

FINANCIAL GLOBALISATION AND THE IRISH ECONOMY

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1.
Introduction

In December 2002, the Central Statistical Office (CSO) released the first-ever official estimates of Ireland's international investment position (IIP).¹ The IIP is a central concept in international macroeconomics, since it lays out the international balance sheet of the foreign assets and liabilities held by Irish residents.² In this way, it captures the extent of Irish participation in global financial (market and non-market) transactions. Moreover, by combining the information on stock positions from the IIP with the data on investment income and financial flows in the Balance of Payments releases, it is possible to calculate estimates of the yields, capital gains and overall returns earned on foreign assets and liabilities.

This article explores the characteristics of the Irish IIP and builds on previous work by Lane (2000a, 2000b) and Lane and Milesi-Ferretti (2001a, 2001b, 2002, 2003) that have explored the economics of international financial integration for a broad panel of countries.

Prior to the release of the IIP data, there were two proxy guides to the state of Ireland's international balance sheet. One was to cumulate the history of capital flows, adjusted for valuation changes using "standard" estimates for rates of return: Figure 1 shows the data for the net foreign asset position over 1970-1998, using the methodology laid out by Lane and Milesi-Ferretti (2001a). According to this approach, the Irish net foreign asset position had considerably improved from the mid-1980s and

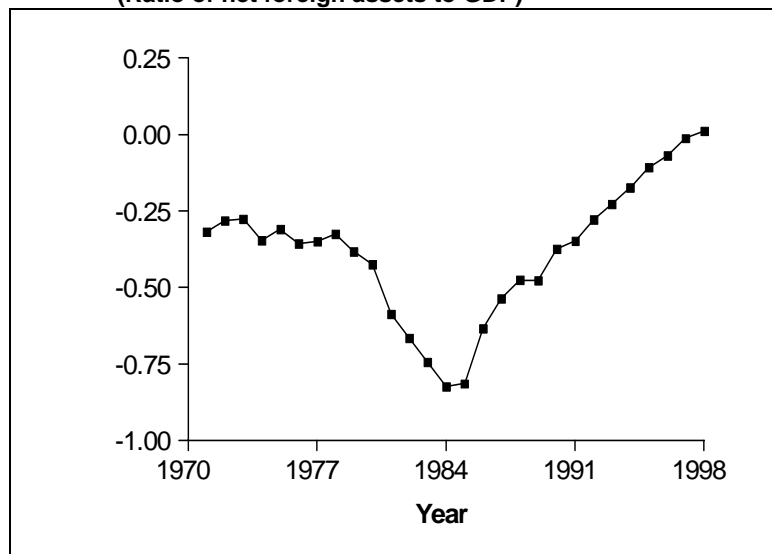
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¹ The publication of the IIP data is part of a broader effort by the CSO to improve collection and compilation arrangements for balance of payments data. The CSO follows the best-practice international methodology in constructing these data.

² The residency concept includes corporate bodies that have a centre of economic interest located here, including branches of foreign-registered companies. As such, it includes entities that may be wholly-owned by foreigners but that maintain some level of activity in Ireland.

was mildly positive by 1998.³ However, a quite different profile is indicated by the investment income data from the Balance of Payments. As is shown in Table 1, these data for 1998-2001 indicate that the differential between investment income outflows and inflows would suggest that Ireland must have large net external liabilities.

**Figure 1: Ireland's Net Foreign Asset Position, 1970-1998
(Ratio of net foreign assets to GDP)**



Source: Lane and Milesi-Ferretti (2001a).

Table 1: Irish Investment Income Flows, 1998-2001

Year	Investment Income Outflows (€million)	Investment Income Inflows (€million)	Outflow As % of GDP (GNP)	Inflow As % of GDP (GNP)
1998	27,094	17,639	35 (40)	23 (26)
1999	36,108	22,724	40 (47)	25 (30)
2000	44,951	29,875	44 (51)	29 (34)
2001	47,387	29,743	41 (49)	26 (31)

Source: CSO Online Database.

Moreover, the gross levels of investment income outflows and inflows are very high relative to GDP or GNP. This pattern implicitly indicates that the stocks of foreign assets and liabilities must be correspondingly high. There appears to be a slight trend increase in both investment income outflows and inflows over 1998-2001, suggesting that the gross scale of the international balance sheet has grown and/or that yields have improved.

Finally, Table 2 shows that the net investment income earned and paid out by IFSC-resident enterprises is close to balance: the vast bulk of the overall net investment income deficit is attributable to non-IFSC

³ The "External Wealth of Nations" dataset constructed by Lane and Milesi-Ferretti (2001a) also reports values for gross financial assets and liabilities and their composition. These data are available at <http://www.tcd.ie/iis/plane/data.html>.

enterprises.⁴ By extension, this suggests that the assets and liabilities of the IFSC sector are not too different in value but there is a significant net external liability position for the rest of the economy.

Table 2: Factor Income Flows: IFSC vs. Non-IFSC, 1998-2001

Year	IFSC		Non-IFSC	
	Income Outflow (€million)	Income Outflow (€million)	Income Outflow (€million)	Income Outflow (€million)
1998	12,254	12,827	14,957	5,002
1999	16,556	17,552	19,664	5,450
2000	22,149	23,980	22,916	6,109
2001	23,307	24,009	24,325	5,947

Source: CSO Balance of Payments Table 3.

However, investment income is potentially an unreliable guide. Most obviously, capital gains and losses comprise a significant proportion of overall returns, especially for equity-type investment categories. A country could have net external assets yet still display a negative investment income balance, if its foreign assets were primarily equities and foreign liabilities low-return debt liabilities. In the other direction, the United States enjoyed the status of being a net debtor during 1985-1998, yet at the same time experienced a positive net investment income balance, since it enjoyed a higher yield on its foreign assets than it paid out on its foreign liabilities. Of particular relevance for Ireland is that transfer pricing practices can also distort the relation between investment income flows and the underlying stock positions: a low-value asset could be measured as generating extraordinarily high yields, if recorded earnings are boosted by tax-driven manipulation of the intra-firm pricing of trade transactions.

For these reasons, the publication of the IIP data potentially represents a considerable advance in our understanding of Ireland's international balance sheet. In Table 3, we begin our analysis of these data by comparing the gross scale of foreign assets and liabilities relative to GDP in Ireland versus other high-income countries. We see that Ireland displays a very high degree of international financial integration by this measure, with a ratio of total foreign assets and liabilities to GDP of 14.5 per cent. For example, this compares to ratios of 3.5 and 1.4 for the European Union and the United States respectively.⁵ It even supersedes by a wider margin the ratios for financial centres such as Switzerland, the United Kingdom and Belgium-Luxembourg.⁶ These differences would be even greater if we scaled international financial positions by GNP or by an index of domestic financial assets and liabilities.

⁴ The International Financial Services Centre (IFSC) was established in 1987, with the purpose of making Ireland an attractive location for the provision of offshore financial services. Firms that were accredited to the IFSC received significant tax benefits, although many of the special provisions have been eliminated in recent years.

⁵ The difference between the European Union and the United States is not truly reflected in Table 3, since intra-EU cross-holdings are included in this measure. A better comparison would be to identify the extra-EU foreign assets and liabilities held by EU countries but this is not easily calculated, given incomplete information on the geographical distribution of foreign assets and liabilities.

⁶ If the data for Luxembourg were reported separately, it could well rank ahead of Ireland.

Table 3: International Financial Integration, 2001
(Sum of total foreign assets and liabilities as a Ratio to GDP)

Country	Aggregate Position
Ireland	14.45
Switzerland	9.27
The Netherlands	6.66
United Kingdom	6.50
Belgium-Luxembourg	5.89
Sweden	3.67
Finland	3.53
European Union	3.51
Portugal	3.20
Denmark	3.15
Austria	3.05
France	3.03
Germany	2.82
Spain	2.25
Norway	2.21
New Zealand	2.11
Italy	1.92
Austria	1.88
Canada	1.78
Iceland	1.76
Greece	1.45
United States	1.41
Japan	1.07

Source: International Monetary Fund *International Financial Statistics* database.

2. Ireland's International Investment Position: A Detailed Analysis

Table 4 gives more details about the asset/liability breakdown for the Irish IIP, with a decomposition between the IFSC and non-IFSC sectors. These data show that 75 per cent of foreign assets and liabilities are attributable to IFSC operations: if these were stripped out, Ireland would fall to fifth in the ranking reported in Table 3.⁷ Table 4 also shows a remarkable dynamic pattern for the net foreign asset position. During 1999, Ireland's net foreign asset position improved from an already-large 44 per cent of GNP to 74 per cent of GNP. This masked a huge measured improvement of 54 percentage points of GNP in the IFSC sector but a decline of 24 percentage points in the non-IFSC sector. The year 2000 saw a massive decline in both the IFSC and non-IFSC sectors, with an aggregate decline of 66 percentage points of GNP. The deterioration in the non-IFSC sector continued in 2001 with a fall of 27 percentage points

⁷ Of course, this is not a 'fair' procedure, since the financial services sector also looms large in the other countries that are highly ranked in Table 3.

of GNP but this was partly offset by a small improvement in the net position of the IFSC sector. Underlying the dramatic decline in the net foreign asset position during 1999-2001 has been a large increase in the foreign liabilities of the non-IFSC sector, whereas both foreign assets and foreign liabilities for the IFSC sector have generally grown rapidly.

**Table 4: Aggregate International Investment Position, 1998-2001
(Expressed as a Ratio of GNP)**

Year	Total			IFSC			Non-IFSC		
	FA	FL	NFA	FA	FL	NFA	FA	FL	NFA
1998	5.33	4.89	0.44	3.46	3.35	0.11	1.87	1.53	0.33
1999	7.15	6.40	0.74	5.30	4.64	0.65	1.85	1.76	0.09
2000	7.71	7.64	0.08	5.75	5.38	0.37	1.96	2.25	-0.29
2001	8.57	8.70	-0.13	6.66	6.22	0.44	1.91	2.48	-0.56

Note: FA is Foreign Assets; FL Foreign Liabilities;
NFA is Net Foreign Asset Position.

Source: CSO (2002) International Investment Position 1998-2001

**Table 5: Net Foreign Asset Dynamics 1998-2001
(Expressed as a Ratio of GNP)**

Year	NFA	NFI	D(NFA)	CA
1998	0.44	-0.14		
1999	0.74	-0.17	0.297	0.004
2000	0.08	-0.17	-0.664	0.001
2001	-0.13	-0.18	-0.202	-0.004

Note: NFA is Net Foreign Assets; NFI Net Foreign Liabilities;
NFA is Net Foreign Asset Position, D(NFA) is Annual Change in NFA, CA is Balance of Payments Current Account.

Source: CSO (2002) International Investment Position 1998-2001.

Table 5 probes the origin of these remarkable dynamics for the net foreign asset position. Net factor (investment) income has been very stable over the 1998-2001 period and the current account balance has been very close to zero. It follows that capital gains and losses on existing stocks of foreign assets and liabilities are primarily responsible for the large swings in the net foreign asset position. In particular, foreign investments in Ireland have been recorded as sharply appreciating in value.

**Table 6: Yields, Capital Gains and Overall Returns Ireland
1999-2001**

	Total		IFSC		Non-IFSC	
	YLDFA	YLDLFL	YLDFA	YLDLFL	YLDFA	YLDLFL
Yields (%)						
1999	6	11	7	5	4	19
2000	6	9	6	5	4	17
2001	4	7	5	5	3	12
Capital Gain (%)						
	KGFA	KGFL	KGFA	KGFL	KGFA	KGFL
1999	18	12	49	14	-9	7
2000	-1	8	3	3	5	20
2001	1	3	8	3	-7	3
Overall Returns (%)						
	RETFA	RETFL	RETFA	RETFL	RETFA	RETFL
1999	24	23	56	20	-5	26
2000	5	17	9	8	10	37
2001	5	10	13	8	-4	15

Note: YLD is the Yield, KG is the Capital Gain, RET is the Overall Return, FA is Foreign Assets; FL Foreign Liabilities.

Source: Author's calculations and CSO (2002).

We elaborate on this point in Table 6 by presenting the calculated yields, capital gains and overall rates of return on foreign assets and liabilities over 1999-2001.⁸ There are several striking findings in these data. First, in the non-IFSC sector, foreign liabilities consistently generate a much higher yield than do foreign assets. This was exacerbated by a further differential in terms of capital gains, such that the average difference between the rates of return on foreign liabilities and assets in the non-IFSC sector amounted to a striking 26 percentage points during 1999-2001. The yields and capital gains for the IFSC sector display much less dispersion, with the exception of 1999: in that year, there was an extraordinary capital gain of 49 per cent on the foreign assets held by IFSC enterprises. This may not be too surprising, since 1999 was an exceptional year for global stock market performance and the returns on US-based assets were further boosted by the strong appreciation of the dollar against the euro during that year.

To provide some extra insight, Table 7 provides some international comparative data on aggregate rates of return.⁹ The mean returns on foreign assets and liabilities refer to the unweighted average of returns across a set of eighteen industrial countries.¹⁰ Table 7 also includes the returns for the United States and the United Kingdom. The most noteworthy difference between the Irish returns in Table 7 is the systematically higher return paid out on Irish foreign liabilities, relative to international benchmark figures.

Table 7: Overall Returns Using International Data, 1999-2001

Year	Ireland		USA		UK		International Average	
	FA	FL	FA	FL	FA	FL	FA	FL
1999	24	23	14	4	9	5	13	17
2000	5	17	-1	1	7	4	11	8
2001	5	10	-2	1	1	1	5	3

Note: FA is Foreign Assets; FL Foreign Liabilities.

Source: Author's calculations based on the dataset constructed by Lane and Milesi-Ferretti (2003).

The extraordinarily high yields on the foreign liabilities of the non-IFSC sector are another manifestation of the “transfer pricing” phenomenon that plagues Irish macroeconomic data. The valuation of assets and liabilities in the IIP data allows us for the first time to confirm these high yields using aggregate data. Moreover, the IIP data also tell us that foreign investments here not only have recorded high yields but also enjoyed above-average capital gains: these assets have not only been highly profitable but also appreciated in value.

Table 8 sheds more light on this issue by reporting a sectoral breakdown of yields, capital gains and overall returns for four categories:

⁸ The yield is measured as the ratio of investment income in year t to the stock position at the end of year $t+1$; the measured net capital gain is the increase in the value of the stock position in year t that cannot be attributed to new financial flows; and the overall rate of return is the sum of the yield and the net capital gain.

⁹ These are nominal domestic-currency returns.

¹⁰ These are the United States, the United Kingdom, Austria, France, Germany, Italy, Netherlands, Sweden, Switzerland, Canada, Japan, Finland, Greece, Ireland, Portugal, Spain, Australia and New Zealand.

foreign direct investment (FDI), portfolio equity (PEQ), portfolio debt (PD) and “other” assets (O), with the latter category primarily comprising bank loans.¹¹ At a qualitative level, the cross-sectoral pattern follows the expected pattern: portfolio equity offers the lowest yields and FDI the highest, with portfolio and other debt in between. In contrast, capital gains are most prevalent for the equity instruments (portfolio and FDI), although they are also non-trivial for the debt category.¹² The pattern for capital gains on the portfolio equity component broadly follows global stock market developments, together with the impact of euro-dollar currency fluctuations.

Table 8: Yields, Capital Gain, Overall Returns, Comparison across Asset Categories for Ireland 1999-2001

	FDIA	PEQA	PDA	OA	FDIL	PEQL	PDL	OL
Yields (%)								
1999	16	2	4	8	40	3	7	6
2000	13	1	4	8	34	3	11	5
2001	12	1	4	5	21	3	7	4
Capital Gains (%)								
1999	12	61	8	13	3	18	9	13
2000	-1	-7	1	2	36	0	2	5
2001	6	-10	9	-2	9	3	3	0
Overall Returns (%)								
1999	28	63	12	20	44	21	17	19
2000	13	-6	5	10	70	3	13	10
2001	18	-9	13	4	30	6	10	4

Note: FDIA and FDIL are Foreign Direct Investment Assets and Liabilities, PEQA and PEQL are Portfolio Equity Assets and Liabilities, PDA and PDL are Portfolio Debt Assets and Liabilities, OA and OL are Other Assets and Liabilities.

Source: Author’s calculations based on CSO data.

However, the most striking feature of Table 8 is the extraordinary recorded returns on Ireland’s FDI liabilities. Overall returns in this category averaged 48 per cent during 1999-2001, including a peak of 70 per cent in 2000.¹³ If these data are interpreted literally, the conclusion is that these investments are extraordinarily productive. However, it may also reflect an under-reporting of the true value of the assets held in Ireland by foreign-owned entities. Indeed, the strong reported capital gains in this category may reflect “accounting catch-up” by which these firms are revaluing their Irish assets in line with the high profits that are generated here. In turn, this could reflect a capitalisation of the gains that are possible by employing transfer pricing to arbitrage the difference between the low corporation tax regime in Ireland and higher-tax systems elsewhere.

Table 9: Comparison of Average Returns Across Asset Categories Using International Data 1999-2001.

¹¹ We cannot make the distinction between IFSC and non-IFSC enterprises at the sectoral level since the published investment income data is not sufficiently disaggregated.

¹² Even non-marketed debt assets and liabilities can generate capital gains, for example through currency movements.

¹³ It seems that the 2000 figure can be largely attributed to a revaluation of assets held in Ireland by one foreign-owned corporation.

	FDIA	PEQA	PDA	OA	FDIL	PEQL	PDL	OL
Overall Returns (%)								
1999	12	33	5	5	7	44	5	7
2000	7	-2	7	9	5	-3	9	12
2001	7	-14	7	6	6	-10	5	8

Note: FDIA and FDIL are Foreign Direct Investment Assets and Liabilities, PEQA and PEQL are Portfolio Equity Assets and Liabilities, PDA and PDL are Portfolio Debt Assets and Liabilities, OA and OL are Other Assets and Liabilities.

Source: Author's calculations based on Lane and Milesi-Ferretti (2003).

Table 9 reports the mean returns for the international panel for the various sectors.¹⁴ This table re-confirms that 1999 was a year of extraordinary returns in international equity markets. It also demonstrates that high returns on FDI liabilities are not a general cross-country phenomenon: the Irish case appears to be quite special.¹⁵

Another implication from Tables 8 and 9 is that overall yields and returns depend on the composition of the international balance sheet among these different asset categories. For instance, a shift towards portfolio equity assets may reduce reported investment income inflows and hence generate a decline in gross national product, even if national wealth increases to the extent that capital gains on portfolio equity generate a higher overall rate of return. Accordingly, Tables 10 and 11 show the sectoral shares for the different investment categories for both foreign assets and liabilities: the decomposition is partial for the breakdown between the IFSC and non-IFSC entities in Table 11, since we cannot distinguish between the portfolio equity and portfolio debt components.

The pattern for the aggregate shares in Table 10 shows that the FDI share on both sides of the international balance sheet has been relatively stable over 1998-2001. There has been a shift in debt holdings from the "other" category to portfolio instruments, with the latter representing an ever-large share of both foreign assets and foreign liabilities. The share of portfolio equity assets has grown but portfolio equity liabilities have declined in relative importance.

Table 10: Composition of Ireland's International Balance Sheet (Shares in Each Category)

	Assets				Liabilities			
	FDI	PEQ	PD	Other	FDI	PEQ	PD	Other
1998	4.9	14.6	31.3	49.2	16.0	28.2	11.1	44.7
1999	5.4	18.7	25.9	50.0	14.1	23.0	31.1	31.8
2000	6.4	20.5	32.6	40.5	17.5	19.4	32.4	30.8
2001	7.4	18.2	40.3	34.1	16.0	15.7	33.6	34.7

Source: Author's calculations based on CSO data.

Table 11 provides the breakdown between the IFSC and non-IFSC sectors. On the foreign asset side, the category shares for the non-IFSC

¹⁴ France and New Zealand are excluded from the calculations for portfolio equity and portfolio debt returns, since these countries do not publish the decomposition of the portfolio category into these components.

¹⁵ The data on FDI positions are based on historical cost in most countries. If we just calculate the mean for those countries reporting market-value FDI liabilities (United States, France, The Netherlands, Sweden and Australia), the figures are 0.17, 0.06, -0.06 for 1999, 2000 and 2001 respectively. These are still far below the Irish figures in Table 5A.

sector have been quite stable: almost all of the action has been in a shift in the holdings of the IFSC sectors towards portfolio instruments. This indicates that the nature of IFSC activity may have shifted in recent years towards asset management and trading in international debt markets. On the liability side, a similar shift is seen for the IFSC sector. However, the composition of foreign liabilities for the non-IFSC sector has sharply changed, with a much larger share attributable to FDI. This is in line with the sharp revaluation of FDI liabilities shown in Table 8, plus strong inflows in this category.

Table 11: Composition of Ireland's International Balance Sheet Between IFSC and Non-IFSC (Shares in Each Category)

	IFSC			Non-IFSC		
	FDI	Portfolio	Other	FDI	Portfolio	Other
Assets						
1998	0	51.0	49.0	13.6	34.1	52.3
1999	0	56.5	43.5	17.7	37.4	44.8
2000	6	67.1	32.3	17.4	35.3	47.3
2001	6	67.1	32.3	18.6	34.2	47.2
Liabilities						
	IFSC			Non-IFSC		
	FDI	Portfolio	Other	FDI	Portfolio	Other
1998	16.3	37.3	46.4	15.3	43.5	41.2
1999	11.7	48.8	39.5	22.9	30.4	46.7
2000	12.0	51.9	36.0	35.5	27.6	36.9
2001	9.7	58.7	31.6	41.0	25.3	33.6

Source: Author's calculations based on CSO data.

3. Conclusions

In this article, we have explored some features of the newly-released data set on the Irish international investment position. We have learned that Ireland is to the forefront of financial globalisation, in terms of the volume of international cross-holdings of foreign assets and liabilities. The data also show that revaluation effects have been crucially important in driving the dynamics of the stocks of foreign assets and liabilities: the investment income data only provide partial information on the returns generated by the underlying foreign assets and liabilities. However, one must suspect that some of the measured capital gains during 1998 to 2001 reflect accounting adjustments rather than just marking-to-market practices. The extraordinary measured returns on FDI in Ireland that are revealed by the IIP data provide yet another insight into the transfer-pricing phenomenon and highlights that importance of accounting strategies for asset valuation in addition to income reporting.

Despite these caveats, the annual updates of IIP data over time should provide a fascinating insight into the evolving relationship between the Irish economy and the global financial system. Finally, it is highly desirable that this new information regarding the international balance sheet be supplemented by greater efforts to track the domestic components of the national balance sheet: we know remarkably little about the value of the assets and liabilities held by the household, government and corporate sectors in Ireland.

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