages across the economy.

The effect of rapid demand growth on inflation in the domestic services sector was compounded by regulatory and private restrictions to competition. The large contribution to inflation by the cost of alcohol, when sold from both licensed and off-license premises, is an example of the consequences of inadequate competition. Product market restrictions limit the ability of potential competitors, both domestic and foreign, to enter into Irish services markets, and by doing so to bid down excessive price growth. The Competition Authority has identified a range of service industries across both the public and private sectors, including transport, insurance and a range of professional services that are characterised by restrictions to competition that may result in higher prices. Restrictions on land availability and the knock on effect this has on house prices and, subsequently, wages has also contributed to inflationary pressures.

Finally, in the twelve months to end January 2003, the price of services provided directly by the State to the consumer grew by 15%, compared with national inflation of 4.8%. The price of government regulated services (e.g. rail transport and health insurance) grew by 7.2% over the same period. More broadly, the prices of all goods and services that are subject to significant levels of government influence accounted for 59% of national inflation in the year to January 2003, compared with an expenditure share of just 28%[5]. Moreover, this does not include the impact on inflation of the rise in the standard rate of VAT from 20% to 21% in 2002. All combined, the administered service price increases, together with increases in indirect taxes (including excise duties), added about 1½ percentage points to the rate of inflation in 2002. This contrasts with an average of ¼ of a percentage point for the euro area as a whole[6]. The rate of inflation in government-influenced products and services accelerated sharply in 2002 and early 2003, pushing the headline rate of annual consumer price inflation up to 5.1% in February 2003 – the highest inflation rate recorded since June 2001.

## 4. Implications of High Inflation on Competitiveness

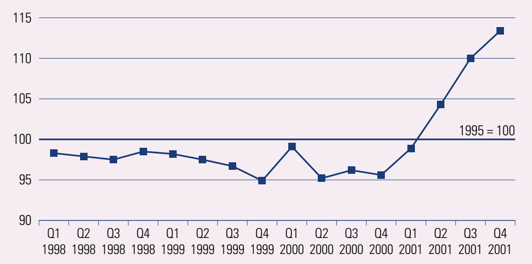
The high and growing differential in domestic services inflation between Ireland and the rest of the EU has already damaged the competitiveness of a range of manufacturing sectors in Ireland. If this trend were to continue, unemployment would quickly rise and the economy’s medium term growth potential would not be realised.

5 In addition to goods and services subject to direct state provision (e.g. hospital services) and goods/services where price changes are subject to Government approval (e.g. VHI insurance), this also includes consumer goods subject to excise duties. Source: *Consumer Pricing Study 2003*, commissioned by Forfás from PwC

6 Central Bank of Ireland, Quarterly Bulletin, Spring 2003

Internationally trading sectors are affected by inflation in the domestic services sector for a number of reasons. Firstly, in order to operate effectively, internationally trading firms must purchase local services, including catering, security, financial and professional services. Secondly, high prices for services deter inward migration of skilled and unskilled workers for industry. Finally, manufacturing and other internationally trading sectors must compete for workers in the same labour market as non-traded services. As a result, fast wage growth in the service sector has fuelled higher wage growth in internationally trading sectors of the economy, the impact of which has only partially been offset by growth in productivity.

*Figure 5* **Unit Labour Costs Weighted by Employment**




*Source: IMF Country Report*

The declining competitiveness of much of Irish industry is revealed in recent analysis by the IMF (see Figure 5)[7]. After several years of relative stability, unit labour costs in Irish manufacturing industry, weighted by employment share, rose by almost 20% in 2000-01[8]. While absence of data prevents similar analysis in internationally traded services, there is no reason to believe that competitiveness developments in these sectors were different. Moreover, continued fast wage growth in 2002, combined with the recent strengthening of the euro against sterling and the U.S. dollar, suggest that competitiveness of much of Irish industry, as measured by unit labour costs, continued to deteriorate quickly in 2002 and into 2003.

Together with the slowdown in global economic growth, this loss of competitiveness is resulting in a contraction of output and employment in the Irish manufacturing sector. CSO data show a seasonally-adjusted quarterly fall in industrial production of 3.4% in the final quarter of the 2002. Similarly, industrial employment fell to 252,900 in December 2002, a drop of 12,300 (4.6%) over the previous 12 months. This point is reinforced by data relating to the development agencies, IDA Ireland and Enterprise Ireland. Employment in agency-supported firms fell to 306,200 in 2002, down from 313,000 in 2001 and from a peak of 318,000 in 2000.

The rising cost of living here also undermines the efforts of our universities and development agencies to build a new generation of "knowledge-intensive" businesses in Ireland. Research and development (R&D) activities in Ireland will thrive only if the costs of carrying out R&D here are internationally competitive and are not burdened with high inflation. Attracting high calibre scientists, researchers and other skilled employees from abroad to Ireland is made difficult by high living costs and the exorbitant cost of housing. According to statistics published by Mercer Human Resource Consulting[9], which are used by companies across the world to set remuneration levels for employees being relocated overseas, Ireland is the most expensive location in the euro area to purchase a combination of food and non-food consumables in a range of low and mid priced outlets. The high price level also makes Ireland a less attractive destination for tourists. This is particularly true, given the price transparency that now exists following the introduction of the single currency.

## 5. Recommendations

High inflation in recent years has resulted in average price levels in Ireland well above those of our European competitors that are not justified by higher levels of productivity here. At a minimum, this differential between Irish and average euro area prices should not be allowed to worsen. It would be desirable, on competitive grounds, that Ireland's price level should be brought back closer to that of the euro area. Irish price increases are expected to moderate substantially falling to an average of 3.2% in 2004[10], reflecting low price growth internationally, the continued appreciation of the euro and more moderate wage growth both this year and

7 IMF Country Report No. 02/171, August 2002

8 Changes in unit labour costs measure changes in output per employee adjusted by wage growth, and are a key indicator of developments in industry competitiveness. The standard measure of Irish unit labour costs, weighted by output, shows a persistent improvement in Irish competitiveness since the early 1990s. However, this measure is heavily distorted by the surge in output and productivity growth from a relatively small number of capital-intensive companies in the chemicals, pharmaceuticals and electronics sectors. An alternative way to gauge changes in ULC and competitiveness is to weight manufacturing sectors by their shares of total manufacturing employment, rather than by production volumes. The measure better assesses developments in the employment-intensive indigenous sectors of the economy, as well as the risks to employment posed by inflation.

9 Source: *Consumer Pricing Study 2003*, commissioned by Forfás from PwC

10 European Commission

next. This should not be a cause for complacency. Even as Irish inflation is forecast to fall, so too is the European rate, and a substantial inflation differential of 1.5% is forecast to remain at least until 2004, leading to further divergence between Irish and average euro area price levels.

The challenge for Irish policy makers is to reinforce the fall in inflation and eliminate the differential with the rest of the euro area. In the absence of independent monetary and exchange rate policy, Irish policy makers can no longer use a currency depreciation to restore the ability of industry to compete internationally after a bout of price and wage inflation. Therefore, domestically determined policies to slow price and wage growth will be required.

## Communications Policy

Most urgent in this regard is effective communication by Government to control public expectations about future inflation. Expectations of continued high inflation can, for a limited period, be self-fulfilling, leading to a wage-price spiral that makes the eventual adjustment all the more painful in terms of lost output and employment. It is of concern, therefore, that the realities of a slowing Irish economy have not yet impacted significantly on public expectations of future price increases, partly because of the effect of higher administered prices on the headline rate of inflation. Monthly survey data published by the European Commission in March 2003 shows consumer inflation expectations in Ireland accelerating since approximately October 2002. Accordingly, despite the slowdown in the economy, high inflation is becoming "embedded" in public expectations, affecting wage negotiations and threatening a price-wage spiral that would ultimately have damaging consequences for employment and growth.

Public expectations of continued high inflation must be addressed by a credible and well-communicated Government commitment to reducing inflation. With the European Central Bank committed to maintaining average consumer price increases in the euro area at 2% per annum, this should entail setting an inflation target at or close to this level. Assuming, somewhat ambitiously, that Irish productivity growth can exceed the euro average by up to one percentage point per year in the medium-term then Irish inflation within 1/2 of a percentage point of the euro area average would be necessary to avoid a further loss of international competitiveness of internationally traded industries in Ireland. The Social Partnership agreement has already implicitly accepted the principle of inflation targeting, stating that "the parties are agreed that bringing inflation down as quickly as possible towards levels comparable with our trading partners' performance and towards the European average must be a top priority if jobs are to be secured"[11].

***Recommendation 1:*** *The Government, in conjunction with the social partners, should lower public expectations of future inflation by committing itself to a credible inflation target. The Council recommends that Government target an inflation rate which is equal to the euro area average rate, with immediate effect. At worst, Irish inflation should exceed the average euro area rate by no more half of a percentage point.*

## Incomes Policy (Short term)

Incomes policy and social partnership have an important role to play in reducing price and wage growth without unnecessary loss of output and employment, particularly through the efficient transmission of new economic realities into labour market negotiations. While the causal relationship between inflation and wage demands is ambiguous, there is growing recognition by all of the social partners that the rates of wage growth recorded in recent years must moderate in order to protect competitiveness and sustain jobs. The commitment by the social partners as part of the new social partnership agreement, *Sustaining Progress*, to set, in the context of a wider package of commitments from all sides, wage increases at 7 per cent over an 18 month period is a welcome development[12]. As part of a more comprehensive set of policy actions to reduce price inflation and protect real income gains, it is imperative that this commitment be fully adhered to. Any wage drift over and above the levels agreed would undermine the credibility of the price inflation target.

11 Sustaining Progress, Annex 7, available from 'www.taoiseach.gov.ie'

12 It should be noted that incomes policy is broader than wage agreements, and would include reference to other sources of income in addition to wages, such as profits, rents etc. These broader issues are beyond the scope of this Statement.

*Recommendation 2: The Council recommends that all of the social partners, in conjunction with the Government, maintain their commitment to moderating inflation through continued engagement in the social partnership process and by implementing agreed actions in relation to both wage demands and price increases.*

## Fiscal Policy (Medium term)

The Council recognises that the loss of independent monetary and exchange rate policy since Irish entry into EMU makes it difficult for domestic policy makers to influence the level of spending in the Irish economy by businesses and consumers. This in turn makes it difficult to manage economic growth in a way that keeps inflation under control. Accordingly, decisions by Government about the levels of public spending and taxation – one of the last remaining tools available to domestic policy makers to influence total spending in the economy – must be taken with great care and with due regard to the prevailing economic circumstances. Within the constraints imposed by the EU Stability and Growth Pact, Ireland needs a budgetary process that is sufficiently flexible to help "fine tune" growth in spending in line with the economy's potential. For example, when export and consumer demand are already growing quickly, avoiding inflationary pressures requires that rapid growth in public investment should be matched by a slowdown in government day-to-day spending and/or by increases in direct taxation. Notwithstanding the recent slowdown in domestic and export demand, prudent Government fiscal policy will be required in the medium-term to keep Irish inflation at or near average euro area rates.

*Recommendation 3: The Council recommends that the Government, drawing from the experience of other EMU members, investigate whether it is possible to develop a fiscal policy framework that better facilitates the necessary budgetary flexibility to manage growth in spending in the economy as economic circumstances dictate. In general, a prudent fiscal policy will be required in the medium-term to keep Irish inflation at or near average euro area rates.*

## Administered Prices and Excise Duties (Short term)

Increases in the price of Government provided/regulated services as well as significant increases in the levels of excise duties have added significantly to the rate of inflation in recent years and, particularly, in the past 12 months. In the absence of further increases in administered prices, excise duties and VAT, the Council forecasts that headline consumer price inflation has the potential to fall towards 3% by January 2004. This alone would have a powerful impact on public expectations of high inflation, and would help to ensure a smooth adjustment to new economic realities in the labour market, without unnecessary loss of exports, output and employment.

The Council recognises that improving public services and infrastructure costs money, and that user charges for public services can make for more efficient use of available resources. But the rapid rise in the cost of public services has sometimes reflected not better quality, but instead rapid growth in wage costs that was not accompanied by higher efficiency and productivity. When these inefficiencies are passed onto the rest of the economy in the form of increases in taxes and administrative charges, our international competitiveness deteriorates and jobs in the exposed internationally trading sectors of the economy are lost.

Instead of further increases in administered prices and indirect taxes, the Government needs to accelerate the process of public service modernisation, increasing public sector efficiency and improving value for money. This should be done through investment in training and technology alongside institutional reform. By eliminating inefficiencies and raising productivity, the Government can facilitate continued improvement of public services and infrastructure without adding to inflation and undermining competitiveness.

The Council recognises that the Government is under pressure to pursue simultaneously a number of different, sometimes conflicting, economic objectives. It is the view of the Council that the number one economic priority for policy makers in 2003 should be to lower inflation and to restore competitiveness.

*Recommendation 4: The Council recognises the difficulty faced by Government in financing necessary improvements to public services and national infrastructure while observing the constraint of the EU Stability and Growth Pact. But tackling Ireland's deteriorating cost competitiveness must be the immediate priority. Accordingly, the Council recommends that the thrust of Government economic policy in 2003 should be to reduce the rate of inflation by avoiding further increases in customs and excise duties, VAT and administered prices for the remainder of 2003 and in Budget 2004.*

## Competition Policy (Medium term)

The difficulty faced by Ireland in controlling spending, and hence inflation, since entering EMU highlights the need for greater "supply-side flexibility" in the economy. "Supply-side flexibility" refers to the ability of the economy and firms, both domestic and foreign, to respond to fast growth in spending by altering the level and composition of national output of goods and services without increasing prices.

As discussed earlier, supply side flexibility in the economy has been constrained by regulatory and private restrictions to competition. The Competition Authority is currently conducting an extensive examination of the insurance and banking industries as well as many professional services (including the legal and medical professions). Recommendations emerging from these and previous studies (particularly the studies by the Competition Authority into transport and liquor licensing) should be given immediate and careful consideration by Government.

The Council believes that a number of other sectors, including the distribution, retailing, transport and privately run refuse collection services need to be examined in greater detail with a view to increasing the level of competition in the economy. In addition, access to professional education also needs to be examined. The Council recognises that the powers and financial resources available to the Competition Authority to investigate and break up anti-competitive practices have been increased significantly by Government in recent years. Given the urgent need to introduce more competition into the economy, and recognising the difficulty faced by the Competition Authority in challenging entrenched and powerful vested sectoral interests, the adequacy of the resources and powers available to the Authority should be kept under constant review by Government. New studies and investigations are important, but these should not be allowed to delay Government action on recommendations already made.

*Recommendation 5: The Council recommends that reforms recommended by the Competition Authority in recent studies, and particularly those relating to transport and liquor licensing regulations, be accorded high priority by Government with a view to full implementation. In addition to current studies being undertaken, the Council recommend that a number of other sectors, including the distribution, retail and refuse collection sectors should be examined to identify anti-competitive practices or highlight any other constraints to competition.*

## Market Access for Foreign Service Providers (Long term)

In addition to facilitating greater competition from domestic providers in a range of Irish services sectors, it is also important to facilitate greater access and competition from overseas services providers. Increasing the "tradability" of service sectors would mean that rapid spending growth in the domestic economy would result less in services inflation, and more in increased imports and balance of payments deficits. While neither is sustainable in the long-run, correcting balance of payments deficits is easier to achieve than lowering inflation.

*Recommendation 6: The Council recommends that Ireland should actively promote the completion of the EU single market for services as soon as possible in order to encourage cross border competition in services which are currently non-tradeable. These efforts should complement the active participation of Ireland and the EU in work being done under the auspices of the World Trade Organisation to remove barriers to international trade in goods and services.*

### Better Regulation (Long term)

At a more general level, the Council believes that there also needs to be a greater recognition by Government and the Social Partners of the hidden costs of Government regulation, and its impact on prices and the cost of living. Clearly, most regulations are implemented for valid public policy reasons. For example, Ireland's retail planning guidelines, which limit the size of new retail outlets, are designed to ensure sustainable transport development and protect the vitality of town centres. But the costs of such regulations, which in the case of the retail planning guidelines come in the form of higher retail prices for consumer goods, should be explicitly stated and compared with the estimated benefits. In many cases, the same objectives can often be achieved by other non-regulatory means with fewer negative implications for efficiency and costs.

Better regulation is increasingly being used across the developed world as a means of developing a competitive edge in the race for investment and jobs. Ireland should not be left behind. For this reason, the Council views as crucially important the programme of regulatory reform that is being led by the Department of the Taoiseach[13]. The Council would like to see greater resources devoted by Departments to testing all major policy proposals, including regulation and legislation with regard to their impact on costs, efficiency and productivity of business. This would be consistent with their adoption of the system of Regulatory Impact Analysis that is to be piloted and introduced across Government Departments.

> ***Recommendation 7:*** *The Council recommends that a framework be put in place for testing major policy proposals, including legislation and regulations, for their impact on costs, efficiency and productivity of business. This function should be carried out by the Department of Enterprise, Trade and Employment and would complement the Regulatory Impact Analysis approach being developed by the 'Better Regulation Unit' in the Department of the Taoiseach.*

## 6. Alternative Future Scenarios

Long term trends in inflation are essentially a monetary phenomenon. In the long run, high and persistent inflation can only continue if it is fuelled by high rates of monetary growth. Within a monetary union, monetary conditions and monetary growth are determined at the level of the union. Given the commitment of the European Central Bank to grow the money supply at a rate that keeps annual consumer price increases across the euro area below 2%, we know that the rate of inflation in Ireland will eventually converge towards this rate.

If public inflation expectations and consequent wage demands do not adjust to the new competitiveness realities facing Irish companies, then Ireland's convergence towards euro area average inflation rates will come about through a painful loss of employment and output in the internationally traded sector.

This is not inevitable. The challenge for Irish policy makers is to ensure that this convergence in inflation and prices takes place without unnecessary losses of domestic employment and output. Government has an opportunity to control the slowdown in inflation while at the same time maintaining current levels of employment. Assuming immediate implementation, the recommendations set out in this Statement are designed to facilitate such a 'soft-landing'. Bringing Irish price levels back into line with the euro area average will facilitate a return to trend growth levels, and further improvements in incomes, profits and living standards.


## Acknowledgements

The Council would like to thank Terry Quinn of the Central Bank of Ireland for his assistance in the analysis of the causes of Irish inflation.


13 Regulatory reform does not automatically imply deregulation or the transfer of activities from the public to the private sector. De-regulation and privatisation do not always lead to the delivery of superior services and need to examined carefully on a case-by-case basis. Regulatory reform means ensuring that regulations are the most the appropriate way of achieving their stated objectives and are designed in a way that achieves those objectives in a least-cost manner.

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