DIRECT INVESTMENT TECHNICAL EXPERT GROUP (DITEG)

OUTCOME PAPER (DITEG) # 3

August 6, 2004

1. **Topic:** Indirect FDI relationships and alternatives to the Fully Consolidated System

2. **Issues:** See DITEG Issue Papers # 3 by the IMF, the ECB and Japan

3. **Recommendations:**

(i) DITEG discussed the rationale behind the Fully Consolidated System (hereinafter, "the FCS") and concluded that it is based on a mixture of "influence" and "control". A layer based on "influence" arises where a direct investor has between 10 percent[1] and 50 percent of the voting power (directly and indirectly) in another enterprise. A layer of "control" arises where a direct investor can control the activities of another enterprise, as a result of its having more than 50 percent voting power (directly or indirectly). As a consequence, a layer based on "control" may include several direct investment enterprises, each more than 50 percent owned by the direct investment enterprise above it in the chain of ownership. DITEG determined that no chain could have two adjoining layers based on influence[2] and that any layer based on influence following the first layer would be considered the last layer in the chain. In the case where the first layer is one of control, the maximum number of layers is two – control followed by influence. In the case where the first layer is one of influence, there could be up to three layers – influence, followed by control, followed by influence.

<u>Combinations of Influence and Control Possible under FCS</u>

	Layer 1	Layer 2	Layer 3
1. Direct Investor	Control		
2. Direct Investor	Control	Influence	
3. Direct Investor	Influence		
4. Direct Investor	Influence	Control	
5. Direct Investor	Influence	Control	Influence

[1] References to the 10% threshold should be changed across the paper should a final decision to move towards a 20% cutoff be finally taken.

[2] That is, an associate of an associate would break the direct investment chain.

(ii) DITEG was of the opinion that, on conceptual grounds, the FCS is closest to the concept that FDI statistics attempt to measure. Therefore, DITEG recommends that the FCS be maintained as the conceptual reference in the updated version of the manuals. However, DITEG recognized the difficulty in applying the FCS and the difficulties encountered by reporters to understand its rationale, all the more as it does not coincide with the rules governing the accounting consolidation process.

(iii) With the aim to simplify data collection while preserving the analytical value of FDI figures several alternatives to the FCS were discussed by DITEG, namely (1) a narrow definition limited to directly held direct investment enterprises; (2) the use of a cut-off of 10 percent or more ownership for both direct and indirect ownership ("10% method"); and (3) the use of the standard 10 percent threshold for direct relationships and more than 50% ownership for indirect relationships ("10/50 % method"). In addition, other countries proposed a complete adherence to consolidation rules applicable in business accounting standards within each country or full alignment to International Financial Reporting Standards (IFRS).

(iv) A majority of DITEG members was of the opinion that the "10/50 % method" was closest to the FCS, since it just skipped layers lower than the first layer based on influence, where they exist,while still covering the rest of the direct investment companies. Some DITEG members also pointed out that this method is also closest to the consolidation rules applicable under IFRS.

(v) DITEG also considered that, in most cases, the "10% method" provides similar results to both the FCS and the "10/50 % method" and was, thus, also regarded as an acceptable approximation to the FCS.

(vi) A concern that was mentioned was restrictions on foreign ownership applied by some countries, which implies that most FDI relationships to those destinations amount to a maximum of 49%. DITEG did not consider this circumstance to pose unique conceptual issues and therefore did not modify its recommendations on this subject.

(vii) Finally, DITEG was of the opinion that whatever the system applied in practice, indirectly owned companies which are, via a circular chain of ownership, in the same country as the direct investor should also be part of the foreign direct investment perimeter.[3]

4. **Rejected Alternatives:**

[3] More specifically, reinvested earnings and equity stocks based on the volume of own funds of direct investment enterprises should include reinvested earnings generated by such resident (indirectly owned) direct investment companies.

(i) DITEG considered that the first option (limited to direct ownership links) should be rejected on the grounds that it would significantly diminish the analytical value of FDI figures.

(ii) While recognising the practicality of a full adherence to accounting consolidation rules, the majority of DITEG was of the opinion that the existence of different accounting rules across countries would pave the way for an increasing level of global asymmetries. Additionally, it would make statistics fully dependent on changes in the accounting framework.

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 agree with DITEG's recommendation to maintain the FCS as the central conceptual reference for the delineation of the direct investment perimeter in the updated version of the manuals?*

(ii) *Do the Committee and the WIIS agree that, from the above-mentioned options, the so-called "10/50 %" method is the closest practical approximation to the FCS?*

(iii) *Do the Committee and the WIIS agree that the so-called "10%" method is an acceptable proxy to the FCS?*

(iv) *Do the Committee and the WIIS agree with the rejection of a narrow definition limited to directly held direct investment enterprises?*

(v) *Do the Committee and the WIIS agree with the concerns expressed by DITEG as regards the possibility to make the statistical definition of the direct investment perimeter fully dependent on accounting rules?*