SUMMARY

Output in 2000 increased by 11.5 per cent in real GDP and 10.4 per cent in real GNP according to the preliminary estimates of the national accounts. This remarkable growth accelerated into the first quarter of 2001 with an estimated annual real GDP growth rate of 13.2 per cent. It is clear that the economy has since decelerated dramatically throughout 2001 in response to the sharp international slowdown and the domestic threat posed by a foot and mouth outbreak. Given the large carry-over impact from last year, our projection for growth in real GDP in 2001 is 6.4 per cent and 4.9 per cent for real GNP.

The terrorist attacks on the United States and their consequences have greatly increased the uncertainty about the economic outlook for 2002. The slowdown in the international economy evident throughout 2001 has become even more pronounced in the third quarter. While the main macroeconomic impact has been upon economic sentiment, particularly reduced consumer confidence, it is the airline and tourism sectors that have borne the brunt of the retrenchment in demand thus far. The economic fundamentals of the major world economies remain sound and the adopted policy mix of loose monetary and stimulatory fiscal policies augurs well for the prospects of a strong recovery in the second half of 2002.

On the basis of an anticipated recovery in the international economies next year, the prospects for the Irish economy in 2002 are reasonably good. Next year, however, is still likely to be the first time in eight years that the Irish economy will grow below its potential output growth rate. Our forecast for output growth in 2002 is 3.4 and 2.6 per cent in real GDP and real GNP terms respectively. It is anticipated that the economy will be returning towards it potential growth of around 5 per cent in real GDP towards the latter part of next year.

The sharp fall-off in economic growth is to likely lead to a small reversal in the almost decade-long trend of declining unemployment. The unemployment rate in 2002 is forecast to be 4.2 per cent, up from 3.8 per cent this year. Inflation in consumer prices is also expected to decline from an annual average of 4.8 per cent in 2001 to 3.1 per cent in 2002. A significant deterioration in the public finances is underway, as the buoyancy provided by higher than anticipated taxation receipts in recent years can no longer be depended upon to mask the overshooting in public expenditure. The re-emergence of an exchequer deficit in response to a sharp slowdown in economic activity is not in itself a worrisome development but it does point to the need to ensure that domestic policy is flexible to cope with inevitable economic downturns.

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	34,702	39,918	5,216	3,435	15.0	4.7	9.9
Public Net Current Expenditure	8,906	9,902	996	481	11.2	5.3	5.4
Gross Fixed Capital Formation	16,501	19,255	2,754	1,159	16.7	9.0	7.0
Exports of Goods and Services (X)	62,222	77,311	15,090	11,089	24.3	5.5	17.8
Physical Changes in Stocks	-57	226	283	345			
Final Demand	**122,274**	**146,612**	**24,339**	**16,510**	**19.9**	**5.6**	**13.5**
less:							
Imports of Goods and Services (M)	52,465	65,749	13,284	8,232	25.3	7.5	16.6
GDP at Market Prices	**69,809**	**80,863**	**11,055**	**8,277**	**15.8**	**3.6**	**11.9**
less:							
Statistical Discrepancy	-307	-626	-318	246			
Adjusted GDP	**70,116**	**81,489**	**11,373**	**8,031**	**16.2**	**4.3**	**11.5**
less:							
Net Factor Payments (F)	10,410	12,875	2,465	1,799	23.7	5.5	17.3
GNP at Market Prices	**59,706**	**68,614**	**8,908**	**6,232**	**14.9**	**4.1**	**10.4**

B: Gross National Product by Origin

	1999	2000	Change in 2000	
		Preliminary		
	£m	£m	£m	%
Agriculture, Forestry, Fishing	2,207	2,346	139	**6.3**
Non-Agricultural: Wages, etc.	28,416	32,613	4,197	**14.8**
Other:	28,070	33,160	5,090	**18.1**
Adjustments: Stock Appreciation	-562	-662		
Financial Services	-2,357	-2,770	-413	**17.5**
Statistical Discrepancy	-307	-626	-318	
Net Domestic Product	55,467	64,062	8,595	**15.5**
less:				
Net Factor Payments	10,410	12,875	2,465	**23.7**
National Income	45,057	51,187	6,130	**13.6**
Depreciation	6,704	7,949	1,245	**18.6**
GNP at Factor Cost	51,761	59,136	7,375	**14.2**
Taxes less Subsidies	7,945	9,478	1,533	**19.3**
GNP at Market Prices	59,706	68,614	8,908	**14.9**

C: Balance of Payments on Current Account

	1999	2000	Change in 2000
		Preliminary	
	£m	£m	£m
Exports (X) less Imports (M)	9,757	11,562	1,806
Net Factor Payments (F)	-10,410	-12,875	-2,465
Net Transfers	927	812	-115
Balance on Current Account	**274**	**-501**	**-774**
as % of GNP	0.5	-0.7	-1.1

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	39,918	43,966	4,048	2,195	10.1	4.4	5.5
Public Net Current Expenditure	9,902	11,290	1,388	535	14.0	8.2	5.4
Gross Fixed Capital Formation	19,255	21,402	2,147	589	11.2	7.9	3.1
Exports of Goods and Services (X)	77,311	89,148	11,837	8,417	15.3	4.0	10.9
Physical Changes in Stocks	226	100	-126	-240			
Final Demand	**146,612**	**165,907**	**19,295**	**11,496**	**13.2**	**4.9**	**7.8**
less:							
Imports of Goods and Services (M)	65,749	74,433	8,684	5,679	13.2	4.2	8.6
GDP at Market Prices	**80,863**	**91,474**	**10,611**	**5,816**	**13.1**	**5.5**	**7.2**
less:							
Statistical Discrepancy	-626	-790	-164	620			
Adjusted GDP	**81,489**	**92,264**	**10,775**	**5,197**	**13.2**	**6.4**	**6.4**
less:							
Net Factor Payments (F)	12,875	15,268	2,393	1,807	18.6	4.0	14.0
GNP at Market Prices	**68,614**	**76,996**	**8,382**	**3,389**	**12.2**	**6.9**	**4.9**

B: Gross National Product by Origin

	2000	2001	Change in 2001	
	Preliminary £m	Forecast £m	£m	%
Agriculture, Forestry, Fishing	2,346	2,370	24	1.0
Non-Agricultural: Wages, etc.	32,613	37,175	4,562	14.0
Other:	33,160	38,225	5,065	15.3
Adjustments: Stock Appreciation	-662	-60		
Financial Services	-2,770	-2,982	-211	7.6
Statistical Discrepancy	-626	-790	-164	26.3
Net Domestic Product	**64,062**	**73,939**	**9,877**	**15.4**
less:				
Net Factor Payments	12,875	15,268	2,393	18.6
National Income	**51,187**	**58,671**	**7,484**	**14.6**
Depreciation	7,949	8,897	948	11.9
GNP at Factor Cost	**59,136**	**67,568**	**8,432**	**14.3**
Taxes less Subsidies	9,478	9,428	-50	-0.5
GNP at Market Prices	**68,614**	**76,996**	**8,382**	**12.2**

C: Balance of Payments on Current Account

	2000	2001	Change in 2001
		Preliminary	
	£m	£m	£m
Exports (X) less Imports (M)	11,562	14,716	3,153
Net Factor Payments (F)	-12,875	-15,268	-2,393
Net Transfers	812	494	-318
Balance on Current Account	**-501**	**-58**	**443**
as % of GNP	-0.7	-0.1	0.6

FORECAST NATIONAL ACCOUNTS 2002

A: Expenditure on Gross National Product

	2001	2002	Change in 2002				
	Forecast £m	Forecast £m	£m Value	£m Volume	% Value	% Price	% Volume
Private Consumer Expenditure	43,966	47,188	3,222	1,759	7.3	3.2	4.0
Public Net Current Expenditure	11,290	12,965	1,675	497	14.8	10.0	4.4
Gross Fixed Capital Formation	21,402	22,954	1,551	526	7.2	4.7	2.5
Exports of Goods and Services (X)	80,148	97,103	7,955	4,627	8.9	3.5	5.2
Physical Changes in Stocks	100	50	-50	-95			
Final Demand	**165,907**	**180,260**	**14,353**	**7,313**	**8.7**	**4.1**	**4.4**
less:							
Imports of Goods and Services (M)	74,433	81,058	6,625	4,183	8.9	3.1	5.6
GDP at Market Prices	**91,474**	**99,202**	**7,728**	**3,130**	**8.4**	**4.9**	**3.4**
less: Statistical Discrepancy	-790	-683	107	11			
Adjusted GDP	**92,264**	**99,885**	**7,621**	**3,120**	**8.3**	**4.7**	**3.4**
less:							
Net Factor Payments (F)	15,268	16,970	1,702	1,120	11.1	3.5	7.3
GNP at Market Prices	**76,996**	**82,915**	**5,919**	**1,999**	**7.7**	**5.0**	**2.6**

B: Gross National Product by Origin

	2001	2002	Change in 2002	
	Forecast £m	Forecast £m	£m	%
Agriculture, Forestry, Fishing	2,370	2,450	80	3.4
Non-Agricultural: Wages, etc.	37,175	40,570	3,395	9.1
Other:	38,225	41,213	2,988	7.8
Adjustments: Stock Appreciation	-60	10		
Financial Services	-2,982	-3,256	-274	9.2
Statistical Discrepancy	-790	-683	107	-13.5
Net Domestic Product	**73,939**	**80,304**	**6,365**	**8.6**
Net Factor Payments	15,268	16,970	1,702	11.1
National Income	**58,671**	**63,333**	**4,663**	**7.9**
Depreciation	8,897	9,742	845	9.5
GNP at Factor Cost	**67,568**	**73,076**	**5,508**	**8.2**
Taxes less Subsidies	9,428	9,839	411	4.4
GNP at Market Prices	**76,996**	**82,915**	**5,919**	**7.7**

C: Balance of Payments on Current Account

	2001	2002	Change in 2002
	Forecast £m	Forecast £m	£m
Exports (X) less Imports (M)	14,716	16,045	1,329
Net Factor Payments (F)	-15,268	-16,970	-1,702
Net Transfers	494	436	-58
Balance on Current Account	**-58**	**-488**	**-431**
as % of GNP	-0.1	-0.6	-0.5

The International Economy

General

The international economic outlook has weakened significantly in 2001. The continuing terrorist attacks in the US, along with the escalating military response, have created huge uncertainty throughout the world. Economic growth internationally has slowed dramatically in 2001, most noticeably in the US from the high growth rates of recent years. The slowdown in Europe continues with domestic demand and confidence having deteriorated throughout the year. The Japanese economy remains weak and in recession. The outlook for the emerging economies of Eastern Europe and Latin America is also less favourable. Thus far, little sign of recovery has emerged, with prospects for growth in 2002 highly uncertain.

US Economy

Recent data releases have confirmed that the economic activity in the US had ground to a halt even before the terrorist attacks on September 11th. On an annual basis, GDP growth in the second quarter slowed to 0.3 per cent from 1.3 per cent in the first quarter. The third quarter is likely to be close to zero on an annual basis but we are factoring a strong recovery during the fourth quarter as the large monetary and fiscal stimuli take effect. Our prediction is for annual GDP growth of 0.9 per cent this year. This momentum should be carried through into 2002, and GDP is expected to grow by 2.2 per cent in 2002. Given the present large uncertainties on how the confidence of the consumer will be impacted upon given the attacks on the US mainland, this forecast is optimistic that US economy will rebound given the extent of restructuring that has occurred during the last eighteen months of slowdown.

The slowdown in the US economy originated in the manufacturing sector, which has been in recession for some time. Industrial production declined for the twelfth consecutive month in September, and was some 5.8 per cent lower than one year previously. This represents the longest uninterrupted industrial decline since the Second World War. The National Association of Purchasing Managers (NAPM) index remained below the key 50 per cent level for the fourteenth consecutive month in September, indicating that the manufacturing sector continues to contract. On a positive note, production and new orders are on the increase in the sector providing some basis for recovery. However, the most recent survey indicated that it is too early to determine the full impact of the terrorist attacks on the sector. As with other sectors of the economy, the outlook remains very uncertain.

The substantial decline in investment discussed in the previous *Commentary* has continued into the third quarter. Equity prices have fallen further, while business and consumer confidence levels have continued to decline, as have corporate profits. These factors have increased the effective cost of capital even as significant excess capacity remains, especially in the manufacturing and Information and Communications Technology (ICT) sectors. The net result has been a decline in gross private investment of over 12 per cent in each of the first two quarters.

The labour market will continue to feel the fallout of the slowdown in the coming months. The unemployment rate increased to 4.9 per cent in August from 4.5 per cent in July. It remained at this level in September despite the most rapid one-month decline in employment since February

1991. First-time requests for unemployment benefits also rose to a nine-year high in September 2001. The airline and aerospace industries will be responsible for a considerable proportion of the increase in numbers unemployed, although many companies in the finance, travel and tourism sectors also face large-scale layoffs. We are predicting an average unemployment rate of 4.6 per cent this year, increasing further to 5.2 per cent in 2002.

The growth in personal consumption expenditures averaged almost 5 per cent per annum between 1998 and 2000, as the consumer sector accounted for two-thirds of overall economic activity. Personal consumption growth slowed in the second quarter of 2001 to just 2.5 per cent. Since then consumer confidence has plummeted, and there are now major doubts whether the consumer sector can continue to prevent the US economy from slipping into recession. The most recent survey has identified a sharp downward trend both before and after the terrorist attacks. However, we remain confident that the extensive stimulus package detailed below should be sufficient to prevent the consumer sector from collapsing. We anticipate some increase in the personal savings ratio to reflect the increased uncertainty and losses in the equity market, but consumer expenditure should remain the backbone of the expected recovery.

There has been a prompt and significant policy response to the threat of recession in the US, with further fiscal and monetary stimuli announced in recent weeks. The Federal Reserve has been loosening monetary policy throughout the year by implementing a series of interest rate cuts. The federal funds rate began the year at 6.5 per cent, but nine cuts since then has left the rate at 2.5 per cent, a rate not seen since the Kennedy administration in the early 1960s. Inflation was 2.7 per cent on an annual basis in August, and this implies that the real interest rate will remain close to zero for the foreseeable future, and may even slip into negative territory thus raising the possibility of a liquidity trap.

On the fiscal side, tax cuts implemented in the second half of the year will provide a further stimulus to the economy. In the wake of the terrorist attacks the Bush administration has proposed a combination of spending increases and tax cuts for businesses and individuals, as well as aid packages, bringing the total stimulus package to almost $130bn. This is in line with a recommendation from Federal Reserve chairman Alan Greenspan that the recovery package be of the order of 1 per cent of GDP. Although both fiscal and monetary policy actions take effect with significant lags, the US economy should start to recover during the second half of 2002 unless the terrorist threat dents economic confidence further.

Box 1: Are the Major Economies Heading for a Liquidity Trap?

As the monetary authorities throughout the world have reduced interest rates to near historical lows in order to provide a stimulus to flagging economic fortunes, the prospect of a liquidity trap has emerged. A liquidity trap exists when the efforts of a monetary authority to increase the money supply in order to reduce interest rates are thwarted by increased cash savings of economic agents.

So far in 2001 nominal interest rates have been cut by four percentage points to 2.5 per cent in the US, while short-term nominal interest rates have remained close to zero in Japan. With little signs of recovery emerging in the global economy, monetary policy may become ineffective in providing a further stimulus to economic growth, as nominal interest rates cannot be set below zero. In the US real interest rates are negative since the rate of inflation exceeds the nominal growth rate. Japan has a much greater difficulty in that its price level is declining such that this disinflation means that real interest rates are rising above nominal rates, which cannot be pushed lower than their current levels. The worry is that if the US were to experience disinflation, it too could experience the liquidity trap experienced in Japan.

Although inflationary pressures are generally regarded as a problem for central banks, particularly in a recession, the presence of inflationary pressures may in fact make the challenge of stimulating economic growth easier for the Federal Reserve as compared with the Bank of Japan. In a country with poor growth prospects, the short-term real interest rate needed to equilibrate saving and investment may well be negative. Since nominal interest rates cannot be negative, inflationary pressures and expectations are required to acquire a negative real interest rate.

For example, given 5 per cent expected inflation, a zero nominal interest rate would mean a negative 5 per cent real rate. A negative real interest rate has the effect of increasing demand by discouraging saving and encouraging investment. When no inflation expectations exist, or worse falling prices are expected, the necessary stimulus to demand cannot be achieved through monetary policy when nominal interest rates are approaching zero.

Economists like Paul Krugman have argued that the current deflation in Japan is the result of the Bank of Japan's determination to eliminate inflation expectations in the 1980s. Krugman suggests that what is needed is a credible commitment by the Bank of Japan to future monetary expansion so as to generate inflation expectations. Such a move would reduce the deflation required to generate a negative real interest rate. The implication is that central banks should not overly concentrate on maintaining strict price stability as it may hinder monetary policy's effectiveness in times of weak economic growth. A modest level of inflation is sometimes necessary for an economy to operate effectively.

Euro Area

Following GDP growth of 3.4 per cent in 2000, economic activity has slowed in the euro area in 2001. Real GDP growth slowed from an annual rate of 2.4 per cent in the first quarter to 1.7 per cent in the second. Weakened external demand has led to a sharp slowdown in export growth. Exports grew at an annual rate of 4.8 per cent in the second quarter of the year as compared with 11.4 per cent in the last quarter of 2000. Significantly, the growth domestic demand has fallen sharply demonstrating that the euro area economy is vulnerable to outside developments. Domestic demand grew by just 1 per cent in the second quarter of 2001 despite a rebound in personal consumption. The recovery of personal consumption in the first half of the year suggests that recent tax cuts in many euro area countries have been successful in making a quick positive impact.

As in the US, investment has fallen sharply in the euro area. The annual growth rate in the second quarter of the year was just 0.1 per cent falling 0.8 per cent quarter on quarter. The weakening of investment in 2002 is in large part due to the deterioration of the external environment, sharp declines in the ICT sector and also the marked weakness of construction investment in Germany. Industrial output grew at an annual rate of 0.6 per cent in the second quarter, declining by 1.4 per cent as compared with the first quarter of the year. Output in the services sector has remained reasonably robust growing at an annual rate of 2.5 per cent in the second quarter.

In response to the weaker economic conditions and to the uncertainty following the terrorist attack on September 11th the European Central Bank (ECB) has cut interest rates by one percentage point in 2001. Despite slowing activity in the euro area economy the headline Harmonised Index of Consumer Prices (HICP) rate of inflation has remained stubbornly above the 0-2 per cent target of the ECB throughout the year. In addition, the M3 broad measure of money supply growth has increased in recent months rising to 6.4 per cent in July. However, the ECB has brought attention to certain technical factors that imply the underlying trend for M3 growth is far closer to their reference value of 4.5 per cent. Furthermore, transitory influences on the HICP such as recent food and oil price shocks should decline over the coming year. Additionally, wage pressures have provided no obstacle to monetary easing thus far. Data for the first quarter of the year indicate that annual wage growth was just 2.3 per cent while current wage negotiations point to continued wage moderation. It is expected that inflationary pressures will recede this year and next, allowing for additional loosening of monetary policy to stimulate a growth recovery. It is forecast that interest rates will drop an additional 0.25 percentage points before the end of 2001 and will rise by 0.5 percentage points in 2002 to around 4 per cent in nominal terms.

Despite the slowdown and uncertainties in the US, the euro remains well below parity with the dollar. A sharp appreciation of the euro is still likely. We forecast that it will move to parity in the first half of 2002 and then strengthening throughout the remainder of the year. A number of factors indicate a euro appreciation in the coming year. The large deficit on the current account of the US balance of payments, the positive differential between euro area and US interest rates and the narrowing of growth prospects between the euro area and US. The sharp appreciation of the euro will bring a significant loss of competitiveness for the euro area as a whole resulting in slowing export growth.

In the first quarter of the year employment growth showed some moderation slowing to 1.9 per cent. Although no official aggregates for euro area employment growth are available for the second quarter, information at the national level and other indicators suggest a sharp slowdown in employment growth in the remainder of 2001. Furthermore, the standardised euro area unemployment rate has stabilised in 2001 falling by just 0.1 percentage points since the start of the year, a far more modest decline than observed in recent years.

The latest information with regard to budgetary developments across the euro area indicates that many countries will have difficulty in achieving budgetary targets. Tax revenue growth has fallen behind expectations because of the slowdown in economic activity. Despite some notable exceptions, overall government expenditure across the euro area seems to be developing broadly in line with government medium-term programmes. In some countries, however, ineffective expenditure controls have led to spending overruns, particularly in the healthcare sector. It is now likely that the deterioration of the consolidated euro area budget balance will be larger than expected. Furthermore, the decline of consolidated euro area general government debt in 2001 will be the smallest in a number of years.

These forecasts are subject to considerable downside risk however. First, the extent of the downturn in the US will have considerable influence on growth in the euro area. Second, the record deficit in the US balance of payments current account makes a sharp appreciation of the euro more likely over the coming year, thus eroding the competitive position of European exporters. If the euro experiences a larger appreciation than forecast, or the US downturn is more severe than anticipated, then output growth in the euro area will suffer further. Given Ireland's greater exposure to the US and UK markets the potential loss of competitiveness arising from such an appreciation of the euro would be greater than that experienced by other European economies.

Box 2: Differences in the European and US Labour Markets

Recent years have seen significant falls in the Euro area unemployment rate. For the most part however, European labour markets have consistently underperformed their counterparts in the US since the oil shocks of the 1970s. Over the last two decades European unemployment rates have for sustained periods remained above 10 per cent failing to recover from the impact of the OPEC oil shocks. Despite recent declines the euro area unemployment rate still remained well above the US level in 2000 at 8.9 per cent as compared with 4 per cent. The contrast between European and US labour markets is striking not only in terms of measured unemployment rates but also the duration of unemployment. In 1998 only 8 per cent of those unemployed had been without work for over one year in the US as compared with over 50 per cent in the euro area. Furthermore, 42.2 per cent of those in the US were unemployed for under a month while over one-third of the unemployed in Europe had been so for over two years. The persistence of long-term unemployment in the EU has been blamed on structural factors. It is often argued for example, that as workers became unemployed in recessions they remained so due to disincentives to employment arising from various unemployment and social welfare benefits[1] although the issue remains the subject of debate.[2]

A second factor contributing to high unemployment in Europe may be the underdevelopment of the services sector, as compared with the US where the sector has provided the main engine of employment growth. This difference is made up of a greater share of European employment in agriculture and industry, sectors in which employment growth has lagged behind the services sector in both Europe and the US. As illustrated by Table 1A, while employment in the EU services sector had by 1997 increased its share by almost 15 per cent since 1978, it remained almost

[1] For an overview see "Developments in and Structural Features of the Euro Area Labour Markets", ECB *Monthly Bulletin*, May 2000.

[2] See Atkinson, A.B. "The Economic Consequences of Rolling Back the Welfare State", MIT Press, Cambridge Massachusetts, and also Layte and Callan "Unemployment, Welfare and the Financial Incentive to Work" (forthcoming).

eight percentage points below its US counterpart. The difference in the share of services sector employment may in part be due to a slower pace of liberalisation within the European economy, combined with larger administrative costs. The development of the services sector may also have been constrained by rigid labour markets constraining employment growth. In addition, rigid wage structures typical of European labour markets may have held back the creation of jobs with low productivity, representing a large proportion of employment potential in services.

Table 1A: Share of Sectoral Employment in Total Employment

EU	**1978**	**1997**
Agriculture	10.1	5.0
Services	50.3	64.4
Industry	37.6	29.4
US		
Agriculture	3.6	2.7
Services	64.1	72.8
Industry	30.6	23.7

Source: OECD Statistical Compendium.

The unequal distribution of unemployment across the European labour market suggests that structural impediments to employment growth have impacted disproportionately on certain groups. In particular, unemployment is more concentrated among women, younger and older workers and the low skilled. Female unemployment has on average exceeded male unemployment by almost five percentage points since the late 1980s. In contrast the gap between male and female unemployment has never exceeded one percentage point in the US. Specific constraints on female employment include the lack of affordable childcare but also tax and benefits systems geared so as to create employment disincentives. The increase in unemployment for older workers has in large part been the result of the restructuring process in industry. Similarly, unemployment among younger workers and the low skilled is also proportionately high. In fact only European skilled men of prime age enjoy a labour market position similar to their counterparts in the US.

An additional feature of unemployment in Europe has been a high level of dispersion at the national and regional level. In 1998 the regional unemployment rate differential exceeded 20 per cent in Italy and Spain, 18 per cent in Germany and 15.7 per cent in France. The presence of high unemployment gaps between regions suggests inadequacies in the wage formation process. In particular national wage agreements may have failed to encapsulate a regional dimension so as to account for contrasting regional labour market conditions.

To address the problems discussed above a number of key structural factors in European labour markets have been identified for potential reform. For example, in the OECD Jobs Strategy, excessively generous social security or unemployment benefits were identified as having the effect of reducing the attractiveness of employment. More generally, it is argued that adverse economic shocks interacting with rigid labour market institutions led to an increase in European structural unemployment.[3] Unemployment in Europe and the US increased sharply following the oil

[3] Blanchard, O. and J. Wolfers, 1999. "The Role of Shocks and Institutions in the Rise of European Unemployment: The Aggregate Evidence", MIT and NBER, and Harvard. Harry Johnson Lecture, April.

shocks of the 1970s. Thereafter, flexible labour markets allowed the US economy to respond to the shock and unemployment to decline from the highs of the 1970s. In contrast the rigidities contained in European labour markets constrained the ability of the European economy to adjust to the adverse economic developments of the 1970s. This had the effect of allowing the sharp increases in unemployment experienced in the late 1970s and early 1980s become of a structural rather than cyclical nature.

In recent years strong growth coupled with labour market reforms have led to sharp declines in the euro area unemployment rate which declined from 10.8 per cent in 1998 to 8.3 per cent in July of this year. Looking forward the broad outlook for unemployment in Europe should be cautiously optimistic. In the short term further declines in the unemployment rate will be more modest than in recent years given the weakening economic environment. Over the next decade however, the continued reform of European labour markets should through the removal of impediments to employment growth contribute to lower structural unemployment.

UK Economy

The UK performed robustly in the first half of the year, but growth is set to slow in line with the weakening world economy. The rate of growth of GDP declined to 2.3 per cent on an annual basis in the second quarter from 2.7 per cent in the first quarter. Domestic demand remains the main driver of growth with households' consumption some 4.2 per cent higher in the second quarter than one year previously. However, the deterioration in global economic conditions will have a negative impact on growth in the second half of the year. Overall, we predict average growth in GDP of 2.2 per cent for both this year and next.

The development of a two-speed economy in the UK is a cause for concern, and may have implications for future growth prospects. For some time now the services sector has continued to expand rapidly while the industrial sector has been contracting. This has become even more acute recently, with service sector output increasing by 3.7 per cent in the second quarter, while industrial production was down 2.5 per cent in the year to July. Manufacturing output alone accounts over 20 per cent of GDP, and this was down 2.4 per cent in the year to July. If the decline continues at this rate it will have a significant negative impact on GDP growth this year. However, the relative strength of the services and household sectors is more than offsetting the downturn in the industrial sector. Evidence of this lies in the retail sales figures, which were 6 per cent higher in August than one year previously. As in the US economy, maintaining the growth in personal consumption will be necessary to underpin economic growth.

The UK labour market remains relatively tight, but is likely to have reached a turning point during the second quarter. Unemployment on an ILO basis was 5.1 per cent in August, representing a decline of 0.2 percentage points from one year previously. However, the rate of decline has slowed sharply in recent months, and unemployment is likely to increase during the coming months in light of recent events. Earnings growth also continued to decline in the three months to August, increasing by 4.5 per cent compared to a peak of 7 per cent in the three months to June. Although claimant unemployment remains below the 1 million mark, there is little doubt that the labour market is weakening rapidly. We are forecasting an average unemployment rate of 5 per cent this year, increasing to 5.3 per cent in 2002.

In line with the slowdown in the world economy, the Monetary Policy Committee (MPC) has reduced interest rates six times this year, by 25 basis points on each occasion. This leaves the rate at 4.5 per cent, down from 6 per cent at the start of the year. However, the MPC has been more prudent than its US counterpart, and rates remain high relative to those in the euro-zone and the US. Nevertheless, they recognise that the impact of the terrorist attacks on consumer and business confidence may reduce expenditure by businesses and households, and have cut rates twice in quick succession to boost the economy. There is also plenty of scope for further cuts if conditions deteriorate further in the coming months.

Inflationary pressures in the UK have increased in recent months, and the underlying rate of inflation breached the MPC's target of 2.5 per cent for the first time in August, when it rose to 2.6 per cent. The rate declined again in September to 2.3 per cent on an annual basis. The main driving forces behind the decline were motoring expenses, housing costs and leisure services. Declining interest rates may fuel inflationary pressures further, but the general slowdown in economic activity should be sufficient to ensure that inflation remains close to the MPC's target range in the coming months. Headline inflation, which includes mortgage interest payments, was 1.7 per cent in August. The internationally comparable Harmonised Index of Consumer Prices (HICP) rose by 1.3 per cent in September, down from 1.8 per cent in August.

The Rest of the World

In Japan the economic situation has continued to deteriorate. It is now likely that the economy will enter its fourth recession in the last decade. The economy contracted sharply in the second half of the year and recent data suggest that economic activity remains weak. Declines in investment and exports have been the main negative factors behind the contraction of the economy in 2001. Overall industrial production has continued to contract throughout this year with the slowdown most pronounced in the manufacturing sector. As in other countries the poor performance of exports was most notable in ICT related products.

Consumer spending rose surprisingly in the second quarter although this was not sufficient to offset the contraction in other areas. Furthermore, recent indicators of consumer spending and confidence have been weak. Unemployment rose to a post war high of 5 per cent in July. With uncertainty increasing, it is highly unlikely that consumer spending will provide any significant stimulus to the economy in the second half of the year.

The ongoing problem of deflation shows no sign of easing. In July consumer prices contracted at an annual rate of 0.7 per cent. In response to the persistence of deflationary pressures within the economy the Bank of Japan reverted to a zero interest rate policy in March. Further attempts to loosen monetary conditions were made by providing excess liquidity to the market and by a series of interventions in currency markets to lower the value of the Yen. Despite the easing of monetary conditions this year however, no substantial sign of a recovery in economic activity or prices has emerged. It is forecast that GDP will contract by 0.5 per cent in 2001. Looking to 2002 the forecast depreciation of the dollar relative to the yen will subdue export growth making any substantial recovery in output growth highly unlikely. GDP growth is expected to recover only slightly in 2002 to 0.4 per cent.

In Asia the emerging export-oriented economies have suffered disproportionately from the global slowdown. While demand for exports from the United States has been weak for some time more recent downturns in the European and Japanese economies have exacerbated the slowdown. While the region has become less reliant on the Japanese economy in recent years significant linkages remain. In total 12 per cent of East Asian exports are sold to Japan with 20 per cent of imports coming from Japan. In addition, many of these countries are also suffering from domestic shocks, such as declining stock markets, pressures on their currency and significant capital outflows. The largest economy of the region, China, is expected to remain relatively robust, but other economies will not fare so well. Singapore is one of the hardest hit, with GDP likely to decline by some 3 per cent this year following growth of almost 10 per cent in 2000. Prospects for the future of the region depend critically on an upturn in the world economy, as well as a recovery in the electronics industry and the maintenance of FDI flows into the region.

Outside Asia the outlook for most developing and transition countries has also deteriorated. Growth prospects have declined significantly in South America, affected by renewed financial difficulties in Argentina, political uncertainties and the energy crisis in Brazil. In the Eastern European economies growth has been adversely affected by a sharp decline in output in Turkey. While export growth has thus far held up relatively well it will increasingly be affected by the slowing of demand in the euro area, particularly in Germany. As a result it is unlikely that current account deficits in many Eastern European countries will fall, a potential source of vulnerability.

Context for Ireland

Being a small regional open economy the growth prospects for the Irish economy rest largely upon the international economic environment. Presently, GDP growth is slowing in almost all regions of the globe accompanied by a sharp decline in trade growth. Growth in the US economy is now close to zero while it is now almost certain that Japan has entered recession. Moreover, the slowdown in GDP growth in 2001 has shown that the euro area economy is vulnerable to external developments.

In response to the deterioration in the international economic environment monetary conditions have been loosened considerably, most notably in the US where interest rates are at a forty year low. In addition, fiscal policies have been relaxed in both the US and EU so as to provide an added stimulus to the economy. Thus far however little sign of any recovery has emerged. The slowing of economic activity in addition to the heightened uncertainty following the events of September 11th provides considerable downside risk to our forecasts for GDP growth. The forecasts are based on a recovery of US and EU growth beginning in the second half of next year.

Furthermore, Ireland is particularly exposed to developments in the ICT sector. Throughout 2001 Ireland experienced a slowdown in export growth and inward investment, primarily the result of weakened activity in that sector. It had been hoped earlier in the year that the large proportions of ICT exports from Ireland destined for European markets would be for the most part unaffected by the US slowdown. However, the significant weakening of European demand in recent months makes further reductions in ICT spending likely. If European demand continues to deteriorate it will further depress an important sector within the Irish economy.

An additional danger for the economy arises from the forecast appreciation of the euro above parity with the dollar during 2002. Thus far the continued weakness of the euro has maintained competitiveness for exporters in Ireland and softened the impact of reduced demand. A sharper euro appreciation than expected combined with continuing rapid rises in domestic labour costs would lead to a larger competitive loss for the economy than anticipated. Such a loss of competitiveness would have severe implications for employment and growth in the economy.

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	2.2	2.2	2.1	2.3	5.1	5.3	5.0	5.3	-1.7	-2.1
Germany	0.8	1.9	2.3	1.4	2.2	2.5	7.9	7.8	-0.9	-0.6
France	2.2	2.3	1.9	1.6	3.4	3.3	8.7	8.5	2.0	2.1
Italy	1.8	2.2	2.5	1.9	2.9	2.9	9.9	9.6	-0.1	0.2
Total EU	1.9	2.1	2.2	1.8	3.1	3.6	7.7	7.6	-0.4	-0.2
USA	0.9	2.2	3.1	2.1	4.5	4.5	4.6	5.2	-4.1	-3.8
Japan	-0.5	0.4	-0.5	-0.2	0.1	0.9	5.1	5.3	2.2	2.3
Total (OECD)	2.0	2.8	2.9	2.6	3.6	3.9	6.3	6.3	-1.3	-1.2
Ireland	4.9	2.6	4.8	3.1	10.3	7.3	3.8	4.2	-0.1	-0.6

The Domestic Economy

General

The official *National Income and Expenditure* accounts indicate that the Irish economy exceeded our expectations and grew by record rates in 2000. Real GDP grew by 11.5 per cent and real GNP by 10.4 per cent. Figures for 1999 have also been revised and now show that real GDP growth was over 10 per cent, with real GNP growth at 8.2 per cent. The preliminary figures also suggest that some price deflators were lower than we had anticipated, namely the deflator for personal consumption and investment. Consequently, our GDP deflator was higher than the final out-turn of 4.1 per cent.

These official figures confirm the picture that activity in 2001 is being compared with a very strong base. We have for some time argued that such growth rates were unsustainable and that the Irish economy would begin to slow. In any event throughout 2001 the economy has suffered a series of shocks. Although statistics for the first half of the year indicate that the economy was still experiencing reasonable growth, preliminary evidence from the second half indicate a sharp deceleration. Thus, growth this year is estimated to have slowed, real GDP increasing by 6.4 per cent and real GNP by just under 5 per cent. Given the carryover of activity from last year and the Quarterly National Accounts for the first three months of the year, our forecast implies a virtually stagnant economy in the second half of 2001.

Based on the assumptions and forecast for the external environment outlined in the International section, our forecast for 2002 is that the economy will slow further. However, in line with an international recovery in the second half of next year it seems likely, following below trend growth for much of 2002, the Irish economy will have returned to potential output levels by the fourth quarter of next year.

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

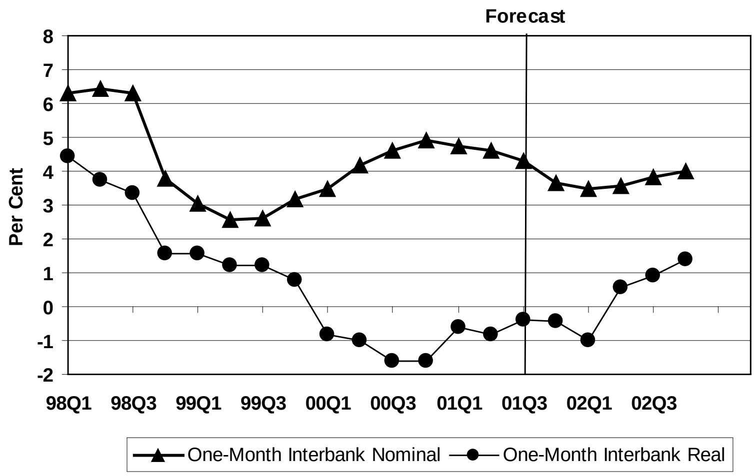
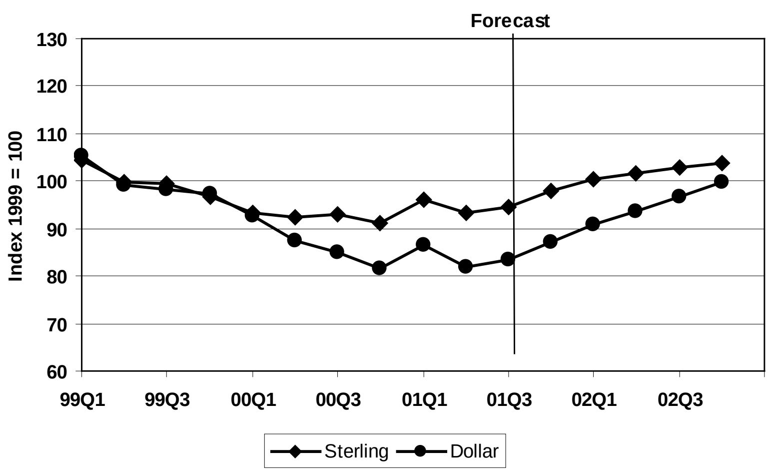


Figure 2: Exchange Rates
Foreign Currency per Euro, Quarterly Averages, 1999=100



Exports

The National Income and Expenditure accounts for 2000 show that the value of exports of goods and services amounted to over £77 billion, a value increase of 24.3 per cent. Allowing for a price deflator of 5.5 per cent means that the volume increase in the export of goods and services amounted to 17.8 per cent. Contrary to expectations, statistics for the year to date show that, export growth has remained quite strong. In the year to July, the value of seasonally adjusted exports rose by nearly 20 per cent in value. Volume figures for the six months to June show a volume increase of just under 18 per cent. Given the sudden shock to the US economy and the slowdown in world trade accompanying the military action in the Middle East, it seems unlikely that Irish exports will remain immune to the downturn in the world economy. On this basis we have revised our forecast for export growth this year to 12 per cent. The impact on services trade is expected to be much more severe and so we have reduced our forecast for tourism and other service exports this year and next. Total exports of goods and services are therefore forecast to grow by 15.3 per cent in value terms and by 10.9 per cent in volume. This implies a lower price deflator than last year, at 4 per cent.

TABLE 2: Exports of Goods and Services

Preliminary

	1999	% Change in 2000		2000
	£m	Volume	Value	£m
Agricultural	3,185	5.5	8.7	3,463
Manufactured	44,367	18.9	25.7	55,791
Other Industrial	4,259	8.2	14.1	4,858
Other	879	43.2	51.1	1,329
Total Visible	**52,690**	**17.6**	**24.2**	**65,441**
Adjustments	-1,966	24.1	30.4	-2,563
Merchandise	**50,724**	17.3	24.0	**62,877**
Tourism	1,948	9.8	16.7	2,272
Other Services	9,550	22.0	27.3	12,162
Exports of Goods And Services	**62,222**	**17.8**	**24.3**	**77,311**

Forecasts

	2000	% Change in 2001		2001	% Change in 2002		2002
	£m	Volume	Value	£m	Volume	Value	£m
Agricultural	3,463	1.0	4.8	3,630	2.0	5.5	3,829
Manufactured	55,791	13.5	18.0	65,856	6.5	9.8	72,311
Other Industrial	4,858	5.2	9.0	5,295	2.4	5.7	5,595
Other	1,329	3.2	7.4	1,428	2.0	4.9	1,497
Total Visible	**65,441**	**12.0**	**16.5**	**76,208**	**5.9**	**9.2**	**83,231**
Adjustments	-2,563	12.0	15.4	-2,957	15.0	3.5	-3,060
Merchandise	**62,877**	**12.0**	**16.5**	**73,251**	**5.5**	**9.4**	**80,171**
Tourism	2,272	0.5	4.0	2,364	-2.0	-0.5	2,351
Other Services	12,162	7.0	11.3	13,534	4.5	7.7	14,581
Exports of Goods And Services	**77,311**	**10.9**	**15.3**	**89,148**	**5.2**	**8.9**	**97,103**

The slowdown in activity in the latter half of this year means that there is likely to be little carry-over of activity from this year into 2002. A continuation of the world slowdown until the latter half of next year, coupled with some euro appreciation is expected to slow merchandise export growth to 8.9 per cent in 2002. A contraction in tourism exports and more moderate growth in exports of other services are also forecast. Thus, we forecast a volume increase of 5.2 per cent in total exports of goods and services for 2002. This implies a further reduction next year in the overall export price deflator to 3.5 per cent.

Stocks

The contribution of stock building to the economic growth last year was more significant than we had forecast. The value of physical changes in stocks in 2000 was £226 million. The change in stocks in value terms is forecast to fall by £126 million in 2001 before falling by a further £50 million in 2002. This reflects the slowdown in the economy and the unwinding of stock building positions, particularly of non-agricultural stocks.

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	12	-118	68	-50	200	150
Irish intervention Stocks	-166	76	-90	90	0	0	0
Other Non-Agricultural Stocks	239	195	434	-284	150	-250	-100
Total	**-57**	**283**	**226**	**-126**	**100**	**-50**	**50**

Investment

According to preliminary official statistics, overall investment grew by 16.7 per cent in 2000. Although this represents a strong growth rate it is lower than rates recorded in recent years which had been above 20 per cent in 1999. The National Accounts also confirm the projected rise in the cost of investment. As the volume of investment rose by just 7 per cent in 2000 this implies a price deflator of 9 per cent, the highest of recent years.

Residential investment increased by 19.6 per cent in 2000, another strong year. Once again a high price deflator, 11.9 per cent, meant that the volume increase was much lower at 6.9 per cent. Investment in building and construction is not expected to perform as well this year. The evidence of a moderation in house price growth prior to September is likely to have been accelerated in the sharp economic slowdown since then. The volume of investment in building and construction is therefore forecast to show a small rise of 1.5 per cent in volume terms in 2001. Much of the slowdown can be attributed to a lower level of house completions this year. House prices and prices in other building are still expected to rise by 9.7 per cent, reflecting the strength of the market at the beginning of the year, and so a value increase for building and construction of 11.4 per cent is forecast for 2001. Real growth in investment in machinery and equipment is anticipated to average 5.8 per cent this year. However, once again this reflects the buoyancy of the economy at the beginning of the year. Thus, gross fixed capital investment is forecast to grow by 11.2 per cent in value. Our forecast of a volume increase of 3.1 per cent indicates an investment price deflator of 7.9 per cent for 2001.

Our forecast for investment in 2002 is based on the assumption that the government use the slowdown as an opportunity to ensure the implementation of the *National Development Plan* and a volume increase of 2.5 per cent in public investment is forecast in 2002. Provided there is increased availability of resources a lower price deflator for public investment of 6.5 per cent implies a value increase of 9.2 per cent in 2002. Some recovery in the volume of house completions is anticipated as lower price growth encourages some of the pent-up demand into the market. Thus, investment in building and construction is forecast to increase in 2002 by 2.2 per cent in volume and by 7 per cent in value. A further slowdown in investment in machinery and equipment is forecast reflecting the lower level of economic growth. Based on these assumptions, gross capital fixed investment is forecast to grow by 2.5 per cent. A lower price deflator than in previous years results in the value of total investment being forecast to grow by 7.2 per cent in 2002.

TABLE 4: Gross Fixed Capital Formation

Preliminary

	1999 £m	% Change in 2000 Volume	% Change in 2000 Value	2000 £m
Housing	5,312	6.8	19.6	6,353
Other Building	4,971	7.8	20.7	6,002
Building and Construction	10,284	7.3	20.1	12,355
Machinery & Equipment	6,217	6.6	11.0	6,900
Total	16,501	7.0	16.7	19,255

Forecasts

	2000 £m	% Change in 2001 Volume	% Change in 2001 Value	2001 £m	% Change in 2002 Volume	% Change in 2002 Value	2002 £m
Housing	6,353	-2.7	7.0	6,800	1.8	4.9	7,130
Other Building	6,002	6.0	16.1	6,967	2.5	9.2	7,605
Building and Construction	12,355	1.5	11.4	13,766	2.2	7.0	14,,734
Machinery & Equipment	6,900	5.8	10.7	7,636	3.0	7.6	8,219
Total	19,255	3.1	11.2	21,402	2.5	7.2	22,954

Consumption

The *National Income and Expenditure Accounts* show that the value of personal consumption in 2000 amounted to £39,918 million, a value increase of 15 per cent. The volume growth in personal consumption is estimated at 9.9 per cent, a growth rate marginally higher than our expectation in the June

Commentary of 9.5 per cent. On the basis of the official figures the personal consumption deflator for 2000 is estimated at 4.7 per cent.

Retail sales figures to July show that some growth in the value and volume of sales for all businesses has moderated. Excluding the more volatile component of motor sales shows that underlying retail sales have remained quite strong, particularly given the slowdown in activity associated with the Foot and Mouth containment measures. However, in common with our forecasts for other indicators we anticipate a sharp fall off in consumption in the second half of this year as the economy copes with the additional impact of the IT slowdown and the uncertainty following the terrorist attacks of September 11th. Accordingly, personal consumption growth has been reduced to 5.5 per cent. As our consumer price deflator has also been reduced margianlly to 4.4 per cent, this results in a 10.1 per cent increase in the value of personal consumption in 2001.

With economic activity likely to be much slower in the first half of 2002, personal consumption growth is likely to slow again next year. This will refelct the heightened uncertainty about the world economy, lower increases in disposable income, and a higher personal savings ratio. Thus, the value of personal consumption growth is forecast to increase by 9 per cent. With a consumer expenditure deflator of 3.2 per cent, we are forecasting an increase in the volume of personal consumption of 5.3 per cent.

The national accounts show that government consumption rose by 5.4 per cent in volume terms in 2000 and by 11.2 per cent in value. A similar growth rate is anticipated for this year, although the impact of pay increases on the deflator will push the value increase in government consumption to 14 per cent in 2001. An increase in public sector employment coupled with pay claims already agreed will lead to a substantial rise in the deflator next year. On this basis, volume growth of 4.4 per cent is forecast with the value increase reaching 14.8 per cent.

Final Demand

In 2001, final demand is forecast to rise by 7.8 per cent in volume and by 13.2 per cent in value. The volume increase in final demand in 2002 will be significantly lower at 4.4 per cent. With inflation also expected to be somewhat lower the current price increase in final demand is forecast to slow to 8.7 per cent in 2002, continuing to represent strong growth. Much of the reduction in growth in final demand from previous years is due to substantially lower export growth rates this year and next.

TABLE 5: Consumption Indicators

	Annual Percentage Change						
	1996	1997	1998	1999	2000	2001 Forecast	2002 Forecast
Consumption Value							
NIE 1997, Personal Consumption	9.1	10.2	11.9	11.9	15.0	10.1	7.3
Retail Sales Index, Value	8.3	9.0	9.5	11.4	16.3	12.5	8.5
Divergence	0.8	1.2	2.4	0.5	-1.3	-2.4	-1.2
Consumption Volume							
NIE 1997, Personal Consumption	6.3	7.4	7.8	8.2	9.9	5.5	4.0
Retail Sales Index, Volume	6.2	7.9	7.8	9.5	11.9	7.8	5.2
Divergence	0.1	-0.5	0.0	-1.3	-2.0	-2.3	-1.2
Consumer Prices							
NIE 1997, Personal Consumption Deflator	2.6	2.6	3.8	3.5	4.7	4.4	3.2
Retail Sales Index Deflator	2.0	1.0	1.6	1.7	3.9	4.4	3.1
Consumer Price Index	1.6	1.5	2.4	1.6	5.6	4.8	3.1

Imports

Official figures show that imports of goods and services rose by 16.6 per cent in volume terms and by 25.3 per cent in value. This indicates that annual average import prices increased by 7.5 per cent reflecting continued euro weakness. With final demand expected to show slower growth this year as the economy slows in the second half of the year, growth in visible imports will slow to 13.2 per cent in value and 8.5 per cent in volume terms, indicating a more moderate rise in average import prices of 4.3 per cent this year. Tourist expenditure abroad is forecast to remain quite strong this year, albeit not at previous levels. The lower forecast for growth in final demand will result in lower growth in other service imports. On this basis the increase in total imports of goods and services is forecast to be 13.2 per cent in value, with a price deflator of 4.2 per cent. This indicates that the volume growth of total imports in 2001 should be 8.6 per cent.

Based on the forecast moderation in economic activity in 2002 we anticipate that import volume growth will also slow. Visible imports are projected to grow by just 5 per cent in volume and by 8.2 per cent in value implying a price deflator of 3.1 per cent. Increases in personal disposable income will underpin growth in tourist expenditure abroad and imports of other services are expected to show some increase. We forecast total imports of goods and services to increase by 5.6 per cent in volume and by 8.9 per cent in value in 2002.

TABLE 6: Imports of Goods and Services

Preliminary

	1999 £m	% Change in 2000 Volume	% Change in 2000 Value	2000 £m
Capital Goods	5,122	12.1	21.5	6,222
Consumer Goods	7,384	11.8	21.3	8,955
Intermediate Goods:				
Agriculture	575	16.3	20.4	705
Other	20,033	20.2	27.1	25,879
Other Goods	1,674	-3.2	1.8	1,717
Total Visible	**34,788**	**16.0**	**24.0**	**43,478**
Adjustments	-2,022	10.7	-20.5	-2,418
Merchandise Imports	**32,766**	**16.3**	**28.5**	**41,060**
Tourism	1,952	6.1	21.1	2,251
Other Services	17,747	15.6	26.3	22,438
Imports of Goods and Services	**52,465**	**15.7**	**27.5**	**65,749**

Forecasts

	2000 £m	% Change in 2001 Volume	% Change in 2001 Value	2001 £m	% Change in 2002 Volume	% Change in 2002 Value	2002 £m
Capital Goods	6,222	8.8	13.4	7,054	6.0	9.2	7,701
Consumer Goods	8,955	7.5	11.6	9,992	5.2	8.1	10,806
Intermediate Goods:							
Agriculture	705	2.0	6.1	748	5.4	7.3	802
Other	25,879	9.1	14.2	29,561	4.7	8.1	31,941
Other Goods	1,717	5.8	8.2	1,859	3.6	6.5	1,979
Total Visible	**43,478**	**8.5**	**13.2**	**49,213**	**5.0**	**8.2**	**53,230**
Adjustments	-2,418	10.0	10.0	-2,660	15.0	15.0	-3,059
Merchandise Imports	**41,060**	**8.4**	**13.4**	**46,554**	**4.4**	**7.8**	**50,171**
Tourism	2,251	7.5	11.9	2,519	4.5	7.3	2,703
Other Services	22,438	9.2	13.0	25,360	8.0	11.1	28,183
Imports of Goods And Services	**65,749**	**8.6**	**13.2**	**74,433**	**5.6**	**8.9**	**81,058**

Balance of Payments

Fourth quarter balance of payments showed that the current account balance moved into deficit in 2000. A high deficit on services was one of the factors contributing to the decline. The forecasts for exports and imports already presented indicate that the surplus on trade in goods and services will increase by over 27 per cent this year, although as the slowdown in economic activity takes effect this is expected to fall to growth of 9 per cent in 2002. This will be driven mainly by deterioration in the service trade balance.

On the basis of our estimate of export and import values it now seems likely that the visible trade surplus increased by almost 23 per cent in 2000, at £21,963 million, or some 32 per cent of estimated GNP. The deficit on trade in services is also believed to have increased sharply by 25 per cent. These forecasts indicate that the growth in the surplus in trade in goods and services is estimated to have been 18.5 per cent.

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

TABLE 7: Balance of Payments

	1999 £m	Change %	2000 £m	Change %	2001 £m	Change %	2002 £m
Visible Trade Balance	17,903	22.7	21,963	22.9	26,995	11.1	30,002
Adjustments	55		-145		-297		-2
Merchandise Trade Balance	**17,958**	**21.5**	**21,817**	**22.4**	**26,698**	**12.4**	**30,000**
Service Trade Balance	-8,201	25.0	-10,255	16.8	-11,982	16.5	-13,954
Trade Balance in Goods and Services	**9,757**	**18.5**	**11,562**	**27.3**	**14,716**	**9.0**	**16,045**
Total Debit Flows	-28,526	35.5	-38,658	17.8	-45,527	12.3	-51,112
Total Credit Flows	18,116	42.3	25,783	17.4	30,259	12.8	34,142
Net Factor Flows	**-10,410**	**23.7**	**-12,875**	**18.6**	**-15,268**	**11.1**	**-16,970**
Net Current Transfers	**927**	-12.4	**812**	**-39.1**	**494**	**-11.7**	**436**
Balance on Current Account	**274**		**-501**		**-58**		**-488**
Capital Transfers	441	115.4	950	-44.2	530	-7.5	490
Effective Current Balance	**715**		**449**		**472**		**2**

When these factors are taken into account, as well as some minor revisions to our credit flow forecasts, net factor outflows are forecast to increase by 18.6 per cent in value during 2001 and by 11.1 per cent in 2002. The result of this is a widening deficit on the current account, from £58 million in 2001 to almost £500 million in 2002. However, this will only represent 0.6 per cent of GNP in 2002.

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

Gross National Product

Our estimates for the volume growth of both GDP and GNP in 2001 have been revised downwards to 6.4 per cent and 4.9 per cent respectively. Current estimates indicate a slight loss in the terms of trade in 2001, with export prices rising fractionally less than import prices. Allowing for a fall in the volume of net current transfers, real gross national disposable income (GNDI) is estimated to have risen by 3.6 per cent. Given the magnitude of the slowdown in the global economy, we have revised downwards our forecasts for GDP and GNP growth for 2002. These now stand at 3.4 per cent and 2.6 per cent respectively. A significant terms of trade gain seems likely in 2002. When current transfers are taken into account, GNDI is forecast to increase in 2002 by 3.0 per cent in volume terms.

Agriculture

The *National Income and Expenditure Accounts 2000* shows a small volume increase of 0.8 per cent in the volume of gross domestic product in the broad agriculture sector last year. It seems unlikely that the sector will continue to grow this year following the negative impact of the foot and mouth scare, coupled with the general economic slowdown, and so a contraction of 7.8 per cent is forecast in real output for 2001.

Some recovery is anticipated in 2002 as demand for food products and food inputs increases as UK producers seek alternative sources of supply other than the domestic UK market following the extensive culling that has occurred there. On this basis, growth in the volume of output of 4.9 per cent for agriculture, forestry and fishing is forecast in 2002.

Industry

The volume of production in industry, including building, rose by 13.7 per cent last year. The monthly volume of production index for manufacturing and industry shows that expansion has been checked during 2001. The index for all industries for the year to July shows an increase compared to the same period of 2000 of 15.3 per cent, However, on a seasonally-corrected basis output in the three months to August declined by 6.5 per cent compared with the same three months last year.

Further evidence of the slowdown is given in the IBEC-ESRI survey, which in recent months has shown some pessimism concerning assessments of order books and order expectations. The NCB Purchasing Managers Index for September shows a contraction in the manufacturing economy for the second month in a row. Despite the slowdown, allowing for the carryover of activity from last year, the volume of industrial production is forecast to rise by just 8.2 per cent in annual terms in 2001.

With lower levels of new capacity expected to come into operation in 2002, combined with slowing international markets and little carry over from this year, growth in 2002 is expected to be much lower at 3.8 per cent in real terms.

Services

The volume of GDP in the services sector, after adjustment for financial services, increased by nearly 10 per cent in 2000. As the economy slows this pace of expansion is unlikely to be sustained. The containment measures for foot and mouth had a major impact on this sector, while increasing economic uncertainty is expected to result in lower levels of consumer spending. Some evidence of this is already emerging. The NCB Index for the services sector shows that this sector contracted in August. Thus, a volume increase in output from the services sector of 6.5 per cent is forecast for this year.

As already outlined in this *Commentary*, personal consumption growth is expected to be lower in 2002. The adjustment of expectations to slower growth in incomes and some rise in unemployment is also expected to have an impact on the services sector. The expected slowing down in domestic demand growth should be reflected in a lower rise in service output next year. An increase of 3.7 per cent in the volume of GDP in services is therefore forecast for 2002.

Employment

Thus far in 2001 the slowdown of economic activity has yet to lead to any significant deterioration of labour market conditions. The latest Quarterly National Household Survey (QNHS) for the second quarter of the year indicated that the unemployment rate remained unchanged from the first quarter at 3.7 per cent. However, employment growth continues to slow in the Irish economy. Total employment stood at 1.716 million in the second quarter a slight increase of just 6,000 persons from the first quarter of 2001. On an annual basis employment grew by 45,800 persons or some 2.7 per cent in the second quarter as compared with 3.6 per cent in the first quarter and 5 per cent in the corresponding quarter of 2000. While by international standards employment growth remains strong, the trend towards an overall slowdown remains and is likely to be exacerbated by the weakening economic climate.

Employment grew in most sectors of the economy with the exception of agriculture, forestry and fishing, (-10,800), hotels and restaurants (-4,200) and other services (-1,100). The impact of the foot and mouth crisis is evident through the decline in employment in the hotels and restaurants sector, which normally experiences a seasonal increase in the second quarter. In contrast to other years employment declined by 1,800 persons in that sector in the second quarter of the year. Similarly, the decline in agricultural employment, twice the amount in the corresponding quarter of 2000, was accentuated by the foot and mouth crisis.

In large part slowing employment growth over the last two years has reflected the constraints imposed by the tightness of the labour market, particularly slowing labour force growth. The QNHS indicates this trend continued in the second quarter. The labour force grew by 57,500 persons between the second quarters of 1999 and 2000. Growth between the second quarters of 2000 and 2001 moderated significantly, however, with just 36,300 entering the labour force in that period. In percentage terms the labour force grew at an annual rate of 2.1 per cent in the second quarter as compared with 3.4 per cent in the corresponding quarter of 2000. The overall participation rate in the labour force as measured by the QNHS was 59.1 per cent a slight increase on the previous quarter. Male and female participation in the second quarter stood at 70.9 per cent and 47.5 per cent respectively.

The latest Live Register Statement for September provides additional evidence that weakening economic activity has yet to impact significantly on labour market conditions. In September the Live Register fell by 8,889 leaving the total number at 140,550. However, all of the decrease in September can be attributed to seasonal factors such as the reopening of schools and colleges. When seasonally adjusted the latest Live Register Statement indicates a small monthly increase of 200. This had no impact on the standardised unemployment rate, which remained at 3.7 per cent based on the April 2001 QNHS.

The resilience of labour market conditions thus far to weakening economic activity may in part be due to more flexible pay arrangements within the private sector than previously thought. In recent years nominal wage growth has accelerated reflecting the continued tightening of the labour market. However, increasingly so wage growth has taken the form of more flexible pay arrangements such as performance-related pay, stock options, bonus payments etc. Flexible wage structures within the private sector that reflect out-turns in the economy may in part explain the failure of the weakened economic environment to impact significantly on the labour market. They may also go some way to explain the particularly sharp decline in the growth of income tax receipts, difficult to reconcile with employment growth and the nominal wage terms of the Programme for Prosperity and Fairness (PPF).

It is forecast that total employment for the year 2001 will average 1.736 million persons rising to 1.760 persons in 2002. In percentage terms this increase implies employment growth of 2.6 this year and 1.4 per cent in 2002. Employment is expected to slow by roughly 3 percentage points in both the industrial and services sectors in 2001 with the slowdown continuing in 2002. Labour force growth is expected to continue its slowing trend with an annual average of 2.1 per cent and 1.8 per cent in 2001 and 2002 respectively.

The unemployment rate is forecast to average 3.8 per cent in 2001 and 4.2 per cent in 2002. This will mean an increase in the average numbers unemployed of 13,000. The annual average number of persons on the Live Register is expected to increase from 140,000 in 2001 to 151,000 in 2002. This will constitute an increase of 8 per cent on the register.

TABLE 8: Employment and Unemployment*

	Annual Averages '000			
	1999	**2000**	**2001**	**2002**
Agriculture	139	130	121	118
Industry	459	488	502	510
Services	1,018	1,075	1,112	1,132
Total at Work	**1,616**	**1,692**	**1,736**	**1,760**
Unemployed	95	76	69	78
Labour Force	**1,711**	**1,768**	**1,805**	**1,837**
Unemployment Rate %	5.6	4.3	3.8	4.2
Live Register	193	156	140	151

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

Incomes

The record levels of growth in both GNP and employment registered last year had a significant positive impact on the growth in incomes. All measures of income increased significantly compared to 1999 (see Table 9). However, in line with the slowdown in economic activity, incomes are forecast to grow much more slowly this year, with a recovery beginning in 2002. If the downturn is more protracted than anticipated, these forecasts may well prove to be too optimistic. In this case, the out-turn for 2002 would be much weaker than presented here, but a recovery is still likely for 2003.

Following a 10 per cent fall in 1999, agricultural incomes rebounded in 2000, and posted growth of 6.3 per cent for the year. This was largely a result of increases in output value across most sectors, although the strength of global demand and the weakness of the euro certainly provided a boost to agricultural exports. However, income growth is likely to be significantly weaker this year as a result of the restrictions introduced to contain foot and mouth disease earlier in the year. We are forecasting a growth in agricultural incomes of just 1 per cent this year. We expect agricultural incomes to recover throughout 2002, and our forecast is for growth of 3.4 per cent next year.

Our forecasts for wage growth have been revised downwards from the last *Commentary*, reflecting the sharp slowdown that is underway. The growth in hourly earnings is expected to be 10.3 per cent in 2001, moderating to 7.3 per cent in 2002 (Table 1). The continued tightness of the labour market is the driving force behind these predictions, which are dependent on employment levels continuing to increase. If the slowdown is sharper than we anticipate, this could result in a decrease in total employment. In this case, the excess supply of labour would alleviate much of the upward pressure on wages, and the growth in hourly earnings would be much more moderate.

TABLE 9: Personal Disposable Income

Preliminary

	1999	Change		2000
	£m	%	£m	£m
Agriculture, etc.	2,207	6.3	139	2,346
Non-Agricultural Wages,	28,416	14.8	4,197	32,613
Other Non-Agricultural Income	10,886	7.8	845	11,731
Total Income Received	**41,509**	**12.5**	5,182	**46,691**
Current Transfers	6,774	23.9	**1,617**	8,391
Gross Personal Income	**48,283**	**14.1**	6,799	**55,082**
Direct Personal Taxes	9,512	14.1	1,339	10,851
Personal Disposable Income	**38,771**	**14.1**	**5,460**	**44,231**
Consumption	34,702	15.0	5,216	39,918
Personal Savings	4,069	6.0	245	4,313
Savings Ratio	10.5			9.8

Forecasts

	2000	Change		2001	Change		2002
	£m	%	£m	£m	%	£m	£m
Agriculture, etc.	2,346	1.0	24	2,370	3.4	80	2,450
Non-Agricultural Wages,	32,613	14.0	4,562	37,175	9.1	3,395	40,570
Other Non-Agricultural Income	11,731	10.8	1,261	12,992	6.8	888	13,881
Total Income Received	**46,691**	**12.5**	**5,847**	**52,537**	**8.3**	**4,363**	**56,900**
Current Transfers	8,391	-2.7	-229	8,162	7.0	574	8,736
Gross Personal Income	**55,082**	**10.2**	**5,618**	**60,699**	**8.1**	**4,937**	**65,636**
Direct Personal Taxes	10,851	7.8	845	11,695	7.8	915	12,610
Personal Disposable Income	**44,231**	**10.8**	**4,773**	**49,004**	**8.2**	**4,022**	**53,026**
Consumption	39,918	10.1	4,048	43,966	7.3	3,222	47,188
Personal Savings	4,313	16.8	725	5,038	15.9	800	5,838
Savings Ratio	9.8			10.3			11.0

The non-agricultural wage bill increased by almost 15 per cent in 2000 to exceed £32 billion. An increase of similar magnitude is anticipated for 2001, as employers in the private sector continue to pay well above the rates agreed in the PPF. We are predicting growth in the non-agricultural wage bill of 14 per cent this year, weakening to 9.1 per cent in 2002. Such a sizeable increase this year in the face of a rapidly slowing economy is representative of the full-employment situation that currently exists. With some increase in unemployment expected next year, the increase in the non-agricultural wage bill will grow more moderately. However, growth rates should remain quite robust, and this will further increase the share of non-agricultural wages in national income.

The growth in net factor income was particularly striking in 2000, with a combination of a weak euro and very strong global demand resulting in net factor payments increasing by over 17 per cent in real terms. Some slowdown from these levels was inevitable, but we are still predicting growth of 14 per cent for 2001, down from a forecast of over 17 per cent in the previous *Commentary*. This is based on the fact that there was a considerable carry-over effect coming into this year, but the continued weakness of the euro has also helped by maintaining our competitive position internationally. However, the slowdown in the world economy will have a disproportionately large negative impact on the multinational sector, and we anticipate that the growth rate of net factor payments will almost halve next year to 7.3 per cent. This is based on the assumption of a deterioration of our competitive position through a combination of rising labour costs and an appreciation of the euro, as well as continued weakness in the world economy.

Other non-agricultural incomes are forecast to increase by 10.8 per cent in 2001, before moderating to 6.8 per cent in 2002. This income mainly represents personal income from profits and rents. The decline will be the result of the sharp downturn in economic activity, particularly corporate profits. Such an uncertain economic climate will increase personal savings in the short term, with the savings ratio likely to return to double figures this year and increasing further in 2002 to average 11 per cent.

Consumer Prices

Although there has been some decline in the rate of consumer price inflation it still remains high, averaging 5.1 per cent over the first eight months of the year. However, as the economy slows it is unlikely that inflation in the latter half of this year or during 2002 will pose the problem that it was for the Irish economy during 2000 and the first half of 2001. The strength of inflation at a time when the economic activity in Ireland has slowed reflects the importance of the exchange rate in the form of a relatively weak euro, as one of the factors determining the domestic rate of inflation. The annual rate of inflation as measured by the EU Harmonised Index of Consumer Prices for August shows inflation in Ireland as below that in Greece, the Netherlands, and Portugal. As can be seen from Table 10, the consumer price index rose by 4.6 per cent in the year to August. Excluding housing the index rose by 3.7 per cent. The annual average rate of inflation in the year so far has been 5.2 per cent. Allowing for some further improvement it now seems likely that the annual average for this year will be below 5 per cent at 4.8 per cent.

On the assumption that the euro will tend to strengthen against other currencies the increase in non-housing prices is likely to be more moderate next year. Furthermore, interest rates are expected to remain low and so a reduction in the price of housing costs is also forecast. Domestically, the anticipated slowdown in economic activity should ease domestic price pressures. On this basis a more moderate rate of consumer price increase is forecast for 2002, averaging 3.1 per cent.

TABLE 10: Consumer Price Index – Recent Trend and Forecast

	Quarterly Trend								Annual			
	1999	2000				2001			1999	2000	2001	2002
	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3				
Index Nov. 1996=100												
Housing	86.7	90.5	96.0	103.4	111.0	114.2	117.8	118.4	91.5	99.6	116.7	117.9
Other	107.5	109.3	111.3	112.4	113.5	113.5	116.0	116.6	105.9	111.6	115.2	118.7
Total CPI	105.9	107.8	110.1	111.7	113.3	113.5	116.1	116.8	104.7	110.6	115.9	119.5
Annual % Change												
Housing	-14.0	-3.3	4.1	11.1	28.0	26.2	22.7	14.5	-10.8	8.8	17.2	1.0
Other	3.4	4.8	5.2	5.7	5.6	3.8	4.2	3.7	2.6	5.4	3.2	3.1
Total CPI	2.1	4.3	5.2	6.2	7.0	5.3	5.4	4.6	1.6	5.6	4.8	3.1
Quarterly % Change												
Housing	-6.9	4.4	6.1	7.7	7.4	2.9	3.2	0.5				
Other	1.1	1.7	1.8	1.0	1.0	0.0	2.2	0.5				
Total CPI	0.7	1.8	2.1	1.5	1.4	0.2	2.3	0.6				

Public Finances

Strong growth in the economy has led to large exchequer surpluses over the last few years. As a consequence the burden of national debt, as measured by the debt to GDP ratio, has fallen dramatically. The exchequer balance is forecast to decline considerably this year and to move into deficit in 2002 on the basis of the economy growing below its trend. The implication for Budget 2002 is that significantly less room exists for tax cutting measures and expenditure increases than in recent years.

The public finances were in their most healthy position in decades in 2000, as a result of the record growth in the economy, which allowed for a generous budgetary outlay last year. The capital borrowing requirement meant that the exchequer surplus measure was equal to £2.4 billion or 3 per cent of GDP. The broader general government surplus for 2000 was £3.7 billion or 4.5 per cent of GDP. In addition, the corresponding general government debt declined from 49 per cent of GDP in 1999 to 39 per cent of GDP in 2000.

Exchequer returns indicate that tax revenue grew by just 2.2 per cent in the first nine months of 2001 as compared with the same period in 2000. Given that tax revenue grew by 15.8 per cent in the year 2000 as a whole, the latest exchequer returns are indicative of a wider slowdown in the economy. The slowdown in tax revenue has been most pronounced in excise duties, which contracted by 7.4 per cent in the first nine months of the year as compared with 2000. Furthermore, the growth of revenues from income tax, corporation tax and value added tax has all significantly slowed this year.

Tax revenue was probably depressed in the first half of the year by temporary factors, such as the effect of foot and mouth containment policies on excise duties and also certain timing issues with regard to corporation tax. However, the greatest conundrum in the exchequer figures is the slow growth of income taxes at 3.6 per cent. It is difficult to reconcile this figure with the strong wage and employment data throughout the economy. Some rebound may be expected in the second half of the year but tax revenue is forecast to slow below budgetary estimates nonetheless.

On the expenditure side, the exchequer returns indicate that current expenditure grew by 11.4 per cent in 2001 as compared with the first nine months of 2000. This comprises of a fall in the central fund and a substantial rise in current supply and services of around 19 per cent. In part, the persistence of inflationary pressures has contributed to expenditure increases being underestimated by budgetary forecasts. Expenditure on the current supply of services is expected to overrun original estimates because of an increased allocation of resources at the finalisation of the Expenditure Estimates for 2001. However, this increase will in some part be offset by the decision to reduce capital expenditure. In addition, capital resources will be £500m higher in 2001 as a result of the sale of the state-owned Industrial Credit Corporation (ICC) and Trustee Savings Bank (TSB). These privatisation receipts will offset somewhat the effect of increased current expenditure on the exchequer balance but will not impact on the general government balance.

Given the considerable uncertainties it is forecast that the exchequer surplus will decline to £1 billion or 1.1 per cent of GDP this year. This means that the exchequer surplus in 2001 will fall short of last year's surplus by almost 1.4 billion. This may be a rather sanguine view as it depends upon a rebound in the tax revenues in the latter half of 2001. Tax revenue growth of 4.0 per cent for the year is forecast. Current expenditure is expected to grow by 14.6 per cent with the impact on the exchequer surplus somewhat offset by privatisation receipts and reduction in capital expenditure.

The broader measure, the General Government balance, which includes the National Pension Reserve Fund and the Social Insurance

Fund, is expected to be £2.2 billion or 2.3 per cent of GDP. This is two percentage points lower than anticipated in the Stability Programme update produced as part of last year's Budget 2001 (Department of Finance, 2000). The general government debt is forecast to decline from 39 per cent of GDP in 2000 to 33 per cent in 2001.

In terms of the opening position for Budget 2002, it is forecast that current trends will lead to a moderate deficit in the exchequer balance in 2002. This projection is made under a number of assumptions. First and foremost a sharp slowdown in GDP growth to 4.3 per cent is expected in 2002. Overall tax revenue is expected to grow by 4.3 per cent. In large part this slight increase in tax revenue growth as compared with 2001 reflects the recovery of excise duties. In addition, inflationary pressures and wage increases are expected to maintain the strong growth of VAT and income tax receipts in 2002.

Current expenditure is expected to rise by 7.2 per cent in 2002. On the one hand, lower interest rates and a declining burden of national debt will contain expenditure on the central fund. However, prior commitments with regard to public sector wage agreements, in addition to increases in public sector employment, are expected to lead to growth of 9 per cent on current supply of services spending.

Capital expenditure is expected to rise by 5.7 per cent to over £5 billion. With no privatisation receipts and other capital receipts in decline, the capital borrowing requirement is set to increase by over £1 billion. In comparison the current budget surplus is expected to decline by almost £450 million in 2002.

In summary, the opening exchequer balance for next year is projected to be a deficit of £433 million or just 0.4 per cent of GDP, see Table 1.2. As compared with the projected out-turn for 2001, this would imply a reduction of almost £1.45 billion in the exchequer balance. The bulk of the decline in the exchequer balance is expected to come from increased capital borrowing. Large capital receipts from the privatisation of state companies have flattered budgetary positions in recent years. While our estimates for current revenue and expenditure are optimistic, the decline in capital receipts, particularly from privatisation, will lead to a sharp reduction in the exchequer balance.

The broader based general government surplus is expected to equal £1.5 billion in 2002 as compared with £2.2 billion in 2001. This is a significantly smaller decline when compared with the exchequer balance. The difference between the projected general government and exchequer balances reflects the exchequer's contribution to the National Pensions Reserve Fund and also the surplus in the Social Insurance Fund, both of which are expected to grow in 2002. The corresponding general government debt is forecast to decline from 33 per cent of GDP in 2001 to 30 per cent in 2002, a much more modest decrease in the debt than experienced in recent years.

TABLE 11: Public Finances

	2000	% Change	2001	% Change	2002
Current Revenue	21,741	4.8	22,775	4.0	23,677
Current Expenditure	16,251	14.6	18,630	7.2	19,980
Current Surplus	**5,491**	-24.5	**4,145**	-10.8	**3,697**
Capital Receipts	2,053	-16.3	1,719	-43.6	970
Capital Expenditure	5,141	-6.1	4,825	5.7	5,100
Capital Borrowing	**-3,088**	0.6	**-3,106**	33.0	**-4,130**
Exchequer Surplus*	**2,403**	-56.8	**1,039**	-141.7	**-433**
as % of GNP	3.5		1.3		-0.5
General Government Surplus	**3,667**	-41.4	**2,150**	-27.9	**1,550**
as % of GDP	4.5		2.3		1.6
Gross Debt as % of GDP	**39.0**		**32.7**		**30.4**

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

General Assessment

The exceptional performance of the Irish economy in the last decade continued up until the first quarter of 2001. The CSO in its preliminary *National Income and Expenditure* for 2001 estimated that real GDP growth was 11.5 per cent in 2000. This is remarkable given that it came on top of seven years of unprecedented expansion. The quarterly time path of output in 2000 indicates that growth was accelerating throughout the year and this carried over into the first quarter of 2001, when real GDP is estimated to have grown at an annual rate of 13.2 per cent. The indications are that this phase of rapid growth reached an abrupt halt during 2001. This is in response to the general slowdown underway internationally and to domestic reaction to the threat of an outbreak of foot and mouth disease in the second quarter.

In the last *Commentary* our forecasts were based on a benign outlook for the likely developments in both the international slowdown and the agricultural crisis cases. Events since then, involving the spate of terrorist attacks in the US and military responses in Afghanistan, have made the outlook for the international economy particularly uncertain. The likelihood is that the anticipated recovery in the US economy will be postponed along with the other major economies until the middle of 2002. Even with this sanguine view, our forecast for 2002 is revised significantly downward. We forecast that growth in real GDP will be 3.4 per cent and 2.6 per cent in real GNP in 2002. While substantial, this downward revision in the forecast for growth of around three percentage points may well be optimistic given the prospect that events may unfold which increase the likelihood that the recovery in the world economy takes longer than we are currently forecasting.

While the Irish economy is entering a period of great short-term uncertainty, the medium-term prospects for the Irish economy remain good, as set out in the recent ESRI *Medium-Term Review 2001-2007* (MTR). The MTR contains a number of model-based scenarios including a "benchmark" forecast which is consistent with the last *Quarterly Economic Commentary*. The MTR scenarios were constructed prior to the terrorist events of September 11th and so the "benchmark" would be revised down significantly in line with the forecasts in this *Commentary*. The MTR has a "slowdown" scenario whereby the US economy undergoes a severe downturn with economic growth only recovering to its potential in 2003. Under this scenario, growth would fall to just under 2 per cent in 2002. Our forecast is consistent with the MTR but is based on the US economy recovering in the latter part of 2002 so leading to somewhat higher growth next year than under the "slowdown scenario". However, the main point from the MTR slowdown scenario is that the Irish economy would begin to recover and that growth would be rapid enough to restore the loss of potential output by 2005.

The buffeting of Irish economic growth rates from international events is to be anticipated, given the small open nature of the economy. We estimate that the underlying potential growth rate is of the order of 5 per cent in terms of real GDP for the next five years. In the period 1995-2000 this potential growth rate was closer to 7 per cent, yet in the first two years of membership of monetary union output growth at around 11 per cent has been well above its sustainable rate. The out-turn for 2001 is likely to be closer to potential but this masks the sharp drop within the year.

Experience would suggest that Irish growth performance can be quite volatile around its potential or trend growth so that mechanisms to smooth adjustment are necessary where possible. As we have argued in recent *Commentaries* the relationship between fiscal and incomes policies, as cemented in the social partnership agreements, needs modification.[4] Modifications in the form of flexibility mechanisms, such as deferred compensation options, that reflect out-turns in the economy, would be a partial solution. This may contribute towards smoothing the adjustment process by dampening competitiveness losses from wage overshooting. The sharp slowdown in the economy may provide the appropriate atmosphere in which the social partners can commence that re-evaluation in earnest.

In the shorter term, attention is likely to focus on the role of budgetary policy in reacting to the changing economic outlook. The room for manoeuvre would seem to have been curtailed by the re-emerging exchequer deficit in 2002. However, it is still the case that the general government balance, used for international assessment of our budgetary position in the *Stability and Growth Pact* (SGP), is strongly in surplus. Coupled with the relatively low levels of national debt, these budgetary balances provide a substantial element of room to ride out a temporary downturn in the public finances.

The law of living memory,[5] however, cautions against an overly proactive role for fiscal policy in Ireland in an attempt to engage in short-

[4] In a paper in this *Commentary*, Anthony Leddin examines the adjustment mechanism available to a small regional economy in a monetary union. He argues that the monetary sector may be a potential source of instability and that fiscal policy alone may be an inadequate policy for bringing about the necessary adjustment. This then shifts the burden of adjustment on to the labour market.

[5] If you do not remember it, you are destined to repeat it.

term demand management. Most commentators now view the late 1970s and early 1980s as an aberration in the story of the Irish public finances. At the end of the 1970s a policy of "pump-priming" the economy by increased public expenditure and reduced taxation was pursued in Ireland on the basis that the economy was in a transition in its development. The low interest rate environment that prevailed internationally encouraged a build up in the national debt to finance the expansion.

Similar rationales could be advanced at this present juncture too. One difference is that the fiscal expansion in recent years is not being financed by foreign borrowing as last time. Another critical difference is that within a monetary union we have no currency to defend and so cannot be punished by higher interest rates for our fiscal profligacy. Membership of monetary union now imposes obligations on fiscal behaviour under the terms of the *Stability and Growth Pact* (SGP). Another is that the demographic profile is now changed. The dependency ratio of the young and old to the working population was exceptionally high twenty years ago as a result of a late 1970s baby boom. The baby boomers have now joined the work force and the dependency ratio is currently among the lowest in Europe and is likely to remain so for the next 15 years. This demographic dividend provides a significant window of opportunity to set Irish public finances on a long-term sustainable path.

Things certainly are different this time in terms of the policy environment but the capacity to underestimate the impact of the economic cycle after a period of sustained growth remains. This is not a uniquely Irish phenomenon. The re-emergence of the economic cycle in the US over the last year has led to the return of fiscal deficits there too. The Exchequer returns indicate that tax revenue grew by just 2.2 per cent in the first nine months of 2001 as compared with the same period in 2000. Given that tax revenue grew by 15.8 per cent in the year 2000 as a whole, the latest exchequer returns are indicative of a wider slowdown in the economy. The growth of tax revenue from income tax, excise tax, corporation tax and value added tax has significantly slowed this year.

The commitment to set aside 1 per cent of national output each year out to 2055 to part pre-fund future public service and social welfare pension liabilities is also likely to be perceived as making the short-term position more difficult particularly when borrowing is required to maintain the fiscal position. However, a long-term policy decision like the National Pension Reserve Fund should not be dictated by short-term cyclical fluctuations in the public finances though its initiation was at a time of exceptional budget surplus.

The lesson from Irish and international experience is that short-term demand management of a small open economy through fiscal policy is unlikely to prove successful. The Irish economy has embarked upon a unique phase of substantial public investment programmes, under the National Development Plan. The future success of the economy is dependent on this infrastructural investment being undertaken so it should not be postponed due to a short-tern downturn in our economic growth prospects. The most appropriate response for Budget 2002 is the pursuit of a neutral position that would involve an indexation of tax and welfare rates. This indexation of tax rates to price inflation and welfare rates to wage growth would require a "giveaway" budget of no more than £900 million.

The main adjustment mechanism for the Irish economy will be through the labour market either in terms of wage growth moderation or job losses. The former is preferable in reaction to a short-lived downturn but the social partnership arrangements as currently configured seem unable to deliver this. If a partial explanation of the unexpectedly low growth in income tax receipts this year is that wage flexibility, in terms of reduced bonuses and overtime, has become an important source of adjustment in the private sector, it is to be welcomed. Such flexibility in the wage bargaining process is what a small regional economy requires to ensure it remains competitive over the difficult eighteen months ahead.