Patrick Honohan: Currency choices in Ireland past and present

Presentation by Mr Patrick Honohan, Governor of the Central Bank of Ireland, at Queen's University, Belfast, 31 March 2015.

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Accompanying charts can be found at the end of the speech or on the Bank Ireland's website.

Introduction

A certain nostalgia has recently been evident, south of the border, for the sterling link period before 1979, when Bank of England notes circulated alongside the Irish pound. But are those traditionalists looking at history through rose-tinted lenses? The financial crisis has certainly highlighted weaknesses in the European economic and monetary union, but previous currency arrangements were not trouble-free either. Irish financial affairs suffered setbacks in the 1950s and 1980s also, which I would like to recall to you today. With careful attention to appropriate fiscal and financial policies, recovery from Ireland's recent difficulties within the euro area should continue to strengthen.

Currency arrangements in Ireland over the past couple of centuries, though mercifully less colourful than in many other countries, have been distinctive to say the least.[1] Despite the Act of Union, the Irish pound fluctuated considerably against sterling in the early decades of the 19th Century until the two currencies were unified in 1826 (Figure 1).[2]

Sterling link 1826–1979

Even after the Irish and British pounds were unified, the Bank of England's commanding banking position in England did not extend to Ireland, which relied on the Bank of Ireland and on an expanding group of its competitors, some headquartered in Belfast, some in Dublin and some in London, to ensure the payments system, including with their own banknotes (though the Bank of Ireland's monopoly on notes did not apply outside most of a 50-mile radius of Dublin). A handful of spectacular, but isolated, bank failures in the 19th Century only served to emphasise the overall stability of the banking system that emerged in those years and which arguably inculcated a degree of complacency about banking and a disregard of its fragility when carelessly managed or supervised.

This system worked so much to the satisfaction of the establishment that few voices were raised against its substantive continuation into the period of the Irish Free State. North and south of the border, the notes of the various banks continued to circulate at par alongside those of the Bank of England and, when a national currency commission was established in Dublin in 1927 – albeit shortly after the unfortunate repegging of sterling to gold at its pre-war level – its notes were explicitly expressed as payable in sterling. Indeed the words "sterling payable to bearer on demand in London" were printed on these Irish notes into the 1950s. By 1979, the one-for-one no margins peg with sterling had persisted for over 150 years. No better evidence of the financial conservatism of the political and business elite in this period could be desired.

But was the sterling link a good system for the Republic? One political argument for retaining it was to ensure that currency distinction would not exacerbate the economic barriers resulting from partition in the 1920s. However, as has been well documented, the intensity of North-South commercial and economic interactions was rather modest in subsequent decades, so

[1] A longer historical time period is covered in Honohan (2002).

[2] The fluctuations prompted the famous Parliamentary *Irish Currency Report* of 1804 (cf. Boyle and Geary, 2004).

this can hardly be thought a decisive consideration. Besides, the idea of "breaking the sterling link" had an attractive political ring to it for some of those keen to sever links with Britain.

On the other hand, trading links across the Irish Sea remained remarkably strong for the early decades of independence. As late as 1960 almost three-quarters of the Republic's exports went to the UK and almost half of her imports came from the UK. Even after six years of EEC membership had contributed to geographic diversification of Irish exports, the UK accounted for about a half of both exports to and imports from Ireland. Of course gravity retained its pull. But the lack of a need to set up foreign exchange hedging or even foreign exchange purchase and sales procedures when exporting to (or importing from) Britain may was sometimes thought to have been an inertial factor slowing the diversification of Irish export trade into more dynamic parts of the European and world economy – though export diversification was certainly in progress.

The openness of the capital account vis-à-vis Britain and the conservatism of the Irish banks, perhaps attributable to few sound lending opportunities presented to them, resulted in a large accumulation of liquid banking assets in the London money market in the early decades of independence (Figure 2). Quite the opposite to what happened later, then, in this regard.

Not surprisingly, interest rates too tended to track those in London. But there were two notable exceptions. The first was in 1932 with the formation of a Fianna Fáil government, in apparent response to which the Irish banks, seemingly fearful of radicalism, widened their lending spreads over the London bank rate (cf. Ó Gráda, 1994). The other notable exception was in the mid-1950s when, in a mistaken presumption that some monetary independence could be retained despite the exchange rate peg, Irish official and bank lending rates were held down despite increases in London. This latter episode was marked by an outflow of funds for which the adopted remedy was an overdose of fiscal austerity (as it would be termed now) associated with a recession and a surge in emigration. The power of the financial markets in influencing fiscal policy was thus displayed earlier than many may realise.

Inflation too tracked that in the UK rather closely in the sterling link decades, except during the period of wartime price controls. The pass-through was not immediate or exact,[3] but, taking one-year with the next, it was inescapable. To that extent, the sterling link imported to the Dublin-based authorities the credibility of the London authorities in regard to inflation, though by the 1970s, this was nothing to write home about (Figure 3).

So, for three-quarters of a century after Independence, Ireland maintained a one-to-one peg with sterling. At first, this was not an unusual position for a post-colonial country. But, one-by-one, each of the former countries of the sterling area abandoned such a link, typically very soon after independence (Honohan and Lane, 1999). Some countries were motivated either by economic nationalism or a desire to exploit the apparent pro-growth potential of an autonomous currency. The break in other countries was driven by unsustainable expansionary money-financed fiscal policy. By 1978 only Sierra Leone and Ireland were left as members of the sterling area.

Exchange rate mechanism of the European Monetary System 1979–1993

Ireland had begun to toy with a break in the arrangement from at least as early as 1976, when sterling took an alarming slide against the US dollar (and against the currencies of the European "snake" linked to the Deutsche Mark), triggering Irish inflation. The strongest economic arguments for a break were (i) the fact that the currency link to what had been the epitome of financial strength no longer provided financial stability, combined with (ii) a perception that the long-period of relative economic decline for the UK would continue and

[3] For example, the standard deviation of inflation in Ireland minus inflation in the UK in this period approached 2 percentage points – even when the war years are excluded. Gerlach and Stuart (2014) discuss Irish monetary and price data for those years.

would augur poorly for an economy too closely linked with it. Yet, lacking a clear alternative policy, and fearful of switching to too tough a regime, the Irish authorities had left any decisive step to change currency policy on the long finger.[4]

Suddenly the landscape changed when, triggered by the French Government's desire to rejoin the currency "Snake" arrangement according to which continental currencies maintained a joint float against the US dollar (the chart of exchange rate movements thus tracing a snake-like appearance), a movement among leading European politicians to create a 'zone of monetary stability in Europe' forced the Irish Government to make a choice. A new type of exchange rate regime, tying Ireland into the seemingly more vigorous, less volatile, continental economies with their recent record of lower inflation seemed to be on the cards.

Should the Irish government join the exchange rate mechanism (ERM) of this new European Monetary System (EMS), even at the risk of having to break the sterling link (if the UK did not join)? Perhaps the new arrangement really would represent something different and more acceptable that the austere Snake – tougher than the sterling link, but weaker than the latter.

After some initial hesitation, largely motivated by the fear of the regime being too strict, but eased by some ad hoc European subsidies (also granted to entrants Italy and Denmark), Ireland joined the ERM, while Britain stayed out.

The outcome did not correspond to expectation. The ERM proved to be a much softer or more lax exchange rate regime for Ireland than the sterling link. Not only did sterling – still the main trading partner currency – strengthen as a result of North Sea Oil and the anti-inflation policies of the Thatcher Government, but the ERM itself failed to live up to its branding as a zone of monetary stability. In particular, with its many realignments, the ERM lacked a "nominal anchor" which would ensure price stability. This allowed less disciplined member states frequent opportunities to offset wage competitiveness drift with adjustments to the peg. Devaluations of the Irish pound against the DM – core currency of the ERM – were thus more frequent than had been envisaged, occurring about once a year in the first eight years of the system. This includes three big Ireland-specific devaluations, in 1983, 1986 and 1993. Furthermore, fluctuations against sterling were high – much higher than during the Napoleonic suspension (Compare Figure 4 with Figure 1).

No longer constrained by the discipline of the sterling peg Irish inflation soared at first in the ERM (Figure 3), though it came under control by the mid-1980s. The inflation surge can be largely attributed to the soaring budget deficit (and accompanying relaxed national pay agreements) 1977–1981, accommodated and reinforced by the sharp weakening of the Irish pound against sterling in the first years of the new system. This experience presaged the deep fiscal crisis of the 1980s. That crisis, which was exacerbated by the UK recession, can hardly be blamed on the change in exchange rate regime. The growing reliance on foreign borrowing by the Government was already well under way in the final years of the sterling link and there is no suggestion that access to foreign borrowing was eased or necessarily hampered by entry into the ERM. Indeed, the decoupling of the Irish pound from sterling arguably somewhat eased the economic pressures of adjustment by allowing Ireland to retain a degree of international competitiveness through that difficult decade.

But the heightened uncertainty about inflation, exchange rate developments and the budget resulted in high nominal and real interest rates. Short-term interest rates, over-compensating for the risk of realignment, did not fall to German levels but averaged over 2½ percentage points higher in real *ex post* terms (Figure 5; Conroy and Honohan, 1994). Clearly markets were not convinced about the conduct of macroeconomic policy in general, and imposed that penalty.

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4 This discussion follows that of Murphy and Honohan (2010).

There is little evidence of the downward trend in the UK's share of Irish exports being either accelerated or slowed by ERM membership (Figure 6a), though the share of imports coming from the UK did finally begin to decline (Figure 6b)[5]. The long-hoped for participation of the UK in the system finally occurred in October 1990, only for sterling to exit again within two years as the system fell apart in the crisis of 1992–1993.

Managed float 1993–1998

The kind of adjustable peg currency regime at the heart of the EMS subsequently became largely discredited (Fischer, 2001). With the ERM fluctuation margins widened after the 1992–1993 crisis to an undemanding 15 per cent, there followed a curious interval during which a seemingly rather under-defined policy actually resulted in considerable exchange rate and inflation stability.

The policy regime was described as a managed float (within the wide ERM bands[6]) with a general objective of price stability. That objective was not quantified, however. Achievement of the objective was said to be "predicated on maintaining a firm exchange rate vis-à-vis other low inflation countries" (Central Bank Annual Report 1996) – so there was an exchange rate objective, though again unquantified. Forex intervention was undertaken to smooth the exchange rate, and the exchange rate objective was "supported by changes in interest rates as required".

Despite the seeming vagueness and *ad hoc* nature of this policy regime, the five-and-a-half years that it covered enjoyed more inflation stability than the subsequent era, with the four-quarter moving average staying almost wholly within a 1–3 per cent band. The *ex post* real interest rate differentials also narrowed significantly in this period. Furthermore, helped by the maintenance of international wage and price competitiveness, the mid-1990s was (as we must remember) a period of rapid employment and output growth and of substantial budgetary consolidation with an international balance of payments surplus. To an extent, this favourable experience is likely to have been facilitated by the determination to adhere to the convergence criteria established for entry to the single currency.

Nevertheless, the chequered history of exchange rate volatility since the end of the sterling link meant that, when EMU finally got under way in 1999, it was ironically with some sense of relief that, less than 20 years after breaking the link between the Irish pound and sterling, Ireland abandoned currency autonomy in favour of the euro.

The euro since 1999

It is fashionable now to decry the initial design of the euro as if its travails were easily foreseeable or indeed inevitable. Certainly important improvements in euro area institutional structures have been launched post-crisis, especially the creation of bailout funds and a centralised bank supervision mechanism. But it is equally true that sufficient existing national policy tools were available to have enabled the regime to survive its first 16 years without the trauma that has been experienced. All that was needed was disciplined national economic policy, supplemented where necessary by sufficient common surveillance of participating countries' policies.

True, when countries like Greece, Ireland, Italy, Spain and Portugal got into trouble, the traditional safety valve of devaluation was no longer available. But, one needs to recall that it

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[5] By 1994 trade with the UK was well below that predicted by a simple gravity model (such as that of Brülhart and Kelly, 1999). But Thom and Walsh (2002) argue persuasively that the decline in Irish-UK trade was driven by factors other than the ending of the sterling link.

[6] Though there was one discrete realignment (involving an appreciation of the 15% band for the Irish pound against the DM) in March 1998 as the start of the euro approached.

was the systematic tendency to over-use that lever that had resulted in the inflationary stop-go of the 1970s and 1980s which was the major backdrop to the determination of many countries to “import the credibility of the Bundesbank” by signing up for the euro. The absence of a devaluation lever must be considered as a feature, not a bug, in the system.

The fault, I am thus arguing, lies not so much in the system’s design as in the inadequacy of national economic and financial policies to take account of the risks that were still associated with the euro. There is another dimension worth mentioning. And that is the complacency of financial markets, which assumed that policies would in the end prove adequate (or, if not, that failing policies would be compensated by bail-outs) and accordingly did not provide to national authorities until it was too late the uncomfortable warning signals for which bond markets are notorious. Indeed, as had been foreseen, for the entire decade before the crisis broke, the single currency removed the risk premium in wholesale Irish interest rates, an achievement which was hailed at the time.

With the Irish economy booming already from 1994 and continuing to grow rapidly after the start of the euro, low interest rates were not exactly what was needed to restrain what was obviously a somewhat overheated economy. But fiscal policy could have taken the strain – as could macroprudential policies.

The creation of a sovereign wealth fund (the National Pension Reserve Fund) can be thought of as a step in this direction, though the annual 1 per cent of GDP contribution to it did not take enough spending power out of the economy. Personal savings were also incentivised by a remarkably generous special savings scheme introduced in 2001, but this scheme disgorged the savings five years later, with the economy still in its boom phase. And fiscal incentives for the already over-dimensioned construction sector continued for far too long. While the overall headline figures for the Government’s finances showed a comfortable position, and the debt ratio fell to 25 per cent of GDP, stable sources of revenue had been displaced by volatile ones, and large expenditure commitments were undertaken making the future evolution of the public finances over-dependent on a continuation of the housing boom.

Getting the public finances back on track after the collapse of the property boom would have been painful enough, but the added borrowing resulting from the bank failures (and from the assumption by Government of banking debts) was the straw that broke the camel’s back, triggering a loss of access to international financial markets as awareness grew of the scale of the losses. Quick action to negotiate a programme of financial assistance from the IMF, and from official EU lenders, stabilised the situation and eventually enabled the Government to finance much of the additional borrowing on favourable terms.

The very fact that the most significant banking failures outside of Ireland in this crisis occurred in non-euro area countries (Iceland, Latvia, the UK, the US) does help to emphasise that the Irish crisis was not a creation of the euro area. True, there were major banking failures in euro area countries too, Spain, Netherlands, Belgium, Germany, France and so on. Banking excesses were essentially a global phenomenon in the first decade of the 2000s. Yes, Irish banks probably found it that bit easier to access foreign funds when no account needed to be taken of exchange rate risk. But Iceland’s banks also sourced international funds without much difficulty.

In the past, exchange rate regimes did not come complete with specific external supervision of domestic policies. To be sure, the International Monetary Fund (IMF) has conducted surveillance of its members’ fiscal policies for decades, regardless of their exchange rate regime. Ireland’s peg to sterling was of course not accompanied by banking supervision conducted by the Bank of England. Nor did the European Monetary System have a banking supervision arm. And that was the decision also when the euro area was established: creation of something like what has now been established as the Single Supervisory Mechanism (SSM) would have been seen as a step too far by anti-federalists. Still, in its enthusiasm for forging an understanding of the euro area as the most relevant policy unit for its actions, the ECB may have gone too far in the other direction of failing to appreciate the dangers posed by intra-euro area capital flows, especially through the banking system.

The IMF did not foresee the Irish banking meltdown, and this realisation may induce some scepticism about the ability of external surveillance to prevent such problems. However, the SSM's analysis and engagement is much more intense, and it has the full powers of a modern banking regulator.

Fluctuations in sterling also contributed to overall economic performance in Ireland during the financial crisis. Sterling weakened sharply in 2007–2008 pushing the bilateral nominal exchange rate for Ireland vis-à-vis the UK to all-time record levels (Figure 7). This surge was largely maintained during the worst of the crisis, though it has since fallen back – though not yet (March 2015) to the levels of mid-2007.

Concluding remarks

Each of Ireland's three currency regimes has seen periods of relative prosperity and of crisis and recession. This should not surprise us. The textbooks have struggled to determine unambiguously what type of exchange rate regime works best in all environments for different types of country. Poor economic policies and bad luck are more reliable determinants of episodes of poor economic performance than choice of exchange rate regime.

During the 1970s the sterling link in practice tended to export Britain's relatively lack-lustre economic performance to Ireland in a way which was only partially offset by domestic policies. The greater flexibility of the ERM could not insulate the economy from the consequences of fiscal collapse and fiscal correction in the 1980s. And policy inattention to the heightened vulnerabilities of the single currency meant that Ireland was one of the worst performing euro area countries in the downturn of 2008–2012.

Should we not conclude that the choice of exchange rate regime for a country like Ireland is of second order importance for national welfare relative to the quality of domestic policy choices and implementation? If so, focussing on these domestic policy issues is what is needed to ensure that Ireland can reach its full potential in the euro area.

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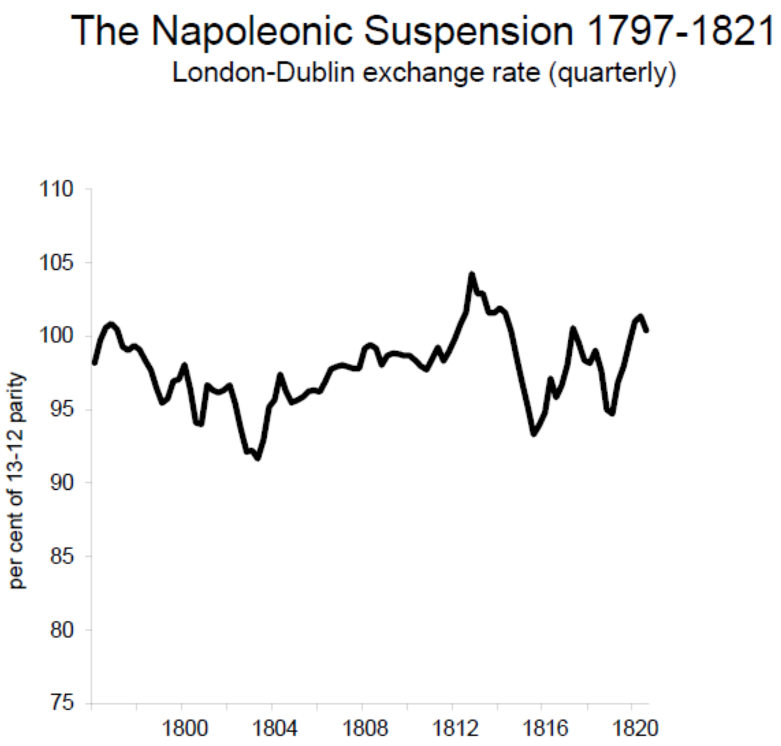
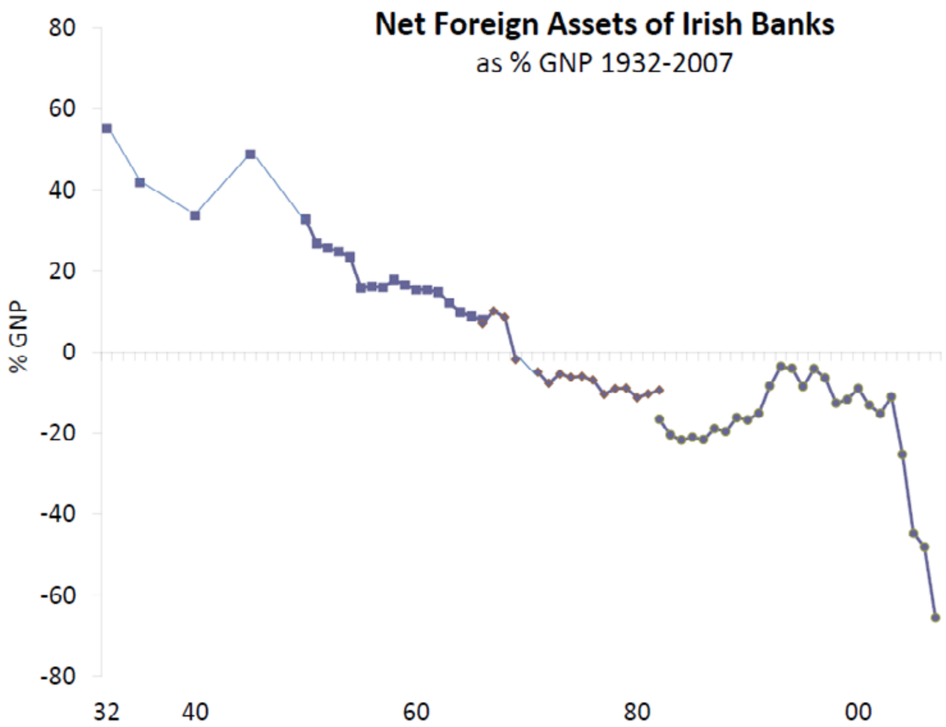
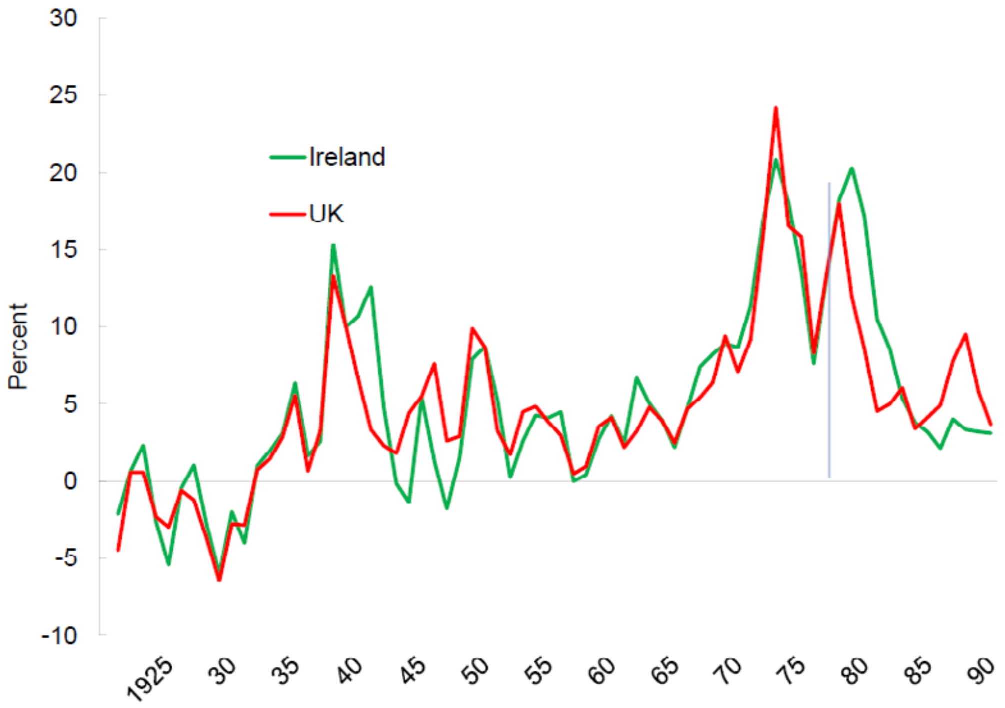

The Napoleonic Suspension 1797-1821
London-Dublin exchange rate (quarterly)
per cent of 13-12 parity
110
105
100
95
90
85
80
75
1800
1804
1808
1812
1816
1820

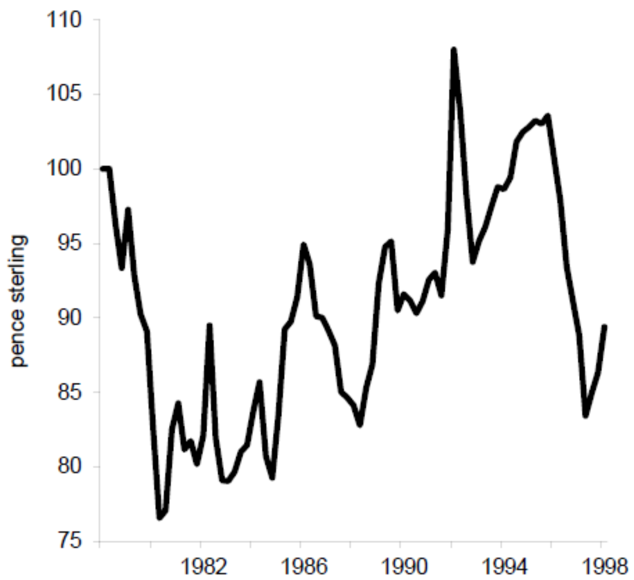

Net Foreign Assets of Irish Banks
as % GNP 1932-2007
% GNP
80
60
40
20
0
-20
-40
-60
-80
32
40
60
80
00

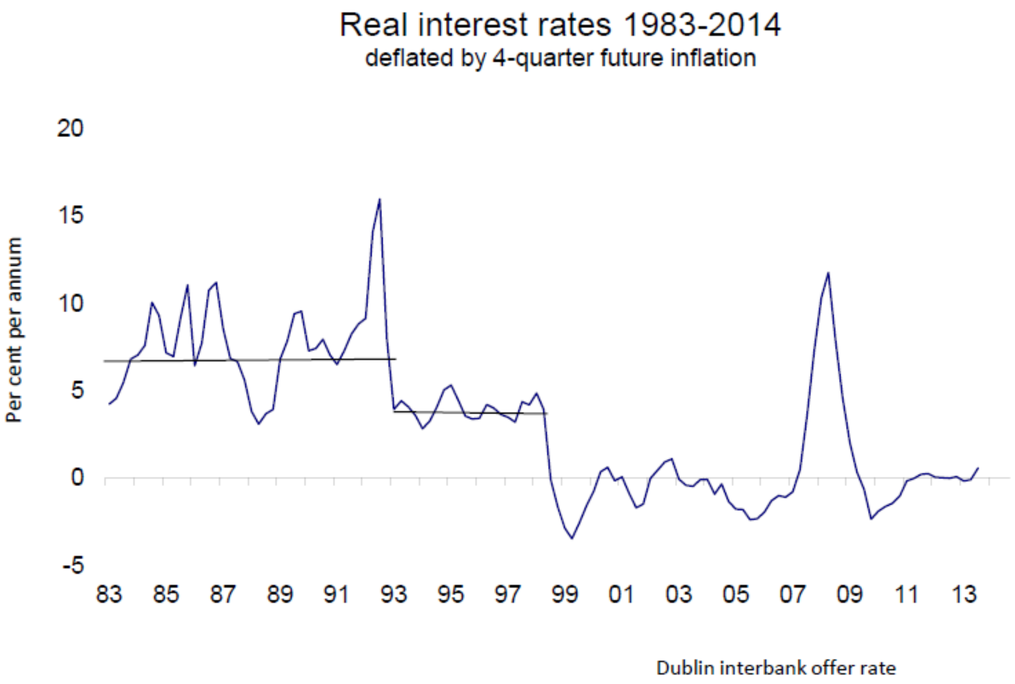
Irish and UK Inflation Rates 1922-1992

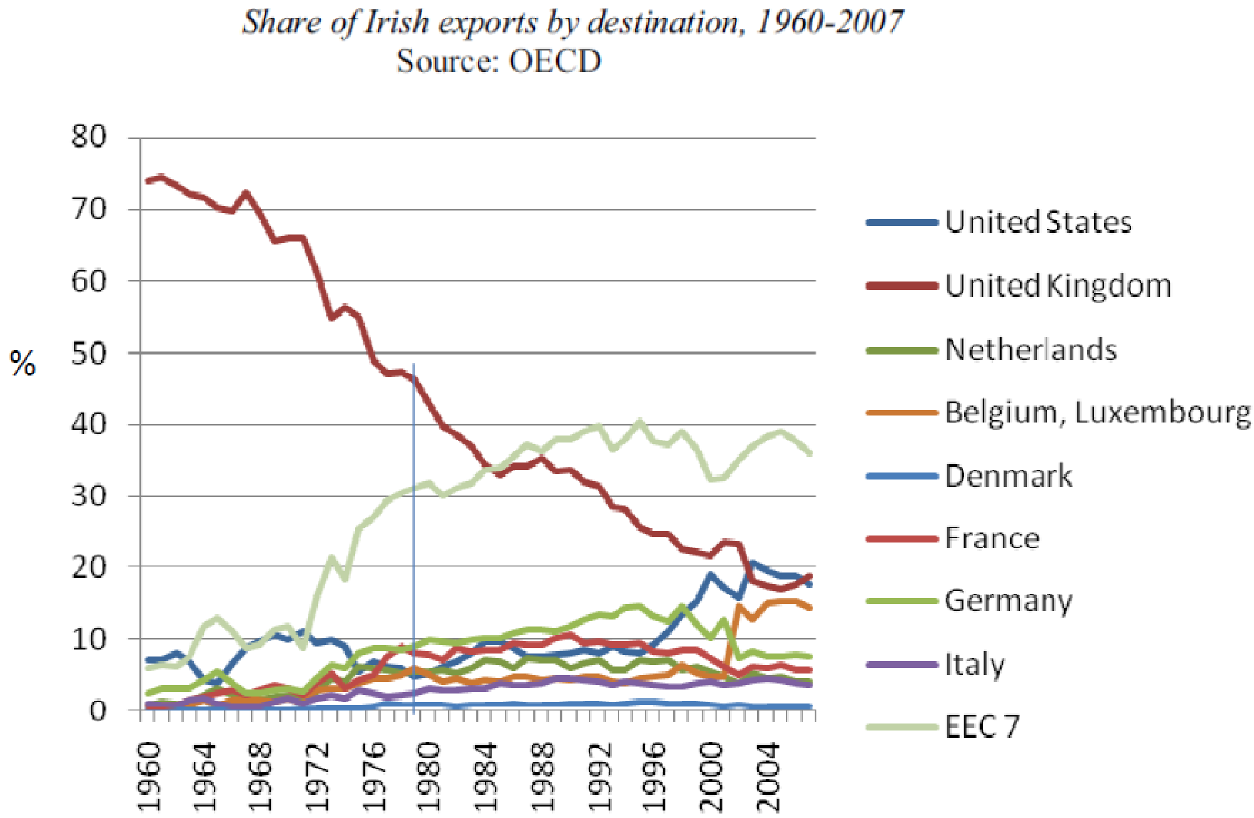


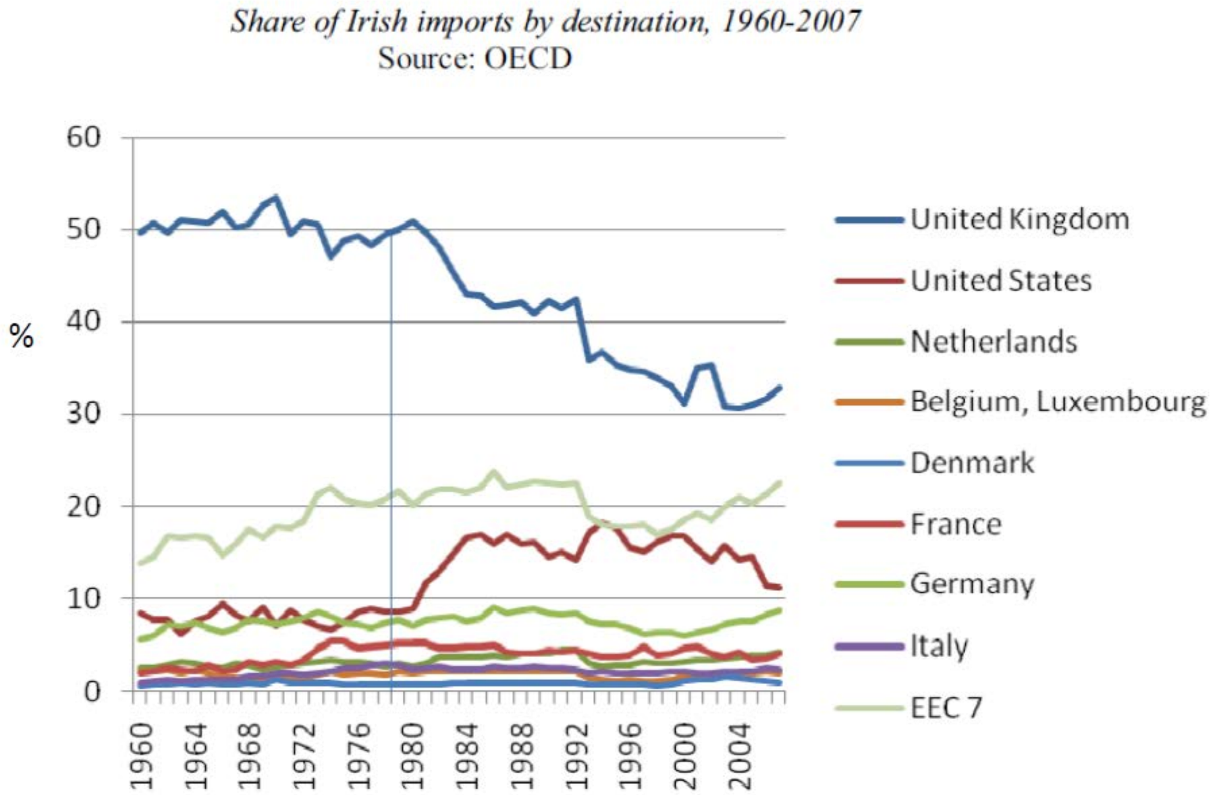
The EMS 1979-98

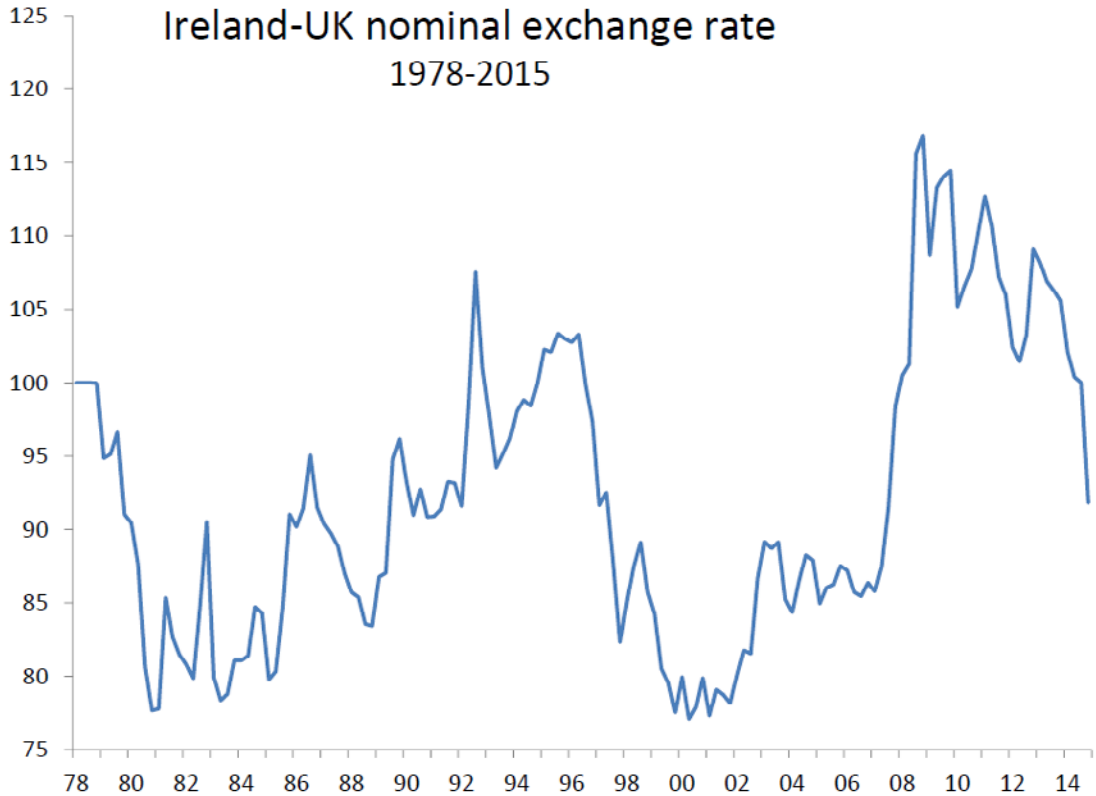
Sterling value of the Irish pound (quarterly)




Real interest rates 1983-2014
deflated by 4-quarter future inflation
Per cent per annum
20
15
10
5
0
-5
83
85
87
89
91
93
95
97
99
01
03
05
07
09
11
13
Dublin interbank offer rate


Share of Irish exports by destination, 1960-2007
Source: OECD
%
80
70
60
50
40
30
20
10
0
1960
1964
1968
1972
1976
1980
1984
1988
1992
1996
2000
2004
United States
United Kingdom
Netherlands
Belgium, Luxembourg
Denmark
France
Germany
Italy
EEC 7





In Irish pence per £ stg
(to 2001, € equivalent thereafter)
(monthly average of third month in each quarter)