SUMMARY

The Quarterly National Accounts for the third quarter of 2005 show GNP to have increased by 7 per cent in volume terms since the same period in the previous year. The corresponding figure for GDP is 4.8 per cent. As the figures in earlier quarters had suggested a slower pace of economic growth, the Q3 figures point to an economy that is (a) performing well and (b) performing better than some had previously thought. We believe that this strong performance persisted for the remainder of 2005 and that it will continue into 2006. For 2005, we think GNP will have grown by 5.0 per cent and that GDP will have grown by 4.8 per cent. For 2006, we forecast growth in GNP of 4.8 per cent and 4.7 per cent for GDP.

Domestic demand was the main driver of growth in 2005 and will continue to be in 2006. We believe that consumption will have grown by 5.7 per cent in volume in 2005 and that investment will have grown by 7.9 per cent. We forecast an outturn for growth in exports of 2.7 per cent. When combined with our forecast for import volume growth of 3.6 per cent in 2006, we arrive at a forecast for the balance of payments current account deficit of 1.9 per cent of GNP in 2005.

In 2006, we expect consumption to continue to grow strongly, at a rate of 5.6 per cent. Investment growth should fall somewhat to 4 per cent as a result of a levelling off in construction. We expect an improved performance in exports, largely due to a pick-up in euro area growth rates but with imports growing more strongly, the current account deficit will rise again

Employment growth has been strong in 2005, with the *Quarterly National Household Survey* for Q3 showing year-on-year growth of 96,000 (or over 5 per cent). We expect further employment growth this year, although at a slower pace of around 60,000. While the growth in employment is to be welcomed, we remain concerned about the heavy reliance on construction.

We expect consumer price inflation to remain relatively low in 2006 and to average 2.6 per cent. With regard to interest rates, we expect rates to rise to 2.75 per cent by the middle of the year but to remain at that level for the remainder of the year. While we expect the sterling/euro exchange rate to remain broadly unchanged, we believe that the dollar will begin its long-anticipated decline and that an average dollar/euro rate of 1.30 will be observed.

While prospects for 2006 are good, it is important to keep in mind the threats that exist. As discussed in the Institute's recently published *Medium-Term Review*, the threats include global imbalances and the economy's exposure to shocks in the housing market.

As the next major economic policy issue to confront the Government will be the social partnership talks, we make the following recommendations: the maximum degree of wage flexibility should be provided for in the private sector and wage growth should be constrained in the public sector. With regard to the private sector, we argue that flexibility has been a characteristic of the labour market in spite of the national agreements and we argue that this has been highly desirable and so should continue. For the public sector, the evidence suggests that (a) public servants are relatively well paid and (b) have seen relatively high increases in recent years. Hence, we do not foresee that pay restraint would lead to recruitment or retention difficulties (at least in general in the public service) and so containing public service pay increases to rates below the private sector should be the objective.

PRELIMINARY NATIONAL ACCOUNTS 2004

A: Expenditure on Gross National Product

	2003	2004	Change in 2004				
		Preliminary	€m		%		
	€m	€m	Value	Volume	Value	Price	Volume
Private Consumer Expenditure	65,227	68,540	3,313	2,506	5.1	1.2	3.8
Public Net Current Expenditure	19,014	20,807	1,793	450	9.4	6.9	2.4
Gross Fixed Capital Formation	31,948	36,290	4,342	2,544	13.6	5.2	8.0
Exports of Goods and Services (X)	116,379	123,519	7,141	8,180	6.1	-0.8	7.0
Physical Changes in Stocks	1,218	793	-425	-452			
Final Demand	**233,786**	**249,949**	**16,163**	**13,227**	**6.9**	**1.2**	**5.7**
less:							
Imports of Goods and Services(M)	94,087	100,687	6,600	7,113	7.0	-0.5	7.6
less:							
Statistical Discrepancy	602	705	104	-107			
GDP at Market Prices	**139,097**	**148,556**	**9,460**	**6,222**	**6.8**	**2.2**	**4.5**
less:							
Net Factor Payments (F)	-22,723	-24,306	-1,583	-1,564	7.0	0.1	6.9
GNP at Market Prices	**116,374**	**124,250**	**7,876**	**4,658**	**6.8**	**2.7**	**4.0**

B: Gross National Product by Origin

	2003	2004	Change in 2004	
		Preliminary		
	€m	€m	€m	%
Agriculture, Forestry, Fishing	2,819	2,912	93	3.3
Non-Agricultural: Wages, etc.	53,484	58,220	4,736	8.9
Other:	52,201	54,289	2,089	4.0
Adjustments: Stock Appreciation	434	-309		
Statistical Discrepancy	602	705	104	17.2
Net Domestic Product	**109,539**	**115,818**	**6,280**	**5.7**
less:				
Net Factor Payments	22,723	24,306	1,583	7.0
National Income	**86,816**	**91,512**	**4,696**	**5.4**
Depreciation	14,646	15,749	1,103	7.5
GNP at Factor Cost	**101,462**	**107,261**	**5,799**	**5.7**
Taxes less Subsidies	14,912	16,989	2,077	13.9
GNP at Market Prices	**116,374**	**124,250**	**7,876**	**6.8**

C: Balance of Payments on Current Account

	2003	2004	Change in 2004
		Preliminary	
	€m	€m	€m
Exports (X) less Imports (M)	22,292	22,832	540
Net Factor Payments (F)	-22,723	-24,306	-1,583
Net Transfers	432	307	-125
Balance on Current Account	**1**	**-1,167**	**-1,168**
as % of GNP	0.0	-0.9	-0.9

FORECAST NATIONAL ACCOUNTS 2005

A: Expenditure on Gross National Product

	2004	2005	Change in 2005				
	Preliminary €m	Forecast €m	€m Value	€m Volume	% Value	% Price	% Volume
Private Consumer Expenditure	68,540	74,113	5,573	3,907	8.1	2.3	5.7
Public Net Current Expenditure	20,807	22,713	1,906	666	9.2	5.8	3.2
Gross Fixed Capital Formation	36,290	41,514	5,224	2,880	14.4	6.0	7.9
Exports of Goods and Services (X)	123,519	127,682	4,162	3,378	3.4	0.6	2.7
Physical Changes in Stocks	793	872	79	79			
Final Demand	**249,949**	**266,893**	**16,944**	**10,832**	**6.8**	**2.3**	**4.3**
less:							
Imports of Goods and Services (M)	100,687	105,432	4,744	3,645	4.7	1.1	3.6
less:							
Statistical Discrepancy	705	666	-40	14			
GDP at Market Prices	**148,556**	**160,796**	**12,239**	**7,173**	**8.2**	**3.3**	**4.8**
less:							
Net Factor Payments (F)	-24,306	-24,925	-619	-972	2.5	-1.4	4.0
GNP at Market Prices	**124,250**	**135,870**	**11,620**	**6,205**	**9.4**	**4.2**	**5.0**

B: Gross National Product by Origin

	2004	2005	Change in 2005	
	Preliminary €m	Forecast €m	€m	%
Agriculture, Forestry, Fishing	2,912	2,950	38	1.3
Non-Agricultural: Wages, etc.	58,220	64,235	6,014	10.3
Other:	54,289	57,362	3,073	5.7
Adjustments: Stock Appreciation	-309	-510		
Statistical Discrepancy	705	666	-40	-5.6
Net Domestic Product	**115,818**	**124,702**	**8,884**	**7.7**
less:				
Net Factor Payments	-24,306	-24,925	-619	2.5
National Income	**91,512**	**99,777**	**8,265**	**9.0**
Depreciation	15,749	17,038	1,289	8.2
GNP at Factor Cost	**107,261**	**116,815**	**9,554**	**8.9**
Taxes less Subsidies	16,989	19,055	2,066	12.2
GNP at Market Prices	**124,250**	**135,870**	**11,620**	**9.4**

C: Balance of Payments on Current Account

	2004	2005	Change in 2005
	€m	Forecast €m	€m
Exports (X) less Imports (M)	22,832	22,250	-582
Net Factor Payments (F)	-24,306	-24,925	-619
Net Transfers	307	129	-178
Balance on Current Account	**-1,167**	**-2,546**	**-1,379**
as % of GNP	-0.9	-1.9	-0.9

FORECAST NATIONAL ACCOUNTS 2006

A: Expenditure on Gross National Product

	2005	2006	Change in 2006				
	Preliminary €m	Forecast €m	€m		%		
			Value	Volume	Value	Price	Volume
Private Consumer Expenditure	74,113	80,298	6,185	4,150	8.3	2.6	5.6
Public Net Current Expenditure	22,713	24,973	2,260	795	9.9	6.2	3.5
Gross Fixed Capital Formation	41,514	44,584	3,070	1,671	7.4	3.2	4.0
Exports of Goods and Services (X)	127,682	135,250	7,568	5,936	5.9	1.2	4.6
Physical Changes in Stocks	872	959	87	87			
Final Demand	**266,893**	**286,064**	**19,171**	**12,680**	**7.2**	**2.3**	**4.8**
less:							
Imports of Goods and Services (M)	105,432	112,640	7,208	5,147	6.8	1.9	4.9
less:							
Statistical Discrepancy	666	167	-499	39			
GDP at Market Prices	**160,796**	**173,258**	**12,462**	**7,494**	**7.7**	**3.0**	**4.7**
less:							
Net Factor Payments (F)	24,925	26,885	1,959	997	7.9	3.7	4.0
GNP at Market Prices	**135,870**	**146,373**	**10,502**	**6,511**	**7.7**	**2.8**	**4.8**

B: Gross National Product by Origin

	2005	2006	Change in 2006	
	Preliminary €m	Forecast €m	€m	%
Agriculture, Forestry, Fishing	2,950	3,009	59	2.0
Non-Agricultural: Wages, etc.	64,235	69,690	5,456	8.5
Other:	57,362	62,266	4,904	8.5
Adjustments: Stock Appreciation	-510	-450		
Statistical Discrepancy	666	167	-499	-74.9
Net Domestic Product	**124,702**	**134,682**	**9,980**	**8.0**
less:				
Net Factor Payments	24,925	26,885	1,959	7.9
National Income	**99,777**	**107,798**	**8,021**	**8.0**
Depreciation	17,038	18,294	1,256	7.4
GNP at Factor Cost	**116,815**	**126,092**	**9,276**	**7.9**
Taxes less Subsidies	19,055	20,281	1,226	6.4
GNP at Market Prices	**135,870**	**146,373**	**10,502**	**7.7**

C: Balance of Payments on Current Account

	2005	2006	Change in 2006
	€m	Forecast €m	€m
Exports (X) less Imports (M)	22,250	22,610	360
Net Factor Payments (F)	-24,925	-26,885	-1,959
Net Transfers	129	240	111
Balance on Current Account	**-2,546**	**-4,034**	**-1,488**
as % of GNP	-1.9	-2.8	-0.9

The International Economy

General

Moving into 2006, the international situation facing Ireland is generally favourable. As with 2005, the US and China should continue to perform well, with Japan also maintaining recent gains in its economic performance. Unlike recent times, the euro area is also showing signs of recovery thereby acting as a further positive stimulus for Ireland in 2006. The UK entered a period of lower growth in 2005 and growth for the year is likely to be around 1.7 per cent. However, an upturn for 2006 is forecast with growth expected to be around 2.3 per cent.

US Economy

Most indicators suggest that the strong growth recorded in the US economy in 2004 has continued well into 2005 also. GDP volume grew by 3.6 per cent year on year in the third quarter, unchanged from the previous quarter's growth rate. This means that growth averaged 3.6 per cent year on year in the first nine months of 2005, slightly lower than the robust 4.2 per cent expansion recorded overall in 2004. Domestic demand is extremely robust; household consumption expenditure rose by 3.8 per cent in volume terms in the third quarter of 2005, similar to the 3.9 per cent growth of the previous three-month period. Spending on consumer durables showed particular strength. Investment demand is experiencing even stronger growth, rising by 4.1 per cent in the third quarter of 2005, with acquisitions of Equipment and Software by firms exhibiting quite rapid growth. Current government spending is the weakest area of domestic demand. It rose by 2.0 per cent in the third quarter of 2005. The volume of US exports rose by 6.9 per cent year on year in the third quarter of 2005, slightly down on the previous quarter's 7.7 per cent growth. Import volumes grew by 5.1 per cent in the third quarter of 2005, a slight deceleration on the 5.7 per cent growth in the second quarter.

Concerns over inflation have cast a shadow over the strong performance of the US economy as gauged by measures like GDP. Consumer Price Index (CPI) inflation hit 4.7 per cent in September 2005, the highest rate recorded since June 1991. The record highs reached by fuel prices in the early autumn were largely responsible for this surge in the economy wide price level. Inflation has decelerated since September, but the general trend is decidedly upward. Concerns about inflation and overheating have prompted the Federal Reserve to increase interest rates on thirteen occasions between June 2004 and December 2005, a cumulative rise of 3.25 percentage points.

The strong output growth has been mirrored by developments in the labour market. The unemployment rate was 5.0 per cent in the quarter ended November 2005, unchanged from the previous three-month period. Growth in house prices is also very robust, with values increasing by 12.0 per cent year on year in the third quarter of 2005, compared with the previous quarter's 14.0 per cent growth.

Strong demand in the US economy pushed the goods trade deficit to a new record in the third quarter of 2005. The deficit now stands at $197.9 billion, from $186.9 billion in the previous quarter. This represents over 6 per cent of GDP. Improvements in the services, incomes and transfers balances more than counterbalanced the deterioration in net trade, meaning that the Current Account deficit fell to $195.8 billion in the third quarter from $197.8 billion in the previous quarter, equivalent to about 6 per cent of GDP. Despite such large shortfalls, net foreign demand for US assets has been sufficient to finance the deficit, and this helped to take the US Dollar to two-year highs against both UK Sterling and the Euro in the final months of 2005.

Growth in the US economy is expected to remain strong. GDP growth is likely to have averaged 3.6 per cent in 2005, and will remain at a similar rate in 2006 (3.5 per cent).

The European Economy

Euro Area

There are indications that the euro area economy entered a more positive phase in the second half of 2005. In the third quarter, GDP grew by 1.6 per cent year on year. This is in contrast to the 1.2 per cent growth rate recorded in the previous three-month period. Investment expanded at a rate of 3.2 per cent, representing an acceleration on the previous quarter's 1.9 per cent increase. The volume of household consumption rose by 1.5 per cent year on year in the third quarter of 2005, similar to the 1.4 per cent growth rate in the second quarter. Government consumption accelerated from 1.1 per growth in the second quarter to 1.4 per cent growth in the third quarter.

External trading activity increased in the third quarter of 2005 when compared with the second quarter. The volume of exports expanded at a 5.2 per cent rate in the third quarter, a strong improvement on the previous quarter's 2.9 per cent growth rate. The volume of imports rose by 5.2 per cent in the third quarter, up from 4.4 per cent growth over the previous three months.

The improving situation with regard to demand and output in the euro area is corroborated by employment data. The rate of unemployment fell to 8.3 per cent of the labour force in the quarter ended October 2005, down from 8.6 per cent in the previous three months. The overall trajectory indicates that unemployment in the euro area is on a downtrend, albeit a slight one. Despite the slowly tightening situation regarding the labour market, there is no evidence yet of serious wage pressures. Hourly labour cost growth fell from 2.5 per cent in the second quarter of 2005 to a 2.2 per cent rate in the third. With regard to consumer prices, the recent situation has been mixed. The annual consumer price increase in August was 2.2 per cent; this rose to 2.6 per cent in September but has since fallen back to 2.3 per cent in November. The main reason for this movement was fuel. When volatile components such as food and energy products are excluded from the measured inflation rate, the inflationary picture is far more benign. Despite this, concern about future inflation prompted the European Central Bank to raise interest rates by 25 basis points in December, the first increase in rates since July 2000. It is possible that further rate rises will occur in 2006.

Developments in Germany, which account for about 30 per cent of euro area GDP, are the key drivers of the rebound in economic fortunes in the single currency zone. GDP growth accelerated to 1.4 per cent year on year in the third quarter, from a near negligible 0.7 per cent growth rate in the previous quarter. There are indications that the recovery persisted into the fourth quarter of 2005, with positive consumer and business sentiment surveys as well as employment data possibly acting as a prelude to further solid GDP growth.

France is the second largest euro area economy and, like Germany, is expected to experience more rapid growth in 2006 relative to 2005. Relative to Germany, domestic demand has not been as flat in France but French exports have been growing more slowly than Germany exports. For this reason, expectations of an improved export performance partly underpin the 2006 forecast for France. Italy's economy remains very weak, with zero growth recorded in the third quarter of 2005, even less than the 0.1 per cent GDP growth rate in the second quarter.

Overall, GDP growth is likely to average 1.4 per cent for 2005. The upturn in domestic demand will propel growth higher in 2006, with a 2.1 per cent rise forecast. Inflation will remain close to the ECB's 2 per cent target, with prices rising by 2.1 per cent in 2006.

UK Economy

Growth in the UK economy in 2005 was weak relative to recent years. GDP increased by 1.7 per cent year on year in the third quarter of 2005, slightly faster than the previous quarter's 1.5 per cent rate. Household consumption grew by 1.6 per cent, with the volume of current government consumption rising by 1.6 per cent also. The volume of investment rose at a fairly substantial 2.8 per cent rate, up from a 2.2 per cent growth rate in the second quarter. External demand is growing more strongly; the volume of exports expanded by 5.6 per cent year on year in the third quarter of 2005, while import volumes increased by 5.1 per cent. Overall, domestic demand increased by 1.7 per cent.

Despite the hikes in fuel prices that occurred in 2005, the lacklustre performance of the UK economy has helped to dampen inflationary pressures. In the three months to November, prices rose at a rate of 2.3 per cent, only slightly higher than the previous quarter's inflation rate. Inflation is concentrated in the labour intense services sector, which is being squeezed by the UK's relatively low rate of unemployment. Prices of goods like clothing and telecommunications continue to fall. The largely benign situation with regard to inflation has led the Bank of England to cut interest rates. Rates were cut by 25 basis points in August in order to stimulate demand in the economy and bring growth back up to potential. Further rate cuts may occur during 2006.

The UK economy's external position deteriorated in the third quarter of 2005 and the current account deficit is expected to be 2.1 per cent of GDP. Despite a period of weakness that began in the middle of 2004, there are some signs of recovery in UK house prices. Price growth hit a trough in September, and momentum has slowly been gained since. According to the *Nationwide* house price index, growth was 2.9 per cent year on year in the final quarter of 2005. Any sustained recovery is likely to impact positively on consumer sentiment, and would boost domestic demand in the UK economy.

Both the Bank of England and the Treasury have revised their growth forecasts down sharply, in light of the deceleration of growth in the UK economy. Our forecast is for GDP growth to average 1.7 per cent in 2005, but a sharp pick up will occur in 2006, with growth rising to 2.3 per cent. Inflationary pressures will increase in line with the acceleration of growth. Consumer price inflation is forecast to be 2.4 per cent in 2006.

The Rest of Europe

A strong rebound of growth has occurred in the Scandinavian countries. Third quarter GDP grew by 4.8 per cent in Denmark, while Sweden's economy expanded by 3.4 per cent over the same period. Inflation remains low in both economies. Growth in Switzerland is at a solid 2.3 per cent rate accompanied by an inflation rate of around 1.0 per cent.

Economic growth is very rapid in several Eastern European economies. The Baltic states are experiencing a rapid pace of growth, with Latvia's economy growing by 9.1 per cent. Hungary and the Czech Republic are both rising at close to 4.0 per cent annually. Poland's economy grew by 4.8 per cent year on year in the third quarter of 2005, though it continues to be plagued by high unemployment. The high price of fuels has acted as a fillip to Russia's economic output, and year on year growth was 6.4 per cent in the third quarter of 2005.

Rest of the World

Japan's economy appears to have entered a sustained recovery from recent weaknesses and significant growth of 2.9 per cent year on year was recorded in the third quarter of 2005. This was supported by household consumption growth of 2.0 per cent and a very strong increase in investment by firms of 8.0 per cent. The rate of unemployment is 4.5 per cent, slightly lower than a year ago. There is no sign that Japan's long bout of deflation is coming to an end, with prices falling by 0.7 per cent year on year in October 2005. Economic growth is likely to average 2.4 per cent in 2005, with 2.0 per cent growth forecast for next year.

China's economy continues to expand rapidly, driven by strong rises in export volumes and investment. GDP is estimated to have increased by 9.4 per cent in the third quarter of 2005. Consumer price growth remains modest with an inflation rate of 2.4 per cent in December. The extremely competitive nature of China's economy is the key to its success as an exporting nation. Its trade surplus was worth $38.4 billion in the year to January 2005. An economic census recently conducted in China revealed that the private sector is larger than previously thought, and this has resulted in an upward revision to the level of China's GDP.

Context for Ireland

The expected recovery in the euro area (which accounts for around 45 per cent of Ireland's exports) will help to bolster demand for Irish exports from that source. Continued solid growth in the US economy (around 20 per cent of exports) will add a further positive impetus. However, we believe that the dollar will depreciate moderately against the euro in 2006, thereby erasing some of the positive impact of US growth. With the UK growth rate increasing in 2006 relative to 2005, it too will provide a positive impetus (about 17 per cent of exports). In spite of all these positives, we forecast that exports will grow in volume terms by 4.6 per cent in 2006, well below the forecast for growth in world trade volumes in 2006 of 6.7 per cent. This forecast is in line with the recent experience of Ireland losing market share for world exports possibly because of a loss in competitiveness.

Figure 1: Interest Rates

Per Cent per Annum, Quarterly Averages

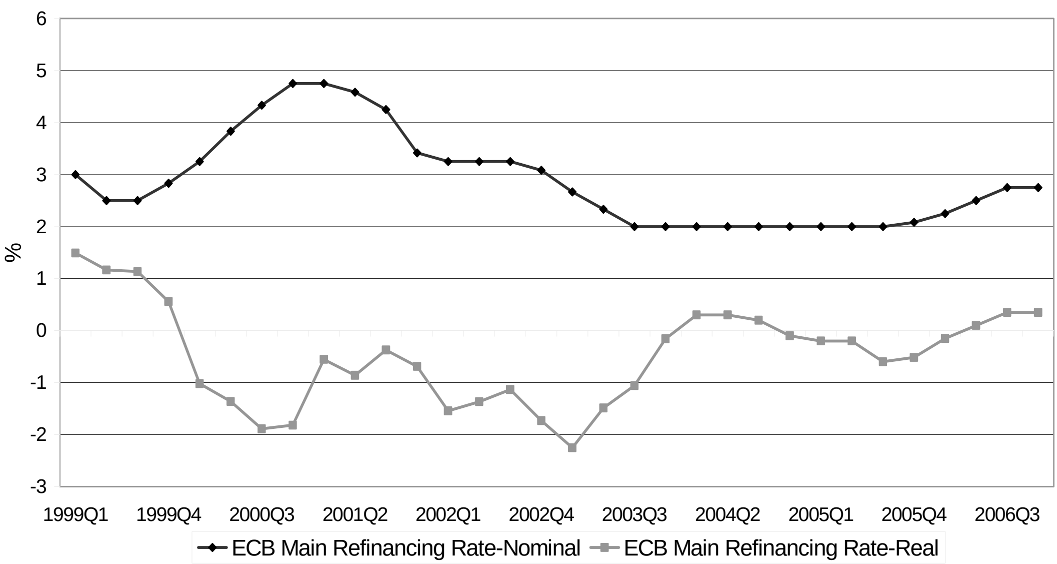
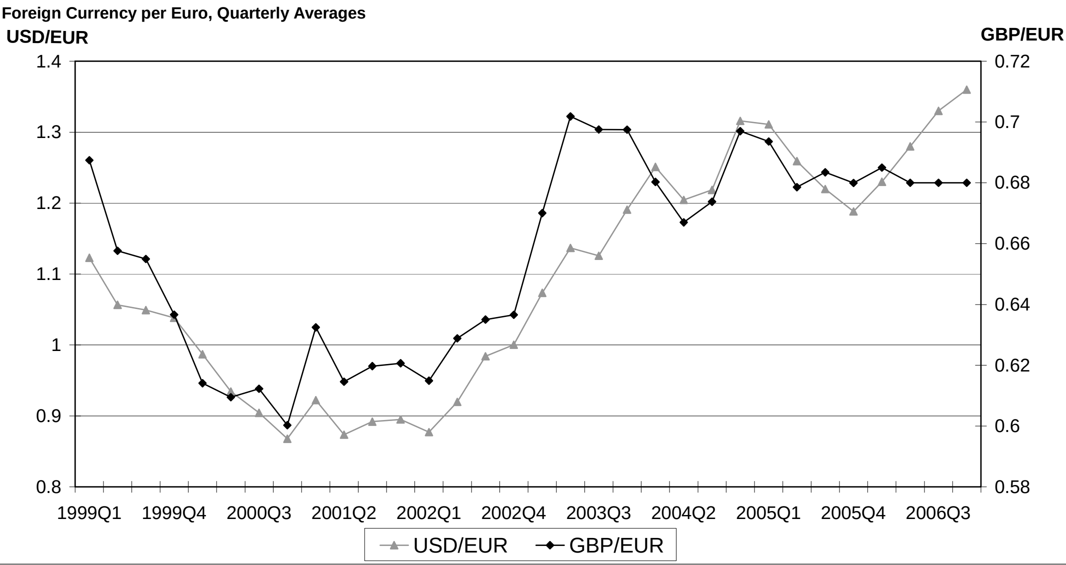


TABLE 1: Short-term International Outlook (sourced from OECD Economic Outlook, November 2005, National Institute Economic Review October 2005 and Own Forecasts)

	GDP Output Growth			Consumer Price Inflation			Hourly Earnings Growth			Unemployment Rate %			Current Account Balance % of GNP		
Country	**2004**	**2005**	**2006**	**2004**	**2005**	**2006**	**2004**	**2005**	**2006**	**2004**	**2005**	**2006**	**2004**	**2005**	**2006**
UK	3.2	1.7	2.3	1.4	2.1	2.4	4.4	4.4	4.8	4.7	4.8	5.1	-2.0	-2.1	-2.2
Germany	1.1	1.1	1.8	1.8	1.9	1.7	-0.3	-0.3	1.2	9.6	9.3	9.1			
France	2.0	1.6	2.1	2.3	1.9	1.7	2.7	2.2	2.7	10.0	10	9.6			
Italy	0.9	0.2	1.1	2.3	2.2	2.7	3.0	2.6	2.2	8.1	7.7	7.5			
Euro Area	1.8	1.4	2.1	2.1	2.2	2.1	2.2	2.2	2.9	8.8	8.7	8.4	0.6	-0.2	-0.3
USA	4.2	3.6	3.5	2.7	3.4	2.8	4.6	4.6	5.0	5.5	5.1	4.8	-5.7	-6.4	-6.4
Japan	2.7	2.4	2.0	0	-0.3	0.1	-0.6	2.4	1.1	4.7	4.4	3.9	3.7	3.5	4.0
China	9.5	9.8	9.0	3.9	1.9	2.0							4.2	6.1	6.5
OECD	3.3	2.7	2.9	2.1	2.3	1.9				6.9	6.5	6.3	-1.4	-1.9	-1.9
Ireland	4.5	4.8	4.7	2.2	2.5	2.6	5.3	5.0	4.8	4.4	4.2	4.2	-0.9	-1.9	-2.8

Figure 2: Exchange Rates



The Domestic Economy

General

Growth in the Irish economy remains firm, with GDP volume growth of 4.8 per cent year on year in the third quarter of 2005, and GNP volume rising by 7.0 per cent. Domestic demand is driving growth, with household consumption and investment particularly strong. Net external demand continues to impact negatively on economic growth with the import growth significantly outstripping the growth in exports. House building remains at a high and growing level, and housing investment now accounts for almost 14 per cent of Irish economic activity. Employment growth is strong, increasing by 4.4 per cent on an annualised basis up to the third quarter of 2005.

Consumption

Personal consumption growth has been strong in 2005 and has been accelerating through the year. The volume of household consumption rose by 4.9 per cent on an annualised basis up to the third quarter of 2005, compared with a 4.4 per cent annualised growth rate in the second quarter. This represents strong spending behaviour by consumers. In terms of value, consumption rose by 6.7 per cent up to the third quarter of 2005, compared with a 5.9 per cent annualised growth rate in the previous quarter.

Retail sales data, which cover a smaller range of categories than the consumption figures, also point to strong spending. In the third quarter of 2005, the volume of retail sales rose by 4.9 per cent year on year against 3.9 per cent growth in the previous quarter. Excluding motor trade the growth in retail sales was even stronger, at 5.6 per cent year on year in the third quarter. Despite this lower growth in the motor trade, new private cars licenced in the period January to November 2005 increased by over 11 per cent. Expenditure in Department stores was very strong with an 8.9 per cent increase in the volume of sales recorded.

The increasing buoyancy of consumers' activity is due to several factors. Strong employment growth is a key driver. Low real interest rates act as an incentive to borrow, with non-mortgage private sector credit increasing by 30.0 per cent year on year in the quarter ended November 2005. Solid and accelerating house price growth acts as a further boost to consumer confidence. House price inflation is currently running at 8 per cent per annum for the first eleven months of the year as estimated by the latest TSB/ESRI house price index. While this is slightly lower than the rate recorded in the same period in 2004 it does represent an acceleration through the year.

Growth in consumer spending is expected to be 5.7 per cent in 2005, before slowing slightly to 5.6 per cent in 2006. Underlying these forecasts is an assumption that anticipated increases in ECB interest rates in 2006 will not have a major impact on consumer demand.

Investment

Investment growth in the Irish economy continues at a very rapid pace. The volume of investment rose on an annualised basis by 7.6 per cent up to the third quarter of 2005, by far the fastest growing category of expenditure. Together with personal consumption, investment is driving the growth in domestic demand and economic growth generally.

House construction remains a major component of investment. Despite a succession of record house completions over the last number of years, it seems likely that house-building activity in 2005 was even higher than in the previous year. Total completions in the first ten months of 2005 were 62,248, 2.3 per cent higher than the same period of 2004. House building has accelerated in recent months, with completions up 9.6 per cent year on year in the quarter ended October 2005. Planning permission data suggest that residential construction activity may soon level off; permissions for dwellings fell by 2.1 per cent year on year in the third quarter of 2005, although permits for extensions rose by 9.8 per cent over the same period. The strength of demand for residential investment is evidenced by the trend in residential mortgage lending to Irish residents. It increased by 26.1 per cent year on year in the quarter ended November 2005.

The value of total capital acquisitions by the industrial sector grew by 13.0 per cent year on year in the second quarter of 2005. Additions to the stock of Land and Buildings were particularly strong, growing by 25.2 per cent. Acquisitions of Machinery and Equipment rose by 9.8 per cent over the same period.

TABLE 2: Gross Fixed Capital Formation

	2003 €m	% Change in 2004		2004 €m	% Change in 2005		2005 €m	% Change in 2006		2006 €m
		Volume	Value		Volume	Value		Volume	Value	
Housing	13,785	12.9	23.0	16,956	2.0	10.7	18,766	-1.0	3.0	19,321
Other Building	9,443	3.4	7.8	10,183	15.0	23.1	12,530	8.0	12.3	14,073
Building and Construction	23,228	9.1	16.8	27,139	7.0	15.3	31,296	2.7	6.7	33,395
Machinery and Equipment	8,720	5.0	4.9	9,151	10.5	11.7	10,218	7.5	9.5	11,189
Total	31,948	8.0	13.6	36,290	7.9	14.4	41,514	4.0	7.4	44,584

House building is projected to level off in 2006, with a 1.0 per cent drop in output forecast. Investment in other building will continue to grow strongly by a projected 8.0 per cent in 2006, so that the construction sector will continue to expand despite the slowdown in housing. Investment in Machinery and Equipment is forecast to grow strongly again in 2006. Growth was 10.5 per cent in 2005, and a 7.5 per cent increase will take place in 2006. Overall investment is estimated to have risen by 7.9 per cent in 2005, and is projected to expand by 4.0 per cent in 2006.

Government Spending and Public Finances

The Exchequer returns for 2005 (published in January 2006) show the public finances to be in a healthy state. Tax revenue for the year was €39.3 billion, €1.75 billion ahead of profile. As spending came in under profile, the Exchequer deficit for the year was substantially lower than had been anticipated at the time of Budget 2005 (i.e., December 2004). While the projection in 2004 was for an Exchequer deficit of €3 billion in 2005, the figure turned out to be €500 million.

That tax revenues were running ahead of profile was already signalled at the time of the framing of Budget 2006 and this provided the Minister with the scope for extra spending and also for tax concessions. Current expenditure is projected to rise by 12.9 per cent in nominal terms, with capital spending (excluding FEOGA payments) projected to rise by 12.3 per cent. However, with current revenue expected to increase by only 5.9 per cent, the Exchequer deficit is forecast by the Department of Finance to be €3 billion for the year.

In terms of the General Government Balance, the outturn for 2006 is projected to be a deficit of €1040 million, or -0.6 per cent of GDP. Much of the difference of €2 billion between the Exchequer balance and the GGB is made up of payments to the National Pensions Reserve Fund. For 2006, an envisaged payment of €400 million by the Exchequer in respect of nursing home charges will not be recorded as expenditure in GGB terms, since, in line with a Eurostat ruling of August 2005, the full €1 billion liability was accrued forward to 2005 and recorded as GGB expenditure in that year. It is envisaged that further amounts of €300 million will be paid out in each of the years 2007 and 2008. In 2006-2008, the GGB will thus be improved, compared to the Exchequer balance by the amounts actually paid out from the Exchequer.

At a time such as this of high economic growth, it might have been more prudent for the Minister to plan for an Exchequer surplus in 2006. Principles of macroeconomic management would suggest that it is preferable not to add demand to an economy that is performing strongly as this can lead to inflationary pressures. In addition, it is useful to build up reserves so that demand can be expanded should an economic downturn occur. However it would be naïve to ignore the realities regarding the stage of the political cycle and their influence on the stance adopted in the Budget. In addition, the tax projections underpinning the Department of

Finance projections for the overall fiscal stance could once again turn out to be conservative, so that the Exchequer deficit may well be lower at the end of the year.

As regards the micro-economic elements of the Budget, we would broadly welcome many of the measures. For example, the movement of lower paid workers out of the tax net and of other workers out of the top tax tier provides the correct incentive with respect to employment in an economy with a tight labour market. Similarly, the proposals in respect of childcare should contribute, even if only marginally, to easing this constraint on labour force participation. Finally, the proposals in respect of third level suggest a commitment on the part of government towards enhanced efforts at human capital formation and the development of a knowledge-based economy.

Turning to the National Account projections for government consumption, we forecast a volume increase of 3.5 per cent in 2006, ahead of the 2005 figure of 3.2 per cent.

TABLE 3: Public Finances

	2004	% Change	2005	% Change	2006
Current Revenue	36,383	9.5	39,849	5.9	42,220
Current Expenditure	30,764	8.9	33,496	12.9	37,823
Current Surplus	**5,619**	**13.1**	**6,353**	**-30.8**	**4,397**
Capital Receipts	1,142	-12.9	995	82.8	1,819
Capital Expenditure	6,729	16.6	7,847	16.5	9,143
Capital Borrowing	**-5,587**	**22.7**	**-6,852**	**6.9**	**-7,324**
Exchequer Balance	**33**		**-499**		**-2,927**
as % of GNP	0.0		-0.4		-2.0
General Government Balance	**2,117**		**643**		**-1,040**
as % of GDP	1.4		0.4		-0.6
General Government Debt as % of GDP	**29.4**		**27.4**		**27.2**

Exports

Irish exports have performed poorly in 2005. The volume of exports rose by 3.5 per cent year on year in the third quarter of 2005 but the first two quarters of the year showed a different story, with a year on year decline in quarter 1 (-1.2 per cent) and no change in the second quarter. In value terms, total exports rose by 4.2 per cent in the third quarter of 2005, with unit export prices rising by 0.7 per cent over the same period, a slight acceleration on the 0.4 per cent growth of the previous quarter.

The value of goods exports rose by 6.2 per cent in the quarter ended October 2005, faster than the 3.6 per cent growth of the previous three months. However, this is due largely to an improvement in prices rather than volumes. Goods export prices rose by 3.5 per cent year on year in the three-month period ended in September, much stronger than the 0.4 per cent increase which took place in the previous quarter.

TABLE 4: Exports of Goods and Services

	2003	% Change in 2004		2004	% Change in 2005		2005	% Change in 2006		2006
	€m	Volume	Value	€m	Volume	Value	€m	Volume	Value	€m
Agricultural	4,251	10.2	8.0	4,592	2.2	1.7	4,669	3.0	3.5	4,834
Manufactured	70,556	3.8	1.7	71,740	1.5	1.0	72,453	4.1	4.6	75,800
Other Industrial	6,319	13.7	11.4	7,038	1.5	1.0	7,108	4.0	4.5	7,429
Other	950	-3.5	-5.4	899	2.0	2.5	921	3.5	4.0	958
Total Visible	**82,076**	**4.8**	**2.7**	**84,269**	**1.5**	**1.0**	**85151**	**4.0**	**4.5**	**89,021**
Adjustments	-3762			-4,040			-4,200			-4,400
Merchandise	**78,314**	**4.8**	**2.4**	**80,229**	**1.5**	**0.9**	**80,951**	**4.0**	**4.5**	**84,621**
Tourism	3,409	-0.8	1.1	3,445	5.0	7.1	3,690	3.0	5.6	3,895
Other Services	33,724	12.9	14.9	38,758	5.0	8.2	41,917	6.0	8.6	45,543
Exports of Goods and Services	**115,447**	**7.0**	**6.1**	**122,432**	**2.7**	**3.4**	**126,558**	**4.6**	**5.9**	**134,059**

Exports to the UK fell particularly sharply, in line with the slowdown in that economy. In the quarter ended September 2005, the value of goods exports to the UK plummeted by 6.8 per cent, having fallen by 1.1 per cent in the previous quarter. The recovery in several European economies may already be benefiting Ireland's export sector. The value of goods exports to the rest of the European Union rose by a very strong 10.3 per cent year on year in the third quarter of 2005, having increased by 7.7 per cent in the second quarter. Goods export growth to North America is weak, though the 0.9 per cent growth rate recorded in the third quarter of 2005 represents an improvement on the 3.4 per cent contraction experienced in the previous quarter.

For 2005, we believe that exports will have risen by 2.7 per cent in volume, a figure that is well down on the 2004 figure of 7 per cent. While the comparison with 2004 is worrying, a comparison with trends in world export growth is perhaps more revealing. According to the European Forecasting Network (EFN) autumn projections, the volume of world trade is forecast to have grown by 6.1 per cent in 2005. With Ireland's exports only growing by 2.7 per cent, we are losing market share in world exports. According to that same report, this loss in Ireland's share began in 2002 and our share of world trade is about 5 per cent lower now than it was in 2002. Although we forecast some recovery in export volumes in 2006 (with a volume increase of 4.6 per cent), this is below the EFN forecast for the increase in world trade (6.7 per cent) and so Ireland's share is projected to continue falling. This clearly has implications for our trade balance and we return to this below.

Imports

The volume of imports rose by 3.4 per cent on an annualised basis up to the third quarter of 2005. Year on year growth rates indicate that in more recent months there has been an upswing in imports. This acceleration coincides with an improvement in the performance of exports, whose import content tends to be quite high. It may also have been driven by the strong expansion in spending by Irish households. Import price growth remains weak, with unit prices rising by only 0.2 per cent year on year in the third quarter of 2005. The overall increase in the value of imports on an annualised basis was 3.7 per cent up to the third quarter of 2005, much stronger than the equivalent 1.2 per cent growth of the previous quarter.

Goods imports are particularly strong. In the third quarter of 2005, volumes rose by 7.4 per cent, slightly down on the 8.7 per cent growth in the previous three months. Falls in the prices of mass produced manufactured items like clothing and electrical equipment more than outweighed increases in the cost of fuel imports. Accordingly, the price of imported goods fell by 2.1 per cent year on year in the third quarter of 2005, a much sharper contraction than the 0.3 per cent fall in the previous three-month period. The overall value of goods imports rose by 4.6 per cent in the quarter ended October 2005, a slowdown on the 5.9 per cent growth rate of the previous quarter.

TABLE 5: Imports of Goods and Services

	% Change in 2004		2004	% Change in 2005		2005	% Change in 2006		2006
	Volume	**Value**	**€m**	**Volume**	**Value**	**€m**	**Volume**	**Value**	**€m**
Capital Goods	14.1	15.0	6,617	6.0	6.5	7,049	5.2	7.5	7,578
Consumer Goods	3.6	3.8	13,172	7.0	8.1	14,235	6.0	7.6	15,315
Intermediate Goods:									
Agriculture	9.5	10.1	1,090	4.0	3.8	1,131	4.0	6.2	1,201
Other	6.0	5.5	28,031	4.5	4.3	29,234	6.0	7.6	31,453
Other Goods	14.2	14.8	2,125	4.0	3.8	2,205	4.0	5.6	2,328
Total Visible	**6.7**	**6.6**	**51,034**	**5.3**	**5.5**	**53,854**	**5.8**	**7.5**	**57,875**
Adjustments			-2,617			-2,800			-2,950
Merchandise Imports	**6.7**	**5.9**	**48,417**	**5.3**	**5.4**	**51,054**	**5.8**	**7.6**	**54,925**
Tourism	1.4	-0.2	4,181	6.0	7.4	4,489	4.5	6.7	4,790
Other Services	9.5	8.4	47,742	1.7	3.7	49,525	4.0	6.1	52,536
Imports of Goods and Services	**7.8**	**6.8**	**100,340**	**3.6**	**4.7**	**105,068**	**4.9**	**6.8**	**112,251**

The growth rate of value of goods imports from several economies has slowed sharply in recent months. Goods imports from the UK rose by 1.9 per cent year on year in the third quarter of 2005, a slowdown from the 8.8 per cent growth rate recorded in the previous quarter. A massive deceleration of growth was recorded in goods imports from North America, with the second quarter's growth rate of 22.0 per cent falling to 3.6 per cent in the quarter ended in September 2005. The value of goods imports from the rest of the EU rose by 2.2 per cent in the third quarter of 2005, a slight slowdown from the 4.8 per cent growth in the previous quarter. Import growth was strongest from developing countries like China.

Strong domestic demand conditions tend to support import growth. It is estimated that growth of 3.6 in the volume of imports occurred during 2005. We foresee that growth in 2006 will continue to accelerate given a recovery in export performance, with a 4.9 per cent growth rate forecast.

Balance of Payments

A current account deficit was recorded in the third quarter of 2005, equivalent to 1.0 per cent of GDP. This is much narrower than the deficit of the previous quarter, which amounted to 2.9 per cent of GDP, and also lower than the deficit of 1.5 per cent of GDP registered in the third quarter of 2004.

A huge merchandise trade surplus was recorded in the third quarter of 2005, equivalent to 20.4 per cent of GDP. However, since services imports exceed exports, the overall trade balance was much narrower. The significant presence of multinational corporations in the Irish economy means that debit factor incomes flows such as repatriation of profits are substantial items in the balance of payments. Accordingly, an incomes deficit of equivalent to 13.7 per cent of GDP occurred in the third quarter of 2005.

The strong performance of imports relative to exports in 2005, particularly in trade in services, is expected to tip the current account into a widening deficit in 2005 and 2006. The deficit is expected to amount to -1.9 per cent of GNP in 2005 and -2.8 per cent of GNP in 2006.

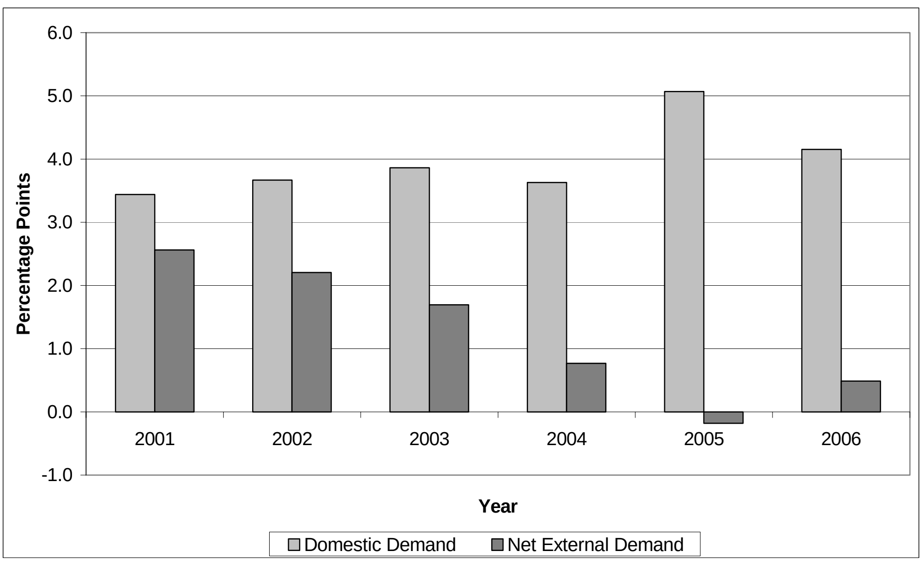
TABLE 6: Balance of Payments

	2003 Euro£m	Change %	2004 Euro£m	Change %	2005 Euro£m	Change %	2006 Euro£m
Visible Trade Balance	34,211	-2.9	33,235	-5.8	31,297	-0.5	31,146
Adjustments	-1,606		-1,423		-1,400		-1,450
Merchandise Trade Balance	**32,605**	**-2.4**	**31,812**	**-6.0**	**29,897**	**-0.7**	**29,696**
Service Trade Balance	-11,090	-12.4	-9,720	-13.5	-8,408	-6.2	-7,888
Trade Balance in Goods and Services	**21,515**	**2.7**	**22,092**	**-2.7**	**21,490**	**1.5**	**21,808**
Total Debit Flows	52,078	10.1	57,362	13.9	65,314	6.2	69,372
Total Credit Flows	30,132	12.1	33,783	21.8	41,149	5.2	43,289
Net Factor Flows	**-21,946**	**7.4**	**-23,579**	**2.5**	**-24,165**	**7.9**	**-26,082**
Net Current Transfers	**432**	**-28.9**	**307**	**-58.0**	**129**	**86.0**	**240**
Balance on Current Account	**1**		**-1,180**		**-2,546**		**-4,034**
Capital Transfers	93	331.2	401	22.4	491	-16.5	410
Effective Current Balance	**94**		**-779**		**-2,055**		**-3,624**

Gross National Product and Gross Domestic Product

We forecast that GNP will have risen by 5.0 per cent in 2005. Because we expect net factor income flows to grow at a much slower rate of 2.5 per cent in 2005 our forecast for GDP growth is lower at 4.8 per cent. In 2006 we expect the growth rate to moderate slightly with GNP growing by 4.8 per cent and GDP by 4.7 per cent. While GNP is generally used as the headline growth rate, GNDI (Gross National Disposable Income) is a more suitable measure of a country's overall level of income since it also includes changes in the terms of trade and net international transfers. Our forecasts imply an increase of 4.4 per cent in GNDI for 2005 and 4.2 per cent for 2006. The difference between this and GNP is accounted for by negative terms of trade effects, with the growth in import prices outstripping export prices. Our figures for 2005 highlight that the main driver of growth is domestic demand, growing at 6 per cent. We expect growth in 2006 to be more balanced between the domestic and external sector with domestic demand forecast to growth by 4.8 per cent. In Figure 3, we demonstrate the point that has been made in the text, namely, that domestic demand is now the main driver of growth.

Figure 3: Components of GDP Growth



Agriculture

The latest *Quarterly National Accounts* data show that the Agricultural, Forestry and Fishing sector of the economy performed poorly in the four quarters ended the third quarter of 2005, with the volume of output in the sector falling by 3.0 per cent on an annual basis over the year as compared to a 3.0 per cent growth rate for the same period of 2004. The most significant deterioration occurred in the third quarter, when output contracted by 7.0 per cent in volume terms year on year. On a seasonally adjusted basis, the volume of output in the third quarter of 2005 fell by 4.1 per cent from the second quarter of the year.

Price developments throughout the year have also been unfavourable; according to preliminary estimates from the CSO for the whole of 2005, it is estimated that output prices rose by a mere 0.3 per cent in 2005 when compared to 2004 while input prices rose by a more substantial 4.5 per cent, resulting in an overall deterioration in the terms of trade of over 4.0 per cent. The rise in the price of energy inputs, which are estimated to have risen by 18.3 per cent over the year, was the main cause.

Advance estimates provided by the CSO on Agricultural incomes show a rise in the value of net subsidies between 2004 and 2005 of over 40.0; however, this rise is largely related to a change in the timing of payments which has arisen in the move to the de-coupling system. As a result of this, the operating surplus (which excludes both interest and land rental payments) in the sector rose by an appreciable 19.8 per cent or €440 million over the year but obviously this overstates the under-lying performance. Given the current trends in the sector, we expect the volume of gross output in the agricultural sector to register a contraction over the whole of 2005, with no improvement in the situation in 2006; we forecast that gross output in the sector will fall by 3.5 per cent in 2005 before contracting further by 0.6 per cent in 2006.

Industry

The Irish industrial sector, including building, has performed relatively well in the most recent quarter of 2005 for which data is available, though the rate of expansion in the volume of output in the sector was slower than in the same period of 2004. The volume of output grew by 3.0 per cent year on year in the third quarter of 2005 as compared to a 6.6 per cent annual volume expansion in the same period of 2004. On a seasonally adjusted basis, the volume of output expanded by 0.5 per cent from the second quarter of the year. The *Industrial Production and Turnover* release shows that growth in the industrial sector has not been driven solely by growth in the construction sector, as industrial production, excluding building, increased by an average of 2.8 per cent in volume terms in the third quarter of 2005 when compared to the same period of 2004. The most recent data for November shows the volume of output in the sector to have expanded by a very significant 14.7 per cent over the year or by 10.6 per cent on a seasonally adjusted basis when compared to the previous month. Both the Traditional and Modern manufacturing industries performed well expanding the volume of output by 3.3 per cent in the third quarter of 2005 when compared to the same period of 2004 or by 5.6 per cent and by 9.1 per cent respectively year-on-year in November.

While such statistics are indicative of a relatively strong performance in the industrial sector, as highlighted in previous *Commentaries*, it is important to assess further the impact of such growth to the domestic economy. This is because in recent years, much of the growth in industrial production could be attributed to certain industries within the Modern manufacturing sector that are predominantly foreign owned, in particular the chemicals and electrical and optical equipment industries. It is often the case that only a small proportion of the value added is allocated to the domestic workforce, with the majority being accounted for by profits, much of which leaks out of the economy. It is therefore useful, in assessing the importance of the industrial sector for the domestic economy, to weight industrial production by employment and the wage bill rather than the gross value added weights traditionally used. The seasonally adjusted output, or gross value added weighted index of the CSO increased by 181 per cent between the first quarter of 1995 and the third quarter of 2005. When industrial output is weighted instead by employment, the series increased by 89 per cent, implying that output growth was weaker on average over the period in the more labour intensive industries. When weighted by the wage bill, the series rose by 99 per cent over the same time horizon and when weighted by the wage bill, excluding the chemicals sector (NACE 24), the index increased by 82 per cent while the wage bill weighted index, excluding both the chemicals and the electrical and optical equipment industries (NACE 30-33) increased by only 45 per cent. Turning to more recent quarters, in 2004 it was found that the output weighted industrial production index implied weak growth in output, while strong growth was implied using wage bill weights. This trend has continued in the third quarter of 2005, when the gross value added weighted index implies that output grew by 0.9 per cent on a seasonally adjusted basis from the previous quarter while the employment weighted index shows a 1.7 per cent growth rate for the same period. The comparable growth rate implied by the wage bill weighted index is 1.5 per cent.

Recent survey data indicates that growth in the industrial sector, excluding building, remained strong up to the end of 2005. The NCB *Purchasing Managers Index* signalled an expansion in the manufacturing sector and an improvement in business conditions in December; a reading of 53.4 was posted on the index for the month (a reading of 50.0 or above indicates an expansion in the sector), representing a slight fall from the November high of 53.7. According to the survey, Irish manufacturers increased production in December for the twenty-eight successive month as a result of increases in current orders as well as the securing of new orders. A pick-up was also registered in the pace of growth of new orders from foreign customers, with demand from the UK and Spain proving particularly strong.

Given the expansion registered in gross output so far in 2005, our forecasts are for strong growth of 5.0 per cent in 2005 with a 5.6 per cent growth rate expected for 2006.

Services

National Accounts data indicate that the services sector registered a volume growth of 5.5 per cent year-on-year in the four quarters to the third quarter of 2005, as compared to a 4.0 per cent expansion in the same period of 2004. The Other Services component displayed the strongest growth, recording an annual volume increase of 5.1 per cent over the year. Distribution, Transport and Communications also performed well, expanding the volume of output by 2.1 per cent, while that of Public Administration and Defence grew by 1.6 per cent.

Recent survey data indicate a likely continuance of the growth in the sector; the NCB's *Report on Services* showed the seasonally adjusted Business Activity Index reading 61.1 in December, representing a slight drop from the 62.1 reading of the previous month, though nonetheless signalling significant growth in the sector (a reading of 50.0 or above indicates an expansion in activity). In addition, the business expectations expressed within the survey show the sample of Irish service providers to be extremely confident about the future with the degree of optimism increasing from November.

Following on from the strength of the services sector so far this year, our forecast is for continued buoyancy in 2006. We expect that the volume of gross value added in the Public Administration and Defence sector will grow by up to 5.0 per cent over the year while that of the Distribution and Other Services sectors is forecast to grow by close to 3.0 per cent and 5.4 per cent respectively. Our forecast is based on strong growth in the personal consumption and personal disposable income over the forecast horizon.

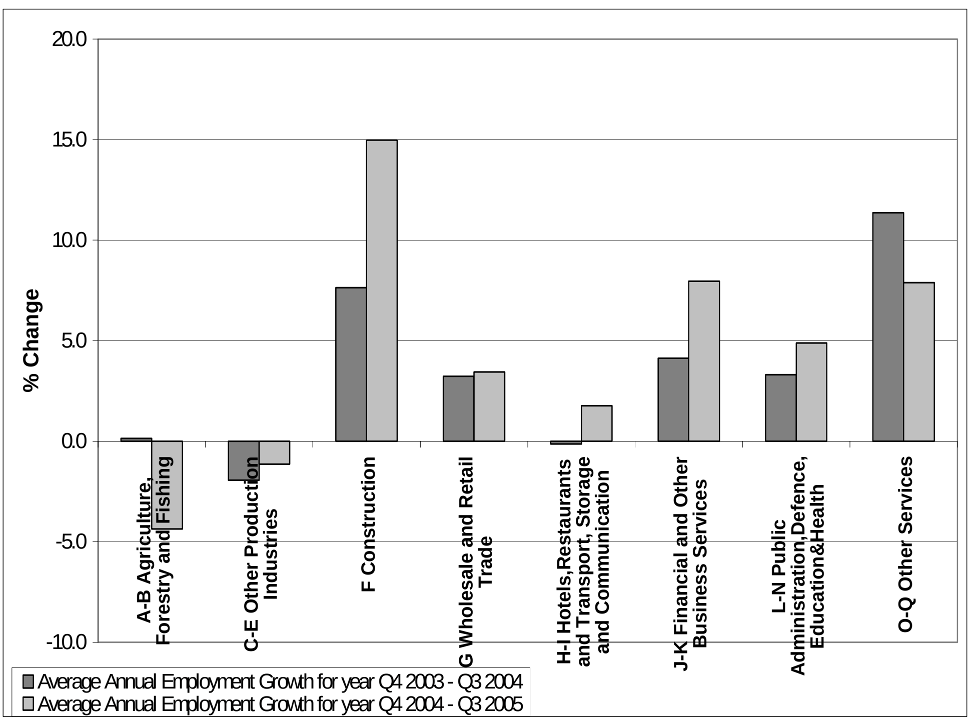
Employment

The latest *Quarterly National Household Survey* (*QNHS*) shows that growth in the labour force has continued unabated in 2005, with an annual increase of 4.3 per cent recorded in the four quarters ended the third quarter 2005 as compared to a 2.6 per expansion registered for the same period of 2004. Over the year, the most significant increase was registered in the third quarter of 2005, when the numbers in the labour force rose by 5.0 per cent, bringing the total number of persons in the labour force to 2.1 million. Labour force growth was largest for those in the 60-64 year age group, with an annual increase of 16.2 per cent recorded in the quarter. The overall participation rate increased to 63.2 per cent in the same period, slightly above the 61.8 per cent registered in the third quarter of 2004. Demographic factors, including changes in the age structure of the population and an increase in the population of those of working age contributed around 58,000 to the labour force over the year, with net migration accounting for approximately 70.0 per cent of this demographic increase. The remainder of the increase came from changes in participation rates.

Employment growth remains robust, with employment growing by an annual rate of 4.4 per cent in the year to the third quarter of 2005, as compared to a 2.8 per cent expansion for the same period of the previous year. Quarterly growth was strongest for the third quarter of 2005, when a 5.1 per cent (or 96,200 in absolute terms) year on year expansion was registered. As a result, the number of persons employed stood at around 2.0 million in the same period. The sustained robust growth in the numbers employed in the economy throughout 2005 mirrors the favourable economic backdrop in the domestic economy.

Employment in Agriculture continued to post declines over the year, with a fall of 0.3 per cent recorded in the third quarter of the year on an annual basis while the numbers engaged in the Industrial sector increased by 3.7 per cent and the numbers engaged in the Services sector rose by 6.2 per cent. In absolute terms, this resulted in a rise of 19,400 employed in Industry and 77,000 in Services. Within the Industrial sector, employment in the construction industry has continued to grow very strongly in the year to the third quarter, with the rise of 30,400 registered outpacing employment creation in any other economic sector of the economy. This trend has persisted now since the fourth quarter of 2004, as shown in Figure 4 below, and thus highlights the increasing importance of the construction sector for employment creation. Of total employment in the economy, employment in construction now accounts for 12.7 per cent, a proportion which has increased steadily since the fourth quarter of 1997, at the inception of the QNHS. Within the Services sector, the largest increase was recorded in the Financial and Other Business Services category, with the numbers employed rising by over 8.0 per cent over the year to the third quarter, bringing the total employed in that area to over 263,000. After adjusting for seasonal factors, the largest quarterly increase was registered in the Wholesale and Retail Trade category, with employment rising by 3.4 per cent between the second and third quarters of the year.

Figure 4: Annual % Change in Employment Levels



There was a slight decrease in the unemployment rate in the third quarter of the year, with a 4.6 per cent rate registered as compared to a 4.7 per cent rate in the same period of 2004. On a seasonally adjusted basis, the rate of unemployment was 4.3 per cent, having also been at this level in the previous quarter of the year.

We forecast that the robust position of the labour market will persist over the coming months, buoyed by the continuance of strong growth elsewhere in the economy. Accordingly, we estimate that employment growth will average 4.5 per cent for 2005. We expect job losses in the Agricultural sector to continue over the year and into 2006, but these will be offset by expansions in the numbers employed in both the Industrial and Services sectors. We anticipate that employment growth will remain strong in 2006, albeit at a lower rate than the record highs observed in 2005. We forecast that the numbers employed in the economy will grow by an average of 3.2 per cent over the year in 2006. Labour force growth is expected to moderate, with an estimated 4.3 per cent increase for 2005 forecast to fall slightly to 3.2 per cent in 2006. The unemployment rate is expected to remain low over the forecast horizon at an estimated 4.2 per cent for both 2005 and 2006.

TABLE 7: Employment and Unemployment*

	Annual Averages 000			
	2003	**2004**	**2005**	**2006**
Agriculture	120	117	112	110
Industry	499	516	544	564
Services	1,191	1,232	1,292	1,337
Total at Work	**1,811**	**1,865**	**1,949**	**2,012**
Unemployed	88	87	86	88
Labour Force	**1,899**	**1,952**	**2,035**	**2,100**
Unemployment Rate %	4.6	4.4	4.2	4.2
Live Register	172	166	165	169

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

Incomes

Given the sustained health of the domestic economy and the continuation of record employment growth, incomes have risen throughout 2005. Hourly industrial earnings are estimated to have risen by an average of 3.8 per cent over the year ended the third quarter of 2005, as compared to a 5.0 per cent rise in the same period of 2004.

Average weekly earnings in Distribution and Business Services are estimated to have risen by 4.0 per cent in the year ended the second quarter of 2005 while those of the Public sector employees (excluding health) rose by 7.5 per cent over the same period. Average weekly earnings in the Banking, Insurance and Building Societies industries rose by an average of 4.2 per cent in the year ended the third quarter of 2005. A larger increase was registered in the average weekly earnings for clerical and operative employees in the Construction sector, with a rise of 7.8 per cent registered, also in the year to the third quarter of 2005.

TABLE 8: Personal Disposable Income

	2003	Change		2004	Change		2005	Change		2006
	€m	%	€m	€m	%	€m	€m	%	€m	€m
Agriculture, etc.	2,819	3.3	93	2,912	1.3	38	2,950	2.0	59	3,009
Non-Agricultural Wages	53,484	8.9	4,736	58,220	10.3	6,014	64,235	8.5	5,456	69,690
Other Non-Agricultural Income	18,988	-1.4	-269	18,719	1.8	336	19,054	5.8	1,106	20,160
Total Income Received	**75,291**	**6.1**	**4,560**	**79,851**	**8.0**	**6,388**	**86,239**	**7.7**	**6,620**	**92,859**
Current Transfers	14,449	7.6	1,091	15,540	16.6	2,854	18,124	7.1	1,294	19,418
Gross Personal Income	**89,740**	**6.3**	**5,651**	**95,391**	**9.4**	**8,972**	**104,363**	**7.6**	**7,914**	**112,277**
Direct Personal Taxes	15,690	14.3	2,242	17,932	7.6	1,356	19,288	5.6	1,072	20,360
Personal Disposable Income	**74,049**	**4.6**	**3,409**	**77,458**	**9.8**	**7,616**	**85,075**	**8.0**	**6,842**	**91,917**
Consumption	65,227	5.1	3,313	68,540	8.1	5,573	74,113	8.3	6,185	80,298
Personal Savings	**8,823**	**1.1**	**96**	**8,918**	**22.9**	**2,043**	**10,962**	**6.0**	**657**	**11,618**
Savings Ratio	**11.9**			**11.5**			**12.9**			**12.6**

Our forecasts are for continued strength in the domestic economy in 2006 and such favourable conditions are expected to provide a positive backdrop for continued employment creation and incomes growth over the year; following an estimated 5.0 per cent growth rate in hourly earnings in 2005, we forecast a rise of 4.8 per cent in 2006. As such, strong growth is expected in the non-agricultural wage bill, with a forecast increase of 8.5 per cent in 2006. Other non-agricultural personal incomes, which mainly represent income from profits and rents, are estimated to rise by 5.8 per cent over the same period, leading to strong growth in personal disposable incomes of around 8.0 per cent.

Consumer Prices

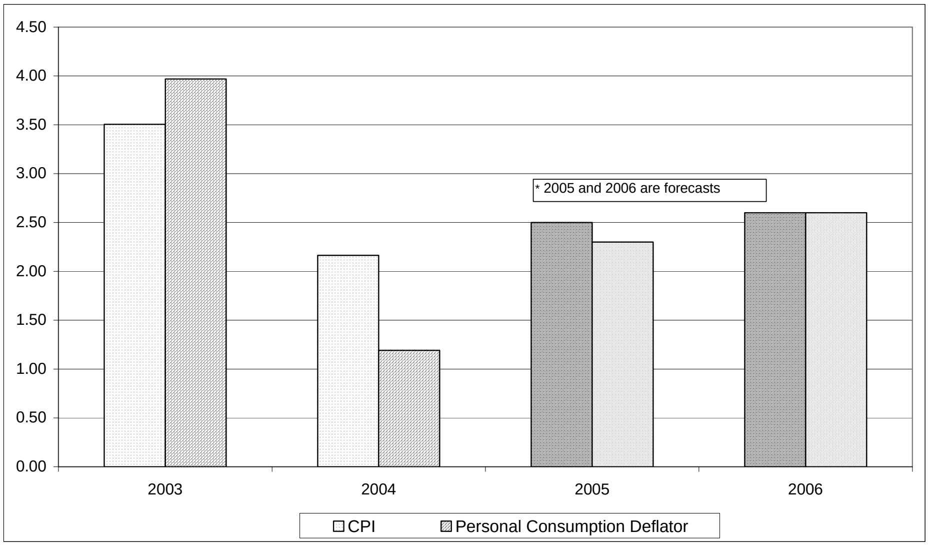
The Consumer Price Index increased by 2.5 per cent in December 2005 compared to the same month of 2004, representing a fall from the 2.6 per cent annual increase registered in the index in November, and bringing the average annual increase in the index for the year to 2.5 per cent as compared to 2.2 per cent in 2004. The strength of inflation in the housing and energy related and non-traded domestic services sector has been a significant contributor to consumer price inflation over the year. In December prices in the Housing, Water, Electricity, Gas and Other Fuels category increased by 10.8 per cent while prices in the Health category rose by 5.8 per cent and 4.9 per cent in Education. Clothing and Footwear displayed the most significant fall in prices between December 2004 and December 2005, with prices falling by 1.9 per cent.

Services price inflation continues to outstrip goods price inflation; the annual rate of inflation for services was 4.2 per cent in December 2005, around eight times that of the 0.5 per cent increase registered for goods. This trend has been in evidence now for some time, and given the traded nature of goods it is likely to remain entrenched in the economy going forward.

The EU Harmonised Index of Consumer Prices (HICP) for the year to December 2005 shows a reading of 1.9 per cent in Ireland, being lower than the average for the euro area, and representing a slowdown from the 2.2 per cent annual rate recorded in November. On a seasonally adjusted basis, the index fell by 0.2 per cent between November and December. For the whole of 2005, the HICP averaged 2.2 per cent, being the lowest reading since 1998.

We are expecting the euro to remain strong in 2006, with an annual average exchange rate of $1.30 and £0.68 per euro forecast. This means that the economy should benefit from cheaper import prices, which will reflect positively on inflation rates for the year. We are nonetheless expecting the inflation rate in terms of the CPI to rise slightly to 2.6 per cent in 2006, with the main cause of the increase being the forecast rise in the ECB main refinancing rate over the year.

Figure 5: Percentage Change in Consumer Price Index and Personal Consumption Deflator[1]



General Assessment

Overall, we expect the economy to continue growing strongly in 2006. While there are threats to this optimistic scenario, such as global imbalances and the over-reliance of the economy on construction, we do not foresee any downturn in 2006. Against this positive background, we will discuss three issues that are likely to generate debate and analysis during the course of 2006. These issues are (a) interest rates, (b) SSIAs and (c) the social partnership talks.

After a prolonged period of no movement in interest rates, the ECB finally increased rates by 25 basis points in December 2005. This decision appears to have been prompted by the increase in euro area inflation in the autumn, as discussed in the *International* section. If the rising inflation had fed into wage demands, a spiral could have begun and it appears that the ECB were eager to guard against such a process taking hold. In a sense, they may have been acting early to avoid more severe action in the future were inflationary pressures to have become embedded through higher inflation expectations and wage demands.

While the above reasoning in favour of a rate increase has merit, other commentators argued against a rate increase. Given the sluggishness of economic activity in the euro area, the argument put forward was that the tentative turnaround, as evidenced in the data

[1] The Personal Consumption Deflator tracks changes in a wider range of items than the CPI. Items which are included in the Personal Consumption Deflator but not the CPI include imputed rent (the value of rent relating to owner occupied accommodation) and services provided to consumers that they do not pay entirely for (examples include education and healthcare).

in the latter part of 2005, should be allowed to gather pace. An interest rate increase risked ending the recovery before it had begun.

Our view on the likelihood of movements in interest rates in 2006 is formed against the background of these opposing views. As rates were increased in response to fears on inflation, the slight fall in inflation in October and November should have eased those fears and hence the need for further substantial increases. More importantly, the lack of evidence of a pass-through from inflation to wage demands (i.e., "secondary effects") should ease those worries further. Balanced against this is the on-going improvement in economic performance in the euro area and hence renewed fears of inflation. In addition, as growth takes hold, fears about choking off growth too early will lessen.

On balance, our belief is that interest rates will rise further but only to a rate of 2.75 by the middle of the year. While this will have a dampening effect on the economy, it will be marginal. Its impact on the housing market will be to contribute to an easing of prices and this is to be welcomed.

With regard to SSIAs, much is being written about the potential impacts once the scheme expires. In truth, it is extremely difficult to forecast how they will impact upon the economy in 2006 and 2007. Here, we will outline some reasons why we think the effect may be more limited than is sometimes reported, especially in 2006.

The first simple point to be made is that only one-third of the accounts will mature in 2006. As the total amount in SSIAs is estimated to be around €15 billion (at the time of maturity), this means that the maximum addition to the economy in 2006 will be €5 billion.

It is likely that a proportion of people with SSIAs were people who would have been saving whether the scheme existed or not. For them, the scheme did not increase savings but only led to a substitution from one savings vehicle to another, highly attractive, vehicle. For these people, there is a high probability that they will re-invest their SSIA funds. Our suspicion is that people who entered the scheme early are more likely to fall into this category and so a higher proportion of the 2006 accounts may be re-invested.

Finally, a long established economic theory suggests that people base consumption decisions not on the amount of money they have at a given point but on some longer run measure. As people have known that they are building up lump sums, it is possible that they have allowed borrowings to accumulate with the expectation of paying off debts once the accounts mature. In this way, we may already be experiencing an SSIA effect.

In sum, although we cannot say what the impact of SSIAs will be with any degree of certainty, we are confident that consumption will not increase €5 billion in 2006.

Turning now to the partnership talks, we will begin by setting out our hopes and will then explain them. With regard to the private sector, we would recommend that as much flexibility as possible be provided whereby wages can adjust to market forces in the next few years. For the public sector, we would recommend pay restraint.

In the case of the private sector, it should be pointed out that the extent to which nationally agreed wage bargains are adhered to is more limited than much discussion would suggest. Fitz Gerald (1999)[2] showed how structural changes in the wage formation process in Ireland pre-dates the partnership arrangement and that market forces were acting in the 1980s to ease wage pressures. He notes the following:

> *While helping to bring about a more orderly labour market, with fewer industrial disputes than in the 1970s, the partnership approach served more to validate the results which market forces had made inevitable. The significant differences in wage rates in individual sectors in recent years reflect the importance of market forces in determining wage rates.* (pp. 162-163)

Just as market forces led to reduced wage pressures in the 1980s, there is evidence to suggest that wages increased well beyond the terms of the national agreements in the mid and late 1990s when labour demand was increasing. Barrett, Callan and Nolan (1999)[3] demonstrated how earnings inequality increased significantly between 1987 and 1994, in spite of the national agreements that would have been expected, a priori, to contain such a trend. In looking for an explanation, they quote a survey of firms conducted by John Geary of UCD in 1996/7. Among the non-union forms, 63 per cent said that their pay awards had exceeded those of the national agreements.

More recently, we can again find evidence of wages responding to cyclical changes in demand conditions in the economy. Around the time of the downturn in late 2001/early 2002, aggregate data suggest that real wages fell. At a sectoral level, nominal wages fell year-on-year in financial institutions while the annual growth rate in wages in construction fell from 11 per cent to 5.4 per cent.

This flexibility has been of value to the Irish economy. At times of increasing demand for labour, employers have increased wages and thereby attracted people into the labour market such as married women and immigrants. At a time of falling labour demand, wage growth seems to have moderated and so the increase in unemployment in the early 2000s was small. These trends have occurred "in spite" of social partnership although it should be noted that the programmes have often included local bargaining and "ability to pay" clauses. We would urge that nothing would be agreed to in the partnership talks in respect of private sector wages that would impede this flexibility.

As regards the public sector, our belief in the need for pay restraint arises from the following considerations. As public sector

[2] Fitz Gerald, J. (1999), "Wage Formation and the Labour Market", Chapter 7 in Barry, F. (ed.), *Understanding Ireland's Economic Growth*, Basingstoke: Macmillan Press.
[3] Barrett, A., T. Callan and B. Nolan (1999). "Rising Wage Inequality, Returns to Education and Labour Market Institutions: Evidence from Ireland", *British Journal of Industrial Relations* Vol. 37, No. 1.

wage increases ultimately translate into higher taxes or lower levels of service provision there is an economic interest in restraining public sector pay since either can lead to a loss in competitiveness. This must be balanced against another public interest, namely, the attraction of able and qualified people into the public service. This latter point suggests that higher public pay may also be in the public interest. At this point in time, we believe that public pay restraint can bring about savings to the taxpayer without endangering the quality of public servants.

In order to justify this belief, we will draw on a paper published in a previous *Quarterly Economic Commentary* by Boyle, McElligot and O'Leary (2004).[4] The purpose of this paper was to provide a systematic analysis of the difference between public sector and private sector pay. Based on a large nationally representative sample of employees covering all sectors, Boyle *et al.,* were able to compare public and private sector wage rates, controlling for other factors that impact upon wages such as age, education and gender. They found that in 2001, public sector employees earned 13 per cent more than private sector employees (again, controlling for other characteristics associated with wages). Repeating the analysis for all years back to 1994, they found the premium to have existed in each year (with a range of 8.3 per cent to 14.6 per cent). They also found that the "public sector premium" was higher in Ireland than elsewhere.

Boyle *et al.,* appear to have provided compelling evidence that public service employees were earning more than private sector employees, even before the benchmarking exercise. Given the increases in public sector earnings relative to others since 2001, it is likely that the public service premium still exists. One piece of direct evidence on this point comes from Russell, Smyth and O'Connell (2005).[5] Based on a survey of people in 2004 who had recently graduated from third-level colleges, wages for this (admittedly narrow) group were 20 per cent higher in the public sector.

As a final point, it should be noted that neither Boyle *et al.,* nor Russell *et al.*, factored in the value of pension entitlements when analysing relative wages. Given the higher rate of pensions coverage in the public sector, this would add to the relative attractiveness of public service packages. Increasingly, it is not just the coverage of pensions but also the nature of the pensions that is adding to the public/private compensation gap. With the decline in defined benefit schemes in the private sector, access to such schemes in the public sector makes employment there all the more remunerative in the long run.

[4] Boyle, G., R. McElligot and J. O'Leary (2004). "Public-Private Wage Differentials in Ireland, 1994 to 2001", in McCoy *et al., Quarterly Economic Commentary*, Winter, Dublin: The Economic and Social Research Institute.

[5] Russell, H., E. Smyth and P.J. O'Connell (2005). *Degrees of Equality: Gender Pay Differentials among Recent Graduates*, Books and Monographs, No. 184, Dublin: The Economic and Social Research Institute.

Our conclusion from the above is that public servants (at least on average) have earnings which will remain attractive relative to the private sector even if earnings grow at a moderate pace for the next two to three years. We do not foresee that recruitment will be threatened and so, on balance, the economy would be best served by holding public sector wage increases to rates below those granted in the private sector.