Foreign Direct Investments in the CR „There is no free Lunch“

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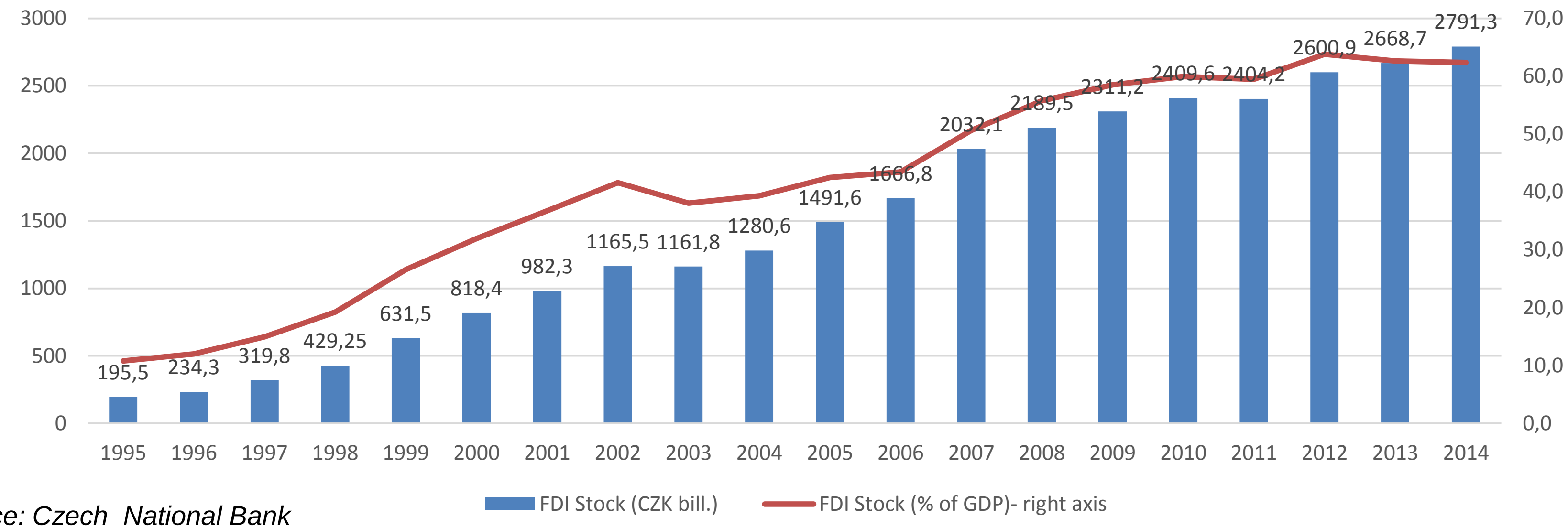
Foreign direct investments (FDI)- definition

- FDI reflects the objective of obtaining a lasting interest by a resident entity in one economy (direct investor) in an entity resident in an economy other than that of the investor (direct investment enterprise)
- Direct investment enterprise - foreign investor owns 10 % or more of the shares of voting power
- Direct investment enterprises = directly + indirectly owned affiliates
  - Subsidiaries (more than 50 % of voting power)
  - Associates (10 – 50 % of voting power)
  - Branches (wholly owned permanent establishments, directly owned by a foreign resident))

Foreign direct investments

- FDI = equity capital + reinvested earnings + other capital
- Equity capital - nonresident investment in the equity of a company.
- Reinvested earnings - direct investor’s share (in proportion to direct equity participation) of earnings not distributed as dividends.
- Other capital covers lending of funds, between direct investors and their affiliated enterprises and fellow companies in the same enterprise group.

Strong inflow of FDI as of 1998



Source: Czech National Bank

- Czech government has supported inflow of FDI as of 1998, FDI incentives as of 2000
  - Tax holidays
  - New jobs revenues
- The stock of FDI (almost two-thirds of GDP) is very high in the world context
- The companies under foreign control create almost one third of GDP

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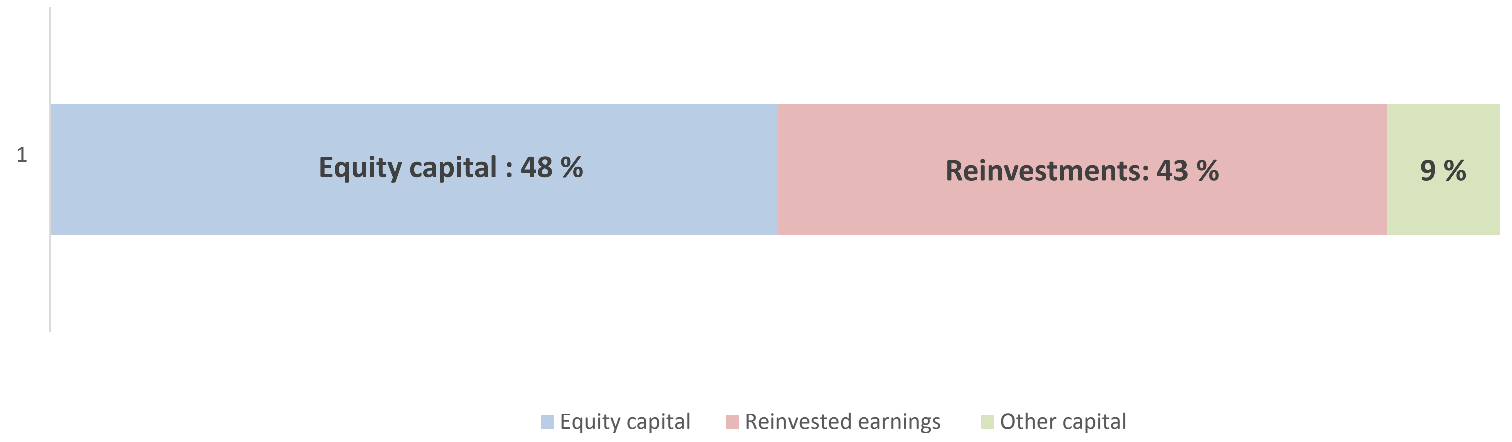
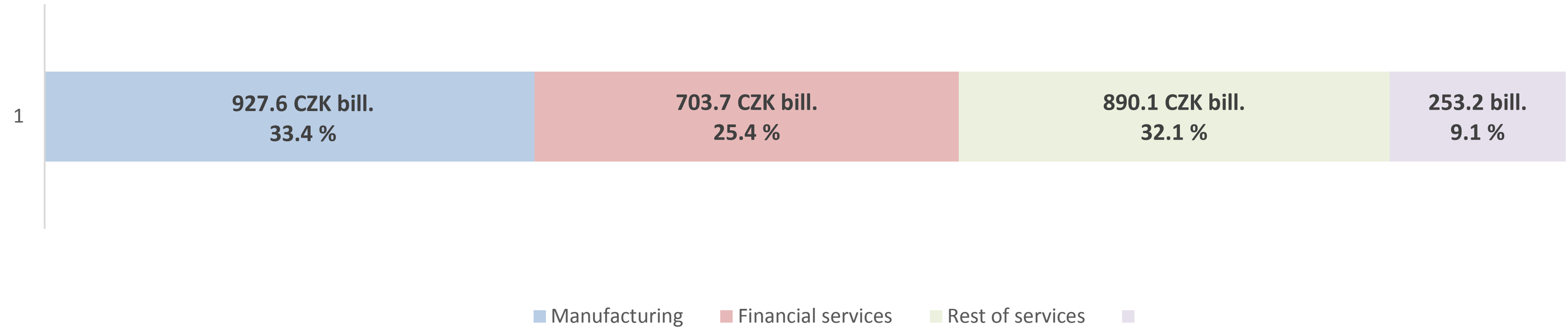
Structure of FDI inward stock



Source: Czech National Bank

- Equity capital – 48 %
- Reinvested earnings - 43 %
- Other capital – net loans granted from mother to daughter -9 %

Structure of FDI inward stock



Source: Czech National Bank

1. Manufacturing – automotive industry, electrical and optical appliances, oil and refinery products - 33.4 %
2. Financial services – 25.4 %
3. The rest of services 32.1 %– Trade services, services in real estate, informatics
4. Rest of economic activities 9.1 % - electricity, gas, water supply, construction, agriculture,

Geographical structure dominated by the Netherlands (28 %), Austria (14.%) and Germany (12%)

Mixed motivations of investors

- 1) **horizontal** (*market seeking*) investments Main goal: penetration into the domestic market – services are typical examples
- 2) **vertical** (*efficiency seeking*)

  Main goal : cutting costs (cheap and qualified labour force)

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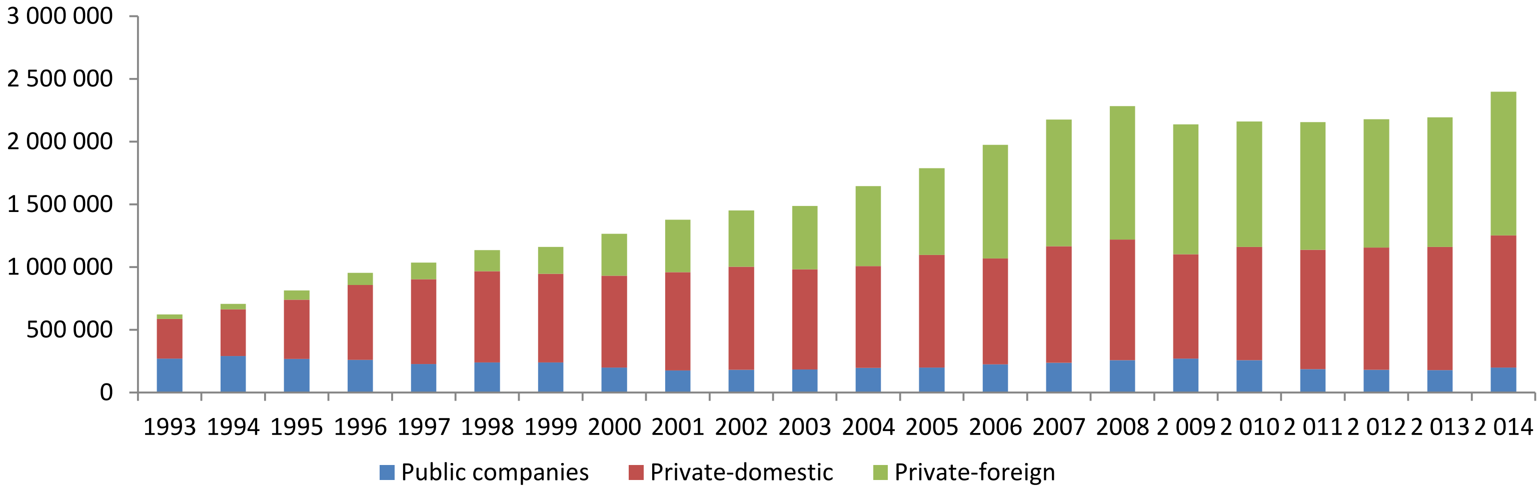
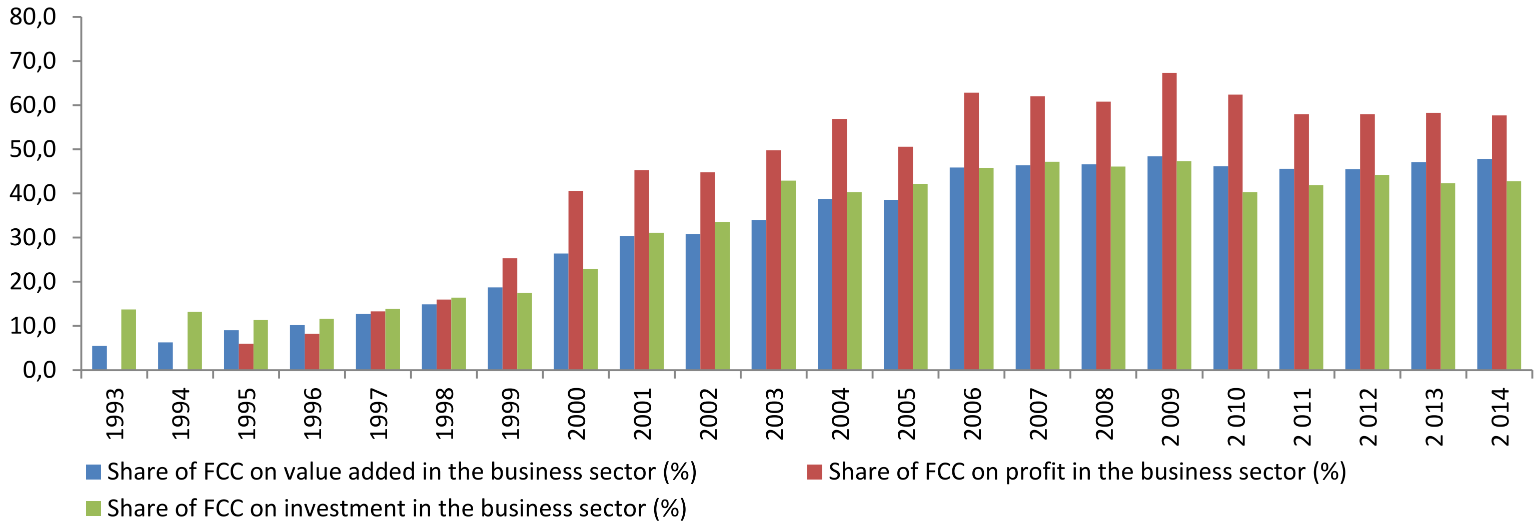
Structure of value added – non-financial companies



Source: Czech Statistical Office

- Strong inflow of FDI resulted in high penetration of companies under foreign control
- As of 2007 , companies under foreign control (FFC) have been creating almost half of valued added in the Czech business sector , eg. in 2014:
  - Automotive industry (96 %)
  - Computers, electronics, optical appliances (93 %)
  - Electrical appliances (78 %)
  - Rubber and plastics (70 %)

Foreign controlled companies in the business sector

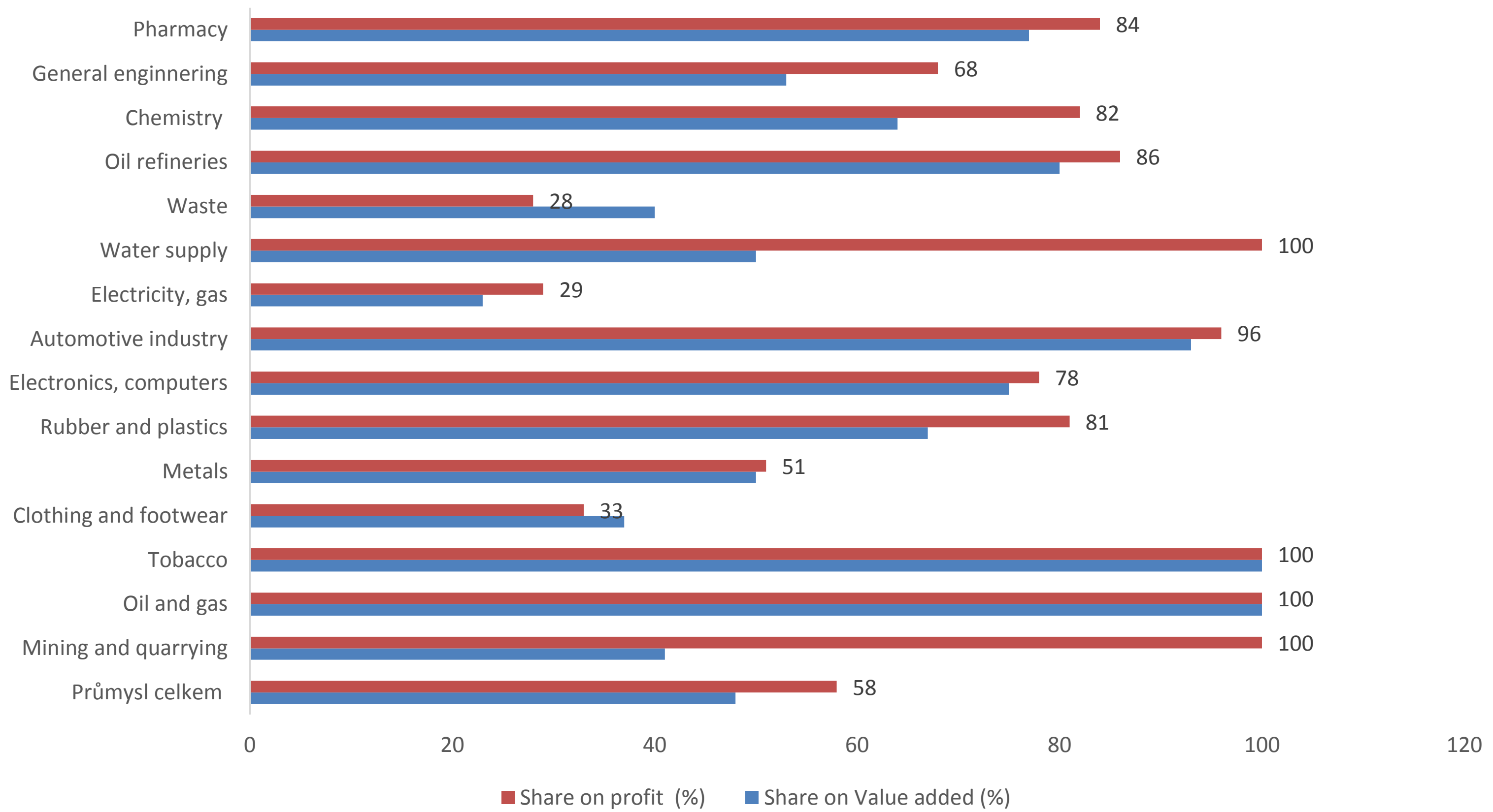


Source: Czech Statistical Office

FCC in the business sector account for approximately:

- One half of value added in the business sector (non-financial companies)
- 60 % of profit in the business sector (non-financial companies)
- 75 % of direct export sales
- Almost half of investments in the business sector (non-financial companies): 46 % (2007) → 40 % (2013)

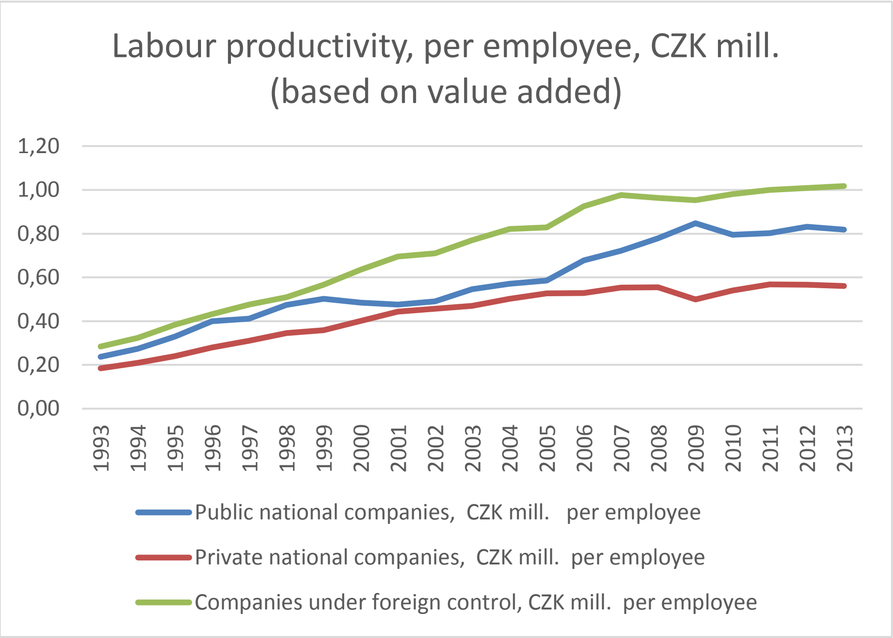
Individual industries – shares of FCCs, 2014

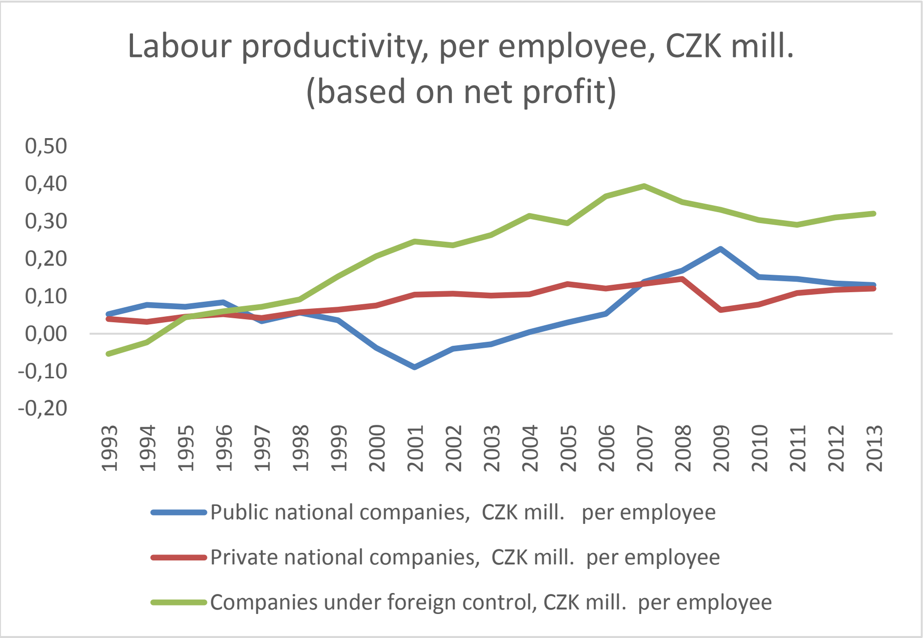


Source: Czech Statistical Office

- Tobacco , Oil and gas , Mining and quarrying, water supply - FFCs create 100 % of profit
- Automotive industry (96 %)
- Electrical appliances, electronics, computers (78 %)
- Rubber and plastics (81 %), Chemistry (82 %), Pharmacy (84 %)

Labour productivity

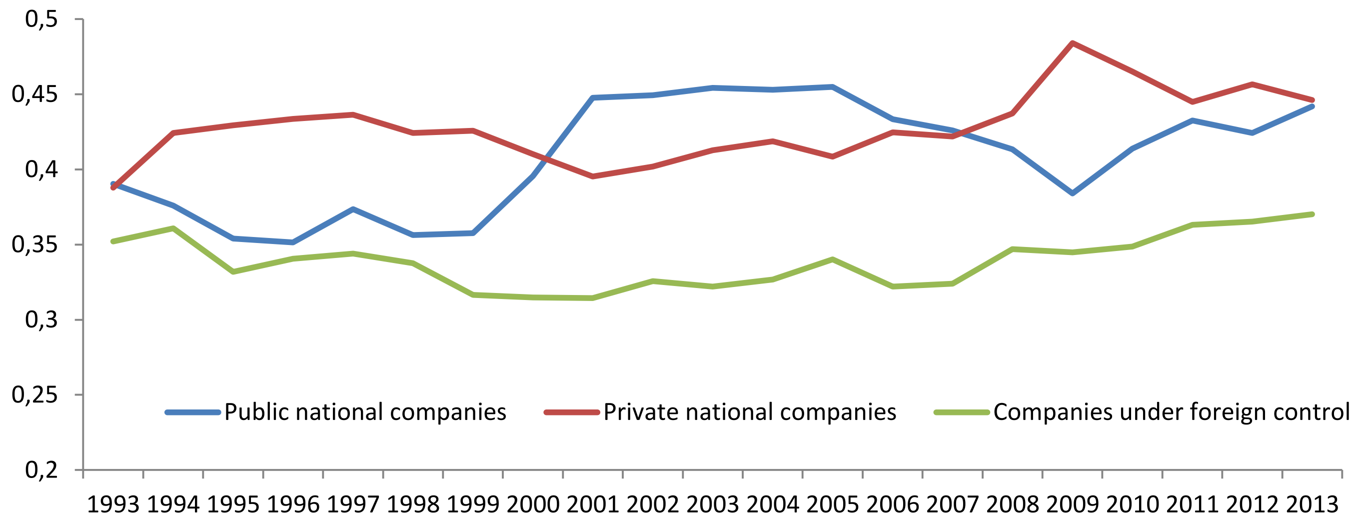




Source: Czech Statistical Office

- Differences in productivity between domestic and foreign private companies have not diminished
- Positive spillovers from FCCs not high enough to prevent persistence of „dual“ economy
- Theory suggests this as an obstacle to further convergence at macro level
- Risks of economy falling into the medium income trap

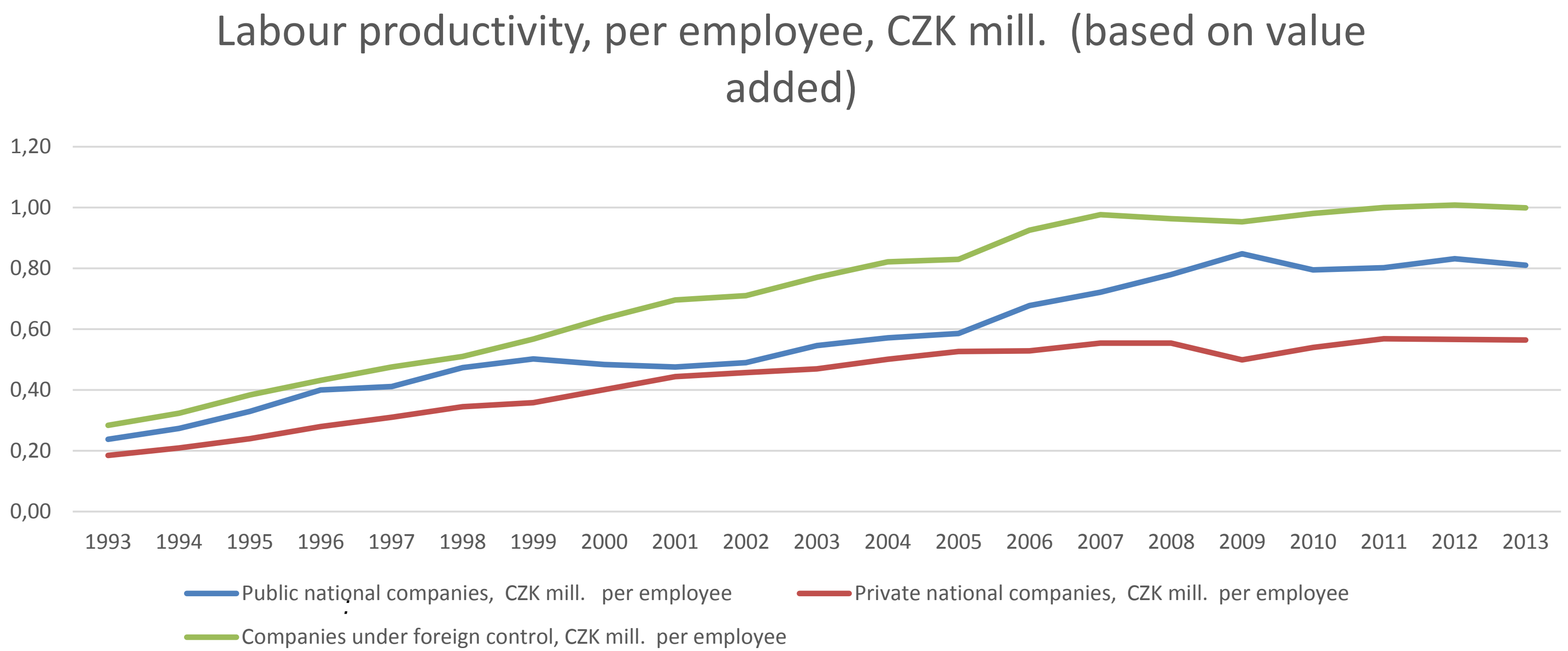
Unit labour costs



Source: Czech Statistical Office

- Lower unit labour costs correspond with higher productivity
  - Lower average wages to high income countries – the role of low labor costs for FDI inflow confirmed in all relevant studies (eg. Král, 2004, Hunya, Geishecker, 2005)
  - Low income trap confirmed

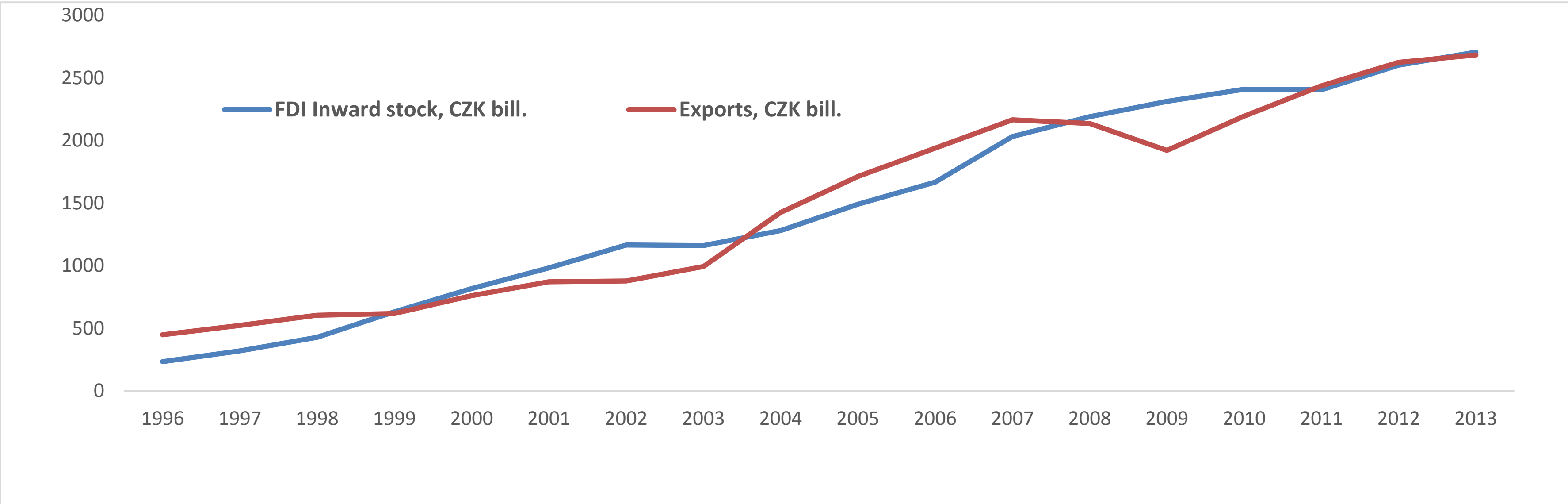
Dual economy has been persisting



Source:CZSO

- The differences in productivity have been persisting
  - measured either by output per worker or value added per worker
- The theory says that persisting duality prevents the positive FDI spillovers to domestic comapnies(Jindra et al, 2009, Narula a Driffield, 2012)
- The studies focused on CR confirm cheap labour force as a very important factor attracting FDI – Král (2004), Hunya a Geishecker (2005)

FDIs benefits

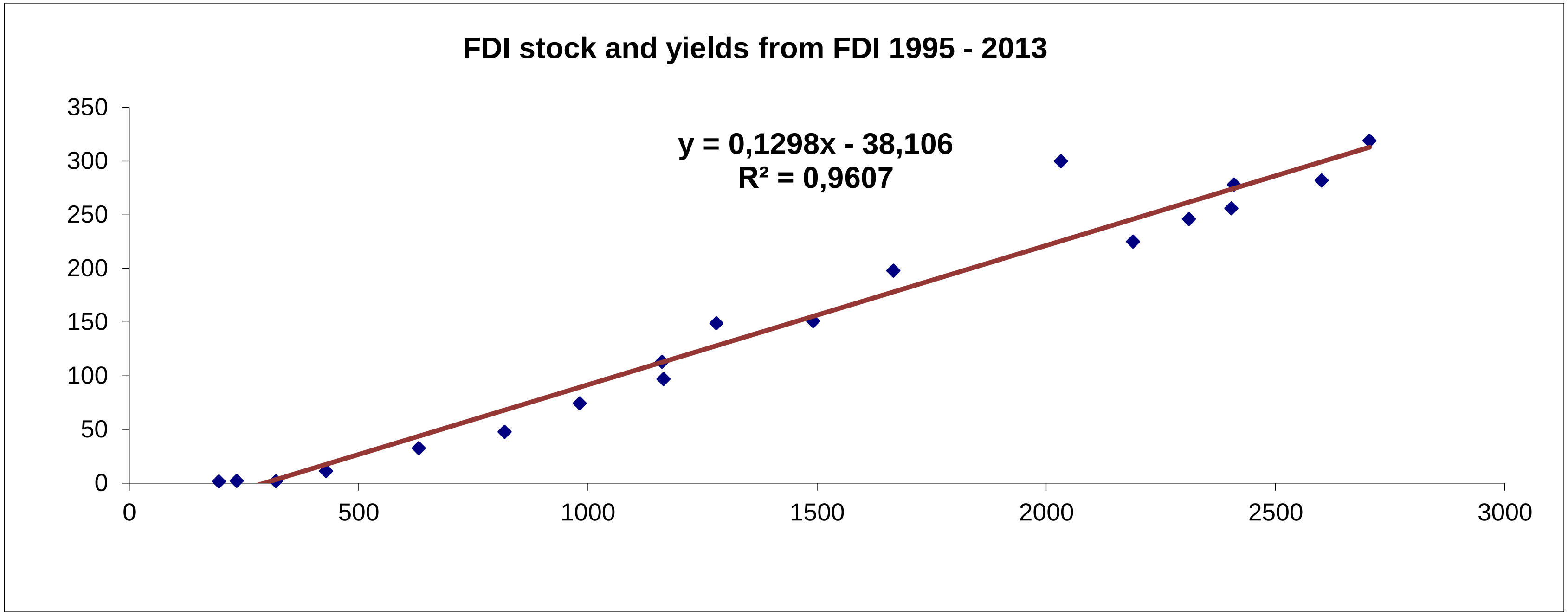


Source: CNB, Czech Statistical Office

FDI have filled the gap between savings and investment in CR and contributed to the economic growth in many ways:

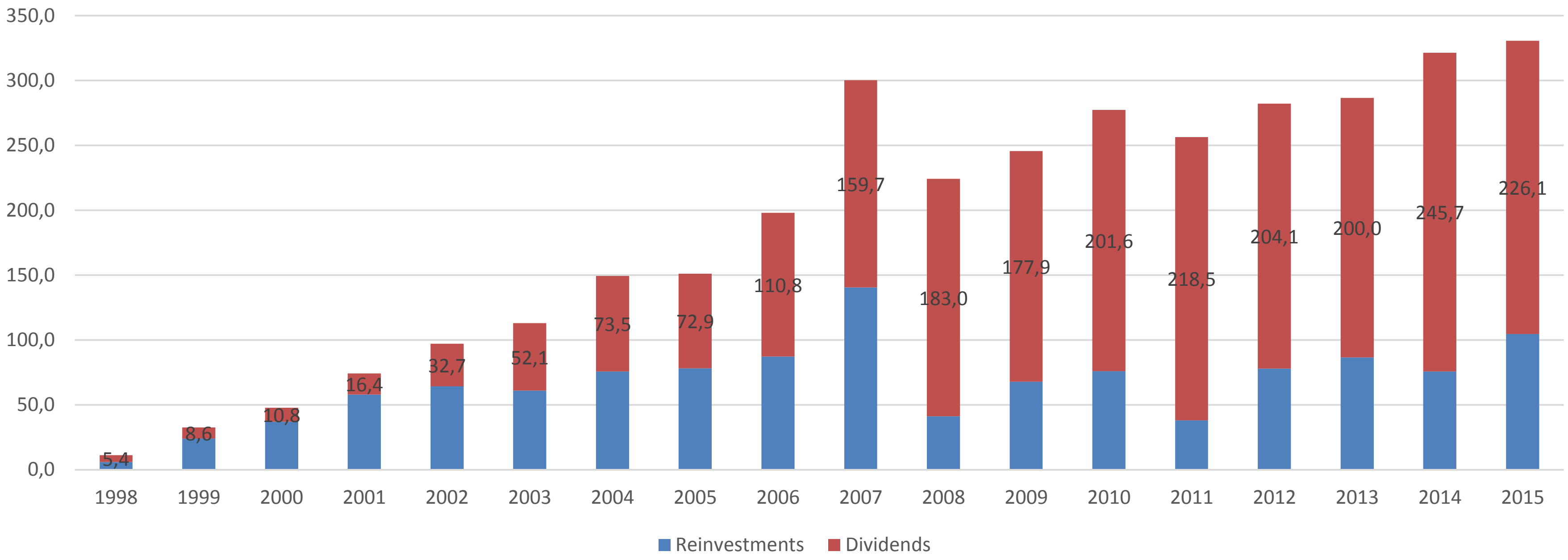
- increasing the export competitiveness, access to world markets
- non-debt financing of investments
- transfer of technology
- managerial skills
- promoting economic growth without pressures on external balance

Stable profitability of FDI



- High correlation between stock and profits from FDI
- ß corresponds to international surveys (UNCTAD 2012)
- ROE of 13 % is among World Top Twenty

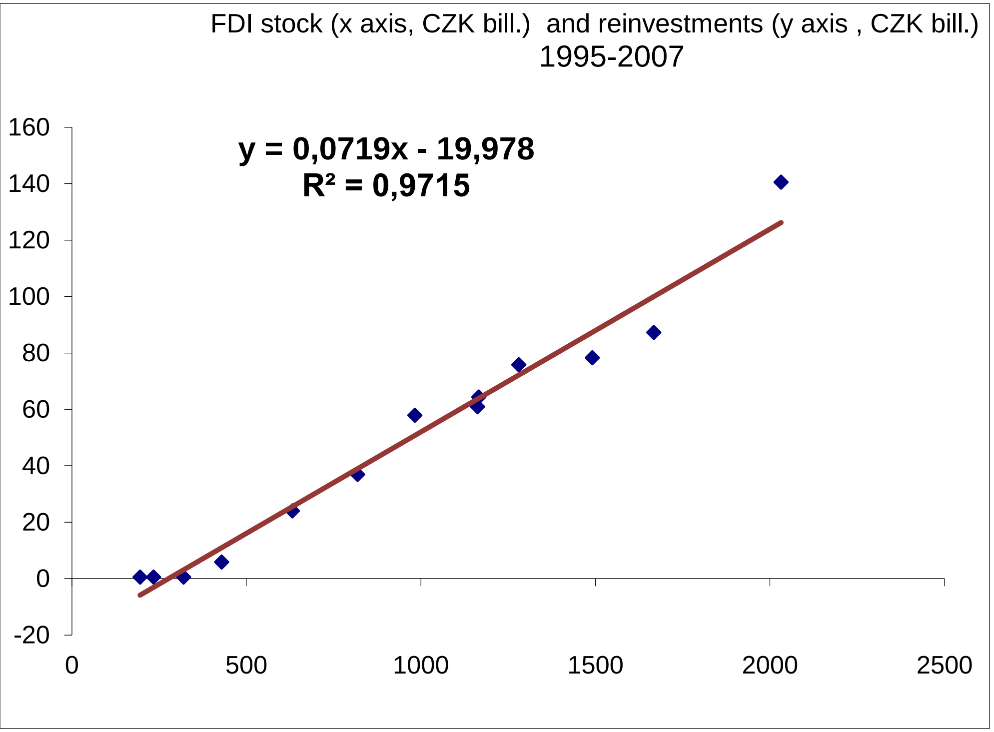
FDI: reinvestments and dividends



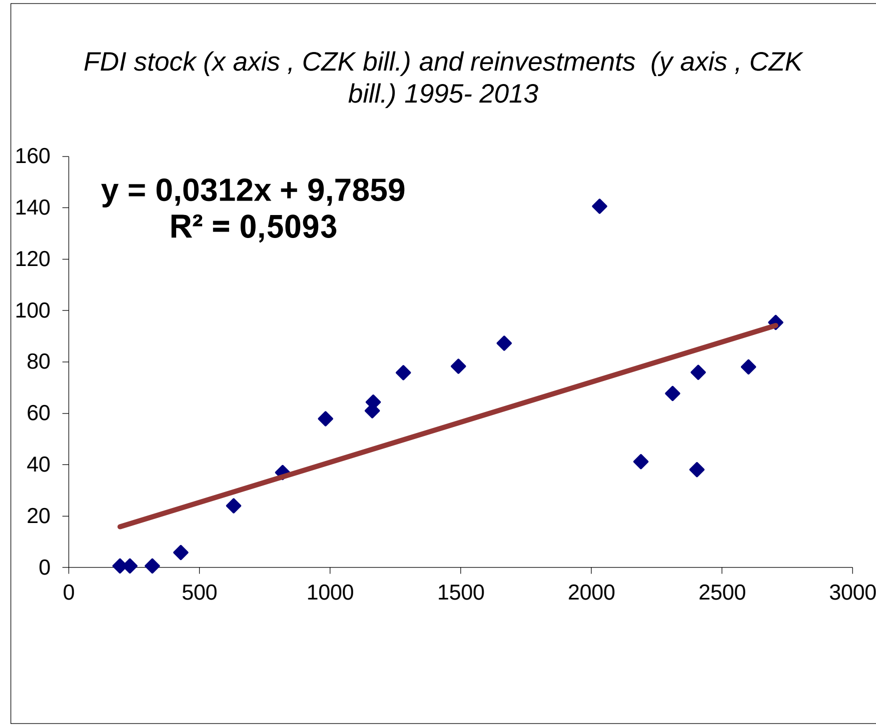
Source : CNB (ARAD, 2016),

- Sharp change of foreign investors behaviour as of 2008
- The FDI life cycle theory cannot give full explanation
- UNCTAD (2006, 2013) suggests long-term ratio between dividends and reinvestments around 55/45 (in case of investors from developed countries)

The crisis has interrupted reinvestments of profits



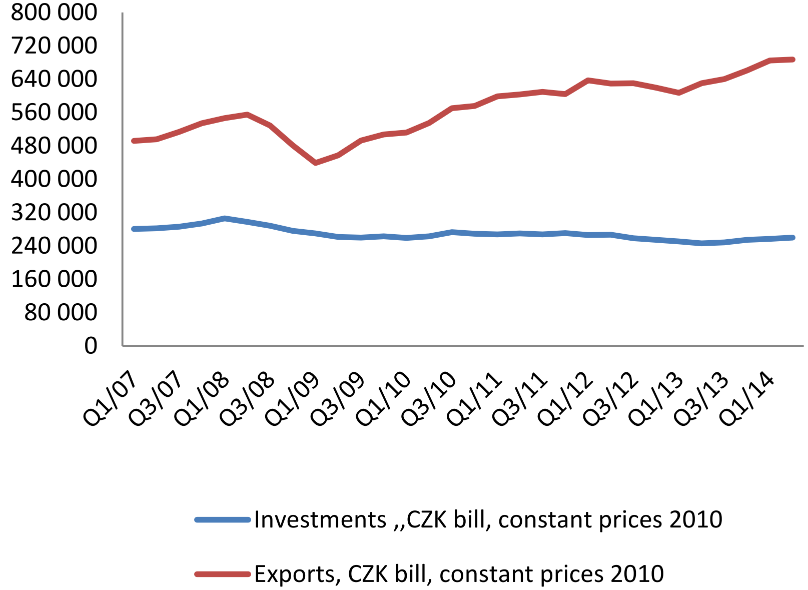
Source: CNB, own calculations

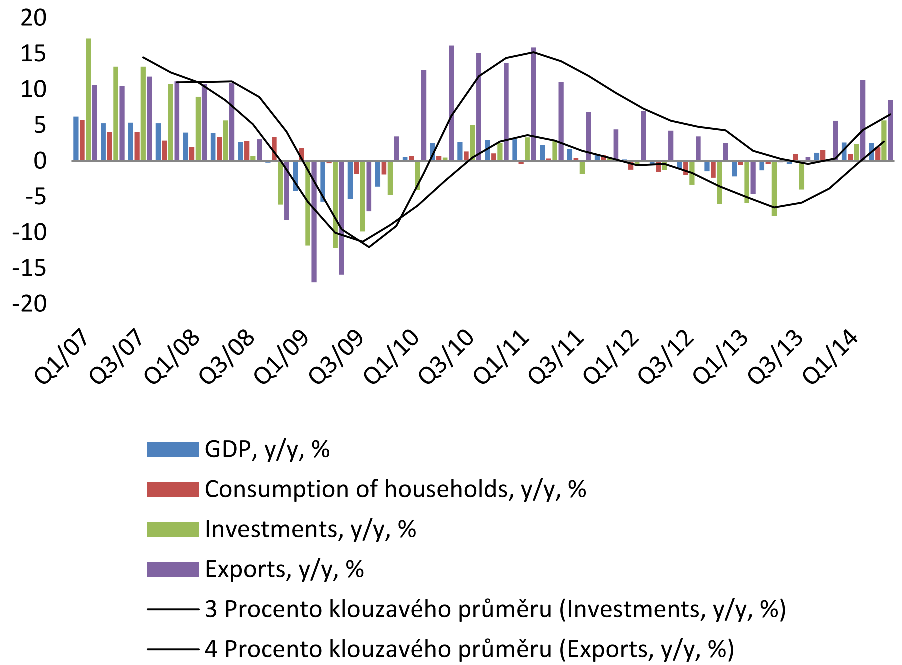


Source: CNB, own calculations

- Profits = reinvestments+dividends
- Strong correlation between FDI stock and reinvestments of profits up to 2007, later on becomes very weak

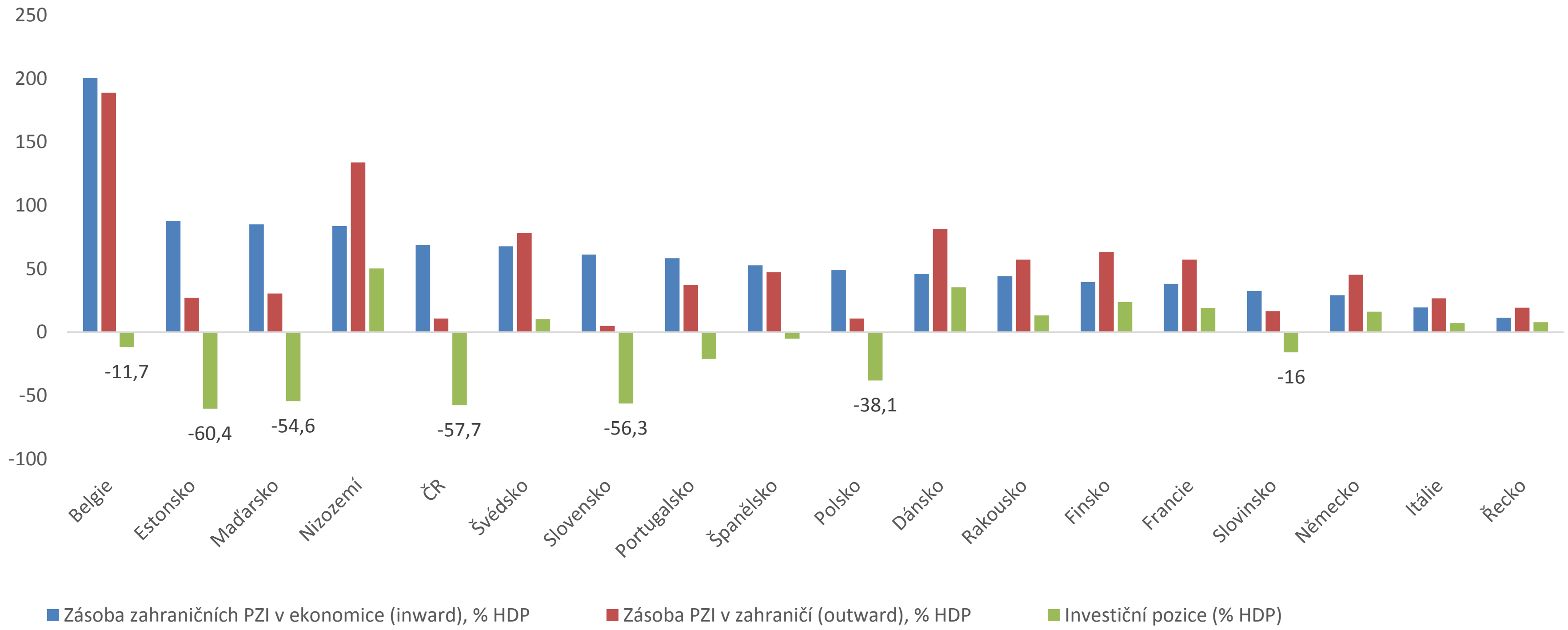
GDP and its factors





- Czech economy was strongly hit by the fall of foreign demand during the crisis
- Exports have recovered soon, which was not the case for investments
- Weak investments were an important factor od prolonged recession (Q2 2012 – Q3 2013)
- The change in behaviour has resulted in a loss of output in the Czech economy (roughly estimated at 1 – 1.5 % of GDP , 2008 – 2013)

FDI : Stock and investment position



Source : OECD

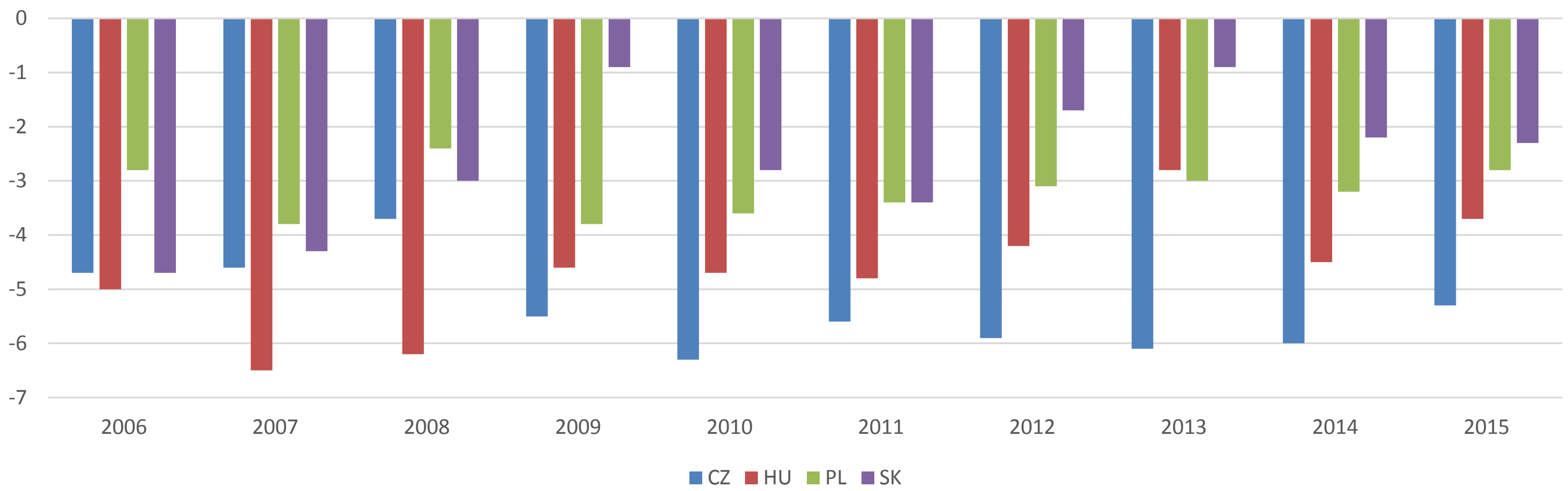
- Not only is the inward stock of the Czech Republic one of the highest within the framework of the OECD…
- …but also the negative investment position has been one of the deepest

Balance of primary incomes

CZK bill.	Net	Income	Expenditure	Expenditure connected to FDI			
	Primary income			**Expenditure (FDI)**	Dividends (FDI)	Reinvestments	Interest
1998	-35,1	55,0	90,1	**11,2**	5,4	5,8	0,0
1999	-46,7	64,3	111,0	**36,2**	8,6	23,9	3,7
2000	-53,0	75,4	128,4	**53,2**	10,8	36,9	5,6
2001	-83,5	84,9	168,4	**81,1**	16,4	57,8	6,9
2002	-115,6	66,8	182,4	**103,3**	32,7	64,3	6,3
2003	-119,9	75,5	195,4	**118,3**	52,1	60,9	5,3
2004	-156,6	87,2	243,8	**156,6**	73,5	75,8	7,3
2005	-128,3	106,5	234,8	**159,9**	72,9	78,2	8,8
2006	-164,6	129,2	293,8	**206,1**	110,8	87,2	8,1
2007	-254,7	153,0	407,7	**309,5**	159,7	140,5	9,3
2008	-147,7	187,2	334,9	**241,7**	183,0	41,2	17,5
2009	-216,7	123,8	340,4	**261,9**	177,9	67,7	16,3
2010	-249,9	116,1	366,0	**296,7**	201,6	75,9	19,2
2011	-223,3	125,8	349,2	**274,3**	218,5	38,0	17,8
2012	-237,5	152,8	390,3	**300,0**	204,1	78,0	17,8
2013	-249,0	134,8	383,8	**305,9**	200,0	86,5	19,3
2014	-260,8	152,8	413,5	**337,7**	245,7	75,7	16,3
2015	-243,5	179,6	423,1	**346,3**	226,1	104,5	15,7

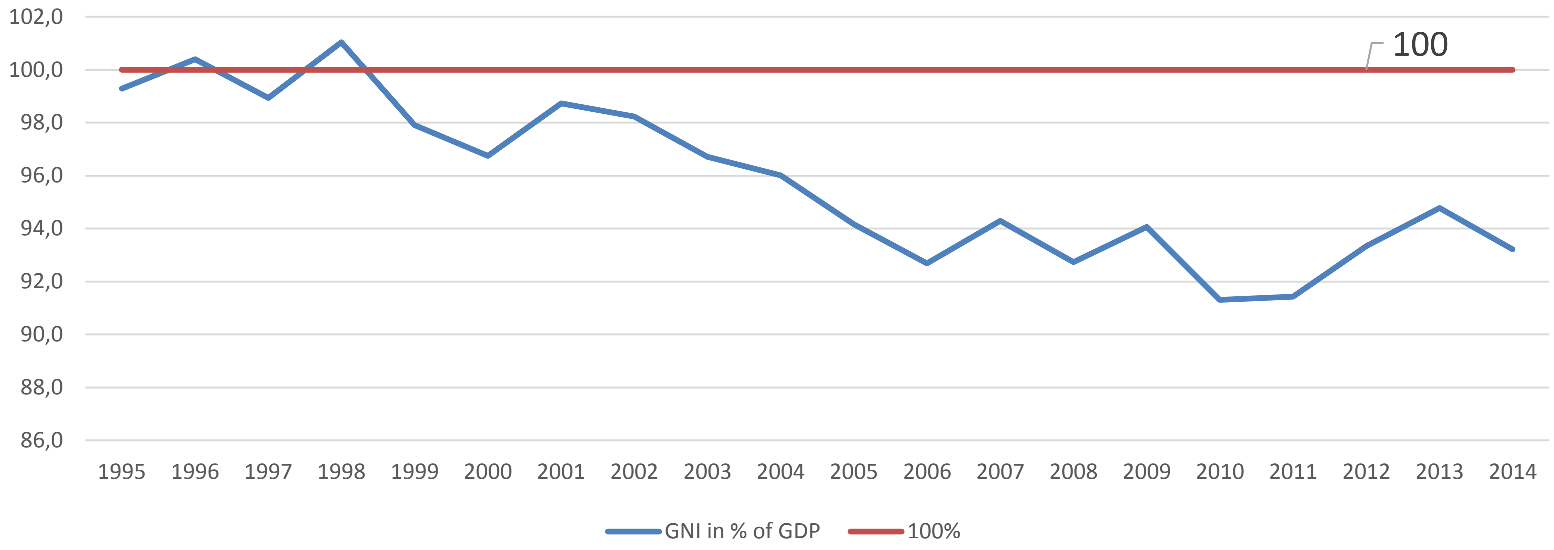
Source : CNB (ARAD, 2016),

Balance of primary incomes



- Balance of primary incomes is a part of the current account
- Cumulative deficit of primary incomes 2006 – 2015
  - 54 % of GDP in the Czech Republic
  - 47 % of GDP in Hungary
  - 32 % of GDP in Poland
  - 26 % of GDP in Slovakia

Gross national income (in % of GDP)



Source: Czech Statistical Office

- Gross national income= gross domestic product + balance of primary incomes (approximately balance of incomes as a part of current account)
- Gross national income reflects the part of GDP disposable in the respektive national economy)
- The difference between GNI and GDP (GNI – GDP) represents the part of value added which is produced in the respective economy but belongs to foreign subjects

Conclusions and policy recommendations

- Strong inflow of FDI has resulted into high penetration of foreign controlled companies into domestic Czech economy
- The pre-crisis success story of the Czech economy was largely driven by foreign controlled companies
- However, high share of companies under foreign control led to new form of dependency
- Solid export performance is not enough for growth of investments and wages – uncertain future ahead
- Conditions and business strategies of mothers will strongly affect domestic companies - sometimes „daughters feeding their mothers“
- Very selective support of FDI inflow needs the strategy first - while the reality was rather the opposite in the past
- Czech policy of FDI incentives just blindly followed neighbouring countries and the CR became winner in the „leap to the unknown“
- Strategy for FDI inflow is an important part of economic policy – contrary to monetary or fiscal policy, theoretical background of short-term versus long-term consequences has been missing as well as the analysis of real impact of FDI incentives in the past

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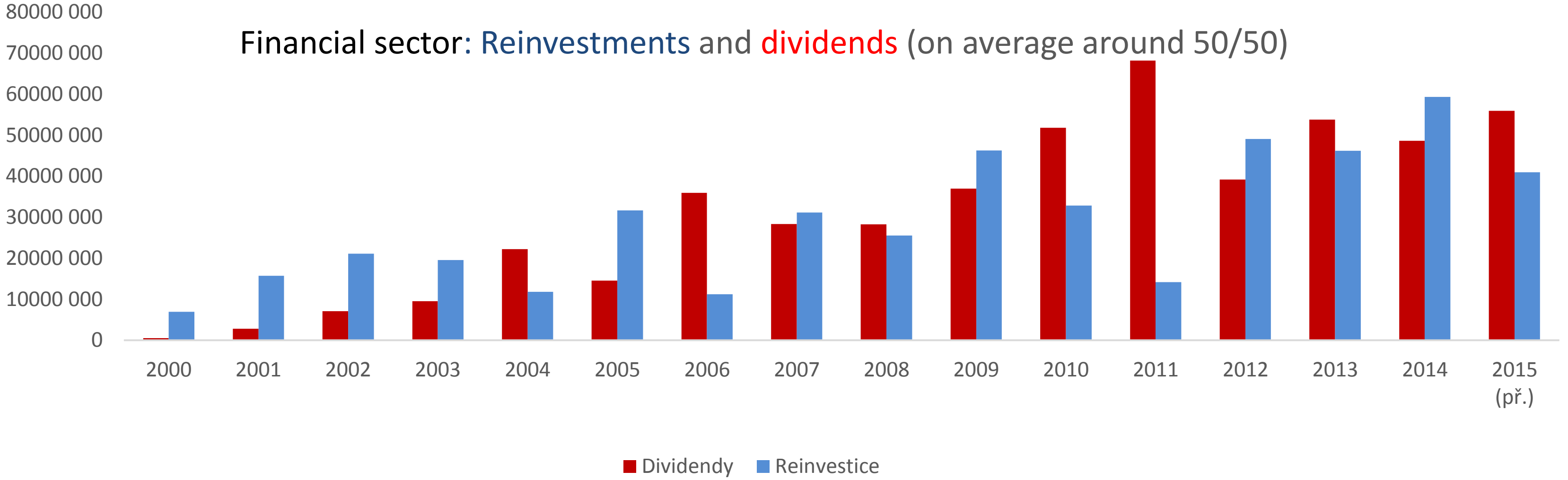
Conclusions and policy recommendations

Strategy first and

- Support of linkages between domestic companies and companies under foreign control to promote positive spill-overs from FCC to domestic ones
- Stable entrepreneurship environment may support the decisions to reinvest the profits in the CR
- Support of domestic SMEs to diversify the sector structure to make the whole economy more resilient against external shocks
- Similar corporate governance in public and private sectors even though the goals may differ
- Strengthening role of domestic SMEs achieving a better balance between big foreign companies under foreign control – long-term stable and transparent environment highly needed

New proposal of Social Democratic Party before the elections – taxation of banks



Source : CNB (ARAD, 2016),

The experience from bank tax :

ECB:

Imposing any ad hoc taxes on banks for general budgetary purposes should be preceded by a thorough analysis of potential negative consequences for the banking sector to ensure that such taxes do not pose risks to financial stability and the provision of credit, which could eventually adversely affect growth in the real economy."

EBRD:
„The levies … have done nothing to curb the risk of relatively risky banks, which presumably pose the greatest threat to financial stability."

IMF 2016 Article IV statement:
„ (IMF) directors welcomed steps to improve financial intermediation, **including by reducing the tax burden on banks**."

Oxford university:
„Analysing a panel dataset with balance sheet information of almost 3000 EU banks, we found that on average bank levies moderately raise lending rates and net interest margins but do not significantly impact deposit rates suggesting a pass-through to borrowers."

Suggested literature

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Suggested literature

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Thank you for attention

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