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Irish Exchange Rate Policy in the Aftermath of the Currency Crisis¹

By Brendan Walsh*

[Sterling's departure from the exchange rate mechanism (ERM) in September 1992 precipitated a crisis for Irish exchange rate policy that was resolved, for the time being at least, by the decision to devalue at the end of January 1993. During the intervening 4 1/2 months, the economy laboured under the burdens of penal interest rates and a misaligned sterling exchange rate. The country's foreign exchange reserves were drained, to be rebuilt later at a substantial cost to the taxpayer.² With the virtual collapse of the ERM at the end of July, Irish exchange rate policy entered a new phase.

This paper reviews the lessons to be learned from the collapse of the ERM and the options facing us in the new international financial environment].

The Crisis in the ERM

Between 1987 and the middle of 1992, the European Monetary System (EMS) appeared to be functioning with enhanced effectiveness. In contrast with the regular realignments that had marked the early years of its existence, there were no significant changes in central rates over this period. The Spanish peseta joined the ERM in 1989, the Italian lira moved to the narrow band in January 1990. The long-awaited entry of sterling occurred in October 1990 and the Portuguese escudo joined in 1992. Several non-EC countries - Austria, Finland, Norway and Sweden - began to shadow the DM. The disparities in inflation and interest rates between European countries diminished and most countries (Italy was a notable exception) made progress in bringing the large fiscal deficits that had emerged during the mid-1980s under control. The signing of the Maastricht Treaty in January 1992 seemed to set the stage for the transition to full Economic and Monetary Union (EMU) among a majority of the member states before the end of the century.

The solidification of the ERM lulled markets into a belief that exchange rates were likely to remain fixed or undergo at most one final realignment. Large amounts of money flowed into the European currencies where interest rates were high relative to those obtainable in DM assets. In what

1. This draft was completed August 20th, 1993 and reflects developments up to that date.
2. There is no agreed way of calculating how much the delay in devaluing cost the country. In its Summer 1993 Bulletin, the Central Bank estimates that the crisis cost the bank between £25 and £35 million. An alternative estimate places the overall cost to the bank and the National Treasury Management Agency in the hundreds of millions (Honohan, 1993).

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came to be known as the "convergence play" (Goldstein et al., 1993) fund managers bought securities in peripheral ERM currencies in the belief that the high yields on offer more than compensated for the currency exposure involved. As part of this trend, German investors enjoyed relatively high yields from Irish government securities over the period 1987-91 without suffering losses on the exchange rate. As a consequence, however, the conditions had been created for massive outflows of funds from the weaker ERM currencies as soon as faith in the continued stability of the system began to ebb.

The advantages to Ireland from participation in the ERM seemed increasingly clear over this period. Whereas the DM/Irish pound exchange rate had declined by a cumulative 30 per cent between 1979 and August 1986, it was stable at close to £1=DM2.65 from then until mid-1992. Helped by significant sales of Irish bonds to foreigners, the differential between Irish and German interest rates fell steadily. It was less than 50 basis points in mid-1992. Irish interest rates did not rise in sympathy with the high short-term rates imposed in Britain to dampen the Lawson boom. Due to the sizeable primary³ budget surplus that emerged after 1986, the Irish debt/GDP ratio fell rapidly. Allowing for some flexibility in the interpretation of the Maastricht criteria, we looked set to participate in the proposed EMU from its commencement.

The crisis in the ERM developed with surprising rapidity during the third quarter of 1992. With hindsight the factors that precipitated it can be readily identified. Pre-eminent among these was the problem of adjusting to the shock of German Economic and Monetary Union after 1990. This called for a significant real appreciation of the DM to allow Germany to shift more of its resources to domestic uses. The German authorities appear to have sought a realignment of the ERM at which the DM would have been revalued early in the 1990s, but this was not conceded due to the French attachment to the *franc fort* and the British reluctance to change sterling's recently-espoused central rate of £1=DM2.95. The refusal to permit a revaluation of the DM was to prove fateful because it could be used subsequently by the German authorities as a reason for relieving them of the obligation of unlimited intervention to support currencies that came under pressure in the ERM.

In the absence of a realignment, a real appreciation of the DM could only be achieved by a reduction in the rate of inflation in the other ERM countries relative to that in Germany. With the Bundesbank determined to

3. That is, net of interest payments.

counter the inflationary effects of a slack fiscal policy, this required other countries to match high German interest rates in what became a competitive disinflation. This intensified the rise in unemployment that was occurring due to the global recession. Eventually these policies proved politically unacceptable. The derailment of the process of ratifying the Maastricht Treaty that started with the Danish "No" vote in June 1992 sent a clear message about the need to temper enthusiasm for an "ever closer union" in Europe with concern for national political and economic priorities. These developments increased the likelihood that speculators could successfully identify and attack currencies whose long-term commitment to the ERM was not credible even though their traditional financial fundamentals were relatively sound. The dismantling of the remnants of exchange controls with the completion of the internal market ensured that once confidence in a currency was lost, the flows across the foreign exchanges would be massive and could not be stopped by central banks.

Following the Danish "No" vote, strains rapidly surfaced in the ERM. The floating of the Finnish markkaa (which had been shadowing the DM) in September 1992 signalled the start of a full-scale crisis, with sterling and the lira centre stage. Initially, the traditional instruments of higher short-term interest rates and central banks' intervention were used to defend the existing parities. However, the British authorities in particular were not prepared to tolerate high short-term interest rates for any length of time for fear of plunging the economy back into recession, while the Bundesbank's willingness to intervene to support currencies such as the lira was limited by fears that it could not sterilise intervention on the scale necessary to beat off the speculators, which would threaten its control over the German money supply.

The attacks on sterling and the lira led to their rapid exit from the ERM in September, followed by significant depreciations. This was followed by a similar sequence of events in November centring on the Swedish and Norwegian crowns, which had been shadowing the DM, and the Spanish peseta and Portuguese escudo, which had recently joined the ERM. By the end of 1992 little remained of the apparently solid ERM edifice that had existed at the start of the year. The formal structure survived, however, until renewed tensions, centring on the French franc, led to widening of the bands to 15 per cent at the end of July. Once the narrow band ERM was abolished, tensions on European currency markets subsided. Rather like birds that did not fly to freedom when the cage door was opened, the main European currencies fluctuated relatively little immediately after they were to all extents and purposes floated. The outlook now is that we will learn

the ERM is far from indispensable and recovery in Europe may start somewhat sooner because it has been dismantled.

The Dilemma for the Irish Authorities

The departure of sterling from the ERM in September 1992 once again posed the dilemma for the Irish authorities of how to stabilise the pound in the ERM while minimising the damage that an unwarranted appreciation of the Irish pound relative to sterling would inflict on the economy. On two previous occasions - March 1983 and August 1986 - the Irish pound had been devalued in response to a sudden weakness of sterling. *Communitaire* considerations apart, the principal economic argument against devaluing again was that to do so would undermine the credibility that had been gained by our equivalent of a *franc fort* policy, pursued since 1986. It was feared that to devalue again would be tantamount to declaring a sterling exchange rate target, which would undermine foreign investors' confidence in our currency and impose a risk premium on Irish interest rates for the foreseeable future. The soundness of our financial fundamentals (the low fiscal deficit and rate of inflation and the sizeable current account surplus) showed that we did not have to devalue simply because sterling had been forced out of the ERM by the mismanagement of its economy since the late 1980s. Our diminished dependence on the British economy, notably the falling proportion of exports destined for Britain, would allow the economy to adjust to the sudden appreciation relative to sterling without undue hardship.

On the other hand, as the crisis evolved it became clear that employment in Irish industry and services remained more sensitive to the level of the sterling exchange rate than the trade statistics indicated. This is because labour-intensive and price-sensitive Irish firms tend to face direct competition from their British counterparts, whereas exports from capital intensive firms in sectors that are not price sensitive tend to dominate our trade with continental Europe. Baker (1993) estimates that perhaps as many as 70,000 out of a total of 190,000 manufacturing jobs are exposed to competition from Britain. To this total should be added many jobs in tourism and other traded services that are also very sensitive to British competition. An economy with over 18 per cent of its labour force unemployed cannot afford to treat these jobs as expendable. It became increasingly clear that failure to correct the misalignment against sterling would prove extremely damaging to the economy.

The behaviour of Irish interest rates during the crisis prompted a critical examination of the relationship between Irish and German rates. It was

shown that the convergence of Irish on German interest rates since we joined the EMS in 1979 was strongly conditioned by the level of the Irish pound/DM exchange rate.⁴ Periods of sterling weakness relative to the DM consistently led to a rise in Irish interest rates relative to those in Germany. The interpretation of this is straight forward: when the Irish pound was strong relative to sterling, there was an increase in the perceived risk that it would be devalued and investors extracted a premium for holding Irish securities to compensate for this risk. Markets had not been persuaded to change this view by the stability of the Irish pound relative to the DM between 1986 and 1992, and it was unlikely that they would do so in the increased uncertainty prevailing after the September crisis. Furthermore, the scope for using increases in short-term wholesale interest rates to defend the pound was limited by the speed with which these were reflected in retail, especially mortgage, rates.

The conflicting views on Irish exchange rate policy that emerged during the crisis crystallized in predictions of how a devaluation would affect interest rates. Those who favoured enduring the pain of the high exchange rate relative to sterling argued that interest rates would not fall if the pound were devalued. On the contrary, it was asserted a lasting penalty would have to be paid in terms of high short-term interest rates if we abandoned our ERM commitment at this stage. This was the essence of the government's defence of its non-devaluation policy. In a statement issued on January 26th, just days before the devaluation, it was claimed that

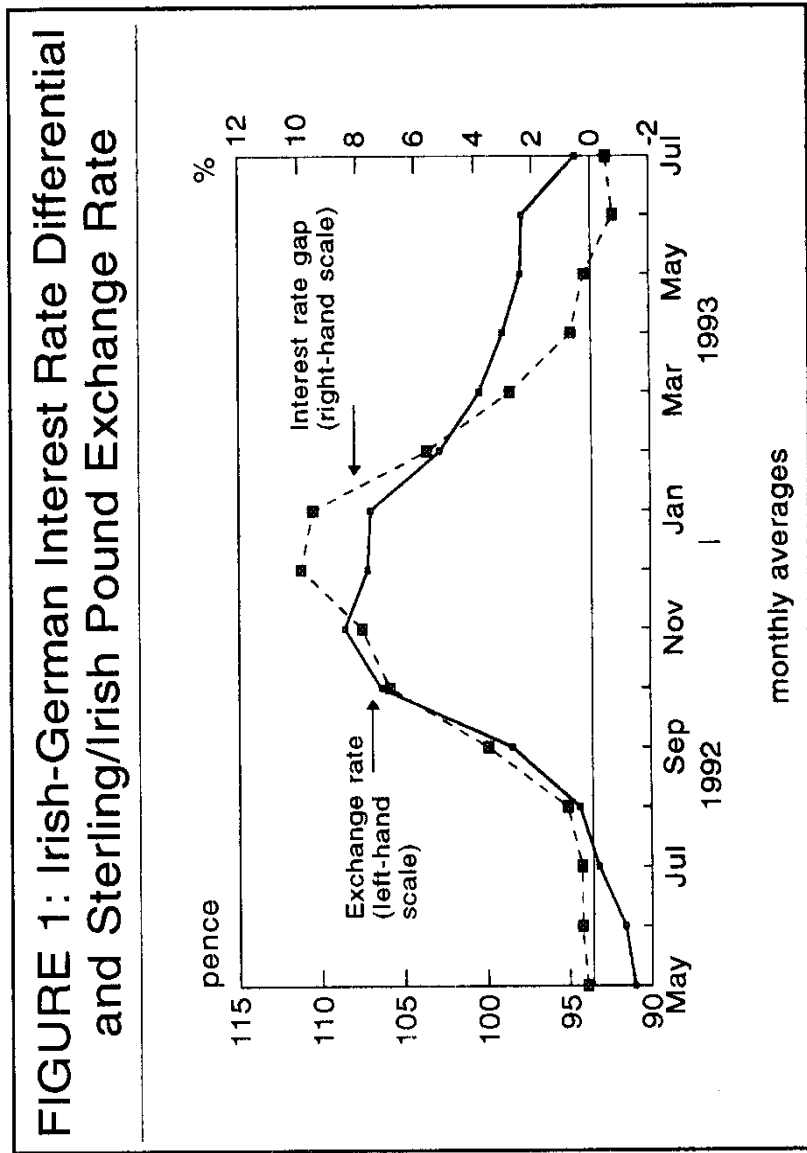
...to devalue now would be to throw away the hard work since 1987 and reduce the future benefits in return for short-run gain. . . There is no guarantee that devaluation would reduce interest rates, which are a burden on the economy. . . Inflation will pick up quickly as the price reductions arising from the fall in sterling are reversed..

On the other hand, those who favoured a devaluation argued that restoring a competitive exchange rate relative to sterling would result in a rapid fall in interest rates. They did not believe that unwinding an unwarranted appreciation would be inflationary.

Rarely in economics do we have as clear-cut an opportunity to evaluate the claims of opposing theories as that provided by the devaluation of January 1993 and its aftermath. As may be seen from Figure 1 (page 8) the prediction that interest rates would remain high after the devaluation was wrong. Once the decline in sterling relative to the DM was halted towards the end of February, Irish interest rates declined rapidly. By the end of April the German-Irish differential was smaller than it was before the crisis

4. In findings circulated independently in December 1992/January 1993 by Jim O'Leary of Davy Stockbrokers, Patrick Honohan and Charles Conroy of the Economic and Social Research Institute, and the present author: see Walsh (1993).

FIGURE 1



broke and by the summer, when the strength of sterling pushed the Irish pound back to its mid-1992 level, Irish interest rates had fallen below German rates. The close link between Irish short-term interest rates and the sterling/Irish pound exchange rate is evident from the behaviour of these variables during the crisis.

The prediction that Irish inflation would be rekindled by the devaluation was also wrong. Even when the influence of lower interest rates on the consumer price index is removed, inflation has remained very subdued. Finally, the belief that any gain to Britain from leaving the ERM would quickly be eroded by inflation also proved wrong.

The rationale proffered for resisting a devaluation of the Irish pound into 1993 was therefore shown to be faulty by the outturn. However, the Central Bank, writing in mid-April, continued to maintain that "it should not be surprising if, over the long term, Irish interest rates carry some small additional risk premium following the realignment" and that there would be "an acceleration in the rate of inflation for the remainder of the year".⁵

Not surprisingly, in view of the fervour with which alternative positions were defended during the crisis, interpretations of the favourable *dénouement* differ. In mid-1993 there was still some regret in official circles that the resistance to the devaluation had not been maintained. The Central Bank claims that "the competitive shock [caused by the appreciation relative to sterling] was less significant than commonly perceived and would have tended to diminish over time".⁶ This claim plays down the importance of competition with Britain to the Irish economy and places a faith in the ability of the Irish economy to adjust domestic costs in a manner which was not evident during the crisis. In fact during the crisis there was strong resistance to moderating wage increases in response to lower-than-expected inflation. The Central Bank has also taken the view that:

the strong defence of the currency . . . underlined Ireland's continuing commitment to the ERM and market perception of this has undoubtedly contributed to the rapid reduction in interest rates since end-January (*Annual Report, 1992, p.9*).

It is too early to arrive at a definitive judgement as to whether any credence can be attached to the claim that the "prolonged and steadfast" defence of the old ERM parity contributed to the favourable trend in Irish interest rates since January, but it is clear that the restoration of the Irish pound/sterling exchange rate to a sustainable level was the key development. This is also the key factor that has averted a marked depreciation of the Irish pound relative to the DM since the ERM bands were widened at the end of July. Official statements have yet to acknowledge this.

5. Quarterly Bulletin, Summer 1993, p.10 and p.21.

6. Quarterly Bulletin, Summer 1993, p.9.

The Lessons to be Learned

It is important not to draw the wrong lessons from the recent currency crisis. It is tempting to try to identify scapegoats in the form of speculators and to reimpose exchange controls or other administrative measures to try to avert a recurrence of the problem. In reality it is impossible to define what is meant by "speculation" or to distinguish between benign and damaging currency transactions. The range of private market participants involved in contemporary foreign exchange markets is very wide - including banks, fund managers and companies, as well as individuals - and the funds at their disposal are vast. Administrative controls on capital flows would run counter to the goal of European economic integration. Equally important, they would be ineffective over the longer run and would undermine foreign investors' confidence in the liquidity of Irish assets. This would impose a premium on Irish interest rates and defeat one of the goals of defending the exchange rate in the first place. Proposals to tax profits gained from taking open positions in a currency that eventually devalues, or some variant of the so-called "Tobin tax", are widely viewed as impractical.

Another issue raised by the crisis is the manner in which the use of high short-term interest rates to defend the currency inflicted damage on the domestic economy. In as much as the Central Bank is correct to refer to a "collapse of the national consensus to defend the currency" it occurred because of the political reverberations of the rise in retail interest rates, especially mortgage rates, caused by the penal interest rates imposed to try to deter speculators from selling the Irish pound short. The Central Bank tried to avert this problem by providing support to the banks for "normal" purposes at lower rates when overnight rates were raised to astronomical levels. However, a strategy of segmenting money markets in this manner distorts the allocation of credit and can only be sustained for short periods. In the longer run, the retail market could have been more effectively insulated from the crisis measures if more household and corporate debt were on a long-term or fixed interest basis, but the switch to this type of arrangement takes time.

Developments since September 1992 have radically altered the context of Irish exchange rate policy. The abatement of tension and relatively smooth adjustment of markets since the collapse of the old-style ERM have shown that the claims made by its devotees were greatly exaggerated. None the less, the potential gains from a single European currency remain significant and worth pursuing. There is a general consensus that in the long run Ireland should be prepared to surrender an independent exchange rate in return for the benefits of participation in an EMU, especially one

that faces up to the problem of assisting its regions to adjust to asymmetric, or country-specific, shocks. However, it is not now clear how long it will take for such an option to evolve in Europe. The prospects for the Irish pound's participation in an eventual EMU remain very dependent on the sterling's relationship with this union. Thus the attempt to uncouple our currency from sterling, pursued sporadically over the period 1979-92, achieved relatively little.

It does not make sense now to continue the Irish version of the *franc fort* policy and keep the pound in a narrow target zone round the DM. If the currency comes under renewed pressure, which could happen for a variety of reasons but most probably because of a renewed weakness of sterling, the level of support from European central banks will be much less than it was between last September and January, and that support proved inadequate to prevent markets having their way in the end. While a freely floating Irish pound would be one of the smallest independent currencies in the world, evidence is beginning to accumulate that even for small economies that are much weaker than ours the benefits of a floating exchange rate can outweigh the disadvantages (Quirk and Cortés-Douglas, 1993). Exchange rate volatility is less damaging than the uncertainty generated when a currency is pegged at a level that markets do not believe is sustainable. Moreover, provided sensible domestic policies are pursued, in the long run a floating Irish pound could be a strong currency.

The authorities should learn from the recent crisis that private market players, whose resources now dwarf those of central banks, form views as to what is a sustainable level of a currency and are in a position to force an adjustment and make their prophecies self-fulfilling. Little is achieved when the authorities pit their view of what is sustainable against that of the market and engage in a trial of strength. Speculators, however defined, base their views of a currency's value on the available information and a model of how markets operate, not on doctrine or notions of national glory, which repeatedly have clouded the vision of politicians and central bankers.

The alternative exchange rate policies open to us at this juncture differ more in degree than in kind. The choice of one over another is unlikely to have a major effect on key variables such as long-term interest rates or central issues such as the trade-off between unemployment and inflation. However, some conclusions should be drawn from the currency crisis about the interpretation of economic "fundamentals" and their bearing on exchange rate policy. The indicators that were widely cited during the crisis as evidence of the ability of the Irish economy to withstand devaluation -

interest and inflation rates, the current account of the balance of payments, the fiscal balance - are important. The stance of monetary and fiscal policy should inspire confidence in the value of the Irish currency. We must take the opportunity of the exceptional inflow of funds under the Community Support Framework to maintain a low fiscal deficit and a current account surplus. But the performance of the real economy, and in particular the level and trend of employment and unemployment, must be brought explicitly into the evaluation of the economy's performance and of the appropriateness of any particular level of the exchange rate. The view that movements in the nominal exchange rate have no lasting implications for the level of output and employment, which is implicit in many pronouncements on Irish economic policy, has been shown repeatedly to be a gross over-simplification and should not be used as the basis of policy. Instead, it should be accepted that an over-valued currency is totally inappropriate in an economy with almost one in five of the labour force out of work. In these circumstances, maintaining competitiveness must receive the highest priority and exchange rate policy should reflect this.

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