SUMMARY

There are clear signs throughout the latter half of 2003 that the international economy has embarked upon a strong recovery. The prospect that this recovery can be sustained over the next few years is now at its strongest since the global downturn began in the middle of 2000. While growth within the EU may lag that of the other major economies, the pick-up in world trade growth in 2004 is expected to be substantial. This context is particularly encouraging for an export-oriented economy like Ireland, notwithstanding the significant erosion in relative competitiveness experienced in recent years arising both from the strength of the euro and the rising domestic cost base.

Our projection for growth in real GDP in 2003 is 2.5 per cent with real GNP growth of 2.8 per cent. The pick-up in economic activity throughout 2003 has helped avert an anticipated reduction in employment. While overall employment grew in the first three quarters of the year, the annual unemployment rate for 2003 is still expected to have risen, albeit moderately, to an average of 4.8 per cent. A combination of the appreciation of the currency, more modest wage settlements, and a decline in interest rates have offset rising administered prices and indirect tax hikes to bring the annual average rate of consumer price inflation down to 3.5 per cent. Inflation by the year-end is heading for 2 per cent but the Irish harmonised inflation rate continues to be the highest within the Euro Area. Notwithstanding the improving trend, even low inflation rates remain a threat to competitiveness given that the Irish price level is already the highest within the Euro Area.

Our forecast for Irish output growth in 2004 is 3.5 and 3.3 per cent in real GDP and real GNP terms respectively. These rates would still reflect an economy growing below its potential and consequently the unemployment rate is expected to rise to an average of 5.0 per cent in 2004. The rate of inflation is forecast to moderate in 2004 to an average of 2.2 per cent. The public finances are also anticipated to dis-improve modestly in line with the economic cycle. Our forecast is for the General Government Balance to be in deficit by around €1.8 billion, or 1.2 per cent of GDP, in 2004. The underlying fiscal stance adopted in Budget 2004 is appropriate for the underlying macroeconomic conditions.

The redistributive impact of the budgetary measures is progressive by favouring those on lower incomes, though modest in scale. The move to introduce five-year capital expenditure envelopes and the reprioritisations contained in the mid-term review of the National Development Plan are sensible. Maintaining future annual public spending growth in the order of 6-8 per cent as set out in the Budget will mean that Irish public finances are unlikely to be a major constraint on the economy reaching its full potential over the coming decade.

With the imminent expansion of the European Union in 2004, it is an opportune time to address the competitive challenges in order to ensure that the Irish economy continues to prosper. While the macroeconomic conditions and policy framework are improving, a sharper focus upon evolving enterprise policy is required to ensure that internationally trading indigenous companies can become a more important source of employment and productivity growth to boost national living standards.

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	52,605	8,396	19.0
Adjustments: Stock Appreciation	219	-156		
Financial Services	-4,085	-4,226	-141	
Statistical Discrepancy	570	1,217	647	
Net Domestic Product	**90,974**	**102,509**	**11,535**	**12.7**
less:				
Net Factor Payments	18,295	25,915	7,620	41.7
National Income	**72,679**	**76,594**	**3,915**	**5.4**
Depreciation	11,619	13,259	1,640	14.1
GNP at Factor Cost	**84,298**	**89,853**	**5,555**	**6.6**
Taxes less Subsidies	12,149	13,576	1,427	11.7
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 Preliminary €m	2003 Forecast €m	Change in 2003 €m Value	€m Volume	% Value	% Price	% Volume
Private Consumer Expenditure	60,118	63,469	3,351	1,383	5.6	3.2	2.3
Public Net Current Expenditure	17,639	19,280	1,641	706	9.3	5.1	4.0
Gross Fixed Capital Formation	28,649	30,038	1,389	-334	4.8	6.1	-1.2
Exports of Goods and Services (X)	121,158	112,688	-8,470	-5,074	-7.0	-2.9	-4.2
Physical Changes in Stocks	11	304	293	235			
Final Demand	**227,575**	**225,780**	**-1,796**	**-3,085**	**-0.8**	**0.6**	**-1.4**
less:							
Imports of Goods and Services (M)	97,014	87,765	-9,249	-5,995	-9.5	-3.6	-6.2
GDP at Market Prices	**130,561**	**138,014**	**7,453**	**2,910**	**5.7**	**3.4**	**2.2**
less:							
Statistical Discrepancy	1,217	148	-1,070	-359			
Adjusted GDP	**129,344**	**137,867**	**8,522**	**3,268**	**6.6**	**4.0**	**2.5**
less:							
Net Factor Payments (F)	25,915	24,,678	-1,237	338	-4.8	-6.0	1.3
GNP at Market Prices	**103,429**	**113,189**	**9,759**	**2,930**	**9.4**	**6.4**	**2.8**

B: Gross National Product by Origin

	2002 Preliminary €m	2003 Forecast €m	Change in 2003 €m	Change in 2003 %
Agriculture, Forestry Fishing	3,155	3,260	105	3.3
Non-Agricultural: Wages, etc.	49,914	53,620	3,706	7.4
Other:	52,605	55,489	2,884	5.5
Adjustments: Stock Appreciation	-156	-182		
Financial Services	-4,226	-4,838	-612	
Statistical Discrepancy	1,217	148	-1,070	
Net Domestic Product	**102,509**	**107,497**	**4,988**	**4.9**
less:				
Net Factor Payments	25,915	24,678	-1,237	-4.8
National Income	**76,594**	**82,819**	**6,225**	**8.1**
Depreciation	-13,259	14,422	1,163	8.8
GNP at Factor Cost	**89,853**	**97,240**	**7,387**	**8.2**
Taxes less Subsidies	13,576	15,948	2,372	17.5
GNP at Market Prices	**103,429**	**113,189**	**9,759**	**9.4**

C: Balance of Payments on Current Account

	2002 €m	2003 Forecast €m	Change in 2003 €m
Exports (X) less Imports (M)	24,144	24,923	779
Net Factor Payments (F)	-25,915	-24,678	1,237
Net Transfers	817	-684	-1,501
Balance on Current Account	**-954**	**-439**	**515**
as % of GNP	-0.9	-0.4	0.5

FORECAST NATIONAL ACCOUNTS 2004

A: Expenditure on Gross National Product

	2003 Forecast €m	2004 Forecast €m	Change in 2004 €m Value	Change in 2004 €m Volume	Change in 2004 % Value	Change in 2004 % Price	Change in 2004 % Volume
Private Consumer Expenditure	63,469	67,006	3,537	2,094	5.6	2.2	3.3
Public Net Current Expenditure	19,280	20,730	1,450	308	7.5	5.8	1.6
Gross Fixed Capital Formation	30,038	31,644	1,607	651	5.3	3.1	2.2
Exports of Goods and Services (X)	112,688	119,140	6,451	4,199	5.7	1.9	3.7
Physical Changes in Stocks	304	225	-79	-85			
Final Demand	**225,780**	**238,745**	**12,966**	**7,168**	**5.7**	**2.5**	**3.2**
less:							
Imports of Goods and Services (M)	87,765	91,289	3,524	2,249	4.0	1.4	2.6
GDP at Market Prices	**138,014**	**147,456**	**9,442**	**4,918**	**6.8**	**3.2**	**3.6**
less							
Statistical Discrepancy	148	59	-89	102			
Adjusted GDP	**137,867**	**147,397**	**9,531**	**4,816**	**6.9**	**3.3**	**3.5**
less:							
Net Factor Payments (F)	24,678	25,846	1,168	1,039	4.7	0.5	4.2
GNP at Market Prices	**113,189**	**121,552**	**8,363**	**3,777**	**7.4**	**3.9**	**3.3**

B: Gross National Product by Origin

	2003 Forecast €m	2004 Forecast €m	Change in 2004 €m	Change in 2004 %
Agriculture, Forestry, Fishing	3,260	3,390	130	4.0
Non-Agricultural: Wages, etc.	53,620	56,155	2,535	4.7
Other:	55,489	58,785	3,297	5.9
Adjustments: Stock Appreciation	-182	320		
Financial Services	-4,838	-4,136	701	
Statistical Discrepancy	148	59	-89	
Net Domestic Product	**107,497**	**114,572**	**7,076**	**6.6**
Net Factor Payments	24,678	25,846	1,168	4.7
National Income	**82,819**	**88,726**	**5,908**	**7.1**
Depreciation	14,422	15,282	860	6.0
GNP at Factor Cost	**97,240**	**104,008**	**6,768**	**7.0**
Taxes less Subsidies	15,948	17,543	1,595	10.0
GNP at Market Prices	**113,189**	**121,552**	**8,363**	**7.4**

C: Balance of Payments on Current Account

	2003 Forecast €m	2004 Forecast €m	Change in 2004 €m
Exports (X) less Imports (M)	24,923	27,850	2,927
Net Factor Payments (F)	-24,678	-25,846	-1,168
Net Transfers	-684	-1,284	-600
Balance on Current Account	**-439**	**720**	**1,160**
as % of GNP	-0.4	0.6	1.0

The International Economy

General

Conditions in the international environment have improved significantly in recent months. The performance of the US and many parts of Asia has been particularly strong in the second half of 2003. One of the more notable characteristics of this recent surge in growth has been the resurgence of investment as an engine of growth. Previously, investment had served as a significant drag on the international economy and its recovery should make a rebound in global activity more sustainable. The Euro Area continues to lag behind the other major economies. However, continued reforms in its major economies should foster growth and make it better able to take advantage of the improved global conditions.

The US Economy

The US economy has gained considerable momentum since the previous *Commentary* with almost every sector showing some signs of increasing activity. This was no more apparent then in the latest estimates for the third quarter of 2003, which showed 8.2 per cent GDP growth at an annualised rate. This is the fastest rate since the first quarter of 1984 and reflects broadly based growth across the economy rather than just resilient consumer spending which had been the case in the past. The major contributors to this surge in GDP were personal consumption expenditures, equipment and software, exports and residential investment.

Although this magnitude of growth is not expected in the final quarter of the year, due to significant once off occurrences including considerable tax-cuts, the outlook for the economy has improved significantly. We have, therefore, revised upwards our forecasts for the US economy both this year and next where we estimate output growth rates of 3.0 and 3.8 per cent respectively. However, despite this improved outlook, the US economy is far from fully recovered, with significant weaknesses remaining in the labour market and in both the economy's fiscal and external positions.

One of the more remarkable elements of the third quarter growth in GDP was the increase in investment expenditures, which had acted as a considerable drag on the economy in recent years. Overall, gross private domestic investment increased by 18.2 per cent in the third quarter at an annualised rate, much of which was driven by significant increases in investment of equipment and software and inventories. This increase in investment bodes well for an overall economy wide recovery and confirms improved expectations about future activity after a number of years where sentiment has been severely hit by a number of shocks to the economic system.

This broader based and sustainable growth outlook for the US economy is also confirmed by recent figures for the manufacturing sector, which had been particularly sluggish throughout the prolonged period of below trend growth. According to the *Purchasing Managers Index* (PMI) from the *Institute of Supply Management* (ISM), US manufacturing accelerated significantly in November, with the index registering 62.8 up from 57.0 in October. A figure greater than

50 indicates expansion in the sector while a figure below 50 indicates contraction. This is the strongest growth in the sector in almost 20 years. The service sector, which accounts for nearly 80 per cent of the total economy has continued to show strength with the ISM Index of Non-Manufacturing Activity coming in at 60.1, albeit down from 64.7 in October. This recovery has resulted from increasing momentum in US firm's investment plans and suggests ongoing recovery in business confidence both in the services and manufacturing sectors.

Although we have seen a resurgence of growth in many sectors, which bodes well for the sustainability of the expansion, the US consumer continued to contribute greatly to growth in the third quarter. Consumer spending rose by 6.4 per cent at an annualised rate in the third quarter after growing at 2.0 and 3.8 per cent rate in the first and second quarters respectively. Much of the strength in consumer spending in the third quarter was due to a 26.5 per cent rate of growth in the sale of durable goods, items meant to last three years or more, and much of that came in sales of motor vehicles and parts. Growth is expected to slow in the fourth quarter with indications that car sales have slowed down. Also, consumers got a boost in the late summer and early autumn from child tax credit rebates and from the tail end of a boom in mortgage refinancing. These effects will have mostly dissipated in the fourth quarter and therefore we expect more moderate growth. Despite the unwinding of these once-off factors, the US consumer remains upbeat about future prospects. Both the *Conference Board* and the *University of Michigan's* indices of consumer sentiment confirm this and show consumer confidence at levels not seen in well over a year. Much of this reflects the expectation of an improvement in labour market conditions next year and beyond.

This recovery in the labour market has failed to materialise as of yet despite the uptake in overall economic activity, although there was a very slight improvement in November. Non-farm payroll employment continued to trend up in November (57,000) and the unemployment rate fell to 5.9 per cent but remained essentially unchanged from October with the number of unemployed persons at 8.7 million. Therefore, it is clear that much of the surge in growth has been jobless with businesses generating increases in output by using existing workers more efficiently in an effort to use up the excess capacity. This has been evident in productivity figures, which show annualised productivity growth of 9.4 per cent in the third quarter, which again is the fastest pace in over two decades. It is expected that this labour market weakness may impinge on consumer spending over the final quarter of 2003 with retail sales figures indicating more cautious behaviour in the run up to Christmas. We estimate that the US unemployment rate will average 6.1 per cent in 2003 before falling to 5.8 per cent as labour market conditions improve in 2004.

There are no signs of a sustained increase in US consumer prices at present, despite the obvious demand side impulses in the economy. The headline Consumer Price Index (CPI) remained flat in October to leave inflation at 2.0 per cent over the previous 12 months. The competing forces of a fall in energy costs and a jump in food costs buffeted this rate. Excluding volatile food and energy prices, the so-called core CPI, rose 0.2 per cent in October leaving the annual rate at 1.3 per cent. In comparison, producer price inflation is running at a much stronger 3.4 per cent.

Despite the significant increase in GDP growth rates as seen in the third quarter, the weakness in the labour market together with the lack of significant inflationary pressures means that the Federal Reserve is unlikely to tighten monetary policy significantly in the near term. Subdued inflation has meant that there is considerable scope for a continuation of the currently accommodative monetary policy without un-due risk to price stability. This was the stance taken by the Federal Reserve Board of Governors in their December meeting when they decided to leave their target rate at the historically low rate of 1.0 per cent.

The Balance of Payments (BoP) 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 BoP current account deficit stood at $480.9 billion or 4.6 per cent of GDP. In the first quarter of 2003, the deficit came in at a record $138.7 billion and remained broadly unchanged at that level in the second quarter. It is estimated that the external position will not improve significantly in the third quarter with an increase in the deficit on goods and services in September to $41.3 billion, $1.8 billion more than the $39.5 billion in August. This BoP current account position is unsustainable over the long run and raises the risk of a sharp correction and a weaker dollar. Since the previous *Commentary*, we have seen a significant depreciation of the dollar, falling to a new record low of over $1.22 per euro.

Euro Area Economy

Following a slowdown in activity since mid-2002, preliminary estimates of GDP growth for the third quarter of 2003 have borne out expectations of a tentative recovery in the Euro Area. According to these estimates real annual GDP grew by 0.3 per cent in the third quarter of the year as compared with 0.7 per cent and 0.1 per cent in the first and second quarters. On a quarterly basis, real GDP grew by 0.4 per cent in the third quarter compared with a contraction of 0.1 per cent in the second quarter and zero growth in the first quarter.

Growth in the third quarter was balanced between a positive contribution from household and government consumption expenditure and net trade more than offsetting a negative contribution from investment and stocks. It had been hoped that domestic demand would prove resilient to the weaker external environment, given the importance of the consumer to the Euro Area economy. However, the latest figures reveal a slowdown in domestic demand. Domestic demand growth moderated to 0.1 per cent in the third quarter as compared to 1.0 per cent in the second quarter. Household consumption expenditure increased at an annual rate of 0.9 per cent in the third quarter providing a significant impulse to overall growth. However growth in household expenditure has been slowing throughout the year with no quarterly growth recorded for the third quarter. We do not expect this trend to continue and recent survey indicators point to strengthening consumer expenditure in the remainder of the year.

Investment continues to weaken in the Euro Area. Gross fixed capital formation contracted in the third quarter at an annual rate of 0.4 per cent, as compared with declines of 0.5 per cent and 0.3 per cent in the first and second quarters respectively. The persistent deterioration in investment is somewhat surprising given the low interest rate environment and may reflect some excess capacity. As economic conditions improve, we anticipate a recovery in investment next year.

The continued appreciation of the euro coupled with weak external demand has not provided a favourable environment for export growth. Annual exports growth declined by 0.1 per cent in the third quarter compared with a reduction of 0.9 per cent in the second quarter and an expansion of 2.4 per cent in the first quarter. Import growth has been sluggish throughout the year and import volumes declined by 0.5 per cent in the third quarter. This largely reflects the deterioration in domestic demand conditions, especially the fall in investment.

The first three quarters of 2003 has seen different growth patterns for the industrial and services sectors. The services sector continues to expand reflecting the less cyclical nature of the sector and this trend is expected to persist. The Reuters *Eurozone Service Sector Business Activity Index* for November saw the highest rate of growth for the sector since October 2000. Trade, transport and communication services grew at an annual rate of 0.7 per cent in the third quarter. Financial services and business activities increased by 0.5 per cent and other services grew by 1.6 per cent. In contrast to the robust performance of the services sector, the industrial sector has been contracting for two quarters. Industrial value added declined by 0.7 per cent in the third quarter and the value added from the construction industry fell by 0.4 per cent. Recent sentiment indicators for the manufacturing and broader industrial sectors suggest that conditions are improving and an upturn in activity is expected in the fourth quarter of this year. The Reuters *Purchasing Managers Index* (PMI) for manufacturing increased to 52.2 per cent in November from 51.3 in October suggesting that strong growth is already occurring in the fourth quarter.

In September the Harmonised Index of Consumer Prices (HICP) for the Euro Area remained unchanged at 2.1 per cent. The preliminary estimates for October suggest the HICP was again 2.1 per cent. Although detailed sub-indices are not available for October, inflation is likely to have been influenced by increases in food prices, especially in unprocessed food prices, due to the hot, dry weather during the summer. The available information with regards to wage developments throughout the Euro Area points to little inflationary pressure from wage growth in the short term. In addition, the forecast continued appreciation of the euro should serve to dampen domestic price pressures. Therefore we anticipate more moderate inflation in the Euro Area averaging 2.1 per cent in 2003 and 1.5 per cent in 2004.

The annual growth of the M3 measure of broad money supply declined further in September to 7.4 per cent, although it remains above the European Central Bank's (ECB) target of 4.5 per cent. At its December meeting, the Governing Council of the ECB decided to leave its main interest rate unchanged at 2 per cent. We forecast that the ECB will begin to gradually tighten monetary policy in the second half of 2004 as economic growth rebounds. However, if the euro were to continue to strengthen this may delay interest rates increases.

The aggregate standardised Euro Area unemployment rate stood at 8.8 per cent in October, unchanged since March. National data for the larger economies show a slight improvement in the German unemployment rate of 0.1 percentage points to 9.3 per cent in October, while the unemployment rate in France increased to 9.6 per cent in October compared to 9.5 per cent in the previous month. Structural reform in Germany should help to reduce the unemployment rate both this year and next. Employment growth in the Euro Area has stagnated during the first half of this year. The latest data reveal annual growth in services employment of 0.7 per cent in the second quarter unchanged from the previous quarter while industrial employment fell by 1.5 per cent in the second quarter compared with a decline of 1.6 per cent in the first quarter. As activity in the labour market generally tends to lag activity in the rest of the economy we do not expect any significant improvements in labour market conditions until next year. We forecast Euro Area unemployment to average 9 per cent this year before moderating somewhat to 8.9 per cent in 2004 as the recovery gains momentum.

Fiscal positions have worsened in the Euro Area with evidence suggesting that France, Germany and Portugal will breach the 3 per cent of GDP deficit ceiling this year. This, in part, reflects lower than anticipated economic growth but also the failure to introduce sufficient consolidation measures in many countries. *The Stability and Growth Pact* (SGP) has recently come under strain again following the Ecofin decision to avoid the disciplinary process against France and Germany. The overall Euro Area general government deficit was 2.2 per cent in 2002 and is likely to be around 0.5 percentage points higher this year with little improvement forecast for 2004.

After weakening somewhat in early November, largely due to better then expected third quarter growth estimates from the US, the euro has been strengthening against the dollar reaching record highs of over $1.22 per euro. Continued uncertainty relating to the size of the US current account and budget deficits together with the mild rebound in activity in the Euro Area economy are all important factors in explaining the rise. It is expected that the euro will continue to rise against the dollar in the short term and this will continue to exert competitiveness pressures on the region, thereby constraining the recovery.

In summary, our forecasts for GDP growth in the Euro Area entail a modest recovery towards the end of this year before the pace of expansion accelerates in 2004. Both fiscal and monetary policy should facilitate the recovery along with the improved global economic outlook. We forecast growth in GDP will be 0.5 per cent in 2003 before rising to 1.6 per cent in 2004.

UK Economy

In comparison to most other European economies, the UK economy has continued to perform robustly throughout the recent international downturn. Following growth of 1.9 per cent in 2002, GDP in the UK economy grew at an annual rate of 2.0 per cent in the second and third quarters of 2003 and 1.8 per cent in the first quarter. Output growth was close to potential in the second and third quarters and previous concerns about the unbalanced nature of UK growth have abated. We are forecasting GDP growth of 2.0 per cent this year, before strengthening to average 2.5 per cent for 2004 as a whole.

Household consumption expenditure increased by 2.5 per cent compared to the same period last year. Retail sales, are also maintaining their buoyancy, and increased by 3.7 per cent on an annual basis in the three months to October. This robust retail sales growth points to household consumption expenditure growth remaining strong. The level of government expenditure is maintaining its rapid growth, expanding by 4.3 per cent in the second quarter compared with 5.0 per cent and 3.9 per cent in the first and second quarters respectively. Growth in gross fixed capital formation has been slowing throughout the year and no growth was recorded in the third quarter with activity contracting by 1.3 per cent on a quarterly basis. The trade balance worsened as exports of goods fell by 4.3 per cent and imports of goods rose by 2.0 per cent. The recent sharp appreciation of sterling against the dollar, to an eleven-year high, if sustained is likely to have a negative effect on the trade balance in the UK.

The strength of the services sector in the UK is confirmed by annual growth of 2.3 per cent in the third quarter. Within this sector, business services and finance grew by 3.0 per cent compared to the corresponding quarter of last year. Government and other services increased by 2.5 per cent and distribution, hotels and catering grew by 2.0 per cent. Transport storage and communications rebounded in the third quarter to record growth, albeit moderate, of 0.1 per cent. The services sector remains the driving force in the economy and although the "two-speed" nature of the economy, discussed in previous *Commentaries*, is still evident, the divergence between the performance of the services and industrial sectors has narrowed somewhat. Survey data suggests continued growth in the sector with the CIPS/Reuters *Business Activity Index* for services rising to 59.6 in November from 59.1 in October, the highest reading since June 1997.

Production output declined by 0.7 per cent in the third quarter compared with a fall of 0.9 per cent in the previous quarter. In the third quarter, manufacturing contracted at an annual rate of 0.4 per cent. However, prospects for manufacturing and the wider industrial sector are improving. The CIPS/Reuters PMI showed that the manufacturing sector expanded for the fifth consecutive month in

November. The headline index was 54.5 in November up from 54.3 in October and this signals the fastest rate of growth since December 1999. Production and new business expanded and firms reported stronger demand, both domestic and foreign, and increased investment spending.

The UK labour market remains in a very healthy state. According to the Labour Force Survey, employment in the three months to September was some 309,000 higher than one year previously. This translates into an employment rate of 74.6 per cent among people of working age, up 0.3 percentage points from the same period last year and very close to its historic high of 75 per cent in the Spring of 1990. The level of unemployment fell in the three months to September compared to the same period last year, leaving the unemployment rate at 5.0 per cent, unchanged from the previous quarter. Following an unemployment rate of 5.1 per cent in 2002, we forecast a slight deterioration in labour market conditions this year with unemployment averaging 5.2 per cent and remaining at that level in 2004.

Inflation as measured by the Retail Price Index excluding mortgage interest payments (RPIX) rose to 2.6 per cent down from 2.8 per cent in September. According to the EU HICP measure, UK inflation stood at 1.4 per cent in October unchanged from the previous month. In its December meeting the Bank of England's Monetary Policy Committee (MPC) decided to maintain the Bank's repo rate at 3.75 per cent following a 25 basis point rise in November. The MPC cited stronger GDP growth than was expected together with the likelihood of underlying inflationary pressures building gradually as demand strengthens and the currency's depreciation feeds through into prices as reasons for the interest rate hike.

An important development for UK monetary policy has been the switch to a symmetric 2 per cent inflation target as measured by the HICP, as used by the European Central Bank (ECB), when setting interest rates. The Bank of England had expressed concerns about this move, citing the problem of the presentation of the change to the public. Currently, the HICP is 1.2 percentage points lower than the RPIX, much of which is due to the rapid house price appreciation, which is included in the latter.

Rest of the World

Along with the US economy, output has been expanding more rapidly than expected in Japan and in much of East and South Asia during most of 2003. Following growth of a mere 0.2 per cent in Japan in 2002, we have revised up our forecasts to 2.2 and 1.5 per cent for GDP growth this year and next. Most of the impetus for this year's revision has been a surge in investment, which has imparted significant momentum to the Japanese economy. Despite a flattening of the headline CPI, deflationary pressures, as measured by the GDP deflator, remain in the Japanese economy. We forecast average deflation to be 0.2 and 0.1 per cent for this year and next respectively.

TABLE 1: Short-term International Outlook

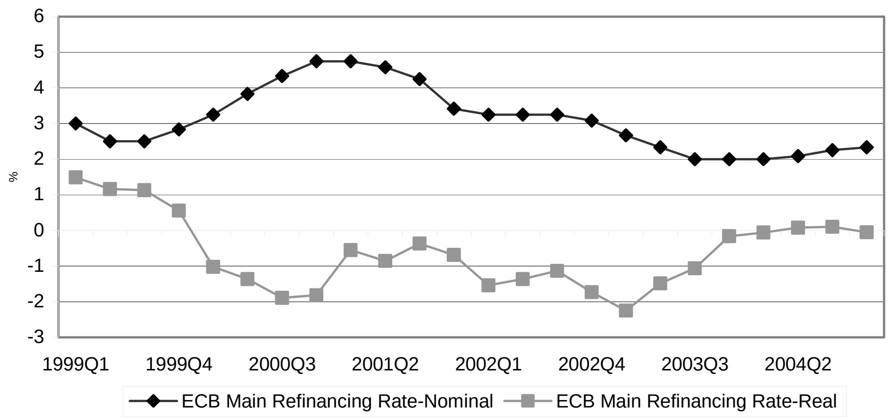
	GDP Output Growth			Consumer Price Inflation			Hourly Earnings Growth			Unemployment Rate %			Current Account Balance % of GNP		
Country	**2002**	**2003**	**2004**	**2002**	**2003**	**2004**	**2002**	**2003**	**2004**	**2002**	**2003**	**2004**	**2002**	**2003**	**2004**
UK	1.9	2.0	2.5	1.6	2.9	3.0	4.0	4.5	4.4	5.1	5.2	5.2	-1.0	-1.1	-1.3
Germany	0.2	0.0	1.4	1.3	0.8	1.0	2.6	2.8	1.3	8.6	9.3	9.0	2.3	1.9	1.5
France	1.2	0.4	1.8	1.9	1.8	1.5	3.4	3.6	3.3	8.8	9.4	9.5	2.1	1.9	1.5
Italy	0.4	0.6	1.4	2.6	2.7	1.9	2.9	3.0	2.8	9.0	8.8	8.6	-0.6	-0.4	-1.0
Euro Area	0.9	0.5	1.6	2.2	2.1	1.5	3.3	3.3	2.6	8.4	9.0	8.9	0.8	0.6	0.4
USA	2.4	3.0	3.8	1.6	2.4	1.3	3.2	3.5	3.5	5.8	6.1	5.8	-4.6	-5.3	-5.2
Japan	0.2	2.2	1.5	-0.9	-0.2	-0.1	-0.9	0.1	0.8	5.3	5.4	5.3	2.5	2.6	2.6
OECD	1.7	2.1	2.7	1.7	2.2	1.4	2.8	3.3	3.2	6.1	6.5	6.3	-1.2	-1.2	-1.3
Ireland	6.9	2.5	3.5	4.6	3.5	2.2	9.0	5.5	3.6	4.4	4.8	5.0	-0.9	-0.4	0.6

Japan's economy has also been supported by external demand, due to its high exposure to Asian markets. Intra-Asian trade has been driven by developments in China, whose exports rose by 22.5 per cent in 2002 and about 30 per cent in the first two quarters of 2003 relative to a year earlier. China's fixed exchange rate regime has allowed it to gain competitiveness, primarily outside Asia, as the US dollar has depreciated. China has seen a strong bounce back in GDP growth after the SARS virus disruption, from 6.7 in the second quarter to 9.1 per cent in the third quarter of this year, which was driven almost entirely by domestic demand. The rise in Chinese domestic demand has raised import demand for goods, especially from neighbouring Asian economies, due to the high level of regional import content of Chinese exports. Most Asian economies export relatively more to China than they import, so the weak US dollar has had a positive impact on total trade growth in Asia despite the more widespread slowdown in world trade.

The strength in China has been mirrored across Asia ex-Japan, albeit not to the same magnitude, with year on year growth in the region as a whole estimated at 6.8 per cent in the third quarter following 3.8 per cent in the second quarter. This is due not only to the release of built up demand following the SARS outbreak but also from strengthening global demand, competitive currencies combined with loose monetary and fiscal policies.

Figure 1: Interest rates

Per Cent per Annum, Quarterly Averages



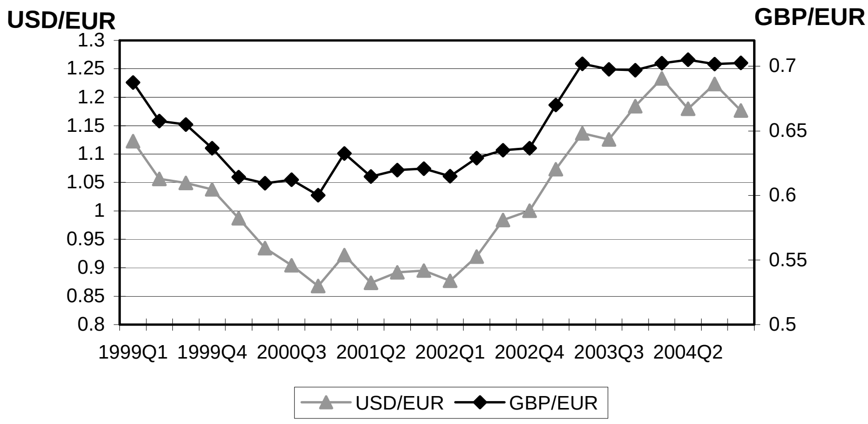
Context for Ireland

The outlook for world growth deteriorated in early 2003, due to a sharp contraction in world trade in the first quarter of the year and a failure to sustain the revival in private sector investment seen in the fourth quarter of 2002. However, conditions improved significantly over the second and third quarters in most regions of the world, with the notable exception of the Euro Area, which is mainly due to the continued exchange rate appreciation. However, despite not keeping pace with many of the other economies, the Euro Area has shown signs of an uptake in economic activity and this strengthening should be consolidated by many of the reforms underway in its major economies.

Prospects for the international economy remain quite good. The most important development has been the resurgence of investment in many of the main economies, which indicates an improving outlook for the short to medium term and makes the current trend of strengthening growth more sustainable. We have revised up our forecasts for the OECD (Organisation for Economic Co-operation and Development) countries, which incorporates the vast majority of our trade partners, to 2.1 and 2.7 per cent GDP growth for this year and next respectively. 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 2: Exchange Rates

Foreign Currency per Euro, Quarterly Averages



However, this exposure also means that the strengthening of the euro, which has recently reached a new high of $1.22 per euro, will continue to exert significant pressures on Irish competitiveness which has been already affected by previous appreciations together with an increasing domestic cost base. The strength of the euro *vis-à-vis* the dollar has not been passed through in recent months to the euro/sterling exchange rate. This is particularly important to the traditional manufacturing sector, which is predominantly exposed to the effects of changes in the bilateral euro-sterling exchange rate. We forecast the euro dollar exchange rate to average $1.20 per euro for the year although significant variation around this rate is expected. We also expect the euro-sterling exchange rate to remain stable in or around its current levels of Stg£0.70 per euro.

The Domestic Economy

General

Quarterly National Accounts for the first half of 2003 show that, although growth improved in the second quarter, the pace of economic growth remains moderate. Furthermore, annual real GNP growth at 2.1 per cent in the first half of the year exceeded real GDP growth of 1.4 per cent. The Quarterly National Accounts for the second quarter also produced, for the first time, a seasonally adjusted series (see Box 1). On the basis of these figures and on other data we have revised our estimates of economic growth in 2003 in volume terms to 2.8 per cent in GNP and 2.5 per cent in GDP. These estimates indicate a much narrower gap between the two measures of economic growth than occurred in 2002. Much more moderate growth in the volume of net factor flows means that we expect the final outcome for this year to show GNP growth exceeding that of GDP.

Box 1: Annualised Growth Rates

The CSO have recently begun to produce seasonally adjusted series of the Quarterly National Accounts. Seasonal adjustment removes the estimated effects of normal seasonal variation from the quarterly estimates of series. Although seasonality is a fundamental part of the quarterly data it can sometimes hinder analysis of series. Movements in a seasonally adjusted series will tend to be smoother then in the original series. Using the quarterly seasonally adjusted growth rates it is possible to produce annualised quarterly growth rates, similar to how national accounts data are reported in the US, Canada and Japan. These annualised quarterly growth rates tell us what growth would be if the present quarterly growth rate were sustained for a year. A rule of thumb for calculating annualised quarterly growth rates is to multiply the quarter on quarter rate by four although this method becomes less accurate for large rates. For accuracy the rate should be compounded by 4. For example, taking this year's second quarter Irish quarter on quarter GDP growth of 2.2 per cent, the annualised figure is derived as $(1 + 0.022)^4 - 1 = 0.093$ or 9.3 per cent.

Table A.1 Comparison of Quarterly Seasonally Adjusted and Annualised GDP Growth Rates

	Ireland		USA	
	Seasonally Adjusted Growth	Annualised Growth	Seasonally Adjusted Growth	Annualised Growth
2000 Q1	0.1	0.4	0.6	2.6
2000 Q2	3.8	16.2	1.2	4.8
2000 Q3	2.3	9.6	0.1	0.6
2000 Q4	4.1	17.6	0.3	1.1
2001 Q1	1.2	4.8	-0.2	-0.6
2001 Q2	-1.0	-4.0	-0.4	-1.6
2001 Q3	0.8	3.3	-0.1	-0.3
2001 Q4	0.5	2.1	0.7	2.7
2002 Q1	5.0	21.7	1.2	5.0
2002 Q2	0.9	3.5	0.3	1.3
2002 Q3	0.9	3.5	1.0	4.0
2002 Q4	0.6	2.3	0.3	1.4
2003 Q1	-1.6	-6.1	0.3	1.4
2003 Q2	2.2	9.3	0.8	3.3

2003 Q3	n.a.	n.a.	2.0	8.2

Table A1 compares quarterly GDP growth rates between Ireland and the USA. Seasonally adjusted growth rates in Ireland are up to four times more variable than those for the USA. The CSO point out that as the quarterly Irish data is only available for a relatively short period of time, and as it deals with a time when there were considerable changes in Irish output, care has to be taken in interpreting movements in the seasonally adjusted series. What is most striking from the Table is the substantial volatility in the annualised quarterly Irish growth rates. Essentially, any economic time series can be decomposed into a cycle, a trend and an irregular component. By seasonally adjusting the data we remove the effects of the cycle but the other factors remain. Annualising quarterly growth rates handles one off or irregular occurrences as though they were happening each quarter which misrepresents the growth rate for that quarter. The Irish GNP series is slightly more volatile then the GDP series, probably due to additional irregularities in the series such as timing issues associated with net factor payments. Consequently, we must be cautious in using annualised growth rates of an economy such as Ireland's for international comparative purposes.

On the basis of an improving international backdrop for the Irish economy in 2004 we expect that GNP growth will measure 3.3 per cent in real terms. With net factor flows starting to grow at a stronger pace we anticipate that the gap between GNP and GDP growth will remain narrow, with GDP projected to grow by 3.5 per cent in volume terms in 2004.

Exports

During the course of 2003 trade statistics were revised to take account of a change in the pattern of distributive trade with Great Britain relating to electrical machinery, appliances and parts. Official figures for the first eight months of the year show that the value of external trade fell by 17.0 per cent when compared with the same period in 2002, while in volume terms the decline was 11.4 per cent. The impact of this re-adjustment masks any slowdown in trade due to a weaker overall economic environment in 2003. The net effect of these factors is that we are continuing to forecast a decline in export volumes this year. Thus, the volume of merchandise trade, adjusted for the Balance of Payments, is estimated to be 6.9 per cent lower this year than in 2002.

Figures for the first half of this year indicate moderate growth in tourism volumes. However, real growth in other service exports is expected to remain low. Taking account of these, the volume of exports of goods and services in 2003 is forecast to fall by 4.2 per cent. Evidence from the export price index and from the manufacturing industries export sales component of the Wholesale Price Index indicate that export prices have fallen and so the price deflator for the export of goods and services is estimated to be negative at -2.9 per cent, implying that the value of exports of goods and services will contract by 7.0 per cent in 2003.

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	-3.3	-7.0	3,792	2.1	3.6	3,930
Manufactured	80,812	1.2	1.7	82,200	-4.2	-7.8	75,755	3.8	5.9	80,207
Other Industrial	5,816	-3.7	-3.4	5,619	-4.3	-6.9	5,232	2.1	3.6	5,422
Other	1,918	3.7	4.0	1,995	-4.5	-6.9	1,858	3.0	4.4	1,940
Total Visible	**92,690**	**0.8**	**1.3**	**93,891**	**-4.2**	**-7.7**	**86,637**	**3.6**	**5.6**	**91,499**
Adjustments	-6,000	-56.6	-55.8	-2,655	90.0	128.0	-6,052	5.0	10.3	-6,673
Merchandise	**86,690**	**4.7**	**5.2**	**91,236**	**-6.9**	**-11.7**	**80,585**	**3.5**	**5.3**	**84,826**
Tourism	3,131	1.8	4.4	3,268	4.3	7.8	3,524	2.6	5.9	3,732
Other Services	23,117	12.2	15.3	26,654	4.1	7.2	28,579	4.5	7.0	30,582
Exports of Goods and Services	**112,938**	**6.2**	**7.3**	**121,158**	**-4.2**	**-7.0**	**112,688**	**3.7**	**5.7**	**119,140**

The impact of the re-adjusted trade figures will not impact on volumes in 2004, as the adjustment finished in the third quarter of 2002. The forecasts for the international economy outlined earlier in this *Commentary* suggest that next year will see stronger economic growth than experienced in 2003. However, the recovery in growth will be slow and the Irish economy will be faced with a stronger euro. Thus, merchandise trade is forecast to grow by 3.5 per cent in volume terms and by 5.3 per cent in value terms. This implies the merchandise export deflator will remain low at only 1.7 per cent.

Competitiveness losses associated with the strong euro mean that we are forecasting lower tourism export growth in 2004 at 2.6 per cent in volume terms. With the volume growth of other service exports remaining broadly unchanged our expectation is that the overall volume of exports of goods and services is forecast to grow by 3.7 per cent. A forecast export price deflator of 1.9 per cent implies value growth for total exports of 5.7 per cent.

Stocks

The Quarterly National Accounts for the first two quarters show that stocks rose by €935 million in volume and by €785 million in value terms. All the sub-components of stock changes are forecast to grow in 2003, resulting in an increase of the overall level of stocks of €304 million. An improving domestic and external environment are forecast to result in a lower increase in stock levels in 2004. Thus, the change in overall stock levels are projected to be €225 million in 2004, due mainly to a decline in the change in farm stocks.

TABLE 3: Stock Changes

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

Investment

Official figures show that the volume of investment contracted in the first half of this year in value and volume terms. However, while investment is expected to contract in 2003 there are some indications that investment activity has started to recover. Registrations of commercial vehicles recorded an increase of 10.2 per cent in the first nine months of the year compared with the same period in 2002. The monthly index of construction employment shows that employment remained steady when compared to the first nine months of 2002. Contrary to our expectations at the beginning of the year, recent Department of the Environment figures confirm that growth in housing supply remains strong and suggest that housing output could reach another new peak this year at over 60,000 units built. However, despite the strength of the housing market, investment in other building and construction is expected to be lower this year. Indicators suggest that machinery and equipment investment will also contract. On the basis of the forecasts for these sub-components we anticipate that, overall, investment activity will decline in 2003 by 1.2 per cent. An estimated price deflator of 6.1 per cent implies that in value terms investment will grow by 4.8 per cent this year.

The growth in housing supply has been very strong in recent years. With slower growth in new house prices and supply meeting projected housing demand it seems unlikely that housing completions will continue to increase at such a pace. We therefore are forecasting a modest reduction in housing completions in 2004. The reduction is expected to be very small and will still leave housing completions at around 60,000. The recovery in economic activity should result in an expansion in investment in other building in 2004. Our expectation is that this sub-sector will record volume growth of 4 per cent. Thus, overall investment in building and construction is forecast to grow in 2004 by 1.5 per cent. With a more modest price deflator than in recent years of 3.4 per cent, the implied growth in the value of investment in building and construction is 4.9 per cent. On the assumption that the economic recovery also provides a stimulus to investment in machinery and equipment, overall investment is forecast to increase by 2.2 per cent in volume terms and by 5.3 per cent in value. This indicates that the price deflator for investment will remain low at 3.1 per cent in 2004.

Consumption

The half-year Quarterly National Accounts show that the volume of personal consumption rose by 2 per cent and the value by 7.1 per cent compared with the previous year, with a price deflator of 5 per cent. Retail sales statistics to September confirm that the moderate growth rate suggested by the national accounts continues. Excluding the more volatile motor trade component of retail sales indicates an underlying growth rate of around 1.6 per cent. On the basis of these figures, personal consumption is forecast to grow by 2.3 per cent in volume terms this year. Coupled with a consumer expenditure deflator of 3.2 per cent this means that the value of personal consumption is estimated to increase by 5.6 per cent in 2003.

With moderate wage growth and some increases in the numbers employed it seems likely that there will be improved growth in personal consumption in 2004. We are forecasting that the value of personal consumption will grow by 5.6 per cent in 2003. A more moderate inflationary environment implies that the personal consumption deflator will be lower, at 2.2 per cent. On this basis the volume growth in personal consumption forecast for 2004 is 3.3 per cent.

Data in the Quarterly National Accounts also indicates that the growth in public spending remains moderate, growing by 3.2 per cent in volume terms and by 8.1 per cent in value terms when compared with the first half of 2002. This indicates that the public expenditure deflator is around 5.0 per cent. Official figures would indicate control has continued to limit growth in public spending this year and so it is estimated that public spending will grow by 9.3

TABLE 4: Gross Fixed Capital Formation

	2001 €m	% Change in 2002 Volume	% Change in 2002 Value	2002 €m	% Change in 2003 Volume	% Change in 2003 Value	2003 €m	% Change in 2004 Volume	% Change in 2004 Value	2004 €m
Housing	9,541	5.1	13.3	10,809	7.5	16.5	12,596	-1.0	3.5	13,032
Other Building	8,568	5.0	7.5	9,212	-4.5	-1.4	9,079	4.0	6.9	9,707
Building and Construction	18,109	5.0	10.6	20,022	1.2	8.3	21,676	1.5	4.9	22,739
Machinery and Equipment	8,858	-2.6	-2.6	8,627	-4.5	-3.1	8,362	3.2	6.5	8,906
Total	26,967	1.7	6.2	28,649	1.2	4.8	30,038	2.2	5.3	31,644

per cent in value terms. With the increase in the public expenditure deflator remaining at 5.1 per cent, the forecasted volume growth in public spending is 4.0 per cent in 2003.

The forecasts contained in the Public Spending Estimates and Budget indicate that control is expected to be maintained over public spending in 2004. Thus, the value growth in public spending is forecast to be around 7.5 per cent. With an increase in the public expenditure deflator, taking account of public service benchmarking pay awards forecast at 5.8 per cent in 2004, this implies a volume increase of just 1.6 per cent.

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	5.6	5.6
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	1.8	1.4
Consumption Volume							
Personal Consumption	7.6	9.3	8.5	5.5	2.7	2.3	3.3
Retail Sales Index, Volume	8.1	9.5	11.9	3.1	0.7	1.5	2.5
Divergence	-0.5	-0.2	-3.4	2.4	2.0	0.8	0.8
Consumer Prices							
Personal Consumption Deflator	3.8	3.0	4.2	4.3	6.0	3.2	2.2
Retail Sales Index Deflator	1.6	1.7	3.9	2.7	3.2	2.3	1.7
Consumer Price Index	2.4	1.6	4.5	5.6	4.6	3.5	2.2

Final Demand

The revision to our forecasts now mean that we anticipate that final demand will have contracted by 1.4 per cent in volume in 2003. With a moderate price deflator of just 0.6 per cent this indicates that the value of final demand also contracted by 0.8 per cent. While the contraction in investment activity will have contributed to this decline the main factor was the large revision to trade flows that occurred during the course of the year. Domestic demand, excluding stocks, is estimated to have risen by 1.6 per cent in volume terms.

The revisions to trade data are not expected to have an impact in 2004 and so final demand is forecast to grow by 3.2 per cent in real terms. An increase in the price deflator to 2.5 per cent implies that, in value terms, domestic demand will grow by 5.7 per cent in 2004. The forecasts outlined in this *Commentary* result in domestic demand growing by 2.6 per cent in volume terms.

TABLE 6: Imports of Goods and Services

	2001 €m	% Change in 2002 Volume	% Change in 2002 Value	2002 €m	% Change in 2003 Volume	% Change in 2003 Value	2003 €m	% Change in 2004 Volume	% Change in 2004 Value	2004 €m
Capital Goods	7,534	-8.5	-6.9	7,013	-3.5	-6.9	6,530	3.5	4.5	6,827
Consumer Goods	12,447	-0.1	1.7	12,662	-4.5	-6.6	11,826	3.3	4.6	12,376
Intermediate Goods:										
Agriculture	942	4.9	-0.4	938	-8.0	-12.4	822	2.0	3.5	851
Other	34,348	2.1	-5.1	32,612	-9.6	-15.0	27,713	2.8	4.5	28,973
Other Goods	2,114	13.5	7.8	2,279	-7.0	-12.8	1,988	2.4	3.7	2,062
Total Visible	**57,384**	**0.7**	**-3.3**	**55,505**	**-7.5**	**-11.9**	**48,879**	**3.0**	**4.5**	**51,088**
Adjustments	-1,187	9.6	8.0	-1,283	100.0	200.0	-3,848	5.0	5.0	-4,040
Merchandise Imports	**56,197**	**0.5**	**-3.5**	**54,222**	**-10.1**	**-16.9**	**45,032**	**2.8**	**4.5**	**47,048**
Tourism	3,206	11.7	23.5	3,958	6.2	8.5	4,296	2.3	4.4	4,487
Other Services	36,299	4.1	7.0	38,834	-2.0	-1.0	38,438	2.3	3.4	39,755
Imports of Goods and Services	**95,702**	**2.3**	**1.4**	**97,014**	**-6.2**	**-9.5**	**87,765**	**2.6**	**4.0**	**91,289**

Imports

Import trade data have also been revised as outlined above in the presentation of our forecasts for exports. Second quarter national accounts show that imports of goods and services contracted by 12.4 per cent in volume. External trade data to September indicates that import volumes have continued to contract. Thus, the volume of merchandise imports are estimated to decline by just over 10 per cent in 2003. Tourism imports are forecast to grow by 6.2 per cent in volume and other service imports estimated to have contracted, reflecting subdued economic activity, by 2.0 per cent in volume. Thus, total imports of goods and services are estimated to have declined by 6.2 per cent in value terms in 2003. With the value of imports also expected to decline in 2003 by 9.5 per cent this indicates that import prices will fall by 3.6 per cent this year.

With some recovery in domestic economic activity on the back of stronger world economic growth, it is forecast that there will be some moderate increase in import volumes. Given our expectation that there will be a return to growth in investment in plant and machinery and that consumer spending and industrial production will continue to grow, merchandise import volumes are forecast to increase by 2.8 per cent and by 4.5 per cent in value terms in 2004. With tourism and other service imports expected to show more moderate growth in 2004 total imports of goods and services are forecast to grow in volume terms by 2.6 per cent. We forecast that the value of total imports will increase by 4.0 per cent, implying that the import price deflator is forecast to be 1.4 per cent next year.

Balance of Payments

The forecast for imports and exports already discussed in this *Commentary* indicate that the value of the surplus on trade in goods and services will expand by 3.2 per cent in value terms to €24.9 billion in 2003, a moderate growth rate when compared to recent years. For 2004 the underlying merchandise and service trade forecasts imply that the surplus will grow by 11.7 per cent in value to €27.9 billion.

Slow domestic activity has resulted in a contraction in debit flows in 2003 of 1.2 per cent in value, primarily due to a decline in distributed profits and in other debit flows. Credit flows are estimated to have continued to grow, albeit in some cases the rate of growth has been marginal. Overall credit flows are estimated to have grown by 2.1 per cent in value in 2003. The result of these growth rates is that the value of net factor flows is estimated to have fallen by 4.8 per cent in 2003. The impact of this is evident from the national accounts table for 2003, which shows GNP growing at a faster rate than GDP. On the basis of these forecasts, we estimate that the current account deficit will be in the region of €440 million in 2003.

With both debit and credit flows growing in 2004 net factors flows are projected to grow by 4.7 per cent in value. The balance on the current account is forecast to improve in 2004 to a surplus of €720 million. This is the equivalent of 0.6 per cent of GNP.

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	-1.6	37,758	7.0	40,411
Adjustments	-4,813		-1,372		-2,205		-2,633
Merchandise Trade Balance	**30,493**	**21.4**	**37,014**	**-3.9**	**35,553**	**6.3**	**37,778**
Service Trade Balance	-13,257	-2.9	-12,870	-17.4	-10,630	-6.6	- 9,928
Trade Balance in Goods and Services	**17,236**	**40.1**	**24,144**	**3.2**	**24,923**	**11.7**	**27,850**
Total Debit Flows	-50,524	6.4	-53,749	-1.2	-53,106	3.6	-55,002
Total Credit Flows	32,229	-13.6	27,834	2.1	28,428	2.6	29,157
Net Factor Flows	**-18,295**	**41.7**	**-25,915**	**-4.8**	**-24,678**	**4.7**	**-25,846**
Net Current Transfers	**302**	**170.5**	**817**	**-183.8**	**-684**	**87.7**	**-1,284**
Balance on Current Account	**-757**		**-954**		**-439**		**720**
Capital Transfers	703	-18.1	576	-7.6	**532**	-9.8	480
Effective Current Balance	**-54**		**-378**		**93**		**1,200**

Gross National Product

The slowdown in net factor flows means we estimate that real GNP growth at 2.8 per cent exceeded real GDP growth at 2.5 per cent in 2003. Gross National Disposable Income (GNDI), a measure of the overall average rise in living standards, increased by 3.6 per cent in volume.

Both GDP and GNP growth are forecast to grow broadly in line next year at around 3.3 per cent, with GNDI increasing by 2.5 per cent. Our forecasts for economic growth have been revised upwards on the basis of the Quarterly National Accounts showing a stronger performance by the Irish economy in the first half of 2003 than we had previously anticipated.

Agriculture

Provisional estimates suggest that agricultural incomes, before deductions for interest and land rental (operating surplus), increased by 2.2 per cent in 2003 following a decline of 8.4 per cent in 2002. This increase is very modest given that the deductions for interest and land rental are quite sizeable for the sector. The main drivers of the increase were the value of cattle output, which increased by 5.5 per cent or €64 million, and the value of crop output, which increased by 4.5 per cent or €50 million. Over the year, net subsidies decreased by 2.2 per cent or €35 million. This meant that for 2003 as a whole it is estimated that net subsidies accounted for 63 per cent of operating surplus as opposed to 65.8 per cent in 2002.

Agriculture has performed very poorly in the last number of years. Figures from the National Income and Expenditure Accounts show that the value added from agriculture, forestry and fishing in 2002 was almost identical to that in 1995, underlying the weakness in the sector, which is likely to continue. We estimate that following contraction of 3.2 per cent in 2002, the volume of gross output increased by 4.7 per cent in 2003. We expect contraction to return to the sector in 2004 where we forecast gross output to decline by 8.9 per cent. Decoupling, which has been described in previous *Commentaries*, is likely to impinge significantly on farm incomes, at least in the short run.

The main problem facing agriculture for much of 2003 has been that of shrinking margins. Preliminary estimates show that input prices increased by 2.4 per cent from 2002 levels while output prices decreased by 0.8 per cent. The terms of trade index decreased by 3.1 per cent, thereby indicating an unfavourable price movement for farmers over the course of the year. Increases in the price of energy, veterinary expenses and fertilisers were the main impulses in the increase in input prices whereas falling livestock and milk prices accounted for the decrease in output prices. This trend has appeared for the last number of years and will no doubt put added pressure on an already weak sector of the economy.

Industry

Estimates from the National Income and Expenditure Accounts indicate that 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. Growth has slowed down significantly in 2003 however, with the Quarterly National Accounts for the first and second quarters of the year showing moderate annual real growth of 0.8 and 1.1 per cent respectively. For the first time, the Quarterly National Accounts produced an official seasonally adjusted series. The seasonally adjusted series are quite volatile and possibly reflect the fact that the seasonal factors used in the process of seasonal adjustment are based on a period of unprecedented growth in the Irish industrial sector. Despite this, the series shows that the volume of industrial production actually contracted by 0.6 per cent in the first quarter compared with the previous quarter but has rebounded in the second quarter, increasing by 3.9 per cent.

The latest *Industrial Production and Turnover* release shows that the volume of production was up by 2.5 per cent in the 12 months up to the first quarter of this year and by 2.6 per cent in the twelve months to the second quarter. Annual growth in the third quarter strengthened somewhat to 6.2 per cent. This strengthening is also reflected in survey data, which has shown the third successive month of expansion in the sector. In particular, the NCB's PMI for manufacturing was 52.8 on a seasonally adjusted basis up from 52.5 in October where a figure greater than 50 indicates expansion. The latest figures indicate that business conditions improved in the sector faster than at any rate in the previous 16 months reflecting robust growth of output and new orders as the international economy strengthened. With regards employment, this component of the index showed only a marginal increase for the sector in November. This underlines the remaining weakness in the sector, which has been hit hard by an appreciating currency and where a full recovery is still a long way off. The forward-looking components of the IBEC-ESRI *Monthly Industrial Survey* reflect this uncertainty with all the expectations components slightly down in the latest October report.

We estimate that gross output in industry will increase by 1.5 per cent in volume terms this year. Due to the continued recovery in the international economy, as seen in the second half of this year, we forecast gross output in industry to increase by 3.0 per cent in 2004.

Services

Estimates from the latest Quarterly National Accounts suggest that output in the services sector increased by 4.6 per cent in volume terms in 2002. This is compared to the robust growth rates of 8.5 per cent and 7.9 per cent recorded in 2000 and 2001 respectively. Activity has slowed throughout 2003 but it continues to expand at a more rapid pace than the industrial sector, probably reflecting the less cyclical nature of the sector. The latest Quarterly National Accounts indicate that the annual volume growth in services was 2.3 per cent in the second quarter of 2003 compared to an increase of 3.1 per cent in the first quarter. On a quarterly basis, the sector contracted by 4.8 per cent and expanded by 2.3 per cent in the first and second quarters although smother growth of 0.2 per cent and 0.4 per cent was recorded for the first two quarters on a seasonally adjusted basis.

Within the services sector, a marked slowdown has occurred in the distribution, transport and communications sector. This sector had been one of the fastest growing in recent years, but growth slowed to 3.9 per cent in 2002 following growth of 10.3 per cent in 2001. The Quarterly National Accounts confirm this slowdown has continued in 2003 with annual growth in the second quarter of 1.9 per cent compared to 2.7 per cent in the first quarter. Following moderate annual growth of 0.5 per cent in public administration and defence, the sector contracted by 0.9 per cent in the second quarter relative to the same period a year earlier. Other services growth moderated somewhat from 3.6 per cent in the first quarter to 2.9 per cent in the second quarter.

Prospects for the services sector are improving, as can be seen by survey evidence contained in the NCB *Monthly Report on Services. The Business Activity Index* increased to 59.5 per cent in November from 57.3 per cent in October signalling the highest rate of expansion since April and the sixth successive month of growth. The index suggests that confidence, new business, and employment are increasing. However, rising input costs and charges are becoming a cause of concern, with higher fuel and energy costs and wage pressures having the highest impact on costs.

Given our forecasts for personal consumption and personal disposable income growth, the demand growth for services in the Irish economy is likely to continue in 2003, albeit at a more moderate rate then before. We expect the volume of gross output in the sector to increase by an average of 3.3 per cent in 2003. However, with upwards revisions in our level of expected economic activity next year, we are forecasting higher growth in the volume of services output at 3.7 per cent for 2004 as a whole.

Employment

The Quarterly National Household Survey (QNHS) for the third quarter of 2003 shows that the slowdown in the economy is starting to impact on the labour market. The unemployment rate rose to 5.2 per cent in the third quarter of 2003 as compared with 4.8 per cent in the second quarter and 4.4 per cent for the whole of 2002. The seasonally adjusted unemployment rate showed a more moderate increase at 4.9 per cent in the third quarter up from 4.6 per cent in the previous quarter. In absolute terms there were 98,900 unemployed in the third quarter of 2003, a significant increase of 17,500 from the previous quarter and an increase of 12,200 on an annual basis.

Employment in the Irish economy grew on an annual basis by 1.4 per cent in the third quarter as compared to growth of 1.6 per cent in the second quarter. In absolute terms, this represents an increase of 26,000 persons to 1.82 million persons employed. However, two-thirds of the annual increase can be attributed to increases in part-time employment, a marked trend evident in the second quarter when it accounted for 44 per cent of the annual increase. The bulk of the increase in part-time employment occurred in the health and hotels and restaurants sectors. This shift 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. In fact full-time employment increased by 0.6 per cent on an annual basis in the third quarter. Females accounted for 65 per cent of the annual increase in employment with the number of married women with a job increasing by just under 15,000.

TABLE 8: Employment and Unemployment*

	Annual Averages			
	2001	**2002**	**2003**	**2004**
Agriculture	123	121	115	112
Industry	504	494	492	499
Services	1,114	1,150	1,182	1,194
Total at Work	**1,741**	**1,765**	**1,789**	**1,805**
Unemployed	71	82	90	96
Labour Force	**1,812**	**1,847**	**1,879**	**1,901**
Unemployment Rate %	3.9	4.4	4.8	5.0
Live Register	142	163	173	186

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

Most of the employment increase occurred in sectors like health (+14,000), construction (+7,000) and hotels and restaurants (+7,700). A substantial fall in industrial employment was recorded with the numbers employed in other production industries, which is predominately manufacturing, declining by 9,600. In addition, agriculture and transport, storage and communications all saw an absolute decline compared to the same period last year. After adjusting for seasonal factors the largest quarterly increases were in health (+4,000) and construction (+2,600) while the most significant fall in employment was in other production industries (-8,800).

Labour force growth strengthened in the third quarter and increased by 2.0 per cent following annual growth of 1.8 per cent in the second quarter. In absolute terms this was an increase of 38,200 persons. Demographic factors, including changes in the age structure of the population and an increase of the population of working age contributed around 90 per cent to the growth in the labour force. The remainder of the increase, approximately 3,100, came from changes in participation rates. The participation rate increased by 0.2 percentage points to 61.2 per cent in the third quarter compared to the same period last year. However, the participation rate fell for the second consecutive quarter for those aged 20 to 24 years.

Overall, conditions in the labour market have deteriorated, albeit more moderately then previously anticipated. The latest *Live Register Analysis* for November 2003 indicates that the register increased by 5,800 on a seasonally adjusted basis or by 5,905 in annual terms. The seasonally adjusted increase in the Live Register confirms the weakening in labour market conditions. However, many headline statistics on the labour market continue to mask important features observable at present such as the shift from full-time to part-time employment and the reduction in hours worked which was 37.4 hours in the third quarter compared to 37.8 in the same period last year. These factors are indicative of excess capacity in the economy.

It is estimated that employment growth will average 1.4 per cent in 2003 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 anticipate more balanced employment growth between the industrial and services sectors. Overall employment growth of 0.9 per cent is forecast for 2004. Labour force growth is expected to remain more moderate than in previous years and we forecast growth of 1.7 and 1.2 per cent in 2003 and 2004 respectively. It is expected that unemployment will increase further in the remainder of this year and we expect it to average 4.8 per cent this year before rising in the first half of next year to average 5.0 per cent for 2004 as a whole.

Incomes

The continued below potential growth in the economy has served to significantly depress income growth compared to rates experienced throughout much of the boom period. Despite the more positive outlook for an economic recovery in the short term, the timing of such a recovery and its impact on incomes remain uncertain. This is particularly the case for hourly earnings growth, which is likely to remain quite moderate as a slack labour market continues to hold wage growth at rates well below those of recent years. Following hourly earnings growth of 9.0 per cent in 2002, we forecast growth of 5.5 per cent in 2003 before moderating further to 3.6 per cent in 2004 as the economy adjusts to a lower inflationary environment.

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	7.4	3,706	53,620	4.7	2,535	56,155
Other Non-Agricultural Income	14,916	8.7	1,297	16,213	-2.7	-435	15,778	8.8	1,396	17,174
Total Income Received	**64,977**	**6.6**	4,305	**69,282**	**4.9**	**3,376**	**72,658**	**5.6**	**4,061**	**76,719**
Current Transfers	11,384	16.7	1,899	13,283	9.3	1,236	14,519	8.2	1,194	15,713
Gross Personal Income	**76,361**	**8.1**	**6,203**	**82,565**	**5.6**	**4,612**	**87,177**	**6.0**	**5,255**	**92,432**
Direct Personal Taxes	14,835	1.3	198	15,033	4.4	655	15,688	6.4	999	16,687
Personal Disposable Income	61,526	9.8	6,005	67,532	5.9	3,957	71,489	6.0	4,256	75,745
Consumption	55,202	8.9	4,917	60,118	5.6	3,351	63,469	5.6	3,537	67,006
Personal Savings	6,325	17.2	1,088	7,413	8.2	6.7	8,020	9.0	719	8,739
Savings Ratio	10.3			11.0			11.2			**11.5**

Incomes in the agricultural sector fell by 5.7 per cent in 2002. This was due to a combination of bad weather conditions and ever reducing margins. Income growth for the sector is expected to be 3.3 per cent this year before strengthening marginally to 4.0 per cent in 2004. However, we expect that decoupling will have a negative impact on agricultural incomes.

We expect growth of the non-agricultural wage bill to moderate in the short term, reflecting a slackening in the demand for labour. Given our hourly earnings and employment growth forecasts, we predict that following growth of 6.8 per cent in 2002, the non-agricultural wage bill will increase by 7.4 per cent this year and 4.7 per cent in 2004. Other non-agricultural incomes, which mainly represent personal income from profits and rents, are estimated to fall by 2.7 per cent in 2003 as a result of the slowdown in general economic activity before strengthening to 8.8 per cent in 2004.

Following extraordinary growth of 42.4 per cent in 2002, we expect volume growth of net factor payments to slow substantially in 2003 to around 1.3 per cent. We forecast stronger growth of 4.2 per cent in 2004. This will result from the rebound in economic activity, which will boost the profits of many of the multinationals located within Ireland and therefore increase repatriations, which make up the vast majority of net factor payments.

Consumer Prices

Official figures, available for the first eleven months of the year, show that inflation moderated considerably during the year. In January the annual rate of inflation stood at 4.8 per cent. By November this had fallen to 2.2 per cent. We are now estimating an annual average of 3.5 per cent for this year. The moderation in the inflation rate has been due primarily to the strength of the euro in 2003. However, there has also been some slowdown in the rate of price increase in many of the non-traded sectors of the economy, while retail competition has also contributed to lower price growth. Furthermore, lower interest rates reduced the cost of the housing component on an annual basis.

Given the currency assumptions underlying the forecast in this *Commentary*, an annual average increase of 2.4 per cent in non-housing prices is projected for 2004. With some rise in interest rates likely towards the end of next year, the housing element of the consumer price index is forecast to rise by 0.8 per cent on an annual average basis. Thus, the total consumer price index is forecast to increase by an average of 2.2 per cent in 2004. Of course, if the appreciation of the euro proves to be stronger than assumed, the annual rise in the consumer price index could be substantially lower.

From an EU perspective, inflation is measured using the Harmonised Index of Consumer Prices (HICP), allowing international comparisons within the EU. The EU measure excludes mortgage interest, building materials, motor car and motor cycle taxation, society subscriptions, and the non-service elements of house and car insurance. These items are included in the CPI and so the HICP represents just under 91 per cent of total CPI expenditure.

The exclusion of mortgage interest means that interest rate cuts during 2003 did not impact on the HICP and so an annual average increase of 4.3 per cent is forecast in 2003. The rate of price increase, as measured by the HICP is forecast to be 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	-0.5	0.8
Other	5.4	4.0	5.0	4.2	2.4
Total CPI	5.6	4.9	4.6	3.5	2.2
EU-HICP (Ireland)	5.2	4.0	4.7	4.3	2.5
Index Dec. 2001 100					
Housing	88.2	102.7	103.7	103.1	103.9
Other	93.6	98.7	102.6	106.9	109.4
Total CPI	92.7	97.9	102.7	106.3	108.7

Public Finances

The deteriorating trend in the public finances continues from the exceptionally high surpluses of a few years back to fairly modest deficits for this year and next. However, the deterioration is in line with the downturn in the economy and does not indicate that the public finance position is unsound. The Stability Programme Update that accompanies Budget 2004 indicates that the projection for the general government balance is for deficits to arise over the period 2004 to 2006. On a cyclically adjusted basis the Stability Update has the general government finances at close to balance by 2006 when the economy is back at it potential growth levels. It remains the case that when measured by the debt to GDP ratio, the Irish debt burden is expected to remain among the lowest within the EU hovering at around 33 per cent.

In this scenario, Ireland in contrast to other EU states is not expected to have difficulty in complying with the criteria in the *Stability and Growth Pact* for both fiscal deficit and debt positions over the medium term. As we stressed in previous *Commentaries*, the nature and scale of the economy means that a significant safety margin should prudently be maintained to ensure that a significant downturn in economic activity or sharp disinflation would not push the public finances beyond the deficit limits. The general government deficit ratios are expected to be in the order of 1 per cent of GDP which would constitute an adequate safety margin.

The opening position for the recent Budget 2004 was a deficit of €2.5 billion for the Exchequer balance and in the order of €1.0 billion for the general government balance. The main measures contained in Budget 2003 are outlined in Box 2 below. The post-Budget outcome is expected to result in the Exchequer balance declining by around €300 million from the opening position.

Box 2: Summary of Measures Contained in Budget 2004

Overall, Budget 2004 appears to be a consolidating one in terms of the overall macroeconomy and the public finances position is expected to remain stable. Similar to Budget 2003, the changes in direct taxation were very modest. In terms of personal taxation there were no changes in income tax rates or the standard income tax bands. There was an increase in the employee tax credit from €800 to €1,040 per annum while the exemption limit for persons aged 65 and over increased from €15,000 to €15,500 (single) and €30,000 to €31,000 (married couple). The combined cost of these two measures in 2004 is estimated to be €223 million.

The non-indexation of the bands means that this is an effective tax rise when expected wage growth is accounted for. The PRSI ceiling increased from €40,420 to €42,160 or by 4.3 per cent. Budget 2004 also introduced a tax credit for incremental R&D expenditures by companies. Under this proposal 20 per cent of these expenditures can be set aside against corporation tax. This will reduce tax revenues by €18 million.

Changes in indirect taxes were also limited in contrast to the last two budgets. The VAT-inclusive excise duty on cigarettes was increased by 25 cent per packet of twenty. On petrol and diesel, the VAT-inclusive excise duty was increased by 5 cent per litre. These increased excise duties are estimated to boost revenues by €243 million in 2004. These modest increases in indirect taxes are likely to have less of an impact on inflation than previous budgets and are likely to add only 0.4 percentage points to the consumer price index.

The expenditure measures contained in Budget 2004 allowed for an increase in gross spending on public services of just under 7 per cent, bringing it just over €41,117 million. Budget day measures accounted for a sizeable proportion of this increase. In particular, Social and Family Affairs received an extra €608 million on their pre-Budget estimate. This was mainly due to increases in social welfare and pension payments, costing €518 million, and child benefit payments costing €61 million.

Overall, the measures contained in Budget 2004 are estimated by the Department of Finance to lead to a current surplus of nearly €3 billion and a capital deficit of €5.8 billion. Therefore, the Exchequer deficit being targeted is in the region of €2.8 billion and a General Government deficit of €1.6 billion.

The budgetary measures, when taken in line with the expenditure increases outlined in the *Public Services Spending Estimates*, are expected to have a very modest impact on the Irish economy in 2004. The *Estimates* along with the Budget expenditure increases provide for an 8.3 per cent increase in net current expenditure. In terms of voted current expenditure we expect an outturn of 7.5 per cent in 2004 with stronger growth in the non-voted central fund of 15 per cent. We expect that net voted capital expenditure in 2004 will rise by around 3 per cent. The inclusion of a multi-annual capital investment over the period 2004-2008 gives the necessary infrastructural investment a more focused and planned approach and is a welcome development. This Budget, in contrast to recent years, has also avoided innovations on timing changes for taxes and shifting funds between general government areas.

On the basis of the *Exchequer Returns* to November, which showed strong revenue growth, our revised forecast is for an Exchequer deficit in 2003 of €1.4 billion. The broader measure, the General Government Balance, which includes the contributions to the National Pension Reserve Fund and the Social Insurance Fund, is expected to be in deficit of around €500 million or 0.4 per cent of GDP in 2003. The General Government Debt to GDP ratio is estimated to be 33 per cent in 2003. The deterioration in the public finances is much less pronounced than would be expected given extent of the economic slowdown. The unexpected boost to tax revenues from capital taxes was a very significant factor in this regard.

We expect overall tax revenue growth of 4.3 per cent in 2004 boosted by improved economic activity. The impact of *Benchmarking* and *Sustaining Progress* wage increases along with a part-time work directive decision will result in the public sector pay bill in 2004 rising by €1.1 billion or by 8.4 per cent. Given our growth forecast, the Exchequer balance for 2004 is projected to be close to €3 billion. We forecast that the more significant general government balance will be in deficit of €1.76 billion or 1.2 per cent of GDP.

TABLE 11: Public Finances

	2002 € million	% Change	2003 € million	% Change	2004 € million
Current Revenue	31,525	4.3	32,874	3.9	34,150
Current Expenditure	26,123	10.4	28,831	8.4	31,250
Current Surplus	5,402	-25.2	4,043	-28.3	2,900
Capital Receipts	1,561	-14.2	1,339	- 6.6	1,250
Capital Expenditure	6,868	-0.7	6,823	3.8	7,083
Capital Borrowing	5,307	3.3	5,484	6.4	5,833
Exchequer Balance	95		-1,441		-2,933
as % of GNP	0.1		-1.3		-2.4
General Government Balance	-246		-525		-1,762
as % of GDP	-0.2		-0.4		-1.2
Gross Debt as % of GDP	32.4		33.0		32.7

General Assessment

Given the prevailing economic uncertainty that has affected the international economy throughout the last three years, the Irish economy has proved to be remarkably resilient. While unemployment has risen from its historical lows, the rate of unemployment is likely to have averaged below 5 per cent in 2003. There are definite signs that the international economy has embarked upon a strong recovery and the economic prospects for Ireland have consequently improved over the course of 2003.

The prospects for a sustained international recovery in 2004 are good, particularly in the US and Asia. While growth within the EU economies may lag somewhat behind, the prospects here too are very positive and world trade growth in 2004 may be the highest since the exceptional performance of 2000. For an export-oriented economy like Ireland this bodes well for growth. Irish cost competitiveness, as measured by the trade-weighted effective real exchange rates has, however, deteriorated substantially in recent years due to a combination of an appreciating currency and a rising domestic cost base.

We estimate that the economy will have grown in real GDP terms at 2.5 per cent in 2003. The exceptional growth experienced in net factor income flows, that drove such a dramatic wedge between GDP and GNP measures in 2002, is not being repeated. Accordingly, we have revised upwards significantly our real GNP growth estimate to 2.8 per cent for 2003. We expect that this growth rebound will continue into 2004, but that competitiveness pressures will remain as the currency appreciates further and Irish inflation remains higher than that in our main trading partners. We expect output growth in the order of 3.5 per cent in 2004, still below the Irish economy's potential level. The second quarter national accounts, which for the first time include seasonally adjusted growth estimates, would indicate that Irish quarter on quarter annualised output growth was over 9 per cent for real GDP terms and near 10 per cent for real GNP. Annualisation must be interpreted with caution given that it amplifies underlying trends but it demonstrates that Irish growth performance is steadily improving from the exceptional divergence in output growth measures in 2002 when real GDP grew at 6.9 per cent and real GNP came to a standstill at 0.1 per cent.

Consumer price inflation, which had appeared endemic in recent years, has ratcheted down towards more competitive rates. The combination of the pass-through from the sharp appreciation of the currency into traded prices, the more modest wage settlements feeding into non-traded prices and the decline in interest rates have offset the short-term impacts of higher administered prices and indirect tax increases to bring down considerably the annual average rate of consumer price inflation.

Notwithstanding the improving trend, even low inflation rates will threaten competitiveness given that the Irish price level is already the joint highest with Finland within the Euro Area. Ireland still continues to have the highest inflation rate, as measured by the directly comparable EU Harmonised Index of Consumer Prices (HICP), and so will have the highest price level among common currency members. The HICP measure is currently higher in Ireland than the more widely watched consumer price index (CPI) measure. The CPI includes mortgage costs, which are excluded from the HICP measure, and so is currently lower as a consequence of European Central Bank interest rate cuts earlier in 2003. Contrary to popular perception, consumer price indices are not designed as a cost-of-living index but rather give a comparison over time and between countries of changing prices. In this context, the comparison between countries might be better served by putting greater emphasis on the HICP measure than before. The absence of mortgage costs from this index need not be an overwhelming objection particularly if greater use of fixed-rate mortgages is encouraged to dampen potential volatility in the housing market. The UK, for instance, has decided in its December 2003 Pre-Budget Report to adopt the EU HICP rate as its inflation target. A directly comparable metric can be a sensible aid to highlighting the competitiveness impact of higher inflation. Greater attention to the HICP measure in Ireland is warranted.

Concern over the direct contribution to consumer price inflation from Government imposed indirect tax rises was an important consideration for Budget 2004. The modest increases in excise duties and no changes in value-added taxes in Budget 2004 will impart a direct 0.4 percentage point rise in inflation next year. This direct budgetary induced increase is significantly smaller than the rises imparted in the two previous budgets. As a consequence of VAT rises coming into effect in March 2002 then followed by a further rise in January 2003, the carryover base effect for the first two months of 2004 is likely to be quite significant. Inflation in January/February 2004 is therefore likely be around 2 per cent or below providing a low inflationary backdrop for renewed social partnership wage negotiations in the Spring. The emerging trend in shifting the burden of revenue raising to local authorities is also likely to push up inflation as a range of administered price rises are expected in 2004. The impact, however, may not be too great for measured inflation as the weight of such local authority charges in the consumer basket is small.

In addition, to its focus on limiting its inflationary impact, Budget 2004 consolidated the control on public expenditure growth re-established in the latter half of 2002. Growth of public spending in the range of 6-8 per cent per annum should prove to be sustainable for the projected growth in the Irish economy over the medium term.

The redistributive impact of the budgetary measures is progressive by favouring those on lower incomes with social welfare increases and tax credit rises, as Callan *et al.,* indicate in an article contained in this *Commentary*. The non-indexation of tax bands will boost revenue but with unchanged tax rates a widening of the tax base would still be desirable. The extension of a range of tax relief schemes continues to militate against this tax base widening.

The impact of the budgetary changes and the estimates for public sector expenditure for 2004 reveal a broadly balanced stance for fiscal policy. This fiscal stance is appropriate for the underlying macroeconomic conditions faced by Ireland. The return to higher economic growth, particularly in GNP terms, should deliver revenue growth in line with expenditure growth such that the public finances need not be a constraining factor over the medium-term. A more immediate threat to the public finances is the impact of a sharp disinflation arising if the euro continues to appreciate strongly over the next year.

As previous *Commentaries* have stressed, the budgetary process needs to ensure sensible funding of capital investment growth by putting in place mechanisms to keep higher yielding expenditure, such as on infrastructure, immune from cyclical developments in the public finance position. The move to introduce five-year capital expenditure envelopes and the commitments to keep annual public investment at around 5 per cent of GNP out to 2008 is a welcome development from Budget 2004. The broad thrust of the reprioritisations contained in the *Mid-term Evaluation of the National Development Plan* produced by the ESRI is also contained within the spending plans for future years.

The difficulties with enforcing the EU *Stability and Growth Pact* (SGP) rules for countries in breech that have emerged in the latter end of 2003 are likely to give rise to a redesign of the Pact sooner preferably than later. The European Commission proposals of 2002 to introduce a degree of flexibility regarding the SGP rules still have great appeal. Public debt levels ought to be taken into account when deciding on the required levels of fiscal effort needed to balance budgets and countries with low debt to GDP ratios should be allowed borrow to finance investment.

The macroeconomic conditions facing Ireland and the underlying policy framework appear favourable at present. With the imminent expansion of the European Union in 2004, it is an opportune time to address the competitive challenges to ensure that the Irish economy continues to prosper in the expanded internal market. The gap that has developed between the levels of GDP and GNP, where the latter is now only 80 per cent of the former, is symptomatic of the ascendancy of a couple of multinational-dominated sectors that have reached the point of seriously distorting the true picture of the macroeconomic performance of the Irish economy and in turn the necessary policy responses.

For instance, the early estimates of the 2002 *Census of Industrial Production* shows that a sector like the *Manufacturer of chemicals, chemical products and man-made fibres* had growth in gross valued added of nearly €4 billion, which accounted for over 27 per cent of the growth in GDP last year. This spectacular performance was achieved on the basis of only an extra 330 workers being employed in this sector. Overall employment in this sector accounts for just over 1 per cent of Ireland's total employment yet its output accounts for 12.5 per cent of Irish GDP. Wages and salaries only account for 5 per cent of the sector's gross value added.

This trend towards highly capital intensive foreign owned firms results in an ever-widening gap between GDP and GNP over time. The stock of foreign direct investment (FDI) in Ireland at the end of 2002 was estimated at €176.1 billion dwarfing by over five times the not inconsiderable €33.2 billion stock of Irish FDI abroad. The focus of attention might fruitfully be placed upon evolving enterprise policy. As the National Competitiveness Council remark in their *The Competitiveness Challenge 2003* report: *While FDI must remain a central part of Irish enterprise development, our enterprise policy should also recognise that indigenous business start-ups have the potential to become a more important source of employment and productivity growth.*

The desire to "move up the value chain" might best be viewed in the macroeconomic context of raising GNP levels. This could grow in tandem with GDP growth through continued attraction of high value added inward FDI but the ability to achieve future productivity growth from this source must be limited given the high rates already being achieved. Indigenous firms operating in the wider EU market might be the better longer-term strategy to provide the productivity growth and employment growth needed to have improving living standards. Fostering a knowledge based internationally trading enterprise culture in Ireland is central to this ideal. The expansion of the EU should be viewed as an opportunity over the longer term in this light.