Membership of the European Monetary System (EMS) had a more dramatic and tangible impact on Ireland than membership of the EEC itself. This is because within weeks after the formation of the System our currency departed from the one-to-one no-margins parity that had been maintained with sterling since 1826. Ironically, the most immediate consequence of the new institutions whose goal was the creation of a wide ‘zone of monetary stability’ was the break-up of the oldest currency union between sovereign states in Europe. In the three years since the EMS was formed, the absence of the United Kingdom has made Ireland’s membership somewhat of an anomaly in view of our continued close economic ties with that country.

In this review of the impact of the first three years of membership on Ireland, the background debate and expectations in the period leading up to the decision to join the System are reviewed, and then our experience since joining is assessed. In the final section, the prospects for Ireland’s continued membership of the EMS are discussed. In an area of rapid change and development, it is important to bear in mind that this chapter reflects the situation as it was at the time of writing, that is, June 1982.

THE STERLING LINK

Before 1979 the only episode of Irish exchange rate independence from the UK was that which occurred during the Napoleonic Wars. When the currency instability that characterised this period subsided, a stable exchange rate was re-established between the UK and Irish pounds. The old 12:13
parity was adopted once again in 1821, but as part of the process of integration of Ireland into the United Kingdom envisaged in the 1800 Act of Union, the independent Irish pound was abolished in 1826. All transactions, debts, contracts, etc. were converted to UK pounds on the basis of 12/13 the amount reckoned in Irish currency.

During the rest of the nineteenth century, and until the establishment of an independent Irish State in 1922, the absence of an independent Irish currency did not figure among the economic grievances complained of by nationalist writers. Nor were currency matters high on the priorities of the fledgling Irish Free State. New token coins were issued in 1926 and a consolidated Note Issue gradually replaced the private banks’ notes, without any fundamental change in the currency system. A Commission on Banking, Currency and Credit set up in 1934 was the only initiative in this area by a new administration that had taken radical steps in the field of industrial protection. The Majority Report published in 1938 firmly rejected various radical proposals and schemes regarding the Irish currency and emphasised that maintaining the sterling link was of paramount importance in view of the high degree of economic integration between Ireland and the United Kingdom, the pre-eminence of the UK as a trading nation, and the difficulty that would be faced in establishing international confidence in an independent Irish currency.

A Central Bank was established in 1942 with limited powers that were only gradually taken up and eventually extended in 1971 into those of a fully fledged Central Bank. During the devaluation of sterling against the dollar in 1949 and 1967, the Irish pound was also devalued against the dollar not as a deliberate beggar-my-neighbour policy but rather as an inevitable consequence of a largely unquestioned adherence to the sterling link.

The first systematic discussion in the post-war era of the costs and benefits of maintaining the sterling link, as opposed to alternative currency arrangements, is an essay written in 1973. Although the analysis was conducted in the light of new ideas about optimal currency areas, the author re-
affirmed the view of the Commission that reported in 1938 regarding the advisability of maintaining the sterling link. However, although strongly of the view that a devaluation would not bestow any real gains on the Irish economy, he held out the possibility that a re-valuation 'would tend to be a powerful anti-inflationary weapon'.

The link between our exchange-rate policy and our inflation rate began to pre-occupy Irish commentators as the rate of inflation in Ireland accelerated pari passu with that in the United Kingdom. Over the entire period 1955–78, the Irish consumer price index rose at an annual average of 6.7 per cent compared with the 6.5 per cent annual increase in the UK retail price index. Although in individual years there were significant deviations between the inflation rates in the two countries, there was no trend in these deviations and no tendency for an enduring gap to emerge between the two. The Irish economy therefore seemed to fit extremely well the small open economy model of inflation.

It was a small step from this finding to the inference that a change of exchange-rate peg would bring about a change in our inflation rate. Specifically, it was argued by a growing body of opinion that a change of exchange-rate policy was at least a necessary condition for lowering our rate of inflation. Some economists went further and implied that a change in the exchange-rate peg would be sufficient to ensure, by some unspecified mechanism, the convergence of our inflation rate on the rate experienced in the country to whose currency we pegged the Irish pound. The spirit of this argument is conveyed by the following quotation from an introductory textbook that achieved a wide circulation in Ireland just as we entered the EMS:

so long as we maintain a fixed exchange rate with any major country with which there is relatively free trade, we will tend in the long run to have that country's rate of inflation. The reasoning amounts to little more than recognising that markets do exist . . .

This line of reasoning can be seen to have influenced official, as well as academic views about exchange-rate policy. The Governor of the Central Bank summarised the
arguments that influenced the Irish decision to join the EMS as it became likely that the UK would not participate in its exchange rate mechanism under the following headings:

1. The inappropriateness of an indefinite prolongation of the sterling link;
2. The benefits in terms of a reduction in inflation to be obtained from adherence to a hard currency régime;
3. A commitment to a major Community initiative; and
4. Community support in the form of a significant transfer of resources.6

In the White Paper issued in December 1978 one of the reasons advanced in favour of Ireland’s membership of the EMS was the belief that ‘the discipline involved in membership of a zone of monetary stability acts as a powerful aid in the fight against inflation’.

Underlying these arguments was, of course, the implicit assumption that sterling would remain a high inflation, depreciating currency. This was made explicit in statements such as ‘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 régime than non-membership’.7 This, of course, represented the consensus view of sterling at the time, and one which was so deeply ingrained that the initial appreciation of sterling relative to the EMS tended to be dismissed as a short-term aberration.

Commentators who anticipated a dramatic moderation of our inflation rate subsequent to entry into the EMS did not intend to convey the impression that this would come about without supportive domestic policies. The need for appropriate income, monetary and fiscal policies was emphasised. Warnings emanating from the Central Bank and the Economic and Social Research Institute drew attention to the inappropriateness in our new situation of rates of increase in money incomes as large as had been the rule in the pre-EMS days. For example, the Governor of the Central Bank warned that ‘for the first time since the establishment of the State, the effects of ill-advised domestic policies and actions will be seen
quickly and obviously in the market's judgement of the Irish pound. But it was assumed in many quarters that appropriate action on these fronts would be inevitable because it was implicit in our decision to join the EMS. It seemed to be widely believed or hoped that membership of the newly formed club would lead to a fundamental change of national attitudes despite the events of the early months of membership when the promise of a substantial 'transfer of resources' fuelled expectations of higher living standards and, if anything, militated against the adoption of an appropriate incomes policy.

It is interesting to speculate whether prescience of the strength of sterling during the period 1979–82 would have affected the willingness of Irish officials and politicians to join the EMS without the UK. It would have been difficult, in view of the acceptance of the argument that a weak exchange rate resulted in increased domestic inflation, to have consciously chosen the EMS as a soft currency option relative to sterling. As events unfolded, this option was in fact accepted but in the guise of following a strong-currency EMS exchange-rate peg!

**THE IRISH POUND IN THE EMS**

With high hopes of dramatic benefits in terms of reduced inflation and 'convergence' of our economic performance to that of the stronger European countries, we joined the EMS at its formation in March 1979. Within weeks sterling had risen to the point where maintaining the sterling link would have entailed re-valuing the Irish pound against the other EMS currencies. Rather than take this step, we opted to stay within our band against the EMS currencies and towards the end of March 1979 the Irish pound floated against sterling for the first time in over 150 years.

The break with sterling was one of the most important consequences of joining the EMS. Almost half our trade, and probably a larger share of our foreign transactions, now entailed foreign exchange dealings. The transactions costs
involved have been estimated at IR£3.5 million in 1979, equivalent to a current cost of about 2.5 per cent of Gross National Product (GNP). The EMS interest subsidies which figured so prominently in our entry negotiations amounted to IR£44m, IR£45m and IR£46m in 1979, 1980 and 1981 respectively, and represent a 1979 value of less than 2 per cent of GNP. Thus, although at the time the question was not explicitly raised, it seems that the ‘transfer of resources’ which was one of the attractions of joining the System no more than offset the cost of the additional foreign exchange transactions incurred by breaking the sterling link.

There were other gains, however. The break with sterling set Gresham’s Law in motion and the substantial quantity of United Kingdom legal tender that had circulated in Ireland was rapidly replaced by Irish currency. There was, therefore, a seigniorage gain to the Irish authorities. It has also been suggested that the break-up of a currency union increases the demand for money. The combined impact on holdings of Irish currency of these two effects has been put at about IR£34m. The modest gain in terms of interest saved on the national debt as a result of this increase in the demand for Irish currency should be included among the benefits from membership of EMS.

During three years of EMS membership there has been an upsurge in the importance of foreign exchange dealings in the Irish economy, and the speed and efficiency with which this new complication to commercial life has been handled are impressive, although sophistication in foreign currency dealing hardly represents a net gain to the economy!

In the three years since the EMS was formed there have been six exchange-rate re-alignments but none of these involved a decision by the Irish Government to alter the value of the Irish pound against its EMS partners. As a consequence of changes in other countries’ exchange rates, the Irish pound’s central rate has appreciated relative to the Italian lira (+13%), the Danish kroner (+11%) and the Belgian and French francs (+9%), and depreciated relative to the Dutch guilder (−10.2%) and German mark (−10.8%). It has
remained virtually unchanged against a trade-weighted average of the EMS currencies. A very different picture emerges, however, from a broader index of the external value of the currency since 1979. In Fig. 8.1 the trade-weighted exchange-rate index is shown. From this, it is clear that the stability that has been maintained relative to the EMS has not been sufficient to achieve an overall stabilisation of our exchange rate. Since joining the EMS the index shows that the external value of the Irish pound fell by 14 per cent. This is due above all to the appreciation of sterling relative to the ECU during 1980-1, and the continued dominance of the UK in Irish trade. Even more disappointing in view of the expectation that the new exchange-rate policy would ensure stability and reduce uncertainty has been the volatility of the Irish exchange rate since 1979. The combination of re-alignments within the EMS and the instability of sterling relative to the EMS currencies has led to increased rather than diminished volatility in Ireland's foreign exchange rate.

![Graph showing exchange-rate index](image)

Fig. 8.1. Effective exchange-rate index, December 1971 = 100, (Quarterly averages).

The benefits of membership in terms of increased stability and reduced uncertainty would, of course, have been greater if the widely anticipated change in the pattern of our trade
flows had in fact followed our entry into the System. One of the most extraordinary features of our experience since 1978 has been the absolute stability of the share of our EMS partners in our trade: these seven countries accounted for 20.8 per cent of our imports and 30.3 per cent of our exports in 1978, and in 1981 the EMS share was 21.2 per cent of our imports and 29.8 per cent of our exports. We remain in the extra-

Fig. 8.2. German mark/Irish pound exchange rate and ratio of German/Irish price indices (Quarterly averages, 1975–82; first quarter 1979 = 100).
ordinary situation of maintaining an exchange-rate peg with
countries that account for only 25 per cent of our trade. If we
can conclude little else with certainty about the experience of
the past three years, we can affirm that a commitment to fixed
exchange rates between groupings of countries is not suffici-
ent to result in a restructuring of trade flows.

But more important from every point of view is the
equally striking failure of the inflation rates of EMS Member
States to converge. This story is by now familiar and most
strikingly illustrated by the contrast between Irish and
German inflation rates (as measured by consumer price
indices) since 1979 (Fig. 8.2). A similar, if somewhat less
dramatic, picture emerges from a comparison of Gross Dom-
estic Product (GDP) deflators or unit labour costs. A broader
evaluation of these issues shows that the standard deviation of
EMS inflation rates was larger in 1980 and 1981 than in 1976,
1977 or 1978, and will remain very high in 1982.

It has to be said that in reviewing the Irish experience since
the formation of the EMS we tend to take a rather parochial
view of our currency's performance. We speak, for example,
of the performance of the Irish pound against sterling as if this
bilateral market had a significant life of its own when in fact
since March 1979 we have held a quasi-fixed rate against the
EMS currencies while sterling has floated. Consequently, the
trend of the Irish pound against sterling is mainly a reflection
of the trend of sterling against the EMS currencies. Viewed
from this perspective, the really major development since
1979 has been the extraordinary real appreciation of sterling
against all its trading partners, as its exchange rate rose
despite a persistence of relatively high inflation. Between
mid-1978 and mid-1980 the real effective exchange rate of
sterling rose by between one-third and one-half, depending
on whether the nominal rate is deflated by retail prices or unit
labour costs. We broke with sterling in the early stages of this
dramatic rise, and consequently participated along with other
EMS countries, but to a lesser extent, in the real depreciation
against sterling, as may be seen from Fig. 8.3. We have thus
steered a middle course between sterling and the EMS cur-
rencies, experiencing a major real depreciation relative to sterling and an almost equally large real appreciation relative to the EMS currencies. During 1982, however, the decline in the UK inflation rate and the weaker trend in sterling have begun to reverse the real appreciation of sterling and we are now entering a phase in which maintaining our EMS exchange rate entails a loss of competitiveness not merely relative to other members of the EMS but also relative to the UK.

Fig. 8.3. Sterling/Irish pound exchange rate and ratio of UK/Irish price indices (Quarterly averages, 1978–82; first quarter 1979 = 100).

A marked feature of the Irish economy since joining the EMS has been the magnitude of the balance-of-payments deficits that have been incurred. Table 8.1 sets out the balance-of-trade broken down by area for the years 1978–81. The current account balance of payments actually deteriorated much more sharply than is indicated by these figures, due to the rapid increase in net factor payments to the rest of the world (see Table 8.4). It is striking that the depreciation of the Irish pound relative to sterling in 1980–1 led to a marked increase in the value of imports from the UK, suggesting a relatively inelastic demand for imports from
that source. On the other hand, exports to the UK grew only slowly, due no doubt in large part to the severity of the UK recession, but perhaps also to a lack of price sensitivity among some Irish exports. The result was a trebling of our balance-of-trade deficit with the UK between 1978 and 1981, despite the enormous gain in competitiveness relative to sterling. A similar train of events occurred following the decline of the Irish pound relative to the dollar in 1981, the value of imports rose by 57 per cent but exports rose by only 43 per cent, with the result that the trade deficit increased by 72 per cent.

Table 8.1. Balance of trade by area for the period 1978–81 in IR£m

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>EMS</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Imports</td>
<td>771</td>
<td>1040</td>
<td>1088</td>
<td>1393</td>
</tr>
<tr>
<td>Exports</td>
<td>896</td>
<td>1084</td>
<td>1310</td>
<td>1444</td>
</tr>
<tr>
<td>Trade balance</td>
<td>+125</td>
<td>+44</td>
<td>+222</td>
<td>+51</td>
</tr>
<tr>
<td><strong>UK</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Imports</td>
<td>1832</td>
<td>2414</td>
<td>2754</td>
<td>3268</td>
</tr>
<tr>
<td>Exports</td>
<td>1396</td>
<td>1625</td>
<td>1763</td>
<td>1920</td>
</tr>
<tr>
<td>Trade balance</td>
<td>−436</td>
<td>−789</td>
<td>−991</td>
<td>−1348</td>
</tr>
<tr>
<td><strong>USA and Canada</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Imports</td>
<td>344</td>
<td>458</td>
<td>548</td>
<td>863</td>
</tr>
<tr>
<td>Exports</td>
<td>221</td>
<td>207</td>
<td>274</td>
<td>393</td>
</tr>
<tr>
<td>Trade balance</td>
<td>−123</td>
<td>−251</td>
<td>−274</td>
<td>−470</td>
</tr>
<tr>
<td><strong>Rest of World</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Imports</td>
<td>760</td>
<td>916</td>
<td>1029</td>
<td>1051</td>
</tr>
<tr>
<td>Exports</td>
<td>446</td>
<td>580</td>
<td>784</td>
<td>1089</td>
</tr>
<tr>
<td>Trade balance</td>
<td>−314</td>
<td>−336</td>
<td>−245</td>
<td>+38</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Imports</td>
<td>3707</td>
<td>4828</td>
<td>5419</td>
<td>6575</td>
</tr>
<tr>
<td>Exports</td>
<td>2959</td>
<td>3496</td>
<td>4131</td>
<td>4846</td>
</tr>
<tr>
<td>Trade balance</td>
<td>−748</td>
<td>−1332</td>
<td>−1288</td>
<td>−1729</td>
</tr>
</tbody>
</table>

*Source: Trade Statistics of Ireland.*

The current account balance-of-payments deficits in the three years 1979–81 have equalled 10, 8 and 13 per cent of
GNP. While some of these extraordinarily large deficits may be attributable to the loss of competitiveness relative to the EMS countries, public sector deficit spending in excess of revenue that can no longer be financed from the private sector’s financial surplus must bear the brunt of the blame for the sustained excess of national spending over national income.

The clearest evidence of a loss of competitiveness may be seen in the sharp fall in net exports to the EMS countries in 1981. These figures exclude the effect of a deterioration in net foreign exchange earnings from tourism, which has also been adversely affected by the real appreciation of the Irish pound. The slow growth of exports to the EMS countries during 1981 is all the more striking in view of the increased exports attributable to the high level of overseas investment undertaken up to 1982 to avail of the tax advantage of Ireland as a base for exports to Europe. Data are not available for exports from these new industries, but the pattern of industrial growth between early 1980 and early 1982 strongly suggests a marked decline in the older, more labour-intensive Irish industries which are most vulnerable to the adverse developments on the competitiveness front. While industrial production as a whole grew by 2 per cent over this period, production in clothing and footwear, textiles, paper and paper products, metal articles, and several other sectors, declined.

In the longer run, a continued real appreciation of the Irish currency relative to the EMS could act as a deterrent to foreign investment. The Committee on Costs and Competitiveness, established in mid-1981 to recommend rates of increase in domestic costs consistent with maintaining Ireland’s international competitiveness, documented the extent to which Ireland’s advantages as a relatively low cost location in Europe had been eroded in the period since joining the EMS. Developments in labour costs during 1982 intensified this trend, as may be seen from Table 8.2. The transformation of the country to a high wage, high productivity economy has been proceeding at a pace that is not consistent with the ex-
tremely rapid growth of our working age population, and some of the 60 per cent increase in the level of registered unemployment since March 1979 must be due to these factors.

Table 8.2. *Trend in unit wage costs in manufacturing industry, 1978–82*

<table>
<thead>
<tr>
<th></th>
<th>In national currencies</th>
<th></th>
<th>In ECU</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Ireland</td>
<td>EMS excl.</td>
<td>EEC-8</td>
<td>Ireland</td>
<td>EMS excl.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Italy</td>
<td></td>
<td></td>
<td>Italy</td>
</tr>
<tr>
<td>1978</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>1979</td>
<td>113</td>
<td>104</td>
<td>110</td>
<td>113</td>
<td>103</td>
</tr>
<tr>
<td>1980</td>
<td>133</td>
<td>112</td>
<td>129</td>
<td>132</td>
<td>110</td>
</tr>
<tr>
<td>1981*</td>
<td>145</td>
<td>118</td>
<td>140</td>
<td>140</td>
<td>115</td>
</tr>
<tr>
<td>1982*</td>
<td>159</td>
<td>125</td>
<td>148</td>
<td>153</td>
<td>122</td>
</tr>
</tbody>
</table>

*e = estimate; f = forecast.*

*Source:* Based on OECD data. EMS and EEC countries are weighted by importance in Irish trade.

The process by which Ireland has succeeded in holding a more or less fixed exchange rate within the EMS despite the massive balance-of-payments deficit is set out in Table 8.3. This summarises the main public sector financial aggregates for the years 1977–82. The extraordinarily high level of public sector borrowing in recent years and the dependence on foreign sources of finance to sustain this borrowing are clear from this table. In 1981 the Government financed more than four-fifths of its borrowing through monetary channels, mainly by borrowing abroad. The repercussions on the country's net indebtedness are shown in the last column of the table. Inevitably the rise in indebtedness to the rest of the world has meant a steady growth of foreign interest payments. The trend in factor payments to and from the rest of the world are shown as a percentage of GNP in Table 8.4. The
sharp increase in interest payments on foreign debt in 1982 will pre-empt all the forecast growth in GDP and lead to a slight decline in GNP. Projection of the budgetary situation in 1983 suggests that it will be extremely difficult to prevent a further rise in the ratio of foreign interest payments to the GNP.

Table 8.3. Public sector financial aggregates, 1978–82 as a percentage of GNP

<table>
<thead>
<tr>
<th>Year</th>
<th>Exchequer borrowing requirement</th>
<th>Public sector borrowing requirement</th>
<th>Government</th>
<th>Total public sector</th>
<th>Gross</th>
<th>Net$</th>
</tr>
</thead>
<tbody>
<tr>
<td>1977</td>
<td>10.0</td>
<td>12.9</td>
<td>0</td>
<td>0.2</td>
<td>22.0</td>
<td>5.0</td>
</tr>
<tr>
<td>1978</td>
<td>12.6</td>
<td>15.3</td>
<td>0.1</td>
<td>1.5</td>
<td>19.6</td>
<td>2.2</td>
</tr>
<tr>
<td>1979</td>
<td>13.6</td>
<td>16.6</td>
<td>6.7</td>
<td>7.3</td>
<td>13.2</td>
<td>14.7</td>
</tr>
<tr>
<td>1980</td>
<td>14.1</td>
<td>18.0</td>
<td>7.7</td>
<td>11.7</td>
<td>15.6</td>
<td>20.0</td>
</tr>
<tr>
<td>1981</td>
<td>17.0</td>
<td>21.8</td>
<td>15.0</td>
<td>17.6</td>
<td>14.5</td>
<td>33.7</td>
</tr>
<tr>
<td>1982f</td>
<td>15.0</td>
<td>20.0</td>
<td>10.9</td>
<td>14.3</td>
<td>15.5</td>
<td>39.1</td>
</tr>
</tbody>
</table>

Notes: a Net = gross reserves less public sector foreign debt.
         $f = forecast
Source: Central Bank of Ireland, Annual Reports

The non-fulfilment of the widely-held expectation that inflation rates would converge within the EMS is more comprehensible in the light of the developments in relation to the public finances since 1979. No one could have anticipated the scale of external borrowing that has taken place in the last three years. This borrowing has been facilitated by membership of the EMS, and in its turn it has facilitated the maintenance of our exchange rate at its original EMS parity by financing the massive balance-of-payments deficits incurred since 1979. Another strand in the explanation of our experience since joining the EMS is a possible shift in the ratio of non-tradeable goods to tradeable goods prices. Although
Table 8.4. Net factor income from abroad, 1976–82 as a percentage of GNP

<table>
<thead>
<tr>
<th>Year</th>
<th>Government interest payments</th>
<th>Net non-government factor payments</th>
<th>Net factor income</th>
</tr>
</thead>
<tbody>
<tr>
<td>1976</td>
<td>-1.4</td>
<td>+1.4</td>
<td>0</td>
</tr>
<tr>
<td>1977</td>
<td>-1.8</td>
<td>+1.2</td>
<td>-0.6</td>
</tr>
<tr>
<td>1978</td>
<td>-2.0</td>
<td>+1.0</td>
<td>-1.0</td>
</tr>
<tr>
<td>1979</td>
<td>-2.1</td>
<td>+1.2</td>
<td>-0.9</td>
</tr>
<tr>
<td>1980</td>
<td>-2.6</td>
<td>+1.2</td>
<td>-1.4</td>
</tr>
<tr>
<td>1981f</td>
<td>-3.1</td>
<td>+1.0</td>
<td>-2.1</td>
</tr>
<tr>
<td>1982f</td>
<td>-4.8</td>
<td>+0.9</td>
<td>-3.9</td>
</tr>
</tbody>
</table>

e = estimate; f = forecast

Source: The Economic and Social Research Institute, Quarterly Economic Commentary, May 1982, Table 12.

Conclusive data are not available, it is generally believed that the rate of pay in the public sector has accelerated more rapidly than that in the private sector since 1979. In addition, the growth of public sector employment has aggravated the growth of the public sector pay bill and of public sector spending in general. Taxation has been steadily increased although, as we have seen, not rapidly enough to match the upsurge in expenditure. The total tax burden has risen from 33 per cent of GNP in 1979 to 42 per cent in 1982. Indirect taxes have risen from 15 per cent of GNP to 20 per cent in the same period. Undoubtedly much of the excess of Ireland's inflation over that experienced elsewhere in Europe in recent years can be attributed to the direct and indirect repercussions of this increased taxation.

Conclusion

In reviewing Ireland's experiences since joining the EMS it is inevitable that broad issues concerning the conduct of economic policy are raised. The technical achievement of maintaining our exchange rate within the System is about the
only aspect of membership that has operated according to our aspirations in 1979. The disappointments and drawbacks associated with our experience within the System can be summarised under the following headings:

1 The continued absence of the UK from the exchange rate arrangements of the EMS. This has meant that maintaining our exchange rate relative to the EMS has not resulted in stability in a broadly defined index of the external value of our currency.

2 The frequent re-alignments of the System have in fact allowed the high and low inflation countries to adjust their exchange rates to their inflation rates, rather than vice versa. Ireland is unique among the high inflation countries in not adopting this pragmatic approach and is, as a consequence, suffering a marked loss of competitiveness relative to other EMS countries. Up to 1982, the rise of sterling (and the dollar) relative to the EMS offset this trend and led to a slight gain in our trade-weighted index of competitiveness, but during 1982, the stability of sterling relative to the EMS implies that the exchange-rate peg with the EMS entails a loss of competitiveness in all our markets.

3 The failure of the EMS to develop into the hoped-for monetary union, with a convergence of economic performance between members, has meant that the long-term benefits from membership which weighed heavily in our decision to join have not materialised.

4 Maintaining a quasi-fixed exchange rate despite extremely high inflation has been facilitated by massive foreign borrowing, which has replenished our foreign exchange reserves at the cost of a steady rise in external indebtedness and consequently in the ratio of foreign interest payments to GNP.

5 It could be claimed that membership of the EMS, far from forcing the adoption of appropriate macro-economic policies, actually encouraged the inappropriate fiscal and incomes policies that have been pursued in recent years by raising expectations of higher living standards as a result of
the widely publicised ‘transfer of resources’ that formed part of our terms of entry and the improved access to lines of foreign credit that membership of the System provides.

Two concluding comments seem warranted. First, the EMS as it has evolved since 1979 cannot be said to provide a satisfactory solution to Ireland’s need to define an appropriate exchange-rate target. As long as sterling floats against the EMS currencies, we may experience major uncertainty and instability even if we successfully adhere to an EMS exchange-rate target.

Secondly, the attempt to impose the discipline of low inflation, monetary, fiscal, and incomes policies on the economy through a strategy of pegging the exchange rate within the EMS has all the characteristics of putting the cart before the horse! Lasting exchange rate stability between members of the EMS presupposes a willingness on the part of national monetary authorities to adopt rates of monetary expansion in line with that adopted by the hegemonial country, which we may assume is Germany. As Korteweg remarked early in the life of the EMS ‘it is highly unlikely that those countries (whose monetary policies have been most expansionary in the past) would indeed adjust their monetary policies as required in the short-run, given the negative effects on employment and economic activity transitorily produced by such adjustments’.11 In fact, this prediction proved incorrect because the author included the UK among those countries whose monetary policies he believed would remain expansionary. (The change in the UK’s policy was not of course attributable to the influence of the EMS!) But in the Irish case, entry into the EMS had no discernible influence on the public sector’s contribution to monetary expansion, as was shown in Table 8.3. The need to implement domestic policies consistent with reducing inflation to the target rate must henceforth receive priority.

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REFERENCES


