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Reinvested Earnings Bias, the 'Five Percent' Rule and the Interpretation of the Balance of Payments - with an Application to Transition Economies

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Abstract


We show that the imputation of reinvested profits of the subsidiaries of foreign firms as a debit item on a host country's balance of payments account tends to overstate the current account deficit. We also show that, because of the workings of the FDI financial life cycle, this phenomenon is most evident for countries that have recently received large inflows of capital. The transition economies of East Europe certainly fall among such countries, and we show that, for the Czech Republic and Hungary, this imputation has a large effect on their reported current account balance. We verify the working of the FDI financial life cycle using two different panels of developed, developing and transition economies.

Keywords: Balance of Payments, Financial Crisis, Foreign Direct Investment, Transition Economies

JEL Classification: F21, F23, F34

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