CENTRAL BANK &
FINANCIAL SERVICES
AUTHORITY OF IRELAND

# Real Convergence within the European Union: The Case of Ireland

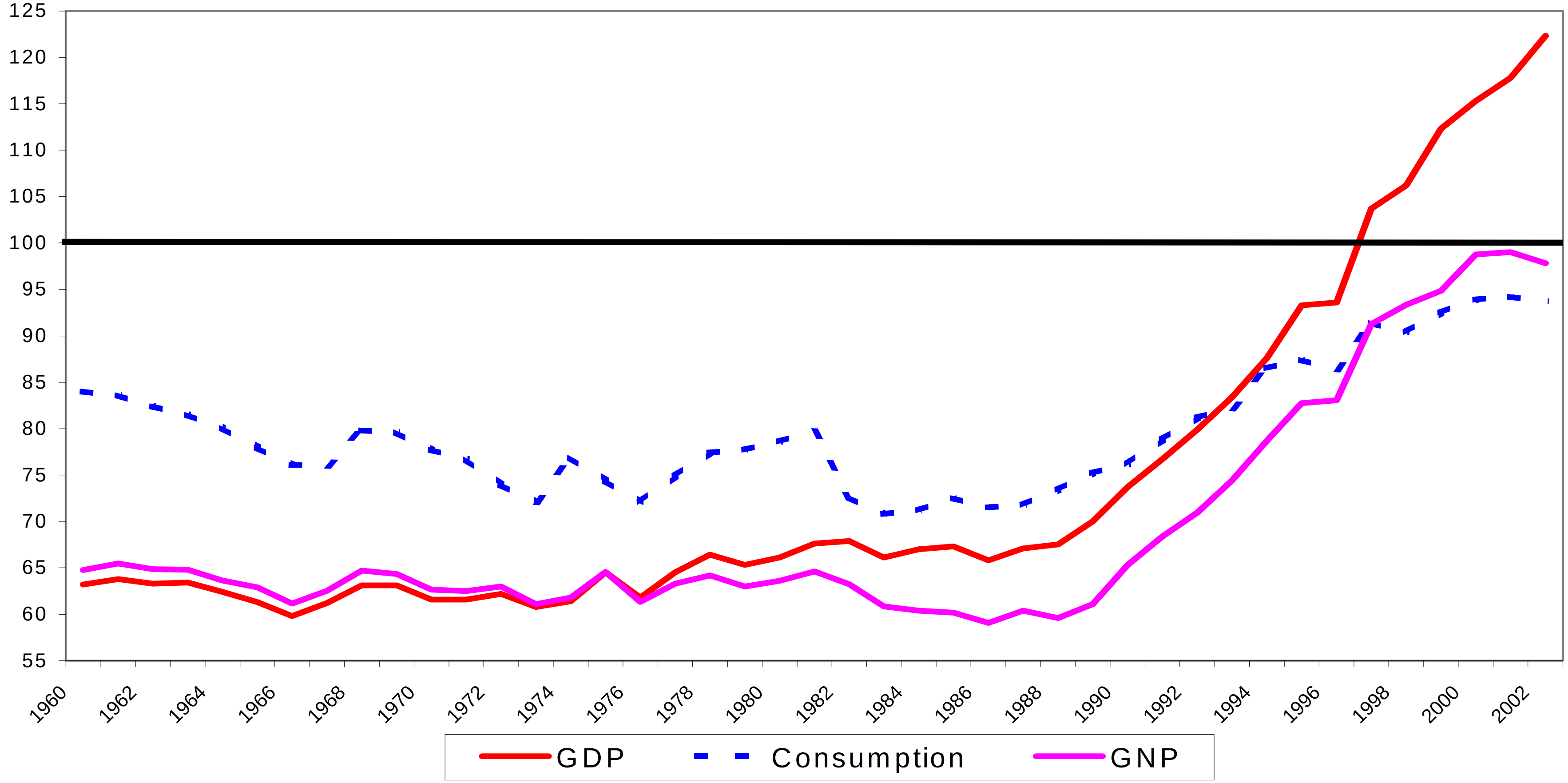
Thomas O'Connell

# Outline

- Introduction
- Background
- Macroeconomic Activism, 1973-1986
- Fiscal Stabilisation and Growth
- Increasing Real and Monetary Integration in Europe
- Achieving Real Convergence
- Current Issues
- Conclusion

# Introduction

**Figure : GDP, GNP and Private Final Consumption per head, PPS, EU 15 = 100**



# Background

**Ireland's close economic ties with the UK**

- Ireland an economic region of the UK with full monetary union
- Mundell's Optimum Currency Area criteria
  - Close Trade Ties
  - Common Labour Market
  - Financial Market Linkages
- Even in 1972, the year before Ireland joined the EEC, 61 per cent of exports went to the UK

# Background

- Ireland pursued protectionist policies until the 1950s
- Overly dependent on the UK and Agriculture
- Progressive opening up to trade and investment from the late 1950s
- Ireland joined the EEC in 1973
- Export-led strategy pursued
- High and volatile inflation in the 1970s – link to sterling increasingly questioned
- Ireland joins EMS in 1978

## Macroeconomic Activism, 1973-1986

- Expansionary fiscal policy in the 1970s to attain full employment and to offset adverse oil price effects
- Mounting fiscal imbalances and a crisis of confidence in the 1980s
- Real exchange rate appreciation, high real interest rates, major deterioration in labour market incentives (tax-benefit system)
- Undisciplined polices resulted in anaemic growth, high unemployment and mass emigration

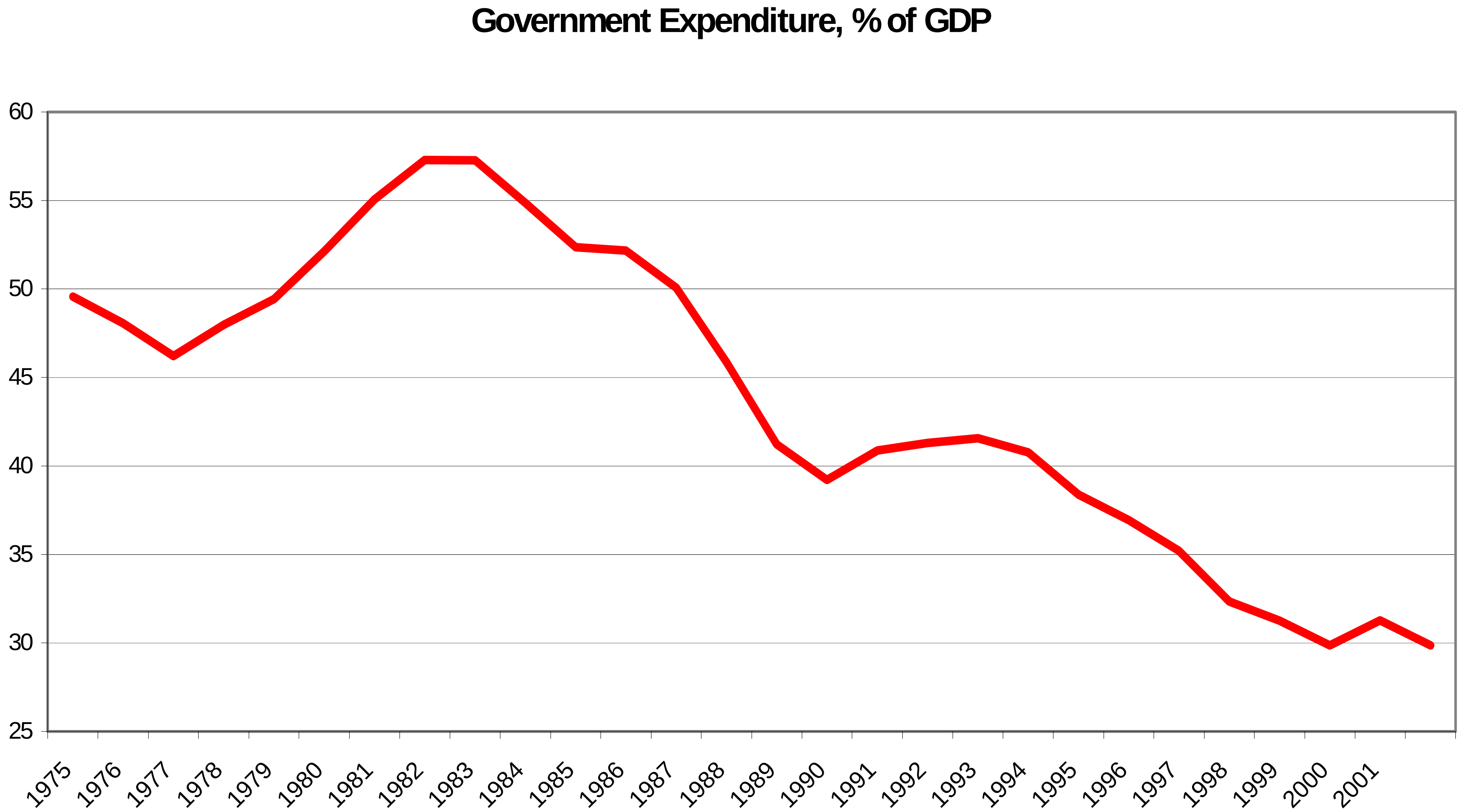
# Monetary and Exchange Rate Aspects, 1979-1987

- EMS – nominal anchor
- (High-powered) Monetary financing of Government borrowing
- Money market disequilibrium – exchange market pressure

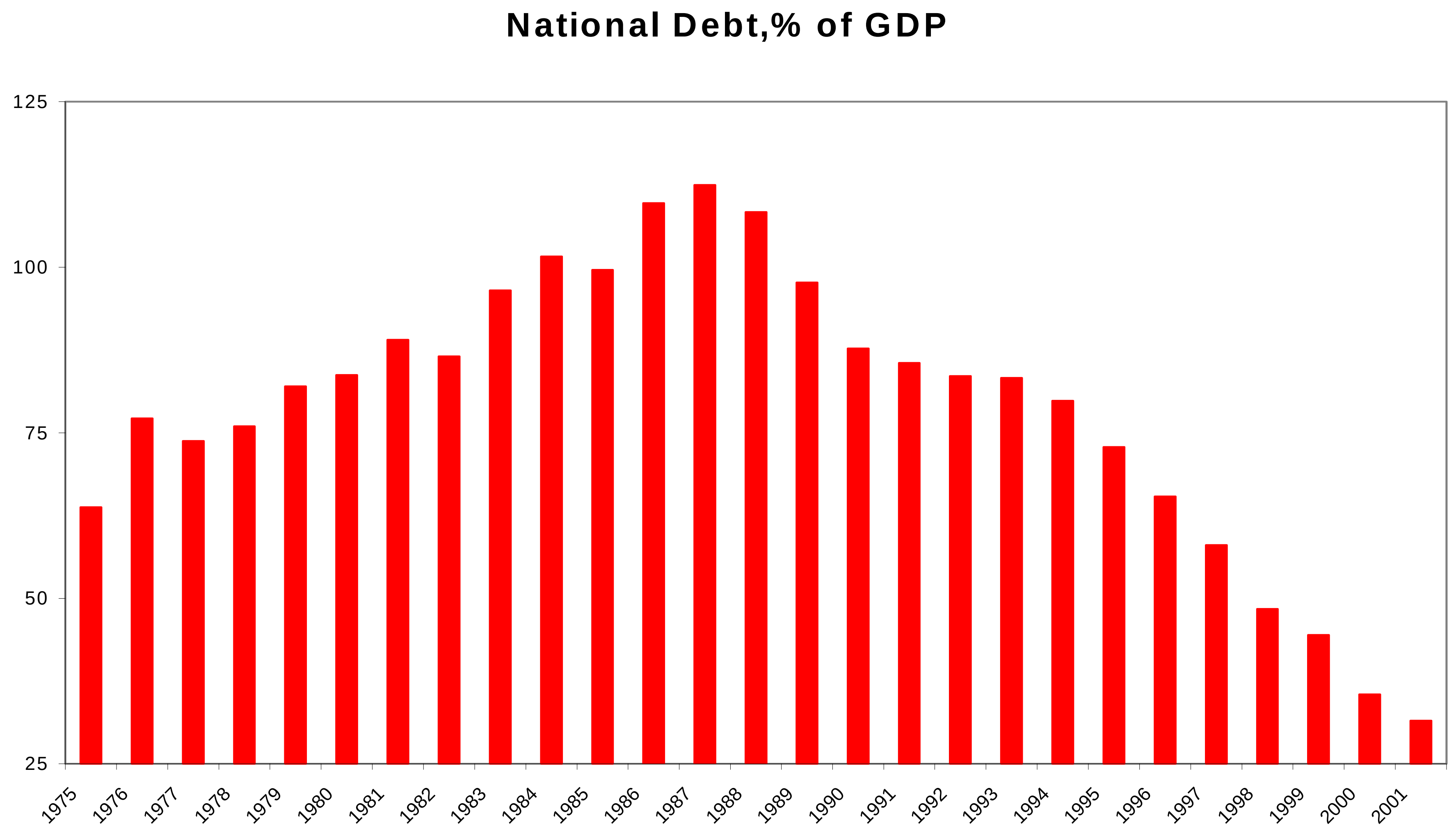
Consequence:

  – Strong rise in public (foreign) debt
  – Dissipation of foreign borrowing in foreign exchange intervention

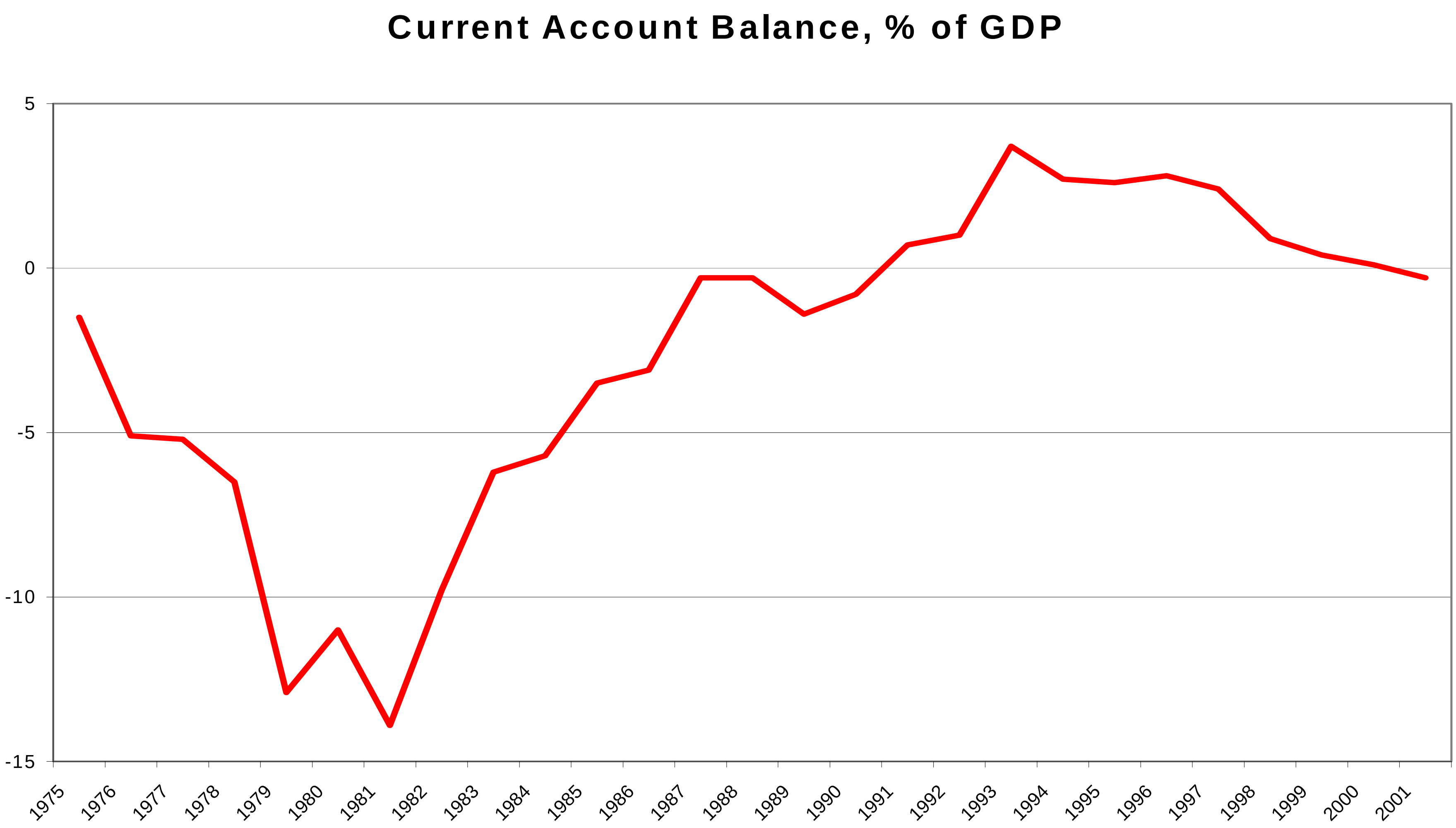
# Macroeconomic Activism, 1973-1986



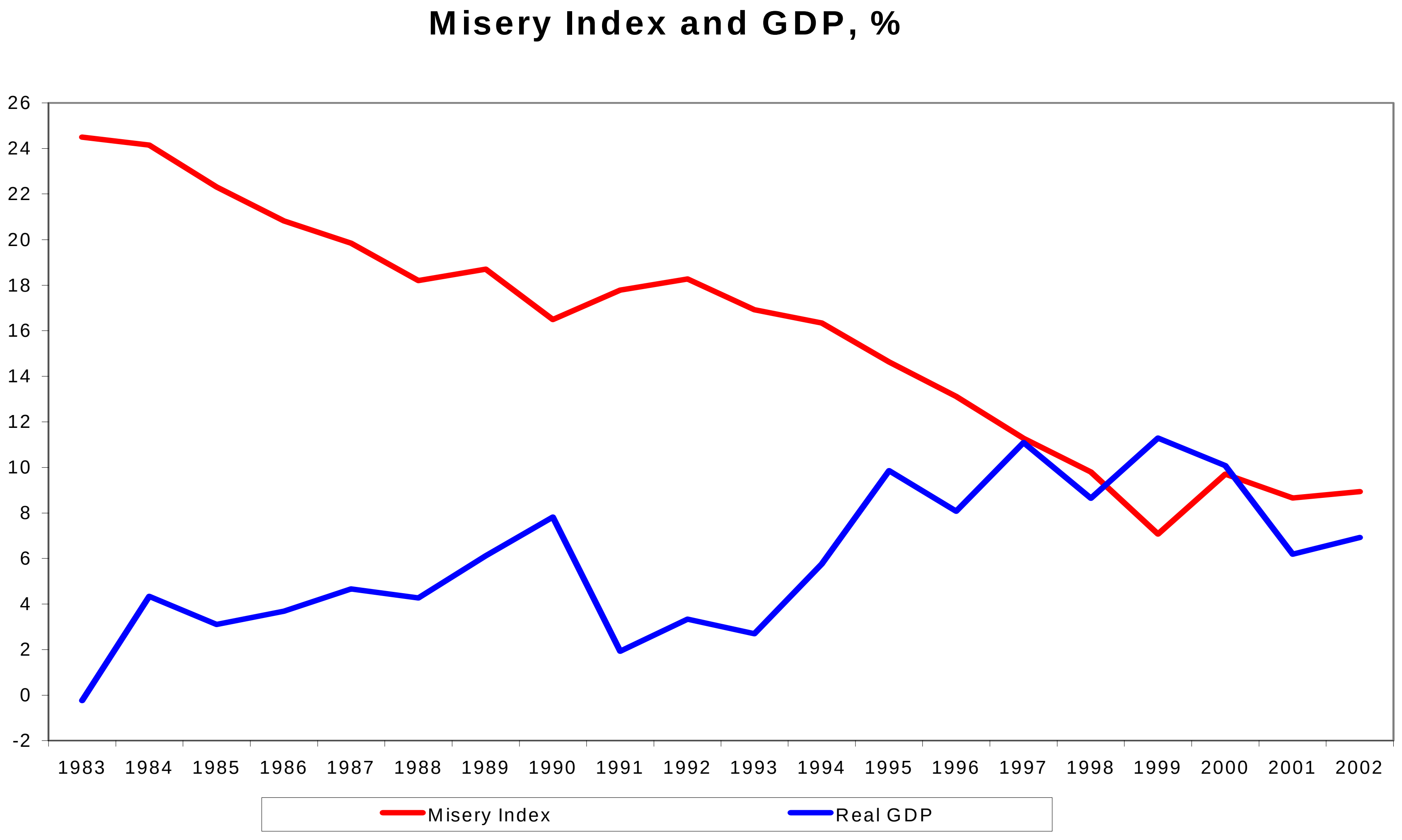
# Macroeconomic Activism, 1973-1986



# Macroeconomic Activism, 1973-1986



# Macroeconomic Activism, 1973-1986



# Fiscal Stabilisation and Growth, 1987 onwards

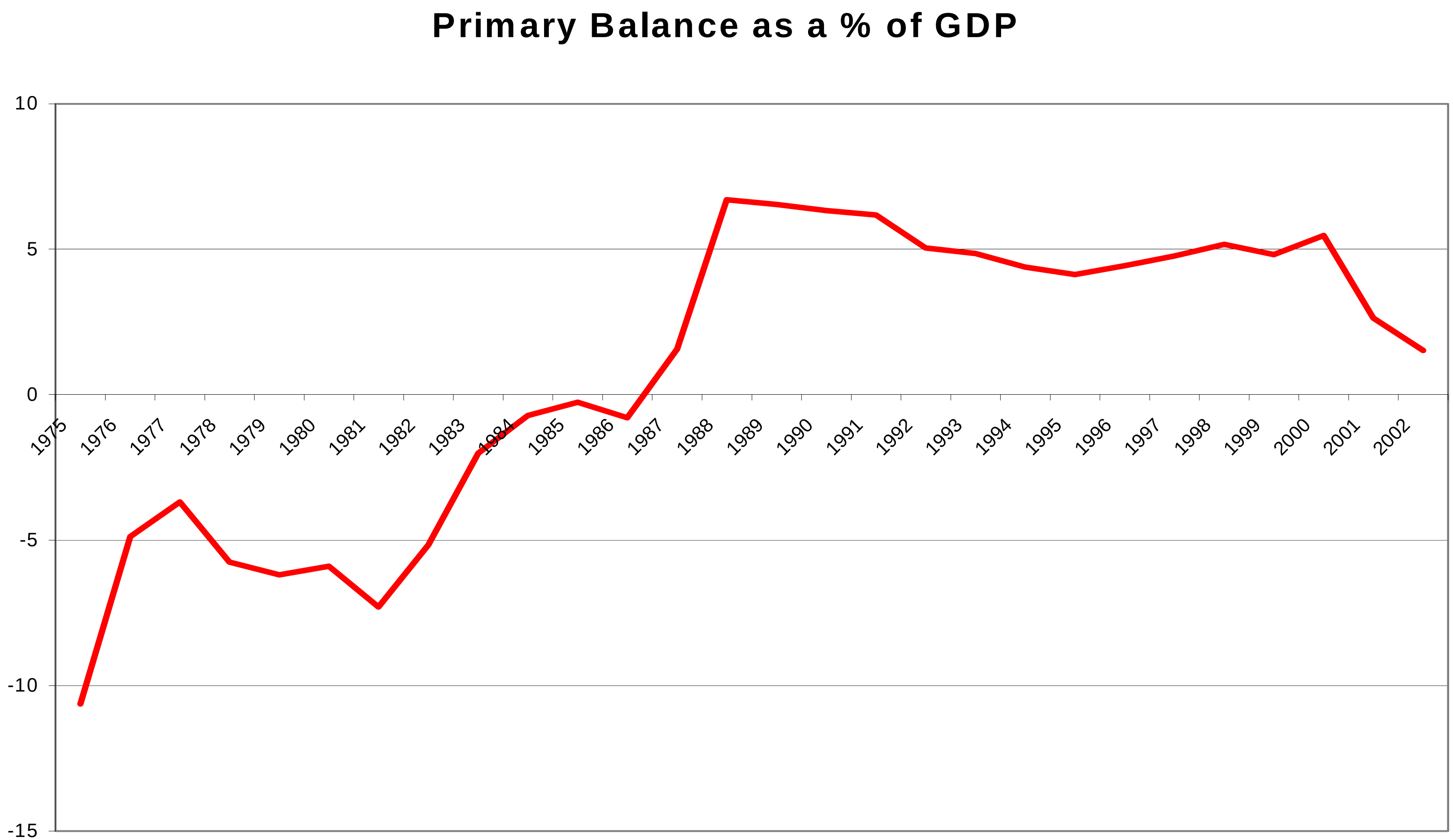
- Radical re-orientation of policy – 3 elements

  I. Substantial cuts in nominal public spending
  II. Tri-parite wage agreement: low nominal pay increases in return for reduced labour taxes
  III. Devaluation of 8 per cent within the EMS

- Improving External Conditions
  - Lower world interest rates
  - Pick up in international growth

- Economic Growth of 9 per cent per annum, from 1994 to 2000

# Fiscal Stabilisation and Growth, 1987 onwards



# Increasing real and monetary integration in Europe

- Little progress on real convergence through the 1970s and 1980s
- Further moves towards fully integrated markets, EMU - fears that Ireland could lose out
- Ireland’s indigenous manufacturing sector had declined, characterised by underdeveloped, inefficient and small scale producers

# Increasing real and monetary integration in Europe

**Risks**

- “Centripetal” Vs “Centrifugal” forces / Core-periphery argument
- Krugman-Venables (1990) economic geography issues
- Ireland had a higher weight of ‘constant returns to scale’

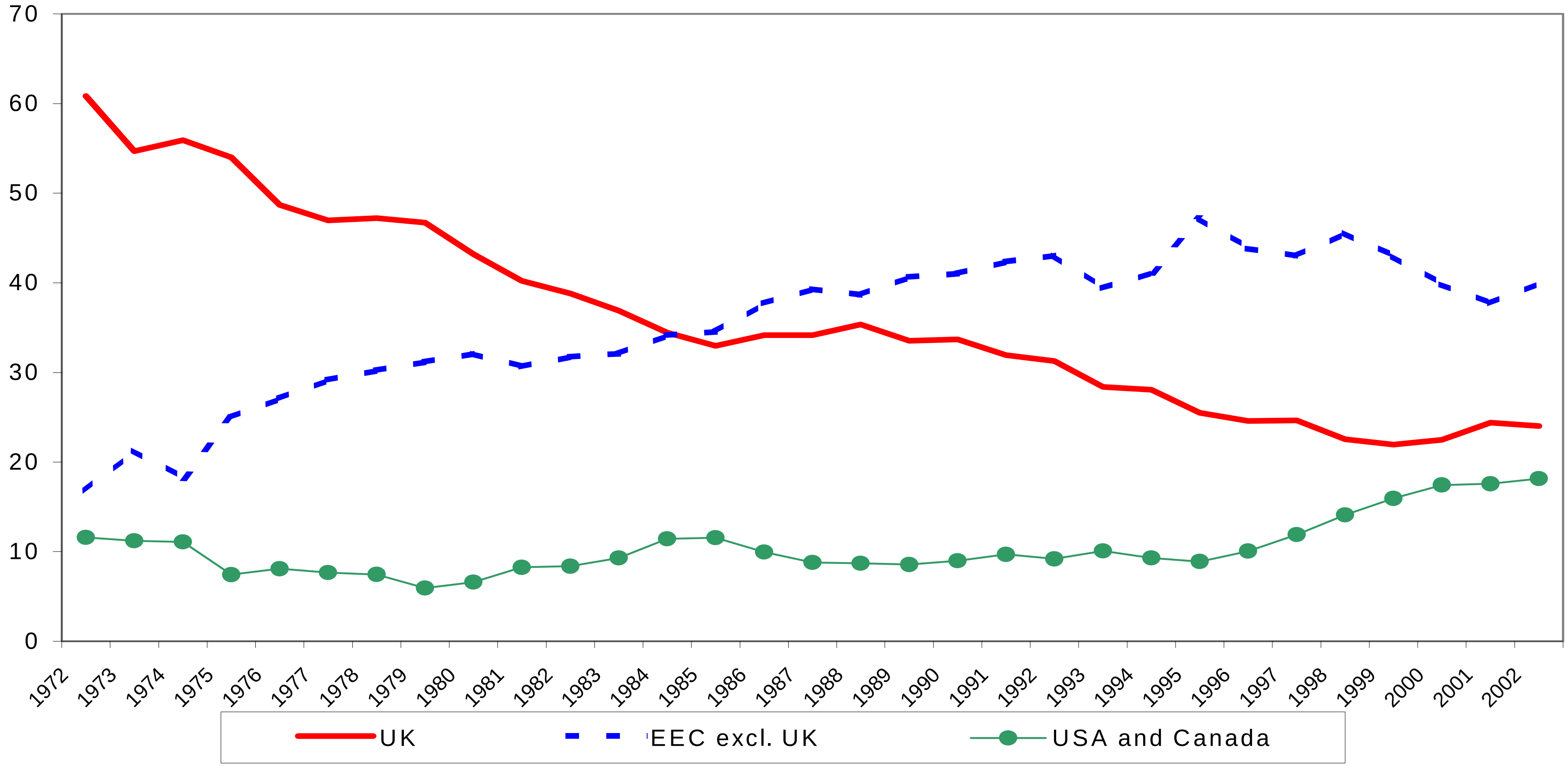
  sectors – limited number of ‘increasing returns to scale’ sectors

# Increasing real and monetary integration in Europe

- A number of factors helped economy to recover:
  - I. Increasing foreign direct investment
  - II. Falling transport costs (Cohesion funds)
  - III. Changing nature of trade
- Developing comparative advantage in human capital intensive sectors
  - Computing and IT
  - Chemicals and Pharmaceuticals

# Increasing real and monetary integration in Europe

**Figure: Irish Export Market Shares, %**

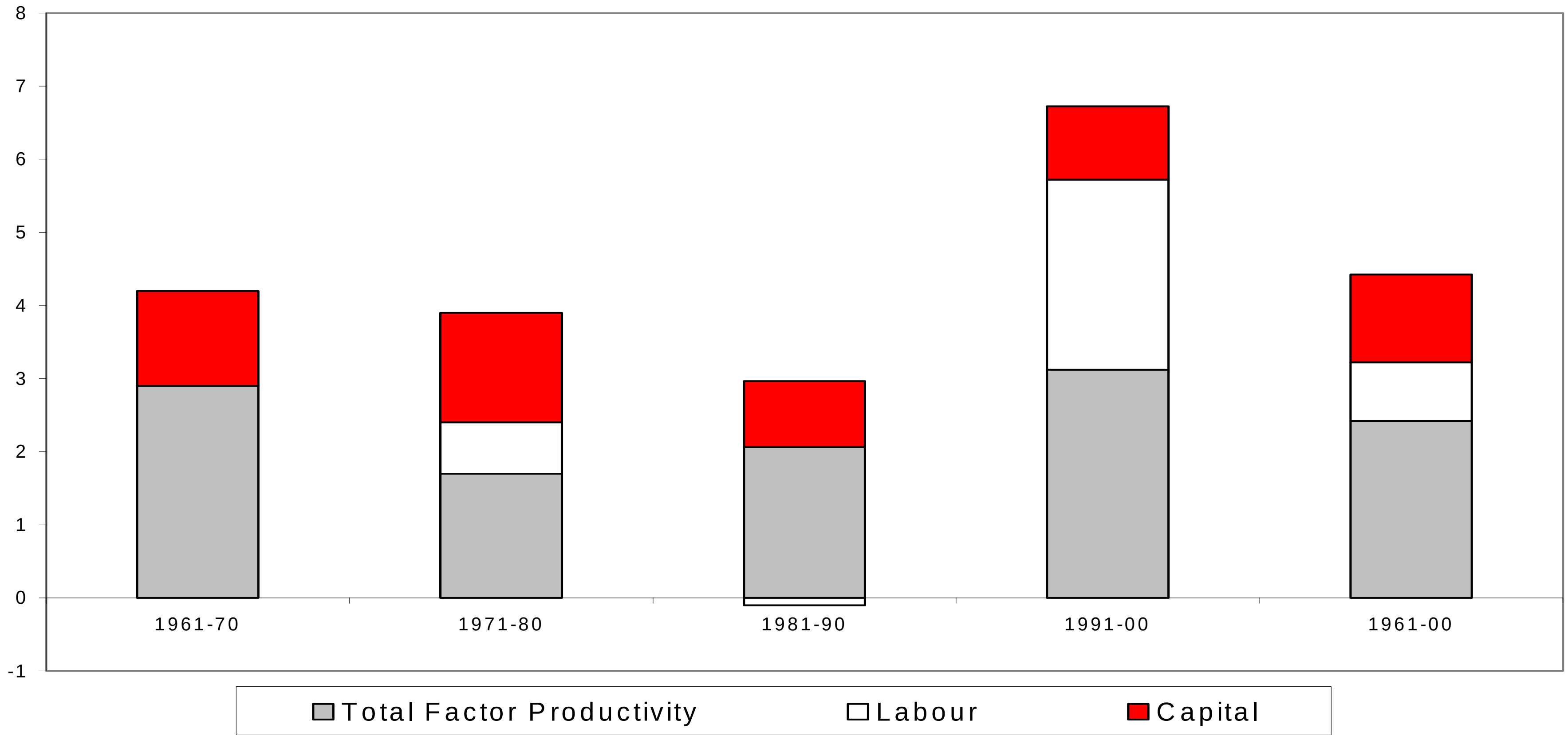


# Achieving Real Convergence

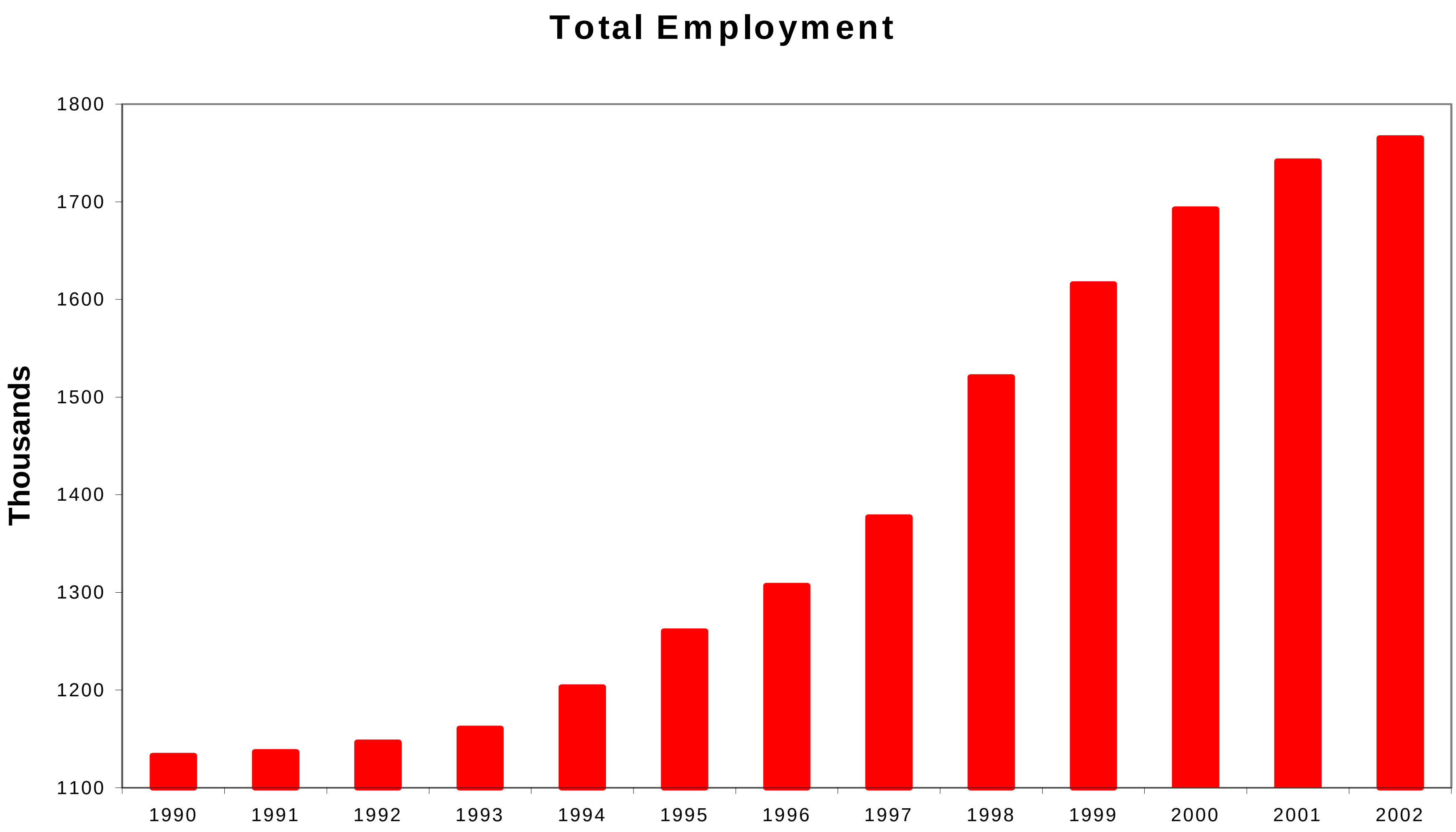
- Re-orientation of macroeconomic policy from 1987
- Improving international environment in the late 1980s and the ‘new economy’ in the US in the 1990s
- Maastricht Treaty – nominal convergence criteria
- Structural reform
  - incomes taxes reduced
  - increasing deregulation
- Foreign direct investment inflows
- Increasing supply of highly educated labour

# Achieving Real Convergence

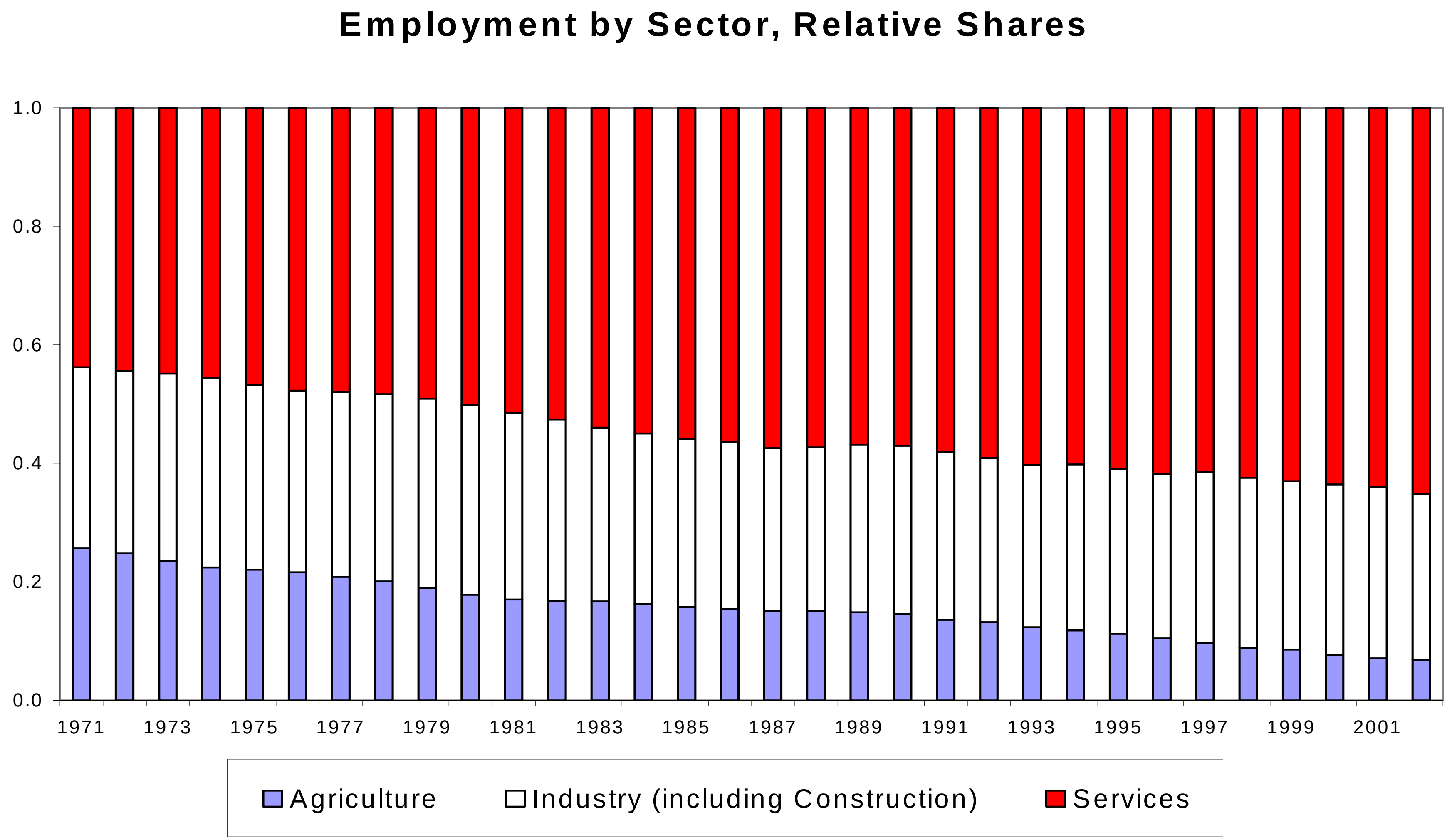
**Figure : Contributions to Output Growth (GNP), %**



# Achieving Real Convergence

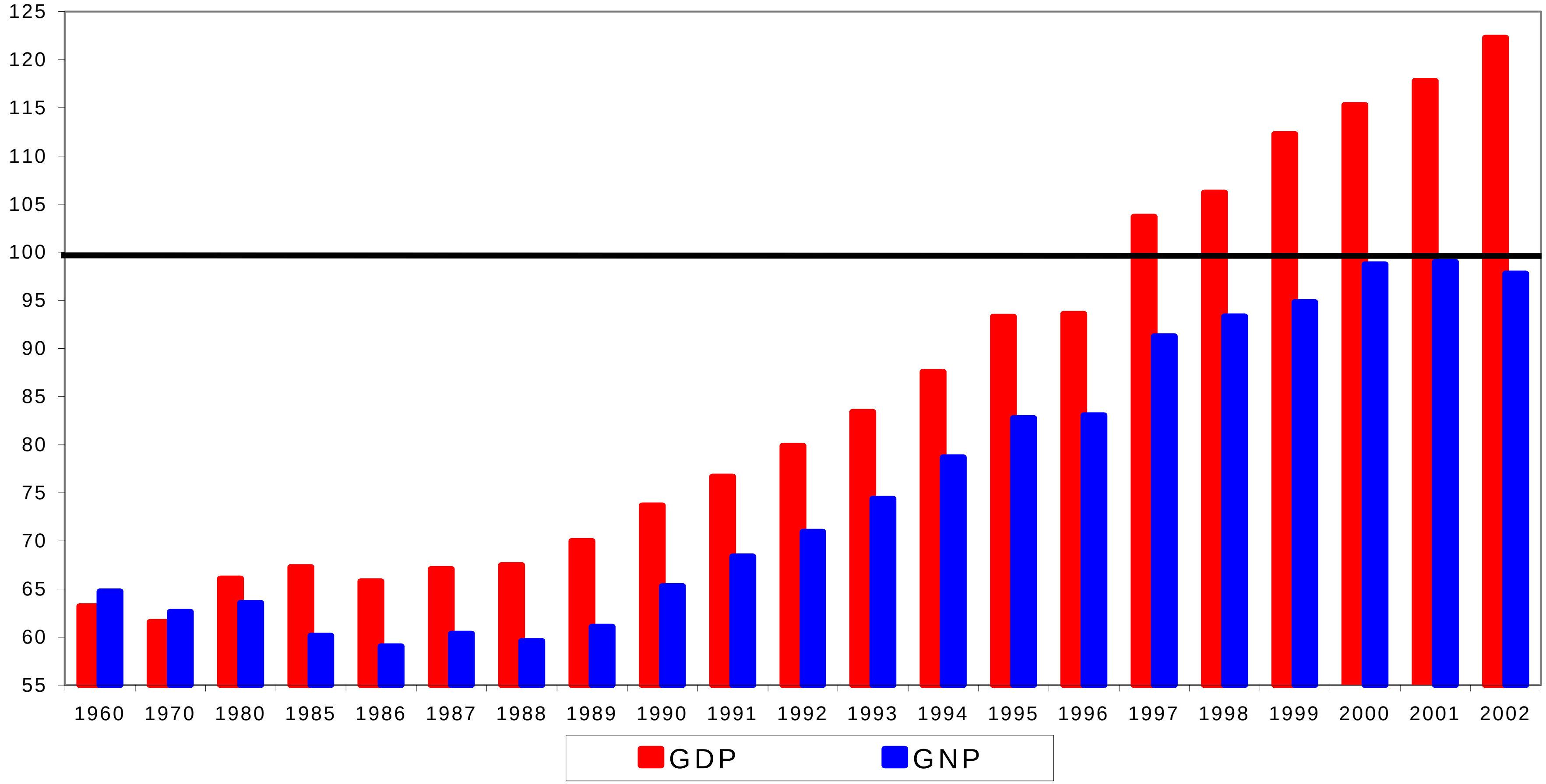


# Achieving Real Convergence



# Achieving Real Convergence

**Figure : GDP and GNP per head, PPS, EU 15 = 100**



# Current Issues

- Marked slowdown in growth in tandem with the international downturn
- The labour market has remained remarkably resilient
- Infrastructural deficit – capacity constraints
- Monetary conditions have been too accommodative
- Property market – is there a bubble?
- Inflation highest in eurozone but now falling

## Conclusion

- Ireland slow to open up the economy, and to invest in human capital – delayed convergence
- Progressive opening up of the economy to trade and investment since the late 1950s
- Major macro and micro policy errors of the 1970s/1980s delayed convergence
- Rapid catch up over the course of the last decade or so
- Multi-faceted explanation for convergence – importance of macro stability, structural reform and foreign direct investment

Thank you