

# QUARTERLY ECONOMIC COMMENTARY

DECEMBER, 1986

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## SUMMARY

Despite some recovery in exports in the final quarter, it now looks as if 1986 was a year of virtual economic stagnation, with GNP growing by only  $\frac{1}{4}$  per cent. Unemployment continued to rise in spite of apparently high emigration, and there was a slight deterioration in the public finances. Although inflation, as measured by the consumer price index, declined to an annual average of under 4 per cent and the current balance of payments deficit fell to about  $1\frac{1}{4}$  per cent of GNP, 1986 must be regarded as a very disappointing year for the economy, given the initial confident hopes of substantial growth.

The indications of increased economic activity towards the end of 1986 lend some encouragement to expectations that modest growth will resume in 1987. In particular, foreign direct investment in manufacturing industry appears set to increase, which, together with a renewed expansion in the volume of industrial exports, a recovery in tourism and some belated rise in personal consumption, could lead to a growth rate in GNP of about 2 per cent. Presuming that weather conditions return to what passes for normal, agriculture, industry and private services could all share in this growth.

This forecast of modest growth in 1987 has been made on the assumption that budgetary targets will be close to the levels proposed in the draft Budget, and that this could permit a limited fall in domestic interest rates in the course of the year. If there is no attempt to reduce the level of exchequer borrowing, it seems probable that these interest rates will remain significantly higher than has been assumed in this forecast. This could offset part of the stimulus given by a softer fiscal stance within 1987, and would damage the prospects for recovery in future years. It is not possible to provide a realistic set of forecasts for intermediate fiscal positions, as the reactions of the capital markets to government economic policy are obviously complex, with many more factors taken into account than the simple size of the borrowing requirement.

With a general election campaign in progress, it would be inappropriate to comment on the detailed proposals in the draft Budget. Nevertheless it is important that immediate action to bring about at least the improvement assumed here in the public finances should be a major element in the economic strategy of any incoming government. In the longer run, the creation of some unity of purpose, with interest groups accepting a degree of responsibility for national economic performance and the general public accepting the reality of economic constraints, could be the most vital contribution towards achieving a lasting national recovery.

**FORECAST NATIONAL ACCOUNTS 1986**  
**A: Expenditure on Gross National Product**

	1985		1986		Change in 1986			
	Preliminary Estimated				£m		%	
	£m	£m	Total	Volume	Total	Price	Volume	
Private Consumer Expenditure ...	9797	10292	495	147	5	3½	1½	
Public Net Current Expenditure ...	3290	3572	282	56	8½	6¾	1¾	
Gross Domestic Fixed Capital Formation	3597	3445	-152	-108	-4¼	-1¼	-3	
Exports of Goods and Services (X) ...	10740	10310	-430	100	-4	-5	1	
Physical Changes in Stocks ...	177	123	-54	-48				
Final Demand ...	27601	27742	141	147	½	0	½	
less:								
Imports of Goods and Services (M) ...	10347	9605	-742	55	-7¼	-7¾	½	
GDP at market prices ...	17254	18137	883	92	5	4½	½	
less:								
Net Factor Payments (F) ...	1992	1952	-40	59	-2	-5	3	
GNP at market prices ...	15262	16185	923	33	6	5¾	¼	

**B: Gross National Product by Origin**

	1985		1986		Change in 1986	
	Preliminary Estimated				£m	
	£m	£m	£m	%		
Agriculture, Forestry, Fishing ...	1346	1265	-81	-6		
Non-Agricultural: Wages, etc. ...	9323	9860	537	5¾		
Other ...	3189	3366	177	5½		
less:						
Net Factor Payments ...	1992	1952	-40	-2		
National Income ...	11866	12539	673	5¾		
Depreciation ...	1600	1680	80	5		
GNP at factor cost ...	13466	14219	753	5½		
Taxes less subsidies ...	1796	1966	170	9½		
GNP at market prices ...	15262	16225	963	6		

**C: Balance of Payments on Current Account**

	1985		1986		Change in 1986	
	Preliminary Estimated				£m	
	£m	£m	£m	£m		
X—M ...	393	705	312			
F ...	-1992	-1952	40			
Net Transfers ...	1050	1050	0			
Balance on Current Account ...	-549	-197	352			
as % of GNP ...	-3½	-1¼	2¼			

**FORECAST NATIONAL ACCOUNTS 1987**  
**A: Expenditure on Gross National Product**

	1986		1987		Change in 1987			
	Estimated £m	Forecast £m	£m		%			
			Total	Volume	Total	Price	Volume	
Private Consumer Expenditure ...	10292	10809	517	206	5	3	2	
Public Net Current Expenditure ...	3572	3768	196	- 18	5½	6	- ½	
Gross Domestic Fixed Capital Formation	3445	3610	165	70	4¾	2¾	2	
Exports of Goods and Services (X) ...	10310	10870	560	410	5½	1½	4	
Physical Changes in Stocks ...	123	158	35	34				
Final Demand ...	27742	29215	1473	702	5¼	2½	2½	
less:								
Imports of Goods and Services (M) ...	9605	10020	415	298	4¼	1¼	3	
GDP at market prices ...	18137	19195	1058	404	5¾	3¾	2¼	
less:								
Net Factor Payments (F) ...	1952	2070	118	87	6	1½	4½	
GNP at market prices ...	16185	17125	940	317	5¾	3½	2	

**B: Gross National Product by Origin**

	1986		1987		Change in 1987	
	Estimated £m	Forecast £m	£m	%		
					£m	%
Agriculture, Forestry, Fishing ...	1265	1328	63	5		
Non-Agricultural: Wages, etc. ...	9860	10378	518	5¼		
Other ...	3366	3612	246	7¼		
less:						
Net Factor Payments ...	1952	2070	118	6		
National Income ...	12539	13248	709	5¾		
Depreciation ...	1680	1764	84	5		
GNP at factor cost ...	14219	15012	793	5½		
Taxes less subsidies ...	1966	2113	147	7½		
GNP at market prices ...	16185	17125	940	5¾		

**C: Balance of Payments on Current Account**

	1986		1987		Change in 1987	
	Estimated £m	Forecast £m	£m	£m		
					£m	%
X—M ...	705	850	145			
F ...	- 1952	- 2070	- 118			
Net Transfers ...	1050	1060	10			
Balance on Current Account ...	- 197	- 160	37			
as % of GNP ...	- 1¼	- 1	¼			

## COMMENTARY

### **The International Economy**

#### *General*

On balance, 1986 must be accounted a disappointing year for the world economy. Although inflation rates fell substantially, both output and trade growth were little higher than in 1985, despite early expectations that they would show a significant improvement. The collapse of oil prices and the weakness of other commodity prices presented the industrialised nations with a terms of trade gain equivalent to over 1 per cent of GNP, but they were slow to respond to this through rising volumes of consumption and investment. Conversely the oil exporters and other developing commodity producers adjusted quickly in reducing investment and imports. Thus the early part of the year showed little or no growth, and only a pick-up in the later months enabled the mediocre performance of 1985 to be matched in 1986.

The process of adjusting to low energy and commodity prices was complicated by the need simultaneously to adjust to major changes in currency parities, in particular the massive depreciation of the dollar against the yen and the mark. The failure of US exports and production to respond favourably to the lower value of the dollar has tended to undermine confidence both in the American economy and in the present set of exchange parities.

Thus several uncertainties surround international economic prospects for 1987. On the one hand the consumer boom in developed countries should still possess considerable strength, even with a partial recovery in oil prices, and can be expected to exert a favourable influence on investment levels. On the other hand trade patterns could be further upset by currency movements, and it is not at all clear whether the expected improvement in the US trading performance will be sufficient to offset the deflationary effects of a tighter US fiscal stance. In these circumstances, the OECD is projecting increases in world output and trade similar to those achieved in 1985 and 1986, with little change in unemployment levels in the developed countries. However, given the uncertainties and conflicting influences, the out-turn could be significantly better or worse than currently forecast.

#### *The US Economy*

The US growth rate in 1986 was about 2½ per cent. The main stimulus was strong consumer spending, facilitated by a substantial rise in real incomes.

Price inflation slowed dramatically to an annual average of  $2\frac{1}{4}$  per cent, with the November to November increase only 1.3 per cent. Aggregate employment grew by about 3 million, so that unemployment rates fell slightly despite increased labour force participation. However, with import volumes increasing by more than 10 per cent, in spite of the lower dollar, industrial production remained almost stagnant and manufacturing was one area where employment declined.

The outlook for 1987 is mixed. The tighter fiscal policy designed to reduce the federal deficit could in itself reduce the growth rate by almost 1 per cent of GNP. At the same time, changes in tax allowances could have an adverse effect on investment, and an acceleration in inflation, resulting from lagged effects of the dollar depreciation and from the recovery in oil prices, could restrict the growth in real personal consumption. Against this, domestic economic confidence appears to remain high, and monetary policy is expected to stay relatively easy, with perhaps some further fall in interest rates. The main positive factor however remains conjectural. This is the possibility that 1987 will witness a belated response to the dollar depreciation since mid-1985 in terms of an improved trade performance. Although agricultural exports seem likely to stay weak, there should eventually be some volume increase in industrial exports and at least a diminution in the rate of growth of imports. Provided that this does come during 1987, the US growth rate should at least match that in 1986 and could be higher. If the trade improvement does not occur, the US economy will tend to stagnate, while protectionist pressure will mount once more.

#### *The European Economy*

After a disappointingly slow start, European economic activity picked up in the course of 1986. In most countries consumption was the main form of growth, as real disposable incomes rose with falling inflation. Slightly easier monetary policies accommodated this expansion, but there was no additional stimulus from fiscal policy, which remained restrictive almost everywhere. The expansion in consumption stimulated import volumes, and also trade within Europe, but external exports, especially to the oil producing countries, fell sharply, thus restricting the growth in GNP to about  $2\frac{1}{2}$  per cent in the EEC as a whole, little more than in 1985.

Provided the rise in oil prices is fairly modest, the growth in consumption volumes should remain quite strong in 1987. Although price inflation is likely to be somewhat higher than in 1986, it will still lag well behind the rise in money earnings, so that disposable incomes will show another significant increase. The growing domestic market, combined with improved profitability during 1986, can be expected to encourage an upturn in industrial and commercial investment during 1987, the early signs of which were already apparent during the later part of 1986. Exports from Europe are likely to remain comparatively weak, however, and this will probably hold back the rise in GNP in the EEC to less than 3 per cent, little higher than in 1986. With West Germany still resisting external pressures for a significant easing of either fiscal or monetary policy, most other EEC countries will also maintain tight policies, either from choice or to protect currency parities within the EMS.

As usual, the UK is something of a special case within the EEC. Because of the depreciation of sterling, UK inflation remains considerably higher than in most Continental countries, and the disparity seems likely to widen further in 1987. Fiscal policy has eased noticeably in recent months, and is expected to become even easier during 1987. If the sale of public assets is treated properly, as the equivalent of borrowing rather than as a form of current revenue, the general budget deficit seems likely to increase to almost 3½ per cent of GDP.

With the rapid expansion seen in 1986 in consumer and housing expenditure likely to continue, and with export volumes perhaps responding favourably to the depreciation of sterling over the past 18 months, final demand in the UK will grow quite strongly in 1987. However, imports also are likely to continue their rapid increase, so that the increase in GNP is unlikely to exceed 3 per cent, while the balance of payments deficit which emerged in the later months of 1986 is set to widen during 1987. In order to prevent too rapid a depreciation of sterling under conditions of rising inflation and a deteriorating current balance, UK interest rates are expected to remain high throughout the year.

Agriculture will once again be a major area of weakness for the EEC as a whole in 1987. The recent steps to reduce milk production will have a depressing effect on agricultural output, but stocks of milk products, meat and cereals could continue to grow in 1987 although at a slower rate than in recent years. Disposal of surplus production could again be difficult, given low incomes in many potential markets and the prospect of either a trade-war with the USA or a negotiated agreement involving substantial concessions.

#### *The Rest of the World*

There were major changes in fortune in the remainder of the world during 1986. The most obvious was the massive fall in the incomes of oil exporting countries due to the oil price collapse. Non oil-producing developing countries benefited from the lower oil prices, although by less than the industrialised countries as their dependence on oil is lower. Reduced international interest rates and the weaker dollar also tended to benefit the debtor developing countries, but weak commodity prices were an adverse factor.

**TABLE 1: Short-term International Outlook**

Country	GNP % Change		Consumer Prices % Change		Hourly Earnings % Change		Unemployment Rate %		Budget Deficit as % of GNP		Current Account Balance as % of GNP	
	1986	1987	1986	1987	1986	1987	1986	1987	1986	1987	1986	1987
United States	2½	3	2	3½	3	3	7	6¾	3½	2¼	3¼	3
Canada	3	3	4¼	4	3½	3¼	9¾	9½	5½	5¼	-1½	-1
Japan	2¼	2¾	¾	0	3½	3	2¾	3¼	1½	1½	4¼	3¾
West Germany	2½	3	-¾	¾	3¾	3¼	7¾	7½	1	1	3½	2½
France	2	2¼	2¼	2	4	3	10½	11¼	3	2½	½	¼
UK	2¼	2½	4	4½	8	7	11¾	11½	3	3¼	0	-¾
Italy	2¾	3¼	6	4	7½	6	11¼	11½	12½	11¾	1	½
Belgium	2	2	1¼	1½	3	2¼	11¼	11¼	9½	7½	3¼	4
Denmark	2¾	½	3¼	2¾	4¼	5½	7¾	8½	-3	-2½	-5¼	-3
Netherlands	1½	1½	0	-1	2	1¾	13½	13	6½	6¾	4¼	3½
Sweden	2¼	1¼	4	4	7	5	2½	2¾	1	¾	1¼	1
Total (OECD)	2½	3	2¾	3	4	4	8½	8¼	3¼	3	-¼	-¼
Ireland	¼	2	3¾	3¼	6¼	5	18¼	18¾	8½	7½	-1¼	-1

Sources: OECD, NIESR, European Economy, London Business School *Economic Outlook*.

Among the more developed countries, Japanese output suffered from the strong appreciation of the yen, reducing the growth in GNP in 1986 to under 2½ per cent. Export volume growth was stagnant, but the massive gain in the terms of trade allowed the current account surplus to climb to a new record level. In contrast to Japan, those newly industrialised countries, such as Taiwan and Korea, which allowed their currencies to depreciate almost in line with the dollar enjoyed a large increase in export volumes.

Assuming that OPEC can enforce its new policy of stabilising oil prices at around \$18 per barrel, there should be a modest increase in the income of oil producing countries during 1987. However, it would seem unlikely that this will result in any major resumption of investment or that import levels will rise much above 1986 levels. Non-oil developing countries are likely to remain depressed in 1987, with little increase in commodity prices and only a limited amelioration in effective interest rates.

Some recovery is expected in the Japanese growth rate, as the successive easing of monetary policy during 1986 works through to reinforce low inflation and mild fiscal measures in stimulating domestic demand. The newly industrialised countries could face protectionist measures from the USA, and might also find commercial forces tending to push up the value of their currencies. On the other hand their penetration of the European market could well intensify, and overall they can be expected to maintain growth rates faster than most of the established industrialised countries.

#### *The Context for Ireland*

As should be clear from the foregoing discussion, there are major uncertainties as to how the external environment will develop during 1987. As they affect Ireland, these are principally concerned with price trends, exchange rates, interest rates, trade patterns, and the volume of new international investment.

While it seems fairly certain that most commodity prices will remain low, there is obvious doubt as to how oil prices will evolve during the year. The recent OPEC agreement appears to have succeeded in the short-term in its aim to bring oil prices up to a level of about \$18 per barrel. However, the futures markets appear to reflect a considerable scepticism as to whether this level can be held once the winter period of peak demand has passed. The exceptionally severe weather in most of Europe is likely to have the effect of boosting oil consumption and reducing the high level of oil stocks built up during 1986. Thus, provided that OPEC can maintain discipline later in the year, it now seems quite possible that earlier expectations of a new fall in prices during the late Spring will prove ill-founded. For the purpose of this Commentary, an average price of \$18 is assumed for 1987. It is worth pointing out that in fact this would result in the average prices of oil imports in 1987 being only a little above that in 1986 as a whole, although of course well above the level reached in the late Summer.

Exchange rates have proved impossible to predict with even an approximate degree of accuracy in the past few years. At present it appears that the dollar remains under some pressure, and that sterling both reflects the potential weakness of the dollar and suffers from independent worries concerning the UK economy. On the basis of internal factors such as relative inflation rates

between member countries, present EMS parities appear reasonably stable, but experience shows that any significant depreciation of the dollar creates strains within the EMS. With the growing dominance of non-trade transactions in the currency markets, exchange rate fluctuations tend to reflect market expectations of future currency movements. In the short, and even medium, run, expectations appear to be only tenuously related to underlying trends in trade and economic performance. Market sentiment has proved volatile in recent years, and is likely to remain so. Thus the exchange rate outlook could appear quite different in a few months time. However, for the purpose of this *Commentary* it is assumed that there will be little change during 1987 from the pattern of exchange rates currently obtaining, and that in particular there will be no further EMS realignment.

No dramatic changes are expected in international interest rates in 1987. There could be marginal declines in nominal rates in the US, and perhaps also in Germany, and, if oil prices do not fall, in the UK. However, while changes in nominal rates are likely to be minor, the decline in real interest rates could be rather more substantial as inflation tends to rise in most countries.

Although the volume of total world trade is forecast to increase only modestly in 1987, imports of manufactured goods, particularly in Europe, seem fairly certain to grow quite rapidly. So far as continental Europe is concerned successive movements in EMS parities over the past 12 months should ensure that Irish manufactured exports are more competitive than in 1985 or most of 1986. With regard to the UK, the depreciation of sterling has clearly damaged competitiveness compared with recent years, but if sterling does maintain roughly its present value, 1987 should see little deterioration compared with 1986. Indeed, as the year progresses the higher rate of inflation probable in the UK could lead to a marginal improvement in Irish competitiveness, provided domestic cost increases are held to a low level. With the total volume of UK imports likely to rise quite sharply, prospects for some increase in Irish industrial exports to the UK appear reasonable. The main area of disquiet for 1987 concerns agricultural exports, where very difficult conditions world-wide seem likely to prevail.

The most hopeful development in the international environment from Ireland's point of view is that there could well be a significant upturn in the volume of investment by multi-national companies. There is some evidence that this got under way in the later part of 1986, and indeed the IDA reports that Ireland has already begun to obtain a share of this increased spending. The nature of the economic growth expected in 1987, with European consumption one of the most rapidly expanding elements, appears favourable for a continuation of this trend in 1987. While it would be rash to predict a return to the levels of foreign direct investment enjoyed at the beginning of the decade, there does seem a reasonable chance that such investment will begin to recover from the trough of recent years.

## THE DOMESTIC ECONOMY

### *General*

Although 1986 was an exceedingly disappointing year for the economy, with little growth and declining employment, there are signs that the final months of the year may have seen a minor recovery. Led by a renewed expansion in electronics, manufactured exports moved above their corresponding 1985 values in October and November. Impressionistic reports suggest that consumer spending was buoyant in December, while the accompanying improvement in VAT receipts means that the deterioration in the public finances has been less severe than was feared during the Autumn.

Facing into 1987, the immediate questions appear to be whether exports will continue to grow, whether the recovery in consumption will be maintained and whether investment will begin to emerge from its long depression. Only if all three questions receive a favourable answer is there any real prospect of mitigating the fall in employment and creating the conditions where it could eventually begin to recover. The external environment contains many uncertainties, but the balance of probabilities is that it should be moderately favourable. The more vital uncertainties concern internal developments, and in particular the course of domestic interest rates. So long as real rates of interest remain at their present levels, private capital investment is unlikely to recover significantly and consumption will also be constrained. While currency speculation and the high level of interest rates in London are both factors tending to keep Irish rates high, the state of the public finances also exerts a major influence. The greater the projected cuts in the current budget deficit and the exchequer borrowing requirement, and the firmer the confidence that any projected cuts will in fact be achieved, the sooner and further domestic interest rates are likely to be reduced. Thus to some degree, fiscal and monetary influences on economic growth could cancel each other in the short run. The deflationary impact of a tighter fiscal stance could be partly offset by the expansionary effects of lower interest rates, while any stimulus from a weaker fiscal position could be impaired by the depressing effects of higher interest rates.

In order to construct a central forecast for this *Commentary* the draft Budget has been taken as the basis of the fiscal policy assumption. Although the precise details of the proposals may not be implemented by any incoming government, it is assumed that the overall balance would be maintained. It is further assumed that the proposed reduction in the exchequer borrowing requirement will enable domestic interest rates to fall significantly after the first quarter. However, the likelihood that UK interest rates will remain high will limit the extent of any fall.

The possible consequences of varying these assumptions, and in particular of allowing the public finances to show no improvement, will be discussed in the general assessment at the end of the *Commentary*.

### *Exports*

With trade statistics available for the first eleven months and preliminary balance of payments estimates for the first three quarters, it seems probable

that exports of goods and services in 1986 amounted to some £10,310 million. This represents a decline of about £430 million, or 4 per cent, in value compared with 1985, and is the first fall in the value of exports since the 1950s. This outcome resulted from a major fall in export prices coinciding with a period of abnormally weak growth in export volumes. As Table 2 indicates, visible exports grew by under 2 per cent in volume while their average price appears to have fallen by almost 6 per cent. At the same time the volume of tourist earnings appears to have declined by about 11 per cent, if the consumer price index is used to deflate preliminary value estimates.

The recovery in manufactured exports in the later months of 1986, and particularly the renewal of strong growth in exports of electronic equipment, raises hopes that 1987 could see a substantial increase in both the volume and the value of manufactured exports. However, until there is evidence of a more sustained upturn, it is prudent to limit the forecast rise in such exports to 4¼ per cent in volume and 5¼ per cent in value. With the massive price declines of 1986 likely to have ended, increases are projected for both the volume and value of other industrial exports. After their mixed performance in 1986, when meat exports were buoyant, but dairy exports were extremely weak, it is difficult to predict the course of agricultural exports in 1987. The volume of meat exports will be reduced, because of lower availability, but the value could be maintained if the shift towards more developed markets, which was observed in 1986, continues. It is possible that the reduction in milk output in other EEC countries due to the intensified superlevy will provide an opportunity for higher Irish butter exports to Europe in 1987, but it seems more probable that such a development could take place in 1988 or 1989. In the meantime, the lack of income in third world markets and the continuing trade dispute between the EEC and the USA will continue to make disposal of surplus dairy products difficult. For the purpose of this forecast it is assumed that Irish dairy exports will be only slightly less depressed in 1987 than in 1986.

After the disappointment of 1986, a recovery in tourist revenue seems probable. Provided that there is no major political disturbance to the international travel market in 1987 the number of American visitors to Europe should be substantially higher than in 1986. However, because the decline in the dollar has made foreign holidays dearer, American tourist numbers are not expected to reach the 1985 level. The most interesting question with regard to

**TABLE 2: Exports of Goods and Services**

	1985	% Change		1986	% Change		1987
	£m	Volume	Value	£m	Volume	Value	£m
Agricultural	1781	-2½	-4	1710	0	2½	1753
Manufactured	6280	2¾	-2½	6120	4¾	5¾	6472
Other Industrial	1556	3	-7½	1438	4	5¼	1514
Other	126			112			120
Total Visible	9743	1¾	-3¾	9380	3¾	5	9859
Adjustments	-216			-230			-215
Merchandise Exports	9527	1¾	-4	9150	4	5½	9644
Tourism	691	-11	-7½	640	4½	7½	688
Other Current Receipts	522	3	-½	520	2	3½	538
Exports of Goods and Services	10740	1	-4	10310	4	5½	10870

1987 is whether the reductions in air and sea access fares will lead to a major expansion in the number of visitors from Europe in general and the UK in particular. At the present time, before most bookings for the coming season have been made, it seems sensible to be fairly cautious about this and to project a moderate rather than a massive increase in the number of visitors from the UK and the Continent. Thus total tourism earnings are forecast to increase by about 7½ per cent in value, leaving them close to the level achieved in 1985.

It is not yet clear how far the apparent check to the increase in the value of other export services in 1986 was due to price effects consequent upon exchange rate movements. Assuming that there were considerable price effects so that the stagnant value concealed a continuing rise in volume, then in the calmer price environment expected in 1987 there could once more be a moderate increase in both the volume and value of other service exports. This would leave the increase in total exports of goods and services at about 4 per cent in volume terms and about 5½ per cent in value.

### *Stocks*

As always at this time of year, one of the principal gaps in the data concerning economic performance in the year just ended is in relation to industrial stock levels. Comparison of import volumes with exports and consumer spending can provide only the most tentative indications of stock movements, which in the past have frequently proved to be mistaken when the results of the CSO stock survey become available in the National Accounts. With this caveat in mind, it is assumed that there was a small increase in the rate of stock-building in the industrial and distributive sectors in 1986 compared with 1985. For 1987, with the level of general economic activity expected to be rather higher, another small increase in the rate of stock-building in these sectors is forecast, as shown in Table 3.

Despite the curtailment of milk output in 1986, intervention stocks of butter grew rapidly although stocks of meat and cereals were reduced. A much slower stock increase is forecast for 1987, based on the expectation that a somewhat higher proportion of milk products will be directly exported, and on the likelihood that the lower number of cattle slaughterings will be reflected in smaller intervention and assisted private meat stocks.

Partly in response to weather conditions, but mainly due to the effect of the Superlevy on the size of the dairy herd, total cattle numbers declined very sharply in 1986. A further fall in livestock numbers is expected in 1987, although the rate of decline should be much less than in 1986.

**TABLE 3: Stock Changes**

	1985 £m	Change in Rate £m	1986 £m	Change in Rate £m	1987 £m
Livestock on Farms	-31	-60	-91	+71	-20
Irish Intervention Stocks <sup>1</sup>	105	-14	91	-66	25
Other Non-agricultural Stocks	103	+20	123	+30	153
Total	177	-54	123	+15	158

<sup>1</sup>Including subsidised private storage.

### *Fixed Investment*

It is clear that 1986 was the fifth successive year in which the volume of gross domestic fixed capital formation declined. The fall was particularly acute in building and construction, the volume of which is believed to have declined by about 5½ per cent. The reduction in the volume of investment in machinery and equipment was less pronounced, but overall fixed investment appears to have fallen by 3 per cent in volume and by 4¼ per cent in value.

Unless interest rates fall faster and further than expected, it seems unlikely that 1987 will see a significant recovery in building output. Construction of Local Authority housing will show a large decline, on the basis both of starts in 1986 and of the general shrinking of waiting lists for such accommodation. Private house-building could increase during 1987, but there is no sign yet that a major expansion is imminent. Provided that interest rates do decline as expected and that there is some general growth in the economy, a recovery in the second half of the year could bring the annual total of new private houses constructed to some 3 per cent above the depressed 1986 total. This would however still imply a fall of about 2 per cent in total new housing.

Investment in new industrial building is expected to increase significantly, and it seems possible that a fall in interest rates could encourage a modest increase in the volume of new commercial building. Agricultural investment in new building seems likely to remain extremely low. The main imponderable is the level of investment in social infrastructure, such as roads, schools and hospitals, as this depends on essentially political decisions. On the basis of the draft Budget it is assumed that the volume of public capital expenditure on building and construction investment actually undertaken in 1987 will show a small decline compared with 1986. Overall, investment in building and construction is forecast to fall by about ½ per cent in volume and to increase by about 2½ per cent in value.

The prospects for investment in machinery and equipment in 1987 are considerably brighter than for building and construction. The increase in approvals reported by the IDA in 1986 should be translated into capital spending during 1987, while the probable reduction in interest rates should also encourage the replacement of medium-term assets. Provided that both exports and personal consumption grow as expected during the year, the upturn in industrial and commercial investment seems likely to be consolidated, with expenditure growing as the year proceeds. Thus, as shown in Table 4, investment in machinery and equipment is forecast to increase by 4 per cent in volume and 6½ per cent in value. If this increase takes place, it will outweigh the small decline in building and construction and lead to the first rise in the volume of fixed capital formation since 1981.

**TABLE 4: Gross Fixed Capital Formation**

	1985		% Change		1986		% Change		1987
	£m	Volume	Volume	Value	£m	Volume	Volume	Value	£m
Building and Construction	1521		-5½	-1½	1500		-½	2½	1538
Machinery and Equipment	2076		-1¼	-6½	1945		4	6½	2072
Total	3597		-3	-4¼	3445		2	4¼	3610

### *Consumption*

Although the retail sales index shows that the volume of retail sales was virtually unchanged between the first 9 months of 1985 and 1986, there are firm grounds for concluding that there was, in fact, an increase in the volume of personal consumption during 1986 as a whole. Reports of buoyant retail spending in December are too widespread to ignore, even if the extent of the improvement will not be known for some time. It also seems probable that the non-retail elements of consumer spending have increased significantly. Certainly the balance of payments estimates for the first three-quarters of the year show a 20 per cent increase in the value of tourist spending abroad, most of which must be accounted for by an increase in volume rather than prices. In total therefore it is estimated that personal consumer expenditure grew by about 1½ per cent in volume in 1986. If the increase in the consumer price index of 3.9 per cent is applied to this, it implies a rise of 5½ per cent in the value of personal consumption. However, in each year since 1981 the implied deflator of personal consumption in the National Accounts has been lower than the change in the consumer price index in that year. Due largely to the difference in the treatment of housing costs between the National Accounts and the consumer price index it seems more than likely that this situation will obtain once more in 1986. Thus a deflator of 3½ per cent appears more appropriate, leaving the increase in the value of personal consumer expenditure at just over 5 per cent. Such an increase in turn, fits in well with what is known about incomes in 1986 and with reasonable assumptions concerning a modest fall in the personal savings ratio.

The likely course of private consumption in 1987 will be primarily determined by changes in nominal and real incomes, although there should be another fall in the personal savings ratio. Thus, the value of personal consumption seems likely to rise by about 5 per cent. With the personal consumption deflator expected to increase by some 3 per cent on an annual basis, the volume of personal consumption could thus show an increase of about 2 per cent in 1987.

Public consumption, or public authorities' net expenditure on current goods and services to give it its National Accounts title, is thought to have risen by about 8½ per cent at current prices and by 1¼ per cent at constant prices in 1986. Both the volume rise and, more especially, the implied price deflator are significantly higher than was allowed for in the 1986 Budget. The deflator, of course, relates in large part to pay rates, and thus has been influenced by special pay increases coming into force in 1986.

It appears from the Book of Estimates that expenditure cut-backs have been concentrated in the areas of transfers and subsidies. On this basis it is assumed that public authorities' net expenditure on current goods and services will increase by about 5½ per cent in 1987. Because of the large increase in public service pay rates, the deflator for government consumption is likely to be about 6 per cent, implying a fall of ½ per cent in the volume of government consumption.

### *Final Demand*

Both the value and the volume of final demand appear to have risen by about

½ per cent in 1986. This very unusual outcome is the result of the fall in average export prices counterbalancing a moderate rise in the prices of the domestic elements of final demand, so that the effective deflator is zero.

For 1987, most prices are forecast to rise again, albeit modestly, so that once more the value of final demand should rise faster than the volume. More significantly, the volume growth is forecast to improve to 2½ per cent from the ½ per cent achieved in 1986. Growth rates of 4 per cent in exports of goods and services, 2 per cent in personal consumption and 2 per cent in fixed investment are forecast to outweigh the ½ per cent contraction assumed in government consumption. Such a composition of growth in final demand could be expected to be moderately, but not extremely, import intensive.

### *Imports*

The value of visible imports continued to run well below the corresponding 1985 levels throughout 1986. For the year as a whole the decline in the value of visible imports was 9 per cent. On the basis of monthly unit value price indices it appears that the entire fall in import value was due to lower prices, leaving import volumes basically unchanged from 1985. In composition, there were volume increases in imports of consumer goods and materials for agriculture, offset by reductions in the volume of imports of capital goods and industrial materials.

Service imports rose sharply in 1986, with tourist spending abroad in particular showing a value increase of about 20 per cent. In fact it could be argued that overseas travel was the first beneficiary of the higher disposable incomes which had been expected to boost the volume of domestic retail sales. In total it seems likely that imports of goods and services grew by about ½ per cent in volume in 1986, although the fall in import prices converted this to a decline of 7¼ per cent in value terms.

The expected upturn in investment in plant and machinery in 1987 seems likely to result in a fairly substantial volume increase in capital goods imports. More buoyant manufactured exports are likely to be reflected in a higher volume of imports of industrial materials, especially as industrial stock-building, other than of oil, may increase somewhat. With consumer goods imports continuing to expand, but materials for agriculture perhaps showing

**TABLE 5: Imports of Goods and Services**

	1985	% Change		1986	% Change		1987
	£m	Volume	Value	£m	Volume	Value	£m
Capital Goods	1253	-4½	-9	1138	4	6	1206
Consumer Goods	2318	7	0	2318	3¼	4½	2421
Intermediate Goods:							
Agriculture	455	5	-5½	430	-4	-4½	411
Other	5376	-2½	-13	4672	3½	4½	4882
Other Goods	30			22			25
Total Visible	9430	0	-9	8580	3¼	4¼	8945
Adjustments	-58			-65			-70
Merchandise Imports	9372	-¼	-9¼	8515	3¼	4¼	8875
Tourism	399	16	20¼	480	2¼	5¼	505
Other Services	576	2½	6	610	3	5	640
Imports of Goods and Services	10347	½	-7¼	9605	3	4¼	10020

some volume reduction, the volume of visible imports is forecast to grow by about  $3\frac{1}{4}$  per cent in 1987.

The course of import prices during 1987 is obviously a matter of some conjecture, but on the assumptions that crude oil prices will stabilise at around the \$18 per barrel proposed by OPEC and that currency movements will be relatively minor, some increase in average import prices can be expected. However, the extent of the fall during 1986 was such that only a minor increase in the annual average is likely in 1987, with some prices remaining lower than their 1986 average. Overall, an increase of about 1 per cent in the annual average of import prices is forecast, leaving the rise in the value of visible imports at about  $4\frac{1}{4}$  per cent.

After its massive jump in 1986 a further modest growth in tourist spending abroad is forecast, roughly in line with the overall rise in consumer spending. As in the case of overseas visitors to Ireland, however, it could be that this projection makes inadequate allowance for the effect of lower fares between Ireland and the UK. With another steady rise in imports of other services assumed, total imports of goods and services are projected to increase by 3 per cent in volume and  $4\frac{1}{4}$  per cent in value.

#### *Balance of Payments*

On the basis of preliminary balance of payments figures for the first three quarters and of probable trends in the fourth quarter, it seems likely that the overall balance of payments on current account for 1986 will show a deficit of about £197 million, or  $1\frac{1}{4}$  per cent of GNP. This represents an improvement of £352 million, or  $2\frac{1}{4}$  per cent of GNP, compared with 1985. Although most of the reduction in the deficit can be attributed to a higher surplus on merchandise trade, largely the result of an improvement in the terms of trade, it is also significant that for the first time since they turned negative there has been a fall in the value of net factor outflows. This is due in part to a reduction in the cost of interest payments on the external national debt because of the decline in the dollar and lower international interest rates, and partly due to a check in the rise of the Irish pound value of profit expatriation. Contrary to expectations earlier in the year that there would be a fall in the level of transfers, especially from the EEC, it now appears as if there was little or no change in net transfer receipts in 1986.

The forecasts for exports and imports suggest that in 1987 the surplus on visible trade will increase from £800 million to about £915 million, and the surplus on trade in goods and services from £705 million to £850 million. Net factor outflows are likely to increase again, but the rise is expected to be quite limited. The carryover effects of currency and interest rate changes in 1986 will help to keep down interest payments in the first quarter, in spite of the additional foreign borrowing in 1986. Profit and related payments should also show only a moderate increase on an annual basis, as the lower value of the dollar will keep profit rates in some industries relatively low and the flat profile of payments in 1986 will limit the annual rise even if there is a considerable increase in the course of the year. A small increase is forecast for transfer payments, with receipts under the new milk cessation schemes offsetting some falls in other forms of farm and intervention financing.

In all, therefore, there could be an improvement of almost £40 million in the current account balance of payments in 1987, reducing the deficit to about £160 million or less than 1 per cent of GNP. However, while this would appear to indicate that the balance of payments is no longer a short-term constraint on economic expansion, it should be borne in mind that the near balance will be achieved at a very low level of domestic economic activity. Any prolonged recovery in the rate of economic growth could see the balance of payments deficit once more emerging as a long-term constraint.

### *Output*

The small amount of growth recorded in the economy in 1986 is the result of a substantial fall in agricultural and building output going far towards offsetting a modest increase in industrial production and near stagnation in the output of services. Positive influences on output forecasts for 1987 include the assumption of a return to normal weather conditions, projections of increased export and private consumption volumes, and a recovery in tourist activity. Despite the assumption of a reduction in the volume of public services, therefore, all the main economic sectors, except building, seem likely to record some growth in output in 1987.

### *Agriculture*

Preliminary estimates indicate that gross agricultural output fell by 3.3 per cent in 1986. The principal decline was in milk production, where a deliberate reduction in the first quarter in order to remain within superlevy quotas for the 1985/86 season was followed by an unplanned shortfall in the key second quarter due to the paucity of spring grazing. With the weather preventing a full recovery of crop yields from the exceptionally poor 1985 levels and cattle production being curtailed by the reduction in the breeding herd, there were few agricultural sectors to show output growth in 1986.

The shortage of fodder carried over from 1985, combined with the late grass growth in the spring, meant that a higher than normal feed input was necessary. This outweighed a reduction in fertilizer usage, so that the total volume of farm inputs increased significantly. Thus gross agricultural product, or the value added in agriculture, fell more steeply than gross output, by 9.9 per cent.

Despite the reduction in the superlevy quota for the marketing year 1987/88 and the voluntary cessation scheme, milk output in the calendar year 1987 could show a small increase over 1986. This is largely because there is room within the current quota year for milk output in the first quarter of 1987 to be significantly above that in the first quarter of 1986. Cattle production seems likely to fall due to the continuing decline in the number of milk cows, and the expected increase in sheep numbers will be insufficient to prevent some reduction in the overall level of livestock production. On the assumption of normal weather, output of crops could be substantially higher than in 1986, enabling an increase in gross agricultural output of perhaps 2 per cent. Although 1986 was an indifferent year for fodder production, it was not as bad as 1985, so assuming that spring grass growth is normal in 1987 and allowing for the reduced numbers of cattle, feed inputs should be at a lower level than

in 1986. Thus gross agricultural product is forecast to increase by about 3 per cent in 1987.

### *Industry*

The industrial production index moved erratically in the Summer of 1986, with extremely low seasonally adjusted figures in June and July being followed by an abnormally high August level, presumably reflecting some shift in the timing of holidays. Averaging out these months, and taking into account the more reasonable September results, it seems likely that the annual increase in the volume of production in manufacturing industry in 1986 was about 1.8 per cent, much the same as the increase for the first 9 months of the year. This would be compatible with the tentative signs in the CII/ESRI Industrial Survey of a slight upturn in production in the later months of the year, matching the similar movement in 1985.

Given the strong recovery, compared with 1985, of turf production in the Autumn, the annual increase in the volume of production of transportable goods is likely to be rather higher than that for manufacturing industry at about 2 per cent. Mainly because of the switch from natural gas to imported coal as a source of some electricity production, output of the utilities decreased slightly in 1986, so that the volume of production of all industries is thought to have grown by about  $1\frac{3}{4}$  per cent. With the volume of building output, even allowing for an increase in that part of building which is treated as consumption in the National Accounts, having fallen by at least 4 per cent, the output of the total industrial sector expanded by only  $\frac{1}{2}$  per cent in 1986.

Provided that the forecasts of increases in the volume of manufactured exports and of personal consumption are fulfilled, manufacturing output should grow more rapidly in 1987, perhaps by almost 4 per cent. With turf output due to rise substantially on the assumption of normal weather conditions, and quarrying output likely to stabilise, albeit at a low level, the increase in output of transportable goods industries could also be about 4 per cent, while output of all industries seems likely to grow by a little less than this. Building activity, including its consumption components, could be roughly static in 1987, in which case the volume of production of the total industrial sector would rise by around 3 per cent.

### *Services*

Although current indicators are not available for most types of service output, it seems likely that there was very little growth in 1986. The fall in the volume of tourism, at around £75 million, was sufficient to offset all of the growth in the volume of public services, and some of the expansion in other private services, which itself does not appear to have been very vigorous.

With a recovery in tourism expected in 1987, together with a slightly faster growth in the volume of other private services, total private service output should grow considerably faster than in 1986. However, the assumptions made concerning public expenditure imply a minor reduction in the volume of public services. Thus an increase in total service output of around  $1\frac{1}{2}$  per cent appears a reasonable forecast for service output as a whole in 1987.

### Employment

Employment in manufacturing industry and in building continued to decline in the first half of 1986, although less rapidly than in 1985. On the basis of the trend in industrial output, it seems likely that any decline in manufacturing employment in the second half of the year would have been very slight. Employment responses in the CII/ESRI Survey, which admittedly have not yet been proved as a reliable indicator of employment trends, lend some support to this view. Building employment on the other hand seems likely to have continued its decline, at least so far as the legitimate economy is concerned, while the poor tourist season obviously had some adverse effects on seasonal service employment during the Summer. Allowing for these various influences, and for a continuing fall in the numbers engaged in agriculture, it seems likely that the annual average number at work during 1986 was around 1,050,000. This represents a decline of some 18,000 or almost 2 per cent in the annual average, similar to that suffered in 1985.

Although faster industrial growth is forecast for 1987, its composition is such that it seems more likely to raise average productivity than total industrial employment. Indeed, with the food industry, which is a large employer, likely to come under some pressure from declining meat supplies during the year, there is some danger of a further fall in manufacturing employment, in spite of the overall output growth. If total building output stabilises on an annual basis then employment in that sector would fall much more slowly than in 1986, with perhaps even no further fall in numbers on a seasonally corrected basis from the level now obtaining. Some growth in private service employment seems likely, if only because of the predicted recovery in tourism, but

**TABLE 6: Employment and Unemployment**

A: Mid-April Estimates '000					
	1984	1985	1986	1987	1988
Agriculture	181	169	161	155	150
Industry	319	305	296	289	288
Services	604	600	600	598	600
Total at work	1104	1074	1057	1042	1038
Unemployed	204	225	230	239	240
Labour Force	1308	1299	1287	1281	1278
Unemployment Rate %	15.6	17.3	17.9	18.7	18.8
Live Register	214	228	232	241	242

  

B: Annual Averages '000				
	1984	1985	1986	1987
Agriculture	175	167	158	153
Industry	311	301	293	288
Services	602	600	599	601
Total at work	1088	1068	1050	1042
Unemployed	217	227	234	239
Labour Force	1305	1295	1284	1281
Unemployment Rate %	16.6	17.5	18.2	18.7
Live Register	214	231	236	241

employment in the public service seems set to fall again. Allowing for a further decline in agricultural employment, the average total at work in 1987 could be about 1,042,000, implying a fall of 8,000 or  $\frac{3}{4}$  per cent from the 1986 average.

In the last two *Commentaries* it was pointed out that the use of unemployment statistics in conjunction with assumptions concerning the size of the labour force might have misled commentators into making unduly optimistic employment forecasts. There seems some danger of the opposite misinterpretation happening now. The very sharp rise in unemployment in the last months of 1986 might be used as evidence of a sudden collapse in the level of employment. In fact it seems more probable that they reflect a decline, temporary or otherwise, in the rate of net emigration, possibly related to the new immigration rules introduced by the USA. With no reliable short-term indicators of migration levels available, predictions of emigration rates, and thus of the size of the labour force, must inevitably remain highly tentative. It is thus difficult to have full confidence in projections of unemployment rates, and the forecast levels for 1987 shown in Table 7 could prove well wide of the mark if the underlying assumption of emigration continuing at a high, but reduced, rate is not borne out in practice.

### *Incomes*

Although agricultural input prices fell more sharply in 1986 than output prices, many other expenses tended to rise. Thus income arising in agriculture is estimated to have fallen by 6.7 per cent. When incomes in forestry and fishing are included, total income arising in the agricultural sector is thought to have declined by about 6 per cent in 1986. If gross agricultural product recovers as forecast by about 3 per cent, income arising in agriculture, forestry and fishing could increase by about 5 per cent in 1987. Relative price movements between inputs and outputs could again be reasonably favourable, unless changes in intervention price levels lead to a larger than expected fall in the price of all cattle. No allowance is made in this forecast of agricultural incomes for the effect of voluntary milk cessation schemes, partly because the timing of payments is still uncertain, and partly because it is not clear how such payments will be treated in national accounting terms.

**TABLE 7: Personal Disposable Income**

	1985		Change		1986		Change		1987
	£m	%	£m	%	£m	%	£m	%	£m
Agriculture, etc.	1352	-6	-81		1271	5	63		1334
Non-Agricultural Wages, etc.	9337	5 $\frac{1}{4}$	538		9875	5 $\frac{1}{4}$	520		10395
Other Non-Agricultural Income	1630	9	147		1777	8	143		1920
Total Income Received	12319	5	604		12923	5 $\frac{1}{2}$	726		13649
Current Transfers	3146	6 $\frac{1}{2}$	205		3351	3 $\frac{1}{2}$	118		3469
Gross Personal Income	15465	5 $\frac{1}{4}$	809		16274	5	844		17118
Direct Personal Taxes	3325	8 $\frac{1}{4}$	275		3600	8	288		3888
Personal Disposable Income	12140	4 $\frac{1}{2}$	534		12674	4 $\frac{1}{2}$	556		13230
Consumption	9797	5	495		10292	5	517		10809
Personal Savings	2343	1 $\frac{3}{4}$	39		2382	1 $\frac{1}{2}$	38		2421
Savings Ratio	19.3%				18.8%				18.3%

Non-agricultural wages, salaries and pensions appear to have risen in aggregate by about  $5\frac{3}{4}$  per cent in 1986. Average earnings grew faster than this, by almost  $6\frac{1}{2}$  per cent in the private sector and by over  $7\frac{1}{2}$  per cent in the public sector, but a part of this increase in average earnings was offset by a decline in the number of employees. For 1987, it seems likely that average private sector earnings will rise by around 5 per cent, with the low rate of price inflation and difficult trading conditions in many markets combining to impose a low norm on new settlements. On the assumption that existing agreements will be honoured but that no new general increase will be applied during the year, average earnings in the public sector appear set to rise by at least  $6\frac{1}{2}$  per cent. However a reduction in the numbers employed in both private and public sectors could bring the increase in aggregate pay down to about  $5\frac{1}{4}$  per cent for 1987 as a whole.

With profit reductions from the large currency movements apparently concentrated in the multinational companies, 1986 has seen the profitability of many Irish-owned companies increase substantially. Thus dividends, as well as interest received and the income of independent traders have tended to be quite buoyant in 1986, and so an increase of 9 per cent in "other" personal income seems a reasonable estimate for the year. With some narrowing of margins and some decline in domestic interest rates in the course of the year, 1987 is likely to see a slightly smaller increase in "other" incomes, despite a higher level of economic activity. A rise of about 8 per cent is forecast.

Current transfer payments are thought to have risen by about  $6\frac{1}{2}$  per cent in 1986, with the level of transfers from abroad not falling as originally expected. The course of transfer payments in 1987 is difficult to predict, as state transfers in the form of pensions, benefits and assistance are clearly a matter for political decisions. On the basis of the draft Budget, state transfers to the personal sector are assumed to increase by about 3 per cent in 1987. If payments under new milk cessation schemes are treated as transfers, there could be a small increase in transfers from the rest of the world. However it must be stressed that the forecast of a  $3\frac{1}{4}$  per cent increase in total personal transfer income shown in Table 7 is both tentative and heavily dependent on policy assumptions.

On the basis of these estimates and projections, gross personal income appears to have risen by about  $5\frac{1}{4}$  per cent in 1986 and seems likely to increase by a similar proportion in 1987. The composition of course is different between the two years, with agricultural incomes faring much better in 1987 but all other forms of personal incomes rising by less in 1987 than in 1986.

Direct personal taxation rose by about  $8\frac{1}{4}$  per cent in 1986, with the introduction of the deposit interest retention tax accounting for most of the difference between the rates of increase of incomes and taxation. From the draft Budget it seems likely that direct personal taxation could rise by about 8 per cent in 1987, with a further substantial increase in DIRT receipts assumed.

Such increases in direct taxation leave the estimated rise in personal disposable income at  $4\frac{1}{2}$  per cent in both 1986 and 1987. Because much of the income liable to the deposit interest retention tax is of a nature that would normally be saved, it appears reasonable to expect the personal savings ratio to fall by about  $\frac{1}{2}$  per cent in each year. If this is so, then the value of consumption would rise by about 5 per cent in both 1986 and 1987.

### *Consumer Prices*

The annual increase in the consumer price index in 1986 was 3.9 per cent, with the November to November increase rather lower at 3.2 per cent. As discussed in previous *Commentaries* this level of price inflation is disappointing in view of the heavy fall in import prices and the fairly moderate level of private sector pay increases.

It seems probable that the current quarter will see a much larger rise than the two preceding quarters. Higher mortgage interest rates, some increase in petrol prices reflecting international trends, removal of the remaining food subsidies and the increases in some rates of excise duty will all exert an upward pressure on the index. However, after this initial increase, it seems reasonable to predict only modest further price rises in the remainder of the year. Although there may be further increases in the price of petroleum products there should also be lower interest charges and stability in the price of many essential services. Moreover the delay during 1986 in passing on import price reductions could have a beneficial effect in 1987 as the lags are finally unwound.

It thus seems likely that the annual increase in the consumer price index in 1987 will be about  $3\frac{1}{4}$  per cent, with the rise from November 1986 to November 1987 being about  $4\frac{1}{4}$  per cent.

### *Public Finances*

As was predicted in the November *Commentary*, the current budget deficit in the 1986 was in the neighbourhood of £1,400 million, rather than the higher figures suggested during the Autumn. Even so, at just over  $8\frac{1}{2}$  per cent of GNP, this was a disappointing and disturbing out-turn for a year in which the burden of overseas interest payments actually declined. It is true that a part of the over-run was caused by essentially temporary factors, such as the impact of poor Summer weather, and the problems of Dublin Gas. However there were also more permanent features in the overspending, the most important of which was the total failure to restrict the public sector pay bill even to the level set out in the 1986 Budget, let alone that proposed in *Building on Reality*.

Indeed the rate of increase in public service pay rates, including phases falling due under special agreements, is one of the principal difficulties in reducing the current budget deficit in 1987. Even assuming a marginal fall in numbers employed, the public service pay bill implied in the Book of Estimates shows a rise of over 6 per cent. The particular impact of the teachers' settlement is clearly apparent in the estimates for primary and post-primary education, where expenditure is scheduled to increase by 15 per cent and 14 per cent respectively, compared with the increase of only 2 per cent in non-capital supply services as a whole.

The intensity of the public pay problem becomes even more acute when it is remembered that the Estimates are based on the assumption that there will be no new general pay increases during 1987, although the current agreement runs out in July.

Given the implied increase of about £170 million in the public service pay bill, the increase in total non-capital supply service expenditure in the Book of Estimates has been held to £134 million by reducing other forms of net expenditure. To some extent the reduction in the value of subsidies and transfer

payments reflects the presumed end of the circumstances which led to temporary measures to assist agriculture during the bad weather of 1986. However, most of the cuts in net spending represent the ending of general food subsidies and the limitation of social welfare expenditure through postponing the indexation of benefits until November, reducing the level of pay related benefits, shortening the period for which unemployment benefit applies and increasing the time or the number of contributions necessary before certain benefits can be claimed. The other major area in which net expenditure cuts are sought is health, where new charges are proposed and overall allocations reduced.

While current supply services are held to a money increase of 2 per cent in the 1987 Book of Estimates, current central fund expenditure is bound to grow much more rapidly. This is because its main components are the cost of servicing the national debt and the Irish contribution to the EEC budget, neither of which is subject to direct government control. Official estimates are that central fund spending will rise by over 8 per cent in 1987, largely because of a substantial rise in the EEC budget contribution and the cost of interest on new borrowing undertaken in 1986 and 1987.

Revenue calculations in the draft Budget allow for the normal revenue buoyancy inherent in the expected increase in current-price GNP, and for additional revenue from not indexing personal tax allowances while partially indexing excise duty rates. A further source of projected revenue in 1987 is the change in regulations to prevent the delaying of some of DIRT payments. In total therefore, taxes on income and wealth are forecast to increase by about 8 per cent and taxes on expenditure by a little over 5 per cent.

Overall, the draft Budget aims for a current budget deficit of £1,293 million, £100 million less than the 1986 level and about £200 million less than might have been expected on the basis of our normal assumptions of revenue indexation and a continuation of recent trends in the volume of expenditure. To achieve this net reduction of £200 million in the deficit, the gross changes in taxation and expenditure must have amounted to about £300 million, because allowance must be made for the deflationary effects on revenue of either reductions in expenditure or increases in effective tax rates. Although these calculations are implicit in the government figures and cannot be replicated exactly, it would appear that in broad terms the gross increase in effective tax rates account for about £100 million and the gross reductions from the trend of expenditure for about £200 million of the total gross adjustment.

In assessing whether the public finance assumptions on which the forecast in this *Commentary* is based are likely to be borne out in practice, it should be remembered that the Book of Estimates possesses constitutional force in controlling departmental spending, and that some of the more important measures, such as the ending of food subsidies and the raising of some rates of excise duty have already been implemented. Thus while any incoming government can, of course, alter the budgetary balance, such alterations will be from the baseline assumed here, rather than from the situation implied by a continuation of 1986 trends.

### *General Assessment*

The virtual stagnation of the economy in 1986 has exacerbated the major problems facing the nation. In spite of both inflation and the balance of payments deficit being at their lowest levels for many years, general confidence appears weak, taking much more account of the continuing increase in unemployment, emigration and the current budget deficit. Nevertheless, towards the end of the year there were some encouraging signs that manufactured exports and external direct investment were beginning to expand again, and that personal consumption was belatedly responding to higher real incomes.

Whether this incipient growth will accelerate in 1987 or whether it will peter out in another series of disappointments is still a matter of some uncertainty. On balance it seems more likely that it will continue at a modest pace, but without achieving sufficient vigour to increase employment levels or generate much additional state revenue in real terms.

On this general assumption, and on the specific assumption that the proposed targets for the current budget deficit and the exchequer borrowing requirement will be approximately met, the central forecast in this *Commentary* projects a growth rate of 2 per cent, an increase in the annual average of the consumer price index of  $3\frac{1}{4}$  per cent, a further reduction in the current account balance of payments deficit and an approximate stabilising of non-agricultural employment levels. Sectorally, this forecast implies some recovery in agricultural output, providing that weather conditions return to something like normal, and modest growth in industrial and private sector service output, partly offset by a reduction in the volume of public services.

A key feature of this forecast is the assumption that as a determination to meet public finance targets in the declared range becomes apparent, there will be a significant fall in domestic interest rates. The extent of the decline will be limited by the continuation of high interest rates in London, and also, possibly by continued exchange rate uncertainties, but nevertheless a reduction of at least 2 per cent appears feasible if the market regains confidence in domestic fiscal management.

Although the corollary to this assumption is that, if there is no attempt to reduce the level of exchequer borrowing, interest rates will remain at their present levels or even tend to rise, there is in practice unlikely to be a simple dichotomy between these two cases. Still less is there likely to be a simple straight line relationship between the rate of interest and the size of the projected borrowing requirement at intermediate points between the two cases. The main factors in determining the market's response to a given target borrowing requirement could well be whether this target appeared to be an integral part of a coherent economic policy, and whether the government were perceived as possessing the will and ability to achieve it.

Given this unavoidable difficulty in establishing a simple trade-off between budgetary targets and the rate of interest, and accepting that the short-term impact of changes in interest rates on the level of economic activity is itself a matter of some conjecture, it is not possible to present a series of precise alternative forecasts based on different budgetary assumptions. It does seem probable, however, that over at least a part of the range of potential budgetary

targets, the interest rate consequences could be sufficiently strong, even within the year, to outweigh any positive short-term multiplier effects of a higher rate of borrowing, and to erode even part of the direct effect. It could thus be, for example, that an exchequer borrowing requirement half a percentage point of GNP higher than that assumed in the forecast could raise the growth rate within 1987 by at least half a percentage point, but that a borrowing requirement one point higher would raise GNP growth by well under one per cent.

What seems more certain is that the longer term consequences of a softer fiscal stance are considerably more dangerous. The direct debt burden to be borne in future years would be greater, tending to reduce living standards and rendering successive budgets yet more difficult. At the same time, interest rates would be pushed upwards, compromising future growth through a lower volume of productive investment. While precise target figures should perhaps not be invested with undue significance it does appear that a borrowing requirement of approximately the magnitude assumed here is the maximum which would be compatible with any reasonable prospect of a lasting economic recovery.

The framework of the *Commentary* is such as normally to impose a very short time horizon on the discussion of economic policy. In this context it is almost inevitable that stress is placed on short term macro-economic policy, and particularly on such questions as the size of the budget deficit. However, while this is important, especially given the present nervous state of the capital market, it should not blind either the commentator or the reader to wider and longer-term considerations.

The poor economic performance of recent years is by no means a consequence solely of inadequate budgetary strategy, or even of imperfect economic management. Leaving aside such important factors as the weather and international currency fluctuations over which no Irish government has any control, the purely domestic problems have been greatly exacerbated by the intransigence of interest groups, excessive concern for short-term self interest, and a general unwillingness to lower unrealistic expectations. A principal task of the incoming government, whatever its political complexion, is to address these fundamental issues, and to attempt to create some unity of purpose.

*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
1980	100.0	100.0	10733	1814.9	227.4	239.0	100.0	100.0
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				1147.9				

Quarterly Averages or Totals

1983	I	110.3	107.8	2990	298.1	204.5	214.2	122.7	120.3
	II	115.6	113.2	2650	367.1	202.2	213.2	130.0	127.0
	III	106.5	108.3	2470	371.5	202.9	213.3	119.4	121.3
	IV	118.1	115.2	2929	345.7	200.3	209.7	134.1	131.3
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	184.9	194.0	171.2	167.2
	III	124.4	122.6	2814	330.6				
	IV				293.2				

Quarterly Averages or Totals Seasonally Corrected

1983	I	111.0	109.9	2721	363.1	205.7	216.0	123.1	121.6
	II	108.7	106.3	2799	330.6	203.0	213.0	121.8	119.3
	III	113.3	112.8	2761	339.1	201.8	212.1	127.7	127.1
	IV	117.8	115.9	2769	351.8	199.4	209.3	134.3	132.3
1984	I	120.5	118.8	2852	336.6	198.7	208.6	137.9	136.1
	II	126.1	126.0	2816	329.3	197.5	207.2	145.2	145.3
	III	125.7	123.8	2859	319.5	195.8	205.1	146.0	144.3
	IV	134.3	131.2	2899	312.6	193.3	202.5	158.0	154.8
1985	I	132.7	130.2	2960	303.5	190.6	199.8	158.3	155.7
	II	130.2	126.7	2966	314.9	189.6	198.3	156.2	152.7
	III	127.3	122.4	3017	303.5	188.1	196.3	153.9	149.0
	IV	130.8	128.0	2984	308.7	187.7	196.2	158.5	155.9
1986	I	133.3	130.0	3045	259.6	186.3	194.7	162.6	159.5
	II	131.4	127.9	3152	286.8	185.5	193.6	161.2	157.9
	III	133.3	128.7	3139	301.0				
	IV				292.0				

Unemployment	Prices						
	9	10	11	12	13	14	
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	
101.5	68.4	100.0	195.6	179.5	91.8	212.0	1980
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						1986

Quarterly Averages or Totals

188.3	102.5	132.0	247.0	237.3	96.1	172.0	1983 I
188.1	105.3	133.7	254.5	247.7	97.3	206.1	II
193.0	108.3	138.8	268.8	257.0	96.7	249.7	III
201.3	110.3	138.5	275.3	263.3	95.6	267.2	IV
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
221.8	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						IV

Quarterly Averages or Totals Seasonally Corrected

182.4	102.7	129.2	No Seasonal Pattern	No Seasonal Pattern	No Seasonal Pattern	No Seasonal Pattern	1983 I
190.0	105.0	131.1					II
196.0	108.1	140.9					III
202.6	110.7	142.1					IV
208.9	113.0	143.8					1984 I
212.8	115.2	146.1					II
215.6	116.7	138.0					III
219.6	118.2	138.2					IV
226.3	120.1	138.1					1985 I
228.6	121.1	136.5					II
234.8	123.1	135.6					III
232.7	124.0	138.1					IV
232.1	125.5	138.2					1986 I
233.8	126.5	135.5					II
238.1	126.8	133.9					III
241.6	127.9						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
1980	321.2	321.0	112.0	111.8	91032	100.0	100.0
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	145.4	89.2
1985	563.0	563.5	110.0	109.9	59592	155.6	90.8

Quarterly Averages or Totals

1983 I	440.6	440.8	102.6	102.4	29851	135.5	92.0
II	458.4	463.1	103.9	104.8	12255	130.2	86.1
III	476.3	475.9	104.9	104.7	12110	135.4	87.6
IV	497.9	497.1	107.7	107.4	6878	148.5	94.8
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	87.3
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	88.8
II	595.9		112.0		17663	154.5	88.2
III					13896	157.3	89.8
IV							

Quarterly Averages or Totals Seasonally Corrected

1983 I	447.1	448.4	104.1	104.2	20604	136.8	93.1
II	456.1	458.0	103.4	103.6	10450	132.0	88.1
III	476.9	477.0	105.1	104.9	13951	137.4	89.8
IV	492.7	493.4	106.6	106.6	13626	141.8	90.8
1984 I	509.3	510.9	107.6	107.8	13363	141.7	89.0
II	516.5	518.5	106.7	106.9	15453	145.6	89.9
III	528.6	529.5	107.9	107.9	13555	145.7	88.8
IV	540.4	541.8	109.6	109.7	12956	148.4	89.1
1985 I	548.9	549.5	109.2	109.2	13945	149.9	88.9
II	559.8	560.1	109.9	109.8	15848	155.0	91.0
III	567.4	568.3	109.8	109.6	15386	157.8	91.7
IV	575.4	576.0	111.2	111.1	14444	159.4	91.6
1986 I	585.9	585.1	111.5	111.1	13528	157.9	90.4
II	594.3		111.7		14461	156.1	89.3
III					16046	160.0	91.5
IV							

Government			Monetary Developments				
23	24	25	26	27	28	29	
Current Revenue	Current Expenditure	Current Deficit	Money Supply M3	Licensed Banks Domestic Credit		External Reserves	
				Government	Non-Gov.		
£m	£m	£m	£m End Period	£m End Period	£m End Period	£m End Period	
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	1775.6	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					1986

Quarterly Totals

Monthly Totals

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	1775.6	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	8161.6	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				2205.3		IV

Quarterly Totals (S.C.)

Monthly Totals (S.C.)

1339	1609	270	No Seasonal Pattern	No Seasonal Pattern	No Seasonal Pattern	No Seasonal Pattern	1983	I
1397	1652	255						II
1493	1632	139						III
1459	1777	318						IV
1448	1672	224					1984	I
1494	1688	194						II
1505	1806	301						III
1493	1826	333						IV
1508	1924	416					1985	I
1599	1799	200						II
1611	1947	336						III
1598	1942	344						IV
1620	1998	378					1986	I
1693	2063	370						II
1640	1954	314						III
1740	2067	327						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£
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	7358.2	6938.2	420.0	165.3	190.2	65.13	0.8222
1984	8913.5	8898.0	15.5	182.6	225.2	62.26	0.8134
1985	9434.5	9742.1	-307.6	188.7	239.9	62.41	0.8234
1986						66.65	0.9147

Monthly Averages

1983	I	585.8	471.5	114.8	167.1	164.8	69.46	0.8943
	II	592.1	575.8	16.4	163.8	192.6	65.14	0.8171
	III	603.0	606.2	-3.2	157.8	195.6	63.28	0.7894
	IV	671.8	658.7	12.1	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	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	801.1	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	808.2	855.8	-47.6	189.3	246.2	61.44	0.8075
	III	740.7	795.3	-54.6	175.0	227.5	62.15	0.7959
	IV	775.9	795.9	-20.0	188.6	233.3	64.11	0.8324
1986	I	732.8	762.5	-29.7	185.0	234.6	66.60	0.8966
	II	723.3	786.6	-64.7	191.4	243.1	67.34	0.8976
	III	668.5	752.7	-84.2	176.1	233.6	66.44	0.9148
	IV						66.22	0.9497

Monthly Averages. Seasonally Corrected.

1983	I	560.7	506.3	54.4	167.1	164.8	No Seasonal Pattern	No Seasonal Pattern
	II	583.1	553.7	29.4	163.8	192.6		
	III	624.5	605.4	19.1	157.8	195.6		
	IV	689.4	642.6	46.8	172.7	207.6		
1984	I	716.1	695.8	20.3	177.7	214.9		
	II	705.1	737.7	-32.6	174.7	227.5		
	III	745.2	725.9	19.3	179.9	218.1		
	IV	804.8	798.7	6.1	190.9	234.2		
1985	I	792.4	862.1	-69.7	185.6	249.6		
	II	795.6	817.8	-22.2	185.5	239.2		
	III	774.5	792.4	-17.9	183.8	227.4		
	IV	796.4	770.5	25.9	194.2	227.1		
1986	I	702.4	809.3	-106.9	176.1	246.2		
	II	717.9	759.5	-41.6	189.3	235.1		
	III	704.7	762.4	-57.7	187.0	237.3		
	IV							

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