The
Irish Economy

THE IRISH ECONOMY
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ASSESSMENT - SUSTAINED GROWTH AHEAD

- The Irish economy continues to record an impressive all-round performance in 2004. GDP is forecast to grow by 5.5% in real terms, employment is rising by 2.5% while the General Government budget surplus looks set to increase.

- Domestic fundamentals are sound and though the international environment remains fraught with risks and uncertainties, the IMF remains upbeat about the global economic outlook, fuelled by the resilience of the Asian economies.

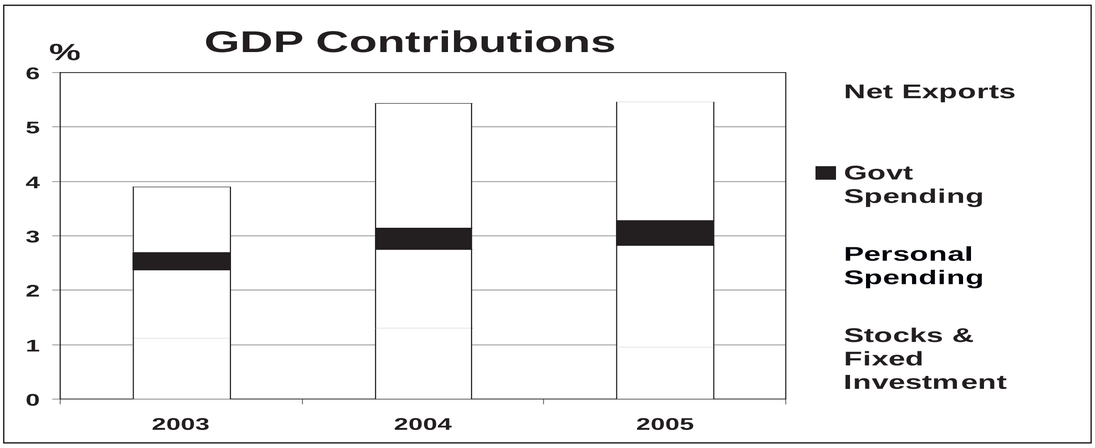
- The Irish economy should grow by a further 5.5% in real terms in 2005, helped by strong domestic demand and a solid contribution from net exports.

- The growth in consumer spending, which remained rather muted in H1 2004, should strengthen in the second half of the year and into 2005. Consumer sentiment is improving and real income growth should pick up.

- The main contributor to the growth in domestic demand in 2004 is fixed investment. Construction is understandably strong, largely due to buoyant residential demand, but the growth in investment in machinery and equipment has been impressive in the first half of 2004. This category of investment should remain robust in 2005.

- Irish inflation has fallen close to the eurozone average. We expect the HICP to rise by 2.4% in 2004 and by about 2.6% in 2005. However, higher mortgage costs could see the headline CPI rise by around 3% next year, up from 2.3% in 2004.

- The high price of crude oil, which may continue over most of 2005, will probably knock up to 1% off cumulative Irish GDP growth over the 2004-05 period.



- One of the most favourable features of the Irish economy in recent years has been the resilient performance of the labour market. We expect this trend to continue, with total employment forecast to grow by 2.5% in both 2004 and 2005. However, because we are experiencing a high level of net inward migration, our unemployment rate is expected to stabilise at around 4.5%.

- The economy is forecast to grow close to potential in 2004 and 2005. Our medium term growth potential remains around 5% per annum. To sustain this, however, will require a productive and expanding labour force, coupled with a competitive domestic economic environment.

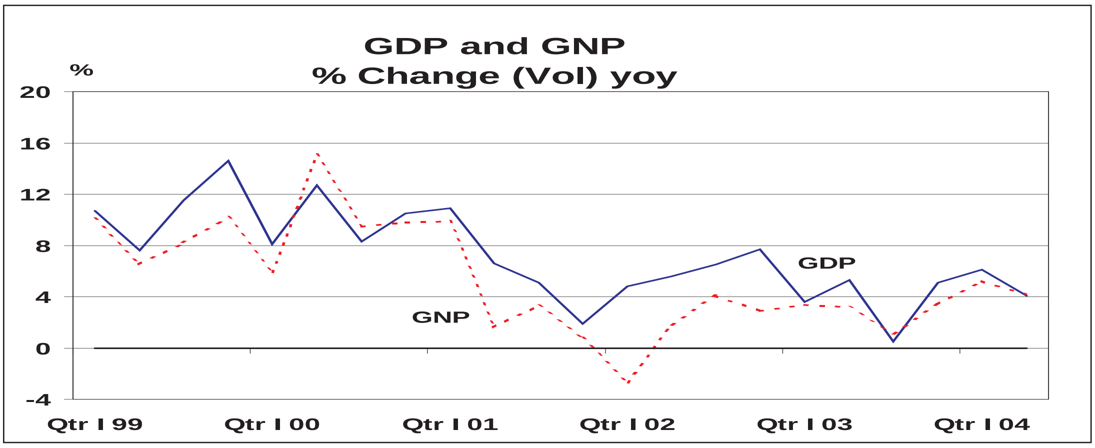
- Budgetary policy must ensure that taxation remains at competitive levels and that distorting levies or taxes are eliminated or avoided. In this regard, given the scope now emerging in relation to the budgetary outturn for 2004, Budget 2005 should at a minimum incorporate full indexation of tax bands and credits so as to ensure no further rise in the personal income tax burden.

- We expect that the US Federal Reserve will raise interest rates to at least 2% by end 2004. Assuming trend economic growth or slightly above in 2005, the Fed is likely to withdraw more of its monetary stimulus by raising official interest rates to 3% by the end of next year.

- In the eurozone, the economic upswing should continue over the coming year. With inflation expected to be close to the ECB's 2% target level in 2005 and with rising household demand for credit, the ECB is forecast to raise the official refinancing rate to 2.75% by end 2005.

- There is currently more downside than upside risk to this ECB interest rate forecast. A factor that could force the ECB to hold rates close to current levels is the outlook for the US dollar. We assume in our forecasts that the euro-US dollar rate will average $1.25 in 2005, compared to $1.2250 in 2004. However, with the US running an unsustainably high current account deficit, there are serious risks of a sharp dollar correction. This would weaken euro area economic growth and dampen inflation.

- A fall in the dollar would clearly have a negative impact on Irish export growth. However, it would also leave the Irish housing market facing an even more protracted period of low interest rates.



- The Irish housing market remains exceptionally buoyant both in terms of price increases and housing supply and demand. Clearly, expected supply levels of 80,000 are unsustainable, though this level could persist into next year. National average house price inflation is moderating. We expect the annual rate to slow to 10% by end 2004 and to decelerate further to a 3-5% range in 2005.

- We remain very optimistic that the housing market will avoid a crash. The buoyant labour market and the low level of interest rates provide a significant cushion. Obviously, there are concerns about the role of investors at this stage. However, the majority are longer term investors and thus are unlikely to be in any great hurry to exit the market. There is little evidence of speculative demand in the market.

- Looking further ahead, the release of SSIA monies into the economy in 2006 and 2007 will provide a major boost to domestic demand that is likely to push GDP growth above potential over this period. However, it will be a once-off, temporary boost to activity that should fade in 2008.

October 2004

EXTERNAL ENVIRONMENT

The external environment for Irish economic growth in 2005 and beyond remains positive, though clearly risks and uncertainties abound. Geopolitical risks continue to plague the global economy and crude oil prices have remained persistently high. Official interest rates are on a modest uptrend but currency markets could pose problems in 2005.

IMF upbeat on global economy

With crude oil prices remaining at very high levels, and possibly going even higher in the final quarter of 2004, doubts have persisted about the outlook for the global economy. The International Monetary Fund (IMF) has just published its semi-annual World Economic Outlook which offered a relatively favourable assessment of developments in 2004 and prospects for 2005.

Compared with its report published in April, the IMF increased its estimate of global growth in 2004 from 4.6% to 5%. The outlook for 2005 was a shade weaker with growth forecast at 4.3%, down from 4.4% in its April assessment. However, with crude oil prices now higher than when the forecasts were prepared, the IMF states that growth in 2005 could be down to 4%, if crude oil prices were to persist at recent levels.

What is interesting about the IMF's latest forecasts is that projected cumulative global growth over the two years is 9.2%. This favourable assessment comes against the background in which Brent crude oil prices could average up to $40 per barrel in 2004 and possibly higher in 2005.

The conclusion must be that while higher oil prices are having a negative impact, there are positive factors at work providing an offsetting cushion to the global expansion. Whether these positive influences can be maintained is another matter. While the IMF is upbeat, it does see risks ahead, particularly the continuing global current account imbalances.

Dollar correction a threat to growth

Financial markets have not penalised the US dollar to any great extent for the growing US external deficit, which is creeping closer to 6% of GDP. Much of this is with Asia. The IMF expects that the Asian economy will remain strong in 2005. However, Asian central banks will have to continue recycling their dollars back into the US in order to prevent a sharp decline of the dollar in 2005.

We are concerned about the outlook for the dollar. We see it weakening to a $1.25-1.30 range versus the euro after the US Presidential election in November. It should also weaken against most other currencies, including sterling. This would leave the euro-sterling rate close to current levels in the short term.

There is general agreement that the mounting US current account deficit must be corrected to some degree over the medium term. Since its peak in early 2002, the US broad trade weighted exchange rate has weakened by less than 13%. This is insufficient to make any inroads into the deficit. A broad dollar adjustment of 25-30% is seen as more appropriate.

If, and when, this could occur is difficult to forecast, but the risk is growing. There is no doubt that the ECB would intervene to limit a serious fall in the dollar. We assume for forecasting purposes that the euro-US dollar rate will average $1.25 in 2005, up from an estimated $1.225 in 2004. For sterling, we assume a euro-sterling rate of £0.69 for 2005.

Inflation well contained

We assume that Brent crude oil prices will average $40 per barrel in 2005, compared with an estimated $39 in 2004. Notwithstanding the direct impact of higher crude oil prices on consumer price inflation, core inflation has remained relatively well behaved in the major economies. This has permitted central banks to adopt a cautious stance towards monetary policy in 2004.

Official interest rates to rise in 2005

We expect that the US Federal Reserve will continue its policy of gradually increasing official interest rates. The Fed funds rate is forecast to rise to at least 2% by the end of 2004 and assuming trend GDP growth or slightly above in 2005, rates should reach 3% by the end of next year. This would still represent an accommodatory monetary stance.

The ECB expects that inflation will fall back below 2% in 2005. This should occur if oil prices at least stabilise. However, as with the Fed, the ECB is expected to withdraw some of its monetary stimulation in 2005. We are forecasting that the official refinancing rate could reach 2.75% by end 2005. However, in the event of greater than anticipated dollar weakness, the ECB may be forced to delay raising official rates.

GLOBAL ECONOMY: KEY ASSUMPTIONS

Annual Average (Unless stated)	**2002**	**2003**	**2004 (f)**	**2005 (f)**
Economic Growth (% Change)				
OECD	1.8	2.2	3.4	2.9
US	2.4	3.1	4.3	3.5
Euro	0.9	0.4	1.9	2.1
UK	1.6	2.2	3.2	2.7
Official Interest Rates (%) (End Period)				
US	1.25	1.0	2.0	3.0
Euro	2.75	2.0	2.0	2.75
UK	4.0	3.75	4.75	5.25
Exchange Rates				
US Dollar-Euro	0.946	1.133	1.2250	1.25
Sterling-Euro	0.629	0.692	0.678	0.69
US Dollar-Sterling	1.503	1.635	1.807	1.81
Crude Oil Prices (Brent $pb)	25.15	28.76	39.0	40.0

More detailed forecasts on interest rates and exchange rates are contained in our other publications Fixed Income Monthly Monitor and Exchange Rate Monthly, available on our website www.aibeconomicresearch.com

THE MACRO FORECASTS

The Irish economy has strengthened over the past year with real GDP growth hitting 5.1% in Q4 2003 and again in H1 2004. The pick up in activity has been led by a rebound in business investment and exports. The prospects for the economy remain favourable with sound domestic fundamentals and improved global economic conditions. We expect real GDP and GNP to rise by 5.5% and 5.0%, respectively, in both 2004 and 2005.

Good growth by Irish economy

The Irish economy has performed well during the past year and looks set to continue growing strongly over the next few years. GDP growth averaged over 5% between Q4 2003 and Q2 2004, with GNP growth averaging 4.2%. By contrast, GNP growth averaged less than 2% from Q2 2001 to Q3 2003. The pick up in activity over the past year has been driven by a rebound in exports and business investment, while growth in housebuilding activity has remained robust.

Net factor income outflows are not having much of a distortionary impact on the relationship between growth in GDP and GNP in 2004. As a result, we expect that GDP and GNP will increase by 5.5% and 5.0%, respectively, this year. Growth is also well balanced with solid increases in all the major components of domestic demand as well as exports.

The prospects remain favourable for the economy in 2005. The world economy is expected to grow strongly again next year. On the home front, moderate inflation, a strong jobs market, low interest rates, a buoyant property market and healthy public finances are all favourable factors supporting a positive outlook for the economy. Thus, we look for GDP and GNP to grow by 5.5% and 5.0%, respectively, again next year. Housebuilding activity should stabilise in 2005 but we look for a strengthening of manufacturing activity and consumer spending.

Continued solid employment growth

This favourable economic outlook points to a continuation of solid employment growth. There has been a shift this year away from growth in part time employment, especially in the public sector, towards stronger growth in full time employment, most notably in construction and private sector services. Irish employment is forecast to grow by about 2.5% in 2004 and 2005, broadly the same as labour force growth. If this occurs, the unemployment rate should remain stable at close to 4.5%.

Meanwhile, inflationary pressures in the economy have eased considerably in the past eighteen months. The gap between the Irish and eurozone HICP rates has narrowed to just 0.2% from 2.7% in February 2003. Helped by a stronger currency and moderate wage growth, Ireland now has the opportunity to re-establish the low inflationary environment that characterised most of the 1990s. We expect the core or ex-mortgage CPI rate to average 2.2% in 2004 and 2.4% in 2005.

Strong budgetary position

Finally, the public finances are expected to remain in good shape. The outturn for 2004 will be well ahead of initial expectations, with a General Government budget surplus of €1bn on the cards. We expect to see significant tax cuts in the December budget. The General Government budget should be close to balance in 2005. Thus, the General Government Debt/GDP ratio should continue to decline, falling to around 30% next year. This sound fiscal position should help underpin confidence and indicates that budgetary policy is not an impediment to economic growth.

GDP growth of 5.5% in 2004 and 2005

Weak industrial production

Subdued inflationary pressures

Public finances in good shape

IRISH MACRO ECONOMIC FORECASTS

Annual average % change unless stated	**2002**	**2003**	**2004 (f)**	**2005 (f)**
Real GNP	**1.5**	**2.8**	**5.0**	**5.0**
Real GDP	**6.1**	**3.7**	**5.5**	**5.5**
Domestic Expenditure	3.7	2.8	4.2	3.9
Personal Spending	2.8	2.6	3.0	4.0
Government Spending	8.6	2.5	3.0	3.5
Fixed Investment	3.0	3.4	8.0	4.0
Contribution of Stocks to GDP growth	-0.3	0.5	-0.3	0.2
Total Exports	5.7	-0.8	5.3	6.5
Total Imports	3.3	-2.3	3.9	5.5
Level of GDP (€bn, current prices)	128.0	134.8	145.7	157.7
Level of GNP (€bn, current prices)	104.5	111.7	121.2	131.2
Industrial Production (Vol)				
Total	7.9	6.3	3.5	7.0
Modern	11.8	7.9	3.7	8.5
Other	-2.3	1.3	2.5	3.0
Housing				
Average House Price (end year)	13.3	13.7	10.0	4.0
House Completions ('000)	57.9	68.8	80.0	80.0
Labour Market				
Employment Growth	1.8	1.9	2.5	2.5
Labour Force Growth	2.4	2.1	2.4	2.5
Unemployment Rate (%)	4.4	4.6	4.6	4.6
Net Immigration ('000)	41.3	29.8	31.6	32.0
Costs and Prices				
CPI	4.6	3.5	2.3	2.9
Core CPI	5.0	4.0	2.2	2.4
Irish HICP	4.7	4.0	2.4	2.6
Manufacturing Output Prices	2.5	0.8	0.5	1.0
Earnings Growth (Whole Economy)	6.0	4.6	5.0	4.5
Unit Wage Costs (Whole Economy)	1.7	2.8	2.0	1.6
Productivity Growth (Whole Economy)	4.2	1.8	2.9	2.9
External Account				
Trade Balance (% of GNP)	+20.3	+18.6	+18.9	+19.0
Current Account Balance (% of GNP)	-1.5	-1.7	-0.8	-0.8
Public Finances				
General Government Balance (€ million)	-296	192	1,000	-400
General Government Balance (% of GDP)	-0.2	+0.1	+0.7	-0.3
General Government Debt /GDP ratio (%)	32.7	32.1	30.7	30.0
Private Sector Finances				
Real Personal Disposable Income	1.8	4.4	3.7	4.0
Personal Savings Ratio (%)	9.4	10.5	11.0	11.3
Private Sector Credit % (end year)	15.0	17.9	22.7	12.0
Private Sector Debt /GDP Ratio (%)	94.4	104.7	118.9	123.1

DOMESTIC DEMAND

Domestic spending is set to register solid growth of over 4% this year, boosted by continued strong rises in housing output and a rebound in business investment. Domestic spending growth should be around 4% again next year, helped by a pick up in consumer spending.

Consumer spending remained sluggish in H1 2004

Consumer spending grew by 2.4% yoy in the first half of 2004, maintaining the pattern of just moderate growth evident in 2002 and 2003. However, growth in consumer spending should pick up in the second half of the year. Certainly, the backdrop for consumer spending is favourable with a marked improvement in consumer confidence over the summer, solid growth in employment and wages and, despite sharply higher oil prices, a much lower level of inflation than in recent years.

Employment rose by 2.6% in the first half of 2004, up from the sub 2% rates that characterised 2002 and 2003. Furthermore, unlike in 2002 and 2003, most of the job growth in H1 2004 was in full time employment. For the year as a whole, we expect employment to rise by 2.5% with a similar increased forecast for 2005.

Good growth in employment and earnings

Wage growth should also be strong this year, boosted by a large rise in earnings in the public sector. The 2004 budget provided for a 9% rise in the public sector pay bill, despite little change in the numbers at work in the sector. Public sector workers received 50% of the increases due under the benchmarking pay awards at the start of the year, equivalent on average to a 4.5% pay rise. Public servants also receive a general pay rise of 7% over the course of this year.

Wage growth in the private sector is also likely to prove relatively robust this year. Data for the earlier part of the year show earnings growing by 4-5% in most sectors. For the economy as a whole, we forecast that wage growth will average at least 5% this year. Combined with a 2.5% increase in employment it points to a 7.5% rise in the non-agricultural wage bill this year. This provides the basis for our forecast rise of 7.2% in gross personal income in 2004, as shown in the table below. There has been a surge in income tax receipts this year, though, which is likely to limit the rise in personal disposable income to around 6%.

Solid rise in disposable income

Turning to 2005, we expect growth in gross personal income to exceed 7% again, helped by continued solid gains in employment and earnings, even allowing for some moderation in wage growth in the public sector. Significant income tax cuts are expected in the 2005 budget, so personal disposable income should rise by around 7% next year.

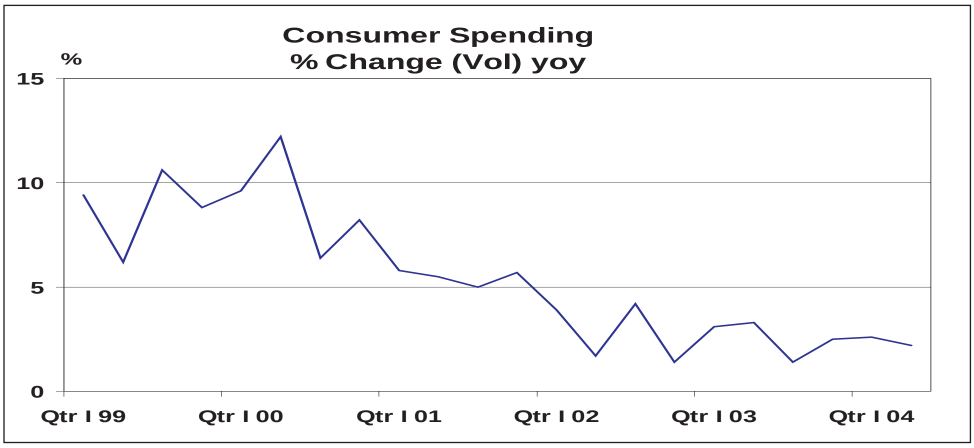
PERSONAL INCOME, CONSUMPTION & SAVINGS

(Nominal % Change)	**2002**	**2003**	**2004 (f)**	**2005 (f)**
Personal Income	5.6	7.3	7.2	7.2
Disposable Income	6.5	8.0	6.1	7.0
Consumer Spending	8.6	6.6	5.5	6.7
Savings Ratio (%)	9.4	10.5	11.0	11.3

Low inflation boosts spending power

Growth in personal consumption in nominal terms seems unlikely to match our forecast disposable income growth of 6% in 2004 . Hence, the savings ratio looks set to rise this year, climbing to around 11%. Consumer purchasing power has been boosted by a marked fall in inflation. Thus, we look for the volume of consumer spending to rise by 3% in 2004, with expenditure picking up momentum in the second half of the year.

We look for consumer spending to continue to pick up momentum in 2005, boosted by solid growth in employment and earnings and tax cuts in the budget at the end of this year. Even allowing for a modest rise in the savings ratio and higher mortgage rates, the volume of consumer spending should grow by 4% next year.



Strong uptrend in housebuilding continues

There was a remarkable rise of 14.4% in housing output last year from already elevated levels of activity. House completions rose to almost 69,000 in 2003. Expectations that the pace of growth in housing output would slow this year have proved ill founded. The volume of housing output rose by 20% in the first half of the year with housing completions rising by 21%. The expectation now is that housing output will rise by around 15% this year, with housing completions rising to 80,000.

But could peak in early 2005

New housing registrations rose by 11% in the first nine months of 2004 suggesting that the uptrend in housing output and completions will extend into early 2005. New housing registrations, though, have levelled off in recent months, so housing activity could well peak in early 2005. The fact that the current high level of housing completions greatly exceeds most estimates of housing demand also suggests that housebuilding activity could peak in 2005. At this stage, we have pencilled in a 1% rise in housing output for 2005.

Meanwhile, non-residential construction activity contracted by 3.6% last year, partly due to budgetary cuts in public capital spending but also reflecting difficult conditions in the private non-residential sector. Non-residential construction output rose by 2% in H1 2004, no doubt helped by the big rise in expenditure in the public capital programme this year. We are forecasting a rise of 2% for the year as a whole. A 3% rise in output is forecast for 2005, as the improvement in general economic conditions eventually spreads into the private non-residential building sector, and as increased resources are allocated to the public capital spending programme next year.

Rebound in business investment

The strong rebound in investment in machinery and equipment which commenced in the final quarter of last year extended into the opening half of 2004, when it grew by 12.8% yoy. The recovery in global economic activity and improved corporate profitability have boosted inflows of foreign direct investment and business investment more generally. We look for investment in machinery and equipment to grow by 7% this year and a further 7% in 2005, as the global economic recovery continues.

FIXED INVESTMENT

(% Change, Volume)	**2002**	**2003**	**2004 (f)**	**2005 (f)**
Housing	5.0	14.4	15.0	1.0
Other Construction	5.6	-3.6	2.0	3.0
Machinery & Equipment	-0.1	1.2	7.0	7.0
Total	3.0	3.4	8.0	4.0

Housing to depress investment growth in 2005

Overall, then, the combination of continued strong growth in housebuilding activity and a recovery in business investment points to strong growth in total investment spending of around 8% this year. With growth in housing output likely to level off next year, the rise in total investment spending could slow to around 4%. The balance of risk is that this may prove an underestimate as housing activity, in particular, could grow more robustly than we have forecast in 2005.

After showing little growth in 2002, stock levels rose strongly by over €500m in volume in 2003, boosting GDP growth by 0.5%. The rise in stocks is likely to moderate in 2004 as a result of improving domestic and external demand. In H1 2004, the volume of stocks rose by £400m, well down on the €968m increase in stocks in H1 2003. We look for stock levels to rise by around €250m in constant prices for the year as a whole. A rise of €400m in stocks is tentatively forecast for 2005.

Growth in government spending has slowed

Finally, growth in government spending decelerated markedly in 2003 to 2.5% in volume terms from 8.6% in 2002 and 10.9% in 2001. The government has finally reined in the runaway spending growth of its departments. The 2004 budget provided for modest growth in spending along the lines of the 2003 budget. There have not been any signs of an overrun in government spending in the Exchequer Returns for the first nine months of the year. Thus, we expect government spending to rise by around 3% in volume terms this year. A somewhat easier fiscal stance is anticipated in 2005 so government spending may rise by 3.5% in volume terms next year.

Domestic spending growing by around 4%

Overall, then, we look for growth in domestic spending to pick up to 4.2% in 2004 from 2.8% last year, helped by a recovery in business investment and continued strong growth in housebuilding. Turning to 2005, we would expect to see a strengthening of consumer spending. However, there is likely to be a marked deceleration in the growth of housing output from its current high levels which will depress the overall growth rate of investment spending. As a result, growth in domestic spending could ease back slightly to just under 4% next year.

EXTERNAL TRADE AND THE BOP

Falling output in the ICT and chemicals sectors is dampening external trade. Nevertheless, we expect exports and imports to rise by 5.3% and 3.9% this year with the respective growth rates accelerating to 6.5% and 5.5% in 2005.

Weak trade prices

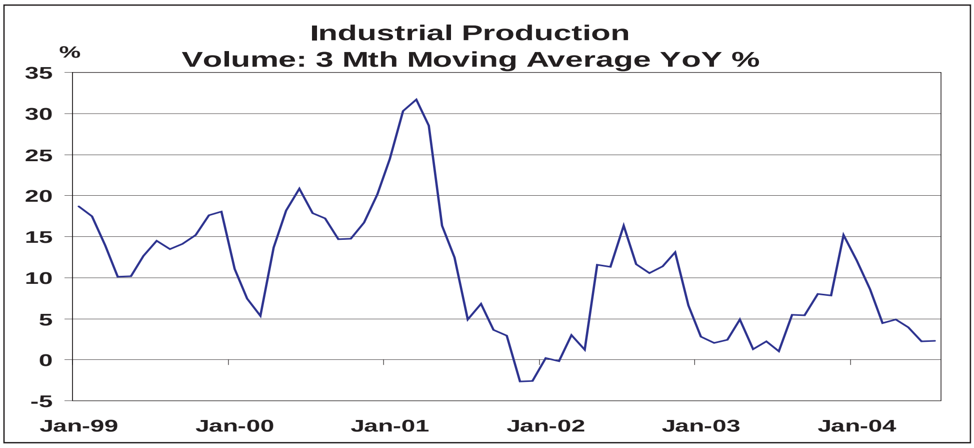
External trade data for the first half of the year show continued weakness in price indices especially in regard to exports. Merchandise export prices fell by 6.6% yoy in Q1 and 2.7% yoy in Q2 2004. Meanwhile, merchandise import prices declined by 2.7% yoy in Q1 and 0.8% yoy in Q2. The price falls reflect both currency movements and the impact of intense competition on global markets.

With the downward pressure on prices easing in Q2 2004, the value of merchandise exports and imports rose on a year-on-year basis for the first time since Q3 2002 and Q2 2002, respectively. There was a particularly impressive jump in imports, which rose by 7.9% yoy. Indeed, in H1 2004 as a whole, the value of merchandise exports rose by 1.2% yoy, while the value of merchandise imports climbed by 3%.

Big jump in service exports

The value of service exports rose strongly by 9.5% yoy in H1, while the value of service imports increased by just 1.6% yoy. Overall, then, the value of total exports of goods and services rose by 3.5% yoy in H1, while the value of total imports increased by 2.3%. Reflecting the downward pressure on goods prices, though, the volume of total exports posted a rise of 5.7% yoy in H1, while total import volumes increased by 3.7%.

Despite the rise in exports in H1, some key sectors performed poorly. Computer exports continued to fall in value terms while there was a marked slowdown in trade in organic chemicals. This mirrors the trend in industrial production data during the first half of the year. Manufacturing output rose by just 3.7% yoy in H1 2004, with a marked slowdown in output growth in the high tech sector. This reflects a very weak performance by the organic chemicals, in particular, and also computers. In Q2 2004 chemical output was down 6% yoy while computer production fell 2% yoy.



Exports to rise by over 5% this year

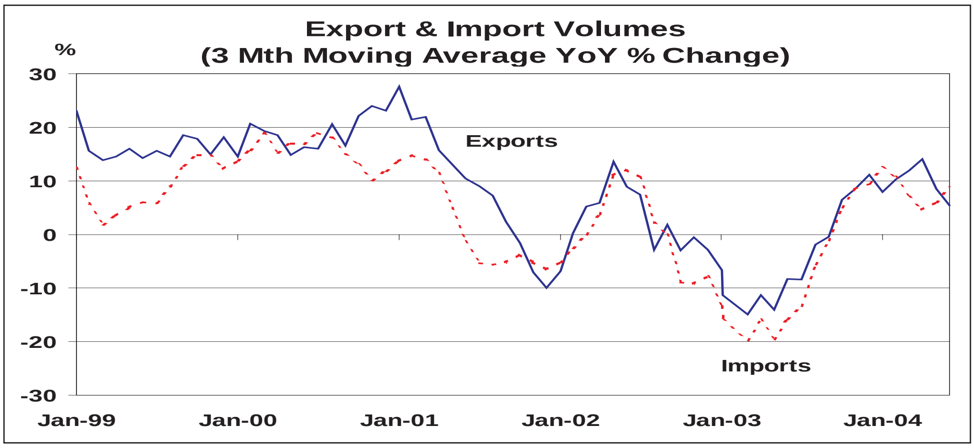
We expect export and import volumes to register good growth in H2 2004. Encouragingly, there was a marked rebound in industrial production in July while PMI data for manufacturing in Q3 pointed to solid output growth in the sector. Consumer spending should strengthen also in H2 2004. Thus, we expect exports and imports to rise by 5% and 4% yoy, respectively, in the second half of the year. For 2004 as a whole, exports are forecast to rise by 5.3% with imports increasing by 3.9%.

Weakness persists in some sectors

This must be seen as a less than stellar performance, though, compared to the growth rates that have characterised exports and imports over the last decade. Furthermore, the IMF expects the world economy to expand by 5% this year, the strongest growth in three decades. The industrial sector of the Irish economy, though, is still suffering from the shake out in the ICT sector, and is also witnessing a downturn in the key chemicals sector. These are the two biggest components of merchandise trade.

Stronger growth in trade in 2005

We feel that growth in Irish external trade could accelerate next year. There has been a marked pick up in business investment this year. This should help boost industrial output, which has performed poorly in H1 2004. Both the domestic and international economies are expected to register strong growth next year. Overall, then, we look for exports to increase by 6.5% in 2005 with imports rising by 5.5%.



BoP deficit narrows in 2004

The current account deficit in the balance of payments contracted by €452m in H1 2004 to €795m. This reflected a marked decline of €1.2bn in the services deficit because of a big jump in the export of services. There was a modest fall in the merchandise trade surplus while net factor income outflows rose by €0.5bn. Current transfers were virtually unchanged. We would expect the merchandise trade surplus to rise in the second half of the year with good growth in export volumes and downward pressure on trade prices abating. This should be partially offset by rising net factor income outflows.

€1bn deficit again in 2005

For the year as a whole, the current account deficit may amount to around €1 bn, well down on its level in the past couple of years. Turning to 2005, we expect to see a sizeable increase in the merchandise trade surplus reflecting good growth in export volumes and more stable trade prices. However, this is likely to be offset by an increase in the services deficit, as well as rising net factory income outflows, leaving the current account deficit unchanged at around €1 bn next year.

BALANCE OF PAYMENTS (€M)

Year	Goods	Services	Income	Transfers	Current A/C
2002	35,442	-14,250	-23,518	707	-1,617
2003	33,421	-12,642	-23,115	440	-1,896
2004 (f)	34,350	-11,500	-24,200	350	-1,000
2005 (f)	37,500	-12,600	-26,200	300	-1,000

LABOUR MARKET

Employment growth has accelerated in Ireland over the past year with the labour force growing strongly and unemployment remaining low. The outlook remains positive for employment growth with the jobless rate expected to stay low.

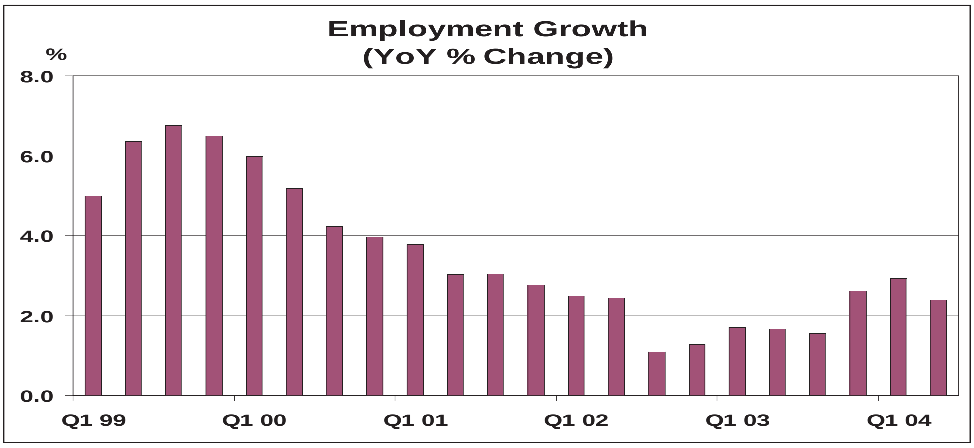
Resilient labour market

The Irish labour market performed surprisingly well during the global downturn in the period 2001-2003. Unemployment remained very low while total employment grew by 1.9% in 2003, and 1.8% in 2002. However, most of the employment growth was due to a big rise in part-time jobs, which increased by 3.8% in 2003 and 2.1% in 2002. Full-time employment, on the other hand, increased by just 0.6% last year, following a meagre 0.3% rise in 2002.

Furthermore, employment growth was heavily concentrated in the public sector in 2002 and 2003, continuing the strong uptrend evident in job growth in this sector in the 1999-2001 period. In the sectors - public administration, defence, health and education - largely comprising public sector workers, employment rose by 7.5% in 2002 and 6.1% in 2003. By contrast, job growth in the private sector was a meagre 0.5% and 0.8% in 2002 and 2003, respectively.

Pick up in private sector employment

The labour market has shown renewed vigour over the past year with a marked rise in full time employment in the private sector, commencing in Q4 2003. Data are only available for the first half of 2004 but they show that growth in full time employment averaged 2.8% yoy compared to a rise of 2.3% in part time employment in the period. Private sector employment grew by 2.7% yoy in the period, outstripping growth in public sector employment of 2.5%.



Employment in construction and services expands strongly

Seasonally adjusted data show differing trends in employment growth across the main sectors of the economy in the first half of 2004. There was a stabilisation of employment in manufacturing and agriculture, two sectors which have seen job numbers decline in recent years. The construction sector, though, continues to boom with employment up by 7.6% in Q2 2004 on year earlier levels.

Overall, service sector employment grew strongly in the first half of 2004, rising by 3.3% year-on-year. Most private sector services performed well with the notable exception of hotels, bars and restaurants. Here employment fell sharply in the second quarter, declining by 5.8% on year earlier levels. There was a slight decline in the numbers employed in public administration and defence, while the marked uptrend in the numbers at work in health and education eased off considerably in H1 2004.

Unemployment rate remains low

The rate of unemployment averaged 4.6% in 2003, up from 4.4% in 2002 and 3.9% in 2001. The long-term unemployment rate averaged 1.4%, up slightly on the 2002 level. On a seasonally adjusted basis, the unemployment rate remained low in the opening half of 2004, averaging 4.5%. The latest Live Register data suggest that unemployment remained low over the summer months.

The labour force grew by 2.1% on average in 2003 compared with 2.4% in 2002 and 2.7% in 2001. This rate of expansion is some four times greater than the euro area average and well ahead of US labour force growth. The growth in the labour force accelerated to 2.6% in year-on-year terms in the final quarter of 2003. It remained strong at 2.5% yoy in the first half of 2004, helped by rising participation rates, continued sizeable net inward migration and a growing indigenous population.

Solid labour force growth

These factors are expected to result in the Irish labour force continuing to grow at a strong rate of 2.5% or thereabouts in H2 2004 and 2005. The prospects are favourable that employment growth will match the rise in labour supply, leaving the unemployment rate stable at around 4.6%. The economy is expected to continue growing strongly next year, helped by a strengthening of consumer spending and exports. GDP is forecast to rise by 5.5% in 2005. This augurs well for the jobs market.

KEY LABOUR MARKET FORECASTS

	2002	2003	2004 (f)	2005 (f)
Employment (‘000)	1777	1811	1855	1900
% Change	1.8	1.9	2.5	2.5
Labour Force (‘000)	1859	1899	1944	1991
% Change	2.4	2.1	2.4	2.5
Unemployment Rate (%)	4.4	4.6	4.6	4.6
Aggregate Hours (% Chg)	1.0	1.0	2.0	2.3

Strong job growth to continue

Looking at individual sectors, the shake out in manufacturing employment appears to be over at this stage, with aggregate employment stabilising in H1 2004. Service sector employment is expected to continue growing strongly given the strengthening of domestic demand, although difficulties may persist in the hotel, bar and restaurant trade. The rapid growth in construction employment could abate over the course of 2005. Modest growth in public sector employment is likely, most notably in healthcare.

The average length of the work week continues to contract, declining by 0.4% in H1 2004 to 37.5 hours, following falls of 0.9% and 0.8% in 2003 and 2002, respectively. It may well continue to edge lower in 2005. Taking into consideration employment growth, it means that aggregate hours worked (or the “volume of work”) should rise by 2.0% and 2.3% in 2004 and 2005, respectively. This is well above the 1% increase recorded in both 2002 and 2003, and is symptomatic of the improvement in general economic conditions in Ireland over the past year.

INFLATION

Inflation remains relatively low even though rising energy and mortgage costs pushed the CPI rate up to a high of 2.7% over the summer months from its trough of 1.3% in the spring. Inflation should remain well behaved next year, although any ECB rate hikes will boost the headline CPI rate.

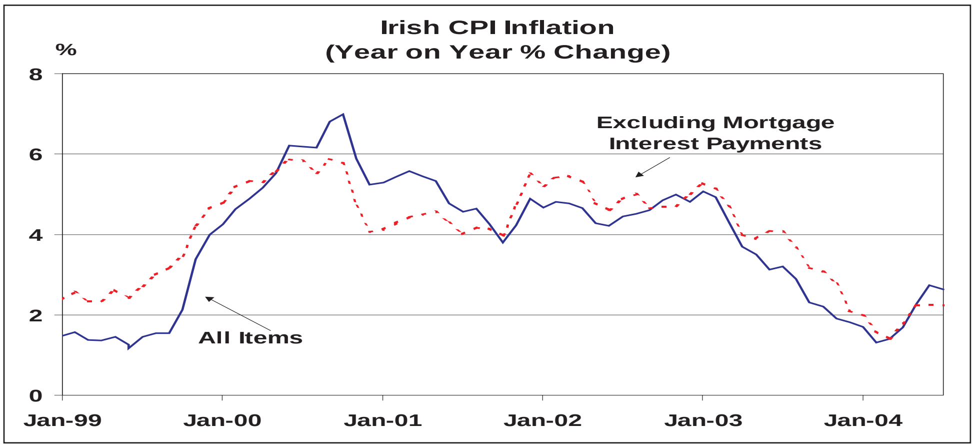
Well behaved prices in 2004

Consumer prices in Ireland have been well behaved in 2004 after a number of years of high inflation. Irish inflation has fallen to around eurozone levels, having been almost 3% above the eurozone average as recently as early last year. We expect the headline rate of CPI inflation to average 2.3% this year, down from 3.5% in 2003 and 4.6% in 2002. The core CPI rate (ex-mortgages) should average 2.2% in 2004, down from 4% and 5% in 2003 and 2002, respectively.

Oil boosts CPI rate over summer

However, the deceleration in Irish inflation evident since the early part of 2003 came to an end in spring 2004. The headline CPI rate troughed at 1.3% in March while the core rate bottomed out the following month at 1.4%. The core CPI rate picked up to a 2.2-2.3% range over the summer, but the acceleration was fully accounted for by rising energy costs.

The pick up in the headline rate has been more pronounced as mortgage interest rate reductions in 2003 have dropped out of the annual comparison, while house price inflation remains high, fuelling large increases in mortgage interest costs. The headline CPI rate stood at 2.6% in August, down from 2.7% in July.



Deflation in some sectors

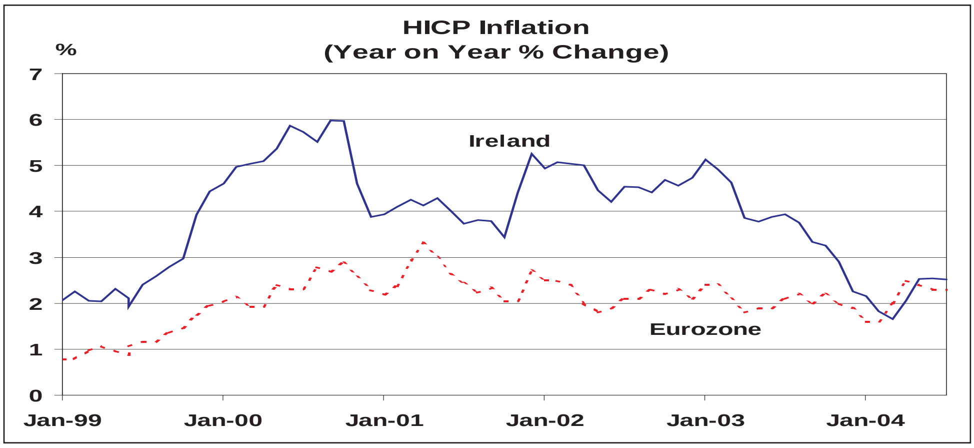
Nonetheless, many of the factors pushing down inflation to low levels in 2003 and early 2004 remained very much in evidence over the summer. Indeed, deflation is still evident in a number of sectors. In August, food prices were down 0.6% year-on-year while clothing, durable goods and miscellaneous goods and services registered annual price falls of 3.9%, 2.0% and 0.5% respectively.

On the other hand, as well as higher energy and mortgage costs, a number of other sectors continue to register significant price rises. Health and education costs were up by 5.6% and 6% yoy, respectively in August, while prices in restaurants, bars and hotels rose by 4.5%. There is still also a wide disparity between inflation in the goods and services sectors. Goods prices rose by 1.4% yoy in August while services sector inflation stood at 3.9%.

Inflation is likely to continue edging higher over the balance of the year, reflecting recent increases in oil prices and rises already sanctioned for electricity and gas prices. Furthermore, declines in the price of food and miscellaneous goods and services, that occurred in the closing months of 2003, may not be repeated the final months of 2004. We look for the headline CPI rate to move up to around 3% in the final quarter of the year, with the core rate rising to 2.7%.

Moderate inflation again in 2005

Assuming that oil prices are more stable next year, the core CPI rate should edge back down towards 2% over the course of 2005. The headline CPI rate, though, may be sustained at around the 3% level should current market expectations that the ECB will tighten monetary policy over the course of next year prove correct. Thus, we look for the headline CPI rate to average close to 3% next year.



Ireland closes inflation gap with eurozone

Having run well above eurozone levels in the period 1999-2003, the Irish HICP rate has fallen close to the eurozone average in 2004. We see the Irish HICP rate averaging 2.4% in 2004 and 2.6% next year, compared to rates of 2.0% or slightly above in the eurozone. These forecast Irish HICP rates are well down on the levels of 4.0% and 4.7% recorded in 2003 and 2002, respectively.

Producer and import prices mirror trends in consumer prices

The trend in retail prices is reflected in other inflation indicators. The annual rate of manufacturing output price inflation for goods destined for the domestic market decelerated from 3.2% at the end of 2002 to -1.0% by March 2004. Since then, the rate of inflation for these goods has risen, and was running at 1% in August. Import prices also fell sharply over the course of 2003, declining on average by 8.4% on 2002 levels. Import prices, though, picked up in H1 2004 from their lows at end 2003.

INFLATION INDICATORS

Annual Average Change (%)	**2002**	**2003**	**2004 (f)**	**2005 (f)**
Consumer Price Index (CPI)	4.6	3.5	2.3	2.9
Core (ex-mortgages) CPI	5.0	4.0	2.2	2.4
Irish HICP	4.7	4.0	2.4	2.6

THE HOUSING MARKET

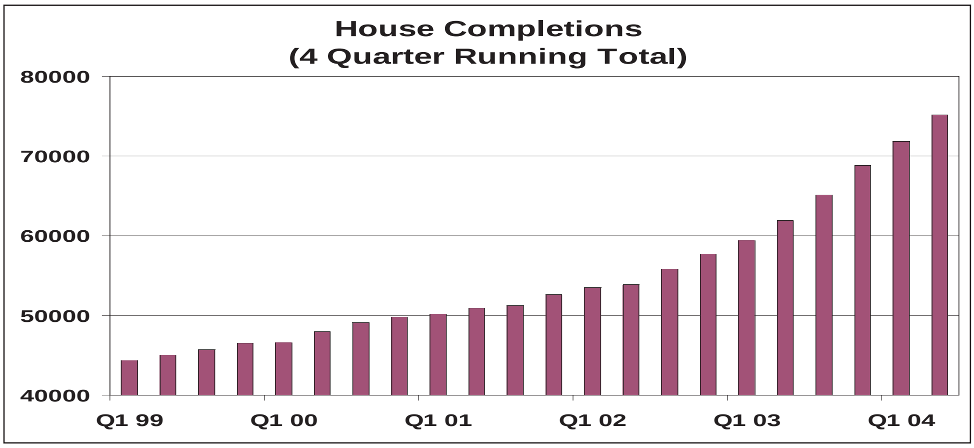
While there are risks, we expect that good affordability, low interest rates and other market supports should prove sufficient to allow a soft landing in the housing market. We think housebuilding activity may level off during 2005, with house price inflation easing further.

Housing market performs strongly

The housing market, both in terms of activity and pricing, has been one of the strongest performing sectors of the Irish economy. Defying the 2001-03 downturn in economic activity, housing supply continued to rise strongly. Completions grew by 19.3% last year to a record 68,819. This followed a 9.7% increase in 2002.

Another record year for completions in 2004

Completions rose by a further 21% in H1 2004 and could well total 80,000 for the year as a whole. New house guarantee registrations, the best proxy for private housing starts rose by 8% in the first quarter of the year. However, after a strong Q2, which saw registrations up by some 25% year-on-year, the pace of growth has eased in more recent months, with registrations broadly flat year-on-year in Q3.



Housebuilding may peak in 2005

While we would expect supply levels to begin to decline over the course of 2005, we await further signs of a slowdown in housing registrations as a leading indicator that developers are indeed slowing the pace of construction. It could yet be that the Q3 slowdown in the pace of growth of registrations is just a reaction to Q2 strength. Even if the housebuilding industry does respond to the risks of oversupply and moderates the pace of construction, completions could well be close to 80,000 again next year.

Supply at these levels cannot be absorbed indefinitely and a sizeable scaling back is required if the market is not to be put at risk. However, we believe that the house building industry will respond so as to prevent over supply threatening the stability of the market. It would more likely take one or even two other factors to cause a housing market crash - a significant deterioration in the labour market situation or a sharp increase in interest rates. Neither of these seems a likely scenario in the short term.

Investor activity needs careful monitoring

Another threat could come from a significant withdrawal of investor interest. Residential property yields have fallen significantly and, for new investors, property only makes sense on expectations of significant capital gains. The housing market would be at increased risk should investors start leaving in the face of falling rental incomes. While there is little evidence of any significant investor withdrawal, the level of investor interest is likely to wane and requires careful monitoring.

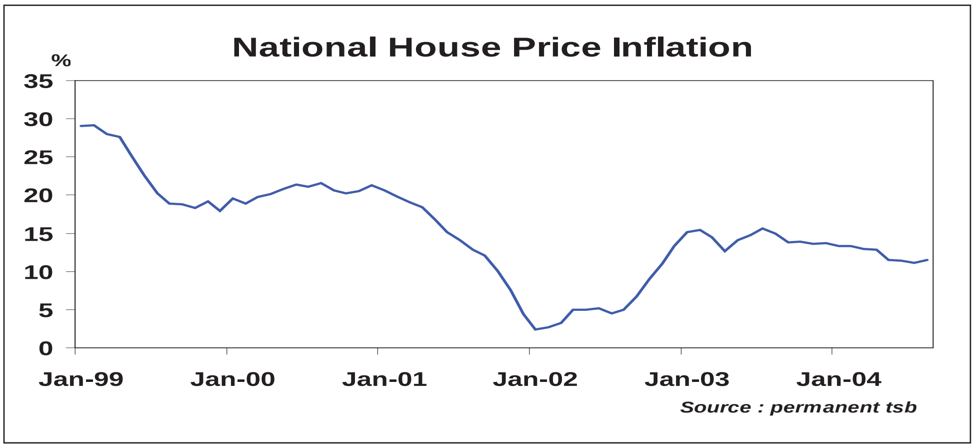
Many factors help support the market

Despite the potential risks, there are several factors that should support the market and help prevent a housing market crash. The interest rate environment is expected to remain relatively benign, especially in the near term. Meanwhile, the improvement in the Irish economic outlook, and robustness of the labour market in particular, should provide considerable support.

On top of these factors, there is still a high level of untapped demand. Any moderate decline in house prices could help release this demand, thus putting a floor under the housing market. In addition, affordability is more comfortable, in part through the extension of mortgage terms, but also through a shift to lower cost housing units.

House price inflation eases somewhat

Permanent tsb data show, however, that after having moderated earlier in the year, house price inflation has stabilised in an 11-11.5% range in the May - August period, with prices up 11.5% year-on-year in August. This, though, is down from the 13.7% inflation rate recorded in December 2003 and well below the recent peak of 15.6% witnessed in July last year.



New house price inflation remains remarkably high, given the scale of supply hitting the market. From mid-2002 to end 2003, the pace of growth of new house prices was significantly less than that for existing properties but this situation has reversed in 2004. New house price inflation continued to increase over H1 2004 to peak at 14.7% in June but has subsequently fallen back to 14.2% in July and 12.7% in August. Existing house price inflation, meanwhile, peaked in January 2003 at 18.6% and had declined to 10.9% in August 2004.

Rise in prices to ease further in 2005

Our earlier expectations that the high level of supply of new houses coming on to the market would dampen new house price inflation have yet to be realised. However, we remain of the view that supply of some 80,000 units per annum will impact on the rate of new house price inflation. This, coupled with a continuation of the downward trend in the inflation rate for existing properties should see the rate of overall national house price inflation moderate over the balance of 2004. By year end it could be down to around 10%. Given the continuing high level of supply, price rises may ease further to a 3-5% range in 2005.

PRIVATE SECTOR BORROWING

The growth in the economy and the expansion of employment of recent years have been accompanied by a sharp rise in the level of private sector debt. The debt to GDP ratio rose to 105% at the end of 2003 and should reach 119% by end 2004. Residential mortgage borrowing is the main factor behind this growth. The ratio is set to rise further in the short term fuelled by continued growth in the housing market.

Rapid growth in private sector debt

The ratio of private sector debt (excluding lending to the non-bank IFSC sector) to GDP rose to 105% in 2003, up from 84% in 1999. The ratio remains low by UK and US standards but is above the average for the eurozone.

A high proportion of the rise in the debt ratio is due to the growth in residential property borrowing. The ratio of mortgage lending to GDP increased from 27% in 1999 to over 40% in 2003. It is expected to reach over 49% of GDP by end 2004. Outside of the personal sector, borrowing has been limited but should improve as the economy strengthens.

MONETARY AGGREGATES

Annual % Change (End Year)	**2002**	**2003 (e)**	**2004 (f)**	**2005 (f)**
Private Sector Credit (adj)	15.0	17.9	22.7	12.0
Residential Mortgage Lending (adj)	23.1	25.5	31.0	15.0
Personal Sector Lending	23.7	21.5	18.0	14.0
Personal Sector Debt/Disposable Income Ratio (%)	86.7	97.4	108.4	115.4
Non-Personal Sector Lending (ex IFSC)	3.2	8.7	10.0	10.0
Residential Mortgage/GDP Ratio (%)	33.9	40.5	49.4	52.5
Private Sector Debt/GDP Ratio (%)	94.4	104.7	118.9	123.1

Further rise in borrowings expected

Housing output has grown very strongly in 2004 but the pace of growth is expected to slow during 2005. Mortgage lending has understandably grown exceptionally strongly this year, but should moderate in 2005. The forecast rise in personal borrowing reflects the strength of the labour market, which we expect to continue in 2005, and our belief that the expected rise in official interest rates next year will be moderate. Thus, we can expect to see a continuation of the rise in personal and private sector debt ratios in 2005.

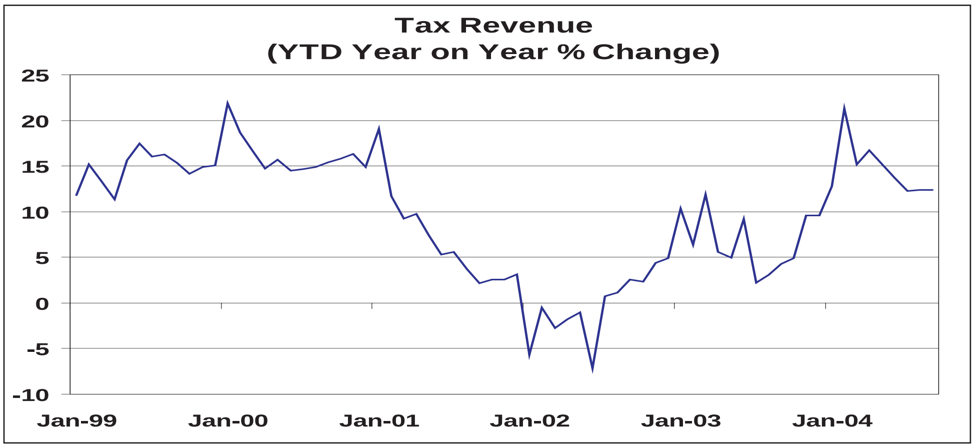
PUBLIC FINANCES

The Irish public finances remain in excellent shape. The General Government budget will be in surplus again this year, with the government debt/GDP ratio falling to 31%. There is scope for significant tax cuts in the next three budgets, if growth in spending is kept under control.

Big EBR undershoot in 2004

In the 2004 budget, the Minister set a target of €2.8bn for the EBR and €1.65bn for the General Government Deficit (1.1% of GDP). This compares to an EBR of €980m in 2003 and a small General Government Surplus of €192m. The budgetary outturn for 2004 will be well ahead of forecasts, largely due to much stronger than expected tax receipts. This reflects a number of factors.

First, the EBR outturn in 2003 was €530m lower than assumed when framing the 2004 budget last December, largely due to a late surge in tax receipts that boosted the tax base. Second, the scheme for the voluntary disclosure of offshore assets has yielded €640m in additional tax receipts this year. Third, underlying tax receipts are also proving far stronger than anticipated, as economic growth has exceeded expectations this year. Thus, tax revenues are set to greatly exceed target in 2004.



Buoyant tax receipts

The Exchequer Returns for the first nine months of the year show tax receipts up by 12.4%, well ahead of the Dept of Finance's projected rise of 4.9%. This put them €1.64bn ahead of target for this period. Excluding the voluntary disclosure scheme, tax receipts were up by 9.5% at end September, €1bn ahead of target. Overall, tax receipts look set to overshoot target by well over €2bn.

Significant General Government surplus in 2004

Meanwhile, savings on debt interest payments tend to be made by the NTMA each year. Capital spending was also running €742m behind schedule at end September and looks set to undershoot target. While there could be a small shortfall in non-tax revenue, the EBR outturn may be just €200m in 2004, way below the budget target of €2.8bn. On this basis, the General Government budget (which does not include Exchequer's contribution of €1.2bn to the National Pension Reserve Fund) should have a surplus of €1.0bn this year.

Looking ahead, the government has scope to introduce significant income tax cuts in the next three budgets, while keeping the General Government budget close to balance, assuming that growth in voted spending is kept to 7-8% per annum.