RESPONSE TO POLICY DISCUSSION FORUM 2:

WHAT HAVE WE LEARNT FROM THE "CELTIC TIGER" PHASE OF IRISH ECONOMIC DEVELOPMENT

THE CELTIC TIGER ERA: DELAYED CONVERGENCE OR REGIONAL BOOM?

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1. Introduction

Cormac Ó Gráda, in his recent paper in the *Quarterly Economic Commentary*, sets out to debunk some myths about the performance of the Irish economy over the Celtic Tiger era. While he is on target with respect to the individual myths, his paper, like almost everything else written on the topic, unconsciously straddles two alternative perspectives on the spectacular growth of the last decade.[1] Ó Gráda's main argument is that this growth represented delayed convergence; it simply made up for several decades of Irish underperformance. This notion also underpins the analysis of Patrick Honohan and Brendan Walsh in their forthcoming article in *Brooking Papers on Economic Activity*. The alternative hypothesis, proposed by Krugman (1997), holds that the period of extraordinary growth should be more appropriately thought of as a regional boom.

My purpose in this note is to try to disentangle these alternative perspectives, primarily in an attempt to separate out their implications for the future. While Ó Gráda criticises the regional-boom perspective behind my 1999 work as over-optimistic, I will argue to the contrary that it is the delayed convergence hypothesis that is hubristic. It suggests that convergence once achieved cannot unwind as long as the same best-practice policies as adopted elsewhere are followed. Potential threats to the economic progress of the last decade loom larger in the alternative perspective.

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[1] I am as culpable as anyone else in this regard. My 1999 and 2002a and 2002b papers promote the regional-boom view, for example, while my 2000 paper toys with the notion of convergence.

2. The "Delayed Convergence" Hypothesis

There is a good deal of international evidence that income convergence occurs amongst economies that are similar in a number of crucial respects, including educational standards, access to technology, openness to trade and general macroeconomic stability. Thus OECD and EU countries have generally converged since the 1950s, with poorer countries growing faster than richer ones. The same has been found to be true of US states, Japanese prefectures and EU regions. Why might one expect this to be the case? The standard (Solow) economic growth model proposes that capital is scarcer and hence more productive in poorer economies. If the policy environment is appropriate so that investment rates are not depressed, investment will generate more rapid growth in poorer economies.

Ó Gráda shows that Ireland underperformed relative to other Western European countries in the convergence stakes up until the late 1980s, but that when economic performance over the Celtic Tiger era is factored in, growth per head over the entire period since 1950 was just as would have been predicted given the country's low starting level of income per capita. What needs to be explained in this view then is not the strong performance of the last decade but the very weak performance of earlier decades.

Ó Gráda and O'Rourke (1996) analyse this in detail. They find the main culprits to be the lingering effects of Ireland's failure to drop its trade-protectionist stance and increase educational throughput until about a decade after the rest of Western Europe. Most of the decade of the 1980s in turn was written off by the struggle to rein in the national debt and re-establish control over the government finances.[2]

To a macroeconomist this might all sound reasonable. To someone who works on international trade, however, the omission of any discussion of what precise goods an economy produces, or what precise markets the country exports into, might seem surprising. Surely these will affect the long-term income per capita of the economy? Surely Zambia's income per head today is affected by the fact that all its export earnings traditionally came from copper, and that world copper prices collapsed some time ago? How are these points taken into account in convergence theory?

The answer is that these are adjustment issues, and that for developed economies adjustment issues are typically resolved over years rather than decades. Given the quality of infrastructure, education, trade linkages, governance etc. in Zambia, it would take many decades for non-traditional export sectors to emerge. Hence something like a terms of trade collapse is not just a short-term issue. In developed economies, however, the collapse of any one sector or group of sectors is unlikely to be as catastrophic; not just because such economies will be more diversified to begin with, but also because industries are more mobile in the developed world. A collapse of a large sector in a developed country will trigger automatic adjustment; the downward pressure exerted on wages combined with an adequate pre-existing infrastructure and a pool of educated labour will attract firms and industries from elsewhere. Hence, the convergence hypothesis does not need to concern itself with such details as the precise basket of goods produced in the country. As educational levels are upgraded, for example, the quality of goods produced or of industries established in the region will

[2] This latter point is the main focus of the Honohan and Walsh paper cited above.

rise automatically and the country will "climb the ladder of comparative advantage".

The delayed convergence perspective suggests that simply getting the various policy dimensions right in the late 1980s allowed automatic convergence. The corollary is that such convergence could have been achieved in any earlier period if the policy environment had been similarly appropriate, as Honohan and Walsh argue. They do not address whether convergence would have been as rapid as was possible in the late 1980s/early 1990s, in my opinion, because of the ready availability of FDI. The logic of the standard growth/convergence model certainly does not require non-orthodox policies such as Ireland's very low rate of corporation tax. Indeed, Ó Gráda terms this a "distortion", writing that:

> *What emerged (in the 1960s) was hardly free trade. Instead Ireland shifted from one form of trade distortion to another: export-subsidising industrialisation (ESI) replaced import-substituting industrialisation (ISI). A trade sector bloated by FDI replaced one shrunk by ISI.* [3]

The most important implication of the "delayed convergence" hypothesis, however, is that the economic progress achieved thus far in bringing Irish income per head up to EU levels can be maintained into the future simply by following the same best-practice policies followed elsewhere in the EU.

3. The "Regional Boom" Hypothesis

A regional economy differs from a textbook "national economy" in that labour can flow more or less freely in and out of a region. This means that wages in the region are largely determined by rates available in the wider encompassing economy with which the region shares an open labour market. This seemingly innocuous distinction has major implications for how a region adjusts to shocks such as the terms of trade shock discussed above with respect to Zambia. If labour cannot flow out, wages will fall and new industries will ultimately arise.[4] If labour can flow freely, wages will not be much affected, and labour will flow out rather than new industries flow in.

Krugman (1997) proposed that we think of Ireland as such a regional economy, where job numbers are determined by labour demand, rather than, as in a more typical national economy, by labour supply creating new jobs via wage pressure. Until the Celtic Tiger era, labour demand had almost never been high enough to mop up Ireland's available labour supply and so emigration had resulted.

I will not repeat here Krugman's fascinating discussion of the range of factors that allowed labour demand in Ireland to grow so strongly from the late 1980s. His regional perspective, however, focuses attention on the economy's export base, as services employment – both public and private – arises largely to service that base. Although indigenous exports have been performing well over the Celtic Tiger era, the bulk of Ireland's exports arises from the foreign-owned sector. Why have we seen such buoyancy in the foreign-owned sector over the boom period? EU membership is crucial of course, as is the low rate of corporation tax. Both

[3] Barro (1991) finds that investment distortions, whether positive or negative, reduce growth.

[4] The extent to which wages will need to fall before new industries arise will be determined by the country's infrastructure, etc. This can obviously lead to huge problems in poor economies.

had been in place long before the boom however. The development of the Single Market in the late 1980s triggered a strong increase in FDI flows into and around Europe (Dunning, 1997a and b), and the long US boom ensured an abundance of finance for US outflows. Ireland would not have attracted as much of these flows as it did had the fiscal crisis not been resolved at the time, and had a new era of industrial peace not emerged. In the "regional boom" view, the most important impact of these factors in on the economy's export base.[5]

To oversimplify, let us view foreign-owned manufacturing as the Irish economy's export base. Now consider a crisis similar to the copper-price collapse discussed earlier. Specifically, let us say something happens that reduces Ireland's attractiveness to foreign industry dramatically. How does the economy adjust? In the textbook national economy new industry will ultimately migrate inwards or arise endogenously given an abundant supply of cheap educated labour. On the basis of long historical experience we would have to guess that the Irish adjustment mechanism would be different: emigration will instead be likely to resume, with the presumptive abundant supply of educated labour showing up in London or Boston rather than in Dublin, and wages failing to fall enough to stimulate new industry.[6]

The adjustment process works very differently in a regional economy than in a national one. A regional economy can grow more dramatically than a national one, with capital and labour inflows stimulating each other to generate "extensive growth" as well as the "intensive growth" in income-per-head terms which is the focus of convergence theory. The regional perspective is in fact quite similar to the model that Blanchard proposes in his comments on the Honohan and Walsh paper.[7]

The problem with regional economies is that, just as they can grow more dramatically than national ones, so also can they decline more precipitously, as Krugman (1993) has warned (in drawing lessons on EMU from the Massachusetts experience).

4. Contrasting the Two Perspectives

There are a number of outstanding issues upon which the delayed convergence hypothesis appears to stumble. One is why Ireland did not converge at all over the course of the 1960s (not to mention the fact that income per head relative to the UK stood at the same level in 1960 as it had in 1913). The conventional answer has to do with the delay in adopting free trade and raising the educational quality of the workforce. If

[5] This is not the whole story of course. Improved cost competitiveness will have a strong impact on services employment, given its labour intensity. These and other effects are drawn together in my 1999 paper.

[6] Ó Gráda, in earlier work, accepts this. Thus in (1997, page 217) he writes that easy access to the British labour market meant historically that "cheaper labour could do little to compensate for Ireland's relative backwardness and isolation, or to generate the investment necessary for faster economic growth".

[7] He proposes that Ireland has behaved more like the so-called AK endogenous growth model (where output moves in line with capital accumulation, because employment is also rising consistently) than like the Solow model of convergence theory (where growth is less dramatic because capital accumulation runs into diminishing returns). Small improvements in competitiveness can have large effects on growth in such a framework. Though Blanchard does not focus on any particular improvements in competitiveness in the Irish case, he does mention the shift towards the production of more capital intensive goods, which has been associated with increased FDI inflows. See also Blanchard (1991).

anything however, Ireland was ahead of the other current EU periphery countries, Greece, Spain and Portugal, in both these respects; yet these countries experienced relatively strong convergence over the course of that decade while Ireland did not. Barry (2002b) argues that this can be better understood within the regional perspective.

Another issue has to do with the rapidity of recent growth and convergence. Most will agree that poor policy inhibits convergence while correct policy facilitates it. There are few models that propose that inappropriate policies act merely as a dam behind which the thwarted convergence forces build up, however, so that when appropriate policies are eventually adopted the lost ground is made up for all the more rapidly. Yet this is the position that supporters of the delayed convergence hypothesis are forced into unless they accept that the abundance of FDI available from the late 1980s onwards facilitated the extremely rapid growth of the period. Had Ireland followed more appropriate fiscal policies in the 1970s and 1980s would the convergence have been as rapid? Honohan and Walsh appear to imply that it could have been.

This discussion of the importance of FDI leads to my final and perhaps most important point. The convergence perspective does not suggest any need for non-orthodox economic or industrial policies. The regional boom view on the other hand proposes that orthodox policies may be *necessary* but are unlikely to be *sufficient* to generate growth in regional economies.[8]

My 1999 paper argued that generating extensive growth in a regional economy requires becoming competitive in internationally-traded sectors *other than agriculture*, since capital accumulation will simply lead to emigration in an agricultural economy. The key achievement of the low-corporation-tax strategy was to develop a non-agricultural export base around which other economic activities could agglomerate. The policies identified as crucial in the convergence story remain crucial, but the *sine qua non* here is the industrialisation strategy.

While Ó Gráda calls this strategy “a distortion”, several theorists have presented models in which peripheral regions can industrialise only by offering some such “distortion”; see e.g. Fumagalli (1999) and Barros and Cabral (2000).

Ó Gráda refers to the regional boom view as over-optimistic for suggesting that high growth rates could continue. Clearly very strong GDP growth cannot be maintained without continued labour inflows. Dascher (2000) and Barry (2002a) however, who develop theoretical “regional boom” models with Irish conditions in mind, show that labour inflows will dry up as housing and infrastructure become congested. If adequate stocks were maintained the boom could continue, in the absence of adverse shocks *exogenous* to the regional economy.[9]

Even if full employment is reached and labour immigration dries up because of the expense of accommodation, must the growth in income per head necessarily grind to a halt just because Ireland has reached the EU average? The regional boom view suggests not. If high-productivity

[8] Thus Markusen (1988) shows that a regional economy needs to subsidise the use rather than the training of skilled labour, which is one of the things low corporation taxes do. Subsidising training will effectively subsidise foreign economies via emigration.

[9] Both papers also consider the question of the desirability of having the boom in GDP (as distinct from GDP per capita) continue.

foreign firms continue to migrate into Ireland they will still be able to find workers, given that they pay substantially higher wages than many existing firms. The fact that Ireland has converged does not necessarily remove this dynamic.

What can most definitely remove the growth dynamic are exogenous adverse shocks to the economy's ability to attract FDI. Let me consider several possibilities in this regard. First is a drying up of US investments in Western Europe, which could be caused by a prolonged US recession, by a change in US corporate strategy or by a refocusing on Central and Eastern Europe for example. Another possibility would be a harmonisation of tax rates across the EU. The delayed convergence perspective would view these as temporary shocks, as in no case has there been a departure from best practice. The regional boom perspective holds out the possibility that these could instead herald a return to the bad old days of unemployment and emigration, leading to an unravelling of the convergence achieved over the last decade. Hence, I cannot agree that the "regional boom" perspective is necessarily the more optimistic one!

5. Conclusions

I have argued that while convergence is the automatic outcome of models based on conventional textbook growth theory, such models are not necessarily appropriate for Ireland. The historical difficulties that the Irish economy faced in its quest to industrialise suggests that it should be thought of instead as a peripheral regional economy. Conventional micro and macro policies cannot be guaranteed to generate convergence in such economies. Thus while Greece, Portugal and Spain all converged on general European living standards in the 1960s, though their policy environments appeared no more benign that Ireland's, Ireland did not. Ireland might have been more appropriately thought of at the time as an economic region of the slowly growing UK rather than as a textbook national economy.

This perspective suggests that Ireland might not have converged had it not adopted the corporation-tax-driven industrialisation strategy that remains in place today. It strongly suggests that convergence would have been much less rapid in the 1970s or 1980s even if appropriate macro policies had been followed at the time, because there would have been much less FDI available than in the era of the Single Market and the burgeoning US boom.

These different perspectives also have different implications for the future. If the convergence view is correct, it suggests that we can now rest on our laurels: as long as we do not introduce inappropriate policies we are unlikely to fall behind average EU living standards. If the regional view is correct however, it suggests that external shocks to our ability to attract FDI might have serious long-term consequences for the economy. Foremost among these possible shocks would be a diminution of US FDI inflows to Europe, a continuation of the trend towards equalisation of corporation tax rates across the EU, or the emergence of some of the more advanced Central and Eastern European economies as serious competitors for the kind of FDI that Ireland has been so successful in attracting in recent decades.

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