

## IV. Reinvested profits of foreign companies in the Czech Republic fell in 2003 for the first time

The growth of non-repatriated profits of foreign-controlled enterprises operating in the Czech Republic stopped in 2003 for the first time since 1999. This is not the only bit of bad news about foreign direct investments in 2003: if we leave aside the value of these reinvested profits produced by the operation of foreign companies in the Czech economy, a mere CZK 5 bn came in the Czech Republic from abroad – just by this amount rose the equity capital of companies with foreign capital participation<sup>1</sup>. The total inflow of foreign direct investments was thus the lowest since 1997. Its volume actually corresponded only to the volume of reinvested profits<sup>2</sup>.

### Very low capital inputs in total

Profits not repatriated by foreign-controlled companies decreased to CZK 62.2 bn in 2003 from CZK 64.3 bn in 2002. It was the first y-o-y drop at all. Yet their volume was of a key importance and had the decisive proportion in the total amount of direct investments in the Czech economy, whose part these reinvested profits are. A look at the volume of capital inputs alone in 2003 is rather dismal: the Czech economy recorded net capital inputs amounting to a mere CZK 4.6 bn in 2003, which was roughly EUR 155 million according to the average exchange rate. Net<sup>3</sup> money inflow from abroad in equity capital of companies in the Czech Republic stood at CZK 206 bn (EUR 6.5 bn) in 2002. The world records held by the Czech Republic in volumes of direct investments per capita in previous years are gone.

Direct investments and reinvested profits 1999-2003

	1999	2000	2001	2002	2003
Direct investments	218.8	192.4	214.6	277.7	72.9
Reinvested profits	23.9	36.9	57.8	64.3	62.2

### Causes of falling investments

The marked decline in inflow of total direct investments, and of inputs in equity capital in particular, accompanied by weakening reinvested profits, cannot be unambiguously explained only by progress in the stages of the three-layer investment cycle according to a financial theory – it says that a country gains capital for an investment alone at the first stage, the investment generates profits reinvested in expanding manufacturing capacity at the second stage, and dividends are paid, which outbalance reinvested profits, at the third stage.

The Czech Republic seems to find itself between the second and the third stages of this cycle – after a revision done by the Czech National Bank, dividends paid showed to be higher than preceding figures suggested: the revision corrected CZK 33 bn to CZK 43 bn in 2003 and CZK 17 bn to CZK 33 bn in 2002. On top of the progress within the cycle, also the consequences of economic stagnation in Western Europe and ensuing lower ability of businessmen operating there to invest in other countries could result in that. However, also beginning economic recovery in the EU, where investment activity is gaining ground and investors prefer their own countries, might be the reason.

Taking account of all the above aspects, a closer look at the statistics of the Czech balance of payments reveals that the fall in direct investments in 2003 is significantly linked with one-off transactions, which particularly affected the weak inflow of investments.

### Major withdrawals from the Czech Republic

The trend in reinvested profits in 2003 was strongly influenced by two transactions in the area of transport and telecommunications. The first one applied to the purchase of the remaining 49% share of Eurotel by Český Telecom from American investor Atlantic West, which made Eurotel a 100% subsidiary of Český Telecom<sup>4</sup>, the second transaction involved the selling of 27% of fixed assets of Český Telecom owned by Dutch and Swiss consortium TelSource (KPN Telecom + Swisscom) to predominantly financial investors from the Czech Republic and other countries (when the TelSource's plan was made public, the share was worth USD 987 million on the market). The result of these property transfers was the outflow of capital amounting to CZK 47.2 bn (hence a decrease in the proportion of foreign investors in the area of transport and telecommunications) and an outflow of reinvested profits (-CZK 11.6 bn).

<sup>1</sup> The sum of total equity capital of companies with foreign capital participation (with investor's participation exceeding 10%), the volume of reinvested profits and other capital amounts to the value of the inflow of foreign direct investments; other capital are credits granted by parent companies to subsidiaries operating in the Czech Republic.

<sup>2</sup> The Czech National Bank estimates reinvested profits in current year and, according to a decision of share-holders about the distribution of profits, carries out a revision of the estimate in following year; according to a definition of the Czech National Bank (derived from definitions of Eurostat and the IMF), reinvested profit is the direct investor's proportion (related to direct capital participation) in profit (loss) reduced by dividends paid and is measured as follows: reinvested profit = profit in current year after taxation + not assigned profit of preceding years – loss of current year – non-paid loss of preceding years – dividends paid.

<sup>3</sup> The result of positive and negative capital inputs, i.e. increase in foreign investors' participations in equity capital of companies operating in the Czech Republic minus decrease in these participations.

<sup>4</sup> This transaction raised the chances of the state share in Český Telecom being purchased by a strategic investor in 2005, for the company is attractive because of its low debt and high profits anticipation in the future due to a high penetration of the mobile market (nine people in ten in the Czech Republic own a mobile phone).

Excluding the above-mentioned transactions in telecommunications, the total financial volume of reinvested profits in the Czech Republic would not have dropped to CZK 62.2 bn in 2003 but grown to CZK 74 bn, which would have been the highest annual value of profits so far not repatriated from the Czech Republic (their annual average in 1999-2002 was CZK 36.6 bn). Apart from transport and telecommunications, also manufacture of food products, manufacture of textiles and textile products (like in 2002), manufacture of chemicals and chemical products and, to a very low extent, two other CZ-NACE divisions (manufacture of other non-metallic mineral products and recycling) experienced an outflow of foreign capital from the CR (amounting to CZK 1.5 bn in total).

On the other hand, most money from foreign investors was channelled into equity capital in the areas of real estate activities and other business activities (CZK 13.8 bn) and trade (CZK 10 bn).

#### Structure of direct investments in the Czech Republic in 2002 and 2003

CZK bn

CZ-NACE		Equity capital		Reinvested profits		Other capital		Direct investments, total	
		2002	2003	2002	2003	2002	2003	2002	2003
01-99	Czech Republic, total	205.7	4.6	64.3	62.2	7.6	6.1	277.7	72.9
15-37	including: Manufacturing	15.1	19.0	25.0	37.4	-7.4	-2.0	32.8	54.4
50-52	Trade and repair	7.9	10.0	4.1	7.0	-6.5	0.5	5.5	17.5
60-64	Transport and telecommunications	131.1	-47.2	4.0	-11.6	8.8	-0.2	143.9	-59.0
65-67	Financial intermediation	26.1	4.9	21.1	21.9	1.3	-1.2	48.5	25.6
70-74	Real estate and other business activities	8.4	13.8	2.4	1.1	1.3	8.8	12.2	23.7

### Industry still in demand

The dominance of foreign-controlled companies in the Czech industry is constantly growing. They make up a fifth of the total number of industrial enterprises in the Czech Republic, but they produce nearly a half of sales in industry and their participation in direct export sales is even 70%. Compared with Czech industrial companies, their productivity is roughly twice as high. Such an engagement affects generated profits, in which foreign-controlled companies participate in a ratio corresponding to their proportion in equity capital.

Direct investments in manufacturing reached CZK 54.4 bn in 2003 (CZK 32.8 bn in 2002). Capital inputs alone were not considerably higher y-o-y (foreign investors' proportion in equity capital of companies in the Czech Republic rose from CZK 15.1 bn in 2002 to CZK 18.9 bn), but reinvested profits in this area grew markedly y-o-y – from CZK 25 bn in 2002 to 37.4 bn in 2003, which was around the annual average over last five years.

The highest volumes of profits produced were non-repatriated by foreign investors in car industry (CZK 8.8 bn), in manufacture of basic metals (CZK 5.8 bn), in manufacture of machinery and equipment (CZK 4.2 bn) and in manufacture of rubber (CZK 4 bn).

#### Structure of direct investments in manufacturing in 2002 and 2003

CZK bn

CZ-NACE		Equity capital		Reinvested profits		Other capital		Direct investments, total	
		2002	2003	2002	2003	2002	2003	2002	2003
15-37	Manufacturing	15.1	19.0	25.0	37.4	-7.4	-2.0	32.8	54.4
	Including:								
24	Manufacture of chemicals and chemical products	0	-1.0	1.4	2.0	2.2	0.2	4.2	1.1
25	Manufacture of rubber and plastic products	1.5	1.9	3.6	4.0	-0.6	0.1	4.5	6.0
27-28	Manufacture of basic metals & fabricated metal prod.	3.3	8.4	1.9	5.8	1.5	0.2	6.6	14.4
29	Manufacture of machinery and equipment	3.3	2.4	3.5	4.2	2.2	0.3	9.0	6.9
31	Man. of electrical machinery and apparatus n.e.c.	1.6	1.0	1.2	2.3	1.2	0.2	4.0	3.5
32	Man. of radio, television and communication equipment	0,6	4,1	-0,4	-0,5	1,4	-3,6	1,6	0,0
34	Man. of motor vehicles, trailers and semitrailers	3,4	1,0	6,8	8,8	-12,6	0,6	-2,4	10,4

### Optically higher proportion of reinvested profits

In 1999 to 2001, reinvested profits grew fast (from 23.9 bn to 57.8 bn in 2001), the growth rate slowed down in 2002 and a low deficit was recorded in 2003. Therefore, development over last three years can be labelled as stagnation.

The value of reinvested profits in CZK dropping for the first time in 2003, their proportion in the value of foreign direct investments (or proportion in the total financial account of the balance of payments) develops differently. Due to a slower inflow of foreign direct investments in the Czech economy, the proportion of reinvested profits in the value of these investments is growing considerably – reinvested profits made up 10.9% of the value of foreign direct investments in 1999 and 85.3% in 2003. This state has been affected by both reinvested profits (a slight y-o-y decrease in 2003) and inflow of direct investments (a sharp fall in 2003).

The marked rise in the proportion of reinvested profits in the inflow of foreign direct investments is reflected also in average values – being roughly at 20% in the period 1999-2002 on average per annum, this proportion was 85.3% in 2003, as aforementioned (for the whole period of five years, the proportion of reinvested profits in annual inflow of foreign direct investments was roughly a third).

Inflow of direct investments in individual years does not correspond with the trend of reinvested profits<sup>5</sup>.

### **Major sales were missing in 2003**

Inflow of direct investments grew by roughly a tenth every year on average in 1999-2002 (even though the bases of preceding years were relatively high), the average annual inflow in the period was CZK 225.9 bn. These record levels, elevating the Czech Republic to the top of the world with respect to received investments per capita, turned into a shock in 2003 when direct investments reached CZK 72.9 bn, which was a 74% fall y-o-y (nevertheless, 2002 was unique in a way, for the state sold its share in gas company Transgas and collected CZK 120 bn). However, although the fall in inflow of foreign investments in 2003 contrasts with the past not only in terms of a y-o-y comparison, but also with the trend of preceding four years, the five years' average is still very satisfactory – the Czech Republic received CZK 195 bn on average every year.

Reinvested profits grew by 41% y-o-y on average in 1999 to 2002. In spite of a slight decrease in the volume of reinvested profits in 2003 (-1.7% y-o-y), the average y-o-y growth in 1999-2003 amounted to nearly 30%. Hypothetically, if the one-off reductions of the above-mentioned transactions in equity capital of Český Telecom had been eliminated, their y-o-y growth would even have been higher than in the exceptional year of 2002.

Reinvested profits of foreign-controlled companies in the Czech economy related to the value of the financial account of the balance of payments recorded, compared with their proportion to direct investments, a different development; also in this respect the data of 2003 show a sharp growth of this proportion – the share of reinvested profits in the financial account of the balance of payments doubled y-o-y and reached 38% (reinvested profits accounted for approx. a fifth of the financial account in 1999, and for only 18.5% in 2002).

According to revised data of the Czech National Bank, the deficit of the current account of the balance of payments in 2003 (CZK 157.2 bn) was attributable to reinvested profits by 40%. As these profits in the same scope are on the opposite side of the balance of payments in the financial account, their impact on the balance is actually zero.

### **Reinvestments particularly from the EU**

Nearly three quarters of the total volume of reinvested profits in 2003 fell on European Union investors. Like external trade of the Czech Republic, also capital flows are closely linked to the EU. It is not surprising, therefore, due to a high inflow of direct investments from the EU Member States so far, that profits achieved correspond to the billions of EUR invested in the Czech economy: 65% of the total volume of profits reinvested in the Czech Republic in 2003 were collected by investors from the Euro-zone.

Reinvested profits of companies from Germany made up more than a third of the total volume of reinvested profits, from Austria 18.5%, from France 14%, and from the USA 10.9%. The outflow of money having a proportion of roughly 13% in the total volume of reinvested profits falls on foreign investors from the Netherlands, Norway, Denmark, and also from Russia and the Ukraine.

### **A higher inflow of investments is expected in 2004**

No major share in companies owned by the state was sold to foreign investors in 2003. According to government agency Czechinvest, Austrian Mayr-Meinhof Sage Paskov (woodworking industry, USD 30 million), Japanese Daikin Airconditioning (electronics, USD 27 million), Dutch Frantschach Pulp & Paper Czech (paper industry, USD 24 million), British Zlin Precision (car industry, USD 22 million) and German Fehrer Bohemia (car industry, USD 20 million) were among the biggest private investments in 2003. The state's share in Unipetrol should be sold to foreign investors in 2004. The Government also decided to speed up the privatisation of Český Telecom (the transaction should be settled, according to an optimistic scenario, in late 2004 or early 2005).

### **No loss of competitiveness**

From the global point of view, both world trade and direct investments grew at a higher rate in the last decade than world GDP; in the USA, for example, foreign-controlled companies produce more than a sixth of GDP in manufacturing. Technology transfers and the subsequent rise in productivity of domestic companies brought about by foreign direct investments lead governments to providing resources attracting foreign capital. According to a study of the International Monetary Fund, the effects of foreign direct investments in 1987 to 1996 contributed by more than 10% to the growth of productivity reached in the same period (for example, the US state Alabama paid USD 150 thousand per new vacancy to be opened to attract a new establishment of car manufacturer Mercedes). Incentives like this seem to be justified only in cases where direct investments generate important positive externalities or technological effects for domestic companies.

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<sup>5</sup> The correlation in 1999 to 2003 is low – the correlation coefficient of absolute values of the time series of annual direct investments inflow in 1999-2003 and absolute values of the time series of reinvested profits is as low as 0.13; 0.12 when changing values are measured; however, the coefficient increases significantly when cumulated state values are measured, amounting to 0.98 and 0.63 (y-o-y dynamics based on states), respectively.

The effects of foreign direct investments in the Czech economy are particularly connected with a positive impact on exports. Direct export sales of these companies in the year 2002 grew substantially y-o-y (+12.5%), while Czech companies reported a decrease of 0.5%; this discrepancy even rose in 2003 – direct export sales of foreign-controlled industrial companies grew by 13.8% and the Czech companies reported a drop of 4.6%.

Although imports of technology accompanying direct investments can aggravate the balance of trade for a certain time, we think that the strength of Czech exports, under economic stagnation in key countries of export destinations, is affected by foreign direct investments.

## **Conclusions**

The underlying cause of the massive increase in the proportion of reinvested profits in the total inflow of foreign capital in the Czech economy in 2003 was not a growth of these profits – on the contrary, they fell. It was fully at the expense of weak flows of foreign direct investments in the Czech Republic, which reached a mere 26% of the 2002 level. The total volumes of both foreign direct investments and reinvested profits were highly negatively influenced by two important transactions in the area of telecommunications, resulting in capital outflow from the country. We can say that the European economic stagnation does not affect the Czech economy by way of weak external demand for goods and services, but through weak flows of capital.