Global Integration, Factor Mobility and EMU:
Implications for the Irish Economy

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Introduction

Two statements can confidently be made about the Irish economy of the late 1990s. First, Ireland, according to all accepted international economic indicators, has become a wealthy country. Second, it has become more closely linked - in economics jargon, more *integrated* - in the European, and the global, economy than ever before. Some 25 years after Ireland's joining the European Community, this is a good time to stand back and review the contribution of economic integration to the Irish economy. Have closer economic links with Europe and the wider world added to Ireland's prosperity? Will deepening this involvement - through the Single Market, through international agreements brokered through the World Trade Organisation, through expansion of the European Union to include Eastern Europe, and through Economic and Monetary Union - consolidate our new-found prosperity? Or will it, as some fear, lead to more job insecurity, rootlessness, and vulnerability to the ups and downs of the global economy? The evidence to date suggests that global free trade in goods and services, and the opening of international capital markets will, on balance, improve the economic position of Irish people. But the gains from trade do not occur automatically, and there will be continuing need for good economic management (McAleese, 1986a, 1987).

How trade creates prosperity

Within the short span of 40 years, Ireland has changed from being a relatively inward-oriented economy to one of the most open and trade-dependent economies in the world. In 1998, exports from Ireland amounted to IR£48 billion, equivalent to 90 per cent of Gross Domestic

Product (GDP). As recently as 1994 the export/GDP ratio was 65 per cent, then considered a high figure, and in 1964 it was only 32 per cent (McAleese and Hayes, 1995). Imports have also grown rapidly, but less so than exports. They totalled IR£40 billion in 1998. Like many countries, Ireland's trade growth has been driven primarily by two-way exchange of rather similar goods (intra-industry trade), much of it involving transactions between different branches of multinational firms (Brülhart and McAleese, 1995).

This two-way expansion of trade has brought several benefits to the economy. *First*, productivity of people employed in Irish manufacturing and agriculture has leaped ahead. Trade has enabled, and indeed forced, Irish business to become more specialised and efficient and to employ best practice techniques used by their foreign competitors. *Second*, the need to survive against stiff international competition in an open international market ensures that Irish business upgrades productivity by staying abreast of best international practice. *Third*, the Irish consumer has benefited through cheaper goods in the shops. Also, the range of choice has been vastly extended. For example, the ability to import from literally the five continents means that goods such as clothing are available in our high streets at relatively cheap prices. One no longer needs to be rich to dress smartly.

Imports have brought one further important benefit: they have enabled Irish people to enjoy the fruits of technological innovation developed outside Ireland. Think of the personal computer. The cost of developing the computer has fallen almost entirely on wealthier countries such as the

United States. Because of foreign trade, the Irish PC user can enjoy the latest technology at falling prices without incurring any of the huge development costs which others have had to incur. In general we can say that more open economies like Ireland have greater opportunities of benefiting from new ideas and techniques developed abroad than more closed economies. Economists have come to regard this as one of the most powerful reasons explaining why open economies have tended to outperform closed economies (International Monetary Fund, 1993).

Trade in services

The process of integration has extended far beyond free trade in goods. International trade in *services* has also been growing and currently accounts for one-quarter of total trade. Services trade includes tourism, transport, consultancy, financial and insurance activities. Entirely new service industries have appeared on the Irish scene, such as the International Financial Services Centre in Dublin, already employing over 3000 people, and telemarketing. The growth in such activities can be explained in the first instance by advances in technology which have reduced the cost of transport and communication between countries. Another factor has been the realisation that an efficient services sector is important for economic development and that such efficiency can best be assured by opening hitherto protected sectors to foreign competition. The European Commission has played a lead role in driving this message home and through a series of directives has forced several reluctant governments (including the Irish government) to remove restrictions on competition in transport, telecom, and banking and insurance. As a result of such liberalisation, cost of inputs to Irish exporters have fallen, Irish industry has become more competitive and all sorts of new products and activities (the mobile phone for instance) have been spawned. Here is another advantage of openness, not mentioned in the textbooks.

Financial transfers

As part of the integration process, Ireland has benefited from *financial transfers* from the EU on an unprecedented scale. These transfers have taken two main forms: resources received from the various Structural Funds and financial supports from the Common Agricultural Policy. Net receipts from the EU have amounted to a staggering £12 billion since 1990 alone, equal to a free gift of £3,500 to every person in Ireland, with virtually no political strings attached. Few countries have ever received *largesse* on such a grand scale. The objective of the Structural Funds is to achieve economic convergence, i.e. convergence of living standards, so that the recipients can play a full and equal part in the progress of the European Union. The only obligation on the Irish government has been to spend the money in a manner agreed with Brussels in advance. Far from proving onerous or intrusive this obligation has led to a considerable improvement in the way public sector investment is planned and monitored (Honohan 1997).

Trade and foreign investment

Free trade and what is called *the internationalisation of production* often go hand in hand, and Irish experience is no exception to this rule. Subsidiaries of foreign multinationals account for one out of every two jobs in Irish manufacturing, and for 40% of our total export earnings. The

US influence has been particularly marked. Some 50,000 Irish people have found well-paying jobs in US subsidiaries in the manufacturing sector alone (Ruane and Görg, 1997). American subsidiaries are visible throughout the length and breadth of Ireland.

Foreign investors are attracted to Ireland for several reasons. First, they can use Ireland's secure access to the EU and other foreign markets as a platform from which to export to these markets. (The Irish market on its own is far too small to attract any significant volume of inward manufacturing investment.) Second, Ireland's well-educated, motivated and English-speaking workforce also encourages inward investment. Third, overseas investors have been attracted by Ireland's low corporate taxes. These and other advantages of the economy have been skilfully marketed by the IDA over many years (Kennedy 1998). Recent experience shows that, as more investors come to Ireland, more tend to follow. Partly this is because of agglomeration economies - as the number of new firms increases, infrastructure is developed which lowers costs for followers. Partly it arises because of informational economies. If one well-known multinational locates in Ireland, its competitors conclude that Ireland must be a good place to invest in - and they follow suit.[1]

Foreign investment, however, does not come cheaply. More countries than ever before are trying to attract foreign investors and, for the right type of investment project, Ireland must either pay the going rate, or lose

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1 Krugman (1997) describes this in terms of 'demonstration' and 'cascade' effects. These effects have been well appreciated by the IDA for many years. A point not sufficiently emphasised by Krugman is the importance of the first entrant being a leader in the industry if these effects are to swing into action.

the project. Grants, subsidies and tax incentives totalling many millions had to be provided by the taxpayer. So far the balance between the gains and costs from foreign investment has rested in Ireland's favour. The Irish Exchequer has certainly gained from their presence. In 1994, for instance, corporate tax receipts from IDA-supported companies of IR£440milllion, while grants provided to them amounted to IR£73m (IDA Annual Report 1995).

With so much foreign industry in Ireland, it is not surprising that questions are regularly raised about the vulnerability of the Irish economy to changes in economic conditions abroad or simply to altered foreign sentiment about Ireland's attractiveness as an investment location. But such worries are misplaced. There is no evidence that foreign industry is more volatile than Irish-owned industry - because of its stronger resources, the opposite is more likely to be the case. Also, foreign investment engenders many positive spillover effects on Irish-owned companies. Multinationals have helped small Irish firms to develop expertise as suppliers. They have also given job experience and training to a cohort of talented young people. In other instances, by taking over small Irish companies, they have provided a significant financial reward for the entrepreneurs who started these companies, and encouraged others to follow. While it is true to some extent that industry in Ireland suffers from the Wimbledon syndrome -- too many international players and not enough local winners -- the locals are fighting back.

Foreign investment has been a two-way process. While foreign firms invest in Ireland, Irish firms are investing overseas, at an increasingly rapid rate. Most firms quoted in the Irish Stock Exchange have acquired substantial investment positions abroad. Irish multinationals such as Smurfits, CRH, Kerry Foods, Glen Dimplex, Bank of Ireland and AIB derive only a fraction of their profits from their Irish operations. Subsidiaries of Irish food companies supply 18% of the UK liquid milk market, 30% of the UK cheese market, and an estimated 55% of the UK red meat market (Irish Farmers Journal, 27 December 1997). Unfortunately we still await a comprehensive economic analysis of the effects of this surge in outward investment on the Irish economy. My guess is that such a study would show that overseas investment makes a positive contribution to the economy by enabling Irish companies to diversify risk, to learn first-hand from foreign business practice, and to escape the confines of the small Irish market.

A key development in recent years has been the growth of foreign investment in the services sector. The influx of major British multiples such as Marks and Spencers, Dixons and Tesco into the Irish market has had a huge impact on the Irish retail market, and further incursions from overseas are likely in hitherto "closed" sectors such as telecoms and energy. Because less evidently advantageous than greenfield investment in economic terms, such investment receives no support from the Irish government. Yet, by exposing the Irish market to more intense competition, it can bring economic significant gains to the Irish consumer. As integration continues, we can expect deeper penetration by overseas firms of our financial sector and, within the next decade, it is quite possible that Irish banks, building societies and insurance sectors will be entirely under foreign control. Already, most Irish shopping centres are mere replicas of those found in any British city. All this may make for greater efficiency and lower prices - but also for a rather duller, less distinctive and less economically independent Ireland. This is another aspect of the integration process that deserves further research.

Portfolio capital flows

As nations trade more intensively, capital moves with it. Banks help to finance foreign trade and, when major companies invest abroad, domestic banks tend to follow their customers and become international themselves - witness the proliferation of foreign banks in the wake of the multinational inflows into Ireland. Borrowing and lending in foreign currencies becomes increasingly easy for governments, firms and individuals.

While the Treaty of Rome involved a commitment to freedom of capital movements, little was done to implement this provision prior to the Single European Act of 1987. Indeed, only since the early 1990s has capital become fully mobile between Ireland and the outside world. The effects have been quite startling. Nowadays, the humblest Irish citizen can invest in equities and bonds from every part of the globe, through a myriad of exotic investment funds. Irish pension funds have increased their overseas holdings to over 40% of their total assets of IR£19 billion, and the process of international diversification of Irish investment funds follows apace. The Irish government's debt agency, the NTMA, scours the world market for the cheapest source of funds. Transactions between companies involve huge two-way flows of money in and out of Ireland. Irish banks too are heavily involved in the global capital market - by mid-1997, their gross liabilities to non-residents amounted to IR£50 billion.

The abolition of capital controls means that Irish capital is free to go to where it can make the highest return and to diversify risk. This freedom to borrow and lend abroad has brought economic benefits to Irish individuals and Irish companies by enabling them to diversify their portfolios and maximise the return on capital. It has also helped to ensure that the government keeps its finances in good order. Any hint of reversion to the irresponsible fiscal policies of the past would lead to prompt capital outflows, higher interest rates for Irish borrowers, and a very clear negative signal to the public about the government's performance. As an Italian economist once remarked, *"capital markets have the heart of a lamb, the legs of a hare, and the memory of an elephant"*. Another benefit of capital mobility stems from its stabilising role in the economy. When the Irish economy is booming, profits flow out of Ireland to the outside world. When the rest of the world is booming and Irish economy is relatively depressed, profits from capital invested abroad flow in, domestic activity is bolstered by increased income. Thus Irish consumers find their spending evened out over the business cycle (Lane 1998).

A less edifying effect of international capital movement has been to make individual capital transactions increasingly difficult to trace and tax. The byzantine financial paths described in the McCracken Tribunal Report (1997) illustrated the difficulty in a graphic way. As a result, tax evasion and avoidance of taxation have become easier than before. Governments in high tax jurisdictions are under pressure to reduce tax rates so as to minimise the incentives to transfer capital to lower tax jurisdictions. The danger of a resultant “race to the bottom”, or fiscal degradation, has caused concern in the European Union, and initiatives are in progress to secure closer co-ordination of capital taxation policies among member states. Globalisation of the private sector, in other words, must be matched by globalisation of public policy.

From Emigration to Immigration

No description of Ireland's integration with the outside world would be complete without reference to movements of people, or in economic jargon, *labour mobility*. For most of the past two centuries, migration meant outward movement, or emigration. There is continuing debate about the effects of emigration on the economies to which the Irish emigrated, on the living standards of emigrants and, most controversial of all, on the living standards of those left behind. Emigration can certainly generate some positive effects in the short run, such as a reduction in the level of unemployment and a mitigation of the decline in living standards during recessions. The longer run effects are more difficult to quantify. But such evidence as exists offers no compelling support for the commonly held view that emigration has impaired the long-run development of the economy, or the growth of income per person (NESC 1991).

Movements of people, like movements of capital, can go both ways. As the Irish economy has grown in prosperity, it has become a magnet for returning Irish emigrants, for skilled Europeans willing to work in the computer and teleservices industries, and also for large numbers of relatively unskilled people from poorer nations. Increasingly one sees advertisements for jobs in Dublin bars and restaurants specifying that "*fluency in English is essential*".

Being a recipient, rather than a source, of surplus labour has proven a disturbingly novel experience for Ireland. The phenomenon is too recent to enable any proper assessment of its economic impact. Inflows of skilled people, many of them returning emigrants, are clearly beneficial to the economy. However, the economic calculus becomes less clear when it comes to judging the value of immigrants who are unskilled, yet ready and eager to work. First, Ireland has an abundance of unskilled people already, languishing in unemployment, and it is reasonable to give them priority ahead of economic immigrants (political refugees are of course another matter). Second, we must ensure that unskilled immigrants find work which will enable them to make the same positive contribution to society as generations of Irish have done in Britain and the United States. Were they to lapse into welfare dependency and long term unemployment, we would lose and so would they in the long run.

As a general rule, economics suggests that moving capital, technology and goods between countries is likely to be less costly and disruptive in social terms than moving people. As the slogan goes, jobs should go to people rather than people to jobs. But when jobs won't move, people of ambition have no choice but to up and go themselves.

EMU - the next step

The next step in the integration process is the introduction of a single currency, the euro, and economic and monetary union (EMU). The surrender of the Irish pound and its replacement by the euro is proving to be a difficult and controversial step.

It is a difficult step because introducing a new currency will be a costly nuisance for every single individual and every single business in the country. By the year 2002, all prices will have to be quoted in euros. Automatic teller machines and accounting systems will have to be adjusted to transactions in euros. The cost of this has been estimated at several hundred million pounds. It will have to be borne by the private sector and ultimately, one suspects, by ordinary consumers - Brussels has made clear that it will not foot the bill. The transition process will create opportunities for confusion, fraud and unwarranted price increases as uneven and awkward figures are rounded up. Economists tend to see these costs as similar to the upfront costs of launching a new product, which should be capitalised and written off against a future stream of benefits lasting for many generations. Viewed this way, the costs of the transition come out as fairly small.

EMU has also proved controversial. The controversy about Ireland's participation in EMU is intriguing in two respects. First, it has divided Irish economists to a degree which no other European initiative has done since membership of the European Community was proposed in the late 1950s. Second, opponents of EMU entry seem to have been uniquely ineffective in changing policy makers' minds. Ireland's main policy political parties, business representatives and trade unions remain as firmly pro-EMU as ever. Fascinating material here, surely, for future economists and political scientists!

There are three standard economic benefits to Ireland of EMU. First, trade and foreign investment with the 11 member states in EMU will be easier and less expensive to transact in a single currency with zero exchange rate risk. Second, the euro will make it easier for people to compare prices in different parts of Europe. Price transparency will ensure that competition is intensified and prices are kept low. Third, over the long run, the elimination of exchange rate risk will reduce Irish interest rates (by somewhere between 1 and 2 percentage points). This will stimulate investment and generate faster growth. Proponents of EMU have found this third advantage to be crucial to the cost-benefit analysis of EMU (Baker et al, 1996; De Buitleir et al, 1995). My own view is that the first two sources of gain could prove ultimately far more important than current estimates suggest!

Against this are ranged two main drawbacks.[2] One derives from Irish firms' vulnerability to changes in sterling given that Britain has decided to opt out of EMU. Business was badly scarred by the weakness of sterling in 1992-93 and also in 1986, and many firms had extreme difficulty in coping with a rate of one Irish pound equal to 110p sterling. Had the single currency been in operation in 1992, Irish firms would have had to cope with the equivalent of 115-120p sterling per IR£ through much of 1995 and 1996. This would undoubtedly have proved a traumatic experience. In recent times, sterling has strengthened, but the possibility of it weakening again cannot be ruled out.

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[2] The case against Ireland joining EMU is made in Thom (1997), Neary and Thom (1998) and Neary (1997). It is worth noting that those articulating the case are by no means anti-European in the colloquial sense of that term. Some, like Neary, happily describe themselves as Europhiles, with emphasis on the capital E of course!

Another objection to EMU is that it will result in inappropriate interest rates for the Irish economy. A booming economy ideally needs higher interest rates to cool things down. But, after EMU, the Irish central bank will surrender control of monetary policy to the European central bank. Interest rates will be determined by the needs of the European, not the Irish, economy. While all members of EMU will be in the same position in this respect, the Irish economy has been weakly synchronised with average EU economic conditions in the past and hence, the argument goes, conflict is likely to arise often in future. Thus when we need high interest rates, we are likely to get lower rates, and *vice versa*.

There would be general agreement that going into EMU has potential downsides. But opponents of EMU tend to underplay the equally serious downsides of staying out.

First, there is the risk that foreign investors would be put off by what would be perceived as a weakening commitment to Europe and a danger, however remote and ill-defined, that Ireland might suffer from not being close to the centre of decision-taking in European monetary policy. The IDA claims that that failure to participate in EMU would have a serious adverse affect on inward investment.

Second, abstention from EMU might weaken the government's commitment to fiscal control and a lower debt/GDP ratio. Were this to happen, failure to join EMU would be regarded by future generations as a truly calamitous decision. It is worth keeping in mind that, without the disciplining effect of the Maastricht criteria on Irish fiscal policy, the economic boom would never have happened. Our present prosperity and competitive exchange rate are, to a significant extent, the consequence of the government's commitment to participate in EMU. Take away this commitment and the Irish economy might quickly cease being an international success story. This is the basic flaw in the "if it ain't broke, don't fix it" argument for staying out of EMU.

Third, the picture promoted by critics of EMU of a high-octane Irish central bank, fine tuning the economy from year to year and providing soft landings or quick recoveries *a la carte,* is not entirely plausible. This strand in the anti-EMU case relies on an exaggerated faith in the effectiveness of counter-cyclical monetary policy. The Federal Reserve Bank in the United States, of course, operates such a system quite successfully. But for a small open country it is a different matter. The problem is that adjusting interest rates according to the cyclical pattern of the economy can generate large, and often uncontrollable, swings in the exchange rate. Business in these countries generally dislikes exchange rate volatility and uncertainty, which explains why companies tend to favour the EMU project (Britain and Sweden not excepted). Studies of the economics of introducing a flexible exchange rate regime in Ireland have repeatedly rejected this option on the grounds that exchange rate uncertainty of such a regime would impose excessive costs on our trade and foreign investment.

Some critics of EMU recommend that the central bank should focus on an effective exchange rate target for the Irish pound, thus steering a middle course between fluctuations in sterling and the euro. But the closer the bank sticks to the middle course in exchange rate policy, the more circumscribed its power to alter interest rates and implement strong counter-cyclical monetary policies.

A curious aspect of the EMU debate in Ireland is that while opponents criticise it on the grounds that it will be bad for Irish business, Irish business itself has generally been strongly supportive of the government's position![3] So also has the Irish voter. There is, for example, the plain fact that the Maastricht referendum in 1992 recorded a 'yes' vote of just under 70% of all votes cast. Some opponents of EMU brush this result aside on the basis that the Irish people did not know what they were voting for. Fortunately for democracy, our politicians and civil servants are unable to dismiss a referendum vote so lightly. Besides, why were the people not informed of the downsides? Criticisms of the Irish government's strategy towards EMU have come too late.[4] In retrospect, it is a pity that the these valid and important criticisms were not fully debated, and alternative strategies proposed, prior to, rather than after, the 1992 referendum.

A further consideration is that Structural Funds, especially those received during the 1990s, were designed to assist Ireland in its professed objective of building up its economic strength and participating fully in EMU. Having received, and spent, this assistance, and subsequently prospered

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3 Ireland's main business and employer organisation, IBEC, has been a pro-active and unequivocal supporter of participation in EMU in the first round. Small business organisations have, perhaps not surprisingly, been more tentative.

4 It is certainly true that the implications of a UK opt-out were not properly debated in the referendum, or even discussed in the government's White Paper preceding it. Reasons for this are discussed in McAleese (1996b).

and passed the Maastricht criteria with flying colours, could an Irish government credibly declare that it had changed its mind and had decided not to join after all, until the UK joins too? After all the sterling factor and the "asymmetric shocks" problem have not hit us out of the blue. More important would such a policy reversal not go against the whole thrust of Irish political economy over the past 30 years which has been to lessen our economic dependence on Britain and establish an independent role on a broader international stage? Finally, following this argument, should more account not be taken of the likelihood that Ireland's economic relations with continental Europe are strengthening all the time and will strengthen further as a result of EMU? Hence past cyclical and trade patterns may not be reliable indicators of future trends.

To summarise, the ineffectiveness of the anti-EMU case can be traced to three main defects. One relates to *timing* – the anti-arguments have come too late in the decision-making process. Another defect relates to *content*. The economic arguments against EMU are substantive, but not compelling. A final problem concerns *perspective*. A decision to go into or stay out of EMU should not be dictated by short-term considerations, whether they be the specific sterling exchange rate in any month or the existence or absence of a housing boom in Dublin in a particular year. This is a long-run strategic decision of immense importance for the future. A policy reversal on EMU at this stage would require the articulation of an alternative strategy for Ireland's long run development, not just a simple "no". However, even if it has not succeeded in reversing policy, the vigorous statement of the anti-EMU case has certainly been worthwhile, if only to alert the public to the existence of serious dangers in EMU and to the need for institutional and structural change to deal with them.

Ireland is ineluctably drawn towards early participation in the single currency. Over the long run, EMU could result in a consolidation of the benefits of fiscal consolidation, low inflation and fast growth experienced in recent years. But we are speaking of probabilities, not certainties. Much will depend on how the levers of domestic policy still left to us are deployed - incomes policy, education and infrastructure policy, tax policy for instance. If the UK stays out of EMU over the long term and sterling is volatile, Irish business and employees (and their trade unions) will have to be prepared to respond far more flexibly than in the past. But for Ireland, the question now is not whether, but how, to adapt to the new disciplines and opportunities which EMU will impose.

Conclusions

Two key global trends in recent years have been: (i) the liberalisation of economies to give greater scope to market forces and (ii) the globalisation of markets. The growing importance of European integration for the Irish economy is the mirror image of processes affecting many countries throughout the world. Ireland’s integration, not just with Europe but with overseas markets generally, has grown at an extraordinary pace. The next step after EMU will be the further enlargement of the EU, from its present 15 members to 20, to include the more developed east European countries. Not long after that an Union of 26 members is on the cards. By then, the EU will have become a truly major economic power, and Ireland will increasingly have assumed the features of a tiny regional economy of the EU.

As a regional economy of a vastly enlarged and more market-driven EU, Ireland will have to survive without many of the supports it has enjoyed over the past 25 years. Structural funds are in process of being phased out, following our graduation into the higher income league. The days of large inflows to our farmers through the Common Agricultural Policy are likewise numbered. If things go wrong, fiscal policy will be severely circumscribed and there will be no friendly and familiar Irish Central Bank to adjust interest rates suited to our needs. In this regard, it is vitally important that Ireland should be allowed to maintain its favorable corporation tax regime. At present, the government has proposed altering the 10% corporations profits tax to a general rate of 12.5% applicable to all businesses. This proposal is currently under scrutiny in Brussels.

Integration in the European economy needs to be managed correctly. There is no evidence that jobs in an integrated economy are less secure than in a protected one. Also, as experience over the past 25 years has demonstrated, while exposure to overseas markets has made the Irish economy more vulnerable to external fluctuations, the trade-off has been an improvement in living standards, health and education level which more than compensates. True the penalty for policy mistakes is likely to increase as a result of integration. But provided such mistakes are avoided, further improvements in living standards are certainly likely. Greater access to knowledge and technology, the stimulus of competition with world class rivals, the resource allocation gains from being able to trade at world prices and better access to the global pool of saving -- these will remain the core sources of economic growth (McAleese, 1997).

Economic forces are notoriously two-handed. For every opportunity there is a challenge; and few economic changes leave everyone a winner. Continued growth for the Irish economy will depend on the ability of firms in Ireland to grasp the opportunities, and on the ability of Irish policymakers to make Ireland an attractive location for export business.

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