

SECTION 3 THE OPEN ECONOMY

Chapter 10 Is Ireland a Small Open Economy ?

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Ireland is clearly 'small' both in geographical and demographic terms (e.g. Ireland's population makes up only 1% of the European Community's total population). In this essay we wish to examine its 'smallness' in an economic sense and then to explore its 'openness' (the different ways in which it is linked to the international economy). Finally, there will be a brief discussion of the implications of the Single European Market post-1992 for a S.O.E.

The theoretical definition of economic smallness is that domestic supply and demand conditions have no effect on international markets, that domestic producers face perfectly elastic demand curves (i.e. no demand constraints), and are unable to influence the prices of their products. The price level in the small economy is hence exogenously determined - the Law of One Price holds for that economy.

In many ways Ireland fits this description. The domestic levels of supply and demand for oil will have no effect on the world oil market, for example. Many firms with downward-sloping demand curves are competing in highly specialized, or 'niche' markets. Even the prices of highly differentiated products such as Waterford glass will be largely given as they fit into broader categories.

But doubt has been cast by many in recent years on the view that Ireland's external economic environment is all important and given. The Law of One Price, although it empirically holds in the long-run, falls far short of explaining all short- and medium-term fluctuations in the Irish price level. Honohan showed that Irish demand levels are not solely determined by world demand levels. This is because of substantial trading costs in many markets. Yet it can be said that the traded sector in Ireland has a relatively important position, enabling Irish producers to break into many new markets, increasing their demand without changing prices. In the long-term the theoretical definition of smallness represents a good approximation to the actual state of the Irish economy.

An issue is whether Ireland's geographic and demographic smallness contributed to its economic smallness such as it is. Many small countries specialize in activities where they have a material advantage and where they can influence world prices, e.g. Saudi Arabia's influence on global oil prices or South Africa's power in setting the price of diamonds. From these examples it would appear that it is possession or non-possession of natural resources which determines the economic smallness of a country. Ireland's main natural resource is land, and here geographical size places limits on the quantity of this resource in a nation's possession. Thus Ireland's small geographical area plays a role in determining its economic size.

The degree of integration of the Irish economy with the international economy determines its 'openness'. Smallness and openness are not equivalent - Albania is small but not open, while West Germany is open but not small. However, size does influence the nature of an economy's openness - for an economy such as West Germany the term means an ability to influence economic activities in other

economies. For a small economy such as Ireland, openness is more likely to mean exposure to, and dependence on, the economic actions of foreign trading partners.

The openness of the economy can be examined by studying its linkages with the rest of the world. Three categories of linkage will be examined, namely trade linkages, factor linkages, and technological linkages.

A major difficulty in analysing trade statistics is that exports and imports are expressed as gross percentages of G.N.P. (X/G.N.P. and M/G.N.P. respectively). These gross figures ignore that exports may be comprised of imported components so that value-added is not properly measured. However, as no other trade figures are available we will use the conventional X/G.N.P. and M/G.N.P. measures. Over the past twenty years these have grown from 25% to 60% and from 35% to 58% respectively. The long history of free trade with Britain may have laid the foundations for such an open economy which has been explicitly sought since the Economic Development Report of 1958. Ireland ranks only behind such exceptional city-states as Hong Kong and Singapore in international comparisons.

The second element of trade linkages is their quality. In Ireland's case the linkages are in production goods rather than consumer goods because Ireland's production is tied to that of the external economy. A small economy with minimal research and development would be unable to match the level and quality of imported technology.

Factor linkages can in turn be subdivided into labour linkages, financial linkages, and corporate linkages. The most obvious form of labour linkages is the flow of emigration according to relative unemployment and wage rate conditions between neighbouring countries. While family and other influences do constrain the level of 'openness' in the labour market, mobility looks set to increase even further as Irish people learn other European languages and adopt a more cosmopolitan outlook post-1992.

An obvious illustration of financial linkage is Ireland's high level of foreign debt (60% of G.N.P.). The domestic stockmarket closely follows movements in London, New York and Tokyo. Interest rates must be comparable in real terms to level in other economies (when expected exchange rate fluctuations are taken into account) and membership of the E.M.S. signifies the relationship between the Irish Punt and the currencies of its major trading partners such as the German D-mark. The recent abolition of capital controls will further integrate Irish financial markets with international ones.

Corporate linkages are widespread, given that multinational corporations employ 86,000 of the 186,000 workers in the Irish manufacturing sector and account for 80% of Irish non-food exports. However many such firms may be said to be 'in, but not of, the domestic economy' as they use mostly imported raw materials and export the bulk of their output. Similarly profit repatriation reduces the value-added to the Irish economy. The importance of M.N.C.s underlies the increasing openness of all liberal economies as different stages in a single production process are spatially dispersed internationally.

A major reason for encouraging foreign investment in Ireland is that a transfer of technology takes place. The huge financial costs of original R&D are beyond the resources of a small economy - domestic R&D is confined to adapting foreign technology to specific Irish circumstances (such as the unusual hardness of Irish water). Given that much technology is developed in an intra-firm manner, encouraging foreign investment here is a more efficient means of acquiring technology than expensive licensing agreements.

Ireland's membership of the E.C. and other international economic organizations such as G.A.T.T. and the O.E.C.D. illustrates that political linkages are ever more important in analysing Ireland's economic openness. Agricultural policy is largely set in Brussels and the 1992 project seeks to implement 300 directives to further harmonize the economic policies of E.C. member nations. One example is the role the E.C. played in regulating the Irish Distillers takeover battle in 1988. The transfer of economic sovereignty implicit in the Single European Act is not only a manifestation of Ireland's political openness but also raises questions as to the future level of openness of the Irish economy.

Two possibilities exist. First, a protectionist 'Fortress Europe' may emerge which may reduce trade with the United States and Japan. This would reduce Ireland's openness to non-European economies and may also mean a reduction in smallness, as domestic firms are more likely to possess market power in the European market than in the global economy.

However, the more likely scenario is a liberal single market with open trade linkages with the U.S and Japan. This will serve to further copperfasten the smallness and the openness of the Irish economy which we have attempted to articulate in this essay.