

EXCHANGE RATE POLICY IN IRELAND: PAST, PRESENT AND FUTURE

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IN EXAMINING exchange rate policy in Ireland, I deal in this paper with inflation, and with its companion; competitiveness. The trends in inflation under different regimes are examined and the issue of devaluation as a means to improving competitiveness is tackled. In considering these issues much attention is paid to credibility and dependency on larger trading blocs. Future avenues for the punt are contemplated and the road to EMU firmly recommended.

PARITY WITH STERLING

The Irish pound, as we know it today, was first printed in 1928 on the basis of exchange rate parity with sterling. The existence of a one-for-one, no-margins parity, together with unrestricted capital (and labour) flows, made the sterling link an effective instance of monetary integration. Inflation levels were almost identical, Irish interest rates were very similar here to those in the UK, and control of the money supply was out of our Central Bank's hands as the unrestricted access to UK financial markets relegated Ireland to mere satellite status (McCarthy, 1980). We effectively had no exchange rate policy, beyond the decision to remain part of the sterling area; monetary policy too was impotent.

In the face of rising inflation in Britain in the 1970s Ireland's price level rose equivalently. Our commitment to sterling floundered as the EMS proposal was tabled. We now had the opportunity to do something pro-European (and anti-British) and break the inflation/depreciation spiral by attaching ourselves to the rock-solid Deutschmark. Furthermore sterling was believed to be a petro-currency with its fate determined by oil price movements, this having an adverse effect on an oil-importing economy such as Ireland (Dowling, 1979). Being tied to sterling in the face of the North Sea oil glut would have meant disaster for Ireland. Additionally, the break with sterling had appeal for economic nationalists, even though the move would add an economic dimension to the border with Northern Ireland. In any case were we not simply just switching ownership of our sovereignty from Britain to "Europe"? It seems the benefits were to outweigh the costs in Irish policymakers' minds as the decision was made to abandon the erratic pound and enlist in EMS in 1979.

THE SWITCH TO THE ERM

Did the switch benefit our fight against inflation? A comparison in 1986 of the evolution of inflation since 1979 reveals no evidence that the decline in inflation rates proceeded faster inside rather than outside the EMS (De Grauwe, 1986). Furthermore the degree of exchange rate stability that has been achieved within the EMS has had little impact on macroeconomic performance. The growth of GNP has been slower, and the rise in unemployment faster within the EMS than in non-EMS countries during the 1980s. Even the supposed advantages for trade of membership may be doubted. The growth of intra-EMS trade has been slower than that between the EMS and the rest of the world or between non-EMS members.

The problem is that the EMS/ERM in its present form is only a quasi-fixed exchange rate system. So by moving from the sterling link to the EMS in 1979, Ireland was not substituting one fixed link for another. Short-run variations in the exchange rate are in fact, controlled by Central Banks, but are of a size to permit short-run variations in the interest rate and thus create exchange rate risk (Dowling 1986). Further, the possibility, and indeed necessity, of permanent adjustments in exchange rates leads to substantial divergences in long term interest rates. Sustaining a particular exchange rate in the Irish case is contingent on the markets' perception of that rate being compatible with sterling.

There is much debate over the importance of the UK market to Ireland. Current figures suggest that 32% of our trade is with Britain. There is the possibility that the real figure is much smaller, somewhere in the 15-20% region, as trade in agricultural and energy products is largely unaffected by sterling exchange rate movements (Sutherland, 1993). Nevertheless, the importance of the sterling/punt exchange rate exceeds the weight of sterling in our trade because several price sensitive sectors (textiles, furniture, clothing and footwear) are particularly influenced by sterling's value. The move to EMS has reduced our export dependency on the British market: it has come down from 90% in the 1920s, 48% in 1978, to approximately 32% today. Moving to EMU would reduce that figure still further but the markets must be convinced of this.

THE POLICY IMPLICATIONS OF A FIXED EXCHANGE RATE

To gain the credibility of markets a certain exchange rate must be backed by appropriate fiscal policies, both domestically and at an EC level. Firstly, the Irish government failed in their attempt to support the recent appreciation in the punt by cutting domestic input costs. PRSI should have been lowered for employers, but this was not done. Instead subsidies to industry were offered but these involved an open-ended exchequer commitment whilst merely postponing the adjustment to real exchange rates which must be accepted in the long run (Walsh, 1986). What the markets did see was a huge increase in public sector pay (which in Ireland arguably set wages for the internationally-competing traded sector too), quite the opposite

measure required in the face of a dear punt.

Leaving aside the crippling influence of interest rates, the old sterling rate could possibly have been endured until German interest rates fell, if the domestic cost base had been targeted sufficiently. It was not, and the loss of credibility drove interest rates unbearably high, forcing a devaluation, the worst possible outcome. Instead of an orderly realignment of the DM last summer (or before) having seen the inflationary impact of one-for-one currency union with Eastern Germany (a policy bitterly condemned by Karl Otto-Pohl, ex-president of the Bundesbank), the ERM plodded along. As cracks appeared, currencies were picked off by sheer weight of money, rather than on the basis of economic fundamentals. This cannot be permitted in the future and a reform of the ERM is required to ensure greater mutual support.

DEVALUATIONS: COSTS AND BENEFITS

Devaluation though, if properly managed, can provide some lasting benefit to a small open economy. The 8% devaluation of August 1986 created a sound platform for economic recovery, accompanied as it was by a temporary incomes policy and tight fiscal policy (McAleese, 1992). The key is pay restraint, involving a real fall in wages but not necessarily a nominal decrease. This is much quicker than allowing inflation to increase competitiveness by slowly eroding the purchasing power of the pay packet.

While the devaluation will have eroded credibility, damage can be limited by fiscal rectitude. Indeed, as in the recent Irish case, if the markets (rightly) view the sterling-punt exchange rate as untenable, then devaluation may be the only credible option? However fiscal tightness is crucial - "stabilisation through cuts in expenditure" - to avoid further calls for devaluation, and resultant higher interest rates. In an economy where the non-traded sector has managed to insulate itself increasingly from real income movements in the traded sector, devaluation is potentially a weapon to cut the real income of this non-traded sector (McCarthy 1982). However this reduction in real income must be permanent, not merely postponed as has been the case here currently with 10% pay increases for public servants. Additionally devaluation provides short term gains to the traded sector by boosting margins.

I am not going so far as to advocate 'escapist' devaluations. While they may be periodically needed, they create the need for risk premiums on interest rates, increase inflationary pressures and damage competitiveness (Sutherland, 1993). Rather the way forward is to link ourselves to a larger trading bloc. While some may argue that a greater readiness to devalue is required (Walsh 1988), long run benefits require a fixed link. But with whom?

FUTURE OPTIONS FOR EXCHANGE RATE POLICY

We are currently apparently adopting a trade weighted approach to exchange rate policy, an attempt to reconcile a depreciating sterling with our commitments to the ERM. But this is not sustainable due to speculation and higher interest rates. We must either pursue a sterling link or a much strengthened ECU link. The former would leave us open to sterling's cyclical weaknesses/fluctuations.

However an ECU link, would be just like the old sterling link (Dowling, 1986). While this would mean surrendering all control of monetary policy to a (hopefully) independent central bank, there is doubt as to whether or not we would have any control under flexible exchange rates either. Ueda (1984) argues that a SOE is forced to tighten their own monetary policy if a large country, upon which it is highly dependent for imported intermediate goods, tightens its monetary policy. This is effected through supply-side influence on price and output stability. In any case a SOE has little leeway in a world where it is a price taker and where the world interest rate is taken as given.

Given the current composition of Irish trade the ECU link would be closer to a trade-weighted exchange rate policy than a sterling link would be (Dowling, 1986).

CONCLUSION

I believe that an ECU link is the way forward. Unfortunately this must involve our single most important trading partner, the UK. Until we have further diversified from our UK trade links, we will not be able to participate in EMU without them.

The EMS has been in trouble before and will be so again. Ireland should be a firm advocate of monetary union, and indeed will be, seeing as we expect to receive from Brussels six times the amount we'll hand over, for 'cohesion' (The Economist 13.06.92). Ireland has much to gain from EMU, despite the dissenting comments from Feldstein (The Economist 13.06.92) who argues that a common currency may actually damage trade. His comments pertain mainly to large economies though, and are largely irrelevant to Ireland.

Looking tentatively to the future then, pressure on the punt will ease as sterling strengthens in the event of recovery and a rising price level. A two speed Europe may now be the only way ahead, and if so, Germany, France and the Benelux countries should form a monetary union as soon as is economically possible. Whether or not Ireland should be part of that 'fast lane' is another issue, for another day.

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