



# The Irish Economy

**THE IRISH ECONOMY**

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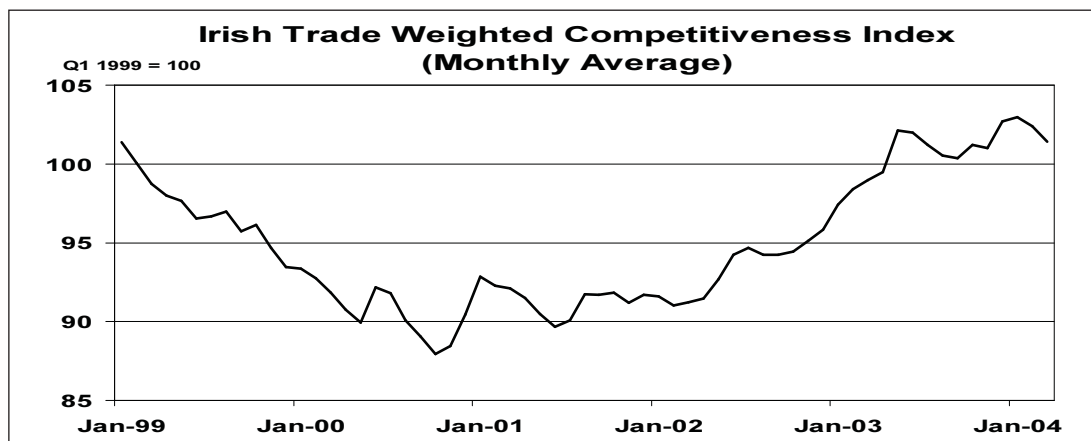
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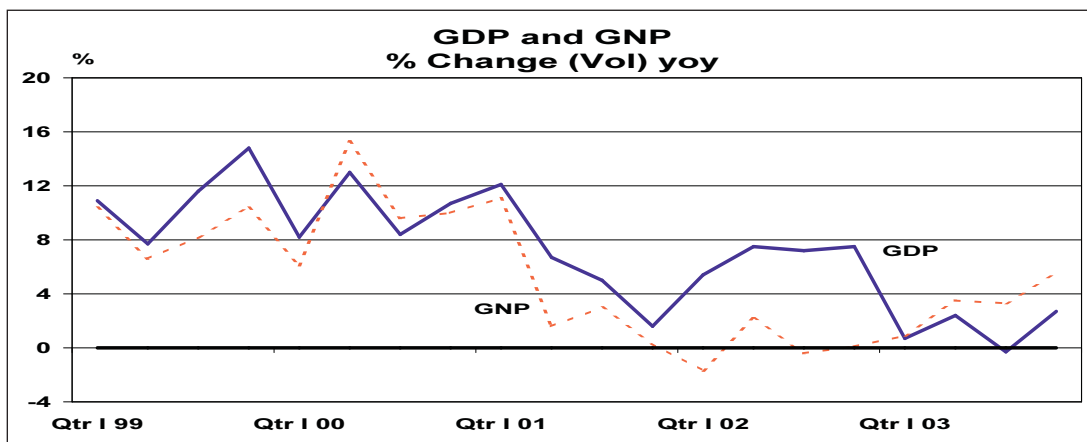
## ASSESSMENT - RECOVERY UNDERWAY

- Though risks and uncertainties abound in the domestic and international economies, the Irish economy has weathered the downturn in the 2001-03 period extremely well and is poised for much stronger growth in 2004 and beyond. There were clear signs of improvement in the latter half of 2003 and many indicators are favourable at the start of 2004.
- The Irish economy is moving on to a firmer footing with real GDP forecast to rise by at least 4% in 2004 and by 5% in 2005. Real GNP is expected to grow by 3.5% this year and by 4.3% in 2005. There should also be a return to more broad based growth as the economy moves closer to realising its medium term potential. Real domestic spending is projected to increase by 3.6% in 2004 and almost 4% in 2005.
- Irish national accounts data are subject to sizeable revisions due to the weighting of external trade in GDP/GNP. The activity of multinationals plays a key role in driving the pace of change in output and in imports and exports. Our projected growth in real GDP of 4% in 2004 is based on a rebound in the growth in real total exports to 6%, with a broadly similar rise in import growth.
- The outlook for the global economy is positive even if financial markets continue to focus on economic "noise" and fret over the sustainability of the US economic recovery, the sluggishness of economic growth in the euro area economy, and the volatility and general weakness of the US dollar. However, we expect solid and stronger growth in Ireland's main export markets in 2004.
- Though our competitive position has obviously worsened, currency movements have not been too damaging to Ireland and the outlook is for greater stability in 2004 and 2005. Some of the euro's gains against sterling have already been reversed, with the possibility that the euro could weaken somewhat further in 2005.



- Official interest rates in the US and euro area remain at extremely low levels. While we do not expect this degree of monetary accommodation to continue, the process of withdrawal will be slow, possibly being delayed until 2005. Indeed, a further rate cut by the ECB could be on the cards in the coming months. Given the importance of variable rates to the Irish corporate and personal sectors, the continuing low interest rate environment will support the economic recovery and provide invaluable support to the Irish housing market.

- The Irish economy has three very favourable fundamental factors at work which support a positive outlook in 2004 and 2005. The first is the resilience of the labour market. Irish labour supply continues to grow at a rate close to 2%. However, net job creation has been maintained at a sufficiently high rate to limit the rise in the unemployment rate to less than 5%.
- It is true that part of the net rise in employment in 2003 was due to an acceleration in the growth in part-time employment, particularly in the public sector. However, the data for Q4 2003 were very encouraging showing a 2.5% year-on-year rise in total employment, heavily weighted towards full-time private sector jobs. Employment is forecast to grow by 1.6% or above in 2004.
- A second major support for the economy is the fall in the annual rate of inflation to 1.3%. Inflation was about 5% just over a year ago. There are clear disinflationary forces now at work in the economy. We expect the rise in the CPI to average 1.9% in 2004, down from 3.5% in 2003. Core inflation (ex.mortgages) is expected to average 2% or slightly below this year compared with 4% in 2003.
- Looking to 2005, core inflation should remain close to 2% but the headline rate will rise, depending on the degree of ECB induced mortgage interest rate increases. The growth in wage income slowed in 2003 and a further deceleration is forecast for 2004. Overall, the marked deceleration in inflation will help improve Irish cost competitiveness and should influence the outcome of the next pay round.



- A third supportive factor is that the economy enters 2004 with limited imbalances. The public finances finished 2003 on a favourable note with the general government budget in surplus. The projected general government deficit target for 2004 of just over 1% of GDP is likely to be well undershot. This would augur well for the 2005 budgetary arithmetic.
- For many, the main domestic risk is perceived to be the outlook for the Irish property market. We are positive on the outlook for this sector in view of the impressive performance of the labour market, the strong underlying demand for residential property and the limited downside to affordability in 2004 and 2005. We expect that the annual growth in house prices will slow down to about 7% by end year but we do not anticipate a major downturn or price crash in the market.

**14th April 2004**

## EXTERNAL ENVIRONMENT

***The external environment for Irish economic growth in 2004 and beyond has improved, but clearly risks remain. Nevertheless, growth prospects for the US and the UK are solid enough, global inflation and key official interest rates will remain low and currency markets are expected to be less volatile than in 2003.***

### *Improving global environment*

The outlook for the global economy in 2004, though not without risks, is better than at any time since 2000. The outlook for Ireland's main trading partners is encouraging. Growth in the US is expected to average at least 4.5%, compared with 3% in 2003. The UK economy has proved to be particularly resilient. Real GDP in the UK is forecast to exceed 3% in 2004, up from 2.2% in 2003. The eurozone is lagging but growth should improve as the year progresses. An average rise in real GDP of around 1.5% is expected in 2004 compared with 0.4% last year.

In the case of both the US and the UK, two economies with relatively high import propensities, growth will be above trend this year but growth in the euro area will remain below potential. These three economic zones account for 80% of Irish merchandise exports and 69% of our imports.

### *Uncertainties and risks but also opportunities*

There are naturally uncertainties and risks surrounding the international outlook. However, there are also opportunities. Key factors include:

- Geopolitical risks including terrorism.
- The US Presidential election.
- The US twin deficit problem and the outlook for the US dollar.
- High commodity prices, particularly oil.
- Financial market volatility and how the markets react to the inevitable, but gradual withdrawal of significant monetary accommodation, especially by the US Fed.
- The risks and opportunities of the increasing integration of China and India into the global economy.
- The contribution of technological change towards improved productivity in an ever expanding services economy.

### *Recovery can be sustained*

We are optimistic that the expansion in the US and UK economies will be sustained at or above trend over the next 12-18 months. Worries about the "jobless" US economic recovery have lessened. The US non-farm payroll data appear to have turned the corner. The pace of recovery in the euro area has been slower than expected due to the sluggishness of domestic demand. However, eurozone external trade has benefited from the pick-up in global demand, notwithstanding the rise in the value of the euro.

### *ECB rate cut cannot be ruled out*

On the monetary policy front, an ECB rate cut cannot be ruled out in the coming months. The ECB continues to closely monitor data on the euro economy in this regard. We think it is more likely, though, that the ECB will stay on hold. Meanwhile, any tightening of ECB policy seems a long way off at this stage.

*US rates may be raised by end year*

We expect that the US Federal Reserve will raise interest rates before the end of the year. Further US monetary tightening is likely to be on the cards in 2005, but policy would still be quite accommodative, given the low level of rates. In the UK, the Bank of England has already tightened policy in 2004 and we expect more rate hikes this year. Looking to 2005, we envisage further modest monetary policy tightening in the UK. Our forecasts are set out in the table below.

A key issue for markets and for the highly open Irish economy is the outlook for currency markets. The US Dollar has fallen by 12% on a broad trade weighted basis over the past two years but this is not enough to make a serious dent in the huge US current account deficit. Nevertheless, there is a view that the dollar's decline against the euro and sterling has reached a limit. Of course, this does not rule out further dollar weakness but we believe that further gains by the euro much above \$1.30 will prove unsustainable over the next year.

*Dollar/euro in \$1.15 - 1.30 range*

On the other hand, we do not see the case for a significant dollar recovery. As a result, a sustainable break much below \$1.15 seems unlikely this year. We expect that the euro will be about 7.5% higher on average in 2004 against the US Dollar with a modest depreciation of about 3% possible in 2005. As regards sterling, the euro gained 10% last year but is forecast to fall by almost 3% in 2004 and could edge lower again in 2005.

| <b>GLOBAL ECONOMY: KEY ASSUMPTIONS</b>                 |             |             |                 |                 |
|--|-------------|-------------|-----------------|-----------------|
| <i>Annual Average (Unless stated)</i>                  | <b>2002</b> | <b>2003</b> | <b>2004 (f)</b> | <b>2005 (f)</b> |
| <b><i>Economic Growth (% Change)</i></b>               |             |             |                 |                 |
| OECD   | 1.8         | 2.2         | 3.2             | 3.1             |
| US   | 2.4         | 3.1         | 4.5             | 3.7             |
| Euro   | 0.9         | 0.4         | 1.5             | 2.3             |
| UK   | 1.6         | 2.2         | 3.2             | 2.8             |
| <b><i>Official Interest Rates (%) (End Period)</i></b> |             |             |                 |                 |
| US   | 1.25        | 1.0         | 2.0             | 3.5             |
| Euro   | 2.75        | 2.0         | 2.0             | 3.0             |
| UK   | 4.0         | 3.75        | 4.75            | 5.25            |
| <b><i>Exchange Rates</i></b>                           |             |             |                 |                 |
| US Dollar-Euro   | 0.946       | 1.133       | 1.22            | 1.18            |
| Sterling-Euro  | 0.629       | 0.692       | 0.672           | 0.66            |
| US Dollar-Sterling                                     | 1.503       | 1.635       | 1.815           | 1.79            |
| Crude Oil Prices (Brent \$pb)                          | 25.15       | 28.76       | 32.0            | 30.0            |

*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 websites [www.aibonds.com](http://www.aibonds.com) and [www.johnbeggs.com](http://www.johnbeggs.com)*

## THE MACRO FORECASTS

***The Irish economy is forecast to strengthen closer to trend growth in 2004 and 2005. Real GDP is expected to rise by at least 4% in 2004 and by 5% in 2005. Real GNP should expand by 3.5% this year and by 4.3% in 2005. The outlook will be helped by more moderate inflation, a resilient jobs market, low interest rates, a buoyant property market, stable public finances and, in particular, the much more favourable global economic environment.***

### *Bright outlook for Irish economy*

The outlook for the Irish economy has improved considerably over the past six months. Our forecasts show a return to 4% real GDP growth in 2004 with a further strengthening to 5% growth in 2005. This follows an estimated increase in real GDP of 1.4% in 2003 and an average of 6.5% in the previous two years. Growth in real GDP could be even higher if export growth turns out to be more buoyant than we are forecasting.

We expect that net factor income outflows will have a less distorting impact on the relationship between the growth in real GDP and GNP in 2004 than in the past couple of years. As a result, we forecast a rise in real GNP of 3.5% in 2004, much the same as in 2003. For 2005, we expect real GNP to grow by 4.3%. These growth rates will be well above the average of our main trading partners over the two year period.

Furthermore, we expect that the recovery in economic activity will be well balanced. We see solid growth in all the main components of domestic demand in 2004 and 2005, accompanied by a marked upswing in exports. Growth in industrial output is likely to run at close to double-digit levels while housing activity should be sustained near its current very high levels.

### *Continued solid employment growth*

This favourable economic outlook points to a continuation of solid employment growth in 2004 and 2005. We look for a shift away from growth in part-time employment, especially in the public sector, towards stronger growth in full time employment, most notably in private sector services. Irish labour force growth is expected to rise at about the same rate as in 2002/2003. If this occurs, there may be a further small rise in the unemployment rate close to 5% in 2004-2005, from 4.7% in 2003.

Meanwhile, inflationary pressures in the economy have eased considerably in the past year with the headline CPI rate falling to 1.3% in March 2004 from 5.3% over a year ago. 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 moderating 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% or slightly below in 2004 and 2.2% in 2005.

Finally, the public finances are expected to remain in good shape with just a small General Government Deficit forecast for 2004 and 2005. Thus, the General Government Debt/GDP ratio should remain stable and low at close to 32% in the next couple of years. This sound fiscal position should help underpin confidence and indicates that budgetary policy should not be an impediment to economic growth.

| <b>IRISH MACRO ECONOMIC FORECASTS</b>        |  |                 |                 |                 |            |
|--|--|-----------------|-----------------|-----------------|------------|
| <i>Annual average % change unless stated</i> | <b>2002</b>                            | <b>2003 (e)</b> | <b>2004 (f)</b> | <b>2005 (f)</b> |            |
| <i>GDP growth of 4% in 2004</i>              | <b>Real GNP</b>                        | <b>0.1</b>      | <b>3.3</b>      | <b>3.5</b>      | <b>4.3</b> |
|  | <b>Real GDP</b>                        | <b>6.9</b>      | <b>1.4</b>      | <b>4.0</b>      | <b>5.0</b> |
|  | <b>Domestic Expenditure</b>            | 3.5             | 0.8             | 3.6             | 3.9        |
|  | Personal Spending                      | 2.7             | 1.9             | 3.5             | 4.0        |
|  | Government Spending                    | 9.4             | 2.1             | 2.5             | 2.0        |
|  | Fixed Investment                       | 1.7             | -2.9            | 4.5             | 5.0        |
|  | Contribution of Stocks to GDP growth   | -0.6            | 1.0             | -0.4            | 0.1        |
|  | Total Exports                          | 6.2             | -5.8            | 6.0             | 7.0        |
|  | Total Imports                          | 2.3             | -5.6            | 5.5             | 6.5        |
|  | Level of GDP (€bn, current prices)     | 129.3           | 131.9           | 140.2           | 150.9      |
|  | Level of GNP (€bn, current prices)     | 103.4           | 109.2           | 115.7           | 123.7      |
|  | <b>Industrial Production (Vol)</b>     |                 |                 |                 |            |
|  | Total                                  | 7.9             | 6.3             | 9.0             | 10.0       |
|  | Modern                                 | 11.8            | 7.9             | 10.0            | 12.0       |
|  | Other                                  | -2.3            | 1.3             | 6.0             | 4.0        |
| <i>House price rises to moderate</i>         | <b>Housing</b>                         |                 |                 |                 |            |
|  | Average House Price (end year)         | 13.3            | 13.7            | 7.0             | 4.0        |
|  | House Completions ('000)               | 57.9            | 68.8            | 69.0            | 65.0       |
|  | <b>Labour Market</b>                   |                 |                 |                 |            |
|  | Employment Growth                      | 1.4             | 1.8             | 1.6             | 1.8        |
|  | Labour Force Growth                    | 1.9             | 2.0             | 1.9             | 1.8        |
|  | Unemployment Rate (%)                  | 4.4             | 4.7             | 4.9             | 5.0        |
|  | Net Immigration ('000)                 | 41.3            | 29.8            | 25.0            | 25.0       |
| <i>Subdued inflationary pressures</i>        | <b>Costs and Prices</b>                |                 |                 |                 |            |
|  | CPI                                    | 4.6             | 3.5             | 1.9             | 2.7        |
|  | Core CPI                               | 5.0             | 4.0             | 1.9             | 2.2        |
|  | Irish HICP                             | 4.7             | 4.0             | 2.0             | 2.3        |
|  | Manufacturing Output Prices            | 2.5             | 0.8             | -0.4            | 1.0        |
|  | Earnings Growth (Whole Economy)        | 6.0             | 4.6             | 4.5             | 4.2        |
|  | Unit Wage Costs (Whole Economy)        | 0.6             | 5.0             | 2.1             | 1.1        |
|  | Productivity Growth (Whole Economy)    | 6.3             | 0.5             | 2.0             | 2.6        |
|  | <b>External Account</b>                |                 |                 |                 |            |
|  | Trade Balance (% of GNP)               | +23.3           | +17.8           | +17.6           | +17.6      |
|  | Current Account Balance (% of GNP)     | -0.9            | -2.4            | -2.4            | -2.2       |
| <i>Public finances in good shape</i>         | <b>Public Finances</b>                 |                 |                 |                 |            |
|  | General Government Balance (€ million) | -258            | 280             | -850            | -1,500     |
|  | General Government Balance (% of GDP)  | -0.2            | +0.2            | -0.6            | -1.0       |
|  | General Government Debt /GDP ratio (%) | 32.3            | 32.0            | 32.2            | 32.4       |
|  | <b>Private Sector Finances</b>         |                 |                 |                 |            |
|  | Real Personal Disposable Income        | 4.4             | 2.4             | 4.1             | 3.4        |
|  | Personal Savings Ratio (%)             | 10.5            | 11.2            | 11.2            | 10.8       |
|  | Private Sector Credit % (end year)     | 15.0            | 17.9            | 14.0            | 12.0       |
|  | Private Sector Credit /GDP Ratio (%)   | 93.4            | 107.0           | 114.5           | 119.0      |

## DOMESTIC DEMAND

***Domestic demand is set to recover after showing very little growth in 2003. We expect consumer spending and business investment to strengthen, in particular, in 2004 and 2005, driven by continuing low interest rates, improving confidence levels and the global economic recovery.***

*Weak domestic spending in 2003*

The domestic economy performed poorly last year with sluggish growth in consumer spending, a marked deceleration in the growth rate of government expenditure and a sharp contraction in business investment. The one bright spot was housebuilding which enjoyed another strong year. Overall, domestic spending grew by less than 1% in 2003, down from 3.5% in 2002 and 5% in 2001.

The pace of domestic activity picked up momentum over the course of last year. Domestic spending fell by 1.5% yoy in Q1 2003 before recovering to show a rise of 4.5% in the final quarter of the year. We expect this recovery to be sustained in 2004, helped in particular, by stronger growth in consumer spending and a rebound in business investment.

*Rising savings ratio last year*

The combination of solid employment growth of 1.8% last year combined with significant earnings growth suggests that personal disposable income may have risen by around 6.5% in 2003. Personal consumption increased by 5.9% in nominal terms last year pointing to a rise in the savings ratio in 2003. By our estimates, the savings ratio may have climbed to over 11% from some 10.5% in 2002.

The prospects are favourable for a pick up in consumer spending this year with both wages and employment expected to register solid increases and given the marked fall in inflation. Robust growth of 9% is forecast by the Dept of Finance for the public sector pay bill, despite little change in the numbers employed in the sector. Public sector workers received 50% of the increases due under the benchmarking awards at the start of this year. This is equivalent to a 4.5% pay rise on average.

*Good growth in disposable income*

Furthermore, public sector workers will see their pay rise by 7% over the course of 2004 under the terms of the current national pay agreement. In the private sector, pay increases are likely to decelerate this year reflecting lower inflation, possibly to around 3.5%. Overall, earnings growth in the economy may average close to 4.5% this year. Employment is expected to rise by around 1.6%, pointing to income growth of over 6% in 2004.

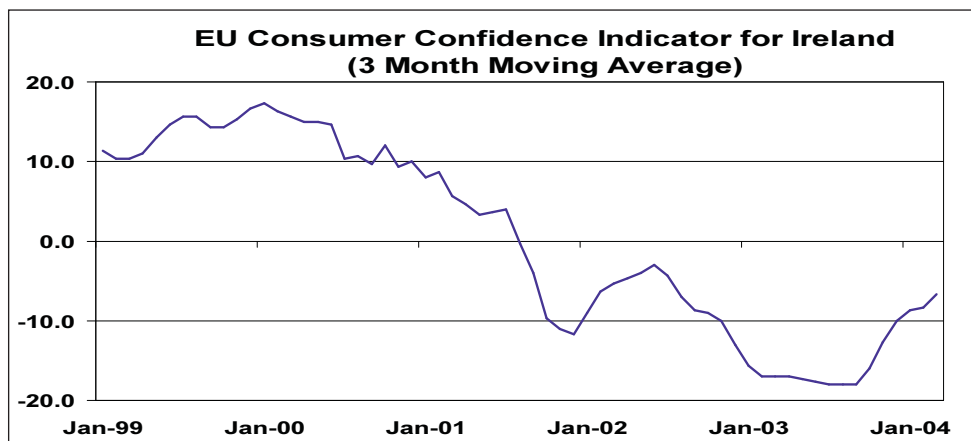
| PERSONAL INCOME, CONSUMPTION & SAVINGS |      |          |          |          |
|--|------|----------|----------|----------|
| <i>(Nominal % Change)</i>              | 2002 | 2003 (e) | 2004 (f) | 2005 (f) |
| Personal Income                        | 7.7  | 6.2      | 6.3      | 6.5      |
| Disposable Income                      | 9.2  | 6.6      | 6.1      | 6.2      |
| Consumer Spending                      | 8.9  | 5.9      | 6.0      | 6.8      |
| Savings Ratio (%)                      | 10.5 | 11.2     | 11.2     | 10.8     |

*Low inflation to boost spending power*

With the improving economic and employment situation, the savings ratio should stabilise at around 11% this year. Thus, personal consumption in nominal terms could rise broadly in line with our forecast disposable income growth of 6% in 2004. This would be on a par with the estimated rise in nominal consumer spending in 2003. However, consumers purchasing power in 2004 has been boosted by a marked fall in inflation. Thus, we look for the volume of consumer spending to rise by 3.5% this year, up from 1.9% in 2003.

*Consumer confidence on the rise*

Such a strengthening of consumer spending would be consistent with the recovery in consumer confidence evident since last autumn. Accelerating credit growth in recent months is also consistent with a pick up in consumer spending. Encouragingly in this regard, new car sales rose by 10% in the first quarter of 2004, the first such increase in four years. Retail sales growth excluding the auto sector also accelerated in the opening month of the year. Overall, then, the omens look good for stronger growth in consumer spending in 2004.



*Divergence in investment activity*

The last three years have been characterised by a marked contraction in business investment but rapid growth in construction output, owing to the buoyancy of housebuilding activity. This was particularly evident in 2003 when investment in machinery and equipment contracted by some 13% while housing output soared by around 14%.

Meanwhile, non-residential construction activity fell by some 4% last year partly due to budgetary cuts in public capital spending, as well as continuing difficult conditions in the non-residential private building sector. Overall, total fixed investment contracted by around 3% last year despite the continued buoyancy of the housing market.

*Strong level of housebuilding*

The prospects look favourable for another rise in housing output in 2004 given the continued strength of new house guarantee registrations. However, with completions already at exceptionally high levels, that exceed forecast demand, the growth in housing output is likely to prove much more modest in 2004 than in 2003. It is also quite possible that builders may begin to slow the rate of house building activity to avoid oversupply in the market. Hence, we look for a rise of just 3% in housing output this year.

*Big jump in PCP in 2004*

Non residential construction activity will benefit from a substantial rise in the public capital programme this year with the government providing for a 12.5% increase in expenditure in this area. Investment in private non-residential building activity may remain subdued this year, with the economy only just embarking on an upswing in activity. Overall, though, total construction output could rise by close to 3% in 2004.

| <b>FIXED INVESTMENT</b>   |             |             |                 |                 |
|---------------------------|-------------|-------------|-----------------|-----------------|
| <i>(% Change, Volume)</i> | <b>2002</b> | <b>2003</b> | <b>2004 (f)</b> | <b>2005 (f)</b> |
| Housing                   | 5.1         | 14.0        | 3.0             | -1.0            |
| Other Construction        | 5.0         | -4.4        | 2.7             | 5.0             |
| Machinery & Equipment     | -2.7        | -13.1       | 7.0             | 10.0            |
| Total                     | 1.7         | -2.9        | 4.5             | 5.0             |

*Business investment to recover*

Investment in machinery and equipment has fallen by 20% in the past three years. The recovery in economic activity and pick up in corporate profitability should see a rebound in investment in machinery and equipment this year. There were some signs of a pick up in capital goods imports towards the end of last year. We tentatively forecast that investment in machinery and equipment will rise by 7% this year. We must admit, though, that this forecast carries a wide margin of error. Overall, with housing output still rising and a rebound in public capital spending, this would imply that total fixed investment may rise by around 4.5% in 2004.

After showing no growth in 2002, stock levels rose strongly by €887m in value terms and €950m in volume in 2003. Total stocks held by industry rose particularly strongly in the period. Overall in 2003, stockbuilding boosted GDP growth by 1%. The rise in stocks is likely to moderate in 2004 as a result of improving domestic and external demand. We look for stock levels to rise by around €600m in constant prices in the year.

*Growth in government spending slows*

Finally, growth in government spending decelerated markedly in 2003 to some 2.1% in volume terms from 9.4% in 2002 and 11.0% in 2001. The government has finally reined in the runaway spending growth of its departments. The 2004 budget provides for modest growth in spending along the lines of the 2003 budget. The government has a good track record in terms of adhering to its spending plans. Thus, government spending should rise by around 2.5% in volume terms this year.

Overall, then, we look for growth in domestic spending to pick up to 3.6% in 2004 from less than 1% last year, helped by a recovery in investment and stronger growth in consumer spending. Turning to 2005, we would expect to see a further strengthening of consumer spending and business investment as the recovery in activity gains traction and given the likelihood of a continuing low interest rate environment. There could be a modest fall in housing output, though, from its current high levels. Overall, domestic spending could grow by almost 4% next year.

## EXTERNAL TRADE AND THE BOP

**External trade is expected to recover reflecting the improved external economic environment and a strengthening of domestic demand. Hence, exports are forecast to rise by 6% in 2004 and 7% in 2005, with broadly similar increases in imports.**

*Sharp decline in external trade in 2003*

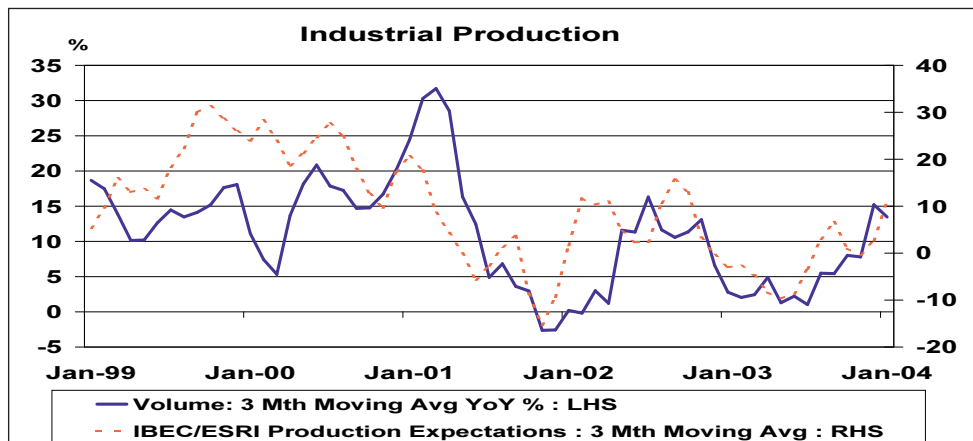
External trade data were heavily distorted in 2001 and 2002 by substantial 'carousel' type trading in electrical machinery with the UK, apparently related to a tax scam. The termination of this 'carousel' trading in late 2002 meant that there was a sharp fall in exports and imports in 2003, even though the net trade balance was not affected.

Overall, total exports of goods and services declined by 5.8% and imports fell by 5.6% in volume terms in 2003, largely because of the termination of this 'carousel' type trading. Excluding this factor, though, the performance of external trade was still weak last year, with exports and imports both declining on an underlying basis.

The sharp appreciation of the euro and corresponding weakness of the dollar depressed trade prices considerably last year. Combined with the large volume fall, it resulted in a sharp drop in the value of external trade in 2003. The value of exports of goods and services fell by 9.8% while imports declined by 7.4% last year.

*But a recovery has been underway for some time now*

Despite the sharp fall in 2003 vis-a-vis 2002 levels, the volume of external trade has actually been on a recovery path since last spring, helped by the rebound in the world economy post the war in Iraq. The volume of exports and imports rose in the final three quarters of 2003. The recovery in external trade is consistent with a marked rebound in manufacturing output in 2003. By the final quarter of last year, manufacturing output was up by some 15% on the corresponding period of 2002. This compares with an annual growth rate of 2.5% in the first half of the year.



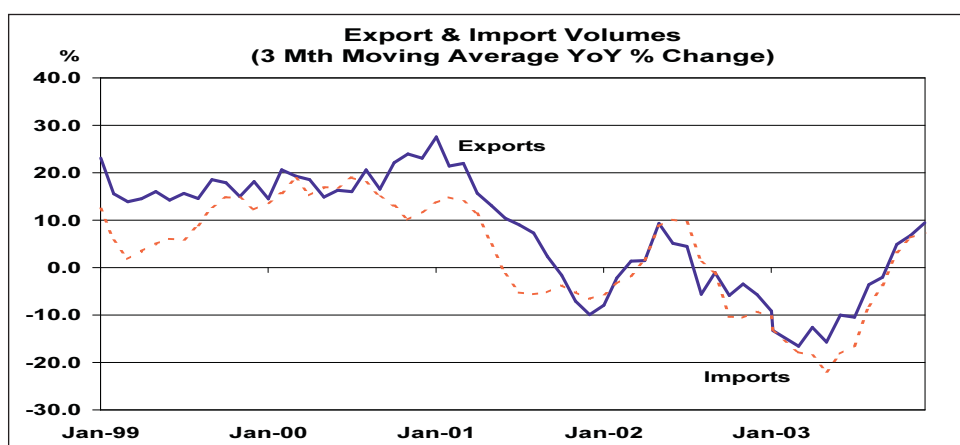
*Merchandise trade swinging upwards*

Not surprisingly, then, by the closing months of last year, merchandise import and export volumes were comfortably above year earlier levels. With the global economy and world trade expected to grow strongly in 2004 and leading indicators of Irish industrial activity pointing upwards, one would expect Irish exports to continue rising over the course of this year. Imports should also maintain their uptrend, boosted by a greater demand for inputs by industry and an expected pick up in domestic demand.

*Good volume growth expected in 2004*

Obviously, the strength of the euro will have some dampening effect on Irish exports. However, this should not be overstated. The Central Bank's trade weighted exchange rate index for Ireland rose sharply between Q2 2002 and Q2 2003. However, the index has been relatively stable since last May, during which time there has been a marked pick up in manufacturing output and exports. Furthermore, the euro is now well off its highs and is currently trading at a twelve month low against sterling.

With external trade volumes benefiting from strong carryover effects from 2003 and likely to be boosted by the upswing in the global economy this year, we expect to see sizeable volume increases in exports and imports in 2004. Overall, we look for exports and imports to rise by around 6% this year. Exports and imports are forecast to grow by 7% and 6.5%, respectively, in 2005.



*BOP deficit widens out*

There was a marked fall in the trade surplus last year, partly due to a particularly sharp decline in export prices. Hence, there was a significant widening of the current account deficit on the balance of payments, despite a big fall in net factor income outflows. The deficit rose to €2.65bn in 2003 from under €1bn in the previous two years. The deficit amounted to 2.4% of GNP, which is in marked contrast to the large current account surpluses run during the 1990s.

Turning to 2004, we expect to see a modest rise in the trade surplus, helped by a recovery in volumes and less downward pressure on prices, assuming that currency markets stabilise somewhat. The pick up in exports, though, is likely to trigger a renewed rise in net factor income outflows, offsetting the improvement in the trade balance. Overall, the current account deficit could rise slightly to around €2.75bn in 2004, amounting to some 2.4% of GNP, and remain at around €2.75bn in 2005.

| BALANCE OF PAYMENTS (€M) |        |          |         |           |             |
|--------------------------|--------|----------|---------|-----------|-------------|
| Year                     | Goods  | Services | Income  | Transfers | Current A/C |
| 2002                     | 37,014 | -12,871  | -25,914 | 815       | -954        |
| 2003                     | 32,107 | -12,652  | -22,701 | 598       | -2,647      |
| 2004 (f)                 | 34,050 | -13,670  | -23,600 | 470       | -2,750      |
| 2005 (f)                 | 36,500 | -14,500  | -25,250 | 500       | -2,750      |

## LABOUR MARKET

***The Irish labour market has been a resilient performer with healthy employment growth, strong labour force expansion and limited rise in unemployment. The outlook remains positive for overall employment though the unemployment rate could edge up closer to 5% in 2004.***

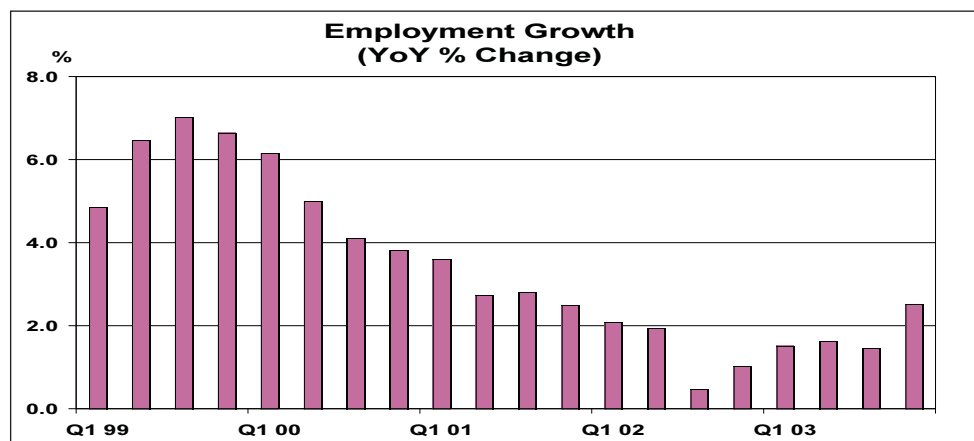
### *Resilient labour market*

The Irish labour market has been remarkably resilient since 2001. Indeed, it has recently shown renewed vigour based on the latest quarterly national household survey (QNHS). Total employment grew by 1.8% in 2003, up from 1.4% in 2002. Most of the acceleration in employment growth was due to the rise in part-time jobs of 3.7% compared with a rise of 1.8% in 2002. Full-time employment increased by 1.4% last year, marginally stronger than in 2002.

Taking account of the composition of employment growth and changes in hours worked per employee (which fell by 0.8%), aggregate hours worked (the “volume of work”) in the Irish economy rose by 0.9% in 2003 compared with 0.6% in 2002 and 2.4% in 2001.

### *Strong job growth in Q4 2003*

Employment growth averaged 1.5% in the first three quarters of 2003 on a year-on-year basis. There was also an average decline in hours worked per employee of about 1.2% in the same period. As a result, aggregate hours worked in the economy rose modestly up to September. However, there was a sizeable turnaround in the final quarter of the year. Not only did employment grow by 2.5% on an annual basis, but also the decline in hours worked was arrested. Full-time employment rose by 2.3% in the same period, more than double the rate of the previous three quarters.



### *Employment in construction and services expands strongly*

With the exception of manufacturing and agriculture, all other sectors recorded employment gains in 2003. Manufacturing employment fell by 2% while construction increased by 4.4%. In the sectors - public administration and defence, health and education - largely comprising public sector workers there was a rise of 6% on average in 2003 with a fourth quarter increase of 5.4% yoy. However, the Department of Finance insists that of a full time equivalent basis public sector employment was largely unchanged over the year to end 2003. A high proportion of the rise in part-time employment in 2003 was probably in the health sector. In the largely non-public services sector, employment increased by 1.7% last year.

*Unemployment rate remains low*

The rate of unemployment averaged 4.7% 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 an unadjusted basis, the unemployment rate rose from a low of 3.7% in the first quarter of 2001 to a high of 5.2% in the third quarter of 2003. The rate had eased to 4.5% by the final quarter of last year.

On a seasonally adjusted basis, the rate never exceeded 5%. It peaked at 4.9% in Q3 2003 before falling to 4.6% in the final quarter, the same as in the last quarter of 2002. The fall in the unemployment rate mirrors the decline in the Live Register in the closing months of last year. The Live Register was broadly stable in the opening quarter of 2004. The resilience of the unemployment rate is all the more remarkable in view of the growth of the labour force due to demographic factors and the rise in the participation rates over the past year from 59.7% in Q4 2002 to 60.2% in Q4 2003.

*Solid labour force growth*

The labour force grew by 2% on average in 2003 compared with 1.9% in 2002 and 2.5% in 2001. This rate of expansion remains some four times greater than the euro area average and ahead of estimated US labour force growth. The growth in the labour force accelerated to 2.5% in year-on-year terms in the final quarter of 2003. The main drivers of labour force expansion remain the increase in indigenous population and net inward migration as well as higher participation rates.

| <b>KEY LABOUR MARKET FORECASTS</b> |             |             |                 |                 |
|------------------------------------|-------------|-------------|-----------------|-----------------|
|                                    | <b>2002</b> | <b>2003</b> | <b>2004 (f)</b> | <b>2005 (f)</b> |
| Employment ('000)                  | 1765        | 1796        | 1825            | 1858            |
| % Change                           | 1.4         | 1.8         | 1.6             | 1.8             |
| Labour Force ('000)                | 1847        | 1885        | 1920            | 1955            |
| % Change                           | 1.9         | 2.0         | 1.9             | 1.8             |
| Unemployment Rate (%)              | 4.4         | 4.7         | 4.9             | 5.0             |
| Aggregate Hours (% Chg)            | 0.6         | 0.9         | 2.0             | 2.3             |

*Another year of good job growth in 2004*

Turning to 2004 and beyond, the outlook for employment is very positive. The manufacturing and agricultural sectors will remain under pressure, particularly in the first half of 2004. Public sector employment may not expand at the same rate as in 2003 but construction and private sector services should see further growth. We expect total employment to rise by 1.6% in 2004. Though slower than in 2003, we also envisage a small rise in hours worked per employee so that in aggregate terms total hours worked is forecast to rise by 2% in 2004, a considerable improvement on 2003 levels.

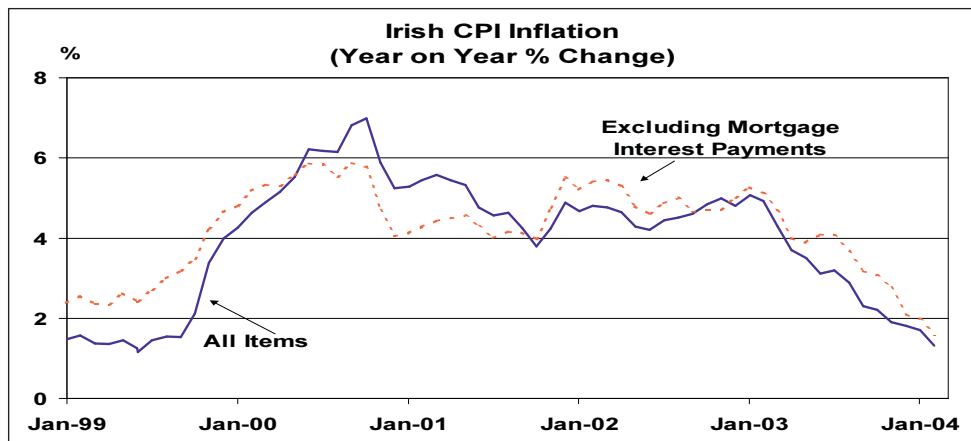
Irish labour force growth is expected to rise at about the same rate as in 2002/03. If this occurs, there may be a small rise in the average rate of unemployment in 2004 to close on 5%. The outcome may be better as our employment forecast is conservative. Based on seasonally adjusted data, there was a rise in total employment of 1.5% quarter-on-quarter in the last quarter of 2003. Thus, there is upside risk to our 2004 forecast for employment growth.

## INFLATION

***Irish inflation has fallen sharply as disinflationary forces and basis effects of smaller increases in indirect taxes and public sector charges offer an opportunity to re-establish a low inflationary environment.***

*CPI rate falls sharply*

The annual rate of inflation (CPI) slowed to 1.3% in March 2004, down from its recent high of 5.1% in February 2003. Inflation averaged 3.5% in 2003 and is forecast to average 1.9% this year. The annual rate could accelerate to 2.7% in 2005 if higher mortgage rates add to the headline CPI rate.



Irish inflation continues to benefit marginally from the fall in mortgage interest rates. The core or ex-mortgage CPI rate declined to 1.6% in March 2004 from its recent high of 5.3% in February 2003. The core rate averaged 4% in 2003 and is expected to average 2% or slightly below in 2004. It is forecast to rise moderately in 2005 to around 2.2%.

*Numerous factors contribute to easing of inflation*

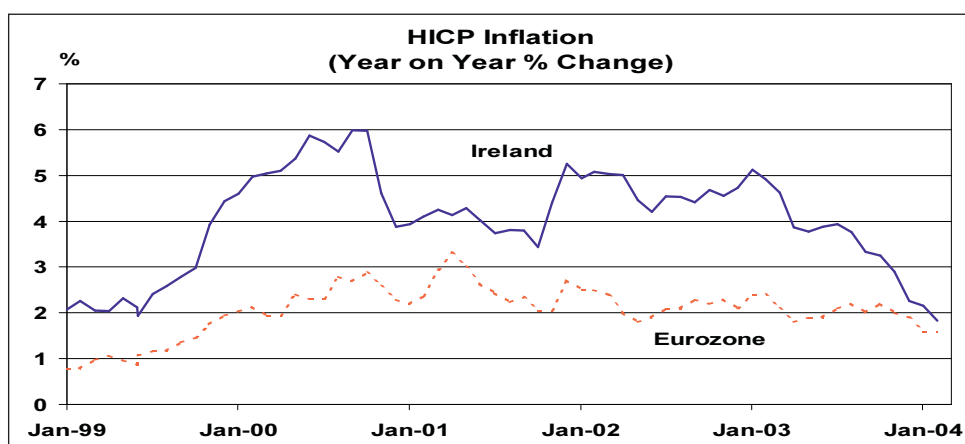
The fall in the Irish rate of inflation over the past year can be attributed to several factors including:

- The emergence of disinflationary forces as Irish consumers become more intolerant to higher prices /costs of consumer goods and adjust their consumption patterns in areas such as food, tourism and the licenced trade.
- Lower import prices due to the rise in the value of the euro. This also helped to absorb part of the impact of higher oil prices in dollar terms.
- A significant slowdown in the rate of food price inflation which has turned negative from +2.5% a year ago, reflecting currency appreciation, increased competitive pressures in the retail sector, and lower farm output prices.
- A fall in insurance costs following a marked decline in road accident fatalities and as the industry gets to grips with the excessive claims culture.
- A slowdown in the growth in Irish wage costs.
- A moderation in the annual rate of change in prices in several services sectors such as health, education and rental accommodation.

- A lower contribution from indirect taxes and public sector charges in 2004 plus the impact of a positive basis effect from higher increases from the same sources in 2003.
- The fall in mortgage interest rates which averaged about 3.45% in March 2004 compared with 4.05% a year ago.

*Ireland closes inflation gap with eurozone*

In terms of the EU HICP measure, Irish inflation dipped to 1.8% in March compared with the eurozone average of 1.6%. Thus, the gap between the two has narrowed considerably to just 0.2% from a recent peak of 2.7% in February 2003. The Irish HICP rate is forecast to average 2% in 2004 and 2.3% in 2005, well down from its level of 4% in 2003.



Overall, the core CPI and HICP rates are now running at their lowest levels since early 1998. Ireland now has the opportunity to re-establish the low inflationary environment that prevailed for most of the 1990s.

*Producer and import prices in decline*

Evidence of abating price pressures is also to be seen 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 -0.8% by end 2003. It has remained negative in the early part of 2004. Import prices also fell sharply over the course of 2003 with the price of imported goods declining by over 5% yoy in the second half of last year.

| INFLATION INDICATORS       |      |      |          |          |
|----------------------------|------|------|----------|----------|
| Annual Average Change (%)  | 2002 | 2003 | 2004 (f) | 2005 (f) |
| Consumer Price Index (CPI) | 4.6  | 3.5  | 1.9      | 2.7      |
| Core (ex-mortgages) CPI    | 5.0  | 4.0  | 1.9      | 2.2      |
| Irish HICP                 | 4.7  | 4.0  | 2.0      | 2.3      |

## THE HOUSING MARKET

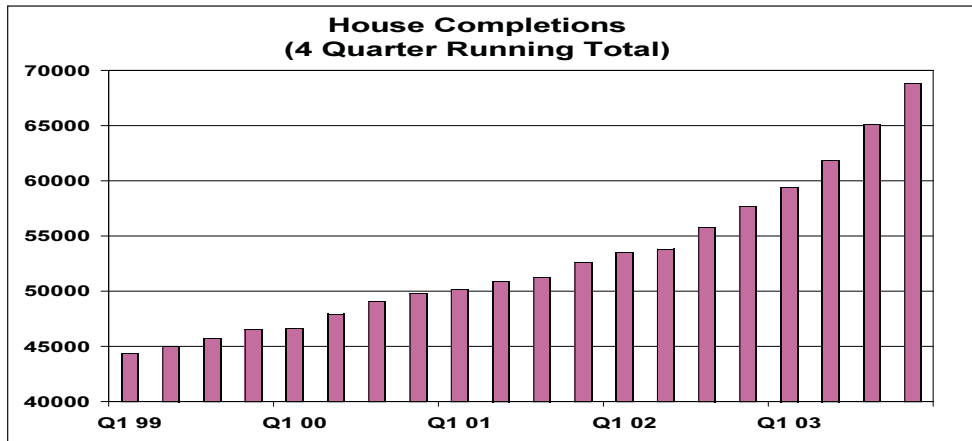
***Though housing supply is at high levels, the market is well underpinned on the demand side. While there are risks, the market should be able to move to more moderate and sustainable growth patterns in terms of both supply and prices.***

*Housing market defies economic slowdown*

The housing market, both in terms of activity and pricing, proved a notable exception to the downturn in Irish economic activity evident since 2001. Indeed, housing supply has risen strongly. Completions rose by 19.3% last year, to a record 68,819. This follows a 9.7% increase in 2002 when completions totalled 57,695.

*Completions to remain at high level*

Expectations are that the level of housing completions in 2004 may well be little changed from 2003, at close to 70,000 units. There was a moderation last year in the pace of growth in new house guarantee registrations, the best proxy for private housing starts. However, they still rose by around 8%, on top of the incredibly strong 77% increase recorded in 2002.



Over the course of 2004 we would not be surprised to see some decline in housing starts. It is quite possible that builders will begin to slow the rate of house building activity in order that the market does not become over supplied. This is particularly so in the face of media speculation about the risks of a market collapse. As yet though, there is little evidence that housing starts have begun to fall. Indeed, HomeBond registrations, which account for some 80% of total house guarantee registrations, were up by 5% year-on-year in the first quarter of 2004.

*Positive demand factors*

Some moderation in supply would seem to be required if the market is not to be put at some risk of a setback, given that the current high housing output levels are outstripping estimates of future demand. However, that being said, the market is relatively well underpinned on the demand side. Demographic factors are supportive, in particular population growth amongst the 25-34 key age group.

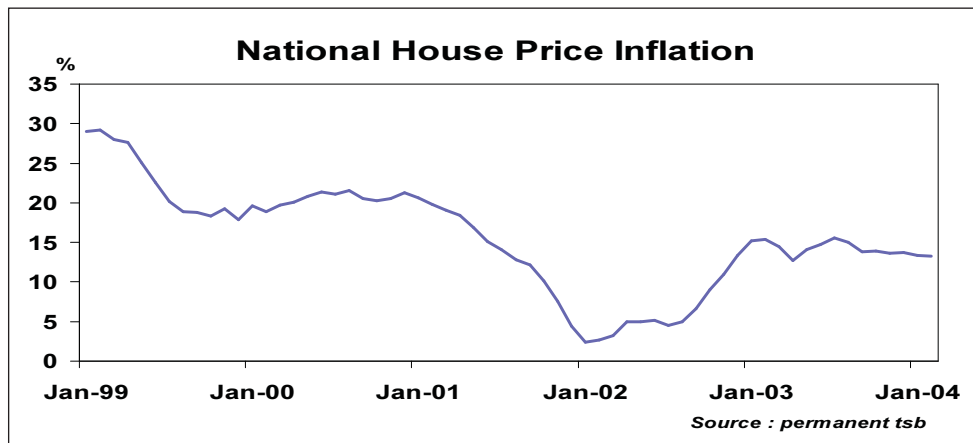
There would also appear to be a significant level of pent-up demand, with younger people having being priced out of the market in recent years. A move towards more affordable housing, such as through smaller units and higher density developments could be the key to unlocking this demand. Indeed, there is some evidence that builders are responding in this direction. The recent shift towards more affordable, longer term mortgages is also a positive development in this regard.

There are some signs that investment demand is waning, in the light of lower rental incomes and difficulties being experienced in renting some properties. However, as yet, on balance investors would appear to be still net buyers of property. Finally, the macro outlook is reasonably supportive, with the economy expected to pick up momentum and interest rates likely to remain relatively low.

*Little moderation yet in house price inflation*

These factors should help to underpin prices. The latest permanent tsb data, for February 2004, show house price inflation growing by 13.3% year-on-year nationally. This is down just slightly from the 13.7% yoy rate recorded in December 2003.

Despite strong supply, it would appear that demand for new houses was exceptionally firm at the beginning of 2004. New house price inflation picked-up to 13.6% in February from 10.8% in December 2003, having averaged 10.1% for 2003 as a whole. This compares with an average 2003 inflation rate of 16.0% for existing properties, which eased slightly to 14.4% yoy in December 2003 and even further, to 12.8%, in February this year.



*Strong supply could eventually see fall in new house prices .....*

We expect, though, that the rate of increase in new house prices will moderate this year, in the light of the high level of supply expected to come on to the market, on top of the record completions last year. Indeed, we would not be surprised if the large number of completions eventually leads to some decline in the absolute level of average new houses.

In the near term, however, a fall in new house prices in absolute terms seems unlikely. Any pass through of increased development levies imposed by local authorities would serve to support new house prices, Furthermore, after several profitable years, developers are probably in a position to hold on to completed or partially completed housing stock, rather than releasing further phases of a development at lower prices.

*.....but overall house prices could still be up by 11% on 2004*

Even if new house prices were to eventual decline, the overall level of house prices may well be supported by gradually rising prices for second hand properties. Here too, though, we would expect some moderation in the price trend. Easing new house price inflation and lowered expectations of future price gains can be expected to take some of the heat out of the second hand market. Overall, by December 2004, the average national rate of house price inflation could have slowed to around 7%. For the year as a whole, though, house price inflation may average around 11%.

## 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 107% at the end of 2003. 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 107% in 2003, up from 84% in 1999. The ratio remains low by UK and US standards but is a little 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 41% in 2003. Outside of the personal sector, borrowing has been limited but should improve as the economy returns towards trend growth.

| MONETARY AGGREGATES                              |      |          |          |          |
|--|------|----------|----------|----------|
| Annual % Change (End Year)                       | 2002 | 2003 (e) | 2004 (f) | 2005 (f) |
| Private Sector Credit (adj)                      | 15.0 | 17.9     | 14.0     | 12.0     |
| Residential Mortgage Lending (adj)               | 23.1 | 25.5     | 20.0     | 15.0     |
| Personal Sector Lending                          | 23.7 | 25.0     | 18.0     | 14.0     |
| Personal Sector Debt/Disposable Income Ratio (%) | 83.9 | 96.1     | 107.0    | 115.0    |
| Non-Personal Sector Lending (ex IFSC)            | 3.2  | 8.0      | 10.0     | 10.0     |
| Residential Mortgage/GDP Ratio (%)               | 33.6 | 41.4     | 46.7     | 49.9     |
| Private Sector Debt/GDP Ratio (%)                | 93.4 | 107.0    | 114.5    | 119.0    |

*Further rise in borrowings expected*

Based on our expectations that housing will continue to grow at a fast pace in 2004, with some slowdown evident in 2005, there will be a further rise in personal and private sector debt ratios over the two years. The rise in the level of borrowing reflects our expectations that the labour market will continue to expand and that the expected rise in official interest rates will be moderate.

## PUBLIC FINANCES

***The Irish public finances have emerged from the recent economic downturn in good shape. The General Government budget is close to balance, with the government debt/GDP ratio stable at a relatively low 32%.***

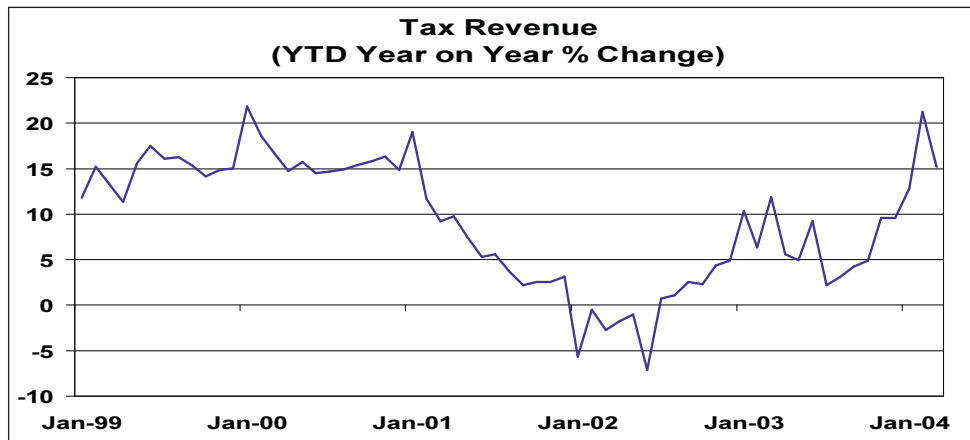
*Small General Government surplus in 2003*

The 2003 budget outturn was better than expected as a late surge in tax receipts saw the EBR come in at €980m, well below the target of €1,869m. Meanwhile, there was a small General Government surplus, equivalent to 0.2% of GDP. This compares with the deficit target of 0.7% of GDP set in the budget.

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). Higher expenditure on debt interest payments and a fall in the Central Bank's surplus income are partly responsible for the projected rise in the budget deficit. Furthermore, the rise in current supply services spending is forecast to exceed the growth in tax receipts this year.

*Deficit undershoot likely in 2004*

The budget deficit in 2004, though, is likely to comfortably undershoot target yet again. The EBR outturn in 2003 was €530m lower than assumed when framing the 2004 budget last December, largely due to higher than expected tax receipts. Thus, tax revenues are now likely to exceed target in 2004. Meanwhile, savings on debt interest payments tend to be made by the NTMA each year



*Buoyant tax receipts*

The Exchequer Returns for the first quarter of the year show a continuation of the strong buoyancy in tax revenues evident in the closing months of last year. Tax receipts rose by 15.2% in Q1 2004 well ahead of the Dept of Finance's projected rise of 10.6%. Accelerated capital tax payments yielded €226m more than expected. However, even excluding capital taxes, Q1 tax receipts were €91m ahead of target.

*EBR of €2bn or less this year*

It is early in the year to be making predictions but it seems to us that tax receipts could overshoot target by up to €700m. Bearing in mind that the NTMA is likely to make savings also, the EBR should be no more than €2bn in 2004. On this basis, the General Government Deficit would amount to around 0.6% of GDP. However, the eventual budget deficit outturns could be considerably less, depending on the impact on tax revenue of the investigations by the Revenue Commissioners into offshore bank accounts.



