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Securing the future of investment

Ireland can bank on future US investment if it manages to retain its competitive edge and strives to upgrade its overall package, writes **Alan Ahearne**

In today's interdependent global economy, changes in economic circumstances in other countries may have unwelcome consequences for us here in Ireland.

The most obvious example of this interdependency is our relationship with the United States. For the past decade, America, along with China, has been the growth locomotive for the global economy. The United States is one of our largest export destinations - exports to America accounted for over 10 per cent of Ireland's GDP last year - and the source of most of the foreign direct investment that has been crucial to our economic success.

Given recent economic developments in the United States, our vulnerability to events across the Atlantic has come back into focus. As Ben Bernanke, chairman of the US Federal Reserve, America's central bank, said recently, the US economy is "entering a period of transition."

After several years of robust growth, America's economy has little or no remaining spare capacity and is showing signs of overheating. The resulting upward pressure on prices has come at a bad time, with inflation already uncomfortably high because of soaring oil prices.

In response, the Fed has gradually raised short-term interest rates 4 percentage points over the past two years, with additional monetary tightening expected over the coming months. These rate hikes have started to have the desired effect of slowing domestic spending in the United States, with recent indicators suggesting that the property market is softening and spending by the over-stretched American consumer has begun to moderate.

The challenge for the Fed over the next few months will be to raise interest rates just enough to achieve a soft landing. If Bernanke overdoes monetary tightening, domestic demand will drop and the economy will fall into recession next year, dragging the rest of the world down with it. If he doesn't tighten enough, inflation will continue to move up, forcing sharper and larger interest rate increases and a deeper recession in 2008.

From Ireland's perspective, the most important question concerning the outlook for America's economy is perhaps not so much what happens to US domestic spending as what happens to the enormous US trade deficit, currently running at a record 7 per cent of GDP.

America cannot continue to live beyond its means forever. At some stage, the trade deficit must shrink, with US exports rising relative to imports. This adjustment may have significant implications for US direct investment in Ireland, and given the deep integration of American firms in the Irish economy, for our standard of living more generally.

The facts about our reliance on inward investment from America make for remarkable reading. More than 600 US firms have based their European operations in Ireland. Roughly one out of every three manufacturing workers here works for a US company, and many more jobs are directly supported by these firms.

Wages at US firms based in Ireland are about one-third higher than at indigenous Irish firms. Two-thirds of Ireland's total manufacturing output and over three-quarters of total manufacturing exports are accounted for by US firms. Although Irish subsidiaries of foreign multinationals face a low rate of corporate tax, they record very high profits, and are significant contributors to Irish tax revenues.

What explains the scale of US investment in Ireland? An often overlooked fact is that Ireland has served as an export platform for US firms for decades. The attractiveness of Ireland as an investment destination owed for a long time to our low corporate tax regime, which has been around in one guise or another since the late 1950s. The generally positive experience of these firms in Ireland was undoubtedly an important factor in their decision to expand operations here. However, the bulk of US investment in Ireland didn't arrive until the 1990s, as US investment abroad surged. In 1990, US direct investment in Europe amounted to $5 billion; by the end of the decade, the figure had ballooned twenty-fold to nearly $100bn.

This surge in investment abroad owed in large measure to the emergence of new technologies that brought dramatic changes in the way goods are produced and distributed.

In particular, advances in information technology enabled the fragmentation of firms' production systems. Against the backdrop of the creation of a single market within the European Union, US corporations rushed to establish and expand operations in Europe in search of lower production costs and easier market access. Today, two-thirds of exports of Irish-based US firms go to countries in the Europe Union, mainly to continental Europe. As a result, the activities of these firms have helped reduce our dependency on the UK.

Ireland managed to attract a disproportionately large share of this investment, thanks largely to our low rate of corporate tax and young, well-educated, English-speaking workforce. Although the tax rate facing new arrivals has edged up, Ireland's corporate tax rate of 12.5 per cent is only about one-third of the average rate in the EU. We also compete strongly in terms of the quality of our workforce, outscoring most other European countries in the percentage of young people with third-level education.

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an especially strong presence in sectors such as computers, pharmaceuticals, medical devices, and financial services. These are skills-intensive industries in which America is the world leader and in which profits are highly fungible and can be readily "booked" in a low-tax country using transfer pricing.

Recent data on US direct investment have been distorted by large once-off repatriations of funds back to the United States in response to tax incentives, but most pointers suggest that the underlying pace of inward investment into Ireland remains solid.

This new investment plays a key role in driving our increasingly knowledge-based economy higher up the value chain. Moreover, US companies continue to act as incubators for start-up Irish firms, with Irish entrepreneurs putting to work the knowledge gained as employees of US corporations.

All this comes at a time when global competition is heating up. Recent years have seen a number of US firms shut their operations in Ireland and relocate to lower-wage locations such as eastern Europe, China, and India.

These regions will continue to attract large amounts of foreign investment in labour intensive sectors, and will increasingly compete with Ireland for mobile capital in more advanced industries. Ominously, China's 3,000 universities currently graduate nearly one million engineers annually, and the number of Chinese students enrolling for PhDs in the sciences is rising rapidly.

Nonetheless, the threat from low-wage economies to Ireland's ability to attract inward investment is sometimes overstated. Decisions about where to locate are usually made by considering the total unit costs of production, not just wage costs, in different candidate countries.

Factors such as the skill level and adaptability of the workforce, quality of local suppliers, infrastructure, and the predictability of a country's political and legal environment all help to determine the overall cost of operating in a given location.

Ireland scores highly on many of these dimensions, though poor infrastructure remains an obstacle to attracting investment to regions outside of Dublin. Having production operations already located here should therefore give us an advantage in attracting highly-prized research and development activities, assuming of course that we can provide enough trained staff.

Arguably, the greatest threat to our ability to attract foreign investment comes not from low-wage countries, but from the United States itself. Adjustment in global trade balances, and the drop in the dollar that will likely accompany this rebalancing, may result in a retrenchment in US direct investment abroad as US multinationals shift production back home to America.

How sensitive US investment in Ireland might be to a fall in the dollar is an open question, but the introduction of protectionist trade policies in America or a change in US tax laws regarding multinationals profits would likely hit Ireland hard.

The challenge will be to continuously upgrade the overall package that we offer to foreign investors. Complacency could be disastrous. The priority should be to make sure that our economy, especially our educational system, is up to task.

Alan Ahearne is a former Federal Reserve economist and currently lectures in economics at NUI Galway.