NESC REPORT NO. 3

THE ECONOMY IN 1974 AND OUTLOOK FOR 75

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NATIONAL ECONOMIC AND SOCIAL COUNCIL

CONSTITUTION AND TERMS OF REFERENCE

1. The main task of the National Economic and Social Council shall be to provide a forum for discussion of the principles relating to the efficient development of the nationa economy and the achievement of social justice, and to advise the Government through the Minister for Finance on their application. The Council shall have regard, *inter alia*, to:

(i) the realisation of the highest possible levels of employment at adequate reward,

(ii) the attainment of the highest sustainable rate of economic growth,

(iii) the fair and equitable distribution of the income and wealth of the nation,

(iv) reasonable price stability and long-term equilibrium in the balance of payments,

(v) the balanced development of all regions in the country, and

(vi) the social implications of economic growth, including the need to protect the environment.

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3. Members of the Government shall be entitled to attend the Council's meetings. The Council may at any time present its views to the Government, on matters within its terms of reference. Any reports which the Council may produce shall be submitted to the Government and, together with any comments which the Government may then make thereon, shall be laid before each House of the Oireachtas and published.

4. The membership of the Council shall comprise a Chairman appointed by the Government in consultation with the interests represented on the Council

Ten persons nominated by agricultural organisations,
Ten persons nominated by the Confederation of Irish Industry and the Irish Employers' Confederation,
Ten persons nominated by the Irish Congress of Trade Unions,
Ten other persons appointed by the Government, and
Six persons representing Government Departments comprising one representative each from the Departments of Finance, Agriculture and Fisheries, Industry and Commerce, Labour and Local Government and one person representing the Departments of Health and Social Welfare.

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7. The Council shall regulate its own procedure.

NATIONAL ECONOMIC AND SOCIAL COUNCIL

The Economy in 1974 and Outlook for 1975

A document prepared by the Council's secretariat

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NATIONAL ECONOMIC AND SOCIAL COUNCIL MEMBERS

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Abbreviations used in the text and tables

$	US dollar
. .	Irrelevant
()	Based on incomplete data
n.s.a.	Not seasonally adjusted
Billion	Thousand million
I, II	Calendar half years
Q1 etc.	Calendar quarters
1973/74	Financial year (April to March)
IDA	Industrial Development Authority
AnCo	Industrial Training Authority
ESRI	Economic and Social Research Institute
ICTU	Irish Congress of Trade Unions
EEC	European Economic Communities
OECD	Organisation for Economic Co-operation and Development
NIESR	National Institute of Economic and Social Research
IMF	International Monetary Fund
CAP	EEC Common Agricultural Policy

PREFACE

At its meeting on 12 July 1974, our Economic Policy Committee requested the secretariat to prepare a document on the *Economy in 1974 and the Outlook for 1975*. A draft was discussed by the Committee at its meeting on 11 October 1974 and at meetings of the Council on 24 October 1974 and 4 November 1974. The Council recommended that the document prepared by the secretariat should be presented to the Government, laid before each House of the Oireachtas and published.

It is the intention of the Council to prepare comments on the economic situation for submission to the Government as soon as possible.

The Economy in 1974 and Outlook for 1975

SUMMARY OF DOCUMENT PREPARED BY THE COUNCIL'S SECRETARIAT

1. In 1974 there have been rapid and disturbing changes in the world economy. The year has been marked by the aftermath of the oil crisis, by accelerating inflation (now running well into double figures), by a sharp slowdown in economic activity, by increases in unemployment, and by the emergence of fundamental disequilibria in international payments of unprecedented magnitudes. Only a moderate deceleration in inflation can be expected in the short term because past increases in oil and commodity prices and recent and current increases in money incomes are still working through to consumer prices. At the same time there has been a marked slowing down of economic growth in the world at large, accompanied by very large and very unevenly distributed balance of payments deficits in industrial countries. If expansionary action had been taken by countries with a strong (or less weak) balance of payments position, that would have helped other countries to improve their position and to minimise the rise in unemployment. Deflationary policies aimed at reducing commodity and oil prices and/or redistributing the balance of payments burden could ultimately be self-defeating and make a major recession a certainty.

2. Developments in the United Kingdom are of particular importance to the Irish economy. While output there was growing rapidly up to mid-1973, it was accompanied by supply problems and a deteriorating external balance. Thereafter, the rise in commodity prices, made more marked by the depreciation of sterling, tended to restrain demand. In December 1973, the fuel crisis brought a tightening of fiscal policy, accompanied by new monetary arrangements which have brought the money supply sharply under control. The three-day week cut back output early in the year. Most forecasts for the UK economy suggest that

by the close of 1975 output will be little different from 1973 and unemployment will have risen sharply. While the balance of payments picture is expected to improve as demand slackens, the rate of inflation still looks disquietingly high. Wage and cost inflation could erode UK competitiveness through 1975. At the same time, reflationary action and its balance of payments implications might cause a further depreciation in the external value of sterling through 1975.

3. The Irish economy has to operate against this background of adverse international developments. The implications for Irish prices of the increased commodity prices (including oil) since September 1973 are disquieting; the secretariat estimates that external influences could add some 10% to consumer prices through 1974. The international situation will affect domestic demand and output adversely.

4. The picture for 1974 is one of very weak growth and increasing unemployment—a disappointing outcome given the much more buoyant views held at the time of the budget. Real output may have risen only marginally in 1974 (by about 1%) and the average unemployment rate was probably the equivalent of 6·3% of the labour force, compared with 5·9% in 1973. As regards agriculture, the principal problems have arisen in cattle production. In recent months producers have been caught in a "pincer movement" between falling beef prices and rising costs. The money incomes of farmers probably fell by about 15% during 1974. Agricultural incomes would be substantially lower if Ireland were not a member of the EEC, and there are prospects for a recovery in farm incomes in 1975 and beyond as the EEC transition period proceeds.

5. An important influence on total money income outside agriculture in 1974 was the 1974 National Agreement. This provided for average rates of increases of 19% over a twelve-month period, with escalator provisions if prices rose by more than 10%. Before allowing for *any* addition through a "16th round" in 1975, average earnings are likely to be about a quarter higher than 1974. In August 1974, consumer prices were 18% higher than a year earlier: all indicators suggest that there will be no slackening in the trend through the remainder of the year.

6. The position in industry could become critical: current and prospective demand is weak, and cash flows have fallen in the corporate sector. There is a danger of a substantial "shake-out" of labour, which would be all the greater if demand remains weak. Any such "shake-out" of labour would further weaken demand and cause further redundancies.

7. There was a sharp deterioration in the trade balance in the first half of 1974. Forecasts for the remainder of 1974 suggest a trade deficit for the year at least twice as great as in 1973. The invisibles account has benefited from increased transfers from the EEC, so that the current deficit may not have deteriorated to the same extent as the trade balance. The estimated outturn for 1974 is a current external deficit which is one of the largest in relation to national output within the EEC. Despite the increased current deficit the reserves have to date shown remarkable buoyancy, in part as a result of increased foreign borrowing by the public sector.

8. On the basis of present policies, 1975 could be another year of poor growth and unemployment could rise well above present levels. The current external deficit could remain very large and the rate of price increase could be at least as fast as in 1974. This depressing picture is partly explained by external developments. But the domestic situation also contributes to the low growth rate that is anticipated. The increases in average earnings still to come under the 1974 Agreement would be expected to increase demand and output under more normal conditions. But in a situation where export demand is weak and many enterprises are being squeezed by higher costs, some firms could run into difficulties before they benefit from any general rise in domestic demand. The resulting redundancies would reduce effective demand, leaving other companies without the benefits of the increase in demand for their products as a result of the higher money incomes, but having to meet these higher money incomes themselves. In this way a vicious circle of falling demand and redundancies could develop.

9. There are therefore major problems to be faced in each of the main areas of concern for short-term economic policy, namely, output, employment, prices and the balance of payments. The simultaneous

deterioration on all four fronts poses extremely difficult problems for economic policy. The problems are made even more difficult because they are inter-related. A frontal attack on one could exacerbate another. For example, faster growth of output could mean less unemployment but, other things being equal, a worse balance of payments position. Again, an increase in the pressure of demand can sometimes increase the rate of price inflation. In present Irish circumstances policies aimed at reducing demand can make only a small contribution towards reducing the rate of price inflation. The short-term demand management problem therefore becomes, in its simplest terms, one of deciding on the degree to which demand can be increased, in order to expand output and reduce unemployment, within the constraints imposed by the balance of payments.

10. The balance of payments over the years prior to the oil crisis showed a current account deficit, a net capital inflow and a tendency for reserves to rise. It is not inappropriate for a small country that is building up its industry to run a current external deficit financed by net long-term capital inflows. Nor would it be appropriate to try to eliminate within a very short period that part of the deficit that is due to higher energy prices, because the necessary structural adjustments could be effected without serious economic disruption only over a number of years. When allowance is made for reducing the oil deficit over six to seven years, for a continuing net capital inflow and for the reversal of temporary influences now having an adverse effect on the external balance, the underlying balance of payments deficit involves a less immediate constraint. When these allowances are made there is some scope for domestic action to curb the growth in unemployment in 1975. It is now too late to do very much about the year to year growth rate between 1974 and 1975, but action could be taken that would make a considerable difference to unemployment levels by the end of 1975.

11. The size of the expansionary stimulus that could be given in 1975 must depend on the availability of external funds to finance the balance of payments deficit. In principle, external finance should be available on some terms, so that the problem is one of ensuring adequate finance on a long-term basis to support the Irish external deficit over the period

in which the economy is adjusting to the higher cost of energy, and achieving a more manageable relationship between its current external payments and receipts.

12. The effectiveness of any expansionary stimulus in 1975 in raising output and reducing unemployment would be much reduced by excessive increases in money incomes under a "16th round". If a "16th round" related changes in money incomes to changes in prices through 1975, an expansionary stimulus which included reductions in indirect taxes would be particularly effective in moderating the rate of inflation, and hence minimising its adverse effects on the external deficit and the domestic economy.

13. One of the main objectives for the next few years must be to reduce the rate of inflation. Inflation brings unease and uncertainty, it tends to redistribute wealth towards those who are financially sophisticated (usually the better-off), it distorts the incentives within the economy and encourages the pursuit of speculative/financial activities rather than increased real output, it favours borrowers at the expense of savers and can jeopardise medium-term economic expansion by eating into real profits and discouraging productive investment. Moreover, inflation tends to feed on itself and to accelerate. There can be no doubt that this country is vulnerable to external price increases. However, even after full allowance is made for external factors a substantial part can be explained only by domestic behaviour.

14. A major underlying cause of the inflation that is generated domestically is the attempt by the members of the community to achieve real incomes that when added together exceed the real output of the community. Inflation can therefore be curbed only to the extent that aspirations and realities are brought into line with each other. This will be more easily achieved if the national output is growing, because all can enjoy some improvement in living standards. If national output is static or falling, then to the extent that some individuals or groups achieve the improvements in real incomes that they seek, others will be forced to accept an absolute fall in their living standards.

15. The domestic inflationary pressures that are generated by demands that cannot simultaneously be met can be defused only by greater understanding of these causes of inflation that operate within the community. Progress towards reducing the domestic element in inflation will not be easy and cannot be achieved instantaneously. It will be achieved only by wider and fuller understanding of the basic domestic causes of inflation among all sectors of the community. It will be achieved more easily if the economy is expanding, and if policy instruments are refined or developed to ensure that expansion is achieved and its fruits distributed in an equitable manner.

The Economy in 1974 and Outlook for 1975

A document prepared by the Council's secretariat

Chapter I

INTRODUCTION

1. This survey* of the economy is divided into three sections. The first deals with international developments, the second with the domestic economy, and the third with economic policy. The timing of the study has been determined by the decision to make the financial year coincide with the calendar year, thus bringing Irish practice into line with that in other EEC countries. International developments are dealt with first because a small economy cannot escape their effects economically—it is not possible to stop the world and let Ireland off. Domestic economic policy is dealt with last—not because it is least important or can achieve little in the face of adverse international developments, but because its aims and the measures to achieve them can only be identified in the context of *all* the problems and difficulties that this country faces.

2. Few up-to-date statistics for 1974 are available, and uncertainties about even the immediate future are more than usually great. Moreover, much more research needs to be done into the relationships between the major economic variables. In addition, no satisfactory model of the economy was available to the secretariat; without this, it was difficult to test the consistency of the different estimates and forecasts. For these reasons, some of the figures in the tables must be treated as informed guesses and many of the conclusions must be regarded as tentative.

3. Qualitative statements about economic problems and about the policies that might contribute to their solution are of limited value. The

*This document was drafted by Derek Chambers. He acknowledges assistance from Tom Ferris, Gerry Hughes, Catherine Keehan and Louden Ryan in the Council's secretariat. The secretariat would also like to acknowledge assistance from members of staff in the Central Bank, the Economic and Social Research Institute, the Departments of Agriculture and Fisheries, Finance and the Public Service, and members of the Council.

magnitude of the problems, and the size of the contribution that different policies might make towards resolving them, must be estimated. In spite of inadequate statistics and other difficulties, an attempt is made in this document to make such estimates. Where statistics or estimates are given in the text or tables, a brief statement of their source or derivation is given in a technical annex. This annex is not published in this document, but copies of it may be obtained on request from the Secretary to the Council. The aim of this procedure is to facilitate and encourage informed discussion and criticism, and it is hoped that it will succeed in doing so.

Chapter II

INTERNATIONAL SETTING

(a) The overall situation

4. Nineteen seventy-four has been a year of rapid and disturbing change for the world economy. It has been marked by the aftermath of the oil crisis, (which has led to some reappraisal of the nature and pace of the economic growth that can be attained in industrial countries), by accelerating inflation now running well into double figures, by a sharp slowdown in economic activity and increases in unemployment, and by the emergence of fundamental disequilibria in international payments of unprecedented magnitudes. To quote the IMF managing director, the world is facing "the most difficult combination of economic policy decisions since the reconstruction period following World War II".

5. The first stages of the crisis can be traced back to 1972–73. That period saw the most rapid growth of demand and output in the western world since the early 1950's. GNP, in real terms, grew by 2 to 3% more than its longer-term average in nearly all countries. The upswing was led by expansionary policies in North America, Japan and the United Kingdom, reinforced and generalised thereafter through the normal pattern of world trading. However, by mid-1973 the slack had been taken up in most countries, and the overall level of demand, allied to the speed with which it had been reached, had produced bottlenecks. Particular types of labour were in short supply, shortages of capacity, materials and components were widespread. The effects of the rapid expansion were particularly marked on commodity markets, where in many cases they coincided with supply difficulties to bring sharp increases in prices through 1972 and into 1973. The upward movement was given additional momentum by speculative pressures. Speculation was encouraged by the persistence of the price rises, the low margin requirements on commodity markets and the relatively poor performance of alternative media for speculation.

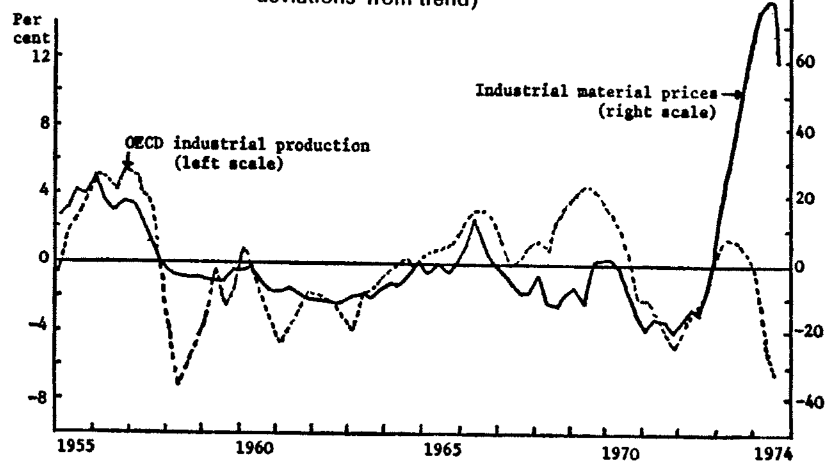
6. By mid-1973 the peak of the output boom had been reached, in part because of supply problems, in part because many countries had adopted more restrictive policies. Some easing in the prices of commodities might, therefore, have been anticipated, because of a reduction in the demand for them. However, the Middle East war produced another and speculative surge in commodity prices. It was followed by the oil embargo and the quadrupling of oil prices by Arab and other producers. As a result, spot prices for commodities rose even higher in 1974, despite an underlying weakening of demand and the deflationary effect—both real and psychological—of the oil crisis. By early September 1973, the *Economist* dollar index for commodities was 130% above its December 1971 level, and it had risen by another 22% by March 1974 (see Diagram 1).

7. Since these peak levels earlier in the year, spot prices have fallen somewhat. As world demand is likely to ease further, the downward price movement could continue. However, it is difficult to judge how far it is likely to go. Oil producers are in a strong market position and can resist any downward pressure on prices. Indeed, they have already considered supply cuts in response to the slight price reductions which have occurred since the beginning of this year. Other primary producers might attempt to exercise more effectively such monopoly powers as they possess. World stocks of foodstuffs are still low. On balance, it seems unlikely that the relative prices of industrial and primary commodities will return to those prevailing at the beginning of the 1970's. Indeed, given the likelihood of an expansion in the demand for food and primary commodities over the medium term, such a reversal could be undesirable, because it would discourage investment and the expansion of output.

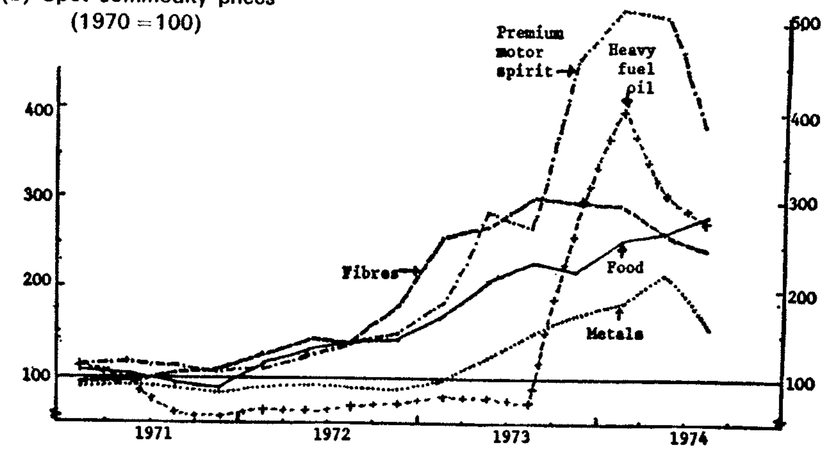
8. The upward surge in the prices of oil and other commodities had three principal effects on industrial economies. First, it increased domestic prices. Second, it led to a deterioration in the current balance of payments of all western countries. Third, it reduced real incomes and demand.

Diagram 1: Commodity prices

(*a*) World industrial output and industrial material prices (Percentage deviations from trend)



(b) Spot commodity prices (1970 = 100)



Oil prices are spot oil barge prices, f.o.b., in Rotterdam. Commodity prices are the *Economist* series. All prices are in dollars and adjusted for changes in the dollar's effective exchange rate. The commodity prices have limited coverage and are weighted by the pattern of imports to industrial countries.

Sources: The Economist; OECD Main Economic Indicators; OECD Secretariat estimates, updated by NESC secretariat; Irish Shell and BP Limited.

9. The OECD has estimated that the impact on the general domestic price level in European countries was about 2% in 1973 and 4% in 1974. The latter figure is made up of 2¼ percentage points attributable to higher import prices for crude oil and 1¾ percentage points because of higher prices for primary products other than oil. These estimates take account of the estimated differences between spot prices and transaction prices (relatively few transactions occur at the extremes of the fluctuations in spot prices so that transaction prices tend to be less volatile). The OECD estimates also allow for the delays before transaction prices work through to output or consumer prices—typically changes in commodity prices take six to nine months to work through to consumers, though this time lag was probably shorter for oil prices, despite delays in the complete adjustment of electricity, gas and transport prices.

10. However, these direct influences are not the only ways in which changes in commodity prices affect prices in importing countries. They can also increase the prices of domestically-produced primary products, and the prices of imported manufactured goods based on oil or other commodities. Moreover, the rise in commodity prices can spark off demands for higher money incomes, both in importing and in supplying countries, thereby generating wage/price spirals. When these influences are taken into account, it is easy to see how the overall effects of the increases in oil and commodity prices on domestic price levels in the typical European country could be in the range 10–15%.*

11. Price increases of this order are clearly disturbing enough in themselves. If it had not been for the peculiar nature of the oil crisis,

*If the initial domestic price impact (P) including rises in domestic energy or commodities were equivalent to 5 per cent, the initial impact on the import price of manufactures from other developed countries (M) were 12½ per cent (manufactured exports tend to be 2 to 3 times as intensive in commodities and fuel as domestic expenditure), the wage reaction both domestically and in suppliers of manufacturers were (W) and the total domestic price reaction were (D)—all in percentage terms—then $D = P + .1M + {\cdot}5W$ (further assuming that manufactured imports have a 10 per cent weight in domestic prices and domestic wages a 50 per cent weight). Now $M = 2{\cdot}5P + {\cdot}5W$ and, if wages simply keep pace with prices, $W = D$. Hence, $D = P + {\cdot}1\ (2{\cdot}5P + {\cdot}5D) + {\cdot}5D$.

So that, ${\cdot}45D = 1{\cdot}25P$, or D is approximately equal to 3P.

Therefore, if P = 5%, D may well be in the 10–15 per cent range.

they might have been part of a particularly severe but temporary fluctuation in world activity, starting with the overrapid expansion in demand and the commodity price boom, leading to balance of payments deficits and measures to deflate demand in industrial countries, and followed by a downturn in industrial production and commodity prices. Money incomes in industrial countries would probably have been adjusted to compensate (or more than compensate) for any net increase in commodity prices over the cycle. In that way, the terms of trade would have been turned back against commodity producers, thus helping to restore the original balance of payments positions and leaving the way clear for policies which allowed a more gradual expansion of output towards full employment levels. Price levels would have been raised, but there would not necessarily have been serious longer-term effects. However, the recent rises in commodity prices may not be wholly reversible, particularly in the case of oil where producers have, and are exercising, monopoly powers.* It is this aspect of the oil crisis which has posed, and is continuing to pose, such difficult problems for economic policy.

12. The most important of these problems are the following:

(i) The initial effect of the increase in oil prices, after allowing for some savings in oil consumption, was to add some $60 billion to the revenues of oil producers in 1974. The oil-producing countries may have increased their purchases from the oil-using countries by $5–10 billion, leaving the latter with a deterioration in their current external accounts of $50–55 billion for 1974. These estimates are not particularly sensitive to the level of economic activity in the developed world—assuming that the oil price does not fall and that massive unemployment is avoided—and it will take several years before oil producers' purchases can be raised to match their increased revenues. In the intervening period non-oil producers will, therefore, have to run extremely large current external deficits.

*Any estimate of how oil prices will behave over the next few years must be argely speculative. However, it seems unlikely that the relative price of oil could be raised much further over the medium-term, because present prices are encouraging exploration and are close to levels which would encourage significant substitution.

(ii) This initial deterioration in the balance of payments was generally of the order of 1½% of GNP. If monetary flows within countries were not affected by increases in their import bills, this would give a rough estimate of the initial effect on domestic output. But as some of the increased imports were probably paid for from lower domestic savings (notably corporate profits), the first round effect was on average probably closer to 1% of GNP. However, the total effect of this deflationary impetus could be significantly greater as it spreads through national economies. This "multiplier" effect will be smaller for a country that depends heavily on imports, because a larger proportion of the initial reduction in spending will be passed on to other countries via reduced demand for their exports. For the developed world as a whole imports form only a small proportion of output and the multiplier is, therefore, likely to be very large. The result could be an overall deflationary effect in a typical country of the order of 3%.*

(iii) The deflationary effect of the increases in oil and commodity prices could have been offset to some extent by reflows of Arab capital. If the higher earnings of the oil-producing countries are to earn a satisfactory return, they must still be invested in the western world. It is difficult to judge how large this offset has been. To take a simple example, if a typical company's investment and employment plans were unaffected by forced substitution of longer-term finance for profits lost as a result of the higher costs of oil-based inputs, and if this finance were readily available, the net deflationary impact of the oil price increase could be small. But these assumptions on businessmen's indifference to their gearing are clearly unrealistic. Nor are there grounds for confidence in the continuing ability of international and domestic financial arrangements to bring returning flows of oil capital into line with requirements. There has, for example, been no international agreement on the recycling of oil funds to ensure that they are available where most needed. This has forced some countries, without ready

*The figures under heading (ii) would be rather higher if they referred only to Europe.

access to sufficient finance to cover their balance of payments deficits to pursue policies of further deflation. Furthermore, Arab funds have so far been placed mainly on short-term deposit, ranging from overnight to six months. The uncertainty that this has created has made it more difficult for governments to assess their longer-term ability to finance balance of payments deficits, and for the banking system to offset some of the deflationary effect of these deficits by lending long-term. Overall, it seems likely that the uncertainty associated with the return flows of capital has precluded any offset to the deflationary impact of the increases in prices of oil and other commodities.

13. While the probable overall effect of the oil price rise on price levels and economic activity is fairly clear, the impact of the crisis varied considerably from one country to another. The United States was affected relatively little; Japan was among the worst hit of the developed countries,* with most European countries lying in between. Of the European countries, Germany was able to overcome the balance of payments effects very quickly, thanks to export orders built up during 1973. Now, early expansionary action was required in those countries with a strong balance of payments position (notably Germany and the United States), if the dangers of a world recession were to be avoided or if other countries were not to be faced with even more difficult balance of payments problems. But while the impact of the crisis varied, so did policy attitudes. There was a danger that the initial price increases would generate more severe domestic wage/price spirals, thus giving a further twist to an already serious inflationary problem. Different countries have rather different wage/price/unemployment interactions—for example, lower demand pressures in the United States and Germany probably help to dampen domestic inflationary forces; at the other extreme (possibly in the United Kingdom) the reverse may be the case.

14. The result has been a situation in which those countries best placed to implement policies that would have helped to maintain economic activity were among those that were most prepared to sacrifice

*The position of the non-oil developing countries is even more serious.

employment opportunities. The reasons may have been the particular sensitivity in these countries to inflation, the likelihood that deflationary policies would slow down their rates of inflation, and perhaps a willingness to tolerate a relatively protracted and severe slowdown in the hope of sharply reduced prices for oil and primary commodities. Consumer spending sprees in many countries early in the year, in anticipation of even higher retail prices, and the length of time it takes for a deflationary policy to work through the economic system, may have masked the underlying dangers of recession.

15. So far no offsetting expansionary policies have been applied in the United States and Germany, and the deflationary impact of the oil rise is now well established. While data on developments are still scarce, Table 1 shows the latest OECD estimates. It is very likely that the estimates for the major countries will be revised downwards. Nevertheless, the figures give some idea of the extent of the downturn. In most countries, output seems to have been growing at considerably less than "normal" rates in 1974. The trend through 1974 and into 1975 has also been weak and unemployment is now rising rapidly in many countries. The table also shows the rapid rates of inflation and the severe deterioration in balances of payments experienced in 1974, largely as a result of the oil crisis, though on both these counts the situation could improve somewhat.

16. To summarise, world inflation rates are running at disturbingly high rates. Only a moderate deceleration can be expected in the short term because past increases in commodity prices and recent and current increases in wage rates are still working through to consumer prices. At the same time a recession has set in, accompanied by very large and very unevenly distributed balance of payments deficits in industrial countries. At this stage, the situation could develop in one of two broad directions: and it is impossible to say which is the more probable. First, an acceptance of the fact that non-oil producing countries as a group are bound to run very large balance of payments deficits for a number of years; expansionary action by countries with a strong (or less weak) balance of payments position would help other countries to improve their position and in that way minimise the rise in unemployment. Second, continuing deflationary policy attitudes aimed at

TABLE 1

Principal indicators of economic activity in major countries

	1962 to 1972 average	1973	1974 *(a)*	1974 I	1974 II *(a)*	1975 I *(b)*
Real GNP (% growth)						
France	6	6	5	9	4½	4
Germany	5	6	−½	2	3½	4
United Kingdom	3	5½	−2	−6	4½	1
United States	4	6	−½	−2¾	1½	3
Major 7 *(c)*	5½	6½	½	−1½	3	4
Consumer prices (% growth)						
France	4½	7	14	15	16	14
Germany	3	7	8½	8½	11	9
United Kingdom	4½	8½	15	16	18½	12
United States	3	5½	10	11½	8	7
Major 7 *(c)*	3½	7	13	15	13	10
Current external balance ($ billion)						
France		0	−6	−6	6	−5
Germany		4½	7	10	4	2
United Kingdom		−3½	−10	−10	−10	8
United States		3	−1	2	−4	−5
OECD total		4½	−38½	−34	−45	−40

(a) Estimated.

(b) Forecasts based on unchanged policies.

(c) Total of Canada, France, Germany, Italy, United Kingdom, United States and Japan.

All figures are shown at annual rates, growth rates are taken for the previous period.

Source: OECD Economic Outlook No. 15, July 1974.

reducing commodity and oil prices and/or redistributing the balance of payments burden; these policies could ultimately be self-defeating but they will make a major recession a certainty.

(b) The United Kingdom situation

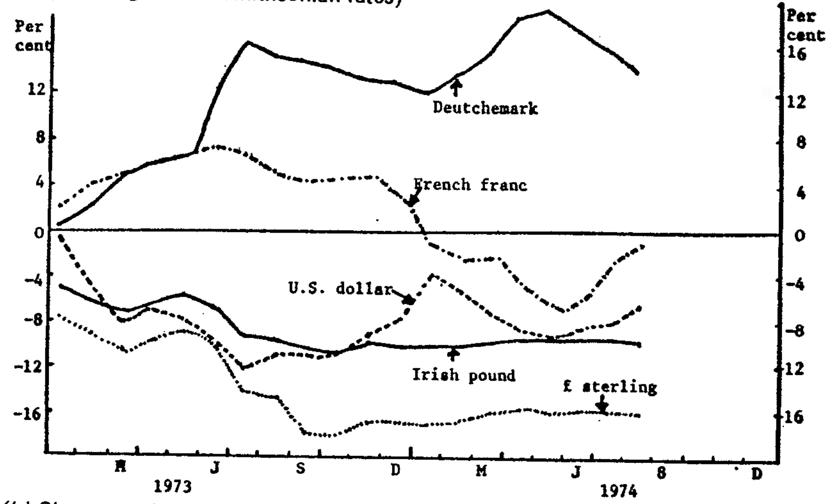
17. Within the overall international situation, developments in the United Kingdom are of particular importance to the Irish economy. While output there was growing rapidly up to mid-1973, it was accompanied by supply problems and a deteriorating external balance. Thereafter, the rise in commodity prices and the depreciation of sterling tended to restrain demand. In December, the fuel crisis brought a tightening of fiscal policy, accompanied by new monetary arrangements which have brought the money supply sharply under control. The three-day week cut back output early in the year. This was followed by the March budget which maintained the restrictive policies, on the understanding that they would be re-examined once the full effects of three-day working had been overcome.

18. Meanwhile, efforts were made to bring down interest rates from their extremely high nominal levels. However, the scope for such action proved to be limited as rates elsewhere began to rise in response to tighter monetary conditions, particularly in the United States, and because world interest rates were raised as countries competed for funds to finance their balance of payments deficits (see Diagram 2). During the year it has become clear that high interest rates, the importance of London in the international money market, and its traditional links with many Arab states were attracting substantial capital inflows. Initially, these took the form of working balances and other short-term funds, and later of longer-term flows going into the property and gilt-edged markets. These flows, together with a major public sector programme of overseas borrowing and the prospect of North Sea oil, have been sufficient to finance the external deficit and maintain confidence in sterling.

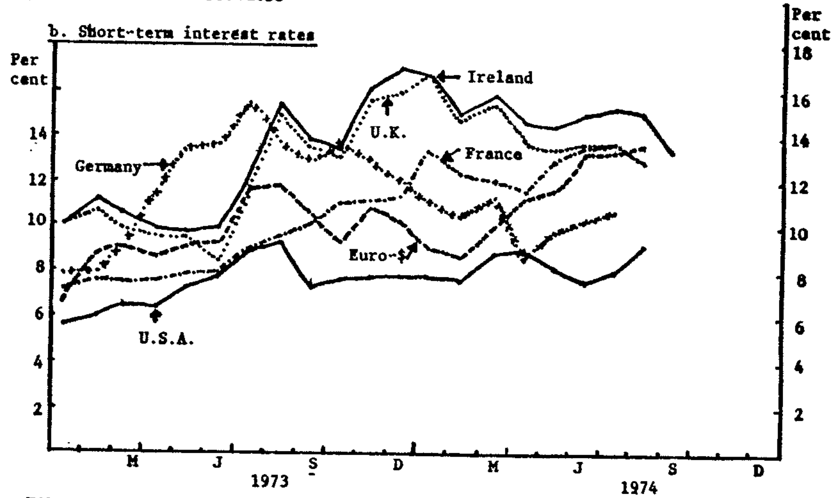
19. As the external pressures on the United Kingdom price level began to ease around the middle of this year, they were replaced by domestic pressures from threshold clauses in wage agreements drawn up under Stage III of the prices and incomes programme. The statutory controls

Diagram 2: Some international monetary indicators

(a) Effective exchange rate changes
(% changes from Smithsonian rates)



(b) Short-term interest rates



Effective exchange rate changes are changes in the parity of a country's currency against other currencies weighted by the pattern of the country's export trading. The short-term interest rates are for 3 months and generally refer to inter-bank dealings, the exceptions being France, where the rate is on call money against private paper, and the United States, where the Treasury bill rate is shown.

Sources: Central Bank of Ireland Quarterly Bulletin; Bank of England Quarterly Bulletin; International Financial Statistics; OECD Main Economic Indicators; OECD Secretariat estimates.

on incomes were removed soon after the new Government came into office, to be replaced by a "social contract" between unions and Government. This brought some improvement in industrial relations which could help to moderate wage (and therefore price) increases next year. However, there seems to be considerable pressure for large increases in money incomes when the threshold arrangements run out.

20. During 1974, the downturn in world activity, the deflationary budget measures, and the squeeze on liquidity caused by price control and higher prices for materials, have placed severe and increasing pressures on the company sector. These have led to a downward revision of investment plans for the next year or so and could intensify efforts to cut down on labour requirements, with consequent redundancies. Table 2 shows the principal elements in the NIESR's latest forecast. The picture is one with which most forecasters seem to be in general agreement. The forecasts suggest that by the close of 1975 output will be little different from 1973 and unemployment will have risen sharply. While the balance of payments picture is expected to improve as demand slackens, the rate of inflation still looks serious: it might be noted that while the 18 per cent growth of average earnings *through* 1975 could be a conservative forecast, more rapid growth in earnings could lead to slower growth of real disposable incomes because of the progressivity in the tax system and the effects on prices.

21. The NIESR forecast is based, of course, on the assumption of unchanged policies. The UK government seem to take a similar view of prospects and to consider that expansionary action is required. However, the cautious policies being pursued elsewhere and the size of the balance of payments deficit will restrict the margin for manoeuvre. An important consideration from the Irish point of view is that wage and cost inflation could erode UK competitiveness through 1975. At the same time, reflationary action and its balance of payments implications might affect confidence in sterling. The possibility of further depreciation in the external value of sterling through 1975 cannot, therefore, be ruled out. The parity between the Irish pound and sterling means that any further fall in the value of sterling would raise the prices for imported products in Ireland.

TABLE 2

NIESR forecast for the United Kingdom

(1973 = 100, unless otherwise stated)

	1973	1974	1975	1975 Q (IV)
GDP, factor cost (volume)	100	99·4	100·8	101·1
Average earnings	100	115·0	139·5	148·0
Consumer prices	100	114·3	134·6	142·0
Real disposable incomes	100	97·5	95·8	95·3
Consumers' expenditure (volume)	100	98·8	93·7	97·7
Employment	100	99·8	97·6	96·3
Unemployment (thousands, GB)	610	(600)	(800)	900
Export prices	100	124·8	148·6	152·5 *(a)*
Import prices	100	146·2	156·1	157·7 *(a)*
Terms of trade	100	85·4	94·0	96·7 *(a)*
Current external balance *(b)*	−1·3	−4·0	−2·7	−2·4 *(a)*

(a) Forecast for 1975 II.

(b) £ billion, the 1975 II figure is expressed at an annual rate.

Source: National Institute Economic Review, August 1974.

Chapter III

THE DOMESTIC ECONOMY

(a) Implications of international developments

22. In Chapter II, the international context in which the Irish economy is now operating, and in which it might have to operate in 1975, were described. At the beginning of this section the probable implications for Ireland of the rise in commodity prices (including oil) and of the recession in world demand and output are examined.

23. An attempt is made in Table 3 to show what the implications could be for Irish prices of the increased commodity prices since September 1973. The assumptions* underlying the figures are given in the footnotes to the table. The orders of magnitude involved are disquieting—especially the possibility that external influences could add some 8½ per cent to consumer prices. However, the results need to be interpreted with care. The main problem is one of timing. While the causes of these influences on domestic prices arose in the year from September 1973, they will *not* have their full impact over the same time period. For example, the direct effect of oil prices has probably already been reflected in consumer prices. This has probably also been the case with solid fuels. The impact of the rise in oil prices coming through other import prices or a wage reaction abroad to oil price increases could be delayed, the extent depending to some degree on the state of world demand. The same can be said of commodity prices.

24. In Table 4, the effects of the various external influences on consumer prices are distributed over the period 1974/76, using a plausible set of assumptions. In addition, Table 4 brings in two further influences on consumer prices not included in Table 3. The first is the commodity price increase up to September 1973, the second the influence of *ad valorem* indirect taxes.

*In general the table takes assumptions on the rise in various types of import prices and applies them to the most suitable set of input/output-derived coefficients in E. W. Henry and S. Scott, "Estimated price increases due to higher costs of petroleum and other imports as calculated from a 38-sector 1968 input-output model", *Quarterly Economic Commentary*, March 1974. The assumptions are for import price increases deriving from events in the year from September 1973. When these increases might be expected is discussed in the text. Additional notes on this table are given in the Annex.

TABLE 3

A summary of external influences on Irish prices

(percentage additions to national accounts price deflation)

Source of increase	Private Consumption	Public Consumption	Fixed Investment	Exports	Imports
Oil price rise					
Oil imports *(a)*	4·0	1·5	2·0	6·0	13·5
Solid fuel imports *(b)*	0·2	0	0	0	0·3
Other import prices *(c)*	0·9	0·3	1·6	1·2	3·5
Wage reaction abroad *(d)*	1·8	0·7	3·4	2·6	7·5
Total	7·0	2·5	7·2	10·0	26·7
Non-oil commodity prices					
Direct *(e)*	0·4	0·2	0·8	0·6	1·7
Indirect *(f)*	0·3	0·1	0·6	0·4	1·2
"Normal" import price rise (g)	0·6	0·2	1·2	0·9	2·6
Total effect	8·4	3·0	10·0	12·2	33·8

(a) It is assumed that the price of imported crude oil rises from $3.00 to $10.75 per barrel. The latter figure compares with an estimated OECD average of $10.50 in 1974 and over $11·00 in early 1975 when oil producing countries' "participation" will have increased.

(b) Based on National Prices Commission evidence on the import prices of Polish and Czech coal and information from the UK Department of Energy on British coal prices, suggesting an average increase since September 1973 of 30%.

(c) The OECD estimates of the direct impact on the export prices of various countries have been revised to bring them into line with the latest assumptions on the price of crude oil and weighted by the geographic pattern of Irish imports to give an estimated overall addition of 3½% to Irish import prices.

(d) If wage and salary rates in industrial countries rise to match the oil crisis impact on their consumer prices this could add a further 5 to 10% to Irish import prices.

(e) Direct commodity imports only, the assumed rise in sterling being 10% over the year to September (compared with a 15% increase in sterling spot prices) or 1¾% on import prices.

(f) The indirect impact via higher prices of commodity-based imports, assumed to add 1¼% to import prices.

(g) A normal annual rise of 2½% in import prices excluding the special cases *(a)–(f)* is assumed. This equals the 1965–1970 average.

TABLE 4

The external influence on consumer prices

	Total effect	Proportion occurring through			Price effect through %		
		1974	1975	1976	1974	1975	1976
Direct fuel	4·2	90	10	0	3·7	0·5	0
Indirect fuel	0·9	50	50	0	0·5	0·4	0
Wage reaction	1·8	20	60	10	0·4	1·2	0·2
Non-oil commodities *(a)*	0·7	20	80	0	0·2	0·5	0
Non-oil commodities *(b)*	3·2	100	0	0	3·2	0	0
"Normal" import prices	0·6	100	100	100	0·6	0·6	0·6
Total	. .	. .	. .	. .	8·9	3·2	0·8
Indirect tax adjustment *(c)*	. .	. . .	. .	. .	1·1	0·5	0·2
Total	. .	. .	. .	. .	10·1	3·8	1·0

(a) Commodity price rise since September 1973, c.f. Table 3.

(b) Commodity price rise up to September 1973. If it generally takes six to nine months for commodity prices to work through to consumer prices, then this rise should still be affecting consumer prices through 1974. The assumptions made are analogous to those made for *(a)*. More detail is given in the Annex.

(c) Assuming an average rate of VAT of 6·75% on the direct fuel impact, 2% on the direct commodity imports (most are zero-rated, others are rated 6·75%), 10% for imports of processed commodities (some are rated at 6·75%, others at 19.5%), and 15% for the remainder. There are also ad valorem import duties, assumed equivalent to 5% overall.

25. Another aspect of the international situation is its influence on domestic demand and output. One way in which this will be transmitted to the Irish economy is through the price increases discussed above. Another will be through reduced demand for Irish exports because of depressed conditions abroad. By themselves (that is, before allowing for increases in money incomes and budgetary changes), these external influences would have added about 10% to consumer prices through 1974 and would have led to a similar reduction in real private consumption. The fall would have been somewhat less if savings had been reduced in an attempt to mitigate the fall in real consumption. If the net reduction in real private consumption had been of the order of 9%, this would have been the equivalent of 4% of GNP. The reduction in export demand is difficult to quantify. One possible yardstick might be the downward revision in OECD import forecasts for major countries as a result of the oil crisis, weighted by the destination of Irish exports. If this is done, it suggests that the demand for Irish non-agricultural merchandise exports through 1974 rose by 5 percentage points less than would otherwise have occurred—the equivalent of nearly 1% of GNP. This total "first round effect" of 4½% of GNP would cut back total wages and salaries and hence demand for domestically produced goods. This would have secondary effects on domestic output. If the "multiplier" were 1½, the total effect on demand could eventually be equivalent to 7% of GNP.*

26. The above analysis provides a very rough and ready measure of the impact of the crisis. It attempts solely to measure the effect of the crisis on the Irish economy, before allowing for any domestic changes (such as increases in money incomes and budgetary changes). Its other limitations are obvious enough, namely:

(i) It takes no account of the effects on total demand of increased prices of categories of expenditure other than private consumption;

(ii) It ignores the domestic effects of international developments on agricultural export prices;

(iii) Multipliers at best reflect "average" behaviour and it is unrealistic to assume linear responses in 1975, given the magni-

*See Annex.

tude of the external events to which the Irish economy will be adjusting itself;

(iv) The overall effect on demand will not be fully reflected in output if conditions of excess demand existed at the outset. This was probably the case in 1973 in Ireland;

(v) The effect on output, like the effects on prices, will be spread through time, and will not occur within a year of the initial "shock" to the economy.

27. Nevertheless, the orders of magnitude suggested by these calculations, which in any case only cover that part of the impact of the crisis that is likely to affect Ireland during 1974, indicate that the deflationary impact (assuming no increases in money incomes or offsetting policy action) on output through 1974 could be the equivalent of 4½% of GNP, diminishing only slightly in 1975.* These demand and price effects of external developments determine the context for the discussion of the domestic economy which follows.† The discussion in this section is kept as factual as possible. Some interpretation is attempted in Chapter IV.

(*b*) *The Policy Background*

28. The Council's first report‡ described developments through 1973

*Assuming (i) and (iv) in paragraph 26 above can be ignored, that the total effect is spread over some years, and applying the analysis to the "first round effects" on consumer prices and merchandise exports in 1974–76. (this last assumed to fall away to zero in 1977) gives the following (for more detail see Annex):

	Total effect	Distributed effect 1974	1975	1976
Through 1974	−6¾	−4½	−2¼	—
Through 1975	−3	—	−2	−1
Through 1976	−1	—	—	−¼
Total	−10½	−4½	−4¼	−1¼

†The external influences on the balance of payments position are also important but are difficult to deal with in a summary manner. They are discussed in section (g) of this Chapter, and in section (a) of Chapter IV.

‡*Report No. 1: Report on the economy in 1973 and the prospects for 1974*, April 1974.

and prospects for 1974 as they appeared prior to the budget. The very rapid growth in 1973 was accompanied by accelerating prices and a deterioration in the balance of payments on current account. The confused international picture and the absence of adequate statistical information on developments in Ireland made analysis and forecasting difficult. However, before the budget the Department of Finance forecasts suggested that output could be almost 4% higher in 1974 than in 1973.* Since the view was taken that the forecast growth in output did not match the underlying growth of the economy's productive capacity, fiscal policy was used to give a further stimulus to the economy (see Table 5). It was officially estimated that the measures taken in the 1974 Budget would raise output by 1% in 1974, bringing the forecast growth rate for 1974 up to about 4¾%.†

29. Monetary policy was geared to the budget strategy, the overall objective being to ensure that the money supply increased in line with the forecast growth in real GNP plus the "inescapable" rise in prices. No changes have been made in the liquidity ratios which the Associated Banks are required to maintain, but steps have been taken to extend the secondary liquidity ratio arrangements to "Industrial" and "Other" banks. The rediscounting of Exchequer Bills is still undertaken at penal rates of interest and the 50% interest-fee special deposit requirement relating to net inflows of capital through the licensed banks has generally been maintained. In addition to these controls, the Bank has

*The most important domestic assumptions behind these forecasts were:

(i) A twenty per cent increase in the capital budget—the rise subsequently budgeted for 1974/75.

(ii) Maintenance of the 1973/74 current budget deficit.

(iii) Wage and salary increases in line with the 1974 National Agreement.

†The budget package included fiscal reforms. There were proposals to replace death duties by capital gains, wealth and capital acquisitions taxes, income tax was extended to farmers, and personal income taxation was modified and simplified. The Council has already commented on the longer-term aspects of some of these (Report No. 2: Comments on Capital Taxation Proposals). The tax changes also provided some of the desired budgetary stimulus—principally through increased allowances against income tax (with the exception of interest charges where a £2,000 maximum was imposed) and the ending of the different income tax treatment of investment and "earned" income. The other major source of stimulus was an 18 per cent increase in social welfare benefits.

attempted to influence the distribution of credit among customers. It has emphasised the increased working capital requirements of the industrial sector, because of higher input prices, and in June it requested that there should be no increase in lending to banks, to hire purchase, property or other financial companies or to the personal sector between May and November. The other major influence on monetary conditions has been persistently high levels of interest, almost entirely the result of external influences (see Diagram 2).

TABLE 5

The current budget 1974/75

(£ million)

Revenue		Expenditure	
Before budget changes:			
Tax revenue	791·80	Road fund payments	17·30
Motor vehicle duties	26·00	Debt service etc.	165·00
Non-tax revenue	123·06	Supply services	780·69
Total	940·86	Total	962·69
Budget changes:			
Reform of income tax	−27·25	Social Welfare	24·47
Other	2·50	Other	0·60
Total	−24·75	Total	25·07
Current deficit	66·65	Less departmental balances	−5·00
Total	982·76	Total	982·76

The figures refer to 1974/75. Although the financial year will end at the close of 1974 these figures give a better idea of the policy position as they are not affected by differences in the timing through the year of receipts and expenditure.

Source: Budget 1974, April 1974.

(*c*) *Developments in agriculture*

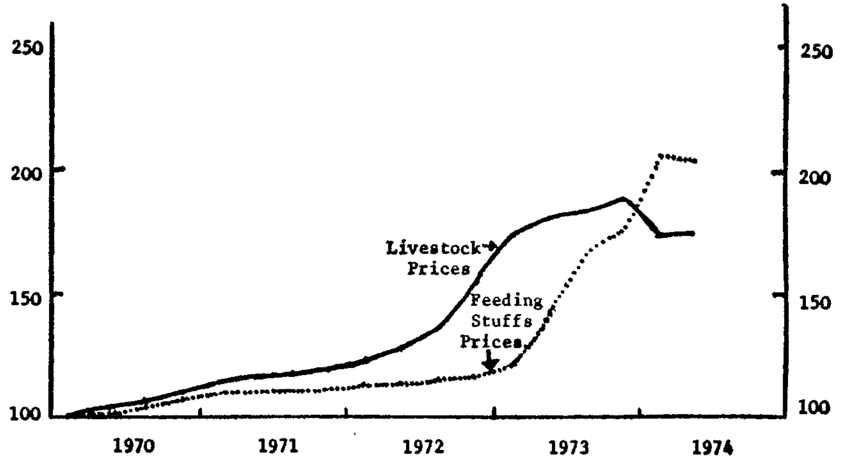
30. The principal problems have arisen in cattle production. The difficulties originated with the sharp rises in beef prices on world markets through 1972 and into 1973—the pattern generally followed by other commodity prices in response to buoyant world demand. In Ireland, the price rises coincided with over-optimistic assessments of the effects of EEC membership on prices and medium-term prospects. This led producers to build up stocks, and to reduce the number of

cattle put on the market, and this helped to drive prices in Ireland even higher. However, this was not a purely Irish phenomenon—as prices rose, steps were taken to expand beef production elsewhere, often with the help of policy inducements. Unfortunately, the very optimistic forecasts were not justified by events. After stabilising or easing somewhat during 1973, world beef prices have fallen this year. This was initially the result of consumer resistance to higher prices and later the fall in real incomes in many countries.

31. The efforts to raise production inevitably brought increasing supplies of beef to world markets, sending prices even lower. Some animals could not be held back much longer because of their age. Very sharp increases in production costs also encouraged slaughtering. The rise in production costs reflected increased feedstuff prices, notably protein supplement and grain. The reasons for the rise in prices are complex, reflecting the general influences affecting all commodities, plus poor harvests, expanding demand and controls on international trade which have affected supplies.

Diagram 3: Beef and feedstuff prices in Ireland

(Indices, 1970 = 100)



Source: Irish Statistical Bulletin, CSO.

The upward swing in prices came somewhat later than for beef (see Diagram 3). In recent months, producers have, therefore, been caught in a "pincer movement" between falling beef prices and rising costs. This situation is becoming increasingly acute in parts of the Northern Hemisphere as pasture runs out and farmers have to switch to other feedstuffs for the winter. Those who feel they cannot afford to feed animals through the winter are being forced to sell.

32. The entry of this country to EEC has given considerable protection to Irish cattle producers. Before entry, the prices received by Irish farmers were well below EEC levels (though a little above world levels). But many agricultural prices are now being brought into line with EEC prices (see Table 6), over the transition period by means of compensatory payments and levies. The Irish Intervention Agency (namely the Department of Agriculture and Fisheries) buys, stores and resells on behalf of the Community in an effort to prevent prices of the main products falling below predetermined levels (in practice, such intervention operations have taken place only in the beef sector). During 1974, intervention stocks of beef have built up rapidly in Ireland and elsewhere in the EEC. Substantial sales at below intervention prices had to be made, principally for export to non-EEC countries. In addition, a temporary ban was placed on all imports of cattle and beef into the Community.

33. While Irish cattle producers were protected to a degree by the CAP, the prices they received were below those obtaining in other member countries. There were five main reasons why this happened:

(i) Irish prices are still being aligned to Community levels and will not reach them until the end of 1977;

(ii) Prices were held down because the exchange rate used to convert Units of Account into pounds had not been altered in line with the depreciation of the pound on foreign exchange markets;

(iii) Meat factory and cold storage capacity were not sufficient to cope with the supplies to be processed or stored;

(iv) In times of over-supply, Ireland would have difficulty in obtaining prices as high as those achieved by producers nearer to the main centres of consumption;

(v) Store cattle prices are not covered by the CAP and they have been falling through 1974. Farmers holding store cattle have been particularly badly affected by falling returns and increased production costs.

TABLE 6

Beef Situation in the EEC

	1963–1967 average level	1968	1969	1970	1971	1972	1973
Original Six							
Cattle numbers (*a*) (*b*)	49·4	105	106	106	104	103	
Production (*c*) (*b*)	3·8	111	110	114	116	106	
Net imports (*d*)	13	11	14	12	12	21	
Consumption per head (*e*) (*b*)	22·7	104	106	108	110	n.a.	
Market prices (*f*) (*g*)	n.a.	26·5	27·2	27·5	29·1	40·2	
Guide Prices (*f*)	n.a.	28·3	28·3	28·3	29·4	30·6	
Market/guide price (*h*)	n.a.	94	96	97	99	132	
United Kingdom							
Cattle numbers (*a*) (*b*)	12·0	101	103	105	107	113	n.a.
Production (*c*) (*b*)	0·9	102	98	107	107	102	
Net imports (*d*)	35	29	40	28	27	31	
Consumption per head (*e*) (*b*)	21·5	95	99	99	96	93	
Market prices (*f*) (*i*)	15·9	18·7	19·2	20·7	24·7	30·2	
Intervention or guide price (*f*)	17·6	19·6	21·2	22·9	24·3	26·0	
Market/guide prices (*h*)	90	95	91	90	102	116	
Ireland							
Cattle numbers (*a*) (*b*)	5·2	106	108	113	116	122	132
Production (*c*) (*b*)	0·3	105	106	109	117	127	133
Net exports (*d*)	73	78	73	71	77	62	56
Consumption per head (*e*) (*b*)	36·9	107	109	114	115	118	n.a.
Market prices (*f*)	n.a.	14·2	16·7	17·9	19·0	21·9	28·6
Guide Price (*f*)	. .	. .	. .	. .	. .	. .	n.a.
Market/guide prices (*h*)	. .	. .	. .	. .	. .	. .	n.a.

(*a*) Levels in millions at the beginning of the year.

Footnotes continued overleaf.

The introduction of slaughter premia and an EEC agreement on agricultural prices in the autumn will help to alleviate some of the pressure on Irish farmers. The EEC measures brought a 5% general rise in reference price levels and, more importantly, the "Green Pound", which brought the agricultural rate closer into line with the market rate, reducing the existing gap of over 14% to about 3%.

34. The situation relating to beef production does not, of course, give the whole story of Irish agriculture. Despite increasing costs and a somewhat disappointing level of production this year, dairying fared somewhat better. Pig production has been affected by high feed costs but export returns in recent months have been attractive; however, output has fallen. There has been a weakening of the sheep market in sympathy with the beef market situation. Arable farming has been helped by the rise in grain prices, but poor weather has had adverse effects on the harvest. The "Green Pound" and general EEC price increases will have limited effect in 1974, but they should lead to a more significant improvement in 1975.

Footnotes to Table 6 (contd.)

(*b*) 1968/74 indicators are indices, 1963/67 average = 100.

(*c*) Levels in million tonnes.

(*d*) % production.

(*e*) Kg/head, beef and veal.

(*f*) Pence per Kg live weight for fat cattle, intervention/guide prices are averages.

(*g*) Average market price for fat cattle in West Germany for the year beginning 1st April of the year stated.

(*h*) %

(*i*) Prices for fatstock certified under the Fatstock Guarantee Scheme for the year commencing 1st April of the year stated. 1973 onwards the invervention price is replaced by the EEC guide price.

Source: *Meat and Dairy Produce Bulletin,* Commonwealth Secretariat; *Annual Review and Determination of Guarantees,* HMSO; Marches Agricoles, Produits Animaux, EEC Agriculture Directorate; Department of Agriculture and Fisheries.

35. However, it would not be prudent to look for a very sharp turnaround in world beef prices. For example, to judge by the herd structure of the main producing countries, the build-up in cattle numbers in the early 1970s would allow for expanded production for some time, despite reduced profit margins. Within the EEC, this appears true of

TABLE 7

Developments in agriculture

	1971	1972	1973	1974	1975
				(estimates and forecasts)	
£ million					
Livestock *(a)*	310	368	469	490	610
Livestock *(a) (b)*	317	407	535	500	610
Crops and turf	71	73	89	100	125
Gross output	388	480	624	600	730
Farm material input	95	102	145	160	220
Net output *(b)*	293	378	478	440	510
Volume, 1968 = 100					
Livestock output *(a)*	110	109	110	119	128
Livestock output *(a) (b)*	110	116	121	115	124
Crops and turf	110	103	95	90	95
Gross output *(b)*	110	114	116	113	119
Farm material input	124	126	139	118	139
Net output *(b)*	106	110	111	111	113
£ million					
Net output *(b)*	293	378	478	440	510
Expenses less subsidies	65	73	81	95	105
Income in agriculture *(b)*	228	307	397	345	405
Land annuities	3	3	3	5	5
Wages and salaries	25	27	30	35	40
Farmers' incomes and profits *(b)*	200	276	364	305	360

(a) Including livestock products.
(b) Including value of changes in livestock numbers.

Sources: CSO, NESC secretariat estimates.

France and the United Kingdom, where current heavy levels of slaughter have not reduced the breeding herd; and elsewhere it applies to the United States, Australia and New Zealand. For Irish producers, much will depend on EEC policy on imports and prices. The course of feedstuff prices is impossible to foresee; the best that can be hoped for is that reasonable harvests will allow for some fall in prices.

36. In Table 7 an attempt is made to give a picture of the possible outturn in agriculture in 1974 and 1975, but the uncertainties and data limitations make this a hazardous exercise. The broad conclusions seem to be that farm incomes probably fell by around 15% this year but should recover in 1975. Agricultural income levels would be substantially lower if Ireland were not a member of the EEC, and the prospects are for continued recovery in farm incomes as the EEC transition period proceeds.

(*d*) *Income and prices*

37. The major influence on total money incomes outside agriculture in 1974 was the 1974 National Agreement. This provided for average rates of increases of 18% or more over a twelve-month period, with escalator provisions if prices rose by more than 10%. The Agreement, like its predecessors, gave larger proportionate increases in remuneration to the lower paid. It included special provisions to reduce the spread of starting dates among participating groups (a legacy of the Twelfth and earlier pay agreements) from about 11 to 2/3 months, and it expressed the view that the bulk of anomaly cases (which had been of some importance as an additional source of wage increase under the 1970 and 1972 Agreements) should already have been dealt with. Table 8 compares the last three National Agreements.

38. In general, the 1974 Agreement has been reasonably well observed. However, it has not been as successful as its two predecessors in preventing industrial disputes. Moreover, the incidence of anomaly claims has been high, noticeably in the public sector. Developments in the private sector are unclear, but it would appear that a number of "anomaly" settlements and "productivity" agreements have been made. On the basis of the information available, it seems probable that anomaly claims could add 4 to 5% to the total wage and salary bill.

TABLE 8

A comparison of recent National Pay Agreements

(eventual percentage additions to average pay)

	1970 agreement	1972 agreement	1974 agreement
Starting date *(E)*	Jan. 1971	July 1972	Jan. 1974
(L)	Jan. 1972	June 1973	June 1974
Number of months covered *(E)*	18	18	15
(L)	17	12	12
Basic pay increase (%) *(E)*	11	12	18
(L)	12	12	19
Reference period for cost-of- *(E)*	Nov. 1971	May 1973	Nov. 1974
living pay increases (year to) *(L)*	Nov. 1972	Feb. 1974	Nov. 1974
Threshold for cost-of-living increases (%)	4	4	10
Retail price rise over *(E)*	8·6	11·7	(20)
reference period (%) *(L)*	8·2	13·5	(20)
Cost of living increases (%) *(a)* *(E)*	6	7½	(10)
(L)	7	9 *(b)*	(10)
Total increase in average pay (%) *(c)*	19	21½	30
Annualised rate of pay increase (%) *(c)*	12½	12¾	28½

Notes on this table are given in the Annex.

(E) = early starters.

(L) = late starters.

(a) Including 4% automatic second phase payments under the 1970 and 1972 Agreements.

(b) This payment was not made, but was included in the 1974 Agreement.

(c) These two lines attribute the effects of the threshold payments due to late starters under the 1972 Agreement, but in fact incorporated in the 1974 Agreement, to the 1972 Agreement.

Source: NESC Secretariat estimates based on information supplied by the Public Service Department.

TABLE 9

Non-agricultural wage and salary earnings *(a)*

(percentage addition to average wage and salary earnings)

	1972	1973	1974	1975
1970 National Agreement	10	5		
1972 National Agreement *(b)*	2	8	4½	
1974 National Agreement *(b)*			10	21
Total of above	12	13	15	21
Unidentified *(c)*	4½	3½	6	5
Average wage and salary earnings *(d)*	17	17	22	27

(a) This table attempts to illustrate the distribution through time of the effects of national pay agreements on average pay outside agriculture. The numbers in the table show the percentage by which average pay in a given year will exceed average pay in the previous year because of the 1970 Agreement, the 1972 Agreement, etc. No allowance is made in the 1975 column for any increases under the Sixteenth Round negotiations due around the turn of the year. If the Sixteenth Round produces a National Agreement with first phase payments due in April and June, the percentage addition to average earnings in 1973 (over and above that shown in the table above) would probably be about 70% of the agreed first phase of the Agreement.

(b) The second phase of the 1972 Agreement, which was not paid to late starters but incorporated in the 1974 Agreement, is attributed to the 1974 Agreement.

(c) Residual item obtained by subtracting the total identifiable wage and salary increase under national agreements from the average increase in the wage and salary bill outside agriculture. This item includes statistical adjustments due to differences in coverage (e.g., not all wage and salary earners are covered by the agreements, and the non-industrial wage and salary bill includes pensions). It also includes, notably for 1972, any remaining influence of pay rounds prior to the 1970 Agreement. Furthermore, it includes overtime payments, anomaly payments and any slippage in adherence to the terms of the agreements. The residual item is assumed to rise in 1974 because of overtime payments carried over from 1973 levels, but to fall again in 1975 because less overtime working may more than offset the effects of increased anomaly settlements.

(d) Changes in non-agricultural wages and salaries less that change accounted for by changes in the numbers employed.

For further detail see the Annex.

Source: NESC Secretariat estimates based on information supplied by the Public Service Department.

39. Table 9 attempts to indicate what could happen to wages and salaries in 1974 and the prospects for 1975 on the basis of such information as is available at present. No allowance is made for pay increases likely under the new round of bargaining about to commence. One main feature is the extent to which current anomaly claims could add to the pay bill: they could account for a 4% increase in 1975, more than offsetting a probable fall in other unidentified sources of pay increase, particularly further reductions in overtime working. Another is the implications for the total wage and salary bill in 1975 of what has already happened in 1974: it would seem that before allowing for *any* addition through new agreements, average earnings are likely to be about a quarter higher than 1974.

40. Turning to prices, developments to date have confirmed the most pessimistic forecasts made at the beginning of this year. In August, consumer prices were 18% higher than a year earlier, while the movements of wholesale and public utility prices since then suggest no slackening in the trend through the remainder of the year (see Table 10). The recent increases in international prices have had relatively severe effects in Ireland, where those categories of private consumption whose prices have risen fastest—notably fuel and food—have a particularly important weight in the total. For example, if the increase in the Irish index in the four years to August is recalculated using Common Market patterns of consumption, the increase over the four years would have been two or three percentage points lower than it in fact was.*

41. In principle, it is possible to look more closely at the build-up of the price increase using input-output tables and this is done in Table 11. However, the results of this exercise require qualification. On the statistical side, the input-output tables give some idea of the magnitudes which can be used, in an accounting sense, to identify the main components of the increase in the consumer price index. One disadvantage is that the input-output tables apply to 1968, so that the weights may

*The distinction is made between weights of food, fuel and light and other consumer prices.

TABLE 10

Consumer and wholesale prices
(percentage changes at annual rates)

	1965–1970 Average	1971	1972	1973	1974
Consumer Prices (August)					
Total	5	9	9	11	18
Food	5	8	14	13	16
Non-food	6	10	5	9	20
Drink and Tobacco	7	5	1	11	5
Clothing and footwear	3	9	10	17	21
Fuel and light	5	12	10	6	59
Housing	8	11	11	6	10
Durable goods	5	8	8	12	21
Other	6	11	7	9	20
Wholesale prices (*a*)					
Ireland					
Home production	5	5	11	18	n.a.
Materials for use in industry	4	4	5	23	n.a.
United Kingdom					
Manufactured goods	4	10	6	8	25
Raw materials for industry	4	4	4	30	66

(*a*) The Irish series do not go beyond 1973. UK data are shown to give some idea of more recent trends. The 1974 figures for the UK are for the year to June.

Sources: CSO *Irish Statistical Bulletin;*
CSO *Statistical Abstract of Ireland,*
OECD *Main Economic Indicators.*

not be entirely appropriate for 1974. A second disadvantage is that the statistical series to which these weights should be applied (the various cost items) are not up to date, the most glaring example being import prices, where in September no data were available for 1974.* Finally, an analysis of this type at best indicates orders of magnitude and does not throw any light on the behavioural relationships behind the figures.

*British series were used to obtain a proxy for the Irish figures.

TABLE 11

Aspects of price increases

(*a*) *Contributions to consumer price increase.*

	Percentage rise in cost per unit of consumption					Percentage contribution to price rise				
	1970	1971	1972	1973	1974	1970	1971	1972	1973	1974
Employee incomes	13	11	13	10	15	46	35	42	26	25
Imports	7	6	3	18	30	22	18	10	43	48
Indirect taxes	11	8	7	5	1	23	15	14	7	1
Agricultural profits	4	5	29	28	−6	2	2	11	8	−2
Non-agricultural profits	0	7	12	11	12	−1	15	26	18	13
Residual	12	26	−4	−4	45	8	16	−2	−2	15
Total (Consumer prices)	8	9	8½	11½	17	100	100	100	100	100

Source: Department of Finance.

(*b*) *Reasons for applications to Prices Commission for higher prices*
(% applications in period to end of month shown)

	1972				1973				1974	
	Jan.*	Apl.	Jly.	Oct.	Feb.	May	Sept.	Dec.	Mar.	Jly.
Material costs	46	40	51	45	36	39	68	65	75	64
Wages and salaries	35	32	27	37	39	35	23	18	15	24
Other costs	19	29	22	18	25	25	9	17	10	12

*From mid-October 1971.
Source: National Prices Commission.

(*c*) *Profits and price control.*
(Post-tax profits as a percentage of net assets)

	1971	1972	1972*	1973*
Exempt firms and firms which have not applied for price increases	9·1	11·6	11·8	15·4
Firms subject to detailed price control	7·3	9·9	8·1	8·1

*Smaller sample than first two columns.
Source: National Prices Commission.

42. Nonetheless, despite these qualifications, the data support some tentative conclusions. First, the role of imported inflation seems as great as suggested in earlier sections of this report. Second, they suggest that profit margins have on balance risen less quickly than prices in general, though margins vary significantly both within and between industries. These two findings are supported and clarified by more direct evidence from the National Prices Commission which is also presented in Table 11. The contribution from higher import prices predominated early in the year; more recently, increases in Irish wages and salaries have become relatively more important. As for profit margins, some squeeze might be expected in a period of rapid wage and material cost inflation. In normal circumstances, these margins would be restored after a lag. However, the criteria which the National Prices Commission are required to apply do not allow for a compensating recovery in real terms—margins are judged in absolute terms.

43. While a large proportion of current income is used for the purchase of consumption goods (whose prices are probably reflected in the consumer price index), it may also be used to finance the purchase of assets, of which by far the most important for the average individual is a private dwelling. In the five years to 1973 new house prices rose by about 20% more than consumer prices, but house prices (but not building costs) seem to have stabilised in 1974. This might suggest that in some sense the rise in the overall "cost of living" in 1974 is overstated by the recent increases in the consumer price index, and that the difficulties of house purchase eased somewhat. However, this is not the case. The levelling off in house prices owes something to the deceleration in the growth in real incomes and to an increase in the supply of new houses, but it can probably also be attributed to institutional arrangements. As interest rates have risen abroad and in Ireland, the building societies have found themselves in an increasingly difficult position. They are obliged to compete for deposits with the banks, yet are reluctant to raise deposit rates as this raises lending rates both to existing and new borrowers.*

*Furthermore, the structure of building society rates is influenced by fiscal concessions.

44. As a result, at various periods over the last couple of years there has been a shortage of funds available for lending. This led to rationing with ceilings placed on the loans available for the purchase of a new or existing house from building societies or under the Local Authority House Purchase Loan Scheme. As a result of this rationing, the market was dislocated—house prices tend to fall very reluctantly and the principal effect in the upper-price range of the market simply seems to have been a sharp fall in the numbers of transactions. Until the middle of October 1974, the lower end was disrupted by the distinction between new and old houses.* In addition to these problems, the cost of a purchase is a combination of price and the cost of finance. It is very difficult to get any indicator that would reflect the command of real incomes over assets. But it seems clear that in recent years, it has become increasingly difficult and costly for an average employee to acquire an average dwelling. In late October 1974 the ceilings on loans from building societies were removed, but the interest subsidy was limited to loans not exceeding £9,000.

45. The discussion in the previous two paragraphs relates only to those with incomes large enough to make house-purchase a feasible proposition. In recent years the numbers in this category may have declined because in general the cost of house-purchase has risen faster than money incomes. For those who cannot, under present circumstances, contemplate house-purchase, the alternative is to seek accommodation for rent from private landlords or local authorities. Because of various problems (such as the existence of differential rents), it is not possible to relate increases in average earnings for this category to increases in rents.

(e) The industrial sector

46. It has been a mixed year for the industrial sector. On the positive

*This type of distinction is probably only useful if sufficient warning is given to allow the construction industry to change its plans and build for the cheaper end of the market only. But even if this had been the case, the old/new distinction is not as clear-cut as it appears, since transactions are rarely isolated events but usually form one of a chain of sales where one person sells old accommodation (for which finance must be available) to move to a new unit. To force new entrants to the market towards new property, while existing owners are kept where they are, imposes an unnecessarily arbitrary constraint on the market.

side, there was a remarkably strong inflow of new foreign projects, averaging about two new firms a week. The employment potential of new projects approved during 1973/74 was 22,000, well in excess of both previous and target levels. These new jobs and the associated output will take some time to come on line, but they are only the latest figures in rapidly expanding foreign investment since EEC membership became certain.

47. Another encouraging feature was the level of activity in the first quarter of 1974, the latest period for which firm data are available. At that time the output of manufacturing industry seems to have been running about 8% higher than a year earlier and had risen sharply from its level in the second half of 1973. It is not clear how reliable the first quarter figures for industrial output are,* but there was undoubtedly some recovery. There may have been some rebuilding of stocks and increased production for export as some of the pre-oil-crisis material shortages were overcome. There may also have been a short-lived boost to demand in anticipation of price increases. Since then, however, the picture seems to have deteriorated as domestic and export markets have become less buoyant. Direct evidence is hard to come by, but the following indications seem relevant:

(a) The information contained in recent CII/ESRI monthly surveys, which shows some weakening in confidence.

(b) Recent increases in redundancies and unemployment and reductions in registered vacancies.

(c) The weakness of indicators of domestic expenditure, such as the index of retail sales.

(d) The pattern of industrial production since the oil crisis in other countries.

*They show a more buoyant picture than other domestic indicators. It appears that similar experience in the UK during the 3-day working (a more buoyant than expected picture of output in relation to expenditure indicators) can be partly explained by the rundown of unrecorded stocks of materials and components.

48. While the present position in industry may not be critical, there are indications that it could become so. The current and prospective weakness of demand is one factor. Another is the profit and liquidity position of the corporate sector. Profits have been squeezed by rapidly rising wage and material costs, possibly by price control on those companies serving the domestic market. Some evidence is available to suggest that profit levels are relatively low in Ireland, and the absence of proper methods of inflation accounting may mean that insufficient provision is being made for depreciation and that "true" profits are being overstated. In addition, working capital requirements have increased enormously. In the absence of offsetting action, this is the situation in which the "multiplier" effects of the oil crisis will be felt. In these circumstances, there is a danger of a substantial "shake-out" of labour, which would be all the greater if demand remained weak. Any such "shake-out" of labour would further weaken demand and cause further redundancies.

(f) Output and employment

49. In this section, an attempt is made to draw together and quantify the tentative conclusions about 1974 that emerge from the above discussion. The main statistics are presented in Tables 12 and 13. The principal new assumptions which had to be made to make possible a full set of estimates are:

(i) a disappointing tourist season which was reflected in lack of buoyancy in the output of the services sector;

(ii) some increase in the outflow of labour from agriculture, though still below levels experienced prior to EEC membership;

(iii) a relatively low emigration figure in relation to a weakening domestic labour market.

Whenever possible the picture has been built up using current economic indicators and, by and large, it accords with *a priori* reasoning in the introductory part of this chapter which dealt with the influence of external developments.

TABLE 12

Labour market developments

	Thousands 1973	Annual average percentage changes				
		1961/71	1972	1973	1974 (*a*)	1975 (*a*)
Employment in:						
Agriculture	261	—3	−1¾	−2¼	−3	−2½
Industry	320	2¼	−2¼	1¼	2¾	− ¼
Services	471	1	1¾	1¼	−1¼	−4
Total at work	1,052	0	− ½	− ½	− ½	−2½
Out of work (*b*)	66	6¼	6·4	5·9	6·9	9·1
Labour force	1,118	¼	− ¼	0	½	0

(*a*) Estimates and forecasts.
(*b*) Census of employment basis, expressed as a percentage of the labour force.

Sources: CSO, *The Trend of Employment and Unemployment in* 1972;
NESC secretariat estimates—see Annex.

50. The domestic picture emerging for 1974 from Tables 12 and 13 is one of very weak growth and increasing unemployment—a disappointing prospect considering the much more buoyant views held at the time of the budget. The broad conclusion is that real output may have risen not much more than 1% in 1974 and the average employment rate* was the equivalent of 6·9% of the labour force, compared with 5·9% in 1973. Furthermore, these annual averages mask developments through 1974 and a better indication of the trend may be an estimated 4% *fall* (seasonally adjusted) in industrial output between the first and fourth quarters of 1974.† Another indication of the trend in unemployment is provided by the increase in the numbers drawing unemployment benefit. These increased from 32,000 in December 1973 to 42,300 in September, 1974, on a seasonally adjusted basis.

(g) External trade and payments

51. There was a sharp deterioration in the trade balance in the first half of 1974, with the figures for the most recent months showing an

*Census of employment basis.
†After allowing for statistical quirks in the surprisingly high output figure for the first quarter of 1974.

TABLE 13

Expenditure and output

(Percentage changes, volume, annual rates)

	1973 (% GNP)	1961 –1971	1972	1973	1974 (*a*)	1975 (*a*)
Private consumption	64	3½	5½	6¾	¼	1
Public consumption	16	4½	10½	7	6	0
Gross fixed capital formation	23	9½	2½	13	½	−2
Final domestic demand	103	5	5½	7½	1¼	0
Stockbuilding (*b*)	3	¼	—1	1	—1	—2
Exports of goods and services	38	7¼	2	10½	11½	11½
Imports of goods and services	45	8½	7½	13	8	3
Foreign balance (*b*)	− 6	− ½	− ½	−2½	½	3½
GNP at market prices	100	4¼	4	7½	1	1½

(*a*) Estimates and forecasts.
(*b*) Contribution to the growth of GNP, foreign balance includes net factor incomes.

Sources: Department of Finance, *Review of 1973 and Outlook for 1974;*
NESC secretariat estimates and forecasts.

import excess running at an annual rate of about £650 million. The value of imports rose sharply early in the year but has since levelled off, while exports have moved up slowly in recent months after a hesitant start in the early months of this year. The increase in the trade deficit has serious implications for the overall balance of payments picture in 1974 and beyond, but analysis is hampered by the absence of information on the extent to which recent changes reflect price or volume changes. At this stage any analysis must at best be based on informed guesswork.

52. The figures for the first half of 1974 show a 45% increase in industrial exports over the same period of 1973 and a corresponding 19% increase in agricultural exports. This would seem to suggest that the volume of industrial exports was still rising strongly in the first half of 1974, accompanied by some increase in prices, possibly because

of export orders built up in 1973 and aided by shortages during the three-day week in the United Kingdom. If this is correct, a slackening in export demand for industrial goods could be expected in the latter half of 1974 and into 1975 as world demand eases. The agricultural export figures reflect the fall in beef prices. The purchase of CAP intervention stocks (which is equivalent to an export as it is financed from abroad but does not as yet show up fully in the trade figures) has also affected statistical series.

53. Imports in the first half of 1974 were dominated by the increased prices of oil and raw materials. But although the growth in imports of raw materials and partly-processed goods was very large, that of consumption and capital goods was also rapid. While world export prices of manufactured goods have risen rapidly since the oil crisis, it is unlikely that price increases have accounted for all of the increase in the value of Irish imports. The volume increases implied by such a view may seem inconsistent with the general picture of the domestic economy presented earlier in this section. Part of the explanation may lie in the large import content of exports, the recent inflows of new industrial projects, and the displacement of Irish goods by imports as tariffs have been reduced. However, it may also be due to a rebuilding of stocks following the shortages which developed in late 1973 and early 1974. If this is so, the growth in the volume of imports might be expected to tail off later this year as the stock adjustment is completed and domestic and foreign demand weaken further.

54. Forecasts based on this view of developments through the remainder of 1974 are incorporated in Table 14, which shows a trade deficit for the year of £570 million. Tourism earnings may have shown little buoyancy this year because of the reduced rates of real income growth abroad (particularly the effects of the three-day week in UK early in 1974), and the spread of violance from Northern Ireland to the Republic early in the tourist season. The invisibles account has, however, benefited from increased transfers from the EEC, so that the current deficit may not have deteriorated to the same extent as the trade balance. The estimated outturn for 1974 shows a current external deficit of £340 million, one of the largest in relation to GNP within the EEC.

TABLE 14

TRADE AND PAYMENTS

% changes, annual rates	1961/71	1972	1973	1974 *(a)*	1975 *(a)*
Exports					
Agricultural, value	9	16½	30	16	30
volume	n.a.	n.a.	n.a.	22	12
price	n.a.	n.a.	n.a.	–4	16
Other, value	15	28½	46	34	33
volume	n.a.	n.a.	n.a.	9	12
price	n.a.	n.a.	n.a.	23	18
Total, value	11	20	36	27	31½
volume	9	6	7	14½	12
price	2	13	27	11	12
Imports, value	11	15	38	47	23
volume	8½	4	13½	8½	3
price	2½	10	21	36	19
Terms of trade	0	+3	–1	–18	–6

£ million	1965/70	1972	1973	1974 *(a)*	1975 *(a)*
Merchandise exports	345	630	870	1,105	1,455
Merchandise imports	500	825	1,140	1,675	2,060
Trade balance	–155	–190	–270	–570	–605
Net services and transfers	125	135	185	235	280
Current balance	–30	–55	–85	–340	–325
Long-term capital	35	17	} 90		
Basic balance	5	–38		375*(c)*	
Short-term capital, etc.	80	88			
Changes in reserves *(b)*	85	50	5	35*(c)*	

(a) Estimates and forecasts.
(b) + = increase.
(c) Assuming no changes in reserves from end-September to end-December.

Sources: Review of 1973 and Outlook for 1974, Department of Finance; NESC estimates.

55. Despite the increased current deficit the reserves have shown remarkable buoyancy. In the year to September, the reserves rose by £25 million, and if there were no change to the end of the year the 1974 current deficit of £340 million would have been accompanied by a £35 million increase in reserves, implying a capital inflow of £375 million. A net inflow of capital is no new experience for Ireland—over the last decade it has averaged £115 million a year. Here again, there is not sufficient information to allow any firm conclusions to be drawn. It would seem that much of the regular inflow of earlier years was associated directly and indirectly with new industrial projects. There was an upturn in such activity in 1974, but not sufficient to account for the increase in the net inflow. Overseas borrowing in 1974 by the public sector also made an important contribution. Other reasons could be advanced for the increased inflow, but there are very great difficulties in trying to identify explanations of changes in the *net* capital inflow when the gross flows of funds in and out of Ireland are huge by comparison. The nature of the capital inflow in 1974 and its durability are, of course, vital to the formulation of policy in 1975, but more detailed information on this matter is required.

(*h*) *Outlook for* 1975

56. In Tables 12 to 14 above, the final column gives a tentative indication of the prospects for 1975. Any economic forecast must be based on a set of assumptions about economic behaviour, usually drawn from past experience. Economic forecasting is not an exact science. The lack of sufficient up-to-date statistical information has tended to retard the development of forecasting in Ireland. Moreover, the changes in the world over the last year or so may make past behaviour an unreliable signpost to the future. The particularly broad margins of error inherent in any forecasts at this stage for 1975 must, therefore, be strongly emphasised.

57. Furthermore, forecasts must necessarily be based on assumptions about the context within which the economy is expected to function. The results of any forecasting exercise must be judged by reference to the assumptions (and their possible validity) on which it is based. The most important assumptions underlying the forecasts presented here are the following:

(i) Sluggish growth in world output and trade, with some decline in non-oil commodity prices, but none in oil prices. These assumptions are consistent with the latest OECD picture.

(ii) Some reflationary action in the United Kingdom;

(iii) No significant change in the Northern Ireland situation;

(iv) The United Kingdom will remain within the EEC.*

It seems likely at this stage that these four assumptions will turn out to be realistic.

58. In addition, assumptions must be made about the changes in Government economic policy and in money incomes. The following two further assumptions are made, not because they are likely to be realistic, but because they are the assumptions which give the best "benchmark" to which the effects of policy changes or increases in money incomes can be related;

(i) No major changes in policy in Ireland. This means no changes in tax rates, expansion of public current expenditure as a result of wages and salaries rising in line with assumption (ii) below, social security benefits, etc. rising in line with prices, and the same rate of expansion in the public capital programme in value terms as in 1974/75;†

*If the United Kingdom were to leave the EEC and Ireland were to remain a member, longer-term prospects for the Irish economy would not deteriorate. Indeed, as the only English-speaking country left in the EEC the rate of new investment and job-creation might well accelerate while the advantages of the CAP were retained. The likely short-term impact is very difficult to foresee, but would certainly involve a period of considerable readjustment.

†As the forecast growth of output is weak these assumptions might imply some increase in the Government's current deficit. In a recession, corrective action would generally require an overall budgetary deficit. To quote a recent OECD report: "There are several ways of looking at the suitability of a particular fiscal policy posture, some more appropriate or sophisticated than others. To look at the current budget position is among the least sophisticated and least appropriate, firstly because it is influenced by the level of economic activity and may be a poor indicator of policy posture, secondly because it is only a partial indicator of the overall budgetary position and thirdly because fiscal policy is probably better judged by its impact on demand and output, prices, employment, the balance of payments and other economic aggregates". Recent press comment has suggested that public expenditure plans are being pruned. Some allowance is made for this in the forecast.

(ii) No increases are assumed in wage and salary rates after the full implementation of the 1974 National Agreement.*

These assumptions must be kept in mind because the forecast for 1975, which is set out below is based on them.

59. On the basis of the assumptions set out in paragraphs 57 and 58 above, the forecast suggests that 1975 could be another year of poor growth and that unemployment could rise well above present levels. The implied unemployment rate (seasonally adjusted) for the end of 1975 is about 9½% of the labour force, or over 100,000. The current external deficit is likely to remain very large (£325 million for the year), and the rate of price increase (see Table 16) could be rather higher than in 1974. This depressing picture is partly explained by external developments, notably weak demand for industrial exports. Some recovery in the prices of agricultural exports is assumed as a result of the recent EEC agreement. But the domestic situation also contributes to the low growth rate that is anticipated. Under more normal conditions, the forecast increase in average earnings would be expected to increase demand and output. But in a situation where export demand is weak and many enterprises have been squeezed by higher costs, firms could run into difficulties before they could benefit from any general rise in domestic demand. The resulting redundancies would reduce effective demand, leaving other companies without the full benefits of the increase in demand for their products as a result of higher wages, but having to face the higher wage costs themselves. In this way a vicious circle could develop.

60. The present position is one of those knife-edge situations in which it is difficult to know which way events will turn. The forecast adopts what may be a middle view.

*This assumption is modified in paragraphs 72 *et seq.* below.

Chapter IV

POLICY CONSIDERATIONS

(a) Short-term problems of demand management and the balance of payments

61. The "benchmark" forecasts outlined above suggest that there are major problems to be faced in each of the main areas of concern for short-term economic policy—namely, output, employment, prices and the balance of payments—on the assumption that there is no change in fiscal policy and no 16th round (see paragraph 58 above). The simultaneous deterioration on all four fronts poses extremely difficult problems for economic policy. The problems are made even more difficult because they are inter-related. A frontal attack on one could exacerbate another. For example, faster growth of output could mean less unemployment, but other things being equal, a worse balance of payments position. Again, an increase in the pressure of demand can increase the rate of price inflation.

62. It is generally recognised that a policy of reducing total national spending (i.e. the level of demand) would not be the correct approach to trying to reduce the rate of price inflation in present circumstances. Moreover, such an approach could have consequences which would generally be regarded as undesirable. In this context, the following points are relevant:

(i) A reduction in demand (or a continuing weakness in demand) would increase unemployment and would be relatively ineffective as a means of combating inflation. The openness of the economy means that increases in money incomes could have a proportionately greater effect on unemployment than on prices, because home-produced goods would be displaced by imports;

(ii) Weakening demand with the associated fall in living standards might produce a defensive spate of wage claims in an effort to protect these standards. Since trade unions have the power to ensure that these claims are met, the net result could be a combination of worse unemployment and faster inflation.

(iii) Even if deflationary policies succeeded in reducing the contribution of increases in pay costs to price inflation, the associated social and industrial stresses might be unacceptable. Any attempt later to return to fuller employment with reasonable inflation rates could in that way be made more difficult;

(iv) There is almost absolute security of tenure in most of the public sector. The main brunt of any deflationary policy would therefore fall on employment in the private sector and on those temporarily employed in the public sector;

(v) Avoidable unemployment is in any circumstances wasteful. The output that is lost can never be made up subsequently.

63. Because these are recognised and accepted, the short-term demand management problem becomes, in its simplest terms, one of deciding on the degree to which demand can be increased, in order to expand output and reduce unemployment, within the constraints imposed by the balance of payments.

64. The balance of payments over the years prior to the oil crisis showed a current account deficit, a net capital inflow and a tendency for reserves to rise. If this long-term inflow could be counted on in the future, then a deficit of similar magnitude on current account would not be a matter for concern. It is not inappropriate for a small country which is building up its industrial structure to run a balance of payments deficit financed by long-term capital inflows. One overall aim, therefore, might be to achieve a zero "basic balance".* In the absence of any analysis allowing for greater precision, the experience through the late 1960s and early 1970s suggests that a deficit of £100 to £120 million on

*The basic balance is the current external account plus net long-term capital flows.

current account could now be consistent with the maintenance of the external reserves. This assumes that over the next few years policies and performance will continue to encourage a rather stronger inflow of new investment projects than in the past.

65. This "target" of a current external deficit in the range £100 to £120 million compares with the 1975 forecast of £325 million. The forecast is based on what is known about recent developments and assumptions about the future. An attempt is made to break down the forecast deficit into its various components in Table 15. There, a distinction is drawn between those influences which are likely to be reversed (for example, some continued unwinding of non-oil commodity prices and a recovery in beef prices, which will not be fully reflected in the average picture for 1975 given by the annual figures), and those which may not be reversed. When allowance is made for these factors, and for the fact that it is assumed that Irish export markets will be less depressed than Ireland itself, then the adjusted balance of payments position is less grave—an underlying current deficit of about £175 million. The aim of short-term policy should be to achieve a measure of domestic stability by "riding-out" these short-term fluctuations, while ensuring that the underlying balance of payments position is satisfactory.

66. Nonetheless, the adjusted position still falls short of what might be acceptable as the objective of medium-term policy. But of the 1975 deficit, some £140 million (as compared with 1973) is attributable to the increase in oil and energy prices—the direct and indirect effects on the terms of trade as outlined in Table 3 above, translated into values for exports and imports. It has already been argued that the developed world's deficit with oil producers can only be reduced over a number of years and only to the extent that oil-producing countries increase their imports. Unless Ireland attempts to shift its share of the common burden elsewhere, then the aim should be to reduce that part of Irish current deficit attributable to oil prices over a period of years. If the time taken were seven years from 1974, then six-sevenths of the oil price rise effect should be allowed for in the balance of payments target for 1975. This is done in Table 15.

TABLE 15

The "underlying" balance of payments position (£ million)

1975 position on the basis of the forecast in Tables 12 to 14

1975 current balance forecast	–325
Adjustment to 1975 forecast of "underlying" current balance position	
(i) Changes in trade prices still to work through	+15
(ii) Adjustment for depressed agricultural prices	+50
(iii) Adjustment for commodity prices	+145
(iv) Adjustment for relative cyclical position	–60
(v) Adjustment for changed competitive position	0
"Underlying" current balance forecast for 1975	–175
Possible targets	
"Basic balance"	0
Current balance *(a)*	–115
1975 allowance for oil deficit	–120
Current balance target for 1975	–235
Margin for manoeuvre in 1975	
(difference between "underlying" position and target)	60

This table compares the desired outcome on the balance of payments with the forecast for 1975, then adjusts this comparison for various influences on the balance of payments position still in the pipeline which will not have come through in 1975. More detailed notes on the table are given in the Annex.

(a) Assuming on average a long-term capital inflow of £115 million, this would be consistent with a zero basic balance.

67. In addition to these "static" adjustments, some adjustment should be made for changes in Ireland's competitive position. It seems, however, that on the assumptions underlying the "benchmark" forecast the foreseeable increases in Ireland's export prices of manufactures may roughly coincide with a similar figure for other countries, weighted by their relative importance in markets for Irish goods. No adjustment is therefore made on this score.

68. The admittedly arithmetic exercise in Table 15 brings the underlying position much closer to the desired balance of payments picture. If the two were very different it would imply that the economy should be run for long periods at unemployment levels (i.e., at a lower pressure

of demand) that were higher than those considered desirable, or that measures equivalent to an exchange rate adjustment would be required. On the basis of the necessarily sketchy calculations above and the assumptions on which they rest, this does not seem to be the case.

69. If this is so, and if it is accepted that attention should be focussed on the *underlying* balance of payments situation and that the aim of policy should be to ride out balance of payments fluctuations in the short-term, then the obvious short-term policy prescription is a more expansionary policy than was assumed in the forecast. It is now too late to do very much about the year to year growth rate between 1974 and 1975, but action could be taken that would make a considerable difference to unemployment levels at the end of 1975. For instance, policies which were aimed at adding the equivalent of 3% of GNP to effective demand by the end of 1975 might reduce forecast unemployment to about 85,000. This would still be high by many people's standards and would leave output still some 3% to 4% short of its trend level.*

70. The room for manoeuvre in 1975 will, of course, ultimately depend on the size of the balance of payments deficit that can be financed. While, in principle, external finance should be available, the problem is one of ensuring adequate finance on a long-term basis and at acceptable terms to finance the Irish deficit over the medium term in which the economy adapts to the higher price level for energy. However, the greater the growth of money incomes in 1975, the worse will be the actual and underlying balance of payments position (see Table 16 below). So the extent to which expansionary policies can be applied in 1975 will depend on the availability of sufficient and suitable external funds to finance the balance of payments deficit and (since there may be a limit to these) on the extent of the growth in money incomes.

*If there was a close approximation to full use of capacity in 1973 and if the trend growth in output is 4½% p.a., then output would have had to grow by about 9% over 1974 and 1975 to minimise unemployment. Growth in 1974 was about 1% and a rate of about 1½% could be expected for 1975 without any expansionary stimulus. If such a stimulus added 3% by the end of 1975, the total achieved during the two years would be about 5½% or 3% to 4% to below the trend level.

(*b*) *Policy Considerations*

71. The orders of magnitude discussed in the previous section are necessarily tentative. They could be changed significantly by a few changes in some of the crucial assumptions on which they were based. However, in the light of the information available in mid-October 1974, the assumptions that have been used are considered to be reasonable.

72. The forecasts for 1975 have so far been based (see paragraph 58 above) on the assumption of no increases in wage and salary rates after the full implementation of the 1974 National Agreement. This assumption is not realistic. Before examining possible policy action in more detail, the implications of a number of other assumptions relating to the growth in money incomes after the 1974 Agreement has expired are examined.

73. In Table 16, an attempt is made to estimate how the "benchmark" forecasts would need to be altered if different assumptions are made about additional increases in money incomes in 1975—that is, for a "16th round". The estimated outturn for 1974 and the forecast for 1975 are given in the last two lines of the table. The rows above show what changes would have to be made to the 1975 "benchmark" forecasts on different assumptions about the "16th round".

74. The broad pattern that emerges from the table is clear enough. A "16th round" which consisted of an across-the-board percentage increase would make consumer prices rise faster, reduce the growth in real output, increase unemployment and raise the external deficit. The deterioration on all these fronts would be the greater, the larger was the percentage increase. A "16th round" which also included compensation on a quarterly basis for increases in prices in 1975 would make for even bleaker prospects. None of the assumptions in Table 16 would raise the growth in real output to the rate required to avoid increased unemployment. Indeed, for a "16th round" that consisted of anything more than an across-the-board increase of 10% or of linking money incomes to price changes through 1975, the growth in real output would be lower than in the "benchmark" forecast. If higher unemployment is to be avoided, expansionary policy action is, therefore, required.

TABLE 16

The forecast with different pay assumptions

(changes to "benchmark" forecasts)

(a) Across-the-board increases

Pay rise (%)	Average incomes (%)	Consumer prices (%)	GNP (%)	Unemployment (Thousands)	Foreign balance (£m)	Foreign balance "margin" (£m)
0	0	0	0	0	0	0
5	5	1½	¼	−5	−20	−15
10	10	3	0	0	−40	−40
15	15	4½	−½	5	−60	−65
20	20	6	−1½	15	−75	−90
30	30	8¾	−5	50	−115	−155

(b) Across-the-board increases with incomes linked to prices

Pay rise (%)	Average incomes (%)	Consumer prices (%)	GNP (%)	Unemployment (Thousands)	Foreign balance (£m)	Foreign balance "margin" (£m)
0	16½	3	0	0	−75	−75
5	23	5	−1¾	18	−95	−110
10	30	6½	−4¼	40	−120	−150
15	36	8½	−7½	70	−140	−200

(c) Memorandum items—the 1974 and 1975 forecasts discussed earlier

	Average incomes (%)	Consumer prices (%)	GNP (%)	Unemployment (Thousands)	Foreign balance (£m)	Foreign balance "margin" (£m)
1974	23	18	1	75	−340	. .
1975	27	20	1½	100	−325	+60

This table shows the effects on the forecast for 1975 presented in Tables 12 to 15 if the assumption that there are no changes in average rates of pay under sixteenth round negotiations is dropped. The top portion of the table (*a*) shows the *changes* which would occur in the forecasts of average incomes, prices, etc. about a year after an across-the-board increase in pay. The second section (*b*) shows the effects of the same across-the-board increases, but with rates of pay also linked to changes in consumer prices. Section (*c*) recalls the estimates for 1974 and 1975 in tables 13 to 15. Since the effects of the changes in wage rates are shown as effects one year later, lines in sections (*a*) and (*b*) cannot simply be added to the 1975 line in section (*c*). *As a rough rule of thumb, if the pay increases occurred on January 1st, about half of the changes shown in* (*a*) *could be added to the* 1975 *line in* (*c*) *to show the revised forecast for* 1975, *and a rather smaller proportion of the results of linking incomes to prices would show up in the adjusted* 1975 *forecast*. Notes on this table are given in the Annex.

75. To the extent that the resulting external deficit can be financed, expansionary policies in 1975 would be appropriate. The expansionary stimulus that would be possible would, therefore, be the greater, the smaller the increase in money incomes under any "16th round". If a "16th round" related increases in money incomes to increases in prices during 1975, a stimulus would best take the form of a reduction in VAT rates. An attempt is made in Table 17 to illustrate the probable consequences of different cuts in present VAT rates (except the zero rate), on the assumptions that increases in earned incomes in 1975 are or are not related to changes in prices. It can be seen, for example, that a reduction of 4 percentage points would in these circumstances probably result in a smaller rise in prices, an increase in the growth rate of about 1½ percentage points by the end of the year, and a reduction in unemployment by the end of the year of about 15,000. There would, however, still be a significant deterioration in the current external deficit.

76. The example of cuts in VAT rates was used in Table 17 because it is an attractive policy if money incomes are linked to prices, since it has a dampening effect on the rate of inflation. However, the expansionary policies required should also take other considerations into account. For example, the following are relevant:

(i) The principal dangers of a recession lie in the corporate sector. Many enterprises are now suffering a contraction in cash-flows. Steps should be taken to ease the squeeze on liquidity, if redundancies and bankruptcies are to be avoided;

(ii) The position of the agricultural sector may still not be regarded as satisfactory. However, the principal policy action must (presumably) come through the CAP;

(iii) Since unemployment is likely to increase into 1975, even if expansionary policies are applied, a social problem could be posed by the inequitable spread of the burden of unemployment between different sectors and age-groups;

(iv) The composition of the Public Capital Programme should be reviewed. The balance of payments position is a major constraint so, where possible, expenditures on the importation of

TABLE 17

The forecast with different fiscal policy assumptions (changes to "benchmark" forecasts)

(a) Cuts in VAT rates

Tax Cut (%)	Average Incomes (%)	Consumer Prices (%)	GNP (%)	Unemployment (Thousands)	Foreign balance (£m)	Foreign balance "margin" (£m)
0	0	0	0	0	0	0
2	0	−1¼	¾	−5	−10	0
4	0	−2½	1½	−15	−20	0
6	0	−4	2¼	−20	−30	0
8	0	−5¼	3	−30	−40	0
10	0	−6½	3¾	−35	−50	0
(b) Cuts in VAT rates with incomes linked to prices						
0	16½	3	0	0	−75	−75
2	14½	1¼	¾	−10	−75	−70
4	13	−½	1½	−15	−75	−65
6	11½	−2¼	2½	−25	−80	−60
8	9¾	−4	3¼	−30	−85	−55
10	8	−5½	4	−40	−90	−50
(c) Memorandum items—the 1974 and 1975 forecasts discussed earlier						
1974	23	18	1	75	−340	..
1975	27	20	1½	100	−325	+60

This table shows the effects on the forecast for 1975 presented in Tables 12 to 15 if the assumption that there are no changes in fiscal policy is dropped. Here assumptions are made that VAT rates are cut (except the zero rates). The top portion of the table (*a*) show the *changes* which would occur in the forecasts of average incomes, prices, etc. about a year after VAT cuts. The second section (*b*) shows the effects of the same VAT changes, but with rates of pay limited to changes in consumer prices. Section (*c*) recalls the estimates for 1974 and 1975 in tables 13 to 15. Since the effects of the changes in VAT rates are shown as effects one year later, lines in sections (*a*) and (*b*) cannot simply be added to the 1975 line in section (*c*). *As a rough rule of thumb, if the VAT cuts occurred on* 1 *January, about half of the changes shown in* (*a*) *could be added to the* 1975 *line in* (*c*) *to show the revised forecast for* 1975, *and a smaller proportion of the results of the changes shown in* (*b*) *would show up in the adjusted* 1975 *forecast.* Notes on this table are given in the Annex.

capital goods and equipment should be postponed, and the funds released devoted to financing expenditures that would benefit employment. A diversion of funds towards housing and construction would be particularly relevant in this context, because (*inter alia*) of their lower import content;

(v) Steps should be taken to achieve a substantial increase in the number of workers in training programmes. It has already been indicated that substantial unemployment in 1975 seems inescapable. It would be far better if people were involved in training programmes that gave them new skills or up-dated their existing skills than that they should be unemployed;

(vi) The balance of payments is the crux of the short-term policy problem. Action directed specifically at reducing the external deficit would, therefore, be particularly useful. *General* import controls would distort the pattern of production away from that desired on longer-term grounds and encourage inefficiency. To minimise the deterioration in the external deficit, steps should be taken (at the very least) to reduce oil imports. The relative price of petrol and oil might be raised. This could be achieved by increasing the tax rates on these products and offsetting these increases by reductions in tax-rates on other expenditures. In addition, a campaign might be launched to persuade private motorists, households, factories and offices to economise on the use of petrol and oil.

Chapter V

THE PROBLEM OF INFLATION

(*a*) *Does inflation matter?*

77. The policies discussed at the end of the previous chapter would only help to mitigate the short-term problems facing the economy. They would not, however, make any significant contribution towards solving some of the basic problems. Of these, by far the main one is the degree of the inflation from which the economy is suffering that is generated within the country.

78. A view seems to be gaining currency that inflation does not matter. It is true that inflation so far does not seem to have had a marked effect on competitiveness of Irish products. However, Irish money incomes are now so close to those of major competitors that if they continued to rise faster here than elsewhere, competitiveness would certainly deteriorate. If this happens, the consequences for employment, output, the external deficit and the possibility of maintaining real incomes will be severe and lasting.

79. Even apart from its possible effects on competitiveness, inflation (and especially the accelerating inflation that has recently been experienced) inflicts costs on the community. These take many forms:

(i) People in general, and housewives in particular, do not like inflation. It makes the day-to-day running of the household more difficult, budgets go awry before the next income increase arrives, and the distribution of income within the household and routine shopping patterns must be continually reviewed;

(ii) Those living on fixed incomes suffer;

(iii) Saving becomes less attractive and investment in real assets a better hedge for the future. The net result is that more investment is diverted towards existing assets than to the creation of new productive capacity. This in turn can lead to a further twist to the inflationary spiral through rapid increases in, for example, house prices (which encourages more hedging or speculation) and through defensive wage claims and resulting increases in the prices of new goods. Something like this may have occurred in Ireland in the early 1970s when house prices rose much more rapidly than consumer prices.* Some indication is given by the increase in bank credit, an increasing proportion of which has, until quite recently, gone to financial and property companies. This happened despite continuing Central Bank pressure to ensure that lending was concentrated on productive purposes;

(iv) Hedging and speculation and the rise in asset prices can lead to arbitrary redistributions of income. If a household does manage to raise finance to buy a house during the inflationary period the average rate of return on investment can be very large. Those who can raise more for additional or more expensive purchases will gain correspondingly more, and wealth will be transferred from the small saver to borrowers;

(v) The redistributional effects which inflation can have are encouraged by an apparent sluggishness in the reaction of "real" long-term interest rates to accelerating prices. This too was true of Ireland in the early 1970s when interest rates were sometimes lower than the rate of price increase. As income-tax rebates on interest charges can bring an actual 9% to 11% interest rate down to an effective 6%–7%,† there is an obvious incentive to invest in assets whose prices are rising at a rate equal to or above a 10%–20% rate of consumer price increase. While real interest rates have at times been negative there does not seem to have been a strong increase in demand for credit for new investment for the industrial sector. This might be attributed to bad management, but the situation could be more complex. The average amortisation period for a piece of industrial equipment is very much longer than the time required, for example, to buy and sell or to build a property. Nor is there a market for second-hand industrial machinery which compares with that for other assets. Hence a businessman needs to judge his interest rate costs over a much longer time horizon than other entrepreneurs;

*Of course other considerations, such as construction costs, were involved.

†For someone paying interest at the standard rates. The discrepancy is greater for those on larger incomes.

(vi) Present accounting procedures and profits taxation do not allow proper account to be taken of the cost of replacing existing machinery or stocks. Although profits may appear to increase (and be taxed accordingly), this may be a purely accounting phenomenon which disguises a real shift in national income away from profits. This could not continue indefinitely without having real effects on investment and therefore on the longer-term growth in the economy and in employment;

(vii) Inflation creates uncertainty. People are less able to foresee and plan their future. This can encourage reaction which may generate further inflation. Continuing experience of inflation also induces expectations that prices will continue to rise, and the very existence of these expectations may make the expectations self-justifying.

80. These views can be summarised briefly: inflation brings unease and uncertainty, it tends to redistribute wealth towards those who are financially sophisticated (usually the better-off), it distorts the incentives within the economy and encourages the pursuit of speculative/financial activities rather than increased real output, it favours borrowers at the expense of savers and can jeopardise medium-term economic

expansion by eating into real profits and discouraging productive investment. Finally, inflation tends to feed on itself and to accelerate.*

(b) Causes of inflation

81. A view has also gained ground that even if inflation does matter, there is little that can be done about it in this country, because the current Irish inflation is explained by external causes that no agency in this country can control. There can be no doubt that this country is vulnerable to external price increases—that indeed was a main theme in Chapters II and III above. However, even after full allowance is made for external influences a substantial part remains to be explained by inflationary causes operating within Ireland.

82. No attempt is made in this report to analyse in depth the causes of inflation in this country. That analysis is being done in a separate study, which will be completed towards the end of the year. A basic cause of the domestic contribution towards inflation is that the real incomes that individuals and groups demand together add up to more than the real output that is available for distributing among them. Individuals, groups and agencies demand increases in the amount of money available to them that would enable them to acquire the share of real output which they feel they need or to which they believe themselves to be entitled. As these sums are spent in the effort to acquire the desired shares of real output, prices are raised. The rise in prices is the process by which the demands of individuals, groups and agencies are cut back in real terms to the real output that is available for distribution among them. This thwarting of what are regarded as reasonable aspirations adds impetus to the next round of increases in incomes and prices. The

*Strictly speaking a distinction should be made in the discussion above between anticipated and unanticipated inflation. Many of the bad side-effects of inflation could be avoided in an economy running a steady or even steadily accelerating, rate of inflation if these were foreseen and the required adjustments made automatically. In practice, however, the adjustments required for the Irish economy to act in this way seem at least as complex and as risky as those required to eliminate some of the evils at lower rates of price increase. The problem is treated, therefore, as being one of bringing the rate of inflation back more into line with what people have generally expected and avoiding some of the dangers of renewed acceleration.

process is therefore self perpetuating, and the stresses and strains inherent in it lead towards its acceleration. The inflation will only slow down as the sum of the demands for real income is brought into line with the real output available for distribution.

83. A few examples will illustrate this inflationary process. First, suppose there is a permanent increase in the price of imported consumer goods. This will lead to higher prices in the shops. Since the more costly imports have to be paid for (if people still decide to buy them), more goods must be exported to pay for them.* Unless there is a compensating increase in productivity and efficiency, the real income of the whole community is reduced. If money incomes are increased to compensate for the higher prices that follow the dearer imports—i.e. if people are successful in their efforts to get more money to try to maintain their real incomes—then an inflationary process follows. It ensues because the aggregate real incomes being sought exceed the real output of the whole community.

84. Second, suppose that productivity is raised in a particular industry and that those employed in it receive higher incomes as a result. Their enhanced incomes reflect their increased real contribution to the community's output. If those engaged in other occupations were to demand and get similar increases in their incomes in order to maintain customary differentials, then again an inflationary process could be initiated. The money claims on real output would again exceed its value at existing prices—the ensuing competition of money for goods and services would raise prices.

85. Third, the Government plays a large and important role in the Irish economy. Suppose a decision is taken to increase the real incomes of the disadvantaged members of the community. This can only be done by transferring command over goods and services—i.e. money—to them from other sections of the community. This means that the latter must pay more in taxes, and *their* real incomes are reduced accordingly. If

*If the imports are consumer goods (as opposed to inputs to exports), there is no reason to think that export prices could be raised to offset the deterioration in the terms of trade, since countries exporting similar goods to those being sold by this country would not be raising their prices.

those that pay the higher taxes will not accept this cut in real income, but demand increases in their money incomes to enable them to escape it, then again an inflationary process could be started, through a sparking off of a spiral of tax rise, money income rise, price rise and tax rise again to achieve the desired increase in the real incomes of the disadvantaged. It is quite possible for individuals, groups and classes to will the end—namely, more for the less well-off—while denying the means by which this can be achieved.

86. Fourth, total public expenditure has risen very rapidly in recent years and may now be equivalent to almost half of gross national expenditure. A counterpart of this increase in public expenditure has been a steady fall in the proportion of output going to private consumption—one of the sharpest in OECD countries. If attention is focussed on "pure" private consumption—that is, that part which is not paid for by transfers through the public sector—the decline has been even more marked. These changes are not undesirable in themselves, because they reflect efforts to promote social justice and welfare and the role of the public sector in maintaining economic expansion. However, if the fall in the share of private consumption in national output is not accepted, then (as in the previous examples) efforts to maintain the share will inevitably have inflationary consequences.

87. Since the underlying cause of domestic inflation is the attempt by the members of the community to achieve real incomes that when added together exceed the real output of the community, the inflation can be curbed only to the extent that these are brought into line with each other. This will be more easily achieved if the national output is growing, because all can enjoy some improvement in living standards. If national output is static or falling, then to the extent that some individuals or groups achieve the improvements in real incomes that they seek, others will be forced to accept an absolute fall in their living standards.

88. The domestic inflationary pressures that are generated by demands that cannot simultaneously be met can be defused only by greater understanding of these causes of inflation that operate within the community. The experience of the National Industrial Economic Council in the sixties (and indeed of other advisory bodies here and elsewhere)

demonstrates that understanding cannot be reached easily or quickly. However, the effort must be made and must be continued until it succeeds.

89. More open and frank discussion of the state of the economy, and of the course it is likely to take, would help towards greater understanding of the problems to be faced and of the importance of reducing domestic inflationary pressures. Some demystification of the way in which economic policies are formulated, of how they operate and of what they are trying to achieve, would also help.

90. As greater understanding of the causes of domestic inflation develops, it might be possible to work towards a closer correspondence between the national output available and the demands being made on it. Progress in this direction will be much easier if the economy is growing, because the closer correspondence can be achieved without any group or agency taking a cut in the real resources available to them. However, general aspirations are not enough, and agreement is unlikely to be reached in general terms (that is, without numbers being mentioned) on the apportionment of an unspecified increment in national output. An essential pre-condition is therefore the re-introduction of economic planning. This would enable the probable increment in national output to be identified. Within the context of the plan, the Government should publish its short-term pre-budget forecasts and the assumptions on which they are based. The Government should enter into more frequent and substantial discussion with interested parties on its conclusions about the probable course of economic events and the problems that must be tackled by policy. The Government should also explain, more fully than in the past, the overall and distributional effects of measures that have been taken.

91. The message of this section is that progress towards reducing the domestic element in inflation will not be easy and cannot be achieved instantaneously. It will be achieved only by wider and fuller understanding of the basic domestic causes of inflation among all sectors of the community. It will be achieved more easily if the economy is expanding, and if policy instruments are refined or developed to ensure that expansion is achieved and its fruits distributed in an equitable manner.