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## International Trade and Investment Report 2001

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# International Trade and Investment

## Report 2001



*A Report by Forfás to the Trade Advisory Forum and the Foreign Earnings Committee*

January 2002



# Preface

International trade and direct investment flows are the lifeblood of the Irish economy. Between 1990 and 2000, the value of international trade in goods and services between Ireland and the rest of the world as a proportion of Gross Domestic Product (GDP) rose from 112 per cent to 176 per cent, making Ireland one of the most open economies in the world. Excluding "micro states", such as Hong Kong and Singapore, in 2000 Ireland registered the highest per capita merchandise exports in the world and was the 22nd largest exporter in absolute terms. For every \$100 dollars generated globally from export sales in 2000, \$1.30 accrued to Ireland. There are now few businesses in Ireland of a significant scale that do not trade in goods and services with foreign customers or suppliers.

This high degree of openness of the Irish economy at the beginning of the 21st century has been no accident. It is the outcome of deliberate and prescient decisions made by successive Irish public administrations over a number of decades, guided by a clear and consistent strategic vision of Ireland's economic and political future. Milestones along the journey included: the introduction of export sales relief in 1956; the decision to establish the IDA and to actively encourage foreign investment; the decision to join the EU (then EEC) in 1973, thereby embracing free trade in industrial goods; the break with sterling in 1979, and the subsequent entry of the Irish pound into the European Monetary System; our support for the Single European Market Programme (1987-92); the decision to enter Economic Monetary Union (EMU) in 1992, requiring the adoption of the euro as our national currency in 1999; and our ongoing support for removal of barriers to trade and investment flows on a multilateral basis under the auspices of GATT, and subsequently the World Trade Organisation.

The resulting deepening of Ireland's integration into the global economy through flows of trade and direct investment over the last three decades is clearly linked with Ireland's gradual transformation into a competitive and successful economy, and the resulting fast growth in employment and living standards over this period, particularly during the last decade. During the 1990s, Ireland secured a share of global mobile direct investment flows out of all proportion to its economic size - investment flows that underpinned a radical restructuring of Ireland's industrial base. Since entering the EU, Irish income per capita relative to the EU average has increased from 58 per cent to 109 per cent. The traditional twin scourges of Irish economic life - involuntary unemployment and emigration - have been seen off by fast growth in global demand for Irish produced goods and services.

As always, the future presents new challenges. In the context of Irish participation in EMU, the growing integration of the Irish economy into that of the United States may present challenges for economic management and stability. This reflects the current small share of total Irish trade with other countries in the euro-zone, which may leave the economy vulnerable to fluctuation in the external value of the euro, particularly against sterling and the U.S. dollar. Remaining barriers to trade between Ireland and our euro-zone partners must be identified and addressed. The narrowness of Ireland's export base has also raised concerns about the vulnerability of the economy as world growth suffers its sharpest deceleration since the first oil crisis in 1972-73. Outward direct investment flows from Ireland, which have increased significantly in recent years are a positive force in national economic development, contributing to rising exports, employment and incomes. But the concentration of Irish outward FDI flows to the UK and the USA may reinforce our isolation from the euro-zone economy. While inward FDI flows must continue to play a central role in moving Irish

industry up the value chain, the large, and rising, share of Irish exports accounted for by multinational companies raises questions about the appropriate balance between indigenous and FDI-led development. Attracting future FDI inflows into Ireland is also facing a number of challenges, including the forecast decline in global FDI flows in 2001-02, infrastructure congestion in the Irish economy and growing competition for mobile FDI flows from low cost locations in Asia, central and eastern Europe, and elsewhere.

Clearly, Ireland's model of industrial development, centred largely around FDI-based export growth, has brought huge benefits to the Irish people. But with the Irish economy's high degree of openness through trade and inward direct investment flows comes an obligation to maintain an investor friendly business environment. Government initiatives in the fields of taxation, employment, education, trade and infrastructure must continue to be scrutinised regarding their impact on the competitiveness of the enterprise sector in Ireland. The purpose of this report is to monitor trends in flows of trade and direct investment between Ireland and the rest of the world and to place Irish developments in an international context. It is also intended to raise international trade and direct investment issues for policy discussion.

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# Glossary of Terms/Definitions

**CSO** – Central Statistics Office

**ECU** – European Currency Unit

**Eurostat** – Statistical Office of the European Communities

**Eurozone** – Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain.

**Foreign Direct Investment (FDI)** is a category of international investment that, based on an equity ownership of at least ten per cent, reflects a lasting interest by a resident in one economy (the direct investor) in an enterprise resident in another economy (the direct investment enterprise). Using this criterion, a direct investment relationship can exist between a number of affiliated enterprises whether the linkage involves a single chain or a number of chains. Once the direct investment relationship is established, all subsequent financial flows between the related entities are recorded as direct investment transactions, whether they comprise equity capital, reinvested earnings or other capital.

**Equity capital** includes equity in branches and ordinary shares in subsidiaries and associates.

**Other capital** covers inter-company debt (including short-term loans such as trade credits) between direct investors and subsidiaries, branches and associates.

**Reinvested earnings** consist of the direct investor's share of earnings not distributed as dividends by subsidiaries or associates and earnings of branches not remitted to the direct investor.

**FDI Flows and Stocks** – Through direct investment flows the investors build up a direct investment stock (position), making part of the investor's balance sheet. The FDI stock (position) normally differs from accumulated flows because of revaluation (changes in prices or exchange rates) and other adjustments like rescheduling or cancellation of loans, debt forgiveness or debt-equity swaps with different values.

**Portfolio investment** covers the acquisition and disposal of equity and debt securities that cannot be classified under direct investment or reserve asset transactions. The securities involved are traded (or tradable) in organised financial markets.

**IFSC** – International Financial Services Centre

**WTO** – World Trade Organisation



# 1 Introduction and Overview

## 1.1 Introduction

- ▶ This is the second **Forfás International Trade and Investment Report**. The purpose of the report is to monitor trends in flows of trade and direct investment between Ireland and the rest of the world, to place Irish developments in an international context, and to raise international trade and investment issues for policy discussion. As the two main pillars of globalisation, trade and foreign direct investment flows are deeply inter-linked. It is therefore appropriate to examine them in a single context.

## 1.2 Overview - Merchandise Trade

- ▶ By both volume and value, global trade in 2000 grew at one of the strongest rates in recent decades. Moreover, this was experienced, to a greater or lesser extent, in all regions of the world. Trade volumes increased over 1999 in a range of 9.5 per cent ( in Latin America) to 17 per cent (in the transition economies of Central and Eastern Europe)
- ▶ 2001 has been very different as the global economy has undergone its sharpest deceleration in GDP growth since the first oil crisis three decades ago. The WTO estimates that the volume of imports and exports trade in the first half of the year was up by a mere 2 per cent on the same period in 2000.
- ▶ The benign environment in 2000 was beneficial to Ireland as one of the most open economies in the world. In absolute terms, the value of merchandise exports rose from €66.9<sup>1</sup> billion to €83.7 billion, an increase of almost 25 per cent. However, unlike recent years, much of this increase was accounted for by a sharp jump in export prices. In terms of volume growth, the rate recorded was more similar to rates in 1998 - 99.
- ▶ Excluding "micro states", Ireland registered the highest per capita merchandise exports in the world and ranked the 22nd largest exporter in absolute terms. The country's disproportionate role in global trade is well illustrated by the fact that of every \$100 generated globally from export sales in 2000, \$1.30 accrued to Ireland according to the WTO.
- ▶ Fast export growth was partly the result of competitiveness gains stemming from a 4.5 per cent depreciation of the real effective exchange rate combined with productivity gains. These developments more than offset higher price inflation affecting imported intermediate goods and domestic product and labour markets. According to Central Bank of Ireland calculations, export prices (denominated in dollars rather than local currency units) actually fell in 2000.
- ▶ Data processing machines (including PCs), organic chemicals and electrical machinery are the three most important export sub categories in value terms. In 2000 they were also the three fastest growing, increasing in value by 28 per cent, 47 per cent and 50 per cent respectively. These three sub-categories of exports increased their share of total exports by almost six percentage points to 53 per cent.
- ▶ Ireland was the third largest exporter of data processing machinery in 2000, accounting for almost 20 per cent of the EU total and surpassed only by the UK and Germany. In organic chemicals, Ireland is the clear leader in the EU, accounting for 27.5 per cent of total EU exports in 2000.

<sup>1</sup> Note that in this document, all monetary amounts sourced as punts have been converted to euro. The standard conversion rate of €1 = IRE0.787564 is used throughout.

- ▶ By contrast, growth was much slower in more traditional sectors of the economy. Exports of food and live animal exports rose by 7.8 per cent in value in 2000, while low-tech manufactured goods (including textiles, metals and paper) increased by 8 per cent.
- ▶ The UK remains Ireland's largest export market. Solid economic growth in the UK was a factor in exports rising to €18.7 billion, a year on year increase in value terms of 27 per cent. Important too was the competitiveness boost of the 7 per cent euro depreciation when compared with 1999. Although the UK's share of total exports has fallen to 22 per cent (down from over a third in 1990) it still accounts for considerably greater proportion of exports than Germany and France combined.
- ▶ The value of exports to the USA in 2000 surged by 37.9 per cent over 1999 and now accounts for 17 per cent of total Irish exports, an unparalleled level among the countries of the euro area. Although the USA has not yet become Ireland's single largest export market, this seems likely in the medium term on the basis of the trend of recent years. However, evidence from the second quarter of 2001 shows a slowdown in export activity as the U.S. economy headed towards recession. The effect of the sharp U.S. slowdown on Irish exports could be severely exacerbated if the euro were to appreciate sharply vis-à-vis the dollar.
- ▶ The value of Irish exports to other euro area countries grew by 15 per cent, considerably less than in other major markets. Despite the removal of exchange-rate risk (since the beginning of 1999) and strong growth (in 2000), the share of exports to the euro area fell from just under 50 per cent of the total in 1998, to around 44 per cent in 2000, and just 37.5% in the first six months of 2001.
- ▶ Industrial output from foreign-owned enterprises is overwhelmingly for export and, as a result, they account for the vast bulk of Irish exports (85.1 per cent in 2000). In contrast, indigenously-owned enterprises continue to rely on the domestic market for the majority of their sales. However, there were tentative signs in 2000 that indigenously-owned enterprises may be becoming more export oriented. Despite the far higher rates of Irish economic growth relative to any export market, the share of total sales being exported rose by over one percentage point to 38.5 per cent.
- ▶ Ireland's import bill reached a total of €55.7 billion in 2000, up sharply from €44.3 billion a year previously (an increase of more than 25 per cent). Even when the sharp increase in import prices is stripped out, volume growth of 15.5 per cent was almost twice the rate of 1999 owing to strengthening demand for all categories of goods—capital, consumer and intermediate.
- ▶ The UK is by some distance Ireland's largest source of imports, accounting for considerably more imports than all the other EU countries combined in 2000. The value of imports from the UK rose by 17.8 per cent, a considerable proportion of which is likely to have been the result of higher prices owing to a weaker euro along with higher oil prices (much of Ireland's oil needs are supplied by the UK). The value of imports from the US (Ireland's second largest source of imports) grew by 23.9 per cent in 2000.

### 1.3

#### Overview – Services Trade

- ▶ Global trade in commercial services, though increasing in value terms by 6 per cent in 2000 to \$1.4 trillion, continued to lag the rates of growth recorded in merchandise trade. This is a reversal from the position throughout most of the 1990s when services grew rapidly and accounted for an increasing percentage of international trade, peaking at almost 20 per cent of the total.
- ▶ The value of services exports in the three main sub-sectors—transportation, travel and "others"—all grew at close to the average of 6 per cent in 2000, considerably stronger than in the past three years. "Other" commercial services, which include financial services, communications, information services, royalties and license fees, accounted for 44.6 per cent of the total in 2000.

- ▶ The value of Irish services exports grew considerably more rapidly than the global average in 2000, increasing to €18.3 billion from €14.6 billion in 1999. According to the WTO, Ireland was the 23rd biggest services exporter globally in absolute terms and third only to Hong Kong and Singapore in terms of per capita exports.
- ▶ In 2000, the three biggest earning categories (computer services, tourism and travel and financial services) accounted for 60.6 per cent of the total services exports. Services accounted for 18.7 per cent of total exports. Services exports to the euro area accounted for one third of the total, up from 30 per cent in 1999.
- ▶ Imports of services are more concentrated than exports. The three largest sub-sectors in terms of payments (royalties/licenses, miscellaneous business services and trade related services) accounted for almost 70 per cent of the total.
- ▶ The value of Irish services imports grew even more strongly in the first half of 2001, rising to €17.5 billion from €13.3 billion in the same period in 2000. However, there were signs in the three-month period to June that the global downturn was beginning to be felt.
- ▶ From a deficit in 1990 of €651m, the imbalance between exports and imports of services rose to €13.1 billion in 2000, equivalent to 12.6 per cent of GDP. In the first half of 2001, the value of services imports was more than double that of exports and the deficit stood at €7.7 billion, up from €5.6 billion in the same period in 2000. The deficit as a percentage of GDP is larger than that of any other developed country.
- ▶ Foreign-owned enterprises account for an even greater proportion of total services output than is the case in manufacturing. With total sales of €13.6 billion in 2000, this was more than three times the sales of indigenously owned enterprises. The export propensity of both foreign and indigenously owned services enterprises was higher than for manufacturing firms. In 2000 foreign owned enterprises exported 89 per cent of their output compared to 44 per cent for those owned indigenously.

#### 1.4 Overview - Foreign Direct Investment

- ▶ Global flows of foreign direct investment (FDI) continued to grow in 2000. At \$1,271 billion, global inflows were almost a fifth higher than in 1999 and more than six times the level of 1990 according to UNCTAD. Although FDI data are not yet available for 2001, mergers and acquisitions (M&A) activity—the motor of FDI growth—slowed in 2001 as the global economy experienced its sharpest deceleration in output growth in three decades. The result will almost certainly be a contraction in absolute levels of FDI for 2001 as a whole, when compared with 2000.
- ▶ Geographic patterns of FDI flows remained largely unchanged in 2000, with the EU accounting for almost one half of total inflows and two thirds of outflows. The second most important region of the world in FDI terms, though some considerable distance behind, was North America, accounting for over a quarter of outflows and a sixth of inflows. The developing world received the bulk of the remainder.
- ▶ Despite the small size of its economy, Ireland accounted for 2.5 per cent of the stocks of inward foreign direct investment (IFDI) in the EU in 2000 according to UNCTAD. At an estimated \$59.4 billion, foreign ownership of Irish assets was higher in absolute terms than countries of similar levels of development and income, such as Denmark and Finland. In the EU only Belgium/Luxembourg and the Netherlands had higher stocks in per capita terms.
- ▶ According to CSO balance of payments data, inward flows of FDI increased more than threefold from 1998 to 2000, rising from €7.9 billion to €26.2 billion in 2000. Ireland was the tenth largest recipient of FDI inflows among developed countries in 2000 according to UNCTAD.

- ▶ The USA has been Ireland's single most important investment partner, according to data from the U.S. Department of Commerce. Flows from the USA rose from \$4.6 billion to \$7.4 billion between 1999 and 2000. Only the Netherlands and UK received larger inflows in absolute terms in 2000. In per capita terms, inflows to Ireland were by far the highest at almost \$2,000, nearly three times those of the Netherlands, the second largest per capita destination.
- ▶ The pattern of direct investment inflows in the first six months of 2001 was in stark contrast to developments in recent years. From €11 billion in the first half of 2000, inflows fell to €9.9 billion in the same period in 2001.
- ▶ Even though the data show that Ireland's FDI inflows are impressive when compared to other countries, they may understate the impact of FDI on Ireland's economic performance. In contrast to other developed countries, where M&A activity characterises the majority of FDI inflows, Ireland has attracted much greenfield investment. These investments are a deeper form of economic integration as they usually involve the construction and fitting out of production facilities (increasing the capital stock) and the hiring of staff (increasing employment). In the case of M&As, a pre-existing firm is involved. As this can frequently involve little more than a change in ownership, its impact on the host economy is usually more limited.
- ▶ By the end of 2000 an increasingly dynamic indigenous private sector had accumulated foreign assets of \$16 billion, equivalent to half of one percent of all foreign assets held by EU countries (although this is still a disproportionately low level given the country's income levels). In per capita terms, Ireland had risen to ninth position among the EU-15, ahead of Austria, Greece, Italy, Portugal and Spain.
- ▶ CSO balance of payments data also show that outflows of FDI fell by a quarter to €4.3 billion in 2000, despite international growth trends. While flows of FDI worldwide slowed in the first half of 2001, Ireland again went against the trend, registering an increase of over 40 per cent compared to the same period in 2000.
- ▶ In 2000, Irish firms actually divested from euro area assets. Anecdotal evidence and data from U.S. sources suggests that most outflows of direct investment from Ireland go to the USA.

## 1.5 Overview – Issues for Policy Consideration

- ▶ **WTO Negotiations.** As the Irish economy becomes ever more dependent on international economic transactions, the strengthening of the multilateral trading system becomes increasingly important. Multilateral rules-based frameworks are, in general, in the best interests of small open economies given their limited political influence and dependence on non-national agents and forces. Few developments have done more to buttress international investor confidence and global economic health than the strong international political commitment at the 4th WTO Ministerial Meeting in Doha to launch a new round of trade liberalisation negotiations. Although the successful completion of a new round may require some compromises by the EU and Ireland in the area of farm supports, these are outweighed by the likely benefits to Irish-owned internationally traded manufacturing and service sectors.
- ▶ **Global Economic Slowdown.** The narrowness of Ireland's export base has raised concerns about the vulnerability of the economy as world growth suffers its sharpest deceleration since the first oil crisis in 1972-73. While there are number of risks as a result of the global downturn, both direct and indirect, the most immediate threat is to the ICT industry. Consideration needs to be given to identifying successor products and industries and encouraging the companies most likely to succeed in their production to locate in Ireland.

- ▶ **Indigenous Industry.** Irish-owned industry's relative immunity to date to the U.S. and global economic downturns seems likely to be short-lived, and the business environment for indigenous industry is set to deteriorate significantly over the coming 6-12 months. In this context, Enterprise Ireland is planning a number of actions to support Irish-owned industry, including an intensification of international marketing activities. Other areas of public policy relevant to indigenous industry that need to be considered include enhancing market access through outward direct investment, expanding access to non-EU markets for indigenous Irish industry through WTO trade liberalisation and preparing indigenous industry for a euro appreciation.
- ▶ **Importing.** Ireland is unique among the 12 EU countries participating in European Economic and Monetary Union (EMU) in that only one third of its trade is conducted with the euro-zone. This exposes the economy to a loss of competitiveness in the event of exchange rate volatility. Greater euro area sourcing has the advantage of reducing exposure to rising import prices as a result of currency movements. Following recent research into the barriers faced by Irish firms to sourcing goods from the euro-zone, the government should consider supporting a business-led "Source Euro" campaign in 2002 to encourage increased euro-zone importing. The Chambers of Commerce of Ireland have offered to design such a campaign in association with Enterprise Ireland and other industry representative bodies.
- ▶ **Inward Direct Investment.** Quite apart from the lower global flows likely this year and next, a number of structural changes, such as fast wage growth and increasingly stringent environmental legislation, present challenges to Ireland's attractiveness as an investment location. These developments make it more necessary than ever that all aspects of the business environment affecting FDI inflows are scrutinised as closely as possible. It may also be timely to make a concerted effort to diversify the source of inward FDI flows away from the USA to other euro-zone countries.
- ▶ **Infrastructure.** Infrastructural inadequacies have become increasingly obvious in recent years. Survey data show infrastructure deficiencies as a serious disadvantage faced by companies operating in Ireland. The highest priority should be given to the implementation, and acceleration where possible, of government's capital development programme, which is indispensable to the medium-term growth of the economy
- ▶ **Outward Direct Investment.** The dismantling of overseas investment restrictions and growing outward FDI flows from Ireland should be seen as an opportunity for national economic development, rather than a threat. As long as the Irish business environment is supportive of value-added activities locating in this country, this process is likely to catalyse a restructuring of the economy up the value chain, with labour intensive lower-tech operations relocating to more cost competitive locations.

While the evidence suggests that outward direct investment is broadly positive for the Irish economy, there does not appear to be any pressing need for stronger public intervention to support outward direct investors at the firm level beyond the non-financial "soft" supports already offered by Enterprise Ireland. Instead, government efforts should continue to be concentrated at the international level: expanding Ireland's tax treaty network and supporting the negotiation of a multilateral agreement on investment rules under the auspices of the WTO that would provide a transparent, non-discriminatory environment for Irish companies investing overseas. The reasons behind the small levels of Irish outward FDI flows to other euro-zone countries should also be examined.

## 2 Trade in Merchandise Goods

### 2.1 Global Developments in Merchandise Trade

The strongest rate of global economic growth in more than a decade was the main explanatory factor in the 12 percent volume increase in world merchandise trade in 2000, one of the highest rates in half a century. With strong economic growth in all but one of the main regions and economies, trade volumes increased over 1999 in a range of 9.5 percent (in Latin America) to 17 percent (in the transition economies of Central and Eastern Europe). In terms of the value of traded goods, differences among the regions of the world were considerable, mostly as a result of exchange rate fluctuations. Also of relevance in terms of values, particularly for commodity exporting countries, was the volatility in the prices of many primary goods, particularly oil. Available data for 2001 show a very different picture. The U.S. economy, which accounts for a quarter of global output, experienced a sharp slowdown in GDP growth in the final quarter of 2000 and into 2001. This radiated out across the globe during 2001, leading to the sharpest deceleration in world economic growth since the first oil crisis three decades ago. Trade has inevitably been affected. The WTO estimates that the volume of imports and exports traded in the first half of the year was up by a mere 2 per cent on the same period in 2000.

**Table 1: Growth in the Volume of World Merchandise Trade by Selected Regions**

(per cent change)	Exports			Imports		
	1990-2000	1999	2000	1990-2000	1999	2000
World	7.0	5.0	12.0	7.0	6.0	12.0
North America	7.0	6.0	10.0	8.5	11.5	11.5
Latin America	9.0	7.0	9.5	10.5	-1.5	11.0
Western Europe	6.5	4.5	10.5	6.0	5.5	10.0
EU	6.5	5.0	10.5	6.0	6.0	9.5
Eastern Europe	5.5	-2.0	17.0	4.0	4.0	15.5
Asia	8.0	7.0	16.0	7.5	7.5	15.5

Source: WTO, International Trade Statistics 2001

At 17 per cent and 16 per cent respectively, the transition economies and non-Japan Asia enjoyed the most rapid rates of export volume growth in 2000, reflecting these regions' trade-orientated growth strategies. Despite strong economic growth, Latin America, along with slow-growing Japan, experienced the lowest rates of export expansion. That said, a creditable rate of 9.5 per cent for both was above their respective annual average rates of export growth in the 1990s. Western Europe and North America both registered double-digit export increases in volume terms, though export growth in both was slightly below the world average.

The value of total world exports increased at a faster rate than volume growth as a result of higher prices - a 60 per cent increase in oil prices in dollar terms over 1999 accounted for much of this price effect. As a result, oil-exporting countries, such as those in the Middle East and the Russian Federation, enjoyed value increases in exports of 46 percent and 39 percent respectively. A 13.4 per cent increase in industrial raw materials prices helped boost African exports in value terms by 27 per cent. At the other extreme, Western European export values (in dollar terms) were depressed by the depreciation of the euro, which resulted in a mere 3 percent increase in the dollar value of exports. Closer to the average were the USA and Japan, while Asia and Latin America enjoyed increases of 18 percent and 20 respectively.

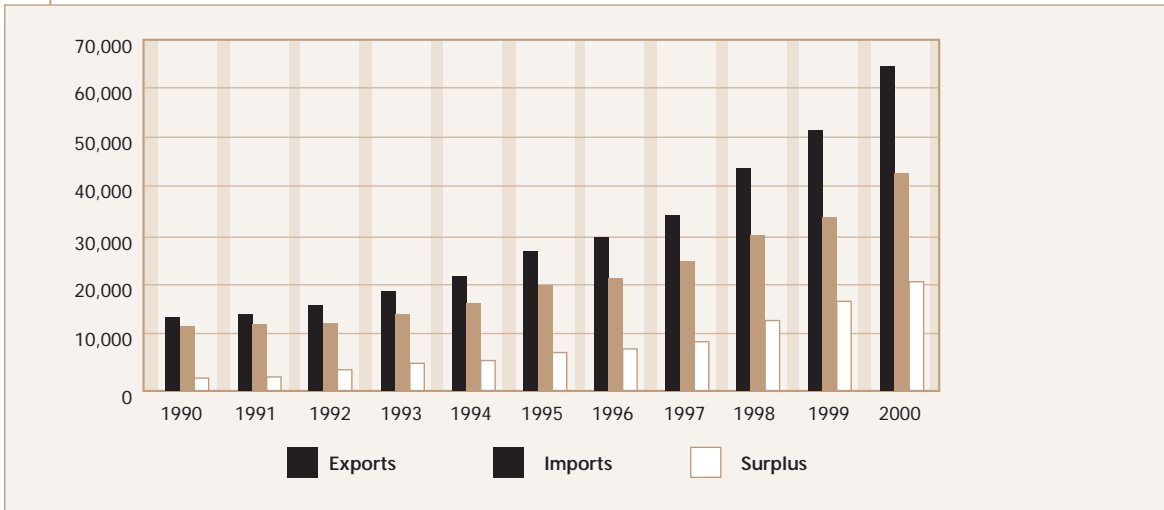
Looking at world trade growth by sector, manufactured goods now account for three quarters of total merchandise trade, a proportion that is increasing steadily as a result of higher long term rates of growth compared to those of other goods categories (i.e. agricultural and mined goods). In 2000, the value of world manufactured exports grew by 10 percent, with office and telecom equipment expanding most rapidly of all sub-sectors as global investment in technology goods continued apace. Indeed, so rapid has been the expansion in this subsection in recent years that the value of office and telecoms equipment exports now exceeds that of all mined products, including oil. The fourth most important export sector, chemicals, increased in value by 8 percent. Though this was below the average for all exports, this industry is less cyclical than others and is thus less affected by the overall tempo of economic activity compared to most other export categories. The weakest growth, of 4 percent, was in automotive goods. In 2000, owing to sharply higher commodity prices, particularly for oil, the value of mined exports rose by 42 percent, far above their average growth of 5 percent in the decade to that year. Agricultural products exports by contrast, grew in line with their low long run average, increasing by just two percent.

## 2.2 Recent Developments in Irish Merchandise Exports Volumes and Values

In a decade Ireland has become one of the most open economies in the world, with goods exports (excluding services) equivalent to 80.1 per cent of GDP in 2000 rising from 52.7 per cent in 1990. The rapid pace of deepening trade integration into the global economy accelerated in 2000. "Micro-states" apart, Ireland registered the highest per capita merchandise exports in the world and was ranked the 22nd largest exporter in absolute terms, despite ranking as the 38th largest economy in the world (calculated on the basis of market exchange rates). The country's disproportionate role in global trade is well illustrated by the fact that, according to WTO data, of every \$100 generated globally from export sales in 2000, \$1.30 accrued to Ireland.

In absolute terms, the value of merchandise exports rose from €66.9 billion to €83.7 billion, an increase of almost a quarter, compared with growth of 15 per cent in 1999. However, unlike recent years, there was a sharp jump in export prices, giving a rate of growth in the volume of exports of 18.4 per cent (closer to growth rates in 1998-99, but still very strong by international standards). The increase in export prices was mostly feed-through from higher prices for imported intermediate goods, particularly oil (see section 2.8 for a more detailed discussion). Rising domestic prices and labour costs are also likely to have contributed to higher export prices, though to a much lesser extent. As measured by the EU Harmonised Index of Consumer Prices, inflation rose from 2.5 per cent in 1999 to 5.3 per cent, while nominal wage growth increased from 7 per cent to 8.4 per cent over the same period.

Figure 1: Growth in Irish Merchandise Trade 1990 - 2000



Source: CSO, External Trade

The strong rate of growth in export volumes in 2000 is accounted for by a confluence of benign factors. First, export demand surged as the world economy grew rapidly (see section 2.1). Second, higher levels of manufacturing capacity, as new capacity came on stream, left Irish-based manufacturers well placed to supply growing global demand. Finally, a 4.5 per cent depreciation of the real effective exchange rate combined with high productivity gains in manufacturing industry more than offset the impact on Irish competitiveness from rising domestic costs. According to the Central Bank of Ireland, Irish export prices denominated in dollars rather than local currency units actually fell in 2000, reflecting the impact of the weakening euro.

In the first half of 2001, the value of Irish exports continued to surge, increasing to €46.3 billion from €38.8 billion in the same period in 2000 (growth of 19.3 per cent). However, these figures mask a slowdown in the rate of export earnings growth in the second quarter of 2001 to almost half that of the first quarter as demand weakened in Ireland's key markets. Moreover, volume increases were more modest still, with growth in the second quarter of 11.6 per cent, down from an average of almost 20 per cent in the previous three years. Further marked declines in the year on year growth rate of export earnings can be expected as the base effects of a rapid rise in export levels from the middle of 2000 work their way out of the trade data's 12-month horizon.

## The Impact of the Global Slowdown on the Irish Economy

After the longest period of uninterrupted expansion in its history, the U.S. economy entered recession in early 2001. This, along with near stagnant growth in Europe, has contributed to the sharp deceleration of economic growth in Ireland in 2001. Even if the U.S. recession proves to be relatively shallow and short-lived, its full effects, both direct and secondary, are unlikely yet to have fully played out in Ireland. A worst case scenario - a profound and protracted US recession in 2002 along with low or non-existent growth in Europe - would impact seriously on Ireland through a number of channels. These include:

### (1) The Impact on Exports

Merchandise exports to the USA in 2000 measured €14.2 billion. (17% of total merchandise exports). Irish exports to the USA comprise mostly ICT goods and pharmaceuticals, most of which are manufactured by U.S. companies here. The sharp slowdown in the USA has already resulted in a reversal of the rapid increases in recent years, with the latest trade data from the second half of the year showing year on year declines in the value of exports, particularly in the ICT sector which accounts for 16% of GDP. This will result in a drag on output growth. However, the direct impact on employment will be considerably less (the sector accounts for 5% of total employment). More positively, the pharmaceuticals industry is far less volatile than most and is not expected to suffer serious reversals. Services exports will also be affected, with U.S. tourism expected to suffer in the wake of the terrorist attacks of September 11th. The European economy has also been slowing since its peak in the first half of 2000.

### (2) The Impact on Investment in Ireland by U.S. Companies

Among the small EU economies, Ireland has been by far the greatest beneficiary of the large and rising levels of U.S. foreign direct investment (FDI) flows into the EU since the early 1990s. Falling U.S. equity prices and the tightening U.S. debt market will limit growth in new U.S. investments in Ireland. The need of U.S. companies to raise cash, reduce costs and lower indebtedness has already forced retrenchment by some existing operations here, particularly in the ICT sector. Further job losses, and possibly factory closures, can be expected in 2002

### (3) Second Order effects

Stagnant or declining export and investment growth is likely to have second order effects in the domestic economy.

**Confidence:** US manufacturers are among the flagship firms in the Irish economy. High profile job losses add to uncertainty at a time of cyclical slowdown following almost a decade of growth. Should private spending patterns change considerably the effect on employment in private services - the engine of employment growth in recent years - could be serious.

**Property:** Asset prices have risen very sharply in recent years. This now appears to have come to an end. Should there be a period of asset price deflation, the resulting negative wealth effect is likely to cause retrenchment in consumer spending. The end of the property boom has also resulted in construction output tapering off. A reduction in public investment in 2002 will exacerbate the effects on the construction industry, which accounts for a greater proportion of GNP than the European average.

### (4) The Impact on Investment in Ireland by Irish Companies

Irish-owned companies will also be somewhat affected by the US slump, through falling share prices, deteriorating investor and consumer confidence, lower exports and lower profits from their US subsidiaries. Partially offsetting this will be an easing of wage pressures as labour market tightness unwinds.

## (5) The Impact on the Euro/Dollar and Euro/Sterling Exchange Rates

Declining global import demand affects Ireland asymmetrically relative to other EMU participants given its uniquely high dependence on non-euro area export markets. The threat posed to the Irish economy by the international slowdown is magnified by the possible depreciation of the dollar vis-à-vis the euro. Usually, U.S. recession is accompanied by dollar weakness in international markets, as rates of return on dollar-denominated assets diminish. While the dollar has remained strong to date, it would be unlikely to remain immune to a sustained period of US economic stagnation.

Although sterling has often been influenced by dollar movements in the past, this link has weakened. Indeed, since the middle of 2000 the UK currency has remained broadly stable vis-à-vis the euro. However, the possibility of sterling depreciation cannot be dismissed, particularly given the strength of the UK economy vis-à-vis that of the euro area and increasing likelihood that the UK government will push for euro adoption (but only at a lower rate of exchange). In contrast to exports to the US, Irish exports to the UK market are dominated by labour intensive firms, many of which suffer competitiveness problems. As such, even relatively small fluctuations in the euro/sterling exchange rate have the potential to impact seriously on employment.

## 2.3 The Differing Profiles of Foreign and Indigenously Owned Enterprises

Any discussion of Ireland's trade relations is incomplete without an analysis of the large differences between indigenously-owned enterprises (IOEs) and foreign-owned enterprises (FOEs). Although above average, neither the number of FOEs in Ireland, nor the value of their assets, is unusual when compared to other countries of similar size and economic development. What marks Ireland out is the value of output and exports levels of Ireland-located FOEs, particularly in comparison with IOEs<sup>2</sup>. It is striking to note, that almost all of the increase in exports in recent years has been accounted for by FOEs.

### Industries

The sectors in which FOEs and IOEs operate are very different. FOEs are mostly large and capital intensive, with long production runs and considerable economies of scale. The most important industries are information and communications technologies, electrical/electronic goods (including PCs) and pharmaceuticals/healthcare goods. IOEs tend to be much smaller in size and more labour intensive (gross value added per employee in 2000 was four times greater in FOEs than IOEs and the gap continues to widen). IOEs operate in a more diverse range of industries, manufacturing medium or low technology goods, food and drink being the most important.

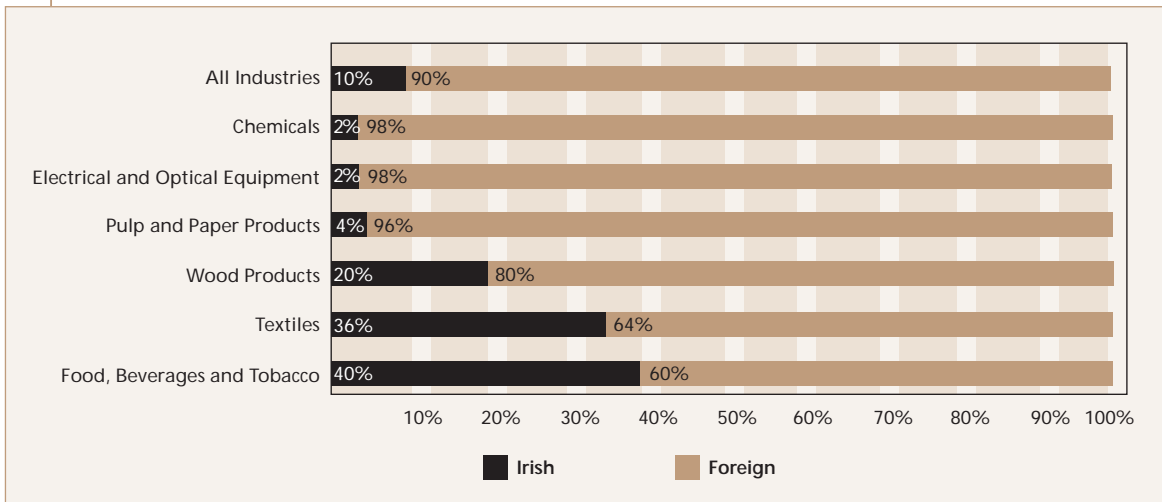
### Output

According to the CSO's 1999 Census of Industrial Production (CIP), the total value of Irish manufacturing output in 1999 came to €67.7 billion. Of this, €11.9 billion (18 per cent) was accounted for by IOEs, while the remaining €55.9 billion (82 per cent) was accounted for by FOEs. More recent data is available from the Forfás-Enterprise Ireland Annual Business Survey of Economic Impact (ABSEI), which measures the contribution to Irish economic development by client firms of the development agencies. According to the latest ABSEI, output (as measured by sales) of FOEs engaged in manufacturing amounted to €46.1 billion in 2000, nearly three times that of the IOE sector (€18.1 billion). By far the most significant sector in terms of total output is electrical and electronic

<sup>2</sup> The analysis here is based primarily on the Forfás-Enterprise Ireland 2001 Annual Business Survey of Economic Impact report. These data differ from CSO data cited in the previous section. They include only client companies of government agencies. Of these, the clients firms of IDA (foreign owned) and Enterprise Ireland (indigenously owned) are by far the most important by any measure. These are used as proxies for FOEs and IOEs where more comprehensive data are not available

goods. Reported output in this sector (in terms of sales) amounted to €24.2 billion in 2000, of which 95 per cent was accounted for by FOEs. Food drink and tobacco was the second most significant sector by output, with sales of €13.5 billion. Two-thirds of these were accounted for by IOEs. Chemicals was the third largest sector by output, with sales of €9.7 billion. This sector, along with the fourth and fifth largest sectors (software development and "other computer related") was dominated by FOEs, which accounted for over 90 per cent of the output of the three sectors combined.

Figure 2: Indigenous vs Foreign Owned Exports by Industry Sector 1999

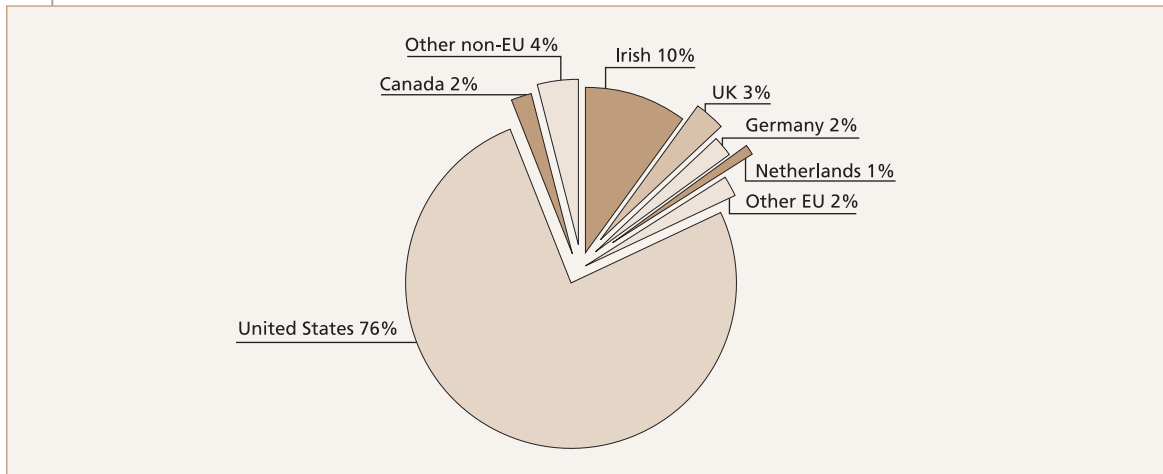


Source: CSO, Census of Industrial Production

### Exports Levels

According to the CSO's CIP, total manufactured Irish exports (not including primary goods) measured €57.8 billion in 1999, up from €46.6 billion in 1998 (an increase of 24 per cent). Exports by FOEs grew from €40.9 billion in 1998 (88 per cent of the total) to €52.2 billion (90 per cent of the total). U.S.-owned firms alone accounted for €43.7 billion in manufactured exports, or 70 per cent of the total. According to the CSO data, manufactured exports by IOEs actually declined over the same period, from €5.8 billion in 1998 (12 per cent of the total) to €5.6 billion in 1999 (10 per cent of the total). It needs to be recalled, of course, that total Irish merchandise exports in the same year, including commodities, farm goods and other primary materials not covered by the CIP, were valued at €66.9 billion. It is likely that the vast majority of the €9.1 billion difference between this total and total manufactured exports was accounted for by Irish-owned firms, bringing the proportion of total exports accounted for by Irish-owned agents up to a possible 22 per cent in that year. Even so, total merchandise exports by Irish-owned agents fell significantly in 1999, to €14.7 billion from almost €16.5 billion a year earlier. Combined with the fall in manufactured exports by Irish-owned firms, this probably reflects the sharp fall in Irish beef exports in that year as a result of continuing fall-out from the BSE crisis.

**Figure 3: Irish Industrial Exports by Country of Firm Ownership 1999 (Total + €57.8 Billion)**



Source: CSO, Census of Industrial Production

Foreign-dominance of Irish exports is most complete in the electrical and optical equipment (including PCs and telecoms equipment) and chemicals (including pharmaceuticals and healthcare) sectors, where 98 per cent of exports from both sectors is accounted for by FOEs. Not far behind was the pulp and paper products sector, where 96 per cent of exports came from the foreign-owned sector. Even in lower technology industries traditionally associated with strong indigenous enterprises, such as wood products, textiles and food, beverages and tobacco, the majority of exports came from foreign-owned firms. Indeed, Irish-owned firms accounted for a minority of total exports in every major industrial sector.<sup>3</sup>

### Contribution to National Economic Development

The relatively poor export performance of the indigenous industrial sector, and its declining contribution to total exports, is a common feature in most industrialised countries, and reflects the huge increase in foreign direct investment flows during the 1990s (see Section 4). With more and more Irish firms being taken over by larger FOEs, an increasing proportion of national exports is accounted for by the foreign-owned sector. It is also possible that indigenous firms have substituted domestic for export sales in order to exploit faster demand growth in the home market during this period. It is also possible that, for some indigenous industries, outward direct investment has replaced traditional exporting as the most efficient mechanism for accessing foreign markets.

From a national economic development perspective, clearly more important than nationality of firm ownership is the quality of the jobs sustained by the firms and the degree of embeddedness of the firms, whether indigenous or foreign-owned, in the local economy through supply chain links. The FOE and IOE sectors expenditure on goods and services in the economy was also broadly similar. The IOE sector's expenditure reached €9.1 billion in 2000, an increase of 6 per cent on 1999. FOE sector spending on goods and services in the Irish economy, growing at 23%, overtook that of the indigenous sector to reach €9.3 billion. While it is clear that the FOE sector is increasingly important in terms of spill-over benefits, this large increase in spending on locally sourced goods and services matched almost exactly the increase in output. As such, it is difficult to conclude there is a growing embeddedness of FOEs in the domestic economy. FOE spending on goods and services in the Irish economy amounted to 20 per cent of sales in 2000, compared with 50 per cent in the IOE sector.

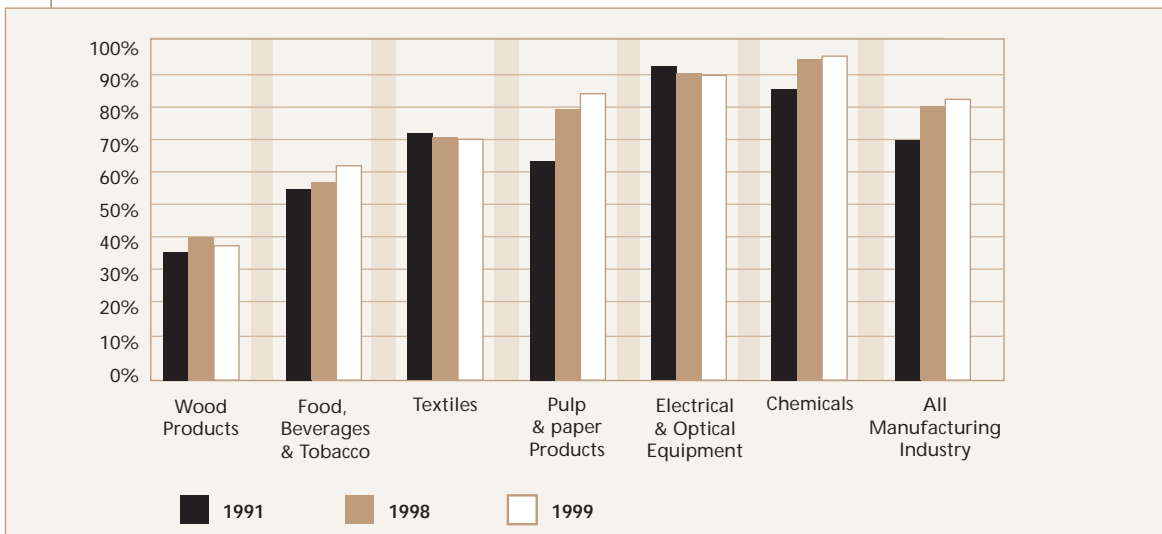
<sup>3</sup> It should be noted that in the food, drink and tobacco sector, exports by foreign owned firms are significantly inflated by exports of cola concentrates; without these, it is likely that Irish exports exceed foreign in this sector.

Given the large FOE "leakages" from the economy in the form of imported inputs and repatriated profits<sup>4</sup>, one can conclude that each €1 million of exports by Irish-owned firms contributes to substantially greater employment in the domestic economy than an equivalent value of exports by the foreign-owned sector.

### Export Markets

The UK remains by far the most important market for IOEs. However, at 44.1 per cent, down from 46.1 per cent just a year ago, dependence on this market is declining. This is explained by the growing export propensity of IOEs and the saturation level of the UK market. For FOEs the EU has traditionally been the most important market by some considerable distance. However, these patterns are changing too, with non-EU markets growing in importance to account for more than a quarter of all exports. North America accounts for most of this, which in turn is accounted for by high-output US-owned manufacturers exporting back to their domestic U.S. market.

**Figure 4: Export Propensities in Selected Manufacturing Industries 1991 - 1999**



Source: CSO, Census of Industrial Production

### Export Propensities

According to the CSO's CIP, 85 per cent of Irish manufacturing output in 1999 was destined for overseas markets. The export propensity (exports as a proportion of total output) was highest in the chemicals (98 per cent export propensity) and electrical and optical (92 per cent) sectors, and lowest in the wood and wood products sector (40 per cent). Export propensity is much higher among FOEs than IOEs. According to the CSO, FOEs exported 93 per cent of their total output in 1999. Clearly, the attraction of Ireland for foreign owned manufacturers is not the small domestic market, but rather the advantageous business environment from which to export. According to more recent data in the ABSEI, the percentage of their output exported rose by close to a full percentage point in 2000. In contrast, manufactured exports by IOEs made up 47 per cent of total sales, indicating that Irish-owned manufacturing firms continue to rely on the domestic market for the majority of their sales<sup>5</sup>. However, there were tentative signs in 2000 that IOEs may be becoming more export oriented. Despite the far higher rates of public and private expenditure growth in the Irish economy relative to any export market, the most recent ABSEI indicates that the share of total IOE sales being exported rose significantly over the previous year.

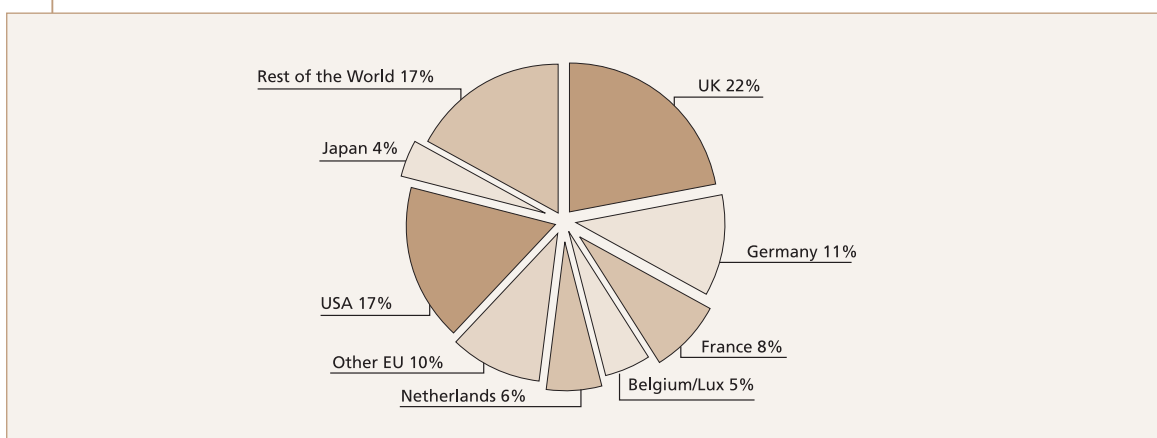
<sup>4</sup> In 2000, more than €25 billion was remitted abroad as income on direct investments in Ireland

<sup>5</sup> This may understate the degree to which IOEs are internationalising. Although the export propensity of IOEs is clearly far less than for FOEs, Irish Firms are increasingly supplying foreign markets from their foreign subsidiaries rather than by exports - the sales of Irish-owned foreign subsidiaries exceed total exports of Irish owned firms operating in Ireland (for further discussion of the internationalisation of the Irish firm see 4.3).

## 2.4 Geographic Orientation of Exports

Trends observed in recent years in the direction of exports continued in 2000. The value of exports to the USA in 2000 surged by 37.9 per cent over 1999, mainly as a result of U.S. manufacturing firms exporting back to the USA. The USA now accounts for 17 per cent of total Irish exports, an unparalleled level among the countries of the euro area. An indication of the absolute size of exports to the USA can be gleaned from Eurostat trade statistics. Of all EU exports to the USA in 1999, Ireland accounted for 5.5 per cent of the total EU, nearly five times the country's relative weighting in the EU in GDP terms. Although the USA has not yet become Ireland's single largest export market, this seems likely in the medium term on the basis of the trend of recent years. This trend continued into the first half of 2001 when the value of exports to the USA continued to record impressive growth rates, although second quarter data provides evidence of a slowdown in U.S.-oriented export activity. This could be severely exacerbated if the euro were to appreciate sharply vis-à-vis the dollar.

Figure 5: Irish Merchandise Exports by Destination 2000



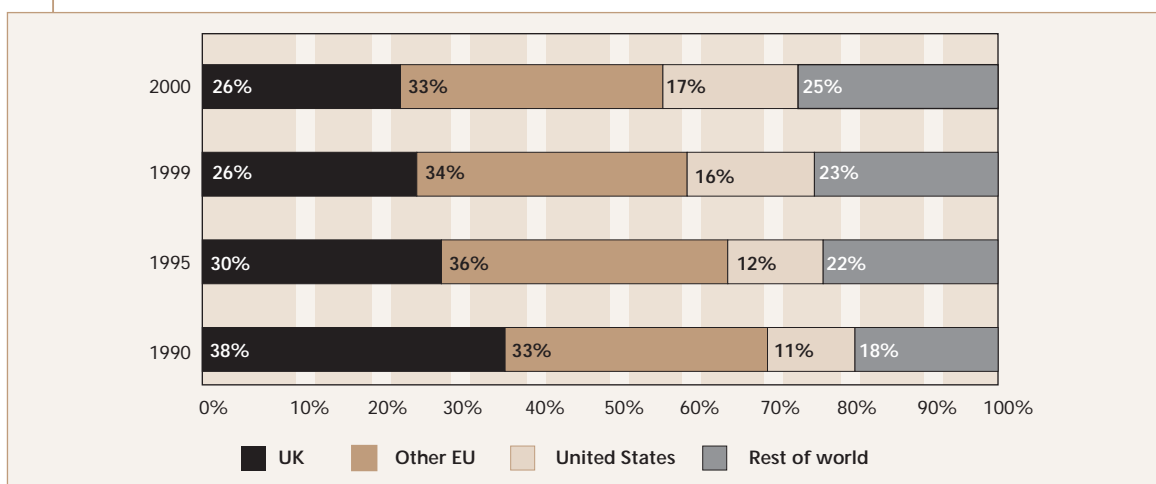
Source: CSO, External Trade

The UK remains Ireland's largest export market. Solid economic growth in the UK was a factor in exports rising to €18.7 billion, a year on year increase in value terms of 27 per cent. Important too was the competitiveness boost from the 7 per cent euro depreciation against sterling when compared to 1999. Although the UK's share of total exports has fallen to 22 per cent (down from over a third in 1990) it still accounts for a considerably greater proportion of exports than Germany and France combined. Ireland's exports in the first half of 2001 remained broadly in line with the trends of recent years. The UK remained Ireland's largest export market and generated export earnings of €9.9 billion in the first six months of 2001, a rise of 14.8 per cent on the same period of 2000.

The value of exports to other euro area countries grew by 15 per cent, considerably less than in other major markets. Despite the removal of exchange-rate risk (since the beginning of 1999) and strong growth in the euro-zone in 2000, the share of exports to the euro area has fallen from just under 50 per cent of the total in 1998, to around 44 per cent in 2000. The first six months saw an even sharper decline, to 37.5 per cent.

In the first half of 2001, exports to the USA totalled €8.1 billion. The value of exports to the euro area - Ireland's third largest export market - also continued to grow in the second quarter despite the economic slowdown, although expansion in value terms was more modest than the USA (but in line with the UK). The slower export growth to other eurozone countries can be partly accounted for by the absence of the competitiveness boost of a depreciating currency. Rapidly expanding export markets further afield in 2000 included Japan (up 60 per cent to €3.2 billion), South Korea (up 196 per cent to €1.1 billion) and Hong Kong (up 85 per cent to €617m).

**Figure 6: Irish Merchandise Trade by Region 1990 - 2000**



Source: CSO, External Trade

## 2.5 Structure of Goods Exports by Composition

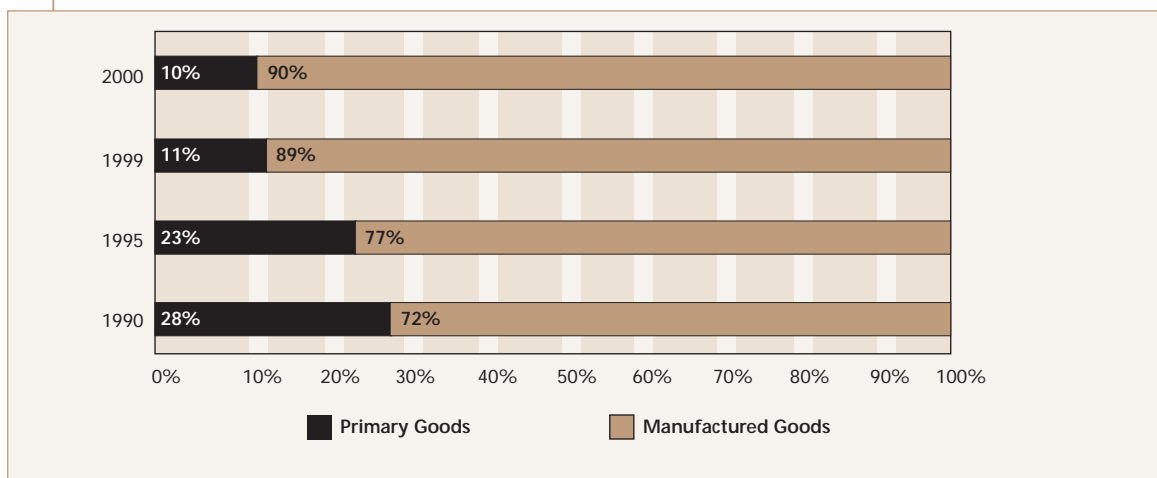
In 2000 and the first half of 2001, patterns in merchandise exports observed in recent years remained broadly unchanged. These included: the continued relative decline of primary goods<sup>6</sup> (from more than 25 per cent of total exports in 1990 to less than 10 per cent in 2001); high rates of export growth in high-technology sectors (and hence the further concentration of exports in these sectors); and low export growth in labour intensive sectors.

Data processing machines (including PCs), organic chemicals and electrical machinery were the three largest export sub categories in 1999. In 2000 they were the three fastest growing in value terms, increasing by 28 per cent, 47 per cent and 50 per cent respectively. The result was that these three sub-categories of exports increased their share of total exports by almost six percentage points to 53 per cent. This trend continued into the first six months of 2001, when these sub-categories accounted for the majority of still-strong growth in the value of exports when compared to the same period a year earlier (the remainder was the result of the fourth most important sub category—medical and pharmaceutical products). These rates of growth were largely accounted for by export volume increases as new manufacturing capacity in these industries came on stream, as well as a modest increase in export prices.

An indication of the magnitude of Irish exports in these sectors can be gleaned by international comparison. Despite the country's small size and traditional lack of a capital intensive industrial base, Ireland was the third largest exporter of data processing machinery in 2000, accounting for almost 20 per cent of the EU total and surpassed only by the UK and Germany. In organic chemicals, Ireland is the clear leader in the EU accounting for 27.5 per cent of total exports in 2000.

<sup>6</sup> Food and live animals; beverages and tobacco; crude materials, mineral fuels; lubricants and related materials; and animal and vegetable oils, fats and waxes.

Figure 7: Structure of Irish Merchandise Exports 1990 - 2000



Source: CSO, External Trade

By contrast, growth was much slower in more traditional sectors of the economy. Exports of food and live animal exports rose by 7.8 per cent in value in 2000, while low-tech manufactured goods (including textiles, metals and paper) increased by 8 per cent. However, the volume increases in these sectors was likely to have been very low given the average increase in export prices of 5 per cent in 2000. The poor relative performance of this sector is brought more sharply into focus when a considerable competitiveness boost from the depreciation of the euro vis-à-vis sterling is taken into account (most export-output from these sectors goes to the UK). In the first six months of 2001, food exports experienced negative growth in value terms when compared to the same period a year earlier, largely the result of the outbreak of Foot and Mouth Disease (FMD). The low-tech manufacturing sector fared well, particularly considering the slowdown in growth in the UK. Volume growth over the first six months was likely to be only slightly below the rate of 2000.

## 2.6 Market Share Analysis

Changing import market share gives a good overall indication of competitiveness trends. By analysing the share of the global import market of any given country over time it can be ascertained whether a country's exported goods are gaining/losing relative to other countries. A country's exports will have to rise at the same rate as global import demand if its market share is to be maintained.

In recent years Ireland's rate of export growth not only matched the marked expansion of global trade (see section 2.1), but exceeded it by a considerable margin. As a result the country's share of global imports has risen sharply, from 0.9 per cent in 1994 to 1.5 per cent in 1999 according to the OECD. The value of Ireland's exports rose from \$28.9 billion in 1994 to \$65.3 billion in 1999. Had Irish competitiveness remained stable vis-à-vis the rest of the world, exports from Ireland could have expected to benefit from increasing global demand by \$10.6 billion. However, as Ireland's competitive position improved, market penetration increased as a result. This accounted for a \$25.8 billion increase in exports, most of which was the result of very strong growth in the chemical/pharmaceuticals sectors.

### Recent Developments in Irish Merchandise Imports Volumes and Values

Ireland's import bill reached a total of €55.7 billion in 2000, up sharply from €44.3 billion a year previously (an increase of more than 25 per cent). Even when the sharp increase in import prices is stripped out, volume growth of 15.5 per cent was almost twice the rate of 1999 owing to strengthening demand for all categories of goods - capital, consumer and intermediate. As a result, imports of merchandise goods as a percentage of nominal GDP rose from 50 per cent in 1999 to 54 per cent in 2000. According to WTO data, this made Ireland the 25th largest goods importer in the world, ahead of countries as populous as India and the Russian Federation. In per capita terms, only Hong Kong imported goods of a value greater than Ireland in 2000.

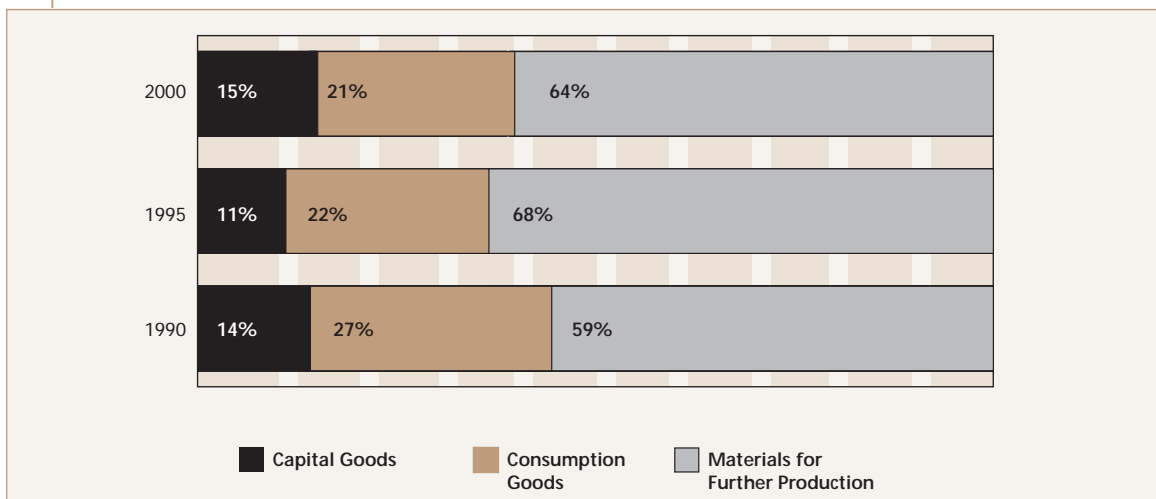
Import prices surged by 8.5 per cent in 2000, up from 3 per cent growth in 1999 and near stability in the previous three years. Two factors accounted for this. First, the depreciation of the euro against the dollar accelerated in 2000. After losing 5 per cent of its value in 1999, the average exchange rate in 2000 fell to US\$0.92:€1 from US\$1.07:€1 in 1999 - a depreciation of more than 13 per cent. The euro also depreciated against sterling. Although the decline was less sharp, at 7.5 per cent over 1999, it was significant given that the UK remains Ireland's largest source of imports. Second, from a 25-year low in 1998, oil prices rose sharply in 1999, before accelerating further in 2000. From an average of €16.69 per barrel, oil prices almost doubled to an average of €30.96 in 2000, the highest since 1985.

The large increase in the import bill in 2000 was more than offset by the increase in export earnings (see section 2.2), giving a trade surplus of €27.9 billion, up by 23 per cent over the 1999 figure. The size of this surplus, equivalent to more than one quarter of GDP, is far higher than any other OECD country (only Norway, the second largest oil exporter in the world, comes close to matching Ireland's surplus).

In the first six months of 2001 the rate of import price inflation fell back considerably, to 2.5 per cent, as oil prices fell from the peaks of the second half of 2000 and the euro stabilised vis-à-vis the dollar at rates similar to those in the second half of 2000. In the first months of 2001 the volume of imports continued to grow, albeit at a rate less rapid than in 2000. However, by the May-June period, there was a quite dramatic turnaround as import volume growth turned negative. As a result of these price and volume developments the import bill fell in absolute terms compared to the equivalent period in 2000.

## 2.8 Irish Merchandise Imports – Composition/Uses

Figure 8: Irish Merchandise Imports by Main Use 1990 - 2000



Source: CSO, External Trade

The broadest breakdown of imports by category is by capital, consumer and intermediate goods. Ireland is unusual in the high ratio of intermediate goods to total imports. This is accounted for by a two of factors. First, given limited natural resources, most raw materials and fuels are imported. Second, the small size of the economy means that manufacturing is only competitive if done on a large, export-orientated scale. As a result, Ireland has become specialised in a narrow range of manufactured goods, few of which are suitable as inputs for other industries in the economy. The high technology FOE sector is unusually import-intensive not only because the scope to source from domestic suppliers is limited, but also because the increasingly global production patterns of these firms mean that inputs are sourced exclusively from subsidiaries located elsewhere (and then frequently exported as inputs to another subsidiary further along the production process).

In 2000 the value of intermediate goods imports increased more rapidly than other categories resulting in the weighting of intermediate goods as a share of total imports rising by two percentage points to over 61 per cent of the total. The large jump in the import bill was mostly related to the higher price of oil. A huge year on year rise of 84.6 per cent in the value of petroleum product imports reflects the sharp spike in oil prices last year, exacerbated by euro depreciation. The rapid growth in intermediate goods imports is also likely to have been the result of significant re-stocking following a run down in inventories in 1999. This restocking was necessary to maintain output as export demand surged (as previously noted, exports are highly import intensive).

The value of capital and consumer goods imports increased less sharply as price rises for these goods were more subdued than for intermediate goods. However, the difference in volume terms is likely to have been narrower. The growth in the value of capital goods imports remained strong, in line with recent years. Much of the increases relate to additional capacity being added to the manufacturing plants of capital intensive FOEs. Consumer goods rose strongly (a large part of which was likely to have been volume driven) in line with near double digit real increases in private spending in the economy as employment surged and nominal wage increases accelerated.

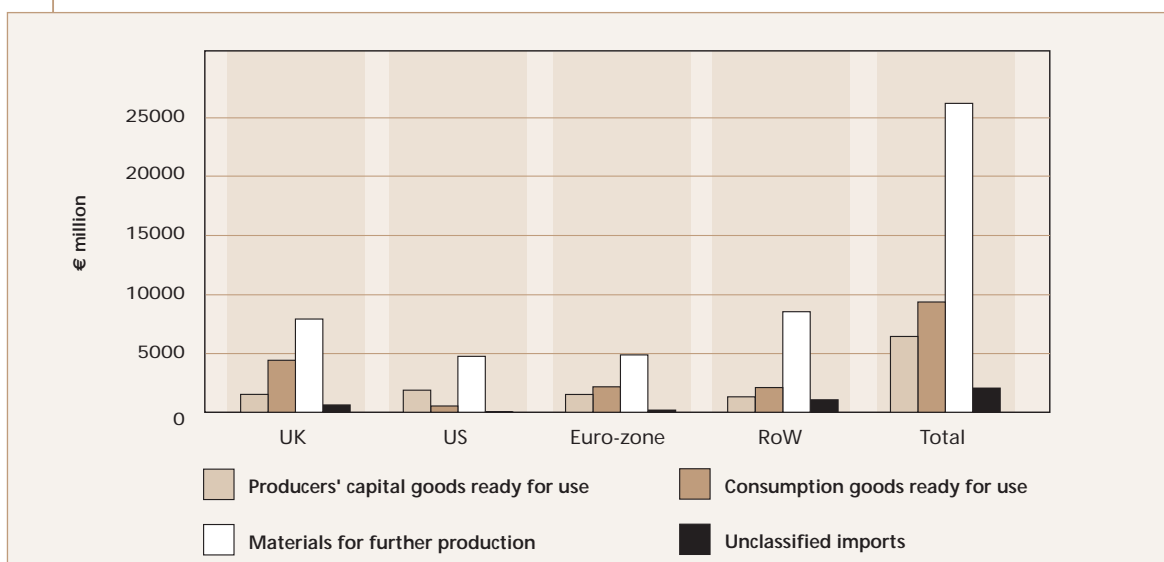
In the first six months of 2001 the value of imports in each category continued to grow, with intermediate goods registering the sharpest increases. However, as mentioned above, the May-June period saw a turnaround. This was mostly accounted for by a collapse in capital goods imports, likely the result of sharply lower business confidence as the then incipient global downturn took hold. The other categories registered less marked changes, although year on year, consumer goods imports declined in value in May before recovering in June. Intermediate goods registered their first year on year decline in June.

## 2.9 Import Orientation by Geography

The UK is by some distance Ireland's largest source of imports. Although the dependence on UK imports has declined gradually over time (from over 40 per cent of the total in 1990 to 31 per cent in 2000), it accounted for considerably more imports than all the other EU countries combined in 2000. The value of imports from the UK rose by 17.8 per cent in 2000, a considerable proportion of which is likely to have been the result of higher prices owing to a weaker euro along with higher oil prices (much of Ireland's oil needs are supplied by the UK). The value of imports from the USA (Ireland's second largest source of imports) grew by 23.9 per cent in 2000, though volume growth is likely to have been similar to the UK owing to the depreciation of the euro vis-à-vis the dollar (considerably sharper than that against sterling). Rising intra-firm trade, among U.S.-owned high tech exporters, has also been a driver of import growth from (and export growth to) the USA.

The value of imports from euro area countries rose by 29.1 per cent in 2000. While this was considerably stronger than imports from the USA or UK, the disparity in the rate of volume increase was likely to have been greater still given that there were no exchange rate effects. Imports grew particularly strongly from France (up 42.4 per cent) and the Netherlands (up 31.2 per cent). The result is that the percentage of imports sourced from the euro area has increased since the currency was launched, from 19 per cent in 1998 to 23 per cent in 2000. While the elimination of exchange rate risk may have accounted for a proportion of this, conclusions cannot yet be drawn. (see section 2.10 for further discussion).

Figure 9: Imports to Ireland by Area of Origin and Main Use



Source: CSO, External Trade

Outside Europe and North America, the Australasia region was the most important supplier of imports, accounting for almost 20 per cent of the total in 2000. Ireland's three main sources of imports in that region are Japan, Singapore and South Korea. The value of import growth from the latter two countries was strong in 2000, rising by 60 per cent and 20 per cent respectively.

UK imports totalled €9.3 billion in the first six months of 2001 (a rise of 12.3 per cent on the same period in 2000), while imports from the US totalled €4.9 billion, up by 18.0 per cent. However, these aggregate half-year figures mask a significant downward trend in US import growth as second quarter year on year growth showed a very sharp deceleration on the rate recorded in the first. In the first half of the year import value growth from euro area countries was remarkably subdued, rising by just 5.9 per cent, compared to 29.1 per cent in 2000.

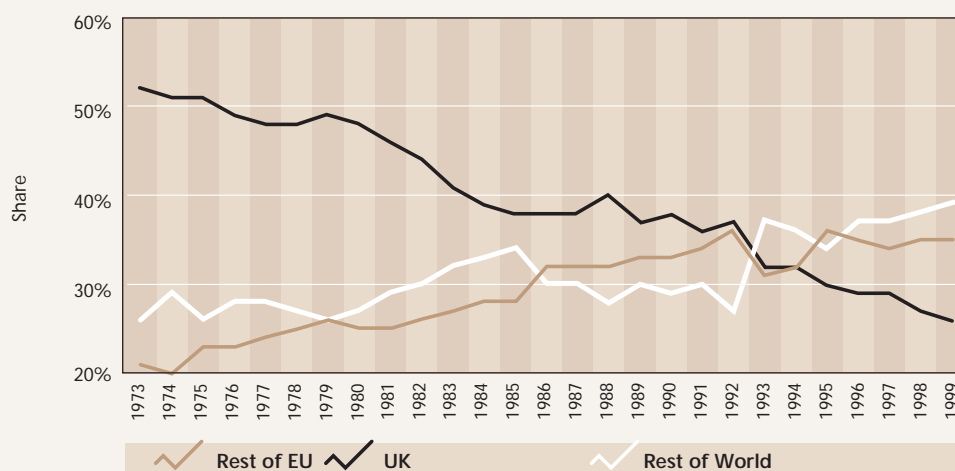
## 2.10 Merchandise trade and EMU

Ireland is unique among the 12 euro-zone countries in that its trade relations with the rest of the bloc account for only one third of combined imports and exports. This means that the Irish economy is exposed to any appreciation of the euro to a considerably greater degree than other participants in the single currency project. This vulnerability is magnified still more by the much greater openness of the Irish economy compared with any other EMU participant bar Luxembourg.

While exports to the euro area have grown in absolute terms, as a percentage of total Irish exports they have shrunk since 1998 - declining from 50 per cent to 37.5 per cent in the first half of 2002. Four factors are likely to have accounted for this. First, and most important, Irish exports have benefited from the 13 per cent and 25 per cent depreciation of the euro vis-à-vis sterling and the dollar since the beginning of 1999. Sharing a currency with other EMU participants meant no such competitiveness boost vis-à-vis these markets. Second, Irish exports are import intensive. Given that more than three quarters of goods are sourced from outside the euro zone, costs have risen relatively more than other euro area countries. Currency depreciation more than offset this effect in non-euro area markets. Third, euro-zone economic growth lagged that of the USA in both 1999 and 2000. Moreover, the growth disparity in rates of investment was considerably greater (much investment spending is now accounted for by ICT equipment, Ireland's leading export). This has meant that demand for Irish exports grew more rapidly in the USA than the euro area<sup>7</sup>. Finally, greater intra-firm trade among US-owned high tech exporters has also been a driver of export growth to (and import growth from) the USA.

*7 While these growth developments would normally be cyclical, there may be a structural element. Most economists now believe that, compared to European economies the USA is on a higher longterm growth trajectory (though there is considerable debate as to the extent of this).*

Figure 10: Irish Merchandise Imports by Origin, 1973-1999



Source: CSO, Trade Statistics.

Note: Caution should be exercised in making comparisons before and after 1992, as the Intrastat system of measuring trade statistics was introduced in 1993.

Imports sourced from within the euro area have increased since the currency was launched. However, the relatively small shift (from 19 per cent in 1998 to 23 per cent in 2000) combined with higher import prices from non-euro area sources (owing to the weak euro) suggest that little, if any, structural change has occurred. This is in line with developments over previous decades. Despite membership of the then European Economic Community in 1973, membership of the Exchange Rate Mechanism from 1979 and the creation of the Single European Market in the late 1980s/early 1990s, imports from EU member states other than the UK have remained remarkably stable at around 21 per cent of total imports. A recent study commissioned by Forfás into barriers to euro area importing faced by Irish firms found that the elimination of exchange rate risk is of limited importance to importers<sup>8</sup>. Also, most respondents believed that there was only moderate scope for further euro zone sourcing of imports.

That said, a number of barriers were identified. Respondents cited product price, product quality and transport costs as the most significant issues. Also considered of relevance were: distance from source markets; unfavourable credit/trading terms; and psychological/informational obstacles, particularly for small and medium sized firms. The issuance of euro notes and coins from the beginning of 2002 is likely to raise awareness of the potential opportunities for euro area sourcing, though the absence of a single payments system in the area will do much to offset this benefit. This is likely to be particularly true for SMEs (the 40 per cent of companies that have not considered such sourcing are likely to be overwhelmingly small and medium-sized). Greater price transparency is another factor that is likely to make euro area sourcing more attractive.

<sup>8</sup> Barriers to Euro-zone Importing in Ireland (September 2001). Commissioned by Forfás and the Chambers of Commerce and conducted by Fitzpatrick Associates Economic Consultants.

## 2.11 Terms of Trade Analysis

A country's terms of trade measures the change in the price of its exports relative to the change in its import prices. For most countries the terms of trade is quite volatile, with a standard deviation in developed countries of around 9 per cent. Owing to the narrowness of Ireland's export base and its almost complete dependence on imported commodities (for which price fluctuations are greater than manufactured goods), the country's terms of trade standard deviation is greater than average.

Ireland's terms of trade deteriorated sharply in 2000, an acceleration of the deterioration experienced in recent years. The trade weighted depreciation of the euro had been the main factor accounting for this, but in 2000, the large increase in the price of oil (Ireland imports all of its requirements) was also of relevance.

This deterioration was a significant factor in the emergence of the first current account deficit in almost a decade, usually a cause for concern, particularly in an open economy such as Ireland's. One reason policy makers are interested in the terms of trade is because sharp changes can cause difficulties in financing the purchase of imports and servicing non-local currency denominated debt. In extremis, the result can be a loss of confidence and sharp depreciation of the currency. It is clear that since the adoption of the euro in 1999, such preoccupations no longer concern Irish policy makers. Now, regardless of how large Ireland's current account deficit were to become, it would not trigger a devaluation of the euro owing to the very small size of the Irish economy relative to the euro area. With all exchange rate risk eliminated, the financing of a current account deficit is as problematic for Ireland as it always has been for, say, Scotland in the sterling currency area or Bavaria in the former deutschmark area.

# 3 Trade in Services

## 3.1 Global Developments in Commercial Services Trade

Global trade in commercial services, although increasing in value terms by 6 per cent in 2000 to \$1.4 billion, continued to lag the rates of growth recorded in merchandise trade of 12 per cent<sup>9</sup>. This pattern, noted in recent years, is a reversal of the position prevailing throughout most of the 1990s when services grew rapidly and accounted for an increasing percentage of international trade, peaking at almost 20 per cent of the total (goods and services). While the absence of price data makes it impossible to measure the growth in service trade volumes (as opposed to values), it seems likely that divergence between volume and value growth in services is likely to be less than in goods. This reflects that fact that oil and commodities, the prices of which rose significantly in 2000, account for a far larger proportion of final value of goods than services. As such, price rises for manufactured goods are likely to have exceeded those of services.

**Table 2** *World Trade in Commercial Services by Selected Regions*

	Exports				Imports			
	Value (\$ bn)	Annual % Change	Annual % Change	Annual % Change	Value (\$ bn)	Annual % Change	Annual % Change	Annual % Change
	2000	1990-2000	1999	2000	2000	1990-2000	1999	2000
World	1,435	6	2	6	1,435	6	2	6
North America	312	8	5	10	241	7	4	13
Western Europe	646	5	0	0	615	5	1	1
EU	577	5	1	0	571	5	1	1
Asia	303	9	4	12	365	7	6	8
Latin America	61	7	0	12	72	8	-5	13

Source: WTO, International Trade Statistics

Unusually, there was little difference in the rate at which the value of services exports in the three main sub-sectors - transportation, travel and "others" - grew in 2000. However, at between 5-6 per cent in value terms over 1999, the increase was considerably stronger than in the past three years. The strongest growth was recorded in transportation services. These were boosted by higher volumes of merchandise trade and higher costs owing to the sharp rise in oil prices. Other commercial services (including financial services, communications, information services, royalties and license fees), which accounted for 44.6 per cent of all traded services in value terms in 2000, grew more slowly at under 6 per cent, below the 1990s average. The slowdown in the information and communications technology (ICT) sector throughout the year is likely to have been the main cause. The slowest growing services sub-sector in 2000 was travel services at 5 per cent, despite the strong increases in private spending in the developed countries, which account for most tourism and business travel. The rate of growth in travel services in 2000 reflected the poorer performance of the sector throughout the 1990s in relative terms. In 2000, its share of total services fell below one third of the total for the first time.

<sup>9</sup> It should also be noted that owing to the inherent difficulties in services (as compared to merchandise goods), this data must be considered with some caution.

One of the main reasons for the relatively low growth in the value of services trade in 2000 was the near stagnation of value growth in western Europe in dollar terms. By far the most important region in the world for services trade, it accounts for 45 per cent of the global total. However, the rate of services trade increase was understated as the euro depreciated considerably in 2000. When measured in dollars (the currency in which the WTO denominates its data), the value of services trade increased by less than 1 per cent, while a rate of growth of 14 per cent was registered when measured in euro - more in line with the strong economic growth in that region in 2000. The other main service trading regions saw strong growth in the value of non-merchandise trade. North America, Asia and Latin America all experienced double-digit growth in the value of service exports, while transition economies registered a rate of 8 per cent. This latter group of countries saw the strongest growth in the value of services imports, at 15 per cent. All other regions bar Western Europe also saw strong growth in services imports.

### 3.2 Irish Services Exports – Values, Directions and Structures

**Table 3: Services Exports by Destination (€ millions)**

Year	1998	1999	2000
Total	11,249	13,811	16,429
EMU	3,282	4,595	5,380
Non-EMU	7,966	9,216	10,938
EU	7,218	9,180	11,062
Non-EU	4,030	4,631	5,368

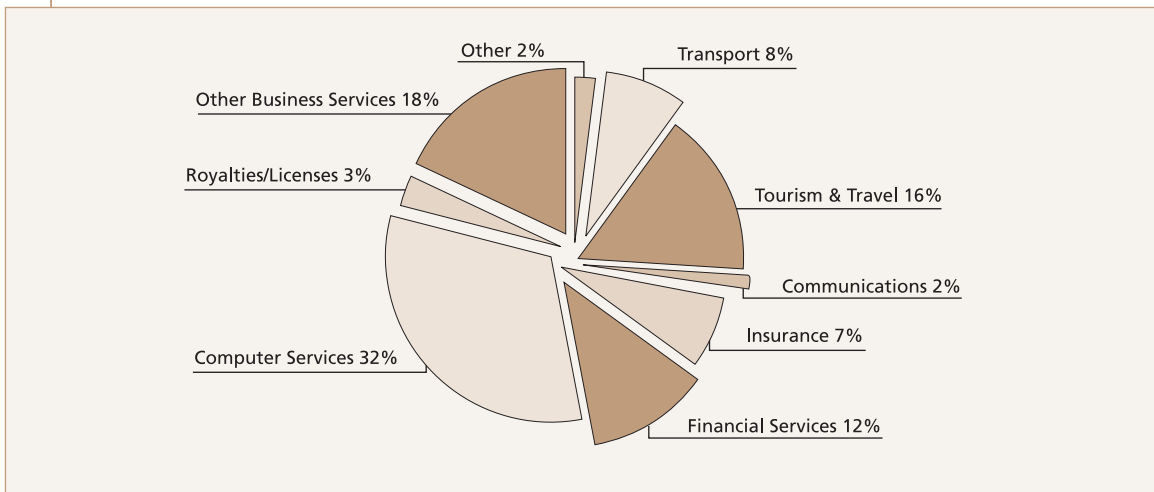
Source: CSO, Balance of International Payments

The value of Irish services exports also grew strongly in 2000, increasing from €14.6 billion in 1999 to €18.3 billion<sup>10</sup>. According to the WTO, Ireland was the 23rd biggest services exporter globally in absolute terms and third only to Hong Kong and Singapore in terms of per capita exports. Services exports accounted for 18.7 per cent of total exports (goods and services) in 2000. In 2000, the three biggest earning categories (computer services, tourism and travel and financial services) accounted for 60.6 per cent of the total, broadly in line with the 1998-99 period. This pattern remained almost unchanged in the first six months of 2001 when export performance remained strong. The value of services sold abroad rose to €9.8 billion, from €8.4 billion in the same period in 2000. Although this was still very strong, it was a deceleration in the rate compared with 2000 as a whole, reflecting more subdued international demand conditions.

Computer services strengthened its position as the single biggest services exports subsectors. The value of these services exports rose from €5.3 billion in 1999 to €6.0 billion, accounting for almost a third of total services exports. The value of receipts from this category is more than twice that earned from tourism and travel, the second biggest earner. Most computer services are accounted for by software delivered electronically to customers, rather than embedded in hardware or sold as CD-ROMs (as such, much of this growth is the reclassification from merchandise exports as electronic delivery becomes increasingly important). The importance of this sector is well illustrated by Ireland's elevation in 2000 to the position of the world's largest software exporter. In the first six months of 2001, the value of computer services continued to rise, albeit at a slower rate than in recent years.

<sup>10</sup> Although more detailed breakdowns of services trade are now available, the data are less reliable than those for merchandise trade. Difficulties include relatively short period for which the data are available (since 1998 only) and the very limited information of origin of imports and destinations of exports broken down geographically. These particular difficulties with the Irish data are compounded by the inherent problems associated with measuring services output (as compared to tangible goods). Differences in measurement methodologies in different countries also make meaningful comparative analysis difficult.

Figure 11: Irish Service Exports by Category, 2000



Source: CSO, Balance of Payments

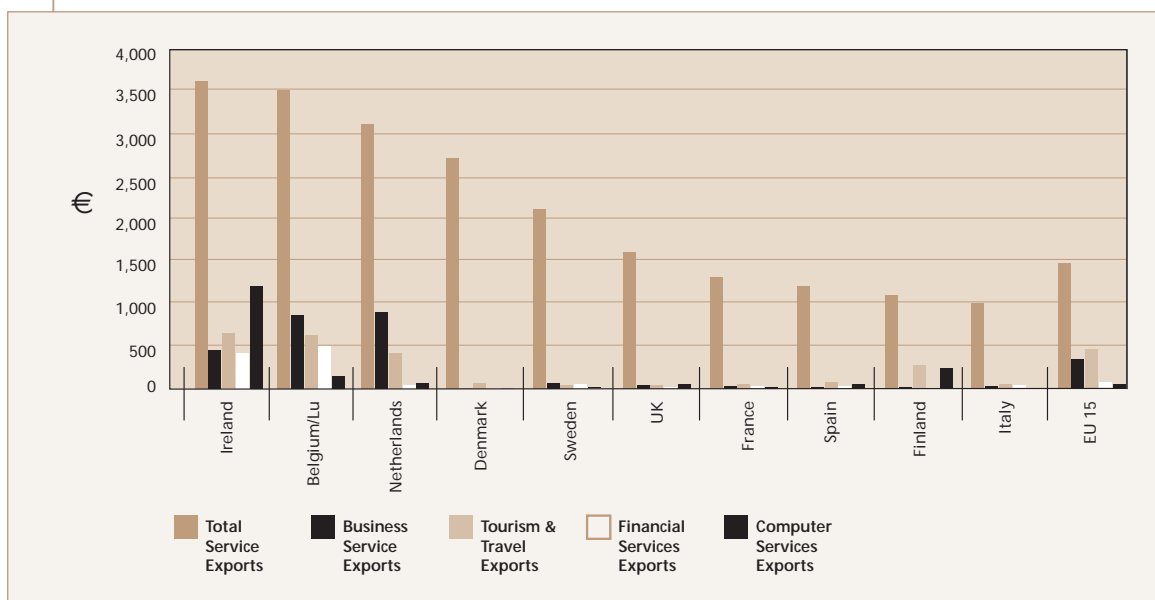
Though not enjoying the rates of growth of the most dynamic sectors, travel and tourism remains the second most important export category in terms of revenue receipts (the labour intensive nature of these services, however, mean that in employment terms, they are the most significant category). The value of tourism exports grew strongly as the industry benefited from higher travel expenditure in its main markets - Europe and the USA - and the boost of a weakening currency. In the first half of 2001, export revenues were marginally higher than in the same period in 2000, although the second quarter saw a small year-on-year decline, most likely the combined result of the foot and mouth crisis and the international slowdown. For the year as a whole, it is very likely that receipts from tourism and travel will fall below 2000 levels as a result of the onset of recession in many important markets and the likely collapse of the important U.S. market following the attacks of September 11.

The value of financial services exports (the third biggest earner) increased very strongly in 2000, rising to €2.3 billion in 2000 from €1.5 billion in 1999 - an increase of 44.5 per cent. This rate of growth was maintained in the first half of 2001, despite international conditions, with exports valued at €1.5 billion, compared to €979 million in the same period in 2000. Dublin's off-shore International Financial Services Centre (IFSC) merits particular mention<sup>11</sup>. Involved in the provision of a range of services, including leasing, insurance and fund management, the IFSC accounted for 26 per cent of total services exports in the first six months of 2001, compared with 20 per cent in 2000.

Of the eight other services sub-sectors, all but one (operational leasing) registered increases in 2000. Of particular note was the 12 fold increase in the value of trade related service exports, from a barely significant €105 million in 1999, to almost €1.3 billion in 2000. These services reflect the fees paid to foreign-owned companies with regional headquarters in Ireland from their affiliates abroad.

<sup>11</sup> Founded in 1987, Dublin's International Financial Services Centre has become one of Europe's most successful off-shore financial centres. With over 500 Irish and Foreign companies engaged in a range of financial services including banking, treasury management, custodial services, insurance, leasing and back-office support, the centre now employs almost 8,500 people and manages funds worth over \$150 billion.

Figure 12: Per capita service exports by selected EU Countries and Services Categories, 1999



Source: Eurostat, EU Trade in Services

On a per capita basis, Ireland is now the biggest exporter of services in the EU. In 1999, there were €3,688 in Irish service exports for every man, woman and child in the country. This compared with €3,555 in per capita service exports for Belgium, €1,640 for the UK and just €952 for Germany. As discussed above, much of Ireland's total is accounted for by computer service exports, which measured €1,278 per capita in 1999, putting Ireland a considerable distance ahead of any other EU country on this measure (Finland was next with just €242 in computer service exports per capita). Indeed, the extent to which large multinational software companies have chosen Ireland as a base for software distribution is evidenced by the fact that Ireland accounted for 26 per cent of total EU computer service exports in 1999. While Ireland also performed strongly in per capita exports of tourism and travel services and financial services (mostly IFSC related) relative to other EU countries, we performed less well in exports of business related services, perhaps indicating the limited development of certain professional service sectors in Ireland, such as consulting, advertising and media-related activities.

The data on the direction of services exports are limited to a breakdown according to EMU and non-EMU, EU and non-EU. Of most significance is that trade in services to other euro area economies appears to be growing more rapidly as a percentage of the total (this is contrast to merchandise goods). In 2000, services exports to the euro area accounted for one third of the total, up from 30 per cent in 1998. This trend continued in the first half of 2001, when the euro area accounted for 40.6 per cent of total services exports. In contrast to trade in goods, the elimination of exchange rate risk appears to have hastened Ireland's integration into the euro area economy in traded services.

### 3.3 Irish Services Imports – Values, Composition and Sources

The value of imports of commercial services continued to grow rapidly in 2000, rising to €31.4 billion, from €25 billion in 1999. Services accounted for 38 per cent of total imports (goods and services combined) in 2000. According to the WTO, Ireland was the world's 14<sup>th</sup> largest importer of commercial services in 2000, despite the small size of the economy. The level of service imports - equivalent to 30.3 per cent of GDP in 2000 - is well illustrated by international comparison. Finland, an economy of roughly similar size and income levels, imported services valued at a little over a quarter (28.6 per cent) of those of Ireland in 2000. More striking still is that on a per capita basis and excluding from consideration micro-states, Ireland is the largest importer of services in the world.

Despite the sharp slowdown in the international economy, the value of imports grew even more strongly in the first half of 2001, rising to €17.5 billion from €13.3 billion in the same period in 2000. However, there were signs in the three-month period to June that the global downturn was beginning to be felt. A quarter on quarter decline in imports was registered, accounted for mostly by lower receipts for business services.

Imports of services are more concentrated than exports. The three largest sub-sectors in terms of payments (Royalties/licenses, miscellaneous business services and trade related services) accounted for almost 70 per cent of the total. Although data are available only since 1998, it appears that these three sub-sectors are growing in relative importance. Payments for royalties and licenses, at €8.6 billion in 2000, was the single largest services import bill, accounting for over a quarter of the total. These "imports" are usually fees paid by manufacturing FEOs in Ireland to their parent companies for the intellectual property content of goods they manufacture. The second largest import, miscellaneous business services, accounting for just under a quarter of the total, is also largely related to the support subsidiaries receive from their parent companies in terms of accounting, marketing, legal and general management functions carried out at headquarters or subsidiaries located in other countries. Although both of these import categories have grown strongly in recent years, they have remained largely static as a percentage of the total since records were first compiled in 1998.

**Table 4: Irish Trade in Services, 2000 (€ millions)**

	Service Exports	Service Imports	Balance of Trade
<b>Total</b>	<b>18,332</b>	<b>31,396</b>	<b>-13,063</b>
Transport	1,475	2,799	-1,323
Tourism & Travel	2,885	2,858	27
Communications	358	375	-17
Insurance	1,221	1,581	-359
Financial Services	2,259	1,572	687
Computer Services	5,964	301	5,663
Royalties / Licences	552	8,599	-8,046
Business Services	3,272	13,242	-9,970
- Merchandising	1,255	5,471	-4,217
- Leasing	587	102	485
- Misc. Bus. Services	1,431	7,669	-6,238
Other Services	345	70	276

Source: CSO, Balance of International Payments

Trade related service imports have seen stronger than average growth, rising from €2.9 billion in 1998 to €5.5 billion in 2000 (from 13.9 per cent to 17.4 per cent of the total). Despite the international downturn, growth in the value of imports of these services accelerated strongly in the first half of 2001 to reach €2.9 billion, almost half as high again as in the same period in 2000. The eight other import sub sectors without exception saw growth in 2000. This continued in the first half of 2001, although, as previously noted, there was some slackening in the second quarter.

As noted in the discussion on exports, the only data available as regards services trade by geographic market is broken down according to EMU and non-EMU, EU and non-EU. In common with developments in export sourcing, it appears that imports of services are increasingly being purchased from the euro-area. In 1998, the euro area accounted for 29.6 per cent of imports. By 2000, this share had risen to 33.5 per cent, ten percentage points above goods imports coming from the same source.

### 3.4 Services Trade Balance

Taking service exports and imports together, Ireland runs a deficit on its services account. This growing imbalance is now larger than any other developed country as a percentage of GDP. This pattern has been in evidence for well over a decade, and continued in 2000 and the first half of 2001. From a deficit in 1990 of €651m, the imbalance between exports and imports of services rose to €13.1 billion in 2000, equivalent to 12.6 per cent of GDP. In the first half of 2001, the value of services imports was more than double that of exports and the deficit stood at €7.8 billion, up from €5.6 billion in the same period in 2000.

Despite being the third largest per capita exporter of services in the world, the services deficit is unusually large for an economy of Ireland's level of development. This has its origins in policy orientation, in place since the late 1950s, that has incentivised export-orientated manufacturing. FOEs have taken advantage of these incentives to a far greater extent than indigenously owned industry. The result has been that as FOE exports have boomed so too have payments of royalties, license fees and inter-affiliate charges (categorised as services imports), to their parent companies. As such, much of the services imbalance is merely the flip-side of exports by these firms and not a sign of chronic lack of competitiveness or over-consumption as a cursory analysis might suggest. More negatively, however, the long-standing preferential tax treatment for manufacturing enterprises (now ended) is likely to have encouraged the crowding out of the services sector to some extent at least.

### 3.5 Services Exports - Foreign vs. Indigenously Owned Enterprises

As in the case of merchandise exports, there is a profound cleavage between the profiles of indigenously-owned enterprises (IOEs) and foreign-owned enterprises (FOEs) in the internationally traded services sector<sup>12</sup>. As in the case of merchandise trade, Ireland's FOEs played a central role in services exports earnings. Indeed, they accounted for an even greater proportion of total exports in their sector than did their counterparts in manufacturing.

*12 The data used here is based on the Annual Business Survey of Economic Impact. As they include only client companies of the state agencies the export levels are slightly below those of CSO. However, as the CSO does not give detailed breakdown, the ABSEI figures from client companies are used as a proxy for all FOEs and IOEs.*

## **Output**

According to the ABSEI, FOEs account for an even greater proportion of total services output than is the case in manufacturing. Total sales of €13.6 billion in 2000 were more than three times those of IOEs, at €3.9 billion. However, the gap is narrowing. According to the ABSEI, IOE services output increased by almost a third in 2000, considerably ahead of growth of 19 per cent among FOEs.

## **Export propensity**

In 2000 FOEs exported 89 per cent of their output of internationally traded services (this compares with 86 per cent of goods output). IOEs in the services sector also have a higher propensity to export than their counterparts in manufacturing at 44 per cent (compared to 39 per cent). Indeed, there is evidence that the IOEs in the services sector are internationalising rapidly. In 2000, the proportion of total sales sold abroad increased by more than two percentage points over 1999. IOEs saw the value of their services exports rise to €1.7 billion, from €1.2 billion in 1999, representing an increase in value terms of over a third.

## **Export markets**

In terms of markets, FOEs exported more than 80 per cent of service output to Europe (compared with only just over half of FOE merchandise goods output). While the UK accounted for around 23 per cent in both 1999 and 2000, other EU countries absorbed almost half of the total. IOEs are very different. Non-Europe exports account for almost half of the total, which is in marked contrast not only to FOEs, but also to goods exports by both foreign and indigenous firms. Furthermore, IOEs export considerably more services to the UK than they do to all other 13 European Union member states combined.

# 4 Foreign Direct Investment

## 4.1 Global Developments in Foreign Direct Investment Flows and Stocks

Foreign direct investment (FDI), along with trade in goods and services and shorter-term capital movements, is one of the three pillars of economic globalisation. And in line with uninterrupted annual increases since 1991, the flows of FDI continued to grow in 2000, reaching yet another peak. At \$1,271 billion, inflows were almost a fifth higher than in 1999 and more than six times the level of 1990 according to UNCTAD. Mergers and acquisitions (M&A) - the motor of FDI growth in the developed world and in the EU in particular - drove the increase in 2000, as it has done in recent years. Although FDI data are not yet available for 2001, M&A activity is likely to have slowed considerably in 2001 as the global economy experienced its sharpest deceleration in output growth in three decades. The result will almost certainly be a contraction in absolute levels of FDI over 2000.

*Table 5 Global Inward FDI Flows and Stocks (US\$ billions)*

	Inward Flows			Inward Stocks		
	1998	1999	2000	1998	1999	2000
World	692	1,075	1,271	2,938	5,196	6,314
EU	261	467	617	1,331	1,835	2,376
Ireland	11	15	16	12	43	59
North Am	197	320	344	659	1,137	1,433
Asia/Pacific (excl. Japan)	96	100	144	584	1,122	1,266
Latin Am and Carib	83	110	86	202	520	607

Source: UNCTAD, World Investment Report 2001

In 2000, as in 1998-1999, almost a half of global FDI inflows went to the EU. Patterns of outflows also remained largely unchanged, with the EU accounting for almost one half of total inflows and two thirds of outflows. The second most important region of the world in FDI terms, though by some considerable distance, was North America, accounting for over a quarter of outflows and a sixth of inflows. The developing world accounted for the bulk of the remainder. However, as inflows to these countries grew by considerably less than the global average in 2000, their share of total inflows fell below 20 per cent of the global total for the first time since 1990.

The sharp rise in recent years of FDI has been stimulated by a number of factors including greater faith in market outcomes, technological advances and the self-reinforcing nature of the process of economic globalisation. Since the collapse of centrally planned economies more than a decade ago, market capitalism has been in the ascendant. The combination of successful open economies as examples for others, the continued failure of closed economies, and the absence of alternative development models, has boosted faith among policy-makers world-wide in market outcomes. One aspect of this is the growing realisation of the benefits of FDI in terms of employment, capital formation and export earnings along with less tangible spill-over effects such as diffusion of

technological advances and management best practices. These developments have resulted in barriers to investment (and trade) being reduced. UNCTAD found that the number of bi-lateral investment treaties rose five-fold during the 1990s, to reach 1,941 by the end of 2000. This process is being complimented, at the domestic level, with the legislative framework in a growing number of countries being adjusted to encourage foreign (and domestic) investment. Of 150 regulatory changes in 69 countries examined by UNCTAD in 2000, the overwhelming majority (147) sought to stimulate FDI. Domestic market liberalisation in previously protected sectors such as utilities and capital markets also stimulates FDI. The removal of restrictions on the functioning of capital markets has been of particular importance in terms of offering increasingly sophisticated means of financing foreign investments (by reducing the cost of capital and encouraging the take-over culture upon which M&A activity is based).

The role of technological change, in transport, communications, production processes and product development remains one of the central elements in both stimulating and facilitating the internationalisation of firms, and, in particular, the establishment of globally integrated production networks. In 2000, strong growth in the world economy boosted profits, a growing percentage of which are generated by international trade and foreign subsidiaries. These profits, and how they have been generated, encourage firms to continue widening the geographical scope of their operations (i.e. to internationalise) and provide them with the higher retained earnings necessary to finance of such investments. This is an example of the self-reinforcing dynamic of global liberalisation.

#### 4.2 Inward Direct Investment into Ireland

**Table 6: Inward Direct Investment in Ireland, 1998-2000 (€ millions)**

	1998	1999	2000
Total	7,905	17,793	22,492
Equity	5,860	7,884	10,143
Reinvested Earnings	4,397	7,232	10,419
Other Capital	-2,352	2,586	1,930
IFSC	4,332	11,720	13,670
Non-IFSC	3,573	6,073	8,820
EU	4,640	6,053	5,247
Non-EU	3,266	11,740	17,371

Source: CSO, Balance of International Payments

In line with global developments, inward foreign direct investment (FDI) flows into Ireland continued their rapid ascent in 2000, reaching a record high of €22.5 billion (up by 26 per cent from a year earlier).<sup>13</sup> Of the total inward FDI flows, €13.7 went into companies associated with the International

*13 In line with international norms, the CSO defines FDI as the value of financial flows (including the value of in-kind assets) from "home" countries to foreign affiliates in "host" countries. A direct investment enterprise is an unincorporated enterprise in which a direct investor owns ten per cent or more of the ordinary shares of the company or voting power (for an incorporated enterprise) or the equivalent for an unincorporated enterprise. Most data on FDI flows take into account only the acquisition or establishment of foreign affiliates involving the use of so-called foreign direct investment funds, consisting of equity, intra-company loans and re-invested earnings. FDI financed through equity or debt issues in the domestic capital market of the host country or in international capital markets, or through equity contributed by local partners in non-wholly owned foreign affiliates, is not included.*

Financial Services Centre (IFSC) in Dublin.<sup>14</sup> This mostly entails large movements of capital by foreign-owned companies to their treasury, fund management and other financial subsidiaries at the IFSC, mostly to be re-invested in overseas assets.<sup>15</sup>

A better picture of inward investment is obtained, therefore, when IFSC-related inflows are stripped out. Such traditional "industrial" investment by foreign-owned firms measured €8.8 billion in 2000, up from €6.1 billion in 1999 and just €3.6 billion in 1998. This covers not only foreign investment in new "greenfield" operations in Ireland, but also foreign purchases of existing Irish companies, as well as all subsequent capital flows from foreign parents to their affiliates and subsidiaries in Ireland, whether in the form of equity capital, debt or reinvested earnings (the undistributed profits of their Irish subsidiaries). Ireland is unusual by the standards of most other developed countries in that only a relatively small proportion of inward FDI flows is accounted for by foreign acquisitions of Irish companies (M&As), while an unusually large proportion of inward flows is made up of greenfield investment in new plants, factories and companies.

Indeed, over the past decade, more than one in every ten new foreign-owned greenfield manufacturing projects coming into Europe was located in Ireland. Ireland's share of inward greenfield FDI projects has, however, declined slightly in recent years, largely to the benefit of Central and Eastern European Countries (CEECs), which have become increasingly attractive as locations for mobile direct investment. Nonetheless, in the pharmaceuticals/healthcare sector, Ireland's share of greenfield FDI projects, though declining, is still greater, in relative terms than any other European country including the UK. Ireland is also joint leader in shared services, but has dropped to joint second behind the Netherlands for electronics.

Developments since 1998 show that virtually all of the large increases in inward FDI were accounted for by non-EU sources<sup>16</sup>. Indeed, FDI from the EU barely changed in 2000 over the previous year, while non-EU inflows almost doubled. The result was to depress further the percentage of EU inflows in the total, from 58.7 per cent in 1998, to less than a quarter in 2000. According to Eurostat data, this marks Ireland out from other EU member states where intra-EU FDI flows account for an average of almost 80 per cent of the total. But while Ireland's EU inflows were very low, non-EU inflows were the highest in per capita terms among the 15 member states and accounted for 10 per cent of all FDI into the EU from non-EU countries in 2000.

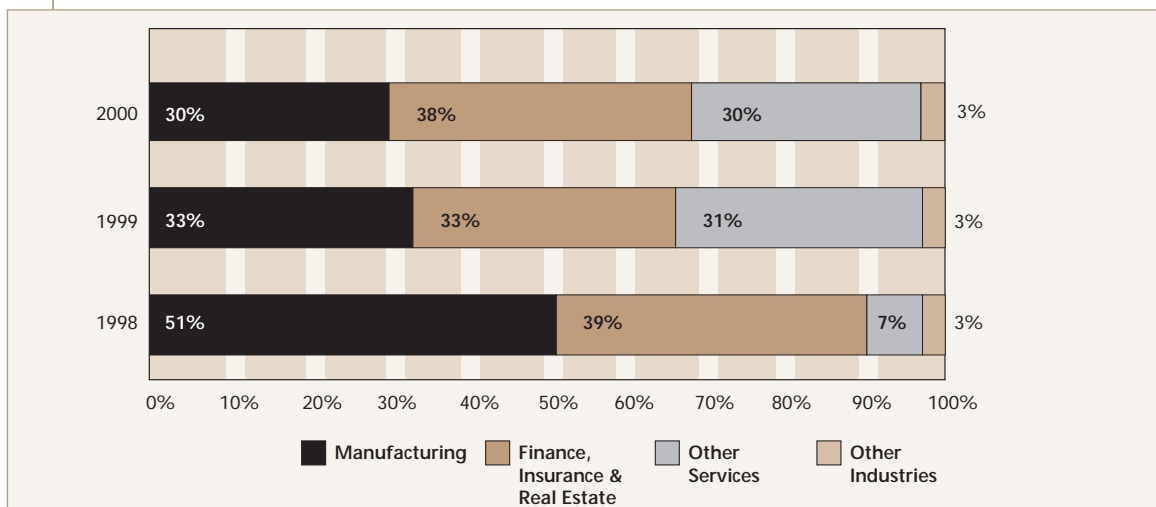
Data from the U.S. Department of Commerce suggest that the vast majority of FDI flows into Ireland from non-EU sources originates in the USA. According to the U.S. data, FDI flows from the USA to Ireland rose from \$4.6 billion to \$7.4 billion between 1999 and 2000. Only the Netherlands and UK received larger inflows in absolute terms in 2000. In per capita terms, inflows to Ireland were by far the highest of any EU country, at almost \$2,000 for every man, woman and child. This was nearly three times per capita U.S. FDI flows to the Netherlands, the second largest per capita destination.

<sup>14</sup> See footnote 11

<sup>15</sup> Overseas investment by IFSC-related enterprises covers mostly the acquisition and disposal of foreign equities, bonds and other tradable financial instruments in the form of portfolio investment, and is not outward direct investment in overseas enterprises.

<sup>16</sup> In geographical terms, the CSO data on flows of FDI are limited, with totals broken down only by EU and non-EU sources and by EMU and non-EMU sources

Figure 13: Composition of US FDI in Ireland by Industry Sector, 1998 - 2000

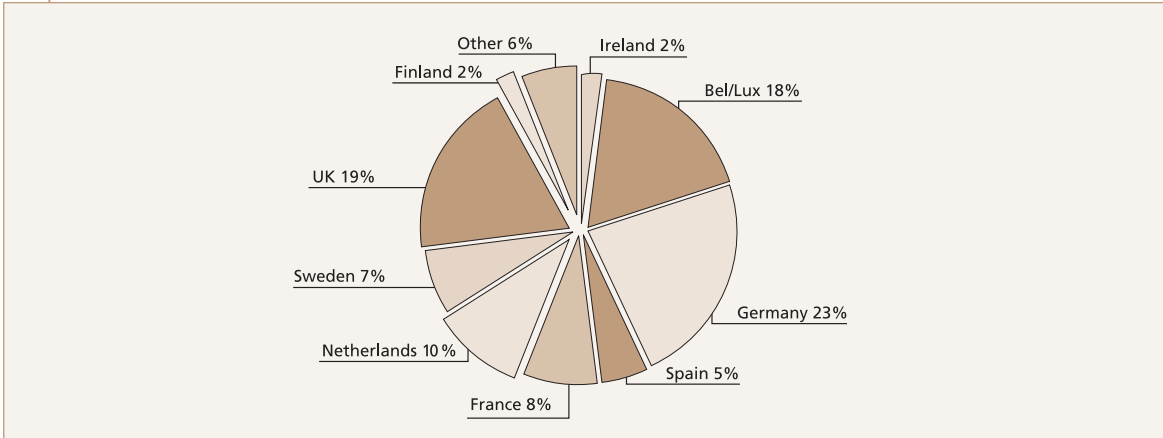


Source: U.S. Department of Commerce, International Investment Data

By the end of 2000, U.S. firms owned assets in Ireland worth \$33.4 billion - equivalent to 40.7 per cent of GDP, up from \$7.2 billion in 1994. At almost \$9,000 per capita, stocks of U.S. FDI in per capita terms in Ireland dwarf those of other EU countries (the UK lags well behind in second place with less than \$4,000). Disaggregated by sector, the data show that services industries accounted for two-thirds of the total of U.S. FDI stocks in Ireland in 2000. This is a considerable turnaround. As recently as 1994, manufacturing made up more than half of the total stock. This is the result of a near seven-fold increase in just six years in services industries stocks, a rate of accumulation more than twice that of manufacturing. Although investment stocks in finance, insurance and real estate have been the single biggest category since 1999, "other services" have grown more rapidly than any other sector.

Ireland was the tenth largest recipient of FDI inflows among developed countries in 2000 according to UNCTAD. Data from Eurostat (which differ from UNCTAD) also show that Ireland continues to be the recipient of a disproportionate percentage of inward FDI, accounting for 2.7 per cent of total EU inflows in 2000. Altogether, Ireland accounted for 2.5 per cent of the stocks of inward foreign direct investment (IFDI) in the EU in 2000, despite making up just one per cent of the EU economy. At an estimated \$59.4 billion, foreign ownership of Irish assets was higher in absolute terms than countries of similar levels of development and income, such as Denmark and Finland. In the EU only Belgium/Luxembourg and the Netherlands had higher stocks in per capita terms.

Figure 14: Share of 1998 - 2000 EU Inward FDI Flows by Member States (€ millions)



Source: Eurostat, EU Direct Investment Yearbook

By any measure, therefore, Ireland's FDI inflows are impressive when compared to other countries. Even so, they may understate the impact of FDI on Ireland's economic performance. This is because greenfield investments, which constitute an unusually high proportion of total Irish inward FDI flows, are a deeper form of economic integration as they usually involve the construction and fitting out of production facilities (adding to the capital stock) and the hiring of staff (increasing employment). In the case of M&As, a pre-existing firm is involved. As this can frequently involve little more than a change in ownership, its impact on the host economy is usually more limited.

### FDI in Ireland: Past and Present

In the decades following the second world war, Europe enjoyed a period of unprecedented boom. Ireland, in contrast, fell further behind the rest of Europe in per capita GDP terms as a result of a combination of factors including autarkic economic policies, a long-standing emphasis on low-growth agriculture (rather than industry and services) and a lack of entrepreneurial dynamism. In the late 1950s a radical turnaround in policy focused on the attraction of foreign-owned export-oriented manufacturing industries with the objective of fast-tracking economic development. The policy proved successful in the following decades. By the 1990s the role of foreign-owned enterprises (FOEs) in the economy, in terms of employment and, in particular, output reached new heights. By the end of that decade full employment had been achieved and income levels had converged with the EU average, in no small part owing to the role of FOEs.

The changing environment has impacted FOE operations in Ireland. Surveys have shown that labour market factors are the most important stated attractions for FOEs operating in Ireland. Over four years, 57 per cent of FOEs have ranked appropriate skill levels as the most important advantage, English language in third place (31 per cent) and motivation and loyalty of staff (30 per cent) in fourth. Ireland's favourable corporation tax regime ranked second (47.5 per cent).

The pattern of direct investment inflows in the first six months of 2001 was in stark contrast to developments in recent years. From €11.0 billion in the first half of 2000, inflows fell to €9.9 billion in the same period in 2001. Moreover, two thirds of the decline is attributable to non-IFSC inflows, a development which is of greater significance for the economy given that IFSC inflows are almost entirely invested in non-domestic assets. Most of the fall-off in FDI inflows appears to have originated in non-EU sources, presumably the USA. This is likely to have been in line with developments internationally as the U.S. and global economies slowed sharply in the first half of 2001.

### 4.3 Outward Foreign Direct Investment from Ireland

Ireland's direct investment relationship with the rest of the world is unusual by the standards of most other advanced economies. As of 1998, the ratio of the stock of outward FDI to the stock of inward FDI was lower in Ireland than in any other advanced economy, and was significantly lower than most other small EU countries (27 percent against an OECD average of 130 per cent). Ireland's rather unique direct investment relationship with the rest of world reflects not only the high levels of inward investment into Ireland compared with other advanced countries (see section 4.2), but also very low levels of outward investment flows from Ireland over this period.

Reflecting Ireland's heretofore relatively low level of economic development, its small size and limited indigenous entrepreneurial success, Irish firms have traditionally held few productive foreign assets. According to UNCTAD, Ireland's stock of outward FDI as recently as 1985 amounted to just \$202m, a tiny fraction of the total of the current 15 members of the EU and joint lowest in per capita terms with Portugal. However, change is ongoing. By 2000 an increasingly dynamic indigenous private sector had accumulated foreign assets of \$16 billion, equivalent to half of one percent of all foreign assets held by EU countries (although this is still a disproportionately low level given the country's income levels and particularly given the degree to which the economy is integrated with that of the rest of the world). In per capita terms, Ireland had risen to ninth position in the EU-15, ahead of Austria, Greece, Italy, Portugal and Spain.

**Table 7: Ireland's Outward and Inward FDI Flows 1988 – 1999 (US \$ Millions)**

	1988-1993 (annual average)	1994	1995	1996	1997	1998	1999	1994-1999 (annual average)
Outward FDI Flows	400	438	820	727	1,008	3,906	5,418	2,053
Inward FDI Flows	787	838	1,447	2,618	2,743	8,579	18,322	5,758
Net Balance	387	400	627	1,891	1,735	4,673	12,904	3,705

Source: UNCTAD, World Investment Report, 2000.

In line with the growth in outward investment stocks, a sharp upward trend is also evident in Ireland's outward FDI flows during the 1990s. Irish outward FDI flows grew from an average of just \$400 million in the period 1988-93 to \$5.4 billion in 1999. While this was still well below total inward FDI of \$18.3 billion in that year, it was not far below non-IFSC related "industrial" inward investment of \$6.5 billion.

**Table 8: FDI Outflows from Ireland, 1998-2000**

(€ Millions)	1998	1999	2000
Total	3,483	5,085	2,881
Equity	910	2,203	2,220
Reinvested earnings	1,526	1,860	1,656
Other capital	1,046	1,023	-994
European Union	1,124	1,510	-805
Non-EU	2,359	3,577	3,689

Source: CSO, Balance of International Payments

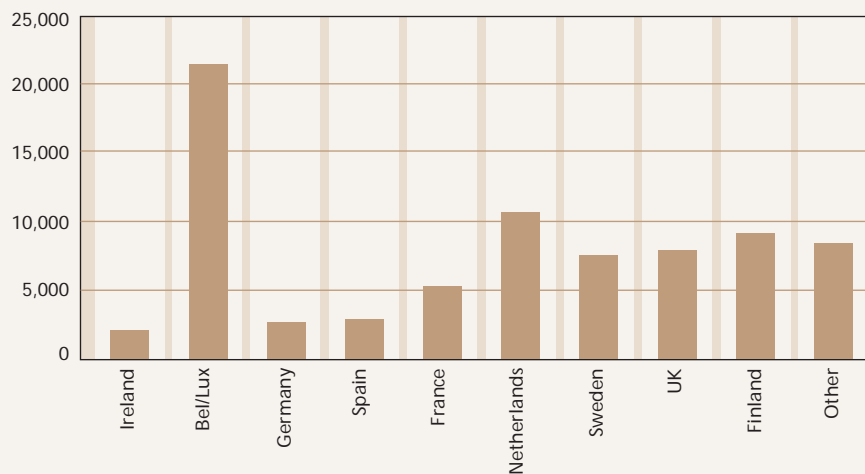
According to the CSO data, outward investment flows grew from €3.4 billion in 1998 to €5.1 billion in 1999, before dropping again to €2.9 billion in 2000. Given the clear direction of the trend since 1985 as indicated by the UNCTAD data (table above), however, it is likely that the drop in 2000 is a temporary aberration in a long-term growth trend. Outward direct investment flows in 2000 in the form of equity capital and earnings reinvested in overseas operations were only marginally down on 1999 levels, while the drop in overall direct investment outflows is almost entirely the result of repayment of debt capital to Irish companies from their overseas subsidiaries (this may even be the result of a single transaction). Nonetheless, the drop in Irish debt-financed outward FDI flows is surprising, as it is through debt capital that many mergers and acquisitions are financed. Given the 2000 was a record year for M&As and that this is the preferred route to internationalisation by Irish firms, it may suggest that flows are returning to more normal levels after 1998-99 (two years in which flows of outward FDI were far above the trend). However, evidence from the first half of 2001 does not support this pessimistic conclusion. While flows of FDI world-wide slowed, Ireland again went against the trend, registering an increase of over 40 per cent compared to the same period in 2000. The increase was almost entirely accounted for by a near-doubling of reinvested earnings.

### Reasons for Higher Outward FDI

The growth in Irish outward direct investment flows in the last decade (from a very low base and notwithstanding the drop in 2000) has, to a large extent, been an inevitable process as the Irish economy expanded. In an international environment in which barriers to trade and investment are low or non-existent, some industries have a strong tendency to internationalise. These include manufacturing and extractive industries in which output has a high volume to value ratio or weight to value ratio (making transportation to market costly); services industries in which provision and consumption occur simultaneously; and any industry in which there are large economies of scale. In such industries, a failure to expand beyond national borders leaves the firm vulnerable in its domestic market. Firms also expand operations overseas not only out of necessity, but also if the domestic market offers no further growth opportunities.

As the economy has reached higher levels of development, Irish companies have increased their investments abroad for these and other reasons, all consistent with the concept of the "Investment Development Path" (IDP) developed by John Dunning<sup>17</sup> in the early 1980s. The IDP theory holds that a country's net outward direct investment position (outward less inward direct investment) is influenced by its level of economic development. With increasing economic development, a country evolves from being a net recipient of investment to being a net outward investor. As the domestic economy becomes more advanced, indigenous firms develop "firm-specific" assets, allowing them to become more internationally competitive and to exploit their competitive advantages by investing overseas (see Section 3). Also, economic development results in rising labour costs in the home economy, leading to a reduction in inward investment flows. According to recent analysis, Ireland progressed steadily along the "Investment Development Path" during the 1990s.

Figure 15: Per capita Outward FDI flows by Selected EU countries 1998 - 2000 (€)



Source: Eurostat, EU Direct Investment Yearbook

<sup>17</sup> John Dunning. "Explaining the International Direct Investment Position of Countries: Towards a Dynamic of Developmental Approach" (1981).

The elimination of exchange rate risk has yet to encourage greater purchases of euro denominated assets by Irish businesses<sup>18</sup>. Indeed, the reverse appears to have been the case according to CSO data. In 2000, Irish firms actually divested from euro area assets, with 84 per cent of Irish outward FDI in the 1998-2000 period going to non-EU countries. Indeed, in 2000 Ireland accounted for over 10 per cent of the total outward FDI flows from the EU. Anecdotal evidence and data from U.S. sources suggest that most of this goes to the USA. Other, less significant, non-EU destinations for Irish outward direct investment include Canada, Latin America, Central and Eastern Europe and the Far East. Only four per cent of Irish Outward FDI flows in the 1998-2000 period went to other euro-zone countries, while 12 per cent over this period went to non-euro EU countries, presumably mostly to the UK.

*18 Counter party evidence suggests that Irish outward FDI stocks are understated owing to a preference among Irish firms to finance their acquisition by tapping into international capital markets rather than raising finance domestically (the later appears on balance of payments data the former does not). With the advent of EMU, euro area capital markets have become more efficient which may make it even more attractive to finance acquisitions that do not appear on the balance of payments.*

# 5 Issues for Policy Consideration

## 5.1 World Trade Organisation Negotiations

More than half of Ireland's exports go to the EU's single market. Trade relations are governed by a set of legally enforceable rules, which offer predictability and transparency. Trade with countries outside the European Economic Area are governed by bi-lateral and multilateral agreements. Though these offer a degree of certainty, they do not have the same legal effect as the EU's law-based framework. As non-EU trade is set to rise - in absolute terms if not relative terms (though this seems likely on the basis of current trends) and the Irish economy becomes ever more dependent on international economic transactions, the strengthening of the multilateral trading system becomes increasingly important. Ireland's ability to influence outcomes at the recently-launched round of WTO trade negotiations, and to open up new markets for Irish exporters, is critically dependent on Irish companies identifying existing barriers to overseas trade and investment. In September 2001, Forfás and the Department of Enterprise, Trade and Employment jointly launched a WTO Industry Consultation Process designed to alert industry to the implications of a new round of trade liberalisation negotiations, and to provide an opportunity for industry to make their views known on the main issues. The consultation process can be accessed at [www.openmarkets.ie](http://www.openmarkets.ie). It is important that more companies, and their representatives bodies, make their views known.

Few developments have done more to buttress international investor confidence and global economic health than the strong international political commitment at the 4th WTO Ministerial Meeting in Doha to launch a new round of trade liberalisation negotiations. Although the successful completion of a new round may require some compromises by the EU and Ireland in the area of farm supports, these are outweighed by the likely benefits to Irish-owned internationally traded manufacturing and service sectors.

## 5.2 Impact of the Global Economic Slowdown

The global economy is experiencing its most severe deceleration since the 1974 oil price shock. In 2000 global growth averaged 4.7%, the fastest rate of growth since 1998. But in 2001 world growth is likely to slow to just 2.2%, the slowest performance since 1992. Sparked by the crash in the Information and Communications Technology (ICT) industry, the downturn began in the USA, but quickly spread to Asia and Europe. The downside risks to the U.S. and global economies have increased further as a result of the terrorist attacks in the USA on September 11, mostly reflecting the impact on consumer and business confidence. Global growth is likely to average just 2.9% in 2002 and OECD growth just 1.5%. Output will be particularly weak in the first half of the year, but a recovery will take hold in the USA and most other industrialised countries in the second half. There is a risk, however, that rising U.S. unemployment and falling confidence (and possibly another serious terrorist attack) will lead to the USA undergoing a far deeper and longer recession than currently expected. The risks to global growth, and even global stability, are now higher than at any time for a decade.

Ireland appears well placed to withstand the impact of a global downturn. This is due to our current low rate of unemployment, the strength of the government finances relative to other EU countries, the strong enterprise base, and our relative immunity to financial market instability as a result of our participation in EMU. Nonetheless, the extensive trade and investment links between Ireland and the rest of the world, and particularly the USA, have quickly channelled recessionary forces in our direction.

In this context, the narrowness of Ireland's export base raises concerns about the vulnerability of the economy as world growth suffers its sharpest deceleration since the first oil crisis in 1972-73. It should be noted, at the outset, that small economies are unavoidably more vulnerable to asymmetric demand shocks owing to the need to specialise (without specialisation it is difficult to become competitive in high value added industries that allow per capita income levels to match those of large economies).

While there are a number of risks as a result of the global downturn, both direct and indirect, the most immediate threat is to the information and communications technology (ICT) industry. In the short term, demand for electronics goods is unlikely to recover owing to reductions in business and consumer expenditure. Structurally, the problems may be more serious still. After years of double-digit growth, many parts of the ICT industry (PCs and mobile phones) appear to be entering the mature (low growth) phase of their product life-cycle, when replacement purchases (rather than first time purchases) account for the bulk of sales. This stage in any product life cycle is usually accompanied by a shake out in the industry as excess capacity is trimmed. Firms that are inefficient and/or have over-invested tend to go out of business or consolidate their operations. The PC industry faces the additional risk that rapid technological change may cut short its product life as substitute products become available. Although there are inherent difficulties in predicting future successful market innovations, consideration should be given to identifying successor products and encouraging the companies most likely to succeed in their production to locate in Ireland.

Irish-owned industry's relative immunity to date from the U.S. and global economic downturns seems likely to be short-lived, and the business environment for indigenous industry is set to deteriorate significantly over the coming 6-12 months. Deteriorating demand conditions are now spreading from the USA to all of Ireland's nine largest markets – a development that seems certain to be reflected in slowing export growth by indigenous Irish companies. Other major risk factors presented by the global economic slowdown over the coming 6-12 months include: a downturn in Irish economy expenditures by multinationals in Ireland; an appreciation of the euro against sterling and the dollar; a further deterioration in equity prices in the financing environment; a decline in domestic Irish business and consumer spending; and increased price competition in global markets. In this context, Enterprise Ireland is planning a number of actions to support Irish-owned industry. These include intensifying international marketing activities, the creation of a "Competitiveness Fund" to support client productivity initiatives, strengthening the flow of new start-ups with export potential and supporting the flow of private equity to industry. Other areas of agency and public policy relevant to indigenous industry should also be considered, including: enhancing market access through outward direct investment (see Section 5.7); expanding access to non-EU markets for indigenous Irish industry through WTO trade liberalisation (Section 5.1) and preparing for a euro appreciation (Section 5.4).

With the Irish economy's high degree of openness through trade and investment flows comes a requirement to maintain an investor friendly business environment. Government initiatives in the fields of taxation, employment, education, trade and infrastructure must continue to be scrutinised regarding their impact on the competitiveness of the enterprise sector in Ireland. While little can be done in the short-term to counter the difficulties that will likely be faced in the coming 6-12 months, the downturn should add increased impetus to ongoing efforts to address major deficiencies in the Irish business environment, particularly regarding infrastructure provision (particularly telecoms), education and the support structures for research and development.

### 5.3 Importing

Ireland is unique among the 12 EU countries participating in EMU in that only one-third of its trade is conducted with other euro-zone countries. This leaves Irish importers more exposed than those in any other euro participant to fluctuations in the external value of the euro, particularly against sterling and the U.S. dollar. As a result, changes in the external value of the euro are quickly translated into domestic prices, adding to economic instability and putting pressure on wage agreements. After almost three years, there is, as yet, little evidence that the elimination of exchange rate risk with other EMU participants has led to deepening economic integration with those economies. Given the size and proximity of the euro area market, it is surprising that less than one quarter of imports are sourced from the euro-zone. While it is rightly the market, and not the state, that is the primary determinant of the geographic direction of trade flows, there is a clear role for public policy in identifying, and, where possible, removing barriers to trade with other euro-zone countries.

While Enterprise Ireland has developed a comprehensive strategy to boost exports to the euro-zone by Irish-owned firms, little work has been done yet on tackling barriers to imports from other euro-zone countries. Greater euro area sourcing of goods and services would have the advantage of reducing exposure to rising import prices as a result of currency movements (as has happened since the launch of the euro). In 2001, Forfás, in conjunction with the Chambers of Commerce in Ireland (CCI), commissioned a study to examine the reasons why Irish companies do not import more from other euro-zone countries and to identify the nature and scale of any barriers to euro-zone importing using a sample of Irish trading companies. While the study indicated that barriers to euro-zone importing were not considered as a major competitive issue for companies in Ireland, a number of problems were identified. These included the quality/suitability of euro-zone imports, high transport costs and the unfavourable credit/trading terms available from euro-zone suppliers. Psychological and informational obstacles were also identified, such as the lack of marketing in Ireland by euro-zone suppliers, the absence of personal contacts in the euro-zone and a lack of familiarity with euro-zone sources.

Given the macro economic and competitive advantages to greater euro-zone importing, the government should consider supporting to a business-led "Source Euro" campaign in 2002 to encourage increased euro-zone importing. The Chambers of Commerce of Ireland has offered to design such a campaign in association with Enterprise Ireland and other industry representative bodies. This should also include an examination of the wholesale and distribution sector in Ireland, in order to determine any measures, potentially in the area of competition policy and regulatory reform, that might increase euro-zone sourcing and, more generally, lead to greater competition in defined product markets. Although cross border cash transactions will become cheaper from 2003,

the absence of a pan-euro area payments clearing system means that cross border money transfer costs will remain higher than in domestic markets. Consideration might also be given, therefore, to supporting the more rapid move towards a single payments system in the euro area.

At a more general level, importing, and the role it plays in raising Irish competitiveness and living standards, should be given more prominence at a national policy level. Representatives of importing companies might be invited to join the Trade Advisory Forum, and issues related to barriers to imports and import policy should be discussed regularly at TAF meetings.

#### 5.4 Irish Exporters' Vulnerability to Exchange Rate Fluctuations

A 1998 report by Forfás, "Actions for Irish Enterprises to Address UK Delayed Entry into EMU – A Competitive Response", identified a number of industries that were vulnerable to an appreciation of the euro against sterling. These included: clothing; textiles; leather products and footwear; confectionery; mushrooms; prepared consumer foods and pigmeat/poultry meat. A recent analysis by Forfás and Enterprise Ireland of the implications of the slowing global economy for indigenous Irish industry suggests that the list of industries at risk has increased, probably reflecting the faster wage growth in Ireland compared with the UK in the intervening period that has to date been hidden by the strength of sterling against the euro. In this context, it appears that the actions recommended by Forfás in the 1998 report to prepare Irish companies for a euro appreciation are just as relevant today. The recommended actions included:

- ▶ Finance Measures (invoicing customers in euros; use of hedging instruments; holding sterling bank accounts);
- ▶ Marketing Measures (developing strong brands capable of absorbing price increases; develop non-sterling European markets; market re-positioning to less price sensitive market sectors); and
- ▶ Production Measures (investment and outsourcing to UK locations; increasing operational efficiency).

Although unlikely, a sharp and sustained depreciation of sterling against the euro is a possible eventuality that Irish industry must prepare for, particularly in the context of the current global economic slowdown.

#### 5.5 Inward Direct Investment

Ireland faces growing challenges in attracting foreign investment. Quite apart from the lower global flows likely this year and next, a number of structural changes, including fast wage growth and more active labour and environmental regulation, may reduce Ireland's attractiveness as an investment location for certain types of industries. Survey data give an insight into the advantages and disadvantages perceived by foreign investors in Ireland. The most important advantages have been perceived to be labour costs. This is now deteriorating, largely owing to full employment conditions prevailing in the labour market, putting upward pressure on wages. At the same time, other countries - most notably those in Central and Eastern Europe - are remedying some of their deficiencies and, closely related, proceeding towards membership of the EU in 2004-05. These developments make it more necessary than ever that all aspects of the business environment affecting inward FDI flows are scrutinised as closely as possible (beneficial to domestic as well as

foreign investment). Given the current downturn in the U.S. economy, and the risks associated with excessive dependence on any one source of FDI inflows, it may also be timely to make a concerted effort to diversify Irish FDI marketing efforts to include a greater focus on other euro-zone countries.

## 5.6 Infrastructure

Infrastructural inadequacies have become increasingly obvious in recent years, and are becoming a significant barrier to future inward investment flows and export growth. IDA survey data show client companies raising infrastructure deficiencies as the third most serious disadvantage they face operating in Ireland. While the National Development Plan (NDP) set out to remedy these problems, to date capacity constraints in the construction industry have hindered the pace of improvement. Given the supply bottlenecks that already exist, it is imperative that investment levels are maintained if current growth rates in inward investment and exports are to be sustained. Even in the context of the lower levels of government revenue envisaged over the next few years relative to earlier projections, the highest priority should be given to the implementation, and acceleration where possible, of government's capital development programme, which is indispensable to the medium-term growth of the economy.

## 5.7 Outward Direct Investment

Direct investment is both a consequence and cause of economic globalisation. For many Irish firms in some industries outward direct investment (ODI) is necessary for continued growth. Indeed, in some industries, a failure to internationalise may imperil the very existence of firms. Moreover, ODI is usually beneficial to the source economy across a range of indicators, including pay levels in parent companies, company profitability and growth, access to skilled labour and the development of globally minded management teams.

The state currently facilitates outward investment by Irish companies at two levels: (1) Ireland's network of double Taxation Agreements (DTAs), which promote trade and investment between Ireland and other countries that might otherwise be discouraged by the possibility of double taxation; (2) Support from Enterprise Ireland and Ireland's overseas diplomatic network. Enterprise Ireland recognises that outward direct investment is becoming an increasingly essential stage in company development for many fast growing Irish companies. Accordingly, Enterprise Ireland already assists, on a case by case basis, indigenous Irish companies seeking to make overseas direct investments and acquisitions. Support comes in the form of information, expert advice and networking services through its network of overseas offices and incubator facilities, and in the form of overseas trade and investment missions.

While the evidence suggests that outward direct investment is broadly positive for the Irish economy, there does not appear to be any pressing need for stronger public intervention to support outward direct investors at the firm level beyond the non-financial "soft" supports already offered by Enterprise Ireland. This view reflects the absence of any evidence of market failures or institutional barriers to outward direct investment requiring state intervention. Instead, government efforts should continue to be concentrated at the international level: expanding Ireland's tax treaty network and supporting the negotiation of a multilateral agreement on investment rules under the auspices of the WTO that would provide a transparent, non-discriminatory environment for Irish companies investing overseas. The reasons behind the small levels of Irish outward FDI flows to other euro-zone countries should also be examined.

The dismantling of overseas investment restrictions and growing outward FDI flows from Ireland should be seen as an opportunity for national economic development, rather than a threat. As long as the Irish business environment is supportive of value-added activities locating in this country, this process is likely to catalyse a restructuring of the economy up the value chain, with labour intensive lower-tech operations relocating to more cost competitive locations. This process should result in higher average wages and living standards in Ireland.

Clearly, as with all channels of economic restructuring, the "winners" and "losers" from growing outward FDI may not be the same, as managerial, professional and technical skills replace labour as the key inputs into enterprise activities in Ireland. Where outward direct investment by Irish companies is associated with economic dislocation, there may be calls for measures to discourage Irish companies from making overseas investments. It is clear from existing overseas and Irish research, however, that outward direct investment is broadly beneficial to the Irish economy as a whole, and such policies should be avoided. Instead, public intervention should focus on providing those negatively affected by outward direct investment with the necessary skills and training to prosper in the new economy.