CounterBlast
Challenging established thinking,
Offering new perspectives

Irish Congress of Trade Unions

The Baltic Fallacy

Drawing Lessons for Ireland from the recent economic experience of Estonia, Latvia and Lithuania.

Victor Duggan

Summer 2012

STRONGER TOGETHER
CONGRESS
Irish Congress of Trade Unions

About the author

Victor Duggan has worked in the European Commission and the European Investment Fund www.eif.org. For three years – until early 2008 – he served as an as economic adviser to Joan Burton TD www.joanburton.ie, the current Minister for Social Protection.

At present, Mr Duggan is undertaking the MPA Program in Economic Policy Management in the School of International & Public Affairs www.sipa.columbia.edu at Columbia University, New York. He writes a monthly column on the Irish, European and Global political economy for Liberty, the newspaper of SIPTU, Ireland's largest trade union.

CounterBlast An occasional series of pamphlets and publications designed to challenge established thinking and offer fresh perspectives on issues of public concern. *The Baltic Fallacy* is the first of the series.

Irish Congress of Trade Unions,
32 Parnell Square,
Dublin 1
Tel: (01) 8897799/ 087 9174171

Contents

In recent months, the wheels have started to come off the German-led, one-sided austerity approach to dealing with the crisis in Europe.

Executive Summary

In recent months, the wheels have started to come off the German-led, one-sided austerity approach to dealing with the crisis in Europe. The election of Francois Hollande has changed the dynamic on the European Council, while the collapse of government in the Netherlands and elections in Greece have further served to undermine the apparent consensus for austerity.

There is now recognition that more and more austerity and prolonged recession is not politically sustainable over the longer term. The growth agenda has taken centre stage. Not so long ago, however, cheerleaders for austerity were to be found not only in Germany, but in Ireland and around Europe.

If one accepts the definition of insanity as doing the same thing over and over again, and expecting different results, then surely re-doubling belt-tightening austerity, and expecting growth, is economic lunacy?

The only part of the Irish economy that is growing in any meaningful sense is our record-breaking trade surplus. Overall, the economy can only grow if this is enough to offset the opposing contractionary forces of fiscal austerity and inconspicuous consumption.

The advent of the Fiscal Advisory Council (FAC), made up of 5 highly esteemed economists, is a welcome development, and one would hope that it evolves to fulfil a role similar to the highly respected, non-partisan Congressional Budget Office in the US. Their most recent assessment of Ireland's economic prospects is undoubtedly correct: the risks to economic growth forecasts are skewed to the downside.

Writing in the Irish Times on April 4th, Dan O'Brien, Economics Editor, knocked down the straw man of a 'zero austerity' approach, but no credible commentator is seriously proposing this. The country is in administration, and our creditors call the shots. The debate centres on whether we should wield the axe harder and faster, and how the pain should be shared.

2 In framing forthcoming budgets, the Irish government faces a binding constraint set by our official lenders: to bring the deficit down to 7.5% of GDP in 2013, 5.1% in 2014, and 2.9% in 2015. How these targets are achieved is subject to negotiation, but they must be met, as things stand.

There is no question of this being an easy task, while a much more aggressive schedule, as the FAC, O'Brien and some others propose, could well cement continued recession. The IMF has repeatedly warned that this is as much as our economy can take, and that chasing our tail with ever-more austerity could be counter-productive.

Some argue that more aggressive austerity would boost credibility with financial markets, but any seasoned market-watcher can see quite clearly that schizophrenia now reigns. Markets, a vast collection of independent but interdependent players, don't have a clear idea of what they want.

Yes, delivering up-front austerity may send a 'credible' signal – and the tougher the measures on citizens the better. Markets also understand, however, that the debt burden is made up of a denominator, GDP, as well as the numerator, debt. Markets care about both sides of this equation. They react negatively if austerity targets are not met, but also when economic growth falls short.

On April 6th, and again on April 20th, O'Brien followed up with articles heralding the Baltic approach, viewed by some fiscal fundamentalists as a model to follow: if only Ireland could accelerate austerity, as the Baltic countries were forced to do, we could bring back the boom.

There are some critical distinctions that render this comparison meaningless, however. The Irish economy of today is neither comparable to the Irish economy of the late 1980s nor to the Baltic economies of today.

Estonia, the most developed of the Baltics, is today only about a third as wealthy as Ireland, measured by GDP per capita. Just as Irish living standards converged rapidly to, then surpassed, the European average in the 1990s, so one would expect the Baltics to now grow faster than Ireland, all else being equal. This is borne out by OECD estimates of potential GDP growth, which is 2.5% higher in Estonia than in Ireland for both 2012 and 2013.

Incidentally, this is also the reason why Ireland will not again sustainably see the convergence rates of growth of the 1990s, and why bringing down our Debt-to-GDP ratio will be far more challenging this time around.

Even if the Baltics were not on a convergence path, they would still be expected to grow faster than their EU neighbours, simply because they were so badly hit by the financial crisis, far worse even than Ireland. Ireland, Lithuania, Estonia, and Latvia suffered peak-to-trough falls in GDP of 10.1%, 14.8%, 17.4% and 20.7% respectively.

The further they fall, the faster they climb because there is so much more slack in their economies, and because they have lost so much of their potential GDP. In part, the Baltics are making up for lost growth as they regain the convergence path.

There is a school of thought that argues that beatings should continue until morale improves, that we should up the dose of austerity just to be on the safe side. The truth is that economists are at a loss to predict the effect of ever-more more austerity when the output gap – a measure of how actual economic output compares to potential – is as wide as it is in Ireland today.

We are dealing with known unknowns, and staying on the safe side probably means sticking to the IMF's advice. Our belt has no more holes, and tightening above and beyond what is absolutely necessary could turn a crash diet into a futile hunger strike.

Ireland	**GDP per capita** GDP Growth Investment % of GDP Inflation Import Growth Export Growth Unemployment Budget Surplus (Deficit) % of GDP Net Government Debt % of GDP Current account balance % of GDP
Estonia	**GDP per capita** GDP Growth Investment % of GDP Inflation Import Growth Export Growth Unemployment Budget Surplus (Deficit) % of GDP Net Government Debt % of GDP Current account balance % of GDP
Latvia	**GDP per capita** GDP Growth Investment % of GDP Inflation Import Growth Export Growth Unemployment Budget Surplus (Deficit) % of GDP Net Government Debt % of GDP Current account balance % of GDP
Lithuania	**GDP per capita** GDP Growth Investment % of GDP Inflation Import Growth Export Growth Unemployment Budget Surplus (Deficit) % of GDP Net Government Debt % of GDP Current account balance % of GDP

2007	2008	2009	2010	2011	2012
€46,152	**€46,079**	**€38,584**	**€35,614**	**€36,548**	**€35,272**
5.2	-3.0	-7.0	-0.4	0.7	0.5
26.1	21.6	14.3	11.0	10.5	9.9
3.2	1.3	-2.6	-0.2	1.9	1.5
7.9	-3.0	-9.3	2.7	-0.7	1.0
8.4	-1.1	-4.2	6.3	4.1	3.0
4.6	6.3	11.8	13.6	14.4	14.5
0.1	-7.3	-14.2	-31.3	-9.9	-8.5
11.1	24.4	42.2	76.9	95.9	102.9
-5.3	-5.7	-2.9	0.5	0.1	1.0
€12,603	**€13,700**	**€11,033**	**€10,875**	**€12,756**	**€12,797**
7.5	-3.7	-14.3	2.3	7.6	2.0
38.6	30.4	18.8	19.5	24.5	24.7
9.6	7.0	-1.7	5.4	4.1	3.5
16.0	0.2	-35.9	15.1	33.5	-2.9
13.0	7.7	-23.1	17.4	31.5	-4.0
4.7	5.5	13.8	17.3	12.5	11.3
2.8	-2.3	-2.1	0.4	1.0	-2.1
-5.7	-3.5	-1.2	-1.8	-0.2	1.9
-15.9	-9.7	3.7	3.6	3.2	0.9
€9,661	**€11,332**	**€8,795**	**€8,216**	**€9,747**	**€9,514**
9.6	-3.3	-17.7	-0.3	5.5	2.0
40.0	31.2	20.5	20.9	26.2	27.3
14.0	10.4	-1.4	2.4	3.9	2.0
16.1	-10.8	-33.3	11.5	20.7	5.6
10.0	2.0	-14.1	11.5	12.6	3.7
6.2	7.8	17.3	19.0	15.6	15.5
0.6	-7.5	-7.8	-7.2	-3.4	-1.2
4.7	11.3	21.5	29.9	29.8	29.9
-22.4	-13.2	8.7	3.0	-1.2	-1.9
€8,960	**€10,893**	**€8,541**	**€8,551**	**€10,058**	**€10,052**
9.8	2.9	-14.8	1.4	5.9	2.0
31.2	26.9	10.5	16.4	18.8	19.8
8.2	8.5	1.2	3.6	3.5	3.3
10.6	10.3	-28.3	17.3	12.7	3.0
3.1	11.4	-12.5	17.4	13.7	3.3
4.3	5.8	13.7	17.8	15.5	14.5
-1.0	-3.3	-9.2	-7.1	-5.2	-2.9
11.1	12.7	23.3	30.7	32.4	34.7
-14.5	-13.3	4.7	1.5	-1.7	-2.0

Conventional wisdom in some circles holds that the new ‘Baltic Miracle’ is a model for crisis-stricken economies like Ireland to follow.

Conservative Conventional Wisdom

Conventional wisdom in some circles holds that the new ‘Baltic Miracle’ is a model for crisis-stricken economies like Ireland to follow as seen in recent statements from IMF Director Christine Lagarde and others, all of which which lauded the Baltic approach as the role model for all fiscally troubled states. Faced with a collapse in demand, soaring budget deficits and unable or unwilling to devalue their currency, so the argument goes, a dose of aggressive austerity is all that is needed. If only countries can slash spending and introduce liberalizing reforms that drive down wages, they can recover competitiveness, boost exports and let the good times roll.

A recent series of articles by the Irish Times´ Economics Editor, Dan O´Brien, epitomize this line of thinking. Writing in the Irish Times on April 4th, O’Brien cites the most recent report from the Irish Fiscal Advisory Council, which called for an accelerated schedule of deficit reduction, and highlights the example of the Baltic countries as successful models of austerity. He followed up with further articles in the same vein on April 6th & 20th. The Baltics introduced even harsher austerity measures in 2009 and 2010 than those seen in Ireland, returning to rapid growth in 2011. This is taken as proof positive that austerity ‘works’.

Writing on April 6th, O’Brien argues that Ireland needs more ‘prudence’ – for which, read more aggressive austerity – to restart its export engine and ‘drag the domestic economy off its knees’.

There are six things wrong with O'Brien's argument:

1) Ireland's export engine is chugging along quite nicely, having weathered the 2009 collapse in global trade better than most;
2) slashing state spending per se has no direct impact on export growth;
3) competitiveness is not all about cost;
4) unit labour costs have fallen further in Ireland than anywhere else in the Eurozone;
5) potential GDP growth is higher in the Baltics than in Ireland because they are poorer; and
6) rather than dragging the domestic economy off its knees, excessive 'prudence' could deliver a killer blow.

Unlike our Mediterranean neighbours, Ireland's economy is not being subjected to wide-ranging structural reform, largely because it already in many ways approximates the neoliberal ideal. This is most clearly evidenced when one compares the conditionality attached to Ireland's bailout programme to those of Greece and Portugal.

In Ireland, the introduction of competition into the legal and medical professions and allowing for Walmart-style out-of-town superstores were deemed worthy of inclusion, but little else. By comparison, Greece's bailout programme envisages wholesale economic restructuring: from mass privatisation to comprehensive labour market reform.

O'Brien is careful to distance himself from the position of some market fundamentalists. He recognises that expansionary fiscal contraction is a myth. Rather, like pruning roses, he argues that austerity now lays the foundation for growth later.

There is little new in the argument that economic shock therapy is key to recovery. Indeed, this has been the stock neoliberal recipe for recovery for decades, but shock therapy is an ideal whose time has passed.

Countries facing economic crisis typically try to make their exports more competitive by devaluing their currencies.

What is Internal Devaluation?

Countries facing economic crisis typically try to make their exports more competitive by devaluing their currencies.

This option isn't open to members of a monetary union, like Ireland or Estonia. Competitive pressures often contribute to a more or less formalised 'currency peg' becoming unsustainable.

In anticipation of eventual Euro membership, Latvia and Lithuania have long pegged their currencies (the Lat and the Lita) to the Euro, bringing the benefit of stability to exporters. In effect, their central banks mimic the monetary policy of the European Central Bank. In addition to giving up monetary policy autonomy, Latvia and Lithuania also gave up the opportunity of competitive currency devaluation in the event of economic crisis.

When crisis struck in late 2007, many economists argued that Latvia and Lithuania should devalue. Indeed, some have similarly argued that Ireland should leave the Eurozone.

If Latvia and Lithuania aspired to join the Eurozone, there was a political imperative to maintaining the currency peg. There was also an economic imperative, however. While the exchange rate was stable, and assuming that the peg was credible in the long term, Latvian and Lithuanian borrowers could borrow in Euros at far lower interest rates than in their own currencies without fear of that debt burden increasing as a result of currency devaluation. This is a familiar pattern in emerging markets with currency pegs.

This led to a post-EU accession consumer led borrowing frenzy in the early part of the last decade, and the build-up of significant exposure to Euro denominated loans in Latvia and Lithuania. Devaluing in late 2008 or 2009 would have imposed a debt shock on domestic borrowers, sending the real debt burden through the roof. This would have led to mass default on loans made by Eurozone banks.

If a country cannot devalue its currency – an 'external devaluation' – it has no alternative than to adopt an 'internal devaluation' strategy if it is to improve competitiveness by driving down its Real Effective Exchange Rate (REER). Whether devaluation is internal or external, the aim is two-fold: 1) to make exports relatively cheaper on foreign markets so that more can be sold; and 2) to encourage domestic expenditure switching where foreign goods and services have become relatively more expensive on the home market. Together, this should improve the Current Account balance through the trade surplus as imports fall and exports rise.

Internal devaluation means either driving down nominal wages and prices, or holding down inflation with respect to a benchmark, for instance Germany. This is the strategy pursued since 2008 by Europe's periphery, including Ireland and the Baltics.

Austerity itself does not directly contribute to internal devaluation, but it can be its natural by-product. Budget cuts and tax hikes may reduce the fiscal deficit, but they do not by themselves improve the trade balance.

In theory, an internal devaluation could be implemented by simultaneously reducing all wages and prices in an economy overnight. In effect, this is what a currency devaluation would achieve, at least in respect of wages and prices in other countries. Because people suffer from the so-called 'money illusion', however, and wages denominated in the domestic currency do not fall, an 'external' devaluation is seen as being far more socially and politically acceptable.

In practice, because wages and prices are 'sticky' downwards, and absent a command economy, internal devaluation is achieved first by reducing those wages and prices which the government directly controls: namely public sector wages.

While public sector wages in Ireland have been hit by two rounds of cuts, including the pension levy, this pales in comparison to the near 30% pay cuts seen in Latvia, for instance. The private sector more directly bore the brunt of the burden in Lithuania, while the outcome was more balanced in Estonia.

It is not the impact on the budget deficit that contributes to internal devaluation, but their signalling effect as a benchmark for private sector wages. Private sector wages in both the tradable and non-tradable sectors are thus the real target for public sector pay cuts.

In practice, moreover, nominal wage reductions in a market economy are only achieved when demand contracts, unemployment increases, and upward wages pressures thus moderate.

An internal devaluation can be simulated more painlessly by shifting the tax burden from direct to indirect taxation. This is the logic behind increasing VAT while reducing employers' PRSI. Unfortunately, the scope for regaining competitiveness through shifting the taxation burden is rather limited.

Much the same impact could be achieved through increasing productivity. If productivity growth outpaces wage growth, and this differential is larger than in competing countries, the labour cost per unit of output will both fall and improve vis-à-vis competitors.

From 2000 to 2006, the Celtic Tiger and the three Baltic Tigers were among the fastest growing developed economies in the world.

Four Tigers Tamed

From 2000 to 2006, the Celtic Tiger and the three Baltic Tigers were among the fastest growing developed economies in the world. All benefited from the cheaper borrowing rates that came from euro membership, or the ability to borrow in euros on the basis of a stable currency peg. Each enjoyed a consumption boom, rapidly rising wages and a run-up in consumer debt.

When the financial crisis struck in 2008, being very small, very open economies, they were among the most vulnerable in Europe. Each experienced dramatic contractions in output, big increases in unemployment, and rapid current account adjustments. By end 2012, none of the four erstwhile tigers are expected to have regained their pre-crisis peak.

Unemployment has stabilised in Ireland and, having peaked in 2010, has begun to fall in the three Baltics. All four will have double digit unemployment at end 2012, double if not triple the pre-crisis rate. Emigration has picked up in all four countries, serving to dampen unemployment numbers. For every Lithuanian that emigrated in 2007, six emigrated in 2010. Emigration has doubled in Ireland and Latvia over the same period while remaining relatively stable in Estonia.

All four enjoyed low (negative in the case of Estonia) levels of net government debt and budget surpluses (or a modest deficit in the case of Lithuania) as recently as 2007. As demand contracted, budgets moved into significant deficit and government debt began to rise, precipitously in the case of Ireland, Latvia and Lithuania. Latvia (2008) and Ireland (2010) were forced to seek external financial assistance.

The collapse in global trade knocked exports in 2009, but all have experienced strong recoveries. In the face of reduced capital inflows – or even capital outflows – all four were forced to rapidly adjust their current accounts. Imports fell in 2009 even more dramatically than exports as demand contracted.

Price inflation decelerated significantly in all four, turning negative in all but Lithuania in 2009. Between 2008 and 2010, Unit Labour Costs had fallen in absolute terms by 10% on average in the four countries. By 2013, according to Eurostat, Unit Labour Costs will have fallen with respect to Germany by 19% in Ireland, and by 13.2% on average in the Baltics.

All four are small, open economies that rely on exports to drive growth. All four share a recent boom-bust economic history. All four are pursuing internal devaluation strategies aimed at improving competitiveness in the hope that economic salvation will be found in export-led recovery.

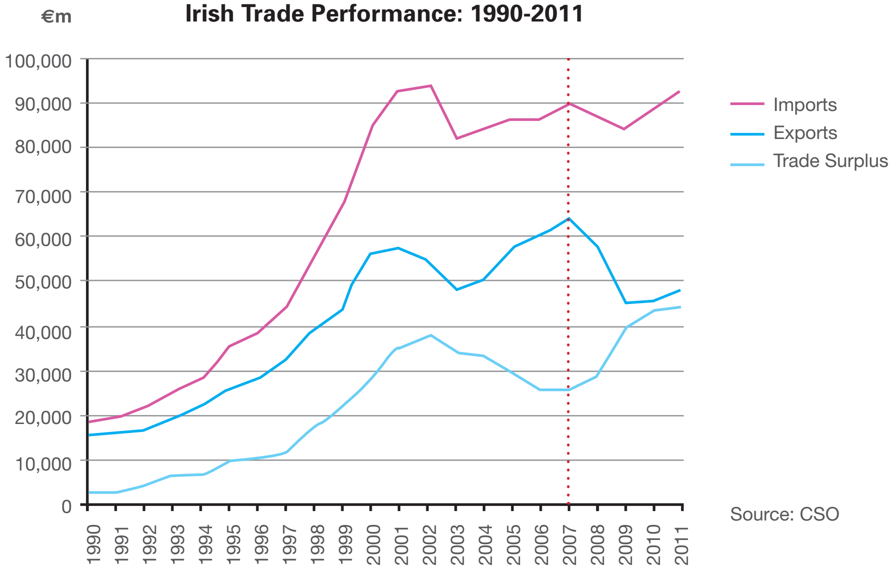
It does not necessarily follow, however, that the Irish economy is directly comparable to those of the Baltics, or that policies appropriate to the Baltics are appropriate to Ireland. In analysing the applicability or appropriateness of a ‘Baltic Strategy’ of aggressive austerity, it is important to begin from a firm foundation of facts, and to dispel certain myths that may be in danger of taking hold.

Myth 1:
Ireland is an exporting laggard

Ireland is among the most open economies in the world, with imports and exports combined totalling nearly 88% of GDP. Ireland is thus highly dependent on global economic and trade trends for its economic well-being.

Much as happened in the early stages of the Great Depression, global trade collapsed in 2009, falling 12%, when the financial crisis struck. One would have expected an open economy like Ireland to take a big hit, but its exports proved remarkably resilient, falling only 5.6% over the 2008-09 period.

Irish Trade Performance: 1990-2011



Source: CSO

Of all Eurozone members, only two avoided a double digit fall in exports in 2009: the Netherlands (-9.7%) and Ireland (-4.2%). Estonia took the biggest hit, exports falling by 23%. By 2010, only four were exporting more than they had been before the crisis: Spain, Malta, the Netherlands and Ireland.

Since 2000, Irish export growth has averaged 5.5%, surpassed in the Eurozone only by Estonia (11.6%), Slovakia (8.7%), Slovenia (6.7%) and Germany (6.4%).

Coming in a shade under €93bn, Irish exports set an all-time record in 2011, growing by 5.9% that year alone. Further growth is expected in 2012, despite global economic headwinds. Globally, trade grew by 5.0% in 2011 according to the WTO, and is expected to slow to 3.7% in 2012, below its long term trend of 6.0%. This suggests, however, that Ireland's market share is growing.

Ireland imports little over half the amount of goods and services that it exports. As recently as 2008, this proportion was two thirds, and before that it was even higher. As a result, the trade surplus – exports less imports – hit an all-time record in 2011.

A growing trade surplus is important because this is the addition that trade makes to GDP. It has grown on average by more than 16% per annum over the past two decades, and by more than 15% since 2008. If the trade surplus continued to grow at similar rates, it would add the equivalent of €7bn to Irish GDP every year, off-setting the contractionary forces of fiscal austerity and weak consumer demand.

Since 2000, Irish export growth has averaged 5.5%, surpassed in the Eurozone only by Estonia (11.6%), Slovakia (8.7%), Slovenia (6.7%) and Germany (6.4%).

Myth 2:
Competitiveness is all about Cost

Competitiveness is a much abused economic concept. Rather than focusing on holistic competitiveness, the focus is too often on cost competitiveness, narrowly defined through measures such as Unit Labour Costs.

However, improving productivity through investing in human capital and modernising infrastructure becomes increasingly important as economies develop and ´move up the value chain´, as Ireland has successfully done since the 1990s. Labour costs are only one, and perhaps not even the most important, factor multinationals take into account when making investment decisions.

Ireland ranks 29th in the latest Global Competitiveness Index, exactly the same as its ranking the previous year. Among those areas where Ireland scores badly include: Macroeconomic environment (118th), and public trust of politicians (62nd). Ireland ranks 6th for exports as a percentage of GDP, 17th for labour market efficiency, but only 115th for financial market development.

Every year, the World Bank ranks countries in their 'Doing Business' survey on how easy it is to set up and run a business in that country. Ireland ranks tenth globally, the highest of any Eurozone member. Where Ireland falls down is in accessing electricity, registering property and enforcing contracts, suggesting investment in infrastructure and institutional development is what is must urgently needed.

If Ireland's export engine is in danger of flagging, it is not because Unit Labour Costs are not falling fast enough or are in danger of rising quickly. Dominated, as they are, by a vibrant FDI sector, Irish exports remain vulnerable to investment decisions made elsewhere, and to downturns in a number of core sectors: software, chemicals, pharmaceuticals and financial services.

There are inherent dangers in putting all your eggs in a limited number of baskets. For instance, pharmaceutical exports could come under threat if those blockbuster drugs produced in Ireland come off patent without a steady pipeline of successor drugs to take their place. Ireland need's a twin pronged approach: leverage our ability to continue attracting high quality FDI while making every effort to develop an indigenous industrial base capable of scaling up to compete at a global level.

Ireland is not competing with China or India for low cost manufacturing jobs, or even with countries like Estonia or Slovakia closer to home. Attracting high-end jobs means continuing to improve Ireland's attractiveness as a place to invest and do business, investing in infrastructure, education, research & development. Relentlessly focusing on labour costs not only ignores facts on the ground, but does a disservice to Irish business and Irish workers.

As an example, writing in the Irish Times on 6th May, Dan O'Brien argued that Ireland needs a *sharper* focus on the competitiveness agenda, by which he presumably means wages need to fall further and faster. What Ireland really needs is a *wider* focus on the competitiveness agenda. We need to focus on what really makes modern, advanced economies productive and competitive: quality infrastructure, superior human capital, sound institutions, R&D investment, and a functioning financial sector.

We need to focus on what really makes modern, advanced economies productive and competitive: quality infrastructure, superior human capital, sound institutions, R&D investment, and a functioning financial sector.

Myth 3:
Irish cost competitiveness has not improved

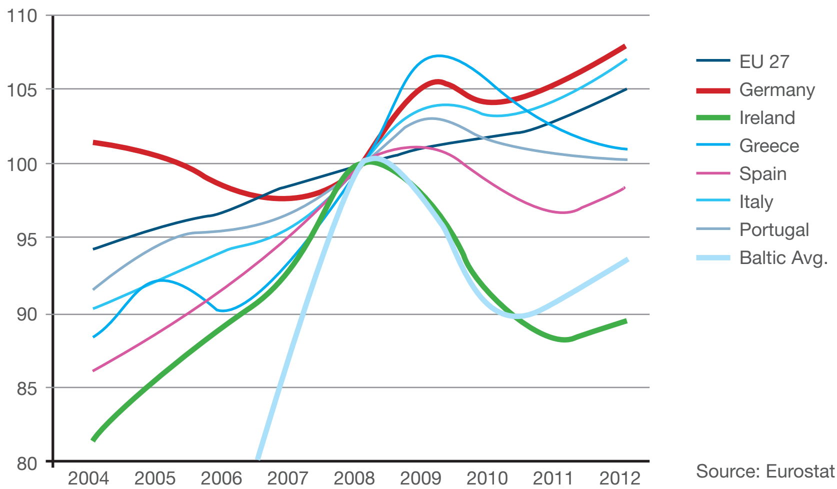
Is it true that Irish labour costs got out of control, undermining competitiveness, during the economic boom and have since failed to adjust?

Unit Labour Costs measure the average cost of labour per unit of output and are often used as a benchmark to compare labour costs across countries. Given that they are calculated as the ratio of total labour costs to real output, they are function of both wages and productivity. Unit Labour Costs can thus fall even when wages are rising, so long as productivity growth outpaces wage growth. Measures aimed at boosting productivity can thus substitute for wage cuts.

Firstly, one should note that Unit Labour Cost is not negatively correlated with export growth. Irish export growth has averaged 5.5% since 2000 while Unit Labour Cost growth averaged 2.2% annually, also one of the highest in the Eurozone. Incidentally, the Eurozone member with the highest export growth over this period (Estonia, 11.6%) was also the Eurozone member with the fastest growing Unit Labour Cost (5.2% annually).

Even if one accepts that rising Irish wages had made our exports uncompetitive by the time the financial crisis hit, is it true that they have not adjusted since, compared to Germany, for instance?

Unit Labour Costs in Europe Index: 2008=100



Source: Eurostat

Countries in economic crisis typically try to make their exports more competitive by devaluing their currencies. This option isn't open to members of a monetary union, like Ireland or Estonia, or those with a currency peg, like Latvia & Lithuania. Unable to devalue, the only option open to these countries if they want to improve cost competitiveness by reducing their Real Effective Exchange Rate is to pursue an 'internal devaluation' strategy. Since 2007, each of these countries has experienced an economic crash, deflation and significant reductions in earnings. This has pushed down wages, in turn driving down Unit Labour Costs.

We see that, on average, Unit Labour Costs across the EU 27 have continued growing at roughly the same rate between 2004 and 2012, although this average conceals deep differences across the Union.

Ireland and the Baltics, which had experienced the steepest increases before 2008, have since seen the most dramatic readjustment. In fact, only Latvia (falling back 16.9% from 2008 to 2010) has seen a bigger adjustment in Unit Labour Costs than Ireland (-11.75% from 2008-2011). One could attribute this to the twin facts that these countries have both suffered the most dramatic contractions in output, and have the most flexible labour markets.

By comparison, German labour costs had been trending downwards before the crisis but, despite dipping in 2010, have since been growing faster than all of the peripheral countries (GIIPS & Baltics), outstripping the EU average. Thus, based on labour costs alone, Germany has since 2008 become significantly less cost competitive vis-à-vis its EU neighbours, and compared to all the peripheral countries in particular, save Italy.

Eurostat forecasts negligible growth in Unit Labour Costs in Ireland in 2012 and 2013. They forecast that by end 2013, they will have fallen vis-à-vis Germany by 19% in Ireland, and by an average of 13.2% in the Baltics.

There is an important caveat in interpreting Unit Labour Cost data. As Ireland and the Baltics enjoyed construction and consumption bubbles up to 2007, economic activity became overly concentrated in low value added non-tradable sectors with limited scope for productivity growth. As these bubbles unwind, and workers in lower productivity sectors lose their jobs, the average productivity of remaining workers will increase, and Unit Labour Costs will fall. It should be recognised that this has been an important driver of falling Unit Labour Costs in these countries in recent years.

One does not have to look very hard to find evidence that the 25% drop in domestic demand since 2007 has in fact 'boosted competitiveness' exactly as one would have expected. Even to the extent that narrowly defined cost competitiveness may have been out of line, Irish labour costs have fallen faster than those of our neighbours. With unemployment expected to remain in double digits for many years to come, there is little doubt that wage inflation will continue to be lower in Ireland than in, for instance, Germany. Cost competitiveness has improved dramatically since 2008, and this trend is likely to continue.

There is an important caveat in interpreting Unit Labour Cost data. As Ireland and the Baltics enjoyed construction and consumption bubbles up to 2007, economic activity became overly concentrated in low value added non-tradable sectors with limited scope for productivity growth.

Myth 4:
The Baltics are Surging Ahead

If one views 2011 GDP growth figures in isolation, it certainly appears that the Baltic Tigers are purring again. Estonia, Lithuania and Latvia grew at rates of 7.6%, 5.9% and 5.5% respectively, compared to Ireland's modest 0.7%.

It is hardly surprising that those economies that fell furthest during the crisis are those that recover fastest. Estonia, Lithuania and Latvia experienced GDP contractions of -14.3%, -14.8% and -17.7% respectively in 2009, compared to Ireland's already eye-watering -7%. These four suffered peak-to-trough GDP contractions of 17.4%, 14.8%, 20.7% and 10.1% respectively.

Moreover, recent Baltic growth appears unlikely to be sustained, with the IMF forecasting a slowdown to 2% growth in each of the Baltics.

Certainly, Estonia enjoyed a blistering export performance in 2011, with 31.5% growth. Incidentally, Estonian imports rose 33.5% in 2011, so that net exports actually fell, meaning international trade was actually a net negative for Estonian GDP growth last year. Moreover, this comes on the back of an equally dramatic 23.1% fall in exports in 2009, while Estonian exports are expected to fall 4% in 2012, even as Irish exports and trade surplus continue to grow.

Equally, at first glance the 2011 reductions in unemployment rates of 4.8%, 2.3% and 3.4% in Estonia, Lithuania and Latvia look impressive. They look distinctly less so when one considers the respective 12.6%, 13.5% and 12.8% increases over the 2007-2010 period. Like Ireland, all of the Baltics will still have double digit unemployment rates by end 2012, more than double their pre-crisis rates.

There is one further, critical distinction to be made. Even now, Ireland is among the richest nations on Earth. The Baltics, while classed as developed, are only a third as wealthy as Ireland or less, as measured by GDP per capita. For this reason, direct comparisons between the Irish economy of today and either the Baltics or, for that matter, the Irish economy of the 1980s are meaningless.

All else being equal, economists expect that poorer countries will grow faster than richer countries, and the bigger the wealth gap, the bigger the expected growth gap. This is known as conditional convergence. For instance, Ireland experienced catch-up growth in the 1990s, eventually surpassing the European average. One would therefore expect the Baltics to grow faster than Ireland for the foreseeable future. This is borne out for instance by the OECD estimates of potential GDP growth, which is 2.5% higher in Estonia than in Ireland for both 2012 and 2013.

Undoubtedly, there is much slack remaining in the Irish economy, and some rebound effect is certainly possible when the impact of fiscal austerity and the private sector debt overhang dissipates, but it is highly unlikely that Ireland will ever again see on a sustainable basis the convergence rates of growth experienced in the 1990s. This is also why reducing Ireland´s Debt-to-GDP ratio will be far more challenging this time around.

Direct comparisons between the Irish economy of today and either the Baltics or, for that matter, the Irish economy of the 1980s are meaningless.

Myth 5:
The Baltics bit the silver bullet

Much commentary on the Baltic experience of internal devaluation likens it to pulling a plaster: painful, but mercifully quick. 2011 economic performance is taken as a 'mission accomplished' signal.

As with most simple economic narratives, the reality is somewhat more complex. It is clear that internal devaluation has been hurting, but is it 'working'?

Evidence from the Baltics demonstrates how the bulk of the burden of internal devaluation is forced on the labour market. Unemployment tripled across the board with non-tradable sectors, like construction, particularly badly hit. As the economy reorients towards tradable sectors, many of these jobs will not be coming back, and long-term structural unemployment is thus likely to remain elevated.

Nominal wages in the Baltics had fallen by 10-15% by early 2010. Public sector wages were slashed by as much as 30% in Latvia. In Lithuania, by comparison, more of the burden fell directly on private sector wages. Wage growth has resumed, particularly in those sectors experiencing skills shortages. Such frictions can serve to undermine 'internal devaluation', particularly where fiscal consolidation leads to the curtailment of the activating labour market policies needed to facilitate ´sector switching´ among workers. As outlined above, shifting the emphasis from cutting wages to boosting productivity can alleviate economic hardship while simultaneously bringing down Unit labour Costs.

Three years on, unemployment rates are still more than double pre-crisis rates across the Baltics, while GDP has yet to reach pre-crisis levels. Having fallen so far in 2008 and 2009, it is hardly surprising that there was a rebound effect in 2011. Growth is expected to slow to 2% across the region as this effect dissipates, and much of neighbouring continental Europe remains mired in recession. Exports have recovered from the 2009 collapse in global trade, but are expected to slow significantly in 2012, even turning negative in Estonia.

Far from being quick, internal devaluation in the Baltics has been long, arduous, and is as yet incomplete. In a world where every country is chasing export-led recovery, while many are attempting to adjust their trade and current account imbalances, gaining market share for exports is likely to remain a daunting prospect.

Internal devaluation is no silver bullet, and may prove politically unsustainable if pursued over the long-term. Indeed, it may prove to be socially, economically and financially unsustainable in the presence of a large public and private sector debt overhang, as in Ireland. Internal devaluation increases the real debt burden as incomes decline while debts are not similarly debased. All else being equal, one would anticipate that internal devaluation, coupled with a large debt overhang and prolonged recession, would lead to more bankruptcies and ultimately more demands for taxpayer funded bank bailouts.

Internal devaluation is no silver bullet, and may prove politically unsustainable if pursued over the long-term. Indeed, it may prove to be socially, economically and financially unsustainable in the presence of a large public and private sector debt overhang, as in Ireland.

Printed by Trade Union Labour

www.ictu.ie

31/32 Parnell Square
Dublin 1
Ireland

Phone: +353 1 8897777
Fax: +353 1 8872012
E-mail: congress@ictu.ie
www.ictu.ie

Carlin House
4 - 6 Donegall Street Place
Belfast BT1 2FN
Northern Ireland

Phone: +02890 247940
Fax: +02890 246898
E-mail: info@ictuni.org
www.ictuni.org