

# DIRECT AND INDIRECT EFFECTS OF FDI ON CURRENT ACCOUNT

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## Summary

*Economic policy makers and development strategists in the EU new member states (NMS) often consider FDI the pillar of the development, and indeed, NMS have been recipients of substantial net capital inflows. Three issues which are usually overlooked are: the unavoidable future outflows of GDP and structural current account deficits which are more and more shaped by the income account, the resulting vulnerability of the countries to financial shocks, and social effects of domestic versus foreign ownership.*

*The paper deals with the first issue, the relationship between FDI and current account balance. While growing deficit in the investment balance or growing gap between gross national product and gross domestic product which is an inevitable result of FDI, FDI can affect current account balance also indirectly by improving or deteriorating trade balance which is determined by the aims and structure of FDI. The indirect effects might outweigh direct negative effects of FDI, they might moderate them or they might contribute to the deterioration of current account balance.*

*In NMS, direct effects of FDI on the current account deficit have strengthened, while indirect effects have only moderated the impact of direct effects. Two major problems might be a consequence of NMS "addiction" with FDI - the outflow of capital speeded up by the opportunities to reallocate production to the countries with even cheaper labor, or sudden interruption of FDI inflows which could result in an exchange rate crisis or, in the NMS countries within Euro zone, in a considerable drop in the standard of living.*

**Key words:** current account, factors services, foreign direct investments

**JEL:** F32, F21

## 1. Introduction

Empirical literature finds mixed evidence on the existence of positive spill-over effects of FDI for a host country.<sup>1</sup> Yet, according to the mainstream economics positive direct and spill-over effects of FDI are taken as granted. Most studies on FDI have been concerned with how to attract FDI and not with the consequences of FDI. The benefits of FDI are considered to be confirmed by actual development which “ignores inconclusive academic literature” (Lipsey, 2006, 1), positive externalities have remained to be publicized by international financial organizations, and FDI has stayed the pillar of the development strategies of EU new member countries (NMS). Indeed, to attract FDI, NMS have been willing to use various forms of subsidies: tax vacations, adaptations of the legal system, or even direct financial assistance to multinationals<sup>2</sup> by which they have replaced contemptible sales of the assets in the period of speedy, often ideologically and politically inspired, privatizations during which the “family silver” in most NMS was sold. In a decade, foreign ownership of productive assets has become major and in some sectors (financial services, telecommunications, retail trade) predominant or even exclusive type of ownership in NMS.

Five channels through which positive spill-over effects of FDI should benefit the host country (OECD 2003) are the following:

- FDI brings new technology and know-how;
- FDI contributes to the development of companies and their restructuring;
- FDI enhances international trade and integration into the world economy;
- FDI increases competition;
- FDI contributes to the creation of human capital.

In reality, spill-over effects of FDI on economic growth and welfare can differ considerably from the above statements. They can be positive or negative, both in the short and in the long run. In the case of NMS, the dominance of negative over positive spill-over effects can be explained by the specificities of FDI in the period following transition<sup>3</sup>.

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<sup>1</sup> See Blomstrom and Kokko (1998), Carkovic and Levine (2006), Gorg and Greenway (2004), Lipsey (2002, 2006), Mencinger (2003);

<sup>2</sup> To convince Renault into production of new cars in its subsidiary Revoz, Slovenian government promised subsidies which were equal to five years of the payroll for all additionally employed workers. To attract Harrah's Entertainment to invest in Slovenia, the Slovenian government adapted tax legislation on gambling to the requests by the company.

<sup>3</sup> However; many similar reasons for large or even prevailing negative spill-over effects could be found in other countries, as well.

First. Many FDI in NMS were cheap cash sale of assets which was an important component of privatizations. They were therefore not investments in the macroeconomic sense of the word, and the proceeds from sales did not necessarily enhance productive assets of the countries. On the contrary, they were spent on consumption and imports. This explains why there is no positive relationship between the share of FDI and the share of gross fixed investments in GDP, and why even in the short run, there is a negative relationship between FDI and current account balance.

Second. A large portion of FDI in the NMS was concentrated in three highly profitable activities: financial services, retail trade, and telecommunications. This implies that FDI does not contribute much to the horizontal or vertical transfer of technology and know how of the host country, and also, that FDI might increase imports more than exports creating trade deficit rather than trade surplus.

Third. There is no doubt that an acquisition of a local company in NMS by a multinational corporation increases efficiency of the company and that foreign multinationals are generally more productive than domestic firms. However, the resulting specialization and purchases of raw materials within a multinational chain can nevertheless have negative impact on the national economy if the links between the acquired company and the rest of the local companies were cut or reduced. In this case, the benefits of the enhanced efficiency accrues to a multinational corporation only rather than to the host country. In addition, the use of transfer prices etc. enables avoiding or lowering taxes on profits.

Fourth. FDI can enhance competition but it is equally likely that FDI reduces competition. Indeed, a multinational can, particularly in a small country, establish a powerful monopoly which destroys and/or prevents creation of potential domestic competitors.

Finally. Multinationals often nominate foreign managers to head the acquired companies and they often transfer existing research activity of the companies abroad which hinders rather than spurs human capital creation in the host country.

In short. There are no reasons to regard FDI as “manna from heaven” which indispensably contributes to economic growth in the host country. Yet, even if FDI contributed to growth of gross domestic product (GDP) this does not automatically imply that FDI contributes to the growth of gross national product (GNP). This assertion brings us to the relationship between inward FDI and current account balance, thus to the long run effects of FDI on the divergence between GDP and GNP.

The aim of the paper is to address the linkages between FDI and current account in NMS. Section 2 deals with the characteristics of current account balance in NMS while section 3 examines the link between the structure of the current account and foreign direct investments. In section 4, a simple

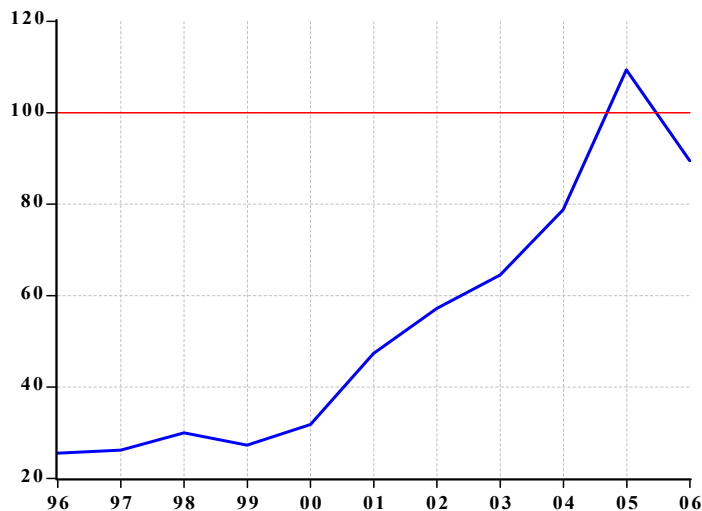
model explaining investment and trade account balances with foreign owned assets is estimated using panel data of eight NMS in the period 1996-2006. Some implications are presented in section 5.

## 2. “Structural” Current Account Deficits in NMS

Current account deficit<sup>4</sup> and corresponding escalation of indebtedness belong, beside unemployment, to a marked feature of post transitional macro economic developments of NMS (the analysis is restricted to eight former socialist countries which entered EU in 2004). Namely, while average GDP growth in the period following transformational depression stabilized at approximately 4 percent; it was accompanied by 12 percent unemployment rate and 6 percent current account deficit. One could therefore talk of “jobless” and “unsustainable” growth. “Joblessness” can be easily explained by fundamental changes in the labor market mechanism during transition (Mencinger, 2000). The term “sustainability” as used here, concerns the dependence of NMS on foreign savings, which is revealed by current account deficits and growing indebtedness.

Graph 1

### The Share of Income Account Deficit in the Current Account Deficit of NMS



While current account deficit has become a steady feature of NMS, the structure of the deficit has been changing. The share of trade deficit, until 2002 larger than the entire current account deficit, dropped to 58 percent in 2006. The shares of transfers and services (both surpluses) have been diminishing as well. The predominant role in shaping current account balance of NMS has been taken over by the

<sup>4</sup> Current account is composed of four accounts encompassing trade, services, incomes and transfers. The income account which is of interest here embraces compensations for labor services and compensations for capital services. The latter are further divided to: flows from direct investments, portfolio investments, and other investments.

income account deficit which began to grow dramatically after 1999; in 2005, the deficit on the income account surpassed the entire deficit by nearly 10 percent.

Average income account deficit (the gap between GDP and GNP) in NMS increased from 0.96 percent of GDP in 1995 to 4.38 percent of GDP in 2006. The variations among countries were substantial. Hungary, in which the outflow amounted to 6.50 percent of GDP in 2006, is followed by Estonia and Czech Republic with 4.67 and 5.69 per cent respectively. In a large Polish economy, outflows were small before 2004 and increased significantly afterwards. In Slovakia, an upward jump of deficit on the income account appeared in 2005. Lithuania had constant but relatively modest income account deficit, Latvia and Slovenia differ from the rest of NMS with some surpluses (due to remittances) and small though increasing income account deficits after 2002. In Ireland, added for comparison, the deficit on the income account in the period 1995-2006 surpassed 14 percent of GDP.

### **3. Current Account Deficit and Foreign Direct Investment**

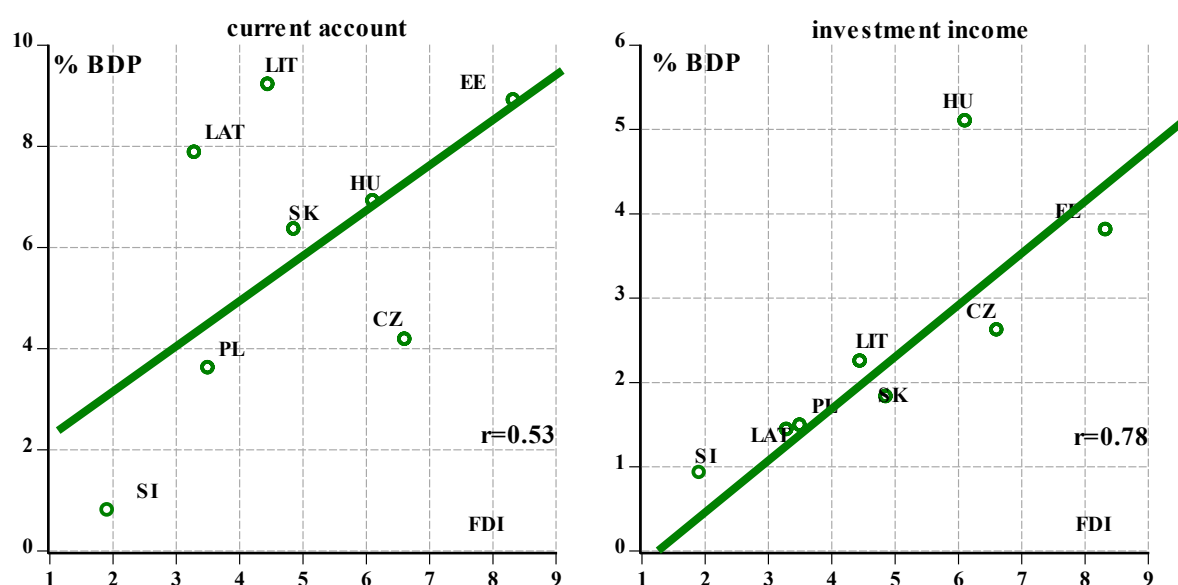
Systemic changes in NMS after 1990 have brought substantial net capital inflows mainly in the form of FDI enhanced by potential membership in the European Union. A natural consequence of these inflows have been also large current account deficits, as the burden of investment income and principal repayment increases over time. Average yearly FDI in NMS in the period 1996-2005 were approximately 20 billions € with the exemption in 2003 when they halved. In the same period, the outflow of profits from NMS was much smaller; indeed it started with 2.5 billions € in 1996 but increased rapidly to 20 billions € in 2005. Though the inflow of capital through FDI in the period 1996-2006 far exceeded the outflow of profits the situation has been changing rapidly. Namely, the accumulated liabilities created by FDI have not been stabilized by trade surpluses. On the contrary, and with exemption of Czech Republic in 2005 and 2006, trade deficits have been enhancing current account deficits in most NMS and they have been even growing in the Baltic countries.

A simple illustrative scatter plot of the long run (eleven years averages) relationship between FDI, current account and investment account in GDP (provided by Graph 2 with the deficits multiplied by (-1)) indicates very strong relationship between investment account and FDI transmitted also to the relationship between current account and FDI.

Graph 2

**FDI, Current Account and Investment account**

(eleven years averages, percentage of GDP)



Let us distinguish between formal or direct and total relationship between FDI and current account balance. Formally, with the identity  $CA + KA = dR$  ( $CA$  - current account,  $KA$  - capital account, and  $dR$  changes in official reserves) and assuming that other capital flows and changes in official reserves are 0, there are three alternative cases of the effects FDI has on the current account balance.

First, if FDI increases capital formation without crowding out domestically financed investment, it worsens the current account by the same amount. Second, if FDI crowds out domestically financed investment, the effects depend on the reduction of domestically financed investment; a part of FDI can be used to finance existing indebtedness of the country. Third, if FDI implies acquisition of the existing assets in the host country, FDI provides a source of financing of the existing current account deficit.

The structure of income account balances in NMS in the 1995-2006 period indicates that financial flows related to FDI were much bigger than flows related to portfolio investment or borrowing abroad, and also that net compensations for labor services (remittances) in the period 1995-2006 were relatively tiny, attaining more than 1 percent of GDP only in Latvia<sup>5</sup>. Indeed, income account balances

<sup>5</sup> The importance of the remittances of the income account will most likely enhance in the near future due to increased mobility of labor within EU.

of NMS have been shaped by FDI and FDI has been a major determinant of their current account deficits, as well.

Table 2  
**The Structure of the Income Accounts, 1996-2006**  
**(shares in GDP)**

	<b>CZ</b>	<b>EE</b>	<b>HU</b>	<b>LAT*</b>	<b>LIT*</b>	<b>PL</b>	<b>SK</b>	<b>SI</b>
<b>Total</b>	-3.24	-3.49	-4.95	-0.36	-2.24	-1.51	-1.35	-0.18
<b>Labor</b>	-0.62	0.31	0.15	1.08	0.70	-0.03	0.47	0.74
<b>Capital</b>	-2.62	-3.81	-5.10	-1.44	-3.14	-1.48	-1.83	-0.93
<b>- direct investments</b>	-3.71*	-4.56*	-3.44	-1.68	-2.72	-3.44*	-	-0.70*
<b>- portfolio investments</b>	-0.16*	0.19*	-1.11	0.04	-0.12	-0.29*	-	0.18
<b>- other investments</b>	0.54*	-0.44*	-0.57	-0.02	-0.29	-0.07*	-	-0.65*

\* shorter time span due to the lack of data

- data were not available

The overall short and long run effects of FDI on current account balance vary in time and may differ from country to country; they depend of the effects, FDI has on domestic savings and economic growth<sup>6</sup>. Indeed, though acquisitions of the existing assets were the predominant type of FDI in NMS, FDI was accompanied by deterioration rather than improvement in current account balance. A large share of the financial means obtained by selling the existing capital stock to foreigners was namely used to increase consumption and imports rather than capital formation. This explains why there is no positive relationship between the share of FDI and the share of gross fixed investments in GDP, why there is a strong contemporaneous negative relationship between FDI and current account balance, and, at least partly, why there is a negative relationship between FDI and growth (Mencinger, 2003).

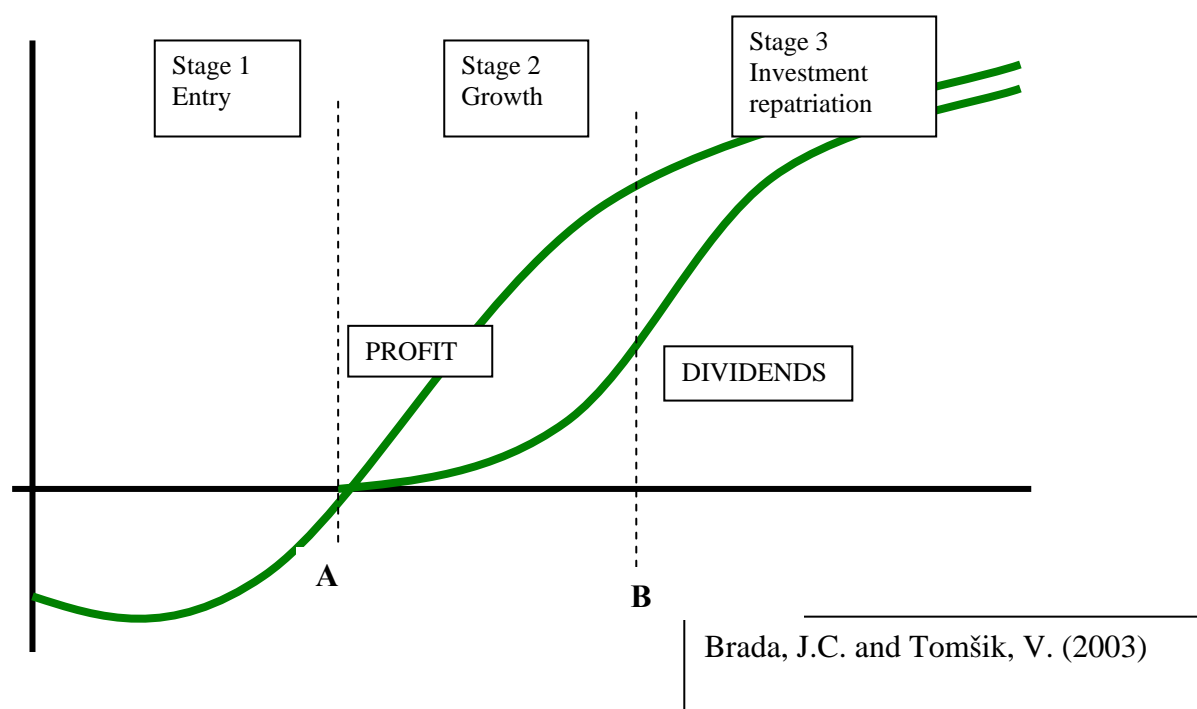
However, even if a positive causal relationship between FDI and economic growth existed, this does not assure that FDI would in the long run increase welfare in a host country. It is namely evident that a part of GDP produced in the host country would flow abroad in the form of profits and dividends. Without expected profits and dividends (straight or disguised, for example, in transfer prices) there would be no FDI. Empirical studies confirm that profits of multinationals in NMS exceed their profits in the home countries and they are less affected by macroeconomic conditions in their host countries. (Havrylchyck O., Jurzyk, E., 2006, Altzinger, 2005). Thus, if FDI did not increase capital formation in the host country and if positive spill-over effects of FDI on economic growth were modest or negative FDI has to deteriorate current account balance in the future.

<sup>6</sup> In South East Asia, FDI should increase investments in fixed assets which would increase growth and reduce current account deficit (Fry,1996). One should not overlook that the article preceded Asian financial crisis.

The assumed development of financial flows related to FDI is presented in Graph 2<sup>7</sup>. In the phase of “entry” i.e. to the left of point A, the costs of FDI outrun the revenues. At point A, foreign owned company begins to have profits; however, in the phase of “growth”, between points A and B, most of the profits are reinvested and only a small portion is repaid to the owners as dividends which enables growth of the company. To the right of point B, thus in the phase of the “repatriation of profits” the share of dividends begins to grow. Most of NMS are between points A and B, thus in the phase of “growth”, with high share of profits being reinvested. However, the opportunities of multinationals to invest in the countries with even cheaper labor within EU (Romania and Bulgaria) or elsewhere (China, India etc.) increases the share of dividends in the profits and diminishes the distance between A and B. The NMS therefore move quickly towards B and to the phase in which transfers of profits abroad might outweigh the inflows of FDI<sup>8</sup>. The opportunities to invest elsewhere also change the production structure of FDI in NMS in favor of services and real estates.

Graph 2.

### Financial Flows of FDI



<sup>7</sup> Taken over from Brada J.C and Tomšik, V. (2003)

<sup>8</sup> Ireland can be used as a case country to the right of B; yearly outflow of GDP in the form of profits in the period 1995-2006 amounted to 14.4 percent and in 2002 to even more than 18 percent of GDP; this was the gap between GDP and GNP<sup>8</sup>. The outflow of profits was nearly twice the inflow of FDI in the same period which amounted to 8.35 percent of GDP.



#### 4. A Simple FDI – Current Account Model

Let us observe the structure of current account as shares in GDP and let us break up the current account balance in year  $t$  ( $CA_t$ ) into three parts:  $CAG_t$ ,  $CASTL_t$  and  $CAI_t$ . The first part  $CAG_t$  is trade balance (CA100), the second part  $CASTL_t$  is composed of balance of services (CA200), net current transfers (CA379), and net compensations of employees (CA310) while the third part  $CAI_t$  (CA320) (investment incomes) is composed of profits on the stock of direct investments, (CA330), earnings on portfolio investments (CA339), and interests on the stock of other investments (CA370). By such partition of current account, direct and indirect effects of FDI on the current account balance can be distinguished; direct effects determine investment account balance while indirect effects influence current account balance by shaping trade balance.

The investment account balance in period  $t$  is determined by the returns on the assets (net foreign asset position) owned by foreigners in the host country, or by the returns on the assets owned by residents abroad ( $B_t$ ).  $B_t$  is a net FDI stock which in turn is the sum of FDI flows  $\sum FDI_{t-i} * (1-d)^i$ , with  $d$  being a depreciation rate, net stock of portfolio investments  $\sum FPI_{t-i}$ , and net debts  $\sum OI_{t-i}$ . In the observed period, majority of foreign owned assets in MNS were created by FDI, and with exception of Slovenia, outward FDI were negligible.

$$B_t = \sum FDI_{t-i} * (1-d)^i + \sum PI_{t-i} + \sum OI_{t-i} \quad (1)$$

The effects of foreign owned assets on the investment account balance are apparent; foreign ownership of the assets implies outflow of incomes from the host country in the form of profits on FDI stock, earnings on portfolio investment, and interests on other investments. The  $a_i$ s in equation (3) should therefore be negative, and their absolute values should differ. Furthermore, one can assume that profits and their outflows depend on current economic situation; the higher the growth, the higher the profits and their outflows.

While direct effects of foreign owned assets on the current account balance are straightforward; foreign ownership inevitably increases current account deficit or decreases current account surplus, indirect effects are ambiguous. FDI namely influences trade balance by affecting exports and imports<sup>9</sup> which in turn might affect FDI. Whether the effects of FDI on trade balance are positive or negative depends on the production structure of FDI, the strongest are supposed to be the links between FDI and manufacturing sub-account (Aizenman, J. and Noy, I, 2005). One would expect positive effects on the trade balance, if the major aim of FDI is to take advantage of cheaper labor in the host compared to

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<sup>9</sup> There are two way linkages between international trade and FDI; in present paper we are concerned only with one of these links: the effects of FDI on trade balance only.

home country, and negative, if the major aim of FDI is to acquire new markets. Trade balance is also influenced by economic growth and availability of foreign credits.

Finally, one can assume that balance of services, transfers, and remittances are not affected by FDI. Thus, one can specify a simple model of three equations:

$$CAI_t = a_1 * \sum FDI_{t-i} * (1-d)^i + a_2 * \sum PI_{t-i} + a_3 * \sum OI_{t-i} + a_4 * rGDP_t \quad (2)$$

$$CAG_t = b_0 + b_1 * FDI_{t-1} + b_2 * \sum FDI_{t-i} * (1-d)^i + b_3 * OI_{t-1} + b_4 * rGDP_t \quad (3)$$

$$CA_t = CAI_t + CAG_t + \underline{CASTL}_t \quad (4)$$

Panel least squares method was used to estimate equations (2) and (3) for eight NMS and 1996-2006 period. Each equation can be estimated as:

$$Y_{it} = \alpha + X_{it} \beta_{it} + \delta_i + \gamma_t + \varepsilon_{it} \quad (5)$$

where  $Y_{it}$  is the dependent variable,  $X_{it}$  is a k-vector of regressors, and  $\varepsilon_{it}$  are the error terms for cross sectional units observed in pooled periods. The  $\alpha$  parameter represents the overall constant, while  $\delta_i$  represents cross-section specific and  $\gamma_t$  period specific effects. One may view the data as a set of cross-section specific regressions, so that we have M cross-section equations, or one may view the data as a set of T period specific regressions. Thus,  $\beta$  coefficients may be divided into sets of cross-section specific, period specific, or common parameters.. If  $\beta$  are common across cross sections and periods equation (7) can be simplified to:

$$Y_{it} = \alpha + X_{it} \beta + \delta_i + \gamma_t + \varepsilon_{it} \quad (6)$$

If  $\beta$  are country specific we have:

$$Y_{it} = \alpha + X_{it} \beta_i + \delta_i + \gamma_t + \varepsilon_{it} \quad (6a)$$

If  $\beta$  are period specific we have:

$$Y_{it} = \alpha + X_{it} \beta_t + \delta_i + \gamma_t + \varepsilon_{it} \quad (6b)$$

The presence of cross-section (country) specific and period specific effects terms  $\delta$  and  $\gamma$  were handled using fixed effects method. Country specific effects improved the estimation results considerably, while period specific effects did not. The results of three different specifications (unrestricted, cross fixed restrictions, and cross fixed restrictions with lagged independent variable) are in Table 3, the results of bolded equations are depicted on Graphs 4a and 4b.

Estimated coefficients for investment balance are in accordance with expectations, with low constant, negative values for all three forms of foreign owned assets, and negative value for GDP growth rate. The inclusion of lagged dependent variable reduces absolute values of the coefficients but does not alter their signs.

Table 3  
**The Estimation Results**

Investment balance								
	constant	$\sum FDI_{t-i}$ $*(1-d)^i$	$\sum PI_{t-i}$	$\sum OI_{t-i}$	rGDP <sub>i</sub>	CAY <sub>(t-1)</sub>	R <sup>2</sup>	Restrictions
1a	0.8024 (2.77)	-0.1215 (-11.87)	-0.0912 (-5.11)	0.0082 (0.73)	-0.1614 (-3.47)		0.74 0.81	Unrestricted
2a	<b>0.6624</b> <b>(2.37)</b>	<b>-0.0986</b> <b>(-8.77)</b>	<b>-0.0575</b> <b>(-2.80)</b>	<b>-0.0286</b> <b>(-2.35)</b>	<b>-0.1632</b> <b>(-3.74)</b>		<b>0.84</b> <b>1.19</b>	<b>Cross</b> <b>Fixed</b>
3a	0.3863 (1.50)	-0.0502 (-3.34)	-0.0476 (-2.57)	-0.0189 (-1.71)	-0.1362 (-3.44)	0.4268 (4.35)	0.88	Cross Fixed
Trade balance								
	constant	FDI <sub>t</sub>	$\sum FDI_{t-i}$ $*(1-d)^i$	OI <sub>ti</sub>	rGDP <sub>i</sub>	CAG <sub>(t-1)</sub>	R <sup>2</sup>	Restrictions
1b	-4.475 (-3.48)	-0.4644 (-3.81)	0.2267 (3.76)	-0.4644 (-3.81)	-0.7738 (-3.44)		0.46 0.79	Unrestricted
2b	<b>-10.706</b> <b>(-16.7)</b>	<b>-0.2255</b> <b>(-2.63)</b>	<b>0.2187</b> <b>(7.17)</b>	<b>-0.2626</b> <b>(-4.61)</b>	<b>-0.0683</b> <b>(-0.62)</b>		<b>0.91</b> <b>1.43</b>	<b>Cross</b> <b>Fixed</b>
3b	-7.5526 (-5.76)	-0.1458 (-1.68)	0.1817 (5.65)	-0.2281 (-4.08)	-0.1751 (-1.55)	0.2749 (2.75)	0.92	Cross Fixed

Specifically ( equation 2a), additional unit of FDI stock increases investment account deficit in GDP by 0.0986 units, one unit of portfolio stock by 0.0574 units, and one unit of other investments (credits) by 0.0286 units. In other words, average rates of returns on FDI (9.86 percent) in NMS in the observed period were nearly two times higher than the rates of return on portfolio investments (5.74 percent) and four times higher than rates of return on credits to

the host country (2.85 percent). Finally, the increase of GDP growth by one percentage point increased the outflow through the investment account by 0.163 units.

The equation for trade balance (2b) indicates that FDI first increases and then begins to diminish trade balance deficit which would imply that the predominant aim of multinationals to invest in NMS was labor cost reduction. On the other hand, loans increased trade balance deficit by enabling imports which were necessitated by economic growth. The inclusion of lagged dependent variable does not alter the signs of the coefficients and also does not significantly alter their values. Highly significant negative constant indicates that a kind of a structural trade account deficit is a “normal” feature of NMS.

Specifically (equation 2b), one unit of FDI increased trade deficit by 0.225 units, while past FDI (stock of FDI) reduced trade deficit by 0.219 units. One unit of other investments boosted trade deficit by 0.263 units, and economic growth by 0.068 units.

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Graph 4a

**Actual and Estimated Investment Balances**



**Graph 4b**  
**Actual and Estimated Trade Balances**



## 5. Some Implications

According to the results, foreign ownership of the assets deteriorates current account balance through the investment account and improves it through the trade account; positive effects of the latter might outweigh or not the negative effects of the former. However, even in the trade balance, positive effects of foreign ownership on trade balance may not prevail over “structural patterns” created by transition<sup>10</sup>, effects of growth, and availability of credits. This implies deterioration in the trade balance and additional deterioration of the current account balance. The MNS average net balances for current account, investment account, trade account, and other accounts (services, transfers, and remittances) are in Table 4a, while yearly averages for NMS considered an entity are in Table 4b. The development in the whole period by country is depicted in Graph 5a and for NMS as an entity in Graph 5b.

Table 4a

### The Structure of the current account balance in 1996-2006 period

Country	Current account	Investment	Trade	Services Transfers Remittances	FDI
Czech R.	-4.54	-2.63	-3.30	1.39	6.61
Estonia	-8.93	-3.71	-16.88	11.67	8.33
Hungary	-6.18	-5.64	-4.24	5.31	6.11
Latvia	-8.61	-1.86	-17.27	10.53	3.29
Lithuania	-8.25	-2.01	-11.05	4.81	4.45
Poland	-3.22	-1.66	-4.26	2.70	3.50
Slovenia	-1.11	-0.90	-3.81	3.60	1.91
Slovakia	-6.01	-1.96	-6.38	2.33	4.86
NMS-8	-5.86	-2.49	-8.37	4.99	

<sup>10</sup> Macroeconomic policies which were in most NMS based on the assumption that Supply<Demand (shortage economy) and which therefore proposed rapid trade liberalization, restrictive monetary and fiscal policies, fixed exchange rate, and wage controls deepened transformational depression caused by the collapse of the economic system and turned most goods to »pure socialist production goods« which could not be sold at home or abroad.

Graph 5a  
**Current account, Investment and Trade Balances**

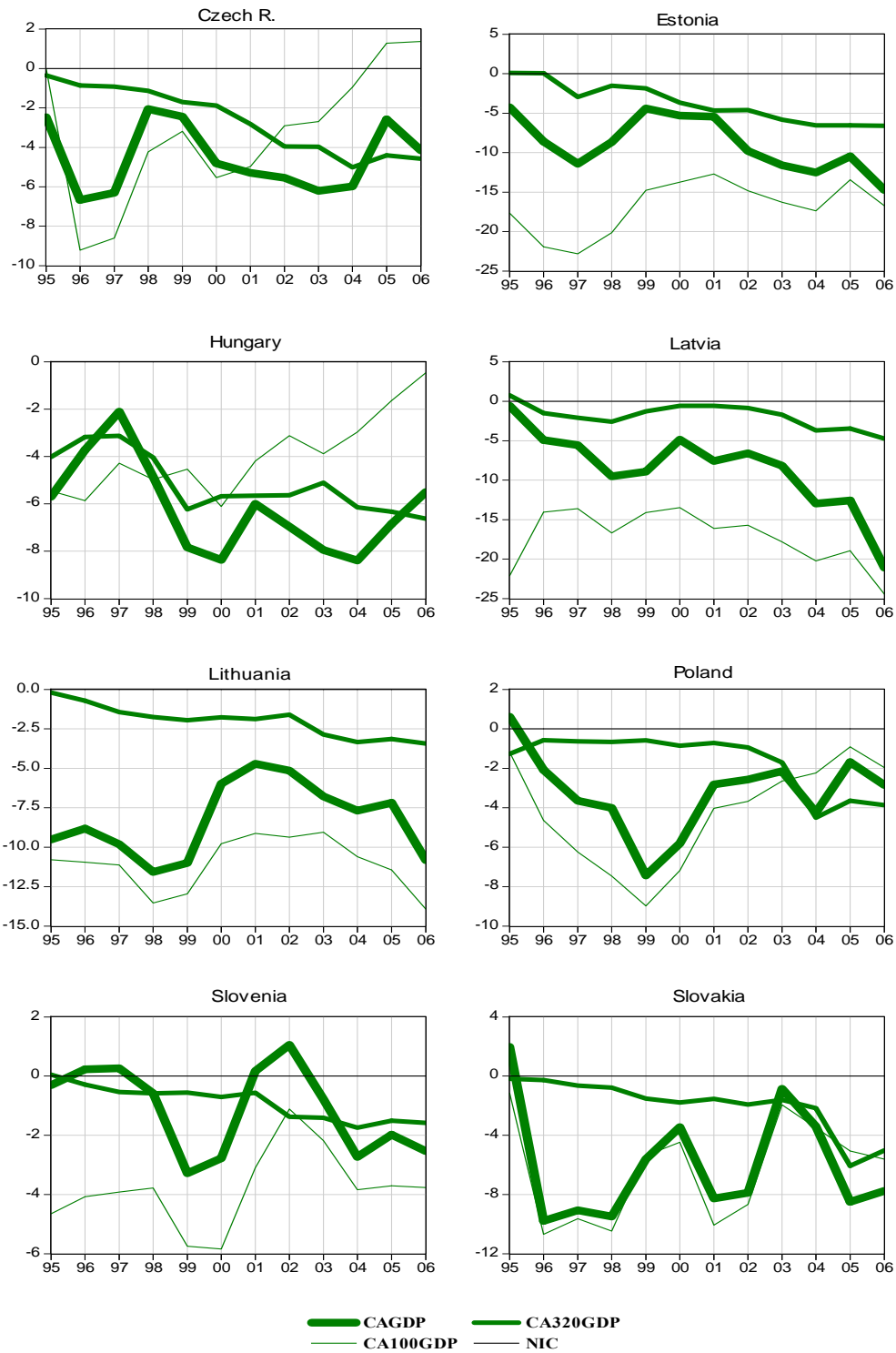
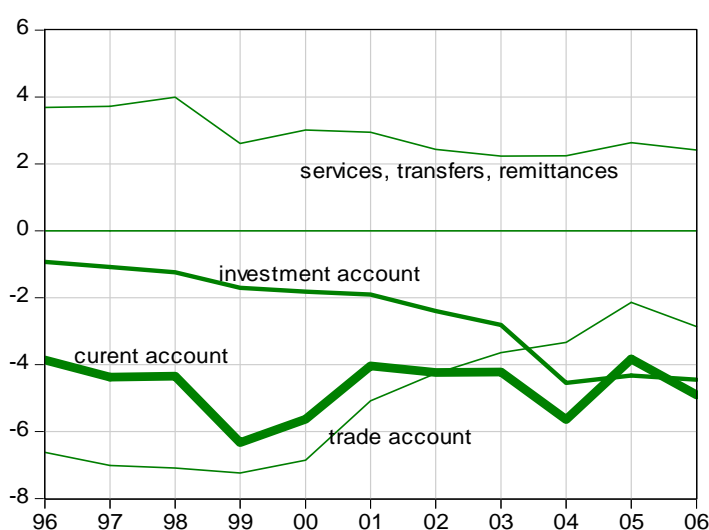




Table 4b  
**The Structure of the current account balance in NMS**

Year	Current account	Investment account	Trade account	Services Transfers Remittances	FDI
1996.	-3.86	-0.93	-6.62	3.69	2.37
1997	-4.37	-1.08	-7.01	3.72	2.50
1998	-4.34	-1.24	-7.09	3.99	3.83
1999	-6.33	-1.70	-7.24	2.61	5.16
2000	-5.63	-1.82	-6.85	3.01	6.07
2001	-4.04	-1.90	-5.08	2.94	4.89
2002	-4.23	-2.40	-4.26	2.43	5.40
2003	-4.22	-2.81	-3.64	2.23	2.26
2004	-5.64	-4.54	-3.34	2.24	4.52
2005	-3.83	-4.32	-2.14	2.63	5.34
2006	-4.90	-4.45	-2.86	2.41	5.37
1995-2006	-4.39	-2.37	-5.01	2.99	

Graph 5b  
**The Structure of Current Account of NMS as an entity**



Tables 4a and 4b and Graphs 5a and 5b confirm that the long run dynamics of the current account balance in NMS has been shaped by the investment account balance while the fluctuations and the country specific levels have been formed by trade balance. Shattering levels of the current account deficits resulting from this two accounts have been reduced by surpluses in services, transfers, and remittances.

The country levels of the investment account deficit differ but the deficit has been growing steadily in all. The country levels of trade balance deficits vary even more while their dynamics differ. In Czech

Republic, Hungary and Poland trade balance deficit has been gradually decreasing; in 2005 and 2006 the trade deficit of Czech Republic turned to a surplus. On the other hand, all three Baltic states continue to have large and even growing current account deficit, a sum of enormous trade account deficit, growing investment account deficit, and large surplus in net exports of services, transfers, and remittances. Slovenia and Slovakia differ in the levels. In Slovenia, trade deficit is nearly compensated by surplus in services, and investment account deficit is low, while in Slovakia current account deficit was until 2003 determined by trade account deficit, and after 2004 enhanced by investment account deficit.

In short, FDI worsens current account balance in all NMS due to increasing investment account deficits which are accompanied by trade account deficits rather than trade account surpluses, and not compensated by surpluses on the accounts of services, transfers and remittances.

Growing disparity between GDP/capita and GNP/capita which better than GDP/capita reveals welfare in a host country is an unavoidable consequence of FDI. Current account deficit in NMS which is more and more shaped by FDI will remain an important issue. Indeed, it might also become a threat for the exchange rate stability in the countries which are not yet in the Euro zone. While exchange rate policy can, at least in theory, influence the development on the trade and services accounts, the ability of economic policy to affect the flows on the investment account is rather weak. There are at least two reasons for the weakness. First, interference of economic policy with income flows is restrained by the EU rules requesting unhindered flows of capital. Second, the investment account balance is to a great extent determined by inflows of capital in the past while current account deficits add up into negative net external position which is financed by foreign savings (direct investment, portfolio investment, and credits). This creates future investment account deficits and contributes to present and future current account deficits. Indeed, MNS face a kind of a vicious circle.

NMS have already sold most of their productive assets and they have been left with only few local companies which could become targets of acquisitions by multinationals. At the same time NMS have been faced with competition for green-field investment from the countries which can offer even cheaper labor. Though, FDI in NMS shifted from manufacturing to real estate, the inflow of capital through FDI might soon lag considerably behind the outflow of capital through the income account. One could say that NMS with exemption of Poland (because of its size) and Slovenia (because of its reluctance regarding FDI, and the membership in the Euro zone) have become seriously “addicted” by FDI and that a sudden termination of FDI inflow could create a situation similar to the situation in the South East Asia (Malaysia, South Korea, Indonesia, Philippines and Thailand) in 1998. Namely, high economic growth, low inflation, and large current account deficit which portray recent development in

NMS also characterized South East Asian countries a decade ago. Sudden interruption of FDI in 1998 was followed by 10 percent drop of GDP and devaluations of approximately 40 percent.

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