

Journal of the Statistical and Social Inquiry Society of Ireland
Vol. XXVIII, Part I

**SYMPOSIUM
ON
ECONOMIC MANAGEMENT IN IRELAND POST-EMU**

(read before the Society, 18 February 1999)

**Economic Management in Ireland Post-EMU:
Policy Implications of Globalisation and Regionalisation**

JOHN BRADLEY

The Economic and Social Research Institute (ESRI)

1. INTRODUCTORY REMARKS

In today's increasingly globalised economy, it is something of a paradox that while policy-making autonomy is being progressively ceded by states to supranational organisations, regions within nation states have also begun to assert their rights to a greater degree of administrative and policy self-determination. However, just as the exercise of certain types of policy autonomy in the past for small states like Ireland was not always without problems, policy integration of regions into nation states – such as Scotland and Northern Ireland – has not necessarily provided them with guaranteed participation in the prosperity of other richer regions within their nation state.

The present symposium was prompted by the advent of Ireland's entry into EMU on January 1st this year and the loss of policy tools that EMU membership implied. Exchange rates seem to hold a fascination often beyond their real significance. On the morning of March 30th, 1979, seventeen days after Ireland joined the *European Monetary System* (EMS), I was in the Central Bank of Ireland and remember the moment when a frisson of excitement tempered by a degree of anxiety ran through the Bank as the news spread that we had just broken the link with sterling. However, I also recall that the then conventional analysis of the consequences of our joining the EMS merely stressed the fairly automatic switch of inflation regimes as well as a range of other rather technical issues that, it was believed, would leave much of the rest of the policy environment intact (McCarthy, 1979).

The recent debate that preceded Ireland's EMU entry was much wider ranging than almost any other on economic policy issues. This was because it correctly identified joining EMU as final confirmation of a fundamental shift in Ireland's policy

environment far beyond the loss of the exchange rate and interest rate instruments, both of which in any case had been heavily circumscribed prior to EMU. The timing of the debate was given an added relevance in that it took place when, to borrow a term used by Intel chief executive officer Andrew Grove, the Irish economy appeared to be at something of a “*strategic inflection point*”, where its policy and performance fundamentals were about to change forever (Grove, 1997).

As I reflected on the last few decades of Irish policy making, I noted that almost exactly forty years ago – on May 1st, 1959 – the Society sponsored another symposium following the 1958 publication of *Economic Development*. The problems and failures being addressed by the First Programme for Economic Expansion were an extraordinary reversal of the issues and challenges that we face today. In the words of Dr Whitaker, in the late 1950s we had “*plumbed the depths of hopelessness*”; today we bask in the world’s admiration of our success. Then we began to take our first tentative steps out from behind stultifying barriers of tariff protection and isolation; today we have embraced the global economy to an extent that few other states have, and we are cosmopolitan citizens of the world. Then we were predominantly an agricultural-based economy, and the 1959 symposium participants dwelt on how that sector might be made more dynamic in order to stimulate wider growth in the economy; now, while agriculture remains important, we are seen to be a major supplier of Europe’s computers, software and pharmaceuticals and our concerns are with maintaining a leading position at the cutting edge of new technology-based manufacturing and quality services.

In my short contribution to this symposium I wish to examine two aspects of the evolution of Ireland’s economic management. First, I will suggest that, since the 1959 symposium on Economic Development, our economic policy-making environment can usefully be characterised as having shifted from one appropriate to a state on the periphery of Europe to that of a region fully integrated into an encompassing European economy. The culmination of this transition was the extraordinary high growth and development of the past few years that has brought our standard of living within striking distance of the EU average. The advent of EMU was merely the most recent in a long line of policy developments that guided this process of economic regionalisation. Second, I suggest how the future tensions between the centripetal forces of globalisation and the centrifugal forces of regionalisation will shape and determine Ireland’s future policy options and choices.

2. FROM STATE TO REGION: THE IRISH POLICY EXPERIENCE

The lowering and eventual removal of tariff barriers was a necessary policy change if the Irish economy was to be reoriented away from import substitution and towards export led growth. Since the Society has always had strong links with Northern Ireland, I might mention that a little known aspect of preparing the economy for outward orientation and the rigors of competition was that the tariffs first came down unilaterally for imports from Northern Ireland just prior to the implementation of the

Anglo-Irish Free Trade Agreement in 1965 (Kennedy, 1997). This initiative of the then Taoiseach, Seán Lemass, with the North gave the South the first opportunity of “*testing the water*” of outward orientation while satisfying other political objectives.

The policy switch to a zero rate of corporate profits tax on exports (replaced later by the low rate of 10 percent on manufacturing profits) was a more dramatic and unexpected exercise of policy autonomy. The steady adherence to a policy of low corporate taxes, combined with aggressive and sophisticated initiatives designed to attract and aid inward investors, provided the anchor to the last four decades of policy making. A consequence was that rates of personal taxation and indirect tax rates remained high and have only recently started to fall.

However, the mere absence of tariffs in association with an attractive corporate tax regime would not in themselves have initiated Ireland’s success as a host for the foreign direct investment that has contributed so much to our recent economic successes. A detailed discussion of the reasons for the strong performance in the last decade would require a separate paper, but for fuller treatments of the recent Irish growth experience, see Barry (1999); Sweeney (1998) and Bradley *et al.*, (1997). Research has identified the many elements that have interacted in creating a virtuous circle of superior performance that replaced the previous vicious circle of under performance identified by Mjoset (1992) in his seminal report for the National Economic and Social Council (NESC). But if forced to do so, I would single out one aspect as being the most important.

The strategic orientation of Irish economic policy making over the past four decades has, with few exceptions, always emphasised the need to face the consequences of the extreme openness of the economy, to encourage export orientation towards fast growing markets and products, and to align the economy with all major European initiatives (such as EMS, the Single Market, the Social Chapter of the Maastricht Treaty, and most recently, EMU). Perhaps this is our major legacy from the policy-makers of the time of *Economic Development*. One might say that the enthusiastic embrace of openness provides the strategic context for economic management.

However, while openness to the full rigors of competition in the international marketplace may be a necessary condition for economic success, it is by no means sufficient. Four broad domestic policy strategies accompanied the external orientation of the economy:

1. The pursuit of policies designed to bring about a steady build-up of the quality and quantity of education and training of the workforce. In the Irish case, this was initiated by the farseeing educational reports and reforms from the 1960s, such as Professor Lynch’s seminal *Investment in Education* of 1966; it was continued more recently by the emphasis given to training and human capital in the allocation of EU Structural Funds from the late 1980s; and although issues of inequality are still of concern, the level of educational attainment in Ireland is

higher than in some other wealthier European states (Breen, Heath and Whelan, 1999).

2. The major improvements in the quality of the economy's physical infrastructure. Perhaps only since the advent of the *Community Support Framework* were successive governments enabled to plan this process in a way that partially decoupled the public capital programme from the vagaries of the annual budgetary process.
3. The facilitation of the growth of a competitive Irish business sector through improved management, quality marketing, better services, lower costs of utilities, and more systematic linkages with other complementary activities (or clustering).
4. The provision by government of a stable domestic macroeconomic policy environment, where 'stop-go' budgetary changes did not disrupt business planning. In the perspective of the past 40 years, here is where we were least successful, at least until the last decade.

Only in the late 1980s was a strategic framework developed within which the above sources of national competitive advantage could be placed (Porter 1990). In Figure 1 we show the so-called Porter diamond. However, Porter's thinking on competitive advantage has advanced since then and we return to the matter briefly at the end.

In connection with the fourth point above – the stability of the domestic macroeconomic environment, which is the aspect of policy normally thought of as economic management - the latter half of the 1970s was the last comparable period of high growth in Ireland. However the growth in that earlier period was unsustainable, driven as it was by massive increases in public expenditure and cuts in tax rates with a consequential destabilising of the public finances. The imbalances that accompanied the growth of the period 1976-81 are quite striking when compared with the balanced nature of the growth performance since the mid-1980s (see Figure 2).

The two 'diamond diagrams' in Figure 2 juxtapose four key macroeconomic indicators in two different periods of high growth: 1976-81 and 1987-96. Along the vertical axis the diagrams show annual averages of real GNP growth and the balance of payments on current account (BoP) as a percentage of nominal GNP. Inflation (growth in the deflator of personal consumption) and the exchequer borrowing requirement (EBR) expressed as a percentage of nominal GNP are measured along the horizontal axis. The diagrams for both periods 1976-81 and 1987-96 are set to exactly the same scale to ease comparison.

Figure 1 Sources of Locational Competitive Advantage (Porter, 1998).

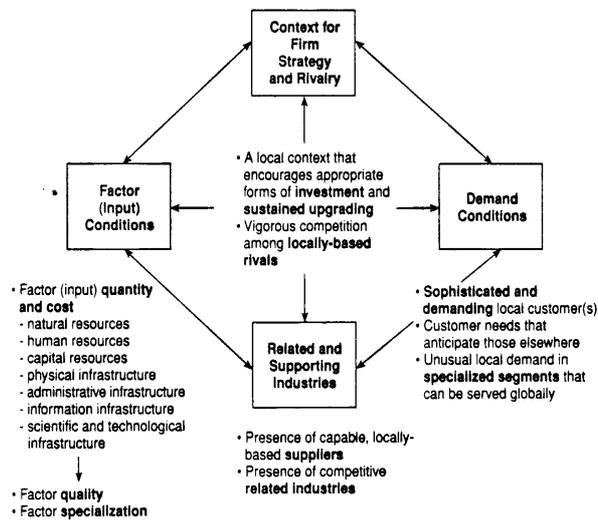
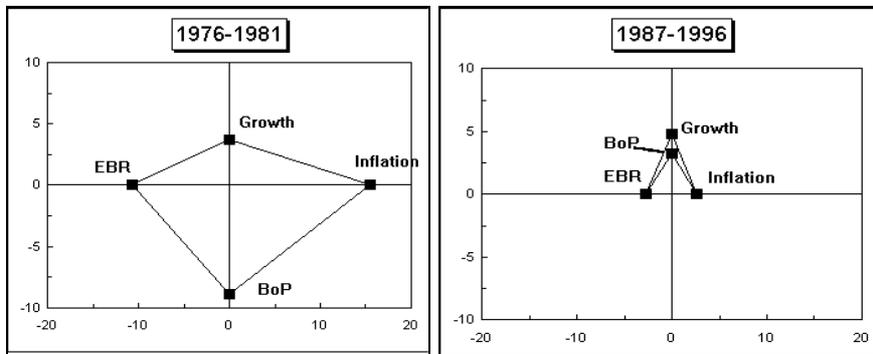


Figure 2 Growth (%), Inflation (%), EBR and BoP (as share of GNP)
 (a) 1976-1981 and (b) 1987-1996



In a stable macroeconomic environment, the BoP, EBR and inflation will tend to cluster around the central point at zero in the diagram where the two axes intersect. The more stable the macroeconomic environment, the closer the economy is to internal and external balance, i.e., with the EBR and the BoP indicators close to zero and with low inflation.

What Figure 2 highlights is the contrast between the two periods in terms that have consequences for the sustainability of growth. In a context of strong average annual growth in both periods (3.7 percent average annual growth in 1976-81 compared with 4.8 percent in 1987-96), the three other macroeconomic indicators - inflation, EBR and BoP - were unsustainable in the earlier period, with a combination of high internal and external deficits and high inflation that shows up as the enlarged diamond shape of the 1976-81 diagram. By contrast, during the past decade the diamond has shrunk: GNP growth has occurred in conjunction with low inflation and with internal and external balance.

Although Figure 2 proves nothing, it strongly suggests that stable growth and development occurs if economic management is prudent and recognises the consequences of policy actions that are inappropriate for an economy as small and as open as Ireland. The fact that the external world environment was more turbulent during the period 1976-81 (with the OPEC I and II oil price shocks and their consequences) than was the environment more recently, does not take from this point. Far from stabilising the economy, the fiscal actions of 1977-81 were procyclical and left the economy in a very vulnerable position as it faced into the 1980s (Bradley *et al.*, 1985).

I suggested earlier that our economic policy-making environment can be characterised as having shifted from one appropriate to a state on the periphery of Europe to that of an region fully integrated into an encompassing European economy. Regions have less policy autonomy than states. For example, fiscal and monetary policy in Scotland is identical to that of the UK as a whole. The recent referendum on devolution introduced the possibility of a modest degree of freedom to vary rates of income tax, but little else has changed. In Ireland, on the other hand, we have progressively ceded our fiscal and monetary autonomy to Brussels. Our willingness to go down this road was perhaps conditioned by the policy failures of the late 1970s and the early 1980s which tended to be made in the area of demand management. Nobody believes any longer that impacts emanating from discretionary demand management and "fine tuning" policies provide useful support for success in the long run. Nor does anyone believe that demand management or monetary policy would be sufficient to shield the Irish economy from a global recession.

Perhaps the basic difference between Ireland and, say, Scotland is that we are discarding those areas of economic management which we believe are best handled within larger blocks, like the EU, and refining those remaining policies that address the specific local efficiency of the supply side of the economy (education, training, competitiveness), as well as issues related to equity in the context of social partnership. Such policies will always retain essentially local characteristics.

A recent report of the *Northern Ireland Economic Council* (NIEC) examined the political and economic governance of four European regions of broadly comparable

size to Ireland: Jutland, Rhone-Alpes, Saarland and Abruzzo (NIEC, 1996). It concluded that the most active regional governments are to be found in the most economically successful regions, and that their ability to exercise a high degree of pro-activity is predicated upon their location within national states characterised by decentralised systems of governance. Successful regions tend to be characterised by distinctive forms of local regulation and governance. Successful regions also have systems of governance which embrace enabling and facilitating institutions within the local state and civil society, as well as bridging the permeable boundaries between them and adjoining regions and states. Part of the problem of less successful regions (such as Northern Ireland, the North of England, and the Saarland) is that they are locked into institutional structures that were relevant to an earlier phase of successful economic development but which now constitute a barrier to moving onto a new development trajectory.

What is revealing in EU regional comparisons is that inter-regional co-operation does not necessarily require complete, or even extensive, harmonisation of economic policies. Rather, it thrives where policy differences are fully understood and are made more transparent against the background of removal of non-tariff barriers to trade through the implementation of the Single Market. Perhaps it is Ireland's misfortune that such a large element of its success is based on a deviation from the EU norm of corporate taxation that is proving too much for our partners to stomach!

3. ECONOMIC MANAGEMENT IN A WORLD OF REGIONS

In his recent perceptive essay on Ireland's growth, Paul Krugman suggested that economies can be viewed in two different ways: as a national economy or as a regional economy (Krugman, 1997). The facts that one is examining may be the same, but the national or regional perspectives will make a big difference to what one believes is important. Regionality involves more than small size and dependence on trade. Krugman suggests that what makes Ireland like, say, Massachusetts, is that its labour market as well as its product and capital markets are very open. Here, it is in sharp contrast to other small EU and CEE states.

It is when he turns to examining the self-reinforcing nature of Irish success that Krugman comes close to the issues that will be central to Irish economic management in the next decade. Krugman suggests that the Irish experience is a working out of classic Marshallian externalities:

- An initial clustering of similar industries (mainly foreign owned and in the areas of computer equipment and pharmaceuticals) supported by local suppliers of specialised inputs subject to economies of scale.
- These clusters generated a local labour market for skilled workers which further facilitated the growth of the cluster.

- Spillovers of information further encouraged growth in the electronics and pharmaceutical sectors and provided the basis for additional clustering effects, often in traditional areas that benefited from new technologies (e.g., food processing).
- A consensual process of social partnership was put in place to ensure that there were as few losers as possible in the economic restructuring that accompanied such a virtuous circle, with the result that growth was less likely to be choked off by industrial unrest as the social partners negotiated over their respective shares of added value.

However, Krugman draws attention to some of the risks to which Ireland is exposed. First, the dynamic foreign manufacturing base is concentrated on a narrow range of technologies that are fast moving towards maturity. Second, the policy initiatives that ensured an advantageous ‘first mover’ status in the early 1960s may not be sufficient to facilitate the inevitable switches to newer technologies since other countries and regions have been learning by watching Ireland doing! Krugman’s third risk (he suggests that Ireland may be caught between a low wage low unemployment UK economy and the high wage high unemployment continental economies), might arise if EU policy makers required us to tax capital at a higher rate. However, we appear to have won some breathing space that may permit a consolidation of our success.

Following on from Krugman’s analysis, Michael Porter in his most recent work has returned to the sources of national and regional competitive advantage and has placed more stress on the role of governments (Porter, 1998). What is not always fully appreciated is that Porter’s methodology of competitiveness analysis approaches national issues by a systematic integration of previous disaggregated analysis at the level of the individual firm and sector. In the future our policy makers are going to have to think increasingly in this way rather than in aggregate macroeconomic terms. Thus, Porter identifies the roles that governments play in economic management as follows:

1. A basic requirement to achieve macroeconomic and political stability;
2. A role in improving the general microeconomic capacity of the economy by improving the efficiency and quality of the inputs to business identified in the diamond in Figure 1;
3. To establish the overall microeconomic rules and incentives governing competition that will encourage productivity growth;
4. To facilitate cluster development and upgrading in order to move beyond factor

cost competition. In the Irish case, cluster development was seeded and reinforced by foreign direct investment, mainly by an industrial policy that distorted competition in our favour. However, future clustering will need to focus on removing constraints to productivity growth in a far wider range of indigenous industries;

5. Finally, governments need to develop and implement long-term programmes of change and renewal which mobilise government agencies, business, institutions, and citizens to upgrade both the general business environment and the array of local clusters.

So, when I reflect on the future of economic management in a post-EMU Ireland, these are the roles I look to government to facilitate and perform. I sleep soundly at night in the knowledge that the rules of monetary policy, as well as the responsibilities for defending the euro against speculative attack, are decided in Frankfurt in the context of the EU as a whole, and that our task in Ireland is to embrace with enthusiasm whatever the outcome happens to be. I am further reassured that the managers of the Irish public finances have Brussels bureaucrats looking over their shoulders, and I await with a curious interest the time when the Irish economy has to ride out a global recession with little or no discretionary macro-policy power. Within such a policy framework, I look forward to the challenge of how the performance of the economy will be guided by policies that are aimed primarily at efficiency targets in production and equity targets for society at large. In a word, I am content to be a citizen of a region-state of the European Union.

References

Barry, F. (ed.), 1999. *Understanding Irish Growth*, London: Macmillan..

Bradley, J., C. Fanning, C. Prendergast and M. Wynne, 1985. *Medium-Term Analysis of Fiscal Policy in Ireland : A Macroeconomic Study of the Period 1967-1980*, Research Paper No. 122, Dublin: The Economic and Social Research Institute.

Bradley, J., J. Fitz Gerald, P. Honohan and I. Kearney, 1997. "Interpreting the Recent Irish Growth Experience", in D. Duffy, J. Fitz Gerald, I. Kearney and F. Shortall (eds.) *Medium Term Review: 1997-2003*, Dublin: The Economic and Social Research Institute.

Breen, R., A. Heath and C. Whelan, 1999. "Educational Inequality in Ireland, North and South", in A. Heath *et al.* (eds), *Ireland North and South: Perspectives from Social Science*, Oxford: Oxford University Press.

Economic Development, 1958. *Economic Development*, Pr 4803, Dublin: The Stationery Office.

Grove, A., 1997. *Only the Paranoid Survive*, London: Harper Collins.

Kennedy, M., 1997. “Towards Co-operation: Sean Lemass and North-South Economic Relations: 1956-65”, *Irish Economic and Social History*, Vol. XXIV, pp. 42-61.

Krugman, P., 1997. “Good News from Ireland: A Geographical Perspective”, in A. Gray (ed.), *International Perspectives on the Irish Economy*, Dublin: Indecon Economic Consultants.

McCarthy, C., 1979. “The European Monetary System and Irish Macroeconomic Policy”, *Central Bank of Ireland Annual Report*.

Mjoset, L., 1992. *The Irish Economy in a Comparative Institutional Perspective*, Report No. 93, Dublin: National Economic and Social Council.

NIEC, 1996., *Successful European Regions: Northern Ireland Learning from Others*, Research Monograph No. 3, Belfast: Northern Ireland Economic Council.

Porter, M. 1990., *The Competitive Advantage of Nations*, London: Macmillan Press.

Porter, M. 1998., *On Competition*, Massachusetts: HBR Press.

Sweeney, P., 1998. *The Celtic Tiger: Ireland's Economic Miracle Explained*, Dublin: Oak Tree Press.