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DIRECT INVESTMENT TECHNICAL EXPERT GROUP (DITEG)

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FDI - OTHER CAPITAL

(WITH FOCUS ON SHORT-TERM)

Prepared by Balance of Payments and Financial Accounts Department
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Introduction

Due to the liberalisation of the capital and money markets, multinational enterprises are nowadays much more involved in funding activities than 10 years ago. More and more, so-called in-house banks perform the activities of banks for the entire group, such as raising funds and transfer money to all group entities.

One of the objectives of in-house banking is “liquidity efficiency”: funds are transferred between group entities as efficient as possible in order to create the highest return on the funds raised. In addition, in-house banks are involved in cash management/pooling such as netting arrangements in which all intra-group accounts are netted everyday amongst the group entities. Other typical short-term intercompany banking transactions are call loans, zero balancing and overnight deposits.

The channelling of money through the company has led to an increase of the other capital component of Foreign Direct Investment (FDI), both on a gross and net basis, especially in the form of short-term capital (loans and intra-group accounts) which can give users a distorted picture of the actual FDI. The question can be raised whether all these transactions (or positions) are real FDI? Do these flows/positions have a ‘FDI character’, i.e. related to lasting interest and/or the company’s strategy? More in general, should **all** transactions/positions between companies in a FDI relationship be included in FDI?

This issue paper explores these questions and goes back to the fundamental question: *what should FDI measure?*

1. Current treatment

According to BPM5, the Benchmark Definition and the Annotated Outline, **all** transactions within a FDI relationship should be classified under FDI once the FDI relationship has been established. All transactions not concerning equity capital or reinvested earnings should be treated as ‘other capital’ (except for certain transactions involving affiliated banks, affiliated financial intermediaries and SPEs which serve as a financial intermediary, see issue papers #9 and #11).

For instance, BPM 5, §370 states: **‘**Other direct investment capital (or intercompany debt transactions) covers the borrowing and lending of funds—including debt securities and suppliers’ credits— between direct investors and subsidiaries, branches, and associates. The borrowing and lending are reflected in intercompany claims and liabilities (receivables and payables), respectively. Both loans to subsidiaries from direct investors and loans from subsidiaries to direct investors are included. In contrast to the treatment of *other investment*, no distinction is made between short- and long-term investment.[1]'

In addition, the 'OECD recommends that short-term loans and trade credit be included as there is often no clear distinction between short-term finance such as a loan repayable on demand but never repaid and long-term finance.' (Benchmark, §23)

2. Concerns/shortcomings of the current treatment

The current treatment does not give any insight in the different types of other capital FDI. Because the current figures may mislead users and may give a distorted picture of FDI, it is important to give users insight in the other capital transactions and positions: what is 'real' FDI and what is part of the in-house banking activities of the company? Should the flows[2] of in-house banks be included in FDI or should the flows be included in Other Investment? Are the activities of in-house banks FDI or not?

The main question is whether all transactions in 'other capital' have a FDI character. An example: All intra-group accounts of group entities with the parent company are 'pooled' on a daily basis by the bank. The next day, the money is being transferred back to the intra-group accounts. This process is known as *cash pooling*. A result of these daily flows is that the gross figures of intra-group accounts can change dramatically on a monthly basis. Although these flows are booked in FDI due to their intercompany nature, these flows may be considered as non-FDI as it lacks a real (lasting) investment character.

A similar argument holds for short-term loans or overnight deposits. These loans and deposits blow up both the monthly gross and net figures. The net balance of these flows is dependent on the amount outstanding at the end of the month. For example, suppose that the net balance of short term loans is EUR + 1 bn end-January and EUR – 0.5 bn end-February. Does this decreased balance lead to less *real* FDI in a particular country in February than in January, when on 1 March the balance may be EUR + 0.3 bn?

In general, do short-term transactions such as short-term loans and overnight deposits have a lasting interest character and/or do they relate to the company's strategy? In our opinion, the answer to this question is 'no'. The FDI nature of long-term intercompany debt is more evident than short-term intercompany debt because long-term intercompany debt is more often real, actual investment in the subsidiary (or associate) and therefore more 'lasting' and strategy-related. However, sometimes long-term loans are routed through a specific country by a so-called Special Purpose Entity (SPE). In that case, one can seriously question the 'real' nature of the investment.

[1] According to the ESA (5.22), long-term investment is investment with an original maturity of > 1 year and short-term investment is investment with an original maturity ≤ 1 year.

[2] 'flows' or 'transactions' may also be read as 'positions'/'stocks'

Alongside, the question can be raised whether transactions involving SPEs should be included in FDI – both transactions in equity and other capital[3]. Should funding and on-lending activities be included in FDI? In general, are these types of activities FDI? Can a company distinguish between transactions that should and should not be included in FDI? Certain transactions of resident MFIs and OFIs with non-resident MFIs or OFIs should already be reported as Other Investment and not as FDI.

Economically speaking, transactions of SPEs give a misleading picture of the FDI figures of a country because these transactions have no influence on the economy in which the SPE is a resident. These types of transactions blow up the FDI figures even though there is no investment made in the economy involved.

To illustrate the influence of other capital on the gross and net flows, please refer to Table 1 below. To highlight one year: of total FDI outward gross outflows in 2003, 85% is other capital. For inflows, the share of other capital in FDI is even higher: 91%. For FDI inward, the percentages are as follows: 90% for inflows and 95% for outflows.

Table 1 Influence of FDI other capital on gross and net FDI flows (EUR billions)

FDI OUTWARD	***1994***	***1995***	***1996***	***1997***	***1998***	***1999***	***2000***	***2001***	***2002***	***2003***
Other capital outward										
Outflows	213	188	264	304	354	442	1.033	1.673	1.230	1.014
Inflows	203	187	257	290	340	375	951	1.624	1.186	987
Total other capital outward	-9	-1	-7	-14	-14	-67	-82	-49	-44	-27
Total FDI outward										
Outflows	240	221	298	356	428	533	1.201	1.932	1.395	1.193
Inflows	218	198	270	318	366	418	1.012	1.725	1.254	1.085
Total FDI outward	-22	-23	-28	-38	-62	-115	-189	-207	-140	-108
FDI INWARD	***1994***	***1995***	***1996***	***1997***	***1998***	***1999***	***2000***	***2001***	***2002***	***2003***
Other capital inward										
Inflows	18	20	17	19	34	67	102	117	130	659
Outflows	14	12	14	19	21	48	63	70	98	624
Total other capital inward	4	8	3	0	13	19	39	47	32	35
Total FDI inward										
Inflows	33	38	37	51	92	120	232	300	294	732
Outflows	18	20	19	23	43	62	87	118	210	657
Total FDI inward	15	18	18	28	49	59	145	182	84	75

Source: Balance of Payments of the Netherlands

[3] This question is also raised in issue paper #11 and will therefore be discussed briefly in this paper.

In Table 2, the 2003 figures are divided into long-term (> 1 year) and short-term (≤ 1 year) FDI-other capital to illustrate the impact on the FDI figures of both categories. The table shows that about 70% of the gross flows is short-term.

Table 2 Division between short-term and long-term FDI other capital (EUR billions)

OUTWARD					**INWARD**			
	Outflows	***Inflows***	***Total outward***			***Outflows***	***Inflows***	***Total inward***
Long-term other capital	-262	226	-36		Long-term other capital	-178	213	35
Short-term other capital	-752	761	9		Short-term other capital	-446	446	0
Total	*-1.014*	*987*	*-27*		*Total*	*-624*	*659*	*35*

Source: Balance of Payments of the Netherlands

3. Possible alternative treatments

It is recognized that not all countries have problems with large amounts of short-term flows, though countries with large multinationals and a large amount of SPEs and OFIs often do. There are some possible treatments for the treatment of FDI short-term other capital which attempt to deal with the overstatement of short-term other capital. Some possible treatments of intercompany debt:

1. To retain all flows within FDI with no separation between short-term and long-term flows (current practice).
2. To retain all flows within FDI with a separation of short-term and long-term flows. The AO also gives consideration to this treatment in paragraph 5.28[4]; however, this is only limited to debt instruments.
3. All short-term other capital transactions should be included in Other Investment (if needed, including an "of which" category for transactions between affiliated enterprises) whereas long-term transactions would remain in FDI-other capital.
4. All FDI-other capital transactions, whether long-term or short-term should be included in Other Investment, including an "of which" category for transactions between affiliated enterprises, so FDI according to the current definition is still identifiable.

[4] AO, paragraph 5.28: 'Consideration will be given to breaking down "debt instruments" into long term and short term, in view of interest in assessing potential vulnerability associated with direct investment. However, the limitations could be noted, as in BPM5 para. 339.' Paragraph 339 of BPM states: 'In the categories of direct investment, portfolio investment, and reserve assets, long- and short-term investment are not formally distinguished. For direct investment, such a distinction is not made because it is essentially determined by arbitrary enterprise decisions and because of the fact that there is no meaningful analytic distinction between the two maturities for intercompany flows.'

5. Only direct lending and borrowing between a parent company and its subsidiaries or associates should be included in FDI. Indirect intercompany lending and borrowing (for instance, between sister companies) would then be included in Other Investment.

All alternative treatments, including their advantages and disadvantages, are given in the next table:

Table 3 All alternative treatments to deal with FDI other capital

	Long-term FDI other capital	***Short-term FDI other capital***	***Split?***	***Advantages***	***Disadvantages***
1	FDI – other capital	FDI – other capital	No	- No change to the current treatment	- Analytical problem other capital: the overstatement of both gross and net short-term flows is accepted
2	FDI – other capital	FDI – other capital	Yes, between long-term and short-term FDI	- Differentiation between short-term and long-term gives insight in type of transaction or position. Therefore the AO also considers this option but only for debt instruments.	- Higher reporting burden - Compilation of back data
3	In FDI – other capital	In Other Investment – other investment, short-term	Possibly in Other Investment - an "of which" category for transactions/ positions between affiliated enterprises	- No disturbance in FDI, clearer view on short-term capital - The counterparty of the transactions or positions is not important for classification of other capital short-term flows/stocks - Users could still re-build back series if the "of which" category were to be considered	- Higher reporting burden - Compilation of back data (if no additional split were to be approved)

	Long-term FDI other capital	***Short-term FDI other capital***	***Split?***	***Advantages***	***Disadvantages***
4	In Other Investment – other investment, long-term	In Other Investment – other investment, short-term	Possibly within Other Investment - an "of which" category for transactions/ positions between affiliated enterprises	- No disturbance in FDI - The counterparty of the transactions is not important anymore for classification for all other capital flows/ stocks - Users could still re-build back series if the "of which" category were to be considered	- FDI will decrease immensely - FDI is only limited to equity capital - Compilation of back data (if no additional split were to be approved)
5	In FDI only when it involves flows/ stocks between a parent and subsidiary or associate (**direct**)	In FDI only when it involves flows/ stocks between a parent and subsidiary or associate (**direct**)	No	- No disturbance in FDI by financial vehicles' activities (such as conduits) because most lending and borrowing involves **indirect** relations and these will be excluded from FDI - Relates to the application of the directional principle as described in BPM5 which also involves direct links only	- Does not fit the treatment of FDI-equity capital which involves all FDI entities, direct and indirect - The counterparty of the flows/positions is important for classification of other capital flows/stocks. This counterparty may be unknown

<u>Two marginal notes on both possible treatments 3 and 4</u>:

- Some companies fund their branches through intra-group accounts (short-term capital). Once the branch is fully operational, the branch is transformed into a legal entity and the intra-group account is being converted into equity capital. Thus, the short-term transaction in the form of an intra-group account is eventually being transformed in real FDI.
- Roll-over loans will be included in Other Investment as well.

<u>A marginal note on possible treatment 5</u>:

- This treatment attempts to exclude transactions involving SPEs which do not function as holding companies (such as conduits) and should be read in relation with issue paper #11 on financial SPEs.

4. Points for discussion

(i) *Do DITEG members think that short-term transactions such as cash pooling, overnight deposits, etc have a character of a lasting interest and/or are related to the company's strategy?*

(ii) *Do DITEG members think that the flows of in-house banks should be included in FDI or that the flows should be included in Other Investment? More in general, are the activities of in-house banks FDI or not?*

(iii) *Do DITEG members think that funding and on-lending activities by SPEs and OFIs should be included in FDI? Are such transactions by these companies FDI? Can a certain type of company distinguish between different types of short-term or long-term transactions?*

(iv) *Do DITEG members agree that, in light of the first point for discussion, intercompany short-term transactions should not be included in FDI?*

(v) *Which option proposed in table 3 has the preference of the DITEG members and why? Should a different treatment be selected for different types of capital (short/long-term), i.e. solution 3 suggested in the paper?*

References

IMF Balance of Payments Manual (1995), paragraphs 330 and 370

IMF Annotated Outline (2004), paragraph 5.28

OECD Benchmark Definition (1996), paragraph 23

European System of Accounts (1995), paragraph 5.22