"The Good Old Days"
An historical plea for economic austerity, free trade, and European Integration.

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The process of European Integration represents the third great chapter in the continent's twentieth century history. Michael Jennings places Ireland's planned participation in the recent moves towards monetary union in the economy's interwar experience and argues for fostering a more outward looking culture.

This essay is not, in essence, a discussion of the economic history of Ireland, but rather of its economic future. It would seem logical to look to the future, whether one is an economist, a government or a concerned individual, intent on ascertaining what is best for Ireland and its people. It is just as logical to look to the future motivated by the past, and a study of the economic history of this small open polity may give us important insights into causations and mistakes, and ways ahead. This essay aims to look ahead considering the topics of economic austerity, free trade and European Integration, which in essence encompasses both of the former. It does not aim, however, to provide specific causational models and highly technical accounts of these topics, but rather argues for them based on some of Ireland's past experiences and their ultimate necessity based on common sense.

Section 1: Fiscal Policy

If we are to evaluate the evolution of economic policy in regard to the fiscal stance of the government, it is best to compare the period of fiscal 'recklessness' in the 1970s and early 1980s, and its consequences, with the remedy that followed it, namely fiscal austerity

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In 1973 the oil shock, in which the OPEC nations quadrupled the price of oil, led to a change in Irish economic policy. Before the 1970s, planned budget deficits were not entertained, and government borrowing was used purely for capital spending, so as to ensure austerity. However, with a depression looming and perceiving the deflationary effects of the crisis, the Irish government followed the lead of many other Western economies and began countercyclical spending, increasing the budget deficit, in order to boost demand. According to Keynesian theory, this was the right response. Theory suggests that as a recession recedes the national debt should be curtailed by curbing government spending. Initially this happened, with the current budget deficit dropping to 3.5%. However, one year later the Fianna Fail government started spending pro-cyclically, fearing high unemployment. This returned the deficit to a high level, of 6.1%. Up until 1982 unemployment. This returned the deficit to a high level, of 6.1%. Up until 1982 public sector borrowing increased and after that remained at a very high level until 1986. During this time, government debt increased substantially with the current budget deficit at nearly 8% p.a. in some years. The costs of this 'experiment' were horrendous. Debt was enormous, reaching 129% of GDP, at one stage the servicing of this accounted for almost all of personal income tax revenue. Furthermore, inflation rose, unemployment figures rocketed, and investor confidence in the stability of the punt plummeted. During this period, no coherent policy was introduced to counter these effects, and they remained until 1986, when the paper "A Strategy for Development" prescribed a stringent fiscal policy. It was clear that there would be no debt write off as there had been in the 1930s, and so salvation had to be sought by curtailing and controlling public spending. The government's strong stance and realism helped set targets and lowered the national debt, reducing the current budget deficit to 1.6% by 1988, and setting the scene for the consistently low Irish deficit throughout the 1990s.

.History however has taught us a lesson, and the consequences of procyclical expansionary fiscal policy in the past are universally recognised. The disastrous period described above serves more as a reminder than an outright lesson, as there is no government today considering a similar policy to the one pursued in the 70s. Although the circumstances may also not reappear in that way, the qualitative deductions still hold true: fiscal expansion creates both inflation and government debt, and the temptation to increase government spending sharply must be resisted. In light of the convergence criteria prescribed by the Maastricht Treaty, such a mistake would be potentially more costly than it was in the 1970s.

Section 2: The importance of Free Trade: *Lessons from the 1930's*
The argument for free trade and economic integration begins here, and the following description of the situation in the 1930s provides the basis for the rest of the essay.

Although we could plausibly look at how positive free trade has been for Ireland in later years, I feel that the message becomes clearest if we concentrate on a negative example, similar to the above discussion of the 1970s. Although it is said that people remember the good times rather than the bad, in economics this is not usually the case. For this purpose the period from 1932 to 1939 presents itself, and it is valuable to look at the years before that in comparison.

From independence until the Fianna Fail government took over in 1932, the Irish economy was characterised by the fact that the state did very little. In essence, it emphasised free trade, removing tariffs on many products and slowly and reluctantly granting protection to a few, nonessential industries. It also retained parity with Sterling, so as to further facilitate free trade. Although the parity with

Sterling was a contentious issue (as we shall see later), this strategy worked well, and the Irish economy, especially the industrial sector, profited from free trade. The shift in 1932 was a paradigmatic one. Eamonn de Valera came to government with two main economic objectives: greater self-sufficiency and the refusal to pay the land annuities owed to Great Britain.. Although it has been argued that his motives were not so much economic as cultural and of course political, obviously the economic element of the self-sufficiency was important and is relevant for this discussion. The world wide recession had led to protectionism becoming *en vogue,* and the Fianna Fail government was no exception. In May of 1932 the Finance Act imposed *ad velorem* duties from 15% to 75 % on 38 classes of goods. Tariffs reached a maximum of 45% in 1936, and were applied in a haphazard and piecemeal fashion in a drive to protect Irish industry and gain more independence from Britain.

The tariffs were also a direct result of the economic war between Ireland and Britain. In various Land Acts, the British government had arranged to provide funding for Irish tenant farmers to purchase their holdings from their landlords. The land annuities then considered due to the Britain were disputed by the new Irish government, and De Valera refused to pay them. The dispute over roughly £5 million lead to a sudden and severe reaction by Britain. It imposed *ad velorem* duties on Irish agricultural exports, and other quotas and restrictions soon followed. Ireland responded with equally harsh measures, and the fight continued until abating from 1936 onwards, finally ending in 1938 with the Defence, Financial and Trade agreements. During this time, much damage had been done to the Irish economy. While industrial output initially rose very fast due to the protectionist measures, it had stagnated by 1936. Unemployment rose fivefold between 1931 and 1934, with a stable population. The total cost of protection is estimated to have been between £7 and £8 million. These figures are debated, and it is argued that the £90 million write-off of foreign debt and the treaty ports, both gained from the agreement with Britain at the end of the economic war, alleviate the negative effects of the protectionist period. I find it impossible to consider this a successful period, however. The 'advantages' were a one-off situation, and do not subtract from the basic argument that protectionist measures in themselves are wrong. Furthermore, the period was to have repercussions into the next decades. Fitzgerald argues that the real effects of the 1930s did not become visible until protectionism ended. Ireland found itself reorienting to export markets in a period in which the world economy was booming. However, much of Irish economy had only been able to survive as a result of the favourable environment that had been created for it, and therefore was ill equipped for reorientation. The economic inefficiencies bred by protection to some extent caused the sluggishness of the 1950s.

The lessons for the 1990s

There are a number of reasons why greater export growth will lead to faster economic growth. One is that exports constitute an important part of demand for a small open economy such as Ireland, and expansion of exports increases output both directly and indirectly. Increased trade and an open market economy bring in new technical inputs, capital stock and human resource that will raise the production function and thereby output. Although exports are not a sufficient condition for growth in an economy, they are an important necessary one.

Trade increases the range of consumption goods available to the consumer, allowing them to purchase finished products that would otherwise not be available on the free market. Also, free trade creates efficiency, as each country explores its comparative advantage in a more competitive environment fostering a higher degree of specialisation.

Section 3: Europe and EMU

This essay concentrates on issues that are as much political as economic, and it is at this point that it most certainly becomes strongly political. This is unavoidable, as much of politics is economic in nature, and, in policy making at least, the converse also holds. It has been argued that the history of European Integration has been a history of 'economic solutions to political problems', and it is the latest 'economic solution' that I now discuss, under consideration of the point made above.

Ireland and Europe

Ireland is a small open economy on the periphery of Europe. It has been linked to its nearest neighbour, Britain, for a large part of its more recent history, and is still closely linked to it. However, for almost a quarter of a century, Ireland has been forging ever closer links beyond Great Britain and towards mainland Europe.
When Ireland joined the EU along with Britain and Denmark, it became part of a customs union that was not yet completed. The 1968 union had been an industrial one, leaving a number of questions unresolved. These were (i) fiscal barriers resulting from differing tax arrangements, (ii) physical barriers due to continued customs checks and administrative costs resulting therefrom, and (iii) technical barriers, created through differing regulations and stipulations, as well as state monopolies and barriers to entry protecting the home market from 'foreign invasion'.

The '1992 Programme', or the Single European Act (SEA), was to remove these constraints on free trade, and create a true customs union. Although Jaques Delors had originally hoped to progress further towards EMU in the SEA than actually happened, a number of barriers named above were removed, and brought a number of significant changes for Ireland.

Negative aspects were put forward as being the convergence of taxes, both VAT and excise, that would become necessary after the SEA. However, for a number of reasons these measures were not adopted, and Ireland's revenue base remained assured. Looking to the future, EMU will bring this convergence, and can be viewed as a negative effect of future integration.

There were, however, many positive effects that should continue to be positive when the next stage of economic integration goes ahead. Due to Ireland's high, and constantly rising propensity to export, the free movement of goods and services as well as capital *could* be viewed as positive for the Irish economy in that they made Ireland the 'gateway to Europe'. Due to the reduction of costs in accessing the European market from Ireland, it was more likely that firms would consider investment in Ireland, due also to other positive factors, such as an English-speaking, educated workforce.

Structural Funds

The importance of structural funds and funding in general to Ireland from the EU cannot be underestimated. In order to alleviate some of the greater inequities in the European Union, the transfers under the EAGGF, the ERDF the ESF and the cohesion fund were conceived to aid the poorer regions of Europe in supporting agriculture and building up infrastructure. It is important to note that although Ireland was one of the four poorest member states when the funds were installed, this is no longer the case, and this should have implications that we will return to later.

Irish experience in the EMS- exchange rate problems

The Irish and British currencies were amalgamated in 1826, and remained so until Independence. Even when the new Irish pound was introduced in 1928, it remained at exact one-to-one parity with sterling. Ireland was effectively in a monetary union with Britain for 153 years. Linking to a major currency has the advantage of warding off speculative attacks on the currency of small open polities. Until 1979, there had been no alternative for Ireland but sterling. The EMS provided the alternative many people had been looking for. There were a number of reasons given not to join, most notably that it would be folly to relinquish the stable exchange rate with Ireland's largest trading partner. However, the possibility of escaping the soaring British inflation was too tempting, and Ireland broke the parity with sterling and entered the EMS. The theory of purchasing power parity dictates that the inflation rate of a small economy moves with the inflation rate of the currency it is linked to, and Ireland hoped to lower inflation by linking to the strong German mark.

The problem created by this was that trade links to Britain remained too strong, and the Irish exchange rate continued to mirror the UK's. This led to an overvalued real exchange rate, which harmed Irish price competitiveness. The adjustment was very slow, which harmed the Irish economy immensely in terms of output and employment. Irish authorities were therefore forced to devalue twice in 1983 and 1986 in order to remain competitive. From 1987 to 1992, the Irish real exchange rates stabilised, and Britain joined the ERM in 1990. This was a smooth period for Ireland, as all its main trading partners (besides the US) were now in the EMS.

At the end of 1992, however, Britain was forced to leave the ERM. Again, Ireland faced severe difficulties as the Irish pound once again became overvalued against sterling. In a show of determination, Ireland resisted devaluation, desiring to break the dependence on the UK. The undertaking was doomed, though, and under intense speculative pressure Ireland was forced to devalue once again in January 1993.There are a number of lessons to be learned from this recent period of Irish economic history. Showing the inevitability of devaluation if wages and prices are not sufficiently flexible.

And The Future....

The currency crisis experience would seem to show that Ireland cannot enter a European Monetary Union without the UK. The trade links are too strong, and there would be no possibility of devaluation with a single currency. The loss of sovereignty would also constitute a large cost for the larger countries in the EU, especially France and Germany. These can use exchange rates as policy instruments and also control money supplies. These options however are becoming increasingly unpopular even in the larger economies, and are not really an option in Ireland. Small economies have little control over the money supply, and it is debatable whether exchange rate policies have a real long term effect. The converse is that due to Ireland's say in the running of a European Central Bank, it may be able to increase its monetary sovereignty through participation in EMU. There are further possible costs for Ireland in particular related to trade in the EU after EMU. It is argued that the Irish trade share will drop due to the 'Golden Triangle Effect', which basically states that due to economies of scale firms will divert production away from the periphery and into the centre of the EU with predictable consequences for Irish production. EMU offers many benefits to Europe as a whole and Ireland in many ways. First, importers and exporters will no longer encounter currency-related transaction costs, and therefore avoid bank charges. Second, exchange rate risk will be reduced, encouraging trade within the EU due to less uncertainty. Finally, a single currency should enhance competition by highlighting price differentials and help to promote the spirit of the single market.

History would seem to instruct policy in so far that many have used it to argue for Ireland to remain outside of EMU. However, this is not necessarily true. It is argued that the constant devaluations of the Irish currency against sterling would not have been necessary if the right measures could have been adopted to counter the loss of competitiveness. With devaluation not an option, measures must be taken to increase the flexibility and competitiveness of the Irish economy. The problems must be perceived, and wages and prices adjusted accordingly. This is, in fact, a strategy that is important for the whole of Europe. In Germany, for instance, Chancellor Kohl is asking for moderation in wage settlements to increase competitiveness. A recent National Economic and Social Council (NESC) report supports this, stating that "*the debate should now focus on how to manage the economy within EMU, rather than concentrating on arguments about whether or not we should join.*"[1]

"Ireland out, UK out"

To complete the jigsaw we must finally consider the alternative scenario, and ultimately return to the historical motivations described at the beginning of this essay. Assuming that the UK is going to remain outside of EMU, what are the implications if Ireland chooses to remain outside as well? Obviously, the above exchange rate problem is solved, and Irish competitiveness in comparison with Britain is assured.

There are many costs, however, which are often referred to as the 'costs of non-Europe'. These basically amount to forsaking the advantages named above, and it is here that I return to the 'precedent' of the 1930s. I propose that the stance Britain is taking now is a 'protectionist' one. The UK fears for the European economy, and is not willing to relinquish its economic sovereignty. Britain would be divorcing itself from the European market and European integration by remaining outside EMU, and Ireland would be following this lead if it remains outside also.

If we accept that history can instruct policy, then Ireland should learn from past mistakes. We looked at the 1930s, and saw that the Fianna Fail government rejected free trade then. They tried to protect Ireland from a hostile world market, believing the time was right for self sufficiency. Although the motivations were undoubtedly different, the effects of action should be much the same. If Ireland remains outside of EMU it is forsaking a process that has brought it better and freer trade in favour of a perverted form of protectionism that many label 'prudence'. The continental countries tired of Britain's 'prudence' a long time ago, and it is doubtful whether they will continue to entertain it- a 'Fortress Europe' seems much more likely. If Ireland finds itself outside of this having

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[1] *Irish Times,* 20th February 1997

bowed to the fear of exchange rate problems, it will simultaneously find itself with many difficulties regarding trade with what is now its biggest trading partner- Europe.

In the 1930s, the drive for self-sufficiency and subsequent protection of fledgling Irish industry fostered a loss of drive in the same, as there was no competition. Ireland would again be shying away from competition if it joins Britain outside of EMU. The effect of 1930's protectionism on Irish industry and economy became apparent as Ireland eventually had to adjust to the global economy in the 1950s. It is doubtful that even Britain can stay out of EMU forever if it becomes a success. If Ireland then enters late with the UK, it will face similar adjustment problems as in the 1950s. The concept of a two speed Europe is admirable, but how is the slower vehicle supposed to catch up if it is already behind? Furthermore, many large companies have hinted that British abstention from EMU would not be viewed positively, and may discourage further investment. The same could then be true for Ireland.

By taking the step and entering, even without Britain, Ireland is committing itself not necessarily to uncompetitiveness, but merely to the challenge of increasing the flexibility of Irish industry. It is also certain that the EU is willing to help with this process. Ireland, for instance, retains its low corporate tax until 2010, and it is possible that other comparative advantages can be arranged. Ireland has a well-educated, English-speaking workforce, and co-operation between employers and employees and rational appraisal of the exchange rate situation could lessen the negative effects of a further 'dealignment' with Britain.

Conclusion

We have seen that the study of economic history can be important for a number of reasons, the most important of which to a modern day economic policy maker is that history may instruct policy. Irish economic history in the twentieth century is especially valuable for this purpose, and I gave two negative example reminding us of two important topics for any country: fiscal/economic austerity and free trade, with the 'precedents' being the 1970s/1980s and the 1930s respectively.

I argue that if we are to learn from history, Ireland's policy must be to take the route that best serves free trade, and this is EMU and the single currency. It should not return to any form of protectionism- the example from the 1930s showed this, and although the conditions are different, the qualitative deduction remains the same. Ireland should not give up the opportunity of joining a collective that is greater than the sum of its parts both economically and politically for no other reason than the fear of change itself.

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