Choice of Entry Rate into EMU for the Irish Pound

The choice of entry rate for the irish pound into EMU has moved centre stage. Although it has been the subject of an increasingly active discussion over the past eight or nine months, the authorities have given little indication of where they would like to see the Irish pound going. Sudden recent falls in the Irish pound risk forcing the authorities' hand and resulting in a lower entry rate than would they would otherwise have chosen. It is not too late to influence market expectations, but it will be desirable to do so if wild currency fluctuations are to be avoided over the next few months.

This short paper sets out the main considerations involved in choosing an entry rate and makes a definite recommendation. In summary, it is felt that, unless sterling falls very sharply between now and the time of the final decision on entry rates in or around May 1998, an entry rate putting the value of the Irish pound in the range DM 2.50 to DM 2.55 would be appropriate. At the time of writing, the currency has fallen sharply into and towards the lower end of that range. A further depreciation would not be called for.

1. Setting the entry rate

The first point to be made about the question of entry rate is that it is of secondary importance relative to the entry decision itself. Even if we get the entry rate right, subsequent events (such as sterling fluctuations) will doubtless move us from time to time into an uncomfortable exchange rate configuration. We will have to learn to cope and adapt to these "misalignments". Entry at the right rate only buys us an initial period of correct alignment of the exchange rate - it does not guarantee it for the long-term.

There are many legalistic details relating to ECU central rates at the time of EMU start-up, but in practice the ECU is irrelevant for the economic decisions at hand. Cutting through the legalistic details, what the Government will have to do in May is to choose (and get agreement of the other participants) to an entry rate in terms of the DM value of the Irish pound at entry. This may be dressed up in various ways, but it is the DM rate that will be the essential goal.

One obvious choice is the existing central rate against the DM in the EMS, namely IR£1=DM2.41. Other participants will probably choose their existing DM central rates, and there is not now likely to be any strong objection to Ireland also choosing that rate, despite the fact that (as discussed below) this will greatly enhance the cost competitiveness of Irish exporters. Indeed, if the market rate moves down any further it may become more difficult for the authorities to argue for a higher rate.

At present it appears that the choice in practice will be between entering at the central rate of 2.41, or choosing a higher rate in the region 2.50-2.55. An even higher rate - say 2.70 - was discussed up to a few months ago, but would have few adherents now. We may call these the low, medium and high entry rate options, respectively.

2. The Irish pound against sterling and the DM in recent years

Figures 1 and 2 show the evolution of the Irish pound against the DM and sterling in recent years. Figure 1 shows the longer-term perspective beginning at the outset of the EMS in 1979, while Figure 2 homes in on the more recent period since just before the currency crisis of 1992-93. Both figures show monthly average exchange rates, except that the final point refers to the closing rates on January 6, 1998 (DM2.52 and 84.7p).

1979-1996

The major trends are well-known. Following an initial sharp fall against sterling in 1980-81 to below 75p, the Irish pound showed a gradual appreciation over the following fifteen years to almost 105p in 1995-96. This appreciation was punctuated by a handful of crises in which sterling suddenly weakened, placing competitive pressure on the Irish economy which was usually released by a large Irish pound devaluation within the EMS (as in 1983, 1986 and 1993). Meanwhile, these occasional devaluations and other EMS realignments caused the Irish pound to depreciate fairly steadily against the DM.

1996-early 1997

Since 1996 the pattern has changed. A weakness of the DM against sterling and the US dollar saw the Irish pound appreciate against the DM and other EMS participants until it approached the top of the wider +/- 15 per cent margins (adopted in the EMS from mid-1993). The Irish pound did not appreciate fully with sterling, but went only part way, resulting in a decline in its sterling value to about 95p by early 1997.

April-December 1997

From April 1997 the Irish pound no longer followed sterling's further appreciation as markets became more aware of the possibility that the EMU entry rate might be at existing parities implying an Irish pound value of DM 2.41, well below current rates. This was only taken as a possibility: forward rates in the foreign exchange market for end-98 continued to imply a much higher Irish pound value on entry.

January 1998

The sharp decline of the Irish pound against both sterling and the DM in the first days of January 1998, implies a higher perceived probability that a low entry rate, such as 2.41, will be chosen. At the time of writing (January 6 rates), the forward rate for the Irish pound for end-98 is still about 2.47. If the market were fully convinced that the entry rate would be 2.41 a further immediate decline of about 2½ per cent in the spot exchange rate would occur.

3. Overvaluation of sterling

The sharp appreciation in the value of sterling since mid-1996 has caused concern in the UK about loss of competitiveness and overvaluation. Most commentators and economic modellers believe that sterling is 10-15 per cent overvalued, perhaps more. That does not necessarily mean that it will surely fall by such an amount against the DM in a short period of time. Exchange rates of large countries can be misaligned for years. Furthermore appreciation of the $ and other currencies could eliminate some of sterling's overvaluation without this showing up in the DM rate. Also, wage restraint in the UK could reduce the ultimate need for a reversal in the exchange rate.

Nevertheless, it remains apparent that the risk of a large downward movement in sterling against the DM has been heightened by its rapid and substantial appreciation during 1996-97) as shown in Figure 3. This is an argument for erring on the side of undervaluation of the Irish pound on entry, so that we have a cushion in case sterling collapses suddenly. Still, it has to be acknowledged that there were only the beginnings of grumbling from Irish exporters to the UK during late 1995 when the rate was almost 105p. A comfortable range would be 95p-100p. Note that a sterling fall of even as much as 15 per cent from January 6, 1998 would still leave the rate within that comfortable range.

4. Overall competitiveness

Clearly, the international cost competitiveness situation at present is a combination of improved competitiveness against the UK and dollar area countries, with reduced competitiveness against the EMS partners and collapsed East Asian tigers. For this reason the average degree of competitiveness is not as informative a concept as it might normally seem.

For what it is worth, though, Figure 4 shows the average wage competitiveness (hourly earnings) relative to Ireland's main trading partners since 1986.[1] This chart shows that, on average, the competitiveness index fluctuated within a +/- 3 per cent band from 1986-1997,

[1]This is the Central Bank's index.

ending that twelve year period close to the most competitive it had been.[2] The latest bout of currency weakness has brought the Irish pound so low that, if current exchange rates persist, the competitiveness index will improve (fall) by about 6 per cent this year - the biggest drop ever.

On this evidence, an entry rate in the region of 2.50-2.55 will (at current values of sterling) leave the Irish economy in a greatly improved average cost competitiveness situation. The high entry rate option would leave wage competitiveness at close to its 1996-97 average.

5. Reduced fear of inflationary spiral

The usual reason for avoiding unnecessary devaluations is that they tend to lead to a cumulative or self-sustaining rise in inflation and inflationary expectations, with the associated higher nominal interest rates and increased uncertainty and ultimately slower growth.

The unusual situation we are in now is that this is the last year of the Irish pound and of Irish exchange rate policy. A single decision to have a low entry rate will certainly have a one-off impact on prices, as higher import prices feed through. But it cannot lead to sustained expectations of further devaluations. Therefore it cannot logically result in a self-fulfilling cumulative process of inflationary expectations. This removes one important argument against a lower entry rate. Indeed, if it were not for this point, it would be evident that current exchange rates are too low on average by at least 4 - 5 per cent. In other words, were it not for this point, the high entry rate would be justified.

6. Possible impact on the national wage agreement in Partnership 2000

On the other hand, a low entry rate will not improve competitiveness if it results in a compensatory wage hike. Wage rates are broadly set for the period to end-1999 in Partnership 2000. This agreement is likely to be sustained unless undue devaluation should trigger price rises sufficient to upset the consensus. The prospects for inflation for 1998 even before the exchange rate falls of the first days of the year were of the order of 2½ per cent. The fall of the last few days could add a percentage point to inflation in each of 1998 and 1999. This might not be enough to derail the agreement, but if it were any higher there might be problems, certainly in negotiating a moderate new round. It seems prudent to take it that the low entry rate option is too risky in that it could destabilize the wage bargaining process.

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[2]The corresponding data for earlier years is not considered as equally reliable but it suggests a gradual rise in comparative wages at about 1 per cent per annum on average over a long period.

7. Overheating of the economy

Overheating of the economy is causing bottlenecks, shortages of labour at least in some sectors, and sharp property price rises. This could limit the ability of the economy to maintain current rates of economic growth, and even might present risks of an excessive rise in property prices followed by a bust. While inward migration and accelerated provision of public infrastructure can help here, there is reason to avoid adding unnecessarily to demand pressures at this time. Other policy measures traditionally available to dampen excessive demand surges are either not available or not being used. Thus, because of EMU, it is no longer a practical proposition to increase interest rates. Likewise, fiscal instruments that could have dampened demand were not employed in the recent budget. This is a reason for avoiding the additional demand impulse which undervaluation of the exchange rate would give.

8. Redistribution effects

Choice of entry rate has arbitrary redistribution effects. A low entry rate damages lenders or holders of Irish pound assets; it helps borrowers. The big players can look after themselves. For small players, unduly large exchange rate movements engineered by policy action can be unfair. The range of possibilities being considered here does not imply a very large redistribution, but some people (for example those with significant family commitments in the UK, or in receipt of British pensions) will be notably affected. This seems to be an argument for a middle course.

9. Reference to previous work

At a conference in July, I argued (see attached paper included as Annex 1) against an early realignment, and suggested a formula whereby we would enter at the central rate of 2.41, unless that brought us below about 87p sterling. At that point the Irish pound was about 5 per cent higher than it is today. Implementing my July recommendation now would give an entry rate of DM 2.59 (DM 2.53 if the sterling floor was set at 85p instead of 87p). This still seems acceptable advice, though clawing one's way back up to DM 2.59 may not be easy to justify in the context of a market rate of DM 2.52 today.

10. Summary and conclusion

Current exchange rates, if chosen as the entry rates, ensure more than adequate competitiveness both on average and against sterling even taking account of the risk of a depreciation of sterling. It is not necessary to seek a much higher entry rate (such as DM 2.70) in order to avoid a take-off of inflationary pressures. On the other hand, it is not optimal to enter as low as the central rate of DM 2.41 (which would, at the current DM/sterling exchange rate, imply a sterling rate of below 81p) in view of the extra fillip this will give to an already overheated economy, adding to congestion and labour shortages. Also, entering at the low rate could be destabilizing to the wage settlement process.

A middle course should be steered, with an entry rate no lower than DM 2.50 to 2.55, or even a little higher. At the current DM/sterling exchange rate that would imply a sterling value of the Irish pound in the region 84-86p. If sterling should fall back between now and May, a higher entry rate against the DM would be justified.

But if the market continues to bring the Irish pound down close to the central rate of DM 2.41, these choices will no longer be open to the Government. We will then likely be subject to the general presumption that currencies will enter at their current mutual central rates. Therefore, the authorities will need to act quickly and decisively now to signal their intentions in this regard. This could be done by announcing an intention ("under present circumstances" - this being a code for the current position of sterling) to seek an entry rate 4-6 per cent higher than the central rate of 2.41. The credibility of such an announcement at this time would be enhanced by the fact that market rates are still within that range.