IMF Committee on Balance of Payments Statistics and OECD Workshop on International Investment Statistics

DIRECT INVESTMENT TECHNICAL EXPERT GROUP

Issue Papers 7 & 8
Directional Principle and Reverse Investment

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Introduction

1. The existing international guidelines for differentiating between direct and portfolio investment, and between direct investment assets and liabilities, have generated interest and discussion. Situations that are being discussed by DITEG include those (a) where there is reverse equity investment, or reverse equity and debt investment, by the direct investment enterprise (DIE) in its direct investor (DI), (b) where there is equity and/or debt investment between siblings (i.e., companies that are both owned by another company, located in a third country), and (c) where there is equity and/or debt investment between grandparents and grandchildren.
2. In addition, changes in the presentation of data on reverse investment are being discussed. In an issue paper on DITEG issues 7 & 8 presented at the June 2004 DITEG meeting (Reverse Investment and Directional Principle, by the IMF Statistics Department), a potential new presentation scheme for reverse investment was explained, which was to more strictly follow an asset/liability presentation instead of netting assets and liabilities under direct investment classifications.
3. My paper touches on both of the above areas. It first discusses conceptual issues regarding what reverse positions should be included in direct investment. It then proposes an alternate presentation.
4. More specifically, the presentation scheme explained in the earlier DITEG paper works best if the following two assumptions hold true. The first assumption is that existing international standards regarding what constitutes direct investment equity (as opposed to portfolio investment equity) is maintained, and the second assumption is that data are of sufficient "density" that the new presentation scheme is workable by a substantial majority of countries. In this paper, I question each of these assumptions. I conclude with a proposal to classify reverse equity investment of less than 10 percent in a direct investor in portfolio investment instead of in direct investment, for both conceptual and practical reasons.
5. For clarity, two cases are briefly separately discussed below – (a) where the DIE owns 10 percent or more of the equity of the DI, and (b) the case where the DIE owns more than zero but less than 10 percent of the equity of the DI.

Discussion

6. The tables from the June 2004 DITEG paper that illustrate an alternative presentation scheme are reproduced below, with rows labeled for ease of reference:

Balance of Payments *

Net changes in assets arising from transactions	*Net changes in liabilities arising from transactions*
Direct investment	**Direct investment**
A1 Abroad	L1 In reporting economy
A2 Equity finance**	L2 Equity finance**
A3 Debt	L3 Debt
A4 In reporting economy (claims on direct investors)	L4 Abroad (liabilities to direct investment enterprises)
A5 Equity finance**	L5 Equity finance**
A6 Debt	L6 Debt

International Investment Position*

Assets	*Liabilities*
Direct investment	**Direct investment**
A1 Abroad	L1 In reporting economy
A2 Equity finance**	L2 Equity finance**
A3 Debt	L3 Debt
A4 In reporting economy (claims on direct investors)	L4 Abroad (liabilities to direct investment enterprises)
A5 Equity finance**	L5 Equity finance**
A6 Debt	L6 Debt

* The table labeled Balance of Payments corresponds to table 3, and the table labeled International Investment Position corresponds to table 4, of the IMF's June 2004 DITEG issue paper, on issues 7 and 8.
** Using terms in *BPM5*, "equity finance" is equivalent to equity capital and reinvested earnings.

7. **Case where the DIE owns 10 percent or more of the equity of the DI**
    a. In this circumstance, the existing international standards (which are not challenged in the June DITEG paper) state that there is a second direct investment relationship. Under these standards, each relationship would be recorded on a gross basis under the asset/liability principle.
    b. Under the existing standards and the June presentation scheme, entries will appear on rows A2 and L2 in the above tables (equity finance assets on direct investment abroad, and equity finance liabilities on direct investment in the reporting economy). No entries will appear on row A5 (equity finance claims on DIs in the reporting economy) or L5 (equity finance liabilities to DIEs).

c. I have no concerns about the existing international standards or about the proposed method of presenting these transactions and positions.

8. Case where the DIE owns more than zero but less than 10 percent of the equity of the DI

a. In this circumstance, the existing international standards (which are not challenged in the June DITEG paper) state that there is reverse direct investment equity investment. In looking at the tables in the earlier DITEG paper, this is the only circumstance that would give rise to entries on row A5 or on row L5.

b. Conceptual issue: In this circumstance, it is not obvious why reverse equity investment of less-than-10 percent is recorded in direct investment rather than in portfolio investment. The equity investment of less-than-10 percent is not for the purpose of exercising a significant degree of influence on the management of the enterprise, and so it would also be consistent with existing concepts to record this level of equity investment in portfolio investment. Stated differently, if there is a less-than-10 percent equity investment in both directions, both investments are classified in portfolio investment. It is unclear why, if one of the parties increases its investment in the other from less-than-10 percent to 10 percent-or-more, it necessarily leads to removal from portfolio investment of the equity investment that had been, and that remains, below the 10 percent threshold.

c. Practical issue: As noted above, under the June DITEG proposal, the types of investments that are to be classified on rows A5 and L5 are quite narrowly defined. Entries would appear on one of these lines only in the case where there is a 10-percent or more equity investment in one direction, and a greater-than-zero but less-than-10 percent equity investment in the other direction. It is unlikely that these arrangements exist to an extent that data could be published at most bilateral levels or, for many countries, even at global levels. It would be inappropriate to develop new standard components for the BOP and IIP accounts where a sizable number of countries could not present any information due to confidentiality issues.

Recommendations

9. For both conceptual and practical reasons, I recommend recording equity investments of less-

than-10 percent in portfolio investment rather than in direct investment. This would be a change from the existing international standards, but such a change seems warranted.

a. I am not recommending any changes to the existing international standards in regard to the classification of debt positions. It perhaps could be argued that, if reverse equity investments of less-than-10 percent are classified in portfolio investment, then debt positions in the same direction should also be classified in portfolio investment. But I believe that it could be argued even more strongly that it is consistent with broad concepts to record such debt investment in direct investment. Note that, if there is zero equity investment in the DI by the DIE, it is noncontroversial that debt liabilities of the DI to the DIE are to be recorded in direct investment. The creation or existence of a small (i.e., of a less-than-10 percent) equity investment in the DI by the DIE does not provide justification for seriously considering reclassifying the debt liabilities of the DI from direct investment to portfolio or other investment.

10. If my recommendation to record equity investments of less-than-10 percent in portfolio investment rather than in direct investment is accepted, then the presentation scheme for reverse investment described in the June paper cannot be accepted, because there will be no entries on the rows pertaining to equity finance claims on direct investors or equity finance liabilities to direct investment enterprises.

11. Even if my recommendation to record equity investments of less-than-10 percent in portfolio investment rather than in direct investment is rejected for some reason, the presentation scheme described in the June paper still should not be accepted, because it would add rows to the list of standard components for which very few countries could show substantial data before encountering confidentiality issues.

12. Finally, if my recommendation is accepted regarding the inclusion in portfolio investment of the less-than-10 percent equity investments, then I propose the presentation scheme shown on the following tables. Compared with the presentation illustrated in the June DITEG paper, the rows pertaining to reverse equity finance investment (A5 and L5) are eliminated (because such investment would be defined out of direct investment). In addition, the subtotals for reverse investment (that had appeared on rows A4 and L4) are replaced with new subtotals, for total debt (assets and liabilities):

Balance of Payments

Net changes in assets arising from transactions	*Net changes in liabilities arising from transactions*
Direct investment	**Direct investment**
Equity finance	Equity finance
Debt	Debt
Debt (claims on DIEs)	Debt (liabilities to DIs)
Debt (claims on DIs)	Debt (liabilities to DIEs)

International Investment Position

Assets	*Liabilities*
Direct investment	**Direct investment**
Equity finance	Equity finance
Debt	Debt
Debt (claims on DIEs)	Debt (liabilities to DIs)
Debt (claims on DIs)	Debt (liabilities to DIEs)

Points for Discussion

1. *In regard to the IMF's June 2004 issue paper on DITEG issues 7 & 8, do DITEG members agree that the rows in the classification scheme pertaining to equity finance claims on DIs, and to equity finance liabilities to DIEs, are very narrowly defined? If so, do DITEG members agree that this raises substantial concerns about their country's or organization's ability to show much data on these rows?*
2. *Do DITEG members agree that, on conceptual and/or practical grounds, there is merit in considering changing the existing international standards, to reclassify equity investment by the DIE in the DI from direct investment to portfolio investment in the case where the ownership interest is less than 10 percent?*
3. *Do DITEG members have comments on any of the other issues raised in this paper?*