EUROPEAN MONETARY UNION:

Should we catch the EMU Express?

Introduction

As we go to press (November 1996) it is widely expected that plans for European monetary union (EMU) will be formally sanctioned at the forthcoming Dublin summit. If the decision is made to go ahead, and if Ireland is among the first members of EMU, the rate of exchange of the punt against the ECU (which will later become the 'Euro') will be "irrevocably" fixed in two years time. In five years time, January 2002, we will be paying for our shopping in Euros rather than Punts.

Up till now most discussion has focused on whether we would be allowed join EMU, i.e. whether we would meet the Maastricht criteria. Now the EMU train looks as if it will leave the station on time. In addition, we meet the criteria to buy a ticket and board it. Before we do so however, we should ask where that train will bring us?

Is 'the rush' to board the EMU train justified on Ireland's part? In particular, is it justified if the UK decides not to join EMU? Is it based on sound economic judgement, taking into account the possible consequences for employment? Or does it derive more from economic nationalism and the desire to be more 'European' and less linked to Britain? The decision whether, and when, to join EMU is one of the most important economic decisions made since the foundation of the State. It is vital that we get it right. This will be a stern test of our maturity and collective judgement.

In Ireland's case there seems little doubt that there will be losses as well as gains in joining EMU and the difficulty is to weigh these up in making a decision. As we do so we should also consider the possible disadvantages of remaining outside EMU.

The Maastricht Criteria:
Our Ticket to EMU

Inflation rate of not more that 1.5% higher than the average of the three lowest rates in the EMS.

Long term interest rate not more than 2% above the average in the three low inflation countries.

Government budget deficit not higher than 3% of GDP.

Government debt moving significantly towards the norm of 60% of GDP.

No devaluation in 2 years preceding EMU.

These covergence criteria are designed to lend fiscal and monetary credibility to the Euro. They are purely nominal or budgetary and say little about the real compatibility of countries for a currency union.

Advantages of EMU for Ireland?

The advantages of European monetary union for Ireland could be considerable. Below we give some of the most common arguments in favour of Ireland's entry into EMU. In each case we add an evaluation.

1) Lower Interest Rates

The biggest single advantage is that interest rates should be about 1-2% lower than they would be if we stayed outside EMU. At the moment interest rates in Ireland are higher than interest rates in Germany. This is because investors who buy Irish currency run a greater risk of the punt devaluing than if they held German marks. So they look for additional interest to compensate for the risk. There will be no need for this difference in interest rates if Ireland is in EMU.

The positive effects of lower interest rates would be felt especially in the building and construction sector. Lower mortgage payments would also boost consumer spending power. The resulting increase in domestic demand would help Irish firms which rely on the home market. In addition Irish firms with high debts would have to pay less interest on them.

Lower interest rates also mean a reduction in interest payments on government debt. If our government debt was 60% of GNP a one percent fall in interest rates would translate over time into a fall in interest payments of about 0.4% of GNP.(i) Such savings could be used in reducing taxation or paying for government expenditure.

The ESRI estimates that industrial sectors employing about 36,000 people have a high or fairly high degree of sensitivity to interest rate

These interest rate gains will also be on-going ones which we benefit from each year.

Evaluation

However the gains are based on a key assumption i.e. **that the interest rates prevailing in the Euro currency area will be 1% lower than Irish interest rates would be if we stayed outside of EMU.**

In effect the assumption is that the Euro and EMU interest rates will behave much like the Deutchmark (DM) and German interest rates behave at present.(ii) So if Ireland stays outside EMU, Irish interest rates will continue to have to compensate for the risk of devaluation just as they currently do against the DM.

We can ask however, is this assumption valid? Or in other words how secure are these gains? For instance there might not be much real gain if the European Central Bank had to put up interest rates to convince the financial markets of the 'macho' credentials of the Euro.

Some economists have indicated possible scenarios where this might happen. One scenario is if relatively large countries with weaker monetary and fiscal credentials such as Italy and Spain join EMU. Another is if France experienced political difficulties such as labour unrest or rising support for right wing parties, and so pushed for laxer fiscal and monetary policies within EMU.(iii)

As against this the Euro has been designed to assuage these fears. The stringent Maastricht criteria, the strict constitution of the European Central Bank, and proposed tighter controls on government spending when in EMU, are all designed to assure the financial markets that the participating EMU currencies will be low inflation economies following a policy of fiscal and monetary rectitude. These should make the Euro appeal to financial markets.

There are also other considerations. It is arguable that the strength of the DM is more a problem than a benefit to the German economy at the moment. Indeed it is severely denting the competitiveness of German exports especially given relatively high German wages. A somewhat weaker Euro would also help Europe retain competitiveness for European exports and make imports from low-wage economies a little more expensive. So the Euro region as a whole might well have a shared interest in opting for a somewhat less 'macho' Euro over the present very 'macho' DM peg. This means there may be less need to raise interest rates in defence of the Euro if it weakens somewhat.

Another question concerns the 'position' the Euro will occupy on global financial markets. It is likely that the Euro will become a major currency used for trade invoicing. Indeed the more currencies join EMU the more the Euro will be in demand for this purpose.

There will also be changes in the foreign exchange holdings of EMU central banks and non-EMU central banks. These are likely to tend to strengthen the Euro against the dollar, and perhaps also to weaken it against the Yen. (iv)

A final consideration is that even if interest rates were to rise in the EMU area we would probably still have to have even higher interest rates here. In the short term financial dealers would re-assess their investments in Ireland if we decided not to join. There could easily be an outflow of funds and consequently higher interest rates. There would also be some on-going risk of devaluation against the Euro that would generate an interest rate premium.

In summary then it seems likely that Ireland would have lower interest rates in EMU than outside and that the savings suggested are probable.

2) Lower Foreign Exchange Costs

EMU would also bring a saving in exchange transactions costs. At present banks charge a commission for changing currencies. Although this represents profits, and jobs, in the banks, it is also 'deadweight' for the economy as a whole. It represents a bigger cost for a small open economy like Ireland than for a large, more closed economy.

There are also indirect foreign exchange costs due to inconvenience in making transactions and lack of transparency. So there could be some boost to trade because of the greater ease of doing business within the same currency area. For instance goods could be bought from Germany through an ordinary cheque in the post.

A single currency will also make for easier price comparisons across borders, promoting competition. For example there are at present large differences (even taking into account different tax regimes) between car prices in different European countries, and greater transparency in prices would allow consumers to 'shop around'.

Travel within the common currency area will be more convenient, with no need to buy travellers cheques or foreign currency.

Evaluation

Here however there are winners and losers. The benefits are spread over all individuals and firms who will save on exchange costs.

The ESRI estimates these gains to be of the order of 0.5% of GNP if Ireland and the UK join EMU, and about 0.25% of GNP if the UK stays out while Ireland joins. (v)

The losses that are the flip side of these gains are concentrated in the financial sector. If all the EU countries, including the UK, enter EMU these losses are estimated at about £143m fall in Associated

Bank revenue, and 10% fall in financial sector jobs. On the other hand, if the UK stays out and Ireland goes in, losses will include about £73m in bank revenue and 7% of financial sector jobs. (vi)

There would also be once off changeover costs when Euros physically replace Irish currency in circulation in 2002.

On balance therefore savings on transactions costs will make life more convenient but are unlikely to affect employment much in the medium term.

3) Increased Business due to Stable Currency

Business confidence could be boosted by the fact that in EMU our currency would be relatively immune to attacks by speculators. It would be more difficult to speculate against a broad-based currency such as the Euro, with the former German mark at its core. So the Euro is likely to be less volatile (ie. subject to fluctuations) than the punt outside of the Euro.

There would be gains from having a currency that was well known and trusted. We might find stronger flows of capital into Ireland. Overseas firms would be more willing to invest in Ireland if our currency was devaluation-proofed.

Irish exporters would no longer have to bear the cost of 'hedging cover' in trading with EMU member countries. Hedging cover is a device to protect firms against a possible fall in value or devaluation of the punt. It is relatively more costly for small companies.

Evaluation

There are two reasons why these advantages from lower volatility are likely to be small. The evidence is that the effects of exchange rate volatility on trade and investment are limited.(vii) So reducing exchange rate volatility is unlikely to lead to much more trade or investment. Also volatility in the exchange rate offers some people in the economy opportunities for making speculative profits. If this volatility is removed they lose those profits. So there is a down side too.

The effect on inward investment is also likely to be small. Direct foreign investment in Ireland is mainly by firms which are insensitive to Irish currency fluctuations. They are large, have high profit margins, £IR denominated costs form a small proportion of their total costs, and their exports are diversified. The principal attractions that Ireland holds as an investment location are low company tax rates, government grant aid, an educated workforce at reasonable wage rates, and an English language environment.

So EMU is unlikely to pull in much more foreign investment. The UK for instance continues to be an attractive location for inward investment despite indications that it will not be in EMU.

4) Lower Inflation Over Time

We could expect to have lower inflation rates over time. EMU countries would no longer be able to run large budget deficits or to increase their money supply. The money supply would be regulated by the European Central Bank (ECB) in Frankfurt. Ireland would have only a single representative on the ECB Board.

Evaluation

Lower inflation was a much more attractive reason a few years ago when our inflation rate was above the European average. Now however, it is one of the lowest in the EU. One could argue however that in the future the ECB and other EMU controls on government spending will generate a more stable low inflation environment.

Irish governments on the other hand always face the temptation to secure political support at the cost of some extra inflation especially before elections.

However there are also going to be different political pressures within the European Central Bank itself. Hence there are doubts about whether it will live up to its low inflation billing. These are essentially the same doubts as those we looked at above in discussing interest rates.

5) Political Benefits of Membership

Currency union would also bring us a step closer to complete economic integration with Europe. This should allow us to share in the political and economic strength of countries like Germany and France.

Evaluation

These effects are hard to quantify. There would be political benefits from being part of EMU as opposed to remaining outside conditional on UK membership.

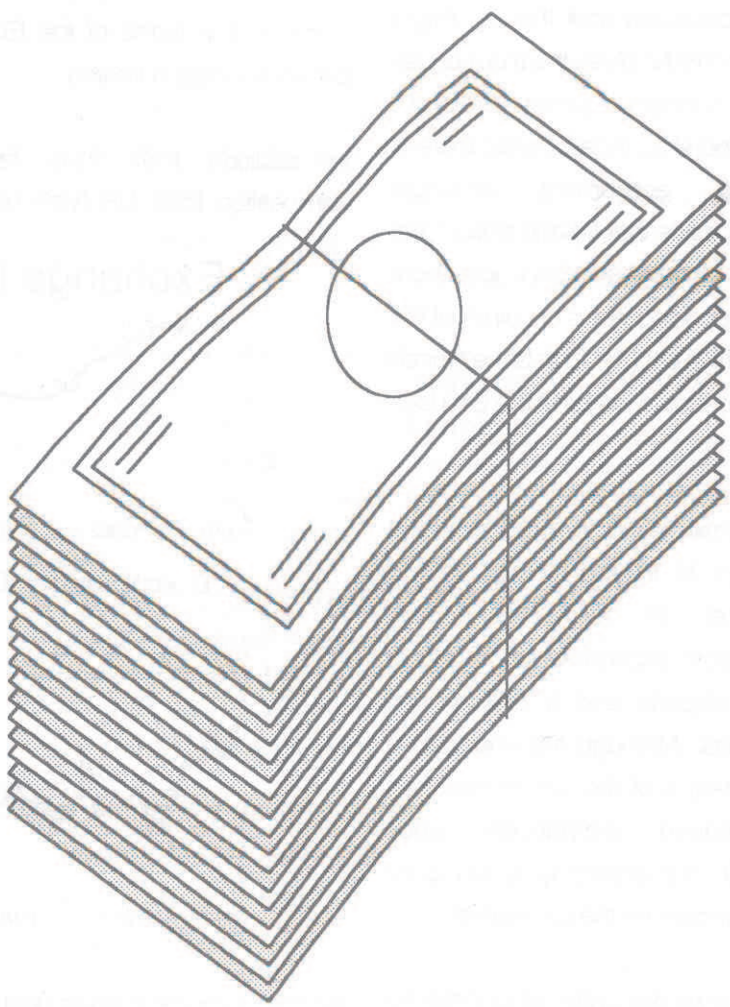
We would have a direct voice in shaping monetary and fiscal policy within the EMU zone. Here as in all other EU affairs a single voice can have a lot of impact if it forms alliances with others.

There are also other political benefits that will come from belonging to the EU hard-core. Overall Ireland's political bargaining power in the EU would be enhanced by membership in the first phase. There may also be economic benefits to this change in political status. These are impossible to quantify, but not less real for that.

On the other hand waiting until such time if any, when the UK would join would re-inforce the political perception of Ireland as tied to the apron strings of the UK economy.

Summary of all the Advantages

Of all these advantages the gain from lower interest rates is the most important quantifiable one. The political advantages could also be considerable although they are non-quantifiable. The remaining advantages are either small in expected effect (eg. lower exchange rate volatility) have offsetting costs (eg. lower exchange costs) or do not meet a current difficulty (lower inflation).



DISADVANTAGES OF MONETARY UNION?

The arguments which can be proposed against monetary union for Ireland, like those in favour, are not certain. In joining EMU we are moving into uncharted waters. Below we give some of the most common arguments against Ireland's entry into EMU. In each case once again we add a possible response or counter-argument.

1) Our main trading partner, Britain, may not be a member of EMU

The possibility that the UK might not join EMU gives the main cause for concern about Ireland's membership. Indeed while there is strong agreement amongst economists that Ireland should join EMU if the UK decides to join, there are opposing views on joining if the UK stays out.(viii) This is the crunch issue: should we join if the UK does not?

The main reason for concern is that Britain is Ireland's main trading partner. In 1994 the United Kingdom accounted for 27.5% of Irish exports and 36.3% of Irish imports. Although the importance for Ireland of the UK market has decreased dramatically since 1960, our economy is still quite dependent on the UK market.

In this we are unlike other potential EMU members. Thirteen of the Fifteen EU countries either have Germany or France as their largest trading partner. Ireland and Portugal are the only exceptions.

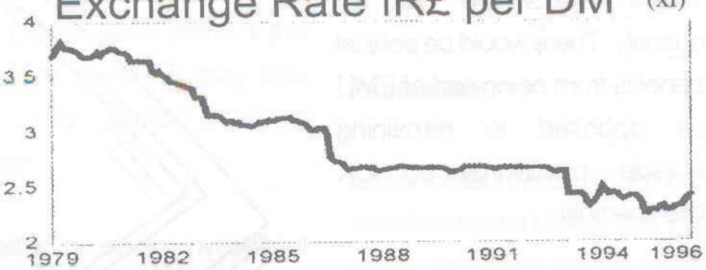
If sterling were to depreciate strongly against the Euro and Ireland were in EMU, then the profit margins of firms exporting to the UK would be squeezed hard. Effectively they would have to maintain the sterling price of their exported goods to remain competitive on the UK market. But that price would be worth much less in terms of the Euro currency in use in Ireland.

In addition Irish firms face competition from UK firms both on the domestic market **and** on third country markets. If sterling devalued against the Euro UK exports would become cheaper both for Irish residents to buy here and also for other EMU country residents to buy in their markets.

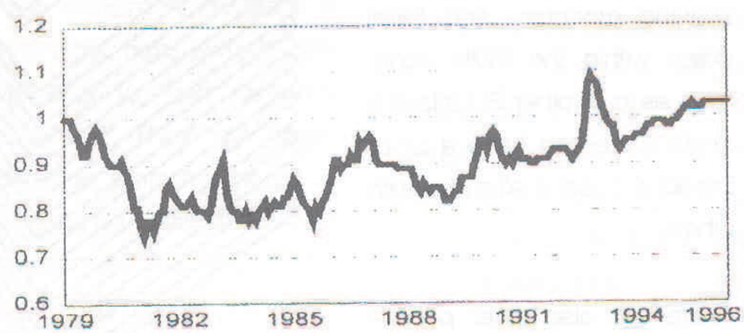
It seems unlikely that the European Union would be willing to give Ireland financial assistance to cope with a sudden sterling devaluation, especially since other EMU candidates, such as Finland (which has heavy trade with Sweden) face a similar problem.

It is also unlikely, after its humiliating exit from the Exchange Rate Mechanism in September 1992, that the UK will agree to enter into any tight exchange rate mechanism with the Euro.

Exchange Rate IR£ per DM (xi)



Exchange Rate IR£ per £sterling



If we look at what has happened to the Irish pound exchange rate *vis-a-vis* the DM and sterling we get some indication of the risk we run. The first diagram (see above) shows clearly that since 1979 the Irish pound has devalued pretty continuously against the DM. It is now worth about 2.4DM as against 3.7DM in 1979.

Against sterling the punt has fluctuated in value widely in a range from 73 pence stg. to about 1.11 pence stg. Yet at present in 1996 it is not far off a 1 for 1 exchange rate with sterling, just as it was in 1979. So despite wide fluctuations there has been no long run devaluation trend.

In fact if there had been no realignments since 1980 of the Irish pound against the German mark, the Irish pound would as high as 171p against sterling in late 1996. Though as we shall see this is a bit of a false comparison

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The danger of a sudden devaluation of sterling against the Euro is real however. It could wipe out many Irish companies. The Table below gives a list of the industrial sectors which are most vulnerable, with the numbers they employ and the reasons why each sector is vulnerable.

Evaluation

Of course this danger will not be present if the UK joins EMU. So assessing the risk of a devaluation against sterling involves a judgment about the likelihood of UK EMU membership. That may well depend on the result of the next UK General Election.

It is also important to notice why the longer run devaluation that Ireland and the UK experienced against the DM is not the real problem. The reason for this is that it more or less matches the higher inflation in Ireland and Britain as against Germany over the period since 1979. With higher inflation in Ireland than in Germany, our exports became relatively dearer for Germans to buy, but the devaluation of our currency compensated for this loss in competitiveness. Now however, with our inflation well below the EU average we do not need the devaluation safety valve that we have benefited from over the past seventeen years.

On the other hand without the devaluation safety valve there is an even greater onus on us not to have wage or price inflation above

Degree of Currency Exposure	Numbers in Work	Description	Reasons for Degree of Exposure
High - Fairly High	25,700 13%	Clothing, Processed Meat Products, Sugar and Confectionery, Other Textiles.	High exports to UK. Domestic market vulnerable to UK competition. In clothing sector, small firms with low margins.
Moderate	47,382 24%	a) Other Transport, Metal Production, Exp. Metal Articles, Domestic Appliances. b) Furniture, Other Chemicals, Paper, Paper Products, Leather and Footwear. c) Meat Production, Dairying,	a) Exposure to UK exports on 3rd. country export mkts. b) Risk of UK penetration of domestic market. c) High domestic inputs and significant exports to UK.
Fairly Low - Low - Very Low	124,962 63%	All other industrial sectors	Relatively protected (or dominant) in domestic mkt. Diversified exports not so vulnerable to UK competition. Or high margin, large exporting firms, with domestic costs a low share of total costs.

that of our competitors in the future. If we do lose competitiveness in this way it will have more immediate impact on output and jobs than it did when we could devalue.

Devaluation over a longer period to offset differences in inflation is a problem we will not have to face if we manage our price and wage inflation well. Indeed EMU should help in managing our inflation.

There is no reason to assume that sterling will be weak in the long run against the Euro. Sterling is a volatile currency however and in recent times it has experienced periods of being overvalued, 1979-82, 1988-92, and a period of being undervalued, 1992-95.(x) Firms therefore are more at risk of sterling **suddenly** losing value against the Euro.

Faced with a severe loss of competitiveness, vulnerable firms can quickly go to the wall. But will the gains that firms make from lower interest payments in EMU offset the possible losses from their exchange rate vulnerability?

Unfortunately things are not so simple. Those firms which gain a lot from interest rate reduction are typically not those who have most to lose through exchange rate vulnerability. Indeed, taking into account exchange rate and interest rate effects the ESRI's figures suggest that about 18,800 jobs are at fairly high net risk, and about 26,200 at moderate net risk. (xi)

2) Insufficient Protection Against Other Regional 'Shocks'

In any common currency area, it is important that there be a mechanism for dealing with regional 'shocks'. A 'shock', in economic terms, is some unexpected event which causes either demand or supply of an economy's products to change sharply. For instance most economies suffered large shocks as a result of the increases in oil prices in the 1970s. Reunification imposed a huge shock to the German economy. The BSE crisis constitutes a moderate shock to many European economies, due to reduced beef exports or consumption, or both.

A *once off* currency devaluation is a key instrument often used to soften the blow of a shock to one country that does not affect its competitors. In 1982 large wage increases in Belgium led to a loss of competitiveness and a trade balance crisis and it was decided to devalue the currency by 8.5%. The devaluation helped it to restore its trade balance. There were also successful devaluations in the same year in France and Denmark. The loss of the devaluation option under EMU should not be underestimated.

Continuous devalution is a self-defeating policy option. It leads to inflation (through dearer imports) and also higher interest rates (as insurance against future devaluation).

Within economics the issue of currency union and asymmetric shocks (i.e. shocks which affect one region within the currency union and not another) has focused attention on the compatibility of countries or regions for currency union. This has been named "Optimum Currency Area Theory". In the two boxes opposite we outline the issues as stake. The left hand side box shows the different ways a country can respond to a shock which affects it alone. The right hand side box mentions the difficulties with each way of responding if Ireland joins EMU.

Evaluation

There is broad consensus among economists that *the EU as a whole is not an optimum (or highly compatible) currency area.* The key reason that they give is that shocks do not appear to affect different EU countries at the same time, as compared with the situation in other currency unions. Also wages in Europe are less flexible than they are in the US for example. Furthermore migration between different countries is far less responsive to wage and unemployment differences than in the US.(xii) A core of EU countries including

Germany, the Benelux countries, Austria and France do form a highly compatible core however. (xiii)

The difficulty with these comparisons however is that they are based on the record of the past, a situation where there has been no monetary union. So it can also be argued that EMU will stimulate greater wage flexibility because the real effects of loss in competitiveness will quickly be seen.

With the single market and the coming of EMU there may also be a change in how sensitive individual countries will be to shocks specific to them. This will work in two conflicting ways. Some industries (where a lot of savings can be made as size increases) will tend to concentrate production in one location. Thus if that industry suffered so would the country where it was located. Other industries where there are economies of scale and **also** wide product differentiation will tend to have greater intra industry trade, i.e. different varieties of the same product produced in different EU countries. (xiv).

Optimum Currency Area and Asymmetric Shocks

Ireland experiences a shock specific to it. So national output and employment fall.

If it can devalue its currency it can boost demand for its exports and thus re-boost output and employment. This softens the initial blow of the shock.

If it cannot devalue then adjustment can typically happen in four ways.

A) If real wages fall relative to competitors then there is a gain in competitiveness. So demand for Irish goods goes up. If real wages fall, those who have lost their job due to the shock are cheaper to re-employ.

B) Those who lose their job could emigrate to a country that has not experienced the shock. For example: Irish emigration to the UK and US.

C) The government could increase its spending to offset the decline in output and employment.

D) There could be a transfer of money from the non-shocked region to the region experiencing a negative shock.

Ireland and the EMU core (without the UK) An Optimum Currency Area?

The shocks affecting the Irish economy are not highly correlated with those affecting the countries at the EMU core, i.e. France and Germany.(xv)

We will not be able to devalue in EMU. So all the burden of adjustment will have to occur in one of the four ways. However there are concerns about each of the paths of easing the burden of the shock

A) Real wages are not very flexible in Ireland.

B) Labour will not be so mobile between Ireland and the EMU core because of language and cultural differences, differences which make job search and the task of taking up employment harder. In any case emigration is not really a solution.

C) Government spending will be strictly controlled within EMU.

D) The transfers through the EU budget are small relative to transfers that occur within other currency unions such as the US.

Turning to C) and D) (see box): Within a country, such as Ireland, the state currently has a number of ways of responding to regional or sector speicific shocks. For instance, if there was massive flooding in the Shannon region or if one particular industry ran into difficulties, the Government could allocate money to alleviate the problem. Currently they could do this even if this meant running a large budget deficit, incurring foreign borrowing, and risking a rise in inflation and a devaluation of the currency.

However in a European currency union national governments would be far more constrained in their ability to deal with shocks affecting only themselves. It is unlikely that they will be allowed to run a budget deficit above a modest and agreed level (of about 2-3% of GNP), and they would not be allowed to take any steps that would trigger European wide inflation, or cause an international lack of confidence in the Euro.

Indeed the forthcoming Summit will discuss the criteria under which governments would be allowed overshoot fiscal spending limits without incurring semi-automatic penalties. This will be part of the EMU Stability Pact. At present it looks as if a 1.5% fall in GNP growth in one year, or some unpredictable event such as severe flooding etc. will count.(xvi).

This gives Governments little room to manoeuvre above expenditure limits. However their hands are not completely tied. By good targeting of expenditure much can be achieved. Similarly, prudent Governments will strive to keep their spending at a level some way below the ceiling and thus give themselves more room for increasing spending in the face of smaller shocks.

An EU response to shocks which affect only a single country naturally could only be taken with the agreement of the whole European community. Other EMU countries would not be likely to look on Shannon flooding or problems in one Irish industrial sector with more urgency than we ourselves would look on say, flooding in the Po region of Italy, or problems with FIAT! This leads some to argue that European political union is not sufficiently advanced to create the kind of solidarity that would be needed to cope with shocks specific to one country.

Furthermore the federal budget of the EU is very small - in 1994 about 1.25% of EU GDP (or only the amount spent on social security in the UK) compared to about 20% in the U.S. Already in 1974 the MacDougall report argued that to have a small public sector the EU would need a budget of about 5% of GDP. However the EU countries are committed to not letting the budget exceed 1.27 % of GDP between now and 1999. Also with more poorer countries joining the EU Ireland's opportunities for special pleading will diminish.

As against this, more recent analysis of EU expenditure has argued that properly targeted spending can have more impact than crude percentages of GDP would indicate. Moreover, targeted spending can form a significant proportion of the GDP of a small EU country, or a region within a larger EU country. Hence such transfers may pack some punch. The impact of the Structural Funds in Ireland is a case in point. In this vein a EU coinsurance scheme could offset the impact of regional shocks. One such scheme has been proposed. It suggests that when a member country's unemployment rose relative to the EU average so could the transfer payments it receives. If these transfers were capped once the change in unemployment differential reaches more than 2% then (on the basis of the past record of unemployment rates) it would add no more than 0.25% of EU GDP to the EU budget.(xvii) Such a program could offset about 20% of a temporary decline in a region's relative income.

3) The desire for currency union is driven by a dubious set of values.

Some might feel that the main reason for the proposed European currency union is only increased efficiency. Yet so far there is little evidence that the process of monetary union stimulates economic growth and employment. The convergence criteria (low inflation, balanced budgets, and so on) are all to do with 'fiscal rectitude', with no obvious concern on the implications for growth or jobs. Moreover, most country's attempts to meet the criteria are actually contributing to slow growth and unemployment.

When EMU finally comes to pass, 'fiscal rectitude' will be more important than ever to preserve harmony between the members of the union. The Stability Pact will set low upper limits for government debt and inflation. In the event of a recession these considerations are likely to have primacy over preserving employment.

Evaluation

This is an important argument and is implicitly acknowledged by several economic comentators. Paul de Grauwe argues that the deflationary Maastricht criteria are designed simply to meet German fears about the loss of the DM.(xviii)

However, it is important to distinguish between the political economy of the birth of EMU and what will happen afterwards. At present the Maastricht criteria are needed to persuade the German people to give up their DM for the Euro. It is also true that the criteria have had a negative impact of growth and employment in Europe by deepening the recent recession.

On the other hand the Maastricht criteria have provided a convenient excuse or legitimation for changes that needed to be made anyway by European governments. The unpleasant medicine of control of public spending would not have been swallowed calmly by Europe's electorates without the EMU logic.

A new situation will arise however when the Euro has been established and the Maastricht criteria have been met. German fears will no longer need to be soothed. Once they have made the switch to the Euro there will be no turning back. Furthermore fiscal and monetary discipline will be stronger in Europe as a whole.

This will encourage Europe to ask afresh **"What is the best macroeconomic policy for Europe"?** In this context Ireland (in EMU) will have a voice at the table in the multidimensional chess game of negotiations that will decide future European macroeconomic policy.

Alternatively if Ireland stays outside of EMU it retains only its current capacity to shape its own fiscal and monetary policy. However this capacity is severely limited in a small and very open economy such as Ireland's.

In this context having one voice at the European table negotiating with others may be a much more effective instrument in securing employment and output objectives than holding onto a single voice deciding policies that only touch "little" Ireland.

In summary then the jury is still out on the objectives and underlying values of European macroeconomic policy. It is clear that setting up EMU gives a deflationary look to monetary union. However everything will be to play for when EMU is actually up and running.

CONCLUSIONS

If the UK decides not to join, the choice facing Ireland with regard to membership of EMU is not an easy one. Sterling is a volatile currency so in joining without the UK we face the risk of sterling depreciating against the Euro. This puts jobs at risk, particularly in more labour intensive Irish owned industry. Other sectors such as retailing, tourism, and agriculture would feel the effects too. It is true that the Irish economy has been changing rapidly over the past 30 years from a low skill, relatively low wage economy to a high skill, relatively high wage economy. Some argue therefore that the sectors which are most vulnerable to sterling devaluation are declining in any case. Joining EMU without the UK only means risking giving them a shove in the direction they are headed anyway. However, the other structural feature of the Irish economy is its persistent high level of long-term unemployment. Indeed three quarters of the long term unemployed have either no qualifications or only have the Junior Cert.. So the composition of our labour force suggests that we need greater total numbers of lower skilled, relatively lower paid jobs and not fewer.

SOME IMPORTANT SAFEGUARDS

This leads us to conclude that if we are to join EMU without the UK it is vital that *some important safeguards are put in place*. These safeguards are designed to lessen the real loss of the option to devalue.

The *first* is some mechanism to cushion the effects of shocks affecting only a single country. This requires the creation of a co-insurance mechanism within the EU budget. Were it well targeted such a fund could make a significant difference to an affected region without involving an enormous increase in Community Expediture. The benefits that Ireland has received from the CAP, and from EU Structural and Social Funds show the potential of a relatively small central budget in helping more vulnerable regions to adjust to changed conditions. As part of this first safeguard it is essential that there be an EU budget committee that can credibly adjudicate on the needs of individual countries in dealing with 'shocks'.

The *second* safeguard is that EU countries who are not members of the currency union be required to be part of an exchange rate mechanism, to prevent (as far as is possible) sudden depreciations of their currencies against the Euro. The exchange rate mechanism **should not be a very tight one** which is vulnerable to speculative attack (xix). Instead it could allow a band of fluctuation of 12%, i.e. 6% each side of the central rate. Within the bands the ECB and non-EMU central banks could operate a coordinated policy of managed floating. This should dampen out any sudden devaluations and revaluations while letting non EMU currencies change in value by successive small amounts. As we noted above this type of gradual change, especially if it compensates for differences in inflation between countries will not have drastic effects on Irish industry.

Whether the EU will put in place such measures will be a measure of the real political solidarity within the Union. They are important however, in enabling us in Ireland to be confident that joining EMU without the UK will be beneficial to our economy and our society.

Finally we may also be able to take measures ourselves that would minimize the risks. One way vulnerable firms could protect themselves against a sterling devaluation would be to agree with their workforce that wages (or part of them) would be paid in sterling. During times when sterling was stronger than the Euro (in use in Ireland) the firm would only pay the Euro value of the sterling wages and save the extra sterling in a 'wage hedging fund'. Then during times when sterling was worth less than the Euro, the firm would top up its sterling wages to Euro values from that fund. Such assistance would obviously have to begin when sterling was relatively strong, as at present. Otherwise there would be nothing in the 'wage hedging' fund when sterling became weak.

This should insulate the firm more from the risk of sterling devaluations. In effect the firm would have a substantial sterling only section covering imports from the UK, exports to the UK, and part of labour costs. We do not underestimate the great difficulty of negotiating and implementing such a mechanism in a way that would give adequate safeguards both to workers and the firm. However some such imaginative proposals may well need to be considered in the more vulnerable sectors of our economy.

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ENDNOTES

i. See Terry Baker, John Fitz Gerald, Patrick Honohan eds., *Economic Implications For Ireland of EMU*, ESRI Policy Research Series, Paper No. 28, July 1996, p. 59. Our 1996 Government Debt - GNP ratio is estimated to be about 74%.
ii. The ESRI report explicitly assumes that EMU will have no impact on real interest rates in Germany. Ibid., p. 153.
iii. J. Peter Neary & D. Rodney Thom,"Punts, Pounds and Euros: In search of an Optimum Currency Area", paper to *Dublin Economic Workshop Economic Policy Conference*, Kenmare, October 14th, 1996, p. 13.
iv. "The Euro and the dollar: strut your stuff", *The Economist,* October 19th, 1996, pp. 87-88; also ESRI op. cit., p. 20.
v. ESRI, op. cit., pp. 60-61.
vi. Ibid., p. 242.
vii. Ibid., p. 20. For a fuller discussion see Paul De Grauwe, *International Money: Post War Trends and Theories,* Oxford University Press, 1989, pp. 217-240.
viii. This discussion began in earnest at the Dublin Economics Workshop Economic Policy Conference. Peter Neary and Rodney Thom of UCD and Jim O'Leary of Davy Stockbrokers, highlighted economic concerns about the "Ireland in - UK out" scenario. John Fitz Gerald and Patrick Honohan from the ESRI on the other hand pointed to their estimates of small net gains for the economy as a whole even in this scenario, and also dangers of higher 'costs' if Ireland stayed out.
ix. Diagrams taken from ESRI, op. cit., p. 144.
x. Ibid., p. 22.
xi. Net risk compares potential interest rate gains against potential exchange rate losses. The fairly high net risk group includes high sterling exposure/fairly high interest rate sensitivity and fairly high sterling exposure/fairly low interest rate sensitivity industrial sectors. The moderate net risk group includes fairly high sterling exposure/moderate interest rate sensitivity and moderate sterling exposure/low or fairly low interest rate sensitivity industrial sectors. Derived from ibid., p. 201 and p. 203.
xii. See Paul De Grauwe, *The Economics of Monetary Integration*, Oxford University Press, 1994, p. 87.
xiii. B. Eichengreen, *International Monetary Arrangements for the 21st Century*, The Brookings Institution, 1994, p. 103.
xiv. Ibid., p. 104.
xv. This is the central argument of the Neary/Thom paper cited above.
xvi. Patrick Smyth, "German 'flexibility' does not signal soft EMU option", *The Irish Times*, Friday Nov. 1, 1996.
xvii. Eichengreen, op. cit., p. 105. Jim O'Leary, in his paper to the Kenmare Conference, "Some Economic Implications of EMU", urged Ireland to launch a diplomatic offensive to establish an EU fiscal mechanism to offset the effects of asymmetric shocks, because "of all the likely participants, it is the one at greatest obvious risk on this score", p. 10.
xviii. De Grauwe, 1994, op. cit., p. 163.
xix. Ibid., pp. 117-121 De Grauwe suggests that narrow inflexible bands that become incredible really offer a one way bet for speculators. He also notes that it was the absence of coordinated effort by European Central Banks (especially the refusal by the Bundesbank to cut its interest rates) that allowed the EMS crisis of 1992-3 to happen rather than the sheer volume of speculative funds pitted against the Central Banks, p. 126. Therefore the combination of wider bands and Central Bank coordination should be able to guard against sudden currency devaluations due to speculative attacks.