

FISCAL POLICY IN A MONETARY UNION: THE CASE OF IRELAND

JOHN FITZ GERALD

1.
Introduction

The dispute between the EU Council of Ministers and the Irish government about the appropriate stance for Irish fiscal policy this year highlights a number of issues that are of much wider importance for the euro area. It raises the question of the extent to which co-ordination of fiscal policy is needed within Economic and Monetary Union (EMU) and, if it is needed, how it is to be implemented. For Ireland there is a separate question: even if the current stance of fiscal policy is unlikely to have any negative implications for other member states in the union, is it appropriate for Ireland?

This article focuses only on the economic issues arising from the current debate about fiscal policy in Ireland and in the euro area. It does not consider the wider legal and diplomatic concerns that have arisen. Also, in considering the need for a development of the current co-ordination framework for fiscal policy in the euro area, it does not confine itself to policy formation within the existing legal framework. Instead it considers how that framework needs to evolve to deal with the changing policy needs of the developing EMU.

Section 2 considers the appropriate stance for Irish fiscal policy from an Irish point of view. It considers the measurement of the fiscal impulse and a range of factors that determine the appropriate stance of fiscal policy: the underlying potential growth of the Irish economy, the extent of inflationary pressures in the labour market and the goods market, and how the Irish economy can best adjust to these pressures. The effectiveness of fiscal policy in dealing with these problems is considered and the implications of medium and long-term prospects for the economy are also discussed.

Section 3 discusses the appropriate objectives for fiscal policy co-ordination in the euro area. It first discusses why co-ordination of fiscal policy is necessary and desirable within EMU. The lessons of German unification in the 1990s are instructive in this regard. The operational experience of the first two years of EMU provides some insights into how fiscal policy co-ordination needs to evolve in the future. In particular, the recent debate about the Irish economy provides some wider lessons.

Section 4 presents conclusions suggesting a need for a change in Irish fiscal policy, as well as a change in the focus of the EU guidelines for fiscal policy.

Over the last twenty-five years many papers have been published on fiscal policy in Ireland. Dowling (1978) set out an approach to measuring a cyclically adjusted budget deficit for Ireland, an approach that is now fairly standard. Most recently, a detailed discussion of a range of different measures of “fiscal stance” was contained in Kearney *et al.* (2000). What all the measures have in common is an attempt to measure how changes in policy on government expenditure and taxation, taken together, impact on domestic demand.

Because government revenue and expenditure are both greatly affected by the state of the economic cycle, the change¹ in the government surplus or deficit on its own is not a good measure of fiscal stance. What is required is a measure of the change in the surplus (deficit), purging out these cyclical effects. Looking at the Irish economy today, it is clear that the growth rate of the last five years is unsustainable. As a result, the government surplus is in some sense exceptional and cannot be relied on to continue at its current level when the economy returns to its trend growth rate. Thus an important element in considering the underlying stance of fiscal policy is an understanding of the potential growth rate of the economy.

POTENTIAL GROWTH RATE OF THE IRISH ECONOMY AND THE FISCAL STANCE

The best estimate of the potential growth rate of GNP in the Irish economy is that, while it was around 8 per cent a year between 1995 and 2000, it should fall to 5 per cent a year over the period 2000 to 2005. The basis for this estimate was set out in the ESRI *Medium-Term Review* (Duffy *et al.*, 1999) and was further discussed in Fitz Gerald and Kearney (2000). It appears that the rate of productivity growth in the Irish economy is currently around 4 per cent a year, measured in terms of GDP, or 3 per cent a year measured in terms of GNP. While employment growth averaged 5 per cent a year in the last five years and labour force growth was 3.4 per cent a year, the growth in labour force is expected to fall to a more moderate 2 per cent a year over the next five years. In addition, with unemployment now at a very low level, the growth in employment in the next few years must be similar to the growth in the labour force. As a result, it is this fall in labour supply that will constrain the rate of growth of the economy to around 5 per cent a year over the period 2000 to 2005.

The estimates of labour supply growth have in the past proved unreliable. In particular, migration has confounded expectations. Modelling work on migration behaviour suggests that labour supply in Ireland has been very elastic in the past. However, infrastructural constraints mean that the country can not accommodate all the returning emigrants, and skilled foreign labour prepared to work in Ireland. If and

¹ What is important is the change in the surplus (deficit), not its absolute value. In a static economy with no growth and no inflation, an unchanging surplus (deficit) would be consistent with unchanging demand for goods and services.

when this infrastructural constraint is relaxed by government investment, the potential growth rate could prove higher than estimated. However, it will be quite a number of years before current investment plans begin to have a big impact.²

The EU Commission use a standardised methodology to estimate the potential growth rate and, as a result, the government's fiscal stance. It is applied by each country and published in the Irish case in the national Stability Programme (Budget 2001). Because the potential growth rate using the EU methodology is derived by applying a filter (moving average) to output in the relatively recent past, it takes no account of the changed circumstances in labour supply, suggesting a potential growth well over 5 per cent in the immediate future. Using this EU Commission methodology, the Budget for 2001 appears as only mildly stimulatory. By contrast, a model based approach, as described in Kearney *et al.* (2000) would indicate that the budget has provided a strong demand stimulus this year. The fact that the expected surplus remains high partly reflects the fact that the economy is still growing well above its long-term capacity growth rate, indicated by a large output gap.

The fiscal stimulus is taking place against the background of an economy operating at capacity. In response to increased demand it is very difficult to actually increase output. As a result, the effect of the stimulus must be some combination of increased imports and a rise in the price of domestic factors of production and non-tradable goods and services.

LABOUR MARKET IMBALANCES

As set out in the last ESRI *Quarterly Economic Commentary* (McCoy *et al.*, 2000), there appears to have been a major change in the responsiveness of the labour market to shifts in demand in the last few years. This arises from the impact of the infrastructural constraints on migration. Until recently the elasticity of skilled labour supply was infinite in the long run because an unlimited number of Irish workers would come back to work in Ireland for wage rates around 5 per cent less than they could get elsewhere (Kearney, 1999). Similarly, many skilled foreigners were happy to come to Ireland. However, the very rapid rise in housing costs has changed the after tax real cost of living in Ireland for migrants compared to what is on offer in the UK, Germany, France and Scandinavia.³

In the past, with an infinitely elastic supply of skilled labour, the effect of tax cuts was to reduce the tax inclusive cost of labour to employers. The demand effects of such a fiscal stimulus were partly offset by the elasticity of labour supply. The result was higher employment at lower cost to the business sector. In these circumstances tax cuts did not have a significant inflationary impact in the labour market.

The moderation in wage formation behaviour in the 1980s and the 1990s was due more to market forces than to the Social Partnership. As discussed in Fitz Gerald (2000), "...while the agreements have probably served to validate the rate of increase in wage rates that market forces

² This is a case where investment in public physical capital can have a very high potential return.

³ While the reduction in net immigration in the year to April 2000 was small, adjustment must be made for the increased influx of asylum seekers, who are not allowed to work. This implies a significant reduction in the supply of labour from outside Ireland.

determined, this ‘validation’ was obtained with less industrial strife than in earlier periods – a significant benefit”.⁴ However, from the late 1990s Ireland has entered a new labour market regime (Walsh, 1999), not just because of EMU entry, but also because a range of factors have reduced the elasticity of labour supply. The supply of labour is now very inelastic. The latest data from the CSO Quarterly National Household Survey show that changing female labour force participation made little contribution to increasing labour supply over the last year, in spite of favourable changes in the tax system. Under these circumstances tax cuts all accrue to employees as a rise in their after-tax disposable income, and there is very little labour supply response. The demand side effects dominate the supply side effects, and tax cuts give a significant impulse to wage inflation.

The 2001 Budget involved discretionary cuts in tax rates which amounted to up to 0.5 per cent of GDP. However, the major fiscal stimulus was on the expenditure side, where the government have budgeted for a big increase in employment in the public sector to provide improved services amounting, directly or indirectly, to between 1 and 1.5 per cent of the total labour force. By further tightening the labour market, this fiscal impulse will fuel the rate of inflation in wage rates.

IRISH INFLATION

All studies of the inflationary process in Ireland over the last twenty-five years have found that goods prices are externally determined. Quinn, Kenny and Meyler (1999) summarise this evidence. In the case of the price of the output of the manufacturing sector, prices are fully externally determined (Callan and Fitz Gerald, 1989).⁵ For aggregate consumer prices this is also true, though the speed of transmission of external shocks has changed with the advent of EMU (Fitz Gerald and Shortall, 1998). While it also holds true for inflation in consumer goods prices, inflation in the price of non-tradables – domestically produced services and house prices – is significantly affected by domestic wage rates (Meyler, 1999, and Kenny and McGettigan, 1999). However, these elements either have a low weighting, 16 per cent in the case of domestic services prices, or do not appear at all in the consumer price index, such as house prices

While the process of convergence in living standards could be expected to lead to higher inflation in Ireland, this can only account for a limited part of the differential in the rate of growth in consumer prices (Blanchard 2001, and Rogers, Hufbauer and Wada, 2001). The main reason for Irish consumer price inflation exceeding the EU average by a significant margin is external factors – exchange rates and the price of oil. However, it is not true to say that Ireland does not have an inflationary problem. This is apparent in the rapid rise in wage rates and in the feedback from the housing market to a reduced propensity to immigrate with the consequential reduction in the elasticity of labour supply. The rapid rise in the rate of wage inflation poses dangers for the Irish economy, but not necessarily for the euro area.

⁴ The “Partnership Approach” brought a wide range of other benefits to policy making in Ireland. These included more cohesive and coherent policy-making process that proved of major benefit in undertaking the necessary fiscal adjustment in the late 1980s.

⁵ The relevant equations in the latest version of the ESRI *HERMES* macro-economic model suggest that output prices are still externally determined.

MACRO-ECONOMIC ADJUSTMENT

In the medium to long term the first priority of fiscal policy will be to invest in adequate public infrastructure to release key bottlenecks in the economy. The *National Development Plan* announced at the end of 1999, provides for such a programme. However, with resources in the building industry stretched to their limits, it is desirable that such investment be accompanied by measures aimed at freeing up resources in the building industry. An overall restrictive stance in other aspects of fiscal policy could help free up resources in the wider economy to undertake essential investment.

The Irish economy is currently suffering from excess demand due to it being “too competitive”. The excess demand is coming as much from the external sector as from domestic demand (Blanchard, 2001). This is reflected in the balance of payments, which has remained close to balance over the last three years, in spite of the very rapid growth in the economy.

As discussed above, the result of the growth in demand is a very rapid rise in wage rates, forecast to be nearly 11 per cent for 2001. The share of labour in value added fell steadily since the early 1980s, indicating an improvement in underlying competitiveness. However, this can not continue indefinitely and some reversal might be expected (Lane, 1998). A real appreciation⁶ is called for to reduce competitiveness and to bring demand into balance with supply in the labour market (Fitz Gerald, Kearney and Morgenroth, and Smyth, 1999). This will reverse the trend growth in profitability.

It is not clear how much of a real appreciation is needed to bring the labour market back into balance. This would be easier to manage through a nominal appreciation of the exchange rate, where overshooting could, if necessary, be corrected through further exchange rate adjustments. However, within the euro area, it must occur through higher wage inflation.

The danger for the Irish economy with this process is that inflationary expectations in the labour market may result in the real appreciation overshooting. People may get used to an annual rate of wage inflation of 10 per cent or more a year. While this may be sustainable this year, if it continued it would rapidly price Ireland out of its external markets. Unless wage rates adjust instantaneously to clear the market in the future, any overshooting of wage rates could prove costly. Under EMU, if nominal and, therefore, real wage rates grow too rapidly, making the economy uncompetitive, correction can only come about through either a cut in nominal wages, or through nominal wage rates standing still while inflation in the euro area catches up. Cuts in nominal wage rates are most unusual. Relying, instead, on a slow process of attrition could see the economy remaining uncompetitive for some time, with a consequential serious cost in terms of unemployment and lost output.

For this reason stimulatory fiscal policy, that aggravates the rate of wage inflation and fuels expectations about future wage increases, is unwise. The rapid increase in domestic labour costs could expose the economy to unnecessary dislocation in the event of an unexpected

⁶ Where the cost of labour in Ireland, measured in a common currency, rises relative to costs in competitors.

3. Effectiveness of Fiscal Policy in a Small Regional Economy

external shock. Blanchard (2001) considers the appropriate adjustment process for both Ireland and Spain. He concludes that, because of the relatively strong balance of payments position of Ireland, the adjustment should come through a combination of wage inflation and some fiscal contraction. In the case of Spain, because of the starting position of a balance of payments deficit, it is appropriate that the bulk of adjustment should be undertaken through a tightening of fiscal policy. Such a nuanced approach to fiscal policy in regions of the euro area needs to be further developed by the EU Commission.

Fiscal policy is not an effective instrument for controlling the rate of inflation in consumer prices in an economy such as Ireland. This has been widely accepted by the economics profession for more than twenty-five years (Geary, 1975). As discussed earlier, where the goods market is fully open and there is perfect competition between foreign and domestic firms (a good approximation in the case of Ireland). In this case fiscal policy can only affect the economy through the balance of payments, the labour market and the market for non-tradable goods and services including housing.

In a monetary union, the balance of payments effects of excess demand do not feed back on the economy through exchange rates or other monetary effects. Unless domestic agents' indebtedness rises to such an extent that the risk premium on lending rises, there is no direct effect through this channel on domestic activity.

Table 1: Effects of Fiscal Stimulus Costing £500 million, Assuming a Rising Labour Supply Curve with No Migration Percentage Change in Levels on No Policy Change Scenario

Year	Increase in Employment in Public Administration		Cut in Income Tax	
	1	3	1	3
Consumer Prices	0.18	0.47	0.05	0.13
Wage Rates	1.37	1.37	0.35	0.35

Source: *Quarterly Economic Commentary*, 2000 December, Dublin: The Economic and Social Research Institute,.

While fiscal policy may be ineffective in controlling consumer price inflation, it can have an important effect on the labour market. As discussed in the December 2000 *Quarterly Economic Commentary*, where the government increases expenditure to hire more labour, the impact on wage rates will be even stronger where labour supply is constrained. Model simulations (Table 1) indicate that the long-run impact of a volume increase in public expenditure of £1 billion is to raise wage rates in the economy as a whole by between 2.5 and 3 percentage points. Where there is full employment wage rates have to rise by enough to free up potential employees from private sector firms (discouraging them from expanding or even putting them out of business) to make them available to the public sector.

In addition to its potential effects through the labour market, fiscal policy can also have an important effect on the allocation of resources within the economy by changing incentives. For example, fiscal policy can have a significant effect on the domestic housing market through changing

household disposable income and through changing the cost of capital for homeowners.⁷ The tax treatment of interest payments on house loans can have a big effect on the cost of capital for homeowners. Because the legal instrument under which mortgage lending takes place is country specific, the taxation or subsidisation of mortgage interest payments is not affected by the country of residence of the financial institution making the loan.⁸

To date the fiscal policy instrument has not been used actively in Ireland to reduce demand for housing in the current boom. It remains possible for the government to eliminate interest relief on mortgage interest payments in the income tax code. In addition there are a range of other fiscal measures that could directly reduce demand pressures in the building sector.⁹

While fiscal policy can be expected to play a significant role in moderating excessive demand pressures (or at least not adding to them) in an open economy, there are some additional factors that may reduce its effectiveness under current circumstances. Because of the exceptionally strong current financial position of the Irish government sector, the effectiveness of fiscal policy may be reduced through “Ricardian equivalence” effects (Whelan, 1991).¹⁰ For example, if the Irish government had tightened fiscal policy this year, raising the general government surplus from the expected 4.6 per cent of GDP to 6 per cent or more of GDP, it would have been quite clear to all economic agents that this was only a temporary measure. Government assurances that in future years there would be big cuts in taxation, or increases in services, would have been readily believed, and many economic agents would have behaved accordingly. Personal and company savings could have been further reduced, partially offsetting the impact of the fiscal tightening. While this effect would only offset a limited amount of any fiscal tightening it might not be a trivial effect where the fiscal tightening occurred through taxation.

However, even if there were some evidence that “Ricardian equivalence” could offset the deflationary effects of higher taxes, this will not be true where fiscal policy is implemented through a change in the rate of increase in public employment. By acting on the labour market, changes in public sector employment directly impact on the rate of wage inflation.

MEDIUM-TERM AND LONG-TERM ISSUES

There are two medium- to long-term issues that must be taken into account when considering the appropriate stance of fiscal policy. First, there are the restrictions on debt financing under the Maastricht Treaty and the need to maintain flexibility in the public finances to deal with unexpected shocks. Second, there is the need to consider the long-term

⁷ Murphy (1998) has shown an elasticity of house prices with respect to disposable household income of close to two.

⁸ While UK financial institutions are lending in Ireland on Irish housing without having an office in Ireland, the mortgage must be registered in the country where the property is located.

⁹ These include a withdrawal of special tax incentives for building.

¹⁰ Individuals may take account of the implications for future tax liabilities of changes in government indebtedness. Thus increased government savings could give rise to the expectation of future tax cuts. Such an expectation could, in turn, affect current consumption.

ageing of the population and its implications for intergenerational equity and the public finances.

As a member of EMU Ireland has taken on an obligation under the Maastricht treaty to ensure that government borrowing does not exceed 3 percentage points of GDP in any individual year. Penalties are specified in the event a country breaks this rule. In an uncertain environment this makes it important to ensure that fiscal policy is operated with a safety margin to ensure that, whatever shocks occur, the economy stays within the Maastricht limit.

The budget of all countries is significantly affected by the economic cycle. To ensure that the budget remains within the limit, while running a neutral budgetary policy, it will be important to keep the deficit, on average, significantly below the Maastricht limit. The extent to which the deficit must be kept below this limit to ensure that it is never exceeded, even in a recession, will depend on how responsive the public finances in an individual country are to cyclical changes in economic activity.

A recent study for the OECD area (van den Noord, 2000) suggests that the structural deficit (at trend growth rates) will need to be between 0.5 and 1.5 percentage points of GDP below the 3 per cent deficit threshold to ensure that this threshold will not be breached in the case of a serious recession. This would allow the automatic stabilisers to work and there would be no necessity to take pro-cyclical action to keep the deficit under control. In Scandinavia and the Netherlands their budgets are more sensitive to the economic cycle because of the characteristics of their public sectors. As a result, they would need a bigger margin to ensure that the limit will not be exceeded in a recession. When other risks are accounted for, this evidence suggests that for most members of EMU the Stability and Growth Pact guideline, that over the economic cycle the government sector should be in balance, is broadly appropriate.¹¹

Duffy, Fitz Gerald and Smyth (2000) undertook a similar study of the sensitivity of the Irish economy to cyclical disturbances. Their conclusion was almost identical to that of van den Noord (2000) for the broad OECD area. For every one per cent reduction in the growth rate below potential, the government surplus would fall by 0.5 percentage points of GDP. This would imply that, provided the budget were maintained in balance over the cycle as required under the Stability and Growth Pact, there would be no danger of the government being forced to take procyclical action to cut the deficit, as happened in the 1980s. Thus the Stability and Growth Pact requirement to maintain balance in the public finances is what prudence would, in any event, require of Irish governments within EMU.

Probably the biggest danger to the Irish economy lies in the possibility of a significant recession in the US. This could affect the Irish economy more than other EU members (Duffy and Fitz Gerald, 2000), exposing any overvaluation of the real exchange rate. However, the robust nature of the public finances leaves Ireland more secure in the face of external shocks than at any time in the last three decades. Even if there was a

¹¹ Barrell and Drury (2000), undertook a very similar exercise using the NiGEM model concluding that the main European economies could run somewhat looser deficit targets (between 1.5 and 2 per cent of GDP) than van den Noord (2000) suggested, while still having a 99 per cent chance of keeping within the limit.

recession in Ireland, it is likely in the first year of low growth the government would still be in surplus, leaving room for a countercyclical fiscal policy.

In framing medium to long-term policy on the public finances the Irish authorities have adopted an innovative approach in providing for advanced provision to cover the long-term costs of ageing. While the problem of the “greying” of their economies is currently hitting many EU countries, it is a long way off for Ireland. The *Medium-Term Review* indicated that Ireland could expect to reap a significant “demographic dividend” over this decade as a result of the very low dependency rate. It will not be for another twenty years that the problem of ageing will begin to have a significant effect on the old-age dependency rate and even then it will be less acute than in many of our EU neighbours. However, to provide for the consequences of ageing the government has established a state pension fund.

The National Pension Reserve Fund will accumulate over the next twenty-five years with an annual contribution from revenue of at least one percentage point of GNP. How this will interact with the commitments under the Stability and Growth Pact has not been made clear but it is anticipated that it will mean that, on average, the public sector will run a small surplus over the course of the current decade (see Lane, 2001). However, as Cronin and McCoy (2000) discuss, the existing EU guidelines have not taken this issue of long-run sustainability into account. The Maastricht guidelines and the Stability and Growth Pact did not envisage a situation where a country needs to run a significant surplus to provide for the effects of ageing.

While the principles behind the establishment of the state pension fund are based on a concept of intergenerational equity, the allocation of one percentage point of GDP to saving to pay future pension liabilities is essentially an arbitrary number (Lane, 1999). Further research is needed to establish a framework in which the appropriate level of savings can be determined. However, whatever the outcome of such a process, it seems likely that the current level of government savings (on a cyclically adjusted basis) is greater than would be required to ensure fiscal sustainability and intergenerational equity in the long run. This means that over the course of the decade there should be a significant reduction in the cyclically adjusted surplus from its current level.

As discussed above there are strong grounds for arguing that fiscal policy is today too expansionary for the needs of the Irish economy. However, once the economy slows down and the inflationary pressures ease in the domestic labour market, it will then be appropriate to wind down the surplus to its long-run sustainable level. This is in line with our recommendations in the last ESRI *Medium-Term Review*. This reduction in the surplus can take place by some combination of tax reductions, improvement in current services and improvements in public physical infrastructure. Because of the “demographic dividend”, provided that the resources are not frittered away through inflation over the next two years, progress should be possible on all fronts over the rest of the decade. The Commission’s strictures only apply to current circumstances. They will not in any way restrict future governments from pursuing an appropriate policy providing for intergenerational equity and long-term sustainability in the public finances.

4. Implications for the Euro Area

The dispute between the European Council of Ministers, the EU Commission, and the Irish government highlights a number of issues of relevance to the wider Economic and Monetary Union.

SUBSIDIARITY

What is the necessary level of co-ordination of fiscal policy within the euro area? Co-ordination is desirable to ensure that fiscal policy action in one country does not adversely affect other euro area members – a good neighbour policy. Membership of EMU means that economic policy in individual members of the union can damage other members' economies in ways that would not be possible if they were not a member of the union.

This negative externality can arise from:

- (i) The risk of default from excessive borrowing in one member raising interest rate risk premia for all;
- (ii) Inappropriate fiscal policy in one country contributing to inappropriate fiscal policy in the aggregate euro area. Too stimulatory a fiscal policy in the euro area, whoever is responsible for it, requires the ECB to tighten interest rates, with adverse effects on all EMU members;
- (iii) Risks to the solvency of the financial system. Any collapse in a regional or national financial system could potentially destabilise the system in EMU as a whole. Even if it did not, it could affect interest rate risk premia in other members of EMU.

In co-ordinating the overall stance of fiscal policy in a national economy in a monetary union it is not necessary, or appropriate, to specify the mix of taxation and expenditure to be pursued in individual countries. What is important is the overall fiscal stance – the change in the cyclically adjusted deficit or surplus. It is this change in government saving that represents the ultimate impact on demand in the euro area. Even if individual countries are to be constrained to follow a particular path in terms of their government savings (deficit), they still have autonomy in determining what mix of expenditure and taxation they will use.

In the medium term, it remains within the competence of individual members of EMU to determine the appropriate level of government saving or borrowing, consistent with the Maastricht guidelines and the Stability and Growth Pact. Any recommendation or directive on fiscal policy stance is essentially temporary – to deal with a cyclical imbalance between demand and supply within the union.

How does membership of the euro area change the role of fiscal policy at the level of a national or regional economy within EMU? If fiscal policy at the level of the euro area is appropriate (not putting pressure on interest rates), then independent action by an individual regional economy does not adversely affect other members. However, if a fiscal stimulus in one country contributes to an inappropriate fiscal stance at the level of the euro area, there is the possibility that it will require a tightening of monetary policy, with negative consequences for all other EMU members. This potential negative externality is the main argument for co-ordination of fiscal policies (Buti and Martinot, 2000). Outside the euro area this need

for co-ordination would not arise because changes in demand in a country outside EMU would not have any direct effect on interest rates in the euro area.

Co-ordinated fiscal policy action does not entail a harmonisation of tax or welfare rates across regional economies. A harmonisation of prices (including taxes and welfare rates) would prevent the normal adjustment processes necessary to promote convergence. Such differences are essential to ensure optimal use of resources within the euro area. However, there may be cases where discriminatory fiscal action may adversely affect other EU members but this will not be confined just to members of the euro area. It is also not an issue for the short-term management of the euro area economy and, as a result, it is not an issue to be considered in the guidelines for fiscal policy.

While not an issue in the case of Ireland today, all the members of the euro area have a clear interest in the stability of regional financial systems within the zone. Instability in one region could easily translate into a problem for all members. However, the supervision of the regional financial systems remains a national prerogative.

With the integration of the EU economy there may be a need to extend co-ordination of policy in this area. The example of the BCCI debacle in the UK shows the difficulties in supervising banking systems in a global environment. Globalisation may require further co-ordination of banking supervision to ensure that problems in multinational financial enterprises do not go undetected.

GAINS FROM CO-ORDINATION

The example of German unification highlights the gains to be obtained from effective fiscal policy co-ordination at the level of the euro area. In 1990 the huge infrastructural deficit that existed in the Eastern Länder of the newly unified Germany posed major problems for its government. However, a decision was made that taxes would not be raised to cover the full costs of unification and government borrowing grew rapidly. This provided a very strong demand stimulus to the German economy. This stimulus was further accentuated by the decision to convert East German savings into deutschmarks at par. The consequence of the stimulatory fiscal policy pursued in Germany was that the Bundesbank had to tighten German monetary policy to offset the inflationary impact of the demand stimulus. However, the rise in interest rates in Germany was transmitted to all the other members of the ERM. Given the nature of the ERM this meant that there were serious negative externalities for the rest of the EU from procyclical German fiscal policy (Gagnon, Masson and McKibbin, 1996 and Barrell, Pain and Hurst, 1996).¹²

If EMU had begun in 1990 with effective co-ordination of fiscal policy, it is likely that fiscal policy in Germany would have been much tighter than was actually the case in the early 1990s. The result would have been that the EU would have escaped the major rise in interest rates that actually occurred. Gagnon, Masson and McKibbin (1996) and Barrell, Pain and Hurst (1996), estimate that the cost of inappropriate fiscal policy in

¹² A realignment of currencies in the EMU, suggested at an early stage as a possibility by the German government, could have reduced this negative impact.

Germany in the early 1990s was a loss in GDP of 2 to 3 percentage points in the UK, France and other EU members (other than Germany). While the increased demand from Germany resulted in increased exports from other EU members, this beneficial effect was more than offset by the negative effects of higher interest rates.

If these estimates of the negative externalities from inappropriate fiscal policy in Germany are put together with the direct cost to Ireland of high interest rates arising from the necessary tightening of monetary policy (Bradley, Fitz Gerald and McCoy, 1991), the results suggest that the Irish boom of the late 1990s would actually have occurred in the early 1990s. A crude combination of the results from these studies would suggest that the reduction in Irish GNP arising from the combined reduction in EU growth and from high interest rates amounted to around 6 percentage points. This represented a very substantial negative shock to an economy that had been growing very rapidly in 1989. The incipient boom in Ireland was halted in its tracks in 1990. The situation was further aggravated by the impact of the slow-down on house prices and consumer confidence, factors not taken into account in the estimated costs to the Irish economy, discussed above.

This is a very clear example where co-ordination of fiscal policy within an EMU could have been beneficial to a small country, such as Ireland. If there had been a monetary union in 1990 Germany would have taken into account the wider impact of its fiscal policy stance. In turn this would have required higher taxation in Germany to pay for unification but the consequence would have been much lower interest rates and higher growth elsewhere in the monetary union.¹³

For the future it is clear that disruptive fiscal policy action in large members of EMU, or disruptive action by a combination of smaller members of EMU, can impose significant economic costs on all member states. Under these circumstances it remains important for small countries that the EU Commission has the power to co-ordinate fiscal policy within the euro area.

PROBLEMS WITH THE RULES FOR EMU

The existing rules for the operation of EMU in the Maastricht Treaty and in the Stability and Growth Pact are clearly inadequate. While they deal with the potential problem of national insolvency in a rather heavy-handed way, they do not provide a mechanism for achieving necessary co-ordination of fiscal policy in the euro area. The concentration on government borrowing and indebtedness is an artefact of when the guidelines were drawn up. At the time debt was very high and rising in many of the putative members of EMU. The guidelines do not adequately deal with the situation where countries are running fiscal surpluses and where indebtedness is falling rapidly, and may even disappear. Commenting recently on the Stability and Growth Pact, Buti and Martinot (2000), say: "In addition, as the cyclical behaviour of the euro area economy adapts to the new EMU environment, the issue of the appropriate medium-term targets for budget deficits will need to be addressed again".

¹³ In the long run such an outcome might also have been better for the German economy.

The Broad Economic Policy Guidelines of the Member States reflects this inadequacy. The general “policy recommendations” section concentrates almost entirely on fiscal consolidation (debt reduction). Only one sentence is allocated to describing the appropriate stance of fiscal policy at the level of the Economic and Monetary Union.

If these guidelines are compared to the national guidelines normally included in member states’ budgetary statements, they can be seen to be very inadequate in their consideration of the stance of fiscal policy. This gives the impression that the EU Commission still thinks of EMU as the total of the policies of the regional economies, rather than considering the appropriate stance of fiscal policy for the union as a whole. The Commission did not include in the Guidelines any measure of the overall impact of euro area fiscal policy.¹⁴ Instead each member state is required to publish a measure of regional fiscal policy stance in its national stability programme. This measure, published for each national economy, uses a similar, rather simplistic, measure.

The inadequacy of the available measure of the stance of fiscal policy in the euro area is reflected in the failure to use it in discussing fiscal policy in the Guidelines. This is a serious gap in information as it makes it very difficult to judge how appropriate fiscal policy is to the economic and monetary conditions in EMU. This problem will become even more acute as new members join the EU and EMU.¹⁵

Even if there were an appropriate methodology for determining the actual stance of fiscal policy within the euro area, it remains to be determined how effective a mechanism fiscal policy will be at the level of the zone in managing demand. A priori one would expect that it would be more effective than at the individual regional (national) economy level.

The approach taken by the Commission is first to consider whether each individual national economy’s fiscal policy is appropriate to the current situation in the individual economies. Thus Ireland’s fiscal policy is measured against the balance between supply and demand within that economy. However, even if the fiscal policy position in each individual regional or national economy is appropriate to the circumstances of its own economy there is no guarantee that the overall stance of euro area fiscal policy will be optimal. Precisely because externalities arise from the operation of national governments’ fiscal policies, there are good reasons for believing that fiscal policy arrived at in this manner will be sub-optimal for the monetary union.¹⁶

It may well be preferable to decide first on the appropriate fiscal policy for the euro area and then to apportion responsibility for implementing it to individual national governments.¹⁷ This need not require constant interference by the Commission in individual national economies. Looking at federal states, such as the USA and Germany, fiscal policy operated

¹⁴ However, in *European Economy* (2000), they do publish such a measure, albeit using a rather crude measure along the lines published in each country’s Stability Programme.

¹⁵ For economies in transition the current method used by the EU Commission to measure fiscal stance is particularly inappropriate.

¹⁶ It is also true that what may be “optimal” for the euro area may not be optimal for an individual country.

¹⁷ Legally, implementation must be achieved through the individual country guidelines.

reasonably successful in the past, in spite of considerable devolution of fiscal powers to individual *länder* or states.¹⁸

For the future, in EMU the Commission need only interfere if the aggregation of national policies is seriously prejudicial to the interests of the union as a whole. A possible approach would be the following: if it is felt that fiscal policy in EMU is too lax, then responsibility for tightening is probably best allocated to those countries pursuing the most inappropriate domestic fiscal policies, measured in terms of their domestic needs. In the current context this would include Ireland.

It would appear that the new context of EMU requires the development of appropriate aggregate measures of fiscal stance for the union. Research will be required to determine how effective an instrument union fiscal policy could be in maintaining balance between supply and demand within the union. 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 (see Bayoumi and Masson, 1995).

Finally, if co-ordination of fiscal policy within EMU can provide clear welfare gains, then an effective method of developing and enforcing co-ordination will have to be enacted. The existing framework is clearly unsatisfactory and it does not include adequate powers to ensure co-ordination actually takes place.

There remains the unresolved issue of how best the stability of regional financial systems within EMU can be ensured. As there exists the possibility that serious negative externalities for all members of EMU could arise from financial failure in national systems, there would also appear to be a need for greater policy co-ordination by the ECB in this area of economic activity.

5. Conclusions

The current controversy between the EU Council of Ministers (and the EU Commission) and the Irish government has political and strategic implications for Ireland that are not considered in this article. Instead the article concentrates on the underlying economic issues.

The new context of EMU means that independent fiscal policy action in one member of the euro area has a new potential to impose costs on other members. As discussed in this article, while membership of EMU has significant economic benefits for its members, the potential to cause damage to fellow members is also significantly enhanced by EMU membership. As a result, there are two different points of view from which to consider the appropriateness of Irish fiscal policy: the point of view of the Irish citizen and the point of view of citizens of the rest of the EMU. While there will often be no conflict between these different viewpoints, there remains such a possibility, given the differing characteristics of the economies of the different member countries.

For the EU Commission, representing the interests of the citizens of the wider euro area, the economic concern must be whether the aggregate stance of fiscal policy in EMU is too stimulatory. If it is then there is the danger that interest rates will be higher than necessary for all members of

¹⁸ While in the US there is no provision for the “bail out” of an individual state, there is in the case of Germany. This gives rise to moral hazard problems (Morgenroth, 2000).

EMU. However, while they did express some concern about the loosening of fiscal policy in EMU in the policy guidelines in the summer of 2000, subsequent events may have reduced their fears. In particular, the major slowdown in the US and the strengthening of the euro eases pressures on euro area one interest rates. Thus from a purely economic point of view, there may be less concern now than there would have been last summer about a pro-cyclical policy in Ireland.

Looking to the longer term, it is very much in Ireland's interest that an appropriate mechanism is developed for achieving the necessary co-ordination of fiscal policy with the euro area. As discussed in this article, Ireland has suffered in the past from inappropriate fiscal policy in the EU and it could suffer again in the future. However, the existing instrument for co-ordination is ineffective, both because it lacks an appropriate economic focus and also because it lacks mechanisms to ensure that such co-ordination is implemented. Developing such mechanisms is likely to be particularly important for the smaller members of the euro area.

As discussed above, co-ordination need not and should not involve extensive restrictions on domestic fiscal freedom. In the spirit of the Maastricht guidelines, it should confine itself to action where the aggregate fiscal policy stance of the euro area is considered inappropriate. It can leave individual countries freedom of action to determine the appropriate mix of tax and expenditure changes needed to achieve a given national target surplus or deficit. Co-ordinated action is likely to prove necessary only in exceptional circumstances. The best national interests of most member states will normally produce a domestic fiscal policy stance consistent with the needs of EMU.

There are lessons to be learned by the EU Commission from the current dispute. Significant further research will be needed to understand how domestic fiscal policies interact to affect the overall euro area economy and there will also need to be further development of the process for co-ordinating fiscal policy within EMU. As part of this process it would be helpful to develop a shared understanding of how individual economies in the EMU actually work.

The danger for the Irish economy with the current expansionary stance of fiscal policy is that, by adding to inflationary expectations in the labour market and in the property market, the real exchange rate may overshoot – there may be an excessive rise in labour costs. Unless wage rates adjust instantaneously to clear the market, wage rate overshooting could prove costly. For this reason stimulatory fiscal policy, that accelerates the rate of wage inflation, is unwise. It could expose the economy to unnecessary dislocation in the event of an unexpected external shock. The cost that would be involved in pursuing a tighter fiscal stance today would be a temporary delay in consumption. The cost involved in the current pro-cyclical stance is an increased danger of significant economic disruption in the future.

The tightness of the labour market today means that it will prove difficult for the government to recruit to fill all the additional jobs in the wider public sector created as part of the 2001 Budget. As a result, it may well be apparent from the first half exchequer returns that there will be a significant underspend this year due to an inability to fill vacancies. Such an outturn could end the current impasse, bringing the overall fiscal stance broadly into line with that desired by the EU Commission.

REFERENCES

- BARRELL, R., and K. DURY, 2000, "An Evaluation of Monetary Targeting Regimes", *National Institute Economic Review*, No. 4.
- BARRELL, R., N. PAIN and I. HURST, "German Monetary Union: An Historical Counterfactual Analysis", *Economic Modelling*, Vol. 13, No. 4, pp. 499-518.
- BAYOUMI, T., and P. Masson, 1995, "Fiscal Flows in the United States and Canada: Lessons for Monetary union in Europe", *European Economic Review*, Vol. 39, pp. 253-274.
- BLANCHARD, O., 2001, <http://web.mit.edu/blanchar/www/latecb.pdf>
- BRADLEY, J., J. FITZ GERALD, and D. McCOY, 1991. *Medium-Term Review: 1991-1996*, Dublin: The Economic and Social Research Institute.
- BUDGET 2001, "Ireland Stability Programme December 2000 Update", <http://www.irlgov.ie/finance/budget/budget01/Chapter3.htm>.
- BUTI, M., and B. MARTINOT, 2000, "Open Issues on the Implementation of the Stability and Growth Pact", *National Institute Economic Review*, No. 4.
- CALLAN, T. and J. FITZ GERALD, 1989, "Price Determination in Ireland: Effects of Changes in Exchange Rates and Exchange Rate Regimes", *The Economic and Social Review*, Vol. 20, No. 2, pp. 165-188.
- CRONIN, D. and D. McCOY, 2000, "Fiscal Sustainability When Time is on Your Side", in Banca d'Italia, *Fiscal Sustainability*, Rome: Banca d'Italia.
- DOWLING, B., 1978, "Budget Deficits and Fiscal Policy", in B. Dowling and J. Durkan (eds.), *Irish Economic Policy: A Review of Major Issues*, Dublin: The Economic and Social Research Institute.
- FITZ GERALD, J., I. KEARNEY, E. MORGENROTH, and D. SMYTH, 1999, *National Investment Priorities*, Policy Research Paper No. 33, Dublin: The Economic and Social Research Institute.
- DUFFY, D., J. FITZ GERALD, I. KEARNEY and D. SMYTH, 1999, *Medium-Term Review: 1999-2005*, Dublin: The Economic and Social Research Institute.
- DUFFY, D., J. FITZ GERALD, 2000, "Has Ireland's Exposure to a Sterling Shock Changed?", *Irish Banking Review*, Winter.
- DUFFY, D., J. FITZ GERALD, and D. SMYTH, 2000, "Ireland's Exposure to a Sterling Shock", ESRI Working Paper No. 135, Dublin: The Economic and Social Research Institute.
- EUROPEAN ECONOMY, 2000, No 71. Luxembourg: Office for Official Publications of the EC.
- FITZ GERALD, J., 1999, "Wage Formation and the Labour Market", in F. Barry (ed.), *Understanding Irish Economic Growth*, London: Macmillan.
- FITZ GERALD, J., D. DUFFY and D. SMYTH, 2000, "Managing an Economy Under EMU: The Case of Ireland", Working Paper No. 127, Dublin: The Economic and Social Research Institute.
- FITZ GERALD, J. and I. KEARNEY, 2000, "Convergence in Living Standards in Ireland: The Role of the New Economy?", Working Paper 136, Dublin: The Economic and Social Research Institute.
- FITZ GERALD, J., F. SHORTALL, 1998. "Pricing to Market, Exchange Rate Changes and the Transmission of Inflation", Vol. 29, No. 4, *The Economic and Social Review*.

- GAGNON, J., P. MASSON, and W. McKIBBIN, "German Unification: What have we learned from multi-country models?", *Economic Modelling*, Vol. 13, No. 4, pp. 467-498.
- GEARY, P., 1975, "Ireland's Policy Options", in *European Monetary Union and the Sterling Link*, Dublin: Irish Council for the European Movement.
- KEARNEY, I., 1999, "Is There a Stable Migration Equation for Ireland?", ESRI, Working Paper No. 97, forthcoming in *The Economic and Social Review*.
- KEARNEY, I., D. McCOY, D. DUFFY, M. McMAHON and D. SMYTH, 2000, "Assessing the Stance of Irish Fiscal Policy", in A. Barrett (ed.), *Budget Perspectives*, Dublin: The Economic and Social Research Institute.
- KENNY, G. and D. McGETTIGAN, 1999, "Modelling Traded, Non-Traded and Aggregate Inflation in a Small Open Economy", *The Manchester School*, Vol. 67, pp. 60-88.
- LANE, P., 1998, "Profits and Wages in Ireland, 1987-1996", *Journal of the Statistical and Social Inquiry Society of Ireland*, 1997/1998.
- LANE, P., 1999, "What Should we do with the Surpluses?", *Administration*, Vol. 47, No. 4, Winter.
- LANE, P., 2001, "The National Pensions Reserve Fund: Pitfalls and Opportunities", Paper presented at ESRI Conference *Issues in Long Term Pension Provision*, Dublin, 5th March.
- MEYLER, A., 1999, "Recent Developments in Services Inflation", *Quarterly Report*, Dublin: Central Bank of Ireland.
- MORGENROTH, E., 2000, "Regionalisation and the Functions of Regional and Local Government", in A. Barrett (ed.), *Budget Perspectives*, Dublin: The Economic and Social Research Institute.
- MURPHY, A., 1998, "Econometric Modelling of the Irish Housing Market", in *An Economic Assessment of Recent House Price Developments*, Dublin: The Stationery Office.
- McCOY, D., D. DUFFY, J. HORE and C. Mac COILLE 2000. *Quarterly Economic Commentary*, December, Dublin: The Economic and Social Research Institute.
- QUINN, T., G. KENNY and A. MEYLER, 1999, "Inflation Analysis: An Overview", *Central Bank of Ireland Bulletin*, Spring, Dublin: Central Bank of Ireland.
- ROGERS, J., G. HUFBAUER and E. WADA, 2001, "Price Level Convergence and Inflation in Europe", Washington: Institute for International Economics Working Paper, <http://www.iie.com/CATALOG/WP/2001/01-1.pdf>
- VAN DEN NOORD, P., 2000, "The Size and Role of Automatic Fiscal Stabilizers in the 1990s and Beyond", OECD Economics Department Working Paper No. 230.
- WALSH, B.M., 1999, "What's in Store for the Celtic Tiger", *Irish Banking Review*, Spring.
- WHELAN, K., 1991. "The Irish Consumption Function and Ricardian Equivalence: The Evidence Re-examined", *The Economic and Social Review*, Vol. 22, No. 3, pp. 229-238.