Ireland Out of Step

When on 22 February 2001 the Council of the EC urged Ireland to change the course of its fiscal policy in order to curb – rather than stimulate – its high rate of inflation, it did so in accordance with Articles 98 and 99 of the EC Treaty. The Articles, ratified by Ireland, stipulate that the member countries conduct – and coordinate – their economic policies in such a way as to further the objectives of the Community laid down in Article 2, among them steady growth, high employment and price stability. In order to safeguard the sustained economic convergence of member countries and the consistency of economic policy with these objectives the Council monitors the performance of each country at regular intervals. Only where it is found that national policy is not consistent with the policy guidelines may the Council issue a formal recommendation. Ireland is the first country where the Council has made use of this competence. Does the country really deserve the criticism?

The Irish economy grew rapidly in 2000 and reached a new record high of 10.7% (1999: 9.8%). Employment growth amounted to a strong 4.5%, leading to a further significant decline in unemployment to only 4.5% (1999: 5.7%). At the same time, inflation accelerated to 5.3%, supported by both domestic demand pull and a strong wages push. The government budget exhibited a vast surplus of 4.7% of GDP, and public debt declined to an estimated 37%, down from 50% a year earlier; by 2003 the debt level is projected to recede to a mere 24%. Ireland reports by far the lowest public expenditure ratio in Europe (32%), and it has used past surpluses to set up a National Pensions Reserve Fund which already amounts to more than 6% of GDP. With the exception of the high rate of inflation this is a formidable performance, to be envied by all other member countries. Was it sheer envy that produced the criticism? And was it another instance of “small-country bashing” (after the ill-fated bashing of Austria)?

For Ireland it does make economic sense to counteract the strong inflationary pressure, even if the rate of inflation has declined somewhat since last December, and even if that rate partly reflects external forces (oil price increase, weak euro) and the Balassa-Samuelson effect typical for emerging economies with high rates of productivity growth. Indeed, as early as in June 2000 the Council had urged Ireland to take fiscal measures against the overheating of its economy. This recommendation was not taken seriously. On the contrary, on 6 December 2000, in the midst of an economic boom, the Irish government presented a budget with major pro-cyclical elements: cuts in direct and indirect taxes amounting to 1.5% and 0.4% of GDP respectively, and increases in current and capital expenditures of 18% and 29% respectively. The Council judged therefore – correctly, one should say – that the budget “will give a further substantial boost to demand in Ireland and its possible supply effects are likely to be small in the short term. It will therefore aggravate overheating and inflationary pressures …”

For Ireland, as for the other member countries belonging to European Economic and Monetary Union (EMU), monetary policy is no longer available as a national tool to counter inflationary pressure. Nor is the instrument of exchange-rate revaluation, an instrument that Ireland last applied in March 1998, before entering the euro area. Further tightening of fiscal policy was no realistic alternative either, given the already high budget surplus. What the government might have done, though, was to maintain the former fiscal stance. This is what the EC Council appears to have had in mind when it recommended that the administration should take countervailing measures in 2001 such as to “ensure that no reduction in the underlying budgetary surplus from 2000 takes place." The Irish government has turned down this recommendation. It sticks to its own approach of a policy mix of tax reduction and (temporary?) wage restraint coupled with long-term productivity effects of public investment.

While the economic arguments put forward by the Irish in favour of fiscal relaxation are less than convincing, it is also true that "Ireland's inflation harms nobody but the Irish", as The Economist put it. With a share of just one per cent of Euroland's aggregate GDP, there is no need to worry about inflation spillovers. At the same time, given the high rate of GDP growth and the increasing shortages in (qualified) labour and in real estate, an appreciation of Ireland's "real" exchange rate is called for. Since a currency revaluation is no longer possible, this "real" appreciation can only be accomplished by allowing inflation for some time to run faster than in the rest of Europe. The only – by no means costless – alternative would be to admit a larger number of immigrants.

Allowing the domestic wage and price level to rise to a new equilibrium level will in the end serve the same purpose as fiscal restraint: it will slow down (foreign) investment, reduce the rate of GDP growth (and demand expansion) and will thus pave the way for sustainable rates of output growth and of low inflation. The adjustment process of the Irish economy would be aided if the fiscal transfers under the EU structural funds were phased out. These transfers have served their purpose well, and Ireland has made good use of them. Now that GDP per capita has risen well above the EU average and the economy is suffering from an overheating, Ireland – in its own proper interest - should no longer demand to be treated as a "less prosperous" country.

If Ireland's inflation has no influence on inflation performance in Euroland and in Europe at large, and all other economic indicators are enviable, why then should Ireland be called to "order"? Two explanations lend themselves. The first is that the European Commission and the EC Council take their business seriously. EMU is more than just a monetary union, it is an economic (policy) union, too. Therefore, the fiscal authorities – in addition to the European Central Bank (ECB) – are called to further the union's objective of (price) stability in accordance with the Stability and Growth Pact. As already mentioned, Articles 98 and 99 ECT set the legal foundations for policy convergence and surveillance. If the union's commitment to stability and policy cooperation is to gain credibility, finance ministers must mind their proper business. According to this line of reasoning the EC Council had to act on Ireland, since failure to do so would have set a bad precedence for future – and perhaps more damaging – misbehaviour by larger economies.

What is puzzling, though, is that the Council has been rather outspoken on an altogether virtuous and laudable country, whereas it remains conspicuously low-key on other countries – both large and small – which are still far from meeting the budget targets of the Stability and Growth Pact, let alone the Irish growth and employment record. Under the Pact, member countries should run a slight budget surplus in boom periods. Yet, in 2000 seven out of the eleven countries participating in EMU still recorded deficits (net of UMTS proceeds), and many of them have postponed fiscal balance to 2002 and beyond. The EC Council's benign neglect of these policy shortcomings might perhaps be justified if they were mainly due to tax reductions aimed at giving a stimulus, often much needed, to higher GDP growth. In fact, however, the protracted deficits mainly reflect the timidity of governments in redressing the high levels of public expenditure, and their readiness to yield to pressure from organised interest groups. The same timidity is observable as far as structural economic reform is concerned.

This observation leads to a second possible explanation for the Council's move on Ireland. Could it be that the formidable Irish example is an eyesore to the inert slow-growers in the EU, to all those who are afraid of policy competition and who therefore wish to force a Community strait-jacket called policy coordination upon the fast and successful?

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