An Chomhairle Náisiúnta Eacnamaíoch agus Shóisialta
National Economic & Social Council

The Euro: An Irish Perspective

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National Economic & Social Development Office NESDO

National Economic and Social Council

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Abbreviations

BEPGs
Broad Economic Policy Guidelines

BIS
Bank of International Settlements

CAP
Common Agricultural Policy

CPI
Consumer Price Index

ECB
European Central Bank

ECJ
European Court of Justice

EEC
European Economic Community

EMS
European Monetary System

EMU
Economic and Monetary Union

ERM
Exchange Rate Mechanism

ESRI
Economic and Social Research Institute

EU
European Union

GDP
Gross Domestic Product

GGB
General Government Balance

GGD
General Government Deficit

GNP
Gross National Product

HICP
Harmonised Index of Consumer Prices

IMF
International Monetary Fund

MTOs
Medium-Term Objectives

MTR
Medium-Term Review

OCA
Optimum Currency Area

OECD
Organisation for Economic Co-operation and Development

SDR
Special Drawing Rights

SGP
Stability and Growth Pact

TEU
Treaty on European Union

TFEU
Treaty on the Functioning of the European Union

UN
United Nations

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Executive Summary

This report on the Euro is part of a wider NESC study of Ireland's changing engagement in the European Union. NESC report No 122, reviewing the overall impact of European integration since the early 1990s, and identifying the conditions for Irish success within the European Union, will be published in autumn 2010.

Analysis

The creation and successful establishment of the euro is an historic step in the process of European integration. There is a strong economic logic for combining deep economic integration with adoption of a common currency. The quest for exchange rate stability is an integral part of the overall project of European integration. In the European context—where the deepening of integration respects the ongoing role of the member states—the creation and management of a common currency is an immensely complex political and policy task.

The design of economic and monetary union (EMU) included a strong division of labour between the European Central Bank (ECB), with responsibility for monetary policy focused on price stability, and the member state governments that have responsibility for fiscal policy, banking supervision, employment and structural reform. It includes the Stability and Growth Pact, which sets limits on national budget deficits and debt, and a range of processes for mutual surveillance and co-ordination of member state policies for employment and structural reform.

The euro has in most respects been a success. However, developments in international finance and international economic policy, and the crisis these have yielded since 2008, have revealed significant problems within the euro area. These included balance of payments deficits in the periphery, surpluses and weak demand in the core, insufficient financial sector supervision at European level, ineffective surveillance of member states' economic policies yielding unsustainable deficits and debt in some member states, asymmetric economic developments and weak overall growth.

For all its undoubted achievements, the design of the euro has not avoided the very deficit and debt crises it was intended to prevent. In addition, the design itself was too narrow in treating all unemployment as structural, all shocks as supply-side and all necessary adjustment as achievable at national, sectoral and firm level. Across the euro area as a whole, there would seem to have been limited political and popular buy-in to the euro as a project of stabilisation, prosperity and global governance. The effect has been that the EU's system of decision making, though remarkable in many other spheres, has not been as effective as it needed to be in the areas most closely associated with the euro.

Ireland's experience in EMU reflects both the euro-area imbalances and domestic policy and behavioural factors. Joining the euro involved a reduction in interest rates and a real exchange rate depreciation. Through much of the period, the country experienced growth and inflation above the euro-area average, a loss of competitiveness and budget surpluses. These trends, and the associated construction boom, were driven by large inflows of finance, borrowed by Irish banks; and reinforced by pro-cyclical fiscal policy. These factors interacted with a set of unresolved political economy issues. Among these were the appropriate scale of public services, the level and incidence of taxation, and approaches to housing supply and land management. The tax windfall created by the property boom allowed the unresolved issues to be glossed over and the macroeconomic perspective on fiscal policy to fade from view. The result was an inconsistent approach across the three categories emphasised by NESC since 1990: macroeconomic policy, distributional policy and structural policy.

Analysis suggests that if Ireland had not joined the euro, it is likely to fared worse in the crisis of 2008-10, because of destabilising capital flows, currency depreciation and interest rate dynamics.

Policy Conclusions

1. **The future stability of the euro area depends on more effective surveillance and co-ordination of member states' fiscal positions and structural policies, stronger EU-level financial regulation and a successful outcome of the ongoing reform process**

The EU institutions have taken a series of actions and decisions in response to the crisis in the euro area. These include the temporary financial support provided to Greece, the stabilisation mechanism available to other member states, decisions to enhance policy co-ordination in the coming years and the creation of a Task Force, chaired by President Van Rompuy, to explore further changes in the way the euro is governed. On these issues, NESC's purpose is not to recommend particular policy actions, but to analyse the current crisis in the euro and identify the issues that the EU must address in the years ahead. While these steps have stabilised the situation, there remain severe challenges on three fronts: the effectiveness of the stabilisation mechanism provided to Greece (and potentially to other member states), the recovery of the whole European economy in the context of fiscal austerity and the continuing risks to the financial system at both global and European level. In addition, large movements in the currencies of EU member states, especially sterling, can damage the economic performance of other member states.

Some see these economic dangers as reason for immediate radical adjustment of the policy competences and decision making systems governing the euro and the EU. Such proposals may take insufficient account of the policy and political risk which Europe faces—deadlock, in which contending perspectives cancel each other out, leading to an insufficient or incoherent EU response to the economic, fiscal and financial crisis. The more pragmatic and gradualist reform agenda set out by the European Council and the Commission includes a focus on better joint surveillance

of economic policies, a closer link between fiscal policy and structural reform and a willingness, in certain circumstances, to adapt the division of labour between monetary and economic policies. In addition it can be argued that the Treaty obiligation to 'regard economic policies as a matter of common concern' should include exchange rates.

It is critical that this approach be open enough to respond to unfolding events and problems. It is in tune with the fact that deeper EU involvement in numerous policy spheres does not, in general, occur by enhancing the authority of a single authority. It recognises that the success of the euro will unavoidably depend on the member states seeing their fiscal policies and structural reforms as part of an EU regime of information sharing, joint learning and policy co-ordination. What is required is a more reliable, better-understood, more-disciplined, widely-endorsed and clearly-articulated process for joint setting of goals, discussion of collective and national-level problems, and how the two relate to each other. The reform process now underway must ensure that the governance mechanisms that the EU has already developed and made effective in other policy spheres are now brought to bear in EMU. At their best, these involve an effective system of joint goal setting, decentralised execution, information sharing, learning and system revision. They can include mandatory surveillance and penalties. Both advocates of immediate radical enhancement of EU authority (to create an 'economic government' for Europe) and defenders of the status quo underestimate the potential of the EU's method of joint goal setting and problem solving.

While the reform process necessarily involves high-level bargaining involving the heads of state/government and the EU institutions, it will only succeed if it leads to a system in which better ongoing monitoring, co-ordination and learning becomes the norm at all levels of member state administrations and is less captive to obstructions based on misguided defence of national sovereignty, defined without sufficient acknowledgement of the national interest in the effective governance of a single currency. If this reform process is undertaken in an open-minded way, it should be possible for the EU to discuss and agree a pragmatic combination of measures that protects the euro, addresses the deficit and debt problems, supports macroeconomic recovery and responds to the risk of further financial sector and exchange rate turbulence. Ireland has a strong interest in the success of this process.

2. To Succeed in the Euro Ireland must learn the lessons of the past decade concerning fiscal policy, prices, competitiveness and financial regulation

NESC is in no doubt that, overall, membership of the euro has been, and is, beneficial for Ireland. However, the experience as analysed in this and other studies, shows that national approaches to fiscal policy, prices, costs and financial regulation were not sufficiently adapted to the disciplines of a single currency. Excess bank borrowing and pro-cyclical fiscal policy created unsustainable growth between 2000 and 2007 and made Ireland especially vulnerable to the global crisis which hit in 2008. The severity of the current crisis should make us absolutely determined to learn the correct lessons and make the necessary changes in policies and behaviours.

The principles which should inform fiscal policy are clear: it must be counter-cyclical, sustainable and respect the EU Stability and Growth Pact. Given our analysis of the difficulty of understanding and adhering to these principles in the past decade, the policy lessons are hard, but also broad. They certainly demand that government maintain a clearer focus on counter-cyclicality and sustainability. Some countries adopt fiscal policy rules (sometimes with legislative or constitutional force) and create an independent advisory fiscal policy council. Indeed, the European Commission has recently made proposals of this kind. The Minister for Finance has asked the Joint Oireachtas Committee on Finance and Public Service to consider the question and to report by September. NESC does not advance a view on fiscal policy rules and an independent advisory council, but does set out some of the evidence and issues that need to be considered.

Among them is that fact that the lessons of the past decade include the need to achieve a more thorough resolution of the distributional and structural tensions that create pressure for pro-cyclical fiscal policy and, tend to crowd out clear analysis of the macroeconomic context. They also include the need to avoid destabilising bubbles in the economy—especially in housing. The feasibility and effectiveness of an independent fiscal council might depend on a sufficient degree of social consensus on the overall tax take and public provision. NESC's analysis would suggest that the whole burden should not be placed on aggregate fiscal policy. Distributional policies—including taxation, social transfers and wage bargaining—need to be consistent with the aggregate fiscal targets and outcomes. Structural policies—especially those that shape the supply of housing and other goods with a public dimension—can help to ensure that fiscal policy is counter-cyclical and sustainable.

3. **At both EU and national level, the effectiveness of policy depends on greater understanding of EU processes and wider public perception that they are being used in support of coherent strategies for prosperity, stability and inclusion.**

Our analysis of both the design of the euro and developments in the past decade suggest that the problems arose, in part, from insufficient policy, political and popular buy-in to the euro as a project for prosperity, stability and global governance. Member states, probably reflecting public sentiment, did not see their voluntary sacrifice of monetary policy as a reason to heighten their collective engagement in those areas where they are the key actors—fiscal policy, employment and structural reform. Instead of balancing a definite and deliberate loss of national control in monetary policy with enhanced collective action on economic policy, they were inclined to balance it with reassertions of sovereignty in the economic area. In Ireland, once membership of the euro was achieved in 1999, there would seem to have been less, rather than more, recognition and acceptance of the disciplines inherent in a single currency.

Consequently, the future effectiveness of the single currency will depend on a higher degree of political and popular identification with the euro and understanding of the division of labour and responsibilities inherent in membership. This requires a greater shared understanding of the how the euro can support the pursuit of stabilisation, employment and sustainable prosperity. In the first instance, this requires that the member states and the EU institutions are seen to be addressing the challenges facing the euro and the European economy.

But building this shared understanding is a task for all economic and social groups who accept the euro as the context within which their goals must be pursued. All whose fate depends on the success of the euro have an interest in the current reform process reaching an agreed and effective conclusion. This certainly depends on the content of the reformed procedures and policies—on joint surveillance, fiscal policy co-ordination, structural reform, debt reduction, macroeconomic recovery and banking supervision. But it also depends on affirmation of the appropriateness of euro-area and EU-level mutual surveillance, benchmarking and learning. In Ireland, this requires a clear narrative on the place of the euro in our long search for a macroeconomic and monetary regime that is supportive of national development and a shared understanding of the disciplines involved. As noted above, this requires more effective domestic resolution of macroeconomic, distributional and structural tensions.

The process of reform and policy correction at EU and national level is far from complete. But the task set—to protect the euro, address the deficit and debt problems of member states, support macroeconomic recovery and sustainable growth, and address the risk of further financial sector turbulence—is worthwhile. Ireland's interest lies in this reform process being open enough to address all the problems as they arise and moving to a successful resolution.

1 Introduction and Summary

> Perhaps most important of all, EMU will change the way Europeans think about themselves and about a multilingual continental market that has become the largest in the world (Mundell, 1998: 10).

> The other great risk derives from a lack of intellectual and political flexibility consequent on the nature of the treaty basis for the Euro-Zone. The Treaty on European Union, plus the Stability and Growth Pact, are very detailed and technical on excessive deficits, with the objective of narrowing political discretion. At the same time they embed a particular economic paradigm of sound money into the operation of the Euro-Zone. The problem arises when changing economic circumstances and problems lead to a re-evaluation of economic policy ideas and theories, for instance by upgrading the role of demand management and of policy co-ordination. In such a context there is a risk that the 'de-legitimization' of the sound money paradigm could produce a de-legitimization of the Euro-Zone's institutional arrangements. At that point of 'paradigm shift' much depends on the capacity of the Euro-Zone's leaders to negotiate changes in institutional relations...The vital co-ordination of policies on employment and growth will require a further process of making ideas compatible (Dyson, 2000: 209).

The transition to the euro was a major development in Ireland's engagement with the EU. It is timely to review Ireland's experience as a founding participant in European Economic and Monetary Union (EMU) after ten years of membership. First, we need to form a view on how well EMU has performed over its first ten years. Second, it important to evaluate how EMU has performed in responding to the current international financial crisis and the associated major macroeconomic recession. Third, it is appropriate to investigate whether EMU was a contributory factor in making Ireland particularly vulnerable to the financial crisis. Fourth, it is vital to consider the effectiveness of national economic policy in the EMU era, the instruments available for responding to the current crisis and the longer-term lessons for the conduct of national policy[1].

This report is part of a wider NESC study of Ireland's changing engagement in the EU[2]. That study, and a number of background papers, will be published in autumn 2010.

1 In order to assist the Council's deliberation on these questions, it commissioned Professor Philip Lane, of Trinity College Dublin, to prepare a discussion paper on European monetary union and macroeconomic stabilisation in Ireland. That paper will be posted on the NESC website when our overall report on the EU is published, along with other background papers (www.nesc.ie)

2 After discussion in the Council, this report was drafted by Noel Cahill, Economist, and Rory O'Donnell, Director, of the NESC Secretariat.

The central theme emerging in NESC's work on the EU is the critical role of national policy in making a success of EU membership and, indeed, in ensuring that the EU itself succeeds. This theme is reinforced when we consider EMU. While membership of the euro has been beneficial to Ireland, there have been undoubted difficulties, which we discuss in detail in this report. Important lessons emerge for national policy and reform. Nevertheless, in the sphere of EMU there are macroeconomic forces at work, which are not amenable to policy action in a small, regional, economy. These unavoidable macroeconomic factors mean that both EU-level policies and institutions and the governance of global finance must be considered in understanding the Irish experience and in thinking about future policy. But, as we emphasise in Chapter 8, this argument should only be advanced in a context in which national responsibility for fiscal stabilisation and structural reform is acknowledged.

The report is organised as follows. Chapter 2 outlines the origin and design of EMU in Europe. It challenges one conventional view, that the economic logic of EMU is weak and the project must be understood as essentially political. By tracing the early history of the EMU project, and placing it in the context of the changing international monetary system, we show that there was a long-standing, widely-held and increasing economic motivation to limit exchange rate volatility in Europe. History and economic analysis show a close connection between economic union and monetary union. Chapter 2 describes the design of EMU adopted in the 1992 Treaty of Maastricht and subsequent political agreements. Key elements of that design were the independence of the European Central Bank (ECB), its focus on price stability and the Stability and Growth Pact (SGP), which sets limits on national budget deficits and debt. Perhaps the most important feature was a strong division of labour between the ECB, with responsibility for monetary policy, and the member state governments and other actors, that had responsibility for fiscal policy, employment and structural reform. Chapter 2 finishes with a summary of the EU's decision making system, emphasising the existence of five policy modes, applied in different policy domains. Some argue that these increasingly share a core, experimentalist, governance architecture, based on framework goals, local autonomy, benchmarking and learning. The various aspects of EMU—monetary policy, economic policy co-ordination and external monetary relations—are conducted using versions of the five policy modes. A key question now is whether EMU as a whole and governance of the euro can acquire some of the characteristics of the experimentalist governance—with its emphasis on framework goals, mutual learning and system revision—which works well in many other EU policy areas.

Chapter 3 describes the expectations, hopes and fears as Europe embarked on the project of the euro. Some economists and commentators, especially in the Anglo-Saxon world, were deeply sceptical about Europe's ambition to create a new currency. Many of those who supported the project, and saw the potential advantages, nevertheless had a range of anxieties. These concerned the balance between monetary and economic governance in the overall design, the effectiveness of the SGP in limiting deficits and debt, the risk of economic disturbances which would affect member states of the euro in an asymmetric way, the continuation of financial supervision at member state level, the vulnerability of the euro to global financial instability and the ability of the EU to adapt the governance of the euro to a change in economic circumstances, such as an international crisis emanating from the US and resultant international recession. Irish expectations focused on the effects of lower interest rates on output, employment and prices.

In Chapter 4 we describe Ireland's experience in the euro area, reporting trends in growth, inflation, interest rates, the balance of payments and international financial flows, cost competitiveness, the public finances and exchange rates. The chapter finishes by describing the crisis of 2008-10, including the depreciation of sterling.[3]

Chapter 5 offers an interpretation of developments in the euro area since the establishment of the new currency in 1999. We emphasise that the euro emerged in the context of structural changes in the world economy, particularly a global savings glut. Major imbalances emerged within the euro area, with balance of payments deficits in the periphery, driven by inflows of capital which fuelled construction booms and asset price increases. We review the effectiveness of the SGP and of EU financial regulation.

Irish experience in EMU is interpreted in Chapter 6. This requires an understanding of why Ireland experienced above average inflation, excessive bank borrowing, a construction boom and a loss of competitiveness. We identify domestic policies —fiscal policy, financial regulation, planning and land management—that could have moderated these pressures. Fiscal policy was shaped by technical factors that were uncertain, political economy issues that were unresolved and assumptions which were mistaken.

Chapter 7 considers how we might move from interpretation to addressing the policy challenging the euro. For all its undoubted achievements, the design of the euro has clearly failed in its own terms, since it has not avoided the very deficit and debt crises it was intended to prevent. Second, the design itself was too narrow in treating all unemployment as structural, all shocks as supply-side and all necessary adjustment as achievable at national, sectoral and firm level. We show that the relationship between the centralised monetary function and the more decentralised stabilisation and structural reform is more complex

3 The Secretary General of the Department of Finance did not consider it appropriate to comment on Budgetary Policy.

than originally conceived. Instead of balancing the definite and deliberate loss of sovereignty in monetary policy with enhanced collective action on economic policy, member states responded by attempting to retain sovereignty in the economic area. Across the euro area as a whole, there would seem to have been limited political and social buy-in to the euro as a project of stabilisation, prosperity and global governance. Contrary to the prediction of Robert Mundell—the father of international monetary economics—quoted above, EMU seems to have had limited effect on the way Europeans think about themselves and about a multilingual continental market that has become the largest in the world.

Chapter 8 discusses the policy challenges and possibilities now facing the euro. In this report, NESC's purpose is not to recommend particular policy actions, but to analyse the current crisis in the euro and identify the issues that the EU must come to grips with in the years ahead. The chapter begins by describing the important steps taken by the EU in recent months and the further reform possibilities under discussion in the European Council, the Council of Ministers and the Commission. We argue that a number of economic dangers remain. These include debt problems facing some member states, the recovery of the European economy and possible further financial instability at either European or global level.

Before considering how these might be addressed, NESC reaffirms Ireland's belief in sustainable public finance and structural reform for productivity, sustainable growth and social inclusion. This prompts the question: how might Ireland ensure that future fiscal policy is counter-cyclical and sustainable? We summarise the argument for new fiscal policy rules and an independent institution and identify some factors that should be taken into account in assessing it.

The dangers facing the euro have prompted economists to propose more ambitious policy measures. These include greater co-ordination with a focus on aggregate EU fiscal policy, deeper 'political union' and 'economic government' of the euro-area, some fiscal transfers to avoid asymmetric shocks having long-term depressing effects on some member states, global monetary and financial reform and a renewed focus on intra-EU exchange movements not covered by the Exchange Rate Mechanism mark II.

It is argued that as well as economic dangers, the EU faces a range of policy and political dangers. These share an important and troubling feature—deadlock, in which contending perspectives cancel each other out, yielding an insufficient or incoherent EU response to the economic, fiscal and financial crisis. We argue that Europe needs to transcend these dualisms and suggest a number of considerations that can help. These share a common characteristic and motivation—to open a space for consideration of policies to address instability, in a way that does not produce further instability by, for example, de-legitimising the euro. As argued by Dyson in 2000, in the quote placed at the head of this chapter, faced with circumstances very different from those that prevailed when the euro was designed, the vital policy response requires 'a further process of making ideas compatible' (Dyson, 2000: 209). This especially requires that the challenge of policy and political buy-in be articulated in a new way. Traditional arguments for 'economic

government', 'political union' and fiscal federalism may take insufficient account of how governance in the EU—and, indeed, in its member states—has changed. Deeper EU involvement in numerous policy spheres has not, in general, occurred by enhancing the authority of a single authority or principal. Instead, what may be required is a more reliable, better-understood, more-disciplined, widely-endorsed and clearly-articulated process for joint setting of goals, discussion of collective and national-level problems, and how the two relate to each other. That is, application to key aspects of EMU of the governance mechanisms that the EU has already developed and made effective in other policy spheres. In that context, it may be possible for the EU to discuss and agree a pragmatic combination of measures that protects the euro, addresses the deficit and debt problems, supports macroeconomic recovery and responds to the risk of further financial sector and exchange rate turbulence.

In the concluding section, 8.8, we outline NESC's three main policy conclusions:

- The future stability of the euro area depends on more effective surveillance and co-ordination of member states' fiscal positions and structural policies, stronger EU-level financial regulation and an ongoing reform process which addresses both the immediate problems and the dangers which threaten the prosperity of the euro area;
- To succeed within the euro, Ireland must learn the lessons of the past decade and take the necessary measures to ensure that future fiscal policy is counter-cyclical and sustainable, prices and costs maintain Ireland's competitiveness, and financial supervision prevents irresponsible banking practice;
- At both EU and national level, the effectiveness of policy depends on greater understanding of EU processes and wider public perception that they are being used in support of coherent strategies for prosperity, stability and inclusion.

The process of reform and policy correction at EU and national level is far from complete. But the task set—to protect the euro, address the deficit and debt problems of member states, support macroeconomic recovery and sustainable growth, and address the risk of further financial sector turbulence—is worthwhile. Ireland's interest lies in this reform process being open enough to address all the problems as they arise and moving to a successful resolution.

2

The Origin and Design of Europe's EMU

2.1 Perspectives on European Economic and Monetary Union

In accounts of European EMU one common view is that the economic logic of EMU is weak and the project must be understood as essentially driven by a political motivation. Perhaps the strongest version of this view is that of Krugman, who said that 'EMU is a crazy process, which can only be understood politically, not economically' (Krugman, 1995; Tsoukalis, 1997). From this view it is a short step to the argument that the difficulties of EMU reflect the limited economic logic of the project, whereas the progress reflects the strength of political conviction of key European governments. While this view is partly understandable—given the key role of political leadership at critical moments such as the establishment of the European Monetary System (EMS) in 1979 or the agreement of the Maastricht Treaty in 2001—it is not an adequate starting point for analysing the political and economic aspects of EMU. It ignores the degree to which, over many decades, there was a strong, long-standing, widely-held, diverse and increasing *economic* motivation for EMU. This must surely explain much of the *progress* achieved in recent decades. Indeed, once this is recognised, we see that the *difficulties* largely reflect the *political* complexity of creating monetary union in European circumstances (Laffan *et al*., 2000).

2.2 EMU as a Response to a Changing Global Monetary System

European monetary developments must be viewed as part of an interdependent global monetary system which contains a potential conflict between domestic economic autonomy and international economic stability (Cohen, 1977; Eichengreen, 1994). The interregnum between British hegemony in the 19th century and American leadership in the 20th was marked by a nationalisation of the world monetary system, floating exchange rates, competitive devaluations and, in Europe, the rise of fascism. That experience had profound effect on European, especially German, attitudes to exchange rate fluctuations.

To a significant extent, Bretton Woods provided Europeans with the exchange rate stability they sought and prevented the sort of exchange rate volatility to which they attributed economic, monetary and political collapse[4]. The development of European monetary union can be seen as a response to the waning credibility and eventual demise of that system in the early 1970s and the simultaneous deepening of economic and political integration within Europe. The ambitious plan for macroeconomic policy co-ordination, set out in Articles 103 through 108 of the Treaty of Rome, was not accompanied by concrete steps (apart from the establishment of the Monetary Committee). This can partly be explained by the fact that Bretton Woods constituted the cornerstone of monetary arrangements; and it can be argued that when Bretton Woods faltered, Europe acted on its own account.[5] The initial existence of Bretton Woods, followed by the failure of European macroeconomic co-ordination in the 1970s, established a tradition in some circles of viewing Treaty articles on macroeconomic economic policy co-ordination as almost entirely aspirational, and divorced from the real business of European integration. This tradition sustained scepticism on monetary union and blinded some observers to the very significant, if low key, advance of policy co-ordination between 1993 and the selection of EMU members in 1998 (see Chapter 5).

2.3 The Link between Economic Union and Monetary Union

The deepening of economic integration in the 1960s and 1970s heightened European interest in continental exchange rate stability. European economies were relatively open, within a highly regionalised world trade system. The new European institutions—particularly the Common Agricultural Policy (CAP) and the internal market—were considered by most Europeans to depend for their survival on exchange rate stability (Giavazzi and Giovannini, 1989). Allowing for the particular global monetary arrangements in place from the foundation of the Community till the early 1970s, it is clear that the quest for exchange rate stability is an integral part of the overall project of European integration.

It is widely agreed that completing the single market in commodities and factors of production can deliver significant efficiency gains. Even if the majority of those gains are technically obtainable despite the maintenance of separate national currencies, 'a single currency may be required to suppress the political resistance that economic integration would otherwise provoke' (Eichengreen, 1994: 108). The more integrated are national markets, the larger are the import surges that accompany exchange-rate-induced shifts in relative prices, and the greater is the pain experienced by affected firms and workers. The complaints over competitive depreciation and exchange dumping that followed the departure of sterling and

4 Bretton Woods refers to the international monetary regime that prenvailed form the end of World War II until the early 1970s. An international conference in Bretton Woods in 1944 created the International Monetary Fund (IMF), the World Band and a system of fixed exchange rates, with the dollar as the reserve currency (Eichengreen, 1996).

5 Action was taken to prevent exchange rate volatility disrupting the Common Agricultural Policy (CAP). In 1964, the role of the Monetary Committee was extended and the Committee of Governors of the Central Banks of the member states was established. The 1967 devaluation of sterling was used by General de Gaulle as an argument to justify his veto of UK membership. The end of the 1960s, the rising concern that exchange rate fluctuations would jeopardise the working of the common market and the CAP led to active discussion of EMU. After revaluations of the mark and devaluation of the French franc in the 1960s, the 1969 Hague summit of Community leaders decided that the Community should seek to move towards EMU. Finally, soon after the collapse of Bretton Woods, the Community devised its own arrangements to limit exchange rate volatility, the snake and the EMS.

the lira from the EMS in 1992 can be seen to illustrate this point. 'Monetary union that prevents "capricious" exchange rate swings, thereby ruling out the associated costs, may be necessary to prevent affected sectors from lobbying against economic integration and to ensure the political viability of the Single Market process' (Eichengreen, 1994: 108-9; see also Helleiner, 1994).

The sequence of events since 1987 strongly supports this link between economic integration and monetary union. Support for EMU was galvanised by two arguments. First, the liberalisation of capital movements, as part of the internal market project, was widely believed to alter the conditions for the conduct of domestic monetary policy, in such a way that it requires either the abandonment of fixed exchange rates or greater co-ordination of monetary policy—the famous 'inconsistent quartet' (Padoa-Schioppa, 1989; Delors 1989). Second, the more the internal market programme was implemented in the late 1980s and early 1990s, the more the key actors came to believe that many of its possible benefits would be lost if separate currencies continued to exist (European Commission, 1990; Frieden, 1996). In its 1989 report *Ireland in the European Community,* NESC recognised this connection between the internal market and macroeconomic and monetary integration:

> Both the conduct of trade and the allocation of productive resources like capital and labour are likely to be disrupted and distorted by the exchange rate and interest rate movements which seems to be inevitable in a common market where macroeconomic policy is unco-ordinated. This is the idea which underlies the widely held and totally justifiable point that rapid progress towards monetary and macroeconomic union is a *necessary* complement to the internal market programme (NESC, 1989: 418).

The present study underlines the validity of the connection between economic and monetary integration and, indeed, the difficulties caused by exchange rate movements (see Sections 5.8, 8.4 and 8.6).

2.4 A New Perspective on the Place of Monetary Union in International Integration

A particularly notable aspect was the increased interest of the smaller and peripheral member states in EMU in the past two decades. This reflected a change of view on the pattern and timing of the overall costs and benefits of integration for weaker economies and regions. NESC's 1989 study reflected, and may have been one of the early statements of, this changed perspective.

In earlier decades most discussion by economists of the regional implications of integration focused on the monetary stage and, within that, on the loss of exchange rate autonomy (Williamson, 1975). While it is commonly noted that this traditional view was based on Keynesian macroeconomic theory, NESC pointed that it was also based on a particular perspective on *free trade* (the customs union stage) and *capital mobility* (the common market stage). In particular, it was based on analytical approaches which suggested that these stages of integration would automatically be relatively *benign*. Developments in microeconomics, macroeconomics and regional theory in the 1980s and 1990s, suggested a different view of the possible regional implications of free trade and capital and labour mobility.

Table 2.1 Views on the Regional Effects of Integration

Integration Stage	Traditional View	New View
Free Trade (Custom Union)	All regions gain Adjustment costs only	Uneven costs and benefits
Capital and Labour mobility (Common Market)	All regions gain Regional differences eroded	Potential costs as well as benefits
Economic and monetary union	Possible deflationary effects	Limited general effects on output and employment

Source O'Donnell (1994).

Even free trade can, in certain circumstances, generate large and unevenly distributed costs and benefits in both the short and long run; international movements of labour and capital may widen rather than narrow differences between regional economies. Although there remained conflicting views on the causes and effects of exchange rate changes, virtually all schools of economic theory lost some faith in the power of devaluation to sustain output and employment and in the ability of governments in smaller, peripheral, economies to use the exchange rate as an active policy instrument (Eichengreen, 1993, 1994; De Grauwe, 1997; Tavlas, 1993; Cohen, 1997). In Ireland, Honohan also noted that 'Declining belief in the usefulness of activist monetary policy is one of the reasons why EMU has become such an attractive proposition' (Honohan, 1991: 73). NESC concluded that 'at the very least this takes the emphasis off monetary integration as the step which raises problems for weaker economies' (NESC, 1989: 428). 'Many of the major forces which cause long-run regional concentration and diffusion will operate on an open economy regardless of the monetary regime in place' (*ibid*). This perspective was endorsed by the Central Bank of Ireland (Reynolds, 1988). In Ireland, this encouraged a renewed focus on the *real economy* and *policy* factors which shape the regional pattern of economic activity in an integrated economic area like the EU, and it supported the consensus—across both the political spectrum and the social partners—on joining EMU (O'Donnell, 1993).

This argument is presented schematically in Table 2.1 which summarises the traditional view and the new view on the regional effects of the three stages of integration.

This new understanding was inserted into a long-standing perspective on Ireland's development challenge. It was that perspective that motivated Irish leaders to seek membership of the EEC and, later, to take the historic decision to break the 150-year old link with sterling to join the EMS and Exchange Rate Mechanism (ERM) on its creation in 1979. Through the 1980s and 1990s, the wider technical and institutional requirements for successful membership of the EC and ERM were, sometimes painfully, identified and constructed. These included recognition of the need for a widely shared understanding of the respective roles and limits of both fiscal policy and exchange rate policy, and development of a more effective wage bargaining regime and industrial relations system than that inherited from

Great Britain. Gradually, Ireland was developing a set of institutions more suited to its structural position in the world economy. Just as Europe had a long quest to limit the damaging effects of exchange rate and monetary instability, so Ireland had a long quest for a monetary and exchange rate regime that could support our national developmental project. The experience and institutions of a number of small European countries suggested the possibility of a more stability-oriented and consensual approach than that which prevailed in the UK in the post-war period. Europe itself offered the chance to move towards such a regime with the creation of the EMS and the path to EMU. The fact that this long quest is not yet complete—and contains considerable complexities—is not a reason to lose sight of its historic importance in the project of Irish development. This view is confirmed when, in Chapter 6, we discuss what might have happened if Ireland had not joined the euro.

2.5 Motivation for Monetary Union Strengthened Over Time

Not only was there strong, if diverse, motivation for exchange rate stability throughout the process of European integration, but this motivation strengthened over time. In assessing the motivation for EMU, care must be taken to focus on the actual choices which actors had, or perceive themselves to have had, rather than the abstract menu of choice suggested by economic theory. In this regard, Europe's long quest for exchange rate stability, and particularly its experience with EMS, was important. It reduced the significance of the wider ruminations—concerning optimum currency areas etc.—and increased the relevance of comparison between fixed-rate systems (such as the hard ERM) and full monetary union. In making *that* comparison, the motivation for EMU increased over time. The experience of an asymmetric fixed-rate system strengthened the attractions of monetary union (Kenen, 1996). Changes in the structure, technology and regulation of financial markets served to 'undermine the viability of the monetary rules under which governments commit to preventing exchange rates from breaching certain limits under all but exceptional circumstances, forcing policy-makers to choose between floating and monetary unification' (Eichengreen, 1994: 6; Cohen, 1994; Gilpin, 1987; Andrews and Willet, 1997). It is important to recognise this 'forced choice' and, indeed, to ask whether developments in financial markets in the past decade are now forcing EU policy makers to major further choices (see Chapter 8).

2.6 The Design of Europe's Economic and Monetary Union

While the intellectual underpinnings of the Werner report in 1970 were primarily Keynesian, the revival of the EMU project, for example in the Delors Report of 1989, reflected a new analytical approach based on a shared paradigm of 'sound money'[6]. The key propositions of this paradigm were:

6 The Werner Report was produced by a committee of financial experts chaired by the Prime Minister of finance of Luxembourg, Pierre Werner in 1970. The report identified three stages in a 10 stage transition to EMU and designed a system of decision making for policy making and co-ordination in a single currency. These plans were put on hold in the face of the economic convultions that emerged in 1971, including the demise of the Bretton Woods system (Gros and Thygesen, 1992).

- Money is neutral and, over the long term, it does not affect growth and employment, which are the consequences of the structure of the economy, especially in product, services, financial and labour markets;
- Inflation is a monetary phenomenon and a phenomenon of expectations;
- Elections provide an incentive for politicians to use fiscal or monetary policy, or both, to pursue expansionary policies irrespective of the economic business cycle;
- In a monetary union, without a supporting framework of European political union, the ECB must take special precautions to ensure that monetary policy is distanced from national political or economic pressures (Dyson, 2009: 151-2).

This understanding was reflected in the 1992 Treaty on European Union (TEU), often referred to as the Maastricht Treaty. In that Treaty the member states agreed the design of EMU, the transition to its launch in 1999 and the criteria for membership. It incorporated several principles which informed the more detailed institutional design and subsequent operating rules. These principles were: the parallel development of economic and monetary integration, subsidiarity, price stability as the main objective of monetary policy, central bank independence, sound public finances and monetary conditions, a sustainable balance of payments and open markets with free competition.

A central feature of the design of EMU is the institutional arrangements for conduct of monetary policy, fiscal policy co-ordination and, most importantly, the relation between the two. The Treaty made provision for conduct of monetary policy by the independent European Central Bank (ECB). It specified a strong division of labour between the ECB, whose focus was to be on price stability within the euro zone, and co-ordination of economic policy by the member states, assisted by the European Commission. 'Above all, there was no provision for explicit, *ex ante* policy co-ordination to manage aggregate demand and ensure the Euro-Zone economy was working at an optimal level of output and employment over a whole business cycle' (Dyson, 2000: 30). This reflected the sound money doctrine that '*ex ante* co-ordination risks blurring responsibilities and destroying incentives, with costs to both stability and employment' (Dyson 2000: 30). Overall co-ordination was to be 'implicit', and would be achieved if each actor performed the functions assigned to it: price stability to be delivered by the ECB, sound fiscal policy to be provided by the member states, co-ordinating through Broad Economic Policy Guidelines (BEPGs), and growth and employment to be ensured by the actions of employers and unions. Although the independence of central banks was increasingly supported in both economic analysis and policy in many countries in the 1980s and 1990s, there is no doubt that the TEU provided the ECB with an extreme version of independence. For example, it is widely acknowledged to exceed that of the Federal Reserve in the US or the Bundesbank in post-war Germany (Dyson, 2000).

Soon after agreement on this Treaty design of EMU, the EMS, in place since 1979, came under speculative pressure. The UK left the system and the ERM was widened. Thus, the convergence path to EMU was less stable and predictable than had been envisaged in designing the process. Nevertheless, 11 member states met the convergence criteria and locked their currencies in 1999[7].

In the two years before the launch of the euro, important steps were taken to elaborate the nature and processes of the economic policy co-ordination. Although the firm division of labour between monetary and economic policy was retained, the different elements of economic policy were identified and brought within defined EU processes. The most prominent of these was the Stability and Growth Pact (SGP), finally agreed in Amsterdam in June 1997, which specifies detailed rules on national fiscal deficits and debt and procedures to be followed in the event of their violation. The SGP was reformed in 2005, in ways that are discussed in Chapter 5.

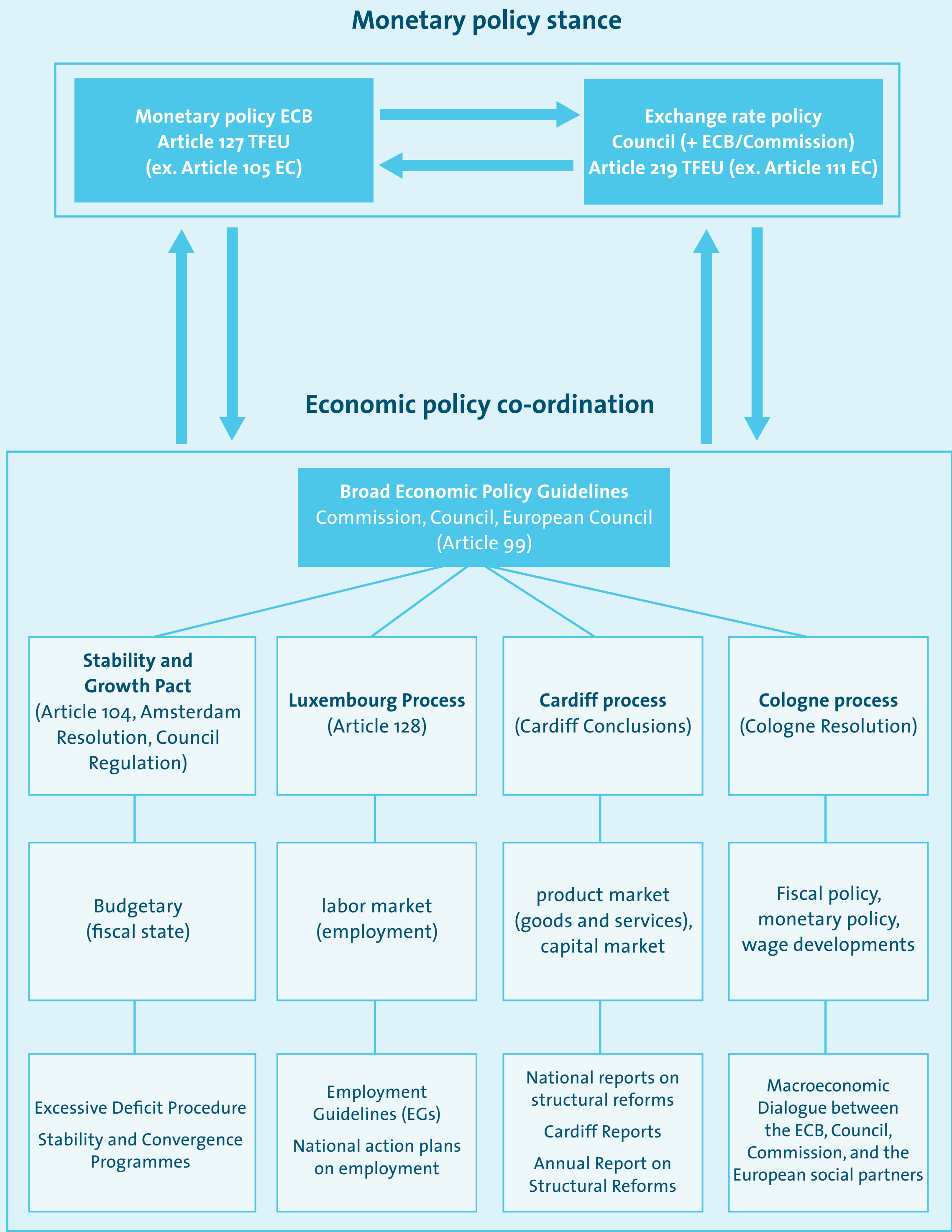
In summary, since the late 1990s, the economic policies of the member states are linked through a range of co-ordination instruments, procedures, and processes. These are the following:

- The Broad Economic Policy Guidelines relate mainly to macroeconomic and structural policies, for both the EU as a whole and for the individual member states;
- The Stability and Growth Pact, relates to co-ordination of fiscal policies;
- The Luxembourg process (begun in 1997), also known as the European Employment Strategy, concerns the co-ordination of employment policies and labour-market reforms;
- The Cardiff process (begun in 1998), focuses on structural reforms of product, services and capital markets; and
- The Cologne process (begun in 1999), involves a 'Macroeconomic Dialogue' on interactions among fiscal policy, monetary policy, and wage developments (Szelag, 2008: 6).

The overall design is depicted in Figure 2.1. It highlights the key features of the overall EMU design. First, a clear separation of monetary policy from the various elements of economic policy, reflecting a clear rejection of *ex ante* and explicit co-ordination—in which the different actors would agree a shared set of formal objectives on growth, employment, fiscal policy, inflation and exchange rates (Dyson, 2009: 161). Second, the figure draws attention to the fact that the ECB's primary focus is monetary policy, aimed at inflation of 2 per cent or less, and not a target for the exchange rate between the euro and other currencies. Third, the figure depicts the various processes for surveillance, benchmarking and co-ordination of fiscal policy, labour market and employment policies, structural reform of product and capital markets and macroeconomic dialogue. These also highlight the division of labour between various actors.

7 Member states joining the euro in January 1999 were Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, Netherlands, Portugal and Spain, Other member states subsequently adopted the currency:. Greece in 2002, Slovenia and Cyprus in 2007, Malta in 2008, Slovakia in 2009. Estonia is due to join in 2011.

Figure 2.1 Framework for Economic Policy Co-ordination in the EU and in the Euro Area (Including the Dialogue with the ECB)



Source Szelag (2008) based on European Commission (2002).

2.7 The Governance Architecture of the EU and EMU

2.7.1 Five Policy Modes in the European Union

The EU adopts different decision-making procedures in a range of policy areas. We discuss these in greater detail in NESC's forthcoming report on Ireland's changing engagement in the EU. However, here it is important to identify where EMU fits in the overall system and the range of governance methods potentially available to address the problems which now confront the euro.

There are several ways of describing and analysing the EU's systems of decision making and implementation. Wallace argues that it displays five policy modes across its different areas of concern, as summarized in Table 2.2 (Wallace 2005, 2010). The classic 'Community Method' was dominant in the early decades of European integration. It grants an important role to the Commission as agenda setter, the Council of Ministers and European Parliament as legislator, and to the European Court of Justice (ECJ) as adjudicator on implementation and compliance.

Table 2.2 Policy Modes in the European Union

Policy Mode	Sectoral example of policy mode
Community Method	Common Agricultural Policy; Fisheries
Distributional Mode	Structural Funds
Regulatory Mode	Market Liberalisation
Policy Co-ordination Employment Strategy, Lisbon Strategy	Macro-economic co-ordination,
Intensive transgovernmentalism	Economic and Monetary Union, Foreign Policy, Justice and Home Affairs

Source Wallace (2005).

As the agenda of the EU widened and deepened, and the number and diversity of member states increased, several other policy modes emerged. They generally involve EU institutions—especially the Commission and the ECJ—in a different fashion and engage the member states intensively. The distributional mode—used in allocating and implementing the Structural Funds—involves both the Commission and intensive bargaining between member states. Since the mid-1980s the regulatory mode has been very important, since so much of the EU agenda has been creating rules and frameworks to make operational the four freedoms that define the internal market—free movement of goods, services, persons and capital.

In some areas this requires that each member state simply open its market to goods and services from other member states; but in many it requires re-regulation at EU level to ensure safety, technical compatibility, quality, prudential regulation, professional accreditation etc. Policy co-ordination has become the dominant approach in policy domains where the EU has limited direct competence, but where there can be spillover effects and/or opportunities for benchmarking and learning between the member states. Finally, what Wallace calls 'intensive trans-governmentalism' occurs where the member states commit to rather extensive engagement and disciplines, but judge the full EU institutional framework to be inappropriate or unacceptable. This has operated in sensitive areas of state sovereignty such as foreign and domestic security, often outside the formal framework of EU institutions.

2.7.2 An Emerging Core Architecture of 'Experimentalist Governance'

Wallace notes that these five policy modes do not include 'the domain of constitutive politics or system-shaping as regards the overall political and institutional architecture of the EU' (Wallace, 2010: 90). She emphasizes that 'most individual policy areas do not fall neatly within a single policy mode' (Wallace, 2010: 91). Indeed, 'variations persist and hybridization across ideal types is prolific' *(ibid)*. As a consequence, these different forms of policy-making cannot be rigidly separated. Indeed, others argue that they increasingly exhibit a common architecture, with four key features:

- Framework goals (such as full employment, social inclusion, or 'good water status') and measures for gauging their achievement are established by joint action of the member states and EU institutions;
- National entitles, such as ministries or regulatory authorities and the actors with whom they collaborate, are given the freedom to advance these ends as they see fit;
- In return for this autonomy, they must report regularly on their performance, especially as measured by the agreed indicators, and participate in a peer review in which their results are compared with those pursuing other means to the same general ends;
- The framework goals, metrics, and procedures themselves are periodically revised by the actors who initially established them, augmented by such new participants whose views come to be seen as indispensable to full and fair deliberation (Sabel and Zeitlin, 2008: 273-74)

They characterise this as a form of 'experimentalist governance' and suggest that it is evident not only in areas in which the EU explicitly adopts a 'soft law' approach, but also in wide range of other policy domains (Sabel and Zeitlin, 2008; 2010). It confounds stereotypical views of the EU as seeking compliance with fixed rules and uniform standards. Rather than viewing diversity between member states as a threat to integration, such a system would capitalise on it by recognising that there is no *'ex cathedra'* or definitive answer to the resolution of issues such as full employment or environmental protection. By requiring member states and agencies to pool their learning and adjust strategies in light of others' greater relative success, experimentalist governance makes a virtue out of diversity. On this view, European integration need not be a uniform process, in which all member states follow the same route, but could help member states discover, in concert with others, the most appropriate and effective way of responding to particular issues.

2.7.3 The Governance Modes in Economic and Monetary Union

EMU provides a good example of the fact that each policy domain can involve a number of the five policy modes described briefly above. Indeed, it illustrates the way in which one mode can lead to others (Wallace, 2010: 102). We see five elements of EMU, each involving a somewhat different mode of decision making and implementation: political agreement on EMU, monetary policy, economic policy co-ordination in the Economic and Financial Affairs Council (Ecofin), benchmarking and dialogue in the Eurogroup and the euro's global role. Here we merely indicate the main policy modes, leaving till Chapter 8 discussion of the challenges of political and popular buy-in now facing the governance of the euro.

From the early 1960s to the late 1990s, intensive transgovernmentalism played the central role in the first element of EMU—political agreement on the project. Sustained intensive cooperation among key heads of state and government, in the European Council, and among national finance ministers and officials and central bankers, was critical in making EMU feasible and eventually acceptable. The basic political choice for EMU having been made, 'The development of EMU then bifurcated between, on the one hand, strong delegation to a collective regime for monetary policy, with the ECB as the collective agent (Community method), and, on the other hand, processes of policy cooperation' (Wallace, 2010: 102).

Although the second element of EMU, monetary policy, can be seen as an example of the Community method, Hodson emphasizes that the ECB is a different kind of supranational actor than the Commission (Hodson, 2010: 168). In particular, the ECB is subject to fewer checks and balances. However, the ECB President does appear before the Economic and Monetary Affairs Committee of the European Parliament four times a year. And, indeed, the Treaty of Lisbon has underlined the fact that the ECB is an intrinsic part of the Community and not, as some have argued, legally separate from it (Hodson, 2010: 170).

The third element of EMU is economic policy co-ordination. In contrast to monetary policy, here there has been no significant delegation of economic policy-making powers to the EU level. This aspect of EMU is governed primarily by the fourth policy mode described above—policy co-ordination. The Ecofin Council has responsibility for building consensus on the priorities for economic policy in the euro area and the individual member states retain considerable autonomy in deciding how they plan to meet these priorities (Hodson, 2010). The principle instrument of economic policy created by the Treaty is the BEPGs, including the SGP. The BEPGs are non-binding guidelines from Ecofin to member states on macroeconomic policies and structural reforms. The Commission has a 'modest but important role in this set-up', evaluating member states' economic policy plans and monitoring their implementation on behalf of Ecofin (Hodson, 2010: 171). While the Commission can sound the alarm, it is ultimately up to Ecofin to issue, or not issue, legally non-binding recommendations for corrective action. As regards the SGP, a distinction should be made between its 'preventative arm' and 'is corrective arm'. The 'preventative arm' involves peer pressure encouraging member states to keep their deficits below 3 per cent and debt below 60 per cent. The 'corrective arm'—involving the 'excessive deficit procedure' and possible financial penalties on euro-area member states—kicks in only if there is evidence of violation of the SGP rules (Van den Noord *et al.*, 2008).

The fourth element of governance of the euro is the Eurogroup. This is an informal body that brings together the finance ministers of the member states in the euro in advance of the Ecofin, in order to discuss the economic situation and shared policy challenges. Hodson suggests that this unusual institutional entity reflects the design of EMU as discussed in Section 2.6. While the French made the case for an 'economic government' to steer economic decision making, the Germans were anxious not risk compromising the independence of the ECB. The compromise was that the euro-area finance ministers would meet informally, behind closed doors, and without decision making powers (Hodson, 2010: 174). While this may seem a limited role, the Eurogroups's working method has been described as 'deliberative intergovernmentalism' (Puetter, 2006). He suggests that, because it has little or no formal decision-making powers, the Eurogroup can exchange information on shared policy challenges in a way that is not possible in a busy bargaining forum such as Ecofin. Indeed, the Eurogroup would seem to have emerged as a powerful caucus within Ecofin. It is now the Eurogroup, rather than Ecofin, that takes the lead in monitoring euro-area member states' compliance with the SGP (Hodson, 2010). Indeed, the reform of the SGP in 2005 was brokered in the Eurogroup, before being formally adopted in Ecofin. The significance—and, indeed, formalisation—of the Eurogroup was enhanced when it moved from a rotating to a permanent chair in 2005. This formalisation was continued in the Treaty of Lisbon, which officially recognised it and defined the capacity of the Eurogroup to adopt those aspects of the BEPGs that relate to the euro-area (Article 137 TFEU and 'Protocol on the Euro Group').

The fifth and final aspect of EMU decision making and governance concerns the euro's global role. As noted in Section 2.6, the basic design of EMU stipulated that the ECB give greater priority to internal price stability than management of the exchange rate of the euro against other global currencies, such as the dollar. The Treaties say little about the global role of the euro or the euro area. It stipulates that the formulation of any possible exchange rate policy is a shared responsibility of the ECB and Ecofin (Article 219 TFEU (ex. Article 111 EC)). The ECB has rarely intervened in exchange rate markets to influence the value of the currency. Most research suggests that the representation of the euro area in the global arena has been 'fragmented' and 'incoherent' (Van den Noord *et al*., 2008; Hodson, 2010). As a result, the euro-area tends to punch below its economic and financial weight.

The expected and actual impact and effectiveness of these different governance methods within EMU are discussed in later Chapters (see Sections 3.3 to 3.9, Chapter 5 and Chapter 7). The challenges—of economic co-ordination, political buy-in and intellectual flexibility—facing the euro are discussed in Chapter 8. A key question is whether overall EMU and the governance of the euro can now achieve the kind of experimentalist governance, with its emphasis on mutual learning and system revision, which is already found in an increasing number of EU policy areas. Or will the evolution of the euro in the these critical years be limited by deadlock and dualisms in which contending perspectives, interests and member states cancel one another out?

3

Expectations, Hopes and Fears

3.1 The Expectations of European Governments, Business and Social Groups

As noted above, through the 1980s and 1990s European governments, central banks, employers, unions and other social groups increasingly came to the belief that the deepening of market integration required a move to monetary union. Their expectations were that this would reduce exchange rate and monetary instability, make macroeconomic management of the economy easier and allow the full potential of the internal market to be realised. While holding these positive expectations, many of them naturally shared a range of the anxieties and fears that we discuss below.

3.2 Is the Euro-area an Optimal Currency Area?

The traditional axis of debate about monetary unions in international monetary economics is the theory of 'optimum currency areas' (OCA). That theory seeks to identify characteristics of countries or regions that make them suitable or unsuitable candidates for a single currency. It focuses on features that give rise to asymmetric shocks—such as differences in economic structure, low labour mobility and wage rigidity—and warns that countries with these characteristics should not enter a monetary union. Or if they do, it will need a large federal budget capable of cushioning asymmetric shocks through inter-regional transfers (see Box 8.5 for further explanation of these ideas). Despite various problems, discussed briefly below, the optimum currency approach was resuscitated and extended in the 1980s and 1990s largely because of the movement towards European monetary union (Isard, 1995). This line of thinking led a number of influential economists, such as Krugman, to argue that Europe was not an OCA—given the diversity of the member states' economies. This was one important source of widespread scepticism about Europe's move to create EMU.

However, others argued that the OCA theory does not offer much of a secure guide to policy. It had been stretched to incorporate more and more criteria and, as a consequence, provided an ever more complex body of contested theories (Goodhart, 1989)[8]. Nevertheless, in its revised form, the OCA theory did help explain why so many European countries chose to join EMU and, in the right hands, it can throw some light on the relation of currency to political union and identity (Laffan *et al*., 2000: 153-8).

8 Its account of the likely costs of monetary union was challenged by major developments in macroeconomics—particularly the expectations-based critique of the Phillips curve and theories of time-inconsistency (De Grauwe, 1997; Tavlas, 1993, 1994). Its assumptions about the definition of currency 'areas' was undermined by the integration of financial markets and the emergence of 'currency internationalisation' and 'currency substitution' (Cohen, 1997).

While the dominant traditional approach within the OCA theory was to view the choice of exchange rate regime as national optimisation subject to given structural characteristics of the national economy, in the 1990s several authors treated it in a somewhat more dynamic way. Eichengreen showed that, although the factors cited in OCA theory—factor mobility, size, openness, specialisation, wage flexibility etc—emerge from a technical economic analysis (of adjustment to a demand shock), they are not, in fact, purely technical phenomena. Several of them—particularly factor flexibility, other asymmetric shocks, susceptibility to inflation and reliance on seigniorage—are endogenous rather than exogenous[9]. They are themselves shaped by the monetary regime in place, the prevailing doctrines of economic management, the degree of consensus on these and the institutional arrangements of wage setting (Eichengreen, 1994). Consequently, the accepted goals of national strategy, the degree of underlying consensus on these and the willingness to reflect them in industrial relations practices and public finance, should not be seen as mere icing on the cake of economic 'fundamentals', which are given, and technical, in nature (Laffan *et al.*, 2000). This is broadly consistent with Dyson's view that 'the most vital condition of all for a stable Euro-Zone' is 'compatible ideas' (Dyson 2000: 166).

Others combined the OCA theory with historical evidence to explore the factors that determine the formation, and sometimes collapse, of currency unions. Goodhart—formerly of the Bank of England—used the OCA theory to draw attention to important, yet ill-defined, relationships between monetary union, social unity, fiscal union and national sovereignty. In his view, the various analytical approaches can be reduced to two common factors determining whether the balance of payments adjustments of some geographical area would be more easily solved as a region within a common currency area, or as an independent country with a separate, and potentially variable, exchange rate. These factors are size and 'social unity with surrounding, contiguous regions' (Goodhart, 1989: 420-21). Historically, the more important factor is social unity. He acknowledged that 'Many of the arguments here resemble the question of precedence of the chicken or the egg'. In Goodhart's view, history suggests two general lessons: (i) that EMU needs fiscal union and (ii) that fiscal union needs a single currency. While he did not offer any practical way out of this chicken and egg problem, the close connection which he saw between monetary union, social unity and fiscal union led him to say emphatically that 'fiscal and monetary harmonisation will march together, or not at all' (424). He noted that there are, no doubt, exceptions to both rules; and considered that the weaker claim, on historical experience, seems to be the former: 'It seems unlikely then that a fixed exchange rate system can be maintained on any permanent basis until political harmony and social agreement allow the division of burdens within the area and the direction of policy in each part of the system to be decided by an accepted central *political* process' (Goodhart, 1989: 428, emphasis in the original). Likewise, on the basis of his analysis of the history of currency unions, Dyson concluded that 'Above all, in the end, an "optimum currency area" was politically constructed' (Dyson, 2009: 160)[10].

9 Seigniorage is the income received by government or central bank from the issuing of currency. It arises from the difference between the face value of a coin or bank note and the cost of producing and distributing it. Seigniorage can be an important source of revenue for some governments.

10 The relationship between currency and statehood is discussed in greater detail in Laffan *et al.*, 2000, Chapter 6.

3.3 The Balance within Europe's EMU

Others, who recognised the risk of various imbalances in EMU, did not share the view of US observers and economic theorists, that EMU was fatally flawed and doomed to failure. This reflected their greater awareness of, and interest in, the political and institutional requirements for achieving agreement on EMU. As Dyson pointed out, 'if the Euro-Zone had been dependent on a comprehensive package-deal embracing monetary, fiscal, wage and structural policies, the scale of collective-action problems would have sabotaged its launch' (Dyson, 2000:123). Others pointed out that it is not easy to replicate at European level the policy process, principles and mechanisms that operate in any given national model. 'Precisely because the political consensus which underlay the German system in the post-war years, does not exist at Union level, it may be necessary to have a monetary union which is more firmly constrained by constitutional provisions and which is less reliant on political processes' (Laffan *et al*., 2000: 151).

Their view was that, once the euro is in place, and its sustainability a collective interest of all those involved, it would become more important and more possible to address these issues. Thus, the focus was not so much on the technical principles as on the institutional arrangements and relationships that would shape the conduct of policy. 'Questions arise about whether its institutional arrangements are adequate and robust enough for dealing with them' (Dyson 2000: 123). The fear was that the core design created a somewhat unbalanced system in the sense that there may be more coherent institutions and policy on the monetary and on the economic side. For many, the central question was whether the set of Community economic policies following the 1992 Treaty on European Union would be sufficient to pursue Community goals other than price stability—especially employment, growth, competitiveness and cohesion. One source of concern was the degree to which as currency union drew closer, the institutions for the conduct of economic policy co-ordination became increasingly centred in the Council of Ministers—and, indeed, the less formal Eurogroup—rather than the European Commission. The fear was expressed that the Council would not have the capacity to formulate and agree a sufficiently clear economic policy, and that the preparation of its expanding workload by another Council body would 'perpetuate, rather than transcend, the proven limits of intergovernmentalism' (O'Donnell, 1992: 29).

Dyson catalogued the various sources of possible stability and instability for Europe's new currency. He suggested that, among other things, this requires a view about whether the established institutional design, and the policy ideas that it embodies, are based on an adequate definition of the problems that are likely to confront the euro area. Writing in 2000, he said:

> The Euro-Zone has inherited a structure which is preoccupied by a 'sound money' view, in which the central risk is perceived to be a 'debt trap' as more and more of government revenue is dedicated to debt servicing. Sound money ideas may not, however, prove adequate if the key threat turns out to come from a 'liquidity trap'. In such a context monetary policy instruments prove unable to counter deflation, and fiscal policy is too constrained by rules of sound finance to act as a counterweight. The central problem and dilemma is how the Euro-Zone can negotiate reforms to strengthen itself—for instance, to deal with a prospective liquidity trap—without unleashing the kind of destabilisation that reforms seek to avoid (Dyson, 2000:9).

Additional worries about imbalance arose among those who believed that the ECB's definition of its price stability objective—2 per cent inflation or less—might prove asymmetric. Given price rigidities, pressing inflation below 2 per cent would force a deflationary bias in monetary policy (Buiter, 1999). Reflecting the possibility of asymmetric shocks, Dyson argued that what is most worrying for the Euro-zone's stability 'is the absence of adequate mechanisms for alleviating potential problems consequent on demand shocks that are more severe in some countries than others' (Dyson, 2000: 162).

3.4 Differential Effects of Interest Rate and Exchange Rate Movements

A further anxiety about asymmetry concerned the monetary transmission mechanism. Various factors suggested that the transmission mechanism—the channel through which changes in monetary policy feed through to borrowing, investment, output and employment—differs across member states. Consequently, ECB interest rate changes were likely to have a differential impact on growth and inflation across the member states (Dornbusch *et al*., 1998). In general, its effects were expected to be smaller and slower in Austria, Belgium, Finland, Germany and the Netherlands, and faster in France, Italy, Portugal, Spain and Ireland. The experience since 1999 broadly confirms this expectation, as we explain in Chapters 4, 5 and 6.

Likewise, changes in the external value of the euro were seen as a further possible source of differential developments within the euro zone. Given their high trade dependence, Belgium, the Netherlands, Ireland and Germany would be more affected by appreciation of the euro (eroding trade competitiveness) or depreciation (imparting an inflationary effect) (Taylor, 1999; Baker *et al*., 1996).

While most of the discussion of exchange rate movements focused on the possible changes in the euro/dollar rate, Irish concerns naturally centred on movements in sterling. This was probably the most salient issue in the debate on whether Ireland should join the euro. In its 1990, 1996 and 1999 Strategy reports NESC discussed the experience of ERM and the challenges arising from deeper European monetary union. The 1999 report confirmed that sharp depreciation of sterling would pose a definite risk to Ireland's competitiveness within EMU and analysed in some detail the policy responses necessary (NESC, 1999).

3.5 Divergent Fears Concerning the Stability and Growth Pact (SGP)

As noted in a recent book *The Euro at Ten*, from the start 'there was a clear sense in the academic and policy community that there was something wrong with the Pact' (Hallerberg and Bridwell, 2008:73). But there was little agreement on whether the SGP in practice would be too restrictive or too lax. This is reflected in the title of one, aptly titled, paper '101 Proposals to Reform the SGP. Why So Many?' (Fischer, Jonung and Larch, 2006).

Feldstein's analysis reflected the thinking that led the member states, urged by central bankers, to adopt the SGP in 1997. He argued that 'the European institutional structure with a centralised monetary policy but decentralised fiscal policies creates a very strong bias toward large chronic fiscal deficits and rising ratios of debt to GDP' (Feldstein, 2005: 1). The bias arises because the existence of a single currency means that excessive fiscal deficits in any individual country do not cause a rise in that nation's interest rates or a change in its exchange rate, as would occur in a country with its own currency. 'In short, there is no market feedback to discipline large budget deficits'. But cumulative budget deficits 'are harmful, not only to the countries that incur them but also to other countries in the EMU...The value of the euro and the long-term real interest rate in the EMU countries will respond eventually to the size of the fiscal deficit and of the national debt in the Eurozone as a whole' (Feldstein, 2005: 2). This 'free rider problem' would become increasingly important as the number of countries in the euro increased. Consequently, it was argued, an effective political agreement among the euro-area countries is needed to prevent those deficits.

At the same time, Feldstein argued, there is greater need in Europe than in the United States to use discretionary fiscal policy to respond to an economic downturn in one member state—a view that is widely shared. This is because of the factors identified in the OCA theory, cited above: labour mobility, wage flexibility and the absence of a centralised fiscal system. 'In short the centralised monetary policy and a decentralised fiscal structure in Europe increases the need for and the effectiveness of counter-cyclical policy...The problem arises when the resulting budget deficit is not reversed in a relatively short time' (Feldstein, 2005:4). On this analysis, the worry was that the SGP would not be sufficient to achieve disciplined fiscal policy and a continued reduction in the levels of national indebtedness. As we discuss in Section 5.5, this worry was reinforced after 2003, given the way in which the SGP was executed and revised.

Likewise, based on his institutional analysis, Dyson suggested that the Achilles heel of the Euro-Zone is budget consolidation. 'Failure here could weaken the euro and set in train a set of negative economic and political consequences' (Dyson 2000: 246). Indeed, he suggested that in order to help EU governments gain reliable and lasting control over their budgets, the euro-area's reach has to extend beyond the aggregate budget numbers that are at the core of the SGP. 'It has to address institutional weaknesses at the micro-budget level leading to deficits—for instance, the need for national pensions reform' (Dyson 2000: 272-3). Given our analysis, in Chapter 6, of the root causes of Ireland's current fiscal policy problems, this is an idea we return to when considering current proposals for strengthening the SGP in Chapter 8.

However, other economists were critical of the SGP for the opposite reason and predicted that it would have damaging effects of others kinds. They argued that the Pact would reduce fiscal flexibility and hamper automatic stabilisers, would work asymmetrically, likely to lend a deflationary bias to the European economy, focused mechanically on an arbitrary level of nominal deficit, rather than long-term sustainability, would disregard the aggregate fiscal stance in the euro-area and discourage public investment (Eichengreen and Wyplosz, 1998; Hughes Hallet *et al*., 1999; Portes, 1994; von Hagen, 2002). Heipertz argued that much of the academic criticism was exaggerated and that the SGP should be seen as 'not the best, but better than nothing' (Heipertz, 2003).

3.6 Anxiety about Decentralised Financial Supervision

As early as 1992 there was some anxiety about the degree to which banking supervision was to remain decentralised in EMU. 'If so', argued Honohan, 'an opportunity may be missed' (Honohan, 1991: 66). He pointed out that a significant contribution to the US saving and loan failures was the fact that regionally decentralised supervisory authorities succumbed to local pressures and allowed unsound banks to stay in operation. While the 'white paper doctrine' of home country control was the key to achieving completion of the single market, it should probably be seen only as a transitional stage insofar as bank supervision and control is concerned[11].

> Arguably, a centralized bank supervision authority (whether a department of the ECB or a separate entity) with wide powers, would be more able to operate above national political pressures in acting decisively to prevent a failing bank from continuing to operate in an unsound manner. There would, of course, be a need to retain a local-based inspection system for supplying the local feel which is essential for detecting the early warning signs of distress. But, so far as action to restrain unsound banking practices is concerned, here again, as in the case of monetary management, it may be worthwhile for national governments to cede power to the centre in order to 'save them from themselves' (Honohan, 1991: 66).

Others shared this anxiety about the continuation of national-level financial supervision and, indeed, linked it to a further possible vulnerability of the euro—global financial instability.

3.7 The Euro's Global Role and Global Risks

The potential global role of the new European currency was a subject of considerable discussion and, to a lesser extent, possible global risks to the euro were also identified. While it might be expected that EMU would increase the influence of the EU in global monetary management and improve the quality of international policy co-ordination, thereby propelling the EU to centre stage in monetary as well as other international affairs, there was reason to doubt that this would occur rapidly (Gros and Thygesen, 1992; Kenen, 1996). As noted above, the design reflected an ECB priority on internal price stability rather than exchange rate policy. This, in turn, reflected the fact that demand played a subsidiary role in the minds of those that negotiated EMU (Dyson, 2000).

This reassured some that the ECB would not be drawn into politically-influenced efforts to manage the exchange rate of the euro against the dollar and other global currencies. Others were troubled by an apparent refusal to see that 'global

11 The 'white paper, doctrine' refers to the White Paper, *Completing the Internal Market*, presented by the European Commission to the European Council in June 1985. It set out ways of facilitating cross-border trade and establishment in a range of goods and services. In business areas subject to significant regulation—such as financial services, telecoms and energy—this requires the EU to decide whether companies are subject the rules of their home country or the markets where they sell services, or some combination of each. 'Home country control' refers to the situation where the bulk of legal control takes place in the country of origin and the country of destination acknowledges the former's regulatory power. For example, a French bank would be free to open a branch in the UK and all prudential supervision would be conducted in France.

demand is a public good' from which all benefit in increased trade, output, and employment. 'The risk of deflation can be met only by a capacity for international leadership that can address the problem of co-ordinating global demand. In default of such co-operation, the global economy has become dependent on 'free-riding' on an expansionary US economic policy' (Dyson 2000: 198). This was seen as a high risk strategy if the US economy were to run into serious difficulties. 'Ultimately, the attempt to construct an island of stability in an ocean of instability is futile... Contagious financial crises provide potentially the most acute threat of systemic breakdown' (Dyson, 2000: 198). Likewise, it was argued that 'while the Union may prefer to build the euro, international financial instability may force it to adopt a more active global role' (Laffan *et al.*, 2000: 163).

In addition, some argued that the global level was the most appropriate one at which to reach decisions on regulation of financial markets, averting financial crises and responding to financial turbulence. 'Here just how effective the Euro-Zone is in shaping the agenda will depend on its perceived internal democratic legitimacy, collective identity, and performance. Measured on these criteria expectations of impact seem low' (Dyson, 2000: 246-7).

3.8 Irish Expectations of Monetary Union

An assessment of the implications of EMU for Ireland was undertaken by economists at the ESRI (Baker *et al*., 1996). Their study identified a reduction in interest rates as the most significant quantifiable benefit of monetary union. The complete removal of any devaluation risk was expected to reduce the premium over German interest rates that had long characterised Irish wholesale interest rates. The primary cost of membership identified in the study was that the loss of the exchange rate instrument would reduce the speed of adjustment of the economy to shocks. This study found the choice of exchange rate regime influenced the long run impact of shocks very little; but the adjustment would de different in the short term (one to three years). In particular, additional costs from shocks would arise if the UK stayed outside the euro. However, it was estimated by Baker *et al*. that the ongoing benefits of lower interest rates would, on balance, exceed the potentially higher costs of adjusting to shocks within EMU. They concluded that the quantified benefits of membership exceeded the quantified costs. In addition, they found that the balance of unquantified—and largely unquantifiable—factors further reinforced the benefits of membership. Among the unquantified benefits of membership of EMU identified by Baker *et al*. were: greater political and diplomatic influence; enhanced assurance of assistance from partners in the event of unexpected adverse developments in the fields of money and banking; and improved perception of Ireland as an investment location.

The policy implications of monetary union were explored by NESC in its 1999 Strategy report (NESC, 1999a). That study pointed out that fiscal policy and labour market adaptability would acquire additional responsibility for economic stabilisation in a monetary union (see Section 6.3).

3.9 Summarising the Expectations: Theoretical Pessimism, Technical Confidence and Cautious Institutional Optimism

Overall, prior expectations about the euro can be classed into three broad groups: theoretical and political pessimism, technical confidence and cautious institutional optimism.

3.9.1 Theoretical and Political Pessimism

As Dyson says in his review of fifty years of Europe's EMU project, 'the path to EMU is a story of the defeat of skeptics' (Dyson, 2009: 144). He notes that it is also a 'hard and thorny' journey—as described by the President of the Bundesbank in 1963. Much of this skepticism was theoretical in origin, derived from the application of the economic theory of the nation state, particularly by US scholars. The more analysts relied on technical cause-effect relationships—and the less they invoked institutional analysis—the more sceptical they were about the possibility and desirability of European monetary union. When this was combined with doubts about the willingness and ability of European policy makers to opt for the euro, achieve the convergence criteria, manage destabilising financial and exchange rate crises and meet the start date of January 1999, it yielded a pervasive skepticism about EMU across much of the Anglo-Saxon world (Laffan *et al.,* 2000; Dyson, 2009).

3.9.2 Technical Confidence

The second broad class of expectation reflected the doctrine that informed the design of EMU and the transition through the 1990s. It was optimistic about the prospects for the new currency and the benefits that would accrue to all the member states and Europe as a whole—provided that all actors played their appropriate, but distinct, roles—as depicted in Figure 2.1. If the ECB was independent of political pressure, especially from member states, it had the technical expertise to manage the new currency in a way that yielded price stability and macroeconomic performance. If the member states conducted national fiscal policy in accord with the SGP and undertook sufficient structural and welfare reform, they would have full employment in normal times and enough headroom for counter-cyclical policy when needed. If trade unions and employers conducted wage bargaining in accord with monetary policy, and cooperated with structural and welfare reform, they would find business opportunities and employment in the large internal market. These positive outcomes would be supported by the action of the European Commission in leading the completion of the single market, executing EU cohesion policies in partnership with national and regional authorities and managing the accession of the countries of Central and Eastern Europe. By any standards, the dissemination of this body of ideas across the continent—and the creation of treaties, institutions and processes to achieve transition to a new currency in 1999—was a remarkable achievement indeed.

3.9.3 Cautious Institutional Optimism

The third general type of expectation might be described as cautious institutional optimism. This was the view of those who shared many of the anxieties and fears outlined above, but believed that the institutional dynamic of European integration had a good chance of addressing most of the problems that might arise.

One reason for this kind of optimism was the remarkable policy and institutional development between the 'collapse' of the narrow-band ERM in 1993 and the launch of the euro in 1999. This included very significant evolution of the Ecofin Council's effectiveness in 'multi-lateral surveillance'. Much of that effectiveness depended on socialisation of finance ministers, peer pressure and the emergence of new norms. 'While the Union has limited power to compel and sanction, it is clear that monetary union has created strong pressure for ongoing reform within member states,-pressure that seems likely to intensify' (Laffan *et al*., 2000: 149). It is interesting to ask whether this trajectory of increasing convergence of ideas and sharing of experience continued after the launch of the euro in 1999—something we discuss in Chapters 5, 7 and 8.

A second reason for cautious optimism was the belief that the EU would find a way to respond to the kinds of risks identified above: asymmetric shocks, the overall monetary-fiscal policy mix, international currency movements and global financial instability. It was recognised that without a system of fiscal federalism, or other identified instruments to address asymmetric shocks, 'the Union will approach particular difficulties in its traditional, ad hoc, manner' (Laffan *et al*., 2000: 149). But it was suggested that 'efforts at crisis-management are also likely to induce evolution of the system as a whole' *(ibid)*. It was argued that the 1992 TEU should not be seen as the end point or the definitive blueprint for EMU, as demonstrated by developments since 1993. While the Treaty was not ambitious in respect to goals other than price stability, 'no definite answer to this question can be given at this stage. It depends, to a large extent, on the manner in which policy co-ordination evolves in the coming years which, in turn, depends on both political and economic debate' (O'Donnell, 1992: 46). Although the provision of the Maastricht Treaty are 'partly contradictory and partly unclear' it was argued that 'the apparent contradictions and the definite obscurities can only be clarified in practice' (O'Donnell, 1991: 24). Thus 'it remains to be seen whether it is sufficient to balance, legitimise and complement the monetary authority in managing the internal and external dimensions of the new European economy' (Laffan *et al*., 2000: 149). It was noted that 'the definition of the political requirements, or political price, of EMU is an ongoing process' and the 'EMU is a novel, experimental, process'. 'It remains to be seen how the process of political evolution will shape the political economy of the new Europe and, indeed, there is little agreement on how it should' (152).

While discussion among all three groups centred on defined risks—such as fiscal stabilisation and asymmetric shocks—Dyson, also a cautious optimist, raised a more pervasive anxiety. 'What remains questionable is the Euro-Zone's capacity to manage the policies of 'hard times', especially sustained recession, particularly if effective fiscal stabilisers are not in place and labour-market, wage, and welfare-state reforms incomplete' (Dyson, 2000: 208). Its policy instruments are better designed to deal with inflation than with deflation and unemployment. Writing in 2000, he said:

> The open question is to what extent the Euro-Zone will display a capacity for self-reflection and learning about what it needs to do and for institutional and policy reforms to ensure its viability. This capacity is more likely to thrive in a Kantian culture of multilateral action and collective interest and identity. Such a culture has a much better than average chance of thriving in an EU context of deepening economic interdependence, growing convergence, abiding historical memories of a collective security problem, and mutual self-restraint. The Euro-Zone is itself a force in helping to secure such a culture....The ECB and the Member States are in the process of creating a culture of co-operation, not simply of 'rule-following'. What matters fundamentally is the nature of the social and political theory that underpins the operation of the Euro-Zone and the wider EU of which it is a part (Dyson, 2000:143).

In our concluding discussion of policy challenges, in Chapter 8, we suggest that the challenges, while certainly highly technical, require precisely such a culture of cooperation, and that this can be built on existing EU processes, if properly understood and fully embraced.

4

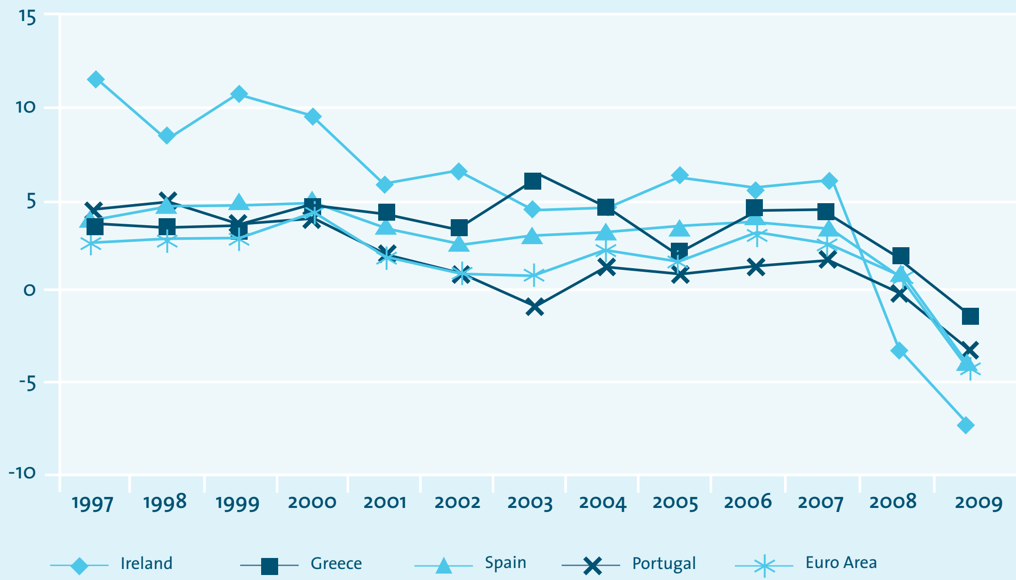
Ireland's Experience in EMU

Ireland's experience of monetary union since 1999 was characterised by strong but unbalanced economic growth followed by a sharp fall in the economy during the current economic crisis. This chapter describes this experience in a comparative manner. The chapter begins with an outline of key developments in the euro-area since the establishment of monetary union, with an emphasis on the Irish experience. This is followed by a description of the current economic crisis. The description of developments in this chapter is followed by interpretation of developments in the euro area as a whole (Chapter 5) and in Ireland (Chapter 6). Key weaknesses of both EU and Irish policy are discussed in those chapters.

4.1 Key Trends in the Euro Area, with Emphasis on Irish Experience

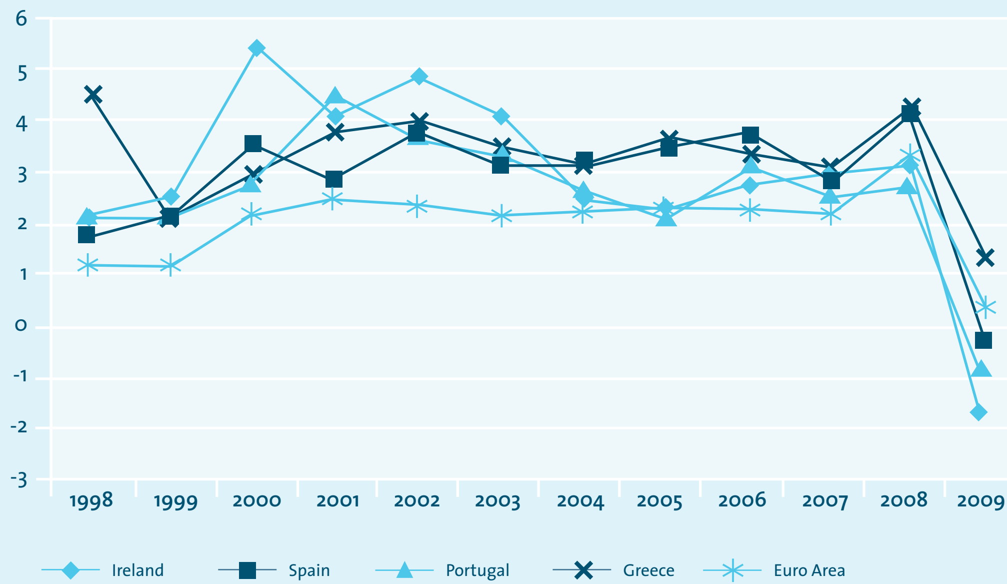
The first decade following the establishment of monetary union in 1999 saw moderate economic growth in the euro area; GDP grew by an annual average of just over 2 per cent over the period 1999 to 2008. Germany and Italy had below average growth, while three of the four geographically peripheral countries of the euro area (Ireland, Spain, and Greece) experienced above average growth; Portugal had weak growth (see Figure 4.1). Inflation in the euro area averaged 2.2 per cent over the first decade (1999 to 2008), according to the standard EU measure, the Harmonised Index of Consumer Prices (HICP). Ireland, Spain, Greece and Portugal all experienced above average inflation rates under EMU. Ireland's inflation averaged 3.4 per cent (as measured by the HICP) over the period 1999 to 2008 (see Figure 4.2). The corresponding averages for the same period were 3.2 per cent for Spain, 2.9 per cent for Portugal and 3.3 per cent for Greece. The cumulative increase in consumer prices over the period 1999 to 2008 was almost 36 per cent in Ireland, considerably higher than the cumulative increase of 23 per cent in the euro area. Ireland had deflation in 2009 of 1.7 per cent as measured by the HICP and 4.5 per cent according to the Consumer Price Index (CPI), with the larger fall in the CPI due to its inclusion of mortgage payments.

Figure 4.1 Annual Percentage Change in GDP 1997 to 2009



Source European Commission, *European Economy*, Statistical Annex, Autumn 2009.

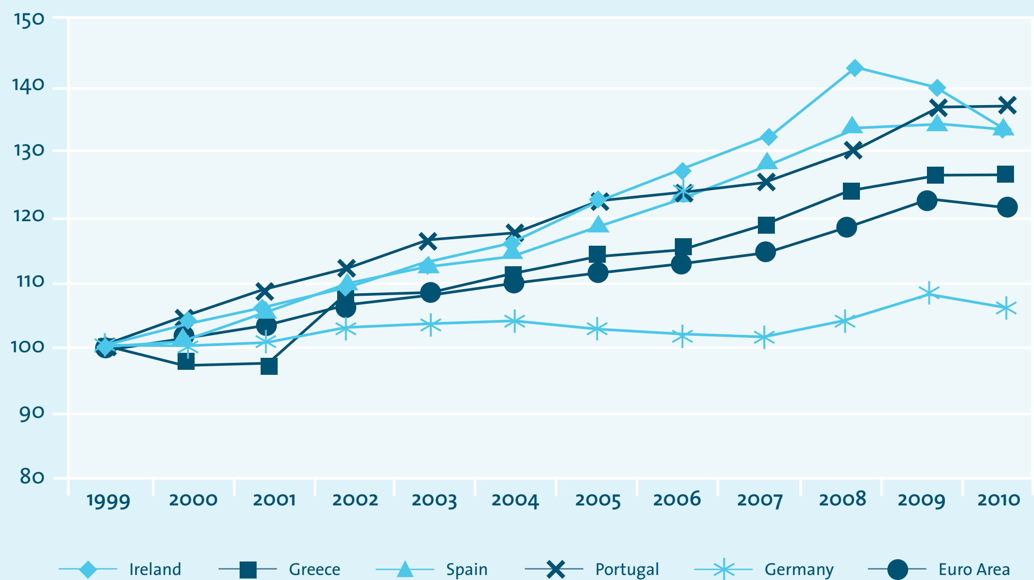
Figure 4.2 Annual Rate of Inflation (HICP) 1998 to 2009



Source Eurostat

Ireland experienced a loss of cost competitiveness in monetary union. In varying degrees, a loss of cost competitiveness was also the experience of the other peripheral countries. Between 1999 and 2008, nominal unit labour costs in Ireland on an economy-wide basis (i.e. nominal labour costs per employee adjusted for growth in GDP per capita) increased by over 41 per cent, far more than the average increase in the euro area of 19 per cent (see Figure 4.3). Wage growth in the euro area was depressed by the exceptionally low wage growth in Germany in this period. Since 2007 sterling weakness has meant a pronounced loss in cost competitiveness for Ireland against the UK. The euro/sterling exchange rate increased from 0.66 in January 2007 to 0.83 in June 2010, an appreciation of 26 per cent. During 2009 and 2010, Ireland has experienced a reduction in unit wage costs which helps to recover competitiveness.

Figure 4.3 Index of Nominal Unit Labour Costs in Euros 1999=100

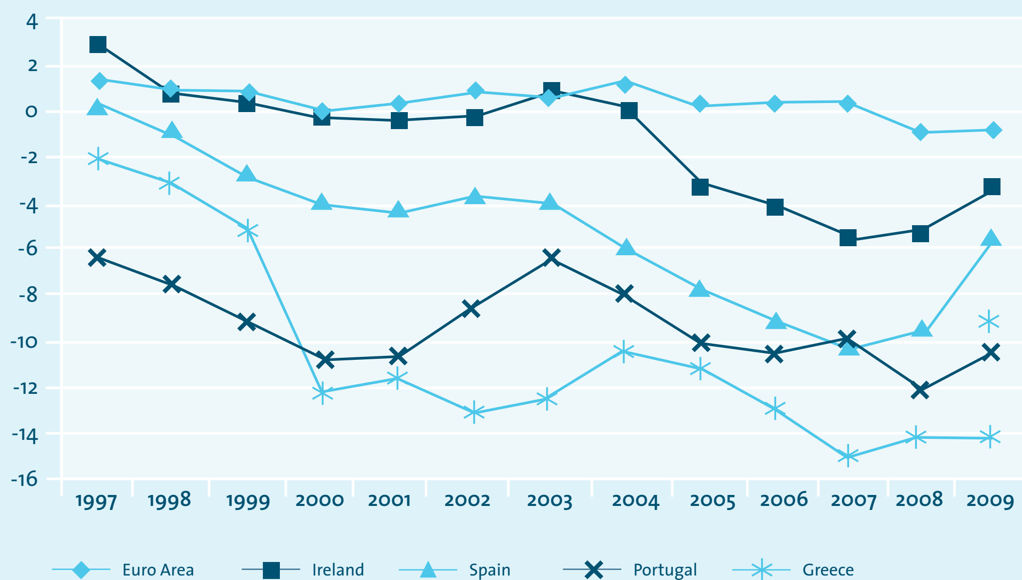


Source European Commission, AMECO database.

Ireland's export growth slowed considerably in the past decade compared to the exceptionally strong growth of the 1990s. Notwithstanding the loss of cost competitiveness, Ireland's annual export growth over the decade 1999 to 2008, at 7.6 per cent, was ahead of the euro-area average of 5.4 per cent. Greece also experienced above average export growth (6.2 per cent) over this period, while Spain and Portugal had below average export growth—4.4 per cent annual growth for Spain and 4.1 per cent for Portugal. The 1999 to 2008 period included some years of exceptionally strong Irish export growth, before problems of cost competitiveness had emerged. The gap between Irish and euro-area export growth narrowed during this period. Over the shorter period 2002 to 2008, Irish export growth averaged 5.2 per cent annually, compared to the euro-area average of 4.6 per cent.

The euro-area has had approximate balance in its current account balance of payments since the establishment of monetary union. However surpluses in countries such as Germany have been offset by deficits in some of the peripheral members of the euro-area (Ireland, Spain, Greece and Portugal). Ireland's deficit peaked at over 5 per cent of GDP in 2007, a lower level than that experienced in the other peripheral countries. The balance of payments moved into substantial deficit in both Greece and Portugal in the late 1990s. In the case of Portugal, total growth was weak over the past decade despite persistent balance of payments deficits; weak economic growth appears to be the core problem for Portugal.

Figure 4.4 Current Account of the Balance of Payments Percentage of GDP



Source European Commission, *European Economy*, Statistical Annex Autumn 2009.

Figure 4.5 General Government Balance as a percentage of GDP 1997 to 2009

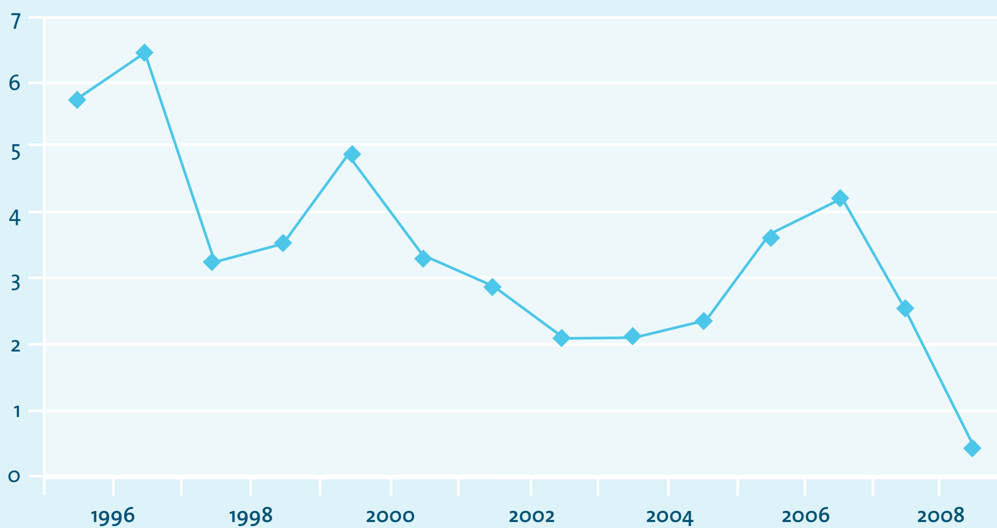
Source European Commission, *European Economy*, Statistical Annex, Autumn 2009 and Eurostat news release, 22 April 2010.

Trends in the public finance balances of selected euro-area countries are shown in Figure 4.5. In the case of Ireland, the public finances were in surplus for virtually every year since 1999, although there was a sharp fall in the surplus in 2001. Ireland's surplus existed after paying for annual public capital investment of 4 to 5 per cent of GNP. Ireland's government savings (an EU measure of the state's current budget balance) averaged 6 per cent of GDP over the period 1999 to 2007, while the corresponding figure for Spain was 5 per cent of GDP. Greece and Portugal had deficits throughout this period. The German public finances were also in deficit for most of the past decade; the German public finance balance closely tracked the euro-area average. The issue of what would have been a desirable fiscal policy for Ireland in this period is discussed in Chapter 6.

A fall in interest rates, in both nominal and real terms, was the most significant channel through which membership of monetary union influenced Ireland and the other countries on the periphery. This was in accordance with the expectation of the ESRI analysis (Baker *et al*., 1996), discussed above. Conefrey and Fitz Gerald (2010) identify two ways in which monetary union affected borrowing in Ireland and Spain. First, it eliminated the exchange rate premium that had resulted in higher interest rates in economies such as Ireland and Spain, compared to Germany and other countries with similar currencies. Second, with monetary union, the banking systems in both Ireland and Spain were not constrained by exchange rate risks in their ability to raise funds abroad to lend domestically. There was a sharp increase in the net foreign liabilities of Irish banks from 2003 onwards. In the case of Spain, the timing of financial liberalisation was different and there was an increase in net foreign liabilities of the banking sector from the late 1990s. The ability to raise funds abroad at low costs facilitated the funding of large housing and construction

booms in both Ireland and Spain. Above-average inflation in Ireland and Spain also contributed to lower real interest rates and hence further reinforced demand pressures. In addition to the impact of monetary union on interest rates, the liquidity in the global monetary system also contributed to sustaining low interest rates and the availability of funds in this period, as discussed above.

Figure 4.6 Ireland: One-month Interbank Interest Rate



Source Central Bank and Financial Services Authority of Ireland, *Quarterly Bulletin*, various issues.

While a monetary union eliminates exchange rate movements among its members, external exchange rates continue to influence developments. In the transition to the late 1990s and continuing into 2000, Ireland experienced a substantial depreciation in its exchange rate. Ireland's nominal effective (i.e. average) exchange rate depreciated by 17 per cent from late 1996 to 2000 due to the strength of the dollar and sterling, as well as a policy decision to manage down Ireland's exchange rate within the ERM in preparation for monetary union. This was undertaken to facilitate a competitive exchange rate on entry to monetary union (Lynch, 2008). The depreciation from late 1996 boosted economic growth at this stage and is identified by Honohan and Lane (2003) as the driver of above-average inflation in Ireland in the early years of monetary union. The boost to domestic demand from low interest rates also contributed to inflationary pressure as did fiscal policy. The sharp fall in the general government deficit of almost four percentage points of GDP in 2001 created inflationary pressure in advance of the housing and construction boom.

In the past decade there was considerable volatility in the euro/sterling exchange rate. The net increase in the value of the euro against sterling between January 2007 and June 2010 was 26 per cent, as noted above; there were larger fluctuations within this period. The exchange rates of the euro against other EU member state currencies have typically been more stable. Some EU currencies participate in ERM II, which allows currencies to float in a range of plus or minus 15 per cent with respect to the central rate against the euro. The Danish currency, which participates in ERM II, is managed to more closely track the euro, as shown in Figure 4.7. Other countries —for example Sweden and the UK—participate in neither the euro nor the ERM II (see Sections 8.4.4 and 8.5.5). As shown in Figure 4.7, the Swedish Krona fluctuates less against the euro and has been less volatile than sterling

Figure 4.7 Index of the euro against the Swedish Krona, Danish Krone and Sterling 1996=100

Source European Commission, *European Economy*, Statistical Annex Spring 2010.

4.2 The Crisis

Problems in financial markets led to a slowing of economic growth globally in 2008, while there was a sharp fall in economic activity in 2009. In the euro area, GDP declined by 4 per cent in 2009. The decline in the Irish economy has been among the steepest in the developed world; in 2009, GDP in Ireland declined by 7.1 per cent, while GNP fell by 11.3 per cent. A modest recovery in GDP is expected in developed countries in 2010, assisted by unprecedented levels of government support for economic recovery.

The economic crisis resulted in the public finances moving sharply into deficit. The euro-area general government deficit went from 0.6 per cent of GDP in 2007 to 6.3 per cent in 2009. The movement into deficit in the public finances in Ireland was the most pronounced in the euro area, reflecting the exceptionally large fall in Ireland's economic output and revenue. Ireland's general government balance went from a surplus of 0.1 per cent of GDP in 2007 to a deficit of 14.3 per cent of GDP in 2009. This was the largest deficit in the euro-area in that year. The deficit includes a capital payment to Anglo Irish Bank of 2.5 per cent of GDP. Excluding this payment, what the Department of Finances refers to as the 'underlying deficit' was 11.8 per cent of GDP in 2009. The UK deficit in 2009 was 11.5 per cent of GDP. The budget projection is for Ireland's GGD to be 11.6 per cent of GDP in 2010; this does not include payments for 2010 to Anglo Irish and Irish Nationwide.

Loss of confidence by the financial markets in Greece's ability to service its debts led to a sharp increase in bond yields for Greece in April 2010. It became impossible at this stage for Greece to raise funds in the bond markets on acceptable terms and there were concerns about the spreading of the problem to other euro economies. This led to the provision of an emergency loan package of €110 billion by euro-area governments and the IMF. This is discussed further in Chapter 8.

5

Interpreting Developments in the Euro Area

In identifying the macroeconomic impact of EMU, it is important to take note of the fact that European monetary union occurred in the context of other structural changes in the world economy over the last decade. This chapter begins with an overview of these developments. Against this background, developments in the euro area are interpreted. The role of balance of payments deficits and internal euro-area imbalances are examined in Sections 5.2 and 5.3 respectively. The role of EU financial regulation is discussed in Section 5.4 while Section 5.5 reviews the performance of the Stability and Growth Pact (SGP) in guiding fiscal policy in the EU. The critical role of structural reform in addressing the challenges of the European economy is discussed in Section 5.6. The impact of the euro on European identity is considered in Section 5.7, while finally Section 5.8 examines the issue of intra-EU exchange rate policy.

5.1 Structural Change in the World Economy

Structural changes in the world financial system are described by Lane (2010b). Key developments in the world economy in the decade prior to EMU include the growth in world trade and a massive increase in cross-border financial positions, the emerging market economies' increased share in world trade and output, the integration of Central and Eastern European economies into the EU and major global shocks such as the collapse of the technology bubble in 2000-2001, the attacks of 9/11, sharp fluctuations in commodity prices (around an upwards trend) and, more recently, the global financial crisis.

It is useful to divide the period since the formation of EMU in 1999 into three distinct phases. First, the transition from multiple currencies to a monetary union represented a major macroeconomic shift and this played out over 1999-2002. In addition, that period included the collapse of the technology bubble, the recession brought on by 9/11 and the major depreciation of the euro against the dollar.

The second phase, from 2003 to 2007 was marked by highly-liquid conditions in global financial markets, generating rapid growth in the balance sheets of many financial intermediaries, a surge in cross-border capital flows and significant downward pressure on long-term real interest rates. World capital markets were awash with liquidity during this period. Financial intermediaries searched for yield by taking on additional risk in areas such as sub-prime mortgages, low-grade corporate debt and sovereign debt. In addition, it was believed that innovations in the securitisation process enabled a superior re-allocation of risk, thereby expanding the range of eligible borrowers and target leverage ratios for financial intermediaries.

The shift in financial markets contributed to increased dispersion and persistence in current account balances. Most obviously, the US current account deficit expanded, with an increase share of the funding sourced from emerging Asia and oil exporters. While Europe collectively did not run a significant external imbalance, very large surpluses in countries such as Germany, Switzerland and Sweden were offset by large deficits in the periphery of the euro area (Ireland, Spain, Portugal, and Greece), Central and Eastern Europe and financial innovators such as Iceland and the United Kingdom.

The third phase began in summer 2007 and is still ongoing. This phase has been dominated by the global financial crisis and the onset of a major global recession. With the global recession there has been a reduction in global financial imbalances. If a global economic recovery is to be sustainable there is a need to finds ways of preventing the re-emergence of comparable global financial imbalances and more effective regulation of global finance. This is a huge challenge as the global institutional arrangements to address these issues on a global scale are fragile (see Chapter 8).

5.2 The Role of Balance of Payments Deficits

While much of the current focus is centred on public debt, the current problems only partly have their origins in the public finances. There are many differences across the peripheral European countries that now have public finance problems, but a common feature of these economies during the years prior to the economic crisis was high capital inflows and associated high current account deficits (see Figure 4.4). In the case of both Ireland and Spain, the current account deficits were essentially due to private financial deficits (i.e., a high level of private investment well in excess of savings) with the public finances close to balance or in surplus. These large private financial deficits for Ireland and Spain in 2007 are shown in Figure 5.1. Greece and Portugal had both government deficits and balance of payments deficits; indeed, the balance of payments deficits were substantially higher than the government deficits, signifying that these economies also had private financial deficits. All of these countries experienced reductions in interest rates on joining EMU and the ease of financing in the euro area facilitated both private and public borrowing. These economies all experienced a loss of cost competitiveness over the past decade.

A country's balance of payments is equal to the gap between national savings (comprehensively defined to include government, corporate and household savings) and investment (private and public). In the case of both Ireland and Spain, national savings have been at similar rates to the euro-area average. The balance of payments deficits arose in these countries on account of exceptionally high levels of investment, particularly in construction (see Table 5.1). By contrast, in the case of Greece and Portugal, investment rates were comparable to the euro-area average. The balance of payments deficits arose because of below average rates of saving.

An analysis by the OECD examined the factors behind the increase in the balance of payments deficits in Greece and Portugal between the periods 1990-98 and 2007-08. In both cases the analysis found that the rise in the deficit was mainly due to a fall in transfers, both EU transfers and emigrant remittances.

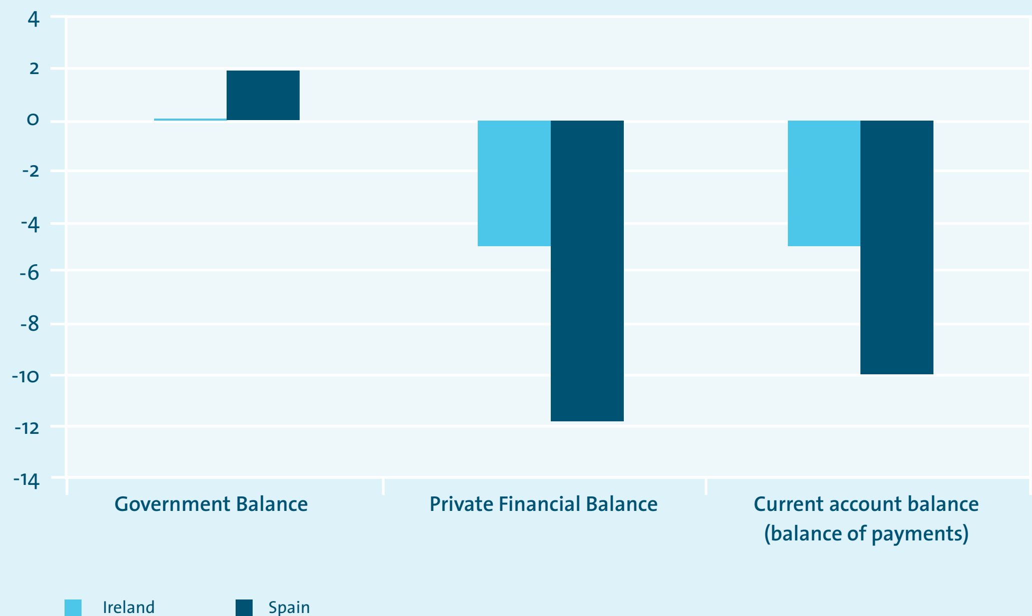
In both periods there were large trade deficits, but in the 1990-8 period the deficits were mostly financed by transfers. There was also a decline in net investment income for both Greece and Portugal, a consequence of growing net foreign liabilities (OECD, 2009).

Table 5.1 Savings and Investment: Key Measures as a Percentage of GDP, 2007

	Ireland	Spain	Portugal	Greece	Euro
Private Sector Savings	17.1	14.2	12.5	9.9	19.8
Government saving	4.5	6.9	-0.1	-2.4	2.7
National savings	20.6	21.0	12.4	7.5	22.5
Investment (public and private)	26.0	31.0	22.2	22.2	22.1
Current account balance (national savings less investment)	-5.3	-10.0	-9.8	-14.7	0.4

Source European Commission, *European Economy*, Statistical Annex, Autumn 2009; Ireland's national savings adjusted for the statistical discrepancy in the national accounts.

Figure 5.1 Government Balance, Private Financial Balance and Current Account of the Balance of Payments for Ireland and Spain as Percentage of GDP, 2007

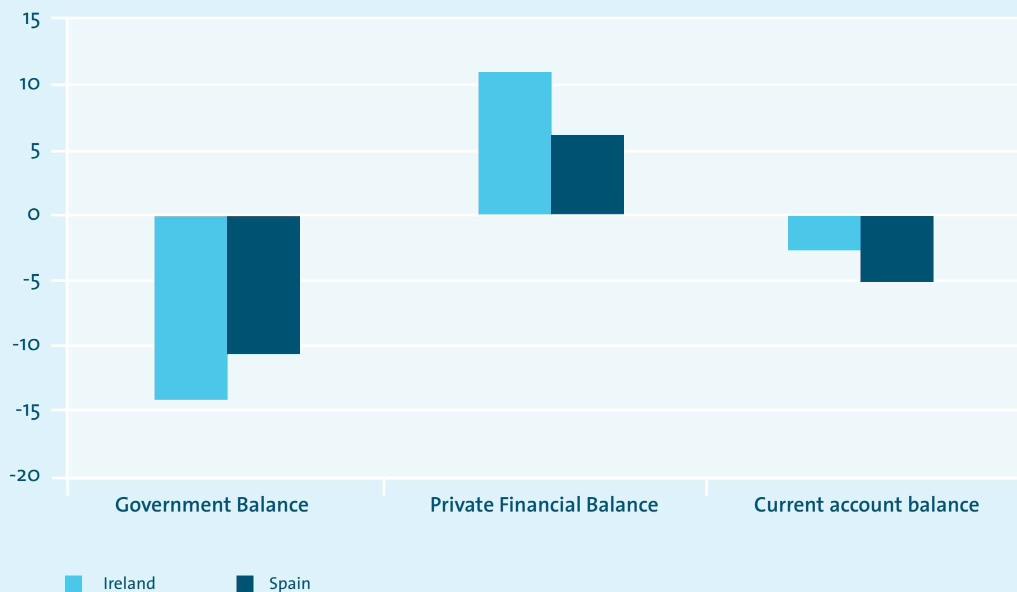


Source *European Economy*, Statistical Annex, Spring 2010.

With the economic crisis in 2008, there was a fall in private sector financial deficits; in the case of Ireland and Spain the private balance moved into strong surplus, reflecting the fall in investment and rise in savings. It was at this stage that very high government deficits arose in these economies. These deficits helped to limit the fall in economic activity that would otherwise have occurred. Figure 5.2 shows the large government deficits that existed in Ireland and Spain in 2009 along with large private financial surpluses.

As discussed above, the years 2003 to 2007 were characterised by highly liquid conditions in global financial markets, low interest rates and a surge in cross-border financial flows. These conditions were significant contributors to the current account deficits of the peripheral euro-area countries.

Figure 5.2 Government Balance, Private Financial Balance and Current Account of the Balance of Payments for Ireland and Spain as Percentage of GDP, 2009



Source See Figure 5.1.

The balance of payments deficits that emerged in some euro countries could potentially have served as warning signals and prompted policy adjustment. The potential of policy to address the imbalances that developed in the Irish economy is examined in Chapter 6.

This sequence of events—current account deficits, followed by a movement into recession and large public deficits—also occurred in the UK (and the US). The question arises as to why there is much greater concern at present about the public finance problems in some euro-area countries, compared to the concern with an apparently similar deficit in the UK. The UK economy is now growing and it has greater exchange rate and monetary policy autonomy.

This meant that it could allow its currency to depreciate, thereby substantially boosting cost competitiveness, and to pursue an expansionary monetary policy, including large-scale purchase of government bonds by the central bank. Growth in both nominal and real GDP makes the debt burden more manageable; i.e., it helps to contain the rise in the debt/GDP ratio. However, as discussed in Section 6.5, it does not follow from this that the euro-area economies now in difficulty would derive the same benefits if they had their own currencies. As Lane (2010b) points out, financial market treat the currencies (and debt instruments) of different countries in different ways. Independent currencies of small peripheral countries have greater difficulties in dealing with financial markets and in the current context would be vulnerable to currency crises.

5.3 Imbalances in the Euro Area

Balance of payments deficits in the peripheral euro countries were accompanied by surpluses in other euro countries, most notably Germany. It had a surplus of almost 8 per cent of GDP in 2007 and continues to have a surplus in its balances of payments (around 4 per cent of GDP in 2010). The significance of internal euro imbalances is the subject to some debate. For the euro area as a whole, its balance of payments with the rest of the world has been close to balance. This is not a necessary requirement. It is possible for the euro area as whole to have a surplus with the rest of the world (like a large Germany), or a deficit like the US. Nonetheless, there is an interaction between deficits and surpluses within the euro area as well as globally. Stronger domestic demand in Germany now would contribute to sustainable growth in the euro area and across the EU and also help in the resolution of debt problems. Structural reforms that facilitated the development of private services in Germany would help to increase domestic demand. However, it needs to be acknowledged that Germany's surpluses are also a reflection of a desire to achieve adequate savings to address the impact of demographic change. Many other countries also have a similar need for savings. Reconciling this with the requirements of macroeconomic balance is complex.

5.4 Financial Regulation

A major weakness of EMU has been the supervision of financial and banking systems. As noted in Chapter 3, financial supervision remained with national authorities upon the advent of EMU. However, the growth in cross-border financial flows and multi-country banking groups meant that financial stability was weakened by the absence of an EU-level supervisory authority. In particular, such a European-level authority could have provided the high-level view of macro-prudential risk at the international level that might have provided a better early warning signal about the risks being incurred by European banking groups during the securitisation boom. Greater European co-ordination would also have been helpful in managing the financial crisis. In particular, the recapitalisation of multi-country banking groups, such as Fortis, has proven to be problematic in the absence of co-ordination. Moreover, the initial lack of co-ordination in providing guarantees on the liabilities of national banking systems was clearly sub-optimal from a collective perspective (Lane, 2010b). The issues in Irish financial regulation are discussed in Chapter 6.

5.5 Fiscal Policy and the Stability and Growth Pact

Here we review the performance of the SGP. This section begins with a brief description of key facts concerning sovereign debt in the EU. The evolution of the SGP is outlined, including earlier efforts at reform. While the SGP has clearly not prevented the current crisis, evidence is presented indicating that it has influenced fiscal policy. The interaction between the SGP and domestic institutions for fiscal policy is discussed.

At one level it may seem surprising that so much concern has arisen in regard to public debt in the euro-area. For the euro area as a whole, the general government deficit in 2009 (6.3 per cent of GDP) was just over half the level of the deficit in the US (11.3 per cent of GDP) and the UK (11.5 per cent of GDP); for the EU the deficit in 2009 was 6.8 per cent of GDP. At the end of 2009, the general government debt was 79 per cent of GDP in the euro area and 74 per cent of GDP in the EU (27). Both of these were somewhat lower than the US (83 per cent of GDP). Indeed, some commentators have criticised EU governments for not having an adequate fiscal response to the economic crisis, which would imply larger deficits.

The concerns with public debt in the euro area have arisen from problems in the first instance in Greece and in a number of other high-deficit countries. Greece has both a high deficit (13.6 per cent of GDP in 2009) and an exceptionally high level of public debt (115 per cent of GDP at the end of 2009). Greece maintained substantial deficits through the past decade, before the current crisis, with an average of 5 per cent of GDP over the period 1999 to 2008. The other peripheral European countries have high deficits, but much lower debt levels.

The SGP was originally agreed in 1996 and came into force in 1998. Its conditions included limiting the general government deficit to 3 per cent of GDP with some exceptions. Adherence to the terms of the original SGP proved difficult. The 3 per cent deficit threshold was first exceeded by Portugal in 2001, followed by the Germany and France in 2002, the Netherlands and Greece in 2003, and Italy in 2004. In 2003 the Ecofin Council decided not to implement the excessive deficit procedures for Germany and France. This resulted in a major dispute between the Ecofin Council and the Commission. The Commission challenged the decision of the Council in the ECJ in 2004. The Commission asked the ECJ to decide whether Ecofin was legally entitled to act as it did by choosing not to impose sanctions despite agreeing that Germany and France were in breach of their Treaty obligations. The ECJ's ruling of 13 July 2004 favoured the Commission and annulled the Council conclusions on France and Germany. But, as Van den Noord *et al*. point out, it did not fundamentally change the situation, 'as it clarified that the Council could not be forced to take a decision against its will' (Van den Noord *et al*., 2008: 13). Likewise, Begg and Schelke (2004) interpret the outcome as effectively advising the Commission and Ecofin to find a sensible way forward.

Significant reforms were introduced to the SGP in 2005. The 3 per cent deficit and 60 per cent debt thresholds remained. The changes involved a shift from rules to a greater role for economic judgement and introduced greater flexibility. Each member state was required to develop 'medium term objectives' (MTOs) for fiscal policy. These MTOs could vary depending on a member state's initial debt level and growth potential. The SGP outlined how adjustments were to be made to reach the MTOs. The revisions provided a less stringent definition of 'exceptional circumstances' under which it was permissible to exceed the 3 per cent deficit target. Under the revised rules, negative growth (or very slow growth) relative to potential growth could be considered exceptional. Clarification was offered on what constituted 'other relevant factors' to be taken into account in determining whether a deficit was excessive.

It is clear that the SGP was not sufficient to protect the public finances from very large deficits in some member states in the current crisis. In the case of Ireland and Spain, the SGP was easily satisfied while the property markets were booming and the SGP may have contributed to complacency (FitzGerald, 2010). In the case of Greece, the European Commission has found persistent failures in the quality of government deficit statistics submitted under the SGP (European Commission, 2010c).

Prior to the crisis, Hallerberg and Birdwell (2008) argued that a comparison of government deficits before and after the introduction of the euro suggested that the SGP had improved fiscal discipline. They noted that the average government deficit in the original 12 euro states was 3.9 per cent of GDP in the years prior to the introduction of the euro (1991-98) while the average fell to 0.6 per cent in the following eight years (1999-2006).

In analysing the impact of the SGP, Hallerberg and Birdwell (2008) distinguish two ways of achieving fiscal discipline: the 'delegation' and 'contracts' modes of fiscal governance[12]. In the delegation approach, the power on budgetary matters is delegated to a strong finance minister. This works well in the absence of significant ideological conflict within the government. In the contracts approach, the parties in government make political, or sometimes even legal, commitments to fiscal targets. Hallerberg and Birdwell (2008) categorise member states on the basis of whether delegation or contracts is the expected form of fiscal governance. Delegation is expected to be used in one-party governments or in coalition governments in which there are not significant conflicts among the parties. The contracts approach is expected in coalition governments with more significant differences between the parties. Ireland was classified as an expected contract state in 1991, but an expected delegation state in 2000/4.

Hallerberg and Birdwell (2008) find a pronounced difference in the operation of the SGP between expected delegation and contract member states. In the period up to 2007, excessive deficits were much more likely in expected delegation states (six out of seven cases), while adherence to recommendations of the Commission was far higher (100 per cent) in expected contract states than in expected delegation states (34 per cent). They interpret the evidence as showing that in those states where contracts are expected, the SGP rules provide useful reinforcement of domestic rules, but the rules do not make a difference in expected delegation states. Typically in expected contract states,

12 This analysis is articulated in more detail in Hallerberg *et al* 2009.

parties in government make domestic commitments to the targets presented to Brussels, while this typically does not occur in the expected delegation states. This analysis points to the key role of domestic institutions within EMU. They conclude that the SGP 'regulations matter when they reinforce domestic institutions and not otherwise' (Hallerberg and Birdwell, 2008: 86). Ireland's experience with the SGP is discussed in Chapter 6, and the question of the possible role of domestic rules and institutions to secure future fiscal discipline is considered in Chapter 8.

Fitz Gerald (2010) points out that the current crisis reinforces concerns regarding the appropriate measurement of the fiscal stance across different regional economies within the eurozone and the diagnosis of the appropriate fiscal policy:

> Over the past eighteen months it has become increasingly clear that there is no simple model to measure appropriately the stance of fiscal policy in a regional economy within EMU and to diagnose the required fiscal medicine. The EU methodology for estimating the cyclical and structural deficits cannot cope with the shock to potential output experienced in many EU members that has resulted from the current crisis. ... For the Eurozone as a whole the development of a more sophisticated approach to monitoring the stance and appropriateness of fiscal policy is a task that needs to be addressed urgently (Fitz Gerald, 2010: 5).

Recent events have demonstrated beyond any doubt that members of a common currency area have a shared interest in the viability of the public finances of all members. Given the implications of the public finances of one member state for the euro and the EU as a whole, there is a case for greater EU involvement in ongoing surveillance of member states. The Commission's proposed reforms and recent decisions of the European Council are discussed in Chapter 8.

5.6 Structural Reform

The Lisbon process was designed among other things to strengthen sustainable economic growth in Europe. While significant reform did take place in many member states, there is broad agreement that many states achieved less than was intended at the launch of the Lisbon Strategy. Limited progress in tackling structural weaknesses is a contributory factor to the current economic weakness with implications for the public finances. However, countries with varying degrees of progress and considerable variation in their underlying economic strengths have entered sharp recessions and have severe public finance problems. There is no doubt that structural economic reform would contribute to the resolution of current difficulties including escaping from excessive debt problems. The peripheral European countries have experienced a loss of cost competitiveness in the euro area. Restoration of competitiveness can be achieved both through direct reductions in costs and underlying improvements in more structural dimensions of competitiveness. The Irish economy, with its strengths in international services and high-tech manufacturing, is better placed than other peripheral economies to achieve a return to sustainable growth and hence manage its high debt burden once the international economy recovers sufficiently. *Europe 2020* is the new EU strategy

for structural reform. This comprehensive strategy—encompassing economic growth based on knowledge and innovation, sustainability and socially inclusive growth—is discussed in NESC report number 122 to be published in Autumn 2010.

5.7 The Euro and Identity among Europeans

Many of the problems of the post-euro path involve failures of domestic political leadership. Especially in the larger euro-area states, political leaders have proved reluctant to 'own' EMU in the sense of facing up to, and providing, a legitimating formula for, the macro- and micro-economic policy implications of renouncing devaluation and interest rates as key instruments of domestic adjustment (Dyson 2009). At the head of this chapter we quoted Mundell—the father of international monetary economics—on the 'most important' likely effect of EMU. Contrary to Mundell's prediction, EMU does not seem to have changed the way European think about themselves and about a multilingual market that has become the largest in the world. In Chapter 8 we argue that a central challenge for the euro is to achieve greater political and popular buy-in to the euro as a project of prosperity, stabilisation and global governance.

5.8 Intra-EU Exchange Rate Policy Gradually Diminished in Significance

In interpreting the creation and evolution of the euro, it is important to note a significant, but little noted, development. As noted above, the path to the euro and the establishment of the new currency involved major developments in economic policy co-ordination. While the crisis of 2008-2010 has revealed co-ordination to be insufficient, it would be a mistake to overlook the deepening and widening of policy co-ordination in the past two decades. The overall framework of monetary and economic policy co-ordination was summarised in Figure 2.1. One side effect of the evolution of policy co-ordination was a reduced EU policy focus on intra-EU exchange rate movements. As discussed in Chapters 6 and 8, this is an important issue, given the dramatic depreciation of sterling in the past two years.

While we cannot provide a detailed analysis of the historical process, there has been an interesting evolution in the scope and nature of European economic policy cooperation. The general Treaty obligation to regard economic policies 'as a matter of common concern' goes back to the Treaty of Rome. In the wake of the unco-ordinated response to the economic shocks of the 1970s, and the consequent creation of the ERM and launch of internal market programme, focus was largely on 'convergence of economic and *monetary policies* necessary for the further development of the Community', with a particular focus on the balance of payments and the need to maintain confidence in member state currencies (Single European Act, Articles 102a and 104, emphasis added). That concern reflected the fact that exchange rate movements can have a number of negative spillover effects. While exchange rate movements can help restore equilibrium, they can also produce destabilising macroeconomic movements. They can constitute a 'beggar my neighbour policy', allowing member states to free ride on the benefits of unrestricted access to the market of all other member states.

Following the Delors report of 1989, the Treaty of Maastricht (1992) concretised the obligation to co-ordinate economic policies, defining a process of Broad Economic Policy Guidelines (BEPGs) and a system of multilateral surveillance (Article 99(2), now Article 121 of the TFEU). But at this point an interesting bifurcation began to emerge. The Treaty assigned the BEPGs two general objectives (Deroose *et al*., 2008). First, Article 98 obliged member states to 'conduct their economic policies with a view to contributing to the achievement of the *objectives of the Community*, as defined in Article 2'—which gave high priority to the internal market, employment and cohesion (emphasis added). Second, Article 99 (4) linked the BEPGs to EMU by stating that warnings and recommendations for corrective action may be made by the Commission and the Council where 'the economic policies of a Member State... risk jeopardising the proper functioning of economic and monetary union' (now Article 121.4 TFEU). Indeed, given the *de facto* suspension of the ERM in August 1993, the Commission explicitly saw the BEPGs as an attempt 'to allow the Community to get back to the convergence path needed to achieve EMU' (European Commission, 1993b: 1). Indeed, the numerical targets in the Treaty of Maastricht and the first BEPGs included definitions of 'sound public finances' and 'excessive deficits' which presaged the SGP which was agreed in 1996 and took effect in 1998.

Four important developments followed in the years 1993 to 2005. First, the BEPGs were widened to include labour market issues (reflecting the European Employment Strategy and the Amsterdam Treaty) and structural reforms (as set out in the Lisbon Strategy of 2000). Indeed, the number of guidelines increased from three in 1993 to 23 general guidelines, four euro area-specific ones, and 94 country-specific recommendations in 2003-5. Second, EU policy-makers became 'more circumspect about using peer pressure to enforce the BEPGs' (Dehousse *et al*., 2008: 838). Third, the euro was launched with some member states granted an opt out. The launch of the euro tended to focus attention on the national economic policies of *Eurogroup member states*. This reflected the view, as put in a Commission study, that spillover effects of one member state policy on others 'are typically more persistent in a monetary union than under a flexible exchange rate regime' (Van den Noord *et al*., 2008: 2). Fourth, a new exchange rate regime, the ERM II, was created to limit exchange rate volatility of currencies outside the euro area, because excessive 'fluctuations in their exchange rates with the euro' or 'misalignments' would damage 'the smooth operation of the single market' (European Commission, 2010e)[13]. The UK and Sweden do not participate in this exchange rate regime.

The net effect of these developments would seem to be a gradual reduction in the focus on intra-EU exchange rate movements and a weakening of policies to moderate them. We discuss this further in Chapter 8.

13 Seven countries now participate in ERM II: Denmark, Estonia, Lithuania, Slovenia, Cyprus, Latvia and Malta. Greece and Slovakia participated in the regime prior to their adoption of the euro (in 2001 and 2009 respectively).

6

Interpreting Ireland's Experience and Policy in EMU

This Chapter interprets Ireland's experience of monetary union and evaluates key policies. Section 6.1 provides a brief statement of key aspects of Ireland's economic performance in EMU: the housing and construction booms, the growth of credit, above-average inflation and loss of cost competitiveness. Section 6.2 examines commentary on the Irish economy over the first decade of EMU. There is a particular focus on how the emerging pressures were interpreted prior to the economic crisis. Section 6.3 then considers the scope of domestic policy to address the pressures that built up in the economy during this period. The factors that shaped fiscal policy are examined in Section 6.4; these include both technical factors and political economy influences. The counter factual of what might have happened if Ireland had not joined EMU is explored in Section 6.5. Section 6.6 concludes the chapter with a discussion of the prospects for Ireland's public finances.

6.1 Key Aspects of Ireland's Experience in EMU

In the late 1990s, the Irish economy was experiencing strong growth, balanced between growth of exports and domestic demand. Growth became increasingly driven by domestic demand over the past decade although growth of services exports remained strong. A major feature of the Irish economy during the current decade was the housing and construction boom and subsequent collapse. Second-hand house prices doubled between 1999 and 2005. Irish incomes had approximately converged with the EU average by the turn of the century but the housing stock relative to the population was substantially below the EU average. Growth in house prices stimulated a major increase in housing output. By 2005 construction accounted for 13.9 per cent of Irish GDP. This was exceptionally high both by historical Irish standards and compared to other countries. The share of construction in Spain, which also had a housing boom, reached 8.9 per cent of the economy in 2005 while in the UK housing was only 3.9 per cent of GDP (Conefrey and Fitz Gerald, 2010).

While there were good reasons for strong growth in house prices in Ireland, Irish house prices grew well ahead of what could be explained in terms of fundamental economic factors. Kelly (2009) has emphasized the extent to which house prices were driven by very strong growth in credit (see Table 6.1). Lending by Irish banks to the Irish private sector (individuals and businesses) increased almost five fold between 1999 and 2008 to reach €367.1 billion by 2008. This was far ahead of the expansion of the economy. In 1999, lending represented approximately 100 per cent of GNP while by 2008 it had risen to 237 per cent of GNP.

The expansion of lending relative to the size of the economy was particularly strong between 2003 and 2008. Lending outstripped the growth in deposits of Irish banks so banks became increasingly reliant on lending from abroad. The net indebtedness of Irish banks to the rest of the world increased from 10 per cent of GDP at end of 2003 to 60 per cent of GDP by 2008 (Honohan, 2009). A particular feature of bank lending was a high concentration in commercial property.

Table 6.1 Trends in Lending of Irish Banks

	1999	2003	2008	2010 (April)	% change 2003 to 2008
Loans to Irish private sector	€76.9	€143.8	€367.1	€328.4	155.3
Loan to GNP ratio	100.1	121.8	237.5	255.6	95.0

Source Central Bank, *Quarterly Bulletins*, Tables C4 and C5; based on balance sheets of retail clearing banks and non clearing domestic banks. The private sector in this table excludes the government sector and monetary financial institutions.

The question arises as to why Ireland experienced such a pronounced housing and property bubble and associated major expansion in credit, followed by the collapse of the bubble. This issue has been the subject of two reports commissioned by the Minister for Finance (Honohan, 2010; Regling and Watson, 2010). These reports identified a series of domestic and external factors that caused the crisis, with the Honohan report particularly emphasising the domestic factors. Relevant contextual factors include the following. First, the period after 2003 was characterised by very liquid conditions in global financial markets. Financial intermediaries in this period searched for higher yields. Second, Ireland's entry to the euro reduced the risk premium on Irish interest rates while membership of the euro also facilitated the ability of banks to raise funds across borders. Third, there was also increased competition at retail level in European countries, particularly in peripheral countries and the new member states. In Ireland this took the form of the subsidiaries of UK banks becoming more active in the Irish market; these subsidiaries offered mortgages at a small premium to money market rates and also offered 100 per cent loan to value mortgages (Regling and Watson, 2010). Internally, the major banks in Ireland also experienced strong competitive pressure from Anglo Irish Bank. Fourth, globally there was a debate on financial regulation and 'some shift away from intrusive supervision, and also a relative neglect of liquidity risks' (Regling and Watson, 2010: 36).

This environment posed major challenges for Irish banks and it is clear that the challenges were not met. Irish banks relaxed their lending standards and funded the huge housing and property bubbles. The role of policy in contributing to these problems is examined below.

Another significant element of Ireland's experience of monetary union was above-average inflation and a loss of cost competitiveness. After 2007, Ireland's cost competitiveness was further reduced by the dramatic fall in the value of sterling. The value of the euro against sterling increased by 36 per cent between January 2007 and December 2009; over the period January 2007 to June 2010, the net increase was 26 per cent.

6.2 Economic Commentary in the First Decade of EMU

It is possible to identify a number of warning signals of imbalances that emerged during the boom years. These include the dramatic rise in house prices in excess of what could be explained by economic fundamentals, the exceptionally high share of construction in the economy, the very strong growth of credit and rising external indebtedness of Irish banks and the emergence of balance of payments deficits. It is relatively easy to identify such warning signals now. The question arises as to what extent such signals were seen earlier and relevant policy actions recommended.

6.2.1 European Commission

An early, prominent criticism of Irish fiscal policy under EMU came from the European Commission in 2001. The Commission regarded Ireland's 2001 budget as excessively expansionary given the strength of the economy, notwithstanding the substantial projected budgetary surplus. Ireland's budget plans were considered to be inconsistent with the EU's Broad Economic Policy Guidelines (BEPGs). Fitz Gerald (2001) and Barry and Fitz Gerald (2001) supported this critique by the European Commission. However, assessments of Irish budgetary policies by the European Commission in subsequent years were broadly positive. In 2007, the European Commission concluded as follows from its assessment of Ireland's Stability Programme for the public finances:

> The overall conclusion is that the medium-term budgetary position is sound and, provided the fiscal stance in 2007 does not prove pro-cyclical, the budgetary strategy provides a good example of fiscal policies conducted in compliance with the Stability and Growth Pact. In any case, it would be prudent on grounds of preserving stability to maintain room for manoeuvre against any reversal of the current growth pattern which has been led by strong housing sector developments (European Commission, 2007b: 6).

Ireland easily satisfied the government deficit and debt requirements of the SGP, up to the economic crisis. The excessive level of private borrowing that damaged the economy was not the focus of the SGP.

6.2.2 ESRI

The ERSI's *Medium-Term Review* (MTR) of 2001 criticised the sharp fall in the budgetary surplus that occurred from 2000 to 2002 while the economy was still growing rapidly, thereby adding to inflationary pressures and a loss of competitiveness. However it considered that the public finances were now back in control and viewed the overall stance of fiscal policy as broadly appropriate. It referred to the possibility of using fiscal policy to limit demand for housing and proposed that if inflation were to continue in the housing market that it might be prudent to take fiscal action.

The 2005 ESRI MTR devoted considerable attention to the risks emerging in the housing market and expressed concern that excessive expansion of the construction sector was bidding up costs in the economy. It considered that a soft landing was increasingly unlikely and noted that a shock to the housing sector could have very serious consequences for the domestic economy. The impact of a shock to the housing sector, whereby housing output fell by 40 per cent, was considered and it was estimated that such a shock could reduce GNP growth to close to 1 per cent in the year that the collapse occurred. It proposed that action be taken to limit demand in the building sector. It considered a number of possibilities and concluded that the most feasible was probably the ending of all tax reliefs for property investment. The ending of the bulk of property tax reliefs on a phased basis was announced in the 2006 budget, with reliefs being phased out by 2008. The MTR also pointed out that it was appropriate for the public finances to run significant surpluses so long as the economy was continuing to grow rapidly.

6.2.3 OECD and IMF

Regular surveillance of Irish economic policy is also provided by the OECD and the IMF. Both of these identified the risks in the housing market during the boom years and expressed concern in regard to inflationary pressures. For example, the 2004 IMF survey noted that the 'extent, scale and duration of the (property) boom in Ireland set it apart' (IMF, 2004: 18). It noted that there were real factors that could explain why Ireland was experiencing an exceptional property boom, but in regard to house prices, it expressed the view that 'there are elements of exuberance beyond those suggested by the fundamentals, particularly in the light of the massive increases in supply seen recently' (IMF, 2004: 19). The IMF considered that there was a strong case for removing the interest deductibility of mortgage payments on primary residences and introducing a property tax. It also advocated a modest degree of fiscal tightening.

The 2006 OECD review of the Irish economy identified housing as the key domestic risk facing the economy (OECD, 2006). At that stage it considered a soft landing as the most likely outcome, but noted that this was not guaranteed. It discussed the risks posed both by a sharp fall in prices and sharp decline in output. The benefits of a property tax were identified but the difficulties of implementing it were noted given the very high level of home ownership. The windfall nature of some current revenue was identified; in particular, stamp duty, capital gains tax and corporate tax receipts. It advocated a prudent fiscal policy to leave sufficient room for manoeuvre. 'In practise, this means returning to balance or running a small surplus' (OECD, 2006: 17).

Both the IMF and the OECD advocated modest fiscal tightening during the boom years but the overall tone of their assessments was positive (O'Leary, 2009b). The IMF's 2007 overview on the Irish economy found that:

> Fiscal policy has been prudent, with a medium term fiscal objective of close to balance or surplus, in line with Fund advice. In the past couple of years, windfall property related revenues were saved and the fiscal stance was not procyclical, in line with Fund advice (IMF, 2007:3).

While both the OECD and the IMF identified risks facing the Irish economy, neither identified the extent to which the public finances were reliant on temporary sources of revenue. All of the bodies undertaking external surveillance of the Irish economy produced regular estimates of the structural budget balance; i.e., the budget balance adjusted for the economic cycle. During the boom, these estimates failed to reveal the underlying deficits that were emerging (O'Leary, 2009b). In its 2007 report the IMF estimated that structural budget balance was for 2007 was a surplus of 0.7 per cent of GDP, implying healthy public finances. However, by 2009 the picture looked very different. For example, the IMF's 2009 review estimated that the structural budget deficit was 8.7 per cent of GDP in 2007. This implied that, allowing for the effects of the boom, there was a large deficit in the public finances in 2007, notwithstanding the actual small surplus in that year. Of course, as O'Leary (2009a) has pointed out, this estimate was constructed with the benefit of hindsight.

6.2.4 NESC

In its 1999 Strategy report the Council argued that it is helpful for policy-makers, the social partners and the wider public to discuss the steps that would be called for by serious shocks to the Irish economy within the euro. 'The purpose of discussing certain scenarios is not to forecast the future but to highlight the relationship between the state of the economy, the tools of stabilisation (fiscal and labour market policies including competitiveness) and the goals of maintaining employment and living standards in ways that promote social cohesion' (NESC, 1999a: 158). The Council asked: 'How might a small economy be affected by a major economic disturbance and what should be the response of policy makers?' (158). Three kinds of possible disturbance were discussed:

- a currency shock, such as a large sudden fall in the value of sterling;
- reduction in demand for European (including Irish) goods, perhaps caused by a financial crisis or sharp fall in the US stock market; and
- a purely domestic shock to the Irish economy; in this case the Council considered the effects of a positive shock, which boosts output employment in the Irish market.

Special mention was made of the housing market 'because of the risk that an economic shock could be considerably aggravated by the susceptibility of the present 1999 levels of house prices to an economic downturn' (1999: 158-9).

From its discussion of these scenarios, the Council derived four main general policy conclusions. First, the impact of a currency shock would be reduced by relatively rapid wage and price adjustments. Second, fiscal policy should seek to maintain substantial overall budgetary surpluses at close to present (i.e. 1999) levels. Third, under conditions of strong growth, economic policy should seek to to ensure that income expectations do not outstrip the capacity of the economy to meet pay demands. Finally, since a house price bubble would greatly increase the vulnerability of the economy, economic stability would be improved by bringing housing supply further into line with demand.

Over the past decade, the Council has proposed that fiscal policy should be conducted in accordance with two core principles: sustainability and stabilisation. The latter implies that at a minimum, it is desirable that the public finances should not add to cyclical fluctuations in the economy and, in general, when the economy is performing well, flexibility should be maintained in order to provide scope for some relaxation of fiscal policy in economic downturns (NESC, 2002a). In addition, the Council supported the management of the public finances in accordance with the EU's SGP.

The Council examined Ireland's housing system in NESC (2004). This study found that given the remarkable strength of demand, 'a significant increase in Irish house prices was inevitable' (NESC, 2004: 1). However it expressed concern at the pattern of housing development:

> Problems of long-run sustainability and rising prices were exacerbated by the dominance of low-density housing in the context of poor transport infrastructure. The predominance of dispersed low-density, car-dependent, green-field development, especially in the East region, was a consequence of a set of land-use, planning and transport systems which did not accommodate a sufficient supply response in and near the main cities (NESC, 2004:1).

In 2005, NESC pointed out that the buoyancy of revenue was, in part generated by the construction boom. 'Not all of this revenue is sustainable and the public finances are vulnerable to a fall in construction output' (NESC, 2005b: 251). The Council identified a number of risks to continued strong economic growth 'including a sharp correction of the property market, a sustained loss of competitiveness or a contraction of the global economy stemming from a correction of the US current account deficit' (NESC, 2005b; 251). In this context, it observed that 'There is a risk that the current flexibility in the public finances could result in excessive short-term variations in tax or expenditure, even within the SGP limits. There is some evidence that this has occurred in the past' (252). The *NESC Strategy 2006* recommended keeping the government deficit within 1 per cent of GDP. Up to the economic crisis the deficit was well within this limit.

6.3 Policy Instruments in EMU

6.3.1 Focus on National Policies and Systems

During the boom of the past decade, membership of monetary union implied that Irish interest rates could not be increased to moderate the boom. There are a number of alternative policy instruments that could have been used for this purpose: aggregate fiscal policy, targeted fiscal policy, financial regulation and planning and land management. Each of these is now discussed.

6.3.2 Aggregate Fiscal Policy

First, fiscal policy could have been used to offset some of the very strong private demand in the economy. Fitz Gerald (2010) has pointed out that, given the conditions in the Irish economy during the recent boom, a rising surplus would have been appropriate: 'a continuing structural surplus has a neutral impact on the economy. It is only as the structural surplus rises, and as increasing sums of money are taken out of an economy, that the impact of fiscal policy is to reduce (excessive) demand' (Fitz Gerald, 2010: 3). It is interesting to consider what policy and/or analytical process might have led to such a policy in real time. The fiscal policy pursued during Ireland's economic boom is discussed below (Section 6.4).

6.3.3 Targeted Fiscal Policy to Moderate the Construction Boom

Second, it would have been possible to use instruments targeted at the excess demand in the housing market. Relevant measures include: the ending of property tax reliefs or mortgage interest relief, the introduction of a property tax (Fitz Gerald, 2001 and Fitz Gerald *et al*., 2005). In the discussion of possible UK entry to monetary union, Muellbauer (2003) pointed to the beneficial stabilising effects of both property and land taxes; he suggested that the Danish land tax helped to increase land supply counter cyclically. Muellbauer proposed that rate of a UK property tax would be set by the Monetary Policy Committee of the Bank of England, analogous to the setting of interest rates.

6.3.4 Better Financial Regulation

Third, in view of the critical role of excessive credit creation in driving the economy, better financial regulation could potentially have helped limit the excessive growth of demand. Financial regulation is also critical in maintaining the solvency of the financial system.

The role of financial regulation in Ireland's banking crisis is the central focus of the Honohan (2010) report and also features in the Regling and Watson (2010) report. Both studies place the issue of financial regulation in the wider national and international economic context—adopting an analysis similar to that of the NESC in our March 2009 report *Ireland's Five Part Crisis* (NESC 2009a). While placing the major responsibility for the banking crisis on directors and senior bank management, as well as significant responsibility on fiscal policy, Honohan's report states that 'it is clear that a major failure in terms of bank regulation and maintenance of financial stability failure occurred' (Honohan, 2010: 7). Significant weaknesses in both micro-prudential and macro-prudential regulation are identified. Honohan found that there was awareness of risks internally from excessive expansion of property-related credit and actions were initiated to address these risks. The Regling and Watson report noted that the Irish authorities were more active than many supervisors in other property boom economies in their decision to impose heavier capital weights on high loan-to-value mortgages. However, Honohan considered that the actions taken were 'tentative and timid' and 'implemented too late and were wholly inadequate to alter behavior' (112). Honohan found that there was a tension, never fully resolved, 'between the need to stop the excesses and the fear that too sharp an intervention would send the economy into an avoidable tailspin' (122). Key actions such as banning 100 per cent mortgages would have encountered consumer resistance and run counter to the then prevailing international regulatory fashion.

In addition, three specific interrelated concerns that seem to have militated against more decisive action are identified by Honohan. First, there was the concern that stronger regulatory action would have adversely affected the competitiveness of credit institutions regulated by Ireland's Financial Regulator. Second, a related concern was that stronger regulation would have adversely affected Ireland as a location for financial services investment. A third concern was that more aggressive use of key instruments to restrain lending would have been contrary to the spirit of principles-based regulation. Honohan examines these concerns but does not accept that they were valid reasons for avoiding stronger actions. On the question as to whether more decisive action would have made a difference to the outcomes achieved, Honohan is unambiguous: there were key instruments available—for example, a far greater increase in capital requirements for risky loans—that would have made a difference, if implemented.

6.3.5 Planning and Active land Management

The impact of investment in housing was shaped by policies on planning and land management and more effective policy is this area could have secured better outcomes. Housing demand was artificially stimulated in areas of low underlying demand while the supply response was slower than desirable in and close to Dublin city (see NESC, 2004 and section 6.4).

6.3.6 A Combination of Fiscal, Regulatory and Structural Measures

With a range of possible tools available during the economic boom, the question arises as to what would have been the best combination of measures to adopt. There is no doubt that higher surpluses in the public finances during the boom years would have been desirable and, indeed, some euro-area members had higher surpluses. However, what was distinctive about Ireland's experience was not the scale of the surplus in the public finances during the boom but the speed of decline in the economy and the public finances when the economic crisis occurred. This suggests that in the first instance it would have been more important to avoid the excessive private lending and property investment, rather than seeking to offset excessive private lending and property investment with higher government saving. This implies measures targeted at restraining the housing boom and stronger financial regulation. A potential limit to the scope of regulation within Ireland arises from the ability of institutions not regulated by the Irish central bank/financial regulator to meet demand for credit, if it were not provided by Irish-regulated institutions (Conefrey and Fitz Gerald, 2010). Honohan considered the issue of the competitiveness of Irish regulated institutions, but nonetheless found that 'decisive intervention could have made a major difference to the length and extent of the property boom' (Honohan, 2010: 13).

In the crisis of 2008-10, the pace of decline in the public finances was even greater than the decline in economic output. A more active approach to land management, planning and housing provision could have met the increased housing need with less expansion of the overall construction industry and less overheating of the housing market. Ireland's tax structure had become increasingly dependent on cyclically-sensitive taxes (corporation tax, stamp duty and capital gains tax): the share of these taxes in exchequer tax revenue increased from 8 per cent in 1987 to 30 per cent in 2006 (Honohan, 2010). A more stable tax structure could have significantly reduced the extent of the revenue downturn in the economic crisis.

6.4 Factors Shaping Irish Fiscal Policy in EMU

The principles which should govern the fiscal policy of a small member state in EMU are relatively clear. First, as noted above, fiscal policy must be seen as the major instrument for stabilisation. Second, the ideal is to run sufficiently large surpluses during boom periods in order to finance the loss of revenue and increased spending commitments during downturns. This means that automatic stabilisers will be available. Third, the optimal deployment of fiscal policy for macroeconomic stabilisation is consistent with either a large or small public sector and tax share of GDP. Fourth, in addition to the overall macroeconomic stance, fiscal policy can also operate via microeconomic channels, such as incentives to the property sector, taxes on employment and measures to influence consumption.

The application of these principles was not straightforward in the past decade, for reasons discussed below. If we are to learn from this episode it is important to reflect carefully on the thinking and pressures that shaped fiscal policy. Reflecting on the experience of the past decade we see that while some things were *uncertain*, other, closely related, issues were *unresolved*. Technically, there was *uncertainty* about three related, but critically important, factors:

- The difficulty of judging the temporary and permanent elements of GDP growth (i.e., estimating the 'output gap'). This required assessing the relative size of three possible drivers of output growth: the genuine expansion of Ireland as a regional economy, the economic cycle and an asset price bubble;
- Distinguishing the temporary versus permanent components in the tax base—a partially separate question because of reliance on asset-based taxes; and
- The timing of the end of the housing boom and, among some, disbelief that it was fundamentally temporary in nature.

These technical uncertainties interacted with, and partly reflected, lack of *agreement* on key dimensions of Ireland's political economy concerning:

- The appropriate scale of the public sector—since part of the expenditure growth since the late 1990s may be attributed to catch-up dynamics and trend shifts in the size of the Irish public sector;
- The organisational and accountability system necessary for high-quality, responsive, public services, the scale of which was increasing;
- The appropriate level and incidence of taxation;
- The best way of meeting increased housing need and the associated approaches to housing and land management; and
- The sources of Ireland's long-term prosperity and the steps necessary to move to the innovation-driven stage of development.

Though contested, positions on these issues were necessarily reflected in public policy. The tax windfall created by the property boom allowed the contested issues to be glossed over and the bigger picture to fade from view. The abundance of tax revenue, the employment and income effects of hyper-growth and the surge in construction meant that many of the pressures, listed above, could be partially

met, but in ways that were ultimately inconsistent and unsustainable. Indeed, the eventual crisis revealed both the mistaken assumptions which underpinned fiscal policy at certain moments and, once again, the cost which the country pays for lack of shared understanding and effective policy on key macroeconomic, distributional and structural issues. In this context, *aggregate fiscal policy was shaped by its components*: capital spending, current spending, public saving and taxation. In the context in which technical issues were uncertain and political economy issues were unresolved, the *macroeconomic* perspective on fiscal policy was relatively muted.

Consequently, the policy lessons of Ireland's first decade in EMU would seem to include both medium-term and immediate elements:

(a) The principles of counter-cyclical fiscal management and regulation identified above;

(b) A more thorough resolution of the distributional tensions and structural weaknesses that tend to create pressure for pro-cyclical fiscal policy and, indeed, crowd-out clear analysis of the macroeconomic context;

(c) The need to avoid destabilising bubbles in the economy; and

(d) Most urgently, a combination of fiscal measures, structural reforms and distributional settlements that create a path through the crisis.

The sharp decline in the Irish economy and in Irish tax revenue illustrates that some of Ireland's economic growth during the past decade was not sustainable in a conventional economic sense. There are also deeper issues concerning the environmental and social sustainability of economic growth. The current crisis is a reminder of the importance of more effectively addressing all dimensions of sustainability.

6.5 If Ireland had Not Joined the Euro

In considering the possibility of staying outside the euro, Lane distinguishes between two types of country (Lane, 2010b). For mature, advanced economies with a strong tradition of monetary independence, it is feasible to chart an independent course, with the domestic central bank focused on delivering price stability and the protection of financial stability. This group includes the United Kingdom, Norway, Sweden and Switzerland. A second group of countries are those with less reputation for price stability, uncertain long-term growth, where firms, households and governments are more likely to incur foreign-currency liabilities and in which speculative capital flows are more prominent. In such countries, the exchange rate is less likely to play a stabilising role. Indeed, the boom and bust cycle can be amplified by exchange rate movements and interest rate policy.

Indeed, the destabilising currency and interest rate dynamics that can play out in emerging economies have been most vividly illustrated by the meltdown of the Icelandic financial system. These pressures are also weighing heavily on a number of Central and Eastern economies, with a variety of strategies being adopted in relation to currency management. A number have already required international support in the form of foreign-currency official loans.

Lane explains that Ireland represents an intermediate case, in that it shares some characteristics with the former group but is also quite similar to the latter group along some key dimensions. In particular, the extraordinary 'Celtic Tiger' growth narrative would plausibly have led to considerable speculative capital flows and strong currency appreciation, posing severe stabilisation challenges if Ireland had remained outside EMU. Moreover, the global liquidity glut during the 2003-2006 period would have encouraged the accumulation of significant foreign-currency debt by Irish banks, corporations, property developers and households, especially if domestic interest rates were high relative to foreign-currency interest rates. In turn, the onset of the current financial crisis could have triggered a destabilising speculative capital outflow (with both foreign and domestic investors seeking to exit), currency depreciation and a more complex type of banking crisis, where financial difficulties could have been augmented by a severe foreign-currency debt problem and an inability of the Irish central bank to provide sufficient foreign-currency liquidity to domestic banks. By this scenario, membership of EMU has provided considerable insulation from the full potential impact of the crisis, since adverse currency dynamics have been avoided and the ECB has acted as the liquidity provider to the domestic banking system.

6.6 The Prospects for Ireland's Public Finances

Notwithstanding the very high deficit in the public finances, there are a number of reasons why Ireland's public finances can withstand current pressures. First, Ireland had the benefit of entering the current crisis with one of the lowest government debt levels in the euro-area. Ireland's government debt to GDP ratio in 2007 was 25 per cent compared to a euro-area average of 66 per cent. Ireland used its current budget surpluses during the boom years to fund public capital investment and achieved budgetary surpluses in virtually every year since the establishment of monetary union even after funding a high level of public investment. At the end of 2009, Ireland's debt had risen to 64 per cent of GDP. Greece has an exceptionally high level of debt, with a debt to GDP ratio of 115 per cent at the end of 2009. Second, the official debt figures do not take account of cash balances or other financial assets. Ireland's debt to GDP ratio, net of cash reserves and the assets in the pension fund at the end of 2009, was 39.5 per cent of GDP. Third, the public authorities in Ireland have demonstrated their commitment to restoring balance in the public finances. The ratification of the Croke Park agreement on public services by a two to one majority demonstrates widespread agreement on tackling some dimensions of Ireland's crisis.

On the other hand, Ireland's national debt figures do not reflect the obligations that the State has taken on for the liabilities of the banking sector. The ESRI's *Quarterly Economic Commentary* (QEC) of spring 2010 considers that net cost to the state could be 'of the order of €25 billion or more'. This is the equivalent of approximately 15 per cent of GDP in 2010. The QEC refers to this cost as 'manageable', although there is obviously a huge opportunity cost in terms of possible alternative uses of this money for economic or social investment. The QEC of summer 2010 projects that there will be capital transfers of a totoal of €13 billion to Anglo Irish Bank and Irish Nationwide during 2010 in the form of promissory notes.

Restoring balance to the public finances would be greatly facilitated by economic recovery. This depends in the first instance on a global economic recovery. If Ireland participates in a global economic recovery, this will greatly reduce our deficit. There are a number of factors that point to Ireland being reasonably well placed to participate in a global economic recovery. First, Ireland's total exports have held up well in the current environment although traditional manufacturing and tourism have been badly hit. Second, there has been some progress towards restoring competitiveness with falling prices and improvements in relative unit labour costs. Third, Ireland has already made a large adjustment in its balance of payments. A low deficit or surplus is an indicator of financial resilience. The ESRI's QEC of summer 2010 projects that the current account of Ireland's balance of payments will move into surplus during 2010 while a small surplus of 0.25 per cent of GNP is forecast for 2011.

There are a number of caveats to this assessment. First, any economic recovery will require an increase in credit provision from the banking system. In the current recession, both the supply and demand for credit have fallen sharply. Supply of credit could become a more pressing issue as the economy recovers so further action may be required to ensure an adequate level of credit. Second the sharp fall in sterling against the euro since 2007 has placed additional pressure on sectors exposed to strong UK competition; the partial reversal of this trend during 2010 is helpful.

7

From Interpretation to EU Policy Challenges Now

In Chapter 2 we outlined the basic design of EMU, drawing attention to its most prominent features: the strong division of labour between the ECB (with responsibility for monetary policy) and the member states and social partners (with responsibility for macroeconomic surveillance, fiscal policy and structural reform). At the heart of this regime was the reluctance to take any step that would engage the ECB in '*ex ante* co-ordination' and thereby in a political process that might push it to compromise its independent pursuit of price stability. This regime was summarized in Figure 2.1. The overall successes and failures of the euro can be expressed and discussed in terms of this core design feature. Two broad conclusions seem hard to avoid.

First, in its own terms, the design did not work well to produce the outcomes that were hoped for. In a technical sense, this is confirmed in studies of fiscal policy co-ordination and reform and in various evaluations of the Lisbon Strategy undertaken since 2003, including the Commission's own review (European Commission, 2010f). In a more elementary sense, it has to be true, given the severe economic, financial, banking and fiscal crisis that confronts the member states of the euro area and the EU as a whole. Later we suggest that the less than optimal combination of independent monetary policy and 'implicit co-ordination' may have resulted, in part, from the limited policy buy-in to, and social identification with, the euro as a project; indeed, this, in turn, may have been an unintended consequence of the strong division of labour that characterised the overall design.

Second, despite some real strengths, the design itself was too narrow in treating all unemployment as structural, all shocks as supply-side and all necessary adjustment achievable at the national, sectoral and firm level. It thereby denied the possible significance of genuinely macroeconomic problems at the European level and of macroeconomic imbalances within the euro-area.

However, these conclusions do not imply that we should reject this way of describing the policy challenges of the euro. But they do imply that we recognise that the relationship between the centralized monetary function and the more decentralised stabilisation, structural reform and macro-dialogue is more complex than originally conceived. Instead of interaction in one way, we can identify at least three sets of relationships between them:

- The relationship as envisaged in the original design—in which the economic effects of an independent monetary policy are determined by the success of structural reform;
- A relationship in which the feasibility and effectiveness of structural reform is shaped by overall macroeconomic and growth conditions; and

- A relationship in which the effectiveness and legitimacy of EMU, in a monetary and economic sense, is shaped by the degree of political and popular buy-in to, and identity with, the euro as a major European project for stabilisation, prosperity and global governance.

We explain each of these relationships below.

First, there is, undoubtedly, the relationship emphasised in the original design of EMU: inflation and debt damage economic performance and society, sometimes profoundly; democratic political processes can, systematically, create pressure for more inflation and debt than is optimal. In any given monetary context, good economic performance depends on structures, markets, welfare and income determination that support productivity and participation. There is real enduring truth in the case for a fair degree central bank independence and clear division of labour between monetary and other policy areas, quite apart from the (important) fact that such a division of labour was a constitutive element of the inter-state bargain that created the euro. Furthermore, there is a strong case for a decentralised approach—with some form of open co-ordination—to most of the supply-side issues that were addressed in the Luxembourg, Cardiff and Lisbon processes. Recognition of these points has important implications for how reform of the euro area should be designed and communicated, as we discuss below.

Second, the achievement of fiscal stabilisation and structural reform at member state level can be aided or made more difficult by the overall macroeconomic context. This can occur in a number of different ways. It has been argued that debt reduction and reform in Ireland, and other member states, in the run-up to euro membership and the early years of the new currency were made easier by strong growth. In like manner, there is evidence that reform was at times more difficult—more enmeshed in the thickets of domestic politics—when there was slow overall European growth and limited resources to compensate those challenged by reform (Dyson, 2009). Indeed, it might also be the case that fiscal and structural reform were at times made harder by the buoyant conditions created by low real interest rates and, importantly, the strong flows of finance to the periphery, reflecting increasing macroeconomic imbalances within the euro area. The easy access to credit—which was in part an EU-wide macro-financial phenomenon—boosted activity (including construction bubbles) and created extra revenue. The apparent rise in market-based prosperity may have deflected attention from deeper economic challenges. The buoyant revenues may have allowed public systems and transfers to be increased without the need for reform. Here we go beyond the relation between monetary/macro policy and structural/fiscal reform as conceived in the core design of the EMU.

Third, the effectiveness of the overall arrangement (with its sharp division of labour between ECB-determined monetary policy and member state-led structural reform) seems to be shaped by the degree of political and popular identification with the euro and understanding of the division of labour and responsibilities inherent in membership. Across the euro area as a whole there would seem to have limited political and social buy-in to the euro and limited emergence of a euro identity around a shared understanding of the challenges of stabilisation, employment and development (Dyson, 2000). If this absence was evident in a low key way over the years 2000 to 2008, it seemed acutely evident in the crisis of the past two years. But, the need to respond to the crisis may, ironically, be a catalyst in the creation of a euro identity.

If the relationship between the two elements of the original design depends on political buy-in and popular identification, it is worth asking why this was so muted. There are probably many reasons. It seems that the understandable German reluctance to give a strong political component to the euro, especially monetary and macroeconomic policy, instead of heightening the degree of member state engagement in those areas where member states *are* the key actors—the Lisbon, Luxembourg, Cardiff and Cologne processes—actually meshed with member state *reluctance to share sovereignty* over fiscal policy, employment, structural reform or macroeconomic dialogue[14]. Thus, these processes—despite an ingenious design, a very promising start in the late 1990s and some real achievements after the launch of the euro—have, in significant respects, failed to produce fiscal stabilisation, employment creation, structural reform and consensus on overall economic management. Is it an exaggeration to say that far from chaffing against their exclusion from monetary policy, member states took it as a template for limited engagement in a range of other areas? Instead of balancing a definite and deliberate loss of sovereignty in monetary policy with enhanced collective action on economic policy, they were inclined to balance it with retention of sovereignty in the economic area[15]. They met independence with independence, rather than collective action. This was compounded by lack of understanding of, and buy-in to, the benchmarking processes that were critical in making the fiscal and reform processes effective—a theme we discuss further in Chapter 8.

14 Dyson makes a similar point when he says 'The context in which co-ordination issues have been resolved is an asymmetry in state attitudes to ceding and sharing sovereignty ... While states were relatively happy to acknowledge the benefits of central bank independence, no such supportive context existed for ceding fiscal or economic policy sovereignty, even sovereignty over banking and financial market regulation and supervision, to technicians. Fiscal and economic policy decisions involved complex value judgements and trade-offs that rested on political legitimacy, not least with respect to taxation, whilst rescuing banks in the collective interest required use of tax-payers' money. Hence EMU did not involve economic and fiscal union or a European-level banking supervisory authority' (Dyson, 2009: 162).

15 Dyson says 'States were even less willing to make 'hard' commitments to economic reforms, notably in some areas of product markets (like energy), services, labour markets, and – to stimulate employment – welfare states. Neither Lisbon I nor Lisbon II was armed with teeth to enforce clearly formulated reform commitments. An exception was the financial market regulation and supervision, where the so-called Lamfalussy process (2001-) accelerated reforms. Even here, it remained unclear who would assume responsibility in the case of crisis in a financial institution operating across borders. Again, there was an unwillingness to cede sovereignty in banking supervision either to the ECB or to a European financial services authority' (Dyson, 2009: 162; see also Posner, 2010)

8

Policy Challenges and Possibilities

8.1 The Argument in Outline

In this closing chapter we discuss the policy challenges which face the euro area, the EU and its member states. Our purpose is to identify the issues which the EU must come to grips with in order to secure the euro and address the existing and possible problems confronting both individual member states and the European economy as a whole. It is not intended to make specific policy recommendations, but to describe the existing and possible policy challenges and the blockages which might prevent the Union responding effectively. NESC seeks to articulate a range of considerations and perspectives that might assist the EU in overcoming the risk of deadlock. Since there are complex issues involved, it is useful to outline the argument here.

In Section 8.2 we describe the initiatives taken by the EU in recent months to address the crisis in the euro area. These include the package agreed to help Greece meet its funding needs and the wider stabilisation mechanism. They also include agreement on ways to improve the functioning of the Stability and Growth Pact (SGP) and the establishment of a Task Force, Chaired by President Van Rompuy, to explore longer-term possibilities to improve economic policy surveillance and co-ordination in the euro area. We finish Section 8.2 by noting that, notwithstanding these important steps, there are grave dangers on four fronts: the effectiveness of the stabilisation mechanism provided to Greece, the recovery of the whole European economy in the context of fiscal austerity, the continuing risks to the financial system at both global and European level and the cross-border damage done to member states and the internal market by large movements in the exchange rate of individual countries, particularly sterling.

However, since identifying these dangers might be seen as special pleading in a country which faces a severe deficit, before discussing them in any detail we insert, in Section 8.3, a strong affirmation of Ireland's belief in sustainable public finance and national responsibility to achieve structural reform to enhance productivity, sustainable growth and social inclusion. Only in that context is it appropriate to name the fact that—even with the measures taken in recent months and the issues to be explored in President's Van Rompuy's task force—at least four serious economic dangers remain.

We outline these four dangers in Section 8.4—drawing on international economic commentary and debate. In Section 8.5 we explain that these dangers have prompted some economists and other actors to propose more ambitious policy measures. At various times in the history of European integration, and again in recent times, these include: greater co-ordination with a focus on the aggregate EU fiscal stance, deeper 'political union' and 'economic government', greater EU fiscal capacity to avoid asymmetric shocks having long-term, or even permanent, depressing effects on prosperity and employment in some member states, and a renewed focus on intra-EU exchange rate movements.

However, in Section 8.6 we argue that in addition to the economic dangers, there are a number of policy or political dangers, particularly the risk of deadlock in which contending ideas and understandings cancel each other out. We describe a number of dualisms that can produce deadlock. To a degree this has already been evident in the EU's efforts to respond to the crisis of the euro and there is a risk it would be even more prevalent in the deliberations of the task force and other EU bodies on possible further policy initiatives. In the introduction to this paper we quoted Dyson's fear, in 2000, that one of the greatest risks for the euro would be 'a lack of intellectual and political flexibility consequent on the nature of the treaty basis for the Euro zone' and his argument that, if confronted with a profound change in economic circumstances, the vital policy response 'will require a further process of making ideas compatible' (Dyson, 2000: 209). In this vein, the final part of our argument, in Section 8.7, is that Europe needs to transcend the dualisms that have created deadlock. We suggest that in seeking to do this, a number of considerations and arguments can be helpful. These share a common characteristic and motivation—to open a space for consideration of policies to address instability, in a way that does not produce further instability by, for example, de-legitimising the EU's institutional arrangements. The final element is transcending dualisms is the possibility of articulating the challenge of political 'buy-in' in a new way, emphasizing the potential of existing EU processes, developed in other spheres, but not made effective in areas most relevant to the euro. We finish by suggesting that in that context, it might be possible for the EU to discuss and agree a pragmatic combination of measures that protects the euro, addresses the deficit and debt problems, supports macroeconomic recovery and growth and responds to the risk of further financial sector turbulence at EU and global level.

In presenting this argument we use a number of text boxes to summarise complex economic arguments and the policy proposals advanced by the EU institutions and various economic analysts. This is designed to simplify the flow of the argument, while not glossing over the technical dimension of the issues and ideas involved.

8.2 Recent Initiatives and Emerging Reform Proposals

Given the acute and chronic problems in the euro area, there is fairly wide agreement that a number of policy responses are required. Indeed, several of these have been initiated in the past year, and especially in the past few months. These include:

- An emergency loan package for Greece;
- A European stabilisation mechanism;
- ECB intervention in bond markets; and
- Enhanced financial regulation.

The contents of the first three of these policy interventions are described in Box 8.1. These European initiatives represent a very significant policy response. They demonstrate the commitment of EU leaders to avoid damaging financial instability and to ensure the future of the euro. They provide considerable reassurance that a member state will not face a financial crisis as a result of loss of confidence in the bond markets. However, they leave many member states with very demanding fiscal adjustment programmes.

It is hoped that the rescue package will provide time for Greece to undergo major fiscal adjustment and restore balance to its public finances. The emergency loan package for Greece, together with the European stabilisation mechanism, seeks to prevent contagion of Greece's problems to other economies. These financial interventions are also designed to prevent problems in the European banks that hold Greek bonds and those of other peripheral economies. A sustained European economic recovery would greatly help in the successful correction of the public finances in Greece and other economies. The considerable risks to the realisation of these hopes are discussed below.

8.2.1 Financial Regulation

The fourth area of current EU policy development is financial regulation. It is now widely agreed that the current crisis highlights the need for improved financial regulation at domestic, European and global levels. At the domestic level, the intention of the proposed Central Bank Commission is indeed to provide a new regulatory regime. At European level, the content of the de Larosiere report should guide the establishment of new regulatory institutions and enhanced cooperation among national-level regulators. At a higher level again, the G20 meetings have accorded prominent roles to the Financial Stability Board and the IMF in promoting global financial stability.

Box 8.1 A Financial Stabilisation Mechanism and ECB Intervention

A series of major policy initiatives were announced at EU level in May 2010. These were as follows:

- An emergency loan package for Greece: Under this agreement, the euro-area member states and the IMF will provide loans to Greece of €110 billion; this will mean that Greece will not need to raise money on bond markets until 2012. The package solves Greece's immediate liquidity problems but does not remove the huge pressures on the public finances in Greece.
- A temporary European stabilisation mechanism: This mechanism enables the provision of loans to a member state affected by a severe financial or economic disturbance caused by exceptional circumstances. This mechanism will facilitate the provision of up to €500 billion in loans. In addition the IMF will support this programme with lending of up to €250 billion. Taken together these mechanisms facilitate total potential lending of up to €750 billion. Member states availing of loans will be subject to strong conditionality; in particular loans offered will be on terms and conditions similar to the IMF.
- ECB intervention: The ECB has decided to intervene in both public and private debt markets. This will include the purchase of government bonds in the financial markets. The aim is to avoid the malfunctioning of these markets. The ECB has indicated that the liquidity injected by these operations will be offset or 'sterilised' by other actions. The ECB decision to purchase government bonds has, unusually, been subject to public criticism by one member of the ECB's Governing Council, Alex Weber, the Bundesbank President (*Financial Times*, 13 May 2010).

8.2.2 But More is Required

However, there is agreement among the member states and the EU institutions that more is required to secure the euro but also the long-term stability and prosperity of the European economy and all of the member states. The European Council, at its meeting in March 2010 established a task force, chaired by President Van Rompuy to examine EU economic governance.

To date, three main sets of proposals have been tabled for consideration by the task force:

- The European Commission's Communication of 12 May 2010, 'Reinforcing Economic Policy Co-ordination'; further development of these proposals is provided in a subsequent European Commission Communication of 30 June 2010.
- A short paper by the German Government; and
- Some ideas presented by President Van Rompuy.

The first two of these are summarised in Boxes 8.2 and 8.3 respectively. At the European Council meeting of June 2010 agreement was reached on a number of reform proposals to improve the co-ordination of economic policies, drawing on the European Commission's proposals and the initial work of the Van Rompuy task

force. It was agreed to strengthen the rules on budgetary discipline. From 2011 onwards, Stability/Convergence Programmes[16] will be presented in spring. This will include advance presentation of key budgetary parameters for the next budget, 'taking account of national budgetary procedures' (European Council, 2010: 5)[17]. It was also agreed to review the sanctions in the SGP and to ensure that all member states have budgetary rules and medium term budgetary frameworks in line with the SGP. Broader macroeconomic surveillance (beyond budgetary matters) is to be improved. A new scorecard is to be developed to this end, with a view to early detection of unsustainable trends along with an effective surveillance framework.

In regard to the financial sector, the June 2010 European Council agreed on the publication of the results of stress tests of major European banks. In addition, it is agreed that additional macroeconomic co-ordination must be accompanied by steps to ensure that the EU reform processes set out in the *Europe 2020: A European Strategy for Smart, Sustainable and Inclusive Growth* are more effective. This is discussed further in NESC's forthcoming report on the EU.

From an Irish perspective, it is of great importance that sufficient steps are taken to protect the euro, enhance macroeconomic co-ordination and create a framework for recovery.

8.2.3 Dangers and Anxieties

In considering options to secure the euro and macroeconomic performance, it is important that the Van Rompuy task force, and subsequently the Commission and Council, take note of a number of economic dangers and policy risks that could greatly qualify the effectiveness of the EU's response to the current crisis and, indeed, the capacity and cohesion of the Union itself. As we explain below, the economic dangers concern the emergency loan package provide to Greece and the stabilisation mechanism now available to other member states, the recovery of the whole European economy in a context of fiscal austerity, possible further financial instability at either European or global level and the damaging effect of intra-EU exchange rate movements. However, articulation of these economic dangers could be misunderstood as special pleading in a country experiencing a severe deficit problem. Consequently, NESC believes that before discussing the Europe-wide dangers it is important to reaffirm two policy positions:

(a) Ireland's need to achieve fiscal stabilisation and, eventually, a return to lower indebtedness;

(b) National responsibility to create whatever policies and reforms are necessary to make possible a return to full employment, sustainable growth, inclusion, innovation and high-productivity.

16 All member states are required to prepare Stability programmes (in the case of members of the euro area) or Convergence Programmes (other member states) that set out medium-term plans for the public finances.

17 There is already publication of projections of some budgetary measures in Stability and Convergence programmes. The most recent update to Ireland's Stability programme was published in December 2009. This set out projections for the public finances to 2014. This includes planned public finance adjustments but the balance between tax and expenditure measures in these adjustments is not specified. The full implications of the new arrangements for the presentation of Stability and Convergence programmes are not yet clear.

Box 8.2 European Commission: Reinforcing Economic Policy

In May 2010 the European Commission (2010d) proposed a series of reforms to strengthen economic policy co-ordination in the EU.

A Stronger Stability and Growth Pact

Key proposals by the European Commission on the SGP are as follows. First, member states would be required to submit their budgetary plans at a much earlier stage to the Commission (in the form or Stability or Convergence Programmes). This would make it possible to provide guidance in time to influence the preparation of the budget. Second, national fiscal policy frameworks would be reformed to better reflect the priorities of EU budgetary surveillance. Third, better incentive and sanctions would be introduced to comply with the SGP.

Macroeconomic Imbalances

Additional measures are proposed to address macroeconomic imbalances in the euro area, as signalled by measures such as current account balances, unit labour costs or real exchange rates. The existing peer review of macroeconomic imbalances, now carried out by the Eurogroup, would be upgraded. Policy recommendations could cover a wide range of areas including fiscal policy, the functioning of labour, product and services markets and credit growth.

Integrated Budgetary and Structural Policy Surveillance

The arrangements for policy surveillance would be reorganised to achieve a more integrated treatment of budgetary and structural policies. Stability and Convergence Programmes and National Reform Programmes would be issued simultaneously by member states.

Framework for Crisis Management

Based on the experience of the temporary crisis resolution mechanism, the Commission will develop proposals for a robust permanent crisis resolution mechanism (European Commission, 2010d).

A subsequent European Commission communication of June 2010 further developed the proposals above (European Commission, 2010b). Macroeconomic imbalances would be subject to annual surveillance. Countries with particularly serious imbalances would be placed in an 'excessive imbalances position' which would be separate from having an excessive deficit in the public finances. For euro-area states, a 'specific enforcement mechanism' could be envisaged for repeated violation of recommendations to address macroeconomic imbalances.

The June 2010 communication proposes additional sanctions for members that do not address excessive deficits. Member states in this situation could be subject to the loss of receipts under CAP and EU fisheries policy.

The new arrangements would require adaptation of the contents of Stability and Convergence Programmes. Member states would not be required to submit fully fledged budgets to the EU before presenting them to national parliaments but 'the programmes should include the necessary information for meaningful *ex-ante* discussions on fiscal policy' (European Commission 2010b: 11).

Box 8.3 German Government Proposals to Strengthen the Euro Area

The German Government's view is that the majority of the European Commission's proposals on economic policy co-ordination are along the right lines but some measures need to be further developed. Its main proposals are as follows:

- **More stringent budgetary proposals within the EU: for euro-area member states this could include examination of Stability Programmes by the ECB or independent research bodies;**
- **A greater role for national parliaments in European fiscal policy;**
- **Euro members should incorporate the rules of the SGP into national law;**
- **European funding should be conditional on solid fiscal policy;**
- **Countries that seriously infringe the rules of Monetary Union should have voting rights suspended in the European Council for at least one year;**
- **A stringent and politically visible procedure should be developed in which infringements of the BEPGs are flagged at an early stage and clear binding recommendations set out, with provision for sanctions in the case of serious infringements; and**
- **If there is movement beyond the current temporary European financial stabilisation instrument, a procedure for orderly state insolvencies should be an integral part of any crisis permanent resolution framework for the euro area.**

8.3 Reaffirming Ireland's Belief in Sustainable Public Finance and Structural Reform

8.3.1 Ireland's Belief in Fiscal Stability and Low Debt

The Council's sees it as important that any discussion of EU policy initiatives be prefaced by an unambiguous reaffirmation of national commitment to fiscal stability and low debt. There are a number of reasons to state this and take it seriously. Among these are:

- In a small open economy, deficit-financed expenditure can only have a very limited and temporary role in sustaining economic activity, public services and transfers. In the medium term, the level of activity and employment depends on global demand, productivity and competitiveness, and redistribution must be funded by raising the appropriate level of revenue;
- High indebtedness brings a severe reduction in national sovereignty, as domestic options are increasingly in the hands of international markets and ratings agencies;
- Recent historical research underlines the damaging immediate and long-run effects which follow from accumulation of high debt, in either the public or private sectors (Reinhart and Rogoff, 2009);
- Finally, Ireland has made solemn commitments in the EU, and especially as a member of the euro, to support a stability culture. For small member states it is particularly important that EU obligations, voluntarily entered into, are taken seriously by all.

Whatever about differences on the details of fiscal policy in recent years, it is important to restate the wide acceptance of this overall perspective across economic and social organisations in Ireland. Indeed, this has been a core element of the Council's analysis since 1986 (NESC, 1986, 1990, 1993, 1996, 1999, 2002, 2005b).

An important question is: how is Ireland going to ensure that, in future, fiscal policy adheres to the core principles outlined by NESC and others? What policy processes or institutions can ensure that Irish fiscal policy is counter-cyclical, sustainable and adheres to the SGP? Most EU countries recognise and discuss this challenge. The European Commission has proposed that member states should have in place national fiscal rules ensuring that domestic fiscal frameworks reflect Treaty obligations and that fiscal rules and credible enforcement mechanisms be codified by national law. International experience shows that, even in a buoyant world economy, individual countries can experience external shocks or internal political and policy developments that sharply increase deficits and debt. In this report NESC does not advance a view on the best way for Ireland to ensure that future fiscal policy adheres to the principles of counter-cyclicality and sustainability. The Minister for Finance has asked the Joint Oireachtas Committee on Finance and Public Service to consider the question and to report by September 2010. The Joint Oireachtas Committee on European Affairs (2010) has recently proposed that all EU governments should establish national fiscal councils to assess budgetary policies and provide independent forecasts. NESC sets out some of the evidence and issues that need to be considered in Box 8.4.

8.3.2 Reaffirming Ireland's Responsibility to Achieve Supply-side Reform for Productivity, Sustainable Growth and Inclusion

Ireland's approach to economic and social development has long been based on activist developmental policy and changing social structure. Ireland's most successful period in the EU, 1987 to 2000, was characterised not only by debt reduction, but also significant reform and structural change. In the past decade, weaknesses lie more in the effectiveness of reform than anything else. The EU dimension to achieving reform, reporting and learning is discussed briefly below and in more detail in Chapter 10 of NESC's forthcoming report on the EU. These issues have been addressed in a series of NESC studies (NESC, 2002; 2005a and b; 2009a and b).

Over the past decade Ireland experienced above average inflation and a loss of cost competitiveness, as discussed in Chapter 4. This loss of cost competitiveness had the effect of deepening the impact on output and employment of the current global downturn. This experience underlines the domestic responsibility to keep competitiveness in view and to adopt a co-ordinated approach to all the factors that drive competitiveness.

In the current environment it is critical to adopt the most effective means of organising services in order to minimize the impact of expenditure cuts on service delivery. Cuts should be based on objective assessment of costs and benefits rather than cutting in areas of least resistance.

Ireland continues to sustain a high level of public capital investment: over the period 2009 to 2014, public investment is projected to average 4 per cent of GNP. NESC emphasises the importance of ensuring the effectiveness of this investment. Public investment and other dimensions of public policy should support a return to a more sustainable spatial pattern of investment than was the case during the economic boom from 2002 to 2008. There is also a need for improved arrangements for the appraisal of capital investment projects.

Box 8.4 Discussion on the Role of Fiscal Policy Rules and Institutions

In recent decades, two related developments are evident and much discussed internationally—the introduction of fiscal policy rules and the establishment of new institutional entities to guide policy. Lane argues that, given the recurrence of pro-cyclical fiscal policy in Ireland, and the severity of our current position, it is time to adopt a new fiscal framework with two key components: (a) a set of fiscal rules and (b) an independent fiscal policy council (Lane, 2010a). He argues that, for a number of reasons, the core rule should aim for an annual surplus in the structural balance in the coming years. This rule should contain 'an escape clause by which a structural fiscal deficit is permitted in the event of a sufficiently large negative shock'. Definition of the conditions that would activate the escape clause 'could be delegated to an independent fiscal policy council' (Lane, 2010a: 18). The independent fiscal council would make recommendations concerning the overall fiscal stance.

While sympathetic to the thrust of Lane's argument, FitzGerald wonders whether a fiscal rule of this kind would have 'tackled the real danger to the Irish economy from unsound fiscal policy pursued over the 2001-2007 period' (FitzGerald, 2010: 3). His conclusion is that 'it is very difficult to establish a simple rule that will apply to a sufficiently high percentage of cases to make it worthwhile' (5). Consequently, he suggests, we are thrown back on the importance of undertaking suitable analysis of fiscal policy on a country by country basis. Since analysis alone may not have much influence on policy, there is, he argues, a case for institutional change. FitzGerald argues that an independent fiscal council would have a greater chance of being listened to if it were established on an all-party basis.

Our analysis of the factors shaping Irish fiscal policy in the past decade suggests that poor policy outcomes emerged, in part, from a combination of technical issues that were uncertain and political economy issues that were unresolved (see Section 6.4) We inferred from this that the lessons of the past decade included not only the need to adhere to the principles of counter-cyclical and sustainable public finance and financial regulation, but also more thorough resolution of the distributional and structural tensions that tend to create pressure for pro-cyclical fiscal policy and, indeed, tend to crowd out clear analysis of the macroeconomic context.

Indeed, it may the case that the feasibility and effectiveness of an independent fiscal council depends on a significant degree of social consensus on the rough size of the tax take and public provision. While exploring the possible role of rules and independent experts in fiscal policy, it will be important to explore the analysis and relationships that can help resolve the tensions that make adherence to fiscal principles difficult. Indeed, NESC's analysis would suggest that the whole burden should not be placed on aggregate fiscal policy. It is also necessary to address problems in housing and land markets. It may be no accident that the countries that ran the best fiscal policies through the international boom of the past decade—the Nordics and the Netherlands—are societies that have a greater balance between private and social housing, and between home ownership and rental, and have policies that limit the influence of land on housing costs.

8.4 Economic Dangers

Here we outline in a little more detail the four economic dangers identified above.

8.4.1 EU Financial Stabilisation Measures

Recent EU measures come to the aid of member states facing limits on their ability to fund debt in the markets. This is a vital step in preventing default and a spread of negative market sentiment across the euro area. However, it does little to soften the adjustment or reduce the risk that the combination of high debt, deficit reduction and low international growth could condemn some member states to a decade or more of depression. It is the peripheral members of the euro area that are most affected by the current sovereign debt concerns. With fiscal adjustment leading initially to lower domestic demand, these member states require export growth to achieve economic recovery and to restore balance in the public finances. But several years of a loss of cost competitiveness complicate the achievement of export-led growth. In the absence of exchange rates, other means of restoring cost competitiveness are essential but difficult to achieve.

The problems for Greece are particularly daunting. Its agreed EU/IMF programme involves fiscal adjustment of 15.5 percentage points by 2013. If the programme goes as planned this would still leave Greece with a debt/GPD ratio of 150 per cent of GDP by 2013. The IMF acknowledges that risks to the adjustment programme are high. It accepts that the very large fiscal adjustment programme, in conjunction with an internal devaluation to restore competitiveness, will limit growth for a protracted period which in turn will have implications for the banking system. The programme is described by the IMF as unprecedented and socially painful.

8.4.2 Weak European Recovery and Sustained Unemployment

The OECD *Economic Outlook* of May 2010 is reasonably optimistic on the prospects for the global economy. For the euro area, it expects GDP growth of 1.5 per cent for the year to the final quarter of 2010 and 1.9 per cent for the year to the final quarter of 2011. Stronger growth is projected for the US. The OECD does not expect the initial stages of economic recovery to be employment intensive so unemployment is projected to fall slowly.

There are considerable risks for European and global economic recovery. The OECD highlights the risk of public debt sustainability in some OECD countries and the associated financial market instability. In recent times, both small and large European countries have signaled their intention to undertake major fiscal retrenchment. While designed to address public debt sustainability, this also poses the risk of cutting off a fragile economic recovery by excessively depressing demand. Commentators who have voiced their concern at significant risks posed by premature fiscal tightening include Martin Wolf, Paul Krugman and Wolfgang Münchau. If European or global recovery weakens, unemployment could remain high for an extended period.

There is a risk of new global financial imbalances developing. The decline in the value of the euro along with fiscal retrenchment in Europe will lead to a substantial euro-area balance of payments surplus. At the same time, China and other Asian countries continue to intervene to keep their currencies undervalued and sustain high surpluses. The counterpart of these surpluses will be a growing deficit in the US. This risks the buildup of new unsustainable financial imbalances (Bergsten, 2010).

Another risk to recovery is the overhang of excessive levels of private debt. This could limit the recovery of private spending, both for consumption and investment. This in turn would prolong government deficits. This has been the experience of Japan.

8.4.3 Financial Sector Risks

Concerns have increased in regard to the financial strength of European banks. This has led to agreement at the June 2010 European Council on the publication of the results of stress tests of major European banks to provide greater clarity to the financial markets. One concern is the exposure of European banks to the sovereign debt of Greece and other peripheral euro economies. The Bank of International Settlements (BIS) has reported that the combined exposure of the German, French and Belgian banks to the public sectors of Spain, Greece and Spain amounted to 12.1 per cent, 8.3 per cent and 5.0 per cent of their respective joint tier-one capital. This represents a manageable exposure. However, there is a far larger exposure to the private sectors of the peripheral European economies. The joint foreign claims of euro-area banks on the public sectors of Greece, Ireland, Portugal and Spain represented around 16 per cent of their total lending to these countries (BIS *Quarterly Review,* June 2010). Uncertainty on the share of bad debts within these loans has led to instability in the financial markets. In the current environment some banks have become increasingly dependent on funding from the ECB.

8.4.4 EU Goals Undermined by Exchange Rate Movements

A fourth concern is less a possible danger than a problem that has already materialised and is likely to recur in the absence of policy developments. It is the way in which large movements in the currencies of EU member states, especially sterling, can damage other member states, weaken macroeconomic and price stability and undermine the internal market. Our account of the origin of and motivation for EMU, in Chapter 2, drew attention to the close connection between economic union and monetary union. As Eichengreen and many others have argued, the more integrated are national markets, the larger are the import surges that accompany exchange-rate-induced shifts in relative prices and the greater the pain experienced by affected firms and workers. In Chapter 4 we reported the movement of other currencies—including those of EU member states—against the euro. This revealed the distinctive volatility of sterling within the EU; it is prone to greater changes in value than other currencies, even those outside ERM II, such as the Swedish krona. In Section 5.8 we noted that a perverse, and unintended, effect of the creation of the euro was some weakening of the EU's traditional policy focus on intra-EU exchange rate movements. In interpreting Ireland's experience in the EMU in Chapter 6, we drew attention to the way in which sterling weakness since 2008 has deepened the contraction of output, employment and revenue.

This reveals the risk of 'beggar my neighbour' developments within the EU. Such a phenomenon would constitute a negative spillover from one member state to another. In addition, in a context of economic difficulty it could prompt resistance to the internal market and encourage lobbying for covert or overt form of protection in vulnerable, cost-sensitive, sectors. As pointed out in the recent Monti Report, *A New Strategy for the Single Market*, deepening, rather than reversal, of the internal market must be a critical part of Europe's response to the global crisis (Monti, 2010).

8.5 More Ambitious Policy Possibilities

These kinds of economic dangers have prompted more ambitious proposals for how EMU should be governed. Among these are:

- Greater co-ordination with a focus on aggregate EU fiscal policy;
- Greater 'political union' and 'economic government' of the euro-area capable of determining the overall mix of monetary and fiscal policy;
- Some system of fiscal transfers to avoid asymmetric shocks having long-term, or even, permanent depressing effect on prosperity and employment in some member states (see Box 8.5); and
- Recognition that regarding 'economic policies as a common concern' should imply a renewed focus on intra-EU exchange rate movements.

In addition, problems with the global monetary system have led to proposals for ambitious policy developments on a fourth front: global monetary reform. Each of these is now briefly outlined without comment. In drawing attention to them NESC is highlighting challenges that the EU must consider and address, rather than endorsing any particular set of proposals. Indeed, as we discuss below, some of the standard proposals for more ambitious EU policy, as traditionally presented, may not be helpful in 'making ideas compatible' and, thereby, assisting the EU to explore new policy possibilities.

8.5.1 Fiscal Policy Co-ordination

The proposed reforms to the SGP discussed above address one dimension of the co-ordination of fiscal policy, i.e., avoiding excessive deficits and debt that pose risks to the stability of the euro area. However, there is another dimension to the co-ordination of fiscal policy. This is to enhance the contribution of fiscal policy to stabilising the economic cycle at EU level. In response to the danger of failed European recovery, many argue for more co-ordinated fiscal policy as an alternative way of stabilising demand.

Krugman (2008) undertook a comparison of the direct impact on GDP of (a) a unilateral fiscal expansion by an average EU economy and (b) an equivalent co-ordinated fiscal expansion. He estimated that the impact on GDP of the co-ordinated fiscal expansion was roughly twice the impact of a unilateral expansion. The much higher return from co-ordinated expansion arises because, on average, two thirds of the imports of the average EU country come from other EU countries. A country will derive considerably more benefits from a fiscal expansion if neighbouring countries are also engaged in expansion, as the fiscal expansion of its neighbours helps to offset the leakage of its own expansion to other economies.

8.5.2 Greater 'Political Union' and 'Economic Government'

It is argued by some that the currency problems of the euro area show that monetary union needs to be complemented by much stronger economic union if it is to work effectively. This is turn would depend on more progress towards a stronger political union which would provide the capability to have 'economic government' for the euro area. While it has never been entirely clear what is meant by 'economic government' (Hall and Peel, 2010), it is usually understood to mean the ability to shape the mix of monetary and fiscal policies for the euro-area.

8.5.3 Fiscal Transfers to Offset Asymmetric Shocks

The third kind of proposal for more ambitious policy measures concerns asymmetric developments within the EU. The financial stabilisation mechanism that has been put in place will provide loans to countries that are excluded from financial markets for a period of time, subject to tough conditionality. This still leaves some member states with a need for major fiscal retrenchment. There are dangers that some member states find themselves in a trap arising from a combination of severe fiscal retrenchment, loss of cost competitiveness, high debt and weak external demand. These problems also affect the financial systems of creditor countries. In existing federal systems some of the impact of asymmetric shocks on an individual state is softened by increasing payments through the federal budget. Some analysts believe that monetary union in Europe requires fiscal federalism. Box 8.5 provides a short summary of how ideas on fiscal federalism have figured in debates on European Monetary Union. In the absence of fiscal federalism, various analysts suggest some fiscal instrument that would provide financial assistance to help the adjustment process of member states in serious difficulties. These arguments confront a number of difficulties, some of which we discuss below.

8.5.4 Global Monetary Reform

The danger of further financial instability, identified above, prompts some to propose more ambitious policies to address financial sector issues at both European and global level. One category is measures to respond to the possibility that the financial crisis is far from over, with the risk of further problems of insolvency and liquidity.

Others concern that fact that with economic recovery, there is a risk of a re-emergence of global financial imbalances. In an uncertain world, many countries like to hold large foreign exchange reserves and to this end run current account surpluses in their balance of payments. This however leads to global financial imbalances and lowers global aggregate demand. A long-standing idea that has reappeared in recent times is the creation of a global reserve currency. Such a currency exists in embryonic form in the form of Special Drawing Rights (SDRs) at the IMF, but their current design means that they play a very limited role at present. They could be redesigned so that they have more of the characteristics of real money. It would then be possible to provide annual allocations of this new reserve currency, perhaps only to developing countries. Such countries would have the security of rising reserves without having to use their current income to fund increases in reserves. This would simultaneously provide increased expenditure that could help reduce global poverty and boost global aggregate demand, without increasing budget deficits in advanced countries. The idea of a global reserve currency was initially proposed by Keynes, and has recently been supported by a UN commission of experts on the restructuring of the global financial and economic system (chaired by Joseph Stiglitz) and the head of China's central bank (Stiglitz,2010).

Further levies or taxes on financial institutions are also being considered. The European Council has agreed that 'Member States should introduce systems of levies and taxes on financial institutions to ensure fair burden-sharing and to set incentives to contain systemic risk' (European Council, 2010: 6). What would be involved in such systems of levies and taxes is not yet agreed and the European Council also noted that the cumulative impact of various measures should be carefully assessed. The European Council also proposed that the introduction of a global financial transactions tax should be explored and developed further in the G20 context. This echoes an early proposal by Tobin for a tax on all foreign currency transactions, with a view to deterring short-term speculative currency transactions (Tobin, 1974). The proposal of a global financial transaction tax, however, did not feature in the conclusions of the G20 summit in Toronto in June 2010. The G20 summit did agree that tough new capital rules for banks would be implemented to ensure that banks would have sufficient buffers for any future crisis.

Box 8.5 Fiscal Federalism and Targeted Fiscal Instruments

NESC discussed the role of EU-level public finance in its 1989 study *Ireland in the European Community* in the context of enhanced cohesion policies and the revival of the EMU project (NESC, 1989). In its 1997 study, *European Union: Integration and Enlargement* it reviewed the analytical and empirical literature and the policy analysis emerging in Europe in the context of the planned launch of the single currency in 1999. It concluded that the core principles of fiscal federalism have largely been confirmed by subsequent economic analysis and continue to operate in existing federations in such a way as to achieve both stabilisation and reduction of inequalities (NESC, 1997: 202). However, it noted that 'adoption of these principles confronts political resistance and the limited size of the EU budget'. Consequently, 'Europe's efforts to achieve overall and inter-regional stabilisation will, in the coming years, go no further than co-ordination of national policies and possible a limited inter-regional "insurance instrument"' (NESC, 1997: 203).

Indeed, as EMU was being designed, there was a new round of research and discussion of public finance in EMU. This work is summarised in *The Economics of Community Public Finance* (European Commission, 1993a) and *Stable Money—Sound Finances* (European Commission, 1993c). In these debates, a number of economists made proposals for more limited instruments, far short of fiscal federalism, which might cushion the effect of asymmetric shocks. Although more modest, these proposals had little influence. NESC observed that the absence of a federal fiscal system, the low degree of labour mobility, the larger differences in initial conditions compared to other federations and potentially more diverse disturbances, 'all suggest that some day attention may be given to the design of an appropriate regional stabilisation fund' (NESC, 1997: 203). We 'cannot rule out the possibility' that future difficulties of Europe-wide stabilisation, and member state deficits at the limits of those allowed in the TEU, 'will prompt developments in the public finance capacity of the EU' (NESC, 1997: 203).

In a 2008 review of fiscal policy in the eurozone, Szelag notes that the debate which developed in both the 1970s and before the introduction of the euro has been reactivated in the economic literature in recent years. This was largely prompted by perceived weaknesses in the system of co-ordination of national fiscal policies (Sapir, *et al.*, 2003; De Grauwe, 2006a and b; Szelag, 2003, 2004, 2007; Jacquet and Pisani-Ferry, 2001). Consequently, economic analysts have again made a number of proposals in recent years. Among these are, for example, a temporary transfer system to be used only in the case of asymmetric shocks (De Grauwe, 2006a). Similar proposals are emerging in discussion of the current crisis of the euro and the EU.

8.5.5 EU Exchange Rate Policy as Part of Economic Co-ordination

The dangers and difficulties identified above might also prompt a renewed focus on intra-EU exchange rate movements. In Section 5.8 we summarised the evolution of economic co-ordination in the EU in the past two decades. The net effect of these developments would seem to be a gradual reduction in the focus on intra-EU exchange rate movements and policies to moderate them. The economic policy co-ordination which involves *all 27 member states* came to focus on fiscal policy, labour market issues and structural reforms—but very little on exchange rate developments. The economic co-ordination *within the euro area* focused on a range of issues, but with a particular, and increasing, emphasis on fiscal policy—given the potential damage to other member states and the currency. The term 'EU exchange rate policy' came to refer, almost exclusively, to the relation between the euro and global currencies such as the dollar. In summary, with the creation of the euro the movement of exchange rates within the EU—which was rightly considered a valid focus of collective concern in the years from 1972 to 1999—has ceased to receive much attention. The participation of 16 member states in the euro, and of a further seven in ERM II, naturally limits the scope of this form of free-riding across the Union. But the analytical validity and practical reality of the potential damage done across member state frontiers in a deeply integrated internal market remains.

In this regard, it is important to be clear that all member states have Treaty obligations. *The Treaty on the Functioning of the European Union* (TFEU) says, in Article 120: 'Member States shall conduct their economic policies with a view to contributing to the achievement of the objectives of the Union, as defined in Article 2 of the Treaty on European Union and in the context of the broad guidelines referred to in Article 121(2)'. Article 121 says 'Member States shall regard their economic policies as a matter of common concern and shall co-ordinate them within the Council, in accordance with the provisions of Article 120'. Clauses 2 and 3 of Article 121 provide for the adoption of broad guidelines on the economic policies of the member states and multilateral surveillance by the Commission. Article 121 (4) provides that, where the economic policies of a Member State 'risk jeopardising the proper functioning of economic and monetary union', the Commission may issue a warning and the Council may address a recommendation to the member state. Following the Lisbon Treaty, Article 139 TFEU identifies the provisions of the Treaties that shall not apply to member states with a derogation from the euro. But these do *not* include the obligation to regard their economic policies as a matter of common concern[18].

There does remain some ambiguity and anxiety concerning the co-ordination of economic policies in the Eurogroup and in the Ecofin Council of 27 member states. Indeed, this ambiguity and anxiety has a number of, somewhat opposite, dimensions.

18 Under Article 139 the provisions of the Treaties that shall not apply to member states with a derogation for the euro include: (a) the parts of the BEPGS which concern the euro-area generally; (b) coercive means of remedying excessive deficits; and (c) monetary agreements and other measures relating to exchange rate policy (as defined in Article 219 TFEU). Article 219 TFEU (ex. Article 111 EC), refers to 'formal agreements on an exchange-rate system for the euro in relation to the currencies of third States'.

On the one hand, the more commonly discussed ambiguity concerns the co-ordination of economic policies *within the euro-area* (see above). The Broad Economic Policy Guidelines (BEPGs) have, since 2003, included guidelines specifically addressed to euro-area members. Deroose *et al*., argue that 'Uncertainty remains over the ownership of these guidelines since they are, firstly, adopted by a Council comprised of representatives from euro-area and non-euro-area member states and, secondly, barely addressed in the National Reform Programmes' (Deroose *et al*., 2008: 843). Consequently, they identify as a challenge for the future 'how to ensure a more thorough follow up to the euro-area specific dimension of the BEPGs' *(ibid)*. Our analysis confirms the validity of this, and it is the subject of an important recent decision by the European Council.

On the other hand, the negative effects of the exchange rate movement of sterling draws attention to ambiguity and anxiety about the co-ordination of economic and monetary policies *within the 27 member* Ecofin Council and the role of the Commission in supporting this. As noted above, the scope of that surveillance and co-ordination—though widened to include labour market issues and structural reform—seems to have narrowed to virtually exclude exchange rate developments of member states outside ERM II. In addition, as Deroose and others note, 'the effectiveness of the BEPGs has been limited by the progressive accumulation of guidelines and because peer pressure has failed to bite as a deterrent against non-compliance' (Deroose *et al*., 2008: 44). NESC believes that among the issues that the EU has to get to grips with is the fact that the Treaty obligation to 'regard economic policies as a matter of common concern' should logically include exchange rates.

8.6 Policy and Political Dangers—Deadlock and Moral Hazard

The economic dangers discussed above are linked to a range of policy and political dangers. These share an important and troubling feature: deadlock, in which contending perspectives cancel each other out, yielding an insufficient or incoherent EU response to the economic, fiscal and financial crisis.

One manifestation of this would be a dialogue in which future possibilities are placed in opposition to past failures. Advocates of more ambitious EU mechanisms argue that a higher level of political agreement is needed to protect the euro, manage European-level demand and address asymmetric shocks. In response, those who emphasise the virtues of the original design of EMU argue that if we *had* greater political agreement and buy-in, we would have had of the fiscal stabilisation and structural reform in the past decade and would not need new instruments now.

Another manifestation would be deadlock arising from the fact that arguments for 'political union' and 'economic government' are seen as a permanent and systemic challenge to ECB independence, creating a risk of long-run inflation and/or unsustainable debt. As Dyson hinted in 2000, this response to instability is likely to create more instability, in both the short and long term. This is because it would undermine a core element of the design and legitimacy of EMU. In addition, if the technical arguments underpinning the design are in general correct, it would have damaging long run economic effects (Munchaü, *Financial Times*, 13 May 2010).

A third possible source of deadlock could arise if arguments for targeted fiscal instruments to address asymmetric shocks were seen as a step on the road to full fiscal federalism and permanent transfers to countries that have relied on deficit financing in the past and are unwilling to make sufficient reforms now.

A further duality was recently identified by Padoa-Schioppa (2010). On the one side is Europe's heads of government and central bankers who:

> have preached that a currency without a state is a smart invention that can last forever...It accomplishes the miracle of removing monetary and trade tensions, while allowing the nation-state to remain the unique master...No other transfer of sovereignty will, or needs to, occur. The European Union can do without the ordinary fiscal, financial and monetary instruments that all the textbooks prescribe (Padoa-Schioppa, 2010).

On the other side are an army of financial market operators who believe it cannot work. In the recent battle, to the great surprise of the markets, the former won. But, argues Padoa-Schioppa, 'in a deeper sense, it lost too'. First, because the attackers will return. More profoundly because they have locked themselves into the 'mistaken belief that the euro and full national sovereignty are compatible'.

Indeed, these dualisms and deadlocks are already evident, to some degree, in the EU's discussions of the crisis of the euro

8.7 Europe Needs to Transcend These Dualisms

Europe needs to transcend these dualisms that have created and will create deadlock. We suggest that in seeking to do this, a number of considerations and arguments can be helpful. These share a common characteristic and motivation—to open a space for consideration of policies to address instability, in a way that does not produce further instability by, for example, de-legitimising the EU's institutional arrangements. As Dyson identified in 2000, faced with a context different from that in which EMU was designed, Europe needs to create 'a further process of making ideas compatible' (Dyson, 2000: 209). In seeking to transcend these dualisms, a number considerations and arguments can be helpful:

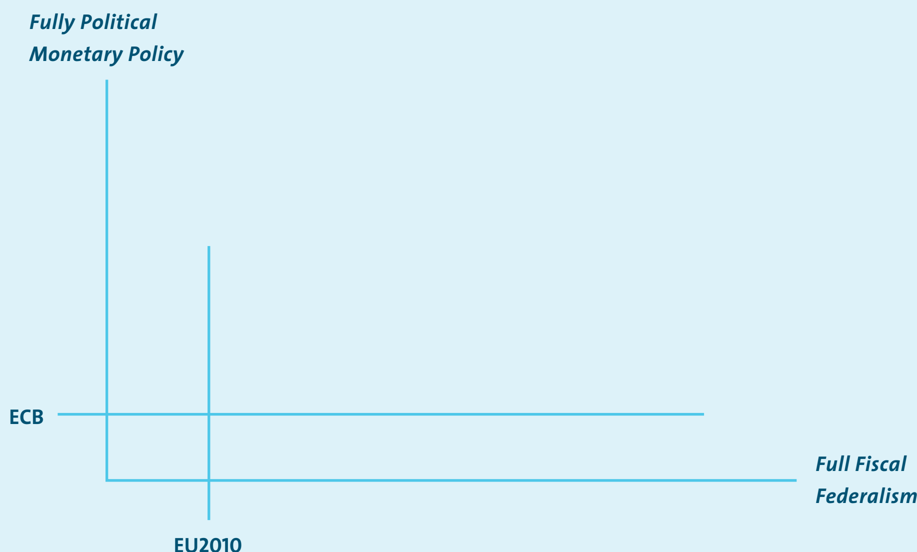
- Recognition of some trade-off between ECB independence and fiscal instruments, and that the stability of the financial system is a consideration in making this trade-off;
- Affirm the value of ECB independence but distinguish normal times from a systemic crisis;
- Resisting the dichotomy between structural reform and macroeconomic recovery as a false choice;
- Distinguish targeted measures from full fiscal federalism; and
- The possibility of articulating the challenge of political 'buy-in' in a new way, emphasizing the potential of existing EU processes, developed in other spheres but not made effective in areas most relevant to the euro.

In the context of *these* considerations it is possible to name the fact that the design of EMU does not encompass all the problems that Europe and its member states face and that growth is the only reliable way to reduce debt. If that becomes accepted, consideration can then be given to pragmatic responses as the current macroeconomic, debt and financial crisis unfolds. We now briefly explain these points in a little more detail.

8.7.1 Trade-off Between ECB Independence and Fiscal Instruments

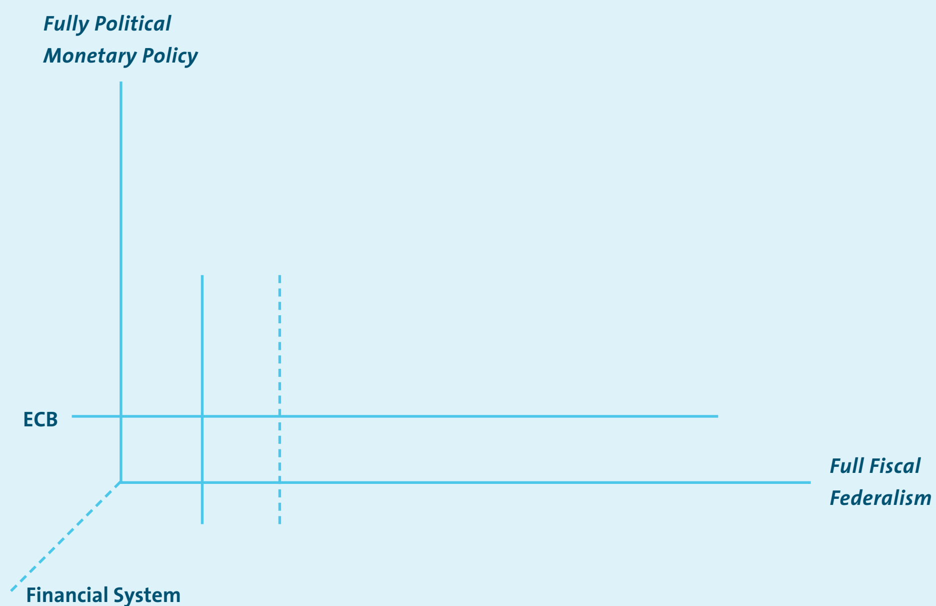
It seems useful to think clearly about the trade-off between ECB independence and fiscal instruments. This is depicted in Figure 8.1. The horizontal axis represents the degree of fiscal union, from the tiny EU budget (towards the left) to full fiscal federalism (on the right). The vertical axis shows central bank independence, with the strong independence of the ECB near the origin, to a fully politically-controlled monetary policy higher up the axis. There is no doubt that the EU context sets limits on both dimensions. The question is: what, if any, modifications to current EU arrangements are desirable and possible? Along which axis might the EU move, if it wants to address the economic dangers identified above and maintain core support for the EMU project? If reform is necessary, what are the trade-offs between creating innovative budgetary mechanisms to address asymmetric developments (and/or EU-level macroeconomic stabilisation), on the one hand, and modifying the remit, instruments or practice of the ECB, on the other? The textbook recipes—'fiscal federalism' and 'economic government'—are too theoretical or general to uncover the real possibilities and too blind to the institutional issues involved. They do not seem to provide a basis on which a convergence of ideas and agreed new initiatives can emerge.

Figure 8.1 Trade-off Between ECB Independence and Fiscal Instruments



Indeed, it is becoming increasing clear that a third dimension—financial sector risks—interacts with the first two (as shown in Figure 8.2). There are good reasons to protect a degree of ECB independence. There is a reluctance to contemplate any fiscal mechanisms. But there may be an overwhelming self-interest in protecting the European banking and financial system.

Figure 8.2 Trade-off Between ECB Independence, Fiscal Instruments and Financial Stability



8.7.2 Affirm the Value of ECB Independence, but Distinguish Normal Times from a Systemic Crisis

In thinking about policy initiatives and reform possibilities, there are advantages to distinguishing between (a) 'normal' times, characterised by relatively mild three to five yearly economic cycles and (b) severe systemic economic and financial crises, such as the Great Depression and the current crisis. Indeed, a distinction of this kind already exists in the EU SGP. This may allow the EU to develop policy instruments to address the current crisis (of indebtedness, liquidity and demand), while making limited changes to the overall design as it applies to 'normal' economic conditions.

The basic design and precepts of EMU may be highly suitable for 'normal business cycle conditions', when the main risk to stability comes from irresponsible, excessive use of discretionary, Keynesian spending above the normal operation of the automatic stabilisers. But as Dyson said in 2000, this approach is less relevant, and indeed could become very damaging, if the Euro-Zone policy makers faced a liquidity trap. In this condition, they find themselves not simply in a temporary recession, but in a slump with a relaxed monetary policy ineffective in stimulating demand:

> To mitigate this risk, which has not been adequately addressed, the Euro-Zone must develop appropriate institutional and mechanisms. Just as there is a limit triggering remedial action against budget deficits in the interest of avoiding a debt trap, so there is, at the minimum, a need for precisely defined conditions indicating when a recession becomes a slump. In such extreme circumstances an institutional structure for explicit, *ex ante* policy co-ordination would ensure joint decision-making on an appropriate mix of fiscal, exchange-rate, wage, and monetary policies. In effect, there would be a provision for a strictly time-limited political over-ride of central bank independence (Taylor, 2000). This structure could be provided by the macroeconomic dialogue in a revised form (Dyson, 2000: 268-9).

His concern was, where necessary, to widen the approach to EMU to address the rare, but extremely serious, instance of a full-scale Keynesian crisis, while preserving the core design of EMU. In a sense, the decisions of 8-9 May 2010 constitute such a one-off over-ride of ECB independence. Although, in that case it was to address the debt funding constraint of certain member states, rather than the European macroeconomy.

8.7.3 Resist the Dichotomy between Structural Reform and Macroeconomic Recovery as a False Choice

The member states of the EU face major structural challenges. Key structural weaknesses for the EU include productivity growth that has been lower than in key economic partners, relatively low employment rates and an ageing population. The EU also has to face major environmental and natural resource issues. The *Europe 2020: Strategy for smart Sustainable and Inclusive Growth* was adopted by Europe's political leaders at the June 2010 European Council. There is undoubtedly a structural dimension to the particular problems of the peripheral European economies and these economies can all benefit from structural reform.

Structural reform will strengthen the supply side and competitiveness of EU economies. However, the level of employment and income in any economy is influenced by the level of aggregate demand as well as supply-side conditions. In the EU at present, aggregate demand is weak and improvements to growth in the short term require stronger demand. The problems in peripheral economies require structural reform, but without stronger demand it may be impossible for the peripheral, or indeed the core, to achieve a return to growth and prosperity.

8.7.4 Distinguish Targeted Measures from Full Fiscal Federalism

It seems important to distinguish between full fiscal federalism, which is socially and politically impossible in Europe, and innovative targeted instruments that might address asymmetric developments within the euro area.

8.7.5 Articulate the Challenge of Policy and Political 'Buy-In' in a New Way

Although the various problems besetting the euro can be analysed in technical economic terms, there seems little doubt that they are connected to problems of policy commitment, buy-in and identity with the euro as a project of stabilisation, prosperity and global governance. Because this is hard to characterise precisely, there is a real danger that the challenge of buy-in will be expressed in familiar,

but unhelpful ways. In particular, the need for more effective policy buy-in and identity with the euro may easily be appropriated by, or assimilated to, two long-standing arguments within European integration: the case for 'political union' and 'economic government', and the case for fiscal federalism (as discussed above). The problem is that each of these are more likely to polarise debate on reform than assist in 'making ideas compatible'. Unless the challenge of buy-in and identity is articulated in some new way it will not progress. The debate on the euro is likely to get stuck in the dualities and deadlocks described above.

There is no doubt these old causes seek to address genuine concerns and are based on serious economic analysis (see above). But arguments for 'economic government' and/or fiscal federalism seem likely to be no more successful this time than in the past. The problem, as expressed by advocates of each, and by most other observers, is that these arguments 'confront the political reality of member state resistance to transferring further functions, resources and sovereignty to the EU level' (Szelag, 2008: 32). But maybe these arguments not only confront political reality, but also *borrow* too much political reality (from existing federations and large states in the post-war period) and *overlook* too much political reality (in the EU, states and federations). For example, fiscal federalism *borrows* political reality by scanning existing federations to see what model of political and fiscal authority at federal level (the American, Canadian, German, Australian) might be most suitable and feasible in the EU context. Both arguments *ignore* too much political reality in taking insufficient account of how governance in the EU has evolved, and how this has parallels with how government and governance are evolving in other states, including large federations. Deeper EU involvement in numerous policy spheres has not, in general, occurred by enhancing the authority of a single authority (or principal, in the sense of principal-agent theory). Successful EU involvement has increasingly taken the form of what has been called 'experimentalist governance' as outlined in Section 2.7 (Sabel and Zeitlin, 2010)[19]. Similar trends are evident in the actual government and governance methods in many states, including the member states of the EU.

On this view, the political leaders of Europe do, indeed, face a profound challenge. But it may not be the one conventionally stated: create a 'political authority', an 'economic government' and more 'political union'—as these are conventionally understood. It may be to take more seriously and develop the methods of shared governance that it has already developed in so many spheres and has not quite made effective in the areas of most relevance to the euro. What is required is a more reliable, better-understood, more-disciplined, widely-endorsed and clearly-articulated process for joint setting of goals, discussion of collective and national-level problems, and how the two relate to each other. Both the conventional arguments for greater political buy-in (articulated as 'economic government' and fiscal federalism), and the orthodox case (that buy-in consists solely of national-level fiscal stabilisation and structural reform) underestimate the potential of the EU's method of joint goal setting and problem solving.

19 We discuss this in more detail in NESC's forthcoming report on the EU.

8.7.6 Conclusion

Our purpose has been to identify the challenges that the EU has to get to grips with in the current crisis, rather than to recommend specific lines of action. The above discussion has sought to identify a context—of ideas and understandings—in which it might be possible for the EU to discuss and agree a pragmatic combination of measures that protects the euro, addresses the deficit and debt problems, supports macroeconomic recovery and growth and responds to the risk of further financial sector turbulence at EU and global level. If existing measure prove inadequate to address the dangers, such a combination of measures could be drawn from the proposals of the European Commission and an innovative combination of elements of the more ambitious possibilities that have been outlined in section 8.5.

8.8 Conclusion

Given this analysis, what is NESC saying about the policy challenges facing the European Union, and especially the member states that share the euro?

Our perspective on these challenges begins from a recognition that the creation and successful establishment of the euro is an historic step in the process of European integration and an epochal change in the global monetary system. There is a strong economic logic for combining deep economic integration with adoption of a common currency. In the European context—where the deepening of integration respects the ongoing role of the member states—the creation and management of a common currency is an immensely complex political and policy task. After several decades of preparation and planning for EMU, the currency created in 1999 has, in most respects, been a success.

However, developments in international finance and international economic policy, and the crisis these have yielded since 2008, have revealed significant problems within the euro area. These include imbalances between member states sharing the single currency, insufficient financial sector supervision at European level, ineffective surveillance of member states economic policies yielding unsustainable credit expansion, deficits and debt in some member states, asymmetric economic developments and weak overall growth. These serious problems within the euro area can be seen as reflecting insufficient political, policy and popular ‘buy-in’ to the euro as a project of prosperity, stabilisation and global governance. The effect has been that the EU’s system of decision making, monitoring and learning, though remarkable in many other spheres, has not been as effective as it needed to be in the areas most closely associated with the euro.

NESC’s three main policy findings can be summarised as follows:

- The future stability of the euro area depends on more effective surveillance and co-ordination of member states’ fiscal positions and structural policies, stronger EU-level financial regulation, as already agreed, and an ongoing reform process which addresses both the immediate problem and the dangers which threaten the prosperity of the euro area;

- To succeed within the euro, Ireland must learn the lessons of the past decade and take the necessary measures to ensure that future fiscal policy is counter-cyclical and sustainable, prices and costs maintain Ireland's competitiveness, and financial supervision prevents irresponsible banking practice;
- At both EU and national level, the effectiveness of policy depends on greater understanding of EU processes and wider public perception that they are being used in support of coherent strategies for prosperity, stability and inclusion.

We explain each of these below.

Reforming Co-ordination and Governance within the Euro

We have described the initiatives taken by the EU and its institutions in response to global financial crisis since 2008 and especially in the first half of 2010. These include actions taken already (such as providing liquidity, buying government bonds and providing loans to Greece), decisions to enhance co-ordination in the coming years and the creation of processes to explore further changes in the way the euro is governed. A key question at both EU and Irish level, is how to view these initiatives and processes.

In approaching this question, NESC and many others observers are quite candid in recognising that, notwithstanding the important steps by the EU, there are severe challenges on three fronts: the effectiveness of the temporary financial support provided to Greece (and stabilisation mechanism potentially available to other member states), the recovery of the whole European economy in the context of fiscal austerity and the continuing risks to the financial system at both global and European level.

Economic analysis of these dangers tends to highlight the possibility of enhanced EU policy instruments to manage aggregate European fiscal policy, address asymmetric shocks with fiscal instruments and reform global finance. Indeed, some see these economic dangers as reason for immediate radical adjustment of the policy competences and decision making systems governing the euro and the EU. At the extreme, radical adjustments are seen as necessary to establish an 'economic government' for Europe, a central authority to determine collective economic and monetary policy and a system of fiscal federalism.

Despite their analytical content, NESC does not believe that these big-bang ideas provide a sound basis for addressing the real problems and undoubted dangers that confront the euro. They take insufficient account of the policy and political risk which Europe faces—deadlock, in which contending perspectives cancel each other out, leading to an insufficient or incoherent EU response to the economic, fiscal and financial crisis. Indeed, such responses to instability risk creating more instability, being seen as a systemic challenge to the design and legitimacy of EMU. Even if they were agreed by the member states, big bang reforms which assume a perfect diagnosis and definite cure run the risk the missing the target. Once taken, a one-shot re-design could make it harder to make further adjustments in response to unforeseen developments.

The more pragmatic and gradualist agenda of reform set out by the European Council and the Commission is, potentially, a better way to address the weaknesses of the past, the definite current challenges and the dangers discussed in this report. It includes a strong focus on joint surveillance of economic policies, a closer link between fiscal policy and structural reform and a willingness, where necessary, to adapt the division of labour between monetary and economic policies. This is reflected in the on-going process of exploration, by a special Task Force on economic governance, chaired by President Van Rompuy.

The key is that this pragmatic and gradualist approach be open enough to see and respond to unfolding events and problems. Indeed, a pragmatic approach which does not set limits to reform is not only more feasible politically, and more nuanced analytically, but potentially more far reaching than a one-shot, high-stakes, re-design of EMU. It is in tune with the fact that deeper EU involvement in numerous policy spheres does not, in general, occur by enhancing the authority of a single authority. It recognises that the success of the euro will unavoidably depend on the member states seeing their fiscal policies and structural reforms as part of an EU regime of information sharing, joint learning and policy co-ordination.

What is required is a more reliable, better-understood, more-disciplined, widely-endorsed and clearly-articulated process for joint setting of goals, discussion of collective and national-level problems, and how the two relate to each other. In this respect, the reform process now underway must ensure that the governance mechanisms that the EU has already developed and made effective in other policy spheres are now brought to bear in economic and monetary union. At their best, these involve an effective system of joint goal setting, decentralised execution, information sharing, learning and system revision. They can include mandatory surveillance and penalties.

While the reform process now underway—centred in the European Council and the Task Force Chaired by President Van Rompuy—necessarily involves high-level bargaining involving the heads of state/government and the EU institutions, it will only succeed if it leads to a system in which better ongoing monitoring, co-ordination and learning becomes the norm at all levels of member state administrations and is less captive to inappropriate high-level obstructions based on misguided defence of national sovereignty, defined without sufficient acknowledgement of the national interest in the effective governance of a single currency. This requires greater political and popular buy-in to, and identification with, the euro as a project for prosperity, stability and global governance (see our third finding, below).

With a reform process of this kind, it should be possible for the EU to discuss and agree a pragmatic combination of measures that protects the euro, addresses the deficit and debt problems, supports macroeconomic recovery and responds to the risk of further financial sector and exchange rate turbulence. Ireland has a strong interest in the success of this process.

To Succeed in the Euro Ireland Must Learn the Lessons of the Past Decade Concerning Fiscal Policy, Prices, Competitiveness and Financial Regulation

NESC is in no doubt that, overall, membership of the euro has been, and is, beneficial for Ireland. However, the experience as analysed in this and other studies, shows that national approaches to fiscal policy, prices, costs and financial regulation were not sufficiently adapted to the disciplines of a single currency. The resulting pro-cyclical fiscal policy, loss of competitiveness and excess bank borrowing created unsustainable growth between 2000 and 2007 and made Ireland especially vulnerable to the global crisis which hit in 2008. The severity of the current crisis should make us absolutely determined to learn the correct lessons and make the necessary changes in the policies and behaviours that shape fiscal policy, prices, costs, bank lending and private borrowing.

Significant steps have been taken in the past year to reform Irish financial regulation and supervision, and NESC does not comment further on this in this report. As regards fiscal policy, it is of the utmost importance that the correct lessons of our current difficult experience are identified and acted upon.

The principles which should inform fiscal policy are clear: it must be counter-cyclical, sustainable and respect the EU Stability and Growth Pact. The core purpose of these principles is to run a sufficiently large surplus during a phase of strong growth to avoid over-heating the economy and to leave room for a degree of fiscal stimulus during a recession and, of course, to avoid a level of debt that pre-empts a large share of tax revenue or reduces national sovereignty. But our analysis shows that the understanding and application of these principles proved difficult in the past decade. Application of the principles requires a correct assessment of the relative size of three drivers of Ireland's economic growth: the genuine expansion of Ireland as a regional economy, the economic cycle and identification of asset price bubbles. The significance of these distinct factors can be seen in the light of recent experience, when policies had the effect of eroding the tax base and created a heavy reliance on property-related taxes. These factors interacted with a set of unresolved political economy issues. Among these were the appropriate scale of the public sector and public services, the level and incidence of taxation, the effect of inflation on incomes and costs, the best way of meeting increased housing need and the associated approaches to housing supply and land management. In this context, fiscal policy was driven by its components and the macroeconomic perspective on fiscal policy was relatively muted. The result was a weakening of the stability culture built between 1979 and 2000 and an inconsistent approach across the three categories emphasised by NESC since 1990: macroeconomic policy, distributional policy and structural policy.

Consequently, the policy lessons of Ireland's first decade in EMU are hard, but also broad. They certainly demand that government maintain a clearer focus on counter-cyclicality and sustainability. To assist government in this, some countries adopt fiscal policy rules (sometimes with legislative or constitutional force) and create an independent advisory fiscal policy council. In this vein, the European Commission has proposed that member states should have in place national fiscal rules ensuring that domestic fiscal frameworks reflect Treaty obligations and that fiscal rules and credible enforcement mechanisms be codified in national law. The Minister for Finance has asked the Joint Oireachtas Committee on Finance and

Public Service to consider the question and to report by September. In this report, NESC does not advance a view on the question of legal fiscal policy rules and an independent advisory council, but does set out some of the evidence and issues that need to be considered (see Section 8.3 and Box 8.3).

A clear lesson of the past decade is the need to achieve a more thorough resolution of the distributional and structural tensions that tend to create pressure for pro-cyclical fiscal policy and, indeed, tend to crowd out clear analysis of the macroeconomic context. They also include the need to avoid destabilising bubbles in the economy—especially in housing. Indeed, it may the case that the feasibility and effectiveness of an independent fiscal council depends on a sufficient degree of social consensus on the size of the tax take and public provision. While exploring the possible role of rules and independent experts in fiscal policy, it will be important to explore the analysis and relationships that can help to resolve the tensions that make adherence to fiscal principles difficult. Indeed, NESC's analysis would suggest that the whole burden should not be placed on aggregate fiscal policy. Distributional policies—including taxation, social transfers and wage bargaining—need to be consistent with the aggregate fiscal targets and outcomes. Structural policies—especially those that shape the supply of housing and other goods with a public dimension—can play a role in ensuring that fiscal policy is counter-cyclical and sustainable. NESC continues to hold the view—outlined in our two reports on *Ireland's Five Part Crisis*—that a broadly-based support for a balanced and consistent framework for recovery holds out the best prospect of ensuring a viable transition from our present economic difficulties (NESC, 2009a and b). It also represents the best prospect of ensuring that a consistent and balanced approach is maintained in future, supporting appropriate fiscal policy choices.

Success in the Euro Requires a Sufficient Shared Understanding

Our third general conclusion is that at EU and national level, the effectiveness of policy within the euro depends on greater understanding of EU processes and wider public perception that they are being used in support of coherent strategies for prosperity, stability and inclusion. An economic analysis of the past decade reveals the degree to which the problems since 2008 reflect imbalances and inadequate policy at both EU and national level in the years since 2000. Thus, the depth of the crisis—especially in Ireland and other countries experiencing deficit and debt problems—reflects earlier balance of payments deficits, excess inflation and asset price growth, ineffective EU-level policy surveillance, insufficient fiscal policy co-ordination, inadequate levels of banking supervision and a lack of structural reform in many member states. But our analysis of both the design of the euro and these developments suggest that these problems arise, in part, from insufficient policy, political and popular buy-in to the euro as a project for prosperity, stability and global governance. At EU level, member states, probably reflecting public sentiment, did not see their voluntary sacrifice of monetary policy as a reason to heighten their collective engagement in those areas where they are the key actors—fiscal policy, employment and structural reform. Instead of balancing a definite and deliberate loss of national control in monetary policy with enhanced collective action on economic policy, they were inclined to balance it with assertions of sovereignty in the economic area. In Ireland, once membership of the euro was achieved in 1999, there would seem to have been less, rather than more, recognition and acceptance of the disciplines inherent in a single currency.

Consequently, the future effectiveness of the single currency will depend on a higher degree political and popular identification with the euro and understanding of the division of labour and responsibilities inherent in membership. This requires a greater shared understanding of the how the euro can support the pursuit of stabilisation, employment and sustainable prosperity. In the first instance, this requires that the member states and the EU institutions are seen to be addressing the challenges facing the euro and the European economy. But building this shared understanding is not a task only for member state governments and the EU institutions, but for all economic and social groups who accept the euro as the context within which their goals must be pursued.

In this respect, the current crisis may be an important stage in the evolution of the euro. Despite the depth of the crisis, within the European Union it has prompted little criticism of the idea of an EU currency; among euro-area member states, it has prompted few second thoughts on the desirability of being within it. There is, of course, debate on the conduct of fiscal, structural and monetary policy—at national, Council and ECB level—within the euro. All whose fate depends on the success of the euro have an interest in the current reform process reaching an agreed conclusion which is effective in addressing the immediate problems and economic dangers confronting the euro. This certainly depends on the content of the reformed procedures and policies—on joint surveillance, fiscal policy co-ordination, debt reduction, macroeconomic recovery and banking supervision. But it also depends on affirmation of the appropriateness of euro-area and EU-level mutual surveillance and collective disciplines. In Ireland, this requires a clear narrative of the place of the euro in our long search for a macroeconomic and monetary regime that is supportive of national development (see section 2.4).

The process of reform and policy correction at EU and national level is far from complete. But the task set—to protect the euro, address the deficit and debt problems of member states, support macroeconomic recovery and sustainable growth, and address the risk of further financial sector turbulence—is worthwhile. Ireland's interest lies in this reform process being open enough to address all the problems as they arise and moving to a successful resolution.

In summary, NESC's analysis of the experience and challenges of euro membership suggests three main policy conclusions:

- The recent decisions to strengthen EU policy coordination, and the ongoing exploration of how to improve the economic governance of the euro area, are in Ireland's interest;
- The fiscal policy lessons of the past decade must be learned and reflected in future approaches to budgetary and other policies;
- The success of Ireland's membership of the euro depends on wide public understanding and support, based on a clearly-articulated perspective in which the monetary and exchange rate framework of the euro is shown to be supportive of strategies for national economic and social development.

Further policy lessons and recommendations will be identified in NESC's wider study of Ireland's EU membership, in report No. 122.

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