

Chapter 2

Fall of the Irish house of cards

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1. Introduction

This chapter examines labour market trends in Ireland since the beginning of the crisis and explores some of its causes. In particular, the chapter considers whether changes in labour-cost competitiveness can adequately explain employment trends since 2008. Alternative explanations for the fall in employment are also explored, with particular attention given to the unsustainable nature of economic and labour market developments in the period leading up to the 2008 crash and how Ireland's idiosyncratic development path from 2001 onwards, combined with a swing to fiscal austerity, caused the subsequent recession and collapse in demand and employment.

An economy's competitiveness can deteriorate for a number of reasons, for example, in the wake of a domestic asset-price or consumption boom, in which upward pressure is exerted on prices across the economy to an extent that is not replicated in trading partners. Competitiveness will also deteriorate if domestic inflation persistently runs ahead of productivity gains and this is not matched by similar levels of inflation in trading partners, or where a country's exchange rate appreciates against that of major competitors and trading partners. A loss of competitiveness will negatively affect net exports as well as employment in the traded sectors, and if sufficiently large enough will induce a balance of payments imbalance.

Countries within a fixed exchange rate regime such as the euro area are unable directly to reverse a loss of competitiveness and balance of payments imbalance through a nominal devaluation of the currency. For a country in this predicament the loss of competitiveness can be reversed only internally, through relative gains in the efficiency of production, often only achievable gradually and over the medium term, or through direct action to reduce individual domestic prices, such as the cost of capital or

the cost of labour. In practice, direct action on domestic prices to induce so-called 'internal devaluation' usually refers to policies aimed at reducing wages and other labour costs.

In the Irish context, internal devaluation policies were usually framed as competitiveness reforms and the term 'internal devaluation' itself was rarely used by policymakers. Internal devaluation policies are those aimed at reducing unit production costs in the economy. In its broadest sense internal devaluation is not only associated with policies to cut wages and other labour costs, but also policies to increase productivity, reduce social benefits and public spending, as well as 'structural reforms' to increase flexibility and reduce job security in the labour market. However, the emphasis tends to be on lowering wage rates. The idea is that falling labour costs will reduce export prices at constant exchange rates, while falling wages will reduce domestic demand for imports so that the overall effect will be to boost net exports. Internal devaluation is much more difficult to achieve than nominal devaluation because it involves changing thousands of prices and wages across the economy. The process is likely to be expensive, slow, uncertain and politically damaging and to have significant implications for the affected workers and businesses.

However, governments that have ceded control over monetary policy often have very limited control over price levels in the economy. While governments do have the power – subject to political constraints – to cut public sector pay and pensions, they do not directly control private sector labour costs. Thus governments operating within a monetary union have very limited direct influence on unit labour costs in the traded export sectors. Even so, governments can indirectly influence private sector labour costs in a variety of different ways, for example, through the tax system, changes to sectoral wage floors and coordinating centralised bargaining. In these ways, governments can indirectly pursue internal devaluation.

This chapter proceeds as follows. Section 2 outlines the major macroeconomic and labour market trends since the beginning of the crisis. Section 3 examines the policies of internal devaluation as applied in Ireland, while Section 4 assesses prices, earnings and labour-cost trends. An alternative explanation for post-2008 labour market trends is presented in Section 5. Section 6 concludes.

2. Macroeconomic and labour market trends in Ireland

In 2008, Ireland entered what would become its longest and deepest recession in over a century. This followed two decades of almost continuously strong annual growth in output and employment. Ireland's seasonally adjusted rate of unemployment, which consistently remained at or below 5 per cent between 1999 and early 2008, increased sharply beginning in 2008, and eventually reached a peak rate of 15.1 per cent in early 2012. The unemployment rate has since slowly but steadily declined and was 10.4 per cent at the end of 2014. Ireland's headline economic developments from 2007 to 2013 are summarised in Table 1 and compared with the performance of the United Kingdom and the euro area.

Table 1 Key economic trends, Ireland, 2007–2013

Employment rates	2007	2008	2009	2010	2011	2012	2013
Total employment (% of working-age population)							
Ireland	69.2	67.6	61.9	59.6	58.9	58.8	60.5
UK	71.5	71.5	69.9	69.4	69.3	69.9	70.5
Euro area	65.5	65.9	64.5	64.1	64.2	63.8	63.5
Unemployment (% of labour force)							
Ireland	4.7	6.4	12.0	13.9	14.7	14.7	13.1
UK	5.3	5.6	7.5	7.8	8.1	7.9	7.6
Euro area	7.5	7.6	9.5	10.1	10.1	11.3	12.0
Gross domestic product (% volume change over previous year)							
Ireland	4.9	-2.6	-6.4	-0.3	2.8	-0.3	0.2
UK	2.6	-0.3	-4.3	1.9	1.6	0.7	1.7
Euro Area	3.0	0.5	-4.5	2.0	1.6	-0.7	-0.5

Notes: Labour market data refer to averages for the whole year; Total employment refers to all persons in employment (ILO definition) aged 15–64 as a proportion of all persons aged 15–64; Unemployment is measured in accordance with the ILO definition and refers to persons aged 15–74.

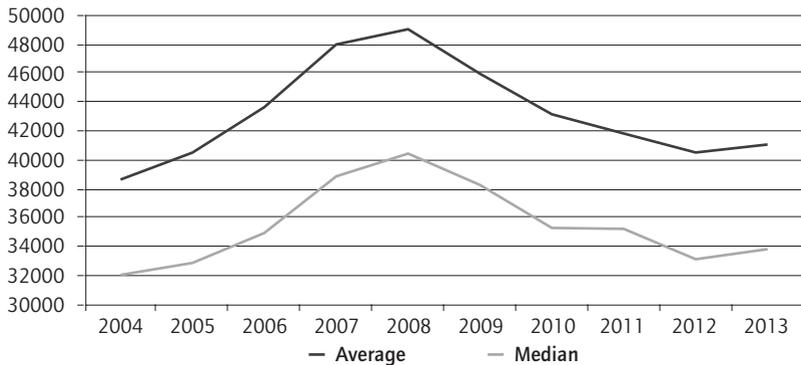
Sources: Eurostat, (2015a, lfsi_emp_a, une_rt-a) and Eurostat, (2015b, nama_10_ma).

2.1 Economic growth

Investment grew strongly every year for more than a decade prior to 2007 – with the exception of 2001 – before stagnating in 2007 as construction activity slowed, and then collapsing in 2008–2010 as the banking system fell into crisis, credit dried up and asset values plummeted. Investment became heavily skewed towards construction activity in the years leading

up to the crash, with construction's contribution to gross value added well above the EU15 average for more than a decade prior to the crash. Personal consumption and government consumption also grew strongly from 1998 to 2008 before falling sharply in 2009 as net wealth declined, confidence evaporated, investment went into reverse and the government began its programme of austerity with the October 2008 budget. Economy-wide disposable household income came under immense pressure from 2008 onwards (Figure 1) due to falling levels of employment (particularly in construction and retail), increases in taxation and reductions in the rates of social transfers. Net exports made a positive contribution to growth each year from 2007 through to 2012. This was partially because imports were falling as a result of declining domestic demand, but it also reflects the strong performance of services exports during a difficult period for the international economy.

Figure 1 Nominal household disposable income, Ireland, 2004–2013



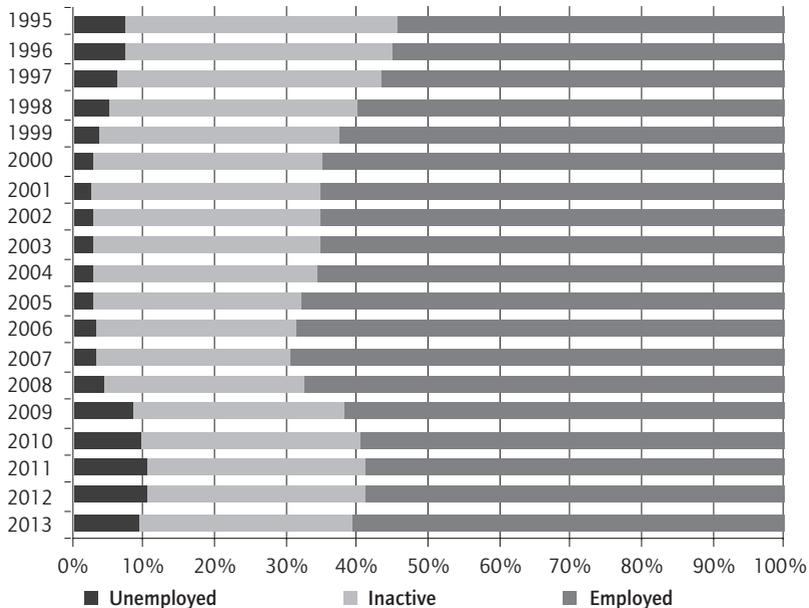
Sources: CSO (2015a, SIA12) and (NERI, 2015).

2.2 Employment

The proportion of working age people categorised as economically inactive gradually declined each year from 1995 through to 2007 (Figure 2). The medium-term trend was partially reversed by the recession, with 30.2 per cent economically inactive in 2013. Employment as a percentage of working age people fell sharply from a peak of 69.2 per cent in 2007 to just 58.8 per cent in 2012. The wholesale and retail sector was the largest employment sector throughout the boom and subsequent recession, notwithstanding the loss of 40,000 jobs in the sector between 2007 and and

2012. However, by far the largest decline in employment occurred in the construction sector. Three out of every five construction jobs were lost between 2007 and 2014 and the fall in construction employment accounts for two-thirds of the total net decline in employment over the period (Figure 3).

Figure 2 Employment and unemployment trends, Ireland, 1995–2013

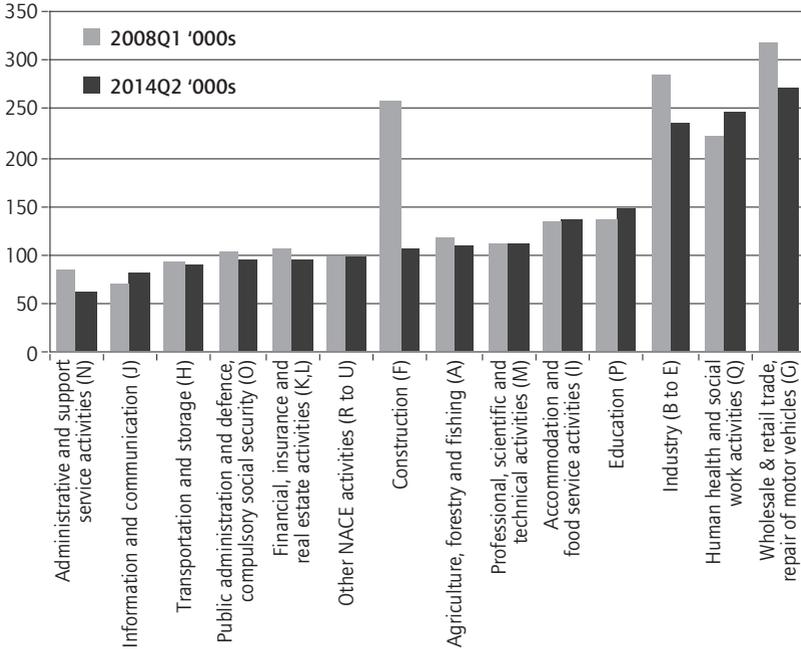


Note: Share of employed, unemployed and economically inactive in the population of working age (15–64 years of age).

Source: Eurostat (2015a, lfsi_emp_a, une_nb_a, lfsi_act_a).

Total employment fell by over 240,000 between 2007Q3 and 2014Q3. However, the rate of decline across economic sectors has been very uneven (Table 2). Indeed, there were net increases in employment in six of the 14 economic sectors and, if we exclude the performance of the construction, industry and retail sectors, we find there was a net increase in employment of 20,000 over the seven-year period. Employment in information and communications rose by almost 18 per cent (+11,900) during the period, while employment in health and social work activities rose by over 11 per cent (+30,600).

Figure 3 Seasonally adjusted sectoral employment changes, Ireland, 2008Q1– 2014Q2



Source: CSO (2015b, QN003).

The net job losses in the (non-tradable) construction sector (–158,400) are equivalent to two-thirds of economy-wide net job losses between 2007 and 2014. This lends support to the narrative of a construction boom and bust driving the overall fall in employment. However the next largest job losses by sector (–68,600) came in the largely tradable industry sector and this ostensibly gives support to a narrative based on declining competitiveness. On the other hand, most of the job losses in the industrial sector came at the height of the economic crash, with net employment in industry declining by 39,800 in just one year (2008Q3 to 2009Q3). The suddenness and timing of this decline is more suggestive of shock-induced decline associated with the global downturn than a decline associated with a gradual loss in competitiveness. Indeed, total employment in industry broadly stabilised after 2010.

Total employment bottomed out in 2012 and since that time the sectors with the largest percentage increases in employment have been two low-

Table 2 Employment shifts by economic sector, Ireland, 2007Q3–2014Q3

Economic sector	2007Q3	2012Q3	2014Q3	Change 2007 to 2014	Employment 2014Q3 relative to 2007Q3
Declining sectors					
Construction	270,800	100,000	112,400	-158,400	41.5%
Industry	307,400	230,800	238,800	-68,600	77.7%
Admin. and support service	83,600	64,700	65,200	-18,400	78.0%
Wholesale and retail trade	310,900	270,900	275,200	-35,700	88.5%
Public admin. and defence	107,900	99,300	98,100	-9,800	90.9%
Transportation and storage	92,800	90,000	87,500	-5,300	94.3%
Financial, insurance, real estate	106,600	100,900	103,100	-3,500	95.2%
Agriculture, forestry and fishing	112,200	84,800	109,700	-2,500	97.8%
Expanding sectors					
Accommodation and food	139,000	119,300	139,800	+800	100.6%
Professional, scientific and tech.	115,400	101,700	116,900	+1,500	101.3%
Other NACE activities	97,700	100,800	101,600	+3,900	104.0%
Education	133,700	145,900	144,100	+10,400	107.8%
Human health and social work	218,900	243,700	249,500	+30,600	111.3%
Information/communication	67,400	78,300	79,300	+11,900	117.7%
Total in employment	2,169,600	1,832,700	1,926,900	-242,700	88.8%

Note: Q3 2007 to Q3 2012 broadly equates to the peak to trough period. Total employment fell by 336,900 during this period with over half of the job losses in construction (170,800). More than one out of every seven jobs (15.5 per cent) were lost in the economy as a whole on a net basis, with most of the losses arising close to the start of the crisis. The economy has recovered 94,200 jobs since Q3 2012 equivalent to just 28 per cent of the jobs lost in the preceding five years.

Source: CSO (2015b, QNQ03).

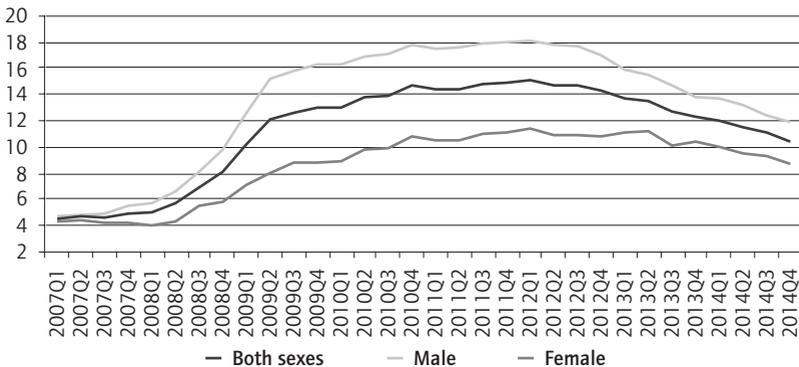
paid ones, namely the highly volatile agriculture, forestry and fishing sector (up 29.4 per cent) and the tradable accommodation and food services sector (up 17.2 per cent), as well as one highly paid sector, namely professional, scientific and technical activities (up 14.9 per cent). The numbers employed in education and public administration continued to decline after 2012 in line with the ongoing programme of fiscal austerity.

2.3 Unemployment

The seasonally adjusted unemployment rate reached its post-crisis peak of 15.1 per cent in February 2012, having been as low as 4.0 per cent as recently as the first quarter of 2008. The large spike in unemployment occurred despite the fact that the labour force declined by 5.1 per cent from 2,277,600 in Q1 2008 to 2,161,500 in Q1 2012 (some of which was due to net outward migration). Net migration turned negative in 2010 following fourteen consecutive years of net inward migration. Net outward migration totalled 143,800 persons over the period 2010 to 2014. By 2014 the annual average unemployment rate had fallen back to 11.3 per cent, although the labour force continued to decline, albeit at a slower pace. This means unemployment is now very close to its long-term (thirty-year) average of 11.0 per cent.

As unemployment rates have increased across Europe the proportion of total unemployed who are long-term unemployed has also increased. The proportion in Ireland is higher than the average for the EU15 and, as of Q2 2014, the long-term unemployed accounted for 58.6 per cent of all unemployed in Ireland (6.8 per cent of the labour force). The high level of long-term unemployed is suggestive of hysteresis effects in the labour force. Such effects are related to an erosion in the stock of human capital. Skills, confidence, tacit knowledge and work habits are eroded as unemployment is prolonged. If this is indeed the case, higher levels of unemployment could become structural within the economy with a permanent effect on potential output.

Figure 4 Unemployment rates (seasonally adjusted), Ireland, 2007Q1–2014Q3



Source: CSO (2015b, QNQ37).

3. Internal devaluation strategies

There have been very few instances of significant internal devaluation in advanced economies over the past thirty years (Shambaugh 2012: 181–82). The generally low levels of inflation across the OECD economies have made internal devaluations difficult to achieve in practice. Ireland and Latvia have been cited as examples of successful internal devaluations in the context of the period since the 2007–2008 economic crash. Both countries have been praised by the European Commission for pursuing internal devaluation strategies to reverse perceived macroeconomic imbalances. On the other hand, internal devaluation strategies have been widely criticised by social and economic commentators for the immense social and economic damage attributed to them.

Internal devaluation strategies were proposed by domestic and external commentators from early on in Ireland's economic crisis. The proposals were based on their assertions that a loss of competitiveness explained, or at least contributed to, Ireland's economic crash and dramatic fall in employment. In addition, the parlous state of the public finances arising from the collapse in employment reduced scope for a conventional Keynesian response. From late 2008 onwards the Irish government explicitly adopted the policies of fiscal austerity, defined here as discretionary cuts to public spending and/or discretionary increases in government revenue. The reason used to justify the move to pro-cyclical fiscal austerity was the need to bring the public finances and the cost of borrowing under control.

In this context, and given the negative consequences of fiscal austerity for domestic demand, the Irish government, at least in rhetorical terms, embraced an export-led growth strategy which, they argued, would have to be driven by economy-wide competitiveness improvements. As Ireland does not control its own monetary policy and therefore cannot devalue its currency, it was argued that such competitiveness improvements would have to be driven by internal devaluation.

While it is reasonable to anticipate gains from internal devaluation in the form of higher net exports, it is also reasonable to anticipate that deflating labour costs will reduce aggregate demand through lower household consumption and investment. It is therefore an empirical question, when anticipating short-to-medium-term outcomes for output and employment, whether, in terms of size, the positive *net export effect* from

internal devaluation outweighs the negative *domestic demand effect* from internal devaluation.

There are risks to internal devaluation strategies. For heavily indebted countries there is the danger that a fall in domestic demand will induce or exacerbate a recession, and in so doing generate a debt deflation spiral in which the burden of international debt actually becomes more onerous as a proportion of national income. In addition, deflating labour costs amounts to reducing labour's share of national income and by extension increasing capital's share of national income. As accumulated net wealth stocks (capital) are much more concentrated over the population than income flows from labour we can reasonably anticipate that strategies based on deflating labour costs risk increasing economic inequality and poverty.

3.1 Policy measures

Official policy decisions have contributed to declining unit labour costs in Ireland in two main ways. Most significantly, the public spending cuts introduced to help close the budget deficit included measures to reduce public sector pay rates. The direct impact on Ireland's competitiveness from the public sector pay cuts is likely to be marginal as the pay cuts took place in non-traded sectors of the economy and there is no direct transmission from public sector pay to private sector pay in the traded sectors.

The second main way that policy has sought to reduce unit labour costs has been through changes to Ireland's wage setting mechanisms. The wage setting mechanisms cover some 23 per cent of total private sector employment. Ireland has, since 1946, used a system of independent Joint Labour Committees (JLCs) to establish sectoral wages in certain industries such as catering, contract cleaning, hairdressing, hotel, retail and security, among others. The various JLCs are responsible for regulating terms and conditions of employment and setting minimum rates of pay. The pay, terms and condition are set out in an Employment Regulation Order (ERO) and generally include matters such as breaks, holidays, overtime, sick pay and Sunday premiums. The JLCs have employer and worker representatives and an independent chair appointed by the Enterprise Minister.

A 2011 ruling by the High Court declared the process of making EROs to be unconstitutional. As a result of the ruling, all seventeen EROs in place at the time ceased to have statutory effect and could not be enforced. In effect, the sectoral minimum wages under the EROs were replaced by the lower national minimum wage. Ireland was a programme country in 2011 and the ‘troika’ of lenders – European Central Bank, European Commission and International Monetary Fund – took an active interest in the legislation that would replace the old 1946 legislation. The troika and the government were both keen to create a wage-setting regime that was conducive to internal devaluation through lower wage rates and more flexible conditions (European Commission 2010). One goal was to prevent distortions of wage conditions across sectors arising from the presence of sectoral minimum wages in addition to the national minimum wage. In addition, the European Commission’s programme report of December 2011 claimed that reducing unemployment in Ireland required increasing labour market flexibility.

Additional troika requirements related to wage-setting mechanisms were inserted in the Memoranda of Understanding (MOUs) agreed between Ireland and the troika after the Fine Gael-led government came to power in 2011. These insertions were at least partially driven by domestic policy preferences and included: (i) clauses to allow enterprises to derogate in a downward direction from the terms (to the level of the minimum wage) where the employer can show there is a risk to the sustainability of the enterprise; (ii) requiring that the JLCs be reviewed every five years; (iii) requiring that wage setting take account of wages in other member states; and (iv) severe restrictions on the content of EROs, which are now limited to providing for a minimum hourly rate of remuneration and no more than two higher hourly rates of remuneration based on criteria such as length of service. Other matters that had been included, such as providing a rate for Sunday working, pay in lieu of notice, redundancy, breaks and holidays, are now specifically excluded by law. In addition, fewer sectors are to be covered by the EROs. The overall impact of the troika’s influence was to push the wage-setting legislation (Industrial Relations Amendment Act 2012) in a pro-employer and anti-worker direction, although this was, in any event, the government’s preferred outcome.

The troika justified the policy stance in the November 2011 MOU on the grounds of ‘reducing the possible negative impact on job creation and competitiveness’ and facilitating flexibility. In September 2012 the Commission described the new legislation as a reform to increase labour market flexibility. In addition to the changes to wage-setting mechanisms

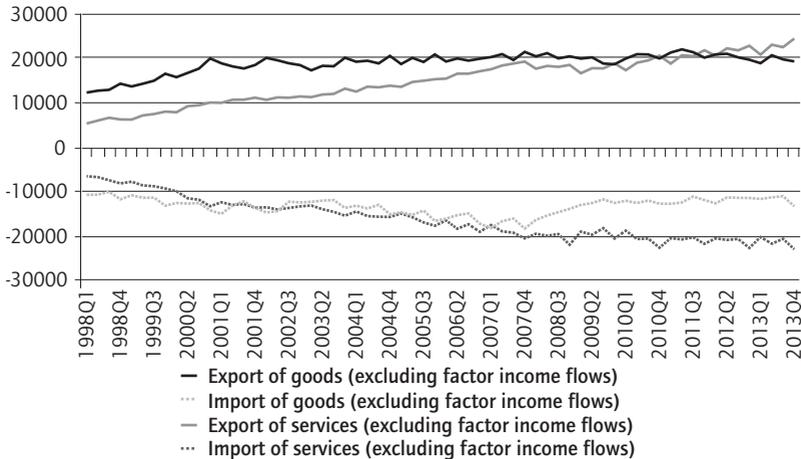
the troika pushed for legislation to enhance competition in professional services, although reforms to legal services were resisted by the Fine Gael-led government. The troika also requested a cut in the national minimum wage in late 2010 and the then government complied by reducing the rate from 8.65 euros to 7.65 euros. The reduction in the rate had, at any rate, already been flagged in the government's 2010 National Recovery Plan (DOF 2010). This measure was subsequently reversed by the new government in early 2011. Finally, various welfare rates were cut (for example, unemployment benefits for the under-25s) with the explicit goals of forcing people into the workforce and reducing entry-level wage rates by increasing the overall supply of labour.

3.2 Trade patterns

Since 2008, Ireland's current account has moved from deficit to surplus, reflecting improved cost competitiveness, allied to reduced consumer demand for imported goods. The current account balance is the trade balance (merchandise and services exports minus merchandise and services imports) less 'current' payments abroad, such as interest payments and the repatriated profits of firms. The current account moved from a deficit of 10 billion euros in 2007 and 2008 to a small surplus in 2010 and a surplus in excess of 10 billion euros by 2013. The only substantial change in trends since the onset of the recession has been the fall in goods imports (Figure 5). Goods exports have remained stable. The fall in goods imports is very much in line with expectations, given the general fall in household disposable income, investment levels and aggregate demand. Service imports and exports have continued to grow along pre-crisis trends and there is no obvious evidence on the services side of a trade impact directly attributable to internal devaluation.

Ireland's share of world trade fell continuously year on year between 2002 and 2006 and again between 2009 and 2012. Specifically, Ireland's share of world trade, which peaked at 1.4 per cent in 2002, had fallen to 1.0 per cent by 2012. Share of merchandise trade fell even further, from 1.4 per cent in 2002 to 0.6 per cent in 2012. The decline suggests a loss of competitiveness in merchandise production. On the other hand, Ireland actually increased its share of the global services market from 1.0 per cent in 2000 to 2.7 per cent in 2012. Ireland's share is broadly unchanged since 2007, which suggests no fundamental improvement or decline in competitiveness in services provision since 2007.

Figure 5 Quarterly Irish imports and exports in real terms (euro millions)



Note: Import figures are represented here in negative terms.

Source: CSO (2015c, NQ024).

4. Prices, earnings and labour costs

One influential narrative suggests that Ireland lost international competitiveness due to a domestic building boom and increasing production costs and, as devaluing the currency was not an available option, it was therefore necessary to cut prices and wages in order to restore lost competitiveness. Since then, wages in the private sector have been largely stable, albeit marginally declining. Even so, Ireland has shown a relatively strong improvement in exports and its current account quickly moved into surplus, despite a difficult international trading situation. This contradicts the devaluation narrative as Ireland improved its net export position rapidly, without a general fall in wages. Falling disposable incomes and reduced demand for imports help explain some of the improvement in net exports. In addition, inflation has also been lower than in the euro area for a number of non-labour categories (for example, utilities, transport, communications and housing) and this has helped to push down costs.

4.1 Prices and earnings

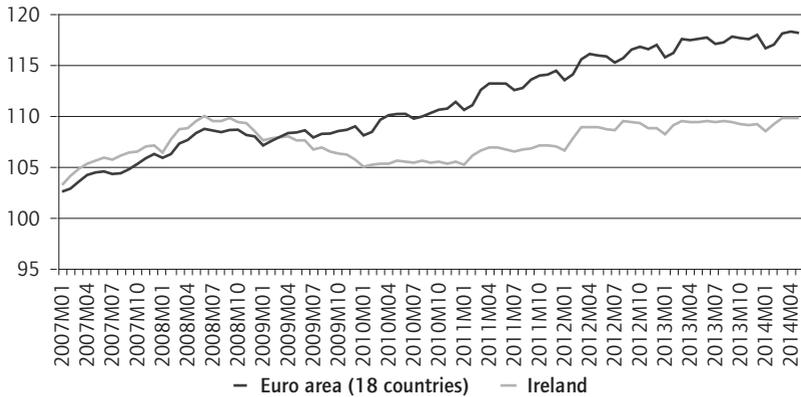
The Central Bank of Ireland (CBI 2015) has developed a Harmonised Competitiveness Indicator (HCI), which it uses to assess Ireland's competitiveness vis-à-vis its trading partners. Ireland's main trading partners are the euro area, the United Kingdom and the United States. So, did Ireland lose competitiveness prior to the crash and then succeed in regaining competitiveness after 2008? The HCI suggests that Ireland's competitiveness improved between 1997 and 2000 before deteriorating between 2002 and 2005, and then again between 2006 and mid-2008. The data shows that Ireland's real HCI improved significantly compared with Ireland's trading partners since the onset of the crisis, with these competitiveness gains coming during the height of the crisis between 2008 and 2012. Cost competitiveness in real terms (producer prices) deteriorated slowly from mid-2012 until mid-2014, with improvements in the period since.

Was there, then, an internal devaluation in Ireland, understood as a policy-driven general fall in wages and prices relative to the economy's main trading partners? While there was a fall in consumer prices, there was only a general fall in wages in the public sector. Figure 6 shows that Ireland had a period (September 2008 to September 2009) of deflation, followed by a period of price stagnation (up to January 2011), followed by moderate price increases. In contrast, euro area inflation was relatively stronger. Prices in Ireland also grew more slowly than in the United Kingdom and the United States. However, price changes in Ireland were driven mainly by market forces rather than by coordinated policy. While there were some policies to reduce VAT in labour intensive sectors linked to tourism, these policies were introduced only from 2011 onwards and were more than offset by an increase in the basic rate of VAT.

Earnings per week fell in absolute terms in both 2010 and 2011, and again in 2013. In 2010 the 1.9 per cent fall in average weekly earnings was somewhat mitigated by a reduction of 1.6 per cent in the rate of inflation (Figure 7). However, in both 2011 and 2013 inflation was positive and so the reduction in nominal earnings was compounded by the changes in prices to generate an even larger fall in real wages (Figure 8). In terms of wages, average hourly earnings actually increased marginally over the entire period, while average weekly wages declined. Nominal average hourly wages increased from 21.53 euros in Q1 2008 to 22.14 euros in Q1 2014, while real average hourly wages increased from 21.53 euros to 22.04 euros over the same period.

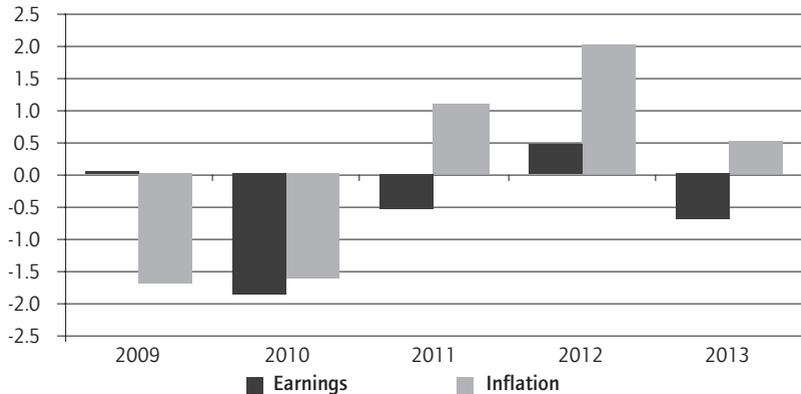
The decline in weekly wages is explained by the reduction in weekly paid hours, from 32.8 hours per week in Q2 2008 to 31.3 hours per week in Q1 2014 (Figure 9). Average weekly hours fell sharply in 2008, with no obvious trend in the meantime. It is the sharp fall in employment between 2008 and 2013 that is the main explanation of the change in total earnings across the economy and the primary reason for the collapse in domestic demand since 2008 (Figure 10).

Figure 6 **Harmonised index of consumer prices in Ireland and the euro area, 2007–2014**



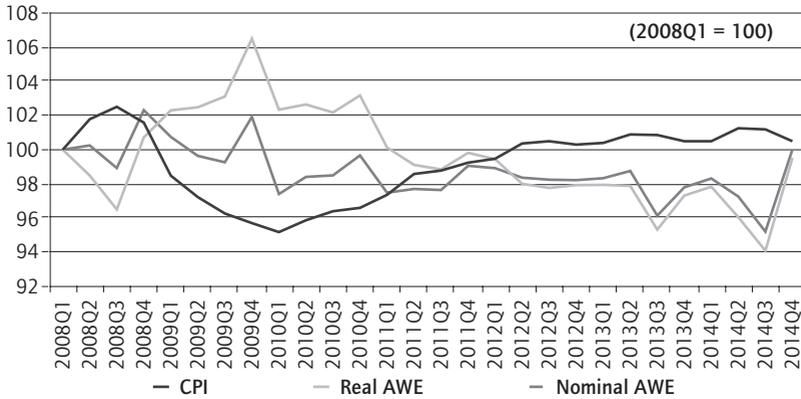
Note: Base year 2005=100.
Source: Eurostat (2015c, prc_hicp).

Figure 7 **Annual trends in earnings and prices (HICP) in Ireland, 2009 to 2013**



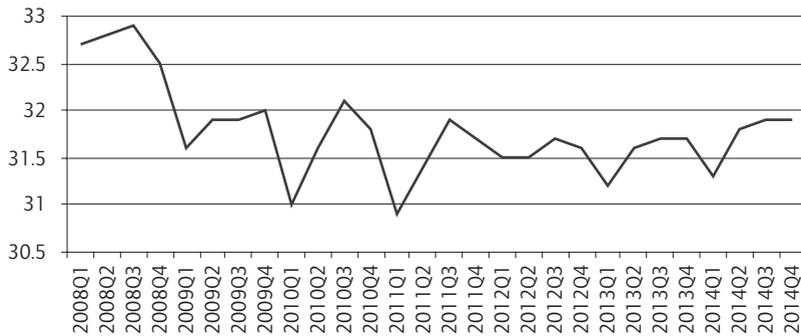
Source: CSO (2015d, CPM05) and CSO (2015e, ELCA2013BL1).

Figure 8 Average weekly earnings (AWE) and prices (CPI), Ireland, 2008–2014



Source: CSO (2015d, CPM02) and CSO (2015e, ELCQ42014TBL1).

Figure 9 Average weekly paid hours, quarterly data, Ireland, 2008–2014

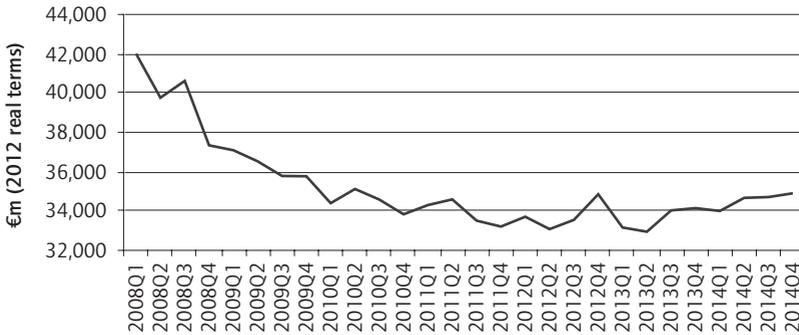


Source: CSO (2015e, ELCQ42014TBL3).

4.2 Unit labour costs

Growth in labour costs was consistently above that of the euro area for a full decade leading up to 2008 (Eurostat 2015d). Growth in labour costs subsequently fell below the euro area average in 2009 before declining in nominal terms in both 2010 and 2011 (while still growing in the euro area). Irish labour costs increased in 2012, and at a rate marginally faster than that of the euro area. However, growth in labour costs was once again lower than in the euro area in 2013 and in 2014.

Figure 10 Final domestic demand in constant 2012 prices, Ireland, 2008–2014 (quarterly data; euro millions)



Source: CSO (2015c, NQQ24).

While the nominal data do appear to suggest that Ireland may have lost wage competitiveness in the decade leading up to 2008 it is actually more instructive to compare annual changes in real unit labour cost. It turns out Ireland did have faster increases in real unit labour costs between 2003 and 2005 and again between 2007 and 2008. Annual changes in real unit labour costs have been lower than in the euro area since 2009, with real unit labour costs declining sharply in 2010 and 2011 and then again, albeit more modestly, in 2012. The much faster growth in real unit labour costs in the euro area since 2009 suggests that Ireland did indeed undergo an internal devaluation vis-à-vis the rest of the euro area in the post-crash period.

However, a ‘successful’ internal devaluation in Ireland may have been due more to chance than to design. Nominal unit labour costs declined somewhere in the range of 11 per cent to 15 per cent, depending on the method of measurement (O’Farrell 2013). Nominal unit labour costs represents the amount an employer must pay to hire someone to produce one unit of a good, and so account for changes in productivity. It is very likely that changes in the composition of the economy following the end of the construction bubble – that is, the loss of less productive construction and retail jobs – give an exaggerated sense of the improvement in nominal unit labour costs.

Some sectors of the economy are more labour intensive than others, and so have higher nominal unit labour costs. For example, the construction sector is more labour intensive than manufacturing. Even if nominal unit

labour costs in each sector are constant, the *average* for the whole economy can change if jobs are lost in the more labour intensive sectors of the economy. We can treat the total of nominal unit labour costs over the economy as the weighted average of the cost for the individual economic sectors. The weights account for the importance of a particular sector in contributing to nominal unit labour costs for a given year. Using the weights of a given year it is possible to control for changes in the composition of the workforce between 2008 and 2012. The results are shown in Table 3 and are described in greater detail in O'Farrell (2013: 14–15).

Table 3 Decomposition of nominal unit labour costs, difference relative to peak of 2008, Ireland (%)

	2000	2004	2008	2012
Total change	-33.9	-18.3	0.0	-16.4
Change in nominal unit labour costs holding sectoral composition constant	-32.5	-19.4	0.0	-0.7
Changing composition, fixed nominal unit labour costs	-4.3	0.9	0.0	-9.7

Notes: The total change in unit labour costs is based on factor cost. The fixed composition uses 2008 sectoral weights.

Source: O'Farrell (2013).

Using the weightings for 2008, nominal unit labour costs only declined by 0.7 per cent between 2008 and 2012. Alternatively, keeping wages constant, but just altering the weights leads to a fall in nominal unit labour costs of 9.7 per cent. Clearly, the change in the sectoral *composition* of employment is the main cause of the improvement in nominal unit labour costs. Qualitatively similar results are gained by using 2012 as the reference year. Interestingly, the same is not true for the period leading up to the 2008 crash. The conclusion is that the decline in nominal unit labour costs in Ireland since 2008 is attributable mainly to compositional shifts in employment (notably the dramatic decline in construction) rather than to declining wages.

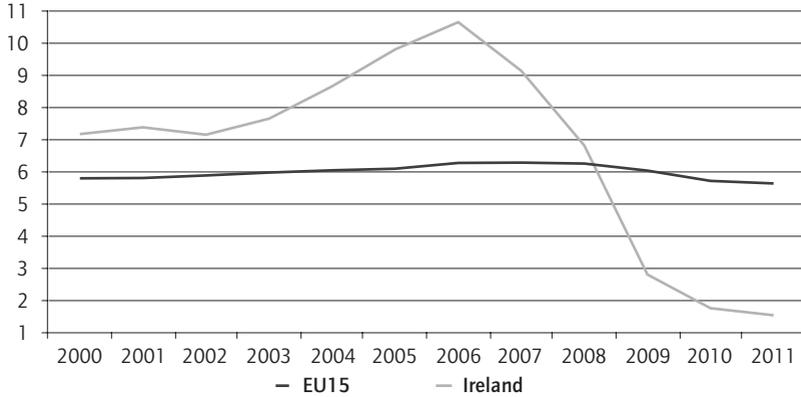
5. Understanding employment trends: an alternative narrative

Overall, there is no compelling evidence that a loss of competitiveness is responsible for Ireland's collapse in employment. A more persuasive argument is that the driving force behind the rise in unemployment was the bursting of a domestic asset-price and construction boom over the period 2008 to 2010. The resulting collapse in private sector investment levels and construction-related employment were inevitable outcomes of the bursting of that bubble. The bubble was itself caused by internal factors, notably weak financial regulation and fiscal policy that encouraged property speculation, as well as external factors, most significantly access to cheap credit from Europe and negative real interest rates within Ireland.

The crash had its origins in an asset-price bubble fuelled by cheap credit. House prices in Ireland quadrupled between 1996 and 2007. Ireland began this period with a relatively small housing stock and initially there were strong fundamentals underlying housing demand as the population was growing and incomes were expanding rapidly in line with productivity and employment gains. At the same time, Economic and Monetary Union and Ireland's membership of the euro area were enabling Irish financial institutions to provide mortgage finance at historically low rates. The response to the increase in housing demand was a construction boom. The stock of dwellings increased from 1.4 million houses in 2000 to 1.9 million in 2008 with annual completions quintupling between 1990 and 2006. The domestic banks became increasingly reliant on international bond borrowings, rising from less than 15 billion euros in 2003 to almost 100 billion euros in 2007 (over half of GDP), with the share of credit becoming increasingly linked to property.

The Irish economy was already at or close to full employment by 2004–2005 and by 2007 the construction sector accounted for an unsustainable 13.3 per cent of all employment. Construction accounted for almost half of total employment growth in the economy between 2000 and 2007. Investment had also become heavily skewed towards construction. The construction sector accounted for almost 11 per cent of gross value added by 2006 and was well above the EU15 average for over a decade prior to the crash (Figure 11).

Figure 11 Value of construction sector as percentage of gross value added, Ireland, 2000–2011



Notes: ESA 2010 basis. In nominal terms gross value added in Ireland attributable to construction fell from a peak of 17.2 billion euros in 2006 to 4.2 billion euros in 2009 and to 2.4 billion euros in 2011. Source: Eurostat (2015b, nama_10_a10) and authors' calculations.

The housing market shuddered to a halt in 2008 as the global economic and banking crisis induced a freeze in interbank lending, which in turn created immense difficulties for the overleveraged Irish banks. In September 2008 the Irish Government legislated for a blanket guarantee of the liabilities of the main Irish retail banks. This was to have profound implications for the public finances and eventually cost the state the equivalent of 40 per cent of GDP in bank bailouts. The domestic context was now a credit freeze, falling employment, deepening recession and collapsing house prices. Average house prices fell by 50 per cent from peak to trough, while real GNP fell by 13.9 per cent between late 2007 and late 2009. Unemployment trebled and the ability of debtors to service loans became increasingly compromised as collateral value fell below loan amounts.

Falling employment and asset prices, rising private sector indebtedness, loss of consumer confidence and weak credit conditions induced a severe balance sheet recession in the Irish economy, with an increase in the savings rate (mainly to support deleveraging) and a sharp decline in personal consumption and private investment. The sudden and sharp fall in domestic demand then generated a second wave of job losses, this time centred primarily on the retail sector.

The years prior to the crisis were characterised by the increasing erosion of the tax base by ever deeper tax cuts and new and more generous tax expenditures, while at the same time the government became increasingly reliant on transaction taxes associated with the construction boom. A yawning fiscal deficit quickly opened in the public finances in 2008 as the effect of the automatic stabilisers took hold (Table 4). Government revenue plummeted along with the private incomes and expenditure it depended upon, while social protection spending increased rapidly in line with much higher unemployment numbers. In addition, tens of billions of euros of public money were being poured into the banking sector. The general government deficit was much larger than in other euro area countries with commensurately less fiscal space for a Keynesian response to the fall in private sector demand.

Table 4 Ireland's general government balance (percentage of GDP)

	2006	2007	2008	2009	2010	2011	2012	2013
Overall balance								
Ireland	2.9	0.1	-7.3	-13.8	-30.5	-13.1	-8.2	-7.4
Euro area	-1.3	-0.7	-2.1	-6.4	-6.2	-4.2	-3.7	-3.0
Overall balance (exc. financial sector supports)								
Ireland				-11.3	-10.5	-8.9	-8.2	-7.4

Notes: IMF estimates for the overall balance are for general government and include financial sector supports. Source: IMF (2014).

Table 5 Cumulative discretionary fiscal adjustments, Ireland, 2008–2014 (euro billions)

	Total	2008-2010	2011-2013	2014
Revenue	10.8	5.6	0.04.3	0.9
Expenditure of which	19.2	9.2	8.4	1.6
<i>Capital expenditure</i>	5.0	1.6	3.3	0.1
<i>Current expenditure</i>	14.2	7.6	5.1	1.5
Total fiscal contraction	30.0	14.7	12.6	2.5

Notes: Figures may not sum due to rounding. For context, Ireland's GDP averaged 174 billion euros over the period 2008 to 2014; adjustments on the expenditure side represent discretionary reductions in spending. Source: Department of Finance budgetary documentation; Budget 2009 to Budget 2014 inclusive.

At a macro level, economic policy was not fundamentally motivated by competitiveness concerns but by the need to achieve a sustainable fiscal position. Competitiveness concerns were very much secondary. The ensuing period of pro-cyclical fiscal austerity (Table 5) squeezed public spending (current and capital) along with household disposable income and exerted further downward pressure on personal consumption. Public sector employment was reduced creating a third motor of falling employment. One consequence of the government's deflationary fiscal stance was that Ireland's investment/GDP ratio became the lowest in the entire European Union in 2011 and 2012, with both the public and private (household and corporate) sectors deleveraging in tandem.

An economy subjected to this type of shock does not simply bounce back to equilibrium. A negative investment shock on the scale experienced in Ireland will inevitably reduce the economy's capital stock relative to what it might otherwise have been. This will have at least some impact on future potential output. Similarly, permanent damage to the stock of human capital known as 'hysteresis shadows' or 'hysteresis effects' can develop in the labour market during a sustained downturn. Skill and work habits are eroded, while the 'learning-by-doing' so crucial to the development of human capital and economic growth becomes stalled. This has implications for the economy's productive capacity – and for the economy's long-run equilibrium.

In other words, demand-side effects can have permanent impacts on the economy and on living standards. Actual unemployment may become structural if it is allowed to persist for long periods of time. The result is a fall in potential output and higher equilibrium levels of unemployment. That may prove to be the long-term price of Ireland's credit bubble, fiscal austerity and internal devaluation.

6. Conclusions

Overall, there is no clear causal link between an internal devaluation in Ireland and the substantial movements in employment after 2008. Irish wages are now relatively lower than in other EU countries (compared with 2008). However, this is not due to a coordinated policy, but to a weak Irish economy and a collapsed construction sector, and in large part to the policies of austerity which served to increase unemployment. The decline in nominal unit labour costs is almost entirely due to a shift away

from the labour intensive construction sector. Experiences with internal devaluation in the euro area have not been happy ones. Countries deemed to have undergone ‘successful’ internal devaluations have also undergone severe recessions.

External (nominal) devaluations based on a depreciation of the currency are likely to be much more effective than internal devaluations because they lower export costs without inducing a decline in domestic demand. Unfortunately, this policy choice is not available to governments in the euro area as they do not control their own currency, although the option of deliberate currency devaluation was always possible and should have been strongly considered by European policymakers and by the monetary authority.

The alternative way to restore lost competitiveness in the euro area periphery, while simultaneously supporting demand, would have been for the more competitive ‘core’ to engage in a process of internal revaluation (increasing domestic wages and prices). Competitiveness issues are ultimately all about relative differences – and competitiveness imbalances are as much about excessive current account surpluses as they are about current account deficits. These differences can be closed through internal devaluation in the less competitive economies or, alternatively, through internal revaluation in the more competitive core economies. Provided inflation is higher in the more competitive economies the competitiveness gap will eventually close. Internal revaluation could be induced within the surplus countries through policies to increase wages, prices and domestic demand.

This is not to say that countries should not act prudently to ensure they remain competitive, or that there should be no European and domestic rules and coordination to ensure this is the case. However, once imbalances have already developed, it is unwise, at least during times of economic weakness, to place the entirety of the adjustment burden on the debtor country. Although internal revaluation is undoubtedly a politically difficult option to sell to the creditor countries it nevertheless represents a much better alternative within a currency union to a strategy focused purely on internal devaluation in the debtor countries. Indeed, the official preference for internal devaluation over internal revaluation has created a deflationary bias for the euro area and for the world economy.

The Irish experience offers little succour for proponents of internal devaluation. A policy rethink is required at the European level.

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