

## **IRISH INTEREST RATES; WHO'S TO BLAME?**

by Ann Dillon

*- "Markets start to wonder how long government can keep from blinking" - Irish Times 29th September 1992*

*- "Too vocal Ahern falls into currency trap" - Irish Independent 7 January 1993*

*- "Punt devalued ten per cent at crisis meeting" - Irish Independent 31 January 1993*

The currency crisis has captured the attention of the general public for the past few months, with the exception of only a few minor intervals. All of this uncertainty brings confusion and panic. Irish interest rates have reflected this by fluctuating in tandem with these events.

The question must be asked as to why have these events occurred. In this essay, I will investigate the standard reasoning as to how interest rates are determined. At the beginning of the currency crisis in mid-August 1992, many banks blamed their increase in interest rates on German interest rates. By running a regression programme based on this information, it will be discovered just how true this claim is. Also examined in this programme, to gauge their influence upon interest rates, shall be the difference in the level of inflation between Ireland and Germany and the variation in the exchange rate with sterling.

### **FUNCTIONS OF INTEREST RATES**

Firstly, a brief introduction to the main basic function of interest rates is necessary. Interest rates are an allocative device. They allocate resources between consumption and saving, and between the various sectors of the economy. They also act as a link between financial markets in different countries. Therefore, the international role of interest rates is to act as a mechanism for distributing funds between the monetary systems of different nations. Countries which require high interest rates tend to be those with high inflation, large balance of payments deficits and weak currencies.

## INTEREST RATES SINCE 1979

On joining the EMS, exchange rate uncertainty, paradoxically, became an important factor in determining interest rates. The difference between Irish and UK interest rates now reflected expectations about the future of exchange rates. If the Irish pound was expected to appreciate over the period, Irish interest rates would be lower than UK rates (and vice versa). At the time of joining the EMS, some people thought that it merely involved a shift from a fixed link with sterling to an almost identical one with a monetary system dominated by Germany(1). But the certainty of the link between the Irish pound and sterling was not replaced by a similar degree of stability. The Irish pound has been devalued three times whilst it has been in the EMS - 21 March 1983, 4 August 1986, 30 January 1993. (In each case this was provoked by a depreciation of relative ERM currencies.) As a result of all this Irish interest rates did not converge to the level of German ones.

Between 1990 and the present currency crisis, Ireland's exchange rate within the EMS was quite stable. Reductions in interest rates in several EMS countries led to a significant narrowing of interest rates vis-a-vis German rates. This declining trend allowed a lower differential between Irish and German rates to emerge. This could be explained by -"the weakness of the DM against the dollar, domestic economic problems in Germany and, to some extent, sound domestic economic fundamentals in Ireland"(2)

But what are the actual determinants of Irish rate levels? The Central Bank does have a number of instruments available to it, in theory at least, with which it can exercise a degree of control over our money supply and hence over our interest rates. However many would argue that we have little control over our domestic rates and that our fate in this regard lies in the hands of 'external influences'. My study sets out to examine this claim.

## REGRESSION

With this in mind, I decided to see how much influence two variables had upon the Irish interest rate. These are the German interest rate (Frankfurt Interbank Offered Rate : FIBOR) and the punt-sterling exchange rate. The estimation of the regression line was done using the Hummer package (with monthly data) and covered a time period dating from January 1990 to November 1992. This meant a total of thirty-five observations.

Under this analysis the Y (dependent) variable is the Irish interest rate. To measure this I have chosen the three-month money market rate. This rate is used mainly because it serves as a direct comparison to the X1 variable, but also because it will not be affected by short term fluctuations or day to day activities. This is necessary to ensure as accurate a measurement as possible on the variables

affecting Y. This Irish rate seems to be quite volatile ranging from 16.54% (Nov. 1992) to 9.99% (Sept. 1991).

My X1 variable is the German three month FIBOR. The main reason why Germany is generally seen as the dominant country in the EMS is because other countries have more faith in the ability of the Bundesbank to control the German money supply than they have in their own Central Banks (3). This German interest rate has witnessed a steady climb since January 1990 when it was at 8.3%. It peaked in July 1992 at 9.9%. It fell suddenly in August 1992 to 9.55%.

The second independent or explanatory variable chosen, X2, is the punt/sterling exchange rate. In this analysis, I have decided to deal only with ex poste exchange rates i.e. with real movements rather than with expectations. When the UK decided to exit the ERM in September 1992, it left Ireland in quite an unstable position which caused pressure on the punt within the ERM and hence caused interest rates to increase.

By regressing Y on X1 (German interest rate) alone, an  $R^2$  of 0.03764 was yielded showing that only 3% of the variations in Irish interest rates were explained by the variations in the German rate. This is quite a poor result, but it must not be taken in isolation (as with any econometric result). Looking at the parameter estimate of -1.13609 shows that X1 has a negative effect on the Irish interest rate. The t-statistic however indicates that this variable is not statistically significant

Independent Variable	Parameter Estimate	t-statistic $H_0 : b=0$
Constant	16.969959	3.36426
X1	-0.629752	-1.13609

The  $R^2$  yielded by regressing Y on X2 (punt/sterling exchange rate) is 0.7583, which suggests that 75% of the variations in Y are explained by the variations in X2. The t-statistic is 10.16731, showing a high degree of statistical significance. This is a strong indication of a causal relationship. It strongly suggests that the sterling exchange rate plays a crucial role in the determination of Irish interest rates. The parameter estimate was also a positive one which suggests that a decrease in the strength of sterling against the punt puts upward pressure on our interest rates.

Independent Variable	Parameter Estimate	t-statistic $H_0 : b=0$
Constant	-21.812744	-6.70149
X2	35.405027	10.16731

## ANALYSIS

Ever since the UK left the ERM, Ireland has suffered as regards high interest rates, uncertainty and threats of devaluation. This regression shows in a dramatic way the importance of British influences in shaping our economy. For example the "weakness" of sterling has had many consequences for Ireland including high interest rates (which has had an adverse effect on economic growth) and a reduction in the competitiveness of Irish exporters to the UK. Business confidence has also been hit. However other forces may have been at work to contribute to this pressure on our currency and hence our interest rates (see list of events in fig. 1). For instance, speculators may also play a key role here, (some believe that it is all due to George Soros that we are having these problems) (4). Others would point to a more autonomous role for indigenous forces such as the policies followed by our Central Bank.

At this point, it might also be worthwhile to compare Ireland's interest rates those of other similar countries. Switzerland's money market rate (three month) has not been very volatile, fluctuating around 7.4% to 8.79% over the same period. But it has seen a decline in the last few months to about 6.88%. Although the Swiss economy is not identical to Ireland's, it is neither a member of the E.C. nor of the ERM, there are grounds for comparison. It is also a small open economy and yet it is not wholly tied to Germany. Portugal is perhaps an even closer proxy and its money market rates have been almost consistently higher than Irish interest rates for the past few years with a sharp increase in the last few months (similar to Ireland). This shows that being a member of the EC does not necessarily imply economic convergence. Recent events have made this subject quite topical. At the moment, it is very hard to say what the future will hold for Ireland's interest rates. Hopefully, this essay has given the reader a little insight into the determination of Irish interest rates. But in no way is this project complete or absolute. Further investigation is required.

## NOTES

1. McCarthy, (1979) in John D. Fitzgerald "The National Debt and Economic Policy in the Medium Term" ESRI Report 1986 p.4
2. Central Bank, (1991) Annual Report (Summer)
3. Leddin and Walsh "The Macroeconomy of Ireland" Chap 10
4. Stephen Dodd Irish Independent 2 December 1992 p.8 "The Money Predators"

## **LISTS OF EVENTS**

- 2 Sept US dollar continues to weaken.
- 3 Sept UK Chancellor, Norman Lamont boosts sterling by borrowing £7.25b
- 5 Sept US dollar weakens further due to : - unexpectedly weak employment figures  
- cutting of key Us interest rate
- 8 Sept European Finance Ministers meet in Bath
- 9 Sept Finland lets its Markka float
- 15 Sept Bundesbank cuts interest rates by a quarter point (to 9.5%)
- 16 Sept Pressure on sterlin to devalue
- 17 Sept Sterling is devalued and allowed to float
- 18 “ Dublin money market rates shoot up.
- 19 “ Punt “stands firm”. But it is revealed that a third of the Central Bank’s reserves have been spent (£1000m approx.) on defending the punt.
- 20 “ France votes “yes” to Maastricht
- 23 “ UK interest rates cut by 1%
- 26 “ Threat of 2% interest rate rise by the banks - suggestion made of a two-speed Europe
- 29 “ Irish interest rates increase by 3%
- 30 “ Bundesbank says it won’t reduce interest rates again this year
- 6 Feb Ireland devalues by 10%