SUMMARY

The uncertainties surrounding the prospects for the global economy that have dominated over the last two years continue to hold sway. Growth within the EU economies has decelerated significantly over the latter half of 2002 and the US economy continues to falter towards recovery after emerging from recession at the start of this year. World trade growth in 2002 is expected to be quite low at just-under 3 per cent, impacting significantly upon the performance of an export-oriented economy like Ireland. Economic growth in the first half of 2002 was quite strong but the combination of euro appreciation and declining international trade will reduce activity at the end of the year, carrying over into the start of 2003.

Our projection for growth in real GDP in 2002 is 4.3 per cent and 2.2 per cent for real GNP. The slowdown in economic growth has brought about a sharp reduction in private sector employment throughout 2002. While overall employment grew in the first half of the year, nearly all of the increase was in the public sector. Third quarter figures indicate that overall employment has begun to fall in seasonally adjusted terms for the first time in nearly a decade. The annual unemployment rate for 2002 is expected to be 4.5 per cent while the annual average rate of consumer price inflation is expected to be 4.6 per cent, still the highest within the euro area.

The prospects for the Irish economy in 2003 will be dependent upon the fortunes of the major international economies and the trend in domestic competitiveness factors. The currency may appreciate further making trading conditions more difficult as the EU economies are likely to have little or no growth in the early part of 2003. Our forecast for Irish output growth in 2003 is 3.8 and 3.0 per cent in real GDP and real GNP terms respectively. The unemployment rate is expected to continue rising to average 5.2 per cent in 2003 as the economy grows below potential levels. The rate of inflation in 2003 is forecast to average 5.1 per cent driven by resilient price growth in the non-traded sector, a series of administered price rises and indirect tax increases in the Budget..

When adjusted for the economic cycle, the fiscal stance in Budget 2003 is mildly contractionary. The general government balance is forecast to be in deficit by €1 billion or 0.7 per cent of GDP in 2003. The Budget marks a shift back towards a traditional mix between tax and spending which seems likely to characterise fiscal policy over the medium term. The need to curtail expenditure growth appears to be focussed unduly upon capital expenditure whilst committing a substantial portion of the increased taxation to fund public sector pay and social welfare rises. This impedes the development of a medium term strategy for public expenditure, in particular for the sustained financing of desirable capital projects. The refinement in the interpretation of the Stability and Growth Pact rules proposed by the European Commission provide the right circumstance for the pursuit of appropriate fiscal rules to suit the unique circumstances of the Irish economy.

PRELIMINARY NATIONAL ACCOUNTS 2001

A: Expenditure on Gross National Product

	2000	2001	Change in 2001				
		Preliminary	€m			%	
	€m	€m	Value	Volume	Value	Price	Volume
Private Consumer Expenditure	50,329	55,144	4,815	2,657	9.6	4.2	5.1
Public Net Current Expenditure	12,880	15,288	2,408	1,391	18.7	7.1	10.8
Gross Fixed Capital Formation	24,767	26,670	1,903	-124	7.7	8.2	-0.5
Exports of Goods and Services (X)	100,889	112,368	11,479	6,726	11.4	4.4	6.7
Physical Changes in Stocks	590	279	-311	65			
Final Demand	**189,455**	**209,749**	**20,294**	**10,625**	**10.7**	**4.8**	**5.6**
less:							
Imports of Goods and Services (M)	86,854	95,491	8,637	5,281	9.9	3.6	6.1
GDP at Market Prices	**102,601**	**114,258**	**11,657**	**5,344**	**11.4**	**5.8**	**5.2**
less:							
Statistical Discrepancy	-307	-221	86	-531			
Adjusted GDP	**102,908**	**114,479**	**11,571**	**5,875**	**11.2**	**5.2**	**5.7**
less:							
Net Factor Payments (F)	14,976	17,677	2,701	1,859	18.0	5.0	12.4
GNP at Market Prices	**87,932**	**96,802**	**8,870**	**4,016**	**10.1**	**5.3**	**4.6**

B: Gross National Product by Origin

	2000	2001	Change in 2001	
		Preliminary		
	€m	€m	€m	%
Agriculture, Forestry, Fishing	3,157	3,315	158	5.0
Non-Agricultural: Wages, etc.	41,433	46,857	5,424	13.1
Other:	40,965	45,182	4,217	10.3
Adjustments: Stock Appreciation	-800	185		
Financial Services	-3,574	-4,038	-464	13.0
Statistical Discrepancy	-307	-221	86	-27.9
Net Domestic Product	**80,874**	**91,280**	**10,406**	**12.9**
less:				
Net Factor Payments	14,976	17,677	2,701	18.0
National Income	**65,898**	**73,603**	**7,705**	**11.7**
Depreciation	10,280	11,466	1,186	11.5
GNP at Factor Cost	**76,178**	**85,069**	**8,891**	**11.7**
Taxes less Subsidies	11,754	11,733	-21	-0.2
GNP at Market Prices	**87,932**	**96,802**	**8,870**	**10.1**

C: Balance of Payments on Current Account

	2000	2001	Change in 2001
		Preliminary	
	€m	€m	€m
Exports (X) less Imports (M)	14,035	16,877	2,842
Net Factor Payments (F)	-14,976	-17,677	-2,701
Net Transfers	994	455	-539
Balance on Current Account	**53**	**-345**	**-398**
as % of GNP	0.1	-0.4	-0.4

FORECAST NATIONAL ACCOUNTS 2002

A: Expenditure on Gross National Product

	2001	2002	Change in 2002				
	Preliminary €m	Forecast €m	€m Value	€m Volume	% Value	% Price	% Volume
Private Consumer Expenditure	55,144	59,411	4,267	1,654	7.7	4.6	3.0
Public Net Current Expenditure	15,288	17,460	2,172	1,315	14.2	5.2	8.6
Gross Fixed Capital Formation	26,670	27,256	586	-48	2.2	2.4	-0.2
Exports of Goods and Services (X)	112,368	119,988	7,620	4,358	6.8	2.8	3.9
Physical Changes in Stocks	279	120	-159	-85			
Final Demand	**209,749**	**224,234**	**14,486**	**7,194**	**6.9**	**3.4**	**3.4**
less:							
Imports of Goods and Services (M)	95,491	99,906	4,415	2,199	4.6	2.3	2.3
GDP at Market Prices	**114,258**	**124,328**	**10,070**	**4,995**	**8.8**	**4.3**	**4.4**
less:							
Statistical Discrepancy	-221	-309	-88	97			
Adjusted GDP	**114,479**	**124,637**	**10,158**	**4,898**	**8.9**	**4.4**	**4.3**
less:							
Net Factor Payments (F)	17,677	21,008	3,331	2,760	18.8	2.8	15.6
GNP at Market Prices	**96,802**	**103,629**	**6,827**	**2,138**	**7.1**	**4.7**	**2.2**

B: Gross National Product by Origin

	2001	2002	Change in 2002	
	Preliminary €m	Forecast €m	€m	%
Agriculture, Forestry, Fishing	3,315	3,040	-275	-8.3
Non-Agricultural: Wages, etc.	46,857	51,208	4,351	9.3
Other:	45,182	48,721	3,539	7.8
Adjustments: Stock Appreciation	185	458		
Financial Services	-4,038	-4,401	-363	9.0
Statistical Discrepancy	-221	-309	-88	-39.8
Net Domestic Product	**91,280**	**98,717**	**7,437**	**8.1**
less:				
Net Factor Payments	17,677	21,008	3,331	18.8
National Income	**73,603**	**77,709**	**4,106**	**5.6**
Depreciation	11,466	12,499	1,033	9.0
GNP at Factor Cost	**85,069**	**90,208**	**5,139**	**6.0**
Taxes less Subsidies	11,733	13,422	1,689	14.4
GNP at Market Prices	**96,802**	**103,629**	**6,827**	**7.1**

C: Balance of Payments on Current Account

	2001	2002	Change in 2002
	€m	Preliminary €m	€m
Exports (X) less Imports (M)	16,877	20,082	3,205
Net Factor Payments (F)	-17,677	-21,008	-3,331
Net Transfers	455	272	-183
Balance on Current Account	**-345**	**-654**	**-309**
as % of GNP	-0.4	-0.6	0.3

FORECAST NATIONAL ACCOUNTS 2003

A: Expenditure on Gross National Product

	2002	2003	Change in 2003				
	Forecast €m	Forecast €m	€m			%	
			Value	Volume	Value	Price	Volume
Private Consumer Expenditure	59,410	63,885	4,475	1,782	7.5	4.4	3.0
Public Net Current Expenditure	17,460	18,999	1,539	175	8.8	7.7	1.0
Gross Fixed Capital Formation	27,256	28,195	940	49	3.4	3.3	0.2
Exports of Goods and Services (X)	119,988	129,850	9,862	6,329	8.2	2.8	5.3
Physical Changes in Stocks	120	275	155	205			
Final Demand	**224,234**	**241,205**	**16,971**	**8,540**	**7.6**	**3.6**	**3.8**
less:							
Imports of Goods and Services (M)	99,906	108,022	8,116	4,153	8.1	3.8	4.2
GDP at Market Prices	**124,328**	**133,183**	**8,855**	**4,387**	**7.1**	**3.5**	**3.5**
less							
Statistical Discrepancy	-309	-392	-83	-352			
Adjusted GDP	**124,637**	**133,585**	**8,938**	**4,739**	**7.2**	**3.2**	**3.8**
less:							
Net Factor Payments (F)	21,008	23320	2,312	1,678	11.0	2.8	8.0
GNP at Market Prices	**103,629**	**110,255**	**6,626**	**3,061**	**6.4**	**3.3**	**3.0**

B: Gross National Product by Origin

	2002	2003	Change in 2003	
	Forecast €m	Forecast €m	€m	%
Agriculture, Forestry, Fishing	3,040	3,260	220	7.2
Non-Agricultural: Wages, etc.	51,208	54,408	3,200	6.2
Other:	48,721	52,519	3,798	7.8
Adjustments: Stock Appreciation	458	19		
Financial Services	-4,401	-4,692	-291	6.6
Statistical Discrepancy	-309	-392	-83	26.7
Net Domestic Product	**98,717**	**105,123**	**6,406**	**6.5**
Net Factor Payments	21,008	23,320	2,312	11.0
National Income	**77,709**	**81,803**	**4,094**	**5.3**
Depreciation	12,499	13,358	859	6.9
GNP at Factor Cost	**90,208**	**95,160**	**4,953**	**5.5**
Taxes less Subsidies	13,422	15,095	1,673	12.5
GNP at Market Prices	**103,629**	**110,255**	**6,628**	**6.4**

C: Balance of Payments on Current Account

	2002	2003	Change in 2003
	Forecast €m	Forecast €m	€m
Exports (X) less Imports (M)	20,082	21,828	1,747
Net Factor Payments (F)	-21,008	-23,320	-2,312
Net Transfers	272	102	-170
Balance on Current Account	**-655**	**-1,390**	**-735**
as % of GNP	-0.6	-1.3	-0.7

The International Economy

General

The major international economies, having undergone a tentative recovery in early 2002, have faltered in recent months prompting monetary authorities in the US and the euro area to renew interest rate cuts. Modest economic growth is expected to continue in the short term but the prevailing global uncertainty will continue to weigh heavily on domestic demand in most regions. While doubts over corporate governance have subsided somewhat, the main uncertainty is to the current geopolitical tensions in the Gulf region and the possible impact that military action may have on international oil prices and stock market developments. Given the renewed monetary easing we expect the major world economies to recover strongly in 2003 and move towards their potential growth levels by year end.

US Economy

The world's largest economy has emerged from last year's downturn with three quarters of positive economic growth in 2002. Gross Domestic Product (GDP) statistics confirm this rather muted recovery. On the back of strong productivity growth, resilient consumer spending and a surge in company profits, first quarter real GDP increased by 5.0 per cent on an annualised basis. The second quarter, however, seemed to indicate that the recovery was faltering with real GDP growth of 1.3 per cent as a result of lower growth in private inventory investment.

Despite this tentative recovery in the first half of the year, the National Bureau of Economic Research (NBER), which is widely regarded as the arbiter of the business cycle, have so far not pronounced that the US recession is ended. However, fears of a "double-dip" recession have receded for the moment with revised figures for the third quarter indicating that real GDP grew at an annualised rate of 4 per cent. The main contributors included an acceleration in personnel consumption, increased government spending and a rise in investment on equipment and software.

We forecast annual average real GDP growth of 2.3 per cent this year and 2.6 per cent for 2003 as the US economy moves closer to its potential growth rate. It is important to note that our forecasts may be sensitive to any potential conflict in the Middle East. In this regard, recent terrorist attacks may serve to depress consumer confidence as we enter the Christmas period in which holiday shopping is a critical determinant for GDP growth.

Consumer spending continues to be a main driving force behind the US's gradual recovery. Personal consumption expenditure has maintained relatively strong growth throughout 2002. In the first quarter of this year, personal consumption expenditure increased at an annual rate of 3.1 per cent. Growth slowed somewhat in the second quarter to 1.3 per cent and then rebounded strongly in the third quarter to 4.1 per cent. This alone contributed 2.9 percentage points to the overall increase of 4 per cent in GDP. Durable goods spending, particularly strong car sales, constituted the bulk of the personal consumption expenditure. This resulted from the extent of "zero interest" finance offers available. This may reduce future spending, however, as households may have brought their durable goods expenditures forward in order to take advantage of these finance offers.

The Conference Board's consumer confidence index increased in November for the first time in five months and currently stands at 84.1, up from 79.6 in October. However, the University of Michigan's confidence measure actually decreased in November from 85 back to 84.2. These mixed indicators reveal the uncertainty that US households have about future economic conditions and the impact of possible military action in the Middle East.

Industrial production growth in the US continued to be fragile. Overall, annual industrial activity has only increased by 1.2 per cent from October last year. The Institute of Supply Managers' (ISM) index of manufacturing activity increased to 49.2 in November. This means the index remained below 50 for a third straight month. A reading below 50 points indicates a contraction while above 50 signals an expansion. The new orders component contracted significantly, as did the intentions of surveyed firms to hire new staff.

Following strong inventory led growth in the first and second quarter of 2002, investment as a contributor to overall GDP growth has lessened somewhat in the third quarter of the year. In the third quarter investment continued to expand at a rate of 3.1 per cent. Importantly, fixed investment increased for the first time since the third quarter of 2000.

The US labour market has recently shown signs of deterioration. There was little change in non-farm payroll employment and the unemployment rate rose in November to 6.0 per cent with job losses in the construction and manufacturing industries partially offset by gains in a number of other industries, among them finance, real estate, and health services. Because labour market activity tends to lag that of other sectors in the economy it may be some time before the expected growth in US output is transmitted to the labour market in the form of lower unemployment. We forecast an unemployment rate of 5.8 per cent in 2002, increasing to 6.2 per cent in 2003 reflecting the economy still below its potential growth rate.

The rather flat employment growth, together with relatively strong GDP growth, for the third quarter of this year has meant that US productivity remains robust. Non-farm business productivity increased by 5.1 per cent at an annual rate accounting for the entire growth in output in that period. In the year to the third quarter, labour productivity grew by 5.6 per cent. This constitutes the fastest growth rate in nearly two decades. Although productivity growth is to be expected in the first year of a recovery, this recent spurt in productivity has been particularly strong.

Unit labour costs increased by 0.1 per cent at an annual rate for the third quarter following a decline of 5.3 per cent in the first quarter and an increase of 2.2 per cent in the second quarter of 2002. Compensation per hour increased by 4.8 per cent in the third quarter as compared to 3.9 per cent for the second quarter. When adjusted to take account of increased prices, real compensation per hour is up by 3.0 per cent for the third quarter as compared to 0.5 per cent for the second quarter. We are forecasting average hourly earnings growth to be 3.6 per cent this year, increasing to 3.8 in 2003.

Since the previous *Commentary*, the US Federal Reserve has loosened monetary conditions further by cutting the target federal funds rate to 1.25 per cent, a reduction of 50 basis points. This is the lowest rate in over forty years and is the only reduction in 2002 following the dramatic series of eleven cuts in 2001. The recent interest rate reduction is largely due to uncertainty regarding the strength of the recovery. However, as interest rates get lower, such monetary easing may become less effective. We would expect that US interest rates will rise in 2003 to finish the year around 2.5 per cent in order to return rates towards neutral levels given the anticipated resumption in economic growth at close to potential levels.

The recent reduction in interest rates by the Federal Reserve would seem to reflect a more sanguine view on the threat of inflation and more concern about the potential for the economy to deflate. The risk of deflation can be amplified in the current situation of low interest rates since the nominal interest rate cannot be negative (See Box 1). This risk of deflation remains remote and our forecast is for an average rate of US inflation of 1.6 per cent for 2002. We expect this to increase to 1.8 per cent in 2003.

The US external deficit has recently widened significantly, reaching 5 per cent of GDP in the second quarter of 2002 at a value of $130 billion from $112.5 billion in the first quarter. This is the largest deficit recorded in the post World War II period. Real exports of goods and services increased by 3.3 per cent in the third quarter as compared with an increase of 14.3 per cent in the second quarter. However, the change was more pronounced with imports, where goods and services increased 2.3 per cent in real terms as compared with an increase of 22.2 per cent in the second quarter. The net effect was that third quarter GDP growth was unaffected by the net exports of goods and services as compared with its negative impact of 1.4 per cent in the second quarter.

Whilst the size of the private sector deficit has been reduced over the past eighteen months, the overall impact on the external deficit has been more than offset by the swing into deficit of the public sector. It is unlikely that external deficits of this magnitude can be sustained indefinitely. The current imbalance could be unwound by either export led growth, an increase in savings thereby reducing demand for imports or a major change in the external value of the dollar. Considerable uncertainty remains about the speed at which any adjustment might occur. Given the current exchange rate trajectory implied by expectations of future interest rate differentials, it appears unlikely that any correction will be rapid. We forecast a depreciation in the dollar from its current levels towards US$1.05 per euro by the end of 2003. With regards to the current account deficit as a percentage of GDP we expect a deficit of 4.6 per cent in 2002. We forecast a slight improvement in 2003 with a forecast deficit of 4.4 per cent of GDP.

Euro Area

Recovery in the euro area as a whole is lagging behind that in the US, the UK and the smaller Asian economies. Persistent falls in investment are largely responsible for this weakness, while the recovery in external demand has progressed more gradually than elsewhere. Economic growth in real GDP was modest at 1.4 per cent in 2001 and this growth weakened throughout the year finishing with a negative growth in the final quarter. There was a tentative rebound in the first quarter of 2002, at 0.3 per cent annual growth. Revised estimates for the second quarter in the euro area show an upward revision of annual GDP growth to 0.6 per cent. This upward revision was mainly due to a stronger contribution from net exports, caused by a downward revision in imports.

First estimates of euro area GDP growth in the third quarter show an increase of 0.8 per cent year on year. The main driving force behind this growth was households' consumption expenditure while investment growth stabilised having fallen in recent quarters. Despite this, clear signs of an upturn in the euro area have been slow to emerge. In particular, the German economy has stagnated. We have, therefore, revised downward our forecast growth in real GDP to 1.0 per cent for the euro area this year and to 1.8 per cent growth next year. The forecast resumption of economic growth in the euro area over the next year is expected to be driven by strong private sector growth, both in terms of personal consumption and investment.

Industrial production in the euro area also weakened by the end of the third quarter of 2002, with an annual decline of 0.6 per cent recorded. There are signs, however, that there is some improvement in the euro area's manufacturing sector with continued increases in the Reuter's Purchasing Managers Index (PMI) since September. The most recent figures show the index rising to 49.5 in November from 49.1 in October. Although this still indicates a contraction in the sector, the size of the contraction is at its lowest for three months. The index was helped by the expansion of both output and new orders but dragged back by continued contraction in employment in the sector.

Domestic demand made a tentative recovery in the third quarter with an annual growth rate of 0.3 per cent as compared with a decline of 0.3 per cent for the second quarter. This was mainly driven by relatively robust growth in the household consumption, which reached 0.6 per cent at an annual rate as opposed to 0.2 per cent in the second quarter. However, recent evidence suggests that this may not be sustained as consumer confidence in the euro area fell to a five-year low in November due to fears about rising joblessness and financial security. The *European Commission's Business and Consumer Survey* found that confidence among euro area consumers dropped to -14 in November from -12 in October. A six-point drop in Germany was the main driving force behind the overall decline.

Annual growth in government consumption was up by 2.4 per cent in the third quarter reflecting increased spending by governments in an effort to stimulate their respective economies. Encouraging for the euro area was the fact that investment or gross fixed capital formation which had fallen for six successive quarters, remained stable. However at an annual rate, investment has declined by 3 per cent in quarter three as compared to 3.7 per cent in the second quarter.

Growth in the first quarter of 2002 was largely driven by net trade, which served to offset falls in domestic demand. Although net trade made a positive contribution to first quarter growth, this is largely explained by falling imports, as export growth remained weak. In the second quarter, net trade made only a slight contribution to the quarter's growth with the growth in exports more than offsetting the growth in imports for the quarter. In the third quarter net trade had no impact on growth on a quarter on quarter basis.

The Harmonised Index of Consumer Prices (HICP) rate of inflation stood at 2.3 per cent in October 2002, up from 2.1 per cent in September 2002. Detailed HICP data showed that some of the largest monthly increases were attributable to clothing and education. However, the most recent estimate indicates that inflation in the euro area may have eased back in November to 2.2 per cent from its six-month high in October. It is likely to increase again in December and thereafter remain stubbornly above the

ECB's target rate of 0-2 per cent. We forecast consumer prices in the euro area to increase on average by 2.2 per cent in 2002. In 2003 the rate of increase will slow somewhat to 1.6 per cent reflecting continued excess capacity in the euro area.

In response to the continued below trend growth in the euro area and the continued decline in investment, the European Central Bank (ECB) cut interest rates in December by 50 basis points to 2.75 per cent. It is the first reduction in borrowing costs by the ECB since November 2001. This is despite inflation continuing to be above target, although there are signs that the inflationary pressures may be easing.

The Governing Council also decided to leave the current reference value for the M3 money supply unchanged at an annual growth rate of 4½ per cent. The annual rate of M3 growth decreased to 7.0 per cent in October from 7.3 per cent in September. The reference value was unchanged as the factors underpinning it, namely assumptions on nominal potential output growth and the turnover of the money supply, were considered to be still valid. The assumptions are for nominal potential output growth of 3½-4 cent per annum and for a trend decline in M3 income velocity of ½-1 per cent per annum in the euro area.

The euro area's labour market showed signs of deterioration with unemployment rising for the first time since July 2002. The International Labour Organisation (ILO) seasonally adjusted unemployment rate rose to 8.4 per cent in October 2002, compared to 8.3 per cent in September. The equivalent figure was 8.0 per cent in October 2001. We estimate that unemployment in the euro area will average 8.3 per cent for 2002 and will increase to 8.4 per cent in 2003 due to continued below trend output growth.

Recent information regarding budgetary developments across the euro area indicates that many countries will have difficulty in achieving budgetary targets. Portugal has breached the 3 per cent of GDP deficit constraint imposed by the *Stability and Growth Pact* (SGP) last year. France, Germany and Italy look set to do likewise this year. While some of the deterioration of the consolidated euro area budget balance is explained by slower than anticipated growth, the ECB point to a failure of many countries to use previous growth to improve their financial position. Germany may also run a deficit of over 3 per cent in 2003.

In the foreign exchange markets the euro has gained strength over the year against most of the main international currencies. It has gone above parity with the US dollar and has reached a three-year high with the Japanese yen. Our forecast is for the euro to appreciate further against the dollar to reach US$1.05 by the end of 2003. This appreciation will imply competitive losses in the euro area and may restrain the rebound in output growth somewhat.

UK Economy

In comparison to most of the other economies, the UK has performed fairly well through the recent global turbulence. The UK economy has grown for forty-one successive quarters, the longest period of uninterrupted growth since World War II. The economy grew by 3.1 per cent in 2000 and 1.9 per cent in 2001. On an annual basis GDP growth in 2002 was 1 per cent for the first quarter and 1.3 per cent in the second quarter. Revised estimates for the third quarter showed an upward revision to annual growth of 1.8 per cent though this may be distorted by the impact of the timing of the Jubilee celebrations. We estimate GDP growth to be 1.5 per cent for 2002 and increasing towards its potential output growth with a forecast of 2.7 per cent in 2003.

Investment in the UK has been declining dramatically across the whole economy. While government investment remained broadly flat, business investment over the year has had its sharpest fall since records began. Most sectors, with the exception of construction contributed to this fall, with the ICT sector in particular continuing to contract strongly. Business investment in the third quarter of 2002 is down 12.4 per cent on a year earlier. This decline follows growth in investment of 1.9 per cent in 2000 and a decline of 0.4 per cent in 2001. Service industries, accounting for almost three-quarters of the total business sector, have made the deepest cut in investment: by 13.7 per cent over the year.

Manufacturing output rose by 1.1 per cent in the three months to September. This follows six successive quarters of decline when conversely the service sector has expanded rapidly. This change in the third quarter was mainly due to growth in the manufacture of transport equipment, paper, printing and publishing materials and chemicals. The CIPS/Reuters Purchasing Managers Index shows the manufacturing sector posting a level of 50.0 for November which is slightly below the October figure of 50.6, but again avoids signalling an outright contraction in the sector. This was mainly due to the expansion of new orders and lower input prices offsetting the contraction in employment. Output in the service sector also appears to have strengthened over the quarter, up by 0.9 per cent.

Private consumption in the third quarter rose by annual 3.8 per cent. This growth is, however, slightly weaker than that of the first and second quarter of 2002 when there was growth on an annual basis of 4.5 and 4.1 per cent respectively. Consumer confidence levels rose slightly in November after falls in October. This combined with personal borrowing figures, which continued to grow in November, cast further doubt on earlier signs of a moderation in household spending. Consumer expenditure is therefore expected to remain strong in the near term boosted by the wealth effect derived from the strong rise in house prices in the last year.

The labour market in the UK continues to be quite strong despite the slowdown in economic activity. The unemployment rate has remained relatively stable over 2002 with no change between the first two quarters and a slight increase of 0.2 between the second and third quarters. On the ILO basis the unemployment rate of 5.3 per cent is close to the lowest rate since the series began in 1984. According to the labour force survey, employment averaged 27.7 million in the 3 months to September and unemployment averaged 1.54 million. We estimate the unemployment rate of the UK to be on average 5.3 per cent for the current year. This is set to increase slightly to 5.4 per cent in 2003.

The UK continues to experience the most prolonged period of low inflation since the 1960s. The Retail Price Index (RPI) was 2.1 per cent in October, up from 1.7 per cent in September. The RPI excluding interest payments, targeted by the Bank of England Monetary Policy Committee (MPC), was 2.3 in October. Services inflation continues to be very strong increasing from 4.6 per cent to 4.8 per cent. The HICP measure of inflation remained unchanged at 1.4 per cent in October. The MPC decided in November that the Bank of England's Repo rate should be maintained at

4.0 per cent. The main impediment to lowering interest rates has been the continued surge in house prices. House prices have grown in excess of 25 per cent on an annual basis to November 2002. The MPC were alarmed both by its effect on inflation and its influence on consumer spending. Official interest rates therefore remain at their current levels, albeit at a forty year low.

Like many other countries the UK has seen a deterioration in its public finance position. In the recent pre-Budget report, the Treasury revised downwards their growth forecasts for the year. Net borrowing this year will be double that estimated in April and will reach STG£20 billion this year and increase to STG£24 billion next year. Borrowing is therefore taking the slack as increased taxes or decreased spending might only serve to depress demand and hurt the already floundering investment in particular. The UK Government's fiscal rules are met but with a lower safety margin than before. Overall, the UK fiscal position remains supportive of growth but if investment does not recover as quickly as is expected in 2003 further revisions to our growth forecasts may be necessary.

The Rest of the World

The Japanese economy is likely to continue to be the slowest growing major economy this year and next. Revised national accounts data indicate that activity picked up in the first half of this year, but this largely reflected higher net export levels, with private domestic demand remaining weak. In Japan, GDP increased by 0.7 per cent during the third quarter of 2002, after an increase of 1.0 per cent during the previous quarter. Exports and imports both recorded weaker growth than in the previous quarter, the deceleration being significantly stronger for exports. For the year as a whole we expect GDP to decline by 0.5 per cent, before rising modestly by 1 per cent in 2003. Progress on implementing structural reforms continues to be slow, and widespread price deflation appears likely to persist in the short term, despite the renewed weakness of the yen. The GDP deflator is forecast to drop again this year, which would be the fifth consecutive annual decline.

Price level deflation is also currently occurring in several other Asian economies, notably Hong Kong, Singapore, Taiwan and mainland China. In part this reflects the exposure of these economies to developments in the ICT sector where prices are extremely volatile. For instance, production of semi-conductors now account for almost 20 per cent of GDP in countries such as Singapore and Malaysia. The downward price pressures also reflect the impact of domestic deregulation and greater competition, especially in China.

TABLE 1: Short-term International Outlook

	Output*		Consumer Prices		Hourly Earnings		Unemployment Rate		Current Account Balance	
			Percentage Change				%		% of GNP	
Country	**2002**	**2003**	**2002**	**2003**	**2002**	**2003**	**2002**	**2003**	**2002**	**2003**
UK	1.5	2.7	1.5	2.5	4.1	4.5	5.3	5.4	-2.1	-2.6

Germany	0.5	1.4	1.4	1.2	3.2	3.0	8.5	8.5	1.6	1.2
France	1.4	2.1	2.0	1.3	3.2	3.3	9.1	9.1	2.2	1.7
Italy	0.7	1.6	2.3	1.8	3.1	3.8	9.4	9.4	-0.3	-0.6
Euro Area	1.0	1.8	2.2	1.6	3.5	3.9	8.3	8.4	-2.1	-2.0
USA	2.3	2.6	1.6	1.8	3.6	3.8	5.8	6.2	-4.6	-4.4
Japan	-0.5	1.0	-1.2	-0.8	0.7	0.3	6.3	6.3	2.5	2.7
OECD	1.5	2.3	1.6	1.7	3.6	3.9	7.0	6.3	-0.9	-1.1
Ireland	4.3	3.8	4.6	5.1	7.9	5.5	4.5	5.2	-0.6	-1.3

*Output growth as measured in GDP terms.

The increasing importance of the Asian economies in global trade means that there is a possibility that deflation in these countries can be exported to other areas. With economy-wide price inflation in the US having recently dropped to its lowest level for forty years, and the prices of many domestically produced goods now declining in Europe and North America, fears have emerged that persistent Japanese-style deflation may appear in other economies as well (See Box 1). Whilst our forecasts show that low rates of inflation are expected to persist for some time, it does not point to sustained outright deflation. In part this reflects a judgement that monetary policy would be eased further if required in order to prevent this. Monetary policy is difficult to operate in a low inflation environment, but it is clear that many central banks have taken a lesson from Japan that prompt action should be taken if the perceived risk of sustained deflation were to rise significantly.

The strong growth of demand in China and India is set to become more and more important in the coming years. Evaluated using purchasing power parity exchange rates in 2001, these two economies now account for 16.7 per cent of world GDP. Their expected contribution to global growth this year and next is likely to be much higher, accounting for over one third of the annual increase in output. Current internal reforms and external liberalisation in both economies should, if continued, offer a significant positive stimulus to the world economy for some time to come.

Box 1: The Threat from Deflation

In the recent past there has been a marked shift by monetary authorities to inflation targeting as the main tool for fostering stability and growth within their respective economies. This practice has become ever more popular since New Zealand pioneered it in 1990. Recently for some economists the fear of increasing prices has been replaced by a new and may be more serious threat – the fear of falling prices or deflation. At present the world is still awash with excess capacity. Until this is eliminated there will continue to be downward pressure on prices. Many believe that the United States and more so Germany are in real danger of following Japan, which has suffered a sustained period of deflation together with weak economic growth after a combination of policy mistakes and the unwinding of its financial excesses following its investment bubble in the 1980's.

Deflation in itself may not necessarily be a bad thing. If falling prices are caused by faster productivity growth, as happened in the late 19th century then it can go hand in hand with robust growth. Even today some prices are falling because of productivity gains resulting from information technology. However, if deflation reflects a slump in aggregate demand and excess capacity it can be dangerous. This is because the decline in the price level reinforces the plunge in output, and creates a vicious downward spiral of rising unemployment, plunging spending and mounting bad debts. There are four main ways in which declining prices can negatively impact on output.

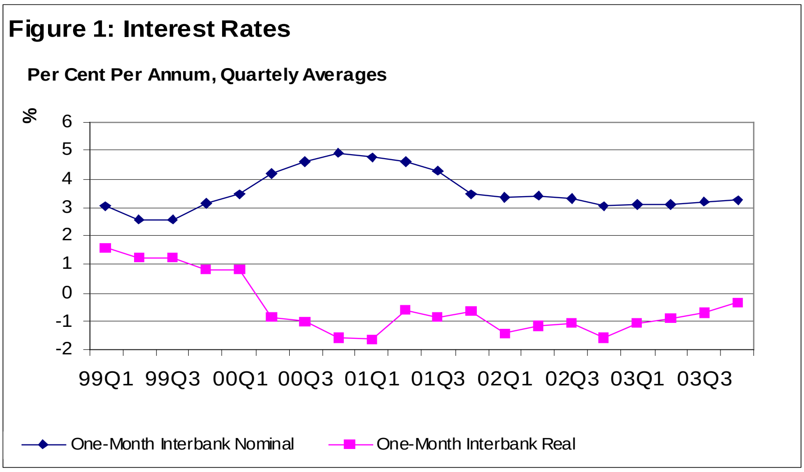
The first is a result of downward rigidity in nominal wages. In times of economic weakness and rising prices firms can usually reduce real wages by offering small nominal wage increases. However, with low or negative inflation the only way to decrease real wages is to decrease nominal wages to which workers are generally very resistant. This can mean a cut in jobs, which contributes to a further decrease in output.

The second negative impact of falling prices is that it swells the real burden of debt. In other words, the purchasing power of each monetary unit borrowed increases over time in periods of deflation. In this way it favours lenders over borrowers. This is particularly important for economies with a lot of debt particularly in the private sector as in the case of Japan, the US and Germany. Because debt burdens increase, the possibility for additional borrowing lessens thereby reducing business spending in capital equipment, new plants and extra capacity, which further reduces aggregate output.

Delayed spending is another detrimental effect of falling prices. Both businesses and consumers may delay expenditures on the expectation that prices will be lower in the future. This reduction in spending leads to further price-cuts, which reinforce the deflationary spiral.

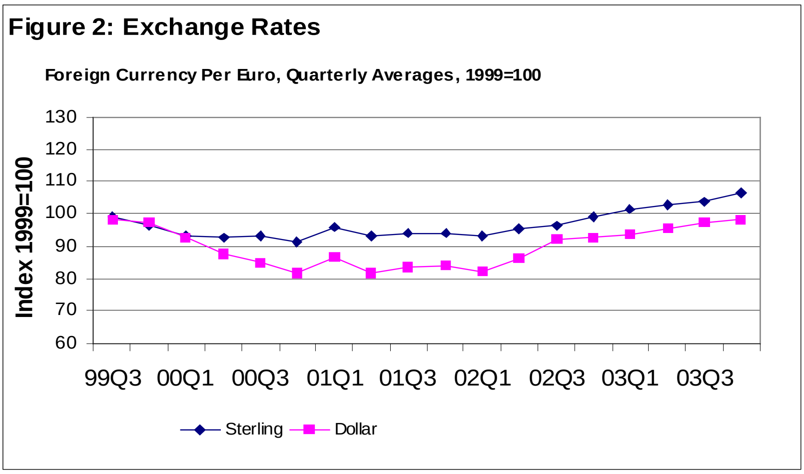
Finally, periods of deflation reduce and sometimes eliminate the role of monetary policy, which may be necessary to stimulate the economy. Because prices are falling, real interest rates remain painfully high at a time when they should be negative to encourage borrowing. Nominal interest rates cannot be less than zero and so conventional monetary policy becomes useless. This is called the liquidity trap. In Keynes' words, monetary policy, in an effort to stimulate the economy, finds itself "pushing on a string". The only way to create a monetary stimulus in this situation is to drastically change price expectations.

As mentioned the US and Germany are most at risk of deflation. This is dangerous because of the size of these two economies. Global deflation, which would be even harder to eradicate than deflation in a single economy as individual countries can have the option of devaluing its currency and so increasing or importing inflation but obviously this is not possible in the case of global deflation. Japans problems were exacerbated by a weak banking system. This may not be the case for the US and Germany and the relevant policy makers are quick to dismiss the possibility of deflation. This may be an effort to avoid a type of self-fulfilling prophecy but in any case there may be a need to switch from limiting inflation to reflating the economies in order to avoid a deflationary spiral, which could be detrimental to global growth.



Context for Ireland

Irish growth prospects for 2003 remain uncertain and are dependent upon a recovery in the international economic environment. The prospect for output in all the major international economies is for below potential growth rates which would result in only a modest rise international trade growth. The half percentage point cut in interest rates in both the US and euro area economies in the final quarter of 2002 may provide some stimulus. However, with interest rates already at very low levels, any positive impact of further reductions needs to weighed-up against the ability to use monetary policy to counteract the threat of deflation.



The main threat for the Irish economy arises from our forecast appreciation of the euro with the dollar during 2003. A sharper euro appreciation than expected combined with continuing rapid rises in domestic labour costs would lead to a larger competitive loss for the economy than anticipated. The prospective loss of competitiveness could have strong implications for employment growth next year. We expect interest rate to remain at current levels until the middle of 2003, before rising moderately thereafter as economic growth resumes towards trend levels.

The Domestic Economy

General

Quarterly National Accounts for the second quarter of 2002 indicate that the economy was still experiencing reasonable growth during the first half of the year. Statistics indicate that growth can be expected to be much slower in the second half of this year. Thus, real GDP is estimated to have increased by 4.3 per cent and real GNP by 2.2 per cent. The gap between GDP and GNP is estimated to have widened this year due to strong growth in net factor flows. Based on the assumptions and forecast for the external environment outlined in the *International* section, our forecast for 2003 is that growth will slow next year to 3.8 per cent in GDP terms and 3.0 per cent in GNP terms, once again below potential.

Exports

Preliminary trade statistics show that the value of visible exports in the first nine months of 2002 was over €3.2 million, 2.9 per cent higher than the corresponding period in 2001. Volume figures for the first eight months show an increase of 1.3 per cent. This rate of growth is much lower than was experienced in 2001 and substantially lower than the rate of growth in 2000 when visible exports grew by 19.3 per cent. The slowdown in export growth appears broadly spread, although in contrast to other high-tech sectors the value of pharmaceutical exports has continued to expand. Given the international environment already outlined the pattern of slower growth has not been reversed since the last *Commentary*. Our forecast for the volume growth of both visible exports and merchandise exports has been revised down again to 3 per cent and 3.6 per cent respectively. With only moderate growth in tourism and other service exports, total exports of goods and services in 2002 are forecast to rise by 6.8 per cent in value and by 3.9 per cent in volume terms. This implies an export price deflator of 2.8 per cent.

Despite a recovery in world trade towards the latter half of next year, the rate of growth in visible exports is forecast to be sluggish. This will primarily be due to losses in competitiveness as a result of a rising domestic cost base and a stronger euro. Some moderate recovery is forecast for tourism exports following the poor performance of 2002 on the back of recovery in the US and Europe. If these forecasts prove correct exports of goods and services are forecast to increase by 5.3 per cent in volume and by 8.2 per cent in value in 2003. On the basis of these forecasts the export price deflator is expected to remain unchanged at 2.8 per cent.

TABLE 2: Exports of Goods and Services

Preliminary

	2000 €m	% Change in 2001 Volume	% Change in 2001 Value	2001 €m
Agricultural	4,431	-11.8	-8.0	4,078
Manufactured	72,197	7.0	12.1	80,945
Other Industrial	5,540	-1.7	3.4	5,726
Other	1,612	5.5	10.0	1,774

Total Visible	**83,780**	**5.4**	**10.4**	**92,523**
Adjustments	-2,858	17.0	39.0	-3,972
Merchandise	**80,922**	**5.0**	**9.4**	**88,551**
Tourism	2,851	1.2	8.3	3,088
Other Services	17,116	15.6	21.1	20,729
Exports of Goods And Services	**100,889**	**6.7**	**11.4**	**112,368**

Forecasts

	2001 €m	% Change in 2002 Volume	Value	2002 €m	% Change in 2003 Volume	Value	2003 €m
Agricultural	4,078	2.2	4.2	4,252	3.3	5.9	4,501
Manufactured	80,945	3.2	6.1	85,874	6.1	8.8	93,391
Other Industrial	5,726	1.7	4.4	5,981	3.0	5.2	6,290
Other	1,774	1.6	4.0	1,845	3.2	5.6	1,948
Total Visible	**92,523**	**3.0**	**5.9**	**97,952**	**5.7**	**8.3**	**106,130**
Adjustments	-3,972	-10.0	-8.2	-3,647	15.0	16.2	-4,236
Merchandise	**88,551**	**3.6**	**6.5**	**94,305**	**5.4**	**8.0**	**101,894**
Tourism	3,088	-2.2	-1.2	3,050	1.2	4.7	3,195
Other Services	20,729	5.9	9.2	22,633	5.4	9.4	24,761
Exports of Goods And Services	**112,368**	**3.9**	**6.8**	**119,988**	**5.3**	**8.2**	**129,850**

Stocks

The National Accounts for the second quarter of 2002 reveal that stocks rose by €544 million in that period. For the year as a whole the increase in stocks is projected at €120 million for total stocks. A moderation in farm stocks next year coupled with an increase in industrial and distribution stocks is forecast to lead to stock levels increasing by €275 million in 2003.

TABLE 3: Stock Changes

	2000 €m	Change in Value €m	2001 €m	Change in Value €m	2002 €m	Change in Value €m	2003 €m
Farm Stocks	-162	136	-26	236	210	-20	190
Irish intervention Stocks	-114	129	15	-15	0	0	0
Other Non-Agricultural Stocks	866	-576	290	-380	-90	175	85
Total	**590**	**-311**	**279**	**-159**	**120**	**155**	**275**

Investment

Official figures confirm that the contraction in investment continued during the second quarter of 2002. Once again the overall decline reflects a sharp decline in investment in machinery and equipment while there was a modest expansion in investment in building and construction.

Indicators of investment activity suggest that the contraction has continued into the second half of 2002. The value of imports of capital goods for the first seven months of the year is 10.8 per cent lower than in 2001. Employment in building and construction in the first nine months of

2002 is 2.8 per cent lower than last year. An annual increase in total investment in building and construction of just 0.7 per cent in volume and 4.4 per cent in value is forecast for 2002. Allowing for an expected decline of 2.0 per cent in volume for investment in machinery and equipment, the forecast increase in total gross capital formation in 2002 is for a decline of 0.2 per cent in volume terms. With the overall investment deflator estimated at 2.4 per cent, significantly lower than in recent years, this implies an increase of 2.2 per cent in value terms.

Given the slow pace of recovery in Europe and the US it is likely that monetary policy will remain loose for much of 2003. While this should bring about some recovery in private sector investment, any increase will remain tempered until recovery is sustained. The need to stabilise the public finances will constrain public sector investment next year although some moderate expansion is forecast.

TABLE 4: Gross Fixed Capital Formation

Preliminary

	2000 €m	% Change in 2001 Volume	Value	2001 €m
Housing	8,157	6.5	17.0	9,541
Other Building	7,632	3.0	11.5	8,509
Building and Construction	15,789	4.8	14.3	18,050
Machinery & Equipment	8,978	-6.5	-4.0	8,620
Total	24,767	-0.5	7.7	26,670

Forecasts

	2001 €m	% Change in 2002 Volume	Value	2002 €m	% Change in 2003 Volume	Value	2003 €m
Housing	9,541	2.2	7.5	10,258	0.5	4.6	10,732
Other Building	8,509	-1.0	1.0	8,593	-1.0	2.0	8,761
Building and Construction	18,050	0.7	4.4	18,851	-0.2	3.4	19,493
Machinery & Equipment	8,620	-2.0	-2.5	8,405	1.0	3.5	8,702
Total	26,670	-0.2	2.2	27,256	0.2	3.4	28,195

Building and construction investment is forecast to decline by 0.2 per cent in volume terms in 2003. On the basis of forecast growth in investment in plant and machinery of 1 per cent next year, overall investment is expected to expand by 0.2 per cent next year. However, the price deflator for total investment is expected to remain moderate at 3.2 per cent, giving rise to a value increase of 3.4 per cent in 2003.

Consumption

National Accounts for the second quarter of 2002 indicate that the value of personal consumption rose by 8.2 per cent. The volume of personal consumption is estimated to have risen by 2.3 per cent implying a consumption deflator of 5.8 per cent.

Excluding the more volatile motor trade retail sales grew by 3 per cent in the first nine months of the year. The uncertain economic outlook means that we do not expect substantially stronger consumer spending growth in the final three months of this year. The IIB Bank/ESRI Monthly Consumer Sentiment Index shows that consumer sentiment stabilised in November, having declined for the previous five months. Thus, total personal consumption is forecast to rise by 3 per cent in volume and 7.7 per cent in value, implying a personal consumption deflator of 4.6 per cent.

Our forecast for growth in personal consumption for 2003 has been revised down. As outlined later in this *Commentary* unemployment is forecast to increase as the economy continues to grow below potential next year. More moderate wage growth, high inflation and reductions in real personal disposable income due to budget measures will all serve to reduce growth. Therefore, a slower rate of increase in the volume of personal consumption is forecast for 2003 at 3.0 per cent. Based on the expectation that the consumer expenditure deflator will remain high the value increase in personal consumption is projected to slow to 7.5 per cent.

According to the Quarterly National Accounts, government consumption in the second quarter of 2002 increased by 9.2 per cent in volume and by 14.6 per cent in value, resulting in a public expenditure deflator of 4.9 per cent. Given the rise in public sector employment over the first nine months of the year, combined with higher spending growth, we expect an annual government consumption growth rate of 8.6 per cent in volume terms for 2002. With cost pressures continuing to underpin the deflator for the public sector this is expected to average 5.2 per cent. On this basis a value increase of 14.2 per cent is forecast for this year. The recent budget is framed against much lower growth in government spending next year. On the assumption that public expenditure growth is kept broadly in line with expectations, growth of 1 per cent in the volume of government spending is forecast. In value terms the growth rate is forecast to slow to 8.8 per cent, implying that the price deflator for government consumption will increase to 7.7 per cent in 2003 due to rising costs and wage inflation.

TABLE 5: Consumption Indicators

	Annual Percentage Change						
	1997	1998	1999	2000	2001	2002 Forecast	2003 Forecast
Consumption Value							
Personal Consumption	10.2	11.9	12.6	13.5	9.6	7.7	7.5
Retail Sales Index, Value	9.0	9.5	11.4	16.3	5.9	4.5	5.5
Divergence	1.2	2.4	1.2	-2.8	3.7	3.2	2.0
Consumption Volume							
Personal Consumption	7.4	7.8	9.0	9.0	5.1	3.0	3.0
Retail Sales Index, Volume	7.9	7.8	9.5	11.9	3.1	1.5	2.2
Divergence	-0.5	0.0	-0.5	-2.9	2.0	1.5	0.8
Consumer Prices							
Personal Consumption Deflator	2.6	3.8	3.3	4.1	4.2	4.6	4.4
Retail Sales Index Deflator	1.0	1.6	1.7	3.9	2.7	3.0	3.3
Consumer Price Index	1.5	2.4	1.6	4.5	5.6	4.7	5.1

Final Demand

On the basis of our estimates for activity in 2002 domestic demand, excluding stocks, is forecast to increase by 3 per cent in volume terms, while exports of goods and services are forecast to grow by 3.9 per cent. Thus volume growth in total final demand in 2002 is estimated to be 3.4 per cent and by 6.9 per cent in value terms. Growth in domestic demand, excluding stocks, is forecast to slow to 2.1 per cent in 2003. On the basis that there is some recovery in the rate of growth in exports of goods and services growth in final demand is forecast to increase marginally to 2003 to 3.8 per cent in volume and 7.6 per cent in value terms.

Imports

Official figures show that visible imports grew by only 2 per cent in volume terms over the first nine months of the year and in value terms imports declined by 1.9 per cent. With no evidence of an upturn in activity levels in the second half of the year, visible import growth is anticipated to remain subdued. Tourism statistics indicate strong growth in the volume of tourism imports (Irish citizens travelling abroad) over the first half of the year. Lower levels of domestic activity this year are expected to result in more moderate growth in service imports. On the basis of these forecasts growth in imports of total goods and services is expected to be 2.3 per cent in volume terms this year. A forecast value increase of 4.6 per cent implies that the import price deflator will average 2.3 per cent in 2002.

Given our expectation that next year will prove a more difficult one for the Irish economy we are forecasting a further reduction in the growth of imports. Visible imports are projected to grow by 3.5 per cent in volume and by 7.3 per cent in value, implying an import price deflator of 3.7 per cent. A more cautious consumer sector implies continued slow growth in tourist expenditure abroad as well as in the import of other services. Thus, growth of total imports in volume terms is forecast at 4.2 per cent and 8.1 per cent in value terms. These forecasts suggest a higher import price deflator in 2003 of 3.8 per cent.

TABLE 6: Imports of Goods and Services

Preliminary

	2000	**% Change in 2001**		**2001**
	€m	**Volume**	**Value**	**€m**
Capital Goods	8,072	-10.1	-7.1	7,502
Consumer Goods	11,478	3.8	7.0	12,286
Intermediate Goods:				
Agriculture	894	2.2	5.5	943
Other	33,215	0.5	3.3	34,328
Other Goods	2,164	-4.3	-2.1	2,119
Total Visible	**55,823**	**-0.5**	**2.4**	**57,178**
Adjustments	-3,034	-11.5	-5.0	-2,884
Merchandise Imports	**52,789**	**0.1**	**2.9**	**54,294**
Tourism	2,750	11.4	16.9	3,216
Other Services	31,315	15.6	21.3	37,981

Imports of Goods and Services	**86,854**	**6.1**	**9.9**	**95,491**

Forecasts

	2001 €m	% Change in 2002 Volume	% Change in 2002 Value	2002 €m	% Change in 2003 Volume	% Change in 2003 Value	2003 €m
Capital Goods	7,502	1.0	2.5	7,690	4.5	8.2	8,318
Consumer Goods	12,286	2.7	4.0	12,781	4.2	8.7	13,891
Intermediate Goods:							
Agriculture	943	2.8	3.9	980	5.0	7.6	1,055
Other	34,328	2.0	3.8	35,645	3.0	6.7	38,036
Other Goods	2,119	3.0	4.9	2,222	3.7	6.8	2,373
Total Visible	**57,178**	**2.1**	**3.7**	**59,319**	**3.5**	**7.3**	**63,673**
Adjustments	-2,884	25.0	25.0	-3,604	15.0	15.0	-4,145
Merchandise Imports	**54,294**	**0.9**	**2.6**	**55,714**	**2.8**	**6.8**	**59,528**
Tourism	3,216	4.4	7.8	3,468	4.8	8.8	3,773
Other Services	37,981	4.2	7.2	40,724	6.0	9.8	44,721
Imports of Goods And Services	**95,491**	**2.3**	**4.6**	**99,906**	**4.2**	**8.1**	**108,022**

Balance of Payments

On the basis of the forecasts for growth in the export and import of goods and services, a 9.3 per cent increase in the visible trade balance is expected this year, and forecast to increase to just under 10 per cent next year. The surplus on trade in goods and services is expected to increase by 19 per cent this year. Faster growth in the deficit on services than on the merchandise trade surplus, will result in the trade surplus in goods and services growing in 2003 by just 8.7 per cent.

More moderate growth in the credit and debit flows that constitute the balance of payments are forecast for this year, as is evident from Table 7. This is on the basis of lower rates of economic activity both in Ireland and internationally. Thus, the rises in net factor flows are expected to be 19 per cent in 2002 and 11 per cent in 2003. Net current transfers are expected to continue their decline. The current account of the balance of payments is expected to remain in deficit in 2002 at around €654 million. This deficit is forecast to widen substantially in 2003 to near €1.4 billion, equivalent to 1.3 per cent of GNP, due mainly to slower than anticipated growth in the trade balance.

TABLE 7: Balance of Payments

	2000 €m	Change %	2001 €m	Change %	2002 €m	Change %	2003 €m
Visible Trade Balance	27,957	26.4	35,346	9.3	38,633	9.9	42,457
Adjustments	176		-1,089		-42		-90
Merchandise Trade Balance	**28,133**	**21.8**	**34,257**	**12.7**	**38,591**	**9.8**	**42,367**
Service Trade Balance	-14,098	23.3	-17,380	6.5	-18,509	11.0	-20,539
Trade Balance in Goods and Services	**14,035**	**20.3**	**16,877**	**19.0**	**20,082**	**8.7**	**21,828**
Total Debit Flows	-45,065	5.7	-47,633	8.0	-51,450	5.8	-54,420
Total Credit Flows	30,089	-0.4	29,956	1.6	30,442	2.2	31,100

Net Factor Flows	**-14,976**	**18.0**	**-17,677**	**18.8**	**-21,008**	**11.0**	**-23,320**
Net Current Transfers	**994**	**-54.3**	**455**	**-40.2**	**272**	**-162.4**	**102**
Balance on Current Account	**53**		**-345**		**-654**		**-1,390**
Capital Transfers	1,206	-44.2	673	-7.5	622	-14.5	532
Effective Current Balance	**1,259**		**328**		**-32**		**-858**

Gross National Product

Real GNP in 2002 is now estimated to have risen by 2.2 per cent, compared with an increase of 4.6 per cent last year and marginally lower than our estimate in the previous *Commentary*. In GDP terms the estimate for volume growth this year is now 4.3 per cent. Taking account of terms of trade adjustment GNP growth of 2.9 per cent is estimated. The adjustment together with a volume decline in current transfers is forecast to result in an increase of 2.7 per cent in Gross National Disposable Income (GNDI).

A terms of trade loss and broadly unchanged net transfers in 2003 are projected to lead to lower growth in real GNDI, forecast to increase by under 2 per cent. This is the lowest rate of growth in GNDI since 1992 and well below the average of 8 per cent growth between 1996 and 2001. Our forecasts for real GDP and real GNP have been revised down since the last *Commentary*. We are now forecasting real GDP growth of 3.8 per cent and real GNP growth of 3.0 per cent next year.

Agriculture

The agricultural sector has had quite a poor year in 2002 as compared to 2001. In 2001 the total value of agricultural output increased by 3.3 per cent. Provisional estimates for 2002 from the CSO indicate that agricultural income, as measured by operating surplus, fell by €223 million or 8.5 per cent before deductions for interest payments and land rental. These deductions can be particularly severe for the agriculture sector, which has seen borrowing double in the last five years. Interest payments now account for 10 per cent of total farm income.

A fall in this year's margins for all the main agricultural enterprises is mainly due to unfavourable weather conditions, falling output prices and rising input prices. The value of milk output fell by €159 million or 10.1 per cent, the value of sheep by €87 million or 30.8 per cent and the value of pigs by €47 million or 13.5 per cent. The output value of cattle also decreased substantially by €78 million or 6.2 per cent. The value of cereals showed the largest percentage change, decreasing by 22.1 per cent or €38 million over the year. Intermediate consumption grew by 0.8 per cent, which was largely due to increases in the value of feeding stuffs and contract work, the value of which grew by 3.8 per cent and 4.5 per cent respectively. Net subsidies also increased by 17.2 per cent over 2002. It is estimated that net subsidies represent 68 per cent of operating surplus in 2002 as compared to 53 per cent in 2001.

The agricultural output price index fell in September by 4.3 per cent on an annual basis. This decrease was driven by the decline in livestock prices with the sharpest falls occurring in sheep, cows for slaughter, and pigs which fell by 16.6, 8.7 and 10.8 per cent respectively. Milk prices also decreased by 7.8 per cent in the twelve months to September 2002. The large fall in the output value of sheep is attributable to high prices in 2001 because of the banning of UK exports of lamb during the foot and mouth outbreak. The resumption of UK lamb export trade is continuing to lead to declining Irish and EU price levels. In contrast, crop product prices increased by 6.8 per cent in September on an annual basis. The price of potatoes saw the largest increase at 31.7 per cent while cereals decreased by 10.0 per cent. The agricultural input price index increased by 1.3 per cent in September on an annual basis. The majority of this was due to veterinary expenses, energy and feeding stuffs, which increased by 4.7, 2.2 and 0.7 per cent respectively, while fertilisers fell by 3.1 per cent.

We therefore expect gross agricultural output to contract by 2.1 per cent in volume terms in 2002. Growth is expected to return to the sector in 2003, with gross agricultural output forecast to increase by 2.3 per cent.

Industry

Estimates from the Quarterly National Accounts for the second quarter of 2002 indicate that the volume of production in industry, including building, grew by 11.6 per cent on an annual basis. The growth rates for 2002 are quite a large improvement on the second half of 2001 during which production in the sector fell by 1.1 per cent. The improvement in the volume of production is also indicated by the CSO's latest statistics on *Industrial Production and Turnover*. Preliminary estimates for the third quarter show that the volume of production for all industries has grown by 11.4 per cent compared to the same period last year. However, the seasonally adjusted volume of production for all industries declined by 6.2 per cent between quarters two and three of 2002, indicating a significant slowdown in annual growth rates for the sector in the second half of the year. This has been driven by a decline in manufacturing industries of 6.3 per cent between quarter two and quarter three of 2002.

Recent survey data confirms the extent of the slowdown in the sector. The NCB Purchasing Managers' Index signalled a contraction in the manufacturing sector in October, when the indicator fell to 48.8, its lowest level since December 2001. There has been a further contraction in November at 49.5. This contraction reflected weaker demand for manufacturing products, most of which was due to postponement of new orders due to current economic uncertainty. The contraction was also due to a reduction in the size of the Irish manufacturing workforce, which fell for the third successive month. This is as result of firms seeking further productivity gains and keeping cost levels contained. The forward-looking components of the IBEC-ESRI Monthly Industrial Survey also indicate that industrial output is likely to slow down for the remainder of the year. We estimate that gross output in industry will increase by 4.0 per cent this year. However, as the international economy continues its tentative recovery we forecast gross output in industry to increase by 4.3 per cent in 2003.

Services

The volume of GDP in the services sector increased by nearly 7.2 per cent in 2001. As the economy slowed in the latter part of 2001, the broad services sector declined sharply. The services sector seems to have made a strong recovery in 2002, as can be seen by survey evidence contained in the NCB Monthly Report on Services. Activity in the sector was very strong at the start of 2002 and held up well over the middle of the year as business activity measures continued to increase, albeit moderately. In October, the business activity index stood at 54.6, indicating strong growth. This has continued in November with the index standing at 53.9. This is the twelfth successive month of activity growth, signalling the continued expansion of new business for firms in the sector. However, sharp increases in input costs and charges are becoming a cause of concern for the sector. Efforts to contain these increased costs, in an effort to protect profit margins, are resulting in continued job cuts. November was the fifth successive month to show employment contraction in the sector.

As already outlined in this *Commentary*, personal consumption growth is expected to slow significantly in 2002. The adjustment of expectations to slower growth in incomes and rising unemployment is also expected to have an impact on the services sector. The slowdown in domestic demand should be reflected in a somewhat lower growth in service output this year. An increase of 4.1 per cent in the volume of GDP in services is therefore estimated for 2002.

Given our forecasts for personal consumption and personal disposable income growth, the demand growth for services in the Irish economy is likely to continue in 2003. However, with downward revisions in our level of expected economic activity next year, we are forecasting slower growth in the volume of services output at 3.1 per cent for 2003 as a whole.

Employment

The Quarterly National Household Survey (QNHS) for the third quarter of 2002 shows that the slowdown in the economy is starting to impact on the labour market. The unemployment rate was 4.6 per cent in the third quarter of 2002 as compared with 4.2 per cent in the second quarter and 3.9 per cent for the whole of 2001. In absolute terms there were 78,700 unemployed in the third quarter of 2002, an increase of 12,300 from the previous quarter and an increase of 7,200 on an annual basis

Employment in the Irish economy grew on an annual basis by 0.5 per cent in the third quarter. This is considerably lower than the annual growth rates of 1.9 and 2.7 per cent for the first and second quarters respectively. In absolute terms, this represents an increase of nearly 45,000 persons to 1.79 million persons employed in the third quarter of 2002. On a quarter on quarter basis, employment grew in the third quarter of 2002 by 2.6 per cent. This is compared with only 0.3 per cent quarter on quarter growth in the second quarter. This increase, however, is largely due to seasonal factors with both the labour force and employment tending to expand strongly in the summer months. This is mainly as a result of student summer work. If we look at the same quarter on quarter changes for 2000 and 2001 we see that employment growth in the third quarter has slowed significantly. Over the same period employment growth was 4 per cent in 2001 and 4.1 per cent in 2000. Seasonally adjusted data show that there is a decline in employment by over 6,000 in the third quarter indicating a considerable deterioration in Irish labour market conditions.

TABLE 8: Employment and Unemployment*

		Annual Averages '000		
	2000	**2001**	**2002**	**2003**
Agriculture	130	124	122	120

Industry	488	505	492	495
Services	1,075	1,114	1,147	1,156
Total at Work	**1,693**	**1,743**	**1,761**	**1,771**
Unemployed	76	71	83	97
Labour Force	**1,769**	**1,814**	**1,844**	**1,868**
Unemployment Rate %	4.3	3.9	4.5	5.2
Live Register	156	142	164	184

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

Most of the employment increase occurred in sectors like hotels and restaurants (11,800), wholesale and retail trade (11,200) and other production industries (11,100), where seasonal employment is significant. Public Administration and Defence sector employment growth slowed significantly in the third quarter. Employment in education, which increased significantly in the second quarter, declined by 5,100 in the third quarter. With the exception of education and services, all other sectors saw an absolute increase in the third quarter. However, compared to the same period last year, agriculture, other production industries, and the financial and other services sectors all saw an absolute decline. Most marked was the other production industries sector where employment declined by 5.1 per cent year on year. Supplementary data from the Industrial Employment release for March 2002, which gave preliminary estimates for June, also show a decline in employment in this sector of 2 per cent in the quarter and 3.8 per cent in the year. Labour force growth moderated somewhat and increased by 0.8 per cent on an annual basis in the third quarter to reach 1.88 million people. This was significantly lower than the increase of the previous year. Demographic factors including the increase in the population of working age and changes in its age structure added around 37,000 to the labour force but this was off-set to a large extent by decreases in participation particularly in the younger age group of 15-34 years.

The latest Live Register Analysis for November 2002 indicates that the register rose by 11,500 on a seasonally adjusted basis or 7.8 per cent in annual terms. The seasonally adjusted increase in the live register confirms the recent deterioration in labour market conditions. The standardised unemployment rate in November was 4.4 per cent, an increase on the 4.3 per cent posted in both September and October.

It is estimated that employment growth will average 1.1 per cent in 2002 and 0.6 per cent in 2003. Employment in the industrial and services sectors is expected to slow to just 0.5 and 0.8 per cent respectively in 2003. This is compared to the expected decline in industrial employment of 2.5 per cent and the growth of 3.0 per cent in services in 2002. Employment growth in the public sector will also slow dramatically in 2003 due to the cap placed on new recruitment announced in Budget 2003. The recent slowdown in employment growth reflects both the slowdown in the economy as well as the slowing of labour force growth, which is expected to decline from 1.7 per cent in 2002 to 1.3 per cent in 2003. We estimate an average unemployment rate of 4.5 per cent this year before rising to an average of 5.2 per cent in 2003. This is an upward revision from the previous *Commentary*. It is expected that unemployment will increase in the first half of 2003 before declining slightly as the economy recovers thereafter. This means that the total numbers unemployed will rise from an average of 83,000 this year to 97,000 in 2003. The numbers on the Live

Register are also expected to rise from an average of 164,000 in 2002 to 184,000 in 2003.

Incomes

On the basis of information available since the previous *Commentary* we have revised down our estimates for income growth in 2002. Slower economic activity than in recent years and an economic growth rate that has slowed over the course of the year should result in incomes growing more slowly.

Data from the *National Income and Expenditure Accounts* indicates that agricultural incomes grew by 5 per cent in 2001. Our projections suggest that 2002 was a more difficult year for agricultural incomes which are estimated to have fallen by 8.3 per cent. Some improvement is forecast for 2003 with agricultural incomes expected to grow by 7.2 per cent.

TABLE 9: Personal Disposable Income

Preliminary

	2000	Change		2001
	€m	%	€m	€m
Agriculture, etc.	3,157	5.0	158	3,315
Non-Agricultural Wages,	41,433	13.1	5,424	46,857
Other Non-Agricultural Income	14,656	-1.8	-266	14,390
Total Income Received	**59,246**	**9.0**	**5,316**	**64,562**
Current Transfers	9,756	16.8	1,639	11,395
Gross Personal Income	**69,002**	**10.1**	**6,955**	**75,957**
Direct Personal Taxes	13,745	6.2	852	14,597
Personal Disposable Income	**55,257**	**11.0**	**6,103**	**61,360**
Consumption	50,330	9.6	4,814	55,144
Personal Savings	4,926	26.2	1,289	6,216
Savings Ratio	8.9			10.1

Forecasts

	2001	Change		2002	Change		2003
	€m	%	€m	€m	%	€m	€m
Agriculture, etc.	3,315	-8.3	-275	3,040	7.2	220	3,260
Non-Agricultural Wages,	46,857	9.3	4,351	51,208	6.2	3,200	54,408
Other Non-Agricultural Income	14,390	-6.4	-922	13,468	11.0	1,481	14,949
Total Income Received	**64,562**	**4.9**	**3,154**	**67,716**	**7.2**	**4,901**	**72,617**
Current Transfers	11,395	17.1	1,953	13,348	14.6	1,955	15,303
Gross Personal Income	**75,957**	**6.7**	**5,107**	**81,064**	**8.5**	**6,856**	**87,920**
Direct Personal Taxes	14,597	1.0	153	14,750	6.2	921	15,671
Personal Disposable Income	**61,360**	**8.1**	**4,954**	**66,314**	**8.9**	**5,935**	**72,249**
Consumption	55,144	7.7	4,267	59,411	7.5	4,475	63,886
Personal Savings	6,216	11.0	687	6,903	21.1	1,460	8,363
Savings Ratio	10.1			10.4			11.6

Our forecasts of a more uncertain and weaker economic environment next year mean that we have revised downwards our forecast for wage growth. Growth in hourly earnings is now estimated at 7.9 per cent this year, slowing to 5.5 per cent in 2003. With the demand for labour forecast to slow in 2003 wage growth is likely to decline. The wage rates forecast for 2003 in this *Commentary*, coupled with forecast employment growth, imply that the labour share of national output will decline. The non-agricultural wage bill is forecast to grow by 9.3 per cent in this year, moderating to 6.2 per cent in 2003. These still represent strong increases in the forecast environment next year and reflect the labour market continuing to remain relatively tight in comparison to the 1990s. With unemployment expected to increase next year, the increase in the non-agricultural wage bill will grow more moderately.

Other non-agricultural incomes are estimated to have fallen by 1.8 per cent in 2001. This decline is projected to have continued into 2002 with a projected decline this year of 6.4 per cent. Recovery in economic activity should boost other non-agricultural incomes in 2003 which are forecast to grow by 11.0 per cent. A more cautious outlook is expected to result in personal savings as a share of disposable income increasing. Thus, the savings ratio is forecast to increase from 10.4 per cent this year to 11.6 per cent in 2003.

Consumer Prices

At an estimated 4.6 per cent the annual average increase in the consumer price index will be lower than that of 2001. However, the moderation is small and the rate of inflation has been consistently over 4 per cent since December last year. The EU Harmonised Index of Consumer Prices shows inflation in Ireland averaging 4.7 per cent to date this year. EU figures also show that Ireland has consistently had the highest inflation rate in Europe this year, generally twice the average prevailing in the EU and euro area. External pressure on inflation will have reduced following the appreciation of the euro. Details by broad commodity group indicate strong price growth in the domestic non-traded service sector has underpinned the overall increase in prices.

Forecast gradual appreciation in the euro during 2003 should put some downward pressure on inflation. The recent cut in interest rates by the ECB should reduce inflation from the housing component. However, we have revised upward our inflation forecast for 2003. As anticipated in the last *Commentary* indirect tax increases were announced in the Budget. These are estimated to add 0.85 percentage points to the annual rate of inflation. The effect of indirect taxes on inflation will be even higher in the first quarter of 2003 as it will include the impact of the increase in the VAT rate from last year's Budget which was implemented in March 2002. Further upward pressure will result from the increases announced for public service prices and our expectation of interest rate rises in late 2003. Thus, the consumer price index as a whole is forecast to increase by an annual rate of 5.1 per cent in 2003.

TABLE 10: Consumer Price Index – Recent Trend and Forecast

	Quarterly Trend								Annual			
	2000	2001				2002			2000	2001	2002	2003
	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3				
Index Nov. 1996=100												
Housing	111	114.2	117.8	118.4	114.7	112.6	114.5	116.3	99.6	116.0	117.0	123.8
Other	113.5	113.5	116.0	116.6	117.8	119.2	122.1	122.3	111.6	116.1	121.9	128.0
Total CPI	113.3	113.5	116.1	116.8	117.6	118.8	121.5	122.0	110.6	116.0	121.5	127.7
Annual % Change												
Housing	28.0	26.2	22.7	14.5	3.3	-0.2	-0.8	0.3	8.8	16.5	0.9	5.8
Other	5.6	3.8	4.2	3.7	3.8	5.0	5.3	4.8	5.4	4	5	5
Total CPI	7.0	5.3	5.4	4.6	3.8	4.7	4.7	4.5	5.6	4.9	4.6	5.1
Quarterly % Change												
Housing	7.4	2.9	3.2	0.5	-3.1	-0.1	1.7	1.6				
Other	1.0		2.2	0.5	1.0	1.1	2.5	0.1				
Total CPI	1.4	0.2	2.3	0.6	0.7	1.0	2.3	0.4				

Public Finances

The deterioration in the public finances from the exceptionally high surpluses of recent years to an anticipated period of deficits is reaffirmed in the Stability Programme Update that accompanies Budget 2003. The projection for the general government balance is for deficits to arise over the period 2002 to 2005. It remains the case that when measured by the debt to GDP ratio, the Irish debt burden is expected to remain among the lowest within the EU. In contrast to other EU states, Ireland is not expected to have difficulty in complying with the criteria in the Stability and Growth Pact for both fiscal deficit and debt positions over the medium term. However, the nature and scale of the economy means that a significant safety margin should prudently be maintained to ensure that a significant downturn in economic activity would not push the public finances beyond the deficit limits.

The opening position for the recent Budget for 2003 was a deficit of €2,000 million for the Exchequer balance and €642 million for the general government balance. The main measures contained in Budget 2003 are outlined in Box 2 below. The budgetary measures, when taken in line with the modest expenditure increases outlined in the Public Services Spending Estimates, are expected to be contractionary in their impact on the Irish economy in 2003.

Box 2: Summary of Measures Contained in Budget 2003

Budget 2003 delivered on December 4th could be described as a return to the traditional mix between tax and spending increases. The downward revisions in forecasted economic activity growth has meant that, unlike previous years, it is now no longer possible to increase expenditure while at the same time reducing tax rates. The Budget outlined a number of additional spending initiatives to those contained in the November Estimates, in the areas of social welfare, public sector pay and transport. These expenditures are largely financed out of a series of increased indirect taxation changes. In contrast to recent years, the changes in direct taxation were very modest.

The main provisions included an increase in employee tax credits from €660 to €800 and no changes in income tax rates or the standard income tax band. The mortgage interest relief ceiling for first time buyers was increased, as were the age exemption limits. The cost of these measures is estimated to be €141 million. The non-indexation of the bands means that this is an effective tax rise when expected wage growth is accounted for.

The PRSI ceiling increased from €38,740 to €40,420 or around 4.5 per cent, slightly lower than expected wage inflation. The lower rate of VAT increased by 1 percentage point to 13.5 per cent, which should yield revenues of about €187 million. Cigarettes increased by 50 cent per packet of twenty, spirits by 20 cent per measure and alcopops by 35 cent per bottle. Diesel increased by 3 cent per litre and the vehicle registration tax rates were restructured. These increased excise duties are estimated to boost revenues by €311 million. These collective increases in excise duties are expected to add about 0.85 per cent to the consumer price index. The standard rate of corporation tax was reduced from 16 per cent to 12.5 per cent.

There were also a number of changes in the stamp duty rates and thresholds for non-residential property. Stamp duty on credit and ATM cards also increased. In total all these stamp duty changes will bring in an additional €269 million to the Exchequer. Changes in capital gains payment dates and tax relief will net a further €270 million.

The expenditure measures announced were considerably less generous than in previous years. Gross spending on public services is estimated to increase by 5.7 per cent in 2003, bringing it to just over €38 billion. Budget day measures accounted for a large proportion of this increase. In particular, social inclusion measures received an extra €500 million on their pre-Budget estimate. This was mainly due to increases in social welfare, costing €395 million, and child benefit payments costing €79 million. The increase in public spending is also due to the €615 million set-aside for public sector pay under the backdated element of the Benchmarking report. In addition, increased spending on roads of €209 million was included in the Budget day measures.

The overall Budgetary package of expenditure amounted to just over €1.3 billion with revenues rising in the order of €950 million.

The Estimates provided for a 4 per cent increase in net voted current expenditure and a 7 per cent decline in net voted capital expenditure in 2003 over the forecast out-turn for 2002. Budget 2003 provided for increases in social welfare payments and public sector pay provisions, which brings the growth in net voted current expenditure to 7.9 per cent for 2003. An additional provision in the capital budget for 2003 for transport means that the decline in net capital expenditure is estimated to be 2.2 per cent.

The budgetary revenue raising measures were concentrated on indirect tax rises which will more than offset the announced expenditure rises in the Budget as they affect the Exchequer balance. The Exchequer deficit post-Budget is expected to decline by around €140 million from the opening position. In contrast, the general government deficit is expected to increase by around €240 million from the opening position. The differential effect on the balances reflects the impact of the budgetary changes on social welfare rates for the Social Insurance Fund, which is counted as part of the general government rather than as part of the Exchequer.

The overall impact of the Budget package of tax rises and expenditure increases provide no significant injection into the economy next year. The increase in supply services, both current and capital, is for a 5.7 per cent increase in gross expenditure and 6 per cent increase in net terms. Given our forecast for 2003 for economic growth in nominal terms of around 7 per cent, the supply services provided by central government will decline as share of overall activity next year. When price inflation in the public sector is accounted for, these increases provide for no increase in supply services in real terms.

Changes in the timing of payment dates for corporation tax and self-employed PAYE workers has resulted in strong revenue growth in the final quarter of 2002. Our revised forecast is for an Exchequer deficit of just over €300 million in 2002. The broader measure, the General Government balance, which includes the contributions to the National Pension Reserve Fund and the Social Insurance Fund, is expected to be around €500 million or 0.4 per cent of GDP in 2002. The general government debt is forecast to be 33.4 per cent in 2002.

We expect overall tax revenue growth of 4 per cent in 2003 boosted by the decision to increase the rate of VAT and to reschedule the timing of capital taxes. Current expenditure is expected to rise by over 10 per cent in 2003, made up of a strong rise in non-voted central fund expenditure of over 26 per cent and voted expenditure growth at over 8 per cent. Payments to the EU were lower in 2002 than expected but this is not expected to be repeated in 2003 so explaining the sharp rise in the non-voted expenditure category. The major item of growth in the voted current expenditure is accounted for by the provision for the public sector pay bill, which is expected to rise by 10.5 per cent if the backdated element of the Benchmarking awards is paid next year. Capital expenditure is expected to be down by nearly 2 per cent next year reflecting the decision to bring the overall public expenditure growth down to single digit rates from the high levels of recent years.

Given our growth forecast, the Exchequer balance for 2003 is projected to be close to €2 billion. We forecast that the more significant general government balance will be in deficit of €1 billion or 0.7 per cent of GDP. Given that we expect the economy to be below potential growth in 2003, deterioration in the share of the fiscal balance of GDP is to be expected. These projections do not include the on-going costs of the full Benchmarking pay awards, though payment in 2003 of the backdated element is provided for.

The gap between the Exchequer balance and the general government balance is not as wide in 2003 as we had predicted in previous Commentaries. Measures like the withdrawal of funds from the Social Insurance Fund and contributions from the Central Bank to the Exchequer are not to be repeated next year, although the Capital Services Redemption Account is again to make a contribution, this time of €250 million. The surplus on the Social Insurance Fund is expected to be €150 million lower than we anticipated, reflecting an upward revision to our unemployment forecast. Net borrowing of local authorities is expected to be €100 million more, reflecting costs associated with the National Development Plan. Lower dividends from the National Pension Reserve Fund and the accrual treatment of VAT returns also contribute towards narrowing the difference between the Exchequer and general government positions in 2003.

TABLE 11: Public Finances

	2001	% Change	2002	% Change	2003
Current Revenue	28,738	9.6	31,504	4.1	32,790

Current Expenditure	24,012	15.2	26,420	8.1	29,100
Current Surplus	**4,726**	7.6	**5,084**	-27.4	**3,690**
Capital Receipts	1,944	-18.9	1,576	-20.7	1,250
Capital Expenditure	6,020	15.9	6,976	-1.1	6,900
Capital Borrowing	**4,076**	32.5	**5,400**	4.6	**5,650**
Exchequer Balance	**650**		**-316**		**-1,960**
as % of GNP	0.7		-0.3		-1.8
General Government Balance	**1,776**		**-515**		**-1,000**
as % of GDP	1.6		-0.4		-0.7
Gross Debt as % of GDP	**36.4**		**33.4**		**32.5**

General Assessment

The Irish economy has proved to be remarkably resilient given the prevailing economic uncertainty that has affected the international economy throughout 2002. The economy grew by 5.5 per cent on an annual basis over the first half of the year in terms of real GDP. However, in terms of real GNP, which may better reflect the economy's base for income and taxation purposes, the growth was much lower at 2 per cent for the first half of 2002 on annual basis. There remains, however, considerable uncertainty about how deep the present international economic slowdown will be and for how long it will last. The outward-oriented industrial structure of the Irish economy means that international trade prospects are a critical determinant of the outlook for the domestic economy next year.

The prospects for a recovery emerging during the first half of next year have been boosted by the interest rate cuts in both the US and European economies. We estimate that the economy will have grown in real GDP terms at 4.3 per cent in 2002, driven in part by a strong performance of exports in the first half of the year, particularly in the Chemicals sector. Export growth has begun to slow in the latter half of the year but overall exports are still likely to have grown by nearly 4 per cent in real terms for 2002 as a whole. Our forecast for real GNP growth is 2.2 per cent for 2002.

The slowdown underway in the Irish economy is being driven by the sharp fall in world demand, a factor that is affecting all economies internationally. While growth has fallen in line with our trading partners, the appreciation of the euro over the year and the rise in the domestic cost structure is leading to losses in Irish competitiveness. The impact on unemployment has been masked by the substantial growth in public sector jobs over the year and by seasonal patterns. However, a strong upward trend in the rate of unemployment in the private sector is emerging. The decision by the Government to cap public sector job growth and to seek a fall of 5,000 posts over three years will in tandem with the downward employment trend in the private sector result in the unemployment rate rising significantly in 2003 as the economy continues to grow below potential levels.

The marked slowdown in tax revenue growth in 2001 was again apparent in income taxation for most of 2002. This reflected the slowing of activity in response to the various shocks and the impact of last year's stimulatory budget. The recent Budget 2003 was framed against the backdrop of the tightening public finance position. The size of the budgetary package was significantly lower compared to last year's, particularly with regard to the welfare measures, though the distributional impact still favours the lower income groups.

The impact of the budgetary changes and the estimates for public sector expenditure in 2003 reveal an underlying contractionary stance for fiscal policy. This stance would follow the pattern of pro-cyclical fiscal policy pursued in Ireland in recent decades. The restriction in expenditure growth falls most heavily on capital projects where substantial declines in real terms are forecast. The additional revenue sources, derived from increased indirect taxes, under-indexing of income tax bands, changes in the timing of capital taxes and contributions from the Capital Services Redemption Fund, have been mainly used to finance additional current spending rather than capital investment. While the sums allocated to capital investment as a share of output remain substantial by international standards, the more modest growth rates facing the Irish economy over the next few years will require real choices being made as to how government expenditure is allocated between consumption and investment purposes.

The Budget has marked a departure from tax cutting budgets of recent years towards the use of higher taxes to fund expenditure. Even with the modest fiscal contraction provided by Budget 2003, the growth prospects for next year depend upon the recovery in the international economy. We forecast that real GDP growth will be 3.8 per cent. This forecast, however, is based on a trajectory for the growth rate to approach potential rates by the year-end facilitated by an upturn in the global economy. GNP real growth will again be more modest at 2.2 per cent. The public finance position will continue to deteriorate with the general government deficit as a proportion of GDP rising from 0.4 per cent in 2002 to 0.7 per cent in 2003.

The budgetary process needs to go further than recognising that current expenditure growth be matched by taxation growth. It is imperative that sensible funding of capital investment growth is put in place to keep it immune from cyclical developments in the public finance position. The recent proposals from the European Commission to provide a more flexible interpretation of the Stability and Growth Pact rules may be opportune.

The Commission's proposals involve five main recommendations. First, that cyclically adjusted budgets would be used to assess the "close to balance or in surplus" condition, though breaches of the SGP still arise from unadjusted fiscal deficits greater than 3 per cent. Second, countries that are far from "close to balance" should reduce underlying deficits by 0.5 per cent per annum or be considered to be in breach of the rules. Third, countries are to avoid pro-cyclical loosening of policies in good times. Fourth, the public debt levels ought to be taken into account when deciding on the required levels of fiscal effort needed to balance budgets. Fifth, countries with low debt to GDP ratios could borrow to finance investment as opposed to current expenditure in a form of the "golden rule" as currently utilised in the UK.

The refinement in the interpretation of fiscal policy rules within the EU provides a helpful background for the pursuit of sensible fiscal rules for the Irish economy. Fiscal rules are never a panacea for deteriorating public finances. Greater efforts to utilise multi-annual expenditure plans, particularly for capital spending, are needed to ensure that budgetary policy remains consistent with policy priorities along with ensuring that publicly financed projects offer acceptable rates of return.