EUROPEAN CENTRAL BANK

BALANCE OF PAYMENTS STATISTICS AND
EXTERNAL RESERVES DIVISION
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ACCRUED INTEREST IN THE EURO AREA BALANCE OF PAYMENTS AND INTERNATIONAL INVESTMENT POSITION

For information of the IMF BOP Committee

Accruals in the euro area b.o.p. statistics

1. As already stated in the last meeting of the IMF BOP Committee with regard to the compilation of income on securities, the ESCB[1] Statistics Committee and the Working Group on Balance of Payments and External Reserves Statistics (WG BP&ER), agreed in the course of 1997 and 1998 in that *(i) stocks should be "marked-to-market" and compilers should record the accrued interest on the basis of (ii) the interest rate prevailing in the market during the period for which calculations are made (the so-called "market principle")*.

2. At the time the decision was taken, the WG BP&ER took into consideration that this methodology was in line with IMF guidelines[2] to use the prevailing interest rate to calculate accrued interest. Some **conceptual** reasons supported this choice instead of other possible options (namely the so-called "debtor approach"), e.g.:

(1) owing to the tradable nature of these instruments, it is the prevailing rate that determines both the debtor's cost of capital and the creditors opportunity cost of having extended capital to the debtor;

(2) for normal bonds, coupon (nominal interest rate) payments should be regarded as withdrawals of investment by creditors and therefore, in any period coupon payments will either be equal to, less than, or greater than the interest accrued in the period thus implying that the difference is reinvested or disinvested, respectively;

[1] European System of Central Banks which comprises the European Central Bank (ECB) and the national central banks of the European Union Member States.

[2] Refer to IMF Compilation Guide (para 620) and to the document entitled, "Recording Interest Income in the Balance of Payments" (6th Meeting of the IMF Committee on BOP Statistics, March 1995).

(3) under this method, the only time where a non-transaction (valuation change) flow is recorded is when interest rates change (this is most appropriate as changes in interest rates reflect changes in the price of debt); and

(4) it ensures a symmetric recording of accrued interest by debtors and creditors;

(5) there seems to be no apparent coherence between market values for stocks and income valued at the time of issuance.

3. From a **practical** viewpoint, prevailing interest rates are readily observable, and market values of positions should be available for the compilation of the international investment position (IIP) statement. Moreover, to ensure a symmetric recording when using the debtor principle, information about each individual security held by creditors, including information on the interest rate at the time the security was issued, should be available to the compiler. This is usually not the case.

4. The Task Force on "Recording of interest" set up in 1998 by Eurostat's Financial Account Working Party (FAWP) agreed that the interpretation of ESA95 and thus, the treatment to be recommended to Financial Accounts compilers should be the debtor principle: accrued interest computed as value of the stock measured at time of issuance multiplied by <u>*the interest rate at the time of issuance*</u>. The main argument at that time was that "the market principle' *may transform fixed rate debt into floating rate debt*, with a direct <u>impact on the assessment of the</u> Excessive Deficit Procedure, foreseen by the Maastricht Treaty.

5. Though acknowledging this inconsistency between financial accounts and balance of payments standards (BOP), following the WG BP&ER agreed proposal, accrued interest within euro area BOP statistics is recorded on the basis of the 'market principle' and euro area IIP stocks are compiled on a marked-to-market basis.

6. Apart from the theoretical background on which the WG BP&ER based its decision, in the coming months the ECB will initiate a fact-finding exercise to test whether actual practices within the euro area comply with the theoretical framework endorsed by the WG BP&ER. If the WG BP&ER deem it necessary, an ad hoc workshop might be set-up in this regard.