SUMMARY TABLE

OUTPUT **(Real Annual Growth %)**	2001	2002	2003	2004
Private Consumer Expenditure	5.1	2.5	2.5	3.2
Public Net Current Expenditure	10.8	8.5	0.8	1.0
Private Investment	-0.5	-0.1	-0.5	1.5
Exports	6.7	4.5	4.2	4.4
Imports	6.1	1.0	3.1	3.6
Gross Domestic Product (GDP)	5.7	5.7	3.0	3.7
Gross National Product (GNP)	4.6	1.1	2.5	3.5
PRICES **(Annual Growth %)**				
Consumer Price Index (CPI)	4.9	4.7	4.3	3.2
Wage Growth	10.3	7.0	4.3	3.3
LABOUR MARKET				
Employment Levels (ILO basis (000s))	1,741	1,765	1,766	1,774
Unemployment Levels (ILO basis (000s))	71	82	99	103
Unemployment Rate (as % of Labour Force)	3.9	4.4	5.3	5.5
Live Register Levels ('000s)	142	163	186	193
PUBLIC FINANCE				
Exchequer Balance (€m)	653	95	-1,915	-3,500
General Government Balance (€m)	1,258	-113	-1,100	-1,900
General Government Balance (% of GDP)	1.1	-0.1	-0.8	-1.3
General Government Debt (% of GDP	36.8	34.0	33.4	33.9
EXTERNAL TRADE				
Balance of Payments Current Account (€m)	-345	-132	-29	975
Current Account (% of GNP)	-0.4	-0.1	0.0	0.8
EXCHANGE AND INTEREST RATES **(Annual Averages)**				
US$/€ Exchange Rate	0.90	0.95	1.08	1.15
Main ECB Interest Rate (%)	4.3	3.2	2.4	2.7

SUMMARY

Irish economic growth in 2002 shows a remarkably different pattern depending on whether the measure used is GDP or GNP. In terms of real GDP, the economy is estimated to have defied most expectations, as well as the international trend, by showing no slowdown from 2001 while in GNP terms a rapid deceleration occurred. Output growth in 2002 is estimated to be 5.7 per cent in real GDP terms but only by 1.1 per cent measured in real GNP terms. The record gap between the measures reflects the large rise in net factor incomes from strong outward profit repatriation, boosted significantly by the exceptional performance in the chemicals sector. Inflation in consumer prices averaged 4.7 per cent in 2002 with the unemployment rate averaging 4.4 per cent.

The prospects for output growth in 2003 and 2004 look more modest as uncertainty continues to prevail in the international economy. The uncertainties arising from the on-going war in the Gulf region means that international growth prospects remain susceptible to the extent and duration of geo-political tensions. Our forecasts for output growth in 2003 have been revised downwards by around three-quarters of a percentage point as slowdown. Growth in 2003 is now forecast to be 3.0 per cent in real GDP and 2.5 per cent in real GNP terms. Predicated on an anticipated return to better international growth prospects, we forecast that output growth in 2004 will be 3.7 and 3.5 per cent in real GDP and real GNP terms respectively. Inflation as measured by the consumer price index is forecast to moderate to an average of 4.3 per cent in 2003 and 3.2 per cent in 2004. The unemployment rate is forecast to continue to rise this year and next to average 5.3 per cent in 2003 and 5.5 per cent in 2004.

The continued appreciation of the euro when coupled with rising domestic costs, is exerting strong competitive pressure on Ireland's crucial exporting sectors. While high relative price inflation should continue to be a preoccupation, the underlying trend for the domestic inflation rate is downward in line with our main trading partners. Domestic income policy, along with budgetary policy, is moving to reflect the new realities for the Irish economy as it enters a period of more modest real growth rates. The wage terms, contained in the narrowly accepted new social partnership agreement *Sustaining Progress* will help to solidify the dis-inflationary trend.

Given the current extraordinarily low interest rate environment, Irish real growth rates will continue to outpace the real interest rate in the short to medium term. However, over the longer term this ratio must come into balance. Given the tighter budgetary situation that has emerged since the National Development Plan was put in place, a more focused sense of national investment priorities needs to be identified to ensure balanced future growth. All projects that offer economic returns and that can be delivered ensuring value for money justify financing. There is no reason to restrict necessary investment. The low interest rate environment creates opportunity for economically justifiable investment to be undertaken while respecting the constraints of the *Stability and Growth Pact*.

PRELIMINARY NATIONAL ACCOUNTS 2002

A: Expenditure on Gross National Product

	2001	2002	Change in 2002				
		Preliminary	€m		%		
	€m	€m	Value	Volume	Value	Price	Volume
Private Consumer Expenditure	55,144	59,066	3,922	1,379	7.1	4.5	2.5
Public Net Current Expenditure	15,288	17,510	2,222	1,299	14.5	5.6	8.5
Gross Fixed Capital Formation	26,670	27,564	894	-21	3.4	3.4	-0.1
Exports of Goods and Services (X)	112,368	120,295	7,927	5,107	7.1	2.4	4.5
Physical Changes in Stocks	279	40	-239	-210			
Final Demand	**209,749**	**224,475**	**14,726**	**7,555**	**7.0**	**3.3**	**3.6**
less:							
Imports of Goods and Services (M)	95,491	96,893	1,402	993	1.5	0.4	1.0
GDP at Market Prices	**114,258**	**127,582**	**13,324**	**6,562**	**11.7**	**5.6**	**5.7**
less:							
Statistical Discrepancy	-221	32	253	81			
Adjusted GDP	**114,479**	**127,550**	**13,071**	**6,481**	**11.4**	**5.4**	**5.7**
less:							
Net Factor Payments (F)	17,677	24,024	6,347	5,423	35.9	4.0	30.7
GNP at Market Prices	**96,802**	**103,526**	**6,724**	**1,059**	**6.9**	**5.8**	**1.1**

B: Gross National Product by Origin

	2001	2002	Change in 2002	
		Preliminary		
	€m	€m	€m	%
Agriculture, Forestry, Fishing	3,310	3,040	-270	-8.2
Non-Agricultural: Wages, etc.	46,857	50,986	4,129	8.8
Other:	44,830	51,431	6,601	14.7
Adjustments: Stock Appreciation	190	375		
Financial Services	-4,038	-4,367	-329	
Statistical Discrepancy	-221	32	253	
Net Domestic Product	**90,928**	**101,497**	**10,569**	**11.6**
less:				
Net Factor Payments	17,677	24,024	6,347	35.9
National Income	**73,251**	**77,473**	**4,222**	**5.8**
Depreciation	11,466	12,462	996	8.7
GNP at Factor Cost	**84,717**	**89,935**	**5,218**	**6.2**
Taxes less Subsidies	12,085	13,591	1,506	12.5
GNP at Market Prices	**96,802**	**103,526**	**6,724**	**6.9**

C: Balance of Payments on Current Account

	2001	2002	Change in 2002
		Preliminary	
	€m	€m	€m
Exports (X) less Imports (M)	16,877	23,402	6,525
Net Factor Payments (F)	-17,677	-24,024	-6,347
Net Transfers	455	489	35
Balance on Current Account	**-345**	**-132**	**213**
as % of GNP	-0.4	-0.1	0.3

FORECAST NATIONAL ACCOUNTS 2003

A: Expenditure on Gross National Product

	2002	2003	Change in 2003				
	Preliminary €m	Forecast €m	€m		%		
			Value	Volume	Value	Price	Volume
Private Consumer Expenditure	59,066	62,843	3,777	1,477	6.4	3.8	2.5
Public Net Current Expenditure	17,510	18,940	1,430	140	8.2	7.3	0.8
Gross Fixed Capital Formation	27,564	28,240	676	-143	2.5	3.0	-0.5
Exports of Goods and Services (X)	120,295	127,104	6,809	5,091	5.7	1.4	4.2
Physical Changes in Stocks	40	230	190	170			
Final Demand	**224,475**	**237,356**	**12,882**	**6,735**	**5.7**	**2.7**	**3.0**
less:							
Imports of Goods and Services (M)	96,893	101,768	4,875	2,991	5.0	1.9	3.1
GDP at Market Prices	**127,582**	**135,588**	**8,006**	**3,744**	**6.3**	**3.2**	**2.9**
less:							
Statistical Discrepancy	32	642	610	-102			
Adjusted GDP	**127,550**	**134,946**	**7,397**	**3,845**	**5.8**	**2.7**	**3.0**
less:							
Net Factor Payments (F)	24,024	25,649	1,625	1,279	6.8	1.4	5.3
GNP at Market Prices	**103,526**	**109,297**	**5,771**	**2,566**	**5.6**	**3.0**	**2.5**

B: Gross National Product by Origin

	2002	2003	Change in 2003	
	Preliminary €m	Forecast €m	€m	%
Agriculture, Forestry, Fishing	3,040	3,260	220	7.2
Non-Agricultural: Wages, etc.	50,986	53,219	2,233	4.4
Other:	51,431	53,845	2,414	4.7
Adjustments: Stock Appreciation	375	19		
Financial Services	-4,367	-4,588	-221	
Statistical Discrepancy	32	642	610	
Net Domestic Product	**101,497**	**106,396**	**4,900**	**4.8**
less:				
Net Factor Payments	24,024	25,649	1,625	6.8
National Income	**77,473**	**80,747**	**3,274**	**4.2**
Depreciation	12,462	13,394	932	7.5
GNP at Factor Cost	**89,935**	**94,141**	**4,206**	**4.7**
Taxes less Subsidies	13,591	15,156	1,565	11.5
GNP at Market Prices	**103,526**	**109,297**	**5,771**	**5.6**

C: Balance of Payments on Current Account

	2002	2003	Change in 2003
		Preliminary	
	€m	€m	€m
Exports (X) less Imports (M)	23,402	25,335	1,933
Net Factor Payments (F)	-24,024	-25,649	-1,625
Net Transfers	489	285	-205
Balance on Current Account	**-132**	**-29**	**103**
as % of GNP	-0.1	0.0	0.1

FORECAST NATIONAL ACCOUNTS 2004

A: Expenditure on Gross National Product

	2003	2004	Change in 2004				
	Forecast €m	Forecast €m	€m Value	€m Volume	% Value	% Price	% Volume
Private Consumer Expenditure	62,843	66,670	3,827	2,011	6.1	2.8	3.2
Public Net Current Expenditure	18,940	20,350	1,410	189	7.4	6.4	1.0
Gross Fixed Capital Formation	28,240	29,373	1,133	438	4.0	3.0	1.5
Exports of Goods and Services (X)	127,104	135,939	8,835	5,551	7.0	2.5	4.4
Physical Changes in Stocks	230	190	-40	175			
Final Demand	**237,356**	**251,921**	**15,165**	**8,364**	**6.4**	**2.8**	**3.5**
less:							
Imports of Goods and Services (M)	101,768	107,713	5,944	3,665	5.8	2.2	3.6
GDP at Market Prices	**135,588**	**144,809**	**9,221**	**4,699**	**6.8**	**3.2**	**3.5**
less							
Statistical Discrepancy	642	1,217	575	-288			
Adjusted GDP	**134,946**	**143,592**	**8,645**	**4,986**	**6.4**	**2.6**	**3.7**
less:							
Net Factor Payments (F)	25,649	27,441	1,792	1,129	7.0	2.5	4.4
GNP at Market Prices	**109,297**	**116,151**	**6,853**	**3,857**	**6.3**	**2.6**	**3.5**

B: Gross National Product by Origin

	2003	2004	Change in 2004	
	Forecast €m	Forecast €m	€m	%
Agriculture, Forestry, Fishing	3,260	3,430	170	5.2
Non-Agricultural: Wages, etc.	53,219	55,250	2,031	3.8
Other:	53,845	58,053	4,208	7.8
Adjustments: Stock Appreciation	19	10		
Financial Services	-4,588	-5,155	-567	12.4
Statistical Discrepancy	642	1,217	575	89.7
Net Domestic Product	**106,396**	**112,805**	**6,409**	**6.0**
Net Factor Payments	25,649	27,441	1,792	7.0
National Income	**80,747**	**85,364**	**4,617**	**5.7**
Depreciation	13,394	14,352	958	7.2
GNP at Factor Cost	**94,141**	**99,715**	**5,574**	**5.9**
Taxes less Subsidies	15,156	16,435	1,279	8.4
GNP at Market Prices	**109,297**	**116,151**	**6,853**	**6.3**

C: Balance of Payments on Current Account

	2003 Forecast €m	2004 Forecast €m	Change in 2004 €m
Exports (X) less Imports (M)	25,335	28,226	2,891
Net Factor Payments (F)	-25,649	-27,441	-1,792
Net Transfers	285	190	-95
Balance on Current Account	**-29**	**975**	**1,004**
as % of GNP	0.0	0.8	0.8

The International Economy

General

Notwithstanding the large degree of uncertainty resulting from concerns over corporate governance and geo-political tensions, world economic growth remained quite strong in 2002 as a whole. Global GDP growth is estimated to have increased to 3.1 per cent in 2002, up from 2.2 per cent in 2001. However, the weakness evident towards the end of 2002 has continued into 2003 with most signals pointing to faltering growth prospects for the majority of the world's major economies. This weakness has triggered monetary easing in the first quarter in both the euro area and the UK, with further rate cuts expected. Geo-political uncertainty persists even with the continuing war in Iraq and is likely to weigh heavily on external demand, consumer confidence and investor sentiment. Therefore, we expect growth to remain well below potential in 2003 for the world's major economies before strengthening somewhat in 2004.

US Economy

The US economy's muted recovery continued up to the end of 2002. Recent seasonally adjusted data show that real GDP annualised growth slowed to 1.4 per cent in the fourth quarter of 2002. This is compared to strong growth in the first quarter of 5 per cent, followed by 1.3 per cent in the second and 4 per cent in the third. The main contributors to the small fourth quarter increase were personnel consumption, government spending, equipment and software and residential investment. These were partially offset by a large negative contribution from net exports.

Preliminary estimates suggest that real GDP increased by 2.4 per cent in 2002 compared with 0.3 per cent in 2001. Personal consumption expenditure, government spending and strong private inventory investment drove most of the annual increase. However, despite unprecedented monetary and fiscal easing by the relevant authorities, growth is forecast to remain moderate and below potential in 2003, due mainly to the restraint imposed on economic activity by business and consumer caution. Therefore, we forecast real GDP growth of 2.0 per cent in 2003, a downward revision from our last *Commentary*, before the economy experiences stronger growth of 3.2 per cent in 2004.

Recovery in the manufacturing sector in 2002 remained very fragile. Recent survey data also suggests that the sector is experiencing renewed weakness in 2003. The Purchasing Managers Index (PMI) from the Institute of Supply Managers (ISM) indicates that, following four consecutive months of growth, the manufacturing economy declined in March. The index fell to 46.2 per cent in March, a decrease of 4.3 percentage points when compared to 50.5 in February. A reading below 50 points indicates a contraction in the sector while above 50 indicates an expansion. Although based on historical relationships, this contraction does not indicate a contraction in the wider economy, the sharpness of the decline is a cause for concern. The components of the index showing the largest drop were that of the new orders Index, which declined from 52.3 per cent in February to 46.2 per cent in March and the production index which fell from 55.4 per cent in February to 46.3 per cent in March. Manufacturing jobs, continue decline with the rate of decrease accelerating in March. This is the 30th consecutive month of declining employment in the sector.

Private Investment remained quite strong in the fourth quarter of 2002 growing by 6.3 per cent at an annualised rate and by 8.9 per cent from the fourth quarter of 2001. However, much of this growth has been due to strong residential investment, which has served to mask the failure of business investment to fully recover in 2002. In particular, non-residential structures have decreased by 16 per cent over the course of 2002. Initially, the recession and the resulting over capacity in the economy were cited as the major deterrent to business investment. However, as the economy recovered in 2002, corporate governance scandals, a poor investor climate and more recent geo-political uncertainties have substantially restrained business confidence and, therefore, investment. Signs of recovery, especially in equipment and software, combined with historically low interest rates and the expected conclusion to tensions in the Gulf region should lead to recovery and moderate growth in the latter part of 2003.

Personal consumption showed its continued resilience throughout most of 2002, remaining the main driving force behind GDP growth over the period, with growth of 3.1 per cent for the year. Although its contribution to overall growth remained robust in the fourth quarter, growth in personal consumption slowed significantly to 1.7 per cent from 4.2 per cent in the third quarter. This is the main factor behind the overall deceleration in real GDP growth in the final quarter. A fall in durable goods spending constituted the bulk of this slowdown in personal consumption. As mentioned in the previous *Commentary*, the extent of "zero interest" finance offers which were available in the third quarter seem to have reduced spending in the fourth quarter as households may have brought forward their durable goods expenditures to take advantage of these offers.

Confidence indicators confirm this slowdown in consumption. The Conference Board's Consumer Confidence Index declined again in March to register 62.5 from 64.8 in February. This is the third consecutive monthly decline and reflects more than a 16-point decline from January. The last time the indicator was lower was in October 1993. The University of Michigan's Index of Consumer Sentiment in March confirmed this trend at 77.6, down from 79.9 in February, and 95.7 in March 2002. Although confidence picked up with the commencement of war, the prospect of on-going uncertainty is likely to continue to adversely affect consumer sentiment. Weak job and financial markets, rising fuel costs, and the uncertainties regarding war appear finally to have taken their toll on a previously resilient US consumer.

The weak economy also continues to press heavily on labour market conditions, which have shown renewed weakness following gains in January. US companies cut more than 300,000 jobs from their payrolls in February and over 108,000 in March. Job losses were widespread, with the largest decreases in services and retail trade. Employment also fell sharply in construction and declines continued in manufacturing, transportation and public utilities. This increase in joblessness has kept the unemployment rate at 5.8 per cent in March. The February job loss was the largest since 327,000 positions were lost in the month after the September 11th terrorist attack. We forecast continued weakness in the labour market in 2003 and project average unemployment of 6 per cent for the year as a whole before moderating to 5.7 per cent in 2004 as the economy starts to move closer towards its potential.

The US economy's characteristically robust productivity growth slowed somewhat in the fourth quarter of 2002. In the non-farm business sector, productivity rose at an annual rate of 0.8 per cent in the fourth quarter of 2002, as output grew 1.7 per cent and hours rose 0.9 per cent on a seasonally adjusted annual basis. The fourth quarter increase in business sector hours followed six consecutive quarterly declines. This is compared to the strong growth in the third quarter where productivity increased by 5.5 per cent at an annual rate; output by 5.2 per cent, and hours declined 0.2 per cent. For the year as whole, non-farm business sector productivity increased by 4.8 per cent with output growing by 2.7 per cent with hours worked falling by 2 per cent. This growth, which is greater than in any year since 1950, is to be expected in the first year of recovery. Evidence from the fourth quarter of 2002 suggests that this annual spurt in productivity growth may diminish in 2003.

Consumer price inflation in the US remained very moderate over the course of 2002 increasing by 1.6 per cent. Inflation has spiked recently with the figure in March rising at the fastest rate in two years as a result of rising oil prices. Consumer prices jumped 0.6 per cent in February from January and were up 3.0 per cent on a year-on-year basis. This increase, the largest since January 2001, was driven by a 5.9 per cent surge in energy prices, the largest since June 2000. Excluding the effect of oil prices, underlying inflationary pressures are expected to remain subdued due to the economy's below potential growth rate and the resulting excess capacity. The US Federal Reserve has maintained interest rates at 1.25 per cent. This is the lowest rate in over forty years and, due to the usual lags associated with monetary easing, its possible effects have yet to be seen to impact fully on the economy. The Fed decided against further rate cuts as it felt that geo-political uncertainties had almost completely clouded the economic outlook and made the risks to its long-run goals of price stability and sustainable economic growth almost impossible to discern.

Recent estimates suggest that the US current-account deficit increased in the final quarter of 2002 to $136.9 billion from $126.3 billion in the third quarter. This reflects a $503.4 billion deficit for 2002 as a whole or 4.8 per cent of GDP. The deficit has increased by nearly 30 per cent compared to 2001. An increase in the deficit on goods and a decrease in the surplus on services accounted for more than two-thirds of the increase. The continuing depreciation of the dollar may help redress some of this imbalance in the US economy.

The deterioration in the US public finance position is also very notable. In January 2003 the Federal budget posted a deficit of $96.7 billion for the first four months of the financial year compared to an $8.4 billion surplus for the same period last year. This significant move into deficit is likely to be compounded by military action in the Gulf region. Based on the assumption of a 30-day conflict, $74.6 billion to fund the invasion has been requested from the US Congress although the costs could, conceivably, be much higher. It is also clear that any possible peacekeeping duties, humanitarian or reconstruction aid could also weigh heavily on the US public finances in the event of a sustained war. This strain on the public finances will be compounded by the recent legislated tax cuts of $726 billion to take place over the next 10 years.

Euro Area

The euro area economic fundamentals remained quite fragile through most of 2002. First estimates for the fourth quarter of 2002 show real GDP growth slowing to 0.2 per cent as compared to 0.3-0.4 per cent in the first three quarters. This slowdown in growth was mainly due to a lower contribution from net exports with investment remaining weak. Compared with the fourth quarter of 2001, GDP grew by 1.3 per cent, albeit from a low base. Consequently, over the whole of 2002, real GDP grew by 0.8 per cent in the euro area compared with 1.4 per cent in 2001. While economic activity recovered well from a weak 2001 year-end, the expected speed of recovery has not come to pass with the geo-political tensions and the resulting weak investor sentiment weighing heavily on the economy. We forecast continuing weak growth of 1.1 per cent in 2003, a downward revision from our previous *Commentary,* and 2 per cent in 2004.

Although most of the euro area's major economies have shown significant weaknesses, Germany remains the major brake on overall euro area economic activity. Germany was the world's slowest growing major economy in 2002 with growth of only 0.2 per cent and renewed signs of stagnation towards the end of the year. Although the global slowdown in growth has undoubtedly been a factor in Germany's weakness, domestic causes have become increasingly apparent. These include rigidities in the labour market, a high tax burden, disincentive effects of the social security system and uncertainty regarding the course of economic policy. Deflation also continues to be a major cause for concern in the German economy given the associated problems that it would bring as explained in the previous *Commentary*. It is therefore clear that a full recovery in Germany, and thus the euro area, is contingent not only on recovery in the global environment but also on a large degree of structural reform. The economy needs to become less rigid and hence better able to adjust to adverse shocks of the kind experienced in the last couple of years.

Growth in the euro area became more balanced over most of 2002 with domestic demand replacing external demand as the foundation of growth. In the fourth quarter, private consumption continued its relatively robust growth with 0.4 per cent compared with the previous quarter, a similar growth rate to the second and third quarters. At an annual rate, this reflects growth of 1 per cent in the fourth quarter. Although private consumption remains the main engine of growth in the euro area, recent survey data suggests weakening signs for consumption at the beginning of 2003. The European Commission's Consumer Confidence Indicator decreased in the euro area in March to -21 from -19 in February. This is the sixth successive month of decline in the index reflecting high unemployment and high uncertainty as regards world and euro area economic developments.

Investment remained weak in the fourth quarter of 2002 shrinking by 0.1 per cent following a 0.2 per cent decline in quarter three. At an annual rate, this reflects a decrease in investment of 1.8 per cent in the fourth quarter. While still contracting, there may be signs that investment has at least stabilised following sharp contractions over 2001 and the first half of 2002, during which period quarterly contractions averaged 0.8 per cent.

Weak industrial activity contributed greatly to the subdued activity in the euro area towards the end of last year with production decreasing by 1.6 per cent in December. For the fourth quarter as a whole, quarter on quarter growth in industrial production was negative. After rising substantially in December 2002, the European Commission's industrial confidence indicator fell back again in January and February 2003, driven by a decrease in production expectations and order books. In contrast, the Reuters Purchasing Managers' Index peaked over the 50 line as new orders reached their highest level in six months.

Similar inconsistent signals are present for the services sector, which accounts for nearly two-thirds of the euro area economy. In February 2003, with the sector showing a rise in confidence, the Services' PMI fell to 48.9 driven by the largest contraction in Germany in the 69-month history of the Index. This indicates the first shrinkage in the sector since last September and is the lowest the index has been since November 2001. These results reaffirm the uncertain climate existing in the euro area business sector and this ongoing weakness is expected to continue in the short term.

The tentative economic environment in the euro area has continued to impact on labour market conditions into 2003. The standardised International Labour Organisation (ILO) euro area unemployment rate increased to 8.6 per cent in January 2003 from 8.5 per cent in December. This continues the trend of 2002, which saw an average monthly increase in the numbers unemployed in the third and fourth quarter of 40,000 and 80,000 respectively. As a result annual unemployment in the euro area was 8.3 per cent in 2002. The month on month increase in January was 104,000 and is the greatest increase since unemployment started its upward trend in May 2001. Weak economic growth will continue to impact on the euro area's labour market and we forecast unemployment to increase to 8.6 per cent in 2003 before moderating slightly to 8.4 per cent in 2004.

The Harmonised Index of Consumer Prices (HICP) measure of inflation continues to remain stubbornly above the European Central Bank's (ECB) target of between 0 to 2 per cent. Euro area annual inflation rose from 2.2 per cent in January to a ten month high of 2.4 per cent in both February and March. Inflation rates continue to vary substantially across the euro area. Ireland retained its position at the head of the inflation league with HICP inflation of 5.1 per cent in February, followed by Greece and Portugal with 4.2 and 4.1 per cent respectively. The lowest rates were observed in Germany with 1.3 per cent followed by Belgium and Austria with 1.6 and 1.8 per cent respectively. The main factor behind the recent rise in inflation has been energy prices, reflecting the recent surge in the price of oil. On an annual basis, food prices have shown the largest increase, with annual food inflation running at 5.1 per cent in February. The ongoing volatility in the oil markets will continue to make it difficult to forecast short-term inflation but once some degree of normality has returned to the markets, more fundamental factors should impact on the inflation rate. HICP growth is expected to slow over the course of the year, thus we are forecasting inflation of 1.7 per cent for 2003 as whole and 1.2 per cent in 2004.

Despite the recent spike in inflation, the ECB in its March meeting, decided to further ease monetary policy in the euro area, lowering key interest rates by 25 basis points to 2.5 per cent following the 50 basis point reduction in December. The Governing Council decided that, notwithstanding the volatility in oil prices, the outlook for price stability over the medium term had in fact improved, due largely to the subdued pace of economic growth and the appreciation of the euro. With regard to the “first pillar” of its monetary policy strategy, the M3 measure of broad money remains significantly above the ECB’s target rate of 4.5 per cent, increasing to 7.4 per cent at an annual rate from 6.8 per cent in the previous month. This strong money supply growth continues to be related to the large degree of economic, financial and geo-political uncertainty, which has led to a sharp rise in the demand for short-term liquid assets as well as the low opportunity cost of holding such assets. This growth was not viewed as a cause for concern by the ECB’s governing council when making its interest rate decision due to the expectation that some of the portfolio shifts will be reversed once the financial market uncertainty diminishes.

Over the course of 2002, external demand has faded as a contributor of euro area growth from its strong contribution in the first quarter. Facilitated by the continued appreciation of the euro, this increasing weakness in external demand over 2002 was due to a rising demand for imports and stalling export growth. In the fourth quarter, while import growth weakened to 0.6 per cent quarter on quarter, export growth flattened resulting in a negative contribution to the overall real growth rate in the quarter. This trend looks set to continue in 2003 with initial estimates suggesting that the euro area trade with the rest of the world in January 2003 was a 1.5 billion euro deficit, against a surplus of 1.0 billion in January 2002. In January 2003, exports and imports, seasonally adjusted, increased by 1.0 per cent and 3.6 per cent respectively compared to December 2002. This deterioration in the euro area’s external balance is expected to continue with global trade remaining weak combined with continued forecast appreciation of the euro.

A number of explanations can be given for the euro’s sustained appreciation. Triggered by weak US growth and an increasing difference between short term interest rates in the US and euro area, it may reflect a correction of previous under valuation in the currency. It may also reflect a greater risk premium demanded by market participants in view of the US’s unsustainable current account deficit. Furthermore, in the recent climate of geo-political uncertainty, the euro has acquired a certain safe haven status as indicated by the movement in its value and capital flows in 2002.

Public finance positions in the euro area showed significant deterioration in 2002, stemming mainly from the operation of automatic stabilisers in a weaker than expected economic environment. The stance of fiscal policy in the euro area has also got significantly tighter in 2002. It is estimated that the deficit to GDP ratio increased from 1.5 per cent in 2001 to 2.2 per cent in 2002. Germany in particular has seen the largest deterioration with a deficit to GDP ratio of 3.75 per cent in 2002, well outside the constraints as set out under the *Stability and Growth Pact*. The overall public debt-to-GDP ratio in the euro area remained broadly unchanged at 69.7 per cent in 2002. According to the Stability Programmes submitted to the EU Council, the euro area average deficit ratio is projected to decline to 1.8 per cent in 2003. This is contingent, however, on quite optimistic growth projections and restraint in primary current expenditure. Ratios in Germany, France and Portugal are projected to remain close to or above 3 per cent in 2003 reflecting not only cyclical developments but also the persistence of sizeable structural imbalances within each economy.

In summary, our forecasts for GDP growth in the euro area entail a weaker than expected recovery in 2003, with strong downward revisions to growth rates in the major economies, most notably Germany and France. Weakening external demand, due to both unfavourable global conditions and the continued appreciation of the euro has increased the need for domestic demand to fill that hole. Currently, a number of factors are holding back domestic spending including geo-political uncertainty, higher oil prices, poor profitability and households' concerns over increasing unemployment. For these reasons the scenario of a strong recovery in 2003 remains unlikely. Growth is expected to strengthen in 2004, albeit still below potential.

UK Economy

In comparison to most of the world's other leading economies, the UK economy has performed relatively robustly in recent years experiencing its longest period of sustained quarterly growth since World War II. Real GDP grew by 3.1 per cent in 2000 and 1.9 per cent in 2001. This resilience continued into 2002 with quarterly growth of 0.6 and 0.9 per cent for quarter two and quarter three respectively. On an annual basis, this reflected growth of 1.3 and 1.8 per cent respectively. In the fourth quarter the economy showed signs of stagnation with growth falling back to 0.4 per cent. The latest data show an overall increase of 1.6 per cent in 2002, which is the smallest increase since 1992. We forecast slightly stronger growth of 2.2 per cent in 2003 and 2.5 per cent in 2004.

Although the slowdown at the end of the year reflected a deceleration in most sections of the economy in the fourth quarter, the weakness was most pronounced in manufacturing which declined by 0.9 per cent and is down 4 per cent for 2002. Overall, industrial production was down 0.7 per cent over the quarter and 3.5 per cent for 2002 as a whole. Output was weakest in electronic machinery and equipment, general machinery and cars. This weakness in the manufacturing sector is likely to continue and is confirmed by the recent CIPS/Reuters Purchasing Managers Index, which fell to a level of 46.1 in March down from 48.6 in February. This indicates a fourth successive month of contraction in the manufacturing sector and is the sharpest contraction in one and a half years. The employment and new orders index showed the largest contraction, both at 44.9.

In contrast to the industrial sectors, growth in the services sector remained impressive in 2002 with 2.5 per cent growth over the year, giving the impression of a two speed UK economy over 2002. More recent data indicates that this notable dichotomy has shown signs of diminishing with even the services sector stagnating in early 2003. The CIPS/Reuters Business Activity Index for the service sector fell to 49.0 in March, indicating marginal contraction in the sector, from 50.2 in February. This is the sixth consecutive month of decline and indicates that the recent slowdown has spread across most sections of the economy.

As mentioned in previous *Commentaries*, UK investment declined dramatically over 2002 with the latest annual data showing business and manufacturing investment falling by 10.1 and 14.9 per cent respectively in 2002. Business investment has shown its sharpest decline since records began and has now declined in seven out of the last eight quarters. This sharp decline follows growth in investment of 1.9 per cent in 2000 and a decline of 0.4 per cent in 2001.

Household consumption was up 1.0 per cent in the fourth quarter of 2002 or 3.6 per cent at an annual rate. This growth is, however, slightly lower than the annual rate of 3.8 per cent in the third quarter and has decreased substantially from the first and second quarter growth rates of 4.5 and 4.1 per cent respectively. This slowdown in consumer spending is reinforced by the latest retail sales figures, a leading indicator of consumer spending, which shows a decline for the first time in over seven months.

The UK labour market continues to remain quite resilient despite the notable slowdown in the economy. On an ILO basis, employment in the three months ending December 2002 was 150,000 greater than in the previous quarter standing at 27.8 million. Unemployment was 1.5 million, thereby reflecting a fall in the unemployment rate from 5.3 per cent to 5.1 per cent. This resilience seems to have continued into early 2003 with February unemployment at 1.46 million reflecting a fall in the unemployment rate to 5.0 per cent. However, because labour market conditions usually tend to lag economic activity we expect the weakening economy to impact on the labour market further into 2003. Following an unemployment rate of 5.2 per cent in 2002 we are forecasting unemployment of 5.3 per cent in both 2003 and 2004.

Since the previous *Commentary*, the underlying inflation rate excluding mortgage interest payments (RPIX) has increased significantly. In December RPIX inflation stood at 2.7 per cent increasing by 0.6 percentage points since September 2002. Although inflation remained at 2.7 per cent in January, with upward pressure from increases in oil prices offset by downward food pressures, the RPIX rose in February by 3.0 per cent with the largest upward influence coming from clothing and footwear. This was due to a strong recovery in prices following the January sales. Despite this continuing above target inflation and the fact that between December and January house prices were up 1.7 per cent or 23.4 per cent on a year earlier, the Monetary Policy Committee (MPC) decided in February to cut the main repo rate by 25 basis points to 3.75 per cent. Although RPIX remained above its target, the MPC felt this was largely as a result of temporary factors that would unwind and not due to underlying inflationary factors present in the economy. At its most recent meeting in March, the MPC decided to maintain interest rates at their current level due to fears that further interest rate cuts at a time when inflation is high, albeit temporarily, would impact on inflationary expectations.

Rest of the World

Due to the marked weakness of Germany, the Japanese economy no longer remained the world's slowest growing major economy in 2002 with growth of 0.3 per cent for the year as a whole. This is despite seeming to have lost some of its momentum in the final quarter of 2002 where real GDP growth slowed further to 0.5 per cent after an increase of 1.0 and 0.7 per cent in the second and third quarters respectively. This slowdown is mainly due to a smaller contribution from domestic demand due mainly to weak consumer spending. Exports rebounded strongly in the final quarter resulting in an external demand contribution to GDP growth of 0.3 per cent.

Deflationary pressures in Japan have eased in recent months. The Consumer Price Index (CPI) fell by 0.4 per cent in January year on year. This follows similar rates in the previous two months and is significantly down from the decline of 0.9 per cent posted in October 2002. For 2002 as a whole, the CPI declined by 0.9 per cent compared with 0.7 per cent in 2001. There are also signs that the new leadership at the Bank of Japan is likely to improve the effectiveness of monetary policy especially in staving off deflation. There is no quick fix solution however and continuing structural reform, particularly in the banking sector, is necessary if policies are to succeed. We therefore forecast deflation to ease back to -0.8 per cent in 2003 and -0.7 per cent in 2004.

TABLE 1: Short-term International Outlook

	Output*			Consumer Prices Percentage Change			Hourly Earnings			Unemployment Rate %			Current Account Balance % of GNP		
Country	**2002**	**2003**	**2004**	**2002**	**2003**	**2004**	**2002**	**2003**	**2004**	**2002**	**2003**	**2004**	**2002**	**2003**	**2004**
UK	1.6	2.2	2.5	1.6	2.7	2.8	4.0	4.7	4.7	5.2	5.3	5.3	-1.5	-2.0	-2.0
Germany	0.2	0.7	1.8	1.3	1.0	0.8	2.6	3.0	1.6	8.2	8.5	8.3	1.8	1.6	1.9
France	1.2	1.8	2.0	1.9	1.5	1.2	3.4	3.8	3.6	8.7	8.9	8.9	2.2	1.7	1.5
Italy	0.6	1.4	2.0	0.6	2.3	1.5	2.9	3.2	3.1	9.0	9.0	8.8	-0.5	-0.1	0.0
Euro Area	0.8	1.1	2.0	2.2	1.7	1.2	3.3	3.5	2.9	8.3	8.6	8.4	0.7	0.5	0.6
USA	2.4	2.0	3.2	1.6	2.2	1.7	3.2	3.7	3.8	5.8	6.0	5.7	-4.8	-5.2	-5.0
Japan	0.3	1.0	1.3	-0.9	-0.8	-0.7	-0.9	0.3	1.1	5.3	5.5	5.9	2.5	2.7	2.9
OECD	1.6	1.7	2.4	1.7	1.8	1.2	2.8	3.5	3.5	6.1	6.3	6.2	-0.5	-0.7	-0.5
Ireland	5.7	3.0	3.7	4.7	4.3	3.2	7.0	4.3	4.0	4.4	5.5	5.7	-0.1	0.0	0.8

*Output growth as measured in GDP terms.

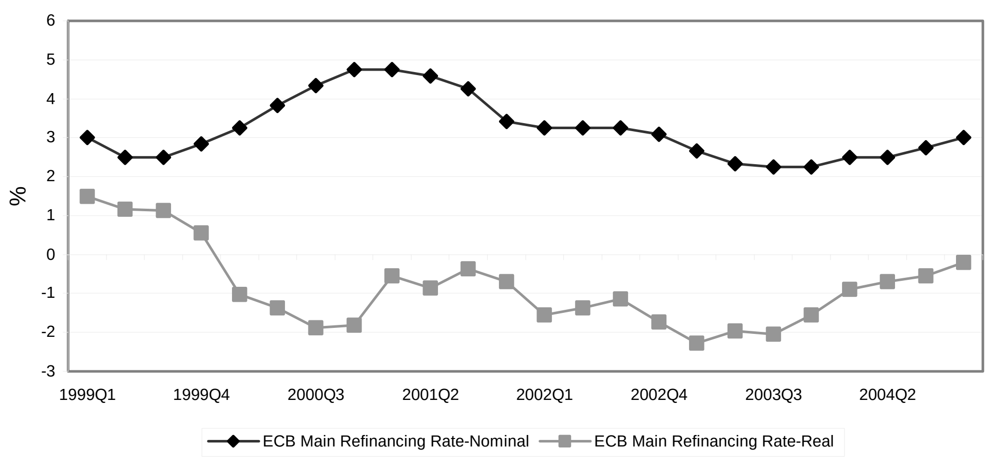
We forecast Japanese recovery to continue in the year ahead, albeit at a slow pace. However, there remain some doubts over the main drivers of recovery in 2003. In 2002, personal consumption and net trade acted as the main forces of growth. External demand is likely to be weak in 2003 and consumption spending is likely to be constrained by subdued developments in disposable income due to declining worker earnings and the continued weakness of the labour market at least in the short term. Therefore, we forecast growth of 1 per cent in 2003 and 1.3 per cent in 2004.

In non-Japan Asia, growth is expected to remain strong and will be driven by exports and manufacturing activity. Domestic demand has also remained supportive of economic activity reflecting the strength of household income. The current uncertain global economic environment has, however, begun to impact on domestic demand in most other Asian economies due to its impact on household and business decisions. China continues to perform better than its neighbours with real GDP growth of 8 per cent in 2002 driven by strong export and fixed asset investment growth. It is interesting to note that China's consumer prices actually rose in January and February following a sixteen-month period of deflation. This return to inflation is due to many factors including oil prices, a 7 per cent depreciation of China's trade weighted exchange rate, stronger demand and the restructuring of its inefficient state owned enterprises who historically had over supplied the market.

Latin America provides some mixed performance, especially among the largest countries. There exists a continued low level of economic activity in Argentina with its significant financial constraints weighing heavily on domestic demand. On the other hand, there are firmer signs of recovery in both Mexico and Brazil.

Figure 1: Interest Rates

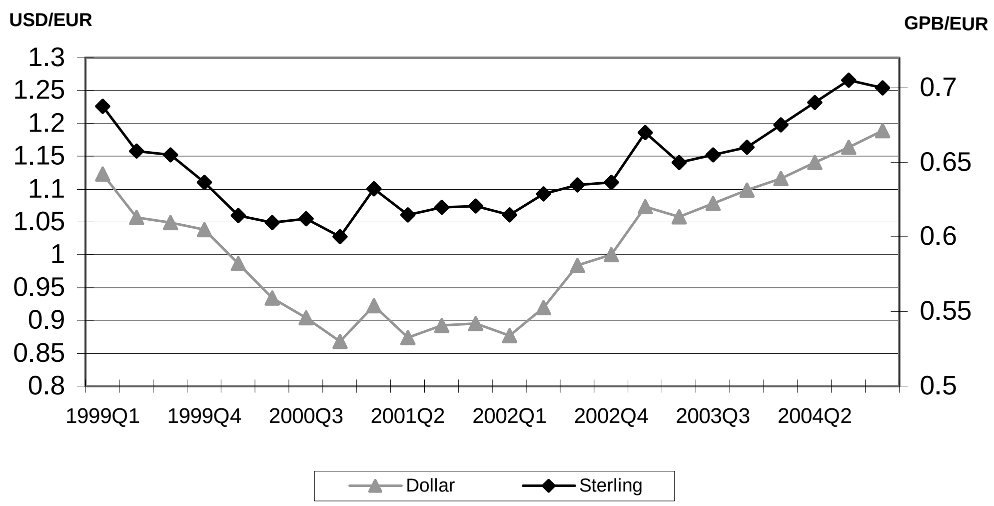
Per Cent Per Annum, Quarterly Averages



The expected recovery in the global economy failed to materialise in 2002 despite accommodative mosnetary and fiscal policy conditions. Continuing from the previous *Commentary*, Irish growth prospects for 2003 and 2004 remain rather uncertain and are dependent upon a recovery in the international economic environment. Recently, renewed weakness in the global economic climate has meant that the prospects for output in all the major international economies is for well below potential growth rates in 2003. This is likely to result in only a modest rise in international trade growth, upon which a small open economy like Ireland is heavily dependent. Economic growth is forecast to move towards trend in most of the major economies in 2004 and we, therefore, expect a positive knock-on effect on Irish trade and therefore overall economic activity.

Figure 2: Exchange Rates

Foreign Currency per Euro, Quarterly Averages



Recent and forecasted interest rate reductions by the main global monetary authorities may provide some stimulus, but with interest rates already at very low levels, monetary policy is likely to become less and less effective. We expect interest rates to fall by a further quarter point around the middle of 2003 and to hold at this level until year-end before rising by as much three-quarters of a percentage point in 2004.

A significant threat for the Irish economy remains the forecasted appreciation of the euro during 2003 and 2004. This will continue to weaken Irish competitiveness, which is already facing significant competitiveness pressures and a difficult external market for exports. The prospect of UK membership of EMU is also likely to become a more important issue for Ireland in the months ahead. The "five tests" of economic credibility, which the UK has to pass before membership of EMU can be recommended, are to be assessed by June 2003. While it is envisaged that these tests could be deemed to be met, our expectation is that the decision to proceed will still be deferred. We do not therefore expect the UK to adopt the euro in the short term because political considerations are likely to override any possible economic justifications. Ireland will therefore have to continue to cope with the possibility of further Sterling depreciation although it may be range bound between €0.67 and €0.70. We expect the euro to appreciate further against the US dollar and to end 2003 and 2004 $1.10 and $1.20 respectively.

BOX 1: Impact of Oil Price Shock

In recent months there has been considerable volatility in the price of oil. Having been around $19 a barrel at the beginning of 2002 oil has traded at over $30 a barrel for much of the year to date, and has fluctuated quite substantially in the lead in to and during the current conflict in Iraq. As oil prices are important, not only for inflation but also for the supply side of the economy it is important to try and assess the impact of an oil price shock. As outlined in the *international section*, considerable uncertainty surrounds the outlook for the world economy at present. Fluctuating oil prices contribute to this uncertainty and significantly higher oil prices could postpone any economic recovery.

Using the NiGEM world model we have simulated the effects of a 100 per cent increase in the price of oil sustained for a year from around $30 per barrel.[1] This provides the international background against which we simulated the effects on the Irish economy using the ESRI *HERMES* macro-model. This simulation is not a forecast but rather it allows us to examine how the world and the Irish economy might respond to an external supply side shock. We have assumed that the monetary authorities view this shock as temporary and so do not respond by changing interest rates.

From a domestic economy perspective the effects depend crucially on how the world economy responds. An oil price shock would result in growth in euro area output being just over 0.4 percentage points lower in the year after the shock and US GDP being 0.8 percentage points lower than otherwise. Output in the UK would rise initially reflecting their position as a net exporter of oil. An oil shock would also cause prices to rise. As measured by the consumer expenditure deflator, such a shock would have the impact of pushing both euro area and US prices 1.4 percentage points higher. The UK would not be as adversely affected with prices being 1 percentage point higher. The simulation also suggests that recovery in output from such a shock would be slow, taking a number of years for the international economy to recover.

The effects of this supply side shock on Ireland would come from the loss of income through the adverse movement in the terms of trade and the slowdown in the international economy. The impact of the shock would be to knock around 0.5 percentage points of GDP and 0.4 percentage points off GNP. As the economy would be growing below its long-term potential rate for a sustained period, there would be an increase in the unemployment rate of just under 0.2 percentage points, compared to what it would have otherwise been. The effect of the rise in oil prices would be to directly raise consumer prices in Ireland. The weakening of the euro as a result of the shock would be expected to have a bigger impact on the price level in Ireland than elsewhere in the euro area, as the Irish labour

[1] The impact on the world economy is based on results from the National Institute of Economic and Social Research NiGEM Model.

market is more flexible. Irish wages would increase by more than wages in competitor countries. This would have a negative impact on competitiveness and would also feed into the price level. By 2005 inflation would be 3 percentage points above base before falling back down to base levels by 2010.

If monetary authorities were to respond to this shock by raising interest rates the impact on Ireland would be more severe. For example, GNP and GDP would be 0.7 and 0.9 percentage points lower respectively than they would otherwise have been. The loss to the Irish economy would be greater than that in the rest of the euro area because of the country's greater sensitivity to interest rate changes. The analysis suggests that any oil price shock, even if temporary, would have a significant short-run impact on the world economy. The results indicate that the international economy remains exposed to oil price shocks. Any such shock would have a greater impact on Ireland than the euro area or the US economy, whether or not there is a response by the monetary authorities.

The Domestic Economy

General

The third quarter 2002 national accounts indicate the extent to which the GDP and GNP measures of economic activity have diverged throughout the course of the year. Volume growth in GDP terms was over 6 per cent while GNP volume growth was much lower at 1.4 per cent. The large gap between these measures relate to net factor income flows in the national accounts. It is worth remembering that GNP is affected by very large flows in the Balance of Payments and is subject to revision. Notwithstanding this caveat the gap is large by historical standards and again reflects the role of the multinational sector. Taking account of the national accounts and data released since the last *Commentary* our estimates for the volume growth in GDP has been revised to 5.7 per cent in 2002 while our estimate for volume growth in GNP now stands at 1.1 per cent.

It seems likely that growth in the Irish economy will slow again this year in an environment of much economic uncertainty. With little prospect of a sharp recovery internationally we are forecasting that GDP will grow by 3 per cent in volume terms in 2003 and that volume growth in GNP will be 2.4 per cent. The gap that emerged between GDP and GNP in 2002 is forecast to narrow on the basis of much weaker economic activity.

Provided the world economy begins to show signs of recovery towards the end of this year the outlook for 2004 is moderately better with GDP growth improving in volume terms to 3.7 per cent. With growth in net factor outflows remaining subdued GNP is forecast to grow at 3.5 per cent in volume terms during 2004.

Exports

Trade statistics show that in 2002 the value of visible exports was over €93.5 million, just 1 per cent higher than in 2001. Most commodity categories showed moderate declines in the value of their exports. Much of the total increase was accounted for by chemicals, especially medical and pharmaceutical products. The official figures also indicate that the volume of visible exports contracted in 2002 by around 0.5 per cent, suggesting an average visible export price deflator of 1.6 per cent in 2002. Merchandise export figures taking account of Balance of Payments adjustments for the first nine months of 2002 show an increase of 4.2 per cent in value terms. On the basis of these figures it is estimated that merchandise exports rose by 6.1 per cent in value terms and 4.4 per cent in volume terms in 2002. Tourism earnings are estimated to have risen by 5.2 per cent in volume terms during 2002, while other service exports rose by 5 per cent. Thus, total exports of goods and services rose by 4.5 per cent in volume terms and by 7.1 per cent in value terms. On the basis of these growth rates then this implies a total export price deflator of 2.4 per cent.

Irish exports are facing a more uncertain world environment in 2003 and 2004. At the same time it seems likely that there will be less new capacity coming on stream as investment and FDI grow at very moderate levels. Furthermore the competitiveness of exports will be adversely affected by the sustained appreciation of the euro. Thus, merchandise exports are forecast to increase by around 4.3 per cent in 2003 in volume terms, broadly similar to the growth rate in 2002. The impact of the war in Iraq on international travel coupled with slow growth in the European economies and high domestic price levels are likely to be reflected in very small growth in tourism exports this year. A less severe slowdown is forecast in other service exports. On the basis of these forecasts total exports are expected to grow by 4.2 per cent in volume terms. This, coupled with a price deflator of 1.4 per cent suggests that total exports in 2003 will increase by 5.7 per cent in value.

TABLE 2: Exports of Goods and Services

	2001	% Change in 2002		2002	% Change in 2003		… 2003	% Change in 2004		2004
	€m	Volume	Value	€m	Volume	Value	€m	Volume	Value	€m
Agricultural	4,078	-2.0	-1.8	4,004	2.0	3.0	4,125	3.1	5.6	4,355
Manufactured	80,945	-0.4	1.4	82,073	4.5	5.3	86,452	4.2	6.6	92,155
Other Industrial	5,726	-1.0	-0.9	5,675	2.8	3.9	5,898	3.1	5.2	6,202
Other	1,774	0.2	0.4	1,781	2.7	4.0	1,853	3.0	5.4	1,952
Total Visible	**92,523**	**-0.5**	**1.1**	**93,533**	**4.3**	**5.1**	**98,328**	**4.1**	**6.4**	**104,665**
Adjustments	-3,972	-110.0	-110.2	405	15.0	16.2	471	15.0	16.2	547
Merchandise	**88,551**	**4.4**	**6.1**	**93,938**	**4.3**	**5.2**	**98,799**	**4.1**	**6.5**	**105,211**
Tourism	3,088	5.2	9.9	3,395	0.5	3.6	3,517	1.3	4.1	3,663
Other Services	20,729	5.0	10.8	22,963	4.5	7.9	24,788	5.8	9.2	27,065
Exports of Goods and Services	**112,368**	**4.5**	**7.1**	**120,295**	**4.2**	**5.7**	**127,104**	**4.4**	**7.0**	**135,939**

As outlined in the *International section* world economic activity is expected to show some recovery in 2004. However, this is expected to be relatively moderate and the factors determining export growth in 2003 will continue to influence growth in 2004. Any world recovery will take time to influence activity domestically and so a slight moderation is expected in merchandise export growth in 2004, mainly reflecting a slowdown in manufactured exports. Some recovery in tourism and other service exports means that for 2004 total exports are forecast to grow by 7 per cent in value terms. With volume growth forecast at 4.4 per cent this implies an export deflator in 2004 of 2.5 per cent.

Stocks

Third Quarter National Accounts 2002 reveal that stocks rose by €39 million in the first three quarters of the year in value terms and by €142 million in volume terms. For the year as a whole the increase in stocks is projected at €40 million for total stocks. A moderate increase in farm stocks next year coupled with an increase in industrial and distribution stocks is forecast to lead to stock levels increasing by €230 million in 2003. The increase in farm stocks is forecast to reverse in 2004 and with a lower rise in industrial and distribution stocks an annual stock change of €190 million is expected in 2004.

TABLE 3: Stock Changes

	2001	Change in Value	2002	Change in Value	2003	Change in Value	2004
	€m	€m	€m	€m	€m	€m	€m
Farm Stocks	-26	166	140	30	170	-40	130
Irish intervention Stocks	15	-15	0	0	0	0	0
Other Non-Agricultural Stocks	290	-390	-100	160	60	0	60
Total	**279**	**-239**	**40**	**190**	**230**	**-40**	**190**

Investment

The Quarterly National Accounts indicate that the volume of investment activity in the first nine months of 2002 contracted by nearly 0.7 per cent. This mainly reflects a decline in the first quarter of the year as investment grew by 2.1 per cent in the third quarter. The main driver behind the growth in investment has been the residential market. It seems likely, on the figures available to date, that housing completions will have reached a new peak again in 2002. However, other short-term indicators suggest that investment in other building or investment in plant and machinery has been contracting over the course of the year. On the assumption that there was not a dramatic reversal of these trends in the fourth quarter overall investment is forecast to have contracted in 2002 by around 0.1 per cent.

Once again the current uncertainty will be one of the main influences on investment activity in 2003. The strength of housing completions over the past number of years should have moved housing supply more in line with housing demand. On this basis it seems unlikely that a new peak for housing construction will be set in 2003. Indeed, we are forecasting a moderate decline of 1.5 per cent in volume terms. On the assumption that completions are close to 57,000 in 2002 this implies that completions will remain high at over 56,000. Economic uncertainty and public finance constraints will contribute to a lower level of investment in other building.

Thus investment in building and construction is forecast to decline by 1.3 per cent in 2003. Following two years of contraction volume growth in investment in machinery and equipment is forecast to be 0.5 per cent. An annual decline in total gross capital formation in 2003 of 0.5 per cent in volume terms is forecast. With overall investment expected to increase by 2.5 per cent in value terms this implies an investment deflator of 3 per cent.

Given the slow pace of activity in Europe it is likely that interest rates will remain low for much of 2003 and into 2004. However, substantial growth in investment is not anticipated until any emerging recovery is seen as being sustainable. A further marginal decline in new house building is forecast for 2004 although a return to growth in other building activity will result in overall investment in building and construction growing by 0.5 per cent in volume. With investment in machinery and equipment recovering to grow by 3 per cent overall investment should grow by 1.5 per cent in volume in 2004. With an unchanged investment deflator of 3 per cent this means that in value terms investment will grow by 4 per cent in 2004.

Consumption

Retail sales statistics for 2002 show that growth in consumption was much more moderate than in recent years, with the overall index growing by just 0.7 per cent in volume terms. Excluding the more volatile component of the motor trade results in an annual growth rate of 2.2 per cent. The Quarterly National Accounts for the first nine months of 2002 also indicate that personal consumption growth will be more moderate than in recent years. On the basis of these indicators we have estimated that consumption in volume terms grew by 2.5 per cent in 2002. Coupled with a consumer expenditure deflator of 4.5 per cent this implies that the value of consumption grew by 7.1 per cent last year.

It seems unlikely that there will be any substantial improvement in personal consumption growth in 2003. Income growth is expected to be lower, the labour market will show some loosening with the unemployment rate rising and the savings ratio is expected to remain high. Since the last *Commentary* the IIB Bank/ESRI Monthly Consumer Sentiment Index has shown consumer sentiment on a downward trend. Thus, total personal consumption is forecast to rise by 6.4 per cent in value. An unchanged rate of volume growth from 2002 results in a personal consumption deflator of 3.8 per cent.

TABLE 4: Gross Fixed Capital Formation

	2001 €m	% Change in 2002 Volume	% Change in 2002 Value	2002 €m	% Change in 2003 Volume	% Change in 2003 Value	2003 €m	% Change in 2004 Volume	% Change in 2004 Value	2004 €m
Housing	9,541	8.2	13.8	10,860	-1.5	2.9	11,179	-0.5	2.5	11,456
Other Building	8,509	-3.3	-1.4	8,393	-1.0	1.8	8,541	1.5	3.7	8,860
Building and Construction	18,050	2.2	6.7	19,253	-1.3	2.4	19,720	0.5	3.0	20,317
Machinery and Equipment	8,620	-3.1	-3.6	8,311	0.5	2.5	8,520	3.0	6.3	9,056
Total	26,670	-0.1	3.4	27,564	-0.5	2.5	28,240	1.5	4.0	29,373

Our forecast for growth in personal consumption for 2004 shows a small improvement when compared with 2002 and 2003. A volume increase of 3.2 per cent is forecast with a consumer expenditure deflator of 2.8 per cent. This indicates that in value terms personal consumption is anticipated to grow by 6.1 per cent in 2004.

According to the Quarterly National Accounts, government consumption or "net expenditure by central and local government on current goods and services" in the third quarter of 2002 increased by 7.5 per cent in volume and by 12.3 per cent in value, resulting in a public expenditure deflator of 4.5 per cent. Strong public sector employment growth combined with pressures on spending means that we estimate annual government consumption grew by 8.5 per cent in volume terms for 2002. The public service deflator is expected to average 5.6 per cent reflecting continuing cost pressures. On this basis a value increase of 14.5 per cent is forecast for 2002. On the assumption that the curtailment of public expenditure growth is successful, growth of 0.8 per cent in the volume of government spending is forecast for 2003. However, benchmarking and public sector pay awards will ensure that the public price deflator remains high at 7.3 per cent resulting in a value increase of 8.2 per cent. These factors also frame our forecast for 2004, although a more moderate price deflator of 3.2 per cent is anticipated. With volume growth of just 1 per cent this implies a value increase of 4.3 per cent in government consumption in 2004.

TABLE 5: Consumption Indicators

	Annual Percentage Change						
	1998	**1999**	**2000**	**2001**	**2002**	**2003 Forecast**	**2004 Forecast**
Consumption Value							
Personal Consumption	11.7	12.6	13.5	9.6	7.1	6.1	3.8
Retail Sales Index, Value	9.8	11.4	16.3	5.9	4.0	6.5	4.2
Divergence	1.9	1.2	-2.8	3.7	3.1	-0.4	-0.4
Consumption Volume							
Personal Consumption	7.6	9.3	9.0	5.1	2.5	2.5	3.2
Retail Sales Index, Volume	8.1	9.5	11.9	3.1	0.7	3.1	2.5
Divergence	-0.5	-0.2	-2.9	2.0	1.8	-0.6	0.7
Consumer Prices							
Personal Consumption Deflator	3.8	3.0	4.1	4.2	4.5	3.8	3.2
Retail Sales Index Deflator	1.6	1.7	3.9	2.7	3.3	3.3	1.7
Consumer Price Index	2.4	1.6	4.5	5.6	4.7	4.3	3.2

Final Demand

Final demand is estimated to have increased by 7 per cent in value and by 3.6 per cent in volume in 2002. Domestic demand excluding stocks is estimated to have grown by 2.7 per cent in volume and by 7.2 per cent in value, while the volume rise in exports of goods and services was 4.5 per cent.

Final demand is forecast to grow by similar rates in 2003 at 3 per cent in volume. A lower price deflator of 2.7 per cent implies value growth of 5.7 per cent. Once again volume growth in exports at 4.2 per cent is forecast to exceed volume growth in domestic demand, excluding stocks, of 1.4 per cent. The forecasts outlined in the *Commentary* result in final demand growth in volume terms of 3.5 per cent in 2004. Exports of goods and services are forecast to grow by 2.2 per cent in volume while domestic demand excluding stocks is forecast to grow by 2.4 per cent. With personal consumption and exports contributing to the growth in demand, the composition of final demand can be expected to be quite import-intensive.

Imports

The trade statistics show that visible imports fell by 3.6 per cent in 2002 in value and by 2.4 per cent in volume. Figures for the first eleven months of 2002 show that the decline in value terms affected capital and intermediate goods while consumer goods showed only marginal growth. This is consistent with other indicators for investment and industrial production. From Balance of Payments estimates for the first nine months of 2002 merchandise imports for the year as a whole are estimated to have fallen by 1.2 per cent in volume and 3.4 per cent in value. The rise in tourism spending abroad is estimated at 4.2 per cent, while other service imports, including royalty payments, increased by 4 per cent in volume. Thus, total imports of goods and services in 2002 are estimated to have risen by 1 per cent in volume. With an estimated price deflator of just 0.4 per cent this implies a value increase of 1.5 per cent, the lowest increase in recent years.

In keeping with our forecast for the rise in domestic demand this year we have revised down our forecasts for the rate of growth of capital goods. Similarly, the lower rate of growth projected for manufactured exports are likely to be reflected in a reduced rate of increase in intermediate goods. Visible imports are therefore forecast to rise by 3 per cent in 2003 in volume terms. Allowing for the Balance of Payments adjustment merchandise imports are forecast to increase by 2.3 per cent in volume. Given a forecast price deflator of 1.8 per cent the resulting growth in value terms will be 4.1 per cent. Some moderation in tourism spending abroad is forecast, reflecting uncertainty and lower disposable income growth and other service imports are also forecast to rise less rapidly than previously estimated. Total imports of goods and services in 2003 are, therefore, forecast to increase by 3.1 per cent in volume and by 5 per cent in value, implying a price deflator of 1.9 per cent.

Based on our assumption that the world economy begins to recover towards the end of 2003 and that this, albeit moderate growth, is sustained throughout 2004 we anticipate that import growth will increase next year. Thus, the volume growth of imports of goods and services is expected to improve to 3.6 per cent in 2004 while a price increase will mean that the growth in value terms will be 5.8 per cent.

TABLE 6: Imports of Goods and Services

	2001 €m	% Change in 2002 Volume	% Change in 2002 Value	2002 €m	% Change in 2003 Volume	% Change in 2003 Value	2003 €m	% Change in 2004 Volume	% Change in 2004 Value	2004 €m
Capital Goods	7,502	-5.0	-3.1	7,269	3.5	5.6	7,674	3.6	5.7	8,109
Consumer Goods	12,286	0.5	2.6	12,606	4.5	7.8	13,595	3.2	4.7	14,241
Intermediate Goods:										
Agriculture	950	0.5	-1.0	940	4.4	6.0	997	4.2	6.3	1,059
Other	34,528	-2.0	-6.4	32,315	2.2	3.2	33,356	3.9	5.8	35,281
Other Goods	2,119	-3.0	-5.4	2,004	3.0	4.2	2,,089	3.7	6.0	2,214
Total Visible	**57,384**	**-1.9**	**-3.9**	**55,135**	**3.0**	**4.7**	**57,711**	**3.7**	**5.5**	**60,904**
Adjustments	-3,090	-13.0	-13.0	-2,689	15.0	15.0	-3,092	15.0	15.0	-3,556
Merchandise Imports	**54,294**	**-1.2**	**-3.4**	**52,446**	**2.3**	**4.1**	**54,619**	**3.1**	**5.0**	**57,348**
Tourism	3,216	4.2	8.4	3,485	3.5	6.1	3,697	3.5	5.8	3,911
Other Services	37,981	4.0	7.8	40,962	4.0	6.1	43,452	4.3	6.9	46,454
Imports of Goods and Services	**95,491**	**1.0**	**1.5**	**96,893**	**3.1**	**5.0**	**101,768**	**3.6**	**5.8**	**107,713**

Balance of Payments

Visible trade figures for 2002 indicate that the trade surplus rose by 9.3 per cent. When account is taken of Balance of Payments trends for the first nine months of 2002 the merchandise trade surplus rose by 21.1 per cent to over €41.4 billion. Our forecasts also suggest that the deficit on trade in services also widened, albeit at a much more moderate rate than in recent years. We estimate the trade balance in goods and services grew by 38.7 per cent in 2002.

On the basis of statistics for the first nine months of the year it is estimated that profit outflows increased by 12.5 per cent in 2002, while reinvested earnings rose by 22 per cent. Both national debt interest and other debit flows are estimated to have declined. Credit flows are estimated to have declined sharply, so that net factor outflows are estimated to have risen substantially by 35.9 per cent to over €24 billion. Net current transfers are estimated to have risen marginally and the overall deficit on the current account is estimated to have narrowed to €132 million. The impact of the divergent trends between debit and credit flows in the Balance of Payments is reflected in the wide divergence between our forecast growth for GDP and GNP in 2002.

TABLE 7: Balance of Payments

	2001 €m	Change %	2002 €m	Change %	2003 €m	Change %	2004 €m
Visible Trade Balance	35,139	9.3	38,398	5.8	40,617	7.7	43,761
Adjustment	-882		3,094		3,562		4,102
Merchandise Trade Balance	**34,257**	**21.1**	**41,492**	**6.5**	**44,180**	**8.3**	**47,863**
Service Trade Balance	-17,380	4.1	-18,090	4.2	-18,844	4.2	-19,637
Trade Balance in Goods and Services	**16,877**	**38.7**	**23,402**	**8.3**	**25,335**	**11.4**	**28,226**
Total Debit Flows	-47,633	5.0	-50,009	5.0	-52,530	4.4	-54,815
Total Credit Flows	29,956	-13.3	25,985	3.4	26,881	1.8	27,374
Net Factor Flows	**-17,677**	**35.9**	**-24,024**	**6.8**	**-25,649**	**7.0**	**-27,441**
Net Current Transfers	**455**	**7.6**	**489**	**-41.8**	**285**	**-33.4**	**190**
Balance on Current Account	**-345**		**-132**		**-29**		**975**
Capital Transfers	654	-4.9	622	-14.5	532	-9.8	480
Effective Current Balance	**309**		**490**		**503**		**1,455**

Our trade forecasts for 2003 and 2004 indicate that the trade surplus in goods and services will continue to rise, although the rate of increase will be much more moderate than in recent years. The slowdown in activity both internationally and domestically is expected to be reflected in much more moderate growth in debit and credit flows over the next two years. The result of this, slower growth in net factor outflows, will see a narrowing in 2003 and 2004 of the gap that emerged between GDP and GNP in 2002. Our forecasts result in the deficit on the current account narrowing to just €29 million in 2003 before moving into a surplus in 2004 of €975 billion. Once account is taken of capital transfers the effective balance on the current account has remained in surplus over the forecast period and is expected to reach €1.4 billion in 2004.

Gross National Product

Real GDP rose by an estimated 5.7 per cent in 2002. This is higher than our forecast in the Winter 2002 *Commentary* and in line with the increase recorded for 2001. The main cause for the revision to our estimate is much weaker growth in imports in 2002 than we had previously anticipated. The CSO *Quarterly National Accounts* show a rise in real GNP of 1.4 per cent for the first nine months of 2002, and our forecast of 1.1 per cent for the year as a whole suggests that the second half of the year was much weaker that the first half of the year and that the annual average owes much to a strong growth figure of 4.1 per cent in the second quarter. The *Quarterly National Accounts* also show that the economy contracted in GNP terms in the third quarter, recording a volume decline of 0.3 per cent. In GDP terms the economy grew by 6.1 per cent in the first nine months. As discussed in the *Balance of Payments* section a wide gap between the two measures has emerged throughout 2002 reflecting very strong net profit outflows.

For the years 2003 and 2004, the projected growth rates in real GNP are 2.5 per cent and 3.5 per cent respectively. The forecast for 2003 represents a downward revision to our previous forecast for the year reflecting the current slowdown in activity. The terms of trade are forecast to deteriorate in 2003 and this together with a reduction in the volume of current transfers means that the rise in Gross National Disposable Income (GNDI) including capital transfers will be 1.8 per cent in 2003. The forecasts for import and export prices suggest a terms of trade gain in 2004 and while current transfers will continue their decline in volume terms the net impact is forecast to be a 3.6 per cent volume increase in GNDI.

Agriculture

The agriculture sector experienced quite a sharp decline in 2002 with preliminary estimates showing that agricultural income, as measured by operating surplus, fell by €233 million or 8.9 per cent. This measure of income is before deductions for land rental and interest payments, which are quite sizeable for the sector. This contraction in the sector is quite stark when compared to the increase of 4.2 per cent the previous year, which included the foot and mouth crisis.

To a large extent, the reduction in incomes reflected unfavourable weather conditions, falling output prices and rising input prices. The value of milk output fell by €147 million or 9.4 per cent, the value of sheep by €81 million or 28.5 per cent and the value of cattle by €82 million or 6.6 per cent. The value of intermediate consumption grew by 2.2 per cent and was mainly driven by increases in feeding stuffs and contract work, both of which grew by 8.6 and 4.5 per cent respectively. The resulting effect on farm incomes has been cushioned somewhat by net subsidies, which increased by 17.4 per cent in 2002. It is estimated that net subsidies accounted for 68 per cent of total operating surplus in 2002 as compared to 53 per cent in 2001.

Looking specifically at prices, the agricultural output price index was down 4.4 per cent in 2002. This reflects large decreases in the price of sheep, pigs and milk, which fell by 15.6, 12.4 and 6.8 per cent respectively.

Milk prices continue to be the most important for the agriculture sector as it accounts for almost one- third of gross output. Input prices also continued to erode farmer's margins in 2002 increasing by 0.9 per cent over the year. This combination of falling output prices and rising input prices meant that the agricultural sector as a whole saw a terms of trade deterioration of 5.2 per cent in 2002.

This trend of increasing input and decreasing output prices has continued in 2003. The January seasonally adjusted input price index increased by 0.4 per cent and the output price index decreased by the same amount, thereby leading to a reduction in the terms of trade of 0.9 per cent. Following the very sharp contraction of 6.9 per cent in volume terms in 2002, we estimate a year on year expansion in the volume of gross agricultural output of 10 per cent in 2003. Contraction is expected to return to the sector in 2004 where we forecast gross output to decrease by 2.5 per cent.

Industry

Estimates from the latest *Quarterly National Accounts* indicate that the volume of production in Irish industry grew by 9.8 per cent in the third quarter of 2002 when compared to the corresponding period of 2001. On an annual basis growth averaged 9.0 per cent over the first half of the year thereby reflecting a relatively strong recovery following negative growth for the sector in the second half of 2001. The latest *Industrial Production and Turnover* release from the CSO also confirms this growth. Volume indices of production for all industries show growth of 10.7 and 7.1 per cent in the third and fourth quarters respectively when compared to the same period last year. However, when the series is seasonally adjusted, both these quarters show a contraction of 3.6 and 1.2 per cent respectively, indicating a significant slowdown in the sector in the second half of 2002.

For 2002 as a whole, the volume of production index for all industries increased by 7.9 per cent and for manufacturing by 8.4 per cent. Both of these increases reflect the lowest growth since 1996 and continue to be greatly exaggerated by the unusual structure of Irish manufacturing. This relates, in particular, to the predominance of the chemical and pharmaceutical sector in which the volume of production grew by over 24 per cent in 2002. The current index has 1995 as its base and uses weights from the *Census of Industrial Production* for the same year. The index is soon to be re-based to 2000 during which the volume of production index for basic chemicals was at 460, as opposed to 209 for total manufacturing industry, implying that the sector will become twice as important in determining future volume of production movements. In contrast to this, the ICT sector continues to experience significant weaknesses with production of electrical and optical equipment falling by 9.4 per cent in 2002 and office machinery and computers by 18.3 per cent.

The slowdown in the manufacturing sector towards the end of 2002 and into 2003 has been confirmed by recent survey data. For March, the *NCB Purchasing Managers' Index* indicated a contraction in the sector for the sixth consecutive month with the index declining to 47.4 from 48.4 in February. Although the rate of contraction was more moderate than in previous months, the last time the index was this low was November 2001. The output component of the index saw a sharp decline in March and posted 46.1 compared to 48.3 in February. Increasing international uncertainty, which has been compounded by the war in Iraq, continues to weigh heavily on the sector. This deteriorating international environment is reflected most clearly in the export orders index which has declined for the eighth consecutive month, although the rate of decline was less pronounced than February's 16-month record low rate. These weaknesses have also had a large impact on employment in the sector, which contracted for the seventh consecutive month in March. A strong recovery in the sector in 2003 looks a remote possibility, especially considering the deteriorating international outlook. We, therefore, forecast more moderate growth of 2.4 per cent for total industry this year, a downward revision from our last *Commentary,* and slightly stronger growth of 3.9 per cent in 2004 due to the forecasted rebound in international economic activity.

Services

Following gross output growth of 7.2 per cent in 2001, growth in the services sector is estimated to have slowed in 2002 to around 4.3 per cent in volume terms. This reflects quite strong recovery in early 2002 following a sharp decline in the sector in the latter part of 2001. The sector has expanded consistently in 2002 and into 2003 as indicted by recent survey data. The *NCB Purchasing Managers' Index* for services has shown an expansion in the sector for the sixteenth consecutive month up to March 2003, although the pace on expansion was the slowest since growth resumed in December 2001.

The business activity index posted 50.3 in March, compared to 51.2 the previous month. This continues to indicate a rise in overall activity even if the rate of increase is quite subdued. Growth in the sector peaked in October 2002 and the consensus view held by those firms interviewed was that slowing growth reflected increased caution in the light of the current geo-political circumstances. Expectations for activity levels in one year's time remained significantly positive in March, with an improvement in the degree of business sentiment reported for the second month running. Employment remained weak with cuts to staffing levels for the ninth consecutive month in March. Much of the recent reduction in employment has been due to firms' efforts to cut costs to allow for more competitive output pricing. In this regard, average costs were reported higher in March with many firms citing higher oil prices as offsetting any mitigating effects drawn from the recent strength of the euro.

We forecast further weakness in the sector in 2003 with output growth of 1.8 per cent in volume terms for the year. Paralleled to the wider economy, we expect activity in the sector to pick up in 2004 where we forecast growth of 3.4 per cent.

Employment

The Quarterly National Household Survey (QHNS) for the fourth quarter of 2002 shows that employment in the Irish economy increased by 1.4 per cent last year, albeit at a slowing rate. This compares to increases of 2.9 and 4.7 per cent in 2001 and 2000 respectively. In absolute terms, average employment in 2002 was 1.765 million persons compared with 1.741 million in 2001. The average unemployment rate for the year finished at 4.4 per cent compared to 3.9 per cent in 2001. Although, the deterioration in the Irish labour market is notable during 2002, it has not been as stark as we might expect in the current climate of decelerating growth. It is clear that much of the expected impact on labour market conditions has not been fully experienced and has been masked by public sector employment increases. These increases will not continue in the short term and more recent live register releases indicate that labour market conditions are continuing to deteriorate in 2003.

Although employment decreased in the fourth quarter of 2002 by 24,100, this was due mainly to seasonal factors such as student summer work, which boosted employment in the third quarter. Seasonally adjusted data suggest that, following the first decline in employment in over a decade in the third quarter, final quarter employment increased by nearly 13,000 or 0.7 per cent. When compared to the fourth quarter of 2001, employment increased by 17,800 or 1.0 per cent. This represents a significant difference from the 2001 fourth quarter annual growth of 2.5 per cent. Sectors showing the largest annual increases were education and health (17,000), construction (6,000) and public administration and defence (5,700). The sectors showing the starkest annual decline in employment are other production industries, which declined by 5 per cent or 15,800 persons and agriculture, forestry, and fishing, which fell by 3.7 per cent or 4,600 persons. Employment growth in the public sector has been the driving force behind total employment growth in 2002. It is therefore expected that employment growth will slow down significantly in 2003 due to the cap placed on new recruitment into the public sector announced as part of Budget 2003.

The number of people unemployed in the fourth quarter was 84,100, an annual increase of 11,500 when compared to the same quarter in 2001. This represents an unemployment rate of 4.5 per cent compared to 4.6 per cent in the third quarter and 4.0 per cent a year earlier. This annual increase in unemployment was concentrated in the 25-44 age group, which accounted for 60 per cent of the overall increase. In the fourth quarter, the male unemployment rate was 4.8 per cent and the female rate was 4.2 per cent. Although the unemployment rate implies an improvement in labour market conditions between the third and fourth quarter of 2002, the latest live register analysis for March 2003 indicates that weak economic growth is continuing to impact on the Irish labour market. Seasonally adjusted, the live register rose by 500 persons or 0.3 per cent in March following a 1.2 per cent increase in February. On an annual basis this represents an increase of 5,800 or 3.5 per cent from March 2002.

TABLE 8: Employment and Unemployment*

	Annual Averages			
	2001	**2002**	**2003**	**2004**
Agriculture	123	121	120	120
Industry	504	494	492	495
Services	1,114	1,150	1,154	1,159
Total at Work	**1,741**	**1,765**	**1,766**	**1,774**
Unemployed	71	82	99	103
Labour Force	**1,812**	**1,847**	**1,864**	**1,877**
Unemployment Rate %	3.9	4.4	5.3	5.5
Live Register	142	163	186	193

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

The expansion in the Labour force also slowed at the end of 2002 with growth of 1.6 per cent or 29,200 persons in the year to the fourth quarter. This is compared to growth of 2.6 per cent in the same period of 2001. Notably, all of the labour force growth was due to demographic factors. It is estimated that if participation rates remained the same the labour force should have increased by 2.1 per cent or 37,900. This therefore reflects reduced participation in the labour force and is particularly evident in the younger 15-34 age group.

It is estimated that employment growth will actually cease in 2003. Continuing the trend of 2002, reduced employment will be experienced in both the agriculture and industrial sectors with the number of persons at work falling by 0.5 and 0.3 per cent respectively. We also forecast the services sector increase to moderate to 0.3 per cent following growth of 3.3 per cent in 2002. Therefore, the service sector increase will be only just insufficient to offset the decreases in the other two sectors, hence no overall increase in employment. We forecast a slight improvement in labour market conditions in 2004 when we expect employment to grow by 0.5 per cent as a result of the forecasted upswing in economic activity. The deterioration in employment growth reflects both a slowdown in the economy and slower labour force growth, which is forecasted to be 0.9 and 0.7 per cent in 2003 and 2004 respectively. We estimate an average unemployment rate of 5.3 per cent this year before rising to 5.5 per cent in 2004. This is an upward revision from the previous *Commentary*. This will mean that the average of total numbers unemployed will increase substantially from 82,000 persons in 2002 to 99,000 and 103,000 in 2003 and 2004 respectively.

Incomes

As a result of deteriorating economic activity over the course of 2002 we have revised down our forecasts for income growth since the previous *Commentary*. In particular, it is forecasted that a more uncertain and weaker economic environment will reduce the demand for labour and will apply downward pressure to wage growth. Growth in hourly earnings is estimated at 7.0 per cent in 2002 and is expected to slow to 4.3 per cent and 4.0 per cent in 2003 and 2004 respectively. The wage rates forecast in this *Commentary*, coupled with the forecast negative employment growth in 2003 imply that the labour share of national output will decline over the course of the year.

Following growth of nearly 5 per cent in 2001, we estimate that agricultural incomes have fallen by 8.2 per cent in 2002. As already discussed in a previous section, this is primarily as a result of reduced operating margins in the sector due to the double impact of increased input prices and reduced output prices. A significant year on year improvement is anticipated in 2003 and we estimate that agricultural incomes will rise from this low base by 7.2 per cent before moderating to 5.2 per cent in 2004.

The non-agricultural wage bill has expanded quite strongly in 2002 and is estimated to have grown by 8.8 per cent. With employment growth expected to halt in 2003, the non-agricultural wage bill looks set to grow more moderately. We therefore forecast more muted growth of 4.4 per cent in 2003 before slightly improving income growth of 3.8 per cent in 2004. The release of the national accounts for the third quarter of 2002 has resulted in substantial upward revisions to the growth of net factor income. Net factor payments are now estimated to have grown by 30.7 per cent in volume terms during 2002 compared to growth of 12.4 per cent in 2001. This has led to a significant decrease in the GNP/GDP ratio, which currently stands at 81 per cent. This considerable increase in net factor flows reflects a marked increase in the repatriated profits of foreign multinationals present in the Irish economy and, to a much lesser extent, the reduction of inflows from Irish investments abroad.

TABLE 9: Personal Disposable Income

	2001	Change		2002	Change		2003	Change		2004
	€m	%	€m	€m	%	€m	€m	%	€m	€m
Agriculture, etc.	3,310	-8.2	-270	3,040	7.2	220	3,260	5.2	170	3,430
Non-Agricultural Wages	46,857	8.8	4,129	50,986	4.4	2,233	53,219	3.8	2,031	55,250
Other Non-Agricultural Income	14,042	-2.7	-379	13,663	12.2	1,668	15,331	6.9	1,064	16,396
Total Income Received	**64,209**	**5.4**	**3,481**	**67,689**	**6.1**	**4,121**	**71,810**	**4.5**	**3,265**	**75,076**
Current Transfers	11,103	20.2	2,242	13,345	6.3	835	14,180	5.5	780	14,960
Gross Personal Income	**75,312**	**7.6**	**5,723**	**81,034**	**6.1**	**4,956**	**85,990**	**4.7**	**4,045**	**90,036**
Direct Personal Taxes	14,832	-0.7	-98	14,734	6.4	946	15,680	4.3	680	16,360
Personal Disposable Income	**60,479**	**9.6**	**5,821**	**66,300**	**6.0**	**4,010**	**70,310**	**4.8**	**3,365**	**73,675**
Consumption	55,144	7.1	3,922	59,066	6.4	3,777	62,843	6.1	3,827	66,670
Personal Savings	5,336	35.6	1,899	7,234	3.2	233	7,467	-6.2	-462	7,006
Savings Ratio	8.8			10.9			10.6			9.5

After an estimated fall of 2.1 per cent in 2001, other non-agricultural incomes, which are mainly constituted by personal income from profits and rents, have suffered continuing weakness in 2002, declining by an estimated 2.7 per cent. Recovery in economic activity should boost other non-agricultural incomes in 2003, which are forecast to grow by 12.2 per cent before moderating to 6.9 per cent in 2004. Therefore, overall personal disposable income looks set to slow in 2003 and 2004 with forecasted growth of 6.0 and 4.8 per cent respectively following estimated growth of 9.6 per cent in 2002. As a result of this weakness, we forecast muted personal saving growth of 3.2 per cent in 2003 and dissaving of 6.2 per cent in 2004. This is forecast to result in a reduction in the savings ratio from close to 11 per cent in 2002 to 10.6 and 19.5 per cent in 2003 and 2004 respectively.

Consumer Prices

Official figures confirm that the consumer price index rose by 4.7 per cent in 2002. Figures for the first two months of this year show that the inflation rate has remained high at 4.7 per cent in January and 5.1 per cent in February. However, we have revised down our forecast for 2003 to an annual average of 4.3 per cent. This is mainly due to the sustained appreciation of the euro and the recent interest rate cuts. Indeed it now seems likely that there will be a further cut in interest rates which is now factored in to our inflation forecast. As has been highlighted in previous *Commentaries* the main contribution to inflation in the current year will remain non-traded domestic services.

On the basis of our assumptions on exchange rates and interest rates, outlined in the context for Ireland section, it seems likely that the continued appreciation of the euro will contribute to an easing of inflation throughout 2004. Some increase in housing costs is likely during 2004 once the interest rate cycle changes. However, oil prices are likely to stabilise at levels lower than current being experienced. If these assumptions prove correct then our forecasts for consumer price inflation in 2004 will result in an annual average of 3.2 per cent.

Table 10: Consumer Price Index – Recent Trend and Forecast

	2000	2001	2002	2003 Forecast	2004 Forecast
Annual % Change					
Housing	8.8	16.5	0.9	0.2	3.3
Other	5.4	4.0	5.0	4.7	3.2
Total CPI	5.6	4.9	4.7	4.3	3.2
Index De . 2001=100					
Housing	88.2	102.7	103.7	103.9	107.3
Other	93.6	98.7	102.6	107.4	110.9
Total CPI	92.7	97.9	102.7	107.2	110.6

Public Finances

Final exchequer figures for 2002, released since the last *Commentary,* confirm the continuing deterioration in the exchequer and general government balances. The outturn for the public finances in 2002, however, was much less severe than looked likely midway through the year. The deterioration from the exceptionally high surpluses of previous years continued, which was to be expected given the sharp slowdown in the economy as measured on a GNP basis, possibly the more relevant indicator of the economy's taxable base. The Exchequer balance was again in surplus for the fifth year at €95 million, down from €653 million in 2001 and €3 billion in 2000. The broader general government balance measure, which includes the National Pensions Reserve Fund and Social Insurance Fund, went into a small deficit in 2002 of €113 million or 0.1 per cent of GDP. This had declined from surpluses of €4.6 billion in 2000 to €1.26 billion in 2001. The corresponding general government debt in 2002 was 34 per cent of GDP.

Tax receipts in 2002 increased by 4.9 per cent over 2001, below the Budget 2002 target increase of 8.6 per cent. Net voted current and capital expenditure at €28,823 million in 2002 increased by 13.9 per cent over the previous year, compared to the target for the year of 14.4 per cent. Total current receipts were €31,525 million in 2002, an increase of 9.7 per cent on 2001. Within this category, tax revenue in 2002 increased by 4.9 per cent over 2001. Total tax receipts amounted to €29,294 million, €1,034 million below the Budget 2002 estimate. The shortfall occurred mainly in corporation tax and income tax. Non-tax revenue totalled €2,231 million, €163 million above the 2002 Budget target. This was mainly accounted for by additional Central Bank surplus income and a higher National Lottery surplus.

Public spending having been running well above target during the year came in at 13.9 per cent, slightly lower than the target for 2002. Central fund services spending of €2,809 million was €614 million below the 2002 Budget estimate and resulted from debt service savings of €317 million and reduced EU Budget payments. Voted current expenditure was €23,314 million, an increase of 14.3 per cent on 2001. This is in line with the increase provided for in the 2002 Budget and Estimates. The net voted capital expenditure amounted to €5,509 million, an increase of 12.3 per cent on 2001 compared with the 14.7 per cent increase provided. Public spending on capital in Ireland now amounts to 5 per cent of GNP which is nearly double that of the EU generally.

Focusing on 2003, the *Revised Estimates* provide for a 9 per cent rise in net voted current expenditure and a 1 per cent decline in net capital expenditure for a combined target rise of 7 per cent. The net exchequer pay and pensions bill is forecast to rise by 10 per cent in 2003. The first quarter exchequer returns for 2003 indicate that the control on expenditure trends evident from the end of 2002 seems to have carried over to this year. The Department of Finance and the Revenue Commissioners have started to publish profiles for monthly voted expenditure and tax receipts. The latest returns show an exchequer deficit of €205 million compared to a surplus of €608 million during the first quarter of 2002. Last year's first quarter return was boosted by euro changeover and social insurance fund draw down which explains the differential.

Total current receipts in the first three months amounted to €7,055 million compared to receipts of €7,189 million for the same period in 2002. Tax revenue, at €6,956 million is 22 per cent of the Budget day target and year on year tax receipts were 11.9 per cent higher than the same period in 2002. The full year Budget target for tax revenue is an increase of 8.0 per cent over 2002. Compared to the profile published, overall tax receipts are broadly on target. However, income tax and corporation taxes are down while VAT returns were exceptionally strong. The strong activity in the housing market and budgetary rate rise may explain the strong VAT return while the slowdown in the economy and rising unemployment is a factor behind the income tax figures. Non-tax revenue in the first three months of 2003 was €99 million and compares to €973 million in the first quarter of 2002. The €635 million transferred from the Social Insurance Fund and €250 million from the Central Bank in respect of accrued public moneys from the issue of coin are the main factors as already indicated.

Overall net voted spending was €6,825 million at end March compared to €6,102 million for the same period last year, an increase of 11.8 per cent. This compares to a planned increase of 6.7 per cent for the year as a whole provided for in the Estimates but is €440 million less than the profile. Net voted current spending in the first quarter was €6,098 million compared to €5,326 million in 2002 – an increase of 14.5 per cent. This compares to an estimated increase of 8.6 per cent for the year as a whole. Net voted capital spending amounted to €727 million in the first three months of the year, a decrease of €50 million or 6 per cent on the same period last year compared with a projected decrease of 1 per cent for the year as a whole.

For the year 2003 as a whole we forecast that the Exchequer balance will be in deficit by €1.9 billion. Tax revenue is anticipated to grow by 8.6 per cent in 2003. On the expenditure side we expect that current expenditure growth will be pared back somewhat as the year progresses to equal 8.9 per cent for the year. Capital expenditure is forecast to rise by 0.5 per cent while capital receipts are expected to fall by 20 per cent. The broader general government balance measure is forecast to be in deficit of €1,100 million. General government debt is forecast to stabilise around 33.4 per cent of GDP in 2003, a modest decrease as compared with recent years. This downward trend is reflected in our forecasts for an Exchequer deficit of €3.5 billion in 2004. The general government balance is forecast to be in a deficit of €1.9 billion with the general government debt rising to 33.9 per cent of GDP.

TABLE 11: Public Finances

	2002	% Change	2003	% Change	2004
Current Revenue	31,525	4.2	32,835	5.8	34,751
Current Expenditure	26,123	11.4	29,100	9.3	31,801
Current Surplus	**5,402**	-30.9	**3,735**	-21.0	**2,950**
Capital Receipts	1,561	-19.9	1,250	-8.0	1,150
Capital Expenditure	6,868	0.5	6,900	10.1	7,600
Capital Borrowing	**5,307**	6.5	**5,650**	14.2	**6,450**
Exchequer Balance	**95**		**-1915**		**-3,500**
as % of GNP	0.1		-1.8		-3.0
General Government Balance	**-113**		**-1,100**		**-1,900**
as % of GDP	-0.1		-0.8		-1.3
Gross Debt as % of GDP	**34.0**		**33.4**		**33.9**

General Assessment

The release of the Quarterly National Accounts for the third quarter of 2002 revealed an extraordinary divergence in the economic growth performance in the Irish economy last year. Real GDP for the first nine months grew at more than 6 per cent while in terms of real GNP, growth was much more modest at 1.4 per cent. The fourth quarter is likely to have proved to be a much more difficult growth period in line with the experience internationally such that our estimate of growth for 2002 is 5.7 per cent in real GDP and 1.1 per cent for real GNP. This gap in excess of 4.5 percentage points is by far the largest divergence between the measures and would bring GNP as a proportion of GDP to near 80 per cent.

The factors that contribute to this large gap in the economic activity measures relate to the determinants of the net factor income flow measure in the national accounts. There was a strong increase in the profits of foreign-owned companies in Ireland last year particularly in the chemicals sector. This sector had a 24 per cent increase in its volume output growth in 2002 with less than a 1 per cent rise in its industrial employment component. Given its high ratio of profits to net output, the growth in this sector as a proportion of national output will tend to boost the profit outflow component. In terms of the inflow side of the net factor income flows, weak earnings in companies with headquarters in Ireland also widened the gap between the GDP and GNP measures in 2002.

The profit outflows in 2002 were also boosted by the sharp fall-off in service import growth. Foreign owned firms tend to make payments to their parent countries in the form of profit repatriations and payments for services like research and advertising which are classified as service imports. These service imports have grown substantially in recent years but this growth appears to have stopped in 2002 resulting in a larger growth in profit outflows.

The consequences of the mixed signals from these activity measures is that the Irish economy was performing at or close to trend on the GDP output measure in 2002, while in terms of GNP, which better reflects income growth, the economy would be considered to have had its worst performance in 17 years. The prospects for 2003 are tentative being dependent upon a strong turnaround in the growth prospects for the major world economies but we anticipate real GNP growth to be closer to real GDP growth at 2.5 per cent and 3.0 respectively. Both measures are expected to record growth of around 3.5 per cent in 2004.

The reassessment of growth prospects remain uncertain, however, given the continuing tensions in the Middle East and the knock-on consequences for volatile oil price movements. The underlying imbalance in the US economy remains, as evidenced by the continued deterioration in the deficit on the current account of the Balance of Payments relative to total output. The long awaited unwinding of this imbalance will result in further appreciation of the euro against the dollar. The anticipated loss in competitiveness from adverse currency movements will hamper European growth and so it is likely that interest rates will remain low until the end of 2003 at least. The threat of deflation still hangs over the major economies and although the prospects for Irish inflation is to ease back over the next two years, high relative inflation with our main trading partners is expected to remain a key challenge for policy-makers.

The strength of price pressures in the Irish economy from non-traded sectors has contributed to pushing the Irish price level well in excess of the euro area average. Inflation in 2002 averaged 4.7 per cent and the first quarter of 2003 has rates of around 5 per cent. Our forecast is for the rate of inflation to moderate significantly throughout the remainder of 2003 and into 2004. This will reflect the combination of the appreciating currency and low price growth internationally reducing the imported inflation contribution and signs of slower, more realistic price growth in the non-traded sector. The non-traded sector is primarily made up of service-based activities where the costs of labour tend to be the most significant component. The continuing rise in the rate of unemployment and the uncertainty internationally have helped reinforce a downward expectation for future wage growth as is reflected by the pay terms contained in the new social partnership agreement, *Sustaining Progress*.

Under this new agreement the pay terms cover an 18 month period reflecting the uncertain environment for wage setting, while the overall programme will run for three years, the typical length of previous social partnership agreements. The overall pay increase will be 7.2 per cent over 18 months. Private sector employees are to receive 3 per cent increase for the first nine months, 2 per cent for the following six months and 2 per cent for the following three months. The public sector will get the same overall increase but lagged to deliver a 6 month pay pause. However, the public sector will also benefit from the Benchmarking process with its recommended pay awards ranging between 2 and 25 per cent and averaging 8.9 per cent. The new agreement allows for one-quarter of the recommended award to be backdated to December 2001 at the start of the agreement, a half from 1st January 2004 and the final quarter by 1st June 2005.

Holding to the wage terms in *Sustaining Progress* would ratchet wage growth from rates of over 10 per cent and 7 per cent in the last two years down towards 4 per cent and 3 per cent for this year and next. The history of the national wage agreements in the last decade is that they have tended to anchor wages rather than be strictly adhered to but even allowing for some drift, this level of wage growth is moving the economy more in line with sustainable, productivity-justified pay.

The strength of the wage growth has been a significant factor in keeping Irish consumer price inflation to the top of the EU league table at the beginning of 2003. We expect consumer price inflation to average 4.3 per cent in 2003 and to remain above Ireland's trading partners even at 3.2 per cent in 2004. The downward trend in the inflation rate reflects an unwinding of external factors but also easing in the domestically generated component of price pressure. The price of housing remains a key barometer for domestic price expectations. House price growth has been particularly strong in the first quarter of 2003, reflecting in part base effects from the low rate of price growth at the start of 2002 but also the continued low interest rate environment and the ease of mortgage finance availability. The supply of houses is expected to have expanded significantly in 2002, with yet another record year for new house completions. Our expectation is that the increased output of the construction sector will begin to bring supply and demand into balance in the housing market over the next two years with prices growing at low, single digit rates.

The new social partnership agreement includes a series of special initiatives to provide social and economic progress. These include measures on affordable housing and the setting up of a group comprising of social partner representatives to identify the causes of worsening inflation in the Irish economy. The objective of this group is to recommend strategies to deter unwarranted price rises. While the underlying trends in the economy may be going a substantial way to delivering on these objectives, it is high relative price growth that damages the crucial competitiveness position of an export-oriented economy like Ireland. The possibility of a wage-price spiral seem remote in the current context but the lesson from the inflationary surge in the last few years is that it is important to lead the next recovery by increasing the economy's supply capacity and to seek to improve competitiveness.

Even with the substantially lower growth environment facing the Irish economy in the next few years, real output growth is still likely to exceed real interest rates. These conditions are not consistent with sustainable growth over the longer term but they do provide a context for Ireland to press ahead with its ambitious plans for infrastructural investment. Projects that offer acceptable economic returns and that can be delivered ensuring value for money can always attract financing. Given the tighter budgetary situation that has emerged since the National Development Plan was put in place, however, a more focused sense of national investment priorities is required during this period to ensure balanced future growth.

The public finance position is likely to deteriorate over the coming years as growth falls below its potential level. However, the deficits that are budgeted for are consistent with a balanced budget position over the economic cycle. The exchequer returns for the last quarter of 2002 and the first quarter of 2003 would suggest that control has been restored over expenditure growth but that revenue growth remains sensitive to the uncertain trajectory of the economic cycle. Current public expenditure is going to be hit in 2004 with the main element of the public sector benchmarking awards and with the new national pay terms coming into effect after the six month pay pause. This will make for harder choices in keeping to public expenditure targets

The low interest rate environment creates opportunity, for economically justifiable investment to be undertaken in capital projects. One option for providing this investment is from private funds which would respect the constraints of the *Stability and Growth Pact* (SGP). The other option is for additional public funding of capital investment. However, under the international commitments entered into under the SGP, this would require choices being made among expenditure alternatives and/or increasing taxation to increase funding whilst holding with the agreed borrowing targets. However, being deemed a capital project is not a sufficient condition to justify borrowing unless the prospective rate of return from the investment is sufficiently high and, therefore, the need to identify national priorities in capital spending will remain.