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**Fast-Growth Economies:  
Sustainable and Unsustainable Examples from Europe and Asia**

**Address by Governor Patrick Honohan  
to Ireland Japan Chamber of Commerce, Tokyo**

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Traveling to East Asia from Ireland, as I have been doing off and on for almost a quarter of a century, has always been accompanied by an air of expectation: What will be the most evident new examples of how fast the Asian economies been evolving? It is no different today. As usual this is the fastest-growing regional economy on earth. And I am coming to you today from what is temporarily a country buffeted by a contractionary shock. Europe as a whole has suffered badly from the global recession, and the Irish economy has been one of the worst hit – reflecting the fact that we had allowed the economy to overheat rather badly.

But it is important to emphasise that Europe too has had its fast-growth regions and countries also in the recent past and will continue to have them in the future. After all, fast growth is not regionally biased, but can occur in at least three distinct ways, which I can call the convergent, the unsustainable and the agglomerative.

- Fast growth of the convergent type is available only to countries which have fallen behind what is often termed the global productivity frontier and are catching up with the rest.

- Unsustainable surges of fast growth are generally driven (or at least supported) by bank credit or public borrowing: this is the boom and bust type.
- The third form is more intriguing, and is observed in some small countries or sub-national regions that secure some special advantage involving economies of agglomeration.

All three forms of fast growth are exemplified both in recent East Asian history, and they are also exemplified in Europe. Not only that, but each type plays its part of the story of Ireland's rapid growth over the past twenty years before the recent set-backs.

### **Convergent growth**

When it comes to the greatest success stories of recent fast-growth economies, of course there is no denying the primacy of the Asian miracle. After all, most of the East Asian economy as a whole is in a phase of convergence, and its great cities benefit from being the entrepôts and the intellectual, entrepreneurial, and administrative centres of the vast expansion in economic activity that is associated with this convergence of living standards for some 2 billion people to what economists have long called the production frontier.

This term production frontier, I guess, was partly inspired by American economists mesmerized by the expansion of European colonisation into the ever retreating Western US frontier of the mid-19<sup>th</sup> Century. Exploiting the agricultural and mineral potential of that continent offered, for a while, unlimited opportunities for growth and underpinned the can-do attitude to prosperity which has survived in that part of the world right to the present day, even though production possibilities are nowadays limited more by access to human and technological capital.

## **Convergent growth in Ireland**

For over three decades after Ireland became independent almost a century ago, policy debate seems to have been largely free of any form of such “frontier” thinking. Rather than converging, Ireland had been exporting what was seen as its surplus population to fuel growth in the New World as well as in the UK and elsewhere. The pattern had long been established of emigration by those who sought a wider horizon and better opportunities than seemed available at home. Economic policy was geared towards a defensive and inward-looking maintenance of the status quo. As late as the 1950s, getting a good price in the British market for our beef and dairy products seemed the height of national ambition.

Then, belatedly, and as a response to the deepening malaise of economic stagnation in the middle of the last century, a new and energetic internationalist mindset suddenly began to take hold in Ireland:

Why could Ireland not become a producer of a wider range of the goods and services in demand worldwide? If it was education that was lacking, that would be provided for all from the public purse; if it was enterprise and market know-how, this too could be sourced, in the first instance by encouraging the entry of foreign multinationals with grants, a low tax rate and above all a welcoming attitude.

That Ireland is now the most globalized economy on earth – OK, maybe Singapore and Hong Kong run us close – is directly attributable to that policy shift of over a half-century ago, a shift which set us on an export-driven course of openness considered conventional today but which was relatively pioneering at the time.

The formula was a successful one, albeit one that was derailed by policy errors in the 1970s from which the 1980s recovery was at first a slow one. Gradually the exodus from traditional labour-intensive agriculture and other low-productivity sectors was absorbed not by emigration but at home in activities – often computer-mediated – that increasingly matched global productivity

standards. Better-educated young women and men took their chances in an increasingly flexible labour market.

New business-like working methods and a respect for the discipline of the market percolated through the economy from the wave of US and other multinational companies who found Ireland a profitable productive base.

Equally important, enthusiastic engagement with cooperative policy development of the European Union helped to leaven traditional approaches to public administration.

Positioned in the geography of ideas mid-way between Boston and Berlin, the Irish economy, as it leapt forward in the 1990s, seemed to benefit from the best of both of these worlds. The momentum built and by the 1990s was spectacular, with rapid employment growth stimulating a reversal of the traditional pattern of migration.

By the late 1990s – the performance of the Irish economy was being talked about in the same awed terms as that of East Asia.

From 1988 to 2007 real GDP expanded by 6 per cent per annum on average (reaching double digits on average during 1995-2000). Even more astonishing, the unemployment rate shrank from 16 per cent (on the ILO basis) in 1994 to 4 per cent in 2000 – essentially full employment for the first time in modern Irish history. Non-agricultural employment jumped from 33 per cent of the population in 1993 to 41 per cent in 2000 and 46 per cent by 2007. With Ireland at the frontier of economic prosperity, surely this was an economic miracle to be studied and replicated.

The Celtic Tiger, it seemed, could grow as quickly as its Asian cousins and for a sustained period. Growth miracles could happen and were happening in Europe also!

## **Unsustainable growth in Ireland**

If we fast forward to the present, the talk is all about the setbacks that have occurred to the Irish economy. It is natural for observers to ask: was it all a chimera: a bubble masquerading as a tiger?

It is important to avoid this interpretative trap. In fact, the rapid and sustained growth of Irish output and employment in the 1990s was – as I have indicated – based on a belated export-led convergence to Western European productivity and living standards as an increasingly well-educated labour force, priced itself competitively and adapted flexibly to the evolving global economy. The role of foreign-based multinational corporations in mediating between Ireland and the rest of the world was already a long-established feature reflecting in particular the favourable tax regime: over half of manufacturing employment was already in foreign-owned firms by the 1980s.

The speed of the convergence in then 1990s reflected how far the economy had been held back by policy errors of the 1970s and 80s—errors which had pushed unemployment close to 20 per cent and had discouraged many women especially from entering the labour force. To be sure, conventional data somewhat flattered the real situation to the extent that some of the output growth reflected profits due to the multinational firms. But the new levels of employment and income reached by the turn of the millennium were real and sustainable. Had Ireland stopped to take stock and consolidate at that point, we would be in a better position now than we are.

But the growth had been so heady, with success seeming to build on success, that stopping to take stock was not on many agendas.

## **The elusive goal of agglomerative growth in Ireland**

Indeed, given the growing rate of net immigration, it was not easy to see what the natural limit on the size of the Irish economy might be. After all, look at Hong Kong and Singapore: with a higher population on a much smaller land platform and living standards as high as Europe. Sure enough, the world

production frontier would define an outer limit to productivity, and as such to per capita income, but the relatively low physical density of population suggested to many that Ireland's population could continue to grow, exploiting economies of agglomeration, if competitiveness were maintained and investment in infrastructure not neglected.

But it was not to be. As the millennium passed, some of the preconditions for sustained expansion began to erode: real wages started to move out of line with international comparators and well ahead of historic competitiveness norms. The export boom slowed. Nevertheless, employment and output aggregates continued to impress, albeit now increasingly heavily reliant on the construction sector, as demand both from final purchasers with good jobs and speculators hoping for continued national prosperity made residential sales easy. The government's budget became increasingly reliant on the property market and vulnerable to any interruption in what was rapidly a world-beating property bubble.

The arrival of the euro – offering an attractive stable monetary platform for continued expansion – may have played a role also in fuelling the construction boom. Nominal and real interest rates dropped sharply as euro membership approached, increasing the affordability of large mortgages and thus seeming to rationalise a higher capital value for property. After a brief pause in 2002-3, the construction and property price boom resumed with heightened vigour. Banks, including foreign-owned banks, began to source more and more of their loanable funds in the global financial market—with no exchange risk, given the borrowing was in euros. By 2006, net foreign borrowing of Irish mortgage lenders exceeded 60 per cent of GDP and Irish banks were even financing the purchase of a growing share of prime property in the UK, US, China and elsewhere by a handful of over-enthusiastic speculative developers.

The Irish banking and property lending debacle had a few things in common with that of the US; but in large part it was a home-grown affair, driven by an over-optimistic misinterpretation of the nature of the Celtic Tiger and the basis of the earlier success. Egregious lending abuses were not prominent features and there was essentially no use of complex mortgage-backed securities.

Only the timing of its denouement really coincided with the global financial crisis. The revulsion and suspicion of financial market lenders after the collapse of Lehman Brothers rationally focused on those banks that had taken the most extreme bets, and in such an environment, the Irish property merry-go-round was doomed.

The same occurred with other – even more damaging – contemporary financial crises in Latvia and Iceland: neither country was directly influenced by euro membership, but still both of them were able to draw on the elastic availability of international banking funds, and both arranged their financial markets in such a way that borrowers were faced with low nominal interest rates.

Contrary, then, to the image of Europe as inevitably slow-growing, peddled by some observers, Ireland is not unique among European countries in exhibiting exaggeratedly rapid growth. Dynamism is present; it simply needs to be harnessed. Policy complacency is what has been the Achilles heel of these rapidly growing economies: they did and do have the potential for relatively rapid growth, but at a lower rate than was observed, and with the need to guard against the emergence of unbridgeable imbalances.

Put that way, we see the relevance also to Greece, though in the case of Greece, the origin of the problem was not in banking, but in fiscal and wage rate aspects—and it may well be that part of the complacency there too was associated with an exaggerated understanding of what the secure platform of the euro can deliver and what it cannot.

Although there are important differences, I would like to emphasise the parallels between what Ireland has experienced and the famous East Asia crisis of 1997-98. In both cases a strong underlying convergence in living standards had been under-way for some years. In both cases the countries had made themselves vulnerable by relying heavily on short-term foreign borrowing through the banking system, and had allowed a property price and construction boom to get out of hand. In this interpretation, a viable convergent process spun out of

control into unsustainable territory. And, encouragingly for us today, recovery from the collapse was – in varying degrees – speedy and comprehensive.

### **Sources of fast and stately growth**

This discussion helps us recognise both of the potential sustainable sources of rapid national economic growth – the convergent and the agglomerative – and the unsustainable type. All three types are also evident in the East Asian experience also.

First then, is convergence to the production frontier. This is exemplified by the early true Celtic Tiger period in Ireland in the 1990s as employment rates in the modern sector of the economy grew. It is also reflected in the rapid growth rates of China, Malaysia and other emerging economies as they have successfully adopted efficient and highly productive technologies throughout more and more of their economies. The transition economies of Central and Eastern Europe have shown that this phenomenon is also very much realisable in that part of the world also. And the fact that Greece lies well inside the production frontier is a consideration which allows some headway for part of their debt management problem to be resolved in time through convergence of productive efficiency.

The second sustainable rapid growth mechanism, agglomeration, is exemplified by what has been achieved by Singapore and Hong Kong even since they reached the production frontier. I include under this loose heading any form of sustainable national or urban growth through the application of both more labour and more capital: because of the efficiencies offered by agglomeration, and also exploiting particular advantages of their locations, these cities have managed to become more highly productive than one might expect from mere replication. But sustainable fast agglomerative growth it is not always attainable even by a small country or region, especially if cost competitiveness is not maintained. There may also be inherent limitations to such growth, as congestion costs increase. As we have seen, the hope that Ireland could become super-productive in this way proved illusory.

The third, and unsustainable, growth path is the property boom financed by credit and driven more by hope than any real underlying demand. The sums borrowed and the resources applied – often from abroad, but sometimes financed by domestic savings – prove to have been wasted. In Ireland, Iceland and Latvia as in parts of East Asia in 1997-98, such bubbles collapsed.

When economies reach the production frontier, as have Japan and Germany, to take the largest examples of both regions, then growth will inevitably be at a more stately rate. Stagnation is not entailed, though there can be a danger of an economy getting passed if complacency seeps in.

### **Learning from historic errors**

Thus, taking both regions together, we find examples of all types of growth path. We can learn from each others' experience – and some of us in Europe should have learnt better from the East Asia crisis.

Fast growth clearly carries the risk of macroeconomic errors as an unsustainable output, property price or wage boom – whether driven by reckless private credit expansion or fiscal deficits – in a potentially fast growing economy (of either of the two sustainable types I have mentioned) can be masquerading as something sustainable.

To an extent, the wider crisis of financial innovation with its epicenter in the US and which spilled over into the UK and into major banks in other mature countries too before triggering the sharp global recession of 2008-9 (itself strongly influenced by the widespread but thankfully contained loss of confidence in financial intermediation generally) was also a misunderstanding of real and unsustainable progress. But such occurrences, which can happen in mature economies – an earlier one was the dot.com and tech bubble of the late 1990s – tend to be smaller in amplitude. The greater risks are in potentially fast-growing economies.

Two policy problems arise: how to prevent such policy errors, and how to recover from an error. The first is more challenging conceptually, the latter more challenging politically.

In the euro area, we could do more to exploit a mechanism not available in Asia, which I believe potentially assists in both of these dimensions. The tight cooperation which exists between euro area countries, both at the level of macroeconomic policy coordination and in the stable anchor of a widely used common currency helps to provide both a discipline and a mechanism for peer review that can be very beneficial to avoiding complacency and other sources of policy error. Exploiting this potential could all work better, though and the EU is working on institutional innovation to help deliver this.

Indeed, it may well be that complacency about the automatic effectiveness of these stabilisers lulled policymakers both in some of the Euro area countries – most conspicuously Greece, but also in others including Ireland, into a sense of false security – in Greece with regard to fiscal policy; in Ireland with regard to banking policy, to speak only of these two.

For it seems the market too had become complacent. Lax policy was not punished by the discipline of the market until it was too late, and until wage rates had gotten out of line and the fiscal vulnerabilities worsened. Admittedly this was much more pronounced in Greece than in others such as Ireland, and the needed adjustment may be more wrenching there. But a lesson has been learnt by all.

Led by Ireland, all of the euro area countries that have come under pressure have begun to take vigorous corrective action on wages and on fiscal deficits generally. Adjustment is a task which will not be accomplished overnight, indeed, when the exceptional financial support needed from government to fill the hole created by the accumulated banking losses in Ireland is added to the fiscal deficit on regular operations, the headline figure for the Irish government deficit in 2010 will experience a remarkable one-off spike in the statistics. That jump is, though, a sign of the thoroughgoing and transparent clean-up that is in

progress on the banking side, and of the measured but tough spending and tax adjustment that is in progress in the rest of the government accounts.

These countries are adjusting, and they know they are supported by the huge backstop financial commitments of EU partner countries announced in May of this year, and by the monetary stability ensured by ECB policy. They also know that they cannot again allow public spending, credit and wages to get out of line, because of the painful adjustments that this implies. Already, national spending is, more or less, back in line with national production in Ireland: by next year there will no longer be a current account deficit in the balance of international payments. When the budgetary adjustment is accomplished, a chastened polity will help ensure stability-oriented policies that will be key to a renewed engagement in the global economy: especially, but not only, for countries such as Ireland which are among the most globalised on earth. The customers for our exports: increasingly Asia for sure. The investors: likely also to be shifting more in the direction of Asia from which investment in Ireland's traditionally highly profitable MNC sector is, to date, still underweight.

Many opportunities then, for what I am confident will be a more stable future.

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