

CASE STUDY

Reinvested Earnings Matter

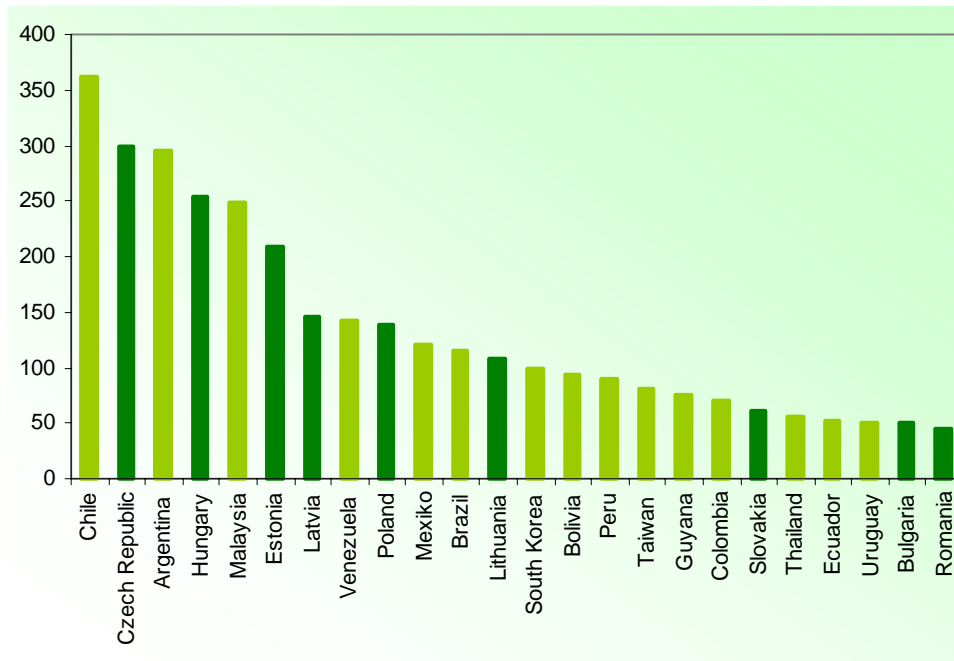
FDI AND REINVESTED EARNINGS

The Central European countries (CECs) have attracted rapid inflow of foreign direct investment (FDI) since the second half of the nineties. The Czech Republic and Hungary also come forward at the FDI inflow per capita in the worldwide comparison. Foreign investors have been attracted by profitable investment opportunities or cost reduction to the CECs, which both imply growth of profits in the foreign owned companies. The most usually mentioned FDI effects on the host economy are the effects in real economy, but

also the growth of profits in the foreign owned companies has an important impact on the structure of the balance of payments and an overall external balance.

The FDI is subdivided into equity capital investment, reinvested earnings, and other capital (intercompany loans) according to the balance of payment methodology. We shift our attention to the reinvested earnings, which haven't been given much attention so far in spite of the fact that this item shows some important methodological specifics and also its soaring trend in recent years.

FDI Inflow to the Emerging Markets and Developing Countries in 1995-1999 (annual average in USD)



Source: UNCTAD FDI Database.

**DOUBLE-ENTRY PRINCIPLE**

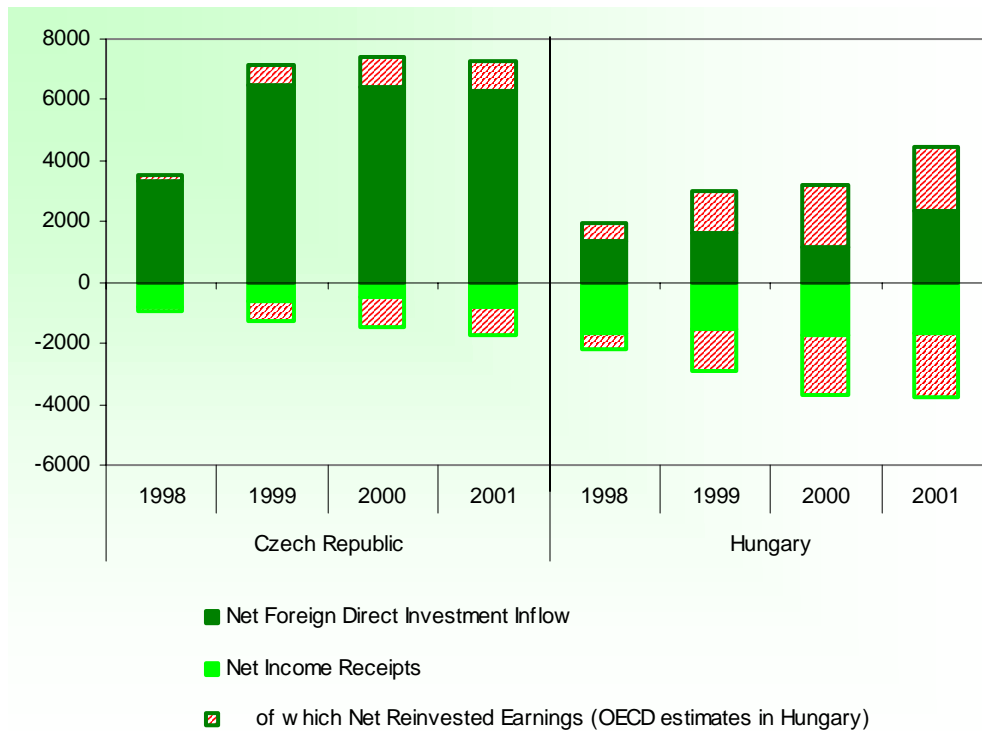
At the company level, reinvested earnings can be defined as the positive or negative difference between a company's profit and the distributed dividends. At the macroeconomic level, reinvested earnings are measured as a balance between reinvested earnings on domestic direct investment abroad on the one hand and on foreign direct investment on the other hand. According to the IMF Fifth Balance of Payments Manual, transactions may be imputed and entries may be made in the balance of payments accounts in some cases when no actual flows occur. The reinvested earnings are the typical example of such a flow as the earnings, whether distributed in the form of income dividends or reinvested in the enterprise, are included in the balance of payments. Reinvested earnings are included in the balance of payments within the double-entry bookkeeping principle. First, reinvested earnings are included in the financial account as the part of the foreign direct investment to reflect the direct investor's increased investment in the foreign subsidiary or branch. Second, reinvested earnings of a foreign direct investment enterprise are also recorded as a liability within net income receipts in the current account to represent the direct investor investment income on equity. The surplus of reinvested earnings in domestic economy has positive impact on the financial account due to increasing net direct investment, though the impact on net income receipts within the current account is of equal amount, but with reverse sign. Thus, reinvested earnings increase the inflow of the foreign direct investment, while they also increase the deficit of the current account. In this respect, the impact of the reinvested earnings on the balance of payments is neutral as its positive impact on the financial account is offset by its negative impact on the current account.

**Double-entry Principle of Reinvested Earnings in the IMF Balance of Payments Methodology**

- A. Current account
  - 1. Trade balance
  - 2. Balance of services
  - 3. Income balance**
    - 3.1. Credit
      - 3.1.1. Interest accepted, income from CB reserves
      - 3.1.2. Income from work abroad
      - 3.1.3. Dividends and Distributed Earnings
      - 3.1.4. Reinvested earnings
    - 3.2. Debit
      - 3.2.1. Interest paid
        - 3.2.1. Costs for foreigners work
        - 3.2.1. Dividends and Distributed Earnings
      - 3.2.4. Reinvested earnings**
- B. Capital account
- C. Financial account
  - 1. Direct investment**
    - 1.1. Abroad
      - 1.1.1. Equity capital
      - 1.1.2. Other capital
      - 1.1.3. Reinvested earnings
    - 1.2. In reporting economy
      - 1.2.1. Equity capital
      - 1.2.2. Other capital
      - 1.2.3. Reinvested earnings**
  - 2. Portfolio investment
  - 3. Financial derivatives
  - 4. Other investment
- D. Net errors and omissions, valuation changes
- E. Change in reserves (-increase)

Source: IMF Fifth Balance of Payments Manual, p. 43-48.

Double-entry Principle of Reinvested Earnings in the IMF Balance of Payments Methodology (EUR mil.)



Note: In 2001 are available only preliminary data. We expect significant upward revision of the reinvested earnings in the Czech Republic.

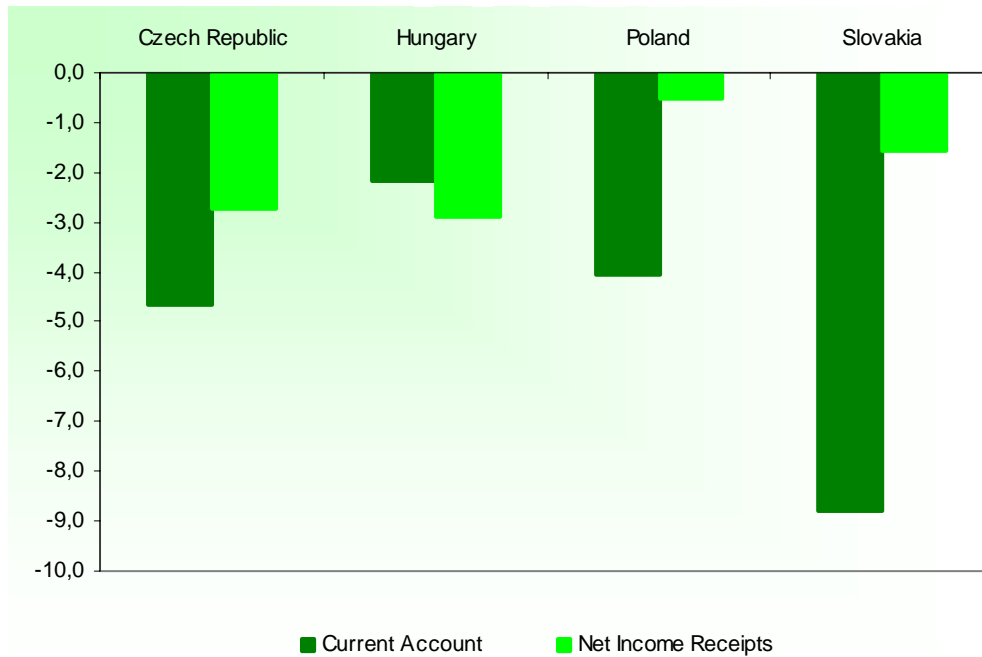
Source: CNB, NBH, OECD.

**BALANCE OF PAYMENTS BIAS**

There is a little doubt that reinvestment of the foreign investor earnings has positive impact on the host economy. Needless to say, the Investment Agencies offer sophisticated mix of investment incentives to attract and also keep the foreign direct investors in the host country. However, as shown above reinvested earnings are included in the current account, while they represent no actual currency flow, which would mean ceteris paribus any real influence on the exchange rate market. Therefore, the reinvested earnings create a

risky bias in the balance of payments. We have to bear in mind that the short-run capital investors shall not realize this rather particular methodological bias and reports on the graduate widening of the current account deficit over 5% of GDP should be a primary impulse for them to reverse their sentiment and leave their investment in the CECs currencies to euro or US dollar, which would result into an exchange rate crisis. There would be also dangerous misinterpretation of the current account deficit in the media or general public.

Current Account Balance and Net Income Receipts in the CECs in 2001 (in % of GDP)



Source: CNB, NBH, NBP, NBS.

**THE REVISIONS**

The investor's sentiment could be also reversed by the misleading deterioration of current account deficit. The most important item of the Czech current account - the trade deficit – has declined due to favourable development of the terms of trade in recent months and the services surplus remains stable in long-term, though, we expect graduate deepening of the income receipts deficit in the Czech Republic. Actually, the Czech National Bank also backed our expectations by sizeable income receipts deficit revision for 2000. Reinvested earnings statistics over current period require relying on surveys, estimates and forecasts, so that no one would have been surprised that the revision took place. However, the range of the revision was rather dramatic as the Czech National Bank revised the income receipts deficit in 2000 up by 80% from former published EUR 828 mil. to EUR 1,488 mil. As a result, the current account deficit jumped over 5% of GDP in 2000, which is the benchmark generally accepted by most of the foreign investors as a threshold of long-term external balance sustainability.

Taking into account the extent of the revision for 2000, one could expect that the income receipts deficit would jump from preliminary published data amounted to EUR 1,728 mil. to alarming EUR 3,000 mil. for 2001.

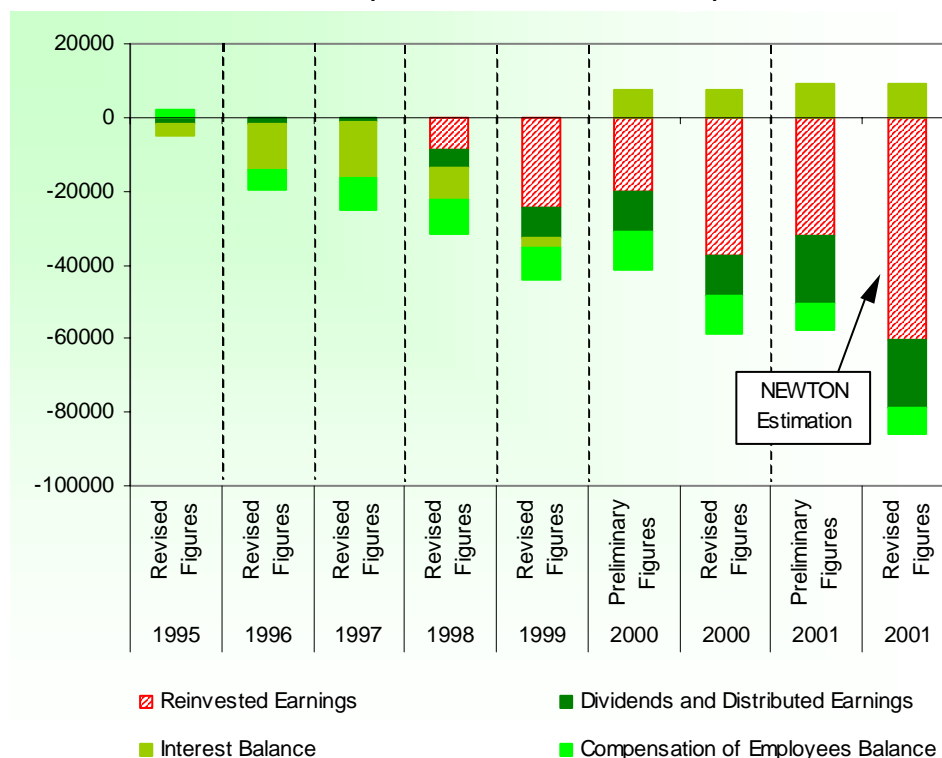
**REINVESTED EARNINGS JUMP**

The amount of reinvested earnings is stabilised in the developed countries in long-term. On the contrary, the value of reinvested earnings jumped more than five times in the Czech Republic since 1998. A cross-country comparison shows that the reinvested earnings become important item of the current account deficit in the CECs as the reinvested earnings amounted to 55% of the net income receipts deficit both in the Czech Republic and Hungary in 2001. Moreover, the massive wave of FDI inflow in recent years will be surely followed by graduating increase of foreign investors earnings also in near future in all of the CECs. As a rule, no matter if the earnings are reinvested or transferred, they will widen the current account deficit in the CECs. However, the exception is the National Bank of Hungary (NBH), which doesn't

include the reinvestment earnings in the Hungarian balance of payments statistics (only OECD estimates are available). Indeed, this is mainly due to shortcoming with data collection, as all the IMF members are obliged

to use the IMF methodology. In this respect, the NBH has also announced its methodology revision on 2003. On the whole, the IMF also admits problems with reinvested earnings data availability in most of the emerging markets.

Structure of Net Income Receipts Balance in the Czech Republic (CZK mil.)



Source: CNB.

**CURRENT ACCOUNT DATA TRANSPARENCY**

Total elimination of the reinvested earnings from the balance of payments statistics is impossible, as it would harm the IMF methodology recommendations. However, it is necessary to take into account the reinvested earnings in any conclusions driven from the current account balance development in the CECs. In fact, this is impossible in the up-to-date data analysis; as for example the CNB doesn't publish reinvested earnings separately in the quarterly balance of payments statistics. The reinvested earnings data are usually available with long time gap up to one year in the comprehensive yearly balance of payments statistics. In this respect, it is impossible to give clear economic interpretation to the

quarterly current account data. Moreover, the reinvested earnings cause a huge backward revision of the current account data as it was the case of data for 2000 and as we expect also sizeable revision of the current account for 2001 in the Czech balance of payments. These revisions are untransparent and hard to interpret, as the short-term data for reinvested earnings are not published. In this respect, we have to be very precise and aware of methodological issues while interpreting the current account balance data for the CECs. Regarding the expected further growth of reinvested earnings in the CECs, we have to pay enormous attention to the double-entry principle of reinvested earnings in the balance of payments analysis.



# NEWTON Holding, a.s.

Macroeconomic analyses, prognoses and comments (including this document) have been prepared by

**Macroeconomic Analysis Team:**

VLADIMIR TOMSIK	Chief Economist	+420 2 22 192 304 <a href="mailto:Vladimir.Tomsik@newton.cz">Vladimir.Tomsik@newton.cz</a>
MIROSLAV PLOJHAR	Analyst	+420 2 22 192 345 <a href="mailto:Miroslav.Plojhar@newton.cz">Miroslav.Plojhar@newton.cz</a>
MARTIN SRHOLEC	Analyst	+420 2 22 192 346 <a href="mailto:Martin.Srholec@newton.cz">Martin.Srholec@newton.cz</a>

Products of Macroeconomic Analysis Team are available at the Internet address:

<http://www.newton.cz/macrosearch>

**Information about all products and activities of Strategic Investment and Corporate Finance is provided by:**

PETR SEDY	Director of NEWTON Finance a.s.	+420 2 22 192 250 <a href="http://www.newton.cz/finance">www.newton.cz/finance</a> <a href="mailto:Petr.Sedy@newton.cz">Petr.Sedy@newton.cz</a>
-----------	---------------------------------	---

**Information about all products and activities of Business Engineering is provided by:**

LIBOR LAICHMAN	Director of NEWTON Management a.s.	+420 2 22 192 371 <a href="http://www.newton.cz/management">www.newton.cz/management</a> <a href="mailto:Libor.Laichman@newton.cz">Libor.Laichman@newton.cz</a>
----------------	------------------------------------	---

**Information about all products of Collective Investment is provided by:**

PAVEL SEMRAD	Director of NEWTON Investment a.s.	+420 2 22 192 200 <a href="http://www.funds.newton.cz">www.funds.newton.cz</a> <a href="mailto:Pavel.Semrad@newton.cz">Pavel.Semrad@newton.cz</a>
--------------	------------------------------------	---

**Information about all products of NEWTON Treasury Team is provided by:**

JOSEF BRCAK	NEWTON Treasury Team	+420 2 22 192 280 <a href="http://www.newton.cz/treasury">www.newton.cz/treasury</a> <a href="mailto:Josef.Brcak@newton.cz">Josef.Brcak@newton.cz</a>
-------------	----------------------	---

**Information about other activities of NEWTON Group is provided by:**

MIROSLAV SAFARIK	Director of NEWTON Holding a.s.	+420 2 22 192 360 <a href="http://www.newton.cz">www.newton.cz</a> <a href="mailto:Miroslav.Safarik@newton.cz">Miroslav.Safarik@newton.cz</a>
------------------	---------------------------------	---

PETR KRAUS	Chairman of the Board of Directors	+420 2 22 192 500 <a href="mailto:Petr.Kraus@newton.cz">Petr.Kraus@newton.cz</a>
------------	---------------------------------------	---

© NEWTON Holding a.s., Politických veznu 10, 110 00 Prague 1, CZ

Phone: +420 2 22 192 111, Fax.: +420 2 22 192 592

Released for printing on July 23, 2002.

**Notification:**

This document was prepared under good faith. All data, prognoses, comments and suggestion included in this document are only informative. NEWTON Holding a.s. does not guarantee the completeness and correctness of this information. All information is subject to change without previous notice. NEWTON Holding a.s. does not take responsibility for any losses caused to other persons from using information presented.

NEWTON Holding a.s. and its employees can have different positions, investment or other activities within the limits of the law (including purchasing and selling orders, consultancy, corporate governance, etc.) than presented in this publication. Further information can be obtained upon request.