

Session Number: 2A
Session Title: Cross-Border Trade and Foreign Direct Investment
Paper Number:
Session Organizer: J. Steven Landefeld
Discussant:

*Paper Prepared for the 29th General Conference of
The International Association for Research in Income and Wealth
Joensuu, Finland, August 21 – 25, 2006*

**Proposed Changes in International Standards for Measuring
Foreign Direct Investment**

**Ralph Kozlow
U.S. Bureau of Economic Analysis**

For additional information please contact:

Ralph Kozlow
U.S. Department of Commerce – BEA
BE-4
Washington, DC 20230
ralph.kozlow@bea.gov
Fax: (202) 606-5311
Tel: (202) 606-9604

This paper is placed on the following websites: **www.iariw.org**
www.stat.fi/iariw2006

*The views in this paper are solely those of the author and not necessarily those of the Bureau of Economic
Analysis or the U.S. Department of Commerce.*

Introduction.

This paper covers a large number of direct investment related topics in a highly summarized form. It covers nearly a 10-year period – from 1999, when work on updating the international measurement standards for direct investment formally began, to 2008, when updates of the major manuals are expected to be released. It describes the major proposals for changes in direct investment measurement standards, and how the measurement changes will result in data that better address emerging issues. In addition, it identifies steps that the United States has taken or expects to take in response to the updated standards, and the impact of these actions on U.S. data. It also discusses efforts now underway or planned worldwide, to enhance world direct investment data quality, both in countries where direct investment is relatively large and data collection programs are relatively advanced, and in smaller countries that are endeavoring to improve their capacity to provide high quality direct investment statistics.

Process for updating the measurement standards.

Work is well along on updating the two primary international standards for measuring direct investment – the third edition of the OECD *Benchmark Definition of Foreign Direct Investment (Benchmark Definition)*, and the fifth edition of the IMF's *Balance of Payments Manual (Manual)* – and many major decisions have been reached by high level committees. The updated *Benchmark Definition* is scheduled for release early in 2008, and the updated *Manual* is scheduled for release at the end of 2008.

The process to update the standards was formally put in motion in 1999, when the IMF's Committee on Balance of Payments Statistics (BOP Committee) asked the IMF to identify issues that should be considered in updating the *Manual*. It has progressed since then along a number of parallel and coordinated channels. Parallel channels are needed because, once the decision was reached to update the *Manual*, it was apparent that virtually all of the world's major statistical standards – including the 1993 UN *System of*

National Accounts and the *Manual on Statistics of International Trade in Services* – also had to be updated, and that separate teams had to be formed for the purpose of updating those other manuals. Coordinated efforts were required to maintain consistency among all of the manuals, as well as to assure that all of the manuals dealt effectively with the major changes in the world economy over the past 10-15 years. These include major changes in the geographic and industry dimensions of direct investment (including greater investment in financial affiliates, some of which are located in small economies), explosion in the size and number of transactions, and increased perceived importance of direct investment (it has increasingly been viewed as an important source of resources for developing countries, and of research and development “spillovers” of knowledge and training to both home and host economies). There also has been an increase in the level of concern about some of the potentially negative aspects of direct investment. Looking at some of these questions from the economy of the direct investor, there have been heightened concerns about the impact of direct investment abroad on employment in the direct investor’s economy, as well as questions about whether direct investors escape taxation through methods that tax authorities may consider controversial (such as corporate inversions, establishment of special purpose entities in tax havens, or misuse of transfer pricing rules).

Two primary committees are overseeing most of the conceptual work on updating the direct investment measurement standards. These are the IMF’s Committee on Balance of Payments Statistics (which has responsibility for setting standards for the international investment position and balance of payments accounts) and the OECD Workshop on International Investment Statistics (which has assumed responsibility for developing standards in the area of direct investment). In addition, the joint IMF/OECD Direct Investment Technical Expert Group (DITEG) was assigned responsibility by the IMF and OECD to research conceptual issues and make recommendations. Other groups, including the OECD Benchmark Advisory Group and various project groups, also contributed to this work. It should also be acknowledged that several individuals, including many members of the IMF’s Statistics Department, provided leadership and made strong contributions on conceptual issues throughout this updating process.

Staff of the U.S. Bureau of Economic Analysis (BEA) serve (or, in the case of DITEG which has now disbanded, previously served) on each of the major groups or teams listed above, typically in a leadership role such as chairman and/or major author.¹ BEA's strategic vision is "to be the world's most respected producer of economic accounts," and its staff is active on every major group formed for the purpose of updating the international measurement standards.²

Summary of major proposals and decisions.

Literally thousands of pages of documents have been prepared and hundreds of hours of meeting time have been spent in connection with the updating of the direct investment standards. Dozens of large and small issues have been identified, debated, and, for the most part, resolved.

Despite these lengthy and lively debates and discussions (or perhaps, because of them), an important characteristic of the decisions in connection with the update of the direct investment measurement standards is that, in general, core principles on how to measure direct investment transactions and positions are more heavily emphasized and strengthened rather than changed. In particular, the market value principle for measuring direct investment equity positions was reaffirmed and more strongly emphasized. In addition, the standard data presentations pertaining to direct investment transactions and positions will be revised in fundamental ways, to align them more closely with other, related data series. Also, OECD countries are placing substantially increased emphasis on providing data on bases that differ from those in the core balance of payments and international investment position accounts, for important analytical purposes. Finally, there are a few changes to the borderline between direct investment and other types of

¹ The author of this paper, Ralph Kozlow, is chairman of the OECD Workshop on International Investment Statistics and is the U.S. representative to the IMF Balance of Payments Committee. He also was co-chairman of DITEG (Neil Patterson of the IMF served as the other co-chairman). Obie G. Whichard, chief of BEA's International Investment Division, serves on the Benchmark Advisory Group and on OECD project teams.

² Bureau of Economic Analysis Strategic Plan for FY 2006-FY 2010; see <http://www.bea.gov/bea/about/Director.htm#Strategic>.

investment that, for some economies and data users, may be significant. These points are separately explained below.

Core principles are more heavily emphasized.

A list of 30 issues – some of them containing several inter-related sub-issues – was jointly developed by the IMF and OECD committees with oversight responsibility for the update. This list can be accessed on the IMF Web site, at <http://www.imf.org/external/np/sta/bop/diteg.htm>. Also located at this same Web site are copies of background papers, issues papers, and outcome papers related to each of these issues.³

From the list of topics, it can be seen that many important changes to the international standards were considered. Major changes to fundamental definitions were evaluated and debated, such as whether direct investment should continue to be defined with reference to a 10 percent ownership threshold, and whether direct investment reinvestment of earnings should continue to be treated as a transaction in the balance of payments accounts. After extensive deliberation, the conclusions reached were to leave virtually all fundamental concepts unchanged. Data users put a premium on time series continuity, and the committees decided that there needed to be a persuasive or compelling reason to make a fundamental change before it would be endorsed.

Although fundamental concepts were not significantly changed, they were significantly clarified and more strongly emphasized. For example, the 10 percent ownership threshold for establishing a direct investment relationship remains unchanged, but substantial work was completed to more fully and clearly articulate all types of direct and indirect relationships that underlie the calculation of ownership interests. Also, the market value principle for the measurement of direct investment equity stocks was reaffirmed and emphasized, but substantial work was completed to more fully and clearly

³ The documents related to work now underway by the OECD to provide additional or supplemental data sets are posted on the OECD's OLIS system, which requires a user ID and password to access.

articulate how direct investment equity should be (and should not be) measured under this principle. In addition, special purpose entities (SPEs) will continue to be regarded as residents in the economies in which they are registered or incorporated, and some work was completed on how SPEs might be identified or defined. Finally, as noted earlier, direct investment reinvested earnings will continue to be included in transactions in the balance of payments accounts, but at the same time compilers endorsed studying the concepts of income and reinvested earnings further.

Data presentations will be revised in fundamental ways, with increased emphasis on alternate or supplemental data presentations.

For presentations of data in the balance of payments and international investment position accounts, there will be a strict application of the asset/liability principle, and claims of direct investment enterprises on their direct investors will no longer be netted against liabilities, or vice versa. For example, all assets will be shown gross, on the asset side of the accounts; similarly, all liabilities will be shown gross, on the liability side of the accounts. This is in contrast with the existing presentation standards, which are based on the “directional principle.” Outward and inward foreign direct investment positions are considered directions of investment. Under the directional principle, both assets and liabilities related to outward direct investment are shown on the asset side of the international investment position (and netted at high aggregation levels), and asset and liabilities related to inward direct investment are shown on the liability side of the international investment position (and netted at high aggregation levels).

Under the new presentations, financial transactions and income flows will similarly be presented on an asset/liability basis rather than on a directional basis. Examples of the existing and proposed presentations of data in the investment position accounts are given below (a similar presentation applies in the case of financial transactions and income):

Existing presentation of direct investment positions

Assets		Liabilities	
A1	Direct investment abroad	L1	Direct investment in reporting economy
A2	Equity capital and retained earnings	L2	Equity capital and retained earnings
A3	Claims	L3	Claims
A4	Liabilities	L4	Liabilities
A5	Other capital (debt)	L5	Other capital (debt)
A6	Claims	L6	Claims
A7	Liabilities	L7	Liabilities

Proposed presentation of direct investment positions

Assets		Liabilities	
A1	Direct investment assets	L1	Direct investment liabilities
A2	Direct investment abroad	L2	Direct investment in reporting economy
A3	Equity capital and retained earnings	L3	Equity capital and retained earnings
A4	Debt	L4	Debt
A5	Direct investment in reporting economy (claims on direct investors)	L5	Direct investment abroad (liabilities to direct investment enterprises)
A6	Equity capital	L6	Equity capital
A7	Debt	L7	Debt

In addition to the changes in presentation of data in the core accounts (as shown above), the OECD is evaluating proposals that would feature alternate or supplemental depictions of direct investment positions and transactions that would be emphasized nearly as much as those for the core accounts.

In particular, due to the increased use of special purpose entities, holding companies and conduits in countries of convenience are accounting for increasingly shares of direct investment transactions and positions. These industry classifications and countries suggest little about the ultimate source, destination, or use of direct investment funds. As a result, conceptual work is being led by the OECD to follow direct investment positions

and transactions up and down ownership chains when there is a series of inter-related transactions and/or positions. The user community interest in this topic is quite high, and data tabulations on alternate bases are needed for bilateral, regional, and industry-level data analyses and other analytical purposes.

Alternate or supplemental data tabulations are also sought on financial transactions related to mergers and acquisitions versus those that are for all other purposes (including extensions of capital to existing affiliates or greenfield investments), and conceptual work in this area is also being led by the OECD. There is considerable analytical interest in identifying direct investment transactions for mergers and acquisitions, because these transactions often follow a different route or have a different impact on the host economy than other types of direct investment transactions. Generally, an extension of capital to an existing direct investment enterprise or a greenfield investment results in the new injection of capital into a business enterprise. In contrast, capital flows for mergers and acquisitions flow to shareholders (who may be individuals) rather than to the acquired businesses.

Changes to the borderline between direct and other types of investment.

Although core principles will be more heavily emphasized in the new international standards, there are a number of important changes to the borderline between direct investment and other types of investment that, for some economies and data users, may be significant.

The most important change to the borderline is probably in regard to the treatment of “permanent debt” investment between financial intermediaries. Permanent debt is defined in the *Manual* as “loan capital representing a permanent interest.” For affiliated banks and other types of financial intermediaries, direct investment positions and transactions are currently defined to include equity investment and permanently invested debt. However, practical problems arose because compilers could not develop a consistent and clear definition of permanently invested debt. Some compilers tried to

define permanent debt using regulatory rules (in particular, Basle tier 2 capital was sometimes used as a guide), but regulatory standards have been revised several times, regulators in different countries have authority to determine for their own country what qualifies as tier 2 capital, and the regulatory definition applies solely to banks and not to other types of financial intermediaries. Compilers also have tried to define permanent debt based on the use of the debt – for example, if debt capital was used by a branch bank to purchase fixed assets, then the debt would be considered permanent. However, this definition also proved unsatisfactory, partly because it required compilers to trace the uses of funds back to the sources of those funds, which is often impossible due to the fungibility of money. Also, just because debt capital was used to acquire fixed assets did not, by itself, imply to some compilers that the debt should be considered permanent. Because different countries were defining and identifying permanent debt differently, a substantial amount of bilateral asymmetry resulted. Thus, largely for pragmatic reasons, compilers have now decided that all debt between affiliated financial intermediaries should be excluded from direct investment in the updated standards. This debt will instead be recorded in portfolio investment or other investment, as appropriate. Making this simplification in the accounts will result in more consistent treatment across countries and less burden and confusion for data providers and compilers.

Another borderline area involves the methodology used to identify companies that are in a direct investment relationship with one another. The existing methodology will be clarified and is expected to change around its borders. For example, under existing standards, a company that is an associate of an associate (that is, a company that is between 10 and 50 percent owned by a direct investment enterprise that is, in turn, between 10 and 50 percent owned by a direct investor) is not considered to be in a direct investment relationship with the enterprise at the top of this ownership chain. However, under the new standards now being discussed, the enterprise at the bottom of the ownership chain would be considered to be in a direct investment relationship with the enterprise at the top *if* there was more than one chain of ownership for the given indirectly owned enterprise and ownership interests along all ownership chains summed to majority ownership.

Finally, an additional borderline area being reviewed involves investment by, or in, mutual funds. The question here is whether equity investment in, and/or equity investment by, a mutual fund should be considered to be a direct investment enterprise if the 10 percent equity ownership threshold is exceeded. A reason to *include* these enterprises in direct investment is that the 10 percent rule is a practical way of determining the existence of direct investment. A reason to *exclude* these enterprises from direct investment is that, when an investor holds a 10 percent or more equity interest in a mutual fund, and also when a mutual fund holds a 10 percent or more ownership interest in another business enterprise, both the “lasting ownership interest” and the “managerial control and influence” elements of traditional direct investment relationships are usually absent. That is, an investor with a 10 percent or more ownership interest in a retail mutual fund typically has invested for the purpose of being relieved of managerial control over the investment, and the investment is often relatively short-term. Similarly, when a retail mutual fund invests in another business, it typically does not intend to exercise managerial control.

The treatment of mutual funds has not yet been resolved, partly because there are many different types of so-called mutual funds or investment companies, and these must be individually considered before consistent rules may be established. For example, there has been a growth in so-called private equity funds that do indeed intend to invest in target companies for a period of several years, with the goal of implementing major changes in the operations of the target companies and then re-selling them. In this circumstance, the “lasting ownership interest” and “managerial control and influence” elements of traditional direct investment relationships are present to a much greater degree than with investments involving retail mutual funds (although to a smaller degree than with more traditional direct investment relationships).

Potential impact of the above changes in direct investment on U.S. data.

The new standards, by themselves, will likely have a limited impact on the data that the United States collects. However, substantial changes in U.S. data presentations may be prompted by the new standards. In addition, the United States expects to provide supplemental estimates, showing investment positions on an ultimate home/ultimate host country basis. Finally, to the extent that the new standards change the borderline between direct investment and other types of investment, U.S. data tabulations would be impacted. The impact of the borderline changes will be relatively small at high levels of aggregations of U.S. data, but could be sizable for individual countries or detailed industries.

The U.S. is following the work now being done to disaggregate financial flows into mergers and acquisitions and all other flows. The U.S. currently publishes some information on new direct investments, and it is not yet clear how new recommendations in this area may relate to the existing information.⁴

Steps the United States may take to align with the expected new standards.

The United States has already taken some steps, and is considering what other steps to take, to align its statistics with the new standards. In particular, the U.S. is identifying where new data collections might be needed (as noted, the new standards are expected to have a limited impact on the data that the U.S. collects), and is considering what changes in presentations to make and the timeline for implementation.

⁴ More specifically, the U.S. currently publishes data annually on “outlays” by foreign direct investors to acquire or establish new direct investments in the United States. However, outlays differ from financial inflows. Outlays include transactions by foreign direct investors *or by existing U.S. affiliates* to establish or acquire new U.S. affiliates. Transactions by existing U.S. affiliates may, or may not, correspond with financial inflows, depending upon whether the foreign direct investor provided the funds used for the new establishment or acquisition.

The new standard for measuring direct investment equity will call for valuing “listed” equity – that is, equity of companies that are listed on U.S. or foreign stock exchanges – at publicly disclosed prices. To meet this standard, BEA has added questions to its benchmark survey of U.S. direct investment abroad, to identify listed companies and their market prices. It should be noted that only a very small proportion of direct investment enterprises are listed on exchanges, and so the impact of this change will be small.

To give another example, the presentation of the U.S. balance of payments and international investment position accounts is not consistent with the recommendations that will be contained in the new standards to present data on a strict asset/liability basis. (As noted earlier, the present standards call for netting reverse investment – i.e., investment by a direct investment enterprise on its direct investor – within the inward and outward direct investment categories.) The United States is now considering various alternate ways of depicting detail for the balance of payments and international investment position accounts. No decisions have been reached either about what changes in presentations to adopt, or the timeline for publishing the new presentations (thus far, discussions have been entirely internal and are at quite early stages), but our hope is to introduce changes relatively soon after the new standards have been released.

In regard to data on alternate or supplemental presentational bases, the U.S. currently releases data on some supplemental bases and expects to broaden and update these presentations. The U.S. is leading much of the international work in connection with some of these supplemental presentations (for example, the U.S. has prepared papers for the OECD and others describing how the “ultimate host country” of investments that flow through intermediate affiliates might be calculated).⁵

BEA will publish an announcement in its monthly journal, the *Survey of Current Business*, after it has completed assessing the impact of the expected new standards on its

⁵ “A Method for Allocating the U.S. Direct Investment Position Abroad to the Country and Industry of Ultimate Destination,” by Obie G. Whichard, Bureau of Economic Analysis, for the OECD Workshop on International Investment Statistics, April 24-26, 2006, Paris.

statistical program and has reached decisions about changes in presentations and the timeline for implementation.

Efforts to enhance capacity of countries to provide high quality direct investment statistics.

The International Monetary Fund (IMF), the Organisation for Economic Co-operation and Development (OECD), and the United Nations Conference on Trade and Development (UNCTAD) are committed to improving direct investment data quality worldwide. For example, in December 2005, UNCTAD hosted a 3-day expert meeting in Geneva on direct investment data compilation and policy formulation for developing countries.⁶ In addition, extensive outreach is planned once final decisions are taken on the new *Manual* and the new *Benchmark Definition*. For example, the IMF is organizing training sessions, mostly in economies of the world that are not heavily involved in updating the statistical standards, to explain the new standards and to help countries adopt them. The OECD also is organizing similar meetings and training sessions, both in OECD member and non-member countries. A number of individual countries also are planning to provide technical assistance. For example, BEA has been active in providing technical assistance. Finally, the IMF has proposed conducting a coordinated benchmark survey of direct investment; this survey is discussed below.

Coordinated benchmark survey of direct investment.

The IMF has stated that globalization has been called “the most important force at play in the world economy today” and this has raised demands by policymakers and others for more complete and comparable statistics on foreign direct investment.⁷ These demands have stimulated the IMF to propose leading a coordinated benchmark survey of direct investment for yearend 2009.

⁶ Ralph Kozlow of the Bureau of Economic Analysis chaired this meeting.

⁷ The IMF Managing Director’s Report on the Fund’s Medium-Term Strategy, September 15, 2005.

In the past, the IMF's work involving direct investment statistics at the international level has largely focused on improving methodologies. The purpose of a Coordinated Direct Investment Survey (CDIS) would be to improve coverage and comparability of the data and to create a global database showing the geographic distribution of the stock of direct investment. More specifically, the objectives of a CDIS would be to (i) collect comprehensive and harmonized information, with geographical detail, on the stock of inward and outward direct investment at book valuations, and to (ii) exchange the bilateral data among the participating countries as well as with other countries. Advanced economies would also be encouraged to seek information in their survey collections on the ultimate investing/ultimate host country of direct investment capital channeled through international financial centers. The coordinated survey would likely involve major countries in all regions of the world.

The IMF established a Task Force to advise it on the feasibility of conducting the CDIS and to advise it on measurement issues.⁸ Although the *Manual* and *Benchmark Definition* recommend using market values as the basis for valuation, these manuals recognize that in practice book values from the balance sheets of direct investment enterprises and direct investors are often used to determine the stock of direct investment. The Task Force concluded that it would not be feasible to adopt market price as the sole basis for collecting data on the CDIS. Both advanced and developing economies would have difficulty in uniformly implementing a market price valuation at the partner country level that is needed to permit a meaningful exchange of data among countries. The Task Force thus concluded that book values should be used in a CDIS.

However, the Task Force also concluded that a common definition of book value was required for the purpose of collecting and exchanging bilateral data. Specifically, it concluded that the valuation method must include capital stock, additional paid-in capital, and retained earnings, and must be based on the books of the direct investment enterprise (not those of the direct investor). Also, most types of financial assets and liabilities of the

⁸ The Task Force included representatives from the OECD, Eurostat, the ECB, UNCTAD, the World Bank, and six countries with substantial inward and outward direct investment, including the United States.

direct investment enterprise should be revalued to market values at least annually (the revaluation of non-financial assets such as property, plant, and equipment may be less frequent). Goodwill and other intangible assets may or may not be reflected in the value. Important attributes of the valuation are that it must include cumulative reinvested earnings; must record all (or nearly all) financial instruments in current period prices; and must reflect cumulative depreciation of plant and equipment, including write-downs of impaired or worthless assets. Both U.S. generally accepted accounting principles and the International Accounting Standards followed by most European countries fulfill these requirements, and so book values based on these sets of accounting principles would be acceptable for reporting on a CDIS.

Conclusion.

This paper summarized proposed changes in the international standards for measuring direct investment. The information has mainly been extracted from documents prepared by international organizations such as the IMF and OECD, or by country experts who serve on international committees. As part of the updating process, substantial work has been completed in clarifying and emphasizing core measurement principles, including in measuring direct investment equity at market prices, and in identifying companies that are in a direct investment relationship with one another.

Core data presentations will be changed in fundamental ways, and data will also likely be presented in alternate ways. Core presentations for the international investment position and the international transactions accounts will show assets and liabilities on a gross basis (rather than netted under outward direct investment on the asset side of the accounts, and netted under inward direct investment on the liability side of the accounts). In addition, work is being performed (led by the OECD) on developing alternate data presentations that “look through” holding companies and special purpose enterprises that are used as conduits, to the ultimate source, destination, and use of funds.

It is clear that the work to update the international standards for measuring direct investment has been and continues to be a substantial and complex worldwide undertaking. The update will no doubt be a success due to the devoted and concerted efforts of many countries, institutions, and talented individuals. Data users who require relevant information for policymaking and analytical purposes will be the prime beneficiaries. I am sure that I speak for contributors generally and not just those at BEA when I say that we are very pleased to be a part of this important work.