IRELAND IN EMU: STRAITJACKET OR SKATEBOARD?

Patrick Honohan [1]

In its first two years the euro has both helped and hindered Ireland. The weakness of the euro explains most of the surge in Irish price inflation to almost 7%. At the same time by making Ireland super-competitive and eliminating the risk premium that had kept Irish interest rates unduly high for a couple of decades, it has boosted demand, though it is just one of many factors that have contributed to the prolonged Irish boom. It is the earlier fall in unemployment that so far has been both the hallmark of the boom and the main cause of the acceleration since 1997 of wage inflation.

A widespread current view is that the increase in Irish inflation to almost 7% over the past 12 months displays a runaway economy escaping from the ECB's goal of price level stability and unable to do anything about it. This paper argues that the focus on CPI inflation is fundamentally misplaced: the surge in price inflation is best interpreted as chiefly an equilibrium response to the euro's movements on the forex market.

The problems of macroeconomic stabilization policy lie in a different direction. Yes, the economy has been growing at or beyond a sustainable rate, but neither the weakness of the euro nor the inability of the Irish authorities to adjust interest rates unilaterally has been the major contributory factor. The acceleration of real wages has other sources and predates the arrival of the euro. Achieving a soft-landing will require other policies, including careful attention to the reaction of wage rates to the surge in price inflation.

Ireland's prolonged expansion

The Irish economic recovery has been ongoing for over 12 years now. Output growth accelerated after 1993. Following decades of underperformance this prolonged expansion has deserved a better title than the universally used mixed-metaphor of the Celtic Tiger.

Its main characteristic has been employment growth rather than productivity. There has been productivity growth, but of a healthy, not miraculous nature. Many commentators are misled by two factors which lead Irish aggregate economic growth figures to exaggerate the productivity element. This can be seen in Figure 1, which distinguishes four key measures of aggregate growth. The first, GDP growth, should more or less never be used as an overall summary for the Irish economy, because it includes the huge and growing profits of multi-national corporations - about 15% of the total. The problem is that much of these profits reflects transfer pricing especially in high margin sectors such as IT equipment and software, pharmaceuticals and soft drink concentrates. It is because of the low corporation tax that sectors like these, having the potential for large-

---

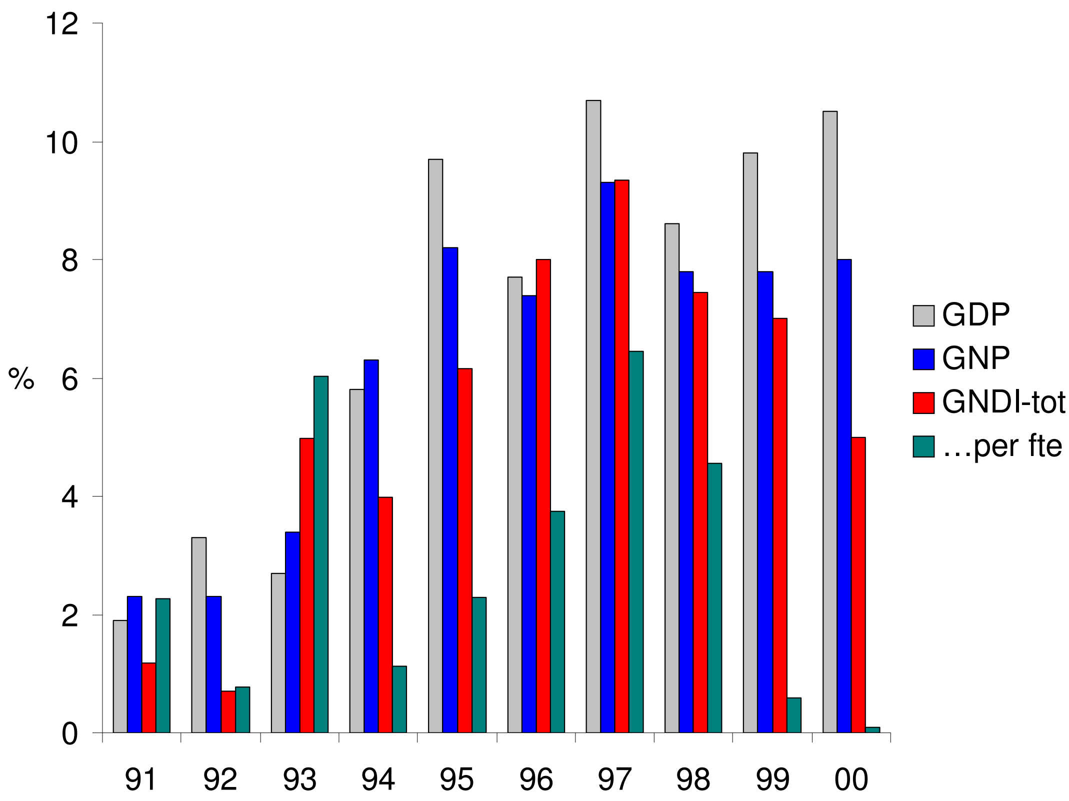
[1] Research Fellow, Centre for Economic Policy Research. This is the revised text of a talk given in London under the auspices of the CEPR, October 2000. I am grateful to Donal de Buitleir, John FitzGerald and Brendan Walsh for helpful discussions. The data is all from CSO sources, except for some year 2000 forecasts and where stated.

scale transfer-pricing, dominate the Irish MNC sector. Though legitimate, this practice gives an exaggerated impression of how much of these firms' production is actually taking place in Ireland.

(Incidentally, use of GDP has given the misleading impression that Irish per capita output passed out that of the UK in 1998; not so if one uses the more conservative GNP data, which puts Ireland still behind in 2000.)

Even the GNP figures give an exaggerated impression of growth in Irish living standards. Because of the short product-cycle of much of the high-tech exports, there is a systematic tendency for the Terms of Trade (the ratio of export to import prices) to deteriorate for Ireland. The third measure in Figure 1, Gross National Disposable Income adjusted for terms of trade, takes account of this. Over the 1990s, this measure (GNDI-tot) grew by an average of 5.4% (as compared with 6.7% for GDP). This provides a better general indicator of the overall growth rate in Ireland. (Actually, in 2000, the exchange rate movements which are discussed below threaten to produce quite a large terms of trade adjustment, as shown in the figure, though that forecast is particularly tentative).

Figure 1: Four measures of output and productivity growth



Note: the right hand column shows growth in GNDI adjusted for terms of trade per full-time employee

And much of the growth has reflected the increase in employment. Over the 1990s, average growth per person employed was just 2% (again using GNDI-tot). Measured per full-time employee, thus ignoring the even larger expansion in part-time work, this productivity measure averaged just over 3%. This is why it is inappropriate to think in terms of the Irish economy having generated a productivity miracle. The performance is very good, but not miraculous.

Figure 2 shows the real Irish miracle, the steady and sharp decline in unemployment, down to 3.7% at October 2000, a level unknown at least for a generation, and essentially corresponding to conventional concepts of full employment. Even the long-term unemployed, hitherto regarded as unlikely to escape that state, have fallen to under 2% of the total workforce. It is this that has helped measures of consistent poverty to decline from a range of 9-15% in 1994 to 6-8% in 1998.

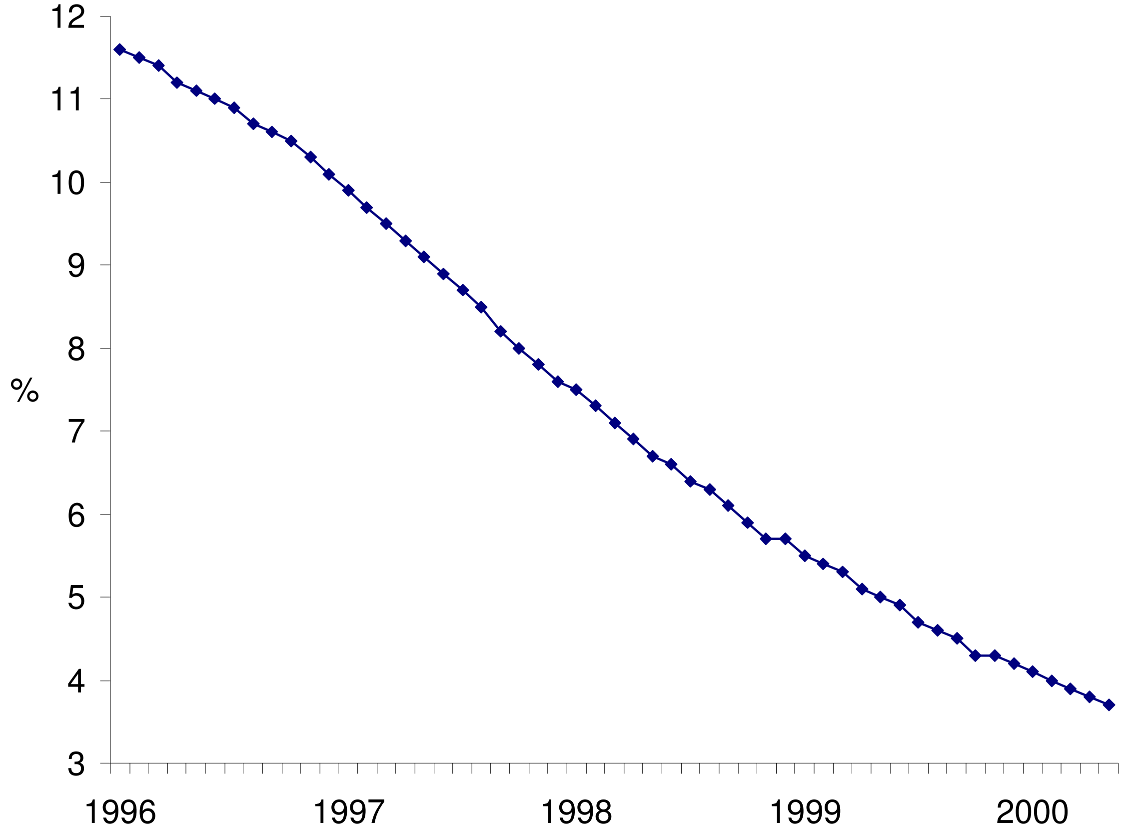


Figure 2: Monthly unemployment rate (per cent of labour force)

Source of the expansion

No single explanation does justice to the successive waves of good fortune, combined with some shrewd action by public and private decisionmakers that have contributed to this satisfactory state of affairs.

To understand what has happened, it is essential to think in terms of factors occurring at three different "frequencies". There has been a series of short-term boosts, which, together with a crucial medium-term sea-change, have been superimposed on longer-term foundations which had been quietly preparing the ground for the success.

Short-term effects.
The initial turnaround in the late 1980s was helped by a number of lucky breaks. A defensive devaluation in mid 1986, responding to a phase of sterling weakness, was turned into a valuable competitive edge by the subsequent strengthening of sterling into the Lawson boom period, when UK labor market conditions allowed a re-opening of that traditional safety valve of emigration. At roughly the same time, worldwide interest rates were falling, a crucial boost for a heavily over-indebted public sector. And the doubling of the EU structural funds came at a crucial moment, allowing many urgently needed but postponed public infrastructural programs to move forward (as well as helping pay for active labor market measures which might otherwise have overwhelmed the fiscal accounts). These funds rose to reach about 3% of GDP by 1993, since when they have generally been falling back, and will decline fairly rapidly in the new decade.

The only significant negative shock to hit the economy in these years was the ERM crisis of 1992-3. This caused interest rates to soar, but the crisis lasted only a few months, and was succeeded by the dismantling of the narrow-band ERM, an event little regretted in Ireland, for reasons explained below.

Medium-term
Decisive fiscal correction from 1997-8 on, and based on cutting spending rather than on raising taxes [2], represented one element of the great sea-change in attitudes and policies of the late 1980s, all of which probably owed much to a shared realization that the way forward had to be built on a realistic self-help approach. This realization extended not only to the new generation of trade union and business leaders, coming together in restrained pay agreements which undoubtedly contributed to the climate for recovery, but also to the individual decisions made by young labour market entrants. These, no longer relying on the government or traditional employers to featherbed them, adopted a more adventurous approach to the job market and found jobs for themselves.

Confidence built on the fiscal correction was not the initial trigger for recovery though. All the data convincingly show that the sequence began with the upturn in exports, followed by consumption, with confidence-sensitive investment late on the scene.

The wage agreements were also problematic in various ways that became more evident over time. One particular aspect is the Faustian bargain obtained by the Government: pay restraint was in return for tax cuts, thereby severely constraining the tools of fiscal policy; a problem which became more acute following the removal of any monetary policy instrument on EMU membership, a point taken up again below.

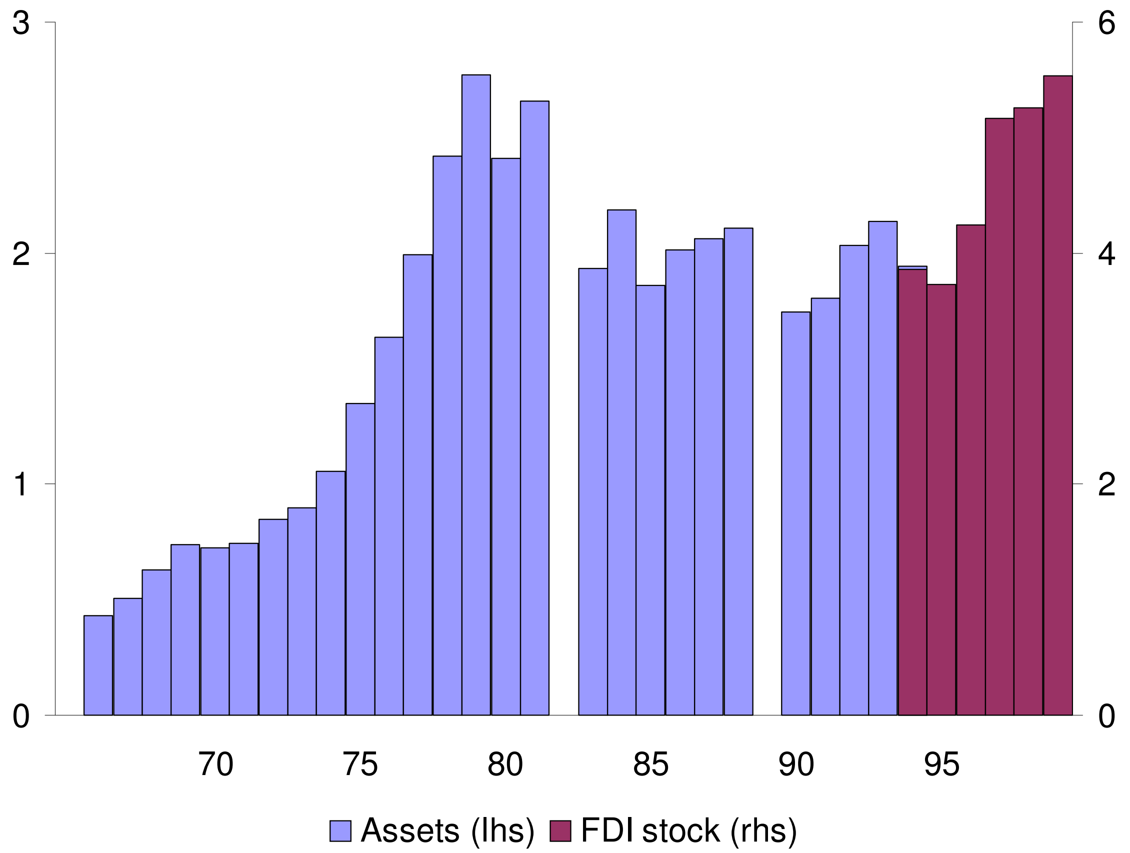
Long-term foundations
The key longer-term factors were the steady growth in human capital, dating at least to the introduction of free secondary education in the 1960s, and including a substantial expansion of third level education more recently. The high birth rate, though it started to

[2] There had been fiscal contraction during the early 1980s, but it was insufficient and inevitably contributed to deepening the recession of those years.

fall rather sharply from 1979, also delivered a steady supply of labor market entrants, essential to sustain aggregate economic expansion, and miraculously converted from being a problem (needed job creation) to a boon by the new efficiency of labour market functioning.

Finally, and more speculatively, there may also have been a shift in worldwide technology favouring Irish aptitudes and workplace attitudes. Computer-based work is more forgiving of imprecision and a casual approach, more rewarding of impatience and impetuosity.

Figure 3: Two measures of the stock of inward FDI from the US: Ireland as % of Europe
(Source: US Department of Commerce data spliced to a common level at 1994)



Positive feedback–inward FDI

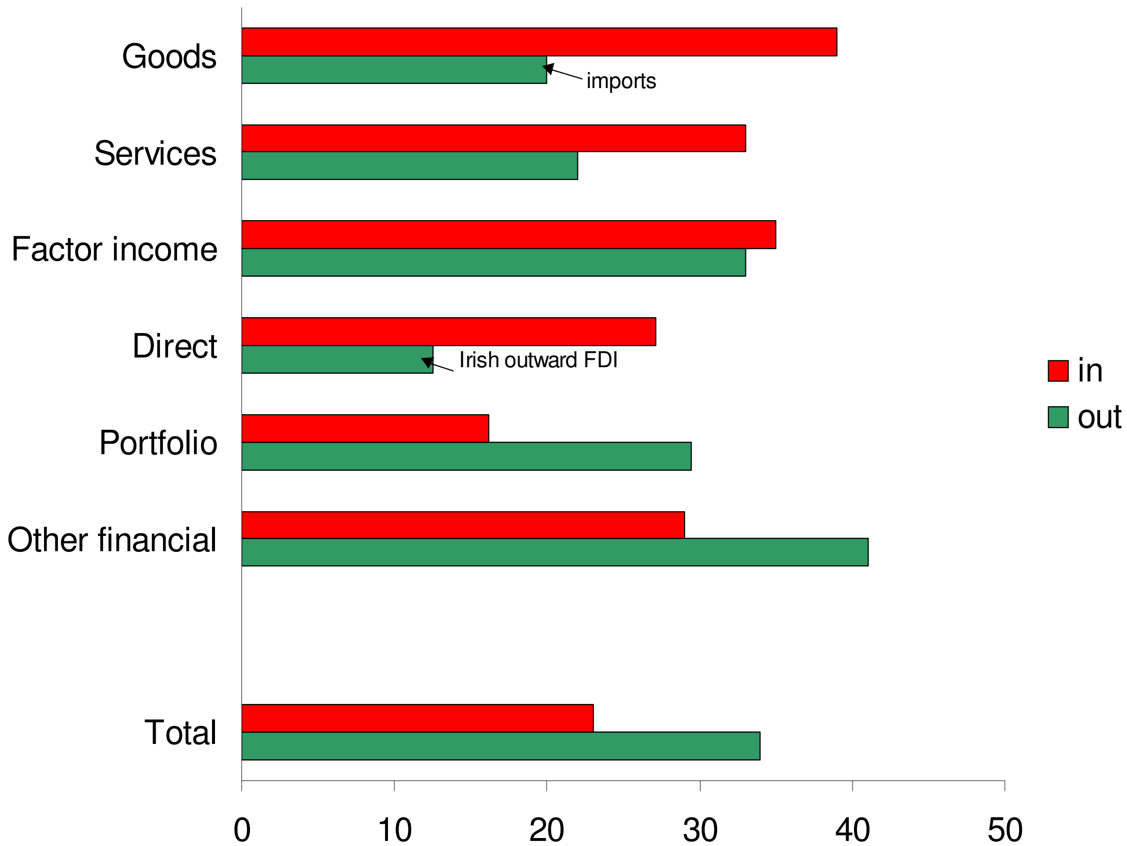
Nothing succeeds like success. With the fiscal position swinging around into a clearly sustainable position internal and external confidence was boosted. This may explain an apparent resumption in the long-term growth in Ireland's share of the stock of US manufacturing foreign direct investment (FDI) into Europe, interrupted since 1979. (This seems, at least, to be the message obtained by splicing together the available series as in Figure 3; noting that financial sector FDI, associated with the IFSC, is about as large again and has shown a much stronger surge in the late 1990s. Note also, though, that Europe's share of US outward FDI has been falling somewhat.) It is not the actual investment that counts here, of course, more the technology transfer at all levels, including managerial and working practices – also the tax revenue, even at the low rates. Worth remarking is the fact that the low corporation tax rate cannot be a cause of the upswing in the Irish economy *per se*. The general features of the current regime have been in effect for over 20 years; they were even more generous before then, and changes in around 1990 have tightened the regime.

The role of EMU

Was EMU a suitable choice for Ireland?

The question whether EMU was a suitable regime for Ireland was exhaustively discussed in economic terms before the decision was made – on political grounds. Evidently the euro does not offer an ideal peg. A very low share of Ireland's transactions - less than 30% (less for imports & FDI) – are with the euro area (Figure 4). [3] The euro area accounts for a much higher proportion (about 40% in 1999) of Ireland's goods exports than of imports (about 20%). About 50% of goods imports come from the UK and US alone, and reliance on imports from these hard currency sources has had an impact on CPI inflation, as well as likely resulting in a significant terms of trade effect in 2000.

Figure 4: Share of EMU-area in Ireland's international payments (%)



[3] In looking at the financial flows data, it is worth bearing in mind that about 80% of these refer to the IFSC.

It can also be argued that one of the key attractions of a single currency from the perspective of the 1970s, namely the potential to lock into a low-inflation zone, seemed less compelling now that inflation had been virtually eliminated during the post-1993 floating period. Still, there was an exchange risk premium to pay, even after the narrow-band ERM was abandoned.

But no other option was clearly superior. Optimal currency areas are all very well, but they are of limited practical application if they do not correspond to political realities. Nevertheless it should be acknowledged that a floating regime would have been viable from the point of view of macro management.

What was expected of EMU, and has it delivered?

Before Ireland joined EMU, there were some matters on which most observers (this author included) were agreed. They expected:

(i) Vulnerability to sterling movements; and this there certainly has been. However, it was a fall in sterling that was the principal risk envisaged *ex ante* whereas what has happened is the opposite - in spades. In an economy that is already overheating, with real wages accelerating well before the arrival of the single currency, the euro's weakness has boosted external demand at an unwelcome time (as if the economy had jumped on to a skateboard).

(ii) Lower interest rates; and this too has certainly happened. Figure 5 shows how high real interest rates were during the narrow-band ERM period, how they fell sharply during the floating period 1993-99, and again more steeply to the recent experience where they have hovered around zero. These lower interest rates must surely have fuelled the property price boom: and may well have caused it to overshoot. But longer term the elimination of the exchange risk-premium on interest rates is good: it removes some of the wedge between the cost of capital and the expected rate of return to savers. Depositors got an unexpected windfall when, over the years, currency depreciation proved to be less than they had allowed for in demanding such high interest rates; while private capital formation was constrained for years by the artificially high cost of capital - a false price.

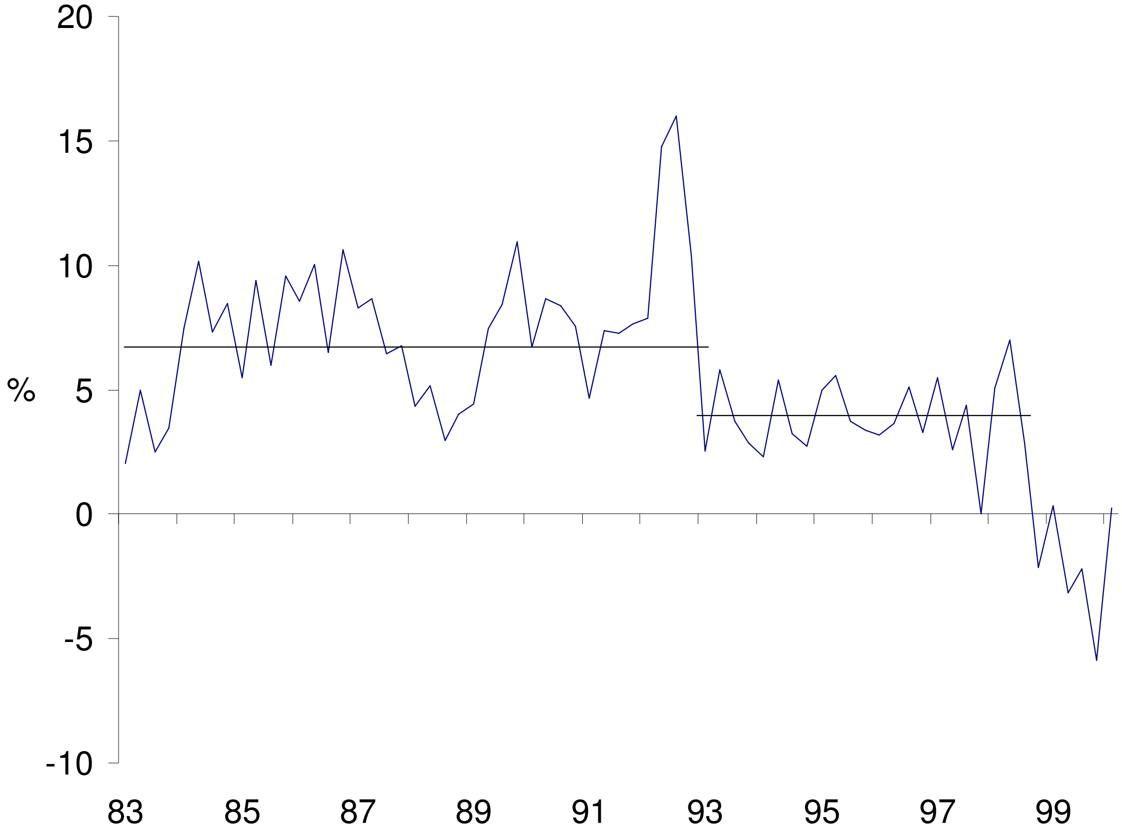
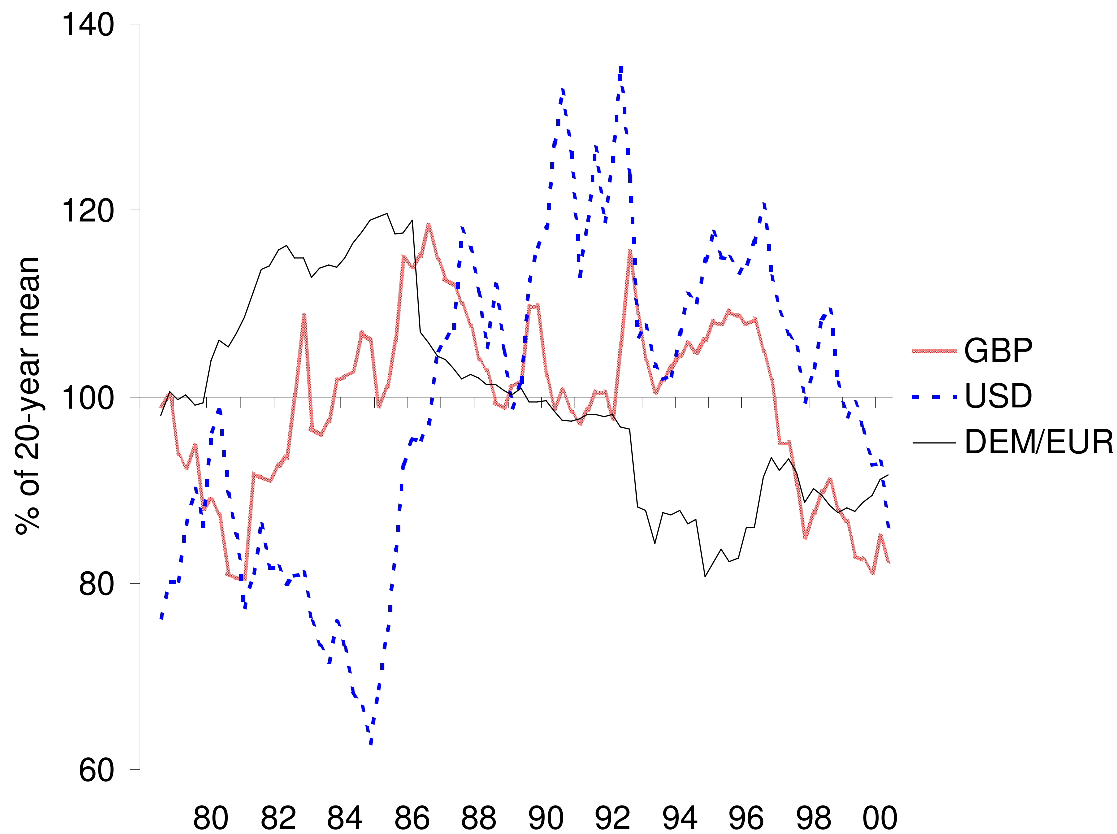


Figure 5: Real short-term interest rates in three exchange rate regimes (ERM-float-EMU)

(iii) To import only German inflation. Here one must recognize that this is an expectation for the long-run average. In the short-run, as always in the past, there are substantial deviations from purchasing power parity, especially on a bilateral basis. Figure 6 shows how large the oscillations of exchange-rate adjusted relative prices have been around their long-run equilibrium. The current deviation from that long-run average is actually *negative*, for all three major trading partners (UK, US and Germany): despite the recent inflation blip, it is not enough to offset previous currency weakness. Against all three currencies then, Irish prices look unusually low. With this background it is hard to get excited about a cumulative 5 or 6 percentage point deviation in recent inflation from that in Germany. (The short-term dynamics of recent inflation are discussed below.)

Figure 6: Real bilateral exchange rates of Irish pound against dollar, mark and sterling



(iii) A straitjacket on interest and exchange rate policy and this has had bite: Ireland has proved to be an EMU outlier, its boom contrasting with more subdued conditions in the zone as a whole. This loss of monetary policy autonomy can be regretted, but it must be acknowledged that, during the ERM period, monetary policy had not been effectively geared to domestic macroeconomic conditions.

(iv) Lower financial transactions costs. This has not yet materialized. Retail money transmission charges still seem extraordinarily high, a fact attributable to the lack of common procedures and a common framework across the zone for making retail payments. Curiously, on the financial sector front, the greatest elements of international integration recently noted for Ireland have come from outside of the euro area: the aggressive entry of UK banks into both the mortgage and deposit markets and the acquisition by the main banks of subsidiaries in Poland, the UK and elsewhere.

Entering the boom phase

Most current commentary focuses on the relative sharp acceleration in CPI inflation. True, this is more than 3 times the ECB's target, but it is important to realize that it has been driven primarily by the fall in the euro. Imports from the non-euro area account for a vastly higher share of GDP than in any other member country. Therefore it is not surprising that the depreciation of the euro should have had a much larger impact here.

Figure 7: Irish CPI acceleration relative to trend

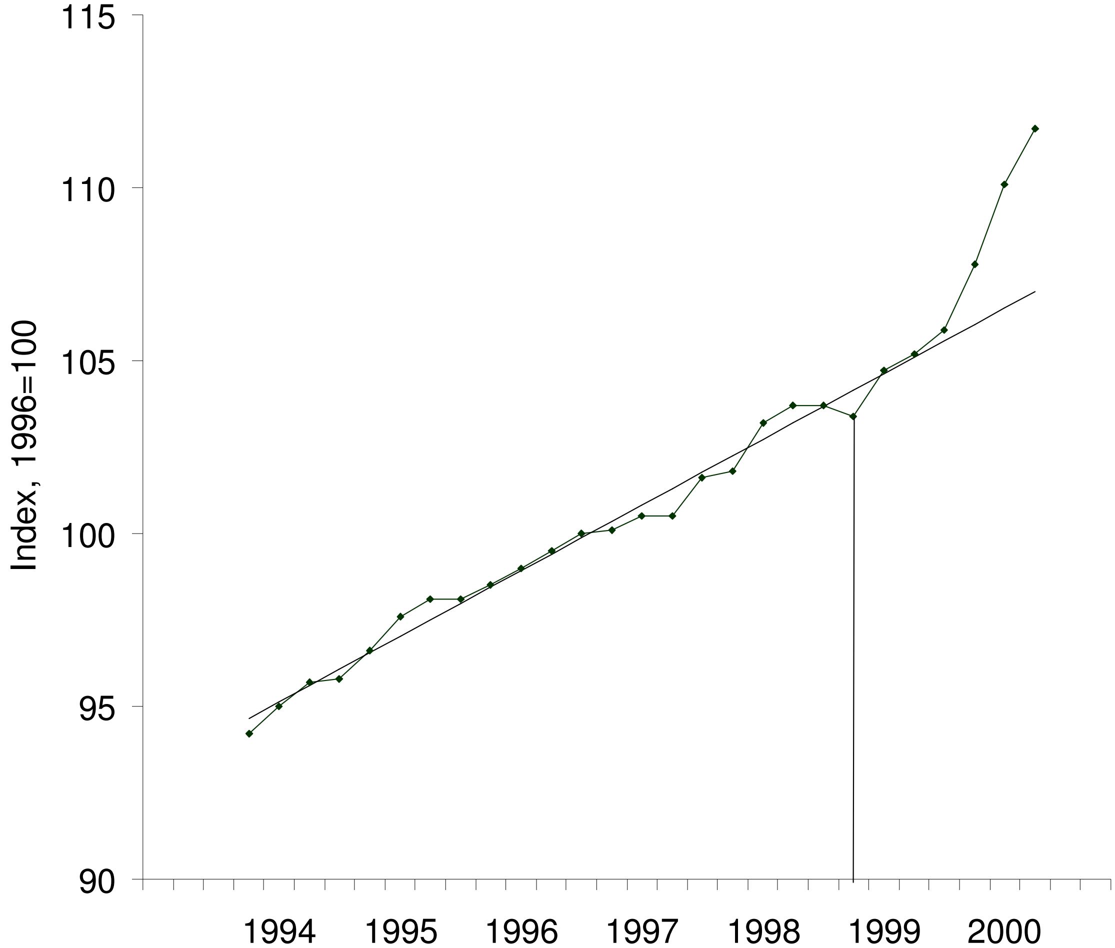
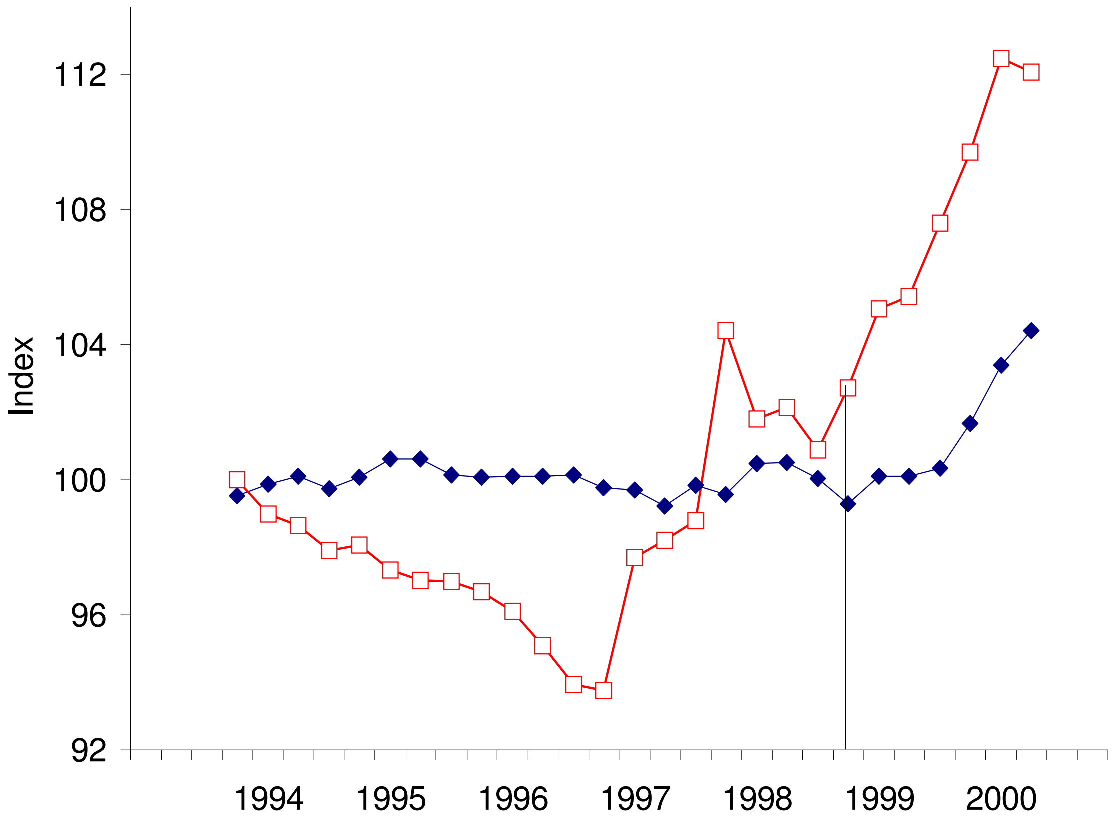


Figure 7 shows the timing of what has happened. Up to the start of EMU, and for three quarters afterwards, Irish CPI inflation hovered around a 2% per annum average. It is only since then that there has been a sharp acceleration. Figure 8 shows the cause of the depreciation, the decline (a rise on the chart) in the average trade-weighted (effective index) value of the local currency. For about three quarters after the euro started to fall consumer prices were unaffected, a familiar delay in pass through reflecting a variety of well-known factors. In this phase, UK-based retailers, many of whom had entered the market in relatively recent times, will have been experiencing a sharp squeeze in margins. Thereafter, consumer prices started to rise to move closer to an equilibrium relationship.

Figure 8: Consumer price index (de-trended) and Irish pound index (inverted)

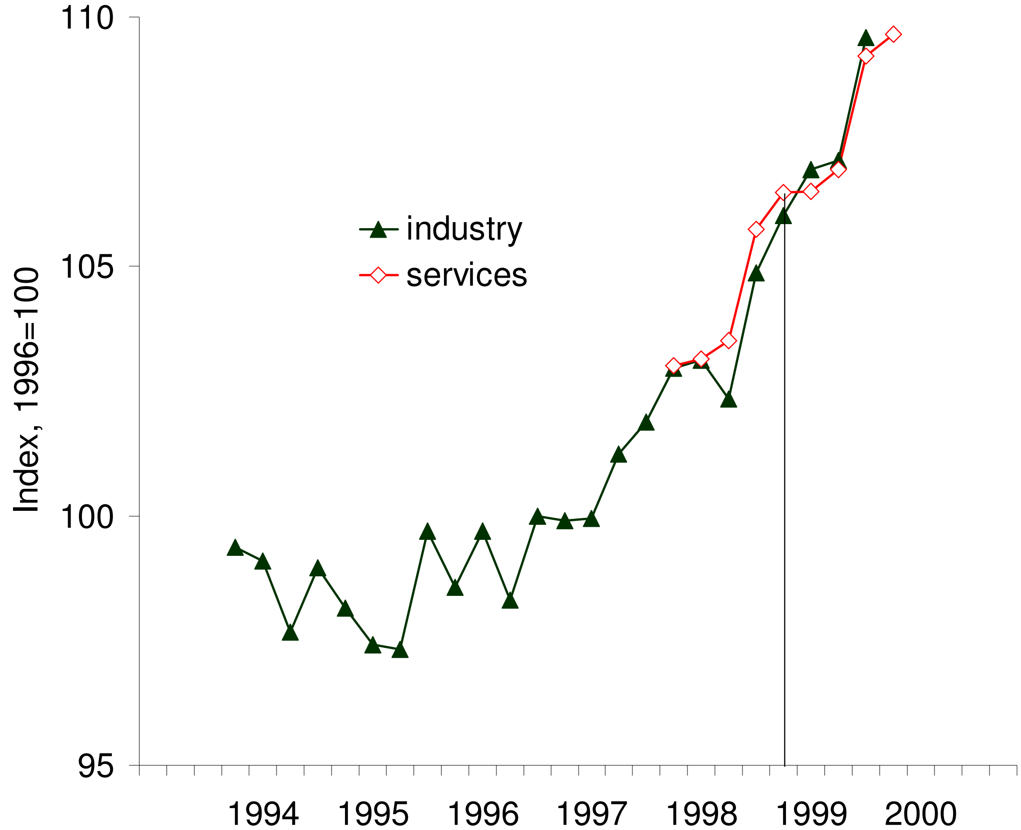


The problem of course lies in the reversibility of this exchange rate movement.

What of wages? Here available systematic data is much less current. Real industrial wages are plotted in Figure 9. Helped by the pay round that took effect in 1997, real wages rose steadily from then on and had jumped by about 10% by late 1999. Of course this does not simply reflect the terms of the agreement, as increasingly private sector deals have *de facto* drifted well beyond the agree parameters. The interesting point is that the jump in real wages began well before EMU started, and well before the CPI acceleration, and can hardly be blamed on it.

But the recent rise in the CPI must now be adding its own twist to wage developments, probably already in the private sector, if anecdotal evidence is to be trusted; and creating industrial unrest in the public sector where the terms of the current agreements are more closely adhered to. Here is where the country is entering somewhat risky territory. Clearly the surge in prices (and also the continuation of rapid house price increases which are not perfectly captured in the CPI) represents an uncovenanted fall in living standards for the affected workers. With the agreement not fully adhered to outside the public sector, there are many reasons to consider special treatment, from reducing staff turnover to fairness (especially in such times of general prosperity). Of course increased wage payments will not help reduce inflation. But neither are they a central cause of the CPI inflation surge as has been shown above. The risk is that an excessive permanent boost to wages could prove a costly mistake if the currency should rebound. Probably the solution is to be found in one-off compensatory payments.

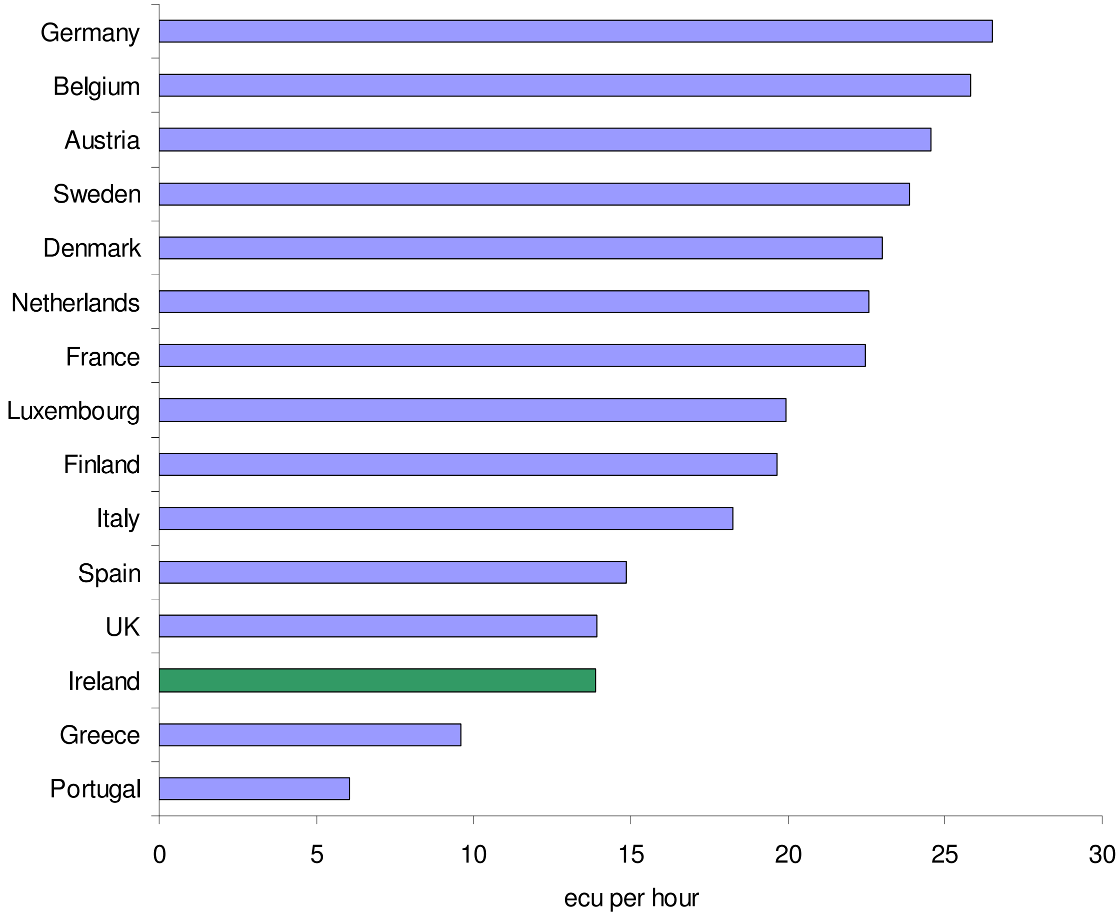
Figure 9: Wage trends in manufacturing and services



Where will it all end?
Higher wages mean lower profitability and lower labour competitiveness. But this is not such a bad thing. Congestion and full employment point to the need for a relative price adjustment: higher wages to slow what will eventually come to an end. Once the desired end-point of the adjustment, in terms of real wages, is known it will be easier to choose policies to get there. The same for house prices, though for that market the calculation of equilibrium is even more difficult.

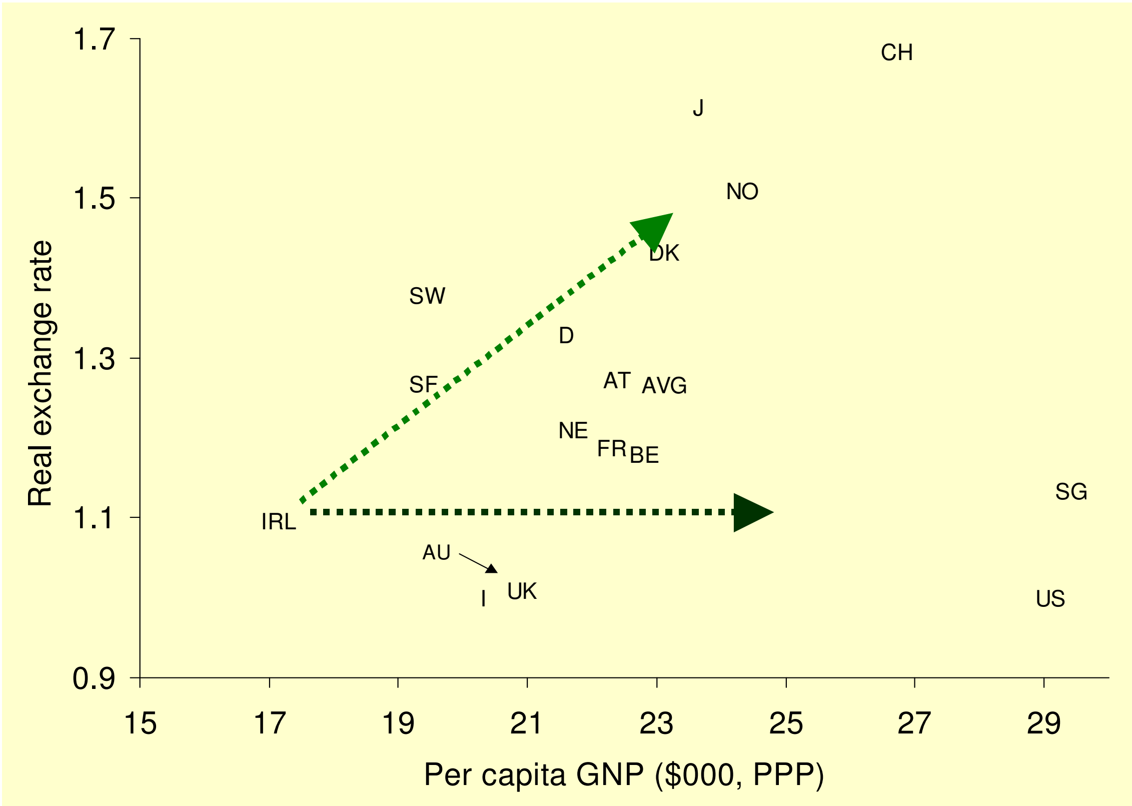
Here there are no definite answers yet. International comparisons (see Figure 10 for 1996 data) suggest that, even after a further 10-15% increase in relative wage rates, Ireland has some way to go before reaching the average wage costs in Germany. But these presumably mask differences in skill-levels and other factors. This matters for deciding where long-run real wages should be.

Figure 10: International comparisons of wage costs, 1996 (source: Eurostat)



A somewhat different guidance is provided by Figure 11 which compares exchange rate adjusted price levels of countries at different levels of national income per capita. A positive slope would link the points for all the countries in the world, had we chosen to plot them. The well-known Balassa-Samuelson theory explains this slope in terms of non-traded goods being costlier in the richer countries because workers in those countries can more efficiently produce traded goods. But for the rich countries, the positive slope is not so evident. Indeed there seems to be a steep slope linking (small) Nordic countries, Switzerland and Japan; a more gradual slope linking other continental countries, and a horizontal line linking Anglo-Saxon countries (Australia, Canada, Singapore, UK and US). Where will Ireland be positioned in the future? Will it climb the Nordic heights, stroll up the continental slope, or remain on the Anglo-Saxon plateau? The groups of countries mentioned differ in the structure of taxation and social benefits and in business regulation, as well as in wage rates. But it is not entirely clear where Ireland's path lies.

Figure 11: Real exchange rates and per capita income in industrial countries
(Source: World Bank Development Indicators)

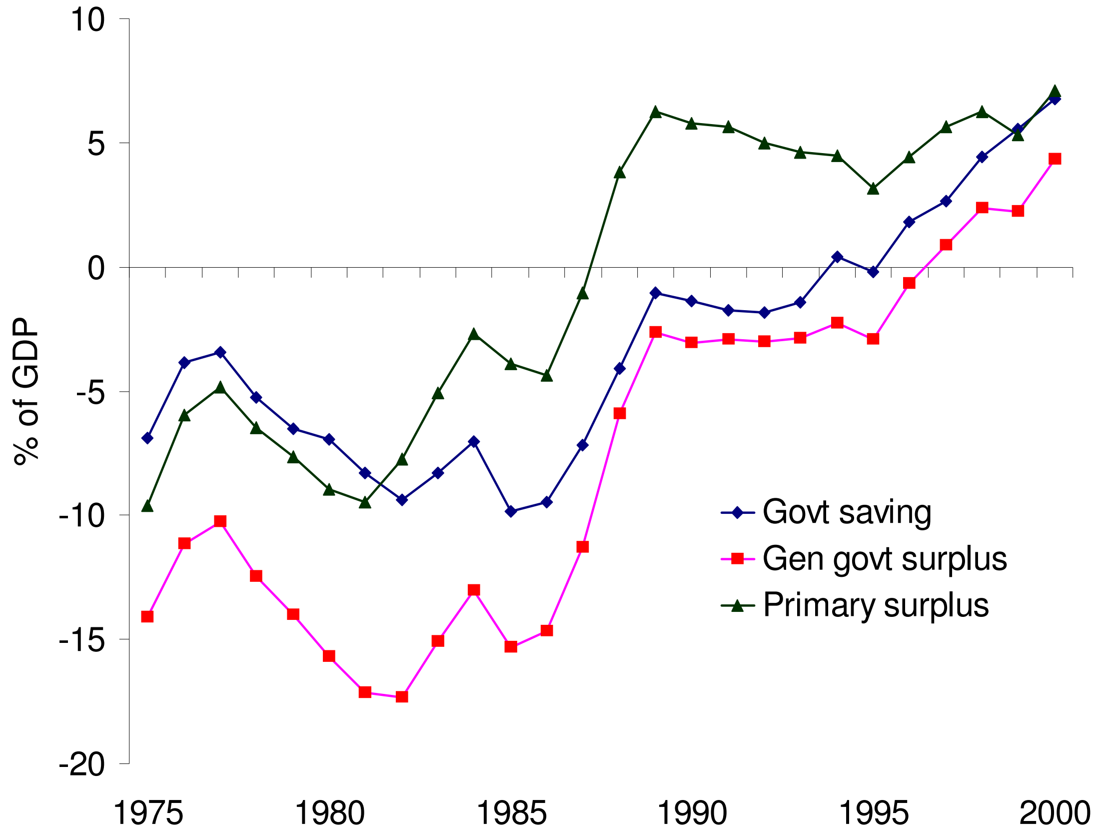


The best bet is that long-term equilibrium will involve somewhat higher average real wages. But this should not be a sudden thing. Even with full employment disruption and costs result from sharp increases in relative wages, such as might happen if big and permanent wage increases were set now, and the euro were to bounce back to $1.17!

Spiralling house prices are a worry from several points of view. This topic would require a paper of its own. Many commentators fear that a property slump is in prospect. Even if property is overvalued, though, it does seem that a financial meltdown is not in prospect. Lenders insist that they have mortgaged houses only to a modest percentage of market value (about 70% on average for the largest mortgage lender). A fall of 30% in house prices would not, therefore, trigger much fear of default.

What should the role of fiscal policy be? Already the government is running a very sizable surplus - about 4% of GDP (Figure 12). And tax increases seem ruled out by the Faustian bargain of the wage agreements. But if the argument presented here that domestic demand factors are not central in the recent price surge is correct, perhaps pre-occupation with adjusting the fiscal balance is misplaced. Instead focus should be on the micro-economics of budgetary policy: ensuring adequate government spending not only to ease congestion and provide the physical infrastructure needed to sustain the higher level of economic activity, but also to pay for those social, educational, health and childcare requirements which a more prosperous population is entitled to expect (some of which, under current arrangements, will not be adequately provided if not subvented by the state).

Figure 12: Trends in the Government balance



Conclusions

In conclusion it has to be said that the economy looks quite capable of a soft landing. Unlike the economies of East Asia in the mid-1990s, Ireland is not especially overborrowed and is actually running a current account surplus.

But the surplus is shrinking. Full employment has been reached and the natural increase in population is steadily slowing. Real wages are catching up to the European leaders.

EMU has been only one – generally positive – shock among many which have contributed to the Irish boom. The fall in the euro makes nominal wage policy now especially tricky, but manageable given flexibility and ingenuity.