SUMMARY

Irish economic growth rates have defied most expectations by continuing to accelerate over the last two years. Output growth in 2000 is estimated to be 10.5 per cent in real GDP terms driven, in part, by strong export growth and reinforced by buoyant domestic demand. The growth in output as measured by real GNP is estimated to have reached a historical high of 9.8 per cent in 2000. Inflation in consumer prices averaged 5.6 per cent in 2000 with the unemployment rate ending the year at 3.6 per cent.

Against this exceptional performance, the prospects for output growth in 2001 and 2002 look more modest, but are also much more uncertain. The uncertainties arise from the prospects for the external environment given the rapid slowdown in the United States and from the economic threat posed by the foot and mouth crises within Europe. Our forecasts are predicated on the balance of probabilities that the US will experience a "soft landing", with economic activity recovering in the latter part of 2001. We have taken a benign view on the impact of the foot and mouth outbreak, assuming that it will be regionally confined and the containment measures will have their greatest impact over a duration of one quarter.

Growth in 2001 is forecast to be 6.7 per cent in real GDP and 6.1 per cent in real GNP terms. This revised forecast for 2001 reduces the growth rate by over half a percentage point. The growth prospects for 2002 are much more susceptible to the extent and duration of the US slowdown. We forecast that output growth in 2002 will be 6.2 and 5.2 per cent in real GDP and real GNP terms respectively. Inflation as measured by the consumer price index is forecast to moderate to 4.2 per cent in 2001 and 3.6 per cent in 2002. The unemployment rate is forecast to continue to decline this year to average 3.3 per cent and levelling off to a 3.2 per cent average in 2002.

The first quarter of 2001 has brought some pertinent realities to the fore for the Irish economy. The first is the capacity to underestimate the impact of the economic cycle after a period of sustained growth, as evidenced most dramatically in the recent US experience. A second is that domestic output growth can fluctuate significantly driven by sharp changes in Irish competitiveness. The weak exchange rate against the main non-euro trading nations has boosted competitiveness considerably, thereby masking the impact of rising domestic cost pressures. The third is the need to configure domestic policy responses to provide a stabilisation role in coping with shocks that impact disproportionately on the Irish economy.

Adapting domestic budgetary and incomes policies to reflect these realities, by moving from the tendency for pro-cyclical actions, can help dampen the inevitable fluctuations around the economy's sustainable growth path. As a by-product such a shift in emphasis from pro-cyclical responses could reconcile Irish budgetary policy with the European Union's Broad Economic Policy Guidelines circumventing a repeat of the distracting dispute from earlier this year.

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	40,137	5,394	3,266	15.5	5.6	9.4
Public Net Current Expenditure	8,753	9,652	899	438	10.3	5.2	5.0
Gross Fixed Capital Formation	16,175	19,723	3,548	1,805	21.9	9.7	11.2
Exports of Goods and Services (X)	60,457	75,868	15,411	11,484	25.5	5.5	19.0
Physical Changes in Stocks	-57	185	242	130			
Final Demand	**120,070**	**145,565**	**25,495**	**17,123**	**21.2**	**6.1**	**14.3**
less:							
Imports of Goods and Services (M)	50,978	64,259	13,282	9,375	26.1	6.5	18.4
GDP at Market Prices	**69,093**	**81,305**	**12,213**	**7,747**	**17.7**	**5.8**	**11.2**
less:							
Statistical Discrepancy	41	257	216	477			
Adjusted GDP	**69,052**	**81,049**	**11,997**	**7,270**	**17.4**	**6.2**	**10.5**
less:							
Net Factor Payments (F)	9,984	12,101	2,117	1,491	21.2	5.5	14.9
GNP at Market Prices	**59,068**	**68,948**	**9,880**	**5,779**	**16.7**	**6.3**	**9.8**

B: Gross National Product by Origin

	1999	2000	Change in 2000	
		Preliminary		
	£m	£m	£m	%
Agriculture, Forestry, Fishing	2,071	2,310	-239	**11.5**
Non-Agricultural: Wages, etc.	28,086	31,946	3,860	**13.7**
Other:	26,809	32,039	5,230	**19.5**
Adjustments: Stock Appreciation	-562	-120		
Financial Services	-2,296	-2,511	-215	**9.3**
Statistical Discrepancy	41	257	216	
Net Domestic Product	54,149	63,920	9,772	**18.0**
less:				
Net Factor Payments	9,984	12,101	2,117	**21.2**
National Income	44,165	51,819	7,655	**17.3**
Depreciation	7,114	8,057	943	**13.3**
GNP at Factor Cost	51,279	59,876	8,598	**16.8**
Taxes less Subsidies	7,789	9,071	1,282	**16.5**
GNP at Market Prices	59,068	68,948	9,880	**16.7**

C: Balance of Payments on Current Account

	1999	2000	Change in 2000
		Preliminary	
	£m	£m	£m
Exports (X) less Imports (M)	9,479	11,609	2,130
Net Factor Payments (F)	-9,984	-12,101	-2,117
Net Transfers	951	810	-141
Balance on Current Account	**446**	**318**	**-128**
as % of GNP	0.8	0.5	-0.2

FORECAST NATIONAL ACCOUNTS 2001

A: Expenditure on Gross National Product

	2000	2001	Change in 2001				
	Preliminary £m	Forecast £m	£m Value	£m Volume	Value	% Price	Volume
Private Consumer Expenditure	40,137	45,131	4,994	3,050	12.4	4.5	7.6
Public Net Current Expenditure	9,652	11,080	1,428	502	14.8	9.1	5.2
Gross Fixed Capital Formation	19,723	23,094	3,372	1,409	17.1	9.3	7.1
Exports of Goods and Services (X)	75,868	85,652	9,784	6,551	12.9	3.9	8.6
Physical Changes in Stocks	185	-30	-215	-25			
Final Demand	**145,565**	**164,928**	**19,363**	**11,488**	**13.3**	**5.0**	**7.9**
less:							
Imports of Goods and Services (M)	64,259	72,323	8,063	5,654	12.5	3.4	8.8
GDP at Market Prices	**81,305**	**92,605**	**11,300**	**5,834**	**13.9**	**6.3**	**7.2**
less:							
Statistical Discrepancy	257	439	182	402			
Adjusted GDP	**81.049**	**92,166**	**11,117**	**5,432**	**13.7**	**6.6**	**6.7**
less:							
Net Factor Payments (F)	12,101	13,848	1,747	1,225	14.4	3.9	10.1
GNP at Market Prices	**68,948**	**78,318**	**9,370**	**4,207**	**13.6**	**7.1**	**6.1**

B: Gross National Product by Origin

	2000	2001	Change in 2001	
	Preliminary £m	Forecast £m	£m	%
Agriculture, Forestry, Fishing	2,310	2,100	-210	-9.1
Non-Agricultural: Wages, etc.	31,946	36,770	4,824	15.1
Other:	32,039	36,188	4,149	13.0
Adjustments: Stock Appreciation	-120	-60		
Financial Services	-2,511	-2,702	-192	7.6
Statistical Discrepancy	257	439	182	71.1
Net Domestic Product	**63,920**	**72,735**	**8,815**	**13.8**
less:				
Net Factor Payments	12,101	13,848	1,747	14.4
National Income	**51,819**	**58,887**	**7,067**	**13.6**
Depreciation	8,057	8,988	931	11.6
GNP at Factor Cost	**59,876**	**67,875**	**7,998**	**13.4**
Taxes less Subsidies	9,071	10,443	1,372	15.1
GNP at Market Prices	**68,948**	**78,318**	**9,370**	**13.6**

C: Balance of Payments on Current Account

	2000	2001	Change in 2001
	£m	Preliminary £m	£m
Exports (X) less Imports (M)	11,609	13,330	1,721
Net Factor Payments (F)	-12,101	-13,848	-1,747
Net Transfers	810	571	-239
Balance on Current Account	**318**	**53**	**-265**
as % of GNP	0.5	0.1	-0.3

FORECAST NATIONAL ACCOUNTS 2002

A: Expenditure on Gross National Product

	2001 Forecast £m	2002 Forecast £m	Change in 2002 £m Value	Volume	% Value	Price	Volume
Private Consumer Expenditure	45,131	50,080	4,949	3,069	11.0	3.9	6.8
Public Net Current Expenditure	11,080	11,950	870	510	7.9	3.1	4.6
Gross Fixed Capital Formation	23,094	26,425	3,331	1,595	14.4	7.0	6.9
Exports of Goods and Services (X)	85,652	96,326	10,674	7,303	12.5	3.6	8.5
Physical Changes in Stocks	-30	160	190	170			
Final Demand	**164,928**	**18,4941**	**20,013**	**12,646**	**12.1**	**4.1**	**7.7**
less:							
Imports of Goods and Services (M)	72,323	82,099	9,776	7,117	13.5	3.3	9.8
GDP at Market Prices	**92,605**	**102,842**	**10,237**	**5,530**	**11.1**	**4.8**	**6.0**
less: Statistical Discrepancy	439	90	-350	-143			
Adjusted GDP	**92,166**	**102,753**	**10,586**	**5,672**	**11.5**	**5.0**	**6.2**
less:							
Net Factor Payments (F)	13,848	16,024	2,176	1,615	15.7	3.6	11.7
GNP at Market Prices	**78,318**	**86,729**	**8,411**	**4,057**	**10.7**	**5.3**	**5.2**

B: Gross National Product by Origin

	2001 Forecast £m	2002 Forecast £m	Change in 2002 £m	%
Agriculture, Forestry, Fishing	2,100	2,360	260	12.4
Non-Agricultural: Wages, etc.	36,770	41,249	4,479	12.2
Other:	36,188	40,079	3,891	10.8
Adjustments: Stock Appreciation	-60	10		
Financial Services	-2,702	-2,894	-192	7.1
Statistical Discrepancy	439	90	-350	-79.6
Net Domestic Product	**72,735**	**80,893**	**8,158**	**11.2**
Net Factor Payments	13,848	16,024	2,176	15.7
National Income	**58,887**	**64.869**	**5,983**	**10.2**
Depreciation	8,988	9,914	926	10.3
GNP at Factor Cost	**67,875**	**74.783**	**6,909**	**10.2**
Taxes less Subsidies	10,443	11,946	1,502	14.4
GNP at Market Prices	**78,318**	**86,729**	**8,411**	**10.7**

C: Balance of Payments on Current Account

	2001 Forecast £m	2002 Forecast £m	Change in 2002 £m
Exports (X) less Imports (M)	13,330	14,227	897
Net Factor Payments (F)	-13,848	-16,024	-2,176
Net Transfers	571	436	-135
Balance on Current Account	**53**	**-1,360**	**-1,413**
as % of GNP	0.1	-1.6	-1.6

The International Economy

General

World economic activity rose at its highest rate for over a decade during 2000, increasing by some 4.7 per cent. However, growth began to weaken during the second half of the year, with rising oil prices and a more rapid than expected slowdown in the United States. Prospects for 2001 are becoming less favourable though, with the probability of a V-shaped recovery in the United States falling. Growth in the euro area is likely to remains robust, though there is some prospect of the US slowdown dampening activity in Europe somewhat. However, moderating inflation in the major economies, coupled with relatively healthy public finances, imply that there is plenty of scope for prompt policy action should conditions deteriorate further. Overall the outlook is for world growth to slow, with GDP growth in the OECD area of 2.3 per cent in 2001 and 2.5 per cent in 2002. The uncertainty attached to these forecasts has increased as the prospects for the US economy remain unclear.

The US Economy

While the US economy grew strongly in the year 2000 the slowdown in growth in the second half of the year has led to fears of recession. Preliminary estimates of GDP growth indicate that the economy grew well below expectations at just an annual rate of 1.4 per cent in the fourth quarter of the year. This slowdown follows on from sluggish third quarter growth at an annual rate of 2.2 per cent, a sharp drop in growth from the first half of the year. Sales and production have weakened significantly. Lower consumer confidence, tighter credit markets and high oil prices are all contributing to weaker economic prospects for the US economy in contrast to recent years.

Consumer spending grew by just 2.9 per cent in the fourth quarter of 2000 down from 7.6 per cent in the first quarter of the year. Prospects for consumer spending in 2001 are even bleaker. Consumer confidence has faltered following stock market slides, an increasing number of corporate job cuts and energy price shocks. The leading Conference Board index of consumer confidence has now fallen for five months in a row to its lowest level in over four years, reflecting weakened expectations in business and employment conditions. Orders for durable goods have also been much weaker than expected

Gross private investment in the fourth quarter of 2000 contracted by 3.7 per cent. Investment by firms in equipment and software dropped by 3.5 per cent in the fourth quarter reflecting a disimprovement in business sentiment. Residential investment fell by 3.4 per cent. The latest figures show no significant recovery, with new home sales in January of this year falling by 10.9 per cent.

The overall *slowdown* of the economy has been most pronounced in the manufacturing sector. The NAPM manufacturing index contracted for the sixth straight month in a row in January consistent with the view that the manufacturing sector is already in recession. Manufacturing output is now at its lowest level since 1991. To some degree the slowdown in manufacturing may be due to a temporary inventory correction as a reaction to reduced business spending.

Although the unemployment rate remains low, the figure for January was 4.2 per cent, increasing from 4 per cent in December. However, non-farm payrolls rose by 268,000 during the month reflecting a surge in construction employment in January. Unemployment is expected to increase over the coming months as recent job cuts work their way into the statistics. Unemployment is forecast to average 4.3 per cent and 4.4 per cent on average in 2001 and 2002 respectively.

Following its surprise half point cut at the beginning of January, the Federal Reserve have cut interest rates by a further 1 per cent. Given that Federal Reserve Chairman Alan Greenspan has identified consumer confidence as critical, further cuts in interest rates are expected in the second quarter. Monetary policy tends to take effect with a substantial lag. It is expected that the interest rate cuts should take effect in the second half of the year allowing the US output to grow on average by 1.8 per cent and 2.5 per cent in 2001 and 2002 respectively. Inflation is expected to average 2.5 per cent and 2.7 per cent in 2000 and 2001.

The European Economy

The euro area is estimated to have grown by around 3.4 per cent last year and despite a slowdown in world-wide economic activity, the euro area should grow by some 2.7 per cent in 2001. Last year external trade was the driving force behind the growth, helped by a combination of a weak euro and strong global demand. With these external conditions reversing, the growth must be driven by domestic demand in the individual member-states. Fiscal policy will boost activity in many countries this year, with tax cuts and expenditure increases providing a stimulus in the major economies such as France, Germany, Italy and Spain. Indeed, the effects of the expansionary fiscal policy described in the previous *Commentary* are already being observed, with very strong growth figures for the final quarter of 2000. This has helped to allay concerns that a slowing US economy would drag the euro area down in its wake.

Monetary policy in the euro area is the subject of much debate following the reductions in US interest rates by the Federal Reserve. The European Central Bank (ECB) are following a "wait and see" policy, despite interest rate cuts in the other main world economies including Japan and the UK. It is clear that interest rates have reached their peak, and the ECB have acknowledged that one-off factors are responsible for pushing up inflation. Nevertheless, headline inflation remains well above its target of between 0 and 2 per cent, and it increased to 2.6 per cent in February. Second round effects of past inflation on wage rates, as well as labour market tightness resulting from substantial employment growth both constitute possible upside risks to inflation, and a rate cut is unlikely while inflation remains above target. Nevertheless, a substantial fall in euro area industrial production in January coupled with falling business and consumer confidence levels imply that Europe is not completely sheltered from the slowdown in the United States, and pressure has mounted for the ECB to cut rates. We expect a 25-basis point cut in the short term, followed by more cuts later in the year.

The European labour market continues to perform well, with unemployment falling in each member state during 2000. By December 2000, the euro area unemployment rate had fallen to 8.7 per cent, from 9.6 per cent one year earlier. The star performers last year were Ireland, France and Spain. The growth in employment is likely to moderate this year as output growth slows. The seasonally adjusted unemployment rate increased marginally to 8.8 per cent in January, but we expect the gentle downward trend to resume in February. Many countries are already reporting labour shortages in certain sectors.

Greece formally joined the European Economic and Monetary Union (EMU) on 1 January 2001, bringing the number of participating countries to twelve. In order to meet the Maastricht criteria for entry into EMU, Greece had to reduce interest rates by almost 4 percentage points over the course of 2000. Hence, while growth is expected to slow in the other euro area countries, this loosening of monetary policy in Greece will strengthen domestic demand and stimulate economic growth. However, inflation will also increase as a result of the rate cuts, and Greece is expected to have one of the highest rates of inflation in the euro area in 2001.

The previous *Commentary* considered the fundamental value of the euro. At that time the euro was trading at around $0.85, from its launch value of $1.17. We argued that the euro was trading at a level inconsistent with its fundamentals, and that all the evidence pointed to an appreciation in the near future. Since then, the euro has appreciated significantly against the dollar, although it has yet to reach parity. We pointed to the fact that growth rates and interest rates were converging between the US and Europe. The euro area actually grew faster than the US in the final quarter of 2000, and is expected to do so again for 2001 as a whole. Also, the ECB has maintained interest rates at 4.75 per cent since October, and the Federal Reserve reduced US rates to 5 per cent in March, with the possibility of further rate cuts if the economy continues to slow. Cognisant of this, we still predict the euro will achieve parity with the dollar during 2001.

According to the German Federal Statistical Office, GDP in Germany grew by 3.1 per cent in 2000, the highest annual growth figure since reunification. The main factors behind the growth were significant increases in exports and investment in machinery and equipment. The weaker growth outside the euro area has had little impact on German exports, which registered another increase in December. However, retail sales fell dramatically, and consumer and business confidence measures have been falling for months now. In February the IFO business climate index fell to its lowest level since July 1999. Nevertheless, continuing tax reform should bolster domestic demand this year, and we anticipate GDP growth of about 2.5 per cent for 2001. The German labour market continues to strengthen, with employment up by 1.5 per cent in 2000, and a corresponding fall in unemployment to 7.8 per cent. Employment growth should moderate to about 1 per cent for 2001 and 2002. Labour productivity per employee rose by 1.5 per cent in 2000, twice the rate of the previous two years. Inflationary pressures are growing in Germany, with consumer prices up by an annual rate of 2.5 per cent in February following an average of 1.9 per cent during 2000, but they should ease later in the year given lower oil prices and an appreciation of the euro.

The French economy continued to expand last year, with GDP growing by 3.2 per cent. As in most European countries, exports and investment were the main drivers of growth. Rising oil prices and a weak euro last year curbed household spending. Consumption is set to rebound due to very favourable domestic conditions. Consumer confidence reached new historic highs in January, driven by tax cuts and substantial employment growth. Some one million jobs have been created in the last two years, enabling unemployment on an ILO basis to fall to 9.2 per cent in December. French inflation remains below the euro area average, and should be less than 2 per cent this year despite some rise in the underlying rate. We expect investment growth to moderate from 6.3 per cent in 2000 to about 4.5 per cent this year, as capacity constraints emerge. Overall, we expect the French economy to grow by slightly less than 2.8 per cent this year and about 2.4 per cent in 2002. A major downside risk for the French forecast is whether the foot and mouth disease is likely to be as widespread as in the UK, given the important role the agricultural sector continues to play in the economy.

The Italian economy posted very strong growth rates in the final quarter of 2000, and doubled its annual rate of economic growth from 1.4 per cent in 1999 to 2.8 per cent in 2000. This was a result of tax cuts and strong export growth. However, this rate was still lower than all other euro area economies last year, although the gap is closing. Inflation remains a problem, with the harmonised index of consumer prices (HICP) remaining above 2 per cent since November 1999, and reaching 3 per cent in February 2001. The reversal of external factors will ease inflationary pressures this year, but we expect Italian inflation will remain above the euro area average throughout this year. The Italian labour market continues to improve, with employment growth exceeding 1 per cent per annum for the last three years. Average earnings have not increased as fast as inflation, and the labour market has become more flexible. This has led to the standardised unemployment rate decreasing to 10.5 per cent in 2000, and it is expected to fall below 10 per cent this year.

Considering briefly those countries on the EU Accession Track, it seems that Poland is making the most significant progress. It is currently in the middle of a successful disinflation process, with the CPI declining from 11.6 per cent in July last year to 7.4 per cent in January, and should reach about 6 per cent by the end of the year. This monetary tightening is at odds with a neutral policy in the Czech Republic, and very loose monetary policy in Hungary, which has left inflation unchanged in these countries. The consequences of these monetary stances are illustrated by domestic demand in these countries, weakening in Poland, strong in Hungary, and moderate in the Czech Republic. Turkey has been less successful in fighting inflation, and recently allowed its currency to float, effectively devaluing the currency. The move followed turmoil in financial markets that resulted in interest rates rising to 4,000 per cent, and is an attempt to salvage the IMF-funded economic programme aimed at eliminating double-digit inflation.

The UK Economy

The UK economy is slowing gradually, but there is little evidence to suggest that a hard landing may be in store. In the fourth quarter of 2000, GDP increased by 2.6 per cent on the previous year, but this was weakened by a number of one-off factors including severe flooding and disruption to the rail network. Manufacturing output and consumer spending remain strong, while industrial production weakened in quarter four due to decreasing energy output. Business confidence is high, and the service sector continues to expand. Consumer confidence is also on the increase, and retail sales were up 4.1 per cent in January on a year earlier. The housing market remains flat, with housing starts and construction orders falling during December, although mortgage lending figures and mortgage approvals both increased in the final quarter of 2000.

The BSE and foot and mouth disease (FMD) crises represent real causes of concern for the sustainability of growth in the UK. Both have the potential to inflict lasting damage on the agricultural sector in the UK, which has far-reaching consequences for the rest of the economy. There are also the negative implications for the UK's trading partners to consider.

In February, the Monetary Policy Committee (MPC) voted unanimously to cut interest rates by 25 basis points. This was the first change in rates since February 2000. The reasons cited for the cut include slowing domestic demand, the weakness of the US economy and the persistent undershooting of inflation. This rate cut, coupled with the increase in government spending, should lead to growth of almost 3 per cent in the UK this year. The MPC has indicated that it is prepared to cut rates again barring an upturn in the US or domestic inflationary pressures.

Inflation remains subdued in the UK. Headline inflation was 2.7 per cent in February, unchanged from the previous month. The underlying rate increased to 1.9 per cent, following the lowest rate since the series began in 1976. The Monetary Policy Committee is obliged to write a letter of explanation to the government if the underlying rate deviates more than one per cent from its target of 2.5 per cent, which is a real possibility over the coming months as Budget measures on fuel and excise duties come into effect. The HICP measure of inflation was down marginally at 0.8 per cent in February.

The UK labour market remains tight, with claimant unemployment falling to 3.4 per cent in February, its lowest level in twenty-five years. The unemployment rate on an ILO basis was down to 5.3 per cent in January from 5.9 per cent one year earlier. Earnings growth has begun to reflect the tightness of the labour market, and increased by 4.4 per cent over the three months to January. The combination of low unemployment and increasing earnings in a tight labour market has led to wages being bid upwards. Given the MPC's inflation target of 2.5 per cent, and an historic average of 2 per cent productivity growth, earnings growth of over 4.5 per cent risks inciting inflationary pressures. Hence, if earnings continue to rise the MPC may be constrained in their ability to cut interest rates in the future.

The Budget in March involved a slight loosening of fiscal policy, but can be considered reasonably prudent given the looming elections. A £3.6bn package of tax cuts, benefits and increased spending on services was announced, while sticking rigidly to the medium-term fiscal rules set out by the Labour government on assuming office in 1997. Low and middle-income families will gain from increases in Children's Tax Credit and Working Families Tax Credit, while pensioners will benefit from increases in the basic pension. The £1.7bn measures proposed in the Pre-Budget Report to appease motorists and hauliers were confirmed, and involve reductions in vehicle excise duty and taxes on ultra-low sulphur fuel. Increased spending on education and health will promote recruitment in these sectors, but may add impetus to already accelerating average earnings on an economy-wide basis. The budget will boost the domestic economy in a time of slowing external demand, and we expect the UK economy to grow by almost 3 per cent in 2001.

Box A: Impact on World Economy of a US Slowdown

The world economy grew by almost 5 per cent in 2000, its highest level of growth for sixteen years. The prospects for world economic growth are far less favourable following the slowdown in growth in the US. If the slowdown in the US develops into a full-blown recession many fear that the fortunes of the world economy will follow suit.

While some countries remain more exposed than others to the US growth, it is expected that world growth will remain strong in 2001 and 2002. The most immediate effect of a US slowdown will be on trade. A US recession will mean reduced American demand for foreign exports. The US remains a relatively closed economy however with imports only constituting 13 per cent of GDP thus limiting the effect on the world economy. With exports to the US accounting for between one-third and one-quarter of GDP, countries such as Canada, Mexico and Malaysia will be most exposed to reduced export demand. On the other hand, both the euro area and Japan would be relatively less affected given that exports to the US only constitute 2 to 3 per cent of their GDP.

The second channel is through foreign direct investment. In particular, European and Japanese companies will be relatively more exposed to the US economy through investment as opposed to trade. For example, the profits of American affiliates of German companies are five times bigger than German exports to the US. Their profits will be reduced by the US slowdown.

The slowdown in the US will reduce demand for primary inputs such as oil. It may be the case that the prices of oil and other raw materials will decline in response to reduced demand. Commodity producers such as Canada and Mexico would again be most exposed while big commodity importers such as the EU and Japan would stand to gain from lower oil and commodity prices.

A weaker US economy would lead to a weaker dollar. As various economic indicators have pointed to economic weakness in the US over the last six months the euro has already appreciated somewhat against the dollar. As the euro continues to appreciate against the dollar the profits of European manufacturers will be significantly affected. On the other hand countries that tie their currency to the dollar such as Argentina and China stand to gain in competitiveness.

The most likely mechanism that might put the US economy into recession is a collapse in overvalued US equity and stock markets. The NASDAQ index has borne the brunt of the slowdown as technology firms have seen their share prices fall dramatically. The market capitalisation rate of IT firms in the US is equivalent to 25 per cent of GDP down from 50 per cent in March 2000. Falling share prices have hit consumer confidence and spending in the US given the large amount of household debt tied up in financial assets.

Consumer spending in Europe, Japan and Asia is far less exposed to a collapse in share prices with far less household holdings in equities. The market capitalisation of IT firms as a percentage of GDP is lower outside the US, 2 per cent in Germany, 7 per cent in Japan and 5 per cent in the rest of Asia. A collapse in financial assets in the US, followed on by similar collapses across the globe would therefore affect consumer spending and confidence in other countries to a lesser extent than the US.

In terms of exposure to a US recession the most vulnerable are those in close geographical proximity to the US, namely Canada and Mexico. While euro area growth is expected to slow in 2001 it should grow faster than the US for the first time in ten years. Furthermore, with lower levels of corporate debt and far less household wealth in shares the euro area is less vulnerable to a stock market crash. Tax cuts throughout Europe should also help the euro area economies sustain economic growth.

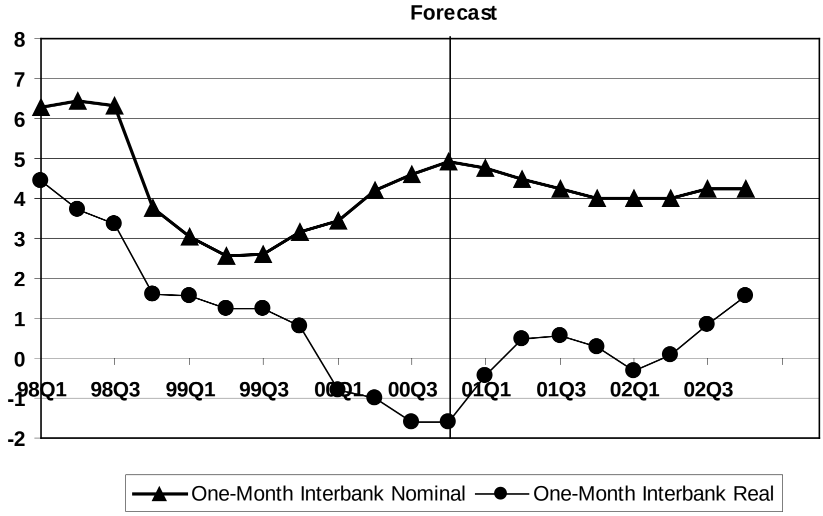
Economic prospects for Japan on the other hand are poor. GDP growth is extremely weak while the threat of deflation remains. It is conceivable that a sharp slowdown in the US could throw Japan back into recession. In summary, Europe can demonstrate that the rest of the world need not necessarily follow the economic trends in the US. The downturn in the US will be offset somewhat by growth elsewhere so that the world economy need not go into recession.

The Rest of the World

The year 2000 was a good one for the Asian region, but the growth was distributed unevenly across countries. Average growth is expected to exceed 6 per cent again in 2001, driven mainly by international trade, which increased by some 11 per cent last year. Poverty rates have fallen dramatically during the recovery, and are nearing pre-crisis levels in the fastest-expanding economies. However, the looming slowdown in world economic activity may prove to be a serious impediment to the recovery. The region is particularly vulnerable to demand shocks, as the 1998 crisis bestowed heavy debt burdens and uncertainty for investors and households.

The economic recovery in Japan remains extremely fragile. GDP growth was about 1.9 per cent in 2000, and is not expected to exceed 1 per cent this year. Industrial production increased by 5.7 per cent in 2000, its fastest rate since 1989, but fell by 3.9 per cent in January. Output growth may be hampered this year given the slowdown in the US and Japan's reliance on exports. Japan's trade surplus declined for the second successive year in 2000, but the current weakness of the yen should boost exports. However, employment and income conditions have shown little improvement, and household consumption has stalled. Consumer prices fell for the eighteenth consecutive month in February, and we expect prices to remain weak as a result of the slowing recovery and the decrease in the price of oil. The Bank of Japan reverted to a zero interest rate policy in an effort to stimulate the weakening economy. The financial stability of the banking system in Japan is also a real concern. Japanese unemployment hit an all-time high of 4.9 per cent in January. Overall, the moderate recovery seems tenuous, and slowing world activity is a major cause of concern for the Japanese economy.

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



The Context for Ireland

There is no doubt that the US economy is slowing, and the policymakers at the Federal Reserve cut interest rates in an effort to ensure a "soft landing" for the US economy. The alternative "hard landing" scenario has serious consequences for the world economy, and in particular for Ireland. The *National Institute for Economic and Social Research* (NIESR)[1] used their NiGEM global econometric model to consider the effects of a collapse in US confidence, resulting in a 20 per cent fall in US equity prices and a corresponding 10 per cent fall in European equity prices. They concluded that output in the euro area would fall by 0.63 per cent from their baseline projection in 2001. Ireland is more exposed to such a shock given the openness of the economy. However, Ireland would not be as affected as many commentators believe, given that most of our trade is within Europe, see Box B. Indeed, recent job losses announced by many large multinational companies do not affect locations in Ireland. This is because production in Ireland serves the European market, which is expected to remain robust in the face of slowing activity in the US.

Ireland's competitiveness on the world markets continues to be eroded, as the euro appreciates and domestic labour costs increase. The euro has appreciated to a level more consistent with its fundamentals. We still expect the euro to reach parity with the dollar by early next year. The only threat to this is a strong resurgence in the US economy, which is looking increasingly unlikely but cannot be ruled out given the aggressive interest rate cuts and proposed fiscal stimuli. With unemployment in Ireland falling to all-time lows, the excess demand for labour has led to significant wage inflation. This has increased unit labour costs and reduced competitiveness, thus making Ireland a less attractive location for investment.

[1] NIESR, *National Institute Economic Review,* No. 175, January 2001 pp. 36-38.

Finally, the agricultural crises in Europe have serious implications for Ireland. Both the BSE crisis in mainland Europe and the recent outbreak of FMD have the potential to seriously disrupt the important agricultural base for indigenous Irish industry. The BSE crisis, given the magnitude of the beef industry in Ireland, has more serious consequences for Ireland than for other EU members. The precautions that are being taken against FMD proved not to be sufficient to keep it out of Ireland, and it has also spread to mainland Europe. This potential epidemic could cause economic losses for the economy. The measures at containment and prevention of further cases also impose significant costs on many sectors of the economy. The uncertainty about the extent and duration of the FMD crisis make forecasting the scale of it impact on the Irish economy difficult. This issue is the subject of Box C later in the *Commentary*.

The confirmation of FMD in the Republic caused the Irish Stock Exchange to plummet in value. This occurred at a time when stock markets world-wide are exhibiting significant volatility. Uncertainty about the future path of world economic growth and the extent of the slowdown in the United States has been driving the volatility. Technology stocks have taken a downturn after trading well above their real value for the past year. Many investors are switching to bonds from equities as these provide a safer return on investment.

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

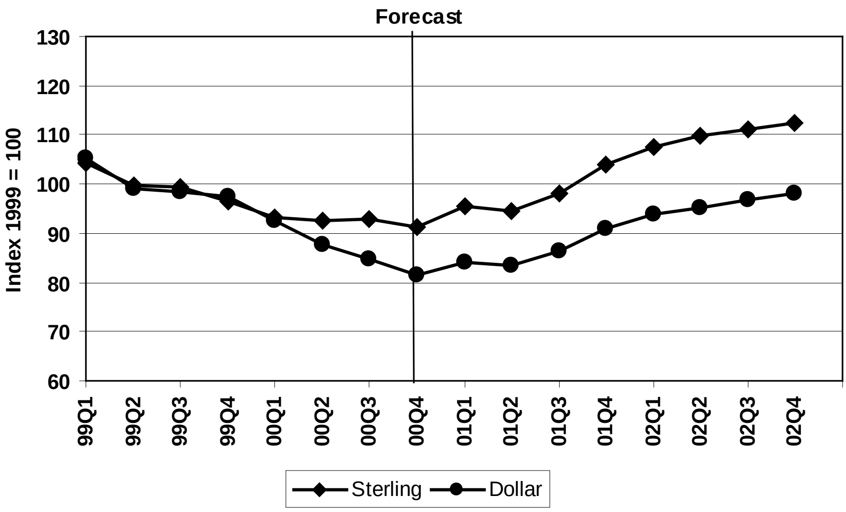


TABLE 1: Short-term International Outlook

	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	2.8	3.1	1.7	2.1	5.2	5.3	5.2	5.2	-1.2	-1.4
Germany	2.5	2.4	2.1	1.9	2.0	2.3	8.2	7.9	-0.5	-1.5
France	2.8	2.4	1.9	1.7	3.4	3.8	8.9	8.7	2.1	2.2
Italy	2.5	2.6	2.5	2.3	3.0	3.1	9.9	9.4	-0.4	-0.3
Total EU	2.8	2.7	2.0	1.9	3.5	3.8	7.9	7.7	0.5	0.4
USA	1.8	2.5	2.5	2.7	4.2	4.5	4.3	4.4	-3.8	-3.9
Japan	1.0	1.3	-0.2	0.0	1.5	1.8	4.6	4.5	2.1	2.2
Total (OECD)	2.3	2.5	2.1	1.9	3.6	3.9	6.2	6.1	-1.0	-1.1
Ireland	6.1	5.2	4.2	3.6	11.1	9.8	3.3	3.2	0.1	-1.6

The Domestic Economy

General

On the basis of the Quarterly National Accounts available for the first half of 2000, the Irish economy's incredible growth shows no signs of abating. While these accounts must be considered provisional and subject to revision, it seems clear that despite some evidence of the economy slowing in the latter half of the year the economy recorded near record real growth rates. Our revised estimate is that output grew at 10.5 per cent in real GDP terms and 9.8 per cent in GNP terms. These rates are comparable to the record performance of 1997.

The prospects for anything near double-digit growth rates in 2001 were always going to be remote. The sharp slowdown in economic activity in the US and the emerging agricultural crises has dented these prospects further. We have taken a fairly benign view on how these events will develop in making our forecasts for 2001, anticipating a strong likelihood of a "soft landing" in the US and the foot and mouth disease threat not developing into a protracted event for the Irish economy. Even with this optimistic view, we expect real GDP growth to be 6.7 per cent in 2001 and levelling to 6.2 per cent in 2002.

Exports

Official trade statistics for the eleven months to November 2000 confirm that growth in exports was very robust as a result of the continued weakness of the euro over the year. Export volumes grew by 20.5 per cent and in value terms exports rose by 25 per cent compared with the first ten months of 1999, implying an export price deflator of 3.7 per cent. Classification of trade by commodity shows that the rise in exports was spread over most categories, although electrical machinery, including office and data processing machines, showed the fastest growth at over 40 per cent. Recent revisions to the trade statistics have resulted in the value of exports for January-September being reduced by £543 million, related mainly to organic chemicals. Some adjustment has also taken place in the geographical destination of Irish exports. Aggregate exports to the US have been reduced by £1,503 million for the same period while aggregate exports to the EU have been increased by £960 million. Although this means that the US has not now become our largest single export destination, it does not alter the increasing trend in exports to this destination, (see Box B). The volume of total exports of goods and services is likely to have grown by 19 per cent in 2000 and by 25.5 per cent in value terms, implying an export price deflator for the year of 5.5 per cent.

The current year is likely to see much lower growth in exports, despite robust growth in the European economy. As is evident from the analysis in this *Commentary*, the Irish economy is operating at capacity. The appreciation of the euro that has occurred and the high rates of wage inflation will result in a loss of competitiveness, reducing export volumes. The recent BSE and FMD scares that have affected the agricultural sector are expected to lead to a volume decline in agricultural exports. The anticipated slowdown in the US economy and the high-tech sector will contribute to a reduction in the volume of export growth from the manufacturing sector. On this basis, volume growth of 8.8 per cent in visible exports is estimated for 2001, substantially lower than in recent years. The price deflator for exports is expected to be 3.6 per cent, implying value growth for visible exports in 2001 of 12.8 per cent. Some further moderation is forecast in 2002, albeit by no means as sharp as this year to a volume growth rate of 8.9 per cent and value growth of 12.3 per cent.

Based on Balance of Payment statistics, tourism receipts in 2000 are estimated to have grown by 8.1 per cent in value terms while other service exports grew by 15.6 per cent. A slowdown in economic growth internationally is expected to result in a moderation of tourism export growth in 2001 to 5.3 per cent. Other service exports, which include financial services, royalties, and computer software are expected to show growth at 13.5 per cent in value terms. On the basis of these forecasts growth in total exports of goods and services of 8.6 per cent in volume and 12.9 per cent in value is forecast for this year. In line with overall trends, a further slowdown is forecast for 2002, resulting in overall exports of goods and services growing by 8.5 per cent in volume terms and by 12.5 per cent in value.

TABLE 2: Exports of Goods and Services

Preliminary

	1999 £m	% Change in 2000 Volume	% Change in 2000 Value	2000 £m
Agricultural	3,173	7.2	9.6	3,477
Manufactured	44,607	20.3	26.8	56,560
Other Industrial	3,869	7.5	12.0	4,333
Other	883	7.3	9.4	967
Total Visible	**52,532**	**18.3**	**24.4**	**65,337**
Adjustments	-2,953	-30.0	**-35.6**	-1,901
Merchandise	**49,579**	21.2	27.9	**63,435**
Tourism	1,898.2	2.8	8.1	2,053
Other Services	8,978.9	10.1	15.6	10,380
Exports of Goods And Services	**60,457**	**19.0**	**25.5**	**75,868**

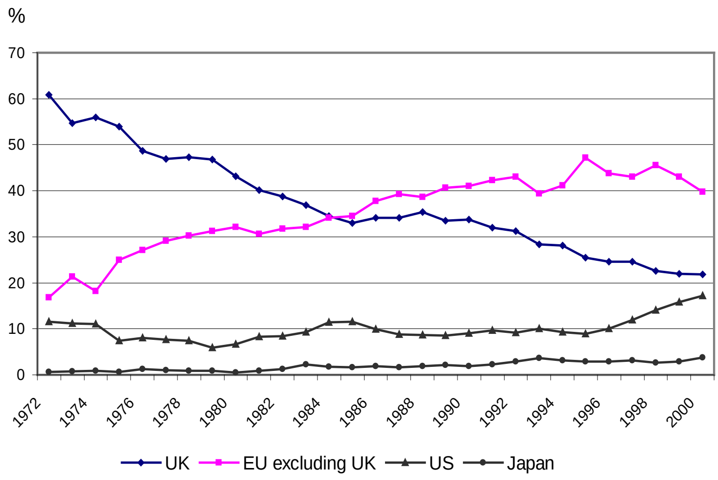
Forecasts

	2000 £m	% Change in 2001 Volume	% Change in 2001 Value	2001 £m	% Change in 2002 Volume	% Change in 2002 Value	2002 £m
Agricultural	3,477	-5.0	-3.3	3,362	7.0	9.1	3,670
Manufactured	56,560	10.2	14.4	64,697	9.5	13.0	73,111
Other Industrial	4,333	3.3	6.4	4,611	3.0	6.5	4,910
Other	967	2.6	4.0	1,006	2.2	5.1	1,057
Total Visible	**65,337**	**8.8**	**12.8**	**73,676**	**8.9**	**12.3**	**82,747**
Adjustments	-1,901	15.0	3.5	-1,968	15.0	3.5	-2,037
Merchandise	**63,435**	**8.6**	**13.0**	**71,708**	**8.6**	**12.6**	**80,710**
Tourism	2,053	1.7	5.3	2,161	1.2	4.5	2,259
Other Services	10,380	10.0	13.5	11,783	9.2	13.3	13,356
Exports of Goods And Services	**75,868**	**8.6**	**12.9**	**85,652**	**8.5**	**12.5**	**96,326**

Box B: Shares of Irish Trade

The growth of the Irish economy throughout the 1990s has coincided with massive export growth. Between 1996 and 1999, goods exported by the economy increased by 73 per cent. The growth of the Irish economy has also been characterised by significant change in Ireland's relationship with the various export markets. Figure B1 shows the export trade shares of Ireland's main trading partners, the US, UK and EU (excluding the UK) and Japan.

Figure B1: Export Trade Shares



Over the last thirty years Ireland has become less dependent on Britain both in terms of exports and imports, Irish firms have made significant advances in penetrating new European markets and most recently the US has emerged as a more important export market for Ireland. The most obvious change has been the continual decline of the UK market as a destination for Irish exports. The share of exports to the UK stood at 61 per cent in 1972 but for the first eleven months of 2000 has declined to 22 per cent. The decline of the share of exports to the UK illustrates the weakening of the traditional dependence of the Irish economy on the UK market coinciding with the emergence of the EEC and later the European single market.

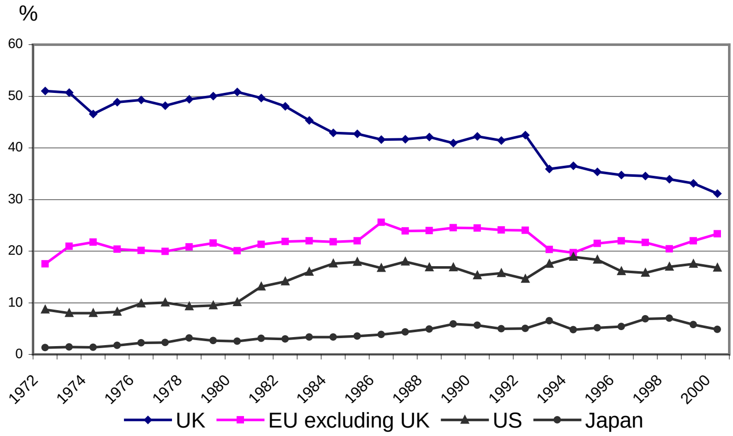
Exports to Europe have increased massively since the 1970s. In 1972 the share of the EEC excluding the UK was 17 per cent, by 1999 this share had increased to 43 per cent of all exports from Ireland. However trade statistics so far for 2000 indicate that the export share of the EU excluding the UK has fallen to 40 per cent. The recent drop in the export share of the EU (excluding the UK) reflects the large increase in importance of the US as a destination for Irish exports. The export trade share of the US increased from 10 per cent to 16 per cent between the years 1996 to 1999.

Trade statistics for 2000 show that this share now stands at over 17 per cent. It is notable that the export share of the US has only increased notably over the last five years, coinciding with the acceleration of growth in the Irish economy. Up until 1995 the importance of the US as an export market remained relatively stable staying just below 10 per cent of total exports for the majority of the previous twenty years. With the US market becoming more important the exposure of the economy to fluctuations of the euro has become more pronounced, although this is somewhat offset by the continued decline in importance of the UK market. Similarly US growth prospects have now become more significant given demand for Irish exports fall as US consumer spending declines.

The export trade share of Japan remains relatively insignificant as compared with Ireland's main trading partners. However the share of exports to Japan stood at just 0.7 per cent in 1972 but has increased substantially over the last three decades to 2.9 per cent in 1999 and 3.8 per cent for the first eleven months of 2000.

Figure B2 shows the import shares of the US, UK, EU (excluding the UK) and Japan. Again, figures for 2000 represent statistics for the first eleven months of the year.

Figure B2: Import Trade Shares



As in the case of exports, the most striking feature of the data is the change is Ireland's trade relationship with the UK. In 1972 over 50 per cent of Ireland's imports came from the UK market, this share has declined to just over 30 per cent in the first ten months of 2000. In a similar manner to exports, Ireland has become less reliant on the UK as the import share of the UK has declined. It is interesting to note that the decline of the UK's export share has not been matched by the decline of the UK's import share. While continuing to be relatively small, the share of imports from Japan has increased from just 1.3 per cent in 1972 to 5.7 per cent in 1999 and 4.8 per cent for the first eleven months of 2000.

The import shares of both the US and EU have both remained relatively constant throughout the 1990s. Irish export growth into the euro area has not been matched by a similar increase in imports from the euro area. However, it is expected that with the introduction of the euro and the completion of the single market that the import share of the EU should increase in the future, reducing Ireland's exposure to fluctuations in the euro.

Stocks

The reversal in stock building from the lows of 1999 continued last year. The value of stock changes is expected to amount to £185 million in 2000. The prospects for 2001 have been substantially revised. The strength of domestic demand and emergence of capacity constraints continue to exert influence, but by far the most significant factor will be the decline in farm stocks. This will occur through a rise in the demand from the British market for Irish produce and a de-stocking in reaction to BSE and FMD crises. The change in stocks in value terms is forecast to fall by £215 million in 2001 but rebounding in 2001 to rise by £190 million in 2002.

TABLE 3: Stock Changes

	1999 £m	Change in Value £m	2000 £m	Change in Value £m	2001 £m	Change in Value £m	2002 £m
Farm Stocks	-130	110	-20	-160	-180	200	20
Irish intervention Stocks	-166	166	0	0	0	0	0
Other Non-Agricultural Stocks	239	-34	205	-55	150	-10	140
Total	**-57**	**242**	**185**	**-215**	**-30**	**-190**	**160**

Investment

All available indicators suggest that the volume of investment in building and construction continued to rise steeply in 2000. We now estimate that the volume increase was 9.1 per cent, compared with our previous forecast of 8.8 per cent. Coupled with our forecast volume growth in machinery and equipment, we now estimate that gross fixed capital formation in 2000 increased by 11.2 per cent in volume and by nearly 22 per cent in value.

Already the international slowdown is having some impact on investment, with some high profile announcements of investment being postponed for up to a year. However, with demand for housing likely to remain high and house prices still tending to rise, another year of high levels of construction of new dwellings is anticipated in 2001. With the economy still growing most other types of investment seem likely to increase again in 2001 and 2002. From a higher base, a lower rate of volume growth of 6.8 per cent in total investment in building and machinery is forecast, with a value increase of 19.4 per cent as the price deflator will remain high in 2001. A further moderation of growth is forecast in 2002 to 6.3 in volume terms. With some moderation in the price deflator to 9.2 per cent, a value increase of 16.1 per cent is forecast for investment in building and construction in 2002.

In line with the slowdown in investment in other areas, investment in machinery and equipment in 2001 and 2002 is expected to show more moderate growth. Total gross fixed capital investment in 2001 is thus forecast to increase by 7.1 per cent in volume and 17.1 per cent in value, slowing to a volume increase of 6.9 per cent in volume in 2002.

TABLE 4: Gross Fixed Capital Formation

Preliminary

	1998 £m	% Change in 1999 Volume	% Change in 1999 Value	1999 £m
Housing	5,209	8.0	27.2	6,627
Other Building	4,836	10.2	20.4	5,825
Building and Construction	10,045	9.1	24.0	12,452
Machinery & Equipment	6,130	14.6	18.6	7,271
Total	16,175	11.2	21.9	19,723

Forecasts

	1999 £m	% Change in 2000 Volume	% Change in 2000 Value	2000 £m	% Change in 2001 Volume	% Change in 2001 Value	2001 £m
Housing	6,627	5.5	19.2	7,900	4.1	13.5	8,964
Other Building	5,825	8.2	19.6	6,965	8.8	19.1	8,298
Building and Construction	12,452	6.8	19.4	14,865	6.3	16.1	17,262
Machinery & Equipment	7,271	7.8	13.2	8,230	8.0	11.3	9,163
Total	19,723	7.1	17.1	23,094	6.9	14.4	26,425

Consumption

The most recent set of retail sales data shows that, in 2000, the volume of retail sales rose by 12.1 per cent and that value rose by 16.6 per cent, implying a retail sales deflator of 4 per cent.

With employment continuing to increase, income tax reductions increasing disposable income and historically low and stable interest rates, personal consumer expenditure is expected to continue to grow. However, some increasing concerns about prospects for the future may be having a negative impact on consumer confidence. Coupled with lower car sales than in 2000 that then means that a lower rate of growth is anticipated. Even so the volume of personal consumption is forecast to grow by 7.6 per cent this year and by 6.8 per cent in 2002.

An increase in the personal savings ratio to 7.6 per cent in 2001 followed by a modest decline to 7.2 per cent in 2002 is forecast. Government consumption is estimated to have risen by about 5 per cent in volume and 10.3 per cent in value in 2000. A slightly higher rise of 5.2 per cent in volume terms is forecast for 2001. A moderation in growth is expected in 2002 with volume growth slowing to 4.6 per cent. However, resource constraints in the economy are likely to result in the price deflator remaining very high, implying value growth of 14.8 per cent.

TABLE 5: Consumption Indicators

	Annual Percentage Change						
	1996	1997	1998	1999	2000	2001 Forecast	2002 Forecast
Consumption Value							
NIE 1997, Personal Consumption	9.3	10.0	11.4	11.3	15.5	12.4	11.0
Retail Sales Index, Value	8.3	9.0	9.5	11.5	16.6	13	12.3
Divergence	1.0	1.0	1.9	-0.2	-1.1	-0.6	-1.3
Consumption Volume							
NIE 1997, Personal Consumption	6.5	7.3	7.4	7.7	9.4	7.6	6.8
Retail Sales Index, Volume	6.2	7.9	7.8	9.5	12.1	10.3	9.2
Divergence	0.3	-0.6	-0.4	-1.8	-2.7	-2.7	-2.4
Consumer Prices							
NIE 1997, Personal Consumption Deflator	2.6	2.5	3.7	3.3	5.6	4.5	3.9
Retail Sales Index Deflator	2.0	1.0	1.6	1.8	4.0	2.4	2.8
Consumer Price Index	1.6	1.5	2.4	1.6	5.6	4.2	3.6

Final Demand

Final demand in 2000 is estimated to have increased by 21.2 per cent in value and 14.3 per cent in volume. These estimates suggest that final demand grew slightly faster than in 1999. Expenditure forecasts for 2001 and 2002 indicate that the growth in final demand is likely to be less rapid, although projections of 7.1 per cent and 6.7 per cent growth in volume terms still represent a strong rate of growth. Most of the reduction in growth is accounted for by slower growth in exports.

Imports

Based on trade statistics to November 2000 the volume of imports is estimated to have grown by 18.1 per cent and by 25 per cent in value for the year as a whole. When tourism and other services imports are included growth in the imports of total goods and services amounted to 18.4 per cent in volume terms. Coupled with a price deflator of 6.5 per cent this implies growth in the value terms for the imports of goods and services of 26.1 per cent in 2000.

Imports of capital goods are expected to slow in 2001, reflecting our forecast moderation of investment levels in machinery and equipment. Lower growth is also forecast in imports of consumer goods. With industrial production likely to increase less rapidly in 2001 and 2002, the rise in imports of raw materials and intermediate goods is also likely to be lower. Thus, total visible imports are forecast to increase by 7.6 per cent in volume and 11.7 per cent in value.

Tourism spending overseas is again likely to increase strongly, although the exceptional rate of 2000 is unlikely to be repeated. A slowdown in the growth of imports of other services is forecast for 2002, again based on our forecast of slower expansion in industrial output.

Thus, total imports of goods and services in volume terms are projected to increase by 8.8 per cent in 2001 and by 9.8 per cent in 2002. This is a slower rate of increase than in 2000, in line with the reduced growth forecast for domestic demand.

TABLE 6: Imports of Goods and Services

Preliminary

	1999	% Change in 2000		2000
	£m	Volume	Value	£m
Capital Goods	5,110	17.4	23.0	6,288
Consumer Goods	7,391	14.4	20.2	8,887
Intermediate Goods:				
Agriculture	573	9.3	11.6	639
Other	19,913	20.4	28.2	25,534
Other Goods	1,664	12.7	18.3	1,969
Total Visible	**34,651**	**18.1**	**25.0**	**43,316**
Adjustments	-2,975	-30.0	-44.0	-1,666
Merchandise Imports	**31,676**	**22.6**	**31.5**	**41,650**
Tourism	1,829	18.2	24.7	2,281
Other Services	17,473	10.7	16.3	20,329
Imports of Goods and Services	**50,978**	**18.4**	**26.1**	**64,259**

Forecasts

	2000	% Change in 2001		2001	% Change in 2002		2002
	£m	Volume	Value	£m	Volume	Value	£m
Capital Goods	6,288	9.5	13.6	6,252	12.5	15.7	8,257
Consumer Goods	8,887	9.0	12.9	8,713	9.7	13.0	11,339
Intermediate Goods:							
Agriculture	639	1.5	3.5	634	5.4	7.3	710
Other	25,534	7.0	11.4	24,056	7.2	11.3	31,648
Other Goods	1,969	5.5	7.9	1,950	4.7	7.0	2,273
Total Visible	**43,316**	**7.6**	**11.7**	**41,605**	**8.4**	**12.0**	**54,227**
Adjustments	--1,666	15.0	15.0	-1,191	15.0	15.0	-2,203
Merchandise Imports	**41,650**	**7.3**	**11.6**	**46,487**	**8.1**	**11.9**	**52,024**
Tourism	2,281	8.0	11.5	2,542	10.1	13.7	2,892
Other Services	20,329	11.9	14.6	23,294	13.3	16.7	27,183
Imports of Goods And Services	**64,259**	**8.8**	**12.5**	**72,323**	**9.8**	**13.5**	**82,099**

Balance of Payments

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.

On the evidence of the Balance of Payments estimates for the first three quarters, net factor outflows are estimated to have increased by over 21 per cent. Allowing for further reduction in net current transfers, the overall surplus on the current account is estimated to have declined to £318 million in 2000, compared with a surplus of £446 million in 1999.

The forecasts for exports and imports already presented suggest that the visible trade surplus in 2001 could increase by 14.8 per cent to £25,229 million. After allowance for adjustments and another large rise in the service trade deficit, the surplus on trade in goods and services is forecast to increase by 14.8 per cent.

Because of slower growth expected in high-technology manufactured exports, a smaller rise in reinvested earnings is forecast for 2001 and 2002. Nevertheless, net factor outflows are forecast to increase by 14.4 per cent this year and by 15.7 per cent in 2002. With a continuing decline in net current transfers the current account is forecast to move into deficit over the next two years, reaching 1.7 per cent of GNP in 2002. This marked deterioration in the current account reflects a number of factors. Our forecast is based on an expectation that the euro will continue its modest appreciation and import growth is forecast to exceed export growth. However, the main factor increasing the size of the deficit in 2002 is a large increase in profit outflows. It should be remembered, as has been stated in previous *Commentaries*, the balance of payments is less important now that Ireland is a member of EMU and no longer has an independent currency vulnerable to speculative attack. But a growing deficit is an indicator of demand growing faster than domestic supply capacity and so should not be disregarded.

TABLE 7: Balance of Payments

	1999 £m	Change %	2000 £m	Change %	2001 £m	Change %	2002 £m
Visible Trade Balance	17,881	23.2	22,021	14.8	25,274	12.8	28,520
Adjustments	22		-235		-52		166
Merchandise Trade Balance	**17,903**	**21.7**	**21,785**	**15.8**	**25,221**	**13.7**	**28,687**
Service Trade Balance	-8,425	20.8	-10,177	16.9	-11,892	21.6	-14,460
Trade Balance in Goods and Services	**9,479**	**22.5**	**11,609**	**14.8**	**13,330**	**6.7**	**14,227**
Total Debit Flows	-28,501	31.7	-37,522	17.3	-44,007	15.4	-50,774
Total Credit Flows	18,517	37.3	25,421	18.6	30,158	15.2	34,750
Net Factor Flows	**-9,984**	**21.2**	**-12,101**	**14.4**	**-13,848**	**15.7**	**-16,024**
Net Current Transfers	**951**	-14.8	**810**	**-29.5**	**571**	**-23.6**	**436**
Balance on Current Account	**446**		**318**		**53**		**1,360**
Capital Transfers	441	41.7	625	-15.2	530	-7.5	490
Effective Current Balance	**887**		**943**		**583**		**-870**

Gross National Product

Reflecting some alterations in composition, our estimate of the increase in real gross domestic product has been revised upwards marginally to 10.5 per cent, the largest rise since 1997. A downward revision in estimated net factor outflows has raised our estimate of real GNP growth from 8.6 per cent to 9.8 per cent in 2000.

Because of the various factors already discussed, we have reduced our growth estimates for 2001. The estimated increase in real GDP has been scaled back from 7.3 per cent to 6.7 per cent and real GNP growth has been reduced from 6.6 per cent to 6.1 per cent. It should be remembered that these are still high growth rates by international standards.

The preceding analysis suggests that a further slowdown in growth is likely in 2002 and so we have forecast real GDP growth of 6.2 per cent and real GNP growth of 5.2 per cent.

Final figures for average import and export prices in 2000 are not yet available. However, the monthly trade price indices, which are not always reliable, suggests there was a deterioration in the terms of trade in 2000, resulting in gross national disposable income, adjusted for terms of trade, (GNDI) growing by 8.2 per cent. An improvement in the terms of trade means that GNDI is forecast to rise by 6.2 per cent in 2001 and 5.3 per cent in 2002.

Agriculture

The agriculture sector is potentially facing its worst crisis in many decades; see Box C, with the outbreak of foot and mouth disease in Ireland. It is estimated that the sector, having grown quite strongly in value terms in 2000, will see much of this reversed in 2001. We estimate that in terms of gross domestic product in agriculture, forestry and fishing in 2001, the fall in value will be about 8.5 per cent or over £200 million. While losing the disease-free status will be a negative factor going forward, a contained outbreak may allow the sector to return to its normal, albeit erratic, growth pattern in 2002. We are forecasting a bounce back with the sector growing at 11 per cent in volume terms in 2002.

Box C: Crises for Irish Agriculture

For a sector that has traditionally faced recurring crises, the double blow of BSE and foot and mouth disease (FMD) scares within Europe in the last four months are by far the most significant threat faced for a generation. While the share of agriculture in the economy has fallen since the last scare from FMD in 1967, the consequences for Ireland of a full-blown epidemic would still be significant. Gross agricultural output accounted for almost 4 per cent of GDP in 1999, about a quarter of its contribution in 1967 but about seven times the equivalent in the UK and three times that of the EU average. While the employment share in the sector has declined dramatically over time to about 7 per cent of overall employment, the diverse geographical spread of the industry, in contrast to the clustering of high technology companies for instance, means that it is a more important driver of economic activity than global shares would indicate.

The agri-food industry has just under a 9 per cent share of total exports and though it has a substantial number of foreign markets, the UK remains the most significant at about 40 per cent of the total exports from the sector. Within the sector beef and dairy are the most significant. Prior to the latest FMD outbreak, the beef sector was hit by the emergence of BSE cases in France and then subsequently in Germany and Spain at the end of last year.

Beef prices had risen sharply in 2000, but with the blow of renewed BSE reducing demand for beef at the European level this year prices had fallen. The FMD crisis in the UK has temporarily at least increased the demand for Irish beef, boosting prices somewhat but the prospects are still very uncertain. The impact of the EU led responses to allay consumer worries like the mandatory testing of cattle over 30 months and the costs of the Purchase for Destruction scheme are major imponderables. With the FMD outbreak raising the prospect of lost export markets, forecasting this normally volatile sector is even more difficult than usual.

In contrast to the BSE issue, FMD is a potential source of crisis not just for beef but also for pig and sheep sectors. Measures aimed at preventing the outbreak of FMD will have a depressing impact on the sector's activity. The impact of prevention measures can have more pronounced impacts in other sectors like tourism and transport. The substantial lasting benefits within the EU to the indigenous agricultural sector from having disease-free status, in contrast to other countries, would have been significant. A confinement of the outbreak may confer some of these benefits in any case, leading to significant re-sourcing of produce from Ireland by large international retail organisations. Even in the short term, factory prices for slaughter had been pushed up as export demand from the UK for beef increased substantially.

The large uncertainty about the FMD as regards its extent and duration requires that we make some heroic assumptions for forecasting. We are taking an optimistic view that the confirmed FMD outbreak in the country remains confined, allowing for export markets to be re-opened within a reasonably short time-frame and that lost activity from prevention strategies last for one quarter.

Industry

The volume of production index for manufacturing rose by 15.1 per cent in 2000. Evidence from the *IBEC/ESRI Business Survey* and the *NCB Purchasing Managers Survey* pointed to some moderation of growth levels in the latter half of last year continuing into the first quarter of 2001. Given the downturn in the international environment apparent in the first months of 2001, the prospects for Irish industry remain relatively upbeat. Output from the building sector should remain robust, with annual growth of around 6 per cent for both 2001 and 2002. The gross output of the broad industry sector is forecast to be 8.3 and 7.7 per cent in volume terms in 2001 and 2002 respectively.

This forecast is in line with the overall slowdown in economic growth predicted. The main risk for this forecast is the impact of the US slowdown for manufacturing industry in Ireland, particularly in the information and communications technology (ICT) sectors. Constituting about 40 per cent of total exports and a substantial part of GDP in 2000, the ICT sector has been an important engine of growth for the Irish economy. The global downturn for computer equipment, particularly the personal computer, has increased the downside risk for Irish industrial growth. A number of high profile job reduction announcements and investment postponements have increased anxiety about Ireland's exposure to this sector but some of these fears seem overdone.

If the slowdown in the US is relatively mild, in terms of reduced output growth, and reasonably short in duration, recovering later this year, then it is unlikely to have major consequences for the European market which is the critical outlet for most Irish based ICT output. Without a significant fall in ICT spending in Europe, the impact on Ireland will be fairly muted though some increase in job losses in the sector is still likely.

Services

The services sector is anticipated to have grown at about 9 per cent in 2000. On the basis of the Quarterly National Accounts for the first half of last year, this would be consistent with a slowdown in the latter half of the year. The bulk of the increase came from the private sector, given a modest rise in the volume of output from public services.

The effect of the measures to prevent and contain foot and mouth disease within the State are likely to have a significant, albeit temporary, impact on the output of this sector in 2001. The duration of the measures, involving cancellations and postponements, is difficult to anticipate. Taking an optimistic view that the majority of the knock-on consequences will have most effect over the second quarter of the year, we forecast volume growth of 5.4 per cent for 2001, declining to 4.8 per cent in 2002.

The tourism sector is likely to take the greatest collateral damage from the FMD measures with output growth declining below 5.0 per cent in real terms in contrast to an average growth in excess of 10 per cent in the last decade. The export contribution from tourism is also likely to be significantly down from previous years. While the private sector will continue to provide the main impetus for growth in the services sector, plans to increase public sector employment in professions like teaching and nursing will make a significant contribution.

Employment

The latest Quarterly National Household Survey (QNHS) for the fourth quarter of 2000 shows that employment in the Irish economy grew on average by 4.7 per cent last year. While Irish employment growth for 2000 is still strong by historical and international standards, the latest QNHS confirms that employment growth is slowing in the economy. Employment grew at an annual rate by 62,900 or 3.8 per cent in fourth quarter as compared to 6.1 per cent in the first quarter.

In part the slowdown of employment growth reflects the slowdown in labour force growth in 2000. The labour force grew by 85,400 between the fourth quarters of 1998 and 1999. Growth between the fourth quarters of 1999 and 2000 moderated significantly, however, with just over 43,000 entering the labour force in that period. The overall participation rate in the labour force between the fourth quarters of 1999 and 2000 as measured by the QNHS was on average 59.4 per cent. Average male participation was 71.5 while average female participation was 47.8 per cent.

In terms of unemployment, both the QNHS and the February Live Register Statement provide further evidence that the economy is moving ever closer to full capacity. For the first time the unemployment rate as measured by the QNHS has fallen below 4 per cent. The latest Live Register Statement indicates that the standardised unemployment rate was 3.6 per cent in February. The Live Register fell by 2,556 persons in February to 139,515. On a seasonally adjusted basis the register is now at its lowest level since December 1981.

Significant inequalities persist between the regions in terms of employment and unemployment. The latest QNHS indicates that unemployment in the Dublin area has fallen below 3 per cent while the Border region has the highest unemployment rates in the country at 5.4 per cent. Employment is growing proportionately faster in the Border, Midland and Western region which experienced employment growth of 5.7 per cent in 2000 as compared to just 3.2 per cent in the Southern and Eastern region.

Full-time employment grew by 53,500 in 2000 making up a large portion of the annual growth whereas part-time employment grew by only 9,400. All of this increase was for females, who account for three-quarters of those in part-time employment. On a sectoral level employment grew most strongly in construction (+23,300), the wholesale and retail sector (+13,300) and education and health (+16,000). The only sectors to experience a decline in employment were agriculture, forestry, fishing and other services.

It is forecast that total employment for the year 2001 will average 1.691 million persons rising to 1.742 million in 2002. In percentage terms, numbers employed are expected to rise by 3 per cent this year and 1.9 next year, see Table 8. The services sector is expected to once again be the main engine of employment growth, with services employment forecast to grow at 4.1 per cent in 2001. However, the overall slowdown in employment growth in 2002 is expected to be most pronounced in the services sector with employment forecast to grow at just 2.2 per cent in 2002. The slowdown in employment growth reflects the forecast slowdown of overall economic growth as the economy moves closer to full employment.

Numbers unemployed are expected to continue falling with an annual average of 3.3 per cent in 2001 falling to 3.2 per cent in 2002. These rates suggest that the economy is moving extremely close to full employment with frictional unemployment, where workers move between jobs making up the bulk of remaining unemployment. For these reasons only a marginal decline of 0.1 per cent in unemployment is expected in 2002, despite strong growth in the economy. Reduced labour force growth will place further capacity constraints on the economy which in turn will limit the scope for employment growth and further drops in the unemployment rate.

TABLE 8: Employment and Unemployment*

	Annual Averages '000			
	1999	**2000**	**2001**	**2002**
Agriculture	139	133	127	126
Industry	459	485	497	508
Services	1,018	1,073	1,117	1,142
Total at Work	**1,616**	**1,691**	**1,742**	**1,775**
Unemployed	95	73	60	59
Labour Force	**1,711**	**1,764**	**1,802**	**1,834**
Unemployment Rate %	5.6	4.1	3.3	3.2
Live Register	193	156	130	125

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

Incomes

Incomes continue to grow at record levels reflecting the high level of output growth in the economy as a whole. The level of income growth in 2000 is expected to have been significantly greater than in 1999 due to record employment growth. The growth of incomes is forecast to decline somewhat in 2001 and 2002, reflecting the expected slowdown in the economy as a whole.

Agriculture incomes are expected to rise by 11.5 per cent in 2000. The large increase in agricultural incomes in 2000 is due to strong output growth and subsidies received under the EU Agenda 2000 package. This year agricultural incomes are expected to contract by 9.1 per cent. Our estimates for agricultural income in 2001 have been revised downwards from the last *Commentary* to reflect adverse developments from the foot and mouth crisis. The threat of BSE may also pose further risks to agricultural incomes by depressing the price of beef, though the impact of FMD disease will depend largely upon the extent of the outbreak within the State.

Continued strong growth in hourly earnings is forecast with growth of 11.1 and 9.8 per cent expected for 2001 and 2002 respectively. In part our estimates for wage growth have been revised upwards to reflect developments in the Programme for Prosperity and Fairness (PPF) with the provision for an additional 2 per cent in 2001 and 1 per cent lump-sum in 2001 on top of the original terms agreed. However, with an extremely tight labour market, wage drift, particularly in the private sector, has the effect of offsetting the impact of newly agreed wage increases in the PPF on the growth of hourly earnings.

The non-agricultural wage bill for the economy as a whole is expected to grow by 15.1 per cent and 12.2 per cent in 2001 and 2002 respectively. National income is forecast to grow by 13.6 per cent this year and by 10.2 per cent in 2002. This means 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 both this year and in 2002. This trend is indicative of an economy approaching full employment with labour shortages leading to an acceleration of wage growth.

While the euro has appreciated somewhat over the last few months, it is still far from parity and has not significantly eroded Ireland's competitive position. While further appreciation of the euro is expected throughout 2001, margins and profitability are expected to remain high, especially in the multinational sector. The growth of net factor payments is forecast at 10.1 per cent this year and 11.7 per cent in 2002.

TABLE 9: Personal Disposable Income

Preliminary

	1999	Change		2000
	£m	%	£m	£m
Agriculture, etc.	2,071	11.5	239	2,310
Non-Agricultural Wages,	28,086	13.7	3,860	31,946
Other Non-Agricultural Income	9,813	21.9	2,150	11,963
Total Income Received	**39,970**	**15.6**	6,249	**46,218**
Current Transfers	7,658	2.6	**202**	7,860
Gross Personal Income	**47,628**	**13.5**	6,451	**54,078**
Direct Personal Taxes	9,512	14.8	1,410	10,922
Personal Disposable Income	**38,116**	**13.2**	**5,041**	**43,157**
Consumption	34,743	15.5	5,394	40,137
Personal Savings	3,373	-10.5	-353	3,020
Savings Ratio	8.8			7.0

Forecasts

	2000	Change		2001	Change		2002
	£m	%	£m	£m	%	£m	£m
Agriculture, etc.	2,310	-9.1	-210	2,100	12.4	260	2,360
Non-Agricultural Wages,	31,946	15.1	4,824	36,770	12.2	4,479	41,249
Other Non-Agricultural Income	11,963	9.6	1,143	13,106	7.0	912	14,018
Total Income Received	**46,218**	**12.5**	**5,757**	**51,976**	**10.9**	**5,651**	**57,627**
Current Transfers	7,860	14.7	1,152	9,012	10.4	934	9,946
Gross Personal Income	**54,078**	**12.8**	**6,909**	**60,988**	**10.8**	**6,585**	**67,573**
Direct Personal Taxes	10,922	11.3	1,239	12,160	12.0	1,455	13,615
Personal Disposable Income	**43,157**	**13.1**	**5,671**	**48,828**	**10.5**	**5,130**	**53,958**
Consumption	40,137	12.4	4,994	45,131	11.0	4,949	50,080
Personal Savings	3,020	22.4	677	3,696	4.9	181	3,878
Savings Ratio	7.0			7.6			7.2

Other non-agricultural incomes, representing mainly rents and profits, are expected to grow by 13.8 per cent this year and by 12.5 per cent in 2002. The slowdown of growth in 2002 as compared with this year reflects the expected appreciation of the euro relative to the dollar and also the overall slowdown of the economy. As a result other non-agricultural incomes are expected to grow less quickly than non-agriculture wages in 2001.

Consumer Prices

Having peaked at an annual rate of 7 per cent in November 2000, the consumer price index rose by 5.6 per cent in 2000, on an annual average basis, with the index for clothing and footwear showing a decline and all other components increasing. The dramatic increase in the rate of inflation meant Ireland was the highest inflation country in Europe for much of last year.

The overall rate of consumer price inflation is likely to be lower in 2001. The substantial increase in the excise duty on tobacco was not repeated in the December Budget which reduced the VAT and some excise duty rates. Furthermore, oil prices appear to have stabilised. Some small reductions in euro interest rates are anticipated and the euro has appreciated somewhat from the low levels of last year.

Thus, the total consumer price index is forecast to rise by an annual average of 4.2 per cent in 2001. On the grounds that these trends continue into 2002, a further decline in the annual average rate of inflation is forecast to 3.6 per cent. These increases are lower than those experienced in 2000 and reflect the importance of the external environment in determining the Irish inflation rate.

TABLE 10: Consumer Price Index – Recent Trend and Forecast

	Quarterly Trend								Annual			
	1999				2000				1999	2000	2001	2002
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4				
Index Nov. 1996=100												
Housing	93.6	92.2	93.1	86.7	90.5	96.0	103.4	111.0	91.5	99.6	112.5	115.8
Other	104.3	105.8	106.3	107.5	109.3	111.3	112.4	113.5	105.9	111.6	115.5	119.7
Total CPI	103.4	104.7	105.2	105.9	107.8	110.1	111.7	113.3	104.7	110.6	115.3	119.4
Annual % Change												
Housing	-8.3	-10.7	-10.9	-14.0	-3.3	4.1	11.1	28.0	-10.8	8.8	13.0	2.9
Other	2.5	2.5	2.6	3.4	4.8	5.2	5.7	5.6	2.6	5.4	3.5	3.6
Total CPI	1.6	1.5	1.4	2.1	4.3	5.2	6.2	7.0	1.6	5.6	4.2	3.6
Quarterly % Change												
Housing	-7.1	-1.5	1.0	-6.9	4.4	6.1	7.7	7.4				
Other	0.3	1.4	0.5	1.1	1.7	1.8	1.0	1.0				
Total CPI	-0.3	1.3	0.5	0.7	1.8	2.1	1.5	1.4				

Public Finances

The public finances continue to be boosted by the strong levels of activity and employment growth within the economy in 2000. Tax revenues increased by 15.8 per cent last year, with current expenditure on supply services up by 9.9 per cent. These components of current revenue and expenditure contrived to yield a Current Budget surplus of £5,498 million. The capital borrowing requirement meant that the Exchequer surplus measure was £2,478 million in 2000. The broader general government surplus for 2000 was approximately £3,800 million, or 4.7 per cent of GDP. The corresponding general government debt to GDP was 39 per cent. On both of these measures, used to assess compliance for the EU Stability and Growth Pact (SPG), Irish public finances comfortably conform to a medium-term sustainability position.

Budget 2001 delivered a substantial package of tax cutting measures, see Box D, which should stimulate the economy this year. The forecast for the public finances over the next two years remains positive. Tax revenue growth is expected to slow in line with employment and economic growth to 11.2 and 9.9 per cent in 2001 and 2002 respectively. Total current expenditure is expected to rise by 11.9 per cent in 2001, with expenditure on supply of current services rising by 18 per cent offsetting the fall in the central fund expenditure. In 2002 total current expenditure is expected to be rise by 10.8 per cent.

The impact on the current budget is for surpluses in excess of £6 billion in both years while the Exchequer surplus is expected to fall in 2002 as capital expenditure rises significantly. The general government surplus is expected to be 4.4 and 3.7 per cent of GDP in 2001 and 2002 respectively. The corresponding general government debt to GDP ratios in 2001 and 2002 would be 32 and 24.5 per cent respectively.

TABLE 11: Public Finances

	2000	% Change	2001	% Change	2002
Current Revenue	21,932	12.5	24,693	10.3	27,237
Current Expenditure	16,434	11.8	18,383	10.8	20,381
Current Surplus	**5,498**	14.7	**6,310**	8.6	**6,856**
Capital Receipts	2,091	-42.8	1,219	-16.2	900
Capital Expenditure	5,111	- 5.6	4,826	12.4	5,425
Capital Borrowing	**3,020**	19.4	**3,607**	25.4	**4,525**
Exchequer Surplus*	**2,478**	9.0	**2,703**	-13.8	**2,331**
as % of GNP	3.5		3.4		2.6
General Government Surplus	**3,809**	8.7	**4,131**	-7.0	**3,844**
as % of GDP	4.7		4.4		3.7
Gross Debt as % of GDP	**39.0**		**32.3**		**24.5**

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

Box D: Budget 2001 and the EU Broad Economic Policy Guidelines

The Budget for 2001 was delivered on December 6th 2000 amid a re-negotiation of the Programme for Prosperity and Fairness (PPF). The agreed adjustment of the wage terms of the PPF, in settlement of a dispute arising from the erosion of the real value of wages through higher than anticipated inflation occurred on December 4th. Crucially, however, this settlement was "in the context of Budget 2001" and was to be voted upon after the Budget was announced. This context is a central element in assessing the Budget that subsequently led to the EU Council of Ministers issuing a recommendation, at the request of the European Commission, on Irish fiscal policy under the Broad Economic Policy Guidelines (BEPG).

The BEPG for Ireland made a number of recommendations for product, capital and labour market objectives. In the context of budgetary policy there were three key recommendations. One was to frame the Budget to address overheating pressures in the economy; a second was to restrain real public consumption, that is mainly current government expenditure; and a third was to make advances on the infrastructural constraints through the *National Development Plan* (NDP).

The broad parameters of Budget 2001 included a widening of the standard tax band, increased tax allowances, reductions in both the standard and top tax rates, a reduction in social insurance rates for employees, increases in social welfare rates and child benefit allowance. These measures when taken in line with substantial expenditure increases could in qualitative terms at least be described as expansionary.

The moves to cut taxes and increase expenditure may not however impart any impulse to expand the economy if these are merely indexing for inflation. It is estimated that income tax cuts of the order of £650 million would be required to index the Budget to overcome this fiscal drag. Budget 2001 contained £1,231 million in full year cost of changes to income tax and PRSI. In addition to direct taxation cuts, indirect tax cuts costing £130 million in a full year were announced. On the expenditure side, an increase of £1,459 or 10.9 per cent in current spending (of which £776 million is on pay) and £740 million or 23 per cent on capital expenditure was envisaged for 2001.

In quantitative terms the entire package of tax cuts and expenditure increases comes in at close to £4 billion or over 4 percentage points of expected GDP in 2001. While an injection of this magnitude is large at any point in an economic cycle, the pertinent question is whether it is appropriate for the Irish economy at this juncture. This is the kernel of the dispute between the EU and the Irish authorities and it revolves around the fundamental uncertainty about what economic stage Ireland is at.

The EU position accords with the view that the rapid economic growth in recent years is the upward phase of a classic economic cycle. The clear prescription then for budgetary policy is to be counter-cyclical by contracting through reduced expenditure and higher taxes. The alternative position, in line with the actions of the Irish authorities, accords with the view that Ireland is on transition to a higher growth path. The rapid economic growth in recent years then is considered to be a part of a convergence to this higher growth path. The prescription in this case is for fiscal policy to facilitate the transition by lowering taxes to stimulate additional labour supply and increasing expenditure to improve infrastructure.

While this polarised characterisation of the positions may be too extreme, the essence of the dispute lies on the weight given to the transition versus cycle view. However, these positions are not mutually exclusive, in that an economy in transition can overshoot its trend growth rate, giving rise to overheating pressures as demand outstrips the supply capacity, at least in the short term. The appropriate policy response in this case, is to slow the domestic demand growth while encouraging increased supply capacity.

The EU, in the BEPG as agreed with Ireland, does not take the stark position of calling for reduced government expenditure nor increased taxes. Instead they seek to restrain real growth in public consumption to 2.7 per cent by 2002. The focus is primarily on current expenditure rather than public capital investment which is encouraged as part of the NDP, though postponement on some capital projects was advised subsequently to ease demand pressures. The Irish government response has been to increase rather than restrain current expenditure. The rationale offered for this increase is as *a contribution to make in containing inflation by underpinning the recent agreement with the Social Partners in relation to public service provision and social inclusion.*[2] In addition, the share of total government current expenditure as

[2] Ireland – Stability Programme December 2000 Update.

a percentage of GDP is still expected to fall to around 25 per cent, having already been the lowest in the EU.

The cuts in income tax were also justified on the basis of supporting the PPF and were seen as a prerequisite for accepting the re-negotiated wage terms. The traditional wage bargaining model used under existing social partnership frameworks has cut income taxes in return for moderate nominal wage growth. The argument advanced that the tax cuts in the past have not led to inflationary pressures was challenged in the last *Commentary*.

The tight labour market means that the desired substitution effect from tax cuts in encouraging greater labour force participation is likely to be quite limited, whereas the income effect from boosting disposable incomes from incumbent labour is likely to be substantial. The boost to the demand side of the economy is expected to outweigh the supply side impact, resulting in greater pressures on wage rates than anticipated. The impact on wage growth, in particular, of current expenditure increases through the labour market channel is expected to be much greater than from the tax cuts.

There should be little dispute that the aim of the Budget was expansionary. Consistent with the transition view, the aim was to expand the supply side. The contrary worry is that it may be unduly stimulatory for demand. The additional motivation of preserving the social partnership agreements could have been addressed without fuelling the demand pressure and avoiding being at odds with the BEPG.

The dilemma is how to pay workers more during good times without boosting contemporaneous demand? While not a panacea the use of deferred compensation measures as advocated in previous *Commentaries* would help break the link. This debate is taken up in the *Policy Discussion Forum* within this Commentary. It is clear that saving the PPF meant that Budget 2001 was pulled in a direction that was at variance with the BEPG.

General Assessment

The prospects for the Irish economy have been given a serious jolt during the first quarter of 2001. The slowdown in the US economy, apparent from the end of last year, has led to a series of investment postponements and announcements of job cuts by US multinationals in Ireland. The confirmed outbreak of foot and mouth disease (FMD) in Ireland, as well as in the UK and parts of mainland Europe, has also raised the prospect of slower economic growth this year. There is, however, considerable uncertainty about how these events are likely to unfold throughout the remainder of this year, making our forecasts quite sensitive to the duration and magnitude of outcomes assumed. Our forecasts, being based on a benign outlook for the likely developments both in the US and with FMD, should be considered as close to a best-case scenario, given the high downside risk the economy may be exposed to.

The economy is estimated to have grown in real GDP terms at 10.5 per cent in 2000. More remarkably, the growth in real GNP is estimated to have been 9.8 per cent, which would constitute the highest rate ever recorded for the Irish economy. The growth has been well balanced between domestic and foreign demand, but it was notable that the weakness in the euro exchange rate throughout last year continued to boost exceptionally strong export growth of over 25 per cent in nominal terms. The strength of domestic demand and the nature of the industrial activity in

Ireland meant that imports grew by 26 per cent in nominal value last year. Unemployment continued its downward tack, ending last year at a rate of 3.9 per cent on the basis of the Quarterly National Household Survey. Inflation in consumer prices, having dominated economic attention throughout 2000, averaged 5.6 per cent for the year, having peaked at 7 per cent in November.

The Programme for Prosperity and Fairness (PPF) had its wage terms revised in December in response to the unanticipated strength of consumer price inflation throughout 2000. Budget 2001 delivered significant tax cuts, both direct and indirect, to bolster the PPF agreement. The re-negotiated wage terms involve a 7.5 per cent nominal wage increase over the next twelve months and a 1 per cent lump sum for the final nine months of the agreement along with the 4 per cent already agreed. The expenditure commitments, in addition to the tax changes, outlined as part of budgetary policy resulted in Ireland receiving a formal recommendation for breaching the Broad Economic Policy Guidelines (BEGP) agreed with our European Union partners.

On entering 2001 at full throttle, on the back of strong competitiveness gains from the weakness of the euro, fears of a derailment from the extraordinary growth path of the last decade have been pronounced. The rapidity of the slowdown in corporate activity in the US, most dramatically observed in large falls in the stock market valuations, and the emerging FMD crisis, have called for reassessment of the growth prospects for this year.

Our forecast for 2001 for real activity in the Irish economy has been revised downward by a half a percentage point since our December *Commentary* to 6.7 per cent for real GDP and 6.1 per cent for real GNP. While the magnitude of the revision appears small, given some of the wilder assertions being made at the height of these scares, it is based on a relatively benign view of how these shocks may develop. In the case of the US slowdown our initial forecast had already factored in low growth in that economy over the first half of the year, with a sharp recovery in the second half, boosted by cuts in interest rates and tax reductions. We continue to view a recovery in the latter half of the year as the most probable trajectory but coming off a lower, near zero, growth base in the first half.

The FMD outbreak by its nature is much more difficult to call. For the purposes of our forecast we assume that it will be a contained outbreak and that export markets are fully reopened to produce from non-contaminated regions within a three-month period. The precaution and containment arrangements will have their main impact in other sectors over one-quarter duration. Against these downward revisions in our forecast, positive impulses through the additional stimulatory nature of the budget and the peaking of the euro area interest rate cycle earlier than we anticipated counterbalance the negatives.

The prospects for the US will be the most significant determinant of the prospects for 2002. Our forecast for 2002 is for growth to slow further towards sustainable rates with real GDP and real GNP at 6.2 and 5.2 per cent respectively. If the slowdown in the US were deeper and more prolonged than we are currently forecasting, this would cause us to reduce forecasts for 2002. The balance of probabilities would suggest that the necessary macroeconomic adjustments required in the US would make a downward revision of Irish growth prospects more likely next year.

Our forecast for the unemployment rate is to average 3.3 per cent and levelling off at 3.2 per cent in 2002. Inflation, as measured by the consumer price index (CPI), is forecast to drop on the basis of favourable external price developments, such as lower oil prices and falls in interest rates compared to last year. Domestic price pressures will continue to rise reflecting higher wage growth, but not by enough to outweigh the falling external price components. Our forecast for the CPI is to average 4.2 per cent in 2001 and dropping to 3.6 per cent in 2002. These inflation rates will still be among the highest in the euro area reflecting, in part, a convergence in Irish price levels to higher European levels.

While the view on inflation may appear sanguine, as we have stressed in previous *Commentaries,* the CPI is a particularly poor measure of overheating pressures for an open economy like Ireland. The excess demand pressures that have characterised the Irish economy in recent years are likely to continue on the basis of the growth forecasted for this year and next. While these will be masked in the CPI, they are picked up more readily in other price measures, such as the GDP price deflator forecast to be 6.6 and 5.0 per cent in 2001 and 2002. The tightness in the labour market is forecast to deliver wage growth far in excess of the PPF terms at 11.1 per cent this year and 9.8 per cent next year. In the context of competitiveness, such wage growth may be affordable in the short-term but given the likelihood of the euro appreciating over the next two years, policies that directly stimulate labour demand are of dubious value.

The difficulty in assessing the extent of overheating pressures within the economy is best illustrated in the debate on the appropriate budgetary policy for Ireland to pursue. The European Commission, as part of the BEPG, sought that the Irish budget be framed to "ensure economic stability given the extent of overheating in the economy". The fiscal policy measures as outlined at the end of last year by the Irish government were considered by the EU Council of Finance Ministers to be inconsistent with the BEPG and they sought in their recommendation that "countervailing budgetary measures" be taken in the coming year. The specific recommendation is to "ensure that no reduction in the underlying budgetary surplus for 2000 takes place".

In order to comply with this recommendation, the "underlying" budget surplus needs to be ascertained. This underlying position can be revealed by accounting for the impact of the economic cycle on the public finances. While in principle this should be a straightforward task, it invariably is not with a wide range of interpretations possible about the potential or trend growth rate used to derive the cyclical impact. This is particularly the case in economies that have experienced rapid growth like in the Irish case. The European Commission, for instance, making use of a high trend growth rate, considers Irish budgetary policy in recent years to be broadly neutral or mildly contractionary. This is in contrast with the expansionary interpretation delivered by the use of lower trend growth rates that are considered by us to be more sustainable.[3] Without clear agreement on what the "underlying" surplus should be, this debate has the potential to remain unresolved.

[3] See I. Kearney, D. McCoy, D. Duffy, M. McMahon, D. Smyth, 2000, "Assessing the Stance of Irish Fiscal Policy", *Budget Perspectives,* Dublin: The Economic and Social Research Institute.

The appropriate stance of budgetary policy needs to take account of a number of factors such as the state of the public finances, the stage of the economic cycle and the growth prospects for the economy reflecting its stage of development. The dispute with the EU has highlighted an additional consideration that membership of monetary union entails, namely the need to ensure that domestic budgetary policy takes account of fiscal co-ordination at the euro area level. As John Fitz Gerald points out, in a signed article in this *Commentary*, "co-ordination need not and should not involve extensive restrictions on domestic fiscal freedom". It is, however, as Fitz Gerald contends "very much in Ireland's interest that an appropriate mechanism is developed for achieving the necessary co-ordination of fiscal policy with the euro area". The point is clear: while small countries by their own actions have little impact on the overall policy mix at a European level, in the absence of a co-ordination mechanism they have no influence over actions by larger countries that can damage their interests.

While the recent impasse between the Irish authorities and the European Commission may, if interpreted dispassionately, prove to be a useful lesson for both parties, it could have been circumvented while serving both domestic and wider European interests. The justification that was offered by the Irish authorities for deviating from the public expenditure guideline in the BEPG was to support the latest partnership agreement, the PPF. The, by now traditional, route of using income tax cuts to support moderate wage terms, while appropriate in times of labour surplus and economic slack, results in additional demand pressures when the economy is operating at capacity.

In order to modify the linkage between providing increased wages, reflecting labour's share from the higher economic growth, and the increased stimulatory demand from tax cuts, the *Policy Discussion Forum* contained in this *Commentary* investigates methods of providing other options. In this forum, Donal de Buitleir and Don Thornhill present a formula to provide a gain sharing arrangement at a national level based on the type of profit sharing arrangements in place in the private sector. In a separate piece, John McHale proposes, as part of the wage bargain process, the use of deferred compensation mechanisms that utilise personal retirement savings accounts.

The introduction of national Special Savings Incentive Accounts in the recent Finance Bill is an attempt to reduce demand pressure in the economy. Such incentives are to be welcomed, but this scheme may constitute a missed opportunity to embed it into the wage bargaining process. While the terms of the scheme are attractive to encourage one of its stated aims, to foster regular savings; it is more difficult to determine whether it will be successful in its macroeconomic aim of reducing aggregate demand by increased aggregate savings. The difficulty in predicting this outcome results from the behavioural responses of economic agents to such government interventions. Almost inevitably, however, a significant part of the response will be the redirection of existing savings, adding nothing to the reduction in existing demand pressures.

The cost of the scheme to the Exchequer is difficult to estimate but given the attractive terms involved is likely to be significant. These State contributions to regular savings, though back-ended in their set-up, will on the accruals basis used in the national accounts, have the impact of increasing government expenditure, giving the impression that fiscal policy is even more stimulatory in contrast to the EU BEPG recommendations. The debate that ensued about Irish budgetary policy and the co-ordination of fiscal policies at the euro area level proved to be a distraction from more fundamental lessons that could be learnt from the events unfolding this year.

The first lesson is that there is a capacity to underestimate the impact of the economic cycle after a period of sustained growth. This is not a uniquely Irish phenomenon. For example, the impact of the economic cycle in the US in recent months has certainly reduced corporate profitability, whose exaggerated values had been supported by the claims of large trend productivity improvements. The interpretation that Ireland is going through a transition to a higher growth path, thereby justifying expansionary, pro-cyclical fiscal policy needs to acknowledge that economic cycles are still at work.

The second lesson is that these economic cycles can be quite pronounced for a small open economy within a monetary union, working through the impact of exchange rate movements on competitiveness. The experience of the Irish economy in the first two years of Economic and Monetary Union (EMU) has been illustrative. The combined economic growth rates recorded in 1999 and 2000 have surpassed even the remarkable growth rates that went before, and occurred at a time when the economy was expected to begin to slow as a consequence of emerging capacity constraints. The weakness of the euro exchange rate in this period provided a strong competitiveness boost for trade with the non-euro area despite rising domestic cost factors.

With no devaluation option available within EMU, competitiveness restoration in response to unfavourable currency movements must come through other mechanisms. Declining profit margins and/or reduced wage bills will be required. The desired flexibility in the wage bill is better achieved through adjustable pay rates than through job cuts. The need to modify the existing wage bargaining component in future social partnership agreements is made all the more pressing in this regard.

The third lesson thrown up by events this year is the need to make provision for contingency measures to deal with shocks to the economy. Both the slowdown in the US economy and the outbreak of foot and mouth disease in Western Europe are not unique shocks to Ireland, but their impact is potentially greater here than elsewhere. The large fiscal surpluses currently available allow considerable leeway in stabilising the negative impacts of these shocks. This is a fortunate position to be in, given the unfolding of these unfortunate events, but it clearly identifies the need to maintain a relatively large fiscal surplus in the long run.

The events of the first quarter of 2001 demonstrate that the Irish economy, having come through a golden age of economic growth, must be vigilant to ensure that it keeps going forward, albeit at slower, more sustainable growth rates. The configuration of two of the remaining domestic macroeconomic policy tools, fiscal and incomes policies, need to be flexible to ensure that Irish competitiveness, the key to improved living standards for a regional economy, is responsive to changing external conditions.