Ireland and Monetary Union - For Better or for Worse?

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The Monetary Union debate is frequently conducted on the plane of politics and nationalism with the economic consequences of such a move reduced to playing second fiddle. Alexis Murphy sets out the purely economic arguments for and against Ireland's participation in the planned Monetary Union.

Introduction

The central focus of this essay is on European Monetary Union (EMU). Other important events which have paved the way towards a more integrated Europe include the abolition of exchange controls, the creation of the single market and the effects of various community funds, of which Ireland is one of the largest net recipients. However the move towards monetary union is by far the most radical move in European politics of this decade. This essay will discuss entry into EMU from an Irish perspective. I will begin with the theoretical argument as to why Ireland should join EMU. Then I will ask whether in this context Ireland is ready for EMU. Finally I will summarise the possible benefits and disadvantages of joining EMU for Ireland.

The working hypothesis of this essay is that Ireland will be accepted under the Maastricht convergence criteria to join the first wave of EMU. It is assumed that the UK will not participate in EMU, while France, Germany, and the Benelux countries will join. Although there are many other possible scenarios, to envisage these would involve political speculation, while the aim of this essay is to put forward the main economic arguments regarding Ireland's participation in EMU.

Optimal Currency Area Theory

A useful framework for analysing the conditions under which Ireland should join EMU is contained in Robert Mundell's pioneering paper "A Theory of Optimum Currency Areas"[1]. The crux of the argument is that countries should participate in an Optimum Currency Area (OCA) in a situation where the benefits outweigh the costs of joining in terms of sacrificing exchange rate autonomy and monetary policy. Furthermore the countries which join a currency area should on the whole have similar economic characteristics.

Mundell says "In a currency area comprising different countries with national currencies the pace of employment in deficit countries is set by the willingness of surplus countries to inflate. But in a currency area comprising many regions and a

[1] American Economic Review, September 1961.

single currency, the pace of inflation is set by the willingness of the central authorities to allow unemployment in deficit regions." Here, he outlines the problems associated with regions which suffer from asymmetric shocks in an OCA. In a situation where one country suffers an asymmetric shock, in the absence of exchange rate policy, three mechanisms should be in place to avoid the adverse effects of the shock:

1. Wage/price flexibility.
2. Internal factor mobility.
3. A Centralised budgetary policy.

If Ireland suffered a loss of competitiveness vis-à-vis Britain, in the absence of the exchange rate option, prices and wages would have to bear much of the burden of the loss. The ESRI[2] suggests that Irish nominal prices take three to four years to adjust to an exchange rate shock while wages take closer to four years. In the interim, Irish output and employment would fall.

When a region of an OCA is hit by an adverse shock, the people who become unemployed should be able to move to a region which is more prosperous. This is the case in America - in Europe, however, geographical mobility of labour is much weaker, due to cultural and linguistic barriers between the countries. Traditionally, the Irish labour force has been very mobile towards America, the UK, and other English speaking countries. Unfortunately, as Mundell pointed out, in an OCA, internal mobility must be encouraged, not external mobility. The argument being that migration out of the OCA would represent a loss in human capital: in Ireland this is most apparent with young university graduates. Occupational mobility is also crucial when a whole industry in the OCA suffers an adverse shock. It is important that the labour force be capable of retraining in order to shift from ailing sectors to thriving sectors of the economy.

Finally, a centralised fiscal system like the US federal budget is necessary for the success of a currency area. Such a system would ensure that a region which is under-performing would pay less taxes while receiving more from the central budget, albeit at the expense of more prosperous regions. This helps to reduce possible disequilibrium between the regions. So far, no provisions have been made for such a system.

Costs of a Single Currency

In the light of the Mundell framework, the problem still remains that our main trading partner, the UK, would not belong to the currency bloc. France, Germany and the Benelux countries only account for 26% of Ireland's trade. Most of our

[2] Honohan et al., 1996.

indigenous, high employment sectors still depend on Britain, both as an export market and an import market for manufacturing inputs. In the manufacturing sector, which employs over 200,000, foreign owned multinationals account for half of net output, whilst only employing 26,000 people. These multinationals mainly target EU and world markets. While it could be argued that participation in EMU will encourage Irish trade to diversify away from the UK, in the short term EMU participation without the UK could have devastating effects for indigenous Irish industry and employment.

If we consider a situation whereby sterling devalued against the Euro, in the absence of exchange rate policy, Irish exports would fall because of their relatively higher cost in the UK market. In addition, imports could increase because they would be relatively cheaper and thus substitute for many nationally produced goods. The decrease in exports and increase in imports would cause unemployment and, in the absence of the three above mechanisms, Irish output would suffer considerably.

In the case of a negative asymmetric shock to the Irish economy, prices and wages would have to fall relative to the rest of the EU, while real interest rates would increase relative to the rest of the EU. The higher interest rates would reduce investment and exacerbate Ireland's problems.

The NESC, in a recent report, stressed the need for an EU fund to compensate for such a loss of competitiveness. If this did not materialise, the Irish economy would suffer further from the fiscal restrictions of Maastricht, which effectively prevent the possibility of Keynesian demand-side management.

The situation in which sterling devalues with respect to the Euro is the most commonly used example of the possible shocks faced by Ireland. However, if sterling appreciated in terms of the Euro Ireland may also face problems. The increase in exports resulting from such an appreciation would increase output and employment. However, depending on whether the economy was working at full capacity, this could increase inflation and reduce real interest rates relative to Europe. It is questionable whether such an imbalance between Ireland and the other members of EMU would be favourable.

As Jim O'Leary puts it, "Membership of EMU without the UK will expose Ireland in an unprecedented way to the risks associated with sterling volatility"[3], both in terms of depreciation and appreciation of sterling relative to the Euro. These effects will carry through to competitiveness of trade and to the volatility of inflation.

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[3] Dublin Economics Workshop, October 19th, 1996.

Ireland's dependence on the UK in terms of trade implies that the Irish economy does not have similar characteristics to the core European economies participating in EMU. In addition to this, the Irish business cycle tends not to move in tandem with the mainland European economies. In terms of growth from 1950 to 1970, the Irish economy consistently under-performed relative to mainland Europe. In the 1990's, Ireland has falling unemployment and high growth performance, while the opposite is the case for both France and Germany. Problems associated with unsynchronised business cycles can be seen in the Maastricht criteria. Although at the moment we will probably qualify for entry into EMU, we are at the top of the business cycle while the core European economies are undergoing a recession.

Benefits of a Single Currency

The most commonly stated advantages of EMU include the elimination of transaction costs between participating countries and a reduction in exchange rate hedging. Ireland's participation in EMU without the UK may encourage more foreign investment from multinationals that need an English speaking country which they can use as a foothold to enter the EU market. Another considerable advantage would be the elimination of the premium on Irish interest rates caused by the risk of devaluation associated with the punt. However the belief that the euro would have low interest rates rests on the assumption that the European Central Bank (ECB) would follow a similar monetary policy to the highly independent Bundesbank. If countries other than Germany have power in the ECB they may wish to pursue a less restrained monetary policy.

Conclusion

Despite the possible advantages of EMU, the issue as to whether Ireland should join remains contentious. Optimal currency area theory would suggest that if the Irish economy is not similar to the other participants, if the mechanisms necessary for an OCA are not in place, and if the business cycles of the EMU participants are not synchronic, Ireland should not participate. Furthermore it can be argued that Ireland's participation in EMU with a small group of participating countries could, far from promoting European integration, drive a wedge between the EMU countries and the rest of the EU, most notably the UK.

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