CHAPTER

6 Functional Categories

A. Introduction

6.1 The functional categories[1] are the primary classification used for each of financial transactions, positions, and income in the international accounts. Five functional categories of investment are distinguished in the international accounts:

(a) direct investment,

(b) portfolio investment,

(c) financial derivatives (other than reserves) and employee stock options,

(d) other investment, and

(e) reserve assets.

6.2 The functional categories are built on the classification of financial assets and liabilities discussed in Chapter 5, but with an additional dimension that takes into account some aspects of the relationship between the parties and the motivation for investment. The functional categories are designed to facilitate analysis by distinguishing categories that exhibit different economic motivations and patterns of behavior.

6.3 While linked to the classification of financial assets and liabilities, the functional categories highlight features that are particularly relevant for understanding cross-border financial flows and positions. For example, a loan can appear under direct investment or other investment, but the different nature of the relationship between the parties in these two cases has analytical significance because the risks and motivations behind the transaction may be different.

6.4 A different relationship exists between the counterparties for portfolio investors compared with direct investors. Direct investment is related to control or a significant degree of influence, and tends to be associated with a lasting relationship. As well as funds, direct investors may supply additional contributions such as know-how, technology, management, and marketing. Furthermore, enterprises in a direct investment relationship are more likely to trade with and finance each other.

6.5 In contrast to direct investors, portfolio investors typically have less of a role in the decision making of the enterprise with potentially important implications for future flows and for the volatility of the price and volume of positions. Portfolio investment differs from other investment in that it provides a direct way to access financial markets, and thus it can provide liquidity and flexibility. It is associated with financial markets and with their specialized service providers, such as exchanges, dealers, and regulators. The nature of financial derivatives as instruments through which risk is traded in its own right in financial markets sets them apart from other types of investment. Whereas other instruments may also have risk transfer elements, these other instruments also provide financial or other resources.

6.6 Reserve assets are shown separately because they serve a different function and thus are managed in different ways from other assets. Reserve assets include a range of instruments that are shown under other categories when not owned by monetary authorities. As reserve assets, however, they have the distinct motive to meet balance of payments financing needs and undertake market intervention to influence the exchange rate.

6.7 Monetary and financial statistics and flow of funds data primarily use the instruments classification, as shown in Chapter 5, so it is desirable that data on the same basis can be derived from the international accounts for compatibility. Table 6.1 shows the linkages between the financial assets classification shown in Chapter 5 and the functional categories shown in this chapter.

[1]The term functional classification is also used in different contexts in other areas of statistics, such as the classification of the functions of government.

Table 6.1. Link between Financial Assets Classification and Functional Categories

2008 SNA Financial Assets and Liabilities Classification	Functional categories				
	DI	PI	FD	OI	RA
AF1 Monetary gold and SDRs					
AF11 Monetary gold					
Gold bullion					X
Unallocated gold accounts					X
AF12 Special drawing rights				X[1]	X[1]
AF2 Currency and deposits					
AF21 Currency				X	X
AF221 Interbank positions				X	X
AF229 Other transferable deposits	X			X	X
AF29 Other deposits	X			X	X
AF3 Debt securities	X	X			X
AF4 Loans	X			X	X
AF5 Equity and investment fund shares					
AF51 Equity					
AF511 Listed shares	X	X			X
AF512 Unlisted shares	X	X			x[2]
AF519 Other equity	X			x	
AF52 Investment fund shares/units					
AF521 Money market fund shares/units	x	X			X
AF522 Other investment fund shares/units	x	X		x	X
AF6 Insurance, pension, and stand. guarantee schemes					
AF61 Nonlife insurance technical reserves	x			X	
AF62 Life insurance and annuity entitlements	x			X	
AF63 Pension entitlements				X	
AF64 Claims of pension funds on pension managers	X			X	
AF65 Entitlements to nonpension benefits				X	
AF66 Provisions for calls under standardized guarantees	X			X	
AF7 Financial derivatives and employee stock options					
AF71 Financial derivatives					
AF711 Forward-type contracts			X		X
AF712 Options			X		X
AF72 Employee stock options			X		
AF8 Other accounts receivable/payable					
AF81 Trade credit and advances	X			X	
AF89 Other accounts receivable/payable	X			X	

Note: DI—direct investment; PI—portfolio investment; FD—financial derivatives (other than reserves) and employee stock options; OI—other investment; RA—reserve assets. X shows applicable functional categories (x shows cases considered to be relatively uncommon) for the most detailed instrument categories.

[1]SDRs: Assets = Reserve assets; Liabilities = Other investment.

[2]Unlisted shares must be liquid, as stated in paragraph 6.87.

B. Direct Investment

References:

Organization for Economic Cooperation and Development (OECD), *OECD Benchmark Definition of Foreign Direct Investment*, fourth edition.

IMF, *Coordinated Direct Investment Survey Guide*.

1. Definition of direct investment

6.8 *Direct investment is a category of cross-border investment associated with a resident in one economy having control or a significant degree of influence on the management of an enterprise that is resident in another economy.* As well as the equity that gives rise to control or influence, direct investment also includes investment associated with that relationship, including investment in indirectly influenced or controlled enterprises (paragraph 6.12), investment in fellow enterprises (see paragraph 6.17), debt (except selected debt set out in paragraph 6.28), and reverse investment (see paragraph 6.40). The Framework for Direct Investment Relationships (FDIR) provides criteria for determining whether cross-border ownership results in a direct investment relationship, based on control and influence.[2] The definition of direct investment is the same as in the fourth edition of the *OECD Benchmark Definition of Foreign Direct Investment*, which provides additional details on the FDIR and the collection of direct investment data. Appendix 6a, Topical Summary—Direct Investment, provides references to paragraphs in which different aspects of direct investment are discussed in this *Manual*.

a. Definition of a direct investment relationship

6.9 *A* **direct investment relationship** *arises when an investor resident in one economy makes an investment that gives control or a significant degree of influence on the management of an enterprise that is resident in another economy.* Operational definitions of control and influence are given in paragraph 6.12. Enterprises in a direct investment relationship with each other are called affiliates or affiliated enterprises. In addition, all enterprises that are under the control or influence of the same direct investor are considered to be in a direct investment relationship with each other.

6.10 Because there is control or a significant degree of influence, direct investment tends to have different motivations and to behave in different ways from other forms of investment. As well as equity (which is associated with voting power), the direct investor may also supply other types of finance, as well as know-how. Direct investment tends to involve a lasting relationship, although it may be a short-term relationship in some cases. Another feature of direct investment is that decisions by enterprises may be made for the group as a whole.

b. Definitions of direct investor and direct investment enterprise

6.11 *A* **direct investor** *is an entity or group of related entities that is able to exercise control or a significant degree of influence over another entity that is resident of a different economy. A* **direct investment enterprise** *is an entity subject to control or a significant degree of influence by a direct investor.* In some cases, a single entity may be, at the same time, a direct investor, a direct investment enterprise, and a fellow enterprise (defined in paragraph 6.17(c)) in its relationships to other enterprises.

[2]The coverage of direct investment is determined from the relationship between the owner and issuer of the financial instrument. That is, it is not determined from the relationship between the buyer and the seller of the instrument. For example, if a direct investor buys shares in its direct investment enterprise from an unrelated party, the direct investor will classify the purchase as direct investment.

c. Definitions of control and influence—definitions of immediate and indirect relationships

6.12 Control or influence may be achieved directly by owning equity that gives voting power in the enterprise, or indirectly by having voting power in another enterprise that has voting power in the enterprise. Accordingly, two ways of having control or influence are identified:

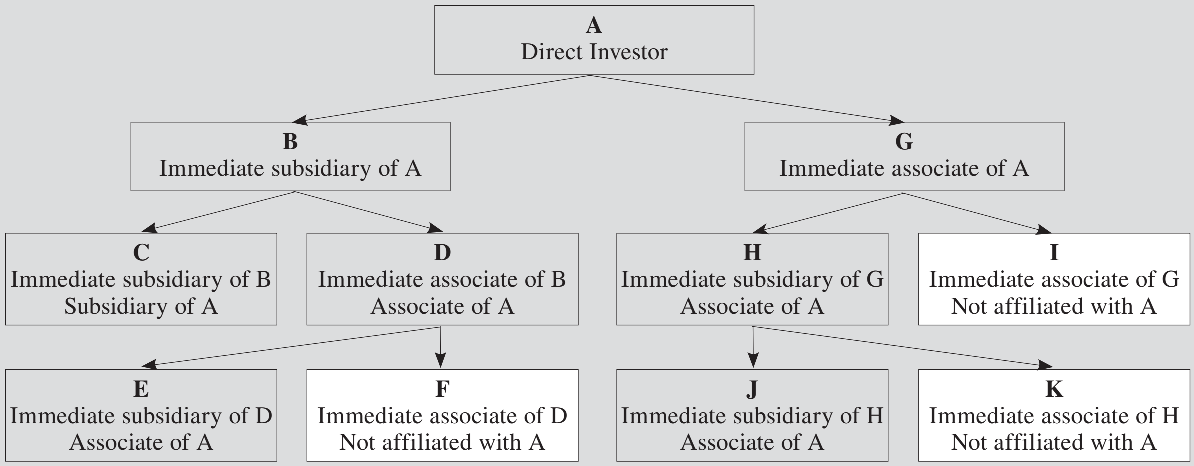
(a) **Immediate direct investment** *relationships arise when a direct investor directly owns equity that entitles it to* **10 percent or more** *of the voting power in the direct investment enterprise.*
- *Control is determined to exist if the direct investor owns more than 50 percent of the voting power in the direct investment enterprise.*
- *A significant degree of influence is determined to exist if the direct investor owns from 10 to 50 percent of the voting power in the direct investment enterprise.*

(b) **Indirect direct investment** *relationships arise through the ownership of voting power in one direct investment enterprise that owns voting power in another enterprise or enterprises, that is, an entity is able to exercise indirect control or influence through a chain of direct investment relationships.* For example, an enterprise may have an immediate direct investment relationship with a second enterprise that has an immediate direct investment relationship with a third enterprise. Although the first enterprise has no equity in the third enterprise, it may be able to exercise indirect control or influence, according the FDIR criteria specified in paragraph 6.14.

In addition to direct investment relationships between two enterprises that arise because one enterprise controls or influences the other, there are also direct investment relationships between two enterprises that do not control or influence each other, but that are both under the control or influence of the same investor (i.e., fellow enterprises, as discussed in paragraph 6.17).

6.13 In practice, effective control or influence may arise in some cases with less than these percentages. These definitions should be used in all cases, however, for international consistency and to avoid subjective judgments.

Box 6.1. Examples of Identification of Direct Investment Relationships under FDIR



Each enterprise is resident in a different economy from the others. Shaded boxes are direct investment enterprises of the Direct Investor A (so all are affiliates of each other).

For further examples, see the *OECD Benchmark Definition of Foreign Direct Investment*. In particular, it considers more complex situations, such as where an enterprise receives investment from two members of the same group.

6.14 The principles for indirect transmission of control and influence through a chain of ownership for the purposes of paragraph 6.12(b) are as follows:

(a) Control can be passed down a chain of ownership as long as control exists at each stage.

(b) Influence can be generated at any point down a chain of control.

(c) Influence can be passed only through a chain of control but not beyond.

Whereas the FDIR applies a criterion of 10 percent or more of voting power for immediate direct investment, transmission through chains of ownership is not linked to a particular equity share, but a chain of control. For example, a chain of ownership of enterprises with each link involving 60 percent of the voting power involves a chain of control, even though the indirect equity by the top enterprise is 36 percent at the second level (i.e., 60 percent of 60 percent), 21.6 percent at the third level (i.e., 60 percent of 36 percent), and so on. The application of these principles may be understood more readily by numerical examples—see Box 6.1 and the *OECD Benchmark Definition of Foreign Direct Investment*.

d. Definitions of subsidiaries, associates, fellow enterprises, and affiliates

6.15 In regard to its relationship with a direct investor, a direct investment enterprise is either a subsidiary or an associate:

(a) *A subsidiary is a direct investment enterprise over which the direct investor is able to exercise control.*

(b) *An associate is a direct investment enterprise over which the direct investor is able to exercise a significant degree of influence, but not control.*

Control and influence are defined in paragraph 6.12 and may arise from an immediate relationship or in indirect relationship through a chain of ownership. The terms subsidiary and associate refer to both incorporated and unincorporated enterprises. The FDIR makes no distinction on the basis of incorporation, so directly owned branches are always treated as subsidiaries.

6.16 Under the FDIR, an entity is a direct investor in another entity where the second entity is

(a) an immediate subsidiary of the direct investor;

(b) an immediate associate of the direct investor;

(c) a subsidiary of a subsidiary of the direct investor (also considered to be an indirect subsidiary of the direct investor);

(d) a subsidiary of an associate of the direct investor (also considered to be an indirect associate of the direct investor); or

(e) an associate of a subsidiary of the direct investor (also considered to be an indirect associate of the direct investor).

However, no direct investor–direct investment enterprise relationship exists in cases in which the entity is an associate of an associate of the direct investor. In this case, the ability of the investor to influence the management of the entity is considered to have become too diluted to be significant.

(These principles are illustrated in Box 6.1.)

6.17 **Affiliates** of an enterprise consist of:

(a) *its direct investor(s), both immediate and indirect;*

(b) *its direct investment enterprises, whether subsidiaries (including branches and other quasi-corporations), associates, and subsidiaries of associates, both immediate and indirect; and*

(c) **fellow enterprises***, that is, those enterprises that are under the control or influence of the same immediate or indirect investor, but neither fellow enterprise controls or influences the other fellow enterprise. Often the direct investor and fellow enterprises are all in different economies, but sometimes the direct investor is in the same economy as one of the fellow enterprises (in which case, it is not a direct investor in that fellow enterprise). This situation is more likely to arise in economies that do not use a local enterprise group as the statistical unit for direct investment purposes.*

All affiliates are in a direct investment relationship with each other. The term affiliated enterprises is also used, because affiliates are almost always enterprises (the exception is a direct investor that is an individual, household, or government).

6.18 Some practical difficulties may be encountered in applying the FDIR in full, and thus similar methods—such as the participation multiplication method and the direct influence and indirect control method-may be adopted. For details, see *OECD Benchmark Definition of Foreign Direct Investment* and the IMF's *Coordinated Direct Investment Survey Guide.*

e. Requirements for a direct investment relationship

6.19 Voting power is obtained as a result of ownership of equity. When decisions are made on a one-share one-vote basis, voting power is in the same proportion as the ownership of ordinary shares. In some cases, voting power can be exercised without commensurate ownership of shares. For instance, for unincorporated entities, including foundations, there are no shares in the sense of a tradable instrument. Additionally, voting power may be greater or less than percentage of shares held when there are "golden shares" or dual classes of shares (i.e., in cases in which nonvoting shares or some shares have higher weights that allow one or more parties to exercise voting power disproportionately to their share ownership). However, voting power is not recognized if temporarily obtained through repurchase agreements (because no change in the economic ownership of the shares has occurred) or through the holding of warrants (because the warrant holder does not possess voting power until the warrants are exercised). In addition, as elaborated in the FDIR, one entity may obtain voting power indirectly in an enterprise by owning shares in an intermediate entity or through chains of intermediate entities that, in turn, own shares in the enterprise.

6.20 A direct investor could be:

(a) an individual or household;

(b) an enterprise, incorporated or unincorporated, public or private;

(c) an investment fund;

(d) a government or international organization. Special treatments for governments that have direct investment enterprises for fiscal purposes are discussed in paragraphs 8.24–8.26;

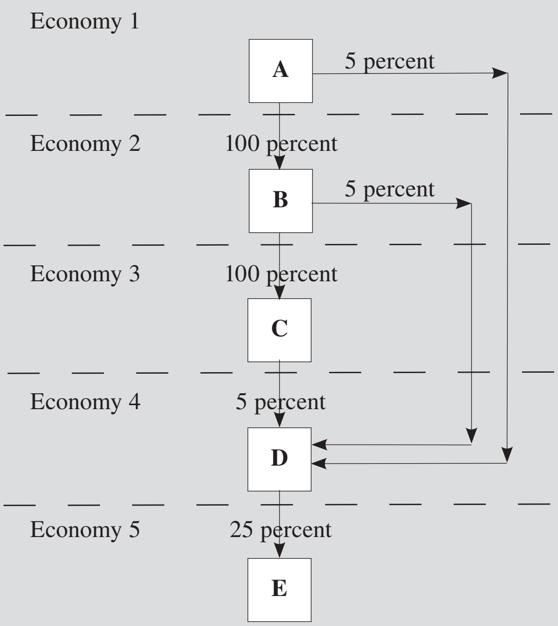
(e) a nonprofit institution in an enterprise that operates for profit; however, the relationship between two nonprofit institutions is excluded from direct investment;

(f) an estate, trustee in bankruptcy, or other trust; or

(g) any combination of two or more of the above.

6.21 For two or more individuals or other entities to be considered a combination, and thus be regarded as a single direct investor, they must be in a direct investment relationship or have a family relationship (in the case of individuals). The different individuals or other entities must be resident in the same economy as each other. They cannot include any investor that is

Box 6.2. Direct Investment Relationships with Combination of Investors



A is a direct investor in D because its own immediate ownership of voting power in D, **in combination** with its control over B and C's stakes in D, means that A has 15 percent of the voting power in D.

For the same reason, B is also a direct investor in D (10 percent of voting power).

C is not a direct investor in D; however, it is a fellow enterprise of D (because C and D have A and B as direct investors in common).

D is a direct investor in E, however E is not in a direct investment relationship with A, B, or C, because in combination, they do not control D, and D does not control E.

If A's voting power in B were only 49 percent, A would not be a direct investor in D, because it does not have control over B, so A's and B's stakes in D are not combined.

a resident of the same economy as the direct investment enterprise. Equity ownership in an enterprise held by a group of related investors acting in combination can be summed to establish either control or influence. However, equity held by an associate is not summed with that from any other enterprise to establish either control or influence because influence is not able to be passed unless there is control of the next affiliate (this concept is illustrated in Box 6.2).

6.22 A government may be a direct investor. Special treatments of positions and transactions apply when a government has a direct investment enterprise that is used for fiscal purposes, discussed further in paragraphs 8.24–8.26. If a government equity holding could qualify as both direct investment and reserve assets, it is included in direct investment, whereas debt instruments are classified as reserve assets provided that the reserve asset criteria are met (see also paragraph 6.98).

6.23 A nonprofit institution may not be a direct investment enterprise, as it is not created with the intention of repatriating earnings to its investor. However, a nonprofit institution may be a direct investor in a for-profit entity.

6.24 A direct investment enterprise is always a corporation, which as a statistical term includes branches, notional resident units, trusts, other quasi-corporations, and investment funds, as well as incorporated entities. Because a direct investment enterprise is owned by another entity, households or governments can be direct investors, but they cannot be direct investment enterprises. A public corporation, as defined in paragraphs 4.108–4.112, in some instances also may be a direct investment enterprise.

2. Coverage of direct investment flows and positions

6.25 Direct investment covers most financial transactions and positions between affiliates resident in different economies. Investment income associated with direct investment positions is also included in direct investment. The exceptions are noted in paragraphs 6.28–6.32.

a. Coverage of debt between affiliates

Definition of intercompany lending

6.26 *Intercompany lending is used to describe direct investment debt positions between affiliated enterprises.* It includes debt instrument transactions and positions other than those excluded by paragraph 6.28; it is not limited to loans. As shown in Tables I and III in Appendix 9, Standard Components and Selected Other Items, and *External Debt Statistics: Guide for Compilers and Users*, intercompany lending is identified separately from other debt for debt analysis, because this lending has different implications for risk and vulnerability compared with debt between unrelated parties. Splits of intercompany lending by type of instrument and maturity are supplementary items that allow comparability with national accounts and financial statistics.

6.27 Although debt and other claims that do not involve voting power are not relevant to defining a direct investment relationship, they are included in direct investment transactions and positions if a direct investment relationship exists between the parties. Debt instruments other than monetary gold, SDRs, currency, interbank positions, and pension and related entitlements potentially can be included in direct investment. However transactions between affiliates in financial assets issued by an unrelated third party are not direct investment transactions. Insurance technical reserves are included in direct investment when the parties are in a direct investment relationship. For example, reserves may arise from reinsurance contracts between affiliated insurance corporations. They also arise with captive direct insurance. (A captive insurance company writes insurance policies largely or entirely with its owners and other affiliates.)

Coverage of debt between selected affiliated financial corporations

6.28 Debt between selected affiliated financial corporations is not classified as direct investment because it is not considered to be so strongly connected to the direct investment relationship. The financial corporations covered by this case are:

(a) deposit-taking corporations (both central banks and deposit-taking corporations other than the central bank);

(b) investment funds; and

(c) other financial intermediaries except insurance corporations and pension funds.

In other words, the usual direct investment definitions apply for captive financial institutions and money lenders, insurance corporations, pension funds, and financial auxiliaries. (These subsectors are defined in Chapter 4, Section D; debt instruments are defined in paragraphs 5.31–5.33.) All debt positions between the selected types of affiliated financial corporations are excluded from direct investment and are included under portfolio or other investment. Both affiliated parties must be one of the selected types of financial corporations, but they need not be the same type.

b. Coverage of other financial instruments

6.29 Financial derivatives and employee stock options are excluded from direct investment and included in the functional category financial derivatives (other than reserves) and employee stock options.

6.30 Investment funds may be direct investors or direct investment enterprises. A "fund of funds" is an investment fund that invests in other investment funds and thus may become a direct investor in one of the funds. In a master-feeder fund arrangement, one or more investment funds (feeder funds) pool their portfolio in another fund (the master fund). In this case, a feeder fund that has 10 percent or more of the voting power in the master fund would meet the FDIR definition of a direct investor. Similarly, retail funds that hold 10 percent or more of voting power in an enterprise are direct investors.

6.31 Direct investment may include real estate investment, including investment properties and vacation homes. As discussed in paragraphs 4.26–4.40, branches or notional units are identified when nonresidents own real estate and other natural resources. The normal ownership threshold for influence or control under the FDIR is applied. Because it may have different motivations and economic impact from other direct investment, if real estate investment is significant, compilers may wish to publish data on such investment separately on a supplementary basis.

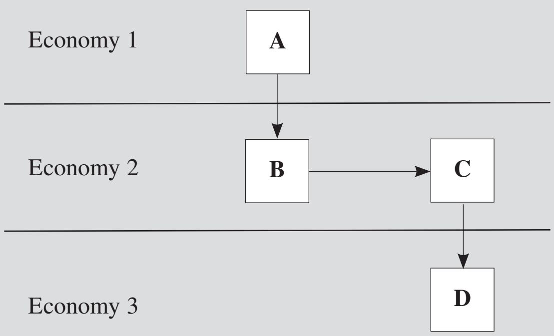
6.32 Equity in international organizations is excluded from direct investment, even in cases in which voting power is 10 percent or more, so equity contributions are included in portfolio investment (if in the form of securities) or other investment—equity (if not in the form of securities). Equity in international organizations would not generally qualify as reserve assets because of the lack of ready availability (see paragraph 6.69).

c. Pass-through funds

6.33 *"Pass-through funds" or "funds in transit" are funds that pass through an enterprise resident in an economy to an affiliate in another economy, so that the funds do not stay in the economy of that enterprise.* These funds are often associated with direct investment. Such flows have little impact on the economy they pass through. Special purpose entities, holding companies, and financial institutions that serve other nonfinancial affiliates are particularly associated with funds in transit, but other enterprises may also have pass-through funds in direct investment flows.

6.34 Pass-through funds are included in direct investment in standard presentations because:

Box 6.3. Direct Investment Relationship Involving Domestic Link



A wholly owns B, which wholly owns C, which wholly owns D.

In this example, despite the domestic link between B and C, A and B are each in a direct investment relationship with D.

(a) they are an integral part of a direct investor's financial transactions and positions with affiliated enterprises;

(b) the exclusion of these funds from direct investment would distort and substantially understate direct investment financial flows and positions at aggregate levels; and

(c) the inclusions of these data in direct investment promotes symmetry and consistency among economies.

However, for the economies through which the funds pass, it is useful to identify inflows and outflows not intended for use by the entity concerned. At the time of writing, there are no standard definitions or methods to distinguish pass-through funds from other direct investment flows. Compilers in economies that have large values of pass-through funds should consider the compilation of supplementary data on funds in transit, based on national definitions.

d. Effect of domestic ownership links on direct investment relationships

6.35 To identify direct investment relationships, the FDIR does not exclude ownership links between enterprises resident in the same economy. Although any transactions and positions between enterprises in the same economy are not included in international accounts, it is possible that a direct investor may have a chain of control or influence in which one link in the chain is a resident-to-resident relationship. Such a relationship does not preclude a direct investment relationship between two enterprises that are resident in different economies from each other. (This case is illustrated in Box 6.3.)

e. Beginning and ending direct investment relationships

6.36 The whole of the transaction that reaches or surpasses the threshold of 10 percent or more of voting power is included under direct investment. Any transactions before that point are not generally classified as direct investment (with the exception of reverse investment—defined in paragraph 6.37(b)—and investment in other affiliates). Any prior positions are shown as being reclassified at the time that the direct investment relationship comes into existence (reclassifications are discussed in paragraphs 9.13–9.20). For example, if the direct investor previously had 9 percent of voting power, then acquired 2 percent more, there would be a direct investment transaction by the purchaser involving 2 percent of voting power, and the reclassification entries in the other changes in financial assets and liabilities account would show a reduction of portfolio investment involving the previously held 9 percent and a corresponding increase in direct investment. Subsequent transactions up to and including a transaction that takes the voting power below 10 percent are classified as direct investment. Once the direct investment equity threshold has been crossed (either upward or downward), any debt positions between the parties should also be changed by a reclassification entry in the other changes in volume account.

3. Types of direct investment transactions and positions

6.37 In the standard components, direct investment is classified according to the relationship between the investor and the entity receiving the investment, namely:

(a) investment by a direct investor in its direct investment enterprise (whether in an immediate relationship or not);

(b) reverse investment by a direct investment enterprise in its own immediate or indirect direct investor, as explained in paragraphs 6.39–6.40; and

(c) investment between resident and nonresident fellow enterprises, as explained in paragraph 6.17.

6.38 These three categories reflect different types of relationships and motivations. For example, the interpretation of a direct investor acquiring direct investment assets is different from a direct investment enterprise acquiring direct investment assets. While the first type of investment involves influence or control, this may not be the case for the other two types, because the investor is not a direct investor. It is important for compilers to monitor trends in the second and third types to identify if they are becoming significant.

a. Reverse investment

6.39 A direct investment enterprise may acquire an equity or other claim on its own immediate or indirect direct investor. These transactions may occur as a way of withdrawing investment, or as a way of organizing finance within a transnational group. For example, for an enterprise that borrows on behalf of its parent company and in cases in which treasury functions are concentrated in a subsidiary (see paragraphs 4.83(d) and 4.86), the subsidiary may lend money to its direct investor.

6.40 *Reverse investment arises when a direct investment enterprise lends funds to or acquires equity in its immediate or indirect direct investor, provided it does not own equity comprising 10 percent or more of the voting power in that direct investor.* In contrast, if two enterprises each have 10 percent or more of the voting power in the other, there is not reverse investment, rather there are two mutual direct investment relationships. That is, each enterprise is both a direct investor and direct investment enterprise of the other.

6.41 Data on reverse investment and investment between fellow enterprises should be separately published, where significant, to assist users in understanding the nature of direct investment. Issues associated with income on reverse investment and investment between fellow enterprises are covered in paragraphs 11.99–11.100.

b. Presentation of data according to the directional principle

6.42 *The directional principle is a presentation of direct investment data organized according to the direction of the direct investment relationship.* It can be contrasted with the asset and liability presentation of aggregates used in standard components in this *Manual*, which are organized according to whether the investment relates to an asset or liability. The difference between the asset-liability and directional presentations arises from differences in the treatment of reverse investment and some investment between fellow enterprises. The directional principle can be applied to the IIP, financial account, and investment income. Under the directional principle, direct investment is shown as either direct investment abroad or direct investment in the reporting economy:

(a) *Direct investment abroad covers assets and liabilities between resident direct investors and their direct investment enterprises. It also covers assets and liabilities between resident and nonresident fellow enterprises if the ultimate controlling parent is resident.* Direct investment abroad is also called outward direct investment.

(b) *Direct investment in the reporting economy includes all liabilities and assets between resident direct investment enterprises and their direct investors. It also covers assets and liabilities between resident and nonresident fellow enterprises if the ultimate controlling parent is nonresident.* Direct investment in the reporting economy is also called inward direct investment.

6.43 The treatment of fellow enterprises under the directional principle is as follows:

- In principle, all assets and liabilities between fellow enterprises are shown in direct investment abroad when the ultimate controlling parent is a resident. In that case, control and influence is exercised from the economy of the resident, so it is useful to view an investment in a fellow enterprise abroad in the same way as outward investment.
- In principle, all assets and liabilities between fellow enterprises are shown in direct investment in the reporting economy when the ultimate controlling parent is a nonresident. In this case, control and influence are exercised from another economy, so it is useful to view investment with the fellow enterprise abroad in the same way as inward investment.
- However, if the residence of the ultimate controlling parent is unknown, assets are treated as direct investment abroad and liabilities are treated as direct investment in the reporting economy. This treatment is allowed for practical reasons. It is recognized that, in some cases, economies may not be able to implement the preferred or "in principle" basis of presentation in their direct investment data, because they cannot identify ultimate controlling parents.

c. Analytical use of the different presentations of direct investment

6.44 Data on both the asset and liability presentation and the directional principle presentation are useful for different kinds of analysis.

- Data on an asset and liability basis are consistent with monetary, financial, and other balance sheet data, and thus facilitate comparison between the data sets. These data are needed on an immediate counterparty basis to adequately monitor flows and positions. For instance, if a jurisdiction of convenience that is the home to large SPEs were to experience a currency or other financial crisis, data users would find data sets that look through the SPEs (or that net data for SPEs without separate identification of gross levels) to be of limited help. SPEs and other entities may transform debt to equity, a long-term instrument to short-term, local currency to foreign currency, fixed to variable rates, and so on, and these transformations alter risk characteristics in important ways.
- Data on a directional principle basis assist in understanding the motivation for direct investment and take account of control and influence. In the directional presentation, reverse investment can be seen as equivalent to the withdrawal of investment. The directional principle may be particularly useful for an economy with large values of pass-through funds or round tripping, because the large investment flows into and out of an economy may not be of primary interest to analysts of direct investment.

6.45 The calculations and relationship between the asset and liability and the directional presentations are shown in Box 6.4. In this *Manual*, the directional presentation appears as supplementary items. Under the directional principle, direct investment abroad and direct investment in the reporting economy include both assets and liabilities, and thus, negative values may arise.

4. Other issues concerning direct investment transactions, positions, and income

a. Round tripping

6.46 *Round tripping involves funds from an entity in one economy being invested in an entity resident in a second economy, that are then invested in another entity in the first economy.* The entity in the second economy often has limited operations of its own. (There may be two or other intermediate economies with round tripping.) Its special nature means that, where it is significant, compilers should consider publishing supplementary information on the extent of round tripping. (Round tripping results in an economy being its own ultimate host economy or ultimate investing economy in partner data.)

b. Relationships other than direct investment

6.47 Some relationships involve cooperation between enterprises that resemble direct investment relations. However, such cases should not be classified as direct investment unless they meet the definition involving control or influence through voting power. For example, there may be representation on the board of directors, a common board of directors but no formal relationship, participation in policymaking processes, material intercompany transactions, interchange of managerial personnel, provision of technical information, or provision of long-term loans at lower than existing market rates. Creditors of an insolvent company may exercise influence or even effectively control it, but they would not qualify as direct investors unless their debt is converted to equity with voting power. Furthermore, an enterprise may have substantial foreign ownership but no individual investor or group of related investors may have a direct investment stake.

c. Additional detail for direct investment

6.48 The financial instrument, maturity, and currency classifications in Chapter 5 can be used for direct investment. Compilers should break down debt instruments relating to direct investment relationships according to the *SNA/MFSM* instrument classification on a supplementary basis. The split by type of instrument is necessary for reconciliation with financial account, flow of funds, and sector balance sheets, because these data use the instrument classification and not the international accounts functional classification. However, because of the relationship between the two parties, the strictness of terms, and risks and vulnerability aspects of direct investment-related debt may differ from those of other debt. For those reasons, intercompany lending is identified separately in *External Debt Statistics: Guide for Compilers and Users* (see also paragraph 6.26).

6.49 Classification by partner economy is discussed in paragraphs 4.146–4.164, with paragraphs 4.156–4.157 dealing with direct investment. Partner data for direct investment can be classified according to either the immediate or ultimate investor or host economy. The

Box 6.4. Derivation of Data under the Directional Principle

The standard components for direct investment positions and transactions are shown in the table below. They may be rearranged to support different kinds of presentation and analysis.

Components of Direct Investment (Asset/Liability Presentation)

Assets	Liabilities
Of direct investors in direct investment enterprises	**Of direct investment enterprises to direct investor**
A1 Equity	L1 Equity
A2 Debt instruments	L2 Debt instruments
Of direct investment enterprises in direct investor—Reverse investment	**Of direct investor to direct investment enterprises—Reverse investment**
A3 Equity	L3 Equity
A4 Debt instruments	L4 Debt instruments
Of resident fellow enterprises in fellow enterprises abroad	**Of resident fellow enterprises to fellow enterprises abroad**
A5 Equity	**L5 Equity**
A5.1 Equity (if ultimate controlling parent is resident[1])	L5.1 Equity (if ultimate controlling parent is nonresident[2])
A5.2 Equity (if ultimate controlling parent is nonresident[2])	L5.2 Equity (if ultimate controlling parent is resident[1])
A6 Debt instruments	**L6 Debt instruments**
A6.1 Debt instruments (if ultimate controlling parent is resident[1])	L6.1 Debt instruments (if ultimate controlling parent is nonresident[2])
A6.2 Debt instruments (if ultimate controlling parent is nonresident[2])	L6.2 Debt instruments (if ultimate controlling parent is resident[1])

[1]That is, resident in the compiling economy.
[2]That is, not resident in the compiling economy.

Asset/liability presentation

Direct investment assets:
Equity: A1 + A3 + A5;
Debt instruments: A2 + A4 + A6
Direct investment liabilities:
Equity: L1 + L3 + L5;
Debt instruments: L2 + L4 + L6

Directional principle presentations

In principle:
Direct investment abroad (outward direct investment):
Equity: A1 – L3 + A5.1 – L5.2;
Debt instruments: A2 – L4 + A6.1 – L6.2

Direct investment in the reporting economy (inward direct investment):
Equity: L1 – A3 + L5.1 – A5.2;
Debt instruments: L2 – A4 + L6.1 – A6.2

Acceptable practical alternative:
Direct investment abroad:
Equity: A1 – L3 + A5;
Debt instruments: A2 – L4 + A6
Direct investment in the reporting economy:
Equity: L1 – A3 + L5;
Debt instruments: L2 – A4 + L6

institutional sector classification (described in Chapter 4, Section D) may also be applied to direct investment. These issues are discussed further in the *OECD Benchmark Definition of Foreign Direct Investment*.

6.50 Classification by kind of economic activity (industry) may be of interest for direct investment. The *ISIC* or some regional or national equivalent can be used to compile data on the kind of economic activity. Although this classification is not used for other functional categories, it is useful for direct investment. It is preferable to prepare estimates on both inward and outward direct investment on a dual basis, based on the industry of the direct investment enterprise and the industry of the direct investor. If data on only one basis can be prepared, the preferred industry classification is that of the direct investment enterprise. Industrial classification applies to units, rather than transactions. Often in direct investment data, the industry classification is applied to economy-specific enterprise groups, or to economy-specific enterprise groups in a single institutional sector. If a direct investment enterprise or enterprise group is involved in different economic activities, it is classified according to the predominant activity.

d. Further issues concerning direct investment

6.51 In addition to the classification issues in this chapter, direct investment is discussed in the chapters concerning positions, financial account transactions, and primary income (Chapters 7, 8, and 11, respectively). The cross-cutting issues and links are shown in Appendix 6a.

6.52 Some aspects of direct investment—other than those directly related to balance of payments and international investment position data—may be of interest, particularly in the host economy, from analytical and policymaking points of view. While the international accounts data show the cross-border flows and stocks, another aspect of the impact of direct investment is on domestic variables such as employment, sales, value added, and gross fixed capital formation. These statistics are called Activities of Multinational Enterprises and are discussed in Appendix 4.

6.53 The foreign-controlled corporations subsector in the *SNA* overlaps with direct investment. The foreign-controlled corporations subsector includes all subsidiaries and branches resident in the economy, as well as any associates or other enterprises resident in the economy that are under de facto foreign control.

C. Portfolio Investment

6.54 *Portfolio investment is defined as cross-border transactions and positions involving debt or equity securities, other than those included in direct investment or reserve assets.* Securities are defined in paragraph 5.15. The negotiability of securities is a way of facilitating trading, allowing them to be held by different parties during their lives. Negotiability allows investors to diversify their portfolios and to withdraw their investment readily. Investment fund shares or units (i.e., those issued by investment funds) that are evidenced by securities and that are not reserve assets or direct investment are included in portfolio investment. Although they are negotiable instruments, exchange-traded financial derivatives are not included in portfolio investment because they are included in their own separate category.

6.55 Equity not in the form of securities (e.g., in unincorporated enterprises) is not included in portfolio investment; it is included in direct or other investment. Equity in time-share accommodation evidenced by a security is usually portfolio investment (although holdings that provided 10 percent or more of voting power would be direct investment, and holdings not in the form of securities and not included in direct investment would be other investment). In a few cases identified in paragraph 6.28, debt securities representing claims on affiliated enterprises are included in portfolio investment.

6.56 Portfolio investment covers, but is not limited to, securities traded on organized or other financial markets. Portfolio investment usually involves financial infrastructure, such as a suitable legal, regulatory, and settlement framework, along with market-making dealers, and a sufficient volume of buyers and sellers. However, acquisition of shares in hedge funds, private equity funds, and venture capital are examples of portfolio investment that occurs in less public and more lightly regulated markets. (However, shares in these funds are included in direct investment when the holdings reach the 10 percent threshold, and in other equity in other investment when investment is not in the form of a security and not included in direct investment or reserve assets.) Portfolio investment is distinctive because of the nature of the funds raised, the largely anonymous relationship between the issuers and holders, and the degree of trading liquidity in the instruments.

6.57 Portfolio investment may be presented by instrument, original or remaining maturity, or institutional sector. Further information on portfolio investment is included in Chapter 7 (concerning positions), Chapter 8 (concerning financial account transactions), and Chapter 11 (concerning primary income).

D. Financial Derivatives (Other Than Reserves) and Employee Stock Options

6.58 The definition of the functional category financial derivatives and employee stock options (other than reserves) largely coincides with the corresponding financial instrument class, which is discussed in detail in paragraphs 5.79–5.98. The difference in coverage between the functional category and the financial instrument is that financial derivatives associated with reserve asset management are excluded from the functional category and included in reserve assets (see paragraph 6.91). This category is identified separately from the other categories because it relates to risk transfer, rather than supply of funds or other resources.

6.59 Unlike other functional categories, no primary income accrues on financial derivatives. Any amounts accruing under the contract are classified as revaluations and are included in the other changes in assets and liabilities account. (These entries are discussed in paragraphs 9.30–9.31.) In addition, as noted in the footnote to paragraph 10.121, an intermediary may provide services associated with transactions in derivatives.

6.60 Recording of financial derivatives separately for both assets and liabilities is encouraged for both positions and transactions. However, it is recognized that measuring transactions on a gross basis may not be feasible, in which case net reporting is acceptable. Information on financial derivatives (other than reserves) and employee stock options is included in Chapter 7 (concerning positions), Chapter 8 (concerning financial account transactions), and Chapter 9 (concerning revaluations); no investment income arises (see paragraph 11.95).

E. Other Investment

6.61 *Other investment is a residual category that includes positions and transactions other than those included in direct investment, portfolio investment, financial derivatives and employee stock options, and reserve assets.* To the extent that the following classes of financial assets and liabilities are not included under direct investment or reserve assets, other investment includes:

(a) other equity;

(b) currency and deposits;

(c) loans (including use of IMF credit and loans from the IMF);

(d) nonlife insurance technical reserves, life insurance and annuities entitlements, pension entitlements, and provisions for calls under standardized guarantees;

(e) trade credit and advances;

(f) other accounts receivable/payable; and

(g) SDR allocations (SDR holdings are included in reserve assets).

6.62 Other equity is included in other investment, when it is not direct investment or reserve assets. Other equity, as defined in paragraph 5.26, is not in the form of securities, so it is not included in portfolio investment. Participation in some international organizations is not in the form of securities and so it is classified as other equity. In most cases, equity in quasi-corporations for branches and notional units for ownership of land is included in direct investment; however, it is included in other investment if the share of voting power is less than 10 percent.

6.63 Other investment may be split by financial asset or liability class, original or remaining maturity, or institutional sector. Information on other investment is included in Chapter 7 (concerning valuation of positions, particularly loans), Chapter 8 (concerning financial account transactions), and Chapter 11 (concerning primary income).

F. Reserves[3]

Reference:

IMF, *International Reserves and Foreign Currency Liquidity: Guidelines for a Data Template.*

1. Reserve assets

a. General definition

6.64 *Reserve assets are those external assets that are readily available to and controlled by monetary authorities for meeting balance of payments financing needs, for intervention in exchange markets to affect the currency exchange rate, and for other related purposes (such as maintaining confidence in the currency and the economy, and serving as a basis for foreign borrowing).*[4] Reserve assets must be foreign currency assets and assets that actually exist. Potential assets are excluded. Underlying the concept of reserve assets are the notions of "control," and "availability for use," by the monetary authorities.[5] The composition of reserve assets and reserve-related liabilities is shown in Box 6.5.

b. Residence

6.65 In accordance with the residence concept, reserve assets, other than gold bullion, must be claims on nonresidents. Conversely, the authorities' foreign currency claims on residents, including claims on resident banks, are not reserve assets. Nonetheless, foreign currency claims on resident banks can be at the disposal of the monetary authorities and can be readily mobilized to meet demand for foreign exchange. Such claims are presented as a supplementary item to the IIP. For the explanation of residence, see Chapter 4, Section E.

[3]A more complete picture of monetary authorities' international liquidity position is given in *International Reserves and Foreign Currency Liquidity: Guidelines for a Data Template (Guidelines)*. The *Guidelines* address a number of key issues, and are drawn on in this text.

[4]For dollarized economies, the need to hold reserves for the purpose of intervention in exchange markets is not relevant for defining the reserve assets of these economies. Dollarization and euroization are defined in paragraph A3.10.

[5]Monetary authorities may sometimes employ fund managers to manage reserve assets. In such arrangements, the fund managers are acting as agents and are paid a fee for their services.

Box 6.5. Components of Reserve Assets and Reserve-Related Liabilities

Reserve assets
- Monetary gold
  - Gold bullion
  - Unallocated gold accounts
- Of which: Monetary gold under swap for cash collateral[1]
- Special drawing rights
- Reserve position in the IMF
- Other reserve assets
  - Currency and deposits
  - Claims on monetary authorities
  - Claims on other entities
  - Securities
    - Debt securities
      - Short-term
      - Long-term
    - Equity and investment fund shares or units
    - Of which: Securities under repo for cash collateral[1]
  - Financial derivatives
  - Other claims

Reserve-related liabilities to nonresidents (memorandum items)
- Short-term (on a remaining maturity basis)
  - Credit and loans from the IMF
  - Debt securities
  - Deposits
  - Loans
    - Repo loans
    - Other loans
  - Other short-term foreign currency liabilities to nonresidents

(See also Appendix 9 Table V for additional supplementary items for reserve-related liabilities.)

[1]In the IIP only.

c. Definition of monetary authorities

6.66 *The functional concept of monetary authorities is essential for defining reserve assets. Monetary authorities encompass the central bank (which subsumes other institutional units included in the central bank subsector, such as the currency board) and certain operations usually attributed to the central bank but sometimes carried out by other government institutions or commercial banks, such as government-owned commercial banks.* Such operations include the issuance of currency; maintenance and management of reserve assets, including those resulting from transactions with the IMF; and operation of exchange stabilization funds. In economies in which extensive reserve assets are held outside of the central bank, supplementary information should be provided on the institutional sector of holdings of those reserve assets.

d. Control

6.67 In general, only external claims actually owned by the monetary authorities can be classified as reserve assets. Nonetheless, ownership is not the only condition that confers control. In cases in which institutional units (other than the monetary authorities) in the reporting economy hold legal title to external foreign currency assets and are permitted to transact in such assets only on terms specified by the monetary authorities or only with their express approval. In such cases, the assets can be considered reserve assets because they are under the direct and effective control of the monetary authorities. To be counted in reserve assets, the conditions to be met are that:

- the resident entity can transact only in those claims with nonresidents on the terms specified by the monetary authorities or only with their express approval; and
- the authorities have access on demand to these claims on nonresidents to meet balance of payments financing needs and other related purposes; and
- a prior law or an otherwise legally binding contractual arrangement confirms this agency role of the resident entity that is actual and definite in intent.

6.68 If such assets are included under reserve assets, to avoid double counting, they should not also be classified as assets, or transactions in assets, in other components of the IIP and balance of payments. They are classified within reserve assets depending on their nature (e.g., deposits and securities are classified as such). Except in unusual circumstances, direct and effective control is not to be construed as extending beyond assets owned by deposit-taking corporations.

e. Availability for use

6.69 Reserve assets must be readily available in the most unconditional form. A reserve asset is liquid in that the asset can be bought, sold, and liquidated for foreign currency (cash) with minimum cost and time, and without unduly affecting the value of the asset.[6]

[6]No time limit is provided, but to qualify as reserves, an asset should be available in a very short period of time given the speed at which experience suggests a foreign exchange need can arise in adverse circumstances.

This concept refers to both nonmarketable assets, such as demand deposits, and marketable assets, such as securities for which there are ready and willing sellers and buyers. The ability to raise funds by using the asset as collateral is not sufficient to make an asset a reserve asset. Some deposits and loans can be liquid and included in reserve assets, although they are not necessarily marketable.

6.70 To be readily available to the authorities to meet balance of payments financing needs and other related purposes under adverse circumstances, reserve assets generally should be of high quality.

f. Further clarifications on reserve assets

6.71 As a consequence of their purpose of meeting balance of payments financing needs, and supporting the exchange rate, reserve assets must be both denominated and settled in foreign currency. Denominated is defined to mean the currency in which the contract is specified. (Currency of denomination and currency of settlement are discussed in paragraphs 3.98–3.103.)

6.72 Furthermore to be liquid, reserve assets must be denominated and settled in convertible foreign currencies, that is, currencies that are freely usable for settlements of international transactions.[7] In addition, assets denominated in gold and SDRs may qualify as reserve assets.

6.73 In some instances, economies may hold assets denominated in the currency of a neighboring economy because the economy's risk exposures are closely related to their neighbor given the composition of their international trade, even though the currency may not be widely traded. These assets should be excluded from reserve assets (and included under the appropriate functional category and instrument) if the currency does not meet the definition of a convertible foreign currency set out in paragraph 6.72, but supplementary data can be provided. Such circumstances are envisaged when an economy is highly dependent on a larger regional neighbor for its international trading activity.[8]

6.74 Assets that are denominated in or indexed to the domestic currency but settled in foreign currency cannot be reserve assets, because the value of such assets would decline along with the domestic currency in the circumstance of a domestic currency crisis.

6.75 An existing asset that is committed for a future use but not encumbered can be included provided that the asset is readily available to meet a balance of payments financing need (and other related purposes stated in paragraph 6.64). An asset should not be denied as a reserve asset simply because the use to which the asset is to be put is a foreseeable one. However, when an asset is not readily available—such as an asset whose use is blocked—the asset should not be counted as reserve assets.

g. Classification of reserve assets

6.76 Reserve assets consist of monetary gold, SDR holdings, reserve position in the IMF, currency and deposits, securities (including debt and equity securities), financial derivatives, and other claims (loans and other financial instruments).

6.77 Monetary gold, SDR holdings, and reserve position in the IMF are considered reserve assets because they are assets readily available to the monetary authorities in unconditional form. Currency and deposits, securities, and other assets in many instances are equally available and therefore qualify as reserve assets.

6.78 *Monetary gold is gold to which the monetary authorities (or others who are subject to the effective control of the monetary authorities) have title and is held as reserve assets.* It consists of gold bullion (including gold coins, ingots, bars with a purity of at least 995/1,000, and gold bullion held in allocated gold accounts, regardless of the location of the account)[9] and unallocated gold accounts with nonresidents that give title to claim the delivery of gold.[10] Gold bullion is usually traded on organized markets or through bilateral arrangements between central banks. To qualify as reserve assets, gold accounts must be readily available upon demand to the monetary authorities.

6.79 **Allocated** and **unallocated gold accounts** are to be distinguished from accounts that are linked to gold (accounts indexed to gold) but do not give title to claim delivery of gold. The latter are classified as currency and deposits and are included within reserve assets provided they meet the criteria of reserves.

6.80 If the monetary authorities deposit gold bullion in an unallocated gold account, the gold bullion is

[7]The term "freely usable" is not used in a restrictive sense to cover the currencies in the SDR basket only.

[8]It is possible but unlikely that such dependence could arise with an economy that is not a neighbor.

[9]However, transactions with residents in gold bullion are not recorded in the balance of payments (see paragraph 9.18).

[10]See paragraphs 5.76–5.77 for definitions of allocated and unallocated gold accounts.

demonetized (see paragraph 9.18) and this is recorded in the other changes in assets account of the monetary authorities. If the account is with a nonresident, a transaction in nonmonetary gold is recorded in the goods and services account. However, transactions in gold bullion as reserve assets between monetary authorities and with international financial institutions are recorded as transactions in gold bullion and are not recorded as other changes in assets. If the unallocated gold account is with a nonresident and available on demand, a transaction in currency and deposits is recorded and then reclassified to monetary gold (unallocated gold accounts) if held as a reserve asset.[11] However, if the deposit is with another monetary authority or an international financial institution, a transaction in unallocated gold accounts is recorded.

6.81 To minimize risks of default in gold lending transactions,[12] monetary authorities can require adequate collateral instead of cash (such as securities) from the depository. Such securities collateral received should not be included in reserve assets, thereby preventing double counting as the gold lent remains an asset of the monetary authorities.[13]

6.82 Allocated and unallocated gold accounts with nonresidents out on swap by the monetary authorities for cash collateral are either (a) included as reserve assets of the original owner with the loan generated reported as a reserve-related liability (a memorandum item) if a liability is to a nonresident,[14] or (b) excluded from reserve assets and either demonetized (gold bullion) or reclassified as other investment, currency and deposits, assets (unallocated gold accounts). In either case, any loan liability to a nonresident is recorded within "other investment," with the foreign currency received (provided it is a claim on a nonresident), and recorded as an increase in currency and deposits within reserve assets.[15] The value of allocated and unallocated gold accounts included in reserve assets and out on swap (see paragraphs 7.58–7.59) for cash collateral is identified in the IIP to facilitate an assessment of the level of reserves adjusted for the swap activities.

6.83 Any unallocated gold account liabilities of resident entities to nonresident monetary authorities are to be classified as other investment, currency and deposits.

6.84 SDR holdings are reserve assets created by the IMF and are equivalent to liquid balances in convertible currencies in nearly every respect. Further information on SDRs is provided in paragraphs 5.34–5.35.

6.85 Reserve position in the IMF is the sum of (a) the "reserve tranche," that is, the foreign currency (including SDRs) amounts that a member country may draw from the IMF at short notice;[16] and (b) any indebtedness of the IMF (under a loan agreement) in the General Resources Account that is readily available to the member country, including the reporting country's lending to the IMF under the General Arrangements to Borrow (GAB) and the New Arrangements to Borrow (NAB). While a member country must present a declaration of balance of payments–related need to make a purchase in the reserve tranche (reduction in reserve position), the IMF does not challenge a member's request for reserve tranche purchases. Convertible currencies from a reserve tranche purchase may be made available within days.

6.86 Deposits refer to those available on demand; deposits with a fixed term that are redeemable on demand or at very short notice without unduly affecting the value of the deposit can be included. Deposits included in reserve assets are those held in foreign central banks, the BIS, and other nonresident deposit-taking corporations, and deposit agreements with IMF Trust Accounts that are readily callable to meet a balance of payments financing need. Because short-term loans provided by the monetary authorities to other central banks, the BIS, and other deposit-taking corporations are much like deposits, it is difficult

[11]Similarly, interest accruing on unallocated gold accounts is recorded as a transaction in currency and deposits within reserve assets by the monetary authority. If national practice is to include such interest under monetary gold, the amount of interest accruing is reclassified in the other changes in assets account.

[12]Sometimes known as gold deposits or gold loans.

[13]If the securities received as collateral are repoed out for cash, a repo transaction should be reported, as discussed below under "securities."

[14]If the liability is to a resident, the liability is not in the balance of payments or IIP, but it is reported under repo loans in other foreign currency liabilities (see Table V in Appendix 9).

[15]If the foreign currency received from a nonresident is a claim on a resident entity, the corresponding entry to the loan liability to the nonresident is a reduction in currency and deposit liabilities of the resident entity, as the transaction reduces the claim of the nonresident on the resident entity.

[16]Reserve-tranche positions in the IMF are liquid claims of members on the IMF that arise not only from the reserve asset payments for quota subscriptions but also from the sale by the IMF of their currencies to meet the demand for use of IMF resources by other members in need of balance of payments support. Repayments of IMF resources in these currencies reduce the liquid claim of the member whose currency was supplied. In Table A9-I-1 in Appendix 9 on currency composition, the reserve tranche positions in the IMF should be classified in the "SDR basket." The domestic currency component of the quota is considered in economic terms to be of a contingent nature and so is not classified as an asset or liability in the international accounts.

in practice to distinguish the two. For this reason, by convention, and consistent with the treatment of interbank positions (see paragraph 5.42), the reporting of deposits in reserve assets should include short-term foreign currency loans that are redeemable upon demand, made by the monetary authorities to these nonresident deposit-taking corporations. Short-term foreign currency loans that are available on demand without unduly affecting the value of the asset, and made by the monetary authorities to nonresident non-deposit-taking corporations, and long-term loans to IMF Trust Accounts that are readily repayable to meet a balance of payments financing need can qualify as reserve assets ("other claims"). But other long-term loans by the monetary authorities to nonresidents not readily available to meet balance of payments financing needs are not reserve assets.

6.87 Securities include liquid and marketable equity and debt securities issued by nonresidents; long-term securities (such as 30-year U.S. Treasury bonds) are included. Unlisted securities (i.e., securities not listed for public trading) are, in principle, excluded unless the securities are liquid.

6.88 Securities that have been transferred under repurchase agreements, or similar agreements by the monetary authorities for cash collateral are assets of the original authorities and are either (a) included as reserve assets of the original owner with the loan generated reported as a reserve-related liability (a memorandum item) if a liability is to a nonresident,[17] or (b) excluded from reserve assets and reclassified as portfolio investment assets. In either case, any loan liability to a nonresident is recorded within "other investment," with the foreign currency received, provided it is a claim on a nonresident, and is recorded as an increase in currency and deposits within reserve assets. The value of securities included in reserve assets and out on repo (or similar arrangements, see paragraph 7.58) for cash collateral is identified in the IIP to facilitate an assessment of the level of reserves adjusted for the repo activities.

6.89 In the case of reverse repos, the funds provided to the counterparty should be recorded as a decrease in currency and deposits within reserve assets, but if the claim (i.e., repo asset) is liquid and available upon demand to the monetary authorities, then it is considered part of the reserve assets in "other claims" (or "deposits" if classified in national measures of broad money).

[17]If the liability is to a resident, the liability is not in the balance of payments or IIP, but it is reported under repo loans in other foreign currency liabilities (see Table V in Appendix 9).

6.90 When securities are lent or borrowed in exchange for other securities and no cash is exchanged, no transaction should be reported. Securities lent are the assets of the original authorities, and securities collateral received are not included as reserve assets of the receiving monetary authorities.

6.91 Financial derivatives are recorded in reserve assets only if the derivatives pertain to the management of reserve assets, are integral to the valuation of such assets, and are under the effective control of the monetary authorities. Because they pertain to the management of assets, these transactions and positions are recorded on a net basis (assets less liabilities) at market value.

6.92 Other claims include loans to nonresident non-deposit-taking corporations, long-term loans to an IMF Trust Account that are readily repayable to meet a balance of payments financing need (see paragraph 6.86), loans arising from a reverse repo (unless classified as deposits) (paragraph 6.89), and other financial assets not included previously but that are foreign currency assets that are available for immediate use (such as nonnegotiable investment fund shares or units as described in paragraph 6.101).

h. Selected cases

Special purpose government funds

6.93 Some governments create special purpose government funds, usually called sovereign wealth funds (SWFs). *Created and owned by the general government for macroeconomic purposes, SWFs hold, manage, or administer assets to achieve financial objectives, and employ a set of investment strategies which include investing in foreign financial assets. The funds are commonly established out of balance of payments surpluses, official foreign currency operations, the proceeds of privatizations, fiscal surpluses, and/or receipts resulting from commodity exports.* The establishment of a special purpose government fund raises the issue of whether or not the external assets held in the fund should be included in reserve assets.

6.94 A key determination is whether some legal or administrative guidance results in the assets being encumbered in a way that precludes their ready availability to the monetary authorities.

6.95 If the special purpose government fund's external assets are on the books of the central bank, or an agency of the central government, that allows the monetary authorities control over the disposition of funds, then the presumption is that the assets are reserve assets (provided all other criteria for being a reserve asset are met). On the other hand, if the funds are held in a long-term fund with a separate legal identity, the presumption is that they should not be included in reserve assets, not least because the ready availability criterion is less likely to be met.

6.96 In some cases, while assets are invested in a separate investment corporation, there may be an agreement that such assets can be readily called back if needed. In other cases, funds could be withdrawn during the annual budgetary process.

6.97 Any final determination of whether an asset can be classified as a reserve asset or not, depends on an examination of the circumstances: namely, is the asset readily available to the monetary authorities and is there a liquid claim of a resident entity on a nonresident in foreign currency? But in the absence of legal or administrative impediments, and given the fungibility of assets, even assets that had been earmarked as part of a special purpose government fund—but that could be used to meet balance of payments financing needs and other related purposes—are reserve assets (subject to the other criteria being met, including, importantly, the control of the monetary authorities over the disposition of the funds).

6.98 Assets held in special purpose government funds that meet the definition of reserve assets are classified within reserve assets depending on their nature. So, if the special purpose government funds hold deposits, securities, and other reserve assets, these are classified as such within reserve assets. Assets held in a resident special purpose government fund that are claims on nonresidents but do not meet the criteria to be classified as reserve assets are classified in the financial account and IIP under the appropriate instrument and functional category. If special purpose government funds own direct investment equity and debt securities that could be classified in either direct investment or reserves assets, as general guidance, in the hierarchy of the balance of payments and IIP between direct investment and reserve assets, the equity securities should be classified as direct investment ahead of reserve assets, and debt securities should be classified as reserve assets ahead of direct investment.

Pooled assets

6.99 As a means of reserve assets management, monetary authorities from different economies might cooperatively invest through an asset pool. Such pooled asset arrangements are collective investment schemes under which funds provided by participants are held in an investment vehicle (usually nonresident of the participants' economies) that conducts investments. The participants have a claim on the collective investment scheme. Some pooled asset arrangements may have features that constrain the use of the claim as a reserve asset. To determine whether the claim on the pooled asset arrangement meets the definition of reserve assets, as with special purpose government funds, an examination of the legal and institutional framework of the arrangement is needed.

6.100 As with other reserve assets, the claim on the asset pool needs to be readily available to the monetary authorities and to be a liquid claim in foreign currency on nonresidents. In addition, other factors should be considered in determining whether the claim is a reserve asset. These include the following:

- **The ability to use pooled assets to raise external liquidity in foreign currency**. Even if the claim is in foreign currency, a high concentration of the underlying assets in claims on the domestic economy that constrains the ability of that economy to generate external liquidity or that results in the foreign currency value of the instrument being significantly affected in a time of crisis (such as a high concentration in domestic currency assets) would cause considerable doubt as to whether the instrument could be included in reserve assets.
- **Whether the assets are truly foreign currency claims**. An asset pool might be structured such that, while the assets are denominated in foreign currency, the monetary authority has a de facto claim in the domestic currency. In this instance, it is inappropriate to classify the asset as a reserve asset for the reasons described in paragraph 6.74.

6.101 Pooled assets are classified within reserve assets depending on their nature. For instance, if the participant can readily transact in these claims only by selling its claim back to the investment vehicle, the claim might need to be classified as a nonnegotiable investment fund share (an "other claim"). Pooled assets that are claims on nonresidents but that do not meet the criteria to be classified as reserve assets are classified in the financial account according to their nature (most probably an equity asset) under the appropriate functional category.

Central bank swap arrangements

6.102 Assets created under reciprocal facilities (swap arrangements) for the temporary exchange of deposits between the central banks of two economies warrant mention. Deposits (in foreign exchange) acquired by the central bank initiating the arrangement are treated as reserve assets because the exchange provides the central bank with assets that can be used to meet the economy's balance of payments financing needs and other related purposes. Reciprocal deposits acquired by the partner central bank also are considered reserve assets, as long as they meet the general criteria for being reserve assets, if they are denominated and settled in a convertible currency.

6.103 Reciprocal currency arrangements between central banks may also take the form of a securities repurchase agreement. In this case, one central bank transfers securities (sometimes denominated in its domestic currency) to another central bank in exchange for foreign currency, with the transactions later reversed, typically three months in the future. Such transactions should be treated as collateralized loans, with the central bank that initiated the transaction paying corresponding interest on the foreign currency received. The cash-taking central bank can therefore include the foreign currency received in its reserve assets if the criteria for reserve assets are met. The cash-providing central bank should not include the securities received as collateral in its reserve assets as the securities are treated as not having changed economic ownership (see paragraph 5.54). See also paragraph 6.90 on securities lending or borrowing transactions in reserve assets.

6.104 When a central bank acquires or disposes of a liquid foreign currency claim on a nonresident from a domestic bank (e.g., through an exchange of foreign and domestic currency deposits, a change in reserve requirements on foreign currency deposits, or other domestic transactions that increase or change the composition of reserve assets), this is recorded through the other changes in volume account. It is not recorded in the balance of payments, however, given that the transaction is between two residents (see paragraph 3.6).

i. Foreign assets that do not qualify as reserve assets

6.105 Lines of credit that could be drawn on and foreign exchange resources that could be obtained under swap agreements are not reserve assets because they do not constitute existing claims. Real estate owned by the monetary authorities is not to be included in reserve assets because real estate is not considered a liquid asset. Silver bullion, diamonds, and other precious metal and stones are not included in reserve assets because they are considered goods and not financial assets.

6.106 Capital subscriptions to international organizations that are not readily available to the monetary authorities do not meet the definition of reserve assets. These subscriptions are included in other investment, unless they are in the form of securities, in which case they are classified as portfolio investment.

6.107 Pledged assets are typically not readily available. Those pledged assets that are encumbered and therefore are not readily available should be excluded from reserve assets. Encumbered assets are distinguished from reserve assets that are pledged under securities lending arrangements and repurchase agreements.

6.108 An example of pledged assets is collateral used for third-party loans and third-party payments. If these assets are encumbered, they should be excluded from reserve assets. However, assets may be pledged as collateral to provide guarantees in the event of default by another entity, or for lines of credit, and may not be encumbered until events occur to trigger the pledge. Such assets can be included in reserve assets until encumbered. Other examples of pledged assets that are to be excluded from reserve assets include (a) assets pledged by the monetary authorities to investors as a condition for the investors to invest in securities issued by domestic entities (such as central government agencies), if such pledged assets are considered encumbered; and (b) assets lent by the monetary authorities to a third party that are not available until maturity.

6.109 The pledged assets should be excluded only to the extent of the value of the pledge; in other words, if the pledge is valued at 100, the maximum amount to be excluded from reserve assets is 100.

6.110 In some circumstances, assets held as reserve assets may be "frozen," such as by a foreign government within whose jurisdiction the assets are located, restricting their availability. In such circumstances, the reserve assets that are affected are to be reclassified to the relevant functional category, such as "other investment" if bank deposits are "frozen."

6.111 Foreign currency claims that are transferred to the monetary authorities by other institutional units in the reporting economy just prior to certain accounting or reporting dates, with accompanying reversals of such transfers soon after those dates (commonly known as "window dressing"), should not be counted as reserve assets.

6.112 Net creditor positions in regional payments arrangements that involve reciprocal lines of credit—a characteristic of loan arrangements (see paragraph 5.51)—are classified as loans in other investment[18] and are not included in reserve assets, except in circumstances in which they are considered readily available to the monetary authorities to meet a balance of payments need and other related purposes. Net asset balances in bilateral payments agreements have much in common with other types of tied loans that authorities make to stimulate exports, provide aid, or further other aspects of government policy. Such bilateral payments agreement balances are therefore conventionally excluded from reserve assets. Also, owing to their nature, working balances of government agencies are not included in reserve assets.

j. Other issues

6.113 Assets owned by the monetary authorities that do not meet the criteria to be classified as reserve assets are classified in the financial account under the appropriate instrument and functional category.

6.114 Currency unions and economies that adopt another currency (such as dollarization and euroization) raise specific issues for the concept of reserve assets. These issues are discussed in Appendix 3.

2. Reserve-related liabilities

6.115 *Reserve-related liabilities are defined as foreign currency liabilities of the monetary authorities that can be considered as direct claims by nonresidents on the reserve assets of an economy.* Though not identified as such in the standard components of the balance of payments and IIP, where they are included in other categories (notably portfolio and other investment), reserve-related liabilities are important to monitor. Reserve-related liabilities can be presented by instrument and maturity (see Appendix 9, Table V). Short-term reserve-related liabilities on a remaining maturity basis are a memorandum item to the IIP (as shown in Box 6.5). Some economies may choose to present the full table of foreign currency assets and liabilities in Appendix 9, Table V, separately identifying the short-term reserve-related liabilities.

6.116 The value of the SDR allocation and loans from the IMF to monetary authorities are included in reserve-related liabilities. Other liabilities covered include:

- Foreign currency loan and deposit liabilities of the monetary authorities to nonresidents, including those arising from foreign currency swaps with other central banks, loans from BIS, and from other deposit-takers;
- Foreign currency loan liabilities to nonresidents associated with securities that the monetary authorities have repoed out;
- Foreign currency securities issued by the monetary authorities and owed to nonresidents; and
- Other foreign currency liabilities to nonresidents, including foreign currency accounts payable and financial derivatives—recorded on a net basis (liabilities less assets)—settled in foreign currency and associated with, but not within the definition of, reserve assets (see paragraph 6.91). Such financial derivatives could include those that are not sufficiently liquid or are not integral to the valuation of reserves assets.

Liabilities to residents and liabilities that are both denominated and settled in domestic currency are not included.

[18]Net debtor positions in such arrangements are also classified as loans.