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# CENTRE FOR ECONOMIC RESEARCH

**The Irish Pound and the ERM:  
Lessons from the September Crisis and its Aftermath**

by

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**Abstract:** This paper examines the effects of the EMS crisis of September 1992 on the Irish pound. A review of the Irish experience in the exchange rate mechanism is presented, including an assessment of the extent to which the hard-currency peg pursued after the devaluation of 1986 could be said to have gained credibility for the Irish pound. The behaviour of Irish interest rates in the aftermath of sterling's departure from the ERM and the reasons for the protracted attempt to avert a devaluation of the Irish pound are studied. Some implications for progress towards a monetary union in Europe are drawn.

Prepared for the Academic Working Group of the Association for the Monetary Union of Europe. Helpful comments on an earlier draft were received from Anthony Leddin and Stefan Collingon. Responsibility for the views expressed is solely the author's.

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## Historical Background<sup>1</sup>.

The financial provisions of the Act of Union between Great Britain and Ireland, which came into force in 1826, suppressed the Irish currency and replaced it with sterling. Following the foundation of a Free State in 1922 a separate Irish currency was introduced in 1927; it was fully backed by sterling reserves and freely convertible at a 1:1 no-margins exchange rate. An Irish Central Bank was not established until 1942, and did not acquire a full range of powers until the legislation of 1971, which among other provisions made it possible to change the exchange rate by government order.

The costs and benefits for the newly-independent state of the sterling link were debated in the 1920s and 1930s, when there was some support for asserting financial independence by breaking the sterling link. More cautious views prevailed, however. The issue received renewed attention when sterling was devalued in 1949 and 1967, but despite some unease at having to share sterling's decline against the dollar, no change was made in the exchange rate regime.

Ireland's adherence to the European (Economic) Community in 1973 and the instability of foreign exchanges caused by the return to generalised floating led to renewed interest in alternative exchange rate arrangements. The merits of the sterling link were once again debated against the backdrop of Britain's failure to remain in the Snake. However, no realistic alternative to the sterling link was available until plans to create a "zone of monetary stability" in Europe began to crystallise in the second half of the 1970s. As the prospect of forming the European Monetary System (EMS) became imminent, the Irish authorities were eager to participate in the exchange rate mechanism (ERM) as long as it seemed that the UK would also join. If Britain participated, over two-thirds of Ireland's external trade would be with countries in the ERM and it would have represented simply an enlargement of the well-established sterling link. However, during the 1970s Ireland had experienced a significant real depreciation against the DM through the sterling link, and it was implied that participation in the ERM, with Britain as a member, would have halted this.

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<sup>1</sup>This summary draws on Leddin and Walsh, 1992, Chapters 11 and 13.

When it became evident that Britain would not participate in ERM, the Irish authorities were faced with an issue that has been at the centre of our exchange rate policy ever since: would the benefits of participating in the ERM outweigh the costs of breaking the exchange rate link with our main trading partner? The arguments in favour of Ireland joining even at the cost of breaking the sterling link were rehearsed. These may be summarised as follows:

\* The belief that the sterling link condemned Ireland to importing high British inflation and interest rates, and to seeing its currency continue to depreciate relative to the continental currencies, whereas a switch to a hard-currency, DM peg would result in lower inflation and interest rates and a stable currency.

\* The fact that over the years Irish trade had become increasingly diversified geographically and less dependent on the UK. This increased the benefits from exchange rate stability with Continental Europe relative to the costs of introducing instability *vis à vis* sterling.

\* The desire to take a *communautaire* stance in relation to a major EC initiative.

\* The belief that the transfer of resources offered by our EC partners would be adequate to assist the country to adjust to any deflationary pressures that the new exchange rate regime might entail.

The risks of entry into the ERM were acknowledged. The White Paper published in December 1978 stated that

In the initial period of operation of the EMS, the parity of our currency might be higher than it would otherwise be. This could impose severe strain on Ireland's competitiveness, leading to a possible loss of output and employment. *Due to higher parity of our currency*

However, the belief was expressed by the Central Bank that "given sensible domestic policies, the adjustment problems will be manageable and of relatively short duration" (*Annual Report, 1979*).

\* The debate over Ireland's decision to participate in the ERM in the absence of sterling was not couched in terms of the Optimum Currency Area literature. It was obvious from the high degree of factor mobility between Ireland<sup>\*</sup> Britain, and the high degree of dependence of our product markets on the British market, that Ireland and

Britain fulfilled the conditions for a single currency area, whereas this was far from the being case with respect to Ireland and continental Europe. In the light of later developments it is clear that more attention should have been paid to the ability of the Irish economy to adjust to shocks transmitted from the UK economy without recourse to a change in the exchange rate. \*

The sharp appreciation of sterling during the first two weeks of the operation of the EMS forced the Irish authorities to choose almost immediately between the commitment to the narrow band of the ERM and retaining the sterling link. It was decided to hold the Irish pound in its permissible range in the narrow band and, at the end of March 1979, it diverged from sterling for the first time since the early nineteenth century. Paradoxically, the launch of the ERM, designed to bring monetary stability to Europe, resulted in the immediate disintegration of the oldest monetary union in Europe, while Ireland's eagerness to participate in the new institution forced it to float its exchange rate with its main trading partner.

### **The Experience in the ERM.**

In reviewing Ireland's experience in the ERM it is logical to distinguish between the early years, when realignments were frequent and there was little evidence of financial convergence, and the second half of the 1980s, which was a period of exchange rate stability and convergence of inflation and interest rates.

#### **The First Phase: 1979-86.**

During these years frequent ERM realignments and an initial sharp appreciation of sterling relative to the narrow-band currencies undermined the discipline that had been anticipated when Ireland decided to join. The outcome was far less favourable than had been anticipated.

#### Nominal exchange rates

During the first seven years of the existence of the EMS the Irish pound was devalued only once, by 3.5 per cent in March 1983, and its central ECU rate fell by only

7.6 per cent. However, by "going through the middle" at most of the realignments it depreciated markedly relative to the German mark and Dutch guilder, while appreciating relative to the French and Belgian francs, the Danish krone and the Italian lira. As may be seen from **Figure 1**, its value in terms of the DM fell by almost one third. Thus the Irish authorities' declared intention of maintaining a stable exchange rate with the hard-currency core of the ERM was not achieved.

Of even greater significance in the light of subsequent events was the depreciation of the Irish pound relative to sterling over these years. Through the entire period from March 1979 to September 1993 the Stg£/Ir£ rate remained below the old 1:1 parity (see **Figure 2**). Contrary to expectations, membership of the ERM proved to be a soft option *vis à vis* sterling and spared Ireland the sudden sharp real appreciation that would have occurred had the sterling link been maintained. When the Irish pound appreciated sharply relative to sterling early in 1983, a decision was taken to devalue in the ERM. The new parity for the Irish pound proved sustainable over the next three years, but during 1986, as sterling and the dollar fell sharply on the foreign exchanges, the competitive pressures on the Irish pound mounted. By July the Irish pound's trade-weighted exchange rate index was 11 per cent higher than it had been a year previously. The pound was devalued unilaterally by 8 per cent at the beginning of August.<sup>2</sup>

It is clear, therefore, that over the first seven years of membership of the ERM there was no serious attempt to adhere to a nominal exchange rate peg, as the Irish pound was allowed to drift down against the DM at ERM realignments and devalued whenever its initial depreciation against sterling was threatened by the latter's subsequent weakness.

#### Inflation and real exchange rates

Hopes of a quick disinflation following entry to the ERM were not realised. In fact Ireland's wage and price inflation accelerated in 1980 and remained over 10 per cent for the next two years. The fall in the nominal DM/Irish pound exchange rate was not sufficient to offset the persistence of excess inflation in Ireland, and there was a marked

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<sup>2</sup>This was the largest unilateral devaluation in the history of the ERM, but it was surpassed by Belgium's 8.5 per cent devaluation in 1982, when Denmark also devalued.

rise in Ireland's real exchange rate relative to the DM (Figure 3) and other narrow-band currencies. However, the sharp appreciation of sterling in the early 1980s, combined with the persistence of similar rates of inflation in Ireland and British, resulted in a significant real depreciation of the Irish pound relative to sterling. This gain was, however, quickly eroded as sterling weakened towards the end of 1982, and inflation in Britain fell while it remained high in Ireland (Figure 4).

The devaluations of 1983 and 1986 checked further real appreciation relative to sterling, but did not restore the favourable real exchange rate that had prevailed in the early 1980s. Thus, despite the decline in the nominal exchange rate, Ireland experienced a significant overall real appreciation after 1981. This consequence of membership of the ERM contrasted with the experience of the 1970s, when the sterling link and a marked real depreciation relative to other currencies led to a modest overall gain in competitiveness.

#### The real economy.

The decision to join the ERM did not alter either the wage setting process or the stance of fiscal and monetary policy in Ireland. During the initial years of membership the economy was clearly on an unsustainable trajectory. As a consequence of having tried to avert the impact of the global recession through expansionary domestic policies, the fiscal deficit and the public debt/GNP ratio rose rapidly. The process of fiscal adjustment was begun in 1982, when the primary (non-interest) deficit peaked at 8.9 per cent of GNP; by 1987 it had been eliminated. The debt/GNP ratio peaked at 129 per cent in 1985, and declined slowly thereafter. However, unemployment, which had risen from 7.1 per cent in 1979 to 11.4 per cent in 1982 reached 17.6 per cent of the labour force before it peaked in 1987.

The rise in unemployment has been attributed the several factors, including

the fiscal correction initiated in 1982, which initially concentrated on tax increases rather than expenditure cuts

the increase in the supply of labour in Ireland due to the fall in net external migration as UK unemployment rose,



the impact of the global recession on Irish net exports,

the rise in the real exchange rate after 1981

the rise in the real interest rate.

the rigidity of the Irish labour market, which was aggravated by the growth of the tax wedge. Labour costs continued to rise even though real take-home pay declined.

It is not possible, on the basis of available research, to allocate the overall rise in unemployment between these factors. However, the Dornbusch (1989) version of the events attributes too much weight to the effects of high real interest rates caused by adherence to the ERM and the need to defend an overvalued currency. While real interest rates rose from -8 per cent to +8 per cent between 1981 and 1986, the evidence, which is discussed in detail below, suggests that despite the persistence of relatively high inflation in Ireland, the differential between Irish and German nominal interest rates narrowed steadily after 1979 *provided the sterling/Irish pound exchange rate was at a sustainable level.*

### **The Second Phase: 1987-92**

These years were marked by increasing stability in the ERM. There were no significant realignments between 1987 and 1992, the ERM was enlarged to include Spain and Portugal, and Italy entered the narrow band. Inflation and interest rates fell throughout the Community and nominal convergence was apparent. The schedule for progressing to full-scale monetary union by the end of the decade proposed in the Maastricht Treaty in January 1992 seemed realistic. Ireland looked forward to satisfying the Maastricht criteria and participating in EMU from the start.

#### Irish Exchange Rate Policy.

The August 1986 devaluation ushered in a period of exchange rate stability for the Irish pound. As may be seen from **Figure 1**, there is a marked contrast between the steady depreciation of the Irish pound relative to the DM over the period 1979-86 and its

stability over the period from August 1986 to August 1992.<sup>3</sup> When the crisis broke in 1992, the Governor of the Central Bank referred to the change of policy that occurred in 1986:

Since 1987, exchange-rate policy has been expressed clearly in terms of the ERM commitment and the Government remains committed to a policy similar to the *franc fort* policy pursued in France. Over this period, financial markets in Ireland have become more closely integrated with continental markets . . . because of the greater credibility of domestic policies, continental investors have become major investors in Irish Government securities. Generally speaking, developments in Irish financial markets-particularly movements in interest rates-strongly mirror developments in our narrow band partners. . .<sup>4</sup>

In the same issue of the Central Bank's *Quarterly Bulletin*, written after the departure of sterling from the ERM, it was noted that "the commitment to price stability, underpinned by a firm exchange rate, continues to be a cornerstone of policy" (p. 5). The perceived benefits of the stability of the Irish pound in the ERM - credibility in the eyes of foreign investors and a narrowing of interest rate differentials with Germany - played an important role in the resistance to devaluation by the Irish authorities over the period from September 1992 to the end of January 1993.

#### Interest rates.

Early in 1986 markets became convinced that a devaluation of the Irish pound was likely at the next realignment. The Irish-German short-term interest rate differential widened by over 500 basis points and, as Irish long-term rates fell, the slope of the yield curve became sharply negative. But even though there was no change in the value of the Irish pound at the April realignment, interest rates subsided and remained stable throughout the summer. There was little increase in interest rates ahead of the August devaluation, even though the real exchange rate appreciated sharply. By resisting devaluation in April and deciding on a quick devaluation in August the authorities took

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<sup>3</sup>The Irish pound participated in the general 3 per cent devaluation against the DM in January 1987, but this had little impact on the market rate.

<sup>4</sup>"From EMS to EMU: The Case of Ireland", Central Bank of Ireland, *Quarterly Bulletin*, Winter 1992, p. 45.

the markets by surprise.

However, both short-term and long-term interest rates rose in October. Sterling had weakened further, so that the breathing space that had been bought by the devaluation was lost. Added to this was the unsettling effect of unexpectedly adverse quarterly exchequer returns. Another devaluation was expected, but did not materialise. A penalty in the form of a widening of the Irish-German short-term interest rate spread was borne until the second quarter of 1987 when a strengthening of sterling took the pressure off and Irish short-term rates fell back.

For the rest of 1987 and the following four and a half years there was a marked narrowing of interest rate differentials between Ireland and the UK and Ireland and Germany. During 1988 Irish rates did not rise in sympathy with UK rates, and a significant negative differential opened up between the two countries and persisted for some time (Figure 5). At the same time, the differential between Irish and German rates narrowed steadily, until by mid-1992 the remaining gap was only 50 basis points. For over three years after mid-1989 the slope of the yield curve was negative. This was the first time (apart from brief episodes associated with surges in short-term rates in anticipation of a devaluation) since Ireland joined the ERM that the markets expected interest rates to fall. These developments, combined with lower inflation in Ireland than in either Britain or Germany, generated considerable optimism. It was widely believed that the long-hoped-for benefits of the ERM were finally within our grasp.

With hindsight, it is easy to point out that this optimism should have been tempered by reference to the continued influence of British variables on Irish financial markets. The econometric evidence shows that while Irish interest rates were increasingly influenced by German rates and less by UK rates, this process was not complete by 1992 (Walsh, 1993). The weights shifted as follows between the first and second half of the period 1986-92:

	86m8-89m7	89m8-92m8
$i^{DM}$	0.438	0.683
$i^{STG}$	0.680	0.315

But although its influence was more than halved in the second period, the sterling interest rate none the less remained a highly significant influence on Irish money markets. The evidence also shows that the sterling/Irish pound exchange rate exercised an important, and persistent, influence on Irish interest rates. Using quarterly data for 1979-92 Honohan and Conroy (1993) estimated that a rise of Stg£0.10 in the nominal exchange rate was associated with a 200-300 basis point increase in Irish interest rates. Using monthly data for the period 1986-92 Walsh estimated that a 10 per cent increase in the real exchange rate raised interest rates by about 350 basis points. This effect persisted even as the time from the 1986 devaluation increased, although its magnitude diminished from 400 basis points in the first three years to 157 in the second three-year period. As the Irish pound strengthened relative to sterling, a devaluation was regarded as increasingly likely and hence an interest rate premium was demanded for holding the currency. This is readily understood in the light of uncovered interest parity theory and Irish exchange rate policy during the first half of the 1980s.

In terms of the target zone literature, both inflation and short-term interest rate differentials, Ireland relative to Germany, show that the narrow-band target zone *vis á vis* the DM lacked credibility from 1979 until the end of 1987. Moreover, the long bond yield lay well outside the limits implied by the DM target zone until 1990, when it approached, but never actually entered, the range (Hughes and Hurley, 1993).

#### The real economy.

The fiscal correction initiated in 1982 was consolidated in the following years. From a peak of 8.9 per cent of GDP in 1981, the primary budget deficit had been converted into a *surplus* of 7.3 per cent of GDP. Since unemployment continued to rise over this period, the adjustment in the underlying, structural deficit was even more impressive. The debt/GNP ratio began to decline and the external debt/GNP ratio fell

even more rapidly<sup>5</sup>.

The Irish economy expanded by over 25 per cent between 1986 and 1990. The rate of unemployment declined from a peak of 17.6 per cent of the labour force in 1986 to 13.7 per cent in 1990, the lowest level since 1981. It is true that increased emigration, in response to the rapid growth of employment in Britain, accounted for some of this reduction, but there was also an impressive growth in private sector employment, which more than offset the contraction in public sector jobs and led to a net increase of 4¼ per cent in total employment between 1987 and 1990. The current account of the balance of payments improved from a deficit of 3.6 per cent of GNP in 1986 to a surplus in each year since 1987. The surplus reached an extraordinary 6.5 per cent of GNP in 1992.<sup>6</sup>

There was initial concern that the transformation in the public finances, which was initially achieved mainly by tax increases rather than reductions in public expenditure, would exercise a deflationary effect on the economy as in the standard Keynesian model. The feared deflationary effects of the fiscal contraction did not materialise, however. Private sector consumption and investment spending increased sharply over the period 1986-89. This prompted a debate as to whether Ireland was experiencing an "expansionary fiscal contraction" *à la* Giavazzi and Pagano (1990).<sup>7</sup> While other factors have to be included in the explanation of Ireland's favourable performance in the second half of the 1980s - the 1986 devaluation, the strength of sterling and overheating of the British economy, the exceptionally large impact of the collapse of oil price on the Irish economy - it is plausible to argue, as have Bertola and Drazen (1993), that the Irish experience after 1986 is an illustration of a successful fiscal stabilisation based on cuts in government consumption that changed the private sector's expectations about future

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<sup>5</sup>There was also a switch from government borrowing in foreign currencies to selling Irish government securities to non-residents.

<sup>6</sup>Both the fiscal and current account balances should be seen in the light of the increased transfers Ireland received from the EC in the second half of the 1980s. In 1991 net international transfers to Ireland amounted to over 8 per cent of GNP.

<sup>7</sup>The meeting of the Irish Economic Association in September 1991 was devoted to this topic and the papers published in *The Economic and Social Review*, April 1992.

deficits and tax burdens and led to a compensating increase in private spending. Whereas the 1982 reduction was achieved mainly by raising taxes and choking off capital spending, the 1986 correction relied more on cuts in government current consumption. The dramatic fall in the deficit in 1987/88 also owed a good deal to increased tax payments, but this was due to a tax amnesty rather than to higher tax rates. The favourable economic developments allowed the government to begin to lighten the burden of taxation while continuing to reduce the debt/GDP ratio. The economy appeared to have escaped from the trap described in Sargent and Wallace's unpleasant monetarist arithmetic and, as long as unemployment continued to fall, the stabilization programme could be deemed successful.

### **The September 1992 Crisis**

First, the sequence of events between September 1992 and mid-1993 is outlined. This is followed by an attempt to draw out some of the lessons to be learned.

#### Chronology of events

When the crisis in the ERM began to develop in the aftermath of the Danish "No" vote in June 1992 there were grounds for hoping that the Irish pound would have gained sufficient reputation to have insulated it from the problems faced by sterling, whose commitment to the ERM was more recent and less firm. This hope was confounded in September. Sterling's departure from the ERM and sharp depreciation pushed the sterling exchange/Irish pound rate to unprecedented heights. From a level of Stg£0.91 in May it touched Stg£1.10 in November and again in January. For reasons we explore in more detail below, the markets regarded these levels as unsustainable, speculative attacks drained liquidity out of the banking system and short-term interest rates rose to astronomical levels (Figure 6). The Central Bank suspended its Short-Term Facility towards the end of November, raising the cost of funds to 100 per cent on occasions<sup>8</sup>. The one-month rate peaked at 44 per cent. Despite efforts by the Central Bank to insulate retail markets from these developments, the cost of borrowing to businesses rose sharply as debt was rolled over and variable mortgage rates were adjusted to reflect the rising cost of money to lenders. Official reserves of foreign exchange had begun to fall during the

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<sup>8</sup>The remaining exchange controls allowed the Bank to prevent Irish banks lending to non-residents wishing to sell the Irish pound short.

summer as tensions increased in the ERM; between September and the end of the year there was an unprecedented loss of official foreign exchange reserves, which were prevented from being completely exhausted through borrowing, central bank interventions, swaps, REPOs and other emergency measures.<sup>9</sup>

Towards the end of December the pressure on the Irish pound eased and the three-month interest rate differential relative to Germany fell to "only" 6 per cent (compared with over 9 per cent at end-November), but as sterling weakened again towards the end of January interest rates rose to new heights and the Irish pound fell below the floor of its band in the ERM. On January 27th the Central Bank again raised its overnight rate to 100 per cent. Rising wholesale rates warranted further increases in retail rates, including mortgage rates, a prospect that was particularly unpalatable to the government. On Saturday January 30, the Irish pound central rate in the ERM was lowered by 10 per cent.

After the devaluation Irish interest rates fell from the crisis levels of January, but remained high relative to German rates as sterling weakened further. However, once sterling passed the low point of Stg£1=DM2.33 at the end of February, Irish rates fell rapidly and by April the Irish-Germany differential in short-term interest rates was lower than it had been before the crisis of mid-1992 and the Irish pound was close to the top of the permissible range in its new band in the ERM. Equally impressive has been the rapid replenishment of the Central Bank's reserves, albeit at considerable cost to the Irish taxpayer.<sup>10</sup> The outcome has been more favourable than even advocates of devaluation expected in January.

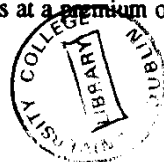
### Interpretation of the Events

It is important to bear in mind that the January devaluation was essentially an unwinding of the unwarranted appreciation of the Irish pound that had been caused by the

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<sup>9</sup>In view of the high level of external government borrowing, the level of the reserves is not significant, but movements in this level are.

<sup>10</sup>It is estimated that the fall in reserves plus the total of increased external borrowing and intervention amounted to about £4 billion, exclusive of foreign currency swaps. Repaying this at a premium of about 8 per cent represents a cost of at least £320 million or just over one per cent of GNP.



depreciation of sterling. As may be seen from **Figure 7** by the end of March the trade-weighted index of the Irish pound the same as it had been at the end of the previous April.

To have maintained the old parity in the narrow-band of the ERM would have implied trying to adjust to a 9 per cent overall appreciation and a much larger appreciation relative to the markets in which our labour-intensive and price-sensitive exports compete.

Accounts differ as to why the decision to devalue was resisted for long and why it was finally taken when it was. It has been attempted to justify the delay in devaluing by claiming that the favourable evolution of events since January reflects the strength of the resistance to devaluation and the resources devoted to the defence of the old central rate. A more plausible explanation, supported by the econometric evidence, is that since September the dominant influences on Irish interest rates have been the Stg£/Ir£ exchange rate and the level of UK interest rates, with the influence of German interest rates receding. The fall in UK interest rates following sterling's departure from the ERM exerted a strong influence on Irish interest rates, and once the Stg£/Ir£ exchange rate was lowered to a level regarded as sustainable by the markets Irish interest rates fell to a lower level, relative to German rates, than had been achieved after six years of stability in the DM/Ir£ exchange rate.

In its commentary in its Spring 1993 *Bulletin* the Central Bank of Ireland attributes an important role to political factors. Having described the improvement that occurred towards the end of December, it goes on to state that

during January, however, market sentiment deteriorated as perceptions changed regarding the national consensus to defend the currency (p. 17).

The background is that when the crisis broke in September the government was adamant that it would not devalue. However, the government was dissolved on 5 November 1992 and the election held on 26 November was inconclusive. A period of negotiation followed before a new government was formed 12 January 1993. The Fianna Fáil party, which had formed the outgoing government on its own, entered into a partnership with the Labour Party. A new government was formed by these two parties and the outgoing Prime Minister and Finance Minister were retained. No difference of opinion emerged between the two parties in the new government on exchange rate policy: it was repeatedly asserted



that a devaluation would be harmful and had to be resisted. However, it was also insisted that the first priority was to tackle the problem of unemployment by creating growth in sustainable employment. Pronouncements on exchange rate policy were divorced from those relating to employment policy.

Whether a consensus to defend the currency ever existed may be questioned. In some circles the position of the Irish pound in the ERM became a symbol of national independence (from Britain?).<sup>11</sup> However, a growing proportion of business and academic opinion favoured a devaluation as the crisis persisted. Even the political commitment to defending the pound was at times equivocal, with hints that the pound might be devalued should an opportunity present itself at a multilateral realignment or should sterling fall beyond some level.<sup>12</sup> But at the end of the day it was the fact that the Irish economy was seriously threatened by the persistence of the high exchange rate relative to sterling and its concomitant, extraordinarily high real interest rates, that made devaluation inevitable.)

In the aftermath of the devaluation there were some recriminations by Irish politicians about the less-than-wholehearted support for the Irish pound by European central banks. The contrast between the Bundesbank support for the French franc and its intervention on behalf of the Irish pound was noted. It was felt that despite assurances of confidence in the appropriateness of Irish policy, the reality was that the currency's pretensions to be considered a candidate for a fast track to EMU were not taken seriously.

The reasons advanced for not devaluing may be summarised as follows:<sup>13</sup>

- ① **Sterling Overshooting.** It was claimed that sterling had overshot and would soon return to its equilibrium value, relative to which the Irish pound was not misaligned. The competitive gain from sterling's devaluation

<sup>11</sup>In an editorial published 9 January 1993 *The Irish Times* stated that "It is the duty of a sovereign government to defend its currency as it would its national territory." After the devaluation, the same newspaper proclaimed its "grief" at the decision.

<sup>12</sup>The specific event which the Bank may have had in mind in its reference to the weakening of the consensus occurred as the new government was being formed during the first week in January. The Finance Minister stated that although he was opposed to devaluation we could not "stagger on indefinitely", the new government would have to review the situation. This caused a temporary surge in interest rates.

<sup>13</sup>A summary of these was contained in a government statement issued just days before the devaluation.

would be quickly eroded as British inflation accelerated. Temporary subsidies would enable smaller firms vulnerable to competition from British firms to survive.

- ② **The Structure of Trade.** While the trade-weighted index of the Irish pound increased by about 8 per cent between the middle and end of 1992, its value in terms of sterling rose by more than 18 per cent. It was argued, however, that the diminished importance of sterling to the Irish economy insulated it from the impact of the sudden real appreciation. Early in the crisis, it was even suggested that firms could overcome the effects of the crisis by quickly diversifying the geographical pattern of their exports!
- ③ **The Burden of External Debt Service.** It was argued that the real burden of servicing the country's large overhang of foreign currency borrowing, which had been concentrated in narrow-band ERM currencies in recent years, would increase as a consequence of a devaluation. An estimate of £84 million was provided, but after the devaluation a figure of £13 million was quoted.
- ④ **Credibility.** The anti-devaluationists were adamant that a devaluation would undermine the credibility that had been gained through the stability of the Irish pound/DM exchange rate over the preceding six years. It was argued that it was in the country's long-term interest to maintain stability via á vis the narrow-band ERM currencies rather than to return to a de facto sterling peg. Furthermore, it was claimed that the evidence from the aftermath of the 1986 devaluation showed that Irish interest rates would carry a risk premium relative to German rates for a long time after a devaluation. The fact that Spanish interest rates had risen after the peseta was devalued in September was cited as further evidence of this.
- ⑤ **"Our Fundamentals Are Sound"** The five indicators which the government repeatedly invoked to buttress this claim were inflation, the fiscal deficit, the current account, the debt/GDP ratio and the rate of increase in hourly earnings. On four of these five indicators the Irish performance in 1992 was superior to the EC average (see Table 1).<sup>14</sup> The exception was the debt/GDP ratio, but this had fallen from 122 to 100 per cent since 1987, whereas the EC average had risen from 51.5 to 63.4 per cent. Ireland was closer to conforming to the Maastricht criteria for admission to EMU than all but a few other EC countries. The Irish authorities were anxious that the Irish pound be taken seriously as a candidate for membership of an inner circle or fast track within the ERM.

<sup>14</sup>The trend in unit labour costs could have been added to the list of favourable indicators: both the level and trend of wages in manufacturing industry adjusted for labour productivity compared favourably with those of other EC countries expressed in a common currency (see Table 1).

It was argued that this prospect would be jeopardised by a devaluation.<sup>15</sup>

**Entrenched Positions.** Trying to avert the devaluation by increased foreign borrowing and central bank intervention increased the cost of capitulating. Rationalising a devaluation is more difficult the more often it has been argued that it was not the right policy.

These arguments were countered by the following considerations:

**Sterling Overshooting.** It rapidly became clear that there was no prospect of sterling returning to its pre-September levels, or re-entering the ERM, in the short- to medium-term. The effects of sterling's depreciation on inflation were very slowing materialising and even in the longer-run would be dampened by the depressed state of the British economy. Ireland could not afford to suffer a competitive penalty for such a long period.

**The Structure of Trade.** This argument was based on data on the geographical pattern of commodity trade which did not reflect the relative contribution of trade to employment nor of the effects of the depreciation of sterling on Irish firms in the domestic market and third countries.

Commentators had long been aware that the balance of trade, the geographical structure of trade and unit labour costs are heavily influenced by the performance of a relatively small number of transnational companies whose output is measured at prices designed to maximise the advantages of the favourable corporate tax regime. For example, three industrial sectors (Pharmaceutical, Office and Data Processing Machinery and "Other Foods") account for 28 per cent of the net output of Irish industry, and 35 per cent of the value of industrial exports, but only 7 per cent of industrial employment. These sectors are dominated by branches of foreign-owned companies and almost all their output is exported, but relatively little of it goes to the UK.<sup>16</sup> Exports of £228,000 are needed to support one job in these sectors. At the other extreme are industries like clothing and knitwear, which account for 9.5 per cent of total industrial employment, but only 2.1 per cent of industrial exports, of which about two thirds go to Britain. Each £21,000 of exports from these industries supports one job in Ireland. For these reasons, it became clear that the traditional trade-weighted index of the geographical pattern of trade was a poor guide to the importance to the real economy of movements in bilateral exchange rates, the sterling/Irish pound rate in particular.

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<sup>15</sup>There was no discussion of whether an Irish devaluation in the circumstances of January 1993 would constitute a devaluation "on the country's own initiative", which is what the Treaty refers to in Article 109j and the relevant Protocol.

<sup>16</sup>Data are for 1988. "Other Foods" includes plants that produce and export well-known soft-drink concentrates.

**The Burden of External Debt Service.** Account was not taken of the countervailing effect of a devaluation on the capacity of the Irish economy to service external debt through the increased Irish pound value of export receipts and transfers from the EC. The costs of increased central banking borrowing to support the pound should also have been set against this consideration.

**Credibility.** This argument against devaluation was based on a mis-reading of the factors influencing Irish interest rates, and in particular the way in which the convergence of Irish and German interest rates had, since we joined the ERM, been contingent on maintaining a competitive sterling exchange rate. The short-term effects of devaluation on British and Italian interest rates should have been taken into consideration more than the special Spanish and Portuguese experience.

**"Our Fundamentals Are Sound."** It was certainly reasonable to argue that the large, and growing, balance of payments surplus did not indicate that the Irish pound was overvalued. Although there the trade import/export ratio with the UK was above unity, it had fallen from 1.25 in 1985 to 1.10 in 1991. The export surplus with other EC countries had grown very rapidly, the import/export ratio falling from 0.62 in 1985 to 0.49 in 1991. However, the debate on exchange rate policy threw ~~he~~ spotlight on some peculiar features of Irish economic indicators.<sup>17</sup> Missing from the list of fundamentals was an awareness of the effects of the sudden appreciation against sterling on the real economy, and in particular on the already grave situation concerning the level of employment and unemployment. The rate of growth of real GDP fell from 8.3 per cent in 1990 to 2.5 per cent in 1991 and 2 per cent in 1992. While these growth rates were the highest recorded in the EC, they were not high enough to generate any net increase in employment. The already-rapid growth of the labour force was augmented by a net inflow of population as conditions deteriorated in Britain. The numbers registered as unemployed increased by one third between early 1990 and the beginning of 1993. Ireland vied with Spain for the unenviable distinction of having the highest rate of unemployment in the EC. Against this background, the sudden real exchange rate appreciation caused by sterling's depreciation was particularly threatening due to the importance of Britain as a competitor in many labour intensive markets such as clothing, knitwear, furniture, food processing, electrical engineering, tourism and other services, as well as a rival location for transnational

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<sup>17</sup>It is also relevant that in March 1993 the Central Statistics Office published revised figures that reduced the estimate of current account surplus from 8 to 6 per cent of GNP. A disturbing feature of the Irish balance of payments data is that, even after the recent revision the estimated net residual (that is, the sum of the current and capital accounts) amounts to 5.8 per cent of GNP in 1990. Following the discontinuation of exchange controls, a new system of data collection based on transactions with non-residents settled through the banking system, ("General Direct Reporting System") is being introduced and will be assumed by the Central Bank. This will be in line with the approach used in all other EC countries with the exception of the UK.

investment.<sup>18</sup> It was also apparent that many of the arguments concerning fundamentals failed to reflect the likely future impact *at the margin* of the appreciation. In view of the difficult employment situation and the rapid growth of the labour force, this was the crucial issue.

The ability of the Irish economy to adjust to the exchange rate shock was severely limited by labour market rigidities. A *Programme for Economic and Social Progress* (PESP) signed in February 1991 had set the general rate of wage inflation for the years (1991, 1992 and 1993) at 4 per cent, 3 per cent and 3.75 per cent. (At the time, this agreement was hailed as evidence of the benefits of low inflation expectations, reflecting the stability of the currency.) Some of the 1992 increase had been postponed from the beginning to the end of the year in order to prevent slippage from the target reductions in the fiscal deficit. This timing was unfortunate, as a larger increase became due at the height of the currency crisis. Although several trade union spokesmen were strong in their support of the government's resistance to devaluation, there was never any serious prospect of negotiating a cut in money wages in order to make the appreciation of the exchange rate sustainable.

The anti-devaluation arguments also tended to ignore the effect of high interest rates on the economy. Most Irish debt is short-term or at variable rates. Despite attempts by the Central Bank to insulate retail credit markets from the effects of the loss of liquidity due to heavy selling of the pound on the foreign exchanges, by the end of 1992 businesses were faced with massive increases in the cost of borrowing and mortgage holders with up to 30 per cent increases in repayments<sup>19</sup>. The allocation of savings was affected as depositors moved money to higher-paying accounts. By early January yields of well over 15 per cent *per annum* were being offered for three months at the retail level to attract funds. Cash was siphoned from businesses into these high-yielding deposits.

Finally, it may be asked whether the reaction of the markets to the rise in the

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<sup>18</sup>During the currency crisis Digital announced that it was moving most of its Galway plant to Scotland as part of a worldwide rationalisation. While this particular move may not have been directly affected by the exchange rate, an overvalued currency would in the long run encourage more such decisions.

<sup>19</sup>Due to recent changes in the tax system, the typical taxpayer enjoyed little relief on the increased interest payments.

sterling/Irish pound exchange rate was rational or were the authorities right to believe that markets could be persuaded that there was no need to devalue? Would it have been possible to have continued to try to convince the markets that the formal target zone *vis á vis* the DM should prevail over the informal one *vis á vis* sterling? If this were feasible, what price should have been paid to reap the longer-run benefits of this policy?

CREDIBILITY  
CONDITIONAL ON  
IRISH EXCH.

To answer these question account should be taken of the econometric evidence, summarised above, which showed that the gain in credibility from Ireland's hard currency policy after 1987 was incomplete and continued to be conditional on the level of the sterling/Irish pound exchange rate. The influence of the sterling exchange rate on Irish interest rates was an established phenomenon throughout the period of Ireland's adherence to the ERM. It did not suddenly emerge during the September 1992 crisis. It could be understood in terms of a model in which markets form a view of the equilibrium sterling/Irish pound exchange rate and believe that positive deviations from this increase the probability of a depreciation because of the effects of a misaligned rate on employment and the political sensitivity on this issue.

The relationship estimated over the preceding years suggested that an 18 per cent revaluation of the Irish pound relative to sterling would have led to an increase of between 3 and 8 per cent in the level of Irish short-term interest rates relative to an average of British and German rates. In the Appendix to this paper it is shown that it is possible to model the behaviour Irish interest rates satisfactorily even during the turbulent period from September 1992 to March 1993. The key influences were the sterling exchange rate and British interest rates. However, a structural break with the past is indicated by the enhanced importance of British interest rates and the sterling exchange rate and the diminished role of German interest rates. This does not suggest that it would have been feasible to change expectations without incurring exceptionally heavy costs in terms of the damage done to the economy through the misaligned exchange rate and the high interest rates necessary to defend it.

### The Lessons to be Learned

A number of lessons should be learned from the Irish experience during and after

the 1992 crisis in the EMS. These include:

Reversing a sudden and unwarranted real exchange rate appreciation by lowering a currency's central rate in the ERM does not undermine credibility. This is borne out by the rapid fall in Irish interest rates since the January 1993 devaluation and by the resumption of the long-run trend reduction in the Irish-German interest rate differential after the 1986 devaluation.

Holding on to an overvalued exchange rate in the face of market sentiment is costly and misguided. Markets had a clear view of the importance of the (real) sterling exchange rate to the Irish economy. It was futile for the authorities to try to shake the conviction that the pound was overvalued or to argue that this did not matter for the real economy. *Real* fundamentals, especially the prospects for employment and unemployment, should not be ignored in deciding on exchange rate policy.

Increased international cooperation, taking the form of large-scale intervention to support the Irish pound, would not have resolved the problem. Even if the market's expectations that the Irish pound was going to be devalued could have been broken, and the interest rate premium removed, the misalignment against sterling would have remained and continued to damage the real economy. The economy clearly lacks the flexibility needed to keep the costs of adjusting to such a shock within acceptable bounds.

It is tempting to seek to blame speculative currency flows for the Ireland's failure to hold its strong exchange rate policy. While the thinness of the Irish foreign exchange market does not encourage frequent large-scale attacks on the currency, the markets clearly identified the currency as "in the firing line" after the devaluation of sterling and the lira. The perception of the currency as overvalued was not unreasonable, and it is doubtful that administrative measures designed to curb foreign exchange trading would have had any long run effect.

The Irish case is unique in the EMS because of the importance of sterling and its volatility outside the ERM. Despite a strong commitment to the goal of monetary union, and a desire to be taken seriously as a candidate for early participation in a system of fixed European exchange rates, the medium-term prospects for the Irish pound are uncertain due to its special relationship with sterling. This uncertainty cannot be resolved by proposals for increased cooperation between central banks to support currencies that come under pressure due to well-founded beliefs about their sustainable level. A move to

the wider band in the ERM might prove helpful, but not very if sterling continues to be as volatile in the future as it has in the past. An agreement by that a realignment of the Irish pound in response to a loss of competitiveness due to a depreciation of sterling does not constitute a devaluation "on its own initiative" would be both realistic and helpful.



## Appendix

### Modelling the Behaviour of Irish Interest Rates

Ireland's situation as a member of the ERM when its main trading partner was not provides an interesting opportunity for modelling the influences on interest rates in a small open economy. Table 2 contains the results of estimating an error correction model based on the considerations: (i) that Irish interest rates are influenced by both German and British rates and (ii) that the level of the (real) sterling/Irish pound exchange rate affects expectations about the probability of a devaluation of the Irish pound in the ERM. (The model was originally applied to the pre-crisis period in Walsh, 1993. The main results of this study are also shown in the Table.)

For the period between the 1986 devaluation and the September 1992 crisis, the model works well and, as has been summarised in the body of the paper, indicates that the weights of German and British interest rates shifted as the time from the devaluation lengthened, with the weight of the German rate increasing and that of the British rate diminishing. The sterling exchange rate was a significant influence throughout, indicating that an appreciation increased expectations of a devaluation and led to higher interest rates in Dublin.

When re-estimated for the period August 1992 to April 1993 (on weekly, as distinct from monthly, data) the model continues to perform well, but the magnitude of the coefficients changes dramatically, indicating a clear structural break. The declining influence of sterling interest rates is reversed and German interest rates can be deleted from the equation without significant loss of explanatory power. When this is done, the hypothesis that the coefficients of the (lagged) Irish and British interest rate variables are equal and opposite in sign cannot be rejected, suggesting that over this period Irish interest rates came back fully under the influence of UK rates. The influence of the sterling exchange rate is also enhanced, and indicates that during the crisis a 10 pence rise in the value of the Irish pound relative to sterling, *ceteris paribus*, added 849 basis points to short-term Irish interest rates. The major, if transitory, impact of the hint by the Finance Minister, early in January, that there might be a change in policy is also striking.

While the switch of from German to British dominance in our financial markets following the events of September 1992 was beneficial in the short run, as sterling's float outside the ERM resulted in much lower rates in Britain than in Germany, the longer-run implication is that the Irish policy of gaining credibility as a member of the inner core of the ERM was undermined, if not destroyed. The prospects for rebuilding this credibility depend ultimately on British policy relating to the ERM.

Table 1: Economic Indicators: Ireland, UK and EC

		1987	1988	1989	1990	1991	1992
Inflation rate	Irl	3.2	2.1	0.4	3.4	3.2	3.0
	UK	4.2	4.9	7.8	9.5	5.9	3.8
	EC	3.3	3.6	5.1	5.7	5.0	4.3
General govt. balance (% GDP)	Irl	-9.7	-4.8	-1.8	-2.5	-2.5	-2.5
	UK	-1.3	1.0	0.9	-1.3	-2.7	-0.6
	EC	-4.1	-3.6	-2.9	-4.1	-4.6	-5.4
BoP Current a/c % GDP	Irl#	-0.3	0.3	-1.6	1.6	3.8	6.5
	UK	-2.0	-4.5	-5.1	-3.5	-1.8	-1.8
	EC	0.8	0.1	-0.1	-0.2	-0.6	-0.4
Debt/GDP Ratio (%)	Irl	122.0	120.4	110.1	103.0	103.0	100.4
	UK	55.7	50.3	45.1	42.8	43.8	45.8
	EC	51.5	81.0	50.3	60.3	61.8	63.4
Hourly earnings (% change)	Irl	4.9	4.3	4.1	4.5	4.5	4.5
	UK	8.0	8.5	8.7	9.4	8.2	6.0
	EC	5.3	5.4	5.7	6.5	6.6	5.6
Hourly earnings*	Irl	114	111	107	113	110	114
Unit wage costs*	Irl	83	77	71	74	71	68

# The Irish figures for recent years are the revised ones published in March 1993.

\* = in common currency, 1980=100

Sources: Government statement of 25 January 1993 and Central Bank of Ireland, *Quarterly Bulletin*.

Table 2: Regression of Irish short term interest rates ( $i$ ) on German interest rates ( $i^{GM}$ ), British interest rates ( $i^{STO}$ ) and the Stg£/Ir£ real exchange rate ( $e^{STO}$ )

Period:	Dependent variable = $\Delta i$				
	86m8-92m8	86m8-89m7	89m8-92m8	92w32-93w16	92w32-93w16
Inter-cept	-6.96 (3.33)	-10.14 (3.13)	-10.69 (3.45)	-45.97 (4.25)	-43.87 (4.06)
$\Delta i^{GM}$	0.1875 (1.11)	0.0983 (0.40)	0.4750 (2.04)	-0.166 (0.13)	
$\Delta i^{STO}$	0.1848 (1.65)	0.2022 (1.25)	0.2589 (1.76)	-0.266 (0.12)	1.298 (0.89)
$\Delta e^{STO}$	0.1445 (4.00)	0.1464 (2.76)	0.1517 (3.72)	0.502 (3.25)	0.421 (2.94)
$i^{GM}_{-1}$	0.1845 (3.49)	0.1296 (0.60)	0.6110 (3.89)	2.161 (1.13)	
$i^{STO}_{-1}$	0.0703 (2.68)	0.2013 (1.53)	0.2819 (4.29)	-0.362 (0.40)	0.662 (2.71)
$e^{STO}_{-1}$	0.0907 (3.36)	0.1181 (3.02)	0.1405 (3.56)	0.359 (2.68)	0.451 (4.38)
$i_{-1}$	-0.265 (3.99)	-0.2961 (3.37)	-0.8946 (4.75)	-0.524 (5.96)	-0.531 (5.99)
D1	2.2940 (4.69)	2.2940 (4.61)			
D2				14.45 (7.02)	13.79 (7.16)
$\bar{R}^2$	0.60	0.66	0.67	0.72	0.71
SE	0.389	0.446	0.254	1.78	1.80
Prob( $F$ ) (serial correlation)	0.568	0.582	0.607	0.271	0.246

## Notes:

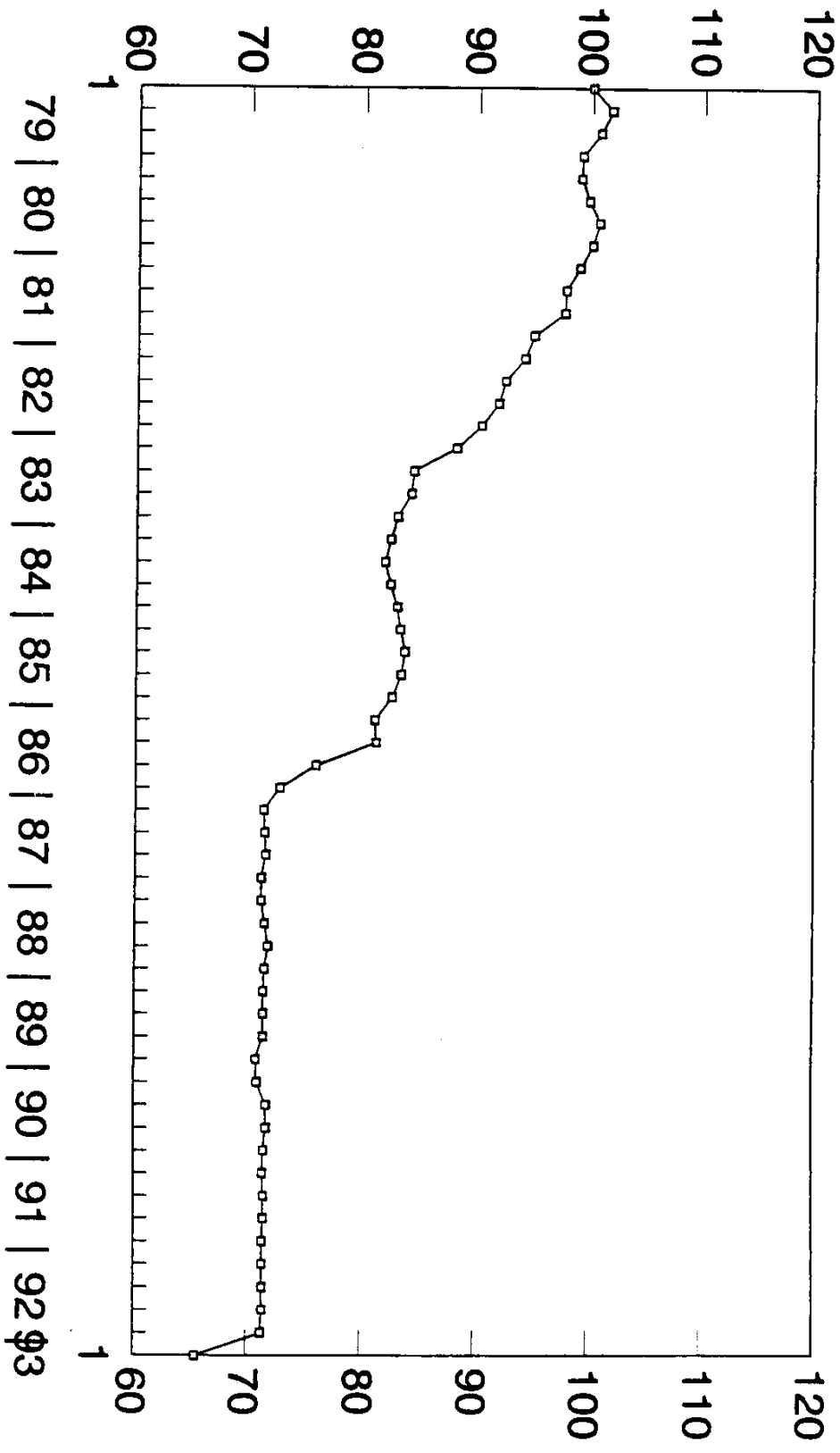
- (1) D1 is a dummy variable for October 1986 to reflect exceptional fiscal developments.
- (2) D2 is a dummy variable for week ending 8 January 1993, to reflect effect of Finance's Minister's statement.
- (3) The  $F$ -statistic is for the Lagrange multiplier test of residual serial correlation.

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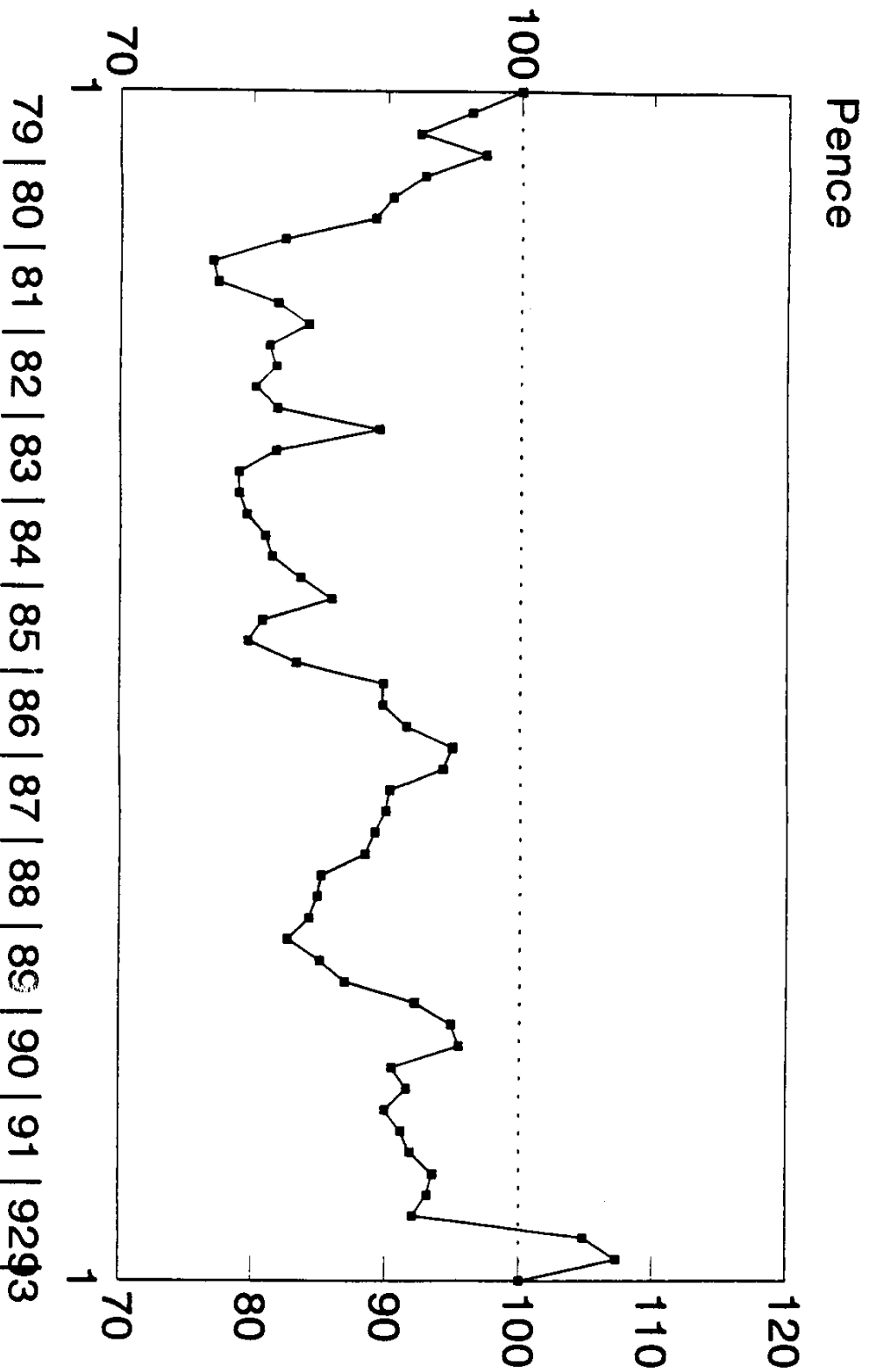
# FIGURE 1: DMI/IRISH POUND EXCHANGE RATE

Nominal

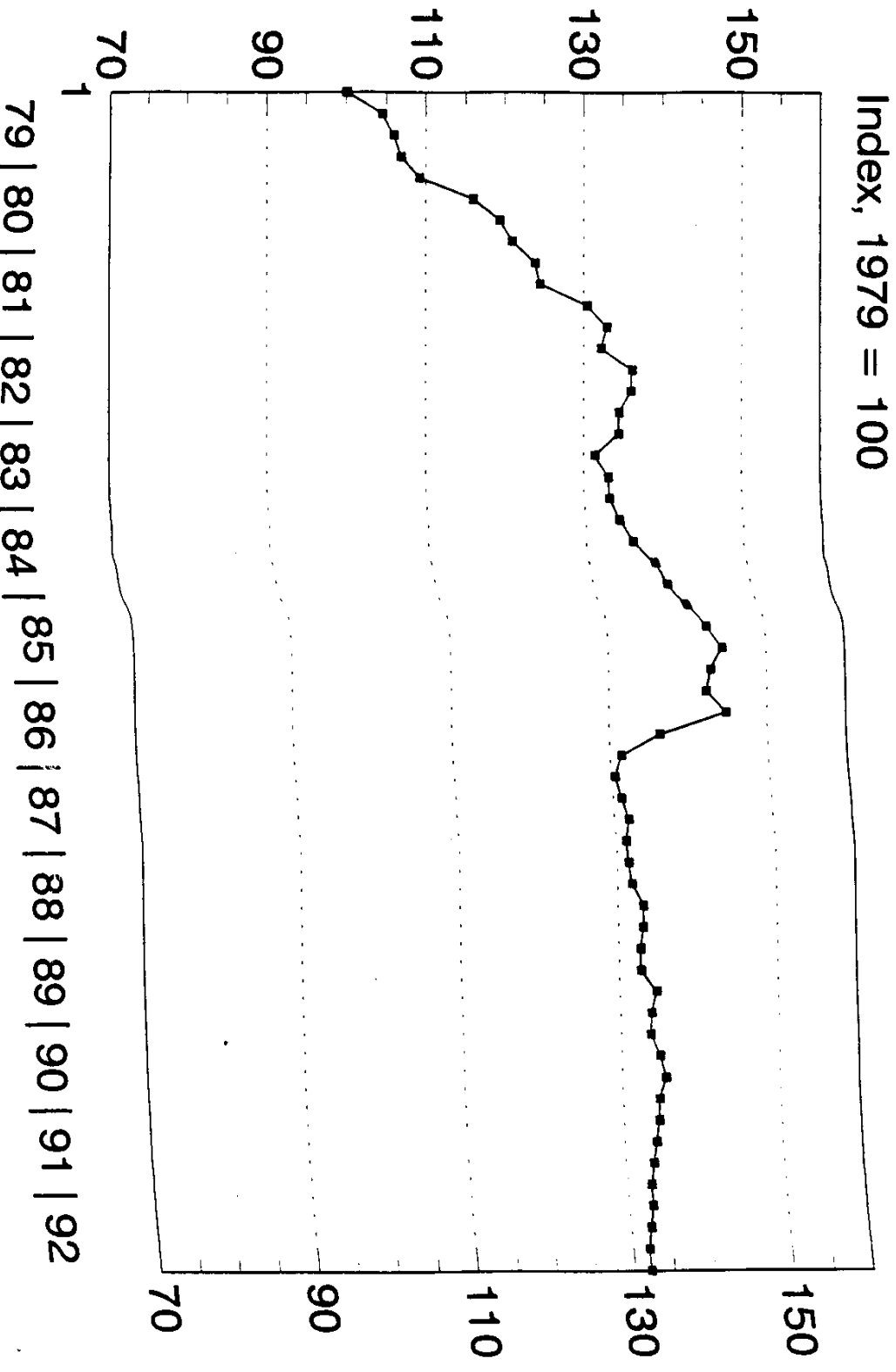


Quarterly, Q1 1979=100

# FIGURE 2 Sterling/Irish Pound Exchange Rate (Nominal)

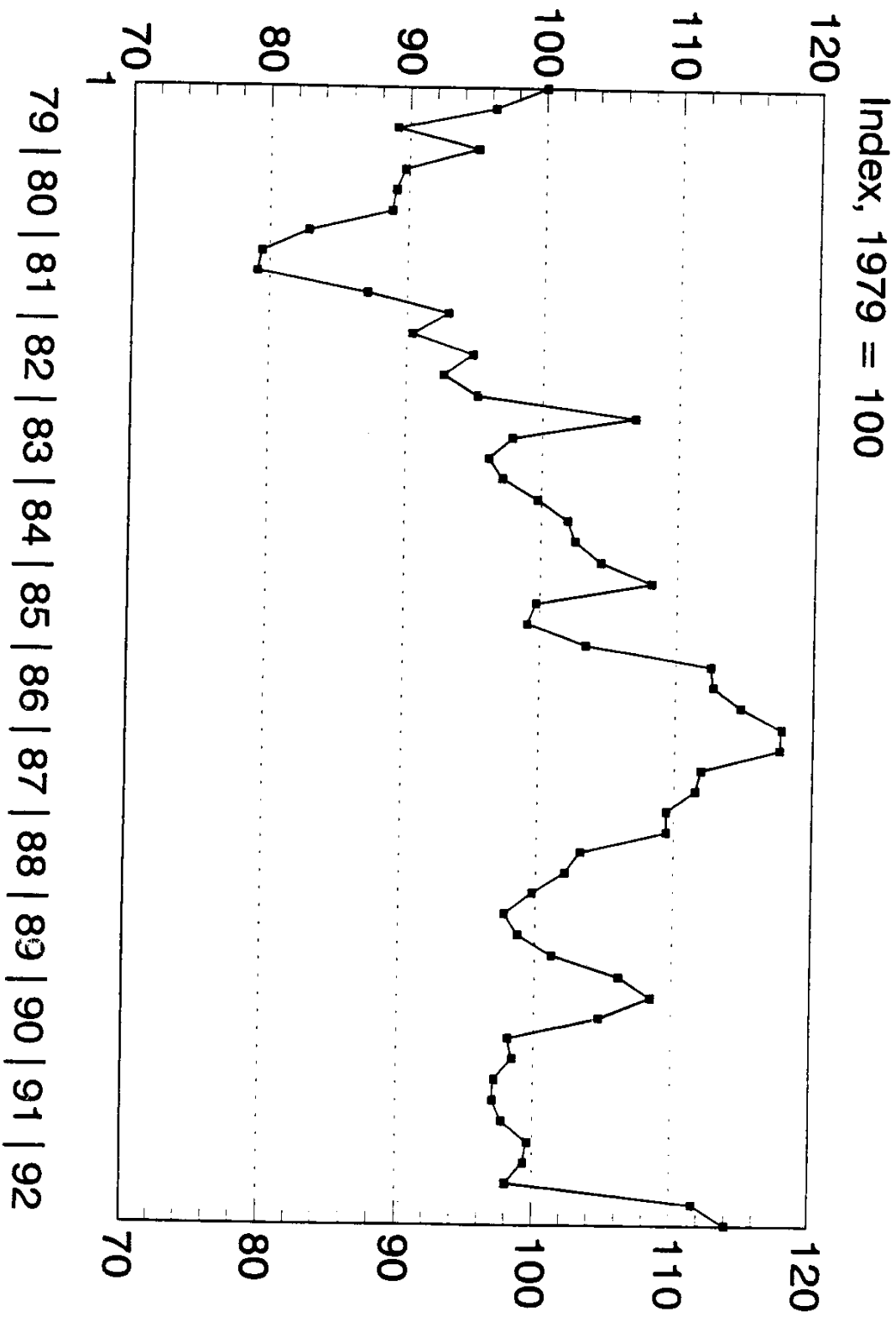


**FIGURE 3: Quarterly DM/Irish Pound Real Exchange Rate**

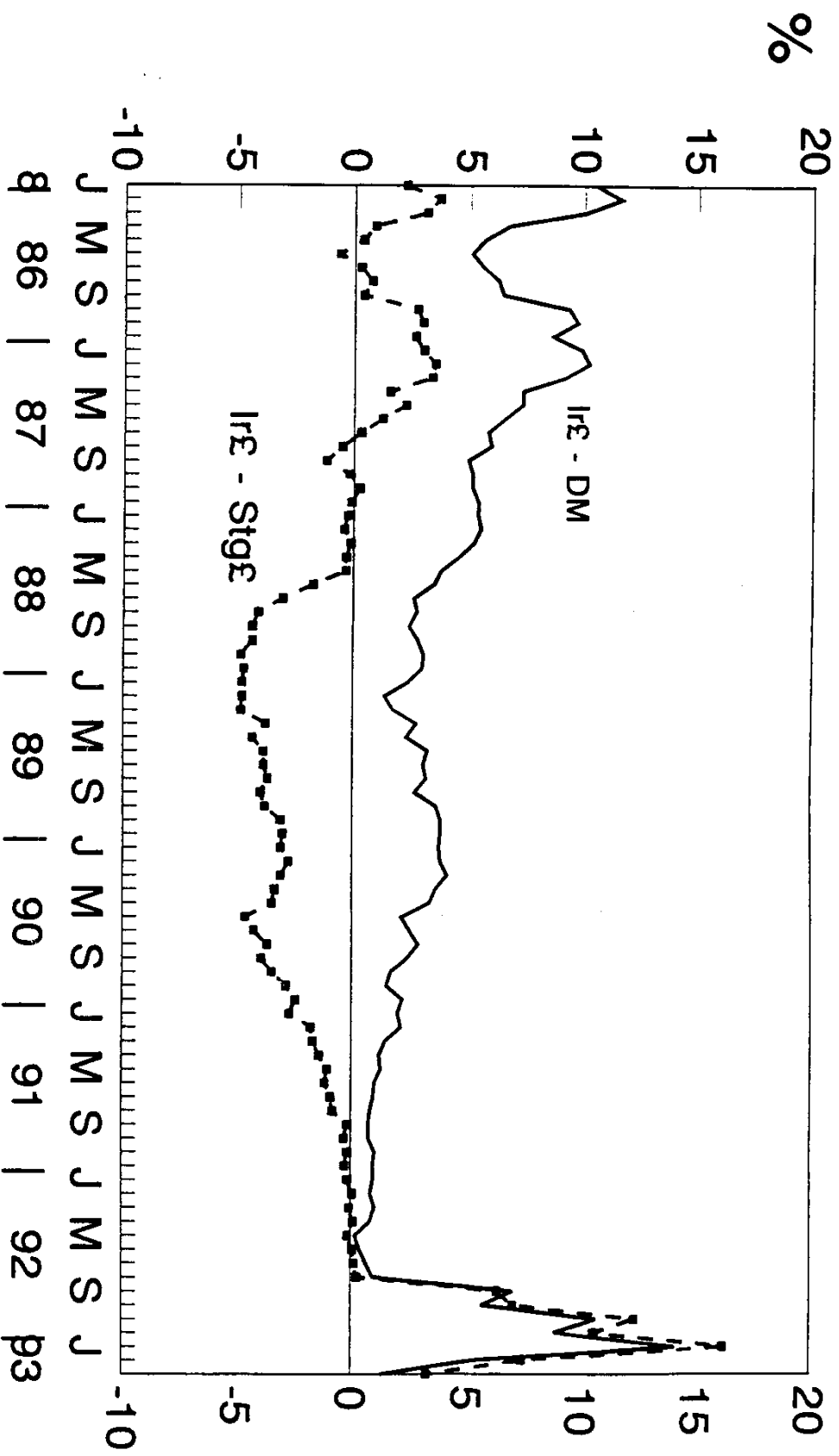




**FIGURE 4: Sterling/Irish Pound Real Exchange Rate**

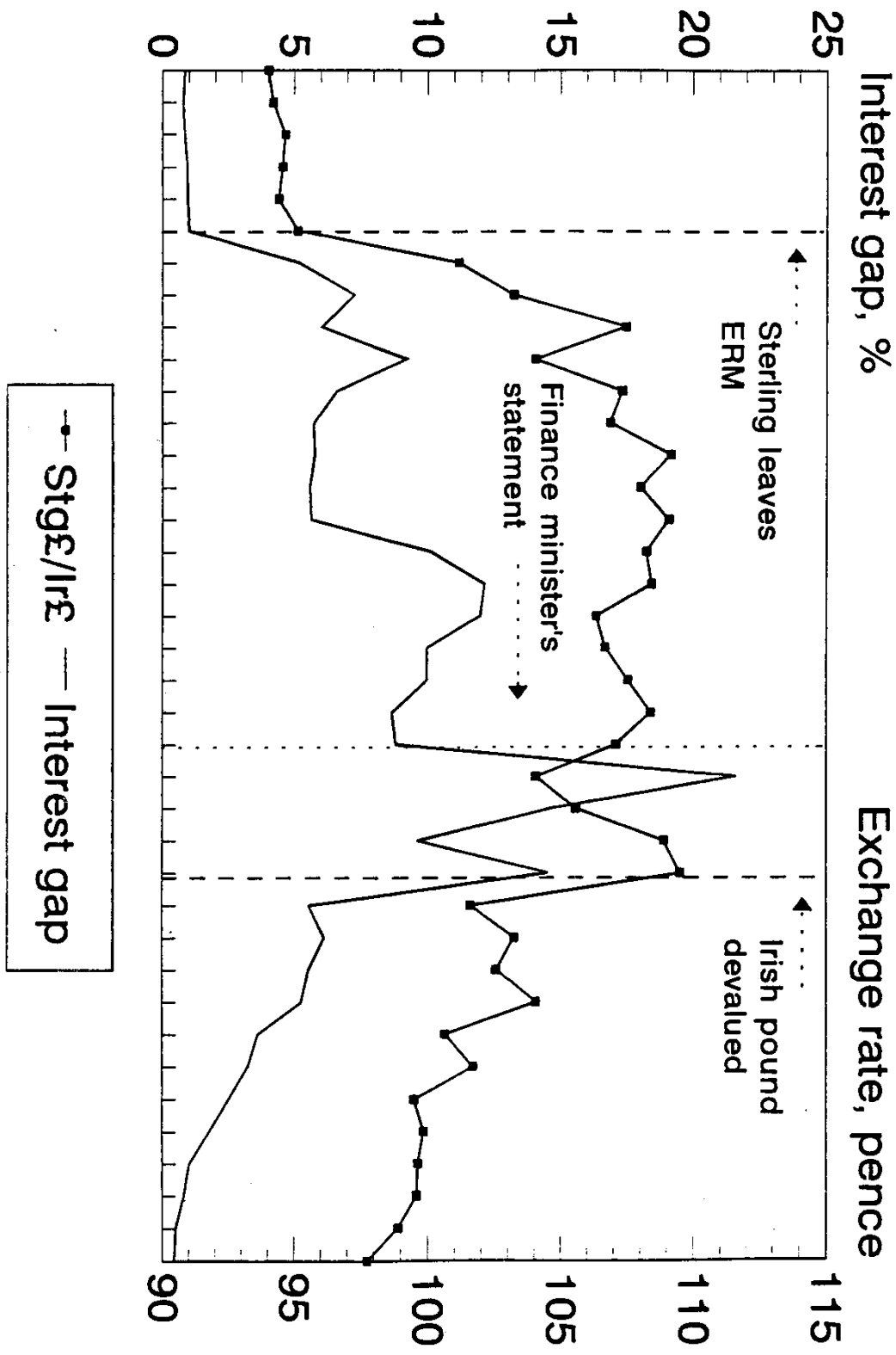


# ... OF ... Three-month Rates



(End-of-month)

**FIGURE 6: Irish-German Interest Rate Differential and Sterling Exchange Rate**



Weekly, from 02 Aug 88 to 02 Aug 93

**FIGURE 7: Trade-weighted Index of Irish Pound**

