SUMMARY

Output in 2002 has been confirmed to have simultaneously increased by an extremely robust 6.9 per cent in real GDP terms while coming to a near standstill at 0.1 per cent when viewed in terms of real GNP. The emergence of such a dichotomy between these standard measures of economic growth is unprecedented internationally among developed economies. The divergence in these measures highlight the sensitivity of the Irish economy to the idiosyncratic growth patterns of a number of large multinational dominated sectors. While growth appears to have been extremely low in the first half of 2003, and accompanied by a sharp deceleration in consumer price inflation, there was a surprisingly modest, but discernible, upward trend in the level of unemployment.

The slowdown in the international economy evident since 2001 has tentatively started to reverse throughout the summer of 2003. Notwithstanding this nascent international recovery the major economies' growth rates are likely to remain below potential levels until 2004 at the earliest. On the basis of a recovery in the international economies being underway, the prospects for the Irish economy's growth moving back towards its potential levels of near 5 per cent are improving.

Our forecast for output growth in 2003 is 2.2 and 1.9 in cent in real GDP and real GNP terms respectively. The corresponding growth forecast for 2004 is for the economy to be still significantly below potential at rates of 3.1 per cent for real GNP and 3.2 per cent for real GDP. Consequentially the trend of rising unemployment is expected to continue with an average unemployment rate in 2004 forecast to be 5.1 per cent, up from 4.7 per cent in 2003. Inflation in consumer prices is also expected to decline from an annual average of 3.7 per cent in 2003 to 2.6 per cent in 2004.

The deterioration in the public finances is expected to continue in line with the cyclical downturn. In this context, the re-emergence of Government deficits does not constitute a problematic development but it does require that Budget 2004 be framed to support the economy in getting back towards its potential growth rates whilst ensuring that all public expenditure constitutes value for money. Securing a continuation of social partnership wage bargaining will be difficult, not least because the conjunction of *Benchmarking* and *Sustaining Progress* pay awards to public sector workers at the start of 2004 will contrast sharply with the private sector pay increase at that point.

Now that Government current expenditure growth has been re-established at rates near nominal potential output growth of 6 to 8 per cent, the prudent fiscal stance is to maintain rates at these levels. Targeting similar rates of revenue growth through tax base widening would mean that the current budget surpluses can continue to be used to fund capital investment. Any shortfall for investment can be supplemented by additional borrowing without seriously reversing the current low national debt to output ratio.

PRELIMINARY NATIONAL ACCOUNTS 2002

A: Expenditure on Gross National Product

	2001	2002	Change in 2002				
		Preliminary	€m		%		
	€m	€m	Value	Volume	Value	Price	Volume
Private Consumer Expenditure	55,202	60,118	4,917	1,490	8.9	6.0	2.7
Public Net Current Expenditure	15,413	17,639	2,226	1,449	14.4	4.6	9.4
Gross Fixed Capital Formation	26,967	28,649	1,682	452	6.2	4.5	1.7
Exports of Goods and Services (X)	112,938	121,158	8,220	6,984	7.3	1.0	6.2
Physical Changes in Stocks	494	11	-483	-411			
Final Demand	**211,014**	**227,575**	**16,561**	**9,965**	**7.8**	**3.0**	**4.7**
less:							
Imports of Goods and Services (M)	95,702	97,014	1,312	2,164	1.4	-0.9	2.3
GDP at Market Prices	**115,312**	**130,561**	**15,249**	**7,800**	**13.2**	**6.1**	**6.8**
less:							
Statistical Discrepancy	570	1,217	647	-78			
Adjusted GDP	**114,742**	**129,344**	**14,602**	**7,878**	**12.7**	**5.5**	**6.9**
less:							
Net Factor Payments (F)	18,295	25,915	7,620	7,750	41.7	-0.5	42.4
GNP at Market Prices	**96,447**	**103,429**	**6,982**	**128**	**7.2**	**7.1**	**0.1**

B: Gross National Product by Origin

	2001	2002	Change in 2002	
		Preliminary		
	€m	€m	€m	%
Agriculture, Forestry, Fishing	3,346	3,155	-191	-5.7
Non-Agricultural: Wages, etc.	46,715	49,914	3,199	6.8
Other:	44,209	52,977	8,768	19.8
Adjustments: Stock Appreciation	219	-156		
Financial Services	-4,085	-4,226	-141	
Statistical Discrepancy	570	1,217	647	
Net Domestic Product	**90,974**	**102,881**	**11,907**	**13.1**
less:				
Net Factor Payments	18,295	25,915	7,620	41.7
National Income	**72,679**	**76,966**	**4,287**	**5.9**
Depreciation	11,619	13,259	1,640	14.1
GNP at Factor Cost	**84,298**	**90,225**	**5,927**	**7.0**
Taxes less Subsidies	12,149	13,204	1,055	8.7
GNP at Market Prices	**96,447**	**103,429**	**6,982**	**7.2**

C: Balance of Payments on Current Account

	2001	2002	Change in 2002
		Preliminary	
	€m	€m	€m
Exports (X) less Imports (M)	17,236	24,144	6,908
Net Factor Payments (F)	-18,295	-25,915	-7,620
Net Transfers	302	817	515
Balance on Current Account	**-757**	**-954**	**-197**
as % of GNP	-0.8	-0.9	-0.2

FORECAST NATIONAL ACCOUNTS 2003

A: Expenditure on Gross National Product

	2002	2003	Change in 2003				
	Preliminary €m	Forecast €m	€m		%		
			Value	Volume	Value	Price	Volume
Private Consumer Expenditure	60,118	63,408	3,289	1,383	5.5	3.1	2.3
Public Net Current Expenditure	17,639	18,890	1,251	229	7.1	5.7	1.3
Gross Fixed Capital Formation	28,649	29,848	1,199	-170	4.2	4.8	-0.6
Exports of Goods and Services (X)	121,158	113,564	-7,594	-4,524	-6.3	-2.6	-3.7
Physical Changes in Stocks	11	304	293	235			
Final Demand	**227,575**	**226,014**	**-1,562**	**-2,847**	**-0.7**	**0.6**	**-1.3**
less:							
Imports of Goods and Services (M)	97,014	87,940	-9,074	-5,455	-9.4	-4.0	-5.6
GDP at Market Prices	**130,561**	**138,074**	**7,512**	**2,609**	**5.8**	**3.7**	**2.0**
less:							
Statistical Discrepancy	1,217	692	-525	-300			
Adjusted GDP	**129,344**	**137,382**	**8,037**	**2,909**	**6.2**	**3.9**	**2.2**
less:							
Net Factor Payments (F)	25,915	26,192	277	985	1.1	-2.6	3.8
GNP at Market Prices	**103,429**	**111,190**	**7,761**	**1,924**	**7.5**	**5.5**	**1.9**

B: Gross National Product by Origin

	2002	2003	Change in 2003	
	Preliminary €m	Forecast €m	€m	%
Agriculture, Forestry, Fishing	3,155	3,260	105	3.3
Non-Agricultural: Wages, etc.	49,914	52,969	3,055	6.1
Other:	52,977	55,576	2,599	4.9
Adjustments: Stock Appreciation	-156	19		
Financial Services	-4,226	-4,440	-214	
Statistical Discrepancy	1,217	692	-728	
Net Domestic Product	**102,881**	**108,076**	**5,196**	**5.1**
less:				
Net Factor Payments	25,915	26,192	277	1.1
National Income	**76,966**	**81,885**	**4,919**	**6.4**
Depreciation	13,259	14,174	915	6.9
GNP at Factor Cost	**90,225**	**96,058**	**5,834**	**6.5**
Taxes less Subsidies	13,204	15,131	1,927	14.6
GNP at Market Prices	**103,429**	**111,190**	**7,761**	**7.5**

C: Balance of Payments on Current Account

	2002	2003	Change in 2003
	€m	Forecast €m	€m
Exports (X) less Imports (M)	24,144	25,624	1,480
Net Factor Payments (F)	-25,915	-26,192	-227
Net Transfers	817	-552	-1,369
Balance on Current Account	**-954**	**-1,120**	**-166**
as % of GNP	-0.9	-1.0	-0.1

FORECAST NATIONAL ACCOUNTS 2004

A: Expenditure on Gross National Product

	2003	2004	Change in 2004				
	Forecast €m	Forecast €m	€m Value	€m Volume	% Value	% Price	% Volume
Private Consumer Expenditure	63,408	67,073	3,665	2,029	5.8	2.5	3.2
Public Net Current Expenditure	18,890	20,150	1,260	264	6.7	5.2	1.4
Gross Fixed Capital Formation	29,848	31,145	1,298	358	4.3	3.1	1.2
Exports of Goods and Services (X)	113,564	117,582	4,017	2,949	3.5	0.9	2.6
Physical Changes in Stocks	304	225	-79	-85			
Final Demand	**226,014**	**236,174**	**10,161**	**5,515**	**4.5**	**2.0**	**2.4**
less:							
Imports of Goods and Services (M)	87,940	89,783	1,843	990	2.1	1.0	1.1
GDP at Market Prices	**138,074**	**146,391**	**8,318**	**4,525**	**6.0**	**2.7**	**3.3**
less							
Statistical Discrepancy	692	1,300	608	114			
Adjusted GDP	**137,382**	**145,091**	**7,709**	**4,411**	**5.6**	**2.3**	**3.2**
less:							
Net Factor Payments (F)	26,192	27,291	1,099	964	4.2	0.5	3.7
GNP at Market Prices	**111,190**	**117,800**	**6,610**	**3,447**	**5.9**	**2.8**	**3.1**

B: Gross National Product by Origin

	2003	2004	Change in 2004	
	Forecast €m	Forecast €m	€m	%
Agriculture, Forestry, Fishing	3,260	3,390	13	4.0
Non-Agricultural: Wages, etc.	52,969	55,555	2,58	4.9
Other:	55,576	58,747	3,17	5.7
Adjustments: Stock Appreciation	19	-450		
Financial Services	-4,440	-4,664	-22	
Statistical Discrepancy	692	1,300	60	
Net Domestic Product	**108,076**	**113,879**	**5,80**	**5.4**
Net Factor Payments	26,192	27,291	1,09	4.2
National Income	**81,885**	**86,588**	**4,70**	**5.7**
Depreciation	14,174	15,151	97	6.9
GNP at Factor Cost	**96,058**	**101,739**	**5,68**	**5.9**
Taxes less Subsidies	15,131	16,060	92	6.1
GNP at Market Prices	**111,190**	**117,800**	**6,61**	**5.9**

C: Balance of Payments on Current Account

	2003 Forecast €m	2004 Forecast €m	Change in 2004 €m
Exports (X) less Imports (M)	25,624	27,798	2,174
Net Factor Payments (F)	-26,192	-27,291	-1,099
Net Transfers	-552	-998	-446
Balance on Current Account	**-1,120**	**-491**	**629**
as % of GNP	-1.0	-0.4	0.5

The International Economy

General

There are continuing indications that the recovery in the world economy has broadened and strengthened following a prolonged period of moderate growth. Higher private consumption, expansionary fiscal and monetary policies, reduced geopolitical tensions together with a rebound in the equity markets have supported this general upturn in economic conditions. The improvement has been driven by the US economy as well as some parts of Asia. Euro Area growth remains subdued and continued structural reform, which should encourage domestic business demand, is necessary if future growth is to become sustainable. Business investment remains weak across the industrialised world and is confirmed by continued below potential growth rates in all the major economies.

US Economy

Preliminary data for the United States suggest that the economy continued to strengthen in the second quarter of 2003 growing in Gross Domestic Product (GDP) terms by 3.1 per cent at an annualised rate following 1.4 per cent growth in the first quarter. Quarter on quarter, this reflected 0.8 per cent growth in GDP following less than 0.4 per cent in the first quarter. The main contributor to growth remained personal consumption. However, the upturn also reflected significant increases in national defence spending and to a lesser extent non-residential fixed investment while changes in private inventories put a strain on GDP growth.

Despite a more favourable economic outlook for the US economy our forecasts remain below potential rates both this year and next. Significant weaknesses persist and are reflected in subdued rates of inflation together with continued weakness in the labour market. The public and external deficits also remain significant causes for concern. On the upside however monetary and fiscal policies remain stimulatory, the equity markets have improved, confidence is up and energy prices are broadly stable. Following GDP growth of 2.4 per cent in 2002, we forecast growth of 2.6 for this year. In 2004, we predict that the US economy will be the only major economy to have fully returned to potential rates of growth, with forecast growth of 3.5 per cent.

As mentioned in previous *Commentarie*s US consumers have remained resilient throughout many of the negative shocks that hit the economy in the last number of years. Consumption has strengthened further in the aftermath of the war in Iraq even though the labour market remains fragile. We expect consumer expenditures to remain robust in the short term, strengthened by growth in personal disposable income due to personal income tax cuts together with a pick-up in the labour market. Consumer confidence, as measured by the Conference Board's index, rebounded in August to 81.3 from a revised 77.0 in July. Optimism about the future was reflected in the "expectations" index component, which rose to 94.4 from a revised 86.3 in July.

Private domestic investment also stabilised in the second quarter of the year following significant contraction in the first quarter. Investment grew by 0.9 per cent at an annualised rate following a fall of 5.3 per cent in the previous quarter. This recovery has resulted from increasing momentum in US firms' investment plans and suggests ongoing recovery in business confidence both in the services and manufacturing sectors. This is confirmed by quite positive survey data for both sectors. The Purchasing Managers' Index (PMI) from the Institute of Supply Management (ISM) indicated that the manufacturing sector, which had shown significant fragility in the first half of the year, grew in September for the third consecutive month. The September index stood at 53.7 where a value greater than 50 indicates expansion in the sector. The services sector, which accounts for the majority of output and employment in the US economy, has shown even more impressive growth with the ISM index for the non-manufacturing sector reaching 65.1 in both July and August, the highest the index has been since it was first compiled in July 1997.

Inflation as measured by changes in the consumer price index (CPI) continues at its historically low levels. Although prices inched up by 0.3 per cent in August, most of the gain was due to a 2.7 per cent jump in energy prices, the effect of higher oil and gasoline prices. Excluding volatile food and energy prices, core CPI rose 0.1 per cent, after rising 0.2 per cent in July. On a year on year basis, the core CPI is up just 1.3 per cent, the lowest such rate since 1966. Much of this restrained price growth is due to the prolonged period of below potential growth in the economy. The main problem posed by the slowing of inflation as expressed by the Federal Reserve, is that it will hurt corporate pricing power and profits, slowing the economy down and threatening the onset of deflation. Inflation in 2002 averaged 1.6 per cent and following a pick-up in economic activity this year we forecast inflation to average 2.2 per cent before moderating to 1.3 per cent in 2004.

Labour market conditions continue to be very uncertain despite the stronger growth in the economy as a whole. Total non-farm payroll employment declined by 93,000 in August following a decline of 43,000 in July leaving the unemployment rate essentially unchanged at 6.1 per cent. Job cuts continue in manufacturing while employment continued to trend up in health care and construction. This weakness indicates that the labour market could be slower than many other parts of the economy to enjoy the rebound, with productivity growing sharply. Productivity, as measured by output per worker hour, grew at a 6.8 per cent annual pace in the second quarter of 2003, up from a 5.4 per cent rate in 2002, which was the fastest pace since 1950. The main difficulty with prolonged weakness in the labour market is that it could eventually weigh heavily on consumer confidence and, perhaps more importantly, wage growth. This in turn could affect consumer spending which fuels two-thirds of GDP. We forecast unemployment to average 6 per cent this year before declining to 5.8 per cent in 2004 as improved economic conditions finally impact on the labour market.

As mentioned previously, the US recovery is being driven by both monetary and fiscal inducements. This has led in particular to a sharp deterioration in its public finance position. In August, the

Federal budget deficit was in excess of $76 billion and with only one month remaining in the fiscal year, the US budget deficit is estimated to come in at over $400 billion or close to 4 per cent of GDP. This position is expected to continue in the short run at least with further fiscal stimulus packages and the military's continued presence in Iraq indicating that in 2004 the deficit could easily breach the $500 billion mark. This deficit-financed expansion in government spending has the potential to damage the long-run potential in the economy in two ways. First, it reallocates resources from the high productivity private sector to the low productivity government sector. Second, most of the stimulus packages encourage consumption as opposed to investment with most of the tax cuts benefiting consumers while the deficit crowds out projects in the private capital market.

Since the previous *Commentary* the Federal Open Market Committee (FOMC) have decided to maintain their main target interest rate at 1 per cent. This should continue to bolster economic activity and although the FOMC noted the weakening labour market as worrying, the predominant cause for concern was the risk of inflation becoming undesirably low. The FOMC also hinted that interest rates would remain at these historically low levels for a considerable period to come.

The Balance of Payments current account deficit remains at its unsustainable level with no clear sign of a correction in the near future. The problem is compounded by the existence of the considerable fiscal deficit. In 2002, the current account deficit stood at $480.9 billion or 4.6 per cent of GDP. In the first quarter of this year the deficit came in at a record $138.7 billion and remained broadly unchanged at that level in the second quarter. In the second quarter, an increase in the deficit on goods was offset by increases on the surpluses for income and for services and a decrease in net outflows for international current transfers. This current account position is unsustainable over the long run and raises the risk of a sharp correction and a weaker dollar. The dollar did move lower against major currencies over the course of the past year reaching its peak against the euro of over $1.19, and is showing some signs of stability around $1.15 as indications of stronger economic growth have emerged.

Euro Area Economy

Following muted GDP growth of 0.8 per cent in 2002, which was restrained by subdued investment, the Euro Area economy has remained sluggish in the first half of 2003. Growth, which had been decelerating since mid-2002, came to a halt at the beginning of the year as geopolitical uncertainties together with significant structural rigidities restrained confidence of industry and consumers. There was no growth in the first quarter compared with the previous quarter and 0.8 per cent growth year on year. The dissipation of the uncertainties regarding the Iraq crisis did not lead to a pick-up in economic activity as expected. In the second quarter real GDP fell by 0.1 per cent compared to the previous quarter and increased by 0.2 per cent compared with the same quarter in 2002. The weakness in the first half of the year has been largely characterised by negative contributions from fixed capital formation and net exports. This was partially offset by strong consumption and a surprisingly strong build-up of inventories in the first quarter. The absence of any contribution to growth in these two components in the second quarter led to the slight contraction.

However, we do expect increased economic activity in the second half of the year due to more favourable domestic and external conditions and signs of this expectation have been indicated by survey data and recent financial market developments. Despite this, we have revised down our forecasts for the Euro Area as a whole from the previous *Commentary*. For this year we predict weak growth of 0.5 per cent before increasing, albeit still below potential, to 1.6 per cent in 2004.

As in the US, although not to the same extent, the consumer remains the backbone of the Euro Area economy. Household consumption increased by 0.5 per cent quarter on quarter or 1.5 per cent at an annual rate in the first quarter of the year which contributed greatly to overall growth during the period. Growth in this component fell off in the second quarter and as a result the Euro Area lost much of any momentum it gained from the start of the year. However, recent short-term indicators suggest that household expenditures may pick up in the second half of the year. The EU Commission's consumer confidence indicator has increased consistently from May to September.

Investment has remained the weakest component of GDP in 2003, declining by 1.2 and 0.4 per cent in the first and second quarters of the year respectively at a quarterly rate. At an annual rate this marks declines of 2.2 and 1.2 per cent respectively. More recent survey data suggest a continued pessimism in the assessment of order books and a worsening of production expectations. Although the continuing low interest rate environment may stir up investor confidence, it is likely that investment's contribution to GDP will remain modest, at best, for the remainder of the year.

To date, developments have differed across the sectors of the economy with the industrial sector continuing to stagnate while the service sector performs relatively robustly. In the second quarter of 2003, industrial value added contracted by 1.0 per cent over the previous quarter and 0.9 per cent over the previous year, thereby acting as a significant drag on overall Euro Area GDP. In contrast construction recovered from a number of successive periods of negative growth to increase by 0.6 per cent over the quarter. Financial services and business activities grew by 0.3 per cent over the quarter or 0.5 per cent at an annual rate as did other services, which increased by the same margin over the quarter and by 1.4 per cent over the year.

So far in the second half of 2003 survey data suggest that activity is spreading itself more evenly across sectors in the Euro Area economy. Industrial production was up 0.6 per cent in July when compared to June with large month on month increases in capital and consumer durable goods. This is confirmed by Reuters PMI, which rose to a six month high of 49.1 in August. Although this figure still indicates a slight contraction in the sector, both the output and new orders components rose above the important 50 mark, indicating expansion. The service sector also has shown renewed strength as suggested by Reuters PMI for the services sector, which reached a thirteen-month high of 52.0 in August after registering 50.2 in July.

Labour market conditions continue to be quite fragile due to the prolonged period of below potential growth experienced in the region. Following an average unemployment rate of 8.4 per cent in 2002, the first quarter of 2003 has seen a significant deterioration in the labour market. The Euro Area's standardised unemployment rate at 8.8 per cent in August reflects a significant deterioration from year-end 2002. In fact, unemployment has been on an upward trend since April 2001. France and Germany continue to have close to the highest rate of unemployment in the Euro Area with 9.4 per cent each. There may be signs however of improvement, especially in the dismal German economy where the steps taken towards structural reform may have been painful but necessary and might finally start to bear fruit towards the end of this year and into next. Survey data suggest that employment prospects remain weak especially in the industrial sector and we forecast no real improvement in labour market conditions in the short term due to the usual lag between a significant upturn in overall economic activity levels and improvement in labour market conditions. For 2003, we forecast average unemployment at 9.1 per cent, remaining at that level in 2004, reflecting an economy with significant excess capacity.

Despite the below potential growth in the Euro Area, inflation actually spiked up to 2.1 per cent in August following a rate of 1.9 per cent in July. Much of the inflationary pressures came from the food and energy components due to the drought over much of Europe over the past summer. We expect this upward pressure to be limited and that disinflationary pressures will continue due to subdued overall economic activity, moderate wage developments and the lagged effects of the strengthening of the external value of the euro. We estimate inflation will average 1.7 per cent in 2003, with further moderation in price pressures in 2004 where we forecast inflation to average 1.2 per cent.

At its latest meeting, the Governing Council of the European Central Bank (ECB) decided to leave its main interest rate unchanged at 2.0 per cent. They felt that although above target the outlook for price stability continues to be favourable in the medium term and the historically low interest rates will carry on lending support to economic activity. Again, this was despite M3 or broad money supply growth, at 8.5 per cent, being well above the 4.5 per cent predicted to sustain non-inflationary growth, which forms part of the first pillar of the ECB's monetary policy strategy. Rather than signalling any possible inflationary pressures in the economy, this was seen as reflecting portfolio shifts, and a sustained preference on the part of investors for short-term liquid assets combined with a low opportunity cost of holding such assets. However, the expected reversal of past portfolio shifts remained limited in the latest month, despite the decline in geopolitical uncertainties and the normalisation in stock market conditions over previous months.

The strength of the euro, although dissipated somewhat, will continue to exert significant competitive pressures on the region. In the seven months to July, exports were down 3.0 per cent while imports remained relatively unchanged. The abatement of much of the geopolitical tensions should pave the way for a pick up in the world economy and therefore external demand, which should offset the impact of lower price competitiveness in the short term. However, the recent weakening of trade's contribution to economic growth in the region underlies the importance of policies geared to reinforcing domestic sources of growth in the Euro Area.

Fiscal developments in the Euro Area remain a cause for concern with evidence suggesting that some countries will miss their budgetary targets for 2003, some by a significant margin. This reflects lower than anticipated economic growth but it is clear that not all countries with severe imbalances have introduced sufficient consolidation measures. In particular Germany, France, Italy and Portugal are expected to run deficits close to or above the 3 per cent limit permitted under the Growth and Stability Pact following similar breaches in 2002. The overall Euro Area government deficit was 2.2 per cent of GDP in 2002 and is likely to be higher again this year. Moreover, it is likely that the debt to GDP ratio, after stabilising in 2002 following five years of decline, will increase for the region as a whole in 2003.

UK Economy

The UK economy has remained one of the most resilient economies in the face of the protracted global slowdown of the last number of years. Following growth of 1.9 per cent in 2002, the UK economy has grown in GDP terms by 2.1 and 1.8 per cent at an annual rate in the first and second quarter of 2003. This reflects 0.1 and 0.3 per cent respectively in each quarter compared with the previous year. Although robust compared to many of the other major European economies, this growth indicates that the UK economy continues to operate below its potential of 2.5-3.0 per cent. However, there are signs that growth looks set to strengthen in the second half of the year before moving towards potential rates in 2004. We forecast UK GDP to grow by 2.0 per cent this year before increasing to 2.3 per cent in 2004.

Household expenditure increased to 1.3 per cent in the second quarter compared to the first following a slowdown in the first quarter. At an annual rate this is growth of 3.4 per cent, which is, a slight moderation compared with growth of around 4.5 per cent over the past six years. This moderation is due to weakening income growth, weakened household wealth as a result of the declines in the global equity market and a high level of debt. However, a relatively strong labour market, recovering equity markets combined with the low interest rate environment should mean that consumption growth will be supported in the short term at least. The level of government expenditure also increased although government investment fell over the quarter.

After a slight rise in the final quarter of 2002, whole economy investment has fallen in the first two quarters of 2003. In the second quarter it was down 0.5 per cent or 1.4 per cent on a year earlier. Much of this reflected a fall in business investment, which fell by 1.1 per cent from the first quarter and 3.5 per cent on a year earlier. Despite these falls, total business investment has stabilised somewhat following significant falls in 2001 and early 2002. Most of the falls have come from the manufacturing sector which have been partially offset by increased investment from the distribution service industries.

This strength in the services sector is confirmed by growth of 0.3 per cent in the second quarter or 2.5 per cent over the year. This sector remains the driving force in the economy and confirms the trend of the "two-speed" economy discussed in previous *Commentaries* even if the sharp dichotomy between it and manufacturing has lessened somewhat. Survey data suggest continued expansion in the sector with the main CIPS/Reuters PMI for services reaching 57.0 in August, an expansion for the fifth consecutive month and the strongest expansion since January 2001. All components including the previously contracting employment component and outstanding business component expanded in August suggesting renewed strength in the sector.

The industrial sector has showed tentative signs of growth in the first half of 2003 with industrial production up 0.5 per cent in the three months to July but down 0.2 per cent on a year earlier. Manufacturing is expected to pick up in the second half of the year in line with an improvement in international economic conditions and the weakening of sterling. This is also confirmed by survey data. The CIP/Reuters PMI for manufacturing posted its highest level in August in over 15 months reaching 51.9 following 51.1 in July. New orders and output showed solid expansion while employment remained below 50 reflecting ongoing measures by firms to keep operating costs to a minimum.

The UK labour market continues to show particular resilience to the long-standing period of below potential growth. Data for the three months to July show a rise in the employment rate, no change in the unemployment rate and a higher growth in average earnings. The number of people in employment rose 63,000 over the previous quarter to a record 27.9 million, leaving the employment rate up marginally at 74.6 per cent over the quarter. The number of people unemployed actually fell by 1,000 in the quarter, thereby leaving the unemployment rate unchanged at 5.1 per cent. The claimant count fell by 6,900 in August from a revised July figure to 930,800. Following an unemployment rate of 5.2 per cent in 2002, we forecast a slight deterioration in labour market conditions this year with unemployment averaging 5.3 per cent and remaining at that level in 2004.

UK Inflation has remained stable for most of 2003. Inflation as measured by the Retail Price Index excluding mortgage interest payments (RPIX) remained unchanged at 2.9 per cent in August. According to the HICP measure, which is internationally comparable, UK inflation stood at 1.4 per cent in August up from

1.3 per cent in July. In its July meeting the Bank of England's Monetary Policy Committee (MPC) decided to reduce its main interest rate by 25 basis points to 3.5 per cent. This is the lowest interest rates have been since the 1950s. The MPC cited the weaker than previously expected global and domestic demand as reasons for its interest rate cut, which was facilitated by the expectation that RPIX would moderate over the course of the year.

An important development for UK monetary policy has been the directive, put forward by the Treasury in its recent euro assessment, for the monetary authorities to switch its inflation target to one based on the Harmonised Index of Consumer Prices (HICP), which is used in the Euro Area. Recently officials on the MPC have expressed reservations about this move, citing the problem of the presentation of the change to the public. Currently the HICP is 1.5 percentage points lower than the RPIX, much of which is due to the rapid house price appreciation, which is included in the latter. It is likely that when the new measurement of inflation is officially introduced, the Bank of England target rate will be changed as well, probably to 2.0 per cent. This means the UK would move from its current position of above target inflation to one of below target inflation, which might be the rationale behind prospective interest rate decisions.

This loosening of monetary policy together with facilitative fiscal policy, an upturn in global conditions and a reversal of fortunes in the equity market should place the UK economy in good stead for stronger growth in the second half of the year before moving towards potential in 2004.

Rest of the World

The economic situation in Japan has improved substantially since the beginning of the year. Having declined continuously since the second quarter of 2002, quarter on quarter real GDP growth rose again in the second quarter of 2003 to 0.6 per cent after 0.3 per cent growth in the first quarter. External demand contributed 0.2 percentage points with domestic demand factors contributing the remainder. Net exports were helped by a fall of 1.1 per cent in imports due to the impact of the SARS virus on tourism related services. At the same time exports recovered slightly, increasing by 1.0 per cent, but remained weak due to the continued sluggish global environment. The full recovery of the export sector is critical if Japan is to fully revitalise its still stagnant economy.

Looking at price developments in the Japanese economy, deflationary pressures are easing somewhat but still persist. The CPI declined by 0.2 per cent year on year in July following a decline of 0.4 per cent the previous month. At the same time the annual rate of decline of the GDP deflator eased from -3.5 per cent in the first quarter of 2003 to -2.1 per cent in the second quarter. This is the 21st consecutive quarter of decline and reflects continued downward pressure on the price of capital goods.

TABLE 1: Short-term International Outlook

	Output*			Consumer Prices Percentage Change			Hourly Earnings			Unemployment Rate %			Current Account Balance % of GNP		
Country	**2002**	**2003**	**2004**	**2002**	**2003**	**2004**	**2002**	**2003**	**2004**	**2002**	**2003**	**2004**	**2002**	**2003**	**2004**
UK	1.9	2.0	2.3	1.6	2.9	3.0	4.0	4.5	4.4	5.2	5.3	5.3	-1.0	-1.1	-1.3
Germany	0.2	0.0	1.3	1.3	0.7	0.5	2.6	2.8	1.3	8.2	9.2	9.2	2.3	1.9	1.5
France	1.2	0.9	2.0	1.9	1.2	1.2	3.4	3.6	3.3	8.9	9.3	9.3	2.1	1.9	1.5
Italy	0.4	0.7	1.6	2.6	2.1	1.5	2.9	3.0	2.8	9.0	9.2	9.1	-0.6	-0.4	-1.0
Euro Area	0.8	0.5	1.6	2.2	1.7	1.2	3.3	3.3	2.6	8.4	9.1	9.1	0.8	0.6	0.4
USA	2.4	2.6	3.5	1.6	2.2	1.3	3.2	3.5	3.5	5.8	6.0	5.8	-4.6	-5.3	-5.2
Japan	0.2	1.2	1.4	-0.9	-0.3	-0.3	-0.9	0.1	0.8	5.3	5.4	5.4	2.5	2.6	2.6
OECD	1.7	1.8	2.5	1.7	2.0	1.3	2.8	3.3	3.2	6.1	6.5	6.4	-1.2	-1.2	-1.3
Ireland	6.9	2.2	3.2	4.6	3.7	2.6	5.4	5.1	3.6	4.4	4.7	5.1	-0.9	-1.0	-0.4

In non-Japan Asia, the growth momentum continues although the SARS virus continued to impinge on economic activity in the second quarter of 2003. The economies most affected were Hong Kong, Singapore, Taiwan and China where the service sectors were particularly badly hit. China, however, continues to register the fastest growth in the region with real GDP growth of 6.7 per cent at an annual rate in the second quarter. Due to the SARS virus weighing heavily on consumption growth most of this came from exports and investment activity.

The Asian economies have benefited from the strength of the US dollar in recent years and are coming under increased diplomatic pressure to allow their currencies appreciate which would reduce the forecasts for higher growth if adhered to. We forecast strong growth among Asian countries excluding Japan this year and next.

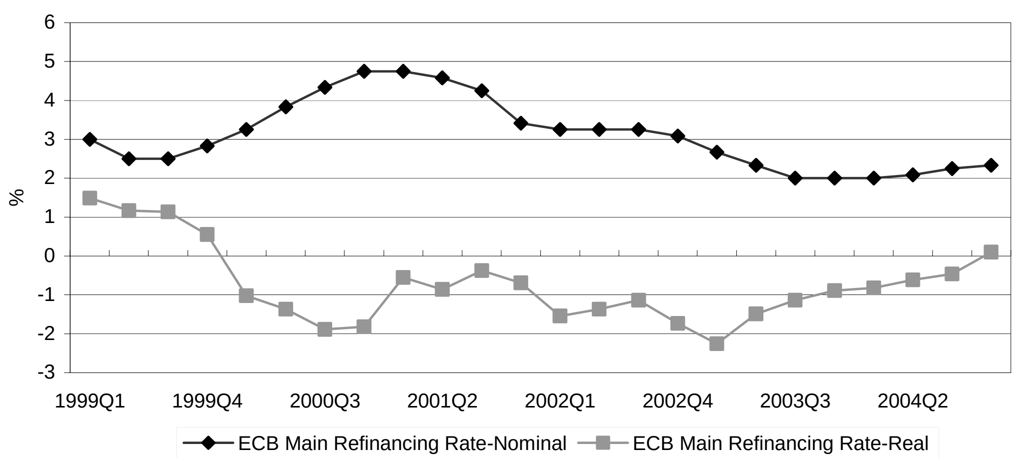
Some of the recent data releases in Latin America indicate that the economic recovery, which began in 2002, is losing momentum. Both Brazil and Mexico have encountered slow GDP growth in the second quarter with the manufacturing sectors being particularly weak. There are also signs of slowdown in Argentina where the economy continues to be hampered by its sizable external borrowing requirements.

Context for Ireland

Prospects for the international economy remain quite good. There are indications that the global economy is strengthening with much due to the increasing vigour in the US and parts of Asia. As a small open economy, Ireland is very much influenced by global events and by the international economic outlook. The continued pick-up in economic activity in the US economy is particularly important for Ireland given our exposure to the US in terms of our trade share and foreign direct investment (FDI).

Figure 1: Interest rates

Per Cent per Annum, Quarterly Averages

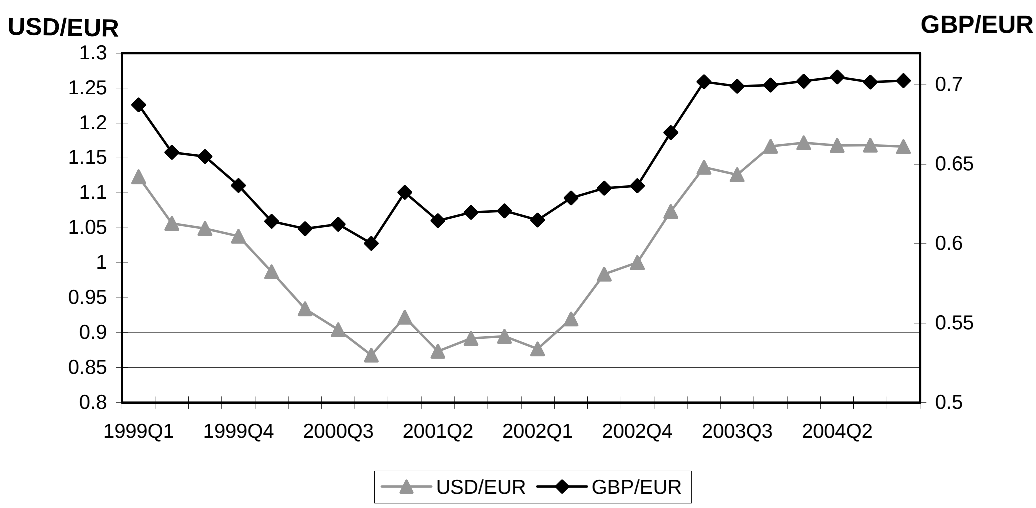


However, offsetting this potential benefit from higher exposure to non-Euro Area trade is the negative aspect associated with the continued strength of the euro. Ireland is more likely to incur greater price competitiveness pressures with an appreciating currency than any other Euro Area country. The euro has depreciated from its high of over $1.19 in July, but recent gains against the dollar will keep the value of the euro, in terms of both the dollar and sterling, one of the most important issues for the Irish economy.

The recent statement from the G7 countries calling for more flexibility of exchange rates and less intervention in the market makes it unlikely that the US will pursue a “strong dollar” policy and therefore improbable that the euro will fall back significantly against the dollar. Many Irish exporting firms are continuing to see profit margins squeezed with the price and volume of exports falling. This trend is exacerbated by a high domestic cost base due to high wage rates together with the range of other cost increases feeding through from the non-traded sectors of the economy.

Figure 2: Exchange Rates

Foreign Currency per Euro, Quarterly Averages



Furthermore, this exposure is reaffirmed by the decision of the UK to remain outside EMU, which leaves much of the traditional manufacturing sector exposed to the effects of changes in the bilateral euro-sterling exchange rate. The recent decision by Sweden to reject EMU membership probably reaffirms the euro scepticism clearly observed in the UK and Denmark. The poor relative performance of the Euro Area, with its weak labour market and faltering economy, is bound to have affected attractiveness to these countries of adopting the euro. Until a full rebound in economic activity in the Euro Area, based on significant structural reform is achieved, it is unlikely that the UK or Sweden will adopt the single currency.

A possible risk for continuing global recovery in the near term might be volatile energy prices, which is confirmed by the recent surprise decision by the Organisation of the Petroleum Exporting Countries (OPEC) to cut oil output, removing 900,000 barrels per day from world supplies ahead of peak winter demand. Low and stable energy prices remain very important, not only for inflation but also for the supply side of the global economy. Although abated somewhat, there still remains considerable uncertainty regarding the outlook for the world economy. Fluctuating oil prices contribute to this uncertainty and significantly higher oil prices could postpone any economic recovery. In the Spring 2003 edition of the *Commentary* we found that any oil price shock, even if temporary, would have a significant short-run impact on the world economy. The loss to the Irish economy would be greater than that in the rest of the Euro Area because of the country's greater sensitivity to interest rate changes. Moreover, these shocks would have a greater impact on Ireland than the Euro Area or the US economy, whether or not there is a response by the monetary authorities.

In general, external conditions are broadly improving for the Irish economy. Competitiveness remains critical if the openness of the Irish economy is to take full advantage of the improving international context.

The Domestic Economy

General

Official statistics for the first quarter of this year confirm that the economy continues to expand at a slow pace. Volume growth in GDP was just 0.5 per cent while growth in GNP amounted to 0.8 per cent. Taking account of these national accounts and data released since the last *Commentary* we have revised our estimates for the volume growth in GDP to 2.2 per cent in 2003 while our estimate for volume growth in GNP now stands at 1.9 per cent. These growth rates suggest a much narrower gap between the two measures than was experienced last year.

With some indications that the much-anticipated international recovery is beginning to become more established we are forecasting that GDP will grow by 3.2 per cent in volume terms in 2004 and that volume growth in GNP will be 3.1 per cent. Once again the gap between GDP and GNP is forecast to remain narrow given the impact of slow economic activity on factor income flows.

Exports

Trade statistics for the first seven months of the year show that the value of external trade fell by 18.9 per cent when compared with the same period in 2002. Volume figures for the first half of the year show a decline of 13.3 per cent. According to the Central Statistics Office much of the fall is due to a decline in the pattern of distributive trade with Great Britain and that the value and volume of imports has also been affected. The net balance of trade however is not significantly affected.

TABLE 2: Exports of Goods and Services

	2001	% Change in 2002		2002	% Change in 2003		2003	% Change in 2004		2004
	€m	Volume	Value	€m	Volume	Value	€m	Volume	Value	€m
Agricultural	4,145	-2.9	-1.6	4,077	-3.0	-6.9	3,796	2.5	4.0	3,949
Manufactured	80,812	1.2	1.7	82,200	-4.0	-7.4	76,150	3.0	4.0	79,219
Other Industrial	5,816	-3.7	-3.4	5,619	-4.5	-7.4	5,205	1.8	2.1	5,314
Other	1,918	3.7	4.0	1,995	-5.0	-7.9	1,836	2.5	3.1	1,894
Total Visible	**92,690**	**0.8**	**1.3**	**93,891**	**-4.0**	**-7.4**	**86,988**	**2.9**	**3.9**	**90,377**
Adjustments	-6,000	-56.6	-55.8	-2,655	80.0	116.0	-5,734	15.0	26.5	-7,253
Merchandise	**86,690**	**4.7**	**5.2**	**91,236**	**-6.5**	**-10.9**	**81,254**	**2.0**	**2.3**	**83,123**
Tourism	3,131	1.8	4.4	3,268	5.0	8.3	3,538	2.3	5.4	3,728
Other Services	23,117	12.2	15.3	26,654	4.5	7.9	28,773	4.2	6.8	30,731
Exports of Goods and Services	**112,938**	**6.2**	**7.3**	**121,158**	**-3.7**	**-6.3**	**113,564**	**2.6**	**3.5**	**117,582**

The combined effect of these changes coupled with the weaker economic environment this year means that a contraction in export volumes is forecast for 2003. Taking account of Balance of Payment adjustments means that the volume of merchandise trade is forecast to fall by 6.5 per cent this year. Although the tourism sector has faced a difficult year there are indications that the performance of this sector may not be as poor as originally thought. Thus we have revised our forecast volume growth for tourism exports up to an annual growth rate of 5 per cent in 2003. However, growth in other service exports is expected to remain subdued in comparison to last year. Taking account of these factors we are forecasting that the volume of exports of goods and services in 2003 will contract by 3.7 per cent. With the price of merchandise exports suggesting that the price deflator for the export of goods and services will be negative this implies that the value of exports of goods and services will contract by 6.3 per cent in 2003.

Given our expectation outlined in the *International* section of this *Commentary* that economic growth will show some recovery internationally, the volume of merchandise export growth is forecast to grow by 2 per cent. This represents a much more moderate growth rate for exports than the Irish economy has experienced in recent years and also reflects the lower base in 2003. With continued growth in the volume of tourism and other services exports the overall volume of exports of goods and services is forecast to grow by 2.6 per cent. A forecast export price deflator of 0.9 per cent implies value growth for total exports of 3.5 per cent.

Stocks

The *Quarterly National Accounts* for the first quarter of this year reveal that stocks rose by €263 million in volume terms and by €193 million in value terms. With all the stock categories showing growth the overall level of stocks are expected to increase by €304 million this year. Stock levels are forecast to reduce next year on the back of an increase in economic activity. The increase in farm stock is expected to reverse. This, coupled with a reduction in industrial and distribution stocks, is forecast to result in an annual stock change of €225 million in 2004.

TABLE 3: Stock Changes

	2001 €m	Change in Value €m	2002 €m	Change in Value €m	2003 €m	Change in Value €m	2004 €m
Farm Stocks	-13	-27	-40	218	178	-48	130
Irish intervention Stocks	14	162	176	-126	50	-15	35
Other Non-Agricultural Stocks	492	-617	-125	201	76	-16	60
Total	**494**	**-483**	**11**	**293**	**304**	**-79**	**225**

Investment

The *Quarterly National Accounts* indicate that the volume of investment contracted in the first quarter of this year in value and volume terms. Construction investment fell by 0.9 per cent. Within this overall figure there was growth of 14 per cent in house building and a decline of 12 per cent in other construction. Investment in machinery and equipment fell by 22 per cent. The weakness of investment spending is partly due to the fact that there was a major investment in transport equipment in the first quarter of 2002. The monthly index of employment in construction shows that employment has remained steady in the first seven months of this year compared with the first seven months of 2002. Registrations of commercial vehicles recorded an increase of 12.3 per cent between January and August compared with the same period in 2002. However, despite the strength of the housing market, a contraction in other building and construction and in machinery and equipment investment means that we continue to forecast an overall contraction in investment activity, albeit relatively moderate at 0.6 per cent in 2003.

With growth in housing completions having expanded rapidly in recent years it seems unlikely that these will continue to expand given our forecasts for housing demand contained in the recent ESRI *Medium-Term Review*. Thus, we anticipate a contraction in the volume of housing completions in 2004. This contraction, at 1.5 per cent is relatively modest and will still leave the number of housing completions at around 2002 levels. Thus, despite some decline, the number of house completions will remain strong in the short term. The economic upturn is likely to result in some investment in other building in 2004. Once again this will be modest but our expectation is that this sub-sector will record volume growth of 2 per cent. Thus, investment in building and construction is forecast to grow in 2004 by 0.3 per cent. With a more modest price deflator than in recent years of 3.5 per cent the implied growth in the value of investment in building and construction is 3.8 per cent. On the basis that investment in machinery and equipment also recovers in 2004 then overall investment is forecast to increase in value terms by 4.3 per cent and in volume terms by 1.2 per cent. This indicates that the price deflator for investment will remain low at 3.1 per cent in 2004.

Consumption

Retail sales statistics for the first seven months of this year show that consumption grew by 1.2 per cent in volume terms. Excluding the more volatile motor trade component indicates an underlying growth rate of around 1.8 per cent. The more moderate pace of growth is also reflected in the *Quarterly National Accounts* for the first quarter of 2003 which show that the volume of personal consumption was up by 1.8 per cent and the value was up by 7.3 per cent compared with the previous year. Our forecasts for growth in disposable income and the outlook for the labour market also

TABLE 4: Gross Fixed Capital Formation

	2001 €m	% Change in 2002		2002 €m	% Change in 2003		2003 €m	% Change in 2004		2004 €m
		Volume	Value		Volume	Value		Volume	Value	
Housing	9,541	5.1	13.3	10,809	3.2	11.5	12,048	-1.5	2.9	12,401
Other Building	8,568	5.0	7.5	9,212	-3.5	-0.6	9,157	2.0	4.9	9,601
Building and Construction	18,109	5.0	10.6	20,022	-0.3	5.9	21,205	0.3	3.8	22,003
Machinery and Equipment	8,858	-2.6	-2.6	8,627	-1.0	0.2	8,643	2.5	5.8	9,143
Total	26,967	4.5	6.2	28,649	4.2	-0.6	29,848	4.3	1.2	31,146

point to a period of slower growth in personal consumption. We are forecasting growth in personal consumption of 2.3 per cent in volume terms for this year. Coupled with a consumer expenditure deflator of 3.1 per cent this implies that the value of personal consumption will increase by 5.5 per cent in 2003.

With only a small forecast increase in the savings ratio in 2004 coupled with continued moderate wage growth and some increases in the numbers employed it seems likely that there will be improved growth in personal consumption in 2004. Thus, we are forecasting that the value of personal consumption will grow by 5.8 per cent in 2004. A more moderate inflationary environment implies that the personal consumption deflator will be lower at 2.5 per cent. On this basis the volume growth in personal consumption forecast for 2004 is 3.2 per cent.

The *Quarterly National Accounts* confirm that the volume growth in public spending has slowed, growing by just 4.4 per cent when compared with the first quarter of 2002. With official figures suggesting that the slowdown in spending growth has continued we are forecasting that public spending will grow by 1.3 per cent in volume terms in 2003. Given the benchmarking award paid already this year it seems likely that the public expenditure deflator will remain strong at 5.7 per cent. Coupled with the forecast volume growth this means that we are forecasting that public spending will grow by 7.1 per cent in value terms in 2003. The need to maintain tight control on public spending is expected to continue into 2004. A moderately lower rate of growth in the public expenditure deflator is anticipated and so the value of public spending is forecast to grow by 6.7 per cent in 2004.

TABLE 5: Consumption Indicators

	Annual Percentage Change						
	1998	**1999**	**2000**	**2001**	**2002**	**2003 Forecast**	**2004 Forecast**
Consumption Value							
Personal Consumption	11.7	12.6	13.0	10.1	8.9	5.5	5.8
Retail Sales Index, Value	9.8	11.4	16.3	5.9	3.9	3.8	4.2
Divergence	1.9	1.2	-3.3	4.2	5.0	1.7	-1.6
Consumption Volume							
Personal Consumption	7.6	9.3	8.5	5.5	2.7	2.3	3.2
Retail Sales Index, Volume	8.1	9.5	11.9	3.1	0.7	2.3	2.5
Divergence	-0.5	-0.2	-3.4	2.4	2.0	0.0	0.7
Consumer Prices							
Personal Consumption Deflator	3.8	3.0	4.2	4.3	6.0	3.1	2.5
Retail Sales Index Deflator	1.6	1.7	3.9	2.7	3.2	1.5	1.7
Consumer Price Index	2.4	1.6	4.5	5.6	4.6	3.7	2.6

Final Demand

The revisions to export growth rates by the CSO have impacted on our forecasts for growth in final demand. Taking account of the revised export figures means we are now expecting final demand to contract by 1.3 per cent in 2003. With the final demand price deflator at 0.6 per cent this implies that the value of final demand will contract this year by 0.7 per cent.

The forecasts outlined above for 2004 result in the volume growth in final demand recovering to 2.4 per cent next year. Domestic demand excluding stocks is forecast to grow by 2.4 per cent in volume while exports are forecast to grow by 2.6 per cent. The growth in domestic demand is anticipated to be import intensive given the growth in personal consumption. Furthermore, given the propensity to import raw materials the return to growth by exports is also expected to underpin the import intensity of domestic demand.

Imports

The import trade data from the CSO has been revised to take account of changes in the pattern of distributive trade with Great Britain, as outlined in the *Exports* section of this *Commentary*. This revision now means that we expect that the volume of merchandise imports will contract in 2003 by 9.1 per cent. The subdued level of domestic activity means that we estimate that imports of other services will contract this year by 2 per cent in volume terms. This coupled with an estimated growth of 6.5 per cent in tourism imports means that we are now estimating that the total volume of imports of goods and services will contract by 5.6 per cent in 2003 and by 9.4 per cent in value terms.

The adjustment to trade data in 2003 will mean that forecasts for import growth in 2004 will be on a much lower base, levels similar to the value of imports in 2000. With domestic economic activity improving as the world economy recovery begins to impact we anticipate that import volumes will increase, although the rate of growth will remain moderate. On the grounds that there will be some investment growth in plant and machinery and consumer spending will continue to grow we forecast that merchandise import volumes will grow by 1.1 per cent in 2004. With more moderate growth in tourism and other service imports in 2004 total imports of goods and services are forecast to grow by 1.1 per cent in volume terms. With the import price deflator forecast to be 1 per cent next year this implies that the value of total imports will increase by 2.1 per cent in 2004.

TABLE 6: Imports of Goods and Services

	2001	% Change in 2002		2002	% Change in 2003		2003	% Change in 2004		2004
	€m	Volume	Value	€m	Volume	Value	€m	Volume	Value	€m
Capital Goods	7,534	-8.5	-6.9	7,013	-4.1	-7.9	6,456	2.4	3.2	6,664
Consumer Goods	12,447	-0.1	1.7	12,662	-3.0	-4.9	12,037	2.8	3.8	12,498
Intermediate Goods:										
Agriculture	942	4.9	-0.4	938	-7.0	-11.2	833	2.2	4.2	869
Other	34,348	2.1	-5.1	32,612	-8.5	-14.4	27,901	2.0	2.5	28,601
Other Goods	2,114	13.5	7.8	2,279	-6.5	-11.6	2,014	1.5	3.2	2,079
Total Visible	**57,384**	**0.7**	**-3.3**	**55,505**	**-6.6**	**-11.3**	**49,241**	**2.2**	**3.0**	**50,710**
Adjustments	-1,187	9.6	8.0	-1,283	100.0	200.0	-3,848	15.0	15.0	-4,425
Merchandise Imports	**56,197**	**0.5**	**-3.5**	**54,222**	**-9.1**	**-16.3**	**45,393**	**1.1**	**2.0**	**46,285**
Tourism	3,206	11.7	23.5	3,958	6.5	8.6	4,300	2.0	4.2	4,482
Other Services	36,299	4.1	7.0	38,834	-2.0	-1.5	38,248	1.0	2.0	39,016
Imports of Goods and Services	**95,702**	**2.3**	**1.4**	**97,014**	**-5.6**	**-9.4**	**87,940**	**1.1**	**2.1**	**89,783**

Balance of Payments

Official figures now show that the deficit on the current account reached €954 million in 2002, compared with a deficit of €757 million in 2001. Recent figures for the second quarter 2003 show that the deficit on the current account of the Balance of Payments was €389 million compared to a deficit of €1,039 million in the first quarter and €471 million a year earlier.

The forecast for imports and exports already discussed in this *Commentary* indicate that the surplus on trade in goods and services will continue to expand by 6.1 per cent in value terms in 2003 to €25.6 billion. The underlying merchandise and service trade forecasts imply that the surplus will grow again in 2004 by 8.5 per cent in value to €27.8 billion.

The slower pace of external and domestic activity has resulted in lower growth forecasts for debit and credit flows than the rates that have been experienced in recent years. This is particularly evident with regard to the reinvested earnings outflows, which, having shown strong double digit growth in 2002, are forecast to grow by just 2 per cent in 2003. The large growth in outflows in 2002 while inflows contracted contributed to the wide gap between GDP and GNP growth rates. With the growth rate in net factor flows estimated for this year to be 1.1 per cent this implies a much narrower gap between the two measures of Irish economic performance. Growth in net factor flows is expected to pick up in 2004 to 4.2 per cent.

The impact of these forecasts is for a wider current account deficit in 2003 of €1,120 million, followed by an improvement to €491 million in 2004. These deficits are the equivalent of 1 per cent and 0.4 per cent of GNP respectively. As Ireland is a member of EMU the balance on the current account is less important than it once was. However, a deficit does point to an economy consuming more than it produces.

TABLE 7: Balance of Payments

	2001 €m	Change %	2002 €m	Change %	2003 €m	Change %	2004 €m
Visible Trade Balance	35,306	8.7	38,386	-1.7	37,747	5.1	39,667
Adjustments	-4,813		-1,372		-1,886		-2,828
Merchandise Trade Balance	**30,493**	**21.4**	**37,014**	**-3.1**	**35,861**	**2.7**	**36,838**
Service Trade Balance	-13,257	-2.9	-12,870	-20.5	-10,237	-11.7	- 9,040
Trade Balance in Goods and Services	**17,236**	**40.1**	**24,144**	**6.1**	**25,624**	**8.5**	**27,798**
Total Debit Flows	-50,524	6.4	-53,749	2.1	-54,901	3.1	-56,594
Total Credit Flows	32,229	-13.6	27,834	3.1	28,709	2.1	29,303
Net Factor Flows	**-18,295**	**41.7**	**-25,915**	**1.1**	**-26,192**	**4.2**	**-27,291**
Net Current Transfers	**302**	**170.5**	**817**	**-167.6**	**-552**	**80.8**	**-998**
Balance on Current Account	**-757**		**-954**		-1,120		**- 491**
Capital Transfers	703	-18.1	576	- 7.6	**532**	-9.8	480
Effective Current Balance	**-54**		**-378**		**-588**		**-11**

Gross National Product

Data from the *National Income and Expenditure Accounts* for 2002 indicates that the gap between GDP and GNP was actually larger than previous estimates had signified. In 2002, GDP grew by 6.9 per cent over the year, which would be accepted as above its potential rate, while the GNP measure virtually ground to a halt, increasing by only 0.1 per cent. This paints a rather confusing picture of the Irish economy, and is largely due to the productive structure of the economy, which is dominated by foreign multinationals. Net factor flows, mainly multinational profits, showed extraordinary growth in 2002 but we forecast quite a large slowdown from this unsustainable level of growth and therefore forecast a narrowing of the gap between these two measures of economic activity, both this year and next. For 2003, we have revised down our GDP and GNP forecast to 2.2 and 1.9 per cent respectively. In 2004 we forecast a significant pick-up in activity, following the global trend, where we forecast growth of 3.2 and 3.1 per cent respectively.

Following a significant contribution to Gross National Disposable Income (GNDI) in 2002, the terms of trade is forecast to maintain a strong contribution in 2003. GNDI growth is therefore forecast to be 3.4 per cent this year before the terms of trade impact unwinds in 2004, thereby slowing GNDI growth to 1.8 per cent.

Agriculture

Recent data releases from the CSO confirm that the agricultural sector experienced a sharp decline in 2002 with the value of goods output falling by 7.7 per cent. This decline is quite stark when compared to the increase of 4.2 per cent in 2001, especially in light of the negative impact of the 'foot and mouth' scare and the subsequent measures to prevent the spread of the disease during the year.

The fall in the value of goods output was driven by a 7.1 per cent decline in the value of cattle output and a 9.7 per cent decline in the value of milk output. The value of livestock fell by 7.8 per cent and although the fall in the value of cattle output dominates this figure, substantial declines were recorded in some of the smaller livestock categories with the value of output of the sheep and pig sectors down 29.3 per cent and 13.6 per cent respectively. Livestock products fell by 9.4 per cent in value terms but price decreases mean that the volume of livestock products fell by 2.7 per cent over the year. The value of crops decreased by 5.1 per cent while the value of intermediate consumption was broadly unchanged. Net subsidies increased by 16.4 per cent and accounted for 65.5 per cent of agricultural income in 2002, compared to 51.7 per cent in 2001. This increase in the proportion of agricultural incomes from subsidies is due to both an increase in subsidy payments and a reduction in the value of the goods output of the sector.

The fall in the value of goods output in 2002 led to a fall in agricultural income, as measured by operating surplus, of €217 million or 8.1 per cent. This measure of income is before deductions for land rental and interest payments, which are quite sizeable for the sector. Estimates of agricultural incomes for the EU indicate a fall of 5.6 per cent for 2002 with Germany, Denmark and the Netherlands experiencing sharp declines, while operating surplus in the UK grew by 7.7 per cent.

The seasonally adjusted agricultural output price index increased by 1 per cent in July on an annual basis. This was driven by increases in the prices of cows for slaughter and store cattle more then offsetting reductions in the output prices of pigs and potatoes. The seasonally adjusted agricultural input price index increased by 1.5 per cent in July on an annual basis with a 1.8 per cent increase in fertilisers accounting for most of this increase. Following a contraction of 3.2 per cent in real gross agricultural output in 2002, we forecast moderate growth of 2.2 per cent in 2003. However, the sector is expected to contract in 2004 with gross agricultural output expected to decline by 7.2 per cent.

The proposals contained in the Mid-Term Review (MTR) of the Common Agricultural Policy and the WTO Round, which are interrelated, are likely to have a substantial impact on European and Irish agriculture over the coming years. For Ireland, the most important changes to the CAP that are proposed as part of the MTR, are those relating to the decoupling of direct payments from animals (and their coupling to farm area) and the modulation of decoupled payments. Decoupling of payments from production would change the incentives faced by cattle and sheep producers, as they would no longer be obliged to produce cattle and/or sheep to receive payments. At the Doha WTO meeting in 2001, the EU agreed to reduce the trade distorting domestic supports for farmers, by reducing export subsidies and by cutting tariffs on agricultural products to improve market access. Given Ireland's position as an open economy and its relatively heavy dependence on export subsidies, any changes made are likely to have a larger impact on Ireland in contrast to other EU countries. As the WTO talks held in September failed to reach an agreement concerning agriculture, the future for these reforms is somewhat unclear as the possibility for concluding the round by the original deadline, which is the end of 2004, is remote.

Industry

The *National Income and Expenditure Accounts* for 2002 estimate the volume of production in industry, including building, grew by 11.0 per cent in 2002, which is a significant increase compared to growth of 6.4 per cent in 2001. However, estimates from the *Quarterly National Accounts* for the first quarter of 2003 indicate a slackening in activity in this sector with the volume of production, growing by 1.0 per cent on an annual basis compared to an increase of 12.6 per cent in the fourth quarter of 2002. This deterioration in the volume of production is also evident in the CSO release on *Industrial*

Production and Turnover. Volume indices of production for all industries show growth of 7.1 and 2.5 per cent in the fourth quarter of 2002 and the first quarter of 2003 respectively when compared to the same period a year earlier. However, when the series is seasonally adjusted, the index reveals a contraction of 1.2 per cent in the final quarter of 2002 and growth of 7.1 per cent in the first quarter of 2003 when compared to the previous quarter. The index shows growth in the second quarter of the year of 2.6 per cent on an annual basis but the seasonally adjusted index shows more moderate growth of 0.2 per cent when compared to the previous quarter.

Recent survey data indicates the rate of deterioration in the sector has slowed markedly. In August, despite remaining below the critical 50-point level that indicates a contraction in the manufacturing sector, the NCB Purchasing Managers' Index rose to 48.1 from 45.8 in July. This improvement in manufacturing business conditions was driven by the easing of the rate of decline of new orders. The rate of decline of output also slowed considerably in August. The contraction in the sector also led to a reduction in employment, although the rate of job loss was the slowest for seven months. The forward looking components of the IBEC-ESRI Monthly Industrial Survey also indicate an improvement in industrial employment. We estimate that gross output in industry will increase by 1.9 per cent in volume terms this year. As the recovery in the international economy takes hold we forecast gross output in industry to increase by 2.8 per cent in 2004.

Services

The *National Income and Expenditure Accounts* for 2002 estimate the volume of GDP in the services sector increased by 4.6 per cent in 2002 compared to 7.9 per cent in 2001. As the economy slowed in 2002 the broad services sector declined and this deterioration is continuing in 2003. The most recent *Quarterly National Accounts* indicate that the volume growth in services was 3.2 per cent in the first quarter of 2003 when compared to the same period in 2002.

However, survey data indicate a recovery may be underway in the sector in the second half of the year. The NCB Purchasing Managers' Services Index rose for the third successive month in August to 53.5, remaining above the critical 50 point level for the third consecutive month. Despite growth in activity and new business, employment in the sector fell for the fourteenth successive month.

As already outlined in this *Commentary*, personal consumption growth is expected to be lower in 2003. The adjustment of expectations to slower growth in incomes and the slight deterioration in the labour market is also expected to have an impact on the services sector. The contraction in the volume of domestic demand forecast for this year should be reflected in a somewhat lower rise in services output this year. An increase of 1.6 per cent in volume of GDP in services is forecast for this year. Looking forward, the market services sector will play a gradually increasing role in raising output in the domestic economy in the future. The forecast recovery in overall economic conditions should see a recovery in this sector and we are forecasting growth in the volume of gross services output of 3.8 per cent in 2004.

Employment

Despite the slowdown in the Irish economy, which has seen growth virtually come to a halt in the first quarter of the year, the labour market seems particularly resilient with employment growth continuing and the unemployment rate remaining stable. However, a note of caution is needed when viewing these headline labour market statistics, as there is evidence that the weak economy is encroaching on labour market conditions, in particular the move to part-time employment.

Figures from the Quarterly National Household Survey (QNHS) suggest that following annual employment growth of 1.4 per cent in 2002, growth increased to 1.5 and 1.6 per cent in the first and second quarters of this year respectively. In the second quarter employment stood at 1.788 million persons and reflected an increase of 28,400 over the year. However, as mentioned, part-time employment increased its proportion of total employment significantly in the second quarter accounting for over 40 per cent of the annual increase. This tends to happen when there is significant excess capacity in an economy and suggests the implied effective employment may be less than the headline rate.

The largest annual increases were in health (10,900), hotels and restaurants (10,500) and construction (9,300). Having adjusted for seasonal factors the largest quarterly increases were in hotels and restaurants (3,900) and construction (3,800) while there was a continued fall in employment in agriculture, forestry and fishing and other services. The number of students in employment in the second quarter of the year accounted for a large proportion of the overall annual increase (9,500), nearly all of which was made up by part-time employment. A notable change in student behaviour was evidenced in the recent QNHS by the quarter on quarter increase of 1,400 in student employment. This is compared to a decrease of 6,400 over the same period last year and is at odds with the presumption that students forfeit employment as the end of year examinations approach.

Unemployment increased by 4,200 in the year to the second quarter, leaving the total numbers unemployed at 81,400 persons. The unemployment rate was 4.4 per cent in the second quarter compared to 4.6 per cent in the previous quarter and 4.2 per cent one year earlier. However, seasonally adjusted, the unemployment rate remained unchanged at 4.6 per cent over the first two quarters of this year. This resilience is confirmed by the most recent live register figures, which show that, the numbers signing on in August actually fell by 900 in seasonally adjusted absolute terms.

TABLE 8: Employment and Unemployment*

	Annual Averages			
	2001	2002	2003	2004
Agriculture	123	121	115	112
Industry	504	494	490	496
Services	1,114	1,150	1,179	1,190
Total at Work	**1,741**	**1,765**	**1,784**	**1,797**
Unemployed	71	82	89	97
Labour Force	**1,812**	**1,847**	**1,873**	**1,894**
Unemployment Rate %	3.9	4.4	4.7	5.1
Live Register	142	163	176	193

* All data (including the unemployment rate) are based on ILO definitions, except for the Live Register.

Following annual growth of 1.6 per cent in the year to the fourth quarter of 2002, labour force growth strengthened marginally in 2003 with growth of 1.7 and 1.8 per cent in the first and second quarters respectively. In absolute terms this was an increase of 32,700 persons. It is estimated that if participation rates remained the same, the labour force should have increased by 2.0 per cent or 35,800 in the year to the second quarter. Therefore, changes in the participation rates, especially in the 25-35 age group, contributed to a net decrease of 3,100.

Overall then, labour market conditions, while on a worsening path, are still very favourable relative to other countries at present. However, much of the headline statistics on the labour market hide a number of important factors which indicate the slack nature of the economy at present. First, there has been a large shift from full-time to part-time employment indicating that the overall amount of labour applied may have stalled or even fallen. Second, the average working week continues to fall, decreasing to 37.2 hours in the second quarter of 2003 compared to 37.7 hours in the same period last year indicative of the excess capacity in the economy. Third, as mentioned in previous *Commentaries,* employment growth in the public sector continues to mask overall labour market conditions and has been the driving force behind total employment growth over the last year. This positive contribution will cease with the intention to cut public sector employment over three years. Finally, other sector specific surveys continue to show evidence at odds with the QNHS data with many sectors showing employment contracting.

We have scaled back our forecasted labour market deterioration for this year and next from previous *Commentaries*. We forecast that the average numbers in employment will grow by 1.1 per cent this year with continued job losses in agriculture and industry being more than offset by employment growth in the services sector. We expect a return to employment growth in the industrial sector in 2004 and therefore forecast employment growth of 0.8 per cent for the year. Labour force growth is expected to remain more moderate than in previous years and we forecast growth of 1.4 and 1.2 per cent in 2003 and 2004 respectively. These forecasts combine to give us an average unemployment rate of 4.7

and 5.1 per cent for this year and next, indicative of a resilient labour market given the period of below potential growth.

Incomes

Income growth is expected to be more moderate in 2003 and 2004, due to the protracted period of subdued economic growth, which has impinged upon the labour market and ratcheted down wage expectations, at least in the short term. In particular, hourly earnings growth, which has been in double-digit figures for much of the boom period, was 5.4 per cent in 2002 and is expected to moderate further to 5.1 and 3.6 per cent in 2003 and 2004 respectively.

Incomes in the agriculture, forestry and fishing sector decreased by 5.7 per cent in 2002, which was mainly due to a combination of bad weather conditions and reduced margins caused by falling output and rising input prices. From this low base, we forecast incomes in this sector to increase by 3.3 and 4.0 per cent in 2003 and 2004 respectively. However, in the medium term, we expect that the decoupling proposals, if introduced, will have a negative impact on agricultural incomes.

Given our hourly earnings and employment growth forecasts, we also predict a slowdown in the growth of the non-agricultural wage bill both this year and next. Following 6.8 per cent growth last year, we forecast growth of 6.7 per cent this year and 4.6 per cent in 2004. In 2003, we predict other non-agricultural income growth of 1.1 per cent before increasing to 10.3 per cent in 2004.

The release of the *National Income and Expenditure Accounts* has resulted in yet another upward revision to net factor payments in 2002, which are dominated by multinational's repatriated profits. Net factor payments are estimated to have grown by 42.4 per cent in volume terms in 2002 following growth of 20.0 per cent in 2001. This magnitude of growth is unsustainable and we forecast growth in net factor payments to slow significantly to 1.1 and 4.2 per cent in 2003 and 2004 respectively.

TABLE 9: Personal Disposable Income

	2001	Change		2002	Change		2003	Change		2004
	€m	%	€m	€m	%	€m	€m	%	€m	€m
Agriculture, etc.	3,346	-5.7	-191	3,155	3.3	105	3,260	4.0	130	3,390
Non-Agricultural Wages	46,715	6.8	3,199	49,914	6.7	3,330	53,244	4.6	2,446	55,689
Other Non-Agricultural Income	14,916	7.9	1,183	16,099	1.1	171	16,269	10.3	1,674	17,943
Total Income Received	**64,977**	**6.4**	4,191	**69,168**	**5.2**	**3,605**	**72,773**	**5.8**	**4,250**	**77,023**
Current Transfers	11,384	16.9	1,923	13,307	0.4	50	13,357	3.1	409	13,766
Gross Personal Income	**76,361**	**8.0**	**6,113**	**82,475**	**4.4**	**3,655**	**86,130**	**5.4**	**4,659**	**90,789**
Direct Personal Taxes	14,835	0.7	108	14,943	3.5	517	15,460	2.8	432	15,892
Personal Disposable Income	61,526	9.8	6,005	67,532	4.6	3,138	70,670	6.0	4,227	74,896
Consumption	55,202	8.9	4,917	60,118	5.5	3,289	63,408	5.8	3,665	67,073
Personal Savings	6,325	17.2	1,088	7,413	-2.0	-151	7,262	7.7	562	7,824
Savings Ratio	10.3			11.0			10.3			**10.4**

Consumer Price Index

Official figures show that the rate of inflation, as measured by the Consumer Price Index (CPI) has slowed over the course of the year, with the annual rate of inflation measuring 3.2 per cent in August 2003. Thus, the figures for the first eight months of the year show that the rate of inflation has averaged 4.1 per cent. On an annual basis lower interest rates have reduced the cost of housing. Although the annual figure represents an improvement, figures for July show that Ireland continues to occupy the top position in the Euro Area inflation table. Non-traded service inflation remains high when compared with traded sectors and some non-traded services such as health, communications, restaurants and hotels, and miscellaneous goods and services remain high when compared to the Euro Area average.

With the expectation of the euro continuing to remain reasonably steady against the dollar, the outlook for inflation for the remainder of 2003 is positive. The forecast in this *Commentary* is for inflation in 2003, as measured by the CPI, to average 3.7 per cent. Indeed, the expectation that recovery in economic activity will be slow, the euro will remain strong and that interest rate increases will not occur until the latter half of 2004 means that inflation is expected to moderate throughout the course of 2004. On this basis the CPI is forecast to average 2.6 per cent next year. An alternative measure of inflation, the consumer expenditure deflator, a broader measure, also indicates a more positive inflationary environment in the short term, averaging 3.1 per cent in 2003 before slowing to an annual average of 2.5 per cent in 2004.

Table 10: Consumer Price Index – Recent Trend and Forecast

	2000	2001	2002	2003 Forecast	2004 Forecast
Annual % Change					
Housing	8.8	16.5	0.9	-0.8	-0.5
Other	5.4	4.0	5.0	4.1	2.9
Total CPI	5.6	4.9	4.6	3.7	2.6
Index Dec. 2001=100					
Housing	88.2	102.7	103.7	102.9	102.4
Other	93.6	98.7	102.6	106.9	110.0
Total CPI	92.7	97.9	102.7	106.5	109.3

Public Finances

The public finances are forecast to decline considerably this year and next, moving substantially back into deficit on the basis of the economy growing below its trend. While the Exchequer recorded a small surplus in 2002, the broader General Government balance had a modest deficit of 0.2 per cent of GDP. The marked departure started in Budget 2003, from the tax cutting, high spending budgets of recent years, is expected to continue. Control over the excessive growth rates in public expenditure that emerged from 2000 would seem to have been achieved in the course of 2003 thus far. Voted expenditure growth of 5.0 per cent made up of 8.0 per cent growth in current expenditure and a 11.3 per cent fall in capital expenditure occurred in the first three quarters of 2003.

Even with the modest fiscal contraction provided by Budget 2003, the low growth performance this year substantially depended upon the muted performance in the international economy. Exchequer returns indicate that tax revenue grew by 4.3 per cent in the first nine months of 2003 as compared with the same period in 2002. Given that tax revenue grew by 4.9 per cent in the year 2002 as a whole, the latest returns are indicative of an economy beginning to stabilise from the wider slowdown in the economy but broadly in line with overall budget targets.

The slowdown in tax revenue has been most pronounced in corporation taxes, which contracted by 4.3 per cent in the first nine months of the year as compared with 2002. The most spectacular rise has been with stamp duties that have unexpectedly been boosted by the on-going strong property market. Non-tax revenue is down significantly in 2003 reflecting the one-off impacts of measures like the withdrawal of funds from the Social Insurance Fund and contributions from the Central Bank to the Exchequer were not repeated as in 2002, although the Capital Services Redemption Account is again to make a contribution of €250 million.

We forecast that the outturn for the Exchequer balance will be a deficit of the order of €1.9 billion in 2003, rising by a further billion in 2004 to near €3.2 billion. The General Government balance, which includes the National Pension Reserve Fund and the Social Insurance Fund, is expected to be closer to a deficit of €1.1 billion or 0.8 per cent of GDP in 2003 and deteriorating further to around €1.8 billion or 1.3 per cent of GDP in 2004. Given the extent of the cyclical downturn predicted for this year and next we could have anticipated the budget balance to have deteriorated by more than we have forecast. Instead, the deficits are consistent with a pro-cyclical fiscal policy stance in line with (the spirit of) the Stability and Growth Pact (SGP) that requires that governments aim for public finances "close to balance or in surplus".

This path for the public finances is consistent with that set out in Ireland's Stability Programme Update produced in last year's Budget 2003 as part of the SGP requirements. The General Government debt to GDP ratio is forecast to stabilise this year and next at around 32 per cent after a decade long secular decline from 96 per cent of GDP in 1993.

TABLE 11: Public Finances

	2002	% Change	2003	% Change	2004
Current Revenue	31,525	2.5	32,308	3.3	33,386
Current Expenditure	26,123	9.3	28,550	6.9	30,520
Current Surplus	5,402	-30.4	3,758	-23.7	2,866
Capital Receipts	1,561	-19.9	1,250	-10.4	1,120
Capital Expenditure	6,868	0.6	6,910	3.3	7,140
Capital Borrowing	5,307	6.7	5,660	6.4	6,020
Exchequer Balance	95		-1,902		-3,154
as % of GNP	0.1		-1.7		-2.7
General Government Balance	-113		-1,066		-1,829
as % of GDP	-0.1		-0.8		-1.3
Gross Debt as % of GDP	32.4		31.8		32.2

General Assessment

The *National Income and Expenditure* annual results for 2002 estimate that real GDP growth was 6.9 per cent and real GNP growth was 0.1 per cent. This dramatic gap between the standard measures of economic activity is unprecedented, even for an economy as remarkable as Ireland has been in recent years. The outturn for growth in 2002 would suggest that the Irish economy remained above its potential growth using the GDP measure, while stalling to a near standstill on the GNP basis. However, on both these activity measures the Irish economy had experienced a substantial deceleration in growth by the first quarter of 2003. Given the available data, the overall picture on the economy for the first three quarters of 2003 is much more opaque.

Irish confidence indicators would suggest that both businesses and consumers are becoming more upbeat in relation to economic and employment prospects. The housing market remains the most potent sign of domestic economic resilience with yet another year of record-breaking house completions in train and robust price growth being experienced across most sectors. Despite the signs of slowdown and difficult trading conditions, employment continues to grow at an annual rate of 1.6 per cent in the second quarter with the unemployment rate edging upwards rather than experiencing a sharp spike as had been anticipated. The overall upbeat employment story does mask trends where both agriculture and industry are experiencing significant employment losses and where public sector employment increases have to-date dominated the rises in the services sector.

Both manufacturing output and retail sales continue to show positive growth, albeit at rates much more modest than in recent years. Manufacturing in the multinational dominated ‘modern’ sectors continues to grow while the ‘traditional’ sectors experience sharp contractions. Retail sales are declining when the fall of new car sales is included. Investment in machinery and equipment fell sharply in the beginning of the year, as has capital expenditure by the public authorities. Government tax receipts have increased broadly in line with expectations, with stamp duties sharply ahead on the back of the housing sector.

The external trade position in the Irish economy in the first half of the year has been truly extraordinary. Merchandise trade figures from the Balance of Payments in the second quarter 2003 show that exports have fallen by 21 per cent in the year, with imports down by 24 per cent. This is far more dramatic than anything experienced elsewhere in the Euro Area in the context of the strong appreciation of the euro. The high profile reason for this spectacular fall is the collapse in trade of computer chip related products arising from a fraudulent trade flow with the UK that peaked in 2002 and has since been stopped. However, the price deflators on both exports and imports have also declined substantially, so that the volume fall in trade flows is significant but not to the same extent as the value declines.

We forecast that real GDP growth will rise from the annual growth of 0.5 per cent recorded in the first quarter to average 2.2 per cent for 2003 as a whole, while real GNP growth expected to be broadly similar at 1.9 per cent as growth in net factor income outflows decelerates significantly from the high rates of last year. Economic growth is expected to pick up again next year in line with a much stronger performance by the international economy, but real GDP growth at 3.2 per cent will still be below trend as will real GNP growth at 3.1 per cent.

The sanguine view of higher Irish inflation in the first three years of EMU participation was that it reflected a convergence to higher European price levels justified by higher productivity in the traded sector of the economy. It has become apparent that Irish prices have risen rapidly so that now they are among the highest in the EU. As we have argued in previous *Commentaries* a realistic view of Irish productivity potential must dispel any complacency about our rising cost structures given the importance to Ireland of remaining an effective export platform. The strength of the euro over the last year has imparted a strong dis-inflationary trend into Irish consumer price inflation which we forecast to average 3.7 per cent in 2003, moderating further to 2.6 per cent in 2004.

Expectations of Irish price inflation moving closer towards the Euro Area average coupled with rising levels of unemployment should steer wage expectations closer in line with productivity trends. The pay terms of the *Sustaining Progress* social partnership agreement allows for an overall pay increase of 7.2 per cent over 18 months. The wage negotiations for the second half of the *Sustaining Progress* programme need to be commenced in the first half of 2004. The timing of these negotiations could have been very favourable in reinforcing downward pressure on wage expectations as they are likely to take place against a backdrop of lower consumer price inflation than when the wage terms of the first half of the agreement were set. However, the timing may be less propitious in that there will be a stark divergence in the contemporaneous pay terms in place at that time under the agreement for private and public sector workers. The public sector get the same overall increase as the private sector but lagged to deliver a six-month pay pause during the latter half of 2003. The public sector is also to benefit from the Benchmarking recommended pay awards that range between 2 and 25 per cent and average 8.9 per cent for the public sector as a whole. The terms of *Sustaining Progress* proposed that one-half of the Benchmark award would come in to place from the 1st January 2004, the same date when the first 3 per cent of the pay agreement starts in the public sector.

Given the conjunction of events, it is likely that there will be an understandable perception that public sector workers will be receiving pay increases of nearly four times the 2 per cent proposed for the private sector at the point of the renegotiation. The difficulties in holding the wage bargaining process together are likely to be compounded in these circumstances. It becomes an imperative then that the proposed productivity improvements in return for the Benchmarking elements are verifiable and transparent, to reinforce the economy-wide need for sustainable, productivity-justified pay.

The issue of public sector pay requirements will also play a critical role in the preparation of the Estimates of Public Services and for Budget 2004. Public sector pay now accounts for 40 per cent of gross voted current expenditure and the likely combined impact of the increased pay rates under Benchmarking and the social partnership agreement could see the public sector pay bill rise in the order of 8 per cent in 2004. This pay bill rise may be tempered further if the intention announced in the last Budget to freeze net public sector recruitment and seek a reduction of 5,000 over three years is achieved. In this context, to keep overall current expenditure growth in the prudent range of 6-8 per cent, will mean that non-pay current expenditure growth has to be kept at low rates. This would leave a very tight envelope for real growth in public services when inflation is accounted for. Attaining real productivity returns for the increased public pay is all the more essential.

The deterioration in the public finances experienced over the last two years is expected to continue. This downturn is consistent with the cyclical downturn in the economy. Indeed given the extent of the slowdown, the public finances might have been anticipated to deteriorate to a more significant extent. The trajectory of the cyclically adjusted general government balance would suggest that fiscal policy is mildly contractionary over the course of 2003 as public expenditure, particularly on capital, has been reined-in considerably.

While the Irish economy remains in a period of short-term uncertainty, the medium-term prospects remain good, as set out in the recent ESRI *Medium-Term Review 20031-2010* (MTR). Provided the current relatively prudent fiscal policy is maintained, the MTR *Benchmark* forecast holds out the prospect of achieving …*a significant improvement in public services in the second half of the decade, with only a limited increase in the tax burden and continued strong commitment to solving the problem of the infrastructural deficit.* Budget 2004, therefore, needs to be framed to support the economy in getting back towards its potential growth rates whilst ensuring that all public expenditure constitutes value for money. For an economy of Ireland's size and openness, at this juncture in the economic cycle and given its on-going infrastructural needs, the prudent fiscal stance is to maintain current expenditure growth at re-established rates near nominal potential growth rates of 6 to 8 per cent, whilst targeting similar rates of revenue growth through tax base widening. The resulting current budget surpluses can then continue to be used to fund capital investment with the shortfall supplemented by additional borrowing without seriously reversing the current low national debt to output ratio. The now traditional, but nonetheless appropriate, recommendation is to move to broadly neutral fiscal stance from the mildly, contractionary position adopted in the last Budget.