Between the Sterling and the Deutsche Mark: The Irish Choice for the European Monetary Integration*

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Abstract:

This paper addresses the question of how Ireland entered European Monetary regime and sustained its membership since 1979. In contrast, Britain, with which Ireland had been engaged in a de facto currency union over a century, chose to stay outside. This paper argues that strong prime ministerial power that characterized the politics of Ireland was the political foundation of economic stabilization, which in turn accounted for Ireland's continuous participation in European monetary regime.

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I. Puzzle

The experience of the Irish economy during the last two decades is often cited as a miracle, its success being parallel to what the Asian newly industrialized countries have accomplished.[1] Between 1979 and 1998, inflation rates decreased from 13.3 to 1.2 percent and long-term interest rates reduced from 15.1 to 6.2 percent.[2] The lower inflation and long-term interest rates show that the Irish economy has succeeded in economic stabilization.

The Irish economic success coincides with its membership in European monetary regime. After the Bretton Woods system collapsed in 1971, the European Community members attempted to bring a stable exchange rate regime at the regional level. While the Snake, established in 1973, failed to secure the commitments of member states, the European Monetary System (EMS) continued to serve as a focal point for monetary cooperation from 1979 until it developed into the European Monetary Union (EMU) with a single currency introduced by the Maastricht Treaty. Ireland, one of the founding countries of EMS, has been a consistent supporter for European monetary integration.

This paper addresses the question how Ireland entered European monetary regime and retained its membership since 1979. The Irish support for European monetary integration provides a puzzle from economic and mainstream international relations perspectives. First, the Irish choice is inconsistent with predictions for Irish actions that are made from the theory of optimum currency areas. This theory posits that the

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[1] See Denis O'Hearn. *Inside the Celtic Tiger: The Irish Economy and the Asian Model.* Pluto Press. 1998; Paul Sweeney. *The Celtic Tiger: Ireland's Economic Miracle Explained.* Oak Tree Press. 1998; Antoin E. Murphy. "The 'Celtic Tiger': An Analysis of Ireland's Economic Growth Performance." European University Institute Working Paper. No. 2000/16.

[2] OECD. *Historical Statistics.* 1994; European Commission. *Convergence Report 1998.* 25 March 1998.

countries coming together to form a currency union or to irrevocably peg their exchange rates should have relatively homogeneous economic structures to get more economic gains than losses from making a currency union (Mundell 1961, Kenen 1969). Without flexible labor mobility across countries, homogeneous economic structures are considered to be crucial so that a currency union will not suffer from asymmetric shocks.

Then, the question is whether Germany and Ireland exhibited so similar economic structures that they might form an optimum currency area. Empirical evidences do not confirm the optimum currency areas argument. In the period from 1973 to 1979 the average annual inflation rates of Ireland were five times higher than those of Germany.[3] Its gross domestic product per head was the lowest in the Community. Using bilateral exchange rate variability indices, which measure the risk of asymmetric shocks, Bayoumi and Eichengreen (1996) classified the Irish punt during the 1970s as a volatile currency, if not excessively volatile, against the Deutsche Mark (DM).

A structural realist view (Waltz 1979, Gilpin 2001) is indeterminate to account for the puzzle of the Irish membership in European monetary regime. This view sees the Irish membership in the European monetary regime as reflecting its position in the regional state system. It argues that because Ireland was a small and peripheral state in Western Europe, it had no choice but to join a regional grouping. International structures are likely to determine actors' decisions in two ways. On the one hand, as Cameron (1978) and Katzenstein (1985) pointed out, small states are highly trade-dependent because they have small domestic markets. Therefore, they are more vulnerable to the impact of fluctuations in exchange rates, which increases uncertainty in international transactions and, hence, reduces the volume of trade with other countries. On the other

[3] OECD. *Historical Statistics*. 1984.

hand, peripheral states tend to have weak currencies, which reflect their less developed economy. Therefore, these currencies will face downward pressures under a floating exchange rate system and, thus, tend to suffer chronic high inflation rates. In sum, we can predict that small and peripheral states will prefer a fixed exchange rate system like the EMS rather than leaving themselves to a floating exchange rate system.

This structural explanation accounts for why Ireland has linked the Irish punt to foreign currencies, whether the British sterling or the DM, rather than going its own way. However, this approach provides only a partial explanation because it does not address the puzzle why Ireland chose the DM instead of the sterling while Britain, with which, Ireland had been engaged in a *de facto* currency union over a century, chose to stay outside of the EMS and the EMU.

This paper provides an alternative explanation that focuses on political actors and domestic political institutions. The role of political actors has been largely ignored in existing literature except McNamara (1998). While she argues that the neoliberal policy consensus among the heads of European governments was crucial for the EMS to succeed, her explanation is limited because she excludes domestic political institutions that constrain the choices of political leaders. I argue that political institutions underpinning prime ministerial power explain how Ireland could choose to stay tied with the DM.

The economic consequence of monetary union for Ireland depended on the strength of its anchor currency. During the 1970s, the British economy showed increasing price instability, which transmitted to the Irish economy through the punt-sterling link. By contrast, the EMS employing the DM as an anchor currency imposed hard domestic adjustment in terms of declining short-term economic growth and rising unemployment on weak currency states like Ireland, Italy, and France. The dilemma exposed to policy-makers was that deflationary economic policy was needed but unpopular among constituents and parliamentarians. No matter how political leaders desired employing deflationary measures, policy choices were dependent on those political leaders staying in office with firm support of the cabinet and the ruling party.

This paper contains case studies for three critical decision points confronting Irish political actors: the making of the EMS and the Irish punt's divorce with the British sterling in 1978, a budget crisis in 1986 and a policy shift to fiscal consolidation, and the signing for the EMU at Maastricht in 1991. These three cases follow an examination of the theories that other scholars used and my own theoretical approach. For each time point, I will try to identify the preferences of major political actors and their actual decisions. Since the Irish government made policy decisions supporting European monetary integration consistently in these different times, those consistent policy outcomes should be explained by a same underlying factor according to J. S. Mill's method of agreement.

II. Existing Approaches

Intergovernmental bargaining theory

Intergovernmental bargaining theory argues that small and peripheral states agreed to take part in European monetary integration in return for the side-payments to which core states would contribute (Pollack 1995: 363-365, Moravcisk 1998: 300). Arranging Community's budget transfers to poorer member states such as Ireland, Greece, Portugal and Spain has been a bargaining strategy that major European powers – France and Germany – frequently used to extract support for European monetary integration from the former countries. Pollack provides a nice summary of redistributive decisions in the European Community to show how major redistributive bargains were accompanied by lager intergovernmental bargaining for European integration (Pollack 1995: 364). For instance, the European Regional Development Fund (ERDF) was agreed in principle in 1972, the New Community Instrument was established in 1978, and the Cohesion Fund was created in 1991 at the same time when important decisions were adopted for European monetary integration.

Although we can observe a degree correlation between the establishment of Community funds and major events of European monetary integration, it is inconclusive whether and to what extent the side-payments Ireland received were crucial in its making policy decisions for joining European monetary clubs. Before 1988, the Community fund was too small to have any significant impact on weaker economies. From 1979 to 1981, the portion of the ERDF allocated to Ireland amounted to only some 3 percent compared to the capital budget of the Irish government (Hart and Laffan 1983: 141). As Brunt put it, "it [the ERDF] was more of a political handout rather than a substantive attempt to address the problems of marginal regions" (Brunt 1993: 33). Considering that Ireland and other peripheral member states demanded more coherent and greater financial resources, we are less likely to believe that the ERDF as a side-payment was a significant factor to induce Ireland to support European monetary integration.

Interest group theory

Interest group theory considers policy outcomes as a product of the interactions between government and societal interests. Two variants of interest group theory have developed according to how the state-society relationship is analyzed. A pluralist approach argues that government policies reflect major interests in society, on which government monetary policy has distributional effects. Frieden (1991, 2001) argues that financial sector, multinationals, and producers of manufacturing goods for export are the major interest groups supporting a common currency regime because they gain benefits from decreasing exchange rate risks and transaction costs.

However, the argument that the Irish choice for European monetary integration reflected those sectoral interests is compromised by the fact that Britain was the most important importer of Irish goods at least when Ireland entered the EMS. Also, the growth of the Irish financial industry was constrained by the exchange control maintained until 1992 (Wyplosz 2001: 127). Furthermore, as Table 1 shows, the amount of foreign direct investment was not significant before it began to surge in the early 1990s driven by the US multinationals.

[Table 1 about here]

Another interest group approach, neo-corporatism, focuses on the emergence of social partnership between business and trade unions, which was encouraged by government. O'Donnell (1998) argues that the Program for National Recovery 1987-1990, an agreement involving employers, trade unions, farmers, and government, was the institutional underpinning of wage and price control and thus it was an essential mechanism to meet the conditions for getting into the EMU. It seems reasonable to argue that Irish government employed social pacts to extract domestic support for its austere programs beginning from the late 1980s, but this was definitely not the case in 1978 when Ireland decided to join the EMS. As of the mid-1980s, the Irish system of industrial relations had been a voluntary one as that of Britain, pay levels being agreed through collective bargaining between employers and trade unions at local work places. It was only after 1987 that the Irish government intervened to induce collective wage bargaining to take place in the context of national economic programs.

The neo-liberal policy consensus argument

McNamara (1998) explains the success of the EMS by the convergence of national leaders' policy stances around austerity. She argues that a shift in national leaders' policy paradigms from Keynesianism to monetarism was necessary so that the fixed exchange rate system could be maintained. To account for the ideational shift, two historical events during the 1970s were important. European countries experienced rising inflation rates during the1970s which were not controlled by traditional Keynesian demand management. However, the German economy was relatively immune to the widespread high inflation rates in the same period, leading other European economies to imitate the German model. The German effect elevated monetarism as the neoliberal policy alternative, which prioritized price stability over growth and full employment, and this new paradigm affected the national decisions on the EMS and the EMU regardless of varying domestic political coalitions and institutions. From the neoliberal consensus perspective, Ireland supported the EMS and finally entered the EMU because Irish political elites imbued with the neoliberal policy idea followed a strong currency, the DM, instead of the sterling to reinstate fiscal discipline and price stability in the Irish economy.

For this argument to be valid, empirical evidence should confirm that main political actors have preferred economic stabilization against output growth and full employment at least since 1979. This leads to a question about who matter in the Irish politics. McNamara focuses on European leaders who are the chief executives of national governments (McNamara 1998: 129-144). It is controversial to define the scope of significant political actors. Having said that, McNamara's measurement of major actors looks arbitrary and unduly narrow. She does not explain why the neoliberal policy consensus had only to exist among national figures of the highest profile such as prime ministers and presidents (in case of France). Why should we not consider coalition partners and backbenchers in the parliament to be important as well while their dissent to the prime minister may result in no confidence of the cabinet in a parliamentary system?

The experience of Ireland from 1979 to 1986 shows the importance of political support for the DM peg from coalition partners. During this period, Irish budget deficits grew larger and larger even though Ireland had participated in the EMS. The huge budget deficits triggered major downward realignments of the Irish punt against the DM, first in March 1983 and secondly in August 1986. The latter depreciation, a record 8 percent, brought a prospect of financial crisis to the Irish economy. Under the Fine Gael-Labor coalition government (1982-1986), Prime Minister Garret Fitzgerald from liberal

Fine Gael sought to lock in fiscal rectitude. However, his "neoliberal" policy drive was blocked by its coalition partner, Labor party, which culminated in the breakdown of the Fitzgerald government in 1986 over the budget cutback. This story tells us that the prime minister's policy preference itself was not enough to perform economic adjustments, which are necessary to stay tied with the DM but also politically difficult. To ensure political support from coalition partners was crucial to execute tight fiscal and monetary policies, which were basically unpopular.

Prime ministerial power

An alternative approach is to combine the neoliberal policy consensus argument with the power resources for the head of government. My basic argument is that given a parliamentary system, where the cabinet is dependent on the confidence of the parliament, the prime minister's policy initiative – whether Keynesian or monetarist – will be least constrained under the following conditions: single-party government and strict party discipline.

The single-party government condition is related to politics within the cabinet. According to Lijphart (1999) a single party cabinet and prime ministerial eminence it entails are the characteristics of a British model of democracy. Under a single party government, typically in Britain, the executive power is exclusively held by the majority party. In this case, the prime minister is granted a broader discretion of appointing and dismissing his or her cabinet members. In contrast, in Netherlands, cabinet ministers are not appointed by the prime minister but they are decided through negotiations between coalition parties. In the process, multiparty coalition governments diffuse the executive power – cabinet portfolios – into different parties coming together. Therefore, it is not surprising that it is difficult for the prime minister to make recalcitrant ministers resign while they are fixed in the coalition contract.

The strong party discipline refers to politics within prime minister's own party. All other things being equal, the hierarchical structure of a ruling party will strengthen the party leadership, usually held by the prime minister. In contrast, if some factions in the ruling party are controlled by autonomous groups, typically trade unions, the prime minister's party leadership will be weakened.

I argue that Ireland could enter and stay within the EMS because strong prime ministers, whose power was buttressed by single party government and strong party discipline, retained the neoliberal policy idea. Since Ireland gained independence, a single party government led by Fianna Fail was the norm in Ireland until the late 1980s. From September 1922 to March 1987 Ireland experienced single party majority governments for thirty-four years and seven months, single party minority governments for fourteen years and seven months, and coalition governments for fifteen years and four months (Farrell 1988). Table 2 presents the various governments in the postwar Irish politics.

[Table 2 about here]

A correlation between single party government and strong premiership looks evident in Ireland. The Irish prime minister has been one of the strongest leaders in parliamentary systems.[4] In terms of prime minister's control over the cabinet, the Irish

[4] The strong formal power of the Irish prime minister indicates that Ireland is built on a British-style majoritarian democracy even though Ireland adopts proportional representation (PR) for its electoral

prime minister has been regarded as a "first above unequals" (Sartori 1994). The constitution provides the prime minister power of appointment of government members while it is subject to parliamentary approval. Moreover, the prime minister may dismiss cabinet members if they refuse to comply with prime minister's request to resign (Elgie 1999: 238-239).

The power of Irish prime ministers has been strengthened by the fact that they also hold party leadership. The two main parties, Fianna Fail and Fine Gael, have been tightly controlled by their leaders (Laver and Schofield 1990: 228). Party leaders have frequently influenced candidate selection in the name of the electoral success of their parties (Laver and Marsh 1999: 161). In addition, party leaders of Fianna Fail and Fine Gael are to a large extent insulated from the intra-party rebellions. They are elected solely by members of parliament, with rank-and-files not being allowed to participate in the selection process.

However, we should not too much stress the stability of party leadership in Ireland. Party leadership has faced party rebels and undergone changes as Jack Lynch of Fianna Fail resigned in 1979, Garret Fitzgerald of Fine Gael in 1987, and Charles Haughey of Fianna Fail in 1992. What is important is that they did not resign simply because of policy divergence with party members. Instead, they were motivated to resign

system, unlike Britain's plurality rule. From the institutional perspective, a parliamentary system with PR should have produced a bias for multiparty coalition governments because all parties, large and small, are accurately represented in relation to their size. However, the degree of existing social divisions may have constrained the effective number of parties under the PR system of Ireland.

The issue dimensions in the politics of Ireland have been historically limited, dominated by national issues involving Britain and North Ireland. The current Irish party system was molded when *Sinn Fein* party was split over the negotiation of a treaty with Britain in the early 1920s. Hawks and doves in *Sinn Fein* fought against each other in the civil war from 1921 to 1923, which led to the formation of nationalist Fianna Fail and liberal Fine Gael, now the two major parties in Ireland. The effect of pro- and anti-treaty division was so profound that Irish Labor party, the third largest party in Ireland, remained weak compared to other Western European counterparts. In the period from 1932 to 1977, the percentage of seats in Dail Labor party occupied never exceeded 15 percent (Chubb 1982: 102).

when exogenous impacts such as electoral debacles and party leaders' involvement in scandals rendered them an electoral liability.

In sum, strong prime ministerial power underpinned by the norm of single party cabinet and strict party discipline was a crucial underlying factor that enabled political leaders to advance their neoliberal economic programs. In the next sections, I will test this proposition with evidence documenting historical events from the birth of the EMS to the Maastricht Treaty.

III. A Critical Juncture

In July 1978 the European Council was held in Bremen to discuss closer European monetary cooperation. Since the Bretton Woods system fell down, member states in European Economic Community were concerned with fostering exchange rate stability. In the Bremen meeting the Council reached an agreement to launch the so-called European Monetary System, in which individual currencies were pegged to the DM with fluctuations of up to 2.25 percent on either side of central rates permitted.

In the Bremen Council meeting, Fianna Fail Prime Minister Jack Lynch and Finance Minister George Colley were supportive of the plan to set up the EMS. They considered the possibility that Ireland, the only peripheral state in the EC, could be isolated if they opposed the Community-wide support for the plan. The Irish government requested 650 million pounds for special grants in the event of Ireland becoming member of the EMS in bilateral talks with French and German governments. While German Chancellor Helmut Schmidt was reluctant, the promise of French President Giscard d'Estaing to provide financial aid in exchange for the Irish membership of the EMS alleviated Irish government's concern about the size of potential pain caused by Ireland joining the league of richer countries. But, the form and the amount of money transfer were never formally agreed between Giscard d'Estaing and Lynch in Bremen.[5]

On December 5 1978 the European Council decided to provide Ireland with a loan of 225 million pounds over five years at an interest subsidy of 3 percent for 15 years in return for the Irish entry to the EMS.[6] The loan would be equivalent to 45 million pounds of grants, which was far inadequate compared to Ireland's original request. When Lynch and Colley proposed the negotiation outcome at the European Council meeting for parliamentary approval, they were confronted with severe attacks from Fine Gael and Labor. Garret FitzGerald, leader of Fine Gael, and Frank Cluskey, leader of the Labor party, rebuked the Fianna Fail government, arguing that the European Council's decision fell short of the condition for Ireland to enter the EMS. They made it clear that they opposed entering the EMS without renegotiating terms related to a transfer of resources from richer members.[7] In this regard, the side-payments do not fully explain the final decision of Ireland on the EMS because the negotiated amount of aid actually failed to buy consent from important Irish politicians who were reluctant to approve the EMS proposal.

The opposing leaders were mainly concerned about the short-term deflationary impact of the EMS on the Irish economy in the event of breaking the traditional link to the sterling. Particularly, they were worried about what would occur if Britain would not join the EMS. The Irish entry to the EMS would lead to the appreciation of the Irish punt

[5] Debates of Dail Eireann. "European Monetary System" Vol. 310. 29 November 1978.
[6] Debates of Dail Eireann. "European Monetary System" Vol. 310. 12 December 1978.
[7] Debates of Dail Eireann. "European Monetary System" Vol. 310. 15 December 1978.

since the punt would be linked to the strong DM. While the revaluation of punt would undermine price competitiveness of Irish industries vis-à-vis other less prosperous non-EC members, the damage would be much more painful to Ireland with Britain staying outside the EMS because of its heavy trade with Britain. For instance, Britain accounted for 47.2 percent of Irish exports and 49.4 percent of Irish imports in 1978.[8] Therefore, under this scenario it looked highly probable that Ireland would suffer the deterioration of balance of payments and incur substantial job loss. Moreover, considering that the unemployment rates of Ireland had already risen up to 8.2 percent as of 1978, Fine Gael and Labor's concern about the negative effect of EMS on growth and employment was not surprising.

For Lynch and Colley, however, price stability took precedence over growth and employment. Table 3 shows the economic instability of Britain and Ireland in the 1970s. During this period Britain suffered a substantial increase in inflation rates, which was being directly imported to Ireland because the Irish punt was fixed at a one-to-one parity with the sterling. Britain reacted to the 1973 oil crisis by using an expansionary monetary policy to accommodate deficit spending. Instead of boosting growth and employment, however, the British economy fell into deep stagflation with its current account balance being deteriorated. This in turn led to a loss of confidence in the sterling in the financial markets and thus the sterling crisis occurred in 1976 as the sterling plummeted from $2.00 in March to $1.65 by late September in the same year. The British Chancellor Denis Healey turned to the International Monetary Fund (IMF) to seek a $3.9-billion loan.

[Table 3 about here]

[8] IMF. *Direction of Trade Statistics Yearbook*. 1980.

In contrast, the German economy seemed to be insulated from the inflationary pressures that prevailed in advanced industrial countries in the same period. Despite the first oil shock German inflation rates were stable throughout the 1970s. As a result, the differentials of inflation rates between Britain and Germany grew by more than three times between 1968-73 and 1973-79.

The Irish government was clearly aware that fluctuations of exchange rates and price instability as a major disturbing factor of Irish economy under the sterling link. Minister of Finance Colley said,

> "The major criticism of the sterling link is that it has been largely responsible for our inability to insulate ourselves from the adverse effects of British economic and monetary policies and this criticism reached a peak during the period of high inflations to 1973 to 1976. It is to be hoped that the greater convergence of economic policies which will be a necessary concomitant of the European Monetary System will prevent a repetition of that experience."[9]

Prime Minister Lynch explicitly confirmed the necessity for sound macroeconomic policies facing Ireland in the event of entering the EMS. He said before the Dail,

> "If the new system comes, the need for discipline will be even greater. The Government will have to operate fiscal and monetary policies which will sustain growth, encourage employment and keep down costs... We all want to a stop to the gallop of inflation; and certainly within the scheme the rate of price increase in the different countries of the Community must converge if the value of currencies is to remain stable in relation to each other."[10]

Lynch and Colley's statements explain why Ireland should join the EMS regardless of what Britain might choose. The policy objective of top government officials mattered for the national decision choosing between the DM and the sterling. If Lynch and Colley had put more emphasis on growing unemployment, they would have perceived the EMS to be disastrous to the Irish economy and, therefore, they would have chosen to remain linked to the sterling.

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[9] Debates of Dail Eireann. "European Monetary System" Vol. 310. 17 October 1978.
[10] *Ibid.*

In this regard, the Irish choice for the EMS was, to a certain degree, a matter of prioritizing macroeconomic objectives. After they experienced the upsurge of inflation rates during 1973-76, Lynch and Colley found the sterling link to be a stumbling block to macroeconomic stabilization. They needed a new standard currency with less fluctuation, which should be buttressed by lower domestic inflation rates. The DM was the only major currency in Europe that had such characteristics.

However, introducing the DM peg needed firm political support because the EMS membership required that Ireland undergo painful economic adjustment to control inflation pressures. Prime Minister Lynch's neoliberal policy initiative was underpinned by a single majority party cabinet and his preeminent position in Fianna Fail. In 1977 elections, Fianna Fail became a sweeping majority, winning twenty more seats than the rest of parties. This provided the Fianna Fail government to put forward Irish participation in the EMS without having to compromise with oppositions in parliament. Cluskey, the Labor party leader, complained that "everyone in the House and in the country knows that Fianna Fail have 84 seats and that they can ram anything they like through the House."[11]

Moreover, Lynch's leadership in Fianna Fail had been unchallenged since he became a Fianna Fail leader in 1966. His strong leadership was clearly shown when he sacked Charles Haughey from his cabinet in 1970 on suspicion of involvement in a conspiracy of importing arms illegally. Haughey, then a popular figure among Fianna Fail backbenchers, was a potential rival to Lynch.

On December 21 1978 Dail Eireann, the House, decided to adopt the motion of Prime Minister to join the EMS without amendments by 77 to 13. Fine Gael deputies

[11] Debates of Dail Eireann. "European Monetary System" Vol. 310. 15 December 1978.

abstained from voting in the anticipation of not being able to kill or amend the motion. The decision to join the EMS coincided with Prime Minister Lynch's preference for price stability. Yet his preference per se does not explain how he got what he wanted. Considering that oppositions were discontent with the negotiated terms for Ireland entering the EMS, Fianna Fail being an absolute majority in parliament was essential to the decision to enter the EMS.

IV. A Test of Political Commitment to the DM in the Hard Times

From 1979 to the early 1980s the Irish punt did not strengthen against the sterling, which was desirable for Irish exports. However, the EMS membership did not lead to lower inflation rates in Ireland. Rather, the average inflation rates during 1979-82 increased to a record 18.6 percent. This was a big embarrassment for the Fianna Fail government, but it was not an inexplicable puzzle. First, the Irish economy suffered the rise in prices in imports due to a large increase in the oil price in 1979. Second, even if the Irish punt formally departed from the sterling, Britain's inflations still influenced the Irish economy through the heavy trade between the two countries. Because Britain absorbed nearly fifty percent of Irish imports, Ireland was vulnerable to the changes in the price of British goods. However, fiscal discipline became a salient issue from the early 1980s while inflations rates for Ireland peaked at 20.4 percent in 1981 and fell to the level of 5.5 percent by 1985 due to tight monetary policy in Ireland and disinflation in Britain under Thatcher government. The Irish government failed to take control of huge budget deficits. In 1982 Ireland's budget deficit was running at 17 percent of gross domestic product, the highest in the EEC, and it was stabilized at the high level until 1986. The Irish government sought to meet increases in government expenditure by increases in income tax.

Why did Irish government fail to impose fiscal discipline? Does this mean that Irish policy-makers abandoned the objective of price stability and returned to Keynesian growth-oriented policy? The Irish government failed to follow up the EMS membership with domestic fiscal discipline because of lack of firm domestic political support. In December 1979 Prime Minister Lynch resigned when he was confronted by backbenchers' rebellion over recent by-election setbacks, an economic slowdown, and his moderate approach to the problem of Northern Ireland. Charles Haughey, Health Minister, succeeded Lynch as Prime Minister and he professed to solve the problems of growing budget deficits and public debts. However, as his near victory (44-38) against his competitor Colley showed, his party leadership was not strong enough to pursue the fiscal austerity, which was unpopular to the electorate and backbenchers. Moreover, in the November 1982 election a coalition government between Fine Gael and Labor Party was created. Prime Minister Garret Fitzgerald and his Fine Gael party needed Labor's agreement to reduce government expenditures substantially while Labor party was a recalcitrant coalition partner in bringing budget discipline.

Despite the fall in inflation rates, huge budget deficits and external borrowing entailed surging interest rates making financial crisis more likely. This adverse economic situation was testing the Irish government's commitment to maintain the EMS membership, particularly when the devaluation of sterling added to the economy problems. By 1985 the Irish punt was relatively stable within the EMS with a single devaluation permitted in 1983. However, the Irish punt faced pressures for devaluation in the mid-1980s, when the sterling fell 30 percent against the DM between July 1985 and February 1987.[12] At this point, Ireland was at the crossroad. High unemployment in 1986, record 17.4 percent, necessitated the devaluation of punt concomitant to that of sterling, which meant Irish withdrawal from the EMS. The other option was to maintain the EMS membership and pursue fiscal austerity. A policy dilemma between employment and stabilization recurred in 1986 as in 1978.

Policy preferences of government actors were not sufficient for policy choice again. The Fine Gael-Labor coalition government devaluated the punt by 8 percent in August 1986. Although the amount of devaluation was accommodated by realigning basic exchange rates of the EMS currencies against the DM, realignment was no more than a temporary solution for the groaning Irish economy. Facing the need for disciplined fiscal policy, Fine Gael Prime Minister Fitzgerald and his Finance Minister John Bruton attempted to cut social welfare expenditures to reduce budget deficits. However, their attempt to achieve budget discipline was confronted with Labor's opposition, particularly with Barry Desmond, Minister of Social Welfare. Labor party withdrew from the coalition government in protest against Finance Minister's plan to cut social spending for the next fiscal year. Thus, the Fine Gael-Labor coalition government collapsed.

There was a general election in February 1987 amid the budget crisis. In the elections Charles Haughey's Fianna Fail won more seats than the sum of what Fine Gael and Labor won, but not an absolute majority. Rather than wooing other parties for making coalition government, Haughey chose to depend on some independents to form a

[12] *Financial Times*. "Fixed Exchange Rates and the Lessons of History." October 10 1990.

single party minority government. Haughey provided independents with increased budget spent for their districts in exchange of their support for the Fianna Fail government. Under the single-transferable voting system of Ireland, individual parliamentary members had the incentive to become identifiable by their constituents in the district so that they could get the most first-order preference votes. Since the government has the authority of distributing fiscal resources targeting specific groups, the government can manipulate independents' support without having to give them cabinet seats. In the politics of Ireland, therefore, single minority government could exercise power almost equal to that of single majority government.

After he was elected prime minister of the minority Fianna Fail government, Haughey and his finance minister Ray McSharry pushed forward with fiscal austerity. Even if his government was a minority, it faced few political constraints on the austere program for two reasons. First, Garret Fitzgerald, the former Prime Minister and leader of the Fine Gael party pledged to support the Government if it took tough fiscal measures.[13] Second, his party leadership strengthened in 1987. There were no rivals that could challenge Haughey for party leadership of Fianna Fail. Truly, the government still faced considerable hostility to its cost-cutting policies from Fianna Fail backbenchers.[14] However, they had no alternative to uniting about Haughey for the electoral success of their own party. Thus, Haughey could execute tough budget measures with his minority government. Figure 1 shows that Haughey government achieved budgetary control in the late 1980s.

[Figure 1 about here]

[13] *Financial Times*. March 13 1987.
[14] *Financial Times*. May 8 1987.

The events that unfolded in 1986 and 1987 confirm that different arrays of political constraints produced different policy outcomes in the same economic environment. FitzGerald failed to bring in fiscal discipline because he was not backed by his multiparty coalition cabinet, where his prime ministerial power was severely weakened. In contrast, Haughey's economic policy was underpinned by the single party government and his strong position in Fianna Fail. Their common propensity for macroeconomic stabilization does not explain why one hurt the credible commitment of Ireland to the EMS while the other restored it.

V. Making the DM Link Irrevocable

Under Haughey government Ireland achieved a low rate of inflation by 1990. The average annual inflation rates between 1987 and 1990 were 3.2 percent, which substantially outpaced Britain.[15] While some economists argued that the consistently overvalued punt led to high unemployment (Dornbusch 1989), inflation control was indeed a major achievement under the EMS. Other member states also understood the EMS to be successful for stabilizing exchange rates and inflation.

Meanwhile, a new momentum for European monetary integration was laid out by the European Commission. The 1989 Delors Report set up a blueprint for establishing a monetary union with a single currency at the European level. According to this plan, states within European monetary union would have to transfer their monetary policy authority to a supranational institution, the European Central Bank. Therefore, they

[15] OECD. *Economic Outlook*. 1995.

would abandon the monetary policy instrument for domestic adjustment to external shocks permanently.

The Haughey government faced a dilemma between the sterling and the DM again. Since Britain entered the EMS in 1990, leaving the EMS became less attractive to Ireland. However, Ireland could have chosen to opt out of European monetary union, retaining its EMS or ERM status. This was the British government's choice at the Maastricht Treaty negotiation, and Ireland could have followed the British choice to reduce unemployment rates that had persisted at a high level throughout the 1980s. During the five years' Fianna Fail government since 1987, annual average unemployment rates hit a high 15 percent, which was the highest among EC member states except Spain. Although the Haughey government claimed the credit for economic stabilization, the employment cost of disinflation was so immense that Fianna Fail backbenchers were concerned about the evaluations by constituents in the next election. The expectation held by many parliamentary members was that the Economic and Monetary Union would be detrimental to employment and income in Ireland because it would be prone to region-specific shocks and would not be able to devaluate the punt to counter these shocks.[16] Then, how did Haughey government choose to join the EMU?

It is argued that intergovernmental bargaining to provide financial transfers to poorer participants in the EMU was essential to the latter states' participation. The Maastricht Treaty made promoting economic and social cohesion one of the tasks of the Community. The Treaty also made a provision for the cohesion fund to be set up, which provided "financial contribution to projects" in the field of environment and trans-European networks in the area of transport infrastructure.

[16] Debates of Dail Eireann. "Economic Monetary Union" Vol. 414. 12 December 1991.

However, the argument that cohesion policy functioned as a side-payment, a compensation for the acknowledged losers of the EMU, is limited because the major development in the EC cohesion policy was already made in the 1986 Single European Act, where "economic and social cohesion" was introduced into the Rome Treaty for the first time. The structural funds were created by the SEA as one of the main pillars of cohesion policy and expanded to account for 25 percent of the Community budget by 1993.

More importantly, the side-payment argument ignores the difference between Ireland and other cohesion countries. While the cohesion policy was a compensation for less prosperous states to cushion the impact of economic adjustment following their entry to the EMU, Ireland had already paid the costs of economic stabilization in the 1980s. As one of the founding members of the EMS, Ireland had undergone disinflation and fiscal austerity programs needed to stay within the EMS. This does not mean that Ireland did not want cohesion funds. More cohesion funds were clearly to Ireland's advantage and for this reason Ireland took the same position as Spain in the Masstricht Treaty negotiation. My point is that for the thirteen years' membership in the EMS Ireland transformed its economy by incurring costs of economic discipline in terms of high unemployment and welfare retrenchment. These costs were sunk costs for Ireland, irrecoverably made to credibly commit Ireland to monetary stability. Therefore, Ireland could not have credibly threatened to opt out the EMU without making a coalition with Greece, Portugal, and Spain.

Also, we should not ignore domestic factors underpinning the Irish choice for the EMU. First, enduring policy objectives of Irish political elites mattered. Prime Minister

Haughey and Finance Minister Ahern opposed the idea that devaluation could be used as a weapon against external shocks. They saw that any devaluation of the Irish punt would threaten the gains of low inflation and interest rates, which were the economic benefit of the strong punt under the EMS.[17] The opposition Fine Gael also supported the EMU, with John Bruton, Fine Gael leader, further maintaining that the Fianna Fail government take a federalist approach to European integration at the Maastricht Treaty negotiation table.[18] He even proposed to tie immediately the Irish punt to DM rather than waiting until January 1997, the starting date for the final stage of EMU when national currencies should be replaced by a single European currency.[19]

For the Haughey government the main economic benefit of the EMU was a strong coordination of economic policies with special provisions against monetary financing and excessive budget deficits.[20] Although Ireland already achieved low inflation and interest rates by 1991, policy-makers understood these outcomes would not be equilibria unless they were locked in supranational institutions. This approach had risk of perpetuating high unemployment in Ireland because the European Central Bank would try to defend the value of an EMU currency by tight monetary policy, although specific regions, especially poorer countries, were in economic slowdown. However, monetary stability took precedence over employment for Irish policy-makers. The choice for the EMU reflected the enduring bias to price stability for political leaders that had initially punctuated the period of 1973-78, when Ireland suffered soaring inflation due to the sterling link.

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[17] *Ibid.*
[18] Debates of Dail Eireann. "Maastricht Summit." Vol. 413. 28 November 1991
[19] *Ibid.*
[20] Debates of Dail Eireann. "Economic Monetary Union." Vol. 413. 28 November 1991.

However, political leaders' preferences do not fully explain the Irish choice for the EMU. We should note that by 1991 Ireland already met most of the Maastricht convergence criteria:

- a government deficit of no more than 3 percent of GDP in "normal circumstances";
- a ratio of government debt to GDP of not more than 60 percent, unless the ratio is "sufficiently falling";
- an inflation rate of no more than 1.5 percent greater than the average of the 3 best performing countries;
- long-term interest rates should not be more than 2 percent greater than the average of the 3 best performing countries;
- membership of the Exchange Rate Mechanism (ERM) without "severe tensions" for at least 2 years before examination.

As of 1991, Ireland achieved 2.4 percent of budget deficit of GDP, 96.5 percent of government debt of GDP, 1.8 percent of inflation rates, and 9.2 percent of long-term interest rates.[21] Ireland's inflation was a Community low and its long-term interest rates were one of the lowest in the EC. Public debt ratio was rather high but it was decreasing significantly. Haughey said,

> "I am fully confident that Ireland will be in a position to move to Stage III of European Monetary Union with the first group of countries. The convergence conditions ... relate to price stability, a sound budgetary position, convergence of interest rates and a stable currency in the Exchange Rate Mechanism of the EMS. We are already in a better position than many member states to meet these conditions."[22]

In terms of macroeconomic performance, the Haughey government modernized the Irish economy to the level of core member states within the EC, even outpacing some of them. This transformation of the Irish economy had a political institutional foundation in that economic stabilization as the EMS membership fee was underpinned by the

[21] OECD. *Economic Outlook*. 1996.
[22] Debates of Dail Eireann. "Maastricht Treaty" Vol. 414. 12 December 1991

British-style majoritarian government, in which the prime mister has strong power over his cabinet members and backbenchers.

In June 1989 Haughey attempted to increase his power even more by calling an election two years early. He sought to win three more parliamentary seats and thereby a majority for Fianna Fail. The electoral outcome was a setback for Haughey. Fianna Fail lost four seats in the Dail, six seats short of an overall majority in the 166-seat assembly. In an unclear political situation, Fianna Fail formed the first coalition government since its establishment with the Progressive Democrat (PD) party led by Desmond O'Malley, who left Fianna Fail over Haughey's leadership in 1985.

The coalition government did not lead to a shake-up of the traditional political system in Ireland. Despite differences in the North Ireland issue between Haughey and O'Malley, economic policy differences between their two parties were minimal. Both leaders concurred on the major political economic issues of sustaining macroeconomic discipline and joining the EMU. More importantly, even though the PD won two cabinet seats, senior portfolios in the cabinet – finance and foreign ministers – were still occupied by Fianna Fail. Haughey's party leadership remained strong until scandals forced him to step down in 1992. When he faced a most severe challenge to his leadership from Fianna Fail backbenchers in 1991, he reasserted his power by dismissing finance minister Albert Reynolds and environment minister Padraig Flynn who joined the rebellion. The internal party rebellion ended with only 22 of Fianna Fail's 77 deputies backing the heave against Haughey in a party vote of no-confidence.

Therefore, Haughey governments before and after the 1989 election are not distinguishable in terms of the government capacity to push forward economic reform despite the apparently different types of cabinets. This continuity in the Irish political system was essential to the Irish choice for European monetary integration.

V. Concluding Remarks

This paper focused on the role of domestic political institutions to explain the puzzle how Ireland chose to stay tied with the DM despite its traditional financial and trade relations with the sterling. By observing the period from 1978 to 1991, not selecting the Maastricht Treaty case only, systematic factors were distinguished from random factors to account for the consistent Irish choice for European monetary integration. A summary of variables and their effects in different time points is shown in Table 4.

[Table 4 about here]

A remaining question is whether strong ministerial power will continue to function as the political foundation of economic stability in Ireland, now a member of the EMU. This question is relevant because coalition governments seem to be the norm of the Irish politics in the 1990s. What is particularly interesting is the "rainbow coalition" formed by Fine Gael, Labor, and Democratic Left in 1994. This coalition government had a prime minister and finance minister from different parties and it contained more coalition partners than the Fine Gale-Labor coalition (1982-1987), but nevertheless it put tight constraints on public spending, over which the Fine Gael-Labor coalition collapsed. Can strong prime ministerial power based on the British model of democracy account for the economic policy of the rainbow coalition?

One possible explanation would be that prime ministerial power has not been eroded under coalition governments. The prime minister's power coordinating fiscal policy was sustained by creating a sub-cabinet committee in 1995.[23] This special committee, charged with discussing budgetary figures spending ministers proposed, consisted of the prime minister, deputy prime minister, finance minister, and minister of state. Fine Gael Prime Minister John Bruton could oversee budget processes by engaging in this budget committee and thereby elevate his premiership over spending ministers.

A further research is needed to examine why coalition partners agreed to coordinate budgetary decision-making in the cabinet in 1995 while they failed in 1986. External pressures from the Maastricht convergence criteria may have worked for coalition partners to seek to avert policy deadlock that happened in 1986. But, from a domestic political view, varying status-quos may have produced different policy outcomes with the same type of government. FitzGerald's coalition government faced the status-quos of large deficits in 1986. Labor party, Fine Gael's coalition partner, opposed a policy shift to fiscal austerity. Therefore, Labor exercised veto power to block Fine Gael's proposal for budget cutbacks. By doing so, Labor could turn their policy preference into policy outcome.

However, after the Irish economy was transformed under the Haughey government in the late 1980s, Bruton's coalition government started with the different status-quo of small deficits in 1994. Labor, Fine Gael's coalition partner again, may have found that it could not resort to vetoing any more to materialize their preference for growth and employment. Since both Fianna Fail and Fine Gael supported the EMU and either party would participate in any coalition for sure, Labor party may have realized

[23] *The Irish Times*. January 6 1995.

that it would be prevented from changing the fiscal status-quo in any circumstance even if it sought to do so. Thus, Labor may have had more incentives to remain in government than to stick to their traditional economic programs.

Therefore, the economic reform under the Haughey government seems to have important political consequences. First, they induced Labor party to act on fiscal policy coordination in the cabinet. Secondly, probably more importantly, an increase in the number of domestic veto players (e.g. coalition government becoming the norm of Irish politics) in the current macroeconomic status-quo will not make the EMU membership of Ireland vulnerable as it did in 1986 but instead irreversible.

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Table 1. Direct investment from abroad in the EMU countries

(Million US dollars)

	Cumulative flows		1988	1989	1990	1991	1992
	1971-1980	1981-1990					
Austria	1455	3274	437	578	647	359	940
Belgium-Luxembourg	9215	27986	4990	6731	7966	9292	11326
Finland	376	2838	530	489	787	-247	406
France	16908	54588	8519	13062	15609	15157	17855
Germany	13816	19691	1163	6928	2962	4729	-2086
Greece	N/A	6145	907	752	1005	1135	1144
Ireland	1659	1371	91	85	258	1168	1244
Italy	5698	24888	6882	2181	6344	2481	3210
Netherlands	10822	37857	4830	8460	12165	6552	7824
Portugal	535	6920	925	1740	2608	2451	1914
Spain	7060	46158	7016	8433	13839	12445	13352

Source: OECD. *International Direct Investment Statistics Yearbook.* 2000.

Table 2. Irish governments in the postwar era

Year in	Prime minister	Government type	Governing party
1932	Eamon de Valera (FF)	Single party majority	FF
1948	John A. Costello (FG)	Coalition	All parties except FF
1951	Eamon de Valera (FF)	Single party majority	FF
1954	John A. Costello (FG)	Coalition	FG, L, CT
1957	Eamon de Valera (FF)	Single party majority	FF
1959	Sean F. Lemass (FF)	Single party majority	FF
1966	Jack M. Lynch (FF)	Single party majority	FF
1973	Liam Gosgrave (FG)	Coalition	FG, L
1977	Jack M. Lynch (FF)	Single party majority	FF
1979	Charles Haughey (FF)	Single party majority	FF
1981	Garret FitzGerald (FG)	Coalition	FG, L
1982	Charles Haughey (FF)	Single party minority	FF
1982	Garret FitzGerald (FG)	Coalition	FG, L
1987	Charles Haughey (FF)	Single party minority	FF
1989	Charles Haughey (FF)	Coalition	FF, PD
1992	Albert Reynolds (FF)	Coalition	FF, PD
1994	John Bruton (FG)	Coalition	FG, L, DL
1997	Bertie Ahern (FF)	Coalition	FF, PD

FF: Fianna Fail
FG: Fine Gael
L: Labor
PD: Progressive Democrats
DL: Democratic Labor
CT: Clann na Talmham

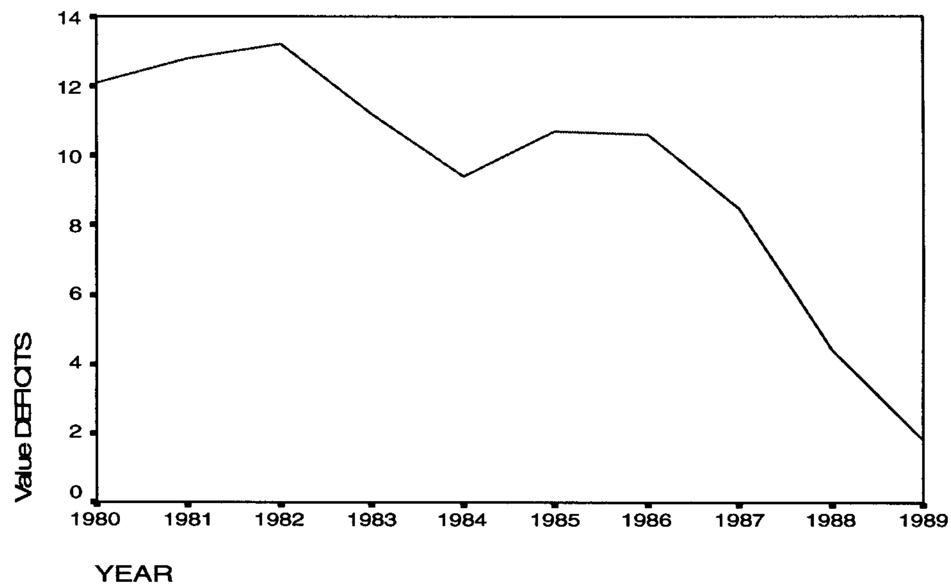
Source: derived from Farrell (1988) with additional material by author.

Table 3. Consumer price indices: Average percentage changes from previous years

	1960-68	1968-73	1973-79
Germany	2.7	4.6	4.7
Britain	3.6	7.5	15.6
Ireland	4.0	8.9	15.0

Source: OECD. *Historical Statistics.* 1984

Figure 1. Ireland's general government deficits as a percentage of nominal GDP



Source: OECD. *Economic Outlook*. 1996

Table 4. Temporal effects of explanatory variables

	1978 EMS	1986 Budget Crisis	1991 EMU
Side-payments	Weak	Not applicable	Modest
Core interest groups	Weak	Weak	Modest
Neo-corporatism	Weak	Weak	Modest
Neoliberal policy idea	Strong	Strong	Strong
Prime ministerial power	Strong	Weak	Strong