SUMMARY

The Irish economy, in line with the international economy, has made a tentative recovery over the first half of 2002 from the sharp slowdown experienced in the latter half of 2001. The economy is estimated to have grown by 5.9 per cent and 5.0 per cent in real GDP and real GNP terms respectively in 2001. The strength of the international recovery remains fragile, however. Uncertainty about the true financial state of many corporations amid concerns about accounting practices is a prime cause of this fragility leading to a reassessment of the benefits claimed for the "new economy".

The swing in the fortunes of the euro toward a sustained and substantial appreciation against other currencies on a trade-weighted basis will inhibit the competitiveness of an export-oriented economy, like Ireland, that has significant non-euro area trade. An appreciating currency, however, may also encourage a less aggressive interest rate response by the authorities to persistent above-target inflation rates in the euro area. The combination of a higher exchange rate and more modest interest rises than previously expected will tend to rebalance the contribution to growth prospects towards domestic and away from external demand factors.

Our forecast for output growth in 2002 is 3.4 per cent in real GDP and 2.9 per cent in real GNP terms. This reflects an average of quite modest growth in the first half of the year, picking up in the latter half toward trend growth rates. The prospects for 2003 are projected to be at close to or above trend at 4.7 per cent for real GDP and 4.5 per cent for real GNP. While the unemployment rate is expected to rise further into the latter half of 2002, wage growth is not abating significantly.

The recommendation arising from the benchmarking process for a near 9 per cent average pay rise for up to one-sixth of the Irish workforce may do little to quell excessive wage expectations at a time of relatively high consumer price inflation. In addition, since the public sector pay bill constitutes nearly half of government net current spending, the scale of the recommended pay increases will put further pressure on the already deteriorating public finance position.

Inflation prospects will be improved somewhat over the next year by the continuing appreciation of the euro. However, persistence in the high rate of increase in domestic factors, facilitated by strong disposable income growth, will mean that Ireland continues to have the highest inflation rate within the EU. Our forecast is for inflation in consumer prices to average 4.5 per cent in 2002 and 3.7 per cent in 2003.

Ireland faces considerable challenges in bringing domestic cost growth under control while simultaneously managing to balance the public finances without compromising the effective delivery of the much needed investment in infrastructure. A successor to the social partnership agreement, if there is to be one, will have to be negotiated in a context where the tax-cutting element of previous arrangements may be no longer viable. Recognition of this reality will mean that the role of government in any future partnership will be focused on delivery of improved standards of living through efficient public service expenditure.

PRELIMINARY NATIONAL ACCOUNTS 2001

A: Expenditure on Gross National Product

	2000	2001	Change in 2001				
		Preliminary	€m		%		
	€m	€m	Value	Volume	Value	Price	Volume
Private Consumer Expenditure	50,685	56,001	5,316	2,433	10.5	5.4	4.8
Public Net Current Expenditure	12,573	14,312	1,739	679	13.8	8.0	5.4
Gross Fixed Capital Formation	24,449	26,642	2,193	115	9.0	8.5	0.5
Exports of Goods and Services (X)	98,164	110,120	11,956	8,257	12.2	3.5	8.4
Physical Changes in Stocks	287	389	102	65			
Final Demand	**186,158**	**207,463**	**21,306**	**11,549**	**11.4**	**4.9**	**6.2**
less:							
Imports of Goods and Services (M)	83,484	92,915	9,431	6,408	11.3	3.4	7.7
GDP at Market Prices	**102,674**	**114,548**	**11,874**	**5,141**	**11.6**	**6.2**	**5.0**
less:							
Statistical Discrepancy	-796	-887	-91	-920			
Adjusted GDP	**103,470**	**115,435**	**11,966**	**6,061**	**11.6**	**5.4**	**5.9**
less:							
Net Factor Payments (F)	16,349	18,690	2,341	1,713	14.3	3.5	10.5
GNP at Market Prices	**87,121**	**96,746**	**9,625**	**4,348**	**11.0**	**5.8**	**5.0**

B: Gross National Product by Origin

	2000	2001	Change in 2001	
		Preliminary		
	€m	€m	€m	%
Agriculture, Forestry, Fishing	2,976	3,140	164	5.5
Non-Agricultural: Wages, etc.	41,983	47,111	5,129	12.2
Other:	41,580	46,889	5,308	12.8
Adjustments: Stock Appreciation	-841	-76		
Financial Services	-3,517	-3803	-286	8.1
Statistical Discrepancy	-796	-887	-91	11.5
Net Domestic Product	**81,385**	**92,373**	**10,988**	**13.5**
less:				
Net Factor Payments	16,349	18,690	2,341	14.3
National Income	**65,036**	**73,684**	**8,647**	**13.3**
Depreciation	10,093	11,148	1,055	10.4
GNP at Factor Cost	**75,130**	**84,832**	**9,702**	**12.9**
Taxes less Subsidies	11,991	11,914	-77	-0.6
GNP at Market Prices	**87,121**	**96,746**	**9,625**	**11.0**

C: Balance of Payments on Current Account

	2000	2001	Change in 2001
		Preliminary	
	€m	€m	€m
Exports (X) less Imports (M)	14,680	17,204	2,524
Net Factor Payments (F)	-16,349	-18,690	-2,341
Net Transfers	1,054	340	-714
Balance on Current Account	**-615**	**-1,145**	**-531**
as % of GNP	-0.7	-1.2	-0.5

FORECAST NATIONAL ACCOUNTS 2002

A: Expenditure on Gross National Product

	2001	2002	Change in 2002				
	Preliminary €m	Forecast €m	€m Value	€m Volume	Value	% Price	Volume
Private Consumer Expenditure	56,001	60,920	4,919	2,296	8.8	4.5	4.1
Public Net Current Expenditure	14,312	16,580	2,268	1,002	15.8	8.3	7.0
Gross Fixed Capital Formation	26,642	28,672	2,030	590	7.6	5.3	2.2
Exports of Goods and Services (X)	110,120	118,767	8,647	5,257	7.9	2.9	4.8
Physical Changes in Stocks	389	90	-298	-121			
Final Demand	**207,463**	**225,029**	**17,566**	**9,025**	**8.5**	**3.9**	**4.4**
less:							
Imports of Goods and Services (M)	92,915	101,039	8,124	4,780	8.7	3.4	5.1
GDP at Market Prices	**114,548**	**123,990**	**9,442**	**4,245**	**8.2**	**4.4**	**3.7**
less:							
Statistical Discrepancy	-887	-193	694	295			
Adjusted GDP	**115,435**	**124,183**	**8,748**	**3,950**	**7.6**	**4.0**	**3.4**
less:							
Net Factor Payments (F)	18,690	20,375	1,685	1,103	9.0	2.9	5.9
GNP at Market Prices	**96,746**	**103,808**	**7,063**	**2,847**	**7.3**	**4.2**	**2.9**

B: Gross National Product by Origin

	2001	2002	Change in 2002	
	Preliminary €m	Forecast €m	€m	%
Agriculture, Forestry, Fishing	3,140	3,090	-50	-1.6
Non-Agricultural: Wages, etc.	47,111	51,124	4,012	8.5
Other:	46,889	49,358	2,469	5.3
Adjustments: Stock Appreciation	-76	13		
Financial Services	-3,803	-4,364	-561	14.8
Statistical Discrepancy	-887	-193	694	-78.2
Net Domestic Product	**92,373**	**99,027**	**6,653**	**7.2**
less:				
Net Factor Payments	18,690	20,375	1,685	9.0
National Income	**73,684**	**78,652**	**4,968**	**6.7**
Depreciation	11,148	11,866	718	6.4
GNP at Factor Cost	**84,832**	**90,518**	**5,686**	**6.7**
Taxes less Subsidies	11,914	13,290	1,376	11.6
GNP at Market Prices	**96,746**	**103,808**	**7,063**	**7.3**

C: Balance of Payments on Current Account

	2001	2002	Change in 2002
	€m	Preliminary €m	€m
Exports (X) less Imports (M)	17,204	17,727	523
Net Factor Payments (F)	-18,690	-20,375	-1,685
Net Transfers	340	272	-67
Balance on Current Account	**-1,145**	**-2,375**	**-1,230**
as % of GNP	-1.2	-2.3	-1.2

FORECAST NATIONAL ACCOUNTS 2003

A: Expenditure on Gross National Product

	2002	2003	Change in 2003				
	Forecast €m	Forecast €m	€m Value	€m Volume	% Value	% Price	% Volume
Private Consumer Expenditure	60,920	65,917	4,996	2,559	8.2	3.8	4.2
Public Net Current Expenditure	16,580	18,200	1,620	630	9.8	5.8	3.8
Gross Fixed Capital Formation	28,672	30,940	2,268	966	7.9	4.4	3.4
Exports of Goods and Services (X)	118,767	129,840	11,073	7,516	9.3	2.8	6.3
Physical Changes in Stocks	90	310	220	205			
Final Demand	**225,029**	**245,207**	**20,177**	**11,875**	**9.0**	**3.5**	**5.3**
less:							
Imports of Goods and Services (M)	101,039	110,582	9,543	6,028	9.4	3.3	6.0
GDP at Market Prices	**123,990**	**134,625**	**10,635**	**5,847**	**8.6**	**3.7**	**4.7**
less: Statistical Discrepancy	-193	-185	8	-49			
Adjusted GDP	**124,183**	**134,810**	**10,627**	**5,877**	**8.6**	**3.6**	**4.7**
less:							
Net Factor Payments (F)	20,375	22,177	1,802	1,194	8.8	2.8	5.9
GNP at Market Prices	**103,808**	**112,633**	**8,825**	**4,702**	**8.5**	**3.8**	**4.5**

B: Gross National Product by Origin

	2002	2003	Change in 2003	
	Forecast €m	Forecast €m	€m	%
Agriculture, Forestry, Fishing	3,090	3,170	80	2.6
Non-Agricultural: Wages, etc.	51,124	54,503	3,380	6.6
Other:	49,358	55,012	5,654	11.5
Adjustments: Stock Appreciation	13	13		
Financial Services	-4,364	-5,009	-644	14.8
Statistical Discrepancy	-193	-185	8	-4.0
Net Domestic Product	**99,027**	**107,504**	**8,477**	**8.6**
Net Factor Payments	20,375	22,177	1,802	8.8
National Income	**78,652**	**85,327**	**6,675**	**8.5**
Depreciation	11,866	12,838	972	8.2
GNP at Factor Cost	**90,518**	**98,166**	**7,648**	**8.4**
Taxes less Subsidies	13,290	14,468	1,177	8.9
GNP at Market Prices	**103,808**	**112,633**	**8,825**	**8.5**

C: Balance of Payments on Current Account

	2002	2003	Change in 2003
	Forecast €m	Forecast €m	€m
Exports (X) less Imports (M)	17,727	19,258	1,531
Net Factor Payments (F)	-20,375	-22,177	-1,802
Net Transfers	272	-127	-400
Balance on Current Account	**-2,375**	**-3,046**	**-671**
as % of GNP	-2.3	-2.7	-0.6

The International Economy

General

Following a year of below-potential growth in 2001, a tentative recovery is now underway in the world's major economies. This recovery should not be taken for granted, and many downside risks still remain. Investors remain very concerned about the magnitude of the current account deficit in the US and also about corporate governance worldwide in the wake of recent accounting scandals. Any adverse developments in these or other areas could derail the fragile recovery process. For the moment at least the recovery seems to be on track, with economic growth strengthening in the US, the euro area, the UK and Japan.

US Economy

Following six successive quarters of below potential growth, including one quarter of negative growth, the US economy rebounded strongly in the first quarter of 2002. Gross Domestic Product increased at an annual rate of 6.1 per cent, its highest rate since the final quarter of 1999. The principal factors underpinning this growth in the first quarter were private inventory investment, personal consumption expenditures and government expenditure. However, these factors were somewhat offset by negative contributions from net exports and also from investment in non-residential structures. The most significant positive contribution came from private inventory investment, and this is unlikely to continue into the second quarter.

Although there is little doubt that a recovery is underway in the world's largest economy, the pace of the recovery is still quite uncertain. Growth during the rest of 2002 is unlikely to match that of the inventory-led expansion during the first quarter and is unlikely to reach its potential rate again before the end of 2002. As a result, we are forecasting average GDP growth of 2.3 per cent for 2002, an upward revision since the last *Commentary*. The recovery is forecast to continue throughout 2003, and GDP is expected to increase by 3.2 per cent for the year as a whole.

Previous *Commentaries* have highlighted the continued weakness of investment in the US, as the economy struggled to overcome a significant inventory overhang that had accumulated in recent years. This process has now been completed, and gross private domestic investment grew by 24.1 per cent in the first quarter of 2002, albeit from a low base. This is the first time there has been investment growth since the final quarter of 1999. The vast majority of this investment is accounted for by changes in private inventories, which contributed 3.4 percentage points of the 6.1 per cent growth in GDP in the first quarter. At the same time, though, residential investment posted positive growth for the first time in over a year and the decline in all other forms of investment slowed significantly. Such growth in gross private domestic investment is unlikely to continue for the remainder of the year, but the prospects for investment in the US have improved markedly since the previous *Commentary*, and the outlook for 2003 is also more sanguine.

Personal consumption expenditures have remained robust and have kept the US economy afloat since the slowdown in activity began in the second half of 2000. Their positive contributions to GDP have staved off a technical recession in the sense of two consecutive quarters of negative growth by dominating the negative contributions that have come from investment and net exports up to the first quarter of 2002. In the first quarter of 2002 personal consumption expenditures increased by 3.3 per cent at an annual rate, and this contributed some 2.4 percentage points to GDP. There was a decline in expenditure on consumer durables, but this was offset by increased expenditures on non-durable goods and services. The household sector will continue to contribute positively to GDP, though the recent equity market declines are likely to undermine this contribution by having a negative impact on household wealth. Looking to the future the government sector and investment will begin to have a greater influence on GDP than in previous years.

The tentative recovery in the manufacturing sector is continuing, although the rate of expansion slowed in both April and May. Industrial production posted its fifth consecutive monthly increase in May, but on an annual basis industrial production was still 1.6 per cent below its level in May 2001. The Purchasing Manager's Index from the Institute of Supply Management (ISM) provides further evidence for optimism. The index stood at 56.2 in June, indicating that activity in the manufacturing sector grew for the fifth consecutive month, with new orders, production and exports all increasing while inventories contracted. Although the pace of recovery in the manufacturing sector might not be staggering, it is clear that the decline in the sector that began in the fourth quarter of 2000 ended in the first quarter of 2002, and the prospects for the sector are improving.

Conditions in the US labour market have begun to deteriorate following a reasonably positive first quarter of 2002. Employment growth has been almost flat since February, and total employment in June was almost one million lower than one year earlier. Given that the labour force has increased by a similar magnitude over the year, this obviously has negative consequences for unemployment. The unemployment rate stood at 5.9 per cent in June compared to 4.6 per cent one year previously. This means that the unemployment rate has increased by 0.4 percentage points since February, and the number of unemployed now stands at almost 8.5 million. Since activity in the labour market tends to lag that in the rest of the economy, it will be some time before the US returns to full employment, even if other sectors recover in the second half of the year. As a result, we are forecasting average unemployment of 5.8 per cent in 2002, declining marginally to 5.5 per cent in 2003.

The previous two quarters have seen unexpectedly strong GDP growth combined with relatively weak employment figures. As a result, it is unsurprising that productivity has increased significantly over the period. Productivity in the non-farm business sector increased by 8.4 per cent in the first quarter of 2002, following an increase of 5.5 per cent in the final quarter of 2000. This was the result of a 6.1 per cent increase in output while hours worked fell by 2.1 per cent. Following an increase of 3.8 per cent for 2001 as a whole, unit labour costs in the non-farm business sector fell by 5.2 per cent in the first quarter of 2002, representing the largest fall in 19 years. Over the same period, hourly compensation of employees increased by 2.8 per cent, but only by 1.4 per cent when allowing for the increase in consumer prices.

Monetary conditions remain very loose on a historical basis in the United States. The interest rate now stands at a 40-year low of 1.75 per cent, unchanged since the previous *Commentary*. The direction of interest rates in the future is now much more uncertain given recent equity market weakness and a weakening of the dollar on foreign exchange markets.

Although rates usually rise as the economy is expanding, the recent slide in stock prices may damage the economy through a reduction in both business and consumer confidence and expenditures. This would put pressure on the Federal Open Market Committee (FOMC) to ease rates further. However, it now seems likely that the FOMC will hold rates constant for the rest of 2002, with some increase early next year. Such loose monetary conditions are possible given the benign inflationary situation in the US. Inflation was only 1.2 per cent in the year to May 2002, and the inflation rate has remained at very low levels even as interest rates have been cut aggressively in the last year. The biggest increase in prices came from the medical component, while energy prices continued to fall, down by 12.3 per cent on one year previously.

The dollar has been under pressure on foreign exchange markets, and recently broke parity with the euro for the first time in over two years. This depreciation is a result of a number of factors. These include investor uncertainty concerning the pace of the recovery, the lack of confidence in corporate governance, given recent accounting scandals, the rapid deterioration of the federal budget from a surplus of 1.7 per cent of GDP in 2000 to a current deficit of 1.5 per cent of GDP, and the renewed deterioration in the current account of the balance of payments. The deficit exceeded $112 billion in the first quarter of 2002, and is likely to worsen in the short run as the trade valuation disimprovement outweighs the anticipated trade volume improvement resulting from the currency depreciation. Hence, the deficit could exceed 5 per cent of GDP later this year and continue to deteriorate into 2003.

Euro Area

Following a slowdown in economic activity throughout 2001, including a quarter of negative growth at the end of the year, preliminary estimates of GDP growth have borne out expectations for a recovery in the first quarter of 2002. Real GDP grew by 0.2 per cent in the first quarter as compared with a contraction of 0.3 per cent in the final quarter of 2001. Consequently, real GDP growth in the euro area failed to satisfy the technical definition of recession defined as two successive quarters of negative growth.

Growth in the first quarter was balanced between a positive contribution from net trade more than offsetting a fall in domestic demand. Export growth rebounded to grow by 0.9 per cent in the first quarter benefiting from a weak euro and some improvement in external demand. Imports fell by 1.1 per cent so that the overall contribution of net trade to GDP growth was equal to 0.7 per cent. However, in some part the decline in imports reflected a worsening of domestic demand conditions, specifically falls in fixed investment and stock building. Gross fixed capital formation fell by 0.7 per cent in the first quarter continuing to suffer from the uncertain global economic environment. Private consumption provided a further negative impulse to growth contracting by 0.2 per cent in the quarter having been adversely affected by weak labour market conditions combined with the impact of inflation on disposable income. These falls, combined with the effect of stocks meant that overall domestic demand contracted by 0.5 per cent in the first quarter.

At a sectoral level, output in the industrial sector expanded by 0.7 per cent having contracted in the three previous quarters. The rebound in industrial output was in line with strong improvements in manufacturing expectations and confidence recorded in the first quarter. Recent indicators of confidence in the manufacturing and broader industrial sectors suggest that this trend should continue into the second quarter of 2002. In June the Purchasing Managers Index (PMI) rose for the eighth consecutive month indicating an expansion of manufacturing output. Output in the services sector grew by 0.4 per cent in the first quarter growing at an annual rate of 1.5 per cent compared with the first quarter of 2001. Confidence indicators for the services sector indicate that output in the second quarter should expand further.

In May the Harmonised Index of Consumer Prices (HICP) inflation rate for the euro area fell to 2 per cent from 2.4 per cent in April. The preliminary estimates for June suggest the HICP inflation rate was 1.7 per cent in June. Although detailed sub-indices are not yet available for June, as in May the bulk of the decrease is most likely the result of base effects associated with strong increases in energy and unprocessed food prices in the same period of last year. While the HICP inflation rate has now fallen below the European Central Bank's (ECB) target rate of 2 per cent, price pressures will remain a concern. When purged of the more volatile energy and unprocessed food elements the HICP inflation rate has remained persistently high equalling 2.6 per cent in the four months to May. Looking forward the outlook for inflation will be strongly influenced by oil price developments and the exchange rate movements. The recent strengthening of the euro, forecast to continue in the second half of the year, will serve to contain import prices. Moreover, the further unwinding of previous price increases will maintain downward pressure on the HICP. It is forecast that the HICP inflation rate will fluctuate relatively close to 2 per cent for the remainder of the year so as to give an average equal to 2.1 per cent for 2002.

The annual growth of the M3 measure of broad money supply equalled 7.8 per cent in May as compared with 7.4 per cent in the previous month. The high level of annual M3 growth, well above the European Central Bank's (ECB) target rate of 4.5 per cent, in large part reflects portfolio shifts in the autumn of last year. Following the events of September the 11th and thereafter, investors faced with economic and financial market uncertainty increased their demand for short-term liquid assets included in the M3 measure. Annual M3 growth moderated slightly in the first half of the year suggesting some reversal of portfolio shifts. The three-month average of the annual growth rates in M3 was 7.5 per cent in April as compared with 8 per cent at the end of last year. Despite the increase in money supply growth in May it is unlikely that the ECD will respond by tightening monetary policy. First, the HICP inflation rate is now below the ECB's target of 2 per cent, and at its lowest level since December 1999. Second, the recent appreciation of the euro provides a tightening of monetary conditions so that interest rate rises are unlikely until the end of 2002.

Employment growth is expected to have slowed in the first quarter of the year given the indications from data at the national level. Employment grew by 0.3 per cent in the fourth quarter of 2001 averaging 1.4 per for the year. An improvement in labour market conditions is unlikely until at least the end of the year since employment tends to have a lagged reaction to the cycle. Indicators of employment expectations point to further modest employment growth in the second quarter although a significant improvement of labour market conditions in the manufacturing sector may be expected. The aggregate standardised euro area unemployment rate stood at 8.3 per in May unchanged from the previous month. Although the euro area unemployment rate has increased slightly since the beginning of the year the increase was for the most part due to methodological changes in the statistics rather than the impact of the slowing euro area economy. Looking forward the euro area unemployment rate is forecast to improve only marginally as the year progresses. As economic growth rebounds in 2003 the unemployment rate is forecast to fall marginally from an average of 8.0 per cent in 2002 to 7.9 per cent in 2003.

Foreign exchange markets in the second quarter of the year were characterised by a depreciation of the dollar against the other major currencies. In this period the euro rose by 14.9 per cent against the dollar. The strength of the dollar in the beginning of the year was largely driven by renewed optimism for the growth prospects of the US economy. In the second quarter this optimism was negated by concerns for the US corporate sector arising from the various accounting scandals. More fundamentally the size of the current account deficit on the US balance of payments has become even more severe, reaching record levels in the first half of 2002. In recent years trade deficits in the US created a supply of dollars as US firms and consumers sold dollars to buy imports. This supply was in part counter-balanced by the demand created by investment inflows into the US. The latest balance of payment figures show that these inflows dried up in the first half of 2002 creating an excess supply of dollars and in turn leading to a depreciation. It is forecast that the euro should continue to move above parity with the dollar by the end of the year and, appreciate further in 2003. The forecast appreciation of the euro will lead to a competitiveness loss for the euro area containing the rebound in output growth.

In summary our forecasts for GDP growth entail a moderate recovery this year before the pace of expansion accelerates in 2003. Both fiscal and monetary policies remain relatively loose facilitating the recovery of economic activity further encouraged by an improved global economic outlook. It is forecast that GDP growth will average 1.6 per cent in 2002 and 2.2 per cent in 2003.

United Kingdom

The UK economy grew by 1.9 per cent in 2001, down from 3.1 per cent in 2000, but still ahead of both the United States and the euro area. However, this was driven by a strong performance in the first half of the year, and GDP growth has been slowing since then. In the first quarter of 2002 GDP increased by just 1.1 per cent on an annual basis. The two-speed nature of the UK economy is still a source of concern, as is the rapid decline in investment. As a result, we are forecasting a marginal decline in GDP growth this year to 1.8 per cent, before strengthening next year to average 2.8 per cent for 2003 as a whole.

Economic growth in the UK continues to be driven by strong performances in the consumer and services sectors. The final consumption of households increased by 4.5 per cent on an annual basis in the first quarter of 2002, the same rate as was recorded for 2001 as a whole. Activity remains strong in the sector, with retail sales increasing by 6 per cent on an annual basis over the three months to May. In the more general services sector output increased by 2.4 per cent in the first quarter of 2002, compared to 3.4 per cent for 2001. These sectors will continue to provide the primary impetus for economic growth in the UK for this year and next.

The industrial sector remains very weak, thus emphasising the two-speed nature of the UK economy. Industrial production continues to decline, and was down 4.9 per cent on one year previously in the three months to April. The manufacturing sector also remains in recession, with manufacturing output in the three months to April down by 5.6 per cent on an annual basis. Prospects for the sector are also weak; with the Purchasing Manager's Index falling to its lowest level in four months in June. Although the index does point to a sustained expansion, it is at a much slower rate, especially in terms of investment and exports within the sector. The manufacturing sector is unlikely to return to growth before 2003, and any recovery will be dependent on conditions improving in the rest of the world.

Investors' confidence in the UK economy has been declining sharply as economic conditions deteriorated worldwide, and this is reflected in recent data releases. Whole economy investment declined by 5.1 per cent on an annual basis in the first quarter of 2002, following growth of just 0.1 per cent for 2001 as a whole. On an annual basis, business investment contracted by 8.9 per cent in the first quarter, while manufacturing investment fell by 14.7 per cent over the same period. The government is providing the only boost to investment in an effort to stimulate economic growth, and government investment increased by a massive 33 per cent on an annual basis in the first quarter, following an 11 per cent increase in 2001. However, such fiscal expansion is not sufficient to return the economy to potential growth, and this will only occur when business investment returns to positive growth. The current environment of weak corporate governance and stock market declines will postpone any recovery in the short run.

The slowdown in economic activity is yet to have a significant impact on the labour market in the UK, which remains in a very healthy state. According to the Labour Force Survey, employment in the three months to April was some 184,000 higher than one year previously. This leaves the employment rate at 74.6 per cent, very close to its historic high of 75 per cent from Spring 1990. The claimant count of unemployed remains below the 1 million mark, giving a claimant rate of just 3.1 per cent. However, unemployment on an ILO basis has been creeping upwards in recent months. In the three months to April some 1.55 million people were unemployed on an ILO basis, giving an unemployment rate of 5.2 per cent. This still represents one of the lowest rates since the series began in 1984, but there has been an increase of 0.2 percentage points over the last year. Further evidence of the flattening out of the labour market comes from the earnings figures, which show annual growth of 3.3 per cent in the three months to April, significantly lower than just one year ago.

The UK is currently experiencing its longest period of sustained low inflation since the 1960s. The underlying inflation rate, excluding mortgage interest payments, has remained within a band of between 1.5 per cent and 3.2 per cent since the Bank of England was given independence in 1997. The underlying rate stood at 1.5 per cent in June, with the headline rate, which includes mortgage interest payments, at 1.0 per cent. Inflation is expected to remain benign in the coming months, which gives the Monetary Policy Committee (MPC) a free reign over interest rates. It has been over 9 months since rates were last changed and they now stand at 4 per cent, their lowest rate for nearly 40 years. Rates are unlikely to change in the short term, but some rise is likely in order to restrain the growth in domestic demand as external demand recovers and public spending increases. This is unlikely to occur until much later in the year.

Rest of the World

In Japan recent data releases confirm that a recovery is under way. In the first quarter of the year GDP grew by 1.4 per cent as compared with contractions of 0.6 per cent and 1.2 per cent in third and fourth quarters of 2001 respectively. In large part the recovery has been export led. Net exports accounted for half the growth in the quarter contributing 0.7 per cent to overall GDP growth. In line with improved export growth the deterioration in industrial production appears to have ended with a 0.2 per cent month-on-month increase recorded in April the third consecutive month in which production rose. However, consumption remains weak and deflationary pressures remain. In April the annual rate of decline in the Consumer Price Index stood at 1.2 per cent. As in the world's other major economies investment continues to contract.

Looking forward, the recovery in the Japanese economy is unlikely to be as strong in the remainder of the year as previously forecast. Despite the intervention of the Bank of Japan and other monetary authorities the Yen has risen against the dollar and is forecast to appreciate further. The appreciation relative to the dollar will contain export growth in the second half of the year. With domestic demand still weak the recovery in GDP will remain at a moderate pace as the year progresses. GDP is forecast to grow by 0.5 per cent in 2002 and at 1 per cent in 2003.

TABLE 1: Short-term International Outlook

	GNP		Consumer Prices		Hourly Earnings		Unemployment Rate		Current Account Balance	
	Percentage Change						%		% of GNP	
Country	**2002**	**2003**	**2002**	**2003**	**2002**	**2003**	**2002**	**2003**	**2002**	**2003**
UK	1.8	2.8	1.8	2.5	4.3	5.1	5.4	5.6	-2.2	-2.3
Germany	1.1	2.3	1.7	1.5	3.2	3.8	8.5	8.3	1.3	1.7
France	1.9	2.4	1.8	1.2	3.6	3.8	9.3	9.1	2.2	2.1
Italy	1.6	2.6	2.4	1.9	3.5	4.0	9.6	9.4	0.6	0.5
Total EU	1.4	2.5	2.1	1.9	3.7	4.2	8.0	7.9	0.1	-0.1
USA	2.3	3.2	1.6	2.3	3.6	4.2	5.8	5.5	-4.4	-4.7
Japan	0.5	1.0	-1.2	-1.0	0.9	0.3	6.1	6.2	2.5	2.6
Total (OECD)	1.9	2.7	1.7	2.0	3.5	3.9	6.8	6.7	-0.9	-1.1
Ireland	3.0	4.6	4.5	3.7	8.4	7.5	4.6	4.5	-2.2	-2.6

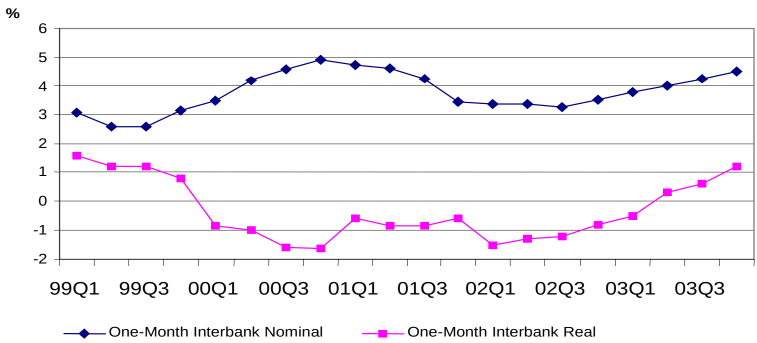
In the other Asian economies increasing signs of economic recovery are evident. As in Japan exports have benefited from the inventory adjustment in the United States and a rise in world market prices for electronic goods and computer equipment. The improved outlook has contributed to upturns in consumer sentiment and retail sales. Looking forward the prospects for the Asian economies will continue to depend on the global recovery and in particular to the fortunes of Japan. In Europe the larger accession countries continue to grow at a relatively sustained pace with relatively robust domestic demand partly offsetting the weakness in external demand. In some cases, however, domestic demand may have been fuelled by expansionary fiscal policies leading to large fiscal deficits. In Latin America the contrast between the fortunes of the largest economies is striking. While Argentina faces its fourth year of recession recent data suggest that the Brazilian economy is recovering slowly. In Mexico the economy contracted at an annual rate of 2 per cent in the first quarter although recent data point to a recovery in economic activity.

Context for Ireland

The turmoil in the international equity markets has raised doubts over the resilience of the global economic recovery evident over the first half of

Figure 1: Interest Rates

Per Cent Per Annum, Quartely Averages



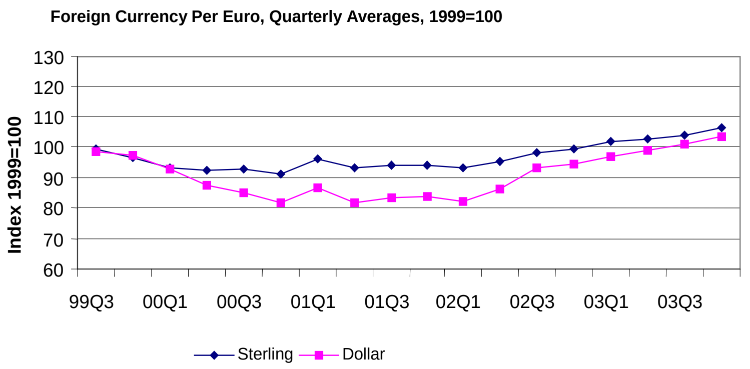
2002. The turnabout in the fortunes of the euro against the dollar has important implications for the global economy and the Irish economy in particular. The increase in the value of the euro will result in downward pressure on inflation. This should remove the need for substantial interest rate increases by the ECB and the international interest rate environment is expected to remain supportive of economic growth internationally in the short term. Although some interest rate increases are forecast in 2003 these will still leave rates at quite low levels. Longer term interest rates have come down this year further supporting the prospects of strong world growth over the next year. Underlying the forecast in this *Commentary* is the assumption that euro interest rates will increase by 0.25 percentage points before the end of 2002 and by a further 1 percentage point by the end of 2003.

Having shown only very marginal growth in 2001, world trade is expected to recover in 2002 and strengthen again in 2003 as the world economies return towards trend growth rates. This improved external environment means that the market for Irish exports should remain favourable despite the loss in competitiveness experienced by the rising euro. The upturn in world economic activity would normally result in an increase in global investment flows. Given the nature of the shock to the

US economy it seems likely that recovery in these FDI flows will be more subdued than in the past. Ireland should continue to attract some of this investment. However, worries about the ability of the Irish economy to facilitate large inward investment projects as well as a rising domestic cost base might cause Ireland to lose some of its share in the short term.

As recovery in the European economies becomes firmer and interest rate differentials change, the appreciation of the euro against the dollar and to a lesser extent sterling is expected to continue. Although the US economy is forecast to recover quite strongly next year worries about the size of the US current account deficit will maintain downward pressure on the dollar against both sterling and the euro. The exchange rate forecasts underpinning this *Commentary* are shown below.

Figure 2: Exchange Rates



The Domestic Economy

General

The fourth quarter national accounts and balance of payments releases confirm the slowdown in the Irish economy. Although GDP growth for the year 2001 equalled a robust 5.9 per cent, economic activity slowed throughout the year. In the fourth quarter GDP growth was flat when compared to the corresponding quarter of the previous year. The slowdown in the economy was pronounced in investment, which contracted in all but the first quarter of the year. Looking forward to 2002 the prospects for the economy remain modest by comparison with recent years. It is forecast that GDP in volume terms will grow by 3.4 per cent this year and 5 per cent in 2003.

Exports

Visible exports in 2001 increased by 10.5 per cent in value and by 6.5 per cent in volume. This increase, which is marginally stronger than we had anticipated, reflects growth in manufacturing and other industrial exports. Exports from the agricultural sector and unclassified exports contracted last year. When the adjustment for balance of payment purposes and service sector exports are taken into account then the volume of exports of goods and services rose by 8.4 per cent. An associated value increase of 12.2 per cent implies an export price deflator in 2001 of 3.5 per cent.

Preliminary figures for the first four months of 2002 show that the value of merchandise exports rose by 5.2 per cent when compared with the same period in 2001. Based on our assumption of some improvement in international activity in 2002 the value of merchandise export growth is forecast to average 8.1 per cent. Merchandise export price growth is expected to be lower this year, reflecting in part the need to maintain competitiveness in the face of a stronger euro. Thus, the volume of merchandise export growth in 2002 is forecast to be 5.0 per cent. Indications are that the volume and value growth in tourism exports will be lower this year. A much more moderate rate of growth in other service exports is also anticipated for 2002 when compared to last year. On the basis of these forecasts total exports of goods and services is forecast to increase by 7.9 per cent in value terms. With an estimated price deflator of 2.9 per cent the volume increase will be in the order of 4.8 per cent.

TABLE 2: Exports of Goods and Services

Preliminary

	2000	% Change in 2001		2001
	€m	Volume	Value	€m
Agricultural	4,432	-11.0	-8.0	4,078
Manufactured	72,209	8.2	12.3	81,095
Other Industrial	5,440	2.3	5.3	5,727
Other	1,809	-5.5	-1.7	1,778
Total Visible	**83,889**	**6.5**	**10.5**	**92,678**
Adjustments	-4,055	17.0	26.6	-5,135
Merchandise	**79,834**	**6.0**	**9.7**	**87,543**
Tourism	2,885	3.1	7.0	3,088
Other Services	15,445	22.0	26.2	19,489
Exports of Goods And Services	**98,164**	**8.4**	**12.2**	**110,120**

Forecasts

	2001	% Change in 2002		2002	% Change in 2003		2003
	€m	Volume	Value	€m	Volume	Value	€m
Agricultural	4,078	2.2	5.7	4,309	3.0	5.6	4,549
Manufactured	81,095	6.0	9.1	88,454	7.5	10.2	97,465
Other Industrial	5,727	2.3	5.2	6,023	3.5	5.6	6,361
Other	1,778	2.0	4.9	1,864	3.0	5.4	1,964
Total Visible	**92,678**	**5.5**	**8.6**	**100,650**	**7.0**	**9.6**	**110,339**
Adjustments	-5,135	15.0	17.3	-6,023	15.0	16.2	-6,996
Merchandise	**87,543**	**5.0**	**8.1**	**94,627**	**6.5**	**9.2**	**103,344**
Tourism	3,088	-1.0	2.5	3,103	1.5	5.4	3,269
Other Services	19,489	4.8	7.9	21,037	6.4	10.4	23,228
Exports of Goods And Services	**110,120**	**4.8**	**7.9**	**118,767**	**6.3**	**9.3**	**129,840**

Although slower growth in investment and FDI flows will mean little new capacity coming on stream in 2003 the international economy is forecast to continue to recover. Furthermore, a small carryover in activity from 2002 should mean that the annual growth in visible and merchandise exports will increase again next year, to around 7 per cent in volume. With some recovery in tourism exports and a small recovery in the exports of other services, this means that we are forecasting that the volume of total exports of goods and services will improve to 6.3 per cent in 2003. With no change in the growth of export prices the value increase is forecast at 9.3 per cent in 2003.

Stocks

The latest figures from the Quarterly National Accounts show that the overall value of physical changes in stocks increased by nearly 36 per cent to €389 million in the year. This is due to a revision to the value of changes in other stocks from the previous *Commentary* allied with the increases in agricultural and intervention stocks.

However in 2002 we estimate that stock changes will fall back to a total of €90 million before increasing again in 2003 to €310 million.

TABLE 3: Stock Changes

	2000 €m	Change in Value €m	2001 €m	Change in Value €m	2002 €m	Change in Value €m	2003 €m
Farm Stocks	-150	86	-63	254	190	40	230
Irish intervention Stocks	-114	114	0	0	0	0	0
Other Non-Agricultural Stocks	551	-99	452	-552	-100	180	80
Total	**287**	**102**	**389**	**-298**	**90**	**220**	**310**

Investment

Preliminary figures from the Quarterly National Accounts indicate that investment increased in 2001 by 9 per cent on the previous year. However, while investment was very strong in the first quarter of 2001 it has been falling gradually in each quarter since which indicates a lower growth rate trend in the value and volume of gross fixed capital formation. The slowdown in investment activity is also evident from a number of other indicators. Imports of capital goods are estimated to have decreased in 2001 by 7 per cent in value terms while employment in construction contracted on an annual basis over the last four months of 2001. Therefore, our estimate for the volume growth in investment in 2001 has been revised down to 0.5 per cent.

Statistics on housing for the first quarter of 2002 show that the number of new house completions increased by 8.2 per cent on an annual basis although they declined from the previous quarter. This decline may be in part due to the fall in the number of planning permissions. The most recent statistics for the third quarter of 2001 show that a total of 18,013 dwelling units were granted planning permission, compared with 24,731 for the same period in 2000, a decrease of 27 per cent. Thus, we are only expecting a moderate increase in the volume of housing output in 2002 of 1.1 per cent. The value of investment in housing and its deflator are forecast to increase by 7.5 per cent and 6.3 per cent respectively which suggests new house prices will rise slightly in real terms. It appears that the slowdown in the construction sector has persisted into 2002 as indicated by the number employed in the sector which continued to fall in the first four months of 2002 on an annual basis. Therefore, we anticipate a volume increase of just 2.1 per cent and an associated value increase of 8.2 per cent. With the volume of investment in machinery and equipment showing reduced buoyancy, volume growth for gross fixed capital formation is expected to increase marginally on the previous year by 2.2 per cent.

Volume increases in public investment and investment in machinery and equipment are expected to underpin overall investment growth in 2003. In contrast investment in housing and building and construction is expected to continue its sluggish growth. Thus gross fixed capital formation is forecast to grow by 3.4 per cent in volume terms. A price deflator of 4.4 per cent results in the value of total investment being forecast to grow by 7.9 per cent in 2003.

TABLE 4: Gross Fixed Capital Formation

Preliminary

	2000 €m	% Change in 2001 Volume	% Change in 2001 Value	2001 €m
Housing	8,067	5.8	20.1	9,687
Other Building	7,621	2.5	12.5	8,573
Building and Construction	15,688	4.2	16.4	18,260
Machinery & Equipment	8,761	-6.2	-4.3	8,382
Total	24,449	0.5	9.0	26,642

Forecasts

	2001 €m	% Change in 2002 Volume	% Change in 2002 Value	2002 €m	% Change in 2003 Volume	% Change in 2003 Value	2003 €m
Housing	9,687	1.1	7.5	10,410	0.8	5.0	10,934
Other Building	8,573	3.2	9.1	9,352	4.2	8.9	10,183
Building and Construction	18,260	2.1	8.2	19,762	2.4	6.9	21,117
Machinery & Equipment	8,382	2.5	6.3	8,910	5.5	10.2	9,823
Total	26,642	2.2	7.6	28,672	3.4	7.9	30,940

Consumption

The latest Quarterly National Accounts for the fourth quarter of 2001 provide us with some evidence of falling growth in the personal consumption of goods and services for last year. It indicates that personal consumption grew by just 4.8 per cent in 2001 in volume terms as compared with 9.9 per cent growth in 2000 and 8.2 per cent growth in 1999. Retail sales figures for 2001 confirm slower growth in consumption. The total value of retail sales rose by just 5.9 per cent compared with 16.3 per cent in 2000 and 11.4 per cent in 1999. The total volume rose by just 3.1 per cent resulting in a price deflator of 2.7 per cent. Excluding the more volatile component of the motor trade raises growth to 11.5 per cent in value terms and 7.5 per cent in volume terms.

Retail sales figures for the first four months of this year also point to a low level of consumption growth again this year. The February to April 2002 three-month period volume figures show a 1.6 per cent decrease compared with the three months ending January 2002. In addition the IIB-

ESRI Consumer Sentiment Index declined for June 2002 to 78.9 compared with 83.8 in May 2002.

Consumers have become less optimistic about the economic situation over the coming 12 months and continue to be concerned about prospects in the labour market. Therefore, we are forecasting that the volume growth in personal consumption of goods and services will slow to 4.1 per cent. With a price deflator of 4.5 per cent this implies value growth in personal consumption in 2002 of 8.8 per cent.

We are expecting growth in personal consumption to remain broadly stable in 2003 even though overall economic conditions are expected to improve. The current uncertainty in the labour market regarding employment growth and wage growth, which are the main drivers of consumption, can be seen as an explanation for this, as there is a tendency for the labour market to lag behind in any recovery.

Thus our forecast for volume growth in personal consumption is 5 per cent in 2003. A marginal decrease in the price deflator to 3.8 per cent means that the value increase in personal consumption is expected to be 9 per cent, in line with the growth rate for 2002.

The latest Quarterly National Accounts show that the volume of government consumption grew by 5.4 per cent. There is uncertainty regarding the future position of government consumption given the tighter position of the exchequer finances, outlined in the Public Finance section of this *Commentary*, and the impending strain resulting from the recent report on the benchmarking process.

We are forecasting that growth in public consumption will rise in 2002 to 7 per cent in volume terms. Furthermore, a moderation in the price deflator to 8.3 per cent is also forecast, implying growth of 15.8 per cent in value terms. This growth is forecast to moderate in 2003 to 3.8 per cent in volume terms and 9.8 per cent in value terms giving an associated price deflator of 5.8 per cent.

TABLE 5: Consumption Indicators

	Annual Percentage Change						
	1997	**1998**	**1999**	**2000**	**2001**	**2002 Forecast**	**2003 Forecast**
Consumption Value							
Personal Consumption	10.2	11.9	11.9	15.0	10.5	8.8	8.2
Retail Sales Index, Value	9.0	9.5	11.4	16.3	5.9	9.5	9.6
Divergence	1.2	2.4	0.5	-1.3	-1.8	-1.0	-1.8
Consumption Volume							
Personal Consumption	7.4	7.8	8.2	9.9	4.8	4.1	4.2
Retail Sales Index, Volume	7.9	7.8	9.5	11.9	3.1	5.6	5.7
Divergence	-0.5	0.0	-1.3	-2.0	-2.7	-1.8	-1.5
Consumer Prices							
Personal Consumption Deflator	2.6	3.8	3.5	4.7	5.4	4.5	3.8
Retail Sales Index Deflator	1.0	1.6	1.7	3.9	4.5	3.7	4.1
Consumer Price Index	1.5	2.4	1.6	5.6	4.9	4.5	3.7

Final Demand

Volume growth in final demand is estimated to be 4.4 per cent in 2002 and 8.5 per cent in value terms. The increase in 2003 will be significantly higher at 5.3 per cent in volume terms and 9.0 per cent in value terms. Given our forecast for lower inflation the price increase in final demand will fall next year to 3.5 per cent as compared with 3.9 per cent this year.

Imports

The value of visible imports increased by just 2.5 per cent in value and by 0.1 per cent in volume in 2001. The size of this increase is much smaller than previously forecast, due mainly to a fall in the import of capital goods and subdued growth in non-agricultural intermediate goods. Inclusion of tourism and other service imports indicates that the value of total imports of goods and services rose by 11.3 per cent and by 7.7 per cent in volume in 2001. This implies an import deflator of 3.4 per cent.

Although growth in the importation of consumer goods is expected to be marginally lower in 2002, recovery in the import of capital and unclassified goods will result in an increase to 4.1 per cent in the volume growth of visible imports. On the basis of an import price deflator of 3.4 per cent, this implies that the value growth of visible imports will recover to 7.6 per cent. Given concerns about employment prospects and more moderate wage growth, tourism and other service imports will grow at a slower rate this year. Thus, the value growth in total imports of goods and services is expected to average 8.7 per cent in 2002. In volume terms we estimate that growth will amount to 5.1 per cent. This implies a total import deflator of 3.4 per cent.

TABLE 6: Imports of Goods and Services

Preliminary

	2000 €m	% Change in 2001 Volume	% Change in 2001 Value	2001 €m
Capital Goods	8,070	-10.1	-7.0	7,502
Consumer Goods	11,486	4.2	7.4	12,340
Intermediate Goods:				
Agriculture	887	3.4	6.7	946
Other	33,170	1.7	3.7	34,408
Other Goods	2,297	-9.6	-7.6	2,123
Total Visible	**55,909**	**0.1**	**2.5**	**57,319**
Adjustments	-3,773	-11.5	-11.5	-3,338
Merchandise Imports	**52,135**	**0.9**	**3.5**	**53,981**
Tourism	2,858	8.2	12.5	3,216
Other Services	28,490	20.0	25.4	35,718
Imports of Goods and Services	**83,484**	**7.7**	**11.3**	**92,915**

Forecasts

	2001	% Change in 2002		2002	% Change in 2003		2003
	€m	Volume	Value	€m	Volume	Value	€m
Capital Goods	7,502	3.4	6.7	8,005	5.6	9.0	8,724
Consumer Goods	12,340	4.0	7.4	13,257	5.3	9.0	14,448
Intermediate Goods:							
Agriculture	946	5.2	7.1	1,014	5.3	7.2	1,086
Other	34,408	4.3	8.0	37,144	5.0	8.5	40,288
Other Goods	2,123	3.4	6.5	2,261	3.8	5.6	2,388
Total Visible	**57,319**	**4.1**	**7.6**	**61,680**	**5.1**	**8.5**	**66,935**
Adjustments	-3,338	15.0	15.0	-3,839	15.0	15.0	-4,414
Merchandise Imports	**53,981**	**3.4**	**7.2**	**57,842**	**4.4**	**8.1**	**62,520**
Tourism	3,216	4.5	7.6	3,461	4.6	7.9	3,737
Other Services	35,718	7.8	11.2	39,736	8.3	11.5	44,325
Imports of Goods And Services	**92,915**	**5.1**	**8.7**	**101,039**	**6.0**	**9.4**	**110,582**

The forecasts outlined in this *Commentary* expect a further recovery in domestic economic activity in 2003. This should support further recovery in import growth, which will be underpinned by some carryover in activity from the end of this year. With imports of all categories continuing to recover, and taking account of balance of payment adjustments, merchandise imports are forecast to grow by 4.4 per cent in volume. Despite the recovery, we still expect consumers to remain cautious and so the growth in tourism imports is expected to remain unchanged from 2002. Coupled with a small increase in the growth of other service imports this means that we are forecasting volume growth in total imports of goods and services of 6 per cent. The deflator for total imports is expected to remain broadly unchanged at 3.3 per cent implying that in value terms imports of goods and services will grow by 9.4 per cent.

Balance of Payments

Official figures show that the current account deficit in 2001 was €1,145 million, substantially higher than the estimate in the Spring *Commentary*, mainly reflecting lower than anticipated net current transfers. Although the growth in exports and imports moderated slightly in 2001 the rate of growth was still strong and so the visible trade balance rose by over 21 per cent to €33,562 million, or 34.7 per cent of GNP.

The deficit on service trade is also estimated to have increased by more than 25 per cent to €16,357 million. Thus, the overall surplus on trade in goods and services grew by 17.2 per cent in value terms in 2001 to €17, 204 million.

The forecast for exports and imports already discussed indicate the likelihood that the surplus on trade in goods and services will increase quite slowly in 2002 to €17,727 million. Stronger growth will resume in 2003 but will remain well below the levels of recent years. Thus, the trade balance in goods and services is forecast to reach €19,258 million in 2003.

The repatriation of profits and reinvested earnings are expected to rise in both 2002 and 2003 as the output and earnings of multinationals recover. When account is taken of national debt interest paid abroad and other debit items debit flows are forecast to grow by 12.1 per cent in 2002 and 9.4 per cent in 2003.

Investment income from Irish direct investment abroad is expected to grow by around 10 per cent in both 2002 and 2003. With other credit flows also continuing to grow total credit flows are forecast to grow by 14 per cent in 2002 and 9.7 per cent in 2003. Thus, on the basis of these forecasts, net factor outflows are projected to grow by around 9 per cent in both years.

The impact of these forecasts on the current account balance is for a further deterioration. The deficit will grow to over €2,300 million in 2002 and by a further €671 million in 2003 to €3,046 million. These deficits are the equivalent of 2.2 per cent and 2.6 per cent of GNP respectively.

Once again it is worth pointing out that the importance of the balance of payments has diminished within a single currency area, although the growing deficit does point to imbalances within the economy.

TABLE 7: Balance of Payments

	2000 €m	Change %	2001 €m	Change %	2002 €m	Change %	2003 €m
Visible Trade Balance	27,981	26.4	35,359	10.2	38,969	11.4	43,405
Adjustments	-282		-1,797		-2,184		-2,581
Merchandise Trade Balance	**27,699**	**21.2**	**33,562**	**9.6**	**36,785**	**11.0**	**40,823**
Service Trade Balance	-13,019	25.6	-16,357	16.5	-19,058	13.2	-21,565
Trade Balance in Goods and Services	**14,680**	**17.2**	**17,204**	**3.0**	**17,727**	**8.6**	**19,258**
Total Debit Flows	-48,900	3.7	-50,732	12.1	-56,895	9.4	-62,230
Total Credit Flows	32,551	-1.6	32,043	14.0	36,520	9.7	40,054
Net Factor Flows	**-16,349**	**14.3**	**-18,690**	**9.0**	**-20,375**	**8.8**	**-22,177**
Net Current Transfers	**1,054**	**-67.8**	**340**	**-19.8**	**272**	**-146.8**	**-127**
Balance on Current Account	**-615**		**-1,145**		**-2,375**		**-3,046**
Capital Transfers	1,206	-44.2	673	-7.5	622	-14.5	532
Effective Current Balance	**591**		**-472**		**-1,753**		**-2,514**

Gross National Product

Our estimates for the volume growth of GDP and GNP growth in 2002 now stand at 3.4 and 2.9 per cent respectively. These forecasts envisage a significant loss in the terms of trade with export prices rising appreciably below those of imports. Allowing for a fall in the volume of net current transfers, real gross national disposable income (GNDI) is forecast to rise by 2.3 per cent this year. Given the on-going expansionary nature of macroeconomic policies internationally we expect a recovery in the world economy by the end of the year, which will facilitate the recovery in GDP growth to its medium-term trend. It is estimated that GDP and GNP will grow by 4.7 per cent and 4.5 per cent respectively.

Agriculture

Recent data releases from the CSO confirm that the agricultural sector performed reasonably well in 2001, especially in light of the foot and mouth outbreak and the subsequent measures to prevent the spread of the disease. The value of goods output increased by 3.3 per cent over the year, driven by an 8.2 per cent increase in the value of milk. The value of livestock output was broadly unchanged over the year, with an 8.8 per cent fall in the value of cattle being offset by substantial gains in the output values of sheep and pigs. There was a modest increase of 3.5 per cent in the output value of crops during 2001, with a 16.6 per cent increase in root crops more than offsetting an 8.3 per cent decline in the value of cereals output. Intermediate consumption grew by 4.5 per cent during 2001, and net subsidies increased by 6.6 per cent over the year. The combination of all these factors meant that operating surplus grew by 4.2 per cent in 2001, marginally above the EU average of 4.1 per cent but below the 5.8 per cent growth of the UK. In volume terms, goods output increased by a more modest 1.3 per cent in 2001.

Data on agricultural prices for 2001 show that the output price index increased by 4.5 per cent. This was driven by a 3.8 per cent increase in the price of livestock and livestock products and a 10.5 per cent increase in output price of crops. The overall input price index increased by 5.2 per cent during 2001. This was the result of a 12.8 per cent increase in fertiliser prices and a 5.1 per cent increase in the price of feeding stuffs, while energy prices fell by 2.9 per cent over the year. These movements in input and output prices imply that the terms of trade decreased by 0.7 per cent, indicating an unfavourable price movement for farmers for 2001 as a whole.

The agricultural sector is likely to experience a fall in producer margins in 2002, primarily due to poor weather conditions, reduced prices in Ireland and the appreciation of the euro against the dollar and sterling.[1] Prices are falling in the beef sector due to a fall in the intervention price, which was agreed under Agenda 2000, and a decline in direct payments in 2002 relative to 2001. The high output values in the sheep industry in 2001 can be largely attributed to the banning of UK exports of lamb during the foot and mouth disease crisis. However, the return of UK lamb exports to EU markets has lead to declining Irish and EU lamb price levels. In the dairy sector, where the volume of output is limited by quota, the price of milk has fallen due to a fall in the world price of dairy products. Rising input prices, except for animal feed, are leading to higher costs of production in the sector as a whole. Poor weather conditions in 2002 will reduce crop yields and although this may lead to increased prices in the short term, due to reduced supply, any price increase will be limited by the availability of imports.

The proposals contained in the Mid-Term Review of the CAP will have the biggest impact on the beef and sheep sectors. For Ireland, the most relevant change proposed relates to the decoupling of direct payments from animals (and their coupling to farm area) and the modulation of decoupled payments by 3 per cent per year until 20 per cent modulation is achieved. Decoupling of payments from production would change the incentives faced by cattle and sheep producers, as they would no longer be

[1] This section was compiled with the assistance of Teagasc.

obliged to produce the cattle and/or sheep to receive payments. This will lead to some producers reducing the size of their enterprise while others may cease production altogether, especially some cattle producers, where market returns fail to cover the costs incurred in cattle production and profits are derived from direct payments. These proposed changes, if they occur, will not commence until 2004.

We expect gross agricultural output to fall by 5.7 per cent in volume terms in 2002. Growth is expected to return to the sector in 2003, with gross agricultural output forecast to increase by 2.9 per cent.

Industry

Preliminary estimates from the CSO indicate that the industrial sector expanded by 8.1 per cent during 2001. This represents a significant slowdown in comparison to growth of 13.7 per cent in 2000, or the average growth of 15.1 per cent in the four years to 2000. However, the overall figure for 2001 masks a significant deterioration in growth over the course of the year. During the first half of the year, industrial output increased by 18.7 per cent. However, the second half of the year saw output actually decline by an average of 1.1 per cent on an annual basis. According to the Quarterly National Accounts, the most significant decline came in the fourth quarter of the year, when output contracted by 3.8 per cent on an annual basis.

Growth in the industrial sector is likely to weaken further in 2002, driven by a very weak start to the year. Although some recovery is anticipated later in the year, gross output in industry is forecast to increase by an average of just 3.6 per cent in 2002. The recovery should gather momentum later in the year as economic conditions improve in all of the world's major economies. This will provide a strong carryover into next year, and we are forecasting output growth of 6.1 per cent for the industrial sector in 2003. Growth of this magnitude is sustainable in the medium term, but a return to the double-digit growth rates of the late 1990s is unlikely.

Recent industrial surveys provide strong evidence that a recovery in the industrial sector will occur later in the year. The NCB Purchasing Managers' Index for June pointed towards the strongest expansion of the manufacturing sector in almost two years. The Index stood at 54.5 in June, the fifth consecutive month that the index has registered a value above 50, which indicates that the sector is expanding. Output, purchases, new orders, export orders and employment all increased in June, thus providing some grounds for optimism. However, the IBEC-ESRI Monthly Industrial Survey remains somewhat less sanguine about prospects for the coming months, with expectations for new orders and employment both weakening in May. Overall, we remain confident that the sector will return to growth later in the year, and indeed exports are already showing strong signs of recovery.

Services

Since the previous *Commentary* we have revised our forecasts for the services sector downwards slightly. We now believe that gross output in the services sector, after adjustment for financial services, increased by 5.9 per cent in 2001 compared to 9.4 per cent in 2000. The outbreak of foot and mouth disease in the Spring of 2001 and the subsequent measures to control the spread of the disease resulted in a significant weakening in services activity in Ireland, especially in the tourism sector. The terrorist attacks in the United States, and their knock-on effects for the world economy, certainly had a further negative impact on services activity worldwide, thus preventing any early recovery.

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 5.1 per cent in 2001 following an average of 12.9 per cent over the five years to 2000. This downward trend looks to have continued into 2002, and we expect gross output in the distribution, transport and communications sector to increase by only 2.3 per cent.

The NCB Monthly Report on Services indicates that overall activity has held up well in the sector during 2002. There was further consolidation in June with business activity, confidence and new business all increasing, albeit at a more moderate pace. According to the Report, employment in services has been increasing for five consecutive months although the rate of expansion has slowed considerably. However, sharp increases in input costs and charges are becoming a cause of concern, with higher oil prices pushing up energy bills and a shortage of suitably skilled labour increasing wages in the sector.

The growth of output in the services sector is likely to continue to slow in 2002. We expect the volume of gross output in the sector to increase by an average of just 2.9 per cent in 2002. However, given our forecasts for personal consumption and personal disposable income growth, the demand for services in the Irish economy is likely to strengthen throughout 2003. With overall economic activity expected to recover from the second half of this year, we are forecasting average growth in the volume of services output of 4.2 per cent for 2003 as a whole.

Employment

The latest Quarterly National Household Survey (QNHS) for the first quarter of 2002 shows that employment in the Irish economy grew by 2.1 per cent from the first quarter of 2001. This compares with the 2.9 per cent growth recorded for the whole of 2001 and 4.7 per cent for 2000. In absolute terms this represents an increase of 35,600 people to 1.745 million persons employed in the first quarter of 2002. The number of females at work increased by 28,500 or 4.1 per cent in the year compared with a rise of only 7,100 or 0.7 per cent in the number of males at work. Almost half of employment growth was recorded in the education and health sector, which increased by 17,000 persons. Close to 96 per cent of this increase was accounted for by females.

However, while Irish employment growth for the first quarter of 2002 remains strong by historical and international standards, the latest QNHS confirms that employment growth is continuing its slowing trend. The numbers employed were down on the previous quarter by 7,400 persons, with the majority of the major sectors of the economy recording a fall. Furthermore, the industrial sector has seen significant decreases in employment. The latest Industrial Employment release from the CSO tells us that there were 259,800 persons employed in the industrial sector in March 2002, a decrease of 10,400 from March 2001. This mainly arose from the sector covering the manufacture of electrical equipment where there was a decrease of 11,000.

The labour force increased by 49,900 persons in the year to reach 1.825 million. This accounts for 59.4 per cent of all persons aged 15 or over, compared with 58.9 per cent in the first quarter of 2001. Female participation rates increased from 47.6 per cent to 48.7 per cent while male participation rates decreased slightly from 70.6 per cent to 70.5 per cent. Demographic factors such as the increasing population of working age and the changing age structure are estimated to have added 42,500 persons to the labour force between the first quarters of 2001 and 2002. The balance of 7,500 was due to a further increase in labour force participation.

The latest QNHS indicates that the unemployment rate was 4.4 per cent in the first quarter of 2002. When seasonally adjusted the rate is 4.2 per cent which compares with 4.0 per cent in the fourth quarter of 2001 and 3.6 per cent in the first quarter of 2001. In absolute terms there were 80,000 persons unemployed in the first quarter of 2002, an increase of 7,400 on the previous quarter and 14,400 on the previous year. Almost all of the annual increase was accounted for by those in short-term unemployment where the numbers increased by over 13,000 persons.

The latest *Live Register Analysis* for May 2002 indicates that when adjusted for seasonal factors, the register rose by 2,300 from the previous month. The unadjusted figures show that the numbers on the register decreased by 1,293 persons in the month of May to 154,944. The figures for the year to May 2002 show an increase of 21,253 persons signing on.

It is significant that redundancy notifications under the Statutory Redundancy Payments Scheme[2] have increased sharply. These data reveal that redundancy notifications deteriorated dramatically after April 2001. In total nearly 20,000 redundancies were notified in 2001, compared with less than 13,500 in 2000, a rise of nearly 50 per cent. More recent data reveal that this trend continued on into the early part of 2002.

Therefore, the short-term prospects for the Irish labour market cannot be regarded as particularly optimistic. In the final analysis, progress on the jobs front will depend primarily on output performance. Annual real GDP growth for 2002 is forecast to be about 3.4 per cent and on this basis the most likely outcome would be a static or slightly declining employment level throughout 2002. Any prospect of an improvement in the short to medium term is crucially dependent on a number of factors. The most important of these relates to developments in the global economy, with regard to which the outlook is looking increasingly uncertain, bearing in mind the current turbulence in the equity markets and exchange rate volatility. Domestically, considerable pressure is building up in the Irish labour market in relation to wage costs – a worrying prospect in view of the

[2] Under the terms of this scheme employers notify the Department of Enterprise, Trade and Employment of impending redundancies (on an individual employee basis). Some of these notifications, on examination by the Department, may not be found to relate to qualified persons, e.g. they may refer to employees who have less than two years eligible service with their employer. However, one can reasonably assume that if an employer signals an intention to declare a worker redundant, then it is virtually certain that the worker will lose his or her job, irrespective of whether the worker qualifies for inclusion in the scheme. Thus, the initial notification figures can be taken as reflecting a valid measure of the trend in job losses.

possible negative effect of this on competitiveness, and ultimately on employment.

It is forecast that employment growth will average 0.7 per cent in 2002 rising to 1.8 per cent in 2003. The unemployment rate is forecast to average 4.6 per cent this year. As economic activity recovers in 2003 unemployment should fall marginally to average 4.5 per cent for the year. In terms of numbers on the Live Register an average of 160,000 is forecast for 2002 before falling slightly to 157,000 in 2003. Any significant improvement in the numbers on the Live Register is unlikely before the second half of 2003 given the lag in the relationship between employment growth and the cycle.

TABLE 8: Employment and Unemployment*

	Annual Averages '000			
	2000	**2001**	**2002**	**2003**
Agriculture	130	123	120	116
Industry	488	504	501	506
Services	1,075	1,114	1,131	1,157
Total at Work	**1,692**	**1,741**	**1,752**	**1,780**
Unemployed	76	71	85	83
Labour Force	**1,768**	**1,811**	**1,837**	**1,863**
Unemployment Rate %	4.3	3.9	4.6	4.5
Live Register	156	142	160	157

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

Incomes

Following relatively robust growth in 2001, the growth in all incomes is likely to be much weaker in 2002. This can be attributed to lower levels of employment growth and the general slowdown in economic activity. However, as conditions improve later in the year incomes can be expected to recover somewhat. Once the economy returns to trend growth in 2003 incomes will experience a corresponding recovery.

Income in the agricultural, forestry and fishing sector increased by 5.5 per cent in 2001, despite the outbreak of foot and mouth disease early last year. This was the result of strong growth in agricultural output, which benefited from high levels of demand, particularly from the UK and also a strong competitive position as a result of the sustained weakness of the euro. The outlook for incomes growth in this sector is considerably weaker for 2002, and we are forecasting a decline of 1.6 per cent for the year. This will be caused by weaker demand conditions and an appreciating euro. However, agricultural incomes should rise again in 2003 and we are forecasting average growth of 2.6 per cent.

Continued strong growth in hourly earnings is forecast with growth of 8.4 and 7.5 per cent expected for 2002 and 2003 respectively. Even though the unemployment rate is forecast to increase this year, it still remains low by both international and historical comparisons and is forecast to fall again in 2003. This implies that the labour market will remain tight both this year and next, and this will contribute to the persistence of high wage growth. The slowdown in the economy, albeit short lived, has served to restrain wage expectations in the short run and we are unlikely to see a return to the double-digit growth rates of 2001.

Given these forecasts for hourly earnings the non-agricultural wage bill is estimated to have increased by 12.2 per cent in 2001. Growth will moderate to 8.5 per cent in 2002 and will fall further to 6.6 per cent in 2003, although this still represents a very robust expansion.

The recent appreciation of the euro will certainly erode Ireland's competitive position. Further appreciation of the euro is expected throughout 2002 and 2003, and this will have a negative impact on both margins and profitability, especially in the multinational sector. This will, in turn, affect net factor payments, which were growing at a rate of 23.7 per cent in 2000 and 14.3 per cent in 2001. The growth in net factor payments will slow significantly to 9 per cent in 2002 and 8.8 per cent in 2003. These forecasts imply that the gap between GDP and GNP will narrow over the next two years.

The growth of other non-agricultural incomes, primarily profits and rents, is expected to slow significantly this year before rebounding in 2003 as the economy returns to trend growth. It is forecast that other non-agricultural incomes will grow by just 3.5 per cent this year before rebounding to grow by 14.2 per cent in 2003. The slowdown of growth in 2002 as compared with 7.9 per cent in 2001 reflects the appreciation of the euro relative to the dollar and also the downturn in the economy. As a result other non-agricultural incomes are expected to grow less quickly than non-agriculture wages in 2002.

Both personal savings and the savings ratio are expected to increase in 2002, although we have revised our estimates downwards to take into account the expected weaker growth in incomes. The savings ratio is forecast to increase to 11.3 per cent in 2002 and it is expected to increase further to 12.0 per cent in 2003, in comparison to 10.8 per cent in 2001.

TABLE 9: Personal Disposable Income

Preliminary

	2000	Change		2001
	€m	%	€m	€m
Agriculture, etc.	2,976	5.5	164	3,140
Non-Agricultural Wages,	41,983	12.2	5,129	47,111
Other Non-Agricultural Income	14,364	7.9	1,138	15,502
Total Income Received	**59,323**	**10.8**	**6,430**	**65,753**
Current Transfers	10,223	13.7	1,400	11,623
Gross Personal Income	**69,546**	**11.3**	**7,831**	**77,376**
Direct Personal Taxes	13,746	6.2	851	14,597
Personal Disposable Income	**55,800**	**12.5**	**6,980**	**62,779**
Consumption	50,685	10.5	5,316	56,001
Personal Savings	5,115	32.5	1,664	6,778
Savings Ratio	9.2			10.8

Forecasts

	2001	Change		2002	Change		2003
	€m	%	€m	€m	%	€m	€m
Agriculture, etc.	3,140	-1.6	-50	3,090	2.6	80	3,170
Non-Agricultural Wages,	47,111	8.5	4,012	51,124	6.6	3,380	54,504
Other Non-Agricultural Income	15,502	3.5	539	16,041	14.2	2,283	18,324
Total Income Received	**65,753**	**6.8**	**4,501**	**70,255**	**8.2**	**5,743**	**75,998**
Current Transfers	11,623	14.8	1,724	13,347	12.4	1,655	15,002
Gross Personal Income	**77,376**	**8.0**	**6,226**	**83,602**	**8.8**	**7,398**	**91,000**
Direct Personal Taxes	14,597	2.1	303	14,900	8.2	1,226	16,126
Personal Disposable Income	**62,779**	**9.4**	**5,923**	**68,702**	**9.0**	**6,172**	**74,874**
Consumption	56,001	8.8	4,919	60,920	8.2	4,996	65,917
Personal Savings	6,778	14.8	1,003	7,782	15.1	1,176	8,958
Savings Ratio	10.8			11.3			12.0

Consumer Prices

Figures for the first six months of this year show that the rate of inflation has averaged 4.7 per cent. The strength of inflation in non-traded domestic services has been one of the main contributing factors to the persistence in the inflation rate. The EU Harmonised Index of Consumer Prices for the year to May 2002 shows that Ireland has been at the top of the EU inflation league since January. The May figure of 5 per cent is substantially higher than the average in the euro area of 2 per cent. Furthermore, while the EU harmonised index for Ireland has remained at around 5 per cent since January there are signs of a downward trend in inflation in a number of other EU countries in recent months.

Lower energy prices and an appreciating euro will have a positive impact on Irish inflation during the remainder of 2002. However, any improvement is likely to be small given underlying domestic inflation. Thus, we are forecasting that the overall consumer price index will average 4.5 per cent in 2002.

The importance of the external environment in determining the rate of inflation should also be reflected in the index in 2003. The recent rise in the value of the euro should result in a more moderate rise in import prices next year. However, our assumption of moderate interest rate increases from the fourth quarter of this year, the housing component of the index will make a larger contribution to inflation. On balance, therefore, we anticipate that growth in the consumer price index will average 3.7 per cent in 2003.

TABLE 10: Consumer Price Index – Recent Trend and Forecast

	Quarterly Trend								Annual			
	2000		2001				2002		2000	2001	2002	2003
	Q2	Q3	Q1	Q2	Q3	Q4	Q1	Q2				
Index Nov. 1996=100												
Housing	103.4	111	114.2	117.8	118.4	114.7	112.6	114.5	99.6	116.0	115.3	118.1
Other	112.4	113.5	113.5	116	116.6	117.8	119.2	122.1	111.6	116.1	121.9	126.3
Total CPI	111.7	113.3	113.5	116.1	116.8	117.6	118.8	121.5	110.6	116.0	121.3	125.7
Annual % Change												
Housing	11.1	28.0	26.2	22.7	14.5	3.3	-0.2	-0.8	8.8	16.5	-0.6	2.4
Other	5.7	5.6	3.8	4.2	3.7	3.8	5.0	5.3	5.4	4.0	5.0	3.6
Total CPI	6.2	7.0	5.3	5.4	4.6	3.8	4.7	4.7	5.6	4.9	4.5	3.7
Quarterly % Change												
Housing	7.7	7.4	2.9	3.2	0.5	-3.1	-0.1	1.7				
Other	1.0	1.0		2.2	0.5	1.0	1.1	2.5				
Total CPI	1.5	1.4	0.2	2.3	0.6	0.7	1.0	2.3				

Public Finances

The first half of 2002 has seen further deterioration in the public finances. Following on from the sharp declines in government balances last year, public expenditure growth has continued to dramatically outpace tax revenue growth. The general government balance is forecast to be in deficit by €947 million this year, a decline of almost €2.9 billion from last year. In terms of the Exchequer the full extent of the decline in the public finances in 2002 will be masked by large inflows of non-tax revenue. For the most part these inflows represent once-off payments, which will not be available to the Exchequer next year to meet spending and tax commitments. This is reflected in our forecasts for an exchequer deficit of almost €3billion in 2003 despite a forecast modest improvement in the general government position to a deficit of €588 million.

Exchequer returns for the first half of this year confirm the worsening position of the public finances. The trends in expenditure and revenue that led to a sharp decline in the exchequer balance last year have continued into 2002. Expenditure on the current supply of services grew by 21 per cent when compared with the same period last year. This compares against the budgetary target of 14.2 per cent for expenditure growth on the current supply of services for the year 2002 as a whole. Similarly, voted capital expenditure grew by 27.8 per cent in the first six months of the year as compared with the 11.1 per cent budgetary target. For budgetary targets to be met current and capital expenditure growth would have to be cut dramatically in the second half of the year to 8.6 per cent and 3.6 per cent respectively.

The consequence for the public finances of overshooting expenditure growth is exacerbated by shortfalls in tax revenue. Overall tax revenue is relatively unchanged from the same period last year, well behind the budgetary target of 8.6 per cent for the growth of tax receipts. The shortfall in tax revenue is most pronounced in income tax receipts, which contracted by 13.4 per cent in the first half of the year. The discrepancy with the budgetary target for income tax receipts of 3.8 per cent growth is in part due to government payments to Special Saving Investment Accounts (SSIA). These SSIA payments are deducted net of income tax receipts and are estimated to cost the Exchequer in excess of €500 million annually from 2003 onwards. The cost to the Exchequer this year will be less because a significant proportion of these SSIA accounts were opened in April.

Looking forward to the end of the year, we forecast that the general government balance will be in deficit by €947 million in 2002. This entails a sharp deterioration in the public finances from the general government surpluses of €1.9 billion in 2001 and €4.7 billion in 2000. Moreover, this forecast is based on the assumption of sharp cuts in the growth of both capital and current expenditure in the second half of 2002. It is forecast that current expenditure growth will be pared back to equal 13.8 per cent for 2002 as a whole. This implies current expenditure growth will be cut to equal 11.6 per cent in the second half of 2002 as compared with the same period in 2001. Likewise capital expenditure growth is forecast to slow to 12.9 per cent in the year as a whole. Tax revenue is forecast to grow 6.1 per cent in 2002. The growth of income tax receipts will recover as the base effects related to rescheduling of the tax year unwind somewhat. Similarly, the rescheduling of corporation tax payments announced in the last budget will add approximately €800m to the Exchequer this year. Capital receipts are forecast to fall by some €500 million to equal €1.4 billion.

In terms of the Exchequer, the full deterioration in the public finance position will not become fully evident this year because of a number of once-off payments into the Exchequer from the broader government sector. These include a transfer from the Social Insurance Fund of €635 million, the use of funds from the Capital Services Redemption Account equal to €500 million and receipts from the privatisation of ACC Bank of €153 million. Furthermore, it is estimated that the contribution from the Central Bank arising from the euro changeover will be in the region of €610 million. Deducting these proceeds from the forecast exchequer balance of €900 million in 2002 gives a better view of the underlying trend within the public finances. The deterioration in the public finances will only become apparent in the exchequer balance next year when these funds are unavailable to meet tax and expenditure commitments. These transfers between government funds highlight the need to focus on the broader general government balance to allow the real impact of expenditure and revenue trends on the public finances to become apparent (see Box A).

Box A: The Exchequer and General Government Balances

The General Government Balance (GGB) is the better measure of the state of the public finances although the focus of public attention has traditionally been placed on the narrower Exchequer Balance. The GGB comprises the finance position of all arms of government. As opposed to the exchequer balance, the GGB is therefore unaffected by the movement of funds between the Exchequer and broader government sectors. The GGB allows for a better appreciation of the impact of expenditure and revenue trends on the public finances than is allowed for in concentrating on the Exchequer balance. Furthermore, Ireland's position under the EU Stability and Growth Pact is assessed using the GGB.

The GGB comprises not only the exchequer balance but also captures changes in the balances of both central and local government. Included within central government are the Exchequer, non-commercial semi-state bodies and extra-budgetary funds such as the National Pensions Reserve Fund and the Social Insurance Fund. Table A1 illustrates the calculation of the GGB by accounting for changes in balances outside of the Exchequer.

Table A1: Adjustments Between Exchequer and General Government Balances

	€m 2001	**€m 2002**
EXCHEQUER		
Revenue	+30,682	+31,816
Transfers from broader government		
Social Insurance Fund Transfer	0	+635
ACC Bank Receipts	0	+153
Central Bank Income from Euro Changeover	0	+610
Expenditure	-30,032	-34,115
EXCHEQUER BALANCE	+650	-901
GENERAL GOVERNMENT		
Transfers to Exchequer		
Social Insurance Fund Transfer	0	-635
ACC Bank Receipts	0	-153
Central Bank Income from Euro Changeover	0	-610
Impact of National Pensions Reserve Fund	+1,260	+1,340
Others*	+32	+12
Net Difference between Exchequer and General Government Balances	+1,292	-46
GENERAL GOVERNMENT BALANCE	+1,942	-947

**This comprises the net balance of non-commercial semi-state bodies and local authorities, transactions with extra-budgetary funds in addition to other adjustments.*

In Budget 2002 a number of initiatives were announced to transfer funds from the broader government sector into the Exchequer. These included the transfer of €635 million from the Social Insurance Fund (SIF) to the Exchequer and a contribution of €610 million from the Central Bank of income arising from the euro changeover. Furthermore, the Exchequer will receive some €153 million from the sale of ACC Bank.

As illustrated by Table A1, the effect of these initiatives is to curtail the size of the emerging exchequer deficit. For example, the Social Insurance Fund is included in the general government sector but not in the Exchequer. The transfer of €635 million from the Social Insurance Fund is counted as an exchequer receipt. However, since this transfer is not a gain in general government terms it is offset in the calculation of the GGB. The transfer has no effect on the GGB but has the superficial effect of increasing the exchequer balance by €635 million.

The same applies in the cases of receipts from the sale of the ACC Bank and the Central Bank income arising from the euro changeover. Both are recorded as receipts, improving the exchequer balance. However, the sale of ACC bank entails a loss of assets equal to €153 million for the broader government sector. This figure is deducted from the calculation of the GGB. Similarly, the contribution of the Central Bank constitutes a transfer from the broader government sector to the more narrowly defined Exchequer. The exchequer balance rises by €610 million but this same sum is deducted from the calculation of the GGB. In both cases the GGB is left unchanged.

The General Government Balance is the most appropriate measure in assessing the state of the nations fiscal position as it attempts to treat the public finance accounts on a consolidated basis. This means that the GGB is unaffected by the movement of funds between the different government sectors so the full impact of revenue and expenditure trends can be assessed.

Looking forward to 2003 the general government balance is forecast to be in deficit by €588 million. This will entail a modest improvement in the public finance position. However, this forecast is based on a recovery in tax revenue growth accompanied by further cuts in the growth of current and capital expenditure. Tax revenue growth is forecast to equal 6.9 per cent in 2003 benefiting from the expected return of the economy to near trend GDP growth of 4.8 per cent. Current expenditure growth is forecast to decline to 7 per cent in 2003 as compared with 13.8 per cent this year. Similarly, capital expenditure is forecast to equal 10.4 per cent as compared with 12.9 per cent this year. In terms of the Exchequer a deficit of €2.9 billion is forecast for 2003 as compared with €900 million this year. This sharp fall will occur because of the flattered position of the deficit this year, benefiting from the once-off payments described above. When these payments from the broader government sector are not available next year the exchequer will decline sharply despite the more favourable tax revenue and expenditure trends.

In summary, the critical feature of our public finance projections involves bringing public expenditure in line with taxation revenue over the latter half of 2002 and throughout 2003. A major consideration for the public finances emanates from the *Report of the Public Service Benchmarking Body*. Our forecasts, as outlined in Table 11, do not factor in the likely costs that full implementation of this Report would involve for the public finances. Box B outlines the possible impact of the Benchmarking proposals for the public finances. The timing of the benchmarking payments remains under negotiation. This uncertainty about the implementation of the Report makes it difficult to determine when this pay award will impact upon the public finances. Box B outlines the possible impact of the Benchmarking proposals for the public finances.

Box B: Public Sector Benchmarking and the Public Finances

The Public Service Benchmarking Body, established under the terms of the *Programme for Prosperity and Fairness*, carried out a detailed examination into the jobs, pay and conditions of public servants and made a comparison with similar jobs in the private sector. The final report, published on 30th June 2002, recommends changes in public service management practices and a range of pay increases, which are linked to modernisation and change within the public service. The Body recommended that one-quarter of any award be implemented and backdated to the 1st December 2001.

The pay increases apply to the public service, which constitutes almost one-sixth of the Irish workforce, and are estimated to increase public sector pay by an average of 8.94 per cent. This would constitute just over €1 billion on the public sector pay bill if implemented in full from 2003 onwards. The public sector wage bill already constitutes about half of government net current spending and so it would have a significant impact on the public finances.

If we make the assumption that the proposal is implemented in full from 2003 onwards with the backdated component of one-quarter payable in 2002, the public finance position we have set out will deteriorate further. The backdated element on the public sector pay bill will be of the order of €250 million in 2002. The impact on the public finance position, when income tax and other taxation drawbacks from this pay rise are accounted for, will be of the order of €160 million in 2002. When the full year impact is considered in 2003, the public sector pay bill will rise by the order of €1.1 billion reflecting an underlying increase in public sector employment and a rise in national pay to at least account for inflation. The net impact on the public finances will be of the order of €700 million in 2003. The impact on the public finances may be even more significant than this when account is taken of the knock-on impact from pressures for indexation of public sector pensions and social welfare payments to the higher rates of public sector pay.

TABLE 11: Public Finances

	2001	**% Change**	**2002**	**% Change**	**2003**
Current Revenue	28,738	10.6	31,773	2.2	32,481
Current Expenditure	24,012	13.8	27,320	7.0	29,220
Current Surplus	**4,726**	**-5.8**	**4,452**	**-26.8**	**3,261**
Capital Receipts	1,944	-25.9	1,441	-9.8	1,300
Capital Expenditure	6,020	12.9	6,795	10.4	7,505
Capital Borrowing	**4,076**	**31.4**	**5,354**	**15.9**	**6,205**
Exchequer Balance	**650**	-238.7	**-901**	-226.6	**-2,944**
as % of GNP	0.7		-0.9		-2.6
General Government Balance	**1,942**	**-148.3**	**-947**	**37.9**	**-588**
as % of GDP	1.7		-0.8		-0.4
Gross Debt as % of GDP	**33.9**		**32.1**		**31.4**

General Assessment

The CSO Quarterly National Accounts to the end of last year reveal that the near decade long, exceptional performance of the Irish economy continued right up until the summer of 2001. At that point, economic growth ground to a halt. Preliminary seasonal adjustment of the quarterly accounts would indicate that the economy contracted in the third quarter before staging a modest rebound in the final quarter. This pattern reflects the general slowdown pattern evident internationally last year.

The available data for the Irish economy in 2002 indicate a strengthening of economic activity in the first half of the year. Given that the first half of 2001 provided a very strong baseline for comparison, the indicators suggest a modest improvement in activity. The underlying trend in consumer demand is still quite brisk and consumer confidence has been steadily improving since its nadir last autumn. This confidence is a reflection of the continued growth in employment, as revealed in the first quarter Quarterly National Household Survey, and continued improvements in disposable incomes boosted by high wage growth and budgetary tax cuts. The price of houses would also seem to be rising strongly again over the first half of 2002.

Confidence in the prospects for industrial activity is more fragile. A steadily improving outlook both domestically and internationally has been disrupted by concerns over the robustness of the recovery. A series of corporate revelations on dubious accounting practices has dented investor confidence as evidenced by the sharp declines in the world stockmarkets to five year lows. This will impact negatively on household wealth positions and has raised fears of a second dip in world economic activity within a year.

The faltering recovery in the US economy in particular has raised doubts about the claims made in recent years for the emergence of a "New Economy" driven by productivity increases through faster adoption of information based technologies. The basic drivers of the productivity acceleration remain in place – the impact of globalisation, strong competition and rapid improvement in information technology. The correction underway in the stockmarkets may reflect a reaction to excessive optimism placed on the valuation of companies utilising the new technologies more than an outright rejection of the fundamental change.

The rate of unemployment has continued to rise throughout 2002, reflecting a lagged response to the earlier slowdown. The notification of redundancies, which is a leading indicator, has also been rising in recent months. The first quarter of 2002 recorded a significant rebound in the external trade position, driven in the main by the Chemicals and related products sector. The strengthening of the euro against the dollar over the summer months can be expected to dampen the contribution of external demand to Ireland's growth.

The government has provided a significant boost to the economy in 2002 through a combination of high tax cuts, large welfare payments and substantially increased public expenditure. Thus, the largest contribution to employment growth this year has come through the public sector. The impact of this expansionary fiscal impulse has led to a sharp decline in the public finance position as evidenced in the half-year Exchequer returns.

Despite the appreciation of the euro, the combination of a significant fiscal boost within a still loose monetary environment is quite positive for economic growth driven primarily by domestic demand in the latter half of 2002 and into 2003.

Our forecasts for economic activity reflect gradual, rather than sudden, erosion in Irish competitiveness through a combination of currency appreciation and domestic cost inflation. The negative carryover from the slowdown last year means that our growth rates in 2002 will be quite modest in contrast to the record levels of previous years. We forecast real GDP growth of 3.4 per cent and 4.7 per cent in 2002 and 2003 respectively. Inflation in Ireland is also anticipated to remain above the euro area average this year and next, driven in the main by the strong price growth in the non-traded sectors of the economy. As highlighted in previous *Commentaries* this trend has the capacity to erode many of the achievements of recent years. It has its origin in unrealistic expectations fostered during the exceptional phase in Irish economic growth.

The test for Irish policymakers will be to rein in expectations about what a small open economy can sustain beyond the short-term in terms of wage growth and public expenditure increases. The pressures on the public finances from unrealistic expectations about simultaneously having lower taxes and rising public expenditure have become evident over the past two years. The CSO estimate that net expenditure by the government on current goods and services rose by 13.8 per cent in 2001 in value terms but only by 5.4 per cent in volume terms. The gap in percentage points terms of over 8 per cent reflects the extent of high cost inflation pervasive in the economy generally. The growth in expenditure over the first half of 2002 is well in excess of 20 per cent while tax revenue growth is quite flat. This position is clearly unsustainable.

The mechanisms available to dampen wage expectation and demands on the public purse are limited. The timing of the *Report of the Public Sector Benchmarking Body* recommending 8.9 per cent average pay rises for up to one-sixth of the Irish workforce is unfortunate. It is likely to further enhance wage expectations significantly at a time of relatively high consumer price inflation. Also, since it forms part of the on-going social partnership agreement, this puts added pressure on the Government to settle in advance of a successor agreement. If there is to be one, a successor social partnership agreement will have to be negotiated in a context where the tax-cutting element of previous arrangements is neither viable nor desirable. The formula to offer tax cuts in return for wage restraint worked well in a depressed economy that needed the demand stimulus created by the disposable income boost. It is less suited to an economy that continues to need wage restraint to prevent an inflationary spiral taking hold.

Recognition of this reality will mean that the role of government in any future partnership will be focused on the delivery of improved standards of living through efficient public service expenditure. The process will need to link pay restraint with sustainable public finance balances in ensuring that better infrastructure and public services are provided. If the Government is to make a credible commitment to any such future bargain, it will be necessary to define suitable medium and long-term objectives and design institutions and rules to ensure the durability of sound fiscal positions.

Our forecasts in this *Commentary* are based on the expectation that expenditure growth and tax revenue growth are brought promptly into line in the second half of this year and in 2003. In light of the recent large divergence between expenditure and revenue growth in the Irish public finances, greater focus on the GGB measure is much better at this juncture. The use of funds from the broader government sector, which constitute once off payments rather than continuous revenue flows, only has the superficial effect of flattering the exchequer balance. Moreover, the use of such funds can delay the inevitable decision to bring government expenditure and tax revenue growth into line with each other.

By focusing on the General Government Balance the appropriate policy prescription of matching revenue and expenditure growth will become apparent while ignoring temporary accounting measures which may only serve to delay the corrective measures required for a sound public finance position. The European Central Bank has recently highlighted the need for European governments to resist the temptation to artificially improve budgetary positions through accounting measures. The treatment of the extra-budgetary funds, as highlighted in Box A1 in the Public Finances section, means that the difference between the exchequer and general government balances will be just €46 million having been €1.3 billion last year. The convergence between the two measures arises from the transfer of funds to the Exchequer from the broader government sector.

In terms of Ireland's Stability and Growth Pact commitments this means the general government deficit will equal 0.7 per cent of GDP this year. Although remaining well inside the 3 per cent deficit limit, Ireland's general government balance will move close to the safety margin of 1.2 per cent estimated by the European Commission as required to cope with fluctuations in the cycle. The apparent relaxation of the Stability and Growth Pact rules currently underway at the European level means that a domestically designed framework to suit the needs of the Irish economy becomes all the more desirable. The *Policy Discussion Forum* contained in this *Commentary* considers some of the issues involved in making the Irish public finance accounts more transparent and comprehensive along with the nature of the fiscal rules that may be considered.

Our forecasts for the public finances in 2003 are predicated on the favourable outcome of Irish economic growth returning towards its medium term trend of around 5 per cent. There are significant downside risks to this forecast however. The necessary deflation in public expenditure growth required to bring the public finances back into alignment may turn out to be greater than anticipated. This fiscal tightening, which may also require higher taxation, would dampen economic activity by curtailing domestic demand. The possibility of an even more rapid appreciation in the value of the euro than currently anticipated also can impact negatively on the public finance position. A stronger currency brings dis-inflationary pressures that reduces the value of forecasted tax revenues.

The contemporary pressures on the public finances should not detract from the ambitious programme for national development. Too often in the past, the stop-go nature of budgetary arithmetic has postponed necessary public investment. The adoption of fixed expenditure rules that allow borrowing only for clearly defined investment purposes may be the best way to proceed but this will necessarily require making hard choices in other areas in respect of reduced expenditure or increased taxation.