



# The economy: handle with care

The steeply rising costs faced by Irish businesses are affecting their competitiveness. Controlling these costs is among the key challenges facing the incoming government. **Brian Skelly** reports

**T**HE Irish economy has outshone all other European economies over the past decade, but it seems like its star may be on the wane. Over the past few months, a growing number of clouds have appeared on the horizon and are starting to take on ominous proportions.

Interest rates have crept up steadily in the past year with the European Central Bank (ECB) base rate climbing from 2pc in early 2006 to 3.75pc today and further increases are expected in June. At the same time, inflation has edged steadily upwards. The average rate of Consumer Price Index (CPI) inflation in April was 5.1pc, driven by increases in housing, water, electricity and gas costs. Meanwhile, productivity rates have fallen significantly from rates that prevailed at the height of the boom, making the economy much less competitive (see panel).

Economists warn that this disparity between productivity on the one hand and costs on the other is a worrying trend and bodes ill for the future.

Dr Alan Ahearne, a lecturer in Economics at National University of Ireland (NUI) Galway, believes the gap between productivity and inflation is a major concern for the Irish economy because it erodes the competitiveness of Irish industry and, unless addressed, it threatens to derail the economy altogether.

While high inflation and wage growth is nothing new in Ireland — both have been running at higher levels than in other euro-zone countries for several years now — the problem now, he maintains, is that, in contrast to the late Nineties and early part of this decade, productivity increases are no longer compensating for the higher cost levels. In fact, a yawning gap has opened up between the two.

“At the moment, we have an average

wage growth of about 5.5pc and productivity is less than 1pc. I would argue that this is not sustainable; it is not consistent with maintaining full employment,” he says.

The problem is compounded, he argues, by the fact that Ireland, as a small open economy, is more vulnerable to external shocks such as sudden exchange rate movements and surges in oil prices than larger, more mature economies. It is further exacerbated by Ireland’s membership of the euro, which restricts the range of economic instruments that can be used to dampen down high inflation.

While there may still be a strong feel-good factor around due to SSIAAs and strong consumer spending, the fact is that the economy is delicately poised and will require careful handling if inflation is to be kept under control, Ahearne believes. Wage moderation is a crucial variable in this equation because, if wages continue to creep up, they will push up inflation and reduce productivity.

“We need to make sure we don’t pay ourselves more than we can afford because it will make us uncompetitive,” he warns.

John Dunne, chief executive of Chambers Ireland, agrees. “Recent inflation is being driven by increases in interest rates and fuel costs — two things that are largely outside our control. If our costs are starting to rise because of those two factors, the last thing we need to do is increase a third category of cost — wages. We need to compensate for cost increases that are outside our control by making savings on things we can influence such as wages, ideally through productivity. Wages account for almost 30pc of energy costs and we would question why savings on this side were not used to offset increased costs in international fuel prices.”

In this context, Social Partnership has assumed even greater significance than usual because of its unique role in control-

ling wage increases. The current partnership agreement, Towards 2016, is the latest in a series of deals stretching back nearly 20 years that have, it's generally accepted, been critical to the Irish economic miracle.

But now, against a backdrop of high inflation levels, some trade unions, notably the teachers' and nurses' unions, are looking to renegotiate the current partnership agreement.

Ahearne believes this would be a "big mistake" for the economy as it could conceivably induce an inflationary spiral, fuelled by wage increases. The reason this is so is because wages are the biggest cost for most firms and, if they face higher wage bills, they will try to push increased costs through to their customers in the form of higher prices.

Dunne is also against the idea of renegotiating the national pay deal and believes it is based on a false premise. He points out that Irish inflation as measured by the Harmonised Index of Consumer Prices (HICP) — the measure favoured by the ECB — is 2.9pc, which is significantly lower than the CPI measure of 5.1pc. HICP represents the true underlying inflation in the economy, he argues, and is therefore the measure that should be used as the benchmark for wage comparisons.

"From the point of view of renegotiating pay deals, we believe there is no need to do that. Several years ago we had a situation where the underlying rate of inflation was 5pc and over. That is not the case now."

Dunne stresses that he is not arguing for wage cuts or freezes but simply that, where wage increases happen, they must be matched by productivity increases. It's a simple case, he says, of not allowing Ireland to live beyond its means.

"Businesses can afford rising wage demands so long as productivity is rising at least as fast as wages and this has not been happening over the past few years."

But wage rates are not the only pain point for Irish business. Dunne indicates that businesses have been hit by spiralling costs on a number of fronts, from big hikes in local authority charges to drastic increases in energy costs — up 60pc since 2000. All told, it's a fairly grim picture.

Ahearne believes that Social Partnership can continue to be a force for good in the Irish economic context, but only if pay rates stay within sustainable parameters. He says the level of wage increases negotiated will have "a crucial bearing on our future competitiveness" and competitiveness has been and must continue to be the backbone of the Irish economy.

"The transformation of the Irish economy from the basket case it was in the Eighties to the rich, advanced economy it is today is based on our ability to export. That in turn is based on our competitiveness. And if we lose that competitiveness, it will be very difficult to get it back."

#### KEEPING A COMPETITIVE PACE

As a new government takes the reins over Ireland's future, there is much potential for success. The economy has performed very well over the past decade, but in the aftermath of our economic boom it has become notably fragile.

To be competitive, Ireland needs a strong, stable government with the conviction to deliver key projects such as Transport 21 and Next Generation Network (NGN) broadband, both of which will greatly enhance the sustainability of Ireland's progress to date and are crucial to our attractiveness as a location for foreign direct investment (FDI).

"These improvements will not just benefit the business community — they will percolate through the economy through increased investment, more competition, lower prices and increased employment," says David Pierce, president of Chambers Ireland.

The key challenges facing the next government include maintaining a competitive business environment, building our regions, delivering a quality virtual and physical infrastructure and addressing energy and environmental challenges.

"For Ireland to continue to grow, infrastructural development — both virtual and physical — must be prioritised and implemented without delay. Furthermore, we must borrow if necessary to plug these infrastructural gaps," continues Pierce.

Ireland's world competitiveness ranking

slipped three places from 11th to 14th in 2007 based on our economic performance, government efficiency, business efficiency and infrastructure (see panel, page 7).

While external shocks are largely out of the incoming government's control, there is much that can be done to halt this downward trend in our competitiveness. "Our corporate tax rate remains a key attraction for FDI and should be sacrosanct – as should the 20pc capital gains tax which is an important incentive for the business community's risk takers," says Pierce.

Furthermore, regulation is having a crippling effect on many businesses – particularly small to medium-sized enterprises. The current level of red tape prevents entrepreneurs from focusing on their core business. To correct that, Pierce believes the government should codify all regulations for business and only allow them to be updated on two set days per year.

"The recently published report of the Business Regulation Forum clearly shows that costs and competitiveness continue to be major concerns for Irish business. Anything which can reduce costs and deliver increased competitiveness is a good thing," continues Pierce. "We must remain vigilant regarding the cost impact of over regulation. There are some eminently sensible suggestions in this report. The crucial issue will be to ensure that these are implemented," he adds.

He also maintains that a review of the decentralisation process will be essential during the lifetime of the next government,

along with the abandonment of any moves that do not yield a financial saving. In addition, there is an acute need to build our regions and correct the imbalance that has developed between urban and rural. "This means creating an independent revenue stream of at least €3bn for local authorities, reviewing the current public service decentralisation programme and supporting the development of an all-island economy," says Pierce.

Ireland remains a disparate economic phenomenon and this needs to be balanced, as there is a severe risk that major urban centres will be over developed while rural communities suffer due to a lack of quality infrastructure, low investment and a brain drain with many graduates moving to major cities.

In this respect, the further expansion of the Business Expansion Scheme (BES) would be a step in the right direction, according to Pierce. "Raising the funding ceiling to €10m would greatly boost the development of many Irish businesses and perhaps correct the regional imbalance that currently exists in Ireland's economy," he says.

While there are many issues for the new government in addition to these (see panel), what is key is the conviction to identify the problems that currently exist and tackle them without delay.

"With the economy in a slightly precarious position at the moment, stability and action are crucial if we are to build on our past success," concludes Pierce.

## WORLD COMPETITIVE RANKINGS

	2007	2006
USA	1	1
Singapore	2	3
Hong Kong	3	2
Luxembourg	4	9
Denmark	5	5
Switzerland	6	8
Iceland	7	4
Netherlands	8	15
Sweden	9	14
Canada	10	7
Austria	11	13
Australia	12	6
Norway	13	12
Ireland	14	11
China	15	18

## IRELAND SLIPS DOWN COMPETITIVENESS LEAGUE

Fears about the eroding productivity of the Irish economy have been borne out by new research, which shows that Ireland continues to slide down the global competitiveness league.

The 2007 'World Competitiveness Yearbook', published in May by Swiss business school IMD, shows that Ireland fell three places in the competitiveness ranking, from 11th to 14th, just ahead of the improving China.

The Republic's highest position in the rankings was achieved in 2000, when it was placed fifth.

The IMD bases its competitiveness assessment on four principal criteria: economic performance, government efficiency, business efficiency and infrastructure.

## ECONOMY AT A CROSSROADS

Low unemployment, buoyant consumer spending, solid growth levels — all indicators of a strong economy and all evident within the current Irish economic landscape. Yet our economy seems to have a fragility about it that it did not have at the height of the boom. Some believe it is at a crucial juncture, from where it can go one of two ways: forward or into reverse.

Below, NUI Galway economist Dr Alan Ahearne outlines what he sees as best and worst case scenarios for the economy. The good news is that we are still masters of our own destiny to the extent that we can control certain variables such as wages through the Social Partnership process. The bad news is that, as a small open economy, we are more vulnerable to external shocks than most. The reality is that if the economy continues on a solid footing for several more years, it will be due to a combination of prudent economic management on the one hand and the absence of severe external shocks on the other.

### BEST CASE SCENARIO

"We get control of our cost increases, which means that wage increases are in line with productivity. Then we continue to implement policies that continue to improve our productivity growth. These would have to do with our infrastructure, our educational system and the overall flexibility of our economy."

### WORST CASE SCENARIO

"We don't control cost increases and are hit by some bad external shock

such as the dollar continuing to drop, which would be very serious for Irish exporters. Ironically, if the German economy continues to improve, the Central Bank would probably push up interest rates so then we would face a perfect storm of falling dollar, higher interest rates and loss of competitiveness."

**'Businesses can afford rising wage demands so long as productivity is rising at least as fast as wages'**

John Dunne, Chambers Ireland

**'At the moment, we have an average wage growth of about 5.5pc and productivity is less than 1pc'**

Dr Alan Ahearne, NUI Galway

**'For Ireland to continue to grow, infrastructural development must be prioritised and implemented without delay'**

David Pierce, Chambers Ireland

# PRIORITIES FOR THE NEW GOVERNMENT

**ROADS** – Develop a fully integrated transport service and deliver Transport 21 on time and on budget.

**AIRPORTS** – Unbundle the three state airports as committed to in the State Airports Act, 2004.

**DECENTRALISATION** – A review of decentralisation and the abandonment of any moves which do not yield a financial saving.

**PUBLIC SECTOR REFORM** – Wage increases should be directly linked to increases in productivity and the benchmarking process must be strictly adhered to.

**EDUCATION** – Support employees investing in part-time training, incentivise students undertaking key subjects required by our economy and lengthen the primary school day by one hour.

**ENERGY** – Break up ESB power generation and promote alternative energy via the extension of the BES.

**WASTE** – Implement the polluter pays principle above a reasonable consumption threshold and develop thermal treatment capacity.

**BROADBAND** – Deliver a futureproofed next-generation national broadband network by 2012.

**CHILDCARE** – Aid access to affordable childcare by excluding childcare supports from employers from benefit-in-kind payment liabilities.

**BETTER GOVERNMENT** – Expand e-government services, assess real productivity gains and publish a statement of national liabilities such as pensions in the National Accounts.

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