Philip R Lane: The African Continental Free Trade Area - creating fiscal space for jobs and economic diversification

Remarks by Mr Philip R Lane, Governor of the Central Bank of Ireland, at the Conference of African Ministers of Finance, Planning and Economic Development, United Nations Economic Commission for Africa Addis Ababa, Addis Ababa, 14 May 2018.

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I am delighted to be here today to address the Fifty First Session of the Conference of African Ministers of Finance, Planning and Economic Development. Thank you Dr Songwe for extending this invitation to me.

The theme for this year's session – the African Continental Free Trade Area: creating fiscal space for jobs and economic diversification – comes in the wake of the historic decision in Kigali earlier this year, when forty-four African Heads of State and Government signed up to a new Continental Free Trade Area (CFTA).

To quote Dr Songwe, the effective implementation of the CFTA may have "a game-changing impact on African economies". Africa can potentially create a single market of 1.2 billion people with over US$3 trillion in continental GDP. Already, intra-African trade is much more focused on value-added products than Africa's trade with the rest of world. Manufactured goods account for almost 42 percent of intra-African trade but only 15 percent of exports from Africa to countries outside the continent, with extra-African trade dominated by commodities.

Africa is projected to see the largest increase in population of any continent in the coming thirty years: this presents both great opportunities and great challenges. In this context, an efficient, continent-wide single market can make a fundamental contribution in promoting inclusive economic growth across a more integrated continent.

Against this background, I want to share with you some of Ireland's experiences as a small country and member of a much larger regional single market and trading bloc – the European Union (EU). Membership of the EU has been a primary driver of our economic transformation over the last forty five years.

Of course, our experience is not directly applicable to the African context and the EU is much more than a free trade area, with extensive economic, social and political inter-linkages. Nevertheless, I think some lessons from Ireland can be useful in informing policy making in some of your countries and in maximising the benefit of the new Continental Free Trade Area.

First, some history. Ireland joined what was then called the European Economic Community in 1973. It was a much smaller Community than it is now – there were six member states with 167 million people, rather than the 28 member states and 512 million people in the EU today. The accession of Ireland (together with Denmark and the United Kingdom) in 1973 expanded the number of members to nine.

Ireland was by far the poorest country in the Community at that time; GDP per capita was just 53 per cent of the EU average. Ireland was a peripheral economy on the edge of Europe and quite dependent on exports of basic agricultural products. Ireland was also heavily economically dependent on our former colonial power, the United Kingdom: in the early 1970s, over 60 per cent of exports went to the UK market. A quarter of the Irish workforce was in the agricultural sector and Ireland experienced high levels of unemployment, high emigration rates and low productivity in key economic sectors.

Forty-five years later, the picture is very different. Ireland has a population of just 4.7 million but firms in Ireland now have access to a single market of over 500 million consumers across the

EU. In turn, a large EU market provides a key foundation for global trading activity, both through scale effects and the assurance that EU membership provides to international customers in relation to regulatory and product standards.

Living standards in Ireland are now comparable to those prevailing elsewhere in the EU. Exporters – both local enterprises and the large- scale multinational sector – are a key driver of overall productivity sector and, being less exposed to domestic demand conditions, provide an important source of economic and financial stability.

The traditional agri-food sector has been transformed, with a shift towards higher value-added activities, while Ireland is an important location for international manufacturing, international business services and international financial intermediation. EU membership has also allowed Ireland to foster trade linkages with a broader range of countries (both inside the EU and outside the EU) than had previously been the case: Ireland has gone from exporting more than 60 per cent of our goods and services to the UK in the early 1970s to just 13 per cent today.

Multinational firms play a significant role in Ireland's export sector. As a small country, the scale and composition of foreign direct investment (FDI) is fully inter-linked with the international trading opportunities provided by EU membership, since the local market is too small to justify significant inward investment. Rather, these firms are typically looking for an EU base to serve customers across Europe, the Middle East and North Africa (the EMEA regions). Equally, domestic firms are able to scale up in the context of the EU-wide single market, enabling better growth opportunities. So how did we do it and what lessons have been learned?

One primary lesson is that, for a small country, gaining access to a large market is an enormous opportunity: it has transformed the outlook of our domestic enterprise sector and has been a fundamental building block of our success in attracting FDI.

A second lesson is that EU membership by itself was not sufficient: domestic policies and domestic institutions must provide the environment conducive to a flourishing enterprise sector.

Despite EU membership, Ireland's economic success was not overnight. An unsustainable growth spurt in the late 1970s was followed by prolonged stagnation during the 1980s, with Ireland caught in a trap of low growth, significant emigration and high debt. This period came to an end in the late 1980s, when a combination of improving external conditions and resolute fiscal actions stabilised the Irish macro-financial situation. In turn, this allowed Ireland to take advantage of structural changes in the world economy in the 1990s that supported expansion in international trade in high-tech goods and business services.

Especially during the 1994–2001 period, Ireland grew at a remarkable pace while maintaining macro-financial stability, with strong increases in output, employment and living standards. The unemployment rate fell from almost 17 per cent in 1987 to just over 4 per cent by the turn of the millennium; the fiscal balance moved from a deficit of over 8 per cent of GDP to a surplus of 2.7 per cent; the debt-to GDP ratio declined from in excess of 110 per cent to under 40 per cent over the same period; and the current account was in surplus. This period up to 2001 was termed the 'Celtic Tiger' era, by analogy to the fast-growing group of emerging Asian economies that had enjoyed rapid expansion in the 1970s and 1980s.

It is important to emphasise that sustainable growth was only possible due to a long period of public investment in the education sector that provided an important local supply of high-skilled workers. In addition, strong employment growth was also supported by a broadening of participation in the labour market, especially with a sharp increase in female participation in the workforce. There was also a reversal in the traditional pattern of net emigration, with many overseas-based Irish people returning home and foreign nationals moving in response to the economic opportunities available in Ireland.

In addition, rapid growth also required ongoing improvements in the public capital stock (especially transportation infrastructure and education) through an effective infrastructural investment programme, which was in part financially supported by the EU system of cohesion and structural funds. It also depended on improvements in locally-supplied business inputs, such as telecoms and energy.

Taken together, it is evident that a wide range of supportive domestic institutional policies had to be in place in order for Ireland to take advantage of the opportunities provided by the international trading system. For foreign investors, the stability of the Irish institutional environment was also vital: long-term, large-scale investments are not likely if the domestic institutional framework is vulnerable to unpredictable shifts in terms of key policy choices. This certainly includes the predictability of the corporation tax regime but also extends to ensuring that "doing business" is facilitated by reasonable regulatory requirements, an efficient legal system, an agile labour market and reliable public and business infrastructures.

An important feature of Ireland's experience has been that international economic integration is not uniform: the strength of Ireland's international linkages varies across countries and sectors. This is quite natural: there are fixed costs and scale effects in developing individual industries and entering different export markets. It follows that, especially for a small country, international trade can lead to specialisation in a small number of sectors and a high dependence on a particular set of export destinations.

While specialisation is beneficial in terms of maximising productivity, resilience and flexibility is required in adapting to shocks in specific industries and export markets. This includes maintaining the fiscal space to cope with a sudden downturn in tax revenues, making sure the financial system is well capitalised, developing a sufficiently strong social safety net to support displaced workers and ensuring that educational and training systems can adapt to shifts in demand for different occupational skills.

So far, I have emphasised the impact of trade openness on exporting opportunities. Of course, it is just as important to recognise the role of imports in driving economic performance and improving living standards. At a basic level, modern production typically involves extensive use of intermediate and capital goods: access to the global supply of such goods is vital for the functioning of many industries. Access to imports also is necessary if the gains to specialisation are to be obtained – a country can focus on production in a select number of industries while maintaining a full range of consumption and investment opportunities through importing all that is required. Of course, this is just a restatement of the classic arguments in favour of international trade, in terms of potential to deliver gains to all countries through two-way flows of exports and imports.

Let me now turn to the implications for the financial system and the balance of payments of an increase in trade openness. Through movements in gross and net international financial flows, the domestic financial system will be affected by changes in the external financial environment. Rather than relying exclusively on external debt, foreign direct investment and equity inflows can help to fund the expansion of both exporters and domestically-orientated firms. Clearly, some scope for foreign-currency funding is feasible for exporters that receive foreign-currency earnings from export markets but regulators need to keep a careful eye on the risks associated with currency mismatches in the financial system. In similar fashion, current account deficits that are financed by equity flows or are directed at productivity-enhancing investment projects pose fewer risks than external deficits that are financed by debt or directed at adding to domestic consumption.

Taking account of all of these considerations brings me to the final lesson that our experience has taught us – the importance of robust policy frameworks, underpinned by strong governance institutions. As I mentioned at the beginning of my remarks, EU membership in 1973 did not immediately deliver prosperity: the gains from economic and trade integration are long-term in nature and accrue only gradually. Moreover, as I have emphasised in this speech, sustainable gains can only be obtained if the domestic policy framework provides the necessary infrastructural supports, establishes a pro-business environment for both domestic and foreign firms and secures macro-financial stability. In turn, a durable and successful domestic policy framework will only prove resilient in the face of external or domestic shocks if there is a shared social commitment to maintaining a robust set of institutions that underpin its foundations.

From a Central Bank perspective, monetary and financial stability also contributed to the creation of more favourable domestic environment during the late 1980s and 1990s. We have seen from the financial crisis at the end of the last decade that a stable and functioning banking system is integral to the performance of the real economy and research on the lessons learned from that period inform current policy at the Central Bank. Today, we have increased powers to supervise and regulate bad practice in Irish financial institutions, and this is done in conjunction with our European partners under the Single Supervisory Mechanism. In relation to the banking system, the European system builds resilience by requiring banks to maintain sufficiently-high capital and liquidity ratios. At the national level, we can add an extra capital buffer if we assess that there is a risk of excessive credit growth. The Central Bank of Ireland has also introduced borrower-based measures in the form of ceilings on loan-to-income and loan-to-value ratios in the mortgage market. These mortgage measures make the banks safer, while also protecting consumers from over-indebtedness.

The real estate and credit boom that so distorted our economy during 2003–2008 and led to so much suffering during the post-2008 crisis was a timely reminder that creating the right policy environment is not a journey with an end point; it is a continual process that demands constant commitment and adaptability. The 2003–2008 boom phase showed the dangers of insufficient risk management, with optimistic projections about future economic prospects spilling over into excessive construction activity and financial speculation. This was amplified by a surge in foreign debt inflows into the domestic banking system. Triggered by the 2008 global financial crisis, the post-boom crash had a devastating impact, especially on those who suffered income and employment losses and those who had incurred unsustainable debts. The clear lesson is that strong economic fundamentals can unleash undesirable side effects in terms of financial speculation central banks and financial regulators have a heavy responsibility to build resilience in the financial system and take counter-cyclical measures to offset the risks associated with domestic credit booms.

To sum up, membership of the EU has been transformational for Ireland's prosperity and growth. Our economy and society are unrecognisable today in comparison to the Ireland that the joined the EU in the 1970s. Access to a large market alone was a necessary (but not sufficient) condition for transformation. It also required an enabling business environment for domestic and foreign companies alike, effective policy frameworks and public investment in physical and human capital.

In terms of the current economic agenda facing Ireland, we need to focus on maintaining an environment that is attractive for business activity in an ever-changing global economy in support of domestic prosperity, while ensuring the ancillary policies are in place to safeguard macro-financial stability. Furthermore, we need to continue to use our voice within the EU and on the global stage to ensure the development of stable, inclusive, sustainable and integrated economies and societies.

I hope my remarks this morning will assist you as you start to plan, both at regional and at national level, for the entry into force of the Continental Free Trade Area. We in Ireland are ready and willing to continue to share our experiences with you as you take forward this ambitious task. I look forward to learning more about your plans during the rest of today's event.