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ECONOMIC STABILISATION, RECOVERY, AND GROWTH: IRELAND 1979-96

Dr. Anthony Leddin, Dept. of Economics, University of Limerick and Prof. Brendan Walsh, Dept of Economics, UCD.

This article reviews the transformation of the Irish economy since the early 1980s. Credit for the initial stabilisation of the economy is given to the shock therapy of cutting expenditure, favourable exchange rate and other external developments. Possible explanations of the higher rate of growth of output now being achieved include a high level of investment in human capital, improved quality of physical capital formation, and a falling burden of taxation. The contribution of the return to centralised wage bargaining and the role of European Union (EU) assistance are also discussed. The prospects for further economic growth over the medium term are considered to be good.

Since the mid-1980s and especially in the 1990s Ireland’s rate of economic growth has been markedly above the European and OECD averages. The country’s recent economic performance has attracted international attention and comparisons have been made with the successful economies of East Asia.

THE PERFORMANCE OF THE IRISH ECONOMY SINCE 1979

The situation facing the Irish economy in the early 1980s was grave (see Figures 1 to 6). Growth had ceased, unemployment and inflation were rising, and the fiscal deficit was at an unsustainable level. Between 1979 and 1985 the economy managed to grow at an annual average rate of only 1.6% - little different from the EU average. Unemployment rose from 7.8% to almost 17% of the labour force and the numbers at work fell when employment in Europe was growing. Further evidence of the poor performance of the Irish labour market was provided by the resumption of large-scale net emigration. Despite having joined the Exchange Rate Mechanism (ERM) of the European Monetary System (EMS) in 1979, the Irish pound continued to depreciate relative to the stronger currencies of Europe - notably the DM - and Irish inflation and interest rates remained well above the EU average. Initial attempts to restore order to the public finances appeared to meet with little success. The general government deficit was still over 10% of GDP in 1986 and, most worrying, the overall

* This paper draws on Walsh (1996) and Leddin and Walsh (1995). An earlier version of this paper was read at a conference on "Economic Growth in Spain and Andalucia", Confederación de Empresarios de Andalucía, Seville, in February 1997. We are grateful to Robert Barro, Geoff Kenny and Donall McGeehan for comments on earlier versions.
debt/GDP and the external debt/GDP ratios continued to rise steeply\(^\text{[1]}\). The deficit on the current account of the balance of payments, although falling, was at an unsustainable level. The need for radical adjustment was obvious, but no consensus existed - among economists much less politicians - on the nature of the appropriate policies.

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\includegraphics[width=\textwidth]{figure1.png}
\caption{GDP Growth}
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\begin{figure}[h]
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\includegraphics[width=\textwidth]{figure2.png}
\caption{Unemployment Rates}
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\begin{figure}[h]
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\includegraphics[width=\textwidth]{figure3.png}
\caption{Net Migration Rate}
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\(^{[1]}\) The external debt/GDP ratio reached 63% in 1988, but an important mitigating feature of the Irish situation was that the ratio of external debt service to exports never exceeded 10%.
It is remarkable that, by the end of the 1980s, most of the unfavourable trends in the Irish economy had been reversed and it was coming to be regarded, sceptically at first but then with growing conviction, as a model of successful macroeconomic stabilisation. Not only had any threat to the country's solvency been removed, but also a higher growth trajectory seemed to have been reached. Since 1986 the output growth rate has been above the EU average. In recent years, the unemployment rate has declined while it has continued to rise in Europe, the inflation rate and the public sector deficit have fallen below the European average, the debt/GDP ratio is falling steadily, and the current account of the balance of payments is in surplus.

The performance of the Irish economy over the years 1994-96 has been remarkable by any standards. The growth rate of real GDP averaged over 7% a year. While initially there was concern about "employmentless growth", the numbers at work are now growing by almost 4% a year and the unemployment rate has fallen below the rising European average. While employment on subsidised schemes has played a part, the growth of private sector non-agricultural employment has been very rapid since the end of the 1980s. Despite the boom in output and employment, wage and price inflation have remained subdued.

At the start of the 1980s Ireland's standard of living was about 60% of the European Community average - much the same as when the country joined the EEC in 1973. The absence of evidence of convergence was especially disappointing in view of the slow growth recorded in Europe over this period. However, Figure 7 shows that, as a result of

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**Figure 7: Convergence**

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<th>EU15 GDP per person at PPS=100</th>
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Countries: UK, Ireland, Spain, Portugal, Greece
accelerated growth since the mid-1980s, Irish living standards have now risen to over 94% of the EU average. Whereas in 1980 Ireland lagged behind Spain and Greece, by 1996 it had overtaken these countries[2].

HOW THE STABILISATION WAS ACHIEVED

Before discussing the longer-term influences on the Irish growth rate, the factors that have been invoked to account for the stabilisation of the Irish economy in the 1980s must be examined. These include:

• the use of “shock therapy” to restore order to the public finances in the late 1980s;
• favourable exchange rate developments; and
• a successful corporatist approach to the wage determination process.

THE FISCAL CORRECTION

Early attempts to reduce the fiscal deficit relied on higher taxation rather than expenditure cuts. They met with little success. The economy seemed to shrink under the rising burden of taxation. The Laffer curve effects of this were high emigration, tax evasion (including large-scale, cross-border smuggling from Northern Ireland) and slow growth. While some progress towards correcting the fiscal imbalance was made in the first half of the 1980s, a decisive turning point occurred in 1987 when the new minority government switched the emphasis from tax increases to expenditure reductions. Current spending fell by 11% in constant prices between 1987 and 1989, and transfer payments by 3.6%. The contraction in public spending was associated with an increase in the growth rate, rather than the recession that Keynesian theory would have predicted.

This has been taken as an example of an “expansionary fiscal contraction”[3]. It has been cited in support of the thesis that “the probability of a successful fiscal consolidation increases dramatically if the consolidation is conducted mostly through expenditure cuts”[4]. It is important, however, not to ignore the complexity of the adjustment. The fiscal correction was a more gradual process than the “shock therapy” view would lead us to believe[5]. By 1985 the primary (that is, excluding interest on the national debt) budget deficit was in surplus and the public finances were on a sustainable trajectory. The current account of the balance of payments deficit had been almost eliminated by 1986. Furthermore, the reduction in the fiscal

[2] Caution must be exercised about comparisons between Ireland and other countries based on Gross Domestic Product. GDP includes the value of production by foreign-owned firms, including profits that are eventually remitted abroad and overstates the living standards in countries, such as Ireland, where foreign firms account for a significant proportion of the growth of domestic production. However, it has been shown that, while Gross National Product provides a better measure of the trend in the country's living standards, the GDP figures do not seriously overstate the rate of growth of national income (Keating, 1995). Thus the trend revealed in Figure 7 may be taken as accurate, but for a truer indication of the relative level of living standards the Irish figure should be reduced by about 13%.
deficit was fairly evenly balanced between tax increases and expenditure cuts, and capital expenditure was pared back much more drastically than current spending. Between 1985 and 1988 public sector investment fell by 47% in real terms and the real value of public sector grants to enterprises fell by 28%. At the time of the fiscal retrenchment, there was a marked improvement in the external economic environment and the subsequent export boom played a crucial role in the economic recovery. Irish interest rates began to fall after the devaluation of 1986, which also provided a competitive boost to exports. A full assessment of how confidence in the Irish economy was restored should take all these factors into account.\[6\]

**EXCHANGE RATE DEVELOPMENTS**

A key feature of Ireland’s stabilisation was the increasing share of output devoted to exports. Non-traditional (“high-tech”) exports to continental Europe accounted for much of this expansion. A combination of factors may be invoked to explain this. The role of foreign direct investment (FDI) was crucial and is discussed below. From a short-term perspective the role of the real exchange rate was important. The 1986 devaluation provided a competitive advantage. Figure 8 shows the Irish pound real effective exchange rate, excluding sterling\[7\].

It is clear that the competitive gains from the devaluations of 1986 and 1993 were not short-lived. The real exchange rate did not revert quickly to the pre-devaluation level, as would be predicted by monetarists who believe that changes in the nominal exchange rate are almost instantaneously offset by changes in national price levels. Recent studies estimate that it takes prices and wages three and four years respectively to adjust to a devaluation under Irish conditions\[8\]. Crucially, it takes longer for nominal costs and prices to fall to offset the effects of

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\[6\] Miesi-Ferretti and Razin, 1996.

\[7\] Excluding sterling gives a clearer picture of the effect of Irish exchange rate policy within the ERM, notably the devaluations of 1983, 1986 and 1993.

\[8\] Kenny and McGettigan, 1996; Baker, Fitzgerald and Honohan, 1996.
a nominal appreciation than it does for them to rise to offset the effects of a devaluation.

The importance of avoiding sudden and unwarranted real exchange rate appreciations derives from the risk that the productive capacity lost as the economy adjusts to an overvalued rate will not be subsequently regained. By and large the Irish authorities succeeded in avoiding an overvalued exchange rate during the 1980s, first by breaking the link with sterling and then by successive devaluations in the ERM.

CORPORATISM AND THE WAGE BARGAINING PROCESS

A third factor that has been invoked to explain Ireland’s stabilisation is the centralised approach to wage bargaining adopted in the second half of the 1980s[9]. It has been suggested that countries with either highly centralised or completely decentralised wage bargaining have enjoyed the best trade-off between inflation and unemployment. In one international study, Ireland was assigned a low index of centralised wage bargaining or ‘corporatism’[10]. However, the process of wage bargaining has varied considerably over time.

There were several National Wage Agreements in the 1970s, but none over the period 1981-87. Between 1979 and 1983 wage bargaining was disciplined by rising unemployment. The real take-home pay of those in employment fell by about 20% and recovered slowly thereafter. In order to consolidate the moderation in wage costs, a series of national pay agreements were negotiated later in the decade - Programme for National Recovery (1988-90), Programme for Economic and Social Progress (1991-93), Programme for Competitiveness and Work (1994-95) and Programme 2000: Employment, Competitiveness and Inclusion (1997-2000). A feature of the agreements has been that in return for low nominal wage demands the government has held out the prospect of a reduction in income taxation, improvements in social benefits and a wide variety of other measures.

Between 1987 and 1997 gross industrial earnings increased by about 15% in real terms, but after-tax earnings rose by a further 9%. Thus reductions in tax rates accounted for about one third of the rise in real take-home pay. In 1988 the standard rate of income tax was 35% and the higher rate 58%; in 1997 these rates are 28% and 48%, and the thresholds at which they are applied have been raised in real terms. The rates of social insurance tax on lower paid workers were also reduced slightly.

In a small open economy the main determinant of price inflation in the long run is the rate of inflation in the country’s trading partners and the nominal exchange rate. Consistent with this theory, since 1988 Ireland’s trade-weighted exchange rate index has been relatively stable and the rate of price inflation has been similar to that of the average of our trading partners.

However, it has been claimed that over this period “domestic inflationary impulses, relative to

foreign ones, have been largely subdued\(^{[11]}\). It is possible that the centralised wage bargaining contributed to this benign outcome, but persistent high unemployment is also relevant. Other countries, notably the United States and the United Kingdom, have combined falling unemployment with low price and wage inflation in a decentralised wage bargaining framework. The tests of Irish corporatism will be reconciling falling unemployment with moderate wage inflation and/or dealing with a major adverse shock.

**THE GROWTH RATE IN THE LONG RUN**

Between 1986 and 1996 the numbers in employment grew by 22%, while the population grew by only 2.2%. A rising participation rate can make a major contribution to raising living standards but it does not reflect an increase in the economy’s long-run growth potential. The key to this lies in the growth of total factor productivity (TFP), that is output adjusted for both labour and capital inputs.

If Ireland’s output growth is adjusted for the growth in the numbers at work (Figure 9), the record looks much less dramatic than when the focus is on the growth of total output. The long-run trend of output per person employed shows no break in the 1980s. The gap between Ireland and the EU widened in the 1990s due to the downturn in the rate of growth of labour productivity in the EU. While impressive by European standards, the Irish record is not in the same league as that of the booming East Asian economies (Sarel, 1996)\(^{[12]}\).

**FIGURE 9: GROWTH OF GDP/WORKER (FIVE-YEAR MOVING AVERAGE)**


\(^{[12]}\) It is difficult to estimate growth of TFP. There is uncertainty about the capital stock and how capital and labour should be weighted. However, recent estimates for Ireland suggest that the annual growth of TFP rose from near zero in the early 1980s to 4% in the 1990s (Kenny, 1996).
Modern growth theory provides a framework that helps organise our thoughts about the determinants of the longer-run growth rate. According to this literature, it is essential that a suitable institutional and legal framework is in place and sensible economic policies are adopted to ensure economic growth. Given these preconditions and similar levels of investment in physical and human capital, the evidence suggests that poor countries grow relatively rapidly and tend to catch up with richer countries\(^{13}\). It is of interest to examine Ireland's performance in this framework.

**INSTITUTIONAL BACKGROUND.**

Although all Irish governments since 1979 have been either coalition or minority governments, and five political parties have participated in government over this period, there has been a high degree of continuity and consistency in the main parameters of economic management. No party is likely to launch a radical attack on property rights or return to large-scale nationalisation. There has been broad support for outward-looking policies since the 1960s, including the desirability of attracting foreign-owned firms to Ireland. All parties have been strongly committed to the EU, the Single European Act and the Maastricht Treaty and even the adoption of the proposed single currency without Britain. Economic controversy has focused on issues such as the desirable level of social welfare payments and redistributive taxation, and the extent of state ownership of productive assets. There has been a reluctance to tackle private sector monopolistic privileges and a slow pace of structural reforms. In these areas Ireland does not differ markedly from many continental European countries.

**GROWTH PROMOTING POLICIES**

The literature does not offer a rich menu of policies that have been shown to promote economic growth. The key factors that have been identified are:

- a high saving ratio;
- a high level of investment in human capital;
- low levels of government consumption spending and taxation.

Other policies may have helped individual countries to achieve high growth rates in recent years, but it is difficult to generalise\(^{14}\).

**SAVING AND INVESTMENT**

Ireland's investment ratio was over 30% at the end of the 1970s - exceptionally high by international standards. It fell sharply in the middle of the decade, mainly due to a sharp fall in the level of public sector investment and is now in the region of 15% of GDP - about

\(^{13}\) Mankiw, Romer and Weil, 1992; Sala-i-Martin, 1996.

\(^{14}\) Sarel, 1996.
the OECD average. It is paradoxical that the recent acceleration of growth followed a period when the investment ratio was declining. This puzzle may be explained by the changed structure of investment. Since the mid-1980s the share of private investment, and FDI in particular, in total investment has grown. The dramatic fall in the incremental capital/output ratio reflects the much higher productivity of this investment compared to that of the public sector investment which predominated in earlier years. It is, however, possible that the physical and social infrastructure provided by the high level of public investment in earlier years had a long gestation period and is now enhancing the productivity of contemporary private sector investment.

**HUMAN CAPITAL**

According to one recent study of the determinants of economic growth, Ireland had the highest rate of investment in human capital of any OECD country over the period 1960-85.[15] However, this study focused exclusively on second-level education and the Irish level of participation in third-level education was below the OECD average until recently. This may help to explain Ireland’s relatively slow growth in the past, while the pay-off to higher levels of investment in more recent years could be part of the explanation for the acceleration in growth in the 1990s.

**THE BURDEN OF TAXATION**

In 1986 the ratio of government spending to GDP was 47.3% in Ireland compared with 45% in the EU; by 1996 the Irish ratio had declined to 37%, while the EU ratio had risen to 47%. A similar picture emerges for the burden of taxation, which declined from 41% to 34% of GDP in Ireland, while it rose from 45% to 46% in the EU. Combined with the reduction in marginal tax rates referred to above, these trends show a marked improvement in the structure of the Irish economy relative to the rest of the EU over the past ten years.

This list of growth promoting factors does not include several that have been cited as contributing to Ireland’s current boom. This is because there is little agreement in the international literature that they do in fact contribute to growth. However, some of these are considered in the following.

**EU ASSISTANCE**

Relative to GNP the inflow of grants and subsidies from the EU to Ireland has been exceptionally large (Figure 10). However, the international evidence shows that the long-term contribution of foreign assistance to growth tends to be negligible. Using data for almost 100 countries over the period 1979-90, Boone (1994) concluded that

"...The marginal propensity to consume (public and private) aid is insignificantly different from one, and the marginal propensity to invest is insignificantly different from zero ... aid does not increase investment and growth, nor benefit the poor as measured by improvements in development indicators, but it does increase the size of the government".

![Figure 10: EU Transfers to Ireland (Net)](image)

It is, however, interesting to note that the same author finds among a few small countries\(^{[16]}\) that have received an exceptionally large volume of aid (generally more than 15% of GDP) "there is a high correlation between aid and investment". Where aid is at such a high level, it is no longer fungible and is more likely to produce the desired net effect on investment and growth. It is possible that EU assistance to Ireland falls into the category of effective, growth-promoting assistance. However, it is salutary to bear in mind that, as a general rule, the international evidence does not support this view of foreign assistance.

**LABOUR FORCE GROWTH**

Should the rapid growth of the labour force be invoked as an explanation of faster growth of output per worker? In neo-classical economic theory the reverse is in fact the case - the growth of the labour force reduces the rate of growth of output per worker due to the capital

\(^{[16]}\) His sample does not include Ireland.
shallowing effect. Ireland's labour supply did not suddenly become more elastic in the second half of the 1980s and the very high levels of youth unemployment throughout continental Europe do not suggest that a shortage of labour in other possible EU locations is an important reason for preferring Ireland as a location. However, at present there is a very large gap between the human capital endowment of labour market entrants and that of older workers and retirees. The exceptional rate of influx of young, well-educated workers to the labour force is having a dramatic effect on the average level of human capital employed. The higher educational levels of current labour market entrants and their increased flexibility with regard to work practices may help to account for the greater success in absorbing them into employment now than in the past.

**INDUSTRIAL POLICY**

The contribution of foreign direct investment (FDI) to Ireland's current boom is not in dispute. FDI is associated with exceptionally high levels of output per employee and very high export orientation. The sales of foreign-owned firms in Ireland amounted to 30% of GDP and 37% of exports in 1996. Sharply increased productivity, wage moderation and a stable nominal exchange rate have led to a 40% decline in Ireland's unit labour costs relative to those of our trading partners in a common currency (RULC) since the mid-1980s (Figure 11).

This measure of the real exchange rate explains the export boom.

**FIGURE 11: UNIT LABOUR COSTS IN A COMMON CURRENCY (RELATIVE TO MAIN TRADING PARTNERS)**

![Graph showing unit labour costs in a common currency relative to main trading partners](image)

It is not easy to explain why the level and quality of FDI should have improved so dramatically as the level of incentives has been reduced and competition from other regions for FDI intensified. Has Irish industrial policy become markedly more effective in recent years? It could be that the promotion of Ireland as a location for FDI is now better focused on sectors such as electronics, information technology, pharmaceuticals, and financial and other traded
services in which Ireland appears to have developed a comparative advantage. On the other hand, the timing of the increased inflow of FDI, and the higher levels of reinvestment now occurring, are consistent with the view that the stabilisation of the economy in the mid-1980s increased the attractiveness of Ireland as a location.

CONCLUSIONS

Economics is known as the dismal science and for much of our history Irish economists had every justification to be gloomy. The exceptionally good performance of the economy since the late 1980s has taken many by surprise and there is still some lingering scepticism as to how genuine the boom is and how long it will last. There are a number of genuine grounds for concern about the way in which the economy has developed. The most important of these is the heavy dependence on FDI and the extent to which the inflow of foreign-owned enterprises to Ireland is attracted by grants and tax incentives rather than more fundamental strengths of the Irish economy. There is a widespread perception that foreign-owned firms are more "footloose", and more likely to reduce their workforce in Ireland during a recession, than Irish-owned firms. While there is little evidence to support this view, the economy's dependence on a narrow range of industrial exports has yet to be tested by, for example, a major recession in microelectronics. There is also the concern that, after the present tax concessions have been re-negotiated with the EU, we shall find it increasingly difficult to attract new projects to Ireland.

The shock therapy of cutting public expenditure played a key role in the successful stabilisation of the economy in the 1980s. It increased domestic and foreign confidence in the economy's solvency and led to a virtuous circle of faster growth and a declining tax burden. The reversal of unwarranted real exchange-rate appreciations in 1986 and 1993 was also important. A moderate trend in costs and prices, initially imposed by exceptionally high levels of unemployment, was reinforced by successive national wage agreements. Good fortune played a part too, principally in the form of favourable external developments over the period 1986-92.

Several factors helped boost the longer-run growth of the economy. First, it should be borne in mind that, given suitable preconditions, countries starting from a low level of output per person tend to grow more rapidly than richer ones. The process of catching up that has been witnessed in Ireland in recent years is in keeping with this convergence tendency. Secondly, modern growth theory predicts that Ireland's increased rate of investment in human capital would lead to faster growth. However, the faster growth that was recorded in the late 1980s seems anomalous in view of the fact that the Irish investment ratio fell sharply during the 1980s. The key to this puzzle may lie in the dramatic change in the composition of investment
over the period, with a much larger proportion of the total accounted for by private investment (and FDI in particular) in the later period. While in the neo-classical model a rapidly growing labour force lowers the growth rate of output per person, it may have had a net positive effect in Ireland because the influx of young, well-educated workers resulted in a dramatic upgrading of the average level of human capital employed. The combination of a marked improvement in the quality of physical investment and a rising level of human capital resulted in a dramatic rise in productivity. An additional factor that may be invoked to explain Ireland’s improved performance relative to the economies of Europe is the decline in the shares of government spending and taxation in GDP at a time when they were rising in the EU.

The international literature is sceptical about the net contribution of high levels of foreign assistance to a country’s long-run growth rate. The evidence suggests that foreign aid generally leads to higher levels of consumption rather than investment, expands the role of the state in the economy and has little lasting impact on growth. The scale of EU assistance to Ireland, and the manner in which it has been implemented, may have allowed us to escape these negative consequences and to reap the expected benefits of the aid inflow.

FUTURE PROSPECTS

This analysis suggests that the key precondition for maintaining a high growth rate is that sensible macroeconomic policies are kept in place. Curbing the ratio of taxation and government spending to GDP helps. Maintaining a high level of investment in human capital is important, both in itself and because it encourages a high level of FDI. On the other hand, doubts have been raised about the contribution of EU assistance to Ireland’s accelerated growth. If these doubts are warranted, then the declining relative importance of this aid can be viewed with equanimity.

The demographic momentum will remain strong as the children of the baby boom of the 1970s enter the labour force and the depleted cohorts of the 1950s reach retirement age, but will begin to slow by the end of the decade. The inflow to the labour market will continue to have higher than average educational endowment. Shortages are most likely to emerge at the lower end of the labour market - in relatively poorly-paid, entry-level jobs. The continued growth of the number of labour market entrants with third-level qualifications will moderate wage pressures at this end of the employment spectrum. This is favourable for the growth of employment in high-productivity multinationals.
The contribution of a pragmatic exchange rate policy to the recovery of the Irish economy in the 1980s has been stressed. The possibility of Ireland participating in EMU after 1999 is a source of uncertainty on this front. If the Irish pound became seriously overvalued as a result of sterling weakness relative to the euro, the real economy would take time to adjust during which the growth rate would fall. This risk has to be balanced against the perceived political and economic gains from joining EMU.

Finally, it needs to be borne in mind that some of the factors contributing to Ireland's current boom cannot persist. The most important of these is the rising labour force participation rate, which has permitted us to achieve a much more rapid growth in output per head of population than in output per worker. The rise in the participation rate has been due above all to the rise in women's labour force participation rates. This will continue to be important for some time, but not indefinitely[17]. It should also be borne in mind that countries starting from a relatively low income level tend to grow rapidly as they catch up with richer countries. Thus, rapid growth contains within it the seeds of its own demise. As we approach the standard of living of the richest countries of the world, the rate of growth of output per worker will be constrained to the rate of technological progress. Over the medium term, as the catching-up process continues, the prospect is for our exceptional growth rate to continue, subject to normal cyclical variations.

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