

International Trade & Investment Report, 2004



*A report by Forfás to the Minister for
Enterprise, Trade and Employment*

Forfás

THE NATIONAL POLICY AND ADVISORY BOARD FOR
ENTERPRISE, TRADE, SCIENCE, TECHNOLOGY AND INNOVATION



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Forum and the Foreign Earnings Committee

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Preface

Despite an upturn in global economic and trade growth in 2003, Irish exports contracted for the first time in more than four decades. In volume terms, provisional data show a fall of 3.7% in 2003. In value terms the decline was more precipitous - export receipts fell from €93.7bn in 2002 to €82bn in 2003, a decline of one eighth. Developments during the course of the year suggest that the low-point was reached in the first half of 2003. The decline in export volumes was concentrated in the foreign-owned sectors of ICT and pharmachems. A significant change may have taken place in these firms production patterns after many years in which changes worked in Ireland's favour.

Import volumes fell by 6.5% in 2003, a considerably sharper decline than the 3.7% contraction of exports. The value of imports declined by 14%, to €47.9bn, as import prices fell by close to one tenth. Lower demand for imported inputs by manufacturers and subdued domestic demand account for the decline. The decline in imports was concentrated in the first half of 2003, and by September of that year volume growth had returned. This continued in 2004, which resulted in a total half-year import bill of €24.3bn, a year-on-year increase of 3%.

Ireland recorded growth of 11% in services exports, to €33.6 bn. This represents a continued deceleration in the rate of expansion since 2000, though this was a relatively strong performance compared to other countries. In 2003, one dollar in every fifty spent on traded services globally accrued to Ireland. Accounting for almost half of the growth in total services exports in 2003 was the rise in computer services, the largest single category of services sold abroad. Business services - the second largest single category of Irish exports - saw growth of almost nine percent in 2003, while the spectacular increase in exports of insurance services of recent years continued apace in 2003.

According to latest national sources, the value of total services imports reached €46.2bn, an increase of just under 4%. In the first half of 2004, the rate of increase fell further, to under 2%. As in the case of exports, this is the continuation of a pattern of deceleration since 2001. By far the biggest portion of the overall import bill is accounted for by business services.

International inflows of foreign direct investment contracted for the third consecutive year in 2003, according to UNCTAD, to stand at \$560bn. This is considerably less than half the all time peak of 2000 when inflows of \$1,388bn were recorded. FDI inflows to Ireland in 2003 fell back sharply from the all-time peak in 2002. The decline, to €23.8bn from €30.8bn in 2002, was accounted for by considerably lower inflows into the international financial services centre (IFSC), which saw direct investment more than halved, to €6bn. By contrast, investment from non-IFSC sources rose by more than 10%, to €17.8bn.

Outward flows of direct investment by Irish residents in 2003 were less than one third of those of 2002, standing at €3.1bn indicating that expansion abroad by Irish firms continues to decelerate from a high-point in 1999-2000.

1. Executive Summary and Overview

1.1 Merchandise Trade

- ▶ In 2003 the volume of world trade grew at 4.5 percent, its most rapid rate of increase since 2000 according to the World Trade Organisation (WTO). The upturn was a result of, and contributing factor in, stronger global economic growth. In value terms, exports grew even more rapidly, at 16 percent in US dollar terms, to reach a record US\$7.3 trillion. This, however, mostly reflects the effect of exchange rate fluctuations (the effective dollar exchange rate fell by more than 11.5 percent on 2002).
- ▶ Of the big exporting regions - the EU, the US and Asia - only the latter saw strong growth in 2003 as the Chinese economy continued to grow rapidly and Japan registered one of its strongest expansions in a decade and a half. The EU saw exports stagnate for the third consecutive year, while US exports contracted.
- ▶ Indications in late 2004 suggest that trade growth will accelerate further in 2004, to 8.5 percent according to the WTO in late October, as world economic growth reaches a 20-year peak. The upswing is being driven by a strengthening of economic growth in the US and Asia. Europe is again expected to contribute relatively little to the increase in global trade.
- ▶ Despite the upturn in global economic and trade growth in 2003, Irish exports contracted for the first time in more than four decades. According to the WTO, Ireland's export growth performance was the fifth lowest of the world's 50 largest exporting countries. As a result, Ireland saw its ranking fall to 22nd among the top 50 exporters, from 19th in 2002.
- ▶ In volume terms, provisional data show a fall of 3.7 percent in 2003. In value terms the decline was more precipitous. Export receipts fell from €93.7bn in 2002 to €82bn in 2003, a decline of one eighth. About half of this fall was accounted for by the uncovering of a multi-billion VAT fraud. The headline figures thus significantly overstate the extent of the downturn. The difference in the value and volume measures is accounted for by a (sharp) fall in export prices - the second consecutive annual decline.
- ▶ Though the full year out-turn for exports was disappointing, developments during the course of the year suggest that the low-point was reached in first half of 2003. By the second quarter of 2004 export volumes were growing by close to 10 percent.
- ▶ The decline in export volumes was concentrated in the foreign-owned sectors of ICT and pharmachems, a significant change may have taken place in these firms production patterns after many years in which changes worked in Ireland's favour. This concern is magnified by foreign investment data which show that little new manufacturing capacity is being added in Ireland by foreign firms, in contrast to the 1990s. The performance of indigenous sectors such as food and drinks helped stabilise the aggregate figure for the volume of exports.
- ▶ The relative importance of Ireland's export markets appeared to change considerably in 2003, with the US becoming the largest single market, overtaking the UK. Exports to the US were worth almost €17bn, representing an increase of just 3 percent (the second consecutive year of low growth).
- ▶ Exports to the EU (including Northern Ireland, but excluding Britain) declined by over €2bn in value, a little more than 5 percent, in 2003. Despite the elimination of currency risk with most countries in "non-Britain" EU, their share of total Irish exports, at 45 percent, is below the 48 percent registered in 1998, the last year before the launch of the euro.
- ▶ For the first time ever in 2003 Britain was not the main destination for Irish exports. Britain's absorbed just 16.4 percent of total Irish exports in 2003, down from one third as recently as 1990.

- ▶ Import volumes fell by 6.5 percent in 2003, a considerably sharper decline than the 3.7 percent contraction of exports. The value of imports declined by 14 percent, to €47.9bn, as import prices fell by close to one tenth. Lower demand for imported inputs by manufacturers and subdued domestic demand account for the decline. On a global basis, Ireland fell back in the rankings of world importers, to 28th largest (from 26th in 2002), making it the third largest per capita importer in the world after Luxembourg and Singapore.
- ▶ The decline in imports was concentrated in the first half of 2003, and by September of that year volume growth had returned. This continued in 2004, which resulted in a total half-year import bill of €24.3bn, a year-on-year increase of 3 percent. In volume terms, the increase was slightly greater at 3.8 percent. As this suggests, import prices continued to fall into 2004, although the rate at which they declined slowed considerably from 2003.
- ▶ By far the most significant import sector is machinery and transport equipment, in recent years accounting for almost half of total merchandise imports. Largely as a result of the previously mentioned VAT fraud operation, imports in this category fell precipitously in 2003.
- ▶ Imports from Britain fell by €5.4bn, to €13.6bn (almost all of which was related to VAT fraud). Despite this, Britain remains by far Ireland's largest source market, accounting for 29 percent of the total. Imports from the EU (including Northern Ireland, but excluding Britain) fell by 9 percent in value terms in 2003, but despite this increased their proportion of total exports to 27 percent.
- ▶ After the UK, by far the largest single national source market for imports is the US, reflecting high levels of intra-firm trade by American multinationals in Ireland. At €7.4bn in 2003, imports declined by almost one-eighth in value terms, mostly reflecting lower export activity. Imports from China continue to boom, to become the fifth largest source market.
- ▶ The trade surplus fell by €3.5bn in 2003, to €34.7bn. This was the first decline in the surplus since 1990. Declines in the pharmachem and ICT surpluses account for this. Despite the large fall, Ireland's trade balance, at 26 percent of GDP, remains the second largest in the OECD after oil-exporting Norway. In the first half of 2004 the trade surplus returned to an upward path, rising by almost €1bn over the same period in 2003.

1.2 Services Trade

- ▶ The value of internationally traded services rose to \$1,763m in 2003. Although this represented an increase of 13 percent, almost all of this was likely to have been accounted for exchange rate movements (the real effective dollar rate of exchange fell by 11.5 percent on the previous year's average).
- ▶ Although the EU accounted for most of the rise in the value of services exports in 2003, given that the euro appreciated by around 20 percent against the dollar, there was likely to have been a contraction in the value of EU services trade when measured in local currency. In real terms, services growth was most likely to have been stronger in Asia and the US.
- ▶ According to the WTO, Irish exports soared in dollar denominated terms by 27 percent - a rate of increase exceeded by only three countries among the top 40 services exporting nations in the world. This strong growth propelled Ireland further up the league table of services exporters, to 14th position in absolute terms. In 2003, one dollar in every fifty spent on traded services globally accrued to Ireland.
- ▶ National sources show more modest growth of 11 percent increase, to €33.6 bn this represents a continued deceleration in the rate of expansion since 2000. The first half of 2004 saw a continuation of the trend, with the value of foreign sales rising by 9.5 percent.

- ▶ Accounting for almost half of the growth in total services exports in 2003 was the rise in computer services, the largest single category of services sold abroad (more than a third of the total). Sales rose to €12.7bn, an increase of almost 15 percent.
- ▶ Business services - the second largest single category of Irish exports - saw growth of almost nine percent in 2003, while the spectacular increase in exports of insurance services of recent years continued apace in 2003, with foreign sales of insurance products growing by a fifth, for the category to become the third largest services export.
- ▶ Tourism and financial services were Ireland's fourth and fifth largest services exports respectively. The former saw low growth in 2003, owing to a series of external and internal factors, while the latter grew strongly as Dublin's International Financial Services Sector (IFSC) continues to thrive.
- ▶ The destination of Irish services exports divides more or less evenly among the euro zone, the rest of the world (RoW) and the UK, in that order. All three main markets for Irish services exports saw growth in 2003, with the fastest expansion coming in the euro area.
- ▶ After Luxembourg, Ireland is the largest per capita importer of services in the world according to calculations based on WTO data. In absolute terms, Ireland became the ninth biggest consumer of foreign services globally in 2003, jumping from 11th place in 2004. The country's continued advance up the league table of services importers was the result of a dollar-denominated growth rate of foreign purchases of almost one quarter, a rate exceeded only by one other country among the top 40 services importers.
- ▶ Given the continued rise in services imports, and the fall in merchandise goods imports, the former exceeded the latter in value for the first time in 2003. In this, Ireland is unique among the major economies of the world according to the WTO (on average services imports account for just one fifth of countries' total imports).
- ▶ According to latest national sources, the value of total services imports reached €46.2bn, an increase of just under 4 percent (the large difference with the WTO increase is explained by exchange rate movements which exaggerated growth in dollar terms). In the first half of 2004, the rate of increase fell further, to under 2 percent. As in the case of exports, this is the continuation of a pattern of deceleration since 2001.
- ▶ By far the biggest chunk of the overall import bill is accounted for by business services (42 percent in 2003). Payments abroad for these services fell by just under €1bn in 2003, to €19.7bn, reflecting currency effects, the lower levels of export activity in the foreign-owned manufacturing sector and the greater sourcing of these services internally or from indigenous providers.
- ▶ The evolving pattern of change in the origin of services imports has been quite constant over six years. Most notable has been the rising share of traded services sourced from the euro area and a decline in purchases from EU countries not participating in the euro project. In 2003, in line with trends in recent years, euro area services imports saw the strongest year on year growth (13 percent), to bring their share of the total to one third - the highest since records were first taken in 1998.
- ▶ The services deficit shrank by a large €1.6bn in 2003, reducing it to €12.6bn, the lowest level since 1999. In the first half of 2004, another large decline, of €1.3bn year on year, was registered. Significant (positive) structural changes account for this.

1.3 Foreign Direct Investment

- ▶ International inflows of foreign direct investment (FDI) contracted for the third consecutive year in 2003, according to the United Nations Conference on Trade and Investment (UNCTAD), to stand at \$560bn. This is considerably less than half the all time peak of 2000 when inflows of \$1,388bn were recorded.
- ▶ Another sharp drop in merger and acquisitions (M&A), which account for most FDI, was the main reason for the decline, as firms' foreign expansion plans lagged economic recovery in home markets (FDI is highly sensitive to rates of GDP growth). Another factor explaining the low level of M&A activity were weak equity markets, which continued to discourage privatisations.
- ▶ In geographical terms, the EU accounted for most of the decline, while inflows to the US, already low in 2002, collapsed, to just \$30bn, less than a tenth of the level recorded in 2000.
- ▶ Indications at time of writing (in late 2004) are that the annual declines registered since 2001, will not be repeated in 2004.
- ▶ According to national data, FDI inflows to Ireland in 2003 fell back sharply from the all-time peak in 2002. The decline, to €23.8bn from €30.8bn in 2002, was accounted for by considerably lower inflows into the international financial services centre (IFSC), which saw direct investment more than halved, to €6bn. By contrast, investment from non-IFSC sources rose by more than 10 percent, to €17.8bn.
- ▶ Despite this, the number of new jobs in IDA-assisted firms declined by nearly a quarter, to 9,182, in 2003. This is the third consecutive year of falling job creation and reflects the shift towards less jobs-rich forms of FDI.
- ▶ In terms of the financing of their investments, foreign firms in Ireland continue to shift towards reinvested earnings, suggesting that the non-indigenous sector is going through a period of consolidation and organic growth, after the 1990s when large numbers of firms were establishing in Ireland for the first time. Equity financing of FDI collapsed to just one over third its 2002 level, to stand at €5.3bn.
- ▶ Inflows of FDI from the euro area grew by a quarter in 2003, the second successive year of such strong growth, bringing this source of direct investment, as a percentage of the total, to more than three quarters. The increase in the relative proportion of FDI accounted for by the euro area is consistent with developments elsewhere, which strongly suggest that adoption of the currency has boosted FDI among the countries participating.
- ▶ Outward flows of direct investment by Irish residents in 2003 were less than one third of those of 2002, standing at €3.1bn indicating that the pace at which Irish firms are expanding their presence abroad continues to decelerating from a high-point in 1999-2000.
- ▶ According to UNCTAD, Ireland accounted for just over half of one percent of all outward FDI from EU countries (down from close to one percent on average in recent years). Of the pre-enlargement 15-member bloc, Irish outflows were the fifth lowest in absolute terms (ahead of Finland, Portugal, Greece and Denmark) and seventh lowest in per capita terms.
- ▶ In 2003 the euro area accounted for the largest amount of total outward FDI, while Irish residents divested themselves of US assets. It is likely that the deepening of European economic integration caused by the euro and resulting in the removal of exchange rate risk has made investing in EMU countries more attractive. This is consistent with findings in other EMU countries, where levels of FDI among the participants has risen strongly since the launch of the single currency.
- ▶ The total stock of outward FDI stood at \$33.5bn according to UNCTAD, a figure that in per capita terms in the EU-15 context is broadly proportionate to the countries population (around 1 percent).
- ▶ UNCTAD records stocks of FDI in Ireland equivalent to 127 percent of GDP in 2003, or \$193bn. In absolute terms, this is the sixth highest level among the EU-15 and by far the largest in per capita terms.

2. Merchandise Trade

2.1 Trends in Global Trade

2.1.1 Trade and global economic growth

In 2003 the volume of world trade grew at 4.5 percent, its most rapid rate of increase since 2000 according to the World Trade Organisation (WTO). The upturn was a result of, and contributing factor in, stronger global economic growth. In value terms, exports grew even more rapidly, at 16 percent in US dollar terms, to reach a record US\$7.3 trillion. This, however, reflects mostly the effect of exchange rate fluctuations (the effective dollar exchange rate fell by more than 11.5 percent on 2002). Following two years of falling export prices, owing to weak demand and excess capacity (which gave rise to fears of global deflation), there was a 3.3 percent increase in world export prices in 2003.

Of the big exporting regions - the EU¹, the US and Asia - only the latter saw strong growth in 2003. Asian exports increased in volume terms by almost one eighth, the second year of double-digit growth. This was attributable to two factors. First, intra-Asia trade was boosted by strong economic growth in the region, with the Chinese economy continuing to grow rapidly and Japan registering one of its strongest expansions in a decade and a half. Second, Asian exports to the US also grew strongly. A combination of strong economic growth in the US combined with Asian central bank intervention to prevent the appreciation of their currencies vis-à-vis the dollar accounted for this. By contrast, the EU saw exports stagnate for the third consecutive year, with a strong appreciation of the euro against all major currencies hampering the competitiveness of euro area exports, while intra-EU trade suffered as a result of depressed domestic demand across much of the continent. Countries in central and eastern Europe (CEECs) saw the strongest regional growth in the world in 2003, in part reflecting deepening trade integration with the EU-15. This was illustrated by the region overtaking the US as a supplier of merchandise imports to the EU for the first time.

2.1.2 US trade imbalance

The US export performance was the poorest among the major traders, with another decline in export volumes in 2003, resulting in that country losing its position as the world's largest exporter (to Germany). Slow growth in the EU dampened demand for imports, despite lower import prices resulting from dollar depreciation. In Asia, domestic growth was much stronger, but US firms benefited little because of intervention by Asian central banks worked against them. The result of these developments in combination is that the current account imbalances in the global economy have become more pronounced, increasing the risk that a sudden unwinding could trigger a downturn in global economic growth.

¹ The EU expanded its membership from 15 to 25 countries on May 1st 2004. As this report mostly covers developments before that date, reference to the EU throughout is to the 15 member bloc unless otherwise stated

Table 1: Growth in the volume of world merchandise trade by selected region

	Exports - % Change			Imports - % Change		
	1995-2000	2002	2003	1995-2000	2002	2003
World	7	3	4.5	7	3	5
N. America	7	-2.5	-1.5	10.5	4	5.5
Latin America	9.5	-0.5	4	10	-7	0.5
West Europe.	6	1.5	0.5	6	0.5	1.5
EU (15)	6	1	0.5	6	0	1.5
CEECs, CIS	7	8	12.5	7.5	7.5	11.5
Asia	8.5	10.5	12	5.5	8.5	11

SOURCE: WORLD TRADE REPORT 2003, WTO

The WTO provides commodity data on trade in three categories: agricultural products; mining products; and manufactures. Mining products saw a significant acceleration in volume growth, from 0.5 percent in 2002 to 2.5 percent in 2003, in part owing to the very rapid expansion in Chinese demand for primary products (both food and non-food) to fuel its manufacturing-led boom. In value terms the rise was greater, as commodity prices (for oil in particular) rose owing to stronger demand combined with supply constraints. The rise in prices accelerated considerably in 2004 and is likely to result in much higher value growth compared to 2003. Manufactures continue to dominate world trade (more than three quarters of the total), and this dominance was strengthened in 2003 as the volume of these exports expanded by 5 percent. Again, the rise was fuelled by China's capacity to produce low cost goods at competitive prices.

Indications in late 2004 suggest that trade growth will accelerate further in 2004, to 8.5 percent according to the WTO in late October, as world economic growth reaches a 20-year peak. The upswing is being driven by a strengthening of economic growth in the US and Asia. Europe is again expected to contribute relatively little to the increase in global trade owing to still-sluggish domestic demand conditions dampening import growth and a strong euro suppressing exports.

2.2 Ireland's Merchandise Exports: Values and Volumes

2.2.1 2003 Ireland's export performance

Despite the upturn in global economic and trade growth in 2003, Irish exports contracted for the first time in more than four decades. Although the headline figures overstate the severity of the downturn in the merchandise export sector (as discussed below), 2003 was undoubtedly a poor year. According to the WTO, Ireland's export growth performance was the fifth lowest of the world's 50 largest exporting countries. As a result, Ireland saw its ranking fall to 22nd among the top 50 exporters, from 19th in 2002. In per capita terms Ireland is the third largest exporter² after the United Arab Emirates and Belgium.

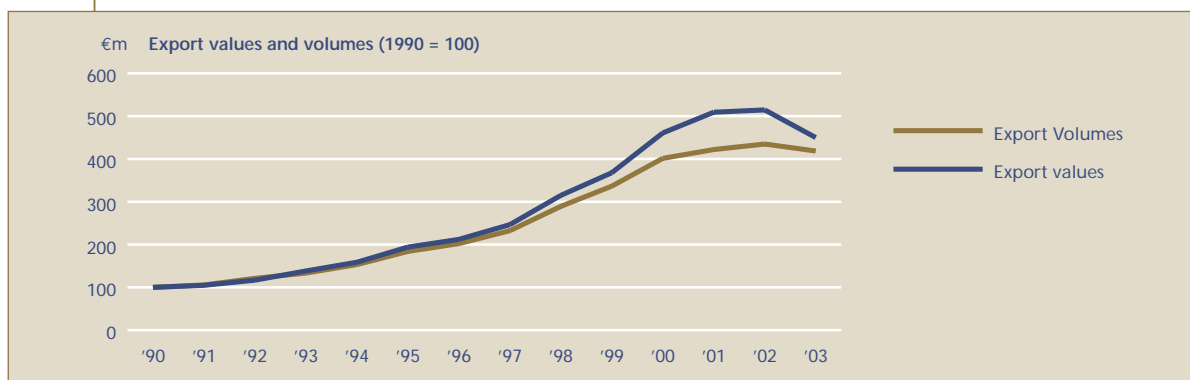
National trade figures give a more detailed picture. In volume terms, provisional data show a fall of 3.7 percent in 2003. In value terms the decline was more precipitous. Export receipts fell from €93.7bn in 2002 to €82bn in 2003, a decline of one eighth. The difference in the value and volume measures is accounted for by a (sharp) fall in export prices - the second consecutive annual decline. There were two principal reasons for this. First, euro appreciation was likely to have forced some firms to cut prices to remain competitive. Second, information, communication and technology (ICT) goods account for an usually large share of exports

² Domestic exports only.

compared to most other countries, so the continued decline in world prices depressed the overall export price index.

Given that economic growth in 2003 accelerated in two of Ireland's three main export markets (strongly in the case of the US and mildly in the UK) and slowed only marginally in the third (the euro zone), weak demand was not a reason for the poor export performance. Explaining almost half of the €11.6bn decline in export receipts was the uncovering of a major VAT fraud by the UK authorities in the first half of 2003. This saw the removal from the subsequent data of the non-existent exports which had been registered by the fraudsters. Thus the figures for 2002 and 2003 do not entirely compare like with like (the former are likely to have been artificially inflated by the scam). Undoubtedly important was the appreciation of the euro. In 2003 it rose 20 percent vis-à-vis the dollar and 10 percent vis-à-vis sterling. However, this by no means explains the full magnitude of the decline (exports to US, for instance, increased despite the euro appreciation). Given that the real decline in export volumes was concentrated in the foreign-owned sectors of ICT and pharmachems, a significant change may have taken place in these firms production patterns after many years in which changes worked in Ireland's favour. This concern is magnified by foreign investment data which show that little new manufacturing capacity is being added in Ireland by foreign firms³, in contrast to the 1990s.

Figure 1: Merchandise Goods Exports: value and volume growth 1990-2003



2.2.2 Return to growth

Though the full year out-turn for exports was disappointing, developments during the course of the year suggest that the low-point was reached in first half of 2003. By the fourth quarter of 2003 export values dropped by just 2 percent while volumes actually increased quite strongly, up by 9.2 percent year-on-year. A renewed dip in the first quarter of 2004, was followed in the second-quarter by an increase in export volumes of close to 10 percent. Although the expansion in the first half of 2004 was modest compared to consistent double-digit rates just a few years ago, it represents a significant turnaround after the performance of 2003. The first half of 2004 also appears to have heralded a change in the direction of export prices. While the rate at which these fell had been accelerating since June 2001, falls became less marked from May 2004.

2.3 Structure of Goods Exports by Composition

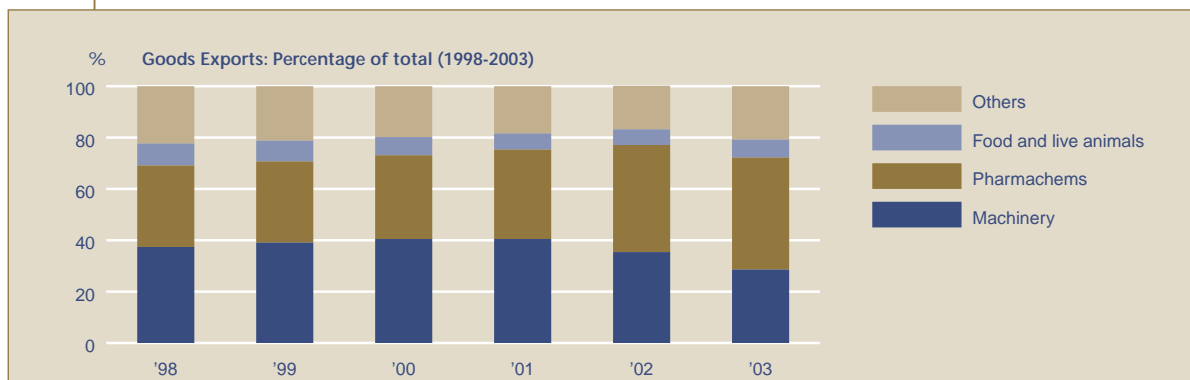
2.3.1 Exports less concentrated

A long-term pattern, in which Irish merchandise exports became increasingly concentrated in just two sectors - the "chemicals and related goods" category and the "machinery and transport" goods - was partially reversed in 2003, when, combined, these fell as a proportion of total exports to 72 percent, from 77 percent in the previous year. Although data from the first

³ The precision instruments sub sector appears to be an exception.

half of 2004 show the main sectors again increasing their share of the total it remains to be seen whether 2003 will mark a halt or reversal in the long term pattern of increased concentration. If, as suggested above, foreign owned firms make permanent changes to their production patterns, a reversal is likely. Even if this does not happen, the rate at which exports have become concentrated is almost certain to slow owing to the lower levels of additional manufacturing capacity being added in these sectors.

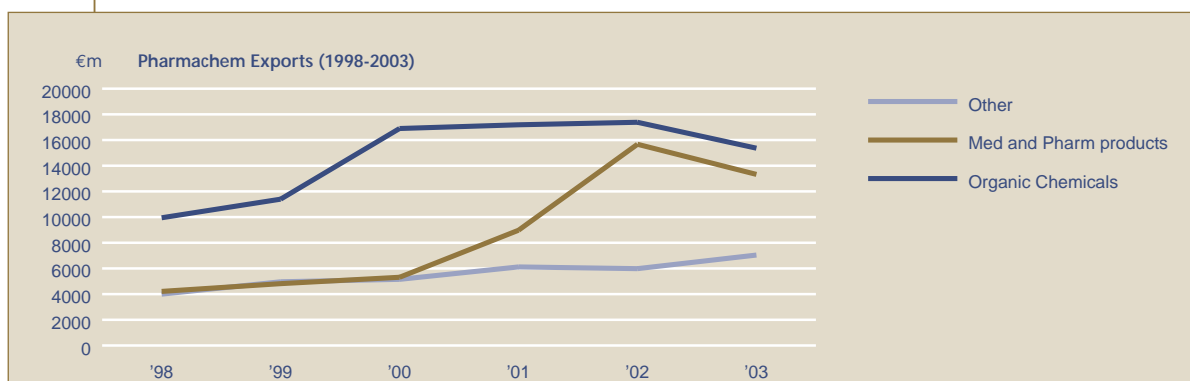
Figure 2 : Merchandise Goods Exports: percentage of total



2.3.2 Pharmachems register export decline

Following a number of years of very strong double-digit growth rates when chemicals and pharmaceuticals became Ireland's largest export, the value of foreign sales fell in 2003 to €35.8bn, representing a decline of €3.3bn. Even when the appreciation of the euro is considered this fall represents a significant reversal in fortunes for an industry whose exports had grown by a factor of 5.8 in the seven years to 2002, to make Ireland one of the leading global suppliers in the pharmchems industry. The decline, explained either by a one-off boom in exports in 2002 or a shift in production away from Ireland⁴, came despite the robust expansion of the industry internationally in 2003 - global trade in chemicals strengthened, growing by almost one fifth in dollar terms according to the WTO. Both of the main sub-categories - "organic chemicals" and "medical and pharmaceutical" - registered declines. The former continues to account for (slightly) more foreign sales following a number of years during which the latter drove growth. The picture brightened in the first half of 2004 when export values grew by 7 percent.

Figure 3: Pharmachem exports

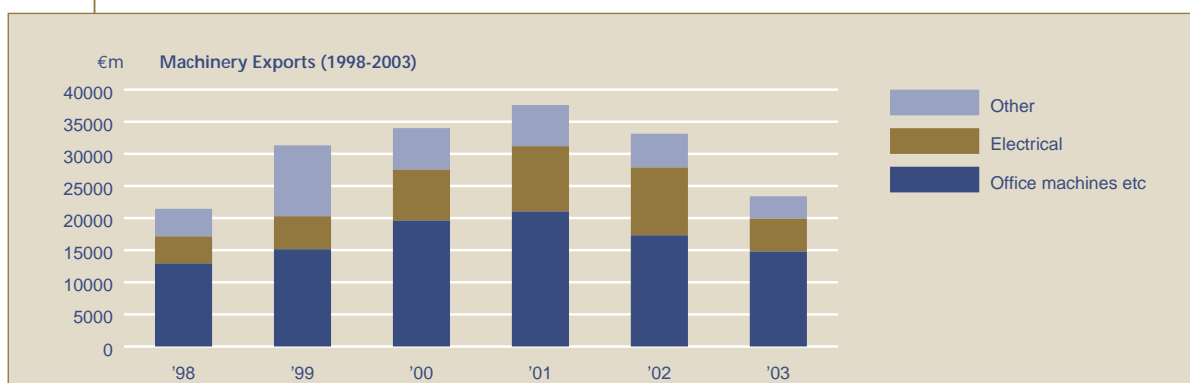


⁴ Detailed bi-lateral trade data between Ireland and Belgium suggest that there are close links between the two countries in this sector. This is illustrated by the sudden 13 fold increase in exports to Belgium in the "medical and pharmaceuticals" sub-category in 2002, which caused these exports to jump from a relatively minor component of trade with Belgium in 2001 to close to two thirds of the total in a single year. As this very high level of exports was not sustained in 2003, negative growth was recorded.

2.3.3 ICT exports

Until 2001, the “machinery and transport equipment” category was the largest single export sector. Dominated by computer hardware, exports have since fallen very sharply, from a peak of €37.6bn in 2001 to €23.4bn in 2003, with a decline of some €10bn recorded in 2003 alone. In real terms, however, the decline of almost a third in the value of exports in 2003 was less than this figure suggest for two reasons. First, the VAT fraud operation mentioned previously involved in this sector. This was likely to have accounted for slightly more than half of the decline. Second, in volume terms, the decline was almost certain to have been less precipitous given falling prices in the sector. However, even allowing for these factors, the industry in Ireland suffered a second bad year and despite the global recovery in the industry international, from the final quarter of 2003, Ireland’s ICT exports suffered a year-on-year fall of 4.1 percent in the first six months of 2004. The decline was driven largely by a 9.5 percent drop in the value of “office and data process machine” exports - the largest single subcategory. The failure of the industry in Ireland to maintain market share as demand recovers internationally is a cause of some concern.

Figure 4: Machinery Exports



2.3.4 Precision instruments exports

The “miscellaneous manufactures” category of exports, which is made up of medium and low-technology exports as well as some higher technology goods (most notably, precision instruments) has historically been a good proxy for assessing the health of the indigenously-owned sector. Positively, it saw the value of exports rise by over 14 percent, to €9.5bn in 2003, to account for almost one eighth of the total. This strong performance came in the face of very considerable challenges. Indigenously-owned firms, which generally operate on much tighter margins than the highly capitalised foreign-owned sector, are more vulnerable to exchange rate fluctuations. The appreciation of the euro, therefore, could have been expected to depress exports from the more labour intensive indigenous manufacturing sector, especially as rates of wage and non-wage inflation were relatively high by international standards.

Despite the strong rate of headline growth it is probable that the twin challenges of higher costs and an appreciating euro have, in fact, seriously eroded competitiveness. An analysis of sub-categories shows that most suffered declining foreign sales in 2003, and that all of the growth was accounted for by a single sub-category - “professional scientific and controlling apparatus”. The phenomenal growth in foreign sales of such precision instruments (at almost 60 percent in 2003) was very likely to have been accounted for by additional manufacturing capacity coming on stream, suggesting investment by a large multinational enterprise

(indigenously owned firms tend to take a more gradualist, organic growth approach to expansion). The pattern continued into 2004, when exports in the sub-category grew by over 40 percent on the same period a year earlier. Again, this increase accounted for all of the growth in entire “miscellaneous manufactures” category.

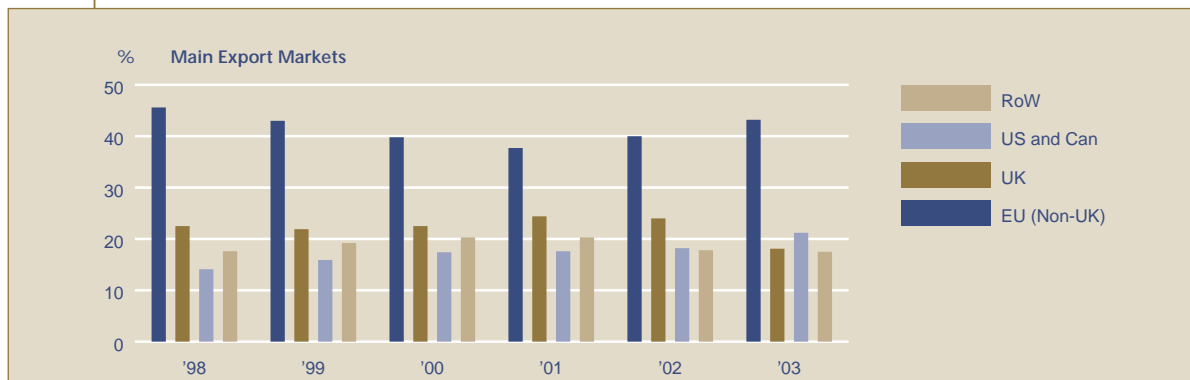
2.4 Destination of exports

2.4.1 Despite low growth, US becomes Ireland's largest national export market

The relative importance of Ireland's export markets appeared to change considerably in 2003, with the US becoming largest single market, overtaking the UK. From a position of accounting for less than one tenth of exports as recently as 1996, the US breached the 20 percent threshold in 2003 when exports were worth almost €17bn. Counter party data from the US, which records a much higher figure of €22.7bn (\$25.7bn), shows Ireland to be that country's 10th largest supplier of merchandise imports. In value terms national figures record growth of just 3 percent (the second consecutive year of low growth), although in volume terms this was likely to have been stronger owing to the fall in export prices. Given the strength of euro appreciation vis-à-vis the dollar, this was a solid performance and is explained, partially at least, by the extent of intra-firm trade which insulates Irish exports to the US from exchange rate fluctuations (many firms in Ireland are large multinationals with corporate financing divisions capable of hedging currency risk). Pharmaceuticals account for more than half of total exports to the US. This category, in turn, is dominated by the organic chemicals sub-category, reflecting the high level of manufacturing of high-grade chemicals which are used in the production of pharmaceuticals in the US. Despite strong economic growth in the US in the first half of 2004 the value of exports fell 2.0 percent on the same period of 2003, reinforcing the view that American firms may be switching production away from their Irish subsidiaries.

For the first time ever in 2003 Britain was not the main destination for Irish exports according to trade data (although it is likely that this change happened before 2003, but was masked by the inflating of export figures as a result of the aforementioned VAT fraud operation). The decline in the value of exports to Britain - by over one third - was largely centred in the “electrical machinery, apparatus and appliances and parts” sub-category (where the VAT scam was uncovered). Britain's absorbed just 16.4 percent of total Irish exports in 2003, down for one third as recently as 1990. There was a rebound in the first six months of 2004 when the value of Irish-made merchandise goods exported to Britain rose by 3.4 percent over the same period a year earlier. Exports of chemicals and ICT goods accounted for almost half of the total exports in 2003, reflecting their strong rates of growth in recent years, 2003 notwithstanding. Reflecting the declining competitiveness of Irish exports, the miscellaneous category has been in decline in recent years and amounted to less than €1.5bn in 2003, around one eighth of total exports to Britain. Historically, Ireland's exports were dominated by food and beverage exports to Britain. Today, both categories combined account for less than a fifth of total exports to Britain, and are now a relatively smaller share of Ireland's global exports.

Figure 5: Main Export Markets



2.4.2 Exports to Belgium continue to fluctuate considerably

Exports to the EU (including Northern Ireland, but excluding Britain) declined by over €2bn in value, a little more than 5 percent, in 2003. The drop was entirely attributable to a fall of more than €3bn in the value of exports to Belgium, Ireland's third largest national market after the US and Britain. Exports to all other important EU member state markets rose on 2002. Despite the elimination of currency risk with most countries in "non-Britain" EU, their share of total Irish exports, at 45 percent, is below the 48 percent registered in 1998, the last year before the launch of the euro. It seems clear that whatever trade creation and diversion effects the elimination of exchange rate uncertainty caused that other factors have more than offset these. In the first half of 2004, fluctuating trade with Belgium was again a notable aspect of developments. Exports to that country jumped by over a third on the same period in 2003, accounting for all of the increase in exports to the EU. Broad stability characterised trade developments with the other main continental markets, reflecting the slow pace of domestic demand growth among the mature economies in the region.

The value of exports to markets other than the EU-15 and US (hereafter described as the Rest of World, RoW), fell by over 13 percent in 2003. Here, the competitiveness-eroding effects of euro appreciation was likely to have been marked, with declines registered almost across the board, including in the two most important RoW national markets: Switzerland and Japan. Also of note was the failure to make inroads into the rapidly growing Indian markets. More positively, exports to China and Hong Kong grew strongly.

2.5 Ireland's Merchandise Imports: Values and Volumes

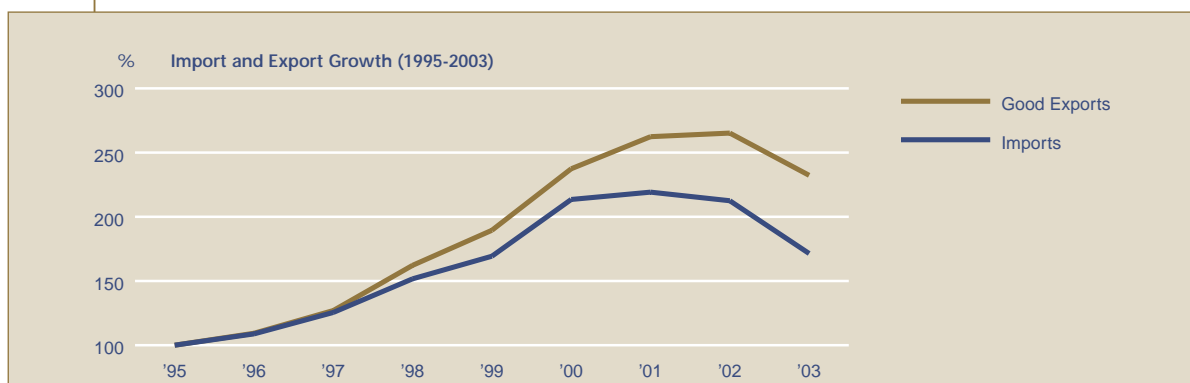
2.5.1 Rate of decline in imports exceeds that of exports

Import volumes fell by 6.5 percent in 2003, a considerably sharper decline than the 3.7 percent contraction of exports. The value of imports declined by 14 percent, to €47.9bn, as import prices fell by close to one tenth. The fall in imports occurred despite the appreciation of the euro, which made imports cheaper and would, other things being equal, normally lead to volume growth. Four factors, presented here in descending order of importance, explain why this did not happen. First, as in the case of exports, the uncovering of the VAT fraud operation exaggerated the magnitude of the decline - of the €7.8bn decline in total imports, €5.5bn was accounted for by the sub-sector in which the fraud was discovered. Second, imports remain closely correlated to exports owing to the import-intensity of a manufacturing sector (58 percent of total imports were accounted for by inputs for further production). Weakness in manufacturing, which saw industrial production growth fall to a ten-year low, depressed

imports of intermediate goods. Third, a contraction in nominal spending on machinery and equipment economy-wide resulted in capital goods imports falling by almost 20 percent. Finally, real private and public consumption growth both expanded at the slowest rates in a decade, contributing to a contraction in the value of consumer goods imports. On a global basis, Ireland fell back in the rankings of world importers, to 28th largest (from 26th in 2002), making it the third largest per capita importer in the world after Luxembourg and Singapore.

The decline in imports was concentrated in the first half of 2003, and by September of that year volume growth had returned. This continued in 2004, which resulted in a total half-year import bill of €24.3bn, a year-on-year increase of 3 percent. In volume terms, the increase was slightly greater at 3.8 percent. As this suggests, import prices continued to fall into 2004, although the rate at which they declined slowed considerably from 2003.

Figure 6: Import and Export Growth



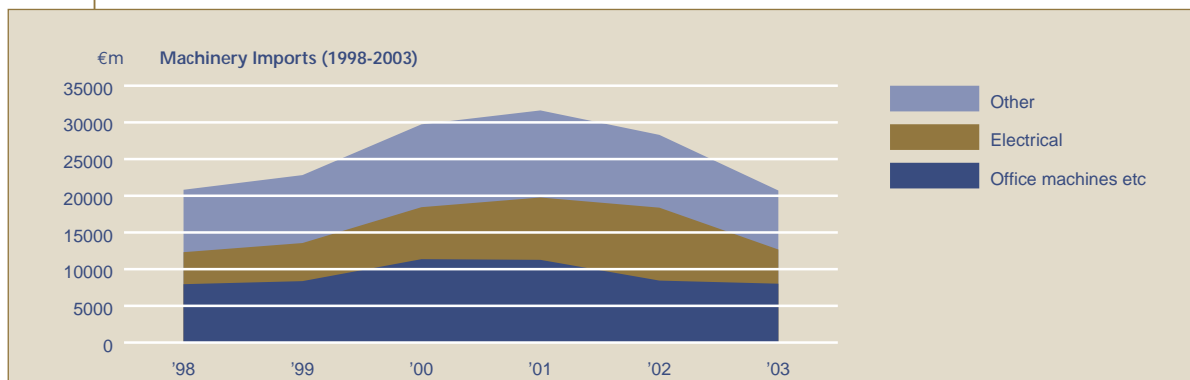
2.6 Structure of Goods Imports by Composition

2.6.1 Five years of ICT growth was reversed in 2003

By far the most significant import sector is machinery and transport equipment, in recent years accounting for almost half of total merchandise imports. Largely as a result of the previously mentioned VAT fraud operation, imports in this category fell precipitously in 2003, with the import bill in this category returning to 1999 levels. The fraud operation was confined to the “electrical machinery, apparatus and appliances” sub-category, which registered a €5.5bn fall (mirroring exactly the contraction in the same category of exports). Sub-categories of machinery and transport equipment exports unaffected by the VAT scam also contributed to the overall decline, even if this was small by comparison. Imports of vehicles and transport equipment together fell by well over €1bn, reflecting subdued consumption and investment spending, while computer imports fell by over €400 million, also reflecting lower investment expenditure along with declining demand for inputs in the export-intensive manufacturing sector.

Despite the decline, this category of imports continued to dominate, accounting for 44 percent of the total in 2003. This share of imports did not change in the first half of 2004, when a growth rate of 4.4 percent year-on-year was exactly in line with the rise in total imports. It should be noted, however, that this increase is skewed by a remarkable surge on a relatively minor sub-category - imports of “other transport equipment” jumped by 385 percent to €816m. This is likely to be attributable to purchases of aircraft by Ireland’s strong aviation sector. As such purchases take place only irregularly, the underlying weakness of demand for this sector’s imports continued into 2004.

Figure 7: Machinery and Transport Equipment



2.6.2 Most import categories remained static on 2002

Ireland's other imports are spread widely across manufactured goods, chemicals and fuels. Of note in 2003 was how little change was registered over 2002, although falling prices likely masked some volume growth. The value of all manufactured goods imports (other than those in the machinery and transport category) stood at €10.4bn, unchanged over 2002. Imports of chemicals and related products were also static, at €6.8bn. A small decline in inputs for the export sector (reflecting lower sales of finished goods) was offset by an increase in imports of medical and pharmaceutical products, the result of continued strong expenditure growth on health services. Fuel imports, which are dominated by petroleum, saw a slight decline, reflecting a fall in euro denominated oil prices⁵.

In the first half of 2004 the unusually steady state of imports across almost all sectors continued. In the broad "chemicals and related products sector", the import bill increased by just 2.3 percent to €3.6bn. Reflecting sluggish private consumption growth and the contraction in investment spending, "other manufactured goods" were also static in value terms, while the food and beverage categories combined saw a statistically insignificant decline. Only fuels registered any strong growth, with the import bill for fuels rising by over one tenth, reflecting rising world oil prices.

2.7 Origin of Imports

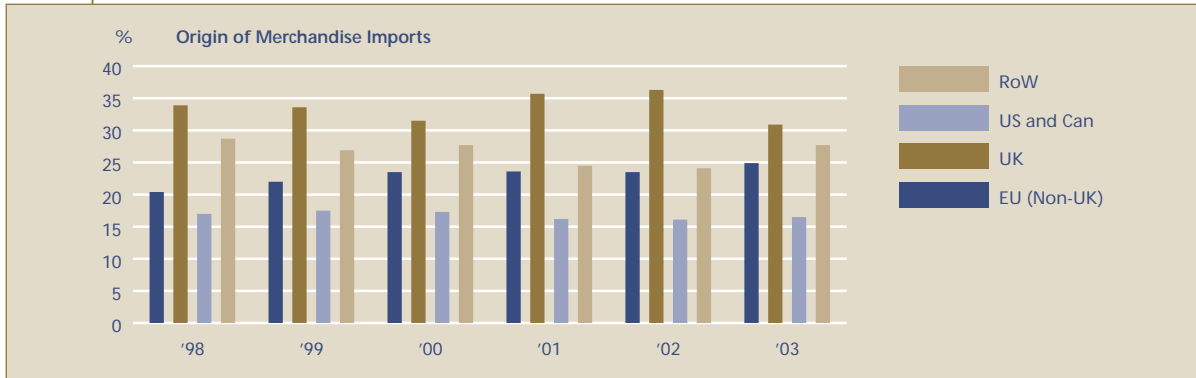
2.7.1 Little sign of trade creation five years after euro's launch

Imports from Britain fell by €5.4bn, to €13.6bn (almost all of which was related to VAT fraud). If ICT goods are excluded, the value of imports was likely to have been largely stable on the previous year. Despite the large drop in the import bill, Britain remains by far Ireland's largest source market, accounting for 29 percent of the total (down from over 34 percent in 2002). In the first six months of 2004, Britain accounted amounted to €6.4bn, a 3.5 percent decline on the same period in 2003.

Imports from the EU (including Northern Ireland, but excluding Britain) fell by 9 percent in value terms in 2003. As this decline is almost identical to the fall in overall import prices, volume change was likely to have been small. The decline in the import bill was mostly accounted for by lower imports from the three largest national sources - Germany, France and the Netherlands. Despite the fall, imports from non-Britain EU rose as a percentage of the total to 27 percent, from 25 percent in 2002. Unlike the case of exports, it appears that the trend since the launch of the euro has been for greater import sourcing from other countries who use the currency - euro area imports have risen from 18.8 percent of the total in 1998 to 22.2 percent in 2003.

5 While dollar-denominated oil prices rose by 15 percent on 2002, the euro appreciated vis-à-vis the dollar by 20 percent.

Figure 8: Main Sources of Imports



After the UK, by far the largest single national source market for imports is the US, reflecting high levels of intra-firm trade by American multinationals in Ireland. At €7.4bn in 2003, imports declined by almost one eighth in value terms (probably less in volume terms owing to price effects), mostly reflecting lower export activity. According to US trade data, which recorded imports of \$7.7bn (€6.8bn) in 2003, Ireland was the 20th largest market for US exports. In the first half of 2004 import growth from the US resumed, if only at low rates.

Imports from the RoW (Rest of the world) were largely unchanged on 2002 in value terms, at €13.6bn. However, as euro appreciation drove down prices for non-euro area imports, it is likely that volume growth was recorded. In the first half of 2004, the value of imports from RoW grew by almost 6 percent. Among the most notable developments in import patterns was the growth of China's market share. Imports from this source grew by just over 50 percent, to €2.2bn - more than double Northern Ireland's imports to the Republic.

2.8 Merchandise Trade Balance

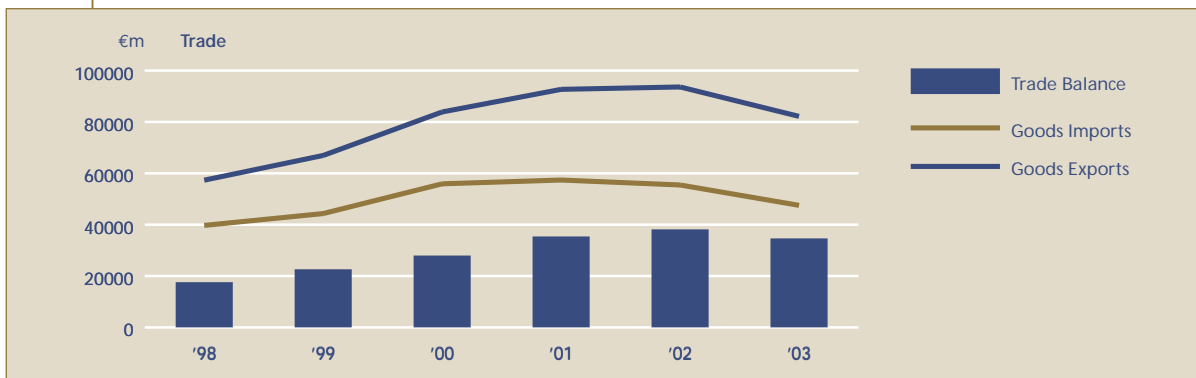
2.8.1 Trade surplus falls for the first time since 1990

Although the contraction in the value of imports was greater than that of exports in percentage terms, in absolute terms the fall in export values was much greater owing to base effects. As a result the trade surplus fell by €3.5bn in 2003, to €34.7bn. This was the first decline in the surplus since 1990. Despite this, Ireland's trade balance, at 26 percent of GDP, remains the second largest in the OECD after oil-exporting Norway.

The most important factor explaining the reversal in the long run trend towards ever larger surpluses was the decline in pharmachem trade balance. While imports in the sector remained static, exports fell by €3.3bn. The trade surplus in ICT goods was almost halved, falling by €2.2bn, as demand for imported hardware fell sharply (it should be noted that the VAT fraud had no effect on the trade balance as the effect on exports and imports was identical). Both of these developments were partially offset by shrinking deficits on other balances.

The contraction in the trade surplus recorded in 2003 is likely to herald a period of shrinking surpluses only if the decline in the pharmachems and ICT sectors becomes structural. Provided that this does not happen, a return to rising surpluses is likely given that the rate of import growth would have to be almost double that of export growth to cause a narrowing because of the much higher absolute levels of exports. In addition, given that a high percentage of imports are used as inputs in the export sector it seems unlikely that import growth will consistently outstrip that of exports by any significant magnitude. Developments in the first half of 2004 supports this view, as the trade surplus returned to an upward path, rising by almost €1bn over the same period in 2003.

Figure 9: Goods Trade Balance



3. Services Trade

3.1 Global developments

3.1.1 Real growth in services was low or non-existent in 2003

The value of internationally traded services rose to \$1,763m in 2003. Although this represented an increase of 13 percent, almost all of this was likely to have been accounted for by exchange rate movements (the real effective dollar rate of exchange fell by 11.5 percent on the previous year's average). This was also below the increase in merchandise goods trade (16 percent), in line with medium patterns which have seen services export growth lag that of merchandise goods. WTO data shows that the EU was the main sources of growth in 2003, The EU, which accounts for almost half of the world's trade in services (more than half of this is intra-EU trade), reached \$781bn in 2003. This represents an increase of 18 percent on 2002. However, given that the euro appreciated by around 20 percent against the dollar, there was likely to have been a contraction in the value of EU services trade when measured in local currency. In real terms, growth was most likely to have been stronger in Asia and the US.

Table 2: Growth in the value of world trade in commercial services by selected region

	Exports:			Imports:		
	Annual 1995-2000	Per cent 2002	Change 2003	Annual 1995-2000	Per cent 2002	Change 2003
World	4	7	13	4	5	13
N. America	7	3	5	9	3	9
EU	4	10	18	4	8	18
Asia	3	7	8	2	4	7
Latin America	6	-3	7	6	-9	4

SOURCE: WORLD TRADE REPORT 2003, WTO

Trade in international services has historically been broken down into three broad categories: business services; tourism and travel; and services related to merchandise trade. In 2003, long term patterns continued, with business services growing as a percentage of the total, to almost half, from 37 percent in 1990. Tourism and travel, which accounted for around one third of all internationally traded services in the mid-1990s has become relatively less important. In 2003, these services accounted for less than 30 percent of the total for the first time, as the SARS outbreak, subdued economic growth in Europe, the Iraq war and continued concerns about terrorism depressed travel spending. Europe, which accounts for half of global tourism arrivals, saw visitor numbers remain unchanged from the previous year according to the World Tourism Organisation. Demand side weaknesses for the European sector included fewer US travellers (owing to international security concerns) and fewer German tourists (owing to continued weakness in economic growth in that country). The impact of an appreciating euro, which made travel in countries using the currency more expensive for those coming from outside it, was also likely to have been significant. Over time, transportation services have been declining most quickly relatively, as technological advances have lowered costs. The fall was halted in 2003, owing to stronger merchandise trade growth and the continued additional costs related to counter-terrorism measures. Trade services accounted for around 23 percent of the total in 2003.

Table 3: Growth in the value of trade in commercial sectors by main service type

	Value		Share	Annual percentage change			
	2003	1995	2003	1995-			2003
				2000	2001	2002	
All commercial services	1795	100.0	100.0	4	0	7	13
Transportation	405	25.5	22.6	3	-1	5	13
Travel	525	33.7	29.4	3	-2	4	10
Other commercial services	865	40.7	48.0	6	3	10	15

SOURCE: WORLD TRADE REPORT 2003, WTO

3.2 Irish Services Exports by Value

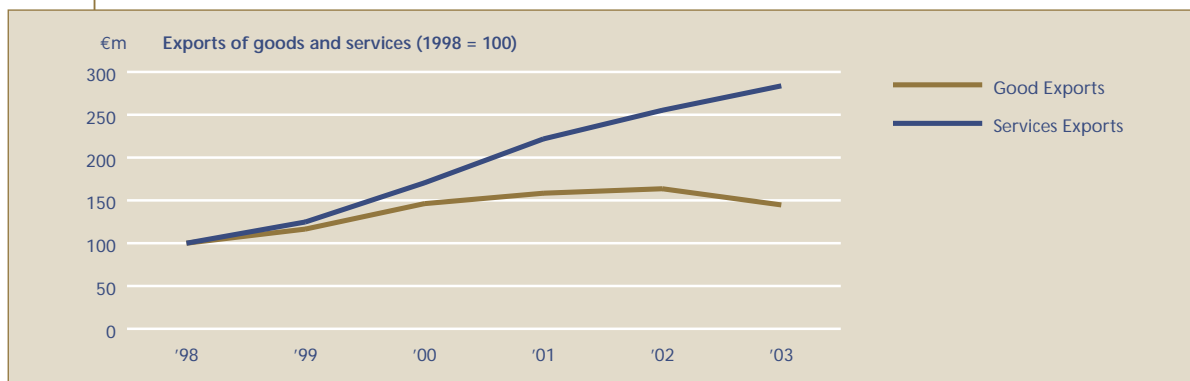
Growth in services exports is among the highest in the world

In 2003 Ireland's exports of services continued to grow strongly. According to the WTO, Irish exports soared in dollar denominated terms by 27 percent - a rate of increase exceeded by only three countries among the top 40 services exporting nations in the world. This strong growth propelled Ireland further up the league table of services exporters, to 14th position in absolute terms. In 2003, one dollar in every fifty spent on traded services globally accrued to Ireland, a share of the world market out of all proportion to the country's size. This is well illustrated in per capita terms: Ireland was the second largest exporter in the world after Luxembourg in 2003.

National sources show more modest growth than WTO figures (a 20 percent appreciation of the euro caused growth in dollar terms to be exaggerated). The 11 percent increase in the value of services exports, to €33.6bn, did, however, represent a further (slight) deceleration in the rate of growth. This is in line with developments since 2000, when growth peaked at exceptionally high levels (36 percent). The first half of 2004 saw a continuation of the trend, with the value of foreign sales rising by 9.5 percent.

The success in recent years of the services sector in absolute terms (a near three-fold increase in foreign sales has been recorded since 1998), and relative to manufacturing (see figure 10), amounts to a structural shift from manufacturing to services in the internationally traded sector of the Irish economy. This expansion in services exports is most readily explained by the sharp reduction in corporation tax for service companies - the rate was cut gradually over a number of years, from more than 30 percent in the late 1990s to 12.5 percent in 2003. This has given a fillip to indigenously-owned services providers and made Ireland a more attractive location for foreign firms at a time when services industries are internationalising more rapidly than the manufacturing sector (foreign direct investment globally is increasingly dominated by services firms). Trends show that the already unusually high levels of services as a percentage of total Irish exports rose further in 2003, to almost 30 percent, considerably above the EU-15 average of just below 23 percent. However, this structural shift may be moving towards conclusion, as suggested by the decelerating rate of export growth.

Figure 10: Exports of Goods and Services compared

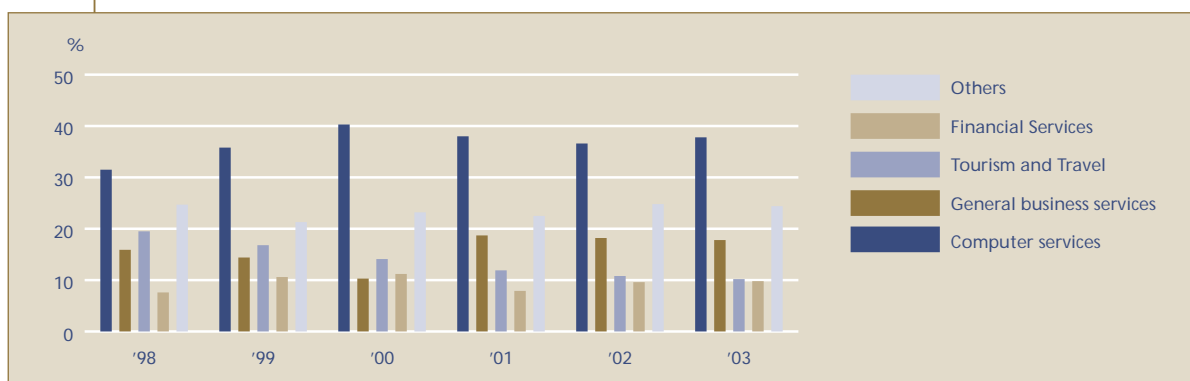


3.3 Structure of Irish Services Exports by Composition

3.3.1 Computer services exports grow despite challenges

Accounting for almost half of the growth in total services exports in 2003 was the rise in computer services, the largest single category of services sold abroad (more than a third of the total). Sales rose to €12.7bn, an increase of almost 15 percent (a considerable acceleration on the rate of increase in 2002). That these exports, comprising mostly of software delivered electronically, continued to grow so strongly was a considerable feat given that the industry internationally remained in recession until the final quarter of the year (as detailed in the previous section, the value of ICT merchandise exports fell sharply in 2003). Despite the upturn in the industry, the rate of export growth slowed in the first half of 2004, to 12 percent.

Figure 11: Composition of Services Exports



3.3.2 Trade services become significant export earner for the first time

Business services - the second largest single category of Irish exports - saw growth of almost nine percent in 2003. Two thirds of the increase owed to the second consecutive large annual jump in trade-related services, the smallest sub-category of business services and one which accounted for just €51 million in foreign sales as recently as 2001. The large increase in foreign sales of such services represents a structural increase in output capacity to provide such services. In recent years Irish subsidiaries of foreign firms have become more involved in the provision of these services for themselves (rather than importing them) and to other subsidiaries. It appears likely be that this is now also happening in trade-related services.

A small expansion in the largest sub-category - miscellaneous services - accounted for the remainder of the increase of business services in 2003. In the first half of 2004, the pattern in recent years became more pronounced, with trade-related services exports more than doubling in value over the same period in 2003, while those of miscellaneous services fell. Aggregated, however, total business services growth accelerated slightly, to more than 11 percent.

3.3.3 Insurance exports boom in 2003, but halt in 2004

The spectacular increase in exports of insurance services of recent years continued apace in 2003, with foreign sales of insurance products growing by a fifth, to reach €4.6bn. From near-insignificance as recently as the end of the last decade, exports from this sector have overtaken financial services and tourism and travel to become the third largest export sector, accounting for almost 14 percent of the total in 2003. A confluence of factors has led to a sharp influx of foreign insurers to Ireland (half of the world's 20 largest insurance companies now operate out of Ireland). These include the internationalisation of the industry, the launch of the euro (Ireland is the only common law, English speaking participant), a favourable regulatory environment and sharp rises in premiums since the terrorist attacks of September 11 2001. In the first half of 2004, export growth came to a halt, an usual development for this industry given its consistently strong rates of increase in recent years. That said, it could be that timing factors account for this and full year figures may tell a different story.

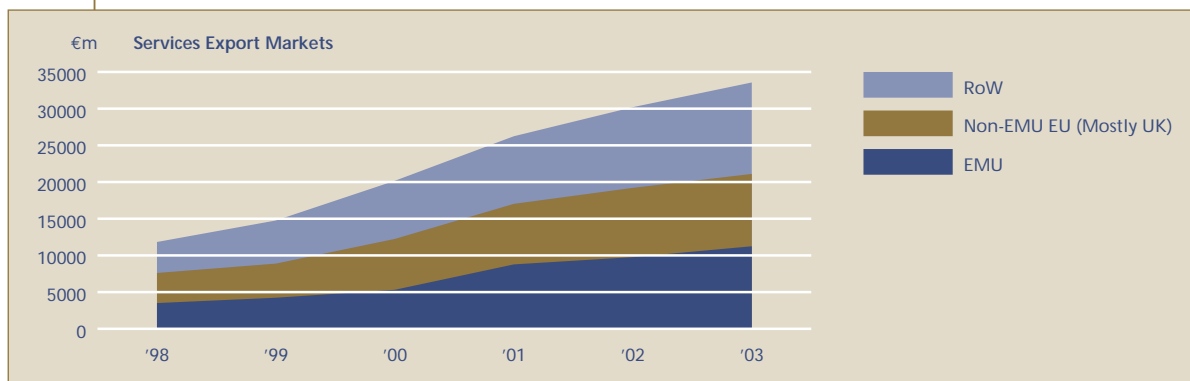
3.3.4 Expansion in range of financial services activities fuels strong growth

Financial services exports, which accounted for just over under one tenth of total services exports in 2003, grew at a rate of 14 percent, slightly faster than the average of all categories combined. This strong expansion took place despite continued low levels of activity in the industry globally, heightened competition for back-office functions provided by low-wage economies and FDI to the international financial services centre (IFSC) declining by more than half over 2002. Despite the latter development, the IFSC continues to thrive, with foreign sales of services growing by more than 17 percent in 2003, accounting for exports worth €10bn, a figure which exceeds the sum of total financial services and insurance exports combined⁶. This growth is attributable to the expansion of the nature of business being carried out at the centre. The backbone of the IFSC since its establishment in 1987 has been the administration of mutual funds. While this business has continued to expand, as the industry has grown internationally, there has been an expansion into the administration of other types of funds, most notably hedge funds, as evidenced from balance of payments data which show "other investment" inflows to the IFSC doubling to a massive €55bn, equivalent to more than 40 percent of GDP.

Activities at the IFSC are increasingly moving beyond funds administration. One such is "pension pooling". This allows firms operating in more than one European country to pool their pension fund (rather than have individual funds in each country with all the associated costs of managing each one). The 2003 Finance Act introduced the legislative changes necessary to facilitate this business. These structural developments, combined with the incipient international cyclical upturn in the financial services industry, saw export growth accelerate strongly in the first half of 2004, growing by 22 percent.

6 It is likely that a considerable proportion of the "business services" category of exports (up to as much as half) are accounted for by the IFSC.

Figure 12: Services Export Markets



3.4 Destination of Services Exports

3.4.1 Euro area market still the fastest growing

Data on Irish services export markets and sources of imports is limited to a breakdown based on EMU and non-EMU and a separate disaggregation: EU and non-EU⁷, a breakdown that offers a quite limited picture of the direction of services trade. In analysing these data it is assumed 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 large market for Irish services exports). Applying these assumptions to the data, it appears as if the destination of Irish services exports divides more or less evenly among the euro zone, the rest of the world (RoW) and the UK, in that order.

All three main markets for Irish services exports saw growth in 2003, with the fastest expansion coming in the euro area. At 15 percent, the increase is likely to reflect the trend (noted above) for the subsidiaries of foreign-owned firms based in Ireland to provide growing levels of services to their sister subsidiaries in continental Europe. In the first half of 2004, the rate of export growth was identical to that in full-year 2003.

3.4.2 Little evidence that euro appreciation has affected exports

RoW markets also expanded vigorously, at more than 13 percent, despite the hindrance of a sharp appreciation of the euro. Much of these sales are likely to be intra-firm, and thus largely unaffected by exchange rate movements. The remainder, are subject to the effects of currency fluctuations, and despite this, developments in 2003 suggest that because exports continued to grow strongly, Irish firms have either wide enough margins to reduce prices and/or have considerable pricing power. An alternative explanation is that there are time lags at work and that the effect of currency appreciation was not fully felt in 2003. Developments in the first half of 2004 lend weight to this thesis, as export growth halted, although full year data will be needed before definitive conclusion can be drawn.

At only 4.4 percent in 2003, export growth to non-EMU EU (effectively the UK) slowed from almost 15 percent in 2002 despite solid economic in that market. As exports to this market have consistently underperformed others since 1998, it was the smallest of the three, accounting for less than 30 percent of the total in 2003. In the first half of 2004 the rate of export growth to the UK accelerated considerably, to just under 12 percent.

⁷ Breakdowns are now available for both EU-15 and EU-25. As the members states who acceded on May 1st 2004 account for less than one percent of total services exports, they are not dealt with separately.

3.5 Services Imports by Value

3.5.1 The value of services imports exceeds that of goods in 2003

After Luxembourg, Ireland is the largest per capita importer of services in the world according to calculations based on WTO data. In absolute terms, Ireland became the ninth biggest consumer of foreign services globally in 2003, jumping from 11th place in 2004⁸. The country's continued advance up the league table of services importers was the result of a dollar-denominated growth rate of foreign purchases of almost one quarter, a rate exceeded only by one other country among the top 40 services importers. Given the continued rise in services imports, and the fall in merchandise goods imports, the former exceeded the latter in value for the first time in 2003⁹. In this, Ireland is unique among the major economies of the world according to the WTO (on average services imports account for just one fifth of countries' total imports).

According to latest national sources, the value of total services imports reached €46.2bn, an increase of just under 4 percent (the large difference with the WTO increase is explained by exchange rate movements which exaggerated growth in dollar terms). In the first half of 2004, the rate of increase fell further, to under 2 percent. As in the case of exports, this is the continuation of a pattern of deceleration since 2001. Four factors account for this. First, the appreciation of the euro caused import prices from non-euro area countries to fall, thus lowering the overall import bill. Second, Irish subsidiaries of foreign firms are increasingly substituting imported services with their own - the fall in both business and transport services was likely to have been attributable to this, in part at least. Third, lower levels of activity in the export-orientated manufacturing sector were also relevant. Ireland's unusually large import bill reflects the presence of a very large foreign-owned export oriented manufacturing sector. Traditionally, services imports have been closely correlated to merchandise exports as foreign-owned exporters buy business services from their parent companies in proportion to goods output. This correlation continued to weaken somewhat in 2003 as import substitution increased. Finally, a slightly lower rate of economic growth in Ireland dampened demand for imports.

3.6 Composition of Services Imports

3.6.1 Imports of miscellaneous business services shrink

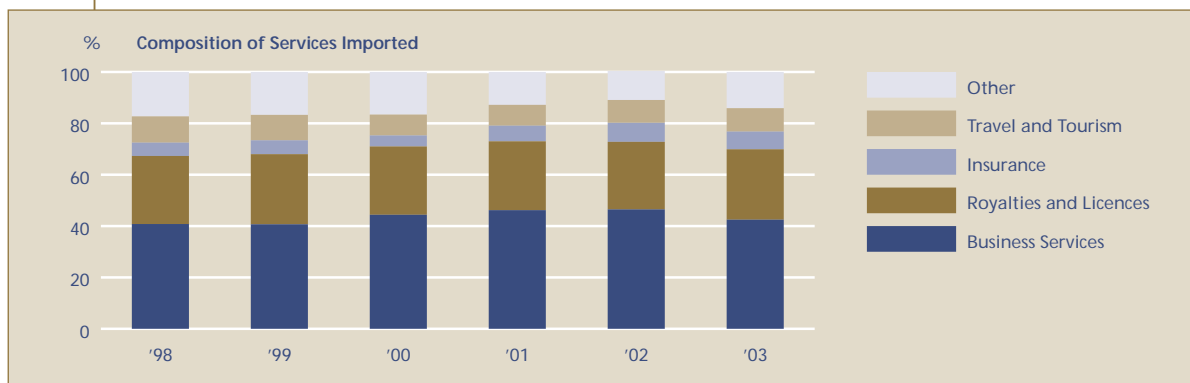
By far the biggest chunk of the overall import bill is accounted for by business services (42 percent in 2003). Payments abroad for these services fell by just under €1bn in 2003, to €19.7bn, reflecting currency effects, the lower levels of export activity in the foreign-owned manufacturing sector and the greater sourcing of these services internally or from indigenous providers. Lower levels of activity and tighter budgets in Irish-owned firms is also likely to have depressed import growth of services. Roughly half of business services spending is trade-related, with the other half accounted for by miscellaneous services, including inter-affiliate management fees. The decline in 2003 was entirely as a result of the decline in miscellaneous services. A decline of a similar magnitude, and for largely the same reasons, was recorded in the first half of 2004.

Payments of royalties and license fees grew by more than one fifth in 2003, an acceleration in the rate of growth registered in 2002. This is difficult to explain given the deceleration in the rate of industrial production growth in 2003 over the previous year. A possible explanation is that there may be lags between the manufacture of goods and the payment of royalties and licence fees. Developments in the first half of 2004 support this: payments grew by a mere 2.6 percent. This category of imports accounted for close to one third of total services imports in 2003 and in the first half of 2004, up from 27 percent in 1998.

8 According to WTO data, Ireland is the fourth largest importer of "other commercial services". This excluded travel and trade-related services

9 This is according to balance of payments data which record slightly lower levels of goods imports than merchandise trade data owing to different compilation methods.

Figure 13: Composition of Service Imports



3.6.2 Financial services imports flat

The fourth and fifth largest services import bills are for insurance and financial services respectively, together accounting for just over one tenth of the total. Imports of insurance services fell back marginally in 2003, while those of financial services increased very slightly. Together imports of these services totalled €4.9bn. Given that IFSC-related services imports totalled €5.7bn, the lion's share of these imports are likely to be accounted for by the off-shore sector. While purchases of foreign-provided insurance services fell slightly in the first half of 2004, there was a very large increase (of more than 37 percent) in financial services imports over the same period in 2003.

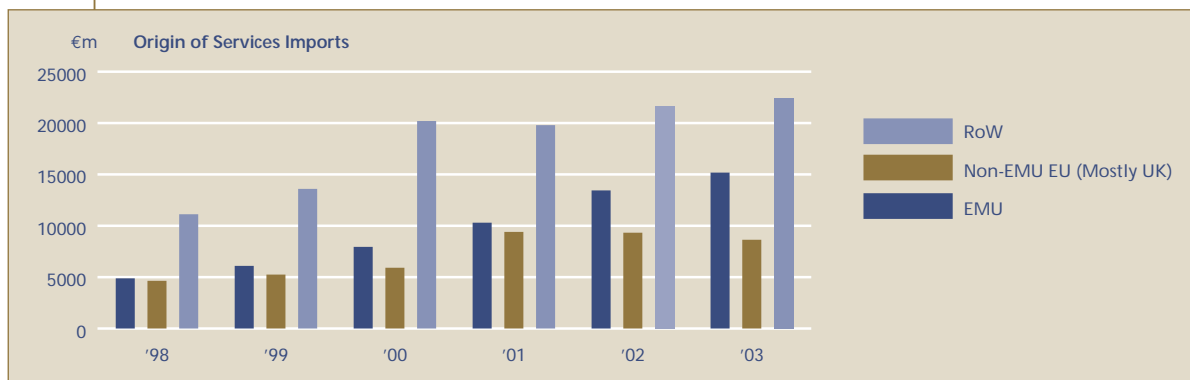
3.7 Origin of Services Imports

3.7.1 Euro area imports grow fastest in 2003

Geographical breakdown of the data is limited (see Section 3.4). The evolving pattern of change in the origin of services imports has been quite constant over six years. Most notable has been the rising share of traded services sourced from the euro area. In 2003, in line with trends in recent years, euro area services imports saw the strongest year on year growth (13 percent), to bring their share of the total to one third - the highest since records were first taken in 1998. The growing market share has been maintained despite the appreciation of the euro, which made sourcing from non-euro area countries cheaper. This (lagged) effect may have come into play in the first half of 2004, however, when a marginal decline in imports from the euro area over the same period a year earlier was recorded.

Services imports from non-EMU EU (assumed to be accounted for in very large part by the UK) countries fell in 2003, and again in the first half of 2004 despite the decline of sterling vis-à-vis the euro (which made services imports from non-euro sources cheaper). It would appear, given the consistency of the patterns over six and half years, that Irish importers of services are gradually switching to euro area suppliers in the place of those in the UK, although it is not possible to say with any certainty if this is related to the elimination of exchange rate risk or if other factors are at play.

Figure 14: Origin of Services Imports



Imports from the “rest of the world” (RoW) remain by far the largest share of the market, even if they are now below half of the total. The dominance of the RoW is assumed to be due to the link between the large US-owned manufacturing sector, which imports services from other subsidiaries¹⁰. The low rate of increase in services imports in 2003 (of just over 3 percent) reflected both the structural change previously mentioned (import substitution) and sluggish growth in the manufacturing sector. In the first half of 2004, the deceleration was reversed as imports grew by more than 5 percent. This almost certainly reflects the upturn in the export-orientated manufacturing sector over the same period.

3.8 Tourism

3.8.1 Tourism revenues continue to grow despite low demand and rising prices

The tourism and travel sector was Ireland’s fourth largest category of services export in 2003, in line with recent years. Receipts of €3.4bn were registered, representing a rise of 4.7 percent in value terms. Given a similar rate of inflation and an increase in the number of visitors of five percent, spending per tourist arrival appears to have fallen. Low rates of economic growth in source markets in continental Europe may have caused a decrease in budgets, while a considerable appreciation of the euro made Ireland a more expansive destination for those coming from outside the zone - notably the US and, to a lesser extent, the UK. Also likely to be relevant are rapidly rising costs in the sector, which have made Ireland a relatively expensive holiday location. According to Forfás’s 2004 study of price levels in the euro area, Ireland is the second most expensive country in the 12 member euro zone after Finland, and in sectors most relevant to tourists - restaurants and bars - the most expensive.

The first half of 2004 saw an upswing in tourism revenue growth, to 6.9 percent, although because the first half of 2003 was depressed by the effects of the Iraq war this rate of increase may overstate the underlying position. While the gap in growth rates between tourism and total services exports was at its narrowest in many years (the former’s increase has lagged the latter by a considerable distance), the persistence of the differential has meant that the tourism industry has suffered a relative decline compared to other higher growth sectors (as illustrated in figure 11). In the first half of 2004, tourism revenues generated just under one twelfth of total services export receipts, less than half the proportion as recently as 1998. The industry nonetheless remains of great importance in terms of employment, particularly in regions where the presence of industry is limited.

¹⁰ US trade data suggest that services purchased by Irish subsidiaries are not from US-based parent companies. Although data on Ireland are not published, the US Bureau of International Accounts shows that the six EU countries not listed individually (Ireland, Austria, Denmark, Finland, Greece and Portugal) purchased just €12.2bn worth of US services in 2003. Given the Irish data showed RoW purchases of €22.4bn, it is clear that services directly imported from the US account for only a small part of the total.

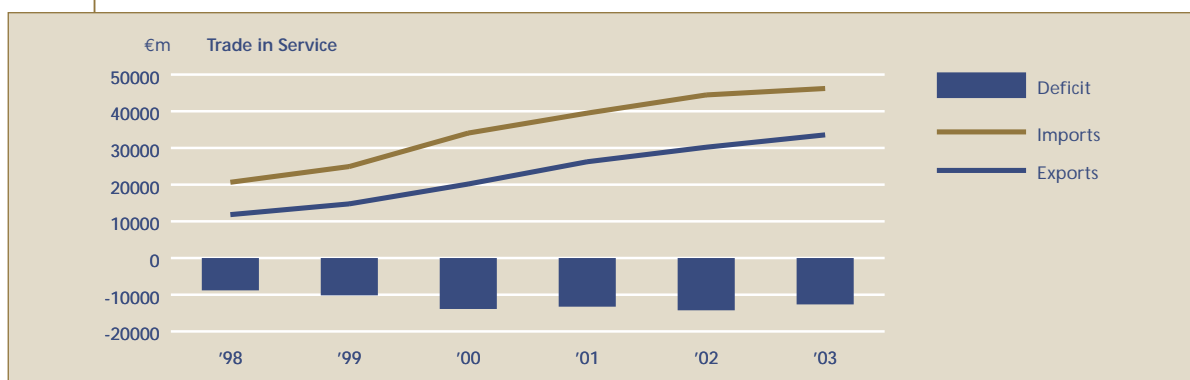
3.8.2 Spending on foreign travel slows

The deficit on the tourism and travel account remained stable in 2003, as the growth in demand for foreign travel slowed sharply, to just over 6 percent, from a year on year increase of almost one quarter in 2002. In the first half of 2004, growth came to a halt. Lower increases in spending by Irish residents on foreign travel reflected sharply lower levels of private consumption growth, as consumers retrenched in the face of economic slowdown and greater uncertainty. The (relatively low) increase in spending on foreign travel in 2003 was broadly in line with the growth of nominal consumer expenditure in the wider economy (after a number of years of far outpacing it). The absence of growth in the first half of 2004 is harder to explain, but is likely to be transitory owing to the upswing in the economy as well as a range of structural factors driving growth in foreign travel. These included: more numerous and cheaper direct flight connections with continental destinations, high levels of investment in foreign property by Irish residents; and the widening gap between Irish price levels and those in most other EU countries.

3.9 Services Trade Balance

The services deficit shrank by a large €1.6bn in 2003, reducing it to €12.6bn, the lowest level since 1999. In the first half of 2004, another large decline, of €1.3bn year on year, was registered. There are four distinct explanations for the narrowing of the deficit. First, the Irish-owned services sector appears to be internationalising successfully, increasing the range, quality and quantity of its output. Second, with rising proportions of foreign direct investment inflows going into services industries, the export capacity of the foreign-owned services providers has also risen sharply. Third, the foreign-owned manufacturing sector appears increasingly to be adding to its capacity to provide the services that it once imported from parent companies or other subsidiaries (up to 2000 this was the main driver behind the widening services deficit). As a result, the close historical relationship which existed between merchandise exports and services imports has been weakening. Finally, the new services provision capacity of foreign firms' Irish subsidiaries is also being used to service other subsidiaries elsewhere, thus generating additional exports.

Figure 15: Services Trade balance



4. Foreign Direct Investment

4.1 Global Developments

4.1.1 FDI falls for the third consecutive year in 2003

International inflows of foreign direct investment (FDI) contracted for the third consecutive year in 2003, according to the United Nations Conference on Trade and Investment (UNCTAD), to stand at \$560bn. This is considerably less than half the all time peak of 2000 when inflows of \$1,388bn were recorded. Given the sharp depreciation of the dollar in 2003 against most major currencies (and against the euro in particular, a currency in which almost half the world's FDI was denominated in 2003) the decline when measured in local currencies was likely to have been greater still. An indication that the protracted contraction in foreign investment may be coming to an end came from data relating to global FDI outflows. In contrast to inward FDI, these registered a small increase in 2003 (although the total was likely to have been exaggerated in dollar terms). While the different figures are the result of accounting anomalies (global outflows must logically equal global inflows), neither is necessarily a better measure of flows than the other.

Another sharp drop in mergers and acquisitions (M&A), which account for most FDI, was the main reason for the decline, as firms' foreign expansion plans lagged economic recovery in home markets (FDI is highly sensitive to rates of GDP growth). Another factor explaining the low level of M&A activity were weak equity markets, which continued to discourage privatisations (a major factor in the FDI boom of the 1990s). This was reflected in the different means of financing FDI: reinvested earnings, equity and intra-company loans. Equity investment is the main vehicle for taking ownership of foreign corporations, and the amount of this type of direct investment declined yet again in 2003. With firms showing considerable caution in their foreign expansion postures it is unsurprising that reinvested earnings¹¹ have become more important as percentage of overall flows. In the developing world in 2003 these accounted for 40 percent of the total, the highest ever in both absolute and relative terms. Intra-company loans were negative in 2003 (having been in decline since 2001).

In geographical terms, falls in inflows to the developed world accounted for all of the decline, which was only partially offset by a 9 percent increase in FDI to the developing world. The EU accounted for most of the decline, while inflows to the US, already low in 2002, collapsed, to just \$30bn, less than a tenth of the level recorded in 2000. Outflows of FDI come almost entirely from the developed world (90 percent in 2003) and, as mentioned above, these saw a recovery in 2003. Outflows from the US were particularly strong, growing by close to half, to account for almost a quarter of total global outflows. The strong economic recovery in that country gave a boost to internationalising corporations which more than offset the negative effects of a weakening dollar (home currency depreciation makes foreign acquisitions more costly). The EU, by contrast, saw a further decline in its outflows of foreign investment, reflecting continued weakness in economic growth in the larger national economies.

¹¹ This is defined as profits generated in pre-existing foreign subsidiaries which are ploughed back into the business rather than being repatriated to the parent company

Table 4: Global Inward FDI Flows and Stocks

	Inflows €bn				Outflows €bn			
	2000	2001	2002	2003	2000	2001	2002	2003
World	1388	818	679	560	1187	722	597	612
EU-15	671	357	374	295	806	429	351	337
Ireland	26	10	25	25	4.6	4.1	3.1	1.9
US	314	159	63	30	143	125	115	152
Asia	146	112	94	107	84	50	38	24
CEEC	28	26	31	21	4.0	3.5	4.9	7.0

(SOURCE: UNCTAD, WORLD INVESTMENT REPORT 2001)

4.1.2 FDI is set to rise in 2004

Indications at time of writing (in late 2004) are that the annual declines registered since 2001, will not be repeated in 2004. In the first six months of the year international M&A activity registered a small year on year increase, in line with stronger global economic growth, improved corporate profitability and strengthening equity markets. Three studies by UNCTAD, published in the first half of 2004, also point to higher flows of FDI in 2004. All three surveys - of multinational executives, national investment promotion agencies (IPAs) and private sector consultants - suggest that global flows of FDI will increase from 2004, even if there is some difference in emphasis in terms of the industries which are most likely to see higher levels of foreign investment. Business and computer services FDI are expected by all three groups to be among the drivers in the services industry, but views on prospects for banking and insurance differ. Over 65 percent of IPAs believe the outlook for FDI in financial services is good compared to just 40 percent of location consultants. Differences on manufacturing investment were greater. Consultants saw prospects in electrical and electronic products and chemicals in the top three industries, with 80 percent and 70 percent believing the outlook to be optimistic. In stark contrast, only 57 percent and 33 percent of IPAs thought these industries would engage in significant FDI.

4.2 Ireland Inward FDI

4.2.1 Ireland's share of global FDI rises

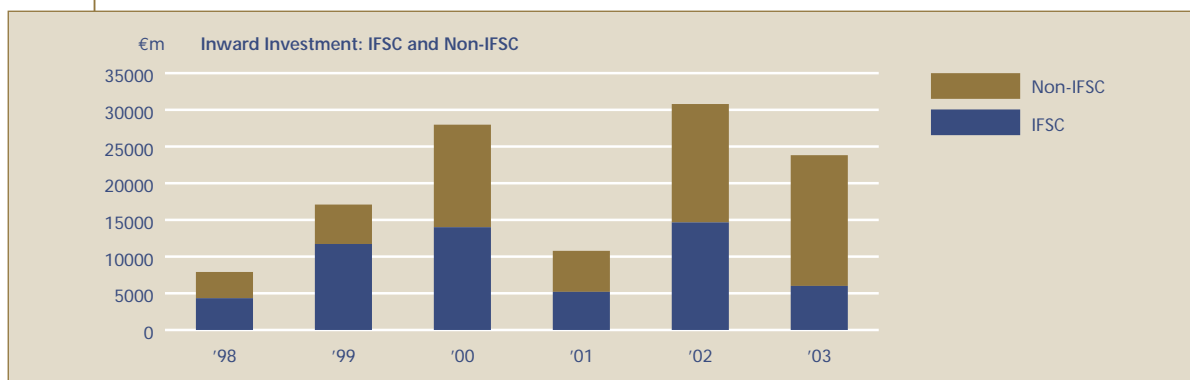
UNCTAD data for Ireland show that inward investment has not followed the global (and regional) pattern in recent years, as the country continues to attract high levels of FDI. Ireland's share of global and EU FDI has risen sharply as a result. From just under four percent of the total in 2000, Ireland accounted for more than one twelfth of total inflows to the EU-15 in 2003. On a global basis, the rate of increase was similar, to reach almost 5 percent of total world inflows. In absolute terms, only five countries (Luxembourg, China, France, the US and Spain) registered larger inflows in 2003. In terms of stocks of FDI, UNCTAD records a figure for Ireland equivalent to 127 percent of GDP in 2003 - \$193bn. In absolute terms, this is the sixth highest level among the EU-15 and by far the largest in per capita terms¹².

¹² UNCTAD gives no data for Luxembourg which, given the massive flows it has seen in recent years, is likely to have higher per capita levels.

According to national data, FDI inflows to Ireland in 2003 fell back sharply from the all-time peak in 2002. The decline, to €23.8bn from €30.8bn in 2002, was accounted for by considerably lower inflows into the international financial services centre (IFSC)¹³, which saw direct investment more than halved, to €6bn. By contrast, investment from non-IFSC sources rose by more than 10 percent, to €17.8bn. It should be noted that these figures need to be considered with caution for two separate reasons. First, as the Central Statistics Office (CSO) FDI data are subject to very large revisions, it is necessary to avoid drawing definitive conclusions from recently released data. Second, headline FDI figures may not always fully reflected the impact of foreign investment on the economy owing to the differing effects of different types of investment. This is illustrated by the absent correlation between FDI inflows and job creation in the foreign-owned sector. In terms of employment in IDA-assisted firms, the number of new jobs declined by nearly a quarter, to 9,182, in 2003. This is the third consecutive year of falling job creation and reflects the shift towards less jobs-rich forms of FDI.

In the first half of 2004, inflows of FDI fell by more than one third over the same period a year earlier. As was the case in 2003, the change was entirely the result of shifts in non-IFSC investment. Past experience shows, however, that half-yearly figures are an unreliable guide to full year outcomes both because, having been released only recently, they are subject to large revisions, and because investment flows tend to be quite erratic from quarter to quarter.

Figure 16: Inward Investment: IFSC and Non-IFSC



4.2.2 The foreign sector is increasingly financing its capital spending by reinvesting profits

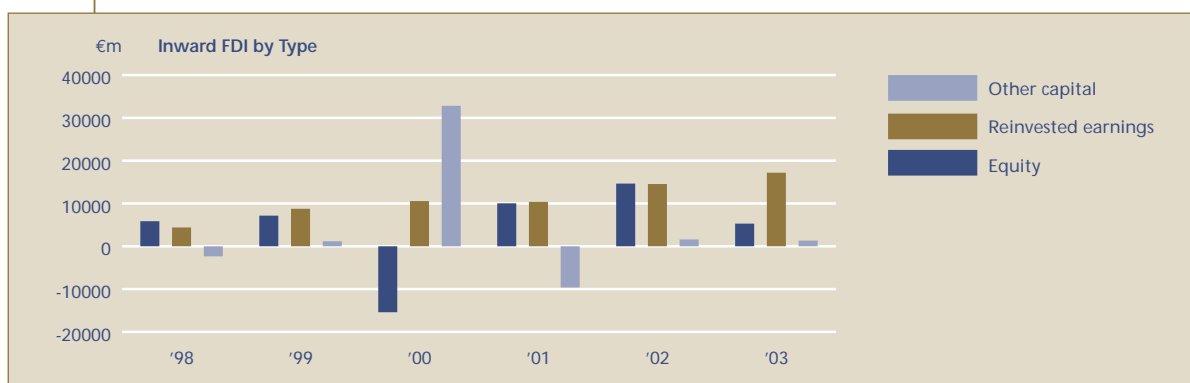
Ireland's FDI figures are disaggregated according to type of investment: reinvested earnings; equity; and other capital¹⁴. In terms of the financing of their investments, foreign firms in Ireland continue to shift towards reinvested earnings, suggesting that the non-indigenous sector is going through a period of consolidation and organic growth, after the 1990s when large numbers of firms were establishing in Ireland for the first time. As illustrated in figure 16, reinvested earnings have been on an upward trend in absolute terms since 1998 and accounted for three quarters of the total in 2003. The "other capital" component comprises, among others, green-field investment by firms establishing a presence for the first time. The low levels of this kind of inflow since 1998 (excluding a massive one-off inflow in 2000) provides further evidence that the number of first-time investors is declining.

¹³ IFSC capital inflows are usually for investment funds which, while domiciled in Ireland, are mostly reinvested abroad. Though IFSC investment brings considerable benefits, non-IFSC inflows generally create greater additionality for the wider economy.

¹⁴ As these disaggregated data are not further broken down according to IFSC/non-IFSC some caution is necessary in their interpretation.

Owing to the high-technology, highly capitalised nature of the foreign owned sector and the structure of the Irish economy (dominated by a few large internationally competitive firms), merger and acquisition (M&A) by foreign firms of Irish ones has historically been limited, accounting for a proportion of total FDI below what is normally found in a developed economy. M&A activity is best gauged by the “equity” component of FDI. In 2003, equity financing of FDI collapsed to just one over third its 2002 level, to stand at €5.3bn. Even more telling are UNCTAD data. According to these, FDI accounted for by M&As shrank to insignificant levels in 2003 (\$185m), after four years of relatively steady inflows of around \$5bn per annum. Slower growth in the Irish economy is likely to have dampened the enthusiasm of foreign investors for acquiring Irish firms. The decline in M&A activity (from already low levels) runs contrary to international trends.

Figure 17: Inward FDI by type



4.3 Origins of Inward FDI

4.3.1 The euro area continues to dominate inflows

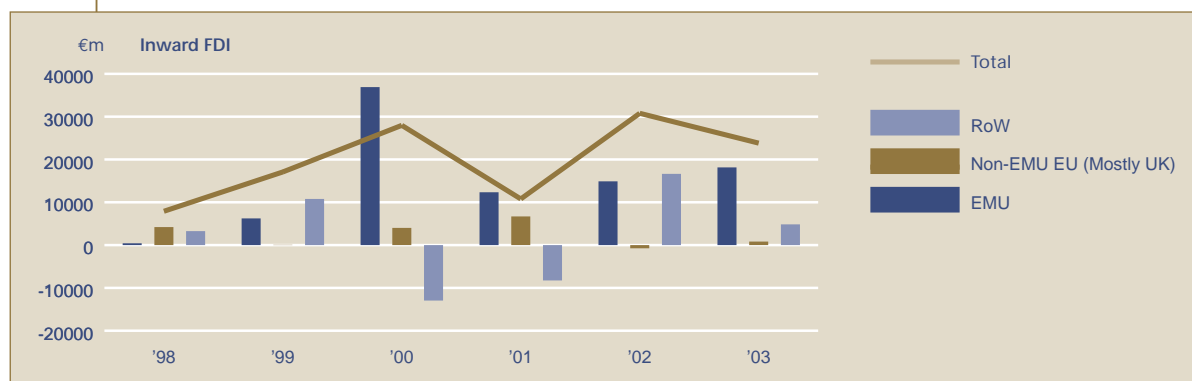
Data on the origins of FDI are not only subject to the large revisions mentioned above, but suffer two additional limitations. First, in geographical terms the CSO data on flows of FDI are limited, with totals broken down only according to EU and non-EU sources and EMU and non-EMU sources. Inflows of FDI from the euro area grew by a quarter in 2003, the second successive year of such strong growth, bringing this source of direct investment, as a percentage of the total, to more than three quarters. The increase in the relative proportion of FDI accounted for by the euro area is consistent with developments elsewhere, which strongly suggest that adoption of the currency has boosted FDI among the countries participating (and caused those remaining outside, such as the UK, to lose out). Inflows from the three EU-15 countries not in the euro area - the UK, Sweden and Denmark - can be readily calculated¹⁵. Following disinvestment in 2002 of €746million, investors from these countries returned to Ireland in 2003, investing €822million. In contrast to euro area investment, which has consistently dwarfed that from these non-euro area EU-15 countries in recent years, the latter's corporate presence (mostly British) is higher. British data register the stock of FDI in Ireland (as measured by the book value of net assets) at €46.6bn in 2002. This is equivalent to almost one tenth of the UK-owned stock on investment in all EU countries.

Among the most notable developments in 2003 was the faltering of inward investment from non-EU sources. At €1.6bn, this was a fraction of the €7.6bn recorded in 2003. Given the close investment relationship between Ireland and the US, counter-party data from the US Department of Commerce (DoC) are illuminating. In 2003 inflows from that country stood at

¹⁵ Counter-party data from the UK National Statistics Office (NSO) suggests that most of this is accounted for by British residents. For the period 1998-2002 the NSO registered outflows from the UK to Ireland of €15bn, while CSO sources give a total for the three countries combined of €16bn.

€8bn, suggesting that residents from other non-EU countries disinvested heavily during the year (this is most likely related to the IFSC). According to the DoC, the stock of US FDI measured on an historical cost basis, stood at €49.1bn in 2003, equivalent to 6.6 percent of total US investment in the EU. This is the fifth highest in the EU in absolute terms and second only to Luxembourg in per capita terms.

Figure 18: Inward FDI by source location



4.4 Outward FDI from Ireland

4.4.1 Outward FDI continues to shrink

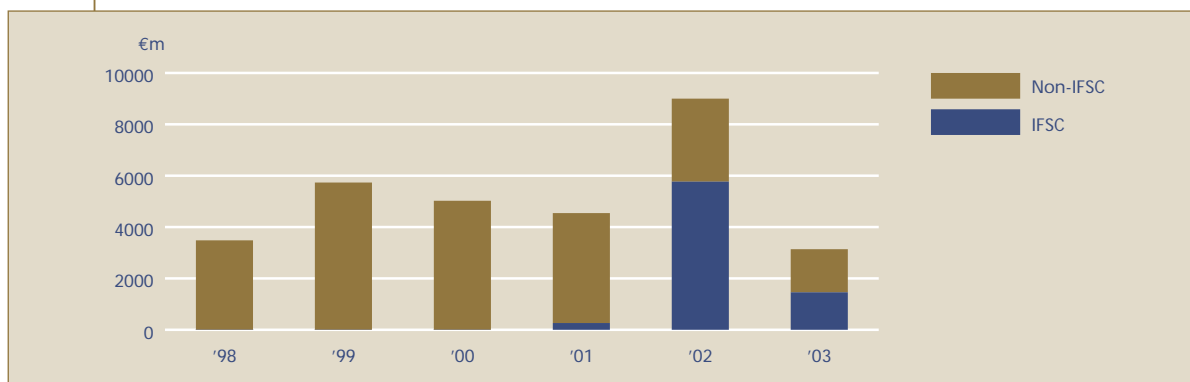
According to UNCTAD, Irish outward FDI fell to its lowest level since 1999. At just \$1.9bn, Ireland accounted for just over half of one percent of all outward FDI from EU countries (down from close to one percent on average in recent years). Of the pre-enlargement 15-member bloc, Irish outflows were the fifth lowest in absolute terms (ahead of Finland, Portugal, Greece and Denmark) and seventh lowest in per capita terms. The total stock of outward FDI stood at \$33.5bn according to the UN agency, a figure that in per capita terms in the EU-15 context is broadly proportionate to the countries population (around 1 percent). Despite the sharp increase in outward flows in the second half of the 1990s (as the Irish economy boomed), the pace of internationalisation lagged the EU-15 average: between 1995 and 2003, the stock of total outward EU FDI increased by a factor of 3.1, while Ireland's rose by a factor of 2.5.

According to national data, outward flows of direct investment by Irish residents in 2003 were less than one third of those of 2002, standing at €3.1bn. As illustrated in figure 19, most of the decline was attributable to a fall in outflows from the IFSC. As is clear from the chart, the IFSC as a source of outward direct investment is a recent phenomenon and likely to be the result of changes in the types of foreign assets Irish-domiciled funds are purchasing¹⁶. Moreover, IFSC direct investment is more an indicator of the health of the Centre rather than a measure of the internationalisation of corporate Ireland, which is far better gauged by levels of non-IFSC FDI. In this regard, the pace at which Irish firms are expanding their presence abroad has been decelerating from a high-point in 1999-2000, when more than €5bn annually was directly invested, to a low of €1.7bn in 2003. There are a number of explanations for this. First, lower levels of economic growth in the Irish economy since the beginning of the decade have meant that Irish firms are less cash-rich and are, therefore, less well placed to expand their presence abroad. Second, the reduction in this "push" factor is mirrored by a weakening "pull" factor of profitable foreign investments. As illustrated by the sharp global decline in FDI since 2000, investment opportunities have been fewer owing to lower economic growth, greater uncertainty and weaknesses in industries that had theretofore been engines of FDI growth. Given considerable anecdotal evidence of Irish investment in foreign property markets, it may

¹⁶ Foreign investment is classified as "direct" rather than "portfolio" when a stake greater than 10 percent of a corporation is purchased. Given that IFSC outward portfolio investment has been growing very rapidly in recent years (in 2003 it stood at a massive €126bn, equivalent to 94 percent of GDP), it is unsurprising that a portion of monies invested in foreign entities cross the definitional threshold of 10 percent.

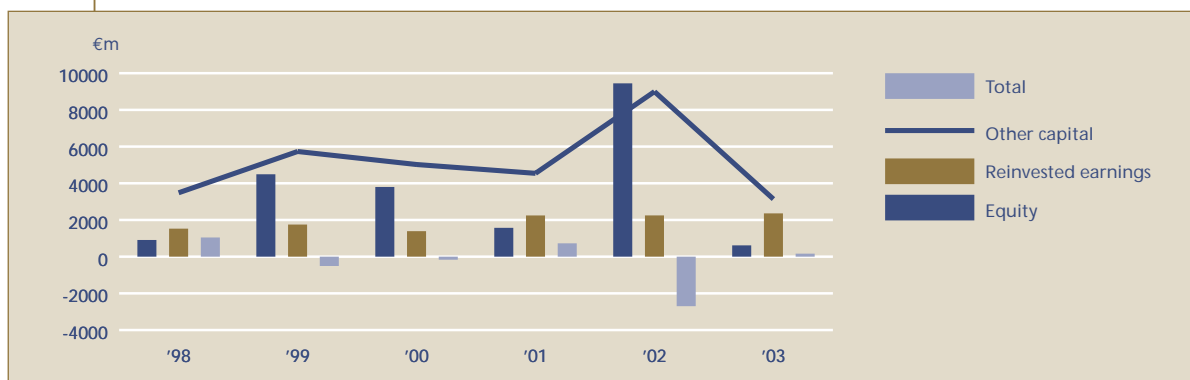
well be that there was divestment by Irish firms in productive capacity abroad. Whether or not this was the case, the 2003 data show that the internationalisation of the Irish firm continued to slow considerably.¹⁷ In the first half of 2004 outward investment soared, rising more than four fold on the same period a year earlier. This increase was likely to have been accounted for by a single large deal as the increase was concentrated in a single category in each breakdown of the data, i.e. in the second quarter, in the “other capital” investment type, to a non-EU destination and from the non-IFSC sector.

Figure 19: Outflows of FDI by Irish residents, 2003



Ireland’s FDI figures are disaggregated according to type of investment: reinvested earnings; equity; and other capital. Equity purchases collapsed in 2003, from usually high levels in 2002. This was accounted for to a considerable degree by a sudden large outflow of this type of FDI from the IFSC (see figure 20). Also of relevance was the global contraction in M&A expenditure owing to greater risk aversion and still-poor financing condition. While this method of financing FDI has been the most common vehicle for Irish investors since 1998, it has been on a downward trend since 1999 (the blip of 2002 excepted). The most stable component of outward FDI has been reinvested earnings, registering a slight upward trend since 1998. This reflects the growing stock of outward FDI: the higher the stock the greater total foreign profits, other things being equal. In 2003, as in 2001 and 1998, reinvested earnings were the preferred means of direct investment abroad.

Figure 20: FDI outflows from Ireland



17 These data are unlikely to reflect the full level of Irish-owned investment abroad. For a small economy with limited financing opportunities, it may be preferable for Irish residents to tap larger, deeper and more liquid capital markets that exist in countries such as the UK and US, home of a considerable proportion of the stock of Irish-owned foreign assets.

4.5 Location of Irish outward FDI

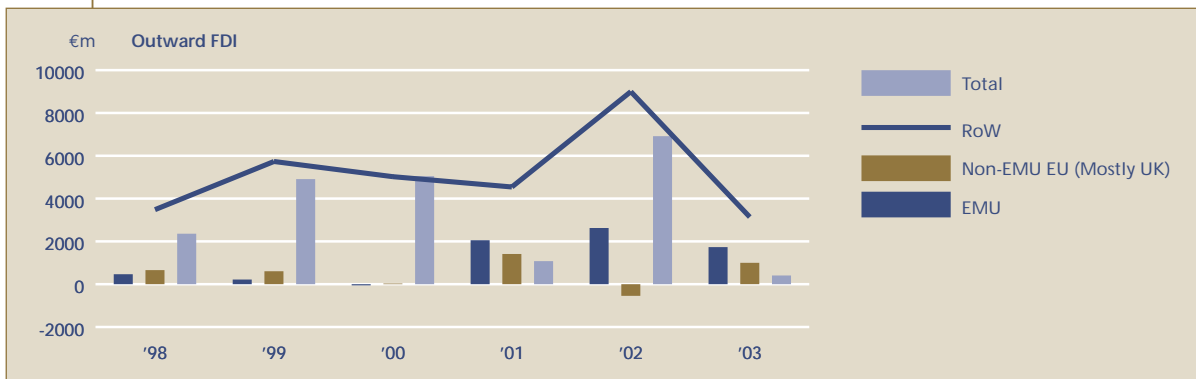
4.5.1 The euro area is the favourite among Irish investors in 2003

As noted earlier, national data on the direction of flows is limited to breakdowns between EMU and non-EMU; EU-15 and non-EU. The direction of outward FDI showed characteristic volatility in 2003. Flows to non-EU locations, which have attracted the overwhelming majority of outward FDI since 1998, collapsed to just €407m, a fraction of the €7bn recorded in 2002. As the magnitude of the decline is similar to the fall in volatile IFSC flows, it is likely that this source of flows accounted for most of the contraction. Counterparty data from the US Department of Commerce (DoC) shows that Irish residents divested themselves of US assets in 2003. This is surprising given stronger US economic growth and a more favourable exchange rate which would, other things being equal, attract higher investment. Non-national figures suggest that the US accounts for an overwhelming majority of Irish investment: DoC data show a stock of Irish investment in the US of \$27.8bn compared to UNCTAD's estimate for total outward FDI stock of \$33.5bn.

Neighbouring Britain has also traditionally been an important destination for Irish investors, with the stock of Irish-owned FDI put at €7.2bn in 2002 by the UK's Office for National Statistics (ONS). Although it could reasonably be assumed that most FDI going to the non-euro EU-15 countries is accounted for by the UK (Sweden and Denmark are the only other countries to fall into this category but economic relations with these countries are not significant), Ireland's CSO data and Britain's NSO show considerable differences in both magnitudes and trends in Irish direct investment into the UK.

Given stock data from the US and UK along with anecdotal evidence, Irish investment in the countries now in the euro area has not been high historically. But the data for the 2001-2003 suggest that this may be changing. In 2003, as in 2001, the euro area accounted for the largest amount of total outward FDI. It is likely that the deepening of European economic integration caused by the euro and resulting in the removal of exchange rate risk has made investing in EMU countries more attractive. This is consistent with findings in other EMU countries, where levels of FDI among the participants has risen strongly since the launch of the single currency.

Figure 21: Outward FDI by location



5. International Trade Developments

5.1 The Services Directive

The draft Directive on Services in the Internal Market is part of the Lisbon Agenda with a view to making the EU the most competitive and dynamic knowledge-based economy in the world. The free movement of people, goods and services across EU borders is one of the main benefits for citizens and businesses alike in the EU, providing greater choice and price competition. The draft Directive is strongly supported by Ireland.

The draft Directive applies to all commercial services, except financial, electronic communications and most transport services. Public services are excluded. It applies only to the providers of commercial services established in a Member State. The main three provisions of the directive are as follows:

E-government: The directive envisages all Member States should be legally required to ensure that all procedures and formalities relating to the provision of a service should be able to be completed electronically by 2009.

Better regulation: The directive proposes a systematic trawl of existing regulations in each country to ensure that the mobility of capital and labour in service industries is not impeded.

Mutual Recognition of Standards: The directive proposes that countries should recognise each others regulatory systems in the case of service providers temporarily operating in their country.

The draft Directive commenced its passage through the relevant Working Party of the Council in February 2004 leading to a first exchange of views amongst Ministers at the March Competitiveness Council. Under the Irish and then Dutch Presidencies, a detailed examination of the proposal has taken place, which was followed by a policy debate at the November Competitiveness Council and a clarified text, which will be the subject of further discussions during the Luxembourg Presidency. The draft Directive is subject to co-decision with the European Parliament. The relevant committee of the Parliament is the Committee on the Internal Market and Consumer Protection. The Parliament held a Hearing on the draft Directive on 11th November 2004. The lead Rapporteur is Ms. Evelyne Gebhardt. She is likely to draft a report early in the New Year and the Parliament's First Reading is expected in mid 2005.

At the time of writing, it is difficult to determine what elements of the directive are likely to be agreed upon. A number of topics have proved politically sensitive, particularly the country of origin principle and the inclusion of healthcare under the scope of the directive.

5.2 Export Credit Management - The Recent Irish Experience

The Irish Exporters Association commissioned two studies, in 1998 and 2004, into the credit management practices of Irish businesses. The purpose of both studies was to generate firm-level data with a particular focus on exporting, managing cross-border risk and on the use of information and the internet on the management of export risk. The 1998 report covered areas such as exporters support from bankers, exporters' usual methods for financing exports, the relationship that they have with their banks and how exporters manage foreign currency. The 2004 report deals with these issues also, but extends the analysis to new issues such as the introduction of the Euro and its effect on trading conditions, the impact of China's WTO accession, forecasts of exporters strategies/concerns in an enlarged Europe, debtors lead time since the EU Directive on late payment and E-commerce/internet and how it has changed export business practice.

The comparison of the two studies shows Irish exporters seemed more willing in 2004 to extend generous credit terms, with 59.2% of the survey reporting an average global period of 60 days

or more, compared to half that amount in 1998. This represents a substantial lengthening of average credit periods, with the 30 day norm (which accounted for 60% of cases in 1998) moving more closely to a 60 day norm. This would reinforce the argument of the greater need for export credit insurance, though may reflect more difficult market conditions and therefore an acknowledgement that customers may be experiencing cash flow difficulties at the time of the 2004 survey.

Both the 1998 and 2004 studies looked at whether geographical location was a dominant factor, and a comparison of the two studies mirror the general finding of a substantial lengthening of credit contract periods in all geographical locations. The relativities between geographical locations were therefore also stable - both studies found that within the Europe and North America credit terms were a lot longer than elsewhere in the world, most notably in the number of sales with no credit. Nonetheless, in 2004 credit periods of 60 days or longer were offered to 40% of customers in Africa, 64% of Middle Eastern customers and half of all Latin American customers. While much lower than Northern Hemisphere countries, all of these are substantially higher than the global average of 30% experienced in 1998.

There is an obvious symmetry between the willingness to extend credit and the payment methods. The patterns observed in 1998 are similar to those observed in 2004, with the following minor changes: In the EU, open account now dominates almost all trade, with the relatively small portion of trade in 1998 requiring advance payment falling to a negligible level. This is also true of trade with North America. The trend in Latin America has changed dramatically, with letters of credit (which accounted for one-third of trade in 1998), becoming relatively insignificant by 2004. Finally, in Africa, the trend towards trade on open account observed elsewhere was not repeated. As in 1998, the preferred methods of payment in 2004 were broadly evenly divided between letters of credit, open account and advance payment. It is not clear why there has been no evolution in the payment method in Africa at a time when the length of credit offered changed so much.

The rate at which payment delays are experienced by Irish exporters in the UK at almost 20% has not changed since 1998, while our experience in other markets also does not seem to have changed significantly. In particular, New Zealand and Australia retain their reputation as one of the quickest payers.

The most notable discrepancy between the two studies is that far fewer companies approached their banks for country risk cover in 2004 than was the case in 1998 when it was relatively common. In relation to the usual method for accessing external finance, it seems that overdrafts as a means of financing may have fallen in relative importance from 1998 to 2004. There is also some limited evidence of a welcome fall in the numbers of exporters who take no special action.

5.3 Progress at the WTO – The July Agreement

The recent completion of the framework 'road-map' for world trade liberalisation at the WTO represents an opportunity for further substantial liberalisation of Irish trade. This agreement represents the outline of a final agreement on the Doha Round which started in 2001, though many important details remain before final agreement is reached, which will probably take around two more years. The Doha Round will certainly not be completed prior to a planned Ministerial meeting in Hong Kong in December 2005.

The road-map was highly specific in some parts, less clear in others. The clear signposts on the map are as follows:

Export subsidies on all agricultural products will be phased out: This represents a success for developing countries, which will establish agriculture as a normal sector within the WTO.

The Singapore Issues: The road-map sets out the framework for negotiations on the least controversial (and probably most beneficial to Ireland) of the Singapore issues, namely trade facilitation, but agrees to drop the other three entirely.

There remain numerous areas for discussion. In particular, aspects of agriculture need to be decided, particularly market access for so-called "sensitive" products. Also, the extent of tariff reductions on industrial goods was left to be determined in future negotiations, but hopes remain high of significant progress in this area also. Finally, efforts to promote liberalisation in Services through GATS remain on the agenda, though the road-map did little more than set a new deadline, which is all that could be expected given the detailed nature of the GATS negotiations. One interesting point is that while Services liberalisation was traditionally seen as being a developed country issue, there are signs that the waves of out-sourcing are inducing a more positive view among developing countries of this issue. In particular, India has turned from being a strong opponent of services liberalisation to becoming one of its chief proponents (their recent success in the ICT sector may have influenced their volte face).

To put the success in context, the successful negotiation of a new trade agreement represents only one of the four strands of world wide trade liberalisation. Other than the Doha round, these are, firstly, the remaining phased elements of the last WTO round of negotiations, the Uruguay Round. Specifically, quotas on textile imports from developed countries will finally be lifted on 1st January 2005. This is very significant – the two first rungs on the development ladder are agriculture and textiles. While the Uruguay ducked the former issue, it was successful in integrating the latter into the rules that govern normal world trade.

Secondly, Regional Trade Agreements as a means to achieve liberalisation have grown in importance over the last decade. Recent examples include the Australia-US agreement and the EU-Mercosur negotiations, though the one key issue that does not seem to be amenable to solution in such fora is agriculture.

Finally, new accessions to the WTO form a silent, but crucial element of trade liberalisation. From 23 member countries in 1947, the WTO has grown to include 147 countries, covering the vast majority of world trade. The accession of a new member state gives them access to lower tariffs on their exports, but also requires reciprocal tariff reduction on their part. As such, every time a country joins the WTO represents the extension of the accumulated law of previous trade agreements.

Failure to agree a road-map so soon after the debacle at Cancún in 2003 could well have provided a terminable blow to the WTO's credibility. However, while the road-map represents an important milestone, details remain to be completed to finalise the Doha Development Round, which is already 3 years old. In particular, the agreements' parameters relating to topics of most economic importance to the EU and US, including tariff reduction for industrial goods and the practical implementation of measures to facilitate trade, were broad, and the upcoming negotiations will need to focus on these to ensure that genuine reform is achieved.

5.4 Sectoral Focus – The ICT Industry in Ireland

That Ireland is the largest exporter of software in the world and that one third of all PC's sold in Europe are manufactured here gives some indication of the very considerable role Ireland plays in the global ICT industry. Although changing, the industry's has long been dominated by foreign-owned firms. The success in attracting inward investment in the sector owes to a number of factors including good cost structures, a favourable trade regime, competitive fiscal incentives and a ready supply of qualified labour (Ireland has a higher proportion of science graduates than any other EU member state).

For most of its half-century history, the IDA Ireland has emphasised these advantages to attract foreign ICT firms to locate in Ireland. Up until the mid-1980s the sector's firms were mainly engaged in the manufacture of computer-related equipment, but since then there have been very significant levels of software-related FDI. Today over 300 overseas ICT companies develop, market and manufacture a wide range of leading edge products in Ireland and seven of the worlds largest 10 firms in the sector globally conduct substantial operations in Ireland.

The sector's manufacturing output is dominated by US firms, and the extent of the presence is well illustrated by data from the US DoC. On an historical cost basis investment by US firms in "computers and electronics products" in 2003 stood at one sixth of the total stock of this type of investment in Europe. The role of US firms in the "information" sector is even more significant, with investment in Ireland on an historical cost basis more than three times that of computers and electronic products. This amounts to almost half of the total stock of US investment in Europe in the sector (Ireland position as the largest exporter of software is more readily explained in this light).

The on-going change in the nature of the industry in Ireland from manufacturing to software is also seen in the composition of exports. In 2003 the balance between merchandise and services exports in the ICT industry continued to shift, with the latter rapidly gaining on the former. In 2003, foreign sales of computer services were only €2bn less than foreign sales of hardware (defined in the merchandise trade statistics as "office machines and data processing machines"). This on-going shift is to a considerable extent accounted for by the continued trend for software to be sold electronically (and registered as a services export) rather than embedded in hard drives (when it is recorded as a manufacturing export).

There is also a shift taking place in the functions carried out by firms once focused almost entirely on manufacturing. Increasingly management-type functions, often associated with headquarters, are being conducted in Ireland. These include shared services, supply chain management and technical support. To a less extent, foreign firms are also shifting into higher value added engineering functions such as software development and R&D (to date Irish operations have been primarily involved in the reproduction, packaging and distribution of software developed elsewhere).

While foreign investment in the manufacturing sector has traditionally created few indigenously-owned spin offs, the experience gained by Irish nationals in the foreign-owned ICT sector has been a significant factor in the founding of a large number of Irish-owned firms in the sector. Moreover, while these firms tend to be much smaller in size than their foreign-owned counterparts they tend to be more product focused, developing and selling applications to niche markets in process industries and financial services.

The sectors impact can be summarised as follows:

- Employment: the sector employed 90,700 people in over 1,300 companies in 2003 (up from 19,000 in 1990) with roughly half accounted for by foreign owned firms. While there has been a decline in the number employed in the manufacturing sector in recent years, services and software employment has held up well despite the difficulties in the industry internationally. The indigenous software sector currently employs 18,000 people, compared with 3000 people in 1992.
- Exports: In merchandise trade terms ICT exports are the second largest category after pharmachems. In 2003 these were valued at €21.3bn, equivalent to more than one quarter of total exports. This, however, represents a sharp decline on the peak of 2001. In contrast (and partially owing to the definitional change mentioned above), exports of ICT services ("computer" and "communications" services, continue to grow rapidly, reaching €13.7bn in 2003. Together, these exports were equivalent to almost one quarter of GDP.
- Research and Development: In 2002, thirty-two IDA-backed ICT companies undertook to invest €120 million in R&D.

The ICT industry globally continues to change rapidly, not least owing to the unrelenting pace of technological advance. Prices of ICT hardware have been on a long-term downward trend owing to rapid technological advance, and this trend has gathered pace in recent years as over-capacity in the industry globally combined with tight corporate expenditure budgets (following over-investment in the late 1990s) has made consumers highly price sensitive. Although the three-year old downturn in the industry come to an end in late 2003, intense competition in and rapid change is likely to continue for the foreseeable future. This provides opportunities and poses challenges for the industry in Ireland.

The greatest challenge is presented by the sharp fall in ICT manufactured exports in the two years to 2003, with much of the decline attributable to shifting production patterns in multi-national firms. It remains unclear as yet why this is taking place and whether it will continue, but it may be that competitiveness issues are becoming a factor, with Ireland's rising cost base making it less attractive as a manufacturing location. In addition, the rising relative attractiveness of central European and east Asian locations suggests that much of the lower-value added industrial activity in the sector will gradually shift from Ireland.

More optimistic is the outlook for the ICT services sector, both and. The diversification of the foreign owned sector and the considerable successes of indigenously-owned firms suggest that Ireland's world market share of ICT services is likely to continue growing. That said, there are challenges including the rise of open source operating systems which are considerably cheaper than the high-cost propriety software based on Unix servers.

18 In the SITC breakdown of trade data, this includes subcategories 76, 77 and 78.

Réamhrá

Is é Forfás an bord náisiúnta um polasaí agus comhairle le haghaidh 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 dílsithe ann. Is é an comhlacht é freisin trína dciomnaítear cumhachtaí ar Fhiontraíocht Éireann le tionscail dúchais a chur chus cinn agus ar ghníomhaireacht Forbartha Tionscail na hÉireann (GFT 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 comhordú polasaithe a chur ar fáil d'Fhiontraíocht Éireann, d'GFT Éireann agus d'aon fhoras eile dá leithéid (a bunaíodh go reachtúil) a d'fhéadfadh an tAire a ainmniú trí ordú
- forbairt na tionsclaíochta, na teicneolaíochta, na margaíochta agus acmhainní daonna a spreagadh sa Stát
- bunú agus forbairt gnóthas tionsclaíoch ón iasacht a spreagadh sa Stát, agus
- Fiontraíocht Éireann agus GFT Éireann a chomhairliú agus a chomhordú ó thaobh a gcuid feidhmeanna.

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 powers for industrial promotion and technology 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. The broad functions of Forfás are to:

- advise the Minister on matters relating to the development of industry in the State
- to advise on the development and co-ordination of policy for Enterprise Ireland, IDA Ireland and such other bodies (established by 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 and IDA Ireland in relation to their functions.

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Broadband Telecommunications Benchmarking Study	January 2004
Research and Development in Ireland, 2001 – at a glance	January 2004
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