**Title**  
Symposium on exchange rate policy and competitiveness

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**Publication date**  
1982-11

**Series**  
UCD Centre for Economic Research Policy Paper Series; No. 2

**Publisher**  
University College Dublin. School of Economics

**Item record/more information**  
http://hdl.handle.net/10197/1350

**Notes**  
A hard copy is available in UCD Library at GEN 330.08 IR/UNI

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SYMPOSIUM ON EXCHANGE-RATE POLICY AND
COMPETITIVENESS

C. McCarthy⁺, J.P. Neary, R. Thom
and B.M. Walsh

Policy Paper No. 2

November 1982

⁺Davy Kelleher McCarthy Ltd.

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College Dublin. All opinions expressed are those of the contributors
and do not necessarily reflect the views of other members of the
Department. A list of other publications of the Centre is given at the
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SYMPOSIUM ON EXCHANGE-RATE POLICY AND COMPETITIVENESS

INTRODUCTION

The four papers in this symposium were originally presented at the Fifth Annual Economic Policy Conference of the Dublin Economics Workshop held in Killarney on October 15-17 1982 and are published together in this Policy Paper with only minor alterations. Taken together, they illustrate the complexity of the issues which must be faced in devising an exchange-rate policy as well as the diversity of views held by economists on the subject.

The careful reader will note that the papers differ in their views on the advisability of a "soft currency" policy, with Thom firmly opposed and McCarthy and Neary cautiously in favour. Despite these differences, all four papers agree that the competitiveness of the Irish economy has deteriorated alarmingly in recent years. Moreover, they all accept, with varying degrees of enthusiasm, that one way of ameliorating this situation (though a way fraught with difficulties) would be a devaluation of the Irish pound (or, more accurately, a reduction of the Irish pound's central rates at the next E.M.S. realignment). However, all four authors would insist that a devaluation is not a "soft option". At best, it may give rise to a temporary improvement in competitiveness. The other and equally serious difficulty now facing the Irish economy - the deterioration in the public finances reflected in the massive balance-of-payments deficit - must be tackled by different means.
I Devaluation, Output and Employment

Rodney Thom

University College Dublin
1. Introduction

This paper considers the effectiveness of devaluation as a means of reducing unemployment and of stimulating output in a small open economy (SOE). The analysis uses Malinvaud's (The Theory of Unemployment Reconsidered, 1977) distinction between 'Keynesian' and 'Classical' unemployment and draws on the work of Cuddington (Journal of International Economics, 1980) who extends Malinvaud's ideas to a SOE. Briefly, Keynesian unemployment exists when there is excess supply of both labour and output, while Classical unemployment corresponds to excess labour supply and an excess demand for output.

Sections 2 and 3 consider the effectiveness of devaluation in each 'model' and demonstrates that the Keynesian assumptions are more favourable in terms of output and employment gains. Section 4 considers the longer run aspects of devaluation and suggests that exchange rate policy is futile in the face of real wage resistance.

2. Keynesian Unemployment.

Consider an economy which produces and consumes two goods - an importable good and an exportable good. The important distinction between these goods is that the economy is assumed to be a price taker for the former but not for the latter. Setting the foreign currency price of importables at unity implies that the domestic price equals the exchange rate (i.e., $P\times e = P^*$, $e$ = domestic currency price of one unit of foreign currency and $P^*$ = foreign price of importables. ) The following are a typical set of Keynesian
assumptions:

(i) Nominal wages and the domestic price of exportables are fixed in the short run. Exportable production is therefore demand determined in the sense that a rise in e will reduce the relative price of exportables and the increased demand will be satisfied by higher production at the given real wage.

(ii) Importable production depends upon the real wage in that sector. If the importable sector is a price-taker then it can sell its output at a given world price. A devaluation will therefore reduce the real wage paid by importable producers and provide an inducement to increase output and employment.

Given these assumptions consider the impact of a devaluation in the presence of Keynesian unemployment. A rise in the exchange rate corresponds to a rise in importable prices and to a fall in the real wage paid by employers. Production and employment in this sector will therefore rise. The direct effect of devaluation on import prices (negative substitution effect) combined with increased importable production will reduce import volume but these effects will be partly offset by any stimulus to imports arising from higher domestic incomes (positive income effect). Devaluation also lowers the relative price of exportables, raising export demand and, consequently, output and employment.

3. Classical Unemployment

Following Malinvaud's definition, classical
unemployment is characterised by excess labour supply and by excess supply in the exportable sector. This situation may arise if the real wage is currently above the full employment level and if domestic demand for both goods is always satisfied. Export volume will then equal the surplus of domestic exportable production. That is, exports are that part of domestic production which is not consumed domestically.

Cuddington justifies this 'rationing' assumption on the basis of lower transport, transactions, queuing and information costs to domestic consumers. Conceivably, domestic producers may, for similar reasons, prefer to supply domestic rather than external markets. Cuddington also gives some North American examples of restrictive export policies such as Canada's restrictions on natural gas exports to the US - it is not too difficult to believe that the Irish government would take the same attitude towards gas exports to Northern Ireland.

Production of exports in this model depends only on the real wage with the consequence that devaluation will not affect either output or employment in the exportable sector. Devaluation will, however, increase domestic demand for the exportable good and lead to a decline in export volume. As in the Keynesian case, devaluation reduces real wages in the importables sector and therefore stimulates both output and employment in that sector.

The effect of devaluation on importables production is the same in each model, but differs with respect to the
exportable sector. In the Keynesian model, production and employment are stimulated in both sectors but only the importable sector is stimulated in the classical model. It is therefore of some importance to decide which model, if any, best describes the Irish Economy. This task is another days work but some headway might be made if we transform 'Keynesian' to 'demand-constrained' and 'classical' to 'cost-constrained'. I would then be in agreement with the February 1982 ESRI Quarterly Commentary - "The circumstances that prevail in the economy with a balance of payments deficit amounting to 10 percent of GNP and a level of unemployment of 11.5 percent indicate an economy which is cost constrained rather than demand constrained." - Although I would in no way suggest that the authors agree with the above transformation.

4. Real Wages.

The critical assumptions in both models are that money wages are fixed and that the domestic currency price of exportables is constant. These assumptions permit a decline in real wages in the importable sector and a change in the relative price of exportables. At this point it is important to distinguish between the real consumption wage and the real production wage. The former is the money wage relative to the consumption price index- a weighted average of importable and exportable prices, while the latter is the money wage relative to the price of the good produced by each sector. The consumption wage is the variable relevant to labour supply decisions and the production wage
determines labour demand.

In each model a devaluation reduces the real production wage in the importable sector and the consumption wage in both sectors. What if workers (ICTU) demand and are granted compensating wage increases. The domestic price of exportables will then rise wiping out any competitive advantage from the devaluation and the real production wage will rise in the importable sector preventing any increase in domestic production. In other words, if workers perceive a devaluation as corresponding to a decline in real living standards then the real impact of the policy will be minimal.

I am not suggesting that money wages adjust instantaneously to the price effects of a devaluation. Clearly there is a period over which real wages are reduced and in which real gains can be made in terms of increased output and employment. But this period may be relatively short - the people who experience real wage cuts may not be dead in this particular 'long-run'. We must choose between a model in which demand policies (fiscal, monetary and exchange rate) force real wage changes or a model in which such policies do not affect real wages. The truth will, of course, fall in between, but my view is that the latter is more realistic. In support of this view I cite Ball and Burns' simulation results for the UK economy. "Output rises to begin with,...,owing to the increase in exports and reduction in imports brought about by the impact of the devaluation. However, ultimately prices rise by the full
extent of the devaluation as the effect of currency
depreciation upon import prices leads to an increase in
wages and inflationary expectations. This offsets the effect
of the exchange rate in improving competitiveness and as a
result exports and imports return to their original level" (Modelling the International Transmission Mechanism, edited
by JA Sawyer, 1979)

5. Conclusions.

It should be obvious that I take the view that
devaluation will not lead to any permanent gains in terms of
increased output and employment. In other words I do not
believe that devaluation is a significant cause of our
present economic problems - unemployment and external
deficit. These difficulties exist because real wages
are, relative to productivity, above the level necessary to
achieve 'full employment' and because the government deficit
is in excess of the private sector surplus. The goal of
full employment requires real adjustments - such as a
decline in real wages of the unemployed - and cannot be
achieved by changing some magic number in an economic
model, whether it be G, e or even M.

Finally, if we accept that devaluation may produce real
gains for say, 9 to 12 months, then why not take these gains?
Unfortunately this argument ignores some of the nastier
aspects of Irish economic life. The process of real wage
adjustment in this country can be socially painful in terms
strikes, go-slow, shortages etc. Further those people who
gain jobs must eventually lose them when real wages are
- 8 -

restored — or will government attempt to halt rising unemployment by handouts, subsidies, and (why not?) another devaluation?
II Exchange-Rate Policy for a Not-so-Small Open Economy

J. Peter Neary

University College Dublin
EXCHANGE-RATE POLICY FOR A NOT-SO-SMALL OPEN ECONOMY

One of the many ironies of recent Irish economic experience has been the complete breakdown of the so-called Small Open Economy (SOE) model just at the moment when economists had succeeded in convincing much informed public opinion of its validity. This short paper attempts to tease out this irony and to note some implications. In particular it updates earlier work by Walsh (1981) on the fate of the punt in the EMS (i.e. post-SOE) era; it reviews some standard arguments in favour of exchange-rate flexibility; and it notes why these arguments may be dangerous if applied in the current Irish context.

I

During the period of the link with Sterling, Irish inflation rates were closely tied to U.K. rates. This was confirmed for example by the detailed statistical analysis of Geary (1976). This empirical regularity justified the popularity of the SOE model, more properly known as the hypothesis of extreme purchasing power parity (PPP): a unit of home currency should have the same purchasing power whether spent at home or abroad. Although, in the Irish context, the implications of this hypothesis for inflation attracted most attention, it is also very relevant to any discussion of exchange-rate policy. For, if PPP holds in its extreme form, a change in exchange-rate parity cannot affect domestic output or employment but merely serves to redistribute the world money supply between the home and foreign countries. Hence it is necessary to examine the relevance of this hypothesis to Ireland before we can even
begin to discuss the desirability or otherwise of exchange-rate flexibility.

The hypothesis of PPP enjoyed widespread support among academic economists in the early 1970's. However, since then it has been found to be empirically inadequate even for relatively homogeneous traded commodities (Isard (1977)); it has been superseded by the assumption of sluggish price adjustment in the more popular models of exchange-rate determination (Dornbusch (1976) and Purvis (1982)); and it has been abandoned even by its most enthusiastic Chicago supporters (Frenkel (1981)). It has also fallen apart for Ireland as charts 1 and 2 illustrate.

These charts update, where possible, the work of Walsh (1981) to the third quarter of 1982. They illustrate, for Germany and the U.K. respectively, the exchange rate (i.e. the foreign currency price of the punt) and the ratio of foreign to Irish consumer prices. The prediction of the extreme PPP hypothesis for this chart is unambiguous. The two series should move in line with one another, either because the exchange rate depreciates to make up for any excess of home over foreign inflation (and conversely), or because the 'discipline' of a pre-determined path for the exchange rate forces the domestic price level to keep in line with that prevailing abroad. (The latter chain of reasoning, which might be termed the 'tail wagging the dog' argument, was widely used as a justification for Ireland's joining the EMS.)

Whatever the chains of causation involved, it is clear from both charts that this prediction is rejected. In the case of Germany, chart 1 shows that PPP worked as a reasonable approximation for the pre-EMS period, despite the considerable fluctuations in the Mark-Punt exchange rate. By contrast, since March 13 1979, the exchange rate has depreciated only slightly whereas the price ratio has moved steadily in Germany's favour. An alternative way of expressing these results is in terms of the real exchange rate (the nominal exchange rate deflated by the relative price ratio, i.e., the ratio of home to foreign prices measured in a common currency). Expressed in this way, the punt experienced between the first quarter of 1979 and the second quarter of 1982 a nominal depreciation of 7.8% but a real appreciation of an astonishing
36%. Clearly a case of 'dog eats tail'!

Chart 2 can be interpreted as providing more support for PPP but even here the length of the time-lags involved suggest that it is a slender basis for short-run or even medium-run policy. Before 1979 of course, the hypothesis is amply confirmed as already noted. However, during the first two years of EMS membership, this traditional relationship was completely overturned by the apparently inexorable rise in Sterling. (Sometimes referred to as a fall in the punt, a nice linguistic confusion reminiscent of a remark by a character in Tom Stoppard's play Rosencrantz and Guildenstern are Dead: 'the sun is going down, or, as the new theory has it, the earth is coming up.') Since then, the drop in UK inflation and the gradual descent of Sterling from its dizzy petro-currency heights have restored some semblance of a PPP-type relationship. Nevertheless, the real depreciation of the punt, which was as great as 20% in the first half of 1981, is still in the second quarter of 1982 equal to 7%.

These empirical findings raise many more questions than they answer. One notable feature, for example, is the relative stability of the UK-Irish price ratio: Irish prices in punts have kept quite closely in line with UK prices in Sterling, an outcome totally at variance with PPP and indeed more supportive of sociological or institutional theories of inflation. These findings also suggest that there may after all be a role for domestic policy in controlling the Irish rate of inflation. However, the implication of these charts on which I wish to focus is that they restore the possibility/using exchange-rate management as a tool for stabilisation policy. I turn next to review some of the standard arguments which defend this role.

II

One of the less pleasurable experiences of every economics teacher is to witness the glazed expressions which descend on every class of students as the differences between the elasticities, absorption and monetary approaches to devaluation are explained to them. Without entering into such intricacies, let me simply note that the proximate effect of a devaluation is to lower the relative price of home to foreign currency. If, in addition, domestic prices and wages do not
adjust immediately, the immediate outcome must be a fall in domestic prices relative to those abroad. Viewed in this light, devaluation is just one method of changing relative prices and of engineering an improvement in competitiveness at the stroke of a pen. Not to make any bones about it, it amounts to an across-the-board cut in real wages, although without many of the disadvantages of a pay freeze since the cut is the same for everyone, whatever their place in the queue of wage settlements.

This change in relative prices is usually assumed to have an 'expenditure-switching' effect, diverting both home and foreign demand towards domestic goods and so improving the trade balance. Of course, a devaluation also raises the aggregate level of domestic demand (though not by enough to offset the improvement in the trade balance). It must therefore be used in conjunction with standard tools of demand management. Provided this is done, and provided we accept the key assumption of sluggish wage and price adjustment, exchange-rate policy is a useful adjunct to the other instruments available to the domestic authorities. (See Neary (1980) and Thom (1982) for recent refinements of these arguments.) Moreover, since changes in equilibrium real exchange rates do occur, purchasing power parity need not be restored even in the long run. (See, for example, Neary (1982) and Purvis (1982)). Adjustments in the nominal exchange rate may be the easiest way of accommodating such changes. Putting this argument the other way round, with sluggish domestic prices, adopting a PPP rule of nominal exchange-rate management may have disastrous consequences for domestic output, as many high-inflation Latin American countries have discovered (see Dornbusch (1982)).

III

So much then for the general principles. How do they relate to the present situation in Ireland? One step in the above chain of reasoning which is often subjected to criticism (especially by non-economists) is the alleged strength of the competitiveness effect: just how much expenditure will be switched in response to a given change in relative prices? Since this issue is to be covered by Brendan Walsh at this conference, I turn instead to three other difficulties with the standard
arguments.

The first of these concerns the relationship between devaluation and domestic wage costs. I have suggested already that, as an instrument to improve competitiveness, a devaluation may be preferable to a pay freeze. But this of course assumes that a devaluation would not be accompanied (at least not immediately) by compensating wage increases, which would offset the effects of the exchange-rate change on competitiveness. In the present state of the Irish economy, it is extremely difficult to predict the extent to which employees would be able to insulate themselves from the harmful effects of devaluation (and so insulate their employers from its benefits). The high rate of unemployment might be expected to exert a moderating influence on private-sector settlements, but on the other hand recent developments in public sector pay negotiation suggest that it would be extremely difficult to resist claims for compensation there, and if these were acceded to they would presumably spill over into the exposed sectors of the economy.

A second difficulty in applying textbook models to the present Irish situation is that our starting-point is not one of external balance but rather of a significant current account deficit which must be financed by increasing our already large external debt, much of it denominated in foreign currency. Kelleher (1982), in the course of making a vigorous case for devaluation, argues that provided the nation's ability to earn foreign exchange is not impaired by a devaluation, the real burden of foreign debt would not be increased by a devaluation. This argument is correct but it misses two further points. Firstly, interest repayments which are fixed in foreign currency constitute a debit item on the current account whose magnitude is insensitive to exchange-rate changes. The size of this item thus tends to reduce the responsiveness of the current deficit to a devaluation. Secondly, although a devaluation is likely to improve the current deficit measured in foreign currency, the initial excess of imports over exports raises the possibility that the deficit may worsen in domestic currency. Cooper (1971) and Krugman and Taylor (1978) have noted that this outcome has followed many devaluations in countries with large initial deficits, with the result that home aggregate demand is reduced. Hence the advantage of devaluation from the point of view of stabilisation policy that it is an alternative to reflation of
domestic demand is lost. If this outcome were to ensue therefore, an Irish government would have to either accept a further fall in employment as a result of a devaluation (despite its favourable effects on competitiveness) or else borrow still more in order to finance countervailing action.

A third difficulty with devaluation in the present Irish context arises from the fact that a relatively small but nonetheless significant volume of private-sector decisions are now insulated from exchange risk which is effectively borne by the Exchequer. The exact magnitude of funds which are protected under the various schemes of this kind is difficult to assess from published data. It includes £50m under the Working Capital Loans Scheme, operated by ICC and the Associated Banks, as well as EIB and World Bank loans administered by ICC and ACC. It seems likely that the total funds covered amount to at least £200 m. These schemes should not be condemned out of hand but they do pose a number of problems: by insulating private-sector decisions from exchange risk, they are likely to encourage resource misallocation; the willingness with which new commitments of this kind are entered into risks becoming interpreted as a measure of official commitment to the current parity; and finally, they constitute an additional hidden cost to the Exchequer of a devaluation, which should not be ignored in discussing its merits or otherwise.

IV

This paper has implicitly assumed that a devaluation of the punt is not inevitable in the near future and has attempted to assess whether or not it may be desirable. While an enormous amount of work remains to be done on this topic, the main points I have made may be summarised as follows:

- the prediction of the extreme small open economy model that the Irish rate of inflation must equal that prevailing in its partners corrected for exchange-rate changes is not borne out by recent evidence;
- in the light of this, the standard textbook arguments concerning
the desirability of devaluation in certain circumstances cannot be dismissed;

- nevertheless, there are reasons to believe that in the present circumstances of the Irish economy, a devaluation might not even have the desirable transitory effects which are the most that can be claimed for it.
REFERENCES


CHART 1  German Mark / Irish Pound Exchange Rate and Ratio of German / Irish Price Indices.

(Quarterly Averages, 1975-1982; First Quarter 1979 = 100)

* = est.
CHART 2  Sterling/Irish Pound Exchange Rate and Ratio of U.K./Irish Price Indices

(Quarterly averages, 1978-1982. First Quarter 1979 = 100)

* = est.
III  A Strategy for Exchange-Rate Policy in 1983

Colm McCarthy

Davy, Kelleher, McCarthy Ltd.
1. Introduction

The link with sterling went in March 1979, at a time when the economy was still expanding, unemployment was below 90,000, inflation was 13% and the public finance and balance of payments problems were only beginning to emerge.

Table 1: Macroeconomic Developments, 1979 – '82

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP % Change</td>
<td>+2.3</td>
<td>+2.6</td>
<td>+1.1</td>
<td>+0.5</td>
</tr>
<tr>
<td>Real Consumption % Change</td>
<td>+2.3</td>
<td>-0.2</td>
<td>-0.5</td>
<td>-5.0</td>
</tr>
<tr>
<td>Inflation %</td>
<td>+13.3</td>
<td>+18.2</td>
<td>+20.4</td>
<td>+17.3</td>
</tr>
<tr>
<td>PSBR - % of GNP</td>
<td>17.5</td>
<td>19.3</td>
<td>21.4</td>
<td>23.0</td>
</tr>
<tr>
<td>BOP Deficit - % of GNP</td>
<td>-10.1</td>
<td>-8.5</td>
<td>-13.6</td>
<td>-10.0</td>
</tr>
<tr>
<td>Net Foreign Debt End-Year, £M</td>
<td>1089</td>
<td>1725</td>
<td>3392</td>
<td>5100</td>
</tr>
<tr>
<td>Unemployment End-Year, '000</td>
<td>88.6</td>
<td>122.2</td>
<td>141.1</td>
<td>175.0</td>
</tr>
</tbody>
</table>

The recession began in earnest early in 1980 and is now ten quarters old, making it the longest recorded in Ireland in recent decades.

The rapid deterioration in the financial position, which has put the foreign-debt-to-income ratio on a par with that of the most troubled Latin American countries, has been a consequence of a very weak income performance which was not reflected in a corresponding downward adjustment of expenditure.

But the performance of the real economy has also been a contributory factor. If real output growth had averaged even 3% per annum since 1979, the 1982 balance of payments deficit would have been only about four hundred million pounds, assuming that total expenditure was at its 1982 level in this, very hypothetical, output situation.

The four year period 1979 – '82 has seen an average output growth rate of only 1.6% in volume, despite a labour force growing at over 1% per annum and a gross investment ratio averaging almost 30% of GNP. These are
remarkable figures - on worldwide comparisons, an economy with labour force growth and capital formation at these levels would have a growth rate of at least 5%. Typical performance in developed economies recently has been slow growth, under 1% p.a., coupled with zero growth in the labour force and gross investment ratios of no more than 15 to 20 per cent of GNP.

So aside entirely from the country's financial mismanagement, there is evidence of a sharply poorer performance of real output - total factor productivity has been falling. Some of the reasons for this have been widely discussed - there is widespread evidence of a declining efficiency of investment, for example. But it is possible that exchange rate policy has been a hindrance also, and that there is now a case for a change of direction.

2. Exchange Rate Policy Since 1979

Our exchange rate link is now with a group of currencies which account for about a quarter of external trade. Changes against these currencies since we joined the EMS are shown in Table 2.

<table>
<thead>
<tr>
<th></th>
<th>End-March 1979</th>
<th>October 1982</th>
<th>% Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>DM</td>
<td>3.84</td>
<td>3.40</td>
<td>-11.5</td>
</tr>
<tr>
<td>F Fr</td>
<td>8.84</td>
<td>9.63</td>
<td>+8.3</td>
</tr>
<tr>
<td>B Fr</td>
<td>60.82</td>
<td>66.07</td>
<td>+8.6</td>
</tr>
<tr>
<td>D Kr</td>
<td>10.68</td>
<td>11.94</td>
<td>+11.8</td>
</tr>
<tr>
<td>Lira</td>
<td>1727</td>
<td>1918</td>
<td>+11.1</td>
</tr>
<tr>
<td>Guilder</td>
<td>4.14</td>
<td>3.72</td>
<td>-10.1</td>
</tr>
</tbody>
</table>

At successive realignments, the Irish authorities have steered a middle course between the realigning European currencies, and have at no stage taken a decision to belong to either the stronger or weaker currencies at a general realignment. This is an administrative, rather than a
policy approach to the exchange rate. It pays no attention to the position of the Irish pound against sterling and the dollar, which account for twice as big a share of external trade than do the EMS currencies. Nor does it take account of the needs of the internal economy, particularly the price/cost position in the open trading sector.

The existing policy could be described as a fixed rate against the "ECU minus sterling", and it is interesting to characterise it in terms of a link to a basket of currencies. This is done in Table 3, which compares the EMS policy with the link to sterling and with the weights in the effective exchange rate index.

Table 3: Currency Weights in Alternative Exchange Rate Policies

<table>
<thead>
<tr>
<th></th>
<th>£Stg</th>
<th>$</th>
<th>DM</th>
<th>FFr</th>
<th>DFl</th>
<th>BFr</th>
<th>Lira</th>
<th>Yen</th>
<th>CS</th>
<th>DKr</th>
</tr>
</thead>
<tbody>
<tr>
<td>Link to Sterling</td>
<td>1.0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>EMS</td>
<td>0</td>
<td>0</td>
<td>.43</td>
<td>.21</td>
<td>.13</td>
<td>.10</td>
<td>.10</td>
<td>0</td>
<td>0</td>
<td>.03</td>
</tr>
<tr>
<td>Trade Weighted</td>
<td>.46</td>
<td>.14</td>
<td>.12</td>
<td>.09</td>
<td>.06</td>
<td>.04</td>
<td>.04</td>
<td>.03</td>
<td>.02</td>
<td>.0</td>
</tr>
</tbody>
</table>

The EMS weights are found by deleting sterling and the IR£ from the ECU and grossing up the weights of the remainder. Stabilising the currency's average value at each realignment against the ECU, ignoring sterling, amounts to a fixed link against a basket of currencies with the weights shown. The authorities have devalued on average 1% per annum against this "index" since we joined EMS.

The weights in the trade-weighted effective exchange rate index, published daily by the Central Bank, have never been released, but the weights in the table, derived explicitly from the trade figures, must be very close to the weights actually used in the computation of the index.

It could be argued that the authorities have behaved at realignments more as if uniform weights had been attached to EMS member currencies at realignments. However the record does not support this view - there has been an average 2% per annum revaluation against such an equal-weight
index in the period since March 1979.

Of course, the exchange rate performance since 1979 has occurred during a series of enormous balance of payments deficits.

Table 4: Reserves and External Debt, 1979 - '82

<table>
<thead>
<tr>
<th>Date</th>
<th>External Reserves</th>
<th>Official Foreign Debt</th>
<th>Net External Debt</th>
</tr>
</thead>
<tbody>
<tr>
<td>March 1979</td>
<td>1138</td>
<td>1337</td>
<td>200</td>
</tr>
<tr>
<td>End - '82 f</td>
<td>1800</td>
<td>6900</td>
<td>5100</td>
</tr>
</tbody>
</table>

The excess supply of Irish pounds has been enormous right through the period since we joined EMS, and the value of the currency has been maintained only at the expense of a very rapid increase in the level of external debt. There is thus a degree of artificiality about the actual performance of the Irish pound, in the sense that its value would have plummeted in the absence of massive Government foreign borrowing.

Table 5: Dollar, Sterling and the Trade-Weighted Index, 1979 - '82

<table>
<thead>
<tr>
<th>Date</th>
<th>US$</th>
<th>£ Stg.</th>
<th>Index</th>
</tr>
</thead>
<tbody>
<tr>
<td>March 1979</td>
<td>2.06</td>
<td>.9943</td>
<td>78.99</td>
</tr>
<tr>
<td>March 1980</td>
<td>1.94</td>
<td>.9945</td>
<td>73.95</td>
</tr>
<tr>
<td>March 1981</td>
<td>1.74</td>
<td>.7754</td>
<td>67.29</td>
</tr>
<tr>
<td>March 1982</td>
<td>1.44</td>
<td>.8048</td>
<td>69.99</td>
</tr>
<tr>
<td>September 1982</td>
<td>1.35</td>
<td>.7963</td>
<td>66.40</td>
</tr>
<tr>
<td>% Change March 1979</td>
<td>-34.5</td>
<td>-19.9</td>
<td>-15.9</td>
</tr>
<tr>
<td>to September 1982</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

What this table illustrates is that Ireland is in a special position within the EMS, in that its trade share with member currencies is easily the lowest of the seven countries involved. Thus EMS membership for Ireland, where sterling and the dollar are floating freely, has involved a greater risk of general exchange rate instability than for other...
In choosing to link with the European currencies, Ireland has chosen to ignore sterling and the dollar, which have a combined 60% weight in the effective exchange rate index. In fact, there have been massive devaluations against both these currencies, and a consequent fall in the effective index.

The ECU weights give about the same relative importance to the EMS currencies as do the trade weights. The "problem", and the potential source of exchange rate instability, is that the dollar and sterling have zero weights.

If a greater degree of stability in the trade-weighted index is desired, this suggests that a more active realignment policy should be pursued, and that particular attention should be paid, at each realignment, to the position of the Î£ against sterling, and, to a lesser extent, against the dollar.

Thus if, over a period of six months, say, there had been no
realignments, but the effective index had fallen because of weakness against sterling and the dollar, there would be a case, other things equal, for a stronger stance at the next realignment. In reality, a passive stance, ignoring our fate against the floaters, has been adopted since EMS membership.

3. The Exchange Rate and Competitiveness

The period before EMS entry was one in which competitiveness, on all available indications was improving. The period since has seen a sharp deterioration. This is a crude generalisation, but is supported by the figures in the next two tables.

Table 6: Unit Labour Costs, % Change expressed in IR£,
Selected Countries, 1975 - '82

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Ireland</td>
<td>30.8</td>
<td>54.2</td>
<td>12.2</td>
<td>126.3</td>
</tr>
<tr>
<td>UK</td>
<td>38.5</td>
<td>92.6</td>
<td>3.8</td>
<td>176.9</td>
</tr>
<tr>
<td>USA</td>
<td>35.7</td>
<td>55.6</td>
<td>19.4</td>
<td>152.1</td>
</tr>
<tr>
<td>Japan</td>
<td>60.7</td>
<td>17.5</td>
<td>2.0</td>
<td>92.6</td>
</tr>
<tr>
<td>France</td>
<td>39.7</td>
<td>36.7</td>
<td>4.3</td>
<td>99.2</td>
</tr>
<tr>
<td>Germany</td>
<td>56.4</td>
<td>23.2</td>
<td>8.4</td>
<td>108.9</td>
</tr>
<tr>
<td>Italy</td>
<td>28.2</td>
<td>36.1</td>
<td>9.2</td>
<td>90.5</td>
</tr>
<tr>
<td>Belgium</td>
<td>50.3</td>
<td>10.6</td>
<td>-7.4</td>
<td>53.9</td>
</tr>
<tr>
<td>Holland</td>
<td>45.5</td>
<td>13.5</td>
<td>9.3</td>
<td>80.6</td>
</tr>
<tr>
<td>Denmark</td>
<td>48.0</td>
<td>11.4</td>
<td>5.5</td>
<td>73.9</td>
</tr>
<tr>
<td>EEC</td>
<td>47.1</td>
<td>39.0</td>
<td>8.0</td>
<td>120.8</td>
</tr>
</tbody>
</table>

Between 1975 and 1978, unit labour costs in Ireland rose 31%, against an EEC average of 47%, and figures of 39%, 36% and 61% in the UK, USA and Japan, after allowing for exchange rate changes. But the position has reversed dramatically in the period since then, and only the UK and the USA have higher rates of increase for the full period.
For the 1978 - '82 period, unit labour costs in Ireland rose 73%, against an EEC average of only 50%, 100% in Britain, 86% in the USA and only 20% in Japan, all expressed in Irish currency.

Since we joined EMS, then, the margin of competitiveness which had been built up has been steadily eroded, and the profitability of the trading sector has been squeezed. Of course, unit labour costs are not the only cost element. Unfortunately, no official index of manufacturing input prices is published in Ireland. But it is possible to fabricate such an index, and the figures given in Table 7, prepared by Brendan Dowling confirm the pattern evident in Table 6.

Table 7: Price of Manufactured Output Relative to

<table>
<thead>
<tr>
<th>Year</th>
<th>Input Costs</th>
<th>Input Costs Adjusted for Labour Productivity</th>
</tr>
</thead>
<tbody>
<tr>
<td>1977</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>1978</td>
<td>101.7</td>
<td>101.2</td>
</tr>
<tr>
<td>1979</td>
<td>104.6</td>
<td>102.2</td>
</tr>
<tr>
<td>1980</td>
<td>109.2</td>
<td>106.4</td>
</tr>
<tr>
<td>1981</td>
<td>113.1</td>
<td>108.7</td>
</tr>
<tr>
<td>1982</td>
<td>115</td>
<td>110</td>
</tr>
</tbody>
</table>

The deterioration since 1978 ' 79 is again quite marked. There will have been firms for whom the cost/price position has worsened even more, some of whom have removed themselves from the sample. There will always be a tendency for price/cost indices not to stray widely from a benchmark, since competitive pressures will force profit margins to some "normal" level.

4. An Alternative Exchange Rate Policy

(i) The inflation rate hit 20% (CPI) in 1981, will be 17% this year, and may fall to 13 or 14% in 1983 if the existing exchange rate policy is pursued. There is a question then, of how quickly it is desired to get inflation down. In the UK, inflation (RPI) hit 18% in 1980, fell to 12%
in 1981 and may be only 8% this year. But unemployment has rocketed and many UK commentators have argued that exchange rate policy has been used to bring down inflation too quickly. Are the Irish authorities in danger of pursuing a Thatcherite exchange rate policy?

(ii) Whatever margin of competitiveness we enjoyed in 1978-79 has been eroded. From here on, any tendency for the exchange rate to be "too high" will exact a more immediate toll in jobs and output.

(iii) The EMS has been a relatively weak currency bloc since 1979, and this has masked our inability to control domestic costs. But it is increasingly unlikely that the DM will sink any further against sterling and the dollar. A strengthening of the DM against these currencies would expose the trading sector of the Irish economy very rapidly.

The above considerations might suggest a softer exchange rate stance in the period immediately ahead. Some commentators have argued that a devaluation would be of no benefit unless domestic costs are brought under control. But this is to stand the argument on its head. Consider the data in Table 8.

<table>
<thead>
<tr>
<th>Year</th>
<th>% Change in Government Current Revenue</th>
<th>% Change in Domestic Credit</th>
<th>% Change in Public Sector Pay</th>
</tr>
</thead>
<tbody>
<tr>
<td>1979</td>
<td>+12.4</td>
<td>+37.6</td>
<td>+25</td>
</tr>
<tr>
<td>1980</td>
<td>+26.9</td>
<td>+31.7</td>
<td>+34</td>
</tr>
<tr>
<td>1981</td>
<td>+24.6</td>
<td>+40.4</td>
<td>+24</td>
</tr>
<tr>
<td>1982</td>
<td>+24.0</td>
<td>+35.6</td>
<td>+19</td>
</tr>
</tbody>
</table>

* Domestic Credit Expansion (Bank lending to private sector plus Government monetary financing) expressed as % of previous end-year's M3.

An essential component of a macroeconomic strategy is a high degree of balance and consistency between the various arms of policy. The key arms of policy are fiscal policy, monetary policy, incomes policy and
exchange rate policy.

These figures are suggestive of a Government which had decided to aim for an inflation rate of at least 20% with these three weapons of economic policy. With the fourth, however, it solemnly decides to opt for what, against Europeans, has been a hard currency policy.

The worst consequences of this degrees of inconsistency in macro policy have been cloaked, quite fortuitously, by our sharp depreciations against sterling and the dollar.

But these depreciations have not been enough to prevent the sizeable erosion of competitive margins which has occurred since 1979, nor have they prevented the decline in agricultural incomes.

Devaluation, in the long run, achieves nothing in a small open economy, other than a higher price level. Wages and prices generally can be expected to adjust fully to exchange rate changes, and there can be no lasting gains to the trading sector. But in an economy where the non traded sector has managed to insulate itself increasingly from real income movements in the traded sector, devaluation is potentially a weapon to cut the real income of the non traded sector. In the short-run it can also boost margins in the traded sector.

More generally, the lack of balance and consistency between the various arms of macroeconomic policy can put the squeeze on particular sectors of the economy. In Ireland, we have chosen to pursue highly inflationary policies in most areas, coincident with a strong exchange rate. It would be difficult to conceive of a strategy better calculated to create problems for agriculture and manufacturing.

To date, the main proponents of devaluation have been the farmers. Manufacturing has been fairly silent on the issue, while some trade union leaders have voiced their opposition. In the short term, devaluation would hurt real wages, but would improve job prospects, so the issue provides an opportunity for trade unionists to reveal their priorities in regard to the desirability of more wages versus more
unemployment.

I am not advocating a devaluation at this point as any kind of panacea for our economic problems. What I am suggesting is a policy rule: If, over the next six months, it becomes clear that, during 1983, we will pursue fiscal, monetary and incomes policies which are highly inflationary, we should cut the exchange rate so as to avoid a further squeeze on the exposed sector. Not to do so would involve the inanity of running an accommodating monetary policy, while refusing to run an accommodating exchange rate policy.

Longer term, if EMS survives, and we survive within it, I would suggest the following approach to the exchange rate:

(i) Decide from time to time what ought to be the average level of the Irish exchange rate against major competitors. Some form of trade-weighted index, perhaps with weights different from those in the existing index, could be used for this purpose.

(ii) At each EMS realignment, make whatever change seems best calculated to keep the "average" exchange rate on its target path.

Decision (i) would pay attention to internal labour market conditions and to competitiveness. Decision (ii) would require that attention be paid also to the position of the EMS against sterling and the dollar. Our policy to date in EMS is open to the accusation that it has ignored these considerations.
IV Employment and Labour Market Aspects of the National Plan*

Brendan M. Walsh

University College Dublin

As we have not yet seen the Plan, I shall present some fairly basic thoughts about our medium term labour market prospects.

Unemployment has been increasing relentlessly since the beginning of 1980. The four demographic groups now identified in the Live Register returns have recorded the following increases, Sept. 1982 compared with Jan. 1980:

<table>
<thead>
<tr>
<th></th>
<th>Males</th>
<th></th>
<th>Females</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Under 25</td>
<td>25 and over</td>
<td>Under 25</td>
<td>25 and over</td>
</tr>
<tr>
<td></td>
<td>+ 122%</td>
<td>+ 60%</td>
<td>+ 149%</td>
<td>+ 47%</td>
</tr>
</tbody>
</table>

If the unemployment figures are weighted by an estimate of the wages of each of the groups, the increase is 70 per cent compared with 79 per cent for the unadjusted total, so not much of the rise can be attributed to the changing demographic structure of unemployment.

The main reason for this rise in unemployment is undoubtedly the persistence of a deep and prolonged recession which has led private sector firms to prune their labour force at a time when the public sector is no longer able to expand employment due to budgetary constraints. At the same time the growth in labour supply remains very high, although down from the exceptional growth of the 1970s when significant in-migration augmented domestic sources of growth. The implications of continued growth in the labour force can be illustrated as follows:

<table>
<thead>
<tr>
<th></th>
<th>1982 (estimated)</th>
<th>1991 (illustrative)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>thousands</td>
<td></td>
</tr>
<tr>
<td>Labour force</td>
<td>1,266</td>
<td>1,407(a)</td>
</tr>
<tr>
<td>Employment</td>
<td>1,136</td>
<td>1,280</td>
</tr>
<tr>
<td>Unemployed</td>
<td>130</td>
<td>127</td>
</tr>
</tbody>
</table>

(a) See Blackwell and McGregor, NESC No. 63, Table 20.

The projection for 1991 shows the labour force on the assumptions of zero net migration (all age groups combined) and continuing declines in labour force participation rates. Employment was projected on the
assumption that the annual average growth rate recorded over the period 1971-79 would be repeated, and unemployment was calculated as a residual. Even on this optimistic assumption about employment there is virtually no reduction in the level of unemployment.

It is by no means easy to specify a sectoral pattern of growth that would result in the realisation of the unemployment target in this illustration. Bearing in mind the greatly reduced contribution that should be expected from the public sector over the coming decade, it is hard to write a credible scenario for the 1980s that presents the level of unemployment or emigration from rising. In Table 1 the actual pattern of sectoral employment change in the 1970s is used as a point of departure for some conjectures about possible growth patterns in the 1980s. It is assumed that the fall in agricultural employment tapers off, that employment in building grows at about the same rate as in the 1970s, and that, despite the budgetary situation, public sector employment grows by a further 30,000. If Manufacturing and/or Private Services are to absorb the remainder of the growth in labour supply so as to achieve the 1991 target level of unemployment, the increases would have to be of the orders of magnitude shown.

Unfortunately, there is no mechanism whereby a rapid growth in labour supply results in a similar expansion in employment, unless it be the pattern identified by Sexton (QEC, Aug. 1982) on the basis of the pattern of employment growth during the 1970s, whereby Private Services employment appears to expand rapidly in response to shifts in the supply of labour to that sector. Unfortunately we have no data on earnings in this sector on which to base any inferences about the elasticities of demand and supply. The rapid growth of employment in this sector could reflect a very elastic demand for labour, as Sexton seems to argue, or it could be the result of considerably greater wage flexibility here than in other sectors, which results in its playing a major labour market clearing role. Whether it could play this role to the extent implied by the outcomes under (a) and (c) in Table 1 is debatable, but on the other hand how else can we reconcile a rapidly growing labour force, high unemployment rates in our traditional
### TABLE 1: Sectoral Changes in Numbers at Work ('000)

<table>
<thead>
<tr>
<th>Sector</th>
<th>1971-79 actual (a)</th>
<th>1982-91 (a)</th>
<th>(b)</th>
<th>(c)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agricultural</td>
<td>-35.1</td>
<td>-20</td>
<td>-20</td>
<td>-20</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>+28.6</td>
<td>+30</td>
<td>+74*</td>
<td>52*</td>
</tr>
<tr>
<td>Building</td>
<td>+18.6</td>
<td>+20</td>
<td>+20</td>
<td>+20</td>
</tr>
<tr>
<td>Services: Public</td>
<td>+64.9</td>
<td>+30</td>
<td>+30</td>
<td>+30</td>
</tr>
<tr>
<td>Other</td>
<td>+37.8</td>
<td>+84*</td>
<td>+40</td>
<td>62*</td>
</tr>
<tr>
<td>Total</td>
<td>+114.6</td>
<td>144</td>
<td>144</td>
<td>144</td>
</tr>
</tbody>
</table>

*residual

(a) Sexton, QEC, Aug. 1982.

migration destination, a prolonged recession in our export markets and persistent "real wage resistance" in many sectors of the domestic labour market?

Of course any acceleration in the growth of employment in manufacturing would ease the pressure on other areas of our labour market. In recent years, competitiveness has been given pride of place among the domestic strategies that could be pursued to stimulate employment in the exposed or trading sectors. Many of the issues at stake have been discussed in the session on Exchange Rate Policy, but those who emphasise the potential contribution of competitiveness to employment growth usually look to moderation in the rate of increase in domestic costs (in domestic currency) rather than to changes in exchange rates. We have every reason to expect that the forthcoming Plan will emphasise domestic incomes policies, rather than exchange rate policy, as the key to improving competitiveness.

I do not wish to revive the debate on devaluation, but I think we must ask whether it is more feasible to curb the level of real wages by an incomes policy or by a devaluation. This important point was raised by Peter Neary in his comments on exchange rate policy.
The Committee on Costs and Competitiveness focussed on Irish unit labour costs, and the rate of increase in this variable, as the key to competitiveness. This was not intended as a demotion of marketing, innovativeness or quality, which undoubtedly play important roles in a wider concept of competitiveness but are much less amenable to short run policy measures.

The Committee expressed concern at the sharp rise in Irish unit wage costs relative to those of the narrow band EMS countries since 1979. This loss of competitiveness relative to Europe was, of course, offset by an even greater loss by the UK over 1980 and 1981, but is being compounded by a reversal of the UK trend during 1982 (see Table 2).

<table>
<thead>
<tr>
<th></th>
<th>Ireland</th>
<th>UK</th>
<th>Germany</th>
<th>France</th>
<th>USA</th>
<th>Main Trading Partners</th>
<th>EEC-8</th>
<th>EMS Narrow Band</th>
</tr>
</thead>
<tbody>
<tr>
<td>1979 = 100</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1975</td>
<td>79</td>
<td>75</td>
<td>76</td>
<td>85</td>
<td>89</td>
<td>80</td>
<td>78</td>
<td>83</td>
</tr>
<tr>
<td>76</td>
<td>78</td>
<td>75</td>
<td>82</td>
<td>86</td>
<td>101</td>
<td>83</td>
<td>80</td>
<td>86</td>
</tr>
<tr>
<td>77</td>
<td>83</td>
<td>77</td>
<td>91</td>
<td>91</td>
<td>107</td>
<td>84</td>
<td>84</td>
<td>94</td>
</tr>
<tr>
<td>78</td>
<td>90</td>
<td>86</td>
<td>96</td>
<td>96</td>
<td>102</td>
<td>94</td>
<td>91</td>
<td>98</td>
</tr>
<tr>
<td>79</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>80</td>
<td>117</td>
<td>132</td>
<td>107</td>
<td>113</td>
<td>105</td>
<td>116</td>
<td>121</td>
<td>107</td>
</tr>
<tr>
<td>81E</td>
<td>125</td>
<td>156</td>
<td>110</td>
<td>123</td>
<td>138</td>
<td>136</td>
<td>137</td>
<td>111</td>
</tr>
<tr>
<td>82f</td>
<td>142</td>
<td>158</td>
<td>118</td>
<td>126</td>
<td>170</td>
<td>145</td>
<td>141</td>
<td>115</td>
</tr>
</tbody>
</table>

E = estimate;  f = forecast (OECD, EEC sources).

Looking ahead, the prospect for 1983 is that earnings will rise very moderately in most of our trading partners. Only in Italy is it likely that they will exceed 10%, in the US they may rise by about 10%, in the UK by about 7%, in France by 5%, and in the rest of the EMS by considerably less than 5% (all of the predictions are, of course, dependent on a host of political events such as the outcomes of the US
Congressional and the W. Germany elections. Bearing in mind the rate of productivity growth that is usually achieved in these countries, there are several countries (Japan, Germany, Belgium, Denmark and the Netherlands) where unit wage costs may well fall during 1983. Applying the methodology of the Committee on Costs and Competitiveness to these figures to calculate what they called the "warranted increase in Irish earnings" for 1983 yields a figure of about 5%, almost all of which is due to the hoped-for gain in productivity. This should be compared with the recommendation in the Report of 11%, subsequently adjusted downward to 8%, or the actual outturn of about 13% for 1982. Although these figures are very tentative, the message obviously is that much lower rates of increase in earnings are warranted in 1983 than were recorded in 1982 if we are to hold our present level of competitiveness. (We should of course also bear in mind how this compares with earlier years).

How much of a contribution this would make to accelerating the growth of employment in the exposed sector is a moot point. Even in the medium term it is difficult to discover a relationship between movements in competitiveness and the level of exports. In fact, we have seen the fastest growth of our export share in precisely those markets where we are losing most in terms of competitiveness. Countries such as West Germany have not been able to stem the rise in unemployment by their impressive performance on export markets.

But the prospect that things may be bad even if we succeed in maintaining or improving competitiveness should not distract us from the likelihood that they will be much worse if we fail to make progress on this front.