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by

T. J. BAKER and S. SCOTT

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SUMMARY

There now appears little doubt that the Irish economy is growing in 1988, as the continued increase in the volume of exports is reinforced by some recovery in private domestic demand. The exact rate of growth is difficult to determine, and in any case is probably less important than the fact that the change in GNP is likely to be positive in spite of severe fiscal deflation. In several respects the forecast presented here of a 1½ per cent growth in real GNP in 1988 can be regarded as cautious, but given the inescapable uncertainties of the economic environment it appears realistic.

Whatever the precise growth rate, 1988 will be notable for a further substantial improvement in the public finances, the lowest inflation rate for almost three decades and the consolidation of the balance of payments surplus. Perhaps most significant of all in the longer term, these developments appear at last to be detaching Irish interest rates from their dependence on trends in London and moving them closer to continental levels.

The scale of the reduction in the budget deficit in 1988 suggests that the normal assumption of unchanged policies in 1989 can be interpreted as meaning that the exchequer borrowing requirement will be the same as in 1988 in money terms, implying a reduction of ½ per cent as a proportion of GNP. On this basis, a growth rate of 2½ per cent in 1989 is projected, with the annual inflation rate remaining under 3 per cent and total employment stabilising, albeit at an unacceptably low level.

Final decisions on the shape of the budget should obviously be postponed until both the current fiscal situation and the growth prospects for 1989 are clearer. It does seems increasingly likely, however, that the next budget will be able to aim for a balance between seeking a relatively minor further improvement in the public finances and permitting sustainable growth in the domestic economy. If in so doing it can lead to a further erosion of the interest-rate differentials between Ireland and Germany, and also maintain a climate of strict pay restraint, then the medium-term prospects for the Irish economy could become among the most favourable in Europe. Even the twin dangers of a future sterling collapse or a UK recession would then not be disastrous for the Irish economy.

FORECAST NATIONAL ACCOUNTS 1988

A: Expenditure on Gross National Product

	1987 Provisional £m	1988 Forecast £m	Change in 1988 £m Value	£m Volume	% Value	% Price	% Volume
Private Consumer Expenditure ...	11481	11911	430	168	3¾	2¼	1½
Public Net Current Expenditure ...	3560	3560	0	− 152	0	4¼	− 4¼
Gross Domestic Fixed Capital Formation	3439	3547	108	33	3¼	2¼	1
Exports of Goods and Services (X) ...	11784	13240	1456	1165	12¼	2¼	10
Physical Changes in Stocks	− 28	− 129	− 101	− 106			
Final Demand	30236	32129	1893	1108	6¼	2½	3¾
less:							
Imports of Goods and Services (M) ...	10461	11280	819	619	7¾	1¾	6
GDP at Market Prices	19775	20849	1074	489	5½	2¾	2½
less:							
Net Factor Payments (F)	1946	2220	274	224	14	2¼	11½
GNP at Market Prices	17829	18629	800	265	4½	3	1½

B: Gross National Product by Origin

	1987 Provisional £m	1988 Forecast £m	Change in 1988 £m	Change in 1988 %
Agriculture, Forestry, Fishing ...	1874	1949	75	4
Non-Agricultural: Wages, etc. ...	10481	10874	393	3¾
Other	3396	3771	375	11
less:				
Net Factor Payments	1946	2220	274	14
National Income	13805	14374	569	4
Depreciation	1916	2031	115	6
GNP at Factor Cost	15721	16405	684	4¼
Taxes less Subsidies	2108	2224	116	5½
GNP at Market Prices	17829	18629	800	4½

C: Balance of Payments on Current Account

	1987 Provisional £m	1988 Estimated £m	Change in 1988 £m
X—M	1323	1960	637
F	− 1946	− 2220	− 274
Net Transfers	886	1000	114
Balance on Current Account ...	263	740	477
as % of GNP	1½	4	2½

FORECAST NATIONAL ACCOUNTS 1989
A: Expenditure on Gross National Product

	1988	1989	Change in 1989				
	Forecast	Forecast	£m		%		
	£m	£m	Value	Volume	Value	Price	Volume
Private Consumer Expenditure ...	11911	12387	476	149	4	2¾	1¼
Public Net Current Expenditure ...	3560	3667	107	- 107	3	6	- 3
Gross Domestic Fixed Capital Formation	3547	3825	278	191	7¾	2¼	5½
Exports of Goods and Services (X) ...	13240	14493	1253	952	9½	2¼	7¼
Physical Changes in Stocks	- 129	- 39	90	85			
Final Demand	32129	34333	2204	1270	6¾	2¾	4
less:							
Imports of Goods and Services (M) ...	11280	12289	1009	675	9	2¾	6
GDP at Market Prices	20849	22044	1195	595	5¾	2¾	2¾
less:							
Net Factor Payments (F)	2220	2416	196	144	8¾	2¼	6½
GNP at Market Prices	18629	19628	999	451	5¼	2¾	2½

B: Gross National Product by Origin

	1988	1989		
	Forecast £m	Forecast £m	Change in 1989 £m	%
Agriculture, Forestry, Fishing ...	1949	1988	39	2
Non-Agricultural: Wages, etc. ...	10874	11336	462	4¼
Other	3771	4232	461	12¼
less:				
Net Factor Payments	2220	2416	196	8¾
National Income	14374	15140	766	5¼
Depreciation	2031	2153	122	6
GNP at Factor Cost	16405	17293	888	5½
Taxes less subsidies	2224	2335	111	5
GNP at market prices	18629	19628	999	5¼

C: Balance of Payments on Current Account

	1988	1989	
	Forecast £m	Forecast £m	Change in 1989 £m
X—M	1960	2204	244
F	- 2220	- 2416	- 196
Net Transfers	1000	1000	0
Balance on Current Account ...	740	788	48
as % of GNP	4	4	

COMMENTARY

The International Economy

General

The world economy has been growing without interruption since the beginning of 1983. This is an exceptionally long upswing, and on normal cyclical considerations a downturn would be overdue. However, there are no signs that a recession is imminent and strong grounds for believing that growth will continue for at least the next two years. The outstanding feature of the growth since 1983 is that it has been much slower than in most previous cyclical recoveries, and has thus avoided creating the worldwide inflationary pressures which have generally preceded recessions. So long as international growth remains steady rather than excessive, there seems no obvious reason why it should not continue for several more years.

Over the past twelve months or so considerable progress has been made in correcting the major trade imbalances which were threatening the stability of the world economy. The US trade balance has improved as resources have shifted into increasing net exports, while domestic demand has replaced net exports as the principal component of growth in Japan and, to a lesser extent, western Europe. The currency movements which were largely responsible for these shifts have been partly reversed in recent months, but the momentum already created should carry the adjustment process somewhat further, and a new currency alignment could revive the process if it does begin to falter.

The US Economy

It is now quite clear that even in the USA the impact of last autumn's equity price collapse has had very little effect on the level of economic activity. With consumer expenditure holding up, industrial investment buoyant and a major improvement in the volume of trade balance, GNP growth in 1988 is likely to approach 3 per cent. Unemployment is continuing to fall and earlier fears of a significant increase in the inflation rate in 1988 are receding, in spite of the possible impact of a drought-induced rise in some food prices.

Two major uncertainties make it difficult to predict US economic performance in 1989. The first is the possible impact on the trade balance of the recent recovery in the dollar exchange rate. It is not yet clear whether the fall in the dollar in the last two months of 1987 was simply a temporary over-reaction to poor short-term trade indications which has since been reversed, or whether it is the more recent recovery which represents an over-reaction, which, if maintained, will check the improvement in the trade balance. The interpretation adopted here is that both the winter decline and the subsequent recovery may both have been excessive, and that the average value of the dollar in 1989 will lie somewhere between the two extremes, permitting a fairly steady improvement in the volume of net exports.

The other unavoidable uncertainty is the economic policy of the incoming administration in 1989. Our assumption is that there will be no radical change in policy but that rather faster progress will be sought in reducing the budget deficit than has been achieved in the pre-election year of 1988.

If these assumptions are correct, US growth in 1989 could be slightly slower than this year, at about 2½ per cent. Unemployment could stabilise, while inflation could rise a little on an annual average basis although the average quarterly increase would be little changed. Further progress is likely to be achieved in reducing the current account balance of payments deficit, although it must be remembered that the increasing weight of interest payments on the foreign debt will make the improvement of the current account much slower than the improvement of the trade balance.

The European Economy

In most European countries, economic growth in the second half of 1987 and the first half of 1988 has been rather stronger than expected. As a result forecasts for growth in 1988 as a whole have tended to be revised upwards, and it now appears likely that EC growth in real GNP will be about 2½ per cent, much the same as in 1987. Such a growth rate could permit a marginal decline in unemployment levels, although these seem set to remain firmly in double figures as a proportion of the labour force.

Inflation rates are tending to converge, and remain relatively low in the major European countries other than the UK. Nevertheless the German authorities are sufficiently concerned about evidence of a slight increase in inflationary pressures, as well as by their perception of an excessive recovery in the US dollar, to have raised interest rates to about the levels they were before the equity shock of October 1987. Those countries traditionally linked with the deutschmark have followed suit, but France has taken the opportunity of relative DM weakness to reduce its rates. None of the interest changes on the continent appears to have been sufficiently large to seriously affect business or consumer confidence and thus materially to change the economic prospects for 1989.

So far as continental Europe is concerned it seems probable that slow growth will continue in 1989, with a general consensus among forecasters that overall EC growth will be slightly lower at about 2 per cent. As in 1988 much of the expansion is expected to be related to domestic demand, as the volume of EC export growth is likely to remain very limited. Little change is expected in unemployment levels, and EC consumer price inflation could edge upwards to about 3 per cent.

The UK Economy

While the major world imbalances are gradually easing, another is rapidly emerging in the UK. This is of minor importance to the world economy, but could have a significant impact on Ireland. In the short run the combination of a rapid growth in UK domestic demand with an overvaluation of sterling is to the benefit of the Irish economy, especially as the long awaited divergence between UK and Irish interest rates has now taken place.

However, current trends in the UK are clearly unsustainable. Both price and pay inflation are well above the EC average, the current account balance of payments deficit is rising rapidly, already matching that of the USA as a proportion of GNP, and sterling, far from falling in response to adverse trade trends, has been rising in line with increasing interest rates. The question is not whether the trends in the UK economy will be reversed, but when and by what methods.

The optimistic view, propounded by the UK authorities and many UK commentators, is that tighter monetary policy will gradually restrain domestic demand, thus easing both the inflation rate and the balance of payments deficit, without any traumatic shifts in either the exchange rate or interest rates. Such an outcome is not impossible, although even if it does transpire it seems likely that it will result at least as much from a cutback in productive investment as from a reduction in consumer spending. This is because practically the only policy tool the authorities appear willing to use is the rate of interest, and experience suggests that investment is far more responsive than consumption to changes in interest rates.

It would be possible to be more sanguine about the prospects for a controlled correction to the UK economy, as well as for an adjustment with less damaging long-term implications, if the authorities were prepared to re-introduce some quantitative controls on the volume of consumer credit or to reinforce monetary policy with some tightening of the fiscal stance. Any form of incomes policy can presumably be ruled out for the duration of the present government's term of office.

If current policies do not appear to ameliorate the problem, then it seems likely that the markets will eventually react in such a way as to force a rapid change. As in the case of the dollar in 1985, a widening current account deficit will at some stage lead to a loss of market confidence in the value of sterling. This in turn will trigger either a sharp depreciation of the currency or the forcing up of interest rates to crisis levels. The former would enable the trade balance to recover in time, as 1986 showed that UK trade is reasonably responsive to exchange rate depreciations. However, in the short run a fall in the value of sterling would exacerbate inflation and might induce further restrictions in monetary and possibly fiscal policy. An attempt to circumvent a fall in sterling by raising interest rates to crisis levels approaching 20 per cent could be expected to result in a sharp recession, especially if it succeeded in keeping the exchange rate high.

At the moment it is difficult to predict whether the unavoidable adjustment in UK economic trends can be achieved by gradual means, or when, if ever, a more traumatic reversal will take place. It is thus reasonable to assume, for the purpose of forecasting 1989, that major shocks in the UK economy will be avoided, and that a relatively controlled adjustment to a lower growth rate will hold both inflation and the external deficit at high, but no longer deteriorating, levels. However, while this is a reasonable central assumption, the dangers of an uncontrolled shift must be kept in mind.

The Rest of the World

Much of the credit for the progress being made in easing world imbalances during 1988 must be apportioned to Japan. A well judged stimulus to domestic demand, together with a limited but effective liberalisation of import barriers have resulted in a steady but not inflationary growth of GNP and a significant reduction in the balance of payments surplus. Provided that Japanese self-confidence remains unimpaired, and the extraordinarily high value of equities on the Tokyo exchange appear to offer acceptable long-term returns, there seems no reason why this successful process of replacing a proportion of external demand with internal should not continue in 1989.

If the prediction that economic growth will continue in the major economies during the remainder of 1988 and 1989 is correct, then most other industrialised or industrialising countries can be expected to share in the expansion. Growth however seems unlikely to be fast enough to induce a general rise in commodity prices, although special factors will obviously influence particular commodities. No dramatic developments are thus expected in third-world incomes as a whole, and the debt problem seems likely to remain chronic but manageable.

Whether OPEC can reimpose control over oil production and thus force up crude-oil prices over the next eighteen months remains an open question. The possibility can never be discounted entirely, but at present it seems more reasonable to assume that there will be no dramatic change in oil prices before the end of 1989.

TABLE 1: Short-term International Outlook

	GNP		Consumer Prices		Hourly Earnings		Unemployment Rate		Current Account Balance	
	Percentage Change						%		% of GNP	
Country	1988	1989	1988	1989	1988	1989	1988	1989	1988	1989
United Kingdom	3½	2¼	4¾	5	8½	8	9¼	9½	−3	−3
West Germany	2¼	1¾	1¼	1½	4¼	4	8	8	3¾	3¼
France	2	1¾	2½	2¾	4¾	4½	10¾	11¼	−½	−½
Italy	2½	2¼	4½	4¼	6	5½	11½	12	0	0
Total EC	2½	2	2¾	3	5	4¾	10¾	11	¼	¼
USA	2¾	2½	4	4¼	2¼	3½	5½	5½	−3	−2½
Japan	4¼	3¾	1¼	1¾	3¾	4	2½	2¾	3	2½
Total (OECD)	3	2½	3½	3¾	3¾	4¼	7½	7½	−½	−½
Ireland	1½	2½	2¼	2¾	4½	4¼	17¾	17¾	4	4

Sources: OECD Economic Outlook, IMF World Economic Outlook, and individual country sources.

The Context for Ireland

The major international agencies are predicting that the growth in world output and the volume of trade will continue in 1989, although perhaps a little more slowly than in 1988. As the foregoing discussion indicates, the very slowness of this growth, together with limited but real progress towards correcting the major international imbalances, strongly supports this analysis.

Thus the general international environment for Irish exports and for investment in Irish industry seems likely to remain quite favourable in 1989. Moreover, both consumer price inflation and pay inflation in Ireland will probably be slightly below the EC and the OECD averages in 1988 and in 1989. With non-labour costs also tending to move relatively favourably in Ireland, competitiveness against most other countries could improve slightly over the next year and a half at current exchange rates.

This moderately benign international outlook is complicated by the uncertainties surrounding the prospects for the UK economy. The present situation of booming UK demand, high inflation and sterling strength is advantageous to Ireland in the short-run. The problem is that this situation is untenable in the long run, but that the timing and nature of the inevitable adjustments are unpredictable. For the purpose of this *Commentary* it has been assumed that the growth of UK demand will taper off during the remainder of 1988 and through 1989, with interest rates remaining near their current high but not crisis levels, and with sterling depreciating only modestly between 1988 and 1989.

Such an outcome would restrain Irish exports to the UK because of the slower growth of the market, but would largely maintain Irish competitiveness *vis-a-vis* the UK due to the differential rates of inflation. If developments in the UK are more dramatic, with a currency collapse occurring late in 1988 or in 1989, then the impact on Ireland would be more severe. Even Ireland's lower inflation rate would not protect competitiveness fully against sterling at a discount against the Irish pound. Although so extreme a currency shift is perhaps unlikely, it is a possibility which cannot be ruled out. However, judicious exchange rate covering against such a possibility would postpone many of the consequences until 1990, by which time the lower rate of Irish inflation would have lessened the problems caused.

The precariousness of the UK economy is thus a powerful motive for ensuring that Irish inflation is kept down at least to continental levels. In the longer run this will enable a substantial sterling depreciation to be weathered by Irish industry, while in the shorter run it will consolidate the beneficial transfer of influence over Irish interest rates from London to the continental financial centres.

The Domestic Economy

General

Against the background of a reasonably favourable international environment, it now seems certain that 1988 will see a small but positive growth in the Irish economy. It also seems certain that the improvement in the public finances will be considerably greater than was expected at the beginning of the year.

The prospects for 1989 depend, as always, on export performance and on consumer and business confidence. It is reasonable to be cautiously optimistic about these underlying factors. However, any assessment of economic growth in 1989 must also be based on assumptions concerning the fiscal stance of the public authorities. The normal assumption, which is made in this *Commentary,* is for a continuation of existing policies. This however can be difficult to interpret, particularly during a period of fiscal stringency, when further expenditure cuts have been signalled but not finalized. Our general interpretation of unchanged policies, which underlies the forecasts presented here, is that in money terms the exchequer borrowing requirement will remain unchanged between 1988 and 1989. This implies some further retrenchment beyond a continuation of end-1988 expenditure volumes and real tax rates. The possible magnitudes involved are discussed later in this *Commentary*.

Exports

Visible exports in the first six months of 1988 have been quite buoyant, at 14 per cent higher in value than in the first half of 1987. However, the composition of this export growth has been different from earlier expectations. Agricultural exports have been considerably higher than anticipated, reflecting large sales of intervention stocks as well as further progress in developing direct sales of agricultural products. Over the remainder of the year, the pace of sales from intervention is likely to slacken as stocks are reduced, while output constraints will limit the growth of direct sales. Nevertheless with a smaller proportion of current output being sold into intervention, total agricultural exports for 1988 as a whole are expected to increase substantially in both value and volume terms.

After their surge in the second half of 1987, industrial exports have remained relatively static in the early months of 1988 on a seasonally corrected basis. However surveys indicate that export orders remain high and that industrial investment is growing strongly. With market conditions favourable, especially in the U.K., and some additional capacity becoming available it is thus reasonable to expect a significant upturn in the level of seasonally-corrected industrial exports in the second half of 1988. Taken in conjunction with the large carryover effect from 1987, this should enable industrial exports for 1988 as a whole to increase by over 10 per cent in volume and over 12½ per cent in value.

TABLE 2: Exports of Goods and Services

	1987 £m	% Change Volume	% Change Value	1988 £m	% Change Volume	% Change Value	1989 £m
Agricultural	2026	7	10	2229	0	3	2296
Manufactured	6919	10½	12½	7784	9	11	8640
Other Industrial	1684	10	13	1903	8	10	2093
Other	95			95			95
Total Visible	10723	9¾	12	12011	7	9¼	13124
Adjustments	- 276			- 220			- 230
Merchandise	10447	10½	12¾	11791	7¼	9¼	12894
Tourism	723	3	5¼	761	5	8	822
Other Services	614	9¼	12	688	10	13	777
Exports of Goods and Services	11784	10	12¼	13240	7¼	9½	14493

With the fall in intervention stocks being reflected in an absence of overseas storage, the negative adjustment between visible and merchandise exports will be sharply reduced in 1988, turning the forecast 12 per cent rise in the value of the former into a 12¾ per cent increase in the latter.

Unless there is an unexpected late surge in tourist numbers, the improvement in tourist earnings in 1988 seems likely to be very modest. With no current indicators available beyond the first quarter, it is assumed that other service exports will continue the growth shown in 1987, but at a slightly slower pace. On the basis of these forecasts for individual categories, total exports of goods and services are shown in Table 2 as rising by 10 per cent in volume and 12¼ per cent in value.

Supply constraints seem likely to restrict agricultural exports once more in 1989, without the compensating factor of a major run down in intervention stocks. Even the forecast of an unchanged volume of agricultural exports implies considerable further progress in improving the value-added content of meat exports.

The projected increase of nearly 9 per cent in the volume and 11 per cent in the value of industrial exports in 1989 rests on the assumptions that world growth will continue, that UK growth will slacken, and that Irish competitiveness will not deteriorate significantly. Provided these assumptions hold, sufficient industrial investment appears to be planned or already taking place to justify the projection, which is relatively modest by historical standards.

With tourism and other service exports projected to increase slightly faster than in 1988, total exports of goods and services are forecast to increase by 7¼ per cent in volume terms and 9½ per cent in value in 1989. The apparent slowdown in the rate of growth is accounted for partly by the once-off nature of intervention stock disposal in 1988 and partly by the very large carryover of export growth from 1987 into 1988. In fact the underlying rate of growth in industrial exports is expected to be slightly higher in 1989 than in 1988.

Stocks

The treatment of stock levels is always one of the most uncertain parts of the forecasting process, as initial official estimates are frequently subject to large subsequent revisions. This inherent lack of confidence in the stock projections needs to be noted especially in years like 1988, when it appears possible that changes in stock levels could have a significant impact on the overall growth rate.

There is reasonable confidence that after several years of decline, farm stocks, which almost stabilised in 1987 will show a marginal rise in 1988.

TABLE 3: Stock Changes

	1987 £m	Change in Rate £m	1988 £m	Change in Rate £m	1989 £m
Farm Stocks	–11	22	11	20	31
Irish Intervention Stocks[1]	82	–242	–140	70	–70
Other Non-agricultural Stocks	–99	99	0	0	0
Total	–28	–101	–129	90	–39

[1]Including subsidised private storage.

Although the dairy-herd is continuing to decline under the impact of milk quotas, increases in the number of other cattle and of sheep should more than compensate. This slow recovery in farm stock levels is projected to continue in 1989.

The most dramatic change in stock-levels in 1988 seems likely to take place with regard to intervention and related stocks. Not only will the intake into intervention be substantially reduced due to lower output, tighter controls and improved direct selling of agricultural products, but a considerable proportion of existing stocks of dairy produce are being sold under specific EC disposal schemes. It is too early in the year to take a definitive view on the end year stock levels, but current indications are that they could fall by some £140 million. A further fall of about half this magnitude is assumed for 1989.

Given the volatility of estimates of industrial and distribution stocks, the technical assumption that these will remain unchanged in 1988 and 1989 does not appear unreasonable. Lower interest rates should have removed some of the incentive for reducing stock levels, which could have contributed to their apparent fall in 1987.

Investment

Although the cuts in the public capital programme will undoubtedly result in a fall in investment in total building and construction in 1988, the decline now seems likely to be less severe than was feared earlier in the year. There is increasing evidence that private building investment is responding to lower interest rates and increasing confidence. This is not surprising, as the key relationships between the cost of borrowing and expected gains in capital and rental values have become much more favourable in recent months. Recent surveys have confirmed that widespread price increases have taken place in many sectors of the residential and commercial property markets, as would be expected at the beginning of a recovery stage. If the expectation becomes general that property prices are likely to rise annually by more than ten per cent, thus exceeding the cost of borrowing, then purchases for investment purposes could increase rapidly and purchases for purely residential purposes would be brought forward, aided by the fact that reduced nominal interest rates increase the borrowing capacity of many households.

TABLE 4: Gross Fixed Capital Formation

	1987 £m	% Change Volume	% Change Value	1988 £m	% Change Volume	% Change Value	1989 £m
Building and Construction	1600	−6	−3	1552	2	5	1630
Machinery and Equipment	1839	7	8½	1995	8	10	2195
Total	3439	1	3¼	3547	5½	7¾	3825

However, no credible recovery in investment in industrial or commercial building or in the upper segments of the housing market would be sufficient to offset completely the decline in publicly funded construction in 1988, but the improvement in private construction could limit the overall reduction in the volume of investment in building and construction to about 6 per cent. This compares with forecasts of a fall of 8 per cent in previous *Commentaries,* and of over 10 per cent in earlier forecasts from other sources.

Even after the cuts of recent years, the public capital programme remains the dominant influence in building investment. Thus forecasting investment for 1989 involves taking a view of the possible size of the public capital programme in that year. The general assumption of unchanged policies is interpreted as implying a volume fall of about 3 per cent in public construction due to the carryover of existing programme cuts, but with no fresh reductions in the volume of the programme. This would leave the value of the construction element of the public capital programme virtually unchanged between 1988 and 1989.

Despite this continued stagnation in publicly funded construction, total building investment is forecast to increase by 2 per cent in volume and 5 per cent in value in 1989. The recovery in private building which has commenced in 1988 is expected to continue, and perhaps to accelerate. Low nominal interest rates, combined with increasing confidence and the likelihood of rising property values should stimulate activity in the residential and commercial sectors, while building for industry is also expected to expand. Indeed the forecast could well prove conservative, as changes of trend in the construction sector are frequently much more violent than the rather modest reversal projected here.

On the evidence of the trade statistics, imports of capital goods are at least maintaining the growth exhibited in 1987. The implied increase in investment in machinery and equipment is forecast to continue through 1988 and 1989. So far as the industrial sector is concerned this expectation is supported by the CII ESRI Investment Survey which shows the highest level of investment intentions for many years. For the economy as a whole, the combination of relatively low interest rates, improving international competitiveness and increasing business confidence can be expected to sustain a substantial increase in the volume of plant investment throughout the period.

Thus the volume of total fixed capital formation, as shown in Table 4, is forecast to grow by a modest 1 per cent in 1988, but by a significant 5½ per cent in 1989. While such a projected increase is high in the context of the '80s, it is worth noting that it remains quite moderate in relation to the '70s, when double figure percentage increases were the norm.

Consumption

In recent years the retail sales index has tended to understate the trend of personal consumption by a significant margin. Despite some volatility from month to month, the average volume of the retail sales index for the first five months of 1988 is almost exchanged from its 1987 level. This suggests that the first half of 1988 has seen an increase in real consumption, while relatively buoyant car registrations and indirect tax receipts confirm this impression. It seems unlikely that nominal personal disposable income grew as fast in early 1988 as in the corresponding period of 1987, as the effects of direct tax concessions will not become apparent until later in the year. Thus this improvement in consumption levels suggests that the rise in the savings ratio which appears to have held back consumption in 1987 has now come to an end.

UK experience, where the personal savings ratio has fallen from a peak of 15 per cent in 1980 to a plateau of about 11 per cent in 1983 and 1984 and has since declined to about 4 per cent, has demonstrated that the ratio is capable of falling very sharply in certain conditions. Similar conditions are unlikely to appear in Ireland in the foreseeable future, so the danger of an excessive consumer boom on the UK model is very remote. However, given the pattern of income increases, low nominal interest rates and growing confidence in the performance of the economy, it does seem reasonable to expect at least a marginal reduction in the personal savings ratio in both 1988 and 1989.

This would permit the value of personal consumption to increase by 3¾ in 1988 and 4 per cent in 1989, while leaving the personal savings ratio in 1989 still above its 1986 level. Given the probable movements in consumer price levels, the volume of personal consumption would thus increase by about 1½ per cent in 1988 and 1¼ per cent in 1989. Of course, a larger fall in the savings ratio would enable consumer spending to increase more rapidly, but still within the bounds of safety because of the strength of the balance of payments surplus. Although such a development is possible it would be premature to base a forecast upon its likelihood, as it would imply a major reversal of the consumer behaviour observed over the past seven or eight years.

Although quarterly exchequer returns are an imperfect indicator of public authorities' net current expenditure, or government consumption, the returns for the first half of 1988 do not indicate any major divergence from the relevant expenditure targets for the year as a whole. An unchanged value of government consumption, implying a volume fall of about 4¼ per cent is a reasonable forecast for 1988.

The general assumption of unchanged policies is interpreted as implying some further cuts in the volume of public authorities' net current expenditure beyond the simple continuation of end-year levels, but on a much smaller scale than the cuts in 1988. This would be compatible with a fall of about 3 per cent in the 1989 volume of government expenditure. Because of phased increases in special pay awards under the terms of the Programme for National Recovery a large rise in average public service pay is expected in 1989. Thus the current price value of government consumption is forecast to increase by 3 per cent in 1989.

Final Demand

Final demand in 1988 is forecast to increase by 6¼ per cent in value and by 3¾ per cent in volume. As in 1987, the entire volume increase is accounted for by exports, with domestic demand items showing an aggregate decline. A considerable proportion of the forecast export growth is in agricultural products, with a corresponding fall predicted in intervention stockbuilding. The composition of forecast final demand growth is thus not particularly import intensive.

A significant recovery in domestic demand, especially investment, in 1989 is expected to offset a slowdown in export growth. The volume rise in final demand is thus forecast to reach 4 per cent. As much of the increased growth is expected to result from relative improvements in building and public consumption, the import intensity of final demand is likely to be slightly lower in 1989 than in 1988.

Imports

The value of visible imports increased by just under 7½ per cent in the first half of 1988 compared with the corresponding period of 1987. However this represents a seasonally corrected rate of imports only 1½ per cent above the monthly average for 1987 as a whole, and 2 per cent below the average import value in the second half of 1987. As in 1987, some upturn in the seasonally-corrected value of imports is expected in the second half of the year, but this is unlikely to raise the annual increase in the value of imports above 7¾ per cent. Average import prices for 1988 as a whole will probably be about 2 per cent higher than in 1987, leaving the volume increase in visible imports at 5¾ per cent.

TABLE 5: Imports of Goods and Services

	1987 £m	% Change Volume	% Change Value	1988 £m	% Change Volume	% Change Value	1989 £m
Capital Goods	1339	10	11½	1493	10	12	1672
Consumer Goods	2414	6	8½	2619	6	9	2855
Intermediate Goods:							
Agriculture	413	–1	3	425	–2	4	642
Other	4947	5	6½	5269	5	8	5691
Other Goods	43			59			62
Total Visible	9155	5¾	7¾	9865	5¾	8¾	10722
Adjustments	–18			–82			–94
Merchandise	9137	5¼	7	9783	5¾	8¾	10628
Tourism	543	5	7½	584	5	7¾	629
Other Services	780	14	17	913	10	13	1032
Imports of Goods and Services	10461	6	7¾	11280	6	9	12289

On the evidence of the first quarter preliminary balance of payments estimates, very rapid growth is continuing in service imports. Assuming that this continues, and allowing for a larger negative adjustment between visible and merchandise imports because the cross-border restrictions will apply for the whole year, total imports of goods and services in 1988 seem likely to rise by about 6 per cent in volume and 7¾ per cent in value.

Given the pattern of final demand, the volume of visible imports is expected to increase at much the same rate in 1989 as in 1988. Again, the fastest increases could be in capital goods, with consumer and intermediate goods imports rising steadily but not dramatically. Import prices could increase rather faster than in 1988, both because of a slight acceleration in world inflation and because of exchange rate movements. Thus the value of imported goods is forecast to rise by 8¾ per cent in 1989, roughly one per cent more than in 1988.

Service imports seem likely to grow more rapidly than merchandise, both in volume and value. As shown in Table 5, total imports of goods and services are thus forecast to grow by 6 per cent in volume and 9 per cent in value in 1989. Such increases seem fully compatible with a rise of 4 per cent in the volume of final demand.

Balance of Payments

On the basis of the export and import forecasts already discussed, the balance of visible trade in 1988 could improve by about £580 million to almost £2150 million. When favourable changes in the balance of payments adjustments are taken into account, the forecast improvement in the merchandise trade balance is almost £750 million, and even a moderate deterioration in the balance of trade in services should allow the overall surplus of trade in goods and services to increase by about £640 million to £1960 million.

TABLE 6: Balance of Payments

	1987 £m	Change %	1988 £m	Change %	1989 £m
Trade in Goods and Services	1323		1960		2204
Factor Flows:					
Profits etc.	- 1275	23	- 1568	14	- 1788
National Debt Interest	- 804	3¼	- 830	3	- 855
Other Debit	- 639	0	- 639	0	- 639
Total Debit Flows	- 2717	11¾	- 3037	8	- 3282
Credit Flows	771	6	817	6	866
Net Factor Flows	- 1946	14	- 2220	8¾	- 2416
Net Transfers	886		1000		1000
Balance on Current Account	263		740		788

Considerable uncertainty attaches to any forecast of net factor flows. Fluctuations between quarters are sufficiently great for projections based on preliminary first quarter balance of payments estimates to provide only a flimsy guide to the likely outcome for the year as a whole. It is clear that profit expatriation will increase sharply in 1988 as a result of the high level of exports by foreign based multinational companies in the second half of 1987 and the first half of 1988 itself. Past experience suggests that an increase in profit outflows of about 23 per cent would be compatible with the rise in relevant exports over that period.

The unexpected recovery of the US dollar has required an upward revision to earlier forecasts of interest payments on the external national debt. Foreign purchases of Irish gilts are also likely to increase overseas interest payments, because, at least in the short run, interest rates on Irish government stock are higher than on direct foreign borrowing. Thus rather than the marginal fall previously projected, we now forecast a small rise of 3¼ per cent to £830 million in total interest payments on the external debt. Assuming no annual change in the rather erratic item of other interest flows, gross factor outflows in 1988 are forecast to rise by £320 million or nearly 12 per cent.

On the evidence of the first quarter balance of payments estimates it is possible that the rise in gross factor inflows which could be expected as the consequence of the high level of private capital outflows in recent years has commenced. Allowing for a relatively modest 6 per cent rise in the annual total of such inflows results in a forecast increase of 14 per cent in net factor outflows to a level of about £2,220 million.

Net transfer payments, largely from the EC, could recover to about £1,000 million in 1988, resulting in a forecast balance of payments surplus on current account of £740 million, or 4 per cent of GNP. On capital account this seems likely to be balanced by a reduction in official borrowing, some increase in private capital outflows, especially through banking transactions, and a substantial increase in official external reserves.

As can be seen from Table 6, only a minor improvement in the current account balance of payments surplus is forecast for 1989. With export growth slowing and the value of imports rising, the projected increase in the surplus on trade in goods and services is less than £250 million. The slower rise in industrial exports should be reflected in a smaller increase in profit outflows, although this is expected to remain substantial. Higher international interest rates and the assumed absence of favourable exchange rate movements could lead to another small rise in interest payments on the external national debt, in spite of the possibility that there may be no net direct foreign borrowing in 1989. Allowing for a further small increase in gross factor inflows, it thus appears reasonable to project an increase of almost 9 per cent in net factor outflows in 1989.

A significant rise in net transfer payments in 1989 is possible, but at this stage of the year, before many of the relevant EC decisions have been finalised, it seems wiser to make the technical assumption of unchanged net transfers. On this basis, the surplus on current account is forecast to increase by only £50 million to £788 millions, remaining about 4 per cent of GNP.

Output

The volume of GDP is forecast to grow by almost 2½ per cent in 1988, and by about 3 per cent in 1989. While these increases are below the growth thought to have been achieved in 1987, the difference is mainly accounted for by the fact that the agricultural sector was in a period of strong recovery in 1987 after the weather-induced setbacks of the two previous years. So far as underlying factors are concerned, all three years should exhibit a moderate and fairly steady output growth.

Agriculture

With favourable weather conditions in the first half of 1988, the volume of gross agricultural product may show only a marginal decline for the year. Although milk output will be lower than in 1987 due to the super-levy quota, the weather could benefit both cattle production, in terms of weight gain, and crop yields. Moreover, the good fodder production, coupled with rising prices for imported feedstuffs could lead to a larger reduction in feed inputs than had previously been assumed likely. When account is taken of continuing growth in the output of fishing and forestry, the volume of net output in the agricultural sector as a whole could increase slightly in 1988.

On the usual assumption of normal weather conditions and with the expectation that quota cuts will be less severe than in the past two years, 1989 could again see a small rise in the net output volume of the agricultural sector.

Industry

Industrial output in the early months of 1988 has been exceptionally buoyant. The average seasonally corrected production index for manufacturing industry for the first four months of the year was 8½ per cent higher than the average for 1987 as a whole. With only a slight increase in the remainder of the year, which would be in keeping with the forecasts for industrial exports, the volume of production in manufacturing industry would be more than 10 per cent higher than in 1987.

Output in the mining sector and the public utilities seems likely to be little higher than last year, while the output of the building industry, including its consumer elements, could decline by about 8 per cent. In total, the increased volume of net output in the industrial sector seems likely to contribute over 2 per cent to the growth of real GDP in 1988.

The annual increase in the volume of production of manufacturing industry is likely to be lower in 1989, largely because the carryover from 1988 will be considerably less than that from 1987. An annual increase of about 7½ per cent appears a reasonable forecast. Offsetting this slower expansion in manufacturing is the likelihood that the building industry will show a small growth rather than a steep decline. As this could also improve the growth rate of the quarrying sector, it seems quite probable that the contribution of the industrial sector as a whole to GDP growth in 1989 could be marginally higher than in 1988, at perhaps 2¼ per cent.

Services

With an almost complete lack of up-to-date indicators on service output, forecasts have to be based on assessments of long-term trends and on consistency with other parts of the forecast. The output of private sector services appears to have been rising slowly in recent years despite the recession in the general economy. It is thus reasonable to expect this expansion to continue in 1988 as the economy as a whole grows. Public service output will decline in 1988, although by less than public authorities' net expenditure,as part of the reduction in the latter is due to increased charges, which do not reduce the volume of output. Total service output in 1988 is forecast to rise by almost 1 per cent, contributing a little under ½ per cent to the growth of real GDP.

The output of public services in 1989 depends to a large extent on policy decisions which have not yet been finalised. On our general interpretation of unchanged policies, there will be a reduction in the volume of public services, due mainly to carryover effects, but this reduction will be smaller than in 1988. Private services are projected to grow a little faster than in 1988, so the output of the total services sector in 1989 could increase by some 1½ per cent, contributing almost ¾ per cent to GDP growth.

Employment

The 1987 Labour Force Estimates recently issued by the CSO indicate that total employment in April 1986 was 5,000 higher than previously shown, and that employment in April 1987 was significantly higher than either our own or government estimates. If one can assume that the latest Labour Force Estimates are correct, then it would appear that the enterprise-based quarterly series on employment in industry and building are failing to capture the increase in employment in very small industrial undertakings, which are revealed only by a household based enquiry such as the Labour Force Survey. At the same time, the increase in jobs in the service sector, for which there are no short-term series, appears to have been much greater in 1987 than would have been reasonable to assume on the basis of general economic trends or of PRSI and revenue receipts.

At the time of writing, it is not clear what proportion of the increase in service employment between April 1986 and April 1987 represents temporary jobs created under government employment schemes, or what proportion comprises part-time jobs in the private service sector. Anecdotal evidence suggests that there has been a significant rise in the proportion of part-time employment in recent years. If this is correct, then the approximate stability in the total number of jobs between 1985 and 1987 would be compatible with the fall in aggregate hours worked which would have been expected given the relative economic stagnation of that period.

Whatever the precise explanation of the revised figures, they clearly raise the base from which forecasts of the future must be made, and also suggest that the underlying trends in total employment are somewhat less negative than had previously been assumed.

Thus, given the expectation of a slightly more labour intensive composition of manufacturing growth in 1988, it is not unreasonable to forecast that manufacturing employment will hold its seasonally adjusted March level through 1988. Allowing for some increase in those industrial jobs which are excluded from the industrial employment statistics but appear in Labour Force Surveys, but also taking into account the continued fall in building employment in the first half of 1988, average employment in the industrial sector as a whole could fall by about 3,000 in 1988, as shown in Table 7.

There could perhaps be a marginal increase in average service employment, despite the reduction in full-time public service jobs. However, what proportion of the increase in other service jobs will be on a part-time basis remains uncertain at present. Assuming a continuation of the secular decline in the numbers engaged in agriculture, it seems possible that the total number at work in 1988 will average about 1,072,000, a fall of about 5,000 on the 1987 average.

If these forecasts are even approximately correct, then the reduction of some 10,000 in the Live Register since mid-1987 must represent a decline in the size of the labour force, mainly through increased emigration.

Provided that the forecasts of continued industrial expansion and of a recovery in building activity are correct, the average employment in the industrial sector could increase slightly in 1989. On the assumption that there will be only minor cuts in public service employment, beyond the carryover effect of existing measures, total service employment could also rise a little.

TABLE 7: Employment and Unemployment

A: Mid-April Estimates '000

	1986	1987	1988	1989	1990
Agriculture	168	164	160	156	152
Industry	306	300	295	297	302
Services	606	616	617	619	624
Total at Work	1081	1080	1072	1072	1078
Unemployed	227	232	232	232	232
Labour Force	1308	1312	1304	1304	1310
Unemployment Rate %	17.4	17.7	17.8	17.8	17.7
Live Register	232	250	241	241	241

B: Annual Averages '000

	1986	1987	1988	1989
Agriculture	166	162	158	154
Industry	304	299	296	299
Services	610	616	618	621
Total at work	1080	1077	1072	1074
Unemployed	230	232	232	232
Labour Force	1310	1309	1304	1306
Unemployment Rate %	17.6	17.7	17.8	17.8
Live Register	236	247	241	241

Even allowing for a further fall in agricultural employment, it is thus reasonable to project a marginal increase in the total numbers at work in 1989.

The impact of employment stability on unemployment levels and emigration respectively has become impossible to predict. For the purpose of this forecast the technical assumption has been made that unemployment will remain constant, apart from seasonal factors, and that emigration and the size of the labour force will adjust to changes in employment trends.

Incomes

Although little change is now expected in the volume of net output in the agricultural sector, agricultural incomes are forecast to increase by 4 per cent in 1988, due mainly to rising output prices. Despite the likely rise in imported feed prices, agricultural incomes could show another small rise, perhaps about 2 per cent, in 1989.

With many settlements conforming with the terms of the Programme for National Recovery, but with some carryover of increases from 1987, it seems likely that average earnings in the private sector will increase by about 4½ per cent in 1988. Average public service earnings are also believed to have risen by about 4½ per cent in 1988. Allowing for some increase in the proportion of part-time working, effective job losses in the private and public sectors combined are likely to exceed ½ per cent, so that aggregate non-agricultural pay is forecast to rise by 3¾ per cent.

Provided that the Programme for National Recovery continues to hold for the majority of the private sector, and with a relatively low carryover in average

TABLE 8: Personal Disposable Income

	1987	Change		1988	Change		1989
	£m	%	£m	£m	%	£m	£m
Agriculture etc.	1880	4	75	1955	2	39	1994
Non-Agricultural Wages, etc.	10497	3¾	393	10890	4¼	462	11352
Other Non-Agricultural Income	2157	2	43	2200	3	66	2266
Total Income Received	14534	3½	511	15045	4	567	15612
Current Transfers	3586	3¼	116	3702	3	111	3813
Gross Personal Income	18120	3½	627	18747	3½	678	19425
Direct Personal Taxes	3949	3¼	128	4077	3½	143	4220
Personal Disposable Income	14171	3½	499	14670	3¾	535	15205
Consumption	11481	3¾	430	11911	4	476	12387
Personal Savings	2690	2½	69	2759	2¼	59	2818
Savings Ratio	19.0			18.8			18.5

earnings from 1988, average private sector earnings in 1989 could well increase by less than 4 per cent. However, due to the timing of special pay phases under the agreement, average public service pay is set to rise by more than 6 per cent in 1989. Allowing for a marginal rise in non-agricultural employment, but some shifts in composition towards lower paid jobs, total non-agricultural earnings in 1989 are forecast to increase by about 4¼ per cent.

Other non-agricultural personal income is difficult to predict with any accuracy, both because it is subject to considerable volatility and because the latest reliable estimates tend to relate to at least two years before the year being forecast. It is probable that income from non-agricultural self employment has been rising roughly in line with wages and salaries in recent years, and will continue to do so in 1988 and 1989. Income from interest dividends and rent is thought to have grown quite rapidly in 1987, but is expected to show little increase in 1988. While dividends are still rising substantially, the reduction in interest rates must inevitably reduce many forms of investment income. Taking this into account it appears reasonable to forecast that "other non-agricultural income" will increase by only 2 per cent in 1988 and by 3 per cent in 1989.

Current transfer payments are likely to grow more slowly in 1988 than in most recent years, largely because the numbers on the Live Register are tending to fall rather than rise. On our technical assumption that the Live Register will remain at approximately its present level and on the assumption that all benefit rates will be indexed in 1989 to a low rate of price inflation, current transfers could increase by 3¼ per cent in 1988 and 3 per cent in 1989.

As Table 8 shows, these projections result in an increase of 3½ per cent in gross personal income in both 1988 and 1989. Despite the buoyancy of total income tax receipts in the first half of 1988, it seems probable that taxes on personal income and wealth for the year as a whole will only increase by about 3¼ per cent. Due to the carryover effects of the 1988 budget into 1989, the assumption of unchanged policies, implying approximate indexation of allowances and tax bands, would result in personal taxation rising marginally more slowly than income in 1989.

On this basis, personal disposable income is forecast to grow by 3½ per cent in 1988 and by 3¾ per cent in 1989. As already discussed in relation to consumption, there are grounds for expecting the personal savings ratio to decline slightly in both 1988 and 1989. A decline of roughly ¼ per cent in each year in the personal saving ratio would still imply some growth in the actual value of personal savings but would permit the value of consumer expenditure to increase slightly faster than the rise in disposable income.

Consumer Prices

With the consumer price index less than 2 per cent above its corresponding 1987 level in both February and May, price inflation in the first half of 1988 has been at its lowest level for well over two decades. A slight increase in the rate of inflation is expected in the second half of 1988, as import prices tend to rise and as the effects of higher food prices become apparent. However, with pay settlements remaining low, and some further reductions in retail interest rates due to affect the August index, any upturn is likely to be very limited. By November, the 12 month increase could reach about 2¾ per cent, making the annual average increase in 1988 about 2¼ per cent.

Unless there is an unexpected surge in world inflation rates, there seems no reason why Irish inflation should accelerate appreciably. With any further interest rate reductions likely to be minor, the consumer price index is however likely to rise a little faster in 1989 than in 1988. An annual average increase of about 2¾ per cent, implying a rise of 3 per cent in the year to November 1989 would appear a reasonable projection, and would bring the consumer index more closely into line with current trends in wholesale prices.

Public Finances

It was suggested in the April *Commentary* that the current budget deficit and the borrowing requirement in 1988 might be slightly below the budget forecasts. From the half-yearly exchequer returns it would appear that assessment was unduly cautious, and that there will in fact be a major improvement over the budget forecasts. While much of the first half increase in direct tax receipts might be due to improved collection of arrears, and thus not necessarily repeatable in the second half of the year, most of the increase in indirect tax receipts seems more likely to be the result of unexpected buoyancy, and could thus continue for the remainder of the year. Total tax revenue for 1988 thus seems set to exceed the budget estimate by at least £150 million.

With regard to current expenditure, a significant saving compared with budget is expected in transfer payments, due to the lower than anticipated number on the Live Register, and there could also be some reductions in the EC contribution and domestic interest payments. Even if there is a slight overrun on some other types of expenditure as a result of modifications of policy since the budget, total current expenditure should remain comfortably below the budget target.

The current budget deficit for 1988 can thus reasonably be expected to be no more than £950 million, or just over 5 per cent of GNP. Assuming that borrowing for capital purposes remains close to its budgeted level, the exchequer borrowing requirement for 1988 should be in the region of £1280 or just under 7 per cent of GNP. This will represent a reduction of £500 million or over 3 per cent of GNP compared with the 1987 out-turn, similar in magnitude to the reduction achieved in 1987.

In spite of this massive improvement in the public finances in two successive years, it is by no means certain that the favourable momentum will be carried forward into 1989. If a significant proportion of the tax buoyancy in 1988 has represented the collection of tax arrears due to improved methods and a limited amnesty, then it would be imprudent to anticipate a similar trend in 1989. DIRT receipts are likely to be depressed by the lower levels of interest rates in the second half of 1988 and in 1989. Non-tax revenue is expected to decline significantly, as the ending of some special payments made in 1988 is unlikely to be matched by increased income from other sources.

On the expenditure side, the phasing of special pay awards under the terms of the Programme for National Recovery is expected to result in a large increase in average public service pay, despite the relatively modest general increase due for the year.

Taking these factors into account, it seems possible that a continuation of end-1988 expenditure volumes and real tax rates could result in a current budget deficit for 1989 approaching £1,100 million and an exchequer borrowing requirement in the region of £1,400 million. In such circumstances the growth in GNP would be perhaps ½ per cent higher than that shown in our central forecast, so that the deficit would represent almost 5½ per cent of GNP and the borrowing requirement just over 7 per cent of GNP. While such an out-turn would not comprise a significant weakening of the public finances, it would be an interruption to the process of reducing the borrowing requirement towards equality with the growth of nominal GNP, and might not be compatible with the interest rate assumptions underlying the forecasts in this *Commentary*.

On the basis of current indications, which could, of course, change considerably before the end of the year, it thus appears that additional net savings of about £150 million would be required in 1989 to meet the central assumption of this *Commentary* that the borrowing requirement will remain unchanged in money terms. If this is achieved, then on our forecast figures the current budget deficit would represent just over 4¾ per cent of GNP and the borrowing requirement 6½ per cent of GNP.

Unless there are strong offsetting factors, such as a resultant fall in interest rates, fiscal retrenchment inevitably tends to depress the growth rate. It is difficult to see what offsetting factors would accompany still further retrenchment in 1989, and so a deliberate attempt to reduce the borrowing requirement below, say, 6 per cent, would probably result in the GNP growth rate falling to under 2 per cent, with an obviously negative impact on employment levels. However, the borrowing requirement in 1989 could indeed be reduced much further than expected, as in 1988, if it turns out that we have significantly underestimated the autonomous growth in the economy.

Interest Rates

We argued in the April *Commentary* that in present circumstances Irish interest rates should be substantially lower than those in the U.K. We also suggested that the emergence of this reverse differential was most likely to be through the process of Irish rates tracking UK rates downwards and then remaining stable when UK rates were subsequently raised.

This is almost exactly what has occurred over the past few months, particularly with regard to wholesale interbank rates and the associated retail and mortgage rates. For the present, the market appears to have accepted the logic that the exchange risk attaches to sterling rather than the Irish pound and that balance of payments and inflation trends are a great deal more favourable in Ireland than in the UK. Provided that this situation continues for another few months, and there seems no reason why it should not, the divorce between London and Dublin short-term interest rates should become absolute, and the Dublin market could well enter into a recognised relationship with the other EMS markets.

If such a transition is completed, then it seems possible that Irish wholesale interest rates could decline a little further in the course of 1988 and 1989. Although German interest rates are tending to rise, the differential remains sufficiently large to permit a small reduction in Irish rates in response to continuing high liquidity in the Irish market. However, any further decline is likely to be minor, and could well be temporarily reversed in the winter months when liquidity tends to be lower for seasonal reasons.

The process of diverging from London interest rates seems much less complete in the case of long-term gilt yields. Despite the fall in yields in recent weeks, the reverse differential so far established is still quite small, and the differential over continental yields remains relatively large. Provided the wholesale money market remains stable, currency strains do not emerge within the EMS, and confidence is maintained in Irish fiscal management, a significant decline in gilt yields could take place in the next few months. It certainly seems reasonable to assume that average yields in 1989 will be well below the 1988 average.

General Assessment

In many ways the Irish economy has made considerable progress in the first half of 1988. Exports and industrial output have continued to grow, the exchequer deficit has been significantly reduced, price inflation is very low by either historical or international standards, and nominal interest rates have fallen well below those in the UK. Perhaps most significant of all, there are several signs that domestic demand, in the form of personal consumption and private sector investment, is beginning to recover slowly from the stagnation of recent years.

The chief task of economic commentators is to predict whether these favourable developments are likely to persist through the remainder of 1988 and 1989, to assess the danger of setbacks occurring, and to indicate whether potential setbacks can be averted or minimised through the adoption of appropriate policies.

The most likely course of the international economy, with moderate growth in output, investment and trade continuing, accompanied by slightly higher inflation and gently rising interest rates would provide a favourable environment for a consolidation of the Irish economic recovery in the next 18 months. However, it must be recognised that this benign international development, although quite likely is by no means certain to transpire. Major imbalances persist in the world economy, and these could at almost any time trigger damaging instability in exchange rates, trade patterns and output levels.

The main external danger, from an Irish point of view, is that the unsustainable inflationary trends in the UK economy will lead to violent rather than gradual adjustments. These could take the form either of a sudden collapse in the value of sterling, with inflation thereafter intensifying, or of a loss of consumer and business confidence triggering an unplanned recession in UK demand. While neither of these setbacks is certain, it would be foolish to ignore the possibility of their occurring, particularly while the UK authorities remain determined to rely on interest rate adjustments as the sole tool of economic management. Either outcome would of course be damaging to the Irish economy, through restricting export growth to a major market and possibly reintroducing a degree of instability to Irish capital markets.

Other, more remote, risks include the possibility of OPEC reaching sufficient agreement to engineer a major rise in oil prices, international inflation accelerating to the point where major governments induce a recession in their attempts to contain it, or conversely an autonomous recession which governments are slow to counteract.

Among the purely domestic dangers to the forecast recovery, the fact that confidence in the future of the economy is relatively new-found implies that it is also still fragile. Such shocks as a temporary rise in interest rates, an ill-designed budget or even a major strike could once more instil a spirit of pessimism, which would tend to be self justifying as negative investment or consumer decisions stifle the growth of domestic demand. Such a reversion to despondency would at present appear to be a greater risk than the opposite danger of over-confidence leading to a revival of inflationary pressures. The state of the labour market and the strong balance of payments surplus give room for considerable economic growth before inflationary problems are likely to become serious.

Given the central forecast of a moderate, but still tentative, recovery in domestic demand within an international environment that will probably remain favourable but could deteriorate suddenly, economic management needs to be cautious without being negative.

From a long-term as well as a short-term perspective the most important single task is probably to enable the financial markets to complete the process of aligning with continental rather than UK trends. Those with long memories may well recall the debate surrounding Irish entry to the EMS in 1979, where the benefits of such a transfer were strongly extolled, with virtually no effect on subsequent behaviour patterns. Now, almost a decade later, the adjustment is taking place and the full benefits could become apparent in the next few years.

In policy terms, the essentials are that Irish inflation, both of prices and of pay, is kept at or below the EMS average, and that the exchequer borrowing requirement is managed in a way that permits some further shrinkage of interest rate differentials *vis a vis* Germany. This in turn dictates the need to budget for the exchequer borrowing requirement to be reduced further in 1989, as a proportion of GNP, because the downward pressure on Irish interest rates is based in part on an expectation that continuing reductions will be made.

Quite apart from its role in consolidating Ireland's emergence as a low inflation, low interest rate economy, there is a more general argument in favour of some further reduction of the borrowing requirement in 1989. Our forecasts indicate, subject to a considerable margin of error, that with no additional cuts the borrowing requirement in both 1988 and 1989 could be roughly 7 per cent of GNP. Superficially this would appear to be just at the upper end of the range generally accepted as necessary to stabilise the debt/GNP ratio. However, this range is itself determined by expectations of the likely annual increase in nominal GNP. In a period of low inflation, nominal GNP growth is unlikely to reach 7 per cent. For instance, our own projection for 1989 shows that the forecast growth of 2½ per cent in real GNP implies an increase of only 5½ per cent in nominal GNP. Given that reducing the borrowing requirment is itself likely to reduce the growth rate, full debt stabilisation in 1989 would probably demand that the borrowing requirement be reduced to well under 5 per cent of GNP.

This arithmetical exercise does not, of course, indicate that the correct budgetary aim for 1989 is an exchequer borrowing requirement of under £1,000 million which would be needed to match the corresponding growth rate in nominal GNP. In the first place, economic forecasts are not invariably accurate, and this forecast in particular is quite deliberately cautious with regard to export performance, private investment and consumer spending decisions. In the second place, there is no commitment or even expectation that stabilisation of the debt ratio should occur in 1989 rather than in 1990. In the third place, and most important, now that the borrowing requirement is close enough to the stabilising level to have virtually eliminated the vicious circle of increased interest charges forcing the budget deficit ever wider, there are strong arguments in favour of a steady medium term approach of gradual annual reductions rather than one last big push.

Unless it has become apparent by January that expansionary forces within the economy have become so robust as to warrant firm fiscal restraint, the budget should ideally balance the need to obtain some further reduction in the borrowing requirement with the desirability of allowing a reasonable increase in real consumer expenditure. Only a sustained expansion in consumption and the increase in domestic investment that this would induce can lead to a significant rise in employment in the medium term.

On present indications therefore it would seem that a borrowing requirement for 1989 of about the same absolute magnitude as in 1988 would be an appropriate aim. This could reduce the borrowing requirement to about 6½ per cent of GNP without unduly depressing domestic demand. This aim would appear to entail net savings of about £150 million, over and above those implied by the continuation of measures already introduced.

The structure of a budget to achieve such an aim is primarily a matter for political rather than economic choice. Political rather than economic factors would appear to preclude any attempt to obtain the desired reduction in borrowing through increased real rates of taxation. Indeed political pressures may well force greater cuts in expenditure in order to finance some reduction in real direct tax rates. It should be noted that the purely economic arguments in favour of such an action are far from convincing, and it is by no means self evident that reduced taxation, financed by greater expenditure cuts, would stimulate either output or employment. Given the likelihood that the savings ratio would be higher among the recipients of tax cuts than among those who had lost income in government spending cuts, such a shift could well reduce the growth rate rather than increase it, and the net employment effect could be negative. The onus would thus appear to rest on the proponents of tax cuts, and particularly of tax cuts on the higher range of incomes, to produce empirical evidence to support their assertions that in present circumstances a reduction in direct tax levels would contribute significantly to Ireland's economic recovery.

There is a much stronger case for some restructuring of the direct tax system, especially as it affects the corporate sector, than there is for a simple reduction in direct taxation as a whole. There is also a powerful case for beginning to reduce some indirect tax rates towards the levels which will become necessary in 1992. One major advantage of a limited restructuring of direct taxes and some reduction of real indirect tax rates is that both moves would help to maintain a climate of income restraint, which will be vitally necessary to general economic strategy in 1989 and beyond.

It is doubly unfortunate that 1989 will see the major cost of the special pay concessions granted to the public service in order to secure the national understanding of 1987. Not only are these pay rises a dominant factor in the difficult budgetary arithmetic facing the authorities in 1989, but as they become apparent they might well undermine the pattern of relatively low pay settlements which has become established in the private sector. If Irish economic variables are to become more closely tied to those on the continent, a private sector pay explosion cannot be permitted. The unions representing private sector employees have acted with notable realism and responsibility in recent years. A combination of modest tax reform, a commitment to low price inflation, the maximum feasible retention of public services and employment, and the re-establishment of firm control over public service pay, seems far more likely to ensure a continuation of this responsibility than would the introduction of large cuts in direct taxation financed by deeper reductions in public spending.

In summary, fiscal policy in 1989 should ideally seek to maintain a balance between further improvement in the public finances and facilitating sustainable economic growth. In this the situation differs from both 1987 and 1988 where the overriding consideration was the improvement in the public finances and the growth that occurred came as an unplanned bonus. However, maintaining balance calls for delicacy of judgement. Sufficient uncertainty exists concerning both growth prospects and the state of the exchequer to preclude accurate judgement at present. Planning must obviously proceed, but final decisions on both expenditure levels and taxation rates should be postponed until much later in the year.

STATISTICAL APPENDIX

	Output Indicators				Employment		Output per Head	
	1	2	3	4	5	6	7	8
	Manufacturing	Transportable Goods	Electricity Output	Cement Sales	Manufacturing	Transportable Goods	Manufacturing	Transportable Goods
	1980 = 100	1980 = 100	G.W.H.	000 Metric Tons	000's	000's	1980 = 100	1980 = 100
1981	102.7	101.6	10767	1812.5	222.5	234.2	105.0	103.7
1982	104.9	103.6	10792	1486.1	215.1	225.8	110.9	109.7
1983	113.7	111.1	11039	1382.4	202.2	212.3	127.9	125.1
1984	125.0	124.0	11424	1298.4	195.6	205.1	145.3	144.5
1985	130.6	127.2	11919	1233.1	187.1	195.8	158.7	155.3
1986	134.4	131.1	12466	1147.9	185.8	193.9	164.5	161.6
1987	149.8	145.8	12866	1142.2	182.7	190.4	186.5	183.0

Quarterly Averages or Totals

1985 I	132.9	128.9	3259	241.3	187.6	196.3	161.1	156.9
II	138.5	134.9	2818	350.4	186.3	196.0	169.1	164.5
III	119.3	117.0	2705	333.1	187.3	195.6	144.8	143.0
IV	132.2	128.3	3137	308.3	187.2	195.1	160.6	157.2
1986 I	132.8	128.3	3356	205.0	184.8	192.7	163.4	159.1
II	140.2	136.9	2996	319.1	185.6	194.7	171.8	168.0
III	124.6	123.0	2814	330.6	187.3	195.1	154.2	150.7
IV	140.1	136.4	3300	293.2	185.6	193.0	171.7	168.9
1987 I	138.0	133.0	3466	218.5	183.2	190.3	171.3	167.0
II	159.2	155.6	3015	323.8	183.6	192.3	197.2	193.4
III	141.1	140.1	2956	321.3	183.7	191.7	174.7	174.7
IV	160.9	154.5	3429	278.6	180.8	187.8	202.9	196.6
1988 I	164.1	157.5	3516	206.0	178.4	185.3	209.7	203.1
II				343.1				
III								
IV								

Quarterly Averages or Totals Seasonally Corrected

1985 I	133.3	130.9	2959	306.8	189.0	198.1	160.4	157.9
II	130.7	126.5	2973	313.6	187.0	195.7	158.9	154.5
III	128.7	124.3	3005	298.6	186.0	194.4	157.3	152.8
IV	130.1	127.0	2990	305.7	186.5	194.9	159.4	155.7
1986 I	133.5	130.6	3044	274.0	186.2	194.5	163.0	160.5
II	132.1	128.0	3161	286.2	186.2	194.3	161.3	157.4
III	134.8	131.2	3120	295.0	186.0	193.9	164.8	161.7
IV	137.9	135.0	3151	289.9	184.9	192.8	169.6	167.3
1987 I	138.1	134.9	3143	292.5	184.6	192.1	170.1	167.8
II	149.8	145.2	3184	287.2	184.2	191.9	184.9	180.8
III	152.8	150.2	3276	288.2	182.4	190.5	190.5	188.4
IV	158.0	152.5	3274	278.2	180.2	187.1	199.9	194.8
1988 I	164.7	160.0	3194	276.1	179.8	187.0	208.8	204.1
II				304.3				
III								
IV								

Unemployment	Prices						
9	10	11	12	13	14	15	
Live Register Av. Monthly	Consumer Price Index	Agricultural Price Index	Import Unit Value	Export Unit Value	Terms of Trade	Price of Stocks + Shares	
000's	Nov. 1982 = 100	1980 = 100	1975 = 100	1975 = 100	1975 = 100	1975 = 100	
127.9	82.4	117.7	232.4	208.4	89.7	219.9	1981
156.6	96.5	127.5	249.4	231.5	92.8	179.9	1982
192.7	106.6	135.4	261.1	251.9	96.5	223.7	1983
214.2	115.8	139.4	286.5	273.0	95.3	296.1	1984
230.6	122.0	135.6	293.2	280.6	95.7	316.8	1985
236.4	126.7	135.2	269.8	267.7	99.2	489.8	1986
247.3	130.7	140.8	259.9	258.5	99.5	707.4	1987

Quarterly Averages or Totals

232.8	119.9	140.7	297.3	280.3	94.3	284.7	1985 I
226.5	121.5	140.2	300.6	288.0	95.8	289.4	II
231.8	123.3	133.1	298.0	289.9	97.3	333.3	III
231.2	123.5	134.3	289.7	282.7	97.6	359.8	IV
238.7	125.4	140.8	279.0	270.0	96.8	426.8	1986 I
231.8	126.9	139.1	266.0	268.4	100.8	508.5	II
235.1	127.1	131.4	266.7	267.5	100.3	509.5	III
240.0	127.4	134.5	267.5	265.0	99.1	514.6	IV
252.1	129.7	143.0	257.1	256.0	99.6	632.4	1987 I
247.9	130.5	143.3	259.2	258.1	99.6	706.2	II
246.3	131.2	140.1	261.3	260.5	99.7	799.8	III
243.0	131.3	139.5	261.9	259.4	99.0	691.3	IV
250.0	132.2	149.1	263.5	268.8	102.0	597.6	1988 I
238.4	132.9					674.1	II
							III
							IV

Quarterly Averages or Totals Seasonally Corrected

226.4	119.9	137.4	No Seasonal Pattern	No Seasonal Pattern	No Seasonal Pattern	No Seasonal Pattern	1985 I
228.7	121.1	136.3					II
234.2	123.1	136.7					III
233.1	124.1	137.8					IV
232.3	125.3	137.5					1986 I
233.9	126.5	135.2					II
237.4	126.9	135.1					III
242.0	128.1	138.1					IV
245.6	129.6	139.6					1987 I
250.1	130.1	139.3					II
248.6	131.0	144.6					III
245.0	132.0	142.7					IV
243.7	132.1	145.3					1988 I
240.4	132.5						II
							III
							IV

	Money Earnings Weekly Averages		Real Earnings		Consumption Indicators		
	16	17	18	19	20	21	22
	Manufacturing	Transportable Goods	Manufacturing	Transportable Goods	New Cars Registered	Retail Sales Value	Retail Sales Volume
	1982 = 100	1982 = 100	1982 = 100	1982 = 100	Total	1980 = 100	1980 = 100
1981	88.6	88.8	103.7	104.0	104645	118.3	99.4
1982	100.0	100.0	100.0	100.0	72603	129.4	94.0
1983	111.7	111.8	101.1	101.2	61094	137.0	90.5
1984	125.3	125.1	104.4	104.3	55893	145.8	89.4
1985	135.3	134.2	107.0	106.1	59592	155.9	91.0
1986	145.4	145.6	110.7	110.9	58760	158.8	90.5
1987	152.6	152.3	112.6	112.4	54341	161.3	89.3
Quarterly Averages or Totals							
1985 I	129.8	129.4	104.4	104.2	19914	147.5	87.5
II	135.1	136.0	107.3	108.0	19200	153.4	89.9
III	136.3	135.7	106.7	106.2	13287	155.3	90.2
IV	140.2	139.3	109.5	108.8	7191	165.8	95.6
1986 I	140.1	139.5	107.8	107.3	19177	155.5	89.0
II	144.3	145.6	109.7	110.7	18202	154.7	88.3
III	147.0	147.7	111.6	112.1	14093	157.3	89.9
IV	150.3	149.9	113.8	113.5	7288	166.4	94.1
1987 I	149.1	148.6	110.9	110.5	17376	155.5	86.8
II	153.8	153.3	113.7	113.3	17619	158.6	88.0
III	152.6	152.2	112.2	111.9	12539	159.0	87.8
IV	156.0	155.2	114.6	114.0	6807	172.3	94.4
1988 I	156.3		114.1		20070	161.5	88.0
II					18854		
III							
IV							
Quarterly Averages or Totals Seasonally Corrected							
1985 I	131.4	131.4	105.6	105.6	14368	150.2	89.0
II	134.7	134.7	107.3	107.2	15550	155.8	91.3
III	136.4	136.0	106.9	106.6	14963	157.2	91.4
IV	138.8	138.4	107.9	107.6	14475	158.6	91.3
1986 I	141.8	141.5	109.2	108.9	14143	158.6	90.8
II	143.7	144.3	109.6	110.0	14497	156.9	89.6
III	147.2	147.8	111.9	112.5	15643	159.3	91.0
IV	148.9	149.0	112.2	112.2	14796	159.0	89.8
1987 I	150.9	150.8	112.4	112.2	13024	159.2	88.9
II	153.1	151.8	113.5	112.5	13862	161.1	89.5
III	152.8	152.4	112.5	112.3	13847	161.1	88.8
IV	154.5	154.3	113.0	112.7	13862	162.7	89.1
1988 I	158.2		115.6		15119	165.1	90.1
II					14834		
III							
IV							

Government			Monetary Developments				
23	24	25	26	27	28	29	
Current Revenue	Current Expenditure	Current Deficit	Money Supply M3	Licensed Banks Domestic Credit Government	Licensed Banks Domestic Credit Non-Gov.	External Reserves	
£m	£m	£m	£m End Period	£m End Period	£m End Period	£m End Period	
3973	4796	823	n.a.	1277.4	n.a.	1473.1	1981
4908	5896	988	7291.9	1564.7	6655.1	1594.0	1982
5711	6671	960	7697.4	1775.6	7493.8	2014.8	1983
5952	6991	1039	8473.9	2247.9	8127.6	2101.2	1984
6331	7615	1284	8924.8	2514.1	8441.1	2271.9	1985
6709	8104	1395	8836.9	2725.7	9065.5	2205.3	1986
7152	8332	1180	9799.5	2754.9	9494.5	2821.4	1987
Quarterly Totals			Monthly Totals				
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	276	8639.4	2421.6	8206.8	3009.6	III
1809	2004	195	8924.8	2514.1	8441.1	2271.9	IV
1416	2057	641	8567.5	2510.1	8730.6	2232.8	1986 I
1736	2051	315	8449.5	2354.6	8596.7	2296.5	II
1591	1845	254	8677.0	2277.8	8744.7	2116.4	III
1967	2152	185	8836.9	2725.7	9065.5	2205.3	IV
1476	2171	695	8838.5	2619.0	9201.8	2295.7	1987 I
1894	2115	221	9216.3	2556.7	9195.1	2477.8	II
1701	1904	203	9549.1	2614.4	9078.1	2810.9	III
2080	2141	61	9799.5	2754.9	9494.5	2821.4	IV
1628	2132	504	9775.0	3011.0	9458.2	3075	1988 I
1812	1959	147				3512	II
							III
							IV
Quarterly Totals (S.C.)			Monthly Totals (S.C.)				
1514	1918	403	No Seasonal Pattern	No Seasonal Pattern	No Seasonal Pattern	No Seasonal Pattern	1985 I
1586	1783	197					II
1620	1959	339					III
1596	1956	360					IV
1634	1989	356					1986 I
1672	2039	367					II
1653	1978	324					III
1735	2095	360					IV
1710	2099	389					1987 I
1817	2102	285					II
1773	2046	273					III
1833	2082	249					IV
1886	2061	175					1988 I
1739	1947	208					II
							III
							IV

	Visible Trade Indicators					Exchange Rates	
	30	31	32	33	34	35	36
	Imports (Value)	Exports (Value)	Trade Surplus (Value)	Imports (Volume)	Exports (Volume)	Effective Index	Sterling
	£m	£m	£m	1975 = 100	1975 = 100	Dec. 1971 = 100	Per IR£
1981	6578.4	4777.6	- 1800.8	166.0	158.3	67.75	0.8002
1982	6816.2	5691.4	- 1124.7	160.3	169.8	67.35	0.8125
1983	7366.8	6943.8	- 422.0	165.3	190.2	65.13	0.8222
1984	8912.2	8897.5	- 14.6	182.6	225.2	62.26	0.8134
1985	9428.2	9743.0	314.8	188.7	239.9	62.41	0.8234
1986	8621.3	9374.3	753.0	194.4	249.5	66.65	0.9147
1987	9155.2	10723.5	1568.3			66.15	0.9089
Monthly Averages							
1985 I	819.9	800.4	- 19.6	194.4	236.6	61.93	0.8586
II	807.2	856.1	48.9	189.3	246.2	61.45	0.8074
III	740.9	795.3	54.4	175.0	227.5	62.17	0.7963
IV	775.4	796.0	20.6	188.6	233.3	64.15	0.8330
1986 I	732.4	762.6	30.2	185.0	234.6	66.65	0.8978
II	723.1	786.4	63.4	191.4	243.1	67.33	0.8976
III	666.9	753.4	86.5	176.1	233.6	66.40	0.9144
IV	754.2	827.0	72.8	198.6	258.8	66.22	0.9497
1987 I	738.9	773.6	34.8	202.4	250.6	66.77	0.9422
II	763.0	927.4	164.4	207.3	298.1	66.01	0.9024
III	731.5	882.7	151.1	197.2	280.9	65.56	0.8997
IV	819.5	992.0	172.5	220.3	317.0	66.31	0.8919
1988 I	802.7	914.7	112.0	214.9	281.4	66.31	0.8853
II	811.9	1023.6	211.7			65.26	0.8511
III							
IV							
Monthly Averages. Seasonally Corrected.							
1985 I	794.8	836.1	41.3	187.4	244.6	No Seasonal Pattern	No Seasonal Pattern
II	797.5	817.7	20.2	186.3	235.1		
III	779.8	810.2	30.4	186.2	232.6		
IV	768.4	782.3	13.9	186.3	231.3		
1986 I	711.4	800.8	89.4	179.1	243.3		
II	721.1	754.8	33.7	188.7	233.0		
III	705.9	763.4	57.5	186.4	237.6		
IV	735.5	810.8	75.3	196.8	256.0		
1987 I	716.1	812.4	96.3	195.2	260.8		
II	762.1	887.7	125.6	204.7	284.1		
III	780.3	903.4	123.1	210.2	289.8		
IV	798.8	970.4	171.6	216.3	315.1		
1988 I	765.0	942.5	177.5	203.7	285.8		
II	810.9	979.8	168.9				
III							
IV							

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