Medium-Term Prospects for Ireland: An Update

John Bradley and John Fitz Gerald

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T. J. BAKER
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Introduction

The Institute publishes its Medium-Term Review approximately every eighteen months. The Review attempts to project likely prospects for the Irish economy, predicated on trends in the world economy and the stance of domestic policy. Since we published our last Review in June 1989, some important and unexpected political events have taken place in Eastern Europe which could have substantial political and economic implications for developments within the EC and Ireland over the next few years. These events were not foreseen when we wrote the Review last June, although many of the other forces determining our future growth have developed as we expected (e.g., the impending slow-down of the UK economy, relatively buoyant growth in the rest of the EC and the implementation of the EC Structural Fund projects, albeit at a lower level and different timing than envisaged in the National Development Plan 1989-1993).

Changes in the Review’s short-term forecast include a rise in nominal and real interest rates and an upward revision in the Irish growth rate for 1989. There is a consequent reduction in the forecast growth for 1990. However, the latest growth forecast for 1990 is still well above average growth for the 1980s. Apart from these changes in the timing of the Irish recovery, economic prospects in the EC and the rest of the world economy remain broadly favourable, implying equally favourable prospects for Ireland over the foreseeable future.

The production of the complete Review involves a major commitment of time and resources. However, because of the widespread use of the Review both here and abroad, we feel it may be useful to provide a limited revision of the medium-term forecasts to take account of developments in Ireland and the rest of the world up to the first quarter of this year. We first discuss the economic environment at home and abroad, concentrating on changes since last June. We then present a revised aggregate benchmark forecast for the period to 1994, eliminating much of the sectoral and other detail of the full Review. Also, we have not considered a range of options or scenarios or explored the sensitivity of our projection to alternative assumptions. Thus the results presented here are more tentative than the fully developed scenarios normally contained in a complete Review.

1The next issue, to cover the five-year period 1991 to 1996, is scheduled for publication in December of this year.
2See this Commentary.
The External Environment

The European Community

The implementation of the Single European Market in the EC and movement towards monetary union will continue to be the strategic forces determining trends in the Irish economy over the next five years. There is still much uncertainty as to what exact changes 1992 will require in Ireland and whether the original time-table will be adhered to. Nevertheless, we already have sufficient information to make some forecasts of the effects on Ireland. Indeed, the effects of 1992 have already begun to be felt both through increased domestic expenditure funded by the Community Support Framework (i.e., the Structural Funds) and through changes in the structure of some sectors of the Irish industry and services (e.g., distribution and financial services).

In analysing the possible impact of 1992 on Ireland in the last Review, a number of problem areas were identified. However, it was felt that overall the impact would be favourable. The areas identified as likely to undergo significant change were the distribution and financial sectors. On balance the effects on the industrial sector were thought likely to be favourable. Although the National Economic and Social Council in a major report published last autumn was less optimistic than we were, the differences may be more apparent than real. The NESC report suggests that without a policy of increased international transfers within the EC, market completion could widen the gap between the richer and the poorer EC members. However, this is consistent with our view that the Irish economy will be better off after 1992 than would be the case if the EC were to continue merely as a customs union and not to progress towards a more complete economic and monetary union.

Since the last Review a number of detailed studies have been carried out under the auspices of the Department of the Taoiseach’s EUROPEN programme. Those covering the engineering sectors and the computer sector indicated that they were unlikely to be adversely affected by the impact of 1992. Because most of the manufacturing sector already operates in a competitive market it should not experience a major change in circumstances after 1992. Obviously there will be some exceptions, especially where firms are very dependent on the home market. One example was the loss of employment in baking during the ‘sliced-bread war’ last year, at least some of which must be attributed to 1992.

Because of the high degree of export orientation of Irish industry, anything which improves access to foreign markets will be beneficial. The ending of restrictions on public procurement within the EC will help a number of Irish firms. However, firms which are dependent on the home market for much of their profits — markets that are likely to be even more fiercely contested after 1992 — may be adversely affected.

The Cecchini Report highlighted the importance of economies which result from the increase in scale of operation for firms in the EC arising from the

5Some further adverse consequences were identified in the distribution sector of services (J. Fitz Gerald, 1990, 1992 and the Distribution Sector, EUROPEN).
larger market. Those firms which can expand to exploit economies of large scale operation will clearly be the winners, and many medium-sized firms may be squeezed out. However, the bulk of Irish industrial production is concentrated in areas which are less likely to be affected by increases in the scale of operation. This means that although we may not benefit greatly from the growth of those firms which win the expansion race and reap the benefits of scale economies, we may not lose either because smaller firms shut down. This is consistent with the NESC view that those areas of the EC which have the likely winners in the scale race will grow more rapidly than the EC average.

Eastern Europe

Our last Review contained not a single reference to Eastern Europe! The lack of importance of this region to Ireland, as perceived last year, can be summarised in FIGURE 1 (which shows Irish imports by countries of origin) and FIGURE 2 (which shows Irish exports by area of destination). In each case, less than 1 per cent of our trade was with the East Block. As regards imports, these are dominated by oil (from the USSR) and coal (from Poland). Exports, although small in size, are more heterogeneous. Of course, within this small overall total export share, Irish companies have been carving out niche markets (e.g., Aer Rianta in the USSR, Guinness-Placid Aviation in other Eastern Block countries). Nevertheless, if COMECON had continued without change, Eastern Europe would have been an unlikely location for dynamic and growing markets.

FIGURE 1
Irish Imports by Countries of Origin
Jan-Nov 1989
FIGURE 2
Irish Exports by Area of Destination
Jan-Nov 1989

All has now changed and the nations of Eastern Europe, within a startlingly short space of time, have rejected central planning and communism and embraced the market economy and liberal democracy. These developments, while universally welcomed in the West, have given rise to considerable uncertainty about the future. It is unusual, though interesting, to see world experts, particularly in Germany, uncertain as to how best to react to changing circumstances. These developments also give rise to some uncertainty about our own economic future because of our close integration into the European economy.

It is necessary to examine the possible consequences of the turmoil and change in Eastern Europe in a wider context than that currently used in the media. In so far as they affect Ireland, the developments in Eastern Europe can be best examined in two parts or stages. The first and more complex set of effects will arise from the political reunification of Germany and the consequential integration of the economies of the Federal Republic (FRG) and the German Democratic Republic (GDR). Because of the central role of the Federal Republic in the EC, the disruption and changes which will affect Germany during a rapid reunification will have a much more immediate impact on the economies of the rest of the EC. The second, more clearcut though longer term, effect arises from the changes in the East Block other than the German Democratic Republic.

German Reunification:
The implications of German reunification for the EC and Ireland are much more complex than are the immediate changes in the rest of Eastern Europe. Because of the central role of the Deutchmark in the EMS and in the world financial system, any shock to the German economy is likely to have large consequential effects on the rest of the EC. Much attention has been focussed on the issue of German monetary union (i.e., the conversion of East German
Ostmark to D-marks at a limited one-for-one exchange). While the direct
effects of this conversion could be inflationary, there are other aspects to
German unification which may have a longer lasting inflationary impact.

The FRG will have to fund further large scale financial transfers to the less
developed GDR. They will also have to deal with, what is for them, a new
phenomenon, i.e., a large unemployed or underemployed labour force. It is
clear that the Federal Republic government has no easy answers and the
government and the Bundesbank have openly disagreed on the correct
approach to the emerging problems.

Until early this year most international forecasters were confidently
predicting a low rate of inflation in the Federal Republic over the next five years
together with a strong D-mark and interest rates below the average for other
developed countries. However, the transfer of funds to what is now the GDR
will tend to raise demand and fuel inflation. Unless deflationary action is taken
in what is now the Federal Republic, some of this demand will flow out through
increased imports leading to a lower German balance of payments surplus.
While increasing demand for exports from Ireland and other EC countries the
reduced surplus would, if unchecked, tend to weaken the position of the D-
mark, further adding to inflation.

In the mid-1970s when the Federal Republic was previously faced with an
inflationary shock due to the rise in oil prices, the reaction was clear-cut.
Interest rates were raised, leading to an appreciation of the D-mark. This
reduced the inflationary pressure and made German firms less competitive.
The result was a fall in employment of over 5 per cent. However, German
unemployment as a percentage of the German labour force only rose by 3 per
cent as many foreign migrant workers were laid off and were obliged to return
to their countries of origin.

The situation is very different today since the newly unemployed and
underemployed will be German citizens. The earlier mechanism for reducing
the labour force is no longer available. On the contrary, there will be a need
to increase employment rapidly in the private sector in the wake of the
adjustment of the economy of the GDR to Western ways. While access to the
new pool of relatively skilled workers in the GDR will relieve German labour
shortages which exist in certain sectors, it is possible that there will remain a
large number of underemployed or unemployed workers. The policy of
maintaining a strong D-mark exchange rate, making German exports less
competitive, will make the solution of this problem much more intractable.

Financial markets not only adjust rapidly, they adjust in the present to
expectations of future developments. The above uncertainty has brought about
a rapid and substantial rise in long-term interest rates in Germany. This rise,
which has not as yet been accompanied by any significant increase in German
inflation, is quite serious for Ireland. If sustained, it could reduce Irish growth
this year and next year. However, as an offset to the negative effect of higher
German interest rates, the weakness of the D-mark will help the convergence
of Irish and D-mark interest rates. Ireland may also benefit from an increase
in competitiveness (caused by a weaker D-mark on world currency markets)
and from the likely increase in the rate of growth of the united German
economy as the eastern region develops.
Eastern Europe:

The opening up of the economies of Czechoslovakia, Hungary, Poland and, to a lesser extent, the USSR will also affect the Irish economy. These countries, with their traditions of industry and their present low labour costs, will potentially be competitors with Ireland in the market place for mobile multinational foreign direct investment. The IDA have already expressed concern about this possibility.6

The growth of an alternative market attracting foreign investment to Eastern Europe could adversely affect Ireland. The attraction of Eastern Europe will be particularly important for German firms. Surveys have shown that as part of the 1992 process many were already considering investing elsewhere in Europe. The attraction of what is now the GDR, which has a relatively low paid but skilled labour force, will clearly prove a major draw for such firms. The tradition in the GDR and Czechoslovakia of heavy engineering industry and the resulting availability of workers with engineering skills will make investment in the East attractive, for example, for car manufacturing firms.

However, while German investment is important to the Irish economy, it has in the past accounted for a minority of the foreign direct investment here. At present 5 per cent of manufacturing employment is accounted for by German owned firms whereas all foreign owned firms, taken together, account for over 40 per cent of total employment in that sector. For firms from other countries, such as the US and Japan, the attractions of possibly lower labour costs in Eastern Europe will probably be outweighed by uncertainty about the future and doubts about access to the EC market. For the moment Japanese computer chips made in Hungary would probably be looked on by the EC with as much disfavour as if they were made in Japan. This will be strengthened by the fact that our workforce has already developed the skills needed by the high-tech firms setting up here.

Secondly, the newly liberalised nations of Eastern Europe are likely to seek some form of association with the EC, perhaps even full membership. Hence, given their low state of development, they will also be competitors in the search for development assistance within the EC. While the assistance to Ireland under the EC Community Support Framework (CSF) is guaranteed up to 1993, the need to aid developing economies in Eastern Europe could lead to a reduction in the funds available to Ireland after that date.

A diversion of the EC budget towards Eastern Europe, including the GDR, is a real possibility. While the EC peripheral regional aid framework (the CSF) does guarantee an increase in the support for Ireland up to 1993, there is no guarantee as to the level of support thereafter. Even before that date Ireland may be called on to increase its contribution to the EC budget to fund assistance to Eastern Europe. The problems of the GDR are likely to make a considerable demand on the resources of the German Federal Republic, the single biggest contributor to the EC budget. It is possible that the GDR’s problems could require a once off transfer of resources from West Germany of around 5 per cent of GNP.

Our position relative to the EC mean income will improve slightly with

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6Similar fears were expressed when Greece, Portugal and Spain became full members of the EC in the early 1980s.
German unity as East German GNP per head is probably below that of Ireland. The membership of other Eastern European states would also raise Ireland's relative position while not directly affecting our absolute standard of living. Taken together such changes could add to pressures for EC funds and make Ireland seem a less deserving case for transfers. Given commitments already made, a reduction in EC support for Ireland is unlikely before 1994 and even then it will probably be gradual in nature.

A third way that Eastern Europe will affect Ireland will be through an increase in demand for goods produced in the West. Just as the Marshall aid of the post-war era served to boost European demand for American goods, much of the aid to Eastern Europe will find its way back to the West in the form of increased demand. A large fraction of these expenditures in the West will be on goods from the EC. While firms in the Federal Republic of Germany are probably in the best position to benefit from this increase in demand, capacity constraints in that economy, combined with the inevitable spill-over of demand to other EC members, will mean that the higher growth will affect Ireland. Much will depend on how distribution channels develop in Eastern Europe to cater for changing patterns of demand. Even if the benefits to Ireland are limited, this process must add to the growth in demand for Irish goods in Europe.

In summary, recent events in Eastern Europe make the external environment for the Irish economy somewhat more uncertain than it otherwise would have been. However, the implications for the Irish economy are certainly not all unfavourable and it is possible that in the medium to long term the changes could add to growth.

**The Domestic Environment**

The likely stance of government economic policy is clearly important in forecasting the growth of the economy up to 1994. Our very large public debt will continue to exert a considerable influence on policy for some time to come. In addition, the high birth rate in the 1970s and 1980s implies demographic changes over the next ten years which differentiate Ireland from most other European nations.

Ireland enters the 1990s with a severe public debt problem. Although state borrowing has been much reduced in recent years there remains a huge overhang of public debt which must be reduced if the economy is to be made less vulnerable to external shocks. The recent rise in interest rates is especially serious for Ireland because of our level of indebtedness. If the rise in real interest rates persists it will substantially reduce the government's room for manoeuvre.

Fiscal policy this year turned out to be more relaxed than anticipated last June, indeed probably more stimulatory than was appropriate. This means that in 1991 and subsequent years there may have to be a return to a less lenient policy, even if there were an unexpected turn down in the world economy. As against this, the phasing of the CSF payments is more in line with the recommendations of the Review.

Over the next five years we assume that, while eschewing the cutbacks of 1987-89, fiscal policy will be somewhat tougher than this year and that the
Exchequer will move into surplus in 1992. This will allow some small debt repayment in subsequent years, reducing our exposure to developments on foreign financial markets. In addition, it will permit cuts in taxation or increases in services each year, albeit on a more limited scale than occurred in this year's budget.

For the rest of the decade, as shown in FIGURE 3, the net inflow into the labour force will, on fairly conservative assumptions, continue at the rate of 22,000 to 25,000 a year. This situation will continue until 1998. Thereafter there will be a rapid fall in labour force entrants and an increase in outflow due to retirals so that by around 2005 the net increase will be down to around 6,000. What this means is that, on present trends, unemployment will, at best, fall slowly and emigration, while greatly reduced, is likely to remain significant till the end of the century. Thus unemployment and emigration will remain the major economic problem facing the economy for the foreseeable future.

**FIGURE 3**

Net Labour Force Inflows

Finally, the success of the *Programme for National Recovery* in moderating wage demands and promoting industrial harmony at a time of rapidly increasing labour productivity has been a key factor contributing to the economic turn-round in Ireland and the increasing profitability of the Irish industrial sector. However, underpinning the "success" of the Pay Agreement is the high rate of unemployment, particularly the disastrous rise in the years immediately preceding 1987. Preparations for negotiation of a new *Programme* are already

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under way and, if successful, the outcome will set the pace of wage inflation for the next few years. Since there has been some improvement in the state of the labour market, the terms of any new agreement are unlikely to be as favourable to employers as the previous one. In preparing medium-term forecasts we have assumed that while moderation continues to be exercised, real wages will rise roughly in line with the trend growth in productivity so that profitability will tend to stabilise. The likelihood that over the foreseeable future tax rates will tend to fall (in contrast to the 1980s) should help underpin wage moderation.

The Medium-Term Prospects for the Irish Economy
The rise in world interest rates, changes in Eastern Europe, and the deterioration in the UK economy over the last six months give rise to some concern. However, while these developments will result in some slow-down in the rate of growth of the Irish economy this year, we feel that the medium-term prospects for the Irish economy remain good. The developments in Eastern Europe need not adversely affect Ireland. The present exceptional level of real interest rates should fall in the medium-term once the situation in Germany becomes clearer. The beneficial effects of 1992 have already begun to affect the economy. As discussed below, on the assumption of a prudent fiscal policy in the medium-term, the burden of our debt will lighten.

The Overall Picture
On the basis of the assumptions set out above we now discuss the likely path of development of the Irish economy over the decade. For the 1990s the growth rate could average just under 4 per cent a year compared to the 1.5 per cent

**FIGURE 4**
**Gross National Product**

![Bar Chart: Annual Percentage Change](chart-image)
a year achieved in the 1980s (FIGURE 4). To some extent in the early 1990s this reflects the rapid growth normal in the recovery phase of the economic cycle. However, the relatively benign external and domestic environment assumed means that sustained growth throughout the decade is likely. If achieved, this performance will compare favourably with that of the Irish economy in the last 30 years (FIGURE 5). It would be roughly in line with the rate of growth achieved in the 1970s, while being well above that achieved in the 1980s.

FIGURE 5
Growth in Gross National Product
(Five Year Averages)

The rate of inflation in consumer prices, which rose to around 4 per cent in 1989 under pressure from a general rise in world inflation would have, in the absence of German unification, fallen back to between 2 and 3 per cent for much of the 1990s.

With the assumed fixed link between the Irish pound and the D-mark within the EMS, the major factor determining the rate of inflation in the long run will be the rate of inflation in Germany. Previous experience indicates that the German monetary authorities have a strong commitment to maintaining inflation at 2 per cent or less a year. If the Bundesbank view had prevailed in a united Germany this would have been transmitted to Ireland via a stronger exchange rate and lower interest rates. However, if, as now seems likely, the German rate of inflation rises as a result of unification to 3 per cent to 4 per cent a year, this will make it even more likely that Ireland will keep pace with German inflation rates (FIGURE 6).

The outlook for domestic wages is less certain than for inflation. The Irish economy has undergone a major improvement in its competitive position since
1986, an improvement that owes much to the slowdown in the growth in pay rates over the period. The economy generally, and the industrial sector in particular, are currently reaping the benefits of this change. In the immediate future there is likely to be a continuation of such wage moderation. This will be sustained by the assumed reduction in tax rates each year over the decade.

However, in spite of such moderation the rise in employment will force some increase in the rate of growth of real wage rates. In the longer term, while the continuing high rate of unemployment will act as a brake on excessive growth in wage rates, we anticipate that in the medium term the pace of growth in real wage rates will rise to around 2 per cent a year (FIGURE 6), more in line with experience prior to 1986. When combined with tax cuts this will allow a rise in real disposable income of between 3 and 3.5 per cent a year from 1992 onwards.

In the absence of a major domestic stimulus from either the public sector or from a fall in the personal savings rate, the balance of payments remains in surplus for the rest of the decade (FIGURE 7). This surplus allows a limited repayment of the debt incurred in earlier years and underpins the steady growth of the 1990s. Net investment abroad, which is the counterpart to the surplus on the current account of the balance of payments, itself feeds the surplus through gradually rising dividends and interest payments received from abroad.

On the fiscal policy assumptions outlined above, the exchequer borrowing requirement effectively disappears in 1991 and moves into surplus in 1992 (FIGURE 8). The moderate exchequer surplus is sustained in subsequent
FIGURE 7
Balance of International Payments

FIGURE 8
Exchequer Borrowing Requirement
(Surplus if Above Zero Line)
years in spite of the substantial reduction in income tax rates and the limited growth in public services assumed over the period. As shown in FIGURE 9 this pattern would be sufficient to reduce the debt/GNP ratio from its current level of just over 120 per cent to 90 per cent in 1994. It would probably be the end of the decade before it would drop close to the current EC norm of 50 per cent.

FIGURE 9
Debt/GNP Ratio

With the continuation of the current recovery, the rate of unemployment will fall slowly up to 1993 and there will be a reduction in the level of net emigration (FIGURES 10 and 11). However, with the rise in real wage rates (and, hence, an end to the improvement in competitiveness) the rate of growth in employment in the industrial sector slows thereafter. Against the background of a rapidly rising labour force, after 1994 both the rate of unemployment and the level of emigration could begin to rise again. While the turn-down in the labour force growth in the first decade of the new century may render any increase temporary, it is clear that the problem of unemployment will remain at the centre of political and economic debate for the foreseeable future.

After a period of net inward migration from 1971 to 1979, outward migration resumed in the 1980s and has now reached high levels similar to the depressed period of the 1950s and early 1960s. The migration mechanism lies at the centre of any discussion of functioning of the Irish labour market. If outward migration flows to the UK had not been facilitated in recent years by high growth in the UK, then the behaviour of the labour market might have been very different. Many factors contribute to the poor performance of the Irish labour market: a weak domestic demand for labour in industry and marketed
FIGURE 10
Unemployment Rate

FIGURE 11
Net Migration Abroad
services; the continuing decline of employment in agriculture; the cessation (indeed reversal) of employment growth in public services; the relatively high natural growth in population. All these factors have combined to keep the rate of unemployment at a high level. A further very serious aspect of the composition of unemployment is the increasing proportion of the long-term unemployed.

Inflation and the Financial Environment

Ireland joined the EMS at the end of 1978 and participated from the start within the narrow band of the ERM. However, because of the serious domestic financial difficulties and the absence of the UK (Ireland's main trading partner) from the ERM, the financial markets did not see a fixed link between the Irish pound and the D-mark as being sustainable. The failure to adopt suitable public expenditure and taxation policies to support such a fixed link meant that interest rates and the rate of inflation did not initially converge towards D-mark rates. Successive depreciations of the Irish pound against the D-mark within the ERM confirmed this pattern. However, since the last devaluation of the Irish pound within the ERM in 1986, circumstances have changed. The balance of payments has moved into surplus; the exchequer borrowing requirement has been greatly reduced and is soon set to disappear; the rate of wage and price inflation has fallen to the EC average, or less.

The prospect that these circumstances will continue to prevail during the 1990s makes the current Irish pound/D-mark rate sustainable. This in turn helps narrow the differential between Irish and D-mark interest rates, further improving competitiveness. These trends will be reinforced by further movement towards EMU. As a result, there is likely to be continuing convergence of the Irish rate of inflation and Irish interest rates towards German rates. The final establishment of credibility for the Irish pound in the EMS may take some time, particularly in the light of Ireland's exposure to the UK economy (and, of course, the UK's absence at present from the ERM), so that the margin between Irish and D-mark interest rates should narrow slowly over the next few years. These trends will be reinforced by further movement towards a European Monetary Union. In addition, if a united Germany were to weaken the D-mark it would make it all the more likely that Irish interest rates would converge to German rates. As a result, a continuing convergence of the Irish rate of inflation and Irish interest rates towards German rates seems probable.

The forecast continuing balance of payments surplus and the emergence of an exchequer surplus will mean that the pattern of investment of the funds available domestically will be very different in the 1990s compared to the 1980s. The exchequer will, if anything, be repaying debt and will have no need for the funds. The balance of payments surplus will involve a continuing capital outflow as either the government repays debt or the private sector invests abroad. The forecast assumes that the surplus funds continue to be invested in financial assets rather than giving rise to an even more rapid increase in the volume of investment in physical assets. This will maintain downward pressure on domestic interest rates with the D-mark rates continuing to provide an effective floor.

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Conclusion

The changes in Eastern Europe over the last six months have introduced a new element of uncertainty about the economic future. It is likely that there will be a more rapid growth in the EC and in the potential foreign markets for Irish goods. The changing nature of these markets could require some reorientation of our industrial and exporting strategy. However, given the relative economic strengths of the EC and the Eastern European countries, the bulk of effective demand for Irish goods will still come from the more traditional EC markets either directly or indirectly.

The changing circumstances arising from German unification will require some review of our domestic policies. The increased rate of growth in Germany will be particularly important for us. However, if it is accompanied by higher real interest rates in the medium-term it will make the domestic task of debt reduction more difficult. This could mean that there will be less scope for tax cuts in the immediate future.

There are a wide range of structural problems facing the Irish economy over the next five years. Policy to deal with them is too often forgotten in the rush to deal with current problems. However, by continuing to ignore them we do little to promote the long-term growth of the economy. While public policy can help create a suitable environment for the Irish economy in the 1990s, it is up to the private sector to seize the new opportunities which present themselves. This will require greater flexibility in dealing with the rapidly changing market in Europe. Opportunities which were not present in the past will arise from the opening up of public procurement. They will also arise from the integration into the Western European economy of the newly emerging democracies in the East.

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<tr>
<th>TABLE 1: Medium-Term Forecast — Major Aggregates</th>
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<td>GNP % Change</td>
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<td>Debt/GNP Ratio</td>
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