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Wages and Ireland's International Competitiveness

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SUMMARY

At the beginning of the crisis in 2008 it was a widely reported view that Ireland had become uncompetitive, leading to calls for wage cuts. Since then wage rates in the private sector have been largely stable. However, Ireland has shown a strong improvement in exports despite a difficult international trading situation. This presents a puzzle. If wages in Ireland were uncompetitive, how could Ireland improve its export position so rapidly, without a general fall in wages?

Ireland can best be described as having moved from a position of 'super-competitiveness' to 'competitiveness'. During the construction boom, exports remained an important driver of growth. Increases in nominal unit labour costs were driven by a general increase in inflation, rather than the labour market. Since 2008, the fall in nominal unit labour costs is almost entirely due to a move away from the labour intensive construction sector. However, while labour costs have been stagnant in Ireland, they have increased amongst our trading partners.

KEY POINTS

- Nominal unit labour costs are the main wage related competitiveness measure in the EU's "Macroeconomic Imbalances Procedure".
- During the construction boom exports drove economic growth of 2.9%.
- From the years 2000 to 2008, the increase in nominal unit labour costs was mainly due to a general increase in inflation, rather than labour market pressures.
- Following 2008, Ireland quickly regained a position whereby its exports paid for its imports and interest owed abroad.
- Since 2008 Irish labour costs have been stagnant, but increased by 8.1% in the rest of the Eurozone.
- Nominal unit labour costs declined by between 11% and 15%, almost entirely due to a shift away from the labour intensive construction sector.

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Research for new economic policies

What is competitiveness?

Both Katie Taylor and Rory McIlroy can be described as competitive sportspeople. However it would be cruel to send Rory McIlroy into a boxing ring against Katie Taylor, and expect him to perform. Competitiveness is not a clearly defined concept that can be reduced to a single number. Both Katie Taylor and Rory McIlroy are competitive in different areas, along different dimensions. Similar economic competitiveness can not be reduced to a single measure. For example, the World Economic Forum looks at 12 'pillars' of competitiveness with over 100 sub-indices, most of which deal with quality, rather than hard numbers.

As the 2008 financial crisis developed into a crisis of EU governments' abilities to finance themselves, the European Commission became worried about imbalances between different countries that are members of the Eurozone. Rather than the crisis being caused by problems in financial markets, the European Commission interpreted the cause of the crisis as imbalances between users of the Euro currency. For example, countries such as Greece were considered to be uncompetitive relative to countries like Germany. When countries have their own currency this is not such a problem. A country can improve competitiveness by devaluing its currency (as Ireland did in the 1992). This has the effect of making a country's exports cheaper.

With a single currency this is not an option. Therefore the European Commission decided to monitor eleven indicators to ensure countries do not reach the point that the Euro is valued too highly for their circumstances. This process of monitoring is known at the "Macroeconomic Imbalances Procedure". The indicator that is most relevant in the discussion of wage competitiveness is Nominal Unit Labour Costs.

What are nominal unit labour costs?

Nominal unit labour costs are how much it costs to hire a person to produce one unit of output. Nominal simply means the cost to hire someone is in everyday cash terms. In

addition to a wage, firms face other costs when employing a worker, such as employers PRSI. All these costs to the firm are included in labour costs. The unit of output refers to what on average can be produced for €1 for a given reference year. For example, if we take the year 2000 as the reference year, it would be possible to buy a cup of tea for €1 in 2000. However, over time, the price of a cup of tea will increase. Despite this, economists still examine how much it costs to hire someone to produce a single cup of tea. The price of a cup of tea is held constant. In practice a basket of goods is examined, and their price held constant. (It is usually only individual organisations that would look at the cost of producing an individual unit of output in great detail, as part of a management accounting exercise).

The measure used by the European Commission takes an 'average' good for the entire economy, and holds its price constant over time. However this leads to a problem with cross-country comparisons as competitiveness relates to the traded sector. Normally we expect nominal unit labour costs to be similar for the traded sector across countries. If one country has higher wages in a traded sector this is due to higher productivity than in other countries. However, it is well known that non-traded products are more expensive in richer countries. People are familiar with restaurants and dental treatment being cheaper in Eastern Europe than Western Europe. These items tend to have similar levels of productivity across countries (it may be possible to automate a car manufacturing plant, but it is hard to automate a restaurant), but wages are higher in richer countries. Therefore nominal unit labour costs for the non-traded sector tend to be higher in richer countries. As the European Commission takes an average for the whole economy, rather than just the traded sector, nominal unit labour costs tend to be higher in richer countries, despite these countries being competitive. The European Commission monitors the change in nominal unit labour costs rather than the level, but it is not possible to disentangle whether changes are

due to changes in the traded or the non-trade sector.

Developments in Irish Nominal Unit Labour Costs?

Changes in nominal unit labour costs can be broken down into changes in three elements: 1) changes in real wages (that is the real value of wages taking account of inflation), 2) changes in labour productivity (output per worker), and 3) inflation.

Between 2000 and 2008 nominal unit labour costs did increase by approximately 34%. They went from a position of being below those of the UK and Germany to above. However, what drove this increase? As shown in a paper by O'Farrell (2013), nominal compensation (that is, in cash terms) increased by approximately 44%. However, inflation also increase by approximately 30%, so in real terms worker compensation increase by 14.5% (an average of 1.5% per year). At the same time productivity grew by 10.4%, so real wage growth only exceeded productivity growth by 4.1% over the nine year period (an average of 0.4% a year). So the main cause of the increase in nominal unit labour costs was a general increase in inflation (caused by huge amounts of money flowing into Irish banks) rather than labour market pressures. It can be argued that a tight labour market drove inflation. However research by Bermingham et al. (2012) suggests this was not the case during the boom.

The industry sector (which is exposed to foreign competition) actually showed real wage growth slower than productivity growth. In the services sector real wages grew faster than productivity by about 10%, showing that for that sector labour market pressures were responsible for about one quarter of the increase in nominal unit labour costs. In the construction sector productivity actually shrank (which was due to overheating in that sector) while wages increased in real terms. Therefore in the construction sector almost 40% of the increase in nominal unit labour costs was due to labour market pressures. On an hourly basis, wages increased in the

industry, the construction, and the services sectors at a similar pace. The vast majority of the change in nominal unit labour costs was due to a genuine increase within sectors rather than a change in the composition of the economy.

However, if Ireland was genuinely uncompetitive by 2008 how did it so rapidly change its export performance, achieving a balanced current account (which measures whether our exports are sufficient to pay for our imports, interest on debt held abroad, and profits repatriated by multinationals) by 2010? Also, could this be achieved without large scale cuts to wage rates in the private sector? Finally, if Ireland was uncompetitive, how did exports drive GDP growth of approximately 3% per year from 2003 to 2007, the peak of the construction boom?

The answer is that in 2000 Ireland has been described as unsustainably 'super-competitive' (O'Brien, 2010). Ireland can best be described as moving from a position of 'super-competitiveness' to 'competitiveness'. Between 2008 and 2012 Irish labour costs have been stagnant, though they have increased by 8.1% in the Eurozone as a whole. However Ireland's export improvement began before this relative change, and is more likely to have been due to sharp falls in other costs (such as the cost of land) rather than relative wage changes.

Although labour costs have been stagnant, nominal unit labour costs have fallen by between 11% and 15% (depending on the method of measurement) between 2008 and 2012. However, almost all of this decrease is due to the economy shifting away from the relatively labour intensive construction sector. There have been increases in productivity within the agricultural sector (this sector does not provide a good indicator for the rest of the economy as productivity can be influenced by changes in the weather) and also in the industrial sector. Productivity growth in the industrial sector picked up from about 2% per year between 2000 and 2008 and 4% per year from 2008 to 2012. It is not clear

however to what extent this is a shift within the industrial sector away from assembly of electrical goods and computers towards the relatively more productive chemical and pharmaceutical sector.

Other indicators used by the European Commission?

Various other indicators are used by the European Commission. One of relevance to wage competitiveness is “Effective Unit Labour Costs”. These combine changes in nominal unit labour costs (in both Ireland and our trading partners) with changes in the exchange rate. When two countries have the same currency, effective unit labour costs just depend on movements in nominal unit labour costs in both countries. However when Ireland trades with a country with a different currency (such as the US) then currency movements can also affect competitiveness. For example, if the Euro becomes weaker relative to the dollar (that means one dollar can buy more Euros than previously) then Irish goods become cheaper relative to those in the US. This boosts competitiveness. Such exchange rate movements are totally beyond the control of the Irish government. Between 2008 and 2012 Sterling depreciated initially (Ireland lost competitiveness relative to the UK, leading to cross-border shopping), but by 2012 the pattern reversed leaving exchange rates at about the same level as in 2008. Relative to the UK, effective unit labour costs decreased by 26.1% between 2008 and 2012, and currency movements played an almost insignificant role overall. Also from 2008 to 2012 nominal unit labour costs in the Eurozone increased by 6.1%, so combined with declines in Ireland, nominal unit labour cost have shown a decrease of 17.9% relative to the rest of the Eurozone. Such figures should be treated with caution however as measures of nominal unit labour costs within countries are not designed with cross country comparisons in mind.

Conclusion

At the beginning of the crisis wage cuts were called for as a means of increasing competitiveness. Since then wages have remained largely stagnant (with cuts in wage rates largely restricted to the public sector), but Ireland’s export performance has improved.

This paradox can best be explained by describing Ireland as having moved from a position of unsustainable super-competitiveness to a position of competitiveness, with a domestic boom also occurring at the same time. Between 2000 and 2008 increases in nominal unit labour costs were driven largely by a general increase in inflation. From 2008 to 2012 decreases in nominal unit labour costs were caused almost entirely by a shift away from the labour intensive construction sector. It should be noted however that competitiveness is a relative concept, and at the same time that wages and labour costs in Ireland have been largely stagnant, they have increased in the rest of the Eurozone, meaning that in relative terms Ireland has shown declines.

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