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**The Practical Implementation of the Directional Principle in Foreign Direct
Investment
Some Countries' Experience and the Belgian Case**

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in foreign direct investment
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Introduction

In the balance of payments' financial account, according to the presentation and methodology described in the 5th edition of the Balance of Payments Manual (BPM5), the various components are broken down on the basis of the assets/liabilities concept, except for the 'foreign direct investment' component where the transactions are classified according to the investment's direction, the so-called 'directional principle'. This methodology should also be applied in the International Investment Position.

The practical implementation of this principle is not as obvious and simple as it looks at first sight. After all, the correct registration of foreign direct investment transactions or positions can also be complex.

The full implementation of the directional principle is not so widespread, not even in the industrialized countries. It often depends on the collection systems in place for the balance of payments and the international investment position data.

This paper shortly describes the definition of foreign direct investment and of the directional principle, provides some examples of recording, quickly outlines the way the principle is applied in some countries, pictures a system in one of the countries and finally treats the Belgian case.

In the part devoted to the Belgian case, a temporarily simplified approach for the application of the directional principle is suggested, in anticipation of a final system..

It should be mentioned that the search for solutions as to the practical implementation of the directional principle is currently on the agenda of the Task Force- Foreign Direct Investment of the European system of central banks (ESCB). It examines practical problems as to the application of the principle and should come up with recommendations on best practices in the euro area.

References

References to the directional principle are made in the Fund's various publications on the balance of payments, as well as in the OECD Benchmark definition of Foreign Direct Investment

In BPM5, §330 stipulates that “ *Direct investment is classified primarily on a directional basis – resident direct investment abroad and non resident investment in the reporting economy- and is subdivided into equity capital, reinvested earnings, and other capital. Equity capital and other capital, in turn, are subdivided into asset and liabilities transactions.*” A similar reference is also made in §369.

§371 suggests how the directional principle should be applied in reverse investment and cross participations.

The Balance of Payments Textbook also specifies in §529¹ that “ *Unlike other financial investments, direct investment is not recorded in the balance of payments on a strict asset/liability basis. Instead direct investment is recorded on a directional basis-...*”

And the Balance of Payments Compilation Guide deals with the direction of investment in §695.

Also in §§ 36 and 40 of the 3rd edition (1996) of the Benchmark Definition of Foreign Direct Investment of the OECD is referred to the directional principle (reverse investment).

Foreign direct investment; definition and special cases

Definition

According to the Guide (§682) “*direct investment is a category of international investment in which a resident entity in one economy (the direct investor) acquires a lasting interest in an enterprise resident in another economy (the direct investment enterprise). Direct investment implies a long- term relationship between the direct investor and the direct investment enterprise and a significant degree of influence (or potential for such influence) by the investor on the management of the direct investment enterprise*”.

The direct investor may be an individual, an incorporated or unincorporated private or public enterprise, an associated group of individuals or of enterprises, a government or governmental agency or another organization, that owns a direct investment enterprise in an economy other than the one in which the direct investor resides.

A direct investment enterprise is an incorporated or unincorporated enterprise in which a direct investor owns 10% ² or more of the ordinary shares or voting power (for an incorporated enterprise) or the equivalent (for an unincorporated enterprise)

Direct and indirect relationships

Direct investment enterprises include branches (wholly or jointly owned unincorporated enterprises), subsidiaries (incorporated enterprises that are for more than 50% owned by the direct investor), and associates (incorporated enterprises that are for 10 to 50% owned by the direct investor).

The relationship between the direct investment enterprise and its direct investor is called the ‘direct’ relationship.

¹ The direction of investment is treated in the Textbook from §529 to §533

² This 10% threshold is not a strict rule but a recommendation of BPM5. Indeed, it might occur that a shareholder owning less than 10% of the ordinary shares or of the voting power, actually has an influence on the management of the direct investment enterprise. In such a case, and when important transactions of direct investment are involved, it might be useful to abandon the 10% threshold and to record the transactions as direct investment. The reverse situation can also occur when a company, although owning more than 10% of the voting power of an enterprise, is not involved in its management. Here too exceptions may be made to the threshold recommendation, in case of important transactions. But in order to allow the mirror registration in the countries involved in the foreign direct investment transaction, and in this way to enhance quality and comparability, the compilers of the other should be contacted .

A direct investment enterprise can also invest in subsidiaries and sub- subsidiaries. The direct investment relationship of the direct investor then extends to the enterprises in the downward chain, unless two successive companies are associates. Then the last company is no associate of the direct investor anymore and the ‘indirect’ direct investment relationship stops with the first of the two associate enterprises.

When enterprises are involved in a direct investment relationship, the direct investor is often called the mother company, whereas the direct investment enterprises are named ‘daughters’ (or fellow subsidiaries). The direct investment relation between two daughters of the same mother is also indirect, as there is no straight link between both.

Special cases of direct investment enterprises ³

- Banks

Bilateral transactions between affiliated banks and/or affiliated financial intermediaries (e.g. security dealers) are only regarded as direct investment when the transactions refer to equity capital or permanent debt (e.g. subordinate loan capital..).

- Special Purpose Enterprises (SPE’s)

Transactions of SPE’s (e.g. holding companies,...), insofar as these companies meet the criteria of direct investment relationship, should be recorded under direct investment. In the case of SPE’s operating only as financial intermediaries for the groups to which they belong, only those transactions which are related to equity capital and permanent debt are regarded as direct investment.

Direction of Investment; principle, theoretical approach and some examples

Principle

The Textbook provides a very clear description; “..direct investment is recorded on a directional basis; resident direct investment abroad and non resident direct investment in the reporting economy. Capital invested by the direct investment enterprise in its direct investor (reverse investment) is regarded as an offset to capital invested in the direct investment enterprise by a direct investor and its related enterprises. Such capital is regarded as a disinvestment by the direct investor rather than an asset of the direct investment enterprise. For the purpose of analysis, these transactions are recorded separately in the BOP standard components.

Theoretical approach

The economy of the direct investor registers the equity capital and other capital invested in the direct investment enterprise of another economy, as ‘direct investment- abroad- claims on affiliated enterprises’ and the economy of the direct investment enterprise, as ‘direct investment- in reporting economy-liabilities to direct investors’.

³ Not all special cases are listed here, such as insurance companies, offshore enterprises...

However, when the direct investment enterprise makes funds available to the direct investor, the economy of the latter will record this transaction as ‘direct investment- abroad- liabilities to affiliated enterprises’ ,and the economy of the former as ‘direct investment- in reporting economy- claims on direct investor’

When a subsidiary or associate company of a direct investment company, receives an investment directly from the direct investor (indirect relationship), the same rule as for the direct relationship prevails; the economy of the direct investor records ‘direct investment- abroad- claims on affiliates’ and the other economy ‘direct investment - in reporting economy - liabilities to direct investor’

But, when a direct investment enterprise invests in an enterprise related to its direct investor (both are daughters), this investment is recorded by the economy providing the investment, as resident ‘direct investment abroad’ and by the economy of the enterprise receiving the investment as ‘direct investment in the reporting economy’. Here the assets/liabilities principle is applied again.

In the case of cross- participations, i.e. when two enterprises or groups of related enterprises hold 10% or more of all voting shares, two direct investment relationships are established. And, as in the previous case, the investments between the two enterprises (or groups of related enterprises) are recorded on a full assets/liabilities basis.

Some examples

1. Enterprise A in the USA has a subsidiary (75%) B in Germany- which, on its turn, has a subsidiary C (60%) in France- and an associate D (30%) in the UK. A increases its equity capital by 100 units in B financed by a loan from B to A. The latter is partly funded by a loan from C to B (60 units), in turn partly financed by a loan from D to C (20units).

Recording (in the Financial Account)

Economy of A;	1.Direct investment	
	1.1 Abroad	
	1.1.1 Equity capital	
	1.1.1.1. Claims on affiliated enterprises	100
	1.1.3 Other capital	
	1.1.3.2. Liabilities to affiliated enterprises	100
Economy of B;	1.Direct investment	
	1.1 Abroad	
	1.1.3 Other capital	
	1.1.3.2. Liabilities to affiliated enterprises	60
	1.2 In reporting economy	
	1.2.1 Equity capital	
	1.2.1.2. Liabilities to direct investors	100
	1.2.3 Other capital	
	1.2.3.1. Claims on direct investors	100

Economy of C;	1.Direct investment	
	1.1 Abroad	
	1.1.3 Other capital	
	1.1.3.2. Liabilities to affiliated enterprises	20
	1.2 In reporting economy	
	1.2.3 Other capital	
	1.2.3.1. Claims on direct investors	60
	1.2.3.2. Liabilities to affiliated enterprises	20
Economy of D;	1.Direct investment	
	1.2 In reporting economy	
	1.2.3 Other capital	
	1.2.3.1. Claims on direct investors	20

2. A Belgian co-ordination centre E (SPE acting as a financial intermediary) is a branch of a German multinational F. The latter has a subsidiary G (75%) in Germany itself, and an associate company H (40%) in Portugal, which in turn has an associate company I (30%) in Angola.

The German multinational F wants to develop the activity of the group on the African continent and therefore asks H to increase the equity capital of I by 100 units and put a short- term loan of 50 at its disposal. These transactions will be financed by E (subordinated loan of 100 and a short- term loan of 50). The multinational F grants a direct long- term loan of 30 units to I and also requests its German subsidiary G to furnish machinery, 20 units worth, to I, as a direct investment of G in I. Finally the surplus of treasury of F, amounting to 15 units, is transferred to a cash account with E.

Recording

Economy of E;	2B1. Direct investment	
	1.1 Abroad	
	1.1.3 Other capital	
	1.1.3.1. Claims on affiliated enterprises	150
	1.2.Liabilities	
	1.2.3 Other capital	
	1.2.3.2. Liabilities to direct investors	15
Economy of F;	2B1. Direct investment	
	1.1 Abroad	
	1.1.3 Other capital	
	1.1.3.1. Claims on affiliated enterprises	15
	2B3 .Other investment	
	3.1 Assets	
	3.1.2 Loans	
	3.1.2.4. Other sectors	
	3.1.2.4.1. Long-term	30
Economy of G;	1.Current Account	
	Aa1. General merchandise	C20
	2B1. Direct investment	
	1.1 Abroad	
	1.1. Equity capital	

	1.1.1.1. Claims on affiliated enterprises	20
Economy of H;	2B1.Direct investment	
	1.1 Abroad	
	1.1.1 Equity capital	
	1.1.1.1. Claims on affiliated enterprises	100
	1.1.3 Other capital	
	1.1.3.1. Claims on affiliated enterprises	50
	1.2 In the reporting economy	
	1.2.3 Other capital	
	1.2.3.2. Liabilities to direct investors	150
Economy of I;	1.Current Account	
	Aa1. General merchandise	D20
	2B1.Direct investment	
	1.2 In reporting economy	
	1.2.1 Equity capital	
	1.2.1.2. Liabilities to direct investors	120
	1.2.3 Other capital	
	1.2.3.2. Liabilities to direct investors	50
	2B3. Other investment	
	3.2.Liabilities	
	3.2.2 Loans	
	3.2.2.4. Other sectors	
	3.2.2.4.1. Long-term	30

3. An Australian enterprise J and a New Zealand enterprise K each hold 20% of the other's ordinary shares. Both companies are involved in the export of wool to Europe. Together they own (50/50) a factory L in the United Kingdom that produces machinery (also for export) for carding and spinning the wool. They also set up a joint (50/50) financial intermediary M in Ireland in order to centralise the financial transactions and to co-ordinate and supervise the collection of the export proceeds. This intermediary grants trade credits to the buyers of machinery (long-term) and of wool (short-term), but pays the exporters cash.

J and K increase their mutual share by 100 units to 40%. Company N in Japan imports machinery for 90 and wool for 70 and receives a trade credit of 18 months for the machinery and of 90 days for the wool. In order to avoid temporary financial problems, L receives a short- term loan of 60 from M but equally funded by J and K.

Recording

Economy of J;	1.Current Account	
	Aa1. General merchandise	C35
	2B1. Direct investment	
	1.1 Abroad	
	1.1.1 Equity capital	
	1.1.1.1. Claims on affiliated enterprises	100
	1.1.3 Other capital	
	1.1.3.1 Claims on affiliated enterprises	30

	1.2 In reporting economy	
	1.2.1 Equity capital	
	1.2.1.2. Liabilities to direct investors	100
Economy of K;	1.Current Account	
	Aa1. General merchandise	C35
	2B1. Direct investment	
	1.1 Abroad	
	1.1.1 Equity capital	
	1.1.1.1. Claims on affiliated enterprises	100
	1.1.3 Other capital	
	1.1.3.1 Claims on affiliated enterprises	30
	1.2 In reporting economy	
	1.2.1 Equity capital	
	1.2.1.2. Liabilities to direct investors	100
Economy of L;	1.Current Account	
	Aa1. General merchandise	C90
	2B1. Direct investment	
	1.2 In reporting economy	
	1.2.3 Other capital	
	1.2.3.2. Liabilities to direct investors	60
Economy of M;	2B1. Direct investment	
	1.1 Abroad	
	1.1.3 Other capital	
	1.1.3.1. Claims on affiliated enterprises	60
	1.2 In the reporting economy	
	1.2.3 Other capital	
	1.2.3.2 Liabilities to direct investors	60
	2B3 .Other investment	
	3.1 Assets	
	3.1.1 Trade credits	
	3.1.1.2. Other sectors	
	3.1.1.2.1. Long term	90
	3.1.1.2.1. Short-term	70
Economy of N;	1.Current Account	
	Aa1. General merchandise	D160
	2B3 .Other investment	
	3.2 Liabilities	
	3.2.1 Trade credits	
	3.2.1.2. Other sectors	
	3.2.1.2.1. Long term	90
	3.2.1.2.2. Short-term	70

The three examples above show that detailed information is needed on the direct investment relationships (both direct and indirect), on the nature of the transaction and in the case of

SPE's even on the activity in order to correctly record the transactions in the balance of payments and the outstanding amounts in the International investment position.

The in- the- field implementation by the various countries does not seem all that easy, especially when indirect relations are involved or special cases occur.

About the practical implementation in some countries

Information received

About 20 countries were asked to supply information on whether or not they apply the 'directional principle' in foreign direct investment transactions and positions and, if they do, on how they implement this principle in their balance of payments statistics and international investment position. Answers were received from 13 countries.

According to the information provided, two thirds of the countries apparently apply the directional principle, two countries do not, and the rest applies it only in part.

In the countries with a partial implementation, either it is applied merely for equity capital, and even then limited to the transaction beyond a given threshold, or for other capital only, and then sometimes merely for short or long- term.

A distinction can be made between the countries that have a survey based collection system, for stocks as well as for transactions (5), and those (8) that use the International Transaction Registration System (ITRS) for transactions, possibly complemented with a periodical Foreign Direct Investment (FDI) survey for the outstanding amounts. In a few countries the stocks are calculated by accumulating flows.

Most of the countries using a survey- based system , collect the data both on transactions and on stocks in one survey form, and this with sufficient detail in order to allow them to apply the directional principle without many problems. However, two countries too, using the ITRS, declared to gather the data in such a detailed way (specific transaction codes), that they could apply the directional principle⁴.

But often, the countries with a settlement- based collection system have to re-treat the basic data in order to obtain the correct recording of direct investment flows, by scrambling them through a database containing all direct and indirect foreign direct investment relationships⁵. Setting up such a database and keeping it up- to- date requires the regular provision of detailed information on the resident and non-resident parties involved and especially on the structure of international groups. The basic information on these relations often result from the outcome of the periodical FDI surveys . But compilers can also refer to publications (e.g. Dun & Bradstreet,..) which contain a lot of information on direct investment relations.

Example

Here is an example of how a country using ITRS, but also organizing an annual FDI survey, adopts the directional principle.

⁴ It often depends on the importance of the role played by the banks in interpreting the transactions and allocating the transaction codes (see also 'The Belgian case).

⁵ Some countries are legally not allowed to ask detailed information on the non resident counterparts, especially regarding individual transactions.

Balance of Payments

Basic data

- The data on FDI flows gathered by the compiler include the identities of both the resident and the non resident counterparts.
- Each counterpart receives an identification code. For the resident party this is usually an existing code also used in other statistics. For the non- resident party should have detailed information and co-ordinates, in order to clearly identify the same non resident with the same identity code.
- Based on the results of the annual survey and, if necessary, also on other sources, the relationship (mother/daughter/sister) can be defined. For each pair of counterparts only the link between both is kept. This can be a direct or an indirect relationship e.g. between the mother and the daughter of a daughter.
- The list of transaction codes provides separate codes for direct investment in the reporting economy and direct investment abroad, as well as for equity capital and short/long-term loans.

Database

- The relationships defined are entered in a database. Two files are created:
 - a file with resident mothers and non resident daughters
 - a file with non resident mothers and resident daughters
- The correct transaction codes of the balance of payments are attached to these files.
- As these relationships may change in the course of time, each relationship receives a validity deadline. Both files are reviewed and updated once a year, but in case of important changes, adjustments can also occur between two revisions.

Principle

- As mentioned before, only the direct link between the two parties is taken into account. This can be a direct or an indirect relationship. But it is always a vertical relationship. A horizontal relationship between two daughters (or fellow subsidiaries) of the same mother, is not recorded in the database.
- Only individual relationships are considered. So no consolidation is possible between mother and daughters established in the same country. This is made possible as both identities, that of the resident party and that of the non-resident counterpart are registered.

Processing

Once or, if necessary, several times a month the foreign direct investment flows are scrambled through an IT- programme confronting the registered transaction codes with the transaction codes in the system on the basis of the individual relationships. For the mother/ daughter relationship the registered codes, when distinct from the correct ones

in the database, are automatically replaced by the latter. For the transactions between sisters originally recorded codes are maintained.

International Investment Position

The annual FDI –survey provides the data for the International Investment Position. Since these data are detailed by individual direct investment relationship, the directional principle can be observed straight away.

The Belgian case; suggestion for temporary simplified implementation⁶

Introduction

In Belgium the directional principle is not applied yet.

The goal of the National Bank of Belgium's Balance of Payments division is to fully adopt the directional principle as prescribed in the BPM5 in the next few years. For this purpose a database with the foreign direct relationships is currently built.

As the current collection system for the balance of payments will be abandoned in 2006 and a new system put in place, the full application of the directional principle probably will not take place before that year.

In the mean time, however, a easier application could be put in place. Some aspects of the directional principle are simplified in order to allow a nearly complete automation of the processing chain producing the balance of payments statistics.

This implies that simplifications, deviating from the theoretical methodology, may have to be integrated in the programs.

Basic data

- In the Belgian collection system⁷, separate transaction codes exist for producing the different details of the foreign direct investment component. As such, a distinction can be made between;
 - equity capital, broken down into
 - establishments and extensions
 - participations (acquisition or sale of existing participations)
 - loans, broken down into
 - long-term
 - short-term

These transaction codes are split into investments abroad and investments in Belgium. Moreover, for equity capital, investments abroad are also broken down into investments in the European Monetary Union and outside the Union.

⁶ This suggestion is only a personal proposal by the author and does not reflect an official position of the National Bank of Belgium.

⁷ The major part of the basic data is provided by the banking system which has to allocate the correct transaction code to each payment on the basis of information supplied by the resident customer. The quality of the data coded by the banks is worsening. For that reason a fine tuning of the transaction codes list by creating new codes, allowing the application of the 'directional principle, is not considered.

Separate transaction codes exist for transactions with foreign banks as well.

- The Belgian system only collects systematic information on the identity of the resident party and on the country of the counterpart, but not on the identity of the non- resident party involved. In order to gather information on the latter, the Belgian respondents have to be contacted for each individual transaction, and this is only done for important transactions.
- The mother/daughter relationships can be retrieved from the foreign direct investment survey conducted annually by the Bank. Also the Dun & Bradstreet publication may be consulted.

Principles

- Only the direct relationships will be considered.

No information on the identity of the non- resident party is available systematically, only on its country. Therefore all enterprises of one group in the same country will be consolidated. It implies that subsidiaries and branches of the mother company established in the same country as the mother is, will be associated with the mother, e.g. a German daughter of Siemens, Germany will be associated with the German mother. By doing so, an important part of the questions to respondents can be dropped.

Although this simplification is in fact close to reality, there is a risk that a loan is granted by a daughter in the same country as the mother, instead of the mother, to a foreign daughter, or that equity capital in a mother company is acquired by a enterprise residing in the same country as the mother, from a foreign company. Although this probably will affect the quality, the impact on the balance of payments must not be overstated ..

Moreover for large transactions, respondents will be systematically contacted.

Database

Two files will be created

- a file with Belgian mothers and foreign daughters
- a file with foreign mothers, with indication of the country of establishment, and the Belgian daughters.

Processing

By automatically confronting the database containing the mother/daughter relationships and the country of the mother company, with the country of the non- resident counterpart of each foreign direct investment transaction, the data can be re-classified according to the 'directional principle'.

The transactions not affected by this re-classification - as it is the case for transactions between sisters (or fellow subsidiaries)- remain under their original codification.

Pro and contra

Once the database is established and the IT-programmes written, the FDI transactions will easily be re-classified according to the directional principle. Requests to respondents will be limited to large transactions.

The database can re-used when the final system will be put in place.

The consolidation of the daughters residing in the same country as the mother, with the latter, certainly affects the quality of the data, but these possible distortions are limited as for all large transactions further investigations will be made.

Conclusions

It appears from the answers received on the requests for information on the practical application of the directional principle in a number of industrialized countries, that the stage of implementation may differ from one country to another. It has been noted that apparently countries with a survey- based collection system mostly fully implemented the directional principle.

The survey forms they use, provide sufficient detail and information to correctly record positions in the IIP and transactions in the balance of payments

Countries with an ITRS are in different stages of implementation. Some apply it fully, others partially and a few not yet. But, in the framework of the ESCB, member countries of the EMU will have to comply with it in the years to come.

The practical implementation is not easy and requests for its transaction and/or position clear and detailed information, not only on the bilateral FDI relationship of the involved parties, but sometimes on the activity of the parties too.

In Belgium the directional principle is not applied yet, but the intention is to fully realize at least in 2006. In the mean time, a temporary, simplified and automated system might be put in place, re-classifying the transactions according to the directional principle, only with one reserve, that could (slightly) affect the quality of the data, namely that all daughters residing in the same country as the mother, are regarded as the mother.

The system that finally will be applied depends on the outcome of the ESCB Task Force on FDI, which will recommend the 'best practices'.

Finally it is suggested that on the practical implementation of the directional principle, some examples be given in the next editions of the Compilation Guide and of the Textbook