# Irish Inflation.......Service Included !

The decline in Irish CPI inflation during 2001 masked the fact that there was continuing strong upward pressure on prices last year. If one excludes changes in mortgage rates and indirect taxes, one finds that the underlying level of inflation remained broadly unchanged during 2001 at around 5%. This is all the more disappointing, as a sharp fall in oil prices should have triggered a decline in the underlying inflation rate last year.

Indeed, there was a marked intensification of price pressures in some sectors of the economy during 2001. Food price inflation accelerated sharply to around 7%. However, a marked pick up in food price inflation was evident throughout the eurozone last year. More worrying was the sharp acceleration in service sector inflation in Ireland last year with the annual rate rising from 4.6% to 8% between January and December 2001.

Why has Irish inflation surged so much in the last couple of years ? The simple answer is a growing imbalance between supply and demand. The economy was able to grow rapidly during the second half of the 1990s without generating inflation because of the considerable degree of excess supply. Investment spending was rising rapidly while the unemployment rate was relatively high. Thus, wage inflation remained moderate.

By 2000, though, the spare capacity in the economy was used up. Full employment had been achieved. Consumer demand, though, remained strong, even in 2001, when there was a marked slowdown in output growth. The result has been a marked acceleration in wage growth in the past couple of years with a knock on effect on service sector inflation in particular.

Wage growth accelerated to some 10% in the public service, financial services and general services sectors in the first half of 2001. Meanwhile, manufacturing and construction were showing annual wage growth rates of 12.5% and 13.5%, respectively, by September 2001. It is little wonder, then, that consumer prices are rising rapidly.

Strong inflationary pressures now appear to be deeply embedded in the economy. Saddled with very low interest rates and a weak exchange rate, there is not much that the authorities here can do. A tighter fiscal policy would be appropriate but there is little appetite for this at the present time. In any event, the scope for fiscal policy to lower inflation significantly, in a small open economy like Ireland, is very debatable.

Today's CPI data for March show inflation rose further as a VAT hike took effect. The headline CPI rate climbed to 4.8% from 4.7% in February while the core ex-mortgages rate rose to 5.4% from 5.2%. With oil prices turning out to be much higher than expected this year, which has also quashed any hope of a further ECB rate cut, we have been forced to revise our CPI forecasts upwards.

We now expect the headline CPI rate to average 4.5% in 2002, up from our previous estimate of 4%. The CPI rate should fall in the second quarter as the sharp rises in food prices in the same quarter of last year drop out of the annual rate. However, rising fuel costs will limit the decline in the CPI rate, which looks likely to remain comfortably above 4% over the balance of the year.

The reversal of indirect tax cuts accounts for the rise in inflation from its lows of last November, when the headline rate stood at 3.8%. Tax cuts in Budget 2001, which depressed the inflation rate by around 0.6% last year, have now dropped out of the annual comparison. Meanwhile, Budget 2002 contained indirect tax rises which have boosted the CPI by an estimated 0.8% in recent months.

Thus, indirect tax changes account for all of the rise in the inflation rate since last November. Meanwhile, rising service sector inflation has also put upward pressure on the CPI rate in recent months. However, this has been more or less offset by declining food price inflation. All in all, then tax increases are now boosting the inflation rate whereas they depressed it during 2001.

A big gap has opened up between the Irish HICP rate which rose to 5.1% in March and the average rate for the eurozone of 2.5% for that month. Obviously, the recent sharp hike in Irish taxes is distorting the picture somewhat, boosting the Irish HICP rate by around 0.8%. Even allowing for this, the gap is still very wide and largely reflects the much higher service sector inflation in Ireland.

Services account for one third of the HICP. The Irish HICP rate for services, at 7.8% in February, is three times the eurozone average of 2.6%. It is difficult to see the gap in service sector inflation narrowing significantly anytime soon, given the differing economic prospects in Ireland and the rest of the eurozone. Thus, Irish inflation looks set to remain well above the eurozone average.