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GLOBAL BANKING LEGISLATION AND SUPERVISION

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The banking industry is going through a rapid transformation in Europe and the internal market has been improved by the introduction of the euro. It is against this background that the European (EU) Commission has formulated an action plan for financial services which will set an important agenda for the coming years.

Risk management and capital adequacy are vital in banking regulation. It is therefore important in this new environment that the present EU Banking Directives are amended to better capture risks.

The Basel Committee has developed a consultative paper on a new capital framework. This is based on three pillars: minimum capital requirements; a supervisory review and rules on transparency. The present paper from Basel gives an important input, but work needs to be done to develop a European response to the Basel initiative.

The Banking Advisory Committee has been working for more than a year with these issues. It has been clear that a reform is necessary and that European countries must take an active part and work in parallel with the Basel process. A document, which will focus on important questions from a European perspective, is being prepared for consultation with the European banking industry in the autumn of 1999.

INTRODUCTION

There have been a number of disturbances in financial markets over the last decade. These disturbances have frequently been linked to the conduct of economic policy. At the same time problems related to the management of risks have been raised. Banks have often been at the centre of these problems and it is in this context that the question of the prudent regulation of banks is most often raised.

*This article is based on an address to an international conference on Global Banking Legislation and Supervision in Dublin on 30th June, 1999, jointly sponsored by the Irish Bankers' Federation and the Institute of International Bankers, New York.

An internal market has been created in Europe. This has been an important achievement for financial services as it has increased efficiency by reducing the regulatory burden and increasing competition. This trend has been amplified by the introduction of the single currency this year.

At present, the industry is going through a rapid transformation with mergers and acquisitions on the agenda of most European countries. However, mergers are not only occurring between banks in the same country, new structures are being created across national borders and across sectors of the financial market such as banking, fund management and insurance.

It is against this background that financial regulation in Europe must be discussed. As there is no room for complacency with what has already been achieved, it is important that the EU Commission has formulated its action plan for financial services, as it sets an important agenda for the coming years of financial services regulation in Europe.

The regulation of capital is certain to receive much attention over the coming years. Capital is the ultimate buffer in financial business to meet risks and absorb shocks so that depositors and third parties are not adversely affected. The Capital requirements for internationally active banks, formulated in the Basel Accord of 1988, served the purpose of setting a global standard for capital to meet risks. Those rules have been under increased debate and criticism for some time now. From a European point of view, the Banking Directives have set out similar rules that have been in line with the Basel Accord.

The Basel Committee has circulated a draft proposal for a new Capital Accord. In Europe this calls for a parallel revision of the Solvency Directives. It is important to amend the European Banking Directives to better capture risks in today’s financial environment, but this cannot be done by merely looking at minimum capital requirements. Instead, the practice of supervision and market discipline needs to be addressed. It is against the background of the current draft from Basel that the following areas will be examined to ascertain how the European response to the Basel initiative should look.

I The main features of the New Capital Adequacy Framework.

II How the Basel process will evolve.

II Questions that need to be addressed from an EU perspective.

I A NEW CAPITAL ADEQUACY FRAMEWORK

It is clear that the present Basel Accord has played an important role in banking regulation. The aim of increasing capital standards and at the same time creating a true global standard for regulation has been achieved. However, the world has moved on due to financial innovation, technology and an increase in cross-border trade in financial services. A number of problems with the present Accord have therefore been identified as follows.

First, the present risk weighting system does not adequately capture risks in the banks' lending operations. One example of this can be seen in the present broad brush approach whereby countries are given either 0% or 100% weighting. Another example shows high quality corporates being treated in the same way as low quality borrowers. The capital cushion, therefore, is not adequately determined in order to reflect a bank's true risk profile.

Secondly, because present rules have become intrusive in banks' capital allocation procedures, banks tend to keep more risky credit on their books, while the high quality borrowers find it cheaper to raise funds via the capital market. This results in a shift in the composition of assets from low risk to high risk.

Thirdly, minimum capital rules are not a sufficient tool to meet the challenges that can arise from disturbances in banking systems. There have been serious problems in the banking sectors of a number of countries, although minimum capital requirements were in place. A lack of efficient supervision and an absence of market discipline have led to an accumulation of risk in the global financial system.

Following an in-depth study, the Basel Committee on Banking Supervision put forward a proposal for a New Capital Adequacy Framework. This proposal, which addresses a number of the aforementioned problems, is based on three pillars as follows:

- minimum capital requirements;
- a supervisory review process;
- rules on transparency in order to improve market discipline.

THE SUPERVISORY REVIEW PROCESS

One of the main points in the proposal is the shift in the focus of supervision. This will change from merely defining minimum rules for solvency to increasingly focusing on how the banks define their optimal capital position and take action if capital standards

are deteriorating. This means that supervisors must ensure that banks manage and control their risk exposure so that it is in line with prudent standards.

The new Accord must contain solutions that are workable both for the most advanced and complex globally active banking groups and for the large number of smaller and less sophisticated institutions. The introduction of the supervisory review process is one way to achieve this. This process can also accommodate further structural and technical development.

For many supervisors this will be an important challenge since the supervisory review process will demand more resources and more expertise in the supervisory agencies. At the same time, it must be extremely clear that supervisors should not take over any responsibility from banks' own management in deciding upon the right level of capital. How this balance is preserved and how supervisors should intervene when capital standards are deteriorating, but are still above the minimum 8%, is one of the questions that needs further examination during the consultative period.

DIFFERENTIATING CREDIT RISK CHARGES

A capital charge for credit risk should reflect the actual risk. This is not as easy as it sounds as measurement of risk is a difficult question, while knowledge of risk is still expanding. Assessment of risk also poses a difficulty, as this assessment is done by different parties; the banks themselves, rating agencies and the market place where tradable financial products are priced. Therefore, different means could be used to achieve a better risk measurement, for example, external rating, internal rating and credit risk models. The development in the area of risk measurement is credit risk modelling. The Basel Committee clearly needed to take a stance on this before contemplating other means of improving the credit risk charges.

The Models Task Force, a task force under the Basel Committee, issued a report in April 1999 analysing current practices and issues in credit risk modelling. In the report the task force identified a number of potential benefits of credit risk models, mainly regarding the institution's internal management and control of credit risk. However, the Committee drew the conclusion that a number of hurdles must be cleared before credit risk models can play a role in setting regulatory capital requirements for credit risk. Two such hurdles concern model validation and data limitation.

Based on this conclusion, the Committee settled for proposing two main alternatives for setting capital requirements: the first being a standardised approach based on a simple improved framework, the second being a scale of risk weights based on banks' internal

ratings. In order to improve the risk weights in the standardised approach, the obvious choice was to introduce external rating agency valuations. Far from being perfect, they correlate to risk and are already being used in banks' internal capital allocation processes.

Internal rating systems need further work before they can be incorporated into the proposal. However, the Committee is of the view that, after further analysis, this will be possible. One of the important problems that still needs to be resolved is how to tie the internal judgements to a common external scale. How can one be sure that Bank A and Bank B make the same assessment of the same quality lending, or at least not differ so much that the level playing field disappears. It is hard enough to assess the different systems used by banks within one country, naturally it will be even more difficult to assess the different systems used by banks in different countries.

Another difficulty arises with internal rating systems whereby the bank's capital requirement is directly tied to the way it evaluates its customers. This may be a risk in that the system is compromised by giving an incentive to indulge in 'wishful thinking' rather than good risk management. To feel confident, supervisors would not only have to review the adequacy of the methods used by the bank in its credit risk assessments, but also to keep under constant watch the risk of "drift" in the system over time.

The question arises as to the difference between credit risk modelling and an internal ratings system. One answer is that an internal rating system does not take risk correlations between different types of assets into account. However, investigations of banks' internal rating systems show that they have developed and are sometimes close to credit risk models.

ADDRESSING OTHER RISKS

Clearly credit risks and market risks are not the only risks facing banks. In the old Accord the risk weights were calibrated so that, overall, they should also cover other risks, although an explicit capital charge for other risks was not introduced. Investigations by the Basel Committee show that credit risk or counterparty risk is the most important risk for banks. However, second to credit risk comes "other risks", while market risks are ranked only third in comparison. At the same time, financial innovation and the distortive effects of crude risk weights means that it is important to calibrate risk weights in line with default probabilities for borrowers.

The solution to this equation is to introduce a new capital charge to cover other risks. This would cover not only operational risk, but also banks' extreme interest risks in their

banking books. The message is clear. Although there might be reasons to reduce risk weights for high quality borrowers, this does not necessarily mean the reduction of capital standards. There are other risks that must be appropriately addressed, one of these being how to measure operational risk.

Many proxies have been suggested, such as an adjusted balance sheet total or total managed assets, total revenues or fee-based income. The trouble is, of course, that while there is some association between operational risk and each of these variables, selecting only one may have unwanted incentive effects on firms. Many feel that banks which work hard on controlling and reducing their operational risks should be able to get some reward in the form of a lower capital charge than their more indifferent competitors. It may well be that the only way to achieve such a differentiation is for the supervisor to apply some qualitative judgement to decide which banks merit a lower risk charge on this basis.

CREATING INCENTIVES FOR PRUDENT RISK MANAGEMENT

Financial innovation has been rapid during recent years. Complex structures are being created where the capital requirements are difficult to apply. Sometimes the application gives a result that is not in line with a bank's true risk profile and therefore distortions are created. The important question that regulators therefore must address is how to better create incentives for hedging that actually reduces risks in the market. However, current rules have penalised such behaviour on occasions.

On a technical level there are many questions raised on how to properly incorporate risk transfer methods such as credit derivatives. The revision of the capital adequacy rules will have to provide the answers here, preferably by laying down some general principles rather than merely providing a long list of instrument-specific rules.

If credit risk is effectively being reduced by the use of collateral or transferred to another party by the use of derivative instruments, the rules should normally take this into account. Another important question is how to treat legally binding netting contracts. On-balance sheet netting is a means for reduction of risk. Proposals had been previously put forward regarding this issue, but what now needs to be contemplated is how such techniques should be put into a broader perspective of other risk mitigation techniques. This is an area where the Committee should have done more and where input from the industry will be extremely important.

II THE BASEL PROCESS

The Basel work process was initiated last year with the aim of presenting a document for consultation in early April 1999. For various reasons, the release was postponed until 3rd June 1999. The Committee will seek comments from the industry up to the end of March 2000. However, the Committee and the respective working groups and task forces will not be idle during the consultation period. The Task Force responsible for designing the proposal will now recommence work, with a two-fold assignment. First it will co-ordinate the project to ensure that work in the different working groups will follow the mandates established by the Committee. Secondly, it will report to the Committee on the overall state of work and seek guidance as necessary.

All of the working groups will be requested to design more detailed proposals during the course of the consultation period. In order to receive constructive input, the groups will have meetings with representatives from the industry. The Committee has also declared that it will release further documents on specific issues during this period. The Committee expect national regulators to achieve implementation into national law in the course of 2002.

It is clear that the Committee will have to conduct an open dialogue with the industry, even during the consultation period, in order to communicate issues where the Committee's thinking has developed and in order to focus the industry on issues where comments are of special value. This open dialogue must not be confined to industry representatives. Equally important is the dialogue with regulators all around the world. If a new Capital Accord should be successful it is imperative that regulators outside the G-10 countries are also actively involved.

III QUESTIONS TO BE ADDRESSED FROM AN EU PERSPECTIVE

For the EU countries the revision of the Solvency and CAD Directives is a major challenge over the coming years. The reasons for this are straightforward and similar to the reasons why the Basel Accord needs a review. One could add to that the fact that European banks today compete in the global market place and that regulation in Europe needs to be compatible with other international markets. Some of the questions of special importance from an EU perspective are as follows.

In Europe the solvency requirements are equally applied to all credit institutions and investment firms. At the same time, the Basel Accord relates to internationally active banks. In the New Framework for Capital Adequacy, Basel still focuses on internationally active banks even though the view is that the new proposal should also be fit to be applied to all banks.

The question of how the EU should view the new proposal is thus raised. Many reasons still speak for a uniform application. However, when regulation becomes more accurate in order to better reflect banks' risk profiles, caution is needed to avoid creating too heavy a regulatory burden.

A new and important area in the Basel proposal is the supervisory review process. Here, supervisors need to develop their methods and legal support to take action against deterioration in bank capital. This will not only call for new resources in Europe but will also call for a suitable legal framework. Clearly this is an issue where different legal traditions might present a hurdle.

The supervisory review process could be based on a system resembling the American Prompt Corrective Action. This means that legal provisions define certain target rates for capital adequacy above the minimum level, where supervisors are obliged to take certain pre-defined measures. Such a system is worth studying and this might be a suitable form for the supervisory review process.

A particularly important question to address when revising the Directives is how an optimal regulation should look. When finance grows more complex, regulation runs the risk of becoming too complex. Since there is little chance that the speed of development will slow down, it must now be identified in what detail regulation should be specified. It is important also to assess how rules and regulations can be adapted practically to changing conditions, while political systems are fulfilling their role in relation to citizens.

The EU Commission stated the following with regard to the review of the Solvency Directives.

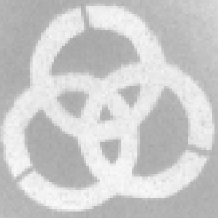
"Core elements of existing EU bank capital requirements are now being re-examined to bring them up to date with supervisory practices and banking trends. This process takes place in parallel with similar discussions in the Basel Committee on Banking Supervision in which the regulators of our main banking competitors participate. The EU should take a leading role in tackling issues to maintain a level playing field … The Union must also take steps to adapt its legislation as swiftly as the regulators of US, Canadian and Japanese banks".[1]

The Commission's Action Plan was endorsed at the Vienna Summit. In its preparations the Commission had at its disposal the Banking Advisory Committee (BAC). According to the Banking Directives, changes therein should be discussed by this Committee

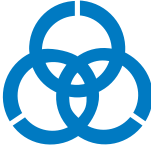
[1] EU Commission's Action Plan, final document

before the Commission puts forward its proposals to the Parliament.
For more than a year the BAC has studied the issues related to capital regulation. It has been clear that a reform is necessary and that European countries must take an active part and work in parallel with Basel. To this end, it has set up a special working structure by forming a Technical Sub-Group (TSG), the results of which will be discussed by the BAC at its September 1999 meeting.

In a comment on the Basel proposal for a New Framework for Capital Adequacy, the EU Commissioner, Mario Monti, welcomed the launch of a review of the Basel Capital Accord. According to the timetable set out by the BAC, a document will be ready for consultation with the European banking industry in the Autumn. This will focus on important questions from a European perspective and the consultation period for it will last until year-end. In this way the European aspects will be fully addressed when the finalisation of a new Basel Accord takes place. It is up to everyone in Europe to take that opportunity.



EMU AND NORTHERN IRELAND: STRATEGIC IMPLICATIONS



Professor John Bradley, Economic and Social Research Institute and Dr Frank Barry, University College Dublin.

The strength of sterling relative to the euro has placed the Northern Ireland economy at a competitive disadvantage. This paper explores how the North is likely to fare if the UK remains outside EMU and suggests that the Northern economy suffers from structural competitiveness problems that have not been adequately addressed in the recent *Strategy 2010* policy review. In particular, the North's industrial and labour market structure makes it less able to absorb sterling-related competitiveness shocks. Manufacturing is concentrated in low profit sectors and small firms which are least able to adjust to a strong sterling. The generosity of Northern industrial grants and subsidies has inhibited evolutionary change.

The border risks becoming an EU policy "fault line", making it more difficult to deepen North–South linkages and continuing to distort the vulnerable and underdeveloped economies of the immediate cross-border region. A wider policy dilemma for the North is that it needs a more effective degree of regional policy innovation to bring about faster and more sustainable private sector growth. The continued absence of the UK from EMU is likely to make this challenge even more daunting.

INTRODUCTION

Very little attention has been devoted to the implications of EMU for the regions of nation states. Regions have tended to be written out of the story of EMU as if the implications were of no specific importance to them. But even if decisions on EMU are taken with national criteria in mind, the consequences for the regions are unlikely to be uniform. This article explores these issues, with particular attention to the problems posed for Northern policy makers and businesses by the present strong sterling-euro exchange rate and the uncertainty as to its future movements.

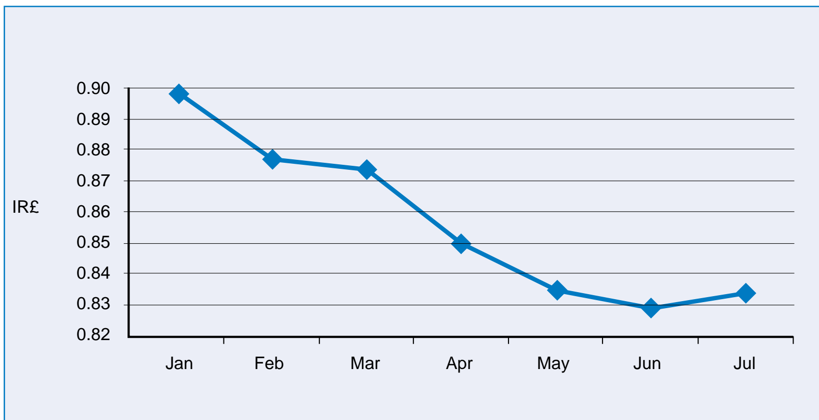
EXCHANGE RATE MOVEMENTS

At the time of writing (July, 1999) sterling is at an all-time high against the euro. Translated into the perspective of the Irish pound, the decline in the sterling-IR£ rate is

charted in Figure 1. The most striking aspect of the graph is that the out-turn was never expected to be like this. The main fear of policy makers, the business community and consumers in the Republic of Ireland was that sterling would decline rapidly against the new euro, and - with the Irish pound inside the monetary union and sterling outside - this would cause a serious loss of competitiveness relative to its most important trading partner. This was the key problem discussed prior to the start-up of EMU and was the major reason why the option on membership needed to be evaluated with prudence and care.

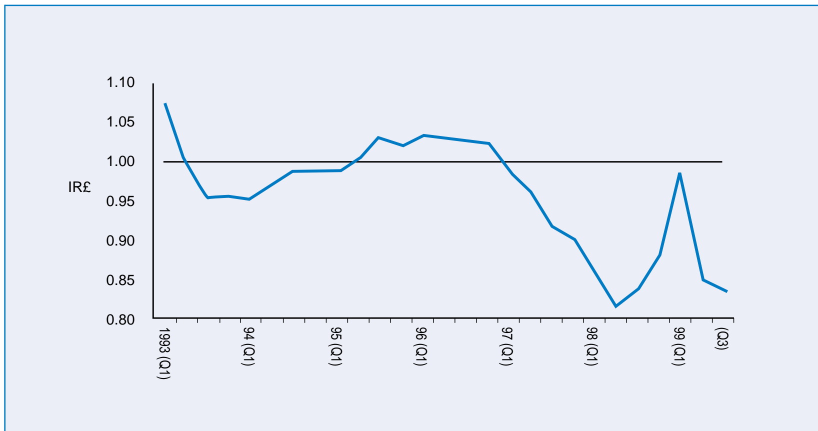
Translated into the perspective of Northern Ireland, the recent trend in sterling relative to the euro IR£ has created a serious decline in competitiveness relative to its main trading partner, which happens to be the Republic of Ireland. In the year 1998 – the most recent for which data are available – the Republic of Ireland was the destination of just over 25% of exports (i.e. sales outside the UK) from Northern Ireland, comprising about 9% of total sales of Northern manufactured goods.

FIGURE 1: STERLING–IR£ EXCHANGE RATE: JANUARY-JULY, 1999



Over the longer term the movements in the IR£-sterling rate have been more variable. For example, between January 1995 and June 1996, sterling was weak and the Irish pound moved for a while above parity (see Figure 2 below). Since mid-1996 sterling strengthened, reaching a high in early 1998. However, in the immediate run-up to the start of EMU, when doubt as to the UK Government's intentions disturbed the markets, sterling weakened. But once events were clarified nearer the start-up of EMU in January 1999, sterling strengthened again and by the end of June was back near its overall high for the second half of the decade.

FIGURE 2: STERLING-IR£ EXCHANGE RATE: 1995-1999



These recent exchange rate movements have taken place in a context where sterling is now considered very unlikely to join EMU for the foreseeable future. National economic and political considerations have influenced the UK decision. However, this article addresses the consequences for Northern Ireland in the context of the competitive structure and performance of the Northern economy as a region of the UK. It attempts to answer a series of important questions:

a) How is Northern Ireland likely to fare relative to other regions of the United Kingdom if the UK continues to remain outside EMU for the next few years?

b) What options are available to policy makers in the UK as well as in Northern Ireland to minimise costs and/or maximise benefits arising from the UK decision?

c) How will the UK decision on EMU influence the new developments in North-South economic and business interactions?

EMU and the wider UK context

In the autumn of 1996 the UK Treasury published an assessment of five criteria that would have to be fulfilled before joining EMU. First, the UK business cycle and economic structure would have to be compatible with that of the main economies of the rest of the EU. Secondly, the UK economy would have to be sufficiently flexible to adjust to shocks. In particular, there would have to be a high degree of flexibility in the labour market. Thirdly, EMU would have to be shown to improve long-run decision

making by firms through stabilising their strategic planning environment. Fourthly, given the importance of the City of London as a global financial services centre, any threat posed by being in or out of EMU would need to be investigated. If staying out were to be shown to have negative effects on the City, then the case for membership would be strengthened. Finally, membership of EMU would have to be shown to promote jobs and growth.

The balance of judgement in the Treasury came down against joining EMU at the outset and this assessment still holds. Although posed in economic terms, it is clear that political as well as strictly economic issues were taken into account in the final judgement. Having taken this decision, it is of interest to reflect on the impacts of a strong sterling on the overall UK economy, since it is into this economy that Northern Ireland sells over two-thirds of its manufacturing output, half locally and half to Britain.

In political terms, the weak performance of the euro has (in the words of the *Economist*, June 12th) "cheered eurosceptics, who have depicted the single currency as a sinking ship that the British would be mad to board". However, the negative effects on UK trade of a strong sterling have been clear and unambiguous. All the main trade categories of manufactured exports fell heavily in value and volume terms during the year between the first quarter of 1998 and 1999. The collapse for a range of more traditional products (iron and steel, non-ferrous metals, textiles, plastics, clothing and footwear) ranged from 10% to 25% in volume. Even though exporters have cut their margins in an effort to maintain market share, volumes have fallen as well as revenues. Unfortunately for Northern Ireland, the negative consequences are even more severe, since its manufacturing sector is even more concentrated in these traditional products.

KEY QUESTIONS TO BE ADDRESSED

The research that forms the basis for this article considered three interrelated questions associated with EMU when a country is considering membership.[1] These relate to the following areas:

- the standard costs and benefits of EMU;
- the implications of EMU for component regions of a state;
- the implications for policy makers in Northern Ireland.

[1] An invitation was extended in late 1996 by the Northern Ireland Economic Council to undertake a study of the implications of EMU for Northern Ireland. (*Regional Economic and Policy Impacts of EMU: the Case of Northern Ireland,* edited by Prof. John Bradley, Research Monograph 6, Northern Ireland Economic Council, April 1998). This was an interesting assignment since it forced us to reflect on how little attention had been devoted to the implications of EMU for the regions of a nation state. Somehow regions had been written out of the story of EMU as if the implications were of no specific importance to them.

The first concerns the standard costs and benefits of EMU as these would apply to the UK as a whole if it eventually joins, in addition to having some region-specific aspects of importance to Northern Ireland. The issues here are reasonably well understood. Potential benefits of any currency union consist of reduced transactions costs, lower interest rates, increased price transparency and, if the European Central Bank does its job properly, lower inflation. Potential costs consist of transitional expenses (cash registers, ATMs, accounting arrangements, price displays, etc.); the fact that more of the costs of adjustment to adverse shocks will have to be borne by the labour market in the absence of a national exchange rate; and the prospect of asymmetric shocks hitting peripheral regions whose interests will not be paramount in the minds of those determining the common monetary policy.

The second question focuses on implication of EMU for the component regions of a state like the UK. Very little previous attention had been given to the implications of EMU for the regions of nation states. Even if decisions on EMU membership are normally taken with "national" criteria in mind, are the consequences for the regions likely to be uniform?

Research shows that regional economies within nation states can be, and often are, very heterogeneous in a variety of different ways as follows.

a) Small regions tend to become specialised into a narrow range of productive activities: the financial sector in London; engineering in the English midlands; textiles in Northern Ireland; whisky in Scotland. This creates the possibility of "asymmetric" shocks, i.e., shocks that effect some regions more than others simply because of their specialised structure.

b) Regions can have very different trading relations with other regions and with the rest of the world. For example, Northern Ireland is more heavily oriented towards trading with the Republic of Ireland than is any other UK region. Hence, anything that affects this relationship must be analysed carefully.

c) Regional labour markets differ in their degree of "flexibility", in the mobility and skills of the local labour force and in their historical experience of unemployment. In some regions, in particular small ones, wage rates are essentially set by national trends and have little to do with local conditions of unemployment. Regions that have suffered high and enduring levels of unemployment tend to be characterised by a high share of long-term unemployed in the total rather than a rapid turnover of short-term unemployment.

d) Finally, national fiscal and monetary policies impact differently on regions. The more prosperous regions of the south of England contribute to the re-distribution of income to the less prosperous regions of the north and west of the UK, for example, while high national interest rates affect traditional industrial sectors with low rates of profit more seriously than they do high-profit modern sectors.

The third question concerns the implications of EMU for policy makers in Northern Ireland. Since regional issues may be significant, and since there are likely to be regional winners and losers in EMU (whether or not the UK eventually joins), what are the important issues for regional policy makers? A range of issues arise here.

- The advent of the Single European Market has already greatly restricted national policy autonomy. EMU continues and reinforces this trend and even UK policy autonomy is affected.

- The deepening of the EU brought about by the Single Market and EMU has led to the emergence of “natural economic zones”, which can be regions within a single nation state as well as areas of intensive cross-border interaction and co-operation between regions in different nation states. These interactions have a logic of their own and place constraints on national policy makers. North-South business links are a case in point.

- In a world characterised by increased international economic integration, purely region-specific policies (in the industrial, educational and social spheres) become very important when national fiscal, monetary, labour market and competition policies are increasingly harmonised on a pan-EU basis. Such regional policies tend to operate on the supply-side of the regional economy, and with recent moves towards more regional devolution within the UK, the optimum degree of regional policy autonomy has become a live issue of debate in Scotland, Wales and Northern Ireland.

- Finally, since regions will always have a lesser degree of formal policy autonomy than the nation as a whole, there is greater need for innovative regional mixtures of public and private sector initiatives and collaboration that remain compatible with being an integral part of a nation state.

IMPLICATIONS OF EMU FOR NORTHERN IRELAND

Since Northern Ireland has had to deal with a strong sterling for many years, what are the features of the economy that influence its ability to absorb the consequences of a

strong currency? One can summarise the position of the NI regional economy among the standard grouping of the eleven UK regions as follows.

a) Northern Ireland is the smallest regional economy in economic terms. Usually this would mean that its trading sectors are more exposed to the external world than those of larger more self-sufficient regions. In part this is indeed the case, but there is a complication (concerning the large size of the public sector) that partially offsets this.

b) Resource utilisation has been lower in Northern Ireland than in most other UK regions. Northern unemployment rates have been among the highest in the regions, although against falling UK and regional average rates of unemployment in recent years. Capacity utilisation is more difficult to measure, but surveys indicate over capacity in some sectors.

c) The Northern sectoral structure is very "unfavourable", with a large agriculture sector, rather too much traditional manufacturing (food processing, textiles, clothing), a very large public services sector but relatively under-developed marketed services (particularly in tourism and financial services).

d) On most of the competitiveness criteria published regularly by the UK Department of Trade and Industry, Northern Ireland scores rather poorly in relative regional terms.

e) Northern Ireland is geographically and economically peripheral within the UK, although this is not necessarily a permanent disadvantage. However, civil unrest and political uncertainty has undoubtedly exacerbated the costs of peripherality.

f) The regional public finances of Northern Ireland are very unbalanced and the resulting inflow of financial resources from the rest of the UK serves to sustain a public sector that is considerably larger (as a share of the economy) than in any other UK region. Using the latest data, almost 33% of total employment in the North is in the broad public sector, compared with 22% in the UK as a whole.

Research into how these features of the Northern Ireland economy are likely to influence its ability to handle the consequences of the UK remaining outside EMU was heavily influenced by the earlier work on the Republic of Ireland, carried out by the ESRI.[2] This study is quite relevant to other EU small economies and to the situation of

[2] *Economic implications for Ireland of EMU*, edited by T. Baker, J. Fitz Gerald and P. Honohan, Policy Research Paper no. 28, The Economic and Social Research Institute, 1996.

Wales, Scotland and (particularly) Northern Ireland. Small open economies like the Republic are very similar to small open regional economies like Wales, Scotland and Northern Ireland. Many of the complex EMU-related issues that arose for the Republic are also going to arise for small open regions in one form or another.

The main uncertainty surrounding the consequences of the decision of the Republic of Ireland to join EMU concerned the danger of a large and sustained devaluation of sterling and this was the subject of particularly careful analysis in the ESRI report. Take as an example a hypothetical devaluation of 20% in sterling: if the Republic of Ireland were in EMU but the UK (its largest single trading partner) were to remain out, the potential losses for the Republic were estimated to be over 1.5% of GNP and some 25,000 jobs. Even though there was a serious risk of a weak sterling outside EMU, the Republic's decision to enter EMU was driven by a long-standing view that a pro-EU policy stance has been good for the medium-term development of the economy, reinforced in this case by the realisation that there was not really any feasible alternative that offered an unambiguously better outcome. It is an irony that the immediate lead-in to EMU, as well as the first six months of its operation, has presented the opposite dilemma for Irish policy makers: how should they deal with a weak euro at a time when stimulation is the very last thing the economy needs!

The analysis of Northern Ireland turned out to be more complex than the case of the Republic. This is mainly because of the enduring very strong Northern Ireland trading links with Britain that co-exist with a relatively large non-traded sector (which sells only into the local market) and a modern export-oriented subsector of manufacturing (that sells strongly outside the UK). In such a complex situation as EMU presents for an economy like Northern Ireland, and given a very limited degree of regional policy autonomy, what strategic advice can one give to policy makers?

There appear to be two conditions that are required for a region to prosper whether or not the nation of which it is a small part is inside or outside EMU:

(i) a high degree of labour market flexibility, in the very widest and positive sense (i.e. high skill levels, mobility, as well as flexible wages);

(ii) a sufficiently large concentration of "high quality" firms in the exposed manufacturing sector and in downstream services.

The limited empirical research that is available suggests that wage rates in Northern Ireland (adjusted for skill levels and sectors) are determined mainly by national analogues. Local labour market conditions in the North appear to have little influence

on wage rates. Concerning labour market flexibility, policy considerations in regions need to focus on wage setting institutions and on improving the regional skills base and labour mobility. This analysis highlighted the fact that the North's continued specialisation in its traditional sectors makes it less able to ride out EMU-related shocks to competitiveness. The high level of industrial grants and subsidies made available to Northern firms has served to perpetuate traditional specialisations and inhibit evolutionary change.

Concerning industrial structure, regions that have many modern industries whose profitability is less sensitive to wage costs will be able to adjust more smoothly to competitiveness shocks. In the North, in Scotland (and, particularly, in the Republic of Ireland), such firms tend to be externally (or foreign) owned. Studies have shown that membership of the EU and access to the Single Market is a much more dominant factor influencing inward investment than relatively random exchange rate changes. However, for firms that are already in production, exchange rate fluctuations can be harmful if their profit margins are low. Damage can be done both by exchange rate levels and fluctuations. Prices often have to be set long before goods are produced or payments are made. Where there is over capacity in the sector, the costs can seldom be passed back to the customer.

EMU AND MANUFACTURING IN NORTHERN IRELAND

As a peripheral region of the UK, there are effectively two "domestic" markets for Northern Ireland to trade in: its own local market and the wider British market. Exchange rate fluctuations will not directly affect the North's intra-UK relationship. However, there are indirect factors to be considered which will impact differently on the local and the national economy. Thus, a high sterling rate against the euro makes UK-produced goods less competitive in the domestic UK market to the extent that there are euro-priced, competing goods in that market. Since many Northern-produced goods are sold as intermediate inputs to other British firms before being exported as final goods, Northern Ireland's crucial intra-UK trade is unlikely to be protected for long from sterling strength against the euro. This is a serious matter since about 80% of manufacturing employment is in domestically (or UK) oriented sectors.

With respect to the impact of EMU and foreign direct investment (FDI), research indicates that short-term exchange rate fluctuations do not appear to be a major determinant of FDI. Foreign firms tend not to have the characteristics that make them vulnerable to random fluctuations in particular exchange rates. Rather, their competitive advantage is built on the firmer grounds of high technology, product design, innovation, R&D, a skilled work force, etc.

In summary, on structural and profitability criteria Northern manufacturing appears relatively vulnerable to competitiveness shocks emanating from the UK's decision to remain outside EMU. Although protected from direct exposure to exchange rate fluctuations (to a considerably greater extent than the Republic of Ireland), there is danger of indirect exposure through dependence on the British market and its exposure to the international market place through exports and competing imports.

EMU AND NORTH-SOUTH TRADE

The peace process that emerged during the 1990s, culminating in the *Belfast Agreement* of 1998, has been associated with rapid growth and deepening of North-South business and economic ties. The mutually beneficial nature of these developments is widely acknowledged. However, is the continued non-participation of the UK in EMU likely to erect new barriers to increased North-South interactions in the economic and business sphere?

One small aspect of this issue can be illustrated by drawing attention to the fact that small firms in Northern Ireland (i.e. with a turnover of less than £500,000 in 1990 or employing less than 50 people) who sell outside the UK do so predominantly into the Republic of Ireland marketplace.[3] Given their structure and profitability characteristics, such firms are also most at risk to EMU-induced loss of competitiveness when sterling strengthens relative to the euro. Indeed, they are already suffering in this way.

More generally, with the UK out of EMU the North-South border will take on the role of a European policy "fault line". Just as with geological fault lines, policy fault lines are going to make it more difficult to encourage the deepening of North-South linkages and structures and will continue to distort the vulnerable and underdeveloped economies of the immediate cross-border region. Northern Ireland will tend to be buffeted in the backwash of the consequences of UK non-participation in EMU. In the Republic these negative consequences are likely to be offset by other positive benefits of EMU membership. So, the characterisation of EMU as driving a wedge between North and South is simply a small element of a greater truth: that EMU is likely to drive a wedge between the UK and the euro zone. EMU, with the UK outside, will undoubtedly complicate the process of building on existing North-South business and economic policy interactions.

[3] Accelerating Growth and Development: Border Effects in Ireland, North and South, by John Bradley and Douglas Hamilton, Economic and Research Institute, December 1998.

POLICY MAKING IN NORTHERN IRELAND: *STRATEGY 2010*

The most recent study on future economic strategy in Northern Ireland is *Strategy 2010*, published earlier this year by the Department of Economic Development.[4] It correctly identifies the rapid globalisation of economic activity as the primary factor setting the future context for the Northern Ireland economy. The opportunities offered by globalisation are obvious with international trade often growing at over twice the rate of local GDP. However, these benefits can only be realised if the local economy can obtain access to external markets through having a high degree of competitiveness, measured in the very widest sense.

The competitiveness performance of Northern Ireland has been the subject of research carried out by the Northern Ireland Economic Council. For example, a recent report written by John Dunning, a leading world expert on foreign direct investment and multinational enterprises, pointed out that, to the extent that Northern firms have any international competitive edge, it is based primarily on low wage costs and is not delivering improved living standards.[5] Dunning also commented that the concept of regional policy that permeates Northern thinking is focused more on the inter-regional distribution of UK central government funding rather than on the creative use of local policy autonomy as a means of promoting self-sustaining wealth enhancement based on interaction with the global economy.

When *Strategy 2010* turns to the international and competitive context for the Northern economy, it is seen to contain little new strategic thinking about the future relationship of the local economy with the external world. Given the likely continued medium-term dependence of the Northern economy on the British market, it is puzzling that *Strategy 2010* treats the nature of, and relationship with, that market in so cursory a fashion. The section of *Strategy 2010* that deals with the UK economy (a mere four pages) contains a crucial assertion that colours and constrains the thrust of the entire Northern policy analysis:

> "The main determinant of economic activity in Northern Ireland is the level of activity in the rest of the UK. An economic development strategy for Northern Ireland therefore needs to be set within, and be consistent with, the overall thrust of national economic policy."[6]

This, in a nut-shell, is Northern Ireland's policy dilemma. On the one hand, it can stick closely to UK economic policy and institutional norms and grow, sometimes above,

[4] Strategy 2010: Report by the Economic Development Strategy Review Steering Group, Department of Economic Development, Belfast, March 1999.
[5] Competitiveness and Industrial Policy in Northern Ireland, by J. Dunning, E. Bannerman and S. Lundan, Research Monograoh 3, Northern Ireland Economic Council, March 1998.
[6] *Strategy 2000*, p. 62

other times below, UK average performance, but with little prospect of rapid convergence to the UK average standard of living. On the other hand, it can seek out a politically acceptable degree of regional policy innovation that might offer prospects of sustainable faster growth in the Northern private sector. The absence of the UK from EMU is likely to make this policy dilemma even more daunting.

CONCLUSIONS

The UK has decided to opt out of membership from the start, a decision that appears to have been taken for a mixture of economic and political reasons. The impact of this decision on the Northern Ireland economy is very complex. However, the ability of that economy to adjust to EMU-related shocks is undoubtedly exacerbated by a range of serious structural competitiveness problems. A low and stable sterling-euro exchange rate would provide a temporary alleviation of competitiveness problems but permanent cures to the underlying issues would need to be sought elsewhere. In any event, the sterling-euro rate is not likely to be influenced to any significant degree by Northern Ireland's region-specific problems.

As for the Republic of Ireland, it would have been better if the UK had also joined EMU and this would have yielded the largest sustainable benefits. However, even without the UK, there are likely to be benefits for the Republic if the economic environment is relatively stable. The main fear for the latter is that sterling-euro fluctuations may come to be driven more by international currency speculation than by shifts in economic fundamentals. A dramatic fall in the value of sterling relative to the euro would cause problems for a narrow range of relatively traditional sectors that are oriented towards serving the UK market and the Northern Ireland subset of that market. But in the wider economy of the Republic, the major gains in structural competitiveness of recent years means that membership of EMU, and the disciplines it requires, are less likely to raise serious difficulties.

SOCIAL HOUSING IN IRELAND: THE NEED FOR AN EXPANDED ROLE?

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Surging demand for housing is likely to persist for a further decade and pressures on the affordability of housing are likely to remain. At the same time, provision of social housing has fallen to historically low levels since the late 1980s and, until recently, there was no talk of expanding it to keep pace with projected housing need. This paper draws attention to the nature and value of the tradition of social housing in Ireland. It begins by outlining the historic role of social housing and its contraction in the last decade. It suggests that exaggerated portrayals of social problems in local authority estates have contributed to contraction in the sector by undermining public confidence in social housing and points to the often neglected positive side of local authority housing. The paper concludes by proposing a major expansion of social housing – either in the form of traditional local authority provision or some functional equivalent – if present and future levels of housing need are to be met.

INTRODUCTION

Recent forecasts have suggested that the Irish housing stock, following rapid growth since the mid-1990s, will need to grow by a further 35–40% over the next decade if the demand for housing is to be met.[1] Recent, as yet unpublished, forecasts are likely to revise upwards existing estimates of future housing needs. The scale of the challenge is staggering. The new housing which will be required amounts to something approaching 500,000 dwellings, which is more than the entire present housing stock of Munster and Connaught combined, or of the entire Dublin area (including the Dublin overspill in Wicklow, Kildare and Meath). It presents an unprecedented planning and building task for Ireland and an opportunity to shape the urban landscape that is unlikely to be repeated for decades to come.

Of the many policy and planning issues which have yet to be addressed in responding to this challenge, one relates to the distributional aspects of housing. How is it possible to ensure that access to new housing will be widely available to the less well-off,

[1] Fitz Gerald *et al*, 1999, pp. 77-80

particularly in the context of rapidly rising housing costs? Until the recent publication of the Planning Bill (1999), responses to that question have been narrow. They have focused mainly on the house purchase option and on the task of keeping the house purchase threshold within the reach of as many people as possible.[2] Little has been said about social housing, the traditional means of providing family accommodation for those below the house purchase threshold, or of the possible role of subsidised private renting, a relatively new form of housing provision for the less well-off. Thus, the question of how access to housing is to be distributed down the income scale in the present housing boom has been largely neglected and needs to be addressed. By proposing that 20% of land developed for housing in the future should be set aside for 'social and affordable' housing, the Planning Bill (1999) has indicated a new awareness of this problem on the Government's part, though it remains to be seen what will emerge in practice from this proposal.

SOCIAL HOUSING – THE BACKGROUND

Social housing consists of rental accommodation constructed with State subsidy where allocation of accommodation is somehow linked to social need and where the landlord usually has a non-profit status or is a state agency.[3] Local authorities have been the major providers of social housing in Ireland since they came into existence a hundred years ago. Voluntary housing agencies, the major providers of social housing in many European countries, arrived on the scene in Ireland in a significant way only in the 1990s.

The impact of the local authorities in that role has been significant. To date, they have built some 330,000 dwellings, which amounts to about 30% of the present housing stock in Ireland. In the first half of the present century, that provision was designed to combat housing scarcity, squalid living conditions and overcrowding in slum housing, both urban and rural. It succeeded in that goal, and went on in the second half of the century to provide access to basic housing for new families in the bottom 20% to 30% of the income range. Over the whole period, local authority housing amounted to a central and largely successful pillar of Irish social policy, so much so that it is hard to imagine what the social and physical landscape of Irish society would have looked like in its absence.

Local authority housing has also played a major but little recognised role in promoting home ownership. Successive schemes of tenant purchase, the first of which was introduced in 1936, have meant that of the 330,000 dwellings constructed by the local authorities, some 230,000 have been sold to tenants (Table 1). These privatised local authority dwellings now account for about one in four of the owner-occupied homes in

[2] Bacon and Associates, 1998, 1999
[3] See Harloe 1995, p. 13, for a fuller attempt at defining social housing

Ireland and are a major reason why the overall level of owner occupation in this country – at 80% of total housing – is so high by European standards. They also mean that local authority housing in Ireland over most of its history could justifiably be considered a deferred ownership tenure (where the householder rents now and buys later) as much as a rental tenure in the conventional sense.

TABLE 1: LOCAL AUTHORITY HOUSE-BUILDING AND SALES, 1898-1998

	Dwellings built (incl. flats)	Dwellings sold to tenants	Still in local authority ownership at end of period
Pre-1964	178,300	74,400	103,900
1964-1998	151,700	156,600	99,000
Totals	330,000	231,000	99,000

Sources: Minister for Local Government (1964), *Annual Housing Statistics Bulletins*

THE SHIFT TOWARDS PRIVATE HOUSING

Despite the long and successful record of local authority housing, recent years have witnessed a shift away from public provision towards private housing in meeting housing need (Fig. 1). This shift is in part an in-built consequence of the aforementioned system of tenant purchase of local authority housing, since tenant purchase is a direct form of privatisation of public housing.

However, in addition, the share of new house construction accounted for by social housing was sharply cut back in the late 1980s and has not been restored to traditional levels since then. Since 1987, social housing construction has consistently fallen below 10% of total new housing construction, in contrast with levels in the range 20-30% which were the long-term norm in the decades prior to the late 1980s. Increased funding for social housing in the public capital programme in 1999 will lead to some increase in output, but (at around 4,000 units) it will still amount to only half the housing output of the local authorities 25 years ago in absolute terms and less than a third in relative terms.

Because of the combined effect of privatisation through tenant purchase and reduced share in new construction, the absolute size of the social housing sector has remained static at around 100,000 units since the early 1960s. Growth in the owner-occupied sector means that its relative size has declined to less than 9% of the total housing stock, compared to almost 20% in the 1960s (Fig. 2).

FIG. 1 (A). NEW HOUSE CONSTRUCTION BY SECTOR – NUMBERS

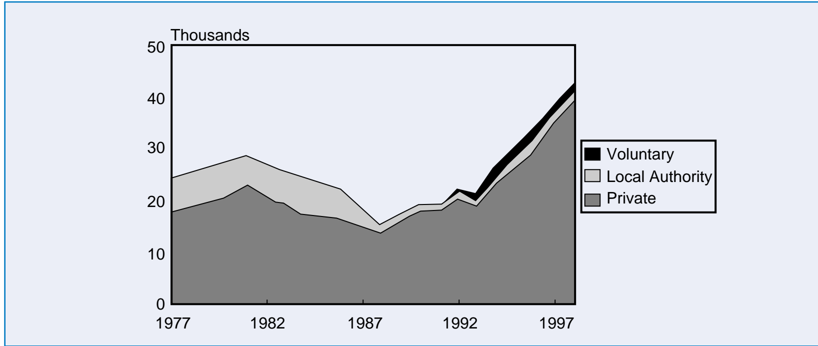
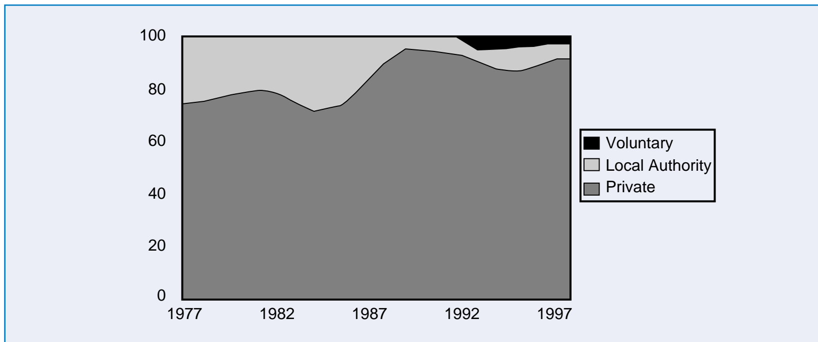


FIG. 1 (B). NEW HOUSE CONSTRUCTION BY SECTOR – %

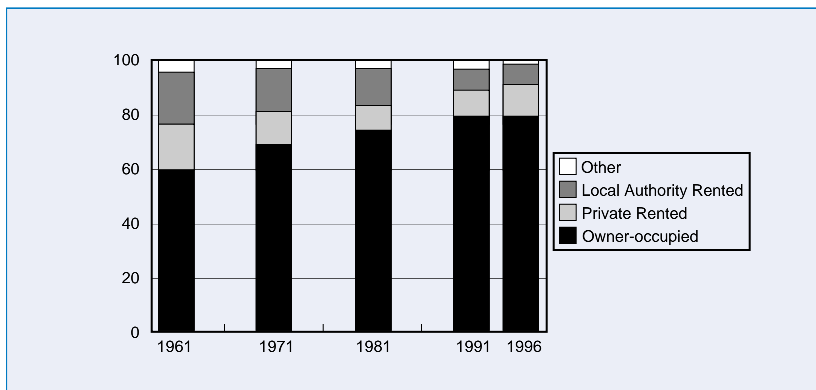


Source: *Annual Housing Statistics Bulletins*

PRIVATE RENTED SECTOR AS SUBSIDISED LOW-INCOME HOUSING

The growth of owner-occupation has affected the private rented sector as much as social housing. By 1991, the share of the housing stock accounted for by private rented dwellings had fallen to 8% from over 17% in 1961. Incentive schemes for inner city housing renewal and apartment buildings had led the sector to stage a modest recovery by the mid-1990s, by which time it had risen to approximately 11% of the housing stock (Fig 2).

FIG. 2. HOUSING STOCK BY TENURE TYPE, 1961-1996



Source: *Censuses of Ireland 1961–91; CSO Labour Force Survey Microdata*

However, more dramatic than any shifts in the size of the private rented stock has been its emergence as a new form of subsidised, low-income housing. This has arisen through rapid expansion of the system of rent supplements which are paid to social welfare dependent households under the scheme of Supplementary Welfare Allowances (SWA). Under this system, the bulk of the rental costs for private rented dwellings may be paid to qualifying tenants (subject to a minimum contribution from the tenant of £6 per week). Generally, only those whose main income source is social welfare can qualify and the scheme is therefore unavailable to most of those in employment.[4] Households in the private rented sector in receipt of rent supplements under the SWA scheme now number about 42,000 in any given month, or close to 40% of the total private rented stock.[5] This number is also the equivalent of over 40% of the households in social housing proper, thus indicating the significance of rent subsidisation for tenants in the private rented sector in overall housing provision for low-income households.

This form of housing support was of small dimensions ten years ago – public expenditure on rent supplementation in the private rented sector amounted to only £6.1 million in 1989, compared to £115 million in 1999. Though a major development in housing provision, it has emerged in a largely unplanned way under the umbrella of social welfare policy rather than of housing policy – the scheme is the responsibility of the Department of Social and Community Affairs rather than of the Department of the Environment and Local Government. To date little consideration has been given to its

[4] NESC, 1988; Fahey and Watson, 1995
[5] Bacon and Associates, 1999

possible role in meeting future housing need.[6] There are limits to its likely role: first, in that the scheme is largely confined to those who depend on social welfare income and so is of little or no relevance to other low or modest income households; and secondly, because structural flaws in the regulatory framework for private rented accommodation – especially insecurity of tenure and the unpredictability of rent increases – mean that its potential for providing long-term family accommodation is reduced.

POLICY SIGNIFICANCE OF RECENT DEVELOPMENTS

Given the prior history of extensive support for social housing, the contraction in new social housing provision in the last decade represents a major change of direction in Irish housing policy. The extent of the change has been accentuated in the present housing shortage. During previous such shortages in Ireland, the local authorities were automatically looked to as major sources of additional supply. Political parties habitually outdid each other at election time in their promises to expand local authority house building. At the peak of the last house-building boom in the mid-1970s, for example, local authority housing accounted for almost one-third of new housing construction. More generally, the implicit rule of thumb underlying social housing provision was that between a quarter and a third of new family households would be unable to buy their own homes directly and would require subsidised rental accommodation in the form of local authority housing.

Today, local authorities have been eclipsed to an unprecedented degree by the private sector in the provision of new housing. Housing provision by voluntary housing associations has added a new dimension to social housing in the 1990s, but on a scale that is still relatively small. Subsidised rental accommodation in the private rented sector has gone some way to filling the vacuum caused by the low level of output in social housing proper but, as already mentioned, there are limits to its role.

The consequence is that mechanisms for distributing housing resources down the income scale have contracted to an exceptional degree. At the same time, surging demand has pushed housing costs upwards and has increased the numbers of those facing affordability problems in housing. Thus, distributive mechanisms are at their weakest for decades, though the need for them is now acute. The problem is particularly severe for that intermediate group which is unable to access house purchase, but yet is insufficiently impoverished to benefit from the provision of social housing and rent-subsidised, private, rental accommodation targeted at those at the very bottom of the income scale. The provisions on development land for social and affordable housing in the recent Planning Bill (1999) provide an indication that the

[6] Fahey and Watson, 1995

Government intends to enlarge and strengthen distributive mechanisms again. Whether these provisions succeed in this goal remains to be seen. But it is important to note that a strong distributive intent has emerged in housing policy again, following its fading from view over the last ten years.

LOSS OF CONFIDENCE IN SOCIAL HOUSING

While the downscaling of social housing amounted to an historic shift in Irish housing policy, it seemed to have come about by drift rather than by conscious decision. If social housing is to expand again in the future it is important to be aware how the recent drift away from it arose. There has been no strong ideological movement against social housing in Ireland of the kind associated with the Thatcher Governments in Britain in the 1980s. Cutbacks in social housing were introduced in the late 1980s as part of fiscal retrenchment, but this does not explain why a low level of provision should persist in the very different fiscal environment of today. The *Plan for Social Housing* (1991), the major policy document of the last ten years, gave no indication that a long-term reduction in the role of social housing was intended.

Of the many possible factors which can be pointed to as causes for the retrenchment in social housing, one possibility is a creeping loss of confidence in the *effectiveness* of local authority housing, especially urban local authority housing. To put it bluntly, local authority housing in many Irish towns and cities had acquired a bad reputation by the late 1980s. This reputation was derived less from careful, balanced reading of factual evidence than from vivid media imagery – imagery of dilapidated inner city flats complexes built in the 1930s and 1940s; of what is now widely seen as the great housing disaster represented by the high-rise flats built in Ballymun in the 1960s; and of the large bleak local authority estates built in the urban fringes up to the mid-1980s. The evils portrayed in this imagery were not those traditionally associated with slum housing in the past, such as rickety buildings, unsanitary housing conditions, overcrowding, exorbitant rents, capricious evictions and so on. Rather, images emerged of new evils in local authority housing. These largely came under the heading of social disorder or social breakdown – vandalism, crime, joy riding, drug addiction, a general sense of social dislocation and damage to the physical fabric of estates which arise from these things.

In the background lay the structural factors which are often thought to cause these problems – high levels of poverty, unemployment and other forms of social marginalisation, all of which were strongly linked to local authority estates.[7] It was the blighting of public space and community life caused by these new problems which most

[7] Fahey, 1999

people came to see as the main failing of local authority housing. And the apparent inability of local authorities to house people in ways which would avoid or mitigate this blight contributed further to the creeping loss of confidence in their capacity to deliver a good housing service to their clients.

This tarnishing of the reputation of local authority housing is a serious matter. It stigmatises those who currently live in such housing and that in itself can be a heavy burden to bear, over and above any burdens that arise from other circumstances in their lives. But it also affects the prospects of social housing more generally. Even those favourably disposed towards the general principles of social housing might begin to feel that the public sector now lacks the techniques to translate those principles into effective practice and that therefore the only hope is to rely even further on the private housing market. As the private market has a doubtful record in the provision of housing for the less well-off, to pin one's hope on it in that way is to offer little comfort to those at the lower end of the housing scale.

THE GOOD SIDE OF LOCAL AUTHORITY HOUSING

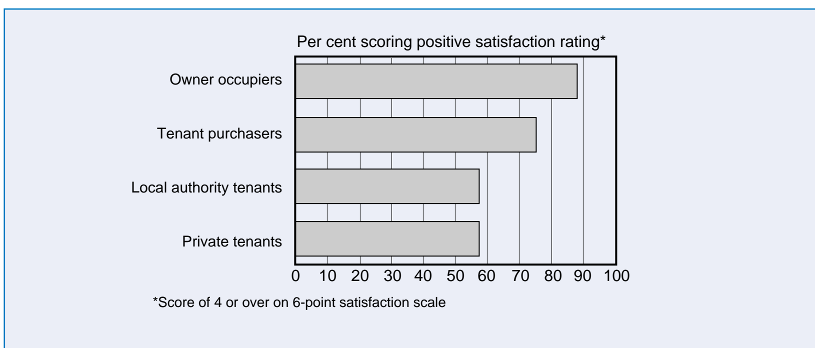
In that context, it is important to point out that the bad reputation acquired by local authority housing is grossly unfair and reflected a distorted, sensationalist view of reality. The fact is that most local authority housing has been and continues to be successful, even where many of its residents are unemployed, poor or otherwise disadvantaged. Most local authority housing has merged seamlessly into the national housing fabric, helped by the long-term effects of tenant purchase. Among those who continue in local authority rental tenure, attitude surveys show that the majority are satisfied with their housing, though the minority which is dissatisfied is large. Those who feel that such things as vandalism and crime are problems in their neighbourhood are fewer than the media imagery would lead one to expect (see Figures 3 and 4). The situation is somewhat different in local authority flats complexes, as flats generally have not been available for tenant purchase due to legal problems with devising suitable title. This has affected their popularity among tenants. But even so, there are whole tracts of flats in the urban social housing stock that are stable, attractive and in high demand among tenants (as, for example, in the Ringsend and Pearse Street areas of Dublin). A recent study of living conditions in local authority housing confirmed the generally positive characteristics of local authority housing provision.[7]

The overall success of local authority housing should cause little surprise given its considerable advantages. The build quality of housing is in general reasonably good, cottage-type or terrace housing in low-density estates is the most typical build form, and, apart from Ballymun in Dublin, Ireland has avoided the high-rise, system-built housing in

large peripheral estates which characterised social housing in some European countries. Furthermore, while local authority *tenure* is strongly associated with poverty and marginalisation, the long-standing tradition of tenant purchase means that the link with poverty is weaker at the level of local authority *estates.* The latter usually contain a tenure mix that steadily evolves over time in the direction of more and more owner-occupation and greater integration into the mainstream housing system.

FIG. 3. OVERALL SATISFACTION WITH HOUSING

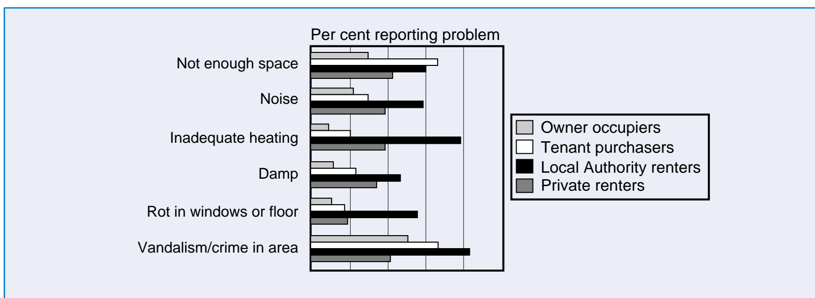
By tenure type in large urban centres



Source: ESRI Living in Ireland Survey, 1994

FIG. 4. HOUSING PROBLEMS

By tenure type in large urban centres



For those who remain in local authority tenure, rents are reasonably low (at less than 8% of tenant households' disposable income in urban areas, according to Household Budget Survey data). Security of tenure is high; local authorities have traditionally been slow to evict and tenancies were heritable in practice in that they were allowed to pass

onto co-residing children on the death of sitting tenants. Finally, resident populations in urban local authority estates are characterised by an exceptionally high degree of cultural homogeneity; they are comprised overwhelmingly of white native residents who have no religious differences, come from the same working class background, speak the same language and generally originate in the city in which they now live. Problems which loom large in social housing in most European countries, such as racial or ethnic marginalisation of local authority estates and conflict between cultural sub-groups in the local authority sector, are relatively minor or completely absent in Irish local authority housing.

FAILURE IN LOCAL AUTHORITY HOUSING

While the overall success of local authority housing is unquestionable, problem segments exist within the sector. No data are available on the extent of such problem housing, nor has there been any attempt to define an official 'difficult-to-let' or 'problem' designation by which troubled estates might be identified and quantified (similar to the 'difficult-to-let' classification utilised by the Department of the Environment in Britain in the mid-1970s). However, it is clear from everyday observation that at least some local authority estates are in difficulty, even though the problem sectors may be much less extensive than is often supposed. While extreme instances of social dislocation are unusual, those that do exist have drawn increasing attention in recent years.[7]

Awareness of the problem segments in local authority housing has been matched by a concern with the weaknesses of local authorities as landlords. Over the past ten years, there has been a growing official and popular consensus that poor housing management by local authorities has contributed to the difficulties of the sector. By the early 1990s, local authorities had come to be seen as inefficient, unresponsive to the needs of their tenants, overly bureaucratic and wasteful in their use of housing assets. Not least among the critics of local authority landlordism was the Department of the Environment.[8] While it was widely accepted that poverty and unemployment among residents and the residual nature of local authority housing in the Irish housing system made it vulnerable to problems, it was also argued that conditions in local authority estates were made worse than they needed to be by the poor management performance of local authority housing departments.

These instances of problem estates and failed housing in the local authority sector have an importance beyond their number. That is so not only because of the human distress they cause to residents – and that distress is undoubtedly real and demands attention.

[8] See, for example, Department of Environment, 1993

It is also so because they have a disproportionate impact on public impressions of local authority housing. Matters are made worse by the apparent casualness of the response often given by local authorities and a seeming indifference both to the distress of residents and the waste of tax payers' money.

Responding to the criticisms of the late 1980s and early 1990s, many local authorities have been going through something of a revolution in their approach to their housing role in very recent years. They have begun to engage much more creatively and energetically with residents and estates, particularly in those areas with serious difficulties. The effects of this revolution were scarcely visible two to three years ago, but the momentum has been growing and today the spirit of reform in local authorities (both in the housing field and in other areas) is quite notable.

CONCLUSIONS

The implicit rule of thumb in Irish housing policy over most of the present century has been that between a quarter and a third of net new households would require their accommodation to be provided on a subsidised rental basis, that is, as local authority rental housing. Although the house purchase threshold has long been kept artificially low in Ireland by means of direct subsidies and fiscal advantages for home buyers, it was nevertheless recognised that a large minority of households would be unable to reach that threshold, at least in the initial stages of their life-cycle, and so would require some form of social housing.

For much of the 1990s, although nobody disputed the continuing validity of that rule of thumb, housing policy seemed to have lost sight of it. Social housing provision was allowed to fall to historically low levels, at least in relative terms, even though in recent years the pressure of rising housing costs increased the number of those who cannot reach the house purchase threshold. This points to the urgent need to expand social housing provision to a level in keeping with the enormity of the overall housing challenge now facing this country. If we were to take traditional benchmarks as a guideline, where social housing typically accounted for something of the order of 25% of new housing construction, this would require an annual social housing output over the next ten years of around 10,000 units per year, compared to an annual average of 2,100 per year over the past ten years. In short, it would require a fourfold increase in social housing output over the next decade compared to the past decade.

This is not to say that social housing on this scale should be provided entirely by local authorities. Some of it might be provided through an increase in shared ownership schemes or other forms of subsidised purchase, though the control of windfall gains for

subsidised purchases might be a difficult task. The contribution of voluntary housing agencies could undoubtedly be expanded. The private rented sector might also play a larger role, through an expansion of something along the lines of the present system of rent supplements. That would require radical refinement and development in the law governing private residential tenancies, something which could be considered desirable in any event, along with a review of eligibility conditions for rent supplementation. Ultimately, however, it is unlikely that such options would be able to meet more than a portion of the need, so that the direct role of local authorities is likely to remain large. In addition, local authorities at present have a broad supervisory role in relation to both voluntary housing and private rented accommodation, so that expansion of the latter would also have implications for the burden to be carried by local authorities.

Local authority housing departments at present are woefully lacking in the capacity to meet a challenge of this scale. They have made a great deal of progress in developing an adequate management approach to their existing housing stock since the mid-1990s but are quite unready to launch a major new housing drive. In fact, the housing management mindset which has been cultivated over recent years has emphasised the desirability of small, high-quality social housing schemes, highly integrated into existing urban environments. However laudable this may be in other circumstances, it is ill fitted to cope with the demands of a mass housing drive, where the scale of need suggests that reasonably large new greenfield or brownfield developments will be hard to avoid.

There has been much talk in recent years of reforming and reviving local government structures in Ireland, possibly entailing the devolution of new functions to local authorities. Talk of such new powers and functions should not distract attention from the powers and functions which they have long possessed, of which housing provides a major example. The housing function of local authorities has been allowed to shrink in the last decade. It is now necessary that it be kick-started into new life so that the scale of the challenge can be confronted.

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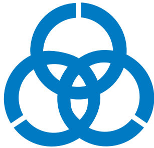
SOME COMPARATIVE ASPECTS OF IRELAND'S ECONOMIC TRANSFORMATION



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The Irish economy performed poorly, while the rest of Western Europe boomed, in the period between the end of the Second World War and the first oil crisis. There are elements of delayed catch-up, therefore, in Ireland's recent growth performance. However, there seems to be something deeper going on also, as evidenced by the fact that productivity in Irish manufacturing appears to have now surpassed that of the UK, even correcting for distortions due to transfer pricing. Total factor productivity growth has also been strong in Ireland, in stark contrast to the East Asian experience during its catch-up phase. Recent outcomes reflect recent policy changes as well as long-established strategies on trade, foreign direct investment and educational access. This paper compares some aspects of the changes in policy in Ireland and the UK and contrasts Irish and British outcomes over the recent period.

INTRODUCTION

The European economy's "Golden Age", which spanned the period 1950-73, was an era of unprecedented growth, cyclical stability and real convergence in living standards. Ireland was out of step in terms of its poor performance during this period. To some extent recent growth can be viewed as a delayed catching-up process. However, there appears to be more going on than this. This article compares some aspects of economic growth during the European Golden Age and during the more recent period for Ireland. East Asia is another region of the world economy that converged dramatically over a short period of time and some aspects of Irish and East Asian catch-up are also compared.

On the policy front, substantial changes in economic administration have been introduced in Ireland since the mid-1980s and in the UK since the late 1970s. The article compares the two sets of policy changes along a number of dimensions and contrasts the associated changes in economic performance of the two economies.

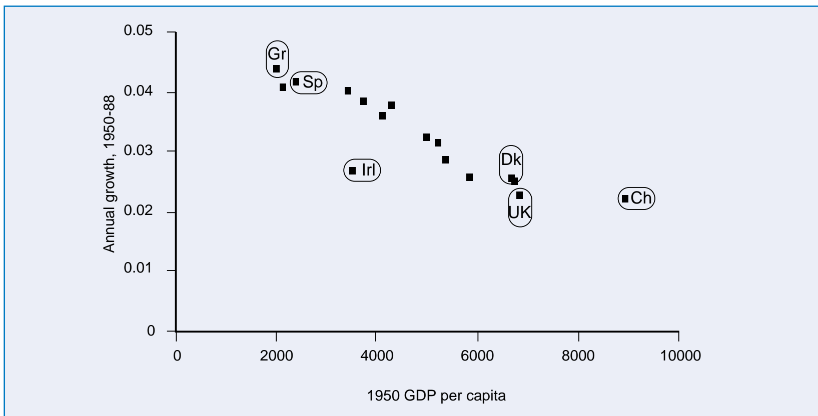
*This article draws on material presented to the conference, *Understanding Ireland's Economic Growth,* May 1999 in Dublin, which was hosted by University College Dublin.

IRELAND'S POOR PERFORMANCE DURING EUROPE'S "GOLDEN AGE"

"Social capability" refers to the fact that what matters for growth is not just the level of investment, but also how well investment decisions are made and how much technological imitation or innovation is occurring. Given some threshold of social capability, poorer countries tend to grow more rapidly than richer ones. This occurs through emulation of the technological and organisational advances of the leading economies, and, with diminishing returns to capital, through a convergence in levels of capital per head.

This process occurred during Europe's Golden Age, from 1950 to 1973, as living standards in Western Europe converged on those in the US. In addition, poorer countries grew more rapidly than richer ones. Figure 1 illustrates the subsequent slow growth of the countries that were richest in 1950 – Switzerland (CH), the UK, Sweden and Denmark – relative to those that started out poorest; namely, Greece, Spain and Portugal. The clear laggard in Figure 1 is Ireland, which is located well below the trend line, indicating substantially slower growth than would have been predicted on the basis of its 1950 level of income per head. Ireland between 1950 and 1988 looks more like a failure than a success.

FIGURE 1: AVERAGE ANNUAL GROWTH RATES, 1950-88, PLOTTED AGAINST 1950 GDP PER CAPITA



Source: Ó'Gráda and O'Rourke (1996)

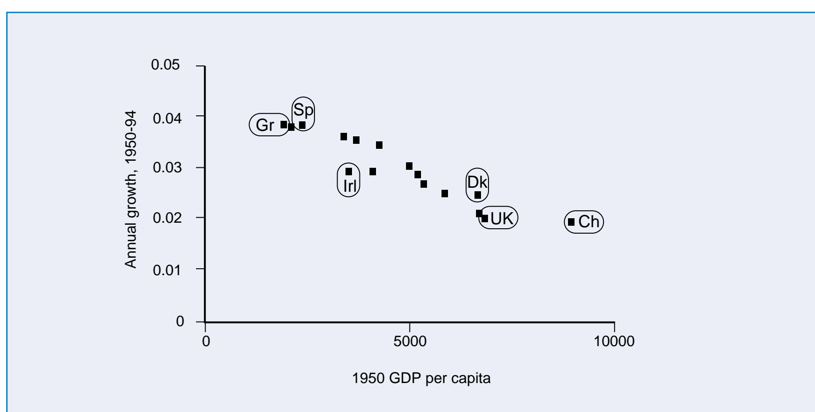
Irish underperformance during this period has been ascribed to a mixture of poor policy choices and inefficient institutions. Ó Gráda and O'Rourke (1996) identify sectoral misallocation of investment and an excessive scope for rent-seeking behaviour as

contributory factors, the latter looming large in Lee's (1989) analysis also. These in turn were associated with inward orientation and excessive interventionism in the early part of the period, while the macroeconomic instability of the 1980s also took its toll. All of these problems were exacerbated by the British-style industrial relations system that prevailed; writers such as Calmfors and Driffill (1989) have shown that countries are better off either with well-organised central bargaining systems or else with only weak unions; while Ireland and the UK would have been located in between, with decentralised collective bargaining systems.

IRELAND'S "GOLDEN AGE" IN COMPARATIVE PERSPECTIVE

Figure 2 extends the data period of Figure 1 by another six years. This shows that, over the whole period 1950-94, Ireland is no longer such a laggard, a conclusion which would of course be strengthened were more recent data added. This suggests the "delayed catch-up hypothesis".

FIGURE 2: AVERAGE ANNUAL GROWTH RATES, 1950-94, PLOTTED AGAINST 1950 GDP PER CAPITA



Source: Maddison (1996)

A deeper perspective on this is obtained by comparing Tables 1 and 2 below, which decompose output growth into three components, representing the contributions of increased capital and labour inputs (the latter adjusted for educational attainment), and a residual, termed "total factor productivity (TFP) growth".[1] Table 1 carries data for Western Europe and Japan, Table 2 for Ireland and Table 3 for East Asia.

[1] Total factoring productivity (TFP) growth is the growth of output due to technological advance.

TABLE 1: THE CONTRIBUTION OF CAPITAL, LABOUR AND TFP GROWTH TO OUTPUT GROWTH IN WESTERN EUROPE AND JAPAN, 1950-73 AND 1973-92

	Capital	Labour	TFP	Output
1950-73				
France	1.6	0.3	3.1	5.0
Japan	3.1	2.5	3.6	9.2
UK	1.6	0.2	1.2	3.0
West Germany	2.2	0.5	3.3	6.0
1973-92				
France	1.3	0.4	0.6	2.3
Japan	2.0	0.8	1.0	3.8
UK	0.9	0.0	0.7	1.6
West Germany	0.9	–0.1	1.5	2.3

Source: Maddison (1996)

Comparing the two time periods 1950-73 and 1973-92 in Table 1 first of all, it can be seen that the end of the Golden Age was reflected in some fall off in capital accumulation and a large drop in total factor productivity (TFP) growth. Looking at the recent Irish data in Table 2, Golden-Age style rates of TFP growth are found alongside a low contribution from capital accumulation. Ireland stands out from the Golden-Age and post Golden-Age European picture in terms of the contribution from increased labour inputs. This reflects the high unemployment and low participation rates prevailing at the beginning of the period, as well as the elastic supply of labour available from the emigrant community abroad.

However, there appears to be more than just delayed catch-up in Ireland's economic transformation. This is suggested by the evidence that, even adjusting for the GDP/GNP gap, Irish manufacturing-sector productivity appears to have surpassed that of the UK.[2]

[2] Barry 1999

TABLE 2. THE CONTRIBUTION OF CAPITAL, LABOUR AND TOTAL FACTOR PRODUCTIVITY GROWTH TO RECENT IRISH GNP GROWTH

	Capital	Labour	TFP	Output
1986-96				
Ireland	0.8	1.8	2.7	5.3

Source: Durkan *et al.* (1999)

Comparing Ireland with East Asia (Tables 2 and 3), it can be seen that labour's contribution has been of the same order of magnitude in both cases, reflecting the elastic supplies of labour available from the agricultural sector as the Asian economies industrialised. The most striking contrast is in terms of total factor productivity. East Asian TFP growth was low even during the period of rapid convergence, most of the output growth directly reflecting increased capital and labour inputs. Irish TFP growth is far more impressive, even more so as it arose in an economy with far less scope for catch-up.

TABLE 3: THE CONTRIBUTION OF CAPITAL, LABOUR AND TFP GROWTH TO EAST ASIAN OUTPUT GROWTH

	Capital	Labour	TFP	Output
1960-94				
Hong Kong	2.8	2.1	2.4	7.3
Indonesia	2.9	1.9	0.8	5.6
Korea	4.3	2.5	1.5	8.3
Malaysia	3.4	2.5	0.9	6.8
Philippines	2.1	2.1	-0.4	3.8
Singapore	4.4	2.2	1.5	8.1
Taiwan	4.1	2.4	2.0	8.5
Thailand	3.7	2.0	1.8	7.5
1978-95				
China	3.1	2.7	1.7	7.5

Source: Crafts (1999)

If Ireland can maintain its “capture” of high-productivity foreign direct investment into the future, this will bode well for a continuation of the country’s strong economic performance.

CHANGES IN ECONOMIC ADMINISTRATION IN IRELAND AND THE UK

UK economic strategy changed substantially under the Thatcher administrations and beyond. Irish strategy has also changed substantially, though from a later date and with less ideological fanfare.

The key elements of the changes introduced by the Conservatives in the UK have been described as comprising:

> privatisation and deregulation, reform of industrial relations, restructuring of taxation and restraints on the growth of public expenditure, radical revision of vocational training and an expansion of higher education. Foreign direct investment was encouraged, rapid de-industrialisation was accepted, and was accompanied by a sharp reduction in subsidies to troubled industries.[3]

Foreign direct investment, of course, had been actively pursued in Ireland since the end of the protectionist era, while less emphasis has been placed here on vocational training. In all the other areas mentioned, reforms were introduced in Ireland as well as in Britain. Before comparing the effects of the two sets of policy changes, those introduced in Ireland need to be examined in a little more detail.

COMPETITION POLICY AND DEREGULATION

The openness of the Irish manufacturing sector, which exports around 70% of gross output, leaves little room for anti-competitive practices, though the range of grants available must be taken to encourage rent-seeking. Aside from some loss-making public enterprises which have been disposed of over the last two decades, the manufacturing sector has largely been ring-fenced from the exercise of monopoly power. Thus, Koedijk and Kremers (1996) find that Ireland comes out best of all EU countries in terms of product-market freedom from regulation. They also find that it scores highly in terms of a freely functioning labour market and they argue that these factors play an important role in recent Irish growth.

[3] Crafts 1998

However, by concentrating on product markets, and by implication manufacturing, they overlook the fact that the scope for anti-competitive practices is greatest in sectors which are closed to international competition. (This is why recent allegations of shady practices and political corruption have revolved around sectors other than manufacturing). In a special report on competition in Ireland, the OECD (1993) argued that barriers to entry are widespread in non-traded areas such as many services sectors. A number of economists have argued that progress in implementing competition in services has been driven more by European law and technological developments (which allow existing regulations to be by-passed) than by an explicit policy agenda.[4] Nevertheless, much progress has been made over the last decade in improving Ireland's standing in the European league tables in regard to the cost of telephone calls, postal charges and the industrial use of electricity.[5]

In one important sphere deregulation was explicitly policy driven and the benefits to the economy have been huge. This refers to the mid-1980s liberalisation in air access, which reduced airfares between Ireland and Britain by over 50% and, in its wake, brought down sea fares by almost as much.[6] These sharp reductions provided a major stimulus to tourism. Since the mid-to late-1980s Ireland's share of world tourism has risen, going against both the current European trend and the Irish trend of the previous 20 years. In consequence, the employment contribution of tourism has doubled since that time.[7]

REFORM OF INDUSTRIAL RELATIONS

There is widespread agreement that an industrial relations system of the traditional British type, which combines low levels of co-ordination of both employers and unions with a high coverage of the workforce by collective bargaining agreements, leads to high levels of equilibrium unemployment. These effects are exacerbated by high labour taxes and generous unemployment benefits that continue indefinitely with little pressure exerted to find or accept work. The response of the Thatcher administration to these problems was to weaken trade union power, reduce the coverage of collective bargaining, lower the replacement ratio (i.e. the ratio of unemployment benefit to earnings) and generally shift the system of pay determination towards the American model.

[4] Fingleton (1995), Barry and O'Toole (1998)
[5] Barry (1999)
[6] Barrett (1997)
[7] Supporting data provided by the National Centre for Tourism Studies at the University of Limerick.

The Irish reform programme went in the opposite "neo-corporatist" direction, in favour of the social-partnership approach. The first such deal was agreed in 1987 and the most recent, designed to last into the new century, was signed a decade later. The partnership agreements purchased wage moderation via the promise of cuts in income tax, ensured that social welfare payments remained immune from public expenditure cuts and generally supported the replacement ratio.

RESTRUCTURING OF TAXATION AND RESTRAINTS ON THE GROWTH OF PUBLIC EXPENDITURE

An interesting aspect of recent Irish experience, and one that has attracted a good deal of international attention, is that the new model of social contract delivered a lower tax burden. This is in contrast to the social contract that prevailed during the European Golden Age referred to earlier, which Eichengreen (1996) describes as offering wage moderation in response to the promise of high welfare spending with an associated high level of taxation.

The new social contract has had interesting short-term (macroeconomic) as well as long-term (growth) effects. To take the short-term effects first, the fact that the economy in the late 1980s proved resilient in the face of public expenditure cuts gave rise to the "expansionary fiscal contraction (EFC) hypothesis" of Giavazzi and Pagano (1990). This held that non-Keynesian responses of private consumption and investment more than dominated the fiscal contraction, so that the net effect on domestic demand was positive. By contrast, it has been argued that "the factors working in the direction of recovery – buoyant world demand, improvements in cost competitiveness and an inflow of foreign investment in the lead-up to the Single European Market – more than outweighed the short-run contractionary effects of fiscal contraction."[8] The link between cost competitiveness and fiscal stabilisation was solidified, however, by the social partnership programmes instituted at that time.[9] The wage moderation exhibited in the late 1980s may therefore have been an early sign of the new post-Golden Age social consensus.

Given the large share of government in the Swedish economy, it is not surprising that Swedish economists were among the first to point out that the social contract of the 1960s could prove self-defeating as the public sector grew. Rather than promoting wage moderation, "excessive government" in Sweden boosted wage demands and reduced competitiveness and growth.[10]

[8] Barry (1991)
[9] Alesina and Ardagna (1998) also find wage modernisation to be the *sine qua non* for fiscal contractions to have expansionary aggregate effects (with the expansionary rightward shift of the aggregate supply curve offsetting the contractionary leftward shift of aggregate demand).
[10] Henrekson, Jonung and Stymne (1996)

The impact of taxation on wage demands therefore appears to hold the key to the long-term growth effects of fiscal policy. At lower government spending levels relative to GDP, the impact of public expenditure appears generally to be positive. At the higher levels prevailing in most present-day OECD economies, the threshold may have been passed and the impact of increased spending appears to be negative. Thus, the reduction in the share of government in the Irish economy may have had beneficial long-term growth effects (though present infrastructural inadequacies argue that the composition of government spending may be at least as important as its level).

ECONOMIC TRANSFORMATION IN IRELAND AND THE UK: A COMPARISON

Ireland and Britain faced similar problems in the 1970s. Both had high inflation and high-profile, industrial relations difficulties. Both were probably below the European average in terms of the quality and coverage of education and training. British productivity growth was low while Ireland suffered low employment growth.

The most striking failure of the Conservative revolution in Britain was in its counter-inflationary strategy; Irish inflation has been significantly lower in the 1990s. The microeconomic changes introduced in the UK, in areas such as product market liberalisation, industrial relations, and reduction of the tax burden, were more successful, showing up in the form of improved productivity growth. In terms of total factor productivity growth in the business sector, the UK moved up from 11th place in a group of OECD countries in 1960-73 to 4th place in 1979-95. Ireland over the same period overtook Japan to move from 2nd to 1st place. Labour productivity in manufacturing in Ireland now appears to be higher than in Britain, even when allowance is made for the GDP/GNP gap.

Ireland has done substantially better than Britain in terms of employment growth in recent times; Ireland created 23% more jobs in the decade from 1987 while Britain created 5%.

Taking the factors that economists traditionally care about, perhaps the only front on which Britain has fared better over the whole reform period is unemployment. While unemployment has come down dramatically in Ireland in recent times, British unemployment has been substantially lower over the last ten years, arguably as a consequence of the deeper changes in the operation of the social welfare system in the UK.

The Irish strategy has been different, but has also been successful in reducing unemployment and purchasing industrial peace: Sweeney (1998) points out, for

example, that in the eight years to 1987 the number of strike days lost averaged 316,000 a year, whereas in the nine years to 1996, under the partnership agreements, the annual average loss was below 110,000. It remains to be seen which wage bargaining system will prove more resilient over the longer term.

Ireland has done substantially better than Britain in terms of equality, measured with respect to disposable income (as opposed to earnings). Callan and Nolan (1999) show that the level of inequality was stable between the mid-1980s and mid-1990s in Ireland while it rose in the UK. This is partly a reflection of the fact that Irish unemployment fell over the period, offsetting shared pressures towards greater inequality, while UK unemployment was more stable. Divergent trends in replacement ratios in the two countries also contributed, as did the increasingly redistributive trend in Irish tax and social security contribution rates over the period. Callan and Nolan (1999) also draw attention to “the dog that did not bark”: the fact that increased female participation in Ireland did not go hand in hand with greater inequality, as it did in the UK and in the US. Jarrett (1999) reads this as an indication that newly-working women were not concentrated among the spouses of well-paid men.

CONCLUSIONS

There is undoubtedly some element of simple “catch-up” in Ireland’s recent economic growth. Many of the factors that led to the economy’s underperformance during the Golden Age of European growth have been reversed. The economy is now amongst the most open in Europe in terms of both trade and foreign direct investment flows. The agricultural sector has diminished in importance, educational participation has caught up on the European average and total factor productivity growth has been running at Golden Age levels. However, the investment rate is surprisingly low by international standards suggesting that changes in the composition of investment have acted to relax what would otherwise be a serious constraint on growth.

Recent performance reflects the impact of more recent policy changes as well as a playing-out of the effects of long-term strategies on openness and educational access. Market liberalisation has been profoundly important, particularly for tourism; it is surprising that interest group pressure is allowed to slow the pace of change so substantially in remaining highly-regulated sectors. The change in the industrial relations environment has been considerable; it is hoped that the partnership approach has promoted sufficient consensus to be able to deliver continued industrial peace now that the economy is running close to full capacity. While the roll-back in the share of government spending in the economy appears to have yielded a considerable growth dividend through a reduction in the tax burden, the country’s infrastructure is now

seriously overburdened. The only way to relax that constraint, when the domestic construction industry is already operating at full capacity, is to import construction services from abroad, enhancing competition and openness even further.

Trends in income inequality also continue to worry policymakers. In Ireland, as in Britain, there has been a dramatic widening of the wage differential between skilled and unskilled labour, driven by the tilt in demand against the low skilled right across the world. It has been argued that countries which have avoided these effects most successfully are ones that produce a relatively compressed distribution of outcomes in terms of skills acquired.[11] A major challenge facing both countries, therefore, is the need to develop education and training systems that ensure a higher level of performance on the part of those in the bottom half of the academic ability range.[12]

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