National Competitiveness and Productivity Council
Bulletin 22-2 Inflation and the Competitiveness of Irish Enterprises

NCPC
National Competitiveness & Productivity Council
An Chomhairle Náisiúnta Iomaíochais agus Táirgiúlachta

- **Recent increases in global energy and transport prices have increased the cost of doing business for Ireland's enterprises**
- **It is important that the desirable transition to renewable energy sources takes into account the impact of volatile oil and gas prices on Irish enterprises**
- **It remains vital that Ireland protects the competitiveness gains made in recent years, and that we continue to act to address inappropriately high domestic costs which are not matched by corresponding increases in productivity**

OVERVIEW

Generating broad-based, sustainable economic growth is fundamental for Ireland's economic prosperity. As a small open economy, it is crucial that we maintain our international competitiveness position. Competitiveness is a complex concept, which results from many different factors. Two key factors determining competitiveness performance are productivity (the efficiency with which factors of production – such as labour and capital – are used to produce output) and cost competitiveness (the relative price of employing any given factor of production).

Both productivity growth and relative price improvements allow Irish businesses to compete more effectively internationally and make Ireland a more favourable place in which to do business for both Irish and foreign firms. Furthermore, the exposure to international competition, and international best practice, can result in further productivity gains.

As a small open economy, dependent on exports and foreign investment as major drivers of growth, any deterioration in Ireland's cost competitiveness can have a major negative impact upon economic growth, employment and our standard of living. More broadly, a competitive cost base can help to create a virtuous circle between prices, wage expectations and productivity.

INFLATION DEVELOPMENTS IN IRELAND

In a market economy, relative prices for goods and services are always changing. In any given year, some prices rise, and others fall. Inflation figures are designed to capture the broad increase in the prices of goods and services, and not the prices of individual items. It is important to note that inflation measures (eg. the Consumer Price Index[1] or the Harmonised Index of Consumer Prices[2]) are based on weights of different goods and services in consumption. Furthermore, they are designed to capture changes in consumer prices, rather than the prices that businesses face. While these measures do not give a precise estimate of the increase in business costs, in the absence of a business price index, they provide a useful proxy for the price changes faced by enterprises.

Periods of high inflation are damaging to the enterprise sector if the sudden rise in the costs of doing business cannot be absorbed by some firms, resulting in the closure of otherwise viable enterprises. Rising costs may also force some firms to postpone innovation and investment spending as they reallocate spending to cover higher current costs. Domestically focused SMEs can also be negatively impacted by lower discretionary consumer spending, as Irish individuals are forced to allocate more of their household budget to the essential goods and services whose prices have risen.

There is a rich academic literature exploring the factors that cause inflation[3]. Demand-pull inflation can be caused by strong consumer demand for goods and services when unemployment is low, the economy is expanding and there is limited spare capacity. Cost-push inflation occurs when prices rise due to increases in production costs, such as raw materials and wages. Expansionary monetary and fiscal policy can also impact on inflation by increasing the

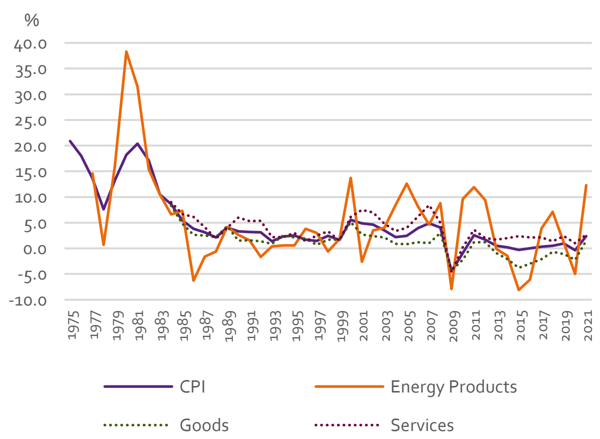
[1] The Consumer Price Index (CPI) measures the overall change in the prices of goods and services that people typically buy over time. It does this by collecting approximately 53,000 prices across Ireland every month & comparing these to the corresponding prices from the previous month.
[2] In the euro area, the Harmonised Index of Consumer Prices (HICP) is used to measure the change over time in the prices of consumer goods & services purchased by euro area households. It is "harmonised" because all the countries in the EU follow the same methodology to ensure that the data for one country can be compared with the data for another.
[3] Samuelson P. and Solow R. (1960): Analytical Aspects of Anti-Inflation Policy

spending power of consumers and enterprises relative to the supply of goods and services[4].

Research on the Irish economy over four decades has found that external factors have been the most important determinants of inflation due to the small size and highly open nature of the economy[5]. Ireland is a price taker for many goods and services with no power to influence international commodity markets. In the late 1970s, the global oil crisis had a significant impact on Irish energy prices and headline inflation. Throughout the 1970s and 1980s, deep linkages with the UK economy saw Irish inflation dynamics closely linked to UK price developments[6,7].

By the end of the 1990s, the strength of the US dollar led to a surge in Irish inflation[8], providing further evidence that much of Ireland's inflation has been determined by external factors over the past 50 years. However, domestic factors have also been found to play a role, particularly in times of recession[9]. This is evident, for example, when inflation turned negative following the bursting of the property bubble and subsequent banking crisis in the late 2000s following a period of higher inflation earlier in the decade when consumer spending was surging, and the economy was overheating (see Figure 1).

Figure 1: Historical Inflation Developments in Ireland

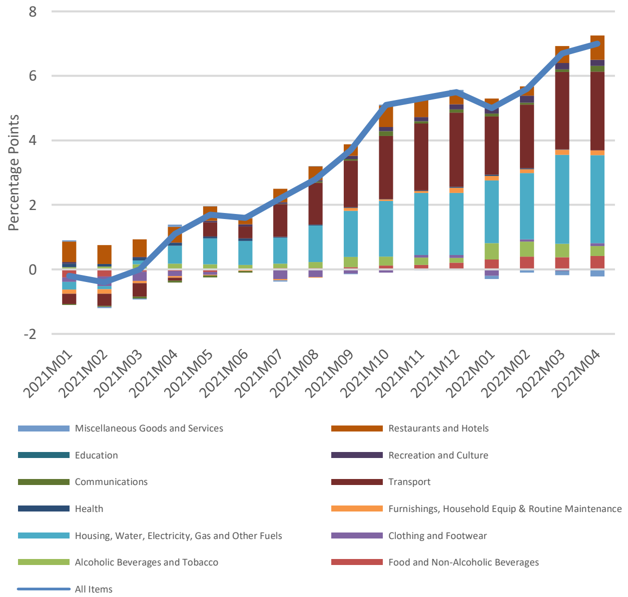


Source: Central Statistics Office

It has been argued that the increasingly globalised nature of the world economy with cheaper imports, increased labour supply, increased competition, and the integration of global supply chains has been responsible for the low and synchronised nature of inflation in advanced economies in recent decades. However, research by the European Central Bank[10] has disputed this argument and instead posited that common shocks and a move to inflation-targeting regimes played an important role in the convergence of inflation outcomes towards low and stable levels.

In Ireland, the recent surge in consumer prices has seen annual inflation reach rates last observed during the height of the Celtic Tiger. The Consumer Price Index (CPI) increased by 7.0% in April 2022 compared to April 2021 (see Figure 2). This is the highest year-on-year change in 22 years. The most notable changes in the year to April 2022 were increases in Transport (up 18.9%), Housing, Water, Electricity, Gas and Other Fuels (up 17.1%), and Alcoholic Beverages and Tobacco (up 5.1%). At the same time, the cost of Education decreased (-0.8%). Soaring energy prices accounted for almost half of the increase in the Consumer Price Index in April 2022.

Figure 2: Contributions to changes in the CPI



Source: Central Statistics Office

Inflationary pressures have been building since mid-2021 driven by rising energy prices, the rapid recovery in the domestic economy following COVID-19-related disruption, international supply chain bottlenecks, and base effects[11] relating to weak price trends in 2020. The Russian invasion of Ukraine in February 2022 has put

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[4] Arestis P. and Sawyer M. (2004): [Re-examining Monetary and Fiscal Policy for the 21st Century]
[5] Byrne S. and Zakipour-Saber (2020): [Evaluating the Determinants of Irish Inflation]
[6] Geary P. and McCarthy C. (1976): [Wage and price determination in a labour-exporting economy: The case of Ireland]
[7] Honohan P. and Flynn J. (1986): [Irish Inflation in EMS]
[8] Honohan P. and Lane P. (2003): [Divergent Inflation Rates in EMU]
[9] Bermingham et al. (2012): [Explaining Irish Inflation During the Financial Crisis]
[10] ECB (2021): [Globalisation and its implications for inflation in advanced economies (europa.eu)]
[11] The base effect can be defined as the contribution to the change in the year-on-year inflation rate in a particular month that stems from a deviation of the month-on-month rate of change in the base month (i.e. the same month one year earlier) from the usual seasonal pattern.

further strong upward pressure on global prices, particularly in energy markets. Whilst rising energy prices have been one of the main drivers of increases in the CPI, the contribution made by other components has also been increasing as energy costs and supply chain disruption begin to feed through into core inflation (excluding energy) as rising input costs impact on the price of food.

These inflationary pressures are not unique to Ireland and have been observed across the majority of advanced economies as the global economy recovers in the aftermath of the COVID-19 shock and as energy prices soar, reinforced by the invasion of Ukraine and the introduction of sanctions against Russia. Ireland is heavily exposed to the changing price of energy on world markets with the majority of Ireland's energy needs being met from imports. These prices have risen significantly in recent months, with global oil prices reaching $123 per barrel in March 2022[12]. European gas prices on average quadruped between early 2021 and March 2022[13] driven overall by supply shortages and by above average spikes triggered by the Russian invasion of Ukraine. These higher oil and gas prices have had knock on effects resulting in higher transport costs, including freight transport with shipping costs between Asia and Europe almost doubling between March 2021 and March 2022[14].

Up to early 2022, it was assumed that the higher levels of inflation being observed in the euro area were temporary in nature and that inflation would steadily decline over the course of the year as pandemic-related supply chain disruptions unwound[15]. However, the invasion of Ukraine by Russia in February and the resulting spike in energy and commodity prices has led to an upward revision in inflation expectations in the short term.

For example, the Central Bank of Ireland forecast an increase of 6.5% in the HICP in 2022 in the April 2022 Quarterly Bulletin, an upward revision of two percentage points since their previous forecast in January 2022[16]. The Department of Finance's Stability Programme (April Update) forecasts a baseline scenario with headline inflation averaging 6.2% in 2022 with the rate of inflation decelerating later this year.

Given the high level of uncertainty, there is an upside risk to the inflation outlook with the Department of Finance noting that a sustained energy price increase could add a further two percentage points to headline inflation for 2022, which would bring their forecast to 8.2%[17]. This notwithstanding, it is worth noting that any easing in the rate of inflation in the second half of this year would reflect a slowdown in the rate of price increases, rather than prices overall falling from their current high levels.

While the short-run economic and inflation outlook are heavily dependent on how the situation in Ukraine evolves, in the medium term there are also concerns that the costs involved in transforming to a zero-carbon economy ("greenflation") and the lingering effects of large volumes of money created by quantitative easing may contribute to a prolonged period of higher inflation[18]. Declining populations in many advanced economies and a growing scarcity of labour are also likely to contribute to higher inflation in the medium to long term.

MONETARY POLICY AND INFLATION RATES

The European Central Bank (ECB), and its Governing Council, is responsible for monetary policy in the euro area and has a price stability mandate to target an inflation rate of 2.0% over the medium term. In order to ensure that inflation remains low, stable and predictable, the ECB uses several instruments to help steer inflation, including interest rates and, in the past decade, asset purchase programmes.

At its 14 April 2022 meeting, the ECB Governing Council held interest rates unchanged and judged that the net asset purchases under its asset purchase programme should be concluded in the third quarter of this year. Looking ahead, the ECB's monetary policy will depend on the incoming data and the Governing Council's evolving assessment of the outlook. Financial markets expect the ECB will gradually raise interest rates this year, possibly beginning in July 2022.

The ECB published its latest set of macroeconomic projections in March 2022. This report noted that the outlook for euro area activity and inflation had become very uncertain on foot of Russia's invasion of Ukraine, but that economic growth would pick-up as 2022 progresses, with the headwinds from the pandemic and supply bottlenecks gradually beginning to fade. Whilst private consumption has contracted as a result of a price-induced drop in real disposable income, growth is expected to average close to 4% for 2022.

[12] Brent crude oil - tradingeconomics.com
[13] EU Natural Gas - tradingeconomics.com
[14] Xeneta Shipping Index
[15] ECB Chief Economist Philip Lane Interview with RTÉ 7 January 2022
[16] Quarterly Bulletin Q2 2022 | Central Bank of Ireland
[17] Based on a scenario analysis where the additional price increases are relative to the baseline prices that underpin the central forecasts.
[18] How does inflation impact businesses? | Henley Business School

In the United States, the Federal Reserve increased its target range for the federal funds rate to 0.75%-1.0% on 4 May 2022, the second rate increase this year. It anticipates that ongoing increases in the target range will be appropriate given the buoyant outlook for the US economy. In addition, the Federal Reserve decided to begin reducing its holdings of Treasury securities and agency debt and agency mortgage-backed securities on 1 June 2022, as described in its Plans for Reducing the Size of the Federal Reserve's Balance Sheet[19].

On 5 May 2022, the Bank of England raised interest rates by 25 basis points to 1.0% to tackle spiralling inflation. The Bank of England decided to hold back from actively selling its £875 billion portfolio of UK government bonds built up through its quantitative easing programme and will provide an update in August on plans for a disposal programme. Financial markets anticipate some degree of further tightening in the months ahead.

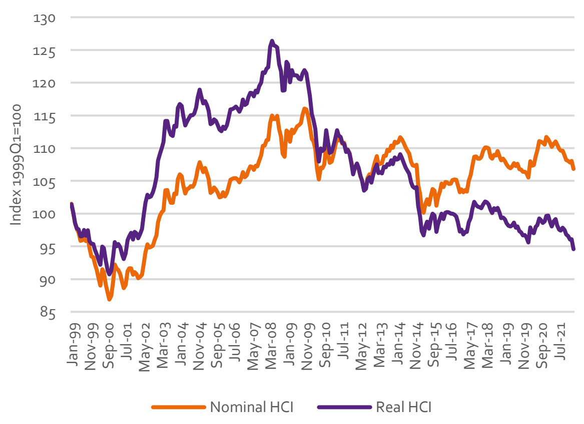
Over the coming quarters, Central Banks around the world will carefully balance the need to stabilise inflation with interest rate rises, while being mindful not to stifle the faltering economic recovery, particularly in Europe, where the effects of the Russian invasion of Ukraine are being felt more acutely.

MEASURES OF OVERALL COST COMPETITIVENESS

Inflation developments in the domestic economy are just one element of Ireland's competitiveness position. Overall cost competitiveness is more complex and is determined by a combination of exchange rates and movements in relative prices between trading partners. For example, for a given exchange rate, Ireland would become more cost competitive if the domestic price of goods and services increased at a slower rate than the price of those goods and services in our competitor countries. Similarly, Ireland would also become more cost competitive if relative prices remained constant, but the euro depreciated against relevant foreign currencies. This is an important consideration for Ireland as approximately 60% of our merchandise trade is with non-euro area countries.

Harmonised Competitiveness Indices (HCIs) effectively apply this concept to the whole economy. The real HCI figures suggest that Ireland experienced a deterioration in cost competitiveness between 2000 and 2008. Following the financial crash there was a gradual improvement in cost competitiveness until 2014 when progress plateaued (see Figure 3). The HCIs have fluctuated in a narrow range in recent years, indicating that Ireland's relative competitive position has remained reasonably stable.

Figure 3: Harmonised Competitiveness Indicators

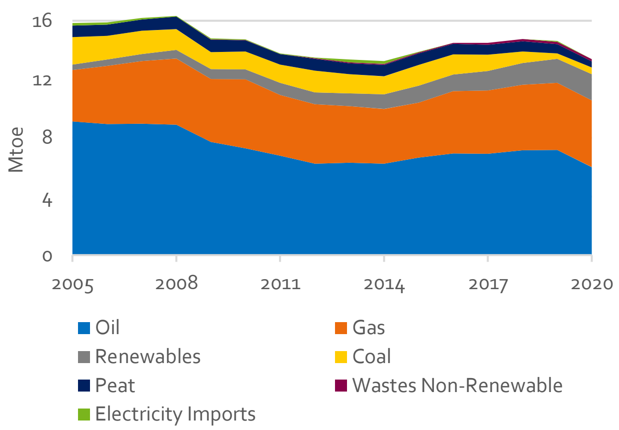


Source: Central Bank of Ireland

FOSSIL FUEL DEPENDENCY

According to the CSO's April 2022 CPI release, 2.98 percentage points of the 7.0% increase in the CPI were driven by energy prices, highlighting the significant impact that developments in international energy markets can have on prices in Ireland.

Figure 4: Primary energy by fuel



Source: SEAI

A recent NCPC Bulletin[20] explored how Ireland is heavily reliant on imported energy (oil, gas and coal) as its primary energy[21] source, with oil (45%) and gas (34%) being the largest primary sources for Ireland's energy in 2020. However, the energy sector is also going through rapid change, with the share of renewable energy in Ireland's

[19] Federal Reserve Board - Plans for Reducing the Size of the Federal Reserve's Balance Sheet

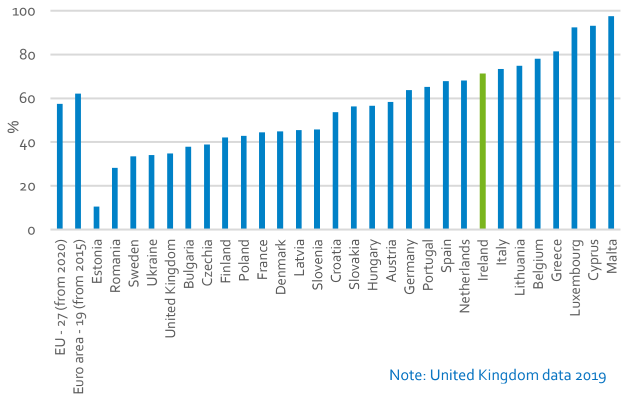
[20] Bulletin 22-1 Energy Security

[21] Primary energy includes the raw fuels that are used for transformation processes such as electricity generation and oil refining.

primary supply growing from 2.3% in 2005 to 13.3% in 2020[22] (see Figure 4).

Ireland's import energy dependency[23] was 71% in 2020, the 8th highest in the EU and above the EU average of 57% (see Figure 5). This average dependency is down from 89% between 2001 and 2015, primarily due to gas coming from the Corrib field in 2015 and the increasing use of indigenous renewable energy.

Figure 5: Import dependency of European Countries 2020



Source: Eurostat

This high import dependency means Ireland is more exposed to external shocks in world energy markets. While Ireland does not import natural gas (directly) from Russia and only a small percentage of our total oil imports come from Russia, the current crisis in Ukraine has accelerated global energy price inflation, with natural gas and oil prices rising to near record levels. As a small open economy, Ireland is acutely exposed to these cost increases and energy supply challenges.

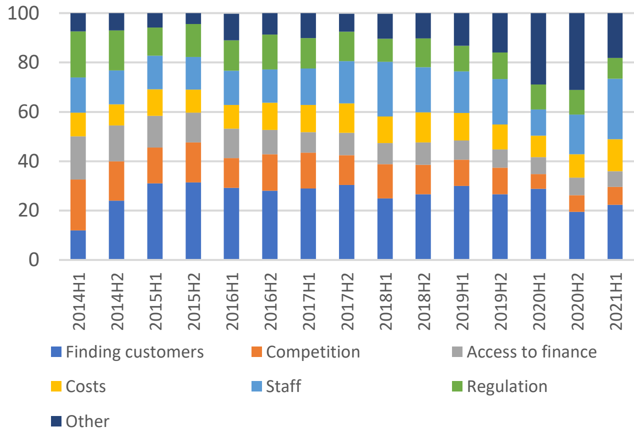
To move towards the goal of achieving net zero greenhouse gas emissions by 2050, Ireland has committed to ambitious targets to move away from fossil fuels towards renewable energy sources. This is reflected in the Climate Action Plan 2021[24], whose target is to increase the proportion of renewable electricity to 80% by 2030, including an increased target of up to 5 Gigawatts of offshore wind.

To meet the growing energy demand in Ireland and to address increased supply uncertainty, the Council believes that there should be an urgent focus on projects that help diversify energy supply sources and that upgrade our electricity infrastructure. These actions will not only improve Ireland's energy security and help achieve our climate action targets but will also help to insulate Irish enterprises and households from future volatility in the international prices of fossil fuels.

OTHER ENTERPRISE CONCERNS

While cost competitiveness matters to all firms, data from the ECB SAFE Survey (see Figure 6) show that only 12.8% of Irish SMEs cited costs as the most pressing issue that they were facing in 2021[25]. In the context of a growing economy, Irish SMEs indicated that finding customers (22.4%) and the availability of skilled staff and experienced managers (24.6%) were more urgent issues than increasing costs. It is important to note that the latest available survey data, relating to April-September 2021, predate the Russian invasion of Ukraine. The next wave of the SAFE survey is due to be published in June 2022 and will cover the period October 2021-March 2022.

Figure 6: Most Pressing Problems faced by Irish SMEs



Source: ECB SAFE Survey

Across the EU, 13.4% of all SMEs considered costs to be the most significant issue they were facing in 2021. In Italy, roughly one in every five SMEs considered costs to be the biggest issue (18.8%), while 12.9% of French firms agreed. The relative importance of costs was somewhat lower in Germany (8.7%), Austria (8.5%) and the Netherlands (8.2%).

When the next SAFE survey is published in June 2022, the relative importance of cost competitiveness may change in light of recent geopolitical developments. However, the results of last November's survey highlights the

[22] Energy Use Overview | Energy Statistics In Ireland | SEAI
[23] The extent to which an economy relies upon imports in order to meet its energy needs.
[24] Climate Action Plan 2021

[25] SAFE Survey Published November 2021. The survey was conducted between 6 September and 15 October 2021 and covered the period from April to September 2021.

importance of taking a holistic view of the enterprise ecosystem and ensuring that areas such as adequate labour supply, appropriate skills base, sufficient access to finance and historically non-competitive domestic markets are not overlooked when an acute issue, such as the current surge in inflation, arises.

SECOND ROUND EFFECTS

More broadly, all sectors of the economy are interlinked and interdependent – high and increasing business costs have implications for the costs of living. These in turn have knock on implications for wage demands, and to the potential creation of inflationary cycles. It remains vital, therefore, that Ireland protects previous gains in competitiveness, and that we continue to act to address inappropriately high costs (where price increases are not matched by corresponding increases in productivity) wherever they arise.

Preliminary evidence from the final quarter of 2021 showed that average weekly earnings were €864.51, an increase of 2.0% from the same quarter one year earlier and an increase of 9.9% from the same period in 2019[26]. When considering the change in average earnings, it should be noted that there may be a compositional effect due to the significant changes in employment in certain sectors that were particularly impacted by COVID-19.

In this regard, there is a role for both the public and private sectors alike to proactively manage their cost base and drive efficiency, thus creating a virtuous circle between the costs of living, wage expectations and cost competitiveness.

CONCLUSION

Ensuring Ireland's international competitiveness is key to underpinning our future prosperity. The NCPC believes that it is essential that Ireland maintains a competitive cost base relative to our key competitors. Over recent months, Ireland has experienced a degree of upward price pressures not seen for 20 years with rising energy prices accounting for almost half of the increase in the Consumer Price Index.

As a small, open economy and price taker on international markets, many of the drivers of Irish inflation are outside our control. In order to better manage our exposure to cost volatility on international energy markets, Ireland must diversify our energy sources away from fossil fuels and towards renewable energy sources, which will also contribute to achieving our ambitious goal of net zero greenhouse gas emissions by 2050, as set out in the Climate Action Plan 2021.

The focus must also remain on implementing domestic reforms to boost productivity and reduce costs where possible. This includes delivery across a range of recommendations set out in the Council's last annual report, *Ireland's Competitiveness Challenge 2021*[27]. These include options to reduce the burden of legal costs (Recommendation 2.1), improve competition in the provision of SME credit (Recommendation 2.3), make childcare costs more affordable (Recommendation 4.4), and make sustained progress under the Climate Action Plan (Recommendation 5.2). The NCPC Secretariat is currently preparing *Ireland's Competitiveness Challenge 2022* which will revisit many of these issues and will make further recommendations on the policy interventions required to boost productivity and ensure cost competitiveness.

Further Reading:

The NCPC reports to the Taoiseach and the Government, through the Minister for Enterprise, Trade and Employment, on the key competitiveness and productivity issues facing the Irish economy and makes recommendations to Government on how best to address these issues. The latest NCPC publications can be found at: www.competitiveness.ie.

This Bulletin has been issued by the Chair, Dr Frances Ruane, and was prepared by Linda Kane and Dermot Coates in the NCPC Secretariat.

[26] Earnings and Labour Costs - Central Statistics Office

[27] Ireland's Competitiveness Challenge 2021