

EMU AND IRELAND'S STERLING TRADE

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1. INTRODUCTION

Background

Trade with the UK is one of the oldest Irish economic policy issues. It remains highly topical today. When Ireland, on joining the EMS in 1979, broke the currency link with Sterling there were fears of negative implications for our trade with the UK. The dilemma was that should Sterling depreciate against the EMS currencies, a significant strain would be placed on the competitiveness of Irish firms exporting to the UK or competing against UK firms in the domestic and third country markets. Irish industry could therefore find itself in a position akin to standing with one foot on each of two wagons which could move apart at any time. Against that the EMS currencies, and in particular the Deutschmark, offered the prospect of lower inflation for Irish enterprise in the longer-run.

Sterling's entry to the monetary system in October 1990 further reduced the risks involved in "hitching" our monetary wagon to the Deutschmark. By 1992, it seemed that worries about the "separating wagons" were unfounded, and that the decision of 1979 had paid off. The Punt seemed fairly secure within the narrow EMS band, and considerable diversification in Irish trade towards the continent was being achieved, with a lessening of dependence on the UK.

However, the departure of Sterling from the EMS in September 1992 has meant that the core dilemma in Irish exchange rate policy returned. The subsequent depreciation of Sterling against the EMS currencies led to the currency crisis of September 1992–January 1993. I need hardly remind this audience of the trauma of that period, which essentially ended for Ireland with a reluctant 10 per cent devaluation of the Punt.

For a considerable part of the period since January 1993 it was once again "All quiet on the Currency Front". However, the renewed weakening of Sterling in 1995 against the Irish Punt shows that the fundamentally conflicting objectives of linking the Punt to the low-inflation DM and of maintaining a competitive exchange rate

with Sterling remain. Moreover, despite the many hitches, European Monetary Union (EMU) is a very real prospect. Equally real is the prospect that UK might not be part of such a Union, at least not initially. The specific trade policy implications of that potentially “worst case” scenario, i.e. an EMU with Ireland inside and the UK outside, is what I wish to explore this evening.

The Currency Review Group

Following the trauma of the 1992/93 currency crisis, the Department of Tourism and Trade (ABT’s parent department) established a Currency Review Group¹. The Group had two objectives, namely:

1. “to recommend a strategy which, in the event of a major currency crisis recurring, would facilitate an effective response to the needs of Irish industry; and
2. to make recommendations on how indigenous SMEs (Small and Medium Sized Enterprises), in particular, can minimise their exposure to currency changes which have a negative impact”.

The Review Group met six times between March and September 1994. The Group’s analysis used data from a number of sources: an interview-based survey of the 240 largest manufacturing firms undertaken by An Bord Tráchtála in mid-1993; a postal survey of 1,000 SMEs from An Bord Tráchtála’s client database undertaken in mid-1993 (with 404 replies); a database on applicants to the Market Development Fund² and a number of smaller surveys of firms undertaken by the Irish Exporters’ Association. The first two of these surveys provide the bulk of the data used in this paper.

Structure of the Paper

My paper will focus on the trade implications for Ireland of EMU membership, assuming that the UK stays out. This reflects the concerns of one directly involved in the practicalities of Irish-UK trade. I do not intend, therefore, to pay any great attention to exchange rate policy as such, nor to other macroeconomic issues to which EMU gives rise³. Instead, I wish to focus on the trade issues involved in the scenario outlined above.

I begin in Section 2 by outlining the importance of Anglo-Irish trade to the Irish economy, including the number of jobs which depend on that trade. The section outlines the continued importance of the UK in Ireland’s foreign trade, showing some important features within this overall dependence. Section 3 makes a distinction between markets and currencies, examining the relative importance of Sterling as against other currencies in Irish trade. Section 4 examines the vulnerability of Irish firms trading in Sterling to an appreciation in that currency,

showing that many Irish firms are poorly equipped to manage their exposure to Sterling fluctuations. Finally, in Section 5, some policy implications are discussed.

2. UK DEPENDENCE OF IRISH TRADE

Overall Trade Dependence on the UK

During and since the 1992/93 currency crisis, various accounts of Ireland's trade dependence on the UK were in circulation. It is of course generally accepted that considerable diversification in trade away from the UK had been achieved since Ireland joined the EC. It is the continuing extent of that UK dependence which is mostly at issue.

Table 1 below shows the trend in UK imports as a proportion of total imports to Ireland in the period 1970 to 1994. This pattern of declining dependence on the UK since the early 1970s is clear. Also evident is a stabilisation of the proportion of imports sourced in the UK from the mid-1980s onwards. A similar pattern is revealed for the proportion of Irish exports destined for the UK. Again, there has been a substantial decline since the early 1970s, with a stabilisation from the mid-1980s. These two trends are brought together in the trade ratio, which is shown in the final column of Table 1. Throughout the UK refers to Britain and Northern Ireland combined.

Table 1 Ireland's Merchandise Trade Dependency on the UK, 1970-1994

Year	Imports % from UK	Exports % to UK	Trade Ratio*
1970	53	66	60
1975	49	54	52
1980	51	43	47
1985	43	33	38
1990	42	34	38
1992	42	32	37
1993	36	28	32
1994 (p)	36	27	31

*Irish Banking Review, Spring 1994. * Exports to UK plus imports from UK as a per cent of total exports and imports*

We therefore know that trade dependence on the UK has declined, but doubts remain as to its precise absolute level. Perhaps this is most clearly demonstrated by the downward move for 1993 and 1994. On the face of it, the data suggests that both the proportion of Irish exports going to the UK and the proportion of Irish imports sourced there fell substantially in 1993. It must be remembered, however, that 1993 was the first year of the new system of collecting trade data which resulted from the

abolition of customs posts under the Single European Act. Whereas prior to 1993, intra-EU trade data was based on customs documentation, the abolition of this paperwork necessitated the introduction of a new survey-based method of collecting trade data, (Intrastat).

Initial results from the Intrastat have shown substantial differences in the country of origin/destination breakdown of the trade of many European countries. In Ireland, for example, while exports to Great Britain are shown to have increased by some 11 per cent, exports to Northern Ireland would appear to have fallen by some 14 per cent. Of course, it seems likely that the most of this change is accounted for by goods going through Northern Ireland to Great Britain (via Larne or the Belfast airports), which had previously been recorded as simply exports to the North. So the downward 'blip' in trade dependence which occurred in 1993, seems likely to be the result of a once-off statistical change, rather than any major real alteration in trade patterns.

Product Breakdown of Irish-UK Trade

Table 2 shows the proportion of Irish merchandise exports going to the UK in 1994, broken down by SITC section. Even at this level of aggregation, there is considerable variance in the proportion of exports destined for the UK. For example, over 80 per cent of animal and vegetable oil exports went to the UK in 1994, as against less than 15 per cent for Chemicals.

Table 2 Irish Exports to the UK, by SITC Sector, 1994

Section	Description	Percent*
0	Food and Live Animals	35.3
1	Beverages and Tobacco	32.0
2	Crude Materials	35.1
3	Mineral Fuels	57.8
4	Animal & Veg. Oils	81.3
5	Chemicals	14.6
6	Manufactured goods by material	39.2
7	Machinery & transport equipment	25.9
8	Misc.. manufactures (nes)	30.7

*Source: CSO. * Proportion of total section exports.*

This variance in export dependence on the UK is even greater at lower levels of aggregation. Table 3 shows the proportion of Irish exports destined for the UK in 1994 for a selection of two-digit SITC divisions within the manufacturing sector. This data tends to confirm the generally held view that it is traditional, low-tech, indigenously owned firms whose exports are most heavily concentrated on UK markets. In contrast, the high-tech, modern, foreign-owned sector is much less

dependent on UK markets. So, for example, the high UK dependence sectors shown in Table 3 include furniture and paper, whereas the computer and electrical engineering sectors exhibit low levels of dependence on the UK market.

Table 3 Irish Exports to the UK, Selected SITC Divisions, 1994

Division	Description	Proportion of Exports
<i>Low Dependence Products</i>		
62	Rubber manufactures (nes)	12.1
75	Office & Data Proc. Equip	26.7
77	Electrical machinery	20.9
87	Professional, Scientific Apparatus	14.7
<i>High Dependence Products</i>		
63	Cork & Wood (excl. furniture)	65.4
64	Paper	80.9
78	Road Vehicles	54.1
81	Prefab Buildings, fixtures & fittings	66.8
82	Furniture	65.7

Source: CSO

The effect of this pattern within the disaggregated data is to increase concerns as to the quantity of employment which is dependent on exports to the UK. We know that these low-tech, traditional sectors are much more labour intensive than in the modern sectors. It follows therefore, that behind our trade ratio of some 30 per cent lies a much greater level of employment dependence than the data initially might suggest.

Table 3 also draws attention to the nature of the “diversification” of Irish exports away from the UK. This is very much a reflection of the role of newer European-oriented foreign-owned firms, rather than any large-scale diversification by the stock of indigenous Irish manufacturers.

UK Trade Dependence by Company Type

Table 4 shows dependence on the UK export market by company type. This is based on ABT’s annual survey of exporters. The table shows two categories of company: “targeted companies” are companies who form the core would have an “economic “ location in Ireland. They are mainly, but not exclusively, Irish owned. “Other companies” refers to ABT client companies who are not in this category.

Table 4 Exports to UK as % of Total Exports by ABT Company Type, 1993

ABT Department	Targeted Companies ¹	Other Companies ²
Consumer	44	37
Engineering	31	24
Food	41	45
Industrial	50	25
International Services	37	30
Total	40	33

Source: *ABT Annual Survey of Exporters*. ¹ Companies with marketing decisions based in Ireland. ² All other companies.

As can be seen, UK trade dependence is higher among the “targeted” than among the “other” across most sectoral groups.

3. STERLING DEPENDENCE OF IRISH TRADE

Analysis of Irish Trade by Currency

Based on ABT surveys, in terms of export values 85 per cent of Irish exports are quoted in foreign currencies⁴. This is shown in Table 5. There is little overall difference between large firms and SMEs.

Table 5 Value of Exports Quoted in Foreign Currencies as a Proportion of Total Export Value

Sector	Large Firms	SMEs	All	N
	%	%	%	
Consumer Products	77.0	90.5	80.2	145
Food and Drink	87.9	96.0	88.7	72
Industrial/Electronic	94.8	84.1	92.3	118
Chemicals	97.2	82.6	96.1	29
Engineering	53.7	75.0	67.2	130
Other	76.7	91.0	77.0	74
All	85.4	82.7	85.0	568

Source: *Based on ABT Surveys*

Table 6 presents the results broken down between “all firms”, “large firms” and “SMEs”. The Dollar emerges as the principal export currency, with a share of just over 31 per cent, while Sterling is next in line at almost 26 per cent. The Deutschmark is used for only twelve per cent of exports while the Punt and other currencies have similar usage level at around 15 per cent respectively. These figures

point to the potential to increase the usage of the Deutschmark as an export currency both within the EU and also with the countries of central and eastern Europe.

Table 6 Percentage share of Total Export Value denominated in various currencies

Currency	Cons. Prods	Food & Drink	Indust. Electronic Prods	Chemicals	Engineering	Other	All
All Firms							
Sterling	40.8	32.6	16.5	12.0	22.5	21.4	25.6
Dollar	15.4	26.9	45.9	61.7	16.2	26.8	31.7
Deutschmark	11.3	13.5	11.0	8.5	15.0	12.9	12.4
Punt	19.8	11.3	7.7	3.9	39.1	23.0	15.0
Other	12.7	15.7	18.9	13.9	7.2	15.9	15.3
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0
N	145	72	118	29	130	74	568
Large Firms							
Sterling	40.2	30.5	13.3	10.7	13.1	21.4	23.8
Dollar	12.8	29.5	52.9	65.5	13.0	27.0	34.4
Deutschmark	11.3	13.7	11.6	6.3	12.2	13.1	12.3
Punt	23.0	12.1	5.2	2.8	46.3	23.3	14.6
Other	12.7	14.1	17.0	14.7	15.4	15.2	14.9
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0
N	23	45	25	16	11	44	164
SMEs							
Sterling	42.7	51.5	27.1	27.6	27.9	22.0	34.8
Dollar	23.9	3.8	22.8	16.6	18.0	16.2	17.4
Deutschmark	11.3	11.3	9.1	33.1	17.7	1.2	12.8
Punt	9.5	4.0	15.9	17.4	34.9	9.0	17.4
Other	12.6	29.4	25.2	5.3	1.5	51.6	17.6
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0
N	122	27	93	13	119	30	404

Source: ABT Surveys

The level of dependence on particular currencies varies across sectors. The consumer products sector is heavily dependent on Sterling which accounts for almost 41 per cent of its export value, as is the food and drink sector. This is shown in Table 7.

Within sectors use of individual foreign currencies differs among SMEs and large firms. Table 7 makes it clear that SMEs are most dependent upon Sterling while the

Dollar is the principal currency for large firms. For SMEs both the food and drink and consumer products sectors are the sectors most dependent on Sterling.

Role of Sterling in Irish Trade

Table 7 Value of Exports Quoted in Sterling as a Proportion of Total Exports

Sector	0	1-30	30-60	60-100	Total	N
	%	%	%	%	%	
All Firms						
Consumer Products	27.6	19.3	13.8	39.3	100.0	145
Food & Drink	19.4	26.4	16.7	37.5 ¹	100.0	72
Industrial/Electronic	26.3	38.1	11.9	23.7	100.0	118
Chemicals	31.0	37.9	17.2	13.8	100.0	29
Engineering	26.9	20.8	16.1	36.2 ²	100.0	130
Other	45.9	31.1	6.8	16.2	100.0	74
Total	28.7	26.9	13.6	30.8	100.0	568
Large Firms						
Consumer Products	43.5	17.4	26.0	13.0	100.0	23
Food & Drink	17.8	31.1	19.9	31.0 ³	100.0	45
Industrial/Electronic	28.0	64.0	8.0	0.0	100.0	25
Chemicals	31.3	37.6	12.5	18.8	100.0	16
Engineering	45.5	18.1	9.1	27.3 ⁴	100.0	11
Other	36.4	38.6	9.1	15.8	100.0	44
Total	31.1	36.0	14.6	18.3	100.0	164
SMEs						
Consumer Products	24.6	19.7	11.4	44.3 ⁵	100.0	122
Food & Drink	22.0	18.5	11.1	48.1 ⁶	100.0	27
Industrial/Electronic	25.8	31.2	12.9	30.2	100.0	93
Chemicals	30.8	38.5	23.1	7.7	100.0	13
Engineering	25.2	21.0	16.8	37.0 ⁷	100.0	119
Other	60.0	19.9	3.3	16.6	100.0	30
Total	27.7	23.3	13.3	35.9	100.0	404

Source: ABT Surveys. The following percentages of firms have sterling proportions over 90%: ¹ 26.3%, ² 25.4%, ³ 24.4%, ⁴ 9.1%, ⁵ 20.5%, ⁶ 29.6%, ⁷ 26.9%.

Table 7 measures dependence on Sterling of the three categories of firms in the surveys. For “all firms”, the proportion of firms with no Sterling dependence is almost 29 per cent. The food and drink sector in particular has a low proportion of firms with no Sterling dependence.

The sectoral analysis identified the consumer products and food and drink sectors as having high overall Sterling dependence. These two sectors also have a large proportion of firms for whom the Sterling proportion of exports is greater than sixty

per cent. The analysis, however, also shows that the engineering sector which did not have a particularly high level of dependence, when measured at sectoral level, contains a sizeable minority of firms with high dependence levels. Indeed, one quarter of firms in the engineering sectors and in the food and drink sector have dependence levels greater than 90 per cent of export value.

Table 7 also illustrates that while there is no difference between large firms and SMEs in terms of the proportion of firms with no Sterling dependence, SMEs are more likely to have high levels of dependence. Over one-third of SMEs have a dependence which is greater than 60 per cent. The implications of this high level of dependence on Sterling are the subject of Section 4.

4. VULNERABILITY OF STERLING DEPENDENT FIRMS

Nature of Foreign Exchange Exposure

The implications of foreign exchange exposure for firms fall into three categories: “transaction”, “translation” and “economic”. “Transaction exposure” occurs when both exports and imports are quoted in a currency other than the local currency in which firms normally transact. For example, a firm based in Ireland which has a contract to receive or pay an amount in a currency other than the Irish Punt, and where there is a risk that the value of the foreign currency may change against the Irish Punt before the contract is fulfilled, is said to face transaction exposure.

“Translation exposure” occurs when financial data denominated in one currency are expressed in terms of another. Where there is the possibility of the conversion of an asset or liability denominated in a foreign currency into domestic currency then the exposure is classified as transaction as opposed to translation. An example of translation exposure would be the risk of balance sheet profit and losses arising from overseas assets, where there is no disposal intention.

“Economic exposure” occurs when a firm’s future turnover and market share are affected by exchange rate volatility. The extent of economic exposure is affected by the supply and demand elasticities for goods produced by the firm.

Currency exposure can also be considered on a gross or net basis. For example, in the case of transaction exposures relating to trade, a firm may have a foreign currency receivable in respect of exports which is offset by a foreign currency payable in respect of imports. The company’s net exposure may be zero if foreign currency receivables and payables are of the same magnitude and fall due on the same date.

Profitability of Sterling Dependent Companies

Irish firms exporting in Sterling fall into two categories when the Punt appreciates relative to Sterling. Those who face a low price elasticity of demand may have freedom of movement to increase their Sterling prices without experiencing a major loss in market share. Other firms, including the vast majority of Irish SMEs, are likely to have less control over their market price, i.e. their product is price elastic or at the extreme they are price takers. Such firms will be forced to quote an unchanged Sterling price, thereby experiencing a reduction in their export revenue in Punt terms.

The exposure of these SMEs can be gauged by considering the impact on their profitability of a once-off appreciation of the Punt against Sterling. The analysis is based on total exports to the United Kingdom rather than narrower Sterling denominated exports. This is because Punt denominated exports to the UK will be put at risk as well as those denominated in Sterling.

The results are derived from an analysis of ABT's SME survey. Two scenarios were developed (a) a one per cent and (b) a five per cent appreciation of the Punt vis-à-vis Sterling for a twelve month duration. In each case, the assumption is that firms would have to maintain their Sterling prices and suffer an equivalent decline in their UK export revenue.

The results are illustrated in Table 8. They indicate that due to the low profitability and high UK dependence of the firms surveyed, even a one per cent appreciation of the Punt will have a very significant impact on profitability. There is a dramatic increase in the number of firms which can be classified as having low profitability, rising from just over twenty per cent to almost 85 per cent.

Many firms will of course be in a position to avoid such losses of profitability through market diversification, cost reductions and other strategies. Nevertheless, the results indicate the severity of the potential exposures which face SME firms in Ireland in the event of a strong Punt/Sterling exchange rate.

Table 8 Impact of Punt Appreciation vis-à-vis Sterling on SME Before-Tax Profitability¹ (cumulative percent of Firms)

Profit level (£000s)	Profitability before	Profitability after (Scenario A)	Profitability after (Scenario B)
Less than			
0	20.1	84.8	90.9
50	41.5	87.2	92.1
100	55.5	90.9	94.5
150	62.8	92.7	95.7
200	71.3	93.3	96.3
300	76.8	94.5	97.0
400	80.5	94.5	97.0
500	83.5	94.7	97.6
Total	100.0	100.0	100.0

¹ See text for explanation.

Extent of Sterling Exposure of Companies

Table 9 examines Sterling denominated exports as a proportion of the total turnover of firms. The results clearly show that on this basis there is widespread exposure to Sterling. Just over 71 per cent of firms surveyed had some degree of Sterling exposure. Over one quarter of firms have a Sterling export/turnover ratio which is above 30 per cent, illustrating that fluctuations in Sterling have the potential to impact very significantly on the profitability of a large number of firms.

The exposure of SMEs to Sterling fluctuations is relatively severe. While exposure is widespread across all sectors, firms in the food and drink, consumer products and engineering sectors are particularly exposed.

With the exception of firms in the consumer products sector, large firms have a more diverse pattern of currency use than their SME counterparts. This reduces vulnerability to fluctuations in Sterling. This can be seen from the fact that, on average, only 14 per cent of large firms surveyed have a Sterling export/turnover ratio in excess of 30 per cent.

Table 10 shows the proportion of total employment in those firms surveyed with “high” Sterling exposure, i.e. in excess of 30 per cent. Employment in such firms accounts for almost 17 per cent of total employment. When SMEs alone are considered, the proportion of employment in high risk firms rises to 27 per cent.

**Table 9 Sterling Quoted Exports as a Percentage of Turnover
(% of Firms having a Sterling/Turnover ratio as indicated)**

Sector	0%	1-30%	30+%	Total	N
All Firms					
Consumer Products	29.5	38.8	31.8	100.0	129
Food and Drink	17.4	59.4	23.2	100.0	69
Industrial/Electronics	23.6	53.8	22.6	100.0	106
Chemicals	31.0	51.7	17.2	100.0	29
Engineering	26.5	41.0	32.5	100.0	117
Other	45.8	41.7	12.5	100.0	72
All	28.4	46.2	25.4	100.0	522
Large Firms					
Consumer Products	43.5	34.7	21.8	100.0	23
Food and Drink	17.8	66.6	15.6	100.0	45
Industrial/Electronic	28.0	64.0	8.0	100.0	25
Chemicals	31.3	56.3	12.4	100.0	16
Engineering	45.5	36.3	18.2	100.0	11
Other	36.4	52.3	11.3	100.0	44
All	31.1	54.9	14.0	100.0	164
SMEs					
Consumer Products	26.4	39.6	34.0	100.0	106
Food and Drink	16.7	45.8	37.5	100.0	24
Industrial/Electronic	22.2	50.5	27.3	100.0	81
Chemicals	30.8	46.2	23.0	100.0	13
Engineering	24.5	41.5	34.0	100.0	106
Other	60.7	25.1	14.2	100.0	28
All	27.1	42.1	30.8	100.0	358

Source: ABT Surveys

Companies' Management of Foreign Exchange Risk

Given the risk to profitability posed by Sterling exposure, there are considerable potential benefits for firms adopting currency-risk management techniques. Such techniques include the netting of foreign receipts and payments, the maintenance of a foreign currency bank account, and the forward buying and selling of currency. Accordingly we attempt below to estimate the extent to which Irish SMEs adopt these strategies.

Netting of Foreign Receipts and Payments

This is an internal technique which firms can adopt to manage exchange risk. The capacity of a firm to adopt this technique is dependent upon the timing and balance of receipts and payments in particular currencies. The SME survey obtained data on

the value of foreign currency receipts and payments in Punt equivalents. The nearer the level of foreign currency receipts and payments which a firm has, the more likely it is that a netting of foreign currency transactions can take place. Over half of the SMEs surveyed indicated that they had neither foreign currency payments nor receipts.

Table 10 Employment and Sterling Exposure (Percentage of Firms having a Sterling Export/Turnover Ratio as indicated)

Sector	0%	1-30%	30+%	Total	N
All Firms					
Consumer Products	16.9	40.5	42.6	100.0	129
Food and Drink	12.8	70.2	17.0	100.0	67
Industrial Electronics	31.7	54.6	13.7	100.0	134
Chemicals	31.9	51.9	16.1	100.0	29
Engineering	43.6	37.0	19.4	100.0	121
Other	17.0	77.6	5.4	100.0	68
All	20.9	61.8	17.3	100.0	522
Large Firms					
Consumer Products	20.2	33.6	46.2	100.0	23
Food and Drink	12.8	66.5	20.7	100.0	45
Industrial Electronics	37.1	50.5	12.4	100.0	25
Chemicals	35.2	46.6	18.2	100.0	16
Engineering	55.4	40.8	3.8	100.0	11
Other	15.8	66.9	17.2	100.0	44
All	20.2	65.0	14.8	100.0	164
SMEs					
Consumer Products	9.5	55.8	34.7	100.0	106
Food and Drink	13.2	67.0	19.8	100.0	24
Industrial Electronics	23.6	51.2	25.2	100.0	81
Chemicals	15.0	33.5	51.5	100.0	13
Engineering	37.4	35.0	27.6	100.0	106
Other	43.0	54.0	3.0	100.0	28
All	23.5	49.5	27.0	100.0	358

Source: ABT Surveys

In Table 11 foreign currency is expressed as a proportion of receipts for firms which have both payments and receipts. The relatively low level of matching between the value of foreign currency receipts and payments is illustrated by the fact that one third of SMEs have receipts three times in excess of the level of their payments, while only 10 per cent have receipts and payments within 25 per cent of each other.

Table 11 Ratio of Receipts to Payments for Firms having both Receipts and Payments

Ratio of Receipts to Payments	% of SMEs
< 0.25	7.4
< 0.25 < 0.50	4.9
> 0.50 < 0.75	7.8
> 0.75 < 1.00	2.8
> 1.00 < 1.25	7.1
> 1.25 < 1.50	8.8
> 1.50 < 2.00	11.7
> 2.00 < 3.00	16.3
> 3.00 < 4.00	8.1
> 4.00 < 5.00	5.3
> 5.00	19.8

Source: ABT Survey. N=283.

Maintenance of a Foreign Currency Bank Account

For firms with substantial receipts and payments enumerated in foreign currencies, a foreign currency bank account can be used to hold foreign currency receivables to offset against subsequent foreign currency payments.

Table 12 Percentage of Firms Maintaining Foreign Currency Bank Accounts: SMEs

Sector	Irish Owned		Foreign Owned		All	
	%	N	%	N	%	N
Consumer Product	56.3	103	71.4	14	58.1	117
Food and Drink	84.2	19	71.4	7	80.8	26
Industrial/Electronic	67.7	62	79.2	24	70.9	86
Chemicals	50.0	8	80.0	5	61.5	13
Engineering	67.5	80	69.7	33	68.1	113
Other	40.7	27	-*	1	39.3	28
All	61.9	299	72.6	84	64.2	383

*Source: ABT Survey. * Only one firm in sample.*

Table 12 indicates that almost two-thirds of all SMEs surveyed maintain foreign currency bank accounts, with foreign-owned SMEs more likely to do so than their Irish counterparts. Sectorally, firms in the food and drink sector are more likely to hold such an account.

Buying and Selling Forward

Over 56 per cent of SMEs surveyed do not engage in forward buying or selling of currency. Table 13 indicates the behaviour of firms in this regard. Approximately one fifth of firms engage in both activities. Firms in the chemicals and the food and drink sectors are more active than other sectors in terms of both activities.

Table 13 Forward Purchasing and Selling Behaviour: SMEs

Sector	Sell only	Purchase only	Purchase and sell	Neither	Total	N
	%	%	%	%	%	
Consumer Products	4.3	20.9	20.9	53.9	100.0	115
Food and Drink	15.4	15.3	34.6	34.6	100.0	26
Industrial/Electronics	11.8	11.8	18.8	57.6	100.0	85
Chemicals	25.0	16.7	33.3	25.0	100.0	12
Engineering	7.1	17.9	17.0	58.0	100.0	112
Other	3.6	3.6	0.0	92.9	100.0	28
All	8.2	16.1	19.0	56.6	100.0	378

Source: ABT Survey

5. CONCLUSIONS

In the context of moves towards EMU, probably an EMU initially without Sterling, the research outlined in Sections 2-4 above show a number of important things. First, the UK is still a very important trade partner for Ireland. Furthermore, the post-1973 decline in its importance may have now bottomed out. Second, and related to this, Sterling is still a very important trade currency. Reflecting trade patterns, it is especially so for smaller indigenous companies in traditional sectors. These companies are likely to face low profit margins and relatively price elastic demands, and so are very vulnerable to Sterling depreciations. Third, and perhaps most worrying, is the finding that many Irish firms do not use even relatively simple currency management techniques.

As I said at the outset, it is not my intention to stray into the area of exchange rate policy. Those of us concerned with the practicalities of foreign trade should accept that exchange rate risk is a fact of life, and get on with the business of dealing with it. Government cannot be expected to insulate us for ever. This is true of both the everyday exchange-rate fluctuations, as well as more dramatic changes such as that which occurred during the currency crisis, or which might occur in the event of EMU. I am also not straying into the wider macro-economic issues of the overall competitiveness of the Irish economy, although fully recognising the importance of these in an EMU context⁵.

Within this general context, however, there is much that can be done to improve the position of Irish business in the event of an EMU scenario where the UK remains outside.

Firstly, it can be argued that “good currency risk management and good business management are synonymous”. In other words, firms that are most exposed to adverse currency movements must ensure that their long-term competitiveness and profitability are such that exchange-rate changes do not trigger a corporate financial crisis. This calls for sound commercial practice in all areas of the organisation.

Secondly, all companies involved in foreign exchange transactions, but most especially exporters, should review their exposure to currency fluctuations, and their techniques and procedures for dealing with further dramatic exchange rate change. Of major significance is the role of training for key financial managers and staff in financial/management and treasury techniques.

Thirdly, companies should ensure that they have access to competent independent advice on foreign currency matters. Where the company already employs outside financial advisors, such as an auditor, it is important that these advisors should be able to provide guidance and support on currency management matters. Moreover, firms should encourage their trade and representative associations to take an active interest in currency matters and to provide information and advisory services in this respect. There is also a role for the negotiation of favourable group purchase terms for the currency services of financial institutions.

Of course, for these recommendations to have any effect there must also be action on the part of institutions, organisations and agencies. Firstly, the accounting and auditing profession must ensure that its members are in a position to provide firms with the range of knowledge and advice that they need. For accountants in both small and large practices, greater awareness and knowledge of currency matters is required.

Secondly, the financial institutions should review their policies and practices in this area, in particular the services they provide at branch or regional level to small customers. For example, it may be possible that financial institutions examine current practice regarding the effect of hedging on credit limits, the provision of more specialised services to appropriate smaller customers (possibly at a group price), the level of awareness and expertise among staff at branch and regional level, and the manner in which internal structures affect the delivery of services/advice to customers (e.g. whether and how the customer will be referred to specialist central services). Moreover, the financial institutions should take positive steps to evaluate clients’ treasury management competence, to encourage good practice and to develop new and improved services as a result.

Finally, the government agencies also have a role to play. An annual audit and review of Ireland's international competitiveness would be a positive step, with appropriate mechanisms being put in place to support this effort. Agency initiatives with respect to currency risk management should be targeted at those companies most at risk. These are the small, indigenous, low-profit, labour-intensive firms who are essentially price-takers in Sterling markets and who use primarily local inputs. The clothing industry is a case in point.

Agencies must also develop greater awareness of the problems of currency risk management and include them in their procedures. Hence Corporate plans being examined with a view to the provision of agency support should be scrutinised from a foreign exchange risk management perspective. Moreover, the agencies must take on the role of developing general awareness of the importance of foreign exchange risk management. This will involve training and promotion activities, which could be run in conjunction with groups such as the Irish Exporters Association, the Chambers of Commerce and the Irish Association of Corporate Treasurers.

If steps such as these are taken, then in the event of the UK staying out, Ireland's entry to EMU will be much less traumatic. Of course, there will still be companies and sectors who will experience serious problems—a fact which will have to be taken into account in policy formulation. The recommendations outlined above will if followed through soften the consequences of Irish entry to EMU without Britain for exporting companies.

Footnotes

1. The group consisted of representatives of the Departments of Tourism and Trade and of Enterprise and Employment, the National Treasury Management Agency (NTMA), Irish Dairy Board, Irish Association of Corporate Treasurers (IACT), Forfas, Irish Exporters Association (IEA), and An Bord Trachtala (ABT). The Secretariat was provided by ABT.
2. This fund provided temporary support to firms during the currency crisis.
3. On wider issues see, for example, D de Buitelir, *Fiscal Implication of EMU*, Institute of European Affairs, 1995, and Maurice F Doyle, "From EMS to EMU: *Central Bank Quarterly Bulletin*, Winter 1992.
4. For an earlier analysis see R Mottiar and L O'Reilly, "Trade Credit and Distribution of Currencies in Irish External Trade", *Central Bank of Ireland Quarterly Bulletin*, Summer 1981.
5. On this see, for example, Tony Kilduff (IBEC Vice-Chairman), Scenarios for the Single Currency and EMU: The European and Irish Perspectives, ICEM Conference, 21st June 1995.

DISCUSSION

Colum MacDonnell: Mr. Chairman, Ladies and Gentlemen, my task is to propose a vote of thanks to Séamus Bannon and to offer some thoughts on his excellent paper.

1. First of all, I think we should recognise that our economy, like Caesar's Gaul can be divided into three parts:
 - Imported industry, mainly medium to high technology, highly export oriented, highly organised in terms of currency questions (a lot of whose dealings are in US \$) producing 50 per cent of our exports, which will probably welcome EMU. In fact as a sector it may grow as EMU will have an appeal from outside the EU and will encourage more inward investment so the existing companies will grow in Ireland while new investors from outside will increase the size of the sector.
 - Native industry consisting of well-managed PLCs and perhaps less well - managed SMEs. Both are fairly heavy into the UK. The SMEs are providing a lot of jobs but are vulnerable to market and currency fluctuations. In a single currency situation they have nowhere to hide and they will also have great concerns about sterling if it stays out.
 - The third category is the so-called sheltered sector (but becoming less so) - the public sector, including state monopolies. Deregulation may affect many in this category more than EMU. This sector definitely impacts on the SMEs in terms of taxes and charges for services.
2. Séamus Bannon's paper proves conclusively that dependence on sterling represents a serious degree of exposure for Irish SMEs. (One interesting aside from the presentation showing the declining share of our exports taken by the UK is the almost parallel decline of Britain's share of our total imports. The price of these imports has declined for currency reasons so one would assume they would supply us more not less and therefore their share of our import bill would increase. Perhaps someone present has an explanation?)

The irony appears to be that Irish companies with low profitability who suffer tremendous disimprovement if the Irish pound appreciates against sterling, as shown in one of Séamus Bannon's tables, are the ones least able to sustain this drop in profitability. They are also the ones least likely to take shock absorbing measures.

A further irony is introduced by the Government operating a policy which makes it difficult if not impossible for an exporter to obtain the Irish Trade Board's package of financial assistance for market development in the UK. This is not

declared Government policy and the manner of its implementation seems completely undemocratic. On the other hand, UK suppliers to Ireland can avail of the various DTI¹ schemes. In an interesting double think about Northern Ireland - is it an export market or not? - we have never grant / aided exporters to develop markets there.

3. For an exporter to the UK the value of sterling is the single most important factor in that exporter's life - being three times as important, on average, as any of the main production factors and that is why it is such a major issue for some exporters.

Séamus Bannon points out that many of our suppliers are in a price sensitive situation and so cannot vary their prices. But this price question is not an absolute - we have to look at the competitive situation vis-à-vis other suppliers to the market.

Our most immediate competitors are UK suppliers who have lower wages, lower payroll taxes, lower telephone costs and postal charges and lower transport costs. So the whole cocktail gets to a stage where the Irish exporter votes with his feet in one of two ways: (a) by sourcing more components in sterling, or (b) by moving the operation entirely to Northern Ireland or Wales or some other part of the UK. This has actually been happening.

Government must face its responsibility in relation to these taxes and charges. Exporters, unlike the State monopolies do not have any derogation which cushions them against the full blast of competition. They have for years had to live with uncompetitive monopoly services provided by the State and look with dismay at the huge settlements it will cost to deal with ESB overmanning and which will undoubtedly arise in the case of Telecom Éireann - legacies of weak management, fuzzy political ideologies and truculent public sector trade unions, according to most media comment.

4. The question about the UK's entering EMU is important. For an insight into the British position, one of the more interesting papers I have read was given by David Howell M.P. chairman of the House of Commons Foreign Affairs Select Committee.

Mr. Howell argues that for Britain, the trade and export figures are very far from providing the whole picture. Far better measures would be the sales and profits of top companies and the location of Britain's enormous overseas assets. On this basis the European market accounts for 16 per cent of the sales and 13 per cent of pre-tax profits of Britain's top 100 companies. Recent analysis of British direct investment shows 21 per cent going to the EU but 35 per cent to the USA and 22 per cent to the Commonwealth.

So there is an influential body of opinion in Britain taking a very cold look at EMU and its effects on UK interests.

Not surprisingly, perhaps, Mr. Howell says that narrow regional plans for creating a rigid currency zone should not allow Britain to be cut off from its much larger trade and investment interests. With the "European issue" properly corralled, as Mr. Howell puts it, the UK can spend more time with its richer, new friends who turn out to be - you've guessed it - their old Commonwealth friends! The Asian tigers have a great appetite for service intensive and information intensive "products" which the UK can supply.

All may not be lost however if, as seems at least possible, we find ourselves inside the tent with the British on the outside. The probability, according to Dr. Tietmeyer and others, is that we would have an EMS II. Sterling would shadow the Euro with a narrow margin of fluctuation and the possibility of a sudden downward movement of sterling would diminish.

5. Séamus Bannon's paper also - perhaps not deliberately as his theme is the sterling effect - provokes a question about the bigger picture - the whole export performance.

Trade Minister Enda Kenny, at a recent press conference, revealed a facet of our elusive² trade policy when he said that Government's aim was to reduce our export dependence on the UK by 2 per cent per annum. The presumption here is that things are going so well in Europe we can afford to ditch the old colonial master? But are they? Figures for the foreign owned sector are fine (if we ignore the balance of payments movements which show that at least 80 per cent of our trade surplus flows out as repatriated profits to foreign owners which appears as factor income in the balance of payments).

Looking at the Irish owned sector we see that, according to ABT surveys of 800 companies supplying Europe, 500 have annual sales there of less than £500,000. This is hardly a good basis for decrying our heavy trading relationship with the UK. Our dependence on our near neighbour (27 per cent) is not startling if we consider Denmark's or Austria's export dependence on Germany (23 per cent and 39 per cent respectively) or Australia's on Japan (25 per cent). All these countries have export volumes similar to Ireland's.

Rather than lament our dependence on one of the world's major markets we should exploit the opportunities there by getting the maximum number of exporters professionally set up with their own sales organisation on the ground - seek to sell them more, not less, and use this market as a springboard to the wider world.

6. In relation to the latter, there are certain actions we need to take including representation in the markets, development of products for markets and an attitudinal change - we need to see ourselves as within the Single Market rather than as an offshore trader. The moment calls for a paradigm shift.
7. In summary, I believe we are only, as Pinafore's Captain said, in a "reasonable state of health" but our politicians are being wafted along on their own hot air vectors ignoring the hard facts that we are amongst the lowest in the world in investment in product development, one of the lowest in the European league of manufacturing investment; our cost base is relatively high, we have very low European language skills - we are ranked third highest in Europe's export dependency league but only twelfth in the linguistics league. Many of our training schemes have been criticised as a waste of time and money.
8. All of these problems could be addressed in a situation of honest dialogue with Government but this seems to be extremely difficult to achieve. For some time we have been promoting the idea of an Export Council where we could thrash out questions of trade policy, trade promotion and competitiveness of our exports. The aim would be a more efficient arrangement between private and public endeavour. It has become more urgent with the creation of new agencies like An Bord Bia. It would also dovetail with the recent Foreign Policy document which makes the point that the Foreign Earnings Committee chaired by the Trade Minister is there to co-ordinate the promotional efforts of the State - how much better if they could include the trading community as well?
9. The Chinese have a saying that the bearer of bad news needs a fast steed and I recognize that even here the messenger is likely to get shot. None of us is immune however - the President of the Bundesbank Dr. Tietmeyer showed both wit and wisdom when he quoted Oscar Wilde in his recent address in Dublin - "please don't shoot the pianist, he's doing his best".
10. It is a great honour to be asked to respond at a meeting of this distinguished Society and I am delighted to propose a vote of thanks to Mr. Séamus Bannon for his very clear and stimulating presentation.

Footnotes

1. UK Department of Trade and Industry.
2. As it has never been articulated.

John Fitzgerald: This paper provides extremely useful information in developing our understanding of the problems and possibilities which EMU poses for the Irish economy. As such, its presentation at the Society is extremely timely. In seconding the vote of thanks I would like first to make a number of general points and then to offer some comments and questions on the paper.

The decision on whether or not we participate in EMU should not be based on short-term considerations. It should be seen as part of a long-term strategy and care must be taken that we are not unduly influenced by to-day's opportunities or problems.

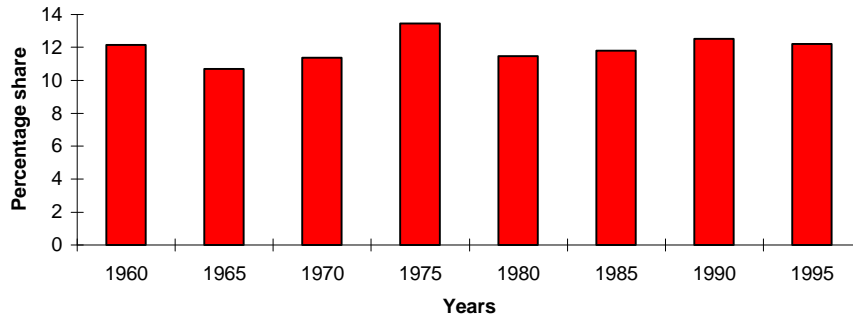
EMU will represent a regime change and, as a result, many of our well understood economic relationships may prove unreliable. Firms and households in Ireland, in the rest of the EMU and in the UK if they do not join, may all change their behaviour in the face of the new circumstances. The response of prices and wages which were apparent in analysis of historical data may prove an unreliable guide to the future.

There are a range of different channels through which EMU would affect Ireland among which are: effects on interest rates; reduced transactions costs; changes in the risks facing business; competitiveness effects. This paper concentrates on a crucial set of data relating to the potential competitiveness effects of EMU and it is this issue which I will concentrate on.

In considering our exposure to the UK in Table I the reduction in the proportion of our trade with the UK over time is documented. However, if one considers our exports to the UK as a proportion of gross output of the Irish economy (proxied as GNP plus imports) our exposure to the UK economy has remained roughly unchanged over the last 35 years (Figure 1); while the share of exports going to the UK has fallen the share of exports in GNP has risen.

Much attention is being paid to the possible implications for Ireland if we join EMU and the UK remains out; how will this affect our competitiveness. There is considerable evidence that in the long run prices and wages in Ireland adjust so that purchasing power parity holds. However, while prices and wages may adjust in the long run, the long run could be so long that some firms could go under during the adjustment period. To determine whether this is a possibility one must consider the speed of adjustment of prices and wages, not only in Ireland but also in the UK. Much of the discussion in Ireland to date has ignored the fact that the UK economy, while much larger than our own, is also buffeted by shocks to the wider EU economy. When sterling falls prices and wages in the UK are eventually affected. The task for research is to consider the speed of response of prices in Ireland and the UK and how this might be influenced by a regime change.

Figure 1 Exports to UK as a percentage of GNP plus Imports, 1960-1995



In this paper, and in much of the wider discussion, attention has centred on the possibility that sterling will depreciate relative to the EURO. However, if, for example, the Saudi royal family were to fall out among themselves with the loss of Saudi oil, oil prices would rise very sharply. In turn this could result in a substantial appreciation of sterling. While this possibility may seem unlikely today, EMU will be for good, not just “a temporary little arrangement”, and we must consider all possibilities. A rise in sterling would probably have inflationary consequences for Ireland putting firms exposed to the EU market under pressure. We need a similar exercise to this paper looking at potential exposure on the wider EU market.

Because of our high exposure to imports the distribution sector will be crucial in determining the speed with which changes in prices and exchange rates pass through into domestic consumer prices and, as a result, into wages. It is important to examine both sides of our trade exposure.

The data in this paper are extremely useful. However, I would caution against placing reliance on the data in Table 8 which are based on the initial response of firms faced with a question from an interviewer. If they had been based on a scientific analysis of accounts one would find it much more useful.

The value of this paper would be further strengthened if details were provided on just how representative the sample of firms covered actually is. The issue of dollar competitiveness, raised by the author, is important and often forgotten. Much of our multinational sector sources its inputs in the US and prices its output in dollars and their success on EU markets depends on the competitiveness of the dollar exchange rate. Unlike much of the rest of Europe, for us a low dollar is good for business and the competitiveness of a significant portion of our industry.

The author refers to the importance of financial instruments, including treasury operations, as a means for laying off risks to competitiveness. His suggestions in this regard seem very interesting.

Finally can I congratulate the author on filling in one piece in an important jig-saw. What I have tried to do is to get some idea as to what kinds of pieces will be needed to complete the puzzle of competitiveness.

Tom O'Carroll: I welcome Séamus Bannon's paper which contains a lot of valuable and interesting information. I would like to make two observations:

First the paper implies that a sterling depreciation of modest proportions would have a very significant effect on indigenous companies' profits (Table 8). This does not sit well with experience of the last year when we have actually experienced a sterling depreciation of about 4 per cent. CSO data for the first 9 to 10 months of the year indicate that, using a rule of thumb for the classification of indigenous and multinational sectors, the indigenous sectors' output increased by about 7 per cent and employment by 3 per cent. In its Review of 1995, ABT estimate that aggregate exports of indigenous companies (as defined by ABT) increased by more than 10 per cent with exports to the UK increasing by about 6 per cent.

Admittedly, we do not have hard data on profits, but it would seem unlikely that firms would be increasing their employment in particular, if profits were under substantial downward pressure. In fact, over the past couple of weeks, a large number of Irish companies have reported a satisfactory profit performance in their Annual Reports for 1995 with their Irish operations doing well. This need not preclude market difficulties in the UK, but these would not seem to be of such a scale that would imply a substantial worsening of profits from UK sales. I wonder whether the results in Table 8 are influenced by the fact that, as I understand it, firms were surveyed in early 1993 and the results may reflect the very difficult circumstances of the preceding period.

A second observation I would make is that the paper notes that indigenous companies are essentially competing with UK firms in the UK market and are frequently, to all intents and purposes, price takers in that market. We in Ireland are sometimes inclined to think that life has been made easy for the UK manufacturing sector by the rather lax macro policies pursued over the years and especially by the softer exchange rate policy. In fact, I note in today's Financial Times (28 March 1996) that UK manufacturing output is currently a mere 1 per cent higher than it was in 1990 and employment is down by 850,000 since 1989. This is scarcely evidence of a thriving manufacturing sector strengthened by devaluation. It contrasts starkly with an increase of more than 20 per cent in the output of Ireland's manufacturing sector in 1995 alone (11 months data). What this seems to suggest is that, while competitive conditions for Irish firms may be tough in the UK, especially when

sterling is weak, UK manufacturing is also facing difficult competitive conditions. Evidently, a weak sterling exchange rate has not proved to be a boon to UK manufacturing,