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by

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SUMMARY

The unexpectedly vigorous expansion in industrial exports has caused an upward revision to the 1987 growth rate. Real GNP is now forecast to rise by 1¾ per cent, with the current account balance of payments deficit falling to below £150 million. Budget targets could be met, and, even if they are not, the slippage is likely to be small. This improvement in the public finances will inevitably keep domestic demand weak throughout 1987, as the benefits of lower interest rates are unlikely to work through the economy within the year. Thus total employment will be significantly lower than in 1986, and emigration will probably remain high.

Provided the pattern of exchange rates remains relatively favourable in 1988, exports of goods and services are expected to increase further, although not as rapidly as in 1987. However, by 1988, the effects of lower interest rates in stimulating private investment, and to a lesser extent consumption, should lead to some strengthening of the domestic sectors of the economy. This is despite the assumption that government policy will be to obtain an improvement in the public finances of roughly the same magnitude as in 1987. On these assumptions, the growth rate in 1988 could be about 1 per cent, with increased profit expatriation preventing much further reduction in the balance of payments deficit.

The nature of the budgetary measures to be taken in 1988 are obviously a matter of speculation at this stage of the year. It seems reasonable to assume that the basic approach will be to restrict the level of net public spending, particularly on current items, rather than to increase tax rates. Some revenue gain is assumed, through restricting allowances and through more efficient collection. The depth of real cuts in services and employment will depend in part on the evolution of public service pay over the coming months. The lower the average pay increase the milder can be the real cuts, while achieving the same budgetary balance.

In these circumstances the case for a very low general pay increase in 1988, with the later phases of existing special agreements being further postponed, seems overwhelming. However, apart from the direct trade-off between pay rates and job-cuts, acceptance of such a deal could be made easier by implementing policy initiatives to improve export marketing and quality control standards in the more labour intensive industries. In this process the leaders of other interest groups such as farmers and industrialists could have an important role to play.

FORECAST NATIONAL ACCOUNTS 1987

A: Expenditure on Gross National Product

	1986	1987	Change in 1987				
	Estimated	Forecast	£m		%		
	£m	£m	Value	Volume	Value	Price	Volume
Private Consumer Expenditure ...	10292	10678	386	78	3¾	3	¾
Public Net Current Expenditure ...	3570	3730	160	-54	4½	6	-1½
Gross Domestic Fixed Capital Formation	3472	3570	98	33	2¾	1¾	1
Exports of Goods and Services (X) ...	10335	11125	790	943	7¾	-1½	9
Physical Changes in Stocks	105	150	45	40			
Final Demand	27774	29253	1479	1040	5¼	1½	3¾
less:							
Imports of Goods and Services (M) ...	9707	10171	464	628	4¾	-1¾	6½
GDP at market prices	18067	19082	1015	412	5½	3¼	2¼
less:							
Net Factor Payments (F)	2032	2145	113	142	5½	-1½	7
GNP at market prices	16035	16937	902	270	5¾	4	1¾

B: Gross National Product by Origin

	1986	1987		
	Estimated	Forecast	Change in 1987	
	£m	£m	£m	%
Agriculture, Forestry, Fishing ...	1280	1343	63	5
Non-Agricultural: Wages, etc. ...	9823	10314	491	5
Other	3356	3598	242	7¼
less:				
Net Factor Payments	2032	2145	113	5½
National Income	12427	13110	683	5½
Depreciation	1680	1764	84	5
GNP at factor cost	14107	14874	767	5½
Taxes less subsidies	1928	2063	135	7
GNP at market prices	16035	16937	902	5¾

C: Balance of Payments on Current Account

	1986	1987	
	Estimated	Forecast	Change in 1987
	£m	£m	£m
X—M	628	954	326
F	-2032	-2145	-113
Net Transfers	1075	1050	-25
Balance on Current Account ...	-329	-141	188
as % of GNP	-2	-¾	1¼

FORECAST NATIONAL ACCOUNTS 1988
A: Expenditure on Gross National Product

	1987	1988	Change in 1988				
	Forecast £m	Forecast £m	£m Value	£m Volume	% Value	% Price	% Volume
Private Consumer Expenditure ...	10678	11105	427	133	4	2¾	1¼
Public Net Current Expenditure ...	3730	3823	93	-56	2½	4	-1½
Gross Domestic Fixed Capital Formation	3570	3735	165	47	4½	3¼	1¼
Exports of Goods and Services (X) ...	11125	11888	763	530	6¾	2	4¾
Physical Changes in Stocks	150	170	20	18			
Final Demand	29253	30721	1468	672	5	2¾	2¼
less:							
Imports of Goods and Services (M) ...	10171	10695	524	342	5¼	2	3¼
GDP at market prices	19082	20026	944	330	5	3¼	1¾
less:							
Net Factor Payments (F)	2145	2360	215	167	10	2	7¾
GNP at market prices	16937	17666	729	163	4¼	3¼	1

B: Gross National Product by Origin

	1987	1988		
	Forecast £m	Forecast £m	Change in 1988 £m	%
Agriculture, Forestry, Fishing ...	1343	1370	27	2
Non-Agricultural: Wages, etc. ...	10314	10778	464	4½
Other	3598	3829	231	6½
less:				
Net Factor Payments	2145	2360	215	10
National Income	13110	13617	507	3¾
Depreciation	1764	1852	88	5
GNP at factor cost	14874	15469	595	4
Taxes less subsidies	2063	2197	134	6½
GNP at market prices	16937	17666	729	4¾

C: Balance of Payments on Current Account

	1987	1988	
	Forecast £m	Forecast £m	Change in 1988 £m
X—M	954	1193	239
F	-2145	-2360	-215
Net Transfers	1050	1050	0
Balance on Current Account ...	-141	-117	24
as % of GNP	-¾	-¾	—

COMMENTARY

The International Economy

General

The outlook for the world economy over the next two years remains clouded by uncertainties, which appear to be inhibiting the growth of productive investment. In recent months the major international agencies, including the IMF, OECD, and the EEC Commission, have expressed their concern over the persistence of major imbalances, while revising their growth forecasts downwards and calling for more expansionary policies in the major surplus countries.

On a more positive note, fears of an imminent collapse in the value of the dollar appear to have receded, and, in the short run at least, there seems to be a reasonable hope of relative stability in the currency markets. Moreover, the current pattern of exchange rates is proving advantageous to the Irish economy, with manufactured exports increasing rapidly and domestic interest rates tending to decline. Provided that the modest growth of the world economy continues through 1987 and 1988, which still seems the most likely outcome, the international environment should permit some improvement in Irish economic performance.

The US Economy

Uncertainties concerning the evolution of the US economy underlie much of the nervousness shown by international financial markets and by commentators on the world economy. Given the size of the adjustments necessary in both the budget deficit and the current account balance of payments deficit if equilibrium is to be restored in the medium term, such uncertainty is inevitable. Latest information suggests that progress in correcting the fiscal imbalance is likely to be slower than previously expected, with budget targets unlikely to be reached in 1987, and agreement on the content of the 1988 budget proving difficult to achieve. On the other hand evidence is accumulating that a major shift in trade volumes has belatedly taken place during the first half of 1987 in response to the depreciation of the dollar over the two preceding years. This not merely holds out a reasonable hope that the external deficit will decline in nominal terms in the second half of 1987 and in 1988, but should also act as a substantial stimulus to the economy in both years.

With domestic demand slowing, but unlikely to actually decline, this improvement in the volume of trade balance should be sufficient to maintain the growth rate of GNP at between 2½ and 3 per cent in both 1987 and 1988. The principal danger to this relatively benign projection is that financial markets, either in the US or abroad, might lose patience with the slow time-scale of improvements in the fiscal and external deficits. In this case, there could be a sharp rise in interest rates which in turn could drive the domestic economy into recession.

It is largely to reduce this danger, which would have serious repercussions worldwide as well as domestically, that the US authorities are eager allies of the international agencies in urging such countries as Japan and Germany to reflate their economies more rapidly. The necessary adjustment to the US balance of trade would obviously be achieved more advantageously through a rise in the value of US exports than through a contraction in imports due to either a US recession or protective measures.

After their scepticism in the spring, the markets at present appear to accept that the US growth rate, exchange rate and interest rates are in approximate short-term balance. Thus downward pressure on the dollar has, at least temporarily, abated. Although a few poor economic indicators could rapidly revive speculation against the dollar, it nevertheless remains reasonable to hope that the coming 18 months will see moderate US growth, combined with a significant improvement in the external balance at exchange rates near their current level.

The European Economy

The performance of the major European economies has been disappointing so far in 1987. The fall in the value of exports to the US and OPEC countries has had an obvious depressing influence, while the expansion of domestic demand has been weaker than expected. Productive investment, in particular, has failed to respond to the growth in consumer demand. It is widely believed that uncertainty generated by the large exchange rate movements of recent years is a major contributory cause of this poor level of investment.

Although growth in most EEC countries has slowed down in the first half of 1987, there seems little fear that this will turn into an actual recession over the coming months. Most commentators, indeed, predict a gradual upturn in activity as the stock adjustments of early 1987 are completed, and as the rate of investment recovers. Nonetheless, forecasts for growth in both 1987 and 1988 have been revised downwards and any lingering hopes that the 1986 fall in oil prices would lead to a substantial boom in the European economy have been abandoned.

The prospect is therefore that the EEC growth rate in both 1987 and 1988 will be about 2 per cent, compared with 2½ per cent in each of the three preceding years. While this will mark an unusually long period of uninterrupted growth, it is clear that the low annual rate of growth will be insufficient to provide any significant increase in employment, and unemployment rates in the EEC as a whole will remain firmly in double figures.

Despite this unsatisfactory prognosis, and in spite of the mounting international pressure for reflation, it does not appear likely that the West German authorities will inject a substantial fiscal stimulus in either 1987 or 1988. Without such action from Germany, there seems little that other EEC countries can do to expand their domestic demand. Even in the UK, where policy has been relatively expansionary over the past 12 months, some tightening might be expected in the post-election circumstances of the coming year.

Nevertheless the prospects for the UK economy remain slightly better than those for the EEC as a whole. Provided that the increase in the value of sterling during the first half of 1987 does not reverse the strong improvement seen in the trade balance over the same period, and so far there is no clear evidence that this is happening, the UK growth rate should be at least 3¼ per cent in 1987, and perhaps 2½ per cent in 1988. Price inflation in the UK will remain well above that in the major continental economies, at over 4 per cent in each year, but unemployment could continue to fall, so that in 1988 it will be below the EEC average. Whether or not the UK opts to join the EMS during the period under review, there seems no strong reason to expect a major change in the value of sterling *vis-à-vis* the EMS currencies.

The Rest of the World

In common with the EEC, Japanese growth will be relatively low in both 1987 and 1988 at about 2 per cent. Even more than in Germany, the principal downward influence stems from falling export volumes, where a decline of 4¾ per cent in 1986 is likely to be followed by a further 2 per cent drop in 1987 and a recovery of only 1 per cent in 1988. Despite these reduced export volumes and a modest growth in import volumes, the higher value of the yen will result in the current balance of payments surplus, in dollar terms, rising by over 10 per cent to $95,000 million in 1987 and only falling to about $82,000 million in 1988.

Unemployment, at over 3 per cent, is already high by Japanese standards, and seems unlikely to fall significantly before the end of 1988, largely because private domestic investment is expected to remain weak. Having fallen sightly in 1986 and the first half of 1987, consumer prices are expected to stabilise in the remainder of 1987 and to rise by almost 2 per cent in 1988.

Partly in response to the sluggish domestic economy, and partly as a contribution towards international currency stabilisation, Japanese monetary policy has been expansionary, with some long-term interest rates falling as low as 2¾ per cent during May. However, fiscal policy remains fairly restrictive, with the emphasis more on reforming the fiscal structure than expanding the economy. Given this priority, together with the cumbersome parliamentary process of budget formation in Japan, it is probably unrealistic to look for any substantial fiscal stimulus in the foreseeable future.

Other industrialised countries, such as Canada, Australia and the non-EEC states of western Europe, are expected to mirror the performance of the US and the EEC over the coming months, with average growth rates of under 3 per cent in 1987 and 1988. In most cases unemployment is predicted to increase slightly, while price inflation may decline a little further, though in many cases remaining well above the average of the major industrial countries.

The newly industrialised countries, particularly those in Asia, appear set to continue their relatively rapid economic expansion, largely on the basis of a growing volume of exports. Although their collective current account surplus may decline slightly in 1988, it will remain very high in absolute dollar terms, triggering some fears of possible protective measures in the importing countries.

The OPEC agreement on production levels appears to be holding firm, and has resulted in crude oil spot prices reaching $20 per barrel in recent months. Although such cartel arrangements are inherently vulnerable, there is no obvious reason why discipline should not be maintained throughout the rest of 1987 and 1988. If this happens, then oil prices should remain at their current official level of $18 dollars throughout the period, with spot prices occasionally exceeding $20 per barrel. Such a price level, even with restricted output, will lead to a considerable recovery in OPEC revenues. During 1988 this could well lead to some increase in levels of investment and in the volume of OPEC imports.

Despite some improvement in the price of many commodities, the non-oil developing countries seem likely to be squeezed by the increase in oil prices. Nevertheless the combination of moderately expanding demand for commodities and policies of domestic austerity in the majority of such countries should be sufficient to prevent the third world debt problem moving from the chronic to the critical stage in the next year or so. Only if the US itself goes into recession, with or without a steep rise in US interest rates, is the debt problem likely to escalate to the point where it could seriously threaten the stability of the international banking system.

The Context for Ireland

The first half of 1987 has seen an apparent contradiction in the relationship between Ireland and the rest of the world. According to OECD estimates the volume of world trade fell by ½ per cent in the first half of 1987, while the volume of trade in manufactures rose by only 2 per cent, its lowest rate for several years. During the first half of 1987 the trade weighted value of the Irish pound remained at roughly the same level as throughout 1986, implying no gain in overall competitiveness. Yet against this seemingly unfavourable background, Irish industrial exports enjoyed their most vigorous expansion since 1984.

The explanation lies only partly in supply considerations, as the amount of new capacity coming on stream did not compare with that becoming available in 1983 and 1984. The most important factor would appear to have been the

TABLE 1: Short-term International Outlook

	GNP		Consumer Prices		Hourly Earnings		Unemployment Rate		Current Account Balance	
			Percentage Change				%		% of GNP	
Country	1987	1988	1987	1988	1987	1988	1987	1988	1987	1988
U.K.	3½	2½	4	4¼	7¼	7	11¼	10¾	−½	−¾
W. Germany	1½	2	¾	1½	3½	3¼	8	8¼	3¼	2½
France	1¼	2	3¼	2½	3¾	3¼	11¼	12	¼	−¼
Italy	3	2½	4¾	5	7¾	7	11½	11¾	½	−¼
Total EEC	2	2	3	3	4½	4½	11½	11¾	1	½
USA	2½	2¾	4	4½	3½	4½	6¾	6½	−3¼	−2½
Japan	2½	2	0	1¾	2½	3½	3	3	4	3½
Total (OECD)	2¼	3	3½	3¾	4	4½	8¼	8¼	−¼	−¼
Ireland	1¾	1¼	3	2¾	5½	5	19¼	19¼	−¾	−¾

Sources: OECD Economic Outlook June 1987.

movement in the exchange rate between the US dollar and the yen. Although this tended to raise the trade weighted value of the Irish pound, because Irish/US trade is very much greater than Irish/Japanese trade, it nevertheless contributed to a major improvement in the competitiveness of the vital electronics industry. With the bulk of the industry in Ireland being American owned, its sourcing tends to be from the US and its pricing tends to be in dollars. The main competition for the Irish industry is Japanese, so that for this industry the dollar/yen cross-rate is of prime importance. Over the same period, the recovery in the value of sterling has relieved some of the pressure on the more traditional Irish industries, which have benefited also from the UK becoming one of the fastest growing EEC countries in 1987.

Looking to the remainder of 1987 and 1988, these special factors which have been advantageous in the recent past may well continue, although their impact is likely to diminish with time. Experience over the last few years has shown the extreme volatility of exchange rates. Thus, although there seems no strong immediate pressure on any of the major currencies, the usual technical assumption that exchange rates will remain at about their current levels cannot be made with any great degree of confidence. On the other hand, if the OECD is correct in expecting some upturn in the volume of world trade in manufactures over the coming 18 months, the environment for exports should remain reasonably favourable even if there is some slight weakening in the competitive position of parts of Irish industry.

Although US interest rates seem likely to remain stable, or even to rise a little, European interest rates, and particularly the key London rates seem more likely to continue their gradual decline. Provided therefore that currency instability is avoided, external influences should be for a continued downward tendency in Irish interest rates over the next year or so.

The relative weakness of international productive investment in the first half of 1987 has been one worrying aspect of the international environment, especially after initial hopes that the volume of such investment would increase substantially in 1987. Provided that confidence in currency stability continues to increase, there are grounds for hoping that the remainder of 1987 and 1988 will see a recovery in investment intentions on a world-wide basis. Ireland's ability to attract a significant share of such investment would then depend largely on domestic factors and on the international perception of Ireland as a stable and advantageous industrial location.

THE DOMESTIC ECONOMY

General

Although at the time of writing the preliminary National Accounts for 1986 are not available, it seems fairly certain that 1986, like 1985, was characterised by virtual economic stagnation and by a failure to obtain any significant improvement in the public finances. It is now looking increasingly likely that there will be a substantial reduction in the public authorities' deficit in 1987 combined with positive growth in real GNP. That such an outcome can be repeated in 1988 is less certain. While there can be little doubt that there will be another severe curtailment of the fiscal deficit in 1988, whether the economy can nevertheless continue to grow depends largely on the performance of industrial exports.

Exports

After approximately 18 months of virtual stagnation, export volumes grew sharply in the final quarter of 1986, and this expansion has continued in the first six months of 1987. The value of visible exports in the period from January to June was 9.9 per cent higher than in the same period of 1986, although average export prices were apparently some 5 per cent lower. Even allowing for the possibility that the unit value index is overstating the price fall, it seems clear that export volumes have increased by over 12 per cent so far this year.

The principal increases have occurred in office and data processing equipment and in miscellaneous foodstuffs, presumably mainly cola concentrates. However, some more traditional sectors have shown modest increases in export value, and organic chemicals are the only major category in which there has been a substantial fall in the value of exports.

In 1985 and 1986 industrial exports tended to decline in the middle of the year after a fairly strong first quarter. This pattern seems most unlikely to be repeated in 1987. The strongly rising trend continued into June, by which time some weakness was showing in the previous years. Moreover, the responses concerning export expectations and order books in the CII/ESRI Industrial Survey, which signalled the mid-year downturns in 1985 and 1986, remain firmly positive in 1987. Thus it seems reasonable to predict that the volume of manufactured and other industrial exports will at least maintain the average level reached in the first six months for the remainder of the year.

Agricultural exports during the first six months were distorted by the transfer of some intervention stocks from Irish to overseas storage. When allowance is made for this, and for the likelihood of a lesser availability of cattle for slaughter in the second half of 1987 than in the corresponding period of 1986, it seems likely that there will be little change in the annual volume of agricultural exports. However, the balance between direct exports, domestic intervention storage and overseas intervention storage is always volatile, so that the likely level of recorded agricultural exports must remain uncertain until late in the year.

Taking a fairly cautious view of export tourism in the light of good first quarter returns and reports of a high level of advance bookings, and assuming a substantial rise in exports of other services, again in line with first quarter estimates, the value of exports of goods and services in 1987 is forecast to increase by about 7¾ per cent. As shown in Table 2 this implies a volume rise of just over 9 per cent, even on fairly cautious assumptions about the extent of the annual price decline.

Turning to 1988, predictions must be influenced by understanding of the causes of the 1987 boom in industrial exports. Clearly this cannot be ascribed to the growth in world trade, which has been very sluggish in recent months, and which is expected to be rather more buoyant in 1988. Increases in capacity, expecially with respect to the cola concentrate trade and to some firms in the electronics sector, have permitted a significant part of the rise in export

TABLE 2: Exports of Goods and Services

	1986 £m	% Change Volume	% Change Value	1987 £m	% Change Volume	% Change Value	1988 £m
Agricultural	1770	0	1	1788	−2½	1	1806
Manufactured	6103	10½	8½	6622	5¾	7½	7119
Other Industrial	1417	16¼	11½	1580	6½	7½	1698
Other	98			88			90
Total Visible	9388	9½	7¼	10078	4¼	6¼	10713
Adjustments	−212			−228			−216
Merchandise	9176	9¼	7¼	9850	4½	6½	10497
Tourism	640	9	12	720	6½	10	792
Other Services	519	5	7	555	5	7	599
Exports of Goods and Services	10335	9	7¾	11125	4¾	6¾	11888

volumes. Some further capacity increases, particularly in electronics and related sectors can be expected during the remainder of 1987 and 1988, facilitating a moderate further rise in export volumes in 1988. The appreciation of sterling since the winter, although much less than its previous depreciation, must have relieved some pressure on companies serving the UK market, and allowed advantage to be taken of the general buoyancy of the UK economy. Although exchange rate predictions are notoriously unreliable, there seems no strong reason to expect significant changes in the sterling/Irish pound exchange rate. If the assumption of roughly constant currency values is correct, then Irish competitiveness *vis-à-vis* the UK can be expected to improve slightly over the coming year or so, enabling some further growth in exports to that market.

The most interesting explanation for the boom in electronic exports since the third quarter of 1986 is that it has largely been due to enhanced competitiveness resulting from the massive depreciation of the US dollar against the yen. If this explanation is correct, then the competitive advantage can be expected to persist into 1988, although its impact on export volumes might tend to diminish over time.

Putting these various influences together, it seems reasonable to predict that the volume of manufactured and other industrial exports will grow by about 6 per cent in 1988, which is about half of the exceptional increase likely to be obtained in 1987. When allowance is made for a small rise in prices, in place of the fall in 1987, the predicted increase in the value of industrial exports in 1988 is 7½ per cent, about three quarters of that in 1987.

Reduced output of milk and cattle seems likely to produce a decline in the volume of agricultural exports in 1988, even assuming a slower build-up of intervention stocks. However, slightly higher prices for meat and milk products, together with a continuation of the trend towards additional processing of beef, could convert this into a small increase in the value of agricultural exports.

Because the tourism growth in 1987 will have included a considerable element of recovery from the special factors of 1986, it would be unrealistic to expect so fast a rate of increase in 1988. Nevertheless, provided access fares remain low by historical standards and domestic inflation is contained, a substantial volume growth could be achieved. Other service exports, particularly in the financial and information fields, can be expected to increase significantly in 1988, as in 1987.

In aggregate, these projections indicate a volume growth in exports of goods and services in 1988 of 4¾ per cent, a little over half the rate likely to be achieved in 1987. Allowing for a 2 per cent rise in average export prices, the predicted increase in the value of exports of goods and services is 6¾ per cent, only 1 per cent less than the growth forecast for 1987.

Stocks

After falling very steeply in 1986, agricultural stocks are expected to show a smaller, but still substantial, decline in 1987. The principal cause is a continuing reduction in total cattle numbers, with the size of the dairy herd in particular being reduced in response to the falling milk quota. This process is likely to continue into 1988, although by then there could be some offsetting increase in the size of the non-dairy breeding herd as well as a stabilisation in the number of beef cattle and a continuing rise in sheep numbers.

Despite the efforts of the EEC Commission to reduce agricultural surpluses, Irish intervention stocks rose substantially in 1986, and appear set to increase again in 1987, although, by a smaller amount. Given this experience, it seems prudent to forecast yet another modest increase in stock levels in 1988, although at some future date the level must stabilise or decline.

TABLE 3: Stock Changes

	1986 £m	Change in Rate £m	1987 £m	Change in Rate £m	1988 £m
Farm Stocks	– 105	+ 55	– 50	+ 30	– 20
Irish Intervention Stocks[1]	82	– 30	52	– 30	22
Other Non-agricultural Stocks	128	+ 20	148	+ 20	168
Total	105	+ 45	150	+ 20	170

[1]Including subsidised private storage.

At the time of writing, the rate of industrial and distribution stock-building in 1986 is not known. Therefore the base for the forecasts for 1987 and 1988 must be regarded as uncertain. On general principles a moderate increase in such stocks seems to be the most probable outcome for both 1987 and 1988. The increase in the volume of industrial production seems likely to be reflected in an increase in work-in-progress, and, less certainly, in stocks of materials and finished goods. Given the likelihood of lower interest rates and a small rise in the volume of personal consumption, distribution stocks also seem more likely to rise than to fall.

On the basis of these tentative projections, total stock-building as set out in Table 3 could exert a mild positive influence on GNP in both 1987 and 1988.

Fixed Investment

Although cement sales in the first half of 1987 are 3½ per cent higher than in the first half of 1986, the balance of evidence suggests that there will be a substantial fall in the volume of building and construction in 1987 as a whole. Housing starts in the first quarter were exceptionally low, reflecting both the run-down in the Local Authority housing programme and a lack of demand in the private sector. Private house-building may recover slightly in the second half of 1987 and more especially in 1988 in response to lower interest rates, but given demographic trends and the general state of the economy, no housing boom can be expected within the next two years.

Apart from the emergency building of silage facilities, agricultural construction has been depressed for some years and seems likely to remain so. With the exception of construction on the Custom House site during 1988, office building is also likely to remain at a low level due to the existence of unused capacity and a reduction in government demand for office space. Investment in industrial and retail building could show some increase in 1987, but not nearly sufficient to offset the falls in other sectors. Expenditure on social infrastructure is likely to fall only slightly during 1987 as existing contracts are honoured, but, given the probability of a restrictive public capital programme, could show a more rapid decline in 1988.

Taken together, these trends and assumptions suggest that the total volume of investment in building and construction could fall by about 5 per cent in 1987, roughly similar to the fall in 1987. The volume of building investment in 1988 will, as always, be heavily influenced by the size of the public capital programme. For the purpose of this *Commentary,* it is assumed that the volume of public capital spending on building and construction will be reduced by about the same amount as in 1987. Given a slightly higher share of private funding, this suggests that an overall volume reduction of 2½ per cent in investment in building and construction, as shown in Table 4, could be a reasonable prediction for 1988, provided interest rates remain relatively low.

TABLE 4: Gross Fixed Capital Formation

	1986 £m	% Change Volume	% Change Value	1987 £m	% Change Volume	% Change Value	1988 £m
Building and Construction	1500	−5	−2	1470	−2½	1	1486
Machinery and Equipment	1972	5½	6½	2100	4	7	2249
Total	3472	1	2¾	3570	1¼	4½	3735

In contrast to investment in building and construction, the volume of investment in machinery and equipment was roughtly constant in 1986 and appears to be growing quite strongly in 1987. Imports of capital goods rose by almost 8 per cent in value in the first five months of the year. For the year as a whole, total investment in machinery and equipment, including that provided from domestic sources, is forecast to increase by 5½ per cent in volume and 6½ per cent in value. The expansion in industrial investment is expected to continue in 1988, although perhaps at a somewhat reduced pace.

The projected increases in plant investment are sufficient to outweigh the predicted falls in building and construction, so that the total volume of gross fixed capital formation is forecast to rise by 1 per cent in 1987 and by 1¼ per cent in 1988. If these forecasts are correct, they will represent a reversal of the trend in the volume of fixed capital formation which has declined in each year from 1982 to 1986.

Consumption

According to the Retail Sales Index, consumer spending through retail outlets was relatively weak in the first quarter of 1987, with the volume of sales 1.9 per cent down on the first quarter of 1986. However, it still seems likely that when total personal consumption is considered, including foreign travel, grant aided house repairs and various non-retail services, the volume of consumer spending for 1987 as a whole will register a small increase.

The course of personal consumer spending in 1988 depends both on the development of aggregate incomes and on the level of direct taxation in that year. Given the prediction that personal incomes will rise by about 4¼ per cent in 1988, and the assumption that personal tax rates will remain high, with perhaps some improvement in the efficiency of collection, personal disposable income is forecast to increase by only about 3¾ per cent in 1988. Allowing for only a slight further erosion in the personal savings ratio, this could permit a rise of about 4 per cent in the value of personal consumption, marginally higher than that now forecast for 1987.

With the personal consumption price deflator forecast to rise by 3 per cent in 1987 and 2¾ per cent in 1988, this results in forecast increases in the volume of personal consumption of ¾ per cent in 1987 and 1¼ per cent in 1988.

Provided that public authorities' net current expenditure on goods and services is kept close to the budgeted level, which appears a reasonable assumption at present, public consumption is expected to increase by about 4½ per cent in 1987. Mainly because of pay increases, the price deflator for public consumption is about double that for private consumption, so that the budget target implies a volume fall of about 1½ per cent. Clearly the level of public consumption in 1988 depends on expenditure decisions yet to be taken. Interpreting the policy stance of the government, it is assumed that the nominal increase in net current spending in 1988 will be held to about 2½ per cent, a little over half the 1987 rate of increase. The carry-over effects of spending cuts made in 1987 will account for a considerable proportion of this reduction. What further real cuts might be necessary will depend to a large extent on the evolution of public service pay rates. If severe pay restraint in the public service can be negotiated or imposed, the assumed nominal increase would translate into a volume cut, including carry-overs, of some 1½ per cent, much the same as in 1987. If pay rises more rapidly than assumed here, then it follows that the volume cuts would be greater.

Final Demand

The forecasts already discussed indicate a growth of 5¼ per cent in the value and 3¾ per cent in the volume of final demand in 1987. Just over half of the value increase, but about 90 per cent of the volume increase, is accounted for by the predicted increase in exports of goods and services. The forecasts for both exports and final demand have been revised upwards quite strongly compared with earlier *Commentaries.*

Largely because the volume of exports is projected to grow more slowly, final demand in 1988 is forecast to increase by 5 per cent in value, but by only 2¼ per cent in volume. Exports again are predicted to account for rather over half the value increase, but their share of the volume increase is projected to decline to 80 per cent. Of course, one of the major factors depressing the domestic contribution to final demand in both years is the decline in the volume of public authorities' consumption.

Imports

Given the pattern of final demand, the volume of imports could be expected to increase quite strongly in both 1987 and 1988. This is confirmed by the trade statistics for the first six months of 1987. The value of imports in that period was 3.3 per cent higher than in the corresponding period of 1986, implying a volume increase of over 8 per cent. Apart from agricultural imports, especially feedstuffs, this volume increase in imports can be expected to continue for the remainder of the year, while average import prices seem likely to rise a little from their first quarter level. Total visible imports for 1987 as a whole could thus rise by 6½ per cent in volume and about 4¼ per cent in value.

Given the reduction in cross-border shopping due to the introduction of the 48 hour rule, the adjustment to merchandise trade on a balance of payments basis should be more strongly negative than in 1986. With tourist spending abroad likely to rise substantially, although not so dramatically as in 1986, and with imports of other services growing very rapidly, on the basis of the first quarter balance of payments estimates, total imports of goods and services in 1987 are forecast to increase by about 6½ per cent in volume and 4¾ per cent in value.

TABLE 5: Imports of Goods and Services

	1986 £m	% Change Volume	% Change Value	1987 £m	% Change Volume	% Change Value	1988 £m
Capital Goods	1192	6	7	1275	4	7	1364
Consumer Goods	2332	3	1	2355	2½	4½	2461
Intermediate Goods:							
Agriculture	432	−4	−9	393	−5	−5	373
Other	4648	9	6	4932	3¾	5	5176
Other Goods	26			33			40
Total Visible	8630	6½	4¼	8988	3	4¾	9414
Adjustments	−14			−78			−94
Merchandise	8616	5¾	3½	8910	3	4¾	9320
Tourism	497	7	10	547	4½	8	590
Other Services	594	17½	20	714	7½	10	785
Imports of Goods and Services	9707	6½	4¾	10171	3¼	5¼	10695

Import projections for 1988 are set out in Table 5. Because a slower growth rate for manufactured exports is assumed, the volume of imports of industrial materials can be expected to rise more slowly, while imports of agricultural materials will decline further if the 1987 fodder harvest is adequate, which at present seems likely. In total the projected increase in the volume of goods and services is roughly half the rate forecast for 1987. However, because prices are expected to be higher, the projected increase in the value of imports of goods and services is slightly larger in 1988 than in 1987.

Balance of Payments

The export and import forecasts indicate a surplus on visible trade of £1,090 million in 1987 and £1,299 million in 1988. When balance of payments adjustments are taken into account, as well as trade in services, the surplus on trade in goods and services seems likely to reach £954 million in 1987 and £1,193 million in 1988. These figures represent a continuation of the very strong upward trend in the trade balance which has been evident since 1982.

With so much of the trade improvement resulting from increased exports by multinational companies, its natural counterpart has been seen in rising outflows of profits and related payments. Econometric analysis suggests that profit outflows tend to lag about 6 months behind exports by the modern sectors of industry. Because of the fall in the value of such exports in the course of 1986, as a result of falling prices in terms of Irish pounds, this analysis indicates that there should be only a small increase in the level of profit expatriation in 1987, despite the increase of export values in the course of the year. Allowing also for some rise in profitability because of improved terms of trade, it seems reasonable to project an increase in profit expatriation of about £50 million or 4 per cent in 1987.

National debt interest paid abroad is forecast to rise by about 7 per cent. This is slightly below the official estimate made at the time of the Budget, and reflects the lower than anticipated level of direct foreign borrowing which now seems likely and the slightly weaker value of the dollar, partly offset by the higher rates of interest which must be paid as a result of larger than expected overseas holdings of Irish gilts.

On the evidence of the first quarter balance of payments estimates, there should be some favourable movement in the balance of other factor flows, mainly interest payments within the financial sector. In total therefore an increase of about 5½ per cent or £113 million appears a reasonable forecast for net factor outflows in 1987, giving a total for the year of £2,145 million.

Given the uncertainties surrounding the EEC budget, the likely level of transfers from the Community cannot yet be established with confidence. On the cautious assumption that there will be a slight reduction in the flow of such funds, the total level of net transfers to Ireland in 1987 could be about £1,050 million, a fall of £25 million on the 1986 level.

These projections result in an overall current account deficit of £141 million or about ¾ per cent of GNP, which would represent more than a halving of the 1986 deficit. At the same time, current indications suggest that the net residual in the balance of payments will be drastically reduced, but not eliminated altogether, in 1987. This is not conclusive proof that the residual was entirely capital in nature, as a positive capital inflow could mask a continuation of unrecorded or underestimated current transactions. However, it does seem reasonable to conclude that current items could not have accounted for a very large proportion of the 1986 residual of £1,566 million. With regard to the residual capital flows it seems clear that during the second quarter these were greatly reduced, perhaps through some unwinding of leads and lags, as currency fears abated in the wake of sterling appreciation, and as confidence grew in the determination of Irish fiscal management.

Looking forward to 1988, a much more rapid growth in profit expatriation can be expected on the basis of rising exports in 1987. However, this could be partially offset by a slower growth in overseas National Debt interest. Not only is total government borrowing being reduced in both 1987 and 1988, but the proportion borrowed abroad is also likely to fall with the improvement in domestic funding prospects. In total, an increase of some 10 per cent in net factor outflows appears a reasonable projection for 1988. Making a technical assumption of unchanged net transfers, this could result in the overall deficit on current account falling slightly to £117 million, still almost ¾ per cent of GNP.

Output

The upward revision in the forecast volume growth of GDP in 1987, from 1½ per cent in the previous *Commentary* to 2¼ per cent in this, largely reflects more buoyant indications of the level of output. Both manufacturing industry and agriculture appear to be expanding production at a faster rate than previously assumed, which more than outweighs the downward revision concerning the output of the building industry.

Output growth is expected to be rather slower in 1988, as agriculture should no longer be in a process of recovery from the exceptionally bad years of 1985 and 1986, while the growth of manufacturing industry seems likely to be more sedate than in 1987. With the volume of public services continuing to decline and building output likely to remain depressed, the growth in real GDP in 1988 is projected at 1½ per cent.

Agriculture

The weather so far in 1987 has been a great deal more favourable in most districts than that in the two previous years. Provided that there is no marked deterioration in the coming months, this could enable the volume of gross agricultural output to remain almost constant in spite of the curtailment of milk quotas and the reduced size of the breeding herd. At the same time the improved pasture and fodder situation will permit a significant reduction in the volume of imported feedstuffs in the remainder of the year. Thus the volume of gross agricultural product, which is the measure of value added in agriculture, could increase by at least 3 per cent in 1987.

The greater volume of stored fodder from the 1987 season should also lead to reduced feed imports in the first half of 1988. However when allowance is made for a further reduction in milk quota and for a continued, albeit more gradual, reduction in the breeding herd, as well as for the fact that an assumption of normal weather conditions will not imply an element of recovery, gross agricultural output can be expected to decline in 1988. The lower level of inputs seems likely therefore to permit only stability or perhaps a marginal increase in the value of gross agricultural product in 1988. On these projections agriculture would contribute about ¼ per cent to the rise in GDP in 1987, but very little in 1988.

Industry

The Index of Industrial Production shows that the gross output of manufacturing industry in the first four months of 1987 was 4.2 per cent higher than in the corresponding period of 1986. Simply maintaining the April level of production throughout the year would lead to an annual increase in the index of 7¼ per cent. With industrial exports remaining buoyant, there seems no reason to expect the mid-year dip in seasonally-adjusted production which was a feature of 1985 and 1986 to be repeated this year.

Indeed the CII/ESRI Industrial Survey indicates that a substantial balance of firms expect production to increase in the coming months, with both new orders and total order books showing a positive trend. Thus a forecast rise of 7 per cent in manufacturing production does not seem excessively optimistic for 1987 as a whole.

With turf production likely to show some recovery from the 1986 level, but with quarrying output likely to remain relatively depressed in line with the construction industry, the annual increase in the production of all industries could be about 5½ per cent.

Given the forecast of a slower rate of growth in industrial exports in 1988, it is reasonable to project also a slower increase in industrial output. A rise of about 4 per cent in the production of all industries would be compatible with the forecast levels of exports and domestic expenditure.

As discussed in relation to fixed investment, the building industry remains in deep recession, with further falls in the volume of construction investment likely in both 1987 and 1988. The consumption element in building output is also likely to decline sharply in the second half of 1987 and in 1988, due to the ending of improvement grants. In total the volume of building output could decline by about 5 per cent in 1987 and 4 per cent in 1988.

Nevertheless this continued weakness in building activity will be outweighed by the forecast growth in manufacturing and other industry, so that the total contribution of industry to GDP is likely to be strongly positive in both years, adding about 1½ per cent in 1987 and 1 per cent in 1988.

Services

The service sector will be subject to conflicting tendencies in both 1987 and 1988. The volume of net public services will decline quite sharply in 1987 as a result of cut-backs already being implemented, while it is assumed that a similar reduction will be imposed in 1988. On the other hand, tourism is recovering strongly in 1987, and is projected to expand further in 1988. Other domestic services are projected to increase only slowly in volume, in line with expectations for consumer expenditure, while export services seem likely to grow more rapidly, but from a relatively small base.

In aggregate, therefore, the total volume of service output is projected to grow modestly in each year, perhaps by the order of 1 per cent. Such increases would contribute about ½ per cent to GDP in both 1987 and 1988.

Employment

Although the output of manufacturing industry is forecast to rise very rapidly in 1987 and quite fast in 1988, it seems unlikely that this will result in a significant rise in industrial employment. Indeed, with output growth concentrated in the modern industries, one should not forget the experience of 1984, when an even more powerful upsurge in manufacturing output was accompanied by a substantial fall in manufacturing employment. Such an outcome seems less likely now. Despite recent announcements which indicate that some traditional industries are still in the process of shedding labour, the employment statistics for 1986 suggest that the major employment rationalisation of the mid-eighties is lessening in intensity. At the same time the expansion in the modern industries is starting from a higher base, so that a given percentage rise in employment here will have a greater impact on the total.

Thus the most likely result seems to be approximate stability in manufacturing employment during 1987 and 1988, providing that the labour intensive food industries make sufficient progress in upgrading their products to compensate for the expected reduction in the volume of raw material supplies. Employment in building however seems set to continue its decline, so that total industrial employment is forecast to fall substantially in 1987 and slightly in 1988.

The public service cuts can be expected to have a considerable impact on total service employment. This should be partly offset by increased employment in tourism, although much of this will be seasonal in character, and by some expansion in export and financial services. On an annual average basis, a decline of 2,000 per year in total service employment would be compatible with the output forecast of this *Commentary*.

Allowing for a continuation of the secular decline in agricultural jobs, the total number at work could average about 1,036 thousand in 1987 and 1,027 thousand in 1988 as shown in Table 6. The projected declines of 14,000 and 9,000 in the total at work are below the average rate of fall in the past four years, but there seems little chance of stability in total employment within the next two years.

The effect of the projected employment declines on the level of unemployment depends on the rate of change in the total labour force. Data on participation rates and on net emigration become available only after a long lag, and there are no reliable up-to-date indicators of trends. With regard to participation rates it seems reasonable to assume that these will tend to fall gradually so long as the labour market remains severely depressed. Changes in migration rates are likely to be more volatile. Given the apparent trends in employment, a major cause of the steep rise in the Live Register last winter must have been a slowing in the rate of net emigration. Whether this was due to hopes of an upturn in Irish job prospects, to fears concerning the new laws on immigrant employment in the USA, or to attempts to avail of legitimate channels of immigration to that country, it is likely to prove to have been a temporary phenomenon.

The projections in Table 6 imply a return to an annual net emigration rate of about 30,000 in the second half of 1987 and in 1988. On this basis, an approximate stabilisation of the unemployment rate at about 246,000 is projected for both years, implying an average annual level of the Live Register of about 248,000. It must be stressed, however, that the migration figure is more of an assumption than a firm prediction, and so the level of unemployment could diverge substantially from that forecast, if the assumption proved incorrect.

Incomes

Given the output forecasts discussed earlier, income arising in agriculture, forestry and fishing seems likely to rise by about 5 per cent in 1987. Falling input prices, especially for fertilisers, will combine with a small increase in average output prices to improve farmers' margins and compensate for some

TABLE 6: Employment and Unemployment

A: Mid-April Estimates '000

	1985	1986	1987	1988	1989
Agriculture	169	161	155	150	145
Industry	305	296	289	285	284
Services	600	600	598	595	594
Total at Work	1074	1057	1042	1030	1023
Unemployed	225	230	245	247	247
Labour Force	1299	1287	1287	1277	1270
Unemployment Rate %	17.3	17.9	19.0	19.3	19.4
Live Register	228	232	250	249	249

B: Annual Averages '000

	1985	1986	1987	1988
Agriculture	167	158	153	148
Industry	301	293	286	285
Services	600	599	597	595
Total at work	1068	1050	1036	1027
Unemployed	227	234	246	246
Labour Force	1295	1284	1282	1273
Unemployment Rate %	17.5	18.2	19.2	19.3
Live Register	231	236	248	248

reduction in subsidy income. Assuming a further modest improvement in margins, perhaps through belated green currency adjustments, agricultural and related incomes are projected to grow by 2 per cent in 1988.

With regard to non-agricultural wages in 1987, the key assumption made is that there will be no general public service pay increase in the remainder of the year. On this basis, average public service earnings can be expected to increase by about 6½ per cent over the 1986 levels. As usual there is likely to be a considerable spread in private sector pay increases, but the rise in average earnings could approach 5½ per cent. Given the likely fall of over 1 per cent in the number of employees, aggregate pay in 1987 is forecast to rise by about 5 per cent.

Private sector wages and salaries seem likely to increase slightly more slowly in 1988, if only because with a falling trend the carryover is reduced each year. The main imponderable concerns public service pay in 1988. Given the assumption of a freeze on general pay increases until the end of 1987 the carryover into 1988 will be low. However, it is probably unrealistic to expect a general public sector pay pause throughout 1988, while the later phases of existing special pay awards, if paid, could add at least 2 per cent to the public sector pay bill. For the purpose of this forecast it is assumed that some trade-off will be made between the special awards and a small general increase, so that average earnings in the public service will rise by about 4½ per cent, including scale drift. The increase in the public service pay bill will be significantly lower than this because of a reduction in the numbers employed. When allowance is made for this fall in the number of public employees, and for a marginal decline in the number of private employees, aggregate pay in 1988 is forecast to increase by about 4½ per cent.

TABLE 7: Personal Disposable Income

	1986	Change		1987	Change		1987
	£m	%	£m	£m	%	£m	£m
Agriculture	1286	5	63	1349	2	28	1377
Non-Agricultural Wages, etc.	9838	5	492	10330	4½	465	10795
Other Non-Agricultural Income	1769	5¼	91	1860	4¼	79	1939
Total Income	12893	5	646	13539	4¼	572	14111
Current Transfers	3365	5	168	3533	4	141	3674
Gross Personal Income	16258	5	814	17072	4¼	713	17785
Direct Personal Taxes	3651	9½	349	4000	6	240	4240
Personal Disposable Income	12607	3¾	465	13072	3¾	473	13545
Consumption	10292	3¾	386	10678	4	427	11105
Personal Savings	2315	3½	79	2394	2	46	2440
Savings Ratio	18.4%			18.3%			18.0%

With interest rates for most of 1987 almost matching those in 1986, dividends tending to rise and the profit margins of many of the self employed still wider than normal following the 1986 currency movements, the total of non-agricultural incomes other than wages is forecast to increase by over 5 per cent in 1987. A somewhat slower increase, projected at 4¼ per cent, seems probable in 1988. On the basis of these projections, total income received from work and property is forecast to rise by 5 per cent in 1987 and by 4¼ per cent in 1988, as shown in Table 7.

Current transfer payments are expected to increase by about 5 per cent in 1987, due largely to increased benefit rates on state transfers. The treatment of benefit rates in 1988 is another major policy imponderable, but the assumption made here is that most forms will continue to be indexed, although conditions for payment might be further restriced. In such a situation an increase of about 4 per cent in total transfer receipts appears a reasonable projection.

Direct personal taxation is budgeted to rise by about 9½ per cent in 1987, converting an increase of 5 per cent in gross personal income into an increase of only 3¾ per cent in personal disposable income. With the distorting effects of the deposit interest retention tax largely worked through by 1988, the rise in personal taxation can be expected to be less severe. However, allowing for some improvement in the efficiency of collection, an increase of 6 per cent in personal direct taxation is assumed, compared with a rise of 4¼ per cent in gross personal income. Such an outcome would leave the increase in personal disposable income much the same as in 1987 at 3¾ per cent.

Consumer Prices

At 2.8 per cent, the rise in the consumer price index in the year to May 1987 was the lowest for 21 years. For February and May combined, representing the first half of the year, the index was 3.1 per cent higher than in the first half of 1986. However the rise of the index was very small in the second half of 1986, so it does not appear realistic to expect much further improvement in the annual rates of increases over the remainder of 1987. Import prices are beginning to rise after more than a year of decline, so that, although some lagged price reductions might still be working through the system, the major downward influence on consumer prices is coming to an end. Falling retail interest rates and the possibility of lower potato prices should help to keep the August index low, and could also have some downward influence on its November level.

Allowing for virtually no change in the index between May and August but for a ½ per cent rise between August and November, both the annual average increase in consumer prices and the November to November increase will be 3.0 per cent.

With import prices trending upwards, but with traders' margins narrowing somewhat, pay increases remaining moderate and interest rates still tending to decline, a relatively slow rate of increase in consumer prices can be expected in 1988. Making the reasonable policy assumption that specific indirect tax rates will be only partially indexed, the average quarterly rate of increase during 1988 might be little over ¾ per cent. This would imply an increase in the consumer price index from November 1987 to November 1988 of about 3 per cent, and an annual average increase of 2¾ per cent.

Public Finances

The exchequer returns for the first half of 1987 can be interpreted as showing that budgetary targets for the year as a whole are capable of being met. For this to happen the cuts in the real level of net public services which have been introduced in recent months must have the expected effect on expenditure in the second half of the year, the effective pay freeze on public service salaries must hold, and unforeseen expenditure and revenue shocks must be avoided.

Expenditure is likely to be swollen by a higher than expected level of unemployment, but this could well be offset by lower than budgeted spending in other areas, such as interest payments. Any slippage in revenue is likely to be minor. The growth in real GNP forecast in this *Commentary* is slightly higher than the official projections on which the revenue estimates were based, but the composition of this growth is less tax intensive, with exports growing faster and consumption slower than was anticipated earlier in the year.

On balance, therefore, while it remains entirely possible for the current budget deficit to be as planned for, it is more prudent to forecast a minor overrun, perhaps of the order of £20 million.

This would put the deficit at £1,220 million, or 7.2 per cent of the GNP forecast in this *Commentary*. Assuming that borrowing for capital purposes will be approximately on target, it implies an exchequer borrowing requirement of £1,880 million or 11.1 per cent of GNP. Such an outcome will represent a major improvement on the 1986 out-turn, both in absolute terms and as a proportion of GNP. However, as is recognised almost universally, a further large reduction in the borrowing requirement will be necessary in 1988 if progress is to be maintained towards bringing borrowing down to a sustainable level.

For the purpose of this *Commentary* therefore it has been assumed that the 1988 Budget will aim to reduce both the current deficit and the borrowing requirement by similar absolute amounts in 1988 as in 1987. This would imply a current budget deficit for 1988 of about £1,020 million and a borrowing requirement of about £1,600 million. On this *Commentary's* forecasts for 1988, such magnitudes would represent 5¾ per cent and 9 per cent of GNP respectively.

Without attempting to predict the shape of the 1988 Budget in detail, it has been assumed in general terms that the principal thrust for reducing the current deficit will come from expenditure restraint, with total expenditure held to a 3 per cent rise in value. Given that national debt interest payments are likely to rise by at least double this rate, the implied value increase in net current Supply Service expenditure is under 2½ per cent. To achieve such a target, it seems clear that subsidies and transfer payments will have to be held under tight control, while the volume of net spending on current goods and services will fall significantly. In part this would result from the carry-over effect of economies effected in the second half of 1987, but it also implies that there will be some further reductions in the standard of services supplied to the public, as well as a continued fall in the number of public service employees. The depth of these implied real cuts will depend in part on the course of average pay levels within the public service.

On the revenue side it is assumed that there will be some increase in the real rate of direct taxation, perhaps through the removal or reduction of some allowances both corporate and personal, and through some improvement in the efficiency of collection. Expenditure taxes are assumed to remain constant or even decline slightly in real terms, although here too an improvement in collection might contribute to revenue. In total the adjustment in the public finances assumed for 1988 relies more on a reduction in the volume of spending and less on an increase in effective tax rates than the similar adjustment made in 1987.

Interest Rates

Real interest rates reached exceptionally high levels in the early months of the year. One of the major causes was perceived as being the adverse reaction of capital markets to the level and trend of government borrowing. Urgent action to improve the public finances during 1987 was thus seen as a necesssary condition if interest rates were to decline. This added an immediate short-term imperative to the underlying structural need for a tighter fiscal stance.

Interest rates have fallen dramatically in recent months, with the important one-month interbank rate being reduced from an average of 14.38 per cent in January and February to under 9½ per cent in mid July. Retail interest rates, such as those on overdrafts or mortgages have been adjusted downwards rather more cautiously, with reductions generally lying between 2 and 3 per cent. However, if wholesale rates remain at recent levels, some further easing of retail rates can be expected.

While the tightening of fiscal policy was almost certainly an important element in this interest rate fall, currency movements have perhaps proved even more vital. The return of capital, both domestic and foreign to the Dublin markets, directly and through the unwinding of leads and lags, followed the significant appreciation of sterling since the end of February, and its apparent stability against the Deutschmark at its current level. The lessening, or even removal, of the perceived exchange risk in the Irish currency has made Irish interest rates attractive in relation to those in other countries, and has thus been the major factor in the reduction in the "black hole" of residual capital outflows.

Unlike 1986, when a steep fall in interest rates in the spring and early summer was followed by a sharp rise in the autumn, there are excellent prospects that rates will remain relatively low for the rest of 1987. Official funding seems well ahead of schedule, so the pressure on capital markets of large issues of gilts late in the year should be avoided. The Central Bank appears to have largely unwound its support position and to possess adequate liquidity to calm any minor market uncertainties. Market confidence in the economic management of the country is undoubtedly higher than at any time in the past two years. Finally and crucially, currency fears are far less acute than in 1986. While these could recur if there were a sudden depreciation of sterling, such an event seems unlikely in 1987, and if it did occur might have a less traumatic effect on the markets than in 1986.

Thus a sustained rise in interest rates seems unlikely in the remainder of 1987. Whether there is a significant further fall depends primarily on the flow of funds and partially on the decisions of the Central Bank. A temporary floor seems to be in the process of forming under Irish interest rates, due to the fact that the interest differential over London has almost disappeared. In the short run it appears prudent to avoid the emergence of a negative differential with London, on the grounds that previous brief periods when it occurred were followed by a sharp reaction as capital outflows increased. In the longer term there is no reason why such a reaction is inevitable. The Irish pound is a member of the EMS, and so long as there is confidence that parity within that system will be maintained, the logical interest differentials to consider are those with the continental fellow members. A gradual acceptance of this relationship would open the possibility of a prolonged negative interest differential with London becoming regarded as a normal and acceptable feature of economic life.

If sterling remains outside the EMS, the key factors would appear to be market expectations concerning the value of sterling *vis-a-vis* the Deutschmark, and perceptions of the likely impact of sterling movements on the Irish pound's EMS parity. As it becomes apparent that Irish inflation has moved firmly below the UK rate, and that Irish trade with continental countries is healthy at current EMS parities, so it should become clear that a minor depreciation of sterling should not force an EMS realignment on the Irish pound. In these circumstances a negative interest rate differential with the UK would merely reflect the discounting of an expected slow depreciation of sterling against all EMS currencies, including the Irish pound.

Conversely, if the UK does join the EMS, a gradual reduction in British interest rates could be expected, as the current large differential between UK and German rates implies the existence of a perceived exchange risk so long as sterling is free to float. However, domestic monetary conditions in the UK would appear to militate against a substantial fall in interest rates over the coming months, and could thus provide an argument against an early entry to the EMS.

With or without the UK joining the EMS, Irish interest rates could, therefore, drift somewhat lower in the course of 1988. Nevertheless, it would be unwise to predict further major reductions, unless there is a significant, and unexpected, fall in international interest rates.

Real interest rates are likely to remain quite strongly positive throughout 1988, although avoiding the crippling periods of double digit real interest rates seen last winter.

General Assessment

The progress being made in 1987 towards correcting the imbalance in the public finances is likely, in itself, to depress domestic demand by well over 2 per cent and real GNP by almost 2 per cent. That the economy is nevertheless forecast to grow by about 1¾ per cent indicates that some fairly strong expansionary forces are present in 1987. To a very limited extent the fall in interest rates which has accompanied the fiscal correction should be acting as a stimulus before the end of the year. Probably more important is the fact that the agricultural and tourism sectors of the economy are in a situation of recovery from their setbacks in 1986. Most important of all is the continued improvement in the external balance, as exports, especially of electronics, experience another period of rapid growth while import volumes remain relatively sluggish. Thus although employment is continuing to fall, the fiscal adjustment seems unlikely to trigger an accelerating recession.

On present indications it seems possible that a similar fiscal correction can be achieved in 1988 without pushing the economy as a whole into decline, although the rate of growth in GNP seems likely to be slightly lower. The recovery element of agricultural and tourism growth will be much weaker, while the current export boom, resulting in large part from a somewhat fortuitous movement in the dollar/yen exchange rate, could be starting to slow down. A much greater proportion of the predicted stimulus thus depends on the positive effect in 1988 of the recent reduction in interest rates. The extent to which private investment in housebuilding, other construction and equipment will respond to the lower interest rates cannot be quantified with any degree of certainty. The view taken in this *Commentary* is that private construction investment will increase slightly, but not by enough to outweigh a further substantial fall in public construction.

If this view proves justified, then by the end of 1988 the major part of the adjustment in the public finances necessary to bring them to a sustainable condition will have been achieved within the context of modest economic growth. The principal cost will have been a deterioration in the standards of some public services and a continuation of the substantial annual fall in total employment which has characterised the Irish economy since 1982.

These costs do not appear to be avoidable if the overriding imperative of correcting the fiscal imbalance is to be obeyed. However, the extent of the costs, their precise nature, and their impact on different sections of the community are certainly open to modification depending on the policies pursued by the government and by major interest groups.

Given the need to act quickly and decisively and the necessity of appearing resolute in the face of sectional outcry, it is understandable that the initial cuts imposed by the incoming government should be crude and in some instances unduly damaging to particular services. By 1988 it should prove possible for the required expenditure restrictions to be based on a more reasoned appraisal of priorities, and for their application to include some elements of flexibility while maintaining the overall degree of resolution vital to the success of the exercise.

At the same time, the employment projections are sufficiently alarming to suggest that the expansionary aspects of the government's economic programme should be given greater urgency in the coming months. It appears that considerable progress has already been made with regard to the establishment of the export service zone at the Custom House site, and it is to be hoped that the attraction of genuine new services will be sufficient to outweigh any danger of revenue loss from the relocation of existing domestic business. Faster progress on some of the other proposals to improve quality control, research, and marketing facilities for Irish industry and services could repay any costs of implementation during 1988.

Quite apart from their intrinsic merit in strengthening the country's export base, these proposals share with tax reform the added quality that they are relevant to any agreement, tacit or overt, with sectional interests on the course of income determination. Market conditions can be relied on to keep private sector pay settlements relatively modest. Public service pay, as usual, is central to the evolution of the economy. Given that the government is committed to a very low rate of increase in nominal public expenditure, the smaller the increase in average public service salaries the less severe need be the cut in the real level of services and the numbers employed.

While this, in itself, is a powerful argument for the relevant unions to accept very low pay increases, including further deferment of the later phases of existing special agreements, some concrete action to improve job prospects would make such acceptance less difficult.

In arriving at an acceptable economic package, industrial and agricultural interest groups could have an important role to play. If unions are to concede severe pay restraint, especially in the public service, as a central element in such a package, some matching concessions are needed from the other parties. These could include a committtment to a faster rate of expansionary investment than might otherwise have been undertaken, and a publicly stated willingness to acquiesce in tax reforms and a reduced level of Irish government subsidies.

If some type of agreement can be reached along these lines, the prospects for more substantial economic growth in the years beyond 1988 are quite promising, and the haemorrhage of falling job levels could be stemmed before the end of the decade.

STATISTICAL APPENDIX

		Output Indicators			Employment		Output per Head	
	1	2	3	4	5	6	7	8
	Manufacturing	Transportable Goods	Electricity Output	Cement Sales	Manufacturing	Transportable Goods	Manufacturing	Transportable Goods
	1980 = 100	1980 = 100	G.W.H.	000 Metric Tons	000's	000's	1980 = 100	1980 = 100
1981	102.7	101.6	10767	1812.5	222.5	234.2	105.0	103.7
1982	104.6	103.6	10792	1486.1	215.3	226.0	110.5	109.6
1983	112.6	111.1	11039	1382.4	202.5	212.6	126.4	124.9
1984	126.7	125.1	11424	1298.4	196.3	205.9	146.8	145.2
1985	130.1	126.8	11919	1233.2	189.0	197.6	156.5	153.4
1986	133.8	130.4	12466	1147.9	185.4	193.5		
1987								
Quarterly Averages or Totals								
1984 I	120.2	117.1	3136	271.5	197.4	206.7	138.5	135.4
II	133.8	133.9	2672	366.3	196.8	207.5	154.6	154.2
III	117.9	118.5	2562	350.0	196.9	206.4	136.2	137.2
IV	135.1	130.9	3054	310.6	194.2	202.8	158.2	154.3
1985 I	132.2	128.1	3259	241.3	189.3	197.9	158.8	154.7
II	137.8	134.4	2818	350.4	188.9	198.6	165.9	161.7
III	119.4	117.1	2705	333.1	189.2	197.5	143.5	141.7
IV	141.7	127.8	3137	308.3	188.4	196.5	158.8	155.4
1986 I	132.5	127.6	3356	205.0	185.0	192.9	162.9	158.1
II	139.2	135.7	2996	319.1	185.4	194.5	170.7	166.7
III	124.7	123.0	2814	330.6	186.5	194.3	152.0	151.3
IV	138.8	135.2	3300	293.2	184.7	192.2	170.9	172.6
1987 I	136.6	131.3	3466	218.6				
II				323.8				
III								
IV								
Quarterly Averages or Totals Seasonally Corrected								
1984 I	120.1	118.3	2854	339.7	198.7	208.6	137.4	135.4
II	126.6	126.5	2814	328.5	197.5	207.2	145.8	145.9
III	126.2	124.5	2857	318.5	195.8	205.1	146.6	145.1
IV	133.8	130.4	2903	311.6	193.3	202.5	157.4	153.9
1985 I	132.0	129.4	2961	307.5	190.6	199.8	157.5	154.8
II	130.7	127.4	2963	313.8	189.6	198.3	156.8	153.5
III	128.1	123.5	3014	302.4	188.1	196.3	154.8	150.4
IV	130.2	127.0	2991	307.2	187.7	196.2	157.7	154.7
1986 I	132.3	129.0	3046	264.5	186.3	194.7	161.5	158.4
II	132.0	128.7	3147	285.3	186.0	194.1	161.4	158.5
III	133.8	129.7	3134	299.7	185.4	193.1	164.1	160.5
IV	137.5	134.3	3150	291.3	184.0	191.8	169.9	167.3
1987 I	135.7	131.9	3143	283.7				
II				289.0				
III								
IV								

Unemployment	Prices						
9	10	11	12	13	14	15	
Live Register Av. Monthly	Consumer Price Index	Agricultural Price Index	Import Unit Value	Export Unit Value	Terms of Trade	Price of Stocks + Shares	
000's	Nov. 1982 = 100	1980 = 100	1975 = 100	1975 = 100	1975 = 100	1975 = 100	
127.9	82.4	117.7	232.4	208.4	89.7	219.9	1981
148.2	96.5	127.5	249.4	231.5	92.8	179.9	1982
192.7	106.6	135.4	261.1	251.9	96.5	223.7	1983
214.2	115.8	139.4	286.5	273.0	95.3	296.1	1984
230.6	122.0	135.6	293.2	280.6	95.7	316.8	1985
236.4	126.7	135.2	260.5	260.0	99.8	489.8	1986
							1987
Quarterly Averages or Totals							
215.2	112.9	146.6	281.5	266.0	94.5	309.6	1984 I
210.8	115.5	150.0	283.7	269.8	95.1	314.9	II
212.6	116.9	135.6	294.3	276.6	94.0	280.7	III
218.1	117.7	134.4	297.9	283.3	95.1	279.1	IV
232.8	119.9	140.7	297.3	280.3	94.3	284.7	1985 I
226.5	121.5	140.2	300.6	288.0	95.8	289.4	II
231.8	123.3	133.1	298.0	289.9	97.3	333.3	III
231.2	123.5	134.3	289.7	282.7	97.6	359.8	IV
238.7	125.4	140.8	279.0	270.0	96.8	426.8	1986 I
231.8	126.9	139.1	266.0	268.4	100.9	508.5	II
235.1	127.1	131.4	266.7	267.5	100.3	509.5	III
240.0	127.4	134.5	267.5	265.0	99.1	514.6	IV
252.1	129.7	143.0	257.1	256.0	99.6	632.4	1987 I
247.9	130.5					706.2	II
							III
							IV
Quarterly Averages or Totals Seasonally Corrected							
209.0	113.0	143.8	No Seasonal Pattern	No Seasonal Pattern	No Seasonal Pattern	No Seasonal Pattern	1984 I
212.9	115.2	146.1					II
215.1	116.7	138.0					III
219.7	118.2	138.2					IV
226.5	120.0	137.4					1985 I
228.7	121.1	136.3					II
234.2	123.1	136.7					III
233.0	124.1	137.8					IV
232.3	125.4	137.5					1986 I
234.0	126.5	135.2					II
237.5	126.8	135.1					III
241.9	128.1	138.1					IV
245.7	129.7	139.6					1987 I
250.2	130.1						II
							III
							IV

	Money Earnings Weekly Averages		Real Earnings		Consumption Indicators		
	16	17	18	19	20	21	22
	Manufacturing	Transportable Goods	Manufacturing	Transportable Goods	New Cars Registered	Retail Sales Value	Retail Sales Volume
	1973 = 100	1973 = 100	1982 = 100	1982 = 100	Total	1980 = 100	1980 = 100
1981	373.8	372.6	108.2	107.7	104645	118.3	99.4
1982	419.1	419.8	103.6	103.6	72603	129.4	94.0
1983	468.3	469.2	104.8	104.8	61094	137.0	90.5
1984	523.8	525.1	107.9	108.0	55893	145.8	89.4
1985	563.0	563.5	110.0	109.9	59592	155.9	91.0
1986	601.7				58705	158.8	90.5
1987							

Quarterly Averages or Totals

1984 I	502.3	503.0	106.2	106.1	19263	139.8	87.9
II	518.5	523.8	107.1	108.0	18443	143.9	88.6
III	528.2	528.1	107.9	107.5	11708	143.5	87.4
IV	546.0	545.6	110.7	110.4	6479	155.8	93.7
1985 I	541.8	542.0	107.8	107.7	19914	147.6	87.5
II	561.6	565.4	110.3	110.4	19200	153.2	89.8
III	566.8	566.3	109.7	109.2	13287	155.2	90.1
IV	581.6	580.3	113.4	113.3	7197	167.6	96.6
1986 I	578.5	577.7	110.1	109.7	19177	155.2	89.0
II	596.9	603.3	112.2	111.6	17663	154.5	88.3
III	608.1	613.6	114.3		13896	157.3	89.9
IV	623.3				7233	166.4	94.1
1987 I					17212	155.6	86.9
II							
III							
IV							

Quarterly Averages or Totals Seasonally Corrected

1984 I	509.1	511.1	107.5	107.7	13510	141.6	89.0
II	517.8	518.6	107.2	107.2	15357	146.4	90.5
III	528.0	529.4	108.0	107.8	13392	145.4	88.5
IV	540.3	541.6	109.0	109.1	12906	147.9	88.9
1985 I	548.6	549.8	109.1	109.1	14233	149.8	88.8
II	561.6	560.2	110.1	110.1	15666	155.6	91.4
III	566.4	568.1	109.8	109.9	15096	157.5	91.4
IV	575.3	575.7	110.5	110.4	14377	158.9	91.5
1986 I	585.6	585.6	111.5	111.3	13939	156.8	90.4
II	596.7	597.8	112.5	110.9	14225	156.8	89.8
III	607.5	615.6	114.4		15652	159.6	91.1
IV	616.5				14541	159.3	90.0
1987 I					12648	158.4	88.5
II							
III							
IV							

Government			Monetary Developments				
23	24	25	26	27	28	29	
Current Revenue	Current Expenditure	Current Deficit	Money Supply M3	Licensed Banks Domestic Credit Government	Licensed Banks Domestic Credit Non-Gov.	External Reserves	
£m	£m	£m	£m End Period	£m End Period	£m End Period	£m End Period	
3973	4796	823	n.a.	1277.4	n.a.	1473.1	1981
4908	5896	988	7291.9	1564.7	6655.1	1594.0	1982
5711	6671	960	7697.4	1775.6	7493.8	2014.8	1983
5952	6991	1039	8473.9	2247.9	8127.6	2101.2	1984
6331	7615	1284	8924.8	2514.1	8441.1	2271.9	1985
6709	8088	1379	8836.9	2725.7	9065.5	2205.3	1986
							1987
Quarterly Totals			Monthly Totals				
1290	1719	429	7697.4	1831.2	7512.5	2117.7	1984 I
1516	1684	169	7934.1	2142.4	7724.4	1952.0	II
1457	1715	258	8161.6	2223.0	7938.4	1875.0	III
1688	1873	185	8473.9	2247.9	8127.6	2101.1	IV
1325	1981	656	8438.9	2166.3	8151.0	2632.5	1985 I
1635	1792	157	8545.0	2319.1	8291.7	3124.8	II
1562	1838	277	8639.4	2421.6	8206.8	3009.6	III
1809	2004	195	8924.8	2514.1	8441.1	2271.9	IV
1416	2056	640	8567.5	2510.1	8730.6	2232.8	1986 I
1735	2052	317	8449.5	2354.6	8596.7	2296.5	II
1591	1844	253	8677.0	2277.8	8744.7	2116.4	III
1967	2136	169	8836.9	2725.7	9065.5	2205.3	IV
1476	2171	695	8838.5	2619.0	9201.8	2295.7	1987 I
1894	2115	221				2477.8	II
							III
							IV
Quarterly Totals (S.C.)			Monthly Totals (S.C.)				
1449	1670	221	No Seasonal Pattern	No Seasonal Pattern	No Seasonal Pattern	No Seasonal Pattern	1984 I
1486	1686	200					II
1508	1809	301					III
1496	1830	334					IV
1514	1919	405					1985 I
1585	1795	210					II
1615	1953	338					III
1603	1947	344					IV
1633	1990	357					1986 I
1670	2058	388					II
1644	1962	318					III
1745	2075	329					IV
1709	2100	391					1987 I
1814	2123	309					II
							III
							IV

	Visible Trade Indicators					Exchange Rates	
	30	31	32	33	34	35	36
	Imports (Value)	Exports (Value)	Trade Surplus (Value)	Imports (Volume)	Exports (Volume)	Effective Index	Sterling
	£m	£m	£m	1975 = 100	1975 = 100	Dec. 1971 = 100	Per IR£
1981	6578.4	4777.6	– 1800.8	166.0	158.3	67.75	0.8002
1982	6816.2	5691.4	– 1124.7	160.3	169.8	67.35	0.8125
1983	7366.8	6943.8	– 422.0	165.3	190.2	65.13	0.8222
1984	8912.2	8897.5	– 14.6	182.6	225.2	62.26	0.8134
1985	9428.2	9743.0	314.8	188.7	239.9	62.41	0.8234
1986	8629.7	9388.2	758.5	194.4	249.5	66.64	0.9147
1987							

Monthly Averages

1984 I	744.5	654.4	– 90.1	186.3	203.8	62.58	0.7951
II	714.9	769.8	54.9	177.4	236.5	62.56	0.8097
III	710.5	722.7	12.2	170.0	216.6	61.86	0.8143
IV	801.3	819.0	17.7	189.3	239.7	62.04	0.8352
1985 I	820.0	800.4	– 19.6	194.4	236.6	61.95	0.8590
II	807.2	856.1	48.6	189.3	246.2	61.44	0.8075
III	740.9	795.3	54.4	175.0	227.5	62.15	0.7959
IV	775.4	796.0	20.9	188.6	233.3	64.11	0.8324
1986 I	732.4	762.5	29.7	185.0	234.6	66.65	0.8966
II	722.9	786.5	63.3	191.4	243.1	67.33	0.8976
III	666.9	753.3	86.4	176.1	233.6	66.40	0.9148
IV	754.2	827.0	71.8	198.6	258.8	66.22	0.9497
1987 I	738.8	773.6	34.6	202.4	250.6	66.77	0.9422
II							
III							
IV							

Monthly Averages. Seasonally Corrected.

1984 I	709.6	684.3	– 25.3	176.8	211.1	No Seasonal Pattern	No Seasonal Pattern
II	705.5	733.1	27.6	174.4	225.5		
III	759.2	733.5	– 25.7	183.5	220.5		
IV	795.6	812.1	16.5	187.7	239.2		
1985 I	794.8	836.1	—41.3	187.4	244.6		
II	797.5	817.7	20.2	186.3	235.1		
III	779.8	810.2	30.4	186.2	232.6		
IV	768.4	782.3	13.9	186.3	231.3		
1986 I	711.4	800.7	89.3	179.1	243.3		
II	715.2	754.8	39.6	188.7	233.0		
III	700.1	763.2	63.1	186.4	237.6		
IV	748.1	810.8	62.7	196.8	256.0		
1987 I	716.9	813.2	96.3	195.2	260.8		
II							
III							
IV							

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