IRELAND AND THE EUROPEAN MONETARY SYSTEM

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1. INTRODUCTION

It is now 19 months since Ireland began its membership of the European Monetary System. To the man in the street the record of those months is a standing warning not to listen to the advice of economists on important matters such as the value of the domestic currency. With the Irish pound at a discount of 20 per cent to sterling at the time of writing there are considerable grounds for resentment among a public who were led to expect a premium over sterling as a bonus (or cost) of EMS membership.

It would be inappropriate here to discuss the reasons why sterling has proved so strong since March 1979. It might be noted, however, that no leading currency forecasters got the direction, let alone the strength, of sterling's movement correct in early 1979.

The reality is that the Irish pound has been stable within the European Monetary System and has been protected from the ferocious squeeze on industrial activity, employment and profits of an overvalued exchange rate. Many who supported Irish membership of the European Monetary System did so on the grounds that it would provide greater exchange rate stability than the sterling link. Some, such as Honohan (1978), argued that an appreciating sterling, due to oil from the North Sea, would prove damaging to the Irish economy which would have the disadvantage of a high exchange rate and none of the oil revenues to offset the effects on net exports. It is sobering to realise that if the Irish £ had remained at parity with sterling the effective appreciation of the Irish £ since EMS membership would have been 10.1 per cent compared to an effective decline of 10.8 per cent. It is not at all clear that Irish industry could have tolerated such an effective appreciation.

Of course it would have suited Ireland better had sterling agreed to membership of the EMS and, therefore, the maintenance of the parity link. I can find no contemporary parallel among countries with diversified trade to the Irish position inside the EMS. We have formed a currency tie with a group with which we conduct only 25-30 per cent of our total trade and with which we had virtually no active financial and monetary arrangements. The achievement of the last 19 months has been considerable when one recognises the difficulties in establishing an effective substitute for a currency link which, however undesirable its consequences for inflation, had the virtue of formalising extensive trade and financial relations. The management of Irish membership of EMS falls into a number of categories, some technical, others of a macroeconomic nature. Tonight I want to deal briefly with a number of issues which have arisen in the course of our 19 month membership. These are the management of the foreign exchange market, the operation of exchange controls, the development of monetary policy and the inter-relation of fiscal and monetary policies.

2. THE MANAGEMENT OF THE FOREIGN EXCHANGE MARKET

In the early days of EMS entry, the Dublin foreign exchange market was relatively primitive with a high dependence on London as a source of foreign exchange quotations.

Clearly, the requirements of a clean float within the agreed EMS bands could not be met without a willingness of the foreign exchange dealers to hold net positions in currencies and to develop an active market for the major EMS currencies. In the early days of EMS entry, the Central Bank acted as market maker quoting narrow spreads on most currencies and so dealers could always trade with the knowledge that net positions could be balanced by transactions with the Central Bank.

Over the early phase of membership this active intervention by the Central Bank was of considerable help in curbing, and to an extent disguising, the downward pressure on the Irish pound. Less than two months after entry, the Central Bank was borrowing from other European Central Banks in order to stem the outflow of funds. As the Government foreign borrowing programme got underway these loans were repaid and reserves built up again. By gradually widening the dealing spreads and increasing the limits on the net positions allowable to banks, the Central Bank had gradually moved out of the foreign exchange market and interventions tend to be limited to smoothing the effects of large flows – such as EEC loans or transfers, oil payments – which could have an unrealistic but temporary effect on the exchange rate. The Bank has also been active in the forward market and has been involved, often for domestic liquidity reasons, in foreign exchange swops with the banks. By and large the development of the foreign exchange market has been smooth and represents a notable success for both the banking system and the Central Bank. I suppose that I should enter a small caveat in that the Central Bank appears to regard the disclosure of historical information on the magnitude of Central Bank support of the currency, loans received from other Central Banks, and foreign currency swops entered into as undesirable without any good grounds for such an attitude. One does not expect the Bank to reveal its day to day position. But the analysis of the Irish £ exchange rate and its relationship to monetary flows is made difficult by the reluctance of the Bank to reveal the scale and extent of its intervention.

3. EXCHANGE CONTROLS

While there would be general agreement that the development of a foreign exchange market in Ireland was both desirable and smoothly effected, there would be far less agreement on the desirability or operation of exchange controls. Kelleher and McCarthy (1980) have outlined the arguments against existing exchange control regulations. As economists they are rightly concerned about the loss of economic efficiency created by the controls. But it is important to distinguish the cost of controls from the cost of breaking the sterling link. The existence of no margins parity with sterling meant that around half our trade could be financed at low cost and considerable efficiency. The break with sterling would have imposed considerable additional costs even if no exchange controls had been imposed. McCarthy (1980) has suggested a cost of £5.5 million plus additional clerical costs to companies and individuals.

Exchange control *per se* probably adds little to the administrative and other costs involved in acquiring a foreign currency and a foreign security. The main cost of exchange controls is the distortion created in domestic capital markets by the inability of investors to seek portfolio investment elsewhere. In the long term that cost may be considerable. But at present I would feel that it is grossly overstated by those who seek an end to exchange controls. In the period prior to exchange controls there is no evidence of sizeable net portfolio investment by individuals or institutions outside Ireland. Indeed, it is probable that Irish residents were net purchasers of Irish securities from UK holders. If the absence of controls on UK investment leads to little gross or net movement of funds the imposition of controls can hardly be said to have had a major effect. It is possible to acquire foreign securities to diversify a portfolio; it is not possible to diversify

the currency aspect of a portfolio. Whether the vast bulk of investment funds, which are held to pay Irish pound pension liabilities in the future, would want to have a significant exposure to foreign exchange movements is debatable. There is, of course, a case to be made that the availability of exchange control permission to buy, for example, a holiday house abroad, is unfair to those who seek portfolios rather than real estate investment. It could be argued that individuals should be allowed to build up net overseas holdings worth, say, £20,000 (adjusted for inflation) and to prevent sudden outflows, the annual increment to any holding below £20,000 might be restricted to £5,000. This would allow Irish investors to share in the fortunes of most of the Irish manufacturing sector – Guinness, Burlington Industries, Digital, Wang, etc. – without damaging the Balance of Payments unduly. In the long run, if restrictions on portfolio investment abroad continues and permission is granted for direct investment abroad, Irish quoted companies are likely to acquire foreign holdings and so offer Irish investors exposure to other economies and currencies without having to acquire foreign securities.

4. FISCAL AND MONETARY POLICY

The experience of monetary and fiscal policy and the co-ordination of the two have been the least happy aspects of Irish entry into the European Monetary System. Although monetary and fiscal policy received little attention in both the White Paper on The European Monetary System and the Appendix to the White Paper *Programme for National Development 1978-81* there was little doubt among commentators that continued membership of the EMS would require fiscal discipline and tighter control of monetary aggregates. The EMS subsidies, which were related to loans provided both by EEC institutions and by private banks in member states, were designed to aid Ireland in maintaining a Balance of Payments deficit compatible with the rapid investment growth required to bring living standards in line with EEC averages. However, the level of Government borrowing in 1979 and 1980 which was directed towards current spending was well in excess of that envisaged in the EMS negotiations. The 1979 Balance of Payments deficit of £730 million and the 1980 deficit of close to £550 million were not, in the main, due to rapid Irish investment growth. Put crudely domestic private sector savings were sufficient to finance all but £225 million of capital spending in 1979 and will be sufficient to finance virtually all 1980 capital spending. The payments deficit in 1979 and 1980 can be seen as a reflection of excessive government borrowing. Of course the equation is more complex than a simple £ for £ reduction in the Balance of Payments deficit per £ of Government current borrowing. A cut in borrowing, depending on how it was arranged, would involve a reduction in domestic demand as well as final demand and so costs, in the form of higher unemployment and reduced economic activity, would be imposed on the economy.

But econometric evidence would suggest that when the economy faces the sort of supply constraints faced in 1978 by the Irish economy there is a strong tendency for increased Government spending to leak away through the payments deficit. In 1980 the position is less clearcut. The 1980 deficit owes much to structural factors such as the rapid decline in the international terms of trade rather than excess demand. But the existence of the deficit indicates that demand is excessive relative to the capicity of the Irish economy to supply that demand. Unless supply can be improved – by higher exports in all probability – then the Balance of Payments deficit will persist until domestic demand is reduced. The Central Bank was unfortunate in that the entry to EMS coincided with serious over-runs in the scale of Government borrowing by the Exchequer and semi-state companies.

Until the break with sterling, the Central Bank did not have to concern itself with the

implications for bank liquidity and money market interest rates of variations in the scale of Government domestic or foreign borrowing. If the Government sold gilts and so absorbed domestic liquidity, this was replenished by flows from the London interbank market. Similarly, excess liquidity created by Government foreign borrowing was bid away by the London market. In effect Irish money market rates were a reflection of UK rates.

The Central Bank could, of course, be broadly concerned with the level of domestic credit growth and could attempt to restrict credit growth by quantative controls. However, such efforts ran the risk of eroding the share of the Irish credit market held by Irish banks. Without effective weapons to penalise the banks for infringements of the guideline, the Central Bank's monetary policy was of the exhoratory kind. With EMS and the absence of the two-way flow of liquidity, the Central Bank had to provide the same kind of facility as had been provided by the access to London.

Had there not been the large payments deficit and the need on the part of the Exchequer to sell substantial amounts of gilts, the Bank might have been able to introduce, more smoothly, facilities for providing or absorbing liquidity in the Irish money market. But the large payments deficit drew liquidity from the system, as from time to time, did large purchases of gilts by institutional investors. The resulting liquidity squeeze forced interest rates to over 20 per cent – at that time well in excess of UK and US rates – and caused the banks to borrow heavily from the Central Bank.

As this borrowing coincided with a reserves crisis, due partly to capital movements arising out of EMS membership but mainly to a rapidly increasing current Balance of Payments deficit, the banks were accommodated at increasing penal rates by the Central Bank.[1] For many banks recourse to the Central Bank for liquidity was far from being as smooth as recourse to the London interbank market in pre-EMS days. The banking system coped, in 1974, with the liquidity problems created by a current Balance of Payments deficit almost as large, in relative terms, as that which occurred in 1979.

The issue raised by the 1979 experience is whether a more remote method of providing (or absorbing) liquidity is required in the future. The London discount market exists, mainly, because of the long-standing belief that banks would be unwilling borrowers from, or lenders to, the Central Bank, a body which notionally controlled their activities. Current theory and empirical evidence, notably on the operation of the US market is no guide as there remain two conflicting views. One is the belief that banks treat loans from the Central Bank or deposits with it on a par with funds obtained from or placed with the interbank market; the other, the view that regardless of the profit consequences, banks prefer borrowing from interbank markets even at higher cost to borrowing from the Central Bank.

While there may be disagreement on the way to view the commercial banks' attitude to Central Bank lending, there is little doubt about the need for a wider range of short-term financial instruments which can be traded for liquidity. The Central Bank has gradually increased the Exchequer Bill issue but too much reliance is placed on providing liquidity by loans to banks secured by short dated Government stock and absorbing liquidity by bidding for short-term deposits in competition with the interbank market. The evolution of Central Bank certificates of deposits would widen the range of longer/short financial instruments as, of course, would the development of a commercial bank CD market. However, the fundamental problem is the existence of the secondary liquidity ratio. In 1979 the Central Bank was lending money, secured by short-term Government securities, to the commercial banks to prevent them reducing their secondary liquid holdings. Indeed the scale of indebtedness incurred by the banks was such that in 1980 the secondary

1. The Central Bank does not publish the rate structure of its deposit liabilities and so it is difficult to estimate the extent to which penal rates were imposed in 1979.

ratio had to be reduced to allow the banks reduce their level of Central Bank debt. There appear to be no good grounds automatically to allocate a fraction of bank resource growth to the Exchequer. Such a process makes more difficult the appropriate control of monetary aggregates and tends to disguise from the Exchequer the monetary consequences of high borrowing.

Kelleher (1980), Kenneally (1980) and Dowling (1980) have all raised the issue of the appropriateness of existing monetary policy targets which impose quantitative constraints on private sector bank lending. The appropriate target ought to be domestic credit expansion which would include Government bank and foreign borrowing. If the Government choose to seek to borrow other than by non-bank gilt sales an amount equal or close to the funds available to the banking system then a proper long-term defence of the currency requires that private sector bank credit demand be squeezed out. If that does not occur – because the Government obtains funds from abroad – then the short-term consequences of high Government borrowing are being suppressed, possibly at the expense of less pleasant longer-term consequences.

A global quantitative restriction to be divided between the public and private sector on the basis of competition for funds would make the domestic consequences of high government borrowing more explicit. In addition, of course, the Central Bank would have to be in a position to withdraw from the market – by sales from its portfolio of Government stocks, by issuing CDs or by raising interest rates on deposits – any funds borrowed abroad by the private or public sector above amounts deemed desirable from a long-term standpoint. This configuration of active monetary policy and global quantitative restrictions would make for greater competition, especially between borrowers, in Irish financial markets.

It might be argued that the quantitative restrictions are unnecessary, distort competition in that banks which are successful in obtaining above-average resource growth are unable to benefit (especially if bank deposit rates are more closely aligned to interbank rates) while banks with poor resource growth suffer little profit penalty. Clearly, the Central Bank could restrict credit supply and demand in other ways – such as open market operations designed to raise interest rates – but UK experience suggests that this may be a slow and cumbersome method leading to undesirable fluctuations in interest rates. The widening of the quantitative restriction to all bank credit, combined with penalties related to the deviation of loan growth from resources growth, could overcome most of the objections to quantitative restrictions.

5. CONCLUSION

It may be said that this paper deals unduly with the impact of EMS membership on financial and money markets and the policy consequences arising from the changed exchange rate environment. While the emphasis of the paper naturally reflects my present concerns, it must also be recognised that it is far too early to say anything very useful or definitive about the effect of EMS membership on the real economy. It seems fairly safe to say that output is higher, production expectations greater and farm incomes greater (or at least no lower) than would have been the case if sterling parity had been maintained. On the other hand, inflation is also higher. But it would be a brave and foolhardy act to try and put a quantitative measure on these consequences at a time when most of the data for 1979 is preliminary and for 1980 in short supply.

Changing exchange rate regimes is essentially a monetary act and, as money and financial markets tend to react and clear faster than goods markets, it is inevitable that any analysis of the first year and a half of experience in the new system will be heavily oriented to the behaviour of the monetary sector. In a couple of years, when it is possible

to disentangle the impact of the world recession and the growth of new industries from the Irish trade pattern, it might be possible to say something more conclusive about the impact on employment, output and inflation of EMS membership.

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