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**The Experience of Monetary Union – Ireland and Spain**

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## **Introduction**

The years preceding the start of Economic and Monetary Union in 1999 saw very extensive debate in the academic literature about the costs and benefits of the new union and how it would affect individual economies. It was also widely recognised that it represented a very significant regime shift and that it would have important implications for how individual member economies were managed in the future. As anticipated, joining EMU has changed the agenda for economic policy makers in all the participating member states. Indeed, the European institutions have been slow to realise the full implications of the changed policy environment, in spite of the obvious change in legal regime (Mathieu and Sterdyniak, 2004). The same is also true of national governments.

These issues are not new in the sense that they are faced every day in long-established monetary unions, such as the United States. However, the absence of an economic "history" of the new union has potentially made the European monetary union more difficult to manage. The Irish and Spanish economies provide an interesting test case on how "one size fits all" monetary policy plays out in practise. This experience of "EMU in practise", and how it contrasts with the expectations prior to 1999 ("EMU in theory") can provide useful guidance in considering the appropriate time path for the New Member States (NMS) in joining EMU.

Economies experiencing strong output growth would expect some real appreciation of the exchange rate. This has been the experience of both Spain and Ireland since 1999. In a currency union, nominal appreciation cannot be relied upon so that real exchange rate appreciation comes about through higher wage growth and inflation than in competitor countries. Higher productivity in the traded sector of the economy is likely to push up prices in the non-traded sectors by allowing real wages to increase through a Balassa-Samuelson type effect. Irish and Spanish consumer prices have risen by an average of 3.8 per cent and 3.2 per cent respectively each year since the start of EMU to end-2004, well in excess of the average for the EMU of 2.1 per cent.

In addition to more rapid growth, both Spain and Ireland have experienced a housing boom in recent years. The extent of the sustained rise in house prices is causing concern, especially in Ireland. To some extent this development may have been caused by the more stable monetary environment under EMU. However, the management of such booms is also much more difficult under EMU where monetary policy is driven by the needs of the broader Euro area economy.

Section 2 discusses the ex ante expectations as to how EMU would play out and Section 3 contrasts this with the actual outturn. The implications of the experience of EMU in Spain and Ireland for economic policy-making in regional economies within the EMU is discussed in Section 4 and conclusions with respect to the implications for the New Member States (NMS) are presented in Section 5.

## **Expectations for EMU**

The potential costs and benefits of EMU were first considered in detail in the EU Commission *One Market One Money* report published in *European Economy* in October 1990. While many potential

effects were identified in that report the subsequent debate on the costs and benefits of EMU centred on two key issues:<sup>1</sup>

- Arising from the literature on optimal currency areas, were the potential new members likely to form an optimal currency area? If they did not, what were likely to be the costs for individual countries such as Spain and Ireland of joining such a union arising from country-specific shocks?
- The second major issue concerned the likely credibility gain from membership; the abolition of the risk premium that had applied to borrowing in currencies other than the DM over the previous twenty years.

The possible gains from savings in transactions costs were felt likely to be small and the possible effect on foreign direct investment, an important issue for Ireland, were also considered to be unquantifiable, but probably not hugely significant.

The subsequent academic debate tended to concentrate on the first of these issues. There was much concern that country specific shocks within EMU could pose major problems for those affected because the exchange rate would no longer be available to ease adjustment. In the case of both Ireland and Sweden all the costs and benefits were considered in specially commissioned reports undertaken in 1996 (Baker *et al.*, 1996 and Calmfors, 1997).

Table 1: Excess Returns from Borrowing in DMs and lending in local currency

	1980-1998	1985-1998
Ireland	2.0	1.6
Spain	1.4	1.9
UK <sup>2</sup>	2.1	

One of the key long-term reasons why membership of EMU was considered desirable for Ireland was the expected impact on interest rates and the cost of capital – the second issue identified above. For countries such as Spain and Ireland historically there was a significant risk premium attaching to borrowing in their own currency relative to borrowing in DMs. Table 1 shows a measure of the risk premium, the excess returns from borrowing in DMs and lending in the local currency for two time periods, 1980-1999 and 1985-1999. This shows that for those who borrowed in the local currency, especially for the household sector, a significant risk premium was payable as a cost of having an independent currency. Multinational firms trading on the world market always had the opportunity to borrow in DMs, availing of the lower cost of finance.

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<sup>1</sup> The issues were considered in a report prepared for the Department of Finance by Baker *et al.*, 1996. For a debate on the likely effects of asymmetric shocks sees Barry, 1998 and Fitz Gerald, 1998.

<sup>2</sup> For the UK it is 1979-1998.

When the decision on membership was made in Ireland in the mid-1990s there was extensive evidence from 15 years of monetary independence, as illustrated in Table 1, that independence was bought at the cost of much higher interest rates (Honohan, 1993). In the light of this evidence, the 1996 study of the prospects for Ireland in EMU (Baker *et al.*, 1996) took the view that with a well managed economy the excess returns in the long run would fall to one percentage point if Ireland were to remain outside EMU. The cost of such a permanent wedge in the cost of capital was considered to be still quite high. It would have resulted in the economy underperforming on a long-term basis, as investment was kept below its potential.

A Swedish government report (Calmfors, 1997) on EMU entry that paralleled the Irish report also considered this issue. They too found that in the past there had been a significant risk premium attaching to Swedish kroner borrowing. However, in the Swedish case it was felt that, with rational markets and good management of the economy, the premium would eventually disappear.<sup>3</sup>

The most significant potential cost for the Irish economy from EMU membership was expected to arise from the increased policy inflexibility, due to the loss of an important instrument - monetary policy. In the 1996 report, a number of scenarios were considered to see how the economy would react to shocks both in and out of EMU. What these simulations showed was that there were likely to be significant costs arising from the loss of flexibility consequent on EMU membership. In particular, in 1996 a sudden major loss of competitiveness against sterling would have imposed substantial temporary costs on the Irish economy.

The possible benefits from increased competition were not expected to be very significant, given the changes that had already taken place as a result of the completion of the internal EU market (Bradley, Fitz Gerald and Kearney, 1992). This contrasts with the study for Sweden (Calmfors, 1997), which expected significant benefits from this channel.

The report on Ireland came to the conclusion that the likely benefits from a reduced risk premium would more than outweigh the costs from a reduced flexibility in the face of future country specific shocks. In the case of the report on Sweden the opposite was felt to be the case – that there would be a small economic cost to joining EMU but that it was still desirable to do so for political reasons.

### ***Experience of EMU***

As outlined above, the three areas where EMU was expected to make a significant difference were in terms of credibility and interest rates, in terms of competition and inflation, and in terms of the response of a regional economy, such as Ireland, to asymmetric shocks.

It is no surprise that the successful implementation of EMU led to the predicted credibility gain for a number of the participants. The gains were particularly significant for Italy, Spain and Ireland (Sinn, 2000). The fall in risk premia on interest rates in anticipation of EMU greatly facilitated the Italian

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<sup>3</sup> The counterfactual to the current situation is not the pre-EMU environment. Both Baker *et al.*, 1996 and Calmfors, 1997 argue that good management of the Irish and Swedish economies respectively would have resulted eventually in a fall in the risk premium. However, while Calmfors anticipated that it would eventually be eliminated for Sweden, Baker *et al.* argued that good management over the 1990s had not eliminated the premium and that it would have been likely to remain significant for the foreseeable future.

government's fiscal adjustment programme. Compared to the pre-EMU situation, this reduction in interest rates must raise the optimal long-run capital stocks for those countries, with a positive impact on growth rates. The corollary of the reduction in interest rates has been a cost for Germany and the Netherlands. However, Sinn, 2000, argues that the overall impact of these changes would be to increase the efficiency with which capital is used in the Euro area.

Probably more important than the immediate reduction in interest rates was the greater certainty that EMU gave about the future cost of capital. Using a model of central bank behaviour, Faust, Rogers and Wright, 2001, have modelled what might have happened to interest rates in individual Euro area economies if EMU had not taken place. Using realistic parameters, in a model of potential output similar to that used by the EU and similar to the model that probably underlay international market expectations, their approach would suggest that interest rates in Ireland would have risen to 10 per cent or more in the late 1990s and that in Spain they would have peaked at 8.6 per cent in 2000. Such exceptionally high interest rates would have resulted from the fact that the method used to model potential output, especially in the Irish economy, greatly underestimated its true potential. This was reflected in the incredulity with which much financial market comment greeted the late 1990s Irish experience. Similar doubts were also expressed about Spain's impressive performance.

The result of such a rise in interest rates would certainly have been an avoidance of the rise in inflation from 2000 onwards. However, it would also have choked off the boom in Ireland well before full employment was reached and earlier than would have been necessary to avoid the inflation that actually occurred. Thus the full benefits of the boom of the 1990s might not have been achieved without membership of EMU.

There is a lesson from this experience for accession countries. Where countries' potential growth rates are uncertain, EMU can avoid the danger that growth may be choked off prematurely through an unnecessary rise in interest rates. The cost of this additional insulation is, of course, that interest rates will be insensitive to inflationary (or deflationary) dangers in individual economies.

There is some evidence that the advent of EMU also changed pricing behaviour by UK firms selling into the Irish market. A shift to pricing in Euros from the previous practise of pricing in sterling probably resulted in some change in inflation dynamics (Fitz Gerald, 2001). Inflation in the late 1990s was probably slightly lower than would have been the case without EMU but a catch up effect in 2000 and 2001 saw a high rate of inflation in Ireland. The importance of exchange rate effects on inflation differentials in EMU has been analysed in Honohan and Lane, 2003. However, while there is some evidence of a change in the dynamics of inflation, there is as yet, little evidence that EMU has created a more competitive environment as envisaged by the Calmfors, 1997, study for Sweden.

The third major effect expected to arise from monetary union was reduced flexibility for national economies in the face of external shocks, as monetary policy ceased to be an instrument for managing the regional economy. In the case of Ireland, the fall in interest rates, while undoubtedly of long-term benefit to the economy, took place at a time when the economy was already booming. As such, it has complicated the management of the economy in the short term.

In 2001 and early 2002, the Irish economy was suffering from excess demand due to it being "too competitive". The excess demand came as much from the external sector as from domestic demand (Blanchard, 2001). This was reflected in the balance of payments, which has remained close to balance

over the last 3 years, in spite of the very rapid growth in the economy. The result of the growth in demand was a very rapid rise in wage rates (forecast to be over 10% for 2001). The share of labour in value added fell steadily since the early 1980s, indicating an improvement in underlying competitiveness. However, this could not continue indefinitely and a real appreciation<sup>4</sup> was needed to reduce competitiveness and to bring demand into balance with supply in the labour market (Walsh, 1999). This reversed the trend growth in profitability.

Blanchard, 2001, considered the appropriate adjustment process for both Ireland and Spain. He concluded that, because of Ireland's relatively strong balance of payments, the adjustment should have come through a combination of wage inflation and some fiscal contraction. In the case of Spain, because of the starting position of a balance of payments deficit, it was appropriate that the bulk of adjustment should be undertaken through a tightening of fiscal policy. Such a nuanced approach to fiscal policy in regions of the Euro Area needs to be further developed by the EU Commission.

### ***Economic Policy in a Regional Economy***

The move to a monetary union changes the nature of the inflationary process in each of the member states. It is the job of the central bank of the union, in Europe's case the ECB, to control the rate of inflation for the Union as a whole. With a common currency and free movement of goods, in the long run, the regional rates of inflation in goods prices can not diverge from the inflation rate for the monetary union as a whole. As a result, the Governor of the US Federal Reserve does not worry about the rate of inflation in Wyoming! While there is significant divergence in the rates of inflation in consumer prices within the new EMU this need not necessarily be a cause for concern.

The advent of monetary union also removes the potential concerns that managers of individual economies have traditionally had concerning the balance of payments. In a monetary union, the balance of payments effects of excess demand do not feed back on the economy through exchange rates or other monetary effects. Unless domestic agents' indebtedness rises to such an extent that the risk premium on lending rises, there is no direct effect through this channel on domestic activity.

Domestic policy concerns about inflation within a regional economy in EMU should focus primarily on domestic wage rates, and domestic asset prices. In the case of wage rates, with inflexible labour markets, it is quite possible for wage inflation to result in significant regional unemployment. It is also possible for regional asset price bubbles to significantly disrupt regional economies.

**Table 2: Number of dwellings completed per thousand population**

Country	1992-3	2000-3
Denmark	3.1	3.0
Finland	7.3	5.9
Greece	8.3	8.5
Ireland	6.3	17.3
Netherlands	6.0	4.1

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<sup>4</sup> Where the cost of labour in Ireland, measured in a common currency, rises relative to costs in competitors.

Poland	3.5	2.7
Portugal	5.6	10.3
Spain	3.3	10.2
United Kingdom	3.3	3.1
United States	4.5	6.1

Source: United Nations Economic Commission for Europe. UK - UK ONS. US - US Census Bureau New Residential Construction. Spanish data for 1993, all others 1992. Irish data for 2003, Netherlands, Spain, UK and US data for 2002. Greece data for 2000. Rest data for 2001.

For those countries where living standards have shown significant convergence to the EU standard of living (Ireland, Portugal and Spain) the relatively high number of adults per dwelling, combined with increased real incomes could be expected to result in a major increase in investment in dwellings by the household sector. It will take many years of high investment to reduce the number of adults per household in the new member states to close to the rate in the more developed EU members.

The effect of EMU has been to reduce the cost of borrowing for households, increasing the optimal stock of dwellings. Previously households were constrained from rapidly adjusting this stock through investment because of the high and uncertain cost of capital. Even though incomes rose fairly steadily over the last fifteen years it was only with the advent of EMU that there has been a boom in the building of dwellings in Spain, Portugal, and Ireland (Table 2). While this boom is not purely attributable to EMU, as discussed earlier, the advent of EMU has brought about a substantial fall in real interest rates for households through the reduction in the risk premium (Sinn, 2000). This reduction in real interest rates was particularly important for households as, unlike businesses, they did not benefit from the lower real rates by borrowing in DMs.

The situation in the New Member States today is rather different. In some of these States households are resorting to borrowing in foreign currencies at nominal interest rates well below domestic rates. While this approach avoids the risk premium on domestic rates it carries serious dangers. The risk premium reflects true risk and a major increase in foreign borrowing by households could leave these economies very vulnerable to shocks outside of EMU.

In addition to its potential effects through the labour market, fiscal policy can also influence the allocation of resources within the economy by changing incentives. For example, fiscal policy can have a significant impact on the domestic housing market through changing household disposable income and through changing the cost of capital for homeowners. The tax treatment of interest payments on house loans can affect the cost of capital for homeowners. Because the legal instrument under which mortgage lending takes place is country specific, the taxation or subsidisation of mortgage interest payments is not affected by the country of residence of the financial institution making the loan.<sup>5</sup> As a result, while there is free movement of capital this does not render domestic tax measures ineffective.

To date the fiscal policy instrument has not been used actively in Ireland or Spain to reduce excess demand for housing in the current boom. Within EMU it remains possible for the government to eliminate interest relief on mortgage interest payments (Ireland) in the income tax code (or even to tax them). This could raise the local cost of capital for households considering investing in housing, while

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<sup>5</sup> While UK financial institutions are lending in Ireland on Irish housing without having an office in Ireland, the mortgage must be registered in the country where the property is located.

the Euro interest rates are the same as in other Euro area countries. In addition, there is a range of other fiscal measures that could directly reduce demand pressures in the building sector.<sup>6</sup> The need to create such an instrument for managing possible inflationary bubbles in the housing market within EMU was recognised by the UK Treasury (2003).

An example of a regional asset bubble was the boom and bust in property prices in the region of the Federal Reserve Board of Kansas (10<sup>th</sup> District) in the mid-1980s. The regional economy was not protected from this bubble by membership of monetary union and it suffered significant disruption when the local economy suffered from a simultaneous shock to two key sectors, agriculture and energy. As a result, property prices collapsed and this caused major problems for the local banking system.

Similar problems occurred in Scandinavia in the late 1980s and in the UK in the early 1990s, though in those cases the problems were aggravated by rising interest rates, related to exchange rate fluctuations. Within a monetary union such asymmetric shocks would not have knock-on effects through raising interest rates. As a result, provided that the domestic banking system is perceived as sound, local problems from bursting local property market bubbles are likely to be reduced inside a monetary union.

However, both the mid-west US crises in the mid-1980s and the Scandinavian crisis at the end of the 1980s were also characterised by local banking crises that aggravated the problems for the local economy. This highlights the continuing importance for regional Central Banks of maintaining financial stability within their countries. The current arrangements within EMU are less clear-cut than in the US on responsibility for dealing with any such crises that should occur in the Euro area in the future. Under these circumstances, prudent central Banking practises in regulating regional banking systems may be all the more important.

## **Conclusions**

The loss of monetary policy as a separate instrument for managing regional economies within EMU undoubtedly complicates economic management. The national balance of payments and inflation in consumer prices are no longer issues that should unduly concern national policy-makers. Instead, the potential problems posed by excessive wage inflation and inflexibility in regional labour markets are enhanced by EMU membership. As before EMU, bubbles in domestic asset prices, primarily in domestic property markets, still have the potential to destabilise the local economy. While monetary policy is no longer available to national policy-makers, suitable fiscal policy instruments can be deployed to target these specific problems.

For New Member States a key lesson from the first years of EMU is that membership, through reducing or eliminating the risk premium on interest rates, may result in higher investment growth, especially in housing. Possibly through good fortune rather than good design, countries in the Euro area have not so far experienced serious asymmetric (country-specific) shocks. However, this does not mean that they won't occur in the future. With serious internal imbalances (e.g. unemployment) still existing in many NMS the "option value" of maintaining an independent exchange rate is still

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<sup>6</sup> These include a withdrawal of special tax incentives for building.

significant. The Irish and Spanish experience illustrates how a reduction in interest rates, consequent on the elimination of the risk premium outside of EMU, can lead to a boom in the residential housing market. At least in the Irish case this boom is a significant cause for concern for the local economy. While under EMU monetary policy may no longer be available to domestic authorities to manage such a boom, a more targeted use of fiscal policy could achieve the same effect. However, this poses clear political difficulties. While households accept as normal Central Banks increasing interest rates in the face of rising prices (though they may not like it), they might be less forgiving of any government that sought to achieve the same effect by taxing interest payments.

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