CELTIC TIGER ON EMU TRAIL

Peter Neary
University College Dublin

This is the full version of an article which appeared, in abbreviated form and with some misprints, in the *Independent on Sunday*, London, 15 June 1997.

Correspondence to: Peter Neary, Department of Economics, University College Dublin, Belfield, Dublin 4, Ireland; Tel.: (+353) 1-706 8334; FAX: (+353) 1-283 0068; Email: JPNEARY@OLLAMH.UCD.IE

The Republic of Ireland's booming economy - the "Celtic Tiger" - is one of the few to qualify for European Monetary Union; all Irish political parties are determined it should be in the first wave of members; and public opinion in this most Europhile of EU members is enthusiastically in favour of the project. Nevertheless, many Irish economists question the wisdom of joining while the UK remains outside. Why this is so raises a variety of issues, some peculiar to Ireland, all relevant to the wider debate on the merits and feasibility of EMU.

It is not difficult to see that Ireland and the core economies of continental Europe make an odd partnership in the absence of the UK. In academic jargon, they fail to meet the criteria for an "optimum currency area".[1] Standard arguments suggest that monetary unions should work best between countries with flexible labour markets, high levels of labour mobility, extensive mutual trade and exposure to similar external shocks. Ireland and the UK together meet the labour mobility and mutual trade tests whereas Ireland and the rest of the EU without the UK probably fail all. More serious from the perspective of coping with asymmetric shocks is the absence of any system of compensating income transfers. Within existing monetary unions such as the USA, such transfers serve to cushion declining regions: individual states which suffer localised recessions get some automatic federal assistance. Not only is there no provision for such transfers in the EU, but the "Stability Pact" (agreed at the Dublin summit in December 1996 and scheduled for ratification at the Amsterdam summit) in effect proposes *pro*-cyclical transfers: countries with severe budgetary deficits may be fined even when these arise from local recessions which lower tax revenue and raise welfare payments.

As against all this, it is often noted that the UK's share in Ireland's exports has been in decline for decades and is now below 30%. But this misses two important points. First, it is not just exporters who face competition from the UK. Proximity, a shared language and, in recent years, deregulation driven by the Single Market have made Ireland a natural target for UK firms in all sectors, including some traditionally thought of as non-traded. Second, the firms responsible for the growth in Ireland's exports to continental Europe, many of them in high-technology sectors such as chemicals and computers, are disproportionately foreign-owned, high-margin and capital-intensive. This makes them much less vulnerable to exchange-rate fluctuations than Irish-owned firms. For both these reasons the exposure of Irish GNP and employment levels to sterling is greater than the UK share of exports would suggest. There is a real danger that a sterling depreciation relative to the *euro* could cause irreversible damage to the indigenous sector and knock stripes off the Celtic Tiger.

Putting this differently, it is generally agreed that one of the reasons for the sustained growth of the Irish economy in recent years (and one of the preconditions for its continuance) is a social consensus institutionalised in national wage agreements which have ensured industrial peace and wage moderation. The same logic which argues that domestic aspects of competitiveness have been significant points towards the need to maintain external competitiveness by avoiding an inappropriate exchange-rate peg.

While proponents of Irish EMU membership concede that sterling-*euro* fluctuations might cause difficulties for competitiveness, they argue that the costs would be more than offset by the benefits of lower interest rates. However, this can

[1] See J.P. Neary and D.R. Thom: "Punts, pounds and euros: In search of an optimum currency area," Working Paper No. 96/24, Centre for Economic Research, University College Dublin, October 1996.

mean at least three different things, none of which would be guaranteed by joining EMU.

First, it can mean low *nominal* interest rates, which is just a synonym for low expected inflation. The view that EMU will ensure this is widespread and reflects a common assumption that the *euro* will automatically inherit the hard-won credibility of the D-mark. This has always been questionable and now looks increasingly less likely, with the German government resorting to creative accounting to meet the Maastricht criteria and the new French government proposing a "Stability Council" with real powers (which if it means anything must mean a diminution of the monetary independence of the European Central Bank). In this new environment it is quite possible that for an initial period the European Central Bank will need to establish its anti-inflationary credentials by keeping interest rates above the level which D-mark rates would otherwise have attained.

Second, low interest rates can mean the absence of a risk premium relative to foreign interest rates, such as Ireland experienced between September 1992 and January 1993, when the Irish pound delayed devaluing after sterling's exit from the European Monetary System. In this context perhaps the best rule of thumb is that countries get the interest rates they deserve - or, to be more precise, the interest rates which the markets believe their current and expected future monetary policy deserves. If the markets took the view (as they did in 1992) that a depreciation of sterling relative to the Irish pound was likely to put intolerable strains on the Irish economy, they would mark down Irish government bond prices accordingly. There is plenty of evidence (for example from Canadian provinces) that sovereign debt issued by individual states in a monetary union can command a risk premium even in stable conditions.

Finally, lower interest rates can mean permanently low *real* interest rates. But who wants them? Not the Central Bank of Ireland for one. In recent months it has warned that the boom may lead to a revival of inflation, necessitating an increase in interest rates. The irony of the current situation is that the *strength* of sterling is part of the problem since it risks contributing to overheating in domestic markets. The Irish pound has already followed sterling up as far as it can go without leaving the permitted ERM range. The current Irish policy dilemma reflects the kinds of problems which would be exacerbated in EMU by the need to tailor a single monetary policy for a group of countries with very different macroeconomic problems.

Of course, in Ireland as elsewhere, a common response to the economic case against EMU is that the project is primarily a political one. To this, it is tempting to reply with Bill Clinton's slogan "It's the economy, stupid!" If EMU results in a significant deterioration in economic performance it could slow rather than hasten progress towards other goals such as the deepening of the Single Market, the admission of new members and the reform of EU institutions. Perhaps the major difference between the debates in Ireland and the UK is that most Irish opponents of EMU share these objectives. Sadly, the subtleties of such a Europhile but *euro*-sceptic position seem unlikely to influence Irish decision makers. If EMU goes ahead on schedule, which still seems probable despite recent developments in France and Germany, Ireland will almost certainly enter without the UK.