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SUMMARY

Despite the poor weather and the relative stagnation in manufactured exports, Gross Domestic Product in 1985 grew by about 2½ per cent, roughly the EEC average. What reduced the growth rate in the more familiar and relevant measure of Gross National Product to a niggardly 1 per cent was a massive rise in net factor payments abroad. Profit expatriation continued to soar, while external interest on the national debt climbed sharply in response to high interest rates and unfavourable exchange rates in the early part of the year. It is worth noting that adverse movements in exchange and interest rates between 1984 and 1985 were largely responsible for the increase of 17 per cent, or almost £300 million, in the total cost of servicing the national debt. This increase made a major contribution to the deterioration in the current budget deficit between 1984 and 1985, although it was the much smaller shortfall in VAT receipts which explained the £50 million excess of the deficit over its budgeted level.

Provided that the world economy conforms broadly to expectations in 1986, it is forecast that Gross Domestic Product should rise by about 2¾ per cent. However, because both interest rates and exchange rates are more favourable, the increase in net factor payments should be much smaller than in the past few years, allowing Gross National Product to grow by 2½ per cent. Such a growth rate should be accompanied by only a marginal further rise in unemployment, consolidation of the balance of payments gain with a deficit of only 2¾ per cent of GNP, and a rate of price inflation of about 4½ per cent.

The improved prospects regarding interest payments suggest that a neutral budget, in which direct tax allowances and indirect tax rates are both indexed to inflation, would result in a current budget deficit of much the same absolute size as in 1985, but representing a reduction from 8¼ to 7¾ per cent of Gross National Product. Whether such an outturn should be tolerated, or whether attempts should be made to obtain a substantial reduction in the deficit so as to move back closer to the path set out in the National Plan, is the principal dilemma to be addressed in the budget. On balance, a modest reduction in the absolute size of the deficit would appear to be the optimum policy aim. The dilemma would be eased if faster economic growth could be achieved within the constraint set by a reduced budget deficit. Such an improvement would seem to depend on an increase in private investment. The recent record of investment by the private sector has not been encouraging, and great caution should be exercised in introducing any incentives which might erode the already inadequate tax base in exchange for an uncertain response. However a limited package of temporary measures designed to bring private investment plans forward in time could prove a worthwhile experiment.

ESTIMATED NATIONAL ACCOUNTS 1985
A: Expenditure on Gross National Product

	1984	1985	Change in 1985				
	Provisional £m	Estimated £m	£m Total	£m Volume	% Total	% Price	% Volume
Private Consumer Expenditure ...	9465	10151	686	166	7¼	5½	1¾
Public Net Current Expenditure ...	3083	3283	200	15	6½	6	½
Gross Domestic Fixed Capital Formation	3415	3677	262	75	7¾	5½	2¼
Exports of Goods and Services (X) ...	9742	10813	1071	633	11	4¼	6½
Physical Changes in Stocks	355	70	– 285	– 250			
Final Demand	26060	27994	1934	639	7½	5	2½
less:							
Imports of Goods and Services (M) ...	9778	10331	553	231	5¾	3¼	2¼
GDP at market prices	16282	17663	1381	408	8½	5¾	2½
less:							
Net Factor Payments (F)	1609	1970	361	265	22½	5	16½
GNP at market prices	14673	15693	1020	143	7	6	1

B: Gross National Product by Origin

	1984	1985		
	Provisional £m	Estimated £m	Change in 1985 £m	%
Agriculture, Forestry, Fishing ...	1474	1365	– 109	– 7½
Non-Agricultural: Wages etc. ...	8740	9420	680	7¾
Other	2600	3090	490	18¾
less:				
Net Factor Payments	1609	1970	361	22½
National Income	11205	11905	700	6¼
Depreciation	1580	1786	206	13
GNP at factor cost	12785	13691	906	7
Taxes less subsidies	1888	2002	114	6
GNP at market prices	14673	15693	1020	7

C: Balance of Payments on Current Account

	1984	1985	
	Provisional £m	Estimated £m	Change in 1985 £m
X—M	– 36	482	+ 518
F	– 1609	– 1970	– 361
Net Transfers	808	990	+ 182
Balance on Current Account ...	– 837	– 498	+ 339
as % of GNP	– 5¾	– 3¼	+ 2¼

FORECAST NATIONAL ACCOUNTS 1986
A: Expenditure on Gross National Product

	1985	1986	Change in 1986				
	Estimated £m	Forecast £m	£m Total	£m Volume	% Total	% Price	% Volume
Private Consumer Expenditure ...	10151	10862	711	244	7	4½	2½
Public Net Current Expenditure ...	3283	3480	197	16	6	5½	½
Gross Domestic Fixed Capital Formation	3677	3974	297	129	8	4¼	3½
Exports of Goods and Services (X) ...	10813	11780	967	624	9	3	5¾
Physical Changes in Stocks	70	115	45	40			
Final Demand	27994	30211	2217	1053	8	4	3¾
less:							
Imports of Goods and Services (M) ...	10331	11192	861	553	8¼	2¾	5¼
GDP at market prices	17663	19019	1356	500	7¾	4¾	2¾
less:							
Net Factor Payments (F)	1970	2137	167	90	8½	3¾	4½
GNP at market prices	15693	16882	1189	410	7½	4¾	2½

B: Gross National Product by Origin

	1985	1986		
	Estimated £m	Forecast £m	Change in 1986 £m	%
Agriculture, Forestry, Fishing ...	1365	1433	68	5
Non-Agricultural: Wages etc. ...	9420	10010	590	6¼
Other	3090	3417	327	10½
less:				
Net Factor Payments	1970	2137	167	8½
National Income	11905	12723	818	6¾
Depreciation	1786	2017	231	13
GNP at factor cost	13691	14740	1049	7¾
Taxes less subsidies	2002	2142	140	7
GNP at market prices	15693	16882	1189	7½

C: Balance of Payments on Current Account

	1985	1986	
	Estimated £m	Forecast £m	Change in 1986 £m
X—M	482	588	+ 106
F	– 1970	– 2137	– 167
Net Transfers	990	1100	+ 110
Balance on Current Account ...	– 498	– 449	+ 49
as % of GNP	– 3¼	– 2¾	+ ½

COMMENTARY

The International Economy

General

Entering 1986, international economic conditions are considerably more favourable to Ireland than they were at the beginning of 1985. At that time the dollar had risen to more than parity with the Irish pound, international interest rates, although below their 1984 peak, were still very high and tending to rise, and there was a general expectation that world trade would slow down, with a particular weakness in the electronic market. In retrospect, world trade fell off by more than was generally forecast at the beginning of the year and the computer slump was even deeper and more prolonged than expected. Although both the dollar and interest rates fell substantially later in the year, their high levels in the first quarter of 1985 determined that the cost of debt service for the year would rise steeply.

The dramatic change during 1985 sees the dollar entering 1986 at more than \$1.20 to the pound, and with an international consensus of the leading countries that it should weaken further. In the process, US interest rates can be expected to decline again, with perhaps a slower fall in European rates. World trade is expected to more or less repeat the slow growth of about 4½ per cent achieved in 1985, but, with a smaller carryover, this implies a somewhat faster rate of growth in the course of the year. The computer industry is believed to have past its trough and should resume its expansion in 1986.

Nevertheless, despite the improved outlook, there are serious uncertainties in the international situation which could affect Ireland's economic performance during 1986. On a general level there remains the risk that the chronic Third World debt problem could turn acute, causing instability in the world banking system. Also on a general level there is the possibility that world trade will fail to reach the modest growth forecast, either because the US enters recession in the effort to achieve some progress in correcting its fiscal imbalance, or because of an inadequate demand response by the other major trading nations to the slowdown of the US economy. Of a more immediate nature is the current instability of the world oil market. In many ways a collapse in oil prices, which is being widely predicted, would act as a stimulus to economic activity in the major oil importing nations. However, too precipitate a fall, or, worse, a period of wildly fluctuating oil prices, could also lead to difficult problems of adjustment. Of particular interest to Ireland is the impact that lower oil prices would be liable to have on the value of sterling. Any further significant fall in sterling would pose severe if temporary problems of competitiveness both in an important export market and with a major supplier of the home market. Conversely, efforts to hold up the value of sterling by means of even higher UK interest rates could also prove damaging to Ireland, which has not yet fully detached itself from the influence of the London financial markets.

The US Economy

Initial estimates place the US growth rate in 1985 at a little under 3 per cent. Although later revisions may alter this slightly in either direction, they are unlikely to change the general picture of 1985 as a year in which a moderate slowdown in domestic demand was converted into a much sharper deceleration in overall growth through the continued deterioration in the trade balance. On the positive side, inflation remained low, unemployment stable, and the growth rate was higher in the second half of the year than in the first.

It seems probable that most categories of domestic demand will be weaker in 1986 than in 1985, with the possible exception of stockbuilding. With the passing of the Gramm-Rudman balanced budget bill in December 1985, with its commitment to scale down the budget deficit to below $50 billion by 1990, it has become likely that fiscal policy will be less expansionary during 1986, even if the aspiration to reduce the budget deficit from over $200 billion to $172 billion proves more than can be achieved.

The prospects for US growth in 1986 are, therefore, heavily influenced by the progress made in improving the trade balance. On the assumption that pressure for significant measures of protection will continue to be resisted, this in turn depends on the extent to which the dollar depreciates, and on the length of the inevitable lag before a dollar decline results in higher exports and/or lower imports. It is to be expected that the balance of payments deficit will show the usual delayed response to a depreciated currency, rising for some months before the desired fall commences, but the length of this adverse phase cannot be predicted with any certainty. However, it is reasonable to hope that the positive result of the depreciation which has taken place in the Autumn of 1985 will be showing by the middle of 1986, with a considerable trade improvement in the second half of the year. Thus while the annual deficit, in dollar terms, may be slightly higher in 1986 than in 1985, it should be moving quite strongly in the desired direction by the end of the year.

Provided that this analysis is correct, the 1986 growth rate seems likely to be of the same order of magnitude as in 1985, at just under 3 per cent. Low world commodity prices, including oil, may serve to offset some of the usual price effects of a currency depreciation, so with domestic inflationary pressures remaining weak the annual increase in retail prices could stay at under 4½ per cent. Not much change is anticipated in unemployment levels.

For the rest of the world, the most important aspects of this forecast are that there will be very little growth in US import volume, with actual declines in some products, that US interest rates are likely to decline further both to stimulate domestic demand and to drive the dollar a little lower, and that the low rate of US growth will keep commodity prices depressed.

The European Economy

The EEC appears to have fulfilled expectations that its average growth rate would be about 2½ per cent in 1985, with the UK exceeding this average and

France lagging at about 1¼ per cent. Inflation continued to fall, with the year end average standing at just below 5 per cent, but unemployment was slightly higher than in 1984.

A broad continuation of these trends is forecast in 1986, with growth perhaps accelerating marginally, inflation falling to about 4 per cent and unemployment stabilising at around 11 per cent. Some reduction is expected in the rate of expansion of export volume, although the direct effects of lower US import growth are expected to be less strong in Europe than in the Pacific countries. Nevertheless, if economic growth in 1986 is to exceed that in 1985, it is necessary that domestic demand grows faster to offset the slower export growth. With incomes tending to increase by more than prices in most countries, the volume of consumption is expected to grow, and this in turn could stimulate industrial investment, which is already rising in some countries, most notably Germany. However, the growth rate envisaged on present policies is insufficient to hold out any prospect of a significant reduction in the very high unemployment rate, and is probably too low to encourage the shift in international investment funds which is needed in the medium term if the strategy of forcing down the value of the dollar is to prove effective.

Present indications are that, in spite of the Group of Five's agreement on exchange-rate policy, both fiscal and monetary policy in Europe will remain restrictive in 1986. Indeed, a relaxation of monetary policy would not be compatible with that agreement, as the fall in nominal European interest rates must be slower than that in US rates if the controlled decline in the dollar is to be engineered. However, a more expansionary fiscal stance would help the process, but would run counter to the anti-inflationary ideologies of the current West German and UK governments. The German authorities in particular argue that the existing and prospective German growth rate of about 3 per cent is adequate and does not call for additional fiscal stimulus, despite unemployment of over 8 per cent. Other European countries, even if willing, feel unable to adopt more expansionary fiscal policies without a German lead. The most that it seems possible to hope for is that the autonomous growth in the German economy will prove stronger than is generally anticipated, and conversely that any unexpected weakening in demand will call forth a countervailing relaxation of fiscal policy.

In the European context, the UK is a special case. The UK government's optimism that 1986 will see relatively rapid growth of around 3½ per cent is not shared by most observers, although there is general agreement that private consumption will expand rapidly in line with real disposable income. The major uncertainty affecting UK prospects is the course of oil prices in 1986. A substantial oil price fall would significantly diminish exchequer revenue, and put strong pressure on the currency market which has, so far, discounted the likelihood of only a moderate fall in oil prices. A further fall in the value of sterling would prevent the reduction in price inflation which is a central aim of government policy, while an attempt to resist market pressures on sterling would involve the maintenance and even the increase of interest rates which are already extremely high in relation to other countries.

The Rest of the World

While Europe hopes to ride out the slackening of US import growth without undue difficulty, the rest of the world cannot entertain similar hopes. Manufactured exports from Japan and the newly industrialised Asian economies were the principal beneficiaries of the overvalued dollar from 1983 to mid-1985, and must be expected to bear the brunt of improved US competitiveness in 1986. Primary producers seem set to suffer from the sluggish demand for the volume of their exports, as well as, in many cases, from the domestic price effects of their products being quoted in terms of a declining dollar.

Despite some deceleration in the rate of export increase, Japan achieved a 5 per cent growth in real GNP in 1985, a record balance of payments surplus, a price inflation of 2 per cent, average unemployment of 2½ per cent of the workforce and a current budget deficit of under 1½ per cent of GNP. Despite the probability of a severe reduction of export growth in 1986, the Japanese authorities appear willing to contemplate only a minor relaxation of fiscal measures in 1986, so that the current budget deficit is expected to fall to under 1 per cent of GNP. This reluctance to adopt a more expansionary policy is of less consequence to the rest of the world than Germany's, and is also more understandable in that, with unemployment already minimal and with the very low Japanese propensity to import finished products, any increase in domestic demand runs a higher danger of inducing domestic inflation.

Third world debtor countries stand to obtain some benefit from the decline of the dollar in which most of their debts are denominated, and from the fall in interest rates in 1985 and 1986. On the other hand, their export earnings are likely to be depressed through a reduced volume of exports to the US and even more by depressed prices for most commodities. Growing impatience with the burdens imposed by debt servicing is likely to impose an increased strain on international debt management arrangements, although it remains reasonable to expect that the strain can be absorbed in 1986 without seriously endangering the stability of the world banking system.

It seems inevitable that the income of OPEC countries will fall substantially in 1986, either through the reimposition of effective production cuts, or, far more probably, through a significant fall in the dollar price of oil, exacerbated by the decline of the dollar itself. In consequence, the ability of OPEC countries to absorb imports from the industrialised nations will be diminished, as will the flow of OPEC-originating liquid funds onto the world's financial markets.

The Context for Ireland

If international economic developments follow the pattern outlined above, the trading context for Ireland should be rather more favourable than in 1985. Although the volume of world trade is forecast to grow at much the same rate as in 1985, the pattern with regard to product mix and destination is relatively well suited to Ireland's main markets. However, it must be pointed out that the outline discussed, and illustrated in Table 1, is a best guess of the most likely outcome, but that any significant deviation is far more likely to be in the direction of lower growth than higher.

TABLE 1: Short-term International Outlook

	GNP/GDP % Change		Consumer Prices % Change		Hourly Earnings % Change		Unemployment Rate %		Budget Deficit as % of GNP/GDP		Current Account Balance as % of GNP/GDP	
Country	1985	1986	1985	1986	1985	1986	1985	1986	1985	1986	1985	1986
United States	2½	2¾	3½	4½	3½	3½	7¼	7¼	4	3¾	—3¼	—3¼
Canada	4¼	2½	3¾	4	4	3¾	10½	10	6½	5½	0	—¼
Japan	5	3¾	2	1¾	4½	4½	2½	2¾	1¾	1	3¾	3¾
West Germany	2½	3	2	2	4	3¾	8¾	8	1¼	1	2	2¾
France	1¼	2	6	5	6	4¾	10½	11	3½	3¼	0	½
UK	3½	2½	5	4½	8	7½	11¾	11½	3½	3½	1	¾
Italy	2¼	2½	9	8	9½	8	10¼	10½	13½	13	—2	—1¼
Belgium	1½	1½	4½	3¾	4½	3¾	13¼	13½	10	9½	—¼	+ ½
Denmark	2½	3½	4¾	2¾	4¼	3¾	9	8¾	2½	¾	½	1½
Netherlands	2	2	2¼	1¾	2¼	2¾	14½	14	5¼	6½	5	4¾
Sweden	2	½	7¼	5½	5¾	5¼	2¾	3	2½	2	—1½	—½
Total (OECD)	2¾	2¾	4½	4½	5	4½	8¼	8¼	3¾	3½	—¾	—¾
Ireland	1	2½	5½	4½	7½	6	17	17¼	8¼*	7½*	—3¼	—3

Sources: OECD *Economic Outlook,* Dec. 1985, Economic Outlook 1985-89, London Business School, N.I.E.R. Nov. 1985, Economic Outlook Forecast. Release Sept. 1985, World Financial Markets Dec. 1985.

* Not directly comparable.

Even within this context of moderate trade expansion, there are elements of direct interest to Ireland which are subject to considerable uncertainty and on which a view must be taken before a forecast of the domestic economy in 1986 can be finalised. These are the interrelated issues of the oil price, exchange rates and interest rates.

Since early December, when Saudi Arabia gave notice that it would no longer carry the burden of unilaterally restricting total OPEC oil production, oil prices have been inherently unstable. There is a general expectation that as increased output reaches the market, and especially when the seasonal peak in European oil consumption ends in the early Spring, there will be a substantial fall in oil prices. There is, however, no agreement on how great the fall will be, with forecasts for spot prices of crude oil varying from $25 per barrel down to $20 or even $15. For the purposes of this *Commentary* a fairly conservative assumption has been made of an average price in 1986 of $23 per barrel, compared with $27½ in 1985, with the fall being reflected in contract prices as well as on the spot market.

The real price of oil for Ireland depends not only on the dollar price of oil but also on the exchange rate of the dollar. As a working assumption, but not as a market prediction, an average value of the dollar in 1986 of $1.26 to the Irish pound has been taken. If oil prices are near the level assumed, the pressure on sterling should be substantial but not irresistable. Thus, a further decline in sterling against the EMS currencies is possible but by no means certain. Against the Irish pound, an average value of 86 pence is assumed. Until late December, there was a widespread expectation that a general EMS realignment was imminent. The recent strength of the French franc, allied to forecasts of a French balance of payments surplus in 1986, has greatly lessened the likelihood of such a realignment. It is, therefore, assumed that there will be no change in EMS parities, including the Irish pound, during 1986. These currency assumptions imply that the trade weighted index of the Irish pound should remain near its current level, representing an overall appreciation of 4 or 5 per cent in the annual average between 1985 and 1986.

Finally, it is assumed that US interest rates will decline by about 2 per cent in the course of the year, and European rates by about 1 per cent. Once the uncertainties caused by the speculation concerning an EMS realignment have been ended, there would appear to be room for Irish interest rates to decline by rather more than the European average.

THE DOMESTIC ECONOMY

General

There can be no denying that the rate of GNP growth achieved in 1985, which seems likely to have been about 1 per cent, was disappointing. To some extent, this low rate can be blamed on the poor summer weather, but more worrying was the virtual stagnation of industrial output and exports through most of the year. Conversely, there was more progress than originally expected towards reducing both the balance of payments deficit and the rate of inflation.

There seem reasonable grounds for expecting a continued small improvement with regard to prices and the external deficit in 1986, together with some recovery in output and the public finances. The extent of such favourable developments is partly dependent upon such volatile external factors as the price of oil and the value of sterling. As discussed in relation to the international economy, "mid-point" assumptions have been made regarding both oil prices and exchange rates, but it must be stressed that there could be considerable divergences from these assumptions as the year progresses.

Exports

With the anticipated upturn in manufactured exports in the later months of 1985 now seeming to have been weaker than expected, it seems likely that total visible exports in 1985 totalled about £9,800 million. This represents an increase of 10¼ per cent in value, and of 6 per cent in volume, over the 1984 level. Although, in themselves, these appear quite considerable increases, the fact that they result from a steep rise during 1984 and into the first quarter of 1985, followed by virtual stagnation in the remaining three quarters, has disturbing implications for 1986. Because of the flat base carried through from 1985, any significant increase in the annual average for 1986 must depend on a rise in exports in the course of 1986 itself. Although there are grounds for expecting such an increase, the rise in the annual average volume of exports seems likely to be the lowest since 1981. At the same time, the rate of price increase, which slowed down dramatically during 1985, is expected to remain low throughout 1986.

Table 2 summarises the composition of exports estimated for 1985 and forecast for 1986. Given that production of dairy products is constrained by the superlevy and that cattle numbers preclude an increase in beef output, any

TABLE 2: Exports of Goods and Services

	1984 £m	% Change Volume	% Change Value	1985 £m	% Change Volume	% Change Value	1986 £m
Agricultural	1725	3¼	3¾	1790	4	6	1897
Manufactured	5623	6	12¾	6340	6½	10½	7006
Other Industrial	1446	6¾	6¾	1542	4	4	1604
Other	103			128			141
Total Visible	8898	6	10¼	9800	5¾	8¾	10648
Adjustments	—212			—205			—190
Merchandise Exports	8686	6¼	10½	9595	6	9	10458
Tourism	591	13½	20½	712	4	8½	773
Other Current Receipts	465	3¼	8¾	506	4	8½	549
Exports of Goods and Services	9742	6½	11	10813	5¾	9	11780

significant increase in the volume of agricultural exports in 1986 will mainly reflect a diversion of output into trade and away from the building up of intervention and related stocks. To a limited extent, such a diversion seems probable, and would be in line with basic EEC policy. Prices for agricultural exports are likely to remain depressed, although they could rise marginally more than in 1985. To the extent that prices of recorded trade are reduced because of a higher proportion of sales to third markets, there should be a corresponding increase in EEC transfers, so that the balance of payments effect of such sales will be more favourable than appears from Table 2.

Manufactured exports suffered in 1985 from world-wide stock adjustment, particularly in electronic products, and from the closure of some major exporting companies in Ireland. The prospects for 1986 are for a resumption of export volume growth by the modern sector of manufacturing industry, although at a less dramatic rate than in 1983 and 1984. The slightly improved rates of economic growth in the major European countries expected in 1986 should assist such export prospects. With regard to the more traditional sectors of manufacturing, the lower average level of sterling in 1986 could be an inhibiting factor, but unless sterling depreciation is greater than assumed here, some modest volume growth of such exports can be expected. Price increases are likely to be quite limited, with actual falls recorded in the Irish pound price of some goods which are normally quoted in dollar terms.

Other industrial exports, which include metal ores, have suffered from a severe decline in prices during 1985. There seems little likelihood of any substantial recovery in metal prices in 1986, so that both the value and possibly the volume of ore exports may be lower in 1986. The remainder of this category, however, is expected to remain buoyant.

After its rapid expansion in 1985, estimated by Bord Fáilte at over 20 per cent in value, it is prudent to expect a considerably slower increase in tourism in 1986, given that the US market will be adversely affected by the fall in the dollar and that there could be some negative reaction to the weather experienced by visitors in 1985. On the other hand, if the improvement in Anglo-Irish relations persists, there could be an increase in the number of UK visitors.

In total, and after allowing for some growth in other exported services, exports of goods and services are forecast to rise by 9 per cent in value in 1986.

With the low rate of price increase expected, this would represent a volume increase of some 5¾ per cent.

Stocks

Fluctuations in the rate of stock-building have had a major impact on the overall growth rate of the economy in recent years. After being negative in the early years of the decade, this impact was strongly positive in 1983 and 1984, contributing 1¼ per cent and nearly 2 per cent to the annual growth rates of those two years. On current indications, stock-building reverted to having a markedly negative effect in 1985, as the increase in stocks failed to approach the extraordinarily high levels officially estimated to have taken place in 1984.

TABLE 3: Stock Changes

	1984 £m	Change in Rate £m	1985 £m	Change in Rate £m	1986 £m
Livestock on Farms	34	—49	—15	0	—15
Irish Intervention Stocks[1]	193	—68	125	—55	70
Other Non-ag. Stocks	128	-168	-40	+100	60
Total	355	—285	70	+ 45	115

[1]Including subsidised private storage of meat.

As Table 3 shows, the value of agricultural stocks is believed to have fallen slightly in 1985, after three years of moderate growth. More significantly, the growth in intervention and related stocks, although still substantial, was considerably lower than in 1983 or 1984. Finally, although no direct indicators are available, it seems overwhelmingly probable that the unexpectedly large increase in industrial stocks and work-in-progress which was recorded in 1984 has been reversed in 1985. The very low volume of import increase during the year, taken in conjunction with domestic consumption and export volumes would suggest a significant run-down of industrial stocks. This impression is strengthened by the evidence of the CII/ESRI Industrial Survey, which indicates that a majority of firms has moved from seeing stock levels as excessive early in the year to barely adequate by the summer.

With regard to 1986, a further small decline in agricultural stocks is expected, as dairy herds are further reduced without being fully compensated by increases in other forms of livestock. Intervention and related stocks are expected to rise again, but at a considerably lower rate than in 1985, thus allowing for some increase in the volume of agricultural exports. The movement of industrial stock levels is always an imponderable factor, but the most reasonable assumption to make is that such stocks will rise moderately in line with a recovery in industrial production and accommodated by lower nominal interest rates.

Fixed Investment

The volume of building and construction is thought to have fallen by about 4 per cent in 1985, with the decline shared by most sectors. On the other hand, and somewhat surprisingly, investment in plant and machinery would seem, on the evidence of the import statistics, to have grown by about 8 per cent in volume terms. If these estimates are correct, then total gross fixed investment will have shown a small volume increase for the first time since 1981.

TABLE 4: Gross Fixed Capital Formation

	1984 £m	% Change Volume	% Change Value	1985 £m	% Change Volume	% Change Value	1986 £m
Building and Construction	1652	—4	2	1685	2	7	1803
Machinery and Equipment	1763	8	13	1992	5	9	2171
Total	3415	2¼	7¾	3677	3½	8	3974

Looking to 1986, there are grounds for expecting a more favourable outcome with regard to building and construction. For the first time in several years there is no reduction proposed in the volume of public capital expenditure affecting the building industry. The 5 per cent increase in the value of such expenditure put forward in the *Public Capital Programme 1986* should at least match the rate of inflation, leaving the volume either unchanged or marginally higher than in 1985. Moreover, the current strategy with regard to building implies some shift from direct public financing towards providing incentives for a greater volume of private financing. If the private sector, including individual households, responds to these incentives, a modest rise in the total volume of building investment seems probable in 1986.

A key factor in determining the level of private building investment will be the course of interest rates. Despite the substantial fall in nominal interest rates during 1985, the real rate of interest remains high, and this is undoubtedly one of the main causes of the sluggish performance of the building industry in 1985. On the assumptions, already discussed, that there will be further falls in both international and domestic interest rates once the present currency speculation has ended, there could be a significant stimulus to building activity, especially in housing. However, the time scale of responses to interest rate changes is not fully known, and it could well be late in the year, or even into 1987, before the effects of such a stimulus became apparent.

Lower interest rates and resumed growth in industrial production should encourage investment in plant and machinery. On the other hand, the completion of some major investment programmes in the semi-state sector, together with the absorbtion of the unexpectedly high level of private sector investment in equipment during 1985, suggest that the increase in expenditure on plant and machinery will be lower than in 1985.

Table 4 summarises the expected outturn for 1985 and the forecast for 1986. It is worth noting that because of the fall in building activity in the course of 1985, the forecast small increase in the annual volume in 1986 in fact implies a fairly substantial rise in the course of the year, and suggests that there could be a significant increase in the annual average in 1987.

Consumption

It has become apparent that there was a substantial recovery in personal consumer expenditure from the early Summer of 1985. This has been the first sustained upturn in the volume of the Retail Sales Index since 1979, and has resulted mainly from a small increase in real personal disposable income during 1985. It is possible that the Retail Sales Index has slightly overstated the rise in total consumer spending, as it could reflect also the effects of the buoyant tourist season and of some diversion of trade from Northern Ireland back to outlets in the Republic. Nevertheless, it is clear that the volume of total personal consumption has increased in 1985 despite a very low first quarter.

For 1986, the factors which led to this recovery seem set to continue. Real disposable income should show a further rise, on the assumption that direct tax rates will be indexed, and lower interest rates should permit a further diversion of spending towards the purchase of goods, especially durables, leading to a marginal decline in the personal savings ratio. With the value of personal consumption rising slightly less than in 1985 at 7 per cent, the lower inflation rate expected leaves the forecast increase in the volume of personal consumption at almost 2½ per cent.

Net public expenditure on current goods and services increased only marginally in volume terms in 1985. On the basis of the Estimates for 1986 and on the assumption of no major innovations in the coming Budget, it appears likely that a similar marginal increase will take place in 1986, due largely to increased spending on various special schemes outweighing a continued small decline in what might be termed "core" expenditure. When allowance is made for a moderate 1986 increase in public service pay, the value of public consumption seems likely to rise by about 6 per cent in 1986.

Final Demand

Putting together the estimates and forecasts of expenditure so far discussed, it seems likely that the value of final demand rose by about 7½ per cent in 1985 and could rise by some 8 per cent in 1986. In volume terms, the forecast increases are 2½ per cent in 1985 and 3¾ per cent in 1986. The composition of final demand is projected to vary quite significantly between the two years.

Stock changes are believed to have exerted a major downward influence on the growth of final demand in 1985, while their impact is forecast as being more or less neutral in 1986. Exports made the major contribution to growth in 1985, although this was largely a carryover from their rapid expansion during 1984. Without a positive carryover from 1985, the contribution of exports will be smaller in the 1986 national accounts, although it is forecast that they will still be the fastest growing category of expenditure. Both consumption and investment are forecast to add considerably more to the volume of growth in final demand in 1986 than in 1985.

Imports

The marked reduction in export growth during 1985 was matched by an even greater sluggishness in the value growth of imports. This was particularly apparent in the case of imports of materials for further industrial production, suggesting a cessation of stock-building in the course of the year. Imports of consumer goods also failed to rise as much as might have been expected in response to the recovery in retail sales during the year and the diversion of some unrecorded trade into legitimate channels.

One major cause of the slowdown in the value of imports is the fact that import prices, as measured by the unit value index, have tended to fall marginally from the peak they reached in April 1985, due to a combination of

TABLE 5: Imports of Goods and Services

	1984 £m	% Change Volume	% Change Value	1985 £m	% Change Volume	% Change Value	1986 £m
Capital Goods	1,084	8	13	1,225	5	9	1,335
Consumer Goods	2,098	4½	9	2,285	4	7	2,445
Intermediate Goods:							
Agriculture	425	3	5	446	3	5	468
Other	5,295	¾	3	5,450	6½	9	5,940
Other Goods	11			34			40
Total Visible	8,913	2¾	6	9,440	5½	8¼	10,228
Adjustments[1]	—29			—70			—75
Merchandise Imports	8,884	2¼	5½	9,370	5½	8¼	10,153
Tourism	379	—	5½	400	3	7½	430
Other Services	515	4	9	561	4	8½	609
Imports of Goods and Services	9,778	2¼	5¾	10,331	5¼	8¼	11,192

[1]The adjustment factor allows for a substantial reduction in the estimated value of unrecorded trade in 1985.

the weaker dollar, depressed commodity prices and the general slackening of world inflation. The breakdown of prices for the various categories of imports shown in Table 5 is not yet available, but it seems likely that the major effect of reduced prices was in goods for further production. Even when allowance is made for the impact of lower prices, however, it is clear that the volume of imports was also unexpectedly small.

If the interpretation that import volumes in 1985 were significantly influenced by a fall in stockbuilding is correct, then it is reasonable to anticipate some rebound effect in 1986. Allowing for this, for the expected upturn in industrial production and exports, for a continued expansion in the volume of consumption, and for a relatively high level of grain imports after the poor 1985 harvest, a substantial increase in the total volume of imports can be expected during 1986. As in the case of exports, however, the fact that there will be no positive carryover effect from 1985 will tend to hold down the annual average rate of growth in import volume. On the currency assumptions made in this *Commentary,* import price increases are expected to be very low in 1986, so that the rise in the value of imports for the year as a whole will seem quite modest in relation to most recent years.

Balance of Payments

The major improvement in the balance of payments on current account achieved in 1985 has been due to the unprecedented attainment of a substantial surplus on the balance of trade, augmented by good results in traded services and an increased flow of EEC transfers, but offset by a very large rise in net factor payments abroad. At an estimated 3¼ per cent of GNP, the deficit is better than the target set for 1985 in the National Plan.

For 1986, it is forecast that the balance of trade will remain in surplus, but with a much smaller improvement than in 1985. Similarly, traded services should show a further, but slower, increase in their net contribution. The remaining items in the balance of payments are much harder to forecast.

Transfers from the EEC depend largely on the financing arrangements for sales of agricultural produce to third countries, and these have yet to be finalised for 1986. On the somewhat doubtful assumptions that they remain as favourable as in 1985 and that third country sales continue to expand as the build up of intervention stocks slows down, a modest growth in total transfers seems possible.

With regard to factor flows, it seems safe to forecast a much slower increase than in 1985, but the precise extent of the amelioration remains imponderable. External interest payments on the national debt could actually fall, given the movements in interest and exchange rates in 1985 and the further favourable shifts expected in 1986. Expatriation of profits and other private flows on the other hand could continue to rise, although here too, it is reasonable to expect some slowdown. The check of export growth during 1985 must have affected the profitability of several of the firms responsible for profit expatriation, and this could well be reflected in the size of their remittances in 1986. However, little is known of either the mechanics or the dynamics of such financial flows, and it would seem imprudent to expect too abrupt a slowdown in such payments. A reduction from an expected increase of over 30 per cent in 1985 to 16 per cent in 1986 seems a reasonable forecast to make.

On this basis, there is likely to be only a slight improvement in the total balance of payments on current account in 1986. Even this, however, should serve to consolidate the large gain made in 1985, and at 2¾ per cent of forecast GNP, the deficit would again meet the target set in the National Plan.

Output

The near stagnation observed in 1985 in relation to economic demand is by definition matched on the supply side. Industrial growth was well below expectations, agriculture suffered a substantial fall in net output and although private services grew moderately, this was not sufficient to maintain a satisfactory overall growth rate in the economy. The prospects for 1986 are considerably more hopeful, although the lack of expansion during 1985 will tend to hold down the annual growth rate for 1986 due to the absence of any carryover into the year.

Agriculture

Although finalised estimates of agricultural output in 1985 will not be available for some months, all preliminary estimates show a substantial decline in agricultural output and incomes. The volume of output in livestock and livestock products increased by almost 2 per cent, but the heavy fall in the volume of tillage production due to the poor weather meant that there was a small fall in the total volume of gross agricultural output. At the same time, the volume of inputs rose, again partly because of the weather, leaving the volume of gross agricultural product, which corresponds to value added, about 2½ per cent lower than in 1984. Lower prices for livestock and crops coincided with increased input prices, placing a severe squeeze on farmers' margins. As a result, the value of gross agricultural product fell by almost 10 per cent, and income arising in agriculture by about 9 per cent. The decline in forestry and fishing, although each was also affected by the weather to some extent, is thought to have been much less marked, so that income arising in agriculture, forestry and fishing probably fell by some 7½ per cent in 1985.

The outlook for 1986 contains both positive and negative features. On the negative side, the fact that milk output at the end of 1985 was running ahead of its superlevy quota for the 1985/86 season implies that milk output in the first quarter of 1986 will have to be reduced to significantly below the corresponding 1985 level. With no likelihood that the quota will be increased, milk output for 1986 as a whole is thus likely to be perhaps 2 per cent below that in 1985. At the same time, the shortage of domestic fodder in certain areas seems likely to increase the volume of imported feed consumed in 1986, exerting a further downward influence on the volume of gross agricultural product. On the positive side, crop production should recover from its 1985 setback, given normal weather conditions, while the price squeeze could be reversed, with modest increases in some output prices combining with price reductions for many inputs to actually raise unit margins.

Although any forecasts of agricultural output and incomes made at this time of year are subject to large uncertainties, it is not unreasonable to project increases of about 1 per cent and ½ per cent respectively in the volume of gross agricultural output and gross agricultural product, and of about 5 per cent in the value of income arising in agriculture, forestry and fishing.

Industry

The industrial production index for the first 9 months of 1985 shows that the volume of production in manufacturing industry was only 4.6 per cent higher than in the corresponding period of 1984. Moreover, the seasonally adjusted index shows a declining trend since the 4th quarter of 1984, as a dramatically reduced rate of growth in the modern industries was insufficient to outweigh continued falls in the output of some of the older industries. The CII/ESRI Industrial Survey suggests that the final quarter of 1985 should have seen some recovery from the depressed output levels of the summer, and the trade statistics for October and November lend limited support to this expectation. Even so, the level of output in the final quarter is unlikely to have been much above that in the last quarter of 1984, leaving the annual increase in the volume of production in manufacturing industry at a little under 4 per cent. For transportable goods industries the picture is even less favourable, as the weather had a devastating effect on turf production. Despite steady growth in the output of the utilities of electricity, gas and water, the annual increase in the volume of production of all industries seems unlikely to have exceeded 3 per cent.

The prospects for 1986 are for a significant improvement on the 1985 performance. Export growth in the modern industries should accelerate, although not to the rates achieved in 1983 and 1984. The adjustments in stock levels of finished products thought to have occurred in 1985 should be completed, if not reversed, and the growth in consumer expenditure should aid firms in the traditional sector of industry. With an assumed return to normal weather conditions, turf output should recover, while the modest upturn forecast for the volume of construction should be reflected in quarrying output. Also, if the expected minor recovery in manufacturing output in the 4th quarter of 1985 did take place, there would be a carryover of about 3 per cent into 1986 in the level of the industrial production index. It thus seems reasonable to predict an increase in industrial production of about 7 per cent for 1986 compared with 1985.

As discussed under the heading of investment, the volume of building output declined by about 4 per cent in 1985, but is expected to reverse the decline of recent years with an increase of some 2 per cent in 1986.

Services

The private service sector was boosted in 1985 by the rapid increase in tourism and by the upturn in retail sales activity. There appears to have been continued growth in the small, but expanding, export service sector, while despite some much publicised problems, the financial sector can be assumed to have increased both the value and the volume of its activity. There are no running indicators to help quantify the level of service activity, but it seems possible that the total output growth in 1985 of the private service sector, including semi-state service companies, lay in the region of 3 per cent.

There could be a similar increase in 1986, with a lower growth rate in tourism being offset by faster expansion in retailing and other services, including export services. With direct public services likely to decline marginally, apart from special employment schemes, the growth in total service activity could well be of the order of about 2 per cent in both 1985 and 1986.

Employment

Given the disappointing trend in industrial output in 1985, it is not surprising that total employment has fallen once again on an annual average basis. However, the unemployment figures suggest that the fall in total employment in the course of the year was minimal, with the expanding service sector almost offsetting a continued decline in industrial employment.

After the failure of employment expectations to be met in the past two years, it becomes increasingly difficult to express optimism concerning prospects for the coming year. Nevertheless, there are good grounds for believing that the employment decline of recent years has come to an end, and that 1986 will see a small increase in total employment. The fact that the relative stagnation in manufacturing output in 1985 appears to have been accompanied by a smaller decline in employment than the rapid output growth of 1984 suggests that the major shake-out in manufacturing employment may be coming to an end. If this is so, then recovery to even modest output growth in 1986 would see stability or a small rise in manufacturing employment during the year. As already discussed, some upturn appears likely in the volume of building output in the course of 1986, again implying at least an end to the fall in building employment. Further job creation can be expected in the private service sector, especially if another good tourist season strengthens confidence in the long-term future of the tourist industry. Finally, after a slow start, it seems that the social employment scheme is becoming operational and will be reasonably close to its target of providing an average of 10,000 part-time jobs in 1986.

For these reasons, Table 6 shows a forecast that the annual average of total employment in 1986 will increase by about ½ per cent, taking it to marginally below the 1984 level. However, the projected increase of 6,000 jobs is not enough to absorb the expected increase in the labour force, so that a small further rise in the average level of unemployment appears probable.

TABLE 6: Employment and Unemployment

A: Mid-April Estimates '000	1983	1984	1985	1986	1987
Agriculture	189	182	179	176	173
Industry	331	320	309	303	307
Services	605	608	613	622*	629*
Total at work	1125	1110	1101	1101*	1109*
Unemployed	184	204	222	234	238
Labour Force	1309	1314	1323	1335	1347
Unemployment Rate %	14.1	15.5	16.8	17.4	17.5
Live Register	188	214	228	237	241

B: Annual Averages '000	1983	1984	1985	1986
Agriculture	186	181	177	175
Industry	328	316	306	305
Services	606	610	617*	626*
Total at work	1120	1107	1100*	1106*
Unemployed	191	211	228	233
Labour Force	1311	1318	1328	1339
Unemployment Rate %	14.6	16.0	17.2	17.3
Live Register	193	214	231	237

* Including numbers estimated to be engaged in the Social Employment Scheme (7,000 in April 1986 and 9,000 in April 1987, 2,000 on average in 1985 and 8,000 average in 1986).

Incomes

It now seems likely that personal disposable incomes rose slightly faster in 1985 than was forecast in the October *Commentary*. Given the latest estimates of agricultural incomes and the higher than budgeted public service pay-bill revealed in the 1986 Estimates, it appears that both gross personal income and personal disposable income rose by about 7 per cent. It is, perhaps, noteworthy that 1985 is the first year in the current decade that direct personal taxation has not absorbed an increased proportion of gross personal income. With private consumer spending thought to have risen by about 7¼ per cent in value, only a marginal fall would appear to have taken place in the personal savings ratio.

As Table 7 shows, the rise in disposable income in 1986 is forecast to be slightly lower in nominal terms at 6½ per cent, but the expected fall in inflation converts this into a faster rise in real terms of 2 per cent, compared with 1½ per cent in 1985. The forecast composition of income increases between the two years differs more than the total. For 1986, it is assumed that agricultural incomes will recover from their fall in 1985, but that all other forms of personal income will grow more slowly in nominal terms than in 1985. With regard to the key item of non-agricultural wages, the detailed assumptions are that private sector pay rates, including the commercial semi-state sector, will average about 6 per cent more than in 1985, with average earnings rising by almost 7 per cent, and that public sector earnings will increase by about 6 per cent. These assumptions imply that new agreements reached during 1986 in the private sector will be considerably lower than those made in 1985, as the

TABLE 7: Personal Disposable Income

	1984 £m	Change %	Change £m	1985 £m	Change %	Change £m	1986 £m
Agriculture etc.	1,474	−7½	−109	1,365	5	68	1,433
Non-Agricultural Wages, etc.	8,753	7¾	681	9,434	6¼	591	10,025
Other Non-Agricultural Income	1,800	10	180	1,980	7½	149	2,129
Total Income Received	12,027	6¼	752	12,779	6¼	808	13,587
Current Transfers	2,894	10	289	3,183	7½	239	3,422
Gross Personal Income	14,921	7	1,041	15,962	6½	1,047	17,009
Direct Personal Taxes	3,123	6¾	211	3,334	6½	216	3,550
Personal Disposable Income	11,798	7	830	12,628	6½	831	13,459
Consumption	9,465	7¼	686	10,151	7	711	10,862
Personal Savings	2,333	6¼	144	2,477	4¾	120	2,597
Savings Ratio	19.8%			19.6%			19.3%

realisation of a low rate of price inflation permeates the labour market. They also imply that the forthcoming general agreement concerning public service pay will be only a little above the present government offer, and that a moderate compromise will be reached on the slow phasing in of outstanding special pay awards recommended but not yet implemented.

The forecast reductions in the rate of increase in other forms of personal income reflect the lower rate of inflation, reduced nominal interest rates and a slowdown in the process of transferring activity from employees to self-employed agents. The slower growth forecast for transfer income rests on the assumption that the rate of indexation of benefits in mid-1986 will be at about 4 per cent and also on the expectation of a much slower increase in the average level of unemployment in 1986.

While it appears that direct personal taxation, including social security contributions, increased by less than gross personal incomes in 1985, and certainly by less than the most tax-intensive income type of non-agricultural employee earnings, it is assumed that direct taxes will match the increase in gross personal incomes in 1986. If the personal savings ratio declines by about the same marginal proportion as in 1985, under the continuing encouragement of lower nominal interest rates, there would be room for the value of personal consumption to increase by about 7 per cent. However, the possibility of a greater decline in the savings ratio, as consumer confidence recovers, cannot be ruled out, in which case a stronger rise in consumption would become apparent during the year.

Consumer Prices

The virtual stability of the consumer price index between August and November 1985, when it rose by only 0.2 per cent, left the increase in the year to November at only 4.9 per cent and the annual average a little below 5.5 per cent. This is significantly below the level assumed in the October *Commentary*, and, like the balance of payments deficit, represents an important facet of economic performance which in 1985 was ahead of the target set in the National Plan.

On the mid-point assumptions made concerning exchange rates and oil prices, and on the further assumptions that the income forecasts in this

Commentary are broadly correct and that indirect tax rates are approximately indexed, it seems likely that the rise in the consumer price index in 1986 could lie between 4 and 4½ per cent. If allowance is made for part of the fall in oil prices to be recouped by a higher than indexation rise in hydrocarbon duties, then 4½ per cent appears a reasonable forecast for both the annual average and the November to November increase in the index.

Public Finances

The publication of the end year revenue returns shows that the current budget deficit, at £50 million above target, was very close to the level forecast in the October *Commentary*. Nevertheless, a deficit of £1,284 million or 8¼ per cent of estimated GNP was undoubtedly a disappointing result, involving as it did a deterioration of almost 1 per cent of GNP. Moreover, the nature of the increased deficit was worrying, with a modest underspending on central fund services and a higher than expected yield from non-tax revenue being more than offset by a shortfall in tax revenue of £123 million or over 2 per cent.

Some examination of this tax shortfall is necessary if projections for 1986 are to be soundly based. After a very heavy shortfall in the first quarter, income tax receipts recovered to the point that for the year as a whole they were only just over 1 per cent below budget. At a 7 per cent increase for the year, income tax revenue was roughly in line with personal income, although the composition of income increases and the failure to index all allowances in the budget might have led to expectations of a slightly higher yield. There could, thus, have been some lengthening in the average delay in tax payment in 1985. The fall in receipts from the income levies was due in part to changes in liability and in part to the fact that the 1984 totals were swollen by delayed payments from the previous year. With other direct taxes in line with or slightly above budget, the overall rise in direct taxation in 1985 was 6 per cent, a little above the rate of inflation although rather below the rate of income increase.

Indirect taxes on the other hand rose by only 4½ per cent, 1 per cent below the inflation rate and more than 2½ per cent below the increase in consumer spending. With the exception of motor vehicle taxes, none of the major indirect taxes matched the value increase in consumer expenditure, but the major shortfall involved VAT, which increased by only 3 per cent and ended the year some £80 million below budget. The budget changes in VAT tax rates on a number of products undoubtedly were responsible for a considerable proportion of this shortfall, but they can hardly be the sole explanation. The timing of VAT payments must also have gone awry, and this in turn is probably related to the unexpected check to import growth and thus to VAT receipts at point of entry.

Turning to 1986, and making the usual technical assumption that income tax thresholds and bands and specific rates of excise duty will be indexed to the rate of price inflation but that all other tax rates will remain unchanged, it seems likely that total tax revenue would rise by about 7 per cent. On direct taxation this involves the implicit assumption that the lag in tax collection will remain roughly constant, with neither a further deterioriation nor a significant recoupment of past delays. With regard to indirect taxes, it is assumed that excise duties will increase more or less in line with consumer spending and customs duties in line with the volume of imports. However, allowance is made for some "rebound" in VAT receipts as import growth resumes, taking the annual increase a little above the expected rise in the value of consumption.

Non-tax revenue rose by a remarkable 15½ per cent in 1985, more than double the budgeted increase. Similar special factors are unlikely to apply in 1986, and it seems prudent to assume no increase in non-tax revenue in 1986.

The 1986 *Estimates for Public Services* set out an expenditure on net current supply service (excluding departmental balances) of £5,698 million, an increase of 4.4 per cent on the 1985 outturn. However, as is normal practice, the Estimates make no allowance for any new increases in public service pay rates in the course of the year, nor for any additional exchequer contribution to the social welfare bill arising from increased benefit rates. Even a modest general pay agreement of 3 per cent from the middle of the year, would add about £40 million to the pay bill, while a phased implementation of disputed special awards already recommended could cost a further £20 million. A 4 per cent rise in all benefit rates from July could add some £30 million to the exchequer element of social welfare expenditure. Thus, on the basis of the published estimates and reasonable assumptions on pay and welfare increases, total net supply service spending in 1986 could reach £5,790 million, an increase of 6 per cent on the provisional 1985 outturn. Allowance for departmental balances would reduce this to about £5,730 million on a budget basis.

Given the dramatic changes which have taken place in exchange and interest rates in 1985, and the further changes which seem likely in 1986, it is clear that the rise in central fund expenditure in 1986 will be very much lower than in any recent year. However, it is difficult to predict accurately either the underlying movements in rates or their impact on the total national debt interest bill. On the assumptions underlying this *Commentary,* and on the assumption that new foreign borrowing in the course of 1986 will be lower than in 1985, it seems likely that there will be no increase in foreign debt interest in 1986 and a small fall is possible. The effect of falling interest rates on the cost of domestic debt servicing will be less dramatic as a higher proportion of such debt is in the form of fixed interest securities, but even here, the rise in 1986 could be limited to under 6 per cent. Allowing for an increase in contributions to the EEC, total central fund expenditure in 1986 could rise by about 4 per cent to about £2,300 million. This compares with an increase of almost 15 per cent in 1985.

On the basis of the Estimates and the assumptions discussed above, total revenue for 1986 would reach about £6,730 million and total net current expenditure around £8,030 million, leaving a current budget deficit of £1,300 million. This would be much the same absolute level as in 1985, although it would represent a reduction from 8¼ per cent to 7¾ per cent of GNP. Of course, these calculations are subject to some degree of error, and make no allowance for any changes, other than indexation, in either taxation or expenditure already planned for inclusion in the budget. However, they do serve to indicate that, even with favourable movements in exchange and interest rates, the budgetary position remains intractable, and that any reductions in the deficit are likely to remain small and slow.

Although the current budget deficit was £50 million above target in 1985, the total exchequer borrowing requirement remained almost exactly in line with target due to a shortfall of £50 million in the borrowing requirement for the public capital programme. With new borrowing by the semi-state sector below budgeted levels, the total public sector borrowing requirement was lower than anticipated, and roughly constant as a proportion of GNP.

The 1986 *Public Capital Programme* allows for a 6 per cent rise in the exchequer borrowing requirement for capital purposes, despite the fact that only ½ per cent increase in the value of the public capital programme is planned. On this basis, there would be an increase of some £70 million in the total exchequer borrowing requirement in 1986, which would reduce exchequer borrowing from the 13 per cent of 1985 to about 12½ per cent in 1986. On the reasonable assumption that borrowing for capital purposes will again fall short of the planned level, there could well be only a marginal increase in the nominal amount of exchequer borrowing, and a fall to about 12 per cent of GNP.

Given that total exchequer borrowing in 1985 exceeded requirements, this prospect of near stability in the total requirement in 1986 suggests that the actual amount to be borrowed could fall slightly. There would appear to be no difficulty in obtaining whatever funds are sought from abroad, although, of course, the long-term arguments against increasing the foreign debt remain valid. Thus, there seems no reason to expect that public funding requirements will place undue strain on the domestic capital market, and it is reasonable to assume that, once the current speculative flurry over the exchange rate has been resolved, domestic interest rates will resume their gradual downward trend.

General Assessment

Economic performance was very mixed in 1985, with substantial progress in relation to the balance of payments and inflation being offset by disappointing results with regard to employment and the public finances. Compared with the time path laid out in the National Plan, the country is ahead of schedule on the former two aims, but so far behind on both employment and the budget deficit as to cast serious doubt on whether the planned targets can be met in 1987 or even in 1988. To some extent, this slippage behind target is due to external factors. World output and trade have both grown more slowly than anticipated in 1985, thus reducing the opportunity for Irish industrial growth and restricting the incentive for additional investment in new manufacturing capacity. The dollar exchange rate and international interest rates both moved in the predicted direction during 1985, but rather later and from a considerably higher starting point than was assumed in the Plan. The main internal factor influencing the deterioriation in the public finances is that public service pay levels increased by considerably more than was allowed for in the Plan.

At first sight, it might appear as if the main effect of these factors is merely to delay the progress laid down in the Plan, so that reductions in the deficit take place some months later than scheduled. Unfortunately, the nature of compound interest is such that any delay in achieving a reduction in the budget deficit involves additional recurring interest charges on the initial extra borrowing. Thus, not only will the improvement come later, but it will also be smaller, as recurrent interest expenditure must be added to the originally planned outlays.

Seen in this context, the policy options for 1986 are particularly challenging. Should a vigorous attempt be made to get back to the path of the Plan, or should past accidents be acknowledged and the authorities be content merely to follow a delayed and slowly diverging time-path? What would not seem to be a realistic or responsible option would be to abandon any of the Plan's aims completely, and to change the direction rather than merely the pace of policy.

The macroeconomic forecast for 1986 presented in this *Commentary* suggests that on a continuation of present policies, economic growth will revive, but insufficiently to prevent a small further rise in unemployment, the balance of payments gain will be consolidated but not significantly augmented, and that the rate of price inflation will decline to 4½ per cent, permitting a rise of about 2½ per cent in the volume of personal consumption. These modest benefits are forecast to come about at the cost of allowing the current budget deficit to rise marginally, in nominal terms, which would represent an improvement of a mere ½ per cent as a proportion of GNP. On this path there would be no chance of a reduction of the deficit to 5 per cent of GNP by 1987, and the strain of attempting to reduce the total exchequer borrowing requirement towards the planned 10 per cent will continue to fall on the public capital programme.

Equally, however, the forecast illustrates some of the dangers that would beset an attempt to move back to the path originally set in the Plan by aiming for a radically reduced budget deficit in 1986. Whatever the long-term advantages, and they could be considerable, the immediate effects of severe additional cuts in public current spending or of substantially increased real tax-rates would be to inhibit the modest growth rate forecast and to cause unemployment to spiral upwards again in 1986.

A further short-term risk arising from such a policy could lie in the field of industrial relations. Implicit in the forecast presented is the assumption that the authorities will remain resolute in their determination to obtain a low increase in public service pay in 1986, and that as a result, settlements will be reached quite close to the present government bargaining position. It seems reasonable to expect that such an outcome can be reached while suffering only minor and isolated industrial disputes, which are unlikely seriously to affect the rate of economic growth. However, were the effort to reduce expenditure to result in the imposition of either a pay freeze or public service redundancies then the possibility of major disruptions, with the power to curtail other economic activity, would have to be faced. Again, the long-term consequences of such a show-down might, perhaps, be beneficial, but the short-term cost could prove unacceptably high.

The risks involved in attempting to revert to the size of budget deficit laid down in the Plan for 1986 would appear to be excessive. However, there is a strong case for using some of the windfall provided by more favourable interest and exchange rates to effect some reduction in the absolute level of the deficit. On balance, a reduction in the current budget deficit of about £50 million would seem a reasonable aim.

The situation would be eased were it possible somehow to increase the growth rate of the economy without additional fiscal stimulus in the form of a wider budget deficit. This, in turn, depends on more and better directed investment by the private sector. Unfortunately, the recent record of private sector investment has not been encouraging, and part of the slippage from the Plan's economic time-path has been due to the failure of private investors to take over a proportion of total capital expenditure let go by the reductions in the public capital programme. Whether additional grants or changes in the tax code to provide greater incentives to private investment would succeed in stimulating activity must remain a moot point. A case can be made for extending experiments in this direction so long as the measures are temporary and very little loss of revenue on existing activity is incurred.

Whatever the fiscal posture adopted for 1986, there can be no doubt that a further substantial reduction in real interest rates would be of assistance both to the public finances and to the general economy. To some extent, such a reduction depends on international trends, and to some extent, it depends on holding exchequer borrowing in check. However, as recent developments in the market demonstrate, it is also heavily dependent on exchange rate expectations.

The Dublin market appears to have decided that an early EMS realignment is inevitable, involving a significant revaluation of the Deutschmark against the Irish pound. While the expectation of a general EMS realignment had broad international acceptance during December, more recent trends indicate a lack of pressure on the French franc. Thus, a general realignment now looks improbable, and there is a reasonable prospect that the EMS will go through 1986 with unchanged parities. A unilateral devaluation of the Irish pound within the EMS remains both undesirable and unlikely, as the long-term costs of allowing the pound to be perceived as unstable would outweight the short-term costs of the temporary loss of competitiveness *vis-a-vis* sterling implied in this forecast. An early market realisation that a Deutschmark/Irish pound revaluation is neither imminent nor inevitable would allow domestic interest rates to resume the downward trend indicated by general economic conditions.

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
1979	100.9	101.2	10853	2067.8	226.7	238.3	101.0	101.5
1980	100.0	100.0	10733	1814.9	227.2	238.8	100.0	100.0
1981	102.7	101.6	10767	1812.5	220.7	232.3	105.5	104.5
1982	102.4	101.7	10792	1486.1	213.8	224.7	108.6	108.2
1983	110.0	108.6	11039	1382.4	201.0	211.3	124.2	122.8
1984	124.6	122.9	11424	1298.4	194.6	204.4	145.3	143.7
1985				1233.2				
Quarterly Averages or Totals								
1982 I	101.6	99.2	2954	335.2	217.2	228.1	106.0	103.9
II	108.5	108.2	2514	436.2	214.7	226.8	114.7	114.0
III	95.8	97.6	2425	405.9	213.5	224.2	101.8	104.0
IV	103.7	101.7	2899	308.8	209.7	219.6	112.2	110.7
1983 I	107.9	105.7	2990	298.1	203.0	212.9	120.7	118.6
II	113.1	110.9	2650	367.1	200.7	211.9	120.7	118.6
III	103.9	105.4	2470	371.5	201.4	212.0	117.0	118.0
IV	115.3	112.7	2929	345.7	198.8	208.3	131.6	129.0
1984 I	117.4	114.6	3136	271.5	195.7	205.2	136.0	133.6
II	132.6	132.4	2672	366.3	195.1	206.1	154.0	153.0
III	116.1	116.4	2562	350.0	195.2	204.4	135.0	136.0
IV	132.6	128.5	3054	310.6	192.2	201.1	156.5	152.7
1985 I	129.3	125.4	3259	241.3	187.5	196.3	156.5	152.7
II	136.0	132.6	2818	350.4	187.1	197.1	165.0	160.7
III	117.7	115.5	2705	333.1				
IV				308.3				
Quarterly Averages or Totals Seasonally Corrected								
1982 I	102.4	101.2	2677	388.2	218.4	229.7	106.4	105.3
II	102.3	102.1	2661	396.0	215.6	226.8	107.7	107.6
III	101.1	100.7	2731	371.4	212.6	223.1	108.0	107.9
IV	103.3	102.1	2721	324.0	208.6	219.1	112.6	111.3
1983 I	109.1	108.2	2715	358.3	204.1	214.5	121.3	120.6
II	106.5	104.5	2807	330.5	201.6	212.0	119.9	117.8
III	110.2	109.4	2769	342.7	200.5	210.9	124.8	124.0
IV	115.0	112.8	2757	358.5	197.7	207.8	132.0	130.0
1984 I	118.3	117.1	2848	326.5	196.8	206.7	136.4	135.4
II	125.0	128.4	2830	328.6	195.9	206.3	144.8	148.8
III	123.3	120.7	2870	322.5	194.2	203.8	144.2	141.5
IV	131.4	128.3	2880	316.9	191.5	201.0	155.8	152.5
1985 I	130.7	128.4	2955	292.3	188.6	197.7	157.3	155.2
II	128.5	125.5	2984	314.8	187.9	197.3	155.2	152.0
III	125.0	119.7	3030	304 7				
IV				311.2				

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. 1975 = 100	1980 = 100	1975 = 100	1975 = 100	1975 = 100	1975 = 100	
89.6	158.5	102.8	165.9	165.0	99.5	215.6	1979
101.5	187.3	100.0	195.6	179.5	91.8	212.0	1980
127.9	225.6	117.7	232.4	208.4	89.7	219.9	1981
148.2	264.2	128.2	249.4	231.5	92.8	179.9	1982
192.7	291.8	135.6	261.1	251.9	96.5	223.7	1983
214.2	316.9	139.7	286.5	271.2	94.7	296.1	1984
230.6						316.8	1985

Quarterly Averages or Totals

146.8	249.5	131.1	243.5	222.2	91.3	192.3	1982 I
149.0	263.9	130.9	248.4	231.1	93.0	174.6	II
159.0	269.5	126.5	254.0	235.0	92.5	175.5	III
171.6	273.8	126.5	255.6	238.3	93.2	178.3	IV
188.3	280.6	132.0	247.0	237.3	96.1	172.0	1983 I
188.1	288.3	133.7	254.5	247.7	97.3	206.1	II
193.0	296.5	138.8	268.8	257.0	96.7	249.7	III
201.3	302.0	138.5	275.3	263.3	95.6	267.2	IV
215.2	309.1	146.4	281.5	266.0	94.5	309.6	1984 I
210.8	316.2	149.8	283.7	269.8	95.1	314.9	II
212.6	320.1	136.1	294.3	276.6	94.0	280.7	III
218.1	322.3	135.2	297.9	283.3	95.1	279.1	IV
232.8	328.3	141.2	297.3	280.3	94.3	284.7	1985 I
226.5	332.7	139.4	300.6	288.0	95.8	289.4	II
231.8	337.6	133.9	298.2	290.3	97.6	333.3	III
231.2	388.1					359.8	IV

Quarterly Averages or Totals Seasonally Corrected

141.5	250.1	128.3	No Seasonal Pattern	No Seasonal Pattern	No Seasonal Pattern	No Seasonal Pattern	1982 I
150.5	263.1	128.4					II
162.1	269.1	128.5					III
172.4	274.6	129.9					IV
182.7	281.2	129.2					1983 I
189.8	287.4	131.1					II
196.2	295.9	140.9					III
202.2	302.9	142.1					IV
209.4	310.0	143.5					1984 I
212.4	315.4	146.9					II
215.8	319.4	138.1					III
219,0	323.3	138.7					IV
226.9	328.9	138.5					1985 I
228.3	332.0	136.8					II
235.2	336.7	135.9					III
232.3	339.3						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	1977 = 100	1977 = 100	Total	1980 = 100	1980 = 100
1979	271.3	271.1	107.9	107.9	95938	87.1	100.7
1980	321.2	321.0	108.1	108.1	91032	100.0	100.0
1981	373.8	372.6	104.4	104.2	104645	118.3	99.4
1982	419.1	419.8	100.0	100.2	72603	129.4	94.0
1983	468.3	469.2	101.1	101.4	61094	137.4	90.1
1984	423.8	525.1	104.1	104.5	5589	145.2	89.2
1985							

Quarterly Averages or Totals

1982 I	393.3	390.6	99.3	98.7	28114	124.4	95.3
II	417.6	423.0	99.7	101.1	21223	125.8	92.1
III	424.0	423.6	99.1	99.1	14012	128.3	91.6
IV	441.3	441.9	101.6	101.8	9981	137.4	96.1
1983 I	440.6	440.8	98.9	99.1	29851	135.5	92.0
II	458.4	463.1	100.2	101.3	12255	130.2	86.1
III	476.3	475.9	101.2	101.2	12110	135.4	87.6
IV	497.9	497.1	103.9	103.8	6878	148.5	94.8
1984 I	502.3	503.0	102.4	102.6	19263	139.8	87.9
II	518.5	523.8	103.3	104.5	18443	143.9	88.6
III	528.2	528.1	104.0	104.1	11708	143.5	87.3
IV	546.0	545.6	106.8	106.8	6479	155.8	93.7
1985 I	541.8	542.0	104.0	104.1	19914	147.6	87.5
II					19200	153.2	89.8
III					13050	155.2	90.1
IV							

Quarterly Averages or Totals Seasonally Corrected

1982 I	400.0	397.9	100.3	99.9	19083	124.8	95.5
II	418.5	418.2	99.5	100.3	18701	128.1	94.4
III	423.5	422.6	99.4	99.2	15862	130.5	93.4
IV	437.3	440.0	100.5	101.3	18786	132.1	91.9
1983 I	447.1	448.6	100.4	100.9	19953	136.7	92.5
II	456.3	457.8	100.0	100.2	10908	132.7	88.1
III	476.7	476.4	101.3	101.3	13824	137.6	89.3
IV	492.5	494.0	103.0	103.0	14599	142.0	90.4
1984 I	509.4	511.4	103.6	104.7	12752	141.3	88.5
II	516.9	517.9	102.9	103.2	16040	146.7	90.6
III	528.1	528.8	104.0	104.2	13644	146.0	89.1
IV	540.3	542.3	105.9	105.9	13105	149.0	89.2
1985 I	549.1	550.5	105.2	105.4	13184	149.3	88.1
II					16640	156.1	91.8
III					15344	158.0	92.0
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	
2384	2905	521	n.a.	1005.9	n.a.	974.7	1979
3155	3708	553	n.a.	1132.6	n.a.	1346.0	1980
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	1775.7	7493.8	2014.8	1983
5952	6991	1039	8473.9	2247.9	8127.6	2101.2	1984
6331	7615	1284					1985
Quarterly Totals			Monthly Totals				
1044	1437	393	n.a.	1334.1	n.a.	1406.0	1982 I
1176	1474	298	n.a.	1369.9	n.a.	1464.6	II
1184	1457	267	n.a.	1510.7	n.a.	1521.0	III
1505	1534	29	7291.0	1564.7	6655.1	1594.0	IV
1220	1646	426	7229.1	1499.9	6888.3	1235.1	1983 I
1405	1654	249	7345.5	1638.4	6904.8	1343.2	II
1440	1560	120	7439.7	1749.7	7302.1	1914.4	III
1646	1811	165	7697.4	1775.7	7493.8	2014.8	IV
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	8161.8	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				3009.6	III
1809	2004	195					IV
Quarterly Totals (S.C.)			Monthly Totals (S.C.)				
1116	1415	229	No Seasonal Pattern	No Seasonal Pattern	No Seasonal Pattern	1375.1	1982 I
1184	1465	281				1554.7	II
1233	1507	272				1528.6	III
1340	1515	195				1463.7	IV
1333	1604	271				1208.5	1983 I
1403	1650	247				1424.4	II
1491	1622	131				1920.2	III
1461	1749	333				2084.7	IV
1434	1666	232				2119.6	1984 I
1506	1688	183				2039.7	II
1501	1789	288					III
1498	1849	351					IV
1485	1915	430					1985 I
1619	1800	180					II
1605	1924	319					III
1607	1970	363					IV

	Visible Trade Indicators					Exchange Rates	
	30	31	32	33	34	35	36
	Imports (Value)	Exports (Value)	Import Excess (Value)	Imports (Volume)	Exports (Volume)	Effective Index	Sterling
	£m	£m	£m	1975 = 100	1975 = 100	Dec. 1971 = 100	Per IR£
1979	4817.5	3501.1	1316.4	170.3	146.5	77.08	0.9646
1980	5419.6	4130.9	1288.7	162.6	158.9	74.01	0.8862
1981	6578.4	4777.6	1800.8	166.0	158.3	67.75	0.8002
1982	6812.3	5687.9	1124.4	160.3	169.8	67.35	0.8125
1983	7355.0	6936.0	419.0	165.3	190.2	65.13	0.8222
1984	8913.5	8897.7	15.8	182.6	226.7	62.26	0.8134
1985							
Monthly Averages							
1982 I	597.7	411.2	126.4	172.8	153.3	67.71	0.8126
II	589.5	503.7	85.8	167.1	180.7	67.72	0.8171
III	532.5	475.0	57.5	147.6	173.2	66.88	0.8022
IV	550.8	506.5	44.3	151.7	176.3	67.10	0.8185
1983 I	585.8	471.5	114.3	167.1	164.8	69.46	0.8943
II	592.1	575.8	16.4	163.8	192.6	65.14	0.8171
III	602.4	606.8	—4.4	157.8	195.6	63.28	0.7894
IV	673.2	658.9	14.3	172.7	207.6	62.74	0.7896
1984 I	744.5	654.4	90.1	186.3	203.8	62.58	0.7951
II	715.0	769.9	—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	801.1	818.9	—17.8	189.3	239.7	62.04	0.8352
1985 I	820.6	800.3	20.3	194.4	236.6	61.95	0.8590
II	808.2	855.8	– 47.6	189.2	246.2	61.44	0.8075
III	740.7	795.3	– 55.6	174.8	227.0	62.15	0.7959
IV							
Monthly Averages. Seasonally Corrected.							
1982 I	586.8	436.4	143.9	169.7	163.4	No Seasonal Pattern	No Seasonal Pattern
II	573.3	500.5	72.8	163.7	181.3		
III	547.4	468.8	78.6	152.0	165.4		
IV	567.1	488.2	79.9	154.5	167.9		
1983 I	570.6	507.7	62.9	163.6	176.2		
II	577.3	565.9	11.4	160.9	191.1		
III	620.6	601.3	19.3	162.5	194.3		
IV	690.2	641.3	48.9	175.5	200.6		
1984 I	722.7	711.6	11.1	180.4	218.8		
II	699.8	741.6	—41.8	174.0	229.6		
III	725.9	711.3	14.6	174.6	213.9		
IV	833.7	800.8	32.9	196.9	233.5		
1985 I	792.4	862.1	—69.7	185.6	249.6		
II	795.6	817.8	—22.2	185.5	239.2		
III	774.3	792.7	—18.4	183.7	227.0		
IV							

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