SUMMARY

The Irish economy continued to experience robust growth in the first half of this year despite the uncertainties arising from the foot and mouth outbreak and the negative overhang arising from the slowdown in the major international economies. While there are signs that the economy is reaching an inevitable deceleration in its remarkable growth performance, the rates of output growth forecast for this year and next are still in excess of those that could be considered sustainable in the medium term. Our forecast for output growth in 2001 is 7.0 per cent in real GDP and 6.0 per cent in real GNP terms. The prospects for 2002 are projected to be 6.4 and 5.4 per cent in real GDP and real GNP terms respectively.

A gradual decline in the pace of activity is indicated by lower growth in tax revenues and private sector credit along with declines in house building and car sales. The slowdown is most marked in the prospects for employment growth. We forecast that employment growth will fall from 4.7 per cent in 2000 to 3.2 and 1.9 per cent respectively for this year and next. This drop-off in employment growth reflects the near full employment conditions and the decrease in the growth of the labour force. Unemployment is forecast to stabilise around a rate of 3.6 per cent in 2001 and 3.5 per cent in 2002.

While output growth is slowing from the exceptionally high levels of 2000, considerable demand pressures remain. These have been boosted by the continued weakness in the euro, low real interest rates, high domestic after-tax income rises and large public expenditure increases. Inflation in consumer prices, while not the most appropriate measure of overheating pressures for a small open economy like Ireland, has nonetheless remained high. The headline inflation rate is expected to average 4.8 per cent in 2001 before moderating to an average of 3.3 per cent in 2002. A further indicator of excess demand pressures in the economy is the re-emergence of a deficit in the current account of the Balance of Payments in 2000 after eight years of surpluses. This deficit is forecast to rise in 2001 and 2002 to 1.1 and 2.0 per cent of GDP respectively.

The Irish economy's transition in just under a decade to above average European income levels is nearing completion. At the end of this transition domestic policy tools need to be configured to consolidate the gains achieved and to alleviate the inevitable bottlenecks that emerge in a period of rapid growth. In the current context for Ireland, notwithstanding the slowing of economic growth, restraining domestic demand whilst increasing supply capacity is an imperative. The onus on managing domestic demand falls on budgetary and incomes policy, while more specific sectoral interventions are required to boost the economy's supply capacity.

Arriving at a turning point in terms of its economic growth, Ireland is in a rather unique position to reflect on the nature and suitability of the current economic governance within the European Union, especially for economies in transitions. By shifting the emphasis on to the economic rules at work within the EU, Ireland can help provide a useful demonstration for aspirant member countries in the pursuit of successful European enlargement.

PRELIMINARY NATIONAL ACCOUNTS 2000

A: Expenditure on Gross National Product

	1999	2000	Change in 2000				
		Preliminary	£m		%		
	£m	£m	Value	Volume	Value	Price	Volume
Private Consumer Expenditure	34,743	40,250	5,507	3,301	15.9	5.8	9.5
Public Net Current Expenditure	8,753	9,652	899	455	10.3	5.3	5.2
Gross Fixed Capital Formation	16,175	19,693	3,518	1,645	21.8	10.5	10.2
Exports of Goods and Services (X)	60,461	75,751	15,290	11,185	25.3	5.7	18.5
Physical Changes in Stocks	-57	152	209	18			
Final Demand	**120,075**	**145,499**	**25,424**	**16,604**	**21.2**	**6.5**	**13.8**
less:							
Imports of Goods and Services (M)	50,978	64,992	14,015	8,993	27.5	8.4	17.6
GDP at Market Prices	**69,097**	**80,506**	**11,409**	**7,611**	**16.5**	**5.0**	**11.0**
less:							
Statistical Discrepancy	43	61	18	153			
Adjusted GDP	**69,054**	**80,445**	**11,391**	**7,458**	**16.5**	**5.1**	**10.8**
less:							
Net Factor Payments (F)	9,988	12,197	2,209	1,548	22.1	5.7	15.5
GNP at Market Prices	**59,066**	**68,248**	**9,182**	**5,910**	**15.5**	**5.0**	**10.0**

B: Gross National Product by Origin

		1999	2000	Change in 2000	
			Preliminary		
		£m	£m	£m	%
Agriculture, Forestry, Fishing		2,071	2,304	-233	**11.3**
Non-Agricultural:	Wages, etc.	28,086	32,029	3,943	**14.0**
	Other:	26,809	31,764	4,955	**18.5**
Adjustments:	Stock Appreciation	-562	-270		
	Financial Services	-2,296	-2,459	-163	**7.1**
	Statistical Discrepancy	43	61	18	
Net Domestic Product		54,151	63,428	9,277	**17.1**
less:					
Net Factor Payments		9,988	12,197	2,209	**22.1**
National Income		44,163	51,231	7,068	**16.0**
Depreciation		7,114	7,960	846	**11.9**
GNP at Factor Cost		51,277	59,191	7,914	**15.4**
Taxes less Subsidies		7,789	9,057	1,268	**16.3**
GNP at Market Prices		59,066	68,248	9,182	**15.5**

C: Balance of Payments on Current Account

	1999	2000	Change in 2000
		Preliminary	
	£m	£m	£m
Exports (X) less Imports (M)	9,483	10,759	1,276
Net Factor Payments (F)	-9,988	-12,197	-2,209
Net Transfers	951	924	-27
Balance on Current Account	**446**	**-514**	**-960**
as % of GNP	0.8	-0.8	-1.4

FORECAST NATIONAL ACCOUNTS 2001

A: Expenditure on Gross National Product

	2000	2001	Change in 2001				
	Preliminary £m	Forecast £m	£m		%		
			Value	Volume	Value	Price	Volume
Private Consumer Expenditure	40,250	45,304	5,053	2,979	12.6	4.8	7.4
Public Net Current Expenditure	9,652	11,180	1,528	512	15.8	10.0	5.3
Gross Fixed Capital Formation	19,693	22,317	2,624	768	13.3	9.1	3.9
Exports of Goods and Services (X)	75,751	87,799	12,047	8,676	15.9	4.0	11.5
Physical Changes in Stocks	152	10	-142	-165			
Final Demand	**145,499**	**166,609**	**21,111**	**12,769**	**14.5**	**5.3**	**8.8**
less:							
Imports of Goods and Services (M)	64,992	75,002	10,009	6,978	15.4	4.2	10.7
GDP at Market Prices	**80,506**	**91,608**	**11,102**	**5,790**	**13.8**	**6.2**	**7.2**
less:							
Statistical Discrepancy	61	-69	-130	185			
Adjusted GDP	**80,445**	**91,676**	**11,231**	**5,606**	**14.0**	**6.5**	**7.0**
less:							
Net Factor Payments (F)	12,197	14,283	2,085	1,537	17.1	4.0	12.6
GNP at Market Prices	**68,248**	**77,394**	**9,146**	**4,069**	**13.4**	**7.0**	**6.0**

B: Gross National Product by Origin

		2000	2001	Change in 2001	
		Preliminary £m	Forecast £m	£m	%
Agriculture, Forestry, Fishing		2,304	2,175	-129	-5.6
Non-Agricultural:	Wages, etc.	32,029	36,801	4,772	14.9
	Other:	31,764	36,461	4,697	14.8
Adjustments:	Stock Appreciation	-270	-60		
	Financial Services	-2,459	-2,647	-188	7.6
	Statistical Discrepancy	61	-69	-130	-212.3
Net Domestic Product		**63,428**	**72,661**	**9,233**	**14.6**
less:					
Net Factor Payments		12,197	14,283	2,085,	17.1
National Income		**51,231**	**58,379**	**7,147**	**14.0**
Depreciation		7,960	8,904	945	11.9
GNP at Factor Cost		**59,191**	**67,283**	**8,092**	**13.7**
Taxes less Subsidies		9,057	10,111	1,054	11.6
GNP at Market Prices		**68,248**	**77,394**	**9,146**	**13.4**

C: Balance of Payments on Current Account

	2000	2001	Change in 2001
	£m	Preliminary £m	£m
Exports (X) less Imports (M)	10,759	12,797	2,038
Net Factor Payments (F)	-12,197	-14,283	-2,085
Net Transfers	924	596	-328
Balance on Current Account	**-514**	**-889**	**-375**
as % of GNP	-0.8	-1.1	-0.5

FORECAST NATIONAL ACCOUNTS 2002

A: Expenditure on Gross National Product

	2001	2002	Change in 2002				
	Forecast £m	Forecast £m	£m Value	£m Volume	% Value	% Price	% Volume
Private Consumer Expenditure	45,304	50,365	5,062	3,171	11.2	3.9	7.0
Public Net Current Expenditure	11,180	12,290	1,110	581	9.9	4.5	5.2
Gross Fixed Capital Formation	22,317	25,360	3,043	1,402	13.6	6.9	6.3
Exports of Goods and Services (X)	87,799	99,369	11,570	7,703	13.2	4.0	8.8
Physical Changes in Stocks	10	145	135	100			
Final Demand	**166,609**	**187,529**	**20,919**	**12,958**	**12.6**	**4.4**	**7.8**
less:							
Imports of Goods and Services (M)	75,002	84,932	9,930	6,922	13.2	3.7	9.2
GDP at Market Prices	**91,608**	**102,597**	**10,989**	**6,037**	**12.0**	**4.1**	**6.6**
less: Statistical Discrepancy	-69	-53	15	193			
Adjusted GDP	**91,676**	**102,650**	**10,974**	**5,844**	**12.0**	**5.3**	**6.4**
less:							
Net Factor Payments (F)	14,283	16,596	2,314	1,668	16.2	4.0	11.7
GNP at Market Prices	**77,394**	**86,054**	**8,660**	**4,176**	**11.2**	**5.5**	**5.4**

B: Gross National Product by Origin

	2001	2002	Change in 2002	
	Forecast £m	Forecast £m	£m	%
Agriculture, Forestry, Fishing	2,175	2,360	185	8.5
Non-Agricultural: Wages, etc.	36,801	41,359	4,558	12.4
Other:	36,461	40,835	4,375	12.0
Adjustments: Stock Appreciation	-60	10		
Financial Services	-2,647	-2,835	-188	7.1
Statistical Discrepancy	-69	-53	15	-22.5
Net Domestic Product	**72,661**	**81,676**	**9,015**	**12.4**
Net Factor Payments	14,283	16,596	2,314	16.2
National Income	**58,379**	**65,080**	**6,701**	**11.5**
Depreciation	8,904	9,851	946	10.6
GNP at Factor Cost	**67,283**	**74,931**	**7,648**	**11.4**
Taxes less Subsidies	10,111	11,123	1,013	10.0
GNP at Market Prices	**77,394**	**86,054**	**8,660**	**11.2**

C: Balance of Payments on Current Account

	2001	2002	Change in 2002
	Forecast £m	Forecast £m	£m
Exports (X) less Imports (M)	12,797	14,437	1,639
Net Factor Payments (F)	-14,283	-16,596	-2,314
Net Transfers	596	436	-160
Balance on Current Account	**-889**	**-1,723**	**-834**
as % of GNP	-1.1	-2.0	-1.0

The International Economy

General

The outlook for the world economy continues to be quite uncertain, tending towards pessimism, driven principally by developments in the United States. Although first quarter growth was 1.2 per cent on an annual basis, subdued investment prospects, increasing unemployment, lower equity prices and worsening corporate positions all pose significant downside risks to the US economy. The fragile situation facing the global economy is exacerbated by continued weakness in Japan, and evidence that the US slowdown is beginning to affect the European Union. Nevertheless, interest rates world-wide have been cut in an effort to boost consumption and investment, and the reduction in levels of trade between countries will be countered to some extent by stimuli to domestic economies.

The US Economy

The US economy remains the focus of considerable international attention, as commentators attempt to estimate the intensity and duration of the current downturn. Recent data releases have been quite mixed. The first quarter of 2001 saw GDP rising by 1.2 per cent on an annual basis, from 1 per cent in the final quarter of 2000. This was driven by a sharp decline in imports resulting in a positive contribution from net exports, and a further reduction in the savings ratio. On the other hand, the manufacturing sector has slipped into recession, equity prices have fallen sharply and consumer and business confidence levels are down. This is expected to result in growth being flat in the second quarter. However, prompt policy action, both fiscal and monetary, by the US authorities should aid the expected recovery in the second half of the year. We estimate output growth of 1.6 per cent this year, strengthening further to 2.5 per cent in 2002.

Industrial production fell in April for the eighth straight month and was 2.8 per cent lower than one year previously. The manufacturing sector continues to be the hardest hit, with manufacturing output down 3.3 per cent on an annual basis. However, the National Association of Purchasing Managers (NAPM) manufacturing index increased during the first quarter and registered only a modest decline in May, and there are reports that the inventory overhang is being corrected in certain sectors.

One of the most striking features of the slowdown has been the fall in levels of investment. Gross private investment fell by over 13 per cent in the first quarter of 2001. The fall in equity prices and lower corporate profitability has pushed up the effective cost of capital for many firms, while there is still significant excess capacity in the manufacturing and information and communication technology (ICT) sectors. Both of these factors make investment less attractive. However, the growth in business investment has turned positive again in the first quarter, and the abrupt halting of this after many years of double-digit growth was one of the main causes of the overall slowdown in the economy.

The consumer sector remains the driving force behind growth in the US economy, accounting for almost two-thirds of economic activity. Private consumption recovered slightly in the first quarter of 2001, registering growth of 3.1 per cent on an annual basis, but this was still considerably lower than the rate of 5.3 per cent for 2000. Nevertheless, increases in household expenditure continue to exceed earnings growth and this has driven the savings ratio down to –1.0 per cent. A gradual correction in consumer expenditure is likely given the loosening of labour market conditions and substantial falls in the stock market. Consumer confidence in the first quarter, while falling have remained remarkably strong given the sharp declines in the corporate sector.

The US labour market has seen considerable loosening in recent months. April saw the largest monthly decrease in employment since the 1990-91 recession. Unemployment rose to 4.5 per cent in April, and has since fallen to 4.4 per cent. We expect unemployment to average 4.5 per cent this year, increasing to 4.7 per cent next year. Unit labour costs will rise substantially this year as productivity growth slows while average earnings continue to rise. Productivity growth was negative for the first quarter of 2001, at an annual rate of –1.2 per cent from 2 per cent in the final quarter of last year. We expect productivity growth to increase in 2002 back towards rates applying in 2000. Federal minimum wages are scheduled to increase in 2001 and 2002, and we predict growth of 4.5 per cent in overall average earnings for this year and next.

We remain confident that an outright recession, in the technical sense of two successive quarters of decline, can be avoided. The Federal Reserve has acted promptly and aggressively, cutting interest rates six times this year by a cumulative 2.75 percentage points to 3.75 per cent, its lowest level in seven years. It has cited the erosion in current and prospective company profitability, leading to a reduction in capital spending as a major source of concern. Also, with over 50 per cent of households holding stock market investments, the rate cuts helped to boost equity prices.

On the fiscal side, it appears that a substantial proportion of the Bush administration's proposed 10-year tax plan will be implemented this year, providing a further boost to the economy. Finally, there is still a need for the current account deficit, now running at almost 4 per cent of GDP, to be corrected. The slowdown may help to achieve redress this imbalance in an orderly manner.

The European Economy

Growth prospects in the euro area have weakened slightly since the last *Commentary*, yet they remain robust. We still expect GDP growth to exceed that in the US for the first time since 1991, but the euro area will expand at a level more consistent with its potential output. The distinction in terms of economic performance between the US and the EU over the last decade has reflected differential productivity growth due to the "new economy" impacts. These distinctions between productivity in the US and EU are explored in Box 1.

Box 1: The "New Economy" in the United States and Europe

In the past ten years the United States has witnessed its longest period of sustained expansion. Between 1995 and the end of 2000 alone, GDP increased by 23.5 per cent in volume terms, compared to a 13 per cent increase in the euro zone. This has led many commentators to herald the dawn of a so-called "new economy", where it is possible to have rapid, productivity-driven growth with low inflation, increasing corporate profits and substantial budget surpluses. Central to the "new economy" paradigm is substantial investment in the Information and Communications Technology (ICT) sector, which many believe has increased the sustainable level of productivity growth to about 3 per cent. This is achieved either by capital deepening (i.e. increasing capital per worker) or by speeding up total factor productivity (the efficiency of labour and capital). Another school of thought denies the presence of any structural change at all, claiming that the impact of ICT is greatly exaggerated, and attributing observed productivity increases purely to cyclical effects. It now appears that the truth lies somewhere in between these divergent schools of thought.

In the first quarter of 2001 productivity in the United States fell by 1.2 per cent, compared to growth of 4.3 per cent for 2000 as a whole. This could signal the end of the "new economy" and a return to the traditional business cycle. However, quarterly productivity figures tend to be quite volatile, so this may be a one-off fall. Also, in the face of a slowdown firms will not immediately cut jobs, in case conditions quickly recover, and so productivity growth will decline. It is apparent that the positive impact on productivity of investment in ICT has been overstated, but some of the productivity gains should remain even as the ICT sector loses steam. The debate in the last few years has centred on what proportion of the productivity growth was cyclical and how much was structural. A recent report by the Bank of England concludes that the evidence so far points towards a large role for structural improvements in productivity growth in the US.[1]

According to Robert Gordon, an influential new-economy sceptic, the new-economy has meant little to the 88 per cent of the economy outside of durable manufacturing, where trend growth in multifactor productivity has actually decelerated in spite of substantial investment in ICT.[2] On the other hand, studies by the President's Council of Economic Advisors and also by the Federal Reserve conclude that most of the increase in labour productivity since 1995 has been structural.

The problem of international comparisons of growth and productivity caused by divergent methods of price measurement should be considered. Since the 1980s the US has incorporated a hedonic approach to calculate price indices for ICT products. This method takes quality changes into account, and only France, Sweden and Denmark use this method in Europe. The more conventional methods are less effective in the face of very large quality changes, which are not reflected in price changes. For many years the ICT sector has demonstrated significant increases in quality, and use of traditional approaches will understate real price reductions. Hence, actual productivity in Europe may not be as far behind the US as originally believed, if both used similar methods of price measurement.

The key issue is whether Europe is in a position to experience any "new economy" effects on productivity growth. A recent report carried out by the European Commission finds that the impact of ICT on productivity growth between 1996 and 1999 was twice as large in the US as in the EU.[3] Further, they find that the impact in the EU between 1996 and 2000 was broadly similar to that in the US between 1990 and 1995 see Table 1A. This would seem to indicate that the EU could lag the US by anything up to five years in the contribution of ICT to the macro economy. Furthermore, there is growing evidence of an improvement in the trade off between inflation

[1] Berry, Stuart and David England, 2001. "Has There Been A Structural Improvement in US Productivity", *Bank of England Quarterly Bulletin*, *Summer,* pp. 205-209.

[2] Gordon, Robert J., 2000. "Does the New Economy Measure Up to the Great Inventions of the Past?", *Journal of Economic Perspectives*, Vol. 4, No. 14.

[3] European Commission, 2000. "Economic Growth in the EU, Is a 'New' Pattern Emerging?", Chapter 3 in *Review of 2000,* Brussels: European Commission.

and unemployment in the EU. Those countries with an already strong ICT sector such as Ireland, Finland and the UK, and countries that have more scope for new ICT production and investment such as Greece and Italy stand the greatest chance of boosting growth in the coming years.

Table 1A: Productivity Growth Rates in the US and EU 1990-2000

	1990-1995	1996-2000
US	1.36	2.74
EU	2.00	1.21

However, the emergence of a "new economy" over the next few years in the EU is far from guaranteed. Any further supply side shocks, such as quantity restrictions leading to increase in oil prices, could derail the process. Also, the world economic slowdown that is currently underway may postpone any "new economy" benefits. Though the long run consequences of new technology are not yet clear, significant capital expenditure on ICT in the EU raises the possibility of real gains for many European businesses.

The slowdown in world activity will reduce export growth, and this will be exacerbated by the expected appreciation of the euro over the course of the year to reflect fundamental values. However, the euro area grew at an annual rate of 2.5 per cent in the first quarter of 2001, driven by strong private consumption as oil prices fell and tax cuts began to affect behaviour. With consumer confidence remaining high, the loosening of monetary policy and the prospect of moderating inflation from the current high rates should permit growth of 2.5 per cent this year, strengthening slightly to 2.6 per cent in 2002.

The industrial sector is the first to feel the impact of the US slowdown. This is unsurprising given that manufacturing is highly integrated globally. Business confidence in the euro area continued to fall during the last quarter, but remains above its historical average. However, the US Purchasing Managers Index has indicated a contraction in industrial activity for the first time since March 1999. Sentiment continues to decline in all the major economies, but evidence of a slowdown is greatest in Germany, where industrial production contracted by 3.7 per cent on an annual basis in April. Hence, the euro area may not be as insulated from a slowdown in the US as originally expected, at least in the manufacturing sector.

Inflation remains stubbornly high in the euro area, with the Harmonised Index of Consumer Prices (HICP) reaching an eight-year high of 3.4 per cent on an annual basis in May. The highest rate was recorded in the Netherlands (5.4 per cent), while France had the lowest (2.5 per cent). Strong increases in food and energy prices accounted for most of the rise, but the underlying rate, which excludes the volatile energy, food, alcohol and tobacco sectors, rose to 2.1 per cent. The headline rate has now exceeded the ECB's target of 0 to 2 per cent since the middle of last year. Inflation has now reached its peak, and will decline in the coming months. Food prices should stabilise in the wake of the foot and mouth crisis, and lower world activity will place downward pressure on energy prices.

However, the current weakness of the euro constitutes an upside risk to inflation.

In May the European Central Bank surprised the markets by cutting interest rates in spite of persistent inflationary pressures and months of dampening expectations of rate cuts by insisting that inflation was its chief concern. The ECB had been under pressure from institutions such as the IMF and the OECD to cut rates, being the only monetary authority not to do so in the face of the slowdown in world economic activity. The risk of a self-perpetuating wage/price spiral was cited as its reason for leaving rates constant, but it justified its decision to cut based on its medium term targets for price stability being met. There has been concern that this has weakened the credibility of the ECB, in the light of inflation data for May, this has led to further pressure on the exchange rate.

The euro area labour market remains in a strong position, although there are some signs of a turning point, especially in Germany. Wage restraint helped to boost employment growth by more than 2 per cent last year, resulting in euro area unemployment falling to 8.3 per cent in April (on an ILO basis), its lowest level since 1991. The unemployment rate has now fallen continuously by 3 percentage points since late-1997. France, the Netherlands and Ireland have been the star performers, with record employment increases in the last few years. However, unemployment in Germany rose for the fourth consecutive month in April and the rate now stands at 9.3 per cent. The slowdown in world activity is affecting the euro zone's largest economy more than other countries. Overall, unemployment will decrease by more modest proportions this year and next, and we predict unemployment rates of 8.5 and 8.4 per cent for 2001 and 2002.

Countries on the EU accession track maintain their process of convergence to the Maastricht Treaty. Inflation is still their main concern, ranging between 5 and 10 per cent in the different countries. Economic growth is expected to remain robust, predicated on a mild slowdown in the euro area and a gradual recovery in world economic activity. Last year growth averaged about 4 per cent for the block, and only a slight moderation is expected this year. One potential risk facing these countries is the level of their current account deficits. This stands as high as 5.5 per cent of GDP in the case of Poland. However, these deficits are usually funded by long-term foreign direct investment (FDI), and under current conditions there is no reason why this will not continue. Finally, Turkey expects to receive a boost from the IMF this year in the form of loans totalling $15.7bn, which will be used to reduce interest rates from recent levels of over 100 per cent and to control inflation.

The UK Economy

The UK economy continues to expand at a healthy pace, despite the impact of short-run supply shocks; such as the foot and mouth disease, disruption to the rail network and a general slowdown in world activity. In the first quarter of 2001, GDP is estimated to have grown by an annual rate of 2.7 per cent. Both fiscal and monetary loosening will boost the domestic economy in the face of a negative contribution from net trade. The fiscal stimulus will come from the government cutting the budget surplus by about 1 per cent of GDP, thus significantly increasing public expenditure. The monetary easing is in the form of interest rate cuts, considered below.

Private consumption has remained very strong, although some slowdown is likely given lower equity prices, a weakening labour market and high debt-income ratios. Manufacturing output has slowed considerably, and increased by only 0.6 per cent on the previous year in the three months to April. Over the same period industrial production was unchanged. The service sector is less affected by the slowdown, with annual output growth of 3.7 per cent in the first quarter. Also, retail sales remain buoyant, rising by 6.4 per cent in the year to May. The foot and mouth epidemic now seems under control, however new cases were still being reported into June. The *National Institute* has estimated that the epidemic will knock about 0.25 per cent from GDP growth this year. Overall, we predict growth of 2.5 per cent for 2001 and 2.7 per cent for 2002.

Inflationary pressures in the UK increased markedly during May. Headline inflation rebounded to 2.1 per cent in May from 1.8 per cent in April. Underlying inflation, which excludes mortgage interest payments rose to 2.4 per cent in April approaching the Monetary Policy Committee's target of 2.5 per cent. The increase was mainly due to food prices resulting from poor weather conditions which hampered planting and harvesting. Oil prices also exerted upward pressure, while housing costs had a negative effect as interest rates fell. Using the internationally comparable Harmonised Index of Consumer Prices (HICP), inflation was 1.7 per cent in May, up from 1.1 per cent in April.

The Monetary Policy Committee has reduced interest rates by 25 basis points on three separate occasions this year, bringing the rate to 5.25 per cent. The rationale behind such monetary loosening was to achieve the medium term inflation target, as inflation has been persistently undershooting the target for many months now. Furthermore, the cuts are intended to boost domestic demand in the face of deteriorating world economic conditions and weakened equity markets. Further rate cuts are likely in the coming months, barring a sudden upturn in inflation or global prospects.

After tightening somewhat in recent months, signs are emerging that the labour market may be close to a turning point. The ILO measure of unemployment fell to 5 per cent in the three months to April, representing a 0.7 percentage point fall over the course of one year. Claimant unemployment remained below one million in May, representing 3.2 per cent of the workforce. However, the rate of decline of the unemployment rate has slowed over the past year, as has the growth in employment. It now looks as if the labour market will stabilise at current levels. The tightness of the labour market is beginning to be reflected in earnings growth, which grew by 5.2 per cent in the three months to April. Up to now wage settlements have shown only moderate increases, helped by the benign inflation situation, but this may be about to change. Finally, productivity continues to grow at long-run average values, and increased at an annual rate of 2.3 per cent in the final quarter of 2000.

The Rest of the World

The high growth rates associated with the recovery in Asia were always likely to moderate, but prospects will be adversely affected by developments in the United States. The downturn in the electronics industry worldwide and sharp falls in regional equity markets will be important contributors to the slowdown. These shocks have asymmetric impacts across regions. The two largest economies, China and India, are less exposed to external developments, and growth should be well maintained. However, many of the emerging economies are more vulnerable to external shocks, and political uncertainty in many of these economies does not improve their investment prospects. Exports, particularly of electronic goods, will fall sharply this year, and this is unlikely to be countered by increased domestic demand. Structural reform in financial and corporate sectors remains critical to boost both domestic and external confidence in many of these economies.

Prospects for the Japanese economy have not improved since the previous *Commentary*. The tentative recovery has stalled, with weak external demand reducing industrial production. Excess inventories of electronic parts will require adjustment, thus keeping industrial production on a downward trend and reducing corporate profits and eventually household incomes. Exports are expected to be the main driver of any growth, helped by the weakness of the yen. However, this is predicated on a recovery in the world economy in the second half of the year and no further deterioration in capital markets. Consumer prices are expected to remain weak, with any upward pressure arising from higher import prices. There is hope that the new Prime Minister and Finance Minister will be able to deliver the structural reforms necessary in the financial sector. Overall, moderate growth of 0.6 per cent is forecast for this year, strengthening to about 1.3 per cent next year.

The Context for Ireland

The extreme openness of the Irish economy means that growth prospects depend fundamentally upon the international economic climate. By the middle of 2001 the major players in the world economy are starting to look more vulnerable to recession. US growth seems to have fallen close to zero in the current quarter and Japan has slipped into another recession. The resilience of the EU in the face of the US economy slowdown has been called into question.[4] Though the euro area is still growing, it has slowed more sharply than had been expected.

It is relatively unusual for a slump to occur in all three major economic blocks simultaneously. Generally over the past couple of decades a decline in one major economy has been offset by a boom elsewhere. It is estimated that, in the three months ending May, the total industrial output of the EU, US and Japan has declined by 0.5 per cent on a year earlier. This contrasts with annual growth of more than 6 per cent on the previous year making for the sharpest-ever annual fall in industrial growth rates.

The start of the 1990s was probably the most notable occasion when the international economy suffered a significant pause in growth. The Irish economy was not immune to that outcome with growth rates being significantly below the trend that was emerging from the late 1980s to the present. While the evidence is still far from clear, it is an alarm call for the Irish economy that the three big economies should now all be slipping at the same time.

[4] Barrell, Ray, 2000. "Strong Growth and Robust Budgets in Europe: Emerging Trend or Developing Cycle", in Alan Barrett (ed.), *Budget Perspectives*, Dublin: The Economic and Social Research Institute.

In addition to sharp slowdown, average inflation in the big three economic blocks has risen at its fastest rate for almost eight years. The combination of slower output growth and rising price has raised the spectre of stagflation. However, while such a prospect should encourage vigilance on behalf on international central bankers, the current inflation spurt generally relates to higher food and energy prices, rather than a re-emergence of generalised inflation impulses in either the US or the EU.

We expect that the ECB will respond to the slowing of output in the euro area towards rates below trend growth by having a further quarter point interest rate cut. This can be justified on the basis that underlying inflationary pressures are likely to see an inflation target of less than 2 per cent being met in 2002 despite the overshoot this year. Some of the interest cuts may be reversed towards the end of 2002 but the prospect is for monetary conditions to be extremely loose for the Irish economy throughout the next eighteen months

The landslide victory for the Labour party in the UK election in June may provide the opportunity for the entry of sterling into the European single currency. If the UK were to join the euro area, it would be a very welcome long-term development for the Irish economy. However, in the first couple of weeks since the election, euro entry speculation has seen sterling begin to decline from its current high exchange rate levels with the euro. Interestingly, sterling has also started to decouple from its tracking with the US dollar in recent years. The expectation is that the entry rate for sterling could be up to 20 per cent lower than current values. This would imply a significant deterioration in Ireland's cost competitiveness in trade with the UK.

In the context of lower world demand, the competitiveness of the Irish economy as an export base will be crucial to ensure a continuing rise in living standards. Rising domestic labour cost increases in excess productivity growth and an expected appreciation in the euro to a level more consistent with its fundamentals will erode some of the super competitiveness enjoyed by the Irish economy in recent years. We still expect the euro to reach parity with the dollar by early next year, particularly when the actual currency finally goes into circulation.

TABLE 1: Short-term International Outlook

	GNP		Consumer Prices		Hourly Earnings		Unemployment Rate		Current Account Balance	
	Percentage Change						%		% of GNP	
Country	**2001**	**2002**	**2001**	**2002**	**2001**	**2002**	**2001**	**2002**	**2001**	**2002**
UK	2.5	2.7	2.1	2.4	5.2	5.3	5.1	5.3	-1.7	-1.9
Germany	2.1	2.2	2.3	1.7	2.2	2.5	8.4	8.2	-0.9	-0.8
France	2.6	2.5	1.6	1.5	3.4	3.3	8.8	8.5	1.7	1.8
Italy	2.3	2.4	2.5	2.2	2.9	2.9	9.9	9.4	-0.1	-0.3
Total EU	2.5	2.6	2.4	2.2	3.1	3.6	7.8	7.6	-0.2	-0.1
USA	1.6	2.5	2.6	2.3	4.5	4.5	4.5	4.7	-4.3	-4.1
Japan	0.6	1.3	-0.5	-0.2	0.1	0.9	5.1	5.1	2.2	2.3
Total (OECD)	2.0	2.8	2.9	2.6	3.6	3.9	6.3	6.3	-1.3	-1.2
Ireland	6.0	5.4	4.8	3.3	10.8	10.0	3.6	3.5	-1.1	-2.0

The restoration of international export markets and the lifting of domestic restrictions in response to the avoidance, thus far, of widespread foot and mouth disease in Ireland provide a positive context for international trade in the agriculture and tourism sectors.

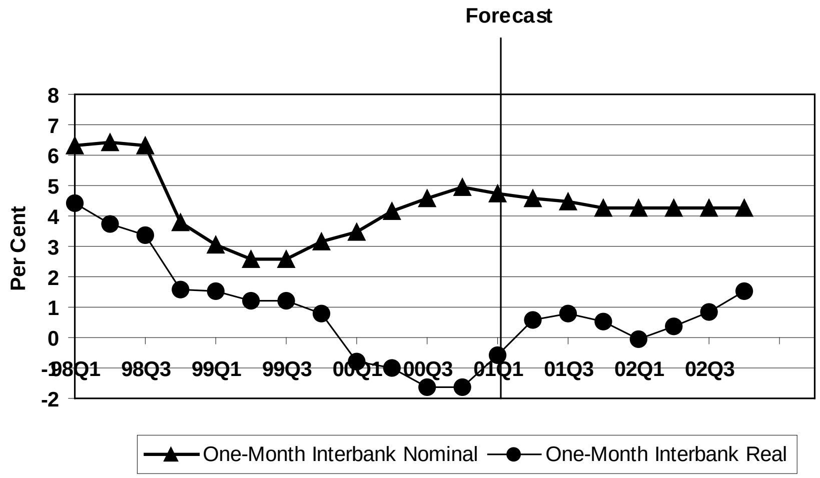
The Domestic Economy

General

The publication of the balance of payments for 2000 shows that the current account has moved into deficit for the first time in nine years. In the context of monetary union this indicator has diminished significance for the economy in terms of pressures it would impose on an independent money supply. However, it is indicative that domestic demand pressures are rising significantly altering the balance away from foreign demand providing the major growth stimulus.

On the basis of the Quarterly National Accounts available for the first

Figure 1: Interest Rates
Per Cent Per Annum, Quarterly Averages



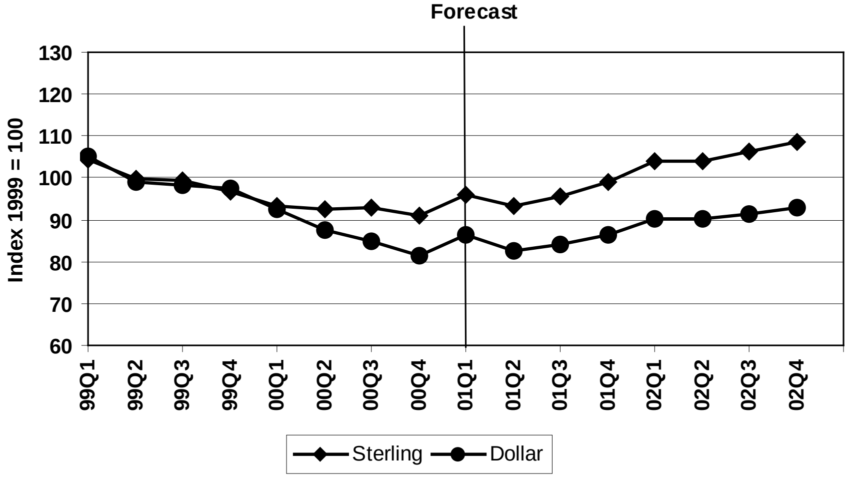
three quarters of 2000, record real growth rates were experienced last year. We have revised our estimate that output grew around 11 per cent in real GDP terms and 10 per cent in GNP terms. This record year will provide a substantial carryover of growth into 2001.

While there have been a significant number of indicators suggesting a substantial slowdown in growth in the first half of 2001, the benign view we took in the last *Commentary* as regards the US slowdown and the foot and mouth crisis looks to be broadly holding. With the euro continuing to languish longer than we had anticipated, we have revised our forecast for real GDP growth slightly upwards to 7 per cent in 2001 and 6.4 per cent in 2002.

Exports

Visible exports in 2000 increased by over 24 per cent in value terms to reach £65.5 billion and by 17.6 per cent in volume. Detailed trade statistics show that almost all categories of exports showed an increase in value, with strong increases recorded in the value of organic chemicals, electrical machinery, and office equipment exports. Geographically there was a large rise in the value of exports to the US, up by nearly 38 per cent, while visible exports to the UK rose by 23.3 per cent. Balance of Payments statistics for the year show that receipts from tourism and travel rose by 15.7 per cent and exports of other services increased by 19.6 per cent in value terms. Total exports of goods and services are therefore estimated to have increased by 25.3 per cent in value and 18.5 per cent in volume, implying a price deflator of 5.7 per cent.

Figure 2: Exchange Rates
Foreign Currency per Euro, Quarterly Averages, 1999=100



Preliminary figures for the first quarter of this year show an increase of 26.3 per cent in the value of total visible exports. An examination of the figures for external trade with non-EU countries reveals some quite surprising trends. The value of exports to non-EU destinations is shown to have risen by 44 per cent, with exports to the US up by 58 per cent. Exports of organic chemicals are shown to have increased by 97 per cent, electrical machinery by 74 per cent, and computers by over 31 per cent in value terms. In 2000 the largest category of exports to the US were organic chemicals, accounting for over 47 per cent. Other important categories were medical and pharmaceutical products, 9.3 per cent, office machinery 11.5 per cent, and electrical equipment at 7.7 per cent.

However, even allowing for some carryover of activity from the last quarter of 2000, it seems unlikely that this pace of expansion will continue. The slowdown in world economic activity, particularly the slowdown in the US, will reduce demand while some appreciation of the euro and domestic capacity constraints are expected to have an adverse impact on competitiveness. These factors are forecast to result in visible export volume growth slowing to 12.1 per cent this year. With the price deflator for exports forecast at 4 per cent, visible exports are expected to grow by 16.5 per cent this year in values, with the increase in merchandise exports likely to be much the same.

TABLE 2: Exports of Goods and Services

Preliminary

	1999 £m	% Change in 2000 Volume	% Change in 2000 Value	2000 £m
Agricultural	3,189	6.3	9.5	3,491
Manufactured	44,744	18.8	25.7	56,239
Other Industrial	3,884	8.0	13.8	4,421
Other	916	37.7	45.3	1,330
Total Visible	**52,732**	**17.6**	**24.2**	**65,481**
Adjustments	-3,153	-19.2	**-15.2**	-2,674
Merchandise	**49,579**	19.9	26.7	**62,807**
Tourism	1,898.2	9.2	15.8	2,197
Other Services	8,983.5	12.7	19.6	10,747
Exports of Goods And Services	**60,461**	**18.5**	**25.3**	**75,751**

Forecasts

	2000 £m	% Change in 2001 Volume	% Change in 2001 Value	2001 £m	% Change in 2002 Volume	% Change in 2002 Value	2002 £m
Agricultural	3,491	1.0	4.8	3,660	2.2	5.3	3,853
Manufactured	56,239	13.5	18.0	66,384	10.2	14.1	75,716
Other Industrial	4,421	5.2	9.0	4,819	3.0	6.6	5,137
Other	1,330	3.2	7.4	1,429	2.3	5.5	1,507
Total Visible	**65,481**	**12.1**	**16.5**	**76,292**	**9.2**	**13.0**	**86,213**
Adjustments	-2,674	12.0	15.4	-3,085	15.0	3.5	-3,193
Merchandise	**62,807**	**12.1**	**16.6**	**73,207**	**9.0**	**13.4**	**83,020**
Tourism	2,197	2.0	5.6	2,320	1.4	5.1	2,437
Other Services	10,747	9.80	14.2	12,273	9.0	13.4	13,912
Exports of Goods And Services	**75,751**	**11.5**	**15.9**	**87,799**	**8.8**	**13.2**	**99,369**

Figures for 2000 show that the number of visitors to Ireland from abroad rose by 5.8 per cent. The UK continues to be the largest origin market, accounting for 55 per cent of visitors. Given the impact of foot and mouth disease on the first half of this year coupled with some loss of competitiveness, we have reduced our forecast for growth in tourism exports over the next two years. A value increase of 5.6 per cent is forecast for 2001 and a further small decline to growth of 5.1 per cent in 2002. Other service exports are expected to grow by 14.2 per cent this year and by 13.4 per cent in value terms in 2002. On this basis, total exports of goods and services are projected to increase by 15.9 per cent in value in 2001 and by 13.2 per cent in 2002. We forecast volume increases of 11.5 per cent and 8.8 per cent for 2001 and 2002 respectively. This implies a price deflator of 4 per cent for both this year and next. While the growth rates presented here represent a slowdown it should be remembered that 2000 appears to have been an exceptional year for economic growth.

Stocks

The contribution of stock changes to economic growth in 2001 is very uncertain. Given the slowdown in international export markets and the impact of the agricultural crises in Europe it would be anticipated that stock building would rise. However, export growth been very strong in the first quarter of the year and the unwinding of stock holding can be anticipated in response to the lifting of restriction on livestock movements. The change in stocks in value terms is forecast to fall by £142 million in 2001 but rebounding in 2001 to rise by £135 million in 2002.

TABLE 3: Stock Changes

	1999	Change in Value	2000	Change in Value	2001	Change in Value	2002
	£m	£m	£m	£m	£m	£m	£m
Farm Stocks	-130	97	-33	-107	-140	175	35
Irish intervention Stocks	-166	166	0	0	0	0	0
Other Non-Agricultural Stocks	239	-54	185	-35	150	-40	110
Total	**-57**	**209**	**152**	**-142**	**10**	**135**	**145**

Investment

Although the preliminary figures from the Quarterly National Accounts are subject to revision they do point to a somewhat lower rate for growth in the value and volume of gross fixed capital formation in 2000 than in the previous year. This is evident from the imports of capital goods that also increased at a slower rate, albeit a rate that remained quite strong. Our forecast for the volume growth in investment in 2000 has therefore been revised down marginally to 10.2 per cent.

With the market for both residential and non-residential private construction showing signs of slowing, the volume of investment in building and construction is forecast to show a small rise of 1.9 per cent in volume terms in 2001. Much of the development in this sector will be as a result of public construction as the volume of housing construction is forecast to decline this year. The number of house completions in 2000 reached 49,812 units, once again a record level of construction. However, figures for 2000 show that the number of "Homebond" (new house guarantee) registrations was substantially lower than the previous year. Under this scheme houses are generally registered prior to commencement of construction and so registration can serve as a useful leading indicator.

Overall, therefore, we are forecasting that the number of new house completions this year will be lower than in 2000, although still remaining high by historical standards. House prices and prices in other building are still expected to rise by 11.6 per cent and so a value increase for building and construction of 13.8 per cent is forecast for 2001. With the economy continuing to expand, further growth in investment in machinery and equipment is anticipated. Thus, gross fixed capital investment is forecast to grow by 3.9 per cent in volume terms and by 13.3 per cent in value, implying a price deflator of 9.1 per cent.

A volume increase of 8 per cent in public investment is expected to be the main driver of growth in 2002. A continuation of house price increases and the strength of factors underpinning demand means that we expect the number of new house completions to remain high. With a small increase in the volume of investment in machinery and equipment gross fixed capital formation is forecast to grow by 6.3 per cent. A lower price deflator than in previous years results in the value of total investment being forecast to grow by 13.6 per cent in 2002.

TABLE 4: Gross Fixed Capital Formation

Preliminary

	1998 £m	% Change in 1999 Volume	Value	1999 £m
Housing	5,209	7.5	25.7	6,546
Other Building	4,836	9.2	20.3	5,820
Building and Construction	10,045	8.3	23.1	12,366
Machinery & Equipment	6,130	13.2	19.5	7,327
Total	16,175	10.2	21.8	19,693

Forecasts

	1999 £m	% Change in 2000 Volume	Value	2000 £m	% Change in 2001 Volume	Value	2001 £m
Housing	6,546	-3.0	9.3	7,156	3.8	12.7	8,066
Other Building	5,820	7.5	18.8	6,913	8.0	16.7	8,071
Building and Construction	12,366	1.9	13.8	14,069	5.9	14.7	16,138
Machinery & Equipment	7,327	7.2	12.6	8,248	7.0	11.8	9,222
Total	19,693	3.9	13.3	22,317	6.3	13.6	25,360

Consumption

Retail sales figures for the first quarter of this year show moderation in the growth of both the value and volume of sales for all businesses. To some extent this was to be expected given the decline in the number of new car registrations from last year in response to exceptional demand for the millennium 00 number plate. Excluding the motor trade from the index shows that underlying retail sales have remained quite strong in the first three months of this year. Concerns about the US economy, the impact of foot and mouth disease and worries about future job prospects are likely to result in higher levels of caution than in recent years.

The new special savings incentive scheme should also encourage some increase in savings, although how much of this will be displacement remains to be seen. However, interest rates have recently been reduced and disposable incomes received a boost in tax cuts introduced in April from Budget 2001. Economic prospects for 2001 do appear somewhat brighter than at the beginning of the year. Accordingly, our forecast for growth in personal consumption has been marginally increased for this year to 7.4 per cent. An expected price deflator of 4.8 per cent results in a forecast value increase of 12.6 per cent for this year.

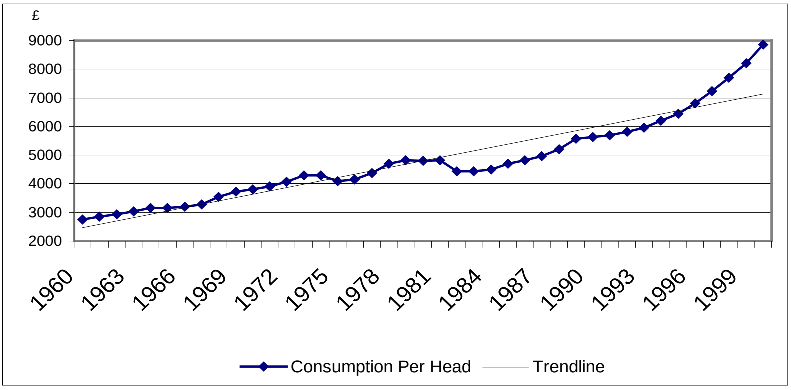
With employment growth forecast to slow and a changed perception of job security, growth in personal consumption is likely to slow marginally next year to a volume change of 7 per cent. With price inflation expected to be lower the increase in the value of personal consumption projected for 2002 is 11.2 per cent.

Box 2: Trend in Personal Consumption

Consumer spending has increased rapidly in recent years growing in tandem with the record growth rates in the Irish economy. Despite declining as a share of GDP from 61 per cent in 1991 to 50 per cent in 1999, consumer spending has grown far in excess of international averages throughout the decade. In real terms the average rate of growth of personal consumption was 5.8 per cent between 1995 and 1999, in comparison to 2.2 per cent on average between 1990 and 1994. The acceleration of consumer spending in the second half of the 1990's can be traced to a number of factors.

Most importantly strong output growth in the economy since the mid-1990s has translated into large increases in disposable income and in turn to consumer spending. In addition, interest rates in nominal terms have declined since the early 1990s.

Figure 2A: Personal Consumption Trends 1960-2000



Tightening of fiscal policy throughout Europe as a part of the desire to join EMU lead to a decline in long-term interest rates. In addition, the sustained success of European monetary authorities in containing inflationary pressures throughout the decade allowed for interest rates to be reduced. The cumulative effect of a fast growing economy in the context of a loosening monetary stance has been an important backdrop for the consumer confidence that has underpinned the exceptional Irish personal consumption growth experienced in recent years.

Furthermore consumption growth has benefited from positive wealth effects as the stock of wealth increased throughout the 1990s as the result of sustained income growth. In addition an improved demographic position has also encouraged consumption with a greater proportion of the population being in the younger cohorts with a traditionally higher propensity to consume. The decline of the dependency ratio, that is the population relative to those in employment, has contributed to increased consumption per head. Inward migration has led to the working age population increasing its weight in the population.

Figure 2A illustrates consumer spending per head at constant 1995 prices. A trend line is fitted over the period 1960-2000, with the estimated annual trend growth of 2.5 per cent. For the first half of the period, actual consumption per head does not deviate significantly from the trend.

However, consumption per head diverges from the trend in the 1980s and early 1990s. In recent years the growth of consumption has lead to a significant divergence above the trend.

Primarily, the divergence from trend in the 1980s was the result of weak output growth. In addition, tight monetary policy throughout Europe and the United States subdued consumption as monetary authorities moved to control inflation by raising interest rates. Consumption growth did begin to converge in the late 1980s. However, this was delayed by the tightening of monetary policy throughout Europe as a result of German reunification.

Given the exceptional performance of the economy in recent years it is uncertain whether consumption per head will return to its overall trend growth in the future. On one hand, recent growth in consumption may represent an element of catch-up due to the previous protracted period of below trend consumption. If this is the case consumption growth will slow in the future so that on average consumption remains close to the overall trend over time.

Alternatively, the exceptional magnitude of consumption growth may be the result of an upward rise in the Irish economy's growth potential. In this case consumption growth would be moving on a new trend not captured in Figure 1A. The recent exceptional growth in consumption can therefore be seen in the context as facilitating the shift of consumption growth from one trend to the other.

In summary, the growth in personal consumption in recent years can be explained partly by an economy close to its cyclical peak but also in terms of a structural change. With GDP growth in the economy forecast to slow in 2001 and 2002 consumption growth can be expected to slow similarly to more sustainable rates. However, with potential growth of GDP estimated to be in the region of 5 per cent and long-term interest rates remaining low, consumption growth should remain consistently above its historical trend.

Our forecast for government consumption has been increased marginally to 5.3 per cent in volume terms for this year on the basis of current policies. With a lower price deflator assumed for next year the value rise in government consumption is forecast at 9.9 per cent in 2002 with a volume increase of 5.2 per cent.

TABLE 5: Consumption Indicators

	Annual Percentage Change						
	1996	1997	1998	1999	2000	2001 Forecast	2002 Forecast
Consumption Value							
NIE 1997, Personal Consumption	9.1	10.2	11.9	11.3	15.9	12.6	11.2
Retail Sales Index, Value	8.3	9.0	9.5	11.4	16.3	12.5	10.7
Divergence	0.8	1.2	2.4	-0.1	-0.4	0.1	0.5
Consumption Volume							
NIE 1997, Personal Consumption	6.3	7.4	7.8	7.7	9.5	7.4	7.0
Retail Sales Index, Volume	6.2	7.9	7.8	9.5	11.9	7.8	7.1
Divergence	0.1	-0.5	0.0	-1.8	-2.4	-0.4	-0.1
Consumer Prices							
NIE 1997, Personal Consumption Deflator	2.6	2.6	3.8	3.3	5.8	4.8	3.9
Retail Sales Index Deflator	2.0	1.0	1.6	1.7	3.9	4.4	3.4
Consumer Price Index	1.6	1.5	2.4	1.6	5.6	4.8	3.8

Final Demand

In 2001, final demand is forecast to rise by 8.8 per cent in volume and by 14.5 per cent in value. The volume increase in final demand in 2002 will be slightly lower at 7.8 per cent. With inflation also expected to be somewhat lower the current price increase in final demand is forecast to slow to 12.6 per cent in 2002, continuing to represent strong growth. Much of the reduction in growth in final demand from previous years is due to substantially lower export growth rates this year and next.

Imports

Visible imports in 2000 are estimated to have increased by 24 per cent in value and by 15.1 per cent in volume. The estimated rise in annual average import prices of 7.7 per cent is unsurprisingly large given the weakness of the euro against sterling and the US dollar. The functional classification of imports shows that imports of materials for further industrial production increased particularly strongly at 28.3 per cent.

On the basis of our forecast of final demand, visible imports will show lower annual growth in 2001 than in 2000. Total visible imports are forecast to grow by just over 10 per cent in volume and 14.9 per cent in value. The implied rise in average import prices is projected to fall to 4.3 per cent this year. A more modest, but still substantial increase in tourist expenditure abroad is forecast for this year. Slower growth in final demand is likely to be reflected in the expected rise in other service imports. On this basis total imports of goods and services are forecast to increase by 10.7 per cent in volume and 15.4 per cent in value in 2001.

Based on the forecast moderation in economic activity in 2002 we anticipate that import volume growth will also slow. Visible imports are projected to grow by 7.6 per cent in volume and by 11.2 per cent in value implying a price deflator of 3.4 per cent. Increases in personal disposable income will underpin growth in tourist expenditure abroad and imports of other services are expected to show some increase. We forecast total imports of goods and services are forecast to increase by 9.2 per cent in volume and by 13.2 per cent in value in 2002.

TABLE 6: Imports of Goods and Services

Preliminary

	1999 £m	% Change in 2000 Volume	% Change in 2000 Value	2000 £m
Capital Goods	5,129	13.3	22.8	6,299
Consumer Goods	7,393	12.4	22.0	9,016
Intermediate Goods:				
Agriculture	575	14.2	20.4	692
Other	20,073	18.2	27.1	25,506
Other Goods	1,709	-4.0	1.8	1,739
Total Visible	**34,879**	**15.1**	**24.0**	**43,253**
Adjustments	-3,203	-13.6	-20.5	-2,546
Merchandise Imports	**31,676**	**18.0**	**28.5**	**40,706**
Tourism	1,829	12.8	21.1	2,216
Other Services	17,473	17.5	26.3	22,070
Imports of Goods and Services	**50,978**	**17.6**	**27.5**	**64,992**

Forecasts

	2000 £m	% Change in 2001 Volume	% Change in 2001 Value	2001 £m	% Change in 2002 Volume	% Change in 2002 Value	2002 £m
Capital Goods	6,299	9.8	14.4	7,206	12.3	15.7	8,336
Consumer Goods	9,016	9.4	13.6	10,239	9.3	12.8	11,549
Intermediate Goods:							
Agriculture	692	2.0	6.1	734	5.2	7.3	788
Other	25,506	11.0	16.2	29,642	6.1	9.9	32,583
Other Goods	1,739	5.8	8.2	1,882	4.5	7.6	2,026
Total Visible	**43,253**	**10.1**	**14.9**	**49,704**	**7.6**	**11.2**	**55,282**
Adjustments	-2,546	10.0	10.0	-2,801	15.0	15.0	-3,221
Merchandise Imports	**40,706**	**10.1**	**15.2**	**46,903**	**7.1**	**11.0**	**52,061**
Tourism	2,216	9.0	13.5	2,515	9.8	13.9	2,863
Other Services	22,070	12.0	15.9	25,583	13.0	17.3	30,008
Imports of Goods And Services	**64,992**	**10.7**	**15.4**	**75,002**	**9.2**	**13.2**	**84,932**

Balance of Payments

The fourth quarter balance of payments estimates showed that the current account balance moved into deficit in 2000. A high deficit on services was one of the factors contributing to the decline. The forecasts for exports and imports already presented indicate that the surplus on trade in goods and services will increase by nearly 19 per cent this year, although as the slowdown in economic activity takes effect this is expected to fall to growth of 12.8 per cent in 2002. This will be driven mainly by deterioration in the service trade balance.

On the basis of our estimate of export and import values it now seems likely that the visible trade surplus increased by over 23 per cent in 2000, to £22,021 million, or nearly 32 per cent of estimated GNP. The deficit on trade in services is also believed to have increased sharply by nearly 21 per cent. These forecasts indicate that the growth in the surplus in trade in goods and services is estimated to have been 22.5 per cent.

With lower levels of output growth in the multinational dominated high-tech sectors, lower growth is forecast for reinvested earnings in 2001 and 2002. However, the need to underpin profitability given the corporate slowdown internationally means that we expect higher growth this year in distributed profits. Once again, this will taper off next year reflecting lower activity levels in 2001.

When these factors are taken into account, as well as some minor revisions to our credit flow forecasts, net factor outflows are forecast to increase by over 17 per cent in value during 2001 and by 16.2 per cent in 2002. The result of this is a widening deficit on the current account, from 1.1 per cent of GNP in 2001 to 2 per cent in 2002.

TABLE 7: Balance of Payments

	1999 £m	Change %	2000 £m	Change %	2001 £m	Change %	2002 £m
Visible Trade Balance	17,853	24.5	22,229	19.6	26,587	16.3	30,931
Adjustments	51		-128		-284		28
Merchandise Trade Balance	**17,903**	**23.4**	**22,101**	**19.0**	**26,303**	**17.7**	**30,959**
Service Trade Balance	-8,420	34.7	-11,342	19.1	-13,506	22.3	-16,522
Trade Balance in Goods and Services	**9,483**	**13.5**	**10,759**	**18.9**	**12,797**	**12.8**	**14,437**
Total Debit Flows	-28,505	34.2	-38,254	17.8	-45,071	13.3	-51,054
Total Credit Flows	18,517	40.7	26,057	18.2	30,789	11.9	34,458
Net Factor Flows	**-9,988**	**22.1**	**-12,197**	**17.1**	**-14,283**	**16.2**	**-16,596**
Net Current Transfers	**951**	-2.8	**924**	**-35.5**	**596**	**-26.8**	**436**
Balance on Current Account	**446**		**-514**		**-889**		**1,723**
Capital Transfers	441	41.7	625	-15.2	530	-7.5	490
Effective Current Balance	**887**		**111**		**-359**		**-1,233**

Although this widening of the deficit is no longer important from a domestic currency viewpoint it does indicate that demand levels within the economy continue to outstrip supply capabilities. Given the magnitude of the flows in either direction, the surplus or deficit is very small by comparison and it could possibly be turned around on revision. However, the trend in recent years is for the current account to move towards deficit indicative of the overheating pressures in the economy.

Gross National Product

Our estimates for the volume growth of both GDP and GNP in 2001 have been revised to 7 per cent and 6 per cent respectively. The increase in our GDP forecast is primarily due to an increase in the estimated volume of exports and would have been much higher were it not for a large downward revision to our forecast for investment from the previous *Commentary*.

Current estimates indicate a loss in the terms of trade in 2001, with export prices rising fractionally less than import prices. Allowing for a fall in the volume of net current transfers, real gross national disposable income (GNDI) is estimated to have risen by 5.2 per cent.

Although there have been some revisions to the composition of growth in 2002 our volume growth forecasts for GDP and GNP are essentially unchanged at 6.4 per cent and 5.4 per cent respectively. A significant terms of trade gain seems likely in 2002. When current transfers are taken into account, GNDI is forecast to increase in 2002 by 5.6 per cent in volume terms.

Agriculture

The prospects for the agricultural sector remain uncertain despite the success of measures aimed at preventing the widespread outbreak of foot and mouth disease (FMD) in Ireland. Following on from strong growth in 2000 a contraction of output in agriculture is expected this year. However, activity is expected to rebound in the second half of this year and in 2002 assuming no further outbreak of FMD. Agricultural exports should benefit from increased demand, particularly in the UK, and also from the re-opening of export markets.

In addition, the relaxation of restrictions on activity within the beef, pig and sheep sectors should also provide a positive stimulus to growth. It is forecast that in terms of gross domestic product in agriculture, forestry and fishing in 2001, the fall in value will be about 6 per cent. Growth is expected to recover in 2002 with output expected to grow by some 8 per cent in value terms.

Industry

While the volume of production index for manufacturing rose by 15.1 per cent in 2000, recent data releases suggest a moderation of growth is occurring in 2001. Despite showing a slight rebound in April, the index of industrial production indicates a deceleration of output growth in the first quarter of the year. Further evidence from the IBEC/ESRI Business Survey and the NCB Purchasing Managers index point to a slowdown in industrial activity.

The rate of expansion in the manufacturing sector, in particular, has slowed considerably to its weakest level in over three years. The downturn in the information and communications technology (ICT) sectors has contributed to the slowdown in manufacturing. It is expected that the moderation of industrial output growth will continue throughout the year in line with the overall slowdown in the economy. The gross output of the broad industry sector is forecast to grow at a still robust rate of 8.2 and 7.5 per cent in 2001 and 2002 respectively.

The main risk to these forecasts is the impact of the US slowdown for the manufacturing sector, in particular for the ICT sector. Despite some high profile employment cuts and investment postponements, the effect of the US slowdown thus far has been limited. The prolonged weakness of the euro has maintained competitiveness in the short term and softened the impact of reduced demand. More importantly, however, a large proportion of exports particularly in the ICT sector are intended for European markets where demand remains relatively robust if slowing. If slowdown in the US is relatively short lived, the European market may remain buoyant without a significant fall in ICT spending such that the impact on Ireland will be fairly muted. It is still likely though that further cost cutting exercises will lead to some additional job losses in the ICT sector.

Services

The impact of the limited foot and mouth outbreak in Ireland in early 2001 is likely to have caused some slowdown in the services sector as measures on containment had knock on consequences for a wide range of activities such as distribution and tourism. Business activity as captured in the NCB Purchasing Managers Index for Services declined in April before recovering by June as demand grew when FMD restrictions began to be relaxed.

We have revised upwards our forecast for volume growth to 6.7 per cent for 2001 on the expectation of a strong rebound in the second half of the year. The expectation is for further robust growth of 5.2 per cent in volume terms in 2002. The main contribution to these growth estimates stem from the private sector this year. Next year, with the economy slowing the planned rise in public sector employment and expenditure will make a bigger contribution to services output growth than previously.

Employment

Employment growth continues to slow in the Irish economy. The latest Quarterly National Household Survey (QNHS) for the first quarter of 2001 shows that on an annual basis employment grew by 59,300 or some 3.6 per cent. This compares with annual growth of 3.8 per cent in the fourth quarter of 2000. Total employment in the economy stood at 1.710 million in the first quarter of the year almost unchanged from the previous quarter. While by international standards employment growth remains strong, the trend towards an overall slowdown remains.

In part the slowdown in employment growth is due to constraints imposed by the slowing of labour force growth. The labour force grew at an annual rate by 2.5 per cent or some 43,300 persons in the first quarter of the year. The magnitude of the slowdown becomes apparent considering that annual labour force growth in the first quarter of 2000 was twice the current rate at 5 per cent or some 82,000 persons. In total the labour force now stands at 1.776 million accounting for 58.9 per cent of all persons aged 15 and over, up from 58.6 per cent in the corresponding quarter of last year.

In terms of unemployment the QNHS indicates that the unemployment rate has fallen to 3.7 per cent in the first quarter of 2001. This compares with 3.9 in the fourth quarter of 2000. The annual fall in unemployment was 15,900 constituting a one percentage point fall in the unemployment rate from the first quarter of last year. The decrease was equally split between long- term and short-term unemployment. On the other hand the Live Register Statement for May 2001 showed an increase of 2,100 persons when seasonal factors are taken into account. In total the Live Register fell by 19,180 in the year to May 2001.

The tightness of the labour market is indicated by the increase in the rate and level of vacancies in the economy last year. The vacancy rate is estimated to be 6.5 per cent in 1999/2000 compared to 5.8 in 1998/99. The level of vacancies is estimated to be 77,600, a rise of 12,900 on the previous year.[5] The extent of the vacancies nationally and the large numbers on the Live Register has raised the question about the employability and the difficulties faced by those on the register taking up a job. A recent study found that people who suffer reduced levels of employability tend to be older, with low levels of education, are rurally based and have limited attachment to the labour market.[6] The numbers requiring extensive interventions to improve employability were found to be rather small suggesting that active management of the Live Register could help increase somewhat the pool of employable labour.

In addition the increased number of work permits issued to foreign nationals this year will help to address labour shortages. Over 14,000 work permits have been issued in 2001 thus far as compared with 18,000 in total for the year 2000. Similar increases in working visas and work authorisations, aimed at skilled professions, should allow extremely tight sectors of the labour market to be partly relieved.

It is forecast that total employment for the year 2001 will average 1.747 million persons rising to 1.781 million in 2002. In percentage terms numbers employed are expected to increase by 3.2 per cent this year and 1.9 per cent in 2002. Employment in services is forecast to grow most strongly in 2001 at 4.2 per cent. However, the brunt of the slowdown in employment growth is expected to be in the services sector with employment forecast to slow to 2.2 per cent in 2002.

Unemployment rates are expected to continue falling with an annual average of 3.6 per cent forecast for 2001 falling to 3.5 per cent in 2002. These rates suggest that the economy is moving ever closer to full employment with frictional employment, where workers move between jobs making up the bulk of remaining unemployment. For these reasons only a marginal decline of 0.1 of percentage point in the unemployment rate is forecast for 2002 despite strong growth in the economy. Labour shortages in the context of slowing labour force growth are combining to place capacity constraints on the economy limiting the scope for employment growth and any further decline of unemployment.

TABLE 8: Employment and Unemployment*

		Annual Averages '000		
	1999	**2000**	**2001**	**2002**
Agriculture	139	130	127	125
Industry	459	488	500	511
Services	1,018	1,075	1,120	1,144
Total at Work	**1,616**	**1,692**	**1,747**	**1,781**
Unemployed	95	76	65	64
Labour Force	**1,711**	**1,768**	**1,812**	**1,845**
Unemployment Rate %	5.6	4.3	3.6	3.5
Live Register	193	156	130	125

*All data (including the unemployment rate) are based on ILO definitions, except for the Live Register.

[5] Williams, James, Sylvia Blackwell and Gerard Hughes, 2001. *National Survey of Vacancies in the Private Non-Agricultural Sector 1999/2000*, Dublin: Report by the ESRI for FÁS and Forfás.

[6] Barrett, Alan, Christopher T. Whelan and J.J. Sexton, 2001. *Employability and Its Relevance for the Management of the Live Register*, *ESRI Policy Research Series* No. 40, Dublin: The Economic and Social Research Institute.

Incomes

Incomes continue to grow at historically high levels reflecting the strong growth of the economy. As a result of record employment growth, the growth of incomes in 2000 is expected to be significantly greater than 1999. The rise in incomes is expected to decline somewhat in 2001 and 2002 reflecting the expected slowdown in the economy as a whole.

Agricultural incomes grew strongly in 2000 as a result of large output growth and subsidies received under the EU Agenda 2000 package. Agricultural incomes are expected to contract this year by 5.6 per cent as a result of the adverse effects from the foot and mouth crisis. The estimated contraction of agricultural incomes has been revised downwards from the last *Commentary* however. Containment policies have been successful in preventing the outbreak of foot and mouth spreading throughout the country. Assuming a regional containment of foot and mouth it is estimated that the economic effects of the crisis will be felt most severely in the second quarter of the year with some recovery in incomes thereafter. Agricultural incomes are expected to rebound strongly in 2002 with forecast growth of 8.5 per cent.

Continued strong wage growth is forecast at 10.8 per cent and 10 per cent for 2001 and 2002 respectively. The growth in wages is in part due to the large increases agreed under the revised terms of the Programme for Prosperity and Fairness (PPF). The tightness of the labour market continues to contribute to large wage growth particularly in the private sector.

The non-agricultural wage bill for the economy as a whole is expected to grow by 14.9 per cent and 12.4 per cent in 2001 and 2002 respectively. National income is forecast to grow by 14 per cent this year and by 11.5 per cent in 2002. This implies that after a sustained period of decline throughout the last decade and in 2000, the share of non-agricultural wages in national income is set to increase this year and next. This trend is indicative of an economy approaching full employment with labour shortages leading to an acceleration of wage growth.

TABLE 9: Personal Disposable Income

Preliminary

	1999	Change		2000
	£m	%	£m	£m
Agriculture, etc.	2,071	11.3	233	2,304
Non-Agricultural Wages,	28,086	14.0	3,943	32,029
Other Non-Agricultural Income	9,811	22.3	2,187	11,998
Total Income Received	**39,968**	**15.9**	6,362	**46,330**
Current Transfers	7,568	5.2	**392**	7,960
Gross Personal Income	**47,536**	**14.2**	6,754	**54,290**
Direct Personal Taxes	9,512	14.8	1,410	10,922
Personal Disposable Income	**38,024**	**14.1**	**5,345**	**43,369**
Consumption	34,743	15.9	5,507	40,250
Personal Savings	3,281	- 5.0	-163	3,119
Savings Ratio	8.6			7.2

Forecasts

	2000	Change		2001	Change		2002
	£m	%	£m	£m	%	£m	£m
Agriculture, etc.	2,304	-5.6	-129	2,175	8.5	185	2,360
Non-Agricultural Wages,	32,029	14.9	4,772	36,801	12.4	4,558	41,359
Other Non-Agricultural Income	11,998	9.6	1,157	13,155	10.2	1,337	14,492
Total Income Received	**46,330**	**12.5**	**5,800**	**52,131**	**11.7**	**6,080**	**58,211**
Current Transfers	7,960	14.5	1,152	9,112	10.4	944	10,056
Gross Personal Income	**54,290**	**12.8**	**6,952**	**61,243**	**11.5**	**7,024**	**68,267**
Direct Personal Taxes	10,922	10.7	1,164	12,085	11.3	1,360	13,445
Personal Disposable Income	**43,369**	**13.3**	**5,789**	**49,158**	**11.5**	**5,664**	**54,821**
Consumption	40,250	12.6	5,053	45,304	11.2	5,062	50,365
Personal Savings	3,119	23.6	735	3,854	15.6	602	4,456
Savings Ratio	7.2			7.8			8.1

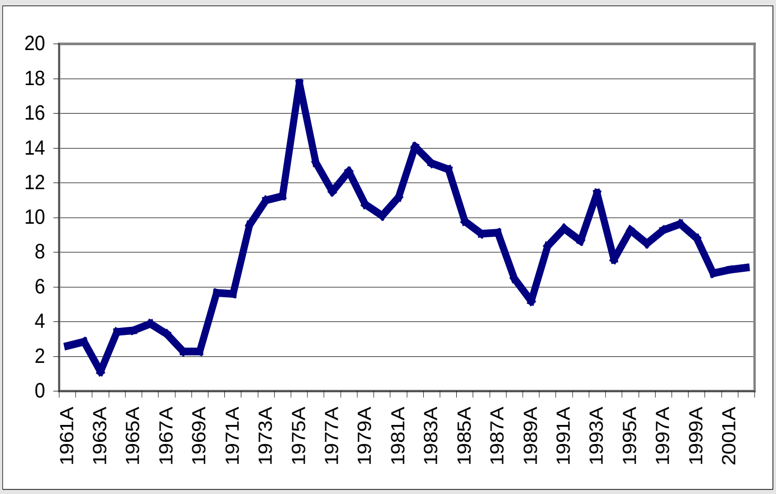
The protracted weakness of the euro continues to maintain Ireland's highly competitive position. While the euro is expected to appreciate somewhat in 2001 this is not expected to significantly affect incomes this year. Margins and profitability are expected to remain strong although the effect of weakening external demand will have a negative influence, particularly on the multinational sector. The growth of net factor payment is forecast to be 17.1 per cent this year slowing to 16.2 per cent in 2002.

Other non-agricultural incomes, representing mainly personal income from profits and rents; are expected to grow by 9.6 per cent in 2001 and by 10.2 per cent in 2002. Personal savings are expected to grow by 23.6 per cent in 2001 and 15.6 per cent in 2002, having declined in the preceding years. See Box 3 for an examination of personal savings in Ireland.

Box 3: Savings in the Irish Economy

Total saving within the economy can be divided into public and private sector saving. Private sector saving can be broken down into personal saving and company saving. Public sector saving is the excess of current revenue over current expenditure, the exchequer surplus. Company saving consists primarily of undistributed profits, while personal savings is the portion of personal income which is not used to purchase goods and services or to pay taxes. Since the mid-1990s the government has moved from a position where expenditure was greater than revenue – public sector dis-saving – to the current situation of large surpluses. Figures from the National Income and Expenditure accounts show that there have also been a number of large increases in the level of company savings over the same time period.

Figure 3A: Personal Saving Ratio 1960-2002

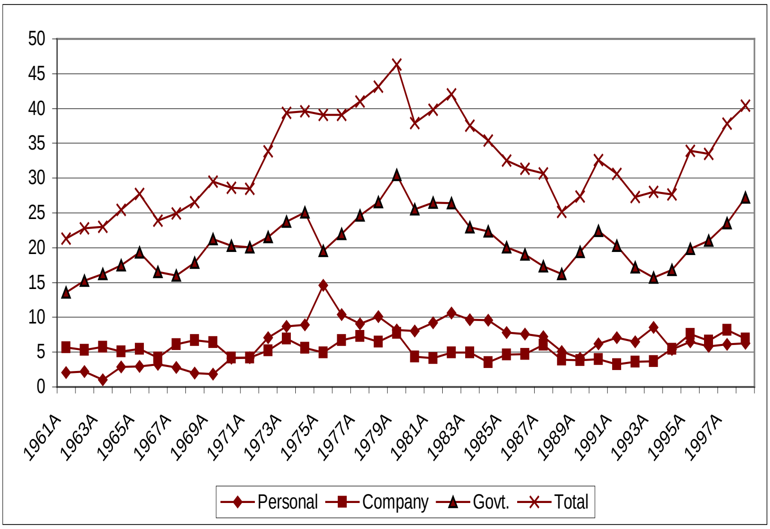


One of the aims of the new government savings scheme is to encourage savings in order to reduce personal demand at a time when resources in the Irish economy are constrained. However, despite increases in consumer spending, a steady rise in household incomes and wealth over the late 1990s meant that the annual household savings rate remained between 8 and 10 per cent of personal disposable income. The last time the personal savings ratio rose dramatically was in 1993 to 11.4 per cent, in response to the currency crisis.

It is estimated that the household savings ratio has now begun to decline and between 1998 and 2000 will fall from 9.6 per cent to an estimated 7.4 per cent. One of the reasons contributing to the decline has been the fall in Irish interest rates (both nominal and real) as Ireland entered EMU. Other factors can be linked to the recent strength of the Irish economy. This has improved confidence levels and reduced the risk of unemployment. In this Commentary the ratio is forecast to stabilise over the next two years at around 8 per cent. Figure 3A shows the trend in the personal savings ratio over the last four decades.

Although the personal savings rate has fallen in recent years, the total savings rate in the Irish economy has not. The total savings as a percentage of GNP has increased above 40 per cent in 1998. In recent years as personal saving has fallen, the level of savings by business and by government have risen as outlined in Figure 3B.

Figure 3B: Total Savings and Its Components as a Percent of GNP 1961-2001



Consumer Prices

Although the rate of consumer price increase has fallen back from the 7 per cent peak reached last November, it has remained higher than expected. Over the first five months of this year inflation had averaged 5.4 per cent. The EU harmonised index of consumer prices (HICP) for April shows that Ireland's HICP having been the highest in the euro area has been below that of the Netherlands and Portugal since January.

Housing costs, transports costs and food prices are the main contributors to the current rate of inflation. Over the remainder of 2001 the housing component of the consumer price index is not expected to make as large a contribution to inflation reflecting lower mortgage interest rates.

Given that the external environment is crucially important in determining Ireland's inflation rate, the remainder of the index is likely to show a more moderate rate of increase throughout the rest of the year, especially as import prices are forecast to rise less than in 2000. An easing in economic activity should also reduce the upward pressure from domestic demand. Thus, for 2001 as a whole the total consumer price index is forecast to rise by an annual average of 4.8 per cent, with a further moderation to an annual average of 3.3 per cent in 2002.

TABLE 10: Consumer Price Index – Recent Trend and Forecast

	Quarterly Trend								Annual			
	1999			2000				2001	1999	2000	2001	2002
	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1				
Index Nov. 1996=100												
Housing	92.2	93.1	86.7	90.5	96.0	103.4	111.0	114.2	91.5	99.6	116.4	116.7
Other	105.8	106.3	107.5	109.3	111.3	112.4	113.5	113.5	105.9	111.6	115.6	119.4
Total CPI	104.7	105.2	105.9	107.8	110.1	111.7	113.3	113.5	104.7	110.6	115.9	119.8
Annual % Change												
Housing	-10.7	-10.9	-14.0	-3.3	4.1	11.1	28.0	26.2	-10.8	8.8	16.9	0.3
Other	2.5	2.6	3.4	4.8	5.2	5.7	5.6	3.8	2.6	5.4	3.6	3.3
Total CPI	1.5	1.4	2.1	4.3	5.2	6.2	7.0	5.3	1.6	5.6	4.8	3.3
Quarterly % Change												
Housing	-1.5	1.0	-6.9	4.4	6.1	7.7	7.4	2.9				
Other	1.4	0.5	1.1	1.7	1.8	1.0	1.0	0.0				
Total CPI	1.3	0.5	0.7	1.8	2.1	1.5	1.4	0.2				

Public Finances

Strong economic growth continues to boost the position of the public finances. Exchequer returns for the first five months of the year indicate that overall tax revenue grew by 7.4 per cent as compared with the first five months of 2000. Compared with tax revenue growth of 15.8 per cent for the entire year 2000, the latest exchequer returns signal a significant slowdown of revenue growth. It is now likely that for the first time in a number of years, tax revenue in 2001 will be lower than expected by budgetary revenue forecasts. The slowing trend in tax revenue lends weight to the view of output growth in the economy moderating significantly this year.

On the expenditure side exchequer returns indicate that current expenditure is growing at over 20 per cent as compared with the first five months of 2000. As compared with expectations for the year 2001 this growth is well above budgetary expenditure forecasts. In part the large growth of expenditure is due to the persistence of higher than anticipated inflation. The continuing decline in the Live Register should see a moderate decrease in transfer payments this year.

The outlook for the overall budgetary position in 2001 remains broadly positive. Tax revenue growth is expected to slow in line with employment and economic growth to 11.2 and 9.3 per cent in 2001 and 2002 respectively. Total current expenditure is forecast to rise by 12 per cent in 2001 with expenditure on supply of current services rising by 18.2 per cent offsetting the fall in central fund expenditure. In 2002 total current expenditure is expected to rise by 10.7 per cent.

It is expected that a current surpluses in excess of £6 billion will be recorded in both 2001 and 2002 while the exchequer surplus is expected to fall in 2002 in response to significantly increased capital expenditure. The broader based general government surplus is expected to be 3.7 and 3 per cent in 2001 and 2002 respectively. The general government debt to GDP ratio is expected to decline to 31 per cent and 27 per cent in 2001 and 2002 respectively. On both of these measures, used to assess compliance for the EU Stability and Growth Pact (SGP), the Irish public finances are set to comfortably conform to a medium term sustainability position.

TABLE 11: Public Finances

	2000	% Change	2001	% Change	2002
Current Revenue	21,932	11.4	24,431	9.1	26,655
Current Expenditure	16,434	12.0	18,406	10.7	20,381
Current Surplus	**5,498**	9.6	**6,025**	4.1	**6,274**
Capital Receipts	2,091	-41.7	1,219	-26.2	900
Capital Expenditure	5,111	2.7	5,250	6.7	5,600
Capital Borrowing	**3,020**	33.5	**-4,031**	16.6	**4,700**
Exchequer Surplus*	**2,478**	-19.5	**1,994**	-21.1	**1,574**
as % of GNP	3.6		2.6		1.8
General Government Surplus	**3,800**	-10.2	**3,413**	-9.8	**3,080**
as % of GDP	4.7		3.7		3.0
Gross Debt as % of GDP	**39.0**		**31.4**		**26.1**

* The Exchequer surpluses are reported after the pre-funding of pensions have been paid out.

General Assessment

Following the record growth performance of the Irish economy last year, the prospects for 2001 were predictably going to appear more modest. The economy does appear to be slowing down by contemporary Irish standards but growth is still forecast to be a multiple of that anticipated for the major world economies. The dual threat posed in the first half of the year by the outbreak of foot and mouth disease and the rapid slowdown in the US economy have thus far had a relatively limited impact on the Irish economy. While the foot and mouth scare would seem to be receding, the threat from the US slowdown along with the recent halt in the expected takeoff in the major European economies still overshadows the prospects for the Irish economy this year and next.

In the last *Commentary* our forecasts were explicitly based on a benign outlook for the likely developments in both the international slowdown and the agricultural crisis cases. This scenario has broadly unfolded over the last quarter. However, the euro has failed to begin the steady appreciation we had anticipated and in the process has delayed the gradual erosion in Irish competitiveness. On this basis we have revised upwards our forecast for economic activity in 2001 as measured by real GDP to 7 per cent and kept real GNP broadly unchanged at 6 per cent.

The outlook for the international economy, and the US economy in particular, will be the most significant factor in assessing the Irish growth prospects going forward. The hoped for so called V-shaped recovery in the US, involving a sharp rebound in the latter half of the year, is looking less likely. We still anticipate that a technical recession of two consecutive quarters of decline in the US will not occur but that the resumption of growth will be more gradual over the latter part of this year. Our forecast for 2002 is for growth in real GDP of 6.4 per cent and 5.4 per cent in real GNP. This forecast may be optimistic given the increasing likelihood that the emerging international slowdown could be deeper and more prolonged than we are currently forecasting.

The immediate concern for the Irish economy with the on-going retrenchment in capital spending and declining corporate profitability in the US is the impact on the multinational sector based in Ireland. While there have been some notable notifications of large-scale redundancies in corporations internationally, the impact on their Irish operations has been much more muted. Indeed there has been strong growth recorded in industrial production and exports, particularly to the US, in the first quarter of 2001. This may indicate that production is being re-directed through the Irish operations as rationalisations occur elsewhere.

While the short-term consequences have been mild, a longer-term concern for Ireland is the large macroeconomic imbalances that have been storing up in the US in recent years. The protracted boom in the US has lead to the emergence of a large balance of payments current account deficit in excess of 4 per cent of GDP.[7] This deficit might be a lot larger if it were not for the substantial government surpluses. The decision to run down these government surpluses through a policy of tax cuts may help the US economy stabilise in the current downturn but it could be at the expense of pushing the deficit in the balance of payments to more precarious levels.[8]

A considerable proportion of the US current account deficit during the last two years has been financed by investment flows from Europe. These flows were in pursuit of the higher earnings capacity offered by the strong growth in the US economy in general and in the equity markets in particular. These flows had the impact of boosting the US dollar against the euro. The expectation on fundamental values, given the rapid slowdown in the US and the aggressive interest rate cuts in comparison to the EU, is that the euro should have appreciated considerably. The fact that the rebound in the euro's value did not occur has been attributed to a number of factors. These include the slow pace of structural reform in the EU and the perceived ineffectual communication of monetary policy decisions by the European Central Bank.

An additional explanation as to why the euro/dollar exchange rate is unreflective of fundamental values is the "virtual" existence of the euro before the notes and coins are circulated at the start of 2002. The current weakness is explained by simple demand for money factors whereby the uncertainty about the conversion process for the large stock of euros in the form of deutschmark holdings in Eastern Europe and in the black market internationally has led to a significant shift into dollars.[9] The unwinding of this uncertainty throughout the year may give some impetus to a recovery in the value of the euro.

The prospect of a significant and rapid turnaround in the exchange rate will severely hit the competitiveness of the Irish economy. Given the importance of trade for Irish growth prospects and ultimately living

[7] It is argued that the statistical measure of the US balance of payments deficit underestimates its true extent given the treatment of foreign owned unrealised capital gains.

[8] Obstfeld, Maurice and Kenneth Rogoff, 2000. "Perspectives on OECD Economic Integration: Implications for US Current Account Adjustment", *Federal Reserve Bank of Kansas Conference Proceedings*, Kansas.

[9] Sinn, Hans-Werner and Frank Westermann, 2001. "Why Has The Euro Been Falling?", CESifo Working Paper No. 493, Munich: IFO Institute.

standards, abrupt erosion of competitiveness should be guarded against when possible.

The Irish economy is beginning to run current account deficits in the balance of payments after a sustained period of large surpluses. The balance of payments deficit reflects the difference between national investment and savings. Within monetary union, Ireland's current account position has little consequence for the euro exchange rate but it is indicative of the build-up of demand pressure within the economy. A continuation of this trend to higher current account deficits would lead to imbalance between the domestic and foreign sources of demand.

The external balance may not be the most important target for an economy with a high potential growth like Ireland may have in the medium term. A spurt for growth to exploit profitable investment opportunities with a view to running external surpluses in the future could be warranted at the expense of higher inflation in the short term.

While the economy is undoubtedly slowing towards its potential growth rate, overheating pressures still remain. As the debate between the European Commission and the Irish authorities demonstrates, it is difficult to assess the extent of overheating pressures for a small, open economy possibly undergoing a transition to a higher growth path. The EU's Broad Economic Policy Guidelines (BEPG) recommendation for Irish budgetary policy to be framed to ensure economic stability is based on the belief that the economy is overheating.

The fiscal contraction option, favoured by the Commission, has an alternative that would allow the economy experience higher inflation leading to a real appreciation in the exchange rate. This inflation option would restore the economy to a slower growth rate by eroding competitiveness. The correct choice of option depends on the source of overheating.[10] The textbook response is that when the source of the overheating pressure is internally generated by domestic factors, then a fiscal contraction is required. When the source is external demand then an increase in inflation to restore relative prices would be required.

At the present juncture there are reasonably balanced contributions to output growth from both domestic and foreign sources in Ireland. The standard prescription would suggest that a combination of wage growth and fiscal contraction be used to slow the economy to sustainable levels. The difficulty with this prescription is that while Ireland may be nearing the end of its convergence transition, it is not yet completed. Wage growth has been significant over the last year and is forecast to rise strongly over the coming year. This high wage growth will reverse the secular decline in the labour share in Ireland since inception of the social partnership agreements in the late 1980s. The difficulty is in gauging the extent of wage growth that is necessary to cool down the economy without wages overshooting with significant losses in competitiveness.

Domestic policy tools need to be configured to consolidate the gains achieved during the transition and to alleviate the inevitable bottlenecks that can emerge in a period of rapid growth. In the current context for Ireland, notwithstanding the slowing of economic growth, restraining domestic demand whilst increasing the supply capacity are imperative. The

[10] Blanchard, Olivier, 2001. "Country Adjustments Within Euroland, Lessons After Two Years", *Monitoring the European Central Bank* No. 3, London: Centre for Economic Policy Research.

onus on managing domestic demand falls on budgetary and incomes policy, while more specific sectoral interventions are required to boost the economy's supply capacity.

Starting at a position of significant fiscal surpluses, the need for large fiscal contractions is not overly compelling. However, the alternative of fiscal expansion through tax cuts and large increases in current public expenditure is not justified. If the expenditure is targeted at capital investment projects it can be justified to increase the economy's supply capacity in addition to a series of sectoral interventions to increase competition.[11] The need for significant capital investment may mean that an external current account deficit is appropriate.

The difficulty of applying a common methodology within the EU Broad Economic Policy Guidelines debate to economies at different stages of development has been brought into sharp relief by the Irish case. There is a clear, justifiable need for policy co-ordination in the context of monetary union.[12] However, with the enlargement of the EU about to get underway, it is an opportune time to re-examine the economic model and the rules that apply within the EU and assess their suitability for the types of economies in aspirant member states.[13] Given its successful convergence and arrival at a point of inflexion in terms of its economic growth, Ireland is in a rather unique position to reflect on the nature and suitability of the current economic governance within the European Union, especially for economies in transition.[14]

[11] OECD, 2001. *Economic Survey of Ireland*, Paris: Organisation for Economic Co-operation and Development.

[12] See Fitz Gerald, John, 2001. "Fiscal Policy in a Monetary Union: The Case of Ireland", in the *Quarterly Economic Commentary*, March, pp 43-62, Dublin: The Economic and Social Research Institute. For a broader view on the co-ordination issue within the EU see von Hagen, Jurgen and Susanne Mundschenk, 2001. The Functioning of Economic Policy Coordination, Working Paper, University of Bonn.

[13] Cronin, David and Daniel McCoy, 2000. "Fiscal Sustainability When Time Is On Your Side", in *Fiscal Sustainability*, Rome: Banca d'Italia.

[14] McCoy, Daniel and John McHale, 2001. "Ireland's Example to the East", *Financial Times*, July 3rd.

Special Articles in the *Quarterly Economic Commentary* 1969-2001

Year	*Author*	*Title*	*Issue*	*Pages*
2001	Fitz Gerald John	"Fiscal Policy in a Monetary Union: The Case of Ireland	March	40-60
2000	Whelan, Shane F.	"Inflation: Impact on the Retired"	December	43-55
	McHale, John	"Options for Inflation Control in the Irish Economy"	September	43-58
	Williams, Brendan Shiels, Patrick	"Acceleration into Sprawl: Causes and Potential Policy Responses"	June	37-68
1999	Baker, Terry	"Irish Economy: Then, Now and Next"	December	35-46
	Kearney, Colm	"Asian Financial Crisis"	February	29-56
	Sexton, Jeremiah J. Nolan, Brian McCormick, Brian	"Review of Earnings Trends in the Irish Economy since 1987"	December	47-76
1998	O'Malley, Eoin	"Revival of Irish Indigenous Industry 1987-1997"	April	35-57
1995	Baker, Terry Duggan, Delma	"An Assessment of QEC Forecasts 1984-94"	Autumn	33-57
1993	Baker, Terry	"Manufacturing Output and Employment by Market Area"	Spring	32-47
1992	Honohan, Patrick	"The Link Between Irish and UK Unemployment"	Spring	33-44
1991	Baker, Terry Wren, Anne	"Assessment of QEC Forecasts, 1984-90"	Spring	31-60
1990	Bradley, John Fitz Gerald, John D.	"Medium-Term Prospects for Ireland: An Update"	April	35-50
1988	Baker, Terry	"Industrial Output and Wage Costs, 1980-87"	October	33-43
	Massey, Patrick	"Exchange Rates and Competitiveness"	October	45-57

Year	*Author*	*Title*	*Issue*	*Pages*

1987	Fitz Gerald, John D.	"Making Economic Time-Series Available to Users of Micro-Computers in Ireland"	October	29-37
1986	Punch, Aidan	"Real Gross National Income Adjusted for Term of Trade 1970-1984: An Assessment of Technical Issues"	April	30-49
1985	Baker, Terry Scott, Sue Hayes, Laurie	"Trends in Manufacturing Output and Wage Costs 1980-1984"	April	26-35
	Barrett, Sean D.	"The Value of Cost Benefit Analysis of Road Projects – A Comment"	April	48-52
	Conniffe, Denis	"Seasonality in the Business Survey"	July	27-35
	Mansergh, Nicholas	"The Value of Cost Benefit Analysis of Road Projects"	April	36-47
	Scott, Sue	"The Revised CII-ESRI Survey – A Note"	July	36-43
1984	Barrett, Sean D. Mooney, David	"The Naas Motorway Bypass – A Cost Benefit Analysis"	January	21-34
	Honohan, Patrick	"The Evolution of the Rate of Unemployment in Ireland 1962-1983"	May	41-58
	Sexton, Jeremiah J. Dillon, Michele	"Recent Changes in Irish Fertility"	May	21-40
1983	Baker, Terry	"The Oil Find – Some Implications"	November	26-32
	Leddin, Anthony	"Private Sector Credit, Policy and Enforcement: 1978-1982"	May	29-41
	Norton, Desmond A.G.	"Export Tourism: Rejoinder to Palmer"	November	38-41
	Palmer, Noel T.	"Export Tourism Input-Output Multipliers in Ireland – A Reply"	November	33-37

Year	*Author*	*Title*	*Issue*	*Pages*
1982	Keenan, J.G.	"Irish Manufacturing Industry – Recent Wage, Price and Productivity Developments"	December	53-64

1982	Norton, Desmond A.G.	"Export Tourism Input-Output Multipliers for Ireland"	May	34-50
	Sexton, Jeremiah J.	"Sectoral Changes in the Labour Force Over the Period 1961-1980 with Particular Reference to Public Sector and Services Employment"	August	36-45
	Sexton, Jeremiah J. Walsh, Brendan M.	"A Study of Labour Force Flows 1961-1980"	May	51-61
1981	Bacon, Peter Durkan, Joe O'Leary, Jim Scott, Sue	"Private Sector Funding of the Public Capital Programme – Some Possible Financial Implications"	July	41-43
	Conway, John	"Government Borrowing, Bank Liquidity and Interest Rates"	January	23-34
	O'Leary, Jim	"Competitiveness Indices for Irish Manufactured Exports"	July	44-60
1980	Kelleher, Robbie	"Recent Trends in Monetary Policy"	January	25-32
	Kelleher, Robbie McCarthy, Colm	"Economic Aspects of the Irish Exchange Control Regime"	April	24-36
	Kenneally, Martin	"Recent Trends in Monetary Policy: Some Further Considerations"	September	21-33
	O'Loughlin, Brian	"The Building Society Mortgage Market in Ireland"	September	34-55
	O'Reilly, Liam Gray, Alan	"Seasonality and Other Components in the Irish Unemployment Series"	April	37-54
1979	Ruane, Frances	"Project Analysis and Industrial Employment in Ireland"	June	17-34
Year	***Author***	***Title***	***Issue***	***Pages***
1978	Durkan, Joe Menton, Brendan J.	"The Housing Market – Some Aspects"	September	30-40
1978	Durkan, Joe Menton, Brendan J.	"The European Monetary System"	September	25-29
1977	McCarthy, Colm	"An Econometric Model of Non-Agricultural Stock Changes"	December	20-28

	Walsh, Brendan M.	"Unemployment, Vacancies and 'Full Employment' in the Irish Manufacturing Sector"	June	25-35
1976	Kirwan, Frank	"Inter-Industry Differences in Male Per cent age Unemployment Compensation – A Cross-Section Analysis for Irish Manufacturing Industry"	November	43-57
	Tussing, A. Dale	"The 'CUB' Budget as a Measure of Fiscal Policy"	January	22-29
1975	Dowling, Brendan T.	"Seasonality and Unemployment in Ireland"	October	37-44
	Kennedy, Kieran A. Bruton, Richard	"The Consumer Price Index and Different Household Expenditure Patterns"	October	27-36
	Neary, Peter	"The CII-ESRI Quarterly and Monthly Surveys of Business Attitudes: Methods and Uses"	March	27-36
1974	Henry, Eamon W. Scott, Sue	"Estimated Price Increases Due to Higher Costs of Petroleum and Other Imports, as Calculated from a 38-Sector 1968 Input-Output Model"	March	26-36
1973	Geary, R.C.	"Quarterly Non-Agricultural Stock Statistics: A Pilot Inquiry"	January	23-29
1972	Baker, Terry Neary, Peter	"A Study of Consumer Prices Part 3"	October	23-37
1971	Baker, Terry Neary, Peter	"A Study of Consumer Prices Parts 1, 2"	March Autumn	16-36 17-35
Year	***Author***	***Title***	***Issue***	***Pages***
1970	Baker, Terry Durkan, Joe	"The Updating of Certain Econometric Models"	September	19-34
1970	Baker, Terry Durkan, Joe	"A Study of Imports Parts 4, 5"	March December	16-28 16-28
	Walsh, Brendan M.	"Econometric Macro-Model Building in the Irish Context"	June	16-26
1969	Baker, Terry	"An Analysis of Industrial Exports"	January	12-28
	Baker, Terry Durkan, Joe	"A Study of Imports Parts 1, 2, 3"	May September December	16-23 20-33 14-26

Policy Discussion Forum in the *Quarterly Economic Commentary* 2001

Topic 1:
How Can Wage Bargaining Within Social Partnership Be Best Modified?

Year	*Author*	*Title*	*Issue*	*Pages*
2001	Donal de Buitleir and Don Thornhill	A Mechanism for Sharing the Fruits of Growth	March	66-74
	John McHale	Adding an Instrument to Social Partnership: A Proposal for Deferred Compensation	March	75-87