

**Through the Foggy Dew: Coming to an Understanding  
of Ireland's Economic Development**

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## **Through the Foggy Dew: Coming to an understanding of Ireland's economic development**

Ireland, a country which has in equal parts been revered for its rich cultural heritage, and maligned for its seemingly perpetual state of conflict, had historically been regarded as a 'back water' European economy. The outlook was so bleak in fact, that *The Economist* was moved to title a survey of the Republic of Ireland, 'Poorest of the Rich' (*The Economist*, January 1988). By the 1990s, however, a massive economic transformation was occurring, by which the country would come of age in the face of an ever-increasing world economy. In fact, to say Ireland experienced an economic recovery during the 1990s would be seen by most as a dramatic understatement. Much to the amazement of the world's economic community, and probably even to the Irish themselves (at least in terms of scale) a turn around in economic fortunes saw the small island nation begin to bridge the gap between its continental neighbours, and even be held up as an example for other emerging economies.

With successive rates of growth, once thought unattainable, the Celtic Tiger was born, leading to the inevitable comparisons with the growth levels experienced in the Pacific Rim by the Asian Tigers. As similar as the two regions may have appeared based primarily on rates of growth, there are significant differences between the regions' development policies. Unlike the direction chosen by Irish policy makers, the likes of Taiwan and South Korea encouraged growth through the creation of strong indigenous sectors and avoided dependence on foreign investment (Kirby 2001 91). Ireland, on the other hand, is seen to resemble more closely the path chosen by Singapore, with incentives used to attract foreign investment and companies who then encouraged domestic growth. Strikingly, a testament to the adage that no one fix exists for all

nations, while the Asian Tigers have since been de-clawed, the Irish economy, though showing signs of cooling off, is far from facing crisis.

In fact, for the year ended 2003, though Ireland recorded GDP growth of 1.8 per cent, forecasts of future growth are in the region of 3.6 and 4.8 per cent for 2004 and 2005 respectively, and so, relative to the rest of Europe, there is cause for continued optimism (Industrial Development Authority 2003). Certainly such rates are far more modest than the heady highs of the mid to late 1990s, as Ireland pushed beyond 10 per cent GDP growth in some years, yet they still represent respectable rates for an economy which sometime ago didn't seem to know whether it was coming or going. Most important, these rates, even if much smaller, continue the trend of positive growth. As Ireland continues to grow, even if its title as the Celtic Tiger ceases to be relevant, the country must face typical high growth problems such as traffic congestion, rapidly rising real estate prices and urban sprawl. Also, the implication of more comparable rates to the rest of Europe, may suggest that Ireland has proved successful in catching up to its neighbours, and could perhaps be entering a new steady-state growth level. After years of underperformance and mismanagement, for surely many of Ireland's ills were self-inflicted, living standards are at new highs, unemployment has been reduced to acceptable levels, and now, after years of unwanted emigration, immigrants play an important role in the country's development. In light of these realities, economists have begun to ask the question as to how and why now. As no one can debate the level of growth, and with talk of Ireland being merely a 'Paper Tiger' refuted (O Grada 2002), attention is turning to unraveling the 'policy and theory' mystery surrounding the Celtic Tiger.

To this end, a significant amount of attention has been given to the state of investment in Ireland. The levels of foreign direct investment (FDI) have risen dramatically over the years, and seem to mirror, if not drive the current push for economic growth. Included in this analysis, is the weight played by exports in current Irish GDP levels, as so much of foreign investment has been concentrated in export strong industries. In development economics, researchers have pondered the question of export-led growth (ELG). For the Irish context, we are interested in the relationship between the performance of export markets and domestic GDP. The so-called ELG Hypothesis, has thus far, not been abundantly successful in clarifying any causality in the relationship between exports and growth. Still, the models developed provide useful insight for meaningful discussion. We will examine the results of previous research on this complex issue and attempt to clarify its relevance to the Irish experience. As other, more esteemed economists have discovered, simply feeding data into a statistical program may not shed sufficient light on the issue. There are certainly a number of factors contributing to both export and GDP growth in Ireland, and it would be naïve to think that we will be able to unravel the complex relationships in this brief study.

Yet before we seek to address such questions, it is important to place the experience of the 1990s in its context. The fact is that Ireland's period of growth came 70 years after the country's independence, and well after the strengths and weaknesses of the domestic economy had been identified by policy makers. What will become obvious is the striking reality that many of the policy elements which are readily recognized as attributing to the success in the 1990s were first identified at least 40 years earlier. There are a number of historical events which have shaped the Irish identity, most notably the

famine years in the 1840s and the Easter Rising in 1916, however, like many former colonial nations, the country and its people's unique identity are only recognized by the outside world after the British ceded power. For Ireland, this occurred in 1922. For our historic review, we will therefore concern ourselves with the events following independence in 1922, when policy affecting the nation's people could truly be considered Irish.

After we have succeeded in outlining Ireland's economic development, including an examination of the Celtic Tiger years, we will turn our attention to specific aspects of the most recent period of growth. By identifying the policy and key economic indicators, we will hope to provide a level of insight into the Irish economy, which will allow us to anticipate the prospects for its future development. It is important to keep in mind when undertaking a study such as this, that we cannot examine any one period in isolation. Nor can we assume that Ireland's development has concluded. The Celtic Tiger is simply the latest period of growth in one of many stages of economic development, which will continue to unfold in Ireland over the coming years, for better or for worse.

## **PART I: Gaining an Historical Perspective**

For the purposes of Ireland's economic history, most researchers readily identify three distinct periods since Independence. Although we will not necessarily limit ourselves to this scope, it does provide a useful road map for our purposes. The first period is identified as 1922-1932, when little changed in terms of economic policy and the status quo of British policy was maintained. The remaining two periods, 1932-1950s and 1950s-the present, represent contrasting economic mechanisms, as being characterised by protectionism and increasing openness, respectively. It will become apparent through the discussion below, that though the fortunes of Ireland have been taking time to mature, this transformation has, although perhaps not always entirely intentional, been well planned. Certainly, any economic policy is subjected to the vagaries of the world at large, however, it was through successive government attempts to exploit Ireland's strengths as a small open economy on the periphery of Europe, that the country was prepared to take advantage of the conditions which existed by the 1990s. In this section we track the change in policy and economic fortunes leading up to Celtic Tiger era.

### *1922-1932: Economic life following independence*

During the years following independence, Ireland essentially maintained the economic policy which had been implemented under British rule. At the turn of the century many have suggested that Ireland was little more than a rural and agricultural society. It is true that by the time independence had been achieved the country was still largely dependent on the farming sector, "which employed 670,000 in a total labour force

of 1.3 million” (Kirby 2001 14). Yet by some accounts, the new independent state did possess, by virtue of its long standing relationship with Britain, a well developed banking system and other significant infrastructure. Still, to some, there existed an apparent need to foster a strong agricultural sector, a direction which would have repercussions for Ireland’s industrialization, or lack thereof. In the years to come, government policy sought to improve national development by focusing its efforts on the growth of the agriculture base.

While the Irish government took the view that the overall prosperity of the economy depended on agriculture, it is interesting to note, there was also recognition of the need for strong export markets to realize fully the potential for industry (Kennedy 1988 34). It was at this time that the government of William Cosgrove “aimed for an open economy and fiscal prudence” (McMahon 2000 52), a policy which reaped few rewards. It is important, that as early as 1922 observers realized the Irish domestic market was far too small to service a level of productive output deemed sufficient to generate jobs and improved living standards, and that exports were recognized as essential for economic growth and success. Significantly, though the economy remained dependent on agriculture it did so with a weak technological capacity. In their efforts to improve the economic conditions of the country through an expansion of the agricultural sector, the government of Cosgrove sought to rectify the reality that the sector was plagued by inadequate capital equipment and farming knowledge (Kirby 2001 15). Sadly, at this time, not only was Ireland dependent on primary industry, but it was dependent on its most rudimentary methods.

It should be noted that, as is often the case, such policy direction had as much political inspiration as it did economic reasoning. It has been argued that the attention and weight placed on agricultural development in Ireland was an attempt to stabilize internal strife after independence and the ensuing civil war, as well as to harmonize Anglo-Irish relations. By exploiting Ireland's apparent comparative advantage in agriculture, the highly rural population and work force would reap the domestic benefits of economic policy. Also, it was feared that attempts to foster industrialization, with the implementation of necessary tariff protections, would erode any remaining good will with Britain. As noted by Kennedy et al. "though Ireland accounted for only 6 per cent of British exports, it was still one of Britain's largest single markets" (Kennedy 1988 35) and any move away from free trade, might lead to a weakening of the long standing financial links between the two countries.

By 1932, efforts had failed to improve output in the agricultural sector, with the implication that any economic benefits enjoyed by the burgeoning economy accrued only to a small minority and would surely be short-lived. Cosgrove's intentions of implementing policy which sought to ensure fiscal prudence while fostering an open economy, may have been well regarded in his current time, however with the benefit of hindsight, it was certainly far too laissez faire for a newly independent, developing country. The lure of fiscal austerity was increased by the economic relationship with Britain, though Britain certainly benefited more. While it is easy to criticize the government of the time, for failing to encourage new direction in the country, given that Keynesian Economics was still some years from gaining strength in policy circles, perhaps this attitude is not so surprising. Still, the reality that Ireland remained heavily

reliant on the agricultural sector surely dictated a need for government policy to direct and guide the nation into the 20<sup>th</sup> century. The lack of such initiative may result from the colonial past of Ireland, which dictated the industrialization of the north (with Belfast a major steel and shipping center) and the maintenance of agriculture in the south.

In terms of independent policy, the most significant moves by the present government were the introduction of the Irish pound (the Punt), the building of the Ardnacrusha hydro electric generation plant and the establishment of the state owned Electricity Supply Board, all occurring in 1927, five years following independence (Murphy 2000 7; Kirby 2001 15). It should be noted that the creation of the Punt was purely a symbolic gesture, as it was immediately placed on a one-to-one parity with the British pound. Sadly, because of the lack of economic activity generated by the new government, the tide of emigration, which had afflicted Ireland since the famine, was not stemmed.

#### *1932-1950: The age of protectionism*

By the early 1930s, a new economic era began to take shape in Ireland. Though this period is often highlighted for different reasons, it is most salient for its high level of protectionism. Such a drastic shift in economic policy was inevitably achieved through the accession into power of a new government. In 1932, Eamon de Valera's Fianna Fail party took office, and with it "the openness of the Irish economy was sharply reduced, both with respect to commodities and capital" (Murphy 2000 7). The new government actively sought to reduce Ireland's dependency on Britain, in all areas, be they political or economic and "was ideologically committed to a policy of greater economic self

sufficiency” (Haughton 1995 30). De Velera’s new direction was guided by perceived intellectual and cultural needs, rather than economic ones. At its heart was an “idyllic vision of a rural, Gaelic society based on self-sufficiency” (Brunt 1988 16), wherein de Velera believed the people of Ireland would be willing to sacrifice material gain in order fully to devote themselves to the cause of Ireland. Although it has been claimed that by the 1950s this vision was out of touch with the realities of the international economic system, I feel it is safe to say that it was out of touch with reality for a Western nation in 1932.<sup>1</sup>

The myopic nature of this policy aside, however, de Velera did recognize one reality which had been ignored for the sake of Anglo-Irish relations. Ireland’s persistence with an agricultural based economy did very little to enhance or encourage the intellectual development of the Irish people. For the country to develop and prosper in the modern world, a degree of industrialization was a necessary step, thus creating employment for the many university educated engineers, chemists and other highly skilled workers present in the Irish labour force. At this time, and in the past, there had been a call for the establishment of infant industries, fostered behind protective barriers, which ideally would provide high skilled well paying jobs. The economic reasoning of the new government was to ensure the “maximum possible level of self-sufficiency within the Irish economy, both in terms of agricultural and industrial production” (Daly 1981 145). This was to be accomplished behind a series of protective tariffs, and where they failed, quotas intended to limit the level of imports into the domestic market.

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<sup>1</sup> This is not meant as a slight on Mr. de Velera’s motives, but rather the practicality of his intentions in the early 20<sup>th</sup> century.

Interestingly enough, John Maynard Keynes, lecturing at University College Dublin in 1933, offered qualified support for such a policy. In the course of his address Keynes stated, that if “I were an Irishman, I should find much to attract me in the economic outlook of your present government towards self-sufficiency” (Quoted in Haughton 1995 30). Keynes did, however, warn that any such moves should be modest, in fear of deteriorating an already low standard of living. The Irish government did, however, do as one would expect politicians to, heeding only the words which served to support their desired policy direction. In fact, it is noted that the new government, through its nationalist agenda sought to limit dependency on England, “even at the price of lower living standards” (Kennedy 1988 40). Few believed that Ireland could be successful in creating strong enough export industries to sustain any development. As Kennedy argues, the pragmatic aims of the new government policy were simply to provide employment and reduce emigration. It had long been the opinion of nationalists, that emigration was not an acceptable solution to the surplus labour in Ireland. It was high time Ireland herself provided solutions for her people (Kennedy 1988 34).

As a part of this ideological shift in policy, the Fianna Fail government also embarked on the contentious move to stop payment of land annuities to the English government. A condition of the independence settlement, agreed upon by the previous Irish government, stipulated that Ireland hand over the full amount of annuity payments, which had been established under various Land Acts during British rule. However, the government of de Valera was of a different opinion, advancing legal and moral grounds as to why Ireland should not be expected to part with, what was from Ireland’s perspective, significant monies: the sum of annuities totaling an approximate annual

value of 5 million pound sterling. The reaction of the British to this action was swift and immediate, with the imposition of duties at levels of 20 and 40 per cent on Irish imports to the UK (Kennedy 1988 31). Predictably, having had the original impetus to initiate the hostility in Anglo-Irish relations, the Irish government was not slow in retaliating in kind to the British measures, and thus began the 'economic war' between the two island nations. This act, like so many of the Fianna Fail government under de Valera's leadership, leaned heavily on political and social motivation, rather than economic. This was a clear statement of Irish independence, which since 1922 had seemed nothing more, at least to Irish nationalists, than a legislative gain.

Initially these policy changes appeared quite positive for the Irish. Between 1931 and 1936 industrial output in Ireland increased by 40 per cent, with the result that, for the first time in nearly 100 years, the population of the country stabilized (Haughton 1995 31). On the surface, these statistics appear to reinforce the policy, however when one considers that in the early part of the 1930s, unemployment growth increased, deeper questions must be asked. It seems likely that the increase in unemployment and the decrease in emigration were not a result of the protectionist stance, but rather the state of the world economy during what was the depression. The depressed nature of traditional ports of call, particularly the United States, meant fewer options for potential emigrants. Also, while industrial output increased significantly, agriculture was to stagnate, as its main export destination had become a very expensive option in light of British tariffs. In fact, between 1926 and 1938, employment and output in the agricultural sector were to fall by roughly 5 per cent (Daly 1981 150). Even without the economic war, the 30s and beyond would prove difficult for Irish farmers, as changes in British policy sought to

encourage expansion in the domestic sector. As time would tell, not only the economic war, but also the pursuit of self-sufficiency itself, was to have negative impacts on the long-term prosperity of the country. In fact, the end result of such policy was to be deemed an utter failure (McMahon 2000 52).

Just as the promising effects of Ireland's policy were to be short lived, so to was the 'economic war' itself. Both nations came to realize the mutual benefits of amicable relations, and each took measures to cool the increasingly heated relationship. Most significant of such measures was the signing of the Anglo-Irish Trade Agreement (AITA) in 1938. The end came for a number of reasons. Significantly, Ireland had failed to establish any other meaningful trading partners, which underlined the importance of the British market. Also, the protectionist policy had failed to ensure the necessary diversification in agricultural production. If Ireland was to be successful in efforts to limit its reliance on the British market, there would need to be a significant increase in domestic products in order fully to meet demand. This failed to occur and so lasting economic success was never to be a realistic goal. From England's point of view, it made little sense to continue the actions against its closest trading partner, particularly in light of political developments on the continent. As part of the agreement, Ireland was required to pay a lump sum of 10 million pounds for the accumulated value of unpaid land annuities. This was seen as a minor victory for the Irish government, as the deferred annuities had been estimated at a value exceeding 100 million pounds (Kennedy 1988 48).

Even with improved Anglo-Irish relations, however, this did not mean the government was about to abandon its protectionist stance entirely. During this period of

protectionism, the government's attempts to create a self-sufficient system had included efforts to encourage infant industries. Although skepticism existed, regarding the likelihood of success, this should be recognized as an important step in Ireland's move to embrace an increasingly industrial economy. Efforts had been made to "generate growth domestically...[with] tariff walls...[and] import substitution [used to] generate jobs and economic growth" (McMahon 2000 52). Ireland had depended on its rural roots far too long, and under British rule, the industrial base of the now Republic of Ireland had almost completely been ignored. Besides the fact that agriculture has been the one sector that domestic countries most readily seek to protect from foreign competition, in terms of increasing overall living standards for the nation, modern economic sectors were required. Given this reality, attempts at protecting infant industries, for a period, could be understood. Furthermore, with the economic pressures of the depression, such policy could even be justified. However, far from protectionism being a short-term policy to foster indigenous companies or provide for stabilisation, the present government saw the goal as a long-term policy in itself, thus justifying longstanding tariff walls.

In a further attempt to discourage foreign economic dependency, in 1932 the government introduced the Control of Manufactures Act (CMA). Under the CMA, foreign firms and investors were prohibited from owning significant levels of Irish industry. The act stipulated that "Irish people had to control 51% of the voting shares in manufacturing companies" (Murphy 2000 6). While it is possible to argue that, under the current conditions, very little existed to attract foreign investment, it is astonishing that if any opportunity had existed, it was, by government proclamation, unwanted. This is even the more glaring given the importance Foreign Direct Investment (FDI) has played

in the quite miraculous turnaround enjoyed in the 1990s (a fact we will examine more closely later). Still, one must not lose sight of the prevailing political environment of the time. The government, as we have stressed, was strongly nationalist in its general political philosophy, and measures such as the CMA sought to ensure that the benefits of the new industrial drive accrued predominately to Irish businessmen (Daly 1981 145).

As the English had anticipated, war did break out on the continent in 1939, during which Ireland remained neutral. An interesting caveat to the Irish economy during World War Two is that the agriculture sector experienced minimal disruption to its output levels. Some have championed this as a form of victory for the Irish workers, however, more appropriately, this should be seen as an indication of how little the industry depended on technical efficiency, and rather placed an enormous weight on land and labour for inputs (Kirby 2001 17). The reality is that due to the CMA, very little capital made its way into the country. Furthermore, given the limited opportunity for industrial growth domestically, whatever domestic capital was generated, including that accumulated by banks, was invested outside Ireland. Certainly levels of capital accumulation and investment were low throughout the world at this time, but any activity, however minimal it may have been, would have been discouraged by government policy. Therefore, very little economic development occurred during the 1940s and the 1950s, the result of which was a “stagnant economy which missed out on the European post-war boom and [experienced] net annual emigration of over 40,000 during the 1950s” (Murphy 2000 9).

Though many observers wanted Ireland to increase its efforts to expand the industrial base, the existence of a very strong lobby for the agriculture industry had thus far scuppered any such actions. As a result, following the war, there was no change in

policy and Ireland continued to hold firm on its protectionist stance. Just as after independence the government of the time was criticized for its lack of creativity in implementing domestic policy, now too did it demonstrate a lack of foresight and imagination in attempts to encourage indigenous industry and growth. Initially, just as in the early 1930s, economic indicators misleadingly justified the continued protectionist stance. Because Ireland had remained neutral during the war, it was able to continue domestic production while the rest of Europe began the process of rebuilding. During, and for a few years following the conflict, the British had introduced travel restrictions and food quotas. As a result, Ireland benefited through increased tourism and food exports to England, however, this was not to last and soon the reality of Ireland's weak economic base and lack of economic diversity was to become painfully obvious.

There is often a degree of confusion that Ireland, who did not sustain any damage from the war, or accumulate any related debts, and which had in fact increased monetary reserves, did not enjoy a lasting post-war boom. This failure can be laid squarely at the feet of the country's dependence on agriculture as the primary industry for employment and growth and the continuation of protectionist policy past its usefulness. As a result, Ireland's inability and seeming reluctance to exploit industrial opportunities, was again a major hindrance to her growth. At this time, "Irish manufacturing was small-scale, technologically unsophisticated and with little or no experience of export marketing" (Kennedy 56). Though this was now recognized, it was not yet apparent to policy makers, how it might be rectified.

One of the first attempts undertaken by the government to redress the deficiencies in the economy, was a large scale program of public expenditure, known as the Public

Capital Programme (PCP). The focus of the spending was two fold. First, it sought to improve the nation's infrastructure, with particular attention paid to schools, hospitals, transportation and communication (Kirby 2001 57). Second, the increase in government expenditure provided a needed boon for the country's construction industry, providing unskilled jobs for the growing level of unemployed, particular those who were being displaced from a declining agriculture sector. Still, little long term planning existed with regard to industrial policy and there was very little room to maneuver within the current protectionist framework. This, it was feared by contemporary economists, would lead to balance of payments difficulties, since home import demand greatly outstretched any export activity. In fact, by 1947 a substantial trade deficit, of 92 million pounds, existed. This difficulty was to be complicated, as seemed inevitable in Ireland's history, by external factors. Being a small periphery economy was proving frustratingly difficult for Ireland.

The significant external disruptions to the Irish economy took the form of the Korean War and Suez Crisis. Further to this, Britain, which had been a source of tourism revenue and agricultural exports during and since the war, ended its domestic policy of rationing and travel restrictions. At this time, even with the implementation of the PCP<sup>2</sup>, the fiscal environment in Ireland was highly deflationary, a condition which obviously did little to ease the recessionary pressures being applied to Ireland because of changes to outside economies. First, the Korean War caused import prices to soar, increasing Ireland's already inflated deficit in its trade balance. Then, in 1957, with the Suez crisis, Irish manufacturing exports, which had enjoyed a resurgence due to the PCP, suffered significantly. The government's failure to provide the necessary fiscal stimulus through

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<sup>2</sup> Public Capital Programme

these years was further exacerbated by a decision to cut program spending. (Kennedy 1988 60-62; Daly 1981 50-51).

For such reasons the 1950s are most remembered in Ireland for the poor economic progress, in fact it was among the worst in Europe, which added to the record levels of emigration. Though the government had failed to act in the appropriate counter-cyclical manner, yet again, during these times groundwork was being laid which would eventually help to spring board the Irish economy to levels of growth in the coming decades. The 50s represents a significant period of transition in the country's economic development. It seemed that finally the lessons were beginning to resonate in government halls and slowly decision makers were beginning to accept that they had taken the goal of self-sufficiency as far as was reasonably possible. Now the time had come to embrace new schools of thought. Though changes in economic policy would require the benefit of time and prove difficult for the country as a whole, such moves would not only lay the foundation for the growth experienced in the 1960s and 1970s, "at a pace not witnessed previously in Ireland for such an extended period," but more importantly, lay the foundations for growth in the 1990s.

#### *1950-1990: Embracing openness*

The economic prosperity enjoyed in the 1960s and 1970s was built on the industrial policy so developed in the 1950s. Policy makers began to realize that the outwardly laissez faire attitude of the government was not instilling the necessary confidence in the labour force, or in the economy as a whole, particularly from an investment perspective. A number of steps were initiated in an effort to rectify this

shortcoming. The first major step was the acceptance that Irish policy had to make a concrete effort to orient itself to outside markets. It had long been recognized that the domestic market was far too small to foster sufficient economic growth and that the country needed to establish a more robust and concerted export strategy. Over the next number of years, the introduction of a number of key policy measures would effectively see Ireland turn away from a policy of development through protectionism, to one of development through exports (McAleese 1986 22).

While steps were being taken to re-orientate the economic direction of the country, they would take time to have an impact. Policy makers faced the fact that in the 1950s, because of previous policy, "Irish manufacturing industry consisted chiefly of firms producing for a home market protected by extensive tariffs and quotas...[and] the small size of the Irish market precluded most firms- native or foreign- from reaching an efficient scale, and little or no effort had been made to prepare them for entry into export markets" (Kennedy 1986 40-41). To redress the shortcomings of Ireland's export industries two government agencies were established. First, in 1951, the state sponsored Irish Export Board was created to provide advice and assistance to companies to market their products abroad. At this time, it was recognized that the problem lay in the range and quality of products, as much as in the lack of productive efficiency. In an effort to encourage investment in these areas the government planned to offer financial incentives as well as beginning a strategy of attracting foreign investment to supplement the level of domestic investment. So, in 1952, the newly established Industrial Development Authority's (IDA) mandate was extended to include the role of attracting foreign industry and to encourage new indigenous firms to emerge (Kennedy 1988 62). Further

institutional boards and arrangements were established to facilitate development in rural areas, to foster stronger tourism links with Europe and the rest of the world and to establish stronger labour training. Many observers have rightly identified this work as proving critical for the unprecedented take off of the economy in the 1960s (Cullen 1987; Brunt 1988; Haughton 1995). Furthermore, this period is the first time in the history of the Republic of Ireland that the government showed a willingness to embrace fully free trade and the role of foreign capital. Such attitudes would be important for the Celtic Tiger era and would undoubtedly make modern World Bank and IMF advisors very happy indeed.

The changes to Irish policy would be developed over a period of two decades. Brunt identifies the publication of "Economic Development" in 1958, by the Department of Finance, as a watershed for economic policy in Ireland (Brunt 1988 17). In the document, the ultimate goals of policy remained unchanged, with full employment, stemming the tide of 'involuntary' emigration and improving the Irish standard of living the main objectives. But now, in contrast to previous measures, new policy sought to encourage foreign investment in industry and in less developed regions of the country. To this end, the government abolished the Control of Manufactures Acts of 1932 and 1934, providing a clear signal to the market that it was ready to welcome foreign investment and industry into the domestic economy. Policy makers had identified that a small domestic market existed not only for productive output, but also for investment. It was decided to encourage foreign sources of investment to make up for the shortfall in Irish investment.

Probably the most important incentive provided by the government for attracting foreign enterprise was the export profits tax relief scheme initiated in 1956. The program also applied to indigenous industry but with less response, however, for foreign companies it offered complete tax exemption for a period of ten years, later extended, on profits derived from new or increased manufacturing exports. Such policy would provide significant incentive for investment, particularly in the 1990s. Also, in line with the increasing openness of the Irish economy, unilateral tariff reductions were introduced in 1963 and 1964, recognizing the damaging nature of the 'beggar-thy-neighbour' protectionist policy. Such concessions helped lead to the implementation of the Anglo-Irish Free Trade Area Agreement in 1966, which further provided for the removal of Irish tariffs on British goods in exchange for improved access of Irish exports to the UK. This increase in openness did not come without a cost, with significant losses in "footwear, clothes, furniture, car assembly and textile industries. But...there was sufficient growth in employment elsewhere in the economy" (McAleese 1986 24). The nature and composition of the Irish economy was changing in a way which was more conducive to growth in the long run.

With the new direction came a more determined approach to policy implementation. The government was now utilizing a more effective form of bureaucracy, which took more responsibility by clearly outlining economic goals and targets under specific government directed programs. As such, the plan for national development was implemented in the guise of three specific programs. The first program, which leaned heavily on "Economic Development," covered the period 1959-1963. A second program followed for the period 1964-1970, which laid out ambitious

goals for specific branches of the economy. The targeted goals of these programs were based on forecasts assuming Ireland's membership in the European Economic Community (EEC). Following Britain's withdrawal from the negotiations as the second program was beginning, however, Ireland's entry into the EEC was delayed, and so the program's targets no longer seemed attainable and subsequently the program was cancelled in 1966. Still, not to be discouraged, a final program was introduced, taking into account failure to gain access to the EEC, laying out modified goals for the period 1966-1972. Again, the ambitious plan was unfulfilled and some heavy criticism was leveled at the government for failing to meet their targets. Such criticism, however, neglects the reality that the programs were a necessary step in re-orientating the economy for freer trade and the inevitable competition with entry to the EEC (Brunt 1988 17). Just as the publication of 'Economic Development' played a role by emphasizing that sooner or later protectionism would have to be abandoned and the challenge of free trade accepted, these programs helped to prepare the Irish economy for the anticipated challenges. As a result, their importance and influence on the growth experienced, not only in the 1960s and 1970s, but also in the 1990s, should not be underestimated.

Ireland had successfully pulled herself out of the economic mire of the 1950s and through the 60s, experienced unprecedented levels of growth. In this decade national output, illustrated in Figure 1, increased by an annual rate of over 4 per cent, with industrial output and exports growing at a rate of 7 and 18 per cent respectively. Furthermore, the move was important as it laid down a precedent for the planning process to take place in the build up and throughout the Celtic Tiger era. The increased communication between trade unions, industry and the public sector, would provide

valuable intangibles for future years. Such frankness and discussion between the various agents involved in the economic process would be a precedent for similar collaboration in the 1980s and 1990s. It must be said that it also likely served to ease concerns about freer trade, given the losses which were already being felt in various sectors of the economy.

Figure 1: Real GDP Growth, 1960-1969



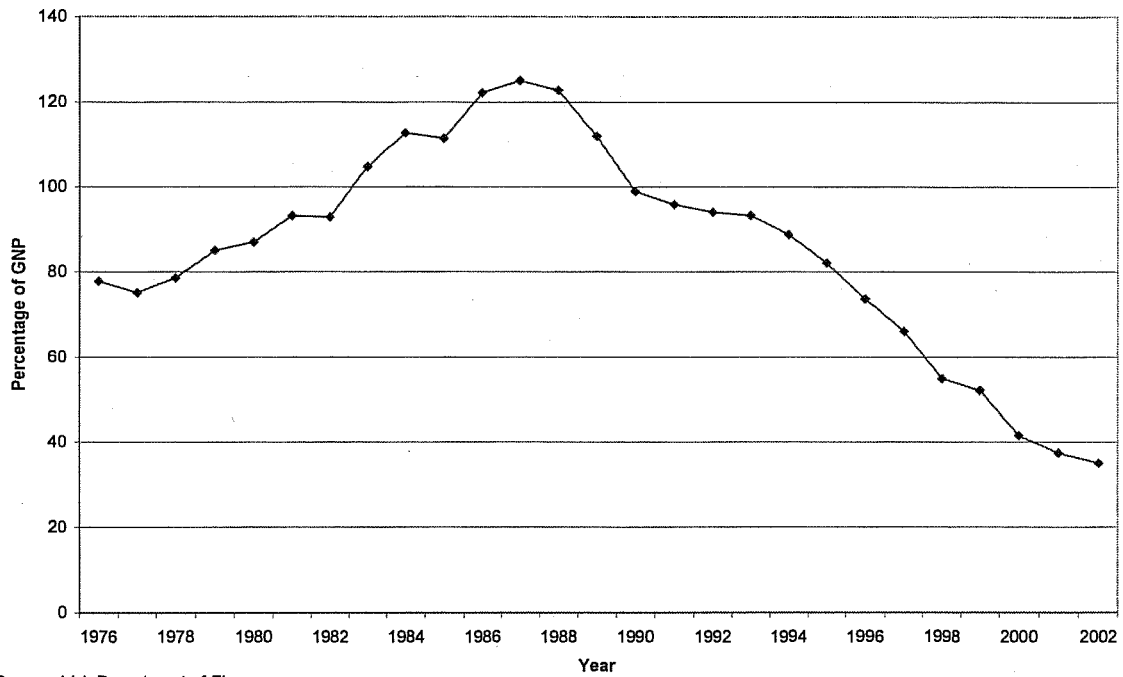
Source: IMF International Financial Statistics

By the 1970s, Ireland seemed to have finally begun the long road to economic recovery, as policy was working to ensure prolonged success. There were great hopes in the early 1970s that entry into the EEC would provide industry with an encouraging boost. The foreign firms Ireland had been successful in attracting were recording profitable years and now with the access to the European market, it seemed that economic goals, of full employment and prolonged growth, were finally attainable. Again, however, outside factors would interrupt this development. The expected gains

from the new growth in industry were “thwarted at first by the oil crisis towards the end of 1973, and the resulting” (Kennedy 1986 43) downturn in world economic fortunes. Ireland followed the lead of other nations, as countries attempted to deal with the new economic phenomena of stagflation: the simultaneous growth in inflation and unemployment. Government spending increased significantly, so much so that “in the aftermath of the first oil price shock government deficits rose strongly...resulting in the rapid growth of government debt and debt servicing costs” (Leddin & O’Leary 1995 162). Though this provided a brief economic stimulus, the increase in debt servicing costs constrained the ability of the government to engage in expansionary fiscal policy in the coming years. The debt/GNP ratio, illustrated in Figure 2, grew from a level of 79 per cent in 1976, to over 100 per cent in 1984, after the effects of the second oil price shock had been felt. Attempts to spend the country out of the domestic and international recession which resulted in the 1980s, created an environment of fiscal mismanagement that would plague the economy throughout the 1980s, though it should be recognized that prevailing monetary policy provided little in the way of flexibility for government intervention, while compounding the debt problem with higher interest rates. As shown in Figure 3, until the fiscal retrenchment of the late 80s, government spending rose to levels over 60 per cent of GNP. The debt/GNP ratio would remain above 100 per cent until the 1990s, after which it would continue to decline on an annual basis, to increasingly more sustainable levels by the turn of the century.

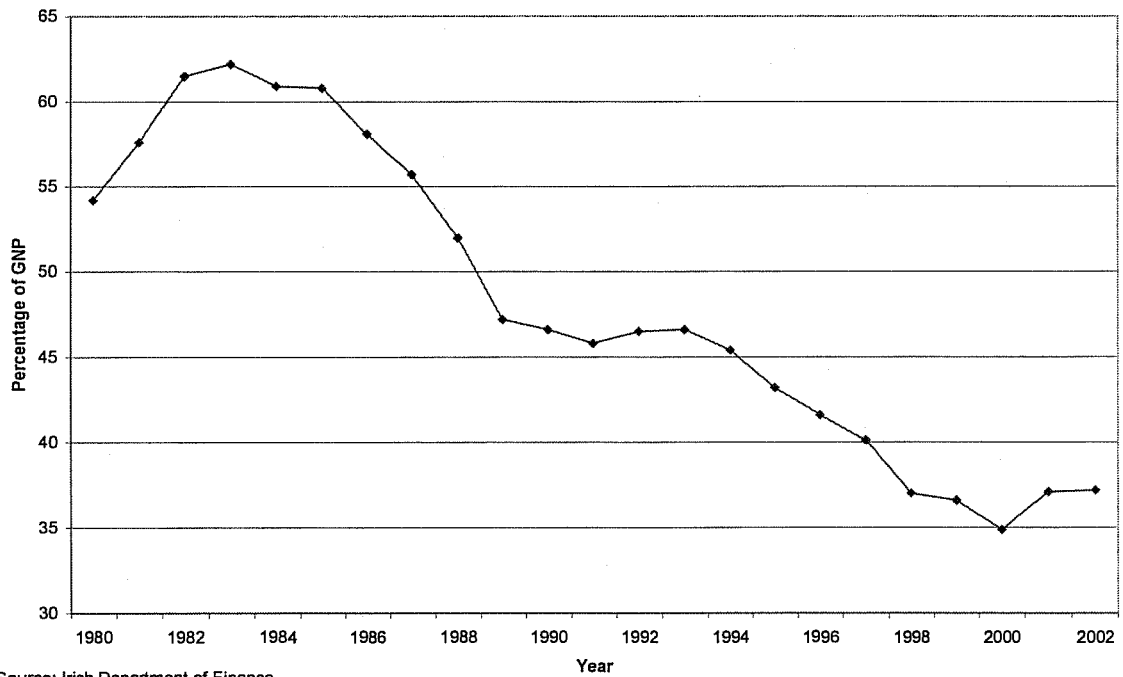
There was much debate at the time about the economic deterioration faced by the country. Factors in Ireland had not been helped by the worsening international situation. Many began to wonder if openness had occurred too quickly for the Irish economy to

Figure 2: National debt to GNP ratio, 1976-2002



Source: Irish Department of Finance

Figure 3: Total government expenditure as a percentage of GNP



Source: Irish Department of Finance

handle. This seems unlikely, given that Ireland had prolonged with protectionist policy long-after the rest of the western world had embraced free trade arrangements. As a result, potential for growth in earlier decades had been thwarted by strict government policy. It seems more plausible that Ireland was in fact still too rigid in its approach to emerging economic conditions. Also, there was the likelihood that the drive to attract foreign investment had occurred at the expense of indigenous firms. The *Telesis Report*, published in 1982 by an American consulting firm, drew on this reality, stating “no country had succeeded in developing high levels of industrialized income without a strong indigenous sector” (McAleese 1986 26). The report also eluded to the rigidity of Ireland’s attempts to deal with the growing openness of its economy. They noted that Ireland likely failed to exploit successfully the opportunities made available by entry to the EEC and the single market and that “...the economy failed to develop the degree of flexibility and adaptability which are essential ingredients of success in a small open economy” (McAleese 1986 26).

The final stage before the Celtic Tiger rose from the ashes of Ireland’s economic history, involved significant moves towards fiscal retrenchment. During the 1980s, the debt to GDP ratio reached incredible levels. Leddin and O’Leary put it quite well, stating that “by the end of 1986 the Irish public finances were in a state that offended against the basic tenets of the Keynesian and neoclassical schools alike” (Leddin & O’Leary 1995 168). As a result, by 1987, the Fianna Fail government once again in power, riding to victory on the promise to increase public expenditures, was forced instead to introduce severe cost cutting measures. What is most telling about this about-face, is that instead of outcries from the opposition, they in fact supported the move, with the qualification, that

the correct cuts to spending be taken. The majority of political and economic observers agreed the measures were necessary. So with the support of the opposition, the new government went about correcting Ireland's precarious fiscal predicament and thus avoided, what many felt was a possible financial meltdown (Murphy 2000 10).

As we have seen in this brief survey of Ireland's economic history, re-orientating the domestic economy has become a major part of Irish policy. Whether attempting to influence economic trends, or industrial progress, the goal has been to embrace Ireland's place as a small open economy on the periphery of Europe. In fact, as recognized by the OECD, Ireland "...among the smaller, geographically isolated OECD economies...was one of the first to fully embrace an outward looking approach to international direct investment" (OECD 1994 7). This was only accelerated in 1973 as Ireland was granted membership in the European Community (EC) and further still with entry into the European Monetary System (EMS) in 1978 and the adoption of the Euro in 1999. With the advent of economic and monetary union, new challenges are faced by all member states. The loss of monetary policy instruments, and the introduction of strict fiscal guidelines under the Maastricht Treaty, calls for a new way of thinking about the operation of the domestic economy in light of events throughout Europe and the rest of the world.

## **PART II: The Celtic Tiger**

### *1990s and beyond: The Celtic Tiger Era*

The coining of Ireland's economic moniker, the 'Celtic Tiger', has been attributed to Morgan Stanley Dean Whitter in August 1994. The title of the country's recent economic success is obviously meant to highlight the similarity between the region's phenomenal growth to that experienced by the economies on the Pacific rim, notably Singapore, South Korea and Taiwan. To illuminate the success of the Irish economy, most observers begin by outlining its "exceptional growth rate since the mid 1990s...both in comparison to past Irish performance and to most countries in the world" (Kirby 2001 29). Doing so does provide for some insightful reading. As noted by Canadian researcher Pierre Fortin, "measured by real GDP per head...the per-capita income generated by the Irish economy increased by 97 per cent between 1989 and 2000" (Fortin 2002 3). By any economy's standard this rate of increase is simply phenomenal.

As we have seen in our survey of Ireland's first 70 years of independent economic development, at an early stage many of the key policy initiatives behind the nation's most recent success had been identified and attempts, with varying degrees of success, made to nurture and exploit them. In fact, as noted by Brendan Halligan, the current phase of economic policy in Ireland, is now 40 years in the making (O'Rourke). A willingness to open up to the world economy, both in terms of trade and, even more significantly, as a source of much needed capital investment, has been particularly important. Also, the presence of the Industrial Development Authority (IDA), though first established in 1952, was crucial, as its extensive work began to come into fruition by the late 1980s (Kirby 2001 34).

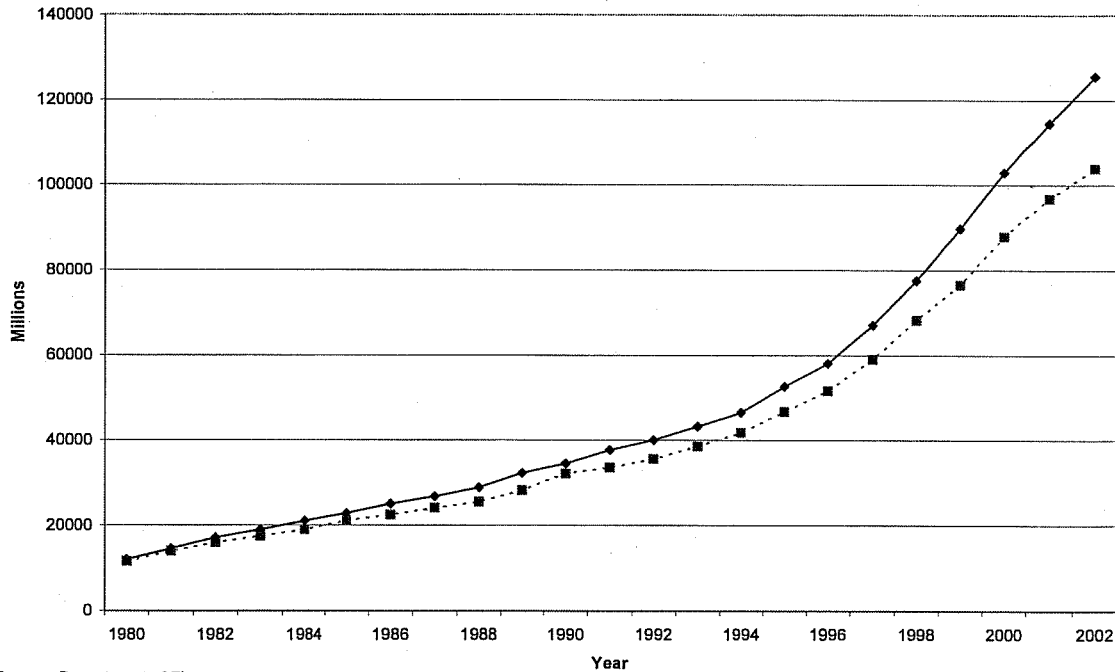
In order that we might gain a simple snapshot<sup>3</sup> of the Celtic Tiger's success, we will now examine the most significant economic indicators, and how they have evolved between the 1980s and the turn of the century. First, the most readily available and most often cited statistic, as a measure of a country's economic success, is GDP growth. Before examining the empirics, we should address a common criticism of the use of GDP to highlight Irish growth. Some observers have suggested that it is "important to remember that in Ireland's case, gross national product (GNP) is regarded as a better measure [since]...foreign multinationals repatriate much of their extensive profits out of the domestic economy" (Kirby 2001 29). Yet this is only relevant when addressing distributional issues. There is no doubt that as a measure of the economic activity within a country, GDP statistics are the most useful. Yet, as we shall see, even if we limit ourselves to GNP figures, they still represent significant gains on the part of the Irish economy over the last ten years, and "Irish GNP income levels are projected to be on par with all other EU states by 2005" (Enterprise Ireland 2003 1).

As illustrated in Figures 4 and 5, the 1980s witnessed early modest growth in Ireland, to be followed by severe contractionary periods. By the 1990s, however, Ireland's relative performance literally took off, surpassing not only national expectations, but growth rates throughout the world (Fortin 2002 3). Though, given that depressed economic conditions have dampened worldwide activity in the last few years, and concerns have developed regarding the longevity of the good times (*The Observer* October 21, 2001; *The Economist*), figures published by the Central Statistic Office (CSO) and the Department of Finance remain encouraging. It would be unrealistic to expect the economy to continue to grow at such levels, even under the watchful eye of

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<sup>3</sup> After all, a picture is worth a thousand words.

Figure 4: GDP and GNP levels at current prices, 1980-2002

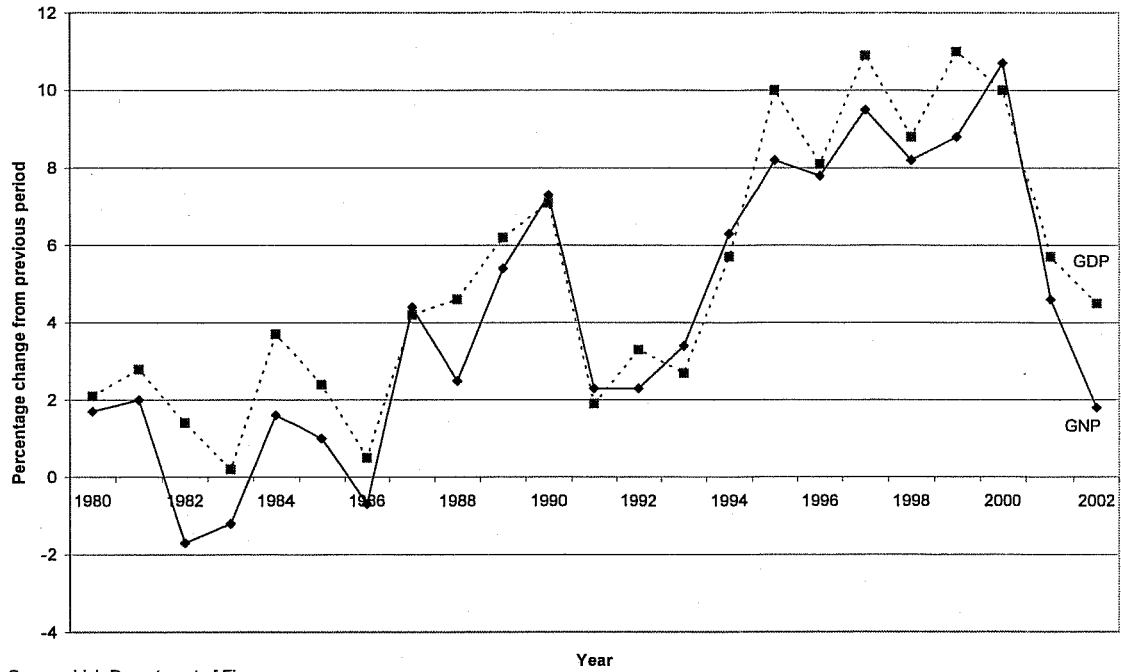


Source: Department of Finance

the so-called New Economy growth theory. Ireland should be proud of its GDP growth in the last ten years, with GDP per person already overtaken Britain's level (*The Economist* Nov 14 1998), and bridging the gap in living standards between itself and the rest of Europe. If the economy does slow to more realistic levels in the region of 3 to 4 per cent per annum, it will only mean to single the successful convergence of the Irish economy to the rest of Europe.

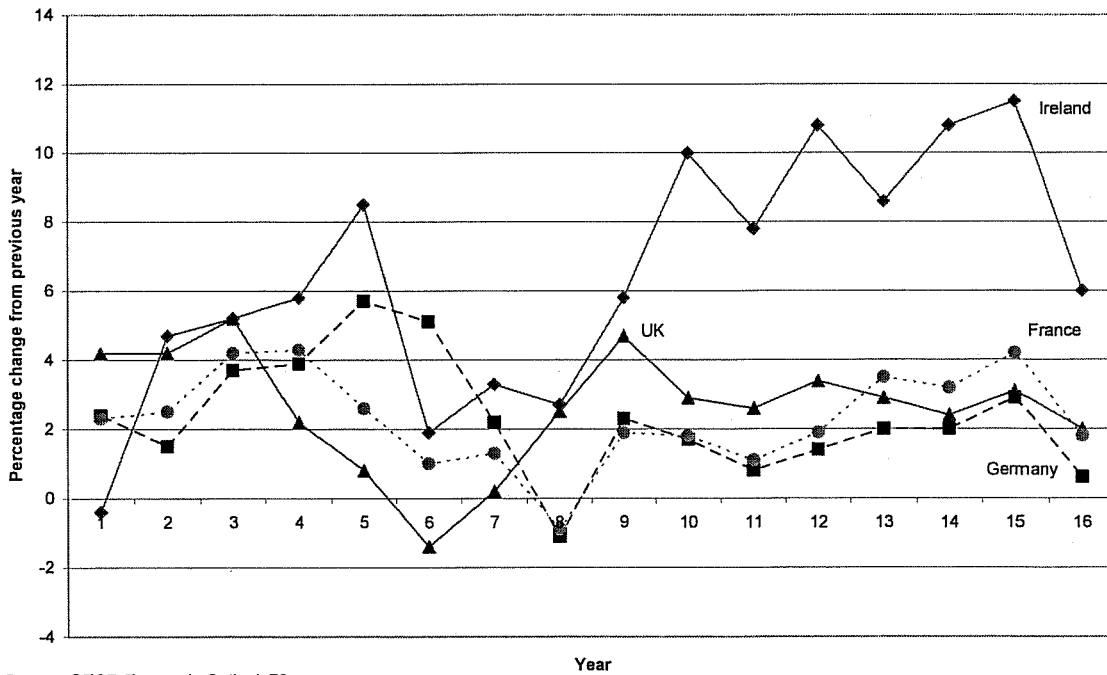
To really appreciate the growth experienced by Ireland, one must compare the rates captured in Figure 5 to those experienced by a number of leading economies. Figures 6, 7 and 8 compare the Irish rates of growth to those experienced by select European countries, North America and the OECD, over the period 1986-2001. These figures clearly illustrate how Ireland's development has greatly enhanced its economic

Figure 5: Annual rates of change, Irish GDP and GNP, 1980-2002



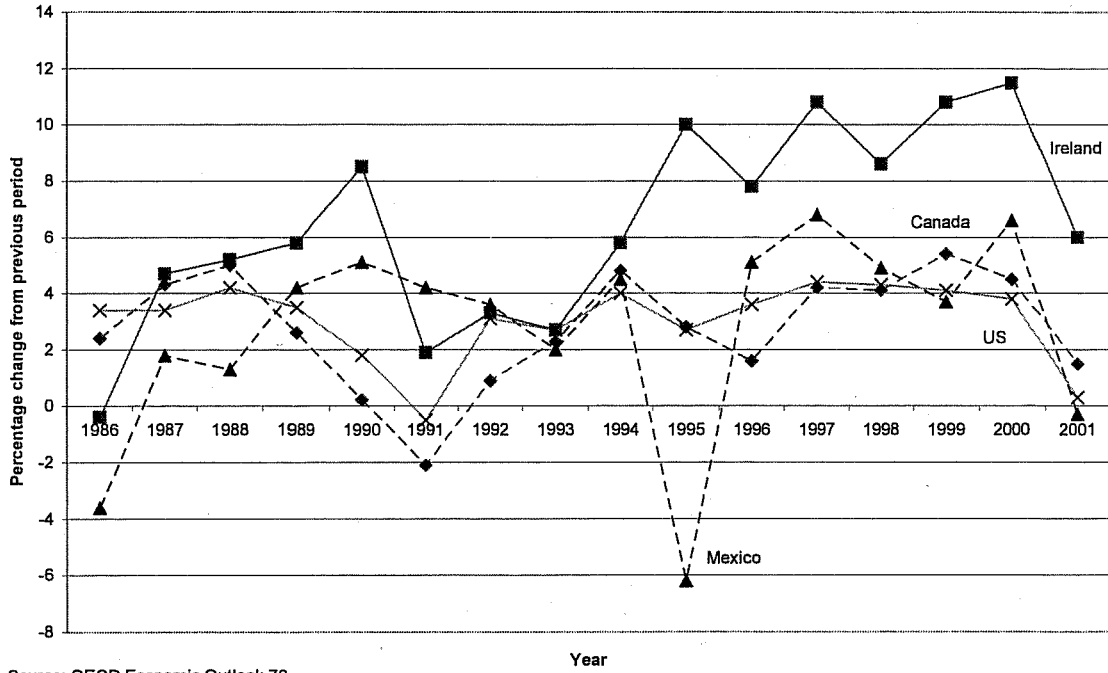
Source: Irish Department of Finance

Figure 6: European real GDP growth, 1986-2002



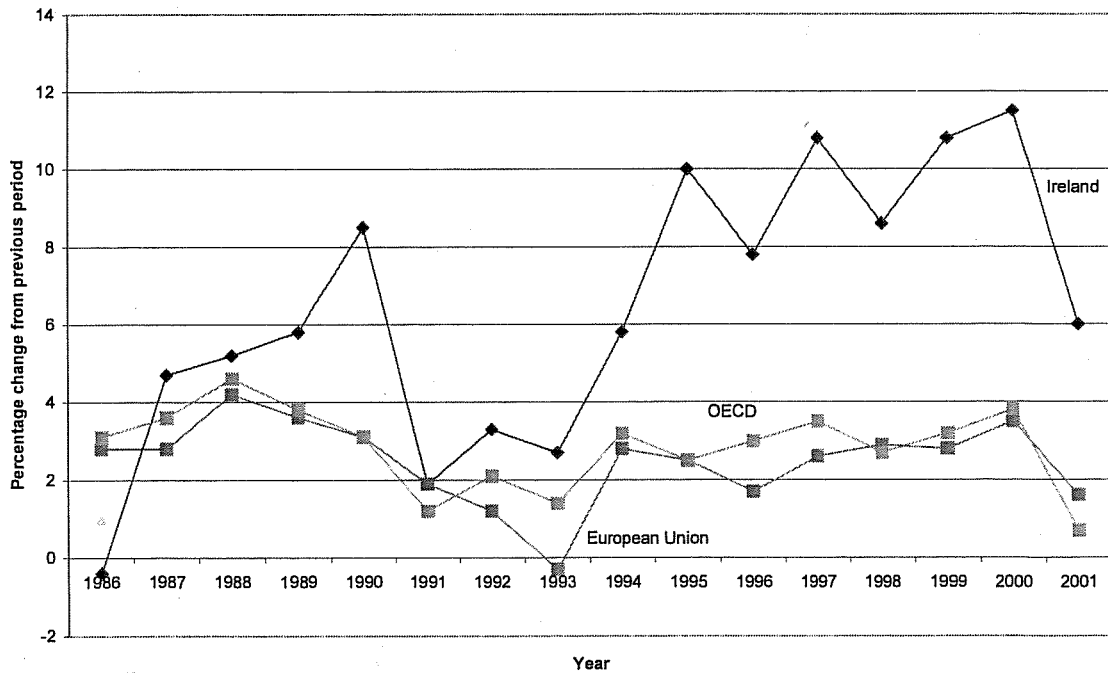
Source: OECD Economic Outlook 72

Figure 7: North American real GDP growth, 1986-2002



Source: OECD Economic Outlook 72

Figure 8: Comparative real GDP growth, 1986-2002



Source: OECD Economic Outlook 72

standing in the world. Further to this, Table 1 lists per-capita GDP and GNP for the same countries. While Ireland still may have some ground to make up, this should not detract from the reality that its economic growth has been unprecedented and unmatched.

Ireland has entered a new level of economic activity, which now has it mentioned in the same breath as the US and Germany, as opposed to being dismissed as an underdeveloped western economy. This can be seen as a victory in itself.

**Table 1: Per capita GDP growth, 1990-1998**

Country	1990	1998	Change (%)
	\$	\$	
Australia	18023	21881	17.6
Canada	19160	20458	6.3
France	25624	27975	8.4
Germany	n/a	31141	
Ireland	13907	23422	40.6
Italy	18141	19574	7.3
Japan	38713	42081	8.0
Mexico	4046	4459	9.2
Netherlands	24009	28154	14.7
United Kingdom	18032	20237	10.8
United States	25363	29683	14.5

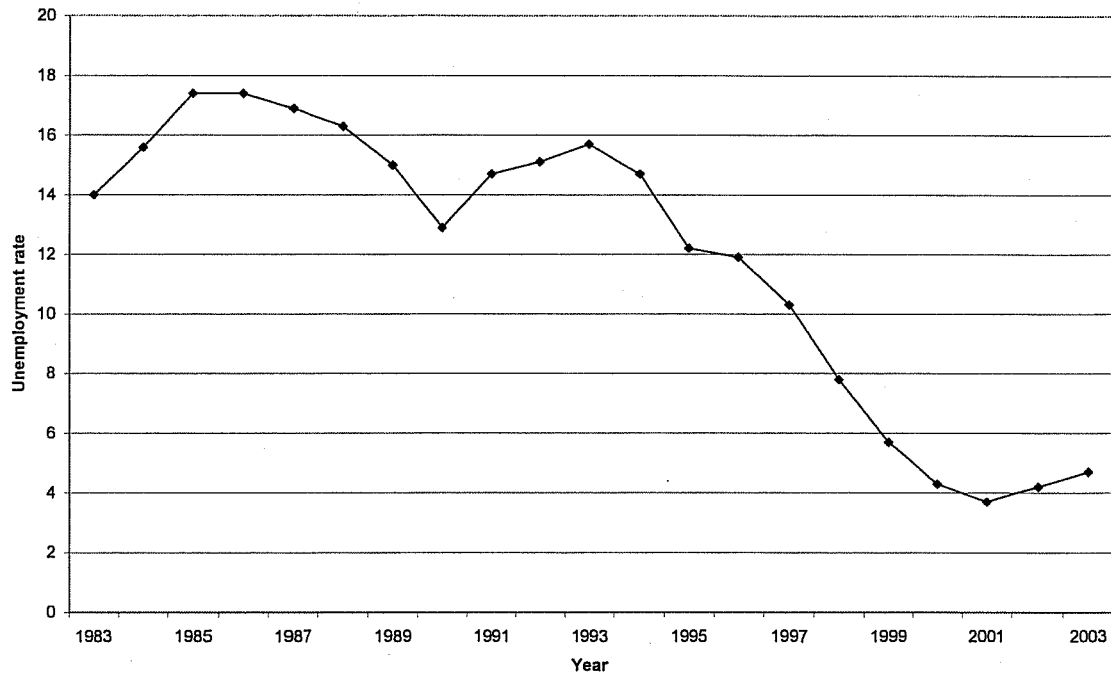
Source: Kirby 2001

A second strong indicator of the progress made by the country is the reversal of pandemic unemployment rates, which are depicted in Figure 9. Over the period 1983 to 1992, Ireland recorded highs in unemployment pushing an upper limit of 18 per cent. Successful growth in the economy meant that by the year 2003, Ireland's unemployment rate was just over 4 per cent, a figure which would be acceptable in any industrial country, given the so-called natural rate of unemployment. One may notice that a peak occurs again in the early 1990s<sup>4</sup>, temporarily eliminating any gains made in the previous

<sup>4</sup> One may also note a related dip in GDP in Figure 5. In fact, each indicator will highlight this, among other stresses on the economy.

years. This aberration can be explained with reference to Ireland's decision to abolish exchange rate control regulations (monetary bands) in the early 1990s. This move left the Irish monetary system open to speculative foreign exchange attacks (Murphy 2000 10).

Figure 9: Seasonally adjust unemployment rates, 1983-2002



Mounting pressure was placed on the Irish currency, as England, facing speculative attacks itself, was forced to withdraw the pound from the European exchange rate mechanism (ERM), resulting in a significant devaluation of the British pound. The market now believed the Irish pound was overvalued and so hedged its bets accordingly. Significantly, the devaluation of the British pound, also affected Irish competitiveness. The Irish government, had in the past devalued the domestic currency in light of such pressures, but this time, chose instead to protect the currency. In their efforts, the government was forced to increase interest rates, thus depressing domestic demand and

therefore increasing unemployment. It is also estimated that the Central Bank exhausted some 5 billion Irish pounds in foreign currency through intervention in the foreign exchange market. In the end, the government was forced to concede defeat, and the Irish pound was devalued by 10 per cent (Leddin and O'Leary 1995 186).

The devaluation of the Irish pound restored confidence in the economy and interest rates declined. This move was also to prove beneficial as it restored Ireland's competitiveness with the UK and importantly, introduced a new level of competitiveness with the rest of Europe. This brief flirtation with all too familiar past performances in GDP growth and unemployment rates aside, however, Figure 9 clearly illustrates Ireland's progress. In fact the episode outlined above, gives further strength to the case in favour of the present policies, as they were able to continue to improve the economic outlook of the country, even after the monetary correction. This ability to be 'flexible' in the face of economic difficulties highlights Ireland's new gained adaptability and the strength in economic fundamentals, so required for sustainable growth.

What is even more remarkable about this decreasing trend in unemployment is that it occurred at a time when the size of the Irish labour force was actually increasing. Ireland had long been a nation which saw unwanted emigration an indictment of its economic weaknesses, however, by the 1990s strong policy had ensured that immigration was playing a vital role in the country's new found growth, as illustrated in Table 3. Over the same period, Ireland's ability to create jobs was unparalleled in the world (Table 2)<sup>5</sup>. As noted by *The Economist* (Aug 28 1999), in 1998 the population of Ireland increased by 44,300 people, almost the exact number which left the country in 1988, the

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<sup>5</sup> An interesting caveat of Table 2 is the question: with US investment and manufacturing proving so important at this time for Irish growth, how many jobs in the US were lost to Ireland?

year recording the highest level of emigration in modern times. Finally, Irish people who had left in order to find work could come home to high skilled, well paying jobs.

It is also worth noting, that given the changing structure of the Irish economy, there is also a changing face of the Irish immigrant. This evolution is outlined in Tables 3 and 4, which illustrate the growing importance of the rest of Europe and the world as a source for population growth. *The Economist* (Aug 28 1999) notes that in order for the economy to maintain levels of growth in the coming years that some 200,000 foreign workers, a tenth of the workforce in 1999, are needed. Further to this, given the growth in new industries, Ireland finds itself scouring the farms of Eastern Europe in an effort to locate and attract the necessary hands to keep agriculture operational. Just as the domestic economy has shifted its dependency away from the farm, so to has the domestic worker.<sup>6</sup>

**Table 2: Employment Growth, 1995-2000**  
Annual percentage change

Country	1995	1996	1997	1998	1999	2000
<i>Ireland</i>	4.9	3.9	3.6	10.2	6.3	5.0
Mexico	-0.6	6.5	5.5	2.7	1.3	3.4
South Korea	2.6	1.9	1.4	-5.3	1.4	4.0
United States	0.7	0.5	0.9	1.6	1.7	1.9
EU	1.1	1.1	1.4	1.0	1.1	1.5
OECD	1.5	1.4	2.2	1.5	1.5	1.3

Source: Kirby 2001

<sup>6</sup> The changing dynamics of Irish immigration should go some way to alleviating the concerns some observers may have regarding an aging population in Ireland.

**Table 3: Estimated immigration by nationality, 1996-2003**  
('000)

	1996	1997	1998	1999	2000	2001	2002	2003
<b>Nationality</b>								
<b>Irish</b>	17.7	20.8	24.3	26.7	24.8	26.3	27	17.5
<b>UK</b>	8.3	8.4	8.6	8.2	8.4	9	7.4	6.9
<b>Rest of EU</b>	5	5.5	6.1	6.9	8.2	6.5	8.1	6.9
<b>USA</b>	4	4.2	2.3	2.5	2.5	3.7	2.7	1.6
<b>Rest of World</b>	4.2	5.5	4.7	4.5	8.6	13.6	21.7	17.7
<b>Total</b>	39.2	44.4	46	48.8	52.5	59.1	66.9	50.6

Source: Central Statistical Office

**Table 4: Estimated migration, country of destination/origin, 1986-2003**  
('000)

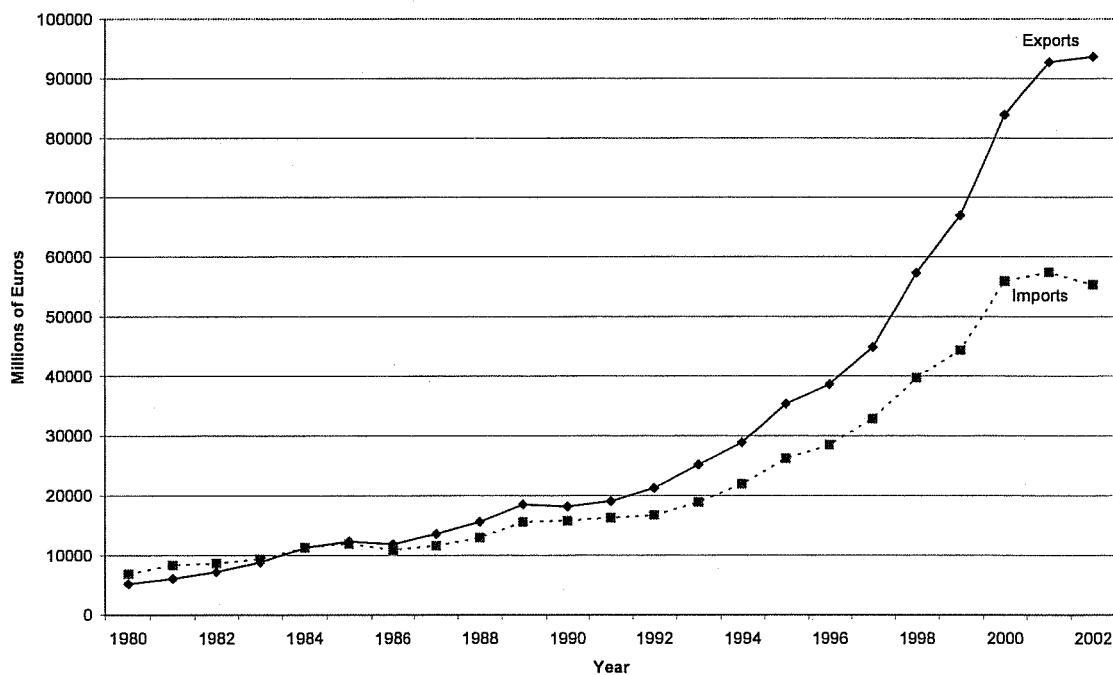
	1996	1997	1998	1999	2000	2001	2002	2003
<b>Emigrants</b>								
<b>UK</b>	14.1	11.6	11.8	11.2	7.2	7.8	7.4	5.9
<b>Rest of EU</b>	5.1	3.8	5.9	5.5	5.5	5.6	4.8	4.6
<b>USA</b>	5.2	3.4	5.3	5.3	4	3.4	4.8	1.9
<b>Rest of World</b>	6.8	6.6	5.6	9.5	10	9.5	8.5	8.3
<b>Total</b>	31.2	25.4	28.6	31.5	26.7	26.3	25.5	20.7
<b>Immigrants</b>								
<b>UK</b>	17.6	20.3	22.1	22.3	20.8	20.6	19.1	13.5
<b>Rest of EU</b>	7.2	8.1	9.1	10.2	11.7	10.3	11.3	9.7
<b>USA</b>	6.4	6.7	5.1	5.9	5.5	6.7	6.6	4.7
<b>Rest of World</b>	8	9.4	9.7	10.5	14.5	21.5	29.9	22.5
<b>Total</b>	39.2	44.5	46	48.9	52.6	59	66.9	50.5
<b>Net Migration</b>	8	19.2	17.4	17.3	26	32.8	41.3	29.8

Source: Central Statistical Office

Closely linked to the previous two indicators, is certainly the level of exports in the domestic economy. As we have seen, Irish policy makers long acknowledged the nation's need, being on the periphery of Europe, to embrace the advantages of the small open economy. One of the economic realities of a small open economy is that a relatively small increase in its share of world trade will cause a dramatic increase in the level of

domestic output (Leddin & O’Leary 1995 162). As we have already discussed, efforts were made to ensure Irish companies could benefit from extensive foreign markets. Exports having played such an important role in the growth of the Tiger, it seems that Ireland is a candidate as an export-led growth economy. Looking at Figure 10 and Table 5 one can clearly see the dramatic increase in Ireland’s terms of trade during the 1990s. Ireland is said to have benefited significantly from a strong US economy and a relatively weak Euro compared to the British pound, as “the effective exchange rate depreciated by 15 per cent from the first quarter of 1999 to the third quarter of 2000” (OECD 2001 24). This drove Irish exports and GDP to what is likely to be their peak of 2001. According to the Central Statistical Office (CSO), between 1990 and 1999, Irish exports grew in value from 14.3 billion Irish pounds to just over 50 billion Irish pounds, while the trade balance grew by almost seventeen times in the same period.

Figure 10: Irish Trade, 1980-2002



**Table 5: Irish trade, 1980-2002**

Millions of Euros

Year	Exports	Imports	Trade Balance
1980	5183.7	6882.9	-1699.2
1981	6066.3	8352.8	-2286.5
1982	7226.6	8654.8	-1428.2
1983	8816.8	9353.9	-537.1
1984	11297.5	11316.2	-18.7
1985	12371.1	11973.0	398.1
1986	11902.9	10946.8	956.1
1987	13616.0	11624.7	1991.3
1988	15623.9	12970.1	2653.8
1989	18534.4	15597.8	2936.6
1990	18203.9	15832.1	2371.8
1991	19070.1	16317.2	2752.9
1992	21260.2	16753.9	4506.3
1993	25178.2	18899.7	6278.5
1994	28890.9	21945.4	6945.5
1995	35330.1	26180.9	9149.2
1996	38608.9	28479.5	10129.4
1997	44868.0	32863.5	12004.5
1998	57321.8	39715.0	17606.8
1999	66956.2	44327.1	22629.1
2000	83888.9	55908.8	27980.1
2001	92741.6	57376.3	35365.3
2002	93659.3	55295.6	38363.7

Source: Irish Department of Finance

*Celtic Tiger: Significant Policy Platforms*

A number of policy platforms have been identified by researchers as having played a significant role in the development of the Celtic Tiger. Here we take a moment to discuss a few of those. One can never be sure why observers are so willing to champion selected policy, given that their effects, it could be argued, took the better part of forty years to materialize fully in the economy. What is interesting is that the one contribution all researchers can agree upon, is that of luck. There is no doubt that a small dash of 'The Luck of the Irish' was necessary. As O Grada notes, by the 1990s with the

corrections of the domestic economy and the creation of the single European market, “...the conditions for an economic recovery in Ireland were right” (O Grada 2002 12).

What is most striking about the elements listed below is that they were all in place at least 20, if not more, years before the boom. Most observers who cite the Irish Miracle as a blueprint for other developing countries note, among others, the following policy elements: access to education and training, EU transfers, low taxes and fiscal health, and the unique industrial policy targeted at unions and workers.

There can be little doubt regarding the role of education in the development of modern economies. This fact has been widely acknowledged by governments for well over 100 years. Human capital training and similar forms of investment are seen as an important element of a country’s move from low level income to high level income industries. Essentially, driven by the needs of the industrial revolution, governments sought to provide access to education in an effort to ensure the basic skill sets and socialization for a new range of workers engaged in factory and administrative positions. This has become even more important in an ever-increasing globalized world. With changes in transportation and communication, and the way business itself is conducted, unskilled workers throughout the world are being mobilized to compete with one another (OECD 1995 57).

Ireland, relative to other western countries, was late to introduce access to higher levels of education, only providing for free secondary education in 1967 (OECD 1999 43). The country and its policy, however, were soon to make up for lost time, recently introducing free undergraduate education and now, “Ireland ranks second among advanced countries in the share of national income devoted to public education” (Kuttner

2000 33). The country has also put in place substantial retraining and skill development programs, targeted at aiding those wishing to hone their skills for the new technology-based economy flourishing in Ireland. Of course such measures did not account for the economic expansion, but few could argue it occurring, let alone sustaining, without significant investment in developing human capital. Indeed, it was not only Ireland's proximity to Europe or its favourable tax system which attracted large amounts of foreign direct investment (FDI). Without a doubt, the presence of an English speaking, well educated labour pool made attractive investment opportunities all the more appealing, and in the end, successful. The OECD has seen the motivation in Ireland's educational reform through the years as being inspired by the need to accelerate its transformation from a low-income agricultural society to an industrial and service-based economy, creating jobs with higher incomes, similar to the rest of Europe. As this has occurred, the OECD feels that the rapid improvement in the average level of the Irish workforce has been significant.

Second, and one element which receives considerable attention from the Celtic Tiger's detractors, is that of EU transfer payments. While the presence of such transfers has had a positive impact on the Irish economy, it must be recognized that they did not change the fundamentals of the economy, but rather provided for greater flexibility by the government. In the past, critics have suggested Ireland's fiscal management and planning have been haphazard at best. However, the presence of structural funds, "gave impetus and direction to Ireland's investment program" (McAleese 2002 48). Those who want to attribute Ireland's success to the EU transfers ignore other examples. For instance, as noted by McMahon "EU transfers to Ireland...are but a fraction of the wealth transferred

by Ottawa to the Atlantic Provinces” (McMahon National Post). This puts into perspective the impact of such monies alone. Without proper direction, as Irish policy was able to provide, the money acts simply as a smoke screen.

With the structural funds being provided by the EU, a certain level of responsibility and long-term planning was required. The EU, as with many of its programs and policies, has in place strict guidelines which must be met in order to continue the receipt of desired funding levels. As a result, Irish public expenditure targeted long-term initiatives and sought ideally to improve under developed infrastructure. Most significantly, at a time when Ireland was engaged in a tough fiscal retrenchment in the late 1980s<sup>7</sup>, the structural funds allowed the government to continue spending in areas which would have otherwise been cut. Spending was concentrated on funding the building of roads, training programs and education initiatives. During the period of tight fiscal correction, Ireland was able to improve vital elements of the country’s infrastructure, which have allowed the country to deal more readily with the realities of a fast growing economy and which have contributed to its growth.

There are critics who argue much of the analysis of such spending ignores the distinction between social and private returns to investment (O Grada 2002 4). It has been suggested that money may have been better spent, for instance, on telecommunications rather than education. Certainly, when discussing education, in the past a great deal of money was exhausted, only for Ireland to experience a dramatic brain drain as is highlighted by Murphy, who recalls that in the 1980s, he ‘watched nearly all of [his] graduating class in Trinity [College] emigrate” (Murphy 2000 23). Now, however, with the fundamentals of the economy having been corrected, many who had left the

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<sup>7</sup> As highlighted in Figure 3.

country, eagerly return to those high paying jobs they could not find in the past. Essentially, the public cost of such funding is being repaid, as workers with strong education and more importantly, experience, return to help the economy continue on its present course. Further to this, it should not be ignored, that such spending can be expected to “yield positive externalities, and as these investments are implemented the economy’s productive potential is progressively enhanced” (OECD 1999 44).

Probably the most discussed feature of the new Irish economy is the steady introduction of a business favourable tax regime. Since the 1950s, the Irish government has attempted to attract foreign investment and encourage export development with financial incentives and competitive tax rates. Specifically, low tax levels were introduced for foreign investors and industries geared toward exporting. Table 6 outlines

**Table 6: Irish tax rates on corporate income and capital investment**

Statutory Corporate Income Tax Rate		Effective Tax Rate on Capital Investment			
Country	Rate	Country	Rate	Country	Rate
Japan	41.0	United States	23.6	France	25.8
United States	39.2	France	23.2	United States	24.8
France	37.8	Canada	22.8	Canada	24.6
Canada	36.4	Japan	22.6	Japan	24.0
Germany	35.0	Germany	21.1	Italy	21.4
Italy	31.3	Italy	18.1	Germany	20.8
United Kingdom	30.0	United Kingdom	17.2	United Kingdom	17.2
Sweden	28.0	Sweden	14.4	Sweden	14.2
Ireland	12.5	Ireland	5.3	Ireland	5.3

Source: Pierre Fortin,  
2002

the tax rates on offer in Ireland for corporate income and capital investment, as compared to other OECD countries. What is striking is the significant difference between Ireland and the other nations. Such a ‘competitive’ tax system is a clear indication from the

government of how it wanted the economy to develop. This discussion, however, often ignores the necessary fiscal austerity which occurred, particularly in the late 1980s, and allowed for changes in domestic tax rates. Though Irish economic indicators, as discussed, have shown tremendous growth, often the state of the public finances is overlooked, but as the OECD notes, it is the “one domain that has shown remarkable progress since the mid-1980s” (OECD 1999 45). Researchers have grappled with the apparent existence of an ‘expansionary fiscal contraction’ in Ireland, whereby the output in growth might be linked to the fiscal consolidation. It seems more likely, that Ireland was again merely lucky, attempting to get its fiscal house in order, just as world economic events were conspiring, in her favour, to encourage domestic growth.

Still, one should not underestimate the role played by the domestic tax authority in helping to foster a positive economic environment. A tax amnesty introduced in 1988 helped to raise revenue in the short term and is said to have permanently reduced the size of the underground economy (OECD 1999 48). Still, since the 1950s, the most significant policy moves have affected corporate tax levels. Specifically, the introduction of the export profit tax relief (EPTR) scheme in 1956, which offered 100 per cent tax remission for profits earned on exports, up to and including the introduction of a 10 per cent Corporate profit tax (CPT). The CPT was introduced following an EU finding that the EPTR was discriminatory, and subsequently phased out during the 1980s. Ironically, the CPT came under heavy criticism after “claims of unfair tax competition from countries such as Germany and Belgium, which were not pleased to see significant relocation of activity to Ireland” (Walsh 2000 668).

The highly favourable regime created with a ten per cent tax rate on all corporate taxes for export-orientated manufacturing and traded services, was successful in attracting the high levels of FDI Ireland benefited from. Pressure from the EU did result in changes to the tax system, but in a direction few had anticipated, and a direction few were please with. Instead of increasing the ten per cent rate, the Irish tax authority introduced new rates for all other industries, lowering the existing 50 per cent level to that of only 12.5 per cent. As a result, pressure from other EU member states still exists (McAleese 2002 48). However, from the domestic perspective, further problems are said to exist with the Irish tax system. Of note is the dualistic nature of the tax system, which has traditionally set lower rates on export industries, with a higher standard rate for the rest of the corporate sector. Also, there exists a large gap between corporate and personal tax rates, giving rise to the fear that personal income, may 'migrate' to the corporate sector (Walsh 2000 668-669).

Finally, one element which has been given considerable attention, and what certainly is a unique element of the Celtic Tiger, is the so-called 'social partnership' agreements. Given Ireland's experience with 'militant' unions in the decades leading up to the Celtic Tiger era, and the many days lost to work stoppages in the 70s and 80s as a result, the Irish government "introduced a series of institutional innovations aimed particularly at reducing the incidence and mitigating effects of long-term unemployment" (Sabel 3). Key to any significant growth that Ireland may have experienced was a need to correct the catalogue of labour problems which plagued the past. The government realized that any benefits obtained if economic growth targets were realized, could be

lost, if the workers were not directly included in the planning process. The precedent for this was of course set in the 1950s.

There have been four such agreements since the late 1980s in which “Ireland adopted a unique model of wage determination, involving extensive consultation and agreement between the social partners” (McAleese 2002 47). A striking benefit of the social partnerships was that it managed to keep Irish wages at competitive levels. Beginning in 1987 with the Programme for National Recovery (1987-1990), the system has extended to the most recent initiative, the Programme for Prosperity and Fairness (2000-2003). The essence of the agreements involve a trade off between low before tax wages and a series of tax cuts, which coupled together, serve to raise after tax incomes. This has proven successful to date, and did allow Ireland to move beyond the recent experience of the 1970s and 80s, where work disruptions caused significant damage to economic productivity and efficiency. This stabilising of industrial relations, also aided in the attraction of FDI, as it eased any possible concerns investors may have had regarding the security of future labour relations. However, in light of the large amount of profits which these foreign firms have repatriated from Ireland during the last decade, many social groups are beginning to wonder if it was the common worker, with lower wages, who has paid for the miracle.

#### *A Note of Caution*

Even in light of the tremendous success of the Irish economy over the last ten years, given the ups and downs of the past, and the failures of other emerging economies, there still remain doubts regarding the sustainability of the latest ‘tiger’ economy.

Critics, or at least observers who wish to encourage caution, are quick to point out Ireland's apparent dependency on foreign investment, particularly from the US. The fear is that just as easily as the money has moved into the Irish system, it can move out (a reality which we have seen on many occasions in the past). As we have discussed above, by the 1950s, Ireland had embraced the economic benefits to be realized by opening up to foreign markets, both in terms of trade and investment. Initially, such moves to attract said investment were intended only to make up the shortfall of domestic investment. But by the mid 1990s Irish investment rates were the lowest in Europe, standing at 15 per cent (OECD 1994). Many international observers, most notably the OECD, have recognised this deficiency in Irish investment, most acutely affecting levels of domestic research and development. This has been attributed to the presence of foreign firms, which are happy to build branch-plant style operations in Ireland, but who like to keep the product of development close to home. It is widely believed that such cutting-edge operations offer greater benefits to the host economy, in terms of quantity and quality of employment and, as well as sustainability.

We must recall that the Industrial Development Authority (IDA) essentially picked winners to back under the current push for growth. The policy of supporting and encouraging development and investment in the information and communications technologies, pharmaceuticals and health care industries and most recently, software and customer service support, was a gamble which paid off. Certainly those industries have performed well, but as Mary O'Sullivan warns: "The nature of industry keeps changing – there is a continuous process of decline in some sectors...and growth in others. So we can assume that a fair share of the industries we have today will decline and decay in the

coming years” (O’Sullivan 2000 313). While the likes of Taiwan and South Korea created strong indigenous industries, Ireland has chosen dependency on foreign investment and thus it is at the mercy of these investors whims, or perhaps more accurately, their profit maximizing behaviour. With the periphery of the EU expanding to the east, there is every reason to believe that these emerging economies will attempt to lure this investment away. Whether they will be successful in their attempts remains to be seen, as does the longevity of the Irish economic boom.

The sustainability of the current period of success in the Irish economy is not, at present, our concern. Instead we first seek to take a closer look at what has developed and unfolded under the surface of the Emerald Isle. We now take a closer look at the potential impact export growth has had on the economy’s development. To this end, we now turn our attention to the economic theory of export-led growth. We will then take a look at the potential prospects for sustaining positive economic conditions in Ireland.

### **PART III: Export-Led Growth**

#### *The current state of Irish trade*

In the previous sections, we began by providing a brief outline of key moments in Ireland's economic history, before introducing significant indicators by which to highlight the transformation of the Irish economy during the 1990s. In this section we expand on the nature of Irish trade and how it has evolved since the decision to embrace openness. In particular, we are interested in the role played by trade in the expansion of the Irish economy and the subsequent growth in GDP during the last decade. In our efforts to understand the nature of the Irish export industry, one can never underestimate the role played by Foreign Direct Investment (FDI), which is generally attributed as an important stimulus to Irish growth. With the presence of such high levels of investment, however, new problems have been presented, including the emergence of 'transfer-pricing.' We will examine each in turn.

Though causality is still unclear (a point to be addressed later), policy makers in many, if not all, developing and industrialized nations readily employ the notion that trade is conducive to economic growth. Ireland, for its part, embraced this attitude with reckless abandon. By 1994 imports of goods and services amounted to 54 per cent of GDP compared to the EU average of only 25%. Significantly, export levels were at similarly incongruent levels, with Irish exports representing 65 per cent of domestic GDP, compared to the EU average of only 27% (OECD 1995). These levels should not be of any surprise given the nature of Irish industry in the 1990s and the fact that whether or not economic growth was caused by trade, growth is certainly conducive to trade.

The mercantilist tradition was the earliest to make export promotion the central part of their economic policy and ever since, observers and governments have attempted to understand the relationship between trade and growth and the appropriate level of influence on its activity. Countries are moved to trade for a number of reasons. Among these reasons would be the desire to expand commodity base, a means to expand output and therefore create jobs and finally, because experience dictates that there are positive gains to be had from trade. With Ireland having such a small domestic economy, and historically being an isolated country, removed from the large European and North American markets, trade was always going to play an important role in Irish economic development. However, at the same time, the country was advantageously located beside England, certainly one of the largest markets in Europe. Now, with the increasing efficiency of transportation, costs and travel time have been significantly reduced, so that Ireland is essentially located beside innumerable large populations and markets. Increases in globalization and a willingness on the part of the Irish to open up their markets have seen to this.

Ireland's increasing openness has provided numerous benefits in the form of spillovers and positive externalities associated with trade. We have seen that IDA recognized Ireland's deficiencies were not limited to productive capacities, but also the range of exports and the country's understanding of marketing to foreign economies for investment and increased trade. Irish policy was initially reluctant to foster such openness, fearing such a move would have significantly negative impacts on indigenous sectors. Yet, behind the protective tariff walls, constructed during the 1930s, Irish firms lacked efficiency and economies of scale. The opening up of the economy, as many

economists would readily argue, and the resultant increases in trade, are believed to have had the effect of “intensifying competition, increasing the incentive for both imitation and innovation and accentuating the rate of technical progress that [has led] to efficiency gains through more competitive cost structures and productivity improvement” (Doyle 2001 31).

A general result of development economics is that as economies begin to evolve, they will shift away from a dependence on primary sectors, such as agriculture, to increasingly more technologically-based sectors. This re-orientation of industrial development in the domestic economy, moves from agriculture (primary industries) to manufacturing (secondary industries) and then to service based activities (tertiary industries). It is easy to trace Ireland’s transformation, particularly given the clear policy which has been introduced to direct economic development. However, it is important to note that the move from primary to secondary industries was greatly prolonged because of myopic policy direction. Subsequently, the shift from secondary industries, into tertiary ones, happened quite rapidly. Many observers see Ireland as having skipped part of its industrialization. This has, however, proved to be most beneficial for recent growth, as antiquated capital and ideas did not have to be replaced on a large scale. Ironically, it would seem that the ‘back water’ nature of Ireland, by virtue of missing out on the machine-driven economy of early industrialization, made the transition to a high-tech economy all the more smooth.

As we saw in Part II, Irish trade, both in terms of exports and imports, has increased significantly in the 1990s. What is interesting to note about this activity, is the changing nature of the commodity composition of trade, which has been driven by a shift

to technology-based sectors. Since the 1960s there has been a decline in the trade of agricultural products, with an increase in the trade of industrial goods. According to the Central Statistical Office (CSO) and the Department of Finance, as highlighted in Table 7, the exports of live animals and food have fallen from a level of 61 per cent of exports

**Table 7: Composition of Irish trade by commodity group**

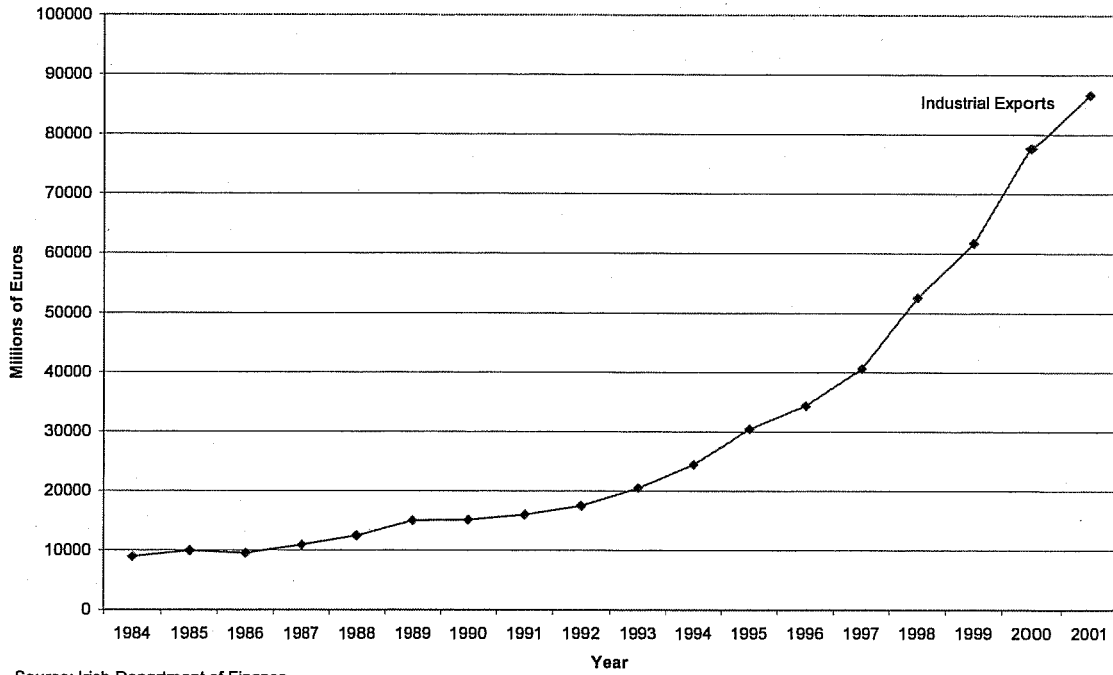
	Exports			Imports		
	1961	1995	1995	1961	1995	1995
	%	%	Irish Pounds	%	%	Irish Pounds
Live animals and food	61	20	4896	16	8	1447
Beverages and tobacco	4	2	490	3	1	181
Raw materials, fuels & oil	9	3	734	19	8	1447
Manufactured goods	18	68	16648	54	74	13380
Other	8	7	1714	8	9	1627
<b>Total</b>	<b>100</b>	<b>100</b>	<b>24482</b>	<b>100</b>	<b>100</b>	<b>18082</b>

Source: CSO, Irish Department of Finance

in 1961 to a level of 20 per cent in 1995. Significantly, the manufacturing goods sector witnessed tremendous growth over this period, with exports rising from a level of 18 per cent in 1961 to 68 per cent in 1995. It is also important to note from Table 7 the growth in imports of manufactured goods over the same 35-year period. This is explained by the growth in the manufacturing industry itself, as there was a greater need to import raw materials for use in the production of industrial goods for export. Given the small size of Ireland and its domestic market, the country “depends on foreign countries for most of [its] raw materials and components, for four fifths of [its] machinery, for necessities such as oil and coal and luxuries such as tropical fruits and wines” (McAleese 1986 19).

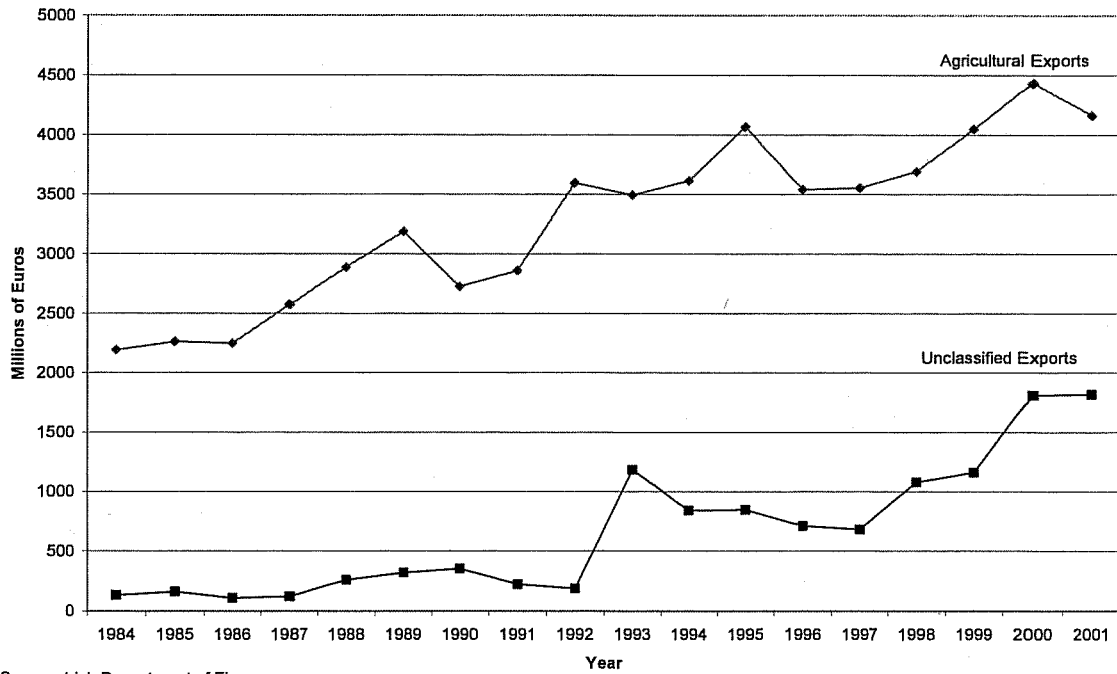
A quick glance at Figures 11 and 12 provides a clear illustration of the change in commodity composition in Ireland, with the change in export-orientation comes the

Figure 11: Irish industrial exports, 1984-2002



Source: Irish Department of Finance

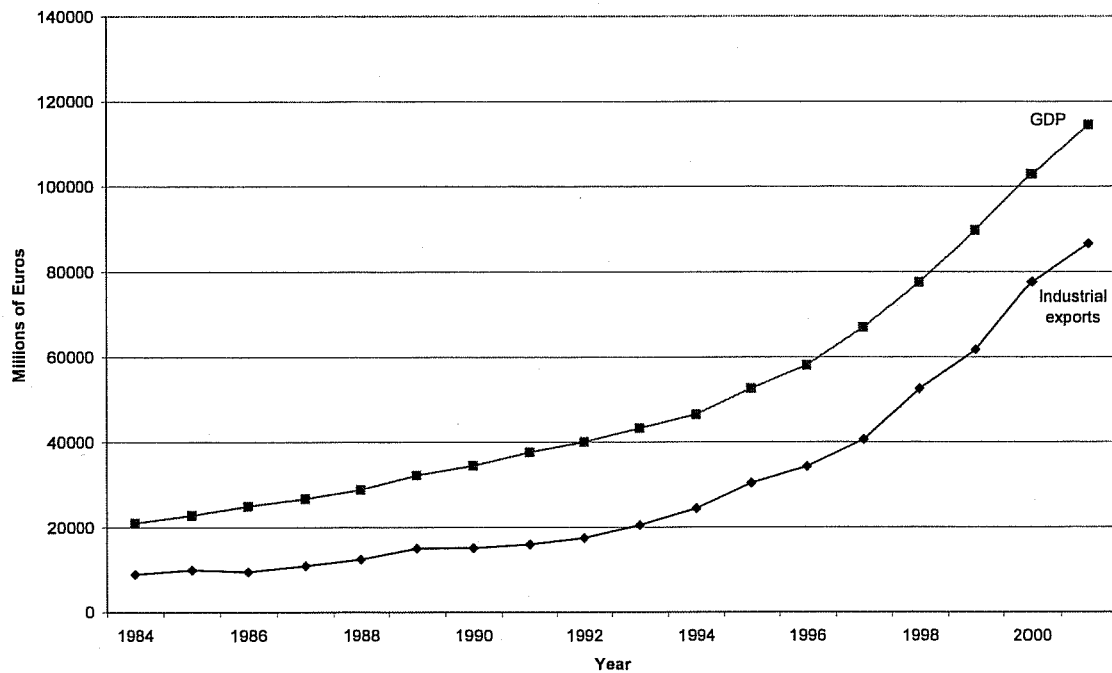
Figure 12: Irish exports classified by sector of origin, 1984-2002



Source: Irish Department of Finance

emphasis on high-tech based trade. The graphs represent the period 1984 to 2001 (as the Irish Department of Finance data permit). As is clearly shown, industrial exports not only have increased some eight times over this period, but also experienced continual positive growth, which along with GDP, took off in the mid-1990s. The relationship between the surge in industrial exports and GDP is highlighted in Figure 13. This graph illustrates the importance of the economies shift to secondary industries, as the growth in both indicators mirror one another. On the other hand, agricultural exports, though experiencing considerable volatility over the period, have not increased by nearly as great a factor even if they have, on the whole, experienced moderate positive growth. This contrast in experience for the two sectors highlights two key components of Irish trade in recent times. The shift to industrial exports will have undoubtedly had a positive impact on GDP growth, as it represents more value added activity. Still, however, the

Figure 13: Irish GDP and industrial export growth, 1984-2001



agricultural sector did experience growth, and although not nearly as significant as the manufacturing industries, the level of agricultural exports did nearly double during the period. This suggests that the openness of the Irish economy, membership in the EU and the subsequent growth of the Celtic Tiger era, seem to have impacted positively on all sectors of the economy. It would seem that the once thought policy, of what is good for agriculture is good for the economy, was in fact, what is good for manufacturing is good for the economy at large.

It is also important to take note of the growing importance of the trade in services, the so-called tertiary industries, in the Irish economy. In modern economic activity, trade services are an important component of world trade, representing an estimated 20-25 per cent of total world trade (McAleese and Hayes 271). Presently, data on such trade in Ireland is unavailable, however anecdotal evidence is sufficient to illustrate the changing face, and increasing importance of this component of Irish trade. Key to the increase in the trade of services has been the revolution in the information technology, the relaxation of exchange controls and particularly in the case of Ireland, the creation of the Single European Market (McAleese and Hayes 271). Such changes have broken down barriers, and have, for example, enhanced Ireland's financial services industry, which can now service clients in all parts of the globe. In fact, considered to be one of the success stories of the Irish boom, is the Irish Financial Services Centre (IFSC), which is said to receive between one third and one half of FDI flows into Ireland (Enterprise Ireland 2003 48). It has emerged as one of the leading locations world wide for international banking, insurance and investment funds, employing over ten thousand people and hosting the

world's top insurance companies and largest banks. It has, almost single handedly, transformed Dublin into one of Europe's major financial centers.

With the boom and efforts to increase competitiveness, Ireland has witnessed an associated surge in tourism receipts. Always a source of income, tourism received a significant boost during the Celtic Tiger era with the liberalization of air access in the 1980s. This move resulted in significantly reduced airfares, which encouraged changes in sea fares by similarly high reductions<sup>8</sup>. As a result, the country's share of world tourism increased, going against current EU and previous Irish trends. This again provides an example of the positive spin-offs associated with policy aimed to improve the competitiveness and encourage further openness in the economy. Many sectors have been greatly enhanced by such measures.

There has also been an increase in the data processing activities in Ireland, particularly in customer service, insurance claims and hotel bookings, with statistics being fed back to the US for any number of sectors. Such outsourcing has come to represent a major political topic in Washington (*The Economist* Feb 21 2004). As noted earlier, the increase in communication and technology allows low skilled workers to compete with one another from the comfort of their home nation. Such transfer of activity is normally associated with third world countries, and perhaps provides the example of likely Irish activity to be lost in the future to other emerging economies.

In addition to the above, Ireland has also witnessed a dramatic increase in construction activity. Once considered a non-tradable, construction work has become a major international industry, with industrialized countries offering their expertise in modern building to less developed regions. Irish construction companies have been

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<sup>8</sup> By as much as 50 per cent by some accounts (Barry and Crafts 1999)

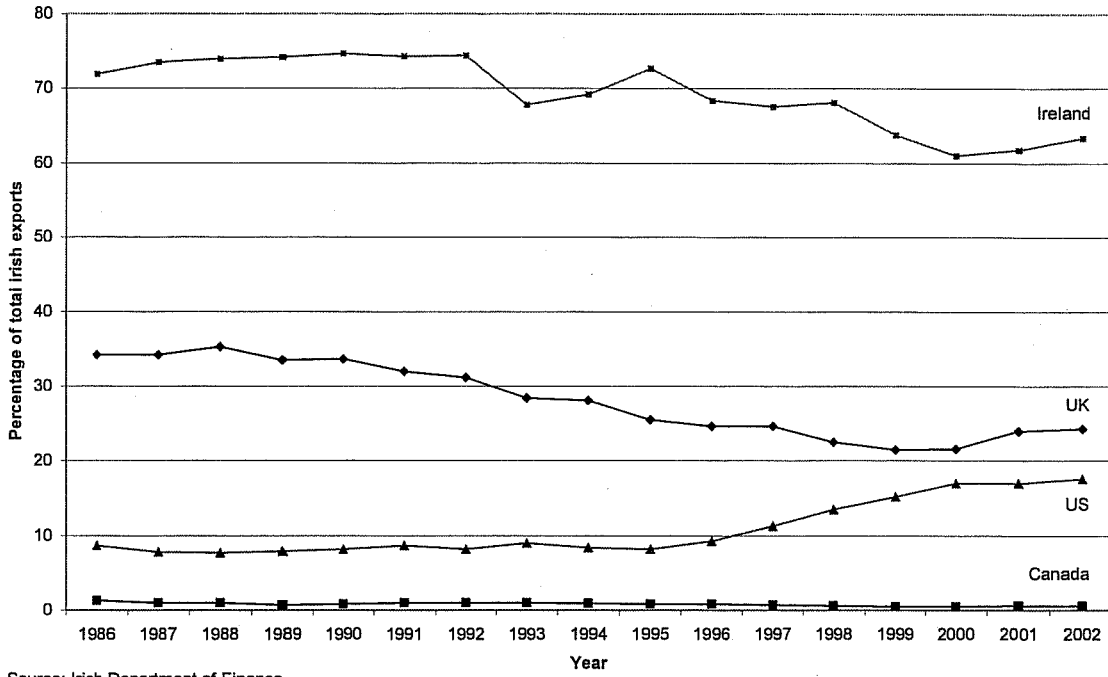
heavily involved in projects in Africa and the Middle East, doing much to enhance their own, and Ireland's, international reputation. Though the aggregate of such activity is presently low, all types of exports are becoming increasingly important to economic growth. Furthermore, they represent a diversification of activity, which is an important step to ensure sustainability and the likelihood of negotiating leaner times.

Though certainly the most significant change in the composition of Irish trade has been the shift away from primary industries, it is also interesting to note the evolution of export destination which has taken place. According to the CSO and the Irish Department of Finance, the UK still represents Ireland's largest single trading partner, accounting for roughly 20 per cent of exports. There has, however, been a shift in concentration, as noted in Figure 14<sup>9</sup>, with the United States becoming a very important partner in the 1990s. Researchers note that the presence of high levels of FDI, most notably from the US, has "facilitated the decoupling of the Irish economy from an almost total dependence on the UK as a trading partner" (Barry and Bradley 1997 1798). As illustrated in Figure 15, exports to the UK have been in decline since the 1960s when they represented more than 70 per cent of exports to only 24.3 per cent by 2001. McAleese notes that while the per cent of exports making their way to the UK has decreased, it does not signify a decrease in absolute terms. In fact, "they grew steadily right through the period [1950s-1990s]...[and the change rather] reflects the rapid growth of exports to other areas" (McAleese 1986 20-21).

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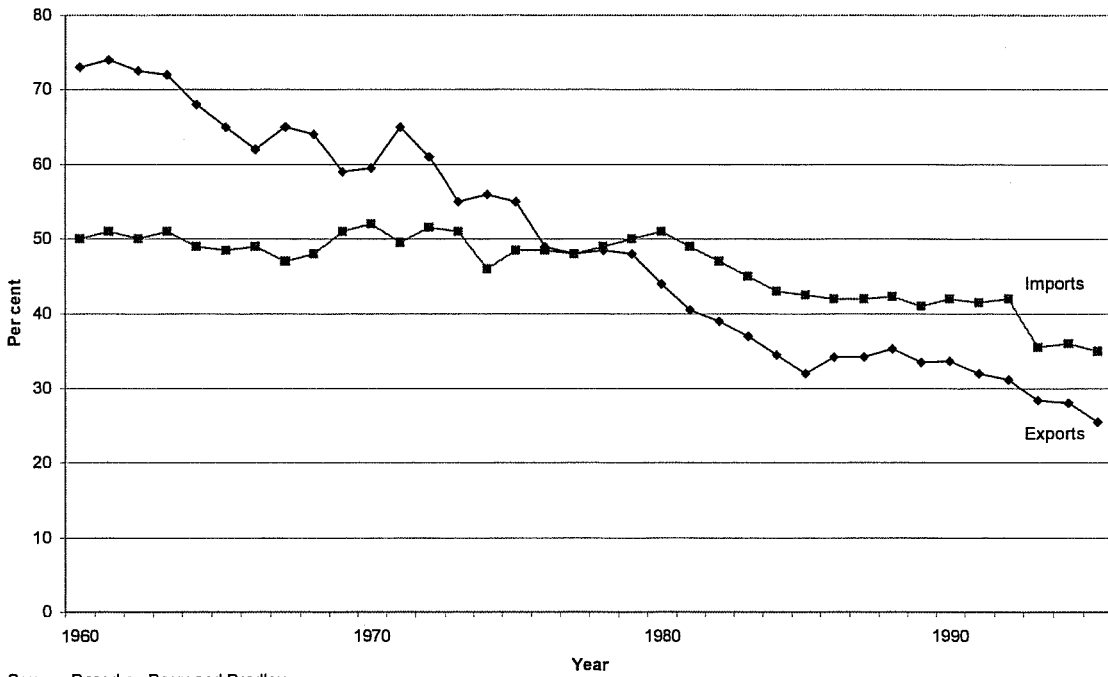
<sup>9</sup> Canada is included simply for reader interest.

Figure 14: Export destination, 1986-2002



Source: Irish Department of Finance

Figure 15: Uk share of Irish Trade, 1960-1995



Source: Based on Barry and Bradley

Interestingly, as evident in Figure 15, imports from the UK although also declining, still remain relatively strong. The reason for the strength in UK imports is thought to be a result of the cultural links which exist between the two countries. Also, because of the decline in exports to the UK, with relative stability in import levels, Ireland now exhibits a trade deficit with the UK, though still recording a strong trade surplus with the entire world, as was illustrated in Figure 10. Furthermore, it appears the growth in export levels to the US, has been at the expense of trade with the UK. Still, while the relative share of exports to the UK has fallen, in absolute terms they have continued to grow steadily over the years. The change has only been in Ireland's decreasing dependency on the UK market. Like most countries, Ireland exhibits a changing pattern of surplus and deficit between different types of goods and services and different parts of the world.

### *Foreign Direct Investment*

The shift in Ireland's trading focus, from the UK to the rest of the world was, as we saw earlier, a policy direction taken by the government during the 1950s. The diversification of trading partners was key to increasing export-orientation and such efforts were greatly enhanced by the willingness of large multinational corporations to establish operations in Ireland. As has already been discussed, with the abolition of the Control of Manufactures Act, Ireland opened its domestic market to foreign investment and, increasingly, to foreign capital. The Irish economy, since the 1950s, went from a zero base of foreign direct investment (FDI) "to a situation where almost 60 per cent of gross output and 45 per cent of employment in manufacturing is in foreign-owned export-

orientated firms” (Barry & Bradley 1997 1798). This represents a significant transformation in the country’s industrial makeup.

The government made a concerted effort to cultivate FDI by means of a favourable tax regime, financial investment grants and a breakdown of protectionist barriers. These companies were also attracted to Ireland because of its proximity to the European market, and in the words of the Industrial Development Authority, “low wage rates relative to the skills and education level of the workforce” (Dorgan 2002 3). It is widely recognized that the presence of these companies has played a vital role in the economy’s turnaround. Barry notes that “almost 50 per cent of Irish manufacturing employment is in foreign-owned industry” (Barry 2000 1391). This level of foreign presence is more similar to the experience of economies such as Singapore, rather than other European nations. Barry argues that though employment growth has obviously been introduced there are also numerous spillovers in the form of productivity growth and indigenous industry jobs creation.

Given the level of FDI in Ireland, its importance in economic activity cannot be understated. Also, the reality that Irish plants export on average, roughly 35 per cent of output, compared to 86 per cent of output being exported by foreign plants<sup>10</sup>, the role of FDI in Ireland seems only to exist in order to facilitate the export industry. The domestic market is of little consequence to foreign firms (Barry and Bradley 1997 1800). Many Irish observers have viewed the high level of foreign investment somewhat suspiciously. The view that the presence of these companies have been nothing more than productive plants set up on Irish soil, simply to take advantage of generous tax concessions, access to Europe and the presence of government policy meant to depress domestic wages, is

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<sup>10</sup> Reaching as high as 96 per cent for US owned plants (Barry and Bradley 1997)

common. Kennedy claims that “in no sense fly-by-night operations, still they [have] few linkages with the rest of the economy” (Kennedy 1986 45-46). Furthermore, while trade dependency is a feature of all small countries, Ireland’s degree of such dependency is exceptionally high, reflecting its pattern of development with comparatively heavy emphasis on export orientated overseas subsidies (Fingleton 1995 297).

Yet, Ireland certainly has benefited from the presence of these firms, in particular the nature of industries they helped develop. The focus for FDI has been mostly concentrated in new secondary and primary industries. It is suggested by the OECD that the presence of foreign multi-nationals in Ireland have been responsible for the transformation of the economy into a high-technology based one (OECD 2001 28), as they focus on producing products such as computer hardware and software, chemicals and pharmaceuticals. This trend is interesting, as the FDI inflows into Ireland have been concentrated in emerging sectors of the economy and not into industries which were primarily considered to hold so-called comparative advantage for Ireland. This would explain, an opinion supported by the OECD, the incredible acceleration of the transition of the country’s industrial structure. Foreign-owned firms are producing as much as 80 per cent of total manufacturing, while employing nearly half of its workers (OECD 2001 28). These industries have been selected by foreign investors as they are believed to provide increasing returns to scale, at least at the firm level (Barry & Bradley 1997 1801).

Besides increasing the rate of technological change in Ireland, and helping to focus export orientation, the presence of such significant FDI is believed to have had other positive impacts in the Irish economy. Given the technological base of many of the

sectors targeted and fostered by the newly acquired foreign capital, it is no surprise that many highly skilled and high paying jobs have been created in Ireland. Interestingly enough, earlier attempts to provide such jobs for the Irish worker, dependant on protectionism and a closed capital market, failed miserably. It was Ireland's ability to increasingly direct the economy outwardly which has provided the impetus for her success. The foreign dominated sectors are believed to employ substantially higher levels of skilled labour and as a direct result pay higher wages, "approximately 25 per cent higher than in indigenous industry" (Barry and Bradley 1997 1802).

Interestingly, according to a 1994 OECD report on FDI in Ireland, some 70 percent of the manufacturing companies operating in Ireland had set up operation after Ireland's accession into the European Community in 1973. Membership in the EC provided these firms with access to a market of roughly 350 million people, a size comparable with that of the US. This longstanding relationship should be enough to quell some of the fears regarding the apparent threat of flight of foreign investment. As McAleese notes, the majority of these early firms coming from the US and Germany (soon to be followed by other European countries) were small to medium sized rapidly growing firms, and not the multinational corporations which make their presence felt today. It was with the success of such operations that large firms followed in, displaying a common trend in the movement of international business: markets which prove successful attract large firms, and once a large firm is present, its competitors soon follow. In fact, today international brands such as Intel, Apple Computers<sup>11</sup>, Hewlett Packard and Microsoft, among others, all have a strong presence in Ireland.

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<sup>11</sup> In fact, Apple's European headquarters is located in Cork.

Currently it is difficult to obtain Irish data clearly disaggregated to highlight foreign and indigenous firm activity, perhaps so as not to highlight the country's apparent dependency on FDI. For, regardless of the many benefits FDI has certainly had for Ireland, there are a number of drawbacks to the inflow of such significant levels of foreign investment. One concern over the years has been the sustainability of economic growth given the potential caprices of investors. However, this steady flow of FDI has established strong industries in Ireland and as a result, a base which should continue to provide a good return on investment for investors. Also, the fear that with the expansion of the EU, further pushing out the eastern border of the union, and the increased potential for new member states to invoke similar policy in an effort to attract their own levels of investment, has always loomed.

This ignores a number of key issues. First, that Ireland enjoys what has been termed "first mover advantage." Foreign firms are already firmly established in Ireland and the incentives to abandon such a base for Eastern Bloc nations are not obvious. Second, the presence of an English speaking, highly skilled work force, is certainly significant for the US firms, which "are easily the most important investors in Ireland" (OECD 1994 11). Third, the long standing political and cultural ties between the US and Ireland, with the result that US firms began to invest in a substantial way as early as the 1970s, suggests a long standing and not entirely one way relationship. Finally, one of the key incentives provided by Irish policy was the potential 'tax amnesty' created by the competitive tax rates offered by Ireland. It is unlikely, given the opposition to Ireland's potentially discriminatory tax policy within the EU, that new member states would be permitted the opportunity to invoke similar policy.

Yet, while there are strong indications foreign firms have significant reasons to remain in Ireland, questions regarding the true extent of backward linkages remain. One such concern is the low levels of R&D spending in Ireland, and the potential consequences this could have for long-term prosperity and growth. The low levels of R&D spending, among the lowest in the OECD, is seen as a by-product of an economy where the emergence of a high-tech sector has been dominated by foreign firms. Such a presence provides little incentive for indigenous firms, and even the government, to invest significant monies in these important areas. The OECD argues that an increase in venture capital would contribute to future technological progress. Such investment has increased, most importantly from domestic sources, but still lags behind levels of comparable industrialized countries. The focus on foreign capital to improve domestic industry faces the reality that foreign firms have little vested interest in the local market and prefer to keep the majority and the most important research projects with the parent company and in the parent country.

One of the problems often cited by observers with high levels of FDI is the possibility that it may reduce national welfare if foreign firms capture market share from indigenous firms. Ireland seems to have been fortunate enough to avoid such a faith, as foreign investment has been concentrated in new, high-tech industries, and not in areas once considered indicative of the Irish economy<sup>12</sup>. As noted by Barry and Bradley, if an economy finds itself at the outset in a state of underemployment, which Ireland certainly was, pushing the limits of 18 per cent annual unemployment during the 1980s, then given the job creation encouraged by FDI, the pressure on the domestic industry is more conducive, than say a shift to imports. Also, given the high level of exports originating

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<sup>12</sup> Industries such as brewing and food stuffs.

from foreign firms in Ireland, one could say these firms exist primarily, if not entirely, to service foreign markets, and so in no way threaten domestic firms who serve the domestic market. However, they do discourage growth in increasingly profitable industries by indigenous firms. In the early 1980s, the National Economic and Social Council commissioned asked US consultants, the Telesis Group, to conduct a study on the state of Irish industry and an assessment of the policy governing it. The report was critical of what it saw as “an overemphasis on foreign industry in the policies to promote industrial development...[and] that this approach was at best a short-term solution to the challenge of industrial development” (O’Sullivan 2000 367). Significantly the Telsis Report (as it is known) argued that the country could not be expected to create and sustain significant economic growth without a strong indigenous sector.

Some see the apparent dependency on US investment, in light of pressure on the US dollar and the US economy in general (*The Economist* Sept. 20 2003), as representing a potential threat to sustainable Irish growth. It would seem that Ireland has shifted its faith and dependency from the UK to the US. Yet, recent research has indicated that to date “foreign firms have been less likely to decline and to close down, during periods of economic difficulty, than is the case with indigenous industry” (Barry & Bradley 1997 1807). This seems likely since the foreign multi-nationals are strong firms and are therefore able to ride the cusp of business cycles. Further to this point, the majority of exports in the foreign-driven economy are targeted primarily to the UK and the rest of Europe, as noted in Table 8, and so one should be more concerned about the state of these economies, rather than the US economy alone. US investment serves as a point of access to the EU. The OECD, in fact, notes that the slowdown in the US economy in the early

1990s did not have a marked affect on FDI flows to Ireland (OECD 2001 32). What US investors are most concerned with is profitability and hence stock prices. If economic indicators prove strong, which forecasts of GDP growth in Ireland continue to be, slowdowns merely provide a convenient opportunity for investors to purchase stock at a lower price.

**Table 8: Export destination (percentage share)**

	UK	Canada	US	Total EU
1986	34.2	1.3	8.7	71.9
1987	34.2	1.0	7.8	73.5
1988	35.3	1.0	7.7	74.0
1989	33.5	0.7	7.9	74.2
1990	33.7	0.8	8.2	74.7
1991	32.0	1.0	8.7	74.3
1992	31.2	1.0	8.2	74.4
1993	28.4	1.0	9.0	67.8
1994	28.1	0.9	8.4	69.2
1995	25.5	0.8	8.2	72.7
1996	24.6	0.8	9.3	68.4
1997	24.6	0.7	11.3	67.6
1998	22.5	0.6	13.5	68.1
1999	21.5	0.5	15.2	63.8
2000	21.6	0.5	17.0	61.0
2001	24.0	0.6	17.0	61.8
2002	24.3	0.6	17.6	63.4

Source: Irish Department of Finance

Perhaps a concern which may be of more interest to the Irish electorate is the level of resources Irish authorities utilize on an annual basis in an effort to attract FDI. The mandate of the IDA has been to attract and encourage the growth of foreign investment in domestic industry. To this end, the government has provided numerous incentives, including financial grants and a favourable tax climate. According to the OECD (1994), financial resources going to foreign firms in the form of grant aid during the 1990s, was near the region of 50 million Irish pounds per annum. Almost

unbelievably, the government spent nearly 1 billion Irish pounds on such grants during the 1980s. Given such a high level of 'investment' by the domestic authorities, in recent years the government has introduced a system to provide greater scrutiny of the firms receiving such grants, similar to tests imposed on EU grants. Firms now face the threat of claw backs in grant level if they fail to meet performance targets, including specific levels of job creation. However, the IDA does continue to defend their mandate, given that the attraction of so many foreign firms has, even with low corporate tax rates, provided for substantial tax revenue, as much as 1.9 billion Euro in 2001 (Dorgan 2002 4). Combined to this, has been the increase in income and indirect taxes associated with the economic growth of the 1990s. Both revenue streams are important, as they help to fund infrastructure and other programs, aimed at sustaining economic growth in Ireland.

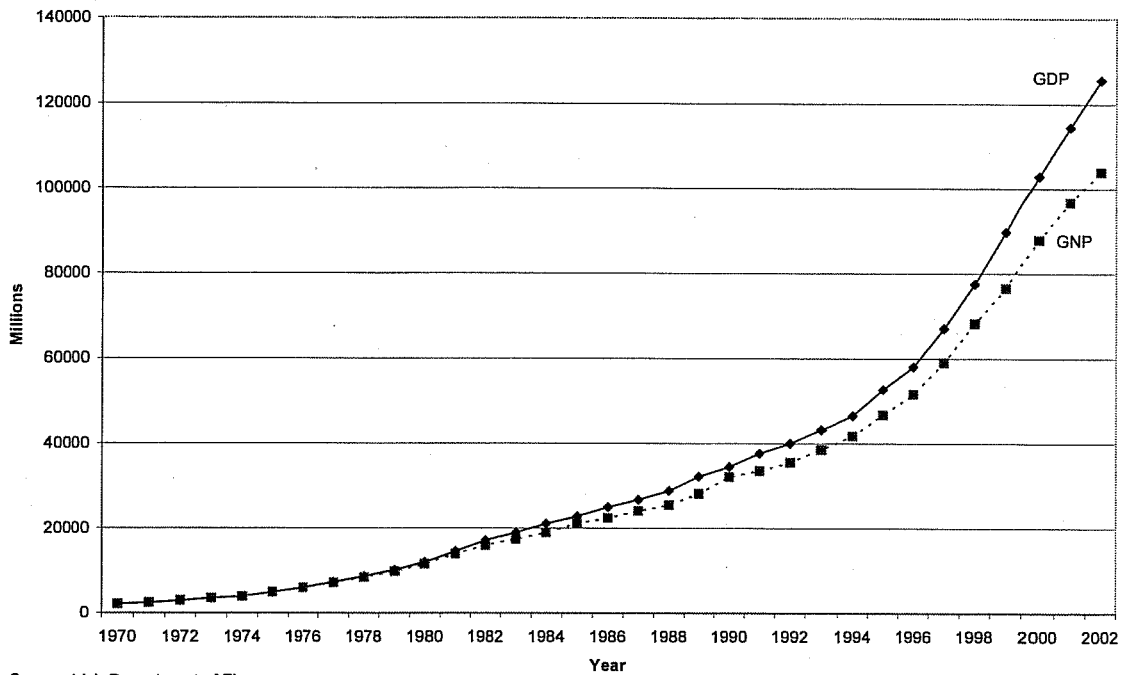
Still such attention being paid to the foreign sector of the economy has undoubtedly had the effect of ignoring the fortunes of indigenous firms. This has not gone unnoticed by Irish policy makers, who have, since the 1980s, made an effort to address a number of the domestic deficiencies. Barry and Bradley site a marked increase in the performance of indigenous firms, both in job creation and also output. This has undoubtedly occurred because of the support provided by the government, but also, one could argue, because of the increase in competitiveness introduced to the Irish economy through openness. Time will tell if such improvements enjoyed in the 90s will be sustained, but certainly a strong indigenous sector is important for a healthy Irish economy.

### *A problem of transfer-pricing?*

Given the nature of Irish policy, and the exhaustive efforts undertaken to attract foreign investment, there has existed the incentive for foreign firms to exploit the advantages inherent in such a system. The attraction for foreign firms has not only been to locate in Ireland, but also to record as much of their profits in the country as possible. This activity is referred to as transfer-pricing. Transfer pricing is essentially a 'device' used by multinational corporations to limit their overall tax burden. It arises from the existence of different tax regimes in the global economy. There are a number of ways firms can take advantage of these 'arbitrage' opportunities, but at its essence, transfer pricing is the practice of reporting profits earned in a high-tax country in a low tax-country. For example, a subsidiary in the low tax country will report high profits, while low profits are reported by the parent company in the high-tax region. In such a scenario, profits are said to be 'transferred' from the high tax country to the low tax country, and the company's overall tax burden is thus lowered. Another example, which is often cited, is the practice "whereby artificially low prices on inputs brought into Ireland and high output prices on exports from Ireland are recorded" (Doyle 2001 35), allowing the firm to pay as much tax on profits as possible under the low tax regime. If the problem is serious enough, basic economic indicators, such as GDP and GDP per capita, as well as productivity rates could misrepresent the actual state of the Irish economy.

A look at Figure 16 shows the relationship between Irish GDP and GNP figures since 1970. By definition this gap is said to exhibit the difference between economic activity by Irish nationals wherever they may be (GNP), and that activity taken within Ireland, regardless of national origin (GDP). As illustrated in Figure 16, GDP has

Figure 16: Historical comparison of GDP and GNP, 1970-2002



exceeded GNP by a significant and growing margin, through the 1990s. One should note that these figures only begin to diverge in the 1980s. Clearly it is the case that as foreign investment and companies increased their presence in the Irish economy, so to did the difference in domestic and national output. Another way to try and capture the level of transfer-pricing activity in Ireland, is to examine the flow of repatriated profits, as it is plausible that a portion of such profits have arisen given the exercise of transfer-pricing. According to O'Sullivan, there has been a clear upward trend in this relationship. For the year 1998, she notes, that profit outflows were 20 per cent of GNP compared with 11.6 per cent in 1993 (O'Sullivan 2000 13). It is also worth noting, however, the advantage to the Irish exchequer of firms 'choosing' to report higher profits in the country. In fact, the practice of transfer pricing presents no loss to the Irish economy and though GDP figures surpass GNP figures, the rate of GNP growth still represents a significant increase in Irish

fortunes. However, the indicators, including export figures, are most likely exaggerated. This does not diminish the role of exports, as these companies still focus their efforts on foreign markets. Still, though many economic indicators, and their differences, are consistent with a transfer-pricing problem, they are not definitive proof of one.

### *Export-led growth hypothesis*

There has been much interest in academic and policy circles in understanding the role played by exports in economic growth. Preliminary work in the field, by the likes of Michaely (1977) and Feder (1982), demonstrated a statistical link between export growth and output growth in industrialized countries. Michaely's work went as far as to suggest that "a minimum level of development was required for a significant relationship to be observed between output growth and export growth" (Doyle 1997 36). Through time, econometric analysis has been refined in an effort to improve the testing of a causal relationship, which is clearly the question of most significance. Such studies have made use of Granger (1969) causality in an effort to clearly determine if growth in exports levels is the cause behind increases in GDP. Empirical research has thus far shed some light on the issue, though failing to entirely clarify the relationship.

In a paper by Henriques and Sadorsky (1996) three likely relationships between exports and GDP are identified. The first is the traditional export-led growth (ELG) hypothesis. Here, growth in the level of domestic exports is said to stimulate economic activity at large, providing significant spillovers and backward linkages, which as previously discussed with regard to Ireland, provide for a positive stimulus throughout the economy. The second relationship they identified is that of GDP growth driven

exports. Under this scenario, export growth is said to be driven by an increase in the level of domestic output. The idea is that an increase in the general level of GDP, which has occurred because of an increase in economy-wide activity, stimulates the export industry, greatly enhancing its level of output. The final relationship identified is that of a two way casual relationship between growth and trade, which has been termed, feedback. The idea, originally postulated by Bhagwati (1998), suggests that increases in trade, for any number of reasons, generates higher incomes, thus facilitating an increase in economic activity, including trade, the result being a 'virtuous circle' (Henriques and Sadorsky 1996 542). As Doyle suggests, Ireland provides an interesting case for the study of causality in the ELG question. Ireland has undoubtedly experienced intense growth in both GDP and exports in recent times. Whether it is possible to determine if one is driving the other is a question we now turn our attention to.

The casual relationship between exports and growth in real GDP is thought to hold for a number of reasons. First of these is that growth in a country's exports may represent an increase in the demand for the country's output and thus serve to increase real GDP at large. Second, it is postulated that the increase in exports may loosen a foreign exchange constraint, with the effect of allowing an increase in the importing of intermediate goods, which in turn allows domestic output to increase. Finally, it is thought that export growth can enhance efficiency, which may lead to a growth in output. The efficiency gains usually identified include: rapid technological change from the exposure to foreign competition, the development of indigenous industries and entrepreneurship, and the exploiting of economies of scale. It is difficult to be sure if Ireland can be said to have directly benefited from the above. Afxentiou and Serletis

(1991) have argued that benefits of exports tend to lose strength with increased industrialization. Given the necessary levels of infrastructure and the already significant levels of competition in developed countries, they raise doubts about the presence of significant spillovers.

In Ireland, export growth clearly has indicated an increase in the nation's output, however, with the presence of transfer-pricing practices, this fact may be exaggerated in the current data. Also, Ireland is said to have benefited initially from a relatively weak Euro, but mounting pressure on the US balance of payments and efforts by the Chinese and Japanese authorities to depress their own currencies, has placed upward pressure on the Euro. Still Ireland is estimated to record growth rates of some 5 per cent this coming year. It may be that the favourable tax regime present in the current Irish set-up is able to have a balancing effect on the levels of Irish activity. Finally, it seems likely that Ireland is benefiting from the associated spillovers of export orientation in a roundabout way. It is likely the case that foreign companies, particularly those from the US, have benefited in the past from their exposure to increased competition and that their presence in Ireland is enhanced by this experience. Also, it seems plausible that Ireland's indigenous sector will experience the spillover effects of increased efficiency from the foreign dominated export sector.

As should be expected, such study is never quite as clear as one would like. The relationship between GDP growth and export growth is extremely complex, and as Henriques and Sadorsky (1996) suggest, it is one influenced by a number of factors, both quantitative and qualitative, including among other likely variables, price fluctuations and political intervention. Therefore, empirical studies on the subject continue to offer

divergent conclusions. For their part, Henriques and Sadorsky conclude that, for Canadian data over the period 1871 – 1991, changes in growth precede changes in exports. As they note, their findings do not prove causality, only that changes in GDP tend to occur before changes in export levels. These results are at odds with other research findings, including Chow (1987), whose empirical work supports “the advantage of export-led growth strategy for small open economies” (Chow 1987 61). Such contradicting results, of course, are not limited to these studies. Any number of papers, (Marin 1992; Bothlo 1996; Balassa 1978), are in favour of the ELG hypothesis. Marin even suggests that the benefits of export strategy are not “restricted to developing countries...as commonly asserted” (Marin 1992 686). We can, however, easily cite research, (Afxentiou & Serletis 1991; Jung and Marshall 1998) which opposes the ELG hypothesis and instead suggest “that export growth is not the magic key to GNP growth and that many of the secrets of growth continue to be hidden among numerous imponderable forces, refusing to reveal themselves in a straightforward quantifiable manner, as desired by economists” (Afxentiou & Serletis 1991 177).

This lack of consensus is by no means surprising, as the history of economic thought is filled with incongruous results. Surely part of the problem lies in the unique factors present in the policy and economic environment of individual countries, and hence, lost among each country’s data. Such problems may be particularly acute in Ireland. Given the nature of the country’s industrial policy over the last 50 or more years, it would seem inevitable that exports would be seen as the major force behind recent economic growth. Yet, given that in 1996, when exports represented 76 percent of GDP in constant prices (Doyle 2001 33), it seems improbable that the export activity would be

anything other than a major contributor to GDP growth. Still, as we have discussed, a number of policy factors and outside economic forces also contributed to the surge in economic activity. Whether or not each of these variables can be fully accounted for in empirical research is certainly debatable.

In her empirical work, Doyle finds that “exports and output have a positive effect on each other in the Irish economy. Therefore, the export-led growth hypothesis does not hold for Ireland since a feedback effect exists in the system” (Doyle 2001 47). This conclusion may prove misleading, if we recall the discussion above, outlining the potential relationships between exports and output. The bi-directional feedback effect still supports the impact played by export growth, though its prolonged effect is believed to feed off general output growth. Exports may not have been the only source of growth in the Irish economy, but they are certainly significant nonetheless.

A few concerns must be raised regarding the validity of Doyle’s findings. First, a problem, which is not of Doyle’s making, exists regarding the quality of available Irish data. For use in her regression analysis, Doyle makes use of the IMF’s International Financial Statistics database. The reason for this, it is assumed, is that the available data from the Central Statistical Office (CSO) or the Department of Finance is not as complete as that provided by the IMF. Unfortunately, this only provides Doyle with 48 observations on each variable<sup>13</sup> for the period 1950-1997. This is likely to prove problematic, as outlined by Rambaldi and Doran (1996), who note that the MWALD statistic, as reported by Doyle, “has comparable performance in size and power to the LR and WALD tests in samples of 50 or more observations” (Rambaldi and Doran 1996 4). Though Doyle reports the series has no unit root, there is no mention of cointegration,

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<sup>13</sup> GDP, exports, imports, terms of trade etc.

which the above statistic attempts to correct for. Given that exports are already reported in GDP levels, not to mention that Irish exports represent significantly higher levels of GDP than most countries, it seems likely that spurious correlations will exist.

A second concern is that real Irish GDP and exports only 'exploded' in 1994, the fourth last period of Doyle's sample. The sample size and proximity of the study to the most significant period in Irish growth therefore, may not permit the regression to fully capture the impact of recent economic activity. Certainly it may be correct to argue that over the last half century Irish exports did not drive economic growth, but anecdotal evidence for the last decade suggests otherwise. It is possible that the surge in export growth since 1994 and the associated surge in GDP may be overwhelmed by the data provided by the previous 44 observations. Certainly further work is required to address the issue of export-led growth during the Celtic Tiger era. However, it may be beneficial to do so at a time in the future when more robust data is at the researchers disposal.

#### **PART IV: A Question of Sustainability**

While it may prove difficult to completely unravel the relationship between GDP and export growth in the Irish context, we can still speculate as to the long-term prospects of the economy. The overriding question on the mind of most observers is of course the sustainability of Irish economic growth. As has been mentioned, and anticipated, Ireland has experienced recessionary periods in the last few years. This, it must be said, should be viewed in the context of the unprecedented growth rates, which as we saw reached levels of 10 and 11 per cent per annum. It could never be reasonably expected that Ireland, or any country for that matter, would be capable of sustaining such levels of growth for a prolonged period of time. Yet, the fact that the economy has slowed to more common levels should not be greeted with any derision. Only a few years ago the OECD noted "concerns have been raised about [the economy's] sustainability as with the economy 'overheating' which might be followed by a hard landing" (OECD 23). It does seem, to the relief of all that the Irish economy has managed to avoid an unceremonious fall from grace. It is hoped that this is the product of the sound economic foundations which the period of expansive growth was built upon. Now many hope, and believe, that it is upon this strong foundation the economy can continue to prosper.

One should recall that an important tenant of development economics is that lagging economies should catch up to more advanced ones. As such, Ireland being a less developed western economy, it may have been perfectly normal for the country to record such high levels of growth and, by extension, see this growth begin to taper off. Though convergence is not automatic, it seems that in the case of Ireland it has been realized. And as noted by many observers, given that the "unsustainable growth rates of preceding

years...the now projected levels...would mean that the economy has managed a soft landing” (Enterprise Ireland 2003 3), a fact which should be celebrated.

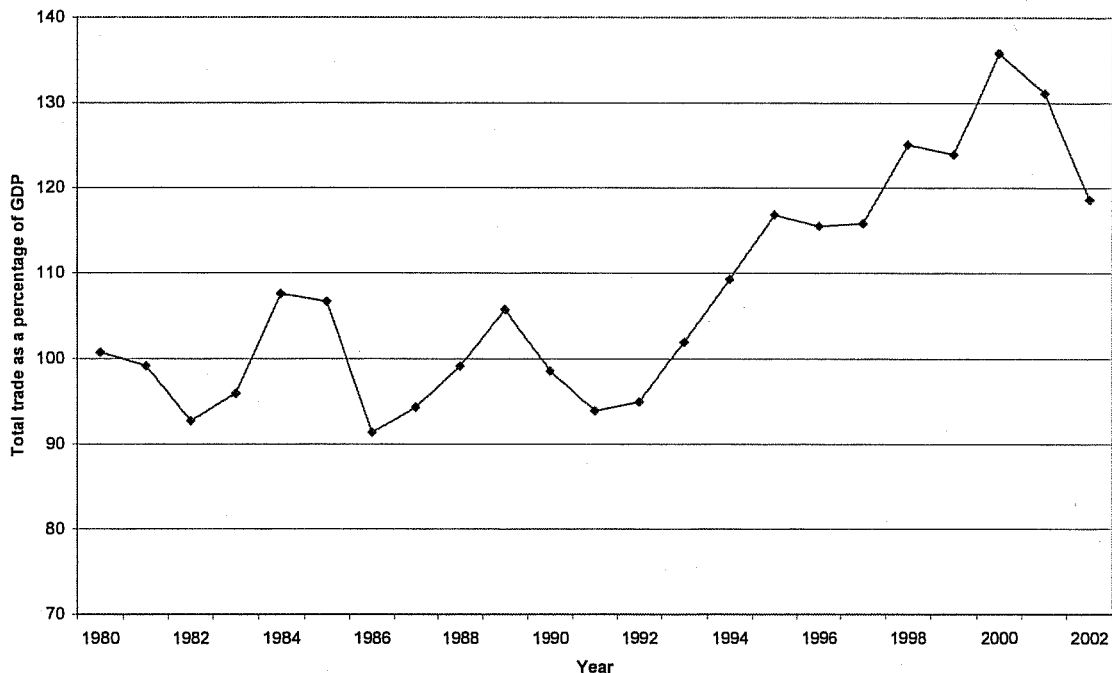
As we have already identified the key components to the Irish success have thus far included strong exports markets, capital accumulation and FDI, an educated work force supplemented by increasing immigration and international competitiveness. As such, it is important to understand the prospects of these areas in the coming years, so as to understand the prospects of the economy at large. Ireland faces a new stage in its economic development whereby the emphasis is no longer on achieving goals, but rather sustaining them. Now, however, policy makers can be sure that a certain level of stability will be guaranteed given the strong economic foundations laid down over the past few decades.

#### *Apparent Trade Dependency*

In the last section we examined the relevance of the export-led growth hypothesis for Ireland. Though preliminary research work by Doyle may fail to clear up the ambiguity surrounding the issue of export causality, the fact Irish exports reached levels as high as 80 per cent of GDP in 2001, the importance of exports, and trade in general, can never be underestimated. As was suggested, it is likely a ‘virtuous circle’ was created, with the impact of trade in the final years of Doyle’s study being understated. As such, if growth in either GDP or exports is greatly hindered, they will both suffer. It was also shown that Irish exports have greatly evolved over the last twenty to thirty years. Not only has the composition changed, but also the destination.

A quick glance at Figure 17 will highlight the potentially precarious position Ireland now finds itself in with regard to export dependency. Figure 17 depicts the Index of Vulnerability, with total trade (exports + imports) represented as a percentage of GDP. One can see that for most of the period 1980-2002, total Irish trade represented far more than 100 per cent of GDP, with a pronounced increase in this relationship with the associated growth of the Celtic Tiger era. Furthermore, Table 9 outlines the level of exports and imports, individually, as a percentage of GDP. Since the late 1980s, the weight of exports to GDP has risen quite dramatically, from slightly above 50 per cent to a high of 82% in 2000. These statistics imply that the prices of traded goods, which are to a large extent determined by the exchange rate and the state of external economies, have an important impact on the domestic economy (OECD 2001 37).

Figure 17: Index of vulnerability, 1980-2002



Source: Irish Department of Finance

**Table 9: Irish exports and Imports as a percentage of GDP**

Year	Exports as a % of GDP	Imports as a % of GDP	Year	Exports as a % of GDP	Imports as a % of GDP
1980	43.3	57.5	1991	50.6	43.3
1981	41.7	57.5	1992	53.1	41.8
1982	42.2	50.5	1993	58.2	43.7
1983	46.6	49.4	1994	62.1	47.2
1984	53.7	53.8	1995	67.1	49.7
1985	54.2	52.5	1996	66.5	49.0
1986	47.6	43.8	1997	66.9	49.0
1987	50.9	43.4	1998	73.9	51.2
1988	54.2	45.0	1999	74.6	49.4
1989	57.4	48.3	2000	81.5	54.3
1990	52.7	45.9	2001	81.0	50.1

Source: Irish Department of Finance

These statistics would prove even more significant if it was not for the changing destination of Irish exports. Tables 10 and 11 outline Irish trade with European and Non-European Union countries. As can be seen, the most significant trading partners are the UK, US and the rest of the European Union. Essentially, though the level of trade with the UK has decreased, it remains relatively strong. The US as an export market, on the other hand, has increased its share dramatically, from 8.7 per cent in 1986 to 17.6 per cent in 2002. This increase, as well as increases in trade to the Pacific Rim countries (Table 12) have shifted export destination from a combination of the UK and EU.

Still, the EU represents the single most important market for Irish exports. This should prove encouraging for sustaining future growth, as Ireland enjoys the benefits of membership in the European common market. As we have seen, this proved useful in the attraction of foreign investment, and should continue to do so. With the adoption of the Euro, roughly 60 per cent of Irish exports are no longer subjected to the pressure of an appreciating currency. As noted in *The Economist* (March 20 2004 61), European

**Table 10: Trade with EU countries (millions of Euros)**

Country	Imports		Exports		Trade Balance	
	2001	2002	2001	2002	2001	2002
Austria	149.7	207.3	407.2	333.5	257.5	126.2
Belgium	864.4	790.8	4431	13519.3	3566.6	12728.5
Denmark	725.6	689.1	595.6	531	-130	-158.1
Finland	450.1	737.2	406	303.4	-44.1	-433.8
France	2751.7	2252.4	5531.5	4667.6	2779.8	2415.2
Germany	3520.5	3533.1	11670.6	6743.9	8150.1	3210.8
Greece	47.5	40.3	326	328.1	278.5	287.8
Italy	1185.4	1091.6	3309.1	3593.1	2123.7	2501.5
Luxembourg	11.7	19.9	91	76.2	79.3	56.3
Netherlands	1860	1821.8	4236.9	3410.4	2376.9	1588.6
Portugal	158.6	171.3	302.3	364.1	143.7	192.8
Spain	645.9	676	2283.3	2230.5	1637.4	1554.5
Sweden	510.8	418.3	1354	1184.5	843.2	766.2
United Kingdom	20481.2	19859.9	22629.8	22431.1	2148.6	2571.2
<b>Total Euro Area</b>	<b>33363.1</b>	<b>32309</b>	<b>57574.3</b>	<b>59716.7</b>	<b>24211.2</b>	<b>27407.7</b>

Source: Central Statistical Office

**Table 11: Trade with Select Non-EU Countries (Millions of Euros)**

Country	Imports		Exports		Trade Balance	
	2001	2002	2001	2002	2001	2002
Canada	621.9	423.1	592.5	510.4	-29.4	87.3
China	1085.9	1492.7	338.5	547.2	-747.4	-945.5
Japan	1990.9	2012.2	3261.1	2642.4	1270.2	630.2
Singapore	1357	1024.7	641.3	741.7	-715.7	-283
South Korea	796.5	902.2	695.9	643.2	-100.6	-259
USA	8699.5	8503.8	15694.4	16385	6994.9	7881.2

Source: Central Statistical Office

businesses have coped well with a stronger Euro because of improved international conditions and since most firms, and by extension countries, export predominately in the Euro zone. Also, with the UK operating outside the common currency it is good news to hear that it has “proven more resilient then any other European economy in the face of

the current downturn” (Irish Department of Finance, Economic Review 10).

Furthermore, given that so much FDI originates in the US, a downturn in US economic conditions, while decreasing FDI flows, will not necessarily have to dampen domestic output, as most of this output is targeted for Europe. Looking even further ahead, as highlighted in Table 12, Asian markets as a whole, now account for roughly 10 per cent of exports. This diverse export destination will prove crucial for continued economic success in Ireland.

**Table 12: Exports to Asian markets (millions of Euros)**

Country	Imports		Exports		Trade Balance	
	2001	2002	2001	2002	2001	2002
China	1085.9	1492.7	338.5	547.2	-747.4	-945.5
Hong Kong	532.6	498.0	670.2	551.5	137.6	53.5
Japan	1990.9	2012.2	3261.1	2642.4	1270.2	630.2
Malaysia	582.4	638.0	1140.3	766.5	557.9	128.5
Philippines	324.9	342.7	769.5	343.6	444.6	0.9
Singapore	1357.0	1024.7	641.3	741.7	-715.7	-283.0
South Korea	796.5	902.2	695.9	643.2	-100.6	-259.0
Taiwan	1075.6	998.1	377.2	347.2	-698.4	-650.9
Thailand	336.1	282.2	144.3	112.8	-191.8	-169.4
<b>Total</b>	<b>8081.9</b>	<b>8190.8</b>	<b>8038.3</b>	<b>6696.1</b>	<b>-43.6</b>	<b>-1494.7</b>

Source: Central Statistical Office

Yet, such economies are obviously not immune to economic downturns. What is most encouraging about the level of activity with particular Asian markets is that the likes of Japan are still awaiting a significant resurgence in domestic fortunes, and this is likely to be accompanied by policy changes to increase openness. Furthermore, strong trade links with such a large emerging world economy as China, provides opportunity for improved domestic output if effectively targeted. Though Ireland’s interest in these

economies is predominately for productive imports<sup>14</sup>, as highlighted in Table 12 by the timely shifts in import and export levels, a strengthening Euro, at least improves Ireland's hand. Yet, given the nature of Irish trade, with increased weight placed on high-tech production, with improved economic conditions throughout the world, the strength of trade with these areas is likely to improve.

Whether much expansion can occur in the confines of the EU is, however, debatable. Ireland only represents about one per cent of total EU GDP (Feldstein 2001 3), and so is by no means a significant economic, and therefore political, force in Brussels. Membership in the EU, though attributed with significant privileges, will also create significant challenges for the Irish economy and policy makers. Most notable is the reaction, or lack thereof, of the EU to economic swings in Ireland. European interest rates, for example, are not likely set with much consideration of the current economic climate of the Emerald Isle. The advantage of the Euro protecting export competitiveness in one instance, is tempered in the next, by the loss of monetary policy. Furthermore, with the constraints imposed by the Maastricht Treaty for fiscal policy, Ireland as a small open economy, who so often felt the brunt of world economic conditions in the past, is even limited in its scope of use of fiscal policy to influence poor economic conditions.

#### *The future of foreign direct investment*

Foreign Direct Investment (FDI) has thus far played a pivotal role in Irish economic development, by helping to facilitate the economy's transition to an increasingly high-tech based one. As we have already mentioned in passing, a fear

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<sup>14</sup> Presently Ireland records a trade deficit with the region, changing in significance given prevailing international economic conditions.

persists among observers that this FDI may vacate the domestic economy at a moment's notice, with devastating effect. However, given that in 2001, Ireland was ranked as the eleventh largest recipient of FDI among developed countries (Enterprise Ireland 2003 8) the business environment continues to be sound enough to encourage investment. Furthermore, though Ireland has undoubtedly placed a heavy emphasis on foreign investment, one must not fail to recognize that the country's authorities have been prudent in their efforts by attracting investment from a range of economic sectors. The Industrial Development Authority's (IDA) work has proven successful not only because of its apparent ability to choose winning sectors, but also the attention paid to ensuring sufficient diversification of investment sources. As noted by Murphy "There is now a balanced portfolio of foreign investment in Ireland" (Murphy 2000 22). This has had the effect of lessening the overall economic impact if one company, or even an entire sector, should experience difficulties.

To illustrate the success of this policy one need only examine the performance of the economy in the last few years. Specifically, by 2001 a worldwide economic downturn had affected Irish growth rates and export levels. Yet, in 2002, as noted by the OECD, "the economy rebounded more rapidly than expected during the first half of the year...with GDP growth reaching around 5½ per cent year on year, driven by strong rising exports" (OECD Economic Outlook 72, 83). What is most striking about this rebound is that while the Information and Communications Technology (ICT) sector grew only modestly, the surge in exports was driven by the pharmaceutical industry. As the world adapted to life after the bursting of the dot-com bubble, Ireland's 'other' high-tech industries continued to flourish. The targeted diversification of investment sources

and recipients has ensured that within the domestic economy there exist sufficiently robust sectors which are capable of shouldering some of the burden associated with an economic downturn. The result has been continued positive economic growth in Ireland, if at less dramatic levels. A small price to pay for continued success, one would have to say.

Still, warranted concerns persist with regard to the forms of FDI entering the Irish economy. It seems that in almost every periodic analysis it publishes, the OECD stresses a need for higher levels of R&D spending, particularly in the form of venture capital. The OECD argues that foreign sources of this investment are “extremely important for Ireland and in 1999 were almost four times as large as investment managed by funds in the country” (OECD 2001 29). These funds are crucial for future technological progress, and the associated spillovers for the domestic economy. Given that foreign sources account for so much FDI, in all its forms<sup>15</sup>, what will continue to be of concern for Irish policy makers is the impending expansion of the EU.

As noted by Enterprise Ireland, increasing competition for FDI has already begun to emerge, with the likes of Hungary and the Czech Republic, making significant headway in efforts to win new FDI. Key is the issue of the domestic economies international competitiveness. What economies like Hungary and the Czech Republic can offer businesses, is a highly educated work force at a lower wage cost. Still, even given these realities, Ireland was able to weather the downturn in activity in the ICT sector, with the top firms even increasing their employment levels since 2000 (Enterprise Ireland 2003 9). It is inevitable that Ireland will face competition for the FDI flows it has enjoyed. Presently, given the size of the economy, Ireland is thought to enjoy

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<sup>15</sup> Domestic venture capital is increasing, but as a % of GDP it still lags behind the EU average.

significantly more investment than it should. If this is the case, the long-run level of FDI may be much lower, but if other aspects of the domestic economy have managed to catch-up to their European counterparts and learn from the foreign presence in the mean time, this may not pose such a problem for the future.

Even still, IDA remains quite optimistic for the future. The agency's CEO, Sean Dorgan, claims that "there is considerable interest in Ireland among many leading international companies for higher level activities. This interest is spurred by [Ireland's] success over the past decade" (Dorgan 2002 9) and the favourable conditions which continue to prevail. With the success of the domestic economy, however, domestic demand has been greatly increasing, which has had the effect of driving up prices, particularly wages. To be sure the country continues to enjoy economic success, it must be sure it is successful in using "FDI, mixed with Irish capabilities, to create new sources of economic wealth" (Dorgan 2002 10). This will help to preserve the economy's international competitiveness. Key to this is a stabilization of increasing wages and/or an increase in domestic productivity.

#### *Maintaining international competitiveness*

We have already seen the improvement in Ireland's level of Real GDP and Real GDP per capita. Both measures are thought to be indicative of a domestic economies success, and suggestive of prevailing living standards. Economies which seek to generate further income may do so in a number of ways, two of which are of interest to us now. The first of these is by means of an increase in real output per worker. The second way is by ensuring a larger fraction of the population is working. Simply put, a country needs to

improve productivity and labour force participation, in order to improve overall economic activity. Ireland's productivity experience has been almost as remarkable as the economic turnaround of the last ten years. A recent study by Pierre Fortin has identified increases in productivity and a growing fraction of the working age who are employed, as the mechanisms behind Ireland's recent economic success. He notes that "since 1976, the growth rate of productivity (output per employed worker) has averaged 3.3 per cent a year...a very fast pace by international standards" (Fortin 2002 9). Behind this increase in productivity has certainly been the shift from primary industries to secondary and tertiary ones. As we are now aware, this shift has been facilitated by the presence of strong FDI flows which brought with it technological know how and expertise.

Improving productivity is a challenge all economies face. In Fortin's study he contrasts Ireland's success in this area, to that of decreasing productivity in Canada. He notes changes in Real GDP per working-age adult in Canada and Ireland, as compared to the US, over the period 1976-2000. While Canada experienced a decline, Ireland was able to control a volatile and low level<sup>16</sup> and with the economy taking off in the 90s, by 2000, Ireland had surpassed the Canadian level. This increase in Real GDP per working age adult can be decomposed to highlight the part played by changes in productivity and employment levels. Canada has suffered losses in both indicators, while Fortin attributes Irish success to an improvement in both (Fortin 2002 5)

It seems that the economic troubles experienced in Ireland during the 1970s and 80s overshadowed what had always been an improving productivity level. It is estimated that during the 25 year period 1976-2000, Irish productivity improved at an average rate of 3.3 per cent (Fortin 2002 7). However, though Irish output per employee is thought to

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<sup>16</sup> Roughly 50 per cent of US Real GDP per working age adult in 1976.

be approaching US levels, the country's productivity has grown more slowly in recent years. Fortin argues that this is not a problem, given that "productivity usually grows more slowly once convergence to the world technological frontier has been achieved" (Fortin 2002 7). The scope of improvement becomes smaller the greater is the productive capacity of the country. In Ireland's case this was achieved by the levels of FDI. In order that Ireland can continue to enhance its international competitiveness, it must either improve productivity still further, or continue to control wage levels.

As we saw earlier, Ireland has made significant gains in employment since the 1980s. Like other European countries, Ireland suffered major employment problems in the late 70s, which persisted well into the 1990s. Such dramatic levels of unemployment, as illustrated in Figure 9, overshadowed improving domestic productivity. With the gains from strong policy, FDI flows and productivity levels, the employment rates have improved significantly in Ireland, further fuelling domestic output. Key to the gains in employment were the social partnership agreements which helped to maintain moderate wage levels. The control of wage growth, coupled with improving productivity, sought to enhance Irish economic performance. Not only did economic growth erase unemployment, it attracted record levels of immigrants, who added to the growing labour force. As outlined in Tables 3 and 4 the composition of immigrants consisted of ex-pats and most importantly, 'new faces' attracted by the booming Irish economy. Ireland had become the land of opportunity so many had left to find. Also, noted by Fortin, "the number of Irish women in the labour force has increased by roughly 65 per cent since 1993" (Fortin 2002 8). It seems that anyone who wants a job in Ireland can now find one.

The OECD has noted (OECD 2001 33) that the increase in the labour force participation rate<sup>17</sup> included a surge in young entrants, who brought with them higher educational levels. Though Irish educational levels for all age ranges are still lower than the OECD average, gains have been made in the younger generation. Coupled with this is the increase in highly educated and experienced immigrants who have supplemented the Irish labour force. The OECD, and other observers, have stressed the importance of immigrants and improved educational levels in the changing Irish economy. Yet, it seems likely that such improvements will generate upward pressure on Irish wages, which will ultimately impact on Irish competitiveness. Already, “extremely tight labour market conditions have led to wage rises in excess of those agreed under [the various social partnership agreements, where]...wages in the manufacturing sector have risen by 7.5 per cent with hourly earnings up by 5.8 per cent” (OECD 41).

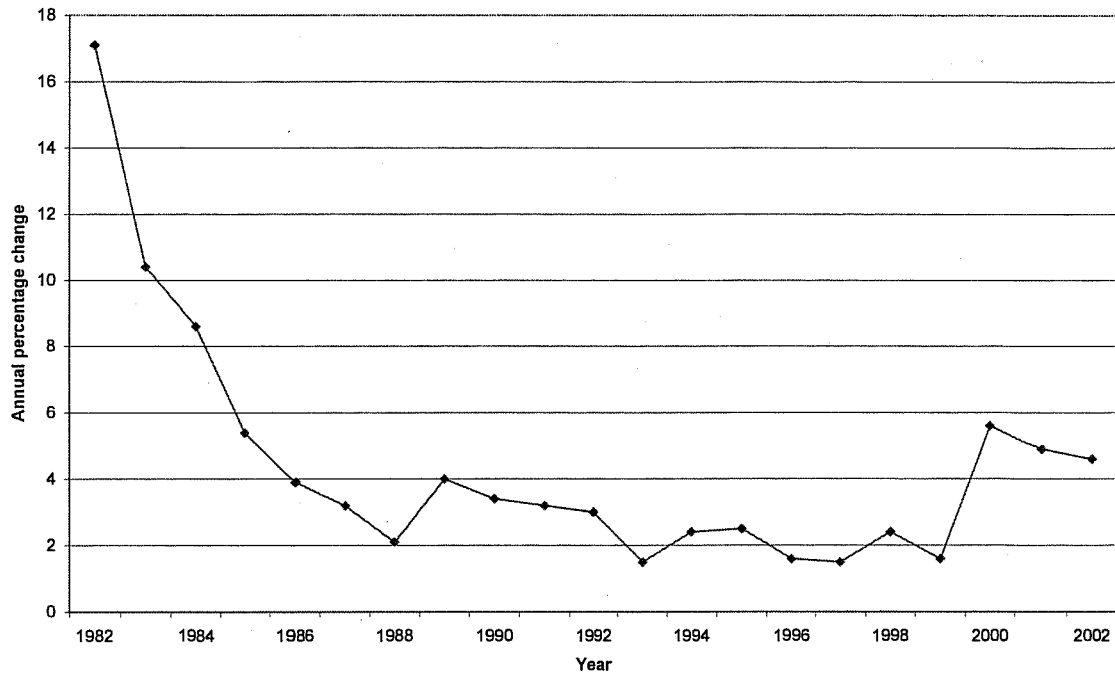
Other associated problems have begun to emerge. Ireland, after coping so well with high inflation through the 70s and early 80s, has now begun to experience overheating, with significant pressure being applied to wages and the domestic real estate market. Figure 18 and Table 13 outline Irish inflation, as measure by the year on year percentage change of the Consumer Price Index. Table 13 lists such changes from 1961. With the associated pressures of the oil price shocks in the 70s, inflation reached relatively high levels. However, the government was able to bring this under control and the country has enjoyed relatively low inflation during the 1990s. Many observers have noted the recent increases in inflation, with Ireland’s rates near double that of Britain (*The Economist* July 29 2000), and have attributed the rise to the economy’s overheating.

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<sup>17</sup> Which increased from 62.6% in 1991-95 to 66.8% for 1996-2000.

Yet, as clearly illustrated in Figure 18, the jump, which occurs in 2000, is a one time change which has persisted, bringing Ireland to a new level of inflation. The increase is surely associated with the adoption of the Euro. As *The Economist*, with almost soothsayer like ability, noted in November 1998, “prudent central bankers would

Figure 18: Consumer Price Index, 1982-2002



normally be hiking interest rates to cool things down”, but with Ireland now at the mercy of the European Central Bank, this is unable to happen. While the ECB struggles with failed attempts to kick-start the German economy, it is hardly concerned with rising domestic prices in Ireland.

Still, it should concern itself with the potential real estate bubble which is growing in Ireland. Concerns persist regarding the speculative nature of Irish housing prices, with international experience suggesting that “prolonged property booms on the scale of Ireland’s may lead to a demand driven by self-fulfilling expectations, followed by price

overshooting” (OECD 2001 44). Ireland’s current experience has its cumulative increase in property prices at 65 per cent, above the average of 62 per cent in other international episodes. Given that they have resulted in a 17 per cent cumulative fall in the four years following the boom, even with signs of a robust property market and efforts by the Central Bank of Ireland to ensure banks are not over exposed to lending risks, the Irish should be bracing themselves for a ‘crash’ of some scale (OECD 2001 44-45).

**Table 13: Consumer price index, 1961-2002**

Annual Percentage Changes				
Year	% Change		Year	% Change
1961	2.7		1982	17.1
1962	4.2		1983	10.4
1963	2.5		1984	8.6
1964	6.7		1985	5.4
1965	5.0		1986	3.9
1966	3.0		1987	3.2
1967	3.2		1988	2.1
1968	4.7		1989	4.0
1969	7.4		1990	3.4
1970	8.2		1991	3.2
1971	8.9		1992	3.0
1972	8.7		1993	1.5
1973	11.4		1994	2.4
1974	17.0		1995	2.5
1975	20.9		1996	1.6
1976	18.0		1997	1.5
1977	13.6		1998	2.4
1978	7.6		1999	1.6
1979	13.2		2000	5.6
1980	18.2		2001	4.9
1981	20.4		2002	4.6

Source: Irish Department of Finance

## **Concluding remarks**

Growth in the 1990s, the famed Celtic Tiger era, ensured Ireland would enter the new century in complete contrast to how it had entered the previous one. At the turn of the 20<sup>th</sup> century, Ireland was nothing more than a rural agricultural society. Now, in the early years of the 21<sup>st</sup> century, things could not be more different. Ireland is now a major exporter of high-tech manufactured goods, with emphasis on computer hardware and software and the pharmaceuticals industry. The country enjoys a significant trade balance with the world, and the state of the public finances, once approaching levels considered by some as untenable, are now sound. Furthermore, the presence of a skilled labour force and favourable business conditions have attracted strong levels of FDI, which continue to play their part in the country's economic success.

Ireland, undoubtedly had under-performed for a number of years, and it was only a matter of finding its policy feet, so that it might properly develop. The path to successful and sustainable development was begun in the 1950s. The country had always recognized its need for favourable terms of trade, however, the role of the government and the type of economy required to achieve its goals remained unclear for some. The early nationalist agenda seems to have been borne out of an insecurity, an attempt to foster a country, and hence identity, uniquely distinct from England. Yet once Ireland clearly began to understand the need to embrace the new ideas of the world economy and industrialism, outside forces conspired to stymie the country's progress. First, the Oil price shocks of the 1970s, to be shortly followed by a worldwide recession in the 1980s, did so much to dampen economic conditions. Had such events not transpired, it is plausible that Ireland's era of growth may have occurred even sooner and may not have

seemed so dramatic. It must be typically Irish then, to endure so much longer, so as to make a show of country's arrival on the world's economic stage.

The most recent, and significant, period of growth, which initiated in 1994 and began to cool by 2002, has helped to change the economic landscape of the world. What is most attractive about the potential Irish model is the successful landing it has made from its phenomenal economic expansion. Still, it might be argued, that again luck was the main factor in the Irish's ability to navigate troubled waters. As the Irish economy entered a stage which many felt would be its undoing, with the economy overheating and perhaps the Celtic Tiger bubble bursting, outside economic conditions proved favourable for the country. The slowdown in the US and other major economies contributed to the gentle landing of the Irish economy. Regardless, what is most important, is that now rates of growth remain at more stable levels and so the challenge facing policy makers is one of sustainable growth, and not the precarious game of a controlled slowdown.

Yet, challenges remain for the economy. Of particular concern will be the booming real estate market, which could do so much to harm the economy, if banks and households find themselves overburdened. The euphoria surrounding Ireland's success is tangible on the streets of Dublin and in the pubs of Temple Bar. This makes it more important for the country to maintain the standards of success and living which it has become accustomed to. As the EU begins to expand, Ireland will face challenges for FDI from other emerging economies. Now, however, Ireland can consider itself a seasoned veteran in such undertakings. Furthermore, the fear that FDI flows will simply migrate to other regions of the EU ignores the strength of the Irish economy, and the fact that new sources and levels of FDI are likely to be created as US and other economies begin to

expand. Still, it should become apparent soon enough, that for these new EU states, membership is only one of the many necessary steps a country needs to take before enjoying the success accorded the Celtic Tiger. Again, convergence is not automatic.

The Industrial Development Authority (IDA) has proven successful thus far in its role in the economy's transformation. Thankfully, IDA recognizes that there is no time to bask in the apparent success. If Ireland wishes to continue to lead the way, it must continue to evolve in ways both conducive to domestic growth, and foreign investment. The fundamentals of the Irish economy remain strong. The Celtic Tiger has not been built upon weak foundations, but rather through an acknowledgement of the strengths of a small open economy, which is accommodating to international business needs, while recognizing the value of its own contribution.

As growth tapers off, and the economy progresses at more reasonable rates, new challenges will emerge. Distributional issues are already beginning to surface, as is apparent regional disparity in development. The Irish government has made significant strides in such areas, but as is inevitable with growing economic activity, there will continue to be perceived winners and losers. Yet many of the problems Ireland now faces, such as traffic congestion and increasing real estate prices, are associated with the successful economy. It is likely, that by and large, these are the problems the Irish people would rather address. Unemployment rates have been cut, job creation has been high, and all and all, the Irish economy and its people are doing very well. Ireland's legacy might well be the Celtic Tiger era and the subsequent soft landing, which turned out to be just as critical as the period of growth itself.

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