SUMMARY

Since the publication of the last *Commentary* in June, the Central Statistics Office has produced revised figures for the National Accounts for the years 2002 through 2004. In the case of both 2002 and 2003, the revisions suggest that economic growth was higher than had previously been thought. For 2004, the opposite is the case. The outturn for GDP growth in 2004 has now been put at 4.5 per cent by the CSO, lower than the 5.3 per cent rate reported in the Summer *Commentary*.

Given the slower pace of economic growth in 2004, the apparent continuation of this slower trend in the first quarter of 2005 and the increasing oil price, it might have been expected that we would have revised downward our forecast for GDP volume growth in 2005. The actual downward revision is very modest and we are now forecasting a figure of 5.7 per cent (down from 6 per cent in the Summer *Commentary*). The main reason for staying with a largely optimistic view is the increase in employment recorded by the CSO in the *Quarterly National Household Survey* (Q2). The year-on-year employment increase of 93,000 (5.1 per cent) suggests that the economy is performing extremely well. For 2006, our GDP volume forecast is 5 per cent, down from 2005 but still high.

For employment, we forecast an average of 1.945 million in 2005, an increase of 80,000 over the 2004 average. We forecast employment growth to be lower in 2006 (49,000), mainly as a result of a marginal decline in house construction. The unemployment rate is forecast to remain at 4.2 per cent in 2005 and 2006. As regards CPI inflation, our forecast for 2005 is an average rate of 2.3 per cent, rising to 2.5 per cent in 2006.

The international context is somewhat mixed. In spite of oil price increases and Hurricanes Katrina and Rita, forecasts for global growth remain upbeat mainly because of strong performances in the US and China. However, closer to home, the UK economy is now performing less well than in recent times and hopes of a sustained recovery in Germany were dealt a blow by the inconclusive election result. The reduced probability of a sustained recovery in Germany has led us believe that any increase in interest rates in 2006 is now more likely to happen in the final quarter. This will be positive for growth in Ireland. In this context we should also note that long-term interest rates have been falling in Europe, thereby providing an additional positive impulse. It is anticipated that this will contribute to a partial recovery in the Euro Area in 2006, with GDP growth rising to 1.8 per cent (from a forecast rate of 1.2 per cent in 2005).

While our overall assessment of the economy is favourable, there are two concerns as we look forward. First, while recent employment gains have been impressive, the fact that they have been so heavily concentrated in one sector (construction) raises a question of sustainability. Second, global imbalances remain a large threat to the world economy and potentially much more so than oil prices. With the US current account deficit over 6 per cent of GDP, the possibility remains of a dollar decline and/or a sharp fall in US imports, both of which would be damaging to Ireland.

PRELIMINARY NATIONAL ACCOUNTS 2004

A: Expenditure on Gross National Product

	2003	2004	Change in 2004				
		Preliminary	€m		%		
	€m	€m	Value	Volume	Value	Price	Volume
Private Consumer Expenditure	65,227	68,540	3,314	2,479	5.1	1.2	3.8
Public Net Current Expenditure	19,014	20,807	1,793	456	9.4	6.9	2.4
Gross Fixed Capital Formation	31,948	36,290	4,342	2,544	13.6	5.2	8.0
Exports of Goods and Services (X)	116,379	123,519	7,140	8,095	6.1	-0.8	7.0
Physical Changes in Stocks	1,218	793	-425	-452			
Final Demand	**233,786**	**249,949**	**16,164**	**13,122**	**6.9**	**1.2**	**5.6**
less:							
Imports of Goods and Services(M)	94,087	100,687	6,600	7,121	7.0	-0.5	7.6
less:							
Statistical Discrepancy	602	706	105	-300			
GDP at Market Prices	**139,097**	**148,556**	**9,459**	**6,301**	**6.8**	**2.2**	**4.5**
less:							
Net Factor Payments (F)	22,723	24,306	1,583	1,656	7.0	-0.3	7.3
GNP at Market Prices	**116,374**	**124,250**	**7,876**	**4,645**	**6.8**	**2.7**	**4.0**

B: Gross National Product by Origin

	2003	2004	Change in 2004	
		Preliminary		
	€m	€m	€m	%
Agriculture, Forestry, Fishing	2,819	2,912	93	3.3
Non-Agricultural: Wages, etc.	53,484	58,220	4,736	8.9
Other:	52,201	54,291	2,090	4.0
Adjustments: Stock Appreciation	434	-309		
Financial Services	0	0	0	0.0
Statistical Discrepancy	602	706	105	17.4
Net Domestic Product	**109,540**	**115,820**	**6,281**	**5.7**
less:				
Net Factor Payments	22,723	24,306	1,583	7.0
National Income	**86,817**	**91,514**	**4,698**	**5.4**
Depreciation	14,645	15,756	1,111	7.6
GNP at Factor Cost	**101,462**	**107,270**	**5,809**	**5.7**
Taxes less Subsidies	14,912	16,980	2,067	13.9
GNP at Market Prices	**116,374**	**124,250**	**7,876**	**6.8**

C: Balance of Payments on Current Account

	2003	2004	Change in 2004
		Preliminary	
	€m	€m	€m
Exports (X) less Imports (M)	22,292	22,832	540
Net Factor Payments (F)	-22,723	-24,306	-1,583
Net Transfers	432	306	-126
Balance on Current Account	**1**	**-1,168**	**-1,169**
as % of GNP	0.0	-0.9	-0.9

FORECAST NATIONAL ACCOUNTS 2005

A: Expenditure on Gross National Product

	2004	2005	Change in 2005				
	Preliminary €m	Forecast €m	€m Value	€m Volume	% Value	% Price	% Volume
Private Consumer Expenditure	68,540	73,901	5,361	3,770	7.8	2.2	5.5
Public Net Current Expenditure	20,807	22,550	1,743	707	8.4	4.8	3.4
Gross Fixed Capital Formation	36,290	40,108	3,818	2,234	10.5	4.1	6.2
Exports of Goods and Services (X)	123,519	129,407	5,888	5,928	4.8	0.0	4.8
Physical Changes in Stocks	793	295	-498	175			
Final Demand	**249,949**	**266,260**	**16,311**	**12,813**	**6.5**	**1.3**	**5.1**
less:							
Imports of Goods and Services (M)	100,687	106,705	6,018	5,350	6.0	0.6	5.3
less:							
Statistical Discrepancy	706	-1,334	-2,040	-1,007			
GDP at Market Prices	**148,556**	**160,889**	**12,333**	**8,471**	**8.3**	**2.5**	**5.7**
less:							
Net Factor Payments (F)	24,306	25,007	701	1,474	2.9	-3.0	6.1
GNP at Market Prices	**124,250**	**135,883**	**11,633**	**6,997**	**9.4**	**3.5**	**5.6**

B: Gross National Product by Origin

	2004	2005	Change in 2005	
	Preliminary €m	Forecast €m	€m	%
Agriculture, Forestry, Fishing	2,912	2,950	38	1.3
Non-Agricultural: Wages, etc.	58,220	64,165	5,945	10.2
Other:	54,291	59,357	5,066	9.3
Adjustments: Stock Appreciation	-309	-510		
Financial Services	0	0	0	0
Statistical Discrepancy	706	-1,334	-2,040	-288.9
Net Domestic Product	**115,820**	**124,628**	**8,808**	**7.6**
less:				
Net Factor Payments	24,306	25,007	701	2.9
National Income	**91,514**	**99,622**	**8,108**	**8.9**
Depreciation	15,756	17,148	1,392	8.8
GNP at Factor Cost	**107,270**	**116,770**	**9,500**	**8.9**
Taxes less Subsidies	16,980	19,113	2,133	12.6
GNP at Market Prices	**124,250**	**135,883**	**11,633**	**9.4**

C: Balance of Payments on Current Account

	2004	2005	Change in 2005
	€m	Forecast €m	€m
Exports (X) less Imports (M)	22,832	22,702	-130
Net Factor Payments (F)	-24,306	-25,007	-701
Net Transfers	306	209	-97
Balance on Current Account	**-1,168**	**-2,095**	**-927**
as % of GNP	-0.9	-1.5	-0.7

FORECAST NATIONAL ACCOUNTS 2006

A: Expenditure on Gross National Product

	2005	2006	Change in 2006				
	Forecast €m	Forecast €m	€m		%		
			Value	Volume	Value	Price	Volume
Private Consumer Expenditure	73,901	80,220	6,319	4,286	8.6	2.6	5.8
Public Net Current Expenditure	22,550	24,500	1,950	812	8.6	4.9	3.6
Gross Fixed Capital Formation	40,108	42,701	2,593	1,361	6.5	3.0	3.4
Exports of Goods and Services (X)	129,407	138,014	8,607	6,276	6.7	1.7	4.8
Physical Changes in Stocks	295	290	-5.0	175			
Final Demand	**266,260**	**285,724**	**19,464**	**12,910**	**7.3**	**2.3**	**4.8**
less:							
Imports of Goods and Services (M)	106,705	113,803	7,099	5,019	6.7	1.9	4.7
less							
Statistical Discrepancy	-1,334	-1,228	106	-164			
GDP at Market Prices	**160,889**	**173,149**	**12,260**	**8,056**	**7.6**	**2.5**	**5.0**
less:							
Net Factor Payments (F)	25,007	26,886	1,879	1,352	7.5	2.0	5.4
GNP at Market Prices	**135,883**	**146,263**	**10,381**	**6,704**	**7.6**	**2.6**	**4.9**

B: Gross National Product by Origin

	2005	2006	Change in 2006	
	Forecast €m	Forecast €m	€m	%
Agriculture, Forestry, Fishing	2,950	3,010	60	2.0
Non-Agricultural: Wages, etc.	64,165	68,974	4,808	7.5
Other:	59,357	63,785	4,428	7.5
Adjustments: Stock Appreciation	-510	-450		
Financial Services	0	0	0	0
Statistical Discrepancy	-1,334	-1,228	106	-7.9
Net Domestic Product	**124,628**	**134,090**	**9,462**	**7.6**
Net Factor Payments	25,007	26,886	1,879	7.5
National Income	**99,622**	**107,204**	**7,583**	**7.6**
Depreciation	17,148	17,988	840	4.9
GNP at Factor Cost	**116,770**	**125,193**	**8,423**	**7.2**
Taxes less Subsidies	19,113	21,071	1,958	10.2
GNP at Market Prices	**135,883**	**146,263**	**10,381**	**7.6**

C: Balance of Payments on Current Account

	2005 Forecast €m	2006 Forecast €m	Change in 2006 €m
Exports (X) less Imports (M)	22,702	24,210	1,508
Net Factor Payments (F)	-25,007	-26,886	-1,879
Net Transfers	209	150	-59
Balance on Current Account	**-2,095**	**-2,525**	**-430**
as % of GNP	-1.5	-1.7	-0.3

The International Economy

General

Before discussing the details of the international economy, we should point out that the forecasts included here are based largely on the work of the European Forecasting Network (EFN). The EFN is a consortium of nine leading research institutes, including The Economic and Social Research Institute (ESRI), that is in the first year of a three-year programme of producing economic forecasts and policy assessment for the Euro Area. The programme is co-financed by the European Commission. It is our intention to continue drawing on the work of the EFN over the life of the consortium so that the material here is informed by the latest thinking from the leading institutes.

As regards the overall assessment of the international economy, two broad points can be made. First, in spite of Hurricanes Katrina and Rita and the rising oil price, the prospects for the US economy remain positive with GDP growth forecast to be 3.3 per cent in 2005 and 3.2 per cent in 2006. Second, closer to home the picture is less optimistic. The UK economy has slowed with growth this year forecast to be 1.9 per cent. And while some positive signs had been emerging from Germany in recent months, the inconclusive election result suggests a delay in further structural reforms and a blow to business and consumer confidence. In spite of this, growth in the Euro Area is forecast to rise to 1.8 per cent in 2006, from a forecast rate of 1.2 per cent in 2005. This is partly explained by a fall in long-term interest rates.

United States

The United States economy continues to record solid growth rates. The volume of Gross Domestic Product (GDP) rose by 3.6 per cent in the second quarter of 2005, when compared with the same period of last year. This is exactly the same as the growth rate attained in the first quarter of this year, though it represents a slowdown on the 4.2 per cent growth in 2004.

Domestic demand continues to be the key driver of economic growth. The volume of consumption rose by 3.8 per cent in the second quarter of this year against the same period of 2004, an acceleration from the 3.5 per cent growth of the previous quarter. Spending on durable goods is particularly strong, rising by 6.6 per cent, while expenditure on services is the weakest segment of consumer demand, up by 2.9 per cent. The traditionally volatile investment component of aggregate demand recorded a sharp slowdown in the second quarter of 2005. The increase of 4.1 per cent contrasts with an expansion of 10.1 per cent in the previous quarter, with the slowdown concentrated in the area of residential investment.

The external sector continues to subtract from the growth arithmetic of the United States economy. The volume of exports rose by 8.3 per cent year on year in the second quarter of this year, against an import volume growth rate of 5.9 per cent. However, given that the level of imports is much higher than the level of exports, the overall contribution of net exports to US demand growth is negative. Notwithstanding this, export growth significantly in excess of import growth has not been observed in the United States in recent years. The sustained acceleration in the growth of services exports in recent quarters has made a vital contribution to the emergence of faster export volume growth overall. Developments with regard to the external sector have resulted in a widening of the US goods and services deficit, which stood at $173.3 billion in the second quarter of 2005, equivalent to 5.6 per cent of GDP. This is a slightly deeper shortfall than the $173.1 billion deficit in the first quarter. The recent sharp upsurge in fuel prices has been a key driver of this deterioration, as fuel constitutes a significant component of the US import profile.

The strong growth in domestic demand evident in the US economy has translated into continued buoyancy in the labour market. The rate of unemployment was 5.2 per cent in the quarter ended May 2005, but it has since fallen to a 5.0 per cent rate in the three month period ended in August.

It is our view that the external imbalances continue to pose a threat to the US economy, partly because of a concern over the ongoing willingness of foreigners to finance the US external deficit. However, for the moment we believe that benign domestic demand conditions will predominate, and solid economic growth will continue for the foreseeable future. Despite concerns surrounding fuel price jumps and the economic disruption following Hurricanes Rita and Katrina, the Federal Reserve's recent interest rate increase suggests that the Fed itself believes that the US economy is still capable of supporting solid growth. Accordingly, it is forecast that GDP growth will average 3.3 per cent this year, and 3.2 per cent in 2006. Inflationary pressures will accelerate somewhat, with price growth of 2.8 per cent this year and 3.4 per cent in 2006.

The European Economy

Euro Area

Figures for the second quarter of 2005 show that Euro Area GDP rose by 1.1 per cent year on year, a slight slowdown from the 1.3 per cent growth rate achieved in the previous quarter. Household consumption expenditure rose by 1.1 per cent, with investment increasing by 1.0 per cent and domestic demand overall expanding by 1.6 per cent. Inventory accumulation was a significant factor in the arithmetic of this growth rate, adding 0.5 percentage points. Movements in the components of external demand were brisk. Exports rose by 3.2 per cent, while imports increased by 4.6 per cent. The net effect of external demand on GDP was negative, subtracting 0.4 percentage points from the growth rate.

The agricultural sector of the Euro Area economy has shown particular weakness in recent times, managing only a 0.2 per cent year on year growth rate in the second quarter of 2005. Construction has come out of contraction to record 0.6 per cent growth. Trade, transport and communication is the only area of the economy to experience sizeable growth, expanding by 2.0 per cent. The pace of the industrial sector has decelerated to a 0.8 per cent growth rate, and the weakness of this sector is corroborated by other indicators. Growth in new industrial orders declined from 3.3 per cent in the quarter ended in March 2005, to a 1.1 per cent rate in the three month period ended June. Industrial production growth weakened from 0.6 per cent to 0.3 per cent over the same period. Predictably, this rather gloomy situation has coincided with a drop in business sentiment. The European Commission's *Business Climate Indicator* fell to -0.24 in the quarter ended July 2005, from a -0.05 level in the previous quarter.

Despite the wave of recent oil price surges, Euro Area inflation has been rather stable over recent quarters. In the three months to July 2005, inflation averaged 2.1 per cent, unchanged from the previous quarter, though July's inflation figure reached 2.2 per cent. Fuels for transport made the largest contribution to price rises, adding 0.42 percentage points to the inflation figure. The 36.3 per cent hike in the cost of heating oil over the last twelve months was responsible for topping up July's inflation rate by 0.25 percentage points. In terms of price decreases, the 0.8 per cent slide in the price of Garments took 0.17 percentage points off the Euro Area inflation rate. Communication costs fell by 2.5 per cent, reducing the inflation rate by 0.13 percentage points.

The poor performance of the German economy has been a significant drag on the Euro Area economy over recent years. In recent months, there are indications that a tentative recovery may be underway. German unemployment has fallen by about 170,000 in the five months to August 2005. Furthermore, official data suggest that a consolidated expansion is taking place in industrial output. A similar upturn in the volume of manufacturing orders augurs well for future growth in the industrial sector. However, the inconclusive result of recent federal elections adds an element of uncertainty. Given the widely held view that reforms to areas of Germany's economic system are required, the failure of either of the main parties to achieve a majority reduces the scope for these decisive measures to be implemented. Considering that about one-third of Euro Area GDP is attributable to the German economy, any sizeable recovery there will have a marked impact on the Euro Area economy generally. The Italian economy remains very fragile, with no upturn likely in the near future. The French economy is performing a little better, with growth expected to top 2 per cent next year.

We expect that growth in the Euro Area economy will remain much the same over the latter half of this year, averaging 1.2 per cent for 2005 overall. Our forecast is for stronger 1.8 per cent growth next year. Inflation this year is likely to average 2.2 per cent, falling to 2 per cent in 2006.

United Kingdom

Latest national accounts data show that the UK economy has slowed. The volume of GDP grew by 1.8 per cent year on year in the second quarter of 2005, down from the 2.2 per cent growth rate in the previous three month period. In terms of the demand components behind the growth, domestic demand rose by 1.5 per cent overall. Investment spending was the most buoyant area of this, expanding by 3.1 per cent. Consumer spending grew by 1.5 per cent. Unusually for the UK economy, external demand made a positive rather than negative contribution to GDP growth in the second quarter of 2005. Its addition of 0.2 percentage points to the GDP growth rate was the net effect of a 6.2 per cent rise in export volumes, and a 4.8 per cent increase in imports. The slowdown in consumer spending may reflect the recent decline in some consumer confidence measures. This, in turn, may be due to the negative effects of recent sluggishness in the housing market, as indicated by the Nationwide and Halifax building society indices. The terrorist attacks on London in July may also have been responsible for some deterioration in consumer sentiment.

The composition of UK economic growth according to sector was quite varied. The services sector returned a solid 2.5 per cent growth rate in the second quarter of this year. However, the production element of the UK economy contracted by 1.7 per cent year on year. In particular, mining and quarrying output fell by 7.5 per cent, and the manufacturing sector shrank by 1.2 per cent. The construction industry grew by 2.8 per cent, but agriculture fell back at a 0.4 per cent rate. The relatively favourable performance of the more labour intensive sectors of the UK economy has underpinned the healthy state of the employment market. The unemployment rate in the quarter ended July 2005 was 4.7 per cent, largely unchanged from the previous quarter and the second lowest rate in the European Union.

There has been some acceleration in the rate of price increase in the UK economy over recent months. The Consumer Price Index (CPI) rose by 2.2 per cent in the quarter ended August 2005, up from the 1.9 per cent growth rate registered in the previous three month period. August's inflation rate of 2.4 per cent was the highest recorded since the inception of the CPI in 1997.

We expect economic growth in the UK to remain below trend in the short-term at least. This rather sluggish outlook prompted the Bank of England to cut interest rates in July. It is forecast that the volume of GDP will grow by 2.0 per cent this year and it will recover slightly in 2006, growing by 2.2 per cent. Despite the recent development in oil prices, we expect that inflation will remain modest. Price rises of 2.1 per cent will occur in 2005 and 2.3 per cent in 2006.

Rest of Europe

The largest of the new members to join the EU last year, Poland, continues to struggle. GDP grew by 2.8 per cent in the second quarter of 2005, and unemployment remains very high. Economic growth in the Czech Republic is at a robust 4.4 per cent rate, while Hungary is experiencing brisk 4.1 per cent growth. The weakness of the German economy is a key factor in the weak 0.8 per cent growth rate of Denmark's GDP. Sweden is faring slightly better, with latest data showing growth of 2.2 per cent. The predominance of oil and gas in Russia's export basket means that high fuel prices have benefited that economy. GDP grew by 5.2 per cent in the first quarter of this year.

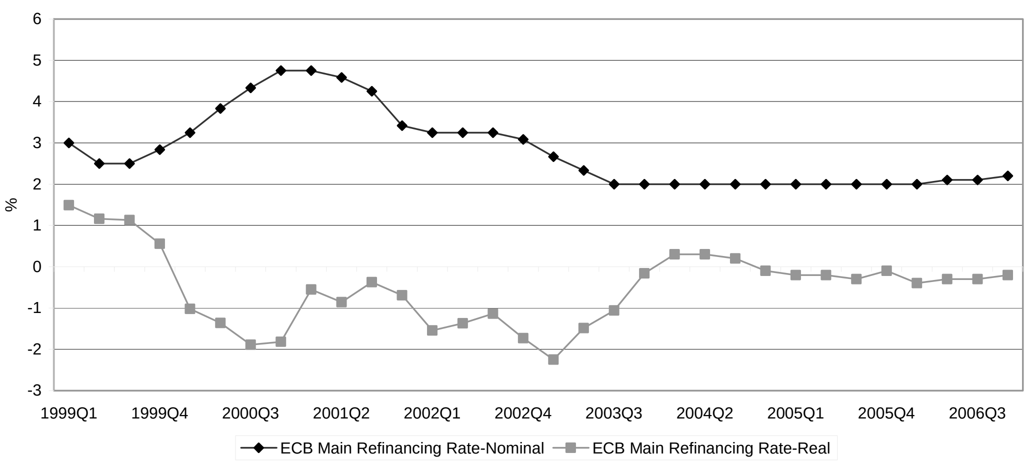
Rest of the World

Japan's economy continues to recover. GDP rose at a rate of 1.4 per cent in the second quarter of 2005 and the EFN is now forecasting growth of over 2 per cent in 2005 and 2006. Domestic demand is the main driver of this growth, with non-residential investment showing significant growth. Unemployment in Japan remains rather low at 4.4 per cent of the labour force. Retail sales are also quite strong, with growth at 3.6 per cent in the year to June.

China's strong economic performance continues unabated. Official data indicate growth of 9.5 per cent in the second quarter of 2005. Remarkably, this rapid pace of expansion is accompanied by subdued inflationary pressures, with consumer prices increasing at 1.8 per cent. One important development in the Chinese economy since the publication of the summer *Commentary* has been the small revaluation of the remnimbi in July. The revaluation was too small for it to have much of an impact of China's trade surplus. Even if it was bigger, doubts surround whether there would be much of an impact for reasons which we explore in the General Assessment below.

Figure 1: Interest Rates

Per Cent per Annum, Quarterly Averages



Context for Ireland

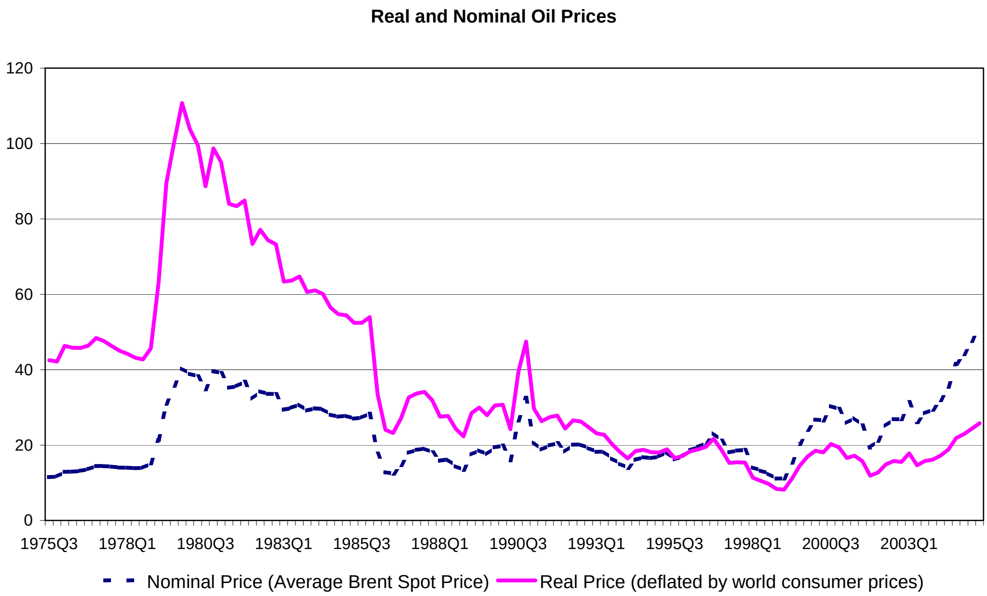
The weak state of the Euro Area economy, and the deceleration underway in the UK will result in limited demand growth for Irish exports from those economies. The continued strength of the US and emerging Asian markets will help to provide some impulse for expansion. The weakness of the Euro Area economy means that any interest rate rises in the immediate future are unlikely, and this will facilitate a strong level of domestic demand. In addition, recent falls in long-term interest rates will provide another positive impulse. The threats posed to the Irish economy from a sudden US adjustment to its external deficit remain a concern.

TABLE 1: Short-term International Outlook

	GDP Output Growth			Consumer Price Inflation			Hourly Earnings Growth			Unemployment Rate %			Current Account Balance % of GNP		
Country	**2004**	**2005**	**2006**	**2004**	**2005**	**2006**	**2004**	**2005**	**2006**	**2004**	**2005**	**2006**	**2004**	**2005**	**2006**
UK	3.2	2.0	2.2	1.3	2.1	2.3	4.5	4.1	5.3	4.8	4.8	4.9	-2.0	-0.3	0.4
Germany	1.1	0.8	1.3	1.7	1.9	1.7	-0.3	0.5	2.6	9.5	9.5	9.2	3.8	3.3	2.8
France	2.0	1.5	2.1	2.3	1.9	2.0	2.7	3.1	3.3	9.7	9.7	9.5	-0.2	-0.6	-0.8
Italy	1.0	0.0	0.9	2.3	2.2	2.6	3.0	3.4	2.0	8.1	7.7	7.7	-0.9	-0.6	-0.7
Euro Area	1.8	1.2	1.8	2.1	2.2	2.0	2.2	2.5	2.9	8.9	8.6	8.4	0.6	-0.3	-0.6
USA	4.2	3.3	3.2	2.6	2.8	3.4	4.6	5.1	5.4	5.5	5.0	4.9	-5.7	-6.4	-6.1
Japan	2.6	2.4	2.3	-0.6	-0.6	-0.5	-0.6	1.0	0.6	4.7	4.2	3.7	3.7	2.8	2.2
China	9.5	9.1	8.1	3.9	3.5	3.6									
OECD	3.4	2.6	2.7	1.7	1.8	2.1									
Ireland	4.5	5.7	5.0	2.2	2.3	2.5	5.3	5.2	4.6	4.4	4.2	4.2	-0.9	-1.5	-1.7

Box A: Oil Price Shocks

In recent months the world economy has had to deal with strong rises in the price of oil. Figure A1 shows the movement in nominal and real oil prices from the late 1970s. Over the course of 2005 nominal oil prices have reached new historical highs, although more moderate increases have been seen in the real price of oil. The real price of oil has doubled since 1999 but it remains relatively low in comparison to the levels seen subsequent to the oil price shock in 1979.



Source: National Institute of Economic and Social Research Database.

Much of the recent rise in the oil price can be attributed to strong global demand, especially from China, while on the supply side low investment in the refining and distribution sector in recent years and geopolitical tensions have generated volatility in the price. Forecasts from the US Department of Energy indicate that growth in global oil demand will remain strong at 2.1 per cent for 2005 and 2006 slightly down from the 3.2 per cent increase recorded in 2004. This robust growth in demand means that oil prices are unlikely to decline in the short term. Underpinning the forecasts in this *Commentary* is the assumption that oil prices will remain at around $60 per barrel until the end of 2006.

Even though we are not forecasting a further increase in oil prices it is important to consider the sensitivity of the economy to such a possibility. The impact of a rise in oil prices on inflation and output varies across countries and depends on the response of monetary authorities and the labour market. In turn, this depends on whether they believe the shock to be permanent or temporary. A permanent shock will have a larger effect on output because, in a world where people look to the future, a permanent shock affects expectations, causing the economy to adjust now to anticipated future conditions. However, it is not clear which type of shock has a bigger impact on prices. If a shock is perceived to be temporary it will not change medium-term inflation expectations so we would expect a temporary shock to have a smaller impact on inflation. In addition, monetary authorities are less likely to respond by increasing interest rates when facing a temporary price shock. However, in the case of permanent shocks the more negative impact on output provides downward pressure on the price level, which will negate some of the upward pressure caused by higher oil prices.

Using the *NiGEM* global model we simulated the impact of a temporary and a permanent $15 increase in the price of oil.[1] The results for the international environment are then used in the ESRI *HERMES* macroeconomic model to examine the impact of the shock on the Irish economy. The results are presented in Table A1 below.

Table A1: Temporary Versus Permanent Oil Price Rises (Cumulative Per Cent Difference from Base)

	$15 Permanent Increase					
	USA		Euro Area		Ireland	
Year	Output	Inflation Rate	Output	Inflation Rate	Output	Inflation Rate
1	-0.3	0.4	-0.2	0.4	-0.3	0.7
2	-0.6	0.9	-0.4	0.5	-0.7	0.3

	$15 Temporary Increase					
	USA		Euro Area		Ireland	
Year	Output	Inflation Rate	Output	Inflation Rate	Output	Inflation Rate
1	-0.1	0.5	-0.1	0.4	-0.1	0.9
2	-0.1	1.3	-0.2	0.5	-0.3	0.2

Note: Output effects are measured by the cumulative per cent difference from base. Impact on inflation rate is measured as percentage points from base. The measure of inflation used here is the consumer expenditure deflator.

Under both simulations the impact of higher oil prices is more negative in the US than in the Euro Area because the US has a higher oil intensity of production. The results also show that the impact is smaller when the shock is temporary. In the US, monetary authorities react more aggressively in the case of the permanent shock to bring inflation under control. The impact on the Irish economy of either type of shock is slightly more marked. Ireland would be impacted through three main channels. First, in both shocks the euro depreciates against the dollar in the short term leading to an adverse movement in our terms of trade resulting in a loss of income. In addition, Ireland is more sensitive to the slowdown in growth in the rest of the world and interest rate hikes.

[1] The impact on the international economy is based on simulation results from the *NiGEM* model of the National Institute of Economic and Social Research. We assume that the $15 increase in oil prices is sustained for two years in the case of the temporary shock.

The impact of a permanent oil price shock would be to knock around 0.3 percentage points off the level of GNP in the first year, and as a result of the lower level of activity the unemployment rate would increase by around 0.3 percentage points (see Table A2). Higher oil prices directly raise the level of consumer prices and have knock on effects for wages. Despite the increase in wages, real personal disposable income would fall due to the impact of higher consumer prices. The impacts on output and employment are less severe when the shock is temporary.

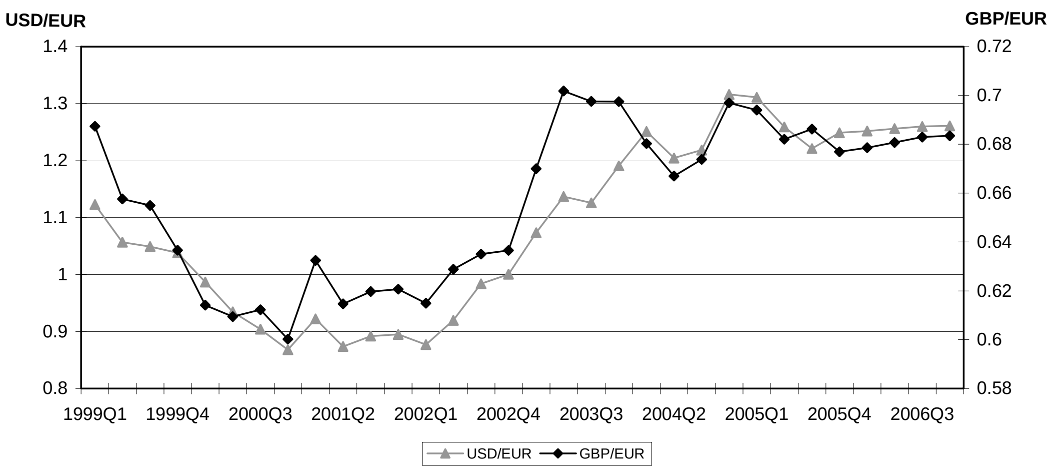
Table A2: Impact of Oil Price on the Irish Economy (Cumulative Per Cent Difference from Base)

$15 Permanent Increase		
	Year 1	**Year 2**
Total Employment	-0.3	-0.6
Unemployment Rate*	0.3	0.4
Real Personal Disposable Income	-0.8	-1.9
$15 Temporary Increase		
	Year 1	**Year 2**
Total Employment	-0.3	-0.4
Unemployment Rate*	0.2	0.2
Real Personal Disposable Income	-0.6	-1.5

* Percentage points from base.

Figure 2: Exchange Rates

Foreign Currency per Euro, Quarterly Averages



The Domestic Economy

General

Relatively robust growth continues in the Irish economy. Domestic demand is particularly strong, and is now the largest driver of economic growth. The direct effect of the external sector on growth has been negative in recent quarters, with export growth being exceeded by increases in imports. Record employment growth, with the accompanying trends of record inward migration and increased participation, point to an economy that is performing strongly. Despite recent fuel price surges, inflation is expected to remain generally modest.

TABLE 2: Exports of Goods and Services

	2003	% Change in 2004		2004	% Change in 2005		2005	% Change in 2006		2006
	€m	Volume	Value	€m	Volume	Value	€m	Volume	Value	€m
Agricultural	4,251	9.3	7.1	4,553	2.2	1.7	4,630	3.0	4.9	4,855
Manufactured	70,556	4.2	2.1	72,029	3.5	3.0	74,177	4.1	6.2	78,763
Other Industrial	6,318	7.2	5.1	6,639	3.0	2.0	6,770	4.0	6.9	7,238
Other	950	-9.6	-11.4	842	2.0	2.5	863	3.5	6.6	920
Total Visible	**82,076**	**4.5**	**2.4**	**84,063**	**3.4**	**2.8**	**86,440**	**4.0**	**6.2**	**91,775**
Adjustments	-3,762	-0.1	1.9	-3,834	-15.0	-6.5	-3,585	-20.0	0.0	-3,585
Merchandise	**78,314**	**4.7**	**2.4**	**80,229**	**4.3**	**3.3**	**82,855**	**5.1**	**6.4**	**88,191**
Tourism	3,409	-0.8	1.1	3,445	4.0	5.9	3,647	3.0	5.6	3,851
Other Services	33,724	12.9	14.9	38,762	6.0	7.6	41,704	4.9	7.0	44,622
Exports of Goods and Services	**115,447**	**7.0**	**6.1**	**122,436**	**4.8**	**4.7**	**128,207**	**4.8**	**6.6**	**136,664**

Exports

Quarterly national accounts in the first quarter of 2005 indicate that the volume of goods and services exports fell by 1.0 per cent year on year. This contrasts with growth of 2.9 per cent in the final quarter of last year. Given that the value of exports fell by 1.3 per cent in the first three months of this year, it can be inferred that the unit value of exports contracted by 0.3 per cent over the same period.

Figures from the second quarter for goods show a more positive story. The export of goods grew by 4.7 per cent for the quarter ended in June 2005. The fact that the value of goods exports for the same period rose by 5.0 per cent implies that the unit value of goods exports rose by 0.3 per cent. Key sectors include chemicals, with the value of exports increasing by 5.1 per cent in the first half of 2005 to €20.4 billion. The machinery and transport equipment category's exports were valued at €10.9 billion, a drop of 3.4 per cent year on year. The weak external environment had some impact on export performance. Several major export markets exhibited weakness during the first six months of this year. For example, goods exports to Germany fell by 5.0 per cent year on year and goods exports to the UK fell by 3.2 per cent to €7.2 billion. The Japanese market showed some growth, rising by 5.3 per cent.

Export growth is expected to average 4.8 per cent in volume terms in 2005, down from 7 per cent growth in 2004. The same rate of volume increase is expected for 2006.

Investment

Latest official data indicate that the volume of investment increased by 10.0 per cent year on year in the first quarter of 2005. This represents a strong rebound from the previous quarter, when investment actually dropped by 0.1 per cent. The recent strong expansion of investment reflects the broad based health of the economy which is evident in employment and output indicators. Up until recently, house building growth was a crucial driver of measured investment increases. It now appears that residential construction activity is broadly holding up on last year's record 76,954 completions. House completions numbered 47,828 in the first eight months of 2005. Some slowdown has occurred in house prices, however, with the Permanent TSB ESRI *House Price Index* showing growth of 6.4 per cent in house prices in the quarter ended July 2005, a slowdown from the previous quarter's 7.3 per cent rise. There are indications that activity in the housing market will continue to remain relatively strong; the number of planning permissions for dwelling units increased by 10.9 per cent in the quarter ended March 2005.

With further growth unlikely in the house building sector, investment expansion depends largely on the corporate sector adding to its capital stock. There is some evidence that this is occurring. The value of capital goods imports rose by a weighty

38.9 per cent year on year in the quarter ended May 2005. This may be a harbinger of further strong investment performance in the short term.

Large rises in machinery investment and non-housing construction will underpin growth of 6.2 per cent in the volume of investment this year. Growth will moderate in 2006 to 3.4 per cent, largely influenced by a levelling off in the building sector.

Consumption

The speed of household consumption growth has accelerated over recent months. The volume of consumption spending rose by 5.8 per cent year on year in the first quarter of 2005, compared with a 3.2 per cent growth rate in the previous quarter. This outturn means that the household sector is now the major driver of demand in the Irish economy, and such exuberance reflects a mix of positive stimuli. These include low real interest rates, easily accessible credit, strong employment growth, a largely benign outlook and positive wealth effects deriving from strong property prices. Despite these circumstances, the ESRI Consumer Sentiment Index fell to 95.7 in the quarter ended August 2005 having measured 99.6 in the previous three months. This decline may be largely due to high profile manufacturing job losses during the review period and increases in the price of oil.

The motor trade has benefited from the strength of the household sector. New private car registrations increased by 10.9 per cent in the second quarter of 2005. The broader retail sales volume measure showed more modest growth, up 3.9 per cent year on year over the same period. The large expansion in the stock of new dwellings supported growth of 8.8 per cent in the volume of sales from the hardware, paint and glass sector. Another area that is performing well is textiles and clothing, where sales are up 8.4 per cent. This demand increase is due in some degree to the falling price of goods in that category. Surprisingly, furniture and lighting sales decreased by 0.8 per cent in the second quarter of this year, while the contraction in bar sales is levelling out, with sales falling only slightly, at a 0.7 per cent rate. The rather resilient state of consumption spending is underlined by the fact that the value of consumer goods imports rose by 6.4 per cent in the quarter ended May 2005.

TABLE 3: Gross Fixed Capital Formation

	2003 €m	% Change in 2004		2004 €m	% Change in 2005		2005 €m	% Change in 2006		2006 €m
		Volume	Value		Volume	Value		Volume	Value	
Housing	13,785	12.9	23.0	16,956	1.5	6.9	18,122	-1.0	1.5	18,390
Other Building	9,443	3.4	7.8	10,183	9.5	13.2	11,529	6.0	9.2	12,588
Building and Construction	23,228	9.1	16.8	27,139	4.6	9.3	29,652	1.8	4.5	30,978
Machinery and Equipment	8,720	5.0	4.9	9,151	10.5	14.3	10,456	7.5	12.1	11,723
Total	31,948	8.0	13.6	36,290	6.2	10.5	40,108	3.4	6.5	42,701

We forecast that private consumption growth will remain strong over the foreseeable future. Growth is expected to average 5.5 per cent both this year and 5.8 per cent next year. This acceleration next year is partly explained by the maturing of some SSIAs. We envisage two types of effects. Firstly, some of the money saved will be spent. Second, for those who were saving in response to the incentive, they may revert to previous consumption levels. Public expenditure will be more muted, rising by 3.4 per cent this year, and by 3.6 per cent in 2006.

TABLE 4: Consumption Indicators

	Annual Percentage Change				
	2002	**2003**	**2004**	**2005 Forecast**	**2006 Forecast**
Consumption Value					
Personal Consumption	8.6	7.5	5.1	7.8	8.6
Retail Sales Index, Value	2.6	3.2	4.4	6.5	5.5
Divergence	6.0	4.3	0.7	1.3	3.1
Consumption Volume					
Personal Consumption	2.8	3.4	3.8	5.5	5.8
Retail Sales Index, Volume	0.1	0.9	3.2	4.5	3.5
Divergence	2.7	2.5	0.6	1.0	2.3
Consumer Prices					
Personal Consumption Deflator	5.7	4.0	1.2	2.2	2.6
Retail Sales Index Deflator	2.5	2.3	1.2	1.9	1.9
Consumer Price Index	4.6	3.5	2.2	2.3	2.5

Final Demand

In the first quarter of 2005, domestic demand jumped by 6.7 per cent, having risen by 1.5 per cent in the previous quarter. Net external demand, on the other hand, plummeted by 20.7 per cent in the first quarter of this year having dipped by 1.3 per cent in the last quarter of 2004. Taking these figures together, Final Demand rose by 2.8 per cent in the first three months of 2005, a slight acceleration on the previous quarter's 2.2 per cent rate of increase. Final demand is projected to grow strongly in 2005, by 5.1 per cent, and by 4.8 per cent in 2006.

Imports

According to the latest set of national accounts, the volume of goods and services imports increased by 4.2 per cent year on year in the first quarter of 2005. This represents a slight pick up on the 3.8 per cent growth observed in the previous three months. Given that the value of imports was 4.5 per cent higher in the first quarter of this year, unit price growth was slight, at 0.3 per cent. Trade figures show that the growth of goods imports is particularly strong. The volume of goods imports increased by 8.8 per cent in the second quarter of the year. When the value growth of 8.7 per cent is taken into account, it is evident that very weak deflation is occurring in the imported goods sector. This may be partly due to the competitive international market conditions prevailing, as well as the rather strong position of the Euro on foreign exchange markets.

In terms of sectors, imports of machinery and transport equipment grew to €12.3 billion in value in the first half of this year, an increase of 12.4 per cent. Chemical imports fell by 1.4 per cent, but still constitute a major portion of Ireland's import profile, valued at €3.7 billion. The steep rise in energy prices has resulted in a predictable increase in the value of fuel imports amounting to 40.6 per cent. The UK is the most significant source of Irish imports with a value of €8.1 billion in the first half of 2005. Imports from the US are valued at €4.1 billion, with Chinese imports now worth €1.6 billion, a 23.1 per cent increase on the first half of 2004.

Import growth will continue for the foreseeable future, symptomatic of the strong state of domestic demand. We forecast a 5.3 per cent rise in the volume of imports this year, and 4.7 per cent growth in 2006.

Balance of Payments

Ireland's Balance of Payments Current Account showed a deficit amounting to €1.4 billion in the first quarter of 2005. This is equivalent to 3.8 per cent of GDP, and is the largest balance of payments deficit recorded in several years. It compares with a surplus of €109 million recorded in the final quarter of 2004. The combination of weaker export growth and stronger import growth contributed to a decline in the merchandise trade surplus from €7.6 billion to €7.1 billion. The widening of the services deficit from €2.2 billion to €2.7 billion was another factor in the overall decline.

We anticipate that Ireland's external dealings will lead to a deterioration in the current account situation this year. It is projected that the deficit will total €2 billion in 2005, and widen to €2.5 billion next year. These deficits are equivalent to 1.5 per cent of GNP and 1.7 per cent of GNP respectively.

Gross National Product

Central Statistics Office figures indicate a rise of 3.9 per cent in the volume of GNP in the first quarter of 2005. This is higher than the 2.6 per cent growth observed in the previous quarter. In recent quarters, GNP growth rates have exceeded their GDP equivalents, a development at variance with the pattern over the last decade. GDP grew by 2.4 per cent in the first three months of this year, only marginally higher than the previous quarter's 2.3 per cent growth rate. The strong growth of GNP relative to GDP is due to the failure of net factor income outflows to keep pace with economic activity. Net factor income outflows rose by 0.3 per cent in the first quarter of this year, following near stagnant 0.1 per cent growth in the final quarter of 2004.

We forecast GNP growth of 5.6 per cent in 2005. Growth will track back in 2006, with GNP rising by 4.3 per cent. Gross National Disposable Income (GNDI), probably the most suitable gauge of living standards from an economic perspective, increased by 3.7 per cent in 2004. We forecast GNDI growth of 4.9 per cent this year, and 4.7 per cent in 2006.

TABLE 5: Imports of Goods and Services

	2003 €m	% Change in 2004 Volume	% Change in 2004 Value	2004 €m	% Change in 2005 Volume	% Change in 2005 Value	2005 €m	% Change in 2006 Volume	% Change in 2006 Value	2006 €m
Capital Goods	5,755	13.7	14.6	6,597	5.0	5.5	6,961	5.2	7.5	7,485
Consumer Goods	12,693	2.8	3.0	13,070	6.0	7.1	13,993	4.0	5.6	14,771
Intermediate Goods:										
Agriculture	990	8.7	9.3	1,082	4.0	3.5	1,120	3.0	5.2	1,177
Other	26,576	5.5	5.0	27,894	6.5	6.0	29,559	5.0	6.6	31,502
Other Goods	1,851	8.6	9.1	2,020	3.0	3.2	2,085	4.5	6.1	2,211
Total Visible	**47,865**	**5.9**	**5.8**	**50,663**	**6.0**	**6.0**	**53,717**	**4.7**	**6.4**	**57,146**
Adjustments	-2,156	-0.8	4.2	-2,246	10.0	10.0	-2,471	-10.0	-10.0	-2,224
Merchandise Imports	**45,709**	**6.3**	**5.9**	**48,417**	**5.8**	**5.8**	**51,247**	**5.4**	**7.2**	**54,923**
Tourism	4,188	1.4	-0.2	4,181	9.0	10.4	4,617	4.5	6.7	4,926
Other Services	44,035	9.5	8.4	47,744	4.5	5.5	50,391	4.0	6.1	53,455
Imports of Goods and Services	**93,932**	**7.6**	**6.8**	**100,342**	**5.3**	**5.9**	**106,255**	**4.7**	**6.6**	**113,303**

TABLE 6: Balance of Payments

	2003 €m	Change %	2004 €m	Change %	2005 €m	Change %	2006 €m
Visible Trade Balance	34,211	- 2.4	33,400	-2.0	32,723	5.8	34,629
Adjustments	-1,606		-1,588		-1,114		-1,361
Merchandise Trade Balance	**32,605**	**-2.4**	**31,812**	**-0.6**	**31,609**	**5.2**	**33,268**
Service Trade Balance	-11,090	-12.4	- 9,718	-0.6	- 9,657	2.6	-9,908
Trade Balance in Goods and Services	**21,515**	**2.7**	**22,094**	**-0.6**	**21,952**	**6.4**	**23,360**
Total Debit Flows	-52,078	10.1	-57,359	5.4	-60,453	5.9	-64,003
Total Credit Flows	30,132	12.1	33,785	7.1	36,196	4.9	37,967
Net Factor Flows	**-21,946**	**7.4**	**-23,574**	**2.9**	**-24,257**	**7.3**	**-26,036**
Net Current Transfers	**432**	**-29.2**	**306**	**-31.7**	**209**	**-28.2**	**150**
Balance on Current Account	**1**		**-1,174**		**-2,095**		**-2,525**
Capital Transfers	93	331.2	401	-10.2	**360**	-5.6	340
Effective Current Balance	**94**		**- 773**		**-1,735**		**-2,185**

Agriculture

The latest *Quarterly National Accounts* point to a continued slowdown in the agricultural sector; output in the sector contracted by 8.4 per cent in the first quarter of the year when compared to the same period of 2004. On a seasonally adjusted basis, output fell by 4.5 per cent in the first quarter of 2005 when compared to the fourth quarter of 2004. The sector has been on a downward trajectory now since the second half of 2004, and this looks set to continue for the remainder of 2005.

Recent statistics on agricultural prices show a rise in input prices in the sector that has surpassed the rise in output prices; on a seasonally adjusted basis, output prices increased by 0.1 per cent month on month in June while input prices rose by 0.8 per cent. On an annual basis, output prices fell by 1.5 per cent in June 2005 when compared to the same month of 2004 while input prices rose by 3.2 per cent over the same time frame, leading to a terms of trade loss of 4.4 per cent over the year. The rise in input prices was largely driven by a 13.7 per cent increase in the price of energy related inputs while the main driver of output price growth was a 5.4 per cent increase in the value of crops.

Data on agricultural incomes for 2004 show that incomes in the sector are rising, driven in part by a rise in net subsidies and also by increasing output values; operating surplus (which excludes both interest and land rental payments) shows an increase of 3.5 per cent, or €76 million over the year. Net subsidies increased by 0.4 per cent in 2004, meaning that net subsidies accounted for 66.1 per cent of agricultural income as compared to 68.2 per cent in 2003. The value of goods output rose by 3.7 per cent in 2004, driven mainly by increases in the value of cattle, milk and cereals. The rise in incomes and output values may seem contradictory given the deterioration in the sector since the second half of 2004. However, the increase in incomes in the sector is likely to be attributable to by the fact that output recorded a 1.8 per cent expansion overall in 2004 while a 2.2

per cent gain in the terms of trade was also registered, when compared to 2003. It seems likely that given the fall in output accompanying the drop in output prices and the loss in the terms of trade so far this year, there will be a fall in the pace of growth in incomes in the sector in 2005.

Given the current trends in the sector, we expect agricultural output to continue to fall with a forecast decrease of 0.5 per cent in volume terms in 2005 and a further fall of 0.6 per cent expected in 2006.

Industry

Industrial sector data in recent months point to a continued slowdown in the sector with a contraction registered in both industrial output and manufacturing sector employment. The latest *Quarterly National Accounts* indicate that the gross value added in industry, including building, contracted by 0.8 per cent in the first quarter of the year when compared to the same period of 2004. On a seasonally adjusted basis, the same magnitude of contraction was recorded in the sector when compared to the final quarter of 2004.

The *Industrial Production and Turnover* release lends further support to the picture of a slowdown in the sector; on an annual basis the volume of production in industry, excluding building, was down by 2.1 per cent in the second quarter of the year. The contraction was based in both the traditional and modern sectors, with a 2.3 per cent and 2.9 per cent decline in the volume of production recorded in each sector respectively. On a seasonally adjusted basis, the volume of production in the sector increased by 0.5 per cent in the second quarter, with the manufacturing industry recording a 1.4 per cent growth in the quarter and the modern sector recording a 0.9 per cent contraction.

The slowdown in the sector is also reflected in survey data which shows a fall off in the pace of growth. In particular, the NCB *Purchasing Managers' Index* posted a reading of 51.1 in August, down slightly from its July reading of 51.4, (a reading of 50.0 and above indicates an expansion in the sector). The fall in the index likely reflects the deterioration in conditions in external markets. According to the survey, input prices increased in the manufacturing sector in August, though at a slower pace than in the previous month, leading to a slight drop in input price inflation. The increase in oil prices was the main contributor to the rise in input costs. In order to counteract some of the increase in input prices, output prices also rose, albeit at a slower pace than input prices.

Given our forecasts for growth in the international economy this year, we expect a pick up in the sector in 2005 when a 5.6 per cent growth rate in real output is forecast. We expect weaker growth of 4.1 per cent in 2006.

Services

The services sector has continued to perform well in 2005 and remains the most significant contributor to growth in the economy.

First quarter results show an expansion in all service categories when compared to the same period of 2004. The distribution, transport and communications sector registered the strongest growth with an increase of 7.1 per cent recorded in gross value added, representing the strongest quarter rise since the final quarter of 2001 (on an annual basis). The 0.8 per cent and 5.1 per cent growth rates recorded in public administration and defence and other services (including rent) respectively represent a slowing of annual growth from the final quarter of 2004.

Recent survey data point to continued growth in the sector going forward; the NCB's monthly *Report on Services* showed the seasonally adjusted *Business Activity Index* reading 62.0 in August, representing a minor fall on the July reading of 62.3, with business sentiment expressed in the survey being optimistic in terms of future growth. According to the report, the expansion in the sector was due both to increased new orders and the start of work on previously secured contracts. This expansion had a positive impact on employment, with further increases in the number of persons engaged in the sector recorded in August, ensuring a continuation of the trend of an expansion in employment levels that has prevailed for two years. One area of concern for the sector highlighted by respondents was the prospect of inflationary pressures going forward. The growth in input costs in August was the highest since June 2002 and strong competition in the sector meant that the service providers were limited in the proportion of this increase that could be passed on to consumers in terms of higher prices.

The growth of output in the services sector is likely to continue throughout the remainder of 2005 and into 2006. We expect the volume of gross output in the sector to increase by an average of 6.7 per cent in 2005. In 2006 we estimate volume growth of 5 per cent in the sector. Our forecast is based on strong growth in personal consumption and personal disposable income in both years.

Employment

The *Quarterly National Household Survey* (*QNHS*) for the second quarter of 2005 points to an extremely robust position in the Irish labour market, reflecting the favourable backdrop provided by the domestic macroeconomic environment. Following on from the substantial increase of 3.9 per cent year on year in the first quarter of 2005, a very appreciable 5.1 per cent annual growth rate was recorded in the number of persons employed in the second quarter of the year, a considerable increase given the already high level of employment and low unemployment rate in the economy. This growth rate represents the highest annual expansion recorded since the second quarter of 2000. In absolute terms, the number of persons employed grew by 93,000 in the year to the second quarter, bringing the total number employed to 1,929,200. This growth in employment was concentrated in both the industrial and services sectors, where 5.9 per cent and 5.5 per cent annual growth rates were recorded respectively. The agricultural sector continued to post employment declines and in the second quarter of the year registered a 2.8 per cent fall in employment levels. Within the industrial sector, construction registered the largest increase in employment, with an exceptional 17.7 per cent rise in the numbers employed recorded, reflecting the continuance of strong output growth in that sector. Within the services sector, increases in employment in public administration and defence and financial and other business services sectors proved largest where a 9.7 per cent and 8.5 per cent growth rate was recorded in each sector respectively.

Accompanying this robust growth in employment was a record expansion in the labour force; a 4.9 per cent annual increase in the labour force was registered in the second quarter of the year, leading to the highest annual increment on record and bringing the total number of persons in the labour force to over two million. This record expansion acts as a positive stimulus for the growth potential of the economy through an increased supply of labour. The overall participation rate was 61.5 per cent in the second quarter, up from 60.0 in the same period of 2004 and 53.6 per cent in 1995. Male participation averaged 71.8 per cent while female participation averaged 51.4 per cent. The bulk of the increase in the labour force was due to demographic factors resulting in an increase in the number of persons of working age, adding an estimated 54,000 to the labour force. Migration is estimated to have accounted for approximately two-thirds of this demographic increase.

The latest *QNHS* indicates that the average unemployment rate was 4.2 per cent (85,600 persons) in the second quarter of the year, down from 4.4 per cent in the same period of 2004. On a seasonally adjusted basis, the rate of unemployment was 4.3 per cent, as compared to 4.2 per cent in the first quarter of the year, and 4.5 per cent in the second quarter of 2004. The *Live Register Analysis* for August indicates a minor increase of 200 in the seasonally adjusted register from July. The standardised unemployment rate was 4.3 per cent in August, representing a decrease from the 4.4 per cent recorded in the same month of 2004.

TABLE 7: Employment and Unemployment*

	Annual Averages			
	2003	**2004**	**2005**	**2006**
Agriculture	120	117	114	112
Industry	499	516	537	543
Services	1,191	1,232	1,294	1,339
Total at Work	**1,811**	**1,865**	**1,945**	**1,994**
Unemployed	88	87	85	87
Labour Force	**1,899**	**1,952**	**2,030**	**2,080**
Unemployment Rate %	4.6	4.4	4.2	4.2
Live Register	172	165	157	157

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

TABLE 8: Personal Disposable Income

	2003 €m	Change %	Change €m	2004 €m	Change %	Change €m	2005 €m	Change %	Change €m	2006 €m
Agriculture, etc.	2,819	3.3	93	2,912	1.3	38	2,950	2.0	60	3,010
Non-Agricultural Wages	53,484	8.9	4,736	58,220	10.2	5,945	64,165	7.5	4,808	68,974
Other Non-Agricultural Income	18,989	-1.3	-255	18,734	-2.4	-447	18,286	10.6	1,944	20,230
Total Income Received	**75,292**	**6.1**	4,574	**79,866**	**6.9**	**5,536**	**85,402**	**8.0**	**6,813**	**92,214**
Current Transfers	14,448	7.4	1,071	15,519	16.4	2,540	18,059	3.7	674	18,733
Gross Personal Income	**89,740**	**6.3**	**5,645**	**95,385**	**8.5**	**8,076**	**103,461**	**7.2**	**7,487**	**110,947**
Direct Personal Taxes	15,689	14.3	2,244	17,933	5.2	940	18,873	8.5	1,605	20,478
Personal Disposable Income	74,051	4.6	3,401	77,452	9.2	7,136	84,588	7.0	5,882	90,469
Consumption	65,227	5.1	3,314	68,540	7.8	5,361	73,901	8.6	6,319	80,220
Personal Savings	8,824	1.0	88	8,912	19.9	1,775	10,687	-4.1	-438	10,249
Savings Ratio	11.9			11.5			12.6			11.3

Given the strength of the labour market so far this year, and the forecast continuance of growth in the wider economy, we anticipate an average increase of 80,000 in total employment this year. In 2006, we estimate that the pace of expansion in employment will decrease slightly, with employment growth of almost 50,000 expected. It is anticipated that the services sector will be the main driver of growth in both years. The unemployment rate is forecast at 4.2 per cent in both years.

Incomes

The record growth rates in employment in recent times, coupled with the sustained strength in economic growth, had a significant positive impact on incomes, with earnings across all sectors of the economy registering strong annual growth in the early part of 2005. Hourly industrial earnings increased by 5.1 per cent in the year to March and with no change in the number of hours worked in the sector, this meant that the average earnings per week increased by a similar magnitude. The construction sector recorded a 4.7 per cent year on year growth rate in weekly earnings in March, driven in part by a 2.8 per cent rise in the number of hours worked. The *Financial Services* and *Distribution and Business Services* sectors recorded a 5.0 per cent and 2.9 per cent expansion in weekly earnings respectively. Weekly earnings in the public sector rose by 6.2 per cent over the same period. Among these sectors, the nominal weekly earnings in March 2004 were highest in the public sector (excluding health), standing at €773, meaning that the annual growth in weekly earnings in that sector, from an already high base, was significant.

Given the favourable domestic economic conditions forecast for both this year and next, coupled with the fact that we expect the recent tightening in the labour market to continue, our forecast is for strong incomes growth in both years. Following an estimated 5.3 per cent growth rate in hourly earnings in 2004, we expect a robust 5.2 per cent increase in 2005 before moderating slightly to 4.6 per cent in 2006. These factors will maintain quite strong growth in the non-agricultural wage bill in both years; following growth of 8.9 per cent in 2004, non-agricultural wages, which account for over three-quarters of total income received, are forecast to grow by 10.2 per cent in 2005 and 7.5 per cent in 2006. This will contribute to strong income growth overall, with Personal Disposable Income expected to rise by 9.2 per cent in 2005 and 7 per cent in 2006. Such growth rates will serve to underpin healthy demand conditions in the economy.

Consumer Prices

Figures for the first eight months of this year for the Consumer Price Index (CPI) show that the rate of consumer price inflation has averaged 2.3 per cent. While the annual rate of inflation of 2.3 per cent in August represents a fall on the 2.6 per cent in the same month of 2004, overall the eight month average is an increase on the 1.9 per cent recorded for the same period of 2004, pointing to the fact that annual inflation rates were higher in the first five months of 2005 than last year. Increases in prices in the *Housing, Water, Electricity, Gas and Other Fuels* category have contributed most significantly to increases in the CPI, accounting for over 55.0 per cent of the overall increase in the index. Within this category, recent energy price hikes have had a substantial impact, with rises in the prices of waste collection and energy products proving most substantial. Mortgage interest payment increases were also significant. Given that there were no increases in interest rates over the year, the rise in mortgage interest payments likely reflects the increasing value of the outstanding mortgage stock, due mainly to increases in property prices.

Service price inflation has continued to outstrip goods price inflation in recent months, a trend that has been entrenched in the economy now for some time. The traded nature of goods and the ensuing competitive pressures means that the degree of price increases that can be sustained is restricted in this area. The continued strength of the euro on foreign exchange markets has meant that imported products are relatively cheaper and this has acted to further restrict the increases in goods prices. The non-traded nature of much of the service sector output means that price increases are less restricted than with goods; a 0.8 per cent annual increase was recorded in goods prices in August while services prices increased by over four times that amount, 3.5 per cent.

Inflation as measured by the Harmonised Index of Consumer Prices (HICP) shows Ireland's inflation rate to have averaged 2.1 per cent in August, just below that suggested by the CPI. The HICP excludes some items that are featured in the CPI, such as mortgage interest, insurance and motor taxes. In the last twelve months, mortgage interest payment increases have added significantly to consumer prices, registering a rise of 12.1 per cent in the year to August. This increase was to some extent offset by a 5.0 per cent fall in insurance payments, while there was no change in motor taxes. These movements offer some explanation of the divergence between the CPI and HICP. The average increase in the HICP for the EU15/EU25 is 2.1 per cent.

Given our forecasts for continued strength in Irish economic activity going forward, the importance of the exchange rate in directing domestic inflation is highlighted. With our current forecast for continued strength of the euro on foreign exchange markets, we expect the inflation rate to average 2.3 per cent this year and 2.5 per cent in 2006. The increase in inflation in 2006 reflects the increase in the price of oil, the likelihood of ECB interest rate rises next year impacting on mortgage interest costs, as well as the possibility of some wage driven inflation due to the tightening nature of the labour market.

TABLE 9: Consumer Price Index – Recent Trend and Forecast

	2001	2002	2003	2004	2005 Forecast	2006 Forecast
Annual % Change						
Housing	102.7	103.7	103.1	107.5	116.7	120.3
Other	98.7	102.6	106.9	109.1	111.0	113.6
Total CPI	97.9	102.7	106.3	108.6	111.0	113.6
EU-HICP (Ireland)	4.0	4.7	4.0	2.3	2.0	2.6
Index Dec. 2001=100						
Housing	16.5	0.9	-0.6	4.3	8.6	3.1
Other	4.0	5.0	4.2	2.1	1.7	2.3
Total CPI	4.9	4.6	3.5	2.2	2.3	2.5

Public Finances

The public finances in the first eight months of 2005 show clear signs of improvement, both against budgeted profiles and against the same period of 2004. Total revenue is up by 4.5 per cent compared with the same period of 2004, with tax revenue up 6.8 per cent and almost 3.9 per cent higher than anticipated in the budget profiles. The base for the revenue figures in 2004 was considerably enhanced by the significant receipts of monies in connection with irregularities in offshore bank accounts. The value of these one-off payments is estimated at near €700 million, primarily related to income tax. Income tax receipts are already up on the inflated base of last year by 5.4 per cent but considerably up when account is taken of the one-off impacts last year. This reflects the strong growth in employment and income levels in the economy.

Other drivers of revenue increases include stamp duties, which have increased by nearly 27 per cent reflective of the still buoyant housing market, and the resurgence in retail sales growth has had a favourable effect on VAT receipts, up 11.9 per cent on last year. Downward pressure on receipts came from corporation tax, which fell by almost 16 per cent against last year which is indicative of the decline in the industrial sector and the relatively poor net export performance in the economy over the first half of 2005.

The value of voted public spending is up by 7.2 per cent on the first eight months of 2004, but 4.2 per cent lower than predicted in the budget profiles. The changes in revenues and expenditure have had the net effect of increasing the Exchequer deficit from €243 million in the first eight months of 2004, to €629 million in the corresponding period of the current year. This deterioration is exaggerated by the absence of one-off gains in receipts from the Revenue Commissioners' investigations in this year's figures. We forecast an overall exchequer deficit of €1.9 billion in 2005, well below the €3 billion deficit budgeted for this year. The wider general government balance surplus is forecast to be in deficit of the order of €0.6 billion, or 0.4 per cent of GDP.

We anticipate an improvement in the public finances in 2006. This will be brought about by an increase in current revenue, in part by an unwinding in SSIA payments, not being matched by similar growth in expenditure. We forecast an exchequer deficit of €1.8 billion in 2006, and a general government surplus of €0.5 billion or 0.3 per cent of GDP. Meanwhile, Ireland's ratio of public debt to GNP will remain low for the foreseeable future, hovering close to 29 per cent level in 2005 and 28 per cent in 2006.

TABLE 10: Public Finances

	2004	% Change	2005	% Change	2006
Current Revenue	36,383	6.9	38,876	8.6	42,215
Current Expenditure	30,763	9.8	33,765	9.4	36,950
Current Surplus	**5,620**	-9.1	**5,111**	3.0	**5,265**
Capital Receipts	1,142	5.1	1,200	45.8	1,750
Capital Expenditure	6,729	24.1	8,350	6.0	8,850
Capital Borrowing	**5,587**	28.0	**7,150**	-0.7	**7,100**
Exchequer Balance	**33**		**-2,039**		**-1,835**
as % of GNP	0.0		-1.5		-1.3
General Government Balance	**2,117**		**-811**		**476**
as % of GDP	1.4		-0.5		0.3
Gross Debt as % of GDP	**29.9**		**28.9**		**27.9**

General Assessment

We have chosen to address two issues in this assessment, one international and one domestic. The international issue is global imbalances and the decision in July by the Chinese monetary authorities to revalue the renminbi. The domestic issue is the labour market and the changing sectoral mix of employment.

Looking first at the international front, we will briefly discuss the Chinese monetary authority's decision in July to revalue the remnimbi from 8.28 against the US dollar to 8.11. This decision was taken in the context of a large Chinese trade surplus and a large US trade deficit. As oil prices have tended to dominate the financial headlines in the last few weeks, on-going concerns about global imbalances have received less attention. However, as the US external imbalances and their possible correction pose a much greater threat to the Irish economy, we think it is important to keep global imbalances at the core of our analysis and to build on the discussion contained in earlier *QECs*, including the Summer issue.

In revaluing the remnimbi, partly in response to requests from the US, China was making US imports cheaper to residents of China and Chinese exports dearer to residents of the US. In this way, the revaluation was designed to reduce the trade imbalance between the two. However, two concerns need to be raised about the potential effectiveness of the move.

The first concern is straightforward. It relates to the simple fact that this revaluation was small and hence unlikely to have much of an effect if no further revaluations are undertaken. The second concern is slightly more intricate. In raising the price of Chinese exports to the US, demand will fall. An additional impact of this demand fall will be to put downward pressure on the Chinese price level. When this happens, the price of Chinese exports to the US falls and some of the initial benefit of the revaluation is lost. Put another way, even though the nominal exchange rate was changed through revaluation, the real exchange rate alters too in response to relative changes in price levels between the US and China.

Were this second round effect to occur slowly, the revaluation would have a positive impact on imbalances. However, simulations conducted by the London-based National Institute for Economic and Social Research[2] suggest that the response is rapid and so the impact of even a substantial revaluation of the remnimbi on global imbalances would be short lived. Nevertheless, it does point to the following important fact. While China has a national savings rate of close to 50 per cent of GDP, its "under-spending" should be recognised as a contributor to global imbalances in addition to US "over-spending". Unless these spending imbalances are addressed, the movement from one currency peg to another will have a limited impact. Hence, even in the context of revaluations, the threat remains of an adjustment occurring in the US economy, such as a dramatic fall in the dollar or in US demand, either of which could be damaging to the Irish economy.

Turning now to domestic issues, annual National Income and Expenditure figures released by the CSO in July showed growth in 2004 to have been below expectations. The Quarterly National Accounts for the first quarter also pointed to a slowing in economic activity. Combining these two pieces of data, and in the absence of any other information, we would have been inclined to significantly reduce our forecast for growth in 2005 and 2006.

The release of the *Quarterly National Household Survey* for the second quarter provided a much more robust picture of the economy and has prompted us to moderate only slightly our earlier forecast for GDP growth in 2005. The annual growth rate in employment of over 5 per cent suggests that the economy is still performing well and that that it is on course to register an annual growth rate in GDP for 2005 of 5.7 per cent.

While the overall employment figures in the Q2 *QNHS* present a favourable picture, a closer analysis gives rise to a number of concerns that are worth highlighting. We will discuss these concerns by referring to Table 11 which shows the changing sectoral composition of employment between 2000 and 2005 (Q2 in both cases).

[2] Published in the European Forecasting Network Autumn Forecast.

Table 11: The Sectoral Composition of Employment, 2000 and 2005

	2000		2005		Change in 000s	Change as % of Total Net Increase
	000s	%	000s	%		
Ag, Forestry and Fishing	132.9	8.0	113.7	5.9	-19.2	-7.5
Other productive industry	309.5	18.5	294.2	15.2	-15.3	-5.9
Construction	166.2	9.9	242.4	12.6	76.2	29.6
Wholesale and retail	235.2	14.1	266.9	13.8	31.7	12.3
Hotels and restaurant	108.1	6.5	111	5.8	2.9	1.1
Transport, storage and communications	101.3	6.1	118.2	6.1	16.9	6.6
Finance and other business	210.8	12.6	257.1	13.3	46.3	18.0
Pub admin and defence	78.4	4.7	98.2	5.1	19.8	7.7
Education	102.8	6.2	123.1	6.4	20.3	7.9
Health	133	8.0	188	9.7	55	21.3
Other services	93.3	5.6	116.4	6.0	23.1	9.0
Total	1671.5	100.0	1929.2	100.0	257.7	100.0

Source: *QNHS*, Q2 2005; ESRI database.

It can be seen from the table that the number of people employed has increased by over a quarter of a million between 2000 and 2005. However, hidden behind this aggregate figure are some notable sectoral shifts. Other productive industry (mainly manufacturing) has seen job losses; as a result, its share of total employment has fallen from 18.5 per cent to 15.2 per cent. In contrast, construction has seen an increase in employment of 46 per cent, with its share rising from 9.9 per cent in 2000 to 12.6 per cent in 2005.

One way of viewing these trends is to see them as characterising a well-functioning labour market in which labour is being reallocated from where demand is declining to where demand is rising. This positive view of the functioning of the labour market is re-enforced when figures on immigration and participation are considered. It appears that the historically high level of immigration is being absorbed into the labour market without an increase in unemployment. This suggests that the adjustment to immigration in the labour market is through reduced wage pressures and not employment. However, the increase in participation observed between Q2 2004 and Q2 2005, most notably for married women, points to rising wage levels so any dampening effect on wages from immigration is being more than offset by upward pressure on wages from increased labour demand.

While positive features are undoubtedly at work in the labour market, we need to return to the changing sectoral composition to highlight our concern. The decline in employment in manufacturing and agriculture combined has been more than offset by the rise in employment in construction, but we are fearful that this process will not continue indefinitely. Ireland's remarkably high level of house building has been commented upon both in previous *QECs* and elsewhere. When the anticipated slowdown occurs, the labour market will lose the sector which has provided a buffer against the employment losses from manufacturing. Should manufacturing continue to shed employment, as we fear it might, the problem of "structural unemployment" could rise whereby the jobs being created in the economy (most likely in the services sector) will require a set of skills not held by those losing jobs in manufacturing. This points to a need on the part of the Government to be mindful of possible training and education needs in the event of a downturn in construction.