MASSES OF GROWTH POTENTIAL

JOHN BEGGS OF ALLIED IRISH BANKS LOOKS AT THE EVENTS SHAPING THE IRISH ECONOMY IN 2001 AND 2002, WITH THE EMPHASIS ON GROWTH AND INFLATION.

The rate of economic growth in Ireland is expected to slow to about 6.5% in 2001, the slowest since 1994. Last year, real GDP grew by an impressive 11.5%. Over the five years to 2000, the Irish economy expanded at an annual average growth rate of 9.9%. Over the same period, the average rate of unemployment fell from 12.2% in 1995, to 3.7% at the end of 2000. The Irish Exchequer benefited from this favourable economic outlook with the fiscal balance moving into surplus equal to 3.5% of GNP by 2000. Ireland's national debt ratio also developed along a very favourable path with the ratio down to 39% of GDP in 2000. A further fall is anticipated in 2001 to an estimated 34% of GDP.

EXTERNAL SHOCKS PRODUCE SLOWDOWN IN GROWTH. The available information on the Irish economy in 2001 indicates that the rate of economic growth has slowed sharply in the course of the year. The main indication of a speedy slowdown comes from Exchequer revenues. However, trade and industrial production figures also point to a deceleration in the rate of activity by mid-year. The projected average performance in 2001 of 6.5% appears favourable by international standards. However, it masks a strong inherited contribution from 2000. As a result of weakening intra-year trend in activity, the average rate of growth in 2002 could slow to about 4%. This is below the economy's trend rate and could imply a slight rise in unemployment to 4.2% in 2002, from 3.7% in 2001. It will also result in a sharp reduction in the fiscal surplus. The slowdown in the rate of economic growth is coming from a number of sources.

- the labour supply has now slowed to about 2%;
- the impact of the sharp slowdown in the US and international economies;
- events in the US in September will compound the global slowdown;
- Ireland's dependence on the hi-tech sector is raising fears for the economy as a whole; and
- the foot-and-mouth disease crisis was a further significant shock to the economy.

This combination of supply constraints and external shocks will bring the economy into line with its longer-term potential more quickly than had been anticipated. But, in doing so, the economy may have been spared a long period of uncompetitive wage increases, which would have left the economy with a less favourable medium-term outlook.

ECONOMY TO GROW BY 4% IN 2002. The projected growth in real GDP in 2002 of 4% will remain impressive by international standards. Growth in the US is expected to be no more than 1%, while the growth in activity in the eurozone is forecast at no higher than 1.5%. The projected rate of growth in the UK could be somewhat higher. Therefore, Ireland is likely to continue its relatively stronger performance against its main trading partners in 2002.

Medium-term forecasts indicate that the Irish economy's growth potential remains robust. However, this potential growth rate, estimated at about 5% over the next five years, is well down on the 7%-8% per year estimated for the 1995-2000 period. One of the main reasons for this is the expected slower growth in the Irish labour force. Increases due to the natural growth in the Irish

'INFLATION HAS EASED, HELPED BY THE FALL IN OIL PRICES AND IN INTEREST RATES. THE ECONOMIC SLOWDOWN SHOULD ALSO DAMPEN COST PRESSURES IN THE SHORT TERM'

TABLE 1

DRIVING THE IRISH ECONOMY

% Change volume	2000	2001(f)	2002(f)
GDP	11.5	6.5	4.0
GNP	10.4	5.5	3.5
Of which:			
Consumer spend	9.9	5.0	4.0
Fixed investment	7.0	2.0	-2.0
Exports	17.8	11.0	5.0
Imports	16.6	9.0	4.0
Memo items:			
Consumer prices (%)	5.6	4.7	3.0
Underlying CPI (%)	5.5	4.0	3.0
Unemployment rate (%)	4.3	3.7	4.2
Government balance (% of GNP)	3.5	1.6	–
Gen Govt/GDP ratio (%)	3.9	3.4	31

Source: AIB

population, net immigration and a rising participation rate, particularly for females, saw Irish labour supply growth peak at more than 5%. More recently, however, the annual growth in labour supply has slowed to about 2%.

Such a rate of expansion is projected over the next few years. Coupled with the continuation of strong growth in national productivity, Irish potential GDP growth is extremely favourable at 5%, or higher. Ireland's favourable underlying economic conditions suggest the economy is capable of fulfilling this potential. After a period of weaker activity in 2002, therefore, a period of stronger economic growth is forecast for 2003 onwards.

The Irish economy is very dependent on the outlook for world trade. This should improve from the end of 2002. Irish cost competitiveness has deteriorated slightly in 2001, but over a longer period, the economy has sustained considerable accumulated gains relative to the country's main trading partners. While wage costs have risen as a result of rapid economic development and the tightening labour market, the weakness of the euro has protected the overall competitiveness of Irish businesses in the non-euro markets.

HIGHER INFLATION ON EURO PARTICIPATION. Ireland's participation in the euro since its launch in 1999 has not posed any significant difficulties. However, the rate of inflation did accelerate towards the end of 1999 and into 2000 as the euro weakened against other major currencies. The UK remains Ireland's main trading partner, accounting for more than 22% of its exports and over 30% of Irish imports. Trade with the US is also very significant.

Consequently, as a very open economy, the weakening of the euro against sterling and US dollar posed significant inflation risks to Ireland. The annual rate of inflation peaked at 7% in November 2000. Since then, the rate has decelerated. Ireland's inflation problem was compounded by the sharp rise in oil prices and by the increase in official eurozone interest rates. The European Central Bank (ECB) raised rates from their low of 2.5% in April 1999 to a peak of 4.75% in 2000. As with the UK's RPI, the Irish Consumer Price Index (CPI) incorporates the effects of changes in mortgage interest costs.

This rise in headline inflation came at an inopportune time because the tightening labour market conditions meant that wage demands were on the increase. The unexpected rise in the annual rate of inflation put significant pressures on the centralised pay agreement. Some upward adjustment to pay rates was conceded as a result. Overall, however, the inflation environment has eased, helped by the fall in oil prices and the reduction in interest rates. The economic slowdown should also dampen cost pressures in the short term. The Irish economy was adversely affected by the foot-and-mouth crisis in the first half of 2001. This reduced the level of demand within the economy, but also resulted in higher food prices. Some of these pressures are expected to ease.

Helped by the overall strength of the economy and the demographic profile, Irish house prices rose sharply in recent years. Low interest rates also helped affordability. House prices have now peaked, though the annual rate of increase remains about 12% on a year-on-year basis. However, in terms of intra year trends, prices have softened in many parts of the market.

With Ireland's strong underlying natural demand for housing and the continued growth in employment of 1.5%-2% a year, the housing market is expected to remain stable. No major setback is anticipated in house prices in the key market segments. The slowdown in the rate of growth of house prices is a welcome development because, as an economy within the eurozone, Ireland does not possess an independent monetary policy with which to influence the evolution of house prices.

Because of a weaker-than-expected euro currency and low interest rates, the Irish economy received a boost in the initial period of euro membership. The rate of economic accelerated in 1999 to 10.8%, from 8.6% in 1998. Growth accelerated further in 2000 to more than 11%. The fall in the exchange rate boosted Ireland's competitive advantage, which resulted in a sharp rise in volume of exports. In hindsight, Ireland entered at too low an exchange rate.

There are some indications that the euro will become more stable in foreign exchange markets in the future. The dollar's long period of outperformance appears at an end. The relationship between the euro and sterling has also became relatively more stable as the markets perceive that UK membership of the euro is possible within a number of years.

The key issue for the UK will be the entry rate for sterling. The current exchange rate of £0.62-£0.63 appears too high. As Ireland's trading partner, the participation of the UK in the euro would be a major source of stability to the Irish economy. Given the historic exchange rate relationship between the two economies, sterling's likely entry rate to the euro of £0.67–£0.70, would not pose any problems for Irish businesses.

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