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AN EXAMINATION OF IRISH CURRENCY POLICY

Patrick Honohan

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ACRONYMS USED

DM	Deutsche Mark
EER	Effective Exchange Rate Index
EC	European Communities
EMU	European Economic and Monetary Union
ERM	Exchange Rate Mechanism of the EMS
EMS	European Monetary System
GDP	Gross Domestic Product
GNP	Gross National Product
OECD	Organisation for Economic Co-operation and Development
SDR	Special Drawing Rights

GENERAL SUMMARY

The signature of the Maastricht Treaty, which was intended to usher in currency stability by transforming the European Monetary System (EMS) into an Economic and Monetary Union (EMU) with a single currency, was instead followed within months by the worst currency crisis for two decades. Ireland was hit by the crisis as badly as any region in the Community and the whole experience had already brought the issue of currency policy to centre stage when, at the end of July 1993, the EMS quite suddenly collapsed under pressure of a new wave of speculation directed mainly against the French franc. This paper reviews Ireland's experience in the EMS and asks whether any changes in currency policy are suggested by recent events. Increasing complacency about the stability of the system over the past five years led to realignment policy within the system becoming too rigid. Its last months highlighted the weaknesses of such a system from Ireland's point of view, including its vulnerability to speculation and the volatility which it entails for the Irish pound-sterling exchange rate.

Taking a longer perspective, the EMS has not been quite as bad a system for Ireland as is sometimes made out. In particular, adherence to the system cannot be blamed for Irish labour pricing itself out of the market. Nevertheless, it is equally wrong to give system all the credit for having reduced inflation and it did not effectively provide insulation from the sharp worsening of joblessness in the UK during the 1980s. Furthermore, it does appear that the system had the undesirable side-effect that real interest rates here were permanently higher than those in Germany, and that it left us prone to surges in interest rates which probably stifled potentially dynamic small businesses.

If EMU is still on the cards it will, I argue, represent an improvement even if the UK stays out. In addition to the elimination of currency transactions costs there will be no recurrence of the upward pressure on interest rates.

But recent events, and the apparently receding prospect of EMU, have opened the question of exchange rate regime choice in a new way. I review the main options here and conclude that, while a combination of political as well as economic arguments inhibited our making an unilateral move away from the narrow-band EMS, the new freedoms allow definition of a

policy which could represent an improvement.

Exchange rate regimes should not be changed very often. Stability of the exchange rate regime represents an element of the financial infrastructure allowing for long-term planning and a coherent basis for the design of contracts. The recent change has been forced upon us, and how the Irish pound is to be managed (if at all) under the new regime remains to be clearly defined. There is much value in announcing and adhering to an explicit and coherent strategy that will rarely require revision. Uncertainty about the regime certainly weakens inflationary discipline without providing any compensating benefits for employment growth.

Since there does not appear to be the immediate prospect of new co-operative exchange rate arrangements in the EC, the Government should now consider explicitly adopting a flexible target zone for a weighted average of the exchange rates of the currency *vis-à-vis* major trading partners, within the context of the wider EMS bands that are now in effect.

INTRODUCTION

While the Exchange Rate Mechanism (ERM) of the European Monetary System (EMS) remains formally in effect, the widening of the permissible margins of fluctuation decided under pressure in August 1993 amounts in practice to effective suspension of the regime which has governed Irish currency policy since 1979. Hampered by a lack of certainty about the future direction of the EMS, the Government nevertheless has to map out a coherent exchange rate policy in the new situation. The purpose of this paper is to review recent Irish currency experience and to consider the options now available.

Organisation of the paper

The paper is organised as follows. After this introduction, we begin in Chapter 1 with an overview of the role of currency policy in national economic policy: what it can and cannot be expected to achieve. In particular we discuss the partly competing functions of exchange rate as a "nominal anchor" and as a means of insulating economic activity from external disturbances. Problems posed by divergent movements of the values of partner currencies, and the difficulties of defending a currency peg against speculation are given special attention. The section concludes with a brief description of the main types of exchange rate regime in operation around the world today. Boxes highlight the experience of three small European countries: Austria, Finland and Iceland.

Chapter 2 turns to a consideration of Ireland's experience in the EMS, identifying the degree to which this system either provided a nominal anchor or insulated us from external disturbances. Three weaknesses for Ireland of the EMS are identified, namely the risk of competitiveness losses against the UK, surges of speculative pressure when sterling is weak and an apparent tendency on a long-term basis for higher interest rates in Ireland. A box looks at the debate about the possible role of the EMS in systematically damaging Irish competitiveness.

Alternative exchange rate regimes are examined in Chapter 3, with special attention to their ability to deal with the identified weaknesses of the EMS. We distinguish between matters which relate to EC-wide policy, and options which are unilaterally available to Ireland. Regimes considered include a free-float, the single currency (EMU) and a regime of wider

margins combined with a flexible target path for the average value of the currency against the main trading partners. The question of whether or not to have a publicly announced and explicit policy is considered. A box summarises recent official EC reports on the 1992-93 exchange rate crisis.

In the concluding section we stress the need for a credible, stable and widely understood exchange rate regime. The events of the past year have revealed weaknesses on all of these fronts. Managed with greater flexibility, the narrow band could have remained a serviceable regime. Nevertheless, had it not been for political considerations deriving from Ireland's full endorsement of and participation in the construction of the European Union, the narrow band EMS would never have been the regime of choice for Ireland. We must take advantage of the new freedoms to establish a regime which is more adapted to the specific needs of the country.

Chapter 1

CURRENCY POLICY: WHAT CAN IT ACHIEVE?

The power to create currency is a deceptive one which can achieve less than is often supposed. Badly regulated, it can be disastrous. Many a hyperinflation and many a recession have resulted from a misperception of the role and function of currency policy. Although a perennial topic – the production and regulation of money has been a matter for government policy for centuries – it is still a source of disagreement among both academics and policy practitioners. This chapter reviews some of the current practice and thinking in an area where few simple prescriptions are universally valid.

Although a predominantly private banking system generally performs most of the functions of the monetary system on a purely commercial basis, the unit of account in which it deals is currency, and the production of currency is a government monopoly. This monopoly, historically employed as a means of securing revenue for government, is nowadays managed in a wider public interest. The stability of the purchasing power of money is high on the list of objectives to be sought for this field of policy. At the same time, there are competing objectives for currency policy, especially the need to maintain wage and cost competitiveness. This second objective arises because most contracts, including wages, are set in terms of money. The apparent ease with which producers' costs can be adjusted relative to those in competing countries by a change in the external value of the currency often leads to calls for currency depreciation in the interests of securing competitive advantage, or of recovering a loss of competitiveness.

Price stability and competitiveness need not always be competing objectives, since the one may often be conducive in the longer run to the other. In the short run, however, they often apparently pull in opposite directions. Can currency policy achieve either, or both? There are certainly limitations on the degree to which the external value of the currency can be maintained at the level chosen by the government. We hardly need reminding of that so far as downward external pressure on the currency is concerned; but there are also cases where it has been difficult and costly for governments to prevent upward currency pressure from capital inflows.

Indeed, the most important determinant of a sustainable exchange rate path is not the authorities' stock of foreign exchange reserves, but the adoption of a coherent set of budgetary and macroeconomic policies. In the absence of such policies both domestic and foreign agents will (in their wage and price setting behaviour and in capital movements) take actions that directly undermine the currency. Furthermore, the macroeconomic imbalances resulting from inconsistent policies, whether reflected in interest rates or unemployment, will render the policy politically unacceptable and lead to its abandonment.

All in all, modern opinion tends to limit the range of objectives to be sought through currency policy.[1] Promotion of growth and reduction of inequality are among the important policy objectives which are best left to other policy instruments. A bad currency policy will hinder their achievement; a good currency policy is a defensive one which creates enabling conditions for other, more positive actions by public and private sector alike.

The experience of soaring inflation in the 1970s, followed by a painful process of disinflation, has tilted the balance of priorities for currency policy in the direction of price stability. In several countries the central bank's mission has been clarified in that sense, and greater independence given to the central bank to pursue this objective in a more or less single-minded manner. But no central bank is altogether insensitive to real economic developments; issues of competitiveness are never wholly absent. Nevertheless, it is generally agreed that, whatever is attempted on the side of maintaining competitiveness, there must be a "nominal anchor" for policy ensuring some degree of price stability.

1.1 The Nominal Anchor

Policies designed to ensure maintenance of wage competitiveness are not guaranteed to deliver price stability. Indeed, because losses of competitiveness tend to trigger policy response more quickly than gains in competitiveness, there is usually an inherent bias towards inflation. The same is true of policies designed to stabilize interest rates.[2] What is needed to keep inflation under control is a policy anchor lowered to prevent

[1]The cost of foreign debt is often raised in this context, especially when devaluation is on the cards, but it is usually a red herring (Annex 1).

[2]Therefore, the nominal interest rate is not a nominal anchor. It was Wicksell who first pointed out a century ago that stabilizing interest rates could easily result in a cumulative inflationary process.

nominal or money prices from drifting in the swirling eddies of internal and external macroeconomic conditions. Such a nominal anchor can be established through targets for some nominal magnitude such as the aggregate quantity of money or credit, nominal GNP or GDP, or in the exchange rate. Each of these has been suggested for inflation control, and there has been a lively debate over which is best.

Controlling the quantity of *money* or credit has been tried in many industrial countries, especially since the 1970s. Data for tracking the monetary aggregates are available quite quickly, and there are normally sufficient policy instruments to allow the authorities to keep the monetary aggregates close to the target path if they are determined to do so. A rule for monetary growth will generally translate into a broadly comparable inflation rate, but experience shows that the link is a fairly rough one – not suitable for fine-tuning price stability. Shifting demand for money due to financial sector innovation[3] is a particular problem, both for the ease with which the money target can be hit and for its impact on inflation. If such shifts are not recognized as such, they could trigger an inappropriate policy response imposing an undue deflation or a temporary increase in inflation. Another difficulty is in knowing just how much corrective action to take. Monetary policy has its impact with a fairly long and variable lag; this inhibits fine-tuning, and can result either in a whipsaw pattern of unduly vigorous corrective action exacerbating economic fluctuations or, on the other hand, in a timidity of policy with too little action being taken too late. Generally speaking, a money target is insensitive to general economic conditions, and using it to lower inflation can result in severe recession, as was evident in the UK in the early 1980s.[4]

By targeting *nominal income* rather than money, the risk of causing a recession may be reduced, but it is a good deal harder to track a particular path for nominal income, especially since the relevant data appears only with a lag. GNP data for Ireland are compiled only on an annual basis: even preliminary data are not available from official sources until the middle of the following year. Accordingly, in Ireland, nominal GNP is not a practical target or nominal anchor for short-run policy.

The *exchange rate* offers a particularly useful anchor for small open economies, because of its quick impact on the domestic price level. The speed of this link between exchange rates and prices, which has been

[3]A recent comprehensive study of the demand for money in Ireland in contained in Hurley and Guiomard (1989).

[4]Reliance on monetary aggregates has diminished in the US and UK, though they are still influential in Germany.

extensively documented for Ireland,[5] guarantees that an exchange rate peg will result in a close correspondence between the consumer price inflation at home and in the country to whose currency we are pegging. Unlike the aggregates, there is no delay in determining what the nominal exchange rate[6] is; accordingly one source of policy lags is removed. It also has the advantage of offering a very simple and visible policy rule.

But it is the *price level* itself that has been growing most in popularity as a policy anchor among monetary policy specialists, especially in large countries. The advantage of the price level is its quick availability and the fact that, unlike the monetary or income aggregates, it needs no decoding. The problem of long and variable lags in response to corrective action remains.

1.2 How Far Can Currency Policy Help Maintain Competitiveness?

In a country as small and as open as Ireland, trade prices as well as domestic prices are highly sensitive to international developments. Most Irish exporters have little or no market power and for many years have invoiced in foreign currency;[7] likewise for most importers. Thus a change in the value of the Irish pound does not usually have much influence on the terms of trade – the relative price of imports and exports. Instead, its main potential effect is on wage competitiveness, to the extent that wages do not respond so quickly.

However, the speed with which wages do respond increased during the 1970s, especially in response to a depreciation of the Irish pound. Such a depreciation, by its impact on consumer prices, tended to lower the purchasing power of wages and resulted in wage renegotiations to recover this lost ground.[8] This tendency, known as real-wage rigidity, undermines the effectiveness of exchange rate depreciation as a means of improving wage competitiveness.[9] In contrast, a sudden appreciation of the currency

[5] Recent contributions here include Honohan and Flynn (1986), Callan and Fitz Gerald (1989), Kremers (1990), Wright (1993a and b).

[6] As already noted, the real exchange rate, whether corrected for differences in purchasing power or wage rates, does not provide a nominal anchor.

[7] Mottiar and O'Reilly (1981). An Bord Tráchtála (1993) indicates that less than 15 per cent of Irish exports are invoiced in Irish pounds, with about 25 per cent in sterling.

[8] Honohan and Flynn (1986). That Irish wage response is relatively rapid by international standards is documented by Bean, Layard and Nickell (1986).

[9] If a lowering of real wages is sought, it may be attainable, if at all, only through incomes policy or through a socially costly period of high unemployment. These may have been relevant at different times during the 1980s, though to what extent is controversial: neither route is guaranteed success. These wider issues of labour market policy are beyond the scope of the present paper.

may not result in a symmetric lowering of nominal wages. Therefore currency appreciation may damage wage competitiveness even if currency depreciation does not help it.

It would take us too far afield to enter into a lengthy discussion of whether real wages in Ireland are "too high". But some general considerations deserve to be noted here. First, rapid increases in real wages undoubtedly put competitive pressure on existing firms, leading to job losses and closures. The impact of higher wages on attracting new firms, whether domestic or foreign, is also clear and has been documented, especially in the context of competition from the Southern European periphery. Probably a majority of economists would agree with the assessment that the relative real wage growth in Ireland over the past quarter century has been an important contributor to disappointing employment growth over the same period. On the other hand, account must be taken of the supply of labour and of the role of migration. Migration flows are largely determined by availability of jobs, with some contribution from relative social welfare benefits, but access to the UK and

The Exchange Rate Regime in Some Smaller Industrial Countries
Finland, Iceland and Austria provide interesting examples of small prosperous countries on the fringes of the EC with varied exchange rate experience.

Austria
A quiet success story, Austria has seen its living standards rise to the OECD average, compared with less than two-thirds of the average in 1950 – the fastest catch-up of any industrial country. The engine of growth has been the manufacturing sector with machinery and equipment exports to the fore. Unemployment has been in the region of 3-4 per cent for the past decade. This success has been achieved with a remarkable stability in inflation and external payments: the current account has been balanced or in small surplus for a decade, and inflation has averaged 3.1 per cent per annum over the same period. General government borrowing has been between 2 and 4 per cent of GDP in recent years, allowing a gentle decline in the debt-to-GDP ratio. About 40 per cent of merchandise trade is with Germany, and in 1982, Austria converted a *de facto* DM link – the Austrian Schilling had depreciated by only 3 per cent since 1971 – into a formal link which has survived to the present. In the words of a recent OECD report "despite the potential adverse impact on competitiveness, the hard currency policy has probably benefited trade as it has kept price and cost pressures down and contributed to stability of expectations in trading relationships...It has also promoted structural change, since international price competitiveness had to be maintained through steady improvements in unit labour costs (in local currency terms) relative to competitor countries" (OECD, 1993).

other labour markets means that relatively depressed real after-tax wages probably also contribute to out-migration. Furthermore, while modest gains in wage competitiveness can reliably be expected to result in expanded exports and employment, a severe cutback in real wages (as advocated by some) may not result in a commensurate boost to jobs, at least in the short run.

Wider dimensions of competitiveness than simply wage competitiveness are important in the medium and longer term. Product and process innovation to control costs and achieve international market penetration are ultimately more powerful instruments in the struggle for higher living standards and more rapid economic growth. A soft currency policy designed to ensure wage competitiveness may, by removing some of the pressure on existing firms, paradoxically result in weaker overall competitiveness in the longer run. This approach has underlain, for instance, the currency policy of Austria for many years. On the other hand,

Iceland

Heavily dependent on the fish-catch, and to a lesser extent on the market for aluminium, Iceland has tried to cope with its volatile fortunes with monetary financing of government deficits and an exchange rate policy that has generally been accommodating of the resultant inflation. Over the period 1970-89 this has resulted in an acute inflationary bias to policy, with average annual inflation of 32 per cent. Still, other features of the economy have been favourable: living standards are not far short of the OECD average, and unemployment averaged less than 1 per cent in the 1980s. Since 1987, the economy has been in recession, with per capita output now running almost 10 per cent below 1987. Unemployment exceeded 2 per cent in 1990, approached 4 per cent in 1992 and is heading for over 5 per cent in 1993. Declining fish catch has, as usual, been responsible for most of the decline, but on this occasion the fiscal and especially the exchange rate policy response has been different. In late 1989, the authorities pegged the value of the krona to a trade-weighted basket of 17 currencies; in 1992 the basket was narrowed to the ECU (76 per cent) the dollar (18 per cent) and the yen (6 per cent). The decision to peg was much less half-hearted than previous attempts to stabilize the currency, and inflation fell from 21 per cent in 1989 to 15 per cent in 1990, 7 per cent in 1991 and 5 per cent in 1992. It is noteworthy that wage inflation also slowed, so that real earnings per worker actually declined by 7 per cent in 1990 and showed little growth in the following two years. The exchange rate crisis of Autumn 1992 led the authorities to consider a wage freeze and tax policy measures to deal with the consequences of sharp depreciations of the currencies of important competitors, but opted instead for a 6 per cent depreciation of the peg. Following the devaluation, interest rates jumped by about 2 percentage points reflecting a loss of confidence by the markets.

the ability of the productive sector to cope with ever-increasing real wages is limited, and a macho approach to exchange rate policy is likely to result in a collapse as has happened to hard-exchange rate policies at the centre of countless Latin American stabilization programmes over the past quarter-century. So here too is a question of balance and realism.

1.3 Theory of Optimal Exchange Rate Regimes

Should exchange rates be flexible or fixed; if fixed, to what should they be fixed; if flexible, what indicators should guide policy in their regard? The variety of regimes operated throughout the world reflects the diversity of opinion on these questions and the diversity of underlying conditions in

Finland

The collapse of its eastern markets in 1991 – exports to the Former Soviet Union fell from 13 per cent of total exports to 5 per cent in that year – was a severe blow adding to the slowdown which had already hit the Finnish economy, and which was a reaction to unsound credit-financed overexpansion in the late 1980s. The ensuing recession has been exceptionally deep and protracted, despite a recovery of competitiveness helped by a very sharp currency depreciation. The value of the Finnish markka had been linked to a trade-weighted basket since the 1970s, with progressively wider fluctuation margins (widened to +/- 3 per cent in 1989). But in the part five years, the markka has followed the path of a roller-coaster: in the boom years of 1987-88, it was allowed to appreciate (first within the band, and then with a 4 per cent upward realignment) in order to dampen export demand, though this led to capital inflows and lower interest rates, boosting domestic demand. During 1989 the widening current account deficit led to a reversal of sentiment, and downward pressure on the markka. This pressure increased when the new government announced its decision in 1991 to switch from the trade-weighted basket to an ECU-peg. Even though this peg was introduced without a realignment at first, speculative pressures (resulting from the deteriorating trade and output situation) that built up again towards the end of the year proved irresistible and the markka was devalued by over 12 per cent in November 1991. Although this created a competitive advantage which allowed considerable diversion of export capacity into Western markets, 1992 was characterised by further declines in domestic expenditure (including tightening of fiscal policy) high interest rates and a surge in unemployment from 3.5 per cent in 1990 to 7.6 per cent in 1991 to 12.7 per cent in 1992 (and reaching 18 per cent in 1993). Further speculative pressure resulted in the currency being floated on September 8, 1992, and by February 1993 it had fallen by one-third in two years to a level which at last allowed a considerable reduction in money market interest rates to levels lower than they had been for years. An explicit inflation target was announce by the authorities to guide the float, and for the present inflation remained at around 4 per cent.

different countries. One view that would generally be agreed is that exchange rate regimes should not be changed very often. Stability of the exchange rate regime represents an element of the financial infrastructure allowing for long-term planning and a coherent basis for the design of contracts. Uncertainty about the regime certainly weakens inflationary discipline without providing any compensating benefits for employment growth.

The literature on choice of exchange rate regimes has evolved in at least four main waves in the post-war period. The findings and insights of researchers in this area are manifold, but it has proved to be a complex field, resistant to simple and uncontested policy prescriptions.

An early stage in the literature raised the issue of the optimum currency area, in terms of an area within which there is sufficient labour mobility to avoid the emergence of unemployment in the face of shocks affecting one region. Such an area would be an appropriate one in which to have exchange rate fixity, but regions or countries with isolated labour markets would do well to retain some flexibility in order to allow full employment to be maintained in the face of a loss of external demand.

Later on analysts tried to infer optimum behaviour through revealed preference by working back from the actual pattern of regime choice and discovering what country characteristics were associated with observed regimes. Though there are many exceptions, there is a tendency for large, closed economies to choose floating exchange rates, while small open ones choose fixed rates, except where fiscal and monetary discipline is not adequate to support this.

Later still, economists became interested in the ability of exchange rate regimes to insulate countries from various types of external and internal shocks: a number of mathematically sophisticated papers explore the circumstances under which different regimes will do this, and the policymaker is invited to choose the regime which best insulates from the most prevalent types of shock affecting the country in question. For large economies, the story here is more complex than for small, open economies where the adjustment to shocks is achieved chiefly through the effect of exchange rate changes on real wages.

The most recent branch of the literature focuses on the discipline effect of exchange rate regimes in a game-theoretic context and seeks to examine the effects of adherence to a particular regime on the ability and incentive for governments to maintain a self-fulfilling reputation for price stability. A fixed exchange rate peg to which the government is credibly committed can act as a powerful anchor against inflationary surges. Thus, a focus of research has been the potential for countries both within the EC

and outside it to benefit from the anti-inflation reputation of the Bundesbank by tying their currencies to the DM.

As already indicated, the conclusions from this research are not decisive, but if there is a common theme in recent writing, it is that adherence to a nominal anchor must not be slavish (Cf. Williamson, 1993). The disastrous consequences of sticking with a grossly overvalued exchange rate have been evidenced by many episodes in the developing economies. The role of overvalued exchange rates in worsening the effects of the Great Depression of the 1930s have also been highlighted. While there should be a nominal anchor, the gales may occasionally (say once a decade) blow so hard as to require weighing the anchor and making for a more sheltered anchorage.

1.4 Exchange Rate Pegs in Practice

International trends in the choice of exchange rate regime is shown in Table 1, which reveals the declining relative importance of exchange rate pegs during the 1980s.[10] Almost one-third of countries have moved from a peg to a more flexible exchange rate regime in the last decade or so, with comparatively few moving towards a peg. The disturbances in the EMS since September 1992 have swung several smaller industrial countries (Finland, Norway and Sweden), along with Italy and the UK away from pegs and into floating regimes. In practice small economies, and those without diversified exports, have traditionally favoured exchange rate pegs, but in general it is not easy to predict the exchange rate regime that a country will choose on the basis of structural characteristics of the economy (Honkapohja and Pikkarainen, 1992).

A straightforward peg provides the most secure exchange rate anchor, provided the peg is to a currency that has low inflation. Half of the countries with a pegged exchange rate fix the peg to just one currency, mainly the US dollar.[11] The other half use a basket or other mixture of currencies. They include the 9 members of the ERM, as well as currencies pegging to the SDR (a basket of the 5 largest currencies, with the US dollar having a weight of 40 per cent). But most have adopted their own basket, corresponding usually to national trade patterns.

[10]Most of the countries involved are in the Third World and some face different issues in exchange rate policy; cf. Aghevli *et al.* (1991), Corden (1993), Quirk and Cortés-Douglas (1993).

[11] Also included are the French franc for a group of African countries (mostly former French colonies), the Russian ruble for some former republics of the Soviet Union, and a handful of others.

Table 1: Choice of Exchange Rate Regime: IMF Member States

	1980	1982	1984	1986	1988	1990	1992
Pegs	94	95	94	91	94	85	84
US dollar	39	38	34	32	36	25	24
French franc	14	14	13	14	14	14	14
Russian ruble							6
Pound sterling	1	1	1	0	0	0	0
Other single	3	4	4	5	5	5	6
SDR	15	15	11	10	8	6	5
Other currency composite	22	23	31	30	31	35	29
EMS	8	8	8	8	8	10	9
Indicators	4	5	6	6	5	3	3
Flexible	34	38	39	45	43	52	71
Managed floating		20	20	21	22	23	23
Independent floating		8	12	19	17	25	44
Limited flexibility		10	7	5	4	4	4
Total no. of currencies	140	146	147	150	150	150	167

Source: International Financial Statistics

The more complex the peg, the less difficult it is for the authorities to adjust it inconspicuously, and therefore the less visible a discipline it represents for anti-inflation policy. A basket peg that is constantly being revised is a dragging anchor. Still, by choosing a basket, a country partially insulates itself from sharp fluctuations in the value of its currency against most other currencies, such as might easily happen with a single currency peg, given the volatility of the main floating currencies. A handful of currencies without a peg adjust the value of their currencies on the basis of indicators of competitiveness.

1.5 The Problem of Multiple Partner Currencies

Most of the current interest in Irish exchange rate policy lies in the fact that our trade is distributed widely among countries whose currencies have fluctuated widely in relative value. This presents a number of problems, both to exporters and importers, and to the analyst. At the risk of labouring the obvious, it is worth spelling out some of these implications.

First is the question of export profitability when a partner currency depreciates – the case of the UK recently. While small countries such as Ireland are price takers in the world market, this is not altogether true of larger countries such as the UK. Thus, a fall in the relative price of sterling *vis-à-vis* the DM will not result in a quick and full increase in all sterling prices in the UK to compensate. As a result, Irish exporters to the UK may be faced with lower prices expressed in Irish pounds and hence with an erosion or elimination of profitability. The problem must not be overstated. For one thing, other exporters to the UK market will be in the same boat, and this will immediately place upward pressure on the UK price, especially to the extent that UK producers are not in a position to supply the domestic market fully at the lower price, or anyway because they wish to expand exports because of the relatively higher price prevailing outside the UK. Furthermore, cost pressures resulting from the devaluation both directly, and indirectly through higher wage settlements as the inflationary effects of the devaluation begin to be felt, will drive up the price at which UK producers are willing to supply the market. Eventually, the "law of one price" will hold sway once more.

The adjustment process outlined above will often be a protracted one (especially where imports do not supply much of UK consumption of the product) and it is not likely to restore the position that prevailed immediately before the devaluation: after all, the devaluation was prompted by the emergence of disequilibria. It is nevertheless important to recognize that much of the sudden loss of profitability for Irish exporters will be transitory. The ability of those exporters to continue to

supply the UK market during the transition will depend, for example, on the degree to which their cost structure is sunk or committed, on the degree to which it is important for them not to lose workers with specialized skills pending price recovery in the export market, and on the capitalisation and financial structure of the enterprise. It is in these dimensions that a number of Irish exporters to the UK are thought to have been vulnerable. Furthermore, some may have expanded their operations in recent years to take advantage of booming demand and unsustainable UK prices: for these, the adjustment to equilibrium will not be enough to restore the profitability they had briefly enjoyed.[12]

A second issue raised by divergent movements in different partner currencies is the question of measuring and interpreting the data on currency movements. If it weakens against some currencies and strengthens against others are we to say that the Irish pound is appreciating or depreciating? The simplest approach is to take an average of partner currency movements, weighted by each country's share in Irish trade. A variety of weighted average measures are available (described in Honohan, 1979), some of them taking account of the consideration that exporters to (say) the UK are competing not only with UK producers but with producers from different parts of the world. Unfortunately, since the end of the sterling link, the divergent movements of sterling and other currencies have resulted in such weighted averages giving rather different answers. Furthermore, there is the question of modifying trade weights to take account of specific product considerations. Thus, it is arguable that exports of agricultural produce subject to effectively guaranteed Irish pound or ECU prices should not be assigned to the currency of the destination country.[13] Likewise, trade in products produced with a low labour content might be weighted differently to the extent that our interest is in maintaining wage competitiveness.[14]

[12]Consideration of these issues needs to be supported by a more detailed analysis based on hard facts. The submissions of many enterprises to the Market Development Scheme would likely provide a valuable source of such information and should be carefully analyzed (subject, of course, to maintenance of strict confidentiality) in order to gain a better understanding of the degree of vulnerability of the Irish market to sterling fluctuations.

[13]The CAP creates other problems: the profitability of secondary processors of agricultural produce – such as biscuit producers – can be hit by measures designed to insulate primary processors and the farmer from exchange rate change.

[14]It is surprising that no official body in Ireland publishes an index of wage competitiveness at better than annual frequency. This should certainly be rectified. The data in this paper are based on the three main trading partners only, and the weights used are somewhat arbitrary (Annex 3 illustrates the effect of changing the weights).

But a more serious measurement difficulty is that an average, however weighted, does not do justice to the asymmetry of effect. An enterprise faced with closure due to loss of competitiveness in one market may not be balanced, at least in the short-run, by expansion of employment in other enterprises geared to exploit increased profit margins in other markets.

In sum then, though measuring them is as yet a most imperfect science, divergent movements of partner currencies create transitory, but nonetheless damaging, shifts of profitability.[15] Because they are transitory and because shifting production to other locations is costly, it will not be in the interest of most enterprises to respond suddenly to every shift in relative currency prices. Instead, they will take a long-term view of likely relative costs before making location decisions. They will also structure their finances to allow for fluctuations in profitability induced by currency movements, and they will hedge their very short-term receivables or payables in the forward foreign exchange market or otherwise.[16]

1.6 Defending a Peg Against Speculators

Recent events may suggest that the currency is necessarily uncontrollable-bobbing about on a turbulent sea of speculation. Can any given exchange rate peg (or a target band) be reliably defended any more? There is no agreement on this point, though even before the disturbances of last Autumn, many economists pointed out the vulnerability of the EMS to speculative attack. An extensive theoretical analysis[17] emphasizes the vulnerability of pegs in general to speculative attack in the absence of effective exchange controls. A speculative attack is much more likely – and simply brings forward the date of devaluation – when domestic macroeconomic policies make the peg unsustainable anyway. Those who discount the importance of destabilizing speculation argue that a speculative attack which drives a currency away from the value that would equate long-term demand and supply is likely to be loss-making for the

[15]The impact on import prices, and through them consumer prices, must not be neglected. Indeed, these may become central in the political debate about currency matters.

[16]Measures such as the Market Development Scheme, introduced in late 1992, and attempting to insulate manufacturers from the decline in sterling, could have the adverse side-effect of reducing the incentive for these enterprises to arrange their affairs so that they can cope with such fluctuations.

[17]Cf. Svennson (1992a), Krugman and Rotemberg (1992).

speculators, and therefore less likely to occur. But even if policy is coherent and credible, a speculative attack may induce a policy response which validates the attack *ex post* (higher wage settlements and credit expansion in response to a forced devaluation, for example). Furthermore, even if financial markets correctly price assets on average, it is inevitable that, especially if offered the prospect of a large gain, they will make many individual pricing errors, which could include the value of the Irish pound.

Given this pessimistic assessment, what is to be done to minimise the risks? We take for granted the general and obvious requirement of a credible policy package consistent with exchange rate strategy being maintained (and that includes being able to deliver the package).

It is clear that speculation cannot be outlawed as such in our type of open trading economy, where what we term pejoratively as speculation is only an aspect of a spectrum of mostly useful financial activities. Modern economics textbooks define speculation in terms of the transfer of capital risk from those unwilling to assume it to those who are. Sellers of a devaluation-prone currency may be on either side of this market, depending on the vulnerability of their overall financial position to exchange risk. Most financial and non-financial companies try to avoid assuming foreign exchange risk. In particular most financial companies act as intermediaries by pooling or diversifying risk. Indeed most banks place strict limits on the risk that their foreign exchange dealers can assume. Non-financial companies that do otherwise are acting unwisely: their internal controls and strategies should be much more effective than legislation to limit such behaviour. While there are professional speculators who enter the market accepting high risk with a view to high returns, most of the problem for the authorities arises when, in the form of the Central Bank intervening in the foreign exchange market, the authorities themselves become the only or main assumers of risk. Private speculators in such circumstances are assuming only a small risk relative to the expected return: the authorities are giving them a bargain. Trying to find a way of achieving exchange rate stability without offering that bargain is the conundrum which faces us.

Three possibilities have been suggested in this connection, and are now considered. First, exchange controls, and analogous quantitative measures; second, a foreign exchange transactions tax; third, wider margins or target zones.

Many economists forecast that elimination of exchange controls would increase the frequency of destabilizing speculation in the EMS. Note, however, that the most severely affected currency was the pound sterling, which had been free of all exchange controls for more than a decade. It is

the liberalisation of financial markets generally, and the greater international integration of the industrial economies, more than the removal of exchange controls *per se*, that has increased the difficulty of pegging exchange rates. Indeed, it is doubtful that exchange controls could be very effective in the modern environment. Those that could be enforced would slow the outward movement of funds a little, and could considerably reduce leveraged speculative operations, but they would still be insufficient to maintain a peg not thought credible by the market. Furthermore, their use over a prolonged period introduces all kinds of distortions by diverting funds through unpoliced channels.[18]

As an alternative to reintroduction of exchange controls there have been suggestions that other types of administrative control could be used, including a limitation on bank lending, as speculators who do not own Irish pounds have to borrow them in order to sell them speculatively. The only merit to such a scheme relative to more traditional exchange controls is that it might not contravene EC undertakings. The same types of distortion would emerge: to whom would the rationed loans go, and at what price?

It is also argued against exchange controls that their use in an emergency indicates a reluctance by the authorities to face up to market realities, and hence is not conducive to the market participants believing that the government has a coherent and credible policy approach. Such confidence arguments are difficult to evaluate, and probably depend sensitively on timing and other contingencies. For instance, an increase in interest rates, which is the first line of defence against the speculators, is often praised at first, as revealing that the authorities are prepared to take politically unpopular actions in order to maintain the parity; later on, successively higher interest rates can destabilize confidence if they are interpreted as desperate or last-ditch attempts to discourage speculation before the inevitable devaluation.

A tax on foreign exchange transactions has been advocated (most notably by Tobin) as a means of reducing the incentive for speculation. The proposal is that a "modest" rate of tax – say 1 per cent – would not materially affect international trade, but would be enough to discourage purchases and sales of currency that are merely motivated by a small probability of moderate exchange rate gain. This proposal has recently been reiterated in the EMS context (Eichengreen and Wyplosz, 1993).

[18]A rather negative evaluation of Irish experience with exchange controls is contained in Mathieson and Rojas Suarez (1993).

While the proposal might stabilize floating currencies, it is hard to see how this would work reliably for the EMS, where potential overnight gains as a result of devaluation can be up to 8 per cent. In addition, the proposal neglects the volume of spot and foreign exchange transactions which occur in the normal course of trade: each commodity trade may trigger several foreign exchange transactions in order to hedge risk. Some estimates put the total value of foreign exchange transactions in Ireland as high as 25 times GDP. Accordingly, even a 1 per cent transactions tax would cascade into something larger than it appears at first sight. Whatever about the merits of a scheme introduced at the European level,[19] it is quite clear that unilateral introduction of such a proposal is totally infeasible: it would simply drive the entire foreign exchange business of the Irish banking system off-shore.

That leaves wider margins. Briefly the point of having wider margins (in the context of reducing the impact of speculation) is to allow for necessary realignments of central parities to take place without any discrete jump in exchange rates at the time of realignment. If there is to be no discrete jump, the potential gain to correctly anticipating a realignment and speculating against the currency is greatly reduced. Thus, identifying wider margins as a remedy for speculation is based on the observation that speculation against a weak currency is not only practically riskless (the currency will not quickly rise in the band) but potentially involves an enormous gain relative to the net interest cost of borrowing the weak currency for a few days. The wider margins remove the enormous gain, and eliminate the lottery character of the foreign exchange market. With the lottery closed, the gamblers will move elsewhere.

The same reasoning applies with stronger force to the proposal (Williamson, 1985) for a weaker form of band or "target zone", where the authorities would not undertake to defend the band absolutely, but would undertake to conduct their monetary and fiscal policy in such a way as to push the currency in the direction of the band were it to slip out of the band due to market forces.

[19]It can be argued that both exchange controls and foreign exchange transactions taxes are incompatible with the move to an increasingly open trading environment and the financial liberalisation which have characterised policy in recent years, and are seen by some as being at the heart of the European single market concept.

Chapter 2

IRELAND'S MACROECONOMIC EXPERIENCE IN THE EMS

This section provides an overview of Ireland's macroeconomic experience in the EMS. We argue that in some dimensions – inflation, competitiveness, unemployment – membership may not have altered economic performance as much as is often thought. On interest rates, however, there do appear to have been generally adverse consequences. We also describe realignment policy and note how difficult it is to characterise the EMS experience in terms of the concept of a "nominal anchor".

The 1978 decision to participate fully in the European Monetary System had far-reaching consequences, both for the structure of the financial system and for macroeconomic developments to the present. There were also more subtle influences on the trend/shift towards commercial and financial relations with continental countries at the expense of the traditional relationships with the United Kingdom.[20]

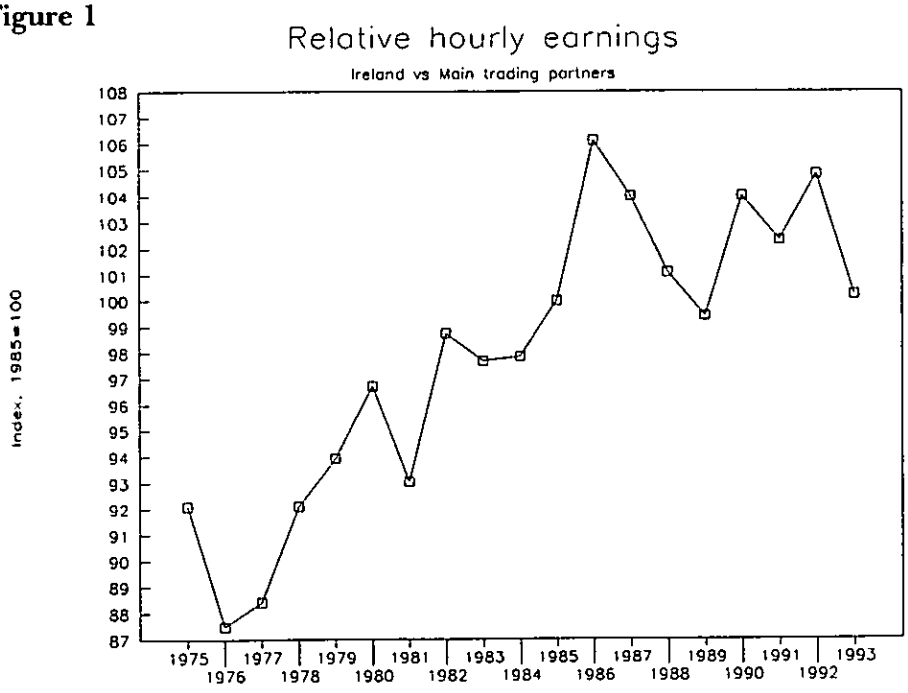
Ireland was surely more affected than any other EC country by the introduction of the EMS. Although other exogenous factors also played a role, the initial side-effects of EMS membership, namely the introduction of exchange controls and the abolition of the one-for-one sterling link, were decisive for monetary developments in the following decade. The EMS introduced a really independent interest rate for the first time, and it also introduced currency transactions costs and exchange risk to a very wide segment of Irish economic activity. Though compensated by interest subsidies, these were damaging features.

2.1 Wage Competitiveness

On wage competitiveness, though, the picture was not as negative as has often been portrayed. In fact wages increased by about 1 per cent per annum faster than the average of our trading partners, after adjusting for exchange rate changes, though relative to EMS countries the increase in

[20]And there was some consequential distortion of cross-border trade (though here tax considerations were probably more important).

Figure 1



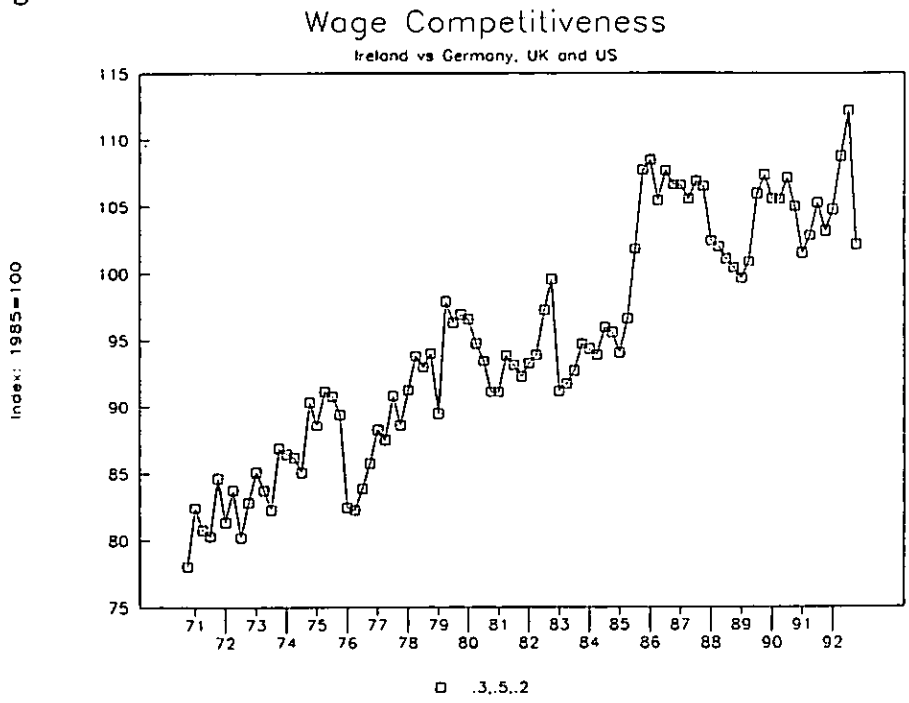
earnings was much higher. This is illustrated by Figures 1 to 4. These show the movements in average hourly earnings expressed as a proportion of the weighted average of the State's main trading partners, all brought to a common base and corrected for exchange rate changes. An increase in this index means a loss of wage competitiveness.[21] A number of features may be noted about the data. First, the rate of increase of the index was as high or higher in the couple of years before EMS began as in the subsequent period. Second, the index is quite volatile, reaching a peak in 1986 before subsequent reversals: this derives from the movements of sterling and the US dollar and illustrates the difficulty of maintaining stability in competitiveness against the background of volatile worldwide exchange rate movements. (For reference, the average trade-weighted index (EER) of the Irish pound – not adjusted for wages or prices – and the bilateral exchange rates against the pound sterling, the Deutsche Mark and the US dollar are plotted in Figures 15-18.)

[21]Thus, for example, the entry 105 for 1992 in Figure 1 means that earnings had, since 1985, increased by 5 per cent more than in the average of the Republic's trading partners, after adjustment for exchange rate changes.

Figure 1 has the most comprehensive country coverage, but is only at annual frequency.[22] It indicates an average loss of wage competitiveness of less than 1 per cent per annum, 1975-93.

Figure 2 is at quarterly frequency, but only includes UK, Germany and US as comparators.[23] By fitting a log-linear trend to the data, we obtain an average loss of 1.3 per cent per annum over 1971-93, but only 1.1 per cent during 1979-93. Thus the quarterly series indicates a slowdown in the loss of wage competitiveness during the EMS period.

Figure 2



[22]For 1981-92 the data is from *Economic Review and Outlook* (1993 and previous issues); for earlier and later periods the *Central Bank Quarterly Bulletin*.

[23]The weights used are constant at 50, 30 and 20 per cent respectively. Changing the relative weights of sterling and the DM does not shift this index by much, but it is sensitive to the weight of the US dollar: by lowering the weight of the dollar to 10 per cent, for instance, we lower the 1971-93 trend to 1.1 per cent per annum; the 1979-93 trend to 0.8 per cent per annum.

Figure 3

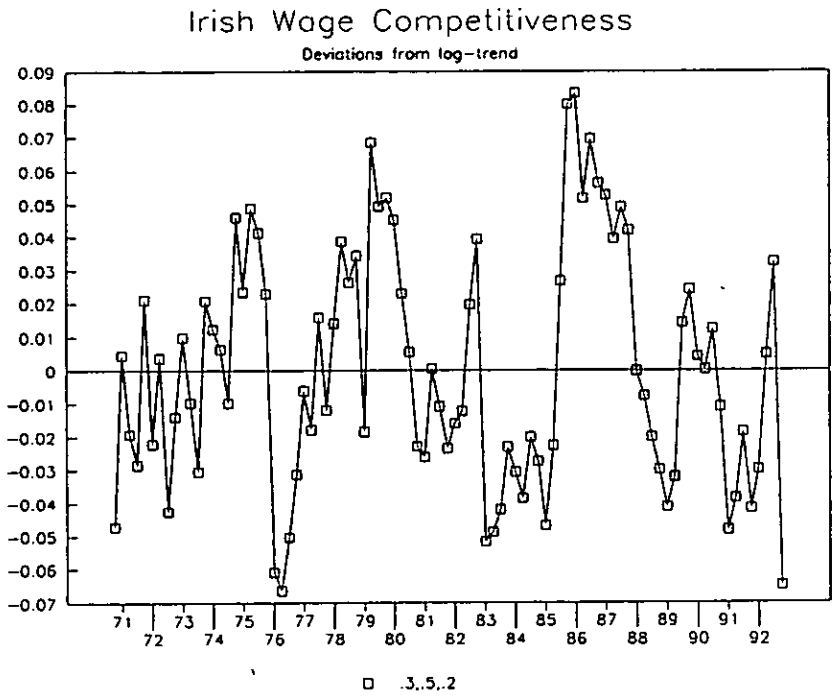


Figure 3 shows the deviations of this index from a linear trend, and highlights sudden losses of competitiveness in early 1983, early 1986 – the peak of the series is in the second quarter of 1986, just before the unilateral devaluation of that year – late 1989 and late 1992.

Figure 4 looks at wage competitiveness against just the UK, a comparison which is of particular interest because of the labour intensity and low-margin nature of much of Irish exports to the UK. Despite considerable fluctuations, this bilateral index shows no trend over time. The index peaked at 111 at the end of 1986, compared with 99 just after the 1993 devaluation.

At what rate, if any, a steady increase in relative wages is sustainable, is a matter which is open to debate. On the one hand, a catching-up process of living standards would imply such an increase. On the other hand, catching-up requires a steady increase in the marginal productivity of the workforce if employment is to be maintained. While average productivity

of labour in manufacturing has jumped over the years, this is largely attributable to the addition of other factors of production, and to the closure of old low-productivity firms. That marginal productivity may not have been growing adequately is reflected in the disappointing employment performance, especially in industry.

The loss of wage competitiveness would, of course, have been higher had it not been for frequent devaluations – and not just the 8 per cent devaluation of mid-1986. In fact, the Irish pound was devalued against the

Loss of Competitiveness in the EMS

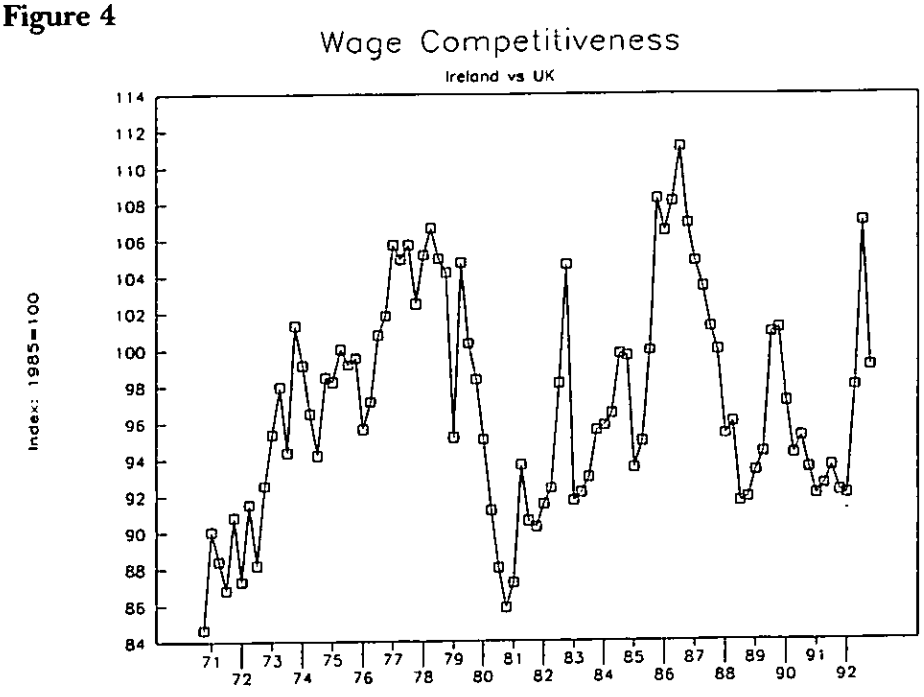
The issue of how serious was the loss of competitiveness in the early years of the EMS is highly controversial. Authors who have stressed this as a problem, such as Dornbusch (1989), Kremers (1990) and Leddin (1990), have tended to look mainly at either relative movements in consumer price indexes or, if they look at wage rates, to use the EMS countries as comparators. Both of these involve important biases. Focusing on consumer price inflation is marred by the fact that an important contribution to consumer prices inflation in Ireland during 1981-83 was the imposition of very much increased indirect taxation – the ratio of customs, excise and VAT revenue to personal consumption rose from 22 per cent in 1980 to almost 28 per cent in 1983 – an increase which would imply a contribution of about 8 per cent to the level of consumer prices. Though they may lead to higher wages being negotiated, such indirect taxes have a negligible direct effect on competitiveness. Likewise, confining the comparison to the EMS countries wholly neglects the strength of sterling and the US dollar in those years, a strength which helped the competitiveness of Irish firms even as competitiveness *vis-à-vis* the EMS currencies was being eroded. On the other hand, published data on competitiveness using unit labour costs provide too rosy a picture, because rapid structural change in Irish manufacturing industry towards enterprises with a low labour share in value added means that changes in unit labour costs greatly overstate the average productivity gain of enterprises.

Since wage competitiveness depends both on exchange rate and wage movements, the role of exchange rate policy in influencing competitiveness is only a partial one. Provided wage-setting institutions are sufficiently flexible, any nominal exchange rate movement can be offset by changes in wages. The fact that wage competitiveness trends have not been noticeably different as between pre- and post-EMS reflects this ability of wage-setting to accommodate to gradual exchange rate movements. However, in practice, wage rates adjust over a time period measured in quarters, whereas exchange rates can change dramatically over periods measured in days or weeks. Thus the ability of an exchange rate regime to smooth exchange rate movements (e.g., through defensive realignments to offset sudden changes) is arguably more important for competitiveness than the average trend in nominal exchange rates.

DM no fewer than 7 times between 1979 and 1987 – just about once a year on average.[24]

Government did make an attempt to limit public sector pay increases as part of the programme to stabilize the public finances. The main motivation for this, and for contractionary fiscal policy generally in the 1980s, came from a recognition that the rapid growth in government debt was unsustainable.[25] It was as a beneficial side-effect that fiscal contraction contributed to the lowering of inflationary pressures in the labour market, but inflation reduction was not the driving priority and in particular there was no strategy to engineer or force a high exchange rate in order to squeeze out inflation. This point is brought out below in the analysis of realignment policy.

Figure 4



[24]And that is the relevant measure because experience shows that realignments do not affect the US dollar value of the DM; thus the realigning currencies adjust around the pivot of the DM (Honohan and McNelis, 1989).

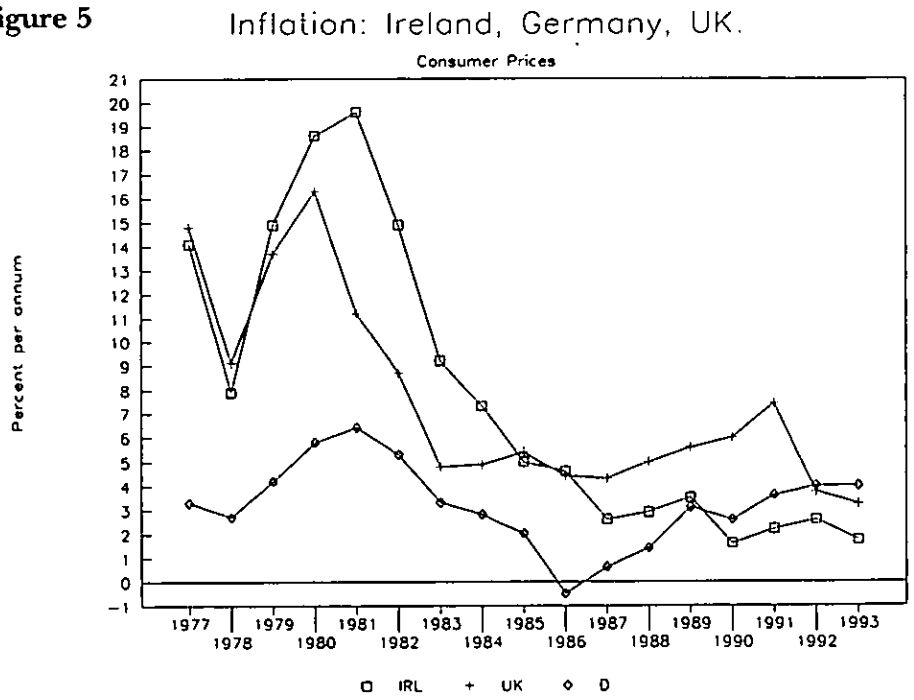
[25]Geary (1992) provides an account of the debate about fiscal adjustment in Ireland, together with references.

2.2 Inflation and Unemployment

To what extent was it membership of the EMS that contributed to lowering Irish inflation over the years? The question is not an easy one to answer, combining as it does issues of political economy with those of macroeconomic linkages. At the level of political economy, it may fairly be said that the EMS undoubtedly provided a kind of brake on any tendency that might have emerged for aggressively devaluationist policies, though that would also have been true of adherence to the sterling link.

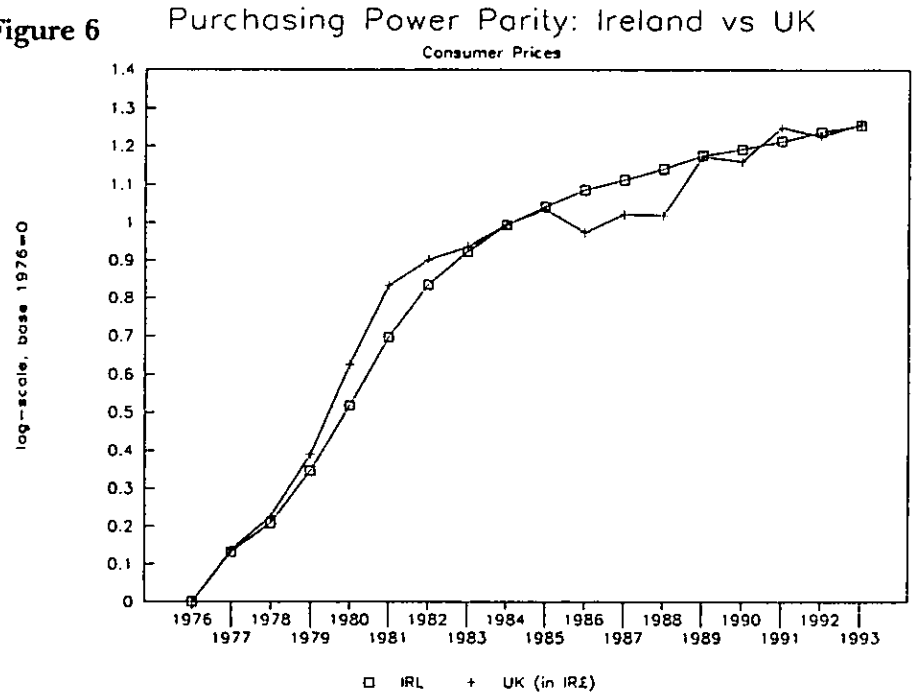
Looking at the dynamic evolution of prices in Ireland, the UK and Germany during the EMS (Figure 5), no deflationary impact of the EMS is very evident. Before the EMS began Irish inflation was always close to that in the UK, for obvious reasons. This correspondence was quickly broken when the EMS began, and Irish inflation at first (1980-82) surged far ahead of that in the UK and also increased relative to that of the other EMS countries. Of course inflation drifted lower as the decade went on, but was that due to factors other than EMS participation? After all, UK inflation also fell rapidly. On the one hand, cross-country research indicates that Ireland is one of the countries whose policy response to inflationary shocks

Figure 5



was more disciplined in the 1980s than previously. On the other hand, the most plausible alternative policy at that stage – a continuation of the sterling link – would surely have produced lower inflation in those early years – as in the UK.[26] In this connection it is worth noting that (as shown in Figure 6), over the whole period since 1979, cumulative Irish inflation has been just a little higher than that in the UK, and the exchange rate has returned to vicinity of parity – much as the purchasing power parity theory of exchange rates and inflation would predict.

Figure 6



But if the EMS has not helped us to get a much better inflation trend than that in the UK overall, it has not fully insulated us from the generally depressed employment trends in that economy either. Links between Irish and UK unemployment remain very strong,[27] and the recent surge in

[26]Admittedly, a looser exchange rate regime, such as a float without any anchor for the price level, could easily have resulted in an upward drift in inflation to Icelandic levels.

[27]Cf. Honohan (1992) which also explains the adjustments to the two series made in Figure 7 to make them comparable and consistent. See also Browne and McGettigan (1993) for a more comprehensive discussion of the factors influencing employment and unemployment.

unemployment here is undoubtedly linked to the contemporaneous sharp deterioration in UK employment conditions. The links here are illustrated in Figure 7, in which unemployment in the Republic and the UK are brought to a comparable scale. The figure shows that each major surge in UK unemployment has been soon followed by an increase in Irish unemployment. Declines in UK unemployment have also been transmitted back across the Irish Sea, though more slowly, and the 1987-89 decline in the UK was too short-lived to make much of an inroad into the Irish figures before the most recent surge took over.

Figure 7

2.3 Interest Rates

By comparison with interest rates in Germany, an investor in Irish bank deposits would have done far better, even after taking account of the declining exchange rate of the Irish pound against the DM. This is an important difference by comparison with previous experience in the sterling link when Irish interest rates scarcely deviated from near-equality with the UK.

These points are illustrated in Figures 8 and 9. Figure 8 shows short-term Irish and German interest rates. Figure 9 combines these with exchange rate

Figure 8

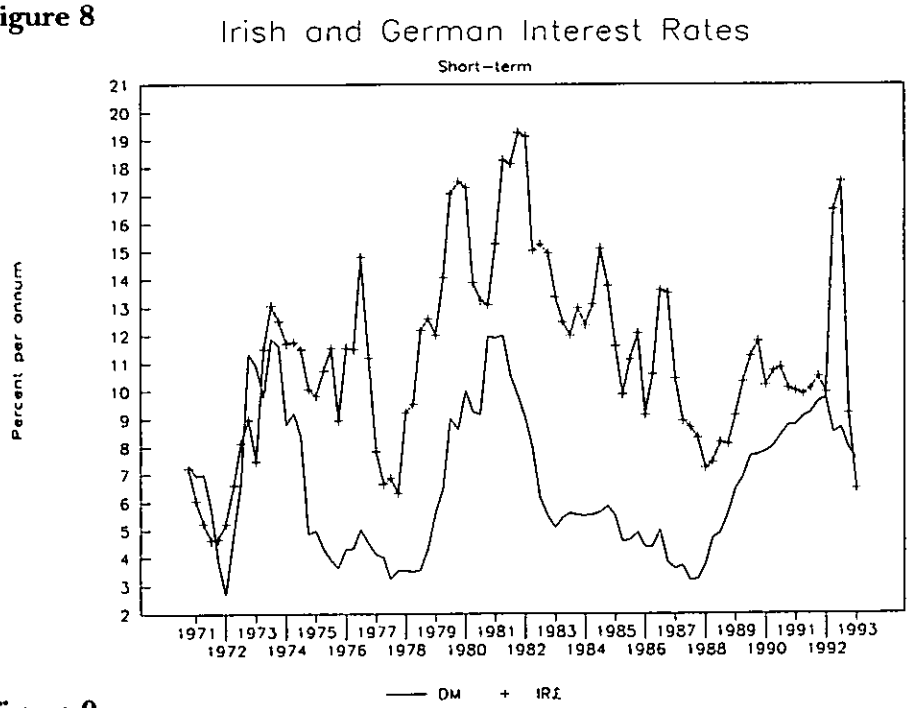
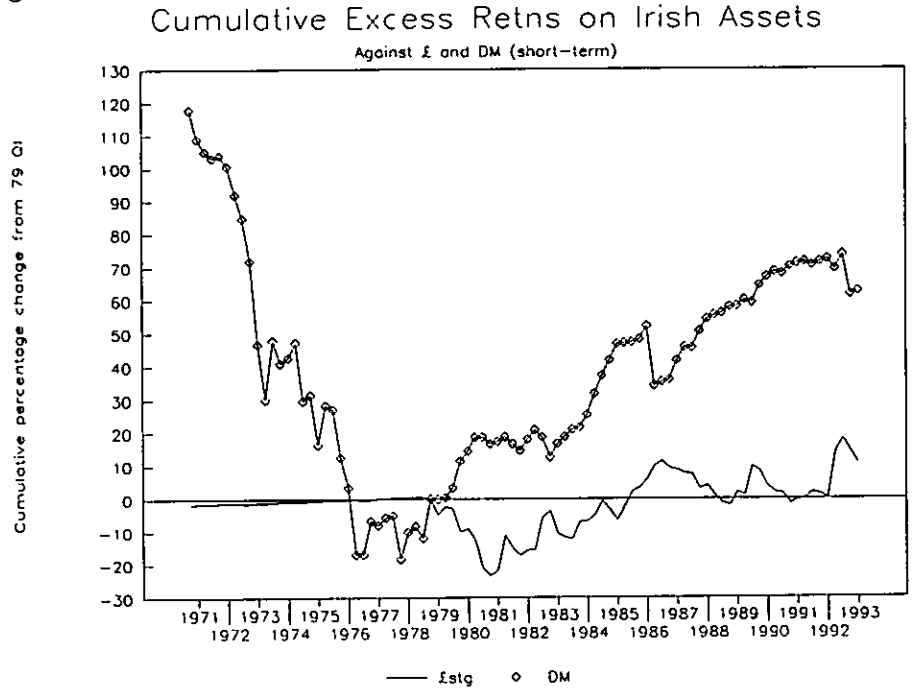


Figure 9



movements to show the cumulative excess returns received by a holder of Irish (wholesale) deposits would have made relative to holders of German and UK deposits respectively, measured from the start of the EMS. The gains are shown by the relatively steady upward trend in the DM line after 1979, contrasting with the flatness of the sterling line before 1979.[28]

While the very large government borrowing which was undertaken during this period probably contributed, a leading explanation for the trend is that the EMS has a built-in devaluation risk and that, try as it may, no government can fully eradicate this perceived risk, resulting in a interest rate premium – sometimes called a peso-factor because it was first noticed in Mexico.

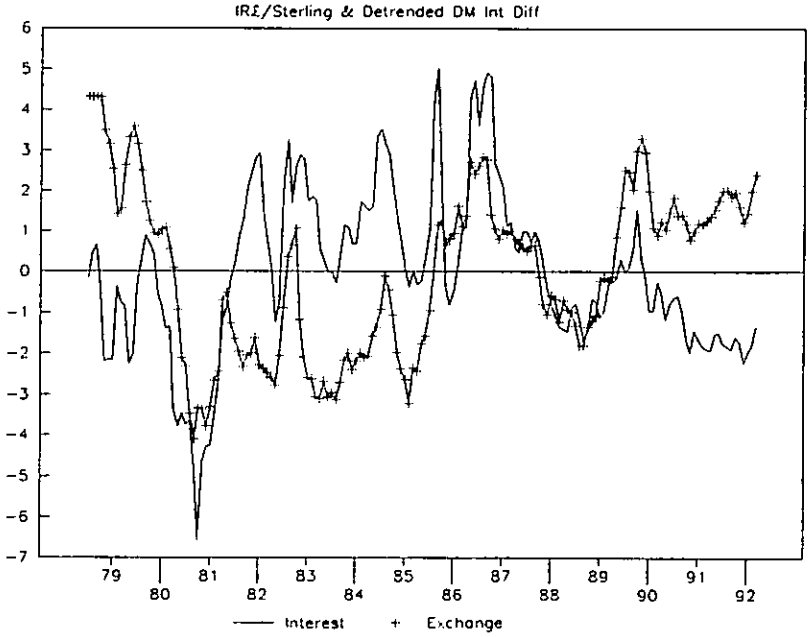
Another aspect of devaluation risk is seen in the fact that movements in the value of sterling have systematically prompted interest rate increases here, evidently as a result of the efforts of investors to hedge their positions against the risk of a devaluation. This is not quite as easy to see from the raw data (Figure 10 plots the de-trended Irish pound-DM interest differential against the Irish pound-sterling exchange rate up to August 1992). However, regression analysis[29] shows that every 10 pence fall in the value of sterling has tended to be associated with an increase in money market interest rates of the order of 2.5 percentage points. This has happened both before devaluations (as in the period November 1992 – January 1993) and during episodes which were not followed by a devaluation (as in 1989-90, or in early 1985).

Since long-term fixed interest borrowing is comparatively rare in Ireland for all but the largest of companies – and the State sector – fluctuations in short-term interest rates have tended to be largely passed back onto the smaller corporate and household borrowers, who thus carry most of the risk of these speculative surges. In the most recent episodes, not all of the fluctuations in money market interest rates were passed through to the smaller borrowers (that this could be done reflected, in part, the continued existence of interest-free or non-interest sensitive categories of deposit). Still, much was passed through, and it is widely argued that the high levels of nominal interest rate had a more severe effect on the economy during the recent crisis than had the loss of competitiveness against sterling.

[28]The generally high sterling interest rates in the 1980s are also evident from the figure in that the excess return on Irish pounds *vis-à-vis* sterling, though very variable, averages out at close to zero. This contrasts with the negative excess returns experienced by both Irish pound and sterling holders relative to the DM in the late 1970s (Honohan and Conroy, 1993b).

[29]Cf. Honohan and Conroy (1993a), O'Leary and Mangan (1993), Walsh (1993).

Figure 10 Exchange Rates & Interest Rates



Comparatively little research has been done on how small corporate borrowers cope with fluctuating interest rates. In the US, it is known from recent research (cf. Gertler and Gilchrist, 1993) that interest rate increases lead to a contraction of bank credit for small firms but not for large, and that this squeeze on small firms plays an important role in converting a credit crunch into a recession. Neglect of such asymmetries between small and large firms may thus have resulted in some economists underestimating the role of cost and availability of credit in influencing macroeconomic developments.[30]

The experience of Irish pound interest rates in the EMS has been somewhat unique. Cross-country analysis[31] shows that most interest rate fluctuations in EMS countries are driven by two factors: one of these factors influences all of the currencies to some extent; the other is essentially an unique Irish pound factor. Thus, especially with the UK out of it, the EMS gives us rather high and peculiarly volatile interest rates, and these interest rate movements are damaging for economic performance. We therefore have a special reason in Ireland to take the lead in analysis and advocacy of reforms in exchange rate arrangements in Europe.

[30]Their important role in the housing market is, of course, well-known.

[31]Koedijk and Kool (1992).

2.4 Did the EMS Provide a Nominal Anchor for Ireland?

During most of the EMS period, it is not clear that a nominal anchor was being used in Ireland. Between realignments, of course, adherence to the EMS did provide short-run stability. But at the relatively frequent realignments that occurred in the EMS over the period 1979-87, the position adopted for the Irish pound tended to be relatively weak, and resulted in a cumulative depreciation of the central parity against the DM of about 29 per cent by January 1987 (and 36 per cent by February of 1993). So it is clear that the DM rate was not an anchor. Nor was the ECU – against which the Irish pound was depreciated by 14 per cent by January 1987. It is hard to find any general rules that applied to the Irish pound in the 11 realignments in the period 1979-87. Clearly, for no country (other than The Netherlands) did adherence to the EMS involve anything like a fixed nominal peg against the DM throughout the period. Ireland's experience in the EMS can be broken into five sub-periods.

Phase 1: 1979-82

In the first, running from the beginning to the end of 1982, Ireland was (unlike Belgium, Denmark, France and Italy) able to avoid any conspicuous crisis in the first 3 years of the system, thanks mainly to the strength of sterling during that period.[32] Even so, the October 1981 realignment allowed the opportunity for a timely devaluation (5.5 per cent against the DM) thereby reversing a relatively rapid loss of competitiveness associated with sterling weakness that Autumn.

Phase 2: 1983-86

By early 1983, renewed sterling weakness put acute pressure on the Irish pound, and the realignment of March 1983, involving an Irish pound devaluation of 9 per cent against the DM was a welcome respite. Meanwhile fiscal contraction and lower world commodity prices helped to slow domestic price and wage inflation sharply to close to German rates. Nevertheless, in 1986 sterling weakness brought the Irish pound to 95 pence sterling (despite a 3 per cent devaluation in April), and the competitive threat posed by this, combined with the fact that the dollar had also been weakening (so that the effective exchange rate index for the Irish pound was 13 per cent above its value of 15 months previously), induced an unilateral devaluation of 8 per cent.

[32]Even so, the Irish pound had depreciated against the DM by 11 per cent by mid-1982, as compared with 19-22 per cent for the 4 weaker members, and only 2 per cent for the Dutch guilder.

Phase 3: 1987-90

The competitiveness gain following the 1986 devaluation allowed a lengthy period of stability, helped along by strength of sterling during 1988 and much of 1989. This stability was evident too for other members of the EMS. With Irish wage and price inflation now running at very low rates the idea that there might not need to be any more realignments involving the Irish pound gained credibility. An export boom, rising employment and lower unemployment, combined with a successful stabilization of the public finances also contributed to the sense that devaluation could safely be ruled out as an option. Thus the renewed sterling weakness of late 1989 and into 1990, though it did result in some increase in domestic interest rates, did not trigger a devaluation. This was the dog that didn't bark, and suggests that exchange rate policy had hardened.

Phase 4: 1990-92

Because it removed the main drawback of the EMS as an exchange rate regime for Ireland, the two-year period of sterling sterling membership in the ERM must be singled out as a particular phase of our EMS experience. At first it might have seemed an ideal situation, removing at last the risk of wide fluctuations in the bilateral rate of exchange between the two pounds. Unfortunately, Britain's adherence to the system, especially at an over-optimistic exchange rate, carried the seeds of the system's demise.

Phase 5: Since September 1992

Four months of turbulence for the Irish financial markets followed the withdrawal of sterling from the system in September 1992. That event did not necessarily entail a devaluation of the Irish pound, but as sterling fell precipitously, the possibility of devaluation became a pressing question. The appreciation of the effective exchange rate index was admittedly lower than had occurred over a period of months before the 1986 devaluation, but it was no larger than had occurred at end-1989 when there was no devaluation. Still, the dramatic nature of the sterling collapse (along with turbulence in the Swedish, Italian and other currency markets) focused attention on the sudden loss of Irish competitiveness in a key market, and led to expectations, justified in the end, that a devaluation would have to follow. Though sterling continued to depreciate following the Irish devaluation, its movement was subsequently reversed so that, by the time of the collapse of the narrow margins regime at the end of July 1993, the Irish pound was

close to pre-crisis levels against sterling, and well down on its 1992 values against other major currencies.[33]

Some measures would suggest that the Irish position in the EMS was overall a fairly weak one – a drifting anchor:

At 2 realignments the Irish pound was more depreciated than any other currency (April 1983, August 1986)

Whenever more than 3 currencies were devaluing, so did the Irish pound; conversely (except for the unilateral 1986 devaluation) the Irish pound never devalued against the DM unless at least 4 other countries were devaluing.

At no realignment did more than 2 currencies depreciate against the Irish pound.

Given the more urgent policy priorities that prevailed in the early 1980s, and the rapid disinflation that did occur anyway, this pragmatic approach proved adequate in the circumstances. Indeed, a tougher exchange rate policy could have been quite damaging. Thus our analysis contradicts the statements of commentators (such as Dornbusch, 1989) who assert that a tough exchange rate policy was adopted by Ireland within the EMS even in the early years. They appear to have overemphasised the relative stability of the Irish pound rate against the DM in the first three years: we have seen that was achieved only because of the strength of sterling. In retrospect, the only period of sudden loss of competitiveness which did not lead to a devaluation was the 1989-90 period, when the economy was otherwise strong. It is also noteworthy that, as shown in Figure 4 above, wage competitiveness against the UK has not deteriorated over time.

Thus, as already mentioned, the achievement of lower inflation by the mid-1980s was more a side-effect of fiscal contraction at home (with associated high unemployment and moderation of wage settlements) and worldwide disinflation, than the result of an aggressively hard currency-induced squeeze on domestic costs. Still, even if the system did not provide a definite and fixed anchor, nevertheless it placed a practical barrier to any

[33]Indeed the effective exchange rate index had fallen to its lowest figure for almost 4 years.

tendency for resort to inflationary or devaluationist policies. Thus it is clear that the authorities regarded their position on realignments as a defensive response to competitiveness loss, and never used them as a means of achieving a competitive advantage. For most of the time devaluations had to await a general realignment, and the authorities preferred taking a middle course to an extreme position. The August 1986 devaluation was a response to a sudden loss of competitiveness on a scale unlikely to be repeated more than twice a decade or so. The evidence for attachment to a nominal anchor is better for the later period 1987-92, but subsequent events showed that the authorities' ability to hold on to the anchor was not absolute, and that occasional defensive realignments would continue to be on the cards.

Chapter 3

THE DIRECTION OF FUTURE POLICY

Having identified excessively high interest rates, speculative surges, and the vulnerability to sterling movements as the chief weaknesses of the old EMS regime, we turn now to consider the merits of alternative exchange rate strategies for Ireland, a topic which has suddenly become of central importance. After all, with margins of fluctuation of +/– 15 per cent, the Irish pound is in an altogether new type of regime. It is a regime which allows for something very close to a free-float, or for a much tighter relationship with EMS or non-EMS currencies, especially if one envisages a flexible approach to realignments. In fact, the new wide-margins EMS does not fully define the regime in which the Irish pound is operating.

Some of the options which one would like to consider are not immediately available, in that they depend on EC-wide agreement. Thus we divide our discussion in two main sections; the first is devoted to what Ireland should be hoping for in terms of reform of the EMS, as it now stands, and especially in terms of the desirability of moving to the single currency. The second section focuses on regimes that are unilaterally available to Ireland, whether or not they are fully compatible with the EMS and thus we include a discussion of the free-float, advocated by some.

3.1 Reform in the EC: Is the Single Currency an Attractive Aim?

The reaction of many policy-makers and economists to the suspension of the narrow-margins EMS seems like a collective sigh of relief, and this response has certainly not been misplaced so far as Ireland is concerned. The discussion of the previous chapters provide little reason for Ireland to support any move to reestablish the old regime, and there is, in any event, no apparent likelihood that such a proposal would soon attract much support elsewhere in the Community. (In case it does, we offer some suggestions below as to how the Irish pound should be managed in a restored narrow-band EMS.) But the Maastricht process of convergence to EMU is now interrupted, without any clear path for the future monetary evolution of Europe. The question of European policy-makers blazing a new trail to the single currency will soon become a pressing one, and it will be important for Ireland to have a clear idea as to whether it is fully in favour of the single currency or not.

3.1.1 The Single Currency: Risks and Benefits

The advantages for Ireland of a single currency system are considerable. To summarize an extensive debate which was widely aired around the time of the Maastricht Treaty,[34] the main advantages of the single currency include microeconomic gains of the elimination of transactions costs, and stabilization of inflation at a low rate through removal from the political arena of a policy instrument whose availability (according to a large body of economic literature) can actually reduce economic welfare even if governments are well-intentioned.

Many British commentators have expressed the fear that adherence to a single currency would remove an important degree of freedom in macroeconomic adjustment for individual member states. The point is well taken in so far as the economic shocks that would give rise to the need for exchange rate adjustment fall unevenly or asymmetrically on different members of the EMU. (If all members require the same adjustment, then this is still available and would be effected by the European Central Bank.) This is a worry more for large economies such as the United Kingdom than it is for Ireland. For one thing, as mentioned, Irish nominal wages are relatively more flexible in adjusting to external cost-price shocks. Imported increases in prices – for example through an exchange rate change – are relatively quickly translated into wages, and this also happens, though somewhat more slowly, for declines.[35] Real wages are not easily changed by external nominal shocks, thus constraining use of the exchange rate as a means of lowering real wages on a sustained basis. Again this should not be overinterpreted: exchange rate changes do have real effects: the point here is that they are smaller and less lasting in Ireland than, for example, in the UK.

Of course it would be better if the UK were also a member, but even if it were not, the single currency would remove the damaging interest rate fluctuations, even if fluctuations in competitiveness *vis-à-vis* the UK would remain. Pending further research, this remains a matter of judgment, but the balance of advantages seems to favour Irish membership. On the credit side there are the microeconomic savings from avoidance of foreign exchange transactions costs and the elimination of exchange rate

[34] I reviewed these issues in my 1991 paper. A much more detailed, if rather partisan, review appeared in Commission of the European Communities (1990), a critical commentary is provided by Bean (1992).

[35] Unfortunately real wages also seem rather resistant to the pressures of unemployment.

uncertainty in markets accounting for over 40 per cent of exports. The avoidance of speculative interest rate surges and elimination of the steady "peso premium" on interest rates is also a plus.[36]

The main negative element is the volatility of sterling and an inability to adjust exchange rates to deal with this. What if sterling should weaken sharply with Ireland in the EMU and thus without the option to devalue? Admittedly, exports to the UK – which account for almost one-third of the total – are relatively labour intensive on average,[37] and many labour intensive firms supplying the domestic market are also exposed to competition from Britain (Baker, 1993). But a resumption of the secular trend, interrupted during the Lawson boom, away from low-margin exports to the UK will progressively narrow the range of companies whose viability is threatened by sterling movements. Besides, such companies will already have been examining ways of reducing their vulnerability through financial hedges and appropriate contracting with unions, suppliers and customers.

It is self-evident that a single currency would benefit the elaboration of cross-border economic relations on the island. The fact that little such activity was observed in the sterling link period is a reason for caution against expecting too much here. But even if some of the hopes and aspirations for expansion of such activities have been overstated by some, it is clear that exchange rate stability and a lack of transactions costs, as would be provided by the use of a single currency, would remove severe barriers to mutually beneficial small-scale cross-border economic activity.

That is not to say that all of the Maastricht plans for EMU are well-conceived. There is good reason to worry about the deflationary effects across Europe of an attempt to meet the arbitrary, and in several respects too restrictive, fiscal guidelines (Cf. Bean, 1992; Buiter, Corsetti and Roubini, 1993).

Imperfect though its detailed design may be, the single currency still represents the best way forward. It follows that a rapid move to the single currency should be favoured. But the single currency now seems at the very best still 6 years away, and may never happen. Is there anything that can be done in the interim?

[36]Gertler and Gilchrist (1993) discuss how damaging credit crunches can be, especially for small firms.

[37]Some are insulated from exchange rate effects by the operation of the Common Agricultural Policy, though this insulation is not perfect and does not extend to all food processing concerns. Others form part of the worldwide operations of multinational companies and are relatively insensitive to sterling movements

One idea, far-fetched though it may seem at first sight, would be to leap-frog the process by abandoning our own currency altogether and adopting the DM[38] as the legal tender of Ireland. The major advantage would be that, by abolishing our own currency, we could never be hit by specific peso-factors driving up our interest rate in anticipation of a devaluation of our currency. The mechanism would be a legal redefinition of all Irish pound contracts in terms of the DM and the retirement of Irish pound currency in favour of new issues of the DM. Without the co-operation of the German authorities as issuers of the DM this would be a costly exercise, as the Central Bank would have to borrow the DM notes and coin and service those borrowings.[39] This cost – the seigniorage – would flow ultimately to the German authorities, and so it is not unreasonable to suppose that an agreement could be arrived at greatly reducing or eliminating altogether the cost. The political feasibility of this option is not unrelated to the prospects for the single currency, as it could be seen as a stepping stone on the way there. Would the loss of sovereignty in this unilateral abandonment of our currency really be unacceptable, given that we do not object to EMU? This option is admittedly a rather radical one, and its technical implementation would require a number of legal and administrative changes. But it should not be ruled out on that ground alone.

In this context mention must be made of proposals to narrow the margin of fluctuation of the Irish pound against the DM down to 1 per cent or so, as was done in the last couple of years by the Belgian authorities, for example.[40] The idea seems to be that announcement of narrower margins will encourage a market belief that the current parity is irrevocable. This is an altogether different proposal to the adoption of the DM as our currency, and has much less to recommend it. Narrow margins encourage speculation by making it less risky. Policy announcements *per se* do not have a reliable effect on confidence. Given our vulnerability to

[38]It has been suggested to me that the French franc might also be a candidate.

[39]We are talking of a sum to be borrowed of about £1.5 billion – or about 6 per cent of GNP. It would involve only a slight degree of rhetorical flourish to remark that the sums lost in the failed defence of the currency over the past winter would have covered 2 or 3 years of the necessary servicing.

[40]Though it is fair to say that most observers do not attach much importance to this policy as a contributor to financial market stability in Belgium. The policy was abandoned under pressure some days before the end of the EMS narrow band.

EC Committee Reports on the 1992-93 Crisis

Two high level EC Committees, the Committee of Governors of the EC Central Banks, and the Monetary Committee (with representatives of Finance Ministries as well as Central Banks), have reported on the lessons to be drawn from the 1992-93 EMS crisis. Though there are differences of emphasis and style, both papers identify two macroeconomic causes of the crisis: a creeping competitive overvaluation of some countries (UK, Spain, Italy) which had been allowed to emerge because of a growing tendency to treat the EMS as already a quasi-monetary union; and the high interest rates necessitated by the German authorities' decision to finance the costs of German unification by non-inflationary borrowing. The proximate causes were the Danish rejection of the Maastricht Treaty and the impact on weaker EMS currencies of expansionary US monetary policy.

Apart from the usual pleas for greater attention to fiscal and monetary policy convergence, the remedy, in the view of both reports, is quicker action on realignments when they are seen as needed, and this may require partner countries to take the initiative in proposing a realignment for a currency whose parity they consider unsustainable. Whether or not a parity is sustainable will depend *inter alia* on the credibility of the government concerned, and in particular on its track record in formulating realistic targets and in meeting them.

Dealing with speculation requires decisive action in raising interest rates in the first instance; delay here may raise doubts as to authorities' willingness to defend the parity, and (by allowing the currency to fall to the bottom of the band) reinforces the potential for speculative gain. But the reports recognize that the authorities may be inhibited from using high interest rates by such factors as the size of public and private debt (in particular the share of floating rate debt), the level of unemployment and the speed of transmission of money market interest rates to sensitive lending rates. These points carry a resonance for Ireland.

In contrast, the reports downplay the relevance of public statements and exchange market intervention in supporting a currency. These can be counterproductive, they say, and there is accordingly no decision to strengthen co-operation on this front.

sterling movements, it would seem a retrograde and unrealistic step to try to adhere to narrower margins against the DM. Much the same argument can be made against trying to hold 2.25 per cent margins unilaterally against the DM.

3.1.2 What if the EMS Narrow Band Were Restored?

Although many public statements have been made to the effect that the wide-band regime is to be temporary, it does not seem very likely that the narrow band EMS will return. Still, for completeness, we should consider how the Irish pound should be managed within the EMS narrow band. The main message of recent months in this regard is that an unduly rigid approach to realignments was not helpful. We would have to return, as indeed we did in early 1993, to an acceptance that defensive realignments must be considered in the face of externally imposed competitiveness shocks. This is sometimes expressed as a return to the regime of the early 1980s, but that would be an over-simplification, and would risk discarding the gains that have been made in terms of reduced wage and price inflation. In the 1980s the authorities realigned opportunistically to maintain competitiveness for a period of years when nominal wage inflation in Ireland was considerably higher than that in Germany. Having eliminated that differential, it would be important not to allow it to re-emerge by means of a lax realignment regime which might be expected to accommodate domestically generated wage inflation. Policy should not be allowed to generate the kinds of shock that might trigger the need for a realignment.

A greater degree of domestic flexibility, particularly in wage settlements, could reduce the need for resorting to realignments (and domestic flexibility will be especially valuable in the EMU context). But in the EMS – whether with narrow or wide bands – defensive realignments should be seen as a normal and correct response in certain circumstances, and not as a necessary evil or a defeat. It is to be hoped that greater international co-ordination on realignments will institutionalise this point in the future, as advocated in the recent official EC reports. The new European Monetary Institute would evidently have a role to play in this context.

It is sometimes held that to realign indicates a loss of credibility and risks placing us in the second rank, with our access to the single currency of EMU potentially compromised.[41] In fact, credibility is lost by adherence to unsustainable and unrealistic policy choices. Adoption of a coherent and sustainable exchange rate regime will give comfort to foreign official and private circles, and make our application for EMU membership more, rather than less, credible.

[41]And indeed the Maastricht criteria require (mistakenly in the view of many) adherence to the narrow band without realignment as a prerequisite for adopting the single currency.

The credibility that government policy has achieved in the past several years has been in other dimensions: for instance in its ability to contain deficit spending and secure low inflation. This credibility was sufficient to allow a defensive realignment in the face of sterling's movements to be undertaken without that generating any fear of a major resurgence of inflation or deficit spending. In contrast, government statements ruling out any realignment had little credibility in a crisis. A greater degree of flexibility does not necessarily imply frequent realignments even in a narrow-band environment. Sudden losses of competitiveness of the type that might trigger a realignment response occurred as a result of sterling movements at most 4 times in the past decade. Furthermore, if sterling were to strengthen sharply, the Irish pound should take a strong position on the occasion of a general realignment.

3.2 Possible Exchange Rate Strategies for the Irish Pound Now

3.2.1 A Floating Exchange Rate

A free float for the exchange rate is an option which has been recommended by some. The three main currencies – US dollar, DM and Japanese Yen – all float with respect to each other, and they have, of course, been joined in the past year by the pound sterling. In addition to Italy, over the past year several smaller industrial countries, namely Finland, Norway and Sweden (who join Australia, Canada and New Zealand and Switzerland in this respect), have also been forced back on to floating. But there is a difference in that the choice of this last-named group of 4 currencies to float has been a deliberate one, not forced by market pressures.

It is important to recognize that foreign exchange markets are strongly influenced by many aspects of macroeconomic policy.[42] Therefore, although a completely freely floating currency is one in which the authorities do not intervene directly by purchase or sale of foreign exchange,[43] exchange rate movements are often the consequence,

[42]Even when a currency is being managed, the authorities often respond to foreign exchange market pressure with action in the domestic money market as well as with direct intervention in the foreign exchange market.

[43]Floats are rarely altogether free, inasmuch as the authorities still allow themselves to make some use of exchange market intervention as a supplementary policy instrument, even if they are not targeting a particular path for the exchange rate.

intended or unintended, of monetary and other policy.[44] Indeed, having a floating currency often has the effect of gearing-up the effectiveness of monetary policy: for instance a monetary tightening will not only raise interest rates, but will also usually result in an appreciation of the currency, both results acting to dampen domestic demand. In the experience of many floating countries (including the United States and the United Kingdom in the early 1980s) exchange rate movements in response to monetary policy have been very sharp and have had the effect of dampening down an overheating economy more effectively and quickly than would interest rate movements alone[45]. In Ireland, the most open economy in the industrial world, the impact of exchange rate movements can be dramatic.

What underlying policy should be pursued if the Irish pound were to float? As already discussed, there needs to be at least an alternative nominal anchor to guide monetary and fiscal policy such as a target for the rate of inflation (as adopted recently in the Canada, New Zealand and the United Kingdom, for example). The attempt to track the desired rate of inflation will have consequences for the exchange rate, but will by no means ensure a steady exchange rate.[46] The inflation rate is a visible indicator, but it responds fairly slowly to policy changes and there is the risk that an unduly lax (or too tough) policy course could become well established before the danger signals from inflation were unambiguous. In other words, by responding to immediate pressures, the authorities might easily find themselves slipping from policy flexibility to policy drift. That is one strong reason for being nervous about the adequacy of a floating exchange rate policy.

[44]In the early days of the wider margins in August 1993, the role of monetary policy and policy expectations was evident, especially in the relation between interest rates and the value of the Irish pound from day-to-day. A sharp fall in the currency from the 6th to the 9th of August resulted in a sharp jump in money market interest rates widely interpreted as reflecting increased policy uncertainty and a fear that the currency might be allowed to drift down. Subsequent money market intervention by the authorities to lower interest rates helped effect a recovery of the currency as policy confidence returned.

[45]Some authors argue that the margins of fluctuation in the EMS could have been used to achieve the same effect, cf. Svennson (1992b).

[46]Of course, the inflation target could be supplemented by a policy of smoothing movements in the exchange rate. Well-intentioned though it might be, smoothing could exacerbate the risk, mentioned immediately below, of policy drift *vis-à-vis* the nominal anchor.

In most circumstances, economists typically advocate paying attention to market signals, and warn of the risks in attempting to hold prices away from market-clearing levels. Such reasoning is sometimes used as a basis for advocating an exchange rate float. But the force of those arguments is weakened in the case of exchange rates by virtue of the degree to which market participants evaluate currencies on the basis of expectations with regard to future government policy. Far from being determined by the intersection of supply from exporters and demand from importers, the exchange rate is determined in a market where the dominant players are deciding between the merits of different currencies as assets. Experience has shown just how far the market can move exchange rates away from purchasing power parity.[47] The huge misalignments of rates which could occur are a strong argument against a floating regime, especially when this could be avoided by explicit adherence to an exchange rate rule offering a more credible nominal anchor.[48]

Do floating exchange rates allow lower interest rates? While they can help by freeing the domestic financial system from the tyranny of devaluation risk, this argument has its limitations. (Certainly the UK's experience in the last year of achieving much lower short-term interest rates in a float is not a reliable indicator of our ability to do the same).[49] For one thing, the level of price and wage uncertainty would be increased and this could discourage Irish pound asset holdings. In addition, the high level of unemployment hangs over Irish macroeconomic policy and is perceived by potential holders of Irish pounds as a medium-term threat to currency stability – and having a floating policy does nothing to dispel that perception. Thus, a floating Irish pound would not have the lowest interest rates compatible with price stability.

It has to be said that, with inflation running at low levels for several years, the adoption of a floating regime would not now be as risky as it

[47]According to calculations by the International Monetary Fund, and published in various issues of International Financial Statistics, in 1985 the US dollar averaged over 45 per cent above its average value in 1978-80, corrected for inflation differentials. The overvaluation of the pound sterling during 1981 was even higher: more than 57 per cent above its 1977 average. Could Irish exporters survive such a surge?

[48]Cf. Krugman and Miller (1993).

[49]First, the size of the UK economy is an important factor in its ability to operate an independent monetary policy. Second, the lower short-term interest rates are not unrelated to the scale of the fall in the value of sterling – leading to some expectation of subsequent recovery. It is also worth noting that the decline in UK short-term rates has not been matched by long-term rates.

would have seemed in the mid-1980s. Nevertheless, it would have to be supplemented by an alternative nominal anchor, and building credibility for that could be difficult. A failure to achieve credibility could lead to a steep – and presumably unsought – decline in the value of the currency, fuelling inflation and potentially resulting in difficult industrial relations and wage negotiations problems as unions sought to restore employees' purchasing power.

Floating would have the advantage of allowing a speedy and inconspicuous response to external shocks, including movements of sterling. But a particular ceiling against sterling would not be guaranteed by a free float, and it could result in an even more volatile sterling rate than we have had. This in turn could make continued successful operation of tight margin exporters exceedingly problematical.

There is also the problem that the ERM still has intervention obligations. A free float could easily see the currency moving outside the permissible range of fluctuation within the EMS thereby presumably calling for – potentially frequent – realignments. Although it is unlikely that this could generate a crisis, it is a somewhat awkward feature of the free-float and could damage Ireland's standing in regard to EC exchange rate co-operation.

On balance, and taking into account especially the risk of policy drift and the consideration that it could sideline Ireland from the common EC approach to exchange rate matters, a free float does not seem the best option. If so, it follows that there should be a definite policy or target for how the exchange rate itself should evolve. Note that such a policy need not necessarily be a publicly announced policy; that is a separate issue.

3.2.2 Some Unattractive Forms of Exchange Rate Target

At the other end of the spectrum from the completely free float is the option of a *fixed currency peg*. Earlier, we reviewed this possibility in a rather special form in relation to the DM as a fast-track to the benefits of the single currency of the EMU. An economic argument could be made for the dollar or sterling as equally appropriate pegs, and a political argument could be made for the French franc. Any such peg would provide a nominal anchor.[50] The problem is that, with our main trading partners

[50]There has been a suggestion that the real value of Irish pound should be pegged to that of the DM. Such a peg would be compatible with arbitrarily high Irish inflation and would not in itself provide a nominal anchor. It could also result in large fluctuations in competitiveness against sterling.

grouped in different currency blocs (DM, £ sterling and US dollar), no simple peg gives a truly fixed exchange rate for us. Any rigid peg risks making us uncompetitive against some major partners (this would have been true for the sterling link had it been held through 1979 and 1980). Furthermore, any peg is prone to speculative attack. This would doubtless apply even to a sterling peg, recommended by some. There is no going back to the certainties of the old link: even if a new link were at one-for-one, it would surely come under pressure if sterling were to strengthen dramatically.

The asymmetry of effect, discussed above, whereby divergent movements in partner currencies could lead to job losses overall, even if the average value of the Irish pound had not changed, has led others to suggest the strategy of tracking the weakest of our major trading partners. This approach is not recommended. It would impart a significant inflationary bias, weaken competitive discipline on enterprises and encourage an expectation of constant bail-out of enterprises, and it would be wholly inconsistent with adherence to a common EC approach to currency matters. Besides, its advocates overstate the difficulties faced by firms in positioning themselves for profitable long-term operation in an environment of fluctuating exchange rates.

Some countries have operated more complex exchange rate regimes with reasonable success. Of these, the *crawling peg* systems[51] can be ruled out: though they provide some form of nominal restraint, it is of a sort that is suited mainly to high-inflation countries. Another complex option would be management of the currency according to a set of indicators or what the IMF term a *closely-managed float*. In this type of regime, the authorities typically fix the exchange rate for short periods of time, but also allow it to drift occasionally in order to track a set of objectives that may be, but more typically are not, formally announced. Countries that opt for this kind of regime include countries with a history of high and volatile inflation (Turkey, Greece, Israel), but also a few low inflation countries which, because of the diversity of their trading partners, might otherwise opt for floating rates but have a generally interventionist approach to economic management (Tunisia, Singapore). Because it allows considerable

[51]Crawling pegs involve depreciation of the currency on a pre-announced schedule. Adjustments can be as frequently as daily, and there may be fluctuation margins. These systems have been adopted in Latin American countries to bring order to the foreign exchange markets, typically as part of a process designed to reduce high inflation gradually.

discretion to the authorities, such a regime could respond promptly to shocks, but by the same token, a weakness of the approach is its lack of a nominal anchor.[52]

3.2.3 The Best of the Explicit Policies: A Trade-weighted Target

Because of the much wider fluctuation margins of +/– 15 per cent now in effect in the EMS, there is a strong argument for supplementing the EMS limits for the Irish pound with a much tighter exchange rate nominal anchor. By taking an active role in managing the value of the currency (within the new margins) in accordance with this supplementary anchor, the authorities could, to some extent, have their cake and eat it: staying with the EMS for reasons of political economy,[53] but also having the possibility of looking over our shoulder at movements of, for example, sterling and the US dollar allowing a more stable evolution of the average value of the currency – and the substantial avoidance of the peso-problem on interest rates.

Realignments

However, under the regime proposed, if the supplementary anchor brought the currency toward either edge of the new EMS band, then there should be a realignment of EMS limits to accommodate this movement. Thus, while the EMS limits would be retained as formal obligations, the real policy would be indicated by the new "supplementary anchor". Because of the width of the new band, realignments would not be frequent. If the nominal anchor was well chosen, it would rarely need to be revised.

While a wider-than-normal (+/– 6 per cent instead of the usual +/– 2.25 per cent) band was used by Italy (until early 1990), Spain, the UK and Portugal, it had not been recommended for the Irish pound at the start of the EMS in 1979. The reason for not opting for wider margins then is equally a reason for supplementing the very wide margins now, namely that such a wide band would lack any disciplinary effect. There is also the problem that sharp movements within the very wide band increase uncertainty and can cause competitiveness – or inflationary – problems. A strategy for movements within the band (and for defensive realignments when necessary) can help reduce the amplitude of such fluctuations.

[52]Bearing in mind the frequency of defensive realignments in the EMS, it might even be said that Irish exchange rate policy had many of the characteristics of a managed float during most of the 1980s.

[53]Though see above on the question of the convergence criteria for graduation to the final stage III of EMU.

The supplementary nominal anchor could, for example, be linked with an explicit sterling objective.[54] But it would seem preferable to maintain some average value of the currency against the main trading partners close to an announced target.[55] Adherence to such a nominal anchor should provide adequate inflationary restraint by ensuring that Irish inflation stayed fairly close to the average inflation of the trading partners, as it is now, and would not pose difficulties of transition. A number of possible averages can be suggested:

The effective exchange rate index, compiled by the Central Bank, is a trade-weighted average of movements in the Irish pound's value against about 10 main trading partners: it could be used as the anchor.

Much the same effect could be obtained by taking an average of sterling, the DM and the US dollar:[56] this would have the advantage of simplicity, and would probably reduce the risk of large movements against sterling. This seems the most plausible option.

Alternatively, one could just use an average of sterling and the ECU: this would be more Communautaire and would probably reduce the frequency of realignments, but would be less sensitive to the movements (potentially important) of non-EC currencies.

Note that a trade-weighted target, though it smooths the average exchange rate value chosen, does not guarantee absolute stability in the bilateral rate against sterling. Annex 2 reports on some simulations showing how a wide margins regime might have worked over the past decade or so. Although 6 per cent margins would not have reduced the frequency of realignments, with 15 per cent margins only 3 realignments would have been necessary. Note, however, that the Irish pound price of sterling – though more stable – is still quite variable. The volatility of

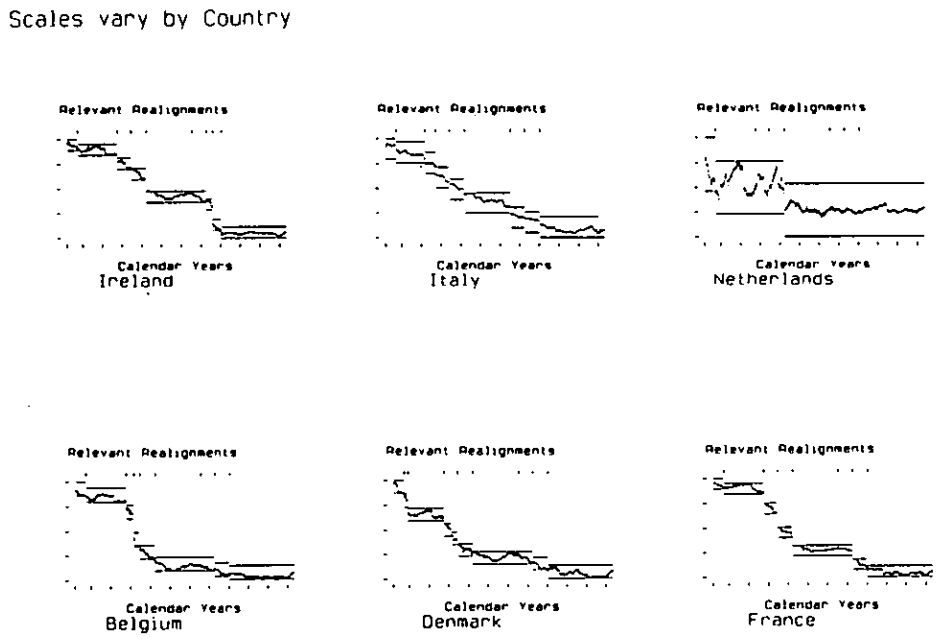
[54]But one can forget about a one-for-one link with sterling being consistent with no realignments in the EMS: the volatility of sterling is simply too great.

[55]What is being suggested here is a target for the nominal trade-weighted value. This would provide a nominal anchor. An alternative – less attractive in present circumstances – would be to have a target for the real trade-weighted value; that would have to be supplemented by some nominal anchor, such as a target for inflation or monetary aggregates.

[56]Either with equal weights or (perhaps preferably) with a rather larger weight of up to 50 per cent on sterling.

Figure 11

Exchange rates against DM and intervention limits, 1979-90.



sterling with respect to other currencies is too great for a simple exchange rate rule to provide as much insulation as we might hope for. It would be possible to tilt the regime in favour of greater stability for the sterling rate. For instance, one could have an even higher weight for sterling in the target, or any of the averages could be combined with a ceiling on the bilateral rate with sterling. But the more arbitrary the target, the greater the risk that it might be subject to modification under pressure and thus the less reliable a nominal anchor it might be.

Although tracking any of the suggested targets could bring the Irish pound to an intervention limit even in the wide-band EMS, wider margins allow realignments to take place without jumps in market exchange rates. Figure 11 demonstrates how this worked in the EMS.[57] The figure shows daily DM exchange rates for the EMS currencies, along with the intervention limits for the DM. Note that at some realignments, the new

[57]The figure is taken from Flood, Rose and Mathieson (1991, Figure 2).

upper intervention limit was still above the old lower intervention limit. When that happened, no change in the market exchange rate against the DM was necessary.[58] This permitted those realignments to be implemented without any large capital gain for speculators. Without the prospect of a large capital gain, speculation against the currency is unlikely to be strong, and interest rates need not move to very high levels to limit capital outflows. Wider margins or more frequent realignments make the achievement of such overlapping bands more likely. Italy, for example, had overlapping bands at each of its 9 realignments against the DM, whereas Ireland has had overlapping bands at only 4 of its 9 realignments.[59]

An important benefit of the new very-wide margins, then, is that they can allow the defensive realignments necessary to track a target for the average value of the currency to be accomplished without any sudden change in the market exchange rate and thus without the huge incentive to speculation which we have seen in recent months – a partial relief to the peso problem is thus provided. Of course, the wider margins are not a panacea against destabilizing speculation. After all, Spain was forced into three realignments in a matter of months despite having wider margins.[60] But they certainly help.

A Soft Buffer Zone

It is clearly important, in adopting a supplementary average target within the wider bands, to avoid reintroducing the one-way-bet for speculators. This can be achieved by following the suggestion of Williamson (1985) that such a target should not be defended by rigid intervention obligations. Instead, the target should be represented as a kind of soft buffer zone: if the currency drifts outside the zone this will be tolerated, but it will trigger graduated monetary and other policy action designed to steer currency back into the zone. In practice, the buffer zone should be about 5 per cent wide: movements within the zone would be tolerated freely.[61]

[58]Though a discrete change may happen, of course, and it may be forced if the market exchange rate before the realignment is higher than the new upper intervention limit against any one of the partner currencies. For this reason, defensive realignments should normally take place before the currency has reached the bottom of the band.

[59]The ratios for the other founding participants are Belgium 5/8; Denmark 5/8; France 2/7; The Netherlands 2/2.

[60]Though Italy managed to survive for over a decade in the system with wider margins, and less than 2 years with the narrower margins!

[61]Though there is no reason why occasional day-to-day smoothing operations in spot or forward foreign exchange could not be envisaged as in the past.

A soft buffer zone would not provide an easy target for speculators, as the authorities would be able to allow speculative pressure to be absorbed in exchange rate movements. Its announcement would not give rise to the problems of credibility of a more rigid system: or in other words not give too great a hostage to fortune.

3.2.4 Should the Policy Be Announced?

The question of how explicit one should be about one's exchange rate policy is an old and thorny one. Traditionally, policy-makers have not wanted to be too explicit about their exchange market intervention intentions, and indeed there is evidence that these interventions can be more successful if not fully anticipated. Furthermore recent experience with the rigid obligations of the EMS tends to discourage the monetary authorities from making too many explicit commitments. On the other hand, the absence of explicit nominal anchors certainly contributed to the great inflations of the 1970s.

Without a clear indication of broadly where inflation is likely to go, it is difficult for negotiators to settle on realistic wage contracts. Such an indication can come either from an announced commitment to an exchange rate evolution, or to an inflation target.

Announcing a target zone for the exchange rate

Announcing a credible soft-buffer exchange rate target zone seems a rather low-risk strategy in this context, and one which would not trigger destabilizing speculation. Indeed, by reducing uncertainty it should make Irish pound assets more attractive and thereby facilitate lower interest rates without threatening the stance against inflation. Of course none of these confidence-related benefits would be obtained if the policy remained secret. Furthermore, if the nominal anchor were secret, it could be easily abandoned or weakened under pressure.

Admittedly, there are some advantages of secrecy here. Thus by adopting a target zone approach, but keeping the policy secret, the authorities could gain some flexibility and effectively reduce their exposure to choice of a target zone that was not credible or sustainable. But on the whole, if a target zone policy is to be adopted it should probably be announced.

Announcing an inflation target

If there is to be no definite target for the exchange rate, still there should be some explicit nominal anchor, probably in the form of an inflation target. As already mentioned, the authorities will almost certainly

want to supplement this with some approach to exchange rate smoothing, with the day-to-day and month-to-month implementation of policy representing a kind of compromise between the need to meet the inflation target and the desirability of exchange rate smoothing. In regard to the latter, our discussion about alternative approaches to choosing an average value of the currency will remain relevant, even if not publicly announced.

At the time of writing, policy seems to be following some compromise approach of this sort, but there has been nothing in the form of a definitely announced commitment. It will be clear from the discussion above that we would favour a greater degree of explicitness of about future policy.

* * *

While the current international vogue is for an explicit inflation target with some exchange rate smoothing, our recent experience with sterling-related problems does seem to imply that relatively greater attention should be given to explicit exchange rate targeting. Overall, the adoption of a soft-buffer trade-weighted target zone within the EMS wide band seems to offer the best option, offering some insulation against the worst swings in interest rates and exchange rates, without threatening a resurgence of inflation. Previous inhibitions to adopting such a regime have been made largely redundant by the collapse of the narrow band EMS.

Chapter 4

CONCLUSION

Ireland should have a credible, stable and widely understood policy in regard to the exchange rate. The events of the past year have revealed weaknesses on all of these fronts. Managed with some greater flexibility, the narrow band EMS could have remained a serviceable regime for Ireland. But, had it not been for political considerations deriving from Ireland's full endorsement of and participation in the construction of the European Union, the narrow band EMS would never have been the regime of choice for Ireland. The collapse of the narrow band EMS offers Ireland new choices and requires new decisions. It is not a good idea to change the exchange rate regime frequently, but this change has been a forced one.

In our discussion, we have identified a number of criteria for an ideal policy with regard to the exchange rate regime in Ireland. First, it should provide a "nominal anchor" ensuring that inflation does not drift up again. Second, it should make adequate provision for maintenance of wage competitiveness (though these two criteria may conflict unless domestic wage-setting behaviour is reasonable). Third, some account must be taken of our dependence on bilateral competitiveness *vis-à-vis* the UK. Fourth, the regime should be able to cope with or preclude speculative attacks on Irish exchange rate policy such as caused havoc in recent months (and also limit the apparently higher interest rates which have persisted for years on end apparently as an insurance against devaluation risk). Fifth, it should be compatible with our full participation in the construction and development of the European Union.

The pros and cons of the main options are summarised under these headings in Table 2. No system clearly dominates on all criteria. The attractions of floating tend to be overshadowed by fears of misalignment and about the reliability of alternative nominal anchors such as an inflation rate target. The EMU provides a good nominal anchor and removes the risk of speculative attacks on Ireland (as does adoption of the DM as our currency), but it is not immediately available (as is now the case with the narrow-band EMS, whether flexible or rigid). Of the immediately available options, staying with the wide-band EMS seems best, but within that, the adoption of a supplementary target for the average value of the currency would offer additional advantages.

Table 2: Alternative Exchange Rate Regimes: Rating on Various Criteria

	Provides Nominal Anchor	Can avoid Loss of Competitiveness	Takes a/c of Sterling	Deals with Speculative Surges	Communautaire	Available Option
EMU (UK out)	++	-	- -	++	++	?
EMU (UK in)	++	-	++	++	++	-
Adopt DM as legal tender	++	-	- -	++	?	?
Narrow, rigid EMS (no realignments)	++	-	- -	- -	+	-
Narrow, flexible EMS	+	+	+	-	++	-
Wide EMS	-	+	+	+	+	+
Wide EMS with average value target	+	+	+	++	+	+
Free float	-	+	-	+	-	+
Managed float	-	+	+	++	-	+
Sterling peg	+	-	++	- -	-	+
US $ or basket peg	+	-	-	- -	- -	+

Removal of the constraints of the EMS narrow band should allow us to avoid the surges in interest rates preceding realignments, and it should be possible to reduce fluctuations in the Irish pound value of sterling. But to ensure that the low inflation that has been achieved is secure, and to bring the general level of interest rates to the lowest level consistent with that, it does appear adherence to the wide-band EMS should be supplemented by a credible and coherent explicit medium-term policy. While this could be expressed in terms of an inflation target (following the new vogue), Ireland's recent experience with sterling-related problems suggests that a better approach would be couched in terms of an indicative soft-buffer target zone for the average value of the currency. While the currency would be allowed to drift outside this zone, graduated policy actions would be employed to steer it back. If the target zone brought the currency near an upper or lower EMS limit, prompt realignment would permit a smooth evolution without speculative pressures.

Exchange rate policy is at its most successful if it sustains low inflation without compromising competitiveness and without generating uncertainty or volatility in financial markets. The wider margins should not be used to engineer a big reduction in the international purchasing power of Irish wages with the objective of improving competitiveness: such an action would threaten future inflation and industrial peace without guaranteeing lasting gains.

Though much of what has been presented here is supported by systematic research, there is need for more work: on the ability of Irish industry to cope with fluctuating competitive conditions, on trends in the responsiveness of private sector wages to changes in exchange rates, and on the appropriate weighting of exchange rate and competitiveness indices, for example. Some of this work is needed to document and confirm matters which have not been systematically researched before; some to update earlier work.

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Annex 1

DEVALUATION AND THE COST OF FOREIGN DEBT

The purpose of this annex is to clarify a point that is often misunderstood when the issue of devaluation arises. Thus it sometimes argued that devaluation (of the Irish pound) would increase the level of foreign indebtedness of the government. This statement is very misleading; Ireland cannot unilaterally change the value of what it owes in foreign currencies. The debt-related effects of a devaluation are more subtle, and considerably smaller, than is generally supposed.

At end-December 1992, the Government's foreign currency debt stood at the equivalent of IR£10.9 billion, made up of 42 per cent in Deutsche Mark, 19 per cent in Swiss Francs, 18 per cent in US$ and the remainder in a variety of other currencies. Ignoring any borrowings or repayments made between then and the devaluation of February 1, it is true that the Irish pound value of these obligations increased by the amount of the consequential change in the market exchange rate of the Irish pound following the devaluation – about 9 per cent. But the number of DMs, US$ and other currencies owed did not change; the Government still owed DM 12.1 billion, SwFr 5.0 billion and US$3.2 billion.

As discussed in the text, because of our small weight in international trade, the devaluation of the Irish pound could have had no effect on the price, measured in dollars or marks, of goods or services internationally. Thus the real value – the international purchasing power – of the foreign currency debt did not change. Only by measuring it with the shrunken measuring rod of a devalued currency did it seem to change. Indeed, to the extent that the devaluation helped wage competitiveness the nation's ability to earn foreign exchange to service the – unchanged – debt was (if anything) probably enhanced, at least in the short run. Thus at a first approximation, the existence of foreign currency debt should never have been thought of as an obstacle to devaluation.

Of course, so far as the domestic currency debt is concerned, a devaluation does lower its real value: that is why foreign holders of Irish currency debt were anxious to sell their holdings, or at least hedge them, when devaluation began to seem likely.

The story does not end there, but some of the other relevant considerations are of considerably less weight than is often implied. For example, one might worry that devaluation might worsen the ratio of National Debt to Gross Domestic Product (GDP), for which a Maastricht convergence target exists. But this ratio would not worsen for long, since GDP would eventually be higher in nominal terms than without devaluation because of the pass-through of higher import prices – slow though this may be in times of recession.

Another suggestion is that devaluation would cause an increase in the Exchequer Borrowing Requirement in order to meet additional servicing costs on the foreign debt. If this were the case, and if it led to higher tax rates to cover the increase, these would certainly impose a true burden on the economy. But here again the proposition is questionable, and at best one of secondary quantitative importance, as tax revenue would also grow as a result of higher prices. Indeed, the Minister for Finance[62] estimated the net impact of the February devaluation on the 1993 Exchequer position at only £13 million – equivalent to an altogether negligible 0.15 per cent of the foreign debt. Furthermore, that calculation was made before the full downward impact of the lower post-devaluation interest rates on the Government's domestic interest bill was appreciated.

That is not to say that the devaluation does not impose capital gains and losses on different enterprises; the point is that these balance out on average for the economy as a whole – and for the Government as a whole, because the Government's receipts are diversified widely across the economy.

Note that this argument does not imply that a decision to use reserves and new borrowings to purchase Irish pounds in the foreign exchange market in a vain attempt to defend the currency is costless. The two questions are quite different: one addresses the decision to devalue given a certain level of foreign debt; the other the decision to borrow for the purpose of buying back Irish pounds in the face of a devaluation risk.

[62]Dáil answer, February 11, 1993.

Annex 2

WIDER MARGINS AND AN AVERAGE VALUE TARGET IN PRACTICE

This annex illustrates how wider margins might have functioned in the past if employed to stabilize the average trade-weighted value of the Irish pound (the Central Bank's Effective Exchange Rate Index – EER). We note that by 1993 the index returned to – and then below – the values reached around 1981, and for the illustration, we have calculated what sterling and DM exchange rates for the Irish pound would have emerged had the EER been fixed exactly at its 1981 level. The results are plotted (using 15 per cent margins) in Figures 12-13.

A number of conclusions may be drawn. First, even with 15 per cent margins,[63] three realignments would have been needed. The exact stabilization of the EER contrasts with the actual situation where very sharp EER shifts were tolerated without realignment. Second, the calculated value of the currency would have been higher during almost all of the period under review, notably from mid-1983 to the end of 1989, when it would have averaged more than 90p, compared with the actual value of less than 86p. That is, of course, a reflection of the level at which the EER is being stabilized in the calculation, but does illustrate that a fixed EER target is by no means a soft option. Third, the variance of the sterling exchange rate is reduced (by almost 40 per cent), as is that of the dollar, but there is an increase in the variance of the DM rate.

What the calculations cannot convincingly indicate is whether the wider margins, combined with reduced probability of large realignment gains, would result in lower interest rates on average.

[63]For 6 per cent margins calculated realignments are almost as frequent as actually occurred.

Figure 12 The IR£/DM Rate Under an EER Target

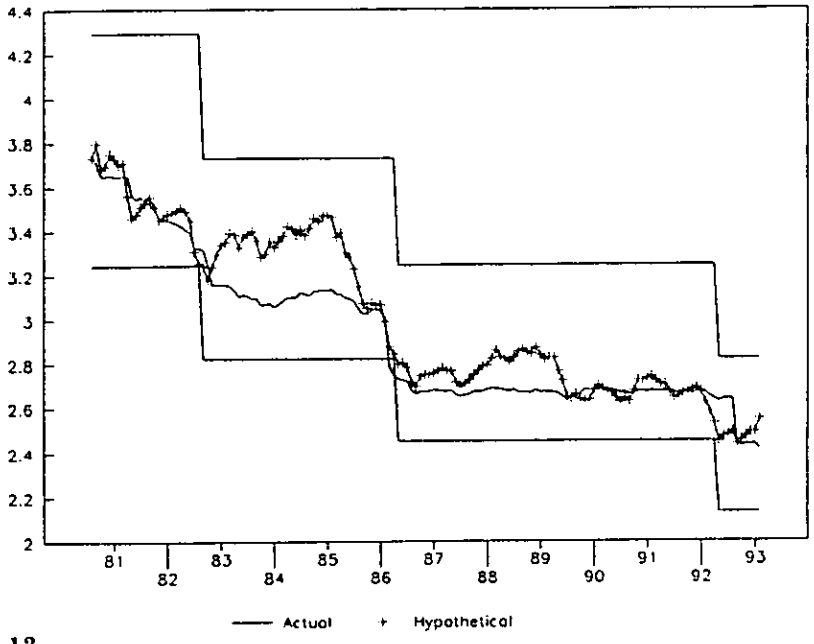
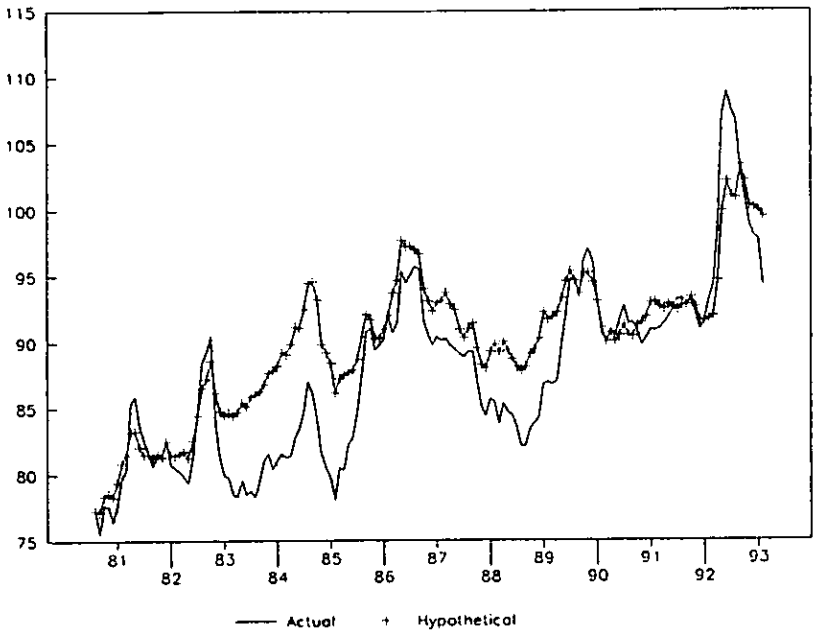


Figure 13 The IR£/£stg Rate Under an EER Target



Annex 3

VARYING WEIGHTS IN THE COMPETITIVENESS INDEX

Perhaps surprisingly, there is no agreement on the relative weights to be attached to different trading partners in a computation of competitiveness. Various considerations need to be brought to bear on the issue. This annex touches briefly only on the main issues and illustrates their quantitative importance. The whole area of competitiveness measures needs to be examined at greater length.

One aspect is the degree to which Irish exports and import-competing goods should be considered as competing in a world market, with the actual destination or source almost irrelevant. (For instance, UK import prices surged by about 8 per cent in the 6 months since sterling dropped out of the EMS. While this is not the full amount of the depreciation, it certainly indicates the degree to which even the UK is a price-taker.) The argument that exports of Irish branches of multinationals could be insensitive to exchange rate movements in their first destination is a related point. There is also the point that many CAP-supported exports are at least partially insulated from local currency movements – though the insulation is not perfect. Double-weighted indexes of competitiveness such as that used by Eurostat, and by the Department of Finance (*Economic Review and Outlook*) are a step in the right direction.[64]

Another part of the problem is that the employment content of exports differs substantially from country to country. For instance, if we weight exports of industrial products by their employment content (using the Census of Industrial Production, 1989), we find that the UK's share jumps from 27.4 per cent to 37.8 per cent.[65] An even higher UK share is attached to tourism exports (43 per cent in 1989, down from 55 per cent in 1980:[66]

[64]Cf. also Edison and Vårdal (1990) for an alternative approach.

[65]The reweighting does not affect the share of the US, which stays close to 10 per cent; the 10 point increase in the UK's share is divided equally between the rest of the EC, whose share falls from 43 per cent to 37 per cent, and elsewhere, whose share falls from 20 per cent to 15 per cent.

[66] In 1989 the US share here was 26 per cent, other EC was 24 per cent.

even though tourism exports are equivalent to only about 4 per cent of industrial exports, their employment content could be as high as 20 per cent of the employment content of industrial exports. Then there is the question of import-competing goods. These points are considered in more detail in Baker (1993).

In addition to providing competitiveness data for the 50/30/20 weighting for the UK, Germany and US, respectively, we therefore also show competitiveness with alternative weightings: 33/33/33 and 40/40/20 (Figure 14). The importance of the US dollar weight is evident. This is because of the sharp movement of the US dollar in 1985-86.

For reference, we also show the nominal effective exchange rate index as published by the Central Bank, and the bilateral exchange rates of the Irish pound against the three main currencies (Figures 15-18).

Figure 14

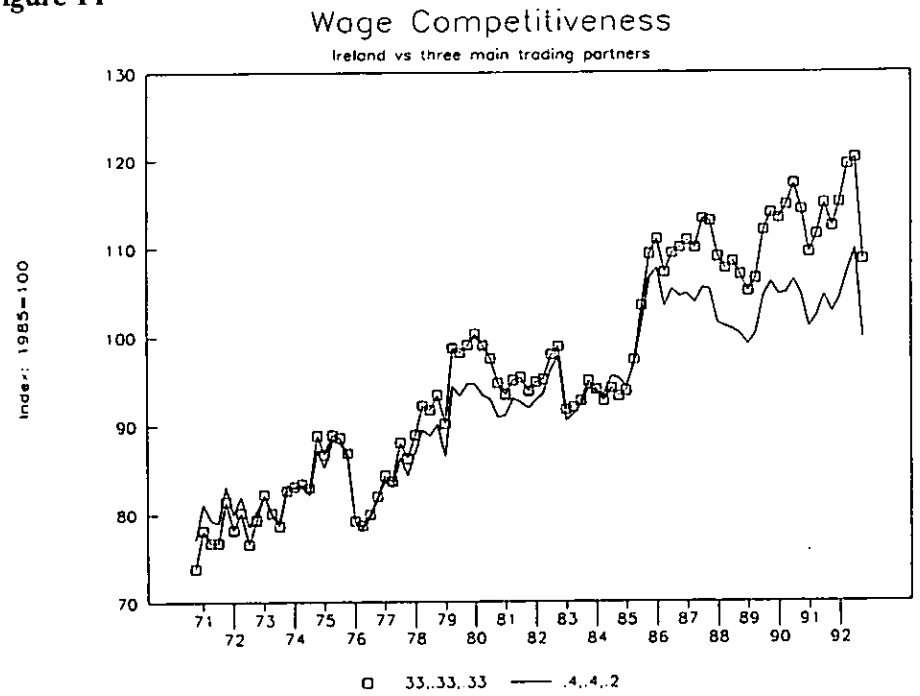


Figure 15

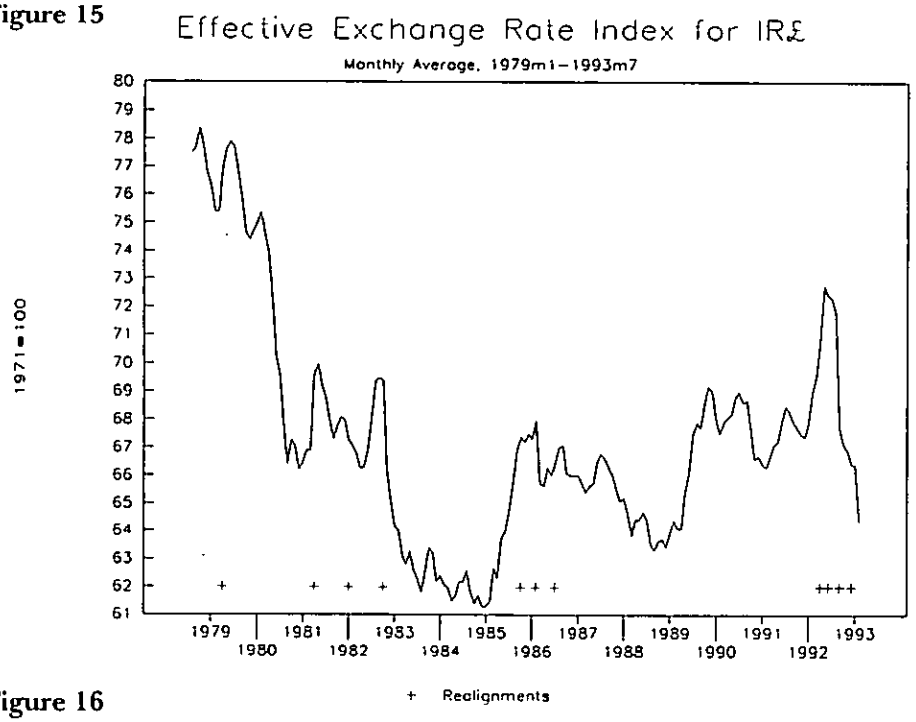


Figure 16

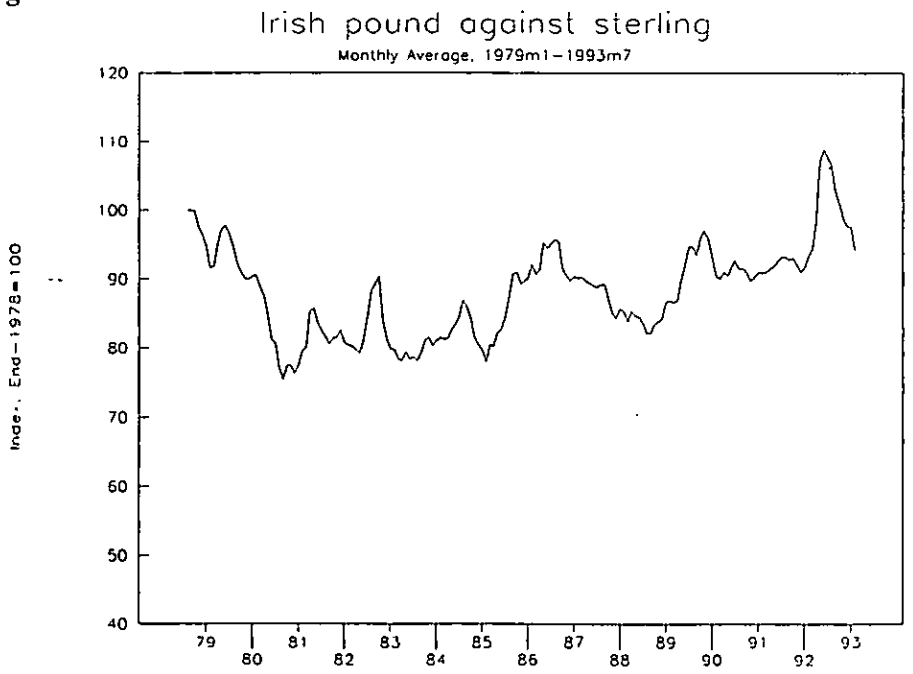


Figure 17

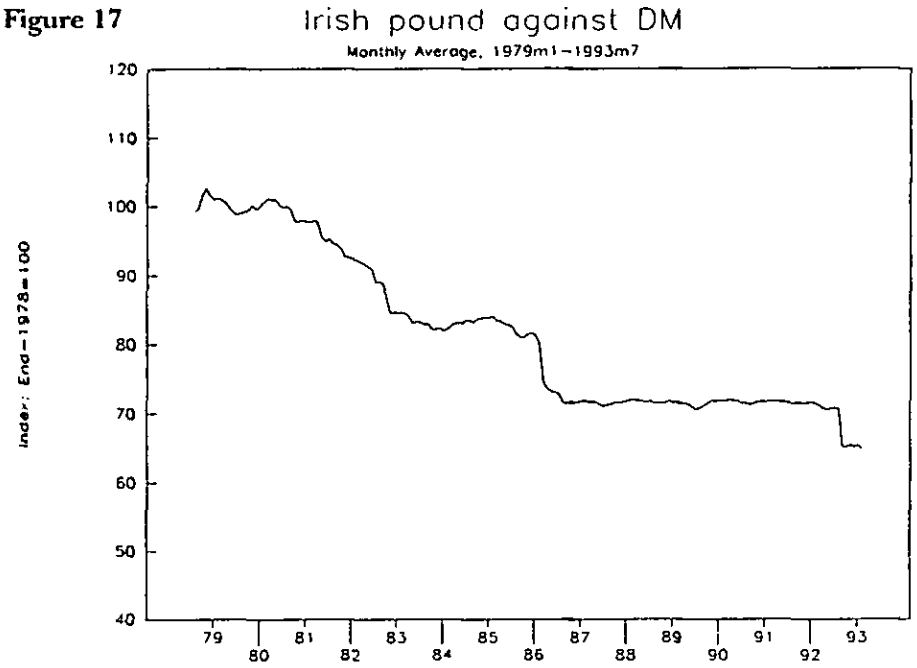
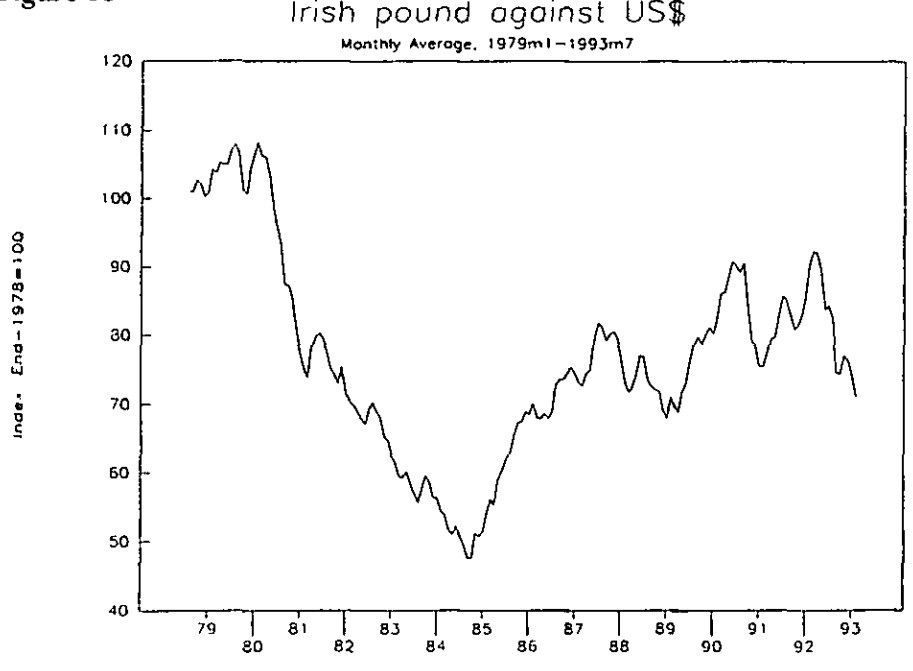


Figure 18



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