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SYMPOSIUM ON THE EUROPEAN MONETARY SYSTEM

THE EMS – IRELAND'S EXPERIENCE AND PROSPECTS

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1. *INTRODUCTION*

Economists argue about the relative merits of fixed and floating exchange rates and, in particular, about which is more conducive to efficient stabilisation policy; most would agree, however, that exchange-rate stability is desirable. Stable exchange rates provide an environment of reduced risk for traders, encourage international trade and investment and, thereby, increase growth and employment. In the 1960s, exchange-rate stability meant fixed relationships between currencies. Today, exchange-rate stability can exist in either a fixed or a floating arrangement but has a looser connotation, i.e., that adjustments in currency relationships take place smoothly and only infrequently.

When the Bretton Woods system of fixed exchange rates broke down in the early 1970s, instability of exchange rates increased. Europeans considered that the disorder brought to the international monetary sphere by difficulties facing the dollar should not, and need not, be allowed to interfere with the arrangements for a fixed-rate system among themselves – the snake – which had been established in 1972 as a select club within the Bretton Woods system. They were wrong. The turbulence generated by the devaluation and subsequent floating of the dollar in 1973 and the large oil price increases put pressure on the cohesion of the "snake". By early-1976, the United Kingdom, Ireland, Italy and France no longer participated in the arrangement which, in consequence, became little more than a Deutschemark zone. The external developments served to exacerbate the internal economic divergences that existed between the member States of the EEC. Ambitious plans for Economic and Monetary Union (EMU) in the Community were shelved, as it was realised that such a union could not be achieved while large divergencies existed between the economic circumstances of member States, particularly between their rates of inflation (Murphy and O'Connor, 1976).

Nevertheless, there was a succession of initiatives on the exchange-rate front. The proponents of these initiatives believed that, irrespective of intra-Community economic divergences, technical arrangements to maintain at least short-term stability on the foreign exchange markets were worthwhile. Several technically ingenious initiatives were propounded, discussed and shelved, until one such initiative coincided with, and seemed to offer a solution to, difficulties being faced by the most powerful country in the Community – the Federal Republic of Germany.

The dollar had been weakening since the middle of 1977 and the Deutsche Bundesbank was intervening to mop up funds moving out of the dollar and into the Deutschemark. The German authorities believed that the large capital inflows into Germany, which

*The views expressed in this paper are the personal responsibility of the author and need not necessarily be those held by the Central Bank.

threatened to undermine German monetary policy, could be spread around Europe if a credible European exchange rate system existed (Fratianni, 1980). When Chancellor Schmidt enlisted the support of President Giscard D'Estaing, who had his own ideas about a more equitable European exchange-rate system, the birth of the European Monetary System was assured. It was to be a pragmatic response to a set of circumstances rather than a relaunching of EMU. Flexible exchange rates had yielded instability and had triggered vicious circles of inflation (Oort, 1979). Adjustments of exchange rates had tended to overshoot their equilibrium levels. A technical arrangement that would tackle these problems and at the same time demonstrate Community co-operation was well received.

2. THE DECISION FOR IRELAND

Before the 1970s, the one-for-one link between the Irish pound and sterling was hardly questioned except when sterling devalued in 1949 and 1967 and, even on those occasions, there was little or no serious talk of an alternative. This attitude was understandable and justifiable. We had a fixed exchange rate for a large proportion of our trade and financial transactions, and a free flow of funds between Ireland and the most developed financial market in the world (Browne and O'Connell, 1978). The link with sterling, because of general currency stability at the time, provided the Irish pound with stability against the major international currencies.

The debate on the appropriateness of the sterling link really began as Britain began to experience rapid inflation. In June 1972, the UK decided to leave the EEC "snake", in which it had participated for only a matter of weeks, and sterling was allowed to float. For the next several years, the fortunes of sterling continued to decline. Domestically-induced difficulties were exacerbated by the reserve role which sterling had played for so long.

The critical examination of the link with sterling centred mainly on how inflation is transmitted in a small open economy (McCormack, 1979; McDowell, 1975; Murray, 1978). As a very small economy accounting for only a very small proportion of world trade, Ireland is largely a price taker on world markets. With a fixed exchange rate, therefore, price movements in our main trading partners have a significant influence on price movements in Ireland. The effects of price movements abroad are felt rapidly in the tradeable goods sector and are quickly transmitted to the non-tradeables sector as factor prices react to developments in the tradeables sector. In the short run, domestic developments or policies can influence domestic costs and prices but, in the long run, with a fixed exchange rate, external influences predominate. Thus, through the early and middle 1970s, as the inflation rate in the United Kingdom worsened, so did that in Ireland (see table).

Consumer Price Indices, Average Annual Percentage Increases

	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980
West Germany	3.4	5.3	5.5	6.9	7.0	6.0	4.5	3.7	2.7	4.1	5
United Kingdom	6.4	9.4	7.1	9.2	16.0	24.2	16.5	15.8	8.3	13.4	18¾
Ireland	8.2	8.9	8.7	11.4	17.0	20.9	18.0	13.6	7.6	13.3	18¼

Source: OECD "Consumer Price Indices".

An extension of this analysis of the main determinant of our rate of inflation leads to a conclusion as regards the effects of an exchange-rate change. In a small open economy a change in the exchange rate will be translated rapidly into a change in the overall domestic price level (Commission of the European Communities, 1976). All prices will adjust over time to those of traded goods, which will rise in national currency terms following a depreciation and fall following an appreciation. A *depreciation* will have a short-run beneficial effect on output in export and import-competing industries and thus on the Balance of Payments. This results from the increased profitability of domestic producers caused by the increase in export and import prices in national currency terms. This increase in profitability will remain only as long as the prices of domestic factor inputs do not respond fully to the general increase in prices, essentially that is as long as real wages are not fully restored to their pre-depreciation level, since labour is the primary input. However, in Ireland money wages tend to adjust fully and fairly quickly to price increases. This is reinforced by the element of indexation in recent national wage agreements. Following an *appreciation*, there will also be a time lag – probably greater than in the case of a depreciation – before factor costs, particularly wages, adjust to the lower price level. During this time, profits will be squeezed and, consequently, unemployment may rise in export and import-competing industries. The adjustment lags for prices will determine to what extent, or rather for how long, the exchange rate appreciation affects output, employment and the Balance of Payments. But such real effects will tend to be in the short term only. In the long run the relationship between domestic prices and world prices and that between factor prices and output prices tend to be re-established and any short-run effects on output and the Balance of Payments will disappear. Thus the conclusion was, and is, that exchange rate policy should not be used in an attempt to achieve increased output or to reduce the Balance-of-Payments deficit but rather could be used, in concert with other policies, to control the rate of inflation.

The emphasis in considering alternative exchange-rate regimes for Ireland was, therefore, on regimes that would yield a strong exchange rate, or at least stability, as opposed to the weakness that was expected of sterling and of a sterling-linked Irish pound. In theory there were several options available, namely, revaluing against sterling but maintaining a link; floating the Irish pound; joining the "snake"; or, adopting an effective exchange-rate objective. The long-run implications of a revised sterling link would have been similar to the old arrangement. Free floating is not a realistic option for a small open economy. The "snake" was seen as a very strong regime for which we were not yet ready. It is hardly revealing any secrets, therefore, to say that the preference was firmly for an effective exchange-rate objective. Specifically, a zero-effective exchange-rate change target would involve choosing exchange rates for the Irish pound against all quoted currencies which would represent no change, on average, in the value of the Irish pound in terms of the currencies of our main trading partners – the averaging being done on the basis of trade weights. The intuitive appeal of this option was that it implied neither an appreciation nor a depreciation against the currencies of our competitors. Since it was expected that sterling would decline, the preference for this option reflected a preference for a stronger regime than a continuation of the sterling link would imply. However, given that sterling has a weight of almost 50 per cent in our trade-weighted effective index, the option would not have been as strong as "snake" membership.

In 1978 a further option was added to those mentioned, namely participation in an EEC exchange-rate mechanism which would, it was hoped, include sterling. This would provide the two-fold advantage of a stronger and, therefore, less inflationary regime than we might expect with the sterling link, and exchange-rate stability with the currencies accounting for 75 per cent of our trade. As such it would be tantamount to adopting a zero effective exchange rate change target. From what I have said, it will be clear that

there must have been a strong predisposition in favour of participation in the EMS. When it became obvious that sterling would not be participating, the nature of the arrangement changed completely from Ireland's point of view, and it was at that stage that the "psyching up" to a stronger regime that had taken place over the previous few years came into play.

3. PERCEPTION OF THE EMS

The exchange-rate mechanism of the European Monetary System comprises essentially the parity grid and intervention requirements of the old "snake" and the new element of a "divergence indicator" which was designed to introduce an element of symmetry into the system. This latter factor was hardly a sufficiently major adaptation of the "snake" to make the system suddenly attractive for us. Furthermore, I would hope that far-seeing politicians and bureaucrats did not decide to make a move with such long-term implications on the basis of the promise of resource transfers in the short term. Thus, the decision to join the EMS can only be interpreted, from an economic viewpoint, as a commitment to a hard-currency regime which was expected to bring benefits in terms of a reduction in inflation. The judgement that the EMS would be a relatively strong regime was based on the belief, widely held at the time, that sterling would depreciate against other major currencies despite the coming on tap of north-sea oil.[1] A further factor in the decision was the expectation that the break between the financial markets in Ireland and the United Kingdom would give greater scope for Irish interest rates to deviate from UK rates. Given that interest rates in the United Kingdom were the highest in the Community at the time, this represented a strong, and politically appealing, argument.

It was emphasised, particularly by the Central Bank (McCarthy, 1979; Murray, 1979A, 1979B), that the benefits of adherence to a strong exchange rate regime could not be enjoyed unless the exchange-rate policy was supported by an anti-inflationary stance in other policy areas. The absence of such supporting policies would lead either to the eventual necessity for very restrictive policies, jeopardising employment and growth, or to a devaluation of the currency with the inflationary effects discussed earlier. The necessary policy measures envisaged would involve short-term belt-tightening but, when the adjustment to a lower inflation rate had taken place, the anticipated stable environment for growth should ensue. Supportive action would be needed in the areas of monetary, fiscal and incomes policy. An over-rapid expansion of domestic credit would boost domestic demand and increase the Balance-of-Payments deficit and/or lead to capital outflows (via a lowering of interest rates) both of which would reduce the level of our external reserves. A too rapid or too large fall in the level of our external reserves would put downward pressure on the exchange rate, requiring either very restrictive policies to get the Balance of Payments and reserves back into shape or a devaluation of the currency which could be the start of a vicious circle of depreciation/inflation. A similar effect on the Balance of Payments could result from overspending by the Government, i.e., lax fiscal policy. The effect on the external reserves could be offset for the time being by Government borrowing abroad, but it would not be a sustainable long-term arrangement. The third area in which restraint would be needed, in a transition to a lower rate of inflation, is incomes. The effects of ignoring the requirement for lower nominal income increases would be seen in higher unemployment and, eventually, pressure on the external reserves and the exchange rate. Large income increases would squeeze the profits of

1. Towards the end of 1978 the major exchange-rate forecasters – NIESR, London Business School, Exchange Rate Outlook – were predicting that sterling's effective exchange-rate index would fall by between three and seven per cent by end-1979. In fact the index rose by over twelve per cent.

exporters and producers of import-competing goods. Loss of competitiveness would lead to business closures and job losses, and to a deterioration in the Balance of Payments and external reserves position. On the other hand, lower income demands in the revised expectation of lower inflation would help that expectation to become self-fulfilling.

4. THE EXPERIENCE TO DATE

A review of how the reality of EMS participation to date differed from the expectation is necessary if any conclusion is to be arrived at as regards the future. The exchange-rate regime which we joined turned out to be significantly weaker than staying with sterling would have been as is shown in Chart 1. Furthermore, it can be seen from Chart 2 that the Irish pound is weaker, on average, now than it ever was and fell more rapidly during EMS membership than at any time since 1976. Thus, on the basis of our earlier analysis, we can conclude that, if we had not joined the EMS but the Irish pound had remained linked to sterling, our inflation rate would be lower. However, it is questionable whether the sterling link could have been maintained with the former ease as the Irish economy was not in a position to benefit from, or perhaps survive, a currency appreciation caused essentially by the oil riches of the United Kingdom and the high interest rates of a tight monetary policy there. The depreciation against sterling gives short-run profitability (or competitiveness) gains to exporters in the non-agricultural sector. These gains are denied the agricultural sector since the system of guaranteed prices expressed in ECUs, together with a fixed "green" exchange rate, does not allow an increase in the domestic currency price of agricultural exports normally forthcoming from a currency depreciation. On the other hand, the depreciation results in higher prices for that large proportion of agricultural inputs – domestic and foreign – which is not covered by the Common Agricultural Policy. Thus, incomes in the farming sector have been squeezed. Of course the EMS is an adjustable-peg system and we have the option of devaluing our currency. This course of action, together with a "green" rate devaluation, has been suggested as a way of increasing agricultural incomes. From our earlier analysis it must be clear that the short-term gains from such a move would be quickly eroded by the resultant increase in inflation. Furthermore, the increase in the inflation rate would be likely to lead to higher interest rates which would further squeeze farmers' net incomes.

The EMS did allow us to be more independent of interest-rate developments in the UK but did not immediately result in the low interest rates many had hoped for. There was a mistaken expectation in some quarters that by joining the EMS our interest rates would quickly fall to the level of interest rates in Germany. The requirement that Irish interest rates closely follow UK rates was relaxed but other factors governing interest-rate levels continued to require high rates (Breen, 1980). The outflows associated with a continuous deterioration in our Balance -of-Payments position put pressure on domestic liquidity driving up interest rates. Irish interest-rate developments also reflected developments abroad. At around the time the EMS was started, international interest rates were generally on a rising trend. This reflected attempts (in less open economies than Ireland's) to contain the inflationary surge resulting from higher oil prices by setting strict targets for monetary aggregates. Ireland had to mirror these interest rate developments to protect the external reserves. Outflows could occur as a result of non-residents, who are not subject to exchange control regulations, moving capital out to take advantage of interest rate differentials or traders using leads and lags on current-account payments to take advantage of the same differentials. The recent fall in interest rates is more like what was expected of EMS membership and would not have occurred to the same extent if the old relationship with the UK financial market still existed. The falls were occasioned by the increase in liquidity on the Dublin market, itself the result of increased foreign borrow-

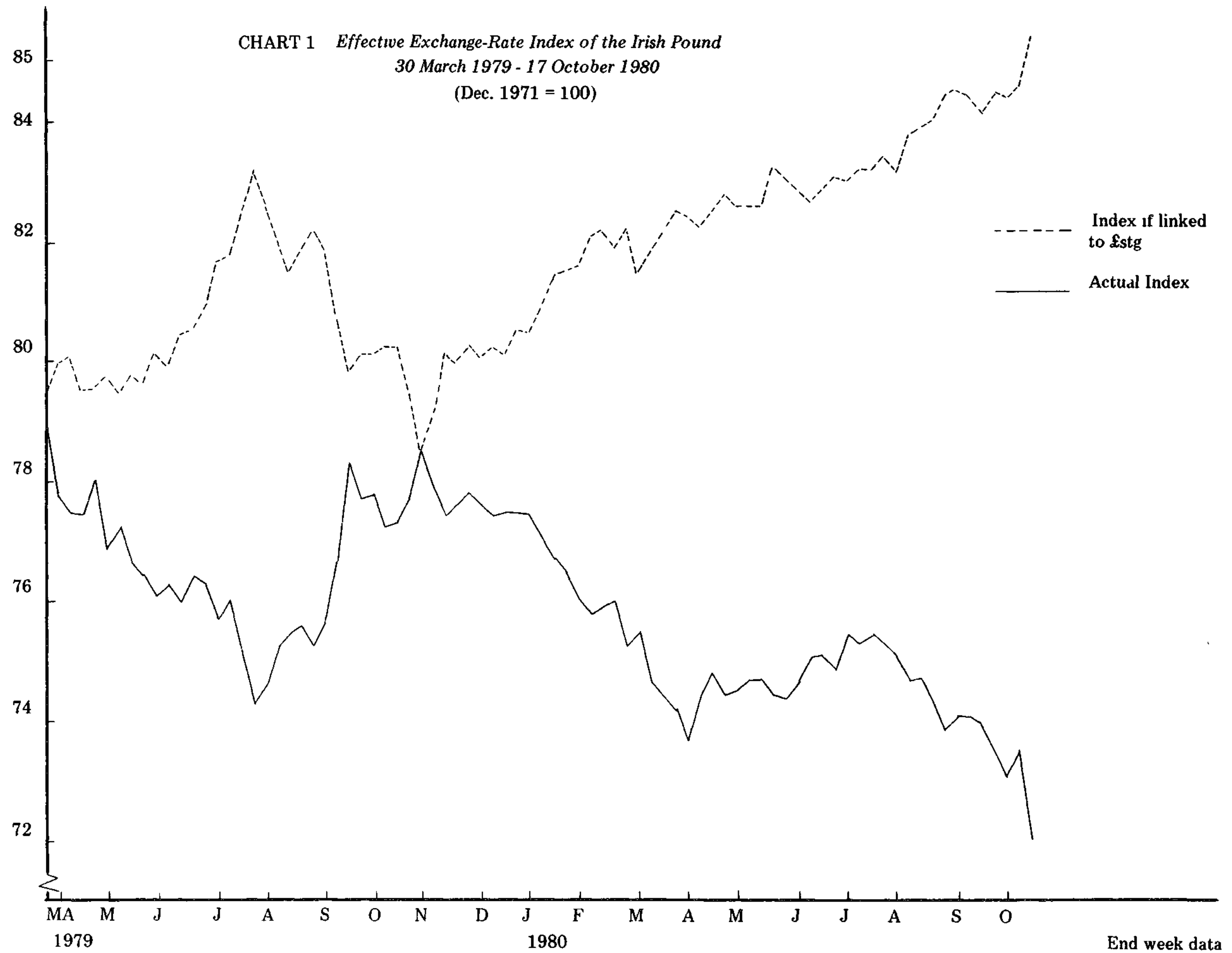

CHART 1 *Effective Exchange-Rate Index of the Irish Pound*
30 March 1979 - 17 October 1980
(Dec. 1971 = 100)

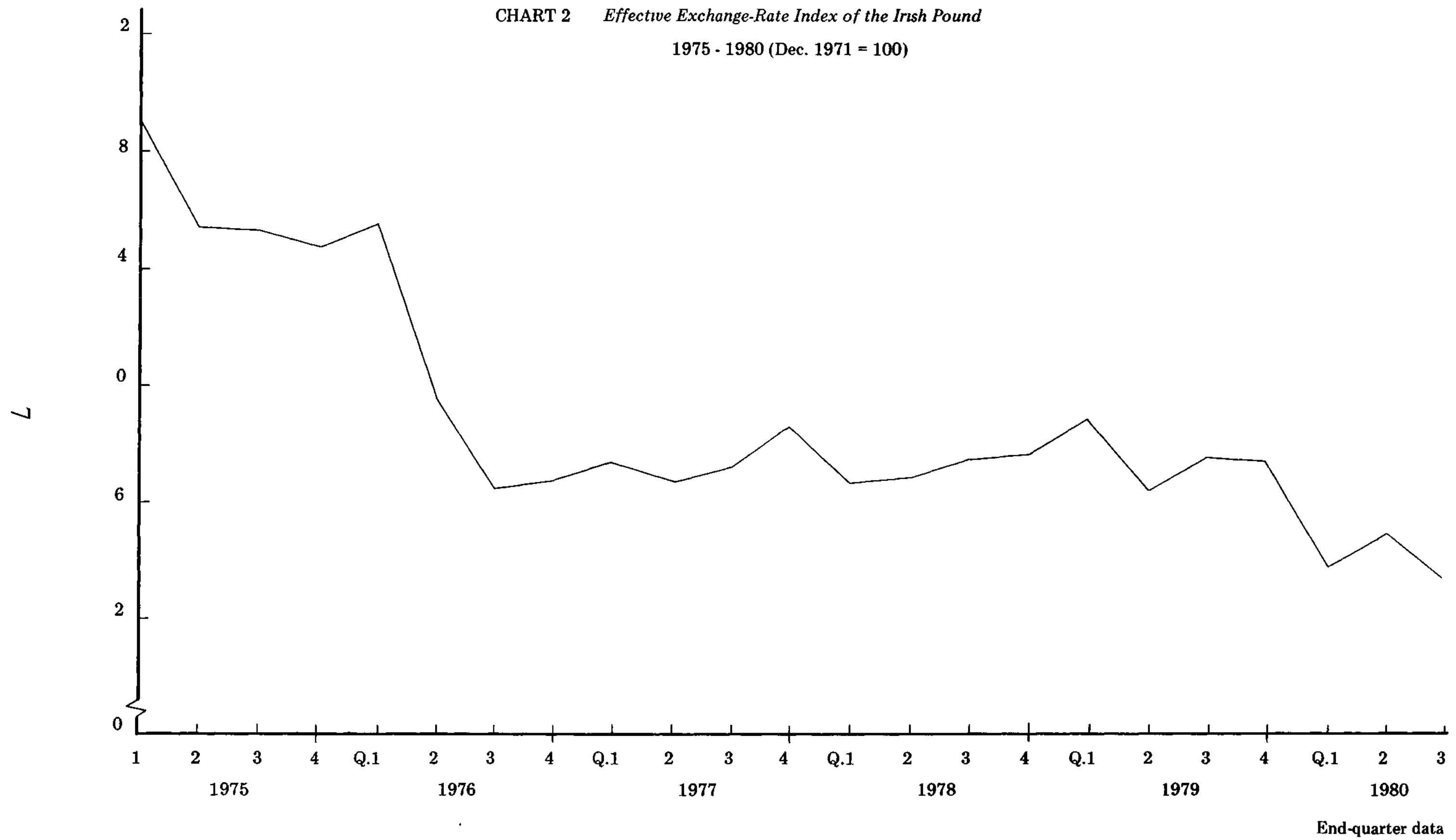

CHART 2 *Effective Exchange-Rate Index of the Irish Pound*

1975 - 1980 (Dec. 1971 = 100)

ing, mainly by the public sector, and by the emergence of recessionary tendencies in the economy. An easing of interest rates abroad over the Summer also facilitated the downward movement in our rates.

The performance of the Irish pound in the EMS band has not given cause for concern to date. Of course, it is only since June 1980 that the level of the Irish pound has been determined primarily by market forces. Up to then the Central Bank administered the rate for the pound within margins narrower than those permissible under EMS, thereby largely determining its position in the band. This was necessary to give the Dublin foreign-exchange market time to develop and to protect the Irish pound from the effects of the outflow of funds, i.e., the portfolio adjustment, which followed the start up of EMS. Since June 1980, the pound has been consistently in the upper half of the band and on occasion was the strongest currency in the system. This situation prevailed mainly because of the relatively large supply of foreign exchange coming onto the Dublin market as a result of foreign borrowing by the public sector and the seasonal improvement in the Balance-of-Payments position which occurred in the Autumn. This improvement was reinforced by the effects of the deepening recession. An encouraging aspect of this situation is that at no time could it be considered that the pound had come under speculative pressure because of a lack of confidence in the currency. Ironically, the short-run effects of the appreciation of sterling against the Irish pound have probably helped the Irish currency to maintain its position in the EMS. A less encouraging aspect of the situation is that the strength of the pound is to such a large extent due to public foreign borrowing, the proceeds of which increased the supply of foreign exchange to the market. This, of its nature, must be a short-run phenomenon. Public foreign borrowing, though offsetting to an extent the effect of the Balance-of-Payments deficit on the official external reserves and thus giving temporary support to the currency, increases the level of the net external liabilities of the public sector. These liabilities could in time reach a level where confidence in the currency would be undermined.

5. CONCLUSION

The outlook for Ireland in the EMS is as uncertain now as it was at the time of joining. In fact, an assessment of likely future developments and requirements reads very similarly to the position late in 1978. It is fairly widely considered that the appreciation of sterling will not continue in the medium term. Thus, the expectation now, as at the time of joining, is that the EMS will become a stronger exchange-rate regime than we have become used to in the recent past. The interlude that occurred as sterling rose and the effective exchange rate index of the Irish pound fell might have been regarded as a respite from the forecast necessity for discipline, and should have been used to begin the implementation of necessary adjustments. Unfortunately, this did not occur and we are now facing the prospect of a more disciplined exchange-rate regime with Government finances in a more difficult position than in 1979 and a National Understanding agreed which is inconsistent with a strong currency and lower inflation rate. It should be emphasised that it is the provisions of the National Understanding and the present state of Government finances that are undesirable; a stronger exchange rate is essential if we are to make real progress towards reducing inflation. The stance of monetary policy in 1979 and 1980 has been more in accordance with the requirement of EMS membership. However, credit restraint applied only to the private sector, while monetary financing of the Exchequer was very large. This tended to weaken the overall stance of monetary policy. Maintenance of the Irish pound in a stronger exchange-rate regime than that experienced in the immediate past will require consistency between monetary, fiscal and incomes policies and that these policies be sufficiently disciplined to defend the exchange rate.

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