SUMMARY

A strong rebound in Irish economic conditions has occurred in the first half of 2004. The principal driver has been the acceleration in international economic demand in the latter half of last year. The robust recovery continued to gain momentum throughout 2004 with the larger trading blocks like the US, Japan and China currently growing at rates above sustainable levels. The strength of global demand has led to a re-emergence in inflationary pressures, most evident in significantly higher raw material and fuel prices. While higher oil prices in particular have caused concerns that a renewed period of substantially higher inflation rates can be expected, the main short-term impact for Ireland is that the sharp downward trend in price growth over the last year has been halted. The Irish inflation rate, as measured by the consumer price index (CPI), having fallen by nearly three percentage points during 2003 to average 3.5 per cent, is beginning to tick back up, albeit from relatively low levels of just over 1.5 per cent averaged in the first half of 2004. It is expected that inflation in Ireland will remain around the euro area average of 2 per cent this year and next. However, broader measures of price pressures, incorporating asset prices like housing, are still likely to be significantly higher.

Our projection for growth in real GDP is 4.6 per cent in 2004 and 5.2 per cent in 2005. This strong surge arises from the more favourable international trading environment and renewed confidence among consumers as the Irish economy enters a cyclical upturn and the labour market has begun to tighten again. The unemployment rate is expected to average 4.5 per cent in 2004 and to drop further to average 4.3 per cent in 2005. The medium-term trajectory is for the Irish economy to move back above its sustainable, potential growth rate of around 5 per cent. Some diminution in expected demand pressures may be brought about by rising interest rates in the euro area over the coming year, echoing the shift in monetary policy stance in the US and UK. In addition, domestic factors that underpin disposable income growth, mainly through wage and taxation measures, need to be coherent with maintaining economic growth rates at levels sufficient to ensure sustainable development along with its necessary counterpart of price stability.

The improvement and strength in the public finance position in spite of the economic slowdown over the last two years may unleash expectations of a significant potential for taxation reductions and higher expenditure during the emerging economic upswing. Such expectations need to be tempered as large windfall receipts arising from voluntary tax disclosures have flattered the current position. At this point in the economic cycle the general government balance, in the spirit of the *Stability and Growth Pact*, should be returning to a "close to balance or in surplus" position. In addition, wage expectations also have the potential to move out of line with Ireland's competitiveness imperative. In this light, the wage terms underpinning the second part of the current social partnership are to be welcomed in that they steer pay rates in line with emerging price and productivity trends.

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	63,646	3,527	1,124	5.9	3.9	1.9
Public Net Current Expenditure	17,639	18,909	1,270	367	7.2	5.0	2.1
Gross Fixed Capital Formation	28,649	30,252	1,604	-839	5.6	8.8	-2.9
Exports of Goods and Services (X)	121,158	109,284	-11,874	-7,010	-9.8	-4.3	-5.8
Physical Changes in Stocks	11	898	887	1,255			
Final Demand	**227,575**	**222,989**	**-4,586**	**-5,104**	**-2.0**	**0.2**	**-2.2**
less:							
Imports of Goods and Services (M)	97,014	89,828	-7,186	-5,471	-7.4	-1.9	-5.6
less:							
Statistical Discrepancy	1,217	1,239	22	-1,420			
GDP at Market Prices	**129,344**	**131,922**	**2,578**	**1,787**	**2.0**	**0.6**	**1.4**
less:							
Net Factor Payments (F)	25,915	22,701	-3,213	-1,583	-12.4	-6.7	-6.1
GNP at Market Prices	**103,430**	**109,221**	**5,791**	**3,370**	**5.6**	**2.3**	**3.3**

B: Gross National Product by Origin

		2002	2003	Change in 2003	
			Preliminary		
		€m	€m	€m	%
Agriculture, Forestry, Fishing		3,155	3,340	185	5.9
Non-Agricultural:	Wages, etc.	49,914	53,830	3,916	7.8
	Other:	52,605	50,649	-1,955	-3.7
Adjustments:	Stock Appreciation	-156	-794		
	Financial Services	-4,226	-4,735	-509	
	Statistical Discrepancy	1,217	1,239	22	
Net Domestic Product		**102,509**	**103,530**	**1,021**	**1.0**
less:					
Net Factor Payments		25,915	22,701	-3,213	-12.4
National Income		**76,594**	**80,829**	**4,234**	**5.5**
Depreciation		13,259	13,567	308	2.3
GNP at Factor Cost		**89,953**	**94,396**	**4,543**	**5.1**
Taxes less Subsidies		13,576	14,824	1,248	9.2
GNP at Market Prices		**103,430**	**109,221**	**5,791**	**5.6**

C: Balance of Payments on Current Account

	2002	2003	Change in 2003
		Preliminary	
	€m	€m	€m
Exports (X) less Imports (M)	24,144	19,455	-4,689
Net Factor Payments (F)	-25,915	-22,701	3,213
Net Transfers	817	599	-218
Balance on Current Account	**-954**	**-2,647**	**-1,693**
as % of GNP	-0.9	-2.4	-1.6

FORECAST NATIONAL ACCOUNTS 2004

A: Expenditure on Gross National Product

	2003	2004	Change in 2004				
	Preliminary €m	Forecast €m	€m Value	€m Volume	Value	% Price	Volume
Private Consumer Expenditure	63,646	67,845	4,200	2,609	6.6	2.4	4.1
Public Net Current Expenditure	18,909	20,410	1,501	397	7.9	5.7	2.1
Gross Fixed Capital Formation	30,252	33,534	3,282	1,263	10.8	6.4	4.2
Exports of Goods and Services (X)	109,284	114,041	4,758	6,017	4.4	-1.1	5.5
Physical Changes in Stocks	898	220	-678	-575			
Final Demand	**222,989**	**236,051**	**13,062**	**9,712**	**5.9**	**1.4**	**4.4**
less:							
Imports of Goods and Services (M)	89,828	92,,955	3,127	3,510	3.5	-0.4	3.9
less:							
Statistical Discrepancy	1,239	990	-249	192			
GDP at Market Prices	**131,922**	**142,106**	**10,184**	**6,010**	**7.7**	**3.0**	**4.6**
less:							
Net Factor Payments (F)	22,701	23,713	1,011	1,275	4.5	-1.1	5.6
GNP at Market Prices	**109,221**	**118,393**	**9,172**	**4,734**	**8.4**	**3.9**	**4.3**

B: Gross National Product by Origin

	2003	2004	Change in 2004	
	Preliminary €m	Forecast €m	€m	%
Agriculture, Forestry, Fishing	3,340	3,360	20	0.6
Non-Agricultural: Wages, etc.	53,830	57,276	3,445	6.4
Other:	50,649	54,015	3,366	6.6
Adjustments: Stock Appreciation	-794	320		
Financial Services	-4,735	-4,926	-191	
Statistical Discrepancy	1,239	990	-249	
Net Domestic Product	**103,530**	**111,035**	**7,505**	**7.2**
less:				
Net Factor Payments	22,701	23,713	1,011	4.5
National Income	**80,829**	**87,322**	**6,494**	**8.0**
Depreciation	13,567	14,851	1,284	9.5
GNP at Factor Cost	**94,396**	**102,174**	**7,777**	**8.2**
Taxes less Subsidies	14,824	16,219	1,395	9.4
GNP at Market Prices	**109,221**	**118,393**	**9,172**	**8.4**

C: Balance of Payments on Current Account

	2003	2004	Change in 2004
	€m	Forecast €m	€m
Exports (X) less Imports (M)	19,455	21,086	1,631
Net Factor Payments (F)	-22,701	-23,713	-1,011
Net Transfers	599	250	-349
Balance on Current Account	**-2,647**	**-2,376**	**270**
as % of GNP	-2.4	-2.0	0.2

FORECAST NATIONAL ACCOUNTS 2005

A: Expenditure on Gross National Product

	2004	2005	Change in 2005				
	Forecast €m	Forecast €m	€m Value	€m Volume	% Value	% Price	% Volume
Private Consumer Expenditure	67,845	71,902	4,057	2,578	6.0	2.1	3.8
Public Net Current Expenditure	20,410	22,050	1,640	776	8.0	4.1	3.8
Gross Fixed Capital Formation	33,534	35,664	2,130	1,084	6.4	3.0	3.2
Exports of Goods and Services (X)	114,041	123,943	9,902	7,351	8.7	2.1	6.4
Physical Changes in Stocks	220	365	145	164			
Final Demand	**236,051**	**253,924**	**17,873**	**11,953**	**7.6**	**2.4**	**5.1**
less:							
Imports of Goods and Services (M)	92,955	99,900	6,945	5,122	7.5	1.9	5.5
less							
Statistical Discrepancy	990	1,378	388	-518			
GDP at Market Prices	**142,106**	**152,646**	**10,541**	**7,349**	**7.4**	**2.1**	**5.2**
less:							
Net Factor Payments (F)	23,713	26,551	2,838	2,065	12.0	3.0	8.7
GNP at Market Prices	**118,393**	**126,095**	**7,702**	**5,284**	**6.5**	**2.0**	**4.5**

B: Gross National Product by Origin

	2004	2005	Change in 2005	
	Forecast €m	Forecast €m	€m	%
Agriculture, Forestry, Fishing	3,360	3,450	90	2.7
Non-Agricultural: Wages, etc.	57,276	60,311	3,036	5.3
Other:	54,015	58,986	4,971	9.2
Adjustments: Stock Appreciation	320	-80		
Financial Services	-4,926	-4,876	50	
Statistical Discrepancy	990	1,378	388	
Net Domestic Product	**111,035**	**119,170**	**8,135**	**7.3**
Net Factor Payments	23,713	26,551	2,838	12.0
National Income	**87,322**	**92,619**	**5,297**	**6.1**
Depreciation	14,851	16,076	1,225	8.2
GNP at Factor Cost	**102,174**	**108,695**	**6,521**	**6.4**
Taxes less Subsidies	16,219	17,400	1,181	7.3
GNP at Market Prices	**118,393**	**126,095**	**7,702**	**6.5**

C: Balance of Payments on Current Account

	2004 Forecast €m	2005 Forecast €m	Change in 2005 €m
Exports (X) less Imports (M)	21,086	24,043	2,957
Net Factor Payments (F)	-23,713	-26,551	-2,838
Net Transfers	250	210	-40
Balance on Current Account	**-2,376**	**-2,298**	**79**
as % of GNP	-2.0	-1.8	0.1

The International Economy

General

The outlook for the world economy remains positive with the US economy maintaining its vigour, China staying buoyant and even Japan showing some signs of robust growth. Business investment continues its upturn in response to these improving conditions, which should make the acceleration in output growth more sustainable. However, the full impact of the recovery has largely bypassed much of Europe with growth in domestic demand and household expenditure remaining anaemic. Although the recent surge in oil prices may pose a threat to the pace of recovery, much of the increases have been due to the strong demand side improvements in the world economy and therefore, unless sustained at high levels, is unlikely to place the favourable international outlook in any immediate danger.

US Economy

The US economy has continued to strengthen into 2004 with preliminary estimates suggesting that the economy grew by an annualised 4.4 per cent in real GDP terms in the first quarter of this year. This is compared to 4.1 per cent growth in the final quarter of 2003. The primary contributor to this increase remained personal consumption. Private fixed investment, in particular equipment and software, as well as national defence spending also continued to make significant contributions to the emerging quarterly growth pattern.

In previous *Commentaries,* we have expressed concerns about the lack of feed-through from the wider economic recovery into the US labour market. However, labour market conditions have recently seen significant improvement and this combined with continued strength of business investment signifies that two of the more important conditions necessary for sustainable growth have been met. This strength will need to be maintained once policy supports, which have bolstered the economy in the recent past, have been removed. The recent surge in energy prices, if continued, might also serve to set back the trajectory of the recovery. However, despite these risks, the conditions necessary for growth have improved since the previous *Commentary* and therefore we have revised upwards our forecasts for the US economy. Following growth of 3.1 pert cent in 2003, we forecast slightly higher than potential growth of 4.3 per cent this year before the economy eases back to growth of around 3.8 per cent in 2005.

The US labour market has finally shown signs of sustained improvement as employers started to hire quite robustly for the third consecutive month in May, during which total non-farm payroll employment increased by 248,000 to 130.9 million seasonally adjusted. This followed a gain of 353,000 jobs in March and 346,000 in April. Despite weaker-than-expected growth in January and February, the average monthly gain has been 238,000 per month so far this year, which bodes well for the economy. The recent increases have been broadly based in the economy and are indicative of businesses regaining confidence in the sustainability of the current economic expansion and output being boosted by employment increases rather than by productivity gains, which had been the case up until now. Another indication of this improvement in labour market conditions has been the easing back of unemployment from 5.7 per cent in March to 5.6 per cent in both April and May. We forecast continued improvement in the labour market, in line with the pace of economic activity, and estimate an average unemployment rate of 5.4 per cent for 2004 as a whole before moderating further to 5.2 per cent in 2005, close to the economy's full employment level.

This labour market recovery, albeit delayed, is a favourable development for the US consumer who increased real consumption by 3.9 per cent at an annualised rate in the first quarter of this year compared to 3.2 per cent in the final quarter of 2003. Growth of 6.6 per cent in the purchase of non-durable goods together with an increase of 4.2 per cent in services expenditure more than offset the decrease in durable goods purchases of 4.2 per cent. The effect of tax cuts voted in 2003 should start to unwind in the second half of 2004 and there are also signs that the boom mortgage in re-financing and equity withdrawal may have eased. In this regard the labour market recovery is a very timely development. Increased employment should help boost income growth and therefore bolster consumption even if interest rates are likely to rise. Confidence indicators are also broadly positive with the Conference Board's consumer confidence index showing increases in April and May. The University of Michigan's index fell somewhat during May after increasing in April. In both cases, the improvement in labour market conditions was offset by fears of inflation, driven by increased energy costs and the resulting expectation of higher interest rates.

The manufacturing sector, which has been the laggard in terms of sectoral growth, has continued to show signs of a rebound. This resurgence has been mainly due to the strong domestic demand as well as an improving international context. Economic activity in the manufacturing sector grew in May for the 12th consecutive month, according to the Purchasing Managers Index (PMI) from the Institute of Supply Management (ISM). The index registered 62.8 where a figure greater than 50 indicates expansion in the sector. This expansion was due largely to an increase in the employment component. In the last number of months, survey based employment growth in the sector, such as the PMI, had not been reflected in the headline non-farm payroll numbers, which had placed some doubt as to the accuracy of the survey's employment findings. However, employment growth in the sector was finally confirmed by the latest non-farm payroll releases, which showed increased employment in the sector over the last three months for the first time in over 41 months. Investment has also seen significant improvement in the last couple of quarters. Accommodative fiscal and monetary policies together with a weaker currency have served to increased corporate profitability, which has, in turn, fuelled this investment, which surged by an annualised 10.1 per cent in the first quarter of 2004.

The strengthening economy has also been reflected in consumer prices, which have recently shown a slight upward trend. The consumer price index, the broader measure of inflation at the retail level, increased 0.6 per cent on a seasonally adjusted basis in May, following a 0.2 per cent rise in April. This left the annual inflation rate at 3.1 per cent in May up from 2.3 per cent in April. The increase in energy prices clearly played a major role in this increase but examining the core CPI, which excludes the volatile food and energy components, suggests that there are also more structural factors at play. The core CPI increased year-on-year by 1.7 per cent in April, slightly down from 1.8 per cent in March but well up on the 1.1 per cent registered at the start of the year. Rising commodity prices as well as the modest pass-through of the dollar depreciation will have also played a role in this increase but the continued elimination of excess capacity in the economy is expected to maintain a slight upward trend in inflation. Recent statements by the Federal Reserve Board of Governors also reflect this, with a noted change in their policy stance from the previous downside price risks to a point where the risks to price stability "have moved into balance". This together with the broad based nature of the economic recovery has increased expectations of an interest rate increase before year-end.

Despite the resurgence in the economy, many weaknesses and imbalances remain a source of concern for US policy makers. First, the high level of indebtedness of households could develop into a possible source of instability if interest rates were to take a sudden jump. Another potential risk includes that of inappropriate macroeconomic policy, especially the large government deficit, which is estimated to be in excess of $520 billion in 2004, or 4.5 per cent of GDP. With a presidential election towards the end of the year, budgetary policy is unlikely to tighten significantly However, if this policy remains expansionary for too long into the recovery, the resulting back-up in long-term interest rates could have significant negative consequences for US as well as the wider international economy via its impact on investment.

Both the household and public sector imbalances combined have led to a historically low national savings rate, which together with the trade deficit has meant that the Balance of Payments (BoP) current account has grown well beyond its estimated sustainable level of 2-3 per cent. Following a deficit of 5 per cent of GDP ($542 billion) in 2003, it is estimated that the deficit will remain at this ratio level in 2004 before improving moderately to 4.6 per cent in 2005. It is clear that, at this level of external deficit, there is still quite a large scope for further dollar depreciation as a means of correction. Up until now, the deficit has been financed by a huge demand for US bonds, primarily by the Asian markets. This has taken pressure off interest rates but how long this appetite for US bonds will remain is debatable. In this regard, these imbalances represent a major obstacle to long-term US economic stability. This is especially true of the soaring federal budget deficits as unlike the trade and household deficits market forces cannot correct this imbalance.

Euro Area

The recovery in the euro area remains quite fragile although the economy is unquestionably strengthening, albeit at a much slower pace than the other major global economies. Recent estimates for the first quarter of 2004 suggest that the economy grew by 0.6 per cent compared to the previous quarter or 1.3 per cent compared to the same period in 2003. This compares to annual growth of 0.6 per cent in the final quarter of 2003. In the first quarter, domestic demand remained sluggish but somewhat stronger than the final quarter of 2003. Private consumption growth, which had been distinctly weak in previous quarters, showed some signs of improvement while investment was slightly down. In the final quarter of 2003 investment rose by 0.6 per cent quarter-on-quarter and made a strong contribution to real GDP growth. However the recent stagnation indicates that the strong recovery in world trade, improving corporate balance sheets together with the supportive stance of monetary policy have not yet combined to facilitate the economy reaching its sustainable growth path.

Overall, the subdued nature of the recovery in the euro area looks set to continue. Weaknesses in Germany and Italy and to a lesser extent France have been the main source of this economic underperformance. Despite monetary policy remaining accommodative, fiscal policy constraints as well significant structural rigidities, have served as a significant drag to the euro area economy. Structural reform is much needed in order to raise resilience in response to future adverse shocks and to stimulate economic growth on a sustainable basis. Further exchange rate appreciation and persistently poor household sentiment could hamper the recovery but in general we expect a continued uptake in activity in the short term. Therefore, following real GDP growth of 0.4 per cent in 2003 we forecast growth of 1.8 per cent this year and 2.2 per cent in 2005.

Despite a slight improvement in the first quarter of 2004, the persistent weakness of private consumption has been an increasingly negative development in recent quarters. The weak performance of household spending in recent years can partly be explained by sluggish growth in disposable income as a result of a weak labour market together with the lagged adverse wealth effects from the equity market collapse. However, even taking into account these determinants, recent consumption trends appear to be weaker than what normally would be expected at this point in the economic cycle. This may be suggestive of negative confidence effects linked to the deterioration of public finances in some member states, to the increasing awareness of the challenges posed by population ageing, the uncertainty generated by a very slow structural reform process and the continuing, even if abated, geopolitical tensions. The anodyne nature of consumption growth is not likely to change significantly in the near future and is confirmed by recent confidence indicators. The European Commission's Consumer Confidence Indicator has been fairly flat since the start of the year and even dropped two points to -16 in the most recent May results. This indicates that personal consumption growth is likely to be quite flat in the first half of 2004.

More recent sectoral data also suggest quite a subdued start to 2004. Industrial activity is showing signs of strength and made a significant positive contribution to euro area real GDP growth in the first quarter of 2004. Despite other indicators for the sector being quite mixed in 2004, there are signs of a pick-up in activity in the sector. Industrial production increased by 0.2 per cent, seasonally adjusted, in the euro area in April compared to March after increasing by 0.3 per cent in March and February. In the twelve months to April production was up only 1.7 per cent. After quite a lot of volatility in recent months, the PMI index for manufacturing rose from 54 in April to 54.7 in May, above the 50 mark that separates contraction and expansion. It was the ninth consecutive rise in the index, which has reached its highest level since November 2000. The index also confirmed that the euro area is depending almost entirely on external growth stimulus, with domestic demand remaining weak.

Meanwhile, although labour market conditions are significantly worse than in many of the other major economies, conditions, at least, remain stable. The quite low level of job loss despite the prolonged downturn primarily reflects the fact that the downturn was initially expected to be short lived combined with the constant rigidities present in the labour market, namely, the high costs of firing as well as hiring. The euro area unemployment rate in April remained unchanged from March at 9.0 per cent.. We forecast that unemployment will remain stable over the course of the year, averaging 8.9 per cent, before improving to 8.8 per cent in 2005 as the economy finally gathers some momentum.

Consumer prices have recently shown a significant upward trend, which appears somewhat contrary to the rather sluggish pace of economic growth in the region. However, this upward pressure has been brought about by many once-off developments rather than any pent up demand from within the economy. Following an annual increase of 1.7 per cent in the Harmonised Index of Consumer Prices (HICP) in March, the rate increased to 2.0 per cent in April and 2.5 per cent in May. As well as reflecting significant increases in the price of alcohol and tobacco over the year, the recent surge has been largely caused by increasing energy prices. In particular, a strong base effect in the energy component, resulting from the marked decline of oil prices last year in the aftermath of the War in Iraq, has caused this notable increase. As a result, the Governing Council of the European Central Bank (ECB), in its most recent meeting, decided that these short-term developments were unlikely to be sustained and therefore inflation rates were expected to remain in line with the goal of price stability. Consequently, the main refinancing rate was left unchanged at 2.0 per cent. The only threat to this expectation would be if energy-related price increases were to feed into wages. This scenario is not, however, contained within our forecasts in which we expect to see inflation moderating in the short term to average 1.9 per cent this year and 1.7 per cent in 2005.

The public finance positions of euro area members remain weak with the overall general government deficit averaging 2.7 per cent in 2003 as compared with a deficit of 2.3 per cent the previous year. This continued weakness, 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. On the basis of the latest Commission forecasts, the average euro area budgetary position is not expected to improve much this year or next. A growing number of countries are likely to report significant imbalances, with many efforts at fiscal consolidation increasingly likely to fall short of commitments.

In the context of a favourable external environment, euro area exports are expected to grow significantly both this year and next. An improvement in the trade balance has already been evidenced by the latest trade statistics, which show that the euro area trade surplus with the rest of the world in April 2004 was €6.0 billion, compared with €2.7 billion in April 2003. The February 2004 balance was €10.8 billion compared with €3.7 billion one year previous. Although much of this improvement is also due to reduced imports as a result of sluggish domestic demand, improvement is expected to be dominated by export growth in the short term.

Overall, we expect the euro area to continue on its path of gradual recovery. There are obvious risks to this scenario. Currently, uncertainties surrounding fiscal policy and structural reforms in some euro area countries would seem to be weighing heavily on consumer and business sentiment alike. However, continued progress on these issues together with the forecasted buoyancy in the external environment should help bolster growth and should eventually feed into domestic economic activity and stimulate domestic demand in the short term.

UK Economy

The UK economy, which has consistently outperformed the other major European economies in recent years, has maintained its robust growth into 2004 with latest estimates showing growth of 0.6 per cent in the first quarter compared to the previous quarter or 3.0 per cent compared to the same period last year. Although more subdued than the 0.9 per cent quarterly increase in the final quarter of 2003, this growth is close to the UK economy's estimated potential rate of growth.

The difference between UK output growth trends and some of the other European economies has been quite notable. The earlier and stronger recovery than in other major European economies, as well as the shallower downturn that preceded it, has been due chiefly to robust growth in domestic demand. Consumption has remained particularly buoyant while the recovery in investment has taken hold and been maintained in the last number of quarters and should continue in the short term. The recent tightening by the Bank of England should ameliorate some of the emerging price pressures in the economy and leave the economy operating at close to its potential rate of growth. We forecast the economy will grow above its potential rate of growth this year, at 3 per cent in real GDP terms, before moving back towards its potential rate of growth in 2005, expanding by 2.7 per cent.

As mentioned, the household sector continues to be the driving force behind the recent acceleration in economic activity with annualised growth of 4 per cent in each of the last four quarters. This has been due to the continued strength of the labour market, the resulting increases in disposable income as well as the significant wealth effect on consumption expenditures following the prolonged period of substantial house price inflation. We expect these broad trends to continue and therefore forecast consumer spending to remain strong over the short term. Retail sales, a leading indicator of consumption growth confirms this trend with volume growth of 7.2 per cent in May compared to the same period in 2003. Domestic demand will also be supported by continued surges in stock building and business investment, both of which are indications of optimistic expectations regarding future economic performance.

The service sector continues to be boosted by this surge in domestic demand, increasing by 0.9 per cent in the first quarter compared to the previous quarter and 2.9 per at an annual rate. In contrast, industrial production continued to show signs of weakness and was down 0.6 per cent quarter-on-quarter or 0.4 per cent compared with the same period in 2003. This quarterly decrease was driven by a 0.5 per cent decline in the manufacturing sector. This sector has been hit by the strength of sterling together with the lack of substantial growth in demand from the other sluggish European economies. There remains considerable uncertainty about the timing of recovery in the sector and a significant re-balancing of the economy, from its current two-speed nature, is not an immediate prospect. However there are indications that conditions in the sector may be slowly improving. The CIPS/Reuters PMI showed that the manufacturing sector expanded for the eleventh consecutive month in May. The headline index, at 55.6, was up from the 55.2 registered in April and, more importantly, remained above the critical 50-point level indicating expansion in the sector, and reflected growth in both the output and new orders components.

The labour market, which has remained remarkably resilient given the global downturn in recent years, has shown definite signs of improvement as the economy moves towards its potential growth. Employment levels continue to increase, as does the employment rate, the unemployment rate is declining, job vacancies are increasing and the claimant count of unemployment is maintaining its downward trend. Employment, at an average of 28.3 million persons in the three months to April, brings the working age employment rate close to record highs at 74.8 per cent while the unemployment rate remained stable at 4.8 per cent, the lowest since this internationally comparable ILO measure began in 1984. All this bodes well for the sustainability of the current expansion and should boost incomes thereby reinforcing growth. Following an unemployment rate of 5.0 per cent in 2003, we forecast an average unemployment rate of 4.8 per cent this year and 4.7 per cent in 2005.

Consumer price inflation, as measured by the CPI (equivalent to the HICP), rose to 1.5 per cent in May, up from 1.2 per cent in the previous month. The main cause of this increase was the surge in energy costs, which was exacerbated by the fall in energy costs around the same period last year. However, once-off increases in duties on alcohol and tobacco duties also played a role in the increase. Despite having one of the lowest inflation rates in the EU, together with the fact that inflation is currently well below the Bank of England's target rate of 2 per cent, the Monetary Policy Committee (MPC), in its June meeting, decided to increase rates by a further 25 basis points following a similar increase in May. This leaves the main Repo rate, at 4.5 per cent, significantly higher than the prime interest rate in most other major economies. The MPC cited a pick-up in earnings growth, commodity price increases as well as diminishing spare capacity in the economy, as risks to price stability in the medium term and therefore the rationale for their decision. However, the pace of house price growth, at close to 20 per cent using some measures, is also of concern as any significant correction could have a devastating impact on the economy's prospects. In this respect, a gradual deceleration of house price growth to levels close to nominal GDP growth of around 4 per cent would be necessary for a soft landing in the housing market.

Rest of the World

The Asian economies continue to demonstrate strong growth with the Chinese economy particularly dominant. Although China accounted for a modest 4 per cent of World GDP in 2003, it accounted for over 13 per cent of global growth, expanding by 9.1 per cent in real terms for the year as a whole. There have been no significant signs of a slowdown into 2004 with annualised growth of 9.7 per cent in the first quarter of the year. Along with substantial increases in exports, which were offset somewhat by the surge in imports, much of this growth has been driven by debt-financed business investment, which accounted for 47 per cent of GDP in 2003. For this reason, there are many fears that the economy is overheating and therefore authorities have deliberately started to tighten policies in order to bring about a soft landing. However, given the rate of expansion in the economy and the natural volatility associated with such an acceleration this may be difficult. Although not contained within our forecasts, the prospect of a hard landing in China would be detrimental for both the Asian and wider global economies.

TABLE 1: Short-term International Outlook

	GDP Output Growth			Consumer Price Inflation			Hourly Earnings Growth			Unemployment Rate %			Current Account Balance % of GNP		
Country	**2003**	**2004**	**2005**	**2003**	**2004**	**2005**	**2003**	**2004**	**2005**	**2003**	**2004**	**2005**	**2003**	**2004**	**2005**
UK	2.2	3.0	2.7	1.4	1.9	2.2	3.6	4.4	4.5	5.0	4.8	4.7	-2.0	-2.3	-2.7
Germany	-0.1	1.6	2.1	1.0	1.2	1.1	3.0	2.5	2.5	9.3	9.2	8.9	2.4	2.7	2.7
France	0.5	1.9	2.3	2.2	2.0	1.9	2.6	3.5	3.7	9.4	9.3	9.0	1.0	1.1	1.3
Italy	0.4	1.5	2.0	2.8	2.5	2.2	3.1	3.0	3.1	8.7	8.6	8.6	-1.5	-2.0	-2.0
Euro Area	0.4	1.8	2.2	2.0	1.9	1.7	3.3	3.1	3.2	8.8	8.9	8.8	0.4	0.8	1.1
USA	3.1	4.3	3.8	2.3	2.0	2.1	5.5	4.0	4.0	6.0	5.4	5.2	-5.0	-5.0	-4.6
Japan	2.5	2.8	1.8	-0.3	0.3	0.3	0.8	2.3	2.0	5.3	5.0	4.9	3.1	3.6	3.6
OECD	2.1	3.3	2.9	1.9	1.7	1.7	3.5	3.6	3.4	7.1	6.9	6.7	-1.2	-1.0	-1.0
Ireland	1.4	4.6	5.2	3.5	2.0	2.3	5.4	4.4	3.3	4.6	4.5	4.3	-2.4	-2.0	-1.8

The Japanese economy continues to benefit from the buoyancy in Asia and particularly China. The economy expanded, in real GDP terms, by an annualised 5.4 per cent in the first quarter of the year following growth of 6.9 per cent in the final quarter of 2003. Although a large proportion of this growth was due to export growth, at 10.1 per cent in volume terms in 2003 and a massive 15.1 per cent at an annualised rate in the first quarter of 2004, there are increasing signs that domestic demand through private consumption and investment, is strengthening. We have therefore revised up our Japanese forecasts in the short term. Following growth of 2.5 per cent in 2003, we forecast an acceleration in real GDP growth to a rate of 2.8 per cent this year before easing back to 1.8 per cent in 2005.

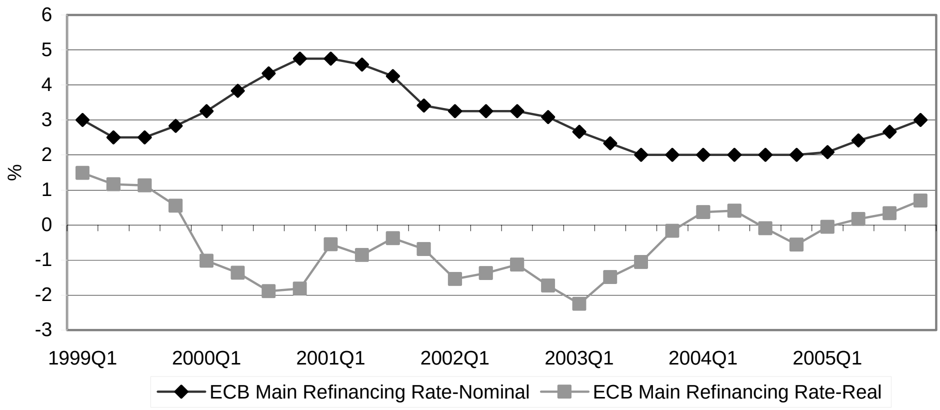
Despite this rather benign outlook, the broad policy stance in Japan is expected to remain accommodative with zero interest rates set to remain in place for a considerable period. Deflation remains a real issue for the economy. Although in April the consumer price index was unchanged on the previous month, the index was down by 0.4 per cent on the same period last year. However, the use of the CPI can serve to somewhat obscure price trends in the economy. Although the headline figure has been trending towards positive territory, inflation, as measured by the GDP or consumption deflator, remains significantly negative. Despite this caveat we expect prices, as measured by the CPI, to increase by an average of 0.3 per cent both this year and next.

For South America as a whole, the expansion that began in 2003 seems to be gaining momentum. This acceleration is being underpinned by favourable international conditions, including high commodity prices and a reduction in sovereign risk premia. Inflationary pressures are likely to remain subdued while the strengthening of domestic demand in the largest economies will boost the region's growth prospects.

Meanwhile, despite their quite strong growth rates, the new EU accession countries are unlikely to provide a major stimulus in the short term to the rather sluggish European economy given their rather limited economic scale (See Box 1). However their entry into the EU undeniably creates more beneficial opportunities for their domestic economies as well as that of pre-existing members, particularly in the medium to long term.

Figure 1: Interest rates

Per Cent per Annum, Quarterly Averages



Context for Ireland

Many of the upward revisions to the international economy will undoubtedly feed through to the Irish economy via the impact on global demand and trade, upon which the economy is heavily reliant. However there remain significant risks to recovery. One of these risks and one that has received a lot of attention has been the surge in commodity prices and, more particularly, oil prices. This has been heightened by the increases in crude oil prices to levels around €40 dollars per barrel. In the Spring 2003 edition of the *Commentary*, we examined the effect of a 100 per cent increase in oil prices, from a base of around €30 dollars a barrel. Using the NiGEM world model we simulated the effects of the increase on the international economy and ran these effects into the ESRI *HERMES* model to simulate the impact specifically on the Irish economy. The impacts both internationally and domestically were considerable in terms of output, employment and prices. Moreover, the impact on consumer prices was greater for Ireland than the international economy more generally, due to both its direct effect and as a result of higher wage growth than in other economies due to the flexible nature of the Irish labour market.

However, this was an extreme scenario. Notwithstanding the magnitude of the simulation, the impacts of oil price changes are very much dependant on what is at the root of the increase. At the time of the simulation, the world economy was sluggish and the price of oil was being pushed up by the fear of future interruptions to supply due to the uncertainty surrounding the war in the Middle East. Although this partially remains the case, given the recent strikes on energy targets in Saudi Arabia, the premium needed for this type of uncertainty is much less than a year ago. It is the increase in energy demand that is currently playing a much larger role in explaining recent oil price movements. Supply is not necessarily the problem. In fact, despite being encouraged to increase their production, oil output is already high by historical standards with many OPEC members already exceeding their quotas. The marked increase in energy demand as a result of improved global conditions, especially in China and the US, from the latter part of 2003 has helped to boost prices with petroleum distribution bottlenecks exacerbating the price increases. Therefore, we would tend to be less pessimistic about recent increases and feel that although further shocks are a definite downside risk to our forecasts, the partial cause of some of the recent increase, that is increased international economic activity, is encouraging.

With regards to exchange rate movements we have seen the euro weaken from the previous *Commentary,* from its high of close to $1.30 per euro to below $1.20. Although the impact of such a movement is much less in trade-weighted terms, it helps ease competitive pressures in the euro area and in Ireland specifically. Much of the gain in the dollar was due to the strong economic growth in the US, in comparison with the lacklustre euro area, and also the diminution in Asian central bank intervention in the foreign exchange market, which had been used in the past to prevent their currencies appreciating. However, while the euro could strengthen somewhat before year end, we expect the dollar/euro exchange rate to average $1.21 for this year before averaging. $1.17 in 2005. This appreciation in the dollar is likely, in part, to come from more aggressive tightening by the Fed in the short term due to the pace of increase in economic activity, which will serve to reduce the interest rate differential between the US and the euro area. We continue to expect relative stability in the sterling/euro exchange rate which we forecast to average Stg£0.68 this year and Stg£0.69 in 2005.

Box 1: The Arithmetic of EU Enlargement

On May 1st 2004, 10 new countries entered the European Union to bring the total number of members to 25. This moved the EU broadly in line with the size of the US economy as measured in nominal GDP terms (based on the outturn for 2003). Despite accounting for 16.2 per cent of the EU-25 population, the total economic size of the AC-10, as measured by GDP, only accounts for 4.5 per cent. In nominal terms, GDP per head, at €5,900, is under 30 per cent of the EU average. However, price levels are significantly lower at just over 56 per cent of the EU-15 average. Taking account of these differences in purchasing power, GDP per capita is almost 49 per cent of the EU-15 average and just over 53 per cent of the EU-25 average. Even at this level, it is clear that there is significant scope for convergence as these countries catch up to living standards in the wider EU as was the case in that past for Ireland, Portugal, Spain and Greece.

This potential for convergence can be illustrated by a few simple calculations. If we assume a long-run nominal growth rate of say 4 per cent in the EU-15 countries (2 per cent volume and 2 per cent price growth), then assumed convergence in terms of GDP per capita by 2020 would require a nominal GDP growth rate of 13 per cent per annum in the accession countries (holding population share constant).

Table 1A: Principal Statistics for the Accession Countries (AC-10) (Refer to 2003 unless otherwise stated)

	EU-15	AC-10	EU-25	% of EU-15	% of EU-25
Population (000s)	382,468	74,164	456,632	19.4%	16.2%
Unemployment rate	8.0	14.3	9.0		
Employed (000s)	170,302	29,311	199,613	17.2%	14.7%
GDP €billion	9,295	438	9,733	4.7%	4.5%
GDP per capita €	24,302	5,901	21,314	24.3%	27.7%
GDP per capita (In PPS)	24,360	11,830	22,280	48.6%	53.1%
Compensation per worker €	33,816	8,869	30,521	26.2%	29.1%
Real GDP growth	0.7	3.5	0.8		
Avg. GDP Growth 1993-2003	2.2	3.8	2.2		
Short-Term interest rate	2.6	5.3	2.7		
Debt as % GDP	64.1	42.4	63.1		
Price level (EU-15=100)*	100.0	56.1	96.4		
Inflation	2.0	2.1	2.0		
% of pop of working age	66.7	69.3	67.1	104.0%	103.4%
% of workers with 3rd level education*	23.3	16.4	23.3	70.6%	70.6%
% of workers with 2nd level education*	71.3	87.8	73.9	123.1%	118.9%
Non-EU-15 FDI €billion^	10,18.8	25,100	1,047.2	2.5%	2.4%

Note: *2002 , ^2001. PPS=purchasing power standards, a measure independent of any currency and removes distortions due to price differences.
Sources: EU Commission 2004 (Ameco) & Eurostat (Newcronus).

If we choose a less optimistic convergence date, say 2030, then the nominal growth rate would have to be just below 10 per cent. Clearly much of this nominal increase would be likely to be inflation driven as the price level simultaneously converges. In fact, for the personal consumption price level to converge by 2030, inflation would need to run over 4 per cent over the period in the AC-10 countries. This eventuality is very unlikely, however, as it is well above the euro area target rate of inflation of around 2 per cent. Despite this, price increases in the AC-10 are likely to run at rates that are consistently higher than that of the EU-15.

Of course, growth rates will vary quite extensively from country to country. Aggregation hides many idiosyncratic features of the individual countries that will lead to some prospering more than others. However, there is little doubt that some degree of convergence will take place among these countries, which will lead to their increasing economic weight inside the EU in the medium to long term.

Because of the current low comparative weighting of these new EU members their higher growth rates are not powerful enough to jumpstart the sluggish EU economy. In 2003, for example, the accession countries' strong growth of 3.4 per cent would have had the effect of increasing the EU growth rate by only 0.1 of a percentage point. On the other hand, the threat of macroeconomic instability brought about by enlargement seems unfounded. Inflation, at 2.1 per cent, was only marginally higher than the 2.0 per cent in the EU-15, thereby leaving the EU-15 and EU-25 rate of inflation almost identical.

Furthermore, the debt to GDP ratio, at 42 per cent, is significantly lower than the average for the EU-15, which is in excess of 64 per cent. The level of debt sustainability is primarily determined by the growth potential of the economy and the existing debt levels. Therefore, the higher growth potential together with comparatively low debt levels will have quite benign implications for the sustainability of the AC-10's public finances. It does, however, raise serious issues about the appropriateness of the current rules under the *Stability and Growth Pact* (SGP), which would be overly restrictive for such countries. Given the importance of economic growth for public finance sustainability, there is a danger with the SGP that economies may be restricted or delayed from growing to their potential which would facilitate meeting the targets.

There is really only one macroeconomic area that may be noticeably influenced by the enlargement in the short term; the labour market. In 2003 the unemployment rate for the new EU entrants was 14.3 per cent. This is very high even compared to the quite hefty rates associated with the rigid EU-15 labour market. If the AC-10 countries were part of the EU in 2003 this would have had the impact of adding one full percentage point to the unemployment rate of the EU.

The New EU Average

Aside from the socio-economic consequences of the enlargement of the EU, the addition of the ten new accession states will have a significant effect on the EU average, the benchmark upon which many states' performances are based. This point can be illustrated clearly by examining the case of Ireland. It is well documented that Ireland has one of the highest price levels in the EU. It is estimated that our price level is around 118 per cent of the EU-15 average. However, as a percentage of the enlarged EU this would increase to 123 per cent.

Table 2A: Ireland v the EU

Ireland	% of EU-15 Average	% of EU-25 Average
	%	%
Price level*	118	123
GDP per capita (PPS)*	121	132
GNP per capita (PPS)*	100	110
Compensation per employee ^	107	119
Nominal GDP per employee ^	133	150

Note: *2002 , ^2003.

PPS=purchasing power standards, a measure independent of any currency and removes distortions due to price differences.

Sources: EU Commission (Ameco) & EuroStat (Newcronus).

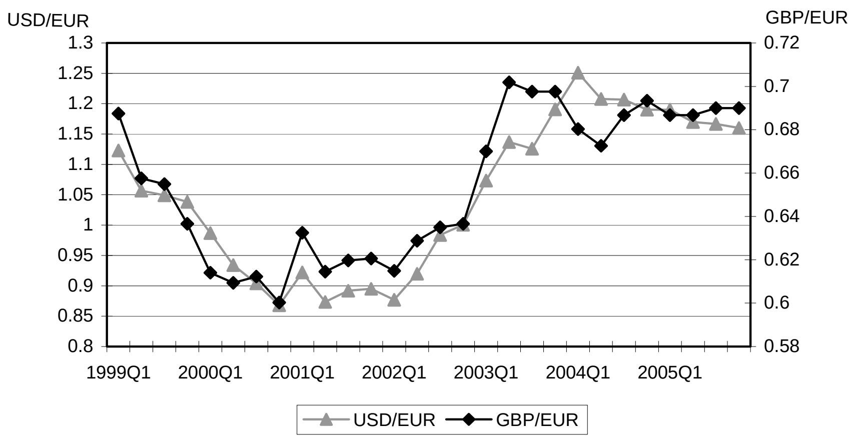
The new EU average also makes a significant difference when looking at GDP or GNP per capita, which are often used as relative measures of wealth. The Irish economy is already flattered by the use of the GDP measure in per capita calculations. In 2002, Irish GDP per capita was 121 per cent of the EU-15 average. However, if the EU-25 average is used, Irish relative prosperity is further exaggerated with a level 132 per cent of the average. The more appropriate GNP measure also shows a significant movement depending on which average is used. If the EU-15 is the benchmark then Ireland is just at the EU average in terms of GNP per head. However, if the wider EU-25 average is used, Ireland jumps to 110 per cent.

This follows through when making competitiveness comparisons such as compensation per employee (labour costs) and GDP per employee (productivity). As can be seen from Table 2A Irish compensation per employee is 107 per cent of the EU-15 average and 119 per cent of the EU-25 average. Even more remarkable is the change in productivity comparisons when using each measure. Ireland seems very productive (See Box 2 for discussion) when compared to the EU-15 average but when the EU-25 benchmark is used, GDP per employee is an extraordinary 50 per cent above the European average.

The above comparisons are only descriptive in nature and conceal many underlying issues that may be at play. However, they do serve to highlight the way in which the move to a new EU average can distort and alter comparisons made within the new European Union, and therefore should be borne in mind by commentators and policymakers alike.

Figure 2: Exchange Rates

Foreign Currency per Euro, Quarterly Averages



The Domestic Economy

General

Quarterly National Accounts for the fourth quarter of 2003 provide preliminary confirmation that GNP grew by 3.3 per cent in volume terms last year while GDP recorded its lowest volume growth in seventeen years, at 1.4 per cent. This was a reversal of the substantial gap that was recorded between the two measures of economic activity in the previous two years. As outlined in previous *Commentaries,* the large gap between these measures relates mainly to net factor income flows, which in turn is significantly influenced by the measurement of productivity in Ireland (see Box 2).

The sharp recovery internationally during 2004 has caused us to significantly revise upwards our forecasts for this year. We have revised our real GDP growth to 4.6 per cent in 2004 with volume growth in GNP of 4.3 per cent forecast. On the basis that global economic growth will continue to be above trend and given that no sharp competitiveness losses are anticipated from adverse currency movements, our forecast for Irish real GDP growth in 2005 is 5.2 per cent and real GNP growth of 4.5 per cent.

Box 2: The Difficulties in Measuring Irish Productivity

Productivity ratios relate measures of output to one or several inputs of production. The most common productivity measure is labour productivity, which links output to the labour input. Ireland's strong growth performance over the last decade has been mainly employment-driven rather than due to exceptional productivity growth which has been healthy rather than miraculous in nature. There are a number of factors, which can lead to potential exaggeration of the productivity element. The source of the problem in this regard is how output is measured.

Aggregate Productivity Growth

Irish productivity growth measures, at an economy wide level, are highly sensitive to the gross output measure used. Productivity growth, as measured by GDP at constant market prices over the last five years (1998-2003) has averaged 3.6 per cent per year. However, this metric includes taxes and subsidies, which should not influence output measures. Therefore, Gross Value Added at factor cost (GVA), which excludes these, is a preferable measure of output. Using this measure, the growth in the volume of output per person averaged 3.8 per cent over the period 1998-2003.

As is widely known, Ireland is notable among developed countries for the size of gap between its Gross Domestic Product (GDP) and Gross National Product (GNP) measures of output. As a consequence, using the GDP measure of output for a given level of employment is likely to greatly exaggerate the actual impact on Irish incomes of productivity. If we use GNP per person employed one can see that the productivity growth rates are much more moderate with average growth of 1.8 per cent over the last five years (see Table 3A). A fourth possible measure of output that could be used is Gross National Disposable Income which is, adjusted for the terms of trade, that is, the ratio of export to import prices. Using this measure output growth averaged 1.5 per cent over the five-year period.

Table 3A: Productivity Growth Using Different Output Measure

	Per Worker				Per Hour Worked			
	GDP	GVA	GNP	GNDI	GDP	GVA	GNP	GNDI
1999	4.7	4.3	2.5	2.0	6.2	5.8	3.9	3.5
2000	5.1	4.8	5.2	2.9	5.6	5.3	5.7	3.4
2001	3.2	4.4	0.9	0.6	3.7	4.8	1.4	1.0
2002	5.5	5.8	-1.3	2.2	6.2	6.5	-0.6	2.9
2003*	-0.4	0.1	1.5	-0.3	0.6	1.0	2.5	0.7
Average Growth 1998-2003	3.6	3.8	1.8	1.5	4.4	4.7	2.6	2.3

Source: CSO National Accounts and the *Quarterly National Household Survey*.
*preliminary.

One drawback in using output per worker is that it does not distinguish between full and part-time staff and therefore may not give an accurate picture of productivity trends. It is clear that a move towards greater part-time employment would serve to depress productivity growth. One way of accounting for this is to use the full-time equivalent employment figures. However, using these figures may not take into account a possible shift towards a shorter working week by full-time employees. Therefore adjusting the productivity measure to take account of hours worked is preferable. Taking account of this would lead to an increase in measured productivity, due to the underlying trend of a reduction in average weekly hours worked in recent years. In particular, the annual average productivity growth rate over the last five years using GDP and GVA at factor cost as our output measure has been 4.4 and 4.7 per cent respectively. This is compared to the more moderate rates of 2.6 and 2.3 respectively if we use the GNP and GNDI measures.

Sectoral Productivity Growth

These aggregate measures of productivity growth do, however, hide significant differences in productivity trends across industries and sectors. This is especially the case for the manufacturing sector. To calculate industrial productivity, the basic procedure is to use a quantity index for industry as a whole. This index is calculated by weighting each sub-sector index by its GVA as a proportion of the total. The problem of analysing productivity growth based on this output measure, like the aggregate figures, is again related to the large multi-national presence in the Irish economy especially in the hi-tech sectors that are characterised by a large value-added and very low labour share.

Sectors with high multi-national presence, like the chemical and ICT sectors, are also characterised by a high return on capital and substantial use of non-industrial services, which include royalties and consultancy fees. This implies that, in addition to physical materials and the other standard forms of inputs, this segment of Irish manufacturing is using invisible or immaterial resources to generate a measured value of output. These immaterial resources reflect technological, scientific/market knowledge, brands and other elements, which contribute to market power and market value. The consequence of a high degree of non-industrial services in the sectoral net output measure is that it exaggerates the value added taking place in Ireland resulting in inflated productivity measures.

In volume terms, industrial production for manufacturing industries has increased by about 160 per cent over the eight years 1995 to 2003 (See Table 4A). However excluding the chemicals sector, industrial production for manufacturing industries has increased by less than 74 per cent over the same period.

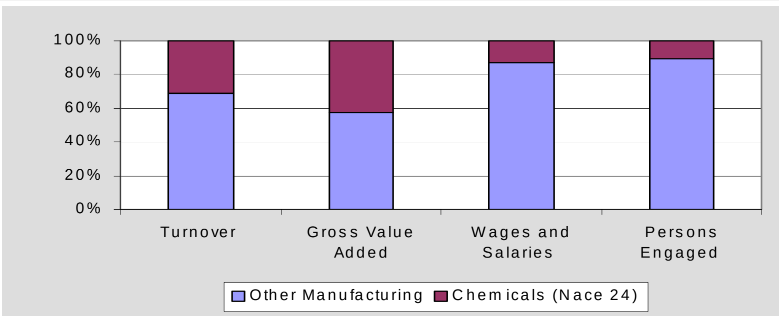
Table 4A: Volume Indices of Production: Manufacturing Index (1995 = 100)

	Output Weighted	Output Weighted (exc. Chemicals)	Wage Bill Weighted
1995	100.0	100.0	100.0
1996	108.5	105.4	106.8
1997	128.8	116.9	121.6
1998	156.1	132.3	140.9
1999	178.8	140.5	154.2
2000	204.1	152.9	175.1
2001	224.5	160.8	188.8
2002	243.8	163.1	195.1
2003	259.9	173.5	205.4

Source: ESRI.

Multinationals dominate the chemicals sector and account for nearly 96 per cent of total gross output (CIP, 2001). Many of these companies are characterised by a relatively low labour share and only a small proportion of the gross value added is distributed to the domestic workforce (see Figure 1A). Therefore, a huge proportion of the value added is attributable to the profits of those companies and are not reflected in Irish incomes. A more appropriate way to deal with this bias in the production figures is not to exclude the sectors that are contributing to the bias but to use wage bill weights rather than output weights for each sub-sector when compiling the volume of production index for manufacturing. This may therefore give better indication of the real effect on the economy from the various productivity gains. Using wage bill weights as opposed to output weights for the various industries, the index increased by about 105 per cent over the period 1995 to 2003 (Table A4). This again is a significant reduction compared to the 160 per cent increase when using only output weights.

Figure 1A: The Chemical Sector's Share of Total Manufacturing



Source: Census of Industrial Production (CIP) 2002 estimate.

In general, the pitfalls to output measurement and therefore productivity growth are numerous and complex for a small open economy with such large multinational presence. In international comparisons Ireland has seen exceptional productivity growth when measured by labour productivity but this has been largely due to the high level of multinational presence (maximised by the use of GDP in productivity calculations). This is compounded by the unusual structure of its manufacturing sector, in particular the dominance of the chemical sector. The crudely measured productivity gains are often not translated into comparable gains for Irish incomes and are therefore largely overstated. In this way the concept of productivity-justified pay, especially when aggregating across the economy, loses much of its meaning and becomes difficult to incorporate into wage setting decisions.

More appropriate productivity measures should not exclude the sectors causing the exaggerated productivity growth in making calculations but instead take account of multiple factor inputs. Also, many of the productivity growth differences across industries are due to differences in unmeasured inputs and therefore a more suitable measure would be a chain index of productivity growth of the different sectors weighted by expenditure or current-value input shares.

Exports

Trade statistics show that in 2003 the value of visible exports was just over €82.1 billion, a substantial fall of 12.3 per cent in value terms on a year earlier. Preliminary estimates would indicate that the volume of visible exports fell by around 5 per cent, suggesting an average visible export price deflator decline of around 7 per cent in 2003. Merchandise export figures taking account of Balance of Payments adjustments for 2003 show a decrease of 15 per cent in value terms. On the basis of these figures it is estimated that merchandise exports fell by 8.9 per cent in volume terms in 2003. Tourism earnings are estimated to have risen by 2.6 per cent in volume terms during 2003, while other service exports rose by 3.7 per cent. Thus, total exports of goods and services fell by 5.8 per cent in volume terms and by 9.8 per cent in value terms. On the basis of these growth rates this implies a total export price deflator decline of 4.3 per cent. The poor export performance during 2003 reflected the poor international environment in the early half of the year, the stronger currency and specifically the ending of the distortion introduced in early years by "carousel" type trading in electrical machinery with the UK to perpetrate a tax fraud.

Irish exports are facing a much more favourable trading environment in 2004 and 2005. Recent trade data confirms this improvement in export performance for the first quarter of 2004. We forecast merchandise exports to increase by around 5.6 per cent in 2004 in volume terms. The pick up in the international economy can expect to be reflected in tourism exports rising 3.5 per cent this year and other service exports by 5.4 per cent in volume terms.

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	4,164	-0.9	0.5	4,187	2.0	1.0	4,228	1.9	1.6	4,295
Manufactured	82,200	-6.3	-14.6	70,367	5.8	4.2	73,332	7.5	10.5	81,039
Other Industrial	5,619	6.5	18.2	6,590	4.0	3.3	6,805	6.2	7.9	7,343
Other	1,995	-20.2	-31.6	1,034	3.2	1.7	1,051	4.0	5.5	1,109
Total Visible	**93,891**	**-5.6**	**-12.2**	**82,178**	**5.4**	**3.9**	**85,416**	**7.1**	**9.8**	**93,786**
Adjustments	-2,655	120.9	92.2	-4,592	2.0	7.1	-4,918	13.0	24.3	-6,113
Merchandise	**91,236**	**-8.9**	**-15.0**	**77,586**	**5.6**	**3.8**	**80,498**	**6.7**	**8.9**	**87,673**
Tourism	3,268	2.6	4.0	3,400	3.5	4.9	3,568	3.3	5.6	3,767
Other Services	26,654	3.7	6.2	28,298	5.4	5.9	29,975	6.1	8.4	32,503
Exports of Goods and Services	**121,158**	**-5.8**	**-9.8**	**109,284**	**5.5**	**4.4**	**114,041**	**6.4**	**8.7**	**123,943**

On the basis of these forecasts total exports are expected to increase by 5.5 per cent in volume terms in 2004. This, coupled with a price deflator fall of 1.1 per cent suggests that total exports in 2004 will rise by 4.4 per cent in value terms.

As outlined in the *International* section world economic activity is expected to recovery strongly into 2005. We expect the recovery in merchandise export growth to continue in 2005 at 6.7 per cent in volume terms. Growth in tourism and other service exports are expected to increase in volume terms by 3.3 and 6.1 per cent respectively. Overall we forecast total exports to grow by 8.7 per cent in value terms. With volume growth forecast at 6.4 per cent, this implies an export deflator in 2005 of 2.1 per cent.

Stocks

The Quarterly National Accounts for the fourth quarter of 2003 reveal that stocks rose by €887 million for 2003 as a whole in value terms and by €950 million in volume terms. A decrease in farm stocks this year coupled with decreases in industrial and distribution stocks is forecast to lead to stock levels decreasing by €678 million in 2004. A modest increase in farm stocks is forecast in 2005 and a small rise in industrial and distribution stocks provides an expected annual stock change rise of €145 million 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	408	368	-238	130	20	150
Irish intervention Stocks	176	-161	15	-15	0	5	5
Other Non-Agricultural Stocks	-125	640	515	-425	90	120	210
Total	**11**	**887**	**898**	**-678**	**220**	**145**	**365**

Investment

The Quarterly National Accounts indicate that the volume of investment activity in 2003 declined by 2.9 per cent. This mainly reflected substantial declines over the first three quarters of the year followed by a strong volume rise in the fourth quarter. The main driver behind the improving growth in investment throughout last year has been the residential market. Housing completions have reached another new peak in 2003, at over 69,000 units. However, other short-term indicators suggest that investment in other building or investment in plant and machinery has been contracting over the course of the year but that a turnaround in these categories is also evident.

The recovery in international economic conditions and improved business confidence has led to resumption in corporate investment growth at rates not seen since before the economic slowdown at the start of the decade. In Ireland, early indications suggest that housing completions may surprisingly reach another new peak this year so we have substantially revised our housing investment forecast for 2004 to a 3 per cent volume growth and a

TABLE 4: Gross Fixed Capital Formation

	2002 €m	% Change in 2003 Volume	% Change in 2003 Value	2003 €m	% Change in 2004 Volume	% Change in 2004 Value	2004 €m	% Change in 2005 Volume	% Change in 2005 Value	2005 €m
Housing	10,809	20.2	31.6	14,221	3.0	14.3	16,259	-1.5	4.4	16,976
Other Building	9,212	-7.6	-5.9	8,668	4.4	7.4	9,312	5.0	7.4	10,002
Building and Construction	20,022	5.7	14.3	22,889	3.6	11.7	25,571	1.5	5.5	26,978
Machinery and Equipment	8,627	-14.9	-14.6	7,363	5.1	8.1	7,963	6.2	9.1	8,685
Total	28,649	-2.9	5.6	30,252	4.2	10.8	33,534	3.2	6.4	35,664

14.3 per cent growth in value terms, implying a new house price growth forecast of 11 per cent. Overall investment in building and construction is forecast to rise by 3.6 per cent in 2004 in volume terms. Following a number of years of contraction, volume growth in investment in machinery and equipment is forecast to be 5.1 per cent in 2004. Therefore, total gross capital formation growth in 2004 of 4.2 per cent in volume terms is forecast. With overall investment expected to increase by 10.8 per cent in value terms this implies an investment deflator of 6.4 per cent.

Given the sluggish recovery in the euro area, it is likely that interest rates will rise only modestly over 2005 and is unlikely to choke off the recovery in investment growth. We estimate a marginal decline in new house building for 2005 although a strong growth performance in other building activity will result in overall investment in building and construction growing by 1.5 per cent in volume terms. With investment in machinery and equipment recovering further to grow by 6.2 per cent, overall investment should grow by 3.2 per cent in volume terms in 2005. With an investment deflator of 3 per cent, this means that in value terms investment is expected to grow by 6.4 per cent in 2005.

Consumption

The Quarterly National Accounts for the fourth quarter of 2003 indicate that personal consumption growth continued its moderating trend of the last few years with growth of 1.9 per cent following 2.7 per cent growth in 2003. Retail sales statistics for 2003 confirm this, showing that growth in consumption was much more moderate than in recent years, with the overall index growing by just 0.8 per cent in volume terms. Excluding the more volatile component of the motor trade results in an annual growth rate of 1.4 per cent. The fact that personal consumption expenditure accounts for around 60 per cent of GNP means that this quite moderate growth contributed greatly to the slowdown in overall economic activity.

There are, however, significant signs of an improvement in personal consumption growth in 2004. With income growth strengthening, the labour market tightening and the savings ratio falling, the conditions for a strong rebound in consumption are forecasted to be present. This improvement has been reflected in a number of lead indicators. Annual volume growth of the retail sales index of 5.0 per cent in March meant that first quarter growth in the index was 2.7 per cent following growth of 0.5 per cent in the final quarter of 2003. Furthermore, since the last *Commentary* the IIB Bank/ESRI Monthly Consumer Sentiment Index has shown consumer sentiment on an upward trend. The index for May, at 91.1, indicates an improvement in consumer sentiment compared to April. Moreover, the index has improved substantially since the end of 2003 where it registered 78.3. The increase reflects consumers becoming more positive about their personal financial situation and the labour market over the next 12 months. The forward-looking sub-index, the expectations index, rose to 85.5 in May from 84.7 in April. Thus, total personal consumption is forecast to rise by 6.6 per cent in value terms. Volume growth is forecast to be 4.1 per cent, implying a personal consumption deflator of 2.4 per cent.

Our forecast for growth in personal consumption for 2005 shows consumption maintaining this strength as the economy moves towards its potential. A volume increase of 3.8 per cent is forecast with a consumer expenditure deflator of 2.1 per cent. This indicates that, in value terms, personal consumption is anticipated to grow by 6.0 per cent in 2005.

The Quarterly National Accounts indicate that government consumption or "net expenditure by central and local government on current goods and services" in the fourth quarter of 2003 increased by 1.9 per cent in volume and by 7.0 per cent in value when compared to the same period last year. The strength of public sector employment growth coupled with the pay awards means that annual government consumption grew by 7.2 per cent in value terms for 2003. The public service deflator, at 5.0 per cent, implies that government consumption grew by 2.1 per cent in value terms for 2003. The efforts to curtail the rate of growth in public expenditure have been reasonably successful and the fact that the bulk of the Benchmarking awards have been paid implies that we are projecting that volume growth in public expenditure, in both 2004 and 2005, will remain quite moderate at 2.1 and 3.8 per cent respectively.

TABLE 5: Consumption Indicators

	Annual Percentage Change					
	2000	2001	2002	2003	2004 Forecast	2005 Forecast
Consumption Value						
Personal Consumption	13.0	10.1	8.9	5.9	6.6	6.0
Retail Sales Index, Value	16.3	5.9	3.9	3.1	3.9	4.3
Divergence	-3.3	4.2	5.0	2.8	2.7	1.7
Consumption Volume						
Personal Consumption	8.5	5.5	2.7	1.9	4.1	3.8
Retail Sales Index, Volume	11.9	3.1	0.7	0.8	2.0	2.2
Divergence	-3.4	2.4	2.0	1.1	2.1	1.6
Consumer Prices						
Personal Consumption Deflator	4.2	4.3	6.0	3.9	2.4	2.1
Retail Sales Index Deflator	3.9	2.7	3.2	2.3	1.9	2.1
Consumer Price Index	5.6	4.9	4.6	3.5	2.0	2.3

However, the public expenditure deflator is projected to remain higher than other deflators in the economy at 5.7 per cent this year and 4.1 per cent in 2005. This will result in a value increase in public expenditure of 7.9 per cent in 2004 and 8.0 per cent in 2005.

Final Demand

In 2003, final demand decreased by 2.0 per cent in value and by 2.2 per cent in volume terms, reflecting the notably strong fall in exports over the year. Domestic demand excluding stocks is estimated to have grown by 0.6 per cent in volume and by 6.0 per cent in value, while the exports of goods and services fell by 5.8 per cent reflecting the subdued external environment.

Final demand is forecast to rebound in 2004, growing by 4.4 per cent in volume terms. A higher price deflator of 1.4 per cent implies value growth of 5.9 per cent. Volume growth in domestic demand excluding stocks, at 3.8 per cent is forecast to be less than growth in exports of 5.5 per cent. The forecasts outlined in the *Commentary* result in final demand growth, in volume terms, of 5.1 per cent in 2005. Exports of goods and services are forecast to grow by 6.4 per cent in volume while domestic demand excluding stocks is forecast to grow by 3.6 per cent. With personal consumption and exports forecasted to be strong this year, thereby contributing to the growth in demand, the composition of final demand can be expected to be quite import-intensive.

Imports

Balance of Payments estimates for the fourth quarter of 2003 show that merchandise imports for the year as a whole fell by 11.9 per cent in volume and 16.1 per cent in value terms. However, growth in the tourism and other service imports offset some of this decrease. The rise in tourism spending abroad is estimated at 6.1 per cent in volume terms, while other service imports, including royalty payments, increased by 1.8 per cent in volume terms. Thus, total imports of goods and services fell by 7.4 per cent in value and by 5.6 per cent in volume in 2003, the largest fall in many years.

Imports are expected to rebound in 2004 following a particularly weak 2003. This will stem from improved domestic demand together with increases in intermediate goods imports in line with improving economic conditions. Visible imports are therefore forecast to rise by 3.7 per cent in 2004 in volume terms. Allowing for the Balance of Payments adjustment, merchandise imports are also forecast to increase by 3.7 per cent in volume terms. Given a forecast price deflator fall of 0.7 per cent, the resulting increase in value terms will be 2.9 per cent. We expect tourism spending abroad to grow by 3.8 per cent in volume terms and we expect other service imports to rise in the order of 4.2 per cent in volume terms. Total imports of goods and services in 2004 are, therefore, forecast to increase by 3.9 per cent in volume and 3.5 per cent in value terms, implying a price deflator fall of 0.4 per cent.

Based on our assumption that the world economy continues to gain momentum 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 5.5 per cent in 2005 while a price increase of 1.9 per cent will mean that the growth in value terms will be 7.5 per cent.

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	7,065	-14.5	-19.1	5,717	2.8	2.3	5,847	3.6	5.5	6,167
Consumer Goods	12,722	-1.0	-1.9	12,476	4.1	3.2	12,871	4.5	6.6	13,719
Intermediate Goods:										
Agriculture	946	1.7	2.8	973	2.0	1.0	982	2.9	4.4	1,026
Other	32,714	-13.0	-19.2	26,421	3.9	3.4	27,314	6.3	8.1	29,528
Other Goods	2,009	-0.5	-3.5	1,939	2.1	-0.6	1,928	4.6	6.0	2,043
Total Visible	**55,455**	**-9.7**	**-14.3**	**47,525**	**3.7**	**3.0**	**48,942**	**5.4**	**7.2**	**52,483**
Adjustments	-1,233	84.4	66.0	-2,047	4.8	4.8	-2,145	5.0	5.0	-2,252
Merchandise Imports	**54,222**	**-11.9**	**-16.1**	**45,478**	**3.7**	**2.9**	**46,797**	**5.4**	**7.3**	**50,231**
Tourism	3,958	6.1	6.5	4,215	3.8	5.9	4,463	4.1	6.7	4,762
Other Services	38,834	1.8	3.3	40,135	4.2	3.9	41,695	5.8	7.7	44,907
Imports of Goods and Services	**97,014**	**-5.6**	**-7.4**	**89,828**	**3.9**	**3.5**	**92,955**	**5.5**	**7.5**	**99,900**

Balance of Payments

Balance of payments figures for the final quarter of 2003 show that the current account deficit in 2003 was €2,647 million compared with a deficit of €954 million in 2002. Although the percentage decline in exports and imports were of similar magnitudes, the fact that the level of exports is much higher implies that the visible trade balance fell by 9.2 per cent to around €34.7 billion. The deficit on service trade is estimated to have decreased by 1.7 per cent to €12.7 billion. Thus, the overall surplus on trade in goods and services fell by 19.4 per cent in value terms in 2003 to €19.5 billion. Profit outflows decreased by 15.1 per cent in 2003, while reinvested earnings rose by 3.2 per cent. National debt interest increased significantly and other debit flows are estimated to have declined 7.6 per cent. Overall, debit flows from the Balance of Payments current account declined by 5.5 per cent in 2003. Credit flows are estimated to have been relatively flat overall, at 0.9 per cent growth in 2003, so that net factor outflows are estimated to have declined substantially by 12.4 per cent to €22.7 billion, reversing some of the spectacular rise recorded in 2002. Net current transfers are also estimated to have declined significantly, all of which has led to the significant increase in the balance of payments deficit which is estimated at 2.4 per cent of GNP, up from 0.9 per cent in 2002. The divergent trends between debit and credit flows in the Balance of Payments implied that GNP rose significantly faster than GDP in 2003.

The forecast rebound in exports and imports already discussed indicate the likelihood that the surplus on trade in goods and services will increase by 8.4 per cent in 2004 to €21.1 billion. Strong growth will continue in 2004 at 14.0 per cent to over €24 billion. The repatriation of profits and reinvested earnings are expected to grow quite strongly in 2004 and 2005. This is due to our underlying assumption of the strong improvement in international conditions and the knock on benefits for Irelands large multinational sector. When account is taken of national debt interest paid abroad and other debit items, debit flows are forecast to grow by 4.3 per cent in 2004 and 7.3 per cent in 2005. Total credit flows are forecast to grow by 4.2 per cent in 2003 and 3.5 per cent in 2004. Thus, on the basis of these forecasts, net factor outflows are projected to grow by around 4.5 per cent in 2003 and 12.0 per cent in 2004.

The impact of these forecasts on the current account balance is for a slight improvement. The deficit is expected to be €2,376 million in 2004 and €2,298 million in 2005. These deficits are the equivalent to 2.0 per cent and 1.8 per cent of GNP respectively. Although the level of the deficit will have increased significantly from recent years, it is worth noting that the importance of the balance of payments has diminished within a single currency area, although the growing deficit does point to imbalances within the economy.

TABLE 7: Balance of Payments

	2002 €m	Change %	2003 €m	Change %	2004 €m	Change %	2005 €m
Visible Trade Balance	38,170	-9.2	34,652	5.3	36,474	13.2	41,303
Adjustments	-1,156		-2,545		-2,773		-3,860
Merchandise Trade Balance	**37,014**	**-13.3**	**32,108**	**5.0**	**33,701**	**11.1**	**37,442**
Service Trade Balance	-12,870	-1.7	-12,652	-0.3	-12,615	6.2	-13,399
Trade Balance in Goods and Services	**24,144**	**-19.4**	**19,455**	**8.4**	**21,086**	**14.0**	**24,043**
Total Debit Flows	-53,749	-5.5	-50,787	4.3	-52,981	7.3	-56,848
Total Credit Flows	27,835	0.9	28,086	4.2	29,268	3.5	30,297
Net Factor Flows	**-25,915**	**-12.4**	**-22,701**	**4.5**	**-23,713**	**12.0**	**-26,551**
Net Current Transfers	**817**	**-26.7**	**599**	**- 58.3**	**250**	**-16.0**	**210**
Balance on Current Account	**-954**		**-2,647**		**-2,376**		**-2,298**
Capital Transfers	576	- 7.6	532	-9.8	**480**	-9.4	435
Effective Current Balance	**-378**		**-2,115**		**-1,896**		**1,863**

Gross National Product

Our estimates for the volume growth of GDP and GNP in 2004 now stand at 4.6 per cent and 4.3 per cent respectively. Current estimates of trade price deflators indicate a slight loss in the terms of trade in 2004, with export prices falling fractionally more than import prices. Allowing for a fall in the volume of net current transfers, real gross national disposable income (GNDI) is estimated to rise by 3.1 per cent. Given the magnitude of the pick-up in the global economy, our forecasts for GDP and GNP growth for 2005 are 5.2 per cent and 4.6 per cent respectively. A small terms of trade gain seems likely in 2005 such that when current transfers are taken into account, real GNDI is forecast to increase by 4.7 per cent in volume terms.

Agriculture

Preliminary estimates for 2003 from the *Quarterly National Accounts* indicate a rebound in activity in the agricultural sector with growth of 5.9 per cent recorded, following a decline of 2.4 per cent in the previous year. Annual growth of 3.2 and 5.9 per cent was recorded for the third and fourth quarters of 2003 and seasonally adjusted estimates indicate a quarter-on-quarter contraction of 0.4 per cent in the third quarter and growth of 0.9 per cent in the last quarter of the year.

Preliminary estimates of agricultural income or operating surplus from the CSO show an increase of 4.9 per cent in 2003 after a decline of 8.1 per cent in 2002. This measure of income excludes both interest and land rental payments, which were equivalent to over 16 per cent of agricultural income in 2003. Estimates of agricultural incomes for the EU in 2003 show anaemic growth of 0.1 per cent, although this masks very different experiences across countries. Sharp declines were recorded in countries such as Germany, where operating surplus fell by 24.1 per cent, and in Denmark, Austria and Sweden. Ireland experienced the fourth highest increase in operating surplus after the UK, Portugal and Belgium. The increase in agricultural income was driven by a 4.7 per cent increase in the volume of goods output in 2003. Strong volume increases in the output of crops, milk production and cattle output dominated falls in sheep and pig output. The volume of intermediate consumption grew by a marginal 0.1 per cent. Net subsidies fell by 0.8 per cent in nominal terms to account for 62.3 per cent of agricultural income in 2003, compared to 65.8 per cent in 2002.

There is likely to be a squeeze on margins in the agricultural sector over the next two years with consequential effects on sectoral income. The agricultural output price index declined by 0.4 per cent in 2003, while the input price index rose by 2.5 per cent resulting in a 3 per cent deterioration in the agricultural terms of trade for 2003. However, the seasonally adjusted index shows some short-term improvement with annual increases in the output index of 2.3 and 4.1 per cent for February and March of this year exceeding the 2.1 and 1.7 per cent increases in the input price index leading to an improvement in the monthly agricultural terms of trade.

Despite the recovery in the sector in 2003, prospects for this sector remain weak, especially given the negative supply-side shocks that have hit the sector in recent years and the full decoupling of premium payments from production which is due to start in 2005. Therefore, we anticipate the volume of gross agricultural output to decline marginally by 0.7 per cent in 2004 and to have no growth in 2005.

Industry

Estimates from the *Quarterly National Accounts* for 2003 indicate that the volume of production in industry, including building, grew by a meagre 2.3 per cent on an annual basis, the lowest growth rate since 1986. However, activity in the sector accelerated throughout the year with growth of 1.2 and 6.0 per cent in the last two quarters of the year when compared to the corresponding quarters of 2002. On a seasonally adjusted basis the sector contracted by 0.7 per cent in the third quarter when compared to the previous quarter and grew by 4.4 per cent in the last quarter of 2003. These seasonally adjusted estimates are quite volatile and caution is needed in interpreting movements in the series as quarterly national accounts data is only available for a relatively short time period and deals with a time when there were significant changes in Irish output.

The deterioration in the volume of production in 2003 is also evident in the CSO's release on *Industrial Production and Turnover*, although not to the same extent. The volume index of production for all industries shows some slowdown in growth to 6.3 per cent in 2003 compared to 7.9 per cent in 2002. On an annual basis, production for all industries in the first quarter of this year increased by 4.9 per cent, with the "Modern Sector", which comprises a number of high-technology and chemical sectors showing annual growth of 5.5 per cent and all other sectors recording lower growth of 2.7 per cent. On a seasonally adjusted basis, the volume of production index for all industries declined by 5.8 per cent in the first quarter of this year compared to the fourth quarter of 2003 driven by quarterly contractions in both the "Modern Sector" and all other sectors.

Recent industrial surveys provide strong evidence that a recovery in the industrial sector will occur later in the year. The seasonally adjusted *NCB Purchasing Managers' Index* on manufacturing rose to 54.5 in May, remaining above the critical 50-point level for the ninth successive month. This improvement in manufacturing business conditions was driven by an increase in new orders. The forward-looking components of the IBEC-ESRI Monthly Industrial Survey also indicate that growth in industrial output is likely to accelerate in the remainder of the year. Given our forecasts for the international economy, we estimate that gross output in industry will increase by 4.4 per cent this year before accelerating to 5.6 per cent in 2005.

Services

The most recent *Quarterly National Accounts* estimate sluggish volume growth of 2.3 per cent in the services sector in 2003 compared to 4.7 per cent in 2002. Slower income growth, the deterioration in labour market conditions and the slow international recovery would have adversely affected demand in the sector. Activity in the services sector slowed throughout 2003 with output in the fourth quarter increasing by 0.9 per cent in the distribution, transport and communications sector and 2.4 per cent in other services while a contraction of 0.5 per cent was recorded in public administration and defence. On a seasonally adjusted basis, quarterly growth of 0.8 per cent was recorded in other services in the final quarter of last year, whereas output in distribution, transport and communications and public administration and defence declined by 0.5 and 0.4 per cent respectively.

However, recent survey data indicate a recovery may be underway in the sector this year. The *NCB Purchasing Manager' Index* on services rose to 58.7 in April, remaining above the critical 50-point no change level for the eleventh consecutive month. Employment in the sector grew for the eighth consecutive month and at an accelerated pace in April, with business expectations and new business remaining strong. Retail sales, a leading indicator of consumer spending and economic activity, increased by 2.7 per cent in volume terms and 3.5 per cent in value terms in the first quarter of 2004.

As already outlined in this *Commentary*, personal consumption growth is expected to increase in 2004 in line with the increased pace of activity in the economy. The forecast recovery in overall economic conditions should see growth in this sector gathering momentum and we forecast an increase in the volume of gross services output of 4.2 per cent in 2004 before rising to 5.7 per cent in 2005.

Employment

The *Quarterly National Household Survey* (QNHS) for the first quarter of 2004 shows that employment in the Irish economy grew by 2.9 per cent (52,300) in the year to the first quarter following an increase of 2.6 per cent in the fourth quarter of 2003. This is a significant increase in the numbers of jobs being created and shows a marked acceleration from the average growth rates of 1.8 and 1.4 per cent for 2003 and 2002 respectively. This acceleration demonstrates considerable pass through of overall improved economic conditions into the labour market. Full-time employment accounted for over 85 per cent of the annual increase, with two-thirds of this due to an increase in male full-time employment.

Employment increased on an annual basis in the year to the first quarter in all sectors with the exception of other production industries, which declined by 8,400, and public administration and defence, which fell by a more moderate 300 persons. The largest employment increases were recorded in construction (13,500), wholesale and retail trade (10,100), other services (10,100) and health (9,400). After adjusting for seasonal factors the largest quarterly increases were in construction (4,300) and the wholesale and retail trade (4,100).

TABLE 8: Employment and Unemployment*

	Annual Averages			
	2002	**2003**	**2004**	**2005**
Agriculture	124	120	119	118
Industry	496	499	504	511
Services	1,156	1,191	1,219	1,246
Total at Work	**1,777**	**1,811**	**1,842**	**1,875**
Unemployed	82	88	86	85
Labour Force	**1,859**	**1,899**	**1,928**	**1,960**
Unemployment Rate %	4.4	4.6	4.5	4.3
Live Register	162	172	167	164

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

Labour force growth continued to strengthen in the first quarter of 2004, at 2.7 per cent, or 50,800 in absolute terms following annual growth of 2.6 per cent in the fourth quarter. Labour force growth was largest for both males and females in the 25-34 and the 45-54 year age groups. The overall participation rate increased to 60.6 per cent seasonally adjusted in the first quarter, slightly above the final quarter of 2003. Demographic factors, including changes in the age structure of the population and an increase in the population of those of working age contributed around 72 per cent to the growth in the labour force in the first quarter of 2004. The remainder of the increase came from changes in participation rates. The most significant increase in participation was recorded for those aged 20-24 years and 45-54 years both of whose participation rates increased by around 1.6 percentage points to 72 per cent and 73.9 per cent respectively in the first quarter compared to the same period last year.

The most recent figures also indicate that the labour market is starting to tighten significantly with indicators of potential labour supply recently trending close to historical lows. The broadest based labour supply indicator, S3, which includes the unemployed, persons outside the labour force who show some interest in obtaining work and underemployed part-time workers, was at 7.8 per cent of the labour force in the first quarter of this year and 7.4 per cent in the previous quarter. This follows a prolonged period of rates well in excess of 8 per cent which had reflected significant excess capacity in the economy in recent years.

In terms of unemployment the QNHS indicates continued improvement in the labour market with the seasonally adjusted unemployment rate falling to 4.4 per cent in the final quarter of 2003 following a rate of 4.5 per cent in the previous quarter. Unemployment decreased by 1,600 on an annual basis in the first quarter of 2004, to leave the total number unemployed at 83,600. The May Live Register Statement showed an increase of 1,800 to 168,000 as compared to a 4,800 fall in April when seasonal factors are taken into account. The standardised unemployment rate has remained relatively stable in the first five months of the year and it currently stands at 4.5 per cent, up 0.1 of a percentage point from the previous month.

It is forecast that total employment for the year 2004 will average 1.842 million persons rising to 1.875 million in 2005. In percentage terms, numbers employed are expected to rise by 1.7 per cent this year and 1.8 per cent next year. The services sector is expected to once again be the main engine of employment growth, with services employment forecast to grow at 2.3 per cent in 2004 and 2.2 per cent in 2005. Sluggish growth in industry has impinged on labour market conditions for that sector, with preliminary estimates of industrial employment from an enterprise-based survey for 2003 from the CSO showing a decline of 4.8 per cent. A decrease of this magnitude is not consistent with the QNHS, and may be attributable to the outsourcing of activities, a phenomenon observed in the US. Overall, we expect industrial employment to grow by 1.0 per cent in 2004 and 1.3 per cent in 2005. Continued declines in agricultural employment, albeit modest, are anticipated. The unemployment rate is expected to decrease over the forecast horizon averaging 4.5 per cent in 2004 and 4.3 per cent in 2005.

Incomes

Growth in incomes is forecast to be stronger in 2004 and 2005 due to a marked improvement in economic conditions and the associated strengthening of labour market conditions. These conditions will continue to apply significant upward pressure on Irish wage growth. The tightening labour market is likely to mean that wage expectations may increase but given the low inflationary environment and competitive pressures present in the economy, wage growth is likely to remain moderate especially compared to the double-digit rates associated with the Celtic Tiger period. In particular, growth in hourly earnings, estimated at 5.4 per cent in

TABLE 9: Personal Disposable Income

	2002	Change		2003	Change		2004	Change		2005
	€m	%	€m	€m	%	€m	€m	%	€m	€m
Agriculture, etc.	3,155	5.9	185	3,340	0.6	20	3,360	2.7	90	3,450
Non-Agricultural Wages	49,914	7.8	3,916	53,830	6.4	3,445	57,276	5.3	3,036	60,311
Other Non-Agricultural Income	16,213	-10.2	-1,650	14,563	5.3	766	15,329	5.7	878	16,207
Total Income Received	**69,282**	**3.5**	2,451	**71,733**	**5.9**	**4,232**	**75,965**	**5.3**	**4,004**	**79,969**
Current Transfers	13,283	13.7	1,819	15,102	7.7	1,161	16,263	7.0	1,137	17,400
Gross Personal Income	**82,565**	**5.2**	**4,270**	**86,835**	**6.2**	**5,393**	**92,228**	**5.6**	**5,141**	**97,369**
Direct Personal Taxes	15,033	3.8	567	15,600	7.4	1,147	16,747	5.5	920	17,667
Personal Disposable Income	67,532	5.5	3,703	72,235	6.0	4,246	75,481	5.6	4,221	79,701
Consumption	60,118	5.9	3,527	63,646	6.6	4,200	67,845	6.0	4,057	71,902
Personal Savings	7,413	2.4	176	7,589	0.6	46	7,635	2.1	164	7,799
Savings Ratio	11.0			10.7			10.1			9.8

2002, is expected to slow to 4.4 per cent and 3.3 per cent in 2004 and 2005 respectively.

We estimate that income in the agriculture, forestry and fishing sector grew by 5.9 per cent in 2003. This seems quite strong but much of this growth was due to a particularly bad year in 2002 and the resulting base effects. We, therefore, expect more moderate growth in 2004 and estimate that agricultural incomes will rise by only 0.6 per cent in 2004 before strengthening somewhat to 2.7 per cent in 2005. Over the medium term at least, prospects for this sector remain weak with the full decoupling of premium payments from production, which is likely to have a significant negative impact on agricultural incomes.

Given the forecasts for hourly earnings, non-agricultural wages are estimated to have increased by 7.8 per cent in 2003. This was quite strong given the slowdown in economic activity for the year. However, growth for 2004 and 2005 is forecast to moderate to 5.3 and 5.7 per cent. Following extraordinary volume growth of over 42 per cent in 2002, net factor payments are estimated to have contracted by 6.1 per cent in volume terms in 2003. However we do expect growth in these payments, which are primarily made up of multinational profits, to return in the short term due to the improved international outlook. We forecast the volume of these flows to increase by 5.6 per cent in 2004 and 8.7 per cent in 2005.

Consumer Prices

The Consumer Price Index (CPI) rose by 3.5 per cent on average during 2003. but within the year the inflation rate declined by nearly three percentage points from 4.8 per cent to 1.9 per cent. The first five months of this year confirmed that this gradual slowdown in the inflation rate has continued but there has been a turn up in the rate, which is currently heading towards 2 per cent and we expect it to go above this rate in the latter half of the year.

The strength of the euro was a significant contributory factor in the moderation in Irish consumer price inflation along with the decline in euro area interest rates last year. With European economic growth remaining slow in 2004, it seems unlikely that an interest rate increase will, through its effect on the housing component, raise the consumer price index. The rise in the price of oil is one of the factors contributing to the recent rise in inflation. Oil prices are expected to continue to impact on the measure of inflation. Given these factors we are currently forecasting that inflation will average 2.0 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 2.4 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 this will be to raise the rate of inflation in 2005 to an annual average of 2.3 per cent, still a moderate rate 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	2.8	3.6
Other	5.4	4.0	5.0	4.2	2.0	2.1
Total CPI	5.6	4.9	4.6	3.5	2.0	2.3
EU-HICP (Ireland)	5.2	4.0	4.7	4.3	2.3	2.2
Index Dec. 2001=100						
Housing	88.2	102.7	103.7	103.1	106.0	109.8
Other	93.6	98.7	102.6	106.9	109.0	111.3
Total CPI	92.7	97.9	102.7	106.3	108.4	110.8

Public Finances

The Exchequer Returns for the first five months of 2003 have shown a marked improvement when compared to recent years and reflect the strengthening economy as well as some once-off receipts. The latest returns show an exchequer deficit of €495 million as compared to a deficit of €1,239 million over the same period last year. This improvement has been primarily revenue driven with tax revenue particularly robust. Overall receipts were up by over 12 per cent on last year, driven by a 15 per cent increase in tax revenue, while total expenditure increased by 5.4 per cent.

For 2004 as whole, 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. Although expenditure growth is running significantly below the government's target, much of this is due to timing issues and we are likely to see expenditure growth accelerating in the second half of the year. Looking at the outturn for receipts in 2004 thus far, tax revenues are running well ahead of target. Although the strong rise in capital gains tax and buoyancy in stamp duties has been maintained, most of the acceleration in tax receipts growth has been due to a surge in income tax receipts which increased by close to €700 million or 22 per cent in the first five months of the year compared to the same period last year.

The most recent figures were boosted by the once-off payments made by taxpayers availing of the Revenue Commissioners' voluntary disclosure scheme for those with undeclared offshore funds. Overall, it is estimated that the Exchequer finances will receive a further €650 million from this source in 2004. Even allowing for these settlements the recent surge in income tax receipts points to a recovery in the jobs market, which is confirmed by other labour market data

Due to the significant once-off factors noted above together with overall improving economic conditions, we have revised our estimate for the exchequer balance in 2004. Following a deficit of €980 million in 2003, we forecast a deficit of €1,098 million in 2004, well below the government budget day target of €2,086 million. Tax revenue growth is forecast to remain strong in 2004, at 9.4 per cent following growth of 9.6 per cent in 2003. Although the fall-off in non-tax revenue payments in 2004, at over 14 per cent, is likely to be less stark than in 2003 where it fell by over 50 per cent, the contraction in this source of revenue implies that total revenue is forecast to increase by 8.7 per cent in 2004. This is compared to more moderate growth of 5.2 per cent in 2003. We forecast current expenditure to increase by 7.6 per cent in 2004, leaving the current account in surplus to the magnitude of €5.1 billion. Total capital expenditure is forecast to increase by 9.3 per cent over the year while total capital receipts are estimated to decline by 14.6 per cent, thereby leaving the capital account in a deficit of approximately €6.2 billion.

Following a surplus of €280 million in 2003, the general government balance, which is a broader measure of the government's financial position, is forecast to be in a slight surplus of €53 million in 2004, or close to balance when expressed as a proportion of GDP. Despite the continued momentum envisaged for the Irish economy, we forecast deterioration in the budgetary position in 2005, due to the once-off receipts present in 2004. We forecast an exchequer deficit of €1.8 billion and a general government deficit of €0.5 billion or 0.3 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).

TABLE 11: Public Finances

	2003	% Change	2004	% Change	2005
Current Revenue	33,157	8.7	36,032	4.6	37,706
Current Expenditure	28,747	7.6	30,930	7.0	33,110
Current Surplus	**4,410**	16.0	**5,102**	-9.9	**4,596**
Capital Receipts	1,288	-14.6	1,100	9.1	1,200
Capital Expenditure	6,678	9.3	7,300	4.5	7,625
Capital Borrowing	**5,390**	15.0	**6,200**	3.6	**6,425**
Exchequer Balance	**-980**		**-1,098**		**-1,829**
as % of GNP	-0.9		-0.9		-1.5
General Government Balance	**280**		**53**		**-523**
as % of GDP	0.2		0.0		-0.3
Gross Debt as % of GDP	**32.8**		**31.2**		**30.3**

General Assessment

The Irish economy looks set to perform strongly in 2004 with output growth rates of around 4.5 per cent, approaching estimated sustainable rates, achieved against a backdrop of relatively low consumer price inflation. The resilience of the labour market during the slowdown of recent years has been a remarkable feature of the Irish economy. Significant churning between sectors has been evident with services employment growth more than compensating for job losses in industry and agriculture. The rate of unemployment is anticipated to remain at or below 4.5 per cent over the next two years, indicative of an economy at close to full-employment conditions. The public finances are operating at close to balance positions along with a relatively low national debt ratio. While the current account of the Balance of Payments has deteriorated, the large macroeconomic imbalances that resulted in high price and wage inflation over recent years have moderated substantially.

The cyclical upturn in Irish growth prospects is directly tied to the improved fortunes in the international economy. Rising consumer and business confidence globally has helped underpin the return of robust international investment and strong trade growth during 2004. The emergence of China as a prospective engine of growth for the world economy has been by far the most significant boost to international growth prospects. Asian economies have begun to emerge strongly from their poor growth performance since the late 1990s, in part driven by the demand generated by the Chinese dash for economic growth. Japan in particular has benefited as it is finally showing signs of making a strong recovery after an extended period of underperformance.

The world's largest economy, the US, has also grown strongly over the last year with increases in employment growth finally beginning to emerge to underpin the productivity-led recovery. However, the macroeconomic imbalances within the US remain with significant deficits on both the current account of the Balance of Payments and Federal fiscal budget. The larger economies of Europe, with the exception of the UK, are still struggling to resume strong growth trajectories despite the potential boon an expanding European Union market can bring.

While the relaxed monetary policy stance of recent years is gradually being reversed, the prospects for a sustained international recovery are at their highest in nearly half a decade. Although stock markets are still a long way from their peak at the start of the Millennium, they are holding on to the gains made over the last year. Volatility in the currency markets has also been less pronounced in the first half of 2004 than in more recent years. The strength of the euro has been a significant factor in moving Irish consumer price inflation downwards to be more in line with euro area inflation trends.

The sharp rise in crude oil prices that has emerged over the first half of this year has attracted considerable international attention. Many view this as a harbinger for an international economic downturn on the basis of similar oil price hikes preceding such an outcome on several occasions over the last thirty years. While the prospect of sustained high oil prices will have a dampening impulse for international economic recovery, its more immediate impact will be to raise the measure of price inflation. However, the current strength of oil prices are more a reflection of strong economic performance rather than necessarily the seed of its undoing.

Previous oil price shocks that impacted heavily upon the international economy had resulted from severe and sudden supply restrictions. While currently there are delivery bottlenecks due to limited refinery capacity and security of supply difficulties related to terrorism threats in the Middle East, there has also been a huge boost to the demand for oil, and raw materials in general, by the strong recovery in international economies and in China in particular.

Having struggled under the spectre of deflationary pressures as recently as last year, the world economy can cope with the modest inflationary consequence of a demand-induced rise in a primary commodity like oil without experiencing any severe setback in economic growth prospects. Oil prices in the order of $35-$40 per barrel are high in nominal terms but are just one-third in real, inflation adjusted terms of the price hikes of the 1970s. The appreciation of the euro also means that the transmission of the dollar-denominated oil price rise is less severe in an European context.

The effect of higher oil prices from an Irish economy perspective depends crucially on how the world economy responds. The main effects on Ireland would come from the loss of income through the adverse movement in the terms of trade and any slowdown in the international economy. For instance, the impact of doubling oil prices would be to knock off around 0.5 percentage points of GDP and 0.4 percentage points off GNP for Ireland. The more immediate effect of the rise in oil prices would be to directly raise consumer prices in Ireland. Excise duties and indirect taxes form a considerable proportion of the retail price so the transmission of crude oil price rises are dampened. However, it is the case that Ireland tends to have a lower proportion of duty on petrol than most other EU countries so the inflationary pass-through may be somewhat higher here than in competitor nations.

The sharp downward trend in Irish price growth over the last year has been halted in the second quarter of 2004. Having fallen by nearly three percentage points during 2003 to average 3.5 per cent, consumer price inflation is beginning to move back up towards rates of 2 per cent which is around the rate we expect inflation will average both this year and next. The relative stability in the effective exchange rate for the euro over the last six months has halted the dis-inflationary trend evident in the sharp declines in measures like the wholesale price index. Manufacturing prices are still declining, as they have been for two years, but the rate of decrease is slowing.

Ireland has notably moved to the euro area average inflation rate as measured by the comparable Harmonised Index of Consumer Prices (HICP), having been at the top of the inflation league for a number of years. Other price pressures show less sign of moving towards low single digit rates, particularly asset prices like housing. The housing market remains incredibly buoyant both in terms of price and the number of dwellings built. The output of new houses grew by 20 per cent in 2003 to record yet another high of 69,000 completions. The initial indicators for 2004 suggest that this level of completions may be surpassed yet again. This remarkable level of construction would far exceed our estimates on the requirements for household formation suggesting a strong demand for second homes or property to let.

This strong supply response would be expected to moderate new house price growth substantially but this has not yet occurred to any significant extent. Mortgage lending has been growing at around 25 per cent per annum, reflecting the brisk demand response to loose monetary conditions and improving economic sentiment. The combination of strong supply and continuing robust demand is expected to underpin house price growth of over 10 per cent in 2004 before moderating slightly to 6 per cent next year.

The issue of housing affordability is often a concern at times of high price growth. Thus, a concern is shared on an international basis at present, as most industrialised economies have experienced sharp house price inflation over the last three years as investors bypassed equity markets. The trends on economy-wide affordability are still reasonably benign in Ireland, as David Duffy sets out in an article in this *Commentary*. While there is an escalation in borrowing and debt positions, the implied affordability constraint is not particularly severe on average compared to other periods in the past. However, the vulnerability of some cohorts of home-owners to economic shocks like higher unemployment and higher interest rates may be much more significant but the aggregate indicators of affordability used do not pick this up.

One group that seems to experience the most severe affordability difficulties with housing are private sector renters. Tony Fahey in an accompanying article in this *Commentary* shows that the proportion of disposable income devoted to housing provision is much higher for renters than for the first-time buyer category, the group that traditionally attracts most attention for housing policy intervention. The provision of affordable housing, regardless of tenure type, must be a central objective for both economic and social considerations. Affordable housing is a cornerstone of the current *Sustaining Progress* social partnership agreement but again the underlying emphasis is on favouring home ownership. The cost of housing is a significant factor in wage negotiations and the persistent strength in house price growth adds pressures for higher remuneration claims.

The second phase of wage terms negotiated in June 2004 as part of *Sustaining Progress* once again covers an eighteen-month period. The rationale for opting to split the wage agreement into two phases of eighteen months each has been vindicated. The first phase was negotiated in a particularly uncertain environment when inflation was close to 5 per cent, though anticipated to fall. As it transpired the dis-inflationary trend was even greater than anticipated giving greater purchasing power to the agreed wage terms. The pay terms agreed in the first phase of *Sustaining Progress* have, as we predicted in Spring 2003, helped ratchet wage growth down towards rates of 4 per cent and 3 per cent for this year and next. This rate of wage growth is important in moving the Irish economy more in line with sustainable, productivity-justified pay.

The wage terms in the first phase provided for an overall pay increase of 7.2 per cent over eighteen months paid in three instalments. The recently negotiated second phase provides for a cumulative 5.6 per cent overall pay increase over the next eighteen months, again in three instalments of six months duration. The wage rate increases are 1.5 per cent, followed by another 1.5 per cent and a final increase of 2.5 per cent which would occur in the latter half of 2005 for private sector workers. The public sector will get the same overall rates of increase but commencing mid-2005. These pay terms provide a 3.0 per cent annualised rate for the first year or 3.7 per cent annualised over the eighteen months.

There is a proposal to have a successor to the still controversial *Public Sector Benchmarking Report,* with a reporting date in the latter half of 2007. The rationale for the original *Benchmarking* process arose from the perception that public sector workers had fallen significantly behind their private sector comparators in pay terms during the Celtic Tiger era. A paper by Boyle, McElligott and O'Leary contained within this *Commentary* challenges this perception, suggesting that on a comparable basis, by accounting for individual characteristics, public sector workers continued to attract a significant premium on the private sector even in 2001 when the *Benchmarking* process was underway. The lack of transparency surrounding the original process makes it difficult, even *ex post,* to assess its merits and any future benchmarking type scheme should be designed *ex ante* to allow open public scrutiny of its subsequent recommendations and the basis on which they were made.

Overall the wage terms agreed under both phases of the *Sustaining Progress* social partnership agreement appear sensible for the contemporaneous needs of the Irish economy and are to be welcomed. Setting wage agreements over shorter periods than the traditional three years has been a progressive move in light of the high uncertainty surrounding forecasts for an economy as open and transitional as Ireland.

The strength of the public finances will allow some scope for taxation measures to help bolster take-home pay. However, expectations that substantial room exists for significant taxation reductions and greater public expenditure during the emerging economic upswing would be seriously misplaced. The re-emergence of strong growth prospects for the Irish economy still requires that expectations be tempered as the public finance position has been boosted by large windfall receipts arising from voluntary tax disclosures and timing changes in a variety of tax categories.

While the general government position is likely to approach balance in 2004 it is expected to return to a moderate deficit position in 2005. However, with the economy growing at or above its potential growth rates, the EU *Stability and Growth Pact* would require that at this point in the economic cycle the general government position be returning to a "close to balance or in surplus" position.

The prospect of a return to strong, balanced growth conditions for the Irish economy, while encouraging, is not inevitable. Domestic policy actions must help to steer the economy to remain on its potential growth path by taking the opportunity to bring to fruition output capacity enhancing measures in terms of infrastructure provision and the speeding up of competition in many sheltered sectors of the economy.