

**Managing an economy under EMU: The case of Ireland**

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## **Managing an economy under EMU: The case of Ireland**

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### ***Abstract:***

Ireland's experience of limited monetary independence within the EMS indicated that such independence was bought at the price of significant risk premia on interest rates. This experience informed its decision to join EMU, and membership has resulted in the expected credibility gain. In addition, in the late 1990s, because there was a widespread underestimation of Ireland's potential to grow rapidly, outside EMU Ireland would almost certainly have ended up with much higher interest rates than occurred within EMU. Such rates would have been very much higher than would have been the case if there had been a correct understanding of the economy's potential growth rate and would have been much higher than would have been necessary to manage the rate of inflation. The result would have been that the boom which took place between 1994 and 2001, would have been choked off before the economy reached its growth potential. This highlights the advantage of EMU membership where the potential growth rate of the economy is not well understood – the case for some of the new members of the EU.

Since the start of EMU inflation in consumer prices in Ireland has risen well above the EU average. However, this need not be a matter of concern within a monetary union. Instead, what should concern the Irish administration is a high rate of inflation in wage rates and domestic asset prices – chiefly housing. While monetary policy is no longer available as an instrument of domestic policy, fiscal policy can still be used to effectively target these problems. The lessons of the first years of membership is that the focus of fiscal policy within Ireland needs to change, and that the EU institutions also need to focus more clearly on the needs of the Euro area rather than on those of individual regional economies.

## **1. Introduction**

The advent of economic and monetary union has changed the agenda for economic policy makers in all the member states. The European institutions have been slow to realise the full implications of the changed policy environment, in spite of the obvious change in legal regime. The same is also true of national governments. Whereas there was previously a clear allocation of appropriate roles for monetary and fiscal policy, the loss of the monetary policy instrument calls for new thinking on how best national economies can be managed as regions of a wider monetary union. These issues are not new in the sense that they are faced every day in long-established monetary unions, such as the United States. However, the absence of an economic "history" of the new union makes management of the new Economic and Monetary Union (EMU) difficult.

Ireland represents an interesting "experimental" economy, which over the course of twenty-five years has tried life in two monetary unions with an intervening period of twenty years of "monetary independence". Ireland was part of the sterling monetary union from the early nineteenth century till the end of 1978. It then experienced twenty years operating within the European Monetary System, finally joining the new EMU at the beginning of 1999.

This paper firstly gives a brief description of Ireland's experience of these three different monetary regimes. Section three describes the economic reasoning behind Ireland's decision to joining EMU<sup>1</sup>. Ireland's experience of the first few years of EMU is discussed in Section 4. The implications of this experience for economic policy in Ireland, and in other regional economies within the EMU, is discussed in Section 5 and conclusions are presented in Section 6.

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<sup>1</sup> The decision to join EMU was essentially made on political rather than economic grounds, though this political decision was informed by important economic arguments.

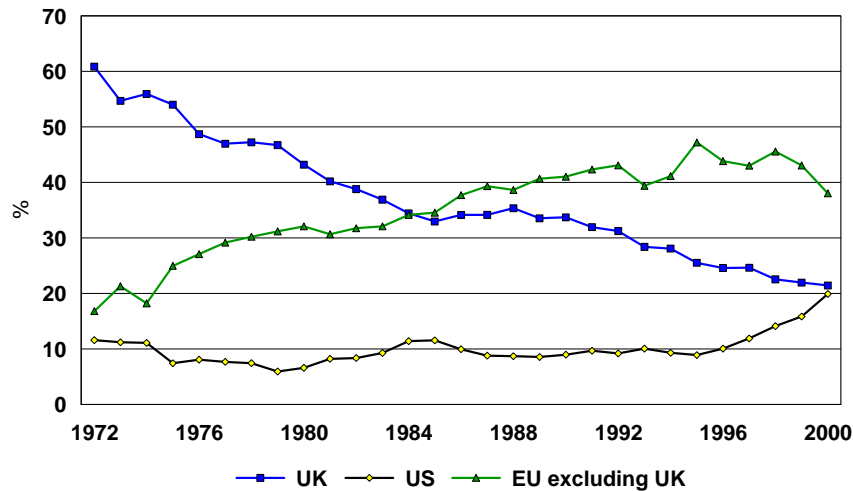
## **2. Experience of Monetary Regimes**

Even though Ireland became independent from the United Kingdom in 1922, the Irish pound remained tied to sterling for the next fifty years, with the value of the Irish pound being defined in law as being equal to one pound sterling. Under this arrangement sterling was exchanged at parity in all banks with no charge and, as a result, sterling still circulated freely within Ireland. While legal changes in 1972 left open the possibility of a change in parity, the no-margins clearing relationship continued until the end of 1978, when Ireland joined the EMS.

Throughout most of this fifty-seven year period, from 1922 to the end of 1978, there was very little consideration given to the possibility of establishing an independent monetary regime. Until the late 1960s the rate of inflation in the UK (and hence in Ireland) remained relatively low and there was no great dissatisfaction with that monetary policy regime. However, after joining the European Union (then the EEC) in 1973 the rate of inflation in Ireland rose rapidly as a consequence of the monetary policy adopted by the *de facto* monetary authority, the Bank of England. The problems posed for the Irish economy by this regime prompted consideration of the need to establish an independent monetary regime. In the event, this did not prove necessary, and Ireland joined the EMS in 1979, leaving the monetary union with the UK of over one hundred and fifty years.

While it was anticipated that the EMS would represent a shift to a hard-currency regime (McCarthy, 1979) the reality of the early 1980s was rather different. Sterling rose rapidly in value against the Irish pound and the other EMS currencies. This eased some of the burdens of the Irish manufacturing sector, which was undergoing the final stages of transition to EU membership, but it also resulted in a relatively high rate of inflation in the early 1980s. However, from the mid-1980s, the regime was rather different, with the Irish pound periodically changing its central rate within the EMS and the rate of inflation gradually falling. (Honohan, 1993). As a result, it represented a significantly weaker currency regime than had originally been expected.

**Figure 1: Export Trade Shares**



Over the course of the thirty years of Irish membership of the EU the pattern of trade has changed dramatically. As shown in Figure 1, approximately 60 per cent of exports went to the UK when Ireland joined the EU in 1973, while today the share is a little over 20 per cent. This fall is reflected in a corresponding rise in the share of exports going to the rest of the EU. While monetary union with the UK made sense in the 1960s and the 1970s, when the Irish economy was so fully integrated into that of the UK, the situation changed dramatically in subsequent years, with its full integration into the wider EU economy. The ending of the monetary union with the UK did not appear to have a significant negative impact on the volume of trade (Walsh and Thom, 2001) with the wider impact of EU membership both changing the direction of trade and also imparting a major stimulus to growth.

The twenty years of experience of the EMS showed that monetary independence was limited. Given the small size of the economy, with free movement of capital, effectively monetary policy was determined elsewhere. As part of the EMS, for much of the period, the Bundesbank determined monetary policy for Ireland. The fluctuations in the bilateral rate of the Irish pound with sterling also had the power to inject significant uncertainty, causing substantial short-term fluctuations in interest rates (Honohan and Conroy, 1994).

While the Irish economy underwent a severe and prolonged recession in the early 1980s, by the end of the decade the public finances had been restored to a sustainable path and economic policy pursued a

consistent and coherent stance thereafter (Honohan, 1999). However, in spite of this, in the 1990s there remained a substantial risk premium attaching to borrowing in Irish pound assets (Baker, Fitz Gerald and Honohan, 1996).

**Figure 2: Cumulative Excess Returns  
Relative to the DM**

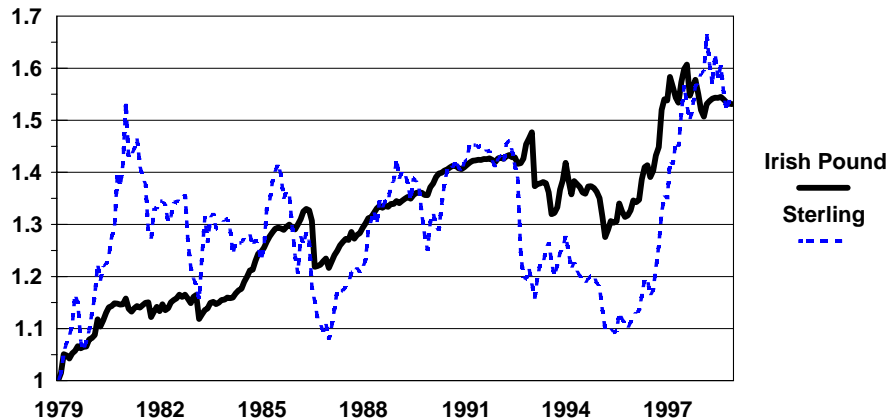


Figure 2 shows the cumulative "excess returns" over the period 1979-99, where the excess is defined as the premium obtained from borrowing in DM in 1979 and lending in Irish pounds at the prevailing short-term interest rates over the 20 year period. Even allowing for exchange rate changes, the higher Irish pound interest rates over the 20 years would have resulted in a cumulative 50 per cent higher return on Irish pound lending than DM lending. This amounts to an excess return of 2 percentage points a year.

The fact that the cost of capital was so much higher in Ireland than in Germany over all of that period had a serious negative effect on the level of investment and, as a result, on the potential growth rate of the economy. Investment by the private sector across a wide range of assets was substantially reduced and, especially in the 1980s when the public finances were in disarray, the higher interest rates led to underinvestment in public infrastructure. The very high interest payments on the debt (largely denominated in Irish pounds) required further tightening of the fiscal stance.

In the light of the crisis in the public finances and the poor performance of the economy generally, it was not surprising that the financial markets exacted a substantial price for lending in Irish pounds in the 1980s. The cumulative excess returns between 1979 and 1988 were 34 per cent, or just under 3 percentage points a

year. However, over the course of the 1990s the Irish economy performed much better and the public finances strengthened continually over the period, yet the cumulative excess returns between the beginning of 1989 and the end of 1998 were 14 per cent, and the average annual excess return was 1.4 percentage points.

By contrast, under EMU, where no exchange risk applies, the margin attaching to Irish government borrowing (and that of the governments of some other smaller economies) compared to German borrowing is less than 0.25 percentage points.<sup>2</sup> It may well be the case that, for a small currency, the price of information to the financial markets is quite high. In the past, if a financial institution wished to invest in Irish pound assets they would have to study the prospects for the Irish pound as well as the prospects for the Irish public finances. In the 1990s, with many other similar government bond offerings from larger economies, the cost of "buying information" on the Irish economy may not have been warranted for individual financial institutions. However, within EMU, lending in Ireland involves no exchange risk and it does not require a special study of the prospects for the Irish pound, allowing for much tighter margins.

The example of German unification highlighted certain disadvantages of the EMS regime. In 1990 the huge infrastructural deficit that existed in the Eastern Länder of the newly unified Germany posed major problems for its government. However, a decision was made that taxes would not be raised to cover the full costs of unification and government borrowing grew rapidly. This provided a very strong demand stimulus to the German economy, a stimulus that also affected Germany's EU neighbours. This stimulus was further accentuated by the decision to convert East German savings into DMs at par. The consequence of the stimulatory fiscal policy pursued in Germany was that the Bundesbank had to tighten German monetary policy to offset the inflationary impact of the demand stimulus. However, the rise in interest rates in

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<sup>2</sup> This margin probably largely reflects differences in the liquidity of the different instruments.

Germany was transmitted to all the other members of the ERM. Given the nature of the ERM this meant that there were serious negative externalities for the rest of the EU from procyclical German fiscal policy.<sup>3</sup>

If EMU had begun in 1990 with effective co-ordination of fiscal policy, it is likely that fiscal policy in Germany would have been much tighter than was actually the case in the early 1990s. The result would have been that the EU would have escaped much of the major rise in interest rates that actually occurred. Gagnon, Masson and McKibbin, 1996 and Barrell, Pain and Hurst, 1996, estimate that the cost of the stimulatory fiscal policy in Germany in the early 1990s was a loss in GDP of 2 to 3 percentage points in the UK, France and other EU members (other than Germany). While the increased demand from Germany resulted in increased exports from other EU members, this beneficial effect was more than offset by the negative effects of higher interest rates.

If these estimates of the negative externalities from inappropriate fiscal policy in Germany are put together with the direct cost to Ireland of high interest rates arising from the necessary tightening of monetary policy (Bradley, Fitz Gerald and McCoy, 1991), the results suggest that the Irish boom of the late 1990s would actually have occurred in the early 1990s. A crude combination of the results from these studies would suggest that the reduction in Irish GNP arising from the combined reduction in EU growth and from high interest rates amounted to around 6 percentage points. This represented a very substantial negative shock to an economy that had been growing very rapidly in 1989. The incipient boom in Ireland was halted in its tracks in 1990. The situation was further aggravated by the impact of the slow-down on house prices and consumer confidence, factors not taken into account in the estimated costs to the Irish economy, discussed above.

This is a very clear example where co-ordination of fiscal policy within an EMU could have been beneficial to a small country, such as Ireland. If there had been a monetary union in 1990, Germany would have taken into account the wider impact of its fiscal policy stance. In turn this would have required higher

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<sup>3</sup> A realignment of currencies in the EMU, suggested at an early stage as a possibility by the German authorities, could have reduced this negative impact.

taxation in Germany to pay for unification but the consequence would have been much lower interest rates and higher growth elsewhere in the monetary union.<sup>4</sup> The ECB under these circumstances would also have targeted the EU rather than the German inflation rate when deciding on the appropriate interest rate stance.

Unlike the rest of the EU, in Ireland migration has played an important role in determining how the economy responds to shocks. The importance of this channel makes Ireland rather different from other EU economies. While this was obviously the case in the past, with huge net emigration from Ireland in the hundred and fifty years from 1800 to the early 1960s (O'Grada, 1994), the gross flows into and out of the country remain large even today (Barrett and Trace, 1998). In this respect it is closer to the economy of a state of the United States. The importance of this mechanism has had a significant impact on the way the labour market operates (Fitz Gerald, 1999), greatly increasing the elasticity of labour supply. This also has implications for how the economy may adjust to shocks under EMU.

### **3. *Expectations for EMU***

Prior to joining EMU the economic debate in Ireland centred on two key issues:<sup>5</sup>

- Arising from the literature on optimal currency areas, were Ireland and the rest of the Euro area likely to form an optimal currency area? If they did not, what were likely to be the costs for Ireland of joining such a union?
- The second major issue concerned the likely credibility gain from membership; the abolition of the risk premium that had applied to the Irish pound over the previous twenty years.

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<sup>4</sup> In the long run such an outcome might also have been better for the German economy.

<sup>5</sup> The issues were considered in a report prepared for the Department of Finance by Baker *et al.*, 1996. For a debate on the likely effects of asymmetric shocks see Barry, 1998 and Fitz Gerald, 1998.

The possible gains from savings in transactions costs were felt likely to be small and the possible effect on foreign direct investment, an important issue for Ireland, were also considered to be unquantifiable, but probably not hugely significant.

One of the key long-term reasons why membership of EMU was considered desirable for Ireland was the expected impact on interest rates and the cost of capital (Baker *et al.*, 1996). When the decision on membership was made in the mid-1990s, as outlined above, there was extensive evidence from 15 years of monetary independence that that independence was bought at the cost of much higher interest rates (Honohan, 1993). In the light of this evidence, the 1996 study of the prospects for Ireland in EMU (Baker *et al.*, 1996) took the view that the excess returns in the long run would fall to one percentage point if Ireland were to remain outside EMU. The cost of such a permanent wedge in the cost of capital was considered to be still quite high. It would have resulted in the economy underperforming on a long-term basis, as investment was kept below its potential.

A Swedish government report (Calmfors, 1997) on EMU entry, that paralleled the Irish report, also considered this issue. They too found that in the past there had been a significant risk premium attaching to Swedish kroner assets. However, in the Swedish case it was felt that, with rational markets and good management of the economy, the premium would eventually disappear.<sup>6</sup>

The most significant potential cost for the Irish economy from EMU membership was expected to arise from the increased policy inflexibility, due to the loss of an important instrument - monetary policy. In the

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<sup>6</sup> The counterfactual to the current situation is not the pre-EMU environment. Both Baker *et al.*, 1996 and Calmfors, 1997 argue that good management of the Irish and Swedish economies respectively would have resulted eventually in a fall in the risk premium. However, while Calmfors anticipated that it would eventually be eliminated for Sweden, Baker *et al.* argued that good management over the 1990s had not eliminated the premium and that it would have been likely to remain significant for the foreseeable future.

1996 report, a number of scenarios were considered<sup>7</sup> to see how the economy would react to shocks both in and out of EMU. Among the shocks considered was a sudden loss of competitiveness against sterling, as well as a major rise in the value of sterling.

**Table 1: Medium-Term Effects of Irish Membership of EMU**

*Average change in level compared to benchmark*

	UK Out	UK In
Effects of:	Change in GNP, %	
Cumulative Effect - Lower Interest Rates etc.	1.4	1.8
Risk of Shocks - Competitiveness etc.	-1.0	-0.4
Net Effect	0.4	1.4

What these simulations showed was that there were likely to be significant costs arising from the loss of flexibility consequent on EMU membership. In particular, in 1996 a sudden major loss of competitiveness against sterling would have imposed substantial temporary costs on the Irish economy.

Using this information in an appropriate model (Gerlach, 1995), the report arrived at an overall assessment of the allowance which should be made for the possible cost of future shocks under different exchange rate regimes. It can be seen as the insurance premium which it would have been worth paying to buy protection against future shocks.

The result of applying this methodology suggested that the allowance for the avoidable cost of shocks need be no higher than the equivalent of 1 per cent of GNP where the UK remains outside EMU. As shown in

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<sup>7</sup> This was done by simulating the external effects of the shock using the National Institute for Economic and Social Research's (London) NiGEM model and the domestic effects were then examined using the ESRI's HERMES model.

Table 1, the risk of asymmetric shocks would be significantly lower if the UK were to join EMU. This premium was insufficient to offset the estimated steady gains of around 1.4 per cent of GNP, largely arising from the lower risk premium on interest rates in the long run (Table 1). Having made provision for the cost of possible shocks, the net benefit of EMU membership in terms of employment was estimated to be of the order of 10,000 (just under one per cent of total employment).

The possible benefits from increased competition were not expected to be very significant, given the changes that had already taken place as a result of the completion of the internal EU market (Bradley, Fitzgerald and Kearney, 1992). This contrasts with the study for Sweden (Calmfors, 1997), which expected significant benefits from this channel.

In planning for EMU, not unexpectedly, significant emphasis was put on the need for increased labour market flexibility (Geary, 1996). While the possibility of migration certainly reduces the Irish economy's vulnerability to shocks, more flexible practices in the labour market could hasten adjustment to future shocks, reducing the need for costly migration flows.<sup>8</sup>

#### **4. Experience of EMU**

As outlined above, the three areas where EMU was expected to make a significant difference were in terms of credibility and interest rates, in terms of competition and inflation, and in terms of the response of a regional economy, such as Ireland, to asymmetric shocks.

It is no surprise that the successful implementation of EMU led to the predicted credibility gain for a number of the participants. The gains were particularly significant for Italy, Spain and Ireland (Sinn, 2000). The fall in risk premia on interest rates in anticipation of EMU greatly facilitated the Italian government's fiscal adjustment programme. Compared to the pre-EMU situation, this reduction in interest rates must raise the optimal long-run capital stocks for those countries, with a positive impact on growth rates. The

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<sup>8</sup> Albeit the bulk of the costs of migration are carried by those migrating.

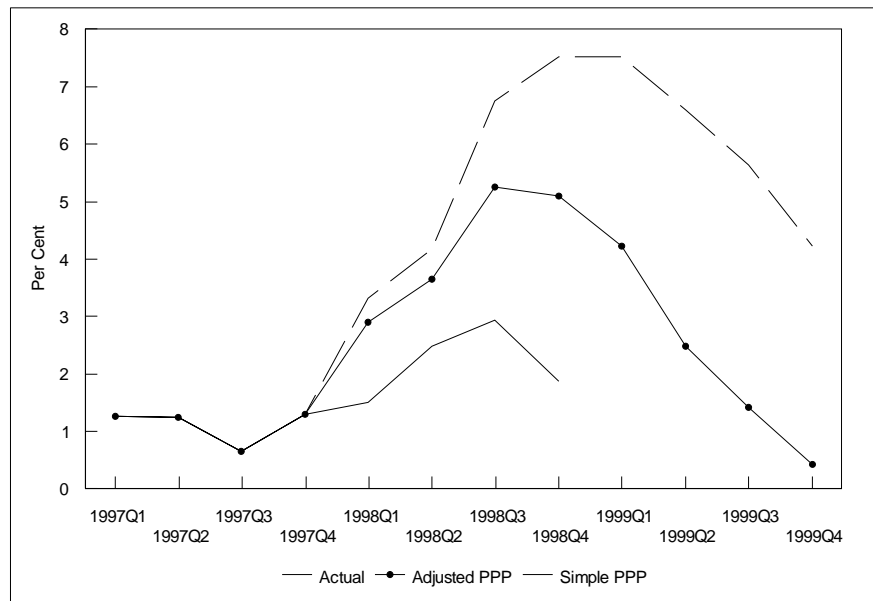
corollary of the reduction in interest rates has been a cost for Germany and the Netherlands. However, Sinn, 2000, argues that the overall impact of these changes would be to increase the efficiency with which capital is used in the Euro area.

Probably more important than the immediate reduction in interest rates was the greater certainty that EMU gave about the future cost of capital. Using a model of central bank behaviour, Faust, Rogers and Wright (2001) have modelled what might have happened to interest rates in individual Euro area economies if EMU had not taken place. Using realistic parameters, in a model of potential output similar to that used by the EU and similar to the model that probably underlay international market expectations, their approach would suggest that interest rates in Ireland would have risen to 10 per cent or more in the late 1990s. Such exceptionally high interest rates would have resulted from the fact that the method used to model potential output in the Irish economy greatly underestimated its true potential. This was reflected in the incredulity with which much financial market comment greeted the late 1990s Irish experience.

The result of such a rise in interest rates would certainly have been an avoidance of the rise in inflation from 2000 onwards. However, it would also have choked off the boom well before full employment was reached and earlier than would have been necessary to avoid the inflation that actually occurred. Thus the full benefits of the boom of the 1990s might not have been achieved without membership of EMU.

There is a lesson from this experience for accession countries. Where countries' potential growth rates are uncertain, EMU can avoid the danger that growth may be choked off prematurely through an unnecessary rise in interest rates. The cost of this additional insulation is, of course, that interest rates will be insensitive to inflationary (or deflationary) dangers in individual economies.

**Figure 3: Forecasts of Irish Price Inflation**



All studies of the inflationary process in Ireland over the last 25 years have found that goods prices are externally determined. Quinn, Kenny and Meyler, 1999, summarise this evidence. In the case of the price of the output of the manufacturing sector, prices are fully externally determined (Callan and Fitz Gerald, 1989)<sup>9</sup>. For aggregate consumer prices this also true, though the speed of transmission of external shocks has changed with the advent of EMU (Fitz Gerald and Shortall, 1998). While it also holds true for inflation in consumer goods prices, inflation in the price of non-tradables - domestically produced services and house prices - is significantly affected by domestic wage rates (Meyler, 1999, and Kenny and McGettigan, 1999). However, these elements either have a low weighting (16 per cent for domestic services prices) or do not appear at all (house prices) in the consumer price index.

It was clear at the outset that EMU would affect the behaviour of the economies of all the members in a wide range of different ways. However, what was possibly less obvious, was that even for non-members within the EU, EMU would also represent a regime shift. UK firms dominate the Irish retail sector and quite a high proportion of goods sold in Irish shops is sourced in the UK. Figure 3 contrasts the forecasts

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<sup>9</sup> The relevant equations in the latest version of the ESRI *HERMES* macro-economic model suggest that output prices are still externally determined.

for inflation in Irish consumer prices in 1998 derived from the model of Fitz Gerald and Shortall, 1998, with the actual outturn, and with forecasts from a simple PPP model. As one would expect, the significant appreciation in sterling in 1997-98 fed through fully into the forecast from the simple PPP model, suggesting an inflation rate of almost 8 per cent by the end of 1998. The adjusted PPP model, which allows for the fact that the UK exchange rate in 1998 was not expected to persist, produced forecasts which were much lower. However, these once again greatly overstated the actual outturn. This over-prediction provides early evidence that a regime change is under way as more and more British firms begin to price in Euros. McArdle, 2000, provides additional supporting evidence, indicating that UK firms are increasingly pricing in Euros rather than in sterling, so that they carry the cost of unexpected exchange rate changes.

The high rates of inflation experienced in Ireland in 2000 and 2001 to a significant extent represented a delayed pass through of the exchange rate changes of 1997 and 1998. The inflationary shock arising from the fall in the value of the Euro was delayed as a result of EMU membership but was not prevented. With the reversal in the position of the Euro over the last year it will be interesting to see how rapidly the higher value of the Euro will be passed through into lower inflation rates in Ireland.

This result is supportive of the arguments made in Calmfors, 1997, about the likely increase in competition as a result of EMU. However, while this would suggest a significant competition effect in Ireland from EMU, there is no evidence yet that it has been significant in other regional economies within the Euro area. It may be some time before it will be possible to assess the importance of this effect for the Euro area as a whole.

The third major effect on the Irish economy expected to arise from monetary union was reduced flexibility in the face of external shocks as monetary policy ceases to be an instrument for managing the regional economy. In the case of Ireland, the fall in interest rates, while undoubtedly of long-term benefit to the economy, has taken place at a time when the economy is already booming. As such, it has complicated the management of the economy in the short term.

In 2001 and early 2002 the Irish economy was suffering from excess demand due to it being "too competitive". The excess demand came as much from the external sector as from domestic demand

(Blanchard, 2001). This was reflected in the balance of payments, which has remained close to balance over the last 3 years, in spite of the very rapid growth in the economy. The result of the growth in demand was a very rapid rise in wage rates (forecast to be over 10% for 2001). The share of labour in value added fell steadily since the early 1980s, indicating an improvement in underlying competitiveness. However, this could not continue indefinitely and some reversal was expected (Lane, 1998) and actually occurred in 2002-4. A real appreciation<sup>10</sup> was called for to reduce competitiveness and to bring demand into balance with supply in the labour market (Fitz Gerald, Kearney and Morgenroth, and Smyth, 1999, and Walsh, 1999). This reversed the trend growth in profitability.

It is still not clear how much of a real appreciation was needed to bring the labour market back into balance. This would have been easier to manage through a nominal appreciation of the exchange rate, where overshooting could, if necessary, be corrected through further exchange rate adjustments. However, within the Euro Area, it must occur through higher wage inflation.

The danger for the Irish economy with this process was that inflationary expectations in the labour market could result in the real appreciation overshooting. People could have got used to an annual rate of wage inflation of 10 per cent or more a year. While this might have been sustainable for one or two years, if it continued it would have rapidly priced Ireland out of its external markets. Unless wage rates adjust instantaneously to clear the market in the future, any overshooting of wage rates could have resulted in a substantial rise in unemployment. Under EMU, if nominal and, therefore, real wage rates grow too rapidly, making the economy uncompetitive, correction can only come about through either a cut in nominal wages, or through nominal wage rates standing still while inflation in the Euro Area catches up. Cuts in nominal wage rates are most unusual. (However, they have, exceptionally, been seen in some exposed manufacturing sectors in 2002.) Relying, instead, on a slow process of attrition could see the economy

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<sup>10</sup> Where the cost of labour in Ireland, measured in a common currency, rises relative to costs in competitors.

remaining uncompetitive for some time, with a consequential serious cost in terms of unemployment and lost output.

For this reason stimulatory fiscal policy, that aggravates the rate of wage inflation and fuels expectations about future wage increases, is unwise and the EU Commission strictures on the Irish economy in 2001 must be seen in this light (Fitz Gerald, 2001). The rapid increase in domestic labour costs could have exposed the economy to unnecessary dislocation in the event of an unexpected external shock.

Blanchard, 2001, considered the appropriate adjustment process for both Ireland and Spain. He concluded that, because of Ireland's relatively strong balance of payments, the adjustment should have come through a combination of wage inflation and some fiscal contraction. In the case of Spain, because of the starting position of a balance of payments deficit, it was appropriate that the bulk of adjustment should be undertaken through a tightening of fiscal policy. Such a nuanced approach to fiscal policy in regions of the Euro Area needs to be further developed by the EU Commission.

For the EU Commission, representing the interests of the citizens of the wider Euro Area, the economic concern must be whether the aggregate stance of fiscal policy in EMU is too stimulatory. If it were, then there would be the danger that interest rates would be higher than necessary for all members of EMU, as in the case of German unification. However, while they did express some concern about the loosening of fiscal policy in EMU in the Policy Guidelines in the summer of 2000, subsequent events have reduced these fears.

## ***5. Economic Policy in a Regional Economy***

The move to a monetary union changes the nature of the inflationary process in each of the member states. It is the job of the central bank of the union, in Europe's case the ECB, to control the rate of inflation for the Union as a whole. With a common currency and free movement of goods, in the long run, the regional rates of inflation in goods prices can not diverge from the inflation rate for the monetary union as a whole. As a result, the Governor of the US Federal Reserve does not worry about the rate of inflation in Wyoming!

While there is significant divergence in the rates of inflation in consumer prices within the new EMU this need not necessarily be a cause for concern.

The advent of monetary union also removes the potential concerns that managers of individual economies have traditionally had concerning the balance of payments. In a monetary union, the balance of payments effects of excess demand do not feed back on the economy through exchange rates or other monetary effects. Unless domestic agents' indebtedness rises to such an extent that the risk premium on lending rises, there is no direct effect through this channel on domestic activity.

Domestic policy concerns about inflation within a regional economy in EMU should focus primarily on domestic wage rates, and domestic asset prices. In the case of wage rates, with inflexible labour markets, it is quite possible for wage inflation to result in significant regional unemployment. It is also possible for regional asset price bubbles to significantly disrupt regional economies.

**Table 2: Inflation in Ireland in Labour Costs and House Prices, %**

	1997	1998	1999	2000
New House Prices	17.22	22.58	18.51	17.03
Average Earnings	6.59	4.40	5.35	8.09
Consumption Deflator	2.64	3.80	3.31	5.80

While the process of convergence in living standards could be expected to lead to higher inflation in consumer prices in Ireland, this can only account for a limited part of the differential in the rate of growth in consumer prices (Blanchard, 2001 and Rogers, Hufbauer and Wada, 2001). The main reason for Irish consumer price inflation exceeding the EU average by a significant margin is external factors – exchange rates and the price of oil. However, as shown in Table 2, Ireland had an inflationary problem from 2000 to 2002, with house prices increasing very rapidly and the rate of wage inflation on a rising trend.

While fiscal policy may be ineffective in controlling consumer price inflation in Ireland, it can have an important impact on the labour market. Where the government increases expenditure to hire more labour, the effect on wage rates will be even stronger where labour supply is constrained. This was the case with the 2001 Irish Budget. Where there is full employment wage rates have to rise by enough to free up potential employees from private sector firms (discouraging them from expanding or even putting them out of business) to make them available to the public sector.

Over the last twenty years labour supply has been exceptionally elastic in Ireland because of migration. This has meant that the incidence of taxation increases, and in the 1990s of cuts in direct taxation, has fallen on employers. Thus the policy agreed in 1987 between the social partners, of trading off tax cuts for wage moderation, reflected market realities (Fitz Gerald, 1999). As taxes were cut and wages inflation moderated, competitiveness gradually improved. This helped underpin the economic recovery in Ireland in the 1990s. However, with major infrastructure constraints and a reduction in the stock of Irish emigrants abroad available to return, the elasticity of labour supply through migration has fallen rapidly. This means that, while in the past tax cuts would affect competitiveness, now the benefits primarily accrue to employees and the labour supply response is greatly attenuated (McCoy *et al.*, 2000). This has meant that the inflationary impact of increased labour demand consequent on tax cuts in the 2000 and 2001 budgets has dominated the beneficial labour supply effects. The result was a further stimulus to wage inflation.

While fiscal policy can be expected to play a significant role in moderating excessive demand pressures (or at least not adding to them) in an open economy, there are some additional factors that may reduce its effectiveness under current circumstances in Ireland. Because of the exceptionally strong current financial position of the Irish government sector, the effectiveness of fiscal policy may be reduced through "Ricardian equivalence" effects (Whelan, 1991).<sup>11</sup> For example, if the Irish government had tightened fiscal

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<sup>11</sup> Individuals may take account of the implications for future tax liabilities of changes in government indebtedness. Thus increased government savings could give rise to the expectation of future tax cuts. Such an expectation could, in turn, affect current consumption.

policy in 2001, raising the general government surplus from the expected 4.6% of GDP to 6% or more of GDP, it would have been quite clear to all economic agents that this was only a temporary measure.

Government assurances that in future years there would be big cuts in taxation, or increases in services, would have been readily believed, and many economic agents would have behaved accordingly. Personal and company savings could have been further reduced, partially offsetting the impact of the fiscal tightening. While this effect would only offset a limited amount of any fiscal tightening, it might not be a trivial impact where the fiscal tightening occurred through taxation.

However, even if there were some evidence that "Ricardian equivalence" could offset the deflationary effects of higher taxes, this will not be true where fiscal policy is implemented through a change in the rate of increase in public employment. By acting on the labour market directly, changes in public sector employment directly impact on the rate of wage inflation.

In addition to its potential effects through the labour market, fiscal policy can also influence the allocation of resources within the economy by changing incentives. For example, fiscal policy can have a significant impact on the domestic housing market through changing household disposable income and through changing the cost of capital for homeowners. The tax treatment of interest payments on house loans can affect the cost of capital for homeowners. Because the legal instrument under which mortgage lending takes place is country specific, the taxation or subsidisation of mortgage interest payments is not affected by the country of residence of the financial institution making the loan.<sup>12</sup> As a result, while there is free movement of capital this does not render domestic tax measures ineffective.

To date the fiscal policy instrument has not been used actively in Ireland to reduce excess demand for housing in the current boom. It remains possible for the government to eliminate interest relief on mortgage interest payments in the income tax code (or even to tax them). This could raise the local cost of capital for households considering investing in housing, while the Euro interest rates are the same as in other Euro

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<sup>12</sup> While UK financial institutions are lending in Ireland on Irish housing without having an office in Ireland, the mortgage must be registered in the country where the property is located.

area countries. In addition, there is a range of other fiscal measures that could directly reduce demand pressures in the building sector.<sup>13</sup>

An example of a regional asset bubble was the boom and bust in property prices in the region of the Federal Reserve Board of Kansas (10<sup>th</sup> District) in the mid-1980s. The regional economy was not protected from this bubble by membership of monetary union and it suffered significant disruption when the local economy suffered from a simultaneous shock to two key sectors, agriculture and energy. As a result, property prices collapsed and this caused major problems for the local banking system.

Similar problems occurred in Scandinavia in the late 1980s and in the UK in the early 1990s, though in those cases the problems were aggravated by rising interest rates, related to exchange rate fluctuations. Within a monetary union such asymmetric shocks would not have knock-on effects through raising interest rates. As a result, provided that the domestic banking system is perceived as sound, local problems from bursting local property market bubbles are likely to be reduced inside a monetary union.

However, both the mid-west US crises in the mid-1980s and the Scandinavian crisis at the end of the 1980s were also characterised by local banking crises that aggravated the problems for the local economy. This highlights the continuing importance for regional Central Banks of maintaining financial stability within their countries. The current arrangements within EMU are less clear-cut than in the US on responsibility for dealing with any such crises that should occur in the Euro area in the future. Under these circumstances, prudent central Banking practises in regulating regional banking systems may be all the more important.

As a member of EMU Ireland has taken on an obligation under the Maastricht treaty to ensure that government borrowing does not exceed 3 percentage points of GDP in any individual year. Penalties are specified in the event a country breaks this rule. In an uncertain environment this makes it important to ensure that fiscal policy is operated with a safety margin to ensure that, whatever shocks occur, the economy stays within the Maastricht limit.

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<sup>13</sup> These include a withdrawal of special tax incentives for building.

The budget of all countries is significantly affected by the economic cycle. To ensure that the budget remains within the limit, while running a neutral budgetary policy, it will be important to keep the deficit, on average, significantly below the Maastricht limit. The extent to which the deficit must be kept below this limit to ensure that it is never exceeded, even in a recession, will depend on how responsive the public finances in an individual country are to cyclical changes in economic activity.

A recent study for the OECD area (van den Noord, 2000) suggests that the structural deficit (at trend growth rates) will need to be between 0.5 and 1.5 percentage points of GDP below the 3 per cent deficit threshold to ensure that that threshold will not be breached in the case of a serious recession. This would allow the automatic stabilisers to work and there would be no necessity to take pro-cyclical action to keep the deficit under control. In Scandinavia and the Netherlands their budgets are more sensitive to the economic cycle because of the characteristics of their public sectors. As a result, they would need a bigger margin to ensure that the limit will not be exceeded in a recession. When other risks are accounted for, this evidence suggests that for most members of EMU the Stability and Growth Pact guideline (that over the economic cycle the government sector should be in balance) is broadly appropriate.<sup>14</sup>

Duffy, Fitz Gerald and Smyth, 2000b, undertook a similar study of the sensitivity of the Irish economy to cyclical disturbances. Their conclusion was almost identical to that of van den Noord for the broad OECD area. For every one per cent reduction in the growth rate below potential, the government surplus would fall by 0.5 percentage points of GDP. This would imply that, provided the budget were maintained in balance over the cycle as required under the Stability and Growth Pact, there would be no danger of the government being forced to take procyclical action to cut the deficit, as happened in the 1980s. Thus the Stability and Growth Pact requirement to maintain balance in the public finances is what prudence would, in any event, require of Irish governments within EMU.

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<sup>14</sup> Barrell and Drury, 2000, undertook a very similar exercise using the NiGEM model concluding that the main European economies could run somewhat looser deficit targets (between 1.5 and 2 per cent of GDP) than van den Noord suggested, while still having a 99% chance of keeping within the limit.

Probably the biggest danger to the Irish economy lies in the possibility of a significant recession in the US. This could affect the Irish economy more than other EU members (Duffy, Fitz Gerald and Smyth, 2000a), exposing any overvaluation of the real exchange rate. However, the robust nature of the public finances leaves Ireland more secure in the face of external shocks than at any time in the last three decades. Even if there was a recession in Ireland, it is likely in the first year of low growth the government would still be in surplus, leaving room for a countercyclical fiscal policy.

## **6. Conclusions**

While the loss of monetary policy as a separate instrument for managing regional economies within EMU undoubtedly complicates economic management, in the case of Ireland that instrument was never fully effective in the past. However, even with the loss of the ability to pursue an independent monetary policy, regional economies still have the ability to use fiscal policy to manage purely national economic problems. In particular, fiscal policy can still be used to limit the problem of excess demand in the domestic labour and housing markets.

What has changed for the Irish government (and the governments of other small Euro area members) are the economic issues that they control. The national balance of payments and inflation in consumer prices are no longer issues that should unduly concern national policy-makers. Instead, the potential problems posed by excessive wage inflation and inflexibility in regional labour markets are enhanced by EMU membership. As before EMU, bubbles in domestic asset prices, primarily in domestic property markets, still have the potential to destabilise the local economy. While monetary policy is no longer available to national policy-makers, suitable fiscal policy instruments can be deployed to target these specific problems.

The danger for the Irish economy with the expansionary stance of fiscal policy over the 2000-02 period was that, by adding to inflationary expectations in the labour market and in the property market, the real exchange rate could overshoot – there could have been an excessive rise in labour costs. Unless wage rates adjust instantaneously to clear the market, wage rate overshooting could prove costly. For this reason stimulatory fiscal policy, that accelerates the rate of wage inflation, is unwise. It could expose the economy to unnecessary dislocation in the event of an unexpected external shock. The cost that would be involved in

pursuing a tighter fiscal stance today would be a temporary delay in consumption. The cost involved in the pro-cyclical stance of the 2000-2002 period was an increased danger of significant economic disruption in the future.

In considering the overall balance on the public finances the Maastricht criteria raise concerns as to what is the “safe braking” distance for the Irish economy. The evidence suggests that for Ireland, as with most other members of EMU it should be sufficient to observe the guidelines in the Stability and Growth Pact – fiscal balance over the cycle. In the Irish case, due to the very favourable demographic circumstances, the public finances showed substantial surpluses through to 2000. The current policy is to contribute at least one per cent of GNP a year to a national pension fund to deal with the likely deterioration in the demographic situation after 2025. This “pension” contribution provides a further safety margin in case of a sudden deterioration in the economy.

For the European institutions there is also a learning process. The EU Commission, representing the interests of the citizens of the wider Euro area, must be concerned about whether the aggregate stance of fiscal policy in EMU is too stimulatory. If it is, then there is the danger that interest rates will be higher than necessary for all members of EMU. However, while they have expressed some concern about the overall stance of Euro area fiscal policy in EMU in the policy guidelines, most of their attention has focused on the stance of national fiscal policies. For the future more attention must be given to the aggregate stance for the Euro area, with the discussion of national policies revolving around the allocation of responsibility for meeting the needs of the Euro area as a whole.

Looking to the longer term, it is very much in Ireland's interest that an appropriate mechanism is developed for achieving the necessary co-ordination of fiscal policy with the euro area. As discussed in this article, Ireland has suffered in the past from inappropriate fiscal policy in the EU, and it could suffer again in the future. However, the existing instrument for co-ordination is ineffective, both because it lacks an appropriate economic focus and also because it lacks mechanisms to ensure that such co-ordination is implemented. Developing such mechanisms is likely to be particularly important for the smaller members of the euro area.

Co-ordination need not and should not involve extensive restrictions on domestic fiscal freedom. In the spirit of the Maastricht guidelines, it should confine itself to action where the aggregate fiscal policy stance of the euro area is considered inappropriate. It can leave individual countries freedom of action to determine the appropriate mix of tax and expenditure changes needed to achieve a given national target surplus or deficit. Co-ordinated action is likely to prove necessary only in exceptional circumstances. The best national interests of most member states will normally produce a domestic fiscal policy stance consistent with the needs of EMU.

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