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Reinvested Earnings—The French Experience

Prepared by the Banque de France

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**REINVESTED EARNINGS
THE FRENCH EXPERIENCE**

This paper aims at:

- describing the compilation method of reinvested earnings in France's balance of payments, in the first part,
- analysing the notion of operating profit and the differences from the IMF 5th Balance of Payments Manual, in the second part.

1. Reinvested earnings in France's balance of payments

1.1 Definition of reinvested earnings

Very simply, reinvested earnings for the Row can be defined as the positive or negative difference between a company's earnings (profit or loss) in a given year, and the dividends distributed in the same year.

Reinvested earnings are calculated on an annual basis on French direct investment abroad on the one hand, and on foreign direct investment in France on the other hand.

Negative reinvested earnings in the balance of payments (in France or in other countries) can result from:

- the magnitude of losses on some countries or sectors, which are not offset by profits made in other countries or sectors, at the global level of the balance of payments;
- tax reasons (in some countries, it may be worthwhile showing a loss or not making a profit) or the intention of smoothing out the payment of dividends, with reserves built up in fat years being tapped in lean years, at an individual company's level.

1.2 Recording in the balance of payments

Reinvested earnings are included each month in the balance of payments, according to the IMF 5th BOP Manual double-entry bookkeeping principle:

- one entry is made in the current account (under "direct investment income").
- the second entry is made in the financial account, under "direct investment", so as to take into account the change in the French investment position abroad or in the foreign investment position in France, that results from reinvested earnings (included in capital). In the case of French direct investment abroad, reinvested earnings add to (or reduce, when they are negative) French claims on the rest of the world. In the case of foreign direct investment in France, liabilities increase (or decrease) by the same amount;

If reinvested earnings are negative, they imply a deduction from a company's own capital, or disinvestment.

The net impact of positive or negative reinvested earnings on the current account is summarised as follows:

Reinvested earnings in:	Positive reinvested earnings	Negative reinvested earnings
- French direct investment abroad	Positive impact on the current account (higher surplus or smaller deficit)*	Negative impact on the current account (smaller surplus or higher deficit)*
- Foreign direct investment in France	Negative impact on the current account (smaller surplus or higher deficit)*	Positive impact on the current account (higher surplus or smaller deficit)*

* The impact on the financial account (direct investment) is of equal amount, but with reverse sign.

It should be stressed also that calculations take into account the different investors' percentage stake in the companies concerned.

For example in 1997, the net balance on reinvested earnings amounted to FRF 7.8 billion, which in turn increased the current account surplus (see in Annex I the annual data for 1989 to 1997).

This figure resulted from:

- positive reinvested earnings for French direct investment abroad. Reinvested earnings increased the receipts of the "direct investment income" item of the current account
- positive reinvested earnings for foreign direct investment. Expenditure of the "direct investment income" item increased accordingly.

Current account	Credit	Debit	Balance
Direct investment income (reinvested earnings)	10.9	3.1	7.8

1.3 Methods of calculating reinvested earnings

Data on reinvested earnings included in the balance of payments go through three successive stages: forecast, estimated, final. Besides, periodic revisions take place gradually on forecast and estimated data, according to the availability of the necessary information, and until the final status.

Final data, estimates and forecasts separately concern profits and dividends from which are inferred, by difference, reinvested earnings.

1.3.1 Annual final statistics

1.3.1.1 Calculation method

Annual final flows of reinvested earnings are calculated from data on profits and dividends recorded each year by the Banque de France in its surveys on direct investment position between France and the rest of the world. Some 9,000 resident companies are surveyed, for both inward and outward direct investment.

Resident investors report their foreign affiliates' profits and dividends paid. Similarly, resident direct investment companies report the total amount of their profits and that of dividends paid (the share of non-resident direct investors in the profits and the dividends is calculated by the Banque de France according to their stake in the equity capital of the company).

The data collected on companies' profits and dividends are then statistically processed so as to include profits and dividends not reported by companies belonging to the sample surveyed¹. After this processing, reinvested earnings, in France and in the rest of the world, can be included in the balance of payments, with a breakdown by economic sector and by country. The geographical breakdown is essential at EMU level for distinguishing between Intra and Extra EMU flows.

1.3.1.2 Timeliness

In France, as in most industrialised countries, final data on profits and dividends are available with a delay of a little more than a year after the end of the year concerned (14 months for profits and dividends on foreign direct investment in France and 15 months for those on French direct investment abroad). This results in particular from the time required for the accounting data to become available, and research is being carried out to improve timeliness.

¹ As at December 31, 1996, the population of companies surveyed was the following:

French direct investment abroad		Foreign direct investment in France	
Number of resident direct investors	2,078	Number of non-resident direct investors	10,881
Number of non-resident direct investment companies	8,495	Number of resident direct investment companies	9,351

1.3.2 Estimates and forecasts

Without final data, reinvested earnings over current periods require relying on estimates and forecasts that are made quarterly, so as to take into account new available data, as time goes by (for instance, in the second quarter of 1998, estimates and forecasts made in the first quarter of 1998 for the previous year, are revised).

Flows are estimated and forecast on an annual basis; then, they are adjusted to a monthly basis and, besides, quarterly broken down by country and sector, according to the known structure of stocks.

1.3.2.1 Estimates for the penultimate year (n-1): for instance, estimates in 1998 of 1997 reinvested earnings

Estimates concern both profits and dividends.

- Estimates of dividends received by French investors or of those paid to foreign investors in year n-1 (1997) rely on dividends already recorded in the balance of payments. Previously, these flows were adjusted according to the difference between figures obtained in annual surveys to companies and those reported each month to the Balance of Payments Division. Currently, this difference is small.
- Estimates of profits for year n-1 are based on the latest positive income available (i.e. n-2, 1996 in our example), to which is applied, as a proxy, a percentage representing the change in economic conditions over n-1. For precautionary purposes, estimates of reinvested earnings for n-1 do not take into account losses of n-2 relating to those companies in deficit.
 - The change in earnings obtained in France in n-1, by resident direct investment companies, is derived from available data. As of 1999, earlier estimates on profits obtained in France by foreign investors could be made from Insee figures and data provided by an annual short survey carried out by the Banque de France.
 - The change in earnings obtained abroad is estimated on the basis of forecasts abroad, globally made from experts' opinion, relying on several sources (IMF, OECD, foreign national statistics, Insee, banks' economics departments, consulting companies).

1.3.2.2 Forecasts for the current year: for instance 1998

Forecasts rely on global hypotheses and concern both earnings and dividends that will be paid or received during the year:

- For dividends, balance of payments flows are extrapolated (on the assumption that the dividend payout ratio will remain stable);
- For earnings, forecasts of changes linked to the expected economic growth are applied to the latest known earnings.

2. The notion of earnings: differences between the IMF 5th Balance of Payments Manual ("operating profit") and France (balance sheet profit)

France, like most European countries (see appendix 1), assesses reinvested earnings from balance sheet profit, and not from the notion of "operating profit" as recommended.

The 5th Manual states that measuring and recording direct investment income should be made from the notion of "operating profit", defined in par. 285 as follows: "Operational earnings represent income from normal operations of the enterprise and do not include any realised or unrealised holding capital gains or losses arising from valuation changes, such as inventory write-offs". This point was adopted as principle by the European Central Bank for the EMU balance of payments statistics.

In the European System of National and Regional Accounts (ESA95, par. 4.64) reinvested earnings on foreign direct investment are defined as "the operating surplus of the foreign direct investment enterprise plus any property incomes or current transfers receivable, minus any property incomes or current transfers payable, including actual remittances to foreign direct investors and any current taxes payable on the income, wealth, etc., of the direct foreign investment enterprise."

The most significant difference between the earnings shown in companies' balance sheet and the notion of operating profit concerns the treatment, in the national accounts, of capital holding gains or losses impacting on the amount of earnings.

On the whole, there will be no errors and omissions if the result of calculation method used in the current account is also used in the financial account.

The issue of the calculation of reinvested earnings only in the Rest-of-the-World account, and not in the resident sectors of the SNA, is probably a much more important source of concern and deserves consideration.

2.1 Some additional remarks on the notion of operating profit

Taking into account the companies' operating profit only, to calculate reinvested earnings, reflects only partly the companies' financial behaviour, since the operating profit does not show the consequences on the accounts of some financial decisions concerning in particular:

- provisions for currency holding losses or bad debt,
- certain reallocations of claims/liabilities within groups, carry back/forward of payables/receivables or conversion of non-financial liabilities into financial ones.

These elements have an impact on the amount of the profit distributed and of reinvested earnings. In this respect, it is clear that the behaviour of investors with large shareholdings is totally different from that of small investors: here, the 10 percent threshold is one correct way of discriminating between them and justify the calculation above the threshold.

2.2 The concrete limits to the calculation of reinvested earnings from the operating profit considering the French experience

Some research has been made on reinvested earnings figures from detailed corporate accounts, but only for foreign direct investment in France since compilers do not have other data than the net earnings for French direct investment flows abroad. Naturally the difference between the overall profit and the operating profit may be positive or negative, according to the year examined, with a range going up to a maximum of about 20 %. At this stage of analysis, it is not planned to introduce dissymmetry in the calculation of reinvested earnings. Other European countries meet the same problem of lack of detailed data on companies. This data availability problem is clearly raised by the IMF in the 5th BOP Manual (par. 285): "Because data for many countries are available only on an all-inclusive basis, when holding gains and losses and other extraordinary income are included in reported earnings, those countries that report earnings on either an operating basis or all-inclusive basis should collect and publish supplementary information on holding gains and losses and other extraordinary items. This practice would enhance international comparability for both flows and stock positions."

Undoubtedly cost-effectiveness and gradualism should be kept in mind when thinking about improvements in the methodology that are indeed desirable.

As conclusion let me put a few questions:

1. An exchange of view might be usefully devoted to better understand the different reasons why reinvested earnings are negative in a number of countries for a number of years in a row?
2. How to better analyze the bias observed at the world level (64 billions USD in 96). France inclusion in the BOPSY (table 14) will, at the margin, increase the gap! Are reinvested earnings -at present mostly reported by industrialized countries and not reported, as counterpart, by the ROW- likely to explain fully the gap?
3. An exchange of concrete experience should be developed also in the compilation of reinvested earnings, in particular for the effective capture of the operating profit and also on the way of assessing the dividends in quarterly surveys?
4. The issue of the calculation of reinvested earnings only done in the Rest-of-the-World account, and not in the resident sectors of the SNA, is also a source of concern and deserves consideration.

FRANCE

REINVESTED EARNINGS IN FOREIGN DIRECT INVESTMENT INCOME

→ *FRF billion*

Year	Reinvested earnings		Balance
	Credit	Debit	
1989	7.87	18.57	-10.70
1990	6.19	14.10	-7.91
1991	6.59	1.00	5.59
1992	-4.77	-21.73	16.96
1993	-5.83	-25.06	19.23
1994	8.13	-4.60	12.73
1995	-15.27	-3.58	-11.69
1996	7.00	-5.40	12.40
1997*	10.92	3.12	7.80

**estimates*

Nota bene : table consistent with the table B14 in BoP Statistics Yearbook