Options for Inflation Control in the Irish Economy

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1. Introduction

Following years of exceptional growth with stable prices, inflation has emerged this year as a pressing policy concern. The Consumer Price Index (CPI) in July was 6.2 per cent higher than a year earlier, rising by 2.4 per cent in just four months. This is in sharp contrast to the years between 1992 and 1999, when the annual inflation rate averaged just 1.9 per cent, peaking in 1995 at 2.5 per cent (Central Statistics Office, 2000). This deterioration has raised fears that the economy is "overheating" in a way that threatens the sustainability of Ireland's remarkable boom.[1]

And booming it certainly is. Recent figures estimate that GNP grew by 7.8 per cent in 1999, with GDP growing by a staggering 9.8 per cent, the sixth straight year of very fast growth. Indications are that strong growth continued in the first half of 2000, propelled in part by substantial tax cuts in the 1999 budget. Although a rise in oil prices, a depreciating euro and a cigarette tax increase in the budget have added to inflation, there is no doubt that strong domestic demand is adding to the price pressures. This is most evident in the even higher rate of service price inflation, which ran at 7 per cent in the twelve months to July, but is also evident in high job vacancies, growing road congestion, inflated house prices, and possibly even in increased industrial unrest.

This sharp increase in inflation has raised fears that a price-wage spiral is taking hold, a spiral that could undermine the economy's evident competitive advantage in attracting foreign investment and also make it more vulnerable to a downturn in demand. The inflation also threatens the latest social partnership agreement, the Programme for Prosperity and Fairness (PPF), with price increases set to wipe out the real gains from the 5.5 per cent nominal wage increase agreed for this year. At the core of the social partnership agreements has been a government offer of tax relief in return for wage restraint, a formula that has worked surprisingly well given the increasing dissatisfaction with corporatist-type arrangements in other European countries (see Phelps, 2000).[2] Initially it provided needed demand stimulus in a depressed economy, while keeping Irish labour costs competitive and providing real, albeit limited, gains to workers.

Unfortunately, the formula is much less well suited to an overheating economy with almost no control over its monetary policy. Tax cuts add to domestic demand, fuelling a price-wage spiral as businesses in the sheltered part of the economy comfortably raise their mark-ups and workers are emboldened to push for higher wages. But if tax cuts are not offered workers will push for wage increases anyway to achieve real gains in living standards. Thus the government faces a dilemma under the current partnership formula-cut taxes and add to demand or hold back tax cuts and add to the spiral for any given level of demand.

This short paper explores some suggestions for getting around this dilemma. To begin with, however, we first ask in the next section if inflation is really so worrisome in the current Irish context. Although economists tend to have a congenital aversion to inflation, some prominent commentators have recently argued both that Irish growth is robust enough to withstand a loss of wage competitiveness and that

[1] See Central Bank of Ireland (2000a) for a detailed review of trends in prices, costs, and competitiveness.

[2] The Netherlands is a prominent exception, where a social partnership agreement that predates the first Irish agreement is given much of the credit for a dramatic economic turnaround.

inflation is a natural part of the adjustment process in a rapidly growing economy. These arguments cannot be easily dismissed. Even so, it is argued that there are real risks that a price-wage spiral will slow Ireland's exceptional trend growth and make the economy more vulnerable to a demand-side slowdown. In Section 3, it is proposed that any anti-inflation strategy should pass two common-sense tests: it should not add to domestic demand and it should not put upward pressure on business mark ups or on real wage demands for any given level of economic activity. Section 4 turns to some imaginative and some not-so-imaginative suggestions for reducing inflation, and finds that a number of prominent proposals fail the common-sense tests. Section 5 has some concluding observations.

2. Is Inflation a Worry?

A number of economic commentators – interestingly many of whom work for financial institutions – have argued that we should not be worried, see for example O'Leary (2000). They offer forceful arguments in support of this confidence in the robustness of the Irish boom. First and foremost is the claim that the boom is being driven by underlying growth in the supply potential of the economy, helped by ever increasing flows of foreign direct investment and favourable demographics. And they contend these favourable factors show few signs of diminishing. Despite rising wages, the competitive advantage of Ireland in the contest for foreign funds is, if anything, improving–witness the recent announcements of expansions by some of the world's leading high technology businesses. This is plausibly attributed to "clustering effects", whereby early investments lead to a local supply of labour with industry-specific skills and induce the setting up of firms and the building of infrastructure dedicated to the supply needs of the multinationals.[3] Rapid productivity growth, then, is more than compensating for rapid wage growth.

Even if inflation does lead to some loss of competitive advantage, there is the further argument that rising relative prices in the non-traded sectors is normal as an initially poor economy rapidly catches up to its richer neighbours. The trend in non-traded goods price is explained by the combination of relatively low productivity growth in the service sector of the economy and the tendency for people to demand relatively more services as their incomes increase. Moreover, a booming service sector is welcome insofar as it helps to spread the foreign direct investment driven prosperity throughout the economy. Relatedly, with unemployment down to 4.4 per cent and falling, we should expect rapid wage growth across all sectors. When unemployment was closer to one-fifth of the labour force it made sense to take the dividend from foreign investment in the form of jobs rather than wages. But in today's dynamic market economy unemployment cannot realistically fall much further. People in work – both in the traded and non-traded sectors – should see their living standards improve.

But can we be so sanguine? The Irish boom is not the first occasion that economists have claimed that an economy can safely ignore the old warning signs of overheating. The boom in the United Kingdom in the late 1980s, during which the Chancellor of the Exchequer famously

[3] For a considered view on the linkages, spin-offs and agglomeration economies in the Irish case, see Barry and Bradley (1997).

declared the widening current account deficit was not a reason for concern since it was caused by buoyant private sector investment, is a useful reminder. More recently, a number of fast-growing Asian economies believed they could ignore growing macroeconomic balances, but experienced deep recessions as international capital flows dried up following Thailand's devaluation in mid-1997. Ireland does not have a large current account deficit, or the financial sector problems that made the Asian economies so vulnerable. Nonetheless, it is not too difficult to think of scenarios in which inflation triggers a hard landing for the economy.

For example, can we really be so sure that foreign investment will continue to flow to the Irish Republic as it loses its cost advantage. The clustering effects may well be outweighing the decreasing labour cost advantage now. But a number of years of relatively high wage growth would compound to a substantial change in Ireland's relative cost position. The market for foreign direct investment is quite competitive, in part because other countries have learned from the Irish success. The claim that high productivity growth offsets the rapid growth in wages also needs to be treated cautiously. Besides the obvious point that productivity growth rates differ between sectors, we must recognise that the improvements in productivity are largely the result of the foreign investments, not the cause. If a particular multinational had invested in Scotland, say, instead of Ireland, then Scotland would have had the boost to productivity. Thus high *de facto* productivity growth does not prove that high wage growth is not undermining the Irish advantage in attracting *future* foreign investment flows. What matters for future investment flows is the relative returns on new investments.[4]

What about the observation that an increase in the relative prices of non-traded goods is a natural part of the catching up process? While the basic point is undoubtedly true, allowing a price-wage spiral to develop could bring the catching up process to a premature end. As prices chase wages and wages chase prices in the non-traded sector, non-traded goods prices will increase substantially while yielding relatively modest increases in real incomes. The rise in non-traded prices puts pressure on wages and other costs in the traded sector. With limited pricing power in competitive international markets and a fixed exchange rate, the competitiveness of the traded sector will be harmed. The bottom line is that though a rise in the relative price of non-traded goods is inevitable, it matters how it happens. Unbalanced growth driven by run away domestic demand could prematurely stop, or at least slow, Ireland's catch up growth.

These counter arguments relate to the affect of inflation on Ireland's long-run growth path, and especially on Ireland's continued ability to attract impressive quantities of foreign direct investment. But it is also worth considering what effect a greater than expected slowing in Ireland's underlying trend growth rate would have on domestic demand.

[4] Even for those who are confident that Ireland's competitive advantage is secure recognise that some cost-sensitive sectors will be harmed. However, the releasing of resources to high value-added sectors is plausibly considered a positive development. But here too a note of caution is warranted. Skill-related income differentials are already rising. If Ireland loses its competitive standing in more assembly-oriented industries, the released workers might not easily be able to find employment in the expanding skill-intensive sectors. There are also regional factors to consider, as the high skill-intensive industries have shown the greatest tendency to form their clusters around the main urban centres.

Expectations of rising incomes and easily available jobs underpin high consumer confidence at present, and they give house buyers the confidence to bid extraordinarily high prices for even modest homes. They also induce the banks and other lending institutions to grant generous credit lines. A diminution in long-term prospects could cause consumers, potential house buyers and lending institutions to retrench. Any fall in house prices would have a negative effect on the net worth of many households, possibly causing them to cut back still further on their spending. Recessions have a nasty way of feeding on themselves in their early stages. Even a small change in the underlying trend growth rate could trigger a temporary fall in output below potential. A steeply rising underlying growth path, which it is reasonable to assume that Ireland will continue to have, does not make an economy immune from an old-style, demand-deficient recession.

Another distinct possibility is that Ireland's trading partners fall into recession. The United States, which has been the main spending engine of the world economy over the last few years, is growing significantly faster than its trend from the 1970s to the mid-1990s. Although there are indications that there has been a new technology-led increase in trend growth, there are also worrying signs of vulnerability. Inflation has started to pick up prompting the Federal Reserve to raise interest rates, and the current account deficit has risen – accompanied by a rising dollar – to close to 4 per cent of GDP. Many economists also worry that US stocks are seriously overvalued. A loss of investor confidence would lead to a sharp correction in stock prices and probably a fall in the dollar. A depreciating dollar would add to inflation, limiting the ability of the Federal Reserve to respond to falling demand with interest rate cuts. A recession in the United States could have a strongly adverse effect on the Irish economy, particularly given the high share of foreign direct investment that is accounted for by US multinationals.[5]

But is this relevant to a discussion of the dangers of Irish inflation? Irish businesses would, after all, be negatively affected by a world recession regardless of the inflation rate. The reason it is relevant is that high inflation, and expectations of high inflation, would make it harder for the Irish government to respond with a counter cyclical fiscal policy.

In sum, then, there probably is reason to worry about the effect of inflation on growth, though the arguments for not worrying cannot be dismissed. We need to be modest in our claims to understand the limits of a small open economy undergoing rapid structural change. Even if we cannot be certain about the greatest risks, on balance we should be cautious and take measures to dampen the inflationary spiral.

[5] The ESRI in the *Medium-Term Review* 1999-2005 (Duffy, Fitz Gerald, *et al.,* 1999) considered the impact of external shock to the Irish economy caused by a 25 per cent fall in the value of the US stock market. In reaction it was assumed that investment in the high-tech sector in Ireland falls temporarily by a third compared to the baseline. Such a shock would push GNP 3 percentage points below the central forecast of the *Review* returning to the baseline after four years; unemployment would rise by 3 percentage points by the second year before returning to baseline in year five.

3. Commonsense Criteria

Inflation dynamics are hard to predict in an economy undergoing rapid change. Experience, however, has taught us two important lessons. First, inflation will rise if GDP growth is pushed beyond some threshold level.[6] With the economy booming and jobs plentiful, businesses can more comfortably raise their margins and workers are better able to push for wages with greater purchasing power. Thus price setters strive to push up prices over their wage (and other) costs, and workers strive to push up wages over prices.[7]

Second, once inflation is established it becomes expected. An unfortunate consequence of this is that even a temporary burst of inflation due to currency depreciation or an increase in the price of oil, say, can have long-lasting effects on the inflation rate. The impact of a temporary rise in inflation due to external factors on the longer-term inflation rate depends to a significant degree on the "policy regime". An oil price led increase in the current inflation rate is unlikely to lead to a revision of inflation expectations for the longer term if an inflation-averse central banker controls demand management.

The danger of spiralling inflation and inflation expectations in an overheating economy suggests two minimal criteria that a good inflation-lowering strategy should meet.

1. Your policy response should not fuel demand still further.
2. The strategy should not cause businesses to increase their price mark-ups or workers their real wage demands for any given level of economic activity.

Focusing on these criteria makes clear the inflationary dilemma that the government faces. On one hand, the government has promised workers tax cuts (and spending increases) in return for wage restraint. On the other hand, the lax fiscal policy is fuelling demand – and thus the price-wage spiral – in an already overheating economy. Last December's budget alone is estimated to have added two per cent age points to the growth in domestic demand, according to the Central Bank (2000b). The government faces a difficult problem: workers' living standards need to be protected from rising prices, while not adding to demand, and without raising employer costs. These are costs that they are likely to pass on in the form of higher prices.

4. A Brief Review of Prominent Inflation Reduction Proposals

The recent rise in inflation, in addition to attracting much comment, has brought forward a number of inflation-control proposals. We examine some of the main strands of options put forward. The foregoing analysis, sketchy as it is, dictates that any proposal to reduce inflation meet the two common-sense criteria. It should not add to demand and it should not increase price mark ups or real wage demands at any given level of economic activity.[8]

4.1 Control the Prices of Items that Enter into the CPI

[6] The Irish experience in the 1990s has shown that this threshold can be quite high and can vary over time.

[7] Layard *et al.* (1991) and Phelps (1994) provide rich models of economies with such features.

[8] We could also reasonably add a third criterion: the policy should enhance rather than diminish the governments stated anti-inflation resolve.

Various price control proposals have been made, including cutting excise taxes, freezing public charges and, disturbingly, direct private sector price controls, such as those imposed on alcoholic drinks in public houses. Insofar as such "index massaging" reduces the headline inflation rate it can have a beneficial effect on inflation expectations. However, it fails the test of not adding to domestic demand, since it frees up money for people to spend on other goods. The most likely effect is that price pressures are redistributed to other sectors in the economy. Added to that is the fact that it is hard to hold down prices indefinitely. Price increases are, in effect, being stored up for a not necessarily more inflationary benign future.[9]

Neither should we forget the vast experience with the unwanted side effects of price controls. Taking controls on drink prices as an example, it is likely they will lead to overcrowding, declining standards of service, added administrative expense, turn publicans into law breakers as the lure of profits leads to a flouting of the price orders, and possibly even corruption. Private sector price controls should not be part of the anti-inflation arsenal.

4.2 Raise Employer PRSI Contributions to Fund Services such as Improved Childcare

The rationale behind this policy is to compensate workers for inflation without going outside the terms for nominal wage agreements in the PPF. The obvious drawback is that it adds to employer costs, costs that will be at least partially recouped by charging higher prices. It thus fails the test of not adding to price mark-ups for a given level of demand. On the demand side the policy has the apparent merit that it involves a tax increase rather than a tax decrease. Since the taxes are earmarked for immediate spending, albeit capital expenditure, the policy might expand rather than contract overall demand.

4.3 Expand Gain-sharing/Profit-sharing Schemes

One of the most innovative proposals for restructuring the social partnership agreements has been to introduce a form of national "gain-sharing". In a well-worked out proposal by De Buitleir and Thornhill (1999), employees would receive a basic pay increase (related, say, to expected inflation in the euro area), and a supplemental increase based on the rate of growth in GNP per worker.[10]

The merits of the proposal are that it gives workers a well-defined stake in economic growth and that it is flexible. It fails, however, the requirement that it not boost domestic demand and wages when the economy is overheating. The increases will be largest when GNP is growing faster than its maximum non-inflationary potential – exactly when restraint is needed. The impetus to demand would probably be greatest when this scheme is applied to the public sector (their intention), as the wage increases have their counterpart in smaller budget surpluses rather

[9] See McCoy (2000) for a critical look at "index massaging" policies.

[10] The strict proposal applied to pay increases for public sector workers, although they made clear that they could be applied in the private sector as well. For details, see De Buitleir and Thornhill (1999).

than smaller profits. One possible way to improve the scheme would be to base the increases on some measure of trend growth, although this would raise serious problems of trend identification in a fast growing economy undergoing rapid structural change (Cronin and McCoy, 1999).

A related alternative is to expand the use of more old-fashioned company profit sharing schemes. In the classic profit sharing scheme workers get a base wage plus some share of the profits.[11] A key element is that the share of profits going to workers as a group is fixed. Businesses have an incentive to hire more workers, assuming of course that the base wage is set lower than the wage without profit sharing. In the colourful words of the profit sharing advocate Martin Weitzman, "[s]hare firms ever hungry for labour are always on the prowl – cruising around like vacuum cleaners on wheels, searching in nooks and crannies for extra workers to pull in at existing compensation parameter values" (Weitzman, 1984, pp. 98-99).

Businesses have, in effect, the incentive to "move down their demand curve" hiring more, producing more and charging lower prices to sell the increased output. It thus more than meets the criterion that the policy should not put pressure on price mark ups. The main obstacle is that such schemes are notoriously hard to negotiate, in part because macroeconomic benefits of adopting the scheme are not reaped by individual businesses. Workers might be only willing to accept the scheme if it offers an increase in overall pay. If workers have a higher propensity to consume than business owners, this would have an expansionary effect on demand.[12] In any case, a significant expansion of profit sharing schemes is really only realistic as a longer-term goal; they are unlikely to be much help in the immediate fight against inflation.

4.4 Limit Increases in Public Capital Spending

The government has committed itself to large increases in capital spending under the National Development Plan and other commitments. There is no doubt that a major infrastructure upgrade is needed. The problem of congestion, for example, has, like excessive wage increases, the potential to undermine Ireland's competitive edge in attracting overseas investment, not to mention the deleterious effects on quality of life. Inadequate infrastructure can also directly contribute to inflation. A good example is the added house price inflation caused by poor prospects for increasing the supply of serviced land.

So there is a difficult trade-off. More government spending directly and indirectly expands domestic demand, but more infrastructure spending is badly needed. The government needs to push ahead with project planning and should not delay the most urgent projects, especially those that will take a long time to complete, such as a Metro system for the capital. Less urgent projects could be held in the pipeline for a time when there is less inflationary pressure. This would help Ireland move away from its tradition of pro-cyclical fiscal policy, see Lane (1998). If the world economy were to fall into recession, a backlog of pre-planned

[11] A related proposal was advanced by Geary (1996) for Irish firms to deal with currency volatility within EMU whereby workers' would have part of their wages linked to currency movements in sterling-linked wage contracts.

[12] A possible effect working in the opposite direction is that workers increase their "precautionary saving" in response to their more uncertain incomes.

projects sensible from a long-term cost-benefit perspective would help prevent an overly sharp decline in Ireland's growth rate.

4.5 Deregulation of Entry and Pricing

Competitive forces could be harnessed to reduce price mark-ups if entry barriers were relaxed in areas such as the taxis, the drinks trade and the professions (OECD, 1998). The main rationale for such policies is to improve resource allocation in the economy.[13] Licensing requirements result in too few taxis, too few (hard to believe as it might seem) and inappropriately located public houses, among other distortions. Increasing competition in these sectors would, however, put downward pressure price mark-ups with minimal contribution to demand,[14] and thus should be beneficial overall from an inflation control perspective.

If the rise in inflation has a "silver lining," it is pressure to remove these damaging impediments to competition. Of course, the beneficiaries of protection will fight hard to protect their profits. Although compromises might have to be made to co-opt affected businesses to support reform, the government should be guided by the principle that sectional interests do not have "property rights" in bad laws and policies.

4.6 Deferred Compensation Measures
– Use of Individual Retirement Accounts or Pension Bonds or Savings Incentives

As noted already, the government faces a difficult task in devising policies that provide increases in real pay but do not add to demand. These twin goals suggest some form of deferred compensation.

One attractive possibility is for the government to use part of its budget surplus to make contributions to some sort of individually controlled personal retirement accounts, building on existing proposals for tax-favoured Personal Retirement Savings Accounts (PRSAs), see McHale (2000). A second option endorsed by the Irish Congress of Trade Unions is a related proposal for pensions bonds, which would be given, in lieu of tax cuts, to social insurance contributors and to retirees. It is envisioned that the pension bonds would offer a return equal to the growth rate of GNP. Lastly, the idea of giving tax breaks for long-term savings as a means for slowing the growth of personal consumption.

These policies need to be evaluated from both the perspective of long-term retirement income policy and the perspective of short-term inflation management. Desirable long-term features of a retirement income policy are that it add to rather than subtract from national saving, that it not distort labour work and retirement decisions, and that it ensures adequate income replacement in retirement. Any proposed policies must also be considered in the context of the existing retirement income system.[15]

[13] It should be added, however, that Irish product markets are relatively lightly regulated relative to many of our European partners.

[14] Demand might increase slightly if the propensity to consume out of real wages is greater than the propensity to consume out of profits.

[15] The main elements of this system are a flat state benefit and supplemental occupational pensions. At 28 per cent of average industrial earnings, the flat benefit is not generous (OECD, 1999). Ireland is also one of the few countries in the OECD without an earnings-

Which of the alternatives is best from the point of view of long-term pension policy? Government contributions to individual accounts and tax incentives for savings should add to national saving if they substitute for broader income tax cuts. Pension bonds, which are simply government IOUs, do not add to national saving directly, but saving is increased if they substitute for tax cuts and allow the government to run a larger budget surplus.

The impact of the personal retirement account plan on work incentives depends on how it is structured. If the contributions are earnings-related, then they increase the overall return to work. If they take the form of a flat contribution to workers and non-workers, they do not improve incentives, and may even reduce labour supply through an income effect.[16]

The impact of tax enticements for saving on work incentives is probably small, though there is some improvement due to the fact that, provided the worker saves something, work buys additional lifetime consumption. Since the pension bond plan envisions giving them to workers and non-workers, it does not improve the incentive to work.

Finally there is the issue of adequacy. This has two dimensions: ensuring pensioners are not living in poverty; and ensuring reasonable income replacement in retirement. Pension bonds or flat contributions to personal retirement accounts are probably best designed for poverty alleviation, whereas earnings-related contributions to personal accounts and saving incentives offer better prospects for higher income replacement rates.[17]

These longer-term issues cannot be ignored in the design of pension policy. In the context of this paper, however, it the short-term macroeconomic management role of pensions policy that is most relevant. The three policy approaches could be used to provide deferred compensation in lieu of tax cuts and in return for wage restraint. Of the three, however, tax incentives for saving is probably the least amenable to inclusion in social partnership negotiations for the obvious reason that it is

related state pension. Only 46 per cent of the population are covered by occupational pensions, a figure that is just 38 per cent in the private sector (OECD, 1999). Given the steep path of Ireland's wage growth, there is a real concern that future retirees will be in a position to maintain the living standards achieved in their late working life. Relatively austere state pensions, however, have led to relatively large pension funds (as a share of the economy). For 1996 the OECD (1998) reports that Irish pension funds amounted to 45 per cent of GDP. This compares with less than 6 per cent in France and Germany and 3 per cent in Italy. All three countries have generous earnings-related systems. Countries with less generous earnings-related systems have accumulated larger pension funds as a share of GDP: 87.3 per cent in the Netherlands, 74.5 per cent in the United Kingdom, and 58.2 per cent in the United States.

[16] By making workers better-off for given number of hours worked, the increase in income may be an incentive to reduce hours worked while retaining a similar or slightly higher income than before.

[17] The Irish population will also get significantly older over the next half century, though the ageing is delayed relative to most of our European partners. Now under 20 per cent, the share of over 64s to the share of people between 16 and 64 is projected to rise to more than 50 per cent by mid-century. The relatively low Exchequer cost of state pensions combined with a more delayed population ageing means that Ireland faces a less daunting pension financing problems than many of our EMU partners. Prompted by a report from the Pensions Board (1998), the Minister for Finance has nevertheless taken the foresighted decision to make an annual set aside of 1 per cent of GDP (along with £2.417 billion of the proceeds of the state telecom business) for future pension obligations. The money is being held pending legislation for a permanent, centrally managed fund. Although this is praiseworthy, an opportunity is being missed to leverage government pension pre-funding to achieve wage restraint.

a tax break for capital income, not labour income. Although capital income will account for an increasing share of total income for a large fraction of the population, after-tax wage incomes are at the core of the social partnership agreements.

4.7 Abandon the Programme for Prosperity and Fairness

Social partnership agreements have evident drawbacks. They lead to rigid wage relativities across sectors, and thus impede the allocation of labour. The ability of non-elected social partners to influence government policy – notably fiscal policy – is also troubling (see Lane 1999). Nevertheless, the sequence of agreements appear to have made an important contribution to the Irish economy's recent success, and there is a good deal of risk in abandoning them to a more decentralised wage-setting process, especially in circumstances where wage and price setters are beginning to expect high inflation.

At the risk of oversimplification, it is useful to contrast Irish wage setting with and without centralised agreements. Under industry wage bargaining between unions and businesses, wage-setters pushed for wages without regard to their overall impact on the economy, and businesses passed on their cost increases in the form of higher prices. Even at moderately high unemployment rates a price-wage spiral tended to develop. To prevent rising inflation unemployment had to be high enough to make workers fearful enough of job loss to curb their wage demands, and market conditions had to be depressed enough to induce businesses to curb their mark-ups. Having an emigration option probably made workers even less likely to settle for lower wages at any given unemployment rate, and may explain the weak relationship between wages and unemployment in Irish data (see Fitz Gerald, 1999, and Walsh, 1999), at least until recently. The result was that under industry-level bargaining only a depressed economy was consistent with price stability.[18]

Under social partnership agreements the effects of wage settlements on the overall level of activity in the economy is directly taken into account. The formula also allowed the government to exchange reductions in the tax burden for wage restraint. Thus the agreements improved the potential for non-inflationary growth and provided a timely boost to demand. As argued already, however, the formula is less well suited to an economy that needs both demand and wage restraint.

Another argument for abandoning social partnership agreements is that wage increases in the private sector are now running well above the terms of the PPF. Put differently, a good case can be made that the PPF is becoming increasingly irrelevant. Nonetheless, the agreement is binding in some sectors (notably the public sector), and it probably provides some restraining influence even in sectors in which "wage drift" is taking place. If the negotiations could be extended to include deferred compensation

[18] Calmfors and Driffill (1988) provide the classic treatment of how bargaining arrangements can affect macroeconomic performance. An important finding is that highly centralised and highly decentralised arrangements are consistent with good performance. Intermediate arrangements, such as industry-level bargaining, are associated with high equilibrium unemployment rates. The success of Irish social partnership since 1987 would challenge this finding. The partnership agreements in Ireland have been much wider than just wage bargaining mechanisms, encompassing of a wide array of economic actors and the inclusion of items that concerned them. See O'Donnell (1999) and Hardiman (2000) for excellent accounts of the Irish social partnership experience in an international context.

elements such as pension bonds or contributions to individual retirement saving accounts, they might help to tame the price-wage cycle. Even if the social partnership process is beginning to outlive its usefulness, it seems foolhardy to abandon it when wage restraint is most needed.

4.8 Allow a once-off special increase in wages under the PPF

One of the most controversial suggestions for stunting the price-wage spiral has been to renegotiate the PPF to allow for a substantial one-time wage increase. The prime motivation for such a proposal, however, is that the private and public sector wage drift is making it harder for sectors adhering to the terms of the agreement to retain and attract talented staff. This is clearly true in a number of sub-sectors of the public service – with nursing being a very visible example. The hope is that if proper market relativities were restored the pressure to abandon the PPF would ease.

Of course the government cannot allow a haemorrhaging of skilled personnel from the public sector to continue. Nevertheless, a substantial one-time increase in wages would almost certainly worsen inflation pressures. Increasing public sector wages would further add to an already expansionary fiscal policy stance, increasing demand, and fueling the spiral in the private sector. There would also be pressure on private sector firms that are not adhering to the terms of the PPF to increase wages to maintain their attractiveness in a tight labour market.

As with the argument for increased capital spending, and indeed the argument for labour income tax cuts, there is a strong microeconomic efficiency rationale for the allowing a one-time upward adjustment in wages. But it is hard to make a case that this policy is a means of controlling inflation. So again there is a trade off. The point on this trade off that we choose will depend, in part, on how dangerous we perceive rising relative inflation to be.

5. Concluding Comments

The paper began by noting the recent sharp rise in Irish inflation, and by asking if it matters. The disastrous experience across the OECD with high inflation in the 1970s, and the economic costs of reducing it in the 1980s, has conditioned economists, policy-makers, and the public to fear its rise.[19] The poor performance of the Irish economy in the 1980s has also made us sensitive to any suggestion of deteriorating cost competitiveness. It is thus disconcerting when we hear that inflation is natural in an economy experiencing rapid foreign investment led growth, and that Ireland's competitive advantage is robust enough to shrug off a period of rising relative costs.

We hope this confidence turns out to be well placed. It is hard, however, to share the confidence that Ireland's competitive advantage can withstand a damaging inflationary spiral. The lessons about how hard it is to get inflation down once it has risen – whatever the initial cause – have been too easily forgotten, as has the frequency with which even economies experiencing strong underlying supply growth can go from overheating to

[19] Of course, the main reason the public dislikes inflation is that it erodes their living standards, and not that it threatens economic growth. Although this can be true in the short run, witness the recent decline in the purchasing power of social welfare payments, history shows nominal wages and other incomes tend to rise at least as fast as inflation over the longer term.

recession. The argument is not about whether the Irish economy is experiencing exceptional growth in its underlying supply (and demand) potential. That much can be taken for granted. The issue is whether allowing growth to move even a couple of percentage points beyond the rate consistent with stable inflation imprudently will put this achievement at risk.

This paper thus urged that efforts be made to dampen the price-wage spiral. The trouble is that many of the policies that have been suggested are useless or worse as inflation management tools, though some have other merits. Some of the options discussed have a better chance of helping – such as proposals for government financed deferred compensation through retirement accounts and the elimination of competition reducing regulations; but these policies face political opposition and are not panaceas. There is also the question of time: policies such as deferred compensation arrangements will take time to establish.[20] At the very least, the government must not in the coming months pursue policies, such as tax cuts beyond the terms of the partnership agreement, that further fuel the spiral.

[20] Even though they would take time to establish, a credible commitment to such an approach could have an immediate impact on wage negotiations.

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