Real Convergence within the European Union:
The Case of Ireland

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1. Introduction

For many years, Ireland was something of a European outlier with living standards, as measured by GDP per capita, averaging between just 60 and 70 per cent of the EU average in the 1960s, 70s and 80s (Figure 1). It has only been in the last decade or so that Ireland attained real convergence, and this rapid catch-up has attracted a good deal of international attention. Perhaps a more interesting question is why Ireland in large part missed out on the golden period of strong economic growth in Western Europe between the late 1940s and the early 1970s. In their recent review of Ireland’s convergence experience, Honohan and Walsh (2002) equally regard the substantial gains of the last decade or so as a deferred and telescoped process compared with the more steady gains of industrialised countries generally over the past half century or so. Ireland’s historic failure in the economic field has been its poor employment performance. With this went a traditionally high rate of emigration, most of which could be regarded as involuntary.

The main lesson from the Irish experience is that there are certain key pre-requisites necessary to sustain high growth, namely, sound macroeconomic policies, a strong commitment to free trade, a lightly-regulated competitive microeconomic environment and a well-educated and flexible labour force. Furthermore, in Ireland’s case as a small open economy, conditions in the international economy have been an important influence on the pace of convergence.
In this paper, the main factors which contributed to convergence are discussed. I will present a view from a central banking perspective to complement the presentation of my colleague whose expertise is primarily a real economy one. As a prelude to this, I begin with a brief overview of issues pertinent to recent Irish economic history.

2. Background

To all intents and purposes, Ireland operated as an economic region of the UK through most of the last century. Since the establishment of the state in 1922, Ireland maintained a no margins one-for-one link with sterling with complete freedom of capital mobility. This amounted to a currency board type of regime with monetary conditions set by the hegemonial currency country. There continued to be extremely close trade, financial and factor market linkages between Ireland and the UK until recent times. Ireland seemed to meet the optimum currency area criteria that should be met in accordance with Mundell’s insights (Whitaker, 1973). This monetary regime served Ireland well, until the breakdown of the Bretton Woods arrangements in the early 1970s, which introduced major uncertainties into what the optimal monetary regime should be. The link with sterling began to be questioned in academic and policy circles during the 1970s as Ireland imported a high and volatile inflation rate from the UK as a consequence of the currency link (see Table A and figure 2). Nonetheless, faute de mieux, the monetary and exchange rate regime continued until the opportunity of joining the European Monetary System arose in 1978 with the prospect of importing lower inflation from the more inflation-averse core EU countries and of developing closer ties with continental Europe. Some commentators at the time noted the apparent
paradox that the creation of a zone of monetary stability that the EMS represented coincided with the breaking-up of an existing monetary union.

Ireland adopted predominantly protectionist and inward-looking policies until well beyond the mid-point of the last century. Notwithstanding the small domestic market, the emphasis of development policy was on promoting domestic industry behind high tariff barriers. Not surprisingly, these misconceived policies were not successful in delivering sustained economic growth and higher living standards. Employment failed to increase and, indeed, emigration for economic reasons rose to very high levels. The legacy of protectionist policies was a small and inefficient indigenous sector, which served the domestic market. The failure of protectionism and over reliance on the agricultural sector were recognised in the late 1950s and, over the course of the next two decades, the economy was progressively opened up to trade and investment. There were two key strands to the adopted “export-led” industrial policy strategy: firstly, to eliminate barriers to trade and secondly, to attract inward foreign direct investment. An industrial promotion agency was set up with the responsibility for promoting an export-oriented manufacturing sector with a special brief for attracting foreign direct investment. The new outward orientation was underlined by the abolition of corporate taxes on profits from exports. Indeed, since the 1960s to the present day, industrial policy has been geared towards attracting high-productivity export orientated foreign industries through a combination of favourable tax breaks and selective grants. At this stage, however, grants are rather limited and, in fact, Ireland ranks rather low among EU countries as far as state aids are concerned.
Economic performance from the early 1960s until the problems caused by the first oil shock in the early 1970s was quite good, certainly relative to previous experience. In the late 1970s, GDP growth averaged a very respectable 4½ per cent (Table 1). However, despite this growth, no progress was made in closing the gap in living standards between Ireland and its neighbours. At the same time, it has to be recognised that during this period substantial structural changes in the economy had to be effected with the large-scale downsizing of inefficient domestic industry and the modernisation of agriculture with attendant large employment reductions in these sectors.

### Table 1: Main Aggregates, Average Annual Percentage Change

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<tr>
<td>GNP</td>
<td>3.7</td>
<td>1.2</td>
<td>4.2</td>
<td>8.5</td>
</tr>
<tr>
<td>GDP</td>
<td>4.5</td>
<td>2.7</td>
<td>4.5</td>
<td>9.3</td>
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<tr>
<td>Inflation (CPI)</td>
<td>14.1</td>
<td>11.0</td>
<td>2.9</td>
<td>2.5</td>
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<tr>
<td>Employment</td>
<td>1.5</td>
<td>-1.1</td>
<td>1.5</td>
<td>5.3</td>
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3. **Macroeconomic Activism, 1973-1986**

Ireland pursued relatively activist macroeconomic policies over the decade and a half or so from the first oil crisis in 1973. In fact, as a consequence, the country has been something of a useful case-study in good and bad macro policies. The public has learned the hard way that the cost of pursuing imprudent policies can be very high and the truth of the old adage that there is no ‘free lunch’. In retrospect, there was a rather naïve intention to promote growth through expansionary fiscal policy and a reluctance to accept the negative real income effects of the adverse movement in the terms of trade associated with oil price increases. During most of this period, fiscal policy was strongly expansionary, with for example the current budget deficit increasing from 0.4
per cent of GDP in 1973 to 6.8 per cent in 1978. Over this period up to 1980, real GDP growth averaged 4.5 per cent per annum.

By the early 1980s, the untenable nature of these policies had become clear. The nadir was reached in 1981 when the government borrowing requirement as a percentage of GDP reached 15 per cent (Figure 3). The mounting fiscal imbalances were coupled with major external imbalances and, between 1978 and 1982, the current account deficit on the balance of payments averaged 10.8 per cent of GDP (Figure 4). With a small domestic capital market, high government borrowing levels had to be financed overseas with the result of an exploding volume of foreign debt. Consequently, the ratio of debt to GDP increased from approximately 50 per cent in the early 1970s to reach 112 per cent by 1987 (Figure 5), with approximately 90 per cent of economy wide income tax receipts being used to service the national debt at this time. Indeed, in the early 1980s, total government expenditure averaged 54 per cent of GDP (Figure 6). The critical state of the public finances is summarised in Table 2 for selected years.

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<tbody>
<tr>
<td>General Government Balance</td>
<td>-15.8</td>
<td>-12.9</td>
<td>-10.8</td>
<td>-2.2</td>
<td>-2.2</td>
<td>4.4</td>
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<td>Primary Balance</td>
<td>-10.6</td>
<td>-6.2</td>
<td>-0.3</td>
<td>6.3</td>
<td>4.1</td>
<td>5.5</td>
</tr>
<tr>
<td>Total Government Spending</td>
<td>49.6</td>
<td>52.1</td>
<td>52.4</td>
<td>39.2</td>
<td>38.4</td>
<td>29.9</td>
</tr>
<tr>
<td>National Debt</td>
<td>63.8</td>
<td>83.7</td>
<td>99.6</td>
<td>87.7</td>
<td>72.9</td>
<td>35.5</td>
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Note: Exchequer Balance used for General Government Balance figures prior to 1990

In the monetary sphere, although the Irish pound joined the EMS in 1979, there was little monetary discipline because of the large scale high-powered money financing of the government deficit. Ex ante monetary financing contributed to increases in the
money stock of the order of 30 to 40 percent in some years, although the demand for money grew by only a fraction of this. The result predictably was large scale deficits on the external current and private capital account. With such strong expansionary impulses and the effect of inertial inflation, there was little surprise that the country did not enjoy the low inflation rates of the core EMS countries that some commentators suggested would be realised soon after joining the EMS.

These undisciplined policies were having an equally adverse effect on the real economy. With the exchange rate being supported within the EMS by the proceeds of foreign borrowing, there was a significant real appreciation, notwithstanding occasional unilateral DM revaluations within the EMS. In 1983, the economy contracted in real GDP and GNP terms with Ireland’s ‘misery index’ above 24 per cent (Figure 7). Consequently, unemployment and emigration soared in the early 1980s, with the unemployment rate increasing by over 10 percentage points to average 17.4 per cent between 1979 and 1986. Growth was anaemic in contrast to more developed economies and total employment in the economy fell by 6.4 per cent over this period. What little growth there was, was accounted for by the still reasonably strong inflows of foreign direct investment. Since much of this was of a capital-intensive nature, the country experienced what became known as ‘jobless growth’.

By the mid-1980s, therefore, the economy had reached a crisis point. Although substantial efforts had been made to arrest the deterioration in the public finances, this seemed like a Sisyphean task for a number of reasons. First, while some progress was made, notably in relation to the primary deficit, a rising stock of public debt and high world interest rates associated with the skewed policy mix in the US increased debt-
servicing costs and made it difficult to make progress. Secondly, the approach to fiscal consolidation was misconceived. The emphasis was placed on increasing taxes, primarily income taxes. At the same time, unemployment and welfare payments were increased in real terms. At one point, marginal tax rates, including employee social security deductions, on average employee incomes were as high as 77 per cent. The effect on work incentives was extremely negative. This approach ran entirely contrary to what experience with successful fiscal consolidation would suggest should have been done (see Mackenzie et al., 1997, and Alesina and Perotti, 1997). This approach, together with competitive problems associated with a real exchange appreciation, weighed on the real economy and contracted the tax base. The third problem arose from the fact that too much reliance was placed on the EMS exchange rate arrangement to serve as a nominal anchor when other policies were not consistent with this. Experience shows that it can be a major policy mistake to put too much weight on the nominal anchor role of the exchange rate to stabilise the economy if this gives rise to an overvaluation of the currency. I can recollect Stanley Fischer writing many years ago that persisting with an overvalued currency was the most serious policy mistake of macroeconomic policy generally. In the early 1980s, no systematic effort was made by the Central Bank to sterilise the large high-powered money creation that flowed from the extensive foreign borrowing of Government. These high rates of money creation relative to the demand for money gave rise to substantial exchange-market pressure in the sense of Girton and Roper (1977). The exchange rate obligations of EMS membership called for substantial foreign exchange intervention by the central bank to support the currency. In a nutshell, there was a carousel effect whereby foreign borrowing by Government was used to support the exchange rate, which was under continuous pressure as a consequence of money market imbalances deriving mainly
from the monetisation of the Government deficit. Obviously, such a situation could not continue without an unstable explosion of foreign debt. The failed efforts to stabilise the economy were the subject of a study, ‘Ireland’s Failed Stabilisation’, by the late Rudi Dornbusch (1989), although, by the time of publication of his paper, there was a sharp re-orientation of fiscal policy, which put the economy back on a sustainable path.

4. Fiscal Stabilisation and Growth

By the mid-1980s, there was a wide public and political acceptance that there had to be a radical re-orientation of policy. The era of high public spending financed by large tax increases and substantial borrowing had to end. The elements of a recovery entailed:

- substantial cuts in nominal public spending,
- a tri-partite wage agreement between employers, trade unions and Government whereby low nominal wage increases were traded off against income tax reductions,
- a devaluation of 8 per cent within the EMS.

The external environment in which this adjustment took place became more benign. In particular, world interest rates eased substantially thereby reducing the large debt-service burden and secondly, economic growth picked up internationally, particularly in the UK, then and still Ireland’s largest single export market. In these circumstances, growth resumed with a recovery in both exports and domestic demand – the latter had been very subdued against the background of a deteriorating economy in the first half of the 1980s. In fact, the phenomenon of increased domestic demand in the context of highly restrictive fiscal policy became the subject of a number of studies (Giavazzi and Pagano, 1990). The sharp improvement in the public finances is evident from Figure 8.
(and previous Figures 3, 5 and 6) which shows that the primary balance as a percentage of GDP moved into surplus in 1987. From that point on through the 1990s, economic performance was very satisfactory apart from the temporary difficulties associated with the currency crisis of 1992/93. Indeed, real GDP growth averaged approximately 9 per cent from 1994 through 2000 (Figure 9 and Table 1). Employment as a lagging variable was somewhat slower to respond; there were, nonetheless, substantial employment increases (Figure 10) with over half a million people finding employment over the course of the decade (an increase of 46 per cent).

5. Increasing real and monetary integration in Europe

Ireland’s failure to converge prior to the 1990s can be attributed to a number of factors, notably the legacy of protectionism and, related to this, the relative lateness in adopting an outward economic orientation together with major macroeconomic policy errors in the decade between the mid 1970s and 1980s. At the same time, the underlying institutional preconditions were in place to facilitate the attainment of advanced country living standards.
As the country began to get to grips with the problems of the public finances in the mid-1980s, there were further concerns as the impetus to a more fully integrated EU single market and monetary union took hold. To some degree this may have reflected the pessimism of the times – in the first half of the 1980s, over half of the manufacturing jobs that existed five years earlier had been lost, although some of these had been replaced by employment flowing from foreign direct investment. The main concern was that in a single market and with a monetary union there would be a danger of a substantial divergence in economic performance between core and peripheral regions of the EU. The then Governor of the Irish Central Bank at the time stated, in a submission on regional aspects of EMU to the Delors Report, that Ireland had no intention of being left behind to become the Appalachia of Europe. In the event, the Cohesion Funds were introduced to prepare the four relatively low-income EU countries for EMU and, in particular, to facilitate further real convergence without putting pressure on the public finances.

The concern was that Ireland was not particularly well placed, both literally and metaphorically, to benefit from the completion of the single market and EMU. Unlike the industrial structure of core EU countries – Germany, France and the Benelux countries - Ireland had only a moderate degree of intra-industry trade with EU countries (Neven, 1990). Ireland was shown to have a revealed comparative advantage in natural resources (food) and high human capital-type industries. At the same time, other studies (O’Malley, 1990) showed that Ireland was relatively under-represented in sectors where economies of scale are most important, i.e., motor vehicles, other transportation, chemicals and manmade fibres. These were the sectors that could be expected to gain from scale economies as the EU became more integrated. In a relatively fragmented EU
market, however, it was scarcely surprising that, with its small market, such sectors were not very significant in Ireland. According to O’Malley’s estimates, only 40 percent of Ireland’s industrial employment was in sectors characterised by scale economies compared with 57 per cent in the EU generally at the time. Perhaps these concerns were overdone. A Krugman-Venables (1990) analysis would suggest, by contrast, that peripheral low-cost countries could stand to gain from a fully integrated market. In this environment, such countries could benefit as industries sought to establish in low-cost countries from which they could supply the entire market. These factors would be reinforced in so far as trade in more knowledge-intensive lighter products became more important (Krugman, 1997). In such a world, transportation costs became less relevant in industrial location decisions, given the rapid expansion in traded services and higher ‘value to weight’ trade in manufactures. An important related factor was that, in these circumstances, comparative advantage can take on a dynamic character. It need no longer be immutably tied closely to endowments in the old Hecksher-Ohlin sense. Investment in human capital and innovation could alter a country’s comparative advantage.

6. Achieving Real Convergence

The reorientation of macroeconomic policy in 1987 and the favourable international economic environment provided the basis for resumed economic growth after the traumas of the earlier period. Performance improved from 1987 and a period of exceptionally strong growth followed from 1994 until 2000 (see Figure 9 and Table 1). Various studies have tried to uncover the reasons for the boom. Perhaps the most authoritative of these are those of the OECD (1999) and Honohan and Walsh (op. cit.). The conclusions of these are that there is no single overriding explanation for this
transformation. Having learned from the unhappy experience of earlier fiscal excesses and the great difficulties encountered in trying to redress these, fiscal policy was put on a sound footing. This commitment was underpinned by the need to meet the nominal convergence criteria of the Maastricht Treaty if Ireland were to qualify for EMU. On the monetary front, following the 8 per cent devaluation of August 1986, the Irish pound continued to participate in the narrow-band EMS. This served to anchor inflation and inflation expectations supported by the modest nominal pay increases agreed as part of the social partnership arrangements. As stated earlier, these low pay increases were accepted in the context of a programme to reduce the very high rates of personal taxation that had arisen over previous years as the government struggled to reduce the borrowing requirement.

The second key policy element post-1987 was the pursuit of a process of structural reform and, in particular, tax reform. To some extent, this was driven by the deregulation process in the UK. As long as Ireland’s labour market remained closely tied to that of the UK, it was clear that policies would have to take account of policy changes being made in the UK.

A growth-accounting decomposition of output into its supply-side factors shows that it was the very substantial increase in labour inputs that explains the upturn in performance (see figure 11 and Table 3). Just as Krugman showed in relation to the earlier Asian miracle, there was no revolution in productivity performance. Increased labour supply was available from a relatively large inactive proportion of the population, a low female participation rate, a large pool of unemployed – still 16 per cent in 1993 – and a significant amount of underemployment in agriculture, an elastic
supply of labour given the large movements of labour between Ireland and the UK, and a relatively strong natural increase in the labour force. In addition, with increased emphasis on education since the late 1960s and active labour market policies, the average quality of labour was rising substantially. Disincentives in the labour market were improved – substantially on the supply side, less so on the demand side where taxes and social security contributions were, in any event, quite low by European standards. Since then, Ireland has generally opted for a light degree of regulation of labour and product markets with the object of promoting well-functioning, flexible markets. This has stood the country in good stead over the past decade or more in coping with various vicissitudes.

<table>
<thead>
<tr>
<th>Table 3: Contributions to Output Growth, GDP Based</th>
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<tbody>
<tr>
<td>Labour</td>
</tr>
<tr>
<td>Capital</td>
</tr>
<tr>
<td>Total Factor Productivity</td>
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<tr>
<td>Total</td>
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During the boom period, the country’s employment rate increased from a little over 50 per cent to over 67 per cent, above the EU average; employment itself increased by over 50 per cent. A notable feature was that over three quarters of this increase was accounted by the services sector (figure 12). The construction sector also accounted for a significant part of the increase. There was a modest increase in industrial employment.
with a fall in the number employed in agriculture. The market services sector in Ireland had long been poorly developed, a point often made by EU Commission commentaries on the Irish economy. A number of factors contributed to this expansion of the services sector. On the supply side, a more strongly pro-business environment was promoted; regulatory reform was progressed and corporate profits tax on services was progressively reduced from a level of 50 per cent to that of industrial companies – 12½ per cent. The Physiocratic philosophy that previously favoured industry had to be altered to ensure a uniform tax treatment of corporate profits for all enterprises on foot of EU legal requirements. On the demand side, higher incomes and a recovery of domestic demand generally from its very depressed levels until the mid-1980s were associated with a rising demand for services. The strong flows of inward direct investment also contributed to this.

Commentators usually attribute an important role to foreign direct investment in this catching-up process. The OECD (1999), for example, regards FDI as the most significant factor in explaining the boom. Over the years, FDI has undoubtedly brought many benefits. It enabled Ireland to pass relatively seamlessly from a largely agrarian economy to a fairly modern high-technology economy without going through a heavy industry phase that most advanced countries had to do. It facilitated the efficient transfer of technology and managerial skills. It also removed what otherwise might have been balance-of-payments constraints, as FDI firms were almost exclusively oriented to supplying export markets. Individually, these firms were generally very large employers by Irish standards and, for this reason, their importance in the economy may have been somewhat overstated. Currently, foreign-owned industrial and service firms employ
about 10 per cent of the labour force, although they do account for over half of industrial employment.

Coming from a central bank, I should say something about the experience with monetary/exchange rate policy during this catch-up period. While the Irish pound participated in the EMS since the outset and this provided a nominal anchor, the markets and the authorities remained conscious of the importance of sterling, given the still important trade and financial links with the UK. Whenever sterling depreciated sharply against EMS currencies, pressure was seen on the Irish pound. In fact, the two substantial devaluations of the currency within the EMS – in August 1986 and in January 1993 - occurred following substantial depreciations of sterling. Financial market analysts talked of the Irish pound riding two horses – the EMS and sterling. Indeed, the government-commissioned study of whether or not Ireland should join EMU revolved around whether the potential benefits of joining EMU outweighed the possible costs that might arise from having to deal with possibly wide variations in the sterling-euro exchange. The study concluded that the balance of the argument favoured participation in EMU.

A second monetary issue that arose during this catch-up phase related to overheating pressures that emerged in the run-in to EMU. The Central Bank considered that it would be appropriate to try to maintain relatively high short-term interest rates even though the market was aware that these would be identical to euro area wide rates at or even before
the inception of EMU. It is unclear whether these efforts had any material effect on behaviour, but it was felt that, at the margin, it was worthwhile taking this restrictive approach.

7. Current Issues

As a consequence of this very strong economic performance over the 1994 to 2000 period, Ireland had closed the gap in employment rates and living standards with the more advanced EU countries that had eluded us for so long. Full employment was reached and, in contrast to earlier decades, there was substantial net inward migration on the part of both Irish people who had emigrated in more straitened times and of those with no previous connection with the country. These major gains have been retained in the more difficult economic conditions of the past few years. As a very open economy, export performance has inevitably weakened and the relatively large ICT sector, which prior to the international shock to that sector accounted for about a quarter of total manufacturing employment, suffered a significant contraction. Nonetheless, the economy has shown a remarkable resilience. This is so, in particular, for the labour market with the unemployment rate still at only 4.5 per cent. This is attributed, in turn, to the flexibility of the labour market in regard to both remuneration and working time arrangements in the face of more difficult times.

Towards the end of the catch-up phase around 2000, significant domestic inflationary pressures began to become evident. This occurred in the context of an economy operating at more than full employment and accommodating monetary policy conditions. Not only were market interest rates negative in real terms (figure 13), but the
weakness of the euro against both the US dollar and sterling imparted a further boost to Irish exporters. Monetary conditions, therefore, facing Ireland were particularly easy. Various estimates suggested that, on the basis of a Taylor rule, for example, interest rates should have been 3 to 4 percentage points higher. In addition, with the government’s coffers overflowing with buoyant tax revenues, fiscal policy tended to be pro-cyclical. While Balassa-Samuelson effects were also at work, this can explain only part of the inflation excess over the euro area generally.

An important aspect of these capacity constraints has been the pressure on infrastructure. The rapidity of the convergence process meant that public infrastructure - transport infrastructure in particular - lagged behind what was required. Other developed countries, for the most part, would have modernised their infrastructure over a much longer time-span against the background of a much more gradual development of their economies. A related issue has been the extremely large rise in property prices. Between 1994 and 2000, house prices rose by 133 per cent, an annual compound increase of 15 per cent. This has been an on-going concern to the financial supervisory authorities. While fundamental factors such as much higher real incomes, basic demographics and employment, together with the regime change to a much lower interest rate environment in EMU, were at work, there remain concerns that prices may have overshot their fundamental values. There is also the possibility that fundamental factors themselves could be vulnerable to extraneous events. Technical studies are inconclusive as to whether or not there is a bubble in current property prices.

8. Conclusion
The Irish economy developed rapidly during the 1990s and the country finally attained the employment rates and living standards of other industrialised countries. Although a small economy, Ireland was relatively late in adopting outward-looking policies that are now seen as an indispensable prerequisite for development; joining the EU in 1973 was the most important milestone in this respect.

The institutional preconditions for real convergence existed, but its achievement was delayed by policy errors of both a macroeconomic and microeconomic kind (Honohan and Walsh, op. cit.). The pursuit of stability-oriented macroeconomic policies and more liberal microeconomic policies, including tax-benefit reform, laid the groundwork for economic advancement from the mid-1980s on. The take-off was greatly assisted by benign international conditions. An important slow-burning factor has been the greatly increased resources devoted to education. Although job opportunities were relatively scarce for this more highly educated workforce for some time, they were quickly absorbed into the more knowledge-intensive modern sectors as these expanded as a result of large inflows of foreign direct investment and increased domestic demand. Modest increases in pay, part of a social partnership agreement between employers, unions and government, were an important factor in facilitating increased employment over much of this period.

The very substantial gains made during the catch-up phase have been retained in the present more difficult economic environment. Not surprisingly perhaps, very strong growth in this phase has created pressure on the country’s infrastructure and greatly pushed up property prices. Foreign direct investment inflows are unlikely to continue on the scale of recent years; with full employment, these could not easily be absorbed in
any event. With Ireland no longer being a low-cost economy, there is some concern going forward that there may be some difficulty in retaining a reasonable flow of this investment. More than most small countries, Ireland has an unusually large high-technology industrial structure, the greater part of which is owned by foreign multinational companies. It remains to be seen whether the economy will be sufficiently robust and adaptable to cope in more difficult times. The resilience seen so far in the face of tougher times would lead one to be quietly optimistic in this respect.
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