



IRISH TIMES STUDIO

Exhibit IV. "Trapped Between a Rock and a Hard Currency Place" *Irish Times* 8
January 1993, Business Agenda, p.3.

THE Minister for Finance, Mr Ahern, this week neatly summed up the position confronting the Government due to the currency crisis as "caught between a bad decision and a worse one".

Since September the Government has tried to face down the turbulence on the foreign exchange markets, knowing that the decisions it made were of fundamental political, as well as economic, importance.

At stake is Ireland's desire to be in the vanguard of the move to EC economic and monetary union. Maintaining a firm exchange rate link to the deutschmark has been one of the cornerstones of economic policy, attracting foreign investment funds into the state which, until the currency broke, had brought Irish interest rates close to German levels. The economy, it seemed, was increasingly moving out of the British sphere of influence and towards the European, a trend which was planned to accelerate in the move to EMU.

But the currency crisis has posed the most serious challenge to this policy approach. The sharp drop in the value of sterling has caused severe pressure on sections of Irish industry and has led international investors to question the sustainability of the pound's ERM exchange rate. Money market interest rates have risen sharply, putting further upward pressure on general borrowing costs. The recent recovery in the value of sterling has offered one chink of light to the Irish authorities.

The unspoken fear of Irish officialdom is that a unilateral devaluation of the pound would destroy Ireland's Euro-credentials and perhaps result, sooner or later, in an eventual move back to a link with sterling. Hopes of membership of any "fast-track" of hard core currencies moving forward to EMU would, officials fear, be well and truly gone.

Participating in a general ERM realignment would, on the other hand, give the cloak of respectability to a readjustment of the Irish pound's value, as other narrow-band currencies would also be involved.

The arguments surrounding the various options facing the Irish authorities are remarkably complex. If, in the near future, sterling were to strengthen substantially further, or Germany was to embark on an aggressive policy of lowering interest rates, it might be worthwhile for the Irish authorities to try to hold the line.

The problem is that the high interest rates levels on the money market are already increasing costs to the business sector and are threatening to feed through to general borrowing rates. The weak level of sterling is also hitting exporting industry, although this pressure has eased in recent days as the British currency gained ground. The fight to defend the pound is taking a heavy toll on the economy and, as Mr Ahern conceded, we cannot "stagger on indefinitely" under current conditions.

The Irish authorities might be able to share in a general ERM realignment. But the French and Danish governments are both strongly resisting such a move. They will only move if their currencies come under intolerable pressure.

The commitment of the German and French governments to defend the franc/deutschmark exchange rate — the "sweetheart deal", as Mr Ahern called it — could help protect the franc, at least until after the French elections in March. By then German interest rates could be on the way down and the general ERM tensions easing.

The option of a unilateral devaluation of the pound

might call into question the future viability of the Irish pound's membership of the exchange rate band by demonstrating clearly the impact of sterling weakness on the currency.

A further fall in sterling, which is now unlikely to go back into the ERM for some time, could lead to renewed pressure on the Irish currency. And if the markets did not believe that a devaluation was

substantial enough and did not have confidence in the new exchange rate, funds would not flow back into the pound and interest rates would remain high.

The positive side is that a devaluation would help exporting industry and, if sizeable enough, say 10 per cent or so, should allow interest rates to fall in the months ahead, as the Central Bank rebuilt its external reserves.

How serious the damage to the long-term credibility of the pound is open to question; at the moment, events in the currency markets show that the currency does not inspire much confidence among international investors as it is. A sharp rise in sterling might, of course, change this picture.

Over the past few months the Irish authorities have had to resort to numerous weapons to defend the cur-

rency, a development which has damaged seriously the reputation of the Irish financial market and will make overseas investors think twice, or demand higher interest rates, before investing here in future.

During the crisis, overseas institutions with holdings of Irish Government gilts have found how difficult it is to hedge their holdings in the Irish market, something they do as a matter of course elsewhere. Last year the exchange controls stopped them borrowing Irish pounds from the Irish financial institutions in order to hedge their exposures. This year the controls have gone, but punitive Central Bank interest rates make it prohibitively expensive to engage in hedging, which they wish to do to limit their losses

if there is a devaluation. The Dublin foreign exchange markets have effectively been closed down periodically since September as the authorities defended the currency.

The risks of a devaluation and the difficulties the pound might face in re-establishing its position in the ERM have led some private sector analysts to suggest privately that the authorities might yet resort to floating the pound on the foreign exchange markets, perhaps with the intention of rejoining the system at a later date. Questioned on Tuesday about the floating option, Mr Ahern said it was "an argument in the equation" which the new Government would examine. This would certainly allow interest rates to fall, although letting the currency fall too far would carry obvious inflationary risks.

The Irish authorities would be reluctant to take this step, with no experience of managing a floating exchange rate. They may feel that the Irish pound is too small and the financial market here too underdeveloped to make it a viable option.

Paired with these considerable uncertainties about the Irish position is considerable scepticism about the whole future of the EMU process, as laid down in the Maastricht treaty. The swing of German public opinion against the project is particularly striking, and the Bundesbank is loath to cede its authority to a European central bank. Other EC states, stung by high German interest rates, may also now be less enthusiastic about the EMU project.

These factors have led to speculation that a small group of states could move ahead to close monetary integration; Holland and Germany, for example, are already effectively a deutschmark zone, with very little variation between it and the guildler.

But the viability over the next year or so of a wider move to closer integration, perhaps also involving France and Belgium, is open to serious question. The Bundesbank would insist that it would run any such arrangement. For France, that would destroy the rationale for the move to EMU, which is to get at least one hand on the monetary levers of Europe. The political viability of such a move is also doubtful.

The domestic and international uncertainties have thus undermined, in a few short months, one of the central elements of Irish economic policy. The central question for Irish policymakers is how to try to revive the Irish economy, while at the same time trying to hold our position in an uncertain Europe.

Exhibit VII. Excerpts from *The Irish Interest Rate Outlook*, Davy, January 1993.

Excerpt 1

Ireland: The Present Position Cannot Be Sustained

The present combination of Irish Pound interest rates and exchange rates can only be sustained at high cost to production and employment. A significant proportion of the output and jobs lost would be permanent. Interest rates aside, the current Sterling exchange rate, if sustained, would result in a fall in output and employment given the existing cost structure of Irish industry. The STG/IEP rate has risen by 13% since early September and the timescale involved, as much as the magnitude of the change, poses severe problems of adjustment for the exposed sectors of the economy.

Despite this, no coherent package of adjustment measures has been introduced. The PESP pay increases for 1993, for example, which will confer a substantial unearned windfall gain in purchasing power on employees, at current exchange rates, appear to be sacrosanct. Against this background the 3% hike in retail interest rates that occurred in September and the more recent and extraordinary increases for corporate borrowers have only served to reinforce perceptions that the current exchange rate policy cannot continue for long.

Since September the authorities have played for time largely in the hope of something happening at a European level to alleviate the situation. The principal focus of such hopes would appear to be the prospect of a general ERM re-alignment involving a devaluation of the French Franc and the Danish Krone.

Little Chance Of Relief From External Factors

For Ireland the menu of external events that would satisfactorily resolve the exchange rate/interest rate impasse is more demanding than that which pertains to Denmark and France. This is because of Sterling's importance to Ireland, not only in relation to trade, but also in relation to the behaviour of domestic interest rates. For the past decade or more, and particularly for the

1987-92 period, Irish interest rate differentials vis-a-vis Germany have been powerfully influenced by movements in the Sterling/Irish Pound exchange rate.

This indicates that, notwithstanding the stability of the DM/IEP exchange rate in recent years, not to mention the dramatic improvement in Ireland's financial fundamentals, the Irish Pound has had to offer a substantial Sterling-related risk premium. It also indicates that the credibility that the Irish Pound has enjoyed within the ERM has been highly conditional on Sterling remaining relatively strong.

Our analysis suggests that, in circumstances where the Irish Pound continues to participate in the ERM, the differential between Irish and German interest rates will decline to the type of margins that obtained before the September crisis only if the Sterling/Irish Pound exchange rate falls towards its trend value of 95-96p. Again assuming that the Irish Pound stays in the ERM, there are values of the STG/IEP exchange rate above this that would allow the level of Irish interest rates to fall below 10% provided German interest rates fell far enough. But the prospects of any of the combinations concerned materialising much before the last quarter of 1993 are slight. Moreover many of these combinations would be inimical to the needs of the Irish economy since they would involve levels of domestic interest rates much too high relative to our main trading partners, and a STG/IEP exchange rate that would continue to pose significant adjustment problems.

Probability Of Exchange Rate Change Is Very High

Ireland faces an acute dilemma. Its broad exchange rate options are as follows: (i) to maintain the Irish Pound's current ERM parities; (ii) to devalue within the ERM; (iii) to re-establish a link with Sterling, and (iv) to allow the Irish Pound to float. For different reasons each is unattractive to the authorities. The third option would reverse an historic decision made 13 years ago and enshrined since as a fundamental

principle of economic policy. The fourth would require Ireland to pursue an independent monetary policy for the first time ever with all the hazards that would entail.

The authorities' strongest instincts will prompt them to maintain the status quo for as long as possible. This will entail interbank rates remaining at or close to current levels and will probably require that the authorities increase their foreign currency liabilities substantially further. Predicting when the breaking point might occur is difficult. Our judgement is that if a fresh round of retail interest rate increases became unavoidable that point would be reached. In this regard the period of highest risk is the immediate aftermath of the abolition of exchange controls on January 1st. It is hard to believe that the total elimination of controls would be consistent with the status quo for more than a few days. Of course, emergency measures may be invoked to inhibit the freedom of capital movement. This might limit outflows after January 1st but would hardly stop them completely.

However the exchange control issue is dealt with, there must be a high probability that a stream of business closures and/or lay-offs will force a change in exchange rate policy early in the new year. In that event, the authorities' instincts again are likely to favour retaining as much of the status quo as possible. This suggests a devaluation within the ERM rather than recourse, at least initially, to either of the more radical options mentioned above.

Interest Rates May Be 8% Or Lower By Year End

The implications of an Irish Pound devaluation within the ERM are complicated by the overall situation in the system. A unilateral Irish move would probably increase the pressures on the Franc and Krone and intensify speculation about these currencies floating. If they were to float, it would leave the Irish Pound in a strange position: still retaining a DM link, albeit at a lower central rate, but perhaps sharing that link only with the Benelux currencies.

Thus, in the event of a unilateral Irish Pound devaluation, some uncertainty would continue to attach to Irish exchange rate policy, independently of the subsequent behaviour of the STG/IEP rate. This might attenuate the interest rate benefits of such a move, though not by much in our view, since we feel that the impact of a lower STG/IEP exchange rate would dominate the effects of residual exchange rate uncertainty. Moreover that uncertainty would probably revolve around speculation that the re-establishment of a formal Sterling link would be the next step. Indeed that is our view of what would happen if the Franc and Krone were to float.

As we see it, there is no plausible scenario under which Irish interest rates (wholesale and retail) would not end 1993 substantially below current levels. We have examined three such scenarios: (i) the DM/IEP parity remains unchanged; (ii) a unilateral 8% devaluation of the Irish Pound occurs within the ERM, and (iii) some link with Sterling is re-established.

The differences between these scenarios reside in the levels at which interest rates would end the year and the timing of reductions in the meantime. The status quo presents the least favourable outlook: retail rates might not be cut until Q2 but could be reduced by a further 3-3.5% over the balance of the year, yielding a cumulative reduction of 4-4.5% for 1993 as a whole. In the straightforward devaluation case the cuts come sooner (2% or more in Q1) and the cumulative reduction over the year could be 6%. In the scenario where a sterling link is re-established the reductions would likely be both deeper and quicker to materialise. Here, retail rates could end the year 7-8% below current levels.