Will FDI’s Investment Profits Outflow Cause the Current Account Deficit?

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Abstract. This paper analyzes the limitation of classic Kalecki theory based on globalization and financial liberalization so as to study whether FDI’s investment profits outflow will make host countries’ current account of BOP deficit, and find that the conclusions of Kalecki theory will be inaccurate as long as host countries scale up their investment overseas and make the income account in Balance of Payments(BOP) positive.

Introduction

Most of governments and institutes treat the current account as a leading indicator to judge the equiliubrium of BOP. As we know, FDI’s investment profits outflow can influence the income account in Balance of Payments and then affect the current account indirectly, it has deficit effect on the current account. Thus, will it lead to the current account deficit in the long run?

Literature Review

Kalecki(1966)[1] studied the problem synthetically that FDI’s profits outflow could influence host countries’ BOP equilibrium firstly. He argued that the deficit of BOP can not be avoided as long as the FDI’s net yield to their profits outflow ratio maintains a fixed rate.

A number of economists study the problem later and most of them have drawn similar conclusions to Kalecki. Woodward(2001)[2] argued that FDI is to get profits like other external capitals, and its profits outflow would bring unfavorable influence to host countries’ BOP which might cause currency crises. Yongding YU(2003)[3] argued that China will have to export goods to pay FDI’s profits outflow and it will probably cause currency crises in the long run. Zhonggen MAO(2005)[4] analyzed the causes of Italian currency crises in 1992, Mexican financial crises in 1994 and Malaysian financial crises in 1997, and found that these crises were not due to the trade deficits but due to the current accounts deficit caused by the numerous outflow of FDI’s profits before crises. Kim et al. (2011) [5]argued that capital inflow might cause the exchange rates appreciation, and then it would worsen the current account and even trigger a currency crisis. Shusong Ba(2013)[6] is afraid that FDI’s profits will probably outflow on a large scale when the foreign enterprises are shocked suddenly by domestic or external economic and political situaion, which maybe cause BOP imbalance. Ling Yin and Xieqiu Wan(2015)[7]argued that FDI’s investment profits outflow will reduce the balance of the current account after co-integration analyzing.

Some other economists, however, have drawn their conclusions differrent with Kalecki. Rossinia and Zanghierib(2009)[8] argued that FDI net inflows (proxy of equity capital) allow emerging economies to sustain larger CA imbalances with respect to CA deficits financed by inflows of more liquid assets. Ansari and Ojemakinde(2003)[9] found the rising share of the service sectors in the US economy had caused the service account surplus, which could also make up FDI’s profits outflow. Yu Zhang and Jiazhi Xie(2011)[10] argued that Kalecki neglected the several factors of short term capital flow, exchange rates regimes and the possible influence of FDI on export in his analysis.

It can be seen that the conclusions about the problem of the effect of FDI's profits outflow on the current account are so different. Under the background of globalization, however, it is necessary to analyze the applicability of Kalecki theory from a new perspective.

Theoretical Analysis and Kaleci Model's Improving

On the basis of Kalecki theory, it is only a time problem for FDI profits to be remitted back to their home countries which own the profits and hence it is sure that the influence on host countries' current account is deficit. Under the background of globalization, however, the situation is changing.

At present most of the literatures focus on the comparison of FDI investment profits outflow with FDI inflow or the host countries' trade balance and neglect the factor of host countries ' investment overseas while analyzing FDI's influence on the current account based on Kalecki theory. For this reason, they argued that the current account would be deficit when FDI inflow or the host countries' trade surplus could not compensate FDI's profits outflow. It can't reflect the relationship between FDI and the current account balance exactly based on IMF《BOP Manual (6th ed)》since their conclusions were not drawn based on the comparison of FDI's investment profits outflow with the host countries' investment return overseas but on the comparison of FDI investment profits outflow with FDI inflow or the host countries' trade balance. This is probably because of the era characteristics of Kalecki living that international economic globalization and financial liberalization had not developed to the extent like nowadays, the scale of capital flow was not large and the activity of investment overseas among world countries was not active during 1960s, thus the status of investment return overseas in BOP, which affected the current account balance weakly, was not obvious so that the researchers tended to neglect the factor while analyzing FDI's influence on the host countries' current account.

With the rapid development of international economic globalization and financial liberalization in 20th century, the status of the investment return overseas in BOP is prominent more and more, and hence it is necessary to pay more attention to the factor while analyzing FDI's influence the on host countries current account. As the return of capital investment, although the income account in BOP includes workers share, the investment return overseas is usually neglected due to its small sum. The income account is very important in the current account since it reflects a country's net capital overseas. If the host country's net investment overseas is not large while FDI inflow is numerous, there will be less opportunities of getting income overseas and more opportunities of paying income to foreign countries, accordingly it needs more trade surplus to compensate the income account deficit for the purpose of maintaining the current account equilibrium. If the service account is also deficit, however, as Kalecki theory describing, it will counteract and narrow the trade surplus, which results in the current account deficit in the end; on the contrary, the current account is not always deficit finally even though the trade account or the service account is deficit if the host country has more net foreign assets, namely it invests more overseas than FDI inflow. TILLE(2008) [11] has also drawn similar conclusion about the problem above.

In fact, there is a hidden hypothesis in Kalecki Model that the host country's income account is always deficit, which can be described with mathematic language below:

Given that: $\Delta profit$ — the investment return balance; $outprofit$ — FDI's investment profits; $inprofit$ — the host country's investment return overseas, then

$$\Delta profit = outprofit - inprofit \tag{1}$$

It can be found in equation(1) that FDI's effect on the income account in the current account depends on the balance between FDI's profits outflow and the host countries' investment returns based on IMF《BOP Mannaul》(6th ed) while the hidden hypothesis in Kalecki Model is $\Delta profit < 0$. Actually, as long as $\Delta profit > 0$, that is $inprofit > outprofit$, the conclusion drawn from Kalecki Model is not correct.

It can be found in BOP that the income account balance is not only correlated with FDI inflow but also with the host countries' investment returns overseas. Assuming that FDI's investment profits is linearly related to FDI inflow, then we can build the following linear regression equation:

$$\Delta\text{profit} = \alpha + \beta\text{FDI} + \gamma\text{inprofit} + \varepsilon \tag{2}$$

Where α 、 β 、 γ are estimated parameters, ε is the disturbance.

As seen in equation(2), Δ profit must be greater than zero if the host countries want to meet the target of the income account surplus. According to the structure of BOP, the credit profits should be greater than the debit profits corresponding to equation(2) where FDI and inprofit happen to move counter and the absolute value of the latter should be greater than the former, namely the host countries should invest overseas and try to make the investment returns overseas greater than FDI's investment profits while introducing FDI. If the host countries decide to introducing FDI, the income account mainly depends on its investment scale and returns overseas.

Furthermore, it is not sure that FDI's profits outflow will lead to the current account deficit even if $\Delta\text{profit}<0$ since it also depends on whether the trade account and service account are surplus or deficit. The correlated analysis is as below:

$$\text{CA} = \text{trade} + \text{service} + \Delta\text{profit} \tag{3}$$

Where CA is the current account balance, trade is the commodity account balance, and service is the service account balance. The relationship between FDI's investment profits outflow and the current account is shown seen in Fig. 1.

Thus, the model can be a theoretic basis to judge the effect of FDI's investment profits outflow on the current account.

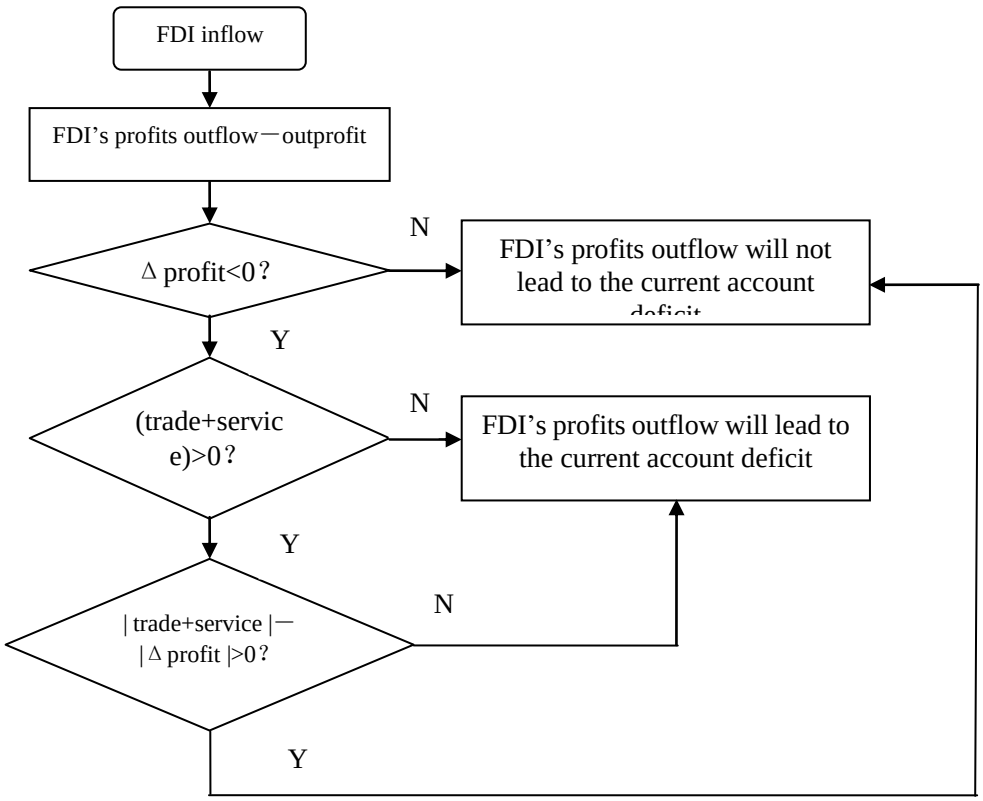

Figure 1 The flow chart of the relationship between FDI's investment profits outflow and the current account

Conclusions

In this paper, the limitation of Kalecki Model about FDI's investment profits outflow is analyzed theoretically under the background of globalization and financial liberalization. It is found that the conclusion of Kalecki Model is not correct as long as the host countries' investment returns overseas is greater than FDI's investment profits by building a regression of the income account balance variable, FDI inflow variable and a host country's investment returns overseas variable. As a result, Kalecki theory is improved.

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