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<th>Recovery, recession and recovery again: some aspects of Irish economic performance and prospects 1987-1993</th>
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<tr>
<td><strong>Authors(s)</strong></td>
<td>Durkan, Joe</td>
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RECOVERY, RECESSION AND RECOVERY AGAIN
SOME ASPECTS OF IRISH ECONOMIC PERFORMANCE AND PROSPECTS 1987 - 1993

by

JOSEPH DURKAN

POLICY PAPER NUMBER PP92/3

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Recovery, Recession and Recovery Again
Some Aspects of Irish Economic Performance and Prospects
1987 - 1993

J Durkan

UCD

Paper delivered at University College Dublin February 1992
Section 1. The 1987 Recovery and the 1990 - 1991 Recession

1.1 Table 1.1 presents aggregates covering the performance of the economy over the 1980's. For many of these aggregates with measures of output showing a significant increase compared with the earlier period, the Balance of Payments on current account going into surplus for the first time, the EBR falling in absolute terms and relative to GNP by a significant amount, and unemployment declining. Inflation had already come down in the mid 1980's, and remained at rates that were low compared with previous experience.

1.2 It has become conventional to assign this improvement in the economy to the pursued by the new Government elected in 1987. This may be the case as to policy and an immediate belief among economic agents that a shift in policy occurred. The recovery in fact depended only in part on policy shifts, as the firms in the UK and the following the collapse in oil prices.

The Growth of the UK Economy

1.3 Gross Domestic Expenditure (GDE) in the UK grew
by just over 3 per cent between 1981 and 1985. Thereafter GDE growth accelerated, reaching 7.8 per cent in 1988 (Table 1.2). Associated with this there was a sharp increase in import volumes. The really sharp increases in import volumes took place in the second and third quarters of 1987 when the quarter-on-quarter rises were 4.1 per cent and 4.8 per cent respectively.

This growth in UK imports was reflected in increased imports from Ireland (Table 1.3), particularly in 1987. Since 1986 however this was reversed, with imports from Ireland increasing by 62.7 per cent while imports from all countries only increased by 56.4 per cent. The increase in 1987 relative to other countries was responsible for this. Ireland's share of these imports is small at about 3 per cent.

1.5 The growth in UK imports of manufactures from Ireland accounted for a significant proportion of increased Irish exports (Table 1.4). Thus it is clear that the growth in UK demand resulted in a marked increase in Irish exports to the UK, relative to other markets and relative to other imports into the UK in the period 1987 and 1988.
1.6 The growth in UK imports was not just due to the growth in demand. The UK experienced a loss of competitiveness from the mid 1980's as demand increased. The inflation and exchange rate was being reached and an inflation (Chart 1.1). It is clear that using a range of measures of competitiveness, UK competitiveness deteriorated toward the end of 1986. While available measures for Ireland are not so readily available (particularly as the interpretation of similar measures is not so clearcut for a small economy) the annual data for Irish unit wage costs in sterling terms and for relative unit wage costs (i.e. relative to competitors) show an improvement in competitiveness in unit wage cost terms in the UK market (Chart 1.2)

1.7 Finally there was a significant increase in the UK. This was associated with an (Chart 1.5).

1.8 This analysis suggests that increased demand in the UK, improved competitiveness and an increase in internally generated resources in the corporate sector were responsible in large part for the recovery begun in 1987. It is important to be clear how this is conventionally expected to have worked. First, with regard to the household sector, a policy shift which resulted in the household sector revising upwards its expectation of future income would be expected to result in a reduction in the personal sector savings rate. It is evident that the major change in the
rate did fall significantly in 1988 and this may have reflected a new view of the future on the part of households (Chart 1.4). Second, the corporate recovery in corporate sector investment did take place in 1988, so that given the lags between changing expectations and actual expenditure, it could be argued that the increase in investment as a proportion of GNP did respond to a change in corporate sector expenditure following the shift in policy in 1987. Equally it could be argued that the rise in the UK and other markets was responsible for a rise in corporate investment.

The 1990 - 1991 Recession

1.9 On the face of it, it is difficult to see how one can talk of a recession when the economy exhibits a rate of unemployment. Yet it is clear that the economy and recovery...

1.10 [The slowdown of activity in the second half of 1990 was originally ascribed to the effects of the it, and a rise of about future developments.] If this was the sole source of a slowdown, the recovery we w... - but perhaps not fully back to the levels that might have prevailed earlier. However this did
not occur, so the source of the downturn and the continued weakness thereafter was

1.11 In fact a more significant source of weakness was the \underline{\text{..}}. UK output grew by 2.2 per cent in 1989, 0.9 per cent in 1990 and \underline{\text{..}}. The quarterly pattern is of some interest (Chart 1.5). As can be seen GDP declined from the peak level reached in the second quarter of 1989. Preliminary estimates of the fourth quarter suggest no change on the third quarter level. Effectively the downturn has lasted six quarters.

1.12 Of perhaps greater interest is the pattern of change of \underline{\text{..}} (Chart 1.6). The average level during 1989 was about the same as in the final quarter of 1988, and while there was \underline{\text{..}} recovering only very slightly in the second half of 1991.

1.13 Import growth reflected this weakness in final demand (Chart 1.7). The \underline{\text{..}}

1.14 The \underline{\text{..}} though somewhat later - in the final quarter. Output declined for four quarters and appears to have
1.15 Of the other major industrial economies, only Canada experienced an actual decline in output over this recession. Germany, for domestic reasons had a rapid growth in domestic demand and output in 1990 and the first half of 1991, with a slowdown occurring in the second half of 1991. (Table 1.5)

1.16 It is clear from the above that the world economy went into recession. Some economies experienced actual declines in output while for others a slowdown in growth relative to trend was the norm. While firm data is lacking for the final quarter of 1991, the available information suggests that in that quarter output stabilised or grew slightly.

SECTION 2. THE 1992 - 1993 RECOVERY

2.1 In Section 1 the basic points on the external side that emerged were (i) the UK economy is still of major importance to the Irish economy and (ii) the world economy went into recession in 1990 and by end 1991 the recovery was not fully in sight.

In this section we propose to examine the prospects for recovery.

2.2 Table 2.1 provides current forecasts for the UK economy over a range of variables. The data are based on the
average of 24 forecasts produced at end 1991. The consensus (or average) forecast is that GDP will increase by 1.7 per cent this year. Only one of these forecasts is for a decline again in GDP this year. Seventeen predict a rise of 1.5 per cent or more. Associated with these GDP forecasts is an expectation that import volumes will increase by about 5 per cent, though there is relatively a much wider range of forecasts for imports.

2.3 It is possible that these forecasts are mostly wrong. The timing and scale of the downturn were poorly predicted. The issues in many respects are
- the turning point, and
- the speed of the recovery

2.4 It was indicated in the previous section that UK GDP stabilised in the second half of last year. There were however no obvious signs of recovery in the data. Survey data, which is used to monitor the very short run, picked up the end of the downturn in mid 1991 and suggested that the UK economy might grow towards the end of 1991. However these data are now much less positive - both business and consumer confidence have weakened again.

2.5 Against this, cyclical indicators that are now available suggest that the turning point is there (Chart 2.1). These indicators have been remarkably good in picking turning points in the past and rely less heavily on sentiment than business survey or consumer survey data. However the latest published cyclical indicators data is somewhat dated and we must
await the next data to see if the downturn effect from sentiment surveys is picked up.

2.6 The foregoing suggest that we must be cautious about predicting a sharp recovery in the UK. But then these forecasts are not of a sharp recovery. If GDP stabilised in the second half of 1991 then annual growth rates of just less than 2 per cent for 1992 represent slow growth during the year. This still seems the best working assumption - the UK economy is in recovery, but the recovery is very slow and GDP could grow by 1.5 - 2 per cent.

2.7 The source of this growth is likely to come from ending the reduction in stocks and increased consumer demand following the fiscal policy relaxation evident in the Autumn Statement. The stock cycle is reasonably certain, but the growth of consumer expenditure will be limited by the extent of current consumer debt.

2.8 Even this modest recovery will result in a significant change in import growth relative to 1991. Then, import volumes fell by 2.5 per cent, while with the recovery import volumes could rise by 5 per cent - a turnabout of 7.5 per cent.

2.9 Growth in the UK could be more rapid if other industrial countries pulled out of the recession faster than currently seems likely. In the US the recovery has stalled, prompting the December interest rate cut. A fiscal stimulus is
likely, but the defence cuts and the adjustment forced on the economy by the cuts leaves the net effect problematic. The best guess forecasts are for a slower growth in the US than in the UK with the economy again operating below its trend.

2.10 Germany is characterised by a loose fiscal position consequent on the reunification and a tight monetary policy to dampen inflationary expectations. The reunification programme and the income and expenditure transfers to the Eastern part of the country are likely to cause the fiscal imbalance to remain over the medium term. The impact of the interest rate increase is not so easy to identify. The recent IG Metall award is almost certainly higher than the Bundesbank would wish - but it is significantly less than seemed likely even a month ago. It is not obvious that awards elsewhere will be as high, particularly in the face of an economy that is growing much less rapidly. Realistically even if interest rates are reduced later this year the impact will not be dramatic in demand terms.

2.11 Finally, in regard to the international economy, the move to market liberalisation in Eastern Europe and the former Soviet Union has been accompanied by significant declines in output and demand. Inevitably in the process of adjustment from command to market economies effective demand for imports will fall given the output fall. It will take many years before positive demand effects are felt in the industrial world.
THE PERFORMANCE OF THE IRISH ECONOMY

EXTERNAL DEMAND

2.12 Our conclusion is that the external environment as far as Irish exports are concerned is more favourable now than it was in 1991, primarily as a result of the turnabout in UK imports. There has already been an increase in UK imports and this has been reflected in an increase in exports from Ireland in the second half of last year. The volume of exports rose in 1991 by about 7 per cent. Excluding agricultural exports, which are likely to be distorted by sales of intervention products, industrial exports this year seem likely to increase by about 10 per cent in volume terms, with those to the UK rising more rapidly both because of the faster growth in UK imports and because of the competitive position of Irish firms in the UK market.

2.13 While this growth in exports might seem high in the face of a poor world economic performance, the fact is that 1991 was the real year of recession. No forecasts currently available predict any major upturn in the world economy, but they do predict upturns. There remains the possibility that the upturn might be more muted than even these forecasts suggest, that the German economy might experience declines in output and that the US economy might experience a further weakening of consumer confidence in spite of lower interest rates and a fiscal boost. If this is the case then even the slow UK recovery is likely to be weaker.
2.14 These fears are common at this stage of the cycle, particularly when output has declined rather than fallen below trend. Output in the world economy bottomed in the final quarter of 1991; in the UK this took place in the third quarter with the final quarter remaining flat; in the US, the recovery of mid-year was not maintained and the final quarter and the current quarter are likely to be very flat; in Germany the period of fast growth has ended with declines in GNP during the year from the second quarter. Looking at the world economy from today the picture is one where previous peaks have yet to be recovered.

2.15 Economies do recover. Destocking ends, output and incomes increase. Consumers reduce their indebtedness to levels where discretionary income is spent rather than used to reduce indebtedness.

2.16 More important from Ireland's point of view, exports to the UK have already increased and this has been maintained. The increase in exports has been broadly based as in 1986 - 89, rather than just a reflection of increased exports from multinationals, so that we expect an increase in employment in manufacturing.

2.17 The recovery in the UK and in other major economies is however expected to be much less than in previous cycles. Even forecasts for 1993 predict only modest growth, with economies still operating well below trend, but with growth rising slightly on this year and with import growth accelerating.
Thus exports from Ireland should continue to grow in 1993 by a significant amount.

2.18 The conventional and traditional approach to evaluating the macro impact of the budget has been to examine the change in the EBR with reference to the previous year. Making some allowance for the state of the economy - the automatic stabilisers - the EBR is then judged to be expansionary, neutral or contractionary. The general judgement on the 1992 budget is that given the forecast growth in the economy it was neutral to expansionary in a demand sense. We have always felt uncomfortable about these easy conclusions, primarily because of changes in expenditure and tax levels, increased EC financed expenditure and of course the supply side effects of policy, assuming that revenue, expenditure and growth figures are consistent.

2.19 Table 2 presents a revised forecast of the budget accounts. Total Current Expenditure is set to rise by 6.5 per cent - total expenditure marginally less. Supply services expenditure is projected to rise by 7.6 per cent in gross terms. The pay element, in spite of the January agreement between Government and Public Sector Trade Unions, will rise in excess of 9 per cent. Excluding this, other supply services expenditure is projected to increase by 6.6 per cent. Excluding social welfare expenditure - the main cyclically sensitive area of expenditure and pay - from the total, there is a rise of 2 per
cent in expenditure. The increase in total expenditure reflects a very significant increase in pay levels and some extra employment, a cyclical element deriving from the increase in employment, and a reduction in real terms in other residual expenditure. Curiously in the Economic Background to the Budget, Government net current expenditure on goods and services is projected to increase by 1.75 per cent in real terms. "Public service numbers must rise by about 1 per cent, with higher non-pay expenditure accounting for the balance". This analysis suggests that this is not the case. The main conclusion however is that while the increase in expenditure might imply a significant increase in direct activity by Government in fact increases in pay and transfer payments are primarily responsible for the rise in expenditure. The extent to which this increases demand in the economy depends, not on Government but on how other agents behave.

2.20 Revenue is projected to rise by 6.3 per cent this year. There were substantial changes in the income tax code with a widening of bands and a reduction in the standard and top rates of tax by 2 per cent and 4 per cent respectively. Income tax receipts are still projected to increase by 5.4 per cent, partly because of the tax implications of the increase in public sector pay this year. The income tax cuts were balanced by indirect tax changes, taxation of benefit in kind and changes in the tax treatment of life assurance and short-term social welfare benefits. The income tax changes will increase nominal disposable income compared with a no change situation by just over 1 per cent this year. More obviously than in other years there are
winners and losers from these tax changes. In general however those on lower incomes and not in receipt of taxed/untaxed benefit in kind will benefit most, and of course public servants whose income has increased most rapidly will experience very significant increases in real disposable income.

2.21 A characteristic of the data from Table 2.2 which deserves mention is the relationship between the EBR and capital expenditure. The reality is that the EBR is only £592 million against capital expenditure of £889 million (what is called other capital expenditure has in the past been restructuring of semi-state companies). The particular form of the Budget Accounts distinguishes between borrowing for current purposes and capital borrowing and obscures the fact that total borrowing is less than capital expenditure. What makes the difference is EC funding. If we believe that capital expenditure is now better than a decade ago the level of borrowing is currently not an issue - though the conditions for EMU membership later in the decade as they now impose a constraint.

2.22 Given the Government's own forecasts for the economy both the revenue and expenditure estimates seem reasonable. The increase in the EBR does represent a slight expansionary influence on the economy, but it will come through the behaviour of consumers to increased disposable income.

2.23 The principal concern one has with the budget is not the numbers, but the realisation that there are a whole series of negative budgetary effects due in 1993. First, public
sector pay will continue to increase sharply, even taking the revisions to PESP agreed prior to the budget. On the basis of the current agreement public sector pay could rise by 8 per cent in 1993 and perhaps 10 per cent in 1994. Second, there will be a cash flow loss from ending VAT at the point of importation. This may result in a change in the present procedures for VAT collection which would impact on the corporate sector. Third, the Deposit Interest Retention Tax (DIRT) cannot be maintained in the face of the relaxation of exchange controls and the absence of a similar tax elsewhere. Fourth, there may still be a need to reduce the top VAT rate from 21 per cent because of the single market programme.

**HOW WILL THE ECONOMY PERFORM?**

2.24 The budget figures in general terms look reasonable given the growth projected for the economy by the Department of Finance. But these growth projections look pessimistic, and contain an implicit assumption that is not obviously tenable. At its simplest the proposition is that private sector savings and indeed only corporate savings, will increase significantly as a per cent of GNP this year. The Department is forecasting a Balance of Payments surplus of 6.75 per cent of GNP in 1992, compared with 5.5 per cent in 1991, and an EBR of 2.4 per cent of GNP compared with 1 per cent in 1991 (when the proceeds of the Irish Life privatisation are considered). These are consistent only with a large increase in corporate savings as a proportion of GNP in 1992. This seems
inherently implausible given the decline in investment that took place in 1991 and the growth in output that took place last year and projected for this year.

2.25 Table 2.3 contains our macro-forecasts for 1992 and 1993. What is driving this forecast is the growth in external demand and continued competitiveness. This increases exports, manufacturing output and overall employment. The rise in incomes for those currently in employment (6 - 7 per cent) and in disposable income for those newly employed is reflected in increased household expenditure, and as the economy performs better the rise in the savings rate that occurred in 1990 and 1991 is reversed. Housing demand is then likely to pick up in the Autumn and new housing starts to accelerate next year. Corporate manufacturing investment will increase this year because of output changes, and this will strengthen in 1993 as domestic demand continues to grow.

2.26 The forecast contained in Table 2.3 is more optimistic than others currently available. But there is another dimension to it that is worth drawing out. The economy really showed very little growth from mid 1990. In the second half of last year the external sector improved. The forecast is really saying that the flat performance of the domestic economy of the last 18 months will be replaced by a growth in gross domestic expenditure (Household Expenditure, Investment and Government purchases of goods and services - taken together) and that this will strengthen over the next two years. This is profiled in chart 2.3.
2.29 I have said nothing about unemployment in this paper. There are two reasons for this. First, short term forecasts have not been very good at picking up the extent to which firms hold, let go, or hire, labour; or the extent to which labour decides to migrate, even in the face of what appears to be a fast growth in the economy. Second, I am reluctant to just make a passing reference to unemployment in the context of the economy. The level of unemployment is the most signal aspect of the failure of economic institutions to adapt to external shocks and domestic supply conditions in the labour market. Short term forecasts have little to offer in this area. We believe that the economy will experience better growth over the next two years, but that this will make little difference to the level of unemployment. Significant changes in the level of unemployment will only come with institutional change. This is our current area of research.
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Chart 1.1: Measures of UK trade competitiveness

- Export prices
- Relative producer prices
- Relative normalized unit labour costs
- Relative export prices (Downward trend shows more competitiveness)

CHART 1: HOUSEHOLD SECTOR SAVINGS RATE
1981 - 1990
CHART 1. UNITED KINGDOM IMPORTS
INDEX Q2 1990 = 100
Cyclical indicators with leads and lags applied
Composite indices of indicator groups.

Chart 2.1
Long term trend=100

- Subject to revision due to trend re-estimation
- Based on incomplete data

These turning points are less marked than previous peaks and troughs

1. The longer leading index has been advanced by 6 months, the shorter leading index has been advanced by 4 months and the lagging index has been moved back by 11 months. This allows a comparison based on past experience, of whether the indices are in step.