IMF COMMITTEE ON BALANCE OF PAYMENTS STATISTICS AND OECD WORKSHOP ON INTERNATIONAL INVESTMENT STATISTICS

DIRECT INVESTMENT TECHNICAL EXPERT GROUP (DITEG)

ISSUES PAPER (DITEG) #3

INDIRECT INVESTMENT: DEFINING THE SCOPE OF THE DIRECT INVESTMENT RELATIONSHIP

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Direct investment is the category of international investment that reflects the objective of an entity resident in one economy obtaining a lasting interest in an enterprise resident in another economy. The lasting interest implies the existence of a long-term relationship between the direct investor and the enterprise and a significant degree of influence by the investor on the management of the enterprise.

Direct investment covers the cross-border transactions of entities that are in a direct investment relationship—in other words, direct investment covers the cross-border transactions with the subsidiaries, associates and branches either directly or indirectly owned by a direct investor, as well as the cross-border transactions among the affiliated group of direct investment enterprises.

This paper addresses the possible need to change the present scope of entities that are in a direct investment relationship.

I. Current international standards for the statistical treatment of the issue

The OECD *Benchmark Definition of Foreign Direct Investment (Benchmark Definition)* and the IMF's *Balance of Payments Compilation Guide (BPCG)* describe the scope of both the directly and indirectly owned enterprises that should be included in the direct investment relationship. For convenience this approach is referred to in the *Benchmark Definition* as the Fully Consolidated System (FCS). (See Annex I for a diagram illustrating the scope of the FCS.)

To be considered to be fully applying the FCS, a country should include in its direct investment statistics:

- The earnings data of indirectly owned direct investment enterprises, and
- All cross-border equity capital and other capital transactions within a group of related enterprises, regardless of the percentage of ownership held by the related enterprises in each other.

II. Concerns/shortcomings of the current treatment

- The FCS can result in inclusions in, and exclusions from, the affiliated group[1] that appear to be at variance with the overall 10 percent ownership rule applied for defining a direct investment relationship:
    - The **inclusion** of enterprises in which the direct investor has an indirect ownership of **less** than 10 percent.
    - The **exclusion** of enterprises in which the direct investor has an indirect ownership of **more** that 10 percent.

- The FCS is complex and often difficult to explain to compilers and survey respondents.

- The FCS is very difficult to fully apply, and few countries are able to do so.[2]

III. Possible alternative treatments

There are several alternatives to the FCS, all of which involve limiting the scope of the direct investment relationship to some extent. The options are to include:

- **Directly owned enterprises only, i.e. to exclude all indirectly owned enterprises**
    - This has the advantage of extreme simplicity.
    - However, it would result in reduced coverage of enterprises and hence an understatement of the level of direct investment, as it would exclude not only transactions between the direct investor and indirectly owned enterprises, but also transactions among affiliated enterprises, such as transactions between "sister" subsidiaries.

- **Directly owned enterprises, plus those enterprises in which the direct investor indirectly owns 50 percent or more.**
    - This has the advantage of being significantly less complex than the FCS to fully apply, and is the option (the so-called EU system) favored by the ECB and Eurostat.[3]

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[1] That is, enterprises in a direct investment relationship.

[2] The results of the 2001 Survey of the Implementation of Methodological Standards for Direct Investment (SIMSDI) indicated that only 11 of the 61 countries surveyed did so at that time.

[3] Also referred to in the *Annotated Outline* for the revision of *BPM5* as the 10/50 option.

- The reduction in the coverage of transactions is unlikely to be significant, given that, as acknowledged in *BPM5*, most direct investment enterprises are either branches or subsidiaries that are wholly or majority owned by direct investors.[4]

- **Directly owned enterprises, plus those enterprises in which the direct investor indirectly owns 10 percent or more.**
    - This is the so-called U.S. System used by the United States, as well as Singapore and Switzerland according to the results of the SIMSDI 2001, and has the advantage of being more obviously consistent with the 10 percent rule used for defining direct investment than the FCS.
    - While simpler to apply than the FCS, it may still present practical difficulties in implementation that may not be warranted by the relatively small increase in coverage. (See footnote 4.)

IV. Points for discussion

1. Do DITEG members consider that the Fully Consolidated System (FCS) for defining the scope of direct investment relationships, as described in the OECD Benchmark Definition and the IMF's Balance of Payments Compilation Guide, should be retained without change, even though only a few countries fully apply it at present?

2. Do DITEG members consider that the scope of the direct investment relationship should be limited to transactions involving directly owned enterprises only?

3. If DITEG members consider that the FCS should be replaced with a less complex system of defining the scope of the direct investment relationship involving indirectly owned enterprises, do they favor adoption of:

(a) The 50 percent criterion for indirectly owned enterprises (the ECB/Eurostat option);

or

(b) The 10 percent criterion for indirectly owned enterprises (the so-called U.S. system)?

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[4] For example, Statistics Canada reported that majority-owned subsidiaries and branches accounted for 93 percent of Canada's stocks of inward FDI, and 94 percent of outward FDI in 2001. The 1992 IMF *Report on the Measurement of International Capital Flows (Godeaux Report)* reported similar ratios for several industrial countries, and noted that "equity holdings in the range go 10 to 20 or 25 percent accounted for only 1 or 2 percent of the stock of direct investment."

References

Balance of Payments Manual, fifth edition (*BPM5),* IMF, 1993.
Paragraphs 359 and 362 regarding the inclusion of both directly and indirectly owned enterprises, and of transactions among affiliated enterprises.

Balance of Payments Compilation Guide, IMF, 1995.
Paragraphs 685-688 on defining the direct investment relationship and the scope of that relationship.

Benchmark Definition of Foreign Direct Investment (Benchmark Definition), third edition, OECD, 1996
Paragraphs 14-19 for a description of the Fully Consolidated System (FCS).
Annex I for tables comparing the balance of payments estimates of direct investment earnings and investment of three alternative systems: the FCS, the U.S. system, and the "unconsolidated system" (i.e. transactions with directly owned enterprises only.)

Foreign Direct Investment Statistics: How Countries Measure FDI, 2001. IMF and OECD. 2003
Paragraphs 4.12-4.16: Treatment of Indirectly Owned Direct Investment Enterprises
Appendix I, Tables 19 and 20: cross-country comparisons of the treatment of indirectly owned direct investment enterprises.
Appendix II: Foreign Direct Investment Terms and Definitions, description of the Fully Consolidated System

Annotated Outline for the Revision of BPM5, IMF, April 2004
Chapter 5, Section B.1, paragraphs 5.16 and 5.17 on defining the direct investment relationship and the scope of that relationship.

Foreign Direct Investment Task Force Report, ECB and Eurostat, March 2004
Chapter 1, Conceptual Issues Related to the Fully Consolidated System and the Coverage of Indirect FDI Relationships, and Chapter 2, Practical Aspects Related to the Coverage of Indirect FDI Relationships. (Available also as a PDF file on the ECB website at http://www.ecb.int/pub/pdf/foreigndirectinvestment200403en.pdf)

ANNEX I

DESCRIPTION OF THE FULLY CONSOLIDATED SYSTEM

BPM5 and the OECD *Benchmark Definition of Foreign Direct Investment (Benchmark Definition)* state that inward and outward direct investment statistics should, as a matter of principle, cover all directly and indirectly owned subsidiaries, associates, and branches. *BPM5* and the OECD *Benchmark Definition* recommend the following definition of these enterprises:

a) Subsidiary companies

Company X is a subsidiary of enterprise N if, and only if

i) enterprise N either

1. is a shareholder in or member of X and has the right to appoint or remove a majority of the members of X's administrative, management or supervisory body; or

2. owns more than half of the shareholders' or members' voting power in X; or

ii) company X is a subsidiary of any other company Y which is a subsidiary of N.

b) Associate companies

Company R is an associate of enterprise N if N, its subsidiaries and its other associated enterprises own not more than 50 per cent of the shareholders' or members' voting power in R and if N and its subsidiaries have a direct investment interest in R. Thus company R is an associate of N if N and its subsidiaries own between 10 and 50 per cent of the shareholders' voting power in R.

c) Branches

A direct investment branch is an unincorporated enterprise in the host country that:

i) is a permanent establishment or office of a foreign direct investor; or

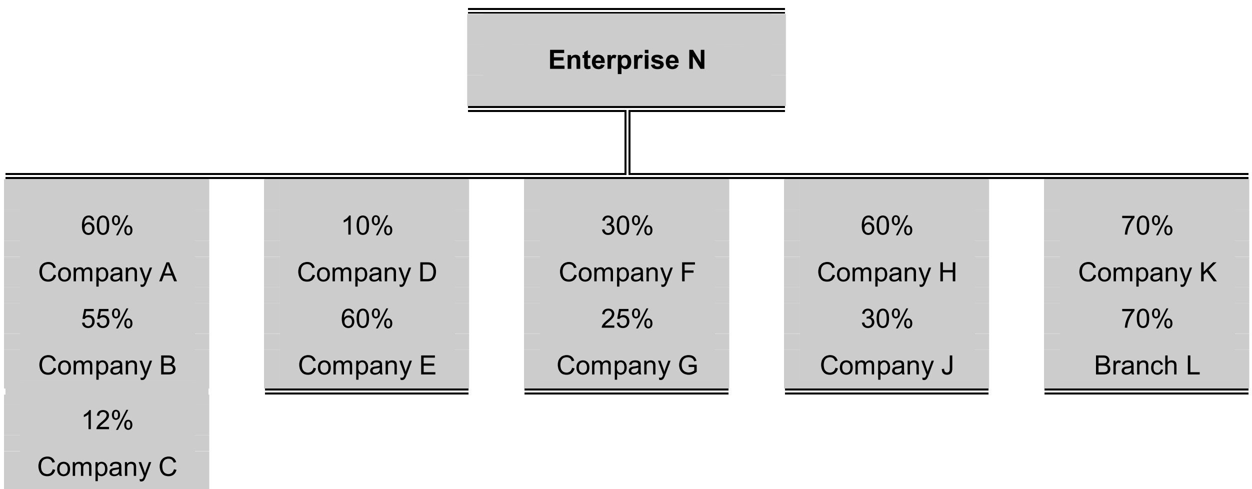
ii) is an unincorporated partnership or joint venture between a foreign direct investor and third parties; or

iii) is land, structures (except those structures owned by foreign government entities), and immovable equipment and objects, in the host country, that are directly owned by a foreign resident. Holiday and second homes owned by non-residents are therefore regarded as part of direct investment; or

iv) is mobile equipment (such as ships, aircraft, gas and oil drilling rigs) that operates within an economy for at least one year if accounted for separately by the operator and is so recognised by the tax authorities. This is considered to be direct investment in a notional enterprise in the host country.

Statistics based on those definitions should, as a matter of principle, cover all enterprises in which the direct investor has directly or indirectly a direct investment interest. For convenience, this approach is referred to below as the Fully Consolidated System. To illustrate the above definitions, assume enterprise N has the following investments:

Figure 1



Under the Fully Consolidated System, Company A is a subsidiary of N. Company B is a subsidiary of A and thus a subsidiary of N even though only 33 per cent of B is indirectly attributable to N. Company C is an associate of B and, through the chain of subsidiaries A and B, of N as well, even though only 4 per cent of C is indirectly attributable to N. Company D is an associate of N, Company E is a subsidiary of D and thus an associate of N even though only 6 per cent of E is indirectly attributable to N. Company F is an associate of N and G is an associate of F, but G is not an associate of N. Company H is a subsidiary of N and Company J is an associate of H and thus an associate of N. Company K is a subsidiary of N and L is a branch of K and thus of N. Thus direct investment statistics based on the Fully Consolidated System would cover A, B, C, D, E, F, H, J, K and L. However, Company G would not be covered.