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Symposium on

Irish Exchange Rate Policy

by

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and
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Policy Paper No. 22

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* J&E Davy

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Contrary to the more pessimistic views expressed in 1979, the EMS has survived and assumed a certain importance as a regional grouping of currencies. The frequency of realignments has diminished over time. Members of the System have enjoyed greater stability in their exchange rates than non-members. Realigments have been used to offset the strains caused by divergences in national rates of inflation, thereby avoidimg serious misalignments between the major participating currencies. All of these achievements have occurred during a period when the other major currencies, notably the dollar, sterling and the yen, have been very volatile and have undergone prolonged periods of over- and under-valuation both between one another and relative to the EMS currencies as a group.

The disappointments and shortcomings of the System have to be mentioned, however:

i. Countries have tended to use the realignments as a "crawling peg" to escape the discipline of adhering to a hard currency exchange standard. For example, the Irish pound/DM exchange rate has declined from 3.80 in 1979:1 to 2.73 now, a fall of 28%.

ii. Even where exchange rates have not been adjusted to offset all of the differential between national

Dermot McAleese had a significant input to the analysis contained in this paper. The opinions expressed are, however, solely my responsibility.

inflation rates and that of the hegemonic currency, the DM, the belief, widely held in Ireland in 1979, that a non-accommodating exchange rate policy would lead to a rapid convergence of inflation rates has been confounded. More generally, a simple comparison of the evolution of inflation since 1979 in EMS and non-EMS countires reveals "no evidence that the decline in the inflation rates proceeded more quickly inside than outside the EMS" (de Grauwe, 1986). eg Ireland.

iii. The degree of exchange rate stability that has been achieved within the EMS has had little impact on the general macroeconomic performance of the member countries. The growth of GNP has been slower, and the rise in unemployment greater, in the EMS countries than in the non-EMS countries during the 1980s. Even the comparison with the non-EMS countries of Europe is unfavourable to the EMS. The growth of intra-EMS trade has been slower than that between the EMS and the rest of the world or between non-EMS members (de Grauwe, op. cit.). The benefits of the "zone of monetary stability", to the extent that one has been achieved within the EMS, cannot be discerned by a simple comparison of relative economic performance.

iv. The EMS has not been enlarged since its formation. The U.K., Greece, Spain and Portugal do not participate in its exchange rate peg. Policy coordination between the world's major currencies seems to ignore the EMS.

Ireland's experience as a member of the System reflects most of the general achievements and shortcomings listed above. We have enjoyed greater stability relative to EMS currencies than relative to sterling and the dollar. This is clear from the time series in Figure 1 and the alternative measure of volatility in Table 1. On the macroeconomic front, however, the expected benefits of membership are difficult to discern, The decline of inflation in Ireland has been roughly in line with that in several non-EMS countries. The growth of the share of the EMS in our international trade has been unremarkable (Figure 2). The influence of German interest rates on Irish money markets appears no greater now than before we joined the System.

The exchange rates shown in Figure 1 are nominal rates, unadjusted for differences in purchasing power. Economists used to believe that freely floating exchange rates would adjust quickly to offset inflation differentials, leading to Purchasing Power Parity as the

normal situation. However, during the 1970s and 1980s there have been sustained and serious real exchange rate misalignments. Even the Americans learned that they could not act as the nth country that would passively accept the external value of the dollar implied by the bilateral exchange rates between the n-1 countries in the rest of the world. (This was the position taken by Federal Reserve Board member Henry Wallich in a lecture delivered in University College, Dublin as late as 1983). The lessons of the sustained overvaluation of the dollar in the 1980s have summarised as follows:

> A substantial and sustained real appreciation of the dollar, driven by macoreconomic policies, has eroded the international competitive position of many otherwise healthy firms and industries. As currency values persist at their present level, they begin to affect the strategic decisions of firms, decisions regarding investment, capital formation and the location of plants. (Weintraub, 1986)

Professor Dornbusch, whose theories on exchange rates have been very influential over the past decade, summarised the recent American experience in the following terms:

> In the short term [overvaluation] involves less inflation and increases real income and hence it wins popularity contests. Only over time, as substitution effects become important and output declines as a result of a loss in competitiveness, do the costs emerge. . . For a while the real appreciation [is] celebrated as a mark of achievement rather than as a highly destructive misalignment. . . . .[Later] the deindustrialization

effects become visible, and politically alarming in the form of protectionism. . . (Dornbusch, 1986).

In Ireland we have had to revise much of the received wisdom with regard to the effect of exchange rates on the economy. In particular our experience since 1979 has shown that, contrary to the experience under the sterling link, there can be sustained real exchange rate changes. This is clear from Figures 3 and 4, which show two measures of the real exchange rate between the Irish pound and three main currencies. (I do not include unit labour costs because productivity is affected by the decline in uncompetitive industries.) The sustained and substantial real appreciation relative to the DM would not have been believed possible by many commentators in 1979.

Although it is clear that real exchange rate misalignments last for much longer than any reasonable definition of the "short-run", there is a tendency in Ireland to downplay the significance of the exchange rate for the real economy. The evidence from periods when the currency depreciated tends to be generalised in a manner that implies that the level of wages and prices will quickly adjust to any nominal exchange rate. For example, a recent study of the effects of changes in rates of exchange concluded:

> . . .our findings support the type of process . . affect only nominal variables in the long run. The results suggest that all prices will adjust fully to an exchange rate change after 18 quarters with the bulk of the adjustment occurring within the first 8 quarters. (Flynn, 1986, p. 115)

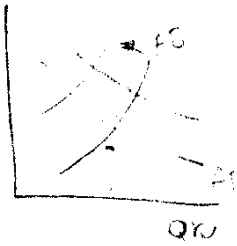
This could be taken to imply that the exchange rate is not really a matter of much significance for the real economy. Certainly, Irish economic policy has been strongly influenced by the view that the exchange rate's main influence is on the price level and that the objective of exchange rate policy should be to exert a moderating influence on the rate of inflation. For example, in response to a recent parliamentary question, the Minister for Finance, Mr John Bruton, stated "the objective of the Government's exchange rate policy has been to seek stability in the context of the EMS with a view to consolidating progress in reducing the rate of inflation" (10 April 1986). However, as we have noted above, this non-accommodating exchange rate policy has not been pursued to its logical conclusion nor has it resulted in any marked decline in Ireland's relative rate of inflation.

All the research of the effects of changes in the exchange rate on the Irish economy has of necessity dealt with devaluations because all of the evidence available for the Irish economy relates to periods when the

exchange rate was falling. It may be seen from Figure 5 that between 1979.1 and 1985.1 the Irish effective exchange rate declined by over 20% and that it never rose for more than two consecutive quarters. The rise in the effective exchange rate index that began in mid-1985 and was only temporarily interrupted by the August 1986 devaluation is without precedent in our recent history.

It may not be valid to make inferences about the effects of an appreciation of the nominal exchange rate from empirical research based on the evidence of the effects of a depreciating rate. The differences between the effects of an appreciation and of a depreciation should be noted: (1) distributors are much quicker to pass on the higher costs resulting from a devaluation than to reduce prices as the currency appreciates, (2) while trade unions are quick to seek compensation for inflation, or increases in the rate of inflation, they are slower to accept a comparable downward adjustment of wages or the rate of increase in wages in response to a moderating rate of inflation, and (3) firms that are put out of business by the loss of competitiveness that occurs because of an appreciation are unlikely to start up again if and when domestic costs eventually adjust to the higher nominal exchange rate, whereas the worst that can happen after a

e Inflation:



devaluation is that a boost to output is not sustained.

A case could be to the effect that the best situation for a country such as Ireland, with a high level of unemployment and a rapidly growing population of working age, would be one where a combination of domestic cost and exchange rate trends resulted in a slight undervaluation of the currency. The resultant competitive gain would provide a stimulus to the internationally traded sectors of the economy. However, our decision to join the EMS was recognized as a move in the opposite direction and indeed this was the rationale for the special package of grants and subsidies negotiated at the time of our entry.

The effects of alternative exchange rate policies on the real economy are difficult to assess. A recent review of the experience of the smaller European economies since 1970 illustrates this point (Sonderstrom, 1985). In the first place, national authorities have not always been able to achieve their targets for the real exchange rate. In some countries, a "hard" currency policy was associated with a real exchange rate appreciation (Austria and Switzerland), whereas in the Netherlands it actually resulted in a real exchange rate depreciation. The wage formation process and the degree of indexation have been

crucial. Furthermore, the effect of real exchange rate movements on industrial output is not readily established. In many cases the industries that appear to be adversely affected by an appreciation are in secular decline and might have contracted regardless of exchange rate developments. On the other hand, there are examples of industries that expand despite a currency appreciation. The successful adjustment of German, Swiss and Japanese industry to long-run currency appreciations are the most striking examples, but it is also interesting to note that the Irish trade balance with the narrow-band EMS countries has improved steadily in the face of a significant real appreciation of the Irish pound relative to these currencies.

Turning from this review of the evidence of the past to the question of policy for the future, it is clear that Irish exchange rate policy is now in a difficult predicament. The origin of this predicament lies in the absence of sterling from the EMS exchange rate pegging mechanism and the continued importance of the sterling/Irish pound exchange rate to the Irish economy. The importance of the sterling exchange rate to the economy exceeds the weight of sterling in our trade because several price sensitive sectors are particularly influenced by the value of sterling. Examples include

Cork and Wood, Paper and Paper Board, Textiles, Furniture, Travel Goods, Clothing and Footwear.

The goals of honouring our commitment within the EMS and averting a severe loss of competitiveness relative to sterling have proved in the long run irreconcilable. In the early 1980s the strength of sterling relative to the EMS currencies allowed us to reconcile the two objectives, but in 1983, and more dramatically in 1986, the fall in sterling revealed the contradiction in our exchange rate policy. Forced to choose between the two objectives this summer, the Irish authorities devalued and implicitly declared a target for the sterling/Irish pound rate. This has introduced a new source of uncertainty into our economy, which is reflected in the effect of the renewed weakness of sterling on interest rates over the past weeks.

The August devaluation occurred only after the effective exchange rate index of the Irish pound had risen by over 11 per cent in a year. While the weakness of sterling relative to the EMS currencies was the main reason, the fall in the dollar also played a role. As these currencies have continued to decline on the foreign exchanges, the effective exchange rate index is again approaching the level reached at the end of July (see

Figure 5).

I have argued that a rigid adherence to a misaligned exchange rate, especially when this entails an overvaluation, can be misguided and costly. It is also clear that any attempt to target a specific exchange rate for sterling would be ultimately incompatible with membership of the EMS. If, for example, we had tried to maintain a stable sterling exchange rate since 1979 (or indeed any year since then) we would not only have had to realign very frequently within the EMS, but also there would have been frequent reversals of previous adjustments as sterling fluctuated both up and down relative to the EMS. It is difficult to see our Community partners regarding such a policy as compatible with EMS membership. Yet as long as the U.K. remains outside the EMS exchange rate peg, and the real sterling/EMS exchange rate fluctuates widely, the only way in which Ireland can avoid serious misalignments in the foreign exchange market where price sensitivity appears to be greatest is by modifying our EMS commitment to take account of the behaviour of sterling. In effect, this involves moving away from a simple commitment to the EMS and towards a policy of maintaining a stable effective exchange rate index.

Maintaining the efective exchange rate index stable would not avert fluctuations in bilateral (sterling/Irish

pound, EMS/Irish pound, dollar/Irish pound) rates, but it would be the best compromise in a world in which the major currencies are volatile. In principle it would be an improvement over the present anomalous situation in which the authorities are formally committed to maintaining the stability of the exchange rate relative to only one group of countries, which accounts for only about one third of our total trade. Over the long run, any tendency for relative costs in Ireland to diverge from those in our main trading partners could be offset by allowing the effective exchange rate to rise or fall, as appropriate.

Note: UK accounts for 40% of our Trade

The real objections to adopting an effective exchange rate target are not technical or economic but political and strategic. Such a decision would represent a major reversal of our policy with regard to the European Community and it might prove damaging to our long-run interests in agriculture and other areas.

Susbsidies to industries experiencing difficulties because of a sudden decline in sterling or the dollar might be considered as an alternative to modifying our EMS commitment. However, this approach would almost certainly violate our obligations under the Treaty of Rome and the GATT. More fundamentally, it has little to recommend it because it involves an open-ended commitment of exchequer

resources and postpones the adjustment to changes in real exchange rates that would have to be accepted in the long run. However, it is striking that the authorities have been willing to promote the competitiveness of the Irish economy by a devaluation at a time when they continue to avoid coming to grips with so many structural problems that require urgent attention. The promotion of competitiveness in the widest sense should be given the highest priority. Unless this is done, devaluations will provide only temporary relief.

We are likely to remain in the narrow-band EMS and to devalue with reluctance as the weakness of sterling and/or the dollar makes this necessary in order to maintain the competitiveness of price sensitive sectors of Irish industry. This compromise policy will generate continued uncertainty. Industry will have to cope with this, in the short run by availing of the sophisticated range of foreign exchange products now available and by diversification of both product and input markets in the longer run. Above all, domestic input costs have to be kept flexible to help firms to cope with the problems inherent in the international environment in which we live.

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TABLE 1

VOLATILITY OF EXCHANGE RATES

Spread between highest and lowest of the average weekly closing rates against Irish pound for each year, 1982-1985

EMS Currencies (Narrow-Band)	1982 %	1983 %	1984 %	1985 %
Deutschmark (DM	6.6	7.2	2.2	2.6
French Franc (FF)	8.1	1.2	2.0	1.8
Dutch Guilder (DG)	6.0	5.5	2.4	2.9
Non-EMS Currencies:				
Sterling (£)	9.2	16.3	9.2	12.8
US Dollar ($)	18.0	23.1	18.8	30.6

(As % of average of high and low)

FIGURE 1

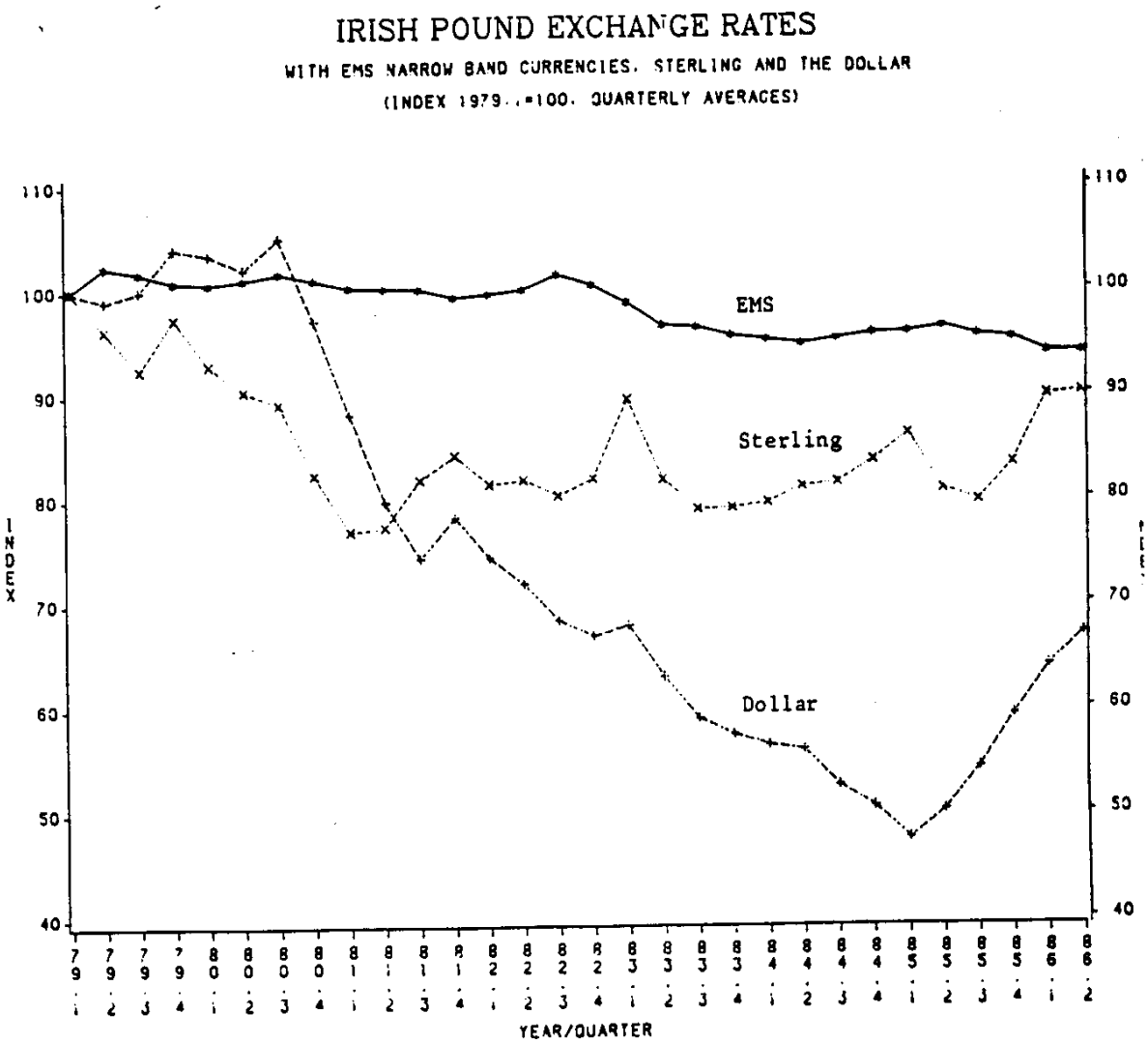
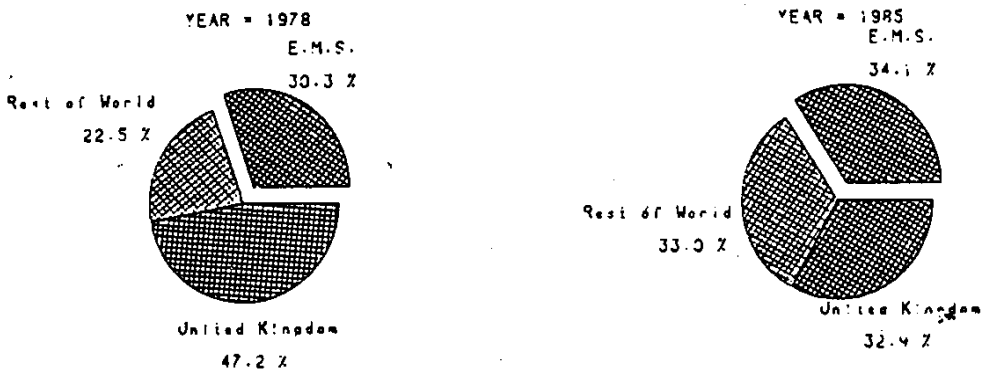

IRISH POUND EXCHANGE RATES
WITH EMS NARROW BAND CURRENCIES, STERLING AND THE DOLLAR
(INDEX 1979..=100, QUARTERLY AVERAGES)
EMS
Sterling
Dollar
INDEX
YEAR/QUARTER
110
100
90
80
70
60
50
40
79 1
79 2
79 3
79 4
80 1
80 2
80 3
80 4
81 1
81 2
81 3
81 4
82 1
82 2
82 3
82 4
83 1
83 2
83 3
83 4
84 1
84 2
84 3
84 4
85 1
85 2
85 3
85 4
86 1
86 2

Figure 2

PERCENTAGE DISTRIBUTION OF EXPORTS BY AREA IN 1978 AND 1985



PERCENTAGE DISTRIBUTION OF IMPORTS BY AREA IN 1978 AND 1985

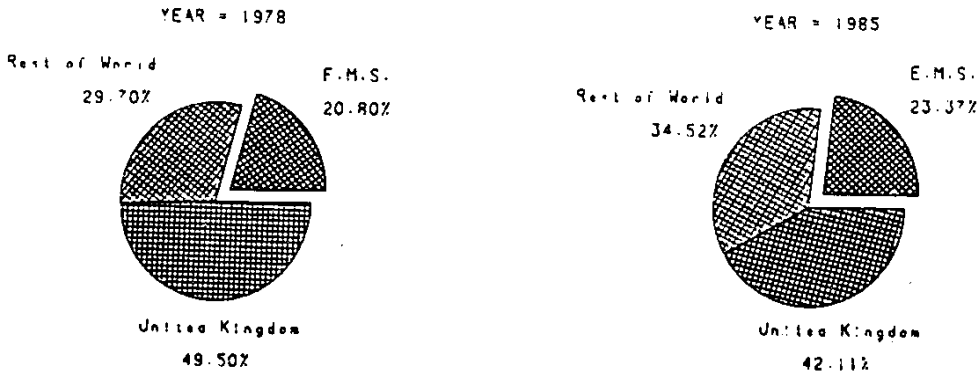


Figure 3

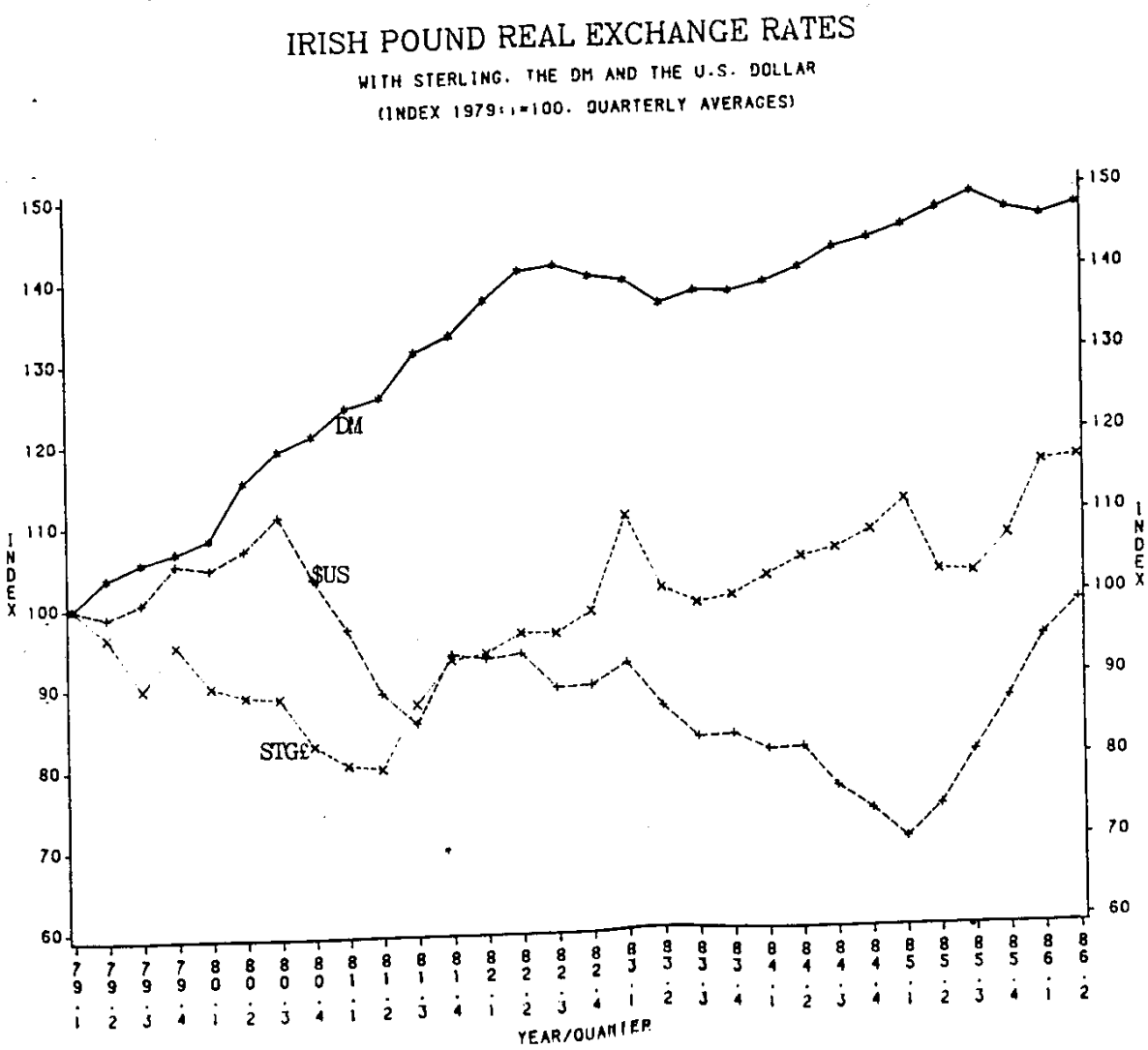

IRISH POUND REAL EXCHANGE RATES
WITH STERLING, THE DM AND THE U.S. DOLLAR
(INDEX 1979:1=100, QUARTERLY AVERAGES)
DM
$US
STG£
INDEX
YEAR/QUARTER

FIGURE 4

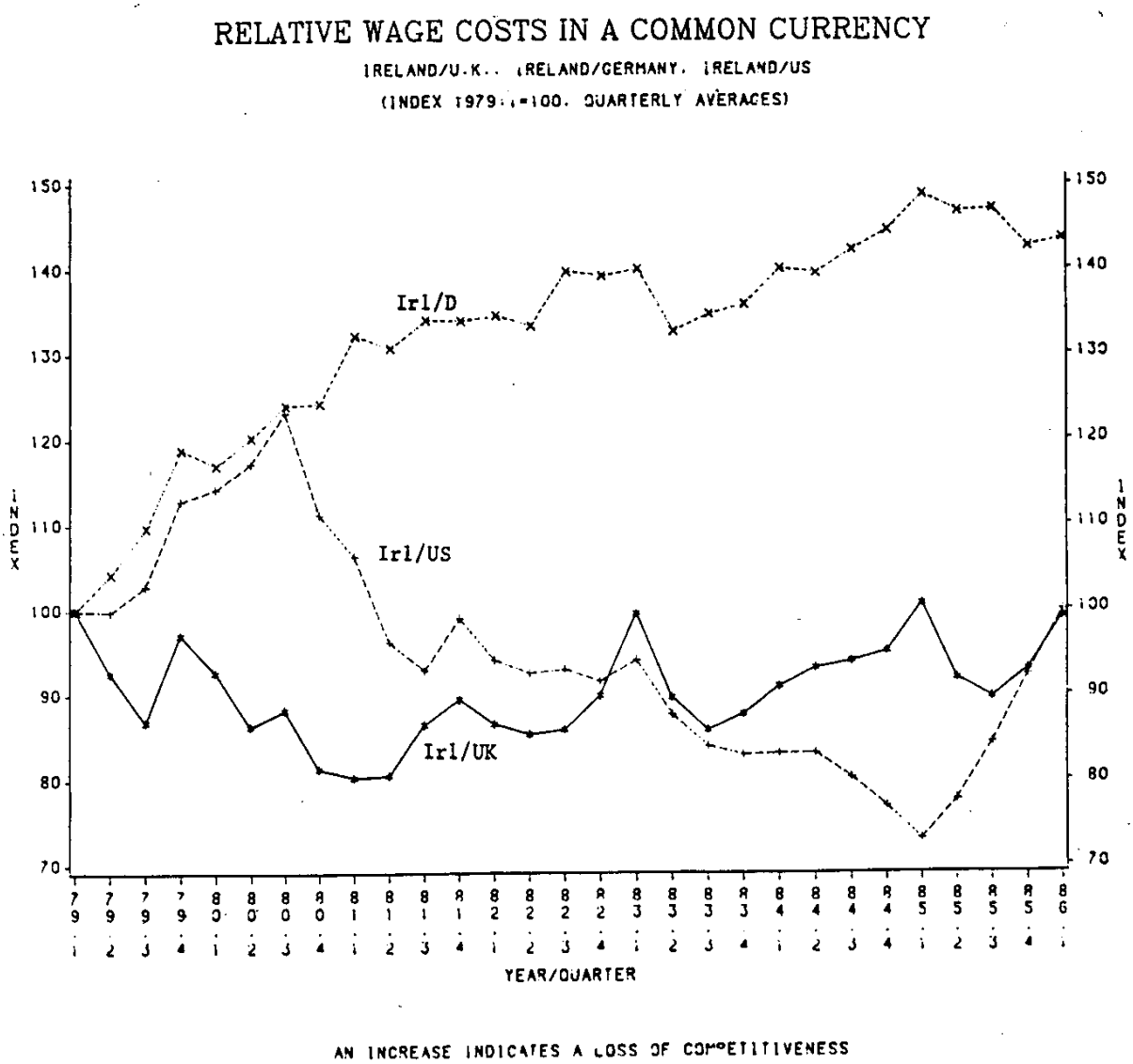
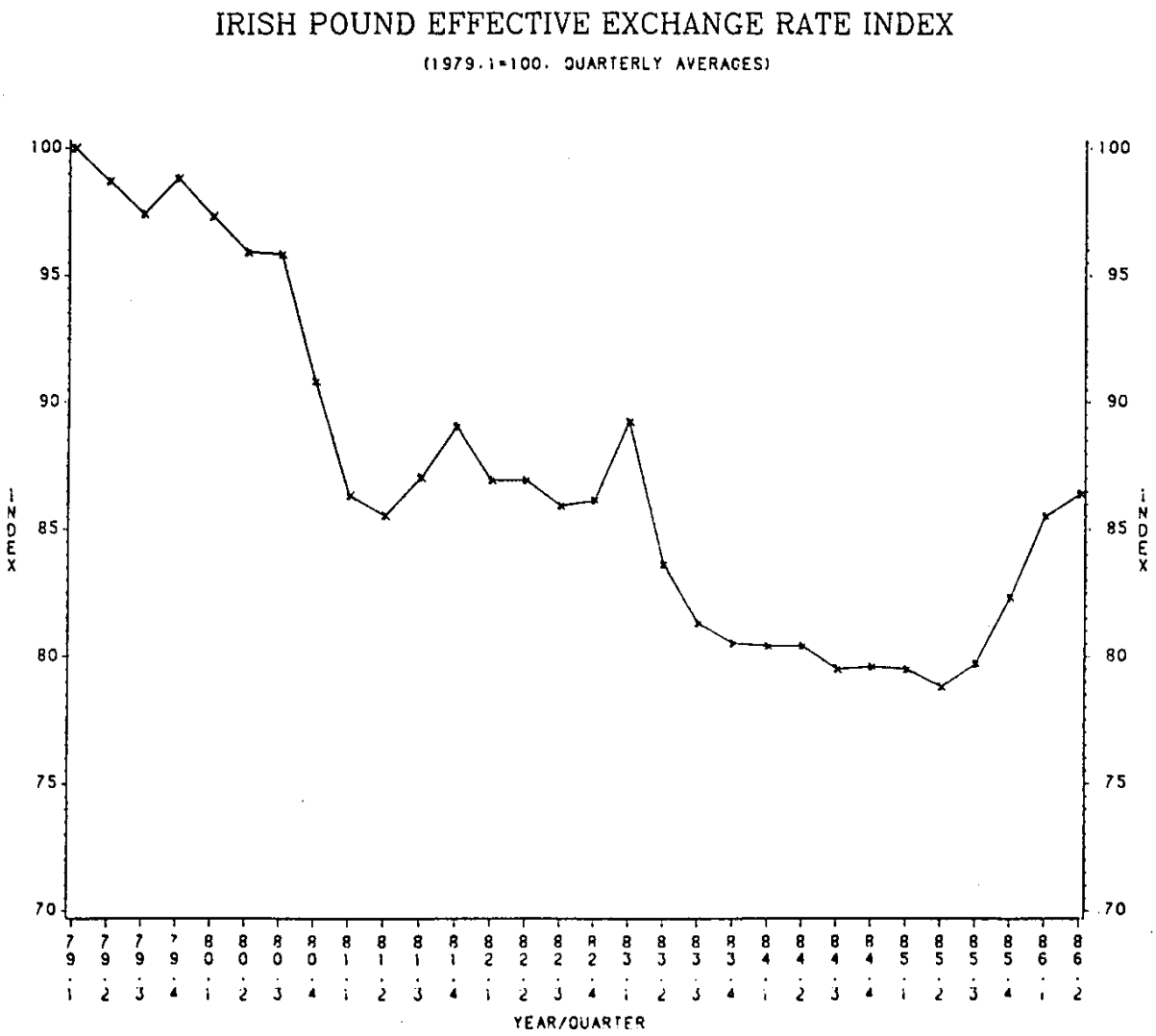

RELATIVE WAGE COSTS IN A COMMON CURRENCY
IRELAND/U.K., IRELAND/GERMANY, IRELAND/US
(INDEX 1979:1=100, QUARTERLY AVERAGES)
Irl/D
Irl/US
Irl/UK
INDEX
YEAR/QUARTER
AN INCREASE INDICATES A LOSS OF COMPETITIVENESS

Figure 5


IRISH POUND EFFECTIVE EXCHANGE RATE INDEX
(1979.1=100. QUARTERLY AVERAGES)
INDEX
100
95
90
85
80
75
70
79.1
79.2
79.3
79.4
80.1
80.2
80.3
80.4
81.1
81.2
81.3
81.4
82.1
82.2
82.3
82.4
83.1
83.2
83.3
83.4
84.1
84.2
84.3
84.4
85.1
85.2
85.3
85.4
86.1
86.2
YEAR/QUARTER

Irish Exchange Rate Policy

Paper By

Brendan Dowling
(J & E Davy)

to Dublin Economic Workshop
Economic Policy Conference
Kenmare
October 11th 1986

IRISH EXCHANGE RATE POLICY

This paper is based on the , hopefully accurate, belief that Brendan Walsh's paper will have already set the scene as far as the historical background and recent performance of the Irish pound is concerned. I will try therefore to concentrate on the policy aspects and in particular the appropriate future policies to be adopted.

Why have an Exchange Rate Policy?

I suppose that the title of this symposium already presupposes that it is normal for Governments to have an exchange rate policy and that Ireland should have such a policy. The usual case made for an exchange rate policy is that the relative importance of trade and international foreign exchange flows makes it impossible for the authorities to be indifferent to the level of the exchange rate.

But it is important to stress that the absence of an exchange rate policy does not mean indifference to the level of the exchange rate. It may simply reflect a belief that the level of the exchange rate will be determined by the quality of domestic economic management , including performance on relative wage costs, balance of payments, monetary and interest rate policy.

However we know that managing the domestic economy is extraordinarily difficult for any Government. Four decades of apparently easy demand management in the developed economies have given way to far greater variations in the level of activity both across countries and time and to the emergence of chronic underemployment in Western Europe.

At the same time - and some might want to argue a causal relationship - there has developed a school of thought, which has exercised a fairly power ful grip on some political leaders which argues that the complex set of macroeconomic policies designed by Governments are largely ineffective in determining the long run performance of the economy. Simple clear cut rules, well known to all agents in the economy, and pursued without deviation are far better policy instruments as they reduce the chance of markets responding to false signals and ensure speedy adjustment to equilibrium in the face of random shocks to the system. In general the simple rule preferred has been that of a constant, low, growth in the domestic money supply. However others have supported a return to gold-backed currencies etc.

Exchange Rate Policy as a Simple Rule

I believe that an exchange rate policy only makes sense if it can be interpreted as a version of the simple single rule designed to inform market participants and ensure smooth adjustment without false signals. Any other interpretation seems to me to come close to tautological; exchange rate policy becomes one of announcing variations in the exchange rate which , in the absence of the policy, would have occurred in any event. At best policy becomes one of smoothing movements determined by policy and other changes in the domestic economy.

There is strong and compelling evidence that an exchange rate policy may be effective as a simple rule and , I would argue, that when it fails to provide such a simple rule it effectiveness is open to question. The evidence of effectiveness is in part derived from theoretical work and part from the experiences of the Irish economy over a half century. When a small economy fixes its exchange rate relative to a much larger (in terms of economic weight and international trade importance) country's currency and that exchange rate is expected to be maintained the small country no longer has to worry about inflation , controlling money supply or credit. It may have to worry about ensuring that the automatic adjustments brought about by the fixed exchange rate do not impose excessive burdens on the real economy.

Thus policy may be directed at removing obstacles to the smoothing working of markets. Exchange controls, credit restrictions etc. are all attempts to blur the signals transmitted through the exchange rate link and , as they are ultimately ineffective, are unecessary. Labour legislation and other internal restrictions may prevent labour markets from adjusting to changes in the economic environment and so cause unemployment. These market rigidities may be compounded by domestic tax and benefit policies. But all such internal policies, macroeconomic and at the micro level, achieve is an alteration in the speed and path of adjustment of the domestic economy to the equilibrium determined by the exchange rate link and underlying real resources in the economy.

As a description of the Irish economy during the period between independence and 1979 the above paragraph may be terse but hardly inaccurate. Virtually all quantative studies of the economy found that macroeconomic policies had, at best, only a temporary impact on the economy and failed to alter significantly the underlying sustainable real level of activity. The fact that today we can hold conference attended by 150 - 175 people who are publicly willing to admit to being economists may be a tribute to the ability of the profession in making others believe they are indespensible rather than any measure of their effectiveness. Three decades ago this conference could probably have been held in one of the local guest houses - that might have been a more realistic assessment of the national requirement for macroeconomic policymakers.

EMS not a substitute for the Sterling link

Economists , perhaps more than other, recognise market realities. It became clear in the late 1960 and early 1970s , as the volume of empirical work on the Irish economy increased, that while it was interesting to play around with theoretical models of the small open economy under a fixed exchange rate there was not much scope for devising countercyclical policies. To a certain extent the debate shifted from the appropriate set of macroeconomic policies to the appropriate exchange rate link to pusue. This debate intensified after Ireland joined the EEC and sterling had one of its periodic bouts of weakness.

After all , it was argued, if the domestic economy adjusts to the exchange rate why not have it adjust to an exchange rate which will give us less inflation. There were no guides in the theoretical literature as to the appropriate exchange rate link to pursue. It was argued, for example, within the Central Bank in the mid-1970s that the benefits of

a fixed exchange rate policy - in terms of imposing constraints on the behaviour of Governments and preventing inflation - could be obtained by pursuing a constant trade weighted exchange rate and, given sterling weakness, this would avoid the transmission of UK inflation to Ireland.

Only with the formation of the EMS did it seem possible to pursue an alternative exchange rate link than that followed for almost two centuries. The break with sterling could, and has, been defended on a number of grounds. These include (a) the unwillingness to accept the rapid transmisssion of disturbances in the UK economy to Ireland and (b) the belief that sterling was a petro-currency and its fate would be determined by oil price movements which would have the opposite effect on an oil importing economy like Ireland. This tended to be an ex post justification given what happened to sterling in 1979.

However it is crucial to stress that membership of the EMS was not equivalent to the substitution of one fixed exchange link with another. The EMS was, and is, a system whereby variations in exchange rates are managed and where short-run fluctuations are controlled by Central Bank intevention. But the allowable short-run varaitions are of a size to permit significant short run variations in interest rates and to create exchange risks for transnational investors.

Further the EMS explicitly recognised that from time to time permanent adjustments in exchange rates could take place. Thus substantial divergences in long term interest rates between members could , and did, occur,

The potential for both short and long run divergences in the cross parities meant the EMS membership no longer provided a simple rule exchange rate policy. Many of the benefits of a fixed exchange rate policy were lost because domestic economic agents - and overseas investors, traders, etc. - could no longer treat the Irish exchange rate as certain.

What is our current exchange Rate Policy?

Because I believe that the shift from a certain to uncertain exchange rate regime is crucial to events which have occurred since EMS membership I shall return to the issue later. But for the moment it is worth considering the nature of the current exchange rate policy being pursued.

In the early period of EMS membership the Irish pound steered a steady course neither appreciating nor depreciating relative to the narrow band EMS currencies. Between 1979 and 1982 the Irish pound performed like a weighted average of the other EMS currencies. Although there were passive realignments between 1982 and mid-1986 over the 6 1/2 years of EMS memberhip until August 1986 the Irish pound depreciated less than 1 per cent per annum on average relative to the narrow band EMS currencies. The realignment in August virtually doubled our underperformance overnight.

For most of the period the tradeweighted value of the Irish pound was in decline. First because of the rise in sterling and then because of the rise in the US $. From mid 1985

however the Irish tradeweignted index ap[preciated sharply as sterling and the US$ slid

.

The justification, ex-post, for the realignment of the Irish pound in EMS in August 1986 was that we were merely restoring the tradeweighted index to a more 'normal' level. Thus it would appear that we are now pursuing a fixed tradeweighted exchange rate policy rather than a fixed link with narrow band EMS currencies. As neither regime has been spelled out formally as exchange rate polciy this shift in policy has to be inferred.

Few benefits From Present Policy

It might be felt that the confusion and uncertainty over Irish exchange rate policy could be ended if the authorities formally commited themselves to a constant trade-weighted exchange rate policy. But I do not believe that such a commitment would permit a return to a fixed exchange rate regime with all the attendant benefits in terms of improved information and greater certainty within the system.

There are a number of reasons why this is so:

1. The weights used in calculating the effective Irish exchange rate are a state secret which the Central Bank refuse to divulge.

2. The weights are likely to change over time so that long term projections of the Irish pound's value would require long term projections of Ireland's trade.

3. The ad-hoc nature of recent Irish exchange rate policy would greatly reduce the credibility of such a policy espcecially since concern over the trade weighted value of the Irish pound seems to have arisen mainly because of changes in the punt/sterling rate

.

4. Most important of all , there is no demand, either internally or externally, for a unit of value representing a basket of currencies weighted by Ireland's trade. Thus no benefits in terms of rapid adjustment of capital markets to savings or expenditure imbalances would be guaranteed by such a policy.

In short such a policy is a poor substitute for the simple rule approach adopted as our pre-EMS exchange rate policy.

What Should We Do?

If a (changeable) policy of maintaining the trade weighted value of the Irish pound is unlikely to confer any more benefits than a policy of adjusting the exchange rate as domestic circumstances require then it is doubtful if we should remain a member of the EMS. A continuation of membership combined with a policy which if implemented would require frequent parity changes simply leads to regular short term currency speculation, higher interest rates and permanent resource losses as the Central Bank regularly put their money on a guaranteed loser. Of course if it was widely believed that Ireland would appreciate within the EMS whenever, or if ever, its trade weighted index

started to decline because of sterling or dollar strength then at least the Central Bank might have a sporting chance of coming out even. But the past 6 1/2 years suggests that our present policy is asymmetric. We will accept a tradeweighted devaluation within a constant EMS framework but not a tradeweighted appreciation.

Given the importance of sterling and the US dollar in Ireland's trade that looks suspiciously like a one way option. The Irish pound is perceived to have little scope for appreciation against the US$ and sterling but unlimited potential for depreciation. This is a recipe for Irish interest rates well above sterling rates.

If a tradeweighted approach is not sustainable or credible what is?. It seems to me that if we are to get the benefits - and the discipline - attached to the pursuit of a fixed exchange rate regime the we can either pursue a sterling link or an ECU link and that the nature of the link will have to be far more formal and ingrained into economic life than EMS membership has been.

At the foundation of the State the choice was made not merely to have a fixed link with sterling but also to require the issue of Irish pounds to be backed by an equivalent amount of sterling. Thus holders of Irish pounds knew that they could always get sterling. The link was not merely a conditional expression of intent but copper-fastened by the method of currency issue.

ECU Link Preferred

We could try and return to the sterling link. Given the experiment of the last 6 1/2 years there could be a feeling of relief among traders, bankers etc. that at last they could return to the days of certainty. But we would still have the problem that the existence of oil leaves open the possibility of another burst of sterling strength and fears about the sustainability of our policy. In addition we cannot rule out continued sterling weakness especially if after the next election the UK becomes committed to substantial fiscal expansion. While many industrialists lobbying for a lower Irish pound would probably welcome a return to the 1970s and sterling weakness they would do so on the unreal assumption that current pay and price inflation would be unchanged. We know that would not happen and, on past performance, the benefits of a competitive exchange rate are soon dissipated in higher domestic costs.

I believe that we should link the Irish pound directly to the ECU - not necessarily at the present rate - and that we should formalise this relationship by a currency reform similar to that which underpinned the sterling link.

This could involve the substitution of ECU for Irish pound as legal tender and as the currency acceptable for the payment of debts. Existing Irish pound contracts would be converted to ECU at the new exchange rate. Henceforth holders of Irish pound debt would be holders of ECU debt.

What would we give up by this reform and explicit link? We would give up the right to change our future relationship between the Irish pound and the ECU - but that is what a fixed exchange rate is all about. If the authorities are to be believed we are willing to give up the right to change the relationship between the Irish pound and a basket of

currencies weighted by Irish trade. All this proposal does is change the mix of the basket of currencies.

There is the additional point that it makes the exchange rate link an integral part of the domestic monetary system, rather as sterling was for almost two centuries.

The major advantage of an ECU link relative to a tradeweighted link is that there is an international demand for ECU. There is no demand for the particular basket of currencies inherent in the Irish pound maintaining an effective exchange rate index. There could well be a willingness on the part of traders and investors to hold the Irish pound against ECU commitments thus giving the Irish pound an international demand it does not currently have.

ECU Link alone is not enough.

Of course it has to be conceded that the credibility of such a policy , in the early stages at least, would depend on the perceived willingness of the authorities to adopt domestic policies - especially on public borrowing - which would permit such an exchange rate policy to be sustained. Of vital importance in this regard would be measures to convince domestic economic agents that this was not a conditional policy so that employers and unions who settled on pay increases out of line with those in the EMS could expect to lose competitiveness and employment.

Given the current composition of Irish trade - including agricultural trade with the UK and third countries - the ECU link would be closer to a trade -weighted exchange rate policy than a sterling link. If the pusuit of a constant trade-weighted exchange rate is deemed desirable but is not a practical proposition within the EMS then an ECU link would be a better alternative.

That is not to say that the sterling/ECU rate will not continue to be of importance and will severly restrict the scope of domestic policy action. Thus the ability of the Exchequer to determine Irish indirect tax rates independent of UK rates will be circumscribed and variations in the exchage rate relative to sterling may give rise to the need for changes in the structure of taxation.

But those are the problems of being a small open economy. Given the choice between total freedom for Irish policy makers and severe restrictions imposed by a fixed exchange rate policy and an easily traversed border with another economy I know which I would choose. While it may limit the range of policy papers at the Kenmare conference it could also ensure that the attendance would not quadruple over the next 5 years.!