Foreign Direct Investment: An Analysis of its Significance

By Mary Everett[*]

ABSTRACT

Ireland is an open globalised economy hosting a large number of multinational corporations (MNCs), whose activities contribute significantly to the growth of the Irish economy. A useful indicator for measuring and analysing capital movements and cross-border transactions of MNCs is foreign direct investment (FDI) data. There have been large and variable FDI flows in Ireland in recent times, with particularly large net outward flows of FDI occurring over the last two years. Consequently, a clear understanding of how FDI data is compiled and interpreted is important for assessing the contribution of FDI to economic growth, and for analysing FDI generally.

In light of the complexities relating to the compilation and interpretation of FDI data, this article reviews the concepts and problems associated with FDI, and the subsequent implications for Irish FDI data. While outward direct investment by Irish-based companies has become very significant in recent years, traditionally, however, the focus of Irish industrial policy has been on inward FDI. Net FDI flows into Ireland over the period 1999-2003 averaged €15 billion per annum. Nevertheless, in 2004 and 2005 there were large outflows of FDI, on the part of foreign-based companies in Ireland, amounting to €8.5 billion and €25 billion respectively. The recent volatility is, however, mainly due to corporate finance, tax issues and IFSC enterprises. These outflows would appear to be temporary and are not related to 'real' economic activity in Ireland. In light of the complications associated with FDI data, it is necessary to consider FDI statistics in conjunction with data relating to 'real' economic activity such as employment, sales, exports and value added to get an indication of the impact of foreign owned companies on the Irish economy.

1. Introduction

The opportunities afforded by globalisation have revolutionised the international business environment and transformed multinational corporations (MNCs) operations and structures. The growth in intra-company trade, financing and direct investment that has taken place in recent years is central to these changes. Accordingly, a solid understanding of the data relating to these activities is required, in order to analyse how economies benefit from them. This article presents an exposition of a number of trends and issues regarding foreign direct investment (FDI) data.

Ireland's reputation as an open globalised economy is widely known and more than adequately substantiated. Active industrial policies, coupled with a favourable company tax regime created

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a conducive environment for the attraction of inward direct investment, see Barry et al (1999) and The EU Economy Review (2005). These factors were complemented by membership of the European Union and the presence of a young, well-educated, English speaking workforce.

Multinational corporations are essential to Ireland's economic welfare, particularly as foreign MNCs now represent a significant proportion of the total population of MNCs in Ireland.[1] The most useful indicator for measuring and analysing international capital movements and cross-border transactions and positions, between home and host countries of MNCs and their affiliates, is FDI data. The desire to analyse international linkages and the financial global economy has further increased the importance of FDI data.

For a small open globalised economy such as Ireland, a clear understanding of how FDI data is compiled and interpreted is important for assessing the contribution of FDI to economic growth, and for analysing FDI generally. This is particularly relevant as FDI flows in Ireland have been large and volatile in recent times and there has been a certain lack of clarity as to what the volume of FDI flows into and out of Ireland signifies. Flows into and out of the IFSC add to this lack of clarity, as the greater part of direct investment flows through the IFSC have a tenuous link with Irish economic activity. For this reason it is necessary to augment FDI statistics with data relating to 'real' economic activity such as job creation, value added, exports and other measures in order to get a more accurate picture of the true value of FDI to the national economy.

At the outset, some provisos need to be made regarding FDI statistics. The international comparability of FDI data is not entirely straightforward as data are compiled according to different principles in different countries despite the presence of international FDI methodological frameworks[2]. Problems of asymmetries between countries' FDI data have arisen as a result. In addition, new methodological problems affecting FDI data have been generated as a result of increasing globalisation and financial innovation. Trends in FDI data can only be analysed properly if the concepts, definitions and classifications underlying the FDI statistics are standardised. Unfortunately, until compilers adopt harmonised international standards, it is necessary to be *au fait* with existing problems within FDI data in order to be aware of how to interpret FDI statistics.

1 Ireland's degree of transnationality — a measure of how important multinationals are to a nation's economic activity — is very high, according to the United Nation's World Investment Report 2005. An indication of the number of foreign affiliates to total multinationals resident in an economy is measured by an internationalisation index, in which Ireland ranks eighth worldwide.

2 IMF 5th BOP Manual; IMF BOP Textbook; IMF BOP Compilation Guide; OECD Benchmark; ESA 95 and the International Financial Reporting Standards.

In light of complexities relating to the compilation and interpretation of FDI data, the concepts and problems associated with FDI are reviewed, and the subsequent implications for Irish FDI data are considered in this article. The differences between the economic and statistical definitions of FDI are outlined in Section 2, while the following section gives an overview of some of the principal methodological issues relating to FDI data. Section 4 sets out how to most usefully interpret Irish inward and outward FDI data. Among the items considered are an assessment of the major components of FDI and the significance of the IFSC for FDI flows. The final section offers some concluding remarks.

2. Explaining Direct Investment

For MNCs to compete successfully at an international level, internationalisation becomes necessary as productive capacities change, and industries gain access to markets and by-pass trade barriers via cross border investment. FDI statistics are used for measuring the flows of capital into and out of an economy. Changes in financial flows resulting from industries locating various parts of their production processes in different countries to gain comparative advantages can also be analysed via FDI statistics. In this section the definition of FDI and how the economic literature has used FDI data for various types of analysis are examined.

2.1 What is direct investment?

Direct investment flows are a component of the balance of payments (BOP[3]) financial account, which provide a measurement of financial assets and liabilities flows to and from affiliated companies. Direct investment reflects the *lasting interest*[4] of a resident entity (direct investor) in one economy, in an enterprise (direct investment enterprise) located in another economy. A direct investment relationship is deemed to exist when a direct investor acquires ten per cent or more of the voting shares/power of a direct investment enterprise, or owns less than ten per cent and still maintains an effective voice in management of the direct investment enterprise. The initial transaction between the direct investor and the direct investment enterprise is recorded as FDI, as are all subsequent transactions between them.

FDI is composed of several constituent parts: *equity capital, reinvested earnings* and *other capital*. Equity capital is the equity and other capital contributions invested in branches, subsidiaries and associates. Reinvested earnings consist of the direct

3 The balance of payments' accounts record an economy's trade of goods, services and financial capital with the rest of the world.
4 The notion of a *lasting interest* implies that there will be a long-term strategic commitment between the enterprises with capital flows arising from this relationship being classified as direct investment.

investor's share of non-distributed earnings and of the dividends of subsidiaries not remitted to the direct investor. The main component of other capital is intra-company loans and other intra-company balances. The financial flows (short-term and long-term loans) within a group structure are recorded as direct investment flows, regardless of the types of financial instruments employed for financing arrangements.[5]

On the other hand, equity transactions worth less than ten per cent of the voting shares/power of an enterprise are classified as portfolio investment. Transactions arising from the acquisition and disposal of equity and tradable securities, such as debt securities and money market instruments are included in portfolio investment flows. The components of portfolio investment are equity and debt instruments, including bonds, notes and money market instruments. These flows include the investment activities of collective investment schemes, money market funds and securitisation vehicles. Portfolio investment does not entitle an investor to legal control over a firm.

2.2 Direct investment and economic literature

Users of FDI data analyse trends in direct investment for a variety of purposes: indications of globalisation, the internationalisation of production, integration of markets and contribution to the growth performance of economies. This section examines how FDI is featured and analysed in economic literature and the resulting interpretations and conclusions.

FDI affects countries' domestic capital, productivity and employment thus contributing to the overall growth of an economy. Traditionally, FDI was a means that MNCs availed of in order to gain access to countries whose trade tariffs would otherwise have prevented them from doing so, and as a means to harness desirable local natural resources. FDI currently affects trading patterns by allowing MNCs to establish affiliates in another country in order to gain access to that country's markets or to use that country as a base for supplying other markets. FDI can boost economies' growth and development both directly and indirectly.[6]

Inward direct investment can boost employment directly. Thus developing countries become more productive as labour intensive industries establish in their economies. Conversely, for more developed nations, Andersen and Hainut (1998) find that distribution channels of MNCs are improved by outward direct investment (ODI) as parts of the production process are

5 The FDI transactions between banks and other financial intermediaries are limited to equity and permanent debt flows. The notion of permanent debt will not be included in FDI flows after the revision of BPM6.

6 A positive correlation between FDI and growth, and subsequent positive spiralling effects has been found by Kumar and Pradhan (2002).

distributed to low cost regions according to skills and costs. Economic and social convergence between developing countries and developed nations, in terms of technology, knowledge, innovation and management skills, necessarily requires the attraction of MNCs and associated FDI into developing countries. According to Moran (1998), a liberal climate will encourage the establishment of export-oriented affiliates of MNCs, which may lead to a clustering of similar MNCs' affiliates. As research by Fukao, Ishido and Ito (2003) has shown, FDI in East Asia has played a significant role in the increase of intra-industry trade in vertically differentiated products. In examining the effects FDI has on growth within sectors, Alfaro (2003) finds that FDI has a positive impact on growth in the manufacturing sector, and that FDI can help a country's development, as it is a source of technology development and management skills as well as capital inflows.

On the other hand, the arrival of MNCs can lead to the contraction of existing enterprises, because, for example, they may not be able to compete with higher wage rates offered by MNCs. This, however, may be part of the process of an economy moving up the value chain in modernising its structure.

FDI can indirectly improve a host economy's competitiveness, productivity and efficiency among local firms, as they adopt similar technologies to those of their country's MNCs in order to compete with them successfully. Bessonova, Kozlov and Yudaeva (2003) find that FDI not only increases domestic competition but also access to inputs, results in increased domestic productivity. Lim (2001) similarly finds evidence of positive spillover effects arising from FDI, particularly as a conduit for technology transfers, as MNCs are normally relatively advanced in technological expertise. The presence of MNCs in a host country leads to technology diffusion into the host country's markets, which in turn gives rise to improvements in the host's competitiveness and domestic standards of living.

3. Shortcomings of FDI Data

The spread of globalisation has increased the international integration of capital flows, thus increasing the problems encountered by users of FDI data. In addition to the traditional problems[7] associated with the collection and compilation of FDI statistics, the ease of capital mobility across national boundaries and the development of complex corporate group structures have brought additional distortions to FDI data. Some of these developments are examined here.

7 For example: asymmetries between country data, deviations from international compilation guidelines, non adherence to the ten per cent ownership rule and difficulties with collecting information from reporting agents on a timely basis.

3.1 Special purpose entities

A special purpose entity (SPE) is an entity established by a group structure, usually in a different jurisdiction to its own resident headquarters, to provide it with internal financial services[8]. The main identifying features of SPEs is that they have little or no economic activity, and employment.[9] They may not even have a physical presence in their resident economy and are frequently referred to as 'brass plate' companies as their only presence may be their registered office. A universal definition is not possible at present due to the national diversity, or lack of legislation guiding SPEs. While agreeing on some common characteristics of SPEs, international recommendations for BOP compilers define SPEs in different ways. Types of SPEs include:

- *Vehicle companies or special purpose vehicles (SPVs)*: used for securitisation purposes;
- *Holding companies*: used to own, control and direct a group of subsidiaries (financial subsidiaries and non-financial subsidiaries);
- *Conduits*: raise funds on behalf of their parent company;
- *Other asset management functions*: holding business and family wealth;
- *Liquidity management SPEs*: used as the 'bank' of the group, cash coordination centres, treasury operations, shared service centres — accounting and administration.

SPEs inflate and distort the 'other capital' component of FDI flows both for their resident host country and also for the countries directing and receiving capital flows via them. *Conduits* and *SPVs* involved in raising funds on behalf of the parent/group, inflate FDI flows in the country in which they are resident, if their capital flows are included in FDI flows. These types of entities, however, are essentially 'pass through' intermediaries and have no economic effect on the economy in which they are incorporated. Consequently, there seems little economic justification for including such flows in FDI. *Holding companies*, on the other hand, control and direct (financial and non-financial) subsidiaries under their remit and therefore are less like other types of SPE 'brass plates', in that they do have features of direct investment.

3.2 Capital in transit

Some countries' direct investment flows can be inflated by capital merely passing through the economy. Capital received from abroad by a direct investment enterprise, which is

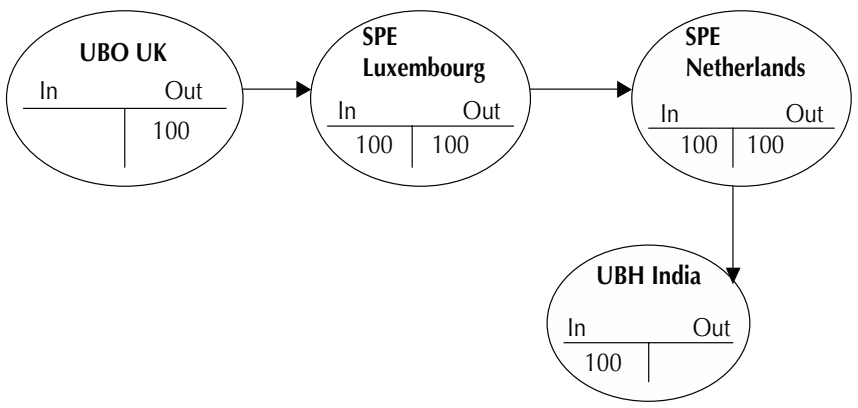
8 The functions of an SPE may depend on the tax regime of their resident country. For example, they may be involved in financial intermediation, administration services and cash management for the group structure.
9 OECD (2003) Report on SPEs and Offshore Enterprises.

immediately reinvested in another economy, is called capital in transit. Capital in transit does not have an economic effect on the economy it passes through. If, however, the capital is transformed or repackaged in the country it passes through, it should be included in FDI data. In these cases, transformed or repackaged capital may give rise to economic benefits through employment and taxation, before being reinvested in another economy.

The above example illustrates the difficulties of interpreting and analysing capital in transit. Based on the first counterpart-reporting rule, it would appear to users of FDI data in China that it received an inward direct investment of 100 units from the Netherlands. The Netherlands, however, was a pass through vehicle for the capital in transit, which ultimately was a Canadian direct investment of 100 units to China. SPEs are typically involved in the transmission of capital in transit flows. Distortions in FDI statistics caused by capital in transit flows are frustrating for users of FDI statistics as they make it difficult to assess a country's success in attracting FDI flows. For example, as these FDI flows are compiled on the basis of first known counterpart, the Netherlands would have difficulty in identifying whether FDI flows are real or just passing through. This issue is explored further in Section 3.3.

3.3 Ultimate beneficial owner/ultimate beneficial holder

Complex corporate structures, comprising SPEs passing capital through economies, impose additional steps to the flows of capital from direct investor to direct investment enterprise. In the framework of direct investment flows, further difficulties encountered by compilers include identifying the initial source and the ultimate destination of the direct investment flows, especially when the flows have passed through one (or several) SPEs. International BOP compilation recommendations have not kept up with the pace of developments in international financial flows. FDI statistics are still reported on the basis of first counterpart country meaning that the initial direct investor and final direct investment enterprise is not immediately identifiable from FDI data. Users of FDI data have a great interest in knowing how to identify the location (and sector) of the ultimate beneficial owner (UBO) of the direct investment and the ultimate beneficial holder (UBH) of the direct investment, and how to look through all the intermediary affiliates of the corporate chain.



In the diagram above, a UK direct investor is investing 100 units in a direct investment enterprise resident in India via SPEs resident in Luxembourg and the Netherlands. Users of Indian FDI data would need to look through the SPEs in the Netherlands and in Luxembourg in order to identify the true UBO of the FDI, i.e., the UK. Similarly the UK needs to look through the SPEs in order to identify where its outward FDI is ultimately going.

3.4 Borderline case between portfolio investment and direct investment

Multinationals not wishing to raise finance directly from financial markets or banks may use SPEs. As a result, the flows associated with SPEs may be classified as portfolio or other investment, as well as direct investment. Take, for example, a multinational issuing a bond, or establishing an SPE in another country to issue a bond and lend the money back to the parent: both of these transactions are classified as portfolio investment, as the SPE has not transformed or packaged the capital raised, and its sole customer is its parent. Borderline cases are common with treasury companies. A treasury company may or may not be influenced by its group parent and affiliates. If a treasury company lends monies to its parent, then the transaction would be classified as direct investment. A borderline case occurs when a treasury company issues a bond and on-lends the monies to the group. This transaction could be either direct or portfolio investment.[10]

3.5 Overcoming the concerns associated with FDI data

It is important that any initiative aiming to solve distortions and inflations in FDI data avoids bilateral asymmetries and still facilitates the compilation of meaningful EU and euro area aggregates. A number of international technical expert groups[11]

10 A treasury company, whose sole clients are affiliate companies within a group structure, issues a bond and lends the money back to the parent of the group; this transaction will probably be classified as direct investment. A treasury company, whose clients include companies outside the group structure, issues a bond and lends the proceeds to the group structure and other clients; this transaction will more than likely be recorded as portfolio or other investment.

11 Direct Investment Technical Expert Group (DITEG), Currency Union Technical Expert Group (CUTEG), Balance of Payments Technical Expert Group (BOPTEG). The ECB and Eurostat both contribute to these international fora.

have been set up to address revisions to the current Balance of Payments Manual (BPM5), with the International Monetary Fund (IMF) Committee on Balance of Payments Statistics acting as the guiding body for the update of the Balance of Payments Manual due to be finalised in 2008. The various interest groups involved in contributing to the updated manual have recommended some of the solutions briefly outlined below for possible inclusion in BPM6.

The problem of SPEs inflating FDI flows could possibly be overcome by separating SPE related FDI flows into a specific sub-category within national FDI statistics. This would allow users of national statistics to identify FDI capital flowing through SPEs and address the inflations in national FDI data. Any potential solution to the capital in transit problem requires compilers to identify capital in transit transactions or the entities acting as pass through vehicles for capital in transit. Netting the transactions of resident direct investors and non-resident direct investment enterprises allows for an assessment of the impact of capital in transit, and facilitates the exclusion of these flows from FDI data.

Similarly, netting out FDI flows, which pass through the links in the FDI chain would eliminate the distortions caused by complex corporate structures and the actual geographical pattern of FDI flows would be more readily identifiable. This would allow compilers to identify the UBO and UBH of FDI. A potential solution to the borderline case would be for the compiler to consider each individual transaction on a case-by-case basis. While this approach could solve the problems of misclassification, it may pose practical difficulties for compilers. Such supplementary information, for example in satellite accounts, would be of significant benefit for analysing FDI flows.

Within the euro area, in order to achieve consistency across Member States, the ECB has recommended how FDI data should be compiled. Although these recommendations are based on international methodologies, some anomalies remain. In this context, the ECB, in association with National Central Banks, is a significant contributor to the international fora involved in recommending and implementing updates in BOP methodologies. Having reviewed the concepts and problems associated with FDI data, the next section examines recent FDI flows into and out of Ireland.

4. An Interpretation of Irish FDI Data

Ireland is one of the world's most 'globalised' economies. In 2005, according to the A.T.Kearney/Foreign Policy Globalisation Index, Ireland ranked second to Singapore, having been ranked as the most globalised nation for the three previous years. Ireland's openness as an economy can be seen from trade

statistics, where imports plus exports accounted for 108 per cent of GDP in 2005. In addition, in 2005, 80 per cent of Irish exports were accounted for by foreign affiliates[12]. Foreign affiliates located in Ireland employed 132,728 people in 2005, whose spending in the economy amounted to €15.5 billion in 2005.[13] Out of 140 countries, Ireland was ranked fifth in 2004 by the UN's World Investment Report's 2005 rankings of the performance of inward FDI. Table 1 below presents FDI stocks, for various years, as a percentage of GDP for a number of economic areas. The importance of FDI differs from country to country, but it is self-evident how important it has been and remains to be for the Irish economy.

Table 1: FDI stocks as a percentage of GDP

Per cent	1990		2000		2003		2004	
	IDI	ODI	IDI	ODI	IDI	ODI	IDI	ODI
Ireland	88.9	27.0	134.1	29.5	141.3	41.9	126.3	52.9
UK	20.6	23.2	30.5	62.4	33.9	68.7	36.3	64.8
EU	10.7	11.5	26.4	37.0	32.8	43.0	31.7	40.9
World	8.4	8.7	18.3	19.7	22.0	24.3	21.7	24.0

Notes: IDI — inward direct investment, ODI — outward direct investment.
Data are sourced from the United Nation's World Investment Report 2005.
For the World (last row), total IDI should be identically equal to total ODI. Differences are due to measurement difficulties.

4.1 Recent FDI flows

Ireland's resident foreign affiliates receive FDI via equity capital, inter-company loans and through earnings reinvested in Irish domestic operations. While the equity capital remains a comparatively stable component, intra-company loans and reinvested earnings both display volatile behaviour. The size of direct investment related to portfolio investment, other investment and aggregate investment flows from the BOP financial account for 2004 and 2005 is shown in Table 2.

Table 2: Aggregate investment flows in 2004 and 2005

€ million	Inward: Foreign-based companies		Outward: Irish-based companies		Net flows: *Inward less outward*	
	2004	2005	2004	2005	2004	2005
Direct investment	–8,543	–25,034	14,552	10,910	–23,095	–35,945
Portfolio investment	149,403	172,151	135,116	118,591	14,287	53,560
Other investment	59,288	91,789	47,858	111,829	11,430	–20,040
Total	200,148	238,906	197,526	241,330	2,622	–2,425

Note: Data are sourced from the CSO Balance of Payments statistics.

12 Here the term foreign affiliates refers to IDA Ireland supported companies.
13 IDA Ireland Annual Report 2005.

Inward and outward investments, respectively, represent the obligations that Irish residents have to non-residents investing in Ireland and the claims that Irish residents have on other countries through their investments abroad. Net investment outflows of €2.4 billion in 2005, a significant decrease from inflows of €2.6 billion recorded in 2004, comprised net portfolio investment inflows of €54 billion, which were more than offset by direct investment and other investment net outflows. Direct investment itself amounted to a net outflow of €36 billion in 2005, compared with net outflows of €23 billion in 2004. While these are evidently very significant outflows, as explained later in the paper, they primarily relate to inter-company financial transactions, and not to the winding-down of direct investment in the Irish economy. As the focus of this paper is on direct investment flows, the components of direct investment are contained in Table 3 for the years 2004 and 2005.

Table 3: Components of direct investment flows

€ million	Inward: Foreign-based companies		Outward: Irish-based companies		Net flows: *Inward less outward*	
	2004	2005	2004	2005	2004	2005
Equity capital	–4,662	1,271	5,038	4,121	–9,700	–2,850
Reinvested earnings	9,291	4,752	2,719	*	6,572	*
Other capital	–13,171	–31,057	6,793	*	–19,964	*
Total direct investment	–8,543	–25,034	14,552	10,910	–23,095	–35,945

Notes: Data are sourced from the CSO Balance of Payments statistics.
* Suppressed for confidentiality reasons.

In 2005, there were outflows of €25 billion on the part of foreign companies, a significant increase in outflows from the €9 billion in the previous year. Lower reinvested earnings in Ireland in 2005 compared with 2004, reduced the impact of inward equity flows. The decrease in reinvested earnings is explained by an increase in distributed dividends and branch profits to the parents of group structures. It is worth noting that losses incurred by a foreign affiliate are recorded in reinvested earnings with a negative sign as a loss implies a reduction in the equity claims (or a disinvestment) of the direct investor.

As regards the 'other capital' component of direct investment, loans between affiliates within a group structure are included in this component. The volatility of the loans component of other capital will depend not only on the internal financial management structure of a multinational group (which in turn depends on financial market conditions, liquidity, interest rates etc.) but also on the tax regimes of the home and host economies. Multinational group structures can distribute tax liabilities via intra-company loans thus reducing their global tax rates. Take the example of an Irish-based foreign affiliate giving a loan to its US parent company. The interest income received in Ireland is taxed at a low rate, while the interest payment is

deductible against tax in the US. Therefore, intra-company loans may be preferred over equity capital as a means of financing direct investment.

Loans, a component of 'other capital' in Table 3, from Irish-based foreign-owned companies to their affiliates located abroad are thought to be the predominant factor behind the outflows in 2004 and 2005. These loans amounted to approximately €17.5 billion in the fourth quarter of 2005 alone, and are a redistribution of funds within multinational corporate structures. This is a corporate finance issue and is effectively not related to economic activity in Ireland.

In fact, the American Jobs Creation Act 2004, a piece of US legislation, which allows for a temporary tax 'holiday'[14] for foreign subsidiaries of US multinationals to repatriate funds held abroad back to the US at a reduced rate of corporation tax, is likely to have been a major factor influencing the reinvested earnings component of FDI flows[15]. The reduction in reinvested earnings, and resultant increase in distributed dividends and branch profits towards the end of 2005 is believed to be related to this legislation. The repatriation of dividends by US firms is likely to be temporary, as the 'holiday' tax period is a short-term provision. It is worth noting that firms actively sought this provision from the US authorities, and restructured their financial arrangements in advance, so as to take advantage of the legislation. Also, the long-term investment decisions of US subsidiaries residing in Ireland are not likely to be affected by this legislation, and this has been signalled by a number of US companies.

4.2 Outward FDI by Irish-based companies

From an analytical perspective, it would be neglectful to ignore outward direct investment (ODI) flows. Improvements in economic growth and the successes of the Irish economy have resulted in the development and internationalisation of Irish MNCs. The expansion abroad of operations by Irish MNCs has predominately been achieved via mergers and acquisitions. Mergers and acquisitions are a beneficial means of entering markets abroad in order to gain access to foreign markets and protect against exchange rate fluctuations. *Horizontal* ODI allows MNCs to access local markets abroad and *vertical* ODI enables Irish MNCs to take advantage of low cost production capacities.[16]

14 The holiday is a period of one year, or alternatively firms can avail of the provision either for the last taxable year beginning before the date of enactment (2004 for calendar year tax payers) or the first taxable year beginning during the one year period starting on the date of enactment (2005 for calendar year tax payers).

15 Dividends and distributed branch profits increased by approximately €2.7 billion in 2005. The increased dividend payments were partly funded by earlier profits which is not very worrying as Ireland is one of the most profitable countries for US multinational corporations.

16 Horizontal implies the same production level within a similar industry. Vertical implies that foreign affiliates contribute to producing inputs or selling outputs for the Irish domestic direct investor.

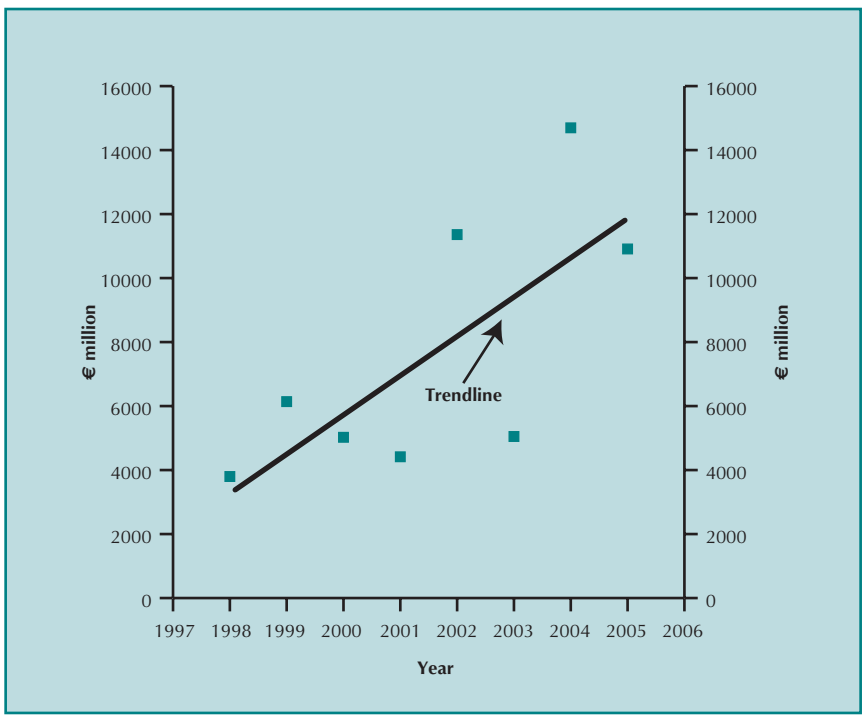
There is a common misconception that ODI is a negative factor for an economy. However, a broader assessment of the significance of ODI for the home country needs to be considered. As companies become very large in their home market, they can access overseas markets through supplying from their home base or, alternatively, setting up operations abroad. ODI to lower cost locations allows Irish MNCs to access low cost production inputs, and/or skills, technologies and patents, which may not be available locally. Consequently Irish MNCs have restructured their Irish operations to enable the development of higher value added skills and activities, such as R&D, supervision, accounting and administration. The Irish economy also benefits from ODI as a result of profit repatriation to resident Irish multinational parent companies. Flows of ODI from 1998 to 2005 at constant 2000 prices are displayed in Table 4, while Chart 1 demonstrates the positive trend in real ODI from Ireland. ODI flows were €14.7 billion in 2004, with other capital abroad accounting for a large part of this increase. ODI amounted to €10.9 billion in 2005; due to confidentiality constraints within CSO data, it is not possible to identify the largest factors contributing to these flows.

Table 4: Outward direct investment flows (constant 2000 prices)

€ million	1998	1999	2000	2001	2002	2003	2004	2005
ODI	3,798	6,139	5,024	4,415	11,359	5,049	14,696	10,910

Note: Data are sourced from the CSO Balance of Payments statistics.

Chart 1: Outward direct investment 1998 – 2005



4.3 Recent FDI flows by region

An FDI survey introduced by the CSO in 2003 publishes the annual stocks and flows of inward and outward FDI with greater geographical detail than the quarterly publications. It provides a general guide to the geographical allocation of Irish direct investment abroad and the geographical source of direct investment in Ireland. The data are compiled on the basis of *first counterpart* country, therefore direct investment inflows from the US to Ireland via the Netherlands will appear in data to be sourced from the Netherlands. A significant amount of US direct investment to Ireland is directed through a number of subsidiaries/pass through companies before arriving in Ireland. Table 5 displays the main sources and destinations of direct investment into and out of Ireland.

Table 5: Sources and destinations of inward and outward FDI flows

€ million	2001		2002		2003		2004	
	IDI	ODI	IDI	ODI	IDI	ODI	IDI	ODI
Euro area	12,347	–2,054	14,074	–6,593	17,311	–2,022	15,652	–4,603
EU – 25	19,045	–3,466	14,537	–7,461	21,455	–3,796	10,279	–7,902
Of which								
UK	8,979	–1,409	2,167	–805	2,987	–1,785	–2,373	–3,467
Netherlands	5,478	–441	5,953	–1,880	9,023	–112	5,710	–1,904
US	–8,088	1,371	6,393	–479	–5,275	580	3,996	–826
Asia, Africa, Oceania and Polar regions	1,461	26	394	–3,593	2	–471	2,110	–260
Totals	10,785	–4,543	31,158	–11,715	20,185	–4,917	8,987	–12,728

Notes: Data are sourced from the CSO. Data relating to 2001 are for the EU 15.
These geographical data are provisional as illustrated, for example, by the large differences in 2004 data in this and earlier Tables. Revised figures for 2004, and figures for 2005 will be published by the CSO in December of this year.

In addition to the US, the UK has been a significant contributor to inward direct investment to Ireland. There were disinvestments associated with Irish affiliates lending to UK related companies in 2004, leading to outflows of €2.4 billion. Although it appears that the Netherlands is a large host for direct investors investing in Irish affiliates, the Netherlands is a haven for SPEs and the greater part of the FDI flows would in fact have originated in other countries. Due to the large volumes of pass through flows going through the Netherlands, their FDI flows are frequently excluded from FDI analysis due to their lack of economic meaning.

There were notable reductions in inward FDI by US companies operating in Ireland in 2001 and 2003, predominately accounted for by Irish affiliates lending to other members of their group structure located abroad. Outward direct investment flows have been increasing over time. The UK, the Netherlands, US and offshore centres account for the largest share of Irish outward direct investment. Increased investment to these geographical

locations and, of course, to other euro area countries reflects the economic successes of Irish multinationals. A recent ad-hoc study performed by the CSO for Lane and Ruane (2006) establishing the ultimate beneficial owner (UBO) relationship of Irish ODI and IDI finds that the US, UK, euro area and offshore centres are the most important partners for Ireland in terms of inward and outward financial flows and offshore centres for outward flows.

4.4 IFSC issues

There are a variety of SPEs resident in Ireland, predominately in the IFSC, providing internal financial services to their group structure. SPEs in Ireland comprise special purpose investment companies, insurance and re-insurance companies, asset finance companies, treasury companies[17] and special purpose vehicles. While it is clear that some activities in the IFSC are direct investment transactions, the major part of the volume of transactions flowing through the IFSC are related to portfolio and other investment. The IFSC flows of inward and outward direct investment in 2004 and 2005 are displayed in Table 6.

Table 6: IFSC and non-IFSC direct investment

€ million		2004	2005
IFSC	*Outward*	526	–441
	Inward	–13,939	–26,432
Non-IFSC	*Outward*	–15,079	–10,469
	Inward	5,397	1,398
Total direct investment	*Outward*	–14,552	–10,910
	Inward	–8,543	–25,034

Note: Data are sourced from the CSO Balance of Payments statistics.

There were significant outflows of direct investment from IFSC enterprises in both 2004 and 2005. Portfolio investment inflows to the IFSC more than offset these outflows over the last two years. Generally, non-IFSC companies are much more relevant to domestic economic activity and employment.

The borderline case between direct investment and portfolio/ other investment is highly relevant to treasury companies. Irish resident and non-resident MNCs create treasury companies to operate risk and liquidity management services, lending and financing activities and manage cash for their group structures. The bulk of treasury companies are classified as direct investment enterprises whose transactions are predominately recorded in the 'other capital' component of direct investment, reflecting their role as lenders and depositors among other things for their group structure. Other types of treasury operations, depending

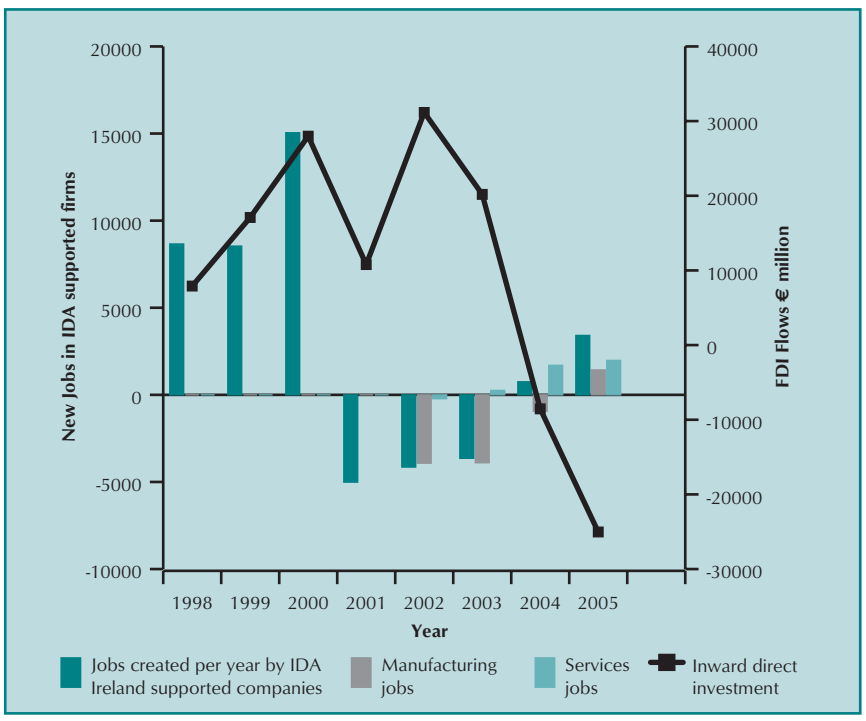
17 Treasury companies with a physical presence are not categorised as SPEs, while agency and captive treasury companies are included in the SPE category.

on their activities, may or may not be classified as direct investment.

4.5 FDI, the real economy and employment

While knowledge of how to correctly interpret FDI flows is beneficial and essential for correct economic analysis, examining other indicators of economic performance can supplement economic interpretations and conclusions. The negative inflows of FDI in 2005 due to decreases in reinvested earnings in Ireland and increases in loans from Irish resident foreign affiliates to members of their group structure located abroad do not appear to have been related to economic activity. For example, the IDA Ireland's Annual Report for 2005 reports a net gain of 3,412 jobs last year, the highest since 2000.

Chart 2: IDA Ireland supported companies' employment, annual change, and annual inward FDI flows



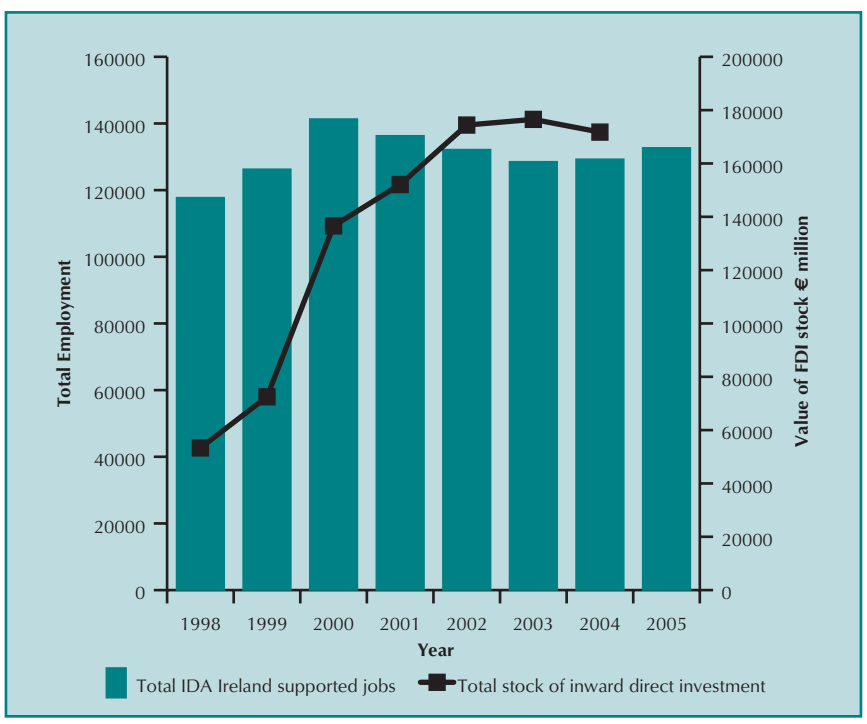
Source: IDA Ireland Annual Report 2005 and the CSO Balance of Payments Statistics

The number of jobs created by IDA Ireland supported companies from 1998 to 2005 is displayed in Chart 2. A plot of inward direct investment, over the same period, is also presented in Chart 2. It can be seen that, for the reasons outlined earlier that complicate the interpretation of aggregate FDI data, there is not a close link between aggregate FDI and employment in IDA Ireland supported companies. Employment in IDA Ireland supported manufacturing has declined in recent years, although in 2005 there was a net increase of 1,432 jobs, largely created in the information and communication technologies' sector. Employment in internationally traded services has been increasing steadily since 2001. Jobs in IDA Ireland supported internationally traded services companies amounted to 47,396 last year, a net increase of 1,980 since 2004. Employment by

financial services companies accounted for over a quarter of total employment in the internationally traded services sector.

Investment in research and development continued to increase in 2005, with total investment by enterprises exceeding €275 million for research and development projects. A high proportion of jobs created in Ireland in 2005 by IDA Ireland supported companies in the science and technology, and financial services sectors required high-level qualifications. Foreign owned[18] manufacturing companies' sales grew by 3.4 per cent in 2004[19], with the manufacturing of medical devices and instruments accounting for the largest part of this growth. Software development was the main contributor to growth in the internationally traded services sector in 2004. The total value added by foreign owned firms to Irish economic activity was €38.3 billion in 2004. Both the manufacturing of chemicals and pharmaceuticals, and internationally traded services had the most significant levels of value added growth in 2004. The recent performance of foreign owned companies in Ireland emphasizes Ireland's drive towards a high level value added innovative economy.

Chart 3: Employment numbers in IDA Ireland enterprises, and stock of FDI in Ireland



Source: IDA Ireland Annual Report 2005 and the CSO Balance of Payments Statistics

Given the difficulties associated with FDI data, the level of employment in foreign owned companies provides a better barometer of the impact of FDI on the Irish economy. The total number employed by IDA Ireland supported companies, plotted against the level of IDI in Ireland, i.e., foreign liabilities are

18 In this paragraph, foreign owned companies refers to foreign owned companies supported by Irish enterprise development agencies.

19 2004 is the most recent year for which this data is available.

displayed in Chart 3. The level of IDA Ireland supported jobs displays a relatively stable pattern, while IDI fluctuates comparatively more over the period, 1998-2004. Charts 2 and 3 together suggest that FDI flows on their own, therefore, can give a misleading impression of their significance. The FDI data need to be complemented by real indicators of economic activity to give a truer measure of their impact on the Irish economy.

5. Conclusions

Robust and meaningful statistics are a necessary basis for good policy decisions. Thus, high quality statistics are required in order to understand phenomena such as global imbalances, financial crises in emerging markets, the pace of internationalisation, exchange rate risk, and issues related to MNCs' risk and liquidity management. The rapid international diversification of production processes, and the movement of financial flows across countries and regions, has highlighted the need to analyse direct investment flows. FDI data are a measure of strategic long-term real investments into (or out of) an economy. International empirical evidence shows that FDI has a significant positive impact on technological progress, R&D, innovations in productive process and, consequently, economic growth.

A number of provisos, however, are associated with the current FDI data. Asymmetries between country data, national interpretations of, and deviations from international compilation recommendations and practical problems associated with the collection of data from reporting agents give rise to anomalies in FDI statistics. Changes in global financial markets, the creation of legal entities to facilitate the operation of new financial instruments, and the path of financial flows from initial direct investor to final direct investment enterprise have resulted in distorted FDI data. A number of solutions that propose to work toward solving these distortions have been developed in the context of revising the IMF Balance of Payments Manual, to be published in 2008. Harmonisation of balance of payments statistics will require timely incorporation by national compilers of the recommendations. The advent of common euro area recommendations for FDI data has enabled a certain level of consistency across Member States, while allowing countries to treat their national anomalies in satellite accounts.

Ireland is an open globalised economy hosting a large number of MNCs, which contribute significantly to the growth of the Irish economy. FDI data is a useful indicator for measuring and analysing the capital movements and cross-border transactions of MNCs. Outward FDI by Irish-based companies has become very significant in recent years. Much of this can be explained by Irish companies needing to expand beyond the small local market and, sometimes, to avail of lower costs elsewhere.

FDI statistics comprise three types of capital flows — equity capital, reinvested earnings and other capital. The general international evidence for developed countries is that normally the first two components tend to be relatively stable. However, the third component, 'other capital', including as it does items like intra-company loans etc., can be volatile. Additionally a factor contributing to FDI volatility in Ireland is the presence of the IFSC, which has experienced large volatile FDI inflows and outflows. The result is that aggregate FDI flows *vis-à-vis* Ireland can be difficult to interpret.

Inter-company loans — the main component of 'other capital' — from Irish-based foreign owned companies to their affiliates located abroad are the predominant factor behind very large FDI outflows in 2004 and 2005. In addition, reinvested earnings in the economy by foreign-based companies declined from €9.3 billion in 2004 to €4.8 billion in 2005. These flows would seem to be linked to corporate finance/tax issues, in particular the American Jobs Creation Act 2004, and are effectively not related to 'real' economic activity in Ireland. A recent commentator has remarked that the Act ''*certainly affected figures for foreign investment, without affecting the investment*''.[20]

The greater part of Irish FDI flows are related to the IFSC. IFSC enterprises are mainly focussed on supplying services to non-residents. Consequently their activities are more tenuously linked to the domestic economy than non-IFSC related investment flows, although an estimated 11,000 people are currently employed in foreign-owned IFSC companies. The flows classified as equity capital and reinvested earnings of non-IFSC enterprises tend to represent 'real' economy activity. However, as indicated, the picture for the past two years has been complicated by the American Jobs Creation Act of 2004.

In light of the methodological complications associated with FDI data reviewed in the paper, FDI data in isolation do not give a good indication of the impact of foreign owned companies on the Irish economy. It is necessary to consider FDI statistics along with 'real' economic indicators such as employment, sales growth and value added to the economy. In this regard, the stock of IDA Ireland supported jobs — employment related to FDI inflows — in the economy has begun to increase in recent times following a slight decline in the wake of the technologies shock in 2001.

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