Should Ireland have joined the euro?

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The Cambridge team skilfully made the case that Ireland has been damaged by its membership of the Eurozone in the first of the Review's bi-annual debates. However, a carefully argued rebuttal comes from Daniel Eve. While recognising the various limitations of the common currency area, in particular with regard to incomplete labour market integration and uncoordinated fiscal policy, Eve argues that Ireland's Celtic Tiger boom was prolonged by its adherence to the euro and that recent events have shown the need for more rapid integration if both Ireland and its European partners are to weather the storm.

Introduction

The current economic crisis has been labelled the worst since the Great Depression[1], providing the first real test for Europe's single currency. Bank nationalisations, sovereign bailouts and British devaluation have left many questioning Ireland's position within the European Monetary Union (EMU) (McWilliams, 2010). This paper aims to look at the EMU as an optimum currency area, why Ireland joined it and what it has delivered. This essay argues that the current economic situation was not precipitated by EMU membership, but rather by poor economic policy at a national level.

A brief exchange rate history

The Irish punt was always a currency searching for stability (Kelly, 2003). The Coinage Act of 1926 tied the newly formed Irish pound, one-for-one, to the pound

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[1] http://www.reuters.com/article/pressRelease/idUS193520+27-Feb-2009+BW20090227

sterling: "[t]he credibility of the new currency being ensured by a full backing with Sterling assets in a currency board" (Kelly, 2003: 89). This meant Irish monetary policy was effectively controlled in London. With the vast majority of Irish trade being with the UK, this link made sense, and it endured for the next 50 years.

However, the 1970s proved to be a decade of change. The breakdown of the Bretton-Woods system of exchange rates, oil crises and Britain's exit from the European Monetary System (EMS) 'Snake' (Baldwin, 2005) eventually led to the break of parity with sterling[2]. Ireland opted to join the EMS in 1979; a system of fixed but adjustable exchange rates that saw all currencies trade in a narrow band against each other and, were essentially anchored against the deutschmark. The EMS ultimately delivered the stability Ireland was looking for and long-run inflation decreased, as low German inflation was 'imported'. In 1999 Ireland, together with ten other European countries, opted to join the EMU. This was a landmark decision especially as Ireland's largest trading partner, Britain, decided to remain outside.

Common currency areas: the USA versus Europe

Labour market integration

Common currency theory states that in a currency union, the free movement of labour is vital for adjustment to an asymmetric shock. If output falls in one region, and hence unemployment increases, then labour will migrate to a different region, where the shock has not taken place. For example, in the United States, if a worker in Virginia loses his or her job then he or she can move to New York to look for another. The problem in Europe is that significant barriers to the free movement of labour still exist[3].

Upon the accession of ten new European Union (EU) member states in 2004, Ireland was the only member state within the EMU to allow the total free movement of labour; with other member states imposing quotas or work permit requirements. The removal of these barriers is vital to the fundamental workings of the currency union and its ability to deal with future asymmetric shocks. With inflexible labour markets, it is quite possible for wage inflation to result in significant regional unemployment. Furthermore, it is possible for regional price bubbles to form which can significantly disrupt local economies (Fitzgerald, 2004). There have been examples of both of these phenomena in Ireland, especially demand-side shocks which have resulted in large increases in nominal wages.

Coordinated fiscal policy

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[2] See Kelly (2003) for a comprehensive discussion.

[3] http://news.bbc.co.uk/2/hi/europe/3513889.stm

In the USA, not only monetary policy but also fiscal policy is centralised. In Europe, each country is responsible for its own fiscal policy. Once again turning to common currency theory, it is evident that the idea of 'fiscal federalism[4]', whereby fiscal policy will be built on top of a federal political structure with mechanisms that permit inter-state transfers (Feenstra & Taylor, 2008), is superior to the current European system. Fiscal federalism offers another mechanism of adjustment when an asymmetric shock affects a particular region. Fiscal transfers from an unaffected region flow to the affected region and this allows such regions to adopt a more expansive fiscal policy in recessionary times.

A lack of fiscal policy coordination can have negative externalities for regions within the Union. During German unification, procyclical fiscal policy combined with a tightening of monetary policy, adversely affected a number of Germany's EMS counterparts. Studies suggest that the rise in interest rates and the reduction in EU growth caused a reduction in Irish GNP of approximately six per cent and: "the results suggest that the Irish boom of the late 1990s would actually have occurred in the early 1990s"(Fitzgerald, 2004: 8).

Culture

Unlike the USA, Europe is not a natural common currency area. Sharp economic and cultural differences exist within Europe, which make labour migration a problem and can create very divergent growth rates in the different regions (Crowley, 2002). Indeed, Ireland is probably culturally closer to the UK and the USA than to the rest of Europe – a fact that is reflected by its principal trading patterns. Eurosceptics will argue that the lack of a common European language is a major barrier to the EMU project[5]. Given Ireland's peripheral location, and with English as its first language, there is less importance attached to learning a second or even third language. Other variables such as home ownership rates differ markedly across European countries and this varies the demand for more efficient and advanced housing-finance systems (Earley, 2004). With the European Central Bank (ECB) controlling the interest rate, it means that countries such as Ireland, Portugal and Spain, which have higher homeowner occupation rates and less elastic demand for housing, will have to increase regulation in this area to avoid regional property bubbles.

Cultural differences such as the above make the intricate workings of a common currency area much more difficult. Returning to the earlier example, if an Irish worker becomes unemployed, it would be difficult for him or her to relocate to

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[4] See Sophie Ward's (2010) article "An analysis of the concept of fiscal federalism in relation to the European Union" for a more in depth discussion on this topic.

[5] http://news.bbc.co.uk/2/hi/special_report/single_currency/66501.stm

another EMU country in search of work if he or she does not possess another European language. In this sense, the USA does not suffer from the same problems as Europe; it has far less linguistic diversity and a federal redistribution system which complements an integrated labour market. Furthermore, policies regarding home ownership and the improvement of social cohesion can be implemented at a federal level.

The euro and Ireland

Risk premiums, interest rates and inflation

Membership of the EMU was widely seen as a credibility gain for Ireland (Posen & Gould, 2006). Failure to join the EMU would have surely resulted in higher interest rates for such a small currency, as the price of information in financial markets would have been much higher for potential investors. As Fitzgerald (2004: 7) states: "[i]n the past financial institutions that wished to invest in the Irish pound would have had to study the prospects for the pound as well as Irish public finances". EMU membership would reduce the risk associated with investment and ultimately, lower the risk premiums the government had to pay. Furthermore, there is evidence that pre-EMU, the cost of monetary independence was higher interest rates (Fitzgerald, 2004). The euro delivered the lower interest rates that it promised and consequently ushered in a period of rising foreign investment in Ireland.

Without accession into the EMU, the boom that Ireland enjoyed would surely have ended prematurely, before reaching its full potential. Ultimately, lower interest rates were a factor in the prolonged roar of the Celtic Tiger. This is not true for Ireland alone; the EMU led to predicted gains for further participants such as Spain and Italy (Fitzgerald, 2004). The promise of 'importing lower inflation' was also a major potential gain for the Irish economy. Despite already being tied to a low inflation zone with EMS membership, continuing with this arrangement was seen as far superior to leaving it and "there was still a gain in the reduction of exchange rate risk premium with other EMU members" (Honohan, 2000).

A shock absorber

An advantage of a single currency area is its ability to react in a more positive manner to a symmetric shock, affecting all its members. Events such as the bursting of the technology bubble, 9/11 and the recent financial crisis are examples of shocks that can affect all members of the Union and the existence of a centralised policy-making body is a major advantage for an efficient policy response (Lane, 2009). For example, the ECB was able to agree currency swap deals with both the American Federal Reserve and the Bank of England to improve overall liquidity and exchange rate controls immediately following 9/11. The previous system of multiple

currencies could well have delivered inefficient policy outcomes and uncoordinated monetary policy would "have generated an inappropriate shift in the intra-European exchange rate" (Lane, 2009: 5). For a small open economy such as Ireland, exchange rate stability is extremely important and any measures to improve this are surely advantageous (Lane, 2009).

The devaluation mechanism

With EMU membership, countries were prepared to give up the devaluation mechanism. This policy tool essentially allows a country to make its own currency cheaper in terms of other currencies, to boost exports in recessionary times. However, with a single currency this is not an option. As the current Central Bank Governor, Patrick Honohan, points out "the loss of monetary policy is regrettable, but it must be acknowledged that during the ERM period monetary policy has not been effectively geared towards domestic macro conditions" (Honohan, 2000: 9). The loss of the devaluation mechanism has hurt some countries more then others, during the recent crisis. Looking at Irish exchange rate history, it is evident that Ireland never had full control over its' monetary policy; managing the economy on fiscal policy alone is by no means a new situation.

Unfortunately, the global crisis has highlighted the drawbacks of losing this devaluation mechanism. With differing rates of growth among the EU members, a common monetary policy was never going to suit everyone. Interest rates were artificially low for countries such as Ireland and Spain, which experienced high growth rates and property booms. This has resulted in increases in real effective exchange rates, as well as current account surpluses turning into large current account deficits: "shifts [that] testify to unsustainable booms in domestic demand" (*The Economist*, 2009).

The euro as a currency peg

The euro did not offer an ideal peg for the Irish pound due to a relatively low share of transactions being with the Eurozone. This meant that exchange rates with Britain and the USA had a greater effect on the rise in the Consumer Price Index (CPI) (Honohan, 2000). This was evident during the sharp depreciation of the euro against the dollar between 1999 and 2002: which represented a positive, differential shock for Ireland vis-à-vis the rest of the Euro area (Lane & Honohan, 2003). The depreciation of the euro caused an increase in Irish competitiveness and boosted the already strong aggregate demand conditions during that period. Essentially, euro movements against currencies such as the dollar and sterling will have a greater effect on the Irish trade balance than most other EMU countries. For Ireland, the

euro depreciations against these two currencies came at an inopportune time as exports were boosted in an already over-heating economy.

Despite not offering an ideal peg, the risk of asymmetric shocks would have been lower if Britain had joined the EMU[6]. As Lane (2009: 12) argues, had Ireland not joined the EMS and instead floated the punt:

> "…the global liquidity glut during the 2003-2006 period would have encouraged the accumulation of significant foreign debt by Irish banks, in turn the onset of the financial crisis would have triggered a destabilising speculative capital outflow, currency depreciation and more complex type of banking crisis."

Despite the problems currently facing Ireland, the euro looks like it may well have cushioned the Celtic Tiger's fall from grace.

Irish management in the EMU

The Irish economy was growing at a steady pace before the inception of the EMU, in large part, due to government policies that fostered growth and increased inward Foreign Direct Investment (FDI), most notably from the USA. It has been suggested that EMU membership helped Ireland to continue to attract unprecedented levels of FDI, as companies looked for English-speaking countries within the EMU (Murphy, 2000). EMU membership did much to boost this growth with lower interest rates, as mentioned above, fostering a culture of investment and growth. However, it is at this point that Irish fiscal policy must be mentioned, as it can still be used to effectively tackle problems in the event of a loss of monetary policy.

With EMU membership, countercyclical fiscal policy is necessary, as fiscal errors cannot be offset by adjustments to monetary policy or the nominal exchange rate (Lane, 2009). Healthy balance of payments positions during the boom years should have been coupled with fiscal contraction. In the Irish case, the rapid growth of the 1990s saw public sector spending decrease relative to Gross Domestic Product (GDP). Accordingly, part of the expenditure growth since then may be attributed to catch-up dynamics and trend shifts in the size of the Irish public sector

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[6] At the time, it was also mentioned that increased labour market integration was necessary to reduce the country's vulnerability to shocks. In addition, it was concluded that having made provisions for the cost of possible shocks, the net benefit of EMU membership in terms of employment was estimated to be of the order of 10,000 jobs (just under one per cent of total employment).

in addition to cyclical factors. Furthermore, the growth in "asset-based tax revenues was primarily used to finance the growth in public spending" (Lane, 2007:17). This was coupled with decreases in income tax rates and a contraction in the tax base (Lane, 2007). Wage increases in the public sector were also irresponsibly high, with growth rates much higher than other sector of the economy. Irish fiscal policy over the boom years took on a procyclical nature, which in a currency area is especially dangerous, when faced with a large symmetric shock.

Conclusion

Should Ireland have joined the Eurozone? The purpose of this article has been to argue that Ireland made the right decision. There is little doubt that EMU membership brought huge advantages, such as the decreased cost of capital, which prolonged the Celtic Tiger. As such, they can be thought of as a 'positive shock' to the Irish economy (Honohan, 2000). It is estimated that excess returns in the long run would have fallen to one per cent if Ireland had stayed outside the EMU. The cost of such a permanent wedge in capital was considered to be quite high (Fitzgerald, 2004).

Ireland has never had its own independent monetary policy and has been used to managing without one. However, the loss of the devaluation mechanism is regrettable. It must not be forgotten that Ireland effectively devalued its currency twice during the EMS period and now that this is no longer an option, fiscal policy takes on increased importance. However, government fiscal management has been poor and not enough was done to curb the rapid rise in wages:

> "…the financial regulator was insufficiently aggressive in curbing excessive credit growth, while national fiscal policy did not accumulate sufficiently large surpluses during the boom to enable a countercyclical response to the current downturn"
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> (Lane, 2009: 1)

The recent global financial crisis has shown that Europe needs more, not less integration. More coordination of fiscal policy on a national level is also needed: "improved cross-border financial regulation" (Lane, 2009: 33). A more fiscally-integrated and efficient Eurozone will ultimately bring increased benefits to its members.

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