SUMMARY

The prospects for the global economy remain positive for 2005 despite some slackening in the pace of activity in the latter half of 2004. The Irish economy has emerged from the difficult trading environment of 2002/03 with a resumption of growth rates in line with its sustainable trend. The strength of the domestic economy is most apparent in the robust performance of the Irish labour market, which is expected to record employment growth of 2.6 per cent in 2004 with the rate of unemployment expected to average 4.4 per cent. Our projection for growth in real GDP in 2004 is 5.5 per cent and 5.1 per cent for real GNP. The annual rate of consumer price inflation for 2004 is likely to be 2.2 per cent, still higher than the average of our main trading partners.

The prospects for 2005 for the Irish economy as ever are linked with the fortunes of the international economy. The on-going recovery in the international economies is expected to continue albeit at a somewhat more subdued pace. There are, however, considerable downside risks given the extent of the macroeconomic imbalances within the US economy and the chances of these being addressed in an orderly manner to maintain global economic stability. We have altered our assessment on the US dollar prospects against the euro in the near term but consider that the Irish economy remains relatively well positioned to cope with the changing exchange rate environment and the entailed loss of competitiveness for the Euro Area economies. Our revised forecast for output growth in 2005 is now 5.0 and 4.6 per cent in real GDP and real GNP terms respectively. Consumer price inflation is expected to average 2.1 per cent while the rate of unemployment is forecast to average 4.3 per cent in 2005.

In terms of income redistribution, Budget 2005 has been strongly progressive in terms of the direction of tax measures, social welfare payments and the absence of indirect tax increases. As regards the Budget's overall fiscal stance. The most appropriate indicator of the budgetary position is the general government balance (GGB), which we forecast to move from a surplus of 1.1 per cent of GDP this year to a deficit of 0.6 per cent of GDP in 2005. This expansionary fiscal stance may not be inappropriate given that there are potential downside risks to our forecasts over the next few years. These risks stem from the necessary international macroeconomic adjustment required to deal with unsustainable imbalances within the US economy that must occur over the coming years and the extent to which Irish economic growth is exposed to the high volume growth of house building. A gradual unwinding from these positions would be in the best interests of the Irish economy. However, unexpectedly sharp corrections in either case – through further sustained dollar depreciation against the euro or falls in the number of new houses built towards levels consistent with household formation requirements – have the potential to substantially reduce predicted economic growth prospects.

PRELIMINARY NATIONAL ACCOUNTS 2003

A: Expenditure on Gross National Product

	2002	2003	Change in 2003				
		Preliminary	€m		%		
	€m	€m	Value	Volume	Value	Price	Volume
Private Consumer Expenditure	59,019	62,935	3,916	1,532	6.6	3.9	2.6
Public Net Current Expenditure	17,692	19,233	1,541	445	8.7	6.0	2.5
Gross Fixed Capital Formation	28,983	31,815	2,832	980	9.8	6.2	3.4
Exports of Goods and Services (X)	119,701	112,759	-6,942	-912	-5.8	-5.1	-0.8
Physical Changes in Stocks	115	499	384	417			
Final Demand	**225,510**	**227,241**	**1,731**	**2,462**	**0.8**	**-0.3**	**1.1**
less:							
Imports of Goods and Services (M)	98,508	91,981	-6,527	-2,307	-6.6	-4.4	-2.3
less:							
Statistical Discrepancy	-990	474	1,464	96			
GDP at Market Prices	**127,002**	**134,786**	**6,794**	**4,673**	**5.3**	**1.6**	**3.7**
less:							
Net Factor Payments (F)	23,518	23,115	-403	1,717	-1.7	-8.4	7.3
GNP at Market Prices	**104,474**	**111,671**	**7,197**	**2,956**	**6.9**	**3.9**	**2.8**

B: Gross National Product by Origin

	2002	2003	Change in 2003	
		Preliminary		
	€m	€m	€m	%
Agriculture, Forestry, Fishing	2,877	2,915	38	1.3
Non-Agricultural: Wages, etc.	49,806	53,402	3,596	7.2
Other:	52,949	52,001	-948	-1.8
Adjustments: Stock Appreciation	-117	409		
Financial Services	-3,870	-4,340	-470	12.1
Statistical Discrepancy	-990	474	1,464	-147.8
Net Domestic Product	**100,654**	**104,861**	**4,206**	**4.2**
less:				
Net Factor Payments	23,518	23,115	-403	-1.7
National Income	**77,137**	**81,746**	**4,609**	**6.0**
Depreciation	13,883	14,933	1,050	7.6
GNP at Factor Cost	**91,020**	**96,679**	**5,659**	**6.2**
Taxes less Subsidies	13,454	14,992	1,538	11.4
GNP at Market Prices	**104,474**	**111,671**	**7,197**	**6.9**

C: Balance of Payments on Current Account

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

FORECAST NATIONAL ACCOUNTS 2004

A: Expenditure on Gross National Product

	2003	2004	Change in 2004				
	Preliminary €m	Forecast €m	€m Value	€m Volume	% Value	% Price	% Volume
Private Consumer Expenditure	62,935	66,313	3,378	1,951	5.4	2.2	3.1
Public Net Current Expenditure	19,233	20,900	1,667	519	8.7	5.8	2.7
Gross Fixed Capital Formation	31,815	37,266	5,451	2,740	17.1	7.8	8.6
Exports of Goods and Services (X)	112,759	119,618	6,859	6,180	6.1	0.6	5.5
Physical Changes in Stocks	499	395	-104	-169			
Final Demand	**227,241**	**244,492**	**17,251**	**11,221**	**7.6**	**2.5**	**4.9**
less:							
Imports of Goods and Services (M)	91,981	97,238	5,257	7,374	5.7	1.5	4.2
less:							
Statistical Discrepancy	474	736	262	13			
GDP at Market Prices	**134,786**	**146,519**	**11,732**	**7,361**	**8.7**	**3.1**	**5.5**
less:							
Net Factor Payments (F)	23,115	24,136	1,021	1,615	4.4	-2.4	7.0
GNP at Market Prices	**111,671**	**122,382**	**11,195**	**5,741**	**9.6**	**4.2**	**5.1**

B: Gross National Product by Origin

	2003	2004	Change in 2004	
	Preliminary €m	Forecast €m	€m	%
Agriculture, Forestry, Fishing	2,915	2,970	55	1.9
Non-Agricultural: Wages, etc.	53,402	57,733	4,331	8.1
Other:	52,001	55,569	3,568	6.9
Adjustments: Stock Appreciation	409	420		
Financial Services	-4,340	-4,471	-131	3.0
Statistical Discrepancy	474	736	262	55.2
Net Domestic Product	**104,861**	**112,957**	**8,096**	**7.7**
less:				
Net Factor Payments	23,115	24,136	1,021	4.4
National Income	**81,746**	**88,820**	**7,074**	**8.7**
Depreciation	14,933	16,358	1,425	9.5
GNP at Factor Cost	**96,679**	**105,178**	**8,499**	**8.8**
Taxes less Subsidies	14,992	17,204	2,212	14.8
GNP at Market Prices	**111,671**	**122,382**	**10,711**	**9.6**

C: Balance of Payments on Current Account

	2003	2004	Change in 2004
	€m	Forecast €m	€m
Exports (X) less Imports (M)	20,778	22,379	1,601
Net Factor Payments (F)	-23,115	-24,136	-1,021
Net Transfers	440	250	-190
Balance on Current Account	**-1,897**	**-1,507**	**390**
as % of GNP	-1.7	-1.2	0.3

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	66,313	70,482	4,169	2,719	6.3	2.1	4.1
Public Net Current Expenditure	20,900	22,806	1,906	648	9.1	5.8	3.1
Gross Fixed Capital Formation	37,266	39,705	2,438	1,485	6.5	2.5	4.0
Exports of Goods and Services (X)	119,618	131,230	11,613	8,306	9.7	2.6	6.9
Physical Changes in Stocks	395	340	-55	5			
Final Demand	**244,492**	**264,563**	**20,071**	**13,162**	**8.2**	**2.7**	**5.4**
less:							
Imports of Goods and Services (M)	97,238	105,582	8,343	5,797	8.6	2.5	6.0
less							
Statistical Discrepancy	736	644	-91	106			
GDP at Market Prices	**146,519**	**158,337**	**11,819**	**7,259**	**8.1**	**3.0**	**5.0**
less:							
Net Factor Payments (F)	24,136	26,667	2,531	1,629	10.5	3.5	6.7
GNP at Market Prices	**122,382**	**131,670**	**9,288**	**5,630**	**7.6**	**2.9**	**4.6**

B: Gross National Product by Origin

	2004	2005	Change in 2005	
	Forecast €m	Forecast €m	€m	%
Agriculture, Forestry, Fishing	2,970	3,030	60	2.0
Non-Agricultural: Wages, etc.	57,733	61,603	3,870	6.7
Other:	55,569	61,239	5,670	10.2
Adjustments: Stock Appreciation	420	200		
Financial Services	-4,471	-4,404	68	-1.5
Statistical Discrepancy	736	644	-91	-12.4
Net Domestic Product	**112,957**	**122,313**	**9,356**	**8.3**
Net Factor Payments	24,136	26,667	2,531	10.5
National Income	**88,820**	**95,646**	**6,826**	**7.7**
Depreciation	16,358	17,752	1,395	8.5
GNP at Factor Cost	**105,178**	**113,398**	**8,220**	**7.8**
Taxes less Subsidies	17,204	18,272	1,068	6.2
GNP at Market Prices	**122,382**	**131,670**	**9,288**	**7.6**

C: Balance of Payments on Current Account

	2004 Forecast €m	2005 Forecast €m	Change in 2005 €m
Exports (X) less Imports (M)	22,379	25,649	3,269
Net Factor Payments (F)	-24,136	-26,667	-2,531
Net Transfers	250	209	-41
Balance on Current Account	**-1,507**	**-809**	**698**
as % of GNP	-1.2	-0.6	0.5

The International Economy

General

International conditions are currently quite benign, although there are signs that the strong recovery witnessed earlier in the year may be weakening. This is particularly true of the Euro Area and Japanese economies, where growth rates have recently begun to stagnate. More impressive growth rates are being recorded in the UK and US economies while vibrant growth rates continue to flourish in emerging economies.

US Economy

The US economy recorded robust growth rates in the first half of 2004, and preliminary figures suggest that this trend was maintained into the third quarter, when real GDP grew by 3.7 per cent at an annual rate, and was 3.9 per cent up on the corresponding period of 2003. The principle demand component underpinning this growth was investment, where growth in 2004 has been in the order of about 14 per cent, and numbered 12.5 per cent in the third quarter. This is in line with the general expansion taking place in the corporate sector. Further evidence of this is the fact that the Purchasing Managers' Index (PMI) averaged 57.7 in the three months ending in November, where a value of 50 or more indicates expansion.

Consumer spending is also supporting growth in the US economy. In the first half of 2004 it increased by 3.9 per cent against the same period of 2003. However, there is some evidence that consumer spending growth is decelerating slightly; in the third quarter, annual growth was 3.5 per cent. The particularly strong growth of expenditure on durable goods may suggest that US consumers find the recent bout of economic growth credible and sustainable. The growth in spending on durable goods was 5.4 per cent in the third quarter of 2004, having averaged 8 per cent in the first half of the year. Despite such outturns, consumer sentiment has been weakening throughout the year. The University of Michigan's Consumer Sentiment Index recorded a 92.8 reading in November. Although this was higher than October's 91.7 value, a general decline in the measure since January has taken place, when a 103.8 value was posted. The feeble state of consumer sentiment may reflect the uncertainty and apprehension created by large increases in oil prices during the year, as well as the perception of a 'soft patch' in the economy during the late summer and early autumn.

The deteriorating external balance of the United States continues to be a cause for concern. Strong growth was recorded in both the export and import components of aggregate demand, but the overall effect was to widen the trade deficit further. In the second quarter of 2004, the US Current Account deficit reached a record $166.2 billion according to preliminary figures, up from $147.2 billion in the first quarter. At almost 6 per cent of GDP, this deficit represents a serious imbalance. Its continued growth is explained largely by the growth differential between the US and its major trading partners. Stronger US growth means that demand for imports is growing faster than demand for exports. Furthermore, the low exchange value of China's currency is conducive to the maintenance of a large deficit in the US's trading relations with China. The trade deficit is mitigated somewhat by surpluses on the services account, and income from US investments abroad. However, private financial transfers out of the US play a significant role in extending the current account deficit. The acquisition of US securities by non residents is the single most important way in which the current account deficit is being financed. In the first half of 2004, foreigners increased their holdings of US assets by $711 billion, compared to the $425 billion worth of foreign assets purchased by US residents. The situation is resulting in the external sector's claim on the US economy increasing, giving rise to the strong likelihood of large and growing factor income outflows from the US in the near term. This will tend to lead to persistence in the US current account deficit in the future.

The strong rate of economic growth has translated into employment growth and a reduction in the unemployment rate. Between November 2003 and November 2004, nonfarm payroll employment has risen by 1.7 million persons. The rate of growth has slowed in recent months however. During the three month period ending in May, 885,000 jobs were created. However, between then and September employment increased by 405,000. This slowdown in employment growth may be partly due to the onset of the 'soft patch' in the US economy characterised by weaker growth and reduced confidence of economic agents. Also, the effect of four hurricanes in the southeast of the United States during September and their consequent economic disruption may have had a negative impact on employment data. In November, nonfarm employment increased by 128,000 bringing the unemployment rate to 5.4 per cent of the labour force. This is lower than the 5.9 per cent rate recorded twelve months previously, with the majority of the decline having taken place late last year and early in the present year. The trend unemployment rate has been broadly stable over the last number of months.

Inflationary pressure in the US economy remains subdued. Latest figures for October suggest an inflation rate of 3.2 per cent. This figure is set against the backdrop of a twelve month period which has witnessed a significant depreciation in the value of the dollar against the euro, steep oil price increases and a strengthening economy. The relatively benign inflationary outturn thus far is probably a reflection of the degree of monetary tightening, which has curtailed demand pressures, and also the quite slack conditions in the labour market. The main sources of inflationary pressure have originated from the energy sector, where prices are 15.2 per cent higher than a year ago. Clothing prices have asserted a downward impulse on the inflation rate, dropping slightly by 0.6 per cent on October 2003.

In terms of the outlook for 2005, we anticipate that the solid economic growth witnessed in 2004 will be maintained. We forecast that real GDP in the US will rise by 3.1 per cent next year. This growth is likely to be supported by the weakness of the dollar against the currencies of its major trading partners, as well as the fact that interest rate hikes undergone in 2004 will not be replicated next year, as interest rates are currently quite close to their cyclical peak. In light of developments since the presidential election, we do not anticipate the US's twin deficits in the spheres of its balance of payments and federal budget to be tackled dramatically in 2005.

The European Economy

Euro Area

Following a modest expansion in the Euro Area in the first half of 2004, recent data points to a slowdown in growth in the third quarter; GDP rose by 0.3 per cent quarter-on-quarter, down from a growth rate of 0.5 per cent in the second quarter and 0.7 per cent in the first quarter. Compared to the third quarter of 2003, this represents a 1.9 per cent increase. The slowdown is mainly attributable to a weaker net trade position; a marked fall in exports and a rise in imports induced a negative trade contribution of approximately 0.7 per cent, reflecting the continued strength of the euro observed in 2004, making Euro Area exports more expensive abroad and imports less expensive. This negative drag on GDP was offset by improvements in capital spending and stock building, which grew by 0.6 and 0.7 per cent quarter-on-quarter respectively. Domestic demand and private consumption on the other hand remained quite subdued, recording minor increases of 0.4 and 0.2 per cent quarter-on-quarter respectively, possibly reflecting a dampening of activity caused by higher oil prices. The latest available data show that Germany and France experienced a significant slowing of growth in the third quarter, registering only a 0.1 per cent increase on the previous quarter. Recent survey data points to a continued slowdown in growth in the Euro Area in the fourth quarter of 2004.

Inflation data also point to a worsening position in the Euro Area. Despite the fact that the recent dampening in domestic demand and the decrease in import price inflation caused by the euro appreciation were expected by some to reduce inflationary pressures and push inflation below 2.0 per cent, the European Statistics Office Eurostat estimates annual inflation to be 2.2 per cent in November. This lies above the ECB's target inflation of less than, but close to 2.0 per cent and as such poses a heightened concern for the ECB. The increase is largely attributable to higher oil prices exerting upward pressure on the index. In terms of the individual countries, recent data on the rate of inflation for the year to September 2004 showed Finland experienced the lowest annual inflation rate, registering only a 0.2 per cent increase in prices. Spain recorded the highest annual inflation rates, experiencing a 3.2 per cent increase over the year.

Against this backdrop of lower than expected growth and higher inflation, the ECB left its main refinancing rate at 2.0 per cent after its latest meeting in December, having remained at that level now since June 2003. Given the recent slowdown in the Euro

Area economy, it seems unlikely that the ECB will raise interest rates any time soon.

Recent unemployment data act as evidence of the structural weaknesses in the Euro Area, with high unemployment rates recorded in several of the Member States; France's unemployment rate stood at 9.5 per cent in October, registering a slight month on month decrease from September. Germany's unemployment rate stood at 9.9 per cent in November, having remained at that level since August of this year, while Spain recorded an unemployment rate of 10.5 per cent in October, down from 10.6 per cent in September, albeit still at a high level, a downward trend has been in play since the beginning of the year. As a whole, the Euro Area has posted an 8.9 per cent unemployment rate so far in 2004 and looks set to remain at this level for the rest of the year.

In line with the observed trends, business sentiment surveys conducted by the European Commission point to depressed confidence among the business community; recent data shows a significant fall in the Business Climate Indicator for the Euro Area, which now stands at 0.39.[1] This represents a reversal in recent readings of the indicator that in previous quarters suggested a rise in expectations of future orders, employment and other conditions as well as actual positive developments in prevailing conditions. Confidence in France and Germany has fallen, as in most other European countries. The main cause of this deterioration has been the continued strength of the euro, while high oil prices have also contributed. Consumer sentiment surveys are also discouraging. They suggest a deterioration in consumer confidence across several of the member states; the Consumer Confidence Indicator recorded a fall of one point to –14.0 in October. As with the erosion in business confidence, the drop in consumer sentiment may reflect the "soft patch" currently observable in the Euro Area. High oil prices and the sustained appreciation of the euro may also have contributed.

The recent announcement of proposed changes to the *Stability and Growth Pact* (SGP) by the European Commission in September sparked further debate about the appropriate fiscal framework in the Euro Area and focused more attention on member States' budget proposals. The Commission highlighted the importance of checking for debt sustainability when examining budgetary positions meaning that more attention should be paid to the surveillance of current debt developments and the factors that might influence its medium and long run dynamics. It was also proposed that countries should be encouraged to use the Broad Economic Policy Guidelines more actively and run larger surpluses in boom times to act as a safety net in times of recession. The need for a more flexible interpretation of the *Stability and Growth Pact* was also emphasized and in particular the need to study current

[1] A rise in this indicator points to an upswing in activity and an improvement in the business climate while a fall suggests a downturn and a deterioration in the business climate.

economic developments when implementing the excessive deficit procedure was highlighted. The ECB is unhappy about the proposed changes, citing the need for the Pact and the excessive deficit procedure to remain firm, as they are the key fiscal cornerstones of European Monetary Union.

On the budget front, Italy's budget for 2005 was announced in October and its deficit forecasted to be 2.7 per cent of GDP, representing a decrease from its forecasted 2.9 per cent of GDP level in 2004. However, it seems likely that Italy's deficit will breach the 3.0 per cent of GDP limit in 2005 if the Italian government introduces its currently proposed plan to cut taxes next year. This has not been incorporated into the published figures.

Greece too seems set to break the SGP rule regarding budget deficits this year, especially considering the fact that it's expenditure for 2004 is likely to be much higher than initially anticipated, given that the cost of the Olympic games is now estimated to total approximately €7.5 billion as opposed to the initially budgeted €4.6 billion. Recent revelations regarding the lack of accuracy of previous budgetary data for Greece has also raised concern about the credibility of the finance minister's claims that it will be possible to reduce the deficit to below 3.0 per cent of GDP in 2005.

While the latest data is somewhat discouraging, the recent slowdown in the Euro Area should be regarded as a temporary delay in recovery and not taken as a sign of a forthcoming downturn. We forecast a pick up in the pace of recovery in the second half of 2005, when the current upswing in oil prices is reversed; a year-on-year growth rate of 2.0 per cent is expected in Euro Area GDP next year. The envisaged improvement will be driven by a rise in domestic demand and consumer expenditure, which are both forecast to grow by 2.0 per cent, as well as an expansion in private investment. A concurrent fall in the inflation rate is predicted, bringing the annual rate of change in the HICP to below 2.0 per cent in 2005.

Box A: The Lisbon Agenda

In March 2000, in a bid to make the European Union the most dynamic and competitive economy in the world by 2010, it was decided by the then EU-15 leaders to commit to a series of reforms and goals that collectively became known as the *Lisbon Agenda*. This was formulated as a means of dealing with the growing concern among EU members that the US was leading the way in the world economy. The success of the US in becoming a world leader by its ability to embrace information and communications technology (ICT) and to use these to promote growth and employment was identified as an important feature for the EU to emulate. It was also recognised that the EU needed to tackle the issues of an aging population, social cohesion, environmental protection and the increasing competitiveness pressures from Asian economies whilst encouraging a business environment that would foster entrepreneurial spirit and innovation.

In order to achieve these aims, the European Commission proposed a number of targets, which should be met within the specified time frame. Among the most important of these were:

1. Reducing the average level of unemployment in the EU to approximately 4 per cent by 2010;
2. Increasing the overall employment rate to 70 per cent by the end of the decade with a subsequent increase in the female employment rate, bringing it to 60 per cent by 2010;
3. Reducing the number of people living below the poverty line to 10 per cent by 2010;
4. Ratifying the Kyoto Protocol and showing sustained progress by 2005 and in particular increasing electricity consumption from renewable energy sources to 22 per cent;
5. Increasing the share of investment in human resources as a proportion of GDP by 50 per cent by 2010 with an increase in spending on R&D to 3 per cent of GDP.

In November 2004, more than four years after the initiation of the Lisbon Agenda, Wim Kok, the former prime minister of the Netherlands, presented a report to the European Council reviewing the progress made on the Agenda thus far. Kok cited external events since 2000 as the main contributor to the lack of progress made thus far as well as a lack of urgency on behalf of the Member States in adopting the proposals. Kok suggested similar means for achieving the Agenda goals as initially proposed. The main difference is the outlining of particular strategic actions that need to be taken to meet the targets and a setting of short time frames for each action. He suggested that the Lisbon Agenda lacks specificity in that while it outlines desirable aims, it neglects to highlight the means of achieving them. Kok concludes that the Agenda is not overambitious and that the 2010 deadline should remain.

With over four of the ten years of the time set out for achievement of the aims expired, relatively little progress has been made thus far raising questions on the Agenda's credibility. It is too far reaching with too many aims prioritised and no clear structures in place to achieve them. It attempted to address all facets of the 'perfect economy', with little attention paid to the realism of creating such an economy over such a short period of time. While the Agenda has arguably served as a means of directing policy towards appropriate activities in the EU, it has thus far failed in achieving its objectives. It is unlikely that the Agenda will be dropped when a mid-term review is undertaken in 2005 by the European Council, a more likely scenario is that there will be a revision of its aims.

UK Economy

The preliminary estimates of the Office for National Statistics (ONS) show that growth in the UK economy has slowed considerably in the third quarter of this year; it is estimated that real

GDP grew by 0.4 per cent in the third quarter of 2004, down from 0.9 per cent in the previous quarter. The drop in growth is largely attributable to a fall in industrial production, estimated to have decreased by 1.4 per cent quarter-on-quarter (a significant drop from a 1.2 per cent increase in the previous quarter), a fall which is to some extent surprising given the backdrop of favourable global demand conditions and business investment observed in the first half of the year. On the other hand, output of services industries increased by 0.8 per cent, with growth in the retail and wholesale sectors being the main contributors. Construction output also improved, registering a 0.8 per cent quarter-on-quarter increase.

Official data suggest that growth in domestic demand has slowed over the past year with a decrease in consumption growth being the main cause; domestic demand growth recorded a 0.8 per cent balance in the second quarter of 2004 following a 1.0 per cent balance in the first quarter and a 1.5 per cent balance in the fourth quarter of 2003. In line with the other major economies, the deterioration may reflect the uncertainty about future growth prospects created by high oil prices and a slowdown in growth in the third quarter.

Following on from the strong investment spending recorded in the first half of this year, the preliminary estimate of business investment, adjusted for seasonal factors, points to a slowdown in growth in the third quarter; business investment grew by only 0.1 per cent quarter-on-quarter, down from a 2.6 per cent growth rate in the second quarter. This slowdown in part reflects the cooling in the housing market observed of late as well as the increased cost of borrowing from second quarter interest rate hikes.

Consumer price inflation, as measured by the CPI (equivalent to the HICP) rose from 1.1 per cent in September to 1.2 per cent in October. It is expected that further increases will occur in coming months, as high oil prices continue to feed through to consumer prices. On the production side, recent survey data shows that input price inflation increased in October, registering a 1.8 per cent increase, up from 1.7 per cent in the previous month, partly reflecting the increase in oil prices observed over the year. Producer output prices have also registered a significant increase, registering a 0.7 per cent increase in October as compared to 0.3 per cent the previous month. The year-on-year producer output price inflation now stands at 3.5 per cent, the highest since December 1995.

Given the fact that the UK inflation rate remains one of the lowest in the EU and the fact that it remains well below the Bank of England's 2.0 per cent target rate, as well as the recent easing of activity and house price inflation, the Monetary Policy Committee (MPC), at its November meeting, decided to leave the official interest rate of 4.75 per cent unchanged. The risk of future hikes nonetheless remains, given the uncertainty surrounding the outlook for future inflation and the favourable effects of improvements in equity markets on demand.

Current employment statistics from the ONS point to moderate employment growth in the third quarter of 2004, representing an improvement on the previous quarter; the total number of people in employment in the third quarter increased by 55,000 on a seasonally adjusted basis, representing a quarter-on-quarter increase of 0.2 per cent in the three months to September, and an annual increase of 0.8 per cent. This compares to a quarterly decrease of 0.2 per cent in the second quarter of the year. The unemployment rate in the third quarter averaged 4.6 per cent, representing a 0.2 per cent decrease on the previous quarter and a 0.4 per cent decrease over the year.

The third quarter of 2004 pointed to a continued cooling in the housing market and the trend looks set to continue in the fourth quarter. Modest falls were recorded in house prices in October with the Nationwide Index reporting a fall of 0.4 per cent and the Halifax Index reporting a fall of 1.1 per cent. While November data showed a slight pick-up in prices, further decreases are expected in the future. The prospects of a house price collapse however, are unlikely. This outlook was highlighted in the Bank of England's latest *Inflation Report*, which cited the lack in the current economic environment of the three main contributors to the house price collapse in the early 1990s (namely large increases in unemployment and interest rates and a severe recession), as the reason for this view.

The continued recovery in the Euro Area and the US, albeit at a slower pace than this year, will lead to improvements in external demand which will positively affect UK growth; we forecast that GDP will grow by 2.6 per cent in the UK in 2005. Inflation is expected to increase slightly to 1.7 per cent in 2005.

The Rest of Europe

Economic growth continues to be strong in the new EU members of Central and Eastern Europe. Official figures suggest that Poland's economy grew at an annual rate of 6.1 per cent in the second quarter of 2004. Despite such a strong expansion, Poland still suffers from a very high rate of unemployment, amounting to almost one in five of the labour force being jobless. Hungary is also enjoying a robust 3.7 per cent growth rate, but the pressures of excess demand have translated into a rather high inflation rate of 6.3 per cent and a sizeable $8 billion current account deficit. Booming industrial production in the Czech Republic is supporting growth of 4.1 per cent in broader economic activity, with inflation at a moderate 3.5 per cent rate.

The high price of energy products is currently benefiting the economy of Russia, a major producer of oil and gas. Latest official figures suggest that the economy grew by 7.4 per cent in the year to June, though an inflation rate of 11.5 per cent has accompanied this growth. The surge in the value of Russia's main exports has seen a sizeable current account surplus of $44.6 billion being recorded in the year to September.

The economic influence of Turkey is likely to increase significantly over the coming years, particularly in light of the probable commencement of negotiations on Turkey's entry to the EU at the beginning of next year. Its fast growing population, now at over 70 million, will make Turkey a key shaper of migrationary trends in the EU. Given that its potential rate of economic growth is over 7 per cent per year, the possibility exists for Turkey to eventually become a major European economy in terms of size. GDP was up 13.4 per cent in the second quarter of 2004 compared to the same period of 2003. This high rate of growth was underpinned by enormous growth in investment. Inflation continues to plummet, from over 60 per cent three years ago to less than 10 per cent now. This is mostly thanks to an aggressive fiscal policy tailored at shaking off Turkey's traditionally high rate of inflation. Turkey's sizeable current account deficit at 4.5 per cent of GDP is the single biggest risk to maintaining a low rate of inflation. Strong economic growth is likely to widen the deficit further, increasing the possibility of the Turkish lira being devalued, and imported goods becoming more expensive.

Rest of the World

There are indications that the strong economic recovery witnessed in Japan since the end of last year is beginning to falter. In the third quarter of 2004, the volume of GDP grew by 3.9 per cent at an annual rate, down from the 6.6 per cent growth rate recorded in the first quarter. Investment and exports are the main contributors to Japan's growth, with consumption making a very minor contribution and public spending declines curtailing the growth rate. Computational errors have resulted in previous estimates of GDP growth in Japan being revised downwards. Encouragingly, Japan's inflation rate has edged slowly into positive territory over the course of the year. Prices rose by 0.5 per cent in the year to October. This may be symptomatic of greater balance between demand and supply being achieved, but it partly reflects developments in international fuel prices. Household durables' prices continue to exert the strongest downward pressure on the inflation rate. The fall in the unemployment rate over the last number of months is indicative of the tightening capacity in the Japanese economy.

The economy of China continues to maintain very large growth rates. Official figures show that GDP grew by an annual rate of 9.1 per cent in the third quarter, down slightly from the 9.6 per cent recorded in the second quarter. There are signs that the enormous rate of investment growth is starting to moderate. In common with Japan, exports make a significant contribution to GDP growth. Inflationary pressure has emerged in recent months with September's rate of 4.3 per cent in stark contrast to the 1.2 per cent rate observed in 2003. This pressure prompted the Chinese central bank to increase interest rates in October, for the first time since 1995.

Latin American economies like Mexico, Brazil and Argentina are experiencing positive spillovers from the strength of the US economy. GDP growth in Mexico, a country heavily dependent on the US and the world's ninth largest economy, was 4.4 per cent in the third quarter of 2004. Brazil is expanding strongly at a rate just above 6 per cent. Argentina continues to bounce back resiliently from the severe recession of 2001 and 2002. Its economy grew by an annual rate of 7.0 per cent in the second quarter of this year, though its 5.6 per cent inflation rate may suggest that such a pace of growth is becoming unsustainable.

Figure 1: Interest Rates
Per Cent per Annum, Quarterly Averages

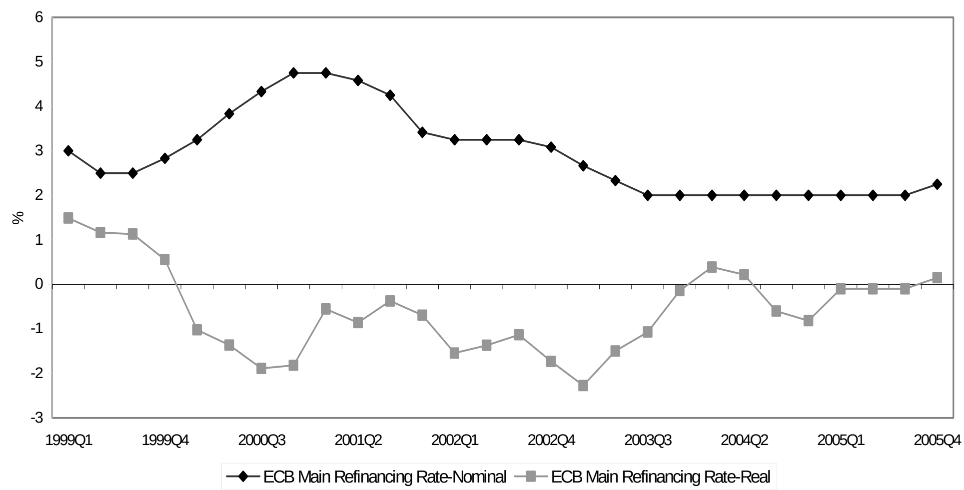


Figure 2: Exchange Rates
Foreign Currency per Euro, Quarterly Averages

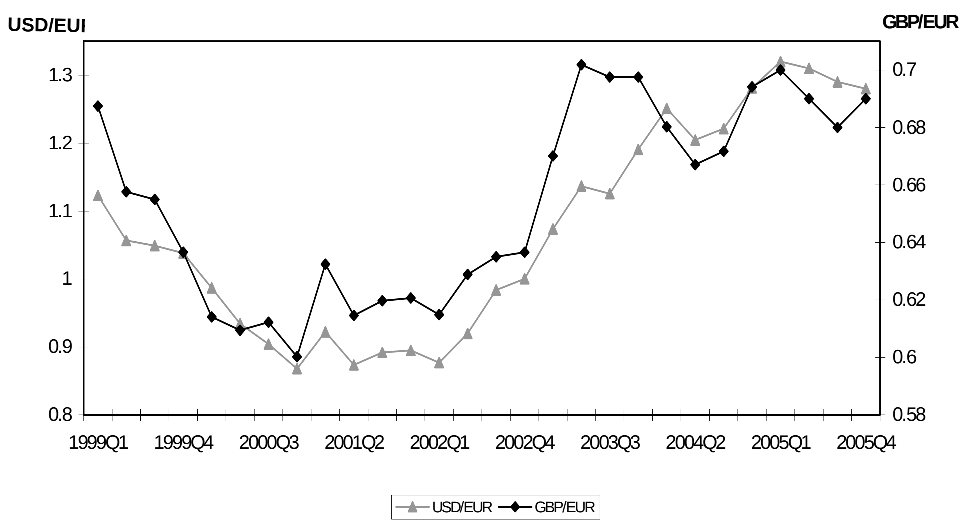


TABLE 1: Short-term International Outlook

	GDP Output Growth			Consumer Price Inflation			Hourly Earnings Growth			Unemployment Rate %			Current Account Balance % of GNP		
Country	**2003**	**2004**	**2005**	**2003**	**2004**	**2005**	**2003**	**2004**	**2005**	**2003**	**2004**	**2005**	**2003**	**2004**	**2005**
UK	2.2	3.2	2.6	1.4	1.3	1.7	3.6	4.4	4.5	5.0	4.8	4.8	-1.9	-2.1	-2.0
Germany	-0.1	1.3	1.7	1.0	1.9	1.8	3.0	2.5	2.5	9.6	9.8	9.9	2.3	2.8	2.6
France	0.5	2.3	2.4	2.2	2.4	1.8	2.6	3.7	3.8	9.4	9.5	9.2	0.3	0.7	0.8
Italy	0.4	1.2	1.7	2.8	2.2	2.2	3.1	3.0	3.1	8.6	8.0	7.8	-1.4	-1.0	-0.8
Euro Area	0.5	1.8	2.0	2.1	2.1	1.9	3.3	3.1	3.2	8.9	8.9	8.8	0.4	0.6	0.7
USA	3.0	4.2	3.1	2.3	2.6	2.2	5.5	4.0	4.0	6.0	5.5	5.1	-4.8	-5.0	-4.7
Japan	2.5	4.2	2.2	-0.3	0.2	0.3	0.8	2.5	2.1	5.3	4.7	4.8	3.1	3.5	3.6
OECD	2.2	3.3	2.7	1.8	2.2	2.1	3.5	3.6	3.4	7.1	6.9	6.8	-1.2	-1.1	-1.1
Ireland	3.7	5.5	5.0	3.5	2.2	2.1	5.4	5.1	4.4	4.6	4.4	4.3	-1.7	-1.2	-0.6

Context for Ireland

The international environment is likely to be broadly conducive to improvements in Ireland's economic well being in 2005. Solid growth in the US economy should nurture improved demand for Irish exports to that economy, as well as supporting the continuation of foreign direct investment into Ireland.

There are significant downside risks posed by some aspects of the international outlook. The current high level of the euro *vis à vis* the dollar will exacerbate the negative economic consequences of Ireland's already high price level in terms of its dealings with the US. Given that the dollar is likely to remain weak for the foreseeable future, there is little prospect of these problems being remedied quickly. Though we have viewed an exchange rate of $1.10 to $1.15 per €1 to be more consistent with economic fundamentals, the large external imbalance of the US economy will act as an obstacle to this being reached in the near term. We have revised our exchange rate forecast for 2005 where we now anticipate an average rate $1.30 to €1 next year. The near static growth rates in the large European economies erases the potential for any significant demand growth being provided from that source. However, given the extent of the imbalances within the US economy the scope for more severe dollar depreciation against both the euro and Japanese Yen in particular is significant. A short-term solution brake on this trend would be a willingness by Chinese authorities to revalue their currency, the Renminbi, against the dollar to help ease the competitiveness losses experienced by the US in their trade with China.

Cheaper imports from the US, and their disinflationary implications are the main benefit to Ireland of the dollar's weakness. The US is the source of about 16 per cent of Ireland's imports. This scenario of a stronger than anticipated euro will postpone ECB interest rate rises until at least the second half of 2005. The effects of this on demand will be positive, particularly in the area of investment.

During 2004, oil prices breached all time highs in nominal terms, and some pass through into measured inflation rates in developed economies occurred. Oil prices are likely to decline during 2005, and the high base offered in 2004 will mean that oil price developments will inject a downward impulse into 2005's inflation rate. The absence of sudden and significant interest rate rises will also facilitate a smoother wind down in the crucial house building sector. The forecast delay in Euro Area interest rate rises allied to the fact that the Euro Area interest rate will ultimately have to climb to its fundamental rate of 4.5 per cent increases the risk of a moderate and quite rapid rise in interest rates occurring at some stage over the medium term.

The Domestic Economy

General

CSO figures indicate that economic growth in the first half of 2004 has been strong. GDP grew by 4.1 per cent in the second quarter of 2004, while GNP recorded 4.2 per cent growth over the same period This brings growth in the first half of the year to 5.1 per cent for GDP and 4.7 per cent for GNP, meaning a further divergence in the gap between these two measures. Investment and external demand have been the main drivers of growth, with investment growth in particular recording double-digit growth rates. Strong growth rates are expected to be maintained into 2005.

Exports

In line with the slowdown in global activity and world economic growth observed in the third quarter of the year, trade statistics point to a deceleration in export growth in recent times; the value of exports of goods and services increased by a mere 0.8 per cent in the third quarter of 2004 when compared to the same period of 2003, as opposed to a 4.3 per cent annual growth rate in the second quarter. The slowdown was largely attributable to a fall in exports recorded in September. Preliminary data for September show a month on month decrease in seasonally adjusted terms of 11.0 per cent, following on from a strong month on month rise in exports in August of 6.0 per cent. The figure recorded for September, of €7,120 million in unadjusted terms, represents an annual decline of 7.0 per cent on the same month of 2003, reflecting the sustained appreciation of the euro *vis à vis* the dollar.

Despite this poor third quarter result, the overall export performance in the first nine months of 2004 remains favourable, with a 3.1 per cent increase recorded on the same period of 2003. The strong growth rates recorded in the first half of the year have more than compensated for the recent deceleration observed in export growth.

We expect exports of goods and services to expand by 5.5 per cent in volume terms in 2004, while the rate of increase is expected to improve further in 2005, when we forecast a 6.9 per cent growth rate. The majority of the increase in 2005 will be concentrated in the visible component of exports, where volume growth of 8.0 per cent is expected.

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	4,167	2.8	1.3	4,219	4.2	2.8	4,339	2.2	2.4	4,443
Manufactured	82,442	-5.9	-14.6	70,442	5.9	6.0	74,673	8.5	11.6	83,369
Other Industrial	5,554	29.1	14.9	6,380	5.3	4.8	6,684	6.8	10.0	7,353
Other	1,512	-29.1	-34.8	987	3.6	3.4	1,020	3.6	6.8	1,090
Total Visible	**93,675**	**-3.8**	**-12.4**	**82,028**	**5.7**	**5.7**	**86,716**	**8.0**	**11.0**	**96,255**
Adjustments	-4,180	-21.0	-32.0	-2,842	4.0	-6.4	-2,660	15.0	20.8	-3,212
Merchandise	**89,495**	**-3.0**	**-11.5**	**79,186**	**5.8**	**6.2**	**84,057**	**7.8**	**10.7**	**93,044**
Tourism	3,256	0.2	4.7	3,409	3.2	4.7	3,571	3.0	5.3	3,759
Other Services	26,950	6.6	11.9	30,164	4.9	6.1	31,990	5.2	7.6	34,428
Exports of Goods and Services	**119,701**	**-0.8**	**-5.8**	**112,759**	**5.5**	**6.1**	**119,618**	**6.9**	**9.7**	**131,230**

Stocks

The value of inventories held by the corporate sector rose by €308 million in the first half of 2004, with all that increase occurring during the second quarter of the year. This stock accumulation is lower than the rise in the value of stocks in the first half of 2003, which amounted to €968 million. The slowdown in stock accumulation may be a symptom of rising demand within the economy. We forecast stocks to fall by €104 million in 2004, and by €55 million in 2005. This may be indicative of the strong level of demand in the economy.

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	-3	-43	198	155	-265	-110
Irish intervention Stock	176	-128	48	-33	15	-15	0
Other Non-Agricultural Stocks	-21	515	494	-269	225	225	450
Total	**115**	**384**	**499**	**-104**	**395**	**-55**	**340**

Investment

Official figures indicate that gross domestic fixed capital formation investment, grew by 14 per cent in real terms in the year to quarter 2, 2004 and by 20.6 per cent in value terms. This implies an investment deflator of 5.8 per cent. Indicators of investment activity suggest that the expansion of investment activity continued into the second half of the year, albeit at a slower pace. The strong growth in house building underpinned investment in building and construction in 2004, contributing to volume growth of 10.5 per cent in this component. Coupled with anticipated growth of 6 per cent in investment in machinery and equipment, the forecast increase in total gross capital formation in 2004 is 8.6 per cent in volume terms. With an overall investment deflator of 7.8 per cent this implies growth in value terms of 17.1 per cent.

As highlighted in the Autumn *Commentary* the outlook for new housing completions currently plays a crucial role in determining our investment forecast. This is examined in more detail in Box B. We expect that the numbers of new houses built in the Irish economy will contract next year by 5 per cent. This will still mean a strong level of output from the residential construction sector with around 74,000 housing completions. Although the volume of investment in other building and construction is expected to grow by 7.8 per cent, the importance of new house building in construction investment means that overall this component is forecast to grow by just 0.9 per cent. With lower growth in new house prices the construction investment deflator will slow to 3.3 per cent implying value growth of 4.2 per cent. Low interest rates are expected to aid investment in machinery and equipment which is forecast to grow by 8.5 per cent in volume terms and by 13.2 per cent in value, giving a deflator for the machinery and equipment component of 4.3 per cent. On the basis of these forecasts overall investment volumes will grow by 4 per cent in 2005 with an investment deflator of 2.5 per cent. These forecasts suggest that the value of overall investment will grow by 6.5 per cent in 2005.

Box B: Impact of a Decline in the Number of Housing Completions

Each year since 1995 housing output has set a new peak in completions. It is estimated that completions will be in the region of 80,000 units this year. The substantial increase in housing output means that investment in new house building now accounts for 30 per cent of overall investment volumes and is estimated to have contributed one percentage point to GDP growth in both 2003 and 2004. Figures from the latest QNHS show that much of the annual increase in employment is accounted for by the construction sector. Construction employment now accounts for around 11.7 per cent of total employment. As is evident from Table 4 in the main text of the *Commentary* the slower growth in housing completions in 2005 explains the much lower growth in overall investment forecast for that year.

Duffy (2002)[2] outlines the housing component of the ESRI macro-model. This shows that the demand for housing is driven by real personal disposable income, the real interest rate, a housing stock per capita variable and the proportion of the population in the key household formation age groups. A shock to any of these factors could contribute to a fall in housing supply.

At some point the increase in housing supply will match housing demand and growth in housing completions will moderate or begin to decline. Current levels of housing completions are substantially above the levels required to meet the long-run housing needs. The underlying demographic demand for housing is estimated at around 30,000 units per annum when account is taken of population growth and changing headship. House building in Ireland is also substantially above the level of completions per head of population in other larger European economies. Housing output now represents a significant contribution to economic activity in Ireland. In order to examine the exposure of the economy to this sector the impact of a decline in housing output is examined as an illustration of the impact of such a shock. Housing completions are assumed to be 50 per cent lower in each year, modelled using the ESRI *HERMES* model. We do not model what might cause such a decline in housing completions. Rather we are interested in the impact of such a decline on the overall macro-economy.

Although unlikely to happen the effect of such a scenario would be to reduce total investment by around 14 per cent in the short term in the absence of any policy responses which in reality would be forthcoming. The consequence would be to reduce activity levels in the Irish economy with GNP growth lowered by

[2] Duffy, D., 2002, A Descriptive Analysis of the Irish Housing Market, *Quarterly Economic Commentary*, Summer, Dublin: The Economic and Social Research Institute.

three percentage points in the short term. Associated with the fall in housing output would be a fall in employment in the building sector, a decline of around 40,000. The shock would impact on emigration and immigration, resulting in a 12,000 reduction in the net inflow in Year 2. The impact of these effects would be to reduce personal consumption growth. The slower pace of economic activity would cause the unemployment rate to rise by around two percentage points and wages would show a small decline of 1.5 percentage points. We assume that the government would not raise taxes to offset the impact of slower growth on the public finances. As a consequence there is a steady increase in the Exchequer Borrowing Requirement (EBR) which by Year 3 is 2 percentage points higher and the debt to GNP ratio rises by 7 percentage points by Year 3. If the government were to respond to the impact on the public finances by raising taxes or by cutting public expenditure then the impact of this shock would be increased. The shock ignores any wealth effects from a fall in housing prices. For example, if a fall in housing completions were caused by a fall in house prices then the effects shown in the Table B1 would be more severe.

Table B1: Effect of a 50 per cent Decline in Housing Completions (Cumulative Per Cent Difference from Base)

	Year 1	Year 2	Year 3
GNP	-3.0	-3.0	-2.8
Total Employment	-3.0	-2.8	-3.4
Consumption Deflator	-0.0	-0.7	-0.8
Non-Agricultural Wages	0.1	-1.5	-1.5
Unemployment Rate*	2.5	2.0	2.3
Net outflow (net migration, actual change)	0	-11,800	-11,600
Consumption	-3.5	-4.0	-3.7

* Percentage points from base.

The results of these shocks highlight Ireland's exposure to the level of housing completions. Work on the Irish housing market shows that the demand for housing is driven by demographic factors, personal disposable income and the interest rate. The forecasts in this *Commentary* suggest that a sharp fall in employment leading to a fall in personal incomes or a sharp rise in interest rates is unlikely in the short run. Furthermore, the prospect of a sharp fall in Irish economic activity due to a world recession is unlikely in the immediate future.

If housing output were to suddenly revert to a level consistent with the demand from population growth and changing headship this would represent a sharp decline in housing output. Although housing completions have increased steadily in recent years, the annual change can be volatile, increasing or decreasing sharply as seen in the 1980s. It is evident that Ireland has become more exposed to a housing output shock as well as the more frequently mentioned exposure to house prices.

TABLE 4: Gross Fixed Capital Formation

	2002 €m	% Change in 2003 Volume	% Change in 2003 Value	2003 €m	% Change in 2004 Volume	% Change in 2004 Value	2004 €m	% Change in 2005 Volume	% Change in 2005 Value	2005 €m
Housing	10,804	14.4	27.6	13,785	15.2	28.4	17,707	-5.0	-0.1	17,696
Other Building	9,245	-3.6	-0.3	9,220	5.4	7.7	9,932	7.8	11.9	11,113
Building and Construction	20,050	5.0	14.7	23,005	10.5	20.1	27,638	0.9	4.2	28,809
Machinery and Equipment	8,933	1.2	-1.4	8,810	6.0	9.3	9,628	8.5	13.2	10,896
Total	28,983	3.4	9.8	31,815	8.6	17.1	37,266	4.0	6.5	39,705

Consumption

National Accounts for the second quarter of 2004 show that that value of personal consumption rose by 3.7 per cent on an annual basis. The volume of personal consumption is estimated to have risen by 2.2 per cent implying a consumption deflator of 1.5 per cent.

Retail sales statistics show that in volume terms sales increased by 2.9 per cent in the first nine months of the year. Given the more uncertain international environment and concerns about high energy prices and the appreciation of the euro we do not anticipate substantially stronger consumer spending growth in the final three months of the year. Thus, total personal consumption is forecast to rise by 3.1 per cent in volume and 5.4 per cent in value, implying a personal consumption deflator of 2.2 per cent.

As outlined later in the *Commentary,* the labour market is expected to continue to perform well. Real personal disposables incomes growth and moderate inflation will underpin personal consumption growth in 2005. Although our forecast for personal consumption growth in 2005 has been revised down slightly to take account of a more uncertain economic environment growth, in volume terms it will remain strong at 4.1 per cent. Based on the expectation that the consumer expenditure deflator will remain broadly at 2004 levels, this means that the value increase in personal consumption is projected to be 6.3 per cent next year.

According to the Quarterly National Accounts, government consumption in the second quarter of 2004 increased by 3.7 per cent in volume terms and by 9.7 per cent in value terms, resulting in a public expenditure deflator of 5.8 per cent. However, it is anticipated that there will be some moderation in this rate of growth in the second half of the year and so an annual increase of 2.7 per cent in volume terms is forecast for 2004. Taking account of the information in the Quarterly National Accounts and the wage terms of the second part of *Sustaining Progress* we expect an annual deflator for public expenditure of 5.8 per cent this year, implying growth in value terms of 8.7 per cent.

On the assumption that tight control is kept on the public finances, volume growth of 3.1 per cent is forecast for 2005. However, cost and wage pressures will underpin the public expenditure deflator which is expected to average 5.8 per cent. This implies that the value of public expenditure will increase by 9.1 per cent next year.

TABLE 5: Consumption Indicators

	Annual Percentage Change				
	2001	2002	2003	2004 Forecast	2005 Forecast
Consumption Value					
Personal Consumption	9.8	8.6	6.6	5.4	6.3
Retail Sales Index, Value	3.3	2.6	3.2	4.2	4.3
Divergence	6.5	6.0	3.4	1.2	2.0
Consumption Volume					
Personal Consumption	5.5	2.8	2.6	3.1	4.1
Retail Sales Index, Volume	1.5	0.1	0.9	3.2	2.2
Divergence	4.0	2.7	1.7	-0.1	1.9
Consumer Prices					
Personal Consumption Deflator	4.1	5.7	3.9	2.2	2.1
Retail Sales Index Deflator	1.8	2.5	2.3	1.0	2.1
Consumer Price Index	4.9	4.6	3.5	2.2	2.1

Final Demand

Final demand, defined as the sum of consumer spending, public spending, investment, stock changes and exports, increased by 4.6 per cent in volume terms in the first half of 2004 compared with the same time in 2003. There was a slight acceleration in the growth of final demand in the second quarter of 2004, its volume was 4.8 per cent higher than in the corresponding period of 2003. External demand, which rose by 5.7 per cent in the first half of the year, was a key driver of the increase in final demand. Domestic demand grew at a rather more sluggish 3.3 per cent rate. The volume of final demand will rise by 4.9 per cent in 2004 and 5.4 per cent in 2005.

Imports

Predictably, the recent acceleration of economic growth in Ireland has been accompanied by a rise in imports. In the first half of 2004, the volume of imported goods and services was 3.7 per cent higher than the same period in 2003. This trend was particularly pronounced in the second quarter, when annual growth amounted to 6.1 per cent, and was 8.5 per cent higher than the previous quarter alone. The divergence between the growth rates of the value and volume of imports suggests that the price of imported goods fell by 1.2 per cent between the first half of 2003 and the corresponding period of 2004. The effects of the appreciation in the value of the euro on foreign exchange markets, weak price pressures externally and a more competitive trading environment are probably the main reasons for these price developments.

TABLE 6: Imports of Goods and Services

	2002 €m	% Change in 2003 Volume	% Change in 2003 Value	2003 €m	% Change in 2004 Volume	% Change in 2004 Value	2004 €m	% Change in 2005 Volume	% Change in 2005 Value
Capital Goods	7,065	-11.9	-19.0	5,726	5.3	6.7	6,108	5.5	8.6
Consumer Goods	12,761	4.3	-0.9	12,648	4.5	5.6	13,362	4.5	7.2
Intermediate Goods:									
Agriculture	946	6.7	4.5	989	2.5	3.5	1,024	3.0	5.2
Other	32,845	-10.2	-19.0	26,595	4.7	6.2	28,234	5.8	8.2
Other Goods	2,009	-0.2	-7.2	1,864	3.5	4.0	1,939	4.5	6.9
Total Visible	**55,628**	**-6.5**	**-14.0**	**47,822**	**4.6**	**6.0**	**50,668**	**5.3**	**7.9**
Adjustments	-1,576	84.4	30.5	-2,057	10.0	11.1	-2,285	-20.0	-20.0
Merchandise Imports	**54,052**	**- 9.1**	**-15.3**	**45,765**	**4.4**	**5.7**	**48,383**	**6.5**	**9.2**
Tourism	3,942	8.4	6.2	4,188	3.8	6.2	4,447	4.6	7.2
Other Services	40,514	5.6	3.7	42,028	4.0	5.7	44,408	5.5	8.0
Imports of Goods and Services	**98,508**	**-2.3**	**-6.6**	**91,981**	**4.2**	**5.7**	**97,238**	**6.0**	**8.6**

Geographically, the United Kingdom remains Ireland's single most important import source accounting for about 30 per cent of all imports. In common with international trends, the value of Ireland's imports from China rose by 38 per cent in the first seven months of 2004 compared with the same period of 2003. Significant growth was also recorded in imports from France, which increased by 14 per cent. Imports from Japan declined by 8 per cent, while UK and US imports were largely static in terms of growth.

We expect that imports will rise by 4.2 per cent in volume terms in 2004 followed by a stronger 6.0 per cent volume growth in 2005. While the growth in the price of imports is subdued in the current year it is expected to accelerate slightly in 2005 to 2.5 per cent from 1.5 per cent this year.

Balance of Payments

Balance of Payments data for the first half of 2004 show a deficit of €795 million on the Current Account. This indicates that current outflows exceed current inflows in terms of Ireland's economic transactions with the rest of the world. However, the scale of the deficit is insignificant as a proportion of national income, amounting to less than 0.1 per cent of GNP. The existence of a current account deficit is consistent with the trend since 2000, a year after which regular current account surpluses were replaced with minor deficits. The emergence of current account deficits is an effect of the growth differential between Ireland and its trading partners' economies.

In terms of contributions to the current account deficit, a sizeable €5.8 billion surplus in merchandise trade was exceeded by net outflows in the services and income categories. In particular, large deficits in Royalties/Licences and Business Services more than counterbalanced the significant €6.9 billion surplus in computer services. The slight deficit in the tourism and travel component of services indicates that Irish residents now spend more on foreign travel than the revenues earned from non-residents in relation to travel to Ireland. Ireland's status as a net debtor is underlined by the fact that a €12.2 billion deficit was recorded in investment income flows in the first half of 2004.

Within 2004, a comparison of data indicates a reduction in the current account deficit from €685 million in the first quarter to €110 million in the second. This was caused by an improvement in both the merchandise and invisible flow balances. The larger merchandise surplus may reflect the improving international environment's effects on exports, but it must be stressed that balance of payments data are not seasonally adjusted and seasonal effects may be at play also.

We anticipate a slight improvement in the current account deficit in 2005, which is likely to total €1.5 billion this year. This will shrink to an €809 million deficit in 2005. The trade surplus will widen next year from €22.4 billion to €25.6 billion next year. However, this will be partially counterbalanced by an increased services deficit. This deficit is likely to amount to €23.9 billion this year and rise further to €26.5 billion in 2005.

TABLE 7: Balance of Payments

	2002 €m	Change %	2003 €m	Change %	2004 €m	Change %	2005 €m
Visible Trade Balance	38,047	-10.1	34,206	5.4	36,049	15.4	41,589
Adjustments	-2,604		-785		-375		-1,383
Merchandise Trade Balance	**35,443**	**-5.7**	**33,421**	**6.7**	**35,674**	**12.7**	**40,206**
Service Trade Balance	-14,250	-11.3	-12,643	5.2	-13,295	9.5	-14,557
Trade Balance in Goods and Services	**21,193**	**- 2.0**	**20,778**	**7.7**	**22,379**	**14.6**	**25,649**
Total Debit Flows	-52,381	-1.5	-51,570	4.0	-53,628	6.2	-56,936
Total Credit Flows	28,863	-1.4	28,455	3.6	29,491	2.6	30,269
Net Factor Flows	**-23,518**	**- 1.7**	**-23,115**	**4.4**	**-24,136**	**10.5**	**-26,667**
Net Current Transfers	**708**	**-37.9**	**440**	**-43.2**	**250**	**-16.4**	**209**
Balance on Current Account	**-1,617**		**-1,897**		**-1,507**		**-809**
Capital Transfers	512	-27.7	370	1.4	**375**	16.0	360
Effective Current Balance	**-1,105**		**-1,527**		**-1,132**		**-449**

Gross National Product

The volume of GNP grew by 4.2 per cent in the second quarter of 2004 at an annual rate, a reduction from the 5.2 per cent growth rate registered in the first quarter. This represents a GNP growth rate of 4.7 per cent for the first half of the year. The fact that a higher 5.1 per cent GDP growth rate was recorded over the same period points to a continued widening of the already significant gap between the two measures, totalling €12.3 billion in value in the first half of 2004. We predict GDP growth of 5.5 per cent this year followed by 5.0 per cent growth next year. GNP is expected to grow by 5.1 per cent overall in 2004 and moderate to a 4.6 per cent growth rate in 2005. However, we estimate that real Gross National Disposable Income (GNDI) will rise by 3.7 per cent this year and a further 4.7 per cent next year. The slight decline in Ireland's terms of trade since the beginning of the year explains the weaker growth rate of GNDI compared to GNP.

Agriculture

While recent data for the first half of 2004 point to continued growth in the agricultural sector this year, the pace of increase is nonetheless slower than recorded in 2003. This is not surprising however, given that the strong growth in 2003 may be attributed to the fact that 2002 was a disappointing year for the agricultural sector, thus acting as a low base from which growth rates in 2003 were calculated. The volume of output in agriculture, forestry and fishing increased by 2.0 per cent over the first half of 2004, as compared to a 4.6 per cent increase registered for the same period of 2003.

The CSO's final estimate of operating surplus in agriculture in 2003 was €2.2 billion, equating to an annual growth rate of 2.6 per cent. Of this figure, approximately 75.0 per cent was accounted for by direct income payments, which totalled €1.6 billion in 2003.

Data on agricultural prices show that the issue of declining margins, which has posed significant concern in the sector in recent years, does not seem to pose as great a problem in 2004; official data show that output prices, while recording a fall in August when compared to the previous month, have registered an increase of 4.1 per cent overall in the first seven months of 2004 when compared to the same period of 2003. On the other hand, input prices have recorded an increase over the same period of 3.9 per cent.

We expect the volume of gross output in the agricultural sector to rise by 2.4 per cent in 2004 followed by a slight 0.7 per cent increase in 2005.

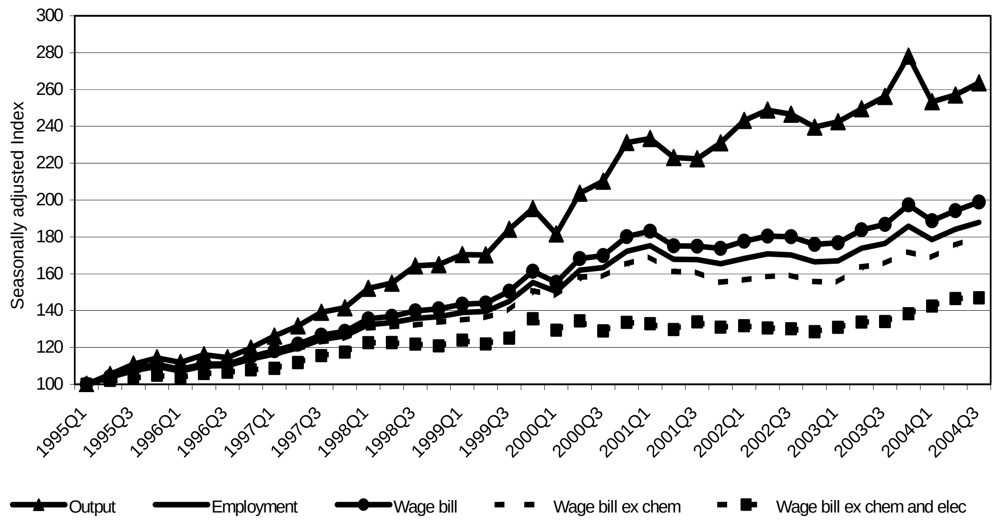
Industry

The latest figures in the *Quarterly National Accounts* indicate an improvement in activity in the industrial sector in 2004; following on from the slowdown observed in 2003, a year-on-year increase of 5.5 per cent was recorded in activity in the first half of 2004. Similar to other sectors in the economy however, the majority of the increase was accounted for by improvements in the first quarter where an annual increase of 8.2 per cent was registered. In seasonally adjusted terms, output actually fell in both the first and second quarters of the year, by 1.9 and 1.6 per cent respectively. However, as reported in previous *Commentaries*, caution is required when drawing conclusions from the seasonally adjusted data.

Preliminary estimates from the *Industrial Production and Turnover* release point to a continued improvement in activity in the industrial sector in recent months; an increase of 5.2 per cent in volume was recorded year-on-year in September. Improvements in the "Modern Sector", which consists of firms involved in the chemical and high-technology sectors, accounted for the largest part of the expansion, registering an annual increase in production of 9.5 per cent in September. As exports from this sector tend to be high, this pick-up may reflect the benign international environment prevailing in 2004. A somewhat disappointing performance was observed in the "Traditional Sector" in the same month, when a decrease of 3.4 per cent was registered. The seasonally adjusted volume of production for manufacturing industries for the three months ended September 2004 also registered an increase when compared to the previous three months, but at a less substantial rate of 2.5 per cent.

Recent industrial survey evidence provides some grounds for optimism, but the results are nonetheless tentative. The IBEC/ESRI October industrial survey suggests progress in the sector in the near future. Expectations of future production, exports and employment all recorded improvements over the period, while there was no change in expectations of new orders. The NCB Purchasing Managers Index (PMI) also supports this view, with the latest figures showing the index at 51.4 in October. While the reading is above the critical cut-off point of 50.0, above which an expansion is expected in the sector, it nonetheless shows only limited optimism about future prospects for the industrial sector and the Irish economy. In fact, the level of the PMI recorded in October is the lowest since September 2003. Significant growth in the output of the building sector will support robust growth of 4.7 per cent in the volume of industrial output in 2004. The slowdown in the building sector which is likely to occur next year will be counterbalanced by improved growth in other industrial sectors, leading to a 5.5 per cent growth rate in 2005.

Figure 3: Industrial Output Using Alternative Weights



Previous *Commentaries* have highlighted how much of the growth in the industrial sector can be attributed to specific sectors within manufacturing such as chemicals (NACE 24) and electrical and optical equipment (NACE 30-33). The industrial production index produced by the CSO is weighted by gross value added and the seasonally adjusted index for manufacturing has increased by 179 per cent from the first quarter of 1995 to the third quarter of 2004. Many of the companies within these groups are multinationals and are characterised by a relatively low labour share with only a small percentage of the gross value added distributed to the domestic workforce. This means a large proportion of the value added is accounted for in the profits of these companies and not in domestic wages.

In an attempt to gauge the importance of the industrial sector to the domestic economy we weight industrial production using employment and wage bill weights. Using either set of weights considerably reduces the intensity of growth, with the employment and wage bill weighted indices increasing by 88 and 99 per cent respectively over the period. Growth in industrial production using a wage bill weighted index and excluding the chemicals sector was 80 per cent over the period and when electrical and optical equipment is also excluded, industrial production only expanded by

47 per cent over the period. In the third quarter of 2004 the wage bill weighted index implies that output grew on a seasonally adjusted basis by 2.4 per cent, whereas excluding the "Modern Sectors" the comparable growth was a meagre 0.3 per cent.

Services

Output in the services sector increased by 3.4 per cent in the second quarter of 2004 when compared to the same period of 2003. The largest proportion of the increase was accounted for by output growth in Other Services where a growth rate of 3.7 per cent was recorded. The growth in Distribution, Transport and Communications was also strong at 3.5 per cent. Public Administration and Defence performed relatively poorly, recording a minor increase of 0.3 per cent.

The NCB Monthly Report on Services, which reports on all private sector services in Ireland, excluding retail and wholesale, indicates a sustained expansion in services activity and new business recorded in October. Survey data point to a robust expansion in activity for the seventeenth month in a row, with expectations for further growth in the future. The report shows the expansion to be broad based across all four sectors of the services economy surveyed, namely Business Services, Financial Services, Technology, Media, Telecoms (TMT) and Transport, Travel Tourism and Leisure. In line with the recent trends observed in the industrial sector, expectations of future activity remains positive, reflecting sustained confidence among service providers about future prospects for the Irish economy. The Business Expectations Index stood at 74.7 in October, remaining well above the critical inflection point of 50.0. While service providers in all four broad sectors of the services industry expressed significant levels of confidence, those in the Technology, Media and Telecoms remained the most optimistic.

Following on from the strength in the services sector so far this year, an overall growth rate of 4.8 per cent is expected for 2004. This rate of growth will be maintained in 2005.

Employment

The Quarterly National Household Survey (QNHS) for the third quarter of 2004 shows that the current upswing in economic activity continues to have a strong positive impact on conditions in the labour market. Employment growth accelerated in the third quarter to 3.1 per cent on an annual basis as compared to growth of 2.3 per cent in the second quarter. In absolute terms, this represents an annual increase of 57,200 persons to just under 1.9 million persons employed. This constitutes the highest level of annual growth in employment since the first quarter of 2001. Increases in full-time employment account for just under 90 per cent of the annual increase, with 61 per cent of this attributable to increases in male employment. The third quarter QNHS covers the June to August period and given that this coincides with school and college holidays, this quarter is usually the one with the highest seasonal factors. When seasonal factors are taken into account employment increased by 0.7 per cent on a quarterly basis.

The largest annual increase in employment was recorded in the construction sector (+21,600), with employment in financial services (+12,500), other services (13,000), wholesale and retail trade (+9,200) and health (+8,300) also showing robust growth. A substantial fall in employment in hotels and restaurants (-7,600) was recorded. In addition, agriculture, other production industries and education all saw absolute declines compared to the same period last year. After adjusting for seasonal factors the largest quarterly increases were in construction (+7,900) and health (+3,600) while the largest fall in employment was recorded in other production industries (-2,000).

Labour force growth strengthened in the third quarter and increased by 2.7 per cent, following annual growth of 2.4 per cent in the second quarter. In absolute terms this was an increase of 52,200 persons with the overall labour force now standing at nearly 2 million. The unemployment rate declined on an annual basis to 4.7 per cent in the third quarter as compared with 5.1 per cent in the previous year. The seasonally adjusted unemployment rate fell to 4.4 per cent as compared to 4.6 per cent in the second quarter of the year. In absolute terms there were 93,900 people unemployed in the third quarter a decrease of 4,900 on an annual basis.

The latest Live Register Analysis for November indicates that the register decreased by 3,500 on a seasonally adjusted basis and by an almost identical amount in annual terms. The seasonally adjusted decrease in the live register confirms the upturn in the labour market. The standardised unemployment rate has been coming down gradually since July and stood at 4.3 per cent in November. Different seasonal factors, especially students in transition to employment, help explain the difference between unemployment rates recorded by the QNHS and the Live Register.

TABLE 8: Employment and Unemployment*

	Annual Averages			
	2002	**2003**	**2004**	**2005**
Agriculture	125	120	119	119
Industry	496	499	511	519
Services	1,156	1,192	1,228	1,259
Total at Work	**1,777**	**1,811**	**1,859**	**1,897**
Unemployed	82	88	86	85
Labour Force	**1,859**	**1,899**	**1,945**	**1,982**
Unemployment Rate %	4.4	4.6	4.4	4.3
Live Register	162	172	166	161

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

It is estimated that employment growth will average 2.6 per cent in 2004 before moderating to average 2.0 per cent in 2005. We expect continued job losses in agriculture to be more than offset by employment growth in the industrial and services sector. We anticipate that employment in the services sector will continue to drive total employment, although industry is likely to make a stronger contribution to employment growth than last year. Labour force growth is expected to moderate, with growth of 2.4 per cent forecast for 2004 and 1.9 per cent for 2005. The unemployment rate is expected to decrease over the forecast horizon averaging 4.4 per cent this year and 4.3 per cent in 2005.

Incomes

Improved domestic economic conditions mean that we have revised up our forecasts for income growth since the previous *Commentary*. We expect that these more favourable economic conditions will foster continued demand for labour and maintain a solid foundation for continued earnings growth. Growth in hourly earnings is estimated at 5.4 per cent in 2003 and is expected to slow to 5.1 per cent and 4.4 per cent in 2004 and 2005 respectively. Although this level of nominal wage growth is quite low compared to recent years, it reflects a low inflationary environment together with continued competitive pressures and the need to anchor the domestic cost base.

Incomes in the agricultural sector are estimated to have grown by 1.3 per cent in 2003. Income growth for the sector is expected to remain weak at 1.9 per cent this year before increasing to 2.0 per cent in 2005. We expect growth of the non-agricultural wage bill to increase in the short term, reflecting the strengthening in the demand for labour. Given our hourly earnings and employment growth forecasts, we predict that non-agricultural wages will increase by 8.1 per cent this year and 6.7 per cent in 2005. Other non-agricultural personal incomes, which mainly represent income from profits and rents, are estimated to fall by 0.4 per cent in 2004 and increase by 3.1 per cent in 2005.

Following extraordinary growth of 29 per cent in 2002, the volume growth of net factor payments slowed substantially in 2003 to around 7.3 per cent. We forecast growth of 7.0 and 6.7 per cent respectively in 2004 and 2005 arising from the strengthening international economy, which will boost the profits of many of the multinationals located within Ireland and therefore increase repatriations, which make up the vast majority of net factor payments.

TABLE 9: Personal Disposable Income

	2002	Change		2003	Change		2004	Change		2005
	€m	%	€m	€m	%	€m	€m	%	€m	€m
Agriculture, etc.	2,877	1.3	38	2,915	1.9	55	2,970	2.0	60	3,030
Non-Agricultural Wages	49,806	7.2	3,596	53,402	8.1	4,331	57,733	6.7	3,870	61,603
Other Non-Agricultural Income	14,316	3.9	553	14,869	-0.4	-66	14,803	3.1	454	15,257
Total Income Received	**66,999**	**6.2**	4,187	**71,186**	**6.1**	**4,320**	**75,506**	**5.8**	**4,384**	**79,889**
Current Transfers	13,174	12.0	1,579	14,753	11.2	1,654	16,407	10.1	1,652	18,059
Gross Personal Income	**80,173**	**7.2**	**5,766**	**85,939**	**7.0**	**5,974**	**91,913**	**6.6**	**6,036**	**97,948**
Direct Personal Taxes	15,048	4.1	617	15,665	10.5	1,646	17,311	6.0	1,040	18,351
Personal Disposable Income	65,125	7.9	5,148	70,273	6.2	4,328	74,602	6.7	4,996	79,597
Consumption	59,019	6.6	3,916	62,935	5.4	3,378	66,313	6.3	4,169	70,482
Personal Savings	6,106	20.2	1,232	7,338	12.9	950	8,288	10.0	827	9,115
Savings Ratio	9.4			10.4			11.1			11.5

Consumer Prices

At an estimated 2.2 per cent the annual average increase in the consumer index will be lower than the 3.5 per cent recorded in 2003. The moderation in the annual rate of inflation has narrowed the gap between inflation in Ireland and the average for the Euro Area. However, the annual rate of inflation has been increasing since April and the most recent official figures show an annual inflation rate of 2.9 per cent in November. At least some of the increase can be attributed to the impact of higher energy costs on the Irish economy.

As outlined in the international section of this *Commentary* the euro is expected to remain strong in 2005. This will put downward pressure on import prices and also means that interest rates are now not expected to increase until the latter half of 2005. These factors, coupled with the absence of changes to indirect taxes in the recent budget, have resulted in a small downward revision to our forecast for the annual average rate of inflation in 2005. We now anticipate that the annual rate of inflation will remain moderate at an annual average of 2.1 per cent.

TABLE 10: Consumer Price Index – Recent Trend and Forecast

	2000	**2001**	**2002**	**2003**	**2004 Forecast**	**2005 Forecast**
Annual % Change						
Housing	8.8	16.5	0.9	-0.6	3.6	4.3
Other	5.4	4.0	5.0	4.2	2.2	2.2
Total CPI	5.6	4.9	4.6	3.5	2.2	2.1
EU-HICP (Ireland)	5.2	4.0	4.7	4.0	2.6	2.3
Index Dec. 2001=100						
Housing	88.2	102.7	103.7	103.1	106.8	111.4
Other	93.6	98.7	102.6	106.9	109.2	111.6
Total CPI	92.7	97.9	102.7	106.3	108.7	111.3

Public Finances

The Irish public finances continue to be in a very strong position boosted by the strength of activity and a series of tax windfalls from on-going revenue investigations. The stronger than anticipated growth for 2004 is likely to see the predicted deficits for both the Exchequer and General Government balances turn out to be modest surpluses. The general government debt ratio continues to be among the lowest within the EU declining towards 30 per cent of GDP. In contrast to most other EU states, Ireland will have little difficulty complying with the criteria in the *Stability and Growth Pact* for both fiscal deficit and debt positions in 2005. The recent Budget 2005 sets outs a series of measures outlined in Box C which when taken within the fiscal framework as set out in the Stability Update accompanying the Budget, underpins the robust state of the Irish public finances.

Exchequer figures for the year up to November show total receipts up by 10.1 per cent on the same period of 2003. Tax revenues have been the sole driver of this increase, having risen by

11.8 per cent. The main components of this increase were Income Tax (up 17.1 per cent), Value Added Tax (higher by 10.7 per cent) and Corporation Tax (up 5.1 per cent). The improvement in tax receipts can be traced to the state of the economy, with growth in employment, incomes and demand. The other categories of government revenue declined, including non-tax revenue, which was due mostly to a one-off decline in the Central Bank's surplus income from a level boosted by the effects of the final post-EMU review of its portfolio. Government expenditure in the first eleven months of 2004 is up by 6.9 per cent on the same period of 2003. The most significant increases were in Health and Children (up 10.6 per cent), Justice (up 5.7 per cent), Social Welfare (7.6 per cent increase) and Education and Science (up by 8.9 per cent). Decreases in spending were recorded in Agriculture and Food (down 10.5 per cent) and in Communications, Marine and Natural Resources (down 17.9 per cent).

The Exchequer deficit at the end of eleven months is small in relation to GDP and we anticipate that year-end a balanced Exchequer outturn for 2004 is most likely. In terms of the General Government Balance (GGB) we expect a surplus of €1.5 billion to result. The gap between these two measures is largely accounted for by the contributions to the National Pension Reserve Fund (NPRF).

Box C: Measures Contained in Budget 2005

The Minister for Finance delivered the government's budget for 2005 on December 1 2004. In terms of its macroeconomic thrust, the Budget was expansionary, with the Exchequer deficit budgeted at about €3 billion in 2005, in excess of the opening balance of €1.9 billion. A wider measure of the fiscal position of the government sector is General Government Balance. This GGB in 2005 is budgeted at a €1.2 billion deficit, compared with an opening deficit of €318 million.

The main taxation changes involved tax credits and bands with no changes on the rates. The €28,000 standard tax band was increased by 5.7 per cent to €29,600. The employee PAYE tax credit was increased by 22.1 per cent to €1,270, while personal credits rose by 3.8 per cent. These measures will increase the disposable income of wage earners, and are designed to remove persons earning the minimum wage from the tax net. The cost of the tax package in 2005 is estimated at around €500 million or €700 million for a full year cost.

The reduction in stamp duty for first-time buyers purchasing second-hand property is aimed at making house purchase more affordable for first-time buyers. The cost of this measure is estimated at around €60 million for a full year. There were no increases in indirect taxes, which will help to keep the measured rate of inflation low, and reduce the risk of further deterioration in Ireland's price competitiveness.

Social welfare measures included: all pensions rising by €12-€14 per week with child benefit and maternity benefit payments also increased. A full year cost of the social welfare package is €680 million. An additional €290 million is earmarked for disability specific services.

An additional €330 million of capital expenditure was announced on Budget Day in areas of health, education and environmental expenditures. The Multi-Annual Capital Envelopes 2005-2007 were also set out with €237 million carried over from 2004. The aim is to maintain investment at 4.7 per cent of GNP over the period.

The Budgetary measures, when taken in line with the expenditure increases outlined in the Public Services Spending Estimates, appear quite stimulatory. The post-budget estimates provide for net current spending of over 10 per cent with net Exchequer-financed capital spending growth in 2005 of over 20 per cent which is significantly higher than last year given the carry-over permitted under the multi-annual programmes. However, a large part of the Exchequer increase in investment involves a substitution for Public Private Partnerships such that the overall stimulatory impact is not as significant as it appears.

The entire package of tax cuts and expenditure increases is expected to be quite stimulatory for the Irish economy given the present juncture of the economic cycle. We forecast that revenue growth in 2005 at 4.5 per cent will lag expenditure growth substantially such that deficits will re-emerge for both the Exchequer and General Government accounts. Tax revenue was substantially boosted by nearly €700 million in 2004 in a once-off windfall from disclosure of offshore accounts which is unlikely to be repeated in 2005. Also, the public finances are likely to be depressed by around €600 million in 2005 due to timing differences related to EU agricultural payments undertaken by the Irish Exchequer but not reimbursed until 2006. We forecast a current budget surplus of €4.3 billion in 2005 offset by a deficit of €7 billion in the capital account. The difference is the Exchequer borrowing requirement €2.8 billion of which €1.3 billion relates to the NPRF contribution. The GGB is forecast to record a deficit of €1 billion or 0.6 per cent of GDP, well inside the *Stability and Growth Pact* limits.

TABLE 11: Public Finances

	2003	% Change	2004	% Change	2005
Current Revenue	33,157	10.6	36,685	4.5	38,350
Current Expenditure	28,747	7.5	30,908	10.2	34,065
Current Surplus	**4,410**	31.0	**5,777**	-25.8	**4,285**
Capital Receipts	1,288	-13.0	1,120	7.1	1,200
Capital Expenditure	6,678	3.0	6,877	20.4	8,280
Capital Borrowing	**5,390**	6.8	**5,757**	23.0	**7,080**
Exchequer Balance	**-980**		**20**		**-2,795**
as % of GNP	-0.9		0.0		-2.1
General Government Balance	**192**		**1,570**		**-1,007**
as % of GDP	0.1		1.1		-0.6
Gross Debt as % of GDP	**32.1**		**30.3**		**29.8**

The decline from a surplus 1.1 per cent of GDP forecast for 2004 to a 0.6 per cent deficit in 2005 exaggerates the extent of the fiscal stimulus when account is taken of revenue windfalls and underspending of capital budgets this year. The fiscal stance, however, remains expansionary even when these factors are accounted for. Still the general government debt is forecast to decline from 30.3 per cent of GDP in 2004 to 29.8 per cent in 2005.

General Assessment

Given the series of economic setbacks that hit the international economy since the start of this decade, the Irish economy continues to produce exceptionally strong growth rates in both output and employment terms. The recovery that began to take hold in the latter part of 2003 has been maintained into the first half of 2004, with real GNP estimated to have grown by 4.7 per cent in annual terms in the first half of 2004. The growth in employment over the first three-quarters of the year has averaged 2.7 per cent, with employment levels converging on 1.9 million and the labour force heading towards 2 million in 2005.

The third quarter indications would point to the Irish economy continuing to grow strongly despite slowing international growth over the period. Retail sales were up by more than 1 per cent within the quarter while non-mortgage credit growth was particularly strong. Tax receipts under nearly all headings showed a strong surge in the latter part of the year and the trend for unemployment, as captured by the Live Register, was markedly downward. Inflation in terms of consumer prices began to rise back up towards 3 per cent in the latter months of 2004, while asset price inflation remains reasonably robust, particularly within the housing construction sector.

Our estimates for output growth in 2004 are 5.5 per cent for real GDP and 5.1 per cent for real GNP. These rates are indicative of the Irish economy growing in line with its output capacity. The anticipation for 2005 is for growth rates to fall back somewhat to 5 and 4.6 per cent for real GDP and real GNP respectively. This slowing in growth is expected to mirror the path of international growth rates, which while still strong are expected to slow in comparison to this year. The strengthening of the euro throughout 2004 will provide a disinflationary impulse for prices next year. We expect consumer price inflation to average 2.1 per cent in 2005 boosted by the lack of indirect tax rises in Budget 2005 and the forecast impact of oil prices moving lower throughout the year.

A significant factor in the growth of the Irish economy in recent years has been the extent of new house construction. As indicated in previous *Commentaries* a sharp reversal in this trend on its own would knock back the growth prospects quite substantially. We anticipate that new house building output will begin to fall moderately next year and move back to levels more consistent with the need for household formation purposes. A gradual unwinding would obviously be the most favourable situation but nonetheless the economy remains quite exposed to the risk of a more sudden reversal.

We have estimated the likely impacts of such a dramatic swing in this sector. While it is not our forecast a scenario using our ESRI model suggests that output growth would be reduced by around three percentage points if house building were halved from its current level of near 80,000 units all other things being equal. The employment impact would also be very substantial given the construction now accounts for over 210,000 persons or 11.7 per cent of the workforce. The exposure of the economy to this sector is therefore substantial. However, it is difficult to engineer a soft landing from a policy-making perspective. Some policy measures that may steer the market include the expected removal of property-based tax-relief's in 2006 and the change in stamp duty on second-hand houses for first time-buyers which may partially reduce the attractiveness of new house construction projects.

One inhibitor to a sudden collapse in housing demand over the next year is that interest rates in the Euro Area are expected to remain low. The expected path for interest rate rises has been pushed back towards the latter part of 2005 and into 2006. The reappraisal on the trajectory stems from an international context where the US dollar is declining substantially against the euro. The European Central Bank, along with other international monetary authorities, have expressed concerns on the impact a continuing dollar depreciation will have on growth prospects in their economic areas. The ensuing loss of competitiveness may put pressure on the ECB to consider lowering interest rates. This pressure is likely to be resisted but certainly it is less likely that interest rates will start to rise in the Euro Area in the short term.

The likelihood is that the US dollar's depreciation against the euro in the area of €1.30 - €1.40 per € will persist as worries about the twin deficits in the fiscal and external accounts in the US economy remain. China continues to resist a revaluation of its Renminbi currency, which they currently peg to the US dollar. The US dollar has fallen nearly 30 per cent against the major world currencies since 2002 and by even more against the euro. However, its difficulties in part could be helped by an appreciation of the Chinese Renminbi. This would also take pressure off the Euro Area and Japan who are bearing the burden of this adjustment through their competitiveness loss against both the US and China.

The US balance of payments is now at 5.5 per cent of GDP and the budget deficit is at 4.2 per cent of GDP. The budget and balance of payments are linked through private net savings or the balance between private income and private expenditure. This ratio is now at a –1.3 per cent of GDP, which is clearly unsustainable but a dilemma arises in its solution. If US private expenditure growth shrinks, the world economy will also weaken. The dependence of the Euro Area countries and Japan on export-led rather than domestic demand led growth is once again highlighted. In Europe the scope for both monetary and/or fiscal stimulation appear limited given the loose monetary conditions and the restrictive fiscal framework in place.

The international macroeconomic policy context would suggest that there are considerable downside risks for the global economy as the evident imbalances are addressed. The policy context for the Irish economy in 2005, however, does still appear relatively benign. The strength of the public finances and the low debt position provides some room for manoeuvre in the context of a negative near-term shock. The fiscal stance in Budget 2005 is not inappropriate given the uncertainties about the international economy and the durability of growth in domestic private investment linked to house building. Being framed against the backdrop of a relatively strong Exchequer position, whilst attempting to keep in place the unique phase of domestically financed capital investment, the size of the fiscal package in Budget 2005 was reasonably in line with the economy's growth performance. The welfare and tax measures had a progressive tilt with a distributional impact that favours the lower income groups but the overall expenditure growth, while high, is not unsustainable for the economy in its current state.[3]

The favourable outturns for the public finances in 2004, where both the Exchequer and General Government Balance might both turn out to have been in surplus when deficits had been anticipated a year ago, once again highlight the volatility in the revenue and expenditure streams. The positive development with regard to expenditure planning as encapsulated in the multi-annual budgeting process is to be welcomed. The public finances are testimony to the robust strength of the economy.

There are, however, substantial downside risks for our positive assessment of the Irish economy. Two perceptible risks can be easily identified. Internationally the main risk for economic prospects arises from the need to tackle the unsustainable imbalances apparent within the US economy. Domestically the high growth in new house building constitutes a significant risk to growth. A gradual adjustment in either case would be the best outcome but unexpectedly sharp corrections have the potential to reduce Irish growth prospects substantially.

[3] See the article accompanying this *Commentary* by Tim Callan *et al.*, on the distributional impacts of Budget 2005.