

**Eighteenth Meeting of the
IMF Committee on Balance of Payments Statistics
Washington, D.C., June 27–July 1, 2005**

Round Tripping

DIRECT INVESTMENT TECHNICAL EXPERT GROUP (DITEG)

OUTCOME PAPER (DITEG) #13

December 23, 2004

1. **Topic:** Round Tripping
2. **Issues:** See DITEG Issue Paper #13 by Hong Kong, China
3. **Recommendations:**
 - (i) The group expressed a high level of interest in the concept of round tripping and agreed that it is an interesting dimension of FDI.
 - (ii) The group expressed some concerns about the methodology presently being used by Hong Kong China, as well as concerns about the difficulty of effectively identifying and covering all round tripping FDI flows. It also recognized the need for more work to be done on developing the methodology and concepts.
 - (iii) The group agreed that it would be useful to extend the analysis of round tripping to cover additional situations, such as where the two ends of the chain of round tripping flows are not in the same country but rather in the same geographical region or economic zone.
 - (iv) The group recognized that many of the issues discussed under round tripping are connected to other FDI conceptual issues, such as Ultimate Beneficial Owners (UBOs), and that it would be necessary to consider these issues in a coherent manner in the new standards.
 - (v) The group agreed that, if it is decided that data on round tripping is to be included in the balance of payments (BOP)/international investment position (IIP) framework in the new manual, the data should be treated as supplemental BOP/IIP presentations rather than as mandatory, standard components.
4. **Rejected Alternatives:**

None.
5. **Questions for the IMF Committee on Balance of Payments (the Committee) and the OECD Workshop in International Investment Statistics (WIIS)**
 - (i) Do the Committee and the WIIS consider that data on round tripping should be included in the framework of the BOP/IIP statistics at this stage, given the experimental nature of the data?
 - (ii) If the answer to (i) is “Yes”, do the Committee and the WIIS consider that any presentation of data on round tripping in the BOP/IIP statistics should be supplemental rather than a standard or mandatory reporting requirement?

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

DIRECT INVESTMENT TECHNICAL EXPERT GROUP (DITEG)

ISSUES PAPER (DITEG) # 13

ROUND TRIPPING

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September 2004

DIRECT INVESTMENT TECHNICAL EXPERT GROUP

ISSUES PAPER (DITEG) #13: ROUND TRIPPING

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

1. The term “round tripping” is not explicitly discussed in the *BPM5* and OECD *Benchmark Definition of Foreign Direct Investment (Benchmark Definition)*. It is defined in the *Annotated Outline (AO)* for the revision of *BPM5* as the channelling by direct investors of local funds to SPEs abroad and the subsequent return of the funds to the local economy in the form of direct investment.

2. Para. 365 of the *BPM5* and para. 39 of the *Benchmark Definition* state that SPEs be included as direct investment enterprises if they meet the criteria of direct investment, except for SPEs with a sole purpose of serving in a financial intermediary capacity. Although SPEs, typically set up in offshore financial centres or tax haven economies, may have different structures or purposes, they are an integral part of the structure of the direct investment network. As such, round tripping funds flowed within the direct investment network are currently recorded as FDI transactions on a gross basis, i.e. as direct investment abroad for the local funds channelled to SPEs abroad, and as direct investment in the reporting economy for the subsequent return of the funds to the local economy.

II. Concerns/shortcomings of the current treatment

3. FDI inflow to some economies has increased significantly in the past several years. A share of the total FDI inflow to these economies⁽¹⁾ is expected to be of the nature of round tripping funds, given that in those economies, investment incentives are available to foreign investors but not domestic ones. In addition to tax and fiscal advantages that are provided to foreign investors, there are other incentives for round tripping, such as safety and risk management of capital, accessing better financial services, etc. Some elaborations on these incentives are given below:

(a) Tax and fiscal advantages

Some economies provide preferential policies to attract foreign direct investment, including low taxation, favourable land use rights, convenient administrative support, etc. Since it is not always easy for local enterprises to find foreign investors who are willing to invest in them, they may firstly channel capital abroad which is then disguised as foreign capital for local investment to take advantage of the preferential treatments only available to foreign investors.

(1) For instance, 40% of total FDI inflow to Hong Kong between 1998 and 2002 was related to round tripping.

(b) Property right protection

Infrastructure for property right protection in some economies is not well established. Therefore, the enterprises in these economies may have the motivation to park their wealth in affiliated enterprises set up in overseas economies having better legal and institutional settings for property right protection. Besides, some investors may prefer to keep their identities anonymous by investing through companies set up in offshore financial centres. Capital will then be brought back to the host economies in the form of FDI if there are profitable investment opportunities.

(c) Expectations on exchange control and exchange rate

Some economies have control on capital account and exchange rate. Expectations on changes in exchange control and exchange rate may generate round tripping for larger flexibility in foreign exchange management.

(d) Accessing better financial services

Financial markets of some economies are not well developed. Enterprises of these economies have to access overseas financial markets for obtaining better financial services, such as listing of companies in overseas stock markets. The funds raised will be brought back to the host economies in the form of FDI. Round tripping may occur as part of this process.

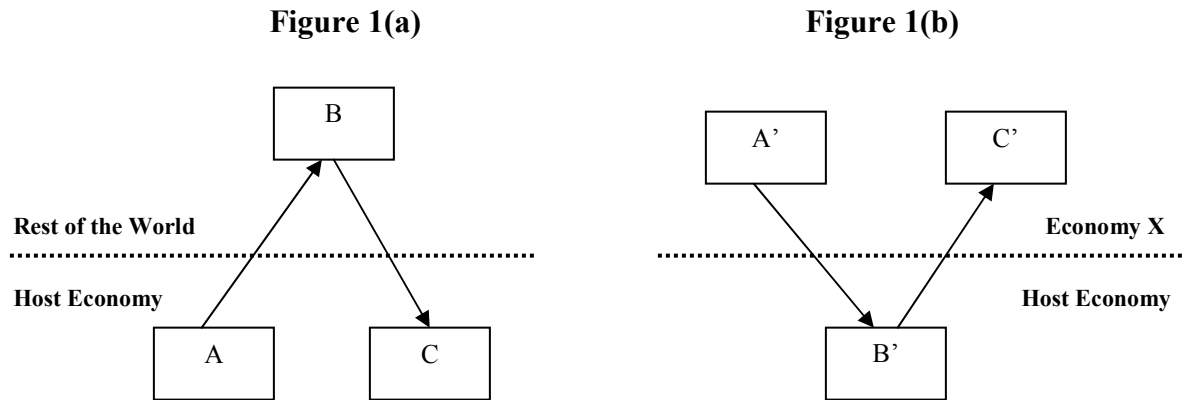
4. Although the current treatment of recording of round tripping funds under FDI is in conformity with recommendations of the *BPM5* and *Benchmark Definition*, some argue that these round tripping funds lead to an overstatement of the true magnitude of FDI. In order to better reflect the ability of these economies to attract FDI other than round tripping, and to enhance international comparability, it is useful to compile a supplementary set of FDI statistics that excludes round tripping funds.

5. While a general description of round tripping activity is given in the *AO*, more specific guidelines are needed in the next BoP manual for both compilers and users to better understand the activity, given that it is often difficult to follow closely the intricate enterprise structure of direct investment network and the funds flowing within the network.

6. From the perspective of the host economy, the following two types of FDI flows are considered as round tripping:

(a) domestic investment disguised as foreign investment through non-resident SPE, e.g. in Figure 1(a), Company A in the host economy provides FDI funds to a non-resident SPE (Company B) for investing back in Company C in the host economy.

(b) channelling of FDI funds through local SPE, e.g. in Figure 1(b), Company A' in economy X channels FDI funds to Company C' in the same economy through a SPE in the host economy (Company B').



7. Since this round tripping of capital funds usually have little economic significance to the host economy, it is useful to exclude them for the purpose of compiling a supplementary set of FDI statistics for the host economy to better reflect its ability in attracting FDI.

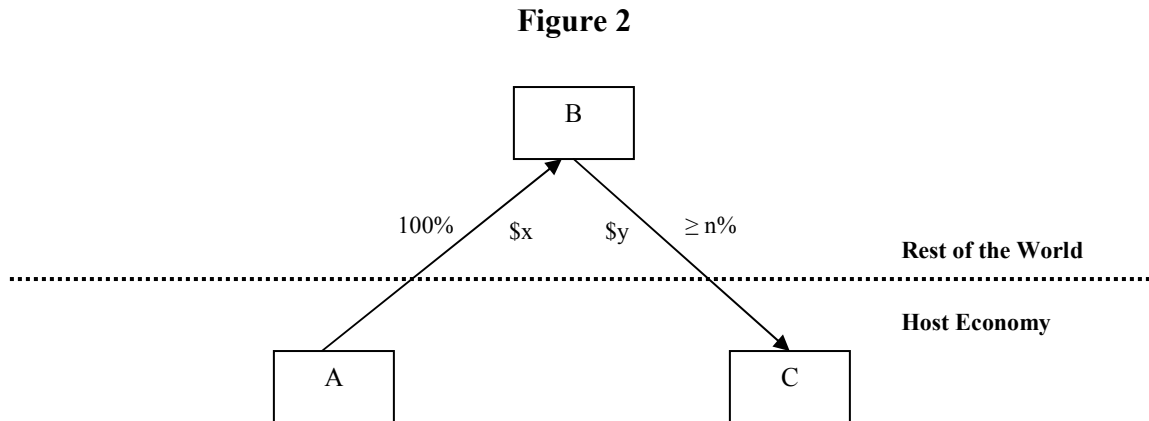
8. To compile the supplementary set of FDI statistics for the host economy, one basic approach is to identify and ascertain the true round tripping nature of FDI funds received from and provided by companies in the host economy. For instance, in case of Figure 1(a), Company C can be asked to confirm whether the FDI funds received from Company B are in fact local funds provided by another company in the host economy, i.e. Company A. Moreover, Company A can be asked to confirm whether the FDI funds provided to Company B would be, and at what time, channelled back to another company in the host economy, i.e. Company C. For the case of Figure 1(b), Company B' can be asked to confirm whether the FDI funds received from Company A' in economy X would be, and at what time, channelled back to Company C' in economy X.

9. Nevertheless, it is difficult to ascertain the true nature of round tripping funds simply by surveying the companies. Because of the inherent underlying incentives for round tripping (e.g. to disguise the capital flows for taking advantage of preferential treatments only available to foreign investors), some companies actually involved in round tripping activities may not be willing to disclose the true nature of FDI flows. For the type of round tripping shown in Figure 1(b), there may be an additional difficulty in trying to contact and obtain information from Company B' since it is a SPE (e.g. a brass-plate company).

III. Possible alternative treatments

10. To overcome the inherent difficulties of directly obtaining comprehensive information from companies on the true round tripping nature of FDI funds, compilers can consider identifying some recognisable structures of direct investment groups to assist in the compilation of round tripping statistics. Since it may be difficult to follow closely a complicated group structure and the funds flowing within the group, focus of the survey work could firstly be placed on those relatively simple group structures that are seen to be conducive to round tripping. For most economies, this approach would end up capturing most

of the round tripping flows, while enhancing the effectiveness of the survey apparatus as the main tool for data collection. An example of a simple group structure that is conducive to round tripping is shown in Figure 2.



Remark: n% is the threshold signifying a direct investment relationship.

11. In Figure 2, Companies A, B and C are members of a direct investment group, where Companies A and C are residents of the same host economy, and Company B is a non-resident SPE. This simple group structure will be conducive to round tripping if the following two conditions are met:

- (a) Company B is wholly-owned by Company A (i.e. the 100% arrow shown in the diagram); and
- (b) Company B does not own any company other than Company C.

12. Under this simple structure of direct investment group, it is likely that FDI funds received by Company C from Company B are in fact provided by Company A, i.e. round tripping. The two conditions given above preclude the possibility that the funds received by Company C are in fact provided by other direct investors or direct investment enterprises of Company B.

13. Of course, it is possible for Company B to borrow funds from unaffiliated companies and channel the funds to Company C in the form of FDI. It is therefore essential to find out from Company C about the source of FDI funds provided by Company B, i.e. whether the funds come from Company A, or are borrowed from other companies. For the purpose of compiling round tripping statistics, in the event that Company C fails to further clarify and ascertain the nature and source of FDI funds provided by Company B, given the structure of this direct investment group, it can be imputed that the funds are actually provided by Company A, i.e. round tripping.

Time of recording

14. In Figure 2, it is obvious that Company A may provide capital funds to Company B at a time different from that when the funds are channelled back from Company B to Company C. At the time when funds flow out from Company A to the SPE abroad, one cannot be certain that they will actually flow back to the host economy, notwithstanding the obvious intention behind and the likelihood. It is therefore reasonable to consider these funds as round tripping funds only when they actually flow back to the host economy. Only at the time when this round tripping nature of the funds is ascertained, both outflow and inflow of round tripping funds can be recorded (i.e. at the time when the funds flow back to the host economy).

15. If the flows of funds in opposite directions (outflow and inflow) in a round tripping activity take place in two different reference periods, say the outflow occurs in period $t - 1$ and the inflow of the same amount occurs in period t , an outflow will need to be imputed and recorded together with the inflow in period t , given the rule of recording stated above.

16. There is a major limitation for this rule of recording. In compiling the supplementary set of FDI statistics that excludes round tripping funds, it is possible that, for a given reference period, the total FDI outflow to a particular economy is smaller than the imputed outflow of round tripping funds to that economy, giving a negative FDI outflow to that economy after excluding round tripping funds. This will be difficult to interpret. Selecting a longer reference period (e.g. one year) and adopting a broader geographical breakdown (e.g. a region) will reduce the chance of recording such a negative outflow of FDI other than round tripping.

Treatment of different flows in opposite directions

17. The definition of round tripping implies that the total sizes of the flows of funds in opposite directions (outflow and then inflow) in round tripping should be identical. In practice, for a given reference period, it is possible that they are different.

18. For the case shown in Figure 2, the outflow of $\$x$ may be greater than, equal to, or even smaller than the inflow of $\$y$ for a reference period. Since funds flowing out to the SPE abroad will only be considered as round tripping funds when they actually flow back to the host economy, $\$y$ should be taken as the size of the recorded round tripping funds in both directions. Even if $\$x$ is greater than $\$y$, only $\$y$ will be recorded as round tripping in the reference period, and the residual (i.e. $\$x - \y) would be taken as returning to the host economy in a later period. On the other hand, if $\$x$ is smaller than $\$y$, the gap (i.e. $\$y - \x) would be taken as having been provided to Company B by Company A in an earlier period.

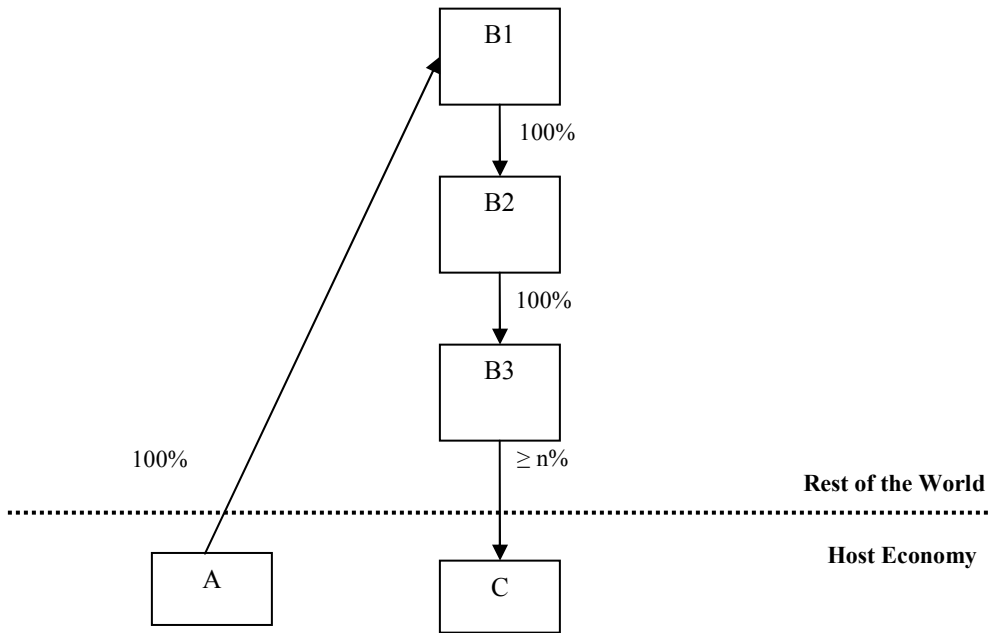
Direct investment components of round tripping funds

19. Round tripping funds may cover any components of direct investment capital, namely, equity capital, reinvested earning, or other capital. It is possible that the components of direct investment capital are different for the opposite flows in round tripping. For instance, Company A may provide other capital to Company B which in turn uses the funds to increase its holdings of equity capital of Company C.

Other structures of direct investment groups conducive to round tripping

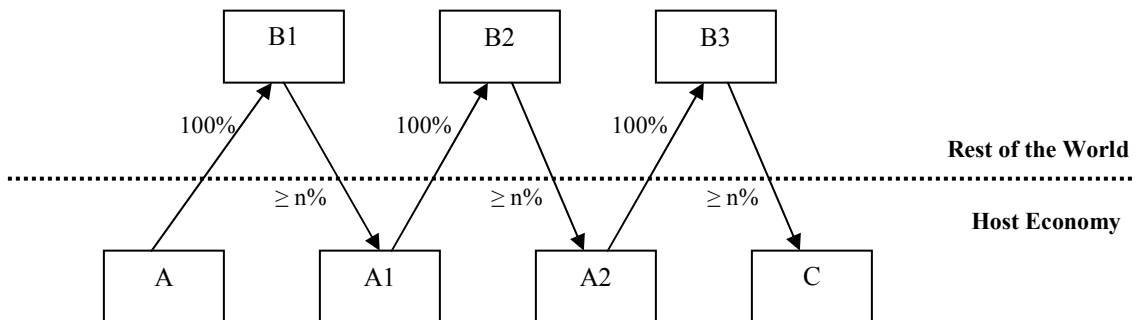
20. The simple group structure shown in Figure 2 can be easily extended to cover other more complicated group structures that are conducive to round tripping and are useful for identifying potential round tripping activities in survey work for the purpose of compiling round tripping statistics. Two examples of these structures are given in Figures 3 and 4 below.

Figure 3



Remark: n% is the threshold signifying a direct investment relationship.

Figure 4



Remark: n% is the threshold signifying a direct investment relationship.

21. In survey work, for a structure of direct investment group to be seen as conducive to round tripping (such as that shown in Figure 3 or 4), the ownership structure of the group should be set up in a way that preclude the possibility that funds received by Company C are in fact provided by other direct investors or direct investment enterprises of Company B3. For the purpose of compiling round tripping statistics, in the event that Company C fails to further clarify and ascertain the nature and source of FDI funds provided by Company B3, it can still be imputed that the funds are actually provided by Company A, i.e. round tripping.

IV. Points for discussion

- (1) *Should both types of round tripping (i.e. domestic investment disguised as foreign investment through non-resident SPEs, and channelling of FDI funds through local SPEs) be excluded in compiling the supplementary set of FDI statistics for the host economy?*
- (2) *In compiling the supplementary statistics of FDI other than round tripping, should survey work be focused only on those structures of direct investment groups that are seen to be conducive to round tripping, given that it is difficult to directly obtain from most companies comprehensive information on the true round tripping nature of FDI funds?*
- (3) *Is the suggested rule of recording for round tripping funds appropriate? Is there any method to overcome the limitation of the possibility of recording negative FDI outflow to an economy after excluding round tripping?*
- (4) *Should round tripping funds cover all components of direct investment capital? Is it appropriate to allow the recording of different components of direct investment capital for the opposite FDI flows (outflow and inflow) in round tripping?*
- (5) *Are there other structures of direct investment groups that are also seen to be conducive to round tripping?*

References

Balance of Payment Manual, fifth edition, IMF, 1993

Benchmark Definition of Foreign Direct Investment, third edition, OECD, 1996

Annotated Outline for the Revision of BPM5, IMF, April 2004