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EXCHANGE RATE POLICY AND COMPETITIVENESS

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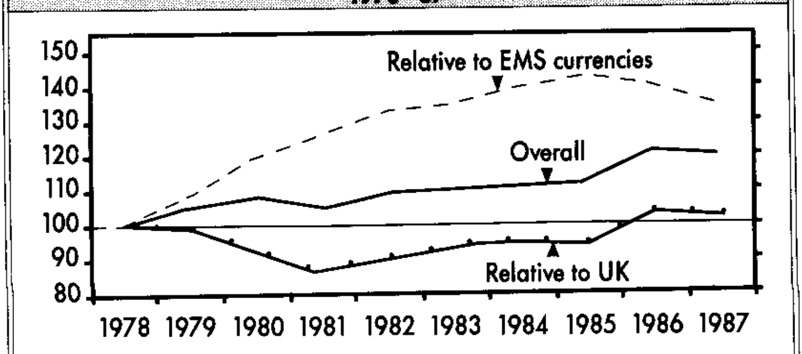
An index of competitiveness measures the trend over time of a country's prices and costs relative to those of its trading partners, all expressed in a common currency. If this is rising, cost competitiveness is deteriorating.

Fig. 7.1 shows the trend in Irish competitiveness by comparing Irish labour costs relative to the EEC and Britain, and the overall average, since 1978. It may be seen that there was a deterioration of about 20 per cent in Irish overall competitiveness over the period 1978–86 according to this index. This has potentially serious implications for the ability of Irish firms to compete successfully on foreign and domestic markets, and consequently for the level of employment and unemployment in this country.

FIG 7.1 **Measures of Competitiveness: Trend in Relative Wage Rates in a Common Currency, 1978–87**



Source: OECD

In this chapter the role of exchange rate policy in relation to the trend of competitiveness is examined. The limited space available precludes discussing in any detail the interaction between movements in the exchange rate and movements in domestic costs, or exploring the magnitude of the impact of changes in competitiveness on the level of economic activity in Ireland. (This topic is dealt with in chapter 4.)

THE INTERNATIONAL SETTING

Since the early 1970s the rates of exchange between the major currencies of the western world have fluctuated widely. Despite repeated attempts by the governments and central banks of the main countries to restore stability, the amplitude of these fluctuations increased during the 1980s. Exchange rate volatility and the accompanying risk of misalignments continue to preoccupy policy-makers.

That fluctuating exchange rates can significantly alter international relative prices and costs in a very short period can be readily illustrated by considering the recent movements of the Irish pound/US dollar exchange rate. In March 1985 the Irish pound was worth 92 cents. By the end of 1987 it had risen to $1.66, an increase of 80 per cent. During this 20-month period the difference between the rates of cost and price inflation in the two countries was relatively slight, so that the change in the *nominal* rate of exchange was almost fully reflected in the *real* rate. The implications for the pattern of international trade and investment of such major changes in countries' relative costs and prices are enormous.

Ireland does not influence the exchange rate policies of the major economic powers. While as members of the European Communities we had some input into the proposals that led to the creation of the European Monetary System (EMS) in 1979, we have not been able to alter the UK's decision to remain outside the exchange rate fixing mechanism, which is the most important feature of the system.

Until 1979 the Irish authorities did not exercise an active exchange rate policy. In the years after independence the most important tasks were seen as ensuring the soundness and international acceptability of the currency, and facilitating international payments for importers and exporters. Preserving the link with sterling seemed to be the best way of achieving these objectives, in view of the importance of that currency in world finance and the fact that almost all our external trade was with the sterling area. The declining status of sterling as an international currency, its repeated devaluation against the US dollar and the growing diversification of Irish trade prompted some discussion of alternatives to the sterling link, but no change was seriously contemplated. Membership of the European Communities in the 1970s and sterling's rapid exit from the precursor of the EMS (the 'Snake') provoked a more extended discussion of the possibility of breaking the link, especially in the light of the important implications of exchange rate movements for the value of our receipts from the Common Agricultural Policy. But despite the changed environment, the link with sterling was retained, because no realistic alternative was available.

The agreement to form the EMS in 1978 radically changed the context of Irish exchange rate policy. We were offered the prospect of joining a new grouping of currencies which, if sterling were included, would ensure exchange rate stability with the countries that account for over two-thirds of our trade. By joining we would continue to play the role of 'good Europeans' and, as a bonus, we would share with Italy in a significant subsidy to offset the deflationary bias inherent in trying to stabilise our exchange rate through a basket of currencies in which the German mark has the largest weight. The new alignment would also mean that Ireland would no longer automatically import Britain's high rate of inflation.

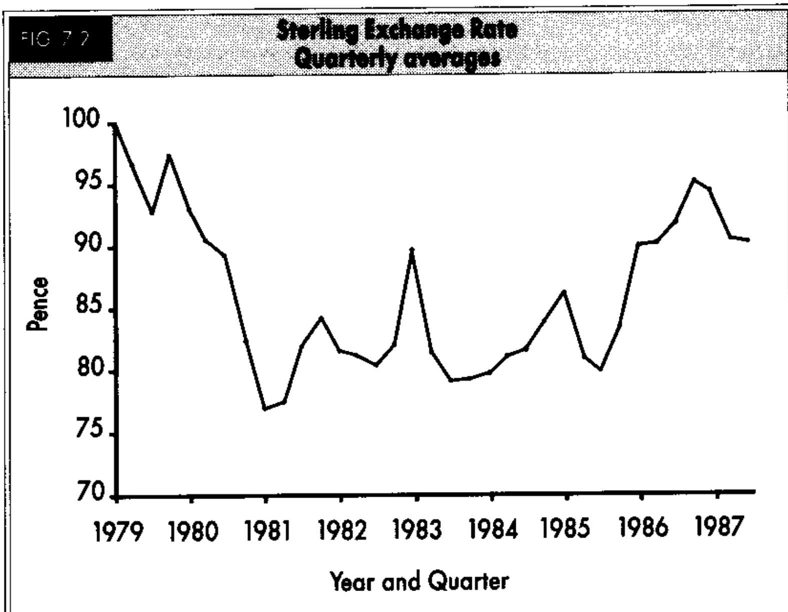
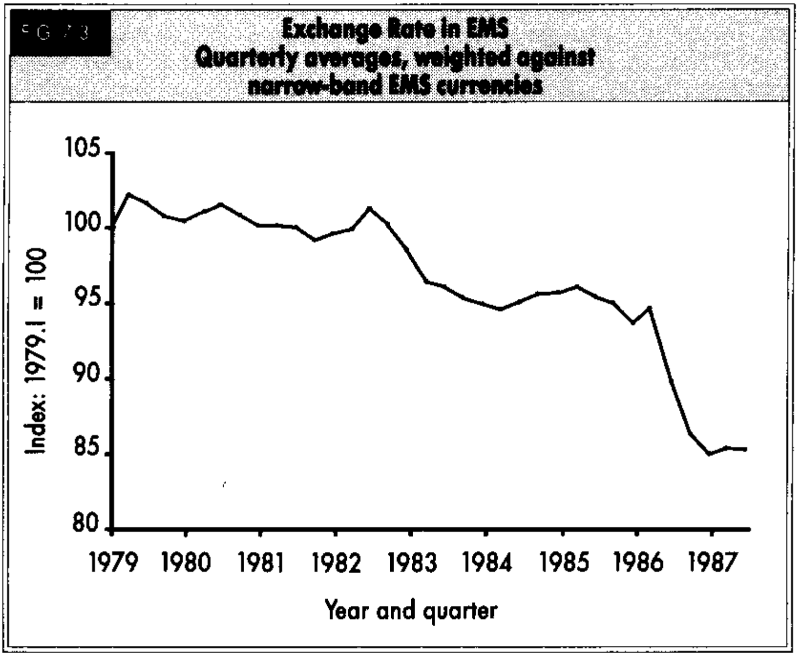


FIG 7.2 Sterling Exchange Rate Quarterly averages

In the event, Britain decided not to participate in the exchange rate peg that is the most important feature of the EMS, and we decided to join anyway. Initially there was the possibility that sterling would remain stable relative to EMS currencies, so that we could honour our commitment to the system without breaking with sterling. However, the unexpected surge of sterling on the foreign exchange markets at the end of March 1979 made this impossible, and the sterling link was broken. The Irish pound has fluctuated relative to sterling for the last nine years (fig. 7.2).

THE IRISH POUND IN THE EMS

Our exchange rate policy since 1979 has been dominated by our obligations under the EMS. Formally these comprise the setting of 'central rates' against the six other currencies in the system, and co-operating to ensure that the value of the Irish pound does not rise above or fall below the point at which the spread between the strongest and weakest currencies in the grid exceeds 2.25 per cent around these rates. (The Italian lira is allowed a 6 per cent spread, but we decided against any concession of this nature.) This obligation has been discharged quite smoothly. The Central Bank intervenes on the foreign exchanges when necessary to support or sell the Irish pound to prevent it exceeding its limits in the EMS, but does not release information on the amount spent on intervention.

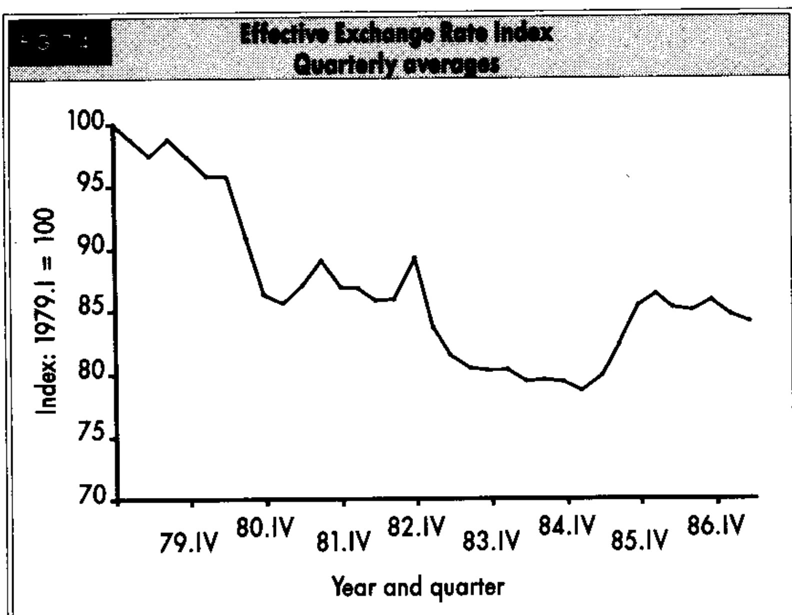


We participate in the discussions surrounding the realignments that have been a regular feature of the operation of the system. In the early years of membership we tended to 'go through the middle' between German revaluations and French and Italian devaluations with the result that the average value of the Irish pound was almost stable within the system between 1979 and the end of 1982 (fig. 7.3). However, in March 1983 and again in August 1986 we devalued (by 8.5 per cent against the German mark and Dutch guilder on the first occasion, and by 8 per cent against all the EMS currencies on the second). Over the entire period of membership, the average value of the Irish pound has fallen by about 15 per cent, or 1.5 per cent a year, against the currencies in the 'narrow band' exchange rate peg, with larger depreciations occurring relative to the German mark and the

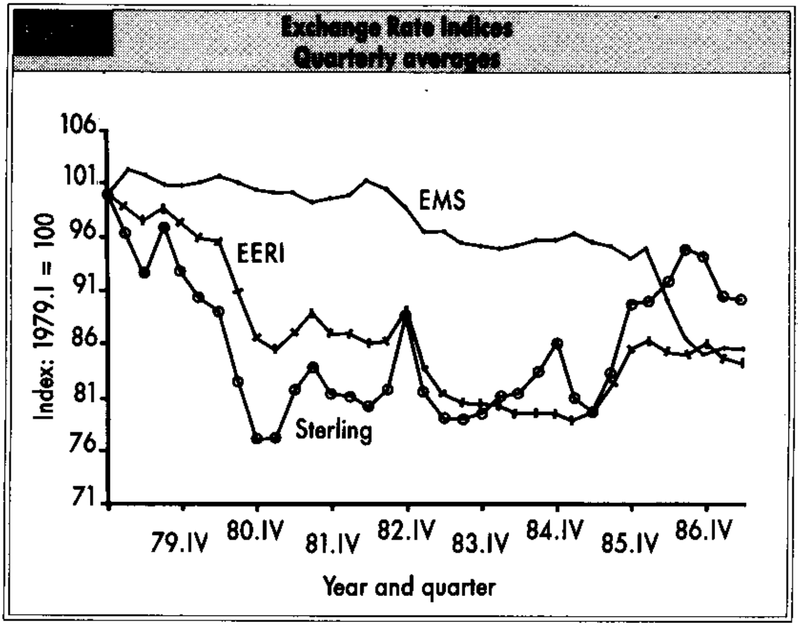
Dutch guilder. In this sense we have operated an 'adjustable peg' within the EMS. However, the decline of the Irish pound has been relatively smooth, and volatility has been kept to a minimum. This is in marked contrast with the wide swings that have occurred in the Irish pound/sterling exchange rate.

THE EFFECTIVE EXCHANGE RATE

In 1986 the EMS accounted for just under 50 per cent of our total exports and 35 per cent of our imports. These proportions are small compared with the importance of intra-EMS trade for all the other members. The continued absence of our largest trading partner, the UK, from the exchange rate peg is a major drawback to membership from the Irish perspective. This became very clear in 1983 when sterling's decline relative to the currencies of the EMS caused the Irish pound to rise to 87p sterling, leading to a serious loss of competitiveness relative to British firms. To redress this difficulty the Irish pound was devalued at the March realignment. History repeated itself in August 1986 when the renewed weakness of sterling threatened to push the Irish pound back to 1:1 parity. On this occasion we devalued without a general EMS realignment.



To obtain a comprehensive picture of the external value of the Irish pound it is necessary to look at an index of its value against a basket of currencies that includes sterling and the US dollar as well as the EMS currencies. The Central Bank publishes an effective exchange



rate index (EERI), based on an unpublished set of weights, which averages the value of the Irish pound with the currencies of our main trading partners. Fig. 7.4 shows how this index has behaved since 1978. The destabilising effect on the EERI of the volatility of sterling relative to the EMS currencies is evident from fig. 7.5, where the sterling and EMS rates are shown on the same scale as the EERI.

During 1979 and 1980 the sharp decline in the EERI reflected the decline of the Irish pound against sterling. The further decline in 1983 was due to the devaluation within the EMS and the continued fall relative to the dollar. After a period of stability from the end of 1983 to mid-1985, the Irish pound began to rise against the EMS currencies, sterling, and the dollar, with the result that the EERI rose by over 10 per cent between June 1985 and March 1986. Relative to sterling the Irish pound rose by about 20 per cent. The August devaluation had the effect of stabilising the EERI at about 85 per cent of its 1979 value, despite the further weakness of sterling later in the year. It required the sharp appreciation of sterling that occurred in 1987 to lower the EERI to a more sustainable level.

REAL EXCHANGE RATES

From the point of view of competitiveness, it is real or inflation-adjusted exchange rates that matter. For example, the value of the Irish pound relative to the German mark has fallen by 30 per cent since 1979, but Irish labour costs have risen by more than 30 per cent in excess of the rise in German labour costs over this period. Thus, in real terms our exchange rate has risen relative to Germany, because the fall in the nominal rate has not been sufficient to fully offset the differential between Irish and German rates of wage inflation.

Fig 7.1 displayed the nominal exchange rates relative to the EMS, Britain, and an overall average, adjusted by the rates of change in wages in manufacturing industry over the years 1979–86. According to this measure of the real exchange rate there has been an overall decline of about 20 per cent in Irish competitiveness since we joined the EMS. This has occurred because the 40 per cent loss of competitiveness relative to the EMS countries has not been offset by a competitive gain relative to sterling or the US dollar.

It is beyond the scope of this short chapter to evaluate in any depth what effect these trends in real exchange rates have had on the economy. It may be noted that despite the major loss of competitiveness relative to the EMS countries since 1978, both the absolute volume and the relative importance of our exports to them have grown significantly. The rapid growth in Irish exports seems to have occurred for reasons that have little to do with Irish cost competitiveness. Most of these exports are from subsidiaries of foreign firms in the pharmaceutical, electrical engineering and instrument engineering sectors, which are not sensitive to local labour costs. Tax planning has played an important role in their decision to locate in Ireland, and a substantial proportion of the profits arising from their exports is repatriated. On the other hand, more employment-intensive industrial sectors and tourism are likely to have been adversely affected by the deteriorating trend in relative costs during the 1980s.

During the period 1979–82 we enjoyed a significant competitive gain relative to Britain, due to the dramatic real appreciation of sterling. However, after 1982 sterling weakened significantly on the foreign exchanges, with the result that by 1986 all of this competitive gain had been lost (fig. 7.1). The more traditional industrial sectors that rely heavily on the British market tended to contract over this entire period, but this trend was most pronounced early in 1983 and during most of 1986, when the weakness of sterling caused severe competitive problems for many firms. They enjoyed a respite as sterling strengthened in 1987.

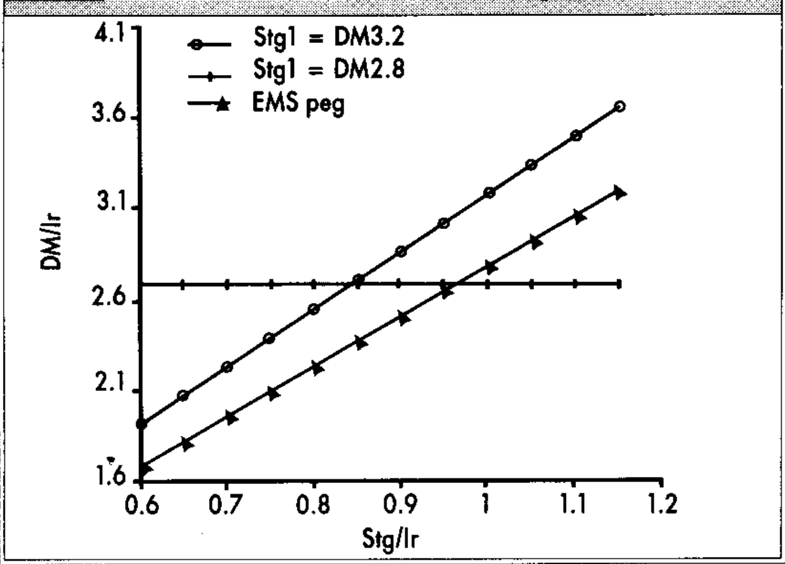
EXCHANGE RATE POLICY

Since joining the EMS, our exchange rate policy has been based on maintaining the average value of our currency within the system. While this objective has been modified to avert sudden increases in the overall value of the currency, it has from time to time entailed a significant loss of competitiveness, because we have not devalued sufficiently to offset the full inflation differential between us and the average of our trading partners.

The rationale for this 'non-accommodating' exchange rate policy has been the expectation that it would bestow important net benefits on our economy. By making it difficult for employers to concede unwarranted wage claims, and by moderating the rate of imported inflation, the policy was expected to place the economy in a virtuous circle in which the rate of inflation would spiral downwards. This would replace the vicious circle of currency depreciation and rising costs and prices into which we were locked during the 1970s. In the pre-EMS discussions there was widespread optimism that the 'hard currency peg' to which we believed we were committing ourselves would lead to convergence of our inflation and interest rates to German levels, within months rather than years.

For most of the ten years that we have been members of the EMS the outcome has been at variance with these expectations. In the first place, we did not maintain our nominal exchange rate rigidly fixed relative to the hard currencies of the system. Instead we pursued a policy of allowing some of our higher rate of inflation to be offset through periodic devaluations. However, we did not operate an outright 'crawling peg', inasmuch as the fall in our exchange rate did not fully accommodate the differential between our rate of inflation and that of Germany. The resultant loss of competitiveness did not, however, appear to exercise a marked moderating influence on our rate of inflation, and a large gap between Irish and German rates of interest persisted. In fact it was not until 1988 that Ireland could

FIG 7.6 **The EMS and the Irish Pound/Sterling Rate**



clearly be seen to enjoy the expected benefits of membership of the EMS, as our rates of inflation and interest moved significantly below British levels. The changed stance of fiscal policy, rather than any change in our exchange rate policy, was mainly responsible for these favourable developments.

A contradiction between these two statements of policy could arise from the movement of the pound sterling relative to the EMS and the impact of this on our EERI, as in 1983 and 1986. There are only two independent exchange rates between sterling (Stg), the Irish pound (Ir), and the German mark (DM). Given the value of the Ir/DM rate, to which we are pegged within the EMS, the Ir/Stg rate follows arithmetically from the Stg/DM rate, over which we have no control. The problem of reconciling targets both for sterling and the EMS (represented by the DM) is illustrated in fig. 7.6. The diagram shows how a given EMS central rate could become incompatible with a desired Stg/Ir rate due to a shift in the Stg/DM rate. In view of the volatility exhibited by sterling relative to the DM in the past, it is clear that the 2.25 per cent band around the central Ir/DM rate affords very little protection from a misaligned Ir/Stg rate.

The second dilemma facing Irish policy-makers concerns the broad issue of the costs and benefits of a 'hard currency peg'. Despite our non-accommodating exchange rate policies, the expected convergence of our rates of interest and inflation to German levels did not occur for most of the 1980s. Moreover, the tenuousness of the benefits of the EMS link was illustrated during the last quarter of 1986 when difficulties in funding the exchequer borrowing requirement led to a sudden loss of confidence in our currency and a sharp widening of the Irish/EMS interest differential in the absence of supporting fiscal and monetary policies. Similarly, the favourable developments that were evident in the Irish economy during 1988 are more readily accounted for by fiscal than exchange rate policy.

A conscious policy of devaluation to stimulate the level of output and employment seems to have been ruled out by the Irish authorities. In the words of the OECD survey, they believe that 'empirical studies show that . . . the only lasting effect tends to be on inflation with no permanent impact on the real economy.'[1] They may also believe that the economy has now adjusted to the prevailing level of exchange rates and that a devaluation would not restore any of the output and employment lost as a result of the real appreciation of earlier years: when firms go out of business due to a loss of competitiveness, the labour force is dispersed, plant is dismantled, and markets may be lost for ever. If this is the case, a fall in the exchange rate is unlikely to reverse this train of events. This line of argument highlights how important it is to avoid a loss of competitiveness in the first place.

The influence of the exchange rate on the rate of inflation during the 1980s is not obvious from the record. The decline in the value of the currency early in the decade did not lead to an acceleration in Irish inflation relative to British, whilst its rise during 1986 seemed to have equally little impact on relative rates of inflation. Estimates of the likely effect of a devaluation in present circumstances should allow for the impact of the exceptionally depressed labour market and how this may alter the response to a devaluation compared with what happened during the 1970s.

The poor performance of the Irish economy relative to the EEC as a whole since we joined the EMS gives no grounds for confidence that the exchange rate policy we have pursued over these years has been that most appropriate for our circumstances. The relatively favourable experiences of Sweden and Belgium following substantial devaluations in the 1980s show that exchange rate adjustment, in tandem with incomes and budgetary policies, can make a contribution to the correction of macroeconomic imbalances in small open economies. It is also relevant to note the contribution of the decline in sterling during 1986 to the rapid growth of the British economy during 1987. Some of the recent improvement in the Irish economy must be attributed to the fall in our exchange rate during 1987/88.

CONCLUSION

The exchange rate policy we have pursued since 1979 has been based on the belief that domestic costs would be brought under control by not devaluing sufficiently to accommodate our relatively high rate of inflation. We have enjoyed some benefits from this policy, but we have paid a price in deteriorating competitiveness, which may have contributed to the economic decline that has been experienced during the 1980s, the most serious manifestations of which are the sharp fall in employment and the crisis levels of unemployment and emigration. It is my view that in the future, exchange rate policy should place more emphasis on maintaining competitiveness than was done during the 1980s. This would require a greater readiness to devalue to avert a real appreciation of the Irish pound and the resultant loss of competitiveness.

Notes

1. Organisation for Economic Co-operation and Development, *Economic Survey of Ireland, 1987/88,* Paris: OECD 1987, 76.