SUMMARY

Output in 2003 increased by 3.7 per cent in real GDP terms and 2.8 per cent in real GNP terms according to the CSO preliminary estimates of the national accounts. This outturn brings these two rates of growth in real economic activity closer together following the notable divergence that emerged during 2002. The improved international economic climate of the last eighteen months has brought a resumption of foreign direct investment flows into Ireland, which has been a significant factor in enhancing consumer confidence and business sentiment.

Economic indicators that cover the first three quarters of 2004 point to substantial economic expansion. Our projection for growth in real GDP in 2004 has been revised upwards to 5.2 per cent and 4.8 per cent for real GNP. The strength of the labour market in particular has been a significant factor in the return to sustainable growth rates. Employment growth of 2.3 per cent is expected for 2004 with an average unemployment rate of 4.4 per cent. In contrast to recent years, a relatively modest rate of consumer price inflation of 2.2 per cent is anticipated for the year.

Despite the international uncertainties reflected in the higher oil prices this year, the world economy is still expected to grow strongly in 2005. All the major economic blocks are experiencing reasonably robust growth trajectories alongside high growth performances of converging economies, particularly China. On the basis of this anticipated strength in the international economies next year, the prospects for the Irish economy are very positive. Our forecast for output growth in 2005 is 5.4 and 5.0 per cent in real GDP and real GNP terms respectively. The labour market is expected to remain tight with the unemployment rate forecast to average 4.3 per cent with inflation in consumer prices at 2.4 per cent in 2005. The public finance position is expected to return towards modest surpluses in the general government accounts both this year and next.

The buoyancy of both the public finances and the overall economic performance is due to a significant extent to record-breaking construction of new dwellings currently underway. House building is estimated to have directly contributed in the order of one-fifth of the real growth in the economy both this year and last. Such a contribution is not anticipated to persist even over the near term; nonetheless it is a reflection of investment priorities among Irish households towards property holding. The extraordinary growth in mortgage credit reflects this rather unique epoch, set as it is against the backdrop of historically low interest rates.

With the cost of credit anticipated to begin rising during 2005, household investment portfolio choices may be expected to alter over the next few years. In this regard the approaching end dates of the SSIA scheme in 2006/07 are stimulating debate on the need for a successor arrangement. The scale of the savings involved, in the order of 10 per cent of national income, could have a significant macroeconomic impact. However, given both the uncertainty of how the funds will be divested and the position in the economic cycle when they mature, it is not sensible to motivate any continuation of such an expensive scheme by appealing to a need for active demand management in the economy.

PRELIMINARY NATIONAL ACCOUNTS 2003

A: Expenditure on Gross National Product

	2002	2003	Change in 2003				
		Preliminary	€m		%		
	€m	€m	Value	Volume	Value	Price	Volume
Private Consumer Expenditure	59,019	62,935	3,916	1,532	6.6	3.9	2.6
Public Net Current Expenditure	17,692	19,233	1,541	445	8.7	6.0	2.5
Gross Fixed Capital Formation	28,983	31,815	2,832	980	9.8	6.2	3.4
Exports of Goods and Services (X)	119,701	112,759	-6,942	-912	-5.8	-5.1	-0.8
Physical Changes in Stocks	115	499	384	417			
Final Demand	**225,510**	**227,241**	**1,731**	**2,462**	**0.8**	**-0.3**	**1.1**
less:							
Imports of Goods and Services(M)	98,508	91,981	-6,527	-2,307	-6.6	-4.4	-2.3
less:							
Statistical Discrepancy	-990	474	1,464	96			
GDP at Market Prices	**127,992**	**134,786**	**6,794**	**4,673**	**5.3**	**1.6**	**3.7**
less:							
Net Factor Payments (F)	23,518	23,115	-403	1,717	-1.7	-8.4	7.3
GNP at Market Prices	**104,474**	**111,671**	**7,197**	**2,956**	**6.9**	**3.9**	**2.8**

B: Gross National Product by Origin

		2002	2003	Change in 2003	
			Preliminary		
		€m	€m	€m	%
Agriculture, Forestry, Fishing		2,877	2,915	38	1.3
Non-Agricultural:	Wages, etc.	49,806	53,402	3,596	7.2
	Other:	52,949	52,033	-916	-1.7
Adjustments:	Stock Appreciation	-117	409		
	Financial Services	-3,870	-4,340	-470	
	Statistical Discrepancy	-990	474	1,464	
Net Domestic Product		**100,654**	**104,893**	**4,238**	**4.2**
less:					
Net Factor Payments		23,518	23,115	-403	-1.7
National Income		**77,137**	**81,778**	**4,641**	**6.0**
Depreciation		13,883	14,933	1,050	7.6
GNP at Factor Cost		**91,020**	**96,711**	**5,691**	**6.3**
Taxes less Subsidies		13,454	14,960	1,506	11.2
GNP at Market Prices		**104,474**	**111,671**	**7,197**	**6.9**

C: Balance of Payments on Current Account

	2002	2003	Change in 2003
		Preliminary	
	€m	€m	€m
Exports (X) less Imports (M)	21,193	20,778	-415
Net Factor Payments (F)	-23,518	-23,115	403
Net Transfers	708	440	-268
Balance on Current Account	**-1,617**	**-1,897**	**-281**
as % of GNP	-1.5	-1.7	-0.3

FORECAST NATIONAL ACCOUNTS 2004

A: Expenditure on Gross National Product

	2003	2004	Change in 2004				
	Preliminary €m	Forecast €m	€m		%		
			Value	Volume	Value	Price	Volume
Private Consumer Expenditure	62,935	66,829	3,894	2,392	6.2	2.3	3.8
Public Net Current Expenditure	19,233	20,650	1,417	423	7.4	5.1	2.2
Gross Fixed Capital Formation	31,815	36,995	5,180	2,618	16.3	7.4	8.2
Exports of Goods and Services (X)	112,759	119,491	6,732	6,553	6.0	0.1	5.8
Physical Changes in Stocks	499	365	-134	-160			
Final Demand	**227,241**	**244,331**	**17,090**	**11,827**	**7.5**	**2.2**	**5.2**
less:							
Imports of Goods and Services (M)	91,981	97,474	5,493	4,161	6.0	1.4	4.5
less:							
Statistical Discrepancy	474	652	179	615			
GDP at Market Prices	**134,786**	**146,204**	**11,418**	**7,051**	**8.5**	**3.1**	**5.2**
less:							
Net Factor Payments (F)	23,115	24,136	1,021	1,640	4.4	-2.5	7.1
GNP at Market Prices	**111,671**	**122,068**	**10,397**	**5,411**	**9.3**	**4.3**	**4.8**

B: Gross National Product by Origin

	2003	2004	Change in 2004	
	Preliminary €m	Forecast €m	€m	%
Agriculture, Forestry, Fishing	2,915	3,050	135	4.6
Non-Agricultural: Wages, etc.	53,402	57,456	4,054	7.6
Other:	52,033	55,846	3,813	7.3
Adjustments: Stock Appreciation	409	420		
Financial Services	-4,340	-4,515	-175	
Statistical Discrepancy	474	652	179	
Net Domestic Product	**104,893**	**112,909**	**8,016**	**7.6**
less:				
Net Factor Payments	23,115	24,136	1,021	4.4
National Income	**81,778**	**88,773**	**6,995**	**8.6**
Depreciation	14,933	16,313	1,380	9.2
GNP at Factor Cost	**96,711**	**105,086**	**8,375**	**8.7**
Taxes less Subsidies	14,960	16,982	2,022	13.5
GNP at Market Prices	**111,671**	**122,068**	**10,397**	**9.3**

C: Balance of Payments on Current Account

	2003	2004	Change in 2004
	€m	Forecast €m	€m
Exports (X) less Imports (M)	20,778	22,018	1,240
Net Factor Payments (F)	-23,115	-24,136	-1,021
Net Transfers	440	250	-190
Balance on Current Account	**-1,897**	**-1,869**	**28**
as % of GNP	-1.7	-1.5	0.0

FORECAST NATIONAL ACCOUNTS 2005

A: Expenditure on Gross National Product

	2004	2005	Change in 2005				
	Forecast €m	Forecast €m	€m		%		
			Value	Volume	Value	Price	Volume
Private Consumer Expenditure	66,829	71,582	4,753	3,007	7.1	2.5	4.5
Public Net Current Expenditure	20,650	22,280	1,630	723	7.9	4.2	3.5
Gross Fixed Capital Formation	36,995	40,614	3,619	1,946	9.8	4.3	5.3
Exports of Goods and Services (X)	119,491	131,583	12,091	8,639	10.1	2.7	7.2
Physical Changes in Stocks	365	340	-25	5			
Final Demand	**244,331**	**266,399**	**22,068**	**14,319**	**9.0**	**3.0**	**5.9**
less:							
Imports of Goods and Services (M)	97,474	106,839	9,366	6,778	9.6	2.5	7.0
less							
Statistical Discrepancy	652	914	261	-347			
GDP at Market Prices	**146,204**	**158,646**	**12,441**	**7,889**	**8.5**	**3.0**	**5.4**
less:							
Net Factor Payments (F)	24,136	26,667	2,531	1,829	10.5	2.7	7.6
GNP at Market Prices	**122,068**	**131,979**	**9,911**	**6,059**	**8.1**	**3.0**	**5.0**

B: Gross National Product by Origin

	2004	2005	Change in 2005	
	Forecast €m	Forecast €m	€m	%
Agriculture, Forestry, Fishing	3,050	3,210	160	5.2
Non-Agricultural: Wages, etc.	57,456	61,029	3,573	6.2
Other:	55,846	61,813	5,967	10.7
Adjustments: Stock Appreciation	420	200		
Financial Services	-4,515	-4,447	68	
Statistical Discrepancy	652	914	261	
Net Domestic Product	**112,909**	**122,719**	**9,810**	**8.7**
Net Factor Payments	24,136	26,667	2,531	10.5
National Income	**88,773**	**96,052**	**7,279**	**8.2**
Depreciation	16,313	17,705	1,392	8.5
GNP at Factor Cost	**105,086**	**113,756**	**8,671**	**8.3**
Taxes less Subsidies	16,982	18,222	1,240	7.3
GNP at Market Prices	**122,068**	**131,979**	**9,911**	**8.1**

C: Balance of Payments on Current Account

	2004 Forecast €m	2005 Forecast €m	Change in 2005 €m
Exports (X) less Imports (M)	22,018	24,743	2,726
Net Factor Payments (F)	-24,136	-26,667	-2,531
Net Transfers	250	210	-40
Balance on Current Account	**-1,869**	**-1,714**	**155**
as % of GNP	-1.5	-1.3	0.1

The International Economy

General

International conditions remain quite favourable with most of the major economies showing strong and close to potential rates of growth over the first half of 2004. Despite recent signs of waning growth, particularly in the US, investment, which is generally indicative of longer-term expectations, remains strong. While oil prices remain high, we expect the recent surge to be temporary, reflecting the risk premium associated with uncertainty of supply. Simulations suggest that although this is likely to lower output growth rates somewhat in the short term, on the whole, the effects are expected to be quite small (see Box B).

US Economy

Although the US economy has grown quite strongly over the first half of 2004, there have been signs recently that this robust expansion has started to falter as the various factors, which have been thus far conducive to strong growth, begin to unwind. Some of this slowdown may be attributed to energy price increases and their effect on business and consumer confidence. However, the tightening of previously accommodative monetary and fiscal policy is likely to have played the major role in the recent deceleration. Following annualised real GDP growth of 4.5 per cent in the first quarter of 2004, the latest estimates suggest that the economy grew by a more moderate but still considerable annualised rate of 2.8 per cent in the second quarter. Compared with the same period last year, the economy grew by 4.7 per cent.

The main reason for the slowdown when compared to previous quarters has been the marked deceleration in consumption expenditure growth. Personal consumption increased by only 0.4 per cent in the second quarter when compared to the previous quarter. In contrast, the average increase in consumption was 1.0 per cent in each of the previous four quarters. This moderation is likely to have been a result of the combination of the receding effects of tax cuts, the slowdown in the mortgage re-financing boom, the expectations of future interest rates hikes and higher oil prices. The weakening of the labour market as well as lacklustre figures for consumer confidence and retail sales indicate that consumption, which had previously bolstered the economy during its downturn, is likely to make less of a contribution to growth over the remainder of the year. It is, therefore, necessary that other areas of the economy counterbalance this more moderate contribution if the pace of overall economic activity is to be maintained.

In the second quarter, the relatively weak consumption performance was partially offset by quite a strong contribution to overall growth from private investment. This would suggest that longer-term confidence in the economy is quite high with fixed investment, particularly in equipment and software, remaining strong. This upbeat assessment for corporate investment is confirmed by the latest data for manufacturing which continues to rebound. The Purchasing Managers Index (PMI) from the Institute

of Supply Management (ISM) registered 59.0 in August where a value above 50 indicates expansion in the sector. Most of the component indices showed solid growth although there were continued signs of weakening employment growth. This is the fifteenth consecutive month of expansion in the sector and reflects improved domestic as well as external demand conditions, a weak currency and continued accommodative monetary policy. This has boosted profits and expectations, which has in turn led to the strength in investment. The Purchasing Managers Index (PMI) for non-manufacturing has also shown expansion in the sector in August, registering 58.2, although it is down from 64.8 in July. However, despite the improving employment conditions in August, there has been no marked rebound in this component in recent months, with the employment index hovering around the 50 mark, indicating no change.

This apparent weakness in employment growth has been confirmed by recent labour market indicators, which showed that in the three months to August employment increased by an average of just over 100,000 persons per month. In comparison, the average monthly increase in the five months previous to June was over 225,000. Whether these recent trends are temporary and a result of lower business confidence deriving from higher oil prices or the commencement of the Federal Reserve's tightening cycle is still not clear. If the weakness continues, it could imply that the surge in economic activity evidenced in the first half of the year may not be continued into the second half. However, there are positive signs that employment may be picking up with the increase of 144,000 in August a substantial improvement on the 73,000 the previous month. Unemployment in August fell marginally to 5.4 per cent from 5.5 per cent the previous month. We expect it to average 5.5 per cent for this year as a whole following an average unemployment rate of 6.0 per cent in 2003. Despite recent signs of weaknesses we do expect further improvement in labour market conditions in 2005 with the unemployment rate forecast to average 5.1 per cent over the year.

Rising energy prices have had a significant impact on consumer prices in the US over recent months. Inflation, as measured by the annual change in the Consumer Price Index (CPI), after averaging 1.8 per cent in the first quarter of the year, averaged 2.9 per cent in the second quarter. In July, the annual change was 3.0 per cent. Core inflation, which excludes food and energy prices, only increased by 1.8 per cent in the year to July. Moreover, the index for energy, which increased by 6.9 per cent in 2003, increased at a seasonally adjusted annualised rate of 25.9 per cent in the first seven months of 2004. Responding to the spike in inflation in recent months, the Federal Reserve Board of Governors has decided to increase interest rates on two occasions since the previous *Commentary,* leaving the base federal funds target rate at 1.5 per cent, which is still regarded as very accommodative monetary policy. The Federal Reserve which, unlike their European counterparts is mandated to target growth as well as inflation, cited these price pressures as temporary and expects the strong pace of economic

expansion to be maintained. Their measured pace of monetary tightening looks set to continue. We expect a further 25 basis points increase before year end as the economy's excess capacity is eliminated and we forecast continued monetary tightening throughout 2005 with the base rate reaching 3 per cent by year end.

Despite the quite robust pace of economic activity in the year thus far, many imbalances remain in the economy with no clear signs of correction in the short term. The level of household indebtedness remains high by international standards. Evidence of this is the household savings ratio, which is estimated by the Organisation for Economic Co-operation and Development (OECD) to be around 2.1 per cent in 2003, by far the lowest of all the developed countries. More importantly in the short-term is the absence of government saving with the government deficit projected by the Congressional Budget Office to be in excess of $420 billion for the fiscal year 2004, lower than previous estimates, but still a substantial 3.6 per cent of estimated GDP. This is highly pro-cyclical as it occurs in a year where the economy is forecast to be growing at or above its sustainable growth rate. One of the dangers of fiscal policy remaining too expansionary for too long would be the resulting rise in long-term interest rates, which could dissipate the pace of the recent expansion both domestically, and in the external environment via its impact on investment.

Following the forthcoming presidential election, there will therefore need to be a consolidation of the public finances by adjusting the tax and/or spending levels in an effort to increase the national savings rate and prepare for impending demographic pressures. This should help to alleviate the US current account deficit, which, at an estimated 5.0 per cent of GDP in 2004, is well above its estimated sustainable level of between 2 and 3 per cent. However there is no immediate sign of an improvement in the US's external position with recent data suggesting that the current account deficit soared to a record $166.2 billion in the second quarter.

Overall, although there have recently been indications that the intensity of the US economic expansion may have slackened somewhat in the third quarter of 2004, we believe that these trends are temporary in nature and due to transitory factors. We forecast that, following real GDP growth of 3.0 per cent in 2003, the economy will grow by a robust 4.3 per cent this year before moderating to 3.6 per cent in 2005.

The European Economy

Euro Area

The modest expansion in the euro area has continued in the first half of 2004 with estimates indicating that the economy grew in real GDP terms by 0.5 per cent from the first quarter to the second following 0.6 per cent growth in the first quarter. Compared with one year previously, the economy has grown by 2.0 per cent in real

terms in the second quarter compared with 1.3 per cent in the first. Net trade was the main driver behind the quarterly increase with accelerating exports more than offsetting accelerating imports, reflecting the strong international demand. Personal consumption slowed somewhat, however, in the second quarter while government spending and investment strengthened but contributed little to overall growth. Although the trajectory of growth for the area as a whole gives the impression of quite a reticent recovery, it does serve to obscure some quite diverse growth patterns across the core regional economies.

France and Germany, which account for over half of euro area output, have both seen some acceleration in growth over the first half of the year, but the driving forces behind each country's growth have been quite dissimilar. In France, the quarterly growth was 0.8 per cent in the second quarter of the year with a 1.6 per cent contribution from domestic demand (including stocks) while net trade acted as a 0.8 per cent drag on the economy. In contrast, the main impetus driving the recovery in Germany has been export growth with domestic demand stagnating. Of the 0.5 per cent real GDP growth in the second quarter of the year, net trade contributed over 0.5 percentage points to economic growth while there was a slight negative contribution from domestic demand of less than -0.1 per cent.

Of these two growth trajectories, the German recovery is the more fragile. With the international economy showing some signs of strain, the German economy is vulnerable to any potential external shocks. Labour market reforms have thus far failed to add vigour to the domestic economy, which implies that the current recovery is not self-sustaining at this stage. The French economy seems set to bolster the euro area with continued signs of strengthening domestic economic activity likely to be complemented by future contributions from net trade as the international economy continues on its path of expansion.

Looking at the individual sectors, industrial production data point to continued growth in the manufacturing sector, with growth of 2.8 per cent in July compared with the same period last year. On a month-on-month basis, production grew by 0.4 per cent in July after falling by the same amount in June. Recent survey data however point to continued resilience in the sector, much of which has been due to strong external demand. As regards service sector activity, survey data in the form of the European Commission's Business Survey and the Purchasing Managers Index point to continued positive growth in the services sector in the second and third quarters of this year.

With regard to inflation, oil prices have continued to exert upward pressure on the Harmonised Index of Consumer Prices (HICP). Preliminary estimates suggest that in the twelve months to August, the annual change in the HICP was 2.3 per cent, unchanged from July, falling from 2.4 per cent in June. In July, for which more complete data are available, if we exclude energy, the increase was more moderate at 2.0 per cent. In the seven months up to July, inflation has averaged 2.1 per cent and we expect it to average this

rate for the year as a whole, due to the envisaged dissipation of the recent oil price increases. For next year as a whole we expect the rate of inflation to fall significantly to 1.6 per cent due to the high base effects carried over from the current year. This will be the first time that the annual inflation rate will have been below the European Central Bank's (ECB) target rate of 2 per cent since 1999.

In its latest meeting in September, the Governing Council of the ECB decided to leave its main refinancing rate at 2.0 per cent, citing that although somewhat stronger inflationary pressure was likely to persist in the short-term, the outlook still remains in line with price stability in the medium-term. They did however highlight some of the upside risks to inflation, stressing particularly the second round effect from recent oil price increases. With regard to the "first pillar" of the ECB's monetary policy strategy, growth of the M3 measure of broad money, at 5.5 per cent in June, remained above the ECB's reference value of 4.5 per cent. However, we have seen significant moderation in the growth of the money supply over the course of 2004 in comparison to 2003 where the growth rate of money supply was in excess of 8 per cent. This strong money supply growth was related to the large degree of economic, financial and geopolitical uncertainty over the year, which led to a sharp rise in the demand for short-term liquid assets. However, in the first half of this year, euro area investors continued to gradually normalise their portfolio allocation, shifting funds towards longer-term assets outside M3.

The labour market remains quite weak in the euro area with the unemployment rate at 9.0 per cent over the second quarter of 2004, up from 8.9 per cent in the first quarter. Employment growth has also been weak in the euro area with the continual decline in manufacturing employment offsetting much of the increases in the service sector. However, survey based indicators suggest that employment growth is strengthening. The European Commission's Business Survey showed signs of stabilisation in employment growth in manufacturing while the equivalent survey for services showed a continuing improvement in employment expectations for the sector. We expect further improvement in the labour market before year-end and forecast an average unemployment rate of 9.0 per cent for the year before moving to 8.8 per cent next year due to the lagged impact of the recent pick up in economic activity. Although an improvement, this will remain a very high rate of unemployment compared to comparator nations. This makes it particularly important that structural reforms of the labour market continue in order to improve the economic fundamentals that would enable the area to take fuller advantage of future upturns in international conditions.

Following a number of years of sharp deterioration in the euro area's public finance position, budget balances are projected to be broadly unchanged in 2004. The European Commission has recently forecast that following a deficit of 2.7 per cent of GDP in 2003, the average budget deficit will remain at 2.7 per cent in 2004. Because the economy is growing below its potential, in cyclically

adjusted terms the average deficit would be 2.2 per cent of GDP. Similar budgetary positions are also expected in 2005. In this scenario, six Member States would post deficits above the 3 per cent reference value in 2004 and/or 2005. In fact, the updated Stability Programmes indicate that a close-to-balance position in cyclically adjusted terms will not be reached in several countries even by 2007. This rather bleak outlook highlights the necessity for some member countries to take further consolidation measures and reform public expenditure policies in a way that fosters potential output growth and reduces existing budgetary imbalances.

Recent proposals from the EU Economic and Monetary Affairs Commissioner for more flexibility in the Stability and Growth Pact (SGP) seem sensible. These proposals, which are based more on peer pressure and less on mechanistic rules, include: softening the "exceptional circumstances clause" which justifies a country running a deficit of over 3 per cent of GDP; increasing the timescale for resolving an "excessive deficit procedure"; allowing countries with sound public finances to run modest deficits; and giving formal warnings to countries that fail to run appropriate fiscal policies during economic upturns. These proposals are however unlikely to be ratified in the new EU economic framework until mid-2005.

UK Economy

The UK economy, as measured by the volume of GDP, grew at a rate of 2.2 per cent in 2003. This represents a relatively favourable outturn *vis-à-vis* other large European economies. The increase was fuelled by solid growth in consumer spending and investment, and aided by a disproportionately small increase in the volume of imports. Public spending growth of over 3.5 per cent bolstered the growth rate, and counteracted the unfavourable effects of static export growth, which was indicative of the weak external economic environment prevailing last year.

The growth of consumer spending in 2003 took place against the backdrop of a falling unemployment rate and continued buoyancy in house price growth. Both factors contributed to improved consumer confidence. The unemployment rate decreased from 5.1 per cent at the beginning of 2003 to 4.9 per cent at the end of the year, averaging 5 per cent for 2003 as a whole. Most indices suggest that UK house prices grew by between 16 and 20 per cent during 2003.

The available data points to an acceleration of economic growth in 2004. Preliminary figures for the second quarter of the current year show annual growth of 3.7 per cent, up from a growth rate of 3.4 per cent in the first quarter. These figures clearly indicate that growth in 2004 is likely to be higher than that recorded in 2003. We forecast an overall growth rate of 3.2 per cent in 2004. The latest figures also signal a pause in the divergent trend observed in the production and service sectors of the UK economy with both sectors growing at a rate of 0.9 per cent in the second quarter compared to the first. This is in contrast to the situation observed

between 2001 and 2003, when repeated strong growth in the services sector outweighed successive declines in the production sector.

Private demand will act as the main component underpinning UK growth in 2004. Consumer spending, further sustained by a continuation of substantial house price growth and reductions in unemployment, grew at an annual 3.4 per cent in the first quarter. Though higher interest rates, decelerating house price growth, and a stabilisation of the unemployment rate will dampen consumer spending growth throughout the remainder of 2004, we expect that it will continue to act as the chief impetus for economic growth.

Investment spending recorded very strong growth in the first quarter of 2004. Its level in the second quarter was 1.4 per cent up on the previous quarter. This represents the outcome of rising confidence amongst the business community about future economic conditions, in addition to a substantial upsurge in home building due to the buoyancy of the house market. The modest increase in share prices over the last twelve months has added to this 'feel good' factor. We expect that investment growth will become slightly more subdued as the year progresses, due to the increasing cost of borrowing and the tapering off in house price growth. However, robust and rising business confidence will solidify investment levels.

The expansionary role of public spending observed in 2003 will continue through the current year and into 2005. The volume of public spending increased at a rate of 2.9 per cent in the first quarter of 2004, acting as a stabilising ingredient in the 3 per cent GDP growth rate observed in that quarter. Further increases in public spending are facilitated by the UK's relatively low level of public debt, which amounts to 40 per cent of GDP. However, the proposal to reduce the public service's size by over 100,000 jobs, if implemented, will reduce future public spending growth rates.

The external sector currently acts as the sole downward impulse in relation to the UK economy. In the first quarter of 2004, the volume of exports shrank by 2.7 per cent. We expect the combination of sterling's forecast depreciation on foreign exchange markets, plus the revival of global economic growth, to reverse the decline in the fortunes of the UK's exports throughout the rest of 2004 and into 2005.

The growth of the UK economy at a pace above its long run sustainable growth rate will erode that economy's already diminishing spare capacity. The risk is that the rate of inflation will accelerate, albeit from its current low level. This concern, along with the danger of an embryonic house price bubble, has prompted the Bank of England to increase its benchmark interest rate by a total of 1.25 percentage points since the end of 2003. We anticipate a further 25 basis point hike in UK interest rates in early 2005, with interest rates remaining at a 5 per cent level for the rest of that year. We expect that the culmination of these hikes will temper the prospect of any significant rise in the UK inflation rate over the next eighteen months. However, the recent boost in oil prices is

likely to instil some upward bias into the measured inflation rate. With these factors in mind, we forecast the UK Consumer Price Index inflation rate to average 1.5 per cent this year and to rise to 2.2 per cent in 2005.

The Rest of Europe

Of the ten states, which joined the EU in May, Poland is by far the largest. Despite weak growth in the euro area, which is its main trading partner, Poland managed to produce a respectable 3.8 per cent growth rate in 2003. Latest figures suggest that economic growth in 2004 will be much stronger. High levels of unemployment, at a rate of around 20 per cent of the labour force, will continue to drag on Poland's economy however. Real GDP grew at a rate of about 3 per cent in both Hungary and the Czech Republic in 2003. A modest acceleration of economic growth will be recorded in both countries in 2004 and 2005, although an uncomfortably high rate of inflation will continue to persist in Hungary. The Baltic states of Estonia, Latvia and Lithuania are currently enjoying a strong economic performance, with growth rates of real GDP ranging from 6.8 per cent to 8.8 per cent. Despite this, a rather high rate of unemployment persists in the Baltic region, amounting to about 10 per cent of the labour force.

Developments in the Swiss economy have mirrored those of the euro area over recent years, with the effect that Switzerland was mired in near stagnation between 2001 and 2003. Sizeable increases in exports, concentrated in the goods sector, boosted the growth rate in the first quarter of 2004, when GDP is estimated to have grown by 2 per cent. This recovery is forecast to continue in 2004, before moderating in 2005.

Negotiations on Turkey's accession to the EU are likely to begin in December. If successful, accession to the EU will add significantly to Turkey's future growth potential. Latest data add credence to the belief that Turkey may be the emerging giant of the European economy. Real GDP has grown at an annual rate of about 7 per cent since 2002, and these growth rates are likely to be maintained into the foreseeable future. Given its population of over 70 million persons, great potential exists for Turkey to become a significant economic player on the European stage. Additionally, there is evidence that the Turkish monetary authorities have finally tamed that country's historically high rate of inflation. In recent months, the rate of inflation has moved into single figures for the first time in many years. The plan by Turkey's central bank to redenominate its currency from January 2005 suggests that this authority believes the era of high Turkish inflation rates is over. The move towards price stability will be conducive to improved economic performance over the medium and longer term.

Rest of the World

China continues to be the star performer on the global economic stage. Real GDP growth in 2003 is estimated to have been 9.1 per cent, all the more impressive considering that China has

experienced similar growth rates for most of the past decade. This growth has been fuelled by enormous expansions in investment and exports, although their effects were diluted somewhat by similarly strong import growth. Despite such rapid economic growth, China's price level has remained broadly stable over the last number of years.

Latest figures suggest acceleration of growth in early 2004. China's GDP is estimated to have grown by 9.7 per cent in the first half of the year. This has resulted in the emergence of previously dormant inflationary pressure, with the inflation rate in 2004 likely to be over 3 per cent, in contrast to the 1.3 per cent rate observed in 2003. We expect that the tightening of economic policy currently underway will, coupled with the detrimental effects of recent oil price increases, reduce the rate of economic growth during the remainder of 2004 and into 2005. However, the improving external environment will still support robust growth rates over the next eighteen months. We forecast real GDP growth of 8 per cent in the current year, and a growth rate of 7 per cent in 2005 (See Box A for a discussion of China's role in world trade growth).

There has been an improvement in economic growth in Japan over the last twelve months. Annual growth rates in the first half of 2004 were the highest in almost five years. A sustained upturn in the Japanese economy appears to be in progress. This has been achieved on the back of the improving global economic climate. Export volumes have recorded annual increases of over 10 per cent since the beginning of 2004, and this is accelerating. Exports in the second quarter of 2004 were 13.4 per cent higher than in the corresponding period of 2003. Improving business confidence has seen large increases in investment, but consumer and public spending remain depressed. Nonetheless, we expect the strong export and investment conditions, plus the falling unemployment rate, to begin to impact on consumer behaviour later in the year. Therefore, we forecast a 4 per cent real GDP growth rate in 2004, slowing to 1.8 per cent in 2005.

Deflation has been a recurrent feature of the Japanese economy in recent years. At its root is the significant reservoir of unused capacity in that economy, accompanied by weak demand conditions. The strengthening in demand discussed above will reverse the fall in the Japanese price level. Combined with tightening supply conditions, evidenced by the falling unemployment rate, as well as rising oil prices, we expect an overall rise of 0.2 per cent in the Japanese price level in 2004, followed by a 0.3 per cent rise next year.

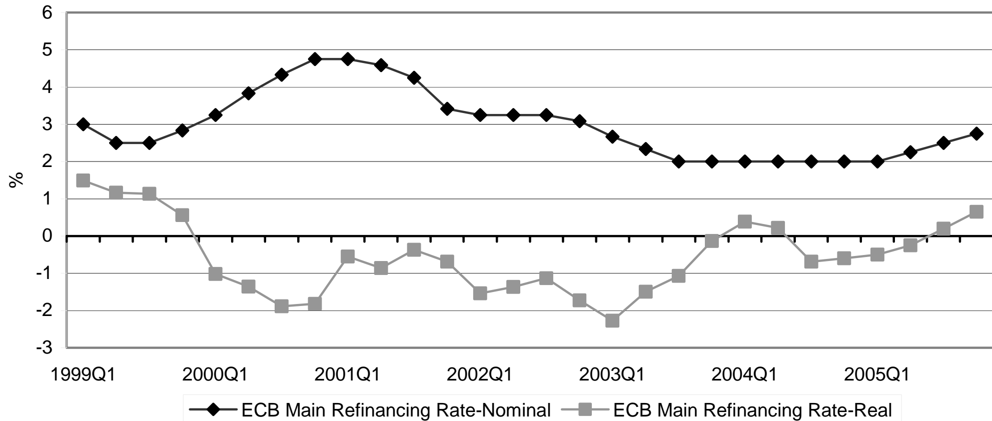
Growth in the other Asian market economies was quite strong in 2003 and is set to accelerate in most countries in 2004. The economic situation in Latin America is, for the most part, solid. Substantial growth rates are being observed in Brazil, while a strong recovery continues in Argentina.

TABLE 1: Short-term International Outlook

	GDP Output Growth			Consumer Price Inflation			Hourly Earnings Growth			Unemployment Rate %			Current Account Balance % of GNP		
Country	**2003**	**2004**	**2005**	**2003**	**2004**	**2005**	**2003**	**2004**	**2005**	**2003**	**2004**	**2005**	**2003**	**2004**	**2005**
UK	2.2	3.2	2.7	1.4	1.5	2.2	3.6	4.4	4.5	5.0	4.7	4.7	-1.9	-2.1	-2.0
Germany	-0.1	1.5	1.9	1.0	1.4	1.1	3.0	2.5	2.5	9.6	9.6	9.2	2.3	2.8	2.6
France	0.5	2.2	2.1	2.2	2.0	1.9	2.6	3.7	3.8	9.4	9.4	9.1	0.3	0.7	0.8
Italy	0.4	1.2	2.0	2.8	2.3	2.2	3.1	3.0	3.1	8.6	8.6	8.4	-1.4	-1.0	-0.8
Euro Area	0.5	1.8	2.0	2.1	2.1	1.6	3.3	3.1	3.2	8.9	9.0	8.8	0.4	0.6	0.7
USA	3.0	4.3	3.6	2.3	2.6	2.2	5.5	4.0	4.0	6.0	5.5	5.1	-4.8	-5.0	-4.7
Japan	2.5	4.0	1.8	-0.3	0.2	0.3	0.8	2.5	2.1	5.3	4.7	4.8	3.1	3.5	3.6
OECD	2.1	3.5	2.7	1.9	2.1	1.7	3.5	3.6	3.4	7.1	6.9	6.8	-1.2	-1.1	-1.1
Ireland	3.7	5.2	5.4	3.5	2.2	2.4	5.4	5.0	4.2	4.6	4.4	4.3	-1.7	-1.5	-1.3

Figure 1: Interest rates

Per Cent per Annum, Quarterly Averages



Context for Ireland

We anticipate that euro area interest rates will begin to increase through 2005. This is due to the forecast rebound in activity toward its sustainable rate of growth and the resulting price pressures which will have to be contained. In recent months, the euro area inflation rate has exceeded the ECB's medium-term target of 2 per cent. Despite this, the ECB has opted to leave interest rates unchanged because of weak internal demand conditions. We expect interest rate rises to commence in early 2005, and to increase by a total of 75 basis points by the end of that year, to reach 2.75 per cent.

We forecast a strengthening of the euro against sterling over the next eighteen months. This is due to the likelihood that the current large gap between UK and euro area interest rates will narrow over the next year and a half as the growth differential between the two economies also narrows. This will induce a shift by investors from UK assets toward euro area assets, bringing the exchange rate closer to its estimated fundamental level of £0.70 per euro. As regards the US dollar-euro exchange rate, we expect the US dollar to strengthen relative to the euro over the next eighteen months. This is based on the view that a credible attempt to narrow the sizeable US budget deficit will be made in the wake of November's presidential election. This will involve some combination of tax increases or expenditure cuts. Such measures will result in a reduction in aggregate demand, leading to a contraction in the trade deficit, and a subsequent strengthening of the US dollar. We also expect further increases in US interest rates to add buoyancy to the dollar's value on exchange markets.

The economic upswing being experienced by our main economic partners is likely to impact positively on Ireland's

economic performance through the channels of higher export demand, increased foreign investment, and the transmission of improved confidence to economic agents in Ireland. Given the strong growth in the US economy this year, combined with the forecast strengthening of the dollar against the euro, we anticipate that the US economy will be instrumental in underpinning demand in the Irish economy. Specifically, increased exports to the US, and higher levels of US Foreign Direct Investment (FDI), will constitute the chief components of these improved demand conditions. FDI will continue to serve as a vital conduit in effecting the transfer of new technologies to the Irish economy.

Since the last *Commentary*, concern about the high level of oil prices has mounted (See Box B in this *Commentary*). Oil currently acts as an important primary input into many avenues of economic production. The most immediate effect of increased oil prices is to heighten the measured rate of inflation, and this may induce contractionary policy measures. Higher prices inject a negative impulse into real economic measures such as output and employment by making production more costly than before, and by undermining the confidence of economic agents through uncertainty. The trend in oil prices over the last eighteen months has been upward; in recent weeks, the price of oil has reached $45 per barrel of Brent Crude, an all time high in nominal terms. Furthermore, futures prices reveal the expectation of the market that high oil prices will persist into the foreseeable future.

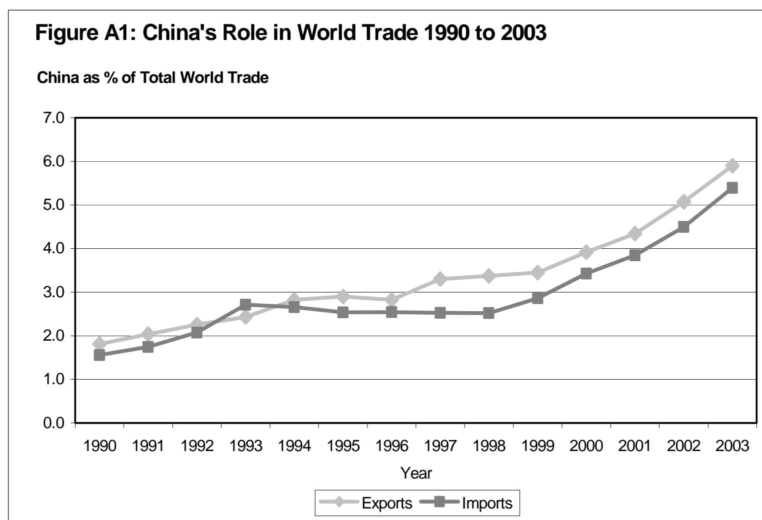
Box A: World Trade and the Emergence of China

The agreement reached in World Trade Organisation (WTO) talks in Geneva in August is a likely precursor to the overall success of the latest round of trade negotiations, which were initiated in Doha, Qatar in 2001. Any eventual deal is likely to involve an easing of trading restrictions worldwide, leading to a greater volume of world trade. This will throw the spotlight on the importance of the external sector for Ireland, where the value of exports and imports totalled 183 per cent of GNP in 2003. Commentators have identified the large Asian economies of India and China as potentially key players in world trade. China has focused on effecting economic growth through manufactured goods orientated exports, while India has attempted to compete in the area of IT services.

Until recently, China has underperformed in the realm of world trade. Despite claiming over 20 per cent of the world's population in 1980, China accounted for just under 1 per cent of the world's imports and exports. Since the 1990s, China's share of the world trade cake has risen significantly and steadily. Annual growth rates of over 20 per cent in export and import volumes lifted China's share of world trade to over 5.5 per cent in 2003. The anticipated sustenance of high growth rates will result in China's share of world trade becoming larger, and make China increasingly influential in shaping world trading patterns.

Growth in India's trading activity has been markedly slower than China's expansion. Between 1990 and 2003, India's share of

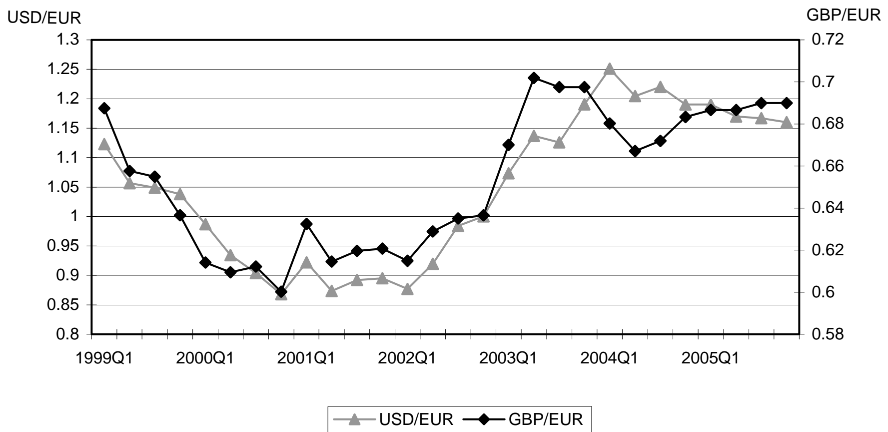
global trade grew slightly, from 0.6 per cent to 0.8 per cent. This represents a poor share, given India's 17 per cent share of the world's population. It is unlikely that India will constitute a force in world trade in the near future.



In terms of its trading relationship with Ireland, developments with regard to China have broadly mirrored global trends. In 1998, 0.1 per cent of Irish merchandise exports were to China. This rose to 0.7 per cent by 2003. This figure indicates that China is currently far from being an important export market from an Irish perspective; however, the growing importance of China as a potentially key market in the future is signalled by the fact that the value of merchandise exports to China rose almost eight fold over the same period.

The story in terms of imports is even more dramatic. China's share of Irish merchandise imports has climbed from 1.6 per cent in 1998 to 4.2 per cent in 2003. This represents a modest share, but the growth of 211 per cent in the value of Chinese imports over the five-year period suggests that China is quickly becoming a significant supplier of resources to the Irish economy.

In terms of structure, Electrical Products (36.1 per cent) and Office Machines (31.8 per cent) are the two largest categories of Irish exports to China. Similarly, Office Machines (64.9 per cent) and Electrical Equipment (6.8 per cent) are the two largest categories making up China's exports to Ireland. It is also worth noting that China is the destination for 4.1 per cent of Ireland's Electrical Goods exports, and that a substantial 17.9 per cent of Ireland's Office Machine imports and 9.6 per cent of Clothing imports originate in China.



The Domestic Economy

General

The *National Income and Expenditure* accounts for 2003 reveal that real GDP grew by 3.7 per cent and real GNP was up 2.8 per cent. Estimates of growth in the first quarter of 2004 indicate an acceleration in economic activity, with real GDP and real GNP growing by 6.1 per cent and 5.1 per cent respectively against the corresponding period of 2003. Investment has been the key driver of growth in both periods, indicative of strong increases in activity in residential construction. The divergent growth rates of GDP and GNP have served to further widen the gap between the two measures. In the first quarter of 2004, GDP was 28 per cent higher than GNP.

Exports

The *National Income and Expenditure Accounts* for 2003 show that the value of exports of goods and services fell by 5.8 per cent to €112.6 billion for the year as a whole. The contraction in volume terms was less notable, at 0.8 per cent, implying a price deflator of 5.1 per cent. This resulted from a rather sluggish international environment, together with the continued strength of the euro. Overall, merchandise exports, which are adjusted for balance of payments purposes, fell by a more notable 11.5 per cent in value terms but this was offset somewhat by quite strong growth in services exports, especially other services which increased by 11.9 per cent in value terms over the year.

TABLE 2: Exports of Goods and Services

	2002 €m	% Change in 2003 Volume	% Change in 2003 Value	2003 €m	% Change in 2004 Volume	% Change in 2004 Value	2004 €m	% Change in 2005 Volume	% Change in 2005 Value	2005 €m
Agricultural	4,167	2.8	1.3	4,219	4.0	2.4	4,322	2.2	2.3	4,422
Manufactured	82,442	-5.9	-14.6	70,442	6.3	5.8	74,505	8.8	12.1	83,494
Other Industrial	5,554	29.1	14.9	6,380	5.5	4.3	6,657	7.0	10.0	7,322
Other	1,512	-29.1	-34.8	987	3.3	2.9	1,015	4.0	7.1	1,087
Total Visible	**93,675**	**-3.8**	**-12.4**	**82,028**	**6.1**	**5.5**	**86,499**	**8.3**	**11.4**	**96,325**
Adjustments	-4,180	-21.0	-32.0	-2,842	4.0	-6.4	-2,660	15.0	20.8	-3,212
Merchandise	**89,495**	**-3.0**	**-11.5**	**79,186**	**6.2**	**5.9**	**83,840**	**8.1**	**11.1**	**93,113**
Tourism	3,256	0.2	4.7	3,409	2.3	3.8	3,540	3.2	5.8	3,744
Other Services	26,950	6.6	11.9	30,164	5.3	6.5	32,112	5.5	8.1	34,725
Exports of Goods and Services	**119,701**	**-0.8**	**-5.8**	**112,759**	**5.8**	**6.0**	**119,491**	**7.2**	**10.1**	**131,583**

We have seen a marked improvement in exports over the first half of 2004 with the value of total visible trade up by 3.7 per cent in the first six months of the year compared with the same period in 2003. There were also indications that export prices continued to fall in the first quarter of the year with figures suggesting that prices fell by 6.5 per cent compared with the same period of last year. This, coupled with the fact that the value of exports increased by 5.1 per cent in the first quarter, implies that the volume of exports surged by 11.9 per cent in the first quarter of 2004 compared with the same period last year. The recent trend of decreasing traded goods prices has been symptomatic, not only of exchange rate movements, but also of increased competition among exporters for market share during a period when international economic activity was somewhat anodyne. However, we do expect the improvement in global demand in 2004 to impact on prices over the course of the year and expect overall prices of exported goods and services to increase by 0.1 per cent. We also estimate that overall value growth will increase by 6.0 per cent over the year, thereby implying volume growth of 5.8 per cent.

We expect a further improvement in 2005 with a significant increase in the volume of merchandise exports to be reinforced by continued strong growth in services exports. We forecast a continuation of price increases for exported goods and services over the year which, coupled with a volume increase of 7.2 per cent, will lead to an overall value increase in the export of goods and services of 10.1 per cent to €131.6 billion.

Stocks

The value of physical stocks held by businesses in Ireland increased by €499 million during 2003. This represents the combination of an increase of €494 million in stocks held by non-farm businesses and a €43 million fall in stocks held by farms, as well as a €48 million rise in EU intervention stocks. In the first quarter of 2004, stock levels increased by €64 million. We forecast stocks to rise by €365 million in 2004, and by €340 million in 2005.

TABLE 3: Stock Changes

	2002	Change in Value	2003	Change in Value	2004	Change in Value	2005
	€m	€m	€m	€m	€m	€m	€m
Farm Stocks	-40	-3	-43	183	140	-250	-110
Irish intervention Stocks	176	-128	48	-43	5	-5	0
Other Non-Agricultural Stocks	-21	515	494	-274	220	230	450
Total	**115**	**384**	**499**	**-134**	**365**	**-25**	**340**

Investment

National Income and Expenditure accounts for 2003 show that gross domestic fixed capital formation (investment) grew by 3.4 per cent in volume and by 9.8 per cent in value terms in 2003. Data from the *Quarterly National Accounts* show an annual increase of 12.4 per cent in volume in the first quarter. The annual figures from 2003 confirm the importance of investment in new housing, accounting for 30 per cent of investment volume. Figures for the first half of 2004 indicate that new house completions have continued to grow strongly this year. In the six months to June 2004, 35,957 new houses were built, an increase of 21.4 per cent on the same period in 2003.

Other indicators confirm the strength of activity in the residential construction sector. Employment in building and construction has also been rising and planning permissions data for new dwellings rose substantially in the first quarter of 2004. On the basis of this information we have revised upwards our growth figures for the volume of investment in new dwellings. We now expect that volume growth will reach 15 per cent in 2004, implying that just over 79,000 new dwellings will be completed this year. This would represent another year of record output and a very high level of residential building for an economy the size of Ireland.

The volume of investment in other building is expected to grow by 5 per cent this year, having contracted by 3.6 per cent in 2003. The modest growth in the volume of investment in machinery and equipment recorded in 2003 suggests that volume growth in this segment should show some improvement this year. We estimate that volume growth in investment in machinery and equipment will grow by 5.5 per cent in 2004. On the basis of these forecasts volume growth in gross fixed capital formation is expected to be around 8.2 per cent in 2004. With an associated price deflator of 7.4 per cent this suggests that in value terms investment will grow by 16.3 per cent this year.

An important factor determining the outlook for investment in 2005 is our forecast for the level of new house completions. If completions were to continue to grow at recent rates then this would imply that in 2005 over 90,000 new dwellings would be completed. On the basis of forecast housing demand, allowing for the bringing forward of house purchase in the face of expected future price increases, and allowing for meeting any pent-up demand, the current level of housing supply is greater than demand.

On the assumption that the level of supply achieved in recent years is addressing the different types of demand listed above and that supply moderates the growth in new house prices, we anticipate a much lower increase in the volume of new house completions in 2005 at just 2 per cent. The forecast of stronger economic growth and the expectation that interest rates will remain low by historical standards means that we expect the growth in investment in other building and in machinery and equipment to increase next year. On the basis of these forecasts, shown in Table 4 overall investment is expected to increase by 5.3 per cent in volume terms, the slower growth in 2005 reflecting much more moderate growth in housing

investment. With overall investment forecast to grow by 9.8 per cent in value terms, this suggests an investment price deflator of 5.3 per cent in 2005.

Consumption

Official annual national accounts revised upwards the estimates for growth in personal consumption. It is now estimated that personal consumption expenditure grew by 2.6 per cent in volume terms in 2003. With an associated price deflator of 3.9 per cent this resulted in value growth of 6.6 per cent. Preliminary national accounts for the first quarter of 2004 indicate a moderate pace in the growth of personal consumption, with volume growth of 2 per cent compared with the same quarter in 2003. Retails sales data covering the first half of the year shows that total sales grew by just over 3 per cent in volume terms in the first six months of the year. Excluding the motor trade, which can be more volatile, the growth rate was 2.7 per cent.

The forecasts outlined elsewhere in the *Commentary* suggest that the economy will enjoy employment growth and rising incomes that should help to underpin growth in personal consumption this year. Furthermore, the IIB Bank/ESRI Consumer Sentiment Index shows that, although there have been some fluctuations, consumer sentiment has been improving. Thus, we are now expecting that personal consumption will grow by 3.8 per cent in volume terms this year. With a price deflator of 2.3 per cent this implies that in value terms personal consumption will grow by 6.2 per cent in 2004. A further improvement in economic growth coupled with an associated improvement in the labour market is forecast for 2005. Although interest rates are expected to increase this is not expected to result in any dramatic increase in the personal savings ratio. On this basis personal consumption growth is expected to increase again in 2005 to 4.5 per cent in volume terms and 7.1 per cent in value terms, resulting in a price deflator of 2.5 per cent.

The national accounts for 2003 show that public expenditure grew by 2.5 per cent in volume terms, down substantially from the 8.6 per cent growth recorded in 2002. Estimates for the first three months of this year show an increase in public expenditure volume growth to 3.9 per cent. This rate of increase is not expected to be maintained throughout the course of the year. Indeed, preliminary seasonally adjusted figures show a volume increase of 1.7 per cent. We expect that in volume terms public expenditure will increase by 2.2 per cent in 2004. Given the national pay deal and benchmarking increases that underpin much of public expenditure a deflator of 5.1 per cent is forecast, implying value growth of 7.4 per cent in 2004.

An increase in the rate of growth to around 3.5 per cent in volume terms is forecast for 2005. With some moderation in the price deflator for government consumption to 4.2 per cent, the value of public consumption is forecast to increase by about 7.9 per cent in 2005.

TABLE 4: Gross Fixed Capital Formation

	2002 €m	% Change in 2003 Volume	% Change in 2003 Value	2003 €m	% Change in 2004 Volume	% Change in 2004 Value	2004 €m	% Change in 2005 Volume	% Change in 2005 Value	2005 €m
Housing	10,804	14.4	27.6	13,785	15.0	27.1	17,517	2.0	8.1	18,940
Other Building	9,245	-3.6	-0.3	9,220	5.0	7.6	9,923	6.5	10.8	10,991
Building and Construction	20,050	5.0	14.7	23,005	10.2	19.3	27,440	4.1	9.1	29,930
Machinery and Equipment	8,933	1.2	-1.4	8,810	5.5	8.5	9,555	7.0	11.8	10,684
Total	28,983	3.4	9.8	31,815	8.2	16.3	36,995	5.3	9.8	40,614

TABLE 5: Consumption Indicators

	Annual Percentage Change				
	2001	2002	2003	2004 Forecast	2005 Forecast
Consumption Value					
Personal Consumption	9.8	8.6	6.6	6.2	7.1
Retail Sales Index, Value	3.3	2.6	3.2	4.2	4.3
Divergence	6.5	6.0	3.4	2.0	2.8
Consumption Volume					
Personal Consumption	5.5	2.8	2.6	3.8	4.5
Retail Sales Index, Volume	1.5	0.1	0.9	3.2	2.2
Divergence	4.0	2.7	1.7	0.6	2.3
Consumer Prices					
Personal Consumption Deflator	4.1	5.7	3.9	2.3	2.5
Retail Sales Index Deflator	1.8	2.5	2.3	1.0	2.1
Consumer Price Index	4.9	4.6	3.5	2.2	2.4

Final Demand

The fall in the volume of exports recorded in 2003 acted as a significant counterweight to the modest increase in domestic demand. The overall effect was a weak 1.1 per cent increase in final demand in 2003.

Quarterly National Accounts figures for the first quarter of 2004 indicate that final demand has grown by 4.8 per cent since the first quarter of 2003. This trend is likely to accelerate over the remainder of the year. This is based on the view that the benign international environment will impact positively on export growth. Improving confidence at home will boost domestic demand, particularly investment. We forecast 5.2 per cent growth in final demand in 2004.

This upswing will be further accentuated in 2005. The international environment will support a large increase in exports. The consistent improvement in economic conditions will allow for more buoyancy in private demand: the outcome will be a robust increase in consumer expenditure, and a particularly sizeable increase in investment spending. We forecast final demand to increase by 5.9 per cent in 2005.

Imports

Statistics from the *National Income and Expenditure* accounts show that imports of goods and services contracted by 6.6 per cent in 2003 in value terms and by 2.3 per cent in volume terms. This implies a price deflator of –4.4 per cent, which confirms the trend of falling traded prices observed in the figures for exports. The value increase

TABLE 6: Imports of Goods and Services

	2002 €m	% Change in 2003 Volume	% Change in 2003 Value	2003 €m	% Change in 2004 Volume	% Change in 2004 Value	2004 €m	% Change in 2005 Volume	% Change in 2005 Value	2005 €m
Capital Goods	7,065	-11.9	-19.0	5,726	5.5	6.6	6,102	6.0	9.2	6,662
Consumer Goods	12,761	4.3	-0.9	12,648	4.8	6.4	13,454	5.5	8.5	14,591
Intermediate Goods:										
Agriculture	946	6.7	4.5	989	2.2	2.7	1,016	2.9	5.0	1,066
Other	32,845	-10.2	-19.0	26,595	5.2	6.5	28,313	7.0	9.6	31,022
Other Goods	2,009	-0.2	-7.2	1,864	3.5	4.0	1,939	4.6	7.0	2,075
Total Visible	**55,628**	**-6.5**	**-14.0**	**47,822**	**5.0**	**6.3**	**50,824**	**6.3**	**9.0**	**55,416**
Adjustments	-1,576	84.4	30.5	-2,057	10.0	11.1	-2,285	-20.0	-20.0	-1,828
Merchandise Imports	**54,052**	**-9.1**	**-15.3**	**45,765**	**4.8**	**6.1**	**48,538**	**7.5**	**10.4**	**53,588**
Tourism	3,942	8.4	6.2	4,188	4.0	6.1	4,443	5.0	7.5	4,777
Other Services	40,514	5.6	3.7	42,028	4.3	5.9	44,493	6.5	8.9	48,475
Imports of Goods and Services	**98,508**	**-2.3**	**-6.6**	**91,981**	**4.5**	**6.0**	**97,474**	**7.0**	**9.6**	**106,839**

comprised of a fall in merchandise imports of 15.3 per cent, a large proportion of which was due to a contraction in the importation of machinery and transport equipment, and was partially offset by an increase in services imports in the order of 4.0 per cent.

Figures for the first quarter of 2004 indicate that import growth may not have rebounded quite as strongly as export growth. Balance of Payments figures for the first quarter show a contraction of 1.6 per cent in merchandise imports compared with the same period of last year. Visible trade statistics confirm this, showing a contraction in the value of imports of around 1.8 per cent. Visible import prices declined by 2.6 per cent over the same period, thereby leading to a modest annual increase in the volume of visible imports in the first quarter of 0.7 per cent. There was, however, a marked increase in the value of imports in the second quarter, which combined with the first quarter implied that the value of imports was 2.7 per cent higher than that of the same period in 2003.

We expect this trend to continue as domestic demand accelerates both this year and next. We forecast that for 2004, the volume of merchandise imports will increase by 4.8 per cent. Service import growth is expected to expand in excess of 4 per cent, which leaves our forecast for real growth in the imports of goods and services at 4.5 per cent for the year as a whole. Value growth of 6.0 per cent implies that, like export prices, we expect the price of imports to increase over the year and the price deflator is forecast to be 1.4 per cent. The pass-through of continued strengthening domestic demand is expected to increase the demand for imports in 2005 also. For the year as a whole, we forecast the volume of imports to grow at a rate of 7.0 per cent in volume terms, or 9.6 per cent in value terms, implying a price deflator of 2.5 per cent.

Balance of Payments

The Balance of Payments release for the first quarter of 2004 showed significant revisions to previous years' figures reflecting, amongst other things, new estimates for previously unrecorded merchandise trade and improved estimates for some components of services, income and current transfers. As a result, for 2002, the deficit on current account was €1,617 million or 1.5 per cent of GNP. This is compared to a previously published €954 million or 0.9 per cent of GNP. Significant revisions, albeit in the opposite direction, also applied to the 2003 figures where the deficit was revised down from €2,647 million to €1,896 million or 1.7 per cent of GNP for the year as a whole.

In 2003, the merchandise trade balance deteriorated by 5.7 per cent reflecting a decline in exports which more than offset the decline in imports. This was somewhat counterbalanced by a reduction of 11.3 per cent in the service trade balance, most of which was brought about by strong performances in the insurance and financial services sectors. Therefore, the overall trade surplus in goods and services, at €20.8 billion, deteriorated by 2.0 per cent in value terms in 2003 with the deterioration primarily reflecting lower traded prices, as domestic exporters tried to offset the effect of a

strong currency. Both debit and credit flows contracted in 2003 in the order of 1.5 per cent. However, as debit flows are over double that of credit flows, overall net factor flows fell by 1.7 per cent in value terms. Net current transfers also fell by almost 38 per cent to €440 million, which implied a Balance of Payments current account deficit of close to €1.9 billion for the year as a whole.

There is some evidence of an improvement in the external position in 2004 with figures for the first quarter showing a deficit of €685 million, a reduction of nearly 18 per cent on the same period last year. The merchandise surplus increased while the services deficit continued on its improving path and fell in the first quarter when compared to the same period last year. However, the net outflow of factor incomes increased year on year and was mainly driven by a surge in the net outflows of reinvested earnings. We expect these broad trends to continue this year with continued improvement in the trade balance in goods and services, and a significant increase in net factor flows. This will be due to the very favourable international conditions present in 2004, which serve not only to boost exports but also to bolster multinationals' profits, much of which are repatriated. Overall, we forecast that in 2004 the deficit on current account, at €1.9 billion, will remain virtually unchanged from the previous year, although as a percentage of GNP the deficit should fall to around 1.5 per cent. Robust export growth in 2005 implies an improvement in the economy's external position, to leave the current account deficit at around €1.3 billion or 1.3 per cent of GNP.

TABLE 7: Balance of Payments

	2002 €m	Change %	2003 €m	Change %	2004 €m	Change %	2005 €m
Visible Trade Balance	38,047	-10.1	34,206	4.3	35,676	14.7	40,908
Adjustments	-2,604		-785		-375		-1,383
Merchandise Trade Balance	**35,443**	**-5.7**	**33,421**	**5.6**	**35,301**	**12.0**	**39,525**
Service Trade Balance	-14,250	-11.3	-12,643	5.1	-13,284	11.3	-14,782
Trade Balance in Goods and Services	**21,193**	**-2.0**	**20,778**	**6.0**	**22,018**	**12.4**	**24,743**
Total Debit Flows	-52,381	-1.5	-51,570	4.0	-53,628	6.2	-56,936
Total Credit Flows	28,863	-1.4	28,455	3.6	29,491	2.6	30,269
Net Factor Flows	**-23,518**	**-1.7**	**-23,115**	**4.4**	**-24,136**	**10.5**	**-26,667**
Net Current Transfers	**708**	**-37.9**	**440**	**-43.2**	**250**	**-16.0**	**210**
Balance on Current Account	**-1,617**		**-1,897**		**-1,869**		**-1,714**
Capital Transfers	512	-27.7	370	1.4	**375**	16.0	435
Effective Current Balance	**-1,105**		**-1,527**		**-1,494**		**1,279**

Gross National Product

The volume of GNP, a measure of real income earned from economic activity by Irish residents, grew by 2.8 per cent in 2003. This was less than the 3.7 per cent GDP growth recorded, indicating an increase in the proportion of the volume of economic output being appropriated by non-residents. In the first quarter of 2004, GNP grew by 5.1 per cent. We expect this growth to

moderate slightly over the remainder of the year. We therefore forecast GNP growth of 4.8 per cent in 2004. The effects of the benign international environment currently prevailing are likely to impact on Ireland's economic activity in 2005, producing similarly robust growth levels. We forecast real GNP growth of 5.0 per cent in 2005. Gross National Disposable Income (GNDI) is a measure of the income appropriated by Irish residents, which takes account of terms of trade effects and international transfers. It is possibly the most appropriate available indicator of the economic well being of Irish residents in a particular year. In 2003, the volume of GNDI increased by a modest 2 per cent. We forecast GNDI to grow by 3.1 per cent in 2004, before accelerating to 5.1 per cent in 2005.

Agriculture

Final figures for 2003 suggest a rebound in the agricultural sector following contractions in both 2001 and 2002. Overall, the volume of gross value added (GVA) for the sector increased by 5.0 per cent over the year. However, this only contributed 0.2 of a percentage point towards overall economy-wide growth in GVA. In the first quarter of this year, the sector grew by 1.9 per cent when compared to the same quarter in 2003. However, when seasonally adjusted, the first quarter registered a contraction of 0.8 per cent when compared to the previous quarter.

Agricultural incomes, as measured by operating surplus, also rebounded somewhat in 2003, growing by 2.6 per cent as compared to a fall of 6.8 per cent in 2002. This measure of income excludes both interest and land rental payments, which were equivalent to over 16 per cent of agricultural income in 2003. Increases in output values in the cattle and milk sectors were partially offset by increases in input costs and decreases in net subsidies. Moreover, net subsidies in 2003 accounted for 68.0 per cent of agricultural income as compared to 71.2 per cent in 2002. This trend of a falling contribution from subsidies is likely to continue in the medium term with the full decoupling of premium payments from production due to start in 2005.

These impending changes in the structure of the agricultural sector are likely to speed up the transformation of a sector that has been hit continually by reducing margins over the last number of years. The Teagasc National Farm Survey for 2003 is quite indicative of this transformation in the sector. Results show that average family farm income was €15,054 per farm in 2003, up from €14,917 in 2002. Of all farms, approximately 62 per cent were classified as part time and these farms earned an average of €6,360. Overall, almost 80 per cent of farms had another source of income with 20 per cent dependent on farming solely for their livelihood. Such huge structural changes are not likely to reverse in the future, especially with decoupling on the horizon, and therefore we feel the longer-term overall outlook for the sector remains quite modest. In the short term however, following moderate growth of 1.3 per cent in 2003, we forecast agricultural output to rebound somewhat in 2004 and 2005, growing by 4.6 and 5.2 per cent respectively.

Industry

Figures from the *National Income and Expenditure* accounts for 2003 indicate that there was a sharp slowdown in the industrial sector over the year, with the volume of real gross value added increasing by only 2.5 per cent. This was despite the inclusion of the booming building sector in this industrial sector category. This is compared to growth of 9.6 per cent in 2002 and average annual growth of 11.9 per cent in the previous five years. A significant portion of this slowdown was due to the volatile reproduction of recorded media sub-sector, whose value added contracted by 45.6 per cent in real terms following an expansion of 64.3 per cent in 2002. The chemicals sector also experienced quite a noticeable slowdown with growth of 4.7 per cent in 2003 as compared with 27.1 per cent growth in 2002.

The *Quarterly National Accounts* suggest that activity in the industrial sector strengthened somewhat in the final quarter of 2003, growing by 9.2 per cent year on year, and this has continued into the first quarter of 2004 with 8.0 per cent growth compared to the same period last year. However, when seasonally adjusted, output in the sector actually fell by 2.1 per cent quarter on quarter in the first three months of this year. Care must be taken, however, when interpreting seasonally adjusted data from this source as the seasonal factors used for the adjustment are taken from a relatively short time period and one which has seen tremendous change and volatility in quarterly sectoral output.

Data from the *Industrial Production and Turnover* release, which excludes the building sector and deals with larger enterprises employing 20 persons or more, paints a somewhat weaker picture for the manufacturing sector. Following growth of 6.4 per cent in 2003, the volume of manufacturing production has increased by 3.8 per cent in the first half of 2004 when compared with the same period last year. However, when seasonally adjusted, the volume of production contracted by 5.9 per cent in the first quarter compared with the previous quarter and by 1.6 per cent in the second quarter. These quarterly contractions have been mainly due to sizeable contractions in the "modern" sectors of the economy.

The NCB Purchasing Managers Index continues to show expansion in the manufacturing sector over the course of 2004 with latest figures showing the index at 54.7 in August, down slightly from 55.2 in July. A figure greater than 50 indicates expansion in the sector. This quite strong performance reflects strength in the new orders component although this was partially offset by increasing input costs. The employment component, at 51.2 in August, remained close to the critical 50 level, indicating some employment growth in the sector. The forward-looking components of the IBEC/ESRI monthly industrial survey suggest that firms are confident of continued expansion in the sector over the next few months, although the June survey suggests that expectations have been scaled back somewhat, possibly reflecting the perceived weakening of international economic conditions, particularly in the US.

In general, improving domestic and external conditions should provide a favourable backdrop for stronger growth in the industrial sector over the next eighteen months. We forecast that output in the sector will grow by 4.7 per cent in 2004 before strengthening further to 5.5 per cent in 2005.

Services

Following growth of 4.8 per cent in 2002, the *National Income and Expenditure* accounts, show that the service sector grew by a more moderate 3.9 per cent in 2003, reflecting sluggish domestic demand. Of this, nearly 1 percentage point was contributed by *Distribution, Transport and Communication* while 2.6 percentage points was attributable to the *Other Services* category. *Public Administration and Defence* contributed only 0.1 of a percentage point.

Figures for the first quarter of 2004 suggest that the pace of activity in the services sector has picked up. When compared to the same period last year, the annual change in output for the sector was 3.0 per cent in the first quarter, which was driven by growth in other services of 5.1 per cent. Seasonally adjusted, the sector grew by 1.2 per cent when compared to the previous quarter or by 5.3 per cent in annualised terms. This strong growth is expected to have continued over the year to date and this is borne out by NCB's PMI for the sector over the first half of the year. The business activity index has remained above the critical 50 level, indicating expansion, since mid-2003 and stood at 58.1 in August. Input costs remained high but this was more than offset by continued strength in new business and positive business expectations about the future.

We expect the upturn in the sector to continue for the remainder of the year and into next on the back of considerable income and personal consumption growth. Beyond this short-term horizon, there is scope for continued growth in this sector in the medium to long term. Currently the sector accounts for 58 per cent of total nominal output in the economy. Although this is quite a substantial share of total output, in comparison to other developed economies this ratio is still quite low. For instance, the equivalent ratio in the EU-25 and the US is 71 and 76 per cent, respectively. Therefore, there is quite a large potential for future growth in the sector, both in terms of output and employment, and we thus expect the sector to continue to contribute more to overall economic growth out into the future.

Improving income and consumption growth will provide the necessary conditions for continued strong growth in the services sector both this year and next. Following volume growth of 3.9 per cent in 2003, we forecast that growth in the sector will pick-up to 4.9 and 5.1 per cent in 2004 and 2005 respectively.

Employment

According to the *Quarterly National Household Survey*, the number of persons employed in Ireland during the second quarter of 2004 (from March to May) increased by 42,800 compared with the same period of 2003, a rise of 2.4 per cent. This employment growth was

concentrated in full-time jobs, which increased by 2.5 per cent on the year. This accounted for 86 per cent of the growth in employment. After seasonal factors are taken into account, employment grew by 2,000 between the first and second quarters of 2004. When analysed by category, annual growth in construction employment was 7.6 per cent, symptomatic of the strong level of house building currently taking place. Job numbers in financial and other business services and other services grew by 4.4 per cent and 14.9 per cent respectively. Employment declines occurred in public administration and defence (3.1 per cent) and in the hotel and restaurant sector (5.8 per cent). In the case of the latter, the decline in employment is in line with the contraction in this sector currently being experienced. Agriculture now employs 6.4 per cent, while industry provides 27.6 per cent of jobs. Services make up 66 per cent of employment.

TABLE 8: Employment and Unemployment*

	Annual Averages			
	2002	**2003**	**2004**	**2005**
Agriculture	125	120	121	121
Industry	496	499	505	512
Services	1,156	1,192	1,227	1,254
Total at Work	**1,777**	**1,811**	**1,853**	**1,887**
Unemployed	82	88	86	85
Labour Force	**1,859**	**1,899**	**1,940**	**1,972**
Unemployment Rate %	4.4	4.6	4.4	4.3
Live Register	162	172	167	164

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

An expanding labour force coincided with these employment increases. Between the second quarter of 2003 and the second quarter of 2004, the number of persons in the labour force grew by 2.4 per cent. Males accounted for 60 per cent of this increase. When seasonally adjusted, the size of the labour force increased by 5,000 persons between the first and second quarter of 2004. This equates to a labour force participation rate of 60.6 per cent, 0.4 percentage points higher than that twelve months earlier. The commensurate increases in both labour force size and employment implies that the seasonally adjusted unemployment rate was 4.6 per cent in the second quarter of 2004, the same as that recorded in the same period of 2003. This figure represents a slight deterioration in comparison with the first quarter of the current year, when the unemployment rate was 4.4 per cent of the labour force in seasonally adjusted terms. Examining the number of persons on the Live Register provides an indication of more recent trends. In August 2004, this figure was 5.5 per cent lower than in the same

TABLE 9: Personal Disposable Income

	2002	Change		2003	Change		2004	Change		2005
	€m	%	€m	€m	%	€m	€m	%	€m	€m
Agriculture, etc.	2,877	1.3	38	2,915	4.6	135	3,050	5.2	160	3,210
Non-Agricultural Wages	49,806	7.2	3,596	53,402	7.6	4,054	57,456	6.2	3,573	61,029
Other Non-Agricultural Income	14,316	5.1	736	15,052	3.1	468	15,519	11.4	1,773	17,292
Total Income Received	**66,999**	**6.5**	4,370	**71,369**	**6.5**	**4,657**	**76,025**	**7.2**	**5,506**	**81,532**
Current Transfers	13,174	10.8	1,421	14,595	8.9	1,295	15,890	6.2	993	16,883
Gross Personal Income	**80,173**	**7.2**	**5,791**	**85,964**	**6.9**	**5,952**	**91,915**	**7.1**	**6,499**	**98,415**
Direct Personal Taxes	15,048	4.2	635	15,683	7.4	1,159	16,842	6.1	1,030	17,872
Personal Disposable Income	65,125	7.9	5,155	70,280	6.8	4,793	75,073	7.3	5,469	80,542
Consumption	59,019	6.6	3,916	62,935	6.2	3,894	66,829	7.1	4,753	71,582
Personal Savings	6,106	20.3	1,239	7,345	12.2	899	8,244	8.7	716	8,960
Savings Ratio	9.4			10.5			11.0			11.1

month of 2003, and had decreased by 4,700 since January after seasonal factors had been accounted for. The result was a 4.3 per cent standardised unemployment rate in August 2004. This represents a reduction of 0.4 percentage points over the previous twelve months.

In terms of the scope for future employment growth, the percentage of persons who are available to provide more labour to the economy declined to near its all time low in the second quarter of 2004. This indicates that capacity in the labour market is being squeezed, and the employment rate may be close to its natural peak. We expect that, following 1.9 per cent employment growth in 2003, growth will strengthen to 2.3 per cent this year before easing back to 1.8 per cent in 2005. We forecast that the unemployment rate will fall slightly to 4.3 per cent in 2005, from an average of 4.4 per cent in 2004.

Incomes

We have increased our projections for income growth in the Irish economy since the previous *Commentary* as a result of improved economic conditions and the resulting tightening in the labour market. The continued elimination of excess labour supply, as evidenced by the forecast diminution unemployment to rates of 4.4 and 4.3 per cent for this year and next, should exert significant upward pressure on earnings growth in the short term. This combined with the agreed wage terms of the second phase of the *Sustaining Progress* agreement and the final instalments of the *Benchmarking* awards for the public service should maintain strong earnings growth. Therefore, following hourly earnings growth of 5.4 in 2003, we forecast hourly earnings growth of 5.0 and 4.2 per cent in 2004 and 2005 respectively.

The prospects of substantial employment creation together with considerable hourly earnings growth are expected to maintain quite strong growth in the non-agricultural wage bill both this year and next. Following growth of 7.2 per cent in 2003, non-agricultural wages, which account for nearly 75 per cent of total income received, are forecast to grow by 7.6 per cent in 2004 and 6.2 per cent in 2005. With national income growing in nominal terms at rates above 8 per cent, this implies that labour's share of value added will continue to decline.

Following remarkable growth of close to 30 per cent in 2002, net factor income flows which are composed chiefly of multinational profit repatriations, actually contracted by 1.7 per cent in 2003 reflecting the high base from the previous year and rather sluggish conditions in the international environment. The uptake in international activity this year is expected to provide a positive stimulus to profitability, especially in the multinational sector, and therefore we forecast that net factor income flows will expand by 4.4 per cent in 2004 before accelerating 10.5 per cent in 2005.

Quite strong growth in other non-agricultural incomes, primarily personal income from profits and rents, coupled with growth in agricultural incomes imply that total income received will

grow by 6.5 per cent this year and 7.2 per cent in 2004. This implies that, when current transfers and direct taxes are taken account of, overall personal disposable income will grow by 6.8 and 7.3 per cent respectively in 2004 and 2005. We expect that personal savings growth will also remain strong in the short term. Following a savings rate of 10.5 per cent in 2003, we forecast a savings rate in the order of 11 per cent in 2004 and 2005.

Consumer Prices

The annual rate of inflation, as measured by the Consumer Price Index (CPI), was 2.6 per cent in August 2004. Although this is slightly lower than the figure for July, the inflation rate has accelerated in recent months, from March's trough of 1.3 per cent. The bulk of the price increase has been concentrated in the service sector, where prices increased by 3.9 per cent over the year. This is a reflection of strengthening domestic demand conditions and of diminishing capacity in the labour market, on which the services sector is particularly dependent. The rather anaemic 1.4 per cent growth in the price of goods, which are internationally traded, owes more to the strengthening in the value of the euro witnessed over the last twelve months and the external backdrop of weak price pressure. Despite the absence of interest rate increases, the cost of mortgage interest increased by 12.5 per cent over the past twelve months. This figure reflects the rising value of the outstanding mortgage stock, mainly due to continued property price increases. The contribution of higher mortgage interest to the overall rate of inflation is 0.58 percentage points, only marginally lower than the 0.77 percentage point contribution made by the energy product price rises, which capture most of the primary effects of recent oil price hikes.

When measured using the Harmonised Index of Consumer Prices (HICP), Ireland's inflation rate registered 2.5 per cent in August 2004, for the third straight month. In contrast to the CPI, the HICP measure of inflation has been broadly stable during 2004, fluctuating between 2 per cent and 2.5 per cent. This is because the HICP excludes some items which feature in the CPI, such as mortgage interest, insurance and motor taxes. These categories have, on balance, added an upward and more volatile element to the CPI over the last twelve months.

The most significant contribution to service sector inflation came from *Restaurants and Hotels*, where prices increased by 4.5 per cent over the last year. The 5.6 per cent increase in *Transport* prices is partly a reflection of oil market pressures. Price falls were recorded amongst several categories of goods, including *Clothing and Footwear* and *Food and non-Alcoholic Beverages*, whose prices fell by 3.9 per cent and 0.6 per cent respectively.

We expect the inflation rate to average 2.2 per cent for 2004 as a whole. We do not expect energy prices to exert significant upward pressure on the inflation rate in 2005. This is because the potential for large percentage increases in energy prices is limited by the already high base such prices stand at in 2004. Nevertheless, we

forecast a slightly higher inflation rate of 2.4 per cent in 2005. This figure reflects the likelihood of ECB interest rate rises in 2005 impacting on mortgage interest costs, as well as the probability of some wage driven inflation resulting from the continued tightening of the labour market forecast to take place next year. The competing effects of the forecast appreciation of the US dollar and the depreciation of sterling are likely to be broadly neutral from an inflationary viewpoint.

TABLE 10: Consumer Price Index – Recent Trend and Forecast

	2000	2001	2002	2003	2004 Forecast	2005 Forecast
Annual % Change						
Housing	8.8	16.5	0.9	-0.6	3.6	4.3
Other	5.4	4.0	5.0	4.2	2.2	2.2
Total CPI	5.6	4.9	4.6	3.5	2.2	2.4
EU-HICP (Ireland)	5.2	4.0	4.7	4.3	2.6	2.3
Index Dec. 2001=100						
Housing	88.2	102.7	103.7	103.1	106.8	111.4
Other	93.6	98.7	102.6	106.9	109.2	111.6
Total CPI	92.7	97.9	102.7	106.3	108.7	110.3

Box B: Impact of Oil Price Shocks

In the Spring 2003 edition of the *Commentary* we simulated a 100 per cent increase in the price of oil from a base of $30 a barrel. The impacts both internationally and domestically were considerable in terms of output, employment and prices and reflected the extremity of the scenario. In recent months the price of oil has increased sharply with Brent crude oil reaching a peak of around $45 a barrel in August having started the year at around $30 a barrel. Strong demand pressures, largely coming from China and the USA, coupled with tight supply side factors arising from terrorist attacks and strikes in oil producing countries have contributed to the increase. This has led to debate about the likely impact on the Irish economy of higher oil prices and whether it will delay the recovery in the international economy.

The magnitude of the impact of higher oil prices on inflation and output depends crucially on the degree of monetary tightening and on the response of wage bargainers to a decline in real wages. The response of the monetary authorities depends on whether they view the shock to be permanent or temporary. A temporary shock is likely to have a smaller effect on output than a permanent shock because, in a world where people look to the future, a permanent shock affects expectations, leading to the economy adjusting now in response to anticipated future conditions.

While output effects are more negative in permanent shocks leading to less upward pressure on inflation, a temporary shock will not change inflation expectations in the long run so it should have a smaller impact on inflation. Monetary authorities are less likely to respond by changing interest rates if they believe that the effect on the price level is temporary.

Using the *NiGEM* world model we undertake a set of simulations to examine the likely impact of a permanent 45 per cent increase in the price of oil and we compare these results to a temporary shock of the same size.[1] The results for the international environment are then used in the ESRI *HERMES* macroeconomic model to determine the impact of the external shock on the Irish economy. The results of the simulations are presented in Table B1. These simulations are not presented as a forecast; but rather they allow us to examine how the Irish economy might respond to an external supply side shock.

Table B1: Temporary vs. Permanent Oil Price Rise (Cumulative Per Cent Difference from Base)

	45% Permanent Increase					
	USA		**Euro Area**		**Ireland**	
Year	Output	Inflation	Output	Inflation	Output	Inflation
1	-0.29	0.62	-0.45	0.36	-0.67	0.53
2	-0.50	1.87	-0.41	0.59	-1.23	0.68
3	-0.58	3.26	-0.33	0.65	-0.76	1.36
	45% Temporary Increase					
	USA		**Euro Area**		**Ireland**	
Year	Output	Inflation	Output	Inflation	Output	Inflation
1	-0.11	0.13	-0.28	0.41	-0.48	0.64
2	-0.16	0.49	-0.13	0.71	-0.92	0.89
3	-0.10	0.74	0.34	0.47	-0.62	0.63

Broadly speaking, the table shows that output effects tend to be larger in the euro area and inflation effects are likely to be larger in the US. This is partly due to the more flexible price system in the US, which means it responds more quickly to shocks. The negative effects on the Irish economy are somewhat greater, reflecting a loss of income through adverse movements in the terms of trade, and a greater sensitivity to both the slowdown in international activity and interest rate changes. In addition, the table shows that the effects of higher oil prices are less marked when the shock is temporary.

A more realistic scenario is that part of the increase in oil prices is permanent and that part is temporary. Table B2 shows the results on the domestic economy of 45 per cent oil price increase with two-thirds of the shock treated as temporary and one-third as permanent.

Table B2: Effect of Oil Price Shock on Irish Economy (Cumulative Per Cent Difference from Base)

	Year 1	**Year 2**	**Year 3**
GNP	-0.55	-1.02	-0.66
Total Employment	-0.22	-0.52	-0.62
Consumption Deflator	0.61	0.82	0.89
Non-Agricultural Wages	0.44	0.47	0.18
Unemployment Rate*	0.18	0.39	0.41
Real Personal Disposable Income	-0.84	-1.67	-1.35
Consumption	-0.70	-1.56	-1.34
Greenhouse Gas Emissions	-0.92	-0.97	-0.43

* percentage points from base.

[1] The impact on the international economy is based on simulation results from the National Institute of Economic and Social Research *NiGEM* model. The temporary shock assumes that the 45 per cent increase in oil prices is sustained for two years.

This shock leads to a lower level of activity in the economy, with economic growth below its long-term potential for a sustained period. Consumer prices will be higher as a result of the rise in oil prices. The weakening of the euro as a result of the shock is likely to have a bigger impact on the Irish economy than elsewhere in the euro area, as the Irish labour market is more flexible so wages would rise by more. This would have a serious negative impact on Irish competitiveness and ultimately output growth.

Despite the increase in wages, the impact of higher consumer prices would lead to a substantial fall in real personal disposable income. This has a marked negative effect on consumption and, in turn, it has knock-on effects for the market services sector, which is largely driven by domestic demand. Interest rates in the euro area would rise by approximately 0.4 percentage points in the short term and this would have a particularly negative impact on investment in Ireland, concentrated in investment in building and market services. The higher oil prices would encourage higher investment in increasing energy efficiency, contributing to a reduction in Ireland's greenhouse gas emissions. In the first year of the shock exports would increase, due to the depreciation in the currency, but this would be reversed thereafter as the economy loses competitiveness.

The lower level of activity in the economy would see a gradual increase in the unemployment rate and also a decline in employment growth with the building and market services sectors being the hardest hit. There would also be some reduction in the level of net immigration, thus helping to contain the increase in unemployment. Overall, this shock highlights how sensitive Ireland is to unfavourable developments in the external environment.

Public Finances

The situation with regard to the public finances in the first eight months of 2004 shows an improvement, both against Budget projections and against the same period of 2003. Total revenue is up by 9.1 per cent compared with the same period of 2003, but is also higher than anticipated in the budget profiles by some 13.1 per cent. The revenue figures are flattered somewhat by the significant receipts of monies in connection with irregularities in offshore bank accounts. The value of these one-off payments is estimated at approximately €650 million. Other drivers of revenue increases include income tax and stamp duties, which have increased by 22.3 per cent and 23.2 per cent respectively over the same period of last year. These figures are a reflection of the strong growth present in the economy, with continued employment and incomes growth, as well as continued growth in house prices. In particular, the resurgence in retail sales growth has had a favourable effect on VAT receipts, up 11.3 per cent on last year. Downward pressure on receipts came from corporation tax, which fell by almost 15 per cent against last year.

The value of voted public spending is up by 5.7 per cent on the first eight months of 2003, but 4.3 per cent lower than predicted in the budget profiles. Compared to last year, the most noteworthy

increases in expenditure occurred in Health (9.1 per cent), Education and Science (9.6 per cent), and Social and Family Affairs (8.5 per cent). These increases were mitigated somewhat by a large 14.7 per cent fall in expenditure by the Department of Environment, Heritage and Local Government.

The changes in revenues and expenditure have had the net effect of sharply reducing the exchequer deficit from €892.3 million in the first eight months of 2003, to €243.1 million in the corresponding period of the current year. We forecast an overall exchequer deficit of €705 million in 2004, well below the €2.8 billion deficit budgeted for 2004. The wider general government surplus is forecast to be of the order of €503 million, or 0.3 per cent of GDP.

We anticipate a slight deterioration in the public finances in 2005. This will be brought about by an increase in current expenditure not being matched by similar growth in revenue. The offshore accounts windfall dropping out of government accounts will also affect current receipts. The benign economic environment will facilitate the maintenance of broadly healthy public finances however. We forecast an exchequer deficit of €1,090 million in 2005, and a general government surplus of €216 million or 0.1 per cent of GDP. Meanwhile, Ireland's ratio of public debt to GNP will remain low for the foreseeable future, hovering close to a 30 per cent level.

TABLE 11: Public Finances

	2003	% Change	2004	% Change	2005
Current Revenue	33,157	9.1	36,175	5.5	38,175
Current Expenditure	28,747	7.6	30,940	6.8	33,055
Current Surplus	**4,410**	18.7	**5,235**	-2.2	**5,120**
Capital Receipts	1,288	-20.0	1,030	11.7	1,150
Capital Expenditure	6,678	4.4	6,970	5.6	7,360
Capital Borrowing	**5,390**	10.2	**5,940**	4.5	**6,210**
Exchequer Balance	**-980**		**-705**		**-1,090**
as % of GNP	-0.9		-0.6		-0.8
General Government Balance	**192**		**503**		**216**
as % of GDP	0.1		0.3		0.1
Gross Debt as % of GDP	**32.1**		**30.3**		**29.1**

General Assessment

The Irish economy has emerged from the global economic downturn with a resumption of strong, employment-intensive growth. While the growth rates are unlikely to match the exceptional performance experienced throughout the second half of the last decade, the trajectory as set out in the *ESRI Medium-Term Review 2003-2010* appears to be back on track. The CSO in its preliminary *National Income and Expenditure* release in July estimated real GDP growth at a creditable 3.7 per cent in 2003. This performance was driven by growth rates above 5 per cent in real terms in the latter part of the year, which has continued on into 2004. The first quarter real GDP growth for 2004 is estimated to

have been 6.1 per cent while employment growth was in the order of 3 per cent. Employment growth has remained strong at 2.4 per cent in the second quarter and with the rate of unemployment moving below 4.5 per cent as the year progresses.

Confidence in the Irish economy, both for consumers and business sentiment, has been underpinned by the resumption of economic growth internationally. Given the extent of the integration of Ireland into the international economy through trade and investment linkages, the resulting strong growth in world trade is a boon for the domestic Irish economy. The success of the Geneva meeting as part of the World Trade Organisation (WTO) Doha Trade Round this summer gives a further fillip to world economic conditions. After failures in ministerial meetings at Seattle and Cancun in recent years this success is to be welcomed as it gives momentum for further reductions in the barriers to world trade.

Given Ireland's position as a small, open economy, trade liberalisation both at a national and international level is recognised as an essential component in ensuring improved living standards. The recently completed review by the Enterprise Strategy Group, *Ahead of the Curve,* explicitly confronts this reality. The stress within that document for a new strategic direction for the economy towards high value added manufacturing and internationally traded services is a sensible one based on Ireland's comparative advantages. Two areas of focus are identified as needed to support this strategy: building technological capability for research and development, and developing expertise in international marketing to promote sales.

Monetary conditions remain accommodating for growth in the euro area where interest rates are anticipated to be held at current low rates for some time, despite the turn in the interest rate cycle in both the US and UK. The ease of credit availability and the strong growth in disposable incomes in the Irish economy have been factors that have driven the demand for housing. The supply response over the last few years has been phenomenal and a substantial contributor to the strong investment-led economic growth being experienced both this year and last.

The record house completions in 2003 of 69,000 units looks set to be significantly surpassed in 2004. At the half point in the year the volume growth was over 21 per cent, which even allowing for some slowdown in the latter half of the year, would constitute nearly one-fifth of the forecast real GDP growth for 2004. The pace of house price growth remains strong and is expected to average in excess of 10 per cent for the year. However, the ability to maintain the extent of volume growth in the housing market would appear improbable and a reversal would constitute a drag on growth in the near future.

While a sharp reversal in the growth of house building may constitute a domestic risk to Ireland's growth performance in the near term, the persistence of relatively high oil prices has attracted considerable international focus over the course of 2004. An analysis of the impact of higher oil prices on the Irish and world macro-economy has been undertaken in this *Commentary,* using the

ESRI *HERMES* model and the UK's National Institute for Economic and Social Research *NiGEM* world model. The extent of the impact largely depends upon the reaction of the monetary authorities and wage bargainers, which in turn depends upon the expectation of whether the rise in oil price is considered temporary or permanent. Temporary shocks are likely to have a smaller effect on output than permanent shocks but have greater impact upon inflation, at least in the short term.

In Ireland, the impact from a 45 per cent rise in prices to over $40 a barrel of crude oil would be to reduce output by 1.25 percentage points below what it would otherwise have been after two years with a permanent shock or by nearly 1 percentage point in the temporary scenario. Crude oil prices constitute around one-third of the pump price of petrol so, while crude prices have risen by around 45 per cent over the year, the impact on retail prices has been more modest at around a 15 per cent increase. The strength of the euro has helped modify the pass through impact such that consumer price inflation is up around 0.9 percentage points after two years in the temporary shock case or 0.7 in the permanent shock scenario.

The recent surge in oil prices has been driven by a combination of strong world demand, a weaker US dollar resulting in a terms of trade loss for oil producers since it is the denominator currency, and supply restrictions from a variety of sources. Oil markets are traditionally very volatile and difficult to predict. There is currently a high, risk premium attached to oil prices in connection with the unstable political situation in the Middle East. This premium could be in the order of $10 a barrel or about a quarter of the market price. The target price for crude oil has been around $22- $28 a barrel since the start of the decade, but it may now have ratcheted up in response to greater international demand, particularly through the emergence of China as an engine of growth. The long-term trend over the next decade may have moved up towards $30 per barrel of crude.

We also looked at the scenario where oil prices rise by 15 per cent permanently but in addition have a temporary component rise of 30 per cent. In that case the impact is to reduce output by around 1 percentage point below what it otherwise would have been after two years, employment would be lower by over 0.5 percentage points, inflation would be up by 0.8 percentage points and greenhouse gases would be down by around 1 percentage point. The weakening of the euro as a result of this shock is likely to have a bigger impact on the Irish economy than elsewhere in the euro area, as the Irish labour market is more flexible, so wages would rise by more.

While the impact of higher oil prices will dampen economic activity, the primary context in which it is occurring is one of strong world economic activity so overall growth remains substantially positive as contained in our forecast.. Rising energy prices driven by external factors is clearly a negative for the Irish economy but this not necessarily the case when increasing energy cost is undertaken by a domestic policy action such as a carbon tax. The recycling of

the revenues from the tax base can be utilised to ameliorate the negative impacts while helping contribute to the goal of greenhouse gas emission reduction.

The recent decision by the Irish government not to proceed with a carbon tax in the forthcoming Budget 2005 is disappointing. The opportunity to establish a tax base, on an activity that causes harm, to raise revenue that could be directed at beneficial activities may have been foregone for some time. Policies directed at long-term objectives like environmental protection need to be consistently pursued to ensure credibility and encourage compliance. Introduction of levies well in advance of the Kyoto protocol's commitment period would have allowed for changes in the long-run price and income elasticities to have been realised.[2] Abandonment in reaction to short-term gyrations in volatile oil markets for instance would not make for time consistent policy formulation.[3]

The EU *Stability and Growth Pact* has become a textbook example of a time inconsistent policy rule. As soon as the point in time was reached to invoke its sanctions on the members states in breach of its rules, the Pact's sanctions were set aside. The decision to set aside the rules in November 2003 by the Ecofin Council of Ministers led to the European Commission seeking a judicial interpretation from the European Court of Justice. While the Court's judgment in July favoured the Commission's position it did not condemn the non-adoption by the Council of the Commission recommendations against France and Germany. The ruling has been that Ecofin can have discretion in the implementation of the Excessive Deficit Procedure (EDP). The consequence is that the Pact's sanctions for deficits above 3 per cent of GDP are no longer automatic. The Council of Ministers can no longer hold the EDP in abeyance and cannot modify the recommendations for correcting an excessive deficit without an initiative from the Commission. Agreement between the Commission and a qualified majority in the Council is now required.

In reaction, the European Commission has brought forward proposals in September 2004 to evolve rather than reform the Pact. These proposals appear sensible in light of the impasse that has developed over the last year but have been viewed in central banking circles as a potential watering down of fiscal discipline mechanisms within the euro area. The proposals revolve around placing more focus on debt and sustainability in the surveillance of budgetary position; that the "close to balance or in surplus" requirement does not appear appropriate and lacks economic rationale given the increasing economic diversification in an EU of 25 Member States; that 'exceptional circumstances' criteria be extended for prolonged periods of sluggish growth by using output gap measures to reflect cyclical positions.

[2] Tax Strategy Group paper "Implementing Greenhouse Gas Taxation", October 2002.

[3] A policy is considered to be time consistent when it remains the desirable policy to pursue for agents at each point in time.

The European Central Bank (ECB) has warned that monetary policy may need to be tighter in response to a weakening in fiscal policy discipline within the euro area. Interest rates may be anticipated to rise in the euro area anyhow over the course of the next few years in light of improving real economic conditions. The level of short-term interest rates that might be considered neutral, given the inflation target and estimated potential output growth rates for the euro area, are in the order of 4.5 per cent. With rates currently at 2 per cent the cost of credit can be expected to rise significantly albeit at a measured pace.

Higher interest rates will alter the relative attractiveness of savings/investment and consumption patterns over the next few years in Ireland as elsewhere. However, this could coincide with the cessation of the Irish Special Savings Investment Account (SSIA) scheme over the period May 2006/2007. This scheme, set up in 2001 to encourage the savings habit during a period of relatively high personal consumption levels, involved contributions provided by the State to top-up individuals' savings.

The SSIA scheme has proved to be extremely popular with a high take-up among the population attracted by the 25 per cent Exchequer top-up on potential maximum annual savings of €3,080 over five years. The Exchequer contribution currently stands at around €540 million per year spread over the 1.13 million individual SSIAs still in operation. This level of contribution is consistent with an average contribution rate of 78 per cent of the maximum contribution level. The incentives are such that contribution rates may increase further as the scheme reaches its termination date, potentially accumulating to an estimated stock of between €14-15 billion in savings by the second quarter of 2007.

This scale of savings will approach 10 per cent of national income by the time the scheme ends and this has raised concerns about how the potential release of this money into the economy during 2006/07 would impact on the macroeconomic performance at that time. These macroeconomic impacts, however, are far from certain, as they ultimately will depend upon the behavioural responses of the accounts holders, both on joining the scheme and their spending/savings decision as their investments mature.

For instance, the extent to which the scheme encouraged new savings as opposed to the redirection of existing savings, or the build-up of corresponding matching debt, remains unclear. The low interest environment and aggressive expansion of the credit market in recent years coinciding with the lifetime of the scheme has meant that consumption smoothing is a possibility with the intention to retire the facilitating accumulated debts when the SSIA funds are released. In this scenario the fears of a consumption boom in 2006/07 would be mollified somewhat.

However, individual intentions in such events are notoriously difficult to predict, as optimal responses like consumption smoothing either prior or post the arrival of the funds might dissipate once the maturity date arrives. This form of time inconsistency might be quite significant with a scheme in the nature of the SSIAs where the Exchequer contribution might be

considered like a windfall gain. Greater use of micro-survey evidence may need to be utilised before any decision on the likely response of households in this regard is taken.

Given both the uncertainty of how the funds will be divested and the position in the economic cycle when they mature, it is not feasible to try to motivate any continuation of this expensive scheme by appealing to a need for active demand management in the macroeconomy. In previous *Commentaries* we have argued that the SSIA scheme was an unnecessary and expensive intervention when viewed as a macroeconomic stabilisation device. Given its stated aim of encouraging a savings habit, then it has either worked and so does not require a successor or it has not worked and so should not be repeated. Therefore, proposals on an extension or successor to the SSIA scheme must be motivated by other societal objectives other than trying to manage the macroeconomic implications.