



An Chomhairle Náisiúnta Eacnamaíoch agus Shóisialta  
National Economic & Social Council

# The Euro: An Irish Perspective

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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 have 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 obligation 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.