SUMMARY

While the international economy struggled during 2003 to restore the conditions necessary for improved economic growth after the significant downturn of recent years, Ireland has continued to weather the global slowdown relatively well. The most significant feature of the Irish economy's resilience was the growth of employment of 1.8 per cent last year. This remarkably strong employment growth, while much lower than some of the rates recorded over the last decade, has kept average unemployment for 2003 at a comparatively low rate of 4.7 per cent. This is particularly impressive given that labour force participation averaged over 60 per cent of the adult population for the first time.

Consumer price inflation averaged 3.5 per cent in 2003 but was rapidly decelerating throughout the year, ending at below 2 per cent, its lowest rate in four years. The deterioration in the general government balance was reversed with stronger taxation growth suggesting an improving economic backdrop. The divergent pattern in the GDP and GNP measures of output growth was again evident in 2003. In contrast to 2002, real GDP is estimated to have slowed dramatically to a growth rate of 1.2 per cent in 2003, while real GNP picked-up from practically no growth to an estimated rate of 3.0 per cent.

The prospects for acceleration in output growth in 2004 and 2005 remain significant despite the re-emergence of uncertainties from international terrorism dampening the influence of improving global economic confidence. Our forecasts for output growth in 2004 and 2005, predicated on improving international growth and favourable currency movements, are 3.5 and 4.5 per cent in real GDP and 3.3 and 4.4 per cent in real GNP terms respectively. Inflation as measured by the consumer price index is forecast to continue to moderate to an average of 1.8 per cent in 2004 and 2.0 per cent in 2005. In terms of the EU Harmonised Index of Consumer Prices (HICP), Ireland is no longer at the top of the EU inflation league and is expected to approach the Euro Area average rate during 2004. The unemployment rate is forecast to continue to rise this year and next to average 4.9 per cent and 5.0 per cent respectively. A significant threat to Irish competitiveness remains, however, if sustained appreciation of the euro were to re-emerge. This would result in significantly lower output growth, higher unemployment and lower price inflation than we are forecasting on the basis of more benign currency movements this year and next.

The decision on the use of Public Private Partnerships (PPPs) in the context of the *Stability and Growth Pact* (SGP) will add flexibility to the treatment of government-backed infrastructural investment. However, this flexibility must not be used to justify public projects that are not, in themselves, economically worthwhile. If it is only the SGP constraints that justify the use of PPPs then this is an argument for changing the SGP, not for treating the accounting of the investment differently.

Despite the forecast moderation in the rates of price and wage inflation, Irish international competitiveness will still be under pressure given the already relatively high Irish cost levels. The enlargement of the EU in May will be a catalyst for greater focus on labour cost competitiveness right across the Union. However, it is important in Ireland, as elsewhere, that attention be given to productivity-justified wage costs when making comparisons. In this regard the true picture of Irish productivity performance is seriously distorted by the flattering contribution provided by a limited number of high value-added activities. The upcoming negotiation on the wage terms for the second part of the *Sustaining Progress* social partnership agreement must bolster Irish competitiveness by steering wage growth towards rates in line with both realistic national productivity growth expectations and cost trends across competitor nations.

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	60,118	63,592	3,473	1,323	5.8	3.5	2.2
Public Net Current Expenditure	17,639	19,200	1,561	617	8.8	5.2	3.5
Gross Fixed Capital Formation	28,649	31,103	2,454	-48	8.6	8.7	-0.2
Exports of Goods and Services (X)	121,158	108,746	-12,412	-8,352	-10.2	-3.6	-6.9
Physical Changes in Stocks	11	595	584	750			
Final Demand	**227,575**	**223,235**	**-4,340**	**-5,710**	**-1.9**	**0.6**	**-2.5**
less:							
Imports of Goods and Services (M)	97,014	88,210	-8,804	-6,777	-9.1	-2.2	-7.0
GDP at Market Prices	**130,561**	**135,025**	**4,464**	**1,067**	**3.4**	**2.6**	**0.8**
less:							
Statistical Discrepancy	1,217	1,261	44	-535			
Adjusted GDP	**129,344**	**133,764**	**4,420**	**1,,602**	**3.4**	**2.2**	**1.2**
less:							
Net Factor Payments (F)	25,915	23,058	-2,857	-1,541	-11.0	-5.4	-5.9
GNP at Market Prices	**103,429**	**110,706**	**7,277**	**3,143**	**7.0**	**3.9**	**3.0**

B: Gross National Product by Origin

	2002	2003	Change in 2003	
		Preliminary		
	€m	€m	€m	%
Agriculture, Forestry, Fishing	3,155	3,260	105	3.3
Non-Agricultural: Wages, etc.	49,914	53,718	3,804	7.6
Other:	52,605	51,786	-818	-1.6
Adjustments: Stock Appreciation	-156	-480		
Financial Services	-4,226	-4,439	-213	
Statistical Discrepancy	1,217	1,261	44	
Net Domestic Product	**102,509**	**105,106**	**2,598**	**2.5**
less:				
Net Factor Payments	25,915	23,058	-2,857	-11.0
National Income	**76,594**	**82,049**	**5,455**	**7.1**
Depreciation	13,259	13,833	574	4.3
GNP at Factor Cost	**89,953**	**95,882**	**6,029**	**6.7**
Taxes less Subsidies	13,576	14,824	1,248	9.2
GNP at Market Prices	**103,429**	**110,706**	**7,277**	**7.0**

C: Balance of Payments on Current Account

	2002	2003	Change in 2003
		Preliminary	
	€m	€m	€m
Exports (X) less Imports (M)	24,144	20,536	-3,608
Net Factor Payments (F)	-25,915	-23,058	2,857
Net Transfers	817	586	-231
Balance on Current Account	**-954**	**-1,936**	**-982**
as % of GNP	-0.9	-1.7	-0.9

FORECAST NATIONAL ACCOUNTS 2004

A: Expenditure on Gross National Product

	2003 Preliminary €m	2004 Forecast €m	Change in 2004 €m Value	Change in 2004 €m Volume	Change in 2004 % Value	Change in 2004 % Price	Change in 2004 % Volume
Private Consumer Expenditure	63,592	67,199	3,608	2,226	5.7	2.1	3.5
Public Net Current Expenditure	19,200	20,730	1,530	442	8.0	5.5	2.3
Gross Fixed Capital Formation	31,103	32,019	917	138	2.9	2.5	0.4
Exports of Goods and Services (X)	108,746	109,886	1,140	4,037	1.0	-2.6	3.7
Physical Changes in Stocks	595	190	-405	-75			
Final Demand	**223,235**	**230,025**	**6,790**	**6,768**	**3.0**	**0.0**	**3.0**
less:							
Imports of Goods and Services (M)	88,210	87,649	-562	2,075	-0.6	-2.9	2.4
GDP at Market Prices	**135,025**	**142,376**	**7,351**	**4,692**	**5.4**	**1.9**	**3.5**
less:							
Statistical Discrepancy	1,261	897	-364	69			
Adjusted GDP	**133,764**	**141,480**	**7,716**	**4,623**	**5.8**	**2.2**	**3.5**
less:							
Net Factor Payments (F)	23,058	23,622	564	997	2.4	-1.8	4.3
GNP at Market Prices	**110,706**	**117,858**	**7,151**	**3,626**	**6.5**	**3.1**	**3.3**

B: Gross National Product by Origin

	2003 Preliminary €m	2004 Forecast €m	Change in 2004 €m	Change in 2004 %
Agriculture, Forestry, Fishing	3,260	3,360	100	3.1
Non-Agricultural: Wages, etc.	53,718	56,674	2,956	5.5
Other:	51,786	54,095	2,308	4.5
Adjustments: Stock Appreciation	-480	320		
Financial Services	-4,439	-4,618	-179	
Statistical Discrepancy	1,261	897	-364	
Net Domestic Product	**105,106**	**110,728**	**5,621**	**5.3**
less:				
Net Factor Payments	23,058	23,622	564	2.4
National Income	**82,049**	**87,106**	**5,057**	**6.2**
Depreciation	13,833	15,103	1,269	9.2
GNP at Factor Cost	**95,882**	**102,208**	**6,326**	**6.6**
Taxes less Subsidies	14,824	15,649	825	5.6
GNP at Market Prices	**110,706**	**117,858**	**7,151**	**6.5**

C: Balance of Payments on Current Account

	2003 €m	2004 Forecast €m	Change in 2004 €m
Exports (X) less Imports (M)	20,536	22,238	1,702
Net Factor Payments (F)	-23,058	-23,622	-564
Net Transfers	586	250	-336
Balance on Current Account	**-1,936**	**-1,134**	**801**
as % of GNP	-1.7	-1.0	0.7

FORECAST NATIONAL ACCOUNTS 2005

A: Expenditure on Gross National Product

	2004 Forecast €m	2005 Forecast €m	Change in 2005 €m Value	€m Volume	% Value	% Price	% Volume
Private Consumer Expenditure	67,199	71,282	4,083	2,822	6.1	1.8	4.2
Public Net Current Expenditure	20,730	22,050	1,320	332	6.4	3.7	2.6
Gross Fixed Capital Formation	32,019	33,307	1,288	710	4.0	1.8	2.2
Exports of Goods and Services (X)	109,886	118,224	8,338	6,894	7.6	1.2	6.3
Physical Changes in Stocks	190	165	-25	-11			
Final Demand	**230,025**	**245,028**	**15,003**	**10,955**	**6.5**	**1.7**	**4.8**
less:							
Imports of Goods and Services (M)	87,649	93,669	6,020	4,739	6.9	1.4	5.4
GDP at Market Prices	**142,376**	**151,359**	**8,983**	**6,216**	**6.3**	**2.9**	**4.4**
less							
Statistical Discrepancy	897	832	-64	-188			
Adjusted GDP	**141,480**	**150,527**	**9,047**	**6,404**	**6.4**	**1.8**	**4.5**
less:							
Net Factor Payments (F)	23,622	25,139	1,517	1,219	6.4	1.2	5.2
GNP at Market Prices	**117,858**	**125,388**	**7,530**	**5,185**	**6.4**	**1.9**	**4.4**

B: Gross National Product by Origin

	2004 Forecast €m	2005 Forecast €m	Change in 2005 €m	%
Agriculture, Forestry, Fishing	3,360	3,450	90	2.7
Non-Agricultural: Wages, etc.	56,674	59,256	2,582	4.6
Other:	54,095	58,139	4,044	7.5
Adjustments: Stock Appreciation	320	-80		
Financial Services	-4,618	-4,571	47	
Statistical Discrepancy	897	832	-64	
Net Domestic Product	**110,728**	**117,026**	**6,299**	**5.7**
Net Factor Payments	23,622	25,139	1,517	6.4
National Income	**87,106**	**91,888**	**4,782**	**5.5**
Depreciation	15,103	16,396	1,293	8.6
GNP at Factor Cost	**102,208**	**108,284**	**6,075**	**5.9**
Taxes less Subsidies	15,649	17,104	1,455	9.3
GNP at Market Prices	**117,858**	**125,388**	**7,530**	**6.4**

C: Balance of Payments on Current Account

	2004 Forecast €m	2005 Forecast €m	Change in 2005 €m
Exports (X) less Imports (M)	22,238	24,555	2,317
Net Factor Payments (F)	-23,622	-25,139	-1,517
Net Transfers	250	-210	-40
Balance on Current Account	**-1,134**	**-374**	**760**
as % of GNP	-1.0	-0.3	0.6

The International Economy

General

The international recovery, which gained considerable momentum in the second half of 2003 has continued into 2004 with investment remaining strong across most economies indicating improving expectations. The US remains the leader in terms of global growth with the potential continuation of the current expansion highly dependent upon an improvement in US labour market conditions, which has thus far not taken place. The international context has improved since the same period last year although the terrorist attacks in Madrid in March may signal a return to uncertainty impacting upon economic confidence.

US Economy

The US continues to lead the way in the international recovery with sustained growth in economic activity since the second half of 2003 when the economy started to gain momentum. Real GDP grew by 4.1 per cent in the fourth quarter at an annualised rate following growth of 8.2 per cent in the third quarter. This strong recovery combined with sluggish growth in the first half of the year implies that real GDP grew by 3.1 per cent over the course of 2003. This was below the economies estimated potential rate of growth but the performance was much better than most of the other global economies.

The major contributors to the increase in real GDP in the fourth quarter were personal consumption expenditures, exports, equipment and software, private inventory investment, and residential fixed investment. Although personal consumption growth eased back from an exceptional third quarter, business took up most of the slack with business investment continuing its strong growth. Investment grew at an annualised rate of 15.8 per cent in the fourth quarter, which bodes well for the supply side of the economy and therefore the sustainability of the recovery. It is also strongly indicative of improving business expectations regarding the future. This is a welcome development for the economy and is in marked contrast to sentiment at the same stage last year where global uncertainty was placing a significant stranglehold on investment expenditures. The terrorist attacks in Madrid may adversely affect this sentiment but the direct impact is difficult to quantify. Despite this, we expect the economy to continue to move towards its potential and forecast quite a strong uptake in economic activity in 2004 where we forecast growth of 4.0 per cent before moderating slightly to 3.4 per cent in 2005.

This recovery, however, will continue to be undermined by a relative lack of rebound in the labour market with most of the output growth due to increased productivity by the existing workforce rather than increased hiring. For 2003 as a whole, business output increased by 3.7 per cent. This combined with a reduction in hours worked of 0.8 per cent implies that productivity growth was a robust 4.5 per cent for the year. It is clear that if the recovery is to continue to strengthen over the year ahead, firms will need to hire more workers. Otherwise, lack of income growth will weigh heavily on the extremely important US consumer. Up to now, tax cuts have given US consumers more to spend. Also historically low interest rates have helped inflate the housing market and therefore encouraged households to borrow on the back of this asset appreciation and build up more debt. This lack of consumer saving combined with significant government deficits means that the current recovery is not as firmly supported or sustainable as it may seem. Therefore increased employment is necessary if consumption expenditures are to become less reliant on fiscal developments and debt financing.

Persistently weak job growth coupled with higher productivity and global job outsourcing have made consumers more uncertain about the timing and extent of future job growth and therefore living standards. The University of Michigan's Consumer Sentiment Index for February fell to 94.4 from 103.8 in January. The expectations index, measuring consumer's hopes for the near future, fell to a revised 88.5 from 100.1 in January.

The re-emergence of the manufacturing sector as a source of growth, indicating more broadly based growth in the economy, has continued with economic activity in the sector growing in February for the ninth consecutive month. Although slightly down, the Purchasing Managers Index (PMI) from the Institute of Supply Management (ISM) registered 61.4 in February from 63.6 in January, where a figure greater than 50 indicates expansion in the sector. This resurgence has been mainly due the strong demand side impulse in the latter half of 2003, the continuing accommodative fiscal and monetary policies and a weak currency all of which has led to increased corporate profitability, which has fuelled investment. This has been also reflected in the ISM's non-manufacturing index, which, although falling to 60.8 in February from 65.7 in January, also indicated continued strong growth in the service sector. It is in this sector that job increases are particularly needed as it accounts for over two-thirds of the US economy. The survey's employment index slipped in February to 52.7 from 53.4 in January, suggesting an improving but still sluggish labour market.

Increased economic activity has as yet failed to translate into significantly improved labour market conditions although there are signs of a moderate recovery. Payrolls outside the farm sector grew by just 21,000 jobs in February, compared with a gain of 97,000 in January. Jobless claims have continued to fall and the unemployment rate has held steady at 5.6 per cent. This anaemic performance causes much concern and unless there is more robust job growth in the near-term the economy could falter as consumption waivers. Following an average unemployment rate of 6.0 per cent in 2003, we forecast improving labour market conditions both this year and next with the average unemployment rate falling to 5.5 and 5.3 per cent for 2004 and 2005 respectively.

Although the threat from deflation has abated significantly, inflation remains at surprisingly low levels given the sharp rebound in economic activity in the second half of 2003. The headline Consumer Price Index (CPI) increased 1.9 per cent over the 12 months to January. However, excluding volatile food and energy prices, which have seen considerable inflation over the year, the core CPI increased only 1.1 per cent over the year. This combined with the sluggishness in the labour market is likely to ensure that interest rates will remain accommodative in the near-term. However, we do expect tightening before year-end. Although the Federal Reserve are only likely to raise rates when there is concrete evidence of a rebound across all areas of the economy, especially the labour market, once they commence monetary tightening they are likely to be quite aggressive. This is mainly due to the fact that rates are coming from a historically low federal funds target rate of 1.0 per cent. Also, the fact that the US real GDP potential growth rate is near 4 per cent, there is quite a large scope for tightening while still leaving this kind of expansion sustainable.

The US fiscal and external deficit positions, or twin deficits, remain at unsustainable levels with no clear sign of a correction in the near future. In its monthly budget statement in March, the Treasury estimated that the budget deficit for the first five months of the government's fiscal year grew to $226.8 billion from $194.2 billion a year earlier. After hitting a record $374 billion in 2003, the budget deficit is expected to shoot even higher this year to a level close to $500 billion. This fiscal deficit has compounded the Balance of Payments (BoP) current account problem, with the deficit continuing to be of a similar magnitude. Following a deficit of 5 per cent of GDP ($542 billion) in 2003, it is estimated that the external position will worsen to 5.2 per cent of GDP this year before improving to 4.6 per cent in 2005. A sustainable current account deficit for the US is estimated to be between 2-3 per cent. Up until now, the deficit has been financed by a huge demand for US bonds by the Asian markets. However, this cannot continue indefinitely and raises the possibility of a sharp dollar correction (see Box 1). Since the previous *Commentary*, we have seen a significant depreciation of the dollar, falling to a new record low of close to $1.30 per euro although it has fallen back considerably since.

Euro Area Economy

Following moderate growth of 0.9 per cent in 2002, the euro area economy remained sluggish in the first half of 2003 although a modest rebound in activity has been observed since then and annual growth for the year is expected to be 0.4 per cent. Preliminary data suggest that activity continued to strengthen in the fourth quarter of 2003 with GDP growing at an annual rate of 0.6 per cent following 0.3 per cent growth in the third quarter. The tentative recovery in the second half of the year was initially largely export led, but the contribution by net exports turned negative in the fourth quarter and domestic demand, specifically a strong expansion in inventories, was the main driver of growth in the quarter. Both domestic and external factors provide an overall positive outlook for activity but increasing geo-political uncertainties, heightened by the terrorist attack in Spain in March, constitute a downside risk to growth.

Growth in the fourth quarter was balanced between a positive contribution from household and government consumption expenditure and inventories more than offsetting a negative contribution from investment and net trade. Although growth in household consumption remained subdued at 0.7 per cent in the fourth quarter, domestic demand increased by 1.3 per cent. Government expenditure grew by 2.3 per cent providing a significant impulse to overall growth. Investment continued to weaken in the euro area albeit at a more moderate rate than earlier in 2003. Gross fixed capital formation contracted in the fourth quarter at an annual rate of 0.8 per cent. As mentioned in previous *Commentaries* the deterioration in business investment is somewhat surprising given the low interest rate environment and may reflect some excess capacity. We expect investment to recover this year, in line with strengthening economic activity. The negative contribution to GDP growth in the fourth quarter of net trade is accounted for by moderate export growth of 0.1 per cent and import growth of 1.8 per cent. The appreciating currency continues to impede export growth while stronger domestic demand is providing the impetus for import growth.

The last quarter of 2003 saw more balanced growth between the industrial and services sectors. The industrial sector expanded at an annual rate of 0.7 per cent following two quarters of contraction although the construction industry continues in recession, recording a decline of 0.4 per cent in the last quarter of 2003. The Reuters Purchasing Managers Index (PMI) for manufacturing, a leading indicator of manufacturing activity, was unchanged in February at 52.5 compared with the previous month. This implies that output has increased in the beginning of this year but the rate of growth is not accelerating.

The services sector continued to expand in the fourth quarter but at a slower pace then the previous quarter. Trade, transport and communication services grew at an annual rate of 0.3 per cent in the fourth quarter, financial services and business activities rose by 0.9 per cent and other services grew by 1.2 per cent. Recent survey data confirm the slowdown of growth in the services sector with the Reuters Eurozone Service Sector Business Activity Index falling to 48.9, below the critical 50-point level, indicating a contraction in the sector with the German index registering its worst contraction to date.

Overall, conditions in the labour market remain stable. No annual employment growth was recorded in the third quarter of 2003, bringing the period of broadly flat employment growth to six quarters. However, this masks the two distinct sectoral trends in employment with growth in services employment offsetting declines in industrial and agricultural employment. The aggregate standardised euro area unemployment rate remained at 8.8 per cent in January for the eighth consecutive month, up from 8.7 per cent a year earlier. The majority of euro area countries for which data are available saw increases in their unemployment rates in the twelve months to January, except Spain where the rate fell by 0.2 percentage points to 11.2 per cent in January 2004. Unemployment averaged 8.8

per cent in 2003 as compared with 8.4 per cent in 2002, consistent with the prolonged period of below potential growth in the region.

The larger economies continue to have the highest unemployment rates with Germany, France and Spain recording rates of 9.2, 9.5 and 11.2 per cent respectively in January. Looking forward the unemployment rate is forecast to be 8.8 per cent this year unchanged from 2003 as activity in the labour market generally lags behind the rest of the economy. As the recovery takes hold we forecast an improvement in the rate to 8.7 per cent in 2005.

Preliminary estimates of the Harmonised Index of Consumer Prices (HICP) measure of inflation indicate that annual inflation rose by 1.6 per cent in February. Although detailed sub-indices are not available for February, sharp oil price increases in the early part of last year should provide a strong downward base effect. Inflation has been coming down since November 2003 and had been close to the European Central Bank's (ECB) target of 2 per cent for three months. In January euro area inflation stood at 1.9 per cent with base effects in energy prices offsetting upwards pressure from tobacco taxes and increases in administrative prices. Although the favourable energy base effects will unwind during the year, the pass-through of exchange rates movements coupled with expected moderate wage growth should continue to impart downward pressure to the inflation rate. The HICP is forecast to average 1.6 per cent in 2004 and 1.5 per cent in 2005.

The annual growth of the M3 broad measure of money supply declined to 6.4 per cent in January as compared to 7.0 per cent in December. Although the level of annual M3 growth remains well above the ECB's target of 4.5 per cent, M3 growth has been abating since the second half of 2003. This downward trend reflects portfolio shifts into longer term and riskier financial assets outside the M3. At its latest meeting the Governing Council of the ECB decided to leave its main interest rate unchanged at 2 per cent. The recent appreciation of the euro provides a tightening of monetary conditions so interest rate rises are unlikely until 2005.

Public finance positions deteriorated significantly in the euro area with the overall general government deficit expected to average 2.7 per cent as compared with a deficit of 2.3 per cent the previous year. This in part reflects the operation of automatic stabilisers in a weaker economic environment but also the failure to introduce adequate consolidation measures in many countries. Both Germany and France are likely to breach the 3 per cent of GDP deficit ceiling of the Stability and Growth Pact (SGP) in 2003 for the second year in a row. There have been renewed calls for flexibility in the rules of the Pact, which may help restore its credibility. The SGP is likely to come under strain again in the next number of months as the European Commission challenges the legality and validity of the Council's decision not to impose sanctions on France and Germany for breaching the Pact. As economic growth rises the euro area general government deficit is likely to improve gradually over the next two years.

In summary, economic activity in the euro area is expected to increase at a more rapid rate in the short term than in recent years and we forecast growth of 1.8 per cent this year before rising to 2.2 per cent next year. However, the negative effect of the strong euro on competitiveness continues to constitute a potential restraint to growth.

UK Economy

Preliminary data indicate that the UK economy is continuing to outperform the major European economies with growth of 2.1 per cent in 2003, up from 1.9 per cent in 2002. This data points to an acceleration in growth in the second half of the year with real GDP increasing by 2.8 per cent at an annual rate in the fourth quarter of 2003 as compared to 2.4 per cent in the previous quarter. This resilience is expected to continue and we forecast stronger GDP growth of 2.7 per cent in 2004 and 2005.

Growth in the UK continues to be driven by strong performances in the household and services sectors. Private consumption was the main driver of growth in the fourth quarter, rising by an annual rate of 3.2 per cent. Retail sales, a leading indicator of household spending, grew by 4.5 per cent in January compared to the same month last year. This indicates that private consumption should maintain its robust contribution to UK growth. Growth in the broad services sector is estimated to have been 2.5 per cent in the fourth quarter of last year. Although a detailed breakdown of the growth is not available it is expected that business services and finance and other services provided the most significant contributions to growth in the sector. The CIPS/Reuters Business Activity Index for services was 59.5 in February broadly unchanged from January's level of 59.8. Prospects for this sector remain positive and it is expected that growth will continue to surpass that of the industrial sector but that the gap between the two sectors will narrow.

Government expenditure grew by 3.4 per cent in the fourth quarter, in contrast to the first three quarters of the year where growth rates were diminishing. Gross fixed capital formation grew by 2.9 per cent in the fourth quarter and a substantial part of investment growth for the year is expected to be attributable to general government investment. This is due to the Chancellor of the Exchequer's decision to raise the share of government net investment from 1 per cent to 2 per cent of nominal GDP between 2002/3 and 2004/5.

Both exports and imports recovered from two quarters of negative growth to increase by 3.2 per cent and 2.0 per cent respectively in the final quarter of last year. The appreciation of sterling against the dollar since last Autumn and the slight appreciation against the euro since the beginning of 2004 may contain the recovery in export growth. However, we expect sterling to depreciate slightly against the euro later this year and to average 0.69 for the year as a whole, the same as last year. This supports a recovery in export growth this year as UK trade with Europe is over three times more important than their trade with the US.

Industrial production declined by 0.1 per cent in the fourth quarter compared with a fall of 0.6 per cent in the previous quarter. The manufacturing sector contracted in the first three quarters of last year although the rate of decrease has slowed from a fall of 1.3 per cent in the first quarter to a decline of 0.1 per cent in the third quarter. The outlook for the manufacturing and the wider industrial sector is slowly improving. The CIPS/Reuters PMI showed that the manufacturing sector expanded for the eighth consecutive month in February. The headline index was 53.2 in February down from 55.8 in January but still above the critical 50-point level indicating expansion in the sector.

Despite below trend growth the UK labour market remains robust. According to the Labour Force Survey, employment in the three months to December was 156,000 higher than one year previously. This leaves the employment rate at 74.5 per cent, down 0.1 percentage points from the same period last year but still very close to its historic high of 75 per cent in Spring 1990. In the three months to December unemployment fell by 55,000 compared to the same period in the previous year giving an unemployment rate of 4.9 per cent down 0.2 percentage points from the same period a year earlier. We anticipate conditions in the labour market will remain benign and we forecast the unemployment rate to be 5.0 per cent this year and 5.1 per cent in 2005.

The UK now use a symmetric 2 per cent inflation target as measured by the Consumer Price Index (CPI), which is equivalent to the HICP euro area measure, when setting interest rates. Inflation as measured by the CPI rose by 1.3 per cent in February down from 1.4 per cent in January. Clothing and footwear provided the largest downward impulse to the annual rate in February. In February, the Bank of England's Monetary Policy Committee (MPC) raised its repo rate by 0.25 percentage points to 4.0 per cent. The MPC cited the accelerating international recovery and strong and above-trend quarterly growth as the main reasons for the rise.

Rest of the World

Asia continues to expand strongly with China and India continuing their robust growth trajectory and Japan showing consistent signs of an upswing in economic activity. In the final quarter of 2003, Chinese real GDP grew by almost 10 per cent year on year, leaving the annual growth rate at a robust 9.1 per cent. For Asia, excluding Japan, as a whole growth in 2003 is estimated at around 6 per cent. This is despite a year disrupted by the SARS and bird flu viruses together with the wider global uncertainty.

TABLE 1: Short-term International Outlook

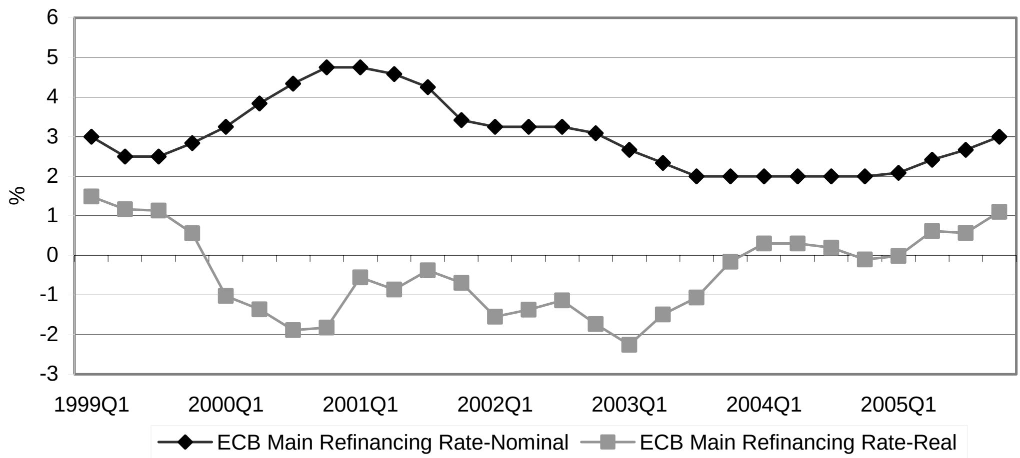
	GDP Output Growth			Consumer Price Inflation			Hourly Earnings Growth			Unemployment Rate %			Current Account Balance % of GNP		
Country	**2003**	**2004**	**2005**	**2003**	**2004**	**2005**	**2003**	**2004**	**2005**	**2003**	**2004**	**2005**	**2003**	**2004**	**2005**
UK	2.1	2.7	2.7	1.4	1.7	2.1	4.5	4.4	4.5	5.0	5.0	5.1	-2.5	-2.9	-2.7
Germany	-0.1	1.6	2.0	1.0	0.9	0.9	2.7	1.3	1.6	9.1	9.1	8.9	2.4	2.5	2.6
France	0.2	1.9	2.3	2.0	1.7	1.6	3.6	3.5	3.5	9.4	9.5	9.6	1.0	1.2	1.3
Italy	0.5	1.6	2.1	2.8	2.2	2.1	3.1	2.9	3.0	8.7	8.6	8.7	-1.3	-1.2	-1.2
Euro Area	0.4	1.8	2.2	2.0	1.6	1.5	3.4	3.0	3.3	8.8	8.8	8.7	0.4	0.8	1.2
USA	3.1	4.0	3.4	2.3	1.6	1.8	3.4	3.7	3.6	6.0	5.5	5.3	-5.0	-5.2	-4.6
Japan	2.3	2.3	1.8	-0.3	-0.2	-0.1	0.2	0.9	1.1	5.3	5.2	5.1	3.1	3.4	3.4
OECD	2.2	3.0	2.8	2.1	1.4	1.5	3.3	3.2	3.4	6.4	6.3	6.2	-1.2	-1.2	-1.0
Ireland	1.2	3.5	4.5	3.5	1.8	2.0	5.3	4.0	2.8	4.7	4.9	5.0	-1.7	-1.0	-0.4

Although there are strong structural factors underlying the expansion of much of Asia, especially in China and India, Japanese growth has been more of the cyclical nature and has benefited greatly from the increase in intra Asian trade together with the more favourable external economic conditions. This has been reflected in the large contribution of net exports to overall economic growth. Therefore, the Japanese recovery is much more tenuous than much of the rest of Asia and it is not yet clear as to whether the upturn will develop into a self sustaining recovery where the economy can finally break its long-term deflationary trend and fully repair its weak financial system. We forecast that the Japanese economy will maintain growth of 2.3 per cent in 2004 before moderating somewhat to 1.8 per cent in 2005. We expect deflationary pressures to abate in the short term with consumer prices falling by only 0.2 and 0.1 per cent in 2004 and 2005 respectively.

Recovery in Latin America has also been maintained with an improved outlook for Brazil with evidence of a restoration in investor sentiment as a result of more credible government policy. Economic performance in Chile has been particularly strong while recovery in Argentina remains sluggish with consumer and corporate expenditure being particularly weak.

Figure 1: Interest rates

Per Cent per Annum, Quarterly Averages



Context for Ireland

The notable upturn in international conditions in the latter half of 2003 and into 2004 is likely to be very advantageous to a small open economy such as Ireland. In particular, the forecast strength of the US and UK economies is important for Ireland given the exposure in terms of trade share and foreign direct investment (FDI). Investment continues to grow globally indicative of improving expectations. A translation of US growth into employment growth is necessary if the global recovery, which is being led by the US, is to prove sustainable. The immediate effects of the terrorist attacks in Madrid are difficult to discern but are likely to weigh on sentiment globally, in particular on the already weak euro area, which continues to lag behind the other major economies.

Since the previous *Commentary*, the euro has continued to strengthen against the dollar, reaching a new high of $1.29. This has led to a number of calls for intervention by the monetary authorities of the Euro Area and the US to counter the serious competitive losses experienced by the euro area economies. In conjunction, there have also been calls for an end to intervention by many of the Asian Central banks who have tried to prevent their own currencies appreciating against the dollar by building up huge amounts of foreign reserves. This has led to the vast majority of the dollar adjustment being felt by the euro area economies. Whatever about this latter scenario of decreased intervention by Asian central banks, the prospects of intervention by either the ECB or the Federal Reserve seems highly unlikely at present and both monetary authorities seem relatively undaunted by the currency trends. The reason for this lack of concern can be discerned by analysing the effective or trade weighted exchange rates. In the year to February 2003, the dollar depreciated against the euro by 19 per cent. In trade weighted terms the dollar depreciated only by around 13 per cent and the euro appreciated by nearly 10 per cent. For Ireland the appreciation has actually been much less, at around 5 per cent. Much of this has been due to the relative stability against sterling, which has only appreciated by just over 5 per cent over the same period. This stability is particularly important to the traditional manufacturing sector, which is predominantly exposed to the effects of changes in the bilateral euro-sterling exchange rate.

Therefore, although competitive pressures remain and are compounded by a high domestic cost base, the negative effects of the strength of the euro can sometimes be overplayed. We forecast the dollar/euro exchange rate to average $1.21 per euro for this year and expect it to continue a downward trend towards its estimated fundamental value of around $1.10-$1.15 in 2005 where we expect the dollar/euro rate to average $1.17. Movements are not expected to be smooth and significant volatility around these levels is likely. In contrast, we expect the sterling/euro exchange rate to remain relatively stable averaging this year around Stg£0.69 before the euro appreciates slightly in 2005 averaging the year at Stg£0.71. These exchange rate assumptions are rather benign and exclude the possibility of a substantial dollar depreciation relative to the euro. Therefore, in Box 1, we simulate this scenario and analyse the likely impacts on the Irish economy.

Box 1: Impact of Dollar Depreciation on the Irish Economy

The ESRI *Medium-Term Review 2003-2010* (MTR) contained a simulation arising from a sharp 20 per cent (and persistent) depreciation of the US dollar against the euro, to a value of $1.40 per euro, accompanied by a 10 per cent depreciation of UK Sterling or a level of around £0.80 per euro. The impacts of this scenario result in quite dramatic losses in economic performance for the Irish economy in terms of reduced output, employment, wages, price and deterioration in the public finance position relative to Benchmark scenario underpinning the MTR. While the US dollar has depreciated over the course of 2003, the $/€ exchange rate has only started to approach €1.30 rather than the $1.40 assumed in the MTR currency shock. In addition, the depreciation of sterling against the euro has thus far not materialised. The underlying policy response of the US Federal Reserve in raising interest rates contained within the MTR scenario is also unlikely to occur in the short term. In light of these significantly different contemporaneous circumstances, the impacts of the recent euro appreciation will be much more subdued than in the more pessimistic MTR dollar shock scenario.

The simulation we describe here is designed to assess the short to medium-term impact of a sharp permanent reduction of 11.5 and 17.5 per cent in the $/€ exchange rate to a level of $1.30 and $1.40 respectively. In addition, the $/£ exchange rate is assumed to reduce by a similar magnitude, thereby leaving the €/£ exchange rate stable. Furthermore, US short-term interest rates are exogenised in the short term to reflect the current stance of the Federal Reserve where they have indicated that rates will remain at their historical low levels for an extended period. The Benchmark scenario remains that contained within the MTR 2003 and therefore all results contained here are referenced to those projections (See Table 1).

The results of the new dollar shock scenarios for the US and EU are estimated using the NiGEM world economic model. In contrast to the MTR 2003, where monetary tightening led to a significant contraction, the effect on US output growth is estimated to be broadly positive compared with the Benchmark, resulting from enhanced competitiveness and loose monetary policy. However, the fall in the value of the dollar would still have a negative impact on European competitiveness so reducing EU output, but by less than if US economic activity simultaneously declined as in the MTR scenario. Overall, the two shocks presented here indicate negative implications for the international economy. Although US growth rates would remain relatively robust, the results still suggest quite significant negative effects for the European economy, especially in the $1.40 scenario. However, the continued growth in the US together with stability against sterling would offset a large proportion of the estimated negative impact for the European economy as set out in MTR 2003.

The loose stance of US monetary policy and its knock-on effect on US growth also means that the implications for the Irish economy would not be nearly as great, albeit non-trivial. The reason for this more muted impact compared to MTR 2003 is testament to our heavy exposure to both the US and UK. Although there are significant competitive losses *vis-à-vis* the US as a result of both shocks, the fact that growth rates in the US remain quite strong as a result of the assumed accommodative policy of the Federal Reserve means that some of the negative effects are offset given Ireland's exposure to US trade and foreign direct investment (FDI). Also, the assumed stability of sterling against the euro would be broadly favourable to the Irish economy especially for the indigenous industry, although the negative implications of a deterioration of UK competitiveness *vis-à-vis* the US would offset some of this.

The implications of the new dollar shock scenarios for Ireland are contained in Table A1. The effect on GNP and employment is quite significant. In the $1.30 scenario, GNP growth, at 1.5 per cent, is down by around 1.5 percentage points in the first year of the shock before the economy adjusts and growth recovers by 2006 although the level of GDP is around 1 percentage point below the 2006 Benchmark. Employment is similarly affected. In the $1.40 scenario the affects are significantly more pronounced with the speed of adjustment slower. Here, the level of GDP and employment are 2.5 and 2.1 per cent down in 2006 respectively compared to the benchmark. The pass-through of both exchange rate shocks into consumer prices, as measured by the consumer price deflator, results in a decrease in inflation out to 2006 compared to the Benchmark. The slight increase in prices 2004 relates to an assumed moderate appreciation of the euro against sterling under the benchmark, which does not take place in each of the scenarios. The disinflationary trend out to 2006 follows through into a decline in non-agricultural wages in both the scenarios by 2006. The decline in wages assumes a level of flexibility in the labour market in the advent of a severe external shock. This measure of flexibility helps to offset some of the negative impact on the labour market over the short to medium term. In both scenarios, the unemployment rate is forecast to increase from its current low levels with a marked increase in the $1.40 scenario, where the unemployment rate could reach over 6.7 per cent by 2006.

Similar to MTR 2003, the adverse implications of an exchange rate shock for the public finances are significant. In this simulation, tax and expenditure levels are held roughly unchanged in order to assess the likely consequences for the budget of such a shock. From Table A1, it can be seen that the impact on the Exchequer-Borrowing requirement is an increase in the deficit in each year compared to the Benchmark in both scenarios with the $1.40 shock having much more potent consequences. This results in a significantly higher debt to GDP levels than at present with the ratio close to 44 per cent in the case of the $1.40 shock by 2006. It is clear that tax increases together with a major downward adjustment in the volume of public expenditure would be necessary if the economy were to avoid an even more drastic medium to long-term outcome.

Overall the shocks contained above, although imparting significant negative implications for the Irish economy, have much less of an impact as compared to the scenario contained within MTR 2003. Moreover, it is important to keep in mind that the shocks contained here are permanent shocks and because of the forward-looking elements of the models used the effects are quite notable. Temporary movements in exchange rates would have much less negative implications than those outlined here which should be kept in mind in the context of recent exchange rate movements. Nevertheless, this shock is indicative of the vulnerability of the Irish economy to an external downturn, especially in an already weak European economy.

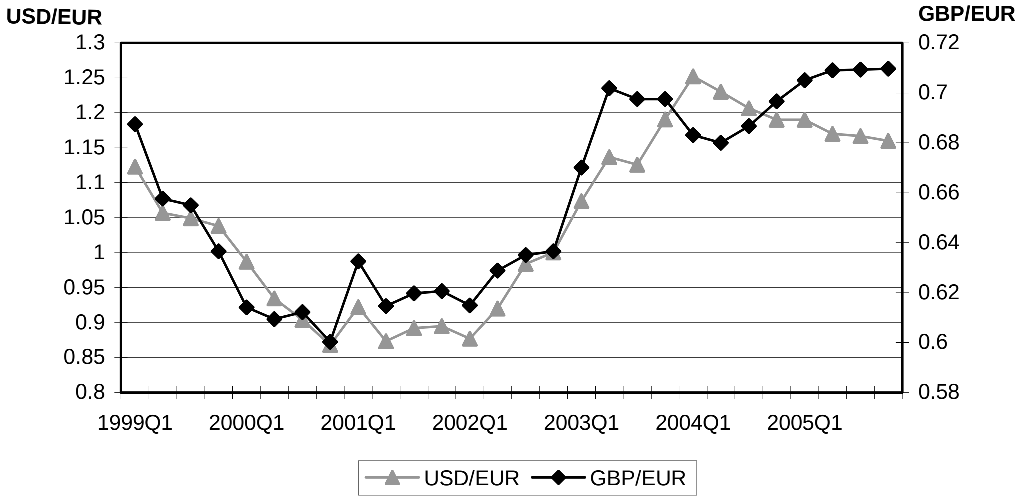
Table A1: External Dollar Shock Simulation Results

The Benchmark Results: (MTR 2003)	**2004**	**2005**	**2006**
% Change Compared to Previous Year			
GNP (%)	3.0	4.7	5.7
Total Employment (%)	1.2	2.4	2.5
Non-Agricultural Wages (%)	2.9	4.4	3.6
Consumer Prices (%)	2.0	3.2	2.8
Per Cent			
Unemployment Rate (% ILO Basis)	5.7	5.4	5.2
Exchequer Borrowing Requirement (% of GNP)	-2.6	-1.9	-1.4
Debt-GNP Ratio	37.3	37.2	36.4
The Simulation Results			
1.30 $/€ Shock			
% Change Compared to Previous Year			
GNP	1.5	5.0	5.9
Total Employment	0.6	2.0	2.5
Non-Agricultural Wages	3.5	3.9	2.7
Consumer Prices	2.2	3.0	2.4
Per Cent			
Unemployment Rate (%ILO Basis)	6.2	6.2	5.9
Exchequer Borrowing Requirement	-3.0	-2.9	-2.6
Debt-GNP Ratio	38.7	39.9	40.4
1.40 $/€ Shock			
% Change Compared to Previous Year			
GNP	0.6	4.8	5.5
Total Employment	0.2	1.6	2.2
Non-Agricultural Wages	3.8	3.5	2.1
Consumer Prices	2.3	2.8	2.1
Per Cent			
Unemployment Rate (% ILO Basis)	6.5	6.8	6.7
Exchequer Borrowing Requirement	-3.3	-3.6	-3.6
Debt-GNP Ratio	39.5	41.8	43.7

Source: *HERMES* Macroeconomic model for the Irish economy.

Figure 2: Exchange Rates

Foreign Currency per Euro, Quarterly Averages



The Domestic Economy

General

The third quarter 2003 national accounts indicate that over the first nine months of the year real growth in GNP exceeded that of GDP. Volume growth of 1.1 per cent was recorded in GDP while GNP volume growth was 2.8 per cent, the gap between the two reflecting the strength of net factor flows. On the basis of the information in these national accounts and on other data that has become available since the last *Commentary* we have revised our economic growth forecasts. Our estimate for volume growth in GDP has been revised to 1.2 per cent in 2003 and our estimate for GNP volume growth has been revised to 3 per cent.

It seems likely that there will be some recovery in Irish economic growth this year as international economic activity picks up. On the back of such an international recovery, with interest rates remaining subdued we are forecasting that GDP growth will rise to 3.5 per cent in 2004 and that volume growth in GNP will increase to 3.3 per cent. These forecasts suggest that the gap between GDP and GNP will reverse from 2003 and return to the more normal case of higher GDP growth. However, the gap will be much smaller than that which has existed historically.

Provided that the world economic recovery remains in place the outlook for 2005 is for a further upturn in growth. Thus we are forecasting that in 2005 real growth in GDP will reach 4.5 per cent and real GNP growth of 4.4 per cent.

Exports

Official trade statistics for the first eleven months confirm that the volume of exports declined in 2003. However, while some of this decline reflects a slowdown in world economic activity the decline is also due to a fall in the pattern of distributive type trade in electrical machinery and parts with Great Britain in 2002. Thus, the volume of exports declined by 6.9 per cent in 2003. Full year figures indicate that the value of exports was down by 10.2 per cent. These figures suggest that the price deflator for exports fell in the order of 3.6 per cent in 2003.

Given the forecasts for the international economy and the exchange rate assumptions already outlined in this *Commentary* we anticipate some recovery in export trade volumes in both 2004 and 2005. Allowing for Balance of Payments adjustments the volume of merchandise exports are forecast to grow by 3.5 per cent this year, while the value of exports will decline by 0.5 per cent given continued price pressure. Although this growth rate does reflect new capacity coming on stream and a continuation of FDI flows into the Irish economy these will be more subdued than in recent years. Furthermore, exports will also be facing a more difficult currency environment given the appreciation of the euro. Currency movements are also expected to impact on tourism exports and so a slower volume growth rate, compared to 2003, of 2.6 per cent is forecast. The upturn in international activity is reflected in an upturn in the growth of other services. The impact of the revisions to our sub-sector forecasts is that we are now anticipating that exports will grow by 3.7 per cent. It seems unlikely that export prices will increase in 2004 and in fact a further decline of 2.6 per cent is included in our forecasts. Thus exports are forecast to grow by a moderate 1 per cent in value terms in 2004.

A continuation of the upturn in international economic activity and some appreciation of the dollar will contribute to an improved export performance in 2005. The most notable change in 2005 will be the move to positive price deflators for the first time since 2002. With all sectors showing some growth the volume of merchandise exports are forecast to increase by 6.8 per cent. A positive price deflator of 1.2 per cent implies that the value of merchandise exports will increase by 8.1 per cent in 2005. Taking account of growth in tourism exports and in other services means that we are forecasting value growth in the exports of goods and services to be 7.6 per cent. With the forecast price deflator being the same as that for merchandise exports implies that the volume of goods and services exports will grow by 6.3 per cent in 2005.

TABLE 2: Exports of Goods and Services

	2002	% Change in 2003		2003	% Change in 2004		2004	% Change in 2005		2005
	€m	Volume	Value	€m	Volume	Value	€m	Volume	Value	€m
Agricultural	4,077	-3.3	-1.8	4,001	1.9	0.9	4,037	2.1	1.5	4,097
Manufactured	82,200	-6.0	-12.4	72,014	3.8	0.2	72,134	7.2	9.3	78,874
Other Industrial	5,619	-5.5	-8.1	5,166	2.1	0.3	5,180	4.1	5.7	5,473
Other	1,995	-4.5	-4.0	1,915	3.0	1.5	1,943	3.6	5.1	2,041
Total Visible	**93,891**	**-5.8**	**-11.5**	**83,096**	**3.6**	**0.2**	**83,293**	**6.7**	**8.6**	**90,485**
Adjustments	-2,655	140.0	116.0	-5,734	5.0	10.3	-6,322	5.0	15.5	-7,302
Merchandise	**91,236**	**-10.1**	**-15.2**	**77,362**	**3.5**	**-0.5**	**76,972**	**6.8**	**8.1**	**83,184**
Tourism	3,268	5.0	7.6	3,517	2.6	3.7	3,648	3.5	5.6	3,852
Other Services	26,654	2.5	4.5	27,867	4.5	5.0	29,266	5.2	6.6	31,188
Exports of Goods and Services	**121,158**	**-6.9**	**-10.2**	**108,746**	**3.7**	**1.0**	**109,886**	**6.3**	**7.6**	**118,224**

Stocks

Third Quarter National Accounts 2003 reveal that the value of physical changes in stocks amounted to €694 million in value and €788 million in volume terms. For the year as a whole it is estimated that the increase in stocks will be €595 million. Smaller increases in farm stocks coupled with more moderate increases in industrial and distribution stocks means that we are projecting that the increases in stocks in 2004 and 2005 will be much lower at €190 million and €165 million respectively. A contributing factor to this is the assumption that there will be no change in Irish intervention stocks in 2004 followed by only a marginal increase in 2005.

TABLE 3: Stock Changes

	2002 €m	Change in Value €m	2003 €m	Change in Value €m	2004 €m	Change in Value €m	2005 €m
Farm Stocks	-40	250	210	-80	130	-90	40
Irish intervention Stocks	176	-161	15	-15	0	5	5
Other Non-Agricultural Stocks	-125	495	370	-310	60	60	120
Total	**11**	**584**	**595**	**-405**	**190**	**-25**	**165**

Investment

The *Quarterly National Accounts* show that the volume of investment activity in the first nine months of 2003 contracted by 2 per cent. This reflects a decline in building and construction other than housing and a decline in investment in machinery and equipment. Indeed the contraction would have been much worse were it not for the strength of the housing sector. Figures from the Department of the Environment indicate that the number of house completions increased by an unexpectedly strong 19.3 per cent.

Although the upturn in economic activity is forecast to be gradual it is anticipated that it will contribute to some upturn in investment activity. With slower growth in new house prices forecast in 2004 some reduction in the volume of housing completions is expected. However, our forecast reduction will still mean that over 60,000 dwellings will be built in 2004. Some foreign direct investment inflows and the continuing programme of public capital expenditure coupled with improved levels of economic activity are expected to result in investment in other building and construction returning to growth in 2004. With investment in machinery and equipment also benefiting from the more positive economic outlook, the overall volume of investment is expected to grow by 0.4 per cent this year. On the basis of a price deflator of 2.5 per cent this implies that the value of investment will increase by 2.9 per cent in 2004.

With the moderation in house price growth forecast to continue we again expect housing completions volumes to show some decline in 2005. Furthermore, interest rate increases are expected to provide some moderation to investment activity, although the impact of this will be offset by stronger economic growth. With investment in other building and construction forecast to improve and a more moderate decrease in housing investment, overall building and construction is forecast to improve by 0.9 per cent in volume terms and by 3 per cent in value, implying a price deflator of 2.1 per cent. A small moderation in the rate of growth in investment in plant and machinery is anticipated. However, the value of overall investment is forecast to grow by 4 per cent and by 2.2 per cent in volume, giving an investment price deflator of 1.8 per cent.

Consumption

Retail sales statistics for 2003 show that growth in consumption improved in 2003, albeit remaining moderate, with the overall volume index growing by just 0.8 per cent. Excluding the volatile motor trade component results in a growth rate of 1.4 per cent. The *Quarterly National Accounts* for the first nine months of 2003 also indicate that personal consumption growth will be moderate. On the basis of these indicators we have estimated that the volume of personal consumption grew by 2.2 per cent in 2003.

Since the last *Commentary* the IIB Bank/ESRI Monthly Consumer Sentiment Index shows consumer sentiment has improved. Furthermore, with the economy continuing to create jobs and incomes continuing to grow at a time of improving economic activity we anticipate that personal consumption growth will improve in 2004. Thus, the value of personal consumption is projected to increase by 5.7 per cent. Price pressures are expected to remain moderate resulting in a personal consumption price deflator of 2.1 per cent, implying that the volume of personal consumption will increase by 3.5 per cent.

With continued international recovery and stronger domestic activity, our forecast for personal consumption growth for 2005 shows a further improvement on 2003 and 2004. A volume increase of 4.2 per cent is forecast with a personal consumption deflator of 1.8 per cent. This indicates that in value terms personal consumption is projected to grow by 6.1 per cent.

According to the *Quarterly National Accounts* government consumption in the third quarter increased by 2.8 per cent in volume and by 7.8 per cent in value, giving a public expenditure deflator of 4.9 per cent. The strength of public sector employment growth coupled with pay awards means that we estimate that annual government consumption growth will be recorded at 8.8 per cent in value terms in 2003, with a price deflator of 5.2 per cent implying volume growth of 3.5 per cent. The efforts to curtail the rate of growth in public expenditure have been reasonably successful and the bulk of the Benchmarking awards having been paid we are projecting more moderate volume growth in public expenditure in both 2004 and 2005 at 2.3 and 2.6 per cent respectively. However, the public expenditure deflator is projected to remain higher than other deflators in the economy at 5.5 per cent this year and 3.7 per cent in 2005. This will result in a value increase in public expenditure of 8 per cent in 2004 and 6.4 per cent in 2005.

TABLE 4: Gross Fixed Capital Formation

	2002 €m	% Change in 2003		2003 €m	% Change in 2004		2004 €m	% Change in 2005		2005 €m
		Volume	Value		Volume	Value		Volume	Value	
Housing	10,809	20.2	32.0	14,266	-8.0	-2.5	13,913	-3.0	0.2	13,940
Other Building	9,212	-2.5	-0.1	9,207	4.3	7.2	9,871	4.8	7.0	10,563
Building and Construction	20,022	8.3	17.2	23,473	-2.2	1.3	23,784	0.9	3.0	24,503
Machinery and Equipment	8,627	-12.0	-11.6	7,630	5.0	7.9	8,235	4.3	6.9	8,804
Total	28,649	-0.2	8.6	31,103	0.4	2.9	32,019	2.2	4.0	33,307

TABLE 5: Consumption Indicators

	Annual Percentage Change						
	1999	2000	2001	2002	2003	2004 Forecast	2005 Forecast
Consumption Value							
Personal Consumption	12.6	13.0	10.1	8.9	5.8	5.7	6.1
Retail Sales Index, Value	11.4	16.3	5.9	3.9	3.1	3.8	4.2
Divergence	1.2	-3.3	4.2	5.0	2.7	1.9	1.9
Consumption Volume							
Personal Consumption	9.3	8.5	5.5	2.7	2.2	3.5	4.2
Retail Sales Index, Volume	9.5	11.9	3.1	0.7	0.8	1.8	2.1
Divergence	-0.2	-3.4	2.4	2.0	1.4	1.7	2.1
Consumer Prices							
Personal Consumption Deflator	3.0	4.2	4.3	6.0	3.5	2.1	1.8
Retail Sales Index Deflator	1.7	3.9	2.7	3.2	2.3	2.0	2.1
Consumer Price Index	1.6	4.5	5.6	4.6	3.5	2.0	1.8

Final Demand

Final demand is estimated to have decreased by 1.9 per cent in value and by 2.5 per cent in volume in 2003 taking account of the exceptionally strong falls in exports during the year. Domestic demand excluding stocks is estimated to have grown by 1.8 per cent in volume and by 7.0 per cent in value, given that the volume of exports of goods and services was down 6.9 per cent.

Final demand is forecast to grow by 3 per cent in both volume and value terms in 2004. Volume growth in exports at 3.7 per cent is forecast to exceed volume growth in domestic demand, excluding stocks, of 2.5 per cent. The forecasts outlined in the *Commentary* result in final demand growth in volume terms of 4.8 per cent in 2005. Exports of goods and services are forecast to grow by 6.3 per cent in volume while domestic demand excluding stocks is forecast to grow by 3.4 per cent. With personal consumption and exports contributing to the growth in demand, the composition of final demand can be expected to be quite import-intensive.

TABLE 6: Imports of Goods and Services

	2002	% Change in 2003		2003	% Change in 2004		2004	% Change in 2005		2005
	€m	Volume	Value	€m	Volume	Value	€m	Volume	Value	€m
Capital Goods	7,013	-3.5	-6.9	6,530	1.4	-2.7	6,357	3.5	4.5	6,645
Consumer Goods	12,662	-4.5	-6.6	11,826	2.5	-0.1	11,819	4.3	5.9	12,488
Intermediate Goods:										
Agriculture	938	-8.0	-12.4	822	2.0	1.0	830	3.1	4.6	868
Other	32,612	-12.0	-18.2	26,690	2.4	-1.2	26,374	6.1	7.9	28,458
Other Goods	2,279	-7.0	-12.8	1,988	2.1	-1.5	1,959	4.5	5.9	2,073
Total Visible	**55,505**	**-8.9**	**-13.8**	**47,857**	**2.3**	**-1.1**	**47,339**	**5.2**	**6.7**	**50,533**
Adjustments	-1,283	100.0	80.0	-2,309	5.0	5.0	-2,424	5.0	5.0	-2,545
Merchandise Imports	**54,222**	**-11.5**	**-16.0**	**45,548**	**2.1**	**-1.4**	**44,914**	**5.2**	**6.8**	**47,988**
Tourism	3,958	6.2	6.7	4,224	2.5	0.4	4,243	3.2	5.4	4,471
Other Services	38,834	-2.0	-1.0	38,438	2.6	0.1	38,491	5.9	7.1	41,210
Imports of Goods and Services	**97,014**	**-7.0**	**-9.1**	**88,210**	**2.4**	**-0.6**	**87,649**	**5.4**	**6.9**	**93,669**

Imports

On the basis of the trade statistics for the first eleven months of 2003 visible imports are estimated to have declined 13.8 per cent for the year in value and fell by 8.9 per cent in volume terms. This is consistent with other indicators for investment and industrial production along with a sharp fall off in exports discussed earlier. From Balance of Payments estimates for the first nine months of 2003 merchandise imports for the year as a whole are estimated to have fallen by 11.5 per cent in volume and 16 per cent in value. The rise in tourism spending abroad is estimated at 6.2 per cent, while other service imports, including royalty payments, decreased by 2 per cent in volume terms. Thus, total imports of goods and services in 2003 are estimated to have fallen by 7 per cent in volume terms. With an estimated price deflator of –2.2 per cent this implies a value decrease of 9.1 per cent, the largest fall recorded for imports in modern times.

The lower rate of growth projected for manufactured exports in 2004 is likely to be reflected in a reduced rate of increase in intermediate goods. Visible imports are therefore forecast to rise by 2.3 per cent in 2004 in volume terms. Allowing for the Balance of Payments adjustment, merchandise imports are forecast to increase by 2.1 per cent in volume. Given a forecast price deflator fall of 3.4 per cent the resulting decline in value terms will be 1.4 per cent. We expect some moderation in tourism spending abroad, reflecting renewed uncertainty and lower disposable income growth and we expect other service imports to rise moderately also, both in the order of 2.5 per cent in volume terms with little change in value terms. Total imports of goods and services in 2004 are, therefore, forecast to increase by 2.4 per cent in volume and falling by 0.6 per cent in value terms, implying a price deflator fall of 2.9 per cent.

Based on our assumption that the world economy continues to recover towards the end of 2004 and into 2005 we anticipate that import growth will increase next year. Thus, the volume growth of imports of goods and services is expected to improve to 5.4 per cent in 2005 while a price increase will mean that the growth in value terms will be 6.9 per cent.

Balance of Payments

On the basis of the Balance of Payments trends for the first nine months of the year it is estimated that profit outflows will have decreased by 14.5 per cent in 2003, while reinvested earnings rose by 18 per cent. National debt interest has increased and other debit flows are estimated to have declined substantially. Overall debit flows from Balance of Payments current account are estimated to have declined by 5.1 per cent in 2003. The credit flows are estimated to have been flat overall at 0.3 per cent growth in 2003, so that net factor outflows are estimated to have declined substantially by 11 per cent to €23 billion reversing some of the spectacular rise recorded in 2002. Net current transfers are estimated to have declined significantly and the overall deficit on the current account is estimated to have risen to over €1.9 billion or 1.7 per cent of GNP. The divergent trends between debit and credit flows in the Balance of Payments indicated that GNP rose significantly faster than GDP in 2003.

Our trade forecasts for 2003 and 2004 indicate that the trade surplus in goods and services will rise as the international economy improves. Net factor outflows will once again begin to grow in 2004 and 2005 restoring a modest gap between GDP and GNP growth rates. Our forecasts result in the deficit on the current account narrowing to €1,134 million in 2004 and €374 million in 2005.

TABLE 7: Balance of Payments

	2002 €m	Change %	2003 €m	Change %	2004 €m	Change %	2005 €m
Visible Trade Balance	38,386	-8.2	35,240	2.0	35,955	8.0	39,952
Adjustments	-1,372		-3,425		-3,898		-4,756
Merchandise Trade Balance	**37,014**	**-14.0**	**31,814**	**0.8**	**32,057**	**6.2**	**35,196**
Service Trade Balance	-12,870	-12.4	-11,278	-12.9	- 9,820	-3.3	-10,641
Trade Balance in Goods and Services	**24,144**	**-14.9**	**20,536**	**8.3**	**22,238**	**10.5**	**24,555**
Total Debit Flows	-53,749	-5.1	-50,986	3.8	-52,927	5.8	-55,970
Total Credit Flows	27,834	0.3	27,928	4.9	29,305	5.2	30,831
Net Factor Flows	**-25,915**	**-11.0**	**-23,058**	**2.4**	**-23,622**	**6.4**	**-25,139**
Net Current Transfers	**817**	**-28.3**	**586**	**- 57.3**	**250**	**-180.0**	**-210**
Balance on Current Account	**-954**		**-1,936**		**-1,134**		**-374**
Capital Transfers	576	- 7.6	532	-9.8	**480**	-9.4	435
Effective Current Balance	**-378**		**-1,404**		**-654**		**61**

Gross National Product

Real GNP rose by an estimated 3.0 per cent in 2003. This is lower than the forecast in the Winter *Commentary*, reflecting the weakness of exports and investment activity. The CSO *Quarterly National Accounts* show a rise in real GDP of 1.1 per cent for the first nine months of 2003 and our forecast suggests that there may have been a marginal upturn in activity in the final quarter. The *Quarterly National Accounts* also show that the economy grew by 2.8 per cent in real GNP terms. As pointed out in the Balance of Payments section the wide gap between the two measures is a reflection of the strength of net profit outflows.

For the years 2004 and 2005 the projected growth rates for real GNP are 3.3 per cent and 4.4 per cent respectively. In GDP terms the forecast are 3.5 per cent and 4.5 per cent respectively, representing a return to the more usual relationship between the two measure of economic activity, albeit with a much narrower difference. The forecast for import and export prices indicate a terms of trade gain in 2004 which together with a small increase in current transfers means that Gross National Disposable Income (GNDI) including capital transfers will increase by 3 per cent in 2004. The terms of trade are forecast to show a small deterioration in 2005 which together with a reduction in the volume of current transfers means that the rise in Gross National Disposable Income including capital transfers is projected at 3.7 per cent.

Agriculture

Revised estimates suggest that agricultural income, as measured by operating surplus, increased by €120 million or 4.9 per cent in 2003 following a sharp decline of 8.5 per cent in 2002. This measure of income is before deductions for land rental and interest payments, which are quite sizeable for the sector. Net subsidies decreased by 0.8 per cent or €13 million, leaving it at 62.3 per cent of operating surplus as compared to 65.8 per cent in 2002.

The main factors leading to this increase were the value of cattle, increasing by 5.3 per cent or €61 million, and the value of cereals output, which increased by 33.4 per cent or €47 million, while the cost of feeding stuffs decreased by 4.8 per cent or €46 million. Some of this was offset by a reduction in the value of pig and sheep output together with an increase in fertilisers.

This improved performance in the sector is also reflected in the *Quarterly National Accounts* with annual growth of 7.7 and 5.4 per cent in the first two quarters of the year before moderating substantially to 0.3 per cent in the third quarter. Seasonally adjusted, there was a quarter on quarter contraction in the sector in the third quarter following growth of 2.8 and 2.0 per cent in the first and second quarters respectively.

The main problem facing agriculture continues to be that of shrinking margins. Preliminary estimates show that input prices increased by 2.4 per cent from 2002 levels while output prices decreased by 0.6 per cent. Although the price of cereals output increased by 18.3 per cent in 2003, this was mainly due to drought conditions in much of Europe in the summer and is unlikely to be maintained into 2004. The year on year increases in 2003 were largely to do with a very negative 2002 and this base effect will unwind in 2004. The sector will continue to be under pressure in the coming years especially in the light of the decoupling proposals. Following an increase of 4.2 per cent in volume terms in 2003, we estimate moderate growth in the volume of gross agricultural output of 0.3 and 1.0 per cent in 2004 and 2005 respectively.

Industry

Growth in the industrial sector was quite sluggish in 2003, following growth in volume terms of 11 per cent in 2002. The latest Estimates from the *Quarterly National Accounts* indicate that the volume of production in Irish industry, including building, grew by 1.2 per cent in the third quarter of 2003 when compared to the corresponding period of 2002. This compares with annual growth of 0.8 and 1.0 per cent in the first two quarters of the year. The recently introduced seasonally adjusted series confirms this rather anodyne performance of industry. The sector grew by 3.6 per cent in the second quarter following a slight contraction in the first quarter. However, in the third quarter the sector contracted by 1.3 per cent when compared to the previous quarter. These seasonally adjusted series are quite volatile, however, and possibly reflect the fact that the seasonal factors used in the process of seasonal adjustment are based on a period of unprecedented growth in the Irish industrial sector.

This rather weak growth in the industrial sector is not fully mirrored in the volume of production index, although growth is notably more subdued when compared to 2002. The Index for all industry is estimated to have increased by an average of 6.6 per cent for 2003 following growth of 7.9 per cent in 2002. The sector does seem to have recovered quite strongly in the final quarter of the year with seasonally adjusted growth of 6.9 per cent when compared to the previous quarter or growth of 15.2 per cent when compared to the same period one year previously. Early estimates for the start of 2004 suggest that the volume of industrial production for all industry increased by 8.9 per cent in the year up to January 2004.

The rebound in the sector in the latter part of 2003 is confirmed by survey data. The NCB Purchasing Managers Index indicated that the manufacturing sector expanded for the sixth consecutive month in February with a seasonally adjusted index of 53.7, where a figure above 50 indicates expansion in the sector. Up until September, the index had been below 50, indicating worsening conditions in the sector, thereby re-affirming the national accounts data. New orders have underpinned the improvement in the index with international sales improving in line with more favourable global conditions. The employment situation remains quite weak with the employment component of the index indicating marginally more manufacturing employment in February, the first such increase in over three months. However, conditions in the sector continue to improve and this is reflected in the forward-looking components of the IBEC/ESRI Monthly Industrial Survey with all the expectations components up in the latest March report.

We expect continued strengthening in the sector in 2004 given our forecasts for the international economy. Following volume growth of 1.5 per cent in 2003, we forecast stronger growth of 2.8 per cent for industry this year, and growth of 4.6 per cent in 2005 in line with global conditions.

Services

Output in the services sector is estimated to have increased by 4.7 per cent in 2002 as compared to the robust growth rates of 8.5 per cent and 7.9 per cent recorded in 2000 and 2001 respectively. The rate of expansion in this sector has been sluggish in 2003 but it continues to outperform the industrial sector, most likely due to the less cyclical nature of the sector. The latest *Quarterly National Accounts* indicate that output in the services sector increased at an annual rate of 1.7 per cent in the third quarter, as compared to 3.0 per cent and 2.1 per cent in the first and second quarters respectively. On a seasonally adjusted basis, quarterly growth has been increasing throughout 2003, albeit very moderately, with growth of 0.6 per cent in the third quarter as compared to 0.05 per cent and 0.4 per cent in the first and second quarters.

Within services, the slowdown in the distribution, transport and communications sector, mentioned in previous *Commentaries*, has continued with annual growth in the third quarter of only 0.5 per cent, the lowest growth rate since the *Quarterly National Accounts* began in 1999. Growth in public administration and defence has been decelerating since the beginning of 2002 and output in the sector contracted by 0.4 per cent in the third quarter of 2003. Growth in other services remains sluggish but better then in the other sectors with 2.6 per cent annual growth recorded in the third quarter of last year.

The NCB *Monthly Report on Services* indicates that overall activity has held up well in the sector in the latter part of 2003 and early in this year. Strong growth in business activity continued in February and rapid monthly growth was recorded in employment. Expectations of increased future activity are high, reflecting most firm's belief that the current recovery will be sustained. However, continued increases in input costs are becoming a cause of concern, with increased wages and salaries and high fuel and energy costs being the main contributors to cost pressures.

Activity in the overall services sector is forecast to strengthen in 2004 compared to 2003, as personal consumption growth rebounds. Gross output in the services sector is forecast to increase by just 2.0 per cent in 2003. The forecast recovery in overall economic conditions this year will boost activity in the sector, and we are forecasting a recovery in services sector gross output to 4.3 per cent this year before rising to 4.4 per cent in 2005.

Employment

Despite the slowdown in domestic activity, the labour market has shown considerable resilience with recent data revealing strong employment growth and a fall in the unemployment rate. The latest *Quarterly National Household Survey* (QNHS) for the fourth quarter of 2003 shows employment in the Irish economy grew on average by 1.8 per cent last year. This compares with 1.4 per cent in 2002 and 2.9 per cent in 2001. In absolute terms average employment last year was 1.796 million persons. The latest QNHS shows a reversal of several patterns that appeared to be emerging in the earlier part of last year. Employment growth was 2.5 per cent in the fourth quarter, a significant improvement on the 1.6 and 1.4 per cent growth recorded in the second and third quarters respectively. Over three-quarters of the annual increase can be attributed to increases in full-time employment, in contrast to earlier quarters where part-time employment accounted for most of the employment growth.

Employment increased on an annual basis in all sectors in the fourth quarter with the exception of other production industries and agriculture, forestry and fishing, with the largest increases recorded in health (12,100) and construction (9,300). Having adjusted for seasonal factors the largest quarterly rates of increase were in other services and transport, storage and communication. Over half of the annual employment growth in the last quarter of 2003 is attributable to the 25-34 year age group.

TABLE 8: Employment and Unemployment*

	Annual Averages			
	2002	2003	2004	2005
Agriculture	121	116	115	114
Industry	494	496	499	504
Services	1,150	1,185	1,206	1,230
Total at Work	**1,765**	**1,797**	**1,820**	**1,848**
Unemployed	82	88	93	96
Labour Force	**1,847**	**1,885**	**1,913**	**1,945**
Unemployment Rate %	4.4	4.7	4.9	5.0
Live Register	163	172	181	187

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

Labour force growth averaged 2.0 per cent last year, the same as in 2002. Growth strengthened throughout the year and an increase of 2.5 per cent was recorded for the fourth quarter. The overall participation rate averaged 60.1 per cent in 2003 up from 59.9 in 2002, the highest level ever recorded. Male participation in the labour force averaged 70.9 per cent unchanged from the previous year. Female participation increased from 49.2 in 2002 to 49.6 per cent in 2003. The bulk of the increase in the labour force in 2003 was due to demographic factors increasing the numbers in working age groups adding an estimated 35,500 to the labour force. The increase in labour force participation is estimated to have added 11,500 persons, with the most significant increase recorded for those in the 25-34 year age-group where participation increased from 83.7 per cent in 2002 to 84.6 per cent.

The latest QNHS indicates that the average unemployment rate in 2003 was 4.7 per cent up from 4.4 per cent in 2002. In the fourth quarter of the year unemployment stood at 4.5 per cent or 86,500 persons as compared with 5.3 per cent in the third quarter. Some of the fall in the unemployment rate in the fourth quarter may reflect seasonal factors such as the re-opening of schools and colleges. On a seasonally adjusted basis the unemployment rate fell to 4.6 per cent in the last quarter as compared to 4.9 per cent in the third quarter. The latest Live Register Statement for February 2003 indicates that, when adjusted for seasonal factors, the register fell by 900 persons in the month and rose by 1,700 in the year. In total, numbers on the register rose to 170,100 in February. This means that the standardised unemployment rate was 4.7 per cent in February, unchanged over the previous three months.

It is forecast that total employment will average 1.820 million persons this year rising to 1.848 million persons in 2005. In percentage terms this means that employment growth will average 1.3 per cent this year and 1.6 per cent in 2005. Following an increase of 0.5 per cent in 2003 employment growth in the industrial sector is expected to accelerate to 0.6 per cent in 2004 and 1.0 per cent in 2005. The numbers employed in agriculture are anticipated to decline in the short term, albeit at a more moderate rate than in recent years. Growth in employment in the services sector is expected to slow in the short term, with an increase of 1.8 per cent

TABLE 9: Personal Disposable Income

	2002	Change		2003	Change		2004	Change		2005
	€m	%	€m	€m	%	€m	€m	%	€m	€m
Agriculture, etc.	3,155	3.3	105	3,260	3.1	100	3,360	2.7	90	3,450
Non-Agricultural Wages	49,914	7.6	3,804	53,718	5.5	2,956	56,674	4.6	2,582	59,256
Other Non-Agricultural Income	16,213	-3.4	-552	15,661	2.1	323	15,984	11.3	1,807	17,791
Total Income Received	**69,282**	**4.8**	3,357	**72,639**	**4.7**	**3,379**	**76,018**	**5.9**	**4,479**	**80,497**
Current Transfers	13,283	13.6	1,806	15,089	7.8	1,174	16,263	4.2	682	16,945
Gross Personal Income	**82,565**	**6.3**	**5,163**	**87,728**	**5.2**	**4,553**	**92,281**	**5.6**	**5,161**	**97,442**
Direct Personal Taxes	15,033	3.8	567	15,600	7.0	1,097	16,697	4.7	790	17,487
Personal Disposable Income	67,532	6.8	4,596	72,128	4.8	3,456	75,584	5.8	4,371	79,955
Consumption	60,118	5.8	3,473	63,592	5.7	3,608	67,199	6.1	4,083	71,282
Personal Savings	7,413	15.2	1,123	8,536	-1.8	-152	8,385	3.4	288	8,673
Savings Ratio	11.0			11.8			11.1			10.8

forecast for 2004 before rising to 2.0 per cent in 2005. Labour force growth is expected to moderate to average 1.5 per cent and 1.6 per cent in 2004 and 2005 respectively. The unemployment rate is expected to deteriorate over the forecast horizon averaging 4.9 per cent and 5.0 per cent in 2004 and 2005 respectively.

Incomes

Improved domestic economic conditions means that we have revised up our forecasts for income growth since the previous *Commentary*. We expect that these more favourable economic conditions will foster continued demand for labour and maintain a solid foundation for continued earnings growth. Growth in hourly earnings is estimated at 5.3 per cent in 2003 and is expected to slow to 4.0 per cent and 2.8 per cent in 2004 and 2005 respectively. Although this level of nominal wage growth is quite low compared to recent years, it reflects a low inflationary environment together with continued competitive pressures and the need to anchor the domestic cost base.

Following growth of 3.3 per cent in 2003, we forecast growth in agricultural incomes of approximately 3.1 and 2.7 per cent in 2004 and 2005 respectively. This slowdown in income growth has become the trend in the sector and reflects shrinking margins as well as a continued structural decline in agriculture more generally. The non-agricultural wage bill looks set to continue to grow quite strongly, albeit at a moderating rate. Following growth of 7.6 per cent in 2003, we forecast growth of 5.6 and 4.0 per cent in 2004 and 2005 respectively.

Following extraordinary volume growth of over 42 per cent in 2002, net factor payments are estimated to have contracted by 5.9 per cent in volume terms in 2003. This is the reason for the higher growth rate of GNP as compared to GDP. However we do expect growth in these payments, which are primarily made up of multinational profits, to return in the short-term. We forecast the volume of these flows to increase by 4.3 per cent in 2004 and 5.2 per cent in 2005. This will primarily be a consequence of improved international conditions and its knock on effect on trade and corporate profitability.

Consumer prices

Official figures confirm that the Consumer Price Index rose by 3.5 per cent in 2003. This overall average masks the moderation in inflation that occurred towards the end of 2003. Figures for the first two months of this year show that this gradual slowdown in the inflation rate has continued. The recent strength of the euro suggests that the economy will benefit from cheaper import prices, as borne out by the negative import price deflator. Furthermore, the Wholesale Price Index indicates that manufacturing industry prices for domestic sales grew at very moderate rates in 2003 and actually declined in December and January. With European economic growth remaining slow in 2004 it seems unlikely that a sharp interest rate increase will raise the housing component of the consumer price index. Indeed, given these factors we are currently forecasting that inflation will average 1.8 per cent in 2004. The consumer expenditure deflator, a broader measure of inflationary trends in the economy, is also forecast to be lower than in 2003 at 2.1 per cent.

Our exchange rate and inflation forecasts are outlined in the International section of this *Commentary*. Our long held view is that Irish inflation is determined primarily by the external environment. We are assuming that there will be some recovery in the value of the dollar in 2005 and that the strength of the economic recovery will allow the ECB to raise interest rates throughout the course of the year. The effect of these will be to raise the rate of inflation in 2005 to an annual average of 2 per cent, still a moderate rate of inflation compared with recent years.

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	1.1	1.5
Other	5.4	4.0	5.0	4.2	1.9	2.0
Total CPI	5.6	4.9	4.6	3.5	1.8	2.0
EU-HICP (Ireland)	5.2	4.0	4.7	4.3	2.3	2.1
Index Dec. 2001=100						
Housing	88.2	102.7	103.7	103.1	104.2	105.8
Other	93.6	98.7	102.6	106.9	108.9	111.1
Total CPI	92.7	97.9	102.7	106.3	108.3	110.4

Public Finances

Exchequer returns for the full year 2003 indicate that despite the sharp slowdown in economic activity, the public finances remain in a sound position. This is quite surprising given the extent of the slowdown in economic activity, which saw GDP grow by only 1.2 per cent over the year. Although GNP, which is possibly the more relevant indicator of the economy's taxable base, grew at a stronger pace of 3.0 per cent, a more pronounced deterioration in the public finance position would have been anticipated. Following a surplus of €93 million in 2002, the Exchequer ran a deficit of €980 million in 2003. Although this was the first Exchequer deficit in six years, it came in significantly under the budget target of €1,869 million. Furthermore, despite this move into deficit, the broader general government balance, which includes the National Pensions Reserve Fund and Social Insurance Fund, registered a surplus of €280 million in 2003 or 0.2 per cent of GDP. This indicates significant fiscal tightening during the year in which output continued to be below its potential. Like 2002, much of the improvement in the fiscal positions came in the latter part of the year. The corresponding general government gross debt in 2002 stood at nearly €43 billion or 32.3 per cent of GDP.

Tax revenue in 2003 increased by 9.6 per cent over 2002 or €457 million above the Budget 2003 target, with increased revenue in capital taxes and company taxes offset by lower than expected revenues in VAT, excise and income taxes. Non-tax revenue was also €51 million above the 2003 Budget target. This was accounted for by the excess from the National Lottery, dividends and the Central Bank surplus. Voted current expenditure, at €25,452 million, increased by 9.2 per cent on 2002. This was €126 million higher than the 2003 Revised Estimates but €75 million lower than the estimated outturn for 2003 published on 3 December last. The lower outturn reflects both additional receipts, such as health levy receipts, and reduced expenditure across a number of departments. This left the surplus on the exchequer current account of €4.4 billion as compared to a surplus of €5.4 billion in 2002. Net voted capital expenditure amounted to €5.3 billion or 97.4 per cent of the 2003 Revised Estimates provision. The savings of €141 million arose across most departments. Capital receipts were €1,288 million for the year while the level of capital spending in 2003 was about 5 per cent of GNP, nearly double that of the EU average.

Focusing on 2004, the Revised Estimates provide for a 7 per cent rise in net expenditure, which encompasses an 8 per cent increase in voted current expenditure and a 3 per cent increase in voted capital expenditure. The net Exchequer pay bill is targeted to rise by 9 per cent. Looking at the outturn in 2004 thus far, tax revenues are running well ahead of target, due to a strong rise in capital gains tax and continued buoyancy in stamp duties. In particular, capital gains tax receipts, at €367 million, were over €300 million above the same period last year and €200 million ahead of the profile target. Compared to the same period last year, tax receipts rose by 21 per cent, which was considerably higher than the 14 per cent target. Overall, more than €5.35 billion in taxes were collected up to the end of February, €300 million more than expected.

On the other hand, capital spending remains below target, particularly on investment projects. Under the capital envelopes system announced in Budget 2004, Departments will have the facility from 2004 onwards to carry forward to the following year annual capital savings of no more than 10 per cent of their annual capital allocation. On the whole, the Exchequer surplus was €430 million for the first two months, compared to a deficit of €127 million for the same period last year. Although it is still very early in the year and future returns may be quite volatile due to timing effects, the latest returns are quite positive and indicate that the exchequer-borrowing requirement may come in below target once again in 2004.

In 2004 we estimate an exchequer deficit of €2.2 billion and a general government deficit of €1.1 billion or 0.8 per cent of GDP. Tax revenue is anticipated to grow by 5.4 per cent in 2004. On the expenditure side we expect that current expenditure growth will be around 8.5 per cent for the year. Capital expenditure is forecast to rise by 6.1 per cent while capital receipts are expected to fall by 3.0 per cent. As the economy moves towards its potential, we forecast continuing improvement in the budgetary position with an exchequer deficit of €2.6 billion and a general government deficit of €1.3 billion or 0.9 per cent of GDP for 2005 as whole. The outturn for 2003 combined with our projections for this year and next means that Ireland remains well within the terms of the Stability and

Growth Pact (SGP). This is in contrast with many of the other European economies, which have seen a significant deterioration in their public finances to a point where SGP constraints have become binding and are unlikely to improve significantly in the short term.

TABLE 11: Public Finances

	2003	% Change	2004	% Change	2005
Current Revenue	33,157	5.0	34,807	6.1	36,930
Current Expenditure	28,747	8.5	31200	7.1	33,420
Current Surplus	4,410	-18.2	3,607	-2.7	3,510
Capital Receipts	1,288	-3.0	1,250	- 4.0	1,200
Capital Expenditure	6,678	6.1	7,083	3.8	7,350
Capital Borrowing	5,390	8.2	5,833	5.4	6,150
Exchequer Balance	-980		-2,226		-2,640
as % of GNP	-0.9		-1.9		-2.1
General Government Balance	280		- 1,075		-1,334
as % of GDP	0.2		-0.8		-0.9
Gross Debt as % of GDP	32.0		31.7		31.2

General Assessment

The Irish economy continued to deliver mixed signals throughout 2003. The stagnation in economic activity apparent in real GNP in 2002 appears to have reversed last year but output as measured by real GDP has declined dramatically from 6.9 per cent in 2002 to an estimated growth rate of 1.2 per cent in 2003, its lowest level in two decades. Real personal consumption has tended to show less volatility than Irish quarterly output and incomes data with growth estimated at 2.2 per cent for 2003 in contrast to 2.7 per cent in 2002. The most dramatic performance in 2003 was the growth in employment of 1.8 per cent, which kept the unemployment rate at an average of 4.7 per cent for the year as whole. This strong employment performance against the backdrop of the higher labour force participation was very significant. While labour cost pressures are significant, the CSO *Quarterly National Household Survey* indicates that private non-agricultural employment had begun to rise substantially in the final quarter of 2003.

Other indications of improving economic conditions were the recovery in taxation receipts in the latter part of last year and into the first quarter of 2004, much improved business and consumer confidence measures, an upturn in non-residential investment while the housing supply has hit yet another unexpectedly high level in 2003. The current exceptionally low interest rate environment looks set to continue for some time yet as the European economy's recovery remains fragile. Irish credit growth, particularly for mortgages, shows no signs of abating in the short term and has reached record levels. Easier availability and cheaper credit can provide an incentive for both the private and public sectors to undertake investments that have weak economic justifications.

The Revised Estimates for Public Expenditure for 2004 would indicate that expenditure growth is likely to be higher this year and that capital investment through the Public Capital Programme is likely to remain substantial. The constraints of the EU *Stability and Growth Pact* (SGP) had potentially limited the ability of governments to undertake economically justifiable capital projects. In contrast to many other EU countries, the Irish public finances have not approached the limits where these constraints have become binding. Indeed the general government balance outturn for 2003 has turned out to have increased towards a small surplus which in the context of the economy growing below potential indicates that fiscal policy has been quite tight over the last year.

Where the SGP constraints are binding, one option for providing capital investment is from private funds. In this regard the recent Eurostat decision in February 2004 on the treatment of Public Private Partnerships (PPPs) relaxes the interpretation of the SGP rules regarding investment. This recommends that the assets involved in a PPP should be classified as non-governmental assets, and therefore recorded off balance sheet for governments, provided both of the following conditions are met; that the private partner bears the construction risk and the private partner bears at least one of either availability or demand risk. Under the new rules where a PPP project is put off the Government's balance sheet, the cost of the project can be spread over its lifetime against the General Government Balance rather than be counted upfront as was previously the case.

While this proposal has some obvious attractiveness in loosening the constraints on government borrowing given the current rules in the SGP, there is a danger that the criterion for project evaluation might be relaxed. This change in interpretation will not make a poor investment project any more desirable although it may add flexibility to the treatment of government-backed infrastructural investment. They are clearly a means towards an end rather than an end in themselves. If it is the constraints on the SGP that justifies the use of PPPs then this is an argument for changing the SGP not for treating the accounting of the investment differently.

The combination of low estimated output growth rates and robust employment growth would indicate that aggregate productivity growth declined in 2003. The volatility of and the divergence between the output measures in recent years would caution against drawing too strong an inference from a single year but there does appear to be a lower productivity growth trend emerging in the Irish economy in contrast to the last decade. The observed productivity outcome could, in large part, be explained by the changing compositional profile of employment sectors where job losses have occurred in output intensive manufacturing activities while job gains have predominately arisen in labour intensive, services based activities.

The difficulties in determining Ireland's underlying productivity performance are compounded by the presence of high value-added activities, dominated by multinationals. The potential for productivity growth differs markedly between sectors within the economy, as does the ability to measure it. Wage growth is more easily justified in those sectors where productivity growth is measurable. For instance the non-market services sector, including many public sector occupations like nursing and teaching, traditionally finds it more difficult to demonstrate productivity growth. In contrast, the high-technology manufacturing firms tend to be export-oriented with measurably high productivity levels making them capable of bidding-up wages in the domestic economy in the context of a still relatively tight labour market. However, the subdued international market has meant that wage growth in export oriented companies has tended to be restrained as firms seek to bring costs down while the *Public Sector Benchmarking* awards will provide a boost to wage growth in the non-market services sector during the latter half of 2003 and into 2004.

The strength of price pressures from non-traded sectors on the back of higher wage costs had contributed significantly to pushing the Irish price level well in excess of the euro area average in recent years. The combination of the appreciating currency and low price growth internationally has reduced imported inflation. In addition, more moderate price growth in the non-traded sector has become apparent reflecting the ratcheting down of wage expectations throughout the economy.

The prospects for 2004 and 2005 are dependent upon a continuation in the ongoing turnaround in the major world economies. We anticipate that real GNP growth will be closer to real GDP growth at 3.3 and 3.5 per cent in 2004 and 4.4 and 4.5 per cent in 2005 respectively. Our forecasts for output growth are set against the anticipated weakening of the euro against the US dollar towards a rate of $1.15 over the next two years. Currency markets are particularly volatile and difficult to predict. Our forecasts are based upon the fundamental equilibrium dollar/euro exchange rate of between $1.10 and $1.15. However, currencies tend to overshoot these equilibrium levels and so there remains a substantial risk that the US dollar could weaken substantially towards levels of $1.30 or $1.40 against the euro. As Box 1 in this *Commentary* outlined, sustained dollar depreciation towards these levels will result in much lower output growth rates, higher unemployment levels and lower price inflation than we are currently forecasting.

Inflation in 2003 averaged 3.5 per cent and the downward trend has continued into the first quarter of 2004 with rates below 2 per cent. Our forecast is for the average inflation rate to stabilise around 2 per cent over the remainder of 2004 and into 2005. While Ireland is no longer the country with the highest inflation rate within the EU using the Harmonised Index of Consumer Prices (HICP), the major impetus for the deceleration has come from the external forces of lower international prices and an appreciating currency. However, the wage terms agreed in the first half of the current social partnership agreement, *Sustaining Progress*, has helped to bring about wage expectations more in line with the trend in price inflation.

Labour cost competitiveness is likely to attract even greater attention with the enlargement of the EU in May. The perceived threat from lower cost environments particularly in Eastern Europe and Asia has dominated a significant proportion of economic policy-making discourse internationally over the last year. In particular the trend toward outsourcing activities to lower cost locations in the services sector has attracted a disproportionate amount of attention. However, it is important that in Ireland, as elsewhere, focus be placed not just on wage levels but rather on a metric of productivity-justified wage costs, such as unit labour costs, when making comparisons. In this regard the true picture of Irish productivity performance is seriously distorted by the flattering contribution provided by a limited number of high value-added activities. The upcoming negotiation on the wage terms for the second part of the *Sustaining Progress* social partnership agreement must bolster Irish competitiveness by steering wage growth towards rates in line with both realistic national productivity growth expectations and cost trends across competitor nations.