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The forecasts in this Commentary are based on data available by mid-March 2005

SUMMARY

Irish output growth returned in 2004 to rates consistent with the economy growing along its potential trend. The strong performance of the economy is best exemplified by employment growth of 3.0 per cent last year, or 54,400 net job increases, with an average rate of unemployment of 4.5 per cent. Output growth in 2004 is estimated to be 5.6 per cent in real GDP terms driven in significant part by growth in construction investment and by a positive net trade contribution as the international economy performed strongly over much of the year. The growth in output as measured by real GNP is estimated to have reached 5.1 per cent in 2004, its highest rate since the peak of 2000. Inflation in consumer prices averaged 2.2 per cent in 2004.

The prediction for Irish output growth in 2005 and 2006 is quite favourable against the backdrop of reasonably robust, if somewhat unbalanced, global economic prospects. Our forecasts are predicated on the balance of probabilities that the US will experience an orderly correction in its macroeconomic imbalances. However, significant uncertainties remain, particularly over the medium-term trajectory for bilateral exchange rates against the US dollar. Growth in 2005 is forecast to be 5.7 per cent in real GDP and 5.0 per cent in real GNP terms, with positive contributions from both domestic demand and net external trade factors. The growth prospects for 2006 are more susceptible to the extent and duration of the correction in global macroeconomic imbalances. We forecast that output growth in 2006 will be 5.5 and 5.8 per cent in real GDP and real GNP terms respectively. Inflation as measured by the consumer price index is forecast to moderate to 2.4 per cent in 2005 and 2.2 per cent in 2006. The unemployment rate is forecast to continue its decline this year to average 4.3 per cent and to level off at this rate in 2006.

Irish living standards, as measured by a metric like output per capita in purchasing power terms, is ranked among the top four countries globally by the OECD. While this is correct when using GDP, which is inclusive of foreign multinational activities, the more appropriate indicator of Irish incomes is GNP whose use would still place Ireland at a creditable 15th ranking. Living standards as captured by Irish real gross national disposable incomes, which take account of terms of trade movements and capital transfers from abroad, are estimated to have grown by 3.7 per cent in 2004. With strong employment growth last year the rise in living standards per person employed was quite modest. Productivity growth in the Irish economy has slowed substantially from the boom years of the 1990s as the economy moves to relatively more labour intensive services' based activities. While rates of Irish productivity per hour remain high within the OECD context, it will be important for future living standards to ensure that they continue to improve. It should be an imperative to ensure that best use is made of our indigenous resources, particularly the expanding workforce. The substantial inflow of migrants to the labour force, whose educational attainments are relatively higher than the norm, would appear to be currently employed in occupations that may not best reflect their skills. This is a potentially significant loss to the Irish economy from what are currently very favourable migratory trends.

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	62,935	66,120	3,185	1,825	5.1	2.1	2.9
Public Net Current Expenditure	19,233	21,100	1,867	539	9.7	6.7	2.8
Gross Fixed Capital Formation	31,815	36,747	4,932	2,492	15.5	7.1	7.8
Exports of Goods and Services (X)	112,759	117,083	4,324	5,896	3.8	-1.3	5.2
Physical Changes in Stocks	499	370	-129	-204			
Final Demand	**227,241**	**241,420**	**14,179**	**10,548**	**6.2**	**1.5**	**4.6**
less:							
Imports of Goods and Services(M)	91,981	94,300	2,319	2,807	2.5	-0.5	3.1
less:							
Statistical Discrepancy	474	652	179	217			
GDP at Market Prices	**134,786**	**146,468**	**11,682**	**7,525**	**8.7**	**2.9**	**5.6**
less:							
Net Factor Payments (F)	23,115	24,655	1,540	1,865	6.7	-1.3	8.1
GNP at Market Prices	**111,671**	**121,813**	**10,142**	**5,660**	**9.1**	**3.8**	**5.1**

B: Gross National Product by Origin

	2003	2004	Change in 2004	
		Preliminary		
	€m	€m	€m	%
Agriculture, Forestry, Fishing	2,915	3,050	135	4.6
Non-Agricultural: Wages, etc.	53,402	58,404	5,002	9.4
Other:	51,956	54,974	3,018	5.8
Adjustments: Stock Appreciation	409	420		
Financial Services	-4,340	-4,560	-220	5.1
Statistical Discrepancy	474	652	179	37.7
Net Domestic Product	**104,816**	**112,941**	**8,125**	**7.8**
less:				
Net Factor Payments	23,115	24,655	1,540	6.7
National Income	**81,701**	**88,286**	**6,585**	**8.1**
Depreciation	14,933	16,401	1,468	9.8
GNP at Factor Cost	**96,634**	**104,687**	**8,053**	**8.3**
Taxes less Subsidies	15,037	17,126	2,089	13.9
GNP at Market Prices	**111,671**	**121,813**	**10,142**	**9.1**

C: Balance of Payments on Current Account

	2003	2004	Change in 2004
		Preliminary	
	€m	€m	€m
Exports (X) less Imports (M)	20,778	22,783	2,005
Net Factor Payments (F)	-23,115	-24,655	-1,540
Net Transfers	440	250	-190
Balance on Current Account	**-1,897**	**-1,622**	**275**
as % of GNP	-1.7	-1.3	0.2

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	66,120	70,754	4,634	2,975	7.0	2.4	4.5
Public Net Current Expenditure	21,100	22,850	1,750	717	8.3	4.7	3.4
Gross Fixed Capital Formation	36,747	39,740	2,993	1,993	8.1	2.6	5.4
Exports of Goods and Services (X)	117,083	123,631	6,548	6,809	5.6	-0.2	5.8
Physical Changes in Stocks	370	295	-75	-55			
Final Demand	**241,420**	**257,270**	**15,850**	**12,440**	**6.6**	**1.3**	**5.2**
less:							
Imports of Goods and Services (M)	94,300	99,204	4,904	4,700	5.2	0.2	5.0
less:							
Statistical Discrepancy	652	-141	-794	-538			
GDP at Market Prices	**146,468**	**158,208**	**11,740**	**8,278**	**7.4**	**2.1**	**5.7**
less:							
Net Factor Payments (F)	24,655	26,809	2,154	2,207	8.7	-0.2	9.0
GNP at Market Prices	**121,813**	**131,399**	**9,586**	**6,071**	**7.9**	**2.7**	**5.0**

B: Gross National Product by Origin

	2004	2005	Change in 2005	
	Preliminary €m	Forecast €m	€m	%
Agriculture, Forestry, Fishing	3,050	3,185	135	4.4
Non-Agricultural: Wages, etc.	58,404	62,666	4,262	7.3
Other:	54,974	60,279	5,305	9.6
Adjustments: Stock Appreciation	420	200		
Financial Services	-4,560	-4,491	69	-1.5
Statistical Discrepancy	652	-141	-794	-121.6
Net Domestic Product	**112,941**	**121,698**	**8,757**	**7.8**
less:				
Net Factor Payments	24,655	26,809	2,154	8.7
National Income	**88,286**	**94,889**	**6,603**	**7.5**
Depreciation	16,401	17,800	1,399	8.5
GNP at Factor Cost	**104,687**	**112,689**	**8,002**	**7.6**
Taxes less Subsidies	17,126	18,710	1,584	9.2
GNP at Market Prices	**121,813**	**131,399**	**9,586**	**7.9**

C: Balance of Payments on Current Account

	2004	2005	Change in 2005
	€m	Forecast €m	€m
Exports (X) less Imports (M)	22,783	24,427	1,644
Net Factor Payments (F)	-24,655	-26,809	-2,154
Net Transfers	250	209	-41
Balance on Current Account	**-1,622**	**-2,172**	**-551**
as % of GNP	-1.3	-1.7	-0.4

FORECAST NATIONAL ACCOUNTS 2006

A: Expenditure on Gross National Product

	2005 Preliminary €m	2006 Forecast €m	Change in 2006 €m Value	€m Volume	% Value	% Price	% Volume
Private Consumer Expenditure	70,754	75,930	5,176	3,396	7.3	2.4	4.8
Public Net Current Expenditure	22,850	24,500	1,650	914	7.2	3.1	4.0
Gross Fixed Capital Formation	39,740	41,977	2,237	1,601	5.6	1.5	4.0
Exports of Goods and Services (X)	123,631	132,630	8,999	6,552	7.3	1.9	5.3
Physical Changes in Stocks	295	290	-5	-55			
Final Demand	**257,270**	**275,327**	**18,056**	**12,408**	**7.0**	**2.1**	**4.8**
less:							
Imports of Goods and Services (M)	99,204	105,595	6,391	4,515	6.4	1.8	4.6
less:							
Statistical Discrepancy	-141	-120	21	-761			
GDP at Market Prices	**158,208**	**169,851**	**11,644**	**8,654**	**7.4**	**2.3**	**5.5**
less:							
Net Factor Payments (F)	26,809	28,354	1,545	1,017	5.8	1.9	3.8
GNP at Market Prices	**131,399**	**141,497**	**10,098**	**7,637**	**7.7**	**1.8**	**5.8**

B: Gross National Product by Origin

	2005 Preliminary €m	2006 Forecast €m	Change in 2006 €m	%
Agriculture, Forestry, Fishing	3,185	3,280	95	3.0
Non-Agricultural: Wages, etc.	62,666	66,939	4,273	6.8
Other:	60,279	64,843	4,565	7.6
Adjustments: Stock Appreciation	200	250		
Financial Services	-4,491	-4,581	-90	2.0
Statistical Discrepancy	-141	-120	21	-15.1
Net Domestic Product	**121,698**	**130,611**	**8,914**	**7.3**
less:				
Net Factor Payments	26,809	28,354	1,545	5.8
National Income	**94,889**	**102,257**	**7,368**	**7.8**
Depreciation	17,800	19,155	1,355	7.6
GNP at Factor Cost	**112,689**	**121,412**	**8,723**	**7.7**
Taxes less Subsidies	18,710	20,085	1,375	7.3
GNP at Market Prices	**131,399**	**141,497**	**10,098**	**7.7**

C: Balance of Payments on Current Account

	2005 €m	2006 Forecast €m	Change in 2006 €m
Exports (X) less Imports (M)	24,427	27,035	2,608
Net Factor Payments (F)	-26,809	-28,354	-1,545
Net Transfers	209	150	-59
Balance on Current Account	**-2,172**	**-1,169**	**1,003**
as % of GNP	-1.7	-0.8	0.7

The International Economy

General

The global economic climate is generally positive, although growth has decelerated in most major economies in recent months. Global growth continues to be rather unbalanced. Relatively weak performance continues to plague the Euro Area economy in particular, while Japan has recently entered recession yet again. The US economy continues to record impressive growth, while the UK economy remains on quite a strong growth trajectory. Amongst emerging economies growth is strong, with China's remarkable expansion proceeding undiminished.

US Economy

Preliminary figures indicate that the US economy, as measured by GDP, grew by 4.4 per cent in 2004, representing its strongest year of growth since 1999. This robust growth was largely driven by substantial increases in investment in the economy, particularly with regard to spending on equipment and software. Growth in the US economy was reinforced by a 3.8 per cent rise in consumer spending. The weakening value of the dollar on foreign exchange markets, as well as the growing international economy, were key drivers of an 8.5 per cent jump in the volume of US exports in 2004. However, this positive external impulse was more than offset by quite rapid growth in the volume of imports, which increased by 9.9 per cent in 2004.

The pace of growth has slowed steadily throughout 2004. Annualised growth in the fourth quarter was 3.8 per cent, down from a 4.0 per cent rate in the third quarter, having registered growth of 3.9 per cent in the first half of the year. The most dramatic slowdown has occurred in the export component of demand, which grew at an annualised 2.4 per cent rate in the fourth quarter, having increased by an annualised 7.3 per cent rate two quarters earlier. Consumer spending growth, on the other hand, has remained largely consistent through 2004, and grew by a solid annualised 4.2 per cent rate in the final quarter of the year.

The resilience of consumer spending was notable given some of the pessimism which characterised much of last year due to the peaks in energy prices and the continued monetary tightening, all under the shadow of impending fiscal correction. Consumer confidence in 2004 was quite buoyant; the University of Michigan's *Index of Consumer Sentiment* averaged 95.2 last year, compared with 87.6 in 2003. Consumer confidence has strengthened slightly over recent months. In the three-month period ending in January 2005, the sentiment index rose by 1.2 points against the preceding three-month period. This rising trend is largely driven by current economic conditions, however consumers appear somewhat less optimistic as they look toward the future. The general optimism is symptomatic of the improving state of the labour market, which provides reassurance to the household sector. The rate of unemployment was 5.4 per cent of the labour force in the US in

February 2005, with employment levels increased by 1.8 million persons from a year earlier, a rise of 1.3 per cent. Employment increases have been largely concentrated in the services sector, while employment in the goods producing sector is up by 361,000 persons over the past year. The improved fortunes of the goods producing sector is encapsulated by figures contained in the Institute of Supply Management's *Purchasing Managers' Index* (PMI). It indicates that the industrial sector has undergone expansion over each of the past twenty months. In the three-month period ending in February 2005, the index averaged 56.3 per cent, down from 58.1 per cent recorded in the preceding three-months. While the pace of the expansion has moderated, this may be due to diminishing capacity in the US economy, as well as concerns about high fuel prices and financial constraints imposed by the Federal Reserve's spate of interest rates rises over the last year.

Despite the weakness of the dollar, the US economy's demand for imports continues to escalate. The combination of large increases in the volume of imports and price hikes in energy imports has fuelled a further widening of the Balance of Payments current account deficit, which amounted to $164.7 billion in the third quarter of 2004, about 5.6 per cent of GDP. US exports have failed to keep pace fully with import growth, and there is evidence that the weakness of the dollar has enabled exporters to hike the prices of their output.

Inflation has risen in the US in recent times with a rate of 2.7 per cent in February 2005. The weakness of the US dollar has contributed to increases in the prices of some imported goods, but the most significant contribution came from fuel price hikes with large increases recorded in consumer goods in the transport and energy sectors. The tightening labour market and its resultant wage pressures has had negative inflationary consequences for certain parts of the services sector. Furthermore, the culmination of the Federal Reserve's six 25 basis point interest rate increases since June 2004 resulted in higher debt servicing costs for some US homeowners. Accordingly we forecast an increase of 2.6 per cent in consumer prices this year, with a further increase to 3.1 per cent in 2006.

We expect the pace of economic growth to continue to moderate in 2005, as the economy expands at a rate more in line with its supply-side capacity. A reasonably benign international climate will continue to support modest export growth while the restrictive fiscal policy embarked upon in the Federal budget will dampen domestic demand, but consumption spending and further investment growth should ensure a relatively favourable outturn. We thus anticipate that the US economy will grow by 3.5 per cent in 2005 and 3.1 per cent in 2006.

The European Economy

Euro Area

A limited recovery in the Euro Area occurred in 2004. First estimates suggest that GDP grew by just under 2.0 per cent in 2004 but the rate of growth decelerated throughout the year. In the final quarter, GDP was 1.6 per cent higher than a year previously. This is a fall back from the 1.9 per cent rate recorded in the third quarter, which itself was a slowdown from the second quarter's 2.2 per cent growth rate. Annualised data points to an even more pronounced slowdown in growth over the course of the year, with the final two quarters showing growth of a mere 0.8 per cent.

Domestic demand has been a significant driver of growth in the Euro Area in recent times. The pace of domestic demand had accelerated over the course of 2004, with quite solid 1.9 per cent growth recorded in the final quarter of the year. Investment and household consumption have made significant contributions to this demand. The household sector has been quite consistent in terms of its growth over 2004; growth in household consumption expenditure averaged 1.2 per cent last year, with an annual 1.3 per cent growth rate recorded in the final quarter. The external sector's effect on demand has been completely neutral, with import growth erasing the positive demand effects arising from export increases. Inventory changes, normally a minor component of domestic demand, contributed a remarkable 1.3 percentage points to the 1.9 per cent growth in the third quarter of the year, and added 0.5 of a percentage point in the final quarter. This unusual situation extends to the sectoral profile of economic growth in the Euro Area also. Agriculture, typically regarded as a rather sluggish sector in developed economies, is currently the fastest growing part of the Euro Area economy, with a robust growth rate of 5.1 per cent in 2004, and a particularly brisk annual rate of 5.9 per cent recorded in the final quarter. This is in contrast to the very weak construction sector, which grew at a mere 0.8 per cent in the final quarter of last year.

Euro Area unemployment remained at an intractably high rate of 8.8 percent of the labour force in January 2005. A rate of this magnitude is related to the accumulation of weak growth in the Euro Area over the last number of years, and the likely absence of strong growth in the future may cause this unemployment rate to become further entrenched. Particularly high rates of unemployment of almost 10.0 per cent prevail in the large economies of Spain, France and Germany. The recent merger of the welfare system and the unemployment insurance system in Germany caused the measured number of unemployed persons to rise by 227,000 in January 2005 alone. The impact of these reforms may move German unemployment rates higher initially, but should result in the level of unemployment falling as active labour market interventions help boosts employment over time.

Inflation in the Euro Area averaged 2.1 per cent in 2004, being just above the European Central Bank (ECB) medium term target of less than, but close to 2.0 per cent. This rate of inflation is surprisingly strong, given the weak economic situation in the Euro Area, the strengthening of the currency and the large amount of slack in the labour market. In the three months to the end of January, inflation averaged 2.2 per cent. Increases in the price of tobacco, fuel and health related products and services were the main contributors to the inflation rate, while price decreases in such areas as telecommunications and clothing helped to dilute the inflation rate somewhat.

Given the recent evidence of a slowdown in growth in the Euro Area in 2004, as well as the moderate rate of inflation, the ECB left the main refinancing rate at 2.0 per cent after its latest meeting in March. We expect a 0.25 percentage point increase in the interest rate in the second half of 2005 with two further quarter point increases expected in 2006. These interest rate rises are expected in the context of a slight pick-up in the pace of recovery coupled with expected low inflation rates during this time.

The Euro Area continues to record a slight Balance of Payments current account surplus, a reflection of the interplay between the relatively weak positions of its domestic economy in relation to stronger demand conditions externally. The current account surplus in the first three quarters of 2004 was €29.3 billion, equivalent to 0.5 per cent of GDP. This is largely made up of a sizeable €85 billion goods surplus, offset somewhat by income and current transfer deficits.

Retail trade, having shrunk earlier in the year, recorded 0.1 per cent growth in the final quarter of 2004. This weak spending behaviour by consumers is testament to the caution and pessimism affecting the household sector, largely induced by the adverse state of the labour market. The corporate sector's relative vibrancy in terms of investment behaviour is indicative of the historically low cost of borrowing, which in real terms is effectively close to zero, as well as the benign condition of the global economy. Factors that are currently tempering business confidence include the strength of the euro, the likelihood of interest rate rises later in the year, as well as the weak economic situation within the Euro Area. There is some evidence that the corporate sector's confidence is waning; the European Commission's *Business Confidence Indicator* fell to 0.35 in the three-month period ending February 2005, having registered 0.48 in the previous quarter.

Our forecast is for a continuance of sluggish growth in the Euro Area in the short-term. We forecast GDP growth of 1.7 per cent for 2005, followed by a growth rate of 1.6 per cent next year. Consumer price developments will remain subdued as a result; the Harmonised Index of Consumer Prices (HICP), which omits the direct effects of any mortgage interest rate increases, is likely to rise by 1.8 per cent this year and 1.7 per cent in 2006. The unemployment rate is likely to remain stuck at a high level is forecast to register an 8.9 per cent rate both this year and next.

UK Economy

The UK economy has experienced its longest period of economic expansion since before the Second World War. Preliminary figures indicate that the UK economy grew by 3.1 per cent in 2004, its strongest year of growth since 2000. This robust performance has rested entirely on strong growth in the services sector, which has more than compensated for the continuing contraction in the productive industries element of the economy. Domestic demand is the chief driver of growth in the UK economy, with especially strong growth in government spending and investment. In the third quarter of 2004, investment was 6.3 per cent up on the same period of 2003, while government spending was 4.8 per cent higher. The external sector is currently acting as a drag on growth; though the volume of exports rose by 3.9 per cent in the third quarter of 2004, very strong import growth of 5.8 per cent more than counterbalanced this. Latest figures suggest that growth in the UK economy has slowed in the fourth quarter, to an annualised rate of 2.8 per cent.

The state of the UK labour market reflects the healthy state of the economy. In the three-month period ending in December 2004, the unemployment rate was 4.7 per cent of the labour force, up by 0.1 percentage point on the previous three month period. However, the general trend over recent quarters points to a slide in the unemployment rate. This low rate of unemployment has been accompanied by increases in the numbers of people at work. Employment rose by 90,000 persons in the quarter ended in December, representing a 0.3 per cent increase. Over the last year, employment has increased by 296,000, a rise of 1.0 per cent.

Despite the healthy state of the UK economy, inflation has remained quite subdued. The key policy measure of inflation, the Consumer Price Index (CPI) had an annual growth of only 1.6 per cent in January 2005. The more broadly based measure, the Retail Price Index (RPI), shows significantly higher inflation in the UK economy. The RPI had an annual growth of 3.2 per cent in January 2005, slightly down on the annual 3.5 per cent rate exhibited in the previous month. Unlike the CPI, the RPI takes into account housing costs and the one percentage point increase in interest rates over the last year accounts for the majority of the differential between the two measures. Another sector exhibiting relatively high inflation is education, where prices rose by 5.0 per cent. In common with most European economies, the UK's inflation rate benefited from a fall of 2.4 per cent in communications prices. The weak inflationary environment as gauged through the CPI has meant that policy interest rates in the UK have remained unchanged since August 2004, with base rates remaining at a 4.75 per cent rate.

The state of the production sector of the UK economy is rather weak. The output of production industries rose by a meagre 0.3 per cent in 2004, and actually fell slightly by 0.1 per cent in the final quarter of the year compared to the previous quarter. Within the productive sector, manufacturing is the strongest area, growing at a

1.3 per cent rate in 2004, although its annual growth slowed to 0.5 per cent in the final quarter of the year. Growth is concentrated in the consumer durables sector of manufacturing, where output rose by 2.6 per cent in the final quarter on an annual basis, a reflection of the UK consumer's strong appetite for household goods. The oil and gas extraction sector shrank hugely in the final quarter of 2004; its output fell by 9.7 per cent against the same period of the previous year.

The relatively strong demand conditions in the UK economy, as well as its relatively high propensity to import has translated into a widening of its current account deficit in the third quarter of 2004 to £8.8 billion (3.0 per cent of GDP), from a £5.8 billion deficit (2.0 per cent of GDP) in the second quarter. This deterioration means that the deficit in the first three quarters of 2004 now totals £21.1 billion, in contrast to a 2003 figure of £13.8 billion. These developments are driven largely by a significant and widening trade deficit, whose magnitude is mitigated somewhat by a net surplus in terms of the return on foreign assets.

The UK's GfK *Consumer Confidence Headline Index* for January posted its highest reading since November 2002, before falling back slightly in February. This positive development is due largely to the robust economic situation coupled with the firm labour market. The benign sentiment of the household sector augurs well for future demand in the economy, and may be a precursor of more exuberant consumer behaviour this year. The upturn in consumer confidence is in spite of the rather precarious position of the housing market; both the flagship Halifax and Nationwide indices show that house prices have remained frozen since the middle of last year, and have even recorded some small monthly declines over that period.

We expect growth in the UK economy to moderate in future years, as it resumes a trajectory consistent with its economic fundamentals. Accordingly, we anticipate a 2.8 per cent expansion this year, followed by 2.9 per cent growth in 2006. The expected relative stability of Sterling's exchange rate and relatively tight monetary policy, aided by the beneficial effects of a moderation in fuel prices, will keep inflation largely in check this year. Accordingly, we forecast CPI inflation of 1.5 per cent this year, with a 2.5 per cent rate next year.

The Rest of Europe

Growth in other European economies is generally strong. Russia's economy expanded at a rate of 6.4 per cent in the third quarter of 2004, while Czech and Polish economic growth numbered 3.6 per cent and 4.8 per cent respectively over the same period. Quite rapid price growth has tarnished this performance however; prices jumped by 11.7 per cent in Russia in the year to December, while Hungary's inflation rate of 5.5 per cent sits uneasily with its modest 3.7 per cent growth rate.

Amongst more established economies, growth is generally sluggish. The economies of Norway, Denmark and Switzerland are all growing by less than 2.0 per cent. However, very low inflation accompanies this. Sweden is an exception to this rule, returning a vigorous 3.9 per cent GDP growth rate, while simultaneously enjoying a practically static price level.

Rest of the World

Though Japan's economy grew at a rate of 2.6 per cent in 2004, the annual figure masks the fact that there were consecutive declines in GDP in the second, third and fourth quarters of the year. The introduction of chain-linked deflators from late 2004 may cause growth rates to be lower than they would have been under the previous national accounting system. This new practice also means that previous published growth rates may have overstated the true output figure as well as overstating the extent of price falls.

The household sector continues to be the engine of demand in the Japanese economy, while public spending and external demand constitute a negative drag on the growth rate. Despite the deceleration in economic growth and an appreciation of the Yen, Japan's rate of inflation has slipped tentatively into positive territory over the past number of months. In the final quarter of 2004, annual inflation was 0.5 per cent, in contrast to a –0.1 per cent rate in the previous quarter, although January's inflation rate was –0.1 per cent. Unemployment is on a clear downward trend, having fallen from 4.8 per cent in the third quarter to 4.5 per cent in the last quarter of 2004, well below the average rate of 5.1 per cent recorded in 2003.

China's economy continues to deliver a strong performance. Despite anticipation of a slowdown in 2004, official figures suggest that GDP rose at an annual rate of 9.5 per cent in the final quarter of 2004. This industry-led economic boom shows little sign of abating, though overheating in the economy has not yet become apparent with China's inflation rate at 2.4 per cent. The undervaluation of the Renminbi, particularly against the dollar, will facilitate further export led growth in the near future.

Large Latin American economies like Brazil, Argentina and Mexico continue to deliver enviable growth rates. Third quarter growth in Argentina in 2004 was 8.3 per cent, while Brazil expanded by 6.1 per cent and Mexico's GDP rose by 4.4 per cent over the same period. The Australian economy is currently enjoying its longest post-war expansion, churning out a 3.0 per cent growth rate, while maintaining a moderate rate of inflation.

The Tsunami tragedy, which occurred in Asia last December, has caused short-term economic damage to the countries affected by it, and the infrastructural devastation may undermine medium term prospects to some extent.

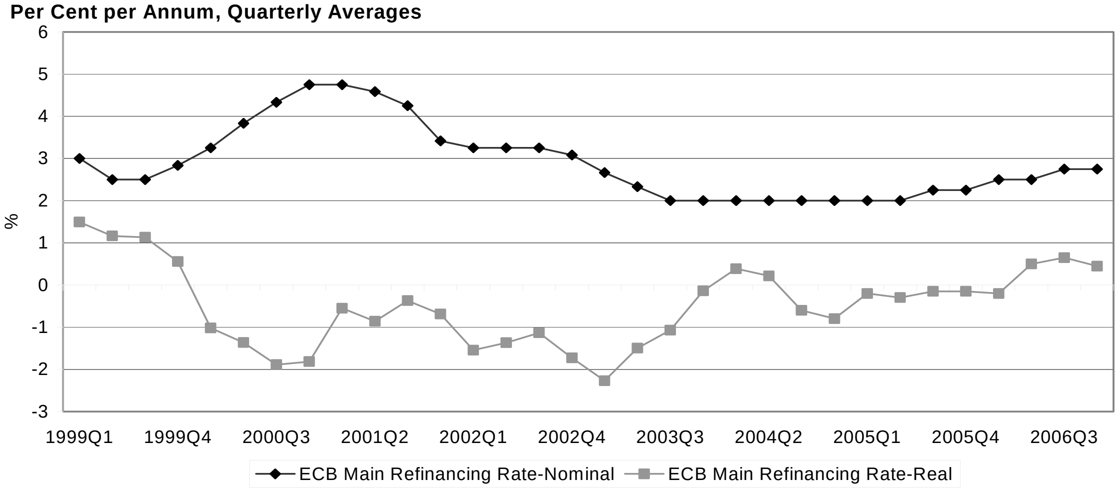
Box A: EUROFRAME – Economic Forecasting Network

The Economic and Social Research Institute, in association with nine other European research institutes,[1] have combined to form a European Forecasting Network (EFN) to produce bi-annual joint forecasts for the Euro Area. The EUROFRAME – EFN consortium is co-financed by the European Commission to produce Spring and Autumn reports over the three years 2005 to 2007. The external economic forecasts for the ESRI *Quarterly Economic Commentaries* are in line with those of the EUROFRAME – EFN. The EFN forecasts will be based upon a consistent macroeconomic model, *NiGEM,* which the ESRI already makes use of for the international section of the *Medium-Term Reviews*.

The EUROFRAME – EFN project will impact directly on exchange rate forecasts for the *Commentary*. In recent years the *Commentary* has forecast bilateral exchange rates on the basis that these will trend towards their estimated fundamental equilibrium values. For instance, in the case of the $/€ bilateral rate, we considered the fundamental level to be in the range $1.10 to $1.15. Our trajectory for the exchange rates was to move from current spot values towards that fundamental range over a two-year horizon. Within the EUROFRAME – EFN, exchange rates are based upon market expectations of forward exchange rates, which tend to be in a relatively narrow range around the current spot rates. In addition, forecasts for individual countries where there is a EUROFRAME – EFN member will tend to reflect the national expertise and assessment of that institute and so may be somewhat different to consensus forecasts the *Commentary* has utilised hitherto.

Figure 1: Interest Rates

Per Cent per Annum, Quarterly Averages



[1] In addition to the ESRI, the other members of the Network are CASE (Poland), CPB (The Netherlands), DIW (Germany), ETLA (Finland), IfW (Germany), NIESR (UK), OFCE (France), PROMETIA (Italy), WIFO (Austria).

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	3.1	2.8	2.9	1.3	1.5	2.5	4.2	4.3	5.6	4.7	4.7	4.6	-2.5	-2.5	-2.5
Germany	1.6	1.4	1.1	1.6	1.5	1.1	0.8	0.0	0.3	9.8	9.9	9.7	3.6	5.0	5.1
France	2.3	2.1	2.0	1.5	1.8	1.7	3.2	2.9	3.1	9.9	10.3	9.9	-0.2	-0.3	-1.0
Italy	1.1	0.9	1.4	2.2	2.6	2.1	2.4	0.8	1.2	7.6	7.6	8.2	0.0	0.7	0.7
Euro Area	1.8	1.7	1.6	2.1	1.8	1.7	2.9	2.0	2.4	8.8	8.9	8.9	0.6	1.2	0.9
USA	4.4	3.5	3.1	2.2	2.6	3.1	4.2	3.7	5.0	5.5	5.4	5.3	-5.6	-5.6	-5.2
Japan	2.6	0.8	1.9	-0.5	0.2	0.6	-1.7	0.7	2.4	4.7	4.6	4.5	3.7	3.3	3.6
OECD	3.1	2.3	2.6	1.8	2.0	2.6	3.0	2.9	3.7	6.2	6.2	6.1	-1.1	-1.1	-1.1
Ireland	5.6	5.7	5.5	2.2	2.4	2.2	5.8	5.2	4.7	4.5	4.3	4.3	-1.3	-1.7	-0.8

Context for Ireland

The international environment is likely to be broadly favourable for Ireland's economic fortunes in 2005. Solid growth in international trade should nurture improved demand for Irish exports to that economy, as well as supporting the continuation of foreign direct investment into Ireland. FDI is a vital instrument in boosting future economic growth, as it adds to the capacity of the Irish economy through technology spillovers, capital accumulation and by enhancing the productivity of the Irish workforce.

There are significant downside risks posed by some aspects of the international outlook. The current high level of the euro *vis à vis* the US 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 relatively weak for the foreseeable future, there is little prospect of these problems being remedied quickly. The near static growth rates in the large European economies erases the potential for any significant demand growth being provided from that source.

Cheaper imports from the US, and their disinflationary implications are the main benefit to Ireland of the dollar's weakness. The continuing relatively strong euro exchange rate will postpone ECB interest rate rises until at least the latter half of 2005, and this will continue to bolster investment in the short term.

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 have risen once again at the start of 2005, but are likely to decline during the year . These 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 transition in the crucial house-building sector, from the current record levels to more sustainable levels. Euro Area interest rates will ultimately have to climb to more neutral levels of around 4.5 per cent over the medium term, which will dampen Irish growth.

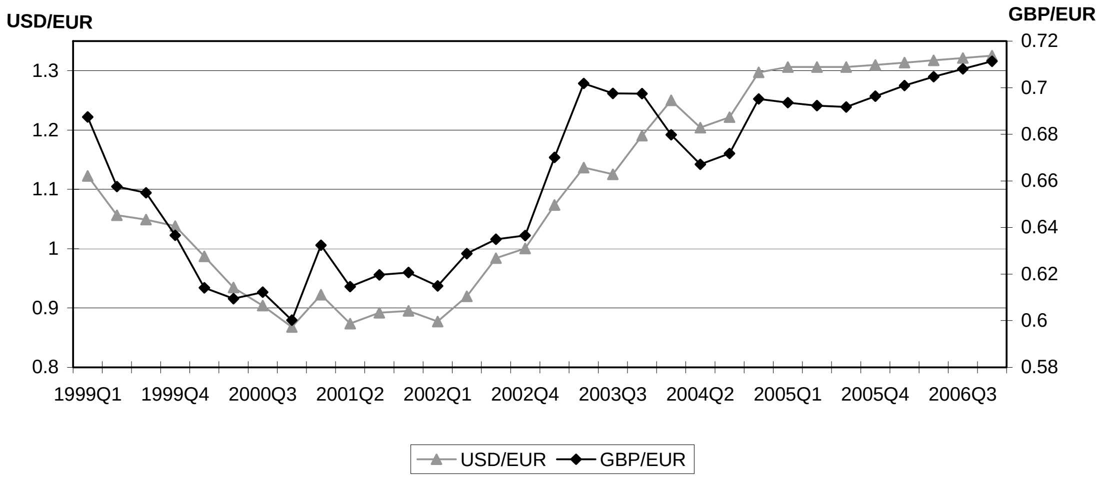
The Domestic Economy

General

National Accounts data from the Central Statistics Office (CSO) point to continued strong growth in the economy. In the third quarter of 2004, GDP grew by 5.8 per cent at an annual rate, while GNP rose by 4.2 per cent. Once again, this suggests a further widening of the already substantial gap between the two measures of the Irish economy's activity. The growth rate of GDP has averaged 5.7 per cent in the first three quarters of 2004, while GNP's corresponding growth rate is 4.9 per cent. The strength of the economy apparent in these figures is corroborated by a wide range of indicators in the realms of employment, retail sales and confidence indicators.

Figure 2: Exchange Rates

Foreign Currency per Euro, Quarterly Averages



Exports

First estimates of trade figures suggest that the volume of exports from Ireland increased by 4.5 per cent in the quarter ended in September of last year against the corresponding period of 2003. This solid export growth is consistent with the generally strong external economic environment, and is despite the recent appreciation of the value of the euro against other major currencies. There is evidence that exporters are responding to this appreciation by cutting the price of their products, as the value of exports in the final quarter of last year was 2.3 per cent lower than a year earlier. Nonetheless, a trade surplus of €33,803 million was recorded in 2004, a slight deterioration on the €34,174 million surplus of 2003. Within the European Union, the UK is Ireland's most sizeable goods exports market, while the United States and Japan are also important buyers of Irish goods. Goods produced in the high value added manufactured sectors continue to be Ireland's most important exports, and include *Organic Chemicals*, *Medical and Pharmaceutical Products* and *Office Machines*. We forecast that the relatively strong international environment will overcome the loss of competitiveness associated with the appreciation of the euro, and anticipate strong export growth of 5.8 per cent this year and 5.3 per cent in 2006.

TABLE 2: Exports of Goods and Services

	2003	% Change in 2004		2004	% Change in 2004		2004	% Change in 2005		2005
	€m	Volume	Value	€m	Volume	Value	€m	Volume	Value	€m
Agricultural	4,219	4.3	2.4	4,321	2.2	1.7	4,394	3.0	4.9	4,608
Manufactured	70,442	5.5	3.4	72,830	7.0	6.5	77,538	5.5	7.6	83,439
Other Industrial	6,380	5.2	3.5	6,604	6.0	4.9	6,931	5.0	7.9	7,481
Other	987	3.6	2.5	1,011	3.5	4.0	1,051	3.5	6.6	1,121
Total Visible	**82,028**	**5.4**	**3.3**	**84,766**	**6.6**	**6.1**	**89,915**	**5.3**	**7.5**	**96,648**
Adjustments	-2,842	4.0	7.1	-3,044	15.0	26.5	-3,851	-15.0	0.0	-3,851
Merchandise	**79,186**	**5.4**	**3.2**	**81,723**	**6.3**	**5.3**	**86,064**	**6.2**	**7.8**	**92,798**
Tourism	3,409	3.2	4.4	3,560	3.2	5.1	3,740	3.0	5.6	3,949
Other Services	30,164	4.9	5.4	31,800	4.8	6.4	33,827	4.0	6.1	35,883
Exports of Goods and Services	**112,759**	**5.2**	**3.8**	**117,083**	**5.8**	**5.6**	**123,631**	**5.3**	**7.3**	**132,630**

Stocks

Latest figures show that the seasonally adjusted value of stocks held by the corporate sector in the economy rose by €110 million in the third quarter of 2004, which is equivalent to a €116 million increase when valued in constant price terms. In the first three quarters of 2004 overall, stocks in the economy rose by €233 million, an accumulation worth €225 million in constant prices. In the same period of 2003, stocks rose by €542 million, or €564 million in volume terms. The marked slowdown in stock accumulation may be evidence of the stronger demand conditions experienced by the Irish economy in 2004. We forecast that stocks will fall by €75 million this year, and by a much smaller amount of €5 million in 2006.

TABLE 3: Stock Changes

	2003	Change in Value	2004	Change in Value	2005	Change in Value	2006
	€m	€m	€m	€m	€m	€m	€m
Farm Stocks	-43	198	155	-270	-115	25	-90
Irish intervention Stocks	48	-48	0	0	0	0	0
Other Non-Agricultural Stocks	494	-279	215	195	410	-30	380
Total	**499**	**-129**	**370**	**-75**	**295**	**-5**	**290**

Investment

There are indications that investment activity has slowed in recent months. Having recorded impressive growth of 13.3 per cent in the first half of 2004, the volume of investment grew at a slower rate of 3.6 per cent in the third quarter. This is in significant contrast to the 15.4 per cent growth rate of the second quarter.

This deceleration in investment activity has been largely driven by developments in the house-building sector. Figures show that house completions in 2004 were nearly 77,000, an increase of 11.8 per cent. As outlined in the previous two *Commentaries* we do not expect this rate of house building to continue. Thus we are anticipating a moderate decline in housing completions in 2005 of around 2.0 per cent with a further decline in 2006 of 3.0 per cent. Despite the decline in the number of houses being built the output from this sector will remain strong, with over 73,000 units forecast to be completed in 2006.

Other building and construction is expected to grow by 7.0 per cent and 6.0 per cent in real terms in 2005 and 2006 respectively. This represents strong growth for this segment of construction investment. However, the importance of the house building component is such that the moderation in housing completions results in a much more moderate growth in overall investment in building and housing. On the basis of the forecasts outlined above investment in building and construction is forecast to grow by 2.2 per cent in volume terms in 2005. With an associated price deflator of 3.8 per cent this implies growth in the value of investment in building and construction of 6.1 per cent this year. The slowdown in house building is forecast to continue to impact in 2006 with the

TABLE 4: Gross Fixed Capital Formation

	2003	% Change in 2004		2004	% Change in 2005		2005	% Change in 2006		2006
	€m	Volume	Value	€m	Volume	Value	€m	Volume	Value	€m
Housing	13,785	11.8	24.8	17,199	-2.0	3.4	17,782	-3.0	-0.6	17,680
Other Building	9,220	4.8	7.5	9,914	7.0	10.7	10,979	6.0	9.2	11,987
Building and Construction	23,005	8.4	17.9	27,113	2.2	6.1	28,762	1.4	3.1	29,667
Machinery and Equipment	8,810	7.0	9.4	9,634	10.0	14.0	10,979	7.5	12.1	12,310
Total	31,815	7.8	15.5	36,747	5.4	8.1	39,741	4.0	5.6	41,977

volume of investment in building and construction forecast to grow by 1.4 per cent. It is expected that the price deflator for construction activity will also moderate to around 1.7 per cent with a resulting increase in the value of construction investment of 3.1 per cent in 2006.

Given an anticipated improvement in economic activity levels, it is expected that investment in machinery and equipment will grow by 10.0 per cent in 2005 and 7.5 per cent in 2006 in volume terms. Given our forecasts for the various sub-sectors, we expect modest investment growth to be sustained into the future, in line with the economy's overall growth path. We expect that the volume of investment will rise by 5.4 per cent in 2005. With value growth of 8.1 per cent in 2005 this implies a more subdued price deflator than recent years at 2.6 per cent. Our forecasted price deflator is expected to slow further in 2006 to 1.5 per cent, primarily due to slower house price growth. Coupled with a growth in the value of investment of 5.6 per cent this implies volume growth in 2006 of 4.0 per cent.

Consumption

Private consumption spending has begun to strengthen from the relatively sluggish volume growth of recent years. In the third quarter of 2004, annual growth of 2.8 per cent was recorded, in line with the 2.9 per cent figure registered in the first half of the year. These trends are corroborated by retail sales data, which cover a narrower spectrum of household expenditure. Provisional figures for 2004 show annual growth of 3.0 per cent in the volume of retail sales, making last year the strongest year of growth since 2000 as adjudged by this measure. This growth held up in the final quarter of 2004, when 3.1 per cent growth was recorded.

The retail sector experiencing the strongest expansion in sales was *Hardware, Paints and Glass*, where sales surged by 14.3 per cent in the final quarter of last year, reflective of the boom in housing construction as was the jump of 7.0 per cent in the volume of *Furniture and Lighting* sales. Some of these rises may be due to price induced demand increases, as retail prices have fallen in both of these areas over the past year. The introduction of a ban on tobacco use in the workplace last year, as well as the perception of high price levels may be responsible for the 4.8 per cent drop in bar sales in the last quarter of 2004.

The generally robust performance of consumer spending is a manifestation of the positive sentiment of the Irish household sector. The IIB-Bank/ESRI Consumer Sentiment Index rose from an annual average of 67.4 in 2003 to 92.7 in 2004. While data for February 2005 indicates that consumers have become somewhat cautious in recent times, the index nonetheless climbed to 103.4 in the three months ending in February 2005, from 101.1 in the previous three months. Both the index measuring consumer's perceptions of current conditions and the index measuring consumer expectations also rose in the three months to February.

The general improvement in confidence is underlined by the fact that sales of new cars rose by 4.6 per cent in 2004, the first year in which an increase has been recorded since 2000. Furthermore, the year-on-year rise in car sales in the three-month period ending in January was 13.8 per cent compared with the same period a year ago. Such strong growth supports the index measuring consumers' expectations of the future and suggests that consumers are optimistic about future economic prospects. Accordingly, we forecast a rise in consumer spending of 4.5 per cent in 2005, and further strong growth of 4.8 per cent in 2006.

The latest Quarterly National Accounts show that the volume of government consumption grew by 2.5 per cent and the value by 9.9 per cent in the third quarter of 2004, resulting in a public expenditure deflator of 7.2 per cent. In line with our expectations of some deterioration in the public finances in 2005, we forecast an increase in government consumption of 3.4 per cent in volume terms this year, rising slightly to 4.0 per cent in 2006. Coupled with the forecast increase in value terms of 8.3 per cent and 7.2 per cent in 2005 and 2006 respectively, this implies an estimated public expenditure deflator of 4.7 per cent this year and 3.1 per cent in 2006

TABLE 5: Consumption Indicators

	Annual Percentage Change				
	2002	2003	2004	2005 Forecast	2006 Forecast
Consumption Value					
Personal Consumption	8.6	6.6	5.1	7.0	7.3
Retail Sales Index, Value	2.6	3.2	4.2	5.5	4.3
Divergence	6.0	3.4	0.9	1.5	3.0
Consumption Volume					
Personal Consumption	2.8	2.6	2.9	4.5	4.8
Retail Sales Index, Volume	0.1	0.9	3.2	3.8	3.5
Divergence	2.7	1.7	-0.3	0.7	1.3
Consumer Prices					
Personal Consumption Deflator	5.7	3.9	2.1	2.4	2.4
Retail Sales Index Deflator	2.5	2.3	1.0	1.6	0.8
Consumer Price Index	4.6	3.5	2.2	2.4	2.2

Final Demand

Final demand in the economy, which is the sum of personal and public consumption, investment, stock changes and exports, rose by 3.8 per cent in the penultimate quarter of 2004 against the same period of 2003. This brings final demand growth to 4.6 per cent for the first three quarters of 2004. However, final demand actually fell at an annualised rate of 2.3 per cent in the third quarter of 2004. The growth of exports and investment has been the most important driver of expansions in final demand. We forecast growth of 5.2 per cent in final demand this year, and 4.8 per cent growth in 2006.

Imports

First estimates of trade data show that the volume of imports to Ireland increased by 3.4 per cent in the quarter ended in September compared to the same period of 2003. The growth in import volumes is coincident with the rise in the value of the euro against other major currencies, which has the effect of making imports relatively cheaper in domestic price terms. Accordingly, the 3.0 per cent growth in the value of imports in the final quarter of last year implies falling import prices, a phenomenon that may also reflect the generally weak inflationary environment globally, as well as strong competition in the traded goods market.

The demands of the corporate sector for intermediate and capital goods account for a substantial share of Ireland's imports. *Chemicals and Relates Products* imports were worth 14.3 per cent of total imports in the first eleven months of 2004, while *Machinery and Transport Equipment,* a sector which includes computers, accounts for 42.9 per cent of the total.

Within the European Union, the UK and Germany are Ireland's most important source of imports. In the last year, China has surpassed Japan to become Ireland's second most important non-EU import source after the United States. The appreciation of the euro, and strong domestic demand will result in strong import volume growth this year of 5.0 per cent, and 4.6 per cent next year.

Balance of Payments

A negligible deficit of just under €0.1 billion on the current account of the Balance of Payments was recorded in the third quarter of 2004, in comparison to the just under €0.2 billion deficit registered in the same period of 2003. This brings the current account deficit to €0.9 billion for the first three quarters of 2004, in comparison to the €1.4 billion deficit of the same period in 2003.

The trade surplus of €8.1 billion recorded in the third quarter of last year is further evidence of Ireland's status as a primarily net exporting economy in the sphere of goods trade. The total trade surplus recorded in the first nine months of 2004 is €24.2 billion, a slight deterioration in relation to the €24.9 billion balance over the same period of 2003.

Net outflows on the invisibles trade account more than outweigh the trade surplus. In the third quarter of last year, the invisibles deficit was €8.2 billion, slightly narrower than in the same period of 2003, when a €8.7 billion deficit was registered. This brings the total deficit in the first nine months of 2004 to €25.1 billion, slightly smaller than 2003's figure of €26.4 billion.

TABLE 6: Imports 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
Capital Goods	5,726	5.3	6.1	6,078	4.5	5.0	6,383	4.5	6.6	6,804
Consumer Goods	12,648	4.5	5.5	13,349	4.8	5.8	14,130	4.0	5.6	14,915
Intermediate Goods:										
Agriculture	989	2.5	3.5	1,024	3.0	2.5	1,050	3.0	5.2	1,104
Other	26,595	4.7	5.9	28,151	4.0	3.5	29,131	3.5	5.1	30,602
Other Goods	1,864	3.5	4.0	1,939	4.5	4.7	2,030	4.5	6.1	2,154
Total Visible	**47,822**	**4.6**	**5.7**	**50,541**	**4.3**	**4.3**	**52,723**	**3.8**	**5.4**	**55,579**
Adjustments	-2,057	15.0	16.2	-2,389	-20.0	-20.0	-1,911	-20.0	-20.0	-1,529
Merchandise Imports	**45,765**	**4.2**	**5.2**	**48,152**	**5.5**	**5.5**	**50,812**	**4.7**	**6.4**	**54,050**
Tourism	4,188	6.5	0.6	4,215	4.2	5.3	4,440	4.6	6.8	4,742
Other Services	42,028	1.5	-0.2	41,933	4.5	4.8	43,952	4.4	6.5	46,803
Imports of Goods and Services	**91,981**	**3.1**	**2.5**	**94,300**	**5.0**	**5.2**	**99,204**	**4.6**	**6.4**	**105,595**

Within the Services component of the current account, significant surpluses have been recorded in *Computer Services*, *Insurance* and *Financial Services*, while sizeable deficits exist in the areas of *Royalties/Licences* and *Business Services*. The importance of the International Financial Services Sector (IFSC) in Dublin is underlined by the fact that the surplus on its services was €1.2 billion in the third quarter of last year, bringing the total surplus to €3.5 billion in the first nine months of 2004. This is equivalent to 3.3 per cent of GDP, and 4.0 per cent of GNP. We expect that there will be some widening of the current account deficit, to €2.2 billion this year, before narrowing in 2006 to €1.2 billion.

TABLE 7: Balance of Payments

	2003 €m	Change %	2004 €m	Change %	2005 €m	Change %	2006 €m
Visible Trade Balance	34,206	-0.1	34,225	8.7	37,191	10.4	41,070
Adjustments	-785		-655		-1,939		-2,322
Merchandise Trade Balance	**33,421**	**0.4**	**33,571**	**5.0**	**35,252**	**9.9**	**38,748**
Service Trade Balance	-12,643	-14.7	-10,788	0.3	-10,825	8.2	-11,713
Trade Balance in Goods and Services	**20,778**	**9.7**	**22,783**	**7.2**	**24,427**	**10.7**	**27,035**
Total Debit Flows	-51,570	7.4	-55,361	6.0	-58,693	6.6	-62,554
Total Credit Flows	28,455	7.9	30,706	3.8	31,884	7.3	34,199
Net Factor Flows	**-23,115**	**6.7**	**-24,655**	**8.7**	**-26,809**	**5.8**	**-28,354**
Net Current Transfers	**440**	**-43.2**	**250**	**-16.4**	**209**	**-28.2**	**150**
Balance on Current Account	**-1,897**		**-1,622**		**-2,172**		**-1,169**
Capital Transfers	370	1.4	375	-4.0	**360**	-5.6	340
Effective Current Balance	**-1,527**		**-1,247**		**-1,812**		**-829**

Gross National Product

National Accounts data for the third quarter of 2004 show that the volume of GNP grew by 4.2 per cent against the same period of the previous year. This takes the growth rate of GNP to 4.9 per cent for the first three quarters of 2004. The corresponding figure for GDP is 5.7 per cent. In terms of measurement, GNP is regarded as the most definitive indicator of the income accruing to Irish residents, while GDP is a more appropriate measure of the level of economic activity taking place in Ireland. A consistent feature of the Irish economy over the last three decades has been a large and widening gap between the two measures, where GDP has consistently outgrown GNP. This is indicative of the large portion of Irish economic value added which is owned by non-residents.

Data for the third quarter of 2004 point to some slowdown in economic growth. At an annualised rate, GDP shrunk by 2.8 per cent on the previous quarter, while GNP experienced a 1.6 per cent drop. However, these data should be interpreted with extreme caution given the short time frame involved and the scope for unreliable seasonal adjustment. Given our expectation that GDP will grow by 5.7 per cent this year against GNP growth of 5.0 per cent, the gap will widen this year between the two measures. This trend is likely to be reversed somewhat in 2006, with GNP growth of 5.8 per cent eclipsing GDP's 5.5 per cent growth rate. Gross National Disposable Income (GNDI), which measures income to Irish residents and takes into account the terms of trade effects and international transfers, is forecast to increase by 4.5 per cent this year before rising to 5.8 per cent in 2006.

Agriculture

The latest National Accounts data show that the Agriculture, Forestry and Fishing sector of the economy grew by 2.8 per cent year-on-year in the third quarter of 2004, an acceleration on the 1.4 per cent rise in the second quarter. This figure was buoyed by a particularly strong 3.0 per cent quarter-on-quarter growth rate in the third quarter.

Recent price developments in agriculture have been unfavourable from that sector's viewpoint. Though output prices rose by 2.2 per cent in 2004, a 3.9 per cent increase in the cost of inputs outstripped this rise. This resulted in a terms of trade loss of 1.6 per cent. This deteriorating trend continued in the final quarter of 2004 with an output price fall of 0.1 per cent year-on-year accompanied by a rise in input costs of 3.8 per cent, resulting in a 3.7 per cent terms of trade decline.

Industry

National accounts data suggest that Irish industry is performing relatively well but the underlying position is rather weaker. The volume of industrial value added increased at an annual rate of 4.9 per cent in the third quarter of 2004, slightly slower that the 5.8 per cent growth in the first half of the year. However, these figures mask the fact that the volume of industrial value added declined in each successive quarter of 2004, with all of the expansion described above occurring in the final quarter of 2003. In the third quarter of 2004, value added fell by 0.3 per cent against the previous quarter.

Provisional industrial production figures show that output rose by 1.1 per cent in 2004, a significant deceleration from the 5.0 per cent growth of 2003. In the final quarter of 2004, industrial output actually fell by 4.7 per cent against the same period of 2003. The steepest fall occurred in the "Modern" sector, which includes Chemicals, Computers and Electrical products, where output declined by 6.8 per cent year-on-year. The broader Manufacturing Industries sector contracted at an annual rate of 5.3 per cent in the final quarter of last year.

Nonetheless, industrial production rose by 0.5 per cent in the last quarter of 2004 against the third quarter, with the Modern Sector expanding by 1.6 per cent. The NCB's Purchasing Managers' Index has strengthened slightly over the last quarter. In the quarter ended in February, the PMI stood at 52.6 as against 51.8 in the previous three-month period. Any reading of above 50 indicates expansion in the manufacturing sector.

The most dramatic declines in output occurred in Chemicals, Tobacco products and Leather products, while significant rises in the reproduction of Recorded Media and Office Machinery/Computers. The strong growth in the acquisition of capital assets suggests that the industrial sector anticipates stronger growth in its output in the future. Capital acquisitions by industry grew at an annual rate of 14.3 per cent in the penultimate quarter of 2004, bringing growth for the first three quarters of last year to 41.0 per cent, indicative of strong investment behaviour by the industrial sector.

Much of the growth in industrial production in recent years can be attributed to specific sectors within manufacturing such as chemicals (NACE 24) and electrical and optical equipment (NACE 30-33). These sectors tend to be dominated by multinational firms that typically have a relatively low labour share and consequently only a small proportion of value added is distributed to the domestic workforce. Box B outlines how the recent underperformance of these sectors exaggerates the slowdown in the Industry sectors.

Box B: Exaggerating the Slowdown in the Industry Sector

In previous *Commentaries* we have attempted to weight industrial production by weights that may better reflect the contribution of this sector to the Irish economy by taking account of the dominance of foreign-owned multinational firms producing high value-added activities with relatively modest sized workforces. The sizeable gap between Irish GDP and GNP measures tend to reflect the divergent patterns within the industrial sector. Some adjustment is therefore warranted to examine the sometimes, conflicting trends within the industry sector.

Over the period 2000-2003 weighting industrial production using wage bill weights serves to significantly reduce the growth of industrial output (see Table B1) and industrial growth is further moderated when the *Chemicals* and *Electrical and Optical Equipment* sub-sectors are excluded.

Table B1: Industrial Output Growth Rates 2000-2004 Using Different Weightings

	Industrial Output (Value Added Weights)	Industrial Output (Wage Bill Weights)	Industrial Output Excl. Chem. & Elec. (Wage Bill Weights)
2000	15.3	12.4	3.9
2001	9.9	5.0	0.2
2002	7.6	1.0	-1.2
2003	5.0	4.3	3.1
2004	1.1	5.2	8.6

An examination of the expansion trends shows that output in the unadjusted industrial output, which is weighted by value-added, was growing strongly at 15.3 per cent in 2000 as was the series adjusted for wage bill weights at 12.4 per cent. When the *Chemicals* and *Electrical and Optical Equipment* sub-sectors are excluded the growth in the output of the remaining sub-sectors was more modest at 3.9 per cent. GDP and GNP growth was also exceptionally high in 2000 also.

When the Irish economy started to slowdown sharply in 2001 and into 2002, industrial output growth was also slowing markedly. The unadjusted output growth has fallen consistently since but remained substantially above the adjusted series in Table B1 during 2002 in particular. Then output growth was a quite strong 7.6 per cent whereas using the wage bill weights it was a modest 1.0 per cent or falling when *Chemicals* and *Electrical and Optical Equipment* sub-sectors were excluded. The gap in the growth rates of real GDP and real GNP were quite wide in 2002 also.

However, this situation appears to be reversed when we look at growth in 2004. The industrial production index implies sluggish growth of around 1.0 per cent, while using the growth rate implied using wage bill weights indicating vigorous growth of 5.2 per cent and 8.6 per cent when the *Chemicals and Electrical and Optical Equipment* sectors are excluded. This is consistent with the reasonably strong industrial employment growth outside of the construction sector in 2004. By reducing the importance of the multinational sector somewhat, this wage bill weighting confirms the strong performance of the remaining indigenous sectors. The indigenous sectors of manufacturing industry were shown by Eoin O'Malley[2] in the Winter 2004 *Commentary* to have had reasonably strong growth over 1991-2001 before experiencing the downturn which have now begun to reverse somewhat.

Services

National accounts data suggest that the services sector of the economy, as measured by value added, grew at an annual rate of 4.0 per cent in the penultimate quarter of 2004. This represents a modest acceleration from the 3.6 per cent growth rate experienced in the first half of the year. Growth was stagnant in the Public Administration and Defence category, with a miniscule increase of 0.7 per cent in the third quarter of last year. Distribution, Transport and Communication is a more active sector, with growth of 3.5 per cent in the third quarter of 2004 following on from an increase of 3.3 per cent in the first half of the year. The Other Services category is the fastest growing within the sector, and notched up annual growth of 4.6 per cent in the third quarter of last year, having grown at 4.2 per cent in the first half of the year.

The NCB Purchasing Managers Service Index indicates that growth in the services sector has accelerated slightly in recent months. The index stood at 58.2 in the three-month period ending in February, up from 57.9 in the previous quarter, indicative of an expanding sector.

Growth in the services sector is by no means universal; earnings from Tourism and Travel declined by 5.0 per cent in the third quarter of 2004 against the same period of the previous year. The fall in actual tourist numbers was smaller, numbering a slight drop of 0.7 per cent, suggesting a fall in per capita visitor expenditure over the

[2] Eoin O'Malley (2004). "Competitive Performance in Irish Industry", *Quarterly Economic Commentary*, Winter 2004, Dublin: The Economic and Social Research Institute.

last year. Despite the decline in earnings from Tourism and Travel, major growth was recorded in other service exports. This includes a year-on-year increase of 36.2 per cent in the value of Business Services exports in the third quarter of 2004, a rise of 20.4 per cent in Computer services exports, and a 7.0 per cent expansion in exports of Insurance services.

Employment

Despite some slowdown in the pace of economic growth internationally in the final quarter, the Irish labour market has shown remarkable resilience in recent times. The latest Quarterly National Household Survey (QNHS) points to continued strength in the Irish labour market with employment growing by 3.0 per cent on average in 2004. This compares with a 1.9 per cent average annual increase in 2003 and a 1.8 per cent average annual increase in 2002. In absolute terms, this represents an average increase of 54,400 persons in employment in 2004, bringing the total number employed to 1.894 million persons at the end of the year.

The rate of employment growth registered in each quarter of 2004 increased consistently over the year, with the 3.6 per cent growth (or 65,200 persons) in employment in the fourth quarter of 2004 representing the highest level of annual growth recorded since the first quarter of 2001, when a growth rate of 3.8 per cent was registered. Increases in full time employment accounted for just over four fifths of the annual increase.

TABLE 8: Employment and Unemployment*

	Annual Averages			
	2003	**2004**	**2005**	**2006**
Agriculture	120	117	116	116
Industry	499	516	524	526
Services	1,192	1,232	1,259	1,287
Total at Work	**1,811**	**1,865**	**1,899**	**1,935**
Unemployed	88	87	86	87
Labour Force	**1,899**	**1,952**	**1,984**	**2,021**
Unemployment Rate %	4.6	4.5	4.3	4.3
Live Register	172	166	161	156

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

Employment in Agriculture decreased by 2.5 per cent on average in 2004 while employment in both Industry and Services increased by 3.4 per cent on average over the same period. Within Industry, the increase in employment was accounted for by an improvement in the Construction sector where employment rose by approximately 10.0 per cent or 19,100 on average over the year. Employment in the Other Production Industries that comprise total Industry fell by just over 1.0 per cent or 3,000 on average over the year, highlighting the importance of the construction sector for industrial employment.

An expanding labour force coincided with these employment increases; the labour force increased by 3.4 per cent in the fourth quarter of 2004 when compared to the same quarter of 2003. This compares to an annual increase of 2.7 per cent in the third quarter of 2004 and a 2.4 per cent increase in the second quarter. Females accounted for the largest part of the increase, albeit only slightly higher than the increase in the number of males in the labour force; annual growth of 53.0 per cent was recorded in the number of females in the labour force compared to a 47.0 per cent increase in the number of males. This corresponds to an annual rise in the male participation rate from 71.1 per cent in 2003 to 71.5 per cent in 2004 and an annual rise in the female participation rate from 49.6 per cent in 2003 to 50.8 per cent in 2004. In absolute terms there was an increase of 64,900 persons to 1.980 million in the year to the fourth quarter of 2004. Demographic factors at an estimated 45,000 accounted for the largest part of the increase in the labour force. Immigration is estimated to have accounted for close to a third half of the increase in the labour force.

The increases in both labour force size and employment implies that there was no change in the seasonally adjusted unemployment rate of 4.4 per cent from the third quarter of the year. The annual unemployment rate in the fourth quarter however fell to 4.3 per cent from 4.5 per cent in the same period of 2003. This represents the lowest annual unemployment rate since the second quarter of 2002 when an unemployment rate of 4.2 per cent was registered. In absolute terms there were 85,600 people unemployed in the fourth quarter, a decrease of 3,000 on an annual basis or a seasonal decrease of 8,300 in the quarter.

The latest *Live Register Analysis* for February 2005 indicates that when adjusted for seasonal factors, the register fell by 14,500 over the same period of 2004. In keeping with recent trends in the labour market, the standardised unemployment rate was 4.2 per cent in February.

It is forecast that the rate of employment growth will slow somewhat this year when an annual average of 1.8 per cent is expected, before rising slightly to 1.9 per cent in 2006. While decreases in employment in the agricultural sector are expected to persist, the job losses will continue to be more than compensated for by employment growth in the industrial and services sectors. Labour force growth is expected to moderate in the future, with growth of 1.7 per cent and 1.3 per cent expected in 2005 and 2006 respectively. The unemployment rate is expected to average 4.3 per cent both this year and next.

Box C: Potential Contribution of Immigrants to the Irish Economy

The Census of 2002 showed that 6.0 per cent of Ireland's population is now made up of non-Irish nationals. More recently, the Quarterly National Household Survey (Q4 2004) showed that one-third of the increase in the labour force between Q4 2003 and Q4 2004 was accounted for by immigration. Given the number of non-Irish nationals now present and the continuing inflow, it is important to have information on the characteristics of this group and their impacts.

A labour market profile of non-national immigrants has just been produced by Barrett *et al.*[3] They use the Quarterly National Household Survey (Q2 2003) to establish how immigrants compare to the native population looking at variables such as education and occupation. In conducting the analysis, they define immigrants as being people who (a) describe themselves as having a nationality other than Irish, (b) were not born in Ireland and (c) have lived in Ireland for ten years or less.

In Table C1, the figures on the education levels of immigrants relative to natives are presented. The most striking feature to emerge is the high levels of educational attainment among immigrants relative to the native population. While 27.3 per cent of the native population have third level qualifications, the corresponding figure for immigrants is 54.2 per cent. At the other end of the educational distribution, while 32.9 per cent of the native population have only lower secondary qualifications or less, only 15.1 per cent of the immigrant population have this low level of attainment.

Table C1: Distributions of Educational Attainment for the Natives and Immigrants in the Labour Force (%)[4]

	Irish	UK	Rest of EU-15	American	Other	Total Immigrants
No formal/primary education	13.7	6.7	1.3		6.8	5.5
Lower secondary	19.2	19.6	2.5	4.3	5.8	9.6
Upper secondary	27.5	18.8	24.9	14.9	23.3	22.0
Post Leaving	12.3	10.5	8.1		8.3	8.8
Third level – non-degree	10.6	15.8	14.5	6.4	12.9	14.0
Third level – degree or above	16.7	28.4	48.6	74.5	42.8	40.2
Total	100.0	100.0	100.0	100.0	100.0	100.0
N	41,612	626	393	47	878	1,944

Source: Derived from the *QNHS* (Q2 2003).
Note: As the sample in the case of Americans is small, care should be used in deriving conclusions specific to that group.

The difference in education levels between immigrants and natives would lead to the expectation of immigrants being more heavily concentrated in high-skill occupations relative to natives. However, the figures in Table C2 show that this is not the case. While immigrants are more heavily concentrated in professional/associate professional occupations, this is only marginally the case. Also, immigrants are less well represented in the management/administrator category. The "other or not stated" category captures the low skilled occupations and it appears that

[3] Barrett, Alan, Adele Begin and David Duffy, 2005. "The Labour Market Characteristics and Labour Market Impact of Immigrants in Ireland", ESRI Working Paper, No.

[4] The "other" category includes people from the following countries, amongst others, ranked according to the number of work permits issued between 1999 and 2003: Latvia, Lithuania, Philippines, Poland, South Africa, Romania, Ukraine, Czech Republic, Russia, Australia, Malaysia and Brazil.

Table C2: Occupational Distribution of Natives and Immigrants (%)

	Irish	UK	Rest of EU-15	American	Other	Total Immigrants
Managers and administrators	17.7	16.8	9.1	22.4	6.9	10.5
Professional	10.5	14.5	15.2	22.4	10.7	12.9
Associate professional and technical	8.7	10.9	10.7	18.4	11.6	11.4
Clerical and secretarial	12.2	11.5	16.8	6.1	6.6	10.0
Craft and related	13.6	13.5	5.6	0.0	10.4	10.1
Personal and protective service	9.8	11.8	19.9	12.2	20.2	17.5
Sales	8.2	5.9	9.3	8.2	6.4	6.9
Plant and machine operatives	9.8	7.2	6.1	4.1	11.6	9.1
Other (includes not stated)	9.6	7.9	7.2	6.1	15.6	11.6
Total	100	100	100	100	100	100
N	41,831	643	428	49	1,108	2,228

Source: Derived from the QNHS (Q2 2003).
Note: As the sample in the case of Americans is small, care should be used in deriving conclusions specific to that group.

immigrants are slightly more concentrated in this group relative to natives.

The discrepancy between the educational and occupational levels of immigrants relative to natives was investigated further using regression analysis. Controlling for the effects of education and age on occupational attainment, Barrett *et al.*, estimate that immigrants were 7.0 per cent less likely to be in the top three occupational categories. As the "occupational gap" does not apply to immigrants from the US and the UK, it might be the result of weak English language skills. It could also result from difficulties for employers in recognising foreign qualifications.

Barrett *et al.*, go on to estimate the impact of immigrants in the labour market. They show that the immigrant inflow in the five years to 2003 would have increased GNP by 3.3 per cent if immigrants were employed in occupations that fully reflected their education levels. However, by accounting for the lower occupational level of immigrants relative to their educations, the GNP increase is estimated to be 2.6 per cent. In terms of GNP per head, the corresponding increases are 1.0 per cent and 0.4 per cent. Comparing the GNP and GNP per head results shows the impact of immigration on living standards is less than its impact on total output. But either way, the results suggest that Ireland may be losing out by not employing immigrants in a way that fully captures their exceptional educational levels.

Another positive impact of immigration is a reduction in earnings inequality. Skilled immigrants increase skilled labour supply and so reduce wage pressures in that section of the labour market. They also lead to an increase in the demand for unskilled labour, thereby bidding up the wages of the unskilled.

These results draw attention to a number of interesting issues. For example, the distributional impact of immigration may be more sizeable than the impact on GNP. Also, policy in respect of migrants after they arrive here may be as important, or even more so, than policy on numbers admitted.

TABLE 9: Personal Disposable Income

	2003	Change		2004	Change		2005	Change		2006
	€m	%	€m	€m	%	€m	€m	%	€m	€m
Agriculture, etc.	2,915	4.6	135	3,050	4.4	135	3,185	3.0	95	3,280
Non-Agricultural Wages	53,402	9.4	5,002	58,404	7.3	4,262	62,666	6.8	4,273	66,939
Other Non-Agricultural Income	14,824	-8.7	-1,288	13,535	7.3	982	14,518	11.6	1,690	16,208
Total Income Received	**71,141**	**5.4**	3,849	**74,989**	**7.2**	**5,379**	**80,369**	**7.5**	**6,058**	**86,427**
Current Transfers	14,753	11.2	1,654	16,407	8.8	1,452	17,859	4.9	874	18,733
Gross Personal Income	**85,894**	**6.4**	**5,503**	**91,396**	**7.5**	**6,831**	**98,228**	**7.1**	**6,932**	**105,160**
Direct Personal Taxes	15,720	13.5	2,122	17,842	6.1	1,080	18,922	7.6	1,446	20,368
Personal Disposable Income	70,173	4.8	3,381	73,554	7.8	5,751	79,305	6.9	5,486	84,792
Consumption	62,935	5.1	3,185	66,120	7.0	4,634	70,754	7.3	5,176	75,930
Personal Savings	7,338	2.7	196	7,434	15.0	1,117	8,552	3.6	310	8,862
Savings Ratio	10.3			10.1			10.8			10.5

Incomes

Figures relating to more recent times show that earnings growth in many areas of the economy has considerably exceeded the rate of price increases. In the construction industry, hourly earnings rose by 6.0 per cent in the third quarter of 2004 and weekly earnings increased at a 6.8 per cent rate over the year, reflecting the increased number of hours worked in that sector. Weekly earnings of employees in the Banking, Insurance and Building Society sector showed a 7.5 per cent increase over the same period, and coincided with a 5.5 per cent rise in weekly earnings in the Distribution and Business Services sector. This strong rate of earnings growth across the services sector is indicative of the speed at which that portion of the economy is growing, as well the tightening of the Irish labour market on which the services sector is strongly dependant. Preliminary figures suggest that agricultural income rose in 2004 and the outlook remains strong this year; we are forecasting a rise of 4.4 per cent for the year. While this growth is expected to decrease somewhat next year, a growth rate of 3.0 per cent is nonetheless expected in 2006.

Pay awards under the Benchmarking process and the Sustaining Progress programme have delivered particularly rapid growth in earnings for those employed in the public sector. A rise of 9.3 per cent in the weekly earnings of public sector workers was observed in the year to September 2004. The relatively tight labour market and strong economic growth will translate into 5.2 per cent wage growth this year and 4.7 per cent growth next year. These hourly earnings growth rates are expected to feed through to non-agricultural wages in the form of somewhat decreased growth prospects; we expect a 7.3 per cent growth rate in non-agricultural wages in 2005, down from the estimated 9.4 per cent in 2004. A further slowdown is expected in 2006, when a growth rate of 6.8 per cent is forecast. Other non-agricultural income is expected to rebound this year before improving further in 2006; a growth rate of 7.3 per cent is expected in 2005, representing a reversal of last year's negative growth rates in this category. A 11.6 per cent growth rate is forecast for 2006.

In light of the approaching expiration dates of the SSIAs in 2006 and 2007, we expect a substantial increase in personal savings this year when a 15.0 per cent increase is forecast on the 2004 figures. A savings ratio of 10.8 of personal disposable income is also forecast. In 2006, we expect a slowdown in the pace of growth in personal savings, given the divesture of the SSIAs for the first tranche of account holders and the fact that the previous years base level will have been quite high; we estimate an increase in personal savings of 3.6 per cent on the previous year. The savings ratio is expected to decrease slightly to 10.5.

Consumer Prices

Official figures confirm that the Consumer Price Index (CPI) rose by 2.2 per cent on average in 2004, representing the lowest annual average inflation rate since 1999. The decelerating pace of inflation observed in the final month of 2004 has continued into the early part of 2005; the rate of consumer price inflation fell by 0.8 per cent in the month to January 2005, leading to a decrease in the annual rate of inflation to 2.3 per cent, down from 2.6 per cent in December 2004. This compares to a month on month decrease of 0.5 per cent for the same period of 2004 and an annual rate of inflation of 1.8 per cent.

The annual rate of inflation for goods was 0.3 per cent in January while it was 4.1 per cent for services. This compares to respective annual inflation rates of 0.5 per cent and 3.0 per cent in January 2004. The significant rise in service price inflation could reflect the recent tightening in the services sector labour market. The largest annual increases in prices were recorded in the Housing, Water, Electricity, Gas & Other Fuels (9.2 per cent), Health (6.2 per cent), Education (5.6 per cent) and Restaurants and Hotels (3.5 per cent). Decreases in prices were recorded in Clothing and Footwear (3.4 per cent) and Furnishings, Household Equipment and Routine Household Maintenance (2.0 per cent).

Annual figures for the EU harmonised index of consumer prices, the HICP show that the Irish inflation rate increased by 2.5 per cent in the year to December 2004. During this time, Ireland registered the tenth lowest inflation rate in both the EU-25 and the EU-15. Disaggregated data show that inflation in Ireland was quite high relative to several of its EU partners in Housing, Water, Electricity, Gas and Other Fuels, Health, Transport, Education, and Restaurants and Hotels.

The continued strength of the euro means that the economy will continue to benefit from cheaper import prices, as shown by the negative import price deflator, which will reflect positively on the rate of inflation going forward. As outlined in the international section of this *Commentary* an increase in interest rates is expected in 2006. Given that mortgage interest rates are included in the CPI but not in the EU HICP, this will contribute to a crossover with CPI inflation below its HICP equivalent in 2006. We forecast that the consumer price index will average around 2.4 per cent in 2005, with a similar annual average of around 2.2 per cent in 2006.

TABLE 10: Consumer Price Index – Recent Trend and Forecast

	2001	2002	2003	2004	2005 Forecast	2006 Forecast
Annual % Change						
Housing	16.5	0.9	-0.6	4.3	6.6	2.8
Other	4.0	5.0	4.2	2.1	2.0	2.2
Total CPI	4.9	4.6	3.5	2.2	2.4	2.2
EU-HICP (Ireland)	4.0	4.7	4.3	2.5	2.3	2.3
Housing	102.7	103.7	103.1	107.5	114.6	117.8
Other	98.7	102.6	106.9	109.1	111.3	113.7
Total CPI	97.9	102.7	106.3	108.6	111.2	113.7

Public Finances

End-year *Exchequer Returns* for 2004 indicate that the Irish public finances have mirrored the fortunes of the wider economy. Current receipts rose by 9.7 per cent compared with 2003. In particular, tax revenue benefited from the strong labour market and demand conditions, rising by 10.8 per cent. Income tax was the main driver of this strong increase, up 16.3 per cent, while Value Added Tax (VAT) receipts also posted robust growth, climbing by 10.0 per cent in the year. The non-tax revenue component placed a slight drag on current receipts, as it fell by 24.0 per cent, mainly due to a reduction in the Central Bank's surplus income.

Government expenditure growth was also strong last year. Current expenditure rose by 7.0 per cent, with increases in voted expenditure on *Health and Children* of 8.0 per cent, *Education and Science* of 12.2 per cent, while *Transport* expenditure fell by 2.8 per cent. National debt interest payments totalled €1.7 billion, a rise of 10.7 per cent on 2003. The current budget surplus in 2004 was €5.6 billion, compared with a €4.4 billion surplus in 2003. The deficit on the capital account widened slightly last year to €5.6 billion, from €5.4 billion in 2003. The overall effect was that the Exchequer balance, which is the sum of the current and capital balances, tipped into a €33 million surplus last year, from around a €1 billion deficit in 2003.

The more broadly based General Government Balance (GGB) was in a surplus of near €2 billion in 2004 or 1.3 per cent of GDP, substantially up on the €0.3 billion surplus in 2003. The underlying state of the public finances reflected the strength of the economic recovery but a substantial proportion of the €1.7 billion improvement in the GGB was due to a series of one-off gains like a carryover of capital spending allocations amounting to 0.2 per cent of GDP and Special Investigations by the Revenue Commissioners contributing up to 0.5 per cent of GDP. Taking account of these and some other one-off factors would indicate that the underlying surplus on the GGB was around 0.5 per cent of GDP. Irish budgetary policy has been running close to balance or in surplus positions over the last two years in the spirit of the EU *Stability and*

Growth Pact, with the underlying fiscal stance in 2004 being mildly restrictive.

The *Revised Estimates for Public Services 2005* envisage increases in all major spending areas this year. The largest increases will take place in expenditure on *Health*, set to rise by 13.1 per cent, expenditure on the *Environment* is estimated to rise by 12.0 per cent, and spending on *Education* will increase by 8.7 per cent. Total expenditure is projected to rise by 10.8 per cent. The *Exchequer Returns* up until the end of February of this year are broadly consistent with this profile. Total expenditure is up by 8.9 per cent on the same period of 2004, with voted expenditure rising by a particularly strong 10.3 per cent. Receipts have risen by 14.4 per cent in the first two months of this year, with especially strong growth in tax revenue. The Exchequer surplus in the year to-date is €0.8 billion, compared to €0.4 billion a year earlier.

Given the expenditure programme for this year and the tax changes contained within Budget 2005, we would anticipate the fiscal stance this year to be much more expansionary than in recent years. However, in light of the need for a supplementary estimate to the Health expenditure for reimbursement for long-stay care patients, it may be necessary to provide an estimate for contingency expenditure over the next couple of years such that the budgetary outturns might deteriorate significantly. It, however, remains the case that the Irish public finances are sound with current budget surpluses anticipated over an extended period; whilst continuing to sustain a significant capital investment programme and maintaining a relatively low General Government Debt to GDP ratio of just below 30.0 per cent.

A further issue in terms of the public finances is the growing exposure of the Exchequer to contributions in relation to Special Savings Incentive Accounts. The average monthly contribution per account is growing steadily as the release date approaches, because the effective annual return is greater on savings made closer to maturity date. The average monthly contribution rose in 2004 to €175 per account, having been €165 in 2003 and €158 in 2002. We would anticipate that monthly contributions would continue to rise in the run up to the commencement of divestures in May 2006. The annual cost to the Exchequer of the SSIA scheme may rise from the current level of €575 million to around €600 million by mid-2006 when this scheme starts to expire.

As regards the outlook for the public finances, we forecast that the expansionary fiscal policy embarked upon in Budget 2005 will result in a €2.8 billion Exchequer deficit this year, but that this will narrow to a deficit of around €2 billion in 2006. The position in 2005 is around 0.4 percentage points of GDP worse-off reflecting timing issues in relation to FEOGA intervention payments being paid by the Irish government this year but reimbursements from the European Union occurring next year. Also, we have provided a contingency fund of around €500 million for both this year and next to cover unplanned expenditures such as refunds to long-term residential care patients.

The more appropriate measure of fiscal stance is the change in the GGB, which is inclusive of the Exchequer balance and also items like the contributions to the National Pension Reserve Fund and local authorities borrowings. In 2005, we expect that the GGB will be in deficit of around €1 billion or 0.6 per cent of GDP. When account is taken of one-off factors the underlying position is expected to be close to balance. The outcome for 2006 is for a relatively small GGB deficit of €0.4 billion or 0.2 per cent of GDP. The underlying trend in the GGB, when account of the economy's cyclical position is taken into consideration, is for a mildly expansionary budget stance in 2005 and a slight contractionary stance in 2006. The general government debt to GDP ratio is expected to remain below 30.0 per cent of GDP both this year and next.

TABLE 11: Public Finances

	2004	% Change	2005	% Change	2006
Current Revenue	36,383	7.3	39,050	7.6	42,005
Current Expenditure	30,763	12.7	34,665	7.5	37,250
Current Surplus	**5,620**	-22.0	**4,385**	8.4	**4,755**
Capital Receipts	1,142	5.1	1,200	40.0	1,680
Capital Expenditure	6,729	24.1	8,350	0.7	8,410
Capital Borrowing	**5,587**	28.0	**7,150**	-5.9	**6,730**
Exchequer Balance	**33**		**-2,765**		**-1,975**
as % of GNP	0.0		-2.1		-1.4
General Government Balance	**1,953**		**-977**		**-364**
as % of GDP	1.3		-0.6		-0.2
Gross Debt as % of GDP	**29.9**		**29.4**		**28.6**

General Assessment

The Irish economy continued its exceptional employment performance since the mid-1990s with another year of high net job growth of 3.0 per cent in 2004. Output growth in the economy is back above 5 per cent in real terms and consumer price inflation rates are well within the mid-range of the Euro Area countries. While growth is unlikely to scale the heights of the late 1990s, the performance of the Irish economy is consistent with one growing along its potential path with near full-employment conditions. The rate of unemployment averaged 4.5 per cent last year, which contrasts markedly to that prevailing within the Euro Area generally at over double the Irish rate.

The most obvious source of domestic growth in Ireland in recent years has been the extraordinary increase in house building. As previous *Commentaries* have set out, the reliance on this sector has reached historic proportions and the growth in new house building was 11.8 per cent in 2004. A slowdown or reversal in this building surge constitutes a significant risk to the growth prospects of the domestic economy. Our forecasts are based upon a gradual rebalancing of housing supply growth in line with fundamental requirements for household formation purposes and slower growth in the demand for second houses. The demand for second homes, many of which remain vacant for considerable periods of time, is one of the most interesting features of the Irish market in recent years as John Fitz Gerald sets out in an article accompanying this *Commentary*.[5]

Growth from net exports has also been significant in 2004 despite the strengthening of the effective euro exchange rate in trade-weighted terms. The strength of the recovery in both the US and UK markets meant that export growth for Ireland remained strong, albeit against the backdrop of falling export prices. The volume increase from the government sector in 2004 was quite modest, though the value rise in terms of incomes was more substantial given the payment of half of the *Public Sector Benchmarking* awards during the year.

Despite reasonably robust growth in disposable incomes and rising employment, the growth in consumer expenditure was once again quite modest in its contribution to overall growth in 2004. This volume growth of less than 3.0 per cent has been a feature of the economy over the last three years indicative of fragility of consumers' confidence in the recovery of the economy and the extent of savings, particularly through mortgage financing of the rapidly growing property market. The role of the Special Savings Incentive Accounts (SSIAs) may also have been a factor in dampening consumption out of disposable income. As this scheme matures from mid-2006 to mid-2007, some pick-up in consumption growth may be expected. As we highlighted in previous *Commentaries*, the extent of the consumption jump is difficult to predict with any certainty but a noticeable rise in consumer confidence would suggest that the consumer may resume being a significant contributor to overall growth in the coming years.

The economy is expected to remain on a higher growth path compared to other countries for the foreseeable future, with growth in output for 2005 and 2006 in real terms expected to be higher than 5.0 per cent. This resumption to a phase of quite rapid growth constitutes an opportunity to ensure that sufficient investment is made to improve future supply capacity of the economy. While inevitably there are risks that such a benign scenario may be undermined, these need not be exaggerated. The most immediate threat arises from the imbalances in the international economy and how these are to be corrected without entailing a rapid depreciation in the US dollar's value. Given the scale of the cross-holding of assets between the major world blocks, it is mutually advantageous to seek an orderly correction involving tighter monetary and fiscal policy in the US while other regions must pursue sustainable higher growth strategies. China is certainly to the forefront on this issue, but also the EU is moving in this direction with a refocus of their *Lisbon Agenda on Competitiveness* towards highlighting economic growth as the most important among the multitude of objectives it contains.

[5] Fitz Gerald, J. (2005), "The Irish Housing Stock: Growth in the Number of Vacant Dwellings", in *Quarterly Economic Commentary*, Spring 2005.

The performance of the Irish economy continues to attract attention internationally. The combination of rising prices and rapid growth has been taken to be an indication of an overheating economy but while the price level is now very high, the acceleration in prices has moderated substantially. This moderation has come through low goods price inflation where the exchange rate pass-through is significant, while services price growth has remained quite strong in line with continued high wage growth.

The presence of continued high wage growth may be explicable within the context of a tight labour market but the fundamental issue for a trade dependent economy is the justification of higher wages in terms of productivity developments. The competitiveness of a regional economy, like Ireland, remains critical for its continued success. The task for the social partners is to find a controlled way to harness the benefits of full employment without damaging the economy's long-run growth potential through excessive wage overshooting.

The relative shift in economic activity towards internationally traded services activity from industrial manufacturing will make high overall productivity growth more difficult to attain because of the nature of the activities. Productivity growth in Ireland as measured by output per hour remains among the highest in the OECD but, as has been demonstrated in previous *Commentaries*, a significant proportion of this positive picture is a consequence of the nature of the activities of the sizeable foreign-owned multinationals based in Ireland.

Overall productivity growth in Ireland appears to have declined when measured as the differential between output and employment growth rates in the 1999-2002 period when it averaged 4.9 per cent while in 2003-2004 it is slightly below 2.0 per cent. The presence of large multinationals in the "Modern" sector have tended to outpace the more indigenous firms dominated "Traditional" sector in recent years. The pattern changed somewhat in 2004. When industrial production is weighted by output a couple of non-employment intensive sectors tend to dominate, such as the *Chemicals* sector. Re-weighting for employment intensity through the sectors' wage bill components would suggest that firms within these more labour intensive sectors had higher real output growth last year in contrast to sectors like *Chemicals*, etc. which had declines. These within-industry shifts may tend to partially explain the overall slowdown in productivity growth but may also exaggerate the overall impact of this slowdown for the wider economy.

Nevertheless, productivity growth in the Irish economy has slowed substantially from the boom years of the 1990s as the economy moves to relatively more labour intensive services' based activities. Living standards, as captured by Irish real Gross National Disposable Income (GNDI), which takes account of terms of trade movements and capital transfers from abroad, are estimated to have grown by 3.7 per cent in 2004. While this is up from 2003, it is in line with the average of recent years since 2001 but substantially lower than the 8.0 per cent average over the 1998-2000 period. With strong employment growth and an expanding population, the rise in living standards in per capita and per person-employed terms is quite modest. We anticipate that real GNDI will rise by 4.5 and 5.8 per cent in 2005 and 2006.

It will be important for future living standards to ensure that Ireland remains a highly productive economy and therefore making the best use of an expanding workforce is crucial. As Barrett, Bergin and Duffy (2005) point out in Box C of this *Commentary,* the substantial inflow of migrants to the labour force have educational attainments that are relatively higher than the incumbent population's and that they would appear to be currently employed in occupations that may not best reflect their higher skills. This is a potentially significant loss to the Irish economy from what are currently very favourable migratory trends. Migration flows can help make a significant contribution to the improvement of living standards within the Irish economy over the coming decades and so should be effectively considered in the context of any emerging policy initiatives for migration policy. Irish livings standards have been ranked 4th in the world by the OECD, behind Luxembourg, Norway and the USA, using GDP per capita in purchasing power terms. When it is taken into account that the more appropriate indicator of Irish incomes is GNP, Ireland is ranked 15th.

The Irish public finances recorded another surplus on the General Government Balance (GGB) in 2004 reflecting the strength of the economic recovery. The public finances are expected to remain sound over the next two years despite the need for a supplementary estimate to the Health expenditure for reimbursement for long-stay care patients. Offsetting this outlay somewhat, will be the prospect that the Exchequer may also benefit from further one-off gains from additional Revenue Commissioners' investigations and in addition the ending of the SSIA scheme from mid-2006 to mid-2007 will boost revenue given that the scheme has been treated as a revenue forgone item from income taxation over its lifetime. While there may be a capacity to finance a potentially large re-imbursement scheme, there nonetheless would be significant resource allocation costs that would manifest themselves in terms of reductions in other expenditures, higher taxation and/or additional borrowing. The underlying position of the General Government is expected to be close to balance both this year and next. The current budget is anticipated to have substantial surplus positions to help finance on-going capital investment projects and maintaining the General Government Debt to GDP ratio at levels below 30.0 per cent. Overall, the Irish public finances are in a strong and sustainable position.