

SUMMARY

The latest *Quarterly National Accounts* show that the preliminary estimates of GNP and GDP growth for 2005 were 5.4 per cent and 4.7 per cent respectively. These figures imply that economic growth in terms of GNP was at its highest rate since 2000. Hence, the economy is performing strongly and is expected to continue doing so in 2006 and 2007. For 2006, we are forecasting a real GNP expansion of 5.1 per cent (4.8 per cent in GDP). For 2007, the corresponding forecast is 5.3 per cent for GNP (5.1 per cent for GDP).

Growth in 2005 was driven by domestic factors. Investment grew by 13.1 per cent, its largest increase so far this decade. Consumption also grew strongly at a rate of 5.6 per cent. However, the export performance of the economy was disappointing with growth of only 1.8 per cent. This poor export performance contributed to a deterioration in the current account balance. In 2004, the current account deficit was equal to 0.9 per cent of GNP; in 2005, this widened to 2.3 per cent of GNP.

For 2006, we expect domestic factors to remain the main drivers of economic growth. Consumption is expected to grow by 5.9 per cent in 2006 and by 6.4 per cent in 2007. The increase in the rate of growth between the two years is largely related to the maturing of SSIA's, the bulk of which will mature in 2007 rather than 2006. Investment demand will remain strong with growth rates forecast of 7.8 per cent in 2006 and 6.9 per cent in 2007. We expect to see an increase in the growth of government spending in 2007 as suggested by previous trends in public spending around elections. This will contribute to the general government deficit rising from zero per cent in 2006 to almost 1 per cent in 2007. Although we include this effect in our forecast, we also warn against excessive increases.

We forecast an improvement in Ireland's export performance with growth rates of 3.5 per cent in 2006 and 4 per cent in 2007. These forecasts are based on a favourable external context, in particular a pick up in growth in the Euro Area. Following growth of just 1.4 per cent in 2005, growth in the Euro Area is expected to rise to 2.2 per cent in 2006 and to remain strong in 2007 at 2 per cent. One additional implication of the improving situation in the Euro Area is that interest rates are likely to rise. We expect the ECB main refinancing rate to reach 3 per cent by the end of 2006 and 3.5 per cent by the end of 2007. Regarding exchange rates, we are forecasting relatively stable rates but remain mindful of the large and growing current account deficit in the United States which has the potential to lead to a dollar devaluation.

On employment, we expect 2006 and 2007 to produce increases of 67,000 and 60,000 respectively. Accounting for new labour market entrants and a marginal increase in participation, these employment increases imply gross immigrant inflows of 53,000 in 2006 and 48,000 in 2007. On inflation, we are forecasting a CPI rate of 2.8 per cent in 2006 and a moderation in 2007 with a rate of 2.6 per cent expected.

In the General Assessment, we highlight two concerns. First, we reflect on the poor export performance of recent years and review the evidence linking Ireland's declining competitiveness to this poor performance. Second, we note the acceleration in house prices in recent months and voice a concern regarding ongoing developments in the housing market.

PRELIMINARY NATIONAL ACCOUNTS 2005

A: Expenditure on Gross National Product

	2004	2005	Change in 2005				
			€m	Preliminary €m	€m		%
			Value	Volume	Value	Price	Volume
Private Consumer Expenditure	68,540	73,875	5,335	3,840	7.8	2.1	5.6
Public Net Current Expenditure	20,807	22,778	1,971	651	9.5	6.2	3.1
Gross Fixed Capital Formation	36,290	43,246	6,956	4,741	19.2	5.4	13.1
Exports of Goods and Services (X)	123,519	127,218	3,699	2,275	3.0	1.1	1.8
Physical Changes in Stocks	793	125	-668	-632		0.0	-79.8
Final Demand	249,949	267,242	17,293	10,720	6.9	2.5	4.3
less:							
Imports of Goods and Services (M)	100,687	106,159	5,472	4,671	5.4	0.8	4.6
less:							
Statistical Discrepancy	705	761	56	-874			
GDP at Market Prices	148,556	160,322	11,766	6,923	7.9	3.1	4.7
less:							
Net Factor Payments (F)	-24,306	-24,699	-393	-236	1.6	0.6	1.0
GNP at Market Prices	124,250	135,623	11,373	6,709	9.2	3.6	5.4

B: Gross National Product by Origin

	2004	2005	Change in 2005	
			€m	%
Agriculture, Forestry, Fishing	2,912	2,898	-15	-0.5
Non-Agricultural: Wages, etc.	58,220	64,424	6,204	10.7
Other:	54,289	56,316	2,027	3.7
Adjustments: Stock Appreciation	-309	-410		0.0
Statistical Discrepancy	705	761	56	7.9
Net Domestic Product	115,818	123,988	8,170	7.1
less:				
Net Factor Payments	-24,306	-24,699	-393	1.6
National Income	91,512	99,289	7,777	8.5
Depreciation	15,749	16,758	1,008	6.4
GNP at Factor Cost	107,261	116,047	8,786	8.2
Taxes less Subsidies	16,989	19,576	2,587	15.2
GNP at Market Prices	124,250	135,623	11,373	9.2

C: Balance of Payments on Current Account

	2004	2005	Change in 2005
Exports (X) less Imports (M)	22,832	21,059	-1,773
Net Factor Payments (F)	-24,306	-24,699	-393
Net Transfers	307	570	263
Balance on Current Account	-1,167	-3,070	-1,903
as % of GNP	-0.9	-2.3	-1.3

FORECAST NATIONAL ACCOUNTS 2006

A: Expenditure on Gross National Product

	2005	2006	Change in 2006				
	Preliminary €m	Forecast €m	€m		Value	%	
			Value	Volume		Value	Price
Private Consumer Expenditure	73,875	80,189	6,314	4,359	8.5	2.5	5.9
Public Net Current Expenditure	22,778	25,056	2,278	729	10.0	6.6	3.2
Gross Fixed Capital Formation	43,246	49,003	5,757	3,377	13.3	5.1	7.8
Exports of Goods and Services (X)	127,218	133,382	6,164	4,453	4.8	1.3	3.5
Physical Changes in Stocks	125	138	13	13		0.0	10.0
Final Demand	267,242	287,769	20,527	12,825	7.7	2.7	4.8
less:							
Imports of Goods and Services (M)	106,159	112,697	6,538	5,202	6.2	1.2	4.9
less:							
Statistical Discrepancy	761	1,187	426	-3			
GDP at Market Prices	160,322	173,884	13,562	7,627	8.5	3.5	4.8
less:							
Net Factor Payments (F)	-24,699	-25,124	-425	-741	1.7	-1.2	3.0
GNP at Market Prices	135,623	148,761	13,138	6,910	9.7	4.4	5.1

B: Gross National Product by Origin

	2005	2006	Change in 2006	
	Preliminary €m	Forecast €m	€m	%
Agriculture, Forestry, Fishing	2,898	2,957	59	2.1
Non-Agricultural: Wages, etc.	64,424	70,297	5,873	9.1
Other:	56,316	59,992	3,676	6.5
Adjustments: Stock Appreciation	-410	-200	210	-51.2
Statistical Discrepancy	761	1,187	426	56.0
Net Domestic Product	123,988	134,232	10,244	8.3
less:				
Net Factor Payments	-24,699	-25,124	-425	1.7
National Income	99,289	109,109	9,819	9.9
Depreciation	16,758	18,105	1,347	8.0
GNP at Factor Cost	116,047	127,213	11,167	9.6
Taxes less Subsidies	19,576	21,547	1,971	10.1
GNP at Market Prices	135,623	148,761	13,138	9.7

C: Balance of Payments on Current Account

	2005	2006	Change in 2006
	€m	Forecast €m	€m
Exports (X) less Imports (M)	21,059	20,685	-374
Net Factor Payments (F)	-24,699	-25,124	-425
Net Transfers	570	350	-220
Balance on Current Account	-3,070	-4,089	-1,019
as % of GNP	-2.3	-2.7	-0.5

FORECAST NATIONAL ACCOUNTS 2007

A: Expenditure on Gross National Product

	2006	2007	Change in 2007				
	Preliminary €m	Forecast €m	€m		%		
			Value	Volume	Value	Price	Volume
Private Consumer Expenditure	80,189	87,284	7,095	5,132	8.8	2.3	6.4
Public Net Current Expenditure	25,056	27,687	2,631	927	10.5	6.6	3.7
Gross Fixed Capital Formation	49,003	54,771	5,768	3,402	11.8	4.5	6.9
Exports of Goods and Services (X)	133,382	140,521	7,139	5,335	5.4	1.3	4.0
Physical Changes in Stocks	138	151	14	14		0.0	10.0
Final Demand	287,769	310,414	22,645	14,712	7.9	2.6	5.1
less:							
Imports of Goods and Services (M)	112,697	119,866	7,169	5,748	6.4	1.2	5.1
less:							
Statistical Discrepancy	1,187	1,354	167	61			
GDP at Market Prices	173,884	189,193	15,309	8,903	8.8	3.5	5.1
less:							
Net Factor Payments (F)	-25,124	-25,591	-467	-1,005	1.9	-2.1	4.0
GNP at Market Prices	148,761	163,603	14,842	7,931	10.0	4.4	5.3

B: Gross National Product by Origin

	2006	2007	Change in 2007	
	Preliminary €m	Forecast €m	€m	%
Agriculture, Forestry, Fishing	2,957	3,046	89	3.0
Non-Agricultural: Wages, etc.	70,297	76,185	5,888	8.4
Other:	59,992	65,000	5,008	8.3
Adjustments: Stock Appreciation	-200	-200	0	0.0
Statistical Discrepancy	1,187	1,354	167	14.1
Net Domestic Product	134,232	145,385	11,152	8.3
less:				
Net Factor Payments	-25,124	-25,591	-467	1.9
National Income	109,109	119,794	10,686	9.8
Depreciation	18,105	19,891	1,786	9.9
GNP at Factor Cost	127,213	139,685	12,472	9.8
Taxes less Subsidies	21,547	23,917	2,370	11.0
GNP at Market Prices	148,761	163,603	14,842	10.0

C: Balance of Payments on Current Account

	2006	2007	Change in 2007
	€m	Forecast €m	€m
Exports (X) less Imports (M)	20,685	20,655	-30
Net Factor Payments (F)	-25,124	-25,591	-467
Net Transfers	350	350	0
Balance on Current Account	-4,089	-4,586	-497
as % of GNP	-3	-3	-0.1

The international context for the Irish economy can generally be described as very favourable.¹ Growth in the world economy was 4.6 per cent in 2005 and it is expected that this rate will be maintained in 2006 and 2007, with forecast growth rates of 4.7 per cent and 4.4 per cent respectively. The volume of world trade also grew strongly in 2005, at a rate of 6.6 per cent. As with world GDP, forecasts for world trade for 2006 and 2007 are optimistic. The forecast for world trade growth in 2006 is 6.9 per cent; the corresponding figure for 2007 is 6 per cent.

Taking a more focused view of developments in the world economy, we will look first at the Euro Area. Following a number of years of sluggish growth in the Euro Area, it is forecast that 2006 will see a return to a stronger rate of 2.2 per cent followed by a slightly lower rate of growth in 2007 of 2 per cent. The countries primarily driving this Euro Area improvement are Germany and France. In Germany, the 2006 and 2007 GDP growth forecasts are 2.3 per cent and 2.0 per cent respectively. For France, the corresponding figures are 2.2 per cent and 2 per cent. While Italy is forecast to experience an improvement on the dismal outcome for 2005 of zero growth, the forecast growth rates of 1 per cent for 2006 and 1.4 per cent for 2007 still point to an economy in difficulty.

Within Germany, part of the story underlying the improved growth forecasts is a pick up in domestic demand. While the German economy has enjoyed a strong export performance over the last few years, weakness in both consumption and investment has acted as a drag on overall growth. The Ifo Business Survey has been posting strong readings and this has prompted an expectation of increases in investment. With regard to consumption, an increase in 2006 is expected partly because a VAT increase is scheduled for 2007 and so some degree of inter-temporal shifting of consumption is expected.

Strong growth in the United States is also forecast to continue, albeit at a slower rate than the most recent past. United States GDP grew by 3.5 per cent in 2005. For both 2006 and 2007, the forecast is for growth to reach 3 per cent. As discussed in previous *Commentaries*, the large and growing US current account deficit continues to weaken the confidence with which these GDP growth forecasts are presented. For 2005, the deficit was 6.4 per cent of GDP and according to the most recent forecast from the Bank of America, this could rise to 7.2 per cent in 2006. One other noteworthy feature of the US in recent weeks has been a softening in the housing market, partly in response to a continuation of interest rate rises in the US. One possible route through which the current account imbalance could adjust is for a fall in housing wealth to lead to a fall in consumption and hence a fall in imports. Such an adjustment would have sizeable implications for Ireland so it will be important to continue watching developments in the US housing market.

For the UK, although 2005 was a weak year in terms of GDP growth relative to recent years, 2006 and 2007 are forecast to be

¹Much of the material in this section is based on the recently published report of Euroframe-EFN, available on www.euroframe.org

stronger. For 2006, the GDP growth forecast is 2.4 per cent; for 2007, it is 2.7 per cent. The weakness in the economy in 2005 had led some to expect falls in the UK interest rate. Given the forecasts for stronger growth, expectations of interest rate reductions have now receded.

Looking to Asia, the huge increases in China's GDP are expected to continue in 2006 and 2007 with growth rates of 9.2 per cent and 8.2 per cent forecast. For Japan, the improved performance of recent years is expected to continue – the 2006 and 2007 growth forecasts are 2.7 per cent and 2.1 per cent. This continued good performance in Japan, when combined with the improved performance in the Euro Area, point to a picture of world growth that is better balanced than in recent years.

Given the improved performance of the Euro Area, it is likely that the ECB will continue to raise interest rates over the coming months. Our expectation is that the ECB main refinancing rate will have risen to 3 per cent by the end of 2006 and to 3.5 per cent by the end of 2007. This would be a moderate rate of increase over the period but would be consistent with (a) a need to avoid choking off the recovery in the Euro Area and (b) limited inflationary pressures. This expected easing of inflationary pressures stems partly from a forecast of an easing in oil price pressures.

Figure 1: Interest Rates

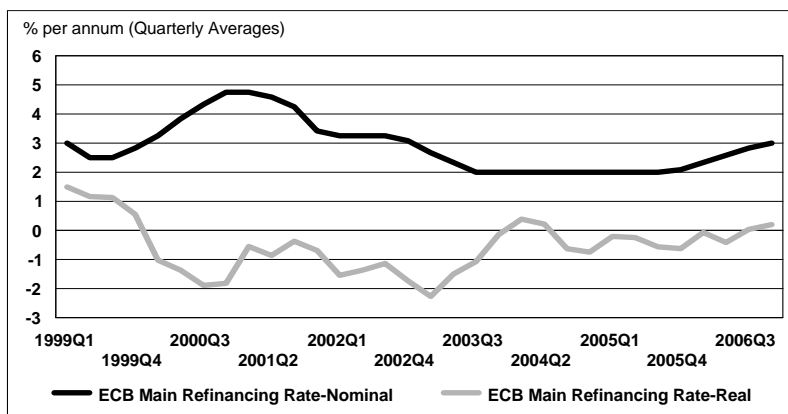
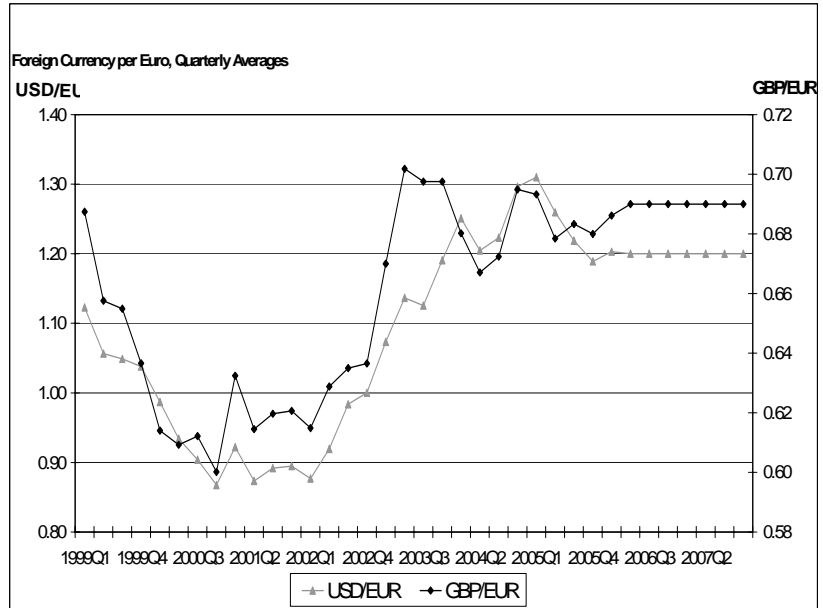


TABLE 1: Short-term International Outlook

Country	GDP Output Growth			Consumer Price Inflation			Hourly Earnings Growth			Unemployment Rate %			Current Account Balance % of GNP		
	2005	2006	2007	2005	2006	2007	2005	2006	2007	2005	2006	2007	2005	2006	2007
UK	1.8	2.4	2.7	2.1	2.2	2.2	4.4	2.3	2.7	4.8	5.1	5.4	-2.2	-2.6	-2.3
Germany	1.1	2.3	2.0	1.3	1.8	2.3	-0.3	0.5	2.7	9.5	9.0	8.7	4.0	3.8	4.7
France	1.4	2.2	2.0	1.2	1.7	1.7	3.5	1.9	1.7	9.5	9.0	8.7	-2.2	-2.9	-2.8
Italy	0.0	1.0	1.4	2.0	2.2	2.1	2.1	2.2	2.1	7.6	7.7	7.8	-2.0	-1.7	-1.0
Euro Area	1.4	2.2	2.0	2.2	2.2	2.2	2.0	2.3	3.3	8.5	8.1	7.8	-0.4	-0.7	-0.3
USA	3.5	3.0	3.0	2.8	3.1	3.2	4.7	4.6	5.1	5.1	5.1	5.0	-6.4	-6.3	-6.1
Japan	2.7	2.7	2.1	-0.8	0.1	0.2	-0.6	2.4	1.1	4.7	4.4	3.9	3.7	3.5	4.0
China	9.9	9.2	8.2	1.8	2.9	2.3							4.2	6.1	6.5
OECD	2.8	3.0	2.7	2.1	2.5	2.6									
Ireland	4.7	4.8	5.1	2.5	2.8	2.6	5.3	5.2	5.0	4.4	4.4	4.3	-2.3	-2.7	-2.8

Source: National Institute Economic Review, January 2006, Euroframe EFN Spring 2006.

Figure 2: Exchange Rates



The Domestic Economy

General

Preliminary estimates for economic growth in 2005 indicate a stronger performance than anticipated, driven by very strong growth in domestic demand. In particular, the very robust growth in investment, at over 13 per cent in volume terms, was far higher than anticipated. Current estimates suggest that GDP and GNP grew by 4.7 per cent² and 5.4 per cent respectively in volume terms in 2005. The very slow growth in net factor outflows – the difference between these two measures – reflects in part strong inflows of investment income through the Balance of Payments. Net external demand made a negative contribution to growth with a very weak export performance. Total employment grew by 4.7 per cent in 2005, implying a very weak growth in underlying productivity.

For 2006 and 2007 we anticipate a modest recovery in export performance, driven by continued growth in the world economy and a pick up in growth in the Euro Area. Nevertheless, our forecast suggests that domestic demand will remain the main driver of growth, with strong growth in both personal consumption and investment. Employment is expected to continue to grow strongly, although at a somewhat slower pace than in 2005 implying somewhat higher productivity growth than in 2005.

²These preliminary estimates of GDP growth imply a substantial statistical discrepancy given a growth rate of 4.0 per cent on an expenditure basis and 5.3 per cent on an output basis.

Consumption

The 2005 estimate of private consumption growth, at 5.6 per cent, is broadly in line with our most recent forecast. The growth in personal consumption has been accelerating throughout the year while the average growth in the price deflator for personal consumption has been relatively stable. The most recent indicators for the first months of 2006 all suggest a continuation of this pattern of exceptionally strong consumption growth. Retail sales grew by 9 per cent in volume terms in January 2006 relative to January 2005, while trips overseas by Irish residents increased by over 18 per cent in the same period. Purchases of new private cars rose by over 15 per cent in the first two months of 2006 compared with 2005. Whilst in February the Consumer Sentiment Index registered a decline relative to January, on an annual basis it registered a pick up relative to February 2005.

The prospects for personal consumption growth in 2006 and 2007 are complicated by several factors. First, strong employment and incomes growth should underpin continued strong growth in consumption. Furthermore the maturation of the SSIA accounts over the course of 2006, and in particular 2007, is likely to fuel a once-off jump in consumer spending. However, the likely effect of rising interest rates over the coming year, with consequent increases in consumer prices, could well dampen consumer confidence, in particular for relatively recent first-time buyers. On balance we feel that the anticipated increases in interest rates underlying our forecast are gradual enough to prevent any significant decline in consumer confidence. Growth in personal consumption is expected to be 5.9 per cent in 2006, rising to 6.4 per cent in 2007. The surge in 2007 reflects the likely once-off effect of the maturation of the SSIA accounts, most of which are expected to come on stream in that year.

Investment

The very high rate of real growth in investment from the preliminary estimates for 2005 at 13.1 per cent was far higher than anticipated, and is the highest since 1999. Even allowing for the once-off effect of purchases of air transport equipment the growth rate in investment would have been over 11 per cent, representing a marked acceleration in the pace of investment in 2005. Strong growth in building and construction investment, in line with previous years, was exceeded by a surge in investment in machinery and equipment, which grew in volume terms by over 22 per cent (16.5 per cent excluding imported airplanes).

Total house completions in 2005 were almost 81,000 and figures for the first two months of 2006 indicate continued increases in the amount of house completions. However, planning permission data for 2005 indicate permissions for new houses are down 1 per cent on 2004. We expect housing construction to level off in the second half of 2006 and to remain flat in 2007. Apart from housing we expect investment growth to remain strong over the next two years, albeit at

TABLE 2: Gross Fixed Capital Formation

	2004 €m	% Change in Volume	2005 Value	2005 €m	% Change in Volume	2006 Value	2006 €m	% Change in Volume	2007 Value	2007 €m
Housing	16,956	5.0	14.5	19,407	2.0	10.2	21,378	0.0	7.0	22,875
Other Building	10,183	17.2	23.3	12,554	12.0	18.2	14,833	12.0	18.2	17,527
Building and Construction	27,139	9.7	17.8	31,960	6.1	13.3	36,212	5.2	11.6	40,402
Machinery and Equipment	9,151	22.4	23.3	11,286	12.0	13.3	12,792	11.0	12.3	14,369
Total	36,290	13.1	19.2	43,246	7.8	13.3	49,003	6.9	11.8	54,771

a much slower pace than in 2005. Investment in non-residential building and construction is expected to continue to grow strongly in 2006 and 2007, by 12 per cent in both years, driven in part by public sector spending under the National Development Plans. Investment in machinery and equipment is more difficult to forecast, but we expect it to grow strongly in 2006 and 2007 so that total investment growth is expected to be 7.8 per cent in 2006 and 6.9 per cent in 2007.

Government Spending and Public Finances

The general government balance showed a surplus of €848 in 2005. For 2006 we expect the surplus of current revenue over current expenditure to fall given that the planned increase in current expenditure of 12.9 per cent runs far ahead of our estimated increase in current revenues of 7.9 per cent. This implies a current surplus of €5,182 million, €785 million higher than forecast by the Department of Finance. The difference is due to our higher forecast growth rate in tax revenue, given the strong growth in consumption, employment and incomes underlying our forecast for 2006. On the capital account we use the latest Department of Finance forecasts which predict a slight widening of the capital deficit by some €374 million in 2006. Overall, this leads to a negligible general government deficit of €69 million in 2006.

For 2007 our forecasts differ from the official forecast because we anticipate a further loosening of fiscal policy in that year. While the official projections predict an increase in current revenue of close to 9 per cent, we project that some leeway on income tax measures at budget time could bring the growth in total revenue down to just over 7 per cent. Similarly on the current expenditure side, we forecast an increase of almost 10 per cent in current spending in 2007 as compared with the projected figure of just over 7 per cent. Combined, this will lead to a general government deficit of almost 1 per cent of GDP in 2007.

While this is our forecast for 2007, we should point out that such a deficit would not be advised. As is discussed in the General Assessment below, fiscal policy at this point in time should avoid adding demand to an economy that is growing so quickly. Recent pre-election experience suggests that the pressures to increase public spending in the run up to an election can be intense. However, we would strongly advise in the run up to the 2007 General Election that this pressure be resisted because the inflationary consequences could be damaging.

TABLE 3: Public Finances

	2005	% Change	2006	% Change	2007
Current Revenue	39,849	7.9	43,011	7.0	46,034
Current Expenditure	33,496	12.9	37,829	9.9	41,569
Current Surplus	6,353	-18.4	5,182	-13.8	4,465
Capital Receipts	995	82.8	1,819	-8.6	1,663
Capital Expenditure	7,847	15.3	9,045	8.9	9,854
Capital Borrowing	-6,852	5.5	-7,226	13.4	-8,191
Exchequer Balance	-499		-2,044		-3,726
as % of GNP	-0.4		-1.4		-2.3
General Government Balance	848		-69		-1,730
as % of GDP	0.5		0.0		-0.9
General Government Debt as % of GDP	27.5		26.5		26.4

Exports

Irish exports performed poorly in 2005; the first estimates for the year point to subdued growth in total exports of 1.8 per cent in volume terms over the year. This represents a significant fall from the 7.0 per cent real growth rate recorded in total exports in 2004. Such a dramatic turnaround in the performance of exports, which used to account for a sizeable proportion of economic growth in the country, raises concerns about the reasons for such a weakened position, especially given the strong growth in world trade of over 6 per cent in 2005 and the pick up in growth in some of our main trading partners. It is possible that the weakening is due in large part to a deterioration in our cost competitiveness as well as a slowdown over the year in industrial sector exports, which have traditionally accounted for a significant portion of the growth in our exports. We return to this point in the General Assessment below.

It is interesting to compare movements in export volumes and exchange rates over the course of 2005, to see if the pattern is consistent with what might be expected. In the first six months of 2005, exports of goods and services fell by 0.5 per cent year on year in volume terms. Over the same period, the euro appreciated by 2.4 per cent *vis-à-vis* the dollar and 1.9 per cent *vis-à-vis* the pound sterling on an annual basis. This appreciation would have increased the price of our exports in markets denominated in these currencies in the first half of 2005, (the UK market accounts for around 16 per cent of the total value of our exports while the US market accounts for about 20 per cent). In the second half of 2005, the volume of exports rose by 4.2 per cent on an annual basis. During this period the euro depreciated by 8.4 per cent and 1.8 per cent against the dollar and pound sterling respectively, which would have decreased the prices of our exports in markets denominated in these currencies. This points to the possibility of exchange rate movements playing a role in the pattern of exports although a more formal analysis would be needed to be definitive on this point.

TABLE 4: Exports of Goods and Services

	2004	% Change in 2005		2005	% Change in 2006		2006	% Change in 2007		2007
	€m	Volume	Value	€m	Volume	Value	€m	Volume	Value	€m
Merchandise	80,229	2.4	3.2	82,798	2.8	3.5	85,663	3.5	4.2	89,241
Tourism	3,445	4.0	6.6	3,674	3.5	6.1	3,898	3.7	6.3	4,143
Other Services	38,758	0.5	2.2	39,630	5.0	7.6	42,652	5.0	7.6	45,904
Exports of Goods and Services	122,432	1.8	3.0	126,102	3.5	4.8	132,212	4.0	5.4	139,288
FISIM Adjustment	1,087			1,116			1,170			1,233
Adjusted Exports	123,519	1.8	3.0	127,218	3.5	4.8	133,382	4.0	5.4	140,521

According to the *External Trade* release, the volume index for visible exports increased by a minor 0.8 per cent between 2004 and 2005, as compared to a 6.6 per cent rate of increase in 2004. The value index for visible exports rose by 4.7 per cent in 2005 while the price index rose by an average of 2.6 per cent. The chemicals sector accounts for the largest proportion of the value of our visible exports, at over 45 per cent of the total in 2005. Over the course of 2005, this sector registered a relatively poor performance in export growth, with a 7.5 per cent value increase registered over the whole year as compared to the 2004 value, being much lower than the annual average growth rate of over 33 per cent recorded in the value of these exports between 1995 and 2000. The performance in the sector was weaker in the first half of the year, but picked up over the second half.

At the same time, services exports were surprisingly weak, compounding the deterioration in total exports performance even further. According to the Balance of International Payments, services exports increased by only 3.5 per cent in value terms over the course of 2005, representing a significant drop from the average annual rate of almost 14 per cent in 2004. The deterioration was driven largely by weakness in insurance exports that fell in value by over 19 per cent in 2005.

The prospects for 2006 are somewhat better, though performance is nonetheless expected to be low by historical standards. We forecast a pick up in real export growth to 3.5 per cent in 2006 before further improving to 4.0 per cent in 2007.

Imports

Import growth was strong in 2005, outpacing the growth in exports. First estimates for the year show the volume of imports increased by 4.6 per cent in 2005, representing a slowdown from the 7.6 per cent volume increase recorded in 2004. The pace of growth in imports picked up in the second half of the year with an annual rate of 5.0 per cent registered in the third quarter of 2005 and an annual rate of 8.6 per cent in the final quarter of the year.

The *External Trade* release shows that visible import growth was strong over the year despite the weakness in exports, reflecting robust domestic demand. The volume of visible imports rose by an annual rate of 8.8 per cent in 2005 as compared to annual growth of 9.2 per cent in 2004. The increase was driven mainly by a rise in imports of Machinery and Transport Equipment, which accounted for over 43 per cent of the value of total visible imports in the year, and which registered a 12.9 per cent annual value increase in 2005. This includes the once-off effect of the purchase of aircraft equipment referred to earlier.

The price index for visible imports fell by 0.4 per cent over the year in 2005 on an annual basis, as compared to a 2.2 per cent fall in 2004. The overall effect of the developments in import volume and prices on the value of imports in the year, was an increase of 10.5 per cent between 2004 and 2005.

TABLE 5: Imports of Goods and Services

	2004	% Change in 2005		2005	% Change in 2006		2006	% Change in 2007		2007
	€m	Volume	Value	€m	Volume	Value	€m	Volume	Value	€m
Merchandise	48,417	6.9	8.5	52,522	6.6	7.2	56,296	6.1	6.6	60,036
Tourism	4,181	10.8	11.7	4,671	5.0	6.1	4,954	5.0	6.1	5,253
Other Services	47,742	1.6	1.8	48,602	3.0	5.1	51,061	4.0	6.1	54,166
Imports of Goods and Services	100,340	4.6	5.4	105,795	4.9	6.2	112,311	5.1	6.4	119,455
FISIM Adjustment	347			364			386			411
Adjusted Imports	100,687	4.6	5.4	106,159	4.9	6.2	112,697	5.1	6.4	119,866

The relative importance of our various merchandise import sources displayed little change between 2004 and 2005, with the EU continuing to account for the largest proportion of the value of our imports, at over 57 per cent. The US is the second most important import source, accounting for 14.1 per cent of the value of our imports while China and Japan accounted for 6.5 per cent and 3.7 per cent respectively.

According to the Balance of International Payments, imports of services increased by 2.6 per cent in value terms on an annual basis in 2005, outpacing the growth in services exports. Financial services and Business services imports accounted for the greatest proportion of the growth in total services imports, with 13 per cent and 9 per cent expansions registered respectively.

Our forecasts suggest that strong growth in total imports will continue this year, bolstered by the continuing robust position of domestic demand, and in particular private consumption. Accordingly, we estimate volume growth of 4.9 per cent in 2006 and 5.1 per cent in 2007.

Balance of Payments

The current account of the Balance of Payments shows whether a country is spending more or less than it earns. As such, a sustained increase in the size of a current account deficit means that a country is increasingly spending more than it is earning with associated borrowing requirements also increasing.

The Irish current account tipped into deficit in 2000 and since then, a trend of current account deficits has become entrenched in the economy. The latest figures from the CSO show a current account deficit of €88 million recorded in the fourth quarter of 2005, representing 0.2 per cent of GDP and reflecting the poor performance of net exports relative to imports already alluded to. While this deficit is lower than those recorded in the first three quarters of the year, it nonetheless represents a deterioration from the situation prevailing a year earlier in the fourth quarter of 2004, when a current account surplus of €101 million, or 0.3 per cent of GDP was registered. More worrying is the pattern observed for 2005 as a whole; a current account deficit of €3.1 billion was registered for the year, equivalent to 1.9 per cent of GDP. This deficit widened by almost €2 billion between 2004 and 2005. Our forecasts suggest that this pattern will continue both this year and next. We estimate a current account deficit of €4.1 billion in 2006 and €4.6 billion in 2007 equating to 2.3 per cent and 2.4 per cent of GDP respectively.

TABLE 6: Balance of Payments

	2004	Change	2005	Change	2006	Change	2007
	€m	%	€m	%	€m	%	€m
Merchandise Trade Balance	31,812	-4.8	30,276	-3.0	29,367	-0.6	29,205
Service Trade Balance	-9,720	2.6	-9,969	-5.1	-9,465	-1.0	-9,372
Trade Balance in Goods and Services on BOP basis	22,092	-8.1	20,307	-2.0	19,902	-0.3	19,833
Total Debit Flows	57,363	12.5	64,538	9.4	70,585	9.6	77,326
Total Credit Flows	33,783	20.1	40,580	14.0	46,245	13.6	52,557
Net Factor Flows	-23,580	1.6	-23,958	1.6	-24,340	1.8	-24,769
Net Current Transfers Balance on Current Account	307	85.7	570	-38.6	350	0.0	350
Capital Transfers	-1,181		-3,081		-4,089		-4,586
Effective Current Balance	401	-22.9	309	-2.9	300	0.0	300
Effective Current Balance	-780		-2,772		-3,789		-4,286

The significant presence of multi-national corporations in the Irish economy and the process of repatriating profits back to parent companies abroad, has been largely responsible for the deficit on the income account of the Balance of Payments. In 2005, this deficit increased by 1.6 per cent to €23,958 million, when compared to 2004. This represents a slowing in the pace of increase experienced in 2004, when the incomes deficit increased by 7.4 per cent from 2003, to reach €23,580. Although income outflows grew strongly by over 12 per cent in 2005, exceptionally strong growth in income inflows, largely driven by growth of over 23 per cent in portfolio and other investment income, served to slow the growth in the net flow position.

Gross National Product and Gross Domestic Product

We forecast that GDP will increase by 4.8 percentage points in 2006, before accelerating slightly in 2007 to 5.1 per cent. Because we expect net factor income flows to grow much more slowly our forecast for GNP growth is higher at 5.1 per cent in 2006 and 5.3 per cent in 2007. This means that we expect the gap between GDP and GNP to continue to narrow over the forecast period, reversing the pattern of the past three decades. Traditionally GDP growth rates have exceeded GNP growth rates because of large profit outflows on the current account of the Balance of Payments. The negative effect of these outflows on GNP is diminished first by the recent poor export performance of the multinational sector in Ireland, and second by the growth in the stock of Irish assets held abroad.

While GNP is generally used as the headline growth rate, GNDI (Gross National Disposable Income) is a more suitable measure of a country's overall level of income since it also includes changes in the terms of trade and net international transfers. Our forecasts imply an increase of 5.0 per cent in GNDI for 2006 and 5.4 per cent for 2007. In 2006 and 2007 we expect positive terms of trade effects to contribute to this growth, with the growth in import prices marginally below the growth in export prices.

The preliminary estimates for 2005 highlight that the main driver of growth is domestic demand, growing at 6.8 per cent, with external demand contributing negatively to the overall growth rate. We expect growth in 2006 to be more balanced between the domestic and external sector with domestic demand forecast to grow by 6.1 per cent (although this does still imply a small negative contribution to growth from the external sector).

Agriculture

The *Quarterly National Accounts* estimates for 2005 show that the Agriculture, Forestry and Fishing sector performed poorly over the year. Real output contracted by 3.5 per cent when compared to 2004, representing a significant deterioration by historical standards. A fall in output was registered in each successive quarter of 2005, though the most significant deterioration occurred in the third quarter of 2005, when the growth rate in real output was –8.0 per cent on an annual basis. On a seasonally adjusted basis, there was a slight pick up in the final quarter of the year, as output grew by 1.0 per cent from the third quarter.

Price developments throughout the year were also unfavourable with a minor increase of 0.4 per cent in output prices being outstripped by a 5.3 per cent rise in input prices, leading to a terms of trade loss of 4.7 per cent in the year. A rise of almost 17 per cent in the price of energy related inputs was the main cause of the increase in total input prices.

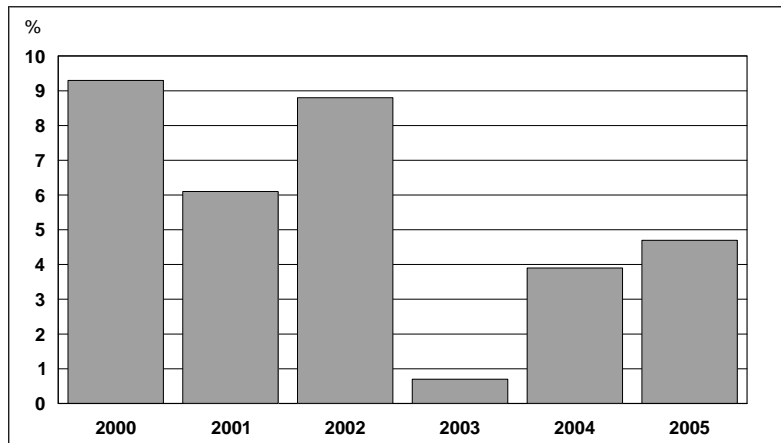
We anticipate that the sector will continue to perform poorly this year and forecast a drop in output in the sector of 0.6 per cent, before a slight pick up in 2007 of 1.0 per cent in real output.

Industry

The *Quarterly National Accounts* for Quarter 4 2005 show 2005 as having been industry's strongest year since 2002 (where industry is defined to include building and construction). The preliminary figure for growth for the year was 4.7 per cent. This was a modest increase on the 2004 figure of 3.9 per cent, but a substantial increase on the 2003 growth figure of 0.7 per cent. However, relative to the early years of this decade, the 2005 growth figure would be viewed as modest (see Figure 3).

Turning to Industrial Production (which excludes building and construction), the growth figures point again to a recovery in 2005 relative to 2004. Across all industries, the volume of production grew by 3 per cent in 2005, compared with 0.5 per cent in 2004. For manufacturing, production grew by 3.1 per cent in 2005 compared to 0.4 per cent in 2004.

Figure 3: Growth Rates in Industry (including Building & Construction) 2000-2005



Source: CSO Quarterly National Accounts, Quarter 4 2005.

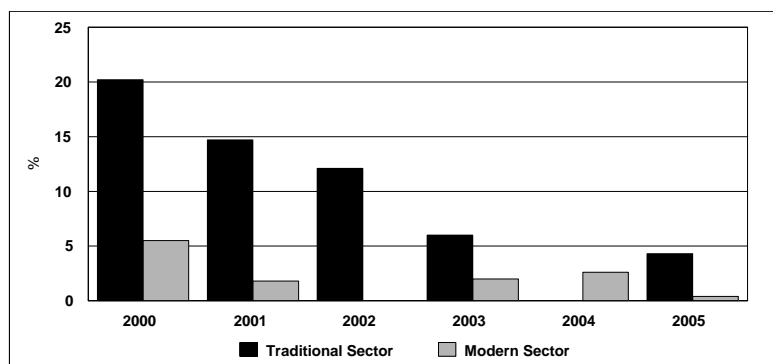
An additional interesting item in the Industrial Production figures concerns the relative performance of the “modern” and “traditional” sectors. In 2004, the volume of production fell in the modern sector by 0.4 per cent whereas production in the traditional sector rose by 2.6 per cent. This represented a reversal of the previously well-established pattern of growth in the modern sector exceeding that in the traditional (see Figure 4). In 2005, a return to the earlier pattern is seen with growth in the modern sector of 4.3 per cent compared to just 0.4 per cent in the traditional sector. This re-emergence of the more usual relative growth performance suggests that 2004 may have been an aberration and that the on-going rise of the modern sector relative to the traditional will continue.

In previous *Commentaries*³ we have highlighted how it may be more appropriate to examine industrial production weighted by wage bill rather than value added weights. In the first three quarters of 2005, the output-weighted index of the CSO suggested a slowdown in industrial production. On a seasonally adjusted basis, output expanded by 3.0 per cent, 0.9 per cent and 0.2 per cent in the first three quarters of the year respectively. Re-weighting industrial production by the wage bill also points to a slowdown in production in the sector, though the extent of the slowdown is less pronounced; industrial production grew by 0.5 per cent, 2.6 per cent and 1.7 per cent quarter on quarter in the first three quarters respectively, on a wage bill weighted basis. This suggests that industrial production growth was much stronger in the more labour intensive industries than the less labour intensive industries like Chemicals and Electrical and Optical Equipment over this period. There has been a reversal of this trend in the fourth quarter of 2005

³ See for example, McCoy, D. *et al.* (2005), *Quarterly Economic Commentary*, Spring, Dublin: The Economic and Social Research Institute.

as industrial production weighted by output increased by 1.7 per cent from the third quarter. Using wage bill weights we estimate that industrial production fell by 0.6 per cent in the same period. When Chemicals and Electrical and Optical Equipment sectors are excluded, we estimate that output fell, on a wage bill weighted basis, by 0.6 per cent in the quarter, pointing to weaker growth in the more labour intensive industries.

Figure 4: Modern and Traditional Sectors



Source: CSO *Industrial Production and Turnover*, January 2006, (provisional) and December 2005 (final).

As regards the most recent indications of business conditions facing industry, the NCB *Purchasing Managers Manufacturing Index* posted a value of 53.2 in January (where a value of over 50 points to positive conditions). This was down slightly on the December reading; however, the index has now been above 50 since mid-2003 and has generally been on an upward trend since mid-2005. The forward-looking components of the IBEC/ESRI monthly industrial survey are broadly consistent with the NCB index, with expectations of production, domestic sales and exports all showing an improvement in January 2006 when compared to the previous month.

The seasonally adjusted quarterly figures in the *Quarterly National Accounts* suggest that activity accelerated in the latter part of 2005. From the seasonally adjusted figures in the *Industrial Production and Turnover* release, we get a similar indication with a rise of 7.2 per cent in production in the three months to the end of January 2006 relative to the preceding three months.

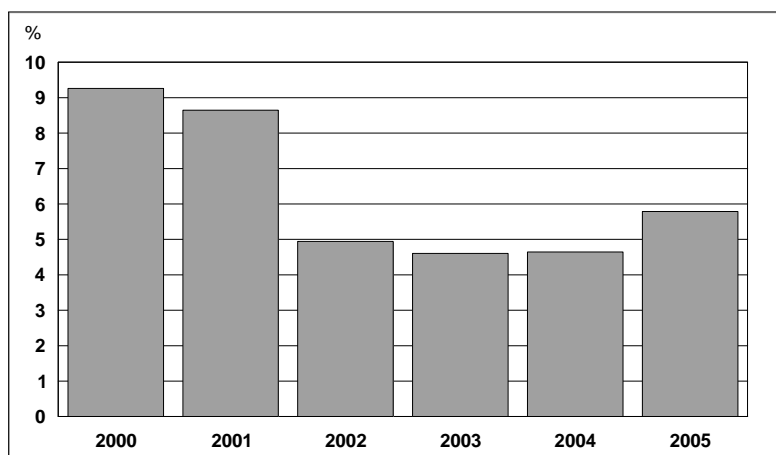
For 2006 and 2007, we are forecasting a continuation of growth at a rate similar to 2005. Our growth forecast for 2006 is 4.5 per cent and for 2007 it is 5.1 per cent. Underlying these figures are slightly different forecasts for building and construction and other industry. For building and construction, we are forecasting a slower rate of growth in 2006 and 2007, relative to 2005 (6.1 per cent and 5.2 per cent as opposed to 9.7 per cent in 2005). This slowdown is largely driven by our expectation that housing investment growth will slow further in 2006 and remain flat in 2007. For other industry, we are forecasting a stronger performance in 2006 and 2007 relative to 2005 (4 per cent and 5 per cent, as opposed to 3.2

per cent in 2005). These forecasts for other industry are linked to our expectation of an improvement in export volumes relative to the poor performance in 2005.

Services

The figures for other services (other than public administration and defence) and distribution, transport and communications in the *Quarterly National Accounts* for Quarter 4 2005 show continued growth in 2005 at a rate slightly higher than recent years. Unlike industry where fluctuations in growth since the beginning of the decade have been seen (see Figure 3 above), growth in services has remained above 4 per cent since 2000, with the 2005 growth rate estimated at 5.8 per cent (see Figure 5).

Figure 5: Growth Rates in Services (other than Public Administration and Defence) 2000-2005



The NCB *Services Purchasing Managers Index* posted a reading of 61 in January, thereby providing an indicator of strongly expanding activity. The quarterly information in the *Quarterly National Accounts* points to a steady rate of growth throughout the year, in contrast to the acceleration seen in industry. In general, the information points to continued growth in the services sector and for this reason we forecast growth of 4.9 per cent in 2006 and 5 per cent in 2007. This forecast for services growth reflects our expectation of strong growth in consumer spending and also an improvement in exports.

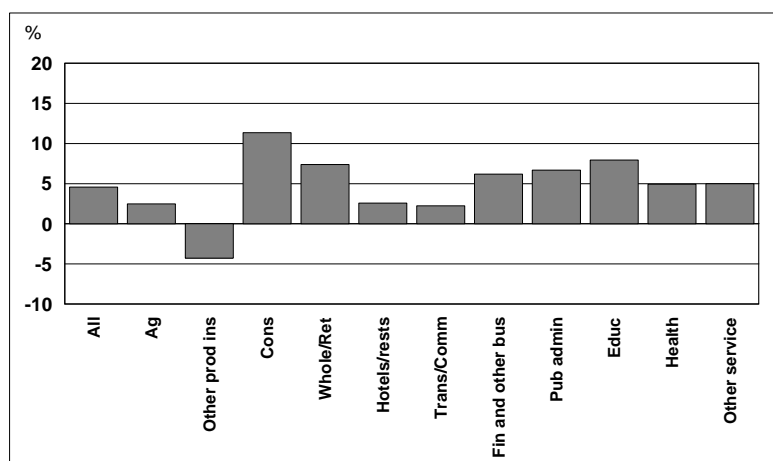
Employment

The *Quarterly National Household Survey* for Quarter 4 2005 confirmed that 2005 was a year of extremely strong employment growth. Employment grew by 87,000, or 4.7 per cent, the highest rate of increase since 2000. While this is to be welcomed, it is important to repeat a concern voiced in earlier *Commentaries* about the distribution of employment growth.

As shown in Figure 6, the largest proportionate increase in employment was in construction, with an increase of almost 11 per

cent. In contrast, “other productive industries” showed a decline of 4.3 per cent. We have argued in previous *Commentaries* that the rate of employment increase in construction is not sustainable in the long run. What is more the level of employment in construction, at almost 13 per cent of total employment, is unlikely to be sustainable. Hence, future years may well bring about falls in construction employment. With a declining industrial employment base, this could be highly problematic.

Figure 6: Employment Growth by Sector



Source: CSO *Quarterly National Household Survey*, Quarter 4 2005.

For the first time, the *Quarterly National Household Survey* for Quarter 4 2005 contains information on the national breakdown of the population by labour force status and sector of employment. The figures reveal that about half of the increase in employment was made up of foreign nationals, i.e., of the 87,000 net new jobs 43,000 were taken by non-Irish nationals. Given that the employment of Irish people expanded by over 40,000, these figures have been interpreted as implying that no displacement of Irish workers is occurring as a consequence of immigration.

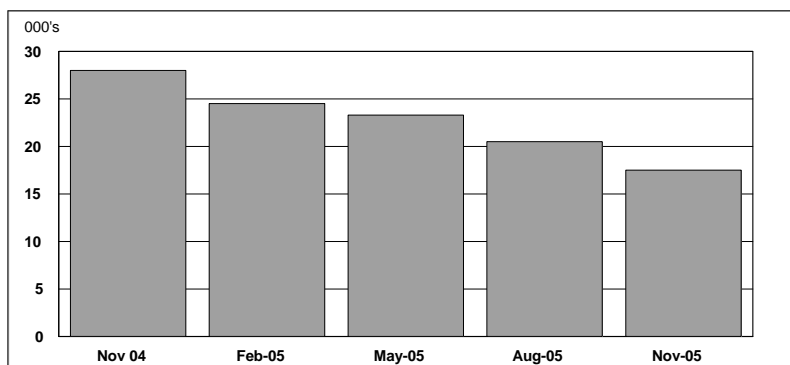
We would broadly agree with this proposition that there is little or no evidence of Irish employees losing jobs to foreign nationals. However, work by Barrett, Bergin and Duffy (2006)⁴ leads us to believe that the level of immigration in 2005 was such that the wages of Irish employees probably grew at a slower rate in 2005 than they otherwise would have. Real wages grew by 3.1 per cent in 2004; this rate of growth fell to 2.8 in 2005. A full analysis linking labour demand, labour supply and wage growth would be needed to establish a conclusive link between the increased immigration in 2005 and the slower pace of wage growth. However, the evidence in Barrett *et al.*, for an earlier period points to the possibility of a link

⁴ Barrett, Alan, Adele Begin and David Duffy (2006), “The Labour Market Characteristics and Labour Market Impacts of Immigrants in Ireland”, *The Economic and Social Review*, Vol. 37, No. 1.

between large-scale immigration and slower wage growth. In the context of a rapidly growing economy that is experiencing wage pressures, and hence competitiveness pressures, this effect should be viewed as positive as long as the wage dampening impact is not concentrated in the lower end of the earnings distribution.

Turning to indicators of the most recent activity in the labour market, we can continue to look at the latest *Quarterly National Household Survey*. The seasonally adjusted figures for employment increases in each quarter reveal a picture of deceleration (see Figure 7). For the quarter ended November 2004, there were 28,000 extra employees compared to the previous quarter (seasonally adjusted). The size of the increase has declined continuously, with the quarterly increase in the period September to November 2005 at 17,500. These figures suggest on-going buoyancy in the labour market but also that the trend in employment increases is downward. Hence, 2006 may not be as strong a year for employment growth as 2005.

Figure 7: Seasonally Adjusted Quarterly Employment Growth



Source: CSO *Quarterly National Household Survey*, Q4 2005.

Box A: The FÁS/ESRI Vacancies Survey (by Nicola Doyle)

We can gain additional insights into the most recent trends in the labour market from the FÁS/ESRI Employment and Vacancies Survey.⁵ This survey shows that economy wide vacancies have increased significantly over the past year to February 2006. The percentage of firms reporting vacancies across all sectors surveyed⁶ rose from 7 per cent in February 2005 to 17 per cent in February 2006. Of the firms reporting vacancies 80 per cent indicated that they were experiencing difficulty filling those vacancies. The position frequently cited by employers across all sectors as difficult to fill was that of managers.

⁵ Survey results of the FÁS/ESRI Employment and Vacancies Survey are available on a monthly basis on the ESRI website: www.esri.ie

⁶The sectors surveyed include the construction, industrial, retail and services (excluding non-market services) sectors.

Table A1: Percentage of Firms with Vacancies by Sector, February 2005 to February 2006

	Feb-05	May-05	Aug-05	Nov-05	Feb-06	Average
All Sectors	7.2	10.6	6.9	18.8	16.7	12.3
Services	8.7	13.2	4.9	26.8	21.9	16.2
Industry	19.5	21.4	17.9	17.6	22.2	16.9
Construction	15.3	20.7	16.5	13.0	8.8	14.2
Retail	2.0	2.4	4.9	3.6	7.2	3.8

Source: FÁS/ESRI Employment and Vacancies Survey.

The increase in economy wide vacancies has been predominantly driven by the services sector⁷ which saw the percentage of its firms reporting vacancies increase by 13 percentage points over the past year. In February 2006, 22 per cent of service sector firms indicated they had vacancies to be filled, up from 9 per cent in 2005. The percentage of service sector firms experiencing difficulty filling their vacancies also rose considerably from 54 per cent in February 2005 to 79 per cent in February 2006.

The services sector's annual average, at 16 per cent, is however below that of the industrial sector. On average 17 per cent of industrial sector firms reported vacancies over the past year to February 2006. Vacancies within the sector were relatively stable throughout the year. The 3-month moving average figure did indicate a slight decline, from 18 per cent in February 2005 to 15 per cent in August 2005, but this was followed by a slight increase which brought the percentage back up to 18 per cent by February 2006.

Vacancies in the construction sector have been relatively stable, averaging at around 14 per cent, over the past year to February 2006. The sector did experience a decrease in the percentage of firms with vacancies to 8 per cent in February 2006. However, such a decline is unusual for the construction sector and brings the percentage of firms with vacancies to its lowest level since May 2003.

The retail sector experienced modest growth in the percentage of firms with vacancies from a very low base of 2 per cent in February 2005 to 7 per cent in February 2006. Of all the sectors covered in the FÁS/ESRI Employment and Vacancies report the retail sector has consistently had the lowest percentage of firms with vacancies. On average over half of the retail firms with vacancies described their vacancies as "difficult-to-fill".

We are forecasting an employment increase of 67,000 in 2006 followed by an increase of 60,000 in 2007. If we assume that half of the net new jobs will be taken by immigrants, an increase in immigrant employment of this level would be consistent with a

⁷ The services sector excludes non-market services and the retail sector.

gross immigrant inflow of about 53,000 in 2006 and 48,000 in 2007. Some of the extra jobs will be filled by new labour market entrants but a marginal increase in participation will also be needed.

TABLE 7: Employment and Unemployment

	Annual Averages 000s			
	2004	2005	2006	2007
Agriculture	117	115	114	112
Industry	516	539	553	563
Services	1,232	1,298	1,353	1,404
Total at Work	1,865	1,952	2,019	2,078
Unemployed	87	89	94	93
Labour Force	1,952	2,041	2,112	2,172
Unemployment Rate %	4.4	4.4	4.4	4.3
Inward Migration	50.1	70.0	53.0	48.0
Change in Participation Rate	0.7	1.5	1.2	0.4

Incomes⁸

Latest data indicate that economy wide hourly earnings⁹ grew by 5.3 per cent between September 2004 and September 2005. This reflects a deceleration on the 7.1 per cent growth rate in the year ended September 2004. The average Irish employee was earning €17.67 an hour in September 2005, compared to €16.79 in September 2004. The increase in average gross earnings was predominantly driven by the construction and non-market services sectors. Both these sectors experienced earnings growth of over 6 per cent.

In terms of the private sector, employees in the construction sector have the highest hourly earnings at over €18.60 while hourly earnings in the hotels and restaurants sector are lowest at €10.51 per hour. Industrial sector employees and employees in other market services experienced the weakest growth in their hourly earnings in 2005. Notably, the growth in earnings in the high-tech industrial sector at 3.6 per cent was marginally below that in other manufacturing industries.

As the Partnership talks are still ongoing at the time of writing, it is not possible to factor in the outcome of those deliberations. For this reason, our wage forecasts are based on an assessment of underlying economic factors. Given on-going high rates of economic growth and hence strong demand for labour, we expect wage growth to be strong again in 2006 and 2007. As noted above under our discussion of immigration, our view is that the current and forecast rates of inflow are acting to moderate wage growth somewhat. In addition, we believe that the weakness in Ireland's export performance in 2005 will refocus attention on

⁸Nicola Doyle (ESRI) contributed to this section and constructed the economy-wide earnings index.

⁹The calculation of hourly earnings is based on the method developed in Casey, B. (2004), "An Economy Wide Perspective on Earnings Data in Ireland", *Quarterly Economic Commentary* Spring 2004, Dublin: ESRI.

competitiveness and thereby act to ease wage pressures. Taking account of these counter-balancing factors, we forecast real wage growth of 2.4 per cent in both 2006 and 2007.

Table 8: Average Hourly Earnings by Sector

Sector	Hourly Earnings	Cumulative Growth	Annual Growth Rate	Annual Growth Rate	Annual Growth Rate	Annual Growth Rate	Annual Growth Rate	Annual Growth Rate
	Q3 2005	Q1 2000 - Q3 2005	2000	2001	2002	2003	2004	2005
	<i>Euro</i>	<i>%age</i>	<i>%age</i>	<i>%age</i>	<i>%age</i>	<i>%age</i>	<i>%age</i>	<i>%age</i>
Economy**	17.67	42.6	7.2	9.7	5.7	4.7	7.1	5.3
Industry	14.06	39.5	8.0	7.8	6.9	4.7	5.4	3.7
Hi-Tech	14.38	42.6	7.8	5.1	8.0	5.3	9.2	3.6
Other Manufacturing***	13.70	36.0	8.2	11.0	5.4	4.1	1.3	3.7
Construction	18.61	52.2	6.6	11.2	12.5	2.0	6.5	6.0
Services								
Non-Market Services	23.52	42.8	2.6	10.3	4.2	4.6	10.2	6.2
Transport & Comm.	17.69	31.9	6.4	10.9	-0.1	4.4	5.0	5.1
Distribution****	16.40	41.4	13.0	7.7	7.1	5.1	4.4	4.8
Hotels and Restaurants	10.51	40.3	7.9	4.6	3.1	7.1	6.6	5.5
Other Market Services	17.99	32.5	9.1	9.3	0.6	5.3	5.0	3.5

Quarter 1 – March, Quarter 2- June, Quarter 3 - September, Quarter 4 – December.

* Annual growth rates are calculated using earnings in September of each year.

** Excludes agricultural and health sector earnings.

*** Excluding utilities and mining and quarrying.

The effect of strong growth in both wages and employment in 2005 together imply an estimated increase in non-agricultural wage income of almost 11 per cent. Taken together with estimates of strong growth in current transfer payments¹⁰ of a similar magnitude, these suggest that the growth in non-wage private income was a modest 5 per cent, following a slight fall in 2004. These differential growth rates mean that there has been a further rise in the wage share of total income in 2005, with a concomitant fall in profitability. While personal consumption growth is estimated to have been almost 6 per cent in 2005 the stronger growth in disposable income implies a rise in the savings rate to 13 percentage points. For 2006 and 2007 we forecast that this will fall slightly given expected high growth in consumption and slightly slower growth in wage income.

¹⁰ Estimates of current transfers are tentative; we have assumed that the payments for nursing homes will be treated in the national accounts on accruals basis over the period 2006-08.

TABLE 9: Personal Disposable Income

	2004			Change			2005			Change			2006			Change			2007		
	€m	%	€m	€m	%	€m	€m	%	€m	€m	%	€m	€m	%	€m	€m	%	€m	€m	%	
Agriculture, etc.	2,912	-0.5	-15	2,898	2.1	59	2,957	3.0	89	3,046											
Non-Agricultural Wages	58,220	10.7	6,204	64,424	9.1	5,873	70,297	8.4	5,888	76,185											
Other Non-Agricultural Income	18,721	4.9	915	19,636	6.1	1,208	20,843	7.6	1,582	22,425											
Total Income Received	79,853	8.9	7,104	86,957	8.2	7,140	94,097	8.0	7,559	101,655											
Current Transfers	15,587	10.9	1,699	17,287	7.2	1,237	18,523	8.0	1,486	20,009											
Gross Personal Income	95,441	9.2	8,803	104,244	8.0	8,376	112,620	8.0	9,045	121,665											
Direct Personal Taxes	17,904	7.2	1,287	19,192	7.4	1,418	20,610	8.1	1,665	22,275											
Personal Disposable Income	77,536	9.7	7,516	85,052	8.2	6,959	92,011	8.0	7,379	99,390											
Consumption	68,540	7.8	5,335	73,875	8.5	6,314	80,189	8.8	7,095	87,284											
Personal Savings	8,996	24.2	2,181	11,177	5.8	644	11,821	2.4	285	12,106											
Savings Ratio	11.6			13.1			12.8			12.2											
Average Personal Tax Rate	18.8			18.4			18.3			18.3											

Consumer Prices

Irish inflation, as captured by changes in the *Consumer Price Index* (CPI) averaged 2.7 per cent over the twelve month period from March 2005 to February 2006, representing a relatively slower pace of increase than for the early years of the decade. However, as a result of the rapid increase in prices in the earlier years, which outpaced the average growth in prices in the Euro Area and EU-15, prices in Ireland are now much higher than in other European countries. In 2005, the National Competitiveness Council revealed Ireland as the most expensive country in the Euro Area for consumer goods and services, and the second most expensive country in the EU, behind Denmark. This means that an average annual increase of 2.7 per cent in prices in the year to February 2006, on an already high base, leads to a substantial increase in costs in the economy, which has important implications for national competitiveness.

In recent months, inflation has edged upwards. On a monthly basis the index increased by 1.1 per cent from January 2006 to February 2006. On an annual basis the index rose by 3.3 per cent in February 2006 when compared to the same month of 2005. This rate of increase in the CPI represents the highest year on year increase in any month in the index since June 2003. The increase was driven mainly by a rise in the *Housing, Water, Electricity, Gas and Other Fuels* category of the index, with inflation in this category accounting for almost half of the change in the index in February. Increases in the *Housing, Water, Electricity, Gas and Other Fuels* category of the index were driven by rises in the price of energy and related products, mortgage interest, and utilities and local charges which registered annualised increases of 14.9 per cent, 17.9 per cent and 6.9 per cent respectively in prices in February 2006. Excluding mortgage interest from the index points to a lower underlying growth rate of 2.6 per cent over the year while excluding energy products points to a much lower inflation rate of 2.3 per cent.

The annual rate of inflation for goods was 2 per cent in February while the corresponding rate was 4.4 per cent for services, implying a narrowing of the divergence between the two rates of inflation when compared with previous months.

The average increase in the *Harmonised Index of Consumer Prices* (HICP) was 2.3 per cent in the year from March 2005 to February 2006. The index recorded a year on year increase of 2.7 per cent in February 2006, as compared to a 2.0 per cent rate registered in the same month of 2005. The divergence between the HICP and the CPI was driven mainly by the increase in average mortgage payments due to higher house prices and the increase in interest rates, which are included in the CPI but excluded from the HICP. The divergence looks set to increase further this year with the ECB main refinancing rate forecast to increase further during the year.

The outlook for 2006 is for the average rate of increase in the CPI to be higher than in 2005, driven both by robust domestic demand as well as increases in interest rates. Inflation is forecast at

2.8 per cent in 2006 before moderating slightly to 2.6 per cent in 2007.

General Assessment

The CSO's preliminary estimate for GNP growth in 2005 of 5.4 per cent shows that the economy is performing strongly. We are forecasting GNP growth rates for 2006 and 2007 of 5.1 per cent and 5.3 per cent, on the basis that we believe that this strong performance is likely to continue in the short term. Despite this optimistic assessment, a number of concerns surround the overall performance of the economy. Below, we discuss two of these: the housing market and exports.

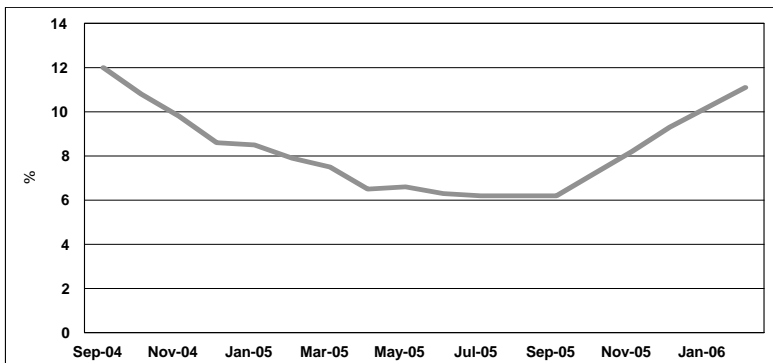
We look first at house prices, a key influence on broader developments in the economy. In its *Quarterly Bulletin* of July 2005, the Central Bank noted that "...the steady decline in the rate of house price inflation over the past year point(ed) towards the likelihood of a soft landing in the housing market". At that time, the Bank was reflecting the view held by many that the increases in house prices up to then had been at a rate which left open the possibility of a sharp and severe adjustment and that the deceleration in mid-2005 was to be welcomed. However, the deceleration turned out to be short lived (see Figure 8).

The upswing in house price inflation since September once again raises concerns about the possibility of a bubble. Much debate surrounds this issue but within that debate we would like to draw attention to the recent OECD estimates that house prices were over-valued by as much as 15 per cent in mid-2005 (OECD, 2006).¹¹ Given the re-acceleration in prices since mid-2005 and the recent ECB interest rate increases, these estimates would suggest that there may now be an even greater over-valuation in house prices relative to the mid-2005 estimate. We consider that the possibility that there is a house price bubble is now a real concern given the current level of house prices and the associated levels of household indebtedness. We should also stress, as the OECD did, that an over-valuation of houses does not imply that a sharp fall will occur. A soft landing is still the more likely outcome. However, the probability of a sharp adjustment increases with the size and duration of the over-valuation and this is a growing concern.

Our concern about house prices arises partly from the negative consequences of a bubble bursting but also from the ongoing effect that high house prices are having on the broader economy. As argued in the ESRI's *Medium-Term Review* (2005), rising house prices are acting to draw resources into the construction sector, in particular labour, thereby raising costs in other sectors. In this way, rising house prices are impacting upon the overall competitiveness of the economy and, as we will now argue, this appears to remain a problem.

¹¹ OECD (2006), *OECD Economic Surveys: Ireland*, Paris: OECD.

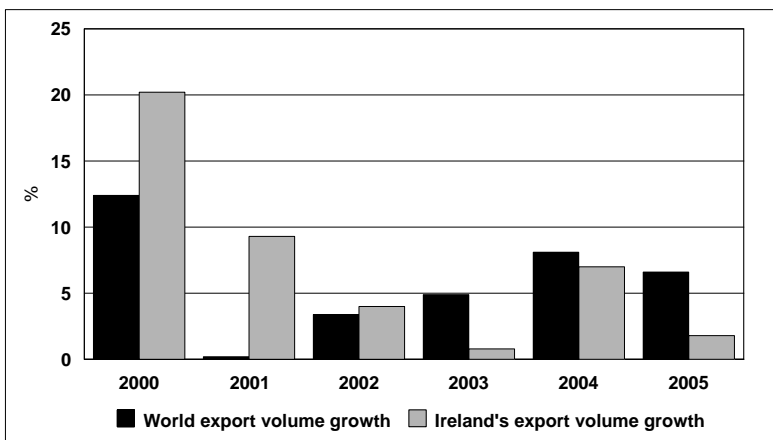
Figure 8: House Price Increases September 2004-February 2005



Source: tsb/ESRI House Price Series.

Turning to exports, although the overall growth performance of the economy was strong this year, the volume increase in exports at 1.8 per cent is disappointingly low both relative to the recent past in Ireland but also relative to the performance of the world economy. In Figure 9, we show the recent trend in Irish and world export volume growth and the relative weakness in the 2005 performance is clear. With the volume of world trade growing by 6.6 per cent in 2005, Ireland’s volume growth of 1.8 per cent represents a decline in our share of world exports. This is a continuation of a pattern that began in 2003 and contrasts strongly with Ireland’s experience between 1990 and 2003 when, according to Cassidy and O’Brien (2005)¹² our share of world exports approximately doubled.

Figure 9: Irish and World Export Volume Growth



Source: CSO National Accounts and NIESR database.

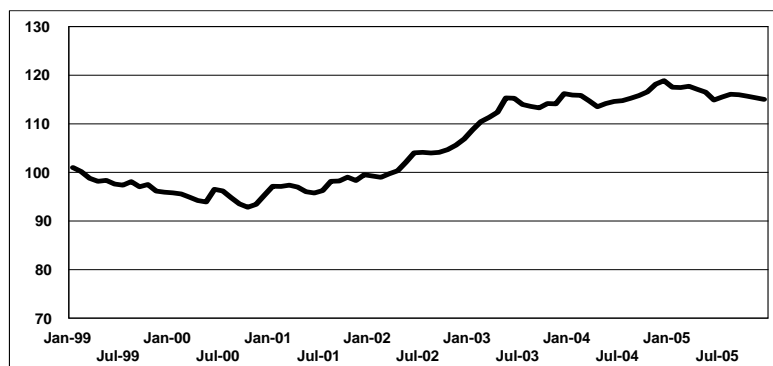
¹²Cassidy, Mark and Derry O’Brien (2005), “Export Performance and Competitiveness of the Irish Economy”, Central Bank *Quarterly Bulletin* No. 3.

The relatively poor performance of exports has led to a deterioration in the balance of payments. For the year 2005, the current account deficit was 2.3 per cent of GNP, up from the 0.9 per cent deficit recorded in 2004. While deficits of this magnitude are not necessarily of concern in the context of a monetary union, they do act as an indicator of a failure to compete in export markets. Given the size of Ireland's domestic market, it is unrealistic to think that growth can be sustained in the longer run without a vibrant export sector and so this poor export performance is a concern.

Cassidy and O'Brien (2005) conduct an analysis of Ireland's export performance, both pre- and post-2002. With regard to the recent weakening of export growth, they look at indicators of competitiveness to see if these can help to explain the decline. One such indicator is the Central Bank's real trade weighted competitiveness index (RTWCI). This index captures changes in the relative price of Irish goods expressed in a common currency. The index can increase (thereby indicating a loss of competitiveness) either because Irish goods are becoming relatively more expensive (due to differences in CPI) or because of an appreciation of the nominal exchange rate.

In Figure 10, we show the RTWCI for the years 1999 to 2005. It can be seen that from early 2002 to 2004, the index has been on an upward trend and that it has fluctuated around this higher level since then. Cassidy and O'Brien explain that between 2002 and 2004 Ireland's inflation rate exceeded that of its trading partners and this partly explains the rising index (and hence fall in competitiveness). Over that time, the nominal exchange rate also appreciated and this compounded the competitiveness loss. According to Cassidy and O'Brien (2005) by the end of 2004 the RTWCI was 20 per cent higher than its value at the time of the introduction of the euro. Exchange rate movements can explain a quarter of this deterioration; the remaining three-quarters can be explained by Ireland's higher inflation rate between 1999 and 2004.

Figure 10: Real Trade-Weighted Competitiveness Index, 1999-2005

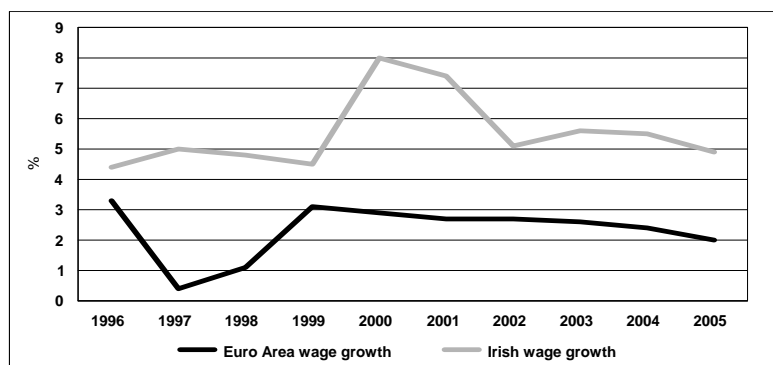


Source: Central Bank of Ireland.

The RTWCI has been improving since the beginning of 2005, largely due to the depreciation in the euro.¹³ However, the index remains 15 per cent higher than its value in early 1999. This implies that Ireland has not been able to regain the losses in competitiveness it experienced between 2002 and 2004 and that it is now operating from a less competitive position relative to the late 1990s.

An alternative way of looking at the issue of competitiveness is to compare input costs. Cassidy and O'Brien (2005) and the National Competitiveness Council (2005)¹⁴ discuss some well-known difficulties in using unit labour costs as measures of competitiveness and we will not go over these points here. Instead, we will simply present one set of figures which are suggestive of a loss in competitiveness in recent years. In Figure 11, we show wage growth in Ireland and the Euro Area over the last ten years. Throughout the period wage growth in Ireland has been higher. Of course, Ireland can still be competitive in a context where wages are growing relatively faster if (a) wage levels were low initially and (b) productivity growth is faster. However, the picture in Figure 11 is certainly suggestive of a relative loss in competitiveness even if Ireland remains competitive in absolute terms.

Figure 11: Irish and Euro Area Wage Growth



Source: AMECO database, available on DG ECFIN website.

As Cassidy and O'Brien (2005) note, an analysis of Ireland's export performance needs to include factors beyond price and cost competitiveness such as the factors that encourage FDI. Nevertheless, price and cost competitiveness are of central importance and so the apparent loss in competitiveness in recent years is a concern. Hence, we need to address the question of what can be done to reverse the decline. In the previous *Commentary*, we addressed the issue of incomes policy so we will not return to that

¹³ At the beginning of 2005, the euro was worth \$1.35 – by the end of 2005, it was worth \$1.20.

¹⁴ National Competitiveness Council (2005), *Annual Competitiveness Report*, Dublin: Forfás.

issue here. Instead, we will look at two other issues: the role of (a) fiscal policy and (b) competition policy.

With regard to fiscal policy, the following quote from Lane (2004)¹⁵ in the context of a discussion on competitiveness sums up an important point: "...it remains an important priority for national fiscal authorities not to add to temporary boom conditions through actively-procyclical fiscal initiatives". The consideration underlying this quote is that fiscal policy can lead to increased inflation (and hence a loss in competitiveness) if it adds significantly to aggregate demand in an economy that is operating at or close to capacity. Given that the economy is forecast to grow by 5 per cent or more this year and next, a fiscal injection at this time would be of the type that Lane is warning against. With the General Election due to be held next year, it is timely to highlight this warning and to register a note of caution about excessively stimulatory fiscal policy.

With regard to competition policy, Lane (2004) again points to the value of this policy instrument in the context of competitiveness. The general principle underlying his view is that greater competition leads to lower prices and hence provides a boost to competitiveness. OECD (2006) goes beyond this general principle and makes a number of specific recommendations. While each of the recommendations in isolation may have only a limited impact on prices and hence competitiveness, a broad programme of market reform could yield benefits. As the OECD (2006) note: "A striking feature of Ireland's economy is its high prices in certain sectors, implying that too many of the benefits of Ireland's boom have been captured by producers rather than being passed on to consumers in the form of lower prices".

Among the recommendations made by the OECD is the integration of the electricity market with Northern Ireland and the UK and a move towards the creation of more competition in the electricity market. They also call for liberalisation in the areas of public houses, the legal profession, pharmacies and the bus market. We would generally support these proposals partly on the grounds of microeconomic efficiency but also from the macroeconomic point of competitiveness.

¹⁵ Lane, Philip R. (2004), "Assessing Ireland's Price and Wage Competitiveness", mimeo IHS and Department of Economics, TCD.