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SYMPOSIUM ON THE ECONOMIC IMPLICATIONS OF PEACE IN IRELAND

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1. INTRODUCTION

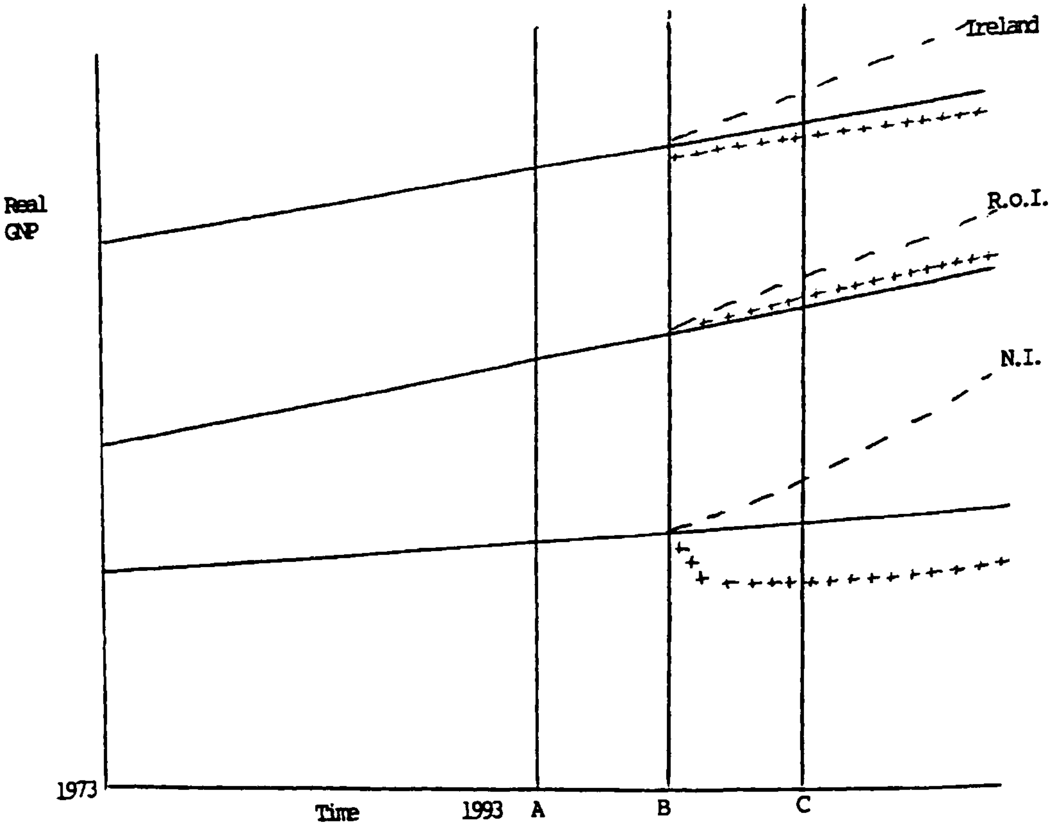
This symposium is concerned with the possible effects of peace between the two parts of Ireland on the economies of both and on the island of Ireland as a whole. It goes without saying that the greatest and overwhelming dividend of peace is the ending of loss of life and human misery, especially in NI. The question before us tonight is the secondary one of whether there is likely to be an economic bonus flowing from the peace and what form it might take.

Any attempt to answer this question must be speculative at best - for a number of reasons. First, there are no analogues in recent history to guide us. The ending of the Cold War and the Re-unification of Germany, for example, could hardly be taken as even approximate models. Second, the results of any "positive shock" are difficult to predict and, in this instance the difficulties are compounded by attitudinal factors, weak economic links and by data deficiencies.

2. OVERVIEW

Most commentators would tend to conceptualise the economic peace dividend or bonus - along the lines of Chart 1 which is stylised, rather than data based. Point A represents the time when peace is announced and B represents the moment at which it is consolidated and widely regarded as durable. One cannot say how much time will elapse between A and B; it is to be hoped that it will be a matter of months rather than years. The unbroken lines show the paths of long-term economic growth for the two regions and for the island as a whole, if there were no peace. Historically, the growth rates of NI were below those of the RoI. We know that over the last 20 years real GNP in the RoI grew by over 3½ per cent per annum. We also know that growth in the UK over this period was no more than 1¾ per cent per annum. Because of civil strife, deindustrialisation[1], poor tourism and so on, it in reasonable to infer that NI did not grow much faster than the UK despite the fact that subventions from the UK were very substantial, amounting to over 30 per cent of NI's GDP in recent years[2]. The actual annual average growth

CHART 1



________ Long-term growth paths.

———— Long-term growth paths with peace bonus and full UK subvention.

xxxxxxxx Long-term growth paths with reduced UK subvention.

rate of NI's GDP between 1965 and 1991 was about 2½ per cent. More up to date figures are not available, while data on GNP for NI do not exist.

Between A and B it is probably unlikely that any significant change in long-term growth paths will occur. In fact, it is conceivable that during this adjustment phase growth might slow down in NI as producers try to adapt to a change in the pattern of demand occasioned by the change from civil strife to peaceful conditions. This would then be followed inter alia, by Foreign Direct Investment (FDI) and, it is to be hoped, by a substantial reallocation of security expenditure (currently some 10 per cent of GDP) to more productive uses. From C on, growth in NI should accelerate. It should also accelerate, though by a lesser degree in RoI. Synergistic effects of closer trading links etc. are implicit in the graphs.

This kind of conceptual framework probably serves as a useful starting point though it begs some questions, for example, the issue of short-term fluctuations around these long-term growth paths. Would such fluctuations tend to be in synch or not? The answer to that question depends on the degree of integration of both economies and on whether some institutional means might be found to fine-tune aggregate demand for the island an a whole. This issue would lead us too far afield and will not be addressed here. In any case it raises additional complex questions about the role of demand-management in an open economy.

Chart 2 and Table 1 show some comparative data which may "flatter" RoI unduly. But it is worthwhile noting the virtual stagnation of industrial production in NI and the UK over the last 20 years as well as the substantial declines in manufacturing employment.

Table 1 Employment in Manufacturing Industry, 1960=100

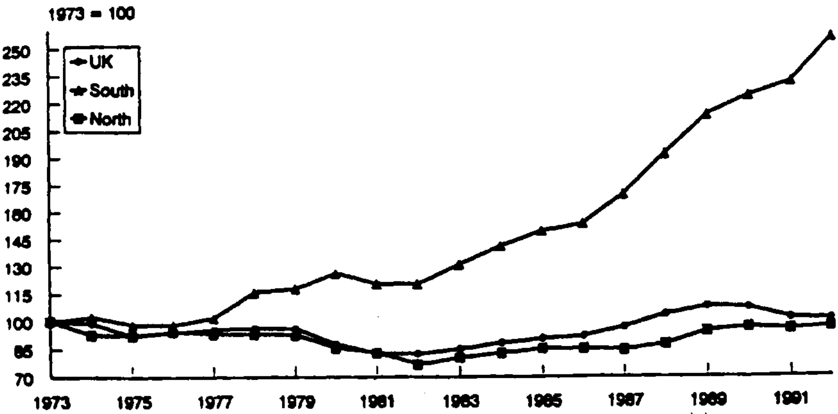
Area	1960	1990
UK	100	63
RoI	100	121
NI	100	57

Source: Murshed, M. et al., 1993.

3. EXTERNAL AND INTERNAL SOURCES

It is important at the outset to distinguish between the sources of the peace bonus. Clearly, the *external* source will be of major significance, eg, capital inflows (mainly in the form of grants[3] and foreign direct investment) which will benefit NI and, to a lesser extent, the RoI. Already the EU has pledged £240m in grants over a 2-year period with an option to renew for at least a further 2-year period. US-sponsored funds (mainly the International Fund for Ireland) will provide a further £130m. Most of the funds will go directly to NI although a not insignificant

Chart 2 Census of Industrial Production, 1973=100



Source: Murshed, M. et al., 1993

proportion will benefit the RoI, especially the border counties. It has to be assumed that the UK subvention will continue and that the security portion of this (about one-third) will be reallocated to other uses. If these assumptions do not hold then there would be very little prospect of any peace bonus during the foreseeable future.

Regarding Foreign Direct Investment (FDI) the expectation would be that NI would benefit considerably. The IDB's package of incentives is relatively attractive - more grant-based than tax-concessional - while labour and other costs, with the exception of energy, are relatively low. Given the rate of disinvestment by UK multinationals[4] (from the RoI as well (McAleese, 1986)) it is likely that most FDI will come from the US. Some of this may be at the expense of RoI but it is unlikely to be a zero-sum game. The RoI, after all, has a considerable reputation, and has achieved a critical mass, given that over the last two decades employment in externally-owned (mainly US) manufacturing companies increased by over 30 per cent. This contrasts sharply with a fall of 50 per cent in NI

If growth does pick up in NI it is likely that employment will respond quite positively. This is because of the lower tax wedge and replacement ratios in NI. To the extent that employment will tend to increase in NI it is likely that the UK subvention in relation to unemployment benefit will diminish pro rata.

The main *internal* source of growth is likely to come from increased trade between NI and the RoI both of which are extremely open economies and need to be. Existing trade links are very weak at present. In 1993, for example, exports to NI accounted for less than 4 per cent of RoI's total exports, while less than 3 per cent of total imports came from NI[5].

There would appear to be considerable scope for both economies to export more to each other. This is not just because of geographical proximity, common language, "just-in-time" factors and so on. Increasing the "domestic" market in this way could bring significant welfare benefits as long as the increased trade develops "naturally" according to market forces, comparative advantage and so on[6]. *Net* exports of *each* of the two economies of course cannot increase at the same time. It would probably be desirable for the island as a whole if the increment to trade took the form of more exports from North to South - since the latter has a considerable balance-of-payments surplus. The high degree of NI's dependence on the UK market may militate against this to some extent and there may be a need for some policy direction of an informational kind to exploit comparative advantage vis-a-vis the RoI where, incidentally, the growth in aggregate demand is likely to continue to exceed that in the UK. It is conceivable that both parts of Ireland could in fact represent an optimal currency area[7] - but development of this idea would take us too far afield.

Closer trading links would also produce dynamic effects such as agglomeration, corporate mergers and so on which could ultimately lead to greater output and exports to third countries. These issues will be addressed later in a supply-side context.

4. LIKELY EFFECTS ON NATIONAL ACCOUNTS AGGREGATES (DEMAND SIDE)

Looking first at the demand side of both economies it is apparent from the last section that net exports are likely to increase in NI and that stronger trade links will bring welfare gains to the island as a whole.

FDI will of course improve the overall investment/ratio, especially in NI. Lower interest rates, resulting from a fall in the existing risk premium should benefit "domestic" investment at the margin. This effect, though slight, may be more noticeable in the RoI than in NI where interest rates will probably continue to match those in the UK. It is worth noting that lower interest rates would also help to reduce debt service payments in the RoI. The average productivity of the capital stock is likely to rise significantly especially if security expenditures are rechannelled into more productive areas. There will also be induced investment effects and downstream activities although experience in RoI indicates that linkages may remain weak[8]. Encouraging the latter as well as investment in human capital and technology will probably not happen automatically and will depend, at least in part, on policy action. Even then perhaps too much should not be expected in relation to these aspects[9].

The effects on consumer spending are hard to predict. On balance, however, improved employment prospects should boost consumption[10], especially in NI via its effects on disposable income and confidence factors generally. The savings ratio in NI has tended to be below that in RoI but is still fairly high by international standards. Consumption in the island as a whole should rise at least in line with GNP; if the consumption *ratio* were to increase it would probably be matched by a fall in Government current spending. There is little reason to expect that monetary savings (resource-gathering) would exercise a restraint on growth although lending institutions may be cautious where first-time entrepreneurs are concerned.

5. SUPPLY-SIDE EFFECTS

Clearly the increase in EU and other grants (assuming no fall off in UK subventions) and in FDI[11] will expand the productive capacity, especially of NI[12]. Although the EU and US grants are not large when compared with the ongoing subsidies received by NI, they should, nevertheless have a fairly significant impact. It is not clear, however, how best these funds might be spent. Infrastructure, for example, is already seen as quite adequate in NI to offset the effects of peripherality (Murshed et al., 1993).

There would seem to be considerable merit in developing the North-South corridor. Almost half of the population of the island as a whole lives in this area and the scope for industrial clustering, externalities, economics of scale and scope and consumer pressure for high standards would seem to be beyond dispute. Developments of this sort - joint ventures perhaps in the food sector - would seem to have very considerable potential and the authorities may have a role in brokering partnerships. Several RoI companies already operate in NI. There is no reason why a two-way flow of investment cannot take place. It is conceivable that the IDA and IDB could work together in some areas and, incidentally, avoid bidding up incentives to MNCs. It might be worthwhile for a multinational company setting up in NI to source part of its inputs from the RoI at least until such time as NI redevelops its manufacturing base and shifts away from the more traditional industries that are becoming increasingly vulnerable to low-cost imports. In general terms a process of cumulative causation could be put in train in the North-South corridor which could go far to reduce the disadvantages of peripherality and improve the prospects for exporting to third countries and for convergence vis-a-vis our EU partners. (I tend to agree with those who argue that convergence will not take place automatically, eg, Lucas 1990, Kennedy 1992 and O'Connell 1992 have discussed this issue thoroughly in an RoI context.)

Even in a region like NI where production costs are relatively low the automaticity of convergence may be lacking despite the arguments of Krugman and Venables, 1990. Technological progress is important and lack of R&D has been identified as a constraint in NI (Begg and Mayers, 1994). It might, however, be easy to exaggerate this problem since small economies may be better off replicating existing technology rather than investing too heavily in R&D, product development and so on. Nevertheless, there would be much to be gained by a joint effort North and South to monitor modern technologies with a view to implementing them at an early date.

It should also be borne in mind that the efficiency of the non-traded sector is vital for competitiveness. A greater degree of competition between the sheltered sectors, North and South, should result in much more competitively priced inputs for the exporting sectors. Such competition, though it may upset some vested interests in the short term, would be quite a significant part of the peace dividend.

Tourism is ripe for development in both economies. At present tourism accounts for only 1.5 per cent of NI's GDP. The ratio for the RoI is three times that and there is no suggestion that there are capacity or absorption constraints in the South. Again, one would hope for even greater co-operation between the two tourist boards. Other sectors have been dealt with by several authors, especially Quigley 1992.

One general aspect which should not be overlooked is the psychological one which economists tend to euphemise as "animal spirits". One should not ignore this aspect just because it is imponderable. One fairly obvious effect relates to the social rate of discount. Will this fall? In other words will people discount the future less heavily in peacetime precisely because they have a peaceful future to look forward to? If "yes" is the answer, then we may well see a dramatic shift into longer-term investment which could prove to be the biggest peace dividend of all.

6. CONCLUDING REMARKS

The peace dividend or bonus may take a number of different forms - albeit with a lag - ranging from greater FDI flows into NI to closer trading links between both economies - assuming that such links reflect market forces. There will be an adjustment period during which lobby groups will argue for the status quo. They will have to be ignored!

Working through the demand and supply-sides of both economies, it is apparent that the potential bonus will be significantly higher in NI than in RoI. However, the latter should still benefit, especially if stronger trade and other economic links can be forged with the revamped NI economy. It is not a time for small or zero-sum minds!

The assumption regarding the maintenance of the UK subvention at over 30 per cent of NI's GDP is vital. Even if expenditure on security (10 per cent of GDP) is withdrawn and not reallocated to other uses, there would of course be no peace bonus.

It is possible that, over time, as NI becomes more economically self-sufficient (a return to earlier days) the UK subvention will be reduced pro rata. This could set up a sort of moral hazard problem, eg, why should economic agents seek to improve their performance if it only results in lower subventions? If this kind of mentality were to take hold, there would be rather dim prospects over the longer term.

Both economies in fact are open, vulnerable and fairly dependent on grants and FDI. In NI aspirations continue to exceed resources because of the UK subvention. In the RoI this imbalance is less marked because of the lessons learnt from the accumulation of debt. (It was a painful way to have to learn such a lesson but, perhaps, on a longer-term view, debt and debt service obligations focus the mind better than unrequited subventions which are assumed to be infinitely renewable.)

One of the fundamental questions (and uncertainties) is whether the private sectors of both economies will rise to the challenge or whether entrepreneurship has been sapped by the liberal provision of grants and subsidies in the past. An added question (in NI) is whether too much talent has gone into the public sector or into those sub-sectors which service it. Even if this is so it is still realistic to suppose that the earlier tradition of entrepreneurship of NI lives on or can be revived. One encouraging factor in this regard is the relatively low tax wedge and replacement ratio in NI. Another is that FDI will create a demand for locally produced goods and services. Since the incentive package in NI is not based on tax concessions there may be less transfer pricing and more linkages with the domestic economy. It is conceivable that the RoI could also get some of this sub-supply business.

Greater trade between NI and the RoI seems likely - with benefit to both economies as well as a lower degree of reliance on slow-growing UK markets. The development of a North-South corridor and joint tourist projects would seem to be very important ways of maximising the peace bonus and lessening the problems of peripherality that confront both economies. Co-ordination with respect to technological progress would also be eminently desirable as a means of aiding economic convergence which is hardly an automatic process.

The attitude of the UK to EMU is unhelpful to monetary and exchange-rate relationships between both economies. It also creates a climate of uncertainty for both islands as a whole. The psychological effects of peace might help to mitigate the adverse effects of uncertainty and lead to a longer-term view being taken of economic prospects and policies. It is worth noting how extremely positive was the reaction of the EU (and the US) to peace, not just at political level but across a wide spectrum of the international business and financial community. Goodwill on such a vast scale can be of immense value.

Both economies depend, and will continue to depend, on FDI. Against a background of increasing globalisation and capital mobility it may not be easy for either economy to attract adequate FDI. In addition, parts of the indigenous traditional sectors of both economies are already finding it difficult to compete with the products of low-cost countries. The question of increasing the "domestic" market by forging stronger trading and other links may no longer be an option as much as a sine qua non of progress.

This paper has not addressed in any detail the question of what policies might be required to maximise the peace dividend. This is not to suggest that the free play of market forces will of themselves deliver the goods. Indeed, because of co-ordination failures and lack of information it is likely that proactive policies will be required. Indeed, to exploit agglomeration economies - for example, in the North-South corridor - the "first movers" would probably require some kind of incentive (Rauch, 1993) at least until the gains of agglomeration were captured. It is to be hoped that the impressive work which is ongoing between the ESRI (Bradley and Wright, 1993) and NIERC (Murshed et al., 1993) will embrace such a policy dimension.

Finally, it might be mentioned that several serious-minded critics, including the late Raymond Crotty, have agreed that there is something fundamentally wrong or inappropriate about the model of development we have pursued in the RoI and that perhaps we have "cloned" UK institutions and practices to an unwarranted degree. Suppose this were also partly true of NI then it would be most interesting to speculate on whether a closer economic symbiosis between North and South would ultimately lead to a radical change in the way we develop the economy of this island as a whole.

Footnotes

1. Employment in manufacturing has fallen by a substantial 60,000 over the last two decades in NI.

2. In fact public spending by the UK in NI is 50 per cent higher than in the UK on a per capita basis. These subsidies have enabled NI to have higher real per capita income and consumption than RoI. Deflators are a problem, however. It is assumed that the rate of inflation in NI is the same as that in the UK - which of course has been higher than that in RoI since the mid eighties.

3. That is, unrequited investment transfers from abroad. For present purposes EU structural funds are ignored since these are not "triggered" by the peace process.

4. In 1973 UK multinationals employed 65,000 in NI. By 1990 this had fallen to 23,000. But UK multinationals still account for 1 in 5 of all manufacturing jobs in NI - which partly explains why 55 per cent of NI's exports go to the UK.

5. The RoI had a trade surplus of almost £300m with NI in 1993.

6. The fact that it has not so developed in the past could be because of market imperfections and co-ordination failures.

7. Certainly, the economic structure seems broadly comparable and "symmetric". The fact that factor mobility has not been greatly in evidence (until relatively recently at least) is probably due to co-ordination failure, broadly defined.

8. Given the process of deindustrialisation that has occurred in Northern Ireland it is doubtful if the downstream sub-suppliers will be adequate to the task immediately. Transfer-pricing should be less of a problem, however, since the incentive package does not include major tax concessions. Hence, the multinational companies may be more willing to source inputs domestically.

9. For example, although high technology may already be "embodied" in FDI it is unlikely that technological progress as such would, at the outset, become endogenous.

10. Although probably not immediately since jobs lost in the security sector may not be made good elsewhere, at least in the short-run.

11. Part of which may come from the UK even though UK multinationals have been pulling out of both parts of Ireland for several years now.

12. An interesting question that arises here is whether the UK will provide the grant incentives (via the IDB) to the increased number of MNCs wishing to set up in NI.

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