TWO RECESSIONS AND A BOOM: WHERE NEXT FOR IRELAND?

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Introduction

While Ireland experienced a boom decade from the mid-1990s through to the middle of the 2000s, this experience has frequently been misunderstood both by Irish and by foreign observers. To foreigners looking in this seemed like an economic miracle and, until recently, many people abroad sought to discover the Irish elixir of eternal growth. At the same time, many Irish people came to feel that economic success was preordained and that Ireland was invincible. Now everyone knows that the façade hid significant problems, at least since the early years of the new century. However, the period of rapid growth was no mirage. It still leaves Ireland a much more prosperous country. It has also contributed to a much wider transformation of the country, which is both reflected in social and cultural change and also affected by that change itself. While all the other papers at this conference are considering the wider cultural links between Ireland and its neighbours, I want to concentrate on the economic changes that have taken place.

In this paper I want to show that the successful decade of 1995-2005 can best be seen as the belated reward for abandonment of failed economic policies which had been pursued with remarkable consistency since the foundation of the state in 1922. What should be seen as most interesting about the Irish economic experience was not that Ireland succeeded but rather how it had managed to continue failing for so long.

The hubris that grew out of the successful decade contributed hugely to the current economic crisis. Like Icarus, Ireland flew too close to the sun and its wings melted. The fact that Daedalus had warned of the dangers does not make the subsequent crash any more comfortable.

In the final part of this paper I want to consider the future. While many in Ireland have switched with amazing rapidity from hubris to despair, I want to argue that Ireland still has a future. The current problems will pass, albeit leaving a lot of wreckage and pain. I want to end this paper by considering some of the key challenges facing the economy over the next decade.

In 2000, having talked about the performance of the Irish economy at a conference organised by the Australian ambassador in Ireland, I was asked by the Tasmanian Prime Minister what role Irish music had in the Irish success story. While this question floored me at the time, it was actually very perceptive. In considering recent Irish economic history it would be a mistake to concentrate solely on numbers and statistics: after all, the economy is made up of people not numbers. The economic successes and failures of the last two decades or so were mirrored in the field of social policy and cultural development. These cultural and social changes, in turn, helped mould a very different Ireland. To understand the changes that have taken place in Ireland one must look further afield: hence the importance of many of the areas being discussed at this conference.

Belated Success

There were two policies of the Irish state which were pursued with greater or lesser vigour over the half century 1920 to 1970, almost guaranteeing economic failure. The first of these was the Sinn Féin economic policy – 'ourselves alone.' The objective was to develop a self-sufficient economy behind high tariff barriers. This approach to economic policy had its mirror image in aspects of cultural policy, such as censorship of literature and films: keep out alien influences. The second policy disaster was the failure to invest major state resources in education, in particular the failure to invest in second level education. Finally, a rather different demographic structure from the rest of the EU has also affected the pattern of growth in the last twenty years or so. This latter difference owes less to deliberate policy than to a combination of cultural, economic, and social forces. It is also something that is not easily reproducible in other European societies, but it did contribute to Ireland's more recent success and it will continue to mould the development of Irish society into the distant future.

Opening Up

From independence in 1922 till the early years of the 1960s, a Sinn Féin ('ourselves alone') economic policy was pursued keeping the economy closed to the outside world. After the nightmare of the Second World War, the rest of Western Europe woke up and embraced economic co-operation and free trade. Ireland continued to slumber in its old ways for a further two decades.

From fruit and vegetables to cars and shoe laces, the objective was to produce everything at home. When I began my career as an economist in 1972 car imports came in two categories: the smaller category was FBU ("fully built up") and the larger was CKD ("completely knocked down"). Basically, cars were built in the UK or France and then taken to pieces for reassembly in Ireland. With the advent of EU membership in January 1973, the CKDs disappeared to be replaced with a normal market which delivered much cheaper and better quality cars to the Irish consumer.

I first came across fresh peaches in the late 1960s, because, of course, they were not easily grown in Ireland and hence off the menu. This regime encouraged very inefficient domestic firms, firms that had no hope of exporting or surviving in a global economy. With massive tariff barriers it was a 'stable equilibrium' leaving Ireland at a very low standard of living.

Having been one of the richer countries in the broader Europe at independence in 1922, Ireland continued to sink down the rankings in the years following the Second World War. By focusing only on the UK, Irish policy makers saw Ireland as being relatively poor in 1922, whereas it was richer than many other European countries at the time. It also meant that Ireland's poor post-war performance was continually compared to one of Europe's economic failures rather than to the much larger number of relevant successes.

More than anything else it was Ireland's entry into the EU in 1973 and its access to the wider EU market that helped transform the economy. Ireland embraced globalisation in an unusual way and Ireland benefited from it. A key part of the strategy was the adoption of a low tax rate. However, this was not the only selling point. An efficient, transparent bureaucracy and consistency in policy-making showed foreign firms that when they bought into Ireland there were no surprises. It seemed like a good deal and proved to be such for many firms. The initial thrust of policy was to encourage foreign investment, and this has resulted in an economy that has a high level of foreign ownership. This was not the only model open to Ireland – Denmark and Finland showed rather different approaches but with similar outcomes. However, the Irish approach worked with Foreign Direct Investment (FDI) bringing new skills and certain access to new markets. Initially, there were fears that Ireland would be exploited by these foreign firms. However, the partnership clearly proved good for both parties.

The advent of the EU single market in 1992 proved particularly good for Ireland. Foreign firms supplying EU government markets had previously been disadvantaged. However, with equal access to such markets, firms supplying health-care products (equipment and pharmaceuticals), telecoms, and other products where governments were major buyers were able to set up in Ireland, having equal access to public markets throughout the EU.

The EU structural funds obviously proved beneficial. However, they were a relatively minor part of the story. More important than the money itself was the discipline the EU structural funds process imposed on Irish public investment. With most major projects part-funded by the EU over the course of the 1990s this meant that the Irish government had to answer to the EU for how it had spent the EU money. Like the good steward in the Gospels, it did a good job and was rewarded with more funds. However, with the disappearance of EU funding in this decade Irish governments showed less concern to get good value for money from how they spent their own taxpayers' funds than it had for how it had spent EU funds. This decline in the standards of oversight of public investment has been a contributory factor in the current economic crisis.

EU membership also had a much wider social and political effect opening up Irish society to the beneficial impact of new ideas from abroad. When Ireland became independent in 1922, the new Department of Finance borrowed a number of civil servants from the Treasury in London to help get the show on the road. While this was seen as a temporary expedient, some of the specialists went 'native' remaining on in Dublin for the rest of their careers. This set the tone for the subsequent fifty years of public administration. Ireland continued to rely on the UK for examples of best administrative practice and for unofficial guidance on how to run an economy.

When I joined the Department of Finance in 1972, one of my first jobs was to put away files dealing with Ireland's external economic relations. These papers covered visits to London in the mid-1960s to negotiate the Anglo-Irish Free Trade Agreement and subsequent missions to seek improved access to the UK market. They also covered advice from UK academics on how to develop the Irish economy. Having filed these papers in the basement of government buildings, they were never again sent for.

From the end of 1972, with the advent of Ireland's membership of the then European Economic Community (EEC), all new files registered on external economic issues related to EU committees and business. This change in focus was dramatic for public servants involved in policy-making. In the previous half century the height of a public servant's expectations had been to travel to London to see how things were done. EU membership moved the same individuals onto a European stage. This entry into the EU meant that many of the policy issues that had been dealt with in Dublin, or more likely not dealt with in Dublin, were for the future resolved as part of the decision-making process in Brussels. This exposed all concerned to a much broader range of administrative and policy-making experience.

EU membership represented a profound cultural change, not only for public servants, but across the broad policy-making community. The injection of new ideas played a vital role in changing both the policy-making process and the nature of the economic and social policies actually pursued. As well as in the obvious economic areas, EU membership drove change across the broad spectrum of social and environmental policy, including the equality agenda. For example, the marriage bar, which had forced all female civil servants, including my wife, to resign on marriage, was abolished from July 1973 because of the EU, ten months too late for us. EU legislation over the course of the 1970s continued to force change in the treatment of women, especially in the labour market. Some degree of equality would probably have arrived eventually, but the EU forced a decisive change in a short period of time.

Initially, the change in the policy-making process affected public servants and politicians. However, the ripples from the new regime spread much more widely than the public service. The social partners, trade unions and employers, suddenly found themselves participating in EU-wide discussions. They learned that there were different models of behaviour from the traditional UK model of endless industrial relations conflict. Many a Friday night representatives of the social partners found themselves in Brussels airport waiting for the delayed flight to Dublin. They had no choice but to socialise and discuss informally a wide range of issues, not just the issues that divided them. The bar in Brussels airport played its role in the developing momentum towards a more consensual approach to policy-making that is now referred to as the "partnership process."

Looking back on almost 40 years of EU membership, it is clear that Ireland was generally successful in protecting what it perceived at the time as its key economic interests through directly influencing the policy-making process in Brussels. Throughout the period Ireland's interest in developing free trade and ensuring access to the EU, and ultimately to the world market, has fitted well with the key focus of EU policy. In the first decade of membership Ireland's vital national economic interest was construed as the promotion of agriculture. To win support for Ireland's position civil servants and politicians had to build support within the EU through coalition-building. For example, success on the EU milk super levy was dependent on mobilising those interested in olive oil and citrus fruit policy – new areas of interest for Irish public servants. The successful achievement of the broad policy goal on agriculture saw a dramatic improvement in farmers' incomes.

As agriculture's share of the economy fell, the focus of policy shifted next to the development of the structural funds process. Ireland's objective in the late 1980s was to maximise the EU budget and to attract as large a share as possible of the structural funds. This injection of EU funds was used to invest in Irish infrastructure, including education and training. Once again a successful coalition was built, and the policy objective was successfully achieved in the 1990s.

Since the late 1990s the focus of attention has switched instead to the protection of Ireland's low rate of corporation tax. Compared to the previous policy agenda this is a more difficult objective to defend as Ireland has fewer allies than in the past. While remaining important for Ireland, in the longer term, it will be desirable to pursue broader objectives than just tax independence if Ireland is to attract the necessary broad support for its interests within the EU in the future. A tax policy is no substitute for an economic strategy, and there is some danger that the costs of protecting the tax regime will continue to distract from the need to develop a more broadly based and economically sustainable long-term economic strategy within the EU context.

However, Ireland has been less successful in developing its independent voice in areas of EU competence that require a broad range of administrative and technical backup. For example, in the environmental sphere Ireland has been content to follow the EU lead instead of trying to shape policy at the EU level in a manner that would directly benefit the environment and the wider EU economy. In the case of macroeconomics, no Irish presidency has been able, or even felt inclined, to launch a significant initiative. To do so would require a broader knowledge of the other economies of the EU than is available to a small administration. Instead, reliance has been placed on the EU Commission to undertake this task. The difficulties in launching a credible EU-wide initiative are common to all small countries who have limited administrative resources. Nonetheless, when faced in 1996 with the initiative on the

Stability and Growth Pact, the Irish administration proved adept in negotiating a successful conclusion during its presidency.

While Irish diplomats have been successful networkers in the EU, this has not been the case for many other government departments. Irish problems in tackling its banking system might have been reduced in the autumn of 2008 if civil servants from the Department of Finance had drunk more beers with EU colleagues in recent years.

A Multicultural Economy

The significance of emigration in Ireland, both as a social and an economic phenomenon, has been reflected frequently in literature and economic and social policy over the last century. Up to the 1930s the American wake was still a feature of Irish life; the family mourned the emigration of one of their children who would probably never be seen again. However, even in the 1930s the nature of the grief expressed at the wake was changing as the emigrants went to England and Scotland rather than to the United States. Even if they would never live in Ireland, they would, in all probability, be seen again on occasional holidays or at funerals. The attitude of the emigrants was also changing. The contrast in the 1950s between the burgeoning economies of Germany and France and the economic depression of an Ireland where they could not find jobs left them bewildered and angry. This anger and bewilderment was reflected in the literature of the time, for example in the works of Brendan Behan and Edna O'Brien. Whereas in earlier generations emigration was accepted as the natural course for many young people, in a post-war Europe that was thriving it was increasingly seen as a symptom of failure by the Irish State.

Since the 1950s, the experience of emigration has changed greatly. Today emigration is still part of the experience of up to a third of each generation (and of every family), but the difference is that the emigrants of today are seen more as homing pigeons rather than the 'wild geese' of the past. The 'best and the brightest' may still emigrate but the expectation and experience suggest that the bulk of them will return. This is a very different situation from the first fifty years of independence.

In the 1980s, high unemployment rates in Ireland, when compared to other labour markets that Irish people had access to, encouraged many people to emigrate. The bulk of those who emigrated were young and better educated than the typical emigrants of the past, leading to fears of a 'brain drain.' However, these latter emigrants proved to be 'homing pigeons.' They brought back skills, experience, even languages with them. Their productivity and earnings have been raised by 10% through their experience abroad. This has been added to by the immigration of skilled labour. It has interacted in an important way with the FDI.

Ireland in the 1950s was a boring place. Censorship stopped 'bad' books from entering. People left and never came back. Nearly everyone spoke English, was Catholic, and the policy-making elite was tiny, and everyone knew everyone else. Even down to the dominant blood group – O – which showed how little influx of new people there had been in previous millennia.

In the first half of the 1990s there was little net migration, as employment prospects abroad deteriorated relative to Ireland. In the second half of the 1990s, strong economic growth and a tighter labour market encouraged inflows into the country, and net immigration contributed around 0.75 percentage points to growth in the labour supply, about half of whom were foreign nationals. The majority of immigrants, Irish or foreign, over this period were highly skilled. From 2000 to 2008, there was a significant level of immigration of unskilled labour. Nonetheless, the Irish experience of immigration has been very different from the rest of the EU with foreign immigrants being substantially better educated than even the reasonably well educated Irish population.

For Irish and foreign firms alike, a significant part of their success has been that they have been able to attract skilled labour from abroad. Initially, this labour was largely Irish emigrants returning. However, the stock of Irish emigrants began to run out over the course of the 1990s and there has been a major influx of skilled labour into nearly all areas of economic activity. In the early 1990s no German or Italian would have come to work in Dublin for an organisation such as the one I work for. However, over the last decade we have been able to attract very skilled staff from around Europe, greatly enhancing our ability to undertake high-quality research. For a century and a half, many in the Irish population sought, and were granted, access to the best labour markets in the world. Over the 1990s this process was reversed and Ireland was transformed into a sought-after location for foreign migrants. The bulk of the immigration into Ireland over the 1990s was skilled labour, about half being returning Irish emigrants; the majority of the rest were EU citizens with a high level of education. Many of those coming to Ireland were spouses or partners of Irish citizens.

This influx of skilled labour played an important role in expanding the productive capacity of the economy, allowing the economy to grow more rapidly and helping to solve the problem of long-term unemployment (Barrett, FitzGerald & Nolan). In addition, it has been shown that returned emigrants have higher productivity and higher earnings because of their experience abroad (Barrett & O'Connell). With almost a third of the younger cohorts being returned emigrants, this effect on individual productivity is affecting the economy as a whole. This improved the welfare of the least skilled in the labour force at the expense of lower wages for skilled labour. The immigration had wider benefits, making the economy more cosmopolitan and increasing productivity.

A final aspect of the migration story that has not yet been properly documented is the extent of the integration of foreigners into Irish society. The 2006 Census shows that 15% of all children aged between 0 and 5 had one parent who was Irish and one who was not Irish. Related to this, the Census also showed that quite a high proportion of foreigners had Irish spouses or partners. This would be particularly true for Germans and British citizens. However, it was true for 7% of Chinese women.

This relatively high level of integration and its social significance needs further study. It probably reflects the high level of educational attainment of immigrants. It probably also reflects the fact that so many Irish emigrate in their twenties, managing to capture foreign spouses and persuading them to come to Ireland. Romance may be a more effective way to capture skilled labour than recruitment drives by companies.

Education

While Northern Europe from the Urals in Russia to Snowdonia in Wales invested in education in the aftermath of the Second World War, Ireland waited till 1967. This delay of a quarter of a century proved very damaging. It locked Ireland into low-quality, low-productivity areas of investment.

Realisation that this was a disaster crept in gradually. Free second-level education from 1967 began the reform. However, over the course of the 1980s and the 1990s major investment took place raising the completion rate for high school to 80% and participation in third level to over 50%. This was reflected in a transformation in the labour force with new skilled high-paid, high-productivity jobs gradually replacing unskilled low-paid employment.

From the mid-1980s, public policy targeted those leaving school with no qualifications as a major problem area. Moving them to minimal qualifications and eventually to high-school graduation has been very important in making them employable and productive, not to speak of the wider social effects. In addition, there was a massive increase in investment in third-level education in the 1990s – now over half of all girls go on to third level, though substantially fewer boys.

Ireland has not been alone in stepping up investment in education. The UK, Spain, and Portugal have also done so. While the UK and Spain are also benefiting from this investment, Portugal is starting from so far behind that it needs further major change.

In most countries, such as Ireland, the returns to education (in terms of higher individual earnings) have held up or increased in spite of the rapid increase in labour supply. This highlights the fact that the world demand for skilled labour is also rising rapidly.

Demographics

It is true that the Irish economy faced a very fortunate set of demographic circumstances over the last fifteen years and will continue to do so for the coming fifteen years. Together these circumstances will conspire to give Ireland one of the lowest rates of economic dependency in the OECD area. The benefits of past investment in education will also continue to produce a significant boost to productivity for some time to come. In addition, the economy, including the labour market, shows considerable flexibility.

The demographic dividend is not a product of policy, but rather of the private decisions made by parents. Having had a very high birth rate over the first eighty years of the twentieth century, babies went out of fashion in Ireland in 1980, and the birth rate declined steeply over the following decade. In the last few years it has risen again, largely reflecting the large number of women in their late twenties and early thirties. There are also very few old people in Ireland today, because so many emigrated in the 1930s, 1940s, and 1950s. As a result, there are a huge number of 25-to-35-year-olds relative to the other cohorts in the population. After that cohort, there are very much fewer children in the younger cohorts until the 0 to 5s. The result of this population structure will be an exceptionally favourable demographic situation for the next twenty years – a very high proportion of the population in the working-age groups and very few dependents.

Female labour force participation was very low in Ireland in 1980. As women were generally better educated than men this represented an untapped pool of skills. Cultural change and economic forces have seen a dramatic change since the mid-1980s. Female labour force participation is now higher than the EU average for those under thirty. This factor (rising participation) added at least 1% a year to the growth rate in the boom years. However, since 2000 Ireland began 'to run out of women' – with most women with a good education already in the labour force there were no reserves waiting to be attracted back into the labour market. Instead, numbers of skilled labour were made up by immigration.

With women representing almost 60% of university graduates and with a very large number of women in their late twenties in Ireland, there are going to be major pressures for social and economic change. If employers want to hold on to their skilled labour there will have to be changes in the way labour is organised to allow skilled employees to both continue to work in the paid-labour market and to bring up children. With limited provision of child care under the age of four this is going to be a big policy issue in the coming decade.

Ignorance and the First Bust

In the late 1970s a new government came to power promising to implement a wide-ranging policy programme. As part of this programme, from 1977 onwards they planned to borrow and stimulate the economy. They assumed that the supply side would respond, that the propensity to import would fall and that wage inflation would be reduced through an adoption of moderation by the population. While they delivered on the first promise, increasing borrowing, the rest of the promised measures over which governments have no control headed in the opposite direction. The tightening of the labour market saw an increase in real wages, a dramatic increase in imports, and a very limited supply side response.

The dangers of this policy were pointed out in April 1978 by a prominent economist early in the programme.[1] However, the government pursued the implementation of its promises with undue vigour, raising the debt but not raising the underlying productive potential of the economy.

The result of this was that when recession hit the world economy in the early 1980s, greatly magnifying the problems of the Irish economy, the next government in 1981 found itself with a huge debt and an even bigger borrowing requirement. In turn, the interest bill on that debt also climbed with the increased riskiness of lending to the Irish government.

Over the rest of the decade there was a slow and painful response to this crisis. While the 1983 budget was one of the most painful of the previous twenty-five years, it did not do enough. Also the focus of fiscal action was on raising taxation and cutting capital-spending. Over the subsequent years a generally deflationary fiscal policy was followed, it slowed but did not reverse the problems with the national debt. By 1986, our research suggested that this slow and painful approach to fiscal retrenchment would eventually restore the economy to a normal growth path. However, it looked like being the end of the decade before the economy would turn the corner.

A new government in 1987 decided to hasten the process and it concentrated on cutting current expenditure. The combination of more vigorous (though painful) action and a bit of luck with an upturn in the world economy meant that by 1989 the public finance crisis had largely been addressed. In that year there were signs of a return to vigorous growth.

The advent of German unification and the resulting fiscal expansion in Germany raised interest rates for all members of the EMS. For Ireland it resulted in a further postponement of the return to vigorous growth. However, the conditions remained favourable and when EU monetary policy was relaxed, the Celtic Tiger took off properly in 1994.

One of the key lessons to be drawn from the painful decade of the 1980s was that when faced with a fiscal crisis it is better to act vigorously rather than to postpone the pain. In tackling such a crisis it is also important to cut current expenditure rather than to rely solely on increasing taxation. These lessons have relevance for the Irish economy today. To date, it appears as if the lesson about acting quickly has been learned by the government. However, it remains to be seen whether they can carry through on it in the budget for 2010. The fact that this time round the crisis is not confined to Ireland but is EU-wide greatly complicates its resolution.

1 Paddy Geary, then of UCD, later head of the economics department in NUI Maynooth. He published his analysis in the magazine *Magill*.

It took a lot of pain and most of a decade to restore order after the very serious policy errors of the late 1970s and the early 1980s. This delayed the realisation of the benefits of EU membership till the 1990s – twenty years after membership. Many of the benefits of EU membership could and should have been reaped a decade earlier, though the investment in human capital was not yet ready.

Hubris

After a decade of generally high growth and low unemployment there was a growing feeling among households and companies that the Irish economy was invincible. Even the short slowdown of 2001-03 did not lead to an appreciable rise in unemployment and, as a consequence, it did not significantly dent confidence in the future. The hubris was particularly reflected in the massive investment in housing. At its peak in 2006, housing investment accounted for around 14% of the economy, fuelling growth in other sectors. The building sector bubble was like a cancer, squeezing out those parts of the economy that exported. To get the resources that it needed the building sector bid up costs, especially wages, which crowded out the rest of the economy. As a result, it now needs drastic surgery to restore balance to the economy.

The unemployment rate was close to the full-employment level between 2000 and 2007, and Ireland was seen to be the most attractive labour market in Europe for many of the mobile young population.

The pattern of behaviour by households reflected a high degree of certainty about the future. The level of gross (and net) household debt rose rapidly; households had confidence that they would be able to service this in the future. Many companies also appeared to be sanguine about the future. This was reflected in very substantial increases in employment. While some firms, especially in the tradable manufacturing sector, were facing difficulties, their woes were masked by the feeling of bonhomie elsewhere in the business sector, especially in all those businesses that depended on the building sector for their success.

While the underlying structure of the economy evolved in a manner that should be favourable to future growth, there were considerable dangers in the situation. In particular, the extremely high level of dependence on the continuing success of the building industry should have been a serious cause for concern. This was compounded by the certainty with which many in the household sector viewed the future prospects for growth.

When Odysseus undertook his long voyage home from Troy, he encountered many dangers. Not least were the distractions that the Lotus-eaters provided for his crew: "They [...] went about among the Lotus-eaters, who did them no hurt, but gave them to eat of the lotus, which was so delicious that those who ate of it left off caring about home" (Homer, Book IX, ll. 83-104).

The lure of good times with the Lotus-eaters nearly derailed the voyage and tough measures had to be taken by Odysseus to get the crew back on board: “I forced them back to the ships and made them fast under the benches. [...] [S]o they took their places and smote the grey sea with their oars” (Homer, Book IX, ll. 83-104).

Today the task of the Irish government is like that of Odysseus – the population will have to go back to the oars in a very unpleasant sea! Whether the crew will mutiny and fire Odysseus remains to be seen.

The Current Crisis – The Second Bust

The Irish economy enjoyed an exceptional period of sustained growth from 1994 through to the early years of the new century. This growth was driven by the expansion in world trade and the very competitive nature of the Irish economy. The result was a rapid increase in world market share for Irish exports at a time when world trade was also rising fast. This produced a rapid but sustainable growth in Irish output and living standards.

By the late 1990s, as unemployment fell to historically low levels, the economy found itself approaching capacity output. Substantial immigration helped relieve labour market pressures (Barrett, FitzGerald & Nolan), but it was clear that growth could not continue at the same rate indefinitely. The natural mechanism to slow the economy was a real appreciation of the currency. In the absence of an independent exchange rate this had to take place through a loss of competitiveness as wage rates and other prices rose more rapidly than in the rest of the Euro Area. Managing this real appreciation through differential inflation was never going to be easy without overshooting. It would have been better, as argued by the EU Commission and the ESRI in 2001 (Conefrey & FitzGerald), if fiscal policy had been tightened to slow the process.

However, the bursting of the dotcom bubble did slow the world economy and hence the Irish economy. This slowdown was less severe than had been initially expected and it effectively provided some breathing room for the Irish economy.

Its particular demographic structure meant that Ireland entered the boom period under-endowed with infrastructure in the form of dwellings. The numbers of adults per dwelling was substantially higher than in the other EU member states (with the exception of Spain). The rapid rise in incomes together with the increased availability of low-cost finance as a consequence of EMU membership and the globalisation of the financial sector resulted in a boom in the building and construction sector. In its early stages this rapid expansion in house building was both sustainable and desirable: people wanted and could afford dwellings. However, from 2003 onwards the housing boom entered a phase that was unsustainable, constituting a growing ‘bubble.’ In contrast to the earlier years when growth was driven by exports, the housing boom drove economic growth over the following years so that the level of actual output rose well above the potential of the economy to deliver in a sustainable manner.

Work by myself and colleagues in 2001 recommended that the tax system be used to prevent the development of a housing bubble. Again in 2003 in the *Medium-Term Review: 2003-2010* we warned of the need for policy action to prevent over-heating in the property sector of the economy (Bergin et al. 84-85). This refrain was repeated in many subsequent reports. The effect of the massive expansion in the building and construction sector was the crowding out of the tradable sector of the economy (FitzGerald & Morgenroth). Wage rates were driven up across the economy by the rapid growth in labour demand in the building and construction sector and, as a consequence, firms that were dependent on export markets suffered. In effect, the building and construction sector 'crowded out' the rest of the economy, especially the tradable sector.

This domestic imbalance as a result of the building and construction boom began to be reflected in the balance of payments. Having run a surplus on the current account over the export-led boom years, a growing deficit emerged. The combination of EMU membership and the globalisation of financial markets meant there was less concern about such a phenomenon than there would have been in the past. It was seen as being easily financeable. To finance the housing boom the banking sector borrowed extensively abroad so that the net foreign liabilities of the banking system rose from a low of 10% of GNP in 2003 to over 60% of GNP by 2007.

The boom in the building and construction sector was only made possible through the availability of ready finance from the banking sector. The potential exposure of the banks to the property market was clearly underestimated by the regulatory authorities. These dangers were only becoming apparent to those outside the financial system from late 2005 onwards (FitzGerald et al. and Traistaru-Siedschlag). Appropriate regulatory action could have reduced the dangers of a banking crisis. Such action could have helped control the property market bubble, but it would also have required a much more activist fiscal policy stance over the course of the Noughties.

From a healthy competitive position at the start of EMU with high productivity, relatively strong cost competitiveness, and a relatively weak exchange rate, the Irish economy has more recently suffered a significant loss of competitiveness. This loss of competitiveness was reflected in the increasing deficit on the current account of the balance of payments in recent years. The most recent report of the National Competitiveness Council (NCC) has highlighted the competitiveness challenge facing the Irish economy. The NCC report for 2008 (NCC) finds that Ireland's trade-weighted exchange rate has appreciated by 18% since 2000, making Irish goods and services more expensive on international markets.

This deterioration in competitiveness in recent years is primarily a result of the labour market pressures exerted by the growing bubble in the property market and the building sector of the economy. However, other inefficiencies, including a lack of competition in key areas of the economy, also contributed to the problem. The exceptionally tight labour market in the period to 2007 saw wage rates and other prices rise very rapidly, although there are significant differences across sectors with the loss of competitiveness proving more severe in low-productivity, non-manufacturing sectors of the economy (NCC). This problem particularly affected the non-tradable sector, resulting in higher domestic prices for services as well as increased labour costs.

To undo the consequences of this loss of competitiveness and to improve the situation to attract new business will require a substantial reduction in relative costs, especially labour costs. Within EMU this must take place through changes in nominal wage rates relative to the rest of the Euro Area. Because nominal wage rates are currently rising very slowly in the Euro Area, such an improvement in competitiveness can only be achieved quickly by a reduction in nominal wage rates in Ireland. Such reductions in nominal wage rates are crucial if the economy is to be restored to full employment. However, it looks as if the actual outcome will be a slow adjustment with wages in Ireland remaining static while there is a limited increase in wage rates each year in the rest of Ireland’s competitors.

The Future

The Irish economy is facing extremely challenging times. It is in the throes of a deep recession, unemployment is rising rapidly, and the Irish banking system is facing serious funding difficulties. As a consequence, by the end of 2010 output per head will have fallen back to its 2001 level. However, the tradable sector of the economy has survived the recession reasonably well. Exports and output are above the pre-recession levels. Given the very severe recession that Ireland is currently experiencing, this means that, when the world economy eventually recovers, the Irish economy can be expected to experience a period of above average growth. Our estimates suggest that there will be a permanent loss of output of at least 15% compared to where the economy might have been. This will represent a very painful permanent ‘scar’ on the economy arising from the current recession.

The dramatic deterioration in the public finances in 2008 and the early months of 2009 exposed the scale of the structural deficit – the deficit in the public finances which would remain very large, even after a world recovery, unless fiscal action is taken to close it. This structural deficit largely reflects the legacy of unwise fiscal policies in recent years. The experience of Ireland in the 1980s and of many other countries since then suggests the importance of taking early action to tackle such a fiscal crisis. The budgets of 2009 and the budget promised for 2010 are together likely to make some inroads. However, the huge costs associated with the banking collapse mean that there will be a long hard road of fiscal retrenchment stretching out to the middle of the current decade if the economy is to be restored to balance.

My assessment is that if the world economy recovers significant momentum, the Irish economy, as long as it regains competitiveness, can be expected to grow quite rapidly in the recovery period, regaining some of the lost ground of the current recession.

The legacy effects of the banking collapse are huge – amounting to around 40% of GDP. It took some time for these losses to be crystallised and they now represent an albatross round the neck of the economy.

The analysis undertaken by myself and my colleagues in the ESRI highlights the importance of improving the competitiveness of the Irish economy – this is essential if the economy is to return to full employment within a reasonable time scale. We envisage a major reduction in the level of costs, including labour costs, relative to the Euro Area over the period 2009-15. In this context, it is important that public policy should do all that it can to speed this essential adjustment.

The Irish economy faces a period of very high unemployment. It will be very important that public policy learns from past research in Ireland and elsewhere on how best to prevent the unemployed of today becoming the long-term unemployed of tomorrow. This problem will be particularly acute for those losing their jobs who have relatively low levels of education and skills. This suggests that priority needs to be given to labour market initiatives that will effectively tackle this skills deficit among many of the unemployed. In preparing for a recovery, the economy would also benefit from increased policy attention to measures to enhance productivity and innovation in the tradable sector of the economy.

Looking to the longer term, Ireland's future, as in its recent past, relies on even closer engagement with the EU economy. The single market, particularly the single market in services, is more important for Ireland than for most other EU members. Having reaped such benefits in the past it will be essential to adapt the economy to meet the changing needs of the EU economy in the future. One danger to this single market that has developed as part of this crisis is the gradual nationalisation of banking systems in individual member states, including Ireland. This development could seriously hamper the recovery, not only in Ireland, but also in other member states. It could also offset some of the benefits of a common market in goods and services.

For Ireland the decisions on the recent EU treaty changes have been crucial. Signalling a continuing engagement with the development of the EU was essential. The opprobrium that could have resulted from multiple NOs could have had incalculable effects.[2]

Looking back over the last quarter of a century, the investment in education has paid off. This pay-off took time. By reducing the supply of unskilled labour it increased unskilled wage rates and it priced the unskilled back into jobs. The same must happen

2 These paragraphs were added after the conference when the result of the referendum in Ireland was known.

in the future. The importance of the investment in education holds lessons for some other EU countries. While the returns on such investment take many years to be realised, failure to invest can permanently relegate an economy to the second division.

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