



An Chomhairle Náisiúnta Eacnamaíoch agus Shóisialta  
National Economic & Social Council

**BACKGROUND PAPER**

### **3. European Monetary Union and Macroeconomic Stabilisation Policies in Ireland**

by Philip Lane (Commissioned by the NESD)





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## Abbreviations

**CBFSAI**  
Central Bank &  
Financial Services  
Authority of Ireland

**ECB**  
European  
Central Bank

**EMU**  
European  
Monetary Union

**ESCB**  
European System of  
Central Banks

**EU**  
European Union

**FSB**  
Financial Stability  
Board

**GDP**  
Gross Domestic  
Product

**IFSRA**  
Irish Financial  
Services Regulatory  
Authority

**IMF**  
International  
Monetary Fund

**MECB**  
Monitoring the  
European Central  
Bank

**NPRF**  
National Pension  
Reserve Fund

**SSIA**  
Special Savings  
Incentive Scheme

**SGP**  
Stability and  
Growth Pact

# 3

## BACKGROUND PAPER

# European Monetary Union and Macroeconomic Stabilisation Policies in Ireland

## 1. Introduction

It is timely to review Ireland's experience as a founding participant in European Monetary Union (EMU) after ten years of membership. In particular, the current international financial crisis has posed tremendous challenges for macroeconomic policy around the world and it is important to evaluate how EMU has performed in absorbing this major shock. Moreover, it is also appropriate to investigate whether EMU was a contributory factor in creating the vulnerabilities that has amplified and propagated the initial impact of the financial crisis. In developing an understanding of its implications for Irish macroeconomic policy, it is important to appreciate that EMU constituted a radical institutional innovation. By eliminating national currencies, the member countries lost the traditional option to devalue in response to negative economic shocks. In return, the member countries now shared monetary sovereignty through the newly-created European Central Bank (ECB), with the prospect of being better able to achieve area-wide price stability and respond more efficiently to common shocks. However, unlike the case for the United States, EMU largely restricted the pooling of sovereignty to monetary policy. In particular, the primary responsibility for fiscal policy and financial regulation remained with national governments.<sup>1</sup> Accordingly, the importance of national fiscal policy actually intensified upon the formation of EMU, since national monetary policy was no longer available to cope with country-specific shocks and (in the other direction) national policy errors could no longer be corrected via the devaluation option. Moreover, the quality of national-level stabilisation policies matter more for member countries of the euro area than for state-level governments in the United States, in view of the lower degree of economic integration across the euro area than across state lines in the United States.<sup>2</sup>

Accordingly, a primary focus of this paper is on the conduct of national stabilisation policies. We pay most attention to fiscal policy, since this is the main instrument available at the national level. However, we also analyse non-fiscal instruments, such as social partnership and national-level financial regulation. In what follows, we first characterise in Section 3.1 the general macroeconomic environment that has faced the euro area over the last decade. In section 3.3 we briefly review the performance of the ECB. In Section 3.2 we outline the country-specific shocks that have contributed to the divergence between Ireland and the rest of the euro area. Section 3.4 goes through some counterfactual scenarios in order to uncover how the Irish economy may

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<sup>1</sup> In the United States, state-level shocks are partly absorbed by the federal government, since net payments to the state from the Federal government rise during bad times and fall during good times. Regulation of the financial sector is largely conducted at the Federal level.

<sup>2</sup> As is documented by Blanchard and Katz (1992), much of the adjustment to regional shocks in the United States takes form of net migration flows. While this channel is also important for Ireland, the scale of cross-border migration in Europe is much lower than the scale of cross-state migration in the United States in response to economic shocks.

have performed outside EMU and describe the likely net impact of any move to exit EMU. Section 3.5 provides an evaluation of national stabilisation policies under EMU. Section 3.6 looks to the future, by describing some institutional reforms that may improve the quality of national stabilisation policies, and offers some concluding remarks.

## 2. The Macroeconomic Environment and EMU

In this section, we describe the evolving macroeconomic environment since the formation of EMU in 1999. It is essential to have a good appreciation of the global economic landscape, since the implications of EMU for the Irish economy can only be understood in relation to the prevailing forces driving the world economy. Next, we briefly review the performance of the European Central Bank (ECB) in operating an area-wide monetary policy, since the success of EMU from a European perspective depends on the quality of decision making by the ECB. Finally, we highlight a host of country-specific factors that were potential sources of divergence between the Irish economy and the general euro area economy. The role of national stabilisation policy for a member country under EMU is in managing such country-specific shocks.

### 2.1 Structural Changes in the World Economy

In identifying the macroeconomic impact of EMU, it is important to take note of that fact that European monetary union occurred in context of other structural changes in the world economy over the last decade. Among these were the growth in world trade and a massive increase in cross-border financial positions, the emerging market economies' increased share in world trade and output, the integration of Central and Eastern European economies into the EU and major global shocks such as the collapse of the technology bubble in 2000-2001, the 9/11 event, sharp fluctuations in commodity prices (around an upwards trend) and, more recently, the global financial crisis.

It is useful to divide the period since the formation of EMU in 1999 into three distinct phases. First, the transition from multiple currencies to a monetary union represented a major macroeconomic shift and this played out over 1999-2002. In addition, that period included the collapse of the technology bubble, the 9/11 recession and the major depreciation of the euro against the dollar.

The second phase, from 2003 to 2007 was marked by highly-liquid conditions in global financial markets, generating rapid growth in the balance sheets of many financial intermediaries, a surge in cross-border capital flows and significant downward pressure on long-term real interest rates. World capital markets were awash with liquidity during this period. Financial intermediaries searched for yield by taking on additional risk in areas such as sub-prime mortgages, low-grade corporate debt and sovereign debt. In addition, it was believed that innovations in the securitisation process enabled a superior re-allocation of risk, thereby expanding the range of eligible borrowers and target leverage ratios for financial intermediaries. The shift in financial markets contributed to increased dispersion and persistence in current account balances. Most obviously, the US current account deficit



expanded, with an increase share of the funding sourced from emerging Asia and oil exporters. While Europe collectively did not run a significant external imbalance, very large surpluses in countries such as Germany, Switzerland and Sweden were offset by large deficits in the periphery of the euro area (Ireland, Spain, Portugal, Greece), Central and Eastern Europe and financial innovators such as Iceland and the United Kingdom. The third phase began in Summer 2007 and is still ongoing. This phase has been dominated by the global financial crisis and the onset of a major global recession.

## 2.2 The Performance of the European Central Bank

It is generally agreed that the ECB has performed well in delivering price stability for the aggregate euro area economy. While there are certainly differences of opinion in relation to specific month-by-month interest rate decisions, the overall performance of the ECB in conducting monetary policy has exceeded prior expectations.<sup>3</sup> In relation to financial stability, it is commonly agreed that the liquidity operations of the ECB since the onset of the global financial crisis in Summer 2007 have been superior to those of the Federal Reserve and the Bank of England.

Since 1999, the euro area economy has indeed experienced major common shocks (as listed above), such that a common monetary policy has proved valuable. It seems likely that the previous European regime of multiple currencies would have delivered a non-coordinated monetary policy response that would have generated inappropriate shifts in intra-European exchange rates and a non-optimal degree of collective monetary adjustment. Indeed, history suggests that movements in intra-European exchange rates would also have been politically disruptive, spilling over into areas of policy cooperation at the EU level (Eichengreen 2003).

In addition to delivering intra-European cooperation, the formation of EMU has also enabled a superior global monetary response, given the ECB's participation in coordinated policy interventions. It is difficult to envisage a similar level of global policy coordination if each member of the euro area had retained its own currency.

In relation to common shocks, the major weakness of EMU has been in relation to the supervision of financial and banking systems. Financial supervision remained with national authorities upon the advent of EMU. However, the growth in cross-border financial flows and multi-country banking groups meant that financial stability was weakened by the absence of an EU-level supervisory authority. In particular, such a European-level authority could have provided the high-level view of macro-prudential risk at the international level that might have provided a better early warning signal about the risks being incurred by European banking groups during the securitisation boom. Greater European coordination would also have been helpful in managing the financial crisis. In particular, the recapitalisation of multi-country banking groups such as Fortis has proven to be problematic in the absence of coordination. Moreover, the initial lack of coordination in providing guarantees on the liabilities of national

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<sup>3</sup> A number of independent bodies conduct periodic evaluations of the ECB. See for example the Monitoring the European Central Bank (MECB) series that is published by the Centre for Economic Policy Research.

banking systems was clearly sub-optimal from a collective perspective.

Given the emergence of euro-denominated inter-bank market and the euro-denominated money and bond markets (see also Lane 2006, 2008) improved oversight of banking systems at the level of the euro area would enhance the capability of the ECB to efficiently provide liquidity services. The identification of these weaknesses led to the creation of the de Larosiere Committee in 2008, which issued its report in 2009. The recommendations of the Larosiere Report now form the basis for the negotiation of a new EU approach to financial supervision and regulation. Furthermore, the April 2009 G20 meeting took steps to improve global coordination of efforts to improve financial regulation and financial stability, with enhanced roles for the Financial Stability Board and the International Monetary Fund. We return to the international reform initiatives later in the paper.

However, it is important to appreciate that such new European-level and global-level entities will not replace the need for national-level supervision and regulation. The main focus of the international agencies will naturally be on the largest multi-country banking groups and international sources of systemic risk. Accordingly, the responsibility for smaller financial institutions and national sources of systemic risk will largely remain with the national authority. This is important, since the country-specific component remains an important driver of economic and financial cycles. Moreover, there is likely to be greater international interest in assessments of national financial systems, given the potential for the transmission of systemic risk across borders even if the original shock is purely national in incidence. In relation to the current crisis, a contributory factor to the general weakness in the euro area banking system has been the bursting of national property bubbles in Ireland and Spain and the exposure of Austrian banks to Central and Eastern Europe. Accordingly, the preservation of area-wide financial stability requires a mixed approach, in which both international and national sources of systemic risk are closely monitored.

As a final remark in relation to the ECB management of common shocks, it is also true that the global crisis poses significant challenges to the general intellectual framework that has guided monetary policy across the advanced economies over the last fifteen years. In particular, the 'inflation targeting' approach arguably paid insufficient attention to the importance of avoiding the emergence of bubbles and excess liquidity in financial markets. It may well turn out that the monetary strategies of the major central banks (including the ECB) will be revised in order to attach a greater weight to avoiding such bubbles in the future.

### 2.3 Ireland and EMU

In relation to the management of common area-wide and global shocks, the Irish economy benefited from participation in monetary union for the reasons outlined above. Moreover, Ireland also benefits from the microeconomic efficiency gains

associated with a single currency (Lane, 2006). However, the nature of a currency<sup>4</sup> union is that the ECB cannot respond to country-specific shocks or international shocks that affect individual member countries in offsetting ways. It so happens that Ireland has experienced several major idiosyncratic shocks since 1999 and these shocks have posed a challenge for national macroeconomic policy.

First, Ireland entered EMU at the peak of the Celtic Tiger output boom, with full employment only recently achieved and the emergence of shortages in the labour market. Accordingly, the initial conditions for Ireland were quite different than for the aggregate euro area economy. A standard prescription in this case is to revalue the exchange rate prior to entering the monetary union, such that price level pressures in the economy are diverted into nominal exchange rate appreciation rather than a differential post-entry inflation rate. While Ireland undertook a small revaluation in Spring 1998, this was inadequate given the scale of the boom.<sup>5</sup> Accordingly, the undervalued conversion rate between the Irish pound and the euro contributed to the inflationary pressures in Ireland in the early years of EMU.

Second, the creation of EMU itself represented an asymmetric shock. In particular, while the 'core' member countries had experienced a convergence in interest rates long before the formation of EMU, there was a substantial decline in interest rates for peripheral member countries such as Ireland, Portugal, Spain and Greece. Accordingly, EMU represented a major economic shock for these countries, since devaluation risk and currency liquidity risk were eliminated. As such, holding fixed other factors, households, firms and the governments in these countries now faced a permanent reduction in the cost of capital. This triggered an expenditure boom in these countries (see also Fagan and Gaspar 2007).

Third, by virtue of its greater involvement in extra-EMU trade, Ireland was more affected by shifts in the external value of the euro than was the case for other member countries. In particular, the sharp depreciation of the euro against the dollar during 1999-2002 represented a positive differential shock for Ireland vis-a-vis the rest of the euro area, since the strong economic linkages between Ireland and the United States meant that Irish competitiveness was boosted by more than in other countries. This contributed to the already-strong aggregate demand conditions in Ireland during that period and the positive inflation differential between Ireland and the rest of the euro area (Honohan and Lane 2003, 2004). More recently, the rapid depreciation of Sterling against the euro during Autumn 2008 has affected the Irish economy more than other regions in the euro area.

Fourth, the effective segmentation of national banking systems that remained even after the formation of EMU meant that shifts in market structure in the Irish banking system were not replicated elsewhere. In particular, aggregate credit growth in Ireland was boosted by the rise of Anglo-Irish Bank as an aggressive lender to property developers, which in turn induced a relaxation of lending standards by other

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4 See Lane (2006) for a review. It is beyond the scope of this paper to examine the welfare impact of EMU in terms of these microeconomic gains, since our focus is on macroeconomic stabilisation policies.

5 Lane (1998a) recommended that Ireland undertake a much larger revaluation. Slovakia revalued by 15 percent in 2008 before it joined EMU at the beginning of 2009..

participants in the Irish loans market (Honohan 2009a, 2009b). Such a country-specific component in credit conditions contributed to faster expansion in Irish aggregate demand relative to other members of the euro area.

Fifth, there have been major shifts in government spending and taxation in Ireland relative to other members of the euro area since 1999. Membership of a monetary union is perfectly consistent with a wide range of variation in terms of the ratios of government spending and tax revenues to GDP. However, the timing of the fiscal expansion has been pro-cyclical in nature, such that fiscal policy has tended to amplify cyclical divergences between Ireland and the rest of the euro area economy.<sup>6</sup>

Sixth, the asymmetric liberalisation of EU labour markets to migrants from the new member states in 2004 represents a further idiosyncratic shock. In particular, Ireland was the only member of the euro area to open its labour market to workers from Central and Eastern Europe and only the United Kingdom and Sweden adopted a similar approach among the existing members of the EU. The scale of post-liberalisation migration far exceeded ex-ante expectations, acting as another structural shock for the Irish economy that was not shared by its fellow members of the euro area.

Taken together, these country-specific factors have meant that macroeconomic stability in Ireland required effective national stabilisation policies. As it turned out, macroeconomic and financial imbalances accumulated in Ireland, rendering it especially vulnerable to the global financial crisis that has gripped the world economy since Summer 2007. National stabilisation policies are discussed further below.

## 2.4 Counterfactual Scenarios

In order to understand the implications of EMU for Irish macroeconomic performance it is useful to consider some counterfactual scenarios in order. The two main alternative cases are: (a) Ireland never having joined EMU, retaining its own currency when EMU was formed in 1999; and (b) Ireland opting to leave EMU and re-launch an independent currency.

In relation to the former scenario, the experiences of those European countries that did not adopt the euro offer mixed evidence. For mature, advanced economies with a strong tradition of monetary independence, it is feasible to chart an independent course, with the domestic central bank focused on delivering price stability and the protection of financial stability. This group includes the United Kingdom, Norway, Sweden and Switzerland.<sup>7</sup> For such countries, part of the response to a recession involves nominal currency depreciation and each of these countries has tolerated a slide in the value of the national currency. Since the central banks of these countries are highly respected, currency depreciation does not affect the confidence of markets that inflation rates will be kept under tight control. Moreover, the mature development state of these economies means that there is an active market in local-currency debt instruments

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<sup>6</sup> Lane (1998b, 1998c) and Hunt (2005) analyse the long-standing procyclical pattern in Irish fiscal policy.

<sup>7</sup> Denmark has followed a divergent path by pursuing a fixed exchange rate against the euro. This has been maintained throughout the crisis but this has required Denmark to offer an interest rate premium relative to the ECB rate, despite the fixed exchange rate.

and the scale of speculative capital flows for these economies is relatively limited. Nevertheless, the monetary independence of even these economies have been constrained by growth in cross-border financial integration.

A second group of countries has different characteristics. First, financial underdevelopment means that there is only a limited appetite for local-currency debt instruments such that firms, households and governments are more likely to incur foreign-currency liabilities. Second, the central bank in such a country may not have a long tradition of maintaining price stability, such that investors do not have a deep level of confidence about the capacity to maintain low inflation. Third, the variable nature of the convergence process means that the output growth prospects tend to be quite volatile, with periods of optimism rotating with periods of pessimism in terms of the speed at which these countries will catch up with the highest-income group of countries. Fourth, such countries tend to be more reliant on foreign capital as a source of technology transfer. For these reasons, speculative capital flows play a more prominent role than in the more mature advanced economies. In turn, the exchange rate is less likely to play a stabilising role.

To see this, consider the boom-bust cycle for such an economy. During a boom period, there is much optimism concerning growth prospects for the economy. Accordingly, there tends to be strong capital inflows, leading to currency appreciation, growth in domestic asset prices and overheating pressures. This poses a dilemma for the central bank, since efforts to cool the economy through a hike in interest rates may only attract further capital inflows in response to the higher yield. Moreover, a large gap between domestic-currency and foreign-currency interest rates will encourage domestic entities to switch to foreign-currency debt in order to save on interest costs.

In symmetric fashion, a downturn in local production and asset markets may be amplified by a sharp increase in capital outflows. While the currency depreciates, the stimulatory impact will be offset by a need to raise interest rates in a bid to retain some capital in the domestic system. Moreover, the burden of foreign-currency debt increases due to the adverse impact of currency depreciation on the ability of domestic entities that rely on domestic-currency income streams to repay foreign-currency debt. Since the domestic banking system may have significant foreign-currency liabilities, this process may trigger a banking crisis, since the domestic central bank cannot provide the required foreign-currency liquidity. Accordingly, the scale of the recession may be quite deep, in view of the adverse interactions between deterioration in financial conditions and declines in the level of real activity.

For this group of countries, the management of the exchange rate takes on great prominence in the operation of monetary policy, in view of the costs of excessive swings in the currency. Given the general volatility in currency markets, the likelihood of making significant policy mistakes is non-trivial, with the central bank either too conservative (thereby running the risk of choking otherwise-sustainable increases in growth) or insufficiently cautious (with an insufficient response to overheating pressures) and possibly oscillating between these two states.

In relation to the current crisis in Europe, the destabilising currency and interest rate dynamics that can play out in emerging economies have been most vividly illustrated by the meltdown of the Icelandic financial system. At the time of writing, these pressures are weighing heavily on a number of Central and Eastern economies, with a variety of strategies being adopted in relation to currency management. A number have already required international support in the form of foreign-currency official loans.

Ireland represents an intermediate case, in that it shares some characteristics with the former group but is also quite similar to the latter group along some key dimensions. In particular, the extraordinary 'Celtic Tiger' growth narrative would plausibly have led to considerable speculative capital flows and strong currency appreciation, posing severe stabilisation challenges if Ireland had remained outside EMU. Moreover, the global liquidity glut during the 2003-2006 period would have encouraged the accumulation of significant foreign-currency debt by Irish banks, corporations, property developers and households, especially if domestic interest rates were high relative to foreign-currency interest rates. In turn, the onset of the current financial crisis could have triggered a destabilising speculative capital outflow (with both foreign and domestic investors seeking to exit), currency depreciation and a more complex type of banking crisis, where financial difficulties could have been augmented by a severe foreign-currency debt problem and an inability of the Irish central bank to provide sufficient foreign-currency liquidity to domestic banks. By this scenario, membership of EMU has provided considerable insulation from the full potential impact of the crisis, since adverse currency dynamics have been avoided and the ECB has acted as the liquidity provider to the domestic banking system.

Another hypothetical scenario is for Ireland to seek to leave EMU, in order to engineer a nominal depreciation of the national currency. There are two types of potential gain from such an exit strategy. First, a slide in the exchange rate has the potential to boost economic activity, by improving international competitiveness. For this to happen, the currency depreciation cannot be accompanied by increases in the levels of domestically-determined prices and wages that would just serve to cancel out the pro-competitive effect of currency depreciation.

The second potential gain is that Ireland could pursue a more expansionary monetary policy on its own than it currently pursued by the European Central Bank. Since the ECB has cut the policy rate to a very low level and is engaging in substantial de facto credit easing through its long-term repo scheme, the main extra tool that could be implemented would be to establish a significantly higher medium-term inflation target than the ECB target of 'close to 2 percent'. The potential gain from a pro-inflation strategy is that the real burden of outstanding domestic-currency debt would be diminished through the decline in the real value of the domestic currency.

However, there is a fundamental conflict between this strategy and the competing desire to boost competitiveness. In particular, a pro-inflation strategy would mean that currency depreciation would be accompanied by similar increases in domestic prices and wages, such that there would be no persistent gain in international competitiveness. Moreover, current depreciation would exacerbate the burden of repaying foreign-currency debt. While it may be argued that euro-denominated debt could be forcibly converted into punt-denominated debt at the time of leaving EMU,

such an action would constitute effective default. Since debt default could be pursued without leaving EMU, that element is analytically distinct from the case for exiting. Moreover, forced currency conversion would constitute a blanket approach to default and would place the State in the centre of the default event, leaving it exposed to legal cases even in respect of private-sector debt. The high level of financial integration between Ireland and the international financial system means that a blanket default would be much more costly in terms of its disruptive impact in comparison to those countries that have a relatively-closed domestic financial system.

In addition, there are prohibitive logistical difficulties in planning an exit from EMU (see Eichengreen 2007 for a detailed analysis). Most importantly, if such an exit were anticipated, domestic and foreign investors would rush to withdraw funds from the domestic financial system, deepening the financial crisis and attenuating any potential gain from launching a new currency. As a practical matter, the capital flight could only be controlled by the imposition of capital controls, in violation of Ireland's EU treaty obligations. By renegeing on such a major institutional commitment, the domestic and international reputation of the State would be compromised, rendering long-term policy formation much more difficult across a wide range of policy areas and damaging Ireland's ability to participate in international policy negotiations.

Finally, the untested nature of the new currency would lead investors to require a risk premium. Over the longer term, the problems of managing an independent currency would mean that any potential initial gain from exiting EMU could be wiped out by the macroeconomic costs of the distortions associated with nominal exchange rate volatility.

The discussion in this subsection has indicated that there are sound reasons to believe that macroeconomic stabilisation may have been even more challenging under an independent currency. Moreover, the prospective costs of leaving EMU dominate any potential gains. Accordingly, it is appropriate the main focus in analysing the relation between EMU and Irish macroeconomic stability should be on an evaluation of the quality of national-level macroeconomic policy under EMU. This is the subject matter in the next section.

### 3. Policy Evaluation

In this section, we evaluate the role played by national economic policies in macroeconomic stabilisation under EMU. We first examine fiscal policy before turning to other policy instruments.

#### 3.1 Fiscal Policy

Fiscal policy is the main national macroeconomic stabilisation instrument for a member of the euro area. There are many dimensions to fiscal policy. At a macroeconomic level, the levels of public spending and taxation affect production and spending decisions across the economy. Moreover, the net fiscal balance influences the overall level of aggregate demand, since a variety of factors mean that net saving by the government influences the aggregate net savings rate. At a microeconomic level, specific fiscal interventions can influence behaviour in targeted sectors and markets.

As already noted, it is important to emphasise that optimal deployment of fiscal policy for macroeconomic stabilisation is consistent with a wide range of views concerning the appropriate average size of the public sector in the economy: cyclical adjustments in fiscal policy may oscillate around a high average level of public spending or around a low average level of public spending. In particular, one country may prefer a larger public sector than another country, in line with differences in preferences in terms of the appropriate levels of public services and redistribution. However, both countries may optimally choose to allow counter-cyclical fluctuations in the public sector payroll around two very different average levels of public sector employment. Accordingly, in principle, it should be possible to analyse the cyclical properties of fiscal policy independently of the debate concerning the appropriate average size of the public sector.

That said, a complicating factor for the Irish economy was that the rapid output growth during the late 1990s was not initially matched by the public sector, which meant that the ratio of public spending to GDP plummeted towards a trough of 31.5 percent in 2000. Accordingly, part of the expenditure growth since then may be attributed to catch-up dynamics and trend shifts in the size of the Irish public sector in addition to cyclical factors (Lane 2007). The extremely rapid growth in GDP during the late 1990s was not initially matched by the public sector, such that some degree of 'catch up' was required in order to attain the politically-desired trend share of public services and public investment in total activity. Moreover, the rapid population growth placed additional pressure on the education and healthcare sectors. Combined with a positive income effect on demand for such public services, this may have justified an upward trend shift in the relative size of the public sector. These factors help to explain rates of public expenditure growth that outstripped the growth rate of potential output.

However, to the extent that the growth in public expenditure represents a trend shift, it would have been optimal to increase the permanent level of tax revenues in line with the permanent level of public spending. Rather, the emergence of the large fiscal deficit in 2008-2009 has revealed that the expansion in public spending was financed with temporary sources of tax revenue. In terms of optimal debt management, that pattern is clearly inefficient in terms of financing trend shifts in public spending. The only exception relates to the surge in public investment: to the extent that this can be interpreted as temporary in nature, the debt-financing of the public capital programme can be justified. However, in the other direction, there is a predictable increase in the future level of public spending due to the ageing of the population, such that optimal public finance would indicate running larger surpluses now in order to avoid a discrete hike in future tax rates.

Accordingly, a key issue in fiscal stabilisation relates to the dynamics of the fiscal balance. The ideal is to run sufficiently large surpluses during boom periods in order to finance the loss of revenue and increased spending commitments during downturns. As such, the structural fiscal position would remain broadly in balance, with the permanent component of spending matched by the permanent component in revenues and, in turn, trend shifts in spending paralleled by trend shifts in revenue. The importance of delivering a counter-cyclical pattern is reinforced by membership of EMU, since fiscal errors cannot be offset by adjustments to monetary policy or the nominal exchange rate.<sup>8</sup>

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<sup>8</sup> Lane (1999, 2000b) analyses the importance of counter-cyclical fiscal policy for Ireland upon entry to EMU.



In relation to the institutional framework for fiscal policy, the EU-wide Stability and Growth Pact (SGP) provides some level of international oversight. Through its surveillance function, the European Commission is able to review each government's fiscal strategy on a regular basis. However, the SGP is asymmetric in its operation in that actions can be taken if a country exceeds the deficit ceiling of 3 percent of GDP, whereas the European Commission can only offer opinions in terms of the appropriate fiscal stance if the ceiling is not violated.<sup>9</sup> In particular, the SGP does not include a mechanism to ensure a country runs a sufficiently large surplus during boom periods. Accordingly, the responsibility for cyclically-appropriate fiscal policy resides with the national authorities.

In order to implement the optimal fiscal plan, it is necessary to be able to distinguish between the temporary and permanent components in the tax base. Traditionally, the main focus has been on measuring the temporary versus permanent components in GDP, under the assumption that the major driver of temporary fluctuations in tax revenues (and expenditure on unemployment benefit) is the size of the output gap (the difference between the current and the permanent value of GDP). While the procedures to estimate the output gap are well developed, the accuracy of such projections is much lower for a small, open economy such as Ireland relative to larger, self-orientated economies such as the United States. In particular, the international mobility of labour and capital means that the permanent component of GDP can shift quite substantially, with immigration and capital inflows pushing up the sustainable level of output but emigration and capital outflows leading to a contraction in the sustainable level of output. It is also more difficult to work out the trend level of productivity growth for an economy that is undergoing structural changes, such as a large increase in the female participation rate in the labour force and shifts in the composition of economic activity across sectors. For these reasons, estimates of the level of the output gap for Ireland are bound to be subject to a good deal of uncertainty.

However, the output gap is not the only source of temporary fluctuations in the tax base. The revenue stream from asset-based taxes is driven by the level and rate of capital appreciation in asset prices and the level of transactions in asset markets. The boom-bust cycle in asset markets may have a different timing and amplitude to the output cycle. In addition, booms in asset markets also affect the level of revenue from consumption-related taxes, due to the operation of the wealth effect.

The rapid growth in asset-based tax revenues was primarily used to finance the growth in public spending, together with reductions in income tax rates and a narrowing of the income tax base. While the government did run general government budget surpluses and achieved a significant decline in the ratio of public debt to GDP, it has turned out that the scale of the budget surpluses were not large enough, given the transient nature of the revenue windfall from the asset markets.

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<sup>9</sup> See Fitzgerald (2001) for a discussion of the European Commission's report at that time that warned against excessive fiscal expansion in Ireland. This report was widely criticised in domestic policy circles at the time.

While it is certainly true that the timing of the end of the housing bubble could not be predicted ex-ante with any great degree of certainty, the fundamentally temporary nature of the boom was clear. First, durables such as housing are inevitably subject to fluctuations in the level of production, since the appropriate rate of new housing construction depends on the gap between the existing stock of housing and the desired stock of housing. As construction activity increases, that gap narrows and feeds back into a lower equilibrium level of housing construction. Second, in relation to the level of housing prices, there were plenty of warnings of the emergence of a bubble in housing prices (see Honohan 2009a for a review of this evidence). Third, rapid growth in credit aggregates are a robust indicator of an increase in the probability of a subsequent financial crisis.

More generally, the proper response to uncertainty about the duration of the housing boom is to act in a more prudent manner, in view of the high costs of a sudden stop. The safer course is to act upon the assumption that the boom will not last, since excessively-prudent fiscal policy can be more easily reversed than the damage incurred by a panglossian approach to the budgetary position. The importance of fiscal prudence is especially strong during periods in which the banking sector is undergoing rapid growth, in view of the frequency and immense fiscal costs of banking crises. Reinhart and Rogoff (2009) provide a comprehensive analysis of banking crises. As noted by these authors, the fiscal costs of a banking crisis extend beyond the direct fiscal cost of re-capitalising the banking system since the recessionary impact of a banking crisis is also associated with a steep decline in tax revenues.

Accordingly, the credit boom provided a further reason for the government to run larger-than-normal budget surpluses. Indeed, Lane (1998d) recommended the establishment of a rainy-day fund such that liquid assets could be accumulated that in turn could be deployed to re-finance the banking system in the event of a crisis, whereby the rainy-day fund could provide the resources to purchase bad assets from the banking system and re-capitalise the banks.<sup>10</sup>

Given the risks, the budgetary approach was insufficiently cautious and failed to take into account the potentially high volatility of the Irish economy, with the scale of the boom in turn creating the conditions by which a downturn could be especially sharp in speed and magnitude. As indicated earlier, the government did run general government surpluses during this period. However, running large surpluses during boom periods is especially challenging for the political system. There are strong electoral and lobbying pressures to cut taxes or raise spending if a persistent surplus is observed.

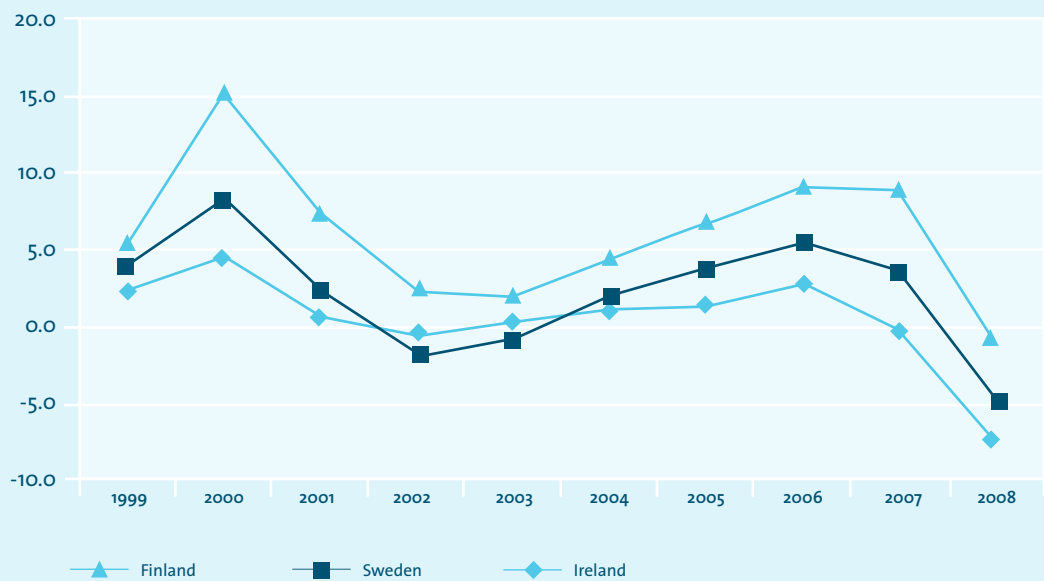
One innovation during this period that may have indirectly helped to constrain pro-cyclicality was the establishment of the National Pension reserve fund (NPRF). While the motivation for the NPRF was to pre-fund the large projected future

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<sup>10</sup> The National Pension Reserve Fund (NPRF) has served as a partial and imperfect substitute for such a rainy day fund. We return to the NPRF later in this section but we note that the long-term nature of its investment horizon and its stated objective of attaining a commercial return to fund future pensions-related expenditure mean that it is not well designed to act as a rainy-day fund.

increases in State expenditure on public sector and social welfare pensions, the accounting treatment of the NPRF may have helped to contain pro-cyclical pressures during the boom period. In particular, while payments into the NPRF do not affect the general government budget balance (since the payments are used to acquire financial assets for the State), the exchequer balance is reduced. To the extent that the domestic media and political discourse is focused on the exchequer balance, the NPRF payments act to reduce the visible surplus and thereby the scale of lobbying efforts to raise spending or cut taxation.

Figure 1 General Government Balance: Finland, Sweden, Ireland



It is worth noting that some other administrations were able to run larger surpluses, despite having smaller booms. Figure 1 shows the budget dynamics for Ireland, Finland and Sweden and highlights that the level of budget surpluses were typically higher in these other countries. It is worth noting that Sweden and some other countries have established independent institutions to advise on the cyclical state of the economy and the fiscal policy assessments of independent forecasters. While versions of such institutions have been adopted by a number of countries, no such institutional development has occurred in Ireland. We return to this point later in the paper.

In addition to the overall macroeconomic stance, fiscal policy can also operate via microeconomic channels. In relation to the property market, a government can alter tax and subsidy rates for the property sector in order to “lean against the wind” by raising the cost of property investment during boom periods and lowering it during contractions. In principle, such a policy can act as an imperfect substitute for an independent interest rate policy in terms of stabilising the property sector. In the Irish context, counter-cyclical housing taxes were advocated by Fitzgerald *et al.*, (2000).

While it would certainly have been desirable to have taken a more counter-cyclical approach to the tax/subsidy policies for the property sector, it is also important to acknowledge the limits to such policies once investors have been gripped by 'irrational exuberance.' In particular, if investors strongly believe in the prospect of large annual capital gains, shifts in the cost of finance may have only a marginal impact on speculative decisions. In an environment in which capital appreciation in the property sector was strong across a range of countries and positive signals could be extracted from a range of fundamental factors, incremental variation in tax/subsidy policies on their own may not have been sufficient to prick the bubble. We return to additional policy instruments in relation to the property sector later in this section.

In relation to microeconomic interventions, a counter-cyclical approach to taxes on employment provide another option in smoothing the economic cycle.<sup>11</sup> In particular, a strategy of raising employment taxes (for example, employer PRSI) during boom periods and lowering these taxes during downturns can act as an effective substitute for a floating nominal exchange rate (see also Calmfors 2003). To see this, consider that the normal pattern for a floating currency is that a domestic output boom is associated with real exchange rate appreciation, by which domestic labour costs increase relative to labour costs in other countries, while a recession is associated with a real exchange rate depreciation, by which domestic labour costs decline relative to labour costs in other countries.

By raising employment taxes during a boom and lowering taxes during a recession, the same cyclical pattern in relative labour costs can be replicated and this can act to stabilise fluctuations in the level of employment. Such a strategy would be neutral in terms of average tax revenue, since the extra taxes collected during the upturn would offset the revenue decline during the recessionary phase. Since it is typically difficult to clearly distinguish between trend shifts in output growth and purely cyclical fluctuations, a pure version of this tax strategy may not be practical. However, it could be implemented in a non-linear fashion, with a 'sufficiently large' positive output gap triggering an increase in employment taxes and a 'sufficiently large' negative output gap triggering a decline in employment taxes.

A further type of microeconomic intervention is to seek to alter the cyclical timing of consumption decisions. By providing a savings subsidy during boom periods that is withdrawn during downturns, a government may be able to stabilise consumption patterns. While the establishment of the Special Savings Incentive Account (SSIA) scheme in 2001 was in part motivated by a desire to cool down the booming economy, the design of this scheme was not targeted at cyclical stabilisation. Most important, its fixed five-year horizon meant that the withdrawal of the subsidy in 2006/2007 was independent of the cyclical state of the economy. In contrast, a cyclically-focused scheme would have specified a subsidy schedule that was conditioned on cyclical indicators.<sup>12</sup>

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<sup>11</sup> For brevity, I simply refer to cyclical variation in employment taxes. However, there is a wide range of labour market interventions that may be deployed in pursuit of cyclical stabilisation. It is beyond the scope of this paper to discuss the relative merits of these alternative instruments.

<sup>12</sup> Another tool for cyclical management of consumption is to operate cyclically-varying levels of indirect taxation and excise duties. However, the limited impact of minor variations in these taxes on prices means that this tool may not be sufficiently powerful to be effective.

Overall, the role of microeconomic fiscal interventions can be viewed as an additional dimension to counter-cyclical aggregate fiscal policy. While a counter-cyclical stance in aggregate fiscal policy can be achieved with constant tax rates (by banking higher revenues during good times in order to offset lower revenues during downturns), the microeconomic element goes further by trying to influence the time pattern of key relative prices. In particular, the microeconomic approach seeks to raise the relative cost of capital and labour during boom times in order to allow a reduction in the relative prices of these factors during recessions. In addition, it may seek to influence the time path for consumption by shifting the relative price of consumption. As indicated, it is most important to deploy such interventions in response to 'large' cyclical divergences, even if smaller fluctuations may be passively tolerated.

Next, we turn to the role of policy vis-a-vis the public sector payroll as a stabilization instrument.<sup>13</sup> In general, it is implicit that a counter-cyclical fiscal policy involves a degree of counter-cyclicity in the public sector payroll. In terms of employment levels, the default position is that the level of most types of public sector employment should vary in line with the trend growth in the economy, since the demand for most public services is acyclical in nature. To the extent that optimal public sector provision has a cyclical component, it is most likely to be counter-cyclical in nature (such as dealing with the extra welfare and health costs during downturns).

In relation to public sector pay levels, there is a natural tendency for public sector pay to contain a pro-cyclical component to the extent that the public and private sectors are in close competition for similar workers. In the other direction, the greater security of public sector employment implies that there should also be a counter-cyclical wedge between wages in the public sector and the private sector, such that the relative wage of a public sector worker falls during good times and improves during recessions.

It is difficult to implement such efficiency-based principles in view of the role of non-market factors in determining public sector pay levels. Accordingly, it is a major policy challenge to ensure that the public sector 'security premium' is appropriately valued during boom times and avoid the risk of a ratchet effect, by which cyclically-induced wage growth that may be achieved under tight labour market conditions is preserved even when private-sector wages fall back during periods of low labour demand.

The cyclical management of the public sector payroll is important for several reasons. Most directly, it is difficult to attain the required counter-cyclical pattern in the overall budgetary position if the public sector payroll grows too quickly during expansion phases. Moreover, moving beyond the public finances, the cyclical pattern in the public sector payroll influences the stability of the aggregate labour market. In particular, a pro-cyclical pattern in public sector employment and excessive pro-cyclicity in public sector pay levels during boom times contributes to overheating and squeezes otherwise-viable private-sector enterprises.

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<sup>13</sup> In what follows, I focus on the public sector payroll. However, the labour market impact of government spending is much broader than the narrowly-defined public sector payroll. In particular, the government is a major purchaser of goods and services from private-sector entities.

Most problematically, cyclical asymmetry in the public sector payroll renders the macro-economic adjustment challenge more difficult during downturns. If pro-cyclical expansion in public sector employment and pay levels during boom periods cannot be easily reversed during downturns, this contributes to the deterioration of the fiscal balance and inhibits the economy-wide reduction in pay levels that is required to restore full employment.

Downward nominal wage rigidity is especially problematic for a member of a monetary union that targets a low area-wide inflation rate. If area-wide price inflation runs at 2 percent, any substantial decline in the required level of inflation-adjusted wages necessarily involves nominal reductions in pay levels. However, membership of a monetary union also alleviates putative concerns that reductions in nominal variables may induce a deflationary spiral by which a recession is deepened by the incentive to postpone spending decisions in the expectation that the price level will be lower than its current value in the future. Such a deflationary spiral cannot persist for a member of a monetary union, since declines in relative price levels are ultimately self-correcting, since a member country that experiences a reduction in its price level will gain in competitiveness that in turn will induce an increase in activity levels and associated upward pressure on prices and wages.<sup>14</sup>

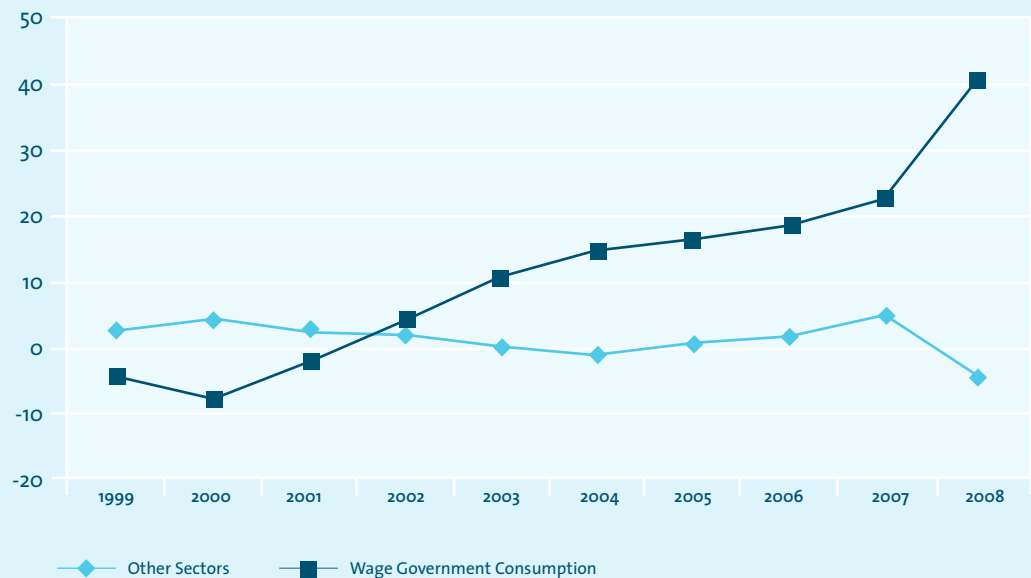
These factors notwithstanding, it is also clear that cyclical factors contributed to the upward pressure on the public sector payroll. Over 1999-2008, the cumulative growth in public sector employment has exceeded the trend level of employment growth calculated by the European Commission, even if the general scale of the employment 'gap' was less than in the private sector. Moreover, the speed of public sector employment relative to trend employment growth was especially high in the neighbourhood of election years (2001-2002 and 2007). While the growth in public sector employment may be in part explained by a positive trend shift in the desired ratio of public to private activities, the failure to raise structural tax revenues in the same proportion was not optimal if that is the explanation. In relation to pay levels, there is no evidence that the awards under the first benchmarking process or under the higher-level pay review were driven by trend shifts in wage levels in comparable private sector occupations. Similarly, the evidence that formed the basis for the second benchmarking process and the 2007 higher-level pay review focused on contemporaneous pay conditions, rather than discounting the cyclical element in prevailing private-sector pay levels at the time.

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<sup>14</sup> Of course, even if deflation (or low positive inflation) is just a temporary phase for Ireland, it can last for several years. It certainly amplifies the extent of the downturn, since it implies the short-term real interest rate (the nominal rate minus the expected rate of inflation) will be higher than otherwise. This is the mirror process of the amplification of the boom period that was generated by the low real interest rate during our prolonged period of relatively high inflation.

Figure 2 shows the cumulative growth in the inflation-adjusted level of wage government consumption and the level of real output<sup>15</sup> in other sectors (each measured relative to the cumulative growth in potential output) over 1999-2008. The pro-cyclical behaviour of public-sector wages helps to explain the pattern that the growth in the inflation-adjusted public sector paybill far outstripped the growth in potential output. Moreover, it exceeded the cumulative growth in other sectors, such that the scale of the expansion in the public sector payroll exceeded that in the wider economy. As indicated earlier, it is possible to explain part of the increase in the share of public sector paybill in the total economy as reflecting a permanent trend shift. However, if that were the full explanation, there should have been a corresponding trend shift in the permanent component of tax revenues, which did not occur.

Figure 2 Cumulative Growth, 1999-2008



Note Measured relative to cumulative growth of potential output.

### 3.2 Other Policy Instruments

In addition to fiscal policy, the government can influence the cyclical behaviour of the economy through other mechanisms. We first discuss social partnership, before turning to the role played by financial regulation in attaining macroeconomic stability.

<sup>15</sup> It would be desirable to study the cyclical pattern in public-sector pay levels, especially compared to private-sector pay levels. However, a detailed examination of occupation-by-occupation pay dynamics is beyond the scope of this paper, in view of the numerous adjustments that would be required to ensure comparability between the two sectors.

### 3.2.1 Social Partnership

In Ireland, social partnership has played a central role in extending the influence of the government beyond fiscal policy.<sup>16</sup> In relation to cyclical stabilisation, a social partnership approach to pay negotiations has the potential to contribute to macroeconomic stabilisation, since a coordinated approach to wage setting may enable employers and unions to take into account macroeconomic factors in addition to sector-specific and firm-specific variables.<sup>17</sup>

However, by the same token, the cumbersome and multi-annual nature of such large-scale negotiations may inhibit rapid adjustment in the event of a sudden shift in macroeconomic conditions. While the national pay agreements have included renegotiation clauses to deal with firm-specific “ability to pay” problems, these are inadequate to deal with macroeconomic shocks that require a correction in the general level of wages. In particular, replicating the impact of a national-level currency devaluation requires a decline in all locally-determined prices and wages.<sup>18</sup> Accordingly, the policy mix requires a combination of economy-wide wage reductions and pro-active competition policy to ensure appropriate pass-through from wage reductions to price reductions.<sup>19</sup> Through this approach, the over-all cost base in the economy is reduced, whereas a strategy of confining wage reductions only to those firms that face imminent closure has a much more limited impact on the level of competitiveness.

This poses a fundamental challenge for the social partnership model, since its success has relied on a common analysis of economic and social challenges facing the country and a consensus on the qualitative nature of the required policies. The current crisis has revealed that no such common understanding exists in relation to the role of wage reductions in tackling a downturn. This raises the question of whether the social partnership model has fully adapted to the implications of membership of a monetary union. Most directly, the classical analysis has it that nominal wage flexibility can act as a substitute for the devaluation option that is eliminated by joining a monetary union. If downward wage flexibility is resisted, this raises the risk of a prolonged increase in unemployment and stagnation in activity levels. For the economy to return to full employment, a similar scale of inflation-adjusted wage adjustment must ultimately occur but only through a drawn-out process by which high unemployment levels suppress wage growth over an extended period. The importance of wage flexibility to the adjustment process within a monetary union is vividly illuminated by Blanchard (2007), who provides a detailed analysis of the slow pace of adjustment in Portugal since its boom dissipated in the early part of this decade. More generally, wage flexibility is required if a member of a monetary union is to simulate the role played by currency devaluation in enabling an economy to recover from a recessionary period.

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<sup>16</sup> In exchange for involving the social partners in the determination of taxation and spending decisions and the broader design of the government's economic and social policies.

<sup>17</sup> More narrowly, social partnership is helpful in the coordination of pay determination across the public sector. A dis-coordinated approach by which the government negotiated with individual public sector unions in a staggered fashion would make it much more difficult to incorporate macroeconomic factors into the setting of public sector pay levels.

<sup>18</sup> For a small economy, the prices of tradable goods and services will be largely fixed in international markets. Devaluation works in these sectors by increasing the profitability of production in Ireland, inducing the reallocation of resources from other sectors of the economy and increased inward investment.

<sup>19</sup> The efficient implementation of competition policy is complicated by several factors, especially since the ratio of price to unit labour costs may optimally vary over the cycle, depending on the importance of fixed costs in production and the cyclical variation in non-labour costs.



Irish macroeconomic performance has repeatedly illustrated the benefits of exchange rate depreciation, with the 1986 and 1993 devaluations proving helpful in stimulating the economy in the wake of the mid-1980s stagnation and the recession of the early 1990s respectively.<sup>20</sup> More recently, external shocks to the real exchange rate have clearly affected the state of the Irish economy, with the low value of the euro against the dollar during 1999-2002 contributing to the high level of economic activity during that period and the strengthening of the euro against Sterling during 2008 clearly contributing to the current downturn. Symmetrically, reductions in domestic costs can boost economic performance, while a failure to tackle a high domestic cost base inhibits the expansion of the traded sector.<sup>21</sup>

The importance of engineering a real devaluation is reinforced by the limited potential for the nontraded sector to grow rapidly as an independent source of demand over the next number of years. The repairing of household balance sheets means lower expenditure on domestic consumption services, while the excess stocks of housing and commercial real estate mean that private investment in the construction sector will be much lower than in the boom years. In related fashion, the scale of public sector spending growth is set to be quite constrained in view of the deterioration in the public finances.

Accordingly, it is important that the traded sector acts as an engine of growth. While the expansion of the traded sector in part involves an increase in the scale of activities of existing firms (the ‘internal margin’ of growth), a substantial proportion of the growth will take the form of the creation of new domestic firms and new inward investment by multinational firms (the ‘external margin’ of growth). The projected medium-term level of domestic costs significantly affects the decisions to establish a new enterprise or to locate a new production facility here. While the gains to real devaluation are increasing in the level of global economic activity, the state of the world economy is outside the control of domestic policymakers. Moreover, the full impact of shifts in real exchange rates tends to occur with a time lag, such that a reduction in the domestic cost base today will pay off over several years. In turn, an expansion in traded-sector activity will contribute to the recovery of the nontraded sector through increased demand for inputs from nontraded industries, increases in employment in the traded sector and improvements in consumer confidence and the public finances.

It is certainly true that the pain of wage reductions could have been ameliorated if fiscal policy had been more counter-cyclical during the boom years, such that the current downturn could have been mitigated by a discretionary fiscal expansion. However, that option has been effectively closed by the lack of fiscal space due to the magnitude of the decline in the fiscal balance.<sup>22</sup> It is also the case that high levels of nominal household debt mean that wage reductions mean that debt servicing imposes a larger burden; it would have been better if credit growth had not been so pro-cyclical. However, the burden of household debt would be larger still in the absence of wage adjustment, given the adverse impact of rising unemployment on disposable income levels.

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20 See Alogoskoufis (1993), European Commission (1994) and Lane (2000c), amongst others.

21 See Razin and Collins (1999) and Rodrik (2009) on the costs of persistent exchange rate over-valuation for economic growth.

22 The IMF has been a leading advocate of fiscal expansion to fight the crisis. However, the IMF position makes an exception for those countries that face unsustainable fiscal dynamics (Spilimbergo *et al.*, 2008).

Of course, a focus on reducing domestic costs is complementary to a wider pro-competitiveness strategy that seeks to promote greater competition in monopolised sectors and improve productivity through improved training and education, a superior public and social infrastructure and a more developed domestic innovation system (see also Lane 2004). Again, the capacity to increase public funding for such schemes during the downturn would have been much greater if fiscal pro-cyclicality had been avoided during the boom. Moreover, the payoff to such initiatives tends to be medium-term in nature and is reinforced by the level of cost competitiveness: the willingness of firms to invest in response to improvements in productivity will be greater, the lower are domestic costs.

As is discussed extensively in Lane (2009), there is little by way of recent examples to guide a process of nominal wage reductions. Historically, for countries with independent currencies, the solution to an over-valued real exchange rate has been to undergo a nominal currency devaluation. There is also evidence that nominal wage reductions are rarely used to cope with firm-level economic problems (see also the discussion in Lane 2009). Accordingly, the attainment of economy-wide nominal wage reductions poses a major challenge for a member country of a monetary union.

It is here that social partnership can play an important coordinating role, since it is difficult for a decentralised approach to wage determination to efficiently respond to macro-economic shocks. In particular, a non-coordinated approach creates relativity problems, by which workers in a given firm or sector worry about whether wages will adjust elsewhere in the economy or whether a sectoral concession on wages will just result in a decline in relative wages compared to other occupations and industries. For such reasons, a national pay agreement that can set an economy-wide benchmark that reflects macroeconomic conditions has considerable potential to enable adjustment at the lowest cost in terms of unemployment and inequality.

Moreover, returning to fiscal policy, social partnership has the potential to be helpful in establishing consensus support in favour of a new institutional mechanism that can improve the cyclical management of fiscal policy. In particular, a fragmented socio-political system is not conducive to 'leaning against the wind' fiscal policy, since each individual lobby group or sectoral interest has no incentive to take into account the macroeconomic situation in pressing for an expansion in spending lines or specific tax cuts (see also Tornell and Lane 1999). In contrast, the coordination mechanism that is provided by social partnership can overcome this free-rider problem.

### 3.2.2 Financial Regulation

Despite the formation of EMU, financial regulation has remained a national-level responsibility. While such regulation takes place within a European-wide framework that seeks to maintain a level playing field between domestic- and foreign-owned banks, the national regulator is responsible for overseeing the activities of domestically-headquartered banks and the domestic affiliates of foreign-owned banks. Since May 2003, the Irish Financial Services Regulatory Authority (IFSRA) has had responsibility for financial sector regulation. IFSRA was constituted as an independent entity within the newly-merged Central Bank and Financial Services Authority of Ireland (CBFSAI).

It is important to emphasise that financial regulation in recent years faced a very difficult challenge. Internationally, the basic structure of banking was undergoing structural change, with an increasing role for wholesale markets in funding banks. With EMU, the pace of structural change was compounded by the expanded possibilities for inter-bank lending within more integrated area-wide inter-bank and money markets. Moreover, the traditional relations between national central banks and national banking systems were fundamentally altered, with each national central bank now functioning as part of the European System of Central Banks (ESCB), with the European Central Bank determining interest rates and market liquidity policies. As part of an integrated monetary system, the net external asset position of the domestic banking system was no longer closely tracked, since foreign borrowing in a common currency did not pose the same types of risks as the accumulation of foreign-currency liabilities and national central banks did not seek to respond to the accumulation of foreign liabilities through the acquisition of liquid foreign assets. For such reasons, national financial regulators had to work out the implications of this new environment for regulatory decisions. In addition, some of the traditional automatic stabilisers in money markets were no longer operative, such that the importance of pro-active anticipatory regulation was greater than ever.

A classic problem in financial regulation is the analysis and management of systemic risk. Lending behaviour that may be rational from the viewpoint of an individual bank may be dangerous from a collective perspective if it leads to increase in the vulnerability of the system as a whole. Most obviously, a more aggressive approach to lending by one bank may increase its market share and may have little impact on systemic risk if no other bank altered its behaviour. However, such a move would likely trigger imitation by other banks, such that the collective decline in credit standards and increase in aggregate lending may lead to a substantial increase in credit risk. A financial regulator that exclusively focuses on a bank-by-bank approach to risk assessment would not adequately take into account such systemic factors.

In similar fashion, it is difficult to make a robust assessment of the vulnerability of an individual bank to macroeconomic or asset market shocks, since the impact on an individual bank depends on the reactions of other banks in the system and the correlated views of funders vis-a-vis the whole system. The wider is the gap between bank-level and system-level vulnerability, the greater is the level of leverage in the system and the extent of cross-collateralisation, in view of the roles played by leverage dynamics, margin calls and the pre-emptive calling in of loans in the amplification of a banking crisis and the migration of borrowers from the state of illiquidity to the state of insolvency. For this reason, stress tests that do not adequately take into account such interdependencies run the risk of understating the extent of systemic vulnerability.

Accordingly, the preservation of financial stability requires excellent judgement on the part of the regulatory authority and a willingness to impose curbs on the behaviour of banks in order to limit macroeconomic and systemic risks. The importance of managing macro-prudential risk suggests that financial stability is best ensured if the connections between macroeconomic analysis and regulatory decisions are optimised.

It is by now clear that macroeconomic factors were not sufficiently influential in guiding regulatory decisions in recent years. For instance, the risk of over-concentration of lending exposures in the property sector, the rapid accumulation of net external debt by the Irish banking system between 2003 and 2006 and warning signals such as very high growth in lending volumes did not seem to prompt sufficient corrective action by IFSRA (see also Honohan 2006, 2009a). Since it is plausible that the excessive autonomy of IFSRA within the CBFSAI organisation contributed to the de-linking of macroeconomic risk and regulatory decisions, the proposal to re-integrate financial regulation and central banking within the new Central Bank Commission appears to be qualitatively correct. In addition, the commitment to searching for the best-qualified individuals to take senior positions within the new institution should help in ensuring that the quality of regulatory decisions is optimised.

In relation to the cross-border dimension of the international financial crisis, the inadequacies of the current regulatory system in dealing with the financial problems of multi-country banking systems has been strongly underlined. One basic problem is that appropriate allocation of losses across national fiscal authorities, where a banking system operates in an integrated fashion across national borders. A second problem is the transmission of systemic risk across borders, especially when countries share a common currency and a common liquidity provider. A third is the monitoring of common sources of risk, such as excessive concentration of lending in specific sectors or over-exposure to untested types of assets and liabilities. For these reasons, the principles behind the recently-announced moves to improve the levels of EU and global cooperation in financial regulation are welcome. At a European level, the de Larosiere report recommends the establishment of an European Systemic Risk Council (ESRC) to be led by the President of the European Central Bank. The ESRC will have responsibility for the identification and monitoring of macro-prudential risk at the European level, which in turn will feed into the functional regulation of banks, insurance and securities markets at European and national levels. In addition, the ESRC will provide an important input into global financial stability operations, via bodies such as the Financial Stability Board (FSB) and the IMF, which are charged with preserving financial stability at the global level.

Finally, one lesson from the current crisis is that an over-concentration of regional risk in lending portfolios can threaten financial stability. Moreover, a regionally-circumscribed banking system may be more risk averse in terms of its lending behaviour, in view of its limited capacity to hedge regional sources of risk. Accordingly, there is a strong case for the emergence of a core set of large multi-country banks that would operate on a pan-European basis and thereby contribute to the diversification of regional risk factors. Since such large banks also pose particular types of stability risks, these large institutions would also require a special European-wide regulatory regime. However, if a satisfactory regulatory regime is put in place, the gains from cross-border consolidation of the European banking system could be substantial (see also Demyanyk *et al.*, 2007 and Lane 2008). In relation to the Irish banking system, the policy regime should be open to the emergence of such a trend towards consolidation.

## 4. Looking to the Future

Lane argues that the costs of the current crisis reinforce the importance of redesigning the institutional framework for Irish macroeconomic policy, both in order to reduce the likelihood of future crises and improve the capacity of the system to manage such crises.

There are three main institutional challenges. First and foremost, macroeconomic stabilisation would be more easily attained if there were a stronger institutional commitment to accumulate sufficiently large surpluses during expansion phases. As is vividly illustrated by the current crisis, the potential volatility of the Irish economy means that large swings in the fiscal balance may be anticipated due to sudden shifts from high growth phases to contractionary periods. In order to have the fiscal space to run a counter-cyclical fiscal stance during the downturns, it follows that the fiscal balance must be sufficiently in surplus that cyclical deteriorations do not compromise the sustainability of the fiscal regime. In related fashion, a fiscal rainy-day fund should be accumulated during periods of credit expansion in order to retain liquid assets that may be required in the event of future banking crises.

Since it is politically difficult to preserve high surpluses against calls for tax reductions and spending increases, the de-politicisation of some key macroeconomic dimensions of fiscal policy may be appropriate (see also Hallerberg *et al.*, 2004, Wyplosz 2006, European Commission 2008 and Beetsma *et al.*, 2009). In this regard, there are a range of options. In order to limit the risk of basing budgets on over-optimistic economic forecasts, the forecasting task could be delegated to an independent agency. More stringently, a legislated fiscal rule could require the government to maintain a structural budget balance, although such a rule would be face implementation problems in terms of precisely determining the structural component in taxation and spending. Alternatively, the task of determining the appropriate fiscal balance in any given year could be delegated to an independent fiscal council that would take into account a wide range of factors in determining the level of the fiscal balance that is consistent with long-term sustainability and macroeconomic stabilisation over the course of the economic cycle. While the size of the aggregate fiscal balance would be taken out of the control of the political system under such reforms, the level and composition of spending and taxation would remain the responsibility of elected politicians. In this way, democratic accountability for fiscal policy is retained, within an institutional framework that preserves macroeconomic stability.

Second, the regulatory regime for the Irish and European financial systems needs to improve, such that the scale of risks incurred in the run-up to the current crisis are no longer tolerated. At the domestic level, the intention of the proposed Central Bank Commission is indeed to provide a new regulatory regime. At the international level, the content of the de Larosiere report should guide the establishment of new regulatory institutions at the European level and enhanced cooperation among national-level regulators. At a higher level again, the recent G20 meetings have accorded prominent roles to the Financial Stability Board and the IMF in promoting global financial stability.

Third, the social partnership model must adapt to the constraints imposed by membership of a monetary union. A timely real devaluation is an effective adjustment mechanism in response to regional downturns within a monetary union and is most efficiently achieved through a coordinated economy-wide downwards adjustment in wage levels. For this reason, a social partnership approach to pay determination has the potential to offer a superior adjustment mechanism relative to a non-coordinated approach, in view of its capacity to incorporate macroeconomic factors into pay negotiations.

There is a strong complementarity between reforms of fiscal institutions and the capacity of social partnership to facilitate downward wage adjustment when a real devaluation is required. In particular, counter-cyclical fiscal injections during recessionary phases can ease the pain of nominal wage reductions. However, if downward wage flexibility is ruled out as a policy option, this should be factored into future pay negotiations. In particular, the absence of this option should lead to a discounting of the growth in wages during good times, in order that future downturns are not exacerbated by excessively pro-cyclical wage growth during expansion phases.

## Conclusions

This essay has reviewed Irish macroeconomic policy since joining EMU in 1999. In relation to the management of common shocks and the delivery of price stability, the ECB has generally exceeded ex-ante expectations and EMU has provided a significant degree of insulation from international financial turmoil. However, in common with the other major central banks, the current crisis has signalled the importance of revising monetary strategies in order to place a greater weight on terminating incipient bubbles. The current crisis has also highlighted the importance of improving cross-border cooperation in financial regulation.

In relation to the role of national stabilisation policies in managing country-specific shocks, the first decade of EMU was especially challenging for Ireland due to the range of special factors that contributed to significant divergences from the rest of the euro area. However, the national financial regulator failed to rein in excessive credit growth, while the scale of fiscal surpluses during the period of strong growth was insufficient to finance a counter-cyclical fiscal response to the current crisis. A more prudent approach to national policies would have been better, by which policy decisions were based not only on median growth projections but also the importance of managing downside risk.

Turning to the future, institutional reforms can help improve the conduct of national macroeconomic policy. A new financial regulation regime is already in train, with the announcement of the new Central Bank Commission. In relation to fiscal policy, this essay has proposed that the pro-cyclical bias in fiscal policy could be attenuated by depoliticising some key decision steps in the determination of the cyclical component of fiscal policy. Finally, we have argued that membership of a monetary union works best if 'shadow' devaluations can be achieved via downward economy-wide wage flexibility during recessionary periods. To this end, the nature of the pay agreements negotiated under social partnership should be redesigned to take into account adverse macroeconomic shocks in determining aggregate wage behaviour.

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