International Trade and Investment Report, 2003

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

Forfás
The National Policy and Advisory Board for Enterprise, Trade, Science, Technology and Innovation
International Trade and Investment Report, 2003

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April 2004
Functions

Forfás is the national policy and advisory board for enterprise, trade, science, technology and innovation. It is the body in which the State’s legal power for industrial promotion and technological development have been vested. It is also the body through which powers are delegated to Enterprise Ireland for the promotion of indigenous industry and to IDA Ireland for the promotion of inward investment. Science Foundation Ireland was established as a third agency of Forfás in July 2003.

The broad functions of Forfás are to:

• advise the Minister on matters relating to the development of industry in the State;
• advise on the development and co-ordination of policy for Enterprise Ireland, IDA Ireland, Science Foundation Ireland and such other bodies (established or under statute) as the Minister may by order designate;
• encourage the development of industry, technology, marketing and human resources in the State;
• encourage the establishment and development in the State of industrial undertakings from outside the State; and
• advise and co-ordinate Enterprise Ireland, IDA Ireland and Science Foundation Ireland in relation to their functions.

Réamhrá

Is é Forfás an bord náisiúnta um polasai agus comhairle le haghai dh fiontraíochta, trádála, eolaíochta, teicneolaíochta agus nuála. Is é an comhlacht é a bhfuil comhactaí dlíthiúla an stáit maidir le cur chun cinn tionscail agus forbairt teicneolaíochta dlíthiúla an stáit a sheachaint le chéile ar a dhuine go bhfuil chumhachtai ar Fhiontraíochta Éireann, GFT Éireann, Fondúireacht Eolaíochta Éireann agus chumhachtai ar Forbartha Tionscail na hÉireann a chuirtear chun cinn agus ar gníomhaireacht Forbartha Tionscail Éireann le hinfheistíocht isteach sa tír a chur chun tosaigh. Is iad feighmeanna Fhorfáis:

• comhairle a chur ar an Aire ó thaobh cúrsaí a bhaineann le forbairt tionscail sa Stát;
• comhairle maidir le forbairt agus comhdhú polasaíthe a chur ar fáil d’Fhiontraíochta Éireann, d’GFT Éireann, Fondúireacht Eolaíochta Éireann agus d’ainmniú triú domhain; dá leithéid (a bunaíodh go reachtúil) a d’fhéadfadh an tAire a ainmníú trí ordú;
• forbairt níos forbairt, níos chomhaontú, níos chomhchuirte, níos chomhaimhniú a dhéanann a spreagadh sa Stát;
• bunú agus forbairt gnóthas tionscailchóirí as a spreagadh sa Stát; agus
• Fiontraíocht Éireann, GFT Éireann agus Fondúireacht Eolaíochta Éireann a chomhchuirí agus a chomhdhú ó thaobh a gcuid feidhmeanna.

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Preface

Over the past decade Ireland has become one of the most internationalised economies in the world. But in 2002 below-trend rates of world output growth combined with domestic developments to slow the pace of Ireland’s hitherto rapid globalisation.

Volume growth of both exports and imports of merchandise goods turned negative after many years of high growth. Exports were affected by a collapse in computer-related exports, owing to a global recession in the industry, and this was only partially offset by the continued boom in the pharmaceuticals and chemicals sector. Also of concern were domestic supply side considerations, as domestic costs rose faster than competitor countries, a trend that effected competitiveness all the more owing to an appreciating euro.

In 2002 the most positive development was the continued boom in the internationally-traded services sector. Despite a slowdown in the growth rate of exports, foreign sales of services continued to surge ahead, causing Ireland to leap three places in the global league table to become the largest per capita exporter of services in the world. There are indications that critical mass in some sectors is being reached. The double-digit rate of growth combined with far more subdued import growth resulted in the traditionally very large services deficit narrowing by 3bn over 2001, a development which may herald a more balanced services account in the future.

Developments in inward foreign direct investment (FDI) were also positive in 2002. Despite the second consecutive year of falling worldwide flows, inward investment into Ireland rose sharply over the previous year, reaching its second highest level ever. That said, it would appear that the nature of this FDI is changing, with most new investment designed to consolidate the positions of foreign firms already located in Ireland, rather than for the expansion of productive capacity. The result is that fewer jobs have been created. Developments in flows of outward FDI were very different. As the purchase of foreign assets fell for the fourth consecutive year, the internationalisation of corporate Ireland slowed.

Trade data in the first half of 2003 showed sharp year-on-year falls to almost every market and in all significant goods categories. Services exports growth continued to slow, and while FDI increased year on year, the full-year picture may not be as positive owing to the highly erratic nature of investment flows. Although at the time of writing in early 2004, the global economy is gathering momentum, the challenges facing the internationally-orientated sector of the Irish economy are plentiful. They include: a considerably stronger euro; imbalances in the world economy; and, domestically, a loss of competitiveness as wage and non-wage costs rise. All in all, the outlook for Irish international trade and investment is uncertain, though the upside potential now outweighs the downside risks.
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Executive Summary

Overview: Trade in Merchandise Goods

Global trade growth accelerated in 2002, increasing by 2.5 per cent in volume terms after contracting by 1.5 per cent in 2001. The rate of increase was still below the average of the previous decade, mainly because of depressed growth in global GDP. The EU, which is by far the world’s most important source of import demand, saw domestic demand decelerate to 0.7 per cent in 2002. The volume of imports was, as a result, lower in 2002 than the previous year. Export growth was slightly stronger, at 1.5 per cent.

Although the WTO has published no aggregate trade data for the first half of 2003 at the time of writing in early 2004, national figures suggest that there was little acceleration in the rate of global trade growth despite recovery from a shallow dip in economic growth in the second half of 2002.

According to the WTO, Ireland’s rate of merchandise export growth in 2002, at 7 per cent in dollar denominated terms, converged towards the world average after years during which it topped the global league table. In per capita terms, however, Ireland extended its lead as the largest exporter in world.

When denominated in euro, the total value of Irish merchandise goods sold abroad increased by a mere 1 per cent to reach €93.7bn, the lowest rate of increase since 1990. In volume terms the performance was worse still, with a recorded increase of half a per cent.

In the first half of 2003 the value of exports fell by 20 per cent over the same period in 2002. Moreover, the value of exports in every major goods category and into each of the biggest five markets also declined.

Irish export prices began to fall in prices in June 2002. Over the following 12 months, the rate at which prices fell gathered pace and by the second quarter of 2003 export prices were 7 per cent lower than the same period a year earlier.

The weakness of aggregate exports sector was accounted for by a number of factors, including depressed global demand, the continuing and protracted slump in the ICT sector, the rise of the euro and the end of the protracted period during which high levels of new manufacturing capacity came on line.

In 2002 a significant shift took place in the composition of Irish exports. The “chemicals and related products” sector continued to surge ahead, overtaking the recession-mired “machinery and transport equipment” industry to become the most important export sector.

The export industries dominated by indigenous firms – miscellaneous manufacturing and food – saw the value of exports fell by 10 per cent, to stand at €8.2bn in 2002 (lower than in 2000). The first six months of 2003 saw exports stabilise over the same period in 2002.

The geographical distribution of trade growth in 2002 was broadly in line with trends internationally and, with a few exceptions, did not shift significantly compared to recent years.

Ireland’s total import bill in 2002 was €55.5bn, a decline of 3.2 per cent on 2001. As was the case with exports, the value of imports turned sharply negative in the second half of the year, with a year-on-year decline of 12.6 per cent in the fourth quarter. The value of imports fell even more precipitously in the first half of 2003, when they were down by almost a quarter on the same period a year previously.
Analysing price developments shows that after a small increase in 2001, import price inflation turned negative in 2002, with year on year declines recorded in every month of the year except February. In 2002 as a whole, import prices fell by 3.9 per cent, and the rate of decline accelerated slightly in the first half of 2003, to 4.3 per cent.

As a result of the fall in imports in 2002, Ireland slipped back one place to become the world’s 26th largest importer in absolute terms according to the WTO. In per capita terms Ireland remained 2nd in the world after Singapore.

Disaggregated according to final use (consumer, capital and intermediate) import data show the largest category, accounting for 60 per cent of the total, are goods imported as inputs for the production of other goods and services. These intermediate goods imports fell back in 2002 by 5.5 per cent. An even bigger fall in capital goods imports of 7 per cent was registered. Imports of consumer goods, which accounted for 23 per cent of the total, increased by 1.5 per cent in nominal terms.

Machinery and transport equipment imports account for around half of total imports. As was the case with machinery exports, imports fell more sharply than any other sector in 2002, reflecting the on-going slump in the information technology industry worldwide. The value of imports in the two largest subsectors – electrical machinery and computer equipment – fell sharply, while the third largest subsector – road vehicles – continued to grow, even if the rate of increase was down on recent years.

Ireland’s very large trade surplus – second only to oil-exporting Norway in the OECD – continued to expand in 2002 despite the slowdown in the rate of export growth. This was attributable to the continued boom in pharmachem exports and the fall in most categories of imports. This latter development was accounted for mostly by a fall in industrial supplies imports. Lower growth in consumer demand was likely to have contributed, though to a lesser extent.

Overview: Trade in Services

According to the WTO, the dollar value of worldwide services exports grew by five per cent in 2002 after a slight decline in 2001. Although this rate of increase appears to be close to the long run average, much of the increase is likely to be attributable to a weakening dollar which increased the value of non-dollar transactions (the vast majority). Moreover, if inflation is factored in, real growth was lower still. This is unsurprising given the demand-depressing effects of sluggish global economic growth, in particular for business services which account for almost half of the total.

Specific challenges were also faced in 2002. These included: a still-depressed international tourism industry and difficulties in the wider travel and transport sectors (these sectors account for over half of all internationally trade services) owing to geopolitical instability and related increases in security measures.

As in the case of merchandise goods trade, the major economies and regions varied considerably in their services trade performances in 2003. In western Europe, which accounts for around half of the world’s trade in services, the rate of export growth outstripped that of imports, though the divergence was less sharp than in goods trade.

According to the WTO, Irish services exports grew far faster than any other of the top 30 exporters in the world in 2002, propelling Ireland to the top of the global league table of services exporters in per capita terms, from third place in 2001. In absolute terms, Ireland became the 18th largest exporter of services in 2002 (up from 21st place in 2001), a global ranking that is now higher than that of merchandise goods.
The value of Irish services exports increased by 14 per cent in 2002, to reach €29.9bn. Although this was half the increase in 2001, the performance was very strong considering sluggish global demand and, to a lesser extent, the appreciation of the euro. The CSO’s breakdown of the components of the services balance shows that the value of exports in all but one of the 11 named categories grew over that period.

The deceleration in the export growth rate registered in 2002 continued into 2003, when, in the first half of the year, the value of foreign services sales rose by a still-healthy 7.4 per cent, with growth in almost all categories.

Computers services exports remain the largest single component of overall services exports, accounting for more than a third of the total. Despite the slowdown in the industry globally and in Ireland, not least as reflected by goods trade, exports from the sector grew by one tenth in value in 2002. This does, however, represent a slowdown on the rate recorded in 2001 when the industry was largely affected by international developments.

Business services exports (in turn disaggregated into three sub-sectors: trade related, operational leasing and miscellaneous business services) are the second largest services export, accounting for around one sixth of the total in 2002. Since records began in 1998, business services exports share of the total has risen slightly as their growth rate of has been marginally ahead of the already-high average. In 2002, however, the rate of increase fell below the average, to a relatively low seven per cent.

In recent years exports of insurance services have been the success story of the wider services export industry (itself one of the Irish economy’s significant success stories). Indeed, so strong has growth been that this sector overtook tourism and travel in 2002 to become the third largest export category. Another boom year in 2002 saw exports grow by close to half to €3.8bn.

Services export growth to the EU, at 17 per cent, accounted for the lion’s share of total growth (these figures also suggest the increase was split quite evenly between the euro zone and the UK). The strong growth to the euro area also represents the continuation of a trend noted over the past five years. From the smallest of the three major markets in 1998-99, it is now the largest.

After growing at the fastest rate in the world in 2001, according to the WTO, growth in the value of Irish services imports slowed in 2002. However, at 12 per cent, this was only slightly below the fastest growing countries. In absolute terms Ireland remained the 11th largest importer, accounting for $2.50 of every $100 spent globally on services imports. In per capita terms, Ireland is by far the largest importer.

According to national figures, imports of services reached €42.8bn in 2002, an increase of 8.3 per cent and half the rate registered in 2001. In the first half of 2003, the rate of growth continued to slow, with imports of services up by a mere 1.8 per cent on the same period in 2002. The sharp deceleration is attributable largely to developments in goods exports.

Business services imports – dominated almost equally by the “trade related” and “miscellaneous” categories – account for close to half of total services imports. The former, which have more than trebled in value in just five years, are most directly linked to the export of manufactured goods, and as such saw a sharp deceleration of growth. Miscellaneous business services imports continued to grow at double-digit rates (11 per cent) in 2002, although even this strong rate on increase was well down on the previous year.
Spending by Irish residents on foreign travel and tourism, at almost €4bn, rose sharply (by over a quarter) in 2002, despite a slowdown in the rate of nominal private spending growth. The increase in foreign travel by Irish residents, which was far above the international average, caused the deficit on the travel and tourism account, first registered in 2001, to widen further in 2002.

Services imports sourced from the euro area were also the fastest growing of the three sources in 2002 by far, expanding by 22 per cent and accounting for considerably more than half of the total increase in services imports.

From a peak €13.9bn in 2000 (equivalent to an unusually large 14 per cent of GDP), the services deficit has since narrowed. In 2002, the deficit was €1bn off its 2000 peak and if the first half of 2003 is a reliable indicator for the full year, a further narrowing of the deficit can be expected for the year as a whole.

**Overview: Foreign Direct Investment**

The sluggish world economy was the main reason for the second consecutive year of contracting direct investment flows in 2002. Other factors contributing to the poor performance included: poor financing conditions globally and higher levels of general uncertainty owing to geopolitical developments.

The result of these factors in combination was that in 2002 the value of world FDI flows fell by 22 per cent, to just under $651bn, according to UNCTAD. Although this was the lowest level since 1997, the rate of decline was less than the 45 per cent decline registered in 2001.

In terms of regional performance, the EU saw only a slight drop in inflows in 2002 despite the region’s sluggish economy and concerns about its future growth prospects. If the UK is excluded, inflows to the EU actually rose. Although the US is historically by far the biggest destination for FDI, its shares of inflows collapsed in 2002 to one twentieth of the total, despite a weakening dollar which made assets relatively cheaper.

According to UNCTAD, inflows of FDI into Ireland rose to $19bn in 2002, an increase of more than a fifth on 2001, and the second highest level of annual inflows ever recorded. In a global and regional context this was exceptional, given that for the second successive year world-wide and EU flows fell. Ireland accounted for its highest ever proportion of global inflows, at almost 3 per cent of the total. As a result, the total stock of FDI in Ireland reached $157bn, the highest in the world in per capita terms after Hong Kong.

National data also show a recovery in total inflows, although to a much greater extent. FDI into Ireland, at almost €26bn, was two and half times greater than in 2001. This recovery continued in the first half of 2003, when inflows almost doubled over the same period in 2002. In both full year 2002 and the first half of 2003, the long run trend of relatively even split between IFSC and non-IFSC categories was maintained, although unlike the long run average, non-IFSC inflows were larger.

With the growing stock of FDI in Ireland, new foreign investment is increasingly accounted for by reinvested earnings of firms already located here. In 2002 this type of investment was by far the most important source of inflows. Bucking the trend in international M&A activity, this form of inflow grew by almost €1bn in 2002 to reach €11bn.

In 2002 inflows from the euro area continue to dominate overall inward investment, amounting to over two thirds of the total. In the first half of 2003 inflows from this source continued to surge, more than doubling year on year.
Non-EU investment (assumed to be mostly from the US) has also been highly erratic. Firms in the category disinvested massively in 2000-01, to the tune of €21bn, before an almost complete reversal in 2002, when inflows of €7.6bn were recorded. Counter-party data, from the US Department of Commerce, confirm these trends. According to these figures, US firms directly invested $4.9bn (€5.3bn) in Ireland in 2002. These data also confirmed the trend towards an increased emphasis on reinvested earnings.

According to UNCTAD, and in contrast to inward direct investment, outflows of FDI from Ireland collapsed to $2.7bn in 2002, to reach their lowest level since 1997. This fall, by more than half, was considerably sharper than either the global or EU averages and resulted in Ireland’s share of EU outward FDI falling from a percentage broadly proportionate to its GDP weighting, of 1.3 per cent of the total in 2001 to 0.7 per cent 2002.

According to national data outward flows also fell in 2002, but less sharply than the UNCTAD data suggest. Continuing a downward trend in evidence since 1999, outflows fell from €5.7bn in that year to €3.3bn in 2002. In 2002 alone, there was a decline of 28 per cent, which was slightly more pronounced than the global average. The first half of 2003 total FDI outflows, at less than €1bn, were a fraction of the €3.4bn registered in the same period in 2002.

In line with patterns in developed countries, equity FDI is the most important type of outflow, though its recovery in 2002 is likely to reflect, at least in part, the new phenomenon of IFSC ODI, rather than a sustained increase in Irish firms expanding their operations abroad by acquisition.

Irish investment outflows to non-EU (assumed to be mostly the US) increased to €2.1bn. Despite this, and the fact that FDI to non-EU locations were larger than to any other location in 2002, outflows fell far short of the very high levels recorded in 1999-2000 and no longer account for the overwhelming percentage of the total that they did in that period.

Counter-party data from the US Department of Commerce record the stock of direct investment owned by Irish residents at $26.2bn. This stock total is the fifth highest in absolute terms among the member states of the EU and accounts for three per cent of the total.

While outflows to the rest of the world fell sharply in 2001, this coincided with an increase in those to the EU from previously negligible levels. In terms of the destination of flows to the EU, investment in the euro area accounted for the lion’s share in 2001-02. It is undoubtedly the case that Irish firms are showing greater interest in the euro area and that their focus is shifting from the UK (in 2002, there was net disinvestment to the UK).
Merchandise Trade

2.1 Trends in Global Trade

Sluggish economic growth depressed trade in 2002...

Since the world economy slowed in 2000, global trade growth has been below trend, and although 2002 registered an acceleration over the previous year (trade volumes increased by 2.5 per cent after contracting by 1.5 per cent in 2001), the rate of increase was still below the average of the previous decade. The principal reason for still-sluggish trade expansion in 2002 was depressed growth in global GDP (trade is acutely sensitive to fluctuations in economic activity levels). The EU, which is by far the world’s most important source of import demand, saw domestic demand slow by 0.7 per cent in 2002. The volume of imports was, as a result, lower in 2002 than the previous year. The second largest source of demand, the US, accounted for most of the world’s import growth in 2002, as domestic demand grew at a rate of 2.9 per cent. Much of this, in turn, was related to an increase in stock-building. This development was also noted elsewhere in the developed world; having reduced OECD GDP growth by almost a percentage point in 2001, restocking by firms added 0.2 percentage points to economic growth in 2002. While economic turmoil in Latin America saw demand collapse, Europe’s transition economies and Asia both experienced strong growth. Of particular note was China’s continued economic boom, which again sucked in imports in 2002. Indeed, China’s domestic demand was so strong in 2002 that it alone accounted for one fifth of the global increase in imports.

The unusual nature of the global slump since 2000 has meant that the impact on different categories of traded goods imports has also been unusual. Unlike the downturns of the 1970s, 80s and 90s, when higher interest rates curbed private consumption, this decade’s slowdown has the result of the unwinding of over-investment in the late 1990s. The result has been that demand for, and hence trade in, capital goods has been reduced significantly, particularly in the sectors worst affected by overcapacity – electronics, semiconductors and IT hardware. That said, the downturn has also had an impact on trade in consumer goods as private demand has been depressed by low or negative employment growth, higher savings ratios in some countries and a negative wealth effect caused by falls in equity prices. While oil prices on average for the year were only slightly higher than in 2001, the recovery in non-oil commodity prices gave a boost to developing countries’ exports in value terms. Prices of food, feedstuffs and beverages rose by almost 13 per cent, while those of industrial raw materials increased by a much more modest 2.2 per cent.

…while economic and political uncertainty mattered, too

Apart from depressed global economic growth, other factors, both economic and political, also played a role in subduing trade growth in 2002 (although, even combined, these reasons are likely to have had less of an impact than low overall demand growth). Firstly, relevant economic factors included: greater currency instability; revelations of accounting scandals which undermined investor confidence; continuing poor financing conditions; and a second consecutive year of falling foreign direct investment flows. Second, increased political uncertainty is also likely to have worked against stronger trade growth. Following the terrorist attacks on the US in September 2001, security measures have been tightened, particular in the US, adding additional costs in money and time for movement of goods across borders. The knock-on effects of the heightened terrorist threat also included greater geopolitical uncertainty, as conflict in Iraq became increasingly likely during the course of 2002, eventually erupting in 2003.
### Table 1: Growth in the value of merchandise trade by selected region (% change)

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Source: World Trade Report 2003, WTO

**American exports slump, Asia’s boom**

The export, performances of the major economies and regions differed considerably from that of imports. In 2002, the US was the only major region to suffer a decline in the value of its exports. This development, despite a more competitive exchange rate, owed to weaker growth in its main markets. In the EU, the dollar value of exports in 2002 rose by 5 per cent, from stagnation in 2001, although in volume terms the increase was a mere 1.5 per cent. The difference is accounted for both by falling prices and an appreciating currency (the euro:dollar exchange rate averaged US$1:€0.94 in 2002 compared with US$1:€0.90 the previous year). The European transition economies and Asia saw the value of their exports rising in line with rates of increase over the past decade. China, and to a lesser extent India, the world two most populous states, saw foreign goods sales surge in 2002.

**No strong recovery in the first half of 2003, though Signals are positive**

National figures suggest that there was little acceleration in the rate of global trade growth for the first half of 2003 despite recovery from a shallow dip in economic growth in the second half of 2002. EU exports contracted year on year, most likely in response to the sharp appreciation of the euro, while US foreign goods sales increased only slightly. Most of the secondary factors relevant in 2002 continued to exert an influence in the first half of 2003, albeit to varying degrees. Most notable among these is the continued malaise that grips the largest European economies, particularly Germany and France, who despite fiscal stimuli (running budget deficits which exceed the Stability and Growth Pact) and monetary stimuli (historically low interest rates) continue to struggle to revive domestic economic confidence. Strong US Quarter 3 GDP figures, coupled with buoyant factory activity in October suggest that the US might be enjoying a late upswing in economic activity. Further, the Reuters Eurozone Purchasing Managers’ Index also rose, up from 50.1 in September to 51.3 in October, while Britain’s manufacturing sector expanded at its strongest rate in almost four years.

### 2.2 Ireland’s Merchandise Exports: Values and Volumes

**Pause in the export boom in 2002**

According to the WTO, Ireland’s rate of merchandise export growth in 2002, at seven per cent in dollar denominated terms, converged towards the world average after years during which it topped the global league table. As a result, Ireland advanced no further in the rankings of exporting nations, staying at 19th position in absolute terms. In per capita terms, however, Ireland extended its lead as
the largest exporter in world owing to near stagnant export growth in the second and third ranking countries, namely Singapore and Hong Kong1 respectively. When denominated in euro, the total value of Irish merchandise goods sold abroad increased by a mere 1 per cent2 to reach €93.7bn, the lowest rate of increase since 1990. In volume terms the performance was worse still, with a recorded increase of half a per cent.

The export performance deteriorated at a rapid rate over the 18 months from January 2002, with year-on-year growth in the first and second quarters giving way to declines in the value of exports from the third quarter, the magnitude of which accelerated into the first half of 2003, with the value of exports falling by 20 per cent over the same period in 2002. Moreover, the value of exports in every major goods category and into each of the biggest five markets declined year on year in the first six months of 2003. When price developments over the same 18 month period are stripped out, the picture changes slightly. In 2000-01, and into the first quarter of 2002, Irish export prices were rising at around 5 per cent, well above the international average and far above the EU average where traded goods prices having been falling since 2001. Quite abruptly, however, Irish export prices began to converge in the second quarter of 2002, and the first year on year fall in prices was recorded in June. Over the subsequent 12 months, the rate at which prices fell gathered pace and by the second quarter of 2003 export prices were 7 per cent lower than the same period a year earlier. As a result, the deteriorating export performance over this period, when measured by volume rather than value, was considerably less sharp. This is likely to have been even more so once the effects of large scale VAT fraud in the UK are stripped out3.

The turnaround in price developments suggests that Irish exporters are facing increased competitive pressures as domestic wage and non-wage costs have risen more sharply than in competitor economies and exchange rate movements have been unfavourable. However, that export prices have been cut may be suggestive of a competitive buffer built up in earlier years of very high productivity growth and subdued cost growth. That said, very considerable differences exist between the tight-margins, labour-intensive industries and the highly profitable, capital-intensive sectors (which enjoy the additional benefit of being insulated from exchange rate fluctuations to a considerable extent owing to high levels of intra-firm trade). Given the sharp decline in the number in employment in manufacturing, the aggregate trade data is likely to be masking the inability of the latter sector to deal with slowdown in key markets on the demand side and higher costs and an appreciating currency on the supply side.

Cyclical and structural changes effect exports

The onset of recession in the export sector was accounted for by a number of factors. First, depressed global demand as described in sections 2.1 and 2.4. A second (sectoral) reason for the stagnation in export growth was the continuing and protracted slump in the information, communications and technology (ICT) sector. As global over-investment in ICT equipment and systems in the late 1990s continued to unwind, demand for these goods fell sharply. While Irish exporter appeared immune to the worsening conditions in 2001, the full impact of the slump was felt in Ireland in 2002 when ICT exports fell to levels below both 2001 and 2000. The third factor negatively impacting exporters was the appreciation of the euro during 2002. Although when annual changes are considered, the appreciation was not sharp (average euro/dollar exchange rate rose by 5.5 per cent in 2002, while the euro/sterling rate rose by just under 2 per cent), the strengthening of the currency accelerated in the second half of the year and into 2003. A further mitigating factor is that a large proportion of export trade is likely to be accounted for by intra-firm exchange and, as mentioned above, is thus less susceptible to changes in the exchange rate.

1 Domestic exports only.
2 The discrepancy between WTO and national figures is explained largely by exchange rate movements.
3 In early 2003 the UK authorities uncovered a VAT fraud ring involving the false booking of exports and imports into and out of that country. The result is that trade figures prior to the discovery are likely to have been artificially inflated, distorting year on year comparisons.
A final explanatory factor relates to a structural shift taking place in the industry and the Irish economy more widely as an extended period during which high levels of new manufacturing capacity came on line has come to an end. This capacity expansion was partly reflected in the very high levels of fixed capital formation in the 1990s with investment growth rates of 14 per cent in 1999, stagnation in the 2001-2002 period and actual contraction in the first half of 2003. Moreover, given that the boom in residential housing construction (fixed capital formation data are not disaggregated) continued in 2001-03, spending on new plant and equipment is likely to have fallen quite considerably in that period. The ending of the capacity growth boom can also be seen in the lower levels foreign direct investment (see section 4.2)

2.3 Structure of Goods Exports by Composition

In 2002 a significant shift took place in the composition of Irish exports. The “chemicals and related products” sector continued to surge ahead, overtaking the recession-mired “machinery and transport equipment” industry to become the most important export sector. Although both categories saw exports decline year on year in the first half of 2003, it would appear that this change in the relative importance of the sectors is persistent. Indeed, this reversal may have occurred earlier than the figures suggest owing to the inflation of historical data on machinery exports owing to VAT irregularities in the UK (see footnote three).

A second pattern-shift noted in 2002 and the first half of 2003 was the ending of a trend towards greater concentration in the four main subsectors – office machines, organic chemicals, medical and pharmaceutical products and electrical machinery. The total share of these subsectors fell from 66 per cent in 2001 to below 60 per cent in the first half of 2003, reversing the trend illustrated graphically in Figure 1. However, it is likely that this represents a temporary reversal of the long run trend for two reasons. First, owing to the small size of the Irish economy there is a certain inevitability in having a narrow industrial base, particularly in relation to the number of large scale industrial sectors in which competitive advantage can be successfully built. Second, there is little to suggest that success is at hand in subsectors in which optimal firm size is small (e.g. machine tools). If anything, the reverse is true as traditional sectors (e.g. textiles) continue to experience structural decline while not being replaced by newer industries.
The pharmachem export boom reverses in 2003

2002 was yet another boom year for the pharmachem industry, with the value of exports increasing by more than a fifth to account for 42 per cent of all Irish goods sales abroad. Between 1995 and 2002, the value of chemicals exports rose almost six fold to just under €40bn. A breakdown of the 2002 data shows that the medical and pharmaceutical subsector again accounted for almost all of the growth in the overall sector as earnings increased by three quarters. This very strong growth in output is explained by the final spurt in new capacity coming on line in the industry. In the first half of 2003, the boom in the medical and pharmaceutical subsector went into reverse, with export sales lower than in the same period in 2002. Despite the expansion of medical and pharmaceutical exports in 2002, the largest industry export subsector remained organic chemicals. In the first half of 2003 the organic chemicals subsector also fell into recession, with sales declining by 21 per cent year on year, a rate of decrease considerably sharper than the medical and pharmaceutical subsectors.

Figure 2: Pharmachem Exports

Deep recession and VAT scam cause ICT exports to plummet

The ICT industry continued to founder in 2002-03 as investment spending on computer-related equipment by firms contracted across the developed world and beyond. According to industry sources cited by the WTO, global sales of electronic equipment and IT hardware fell by 5 per cent, while semi-conductor plant equipment spending declined by 20 per cent. As illustrated in Figure 3, the export performance of the Irish machinery and transport sector was, surprisingly, little affected by depressed global conditions in the industry in 2001. However, the full force of the recession was felt in 2002 when exports fell to €33bn, nearly €5bn down on 2001 and €1bn below 2000 levels.

Broken down by subsector, exports of computer equipment, at €17.5bn, accounted for the largest share of total export earnings, despite a sharp fall from their 2001 level. Although recession in this subsector was the reason for most of the overall decline, nearly all other subsectors also saw export earnings fall back. In the first half of 2003, the data show an even more precipitous decline, when a reduction of 40 per cent in foreign sales was registered. Although these data overstate the magnitude of the decline as VAT fraud uncovered in the UK (see footnote three) was concentrated in this sector, it is likely that the underlying performance continued to be badly effected by the on-going unwinding of the late 1990s investment bubble.

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4 Although there is little doubt that value added in the industry is very high, it is likely that transfer pricing accounts for at least some of this growth.

One of the difficulties in assessing Ireland’s economic performance is in providing an appropriate metric by which to track indigenous Irish producers. In effect, comparing the performance of Irish companies with Multi-National Companies (MNC) based in Ireland is not comparing like with like. Due to scale economies, some industrial sectors are dominated by a handful of very large MNCs which have the world market as their primary target, and supplying the domestic market is often of secondary importance. On the other hand the export industries dominated by indigenous firms – miscellaneous manufacturing and food – operate on tighter margins and the majority of their exports go to the UK market.

In 2002 the values of exports fell by 10 per cent to stand at €8.2bn in 2002 (lower than in 2000) but still accounting for one twelfth of the total. The first six months of 2003 saw exports stabilise over the same period in 2002. Given developments in both supply (continued high wage and price inflation and a much stronger euro) and demand (weaker growth in the UK), this was a creditable performance and leaves a question mark over whether the poor performance in 2002 was the result of a loss of competitiveness.

As can be seen in Figure 1, the food industry, which is dominated by processed foods, has suffered a decline in relative and absolute importance as the sector played no part in the export boom of the late 1990s (the value of this sector’s exports in 2002 was below the level of 1995). Although growth opportunities in this industry are low, it would appear that limited progress has been made taking advantage of those that exist, namely in new, higher value-added markets. In the first half of 2003, there was a further (slight) decline.

2.4 Destination of Exports

**VAT fraud appears to have overstated UK exports in recent years**

The geographical distribution of trade growth in 2002 was broadly in line with trends internationally and, with a few exceptions, did not shift significantly compared to recent years (see Figure 4). In 2002 the UK was the largest single destination for Irish exports according to national trade data, accounting for almost a quarter of the total value and amounting to €22.4bn, a slight decline on 2001. This headline rate masks a very steep decline during the course of the year, from growth of over 20 per cent in the first quarter of 2002 to an equally sharp downturn in the final quarter, a pattern that is
somewhat surprising given that the UK’s total imports remained largely steady over the course of the year as domestic demand actually strengthened in the second half of the year. Although the appreciation of the euro is likely to have had some impact on Ireland-based firms’ UK sales, it does not by any means explain the magnitude of the decline in exports in the second half of the year. While it is tempting to conclude that rising wage and non-wage costs are pricing Irish goods out of one of their most important markets, evidence from the lower-margin industries from the first half of 2003 suggest that this is not necessarily the case. Trade data for 2003 disaggregated by country do not give a reliable indication of year on year developments owing to the effects of the uncovering of a large VAT scam.

In 2002 the percentage of total exports accounted for by the UK was broadly stable when compared to recent years, after experiencing a relative decline over decades. However, the previously mentioned VAT fraud suggests that the stabilisation of recent years indicated by the trade data may have masked a continued underlying fall in the relative importance of the UK market. In the first half of 2003 exports to the UK accounted for just 18.3 per cent of the total, a share that if recorded for the full year will be an historic low.

Figure 4: Main Export Markets

![Figure 4: Main Export Markets](image)

**Euro zone exports continue to growing**

Western Europe, the world’s major trading zone and Ireland’s biggest market by far, saw import volumes stagnate according to the WTO, as economic growth slowed. That domestic demand was even lower resulted in depressed demand for foreign goods. Despite this, Ireland saw growth in exports earnings to the zone accelerate over 2001, to reach 7.8 per cent, or €35.6bn in 2002. However, the trend was reversed in the first half of 2003, despite a slight acceleration in EU domestic demand growth. Only two significant euro area markets – the Netherlands and Spain – increased their purchases of Irish-manufactured goods during the period, and in both cases the increases were small.

As was the case in 2001, developments with individual countries in 2002 were highly erratic, largely owing to shifts in the international production patterns of multinational firms, though this volatility showed signs of abating in the first half of 2003. The greatest swings were registered in exports to Belgium, now Ireland’s third largest single export market after the UK and the US. Merchandise goods sales to that country registered in excess of a threefold increase in 2002, but fell back by a quarter in the first half of 2003. Meanwhile exports to Germany, the fourth largest market, were almost halved in 2002 after a sharp one-off spike in 2001, but remained broadly stable in the January-June period of 2003. This is likely to be reflective of Belgium status as Europe’s leading entrepôt, and probably does not reflect changes in the destination of actual final demand.
Among the more unexpected developments in the Irish economy in recent years has been the relative decline in the importance of the euro zone despite the complete elimination of exchange rate risk at the beginning of 1999. Economic theory suggests that the removal of exchange rate risk with a given trading partner boosts commercial exchange by “creating” trade that would not have existed in a riskier environment and by “diverting” trade from economies still subject to exchange rate fluctuation. Exports to the euro area accounted for 38 per cent of the total in 2002, slightly up on 2001 but still well down on 1998 when the zone absorbed half of Irish exports. Despite the fall in export values in the first half of 2003, the euro zone percentage of the total rose slightly.

The US is now the biggest national market

The value of Irish exports to the US rose by 4.4 per cent, broadly in line with the size of market, to reach a total of €16.4bn in 2002. Although the highest increase of the top five markets after Belgium, this was a poor performance relative to the high double digit rates recorded of recent years (2001 included) and is the result of growth in US-owned manufacturing capacity falling back sharply. Cyclical factors helped to offset the effects of this structural change as US import growth accelerated over the previous year despite the appreciation of the euro vis-à-vis the US dollar from April 2002. Despite the dollar’s depreciation the US powered global import growth in 2002. A highly expansionary fiscal-monetary policy mix helped to ensure that domestic demand growth accelerated rapidly (from 0.2 per cent in 2001 to 2.9 per cent in 2002). In the first half of 2003 a marginal decline in the value of exports was recorded partly as a result of US import growth falling back. Accounting for around 20 per cent of total exports in 2001, 2002 and the first half of 2003 (a doubling since the mid-1990s) it is now likely that a plateau has been reached, for the foreseeable future at least, after a period in which the US share of Irish exports grew rapidly. Despite this, the recent revision of data on exports to the UK has meant that the US has become Ireland’s largest national market.

2.5 Ireland’s Merchandise Imports: Values and Volumes

Imports fall more sharply than exports

Ireland’s total import bill in 2002 was €55.5bn, a decline of 3.2 per cent on 2001. As was the case with exports, the value of imports turned sharply negative in the second half of the year, with a year-on-year decline of 12.6 per cent in the fourth quarter. The value of imports fell even more precipitously in the first half of 2003, when they were down by almost a quarter on the same period a year previously. Analysing price developments shows that after a small increase in 2001, import price inflation turned negative in 2002, with year on year declines recorded in every month of the year except February. In 2002 as a whole, import prices fell by 3.9 per cent, and the rate of decline accelerated slightly in the first half of 2003, to 4.3 per cent. Because import prices declined, the fall in the volume of imports was less sharp than when measured in value terms. However, regardless of whichever measurement is used, the fact remains that imports were very sharply down, particularly in the first half of 2003. As in the case of exports, the issue of VAT fraud accounts for a considerable amount of the more recent sharp decline. The next most important factor in 2003, and by far the most important factor in 2002, related to the high import-intensity of the large export sector, which means that trends in Irish imports have tended to mirror those of exports (see Figure 7).

One important and increasingly relevant exception notwithstanding, this remains the case, and as export growth fell back sharply, so too did imports. A final significant factor in the decline in the volume of Ireland’s imports was the slowing of domestic demand in general and a weakening of private consumption in particular, a development that was partly offset by the appreciation of the euro (a development which made goods from non-euro sources cheaper in local currency terms).

6 The lower import-intensity of the until-recently booming pharmaceutical industry (see figure 8 and discussion in section 2.7) is very low and as the industry’s output has boomed, leading to its growing significance to the overall export picture, this has led to a partial decoupling of the very close correlation that had existed between imports and exports.
As a result of the fall in imports in 2002, Ireland slipped back one place to become the world’s 26th largest importer in absolute terms according to the WTO. In per capita terms Ireland remained second in the world after Singapore. There are a number of reasons to explain this very high level of foreign goods dependency. First, being self-sufficient in few goods, having a narrow industrial base and not being endowed with abundant natural resources, Ireland imports most of what it consumes. Even more important is the aforementioned high import-intensity of the large export sector – inputs for further production accounted for a proportion of imports that is well above the average for developed countries.

2.6 Structure of Goods Imports by Composition

Imports of intermediate and capital goods declines in 2002

Disaggregated according to final use (consumer, capital and intermediate) import data show a number of unexpected developments. By far the largest category, accounting for three fifths of the total, are goods imported as inputs for the production of other goods and services. These intermediate goods imports fell back in 2002 by 5.5 per cent in value, a surprisingly sharp decline, given an increase in industrial production output of 7.7 per cent. An even bigger fall in imports of capital goods, down 7 per cent on 2001, was registered despite a slight acceleration in levels of fixed capital formulation – usually the principal determinant of capital goods imports. This probably reflects the ending of a protracted period of foreign firms building from scratch or adding to new manufacturing production capacity in Ireland. Developments in imports of consumer goods, which accounted for 23 per cent of the total, increased in value by 1.5 per cent in nominal terms, well below the 4 per cent nominal increase in retail expenditure, suggesting a switch to Irish goods by consumers.

BOX 1: The Multilateral Trading System

A Post War Success Story …

The General Agreement on Tariffs and Trade was born in 1947, and established the general rules that were to become the cornerstone of post-war trade negotiations, those of multilateralism and non-discrimination. This meant that trade liberalisation for one would become trade liberalisation for all, and established, for the first time, an ongoing institution dedicated to the reduction of barriers to trade throughout the world. The average tariff imposed by the United States declined by nearly 92 per cent over the 33 years from the Geneva Round of 1947 to the Tokyo Round of 1974-79. From 1953 to 1973, world real GNP grew at an average rate of 4.7 per cent, and world trade at a rate of 7.5 per cent per year.

The trade liberalisation that occurred post-WWII can largely be accredited with the expansion in trade, which in turn can explain some of the subsequent economic prosperity. Intra-industry trade became very important in the post-World War II era. World trade became not the exchange of coffee for washing machines, but the exchange of small cars for large cars, or of high-priced silks for moderate-priced synthetics. The post-World War II industrial world was populated by a large number of firms making differentiated products, and then selling these products worldwide. The added scope of the market allowed for a greater division of labor, consumers’ choice, and in productivity. Moreover, the overwhelming predominance of economic evidence has documented a strong link between trade liberalisation and economic performance.

In November 2001, a new round of multilateral trade negotiations was launched under the auspices of the World Trade Organisation in Doha, Qatar. Called the “Development” Round, the talks, which have an end-2004 target date for completion, have as their objective the further freeing of trade in a manner that would boost global economic growth and, in particular, benefit developing countries.
Despite agreement on an agenda and timetables achieved in a spirit of compromise in the immediate aftermath of the September 11th terrorist attacks on the US, underlying tensions quickly resurfaced. The talks became increasingly acrimonious, with deadlines missed repeatedly in the run up to September 2003 ministerial conference in Cancun, Mexico.

The objective of the Cancun meeting was to return the talks to schedule by agreeing modalities for the completion of negotiations at the end of 2004, though these in turn collapsed. The failure of the meeting to meet any of its objectives, in line with the very slow pace of progress since the last trade round was a greed almost a decade ago, appears curious given that the intellectual case for free trade has never been more widely accepted and given the almost complete consensus among trade economists that multilateral trade agreements are the most effective way of boosting economic growth. To understand the collapse of the Cancun meeting, and its wider context, four underlying trends in multilateral trade liberalisation can be considered.

**The emergence of bilateral and regional deals:** The WTO noted in its 2003 World Trade Report that “many countries seem to be taking the multilateral trading system for granted, while pursuing their commercial interests on a preferential basis in the belief that this will not jeopardise multilateral, non-discriminatory trade relations”. There is a lot of disagreement as to whether regionalism causes weakness in the multilateral approach, or whether it grows from an understandable frustration as to the (lack of) progress at the WTO. Large controversy also remains over the economic value of these agreements – on the one hand they are economically sub-optimal to multilateralism, though on the other their proponents argue that such disagreements do not crowd out multilateral agreements, but rather provide an alternative in the face of multilateral lethargy.

**The absence of leadership:** Since its foundation, the US has been the country to drive the multilateral freeing of trade. From its offering of non-reciprocal access to the US market in the early days of the GATT, to its long-time refusal to engage in bi-lateral or regional trade deals, the US gave primacy to multilateralism. However, the US policy stance has since shifted to finding alternative routes to liberalisation, largely due to frustration with the lack of progress at the WTO. This is evidenced by the signing of the Nafta agreement with Canada and Mexico a decade ago, and has continued in 2003 with the negotiation of bilateral deals with Chile and Singapore. However, the continued commitment of the US to the WTO, not to mention the importance of US leadership to the multilateral system, was shown by the impetus given by the USTR to the Doha round in early 2004, which looks likely to reinvigorate the Doha round.

**More assertive developing countries:** The eclipse of the Cairns Group and the emergence of the G21+ (a loose coalition of developing nations), allied with the ACPs on matters related to agriculture, has opened a clearer cleavage between developed and developing countries. Greater cohesion among the developing countries on this issue, reinforced by their more assertive stance, has made negotiations more fraught. An additional factor bolstering the developing countries has been the assistance given to then by (usually) western non-governmental organisations (NGOs). However, a downside to this is that many of the NGOs are ideologically opposed to free trade and may have encouraged some countries to overplay their hand (by any rational calculation ACP opposition to transparency measures did not appear in their own interests).

**Increasingly unwieldy WTO structures**

Compared to the GATT, the WTO is far bigger, with membership growing rapidly in recent years to 148 countries. Unlike other multilateral institutions of similar size, such as the IMF, the WTO does not weight voting power in any way and every member country wields identical veto power. This arrangement combined with the sheer size of the organisation and the complexity and breadth of the agenda has made negotiation increasingly difficult and reaching agreement even more so.
Machinery imports fall sharply

Machinery and transport equipment imports account for around half of total imports. As was the case with machinery exports, imports fell more sharply than any other sector in 2002, reflecting the on-going slump in the information technology industry worldwide. The value of imports in the two largest subsectors – electrical machinery and computer equipment – fell sharply, while the third largest subsector – road vehicles – continued to grow, even if the rate of increase was down on recent years.

Continued growth in this subsector reflects lower (but still positive) private spending growth. Mirroring export patterns almost exactly, the fall in the value of this sector’s imports in the first half of 2003 reached 39 per cent. This was caused mostly by a collapse in imports in the electrical machinery subsector, the value of which stood at a third of the level in the year earlier period. As in the case of exports, this was related to a considerable extent to the uncovering of VAT fraud. The computer subsector also continued to languish, with the value of imports again falling by 10 per cent. Reflecting the continued deceleration in private consumption growth, imports of road vehicles fell in the first six months of 2003. The appreciation of the euro is likely to have offset to some degree at least the decline in imports.

Figure 5: Imports of Machinery and Transport Equipment

Although all other import categories each account for relatively small proportions of the total, the chemicals and related products import category is worth special mention: because it was the only category to grow significantly in 2002; because it is the second largest (accounting for one eighth of the total); and because its correlation with the corresponding export sector is so unusual. In 2002, imports of pharmachems rose by over 10 per cent in value terms to reach almost €7bn, while in the first half of 2003, imports remained almost unchanged on the same period in 2002, a pattern quite different from the export side of the industry. While the broad chemicals and related products category has been the exporting phenomenon of recent years, increasing almost six fold since 1995, imports registered little more than a two fold increase over the same period. In absolute terms, imports of pharmachems are a mere sixth of exports. A number of factors explains this. First, the import-intensity of Irish pharmachem exports is lower than other industries. Second, the valued added in the export sector is unusually high. Finally, and not unrelated to the second point, it is also possible that the phenomenon of transfer pricing may be particularly relevant to this sector.
2.7 Origin of Imports

**UK penetration of import market at all-time low**

The UK was Ireland’s largest source of import in 2002, accounting for 36 per cent of the total, at €20bn. This, however, represented a 3 per cent drop on the previous year, a decline accounted for largely by the fall in the import bill for oil, most of which is sourced from the UK’s North Sea fields. Although far less significant, the decline in consumer spending during the course of the year almost certainly effected UK imports. It is also likely that industrial goods imports by indigenous industry, which are sourced mostly from the UK, were down as the data suggest that Irish-owned firms cut output. The weakening of sterling against the euro during 2002, which made UK goods cheaper, may have lessened the impact of this.

As in the case of exports, the UK VAT fraud distorted considerably that country’s trade relations with Ireland, and it now appears as if the halting of the long term decline of the UK’s share of the Irish market in recent years has not, in fact, taken place. The most recent data, relating to the first half of 2003 were collated after the fraud was uncovered and show a precipitous decline over the same period in 2002. At €7.1bn, UK imports accounted for just over 30 per cent of the total in the first half of 2003 – a percentage, if registered for the year as a whole, will be an all-time low.

**No premium yet from euro adoption**

Imports from other euro area countries declined year on year by 3.7 per cent in 2002 and by a much sharper 16 per cent in the first half of 2003. While the euro area’s share of the total value of imports remained largely unchanged on the previous year, at 21.5 per cent (and 22.8 per cent in the first half of 2003), the share is broadly in line with the level over in the three decades since Ireland joined the then EEC (now EU). Even when the impact of the overstatement of UK imports prior to the VAT scam is allowed for, the euro area share of imports remains surprisingly low given the absence of exchange-rate volatility since January 1999. As such, there appears to have been little fundamental change in the pattern of sourcing of imports. Moreover, the appreciation of the euro is likely to make sourcing from other regions more attractive going forward, particularly during a period when cost control will become a matter of survival for many firms.

**Figure 6: Origin of Merchandise Imports**

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7 Economic theory suggests that the elimination of exchange rates risk results in increased commercial exchange both in terms of trade creation and trade diversion
As was the case for the euro zone, imports from North America remained steady as percentage of the total in 2002 when compared with 2001. The total value of imports from the US declined year on year by 2.3 per cent, to €8.5bn. In the first half of 2003, the US again saw purchases of its goods fall sharply, in this case by more than a quarter, despite the boost that a weaker euro gave dollar-priced goods (further evidence to suggest the exchange rate developments have only limited effect on Ireland-US trade owing to the importance therein of intra-firm exchange). Despite the fall, the US remained by a considerable distance the second largest source of imports, accounting for 15 per cent of the total in the first half of 2003.

As China continued rapidly to grow its share of world trade, its penetration of the Irish market increased by more than a third to make it the country’s seventh largest supplier. The rate of growth accelerated in the first half of 2003 to 50 per cent, making it Ireland’s fifth most important source of imports. Japan also increased its share of the Irish market in the first half of 2003 to become the fourth largest source of imports. Together, these two Asians economies accounted for almost 9 per cent of all imports.

2.8 Trade Balance

Ireland’s very large trade surplus – second only to oil-exporting Norway in the OECD – continued to expand in 2002 despite the slowdown in the rate of export growth (see Figure 7). This was attributable to the continued boom in pharmachem exports and the fall in most categories of imports. This latter development was, in turn, accounted for mostly by contracting industrial supplies imports. Lower growth in demand for consumer goods was also likely to have contributed, albeit to a lesser extent. In the first half of 2003, the seemingly ever-widening surplus contracted sharply year on year owing largely to a fall in pharmchem and office equipment exports (the impact of the uncovered VAT fraud had little effect on the trade balance as the import and export revisions cancelled each other out).

Figure 7: Trade Balance
Trade in Services

3.1 Global Developments

Services trade rebounded in 2002, but not by much

According to the WTO, the dollar value of worldwide services exports grew by five per cent in 2002 after a slight decline in 2001. Although this rate of increase appears to be close to the long run average, much of the increase is likely to be attributable to a weakening dollar which increased the value of non-dollar transactions (the vast majority). Moreover, if inflation is factored in, real growth was lower still. This is unsurprising given the demand-depressing effects of sluggish global economic growth, in particular for business services which account for almost half of the total. Specific challenges were also faced in 2002. Specifically, a still-depressed international tourism industry and difficulties in the wider travel and transport sectors, which account for over half of all internationally trade services, owing to geopolitical instability and related increases in security measures.

As in the case of merchandise goods trade, the major economies and regions varied considerably in their services trade performances in 2003. In western Europe, which accounts for around half of the world’s trade in services, the rate of export growth outstripped that of imports, though the divergence was less sharp than in goods trade. The value of US services exports, in stark contrast to goods exports, returned to positive territory, while imports soared into double-digits, again reflecting the sharp acceleration in domestic demand in that economy. Although trade in services tends not to be as sensitive to fluctuations in GDP as is the case for merchandise trade, Asia’s trade in services swung from contraction in 2001, to growth in 2002, as the region’s economy recovered.

In 2003, the same influencing factors continued to play a role, with security and stability concerns moving to the forefront in the run-up to conflict in Iraq, which began in March. Although these abated as quickly as formal hostilities ended, they are likely to continue to have had an impact on the internationally-traded services sector over the remainder of the year.

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<td>Latin America</td>
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Source: World Trade Report 2003, WTO

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8 Although data on services prices and volumes are not produced, services sector inflation is usually well ahead of manufactured goods, largely because the wage component of services tends to be higher.

9 This includes intra-EU trade.
3.2 Irish Services Exports by Values

Ireland becomes biggest per capita exporter in 2002

According to the WTO, Irish services exports grew far faster than any other of the top 30 exporters in the world in 2002, propelling Ireland to the top of the global league table of services exporters in per capita terms, from third place in 2001. In absolute terms, Ireland became the 18th largest exporter of services in 2002 (up from 21st place in 2001), a global ranking that is now higher than that of merchandise goods. In terms of world market share, Ireland accounted for 1.7 per cent of the total in 2002, higher that the country’s share of global goods exports, which stood at 1.4 per cent.

Figure 8: Exports of Goods and Services Compared

The rate of export growth slows into 2003

The value of Irish services exports increased by 14 per cent in 2002, to reach €29.9bn. Although this was half the increase in 2001, the performance was very strong considering sluggish global demand and, to a lesser extent, the appreciation of the euro. It is also noteworthy that, as was the case over the previous four years, services exports again expanded even more rapidly than goods exports (see Figure 8). Moreover, the CSO's breakdown of the components of the services balance shows that the value of exports in all but one of the 11 named categories grew over that period. The across-the-board growth in 2002 was in line with developments in earlier years and has resulted in a broadly stable structure of services exports, as is illustrated in Figure 8. The deceleration in the rate of export growth registered in 2002 continued into 2003, when, in the first half of the year, the value of foreign services sales rose by a still-healthy 7.4 per cent, with growth in almost all categories, albeit at varying levels.

Although a breakdown in terms of services exports by firm ownership for 2002 is not yet available, it is likely that strong growth in both indigenously and foreign-owned firms contributed to the overall expansion as has been the case in recent years. The exports of internationally traded services produced by indigenous Irish firms has increased six fold in nominal terms since 1990 and now accounts for around 20 per cent of aggregate indigenous Irish exports. Although the latter accounted for more than three quarters of the total services in 2001, the gap is narrowing as home-grown services sector exports have grown even more rapidly than those of foreign firms in recent years. As discussed below in relation to outward direct investment, Irish services firms have been internationalising rapidly in recent years. This is particularly the case in the software\textsuperscript{10} and pharmaceutical/biotechnology industries. Irish headquarters are now likely to be providing their overseas affiliates the same range of high value-added management services that foreign-owned firms have long provided their Irish subsidiaries\textsuperscript{11}.

\textsuperscript{10} Although enduring a sustained downturn, the indigenous information, communications and technology (ICT) sector has grown exponentially over the past decade and now employs 18,000.

\textsuperscript{11} Foreign investment by Irish firms may also an export-depressing effect. This is because the market in which the investment is located is more likely to be served by the affiliate in situ, rather than by exports from the parent company in Ireland.
It may be that the indigenous industry has reached critical mass in some sectors. As regards the foreign-owned sector, its increase in services exports can be partially explained by the changing profile of operations in Ireland. A number of these companies have located their regional headquarters in Ireland and these are increasingly likely to provide services to their sister companies in Europe and elsewhere.

For both indigenous and foreign firms alike, the sharp fall in corporation tax to 12.5 per cent in recent years is likely to have been a significant factor in expanding capacity as the level of after-tax profits is one of the most important factors in determining investment. It has also levelled the playing field between the manufacturing and services sectors, the former having been incentivised in the past by special low rates of corporation tax. This can at least partially explain the Irish economy’s unusually large manufacturing sector.

3.3 Structure of Services Exports by Composition

Exports of computer services slow, but remain strong

Computers services exports remain the largest single component of overall services exports, accounting for more than a third of the total (see Figure 9). Despite the slowdown in the industry globally and in Ireland, not least as reflected by goods trade, exports from the sector grew by one tenth in value in 2002. This does, however, represent a slowdown on the rate recorded in 2001 as the industry was affected by international developments, particularly the slowdown in ICT related investment. Moreover, current levels of growth may be explained mostly by a phenomenon noted in recent years whereby software exports are reclassified from the merchandise account to the services account as electronic transmission (via the Internet and email) replaces tangible formats, such as CD-ROM and software embedded in hard drives. The rate of increase in 2002 was little changed in the first six months of 2003, suggesting that a bottom may have been reached in the industry’s three-year downturn.

Figure 9: Composition of Services Exports

Exports of business services buck the overall trend in 2002-03

Business services exports (in turn disaggregated into three sub-sectors: trade related, operational leasing and miscellaneous business services) are the second largest services export, accounting for around one sixth of the total in 2002. Since records began in 1998, business services exports share of the total has risen slightly as their growth rate of has been marginally ahead of the already-high average. In 2002, however, the rate of increase fell below the average, to a relatively low seven per cent. Moreover, this increase was accounted for by a €384m hike in trade-related services exports,

12 With the exception of firms based at the IFSC, which for long enjoyed a special low 10 per cent rate of corporation tax.
from previously negligible levels. This development is most likely to have been a one-off given that the surge took place in a single quarter. However, it may be accounted for by the apparent emergence of a trend, as described above, for foreign multinationals based in Ireland to sell services to their sister companies in Europe and beyond. In the first six months of 2003 the rate of business services export growth surged to 16 per cent. Unlike 2002, the miscellaneous sub-category (the largest) accounted for most of the growth.

In recent years exports of insurance services have been the success story of the wider services export industry (itself one of the Irish economy's significant success stories). Indeed, so strong has growth been that this sector overtook tourism and travel in 2002 to become the third largest export category. Another boom year in 2002 saw exports grow by close to half, to reach €3.8bn. That the rate of increase was far ahead of the growth rate of imports of insurance services suggests that export growth is not explained merely by higher premia internationally (a phenomena noted after the September 11, 2001 terrorist attacks), but that the capacity of the internationally-traded segment of the insurance industry in Ireland is growing rapidly. This is linked to the entry into the Irish market of 27 "captive" insurers in 2001. There was no such addition to the industries output capacity in the first half of 2003 and, as such, a sharp deceleration in the rate of export growth, to 8.5 per cent, was registered.

**BOX 2: The Spanish Economy**

Spain is now the fifth largest market in the EU, of which it has been a member since 1986, and the fourth largest in the euro area, of which it has been a member since the currency was launched in 1999. The relatively fast growth rates of Spain and the fact that further catch-up growth can be expected (per capita income is still only 83 per cent of the EU-15 average) would suggest that there is scope for the strong growth in bilateral trade in recent years to intensify.

**Economic Background**

As was the case with Ireland, Spain did not participate in the post-WWII opening of global trade, preferring instead to remain on the path of autarkic self-sufficiency. As was also the case in Ireland, this stance became increasingly untenable in the 1950s as the economy stagnated and joblessness and emigration grew. In response, the economy was opened gradually, triggering an unleashing of pent-up dynamism – in the 1960s, GDP growth accelerated strongly, averaging 7.3 per cent over the decade. This was far above the EU (and Irish) average. The economy slowed sharply with the onset of the oil crises in the 1970s, and growth remained below potential until 1986, when Spain entered the then European Community. Domestic demand boomed after accession, widening the already large structural current account deficit. This period of unsustainable growth ended in a sharp economic correction in the first half of the 1990s.

From the mid-1990s export-led growth and the confidence-boosting effect of fiscal consolidation (in order to qualify for euro adoption) triggered another boom. This strong expansion facilitated some politically painful liberalisation of product, capital and labour markets, which, in turn, helped to raise the non-inflationary growth potential of the economy. Unemployment fell from 24 per cent in 1994 (by far the highest in the EU) to 11 per cent in 2002. The moves towards EMU participation proved especially beneficial for Spain. An historically weak currency had made it vulnerable to exchange rate crises in emerging markets much further afield. This had the effect not only of increasing uncertainty generally, but also of pushing up interest rates for both private and public sector borrowers. Once on the guide path for euro adoption, interest rates fell sharply, triggering an investment boom. The dramatic narrowing of yield spreads also eased the burden of fiscal retrenchment.
In the post-euro period, Spain has been by far the fastest growing of the large EU economies and has managed to continue to enjoy growth in excess of 2 per cent per annum in recent years despite the global slowdown. However, in yet another parallel with Ireland, credit growth remains very strong, and property prices have risen only slightly less sharply than in the Republic (Central Banks in both countries became increasingly concerned about the level of private indebtedness towards the end of 2003). It has been argued that while adoption of the euro has brought major long term benefits for Spain, because it accounts for only about 9 per cent of total euro area GDP, conditions in the domestic economy have little bearing on ECB decision-making and that this has meant inappropriately loose monetary conditions.

Bi-lateral economic relations
Trade data from the CSO show that exports to Spain have grown strongly over two decades. From €141m in 1985, Spain’s accession to the EU appears to have triggered a surge in exports, which reached €364m by 1989. As the trade-creating/diverting effects of accession wore off, and the Spanish economy fell into recession, the rate of increase was more subdued in the first half of the 1990s. A relaunch occurred in the second half of the decade as Ireland’s export boom coincided with the boom in the Spanish economy, causing the value of exports to increase by almost 150 per cent in the four years to 2000. The removal of exchange rate instability after the creation of the euro in 1999 appears to have had little impact. Indeed, the rate of increase slowed considerably in the two years after the launch compared to the two years before, despite identical rates of economic growth. In line with a slowdown in the wider economy, export growth rates fell off in the 2001-02 period, with sales of Irish goods at €2,231m in 2002. This is equivalent to 2.4 per cent of total exports. More significant perhaps is that these sales amount to 6.6 per cent of sales to the euro area. Given that Spain accounts for just under a tenth of total euro area GDP this suggests that there is considerable scope to increase exports to Spain closer to the average for other euro area countries.

Figures from counter-party sources allow Ireland’s share of the Spain’s market to be calculated. According to the Spanish statistics office, Instituto Nacional de Estatisticas, Irish goods sales in Spain are higher than suggested by CSO figures (the gap in 2002 was more than a quarter of a billion euro). Market share rose from of 0.9 per cent of total imports in 1993 to 1.2 per cent in 1997 (when a very large increase of more than 50 per cent occurred). Strong growth continued until recently, although Irish and Spanish data show slightly differing trend. Irish goods accounted for slightly more than 1.45 per cent of Spain’s total goods imports in 2002.

These same counterparty data also offer a more detailed breakdown than CSO data, and provide an insight into the composition of goods imported from Ireland. Irish good sold in Spain are accounted for mainly by three categories of goods: “chemical products”; food, beverages and tobacco; and “electrical equipment and informatics”. Reflecting the boom in the pharmachems industry in Ireland, this category of goods has come to dominate Irish exports from Spain, rising from 39 per cent in 2001 to more the half the first eight months of 2003. Somewhat surprisingly perhaps, the more traditional sectors related to processed and unprocessed foods, live animals, drink and tobacco, when aggregated, are the second largest category of Irish goods sold in Spain, having overtaken the recession-hit electrical machinery sector in 2002. The latter accounted for just over one tenth of the total in the first eight months of 2003, half the full year proportion in 2001.

Although the trade balance with Spain is heavily in Ireland’s favour by a ratio of about 3:1, penetration of the Irish market by Spain has increased in recent years (albeit from a very low base). In the four years to 2000, the value of Spanish goods sold in Ireland increased by 250 per cent to reach €883m, although there has since been a slight reversal. Reflecting Spain’s position as Europe’s third largest carmaker (after Germany and France) and the world’s fifth biggest; transport vehicles are by far the largest Spanish export to Ireland, accounting on average for more than a third of the total in recent years.
Tourism grows despite difficulties

Although nominal receipts from foreign tourists rose by more than 40 per cent in the five years from 1998, their relative importance in overall services exports almost halved over the same period, to just over a tenth of the total. This is indicative of the slower-growing nature of what is a mature industry compared to many internationally-traded niches of the business and financial services sector. Despite yet another difficult year in the tourism industry in 2002, receipts grew by 4.4 per cent. This was a deceleration on the previous year, owing both the slower economic growth and the effects of terrorism fears. It was, however, a creditable performance given that tourist arrivals in western Europe barely rose in 2002 according to the World Tourism Organisation. The year on year rate of increase slowed further in the first half of 2003, to just 2 per cent, to a considerable extent owing to the effects of the conflict in Iraq (and the prospect of conflict, which if anything, had a greater effect). Transatlantic business travel and tourism were likely to have accounted for nearly all the slowdown as there is no evidence to suggest that intra-European travel was effected.

Financial services exports, now the fifth largest category, surged by nearly 40 per cent in value in 2002. Statistics relating to this subsector have been subject to particularly large revisions and, given difficult conditions in the industry globally, it may be that the increase in the sector was overstated. Data relating to the first six months of 2003 show that the sector’s exports grew by 6 per cent, a rate of increase more in line with developments internationally.

3.4 Destination of Services Exports

Data on export markets is limited

Services trade data are disaggregated in two ways only: with EU countries or non-EU countries (the latter being described here are the rest of the world, or RoW); and with the euro area or non-euro area, a breakdown that offer a quite limited picture of the direction of services trade. In analysing these data, two broad assumptions are made. First, that RoW trade is accounted for mostly by the US. Second, that the difference between EU and euro area trade is almost entirely accounted for by the UK. Sweden and Denmark are the only other countries in this category and merchandise trade data suggest that neither country is a major market for services exports. Applying these assumptions to the data, it appears as if the destination of Irish services exports is greatest in the euro zone, the US and the UK, in that order.

Latest CSO balance of payments, which were revised significantly in September 2003, show that in 2002, services export growth to the EU, at 17 per cent, accounted for the lion’s share of total growth (these figures also suggest the increase was split quite evenly between the euro zone and the UK). The strong growth to the euro area also represents the continuation of a trend noted over the past five years. From the smallest of the three major markets in 1998-99, it is now the largest (see Figure 10). Two possible explanations suggest themselves. First, that foreign-owned firms in Ireland are increasingly providing services to their sister companies in Europe. Second, that the elimination of exchange rate fluctuations has had a greater trade-creating effect on services trade than is the case for goods trade (services imports from the euro area have also been the fastest growing source since 1998). In the first half of 2003, export growth to the euro area slowed sharply.

Services sales to the UK were only slightly higher than in the year earlier period. This may mean that the impact on exports to the UK of the appreciation of the euro vis-a-vis sterling is considerable and has a greater effect than the appreciation vis a vis the dollar. Despite the strength of the US economy, Irish export growth to the RoW slowed to 8.4 per cent in 2002. However, the trend was reversed in the first half of 2003 when the value of exports to the RoW accelerated (to 13 per cent). The developments in 2002-03 run counter to what would be expected given both exchange rate and domestic demand developments.
3.5 Services Imports by Value

Growth of services imports slows

After growing at the fastest rate in the world in 2001, according to the WTO, growth in the value of Irish services imports slowed in 2002. However, at 12 per cent, this was only slightly below the fastest growing countries. In absolute terms Ireland remained the 11th largest importer, accounting for $2.50 of every $100 spent globally on services imports. In per capita terms, Ireland is by far the largest importer, purchasing almost twice the value of services per person of nearest rivals – Singapore and Hong Kong. These very high levels of foreign services purchases means that close to half of total imports are accounted for by services.

According to national figures, imports of services reached €42.8bn in 2002, an increase of 8.3 per cent and half the rate registered in 2001. In the first half of 2003, the rate of growth continued to slow, with imports of services up by a mere 1.8 per cent on the same period in 2002. The sharp deceleration is attributable largely to developments in goods exports. The main reason for Ireland’s unparalleled consumption of foreign services relates to the importance of foreign-owned exporters operating in the country. These multinational manufacturing firms purchase services from, and pay royalties to, their parent companies abroad in proportion to the volume of goods they export. It should be noted that the relationship between services imports and goods exports is non-linear as the latter have grown more rapidly than the former over the past five years. Therefore, as overall merchandise exports growth declined in 2002-03, so too did the increase in imports of services. A likely explanation for the imperfect correlation is the increasing ability of indigenous firms to provide import-substitution services as the sector becomes more sophisticated and critical mass is achieved. Another factor explaining the decline in the rate of import growth relates to overall levels of demand in the domestic economy. Final domestic demand (total domestic demand less stock changes) decelerated from five per cent in 2001 to 3.5 in 2002, before contracting in the first half of 2003 compared to the year-earlier period, developments which are in line with import growth patterns.

13 If anything, these data are likely to understate the value of purchases of services from abroad owing to the phenomenon of transfer pricing whereby multinational firms book as much of their global profits in low corporation tax jurisdictions. Among other ways of achieving this, affiliates in low tax countries minimise purchases from sister companies in areas of higher corporation tax in order to increase the proportion of worldwide profits in the jurisdiction with the lowest rate of corporation tax.

14 The discrepancy with the WTO dollar-denominated figure is likely to be accounted for by exchange rate fluctuations.
3.6 Composition of Services Imports

Business services imports follow the average down

Business services imports – dominated almost equally by the “trade related” and “miscellaneous” categories – account for close to half of total services imports (see Figure 11). The former, which have more than trebled in value in just five years, are most directly linked to the export of manufactured goods, and as such saw a sharp deceleration of growth, in line with developments in goods exports. It is also likely to reflect a shift in the structure of goods exports. In recent years pharmachem exports have become the most important single export. Given that their trade related costs are lower than other manufactured goods, owing to their very high value to volume ratio which means costs of getting them to market are lower. Miscellaneous business services imports continued to grow at double-digit rates (11 per cent) in 2002, although even this strong rate on increase was well down on the previous year, reflecting the general slowdown in activity in the Irish economy affecting both export and domestic sectors. In the first half of 2003 import growth of business services came to an effective halt, reflecting the contraction in goods exports. Both trade related and miscellaneous subcategories stagnated.

Royalty and license payments to non-residents are the second largest services import, accounting for a quarter of the total in 2002 (broadly in line with earlier years). The pattern of these payments is similar to that of business services – foreign-owned firms pay their parent companies for the rights to manufacture goods in Ireland. As a result there has tended to be a close correlation between these payments and the export of manufactured goods. While this was the case in 2002, when the value of R&L payments growth decelerated to just under 4 per cent, an increase to nearly 5 per cent in the first half of 2003 was registered despite negative developments in merchandise exports. This may be accounted for a lag between payment and manufacture.

Figure 11: Composition of Imports by Major Category

Foreign travel spending soars

Spending by Irish residents on foreign travel and tourism, at almost €4bn, rose sharply (by over a quarter) in 2002, despite a (slight) slowdown in the rate of nominal private spending growth. The increase in foreign travel and tourism expenditure be Irish residents, which was far above the international average, caused the deficit on the travel and tourism account, first registered in 2001, to widen further in 2002. Although the rate of increase decelerated in 2003, spending on tourism
still increased by 11.6 per cent over the same period in 2002, reflective of spending developments in the wider economy. That said, it appears that even though the rapid increase in incomes growth in recent years has abated, the appetite for increased foreign travel is far from satisfied. This is can be explained primarily by shifts in consumer preferences, with lower airline fares, increased seat capacity and a wider range of direct-flight destinations also likely to have played a part. Strong growth has ensured that travel and tourism spending has remained largely unchanged as a percentage of the total, accounting for around one tenth over the past five years (see Figure 11).

In line with developments internationally in the insurance industry, payments to foreign insurers rose by nearly 30 per cent in 2002. This increase is likely to be almost entirely the result of the higher premia globally in the wake of the September 11th 2001 terrorist attacks. This strong increase means that, insurance imports consolidated their position as the fifth largest import in 2002, after overtaking those of financial services in 2001. In the first half of 2003, however, imports contracted, possibly explained by the base effects of the sharp hikes in premia in early 2002.

3.7 Origin of Services Imports

*Euro-area imports continue to boom*

Services trade data are disaggregated in two ways only: with EU countries or non-EU countries (the latter being described here are the rest of the world, or RoW); and with the euro area or non-euro area, a breakdown that offer a quite limited picture of the direction of services trade. In analysing these data, the same two broad assumptions made in the case of exports are also made for imports. As noted in the case of services exports, imports from the euro zone have grown by almost 200 per cent, far more rapidly than either the US or the UK. Services imports sourced from the euro area were also the fastest growing of the three sources in 2002, expanding by 22 per cent and accounting for considerably more than half of the total increase in services imports. In the first half of 2003, imports from the euro area continued to surge, growing by 18 per cent. As this was higher than both the UK and the rest of the world (i.e. mostly the US), euro area services imports reached one third of the total, the highest proportion since records were first taken in 1998. This suggests that unlike the case of manufactured imports, the elimination of exchange rate risk may have caused consumers of foreign services in Ireland to source increasingly from the euro zone.

The RoW accounts for around half of total services imports, a small decrease over five years. This reflects the fact that the majority of foreign-owned export capacity in Ireland is US-owned, and hence intra-firm payments for services go the US. In 2002, the growth in the value of imports from this source, at 8 per cent, was broadly in line with the average, before contracting in the first half of 2003, reflecting a contraction in the value of manufactured goods exports.

Services imports from the UK contracted in 2002 and the first half of 2003, extending the relative decline of the UK as a source market. This is curious. Ireland has traditionally been heavily dependent on the UK for merchandise goods imports. Given that the UK is more competitive in services exports than imports (it is the world’s second largest exporter of the latter, but only the sixth largest of the former), it might be expected that dependency would be higher not lower. However, the data show that the UK accounted for just over one fifth of the total in 2002.

15 First, that RoW trade is accounted for mostly by the US. Second, that the difference between EU and euro area trade is almost entirely accounted for by the UK (Sweden and Denmark are also in this category and merchandise trade data suggest that neither is a major market for services exports).
3.8 Services Balance

*Structural shifts probably explain the narrowing deficit*

Ireland’s services balance has long been deep in deficit, a position which is in large part a mirror-image of the huge trade surplus owing to the aforementioned link between foreign-owned goods exports and services imports. However, from a peak €13.9bn in 2000 (equivalent to an unusually large 14 per cent of GDP), the services deficit has since been narrowing (see Figure 13). In 2002, the deficit was €1bn off its 2000 peak and if the first half of 2003 is a reliable indicator for the full year, a further considerable narrowing of the deficit can be expected for the year as a whole.

While the shrinking of the deficit in the 2001-03 period undoubtedly reflects a cyclical element, it would appear that structural changes are a more powerful explanatory factor. On the import sides, the correlation between the export of merchandise goods and imports of services showed signs of weakening. Although it is too early to be sure if is a long term trend, the growing capacity of the services industry in Ireland (both indigenously and foreign-owned) would suggest a trend towards import-substitution. On the export side, insurance services boomed. Although the increase was far greater than the growth of imports, it remains to be seen whether this signals a real strengthening of the industry in Ireland or whether patterns have been temporarily distorted by developments following September 11, 2001. Similarly, there are some doubts about the sustainability of growth in computer services exports as much of the recent growth is accounted for by software being reclassified as a service now that delivery is increasingly electronic.
Foreign Direct Investment

4.1 Global Developments

FDI falls again in 2002

Foreign direct investment (FDI) data for 2002 confirm that the decade-long boom of the 1990s, which peaked in 2000, had paused. After global economic growth underwent its sharpest deceleration in three decades in 2001, the world economy remained sluggish in 2002. This was the main reason for the second consecutive year of contracting direct investment flows, as FDI is far more sensitive to changes in the wider economy than other forms of cross border economic activity, such as trade in goods and services. Other factors contributing to the poor performance included: poor financing conditions globally; and higher levels of general uncertainty owing to geopolitical developments.

The result of these factors in combination was that in 2002 the value of world FDI flows fell by 22 per cent, to just under $651bn, according to UNCTAD. Although this was the lowest level since 1997, the rate of decline was less than the 45 per cent decline registered in 2001. Moreover, the decline in cross border corporate integration is likely to have been less sharp than the figures suggest. This is because most FDI is accounted for by mergers and acquisitions (M&As) rather than the establishment from scratch of a new entity. Given the equity prices in 2002 were well below their 2000 levels, a considerable proportion of the over decline was the result of price effects. This is illustrated in that the average value of M&As in 2002 fell to 82m, from 145m in 2001.

However, the lower level of M&A activity could also reflect a significant structural change. While there have long existed doubts about the efficacy of M&As in terms of cost savings and unlocking imagined synergies, the reassessment after the boom of the late 1990s has produced considerable evidence that attempting growth by acquisition not only fails to add to share-holder value, but actually lessens it. Working in the opposition direction in terms of numbers of M&As in the medium term, in Europe if not in all regions, is the scope for consolidation in financial services and utilities. Although considerable restructuring in the former has already taken place (it is usually the largest single source of cross-border M&A activity according to UNCTAD data), the retail banking sector in EU countries remains dominated by domestic players in most cases. Although there is now less likelihood of a handful of massive and integrated financial services players emerging, it is likely that there is considerable scope for further consolidation, perhaps along the lines of the Nordic banking market.

As regards utilities, liberalisation of the energy sector in the EU suggests significant future cross-border M&A activity as pan-European players emerge.

Euro area sees inflows rise

In terms of regional performance, the EU has accounted for slightly less than half of inflows and well over half of outflows over the past five years. In 2002, only a slight drop in inflows was recorded despite the region’s sluggish economy and concerns about its future growth prospects. Indeed, if the UK is excluded, inflows to the EU actually rose. Given that the UK economy suffers fewer structural impediments to economic growth than the other major EU economies, developments in recent years are indicative of the complexity of the factors involved in firms’ decisions on where to locate their foreign operations. The former communist countries attract only a small, but growing, fraction of world inward FDI flows.

16 Low equity prices are themselves a reason for lower levels of M&A activity. Although theory suggests, that the purchase of equity in another firm is done when the price is low, the reverse is usually the case. This is for two reasons. First, most companies use their own equity to buy other firms. Second, the target firm’s managers, who in most case own some of their companies’ stock, are more likely to agree to the purchase if their stock is high.

17 A study of US M&As by consulting firm, Boston Consulting Group, found that of 277 mergers in the US between 1985 and 2000, 64 per cent destroyed value for the acquirer.
Although the US is historically by far the biggest destination for FDI, its shares of inflows collapsed in 2002 to one twentieth of the total, despite a weakening dollar which made assets relatively cheaper. According to UNCTAD, much of this was owing to the repayment of loans by foreign affiliates (this counts as disinvestment). More positively, outflows from the US increased in 2002, despite weak growth in many regions, poor financing conditions and heightened geopolitical risk. This points to the resilience of US corporates.

Table 3: International FDI Flows

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Developing world inflows relatively unaffected

According to a survey by UNCTAD of 106 investment promotion agencies (IPAs), taken in February-March 2003, the industrialised countries were again the worst effected in 2002, with almost half the IPAs from those countries saying that they had suffered disinvestment. Developing countries, by contrast, experienced far less severe swings, as was the case in 2001. The reason for the differing performances is that intra-rich world flows is twofold. First, as mentioned above, M&A activity, which is more important in developed countries, contracted sharply again in 2002. Second, flows of FDI from the developed world to the developing, by contrast, tend to be more focused on Greenfield investment – usually extractive industries and lower value-added manufacturing functions. Some 62 per cent of respondents saw the shift from M&As to Greenfield investment as a trend, although this view was more pronounced in less developed regions.

Although no global data for the first half of 2003 exist, developments in M&As provide a good indication as to the broad trend. According to Thompson Financial, the value of non-US M&As in the first nine months of 2003 fell again when compared to the year earlier period, although the rate of decrease had again slowed considerably, suggesting that the downturn had bottomed out. This suggests that FDI flows in 2003 will be at similar levels to 2002, and given that the underlying forces of globalisation remain unspent, an upturn in 2004 is anticipated provided the world economy continues on its path towards trend growth rates and the geopolitical situation does not take a dramatic turn for the worse.

In UNCTAD’s previously-cited survey, IPAs were asked the industries they believed most likely to be a source of FDI in the future. Significantly, many of the industries of relevance to Ireland were frequently cited by respondents: telecomms (2nd position), pharmachems (5th), electrical and electronics (6th) and financial services (7th). Only information technology (ranked 14th) was considered to have limited prospects. However, it may be that the protracted global slump in the industry has engendered excessively strong feelings of pessimism.
4.2 Inward FDI to Ireland

Inward FDI rebounded in 2002-03

According to UNCTAD, inflows of FDI into Ireland rose to $19bn in 2002, an increase of more than a fifth on 2001, and the second highest level of annual inflows ever recorded. In a global and regional context this was exceptional, given that for the second successive year world-wide and EU flows fell. Ireland accounted for its highest ever proportion of global inflows, at almost 3 per cent of the total. As a result, the total stock of FDI in Ireland reached $157bn, the highest in the world in per capita terms after Hong Kong. In terms of inflows to the EU as a whole (which includes intra-EU flows) Ireland received slightly more than five per cent of the total and in absolute terms Ireland was the seventh largest recipient, and the second largest in per capita terms (after Luxembourg). Like Luxembourg, however, flows into Ireland are skewed by the large offshore financial services sector. Unlike UNCTAD data, national figures disaggregate according to inflows accounted for by the International Financial Services Centre (IFSC) and those which do not. Since records began in 1998, the IFSC has seen cumulative inflows of €47bn, slightly more than non-IFSC inflows over the same period (see Figure 14). As the proportion of IFSC inflows invested in Ireland are small (most are re-invested in international assets), they have little direct impact on the domestic economy compared to non-IFSC inflows.

Figure 14: Inward Investment: IFSC and non-IFSC

According to the national data, FDI into Ireland, at almost €26bn, was two and half times greater than in 2001. This recovery continued in the first half of 2003, when inflows almost doubled over the same period in 2002. In this period, flows were almost evenly split between IFSC and non-IFSC, in line with the long run trend. However, despite the record amounts, evidence from the IDA shows that firms it assisted in 2002 created almost 20 per cent fewer jobs, which would imply that the nature of the non-IFSC is changing, with less investment going to construct new manufacturing capacity and more to upgrade existing plant. Note the statistics in this area are erratic, subject to major periodic revisions and there seems to be limited correlation between any of the three sets of disaggregated data. Therefore, any conclusions are tentative at best.

Greenfield investment appears to be waning

The fall off in Greenfield investment is evidenced by FDI figures disaggregated according to type of investment: reinvested earnings; equity; and “other capital”. With the growing stock of FDI in Ireland, new foreign investment is increasingly accounted for by the reinvested earnings of firms

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18 No stock data are available for Luxembourg, but given the very high levels of stocks given jointly for Belgium/Luxembourg it may well be that the Grand Duchy has higher per capita levels than Ireland.

19 The reason for the difference between Unctad data and those nationally sourced is the subject of on-going academic enquiry.

20 As these disaggregated data are not further broken down according to IFSC/non-IFSC some caution is necessary in their interpretation.
already located here, a trend observed in recent years. This type of investment is now by far the most important source of inflows, more than doubling in 2002 and growing by slightly less than 30 per cent in first half of 2003. The high level of reinvested profits is also testament to the continued profitability of doing business in Ireland. These developments suggest that those firms already operating out of Ireland are sufficiently satisfied with the business environment to renew and upgrade existing capacity.

Direct equity investment involves the purchase by non-residents of a pre-existing commercial entity, or a stake therein\(^\text{21}\). Bucking the trend in international M&A activity, this form of inflow grew by almost €1bn in 2002 to reach €11bn. More than one third of this was likely to have been accounted for by just two deals. According to UNCTAD’s list of €1bn+ cross-border M&As in 2002, two involved the foreign acquisition of Irish firms, which together were valued at $4.3bn. In the first half of 2003, the upward trend observed in 2002 was reversed, when a fall in equity inflows of slightly in excess of €11bn was recorded. That said, the inflows were significant and were likely to have been boosted by additional de-listing from the Irish stock exchange. The pattern in 2003 was more in line with international M&A activity, which remained subdued in the first half of 2003. UNCTAD data on M&A values provide an alternative perspective and support other evidence that suggest a shift is taking place in the nature of Irish FDI inflows. Prior to 1999 Ireland received little inflows related to M&As, however, since then this form of FDI has accounted for around one quarter of the total.

**Figure 15: Inward FDI by Type**

The third and final sub-category, “other capital”, can include, among others, the establishment of greenfield projects either by firms already present or those locating in Ireland for the first time. A negative figure of €1.6bn recorded in 2002 shows that disinvestment took place in this category. In the first half of 2003, there was a dramatic turnaround, when inflows amounted to almost €5bn\(^\text{22}\).

Given such large swings, the lack of specificity of “other capital” sub-category and an inability to know how much is accounted for by the IFSC, there is little by way of conclusion that can be drawn from these developments other than it may suggest that greenfield investment was lower in 2001-02 after big increases in 2000.

On the basis of CSO data, counter party data from the US (see below) and IDA findings, it would appear that the profile of Irish inward investment is changing in that new FDI is mostly accounted for by firms already located here who are expanding/modernising their operations. A number of factors, both domestic and international, are likely to account for this. Among the domestic changes that influenced FDI patterns are: a more selective approach by the Irish authorities to assisting foreign

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21 To be classified as direct investment, stakes must exceed 10 per cent of equity. Although this is relatively arbitrary, it is considered internationally as the level at which a longer-term controlling interest is reached.

22 Such erratic movements are not unusual. Inflows in this category of no less than €33bn in 2000 were followed by disinvestment of €10bn in 2001.
firms; more limited state incentives allowable generally; rising costs; and skills shortages in some sectors. The non-domestic factors, which are much more important in explaining recent trends, include: firms canceling or postponing major new international investment decisions owing to economic, and to a lesser extent, geopolitical uncertainty; and fierce competition among IPAs for jobs-rich investment.

4.3 Origins of Inward FDI

Euro area remains the major source

As in the case of trade in services, the direction of FDI outflows and inflows is not recorded on a country by country basis, but only according to two categories: EMU and non-EMU; EU and non-EU. Although this allows insights to be gleaned, the reader is again reminded that caution is necessary when assessing these figures as it in not clear whether, in each category, flows comprise IFSC or non-IFSC investment. In addition, origin data are highly erratic, often swinging with no apparent correlation to any of the other breakdowns, as is illustrated in Figure 16.

In 2002 inflows from the euro area continue to dominate overall inward investment, amounting to over two thirds of the total. In the first half of 2003 inflows from this source continued to surge, more than doubling year on year. However, as there is only limited evidence of an increased continental corporate presence in Ireland, much of this can be assumed to be IFSC-related. Inflows from non-euro EU countries (assumed to be almost entirely the UK) amounted to just over €500m in 2002, a fraction of the €6.7bn recorded in 2001. In the first six months of 2003, inflows recovered somewhat, reaching €1.8bn.

Figure 16: Inward FDI

Non-EU investment (assumed to be mostly from the US) has also been highly erratic (see Figure 16). Firms in the category disinvested massively in 2000-01, to the tune of €21bn, before an almost complete reversal in 2002, when inflows of €7.6bn were recorded. Although inflows of more than €6bn were recorded in the first half of 2003, this was down by almost a fifth on the same period in 2002. Counter-party data, from the US Department of Commerce, confirm these trends. According to these figures, US firms directly invested $4.9bn (€5.3bn) in Ireland in 2002, after a disinvestment in 2001. Also confirming the trend towards an increased emphasis on reinvested earnings, this type of investment accounted for three quarters of the total according to the US data. Although a detailed breakdown by industry is also given, much of the data is suppressed in order to protect the confidentiality of the firms providing data. That said, 2002 confirmed the trend away from

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23 Data from national and US sources for 2000 are contradictory. According to national figures massive disinvestment was recorded by non-EU residents, while US data show almost $10bn flowed into Ireland from that source.
manufacturing investment, with the largest single source coming from the finance and insurance sector, more than the chemicals, computer and electronic industries combined. In terms of stocks, US investment in Ireland stood at $41.6bn, the fifth highest in absolute terms in the EU and the highest on a per capita basis by some distance.

BOX 3: The Pharmaceutical/Chemicals Industry

The pharmaceuticals and chemicals industry is one of the success stories of the Irish economy. It is only in the past 12-18 months that the sector has stopped for breath after years of very rapid expansion. The reasons for the success of the industry are manifold. These include aspects of the Irish business environment that have proved conducive to Irish and foreign-owned firms in general such as: unimpeded access to the EU's single market; a pro-business policy framework; a favourable tax and incentive framework; and a flexible and English-speaking workforce. Aspects of doing business in Ireland that have been of particular benefit to the pharmachem industry include: a transparent and well-organised regulatory framework; the tax free status of patent royalty income from intellectual property created and exploited in the country; and the responsiveness of the educational system to adapt to changes in market demand.

Structure

The pharmachem industry is modern, highly capitalised and ultra competitive, with a production focus on relatively small batch output of very high value-added materials, rather than the large-scale production of bulk materials with which the industry is frequently associated. In Ireland’s case, only agriculture-related products (fertiliser and ammonia) fall into this category, and these account for a small proportion of the sector’s total output. This very limited emphasis on bulk production has the added advantage of minimising the industry’s environmental impact in terms of both production and transportation (value to volume/weight ratios tend to be high resulting in low transport costs). Despite some exceptions, the Environmental Protection Agency has found that the industry has a very high compliance rate with minimum standards and has a good record in environmental management.

The structure of the industry in Ireland can be subdivided into two broad sub-categories – pharmaceuticals and chemicals. In the case of the former, nine out of ten of the largest global firms operate production facilities in Ireland, while 12 of the world’s biggest 30 chemicals firms also have operations in the country. As none of these 19 multinationals is Irish, output and employment in the industry is dominated by foreign-owned firms. In geographical terms, of the 80 or so facilities in Ireland, the majority are clustered around the Dublin and Cork areas. There is significant evidence that critical mass in the industry has been created with the emergence of “positive externalities”. These include the emergence of a pool of skilled industry labour and the forging of links between firms and educational establishments, to the benefit of both.

Impact

- **Employment:** From 16,300 people in the sector in 1995, there was a near doubling to 33,000 in 2002, with salary levels well above economy-wide averages. Half of all employees in the sector are graduates, and it absorbs most of those who leave third level education with science and engineering degrees. The pharmaceuticals subsector is the biggest employer, accounting for all jobs growth in recent years.

- **Tax:** In 2001, the industry paid corporation tax of €700m (around 2 per cent of total general government revenue). If wage, income and consumption taxes were included the figure would likely be well above €1bn.
Exports: In 2002, pharmachem exports were over €10,000 for every inhabitant of the country, a level higher than total exports of goods and services in many developed countries. When considered in terms of the overall trade balance, the contribution is more significant – due to the low import-intensity of the sector, there is a massive €33bn surplus, indicative of the extent of value added in the production process. Of EU external pharmachem's trade, Ireland accounted for 20 per cent of the total.

Prospects

The industry in general, and pharmaceuticals in particular, is highly profitable (due to extensive patenting), relatively recession-proof (inelastic nature of demand) and is likely to enjoy steadily increasing demand for the foreseeable future (high income elasticity of pharmaceuticals plus aging populations in many developed countries). This growth potential and the limited effects on demand of the business cycle make the industry attractive as a source of stable and sustainable economic growth. The industry is also attractive because although its production facilities are highly globalised, it is not foot-loose. Location decisions in the industry tend to be long term as high levels of capital investment requirements mean that recouping costs requires returns over an extended time period, and as an unusually low percentage of total costs is accounted for by labour costs means that wage inflation has a limited effect on competitiveness. As such, relocation to cheaper labour economies is an infrequent occurrence.

However, none of this is to say that there are no challenges facing the sector in Ireland. A source of rapid change in the industry is the development of new products and the expiry of patents on older ones. In the case of the former, intra-firm competition poses a threat to the Irish industry as headquarters decide on which of their global facilities to allocate production of new drugs. In this regard, Singapore and Puerto Rico are among the other major locations of the globalised industry. In response to this, tax credits for R&D were introduced in the 2004 budget. Although it is agreed that owing to the non-globalised nature of R&D activity, Ireland has little chance of attracting significant amounts of this function, focus on less mobile and higher value-added functions is necessary, particularly process innovation, some of which already happens in Ireland (it is estimated that 400 people are employed in total).

Another important factor for the industry is the regulatory framework. In this regard two important issues are of immediate relevance. First, in the field of biotechnology, an ethical framework is currently being agreed at EU level. Second, although the current draft of the EU's REACH directive on the regulation of the chemicals industry is considerably less burdensome than its forerunners, concerns remain. Should the legislation once enacted add significantly to the cost of production in the EU vis-à-vis other locations there is a real danger of production migrating further afield over time.

In terms of employment, the outlook for the industry is mixed, owing largely to lower inward investment. Also relevant is the double-edged sword of rapid productivity growth. The number of workers required to produce a given level of production falls as productivity rises. Now that output growth has leveled off, productivity gains are likely to result in shrinkage of the workforce, other things being equal. There is already some evidence of this from the employment data in the first half of 2003. These show the loss of approximately 3,000 jobs in the sector, almost 10 per cent of the total, when compared to a year earlier. While the sector's demand for labour may not rise rapidly, there remains a danger of skills shortages choking off growth. Although Ireland has the highest percentage of science and engineering graduates in the world in the 20-34 age group, there has been a worrying trend away from science courses at tertiary level. The ICSTI study found a particular need for more organic and analytical chemists and chemical engineers.
4.4 Outward FDI from Ireland

*Irish investment abroad continues to fall*

According to UNCTAD, and in contrast to inward direct investment, outflows of FDI from Ireland collapsed to €2.7bn in 2002, to reach their lowest level since 1997. This fall, by more than half, was considerably sharper than either the global or EU averages and resulted in Ireland’s share of EU outward FDI falling from a percentage broadly proportionate to its GDP weighting, of 1.3 per cent of the total in 2001 to 0.7 per cent 2002. In contrast to inward direct investment, Ireland compared poorly with other EU countries in absolute terms, with only Greek residents directly investing less abroad. In per capita terms, Ireland was much closer to the average, ranking eighth out of 15. When stocks of outward FDI are measured Ireland’s relative position is similar, with $36.5bn worth of foreign assets owned by Irish residents.

According to national data outward flows also fell in 2002, but less sharply than the UNCTAD data suggest. Continuing a downward trend in evidence since 1999, outflows fell from €5.7bn in that year to €3.3bn in 2002. In 2002 alone, there was a decline of 28 per cent, which was slightly more pronounced than the global average. Moreover, these headline figures understate the magnitude of the retrenchment in foreign investment by Irish firms. As recently as 2000, none of the outflows from the International Financial Services Centre were recorded as FDI, owing to the nature of the investment vehicles used. However, this changed in 2001 when IFSC direct investment outflows of €263m was recorded, before a very large increase in 2002, to €1.8bn (see Figure 17). Thus when IFSC-related investment is stripped out, Irish residents bought only €1.4bn worth of foreign assets classified as direct investment in 2002, one third of their purchases in 2001. This represents a significant slowdown in internationalisation of corporate Ireland in recent years.

**Figure 17: Outward Direct Investment by Source**

In the first half of 2003 total FDI outflows, at less than €1bn, were a fraction of the €3.4bn registered in the same period in 2002. However, as they were accounted for entirely by non-IFSC, the change is far less sharp. Moreover, given the rather extreme fluctuations in flows from quarter to quarter, the outcome for the full year may well be very different from the first six months and as such less focus is paid to these data in the analysis that follows.
The data are broken down according to type of investment: equity; reinvested earnings and “other capital” shows. In line with patterns in developed countries, equity FDI is the most important type of outflow (see Figure 18). However, its recovery in 2002 is likely to reflect, at least in part, the new phenomenon of IFSC outward direct investment, rather than a sustained increase in Irish firms expanding their operations abroad by acquisition. As is usually the case internationally, and in the case of outwards flow, the reinvestment profits category tends to be the most stable, as it is used by firms to finance on-going capital expenditure in their foreign operations. Ireland is no exception, with reinvested earnings FDI fluctuating less than the other categories but accounting for around 40 per cent of the total, a share that has risen slightly in 2001-02, possibly reflecting the rising total stock of foreign assets. Other capital was a not a significant means of investing directly abroad for Irish residents in the 1998-2001 period, accounting for slightly more than €1bn in total over the four year period. In 2002, disinvestment of €2.7bn was recorded. The pattern here reflects the low level of outward greenfield investment by Irish firms.

4.5 Location of Irish Outward FDI

Investment shifts towards the euro area

Indigenous software and pharmaceutical firms have tended to look almost automatically to the US when investing abroad owing to that country’s advantages: a relatively large supply of venture capital; leading-edge technologies; a light regulatory burden; and a shared language among others. Reflecting conditions in the US economy in 2001, Irish investment outflows to non-EU (assumed to be mostly the US) fell to a low of €1.1bn, before bouncing back in 2002, to €2.1bn. Despite this recovery, and the fact that FDI to the RoW was larger than to any other location in 2002, outflows in 2002 fell far short of the very high levels recorded in 1999-2000 and no longer account for the overwhelming percentage of the total that they did in that period. Investment flows to the non-EU world turned negative in the first half of 2003. As in the case of inward investment, counter-party data, from the US Department of Commerce, confirm these trends, if not the size of the flows.

From negative investment in 2001, FDI from Ireland to the US amounted to $1.2bn (€1.3bn) in 2002, bringing the stock of direct investment owned by Irish residents to $26.2bn. This stock total is the fifth highest in absolute terms among the member states of the EU and accounts for three per cent of the total.

Flow data are likely to consistently understate the extent of Irish owned assets in the US. Due to the deep and breadth of US capital markets it is very likely that a considerable amount of American asset purchases by Irish residents are financed in the US and thus do not appear on the balance of payments.
While outflows to the rest of the world fell sharply in 2001, this coincided with an increase in those to the EU from previously negligible levels\(^{25}\). In terms of the destination of flows to the EU, investment in the euro area accounted for the lion’s share in 2001-02 and may reflect IFSC outward investment. Despite this, it is undoubtedly the case that Irish firms are showing greater interest in the euro area, probably in response to monetary union, and that their focus is shifting from the UK (in 2002, investment to the UK turned negative, signify disinvestment).

**Figure 19: Outward Direct Investment by Destination**

\(^{25}\) Given the low overall levels of FDI to the European Union, single takeovers by Ireland's small number of multinational firms could easily cause such year to year swings.
Issues for Policy Consideration

A

Trade Policy

The failure to reach accord at Cancún leads two questions open: Firstly, will it be possible to reach a conclusion on the Doha Development Agenda in a multilateral framework; and secondly, what role has regionalism as a complement to the troubled multilateral system, or is regionalism the cause of the multilateral frailty? Preferential Trade Arrangements (PTAs) have flourished so rapidly all over the world that nearly all WTO members are now party to at least one arrangement. Several commentators have expressed the apprehension that the Cancún impasse will divert US and perhaps even EU attention to bilateralism and regionalism in trade negotiations.

Ireland, as with any country wishing to promote trade, is faced with the strategic question of whether to opt for a uniquely multilateral approach or to a PTA plus multilateral liberalisation route. In general, there is rightly a consensus over the superiority of the multilateral approach, so there is no question but that Ireland should remain strong proponents of the WTO. This argument can be made on pure economic efficiency grounds, the argument that regional agreements are usually less comprehensive, and often do not cover subsidies and other “behind-the-border” policies that affect trade, the importance of a policing mechanism and the legitimacy of law created by the WTO.

However, given that the international policy environment and possible flaws in the WTO’s modus operandi makes negotiating a multilateral trade agreement extremely difficult, preferential arrangements have been put forward as being a more practical and feasible route to reach broad liberalisation. Indeed, two of the most significant recent developments in Europe’s international trade, namely the eastern expansion of the EU and the ‘Everything but Arms’ agreement, take the form of preferential trade agreements. Ireland, through the EU, should investigate the use of such agreements as a complement to our efforts at the WTO to achieve a wider trade liberalisation.

Further, we should commit to reforming the structures underlying the WTO to strengthen the multilateral framework. In particular, it should be asked whether WTO Ministerial meetings (of which two of the last three have collapsed) are run in a manner most likely to achieve progress. Three specific issues should be examined: firstly, whether unanimity among a grouping of 150 countries is efficient or democratic; secondly, whether the current consultation mechanisms with civil society are appropriate; thirdly, whether current efforts to help build capacity among developing countries are adequate.

B

Transatlantic Relations

Most analysts of international relations on both sides of the Atlantic share the view that underlying factors and changing fundamentals mean that EU-US relations will be less close in the future. While much focus is on the prospects for security and political co-operation (such as the future of Nato), there are also concerns as to how this could affect the continents’ hugely important bi-lateral economic relations. Trade, competition, accounting standards, banking regulation, data privacy and container security are some of the many regulatory dimensions to this relationship. While cooperation in some areas, such as competition, is, if anything, improving, strains in other areas are intensifying. One area where this is evident is the ongoing trade disputes between the two sides, namely FSC, Hormones and GMOs. This is a matter of critical concern to Ireland given its unique position in the transatlantic economy. Although Ireland has limited influence in the wider world, there may be scope for a more pro-active, honest broker position by Ireland to help attempt to smooth some of these economic and technical issues.
Among the most specific and immediate transatlantic issues of relevance to Ireland is the importance of improving maritime transport security and the need to protect trade against any threat of terrorist attack, concerns that are likely to grow in importance over the next number of years. In many respects, increased mobility of goods, capital and labour make ensuring our security substantially more difficult. However, in implementing any necessary security measures, we must be cognisant of any increased difficulties that these measures have for exporters, particularly small to medium sized exporters, as well as companies in developing countries who do not have the logistical backup to deal with complex international regulations. By doing this, we can ensure that increased security can be to the benefit of continued international trade, not at the expense of it. This can best be achieved by agreeing common international standards, such as a mutually acceptable container security system covering the whole EU which would integrate the needs for securing international trade in containers. A decision by the EU and US in November 2003 to negotiate a single agreement augurs well for the satisfactory resolution of this issue, after eight EU member states had agreed bi-lateral deals with the US which could have caused difficulties for the common customs regime.

C EU Enlargement and Other Opportunities

On May 1st 2004, during Ireland’s presidency of the EU, 10 new member states will join the Union. Although this will add only 5 per cent to the EU’s GDP, the growth potential of the accession states is considerably higher than the existing member countries as they enjoy catch-up economic growth in the aftermath of replacing command economies with free markets. This offers considerable potential for increased trade flows (in the first half of 2003 exports to the three largest markets of the accession 10 – Poland, Czech Republic and Hungary – amounted to just €159m). Further afield, among the most noticeable developments in trade patterns has been the rise and rise of China, and to a lesser extent, India in terms of world share of both imports and exports. As these countries together account for more than a third of the world’s population, the scope for strengthening trade relations is considerable, particularly given that in the first half of 2003, exports of only €300m in total were sold to both countries (less than one per cent of Ireland’s total exports). A state visit to China in late 2003 by the President, Mary McAleese, which was accompanied by a large delegation from the business community, may require sustained follow up, and the exploration of closer ties with India should also be examined.

D Cost Issues

As Ireland has converged with continental European incomes levels, the broad price level has risen. However, as a report by Forfas in 2003 illustrated, prices of many goods and services are now above the euro area average, thus threatening competitiveness. Although there does not yet exist strong and convincing evidence that high relative price and wage inflation has caused a significant loss of market share, this will inevitably be the case should price developments not return to levels in line with those in our trading partners.

Two separate sources of increased costs for business can be identified: one benign, the other less so. The first broad category relates to a shift towards specific charges and taxes so that their prices reflect the full economic cost of their use. The bin charges are an example of such a measure. More generally, the shift to specific charges and taxes allows other taxes to remain low, including corporation tax. The second source of increased business charges is far less benign as it is the result of structural weaknesses/inefficiencies in the economy that erode competitiveness. Among the most significant of these structural weaknesses is the continued absence of competition in some sectors which causes prices to rise to levels that are often beyond those in countries of similar levels of developments with whom we trade. In a range services sectors, both private and public, increased efforts should be made to remove the barriers to greater competition.
Intensification of Competition for Foreign Investment

As successive UNCTAD annual surveys have shown, and in contrast to as recently as a decade and a half ago, there is almost universal acceptance of the benefits of hosting foreign companies in terms of employment, fixed capital formation and less tangible spillovers such as new technologies and best-practice management techniques. Nowhere has the change been more obvious than in former communist countries, many of whom will take the final step in reuniting with democratic Europe when they accede to the European Union in 2004. The prospect of enlargement and, more particularly, the reforms implemented by acceding states, have increased competition for FDI projects. That said, the competitive threat should not be exaggerated. Evidence from previous enlargements, surveys of business investment plans and comparative business environment indicators suggest that there will be a continued gradual increase in competition after enlargement, rather than a sudden sharp change in FDI patterns. Moreover, developments in inward FDI, with high levels of reinvested earnings, suggest that firms already operating out of Ireland are sufficiently satisfied with the business environment to renew and/or upgrade capacity. However, the achievement of critical mass in a sector does not by any means guarantee that it becomes self-sustaining given the pace of change in most industries today.

Infrastructure

The continued upgrading of the country’s infrastructure due to the NDP is starting to result in major projects coming on stream. The key objective of the infrastructural component of the NDP is a major enhancement of Ireland’s infrastructure in key areas such as transport, environmental services, health and social housing. This is a competitive imperative as worsening congestion and lengthening journey times are exerting a drag on economic performance – reducing efficiency levels, inhibiting labour mobility and hindering efforts to increase the pace of development in peripheral areas of the country, notably the less developed border, midlands and western (BMW) regions. Furthermore, given Ireland’s export orientation, it is vitally important for companies currently operating in the country to have ready access to the ports and airports. As part of the NDP main roads from Dublin, to Cork, Limerick, Galway, Waterford and Belfast are being upgraded to motorway or improved dual carriageway status. Further major infrastructure works in the capital include: the completion of the M50 ring road, linking Rosslare, Dublin and Belfast; the Port Tunnel, which is intended to remove heavy vehicles from the city centre; and the Luas. Government proposals that the three airports run by Aer Rianta be managed independently in order to generate competition are also moving ahead. There also plans for a second terminal at Dublin Airport, which may be built and run by an outside entity, an option that according to the independent Commission for Aviation Regulation works well elsewhere.

Although there has been considerable improvement in the range (and cost) of telecoms services provided since liberalisation began in the mid-1990s, Ireland has fallen behind most other EU countries in the coverage, take up and price of its broadband network. Forfas figures show that broadband penetration was very low in comparison with other countries, at 0.42 per cent of the population. This low figure is attributable to the late roll-out of broadband services; the high cost of such services; the nature of the Irish market, characterised by low population density and low urbanisation, which makes broadband provision uneconomical in rural areas; and the low level of competition in the market. Either increased government investment or stronger regulatory actions are required to increase the pace of adequate broadband provision.

The European Commission has supported an increase in the EU’s contribution to the cost of major infrastructure projects from 10 per cent to 30 per cent and to make €100 billion available in loans from the European Investment Bank. The objective of the plan would be to reduce customs bureaucracy, improve port facilities and encourage the emergence of new ferry companies. For
Ireland, the significance of the project lies in the possibility of greatly reducing the exchequer outlay, while also boosting investment road and rail links between Cork, Dublin and Belfast, as well as promoting a “motorway of the sea” between Ireland and Spain.

G The Lisbon Agenda

The Lisbon agenda represents one of the most important, ambitious, not to say daunting, challenges that Europe faces today. If Europe succeeds in implementing Lisbon in full, the rewards promise to be great. The Lisbon objectives of increased productivity, greater social cohesion, greater innovation and environmental protection promise to make Europe one of the primary worldwide locations to invest, to work and, most importantly, to live by 2010. Further, by not being overly prescriptive, they show a federal system at its best – setting and insisting on the highest standards, but allowing subsidiarity so that local problems can be solved at the local level.

One of the greatest strengths, but also the greatest challenges, of the Lisbon agenda is the sheer size of its ambition in terms of goals and metrics, making engagement with the intelligent layman on the Lisbon process quite difficult. It will be incumbent on Ireland in its role as President of the EU to give greater focus to the economic aspects of the Lisbon Agenda, particularly under the auspices of the Competitiveness Council. After decades of postwar convergence during which Europe gradually drew closer to the US in productivity terms, the period since the mid-1990s has seen a reversal of this trend, a reversal which is expected to continue. The latest growth forecast published by the OECD predicts that EU growth in 2004 will be 1.9 per cent, while US growth is expected to be 4.2 per cent.

Trade, both internal and external to the EU, can play an important role in ensuring that these competitiveness challenges are met. This process can be aided by the successful negotiation of the Doha round of world trade negotiations, the expeditious completion of all aspects of the single market and the rapid integration of the Eastern accession countries into the union. What’s more, these are policy areas that are largely the competence of the federal rather than national authorities, making them much more amenable to influence from Ireland as holders of the presidency of the EU.

H Services Statistics

One of the problems faced in the analysis of Irish trade is the paucity of data relating to services exports and FDI stocks and flows. Given the importance of these sectors to the national economy, this dearth of information will hinder the understanding of on-going changes as they unfold, making appropriate policy responses significantly more problematic. Therefore efforts by the CSO in this area should be re-examined with the aim of providing information in detail and timeliness comparable to other developed countries.

I Emissions Trading

In July 2002 the EU council of ministers adopted a directive establishing a European greenhouse gas emission trading system. The directive provides for the implementation of the system in 2005-07, with the objective of initiating a trading system in emissions as a means of helping EU countries to meet their Kyoto Protocol obligation of an 8 per cent overall reduction in greenhouse gas emissions by 2008-12. Careful consideration should be given to how the directive can be transposed into national law in a manner that allows its aims to be met with the minimum impact on the competitiveness of Irish enterprise.
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