Annex 1

Return on Foreign Direct Investment

The National Bank of Slovakia decided to extend the balance of payments by including reinvested earnings from foreign direct investment (with effect from 2005), in accordance with the international standards.

Before 2005, reinvested earnings had not been included in the balance of payments on current account. Reinvested earnings were recorded in the financial account only, under the 'foreign direct investment' item, on the basis of data reported from the corporate sector in the DEV 1-12 monthly report (annual data from this report contained values at the level of several millions and/or tens of millions of Slovak koruna).

In 2004, the NBS introduced a new annual report on foreign direct investment, in which reinvested earnings are recorded according to the principles of international accounting standards. With regard to the fact that the inflow of foreign capital into Slovakia via direct investment exceeds its outflow several times, the use of data from this report will mean an increase in the current account deficit. Reinvested earnings will get balanced within the capital and financial account, where foreign direct investment will increase in terms of both flows and stocks, in both Slovakia and abroad.

Current Account Developments - Czech Republic **(% of GDP)**

---- Current account ---- Current account, excluding reinvested earnings

Source: Central bank of the Czech Republic.

Current Account Developments Hungary **(% of GDP)**

---- Current account ---- Current account, excluding reinvested earnings

Source: Central bank of Hungary.

Current Account Developments Estonia **(% of GDP)**

---- Current account ---- Current account, excluding reinvested earnings

Source: Central bank of Estonia.

Data from the Czech Republic, Hungary, and Estonia show that, with reinvested earnings being included in the balance of payments, the current account deficit in the years 1998 – 2003 increased by an average of 2% (Czech Republic) and 2.5% (Hungary and Estonia), while the deficit in the last three years increased by almost 3% and, in Estonia in 2003, by more than 5%. If we assume that Slovakia is lagging behind the aforementioned countries in terms of FDI by roughly three years, the application of the data under analysis with reinvested earnings being included (instead of data according to the previously applied methodology for calculating the current account deficit) is expected to cause a nearly 3% increase in the current account deficit for 2005 (the NBS assumes that the difference between the current account deficit with and without reinvested earnings will be 2.3%).

In comparison with the neighbouring countries, the inflow of FDI into Slovakia began with a certain delay. While the ratio of FDI to GDP (the volume of FDI – capital participation without reinvested earnings) reached 30% in Slovakia in 2002, the same ratio in the Czech Republic was achieved in 1999 and in Hungary and Estonia even before 1998.

Foreign Direct Investment (% of GDP)

---- Czech Republic ---- Hungary ---- Estonia ---- Slovakia

Source: National central banks.

Foreign investors enter a country either through the acquisition of an existing company or by making a so-called green-field investment (building a new production plant). When the company becomes profitable, the foreign investor receives yields from its basic capital, which may be divided into reinvested earnings and dividends.

Return on Foreign Direct Investment
(dividends + reinvested earnings in relation to FDI) (%)

---- Czech Republic ---- Hungary ---- Estonia

Source: National central banks.

Chart 35 shows that the return on FDI (capital participation) in the Czech Republic and Estonia increased in 2003 more than four times in comparison with 1998, while the average figure for 2001–2003 hovered around the level of 13% in all three countries (according to NBS estimates, the rate of return in Slovakia will be roughly 11% in 2004).

Repatriation of Dividends in Relation to FDI (%)

---- Czech Republic ---- Hungary ---- Estonia ---- Slovakia

Source: National central banks.

In the following two years, foreign direct investors repatriated roughly 2% of GDP in the countries under analysis (Slovakia approached this figure in 2004). In relation to the total volume of FDI, dividend payments recorded a marked increase in Slovakia in 2004, up to 5.6%. The payment of dividends in 2004 was affected by short-term factors (increase in the profits of SPP [Slovak Gas Industry] and other energy suppliers, repatriation of earnings from the past, weak growth in EU countries, etc.). Hence, dividends are expected to grow at a slower rate in the coming years and their share in the volume of FDI is also likely to decrease somewhat (the growth in foreign direct investment in Slovakia will take place largely in green-field investments, which will generate profits only after a few years).

Reinvested Earnings in Relation to FDI (%)

---- Czech Republic ---- Hungary ---- Estonia

Source: National central banks.

From the economic point of view, the recording of reinvested earnings in the balance of payments has no effect on the current external balance. On the other hand, however, it gives a more accurate picture of the function of foreign direct investment in the economy. Reinvested earnings are calculated from after-tax profits by deducting the due dividends. Apart from the volume of FDI, a country can be characterised by several other factors (the profitability of enterprises, tax system, etc.), which influence foreign direct investment. For that reason, experience from other countries can hardly be applied to the Slovak economy. Even data from the three countries under analysis give no clear picture of developments in reinvested earnings, their size in absolute terms and as a share of dividends. Data for 2001–2003, mainly from the Czech Republic and Hungary, indicate that the ratio of reinvested earnings to the volume of FDI (capital participation only) was roughly 8% and that of reinvested earnings to GDP stood at 2.6% in that period. For the time being, these ratios seem to be acceptable for the Slovak economy as well (in 2004, such ratios would bring reinvested earnings in the amount of roughly Sk 30 billion. Although forecasts indicate that there will be larger capital inflows than in previous years, this will not necessarily generate a marked increase in reinvested earnings or dividends, since the capital will be used largely in green-field investments, which yield profits only after several years.

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