THE IRISH POUND IN THE EMS

B. O'LOGHLEN
Commission of the European Communities

1. INTRODUCTION

On the 13th June 1980, the Central Bank of Ireland ended the transitional arrangement for the Irish pound in the EMS and allowed the pound to float up to the maximum permitted margins of the EMS. The pound is now in the same position as the other currencies in the system and is free to fluctuate over the full width of the EMS band (4½ per cent) and to reflect market pressures up to the agreed intervention limits. The abolition of the transitional arrangements and the establishment of the IR£ within the system on a comparable basis to the other members gives a useful opportunity to review some of the implications of the EMS for Ireland.

2. THE IMPLICATIONS OF THE EMS

The EMS was established in response to the exchange rate instability associated with floating exchange rates, particularly in the post oil-crisis period from 1974. The aim was to establish a zone of stable exchange rates in Europe with a view to allowing greater prospects of economic growth which would not lead to a deterioration in the rate of inflation. However, given the disparities that existed when the EMS was first proposed, it was immediately recognised that ultimate stability of exchange rates was a target to be aimed at rather than something which was immediately achievable. Exchange rate changes are not ruled out and indeed will be essential to the proper working of the system. On the other hand, a degree of immediate exchange rate stability was considered necessary if a more stable monetary environment was to be created in the Community.

The exact balance between stability and change in exchange rates has not been defined or is indeed not really defineable. Hence, the members of the EMS still have a certain choice in the extent to which they use the various instruments of economic policy, including the exchange rate, albeit within the context of the ultimate aims of the EMS and of the agreed procedures (Joint consultation, etc.). Membership of the EMS, while imposing discipline, imposes no unique set of policies on the members or precludes the use of any economic instrument. Over the longer term, exchange rate changes can and will occur. Furthermore, attitudes to the use of the exchange rate instrument may vary somewhat from member to member. There are no acceptable objective criteria for deciding upon exchange rate changes and such changes depend largely on the economic and exchange rate policies of the members. Thus, in the precursor to the EMS, the snake, for example, exchange rate policies were not entirely homogeneous between the members; Belgium pursued a very clear policy of refusing to devalue in the face of market pressures on the grounds that changes in the exchange rate would have little impact on real output or the Balance of Payments but would only cause a deterioration in the rate of inflation; Denmark, on the other hand, devalued its currency relatively frequently and allowed currency changes to reflect, at least partially, domestic inflationary developments: Germany pursued a policy of deliberate appreciation to offset the impact of externally generated inflation. Hence, membership of the snake imposed no rigid or common exchange rate policies on the members although there was a general tendency to maintain a firm currency.

A similar situation applies in the EMS. The EMS does not impose a unique set of policy constraints on the members. The homogeneity that the EMS imposes is defined more in terms of objectives to be achieved than instruments to be used. In this respect it is wrong to overemphasise the exchange rate mechanisms of the EMS rather than the overall concept and the total arrangements, existing and planned. Nevertheless, the exchange rate instrument and its use remains central to the workings of the EMS and to its ultimate aims.

3. THE EXCHANGE RATE AS AN INSTRUMENT OF ECONOMIC POLICY

The approach to the use of the exchange rate as an instrument of economic policy, even within the context of the EMS, depends fundamentally on the view that is taken of the role and effect of exchange rate changes. The central question that is debated today is the extent to which adjustments in the exchange rate affect the rate of domestic inflation, output and the Balance of Payments. Prior to the 1970s most economic text books emphasised the real effects of exchange rate changes, i.e., the extent to which changes led to adjustments in real output and the Balance of Payments. In the 1970s, however, increasing emphasis was put on the extent to which exchange rate changes affect the domestic rate of inflation. Some economists believe that significant real changes in the exchange rate are only obtainable for short periods and that the real output effects are small or very short lived; domestic costs and prices adjust rapidly and fully to changes in external prices. In the extreme this approach would suggest that exchange rate changes are totally useless as an adjustment device for the Balance of Payments and absolute fixity or even appreciation of the currency would be the appropriate policy to combat or minimise inflationary impulses.

To some extent this is the underlying philosophy of the EMS, at least in its early stages. The proposition to create a zone of stable exchange rates in Europe arose out of the experience of the 1970s, particularly in the Community where there was a clear dichotomy between the low inflation countries which had maintained stable or appreciated exchange rates and the high inflation countries which had suffered substantial devaluations. Increasing reference was made to the existence of vicious and virtuous circles relating inflation rates to exchange rate depreciation or appreciation and the contribution of exchange rate stability to maintaining or achieving low rates of inflation was emphasised.

This particular approach has led to what might be called the hard currency approach to economic management. If devaluations are not very good at achieving real adjustment, but have as their main consequence an increase in the domestic rate of inflation to match or almost match the extent of the devaluation, then devaluations should be avoided. This particular approach can have a number of variations; thus, even low inflation countries could benefit from appreciation of their currencies, in nominal terms, by avoiding external impulses to the domestic rate of inflation (the German case); higher inflation countries could seek to lower their domestic rate of inflation by avoiding devaluation pressures, i.e., by allowing the real rate of exchange to rise.

4. THE CASE OF IRELAND

Would this be an appropriate strategy for Ireland and if so, to what extent? Should the Irish pound over the longer term be allowed to appreciate, perhaps even in nominal terms, in order to combat inflation?

In considering a strategy for the Irish pound it should first be noted that, in present circumstances, there is a problem of defining the appropriate exchange rate objective. Less than 30 per cent of Ireland's trade is with the EMS currency countries and more

than 70 per cent with external currency countries. Hence, an exchange rate objective set in terms of the EMS currencies could lead to either an appreciation or a depreciation of the Irish pound in effective terms, depending on the behaviour of external currencies, in which case the exchange rate would not be a positive instrument of economic policy as it could act to increase or decrease domestic inflation and to decrease or increase the Balance of Payments constraint. On the other hand, an exchange rate objective set in terms of the effective rate index might imply frequent adjustments in terms of the EMS currencies. It is clear that the absence of sterling from the EMS poses problems for Irish exchange rate policy. Thus, the present strength of sterling has led to an effective devaluation of the Irish pound and it is not clear that this is the intention or policy of the authorities. In general, most Central Banks would avoid the suggestion that exchange rate changes should be based on anticipated developments or forecasts. Yet, in present Irish circumstances, it would be difficult to define an exchange rate strategy which avoids taking a view of the future of sterling given the importance of sterling in Irish trade relations. If, on the other hand, sterling were a member of the EMS then 70 per cent of Ireland's trade would be with EMS currency countries and defining a strategy for the Irish pound in terms of the EMS would be more workable.

Despite this difficulty it seems, nevertheless, worthwhile to consider the kind of exchange rate strategy that would be appropriate in Irish circumstances. Ireland is the epitome of a small open economy and it is in small open economies that the real effects of devaluations are held to be minimal and the inflationary effects to be large. Because of the openness of the economy, domestic costs and prices adjust rapidly and fully to changes in external prices. Hence, the beneficial effects of devaluation are short lived and the main effects are to raise the domestic rate of inflation so that relative costs and prices are quickly restored to their pre-devaluation levels. Since devaluations are relatively ineffective in adjusting Balance of Payments deficits and serve merely to increase the rate of domestic inflation, then currency changes should be ruled out even in the face of loss of external competitiveness. In real terms the exchange rate should be allowed to appreciate in order to avoid extra inflationary pressures.

This approach appears to be a commonly accepted one in Ireland at least in analytic terms if not also as the basis of policy. Numerous references have been made to the openness of the economy and to the extent to which external factors influence the domestic rate of inflation and to the rapidity with which domestic inflation responds to devaluation. There are, however, a number of factors which might mitigate the extent to which the hard currency approach to economic management could be applied in Ireland. It must be noted that those countries which, in the past, have been most associated with a hard currency approach (Germany/Switzerland/Belgium) have had Balance of Payments surpluses (the situation is now different both in terms of exchange rate trends and Balance of Payments developments). These countries have had, therefore, a margin on their Balance of Payments with which to take risks in their exchange rate strategy. Ireland, however, has a permanent or structural current account deficit (equal to 3 per cent of GDP over the past 20 years) and the current account position has been the main constraint on economic policy. The question arises as to whether Ireland can pursue an exchange rate policy which may effectively increase the Balance of Payments constraint.

Furthermore, for structural reasons Irish economic policy has been based on a high growth rate strategy which has kept the country at the margin of its Balance of Payments constraint. These structural factors are well known, namely, the existence of a high average level of unemployment, a historical tendency to emigration and latterly the high rate of population growth and the age structure of the population. More recently, there has been a consciousness in Ireland that it is the poorest member, at present, of the Community and that there is a certain leeway for catching up in terms of income per

head with the other members. The result of these factors has been that growth has been a commonly accepted priority in economic policy over the past twenty years. Of course the existence of these factors would not argue against the occasional recession but there would be a reluctance in Ireland to accept a more prolonged decline in the growth rate than might be the case in more wealthy countries. The question arises as to whether a policy of maintaining an appreciated currency might not put at risk the high growth strategy over a longer period than would be acceptable.

For those who believe that changes in real exchange rates are only obtainable for very short periods of time then an appreciation which lowered import costs should lower domestic prices and export prices and hence re-establish the real exchange rate at its former level. In this case a nominal appreciation or the maintenance of stable rates when inflation is high relative to competitor countries would ultimately become self justifying.

Not all economists, however, would share the view that real exchange rate changes are only obtainable for short time periods. Furthermore, it is not entirely clear how symmetrical the effects of exchange rate changes are. Thus, while it may be generally accepted that devaluation in small open economies are quickly and fully offset by domestic price adjustments it is not clear to what extent similar effects in the opposite direction can be expected from appreciations. Because of the well-known downward rigidity of wages and prices the real effects of an appreciation may be much longer lasting than those of a depreciation. Hence, it is possible that the effects of devaluations and appreciations are not symmetrical and that whereas devaluation may have little effect on adjusting the Balance of Payments, appreciation could act as a positive barrier to exports.

While there may be no consensus among economists about the strength of these factors, nevertheless, given the existence of Ireland's Balance of Payments constraint, the extent to which Ireland can use the exchange rate as an anti-inflation devise may be limited and a strategy based on allowing a degree of real appreciation of the pound may be subject to substantial limitations.

An alternative approach would consist of what might be called a policy of neutrality, i.e., the exchange rate would not be used as an anti-inflation instrument but would be adjusted to reflect the success or otherwise of domestic economic instruments in achieving domestic stability. Thus, if it is accepted that devaluation tends to be relatively weak in terms of Balance of Payments adjustment but that appreciation may be relatively risky in a country which suffers a permanent and occasionally severe Balance of Payments constraint, then a sensible policy may be to avoid using the exchange rate in any positive way but to allow the burden of adjustment, particularly for inflation, to fall wholly on domestic instruments. In this case the exchange rate would be adjusted from time to time to reflect the success or failure of domestic policy in bringing inflation down to similar levels as that of competitors. The neutrality strategy, therefore, would involve broadly maintaining the competitiveness of exports through adjustments in the exchange rate from time to time. In the context of the EMS these adjustments would occur at discrete intervals between which some build up of competitive pressure might occur and hence the currency might appreciate in real terms for temporary periods. Putting the entire burden of the adjustment of the economy on to domestic instruments would have the advantage of allowing some improvement in the Balance of Payments position both through the normal fall in imports that occurs when a recession is induced and through the possibility of a continuing growth in exports, whereas adjustments through exchange rate appreciation may bring no relief to the Balance of Payments constraints. Similarly, in the longer term if the growth rate of the economy is directly related to the pace of expansion of exports, maintaining competitiveness may allow better prospects for growth. It should be stressed that a neutral strategy for the exchange rate is not to be interpreted as being less strict in terms of combatting inflation; it is simply a question of what are the

best instruments to use in inflationary circumstances.

There is also another possible strategy which some people in Ireland might consider attractive, namely, to pursue a growth strategy and allow the exchange rate to adjust as necessary. However, whatever the arguments among economists about the effects of exchange rate changes there are very few who would support such a strategy in a small open economy such as Ireland. In its extreme form such a policy would run the risk of setting up a spiral of inflation and devaluation leading to a high degree of instability. Even a more moderate version of this policy would still be risky more especially since the break in the link with sterling. Previously, the Balance of Payments constraint in Ireland was essentially financial, i.e., the constraint was the extent to which the current account deficit could be comfortably financed but, during the period of the sterling link, there was never any added pressure of short-term capital on the exchange rate as the market accepted the historical parity policy. Now, however, there is an added risk to the Balance of Payments in that the new situation has increased the awareness and possibility of exchange risk so that Balance of Payments pressures will appear directly on the foreign exchange market. Unless one is willing to ignore inflationary risk it does not seem possible that the exchange rate in Ireland could be allowed to be determined in a purely residual manner. Furthermore, it should be noted that such an approach would be contrary to the spirit and obligations of membership of the EMS.

5. CONCLUSION

Overall, the main question in terms of exchange rate policy in Ireland must centre on the role that the exchange rate can play in terms of contributing to a lower rate of inflation. Given the historical tendency for the Irish inflation rate to be above the average of its EMS partners, adherence to the EMS implies that efforts must be made to bring the inflation rate more into line with our EMS competitors. Since in the EMS stability of exchange rates is seen as an important factor in the achievement of domestic stability the question arises as to how positive an instrument the exchange rate can be in the achievement of a lower rate of inflation in Ireland? To discuss the choice of instrument or the balance of instruments to be used is not to lessen the degree of priority that should be given to a reduction in the rate of inflation. Thus if, in Irish circumstances, it can be argued that the exchange rate instrument should have a somewhat more neutral and less positive role to play in anti-inflation policies this is not to argue that anti-inflation policies are less important but rather that domestic adjustment must play a greater role.

DISCUSSION

Sean Cromien: I wish to congratulate the three speakers on the excellence of their contributions. They have given us a spectrum of very useful ideas on this important subject.

Entry into the EMS was a sign that the Irish economy had come of age. As in the case of the human being, this stage in an economy brings responsibilities as well as certain freedoms with it. The papers comment on these responsibilities. Mr O'Connor in his paper rightly draws attention to what the Central Bank said about these in 1979. The point was of course emphasised in many other forums as well, including the White Paper on the EMS which the Government issued before we joined the system, the debate in the Dáil and many subsequent speeches by Ministers and commentaries by distinguished economists.

The papers ask to what extent have the exhortations been listened to and policies pursued appropriate to the EMS. Here we must take account of the fact that it takes time in a democracy for people to adjust to new situations. Again as in the parallel of a person coming of age, the community does not become fully adjusted to a new situation immedi-

ately. Of course there are serious penalties if the adjustment is delayed too long.

There a number of references in the papers to the extent of Government borrowing in recent years. This is a matter of public policy on which it would not be appropriate for a civil servant to make but the most general of comments. However, any reference to borrowing must take account of the economic recession which we have been passing through. We saw yesterday in the newspapers that unemployment is now at a deseasonalised figure of 115,000. This is a factor which must be in people's minds when they talk about the pursuit of alternative economic policies. I note that Mr O'Loghlen is aware of the importance of growth in the Irish economy in his presentation when he examines the use of the exchange rate as an anti-inflation device.

Brendan Dowling suggests that the appropriate target ought to be domestic credit expansion which would include Government, bank and foreign borrowing. This raises questions which would really require the debate to be broadened somewhat beyond the question of EMS membership. How would the economy's performance be monitored and who would take action about it? Would it mean a change in the degree of responsibility for national economic policy which is at present exercised by the Government? The questions raised are interesting but cannot be gone into here tonight in any detail.

I found Mr O'Loghlen's survey of exchange-rate strategies stimulating at an analytical level. However, I noted a certain preoccupation with "what might have been". The reality is that we took a conscious decision to join the EMS and we accept the consequences that flow from that decision.

I should like to comment finally on a point from Mr O'Connor's paper. He appears to suggest that the decision to join the EMS was intended solely as a means of bringing about a reduction in inflation. There were, in fact, wider considerations involved. There was the strengthening of the European Community, the strengthening of the CAP mechanism and the pursuit of greater exchange rate stability.

Pádraig McGowan: The hallmark of central banking is to be unpredictable in its interventions in the markets. Equity considerations also inhibit Central Banks because they have to be careful to avoid conferring an advantage on some participants in the markets at the expense of others. So for these reasons I will concentrate on institutional issues and allude briefly to some policy considerations. I will confine my remarks to two of the papers – Mr. Dowling's and Mr. O'Loghlen's.

There are three main themes in Mr. Dowling's paper to which I will refer – the first being developments in the foreign exchange market. Mr. Dowling has given a balanced account of what has been happening over the last year or so but, on the question of the provision of additional information by the Central Bank on borrowings abroad and interventions in the markets, I would like to make a few points. The Central Bank has been gradually withdrawing from the foreign exchange markets with the result that interventions are becoming rarer. Even if the Central Bank were to publish statistics about the magnitude of its interventions it would not throw much additional light on what has been happening. With a substantial external deficit on private account, financed in the main by external borrowing abroad by the public sector, it is fairly obvious that most of the interventions by the Central Bank are in one direction. Basically, what the Central Bank has been doing is feeding the proceeds of foreign borrowing by the Government and State bodies to balance the private sector's excess demand for foreign exchange. The magnitude of these interventions from quarter to quarter can be derived from the statistics that are already published.

As regards the suggestion that information on the Central Bank's dealings with other Central Banks be published retrospectively, it must be recognised that even if the Central Bank were willing to make that information available the wishes of the lenders must be

respected. The usefulness of co-operation among Central Banks is enhanced because of its confidentiality. In providing the information retrospectively there would be the concern that the markets would learn to anticipate supportive action between Central Banks thereby undermining the purpose of this type of international co-operation.

Mr. Dowling advocates that there be further development of the financial market – the second main theme. I fully agree with this objective. The Central Bank has been moving in this direction for the past year and a half with a view to ensuring that, over time, the interest rates and the flow of funds through the financial markets will fully reflect underlying economic realities. A number of suggestions were made with a view to improving the markets; for example, the abolition of the secondary liquidity ratio. Regarding this suggestion, I enter a caveat to say that some banks hold secondary liquidity for prudential and operational reasons as well as for the specific purpose of financing Government expenditure. The suggestion that the issue of Exchequer bills be increased also appears reasonable but this raises an issue of how best to finance the Exchequer, namely, the extent to which it would be by short-term rather than by long-term instruments. It has not been mentioned that in early 1980 the Central Bank put in train an arrangement between a number of banks which may lead to the emergence of a market in bank acceptances. Another area of significance is the distancing of the rates of interest paid by the Central Bank from those prevailing in the money markets. The Central Bank could pay rates of interest on certain bankers' deposits that was less sensitive to market conditions because much of the funds held by banks at the Central Bank are more or less frozen and are not directly available for influencing supply and demand in the money markets. The Central Bank, in times of an overall shortage of liquidity, should be mainly concerned with the rates which it charges for accommodation to banks and, in this way, have an influence, if it so wishes, on the markets. These are various suggestions about how the markets might be developed but we must keep in mind that it is an inherent characteristic of markets that they should evolve in a reasonably free manner rather than have rigid structures imposed on them. So we should not be surprised if the suggestions along the lines mentioned here tonight turned out to be rejected by the markets in substitution for other arrangements that have not yet been put forward.

Now I come to the third major theme mentioned in Mr. Dowling's paper, that is, the instruments used by the Central Bank to control domestic credit expansion. There may be an implication in what Mr. Dowling said that the penalties used for the purposes of limiting the growth in bank lending in the recent past were close to the interest rates prevailing in the markets. From our experience over the last eighteen months there is less of a connection between these rates than may be suggested. The penalties were applied in circumstances of excess lending beyond what the Central Bank regarded as desirable and, in these circumstances, the idea was to impose a penalty so as to discourage the banks from continuing with the excess. It is difficult to relate the magnitude of these penalties directly to market interest rates and it is not necessary for a very precise relationship to exist between such rates for this type of penalty system to be effective. It is the increment of profit from excess bank lending that is the major concern when trying to establish what ought to be the optimal level of penalty.

The suggestion that there be more flexibility in the manner in which the Central Bank influences the growth in bank lending is an important issue. The present system of ceilings became effective in exceptional circumstances – in 1978/79 when there was an annual rate of increase in bank lending of close on 40 per cent. The issue at that stage was to consider the gains from quickly arresting a seriously deteriorating external payments position against the costs of rigidity in the form of monetary control. In critical circumstances the gains from avoiding a crisis in the Balance of Payments exceed the efficiency costs of rigid controls on bank credit. In more normal circumstances,

however, a more flexible method of control may be desirable. One way of achieving this, suggested by the late Peter Sloane, would be for the banks to sell to other banks unutilised tranches of credit that they are permitted to extend under the Central Bank's guidelines. This would encourage competition between the banks and result in the credit being extended by those that are relatively efficient in collecting resources and extending credit. I doubt if banks would be enthusiastic about admitting to one another that they had not been able to reach their guideline and were prepared to accept a smaller share of the market.

It has also been mentioned that open market operations, as in many other countries, may not be all that effective in Ireland. In a number of continental countries open market operations are not used to any substantial extent but in some of these countries the banking system is heavily indebted to the Central Bank. In such circumstances the Central Bank is in a relatively strong position to influence liquidity as it can vary the amount of credit available to banks and the price at which it is extended. This may be a more effective way of influencing liquidity rather than using open market operations.

Turning now to a policy-oriented issue, namely, the implications of the emergence of an inconsistency between monetary and fiscal policies. At the beginning of the policy year there tends to be no fundamental inconsistency between the objectives of these policies. However, over the course of the year they can drift apart as has been happening this year with the result that there can be an embarrassment of liquidity in the financial markets as a result of drift in the public sector's financial operations. What this means is that fiscal policy is no longer supporting monetary policy. Rather it may be undermining it as Mr. Dowling has identified in his paper. He suggests that what the Central Bank should be concerned with in such circumstances is not only domestic borrowings by both the private and public sectors from the banking system (including the Central Bank) but also borrowings from abroad by the public sector (including the State bodies). If, in aggregate, there is more borrowing from both the banking system and abroad by the State bodies and the Exchequer than was initially intended then the Central Bank should consider reducing or lowering the rate of growth in bank lending to the private sector. This is an attractive viewpoint but it would be necessary to go further in our thinking and consider what would happen if the Central Bank were to contract bank credit quite severely in order, for example, to attain a target for the current Balance of Payments deficit that was consistent with both monetary and fiscal policies at the start of the policy year. With a tight squeeze on the availability of Irish pounds, the private sector would probably borrow abroad thereby leading to looser monetary conditions than was originally intended (primarily because of the additional public sector borrowing). It might be appropriate to consider using exchange controls in such circumstances to discourage firms and individuals from borrowing directly from banks and other sources abroad but there would still be substantial slippage on the capital account, for example, by way of leads and lags. A move in this direction would require serious investigation and is one that would bring to the fore any inconsistency between fiscal and monetary policy; place in perspective the crowding out that occurs, from time to time, of the private sector by the public sector; and focus attention on whether it is appropriate to adjust the Balance of Payments by contracting private sector credit and, in turn, private investment at a time when current budget deficits are being incurred and unemployment is increasing.

Let me turn to Mr. O'Loghlen's paper. In his concluding section he advocates that the exchange rate should be fully supported by appropriate domestic economic policies. I have interpreted this as meaning appropriate monetary, fiscal and incomes policies and I am glad to see that what he is suggesting is consistent with what Mr. O'Connor has outlined in the last few paragraphs of his paper. The appropriate domestic policies must be in place and implemented in order that the fruits of a particular exchange rate objective be realised.

Mr. O'Loghlen has also referred to the implications of an effective exchange rate target. In Ireland the effective exchange rate index fell by about 20 per cent over the 1970s nearly half of which occurred in one year, 1976. During the first year of EMS membership there was little change in the effective exchange rate index of the Irish pound. But so far in 1980 there has been a very large depreciation (in effective terms) of about 10 per cent of which 5 per cent occurred up to September, the remainder having been experienced in recent weeks. Mr. O'Loghlen has hinted at the implications for Ireland (a country with a large proportion – 70 per cent – of its trade with countries other than those whose currencies are members of the EMS) of having an effective exchange rate target at the same time as being a member of the EMS. I think that Mr. O'Loghlen has been searching for ways in which these two objectives might be reconciled by perhaps an upward movement of the Irish pound in the EMS in order to minimise the drop in the effective exchange rate when sterling and the US dollar appreciate. This would be a difficult course to pursue and it would not be easy to persuade our EMS partners or the markets that it was an appropriate course when account is taken of the trends over time in the Irish economy compared with those in other member countries especially those with relatively low rates of inflation and strong external positions. Nevertheless, we are confronted with this issue of how to avoid the inflationary implications of a depreciation of the effective exchange rate while at the same time reaping the benefits of stability between the Irish pound and the currencies in the EMS.

Finally, I would like to take the opportunity to say that the three papers presented to us here tonight identified the major issues concerning EMS membership. We have had a succinct account from Mr. O'Connor of the gradual build-up over the 1970s to the change in our exchange rate regime in March 1979 and of the advantages, which this change has offered us the opportunity of realising, by applying appropriate domestic policies. The paper by Mr. Dowling has given us an overview of the implications of EMS membership for the development of the financial markets and, in the third paper, Mr. O'Loghlen considered the implications of the new exchange rate regime for the future and outlined the policies that ought to be pursued in order to maximise the advantages of the new arrangements. What we have got is a clear account of the implications for policy making in the future of having a visible exchange rate. We are indebted to our three authors and it is a great pleasure for me to second the vote of thanks.

S.J. Sheehy: There is virtually no reference in the Papers presented to the experience of the agricultural sector since the EMS link despite the serious national implications of what is happening.

The agricultural lobby was among the leading advocates of the EMS link in the debates preceding the decision. The expected outcome was warmly welcomed. This outcome was stated by the Taoiseach as follows:

> If the new system [the EMS] comes, . . . the Government will have to operate fiscal and monetary policies which will sustain growth, encourage employment and keep down costs. The social partners will be under an inescapable obligation to complement these efforts. In particular, it will be essential to ensure that the rate of increase in incomes does not outstrip productivity. Expectations must be rapidly adjusted to the sharply lower rate of inflation that may be expected to rule in the EMS. (Dáil Debates, Vol. 308, No. 3, p. 417)

If the world had evolved as the Taoiseach envisaged, there would not be a major crisis in agriculture today. The record shows, however, that the Government did not modify its fiscal and monetary policies and the social partners did escape their obligation to adjust

their behaviour. Farmers find themselves in 1980 sharing the same EEC common price increase of about 3 per cent with West German farmers even though the Irish inflation rate is running at 18 per cent in contrast to 5 per cent in West Germany.

Inflation affects farmers not just through the prices they pay for their inputs, as mentioned by O'Connor, but also through processing costs and through the general cost of living. Price increases under the CAP apply at ex-factory rather than at farm-gate level. Therefore, while the West German farmer could reasonably hope that some of the 3 per cent common price increase at ex-factory level would get back to him, there is little hope of that happening if processing costs are inflating rapidly. The official data now show that after the common price increase in June (which was heralded as 5 per cent but was actually 3 per cent), prices received by farmers since June have been up to 6 per cent below last year's level. The expected outcome for the entire 1980 year is for a fall of 3 per cent in prices received by Irish farmers and a rise of 1 per cent for West German farmers.

The biggest effect inflation has on farmers is the erosion of the purchasing power of their net income after inputs have been paid for. In West Germany this year real prices received by farmers are expected to fall by 4 per cent whereas the fall in Ireland is likely to be 18 per cent. The deviation in real income developments will probably be of even a greater magnitude. This is the true measure of divergence arising from differential inflation rates with a fixed exchange rate.

It is relatively easy to quantify the strangulation of agriculture by high inflation within the CAP. In 1981, for example, every extra point of inflation assuming normal relationships between general inflation, processing costs, farm inputs prices and interest rates will reduce average real net incomes in farming by some 5 per cent.

Since the summer of 1979 real prices received by farmers have fallen to an extent which has totally cancelled the transition price increases from EEC accession. This represents a loss not just to farmers but to the country as a whole in the form of deteriorating terms of trade. Retaining the sterling link would not have prevented this loss but, in so far as it would have pressurised the country to either behave as the Taoiseach outlined or to devalue the Punt before now, it would have reduced the loss.

Further losses will arise so long as the Irish inflation rate will exceed market price increases which are likely to continue to be related to common price increases which in turn are related to the average inflation rates of other EEC countries in the absence of a Punt devaluation. And to make this problem worse from the agricultural point of view, these losses in real prices and real incomes are not reversible within the CAP system except by achieving an inflation rate below the average of the EEC.

The critical question then for the future of Irish agriculture is the extent to which Irish inflation can deviate from those of other EEC members without having to adjust the exchange rate of the Punt. Unfortunately, the Papers presented here provide no insight into the pace of convergence with the EMS.

L. Smith: I would like to make three points:

The first point follows Professor Sheehy's. Export destination should be designated in currency area rather than geography for the purpose of these papers. Irish agricultural exports under the Common Agricultural Policy are designated in EUAs, not in sterling, even when the destination is Britain. Put in this way, our distribution of exports is not 30 per cent to EMS and 50 per cent to the UK. Our exports are predominantly to EMS countries. If this distinction is accepted, we also see that Ireland had devalued her Green Pound before entry to the EMS and while maintaining sterling parity. For CAP products, about 30 per cent of all exports, we devalued by, say, 20 per cent relative to sterling, which was an overall devaluation of about 6 per cent.

As Professor Sheehy said, our farmers were hurt first by the devaluation of sterling in the 1970s which caused a levy (MCA) to be placed on our exports and also depressed the home market price. We now pay a levy to Brussels of 11 per cent on our exports to the UK. If we had appreciated with sterling, we would, like the British farmers, be getting 11 per cent subsidy on our other exports. From the narrow agricultural viewpoint, we have always seen that the stronger the currency is, the better.

Too little attention is paid to our Terms of Trade. Exports and imports are each about 50 per cent of GNP, so a 2 per cent change in the Terms of Trade is equivalent to 1 per cent change in GNP. With base 1970, our Terms of Trade reached 122, and is now 94, and falling. This was a major factor in our boom of the early 1970s and is equivalent to a cut of 14 per cent in our purchasing power since then.

The non-tradeable sector – principally State companies and employees such as civil servants, teachers, professors – claim full recoupment of increased prices. The result can only be inflation and Balance of Payments difficulties in endangering the maintenance of our EMS parity. Devaluation would be the result, not the cause of the unrealistic demands in the non-competing sector. Exporters, like farmers, would be unable to raise their prices, and so would become poorer.

Dr. McGowan spoke of Central Bank policy and controls. I am sceptical of the efficacy of these measures in so open an economy as Ireland. Much of our trade is intrafirm at prices which cannot be checked by reference to markets; leads and lags could upset the trade flow; capital can be raised abroad. There is no end to the leakages which can occur once regulations begin to bite.

The Central Bank can certainly restrain some sectors, such as small Irish firms which must rely on Irish borrowing, or certain types of lender, typically the associated banks. Such intervention may merely distort the market to the benefit of transnational companies, or other financial agencies, such as building societies, without effective overall control.

In summary, if, under CAP, farmers are to receive a fixed price in their own currency, regardless of the current rate of exchange for other commodities (the difference being made up by positive or negative MCAs), then it is in the interest of farmers that their currency appreciate as much as possible. The country exporting agricultural produce has the same interest as a farmer.

In the case of Ireland, when agricultural exports are important and internal prices for all goods very quickly reflect import prices at the current rate of exchange, the Barter Terms of Trade move against Ireland if our currency is weak. Farmers in particular are caught with living costs and farm inputs rising to reflect the exchange rate after devaluation, but produce prices are held at a fixed Irish Pound prices by MCAs.

Dermot McAleese: All three speakers are to be congratulated for providing the society with such thoughtful and informative papers. My own comments amount to no more than a gloss on one aspect of the discussion – short-run vs. long-run effects – which the papers touched upon but on which each author placed a slightly different emphasis.

A good part of the pre-EMS debate in this country took place in the context of assumptions that the pound sterling would depreciate and that by breaking the sterling link the Irish economy would be attaching itself to a hard currency area. Economists warned of the adverse consequences which would follow from failure to adapt domestic policies to the discipline of a strong exchange rate regime. While the economics profession cannot be too happy about getting its forecasts wrong, Padraig O'Connor consoles us with the thought that we were not alone in underestimating the strength of sterling. No econometric model, however sophisticated, could have predicted the dimension of the Iranian

crisis and steely determination of Mrs. Thatcher which underpinned the rising value of the British pound.

Experience in Britain during the last eighteen months, however, has strongly vindicated the view that a mismatch between an economy's exchange rate and its inflationary performance and expectations can have important "real" effects on the economy. The appreciation of sterling has not been accompanied by the necessary curtailing of nominal wage claims and the consequential effect of this time-lag in adjustment on the level of manufacturing exports and employment is painfully evident. The difficulty is compounded by the fact that financial markets, which anticipate changes in inflation and monetary policy, further strengthen the exchange rate and exacerbate the effects of the higher-than-equilibrium real wage. All this serves to emphasise the importance of adjustment lags (and leads) in exchange rate analysis.

Brian O'Loghlen's point about the asymmetry between appreciation and devaluation, in so far as wage reactions are concerned, is well taken. The real effects of an appreciation may, as Mr. O'Connor states, be only a short-run phenomenon but UK experience shows that the short run can be sufficiently long to create highly undesirable consequences. In sum, EMS may not have worked out as expected in late 1978 but British experience shows that warnings about the adverse consequences of over-valuation, which were frequently adverted to at that time by economists and institutions such as the Central Bank, were well justified.

Adjustment lags are also relevant in two other contexts mentioned this evening. The effects of the appreciation of sterling on Irish import prices and through them on our level of inflation and balance of payments is one such instance. Padraig O'Connor's figures show a UK inflation rate of 18½ per cent in 1980, a large part of which will be reflected in higher UK export prices. If to this is added the average 8 per cent appreciation of sterling *vis-à-vis* the Irish pound during the year, a rise in UK import prices of upwards of 20 per cent can be anticipated. Extending the analysis to include both exports and imports, it may be possible, when further data become available, to investigate whether a J-curve element was at work leading to temporary deterioration in the 1980-1981 Balance of Payments. The J-curve effect would, of course, be diminished to the extent that UK exporters decided not to pass on the higher sterling price but to absorb it from profits in order to maintain their share of the Irish market and to the extent that Irish importers can shift their sources of supply from UK to non-UK suppliers.

The importance of short-run effects is further illustrated in the case of agriculture and the green pound. Difficulties are bound to arise as long as the green pound rate is tied to the EMS central rate, which can be altered only after a time lag, rather than to an effective exchange rate. With the increasing divergence between the Irish and European inflation rates, some institutional adjustment is required but this clearly will require time and in the interim we shall probably have to be satisfied with *ad hoc* improvisations. The implications of sterling's exclusion from the EMS (and the absence of a UK government "position" on the pound relative to the ECU) and of fluctuations in the ECU vis-à-vis non-member currencies generally have, in retrospect, turned out to be much more important and wide-ranging than was thought two years ago. Performance of sterling is the more vital consideration and, taken in conjunction with a possible zero-effective-exchange-rate target mentioned by Mr. O'Connor, raises interesting questions about the exchange rate objectives facing the Irish economy in the early 'eighties.

V. Armstrong: I wish to disagree strongly with Mr. Brendan Dowling regarding the section of his paper dealing with Exchange Controls. It would be a great pity if the representatives of the Central Bank and Government Departments who are present this evening are persuaded by Mr. Dowling's charm and fluency that the argument for relaxa-

tion of overseas portfolio investment controls is "grossly overstated". I deprecate the mandatory restriction on pension funds and insurance companies that no less than 90 per cent of their assets must be invested within Ireland.

At present the insurance industry is active and expanding whilst pension funds are burgeoning and, in my opinion, it is very wrong to continue such a draconian restriction regarding their investments. Institutions are impersonal and vulnerable to attack but this matter concerns the plain people of Ireland, policy holders and potential pensioners.

As a Consulting Actuary concerned mainly with pension funds I note with alarm the present tendency of pension managers to invest heavily in Irish property. There are too few Irish quoted companies for adequate participation in equity shares and there is a natural limit to investment in Irish gilts so that this tendency is not surprising. And as a citizen of Dublin I am delighted to see new offices going up but I must say that I would be very much happier if the potholes in our streets were filled in first.

In my opinion the Central Bank limits are resulting in excessive investment in Dublin property which is almost certainly bound to lead to problems in the future.

Reply by Padraic O'Connor: I would like, first of all, to comment briefly on Brian O'Loghlen's paper. I think the difference between what he and I are saying is not as great as might first appear. He is recommending a pragmatic approach to exchange-rate policy; we must all be in favour of pragmatism. I would agree that the effects of devaluations/ revaluations may not be symmetrical. It is probable that a depreciation would have its effect on the domestic price level much more rapidly than an appreciation. Recognition of this likelihood is reflected in the thinking of the authorities prior to joining EMS. In my remarks I was careful to say that what was being sought was an exchange rate regime that would yield stability, as opposed to the weakness that was expected of sterling and of a sterling-linked Irish pound. In other words, what was paramount was the need to avoid the inflationary effects of a depreciation, though at the time an effective appreciation of the currency was expected. The attachment to this idea of stability was reflected in the preference for a zero-effective exchange-rate change target before the EMS mechanism was launched. I presume that Mr. O'Loghlen's suggestion for an alternative exchange-rate strategy is only theoretical in present circumstances. The recent sharp fall in the exchange rate of the Irish pound against sterling and the consequent fall in the effective exchange-rate index was not planned and is not desirable. A further depreciation, as an act of policy, must be the furthest thing from our minds. In present circumstances, an appreciation of the Irish pound would be desirable before the recent depreciation had had a chance to work through to the inflation rate.

Mr. Cromien has suggested that the high level of Government borrowing might be justified by the fact that the economy is in recession. This is a valid point in principle but its long-term validity is weakened if we look back a few years. The state of the Government's finances is not the result of any one year's events but rather has been deteriorating for some time. The present position has been reached not only because of high borrowing in 1979 and 1980 but also because of the level of borrowing in 1977 and 1978 when the economy was not in recession and pro-cyclical fiscal policies were implemented. The scope for Government borrowing in a recession would be enhanced if pro-cyclical policies were avoided in good years.

The previous speaker from the floor sees no future for the EMS. He made the point that if there is no willingness to surrender control to a central policy-making body in the EEC the EMS cannot continue in existence. I think that as long as there is no political will to centralise economic decision making, *Economic and Monetary Union* cannot be achieved. It was in full knowledge of this reality that it was decided that a technical mechanism to limit the short-run fluctuations between currencies would be worthwhile.

The EMS is little more than this at present. Of course, economic divergences between member States cannot be ignored; but if the EMS is regarded as an adjustable peg system it can continue to be a useful mechanism despite divergences between member State economies. Furthermore, as an incentive to exchange-rate discipline, the EMS could help to reduce the divergences.

Reply by Brendan R. Dowling: A number of points arising from my paper have been made by speakers from the floor.

Both Dr. McGowan and Mr. Cromien have raised the question of the appropriateness of a DCE target and Mr. Cromien in particular, is concerned about the possible loss of economic freedom such a target implies.

Yet a DCE target is the only consistent and sustainable long-run monetary target given the decision to circumscribe domestic economic freedom by adopting a fixed exchange rate policy. Governments may not like the notion that for a given foreign exchange reserve level, the more they borrow, the higher the cost and the lower the availability of funds to domestic borrowers. But the alternative would be to abandon the fixed exchange rate regime implied by membership of the European Monetary System. Of course, the DCE approach is likely to make the Central Bank less popular and also lead to criticism of Government policies. Fear that the public might discover the true long-run consequences of Government borrowing policies is an insufficient reason for the delay in adopting monetary policies consistent with the exchange rate objectives.

Professor Smith has made the valid point that agricultural exports to (and imports from) the United Kingdom are, in effect, ECU denominated and that this reduces the apparent non-EMS share of total trade. It is true that if all food and live animal trade is treated as EMS currency trade, then some 54 per cent of Irish exports and 38 per cent of all Irish trade in 1980 was EMS related. That still leaves almost two-thirds of trade in non–EMS currencies.

I simply cannot follow Professor Smith's line of argument on the impact of remaining with Sterling on farm incomes. Farmers exporting to France would receive an 11 per cent subsidy had we remained with Sterling. But the French francs received from the exports would buy 20 per cent fewer Irish pounds. On November, 13, 1980 we were 10.62 French francs to the £ Sterling and 8.65 French francs per IR£. An Irish farmer selling goods to France for 1,000 frc. would receive IR£115.6.

Had the Irish £ remained at par with Sterling, the farmer would receive IR£94.16 (=Stg. £94.16) plus an 11 per cent subsidy giving a total of IR£104.52 – only 90.4 per cent of the present rate.

If, as tends to happen over time, countries are required to adjust their Green pounds in line with market rates then farmers in countries with appreciating currencies will lose out. Of course, it tends to happen that countries with appreciating currencies are also those with low inflation. So what farmers lose in terms of nominal price rises they may gain in the form of lower cost inflation.

I would not wish my remarks to be interpreted as a defence of present exchange controls as Mr. Armstrong appears to have done. I agree with most of his objections: however, most of the supposed short-run costs of control arose from the break with Sterling parity rather than the controls themselves.

Reply by Brian O'Loghlen: A high rate of inflation can cause severe problems for the Irish economy as Professor Sheehy has clearly shown in the case of Irish agriculture. A reduction in the rate of inflation must be a priority in Irish economic policy. At the time of the decision to join the EMS it was optimistically assumed that linking the Irish pound to the Deutschmark would lead to German rather than UK levels of inflation

in Ireland. This was partly based on the assumption that an appreciating currency would help to lower inflation although as Professor McAleese points out in relation to the UK, this may not always or necessarily be the case. In effect, the Irish pound has not appreciated owing to the sharp rise in sterling although there has been a substantial real, i.e., inflation adjusted, appreciation *vis-à-vis* the EMS currencies. Nevertheless, whatever the fluctuations of sterling, it was always unduly optimistic to assume that a change in the currency link would of itself alter the propensity to inflate in Ireland or even that the necessary domestic policy adjustments would need to be of short duration. Clearly, the inflationary process in Ireland will take time to correct. In these circumstances it is unrealistic to expect domestic policies to adjust to an exchange rate target rather than that the exchange rate should be allowed to reflect the success or otherwise of domestic policies in combatting inflation. In other words, and contrary to the analysis in Mr. O'Connor's paper of the role and effects of exchange rate changes and to Dr. McGowan's interpretation of my paper, a strategy of maintaining a firm or appreciated currency is not a realistic option for Ireland in the light of the Balance of Payments constraint and the need for economic growth. Fortunately the unexpected rise in sterling has prevented such a strategy from being realised in practice.