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**Working Paper**

## The Irish single-currency debate of the 1990s in retrospect

TRiSS Working Paper Series, No. 02-2017

**Provided in Cooperation with:**

Trinity Research in Social Sciences (TRiSS), Trinity College Dublin, The University of Dublin

*Suggested Citation:* Barry, Frank (2017) : The Irish single-currency debate of the 1990s in retrospect, TRiSS Working Paper Series, No. 02-2017, Trinity College Dublin, The University of Dublin, Trinity Research in Social Sciences (TRiSS), Dublin

This Version is available at:

<https://hdl.handle.net/10419/226782>

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## TRiSS Working Paper Series

No. 02-2017

Version #1

### The Irish Single-Currency Debate of the 1990s in Retrospect

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21<sup>st</sup> August 2017

**Abstract:** Ireland was one of the initial EU member states to move to currency union as of January 1<sup>st</sup> 1999. The single-currency project, and Ireland's participation in it, had been vigorously debated within the Irish economics community in the 1990s. The paper reviews this debate with three particular questions in mind. To what extent was it recognised that membership might increase Ireland's vulnerability to external shocks? Would membership inhibit or facilitate an appropriate response, and were the implications of membership for the appropriate conduct of economic policy correctly identified? The paper also briefly reviews current thinking on necessary reforms to eurozone structures. It ends by considering the counter-factual – what exchange rate regime would Ireland have adopted if it had not joined the euro, and what might the consequences have been? – and offers a retrospective assessment of the debate that took place prior to membership.

**Keywords:** Monetary union, single currency, Ireland

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<sup>1</sup> This paper was read to the Statistical and Social Inquiry Society of Ireland in February 2017. An earlier version had been presented at the 2015 Annual Conference of the Dublin Economics Workshop. I thank seminar participants for their helpful comments and suggestions.

# **The Irish Single-Currency Debate of the 1990s in Retrospect**

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August 2017

## **ABSTRACT**

Ireland was one of the initial EU member states to move to currency union as of January 1<sup>st</sup> 1999. The single-currency project, and Ireland's participation in it, had been vigorously debated within the Irish economics community in the 1990s. The paper reviews this debate with three particular questions in mind. To what extent was it recognised that membership might increase Ireland's vulnerability to external shocks? Would membership inhibit or facilitate an appropriate response, and were the implications of membership for the appropriate conduct of economic policy correctly identified? The paper also briefly reviews current thinking on necessary reforms to eurozone structures. It ends by considering the counter-factual – what exchange rate regime would Ireland have adopted if it had not joined the euro, and what might the consequences have been? – and offers a retrospective assessment of the debate that took place prior to membership.

## **Introduction**

The turnaround in Ireland's economic fortunes over the course of the financial and eurozone crises was dramatic. Strong growth in the two decades to 2007 had seen the country converge on and then overtake average Western European income per head. The government budget in 2007 was in surplus and the debt-GDP ratio was around half the eurozone average. The subsequent crash involved a property market collapse, a full-scale banking crisis, a quadrupling of the unemployment rate and a dramatic turn-around in the public finances. The government was forced in 2010 to relinquish economic sovereignty and agree to an adjustment programme overseen by the 'Troika' of the European Commission, the International Monetary Fund and the European Central Bank (ECB).<sup>1</sup>

Ireland had been one of the initial 11 EU member states to move to a currency union as of January 1<sup>st</sup> 1999. The single-currency project, and Ireland's participation in it, were strongly contested issues within the economics community in Ireland in the 1990s. The present paper reviews this debate with three particular questions in mind. Firstly, to what extent was it recognised that membership might increase Ireland's vulnerability to external shocks? Secondly, would membership inhibit or facilitate crisis management and an appropriate response to such shocks? And thirdly, were the implications of membership for the conduct of economic policy correctly identified?

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This paper was read to the Statistical and Social Inquiry Society of Ireland in February 2017. An earlier version had been presented at the 2015 Annual Conference of the Dublin Economics Workshop. I thank seminar participants for their helpful comments and suggestions.

<sup>1</sup> Accounts of the Irish crisis are provided by, among others, FitzGerald (2012), Lane (2014) and Whelan (2014).

The paper proceeds as follows. The next three sections consider the driving forces behind the introduction of the euro, the politics of the Irish position and the Irish debate on the project and on the appropriate Irish position to adopt. Following sections consider in turn the crisis period and the Irish and EU responses, and current thinking on necessary reforms in eurozone structures. The paper ends with a brief consideration of the counter-factual and an overall evaluation of the debate.

## **2. The Driving Forces behind Monetary Union**

The October 1990 publication of the European Commission report *One Market, One Money* can be seen as the opening salvo in the public debate in Ireland on monetary union.<sup>2</sup> Subtitled *An Evaluation of the Potential Benefits and Costs of Forming an Economic and Monetary Union*, the report was presented by its lead author Michael Emerson at a series of seminars across Europe, including one at the Economic and Social Research Institute in Dublin.

The most surprising feature of the report was its downplaying of what had been the conventional wisdom up to then on the necessary preconditions for monetary union. The 1977 MacDougall Report on the *Role of Public Finance in European Integration* had stated for example that:

As well as redistributing income regionally on a continuing basis, public finance in existing economic unions plays a major role in cushioning short-term and cyclical fluctuations... If only because the Community budget is so relatively very small there is no such mechanism in operation on any significant scale as between member countries, and this is an important reason why in present circumstances monetary union is impracticable.<sup>3</sup>

The Emerson report admitted that “since the Community budget only amounts to 2 percent of total EC government expenditures, neither its interregional nor its global function can be compared to that of federal budgets”. It went on to state that “in so far as shocks affect incomes of Member States in an asymmetric way, other adjustment mechanisms will have to take the place of a central budget as an automatic stabilizer. To the extent that aggregate fiscal policy measures are required, most if not all of this policy will have to be implemented through coordination among Member States”. It offered no suggestions as to how this coordination might be effected however.

O'Donnell (1991: 106) explains that while cohesion had been closely linked to discussions on EMU since the late 1960s, the issues became decoupled around this time, for two reasons. One was the reluctance to raise budgetary issues given contemporary German and UK concerns over the Community budget. The second was a general loss of faith in the effectiveness of counter-cyclical macroeconomic policy.

The single currency project had come to seem more urgent given that the transformational Single Market Initiative was close to completion.<sup>4</sup> This initiative entailed, inter alia, the removal of

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<sup>2</sup> The terms currency union and monetary union are used interchangeably here, though many analysts now deem an integrated banking system to be a key component of monetary union.

<sup>3</sup> This point had been made in the ‘optimum currency area’ literature by Kenen (1969).

<sup>4</sup> This was the first of the three stages set out in the Delors Report of 1989 by which economic and monetary union was to be achieved.

capital controls and customs frontiers and the outlawing of restrictive public procurement practices across member states.<sup>5</sup> As the removal of capital controls would facilitate speculative attacks on individual currencies, it was recognised that intra-EU exchange rates might become more volatile. It was feared that the resulting possibly dramatic fluctuations in international competitiveness could give rise to protectionist pressures that would threaten the single market.<sup>6</sup>

The Maastricht Treaty, agreed by the heads of government in December 1991, contained the blueprint for monetary union. The Danish electorate's rejection of the treaty in June 1992 however, alongside uncertainty as to the likely outcome of the French vote scheduled for September 1992, shattered the perception that monetary union was inevitable and that exchange rates would remain stable in the interim. Several currencies – notably that of the UK – came under speculative attack and the narrow-band exchange rate regime then prevailing in Europe came to an end in Summer 1993. The Madrid Summit of European leaders in 1995 responded by announcing the decision to proceed to currency union in 1999.

Europe's political and administrative elites were at least partly aware of the dangers of proceeding to currency union without first having a fiscal insurance mechanism in place. The path by which the EU had advanced throughout its history is described by Monnet collaborator George Ball (cited by Spolaore, 2013):

“There was a well-conceived method in this apparent madness. All of us working with Jean Monnet well understood how irrational it was to carve a limited economic sector out of the jurisdiction of national governments and subject that sector to the sovereign control of supranational institutions. Yet, with his usual perspicacity, Monnet recognized that the very irrationality of this scheme might provide the pressure to achieve exactly what he wanted - the triggering of a chain reaction. The awkwardness and complexity resulting from the singling out of coal and steel would drive member governments to accept the idea of pooling of other production as well”.

Contemporary quotes from Wim Duisenberg, first President of the European Central Bank, and Helmut Kohl, contemporary Chancellor of Germany, support this hypothesis, which NES (1989, 423) refers to as the ‘integrative logic’ behind the EU's development. Duisenberg had said that “EMU is, and was always meant to be, a stepping stone on the way to a united Europe”, while Chancellor Kohl stated in 1991 that “it is absurd to expect in the long run that you can maintain economic and monetary union without political union” (Spolaore, 2013). The Four Presidents’ Report of 2012 and the Five Presidents’ Report of 2015 propose just such a route to rectify the design flaws that had become more apparent over the course of the eurozone crisis.<sup>7</sup>

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<sup>5</sup> The latter component would prove particularly beneficial for Ireland, given the role the country plays as an export platform for foreign MNCs (Barry, 2007).

<sup>6</sup> Exchange-rate rigidity had itself given rise to such pressures in the past however. The US, for example, had justified its imposition of a 10 percent surcharge on all imports in August 1971 on the basis of the “unfair” exchange rates prevailing at the time. These and other historical episodes of relevance were reviewed in Barry (1998).

<sup>7</sup> Lane (2012) suggests that “the most benign perspective on the European sovereign debt crisis is that it provides an opportunity to implement reforms that are necessary for a stable monetary union but that would not have been politically feasible in its absence”.

Currency union was a hugely ambitious stretch and the ‘integrative logic’ perspective now appears to have been overly optimistic. Orphanides (2014) offers the opinion that “the success of the euro rested on the belief or hope that if and when a crisis erupted governments would work together towards completing the project in a reasonable fashion. The experience of the last few years suggests that this belief or hope was misplaced”. The clash of interests between creditor and debtor nations has led to sustained policy paralysis, since more symmetrical adjustment mechanisms (entailing “internal revaluation” in creditor countries alongside “internal devaluation” elsewhere) had not been put in place when the project was initiated.

Stiglitz (2016: 20, 343) notes that one of the main lessons he learnt during his time at the World Bank was the importance of the careful sequencing and pacing of reforms and ensuring the buy-in of citizens. “Putting a single currency before the institutions that would make it work”, he concludes, “has been an economic and political disaster – *impeding* further economic and political integration”.<sup>8</sup> Baldwin et al. (2015) conclude that “Europe’s bad luck exposed the costs of relying on Monnet’s view”.

Jacques Delors denied in an interview in 2011 that he personally had underestimated the dangers: “Jean Monnet used to say that when Europe has a crisis it comes out of the crisis stronger ... but there are some, like me, who think that Monnet was being very optimistic.” Delors recalls failing to win the argument in 1997 that successful monetary union would require either a greater transfer of sovereignty or a commitment to common economic policies “founded on the co-operation of the member states” (Moore, 2011)

The dangers might also have been foreseen by those who had given deeper consideration to previous episodes of relevance. Recall that Keynes’s proposal at Bretton Woods – that responsibility for rectifying balance of payments disequilibria should be shared between surplus and deficit nations – had been rejected by the United States, which was at the time the leading surplus country. In the later years of the Bretton Woods system, with the United States now in deficit, the surplus countries of the time similarly refused to share the burden. This suggested that the fiscal coordination posited in the Emerson report of 1990 to take the place of a central budget as an automatic stabilizer would be difficult to achieve under crisis conditions when agreement on it had not been secured in advance.

### **3. The Politics of the Irish Position**

Though Irish independence had been achieved almost forty years earlier, by 1960 there had been little diversification in its external economic linkages. The UK remained the destination for 73 percent of Irish exports and a quasi-Currency Board arrangement maintained the Irish pound at parity with sterling. Tariff-jumping FDI was significant and these flows also came almost exclusively from the UK.

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<sup>8</sup> Neary (1997) had warned that “if EMU results in a significant deterioration in economic performance it could slow rather than hasten progress towards other goals such as the deepening of the Single Market, the admission of new members and the reform of EU institutions”. He pointed out furthermore (writing for a British newspaper) that “perhaps the major difference between the debates in Ireland and the UK is that most Irish opponents of EMU share these objectives”.

The initial diversification of the economy came via FDI inflows as new export-oriented policies adopted in the late 1950s proved particularly attractive to continental European and US firms. Ireland's accession to the European Economic Community in 1973 triggered substantially increased US FDI inflows and significant export-market diversification, while the sterling link was eventually broken in 1979 when Ireland entered the EMS without the UK.

As Baker, FitzGerald and Honohan (1996, 3) note, the latter move “represented a political choice for staying in the vanguard of European integration rather than a view on the technical merits of the EMS as an exchange rate regime for Ireland.” Among the factors behind the decision to break the sterling link were the fact that it no longer provided financial stability (sterling having fallen sharply against both the dollar and the Deutsch mark in the mid-1970s) and the perception that the UK's long-period of relative economic decline would continue, and that this would prove disadvantageous for economies too closely bound to it (Honohan and Murphy, 2010).

As an official statement of the broad principles underlying Irish foreign economic policy states:

“One of the central thrusts of Irish economic policy... has been to reduce the country's trade dependence on the UK. Policy initiatives with this aim in mind have included EU entry in 1973, the break with sterling in 1979 and subsequent entry of the Irish pound into the European Monetary System, support for the establishment of the Single European Market in 1992, and adoption of the euro in 1999” (Forfás, 2003).<sup>9</sup>

The Irish electorate had strongly supported the government position in EU-related constitutional referendums in 1972 (on accession) and 1978 (on the Single European Act). The Maastricht Treaty was also passed by a substantial majority in the referendum of June 1992, though the margin between the two sides declined in each successive referendum.<sup>10</sup> Rereading the newspapers of the time, however, it is clear that monetary union played little part in the debates on Maastricht, which focused instead on the issues of abortion, neutrality and the amount of regional aid to be expected from Europe.<sup>11</sup>

Taoiseach Albert Reynolds, speaking in parliament on 16 December 1992, noted that:

“During the course of the referendum campaign earlier this year on the Maastricht Treaty, I said that our objective was to obtain about IR£6 billion over the five years to 1997, as implied by the original Commission proposals. Many people accused me of raising unreal expectations. From the Maastricht referendum campaign right through to the recent election the issue was used to denigrate my credibility”.

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<sup>9</sup> Forfás was at the time the policy advisory board for enterprise, trade, science, technology and innovation.

<sup>10</sup> The Nice Treaty would be rejected by the electorate in 2001 and the Lisbon Treaty in 2008, though both results were reversed when slightly amended versions of what was on offer were placed before the electorate.

<sup>11</sup> Neary (1997) too notes that “the Maastricht Referendum of 1992 was fought over different issues and in the absence of significant new information such as the details of the Stability Pact and the salutary reminder in 1992-1993 of the continuing importance of sterling”.

The Edinburgh Summit of December 1992 had significantly expanded the amounts allocated to the lagging regions of Western Europe, including Ireland. In its end-of-year review, the *Irish Times* edition of 31 December 1992 reported that:

“In the end, economic considerations appear to have swayed the Irish vote. The decision of the Edinburgh summit earlier this month, which indicates that Ireland can reasonably expect to get about £8 billion from the structural funds *and the separate cohesion fund* (italics added) over the next seven years appears to have vindicated the Government’s hard sell of such benefits during the campaign”

The reference to the new cohesion fund is significant. Structural funds were distributed widely across the EU, to advanced as well as less advanced countries. Eligibility for funding from the new instrument however, which was explicitly established to assist countries in meeting the EMU convergence criteria, was confined to the four less prosperous EU member states of the time: Greece, Spain, Portugal and Ireland. As Lindner (2006) explains:

“During the (Maastricht) treaty negotiations, the less prosperous member states, led by Spain, had made their support for monetary union dependent on a guarantee for further financial transfers from the EC budget. Given that unanimity was necessary for treaty decisions, the bargaining power of Spain had been very strong. Thus the member states had to accept Spanish demands for side-payments. They had added a protocol to the Maastricht Treaty that guaranteed Spain, Portugal, Greece and Ireland the establishment of a cohesion fund.”

Laffan and O’Mahony (2007) posit that “Irish governments agreed to projects such as economic and monetary union and foreign and security policy reforms in return for increased structural funds”, though they also suggest that “the desire to be seen as broadly *communautaire* led successive Irish governments to go with the emerging EU consensus, unless an issue was thought to be a particularly sensitive one”.

NESC (1989, chapter 13) had been highly critical of the sidelining of the MacDougall Report’s recommendation that monetary union be considered only in the context of a Community budget capable of cushioning cyclical fluctuations. Its advocacy of Irish participation however was based on the belief that the ‘integrative logic’ that had characterised EU development up to that point would continue to prevail, maintaining that an EMU with a centralised budget was a *sine qua non* for cohesion.

Among the reasons for optimism, as NESC (2010, 29) puts it in retrospect, “was the belief that the EU would find a way to respond to the kinds of risks identified above: asymmetric shocks, the overall monetary-fiscal policy mix, international currency movements and global financial instability. It was recognised that without a system of fiscal federalism, or other identified instruments to address asymmetric shocks, ‘the Union will approach particular difficulties in its traditional, ad hoc, manner [though] efforts at crisis-management are also likely to induce evolution of the system as a whole’ (Laffan *et al.*, 2000: 149). The Maastricht Treaty of 1992 “should not be seen as the end point or the definitive blueprint for EMU.. The apparent contradictions and the definite obscurities can only be clarified in practice” (O’Donnell, 1991: 24).



O'Donnell (1991: 129-131) summarises this perspective, which is likely to have been the official Irish view, as follows: "Once the decision in favour of EMU has been made, the question of cohesion becomes the more practical one of devising ways to promote Ireland's progress towards average Community living standards and levels of unemployment.. The greatest Community contribution to cohesion is likely to arise from the development of the Community budget... Achievement of a genuine common market, and of efficiency within it, requires Community involvement in a wide range of policy areas. Thus the Community budget and greater fiscal union would grow as a concomitant of the growth of the Community's competence in various policy fields."<sup>12</sup>

Over the course of the Irish debate, a number of contributors made the point that it would have been politically difficult for Ireland – having voted in favour of Maastricht and having accepted the increased funding – to opt out. Laffan and O'Mahony (2007) concur. Only three countries which were technically eligible for membership opted not to join. The UK had secured through negotiation the right to opt out, Denmark had secured the right to subject the issue to referendum, which resulted in a 'no' vote, while Sweden exploited a loophole by refusing to enter the exchange rate mechanism. None of these three however had been in receipt of cohesion funds. That Greece and several other states that failed the criteria were nevertheless accepted into the union illustrates the importance for the project – even on narrowly economic (i.e. transactions costs) grounds – of having more rather than fewer members. Ireland would have been unique among the cohesion countries had it declined to join.

Baker, FitzGerald and Honohan (1996, 15) are particularly forceful on this point, writing that: "Unlike almost all previous developments in the Union, the single currency will divide the Union into an inner and an outer group. Whatever other derogations Ireland may have received over the years, they are as nothing compared with failure to join the EMU. Such a result would entail risks which are hard to evaluate, but may be considerable. The history of international co-operation in monetary affairs suggests that the political advantages of membership in a co-operative monetary and economic area are less evident when economic conditions are good; it is in the downturn when outsiders may be penalised or at least when assistance to a non-member may be more needed and less forthcoming."

Though Ireland had similarly received cash transfers from the EU at the time the sterling link was severed in 1979, little formal economic analysis of the policy choices available at that time had been carried out (Honohan and Murphy, 2010). The purpose of these earlier transfers was to absorb the competitiveness losses that the country would suffer if sterling were to depreciate in the short term, as had been expected. In the event however, the policies followed by the new Thatcher administration in the UK led to a strengthening of sterling.

In the case of the single currency, the Economic and Social Research Institute (ESRI) was commissioned in 1996, following a competitive tendering process, to evaluate the costs and benefits for Ireland of participating in the project.

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<sup>12</sup> Irish proponents of EMU did not consider the implications of Ireland having to surrender its corporation tax regime as part of ongoing fiscal integration.

#### 4. The ESRI Report and its Critics

The ESRI report (Baker, FitzGerald and Honohan, 1996) concluded that "Ireland can expect to benefit modestly in terms of income and employment through membership of Economic and Monetary Union". The Irish debate over the economics of participating in the single currency project without the UK began in earnest after the publication of the ESRI report.

There was agreement across all sides as to the benefits of the savings in transactions costs, though these would be less significant without UK participation. The main danger focused upon in the debate between the ESRI and its critics concerned the consequences of sustained sterling weakness. Under the broad-band exchange rate system in operation since the summer of 1993, the Irish pound had followed a path co-determined by the movements of sterling and the Deutsch mark. The Irish pound weakened as sterling did, thereby cushioning the competitiveness shock (Neary and Thom, 1997). The euro would not respond in similar fashion. The ESRI determined that the benefits of the lower interest rates available to Ireland with the disappearance of the currency-risk premium would marginally dominate the difficulties that would arise in the event of sterling weakness.

The main debate henceforth centred around two issues. Had the ESRI correctly evaluated the dangers of sterling weakness, and were they correct in their analysis of the interest rate effects? We discuss four points raised over the course of that debate. With the benefit of hindsight it is possible to see their relevance to the later eurozone crisis, though the context in which they were discussed proved not to have been the appropriate one.

Both sides agreed that sterling weakness would require a downward adjustment in Irish real wages. Since this is more easily achieved through inflation than through nominal wage reductions, 'internal devaluation' would be more difficult in the low-inflation environment of EMU, while sterling weakness would itself lower Irish inflation. FitzGerald and Honohan (1997) accepted the validity of this argument, as advanced by the present author, agreeing that "there is a need to reconsider the way in which wage bargains are set, to allow for an orderly and rapid adjustment when needed in EMU". Barry (1998) responded to this, and to the claim in *One Market, One Money* that wage adjustments were likely to be more rapid than otherwise when domestic policy responses are constrained, by pointing to the research on France that found little evidence of increased wage flexibility as the Franc-DM peg gained in credibility.

NESC (1996, chapter 5) argued that that the social partnership process was likely to facilitate internal devaluation if required.<sup>13</sup> Barry (1997) was less sanguine, pointing to the refusal of Irish unions to renegotiate nominal wage agreements when sterling fell sharply on departure from the ERM in 1992. Neary and Thom (1997) were also sceptical, as was Fitzgerald (1999), whose econometric modelling of the Irish labour market led him to believe that partnership merely validated the results that market forces made inevitable.

A second point raised in the debate had to do with the behaviour of real interest rates. With the nominal interest rate set by the ECB, a weak sterling, which would lower Irish inflation, would

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<sup>13</sup> While NESC rejected the "monetarist" view that exchange rate changes could be of no benefit, it deemed it worthwhile to surrender this instrument in order to achieve less variable inflation, which would substantially reduce the difficulty of securing wage agreements.

lead to a higher real interest rate. This would impart a further contractionary shock to the economy.<sup>14</sup> EMU would thus increase macroeconomic volatility.

A third point challenged the ESRI assumption that Irish interest rates under EMU would necessarily be reduced to German levels. Neary and Thom (1997) suggested that while the Irish government was likely to be able to borrow at premium rates under normal conditions, this could change in the event of a rapid deterioration in the fiscal position, driven possibly by sterling weakness. This would have a further destabilising impact. Barry (1998) pointed out that the experience of Canadian provinces and US states suggested that regional debt could command a risk premium even within a monetary union, to which Honohan (cited in Barry, 1998) responded that national economies would not be subject to the same risk premia as federal states and provinces because of the vastly greater tax-raising powers they possessed.

A fourth point made by critics of the ESRI position was that the Ireland of the late 1990s – which had been experiencing an economic boom for most of the decade – did not need lower interest rates (see e.g. McCarthy, 1998). Neary and Thom (1997) pointed to the international evidence that the Irish business cycle was out of synch with that of the eurozone core: only a small number of core countries had been found to fulfil the ‘optimal currency area’ criteria for currency union with Germany. This suggested that the level of the eurozone interest rate might generally be inappropriate for Ireland. In the specific circumstances then prevailing in the country, they wrote, “lower interest rates are likely to raise demand and lead to further increases in the prices of non-tradables such as housing. Joining EMU could then worsen competitiveness even without any depreciation of sterling, initially reinforcing but ultimately choking off the current Irish boom.”<sup>15</sup>

## **5. Some Broader Issues Raised in the Debate**

A number of issues other than those stemming from the ‘optimal currency area’ literature also surfaced in the Irish debate. McAleese (1998) reported Ireland’s inward-investment agency, the IDA, as claiming that “failure to participate in EMU would have a serious adverse effect on inward investment”. When the present author queried this, the memo the agency released to him proved less apocalyptic, stating that “the majority of companies interviewed did not see EMU membership as being an important location determinant, but, of those who saw it making an impact, the vast majority were of the view that it would encourage facilities in Ireland”.

A second issue raised by McAleese (1998) was that abstention from the single currency might weaken the government’s commitment to fiscal control. “Were this to happen”, he wrote, “failure to join EMU would be regarded by future generations as a truly calamitous decision”. McAleese at the time was the leading proponent in Ireland of the “expansionary fiscal contraction” hypothesis proposed by Giavazzi and Pagano (1990), which argued that the fiscal contraction of the 1987-89 period had led to a demand-side expansion of the economy.<sup>16</sup>

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<sup>14</sup> This point was made by private-sector economist Jim O’Leary, as reported in the *Irish Times* of October 21 1996. This implied that fiscal policy within EMU would have to lean even further against the wind.

<sup>15</sup> Honohan (2000) would later accept that these EMU-induced lower interest rates had fuelled the property price boom “and may well have caused it to overshoot”.

<sup>16</sup> See the debate between McAleese (1990) and Barry (1991).

“Without the disciplining effect of the Maastricht criteria on Irish fiscal policy”, he continued, “the economic boom would never have happened”.

More Keynesian-oriented economists worried that there was a contractionary bias to the single currency project. Neary (1997a) warned that the tight controls enshrined in the Stability and Growth Pact signed in Dublin in December 1996 were likely to deactivate national ‘automatic stabilisers’ when they were most needed.<sup>17</sup> Emasculating the automatic stabilisers and closing off the possibility of nominal exchange-rate adjustment “throws all the burden of adjustment onto domestic wages and prices, with consequences for which we are totally unprepared”.<sup>18</sup> He noted that the (strongly pro-EMU) commissioner in charge of implementing the project had stated that “people who hope that the euro means the end of Thatcherism in Europe have got it precisely backwards”.

Though McAleese’s position – that abstention from the single currency might weaken the commitment to fiscal control – was undoubtedly tenable, several countries were invited to adopt the new currency without having met the Maastricht criteria. Eichengreen (2012) would later write, with a specific focus on Greece, that “one can say that this belief that fiscal discipline could be outsourced was more than a little naïve”.

A further point raised in the debate that was of much broader than purely Irish interest was the absence of a local ‘lender of last resort’. As Lane (1998b) noted:

“Under EMU, national central banks will not have the monetary autonomy to act as local lenders of last resort. Moreover, the ECB is unlikely to intervene in the case of a purely regional financial crisis that does not pose a systemic risk to the overall euroland financial system. One solution to a regional crisis would a fire-sale of local financial institutions to deep-pocketed international banks. If the government rather wished to maintain locally-owned banks, an alternative may be to establish a fiscal ‘reserve fund’ that could fulfil, at least partially, a lender of last resort function...

In addition to the provision of liquidity, a fiscal reserve fund may also be helpful in financing a reorganisation, were the banking sector to fall into chronic difficulties. As has occurred in such circumstances elsewhere, it may be efficient for the government to restart normal lending activity by buying out the nonperforming loans of the banking sector [the ‘bad bank’ option]. The international experience is that such bailouts may entail upfront costs in excess of 10% of GDP and, in the absence of a reserve fund, this could severely damage the government’s fiscal position and have especially adverse implications in the context of the limits imposed by the Stability and Growth pact.”

Building up a fiscal reserve fund would of course necessitate immediate fiscal consolidation across the eurozone.

On 5 December 1997 the *Irish Times* published an article by John FitzGerald and Patrick Honohan, co-authors of the ESRI study, that identified three distinct groups – each with its own distinctive perspective – as having been involved in the debate on EMU. First was the political

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<sup>17</sup> See also Barry (2001).

<sup>18</sup> On this, see also De Grauwe (2003, 227).

and administrative establishment. FitzGerald and Honohan described them as “impatient with small-minded nickel-and-dime calculations of the costs and benefits of the single currency”, viewing EMU “as part of a grand project from which Ireland must not be excluded”. They concluded that “this perspective helps us to understand why there is no real doubt as to whether Ireland will enter: the political and administrative establishment is unshakeable on this.”

The second group comprised “the commercial and financial elite”. FitzGerald and Honohan deemed them to be “overweight [relative to the rest of the economy] in dealings with Britain” and therefore tending to see the important trade link with Britain as “the be-all and end-all of economic prosperity.” This, they suggested, could induce an excessive focus on the dangers of sterling fluctuations.<sup>19</sup>

The third group was the academic community. “Economists, ourselves included,” they pointed out, “are strongly influenced by attitudes in North America – the home of modern economics – and in particular by American scepticism about the European weakness for grandiose statist projects, of which EMU is undoubtedly an example”.

What US economists were saying at the time is summed up in the title of a recent survey by Jonung and Drea (2010): “It can’t happen, it’s a bad idea, it won’t last: U.S. economists on EMU and the euro, 1989-2002”. Nobel laureate James Tobin, they write, “summarized the factors underlying the scepticism of many U.S. economists towards EMU: the absence of an authority for centralized fiscal redistribution, sticky wages, and a monetary policy objective that took no account of employment, production or growth.”

As Jonung and Drea (2010) note, Barry Eichengreen was one of the US economists who followed and commented on EMU consistently throughout the 1990s. His work with Tamin Bayoumi, which found that only a small number of core continental European countries were suited to currency union with Germany, was particularly influential on the ‘no’ side of the Irish debate, featuring prominently in the contributions of Barry (1998) and Neary and Thom (1997). The absence of fiscal federalist structures was also regularly referenced in the Irish debate.<sup>20</sup>

One important contribution by a US economist that Jonung and Drea (2010) failed to cite but that was picked up in the Irish debate was Krugman (1987), though this particular analysis focused not on EMU but on the European Monetary System that preceded it. The increasing integration of the European economy, Krugman argued, generates “a bias towards excessive restriction because each country ignores the impact of its actions on the others’ exports”. This bias is accentuated by increased labour mobility since some of the employment increase associated with fiscal expansion would be accounted for by immigration. He noted that:

Achieving co-ordination of fiscal policies is probably even harder politically than co-ordination of monetary policies. There is not even temporarily a natural central

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<sup>19</sup> Neary (1997) pointed out however that “the exposure of Irish GNP and employment levels to sterling is greater than the UK share of exports would suggest”.

<sup>20</sup> FitzGerald (2001) was quite circumspect on this, writing that “research is also needed to determine whether there is a loss in efficiency in defining optimal fiscal policy at a national level, as is currently the case, rather than determining it at the level of the union”.

player whose actions can solve the co-ordination problem. None the less, in surveying the problems of European integration, it is hard to avoid the conclusion that this is the systemic change most needed in the near future”.

The suggestion here is that a central (Washington-style) budget may be required for Keynesian stabilisation purposes, and not just as a cushion for region-specific/‘asymmetric’ shocks. A particularly prescient contribution came from the Belgian economist Paul de Grauwe in an article in the *Financial Times* of 20 February 1998 entitled “The Euro and Financial Crises”:

“Suppose a country, which we arbitrarily call Spain, experiences a boom which is stronger than in the rest of the euro-area. As a result of the boom, output and prices grow faster in Spain than in the other euro-countries. This also leads to a real estate boom and a general asset inflation in Spain. Since the ECB looks at euro-wide data, it cannot do anything to restrain the booming conditions in Spain... Unhindered by exchange risk vast amounts of capital are attracted from the rest of the euro-area. Spanish banks, that still dominate the Spanish markets, are pulled into the game and increase their lending. They are driven by the high rates of return produced by ever increasing Spanish asset prices, and by the fact that in a monetary union, they can borrow funds at the same interest rate as banks in Germany, France etc. After the boom comes the bust. Asset prices collapse, creating a crisis in the Spanish banking system.”

This contribution does not appear to have been picked up in the Irish debates of the time, though, surprisingly, such fears also barely register in the 2003 edition (a mere five years later) of De Grauwe’s book on *The Economics of Monetary Union*.<sup>21</sup> Indeed the book asserts that the principles of *home country control* (where responsibility for bank supervision rests with the authorities of the country where the banks have their head office) and *host country responsibility* (where the host country is responsible for financial stability in its own market) are unlikely to create major problems as long as national banking systems remained largely segmented.

The 2003 edition of De Grauwe’s book also made no reference to the importance of common deposit insurance. It was critical however of the fact that the ECB mandate made no mention of financial stability, which it interpreted as evidence of the influence of monetarism.<sup>22</sup>

Both sides in the Irish debate recognised that currency union would require a retuning of many aspects of Irish economic policy. Fiscal policy would have to be exercised more carefully to ensure that adequate funding would be available to deal with any crisis that might emerge. Lane (1998a) warned that “in order to retain cyclical flexibility in the future, the government should be running substantial budget surpluses during the current boom”. The paper by Barry and FitzGerald (2001), the authors of which had been on opposing sides in the Irish debate, sided

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<sup>21</sup> De Grauwe (2013) appears to include himself in his criticism of macroeconomists for having failed to take adequate account of banking and finance in their models. The post-crisis review of IMF performance conducted by the organisation’s Independent Evaluation Office (IMF IEO, 2011) commented that “IMF economists tended to hold in highest regard *macro models that proved inadequate* for analyzing macro-financial linkages”. This problem, it notes, was widespread in the profession, citing similar reflections by Paul Krugman and Kenneth Rogoff. A similar point was made by John FitzGerald (2015) in his testimony to the Banking Inquiry.

<sup>22</sup> De Grauwe (2003, chapter 7).

with Brussels in its criticisms of the Irish government's fiscally-fuelled overheating of the economy and property market at that time. These warnings were not heeded.

Similar warnings were coming from within the bureaucracy itself, as revealed in the post-crisis reports commissioned by the government into the pre-crisis performance of the Central Bank, the Financial Regulator and the Department of Finance, though the reports were critical of how the warnings were communicated. As to why the Central Bank and Financial Services Authority of Ireland did not warn more aggressively of the risks of the inflating property market, the Honohan Report of 2010 states that "although some initiatives were taken, deference and diffidence on the part of the CBFSAI led to insufficient decisive action or even clear and pointed warnings". With reference to the Department of Finance, the Wright Report of 2010 notes that "it did provide warnings on pro-cyclical fiscal policy and expressed concern about the risks of an overheated construction sector. However, it should have adapted its advice in tone and urgency after a number of years of fiscal complacency. It should have been more sensitive to, and provided specific advice on, broader macroeconomic risks". And again later, "after several years of fiscal action well above that clearly recommended by the Department, one would have expected the tone, and shape, of advice on the risks of this path to increase vigorously. We would have expected more initiative to make these points in new ways. This did not happen."

Similar criticism has been made of the commentaries of the international institutions. O'Leary (2010) suggests that "a reasonable reading of international assessments of the Irish economy published [by the IMF, the OECD and the European Commission] between 2001 and 2007 is that the risks that characterised the public finances were matters of second-order importance by comparison with the perceived prudence and soundness of the overall fiscal stance".

The importance of bank supervision and financial regulation in a currency union received much less attention than the issues surrounding fiscal policy. Honohan (1991) had argued for the centralisation of bank supervision as a centralised authority would be better able to withstand national political pressures and act decisively to close failing banks. He also argued for stronger capital adequacy standards than had been enshrined in the Basle Agreement. Lane (1997) pointed out that the lack of an independent exchange rate and the scope for foreign borrowing in a monetary union "calls for more vigilant monitoring of lending activity to minimise the potential for over borrowing and bubbles in asset and housing markets and hence reduce the potential for a financial crisis".<sup>23</sup> FitzGerald and Honohan (1997) also pointed to the need for increased prudence on the part of lenders in matters such as loan-to-value ratios. In this case also, external commentary proved deficient.<sup>24</sup>

By contrast the warnings issued by both the OECD and the IMF on the property bubble, particularly since 2003 – and their advocacy of fiscal measures to rein it in – have been belatedly

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<sup>23</sup> Lane (1998b) noted the increased importance of international diversification under monetary union, proposing that "the tax treatment of savings should be altered so that investment in the risky local property market is not favoured over foreign assets that have more attractive return properties from a diversification perspective."

<sup>24</sup> The Honohan Report of 2010 suggests that the IMF's conclusion in 2006 that the Irish financial system was fundamentally sound would have assuaged internal doubts about its resilience.

praised, though both institutions failed to consider the possibility of a near-total collapse of the construction sector and the consequences this would have for employment, output, the banking system and the public finances (Casey, 2014).

## **6. Crisis and Response**

As we have seen, the main crisis scenario that featured in the Irish debates on the euro was an asymmetric shock brought about by a period of sustained sterling weakness. As it transpired, the asymmetric shock that proved to be of most relevance for the eurozone periphery was the single currency itself. Its adoption saw nominal interest rates fall to German levels, as the ESRI had predicted. The resulting boom saw inflation in the periphery pick up (the initial weakness of the euro against both sterling and the dollar was an additional contributor to Irish inflation), and the reduction in real interest rates aggravated the boom (de Grauwe, 2013). The currency union was destabilising in this sense, as had been noted in the Irish debate, and macroeconomic policy was not retuned to take this into account.

Monetary union gave Irish and other periphery banks access to much broader eurozone capital markets. The failure of periphery interest rates to rise, as would have occurred outside monetary union, allowed much greater imbalances to emerge, though – as elsewhere – the global savings glut was a further contributory factor. As Honohan (2006) puts it, the watchdog role that finance had traditionally played was muzzled by the arrival of the single currency. Heavy foreign borrowings by Irish banks facilitated excessive mortgage lending and the expansion of the Irish property bubble.

Sovereign spreads became vastly more responsive to the weaknesses of countries' financial sectors over the course of the global and eurozone crises (Mody and Sandri, 2012). Triggers included the rescue of Bear Sterns in March 2008, the bankruptcy of Lehman Brothers in September 2008, the nationalisation of Anglo-Irish Bank in January 2009 and the announcement by Chancellor Merkel and President Sarkozy at Deauville in October 2010 of future private-sector 'bail ins'.<sup>25</sup> The eurozone now found itself paralysed by international disagreements as to the appropriate policy response.

The periphery banks were in crisis, as de Grauwe's *Financial Times* contribution had predicted, and, with no real lender of last resort, the 'doom loop' (by which the fate of the banks and the sovereign are bound together) surfaced. The periphery countries had no way to respond other than through 'internal devaluation' and structural reform as they had no fiscal space at their disposal.<sup>26</sup> Exchange-rate devaluation was not an option, there was no central EU budget to serve as a cushion, there was no central player to co-ordinate an EU-wide fiscal expansion, and the ECB had no mandate to concern itself with anything other than inflation. Eventually the ECB did respond of course – with the Draghi announcement of July 2012 – to the chagrin of

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<sup>25</sup> Baldwin et al. (2015) refer to this as a 'sudden stop with monetary-union characteristics', as opposed to the precipitous sudden stop seen in the case of Iceland for example.

<sup>26</sup> Stiglitz (2016: 75) argues that if structural reforms were the solution to the periphery crisis, one might have expected a lack of structural reform to have shown up in poorer performance before 2008 as well as afterwards.



some important stakeholders whose analysis of the crisis seemed to mirror that of the Austrian school of the 1930s.<sup>27</sup>

The eventual monetary expansion was not mirrored on the fiscal side. The contractionary bias that had been identified primarily by US Keynesians appeared as a clear reality, as reflected by the much more vigorous fiscal response in the US for example. The burden of adjusting to imbalances in the eurozone fell almost entirely on the periphery deficit countries (De Grauwe, 2013, Figure 8).

As Baldwin et al. (2015) put it, “there was nothing in the EZ institutional infrastructure to deal with a crisis on this scale. EZ leaders faced the dual challenge of fire-fighting and institution-building – all in a situation where the interests of debtors and creditors diverged sharply and European electorates were closely following developments.”

According to Orphanides (2014), “the underlying cause of tension is a misalignment of political incentives... Because Europe is a loose confederation, European institutions face difficulties in blocking decisions, even when these are clearly detrimental for the euro area as a whole... At present, no political authority has the power and incentives to advance and protect the common good.” The European Commission might have been expected to play this role, but as Spolaore (2013) notes, “supranational agents’ ability to take autonomous decisions can only be sustained in matters where the extent of disagreement among national governments over policy outcomes is relatively low”.<sup>28</sup>

Irish competitiveness has been recovering but not by nearly as much as suggested by the relative *unit labour cost* measures employed by Whelan (2014) for example, which are distorted by the strong productivity growth recorded by the foreign-MNC sector in Ireland.<sup>29</sup> The partial restoration of competitiveness has been achieved not by real wage reductions – which, as is generally recognised, are very difficult to achieve in a zero-inflation environment – but by a wage standstill as trading partners’ wages increased (O’Farrell, 2015).<sup>30</sup>

Ireland’s strong recovery over recent years has been driven primarily by the characteristics of the country’s export structure rather than by internal devaluation. The relatively early recoveries of the US and the UK have been significant, given their importance as destinations for Irish exports,

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<sup>27</sup> Compare, for example, the analyses of De Grauwe (2013) and Sinn (2014). Wyplosz (2015) refers to “generally accepted macroeconomic principles” colliding with the “Hayekian and ‘ordoliberal’ ideas prevalent in Germany”.

<sup>28</sup> The sidelining of the European Commission is particularly detrimental to smaller member states as the Commission had traditionally served as guarantor of their interests.

<sup>29</sup> As O’Brien (2010) puts it, “developments in the chemicals sector in particular have tended to drive up measures of productivity growth and push down unit wage costs to such an extent as to reduce the relevance of output-weighted measures”. This is because of the relatively small weight of pharma-chem in employment compared to its very high output and export shares.

<sup>30</sup> The Irish crisis was nevertheless characterised by remarkable industrial peace, which Barry (2014) credits to the legacy of social partnership.

as has the general weakness of the euro.<sup>31</sup> Also of major importance has been the relative immunity to the business cycle of Ireland's key export sectors: pharma, agri-food, and IT and other business services (Byrne and O'Brien, 2015; Barry and Bergin, 2017).

## **7. The Eurozone Today: The State of Play**

A broad degree of consensus has by now emerged as to the causes of the eurozone crisis, as reflected for example in Baldwin et al. (2015).<sup>32</sup> Baldwin and his co-authors identify three types of underlying causes: policy failures that allowed the imbalances to expand so dramatically, the absence of shock-absorbing institutions at the eurozone level, and failings in real-time crisis mismanagement.

The imbalances that set the stage for the crisis involved public and private debt as well as cross-border borrowing and lending. At the heart of these failures, they write, lies the simple fact that the eurozone was designed without mechanisms that could moderate divergent economic developments.

Nothing was put in place to monitor large intra-eurozone capital flows: "To use the language of software engineers, the big flows were viewed as a feature, not a bug". Neither was any attention paid, in either surplus or deficit countries, to what the credit flows were financing. There was nothing to prevent the massive bank leverage that emerged. Banks' balance sheets were left to national authorities. "Coordination of banking rules was at best mentioned in passing in the 1990s, and few thought of moving deposit insurance, supervision, or bank resolution to the EZ level... The real failure here was the intellectual climate of the 1990s that viewed existing micro-prudential rules as sufficient."

On shock-absorption, they suggest that bank recapitalisation should have been done at the eurozone level to avoid the concentration of risk within individual countries. They note that the automatic stabilisers initially dampened the shock and "prevented the Great Recession from becoming the second Great Depression. From 2010, however, the fiscal policy stance flipped... To avoid a lingering recession, active aggregate demand management at the level of the eurozone would have been needed. But this was not to be."<sup>33</sup>

Crisis management suffered from the fact that, with no explicit crisis-management mechanisms in place, most decisions had to be made by consensus. This proved extremely difficult because of the conflicting interests at stake. "The decision to set up the ESM went in the right direction, but the choice to structure the new institution as an intergovernmental body weakened the Commission, with long-run consequences."

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<sup>31</sup> While it was understood that internal devaluation would be more difficult in a low inflation environment, no-one would have been able to predict that these difficulties would be offset to some extent for Ireland by euro weakness over much of the crisis period.

<sup>32</sup> Though the authors of the study come from diverse backgrounds, they note that they found it "surprisingly easy" – given the diverse narratives to which eurozone policymakers remain attached – to agree on a shared narrative.

<sup>33</sup> Barry (2014) makes the point that even rigorous adherence to fiscal discipline does not obviate the need for a centralised demand management policy: even the best behaved economies in Asia suffered contagion when crisis swept the region in the late 1990s.

This analysis is very similar to that presented by Joseph Stiglitz in his recent book *The Euro and its Threat to the Future of Europe*. The key feature tying the structural flaws together, he argues, was “a misguided economic ideology prevalent at the birth of the euro” – a belief in the inherent stability of the private sector.<sup>34</sup> This belief distracts attention from the necessity for macro-prudential regulation.<sup>35</sup> It also implies that fiscal disequilibria are the only driver of current account imbalances that need to be guarded against; property bubbles and other private sector-generated disequilibria are assumed away.<sup>36</sup>

Stiglitz also refers to a need for “deep political solidarity”. Transfer unions achieve certain common desirable political ends.<sup>37</sup> Well-functioning political unions are also conducive to reform in that they embody an implicit deal that those who lose out from one set of reforms can reasonably anticipate benefitting from others.

Resolution of the crisis was hugely impeded by the fact that the balance of payments disequilibria of the pre-crisis years had divided the eurozone into debtors and creditors.<sup>38</sup> Baldwin et al. (2015) agree, noting also that the importance of the “interlinkage between core-nation banks and periphery-nation borrowers”. The task of setting up shock-absorbing mechanisms was made much more difficult by the fact that it was now clear which eurozone members would be benefitting directly and which would be bearing the up-front costs.

While Baldwin et al. (2015) anticipate greater difficulty in arriving at a consensus view on the way forward, a *Financial Times* review of Stiglitz’s book argues that “if the eurozone leaders took his advice on policy choices, they would disprove his bigger claims about the euro’s supposedly unsustainable structure”.<sup>39</sup>

Stiglitz’s proposals are motivated by the view that the diversity of eurozone member states necessitates institutions that can help the countries for which the single exchange rate and interest rate are not well suited, while there needs to be sufficient flexibility in the rules to allow for differences in circumstances, beliefs and values. Saving the euro, he believes, requires “more Europe”. While what he sees as the minimum requirements do not entail as extensive a degree of fiscal federalism as in the US case, he is pessimistic as to whether Europe can achieve the

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<sup>34</sup> De Grauwe (2003, 80) also suggested that the popularity of monetarism in the 1980s, which is closely aligned with this view, “helps to explain why EMU became a reality in the 1990s”. (See also De Grauwe, 2003, 150). Stiglitz also refers to the monetarist belief at the time of the eurozone’s birth that monetary policy alone would be sufficient to deal with a eurozone-wide adverse shock.

<sup>35</sup> As Alan Greenspan, former Chairman of the Federal Reserve, would later admit: “I made a mistake in presuming that the self-interest of organisations, specifically banks and others, was such that they were best capable of protecting their own shareholders” (cited in the *Financial Times*, October 23, 2008).

<sup>36</sup> Stiglitz (2016, pps. 107-114). The alternative perspective suggests that capital market integration, particularly in the absence of banking union, is associated with pro-cyclical flows (Stiglitz, 2016, p. 28).

<sup>37</sup> Some historians suggest that the Common Agricultural Policy, which is by far the largest component of EU expenditure, was introduced to reduce support for far-right political parties. This was certainly the logic of the post-World War II welfare state. Economic malaise is again today of course feeding extremist views and nationalistic tendencies.

<sup>38</sup> Stiglitz (2016, pps. 117-119, 140).

<sup>39</sup> Sandbu (2016).

political consensus to implement them. The major structural reforms that Stiglitz believes are required include full banking union, a change in financial regulation and the mandate of the ECB, discouragement of current account surpluses, automatic stabilisers at the eurozone level, and some degree of debt mutualisation.<sup>40</sup>

We comment here only on the issue of banking union, which as we have seen – though widely recognised today as being of paramount importance (Gros, 2012) – received remarkably little coverage in the discussions preceding monetary union. Stiglitz warns that proposals for common regulations and a common resolution mechanism without common deposit insurance – the model supported by Germany – may make matters worse rather than better. The rigid application of common regulations will preclude ‘forbearance’ for example (i.e. the easing of regulations in times of economic downturn). Without common deposit insurance this will make it even riskier for depositors to keep their money in the banks of a weak country, which will exacerbate the problem of divergence.<sup>41</sup>

## Conclusions

By far the most difficult task in drawing conclusions is determining the appropriate counter-factual: what exchange rate regime would Ireland have chosen if it had decided not to adopt the euro, and what would the consequences of this choice have been?

Leddin and Walsh (2003:258) refer to the conduct of exchange rate policy over the “broad-band” EMS period (1993-1998) – when the effective exchange rate was stabilized by playing off sterling movements against those of the Deutsch mark – as “probably the Central Bank’s ‘finest hour’.” Those opposed to euro membership felt that this should continue to be the general practice.

Eurozone membership was not of course a pre-condition for eurozone periphery-type crises, as the examples of Iceland and Latvia reveal.<sup>42</sup> Most analysts agree however that imbalances would have been less severe had Ireland not joined the euro.<sup>43</sup> Ireland’s remaining outside would have entailed higher interest rates, lower international borrowing by the banks and others, a less extensive property bubble and, with less buoyant property-related tax revenues, reduced public pressure for pro-cyclical fiscal spending.

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<sup>40</sup> Stiglitz (2016: 240).

<sup>41</sup> Stiglitz (2016: 130-131).

<sup>42</sup> Latvia had followed a fixed exchange rate policy since 1994, initially pegging to the SDR and latterly to the euro. Iceland’s case is more complicated. The academic literature identifies inflation targeting as one of the sources of Iceland’s problems. The Icelandic boom pushed up inflation and interest rates, sucking carry-trade capital into the economy. Inflation targeting then led to monetary contraction and higher interest rates, which exacerbated the problem. Ireland would have been unlikely to have been caught in this trap because sterling would have remained an important anchor for an Irish pound exchange rate.

<sup>43</sup> Eichengreen (2015) and Honohan (2000, 2006) concur. Lane (2015) avoids the question in addressing how the crisis might have been resolved had Ireland not been in the monetary union, assuming “for the purpose of this argument.. that a similar credit expansion could have occurred even without the euro.”

Would crisis resolution have been more or less difficult had Ireland remained outside? Lane (2015) argues that membership provided an important bulwark against the global financial shock by allowing cross-border liquidity flows (from the ECB and, for banks with insufficient eurosystem-eligible collateral, through ELA from the national central bank) to replace cross-border private flows. In their absence, he suggests, the initial recession would have been deeper, with larger movements in interest rates and asset prices, though he accepts that foreign investors would have shared more of the costs of adjustment through greater write-downs of debt. Medium-term recovery, furthermore, might have taken hold more quickly through currency devaluation and local-currency provision of liquidity to the banking system.

O'Rourke (2015) argues that small crisis-ridden countries are much more vulnerable inside the eurozone than out: "Outside, you will deal with the IMF on its own, and they have a standard policy template: debts will be written down, currencies will be devalued, and yes, there will also be austerity. Inside the Eurozone creditor countries will sit alongside the IMF at the table and you may find that *neither* of the first two policies will be feasible, which will make the austerity far more harmful than it would otherwise be, both economically and politically".<sup>44</sup>

Eichengreen (2015) is critical of a number of ways in which the EU and the ECB responded to the Irish crisis:

"The Irish authorities.. did not receive wise counsel from the EU. Ireland's policy that no bank would be allowed to fail was also the EU's policy, de facto if not de jure. Uncertainly surrounded the provision of ELA [emergency liquidity assistance]: the Irish authorities received no assurance that if they immediately put Anglo Irish and Irish Nationwide into receivership other banks would receive unlimited liquidity support. The absence of a mechanism for directly recapitalizing the two troubled banks allowed the sovereign-bank doom loop to come into operation. The ECB applied pressure for Ireland to request a Troika program in 2010, to refrain from administering haircuts to holders of senior unsecured and unguaranteed debt, to undertake sales of bank assets more quickly than Irish officials thought best, and to sell off the long-term bonds acquired by the Central Bank of Ireland at a pace that posed risks to the government's finances".<sup>45</sup>

Many of the problems that eurozone membership was likely to entail were recognised by both sides in the Irish debate of the 1990s. The likelihood of asymmetric shocks was well flagged and the fact that the Irish business cycle was out of synch with that of the eurozone core indicated that the creation of the currency union might itself represent a significant shock. It is surprising

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<sup>44</sup> Ireland's heavy reliance on foreign direct investment might temper this conclusion since the international evidence suggests that default can adversely affect FDI inflows even when these investments are not directly affected by the default. The salience of this point might be reduced however by the fact that the US – the main source of inward FDI in Ireland – would not have been a significant creditor in terms of the debts being written down.

<sup>45</sup> To this might be added the fact that, were it not for the support of the IMF, Ireland might have been forced to accede to the demands of some powerful eurozone member states that it raise its corporation tax rate in return for assistance. This might have substantially impacted on Ireland's possibilities of recovery.

in retrospect that sceptics focused so much on the possibility of a sterling shock rather than on the shock that euro membership itself entailed.

Monetary union proved to have much stronger pro-cyclical tendencies than its supporters had recognised. The low interest rates that the ESRI report had focused upon proved a double-edged sword, inflating the property bubble and supporting the accompanying pro-cyclical fiscal expansion. Advocates of membership had been careful to warn of these possible dangers however and there were some prescient hints as to possible adverse consequences for the banking system. They had warned of the need for prudent bank lending and careful bank regulation but may have been over-optimistic in their belief that these issues would be addressed.

Both sides had warned of the greater degree of care required in how fiscal policy was conducted within EMU. The paper by Barry and FitzGerald (2002) illustrates the degree of consensus between economists who had been on opposing sides of the EMU debate.

The sudden stop showed definitively that interest rates could deviate sharply from German levels even within EMU. Most Irish economists recognised that in the absence of the exchange-rate instrument a centralised fiscal expansion would have been hugely beneficial in staving off recession and reducing the need for austerity.

Many on both sides had been greatly concerned at the absence of a centralised fiscal shock absorber, which the “small open economy” perspective suggested would be necessary even were domestic automatic stabilisers not deactivated under the terms of the Stability and Growth Pact. Advocates of participation were much more optimistic than their opponents that Europe would be able to resolve these issues speedily if a crisis of sufficient magnitude struck.

One issue – now universally agreed to be of critical importance – that received remarkably little attention over the course of the single currency debate, either in Ireland or elsewhere (including from US economists), was the issue of banking union.

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