

## EXCHANGE RATES AND IRISH COMPETITIVENESS

- The weak Euro exchange rate with both Sterling and the US Dollar has boosted Irish export competitiveness over recent years
- Ireland’s exposure to currency fluctuations – arising from our high level of trade outside the Euro area, particularly with the UK– reinforces the need to maintain focus on domestically influenced aspects of competitiveness
- Exporting firms need to ensure that appropriate currency risk strategies are in place and a sustainable cost base is maintained
- Policies which facilitate the development of a more diverse export base are necessary to reduce exposure to external demand shocks such as exchange rate fluctuations

### INTRODUCTION

Exchange rates have a significant impact on Ireland’s national competitiveness. A favourable exchange rate vis-à-vis our main trading partners makes firms based in Ireland more cost competitive and allows them to trade more effectively in international markets. In particular, the value of the Euro against the US Dollar and UK Sterling is intrinsic to our export cost competitiveness. Exchange rate movements have boosted Ireland’s relative cost competitiveness in recent years. However, we cannot rely on external factors such as benign currency movements, to protect our international cost competitiveness. Such gains can be lost as quickly as they are accrued. As a member of the Euro area, Ireland has no direct influence on exchange rates and limited impact on monetary policy. Nonetheless, policymakers and Irish based exporters selling to markets outside the euro area need to be mindful of currency exposure and consider appropriate strategies to mitigate against adverse exchange rate developments.

### CURRENT CONTEXT

The factors affecting the value of the Euro are complex. International capital flows, investor sentiment, economic performance, market conditions as well as monetary and fiscal policy at EU, ECB and global levels have substantial effects on exchange rate value and volatility. Volatility in exchange rates can affect the Irish economy through a number of channels. If passed on through increased prices, exchange rate fluctuations may generate expenditure switching effects between foreign and domestic goods both at home and in trading partners thereby affecting net exports. To the degree that the impact of exchange rate changes are absorbed by importers/exporters rather than passed on through changes in prices, exchange rate movements may also affect firms’ cash flow and profit margin, with possible knock on effects on investment and employment levels.

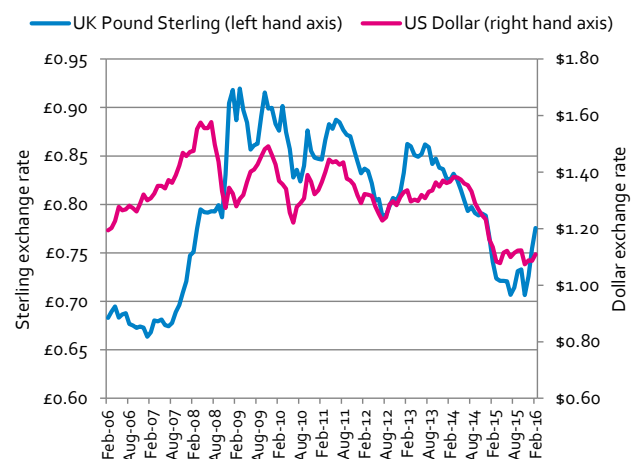
The scale of Ireland’s non-Euro denominated trade (i.e. with the UK and US) means movements in the value of the Euro have a greater impact on our relative international

competitiveness, than is the case for many Euro area countries. Ireland has the second highest ratio in the EU in terms of exports to non-Euro area countries (goods and services) relative to GDP. The UK and the US are Ireland’s principal bilateral trading partners and together account for 36 per cent of our exports and 40 per cent of our imports.

### BILATERAL EXCHANGE MOVEMENTS

The bilateral exchange rate is the common way of quoting the relationship between two currencies. An appreciating Euro relative to the currencies of our trading partners generally makes imports cheaper and Irish exports more expensive. A depreciating currency lowers the price of exports relative to the price of imports. While a depreciation of the Euro reduces the relative cost of local inputs, it can also increase the cost of imported inputs. Figure 1 shows that over the past decade, the value of the Euro relative to the Dollar and Sterling fluctuated considerably.

Figure 1: Euro v Dollar & Sterling Movements 2006-2016



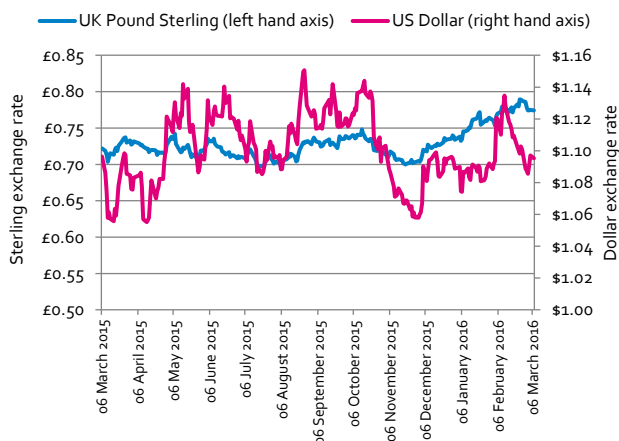
Source: European Central Bank

The average value of the Euro against the Dollar was \$1.32 and its value has ranged from a minimum of \$1.07 to a maximum \$1.57. The average value of the pound was £0.79 and has ranged from £0.66 to £0.91. The Euro depreciated and was weak relative to the Dollar and Sterling throughout

most of 2013, 2014 and into 2015. The weak Euro was a significant boost to Ireland's competitiveness performance in this timeframe. For example, in the tourism sector, in 2011-2015 the number of overseas trips to Ireland from North American and the UK increased by 24 percent and 76 per cent respectively. Figure 2 shows that in the past year the Dollar has fluctuated and Sterling has appreciated sharply vis-à-vis the Euro. Bord Bia estimates that currency developments helped to boost the competitiveness of Irish exports by around €950 million in 2015<sup>1</sup>.

As of March 2016, the Euro/Dollar exchange rate was \$1.09 having settled around this level in Q4 2015. In year-on-year terms, the Euro has depreciated against the Dollar by 7 per cent. In recent months the Euro strengthened and appreciated by over 14 per cent against Sterling amid concerns over the UK's economic performance and BREXIT uncertainty.

Figure 2: Euro v Dollar & Sterling Movements 2015-2016



Source: European Central Bank

### FOCUS ON THE EURO AND STERLING

The value of the Euro against Sterling is particularly critical for Irish exporters, particularly SMEs and employment intensive sectors, such as the agri-food sector, which are very dependent on strong trading activity with the UK.

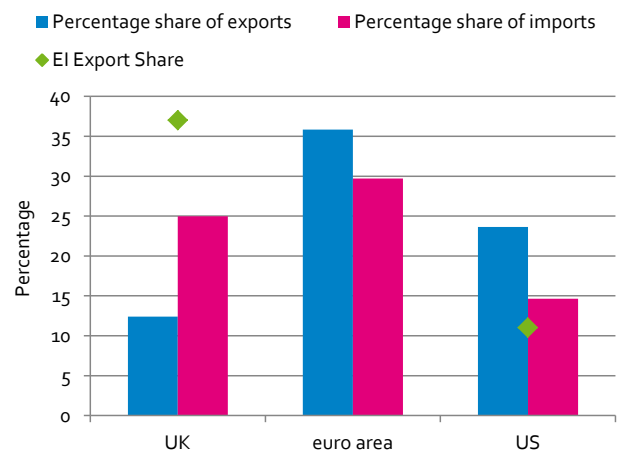
Figure 3 shows that in 2015, the UK accounted for 12 per cent of total exports from Ireland and 25 per cent of imports. The UK is the most important export destination for Enterprise Ireland (EI) supported companies. In value terms, 37 per cent of EI client companies' exports are to the UK.

Analysis by the ESRI<sup>2</sup> shows Irish exports to the UK are concentrated in a few sectors. The top four exporting sectors, Food and Beverages (26.4%), Chemicals, Pharmaceuticals and Non-Metallic Minerals (24.8%), Financial Intermediation (11.9%) and Business Services (10.2%) account for 73.3 per cent of total exports to the UK.

Imports are more evenly distributed. The top four sectors account for 54.9 per cent of total imports from the UK. These are Business Services (16.5%), Financial Intermediation (15.7%), Chemicals, Pharmaceuticals and Non-Metallic

Minerals (13.4%) and Wholesale, Retail, Hotels and Restaurants (9.3%).

Figure 3: Exports & Imports by Principal Markets, 2015

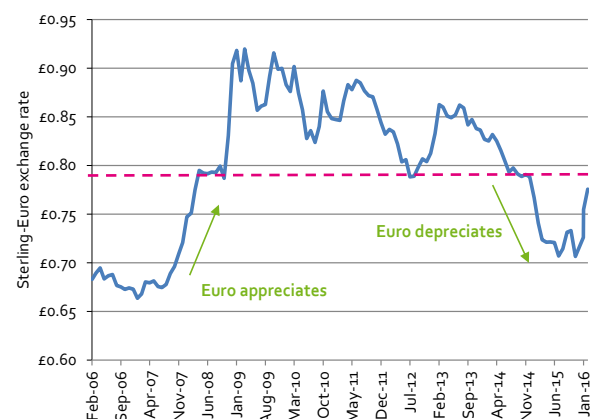


Source: CSO/Enterprise Ireland (EI data refers to 2014)

While the level of external demand is considered more significant for export performance than international price competitiveness, exchange rates are an important driver of levels of inward investment and exports and competitiveness<sup>3</sup>.

Figure 4 shows the evolution of Sterling's value against the Euro over the last ten years. Over the past ten years the average value of Sterling to the Euro (as represented by the dashed line) was €0.79. In the period 2007-2009, the Euro appreciated by 35 per cent against Sterling and the Euro was trading at €0.91 in March 2009. Between 2013 and 2015 changes in the value of the Euro and Sterling saw the rate fall to €0.70 in July 2015. This period of depreciation made Irish goods and services relatively cheaper in the UK.

Figure 4: Sterling/Euro Exchange Rate 2006-2016



Source: European Central Bank

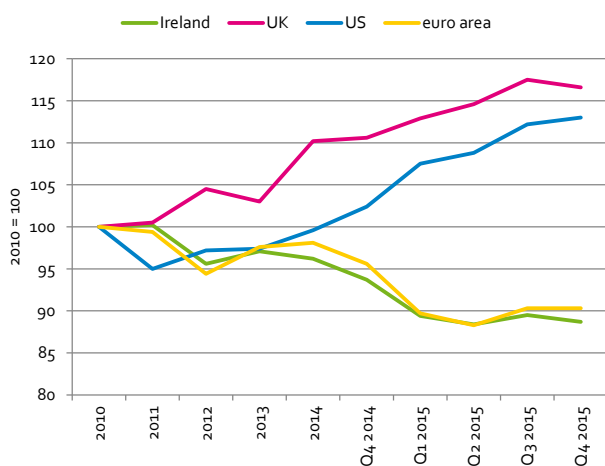
The exchange rate has fluctuated in recent months and the Euro began to appreciate sharply in November 2015. Sterling was valued at €0.77 in March 2016 – down 7 per cent on a year-on-year basis. While these recent fluctuations pose challenges for exporting firms, taking a longer term view the current exchange rate is relatively more favourable to Irish exporters than at many stages over the last decade. However, a

**sustained fall** in the value of Sterling would represent a significant challenge for enterprise, particularly for those indigenous exporters who are solely focused on the UK market or those who compete against UK firms in other markets.

## REAL EFFECTIVE EXCHANGE RATE

In the global economy, bilateral exchange rates do not move together in isolation. To assess the overall strength or weakness of a currency, multilateral exchange rates are used. Real effective exchange rates (REERs) take account of the exchange rate of a currency vis-à-vis a range of other currencies weighted by their share in world trade and price level changes between countries. The REER is considered the most appropriate indicator to assess changes in the competitive position of a country relative to its competitors.

**Figure 5: Relative Price Index 2010-2015 (base 2010=100)**



**Source: Bank of International Settlements**

Figure 5 shows the effect of the appreciation of the Dollar and Sterling. The differential vis-à-vis the Euro area and the US and UK has been especially pronounced and sharp since 2014. Low rates of inflation and the depreciation of the Euro should serve to strengthen the competitiveness of Euro area exporters. These recent movements particularly benefit countries such as Ireland that have high levels of trading activity with the US and the UK. The Council has also published a Bulletin (16-5) analysing and assessing Ireland's competitiveness performance as measured by a number of different trade-weighted competitiveness indicators.

## Conclusions

A favourable exchange rate allows firms to compete more effectively in international markets. A weak Euro results in exports from Ireland becoming more price competitive on world markets. Compared to other EU Member States, Ireland has a high share of trade outside the Euro area, with the UK and US our biggest trading partners. The value of the Euro against the Dollar and Sterling, therefore, plays a crucial role

in determining our international export competitiveness. In recent years the relative value of the Euro has been the biggest driver of the improvement in Ireland's cost base and coupled with low inflation, has boosted Irish competitiveness and helped facilitate record levels of export growth. Between mid-2013 and mid-2015, a very favourable exchange rate vis-à-vis Sterling helped to boost the competitiveness of Irish exports to the UK. While the value of Sterling against the Euro remains below its long run average, in recent months the swift appreciation of the Euro serves to highlight the volatility of exchange rates. A high proportion of Irish SMEs trade in international markets, primarily, the UK, EU and US. Exporters need to ensure that appropriate currency risk mitigation strategies are in place and that their cost base is sustainable.

Variations in exchange rates can significantly and rapidly impact upon firm level competitiveness and affect financial performance. Irish based exporters should continue to scale and diversify sustainably and strategically to reduce exposure to external economic shocks. To increase competitiveness, economic growth and sustainable jobs, we need a strong and dynamic range of FDI firms, Irish owned businesses that export, an increased level of startups with the potential to scale and internationalise supported by an administrative and regulatory framework that facilitates enterprise and exports. Irish policymakers cannot influence exchange rates, and the trade performance of a small open economy such as Ireland will always be conditional on the ebb and flow of global markets. However, a competitive, sustainable, cost base can help to create a virtuous circle between inflation, wage expectations and productivity, and can provide a buffer against such exchange rate fluctuations and other uncontrollable, external factors. While continuing to maximise export opportunities from established markets, policies which facilitate the development of more diverse export markets can help reduce exposure to bilateral exchange rate fluctuations. This can help facilitate greater stability in export earnings and deliver sustainable growth.

### Further Reading:

For an overall summary of Ireland's recent competitiveness performance, see Ireland's Competitiveness Scorecard 2015, available from [www.competitiveness.ie](http://www.competitiveness.ie). The NCC reports to the Taoiseach on key competitiveness issues facing the Irish economy. This Bulletin has been issued by the NCC Chair and Secretariat.

<sup>1</sup> Bord Bia, Export Performance & Prospects 2015/2016

<sup>2</sup> Barrett, A. et al, Scoping the Possible Economic Implications of Brexit on Ireland, Research Series Number 48, ESRI, November 2015

<sup>3</sup> European Commission, European Economic Forecast, European Economy 1-2015, Winter 2015