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EXPERIENCE OF THE EUROPEAN MONETARY SYSTEM:
AN IRISH VIEWPOINT

by

Brendan M. Walsh

Policy Paper No. PP89/3

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This paper was first read to the Irish Economic Association Conference "A Decade of the European Monetary System: Achievements and Prospects" in Trinity College Dublin on March 20, 1989.

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Between the idea
And the reality
And where the sun shines
Falls the Shadow.

T.S. Eliot
The Hollow Men (1925)

Introduction.

Almost exactly ten years ago, Ireland's participation in the exchange rate mechanism (ERM) of the newly launched European Monetary System (EMS) made it impossible to maintain the one-to-one no margins exchange rate peg between the Irish pound and the pound sterling. As sterling appreciated relative to German mark and the other currencies of the narrow band EMS (EMS-NB), we were faced with the stark choice of abandoning the century-and-a-half old link with sterling or realigning within the EMS. To have realigned by the amounts required to maintain the sterling link so soon after joining the EMS would have been tantamount to leaving it. We chose therefore to allow the Irish pound to depreciate relative to sterling. Thus, paradoxically, an almost immediate consequence of the coming into operation of the EMS was the break-up of the oldest currency union in Europe! For the first time, too, the two parts of this island came to have an exchange rate and exchange controls between them and trade between the Republic and the United Kingdom became subject to the added costs associated with a fluctuating rate of exchange.

At the tenth birthday of the system it is timely to review

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1I am grateful to my colleague Rodney Thom for providing me with some of the data used in this paper. But he will get no further recognition from here.
Ireland's experience as a member.[1] I shall start by summarising the considerations that led us to join the EMS and our expectations of the benefits of membership. Then I shall review the outturn over the past ten years. I conclude with some reflections on the costs and benefits of membership and some thoughts about the prospects for the future.

Why We Joined or Great Expectations

The link with sterling had been a central part of the financial and monetary policy of the Irish state since Independence, endorsed by international advisers and established domestic opinion alike. It was questioned only by a small minority, although doubts became more widespread when sterling was devalued in 1949 and 1967 and the link with sterling led to an automatic fall in the value of our pound against third currencies. The alarming rate of inflation recorded in the mid-1970s brought home the limits to the benefits of the link with sterling. There was a heightened awareness that the rate of inflation in the United Kingdom was persistently higher, and its rate of economic growth lower, than those in most other developed countries. Moreover, after 1973 membership of the European Economic Community increased the importance of our exchange rate with third countries, not least because agricultural support prices were now paid in EUAs. Thus by the end of the 1970s circumstances were favourable for Ireland to respond positively to a Community initiative to create a regional currency union. We were also predisposed to respond favourably, even if the United
Kingdom (UK) declined, because of our generally communautaire stance.

The intellectual grounds for a favourable response had been provided in the course of the debate on the causes of Irish inflation during the 1970s. Although some economists argued on the basis of an input-output model that half of our inflation was home-grown and half imported, the econometric evidence favoured the Small Open Economy (SOE) paradigm of inflation, according to which the fixed exchange rate with sterling condemned us to import the United Kingdom's rate of inflation.[2]

It was a short step from the SOE model of inflation to the view that a change in our exchange rate peg would lead to a change in our rate of inflation and several Irish economists took this step. The former Secretary of the Department of Finance and Governor of the Central Bank of Ireland, T.K. Whitaker, in a systematic review of the costs and benefits of the sterling link, concluded that "revaluation would tend to be a powerful anti-inflationary weapon" [3]. Others argued that it would not be possible to get our rate of inflation down without breaking the sterling link. The lower rate of inflation in Denmark after it broke with sterling in 1968 was cited as a lesson from which we could learn. It was stated that a decline in the rate of inflation could be evident within a year of the change in the peg.[4]

By the time an alternative to the sterling link became
available to us through the proposals of the Bremen meeting of the European Council in July 1978, opinion in Ireland was convinced that the balance of advantage had tipped in favour of abandoning sterling if this was required in order to join the new "zone of monetary stability". Sterling was seen as a weak, inherently inflation-prone currency. If Britain was not willing to accept the discipline of the EMS, we would enjoy a lower rate of inflation if we were prepared to break the sterling link and accept the hegemony of the German mark. As the Governor of the Central Bank of Ireland put it at the time, "it would be prudent for us to proceed on the assumption that, in the longer-run at any rate, membership of EMS involves a harder currency regime than non-membership" [5]. The Irish Government's White Paper on the EMS, published in December 1978, reflected this line of thinking when it stated that:

the discipline involved in membership of a zone of monetary stability acts as a powerful aid in the fight against inflation. (p. 9)

At the same time, however, it argued that we would face initial problems due to the fact that

in the initial period of operation of the EMS, the parity of [our] currency might be higher than it otherwise would be. This could impose severe strains on Ireland's competitiveness, leading to a possible loss of output and employment. (p. 10)
To overcome these anticipated difficulties, Ireland informed its Community partners that additional aid of the order of EUA 200 million over a five year period would be required. This estimate was based on a "detailed review of the programme of public investment aiding infrastructural and industrial development".[6] There was no mention of the cost of the additional foreign exchange transactions imposed on the economy by the break with sterling. The value of the extra grants offered to Ireland by the Community in 1979 was probably not enough to compensate for this additional burden.

There was a tendency among Irish economists to believe that convergence on the lower rates of inflation and interest obtaining in Germany would be rapid and almost automatic following the coming into operation of the EMS. They also held out the prospect that stable rates of exchange would lead to closer integration with the faster-growing economies of the Community and to higher levels of trade, direct inward investment and, in due course, accelerated economic growth.

With hindsight it is easy to see that too little emphasis was placed on the point that none of these benefits would follow unless we conducted our monetary and fiscal policy in a manner that would inspire confidence in our commitment to the new exchange rate regime. It was noticeable that our entry into the new system made little impact on the expectations or behaviour of trades unions, employers or government. In the wage
negotiations conducted during 1979 neither side paid much regard to the predictions of German levels of inflation, while our fiscal and monetary policy was to continue on a wildly expansionary course until 1981.

There was a quixotic element in Ireland's decision to join the EMS in 1979. As long as the UK remained outside the ERM, we were pegging our currency to a group of countries with which our economic and financial ties were not particularly close. The degree of our integration with the EMS countries was considerably lower than that of the other members. (However, if the UK had joined, or were to join, then our integration with the enlarged EMS would be very high.)

"The first ten years are the hardest."

Let us briefly review the outturn over the first ten years of our participation in the EMS, looking at nominal rates of exchange, interest rates, inflation and competitiveness.

**Nominal Exchange Rates.**

Joining the ERM involved a commitment to maintain the nominal value of our currency stable within the EMS-NB. Figure 1 displays the value of our exchange rate against a trade-weighted average of the EMS-NB currencies. Apart from the down-steps in 1983 and 1986, it is striking how stable the Irish
pound has been against this basket of currencies. In fact, during the first four years of the System's operation, the Irish pound was the most stable currency in E.E. We adopted a middle course between the revaluations of the mark and the devaluations of the lira. Since the beginning of 1987 the Irish pound has once again been very stable within the System. However, as a consequence of the 1983 and 1986 devaluations the pound is now 97% below its value in 1979:1 relative to the EMS-NB. It is worth a whole German mark (or 28%) less than it was at the start of the EMS. Thus, the decision to join did not commit us to a rigid peg as was assumed in the discussion at the time of entry. [7] This has clearly made it easier for us to remain in the System, but it also accounts for some of the divergences between our expectations of the benefits of membership and the outcome.

The Irish pound-sterling exchange rate is shown in Figure 2. The jaggedness of this graph is in striking contrast with the smoothness of the previous one. This is due to the volatility of the pound sterling relative to the EMS currencies.

If the behaviour of the two rates of exchange are linked, it becomes clear that we have maintained a stable exchange rate with the EMS-NB currencies when sterling was strong on the foreign exchanges, between 1979:1 to 1981:1 and since 1986:4. The devaluations of 1983 and 1986 both occurred during periods when sterling was weak. The sterling-Irish pound exchange rate rose from 0.79 in 1985:2 to 0.95 in July 1986. At the same time
the US dollar was also falling on the foreign exchanges. Our Effective Index rose by 12% over this interval (Figure 3). It was against this background of an appreciating exchange rate and growing anxiety about loss of competitiveness in the British market in particular, that the decision was taken to devalue.[8] Similarly, the decision to devalue at the March 1983 realignment was taken after a 10% rise in the value of our pound relative to sterling over the previous quarter.

Thus, our commitment to a "hard currency peg" in 1979 has had some curious results. The value of our pound fell by 25% against sterling in the first two years. Two major devaluations within the EMS have lowered the its value against the average of those currencies by 15%. The overall volatility of our exchange rate increased as a result of joining a "zone of monetary stability" of which sterling is not a member.

The Pattern of Trade.

It was expected in 1979 that our commitment to a stable exchange rate within the EMS would lead to a rapid change in the pattern of trade, especially if sterling did not participate in the EMS. In fact, the reduction in exchange rate volatility, relative to the EMS currencies seems to have had little or no effect on the pattern of trade. Price and income elasticities, and differential growth rates, have been much more important.[9] As may be seen from Figure 4, the United Kingdom has remained remarkably dominant in both our import and export markets, but
especially in the former. After ten years the EMS-NB currencies still account for only 20% of our imports and 33% of our exports. There was an element of "marry me first and the love will come later" about the decision to join the EMS in 1979. However, the first ten years have been something of a marriage blanc.

Rates of Interest.

Another expectation that followed from switch in our exchange rate peg was that Irish interest rates would decouple from UK rates and converge on German rates. Interest-rate parity theory suggested that the interest rate differential between Ireland and Germany would be eroded as confidence in our commitment to maintaining the Irish exchange-rate floor increased, however, the reality has proved to be very different from predictions based on theory. As may be seen from Table 1, Irish rates did decouple from UK rates after 1979, but the Irish rate was on average 2% higher than UK rate, and 6.2% than the German rate, over the period from 1979:1 to 1987:2. [10]. This was a disappointing outcome when set against our expectations on joining the EMS. However, real interest rates have been 0.83% and 1.4% lower in Ireland than in the UK and Germany, respectively. While this could be regarded as a benefit of membership, it has come about only because our rate of inflation exceeded that of Germany and the UK by even more than our nominal rate of interest exceeded theirs! [11]
The forward discount of the Irish pound against the DM over the period 1981-87 was much larger than was justified by the actual change in the exchange rate. There were long periods when the higher rate of interest in Dublin relative to Frankfurt more than outweighed the decline in the Irish pound/DM exchange rate. A German purchaser of Irish gilts would have had to have been unfortunate enough to have bought fairly soon before either of the two devaluations not to have done better in Dublin than in Frankfurt over the entire ten year period, but nonetheless the uptake of Irish gilts by non-residents remained very low until 1988. The reasons for this undoubtedly lay in the lack of credibility of our commitment to the EMS-NB, arising from our continuing fiscal imbalances.

The behaviour of the Irish-UK interest rate differential since the end of 1985 deserves detailed examination (Figure 6). The sharp, but relatively short-lived, widening of the differential in the first quarter of 1986 was associated with leading and lagging of foreign exchange payments arising from anticipation of a possible devaluation of the Irish pound at the April 1986 EMS realignment. After the realignment, which left the value of the Irish pound virtually unaltered, there was a sharp fall in Irish interest rates and an improvement in liquidity. In the aftermath of the 1986 devaluation, however, Irish interest rates climbed steeply relative to British rates. The combination of the continued weakness of sterling, the uncertainty engendered by the devaluation, the lack of progress in correcting the fiscal imbalances and increasing political
uncertainty generated a crisis atmosphere which was not resolved until the second quarter of 1987, after the introduction of a stringent budget by the new government and a strengthening of sterling.

The evolution of events since mid-1988 has been remarkable, with the Irish money markets ignoring the surge in UK rates. The magnitude of the gap between Dublin and London that now exists, and the relatively small gap with Frankfurt, indicates the credibility of our exchange rate commitment within the EMS. This in turn reflects the progress that has been in reducing the size of the public sector deficit and the sharp rise in the value of sterling on the foreign exchanges.

Irish Inflation in the EMS.

As we have seen, our hopes on joining the EMS centred around a fall in our rate of inflation to the German level. These hopes were generated by the influence of a variant of the SOE model of inflation according to which our rate of inflation was determined by that prevailing in the country with which we had a fixed rate of exchange. At the time of entry some commentators predicted that the effects of the change in the exchange rate regime would be apparent very quickly.

In fact, things did not work out this way, at least not during the first seven years of membership. Between 1979:1 and 1985:4 consumer prices rose by 122% in Ireland, compared with an
increase of 81% in the UK and only 29% in Germany. By this yardstick, one of the most important expected benefits of EMS membership failed to materialise during the first seven years of membership.

There are several reasons for the gap between expectations and outcome in regard to the rate inflation after joining the EMS. In the first place, as we have seen, Irish exchange rate policy within the EMS was much less clear-cut than the rigid peg with the DM on which the predictions of convergence to German rates of inflation were based. In effect, we operated an adjustable peg within the EMS, while at the same time experiencing a major depreciation against sterling. Moreover, because the sterling-DM real exchange fluctuated quite widely, the Irish pound could not have maintained stable real exchange rates against these two currencies simultaneously, an eventuality that was not foreseen in 1979!

Secondly, the influence of the new exchange rate regime on the rate of inflation was much more complex than anticipated by Irish economists who had only the experience of the sterling link to work with.[12] Recent empirical research on the determinants of Irish inflation before and after 1979 has shown that while in the short run PPP cannot be said to hold, domestic costs continue to play only a minor role in the determination of the prices of manufactured goods. In the long run, not surprisingly, foreign prices are the dominant influence on the behaviour of Irish manufacturers' prices. Callan and Fitzgerald
conclude that "the effects of movements in exchange rates on prices are slower to materialise than are the effects of changes in foreign currency prices" and that "in the post-EMS period [Germany] plays at least as important a role in output price determination as does the UK". [13]

A final point that should be borne in mind in discussing Irish inflation since 1979 is that there has been a significant difference between the rate of inflation in consumer prices and that in manufacturing output prices. The annual average rate of increase is the former has been 9.8% compared with 7.1% in the latter. The lower rate of increase in the price of traded goods reflects the fact that the discipline of the currency peg operates more effectively here. This was a distinction that we were not very conscious of in 1979!

Competitiveness.

The measurement of the trend in competitiveness in Ireland is complicated by several issues. Among these are the following:

i. The base year with which the comparisons are made. Massey cites van Ypersele to the effect that the Irish pound entered the EMS at a relatively competitive level [14]. The evidence for this is the fact that the real exchange rate (that is, the nominal rate adjusted by an index of the ratio of domestic to foreign earnings) relative to the EMS currencies was
some fifteen per cent below its 1970 level in 1978. However, the same index of the real exchange rate against a weighted average of our main trading partners was about 10% higher in 1978 than in 1970, due to a thirty per cent appreciation against sterling.

ii. Another issue that bedevils the measurement of competitiveness in an Irish context is the question of how to allow for the fact that the firms that lose competitiveness disappear from the statistics. An incipient loss of competitiveness will therefore boost productivity. During the 1980s there was a 25% decline in employment in Irish manufacturing industry. Whole sectors virtually disappeared, and these tended to be those that were most labour-intensive. Moreover, a small number of sectors (pharmaceuticals, various high-technology electronic engineering industries and some food processing industries) have recorded exceptional productivity gains that reflect a variety of tax and pricing factors. The fact that Irish unit labour costs in manufacturing fell by 33% relative to those of its main trading partners in a common currency between 1979 and 1988 has to be interpreted in the light of these considerations. Massey's data show that, when the sectors listed above are excluded, unit labour costs rose by about 6%.[15]

If the trade balance is taken as in some sense a "bottom line" indication of competitiveness, the evidence for the period since 1978 is complex. The large, and growing, balance of trade
surplus with the EMS-NB countries offers no support for the belief that we have lost competitiveness in this market. In 1978 our exports to the EMS-NB exceeded our imports by 24%; in 1987 this excess had grown to 60%. It is generally believed, however, that our merchandise trade with these countries is not very price sensitive, with exports in particular being driven by supply-side considerations such as the location in Ireland of subsidiaries of U.S. firms that use this country as their EC manufacturing base. Moreover, the improvement in the trade balance since 1981 owes a great deal to the fact that the growth of demand in Ireland's export markets greatly exceeded the growth of domestic demand in Ireland.

Any attempt to assess the competitiveness of the Irish economy since 1979 cannot ignore its striking underperformance relative to the rest of the OECD over this period. Since 1979 the rate of unemployment in Ireland has risen from 7.1% to 10.5%. It has remained at this extraordinary level despite an annual outflow of about 1% of the population in each year since 1985. Employment in manufacturing has declined by 25% and total employment by 5.7%. The shares of agriculture, manufacturing industry (excluding the repatriated profits of foreign-owned firms) and tourism in GNP have declined quite sharply, while that of the non-traded services sector has increased. On the basis of this evidence, it is difficult to disagree with the verdict of the OECD in its 1987/88 Survey of Ireland that "the fundamental performance of the Irish economy in recent years indicates that the present level of competitiveness needs to be
improved" (p. 72).

Irish Exchange Rate Policy in the EMS.

The way in which we have conducted out exchange rate policy since 1979 may be explored by looking at the behaviour of the two components of the real exchange rate separately, that is, the ratio of foreign to domestic prices and the exchange rate (defined as the foreign price of a unit of domestic currency). This is done for the Irish pound and sterling in Figure 7 and for the Irish pound and the DM in Figure 8. Wholesale or manufacturers' output prices are used and it should be borne in mind that these prices cannot be expected to deviate very far or for any length of time from "world" prices. These graphs allow us to observe the behaviour of the real exchange rate and the level of competitiveness. If the real exchange rate were constant, these two lines would not diverge. When the exchange rate curve falls below the relative price line, the real exchange rate is falling and Ireland is gaining competitiveness.

It is important to try to distinguish between situations where the two lines converge because of a policy decision to use the exchange rate to restore a competitive position and those where this convergence reflects the effects of the exchange rate on relative rates of inflation. The latter was the mechanism by which the change of exchange rate regime in 1979 was expected to benefit the Irish economy. [16] Inspection of the evidence in
Figure 8 strongly suggests that our devaluations within the EMS were essential in order to avert a much more severe loss of competitiveness than actually occurred. [17] During the first two years of the EMS, as sterling rose and Irish wholesale price inflation fell below the UK level, we experienced a marked gain in competitiveness relative to sterling. [18] Over the two and a half years from January 1981 to March 1983, however, we can see the two curves moving inexorably closer together as the rate of inflation in Britain moderated and sterling weakened on the foreign exchanges. The 1983 devaluation and the subsequent strength of sterling alleviated this loss of competitiveness. The 1986 devaluation can be similarly interpreted, even though by then Irish inflation was moderating relative to British. It is interesting to note that the recent strength of sterling has increased the gap between these two lines to the point where it is now wider than it has been at any time since the end of 1980.

The evidence of the behaviour of Irish-German relative inflation and exchange rates (Figure 8) is straight-forward. The Irish rate of wholesale price inflation has been consistently more rapid than the German, with the result that the ratio of the price indices has declined by over 35% since 1979. The Irish pound-DM exchange rate has also declined, but at a slower pace. The result of this "not-fully-accommodating" exchange rate policy has been a tendency to lose competitiveness, which was most marked between the beginning of 1984 and the devaluation of August 1986. The recent stability of the Irish pound within the EMS has occasioned a significant rise in our real exchange rate.
against the DM. This has been more than offset, however, by the fall relative to sterling.

Conclusion.

Any evaluation of the Irish experience as a member of the EMS has to take account of the extraordinary evolution of Irish fiscal and monetary policy during these years. Figure 10 shows how Domestic Credit Expansion as a percentage of the previous year's money supply declined from almost 50% in the early years of our participation in the system to about one quarter that rate in the last two years. Most of the marked improvement in relative rates of inflation and interest have to attributed to this change in macroeconomic policy rather than to adherence to the EMS. While it can be argued that membership of the system encouraged the transition to moderate fiscal and monetary policies, there was very little evidence of this during the first three years in particular, and the crisis at the end of 1986 revealed how precarious our situation remained as long as appropriate domestic policies were not in place.

Irish exchange rate policy within the EMS has been a difficult balancing act. We have not operated a simple "adjustable peg" within the system in as much as we have not the brought our exchange rate down by as much as would have been required to offset in full the excess of Irish over German inflation. On the other hand, we have clearly continued to pay considerable attention to the behaviour of the Irish pound-
sterling exchange rate. The dilemma we face can be illustrated by a diagram adapted from one prepared to illustrate a similar point with regard to the UK's possible participation in the ERM (Figure 9) [19]. The Irish pound-sterling exchange rate follows arithmetically from the DM-Irish pound and sterling-DM rates. We have no control over the latter and we can only control the former by realigning within the EMS. In periods, such as the present, when sterling is strong relative to the DM, there is no conflict between maintaining our EMS peg and enjoying a sterling exchange rate with which we are comfortable. The real test comes during periods when sterling's weakness moves us out of the target zone of our sterling exchange rate.

Although the prospects for sterling remain, as always, uncertain, it is likely to decline from its present high level. However, the magnitude of the depreciation that is being predicted (say, 4% over the year) is nowhere near large enough to move the Irish pound/sterling rate to the level at which the competitiveness argument in favour of realigning within the EMS would be irresistible. Moreover, the case for resisting this argument is much greater now than it has been at any other time since 1979 because maintaining a stable exchange rate in the EMS is now working along with the improvement in our monetary and fiscal situation and allowing us to enjoy lower interest rates and a moderation in the rate of imported inflation. While the adverse effects on the internationally trading sectors of our economy of a sustained misalignment of our exchange rate should not be ignored, renewed uncertainty regarding our commitment to
the EMS would do nothing to restore what may have been lost due to misalignments since 1979. Let us hope that the behaviour of sterling over the medium term does not jeopardise our belated enjoyment of the fruits of our commitment to the EMS.
Endnotes


[4] The relevant quotations are in the essay in the de Cecco volume.


[6] A similar calculation is now being made of the amount needed to prepare us for the coming into effect of the Single European Act!

[7] To quote the White Paper again, "Devaluation, particularly if repeated, would call into question the credibility of Ireland's continued membership of the system" (p. 11).

[8] At the August 1986 realignment only the Irish pound realigned. Our 8% devaluation was the second largest recorded by a participating currency.

[9] In this the Irish experience is similar to the EMS as a whole. Paul de Grauwe found little evidence that reduced exchange rate volatility has stimulated additional intra-EMS trade.
[10] Between 1973:1 and 1979:1 the average difference between Irish and U.K. rates was only 0.31, which leads Leddin to conclude that the higher nominal interest rate was a penalty of membership of the EMS. See A. Leddin, "Interest and price parity and foreign exchange market efficiency: The Irish experience in the European Monetary System", The Economic and Social Review, Vol. 19, No. 3 (April 1988), pp. 215-231.

[11] This point is made by Leddin, loc. cit.

[12] It is true, however, that there was too little awareness in Ireland in 1979 of the growing evidence of the importance of departures from simple PPP under floating exchange rates.


[15] Massey actually uses his findings to argue that the loss of competitiveness since joining the EMS has not been as great as appears from data on earnings unadjusted for productivity.

[16] This issue is not addressed in any of the studies of Irish inflation in the EMS cited above.

[17] The role of these devaluations in preventing these series from diverging must be borne in mind in statistical/co-integration, etc. See Rodney Thom, "Real Exchange Rates, Co-integration and Purchasing Power Parity: Irish Experience in the EMS", The Economic and Social Review.

[18] This bilateral gain has to be viewed in the light of the fact that all other countries were also gaining in the British market.

Figure 5. *Differentials in Nominal and Real Interest Rates*
Ireland, W. Germany and the United Kingdom

**Nominal Interest Rates**

**Real Interest Rates**


Source: OECD Main Economic Indicators.
Figure 8. Irish pound and DM exchange rate, and relative prices
FIGURE 7. Irish pound and sterling exchange rate, and relative prices.
BRITISH AND IRISH INTEREST RATES

Three Month

DOMESTIC CREDIT EXPANSION
The EMS and the Irish Pound/Sterling Rate

- STG1 = DM3.2
- STG1 = DM2.8
- EMS PEG

Graph showing the relationship between DM/IR and STG/IR.