QUARTERLY ECONOMIC COMMENTARY

Spring 2007

ALAN BARRETT
IDE KEARNEY
YVONNE MCCARTHY

The forecasts in this Commentary are based on data available by mid-March 2007

Special Articles

Delayed Indefinitely:
Regulatory Reform of the Irish Bus Industry

by

Patrick Massey

Developments in Industrial Relations and Human Resource Management in Ireland

by

William K. Roche

Macroeconomic Adjustment in Ireland under the EMU

by

Iulia Traistaru-Siedschlag

SUMMARY TABLE

	2005	2006	2007	2008
OUTPUT				
(Real Annual Growth %)				
Private Consumer Expenditure	6.6	6.8	7.8	4.5
Public Net Current Expenditure	4.6	4.7	4.5	3.5
Private Investment	12.8	7.5	5.0	3.9
Exports	3.9	6.0	5.6	5.2
Imports	6.5	6.7	7.0	5.7
Gross Domestic Product (GDP)	5.5	6.1	5.4	3.9
Gross National Product (GNP)	5.3	6.3	5.4	3.9
GNP per capita (constant prices)	3.1	3.7	3.2	2.2
PRICES				
(Annual Growth %)				
Consumer Price Index (CPI)	2.5	4.0	4.6	2.6
Wage Growth	5.6	5.3	5.8	4.6
LABOUR MARKET				
Employment Levels (ILO basis (000s))	1,952	2,039	2,117	2,150
Unemployment Levels (ILO basis (000s))	89	93	97	106
Unemployment Rate (as % of Labour Force)	4.4	4.4	4.4	4.7
PUBLIC FINANCE				
Exchequer Balance (€m)	-500	2,256	410	- 91
General Government Balance (€m)	1,745	4,382	3364	3,455
General Government Balance (% of GDP)	1.1	2.5	1.7	1.7
General Government Debt (% of GDP)	27.4	24.8	22.4	21.1
EXTERNAL TRADE				
Balance of Payments Current Account (€m)	-4,200	-6,748	-8,833	9,846
Current Account (% of GNP)	-3.1	-4.5	-5.4	-5.6
EXCHANGE AND INTEREST RATES (end of year)				
US$/€ Exchange Rate	1.24	1.30	1.35	1.40
STG£/€ Exchange Rate	0.68	0.68	0.68	0.68
Main ECB Interest Rate	2.25	3.50	4.00	4.00

SUMMARY

Real GNP is likely to have grown by 6.3 per cent in 2006, driven mainly by strong growth in both consumption and investment. For 2007, we expect another strong year of growth, with real GNP forecast to grow by 5.4 per cent. Looking ahead to 2008, we expect a return to a more sustainable growth rate and forecast real GNP growth of 3.9 per cent. In terms of GNP per capita, the growth rate for 2006 is likely to have been 3.7 per cent, with the corresponding figures for 2007 and 2008 being 3.2 per cent and 2.2 per cent respectively.

The external environment is likely to be generally positive for Ireland in 2007 and 2008. The Euro Area is experiencing a period of strong growth. Real GDP increased by 2.8 per cent in 2006 and growth rates of 2.5 per cent and 2.2 per cent are expected for 2007 and 2008 respectively. For the US, the situation is more uncertain. Growth in 2006 was 3.3 per cent. The growth rates in 2007 and 2008 are likely to be lower but there is disagreement among commentators about precisely how much lower.

In spite of the positive external environment, we expect domestic demand to contribute most to growth in 2007 and 2008, with net external trade making a limited contribution. Import growth is forecast to exceed export growth in both years. Partly as a result of these trends, the current account deficit (as a per cent of GNP) is forecast to rise from 4.5 per cent in 2006 to 5.4 per cent in 2007 and to 5.6 per cent in 2008.

The slower rate of growth in 2008 relative to 2007 will have a number of implications. Growth in current public revenues is anticipated at 9.9 per cent in 2007 but this is forecast to fall to 6.6 per cent in 2008. Net inward migration is projected to fall from 55,000 in 2007 to 35,000 in 2008. The rate of unemployment is forecast to rise from 4.4 per cent in 2007 to 4.7 per cent in 2008.

Consumer Price Index (CPI) inflation is expected to average 4.6 per cent in 2007 and a much lower 2.6 per cent in 2008. Most of the difference between the two periods relates to an assumption of no further interest rate increases after the European Central Bank's main refinancing rate reaches 4 per cent later this year.

In the *General Assessment*, we return to a number of vulnerabilities in the economy that have been addressed in earlier *Commentaries*. In the last issue, we raised concerns about the increasing deficit on the current account. A more detailed look at data on the international flow of funds to and from Ireland suggests that much of the increase in activity in house building has been linked to an inflow of borrowed funds. This suggests that the economy is building up foreign debt to invest in an asset with a long-run low rate of return. We also discuss how house prices appear to remain over-valued. This is based on the estimation of an equation which suggests that fundamental drivers of house prices cannot explain the current levels of those prices. Finally, we show how increases in the CPI in Ireland tend to feed into wage increases in a rapid manner. A repeat of this phenomenon in the current context of high growth in the CPI would be particularly damaging to competitiveness.

FORECAST NATIONAL ACCOUNTS 2006

A: Expenditure on Gross National Product

	2005	2006	Change in 2006				
		Forecast	€m		%		
	€m	€m	Value	Volume	Value	Price	Volume
Private Consumer Expenditure	74,114	81,528	7,414	5,040	10.0	3.0	6.8
Public Net Current Expenditure	22,952	25,361	2,410	1,079	10.5	5.5	4.7
Gross Fixed Capital Formation	43,582	50,052	6,470	3,258	14.8	6.9	7.5
Exports of Goods and Services (X)	131,001	142,164	11,164	7,833	8.5	2.4	6.0
Physical Changes in Stocks	98	108	10	10		0.0	10.0
Final Demand	**271,746**	**299,213**	**27,468**	**17,213**	**10.1**	**3.5**	**6.3**
less:							
Imports of Goods and Services (M)	110,553	121,632	11,079	7,379	10.0	3.1	6.7
less:							
Statistical Discrepancy	30	30	0	-24			
GDP at Market Prices	**161,163**	**177,551**	**16,389**	**9,858**	**10.2**	**3.8**	**6.1**
less:							
Net Factor Payments (F)	-25,248	-27,329	-2,081	-1,250	8.2	3.1	4.9
GNP at Market Prices	**135,914**	**150,222**	**14,308**	**8,614**	**10.5**	**3.9**	**6.3**

B: Gross National Product by Origin

	2005	2006	Change in 2006	
		Forecast		
	€m	€m	€m	%
Agriculture, Forestry, Fishing	3,399	3,569	170	5.0
Non-Agricultural: Wages, etc.	65,272	71,877	6,605	10.1
Other:	57,380	62,202	4,822	8.4
Adjustments: Stock Appreciation	-578	-200	378	-65.4
Statistical Discrepancy	30	30		
Net Domestic Product	**125,503**	**137,477**	**11,975**	**9.5**
less:				
Net Factor Payments	-25,248	-27,329	-2,081	8.2
National Income	**100,254**	**110,148**	**9,894**	**9.9**
Depreciation	16,896	18,160	1,264	7.5
GNP at Factor Cost	**117,150**	**128,308**	**11,158**	**9.5**
Taxes less Subsidies	18,764	21,914	3,150	16.8
GNP at Market Prices	**135,914**	**150,222**	**14,308**	**10.5**

C: Balance of Payments on Current Account

	2004	2005	Change in 2005
		Forecast	
	€m	€m	€m
Exports (X) less Imports (M)	20,447	20,532	84
Net Factor Payments (F)	-25,248	-27,329	-2,081
Net Transfers	601	50	-551
Balance on Current Account	**-4,200**	**-6,748**	**-2,548**
as % of GNP	-3.1	-4.5	-1.4

FORECAST NATIONAL ACCOUNTS 2007

A: Expenditure on Gross National Product

	2006	2007	Change in 2007				
	Forecast €m	Forecast €m	€m		%		
			Value	Volume	Value	Price	Volume
Private Consumer Expend Private Consumer Expenditure	81,528	90,922	9,393	6,318	11.5	3.5	7.8
Public Net Current Expenditure	25,361	28,151	2,790	1,141	11.0	6.2	4.5
Gross Fixed Capital Formation	50,052	54,541	4,489	2,515	9.0	3.8	5.0
Exports of Goods and Services (X)	142,164	153,587	11,423	7,962	8.0	2.3	5.6
Physical Changes in Stocks	108	119	11	11		0.0	10.0
Final Demand	**299,213**	**327,319**	**28,106**	**18,018**	9.4	3.2	6.0
less:							
Imports of Goods and Services (M)	121,632	132,439	10,807	8,512	**8.9**	**1.8**	**7.0**
less:							
Statistical Discrepancy	30	30	0	-1			
GDP at Market Prices	**177,551**	**194,850**	**17,299**	**9,508**	**9.7**	**4.2**	**5.4**
less:							
Net Factor Payments (F)	-27,329	-30,032	-2,702	-1,409	9.9	4.5	5.2
GNP at Market Prices	**150,222**	**164,819**	**14,597**	**8,100**	**9.7**	**4.1**	**5.4**

B: Gross National Product by Origin

	2006	2007	Change in 2007	
	Forecast €m	Forecast €m	€m	%
Agriculture, Forestry, Fishing	3,569	3,712	143	4.0
Non-Agricultural: Wages, etc.	71,877	79,190	7,314	10.2
Other:	62,202	67,747	5,545	8.9
Adjustments: Stock Appreciation	-200	-200	0	0.0
Statistical Discrepancy	30	30		
Net Domestic Product	**137,477**	**150,479**	**13,001**	**9.5**
less:				
Net Factor Payments	-27,329	-30,032	-2,702	9.9
National Income	**110,148**	**120,447**	**10,299**	**9.4**
Depreciation	18,160	19,884	1,724	9.5
GNP at Factor Cost	**128,308**	**140,331**	**12,023**	**9.4**
Taxes less Subsidies	21,914	24,487	2,574	11.7
GNP at Market Prices	**150,222**	**164,819**	**14,597**	**9.7**

C: Balance of Payments on Current Account

	2006	2007	Change in 2007
	Forecast €m	Forecast €m	€m
Exports (X) less Imports (M)	20,532	21,148	616
Net Factor Payments (F)	-27,329	-30,032	-2,702
Net Transfers	50	50	0
Balance on Current Account	**-6,748**	**-8,833**	**-2,086**
as % of GNP	-4.5	-5.4	-0.9

FORECAST NATIONAL ACCOUNTS 2008

A: Expenditure on Gross National Product

	2007	2008	Change in 2008				
	Preliminary €m	Forecast €m	€m		%		
			Value	Volume	Value	Price	Volume
Private Consumer Expenditure	90,922	96,913	5,992	4,091	6.6	2.0	4.5
Public Net Current Expenditure	28,151	30,685	2,534	985	9.0	5.3	3.5
Gross Fixed Capital Formation	54,541	57,912	3,372	2,109	6.2	2.2	3.9
Exports of Goods and Services (X)	153,587	165,143	11,556	7,938	7.5	2.2	5.2
Physical Changes in Stocks	119	130	12	0		0.0	0.0
Final Demand	**327,319**	**350,784**	**23,464**	**15,218**	**7.2**	**2.4**	**4.6**
less:							
Imports of Goods and Services (M)	132,439	142,792	10,353	7,584	7.8	2.0	5.7
less:							
Statistical Discrepancy	30	30	0	45			
GDP at Market Prices	**194,850**	**207,962**	**13,111**	**7,589**	**6.7**	**2.7**	**3.9**
less:							
Net Factor Payments (F)	-30,032	-32,247	-2,215	-1,125	7.4	3.5	3.7
GNP at Market Prices	**164,819**	**175,715**	**10,896**	**6,465**	**6.6**	**2.6**	**3.9**

B: Gross National Product by Origin

	2007	2008	Change in 2008	
	Preliminary €m	Forecast €m	€m	%
Agriculture, Forestry, Fishing	3,712	3,860	148	4.0
Non-Agricultural: Wages, etc.	79,190	84,269	5,079	6.4
Other:	67,747	72,412	4,665	6.9
Adjustments: Stock Appreciation	-200	-200	0	0.0
Statistical Discrepancy	30	30		
Net Domestic Product	**150,479**	**160,371**	**9,892**	**6.6**
less:				
Net Factor Payments	-30,032	-32,247	-2,215	7.4
National Income	**120,447**	**128,124**	**7,676**	**6.4**
Depreciation	19,884	21,194	1,310	6.6
GNP at Factor Cost	**140,331**	**149,318**	**8,987**	**6.4**
Taxes less Subsidies	24,487	26,397	1,909	7.8
GNP at Market Prices	**164,819**	**175,715**	**10,896**	**6.6**

C: Balance of Payments on Current Account

	2005	2006	Change in 2006
	€m	Forecast €m	€m
Exports (X) less Imports (M)	21,148	22,351	1,203
Net Factor Payments (F)	-30,032	-32,247	-2,215
Net Transfers	50	50	0
Balance on Current Account	**-8,833**	**- 9,846**	**-1,013**
as % of GNP	-5.4	-5.6	-0.2

The International Context

The main developments of note are as follows:

- The Euro Area recorded growth of 2.8 per cent in 2006. This was above growth rates in recent years and also above the expectations that were held for most of the year.
- With growth of over 2 per cent expected to continue in the Euro Area through 2007 and into 2008, pressure for further interest rate rises will be present. However, inflationary pressures appear to be easing and so this will act in the opposite direction. On balance, we expect one more quarter point interest rate rise in 2007.
- While growth is slowing in the US, the view of the Federal Reserve that a recession is unlikely leads us to think that a severe slowdown is unlikely.

United States

Concerns emerged during the course of 2006 about the prospects for the US economy, as a falling off in housing investment contributed to a slowing in growth. Although these concerns have not disappeared, the signs in the latter part of the year were more positive. According to early estimates, real GDP grew by 3.3 per cent on a quarterly annualised basis in the last quarter of 2006, up on the figure for the previous quarter of 2 per cent. Consumer spending held up well in 2006 and grew by 3.2 per cent, boosted in part by stronger earnings growth relative to recent years. Business investment accelerated in 2006, growing by 7.4 per cent.

The release of data showing an increase in the rate of mortgage defaults in early-March raised concerns about the prospects for the US economy but other indicators, such as job creation, have been more positive. The Federal Reserve, in its *Monetary Policy Report to the Congress* in February gave a generally positive assessment of prospects for 2007. It said that the US economy would expand at a "moderate rate" in 2007 and that "the drag on economic growth from declining construction activity is expected to diminish later this year". The Federal Reserve has left rates unchanged in recent months, thereby suggesting that it was not overly focused on the prospect of a recession in the US. However, the most recent statements from the Federal Reserve has again increased expectations of an interest rate cut later this year.

According to the Euroframe-European Forecasting Network (EFN), real GDP is forecast to grow by 2.4 per cent in the US in 2007 and by 2.3 per cent in 2008. Housing investment is expected to decline in 2007, by 7.7 per cent, but it should rebound again in 2008 and is expected to grow by 3.4 per cent in that year. Consumption spending growth is expected to ease in 2007 and 2008, with growth rates of 2.7 per cent and 1.8 per cent respectively. The deficit on the current account is expected to have peaked in 2006, at 6.5 per cent on GDP. While this is forecast to fall to 6.0 per cent of GDP by 2008, it is still above a level that would be considered sustainable and so concerns persist about the prospects of an adjustment.

United Kingdom

Real GDP grew by 2.7 per cent in the UK in 2006. This growth was underpinned by growth in consumption and investment. External trade generally made a negative contribution to growth during the year. While the growth performance of the economy has been good, relatively high rates of inflation remain a feature of the UK economy. The year-on-year Harmonised Index of Consumer Prices (HICP) reached 2.7 per cent in the fourth quarter of 2006, with a spike of 3 per cent recorded in December. This led the Bank of England to increase interest rates by 25 basis points in January, following similar rate rises in August and November of 2006.

For 2007, the EFN forecasts real GDP growth of 2.6 per cent and hence another year of good economic growth. Consumption is forecast to grow by 2.8 per cent, partly on the basis of strong consumer sentiment readings at the beginning of 2007. For 2008, a slightly slower pace of growth is forecast, at 2.4 per cent. Consumption growth is again likely to be a significant component of the growth.

The unemployment rate grew in 2006 and averaged 5.4 per cent for the year, up from 4.9 per cent in 2005. High rates of inward migration are thought by some to explain the observation of increasing employment and unemployment. These trends are forecast to continue in 2007 and 2008, with the rate of unemployment rising to 5.7 per cent in 2007 and to 5.8 per cent in 2008. Blanchflower *et al.* (2007)[1] argue that migration from Eastern Europe is lowering inflationary pressures in the UK. The reasoning is relevant to Ireland and we refer to this paper again below.

Euro Area

The headline story for the Euro Area in 2006 was a rate of growth that exceeded expectations, both at the start of the year and during the course of the year. Real GDP is thought to have grown by 2.8 per cent, well above the 2005 rate of 1.5 per cent. In our Winter *Commentary*, we had expected the Euro Area growth rate to be 2.6 per cent so the on-going improvement in performance is evident. This good performance has translated into reduced unemployment, with the rate falling from 8.6 per cent in 2005 to 7.8 per cent in 2006. The main driver of the improved performance was investment, which grew by 5.3 per cent in 2006. Consumption also began to pick up and grew by 1.8 per cent. While export growth was strong, at 8.1 per cent, so also was import growth (7.5 per cent), thereby limiting the contribution to growth of net exports.

For 2007 and 2008, the EFN forecast real GDP growth rates of 2.5 per cent and 2.2 per cent respectively. In so doing, the network is showing a belief in the sustainability of the Euro Area's recent good performance. The rate of unemployment is expected to fall further,

[1]Blanchflower, D.G., J. Saleheen and C. Shadforth (2007), "The Impact of Recent Migration from Eastern Europe on the UK Economy", IZA Discussion Paper No. 2615.

to 7.2 per cent in 2007 and to 6.8 per cent in 2008. This fall in unemployment will contribute to a stronger rate of consumption growth, with growth rates of 2.1 per cent and 2.3 per cent forecast for 2007 and 2008 respectively.

The improved growth performance, combined with fears over inflationary pressures and a perception that monetary policy remains "accommodative", has prompted the European Central Bank (ECB) to continue with its series of interest rate rises. The most recent rise occurred in March and brought the main refinancing rate to 3.75 per cent. While many commentators now expect rates to rise to 4 per cent by the middle of the year, there is less agreement on whether further increases will be made. Our view is that 4 per cent will represent a plateau for the remainder of the year, partly on the basis that inflationary pressures appear to be easing. For example, the European Commission is forecasting HICP inflation of 1.8 per cent for 2007, below the ECB's target rate of 2 per cent. For 2008, we have made a technical assumption of rates remaining at 4 per cent but this should not be seen as a forecast.

We now turn to the three largest economies within the Euro Area. Germany recorded real GDP growth of 2.9 per cent in 2006. Strong investment growth of 6.8 per cent and a boom in exports of 11.5 per cent were the main factors in the growth. With unemployment falling from 9.5 per cent in 2005 to 8.4 per cent in 2006, consumer confidence is being boosted. For this reason although consumption was artificially buoyed in 2006 by the VAT increase of 2007, the rate of growth in consumption is not expected to fall between 2006 and 2007. For 2007, the EFN forecast real GDP growth of 2.5 per cent; for 2008, the network forecasts growth of 2.2 per cent. In 2008, consumption is expected to play an increasingly important role in growth and as such this "weak link" in Germany's economic performance in recent years should no longer be a drag on growth.

The pace of growth in the French economy slowed during the course of 2006, with no growth in GDP in the third quarter. Growth did pick up again in the fourth quarter so for the year as a whole, real GDP growth was 2 per cent. This pick-up in the latter part of the year and the latest indicators suggest that 2007 will be a stronger year. The EFN is forecasting real GDP growth of 2.2 per cent in 2007, although this is expected to ease back to 2.0 per cent in 2008.

Italy benefited from accelerated growth in the German economy in the latter part of 2006 and saw a surge in industrial production and an acceleration in quarterly GDP growth. This helped to bring real GDP growth to 1.9 per cent in 2006, a huge improvement on the 2005 figure of just 0.2 per cent. For 2007, the EFN is forecasting real GDP growth of 1.7 per cent but for 2008 this is expected to moderate to 1.4 per cent. Implicit in these figures is an improvement in the public finances, with the general government deficit expected to fall from 4.4 per cent in 2006 to 2.6 per cent in 2007 and to 2.2 per cent in 2008. Given the current political instability in Italy, it is unclear as to whether this will be achieved.

Figure 1: Interest Rates

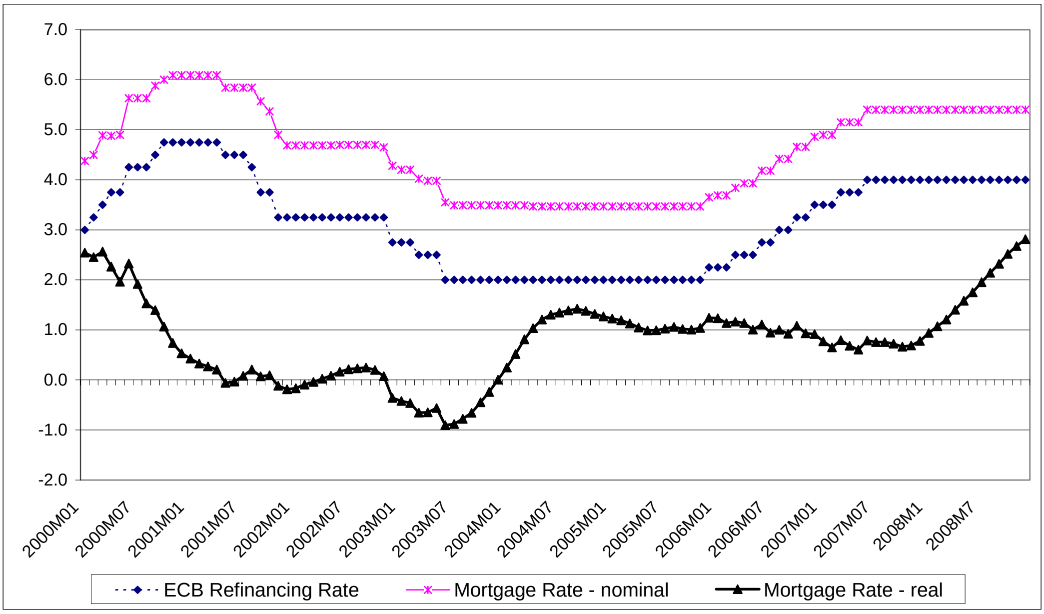


Figure 2: Exchange Rates

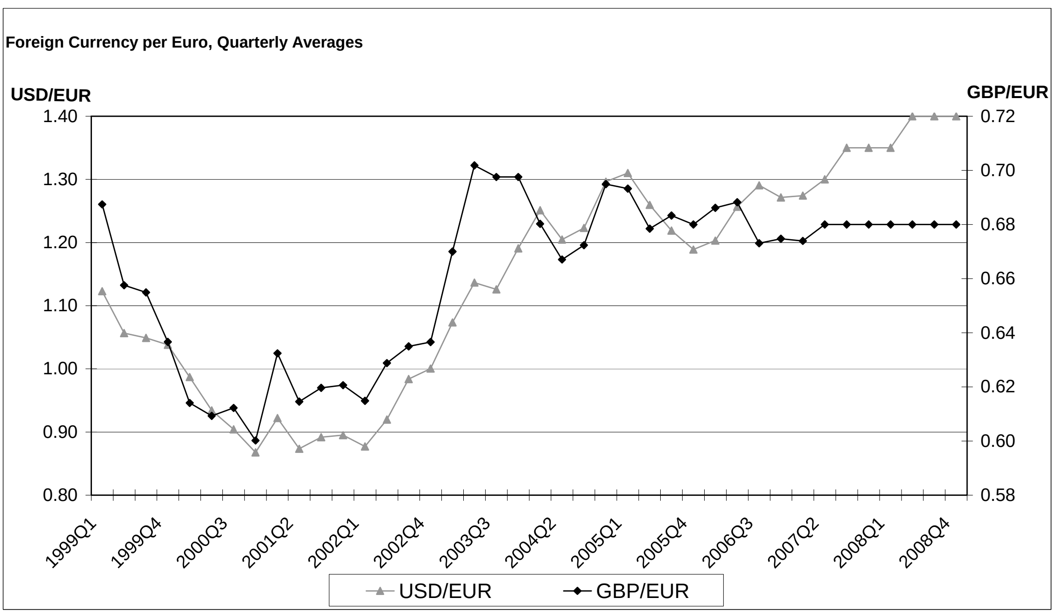


TABLE 1: Short-term International Outlook

	GDP Output Growth			Consumer Price Inflation			Hourly Earnings Growth			Unemployment Rate %			Current Account Balance % of GNP		
Country	**2006**	**2007**	**2008**	**2006**	**2007**	**2008**	**2006**	**2007**	**2008**	**2006**	**2007**	**2008**	**2006**	**2007**	**2008**
UK	2.7	2.6	2.3	2.3	2.9	2.7	4.9	4.7	4.7	5.4	5.7	5.8	-2.9	-3.4	-3.2
Germany	2.9	2.5	2.2	1.3	1.5	1.9	1.0	2.5	3.5	8.4	7.3	6.3	4.4	5.3	4.9
France	2.0	2.2	2.0	1.2	1.6	1.6	3.1	1.8	2.5	9.0	8.4	8.5	-1.9	-2.1	-1.9
Italy	1.9	1.7	1.4	2.7	2.4	2.2	3.0	2.6	3.3	7.0	6.7	6.5	-2.2	-1.4	-1.7
Euro Area	2.8	2.5	2.2	2.1	2.0	1.9	2.6	3.0	3.6	7.8	7.2	6.9	-0.2	-0.1	-0.2
USA	3.3	2.4	2.3	2.8	2.3	2.5	4.7	4.3	4.4	4.6	4.8	5.6	-6.5	-6.0	-6.0
Japan	2.2	2.3	2.1	-0.3	0.4	1.2	-0.4	2.1	1.8	4.1	3.9	3.8	3.9	4.1	4.3
China	10.7	9.8	9.1	1.5	2.0	1.8									
OECD	3.1	2.4	2.5	2.2	2.2	2.3									
Ireland	6.1	5.4	3.9	3.9	4.6	2.6	5.3	5.8	4.6	4.4	4.4	4.7	-4.5	-5.4	-5.6

Source: Euroframe-EFN Spring 2007.

Asia

The recent good performance of the Japanese economy persisted throughout 2006 and led to an annual rate of economic growth of 2.2 per cent. The growth was largely driven by investment and exports. Investment grew by 7.3 per cent, with exports growing by 9.7 per cent. The EFN forecast accelerated growth in 2007 and 2008, with a rate of 2.3 per cent expected in 2007 and 2.1 per cent in 2008.

This improved performance is expected to lead to a continued fall in the rate of unemployment and to an improvement in the public finances. Unemployment was at 5.3 per cent in 2003 but has fallen steadily since and is expected to fall below 4 per cent in 2007. The general government deficit was over 8 per cent in 2002 but had fallen to 4.7 per cent in 2006. In spite of this, Japan's government debt, at 175 per cent of GDP, remains large by international standards. Inflation remains very low and was running at just 0.3 per cent on an annual basis in December. This prompted the Bank of Japan to leave interest rates unchanged at 0.25 per cent.

China continues to grow strongly, with real GDP growth of 10.7 per cent in 2006. High levels of growth are expected to continue in 2007 and 2008, albeit at a slightly lower rate. Recent weeks brought another reminder of China's integration into the world economy when a fall on the Chinese stock exchange provoked a fall in the value of stocks globally.

International Outlook and the Context for Ireland

The external environment looks generally positive from Ireland's perspective. World GNP growth is expected to be 4.8 per cent in 2007 and 4.5 per cent in 2008, with growth more balanced across regions than has been the case in recent years. World trade is expected to grow by 6.4 per cent in 2007 and by 6.2 per cent in 2008. The Euro Area is experiencing its strongest performance of recent years and the indications are that this will continue. With the UK and Asia also doing well, this adds to the favourable environment. The largest doubts surround developments in the United States. The recent reactions of stock markets to comments from a former Chairman of the Federal Reserve and also to data on mortgage defaults suggest that there is nervousness in the markets about prospects. However, the generally positive views being expressed by the current Chairman of the Federal Reserve lead us to believe that a severe downturn in the US is unlikely. As the course of US interest rates is more likely to be downward than upward and with the opposite holding in the Euro Area, we envisage a weakening of the dollar relative to the euro both this year and next. The on-going existence of a large US current account deficit is another factor underlying our expectations of dollar movements.

The Domestic Economy

General

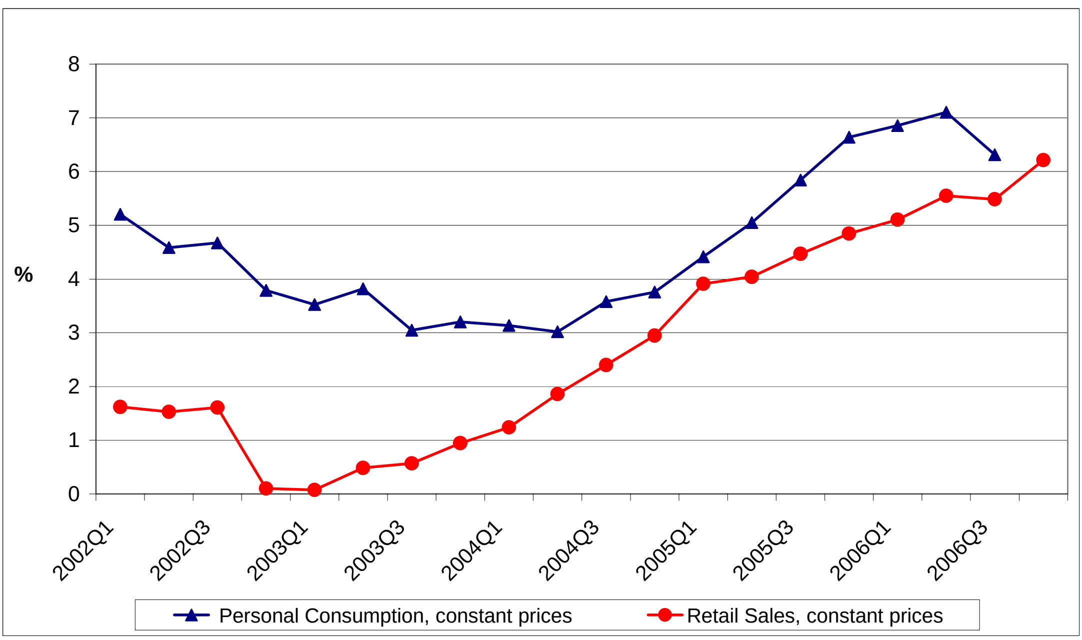
Following a year of exceptionally robust growth in 2006, we expect further expansion in 2007, driven by strong growth in consumption. Looking beyond 2007 we expect a return to more sustainable rates, with GNP expected to grow at just below 4 per cent. This slowdown is driven both by a return to more typical growth rates in consumption and by a moderate easing in residential property construction.

Employment is expected to continue to grow strongly in 2007 before slowing in 2008. We expect that this should result in a slowdown in immigration into the country in 2008. Nevertheless, we anticipate that the slower growth in employment in 2008 will contribute to a small upward move in the unemployment rate, from 4.4 per cent in 2007 to 4.7 per cent in 2008.

Consumption

According to the *Quarterly National Accounts* for the third quarter of 2006, the pace of consumption growth slowed in the third quarter of the year. The four quarter moving average growth rate for the volume of consumption was 6.3 per cent in the third quarter, down from 7.1 per cent in the second quarter.

Figure 3: Annual Growth Rates in Personal Consumption and Retail Sales



Despite the slight slowdown in expenditure in the third quarter, the latest retail sales data point to a strong rebound towards the end of 2006. The volume of retail sales expanded by 6.2 per cent in 2006, with the final three months of the year showing more robust growth than earlier months of the year. The 2006 retail sales growth represents an increase on the 4.9 per cent rate of expansion registered in 2005. Excluding motor trade, the growth in retail sales was even stronger, at 7 per cent year on year in 2006. As a result, we believe that private consumer expenditure volumes will have grown by 6.8 per cent in 2006.

The Consumer Sentiment Index in recent months has suggested that consumer sentiment has been dented by interest rate increases, cost of living increases and reported job losses. However, incomes and employment growth are forecast to remain strong in 2007 and so we expect further strong growth in consumer expenditure. Consumption will also be buoyed by the release of SSIA funds. We are forecasting growth of 7.8 per cent in consumption volumes for 2007. Looking ahead to 2008, consumer expenditure is likely to slow from the highs of the previous two years, mainly due to the dissolution of the SSIA effect on expenditure, but also due to the slower growth in employment. Our forecast rate of growth is 4.5 per cent in consumption volumes in 2008.

Investment

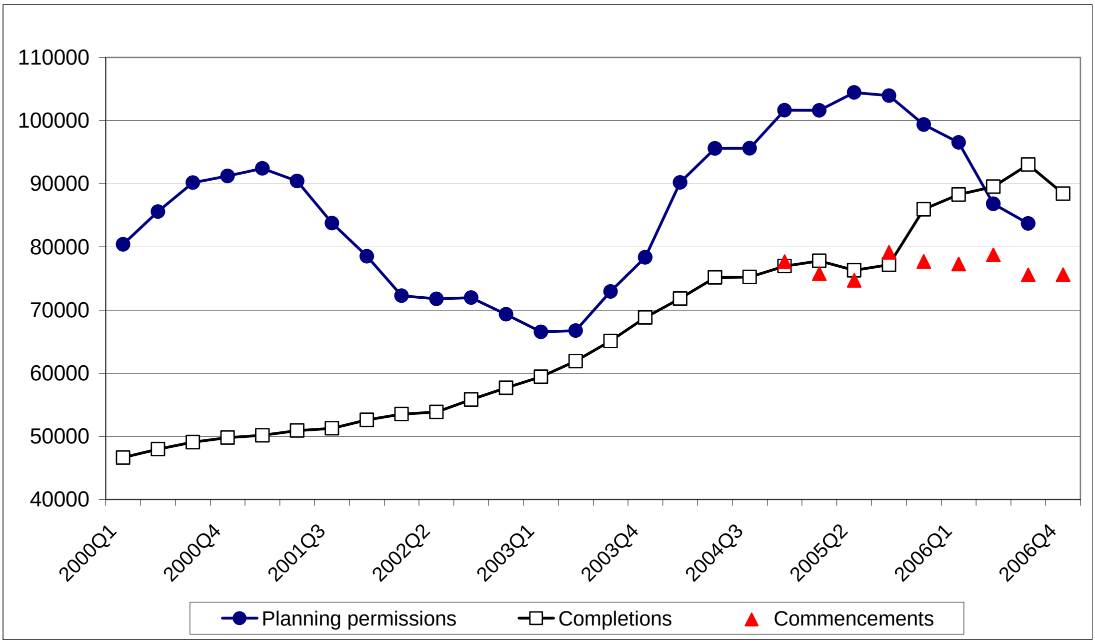
Investment growth in the Irish economy was 6.4 per cent in the year ended the third quarter (measured as a four quarter moving average growth rate). While this represents a slowdown from the 9 per cent growth registered in the same period of 2005, it is largely the result of low investment in the second quarter of the year, which was related to unusually weak machinery and equipment investment. We expect a recovery in investment growth in the fourth quarter of the year so that our estimate for 2006 as a whole is for growth of 7.5 per cent in volume terms.

Turning to the housing market, indicators of investment activity suggest a slowdown in housing output this year. Commencements data registered a 2.7 per cent fall in 2006 vis-à-vis 2005, suggesting that completions may register slower growth over the year. Planning permissions also fell in 2006; the four quarter moving average registered a 15.6 per cent fall in the third quarter as opposed to growth of almost 1 per cent in the same period of 2005. We expect total housing investment in 2007 to fall by 1 per cent in volume terms, compared with growth of 4 per cent in 2006. In 2007 we expect that SSIA monies will buoy the total value of housing investment, where such investments are more likely to occur in the form of home improvements rather than new house completions. In 2008 we expect housing investment to register a fall of 3 per cent in volume terms, as the impact of SSIA related expenditure disappears and slower price growth impacts upon supply.

TABLE 2: Gross Fixed Capital Formation

	2005 €m	% Change in 2006		2006 €m	% Change in 2007		2007 €m	% Change in 2008		2008 €m
		Volume	Value		Volume	Value		Volume	Value	
Housing	20,890	4.0	14.4	23,898	-1.0	3.0	24,606	-3.0	-2.0	24,106
Other Building	11,279	9.0	15.0	12,970	10.0	16.6	15,123	10.0	15.5	17,467
Building and Construction	32,169	5.8	14.6	36,868	3.1	7.8	39,729	2.1	4.6	41,573
Machinery and Equipment	11,413	12.0	15.5	13,183	10.0	12.4	14,812	8.0	10.3	16,339
Total	43,582	7.5	14.8	50,052	5.0	9.0	54,541	3.9	6.2	57,912

Figure 4: Housing Statistics: Annual Planning Permissions, Commencements and Completions [2]



Source: Deptment of Environment, Heritage and Local Government and CSO.

Turning to house prices, the latest permanent tsb/ESRI index suggests that new house prices have risen by an annual average rate of 12.4 per cent in January 2007[3] as compared to 8.6 per cent in the same period of 2006. There has been a slowing of house price growth in recent months. Assuming that current and anticipated interest rate hikes impact on demand for housing, we expect average house price growth to slow further over the forecast horizon.

Investment in non-residential building and construction is expected to continue to grow strongly in 2007 and 2008, by 10 per cent in both years, driven to a large extent by public sector investment under the National Development Plan. Investment in machinery and equipment is forecast to expand by 10 per cent this year and 8 per cent in 2008 in volume terms, partly driven by the purchase of aeroplanes. In 2007 aircraft investment is expected to add over 5 percentage points to the total value of machinery and equipment investment while the corresponding figure for 2008 is likely to be over 3 percentage points.

Growth in machinery and equipment investment and non-residential building will help offset the expected fall in housing output in 2008. Nevertheless, growth in investment is expected to

[2] The 2005 estimate includes an upward adjustment by the Central Statistics Office (CSO) of about 5,200 units. The adjustment takes account of work in progress which had not been included in the Department of the Environment, Heritage and Local Government data for 2005.

[3] Measured as a twelve month moving average.

slow significantly from current rates. Our forecast is for investment volumes to expand by 5 per cent this year and by 3.9 per cent in 2008.

Government Spending and Public Finances

The February exchequer returns indicate that tax revenues increased by 12.8 per cent over the same period last year. While this represents strong growth it is a significant slowdown on the equivalent growth rate of 19.4 per cent in the first two months of 2006 relative to 2005. We expect this slowdown to persist throughout 2007 with forecast growth in exchequer tax revenue of 10.2 per cent for the year as a whole, down from 16 per cent in 2006. There are two main reasons behind this slowdown: (a) corporation tax is expected to grow by less than 3 per cent due to once-off effects of changes in payment schedules, and (b) our expectation that growth in the housing market will ease this year will reduce the growth in stamp duties and capital gains taxes. In 2008 we expect tax revenues to grow by just over 6.7 per cent. This is driven by both our forecast slowdown in the property market and the lower growth in consumption, incomes and employment forecast for 2008. As discussed in the previous *Commentary,* more than one-third of total stamp duties paid relate to the residential property market. We expect revenues from this source to remain broadly unchanged out to 2008. However, we are predicting strong growth in non-residential building and construction, and this, together with continued growth in non-property stamp duties, will help ensure double-digit growth rates in stamp duties over the next two years.

In terms of voted expenditure, the most recent exchequer returns suggest a significant acceleration in the pace of growth. Voted expenditure grew by 17.8 per cent in the first two months of 2007 relative to 2006, the equivalent figure for 2006 was 4.3 per cent. For 2007 and 2008 we have used official forecasts of current expenditure, however, for 2008 we have increased the capital expenditure figure for 2008 to reflect planned expenditures published under the National Development Plan. Taken together these figures imply an Exchequer Balance of €410 million in 2007 and -€91 million in 2008. In turn this implies an estimated General Government Balance of 1.7 per cent of GDP in 2007 and 2008.

These figures suggest a fairly rapid shrinking of the current large government surplus by almost €1 billion, within two years, which translates into a significant fiscal stimulus over the forecast period. This is driven by higher rates of expenditure growth – 2007 has the highest growth rate of current expenditure since 2001 – and slowing tax revenues, driven both by the slowdown in the property market and the anticipated slowdown in the economy generally in 2008. Nevertheless the government accounts remain in surplus which leads to a continued fall in the level of gross debt, which falls to 21.1 per cent of GDP by 2008. The National Treasury Management Agency also produce a measure of "net debt" which excludes the national pensions fund and the social insurance fund, in 2006 this stood at

12.7 per cent of GDP and by our estimates it could fall as low as 6.1 per cent by 2008.

TABLE 3: Public Finances

	2006	% Change	2007	% Change	2008
Current Revenue	46,145	9.9	50,728	6.6	54,099
Current Expenditure	36,984	12.8	41,701	6.5	44,426
Current Surplus	9,161	-1.5	9,027	7.1	9,673
Capital Receipts	1,871	-20.7	1,483	-0.4	1,477
Capital Expenditure	8,776	15.1	10,100	11.3	11,241
Capital Borrowing	-6,905	24.8	-8,617	13.3	-9,764
Exchequer Balance	2,256		410		- 91
as % of GNP	1.5		0.2		-0.1
General Government Balance	4,382		3,364		3,455
as % of GDP	2.5		1.7		1.7
Gross Debt as % of GDP	24.8		22.4		21.1
Net Debt as % of GDP*	12.7		9.1		6.1

*Net of pensions fund and Social Insurance Fund.

Exports

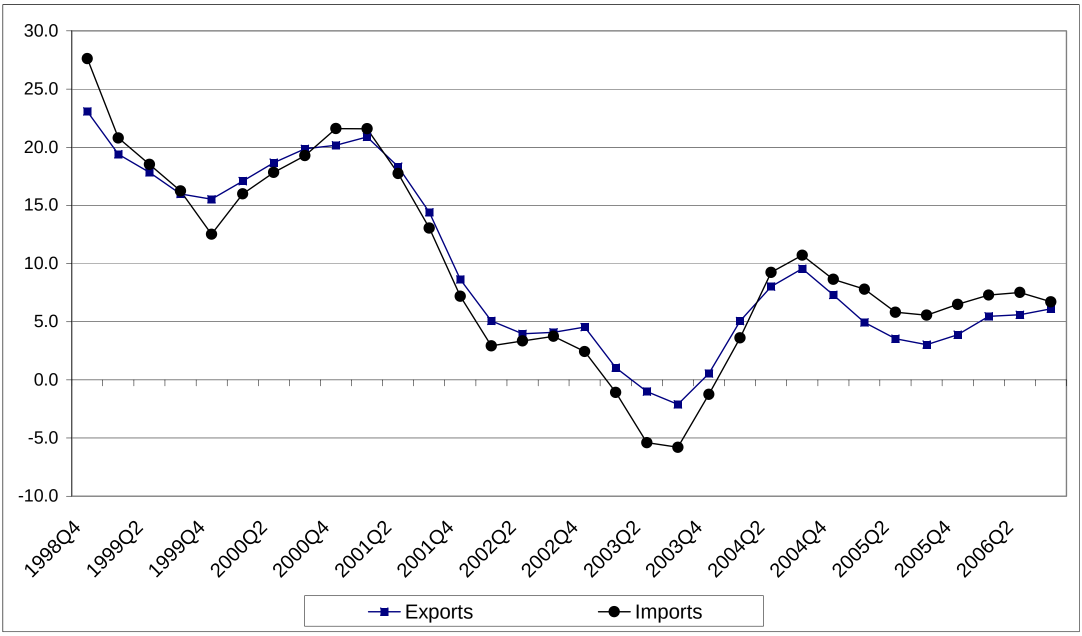
The most recent *Quarterly National Accounts* data suggest that exports grew by 6.1 per cent in volume terms and 9.1 per cent in value terms to the end of Quarter 3 2006. These figures reflect a trend towards cautious recovery in export growth rates over the past eighteen months, albeit a far cry from the heady days of export-led growth a mere five years ago (see Figure 5). According to the *Balance of Payments*, which only provides data in current prices, this growth was largely due to a strong expansion in services exports, with non-tourism services exports growing by 17.5 per cent and tourism exports by 11.1 per cent. The growth in merchandise exports was significantly lower at 4.9 per cent.

We argued in the previous *Commentary* that while the performance of merchandise exports remains disappointing there are signs that there is a recovery underway from the years of negative growth rates in 2003 and 2004. This recovery is clearly seen in the growth rates in recent quarters in the *Balance of Payments* data which have been climbing steadily throughout 2006. Set against this, however, is the performance of merchandise exports in the closing months of 2006, as measured in the *External Trade* statistics, where growth in the value of (seasonally adjusted) merchandise exports was just 2.5 per cent. Some of this slowdown may well be due to a fall in merchandise export prices in the closing months of 2006 rather than a slowdown in volumes; the wholesale price index for manufacturing, which is a good indicator of merchandise export prices, fell in the closing months of 2006 and in January 2007. For 2006 as a whole we estimate growth in the value of merchandise exports of 5 per cent, in line with *Balance of Payments* data, with volume growth of 3.4 per cent. In 2007 and 2008 we expect growth in the value of merchandise exports to be lower at 4.5 per cent and 4 per cent respectively. We expect merchandise export prices to increase by less than 1 per cent in both 2007 and 2008.

TABLE 4: Exports of Goods and Services

	2005 €m	% Change in 2006 Volume	% Change in 2006 Value	2006 €m	% Change in 2007 Volume	% Change in 2007 Value	2007 €m	% Change in 2008 Volume	% Change in 2008 Value	2008 €m
Merchandise	83,692	3.4	5.0	87,877	3.6	4.5	91,831	3.1	4.0	95,504
Tourism	3,813	8.7	12.0	4,271	7.2	11.0	4,740	7.8	10.0	5,214
Other Services	42,304	10.7	15.0	48,650	9.2	14.0	55,461	8.6	13.0	62,670
Exports of Goods and Services	129,809	6.0	8.5	140,797	5.6	8.0	152,032	5.2	7.5	163,389
FISIM Adjustment	1,192			1,367			1,555			1,754
Adjusted Exports	131,001	6.0	8.5	142,164	5.6	8.0	153,587	5.2	7.5	165,143

Figure 5: Volume Growth Rates (from National Accounts, Annualised)



Since 2000 services exports have almost doubled their share of total exports and we expect this trend to continue. In 2006 we estimate that services exports grew by almost 15 per cent. Looking forward, we expect the pattern of more services-intensive export growth to continue, with growth in the value of services exports of 14 per cent and 13 per cent in 2007 and 2008 respectively. However, given our forecast acceleration in inflation in 2007, which feeds into the price of services exports, the respective volume growth rates are somewhat lower at 9.2 per cent and 8.6 per cent respectively.

Our forecast for 2007 is for 5.6 per cent growth in the volume of exports of goods and services. This is an upward revision on our December forecast of 5.1 per cent, and reflects the improved forecast for growth in the EU area. We expect export growth to ease slightly to 5.2 per cent in 2008, partly reflecting the forecast weakening of the dollar and US growth.

Imports

The most recent data for 2006 from the *Quarterly National Accounts* estimate volume growth at 6.7 per cent and value growth at 10.5 per cent in the year ending Quarter 3 2006. The *Balance of Payments* data suggest that this growth was largely due to a strong expansion in services imports, with non-tourism services imports growing by 13.3 per cent and tourism exports at 12.5 per cent. The growth in merchandise imports was significantly lower at 8.4 per cent.

TABLE 5: Imports of Goods and Services

	2005	% Change in 2006		2006	% Change in 2007		2007	% Change in 2008		2008
	€m	Volume	Value	€m	Volume	Value	€m	Volume	Value	€m
Merchandise	54,086	6.4	8.5	58,683	6.4	7.5	63,085	5.9	7.0	67,500
Tourism	4,882	10.2	13.0	5,517	11.3	13.5	6,261	7.8	10.0	6,888
Other Services	51,325	6.7	11.5	57,227	7.2	10.0	62,950	5.2	8.5	68,301
Imports of Goods and Services	110,293	6.7	10.1	121,427	7.0	9.0	132,296	5.7	7.9	142,689
FISIM Adjustment	260			205			143			103
Adjusted Imports	110,553	6.7	10.0	121,632	7.0	8.9	132,439	5.7	7.8	142,792

The pattern of export growth rates over the past five years discussed above is mirrored in import growth rates. Figure 5 shows the annualised growth rates in the volume of imports from the *Quarterly National Accounts* since 1998. There is a clear recovery from the decline recorded in 2003 and 2004. Most notably recent growth in imports has tended to exceed export growth rates. Data from the *External Trade* statistics suggest that total merchandise imports grew by 6.4 per cent in 2006. In the first eleven months of 2006 there was strong growth in imports of computer equipment, petroleum and related products and medical and pharmaceutical products. In terms of services imports, data from the *Balance of Payments* indicate that imports of services have outstripped imports of merchandise goods since the end of 2003. Within services imports, royalties and licences and business services together account for well over two-thirds of total services imports.

We forecast import volume growth of 7.0 per cent in 2007 driven by very strong growth in consumption. In 2008 this slows to 5.7 per cent. This fall is mainly due to a slowdown in services imports growth, as the pace of consumption growth slows. The equivalent value growth rates are 8.9 per cent in 2007 and 7.8 per cent in 2008.

Balance of Payments

Our forecasts of merchandise exports and imports for 2007 and 2008 lead to a further narrowing of the merchandise trade surplus in those years. Offsetting this is a narrowing of the service trade deficit. On balance, we expect the trade surplus to increase slightly in 2007 and 2008. In relation to net factor flows, we forecast an increase of 7.6 per cent in 2006. A great deal of uncertainty surrounds this figure. The latest data from the *Balance of Payments* and the *Quarterly National Accounts*, suggest growth of 5 per cent in net factor income in the year ended Quarter 3 2006 but the equivalent figure for the year ended Quarter 2 was -0.8 per cent.

Our forecasts imply an effective current account deficit of 4.3 per cent of GNP in 2006. With a very small increase the trade balance and a forecast growth of net factor flows of 9.4 per cent in 2007 and 6.9 per cent in 2008, the current account deficit expands sharply to 5.2 per cent in 2007 and 5.4 per cent in 2008. As can be seen from Table 6 this implies a very rapidly emerging balance of payments deficit which, as we discuss in the *General Assessment* below, we consider to be an important indicator of the growing imbalances in the economy.

TABLE 6: Balance of Payments*

	2005 €m	Change %	2006 €m	Change %	2007 €m	Change %	2008 €m
Merchandise Trade Balance	29,606	-1.4	29,193	-1.5	28,746	-2.6	28,004
Service Trade Balance	-10,090	-2.6	-9,824	-8.3	-9,011	-18.9	-7,304
Trade Balance in Goods and Services on BOP basis	19,516	-0.8	19,369	1.9	19,736	4.9	20,700
Total Debit Flows	67,764	24.8	84,543	15.5	97,667	15.6	112,856
Total Credit Flows	43,447	34.4	58,376	18.3	69,048	19.1	82,260
Net Factor Flows	-24,317	7.6	-26,167	9.4	-28,619	6.9	-30,596
Net Current Transfers	601	-91.7	50	0.0	50	0.0	50
Balance on Current Account	-4,200		-6,748		-8,833		- 9,846
Capital Transfers	266	12.8	300	0.0	300	0.0	300
Effective Current Balance	-3,934		-6,448		-8,533		- 9,546
% of GNP	-2.9		-4.3		-5.2		-5.4

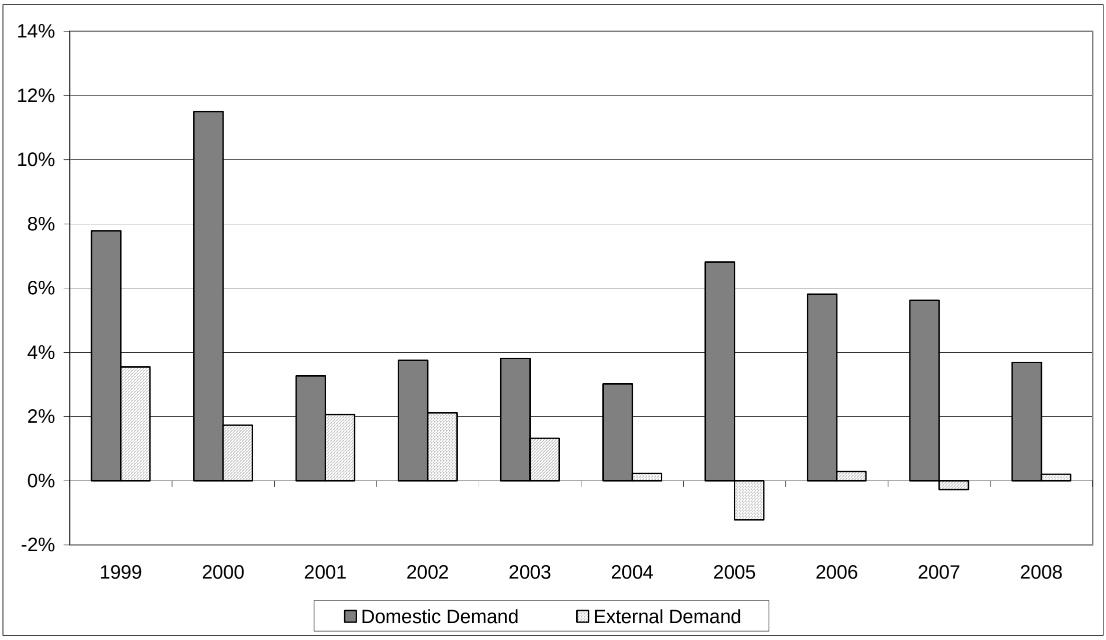
*This table includes adjustments to Balance of Payments basis.

Gross National Product and Gross Domestic Product

We estimate that GNP grew by 6.3 per cent in 2006 while GDP growth will come in lower at 6.1 per cent as we expect net factors flows to have grown at a rate of 4.9 per cent in the year. We expect that growth will remain strong in 2007, with GNP and GDP volumes both forecast to grow by 5.4 per cent. GNDI (Gross National Disposable Income) – a more suitable measure of a country's level of income as it incorporates changes in the terms of trade and net international transfers – is forecast to grow by a robust rate of 5.9 per cent in 2007. In 2008, GNP and GDP growth are forecast at 3.9 per cent. The slowing in the pace of growth is anticipated largely as a result of lower consumption, as discussed earlier as well as a slowing in the pace of growth of private investment and public expenditure. GNDI is expected to grow at the slightly faster rate of 4.2 per cent, due to favourable terms of trade movements.

Our figures for 2007 and 2008 highlight the continuing importance of domestic demand for output growth in the economy, with the external sector expected to make a negative contribution to growth in 2007 and only a small positive contribution in 2008, as shown in Figure 6.

Figure 6: Components of GDP Growth



Agriculture

The most recent *Quarterly National Accounts* show annual growth of 4 per cent in agricultural output in the year ended the third quarter of 2006. However, the distortion in the figures that arose from a change in the timing of subsidy payments around 2005 was still impacting upon the figures as of the third quarter. A more complete picture for 2006 is contained in the CSO's *Preliminary Estimates of Output, Input and Income in Agriculture*. According to the figures in that release, the operating surplus is estimated to have fallen by 14.2 per cent in 2006. The value of goods output rose by 2.9 per cent but net subsidies fell by 14.4 per cent, following a rise of 43 per cent in 2005. The volume of livestock and crops fell in 2006 (by 2.3 per cent and 3.5 per cent respectively), although price increases led to an increase in the value of output under those headings (a 4.5 per cent rise in the case of livestock and a 4.2 per cent rise for crops). For livestock products, the volume of output rose by 3.7 per cent but the value of output fell by 1 per cent.

We expect output to grow by 3 per cent in volume terms in 2007 and by 4 per cent in value terms. For 2008, the corresponding forecasts are 2 per cent and 4 per cent.

Industry

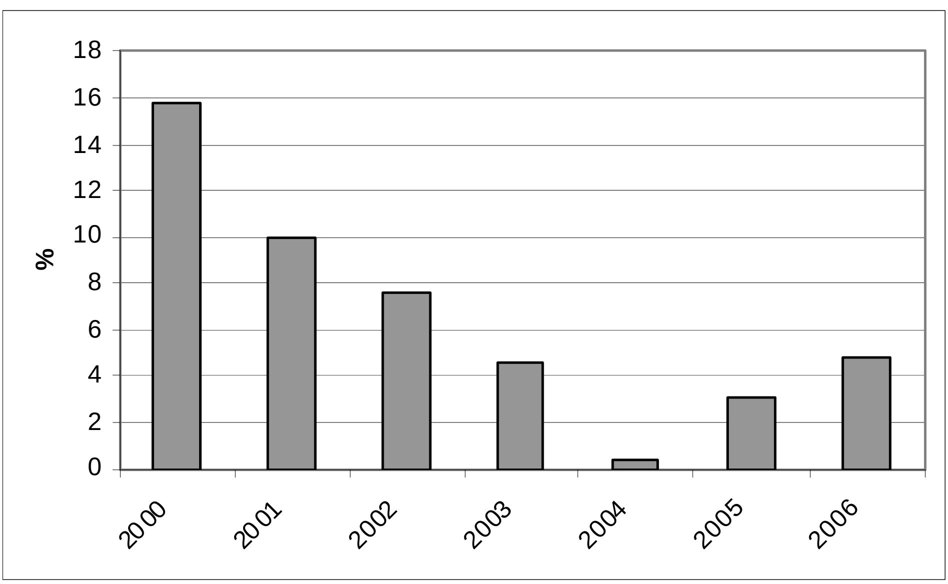
According to the *Quarterly National Accounts* for Quarter 3 2006, output from industry (including construction) grew by 5.9 per cent on an annual basis in the year ended the third quarter of 2006. As the trends for manufacturing and construction have differed so much in recent times, it is more useful to look at the CSO's volume indices of production to get a clearer view of recent trends in manufacturing.

In Figure 7, we show the annual growth in output in manufacturing from 2000 to 2006. The figure shows the rapid expansion in production that was occurring at the start of this decade and then the reduction in the pace of expansion through to 2004 when output was almost unchanged. Since 2004, growth has increased and so the question arises of whether the trend observed between 2004 and 2006 will continue.

Our thinking on this point is influenced by the phenomenon of manufacturing tending to account for a decreasing share of national output as an economy moves through the stage of development currently underway in Ireland. Over the medium term, this is likely to be the case but it is difficult to forecast in the short-run how manufacturing output will move. The latest Purchasing Managers Index for manufacturing from NCB showed a reading of 53.3, thereby pointing to continued expansion in the short run. In spite of this, we think that a rate of growth in industry, including manufacturing, below that of the economy in general is the most likely outcome for 2007 and 2008. For 2007, we envisage industrial output growth of 3.5 per cent and for 2008 the forecast is for growth of 3.0 per cent.

As a final note on industry, the low rate of employment growth and the moderate pace of output growth in 2006 meant that productivity growth hit a recent high at 6.1 per cent. This is well up on the 2004 and 2005 values of 4.6 per cent and 4.2 per cent respectively. It is not possible to tell if this is the result of a changing composition of firms in manufacturing or of productivity growth at the level of the firm. Either way, it means that industry boosted the productivity performance of the economy in general in 2006.

Figure 7: Annual Percentage Change in the Volume of Production in Manufacturing, 2000 – 2006



Source: Central Statistics Office, (2007), *Industrial Production and Turnover*, Dublin.

TABLE 7: GDP by Sector

	2005 €m	Change Volume	Change Value	2006 €m	Change Volume	Change Value	2007 €m	Change Volume	Change Value	2008 €m
Agriculture	4,103	4.0	5.0	4,308	3.0	4.0	4,480	2.0	4.0	4,659
Industry:	50,929	5.2	9.1	55,578	3.4	5.8	58,807	2.8	4.2	61,272
Other Industry	36,689	5.0	7.0	39,257	3.5	5.0	41,220	3.0	4.0	42,868
Building & Construction	14,241	5.8	14.6	16,321	3.1	7.8	17,587	2.1	4.6	18,404
Services:	87,337	6.8	9.5	95,722	6.5	11.8	107,046	4.2	8.0	115,604
Public Administration & Defence	5,137	1.8	8.5	5,574	2.5	8.5	6,048	1.0	7.0	6,471
Distribution, Transport and Communications	22,086	4.6	7.4	23,717	4.0	5.7	25,060	2.0	3.8	26,008
Other Services (including rent)	60,113	8.1	10.5	66,431	7.7	14.3	75,938	5.2	9.5	83,124
GDP at Factor Cost - output basis	**142,369**	**6.1**	**9.3**	**155,608**	**5.3**	**9.5**	**170,333**	**3.6**	**6.6**	**181,535**

Services

Services growth for the year ended the third quarter of 2006 was 6.2 per cent. As regards divisions within the sector, the corresponding growth figures were as follows: distribution, transport and communication, 4.6 per cent; public administration and defence, 1.6 per cent; other services (including rent), 7.2 per cent.

The Services PMI produced by NCB showed a reading of 62.7 in February, well over the 50-point mark which indicates expansion. The index has been above 50 since mid-2003 so the survey is showing a prolonged period of expansion, one that is consistent with the official data.

As regards our forecasts, we remain optimistic about the on-going growth of the services sector. This view is partly motivated by the reasoning advanced above when discussing industry, i.e. that Ireland is at a stage of development in which there is a shift away from industry and towards services. This process is clearly well underway and services now account for almost two-thirds of the economy in value added terms. In spite of this, the amount of official data on the sector is limited relative to industry and also relative to agriculture. This is a situation that needs to be reversed if we are to develop a clearer understanding of trends in services.

For 2007, we expect growth of 6.5 per cent in the volume of services output. For 2008, we expect growth of 4.2 per cent. While the 2008 figure is lower than the 2007 figure, it is higher than the forecasts for GNP and GDP growth, thereby reflecting the trend towards a greater service intensity of output. As regards the sub-sectors within services, we expect the relative growth rates of recent years to be broadly repeated. Public administration and defence is expected to show the slowest rate of growth, with volume growth rates of 2.5 per cent in 2007 and 1 per cent in 2008. Distribution, transport and communications is forecast to grow by 4 per cent in 2007 and by 2 per cent in 2008. Finally, "other services (including rent)" is forecast to grow by 7.7 per cent in 2007 and by 5.2 per cent in 2008.

Employment

Last year was an exceptionally good year for employment creation, with an annual rate of employment growth of 4.4 per cent or almost 87,000 jobs. We have written many times before about the uneven distribution of the employment increases but it is still important to draw attention to this fact. Of the 87,000 extra jobs in 2006, almost 24,000 (or 27 per cent) were in construction, while a further 15,500 were in health (18 per cent of the increase). With almost 15 per cent of the extra jobs being in retail and wholesale, this means that almost two-thirds of the extra jobs were in non-traded activities. Other productive industries registered an employment fall of 3,000 in 2006.

A large part of the general employment story in 2006 involved immigration. Over 50 per cent of the newly created jobs were filled by non-nationals, thereby bringing the proportion of non-nationals in total employment to over 10 per cent (216,000 non-nationals in an employment total of just over 2 million). With the unemployment rate remaining relatively stable at around 4.4 per cent, it appears that immigration is not leading to displacement. However, research that we have previously reported on would suggest that immigration is acting to reduce wage pressures, a point which we return to below in the *Incomes* section.

For 2007, we envisage another year of strong employment growth and expect 78,000 new jobs to be created (an increase of 3.8 per cent). This pace of job creation will ensure that the rate of unemployment remains low at 4.4 per cent and that the rate of net inward migration remains high. In the case of migration, we expect a net inflow of 55,000.

For 2008, we expect the generally lower rate of economic growth to feed into a lower rate of employment growth. We foresee employment expanding by almost 34,000 or 1.6 per cent. While this might appear low relative to 2007 and other recent years, it should be noted that this is in line with employment growth rates in the EU. In 2006, employment growth in the EU-25 averaged 1.9 per cent.

Our forecasts for GNP growth and for employment growth are consistent with a growth rate in productivity of 2 per cent. If correct, this would imply a recovery in the economy's performance on this measure relative to 2006 and 2007.

TABLE 8: Employment and Unemployment

	Annual Averages 000s			
	2005	**2006**	**2007**	**2008**
Agriculture	115	117	116	115
Industry	539	560	574	577
Services	1,298	1,362	1,427	1,459
Total at Work	1,952	2,039	2,117	2,150
Unemployed	89	93	97	106
Labour Force	2,041	2,132	2,214	2,256
Unemployment Rate %	4.4	4.4	4.4	4.7
Net Migration	53.4	69.9	55.0	35.0
of which: Inward Migration	70.0	86.9	72.0	52.0
Change in Participation Rate*	1.7	1.2	1.1	0.3

* *Note*: Participation rate measured as share of population aged 15-64 years.

A lower rate of employment growth must translate into some combination of a reduced rate of inward migration, an increased rate of unemployment and/or a reduction in participation. It is difficult to forecast precisely how these variables will work out largely because we know little as yet about the behaviour of Ireland's immigrant community in response to a slower rate of growth, or about the possible response of prospective immigrants to Ireland. It could be that a slower pace of growth will result in potential immigrants putting plans on hold or in existing immigrants returning home or moving on to third countries. We simply do not know. For this reason, we have spread the potential adjustment to the slower pace of employment growth across the three variables of migration, unemployment and participation. This leads to a forecast for net inward migration in 2008 of 35,000. The corresponding forecast for the rate of unemployment is 4.7 per cent. On participation, we forecast an increase of 0.3 per cent, down from over 1 per cent in the preceding three years.

Incomes

In Table 9, we present data on weekly earnings growth based on data from the CSO. The first line of data shows weekly earnings growth for the economy (excluding the agriculture and health sectors), with the figure for 2006 being based on the first three quarters. This line contains the familiar picture of wage increases generally in excess of 5 per cent in recent years.

The distribution of wage increases across sectors varied somewhat in 2006, with the lowest rate of increase being recorded in construction. This observation prompts the question as to whether or not immigration was a factor in restraining wage growth in this sector, relative to others. While this might have been the case, it is difficult to establish such a link based on a simple comparison of wage growth and immigrant inflows into a sector. For the year 2006, the inflow of 44,300 immigrants into employment amounted to an addition to employment of almost 2.2 per cent. For construction, the immigrant-related increase in employment was almost 5 per cent and so well above the average. However, the sector which experienced the next lowest wage growth, industry, saw an inflow of immigrants that amounted to 1.8 per cent of total employment and so was below the national average. This low rate of wage growth could be related to the tradable environment in which industry operates and hence constraints on its ability to pay higher increases.

Wage determination across sectors involves a complex mix of factors and so the lack of a readily observed strong relationship between immigrant inflows into sectors and wage growth does not suggest that no relationship exists. Our view of the impact of immigration on the labour market is still influenced by the work of Barrett *et al.* (2006)[4] who showed that immigration puts downward pressure on wages. The results of Blanchflower[5] *et al.* (2007), which examines the impact of immigration in Britain, points to similar impacts there. According to this paper, immigration into Britain in recent years has tended to increase supply more than demand and so has "…acted to reduce inflationary pressures". The authors also note that there seems to be broad agreement "…that immigration is likely to have reduced the natural rate of unemployment in the UK over the past few years".

[4] Barrett, A., A. Bergin and D. Duffy (2006). "The Labour Market Characteristics and Labour Market Impacts of Immigrants in Ireland", *The Economic and Social Review,* Vol. 37, No. 1, pp. 1-26.
[5] op. cit., p. 6.

Table 9: Growth in Average Weekly Earnings 1999-2006

	Weekly Earnings Q3 2006	Cumulative Growth Q1 1999 - Q3 2006	Annual Growth							
			1999	2000	2001	2002	2003	2004	2005	2006**
	Euro	*%*				*%*				
Economy*	722.80	56.0	5.6	8.0	9.2	5.5	4.7	5.8	5.3	5.1
Industry	600.99	51.7	5.6	6.6	8.0	6.5	6.8	4.7	3.6	3.1
Construction	770.35	74.4	8.3	12.4	8.7	9.9	4.2	4.8	7.2	2.8
Distribution	690.56	61.7	5.4	11.2	9.2	6.2	5.1	4.0	4.5	6.2
Hotels and Restaurants	434.02	45.0	6.1	6.0	5.4	2.3	5.8	7.7	5.8	4.1
Transport, Storage and Communications	757.81	44.3	3.6	6.0	8.8	0.7	5.1	5.0	4.1	5.7
Non-Market Public Services	884.47	54.7	4.2	5.7	9.9	4.8	4.3	8.5	5.9	5.2
Other Market Services	719.59	46.6	5.9	8.6	7.1	2.5	5.4	4.9	3.4	4.0
Financial and Other Business	821.20	46.7	3.5	6.2	10.9	4.4	1.6	5.6	4.3	6.4

* Weighted by employment, excludes agriculture and health sector earnings.
** Annual growth for years 1999 to 2005 defined as the annual growth in the four quarter moving average ended in Quarter 4. Annual growth in 2006 defined as the annual growth in the four quarter moving average ended in Quarter 3.

For 2007, we expect nominal wages to rise by 5.8 per cent and for real wages to rise by 1.1 per cent. This implies that 2007 would see a higher rate of nominal wage growth than in 2005 and in 2006; however, given the anticipated rate of inflation in 2007, real wage growth in 2007 would be lower than in either of the earlier two years. For 2008, we expect a nominal wage rise of 4.6 per cent and a real wage rise of 1.9 per cent. The expected increase in the rate of growth in real wages between 2007 and 2008 is partly related to a catch-up effect where wage increases are sought in early 2008 to compensate for high inflation in 2007.

Combining our wage growth forecasts and our employment forecasts leads to a forecast increase in the non-agricultural wage bill of 10.2 per cent in 2007 and 6.4 per cent in 2008. The slowdown between the two years is mainly related to our expectation of slower employment growth in 2008. As discussed in the section on the public finances, this will have the effect of reducing the rate of growth in income tax revenues. As 2008 will be in the post-election period, we expect a slower rate of growth in transfers in that year relative to 2007. For 2007, the growth in transfers of 15.3 per cent is related to the generous social welfare package delivered in Budget 2007. Although incomes are likely to grow less slowly in 2008, so too will consumption. For this reason, the savings ratio is expected to remain relatively stable.

TABLE 10: Personal Disposable Income

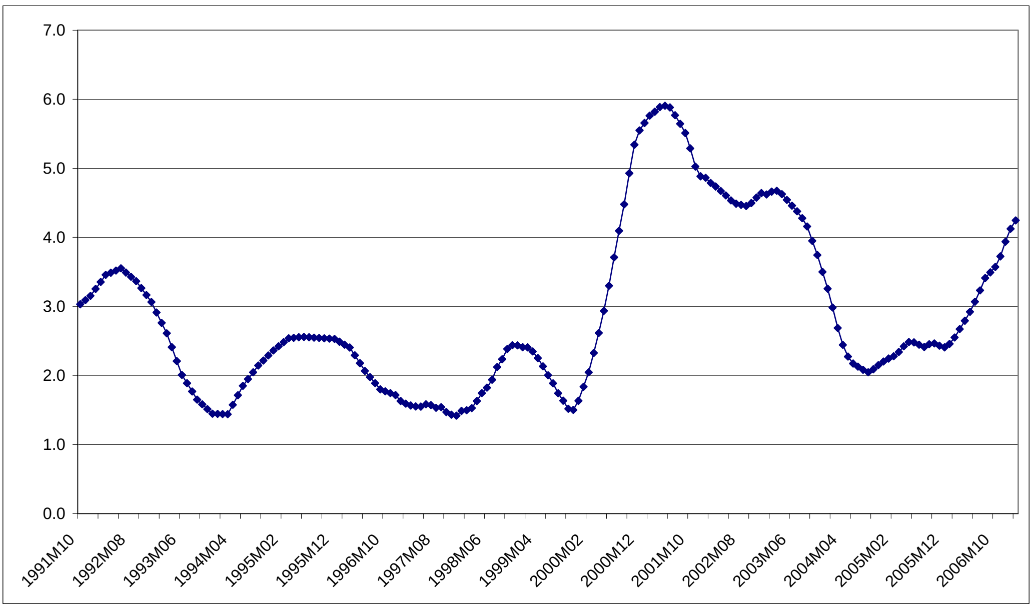
	2005	Change		2006	Change		2007	Change		2008
	€m	%	€m	€m	%	€m	€m	%	€m	€m
Agriculture, etc.	3,399	5.0	170	3,569	4.0	143	3,712	4.0	148	3,860
Non-Agricultural Wages	65,272	10.1	6,605	71,877	10.2	7,314	79,190	6.4	5,079	84,269
Other Non-Agricultural Income	16,956	2.8	473	17,428	10.0	1,750	19,178	6.5	1,252	20,430
Total Income Received	85,627	8.5	7,248	92,874	9.9	9,206	102,080	6.3	6,479	108,560
Current Transfers	17,633	6.7	1,190	18,823	15.3	2,871	21,694	6.2	1,354	23,047
Gross Personal Income	103,260	8.2	8,437	111,697	10.8	12,077	123,774	6.3	7,833	131,607
Direct Personal Taxes	19,578	9.0	1,758	21,336	10.2	2,179	23,515	5.6	1,328	24,843
Personal Disposable Income	83,682	8.0	6,679	90,361	11.0	9,897	100,259	6.5	6,506	106,764
Consumption	74,114	10.0	7,414	81,528	11.5	9,393	90,922	6.6	5,992	96,913
Personal Savings	9,568	-7.7	-735	8,833	5.7	504	9,337	5.5	514	9,851
Savings Ratio	11.4			9.8			9.3			9.2
Average Personal Tax Rate	19.0			19.1			19.0			18.9

Consumer Prices

According to the Consumer Price Index (CPI), the annual rate of inflation registered in February was 4.8 per cent, down from 5.2 per cent in January and 4.9 per cent in December. Despite the slight slowdown in the annual rate, inflation has been high and above 2 per cent since the end of 2004, and in recent months has reached five-year highs; the January rate was the highest registered since the middle of 2001.

Figure 8 shows the twelve-month moving average rate of inflation since 1991. Following a spike of almost 6 per cent in 2001, inflation moderated to reach a low of 2 per cent in September 2004. However, since then inflation has moved upwards and the average of the twelve months to February 2007 reached 4.2 per cent, suggesting surging price pressures in the economy.

Figure 8: Rolling Twelve-Month Average Inflation Rate



The rate of inflation in February was driven mainly by external forces, though domestic price pressures also added an upward stimulus to the index. Of the twelve aggregate categories covered by the CPI[6], the three largest contributors, with the percentage of the total inflation rate in February accounted for by these categories given in parenthesis, were:

Housing, Water, Electricity, Gas and Other Fuels (77.7 per cent)
Hotels and Restaurants (13.7 per cent)
Alcoholic Beverages and Tobacco (6.9 per cent)

[6] The twelve categories covered by the index are: Food and Non-Alcoholic Beverages; Alcoholic Beverages and Tobacco; Clothing and Footwear; Housing, Water, Electricity, Gas and Other Fuels; Furnishings, Household Equipment and Routine Household Maintenance; Health; Transport; Communications; Recreation and Culture; Education; Restaurants and Hotels; Miscellaneous Goods and Services.

The "Housing, Water, Electricity, Gas and Other Fuels" category includes items like *Rents*, *Mortgage Interest*, *Maintenance and Repairs*, *Electricity, Gas and Other Fuels*. The most important of these components for the "Housing, Water, Electricity, Gas and Other Fuels" category's contribution to total inflation in February was the *Mortgage Interest* component. This component has driven price increases in the "Housing, Water, Electricity, Gas and Other Fuels" category since the end of 2004.

The "Housing, Water, Electricity, Gas and Other Fuels" category has the largest weight in the CPI, reflecting the importance of expenditure under this heading for the average consumer. In fact, expenditure under this heading represents 16.5 per cent of the average consumer's total spend. This weighting increased from 12.3 per cent in December 2001.

The "Hotels and Restaurants" category registered an increase as a result of price rises in both catering services and accommodation services. Catering services recorded a 3.6 per cent price hike in January 2007 relative to January 2006 while Accommodation service prices registered 9 per cent growth. Under the "Alcoholic Beverages and Tobacco" category, alcoholic beverages actually registered a price decline in the year to February, but this fall was offset by an increase of over 10 per cent in the price of tobacco.

The outlook for 2007 is for a higher rate of inflation than 2006. Over the coming months, we expect annual inflation to come down from the peak registered at the start of the year, though nonetheless remaining high. The annual average rate of inflation for the year is forecast at 4.6 per cent. This is significantly higher than the 3.9 per cent figure forecast in the previous *Commentary*. The main reason for the higher forecast is that we now expect a second interest rate rise in 2007, as discussed in the *International* section.

In 2008, we forecast a rate of inflation of 2.6 per cent. The slowdown in inflation in 2008 is likely on the assumption that there are no further interest rate increases in that year, and the slow down in consumption growth will ease some inflationary pressures.

Inflation as measured by the Harmonised Index of Consumer Prices (HICP) was 2.6 per cent in February. This compares to a rate of 2.7 per cent in the same period of 2006 and ranks Ireland with the second highest inflation rate in the Euro Area.

Table 11: Inflation Measures*

	2000	2001	2002	2003	2004	2005	2006	2007	2008
	%	%	%	%	%	%	%	%	%
HICP	5.2	4.0	4.7	4.0	2.3	2.2	2.7	2.5	2.2
CPI	5.6	4.9	4.6	3.5	2.2	2.5	4.0	4.6	2.6
Mortgage Interest	12.5	24.7	-7.6	-8.3	5.4	12.3	31.5	39.1	5.4

*Based on December 2006 weights.

General Assessment

The latest economic indicators suggest that 2006 was a year of exceptionally strong growth in both output and employment, with GNP growth estimated at 6.3 per cent and total employment increasing to over 2 million. Growth in 2006 was dominated by increases in consumer expenditure and investment spending. In 2007 we expect the pace of consumer expenditure growth to accelerate further to 7.8 per cent, driven by the maturing of SSIAs, while the pace of investment growth is projected to moderate, with housing investment expected to level off. The prospects for 2008 point to a slowdown in GNP growth to below 4 per cent, as consumption expenditure growth reverts to more normal rates and the pace of investment expansion continues to slow.

These figures sketch a picture of continued strong growth in output and employment in 2008, albeit at a significantly slower pace than in the years 2005 to 2007. We believe that the recent growth performance of the economy raises a number of serious concerns about the sustainability of the current growth trajectory. As discussed in previous *Commentaries*, growth in the past three years has been entirely domestically generated and is likely to remain so in 2007 and 2008 (see Figure 5 above). Since 2004, Ireland's net export performance has ceased to be a driver of growth. Instead the current boom has been entirely driven by domestic demand, which we believe is unsustainable in the medium term. In this *General Assessment* we have chosen to focus on three areas of concern within the domestic economy: the growing balance of payments deficit, the size of house building in the context of the overall economy, and wage determination.

As discussed in previous *Commentaries* the current account of the balance of payments has widened rapidly since 2003 and is forecast to continue to widen out to 2008. Taking a look at this from the perspective of financial flows produces some interesting insights. The corollary of the widening current account deficit has been an increase in net investment inflows into Ireland through the financial account of the balance of payments. These inflows have been used to fund the growth in investment's share in GDP since 2003. Table 12 illustrates the point. Gross investment as a share of GDP has risen from 24 per cent in 2003 to an estimated 28 per cent in 2006. Over this period net national savings and depreciation have remained broadly stable so that this increase in investment has largely been funded by the increase in the item termed "net foreign disinvestment", which is net foreign investment inflows through the capital and financial accounts of the balance of payments.

In the December *Quarterly Economic Commentary* we discussed the implications of the rapid widening in the current account deficit, in particular as a symptom of imbalances emerging elsewhere in the economy. The factors underlying the deficit are critical in assessing implications. The crucial issues that determine possible impacts are whether the deficit can be regarded as the consequence of rapid investment to fund Ireland's broad infrastructural deficit – compatible with a sustainable growth trajectory – or whether it is driven by borrowing on international markets to fund a specific housing boom.

Table 12 indicates that the increase in investment inflows since 2003 is matched by an increase in the share of building and construction investment in Ireland, specifically the phenomenal growth in housing investment. If the growth in investment in housing has been the driving force behind the recent growth in net foreign borrowing, then this could be expensive in the future in terms of financing the debt since the rate of return on housing investment is lower than more productive investments. While the evidence is not yet conclusive, Honohan[7] (2006) highlighted that the net foreign borrowings of Irish credit institutions to lend to Irish residents have grown with "astonishing speed" since 2003. If it is true that the increase in net foreign borrowing is being use to fund the very rapid growth in private sector credit, which in turn is being used to finance the current boom in the housing market, then this situation is not sustainable.

Table 12: Savings and Investment as Share of GDP

Savings	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006e**
	%	%	%	%	%	%	%	%	%
Net National Savings	16	16	16	13	12	14	14	14	14
Net Foreign Inflows	-1	0	0	0	1	-1	1	3	4
Foreign Capital Transfers	1	1	1	1	0	0	0	0	0
Net Foreign Disinvestment	-2	-1	-1	0	0	-1	0	2	4
Depreciation	9	10	10	10	10	10	10	10	10
Gross Savings*	24	24	25	24	23	24	25	27	28
Investment:									
Building and Construction	13	15	15	16	15	17	18	20	21
of which: Housing	7	7	8	8	8	10	11	13	13
Machinery and Equipment	9	9	9	8	7	6	6	7	7
Gross Domestic Phys. Cap. Form.**	24	24	25	24	23	24	25	27	28

Source: NIE 2005; 2006 QEC estimates.
*adjusted for stock appreciation and statistical discrepancy.
**adjusted for stock appreciation, stock changes and statistical discrepancy.

Our second area of concern is related to the first and involves the sustainability of the current rate of house completions. In our forecasts for 2007 and 2008 we expect the rate of house building to slow gradually. Many economic commentators have for some time been taken aback by the strength of the housing market in recent years, both in terms of the acceleration in the rate of house completions and the rate of house price inflation. A simple decomposition of the current rate of house completions, based on recent rates of household formation and allowing for depreciation, suggests that over the past five years 2002-2006 almost one-quarter

[7] Honohan, P. (2006). "To What Extent Has Finance Been a Driver of Ireland' s Economic Success?", *Quarterly Economic Commentary*, Winter, pp. 59-72. Dublin: The Economic and Social Research Institute.

of new houses built have been for second dwellings. The equivalent figure for the five-year period 1997-2001 was one-eighth. This rapid growth in the demand for second dwellings may help to explain the persistent growth in house prices in recent years.

The corollary of this is that house prices are over-valued given the current rate of house completions and the underlying demand for primary dwellings. In the Spring 2006 *QEC*, we discussed OECD estimates that house prices were as much as 15 per cent overvalued in mid-2005 and raised the spectre of a possible house price bubble in the Irish market. We have revisited this prospect here using an equation for housing demand described in Duffy, Fitz Gerald and Kearney (2005),[8] and given our forecast numbers for income, house building, population and real interest rates. Based on this analysis our simulation results would suggest that house prices in 2006 were overvalued by a similar level of magnitude.

In this context our forecast for housing investment in 2008 can be regarded as relatively benign, implying a soft landing for the Irish housing market. Our calculations on the very rapid growth in the market for second dwellings in recent years raise the possibility that this may incorporate speculative investment on the asset value of residential property. In these circumstances a decline in real house prices could lead to a much larger reduction in the scale of house building. Given the growing importance to the exchequer of property-related taxes – stamp duties and capital gains tax together accounted for over 16 per cent of total tax revenue in 2006 – such a contraction could result in lower revenues from these sources.

Our third area of concern relates to the current pace of wage inflation. Since 2002 labour's share of income has been rising (see Table13). Between 2002 and 2006 labour's share of GNP rose by four percentage points. This has been driven by both strong growth in real wages and sluggish productivity growth. Between 2002 and 2006 real wages increased by 10 per cent while productivity growth was just 6 per cent. While in 2006 real wage growth was low at 1.3 per cent, this does not reflect a significant slowdown in nominal wage growth but rather the very high, largely unanticipated growth in CPI inflation of 4 per cent. In this context we are especially concerned that the strong growth in CPI inflation in 2006 and the forecast strong growth in 2007 would feed into a further growth in nominal wages. A simple regression,[9] estimating the transmission of inflation into wages found that over 50 per cent of changes in the CPI are transmitted into average wages within three months. This points to a rapid pass-through of CPI inflation into wage demands in the past.

[8] Duffy, D., J. Fitz Gerald and I. Kearney (2005). "Rising House Prices in an Open Labour Market", *The Economic and Social Review*, Vol. 35, No. 3, Winter, pp. 251-272.

[9] $\Delta\log(W) = 0.025 + 0.56\ \Delta\log(P\ (t\text{-}1))$

W= average weekly earnings (excluding agriculture and health), P=CPI. 1998 Q1 – 2006 Q3. This equation was estimated using first differences (by quarter) with all variables in logs. We initially ran a regression of wages on prices and labour productivity using four lags and including seasonal dummies. Insignificant lags were dropped from the final equation.

Table 13: Competitiveness Indicators

	2000	2001	2002	2003	2004	2005	2006
Labour share[10]	51.5	51.5	49.6	50.5	52.3	53.2	53.6
Labour productivity[11] (% change)	3.8	4.4	4.4	1.4	2.0	0.8	1.6
Real wage[12] (% change)	2.1	2.5	0.9	1.5	4.1	3.1	1.3
Nominal wage (%change)	7.8	7.5	5.6	5.0	6.4	5.6	5.3

The failure of net exports to contribute to the growth in the economy over a number of years suggests that the Irish economy is already facing problems in terms of overall competitiveness. In this context the recent pattern of strong real wage growth is worrying. This pace of wage growth is also noteworthy since over the past three to four years Ireland has experienced record levels of immigration. The recent study by Blanchflower[13] *et al.* (2007) estimated that immigration from Eastern Europe into the UK served to dampen the growth in wages and reduce inflationary pressures in the UK. It may be the case that immigration into Ireland has similarly helped to reduce incipient wage and price pressures in the economy. Nevertheless, wage inflation in Ireland remains persistently high.

Given these recent trends, we would argue strongly that it is now imperative that the competitiveness of the economy not deteriorate further. As we have seen in recent months, the economy is vulnerable to employment losses in manufacturing, while in the future the construction sector is unlikely to be able to absorb labour at the pace witnessed in recent years. Any further deterioration in competitiveness would only exacerbate these processes and, within EMU could take many years to rectify.

[10] Measured as labour's share of non-agricultural value added.
[11] Output per non-agricultural worker, output measured as GDP at factor cost.
[12] Deflated using the CPI.
[13] op. cit., p. 6.