Executive Summary
Just over a decade ago, the Irish economy was in shambles. The high rate of inflation was detrimental to output and the standard of living was low. Budgetary policies were adopted over the next ten years to save Ireland from its poor economic status. Today, Ireland can claim complete financial recovery because of these budgetary policies. It is now a model macroeconomic performer in the European Monetary Union.

The Irish economy has been growing rapidly over the past ten years and the country is enjoying a decreasing level of unemployment. Because Ireland’s policies to achieve economic expansion are not consistent with those of the European Monetary Union (EMU), the government was given a strong reprimand from the European Union (EU) in February 2001. The EMU has urged Ireland to constrict its economic growth by limiting tax cuts and government expenditures. Should Ireland conform to the recommendations of the EMU or pursue other policy options to maintain economic growth?

Recent Macroeconomic Performance
General Economy:
Ireland has experienced dramatic growth in recent years. Irish GDP in 2000 was valued at 103,479 million Euros. It has nearly doubled from 52,696 millions Euros in 1995. Consequently, GDP per capita has also nearly doubled from 1995 to 2000: 14,634 million Euros in 1995 to 27,322 million Euros in 2000. Last year, Ireland saw its economic growth slow (see figure 1), but this decline was expected. The slowdown of the world economy, the cyclical nature of the Irish economy, and the decrease in foreign direct investment from the United States following the September 11 terrorist attacks were all significant factors in the decline. Ireland has managed to avoid the severity of the recession affecting many other industrialized countries.

Labor Force:
In 1997, Ireland had an unemployment rate of 9.8%. Unemployment in 2001 was down to 3.8%, but recent data revealed an increase in 2002 unemployment at 4.1%. This slight rise in unemployment rates is also linked to the slowdown of the world economy. Corporate tax cuts have enticed many multinational corporations to locate their bases of operation in Ireland and bring foreign direct investment. This has created a high demand for skilled and unskilled labor. The demand is so large that Ireland has used more tax cuts to stimulate an influx in foreign labor to fill the jobs. These multinational corporations are a primary feature of Ireland’s booming economy and changing the budgetary policies could cause them to move out of the country.

Trade:
Ireland has recently been running a trade surplus, with the bulk of exports going to the United States. According to the Direction of Trade Statistics, exports in the second quarter of 2001 were at $20,183 million and imports were at $12,207 million. The nominal exchange rate in Ireland has been slightly higher than the greater Euro Area suggesting that purchasing power parity might lead products in Ireland to cost more than other countries in Europe. Ireland’s nominal exchange rate is 89.61 Euros/ $1 compared to 80.21 Euros/ $1 in the Euro Area International Monetary Fund.

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1 http://www.cso.ie/principalstats/pristatlab.html
2 International Financial Statistics, International Monetary Fund, March, 2002
**Inflation:**
According to the macroeconomic theory behind the Phillip’s Curve, low unemployment rates are correlated with higher inflation. This holds true for Ireland, however the dramatic decrease in unemployment has led to only a small rise in inflation in the short run (see figure 2). The nation states of the EMU try to keep the inflation rate per year of their economies around 2%. Ireland’s rate of inflation is approximately 4%, twice the recommended level. Inflation may continue to rise over the next several years in response to new employment trends. Fear of price changes fueled the EMU’s criticism of Ireland last year.

The rate of inflation is not the only factor responsible for the high prices in Ireland. Due to the incredible growth rate and low unemployment rate in Ireland, its purchasing power per person has increased tremendously and is one of the highest in the EMU. As individual wealth in Ireland increases, demand for consumer goods increases. Increased demand naturally leads to increased supply at higher prices. Consequently, more goods can be bought at increasing prices.

Prices in Ireland have also been increasing to accommodate massive gains from trade. Ireland has been doing a great deal of business with non-euro countries, especially the United States (a much larger amount in comparative terms than the other member states of the European Union), and earning large amounts of other currencies. Most of the other member states do a significant amount of their trading in euros. Ireland enjoys a monetary windfall when the currencies that it earns are exchanged into the euro because the euro is relatively weak.

**Interest Rates:**
Interest rates have been fluctuating in response to internal fiscal policies and the world economy (see figure 3). Ireland must maintain an average nominal long-term interest rate not exceeding more than 2 percent of the three best-performing member states, according to the Maastricht Treaty.

**Pension Plan:**
The European Commission fears the pension crisis that could arise with Ireland’s inflationary policy of low taxation. Social security systems in large member states like Germany, France and Italy are badly in need of reform. Their populations are also rapidly aging. In the near future, the funds needed to pay their pensions may be insufficient. Ireland will be forced to help pay for these poorly constructed policies, as will the rest of the member states. At the same time, Ireland will need to pay for its own population of pensioners. The European Commission claims that there are two ways to ensure the payments will be made: by cutting existing benefits (which is unlikely because it would be politically unfavorable) or by increasing taxes. The European Union does not want Ireland or any other member state lowering its taxes or increasing public spending without preparing for this problem.

**Macroeconomic Problem: Monetary Independence v. Monetary Union**
The Amsterdam European Council passed the Stability and Growth Pact in June 1997. This legislation outlined procedures for the governments of each member state of the European Monetary Union to follow in order to guarantee that sound financial and economic policy would be enacted. The Council felt that the Pact was necessary to strengthen price stability, improve conditions to encourage employment, reduce inflation, and to ensure that national budget plans would lead to stable monetary systems.

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3 http://www.rferl.org/nca/features/2001/02/13022001113027.asp
4 Exports to the United States totaled $3,551 million, 20.5% of all exports to industrialized countries in 2000 according to the Direction of Trade Statistics, December 2001
6 http://redbrick.dcu.ie/~odyssey/Politics/Ireland/OpReb%20%20EU%20Commission
Each member state was issued its own Stability Programme as a way for the European Commission to assess how well the member state was complying with the requirements of the Stability and Growth Pact. The most critical part of the Pact was that member states would keep their budgets close to balance or in surplus in order to handle cyclical fluctuations while keeping the government deficit within the reference value of 3% GDP.\(^7\)

The Broad Economic Policy Guidelines for 2000 were an updated version of these Stability Programmes. Each member state was issued particular recommendations for its own economic activities, taking into account current economic status. The Guidelines specific to Ireland recognized the rapid growth of the Irish economy. They also expressed serious concerns regarding the nature of Ireland’s budget policy at the time and its potential to make the increasing inflation problem much worse.

The trademark characteristics of the Irish national budgets for the last ten years have been massive tax cuts for individuals and corporations coupled with huge increases in public spending. In 2002, Ireland plans to significantly improve its public infrastructure and continue its public spending habits despite a slowdown in the economy. These policies led Europe’s most rapidly growing economy to increase at a rate of 11.5% in the past year.\(^8\) Even if this growth rate decreases in the next year as predicted, it will still surpass the European Union’s average growth rate handily. “As a percentage of gross domestic product, Ireland has the European Union’s biggest budget surplus, the second lowest amount of debt, the greatest reduction in government debt, the lowest level of government spending and the lowest level of total taxes.”\(^9\)

On February 12, 2001, the European Union finance and economic ministers (ECOFIN) formally criticized Ireland for its proposed 2001 budget by accepting a recommendation issued by the European Commission. ECOFIN claimed that this budget would not only fuel the inflation already on the rise in Ireland, but hurt the European Union by weakening the entire Euro-zone. It recommended measures that would need to be taken to bring the 2001 Irish budget into compliance with standards set by the 2000 Broad Economic Policy Guidelines.

In relative terms, Ireland’s economy has vastly outperformed all of the other nation-states in the European Monetary Union. Though the macroeconomic policies may not conform to the exact specifications set to bring unanimity and stability to the Euro-zone, they are created in the best interests of Ireland. These policies are critical to maintaining not only the economic and political stability of Ireland, but also preserving its delicate social balance.

Before the admonishment issued by ECOFIN, no other EMU member state had been criticized in such a manner for its economic policies. Ireland is faced with the decision to either respect the wishes of ECOFIN and comply with the standards of the European Monetary Union or continue to enact macroeconomic policy that benefits itself but does not necessarily meet the stabilization criteria to which it previously agreed.

Because individual member states no longer have control over inflation rates, manipulating them to protect Ireland’s economy from overheating is no longer an option. Minor increases in these rates promote economic growth in the large economic powers like Germany, France, and Italy, but the extreme changes needed to positively affect Ireland would cause catastrophic problems for these nations. It is

\(^8\) http://interactive.iol.ie/finance/new/fb_feature4.htm
\(^9\) http://www.freedomandprosperity.org/Aricles/wsj02-14-01.shtml
impossible for a single macroeconomic policy controlling interest and exchange rates to slow down an overheating economy while stimulating a large slow economy.

The European Commission would like Ireland to consider the implementation of high taxes, lower government spending, and impose huge minimum deposits for purchases made. From a political standpoint, these policies are all extremely unfavorable and the general public of Ireland would be upset with their implementation. Broad economic policies imposed on the entire EMU to promote conformity must sacrifice practicality and effectiveness, especially with the smaller nation-states.

Addressing the Commission’s Reprimand
When the European Commission reprimanded Ireland for its expansionary budget on February 12, 2001, it marked the first time that the Commission had moved to intrude upon a member state’s fiscal policy. The European Commission is not concerned with the economic well being of an individual member state, but rather the European Union as a whole. All of the member states are expected to enact macroeconomic policy in the EMU’s best interests. There must be a sacrifice of sovereignty to the whole, especially for the smaller member states.

Policy Options

1. Ireland should remain in the EMU and adhere to the economic mandates to which it originally agreed.

   The Irish budget was deemed too dangerous, expansionary, and pro-cyclical for an economy that has been prone to overheating in past years. It presented a great risk of creating negative spill over effects that would hurt the entire euro-zone. The European Commission wants to avoid increased inflation in Ireland because it claims that the high rate of inflation will drive up both prices and wages across the euro-zone. The high inflation will then erode competition and limit foreign investment, while making Ireland vulnerable to external shocks to its economy. A member state with a weak economy would drag down the value of the euro. The European Commission also fears that a busted, recessive Irish economy could destroy the budding interest that member states of the European Union have in restructuring their economic policies to conform to one another.

   If Ireland adopts the policies suggested by the EMU it risks halting economic growth and high employment. On the upside, Ireland will no longer be the focus of the EMU’s concern and terminates the threat of instability in the Euro currency.

2. Ireland should remain in the European Monetary Union but continue to enact pro-Ireland macroeconomic policy.

   Ireland’s reprimand from the European Commission is an attempt to reign in the member states whose level of monetary and fiscal discipline is not good for the whole. The European Commission fears that if Ireland is not reprimanded, other countries will follow, and this will undermine the common economic policies that it seeks. Should Ireland be allowed to pursue the economic policies it has proposed, a domino effect could ensue where one of the larger economies in the European Union like Italy or France would begin operating in a similar manner. Then others would follow suit until the entire euro-zone crumbled. In the short run Ireland may see continued economic expansion, however in the long run the decay of the European Monetary Union will have negative effects on Ireland’s economy.

3. Ireland should remove itself from the European Monetary Union.
Ireland is primarily susceptible to fiscal shocks, especially those that come from external sources. As a major source of foreign direct investment into Ireland, developments in the U.S. manufacturing sector are of particular importance. In order to address fiscal shocks to the economy, it is important that Ireland has control over its monetary policy. With a fixed exchange rate system real shocks in the goods market are magnified and could devastate Ireland’s economy.

Ireland must consider the political consequences of leaving the EMU. The EMU does lower transaction costs involved with exchanging currencies in a free market, as well as price discrimination. Exchange-rate stability increases certainty of prices and revenues, which improves the quality of production, investment and consumption decisions (which increases collective welfare). As a member-state in the EMU, Ireland also receives significant political benefits. The Euro rivals the dollar for dominance in the global currency market and Ireland has the weight of the entire EU backing it on other global political economic, and social issues.

**Recommendation**

Given the nature of Ireland’s economic shocks and the political consequences of reversing their fiscal policy, we recommend that Ireland remove itself from the European Monetary Union. Though there is risk of being isolated from the Europe and incurring significant costs should their economy falter, the benefits of being free to operate in the global market as it sees fit makes this policy most appealing to Ireland.

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Appendix: Tables and Graphs

**Year on year growth rates**

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<th>Year</th>
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<th>GDP</th>
<th>% Change</th>
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**Consumer Price Index - all items**

**Annual Percentage Change**

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<td>Mar 2002</td>
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Figure 3
Data Source:  http://www.bof.fi/env/fin/tilastot/kuvab/221ev-b.gif