

## **“Fiscal Policies, Devaluations and Exchange Rate Regimes”: A Comment**

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A characteristic of many small countries is their propensity to compare domestic performance with that of the outside world. The Irish are much given to this practice. Different comparators are taken depending on the nature of the problem and the mood and ideological preference of the writer. In discussions of Ireland's economic performance, a wide variety of countries has been chosen as critical benchmarks. Examples to emulate have included, as fashion dictates, Denmark (agriculture; co-operatives; indigenous industry), Sweden (full employment policies; incomes policies), Finland (industrial growth on the periphery), France (economic planning), Holland (an exemplar on everything), Germany (labour training), Austria (social consensus) and even the USA (success in generating jobs). The UK is a constant standard of comparison, sometimes challenging (privatisation, post-Thatcher industrial relations) and sometimes reassuring and exculpatory (low growth relative to EC).

This is the first time to my knowledge that a sustained comparison has been made between Greece and Ireland. Applying theoretical insights to his expert knowledge of the Greek economy and an admirably well-informed understanding of the Irish economy, Professor Alogoskoufis has provided a useful starting point to our discussions of adjustment policies. Both countries are members of the European Community, have relatively low incomes and serious fiscal problems. Ireland's record on fiscal reform is better than that of Greece in recent years but, and this proviso should not be underestimated, the Irish unemployment rate is nearly three times higher.

My comments relate to three aspects of the paper's analysis: (a) the lessons to be drawn from Ireland's second adjustment 1987-90, (b) the rôle of the 1986 "devaluation" and inflationary expectations and (c) the unemployment problem.

*Adjustment 1987-90 and Expansionary Fiscal Contraction (EFC)*

Alogoskoufis places strong emphasis on the second adjustment's primary focus on expenditure curbs as a means of restoring budgetary balance. Increases in tax revenues, of course, also helped but these arose in the context of tax *rate* reductions and a credible programme of continued tax reform.

The advantages of curbing expenditure are explained in terms of supply-side efficiency effects. Tax rate increases worsen the tax-wedge problem and discourage investment — two aspects of particular relevance to Ireland. The paper's analysis could be strengthened by adding that the tax increases in the early 1980s spawned a thriving tax avoidance and rent-seeking industry. High income taxes, moreover, encouraged perverse migration patterns by providing Ireland's relatively scarce skilled labour with an incentive to leave the country. Associated with this, high replacement ratios combined with a generous social welfare system gave its relatively abundant unskilled labour with an incentive to stay in Ireland.

In addition to setting the economy on a more efficient growth track, Ireland's second stabilisation, in Alogoskoufis' view, had a further and somewhat paradoxical effect: *it encouraged private sector growth:*

the second Irish stabilisation consolidated the public finances through credible reductions in government expenditure. This, and the associated tax reform, signalled that taxes in the future would be lower than otherwise and caused private consumption and, more importantly, private investment to increase. As a consequence there was no recession. (p. 231)

Irish critics of the EFC hypothesis have tended to work on the mistaken assumption that the expansionary effects apply only to consumers. Investment effects are also important and, as Geary points out elsewhere in this *Review*, the export/import sectors might also have been influenced. The need to explore EFC in terms of once-for-all threshold effects also bears repetition. Another feature of the second stabilisation might be added to those noted in the paper: the associated improvement in the public finances has proven resistant to the slowdown in the world economy and the UK recession. This further adds to the merits of an expenditure-curbing approach to adjustment.

*The Rôle of Devaluation*

The part played by the 1986 devaluation in creating a sound platform for recovery is emphasised by the paper. I agree with this analysis. The realignment had all the ingredients of success: the market was taken by surprise; there was no accompanying increase in the Irish inflation rate and no serious damage was done to the government's anti-inflation credibility.

The purpose of the 1986 devaluation, however, needs to be carefully assessed. It was to correct what the Central Bank called an "unwarranted appreciation" of the Irish pound rather than to steal a competitive march on our competitors in the classical textbook sense. The need for the realignment arose from the sudden weakening of sterling in mid-1986 which left Irish industry and the Irish labour market very vulnerable. Had no action been taken, the Irish pound would have broken the parity barrier and risen to £1.03 sterling by January 1987 — up from 0.78p in July 1985, a nominal appreciation of 32 per cent in the space of eighteen months. To maintain competitiveness against Britain, Irish wages and prices would have had to fall steeply in nominal terms, hardly a feasible prospect. The combination of a realistic exchange rate, domestic cost-reducing policy (e.g., wage agreements and deregulation), and rising inflation in the UK provided essential backing for a competitive traded sector.

This line of thinking has been pushed further by those who suggest that the realignment was responsible for the subsequent fall in domestic interest rates. But this surely is going too far. The Irish-German nominal interest rate differential only began to fall in 1987. Had it not been for the fiscal adjustment, the market would have judged the new exchange rate untenable, expectations of further devaluations would have been fuelled, with predictable consequences for Irish interest rates. More generally, it is a mistake to see fiscal adjustment and the improvement in Ireland's competitiveness as separate and distinct. The credibility of the post-1986 exchange rate and the sharp downward pressure on domestic wage and other costs during the second stabilisation were closely related to the change in fiscal policy. The promise of tax cuts and tough public expenditure control acted as a restraining force on the trade unions. Devaluation met the Alogoskoufis criterion of being combined with a "temporary" incomes policy: the consequent real devaluation represented a shock whose beneficial effects persisted. We come back again to the virtues of "stabilisation through cuts in expenditure".

Looking to the future, an important lesson is suggested by the paper's interpretation of Irish experience. Ireland will not be fully comfortable in a European Monetary Union which excludes a trading partner and associate labour market of the UK's significance. The economy's recent successes may have generated undue complacency about these dangers in my view.

### *Stabilisation and Unemployment*

Unemployment is brought into the picture in Section V. The paper's attribution of some of the increase of unemployment in the early 1980s to the effects of disinflation and delayed appreciation by the public of the anti-inflationary resolve of the authorities is quite justified. Hourly earnings in manufacturing measured in common currency rose by 14 per cent relative to our major trading partners between 1980 and 1986. Some OECD indicators show a real currency appreciation of over 20 per cent during the period. This loss in competitiveness was bound to have an adverse impact on the labour market. Unfortunately, the process of disinflation almost always has this effect in a country with Ireland's low degree of labour market flexibility.

But this is not the whole story. Other factors — external and internal shocks — were in operation, e.g., the collapse in UK manufacturing output and the adverse confidence effects of the first stabilisation 1981-84 (which is generally agreed to have been an instance of non-paradoxical contractionary fiscal contraction). As the 1980s wore on, inflationary expectations fell and "surprises" were fewer. In Alogoskoufis's view, labour market imperfections then took over as the explanation for Ireland's high unemployment. It is hard to find fault with this conclusion. Greece's success in restraining unemployment, despite its manifold problems of failed adjustment and persistent inflation, suggests that a comparison between labour market mechanisms in our two countries should be placed on the research agenda. Certainly, there is no shortage of imperfections and labour-hiring disincentives in the Irish labour market! In addition, Ireland is more exposed to international migration flows than Greece.

### *Concluding Comments*

A missing ingredient in the paper is consideration of the income distributional consequences of the Greek stabilisation programmes and whether these have had any bearing on the failure of the adjustment. Irish experience offers some hopeful signs in the sense that the second adjustment seems to have been effected with minimal regressive consequences (see Callan and Nolan in this *Review* for a carefully calibrated analysis and conclusion).

The discussion of macro stabilisation policy is particularly germane to the forthcoming Maastricht Treaty on European Union. The Treaty provides for the co-ordination of fiscal policy among member states. This means in turn that countries will eventually have to limit their deficits to 3 per cent of GDP (anything above that counts as "excessive"). Their public debt ratios will also be subject to surveillance and sanctions can be imposed if the standards are not met. Is the surrender of fiscal sovereignty implied by acceptance of these rules a serious matter? An onerous obligation? The consensus seems to be

that it is not. One suspects that the fiscal mismanagement of the last decade would dispose Irish (and also perhaps Greek?) citizens to welcome rather than dispute the value of these financially conservative constraints imposed from Brussels. The Irish government, though sensitive about its independence in other ways, has expressed no reservations about them to date.

One conclusion stands out from this paper: getting macro policy right does not solve all an economy's problems, but getting it wrong, as Greece and Ireland have done during the 1980s, can be enormously damaging.