BREAKING THE LINK WITH STERLING

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1. Introduction

The Irish £ was established in 1927. It was fully convertible at a one-for-one rate with sterling and full backed by reserves of sterling and gold. This strong link between the two currencies has only been modified in some minor respects since 1927. At that time, the overriding arguments in favour of the link were to ensure public confidence in the new currency and to minimise disruption to banking and to trade. However, repeated depreciation of sterling and the prospect that this will continue has recently provoked criticism of the link. Since the end of 1971, the value of the £ sterling has fallen by about 7.5 per cent in terms of the dollar and by over 30 per cent in terms of the so-called snake currencies. The snake was established in May 1972. It is a system under which EEC members maintain narrow margins of variation between one another's currencies. The system also provides mutual support to help countries maintain these margins. Initially, all EEC currencies took part in the snake but the £ sterling, the French franc and the Italian lira, have since defected, leaving the remainder floating together.

Because of the link, the Irish £ has fallen exactly in step with sterling. Our attachment to a falling currency has been criticised for a number of major reasons:

(i) It is argued by some economists - and I go a long way with them - that the fixed link with sterling forces the British long-run inflation rate on Ireland, an inflation rate far higher than in any other EEC country.

(ii) It is pointed out that depreciation reduces the foreign exchange value of agricultural exports because of EEC regulations. However, recent changes in the Irish green £ takes some of the force out of this argument.

(iii) Finally, it is argued that by promoting continued close trading links with Britain, the link has made us more vulnerable to the effects of Britain's slow economic growth and the stop-go economic policies adopted to protect sterling.

2. Examination of the Link

Having noted these criticisms, I will now examine some of the benefits of the link and some practical consequences of breaking it. The convenience for trade with the United Kingdom of a fixed one-for-one parity with sterling is certainly an important benefit. The extra mental chore of translating values is avoided because any price quoted in Irish £s is of equal value in terms of sterling. The actual expense of trade with Britain is also minimised, for exchange transactions need not be undertaken. A cheque drawn on an Irish bank is perfectly acceptable as payment for imports from Britain and vice versa. Breaking the link with sterling would change this. It is likely that Irish cheques would be less acceptable in the U.K. Irish importers would, then, have to get drafts from their bank made out in sterling to pay for imports. This would involve extra cost. On top of this, the possibility of exchange variation between the two currencies would introduce a risk into trade. An importer placing an order for goods to be delivered in three months' time might find that he had to pay more Irish £s than he expected because the currency had depreciated in the meantime. The risk of loss in this way can loom large in terms of the profitability of trade, particularly if the value added in Ireland is relatively small. A forward exchange market would have to be established in Ireland to allow traders cover themselves against this risk. But, hedging in a forward exchange market, again, involves extra cost and, presumably, the cost will be proportionately greater in the small Irish market.

No one has ever estimated how much the trading convenience of the sterling link is worth to Ireland, but it is certainly relatively smaller now than it was in 1927. Some further practical difficulties of breaking the link may be mentioned. British currency would have to be taken out of Irish circulation and new Irish coins would have to be introduced. On the other hand, there would be an offsetting gain because the circulation of British currency in Ireland is equivalent to an interest free loan to Britain. A side-effect of breaking the link is the windfall loss inflicted on Irish holders of British currency and investments (in the case of a revaluation). A person with the bad luck to have an English 'fiver' in his pocket would suffer, but the trader who owed sterling would gain.

The major disadvantage of the link is the surrender of a potential policy instrument for the achievement of economic goals. Most of the rest of this paper will be devoted to evaluating the effectiveness of the various ways of using exchange rate as an instrument of policy.

3. Changing the Exchange Rate Against All Currencies

Macro-economic policy tries to secure (i) a high rate of employment and of economic growth; (ii) balance of payments equilibrium; and (iii) an acceptable rate of inflation. No one policy can achieve all of these goals and there must be at least as many policies as there are goals. Exchange rate policy is no different in this respect. It is not a cure-all solution to all our economic ills. To illustrate this, consider a devaluation of the Irish £ against all other currencies, including sterling. This would raise the home price of our imports, but lower the price of our exports in terms of foreign currency. Irish producers would then be more competitive on both the home and the export market. This would result in an improvement in our balance of payments, provided the demand for Irish imports and exports are reasonably price-responsive. The available evidence suggests that, taken together these demands are sufficiently responsive to secure an improvement through devaluation. However, there is considerable uncertainty about the length of time it would take for the improvement to come about.

On the employment front devaluation would be a stimulus because of the increased sales at home and abroad. However, it would tend to aggravate inflation. This would occur initially through the rise in the domestic price of imports and import substitutes for consumption and, in most cases also, through a rise in the domestic price of exportables retained for home consumption. Besides the immediate effect on consumer prices, there would be a follow-up effect through two channels: (i) increased production costs due to higher-priced raw materials and (ii) increased wage costs as unions seek compensation for the initial increase in the cost of living. A wage-price spiral could be triggered off in this way, that would tend to erode the initial improvement in the balance of payments and employment. In the extreme case, where income earners received full compensation for price increases, the initial improvement in competitiveness would be entirely lost and employment and the balance of payments would return to their pre-devaluation state. This highlights the crucial point that devaluation can only help employment and the balance of payments to the extent that it is effective in reducing the real value of domestic money incomes. It is for this reason that exchange rate policy is often thought inappropriate for small open economies such as Ireland. If a great deal of income is spent on internationally traded goods, it will be difficult to achieve a reduction in real incomes large enough to have a significant impact on the balance of payments. In Ireland's case, tradeables are important both for consumption and as raw materials. Moreover, in recent years, the tendency to look for compensation for price increases has grown in this country. As a result, a significant improvement in the balance after all adjustments had been made would require a sizeable devaluation and would be accompanied by a very considerable rise in prices. A once-over devaluation should not affect the rate of inflation in the long-run. However, if further devaluations were used in an attempt to prevent the initial improvement in the balance of payments being eroded by demands for price compensation, then, a continuous wage-price spiral would be set in motion.

The long-term effects of devaluation on the economy would largely depend on how investors reacted. Expansion of sales at home and abroad should encourage investment, unless inflation or uncertainty completely eroded the benefits of devaluation.

Revaluation

The other possible exchange rate alteration is to upvalue the Irish £ against all other currencies. This would damage the competitiveness of Irish producers in both the home and export markets, and result in a deterioration in the balance of payments and employment. The rate of inflation should be moderated in the short-run as the fall in import prices worked their way through the system, but the degree of moderation may not be great due to a reluctance to reduce wages and prices. Moreover, to maintain a lower rate of inflation in the long run would require repeated appreciation of the currency, not a once-over change. Anyhow, it seems that internationally revaluation is a response to conditions of high employment, low inflation, and balance of payment surplus, rather than a means of coming to grips with the problem of inflation. Possibly this is because loss of sales at home and abroad is adverse to investment and growth.

Free Float

A free float of the Irish currency would raise additional difficulties to those relating to devaluation and revaluation. First, trading uncertainty would be greater through having no link with any major currency. Secondly, the viability of Irish firms could be severly affected by periodic changes in the exchange rate, for although short-run losses due to fluctuations can usually be hedged, nobody can hedge against a whole business becoming unviable. Thirdly, there could be a danger of perverse speculation against the currency in a small foreign exchange market. Finally, some might take the gloomy view that, with floating exchange rates, government and private interests would make little effort to prevent rapid inflation, because its effects on employment could be avoided in the short-run by gradual depreciation of the currency.

Fixed Exchanges

Many economists have suggested that, for small open economies, fixed exchange rates are preferable. They argue that balance of payments difficulties can be remedied by relatively small changes in domestic spending. The employment objective, they say, can be secured, by striving to have a slightly lower rate of inflation than that of trading partners. This could be achieved through a prices and incomes policy, along with fiscal and monetary measures. At any rate, maintaining a fixed rate of exchange does not hamstring an economy completely with regard to competitiveness. A 10% export subsidy plus a 10% import tariff is formally equivalent to a 10% devaluation, and Ireland has made quite extensive use of both export subsidies and import tariffs at various times since 1927. It has also made some attempts to introduce a prices and incomes policy, but not always with the greatest of success.

To summarize this section, I have tried to show that a change in the exchange rate is very often a two-sided weapon, it promotes some of the targets of economic policy but puts others further from reach. The textbook remedy in Irish economic circumstances, namely a persistent tendency to high unemployment and balance of payments deficits, is to devalue. However, in view of the openness of the economy, significant gains on these fronts would require a sizeable devaluation and would be achieved at the cost of a very significant increase in inflation at least in the short run. At the same time, it would involve considerable convenience costs.

4. A Possible Alternative

However, to say that upward or downward changes in the exchange rate with respect to all currencies are not on for Ireland does not answer the complaint that Ireland will suffer through being fixed to a falling £ sterling. In the event of a further major decline in sterling, some people have argued that the Irish £ should only sink part of the way with sterling, then break the link and attach to the snake currencies. The principal argument put forward in favour of this move is that it would give Ireland the opportunity to bring its accelerating rate of inflation under control.

The relevant choice here is : if sterling sinks, do we follow her down, or do we at some point call a halt and decide a further drop is not appropriate for Ireland. At that point we would link to the snake. In making the choice, the present state of affairs is not a relevant alternative, and the emphasis in the rest of the discussion will be on the relative merits of the two options, rather than enquiring would we be better off than we are now. However, some reference will also be made to the present situation, for this comparison is of clear interest to those considering what adjustment would have to be made to existing plans.

In assessing the two options, I will discuss the different sectors of the economy separately. The discussion concentrates on the effect on the balance of payments in each sector. For this reason, I examine the effect on the value of trade in terms of foreign currency, ignoring the important consideration of the impact on incomes in terms of home currency.

Agriculture

In the case of agriculture, the CAP will dominate what happens to the foreign exchange value of exports. The CAP covers almost all agricultural products amounting to about 95% of our agricultural exports. If both the Irish and U.K. green £ parities remained unchanged regardless of the moves in exchange rates, then Monetary Compensatory Amounts would claw back the normal gains of devaluation. A loss in the value of agricultural exports would be incurred by devaluing in step with sterling. The loss depends on the extent of the devaluation and, therefore, it would be smaller if we do not go all the way down with sterling. On the other hand, if the Irish green £ devalued in line with the Irish £ for all other purposes but the British green £ remained unchanged, then MCAs would not be levied on Irish exports but subsidies on sales to the British market would still be given. This would leave the value of agricultural exports unchanged regardless of how far we sink with sterling. On the imports side, MCAs would operate in Ireland's favour under either proposal; more favourably if we go down fully with sterling. Negotiation of a green £ would again make the two options identical. On the whole then, if no green £ was negotiated, letting sterling sink away from the Irish £ would be less adverse to the balance of agricultural payments. But if a green £ devaluation was secured, the balance would be unaffected by either option.

Industry

We turn now, to look at industrial trade. Sinking fully with sterling would improve Irish competitiveness relative to foreign producers other than the British. However, less price-responsive goods are traded with these countries (raw materials for example, which we cannot do without). Thus, the improvement in the balance of payments would not be great. Gains on the employment front would also be moderate.

If we do not follow sterling the whole way down, our competitive gain over foreigners would be reduced and competitiveness would be damaged relative to the British. Initially at least, the effect on the balance of payments would be adverse. The deterioration would be particularly serious in the case of trade with Britain, where the type of goods traded tends to be more price-responsive.[1] The indirect barrier to trade with Britain due to increased trading costs once the sterling link was broken would cause further losses to Irish exporters but, on the home market, losses would be moderated. The net effect of this barrier on the balance of payments would hardly be great, so it would not materially affect the expected deterioration caused by sinking by less than sterling.

On the employment front the effect would also be adverse. This would apply to all sections of industry. However, the damage to industry competing with European and American firms would be a smaller improvement

1. This is so both because of the composition of trade, and because contacts, etc, are probably of greater importance relative to price in the more distant markets.

than they would otherwise have enjoyed, while industries who compete with British firms would suffer an absolute deterioration in employment. Traditional Irish industries, such as textiles, clothing, and footwear, would appear to be the principal sufferers. These industries are already under pressure in free trade.

Invisibles

Next, we must consider invisible trade. Invisible receipts, other than from tourism, are usually in terms of foreign currency, and they would be unaffected by either proposal. Tourist receipts would fall in terms of foreign currency by devaluing in line with sterling but the fall would probably be greater if we did not sink the whole way. As regards employment in industries serving the tourist, breaking the link would be a gloomy prospect. Many British tourists would probably be lost, discouraged both by price and the inconvenience of having to change money.

Invisible payments abroad may be denominated either in Irish or in foreign currency and those paid in Irish currency would cost more if we do not depreciate by as much as sterling. Looking then at the balance of invisible payments - it would be more adversely affected if we do not follow sterling down to the full extent.

Current and Capital Balance

Combining agricultural, industrial and invisible trade, it seems that, even if no green £ were negotiated, breaking with a downward float in sterling would cause a relative deterioration in the overall current balance of payments. It might not be very great, because of the low import content of improved agricultural earnings. If a green £ devaluation were negotiated the relative deterioration in the balance would be all the greater. The relative effect on employment would also be damaging, and would be felt most acutely in industries already under severe pressure.

Less can be said with certainty about the balance of payments on capital account. Sterling would certainly hold additional risk for Irish investors, and vice versa for British investors in Ireland. On the part of Irish investors, this would probably reinforce recent trends for a greater volume of lending on Irish financial markets. But it would be a disincentive to British investors, and the ease with which the government could borrow in the United Kingdom might be impaired. The capital balance would be improved by an increase in the value of certain capital inflows from EEC funds denominated in terms of Irish currency. Overall, moves in the capital balance would depend very largely on foreign investor confidence in Ireland's growth prospects following the break with sterling.

Inflation

The main hope pinned on breaking the link with sterling is that it would help control inflation. By breaking the link, the increase in the home price of all traded goods would be reduced and inflation would be moderated in the short run. However, the crucial question is not the impact effect on inflation but whether Ireland would be able to reduce domestic inflation after the break was made. To do so, two conditions would have to be met. Firstly, a faster rate of inflation in Britain than in the rest of the EEC must be reflected in a continuation of sterling's downward float. It is at least conceivable that confidence in the long-run prospects of the British economy would prevent this happening. Capital inflows might sustain the exchange value of sterling despite faster inflation. If so, then, even though the sterling link was formally broken, British inflation would still be transmitted to Ireland through our trade, and the costs of breaking the link would have been fruitless.

However, even if sterling continued to sink downwards, the break would not be sufficient on its own to reduce Irish inflation in the long term. The whole project would stand or fall on the second requirement, namely an effective counter-inflationary policy at home. Economic analysis cannot give much guidance on whether this would be achieved, much would depend on the political will. However, some of the difficulties may be mentioned. If employment was to be protected, great restraint on pay demands would be needed in the first six months or so after the break and even before the break was made. Claims could not be made on the basis of continued inflation at past rates nor on the basis of money income movements in Britain. This would call for a far-reaching change in behaviour, and agreements already made would probably have to be altered. If restraint failed to bring inflation under control, then Ireland would have to choose between letting the Irish £ float down or suffering a severe recession, to force inflation down to a level that would hold our competitiveness in the snake.

Investment and Growth

How investment and growth would be affected by breaking the link is difficult to predict. Initially, investment would probably be discouraged. Uncertainty and the loss of competitiveness relative to Britain would put off investors interested in selling to the U.K. market. In the long term, much would depend on our success in bringing domestic inflation under control. If successful, the prospect of closer links with European currencies would attract investors interested in EEC markets. Indeed, initial success in moderating inflation could become a virtuous circle, as increased capital inflow make subsequent adjustment less onerous.

Some other issues may be raised on the question of growth. We should realise that breaking the link would not shelter us from the impact of slow growth or stop-go economic policies in Britain. Only in the very long term would Ireland become less vulnerable to Britain's growth performance. This would happen as Irish exports were diverted to markets outside Britain. Indeed, in the short run, Irish trading relations with Britain would be hit by a new source of stop-go, namely moves in exchange rates between the currencies.

Speculation

The possible destabilising influence of speculation in a thin Irish market for foreign exchange is sometimes mentioned as a reason for avoiding the break with sterling. It is difficult to assess how liquid funds would flow. However, under the arrangement we are considering, the attachment to snake currencies would make funds available to us to counter destabilising speculation.

A Practical Problem

Finally we must return to the serious practical problem for a Minister of Finance of choosing the point at which we break with sterling.

If we break early in sterling's decline, then we expose ourselves either to the risk that the decline never materialized; or if it did, to serious difficulties for employment and the balance of payments. On the other hand, if we decline a considerable distance before breaking, then while problems for the balance of payments might be reduced, our inflation would have worsened in the meantime and efforts to bring it under control in the longer run made more difficult. It is important to recognize the practical difficulties caused by the free float mechanism.

To summarise this section, I have tried to show that if sterling sinks further, breaking the link would involve costs as well as benefits. The costs are in terms of trading convenience, uncertainty, and an initial deterioration in employment and the balance of payments. The benefits are mainly long term, the opportunity to reduce inflation and put the economy on to a better growth path. But the crucial point is that these benefits are not automatic. They depend on our own success in bringing inflation under control once we are released from the obstructive influence of British inflation. A number of other imponderables also surround the proposition, in particular, what happens to sterling subsequently, how business confidence reacts, and how international investors react.

7. Conclusion

I hope I have managed to throw some light on a complex problem. However, even if I have not succeeded in clarifying all the issues, perhaps I have, at least, brought home to you that it is a complex problem and one on which you should be warned against glib solutions.

No matter what the circumstances, breaking the link with sterling is not an elixir for all diseases. It is salutary to recall Dr T.K. Whitaker's words in 1958. He wrote that there was no use "in suggesting that through some simple expedient --- rapid expansion of employment and living standards can be assured ... Unless, the individual members of the community have sufficient patriotism and realism to accept the standard of living produced by their own exertions ... the basis for economic progress simply does not exist". There is always a tendency in times of crisis to latch onto one simple unique solution. No economic policy can offer that, and breaking the link with sterling is no different. Indeed, I would venture to suggest that issues of far greater consequence for economic policy are:-

(i) How can we secure restraint in income demands?

(ii) How can we achieve real growth in agriculture and industry?

(iii) How can we ensure efficiency and fairness in public expenditure?

Whatever way we go with regard to sterling will have advantages and disadvantages. We may have to be content to take a course that is not an absolute improvement but is one that will be the least disadvantageous. The decision is all the more difficult because it has to be taken in conditions of uncertainty, so that even the advantages and disadvantages are not always clear. The final outcome will depend not one one decision, but also on the use of other policy instruments and on the response of key groups (such as trade unions and foreign investors).

However, some conclusions are suggested by the discussion. First, unilateral devaluation of the Irish £ would seem to be out, because it would aggravate inflation. Second, a unilateral revaluation would also seem to be out, because the appropriate conditions of balance of payments surplus and over-full employment do not exist in Ireland. Finally, the most likely contingency is that, if sterling floats down again, we might want to break away from this at some point. But, if we are to do so successfully, the role of an incomes policy is even more important than before. It would be necessary to have prior agreement that the break would create a new situation for pay claims. Existing pay agreements might have to be modified, if employment was to be protected and sustained moderation would be necessary to maintain our position within the snake in the long-run.