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**Treatment of Resident-to-Resident Transactions in Foreign Securities**

**Prepared by the Central Bank of Russia**



## Treatment of resident-to-resident transactions in foreign securities

### I. INTRODUCTION

1. The paper covers the methodological changes in treatment of resident-to-resident transactions in foreign securities in the new *Balance of Payments and International Investment Position Manual* (BPM6). The paper is intended to identify the main innovations in BPM6, as compared to BPM5 and the effects of these changes on transparency of information, provided by the BOP. All assumptions made in the paper are disputable.

### II. BACKGROUND

2. The BPM6 has clarified the recording of transactions between two resident institutional units in external assets: “Transactions between two resident institutional units in external assets are domestic transactions. Such transactions, however, affect the external asset positions of the two resident units involved. The external asset position of one resident unit is reduced and the position in the same external asset of another resident unit is increased, and, thus leads to a change in domestic sectoral breakdown if the two parties are in different sectors. Such transactions result in changes in structure of external asset positions and should be recorded in the international accounts as a reclassification of sectors of holding (that is, in the other changes in financial assets and liabilities account). If both units fall in the same institutional sector, such reclassification entries cancel each other, thus, have no effect on sectoral positions.” (paragraph 3.7). This clarification is definitely positive: it facilitates the uniform accounting of resident-to-resident transactions in BOPs of two partner countries.
3. In practice, the recommendation to record in the BOP all transactions that have an impact upon the change of debtor/creditor relationship can hardly be implemented. The BOP data collection system in some countries is focused exclusively on resident-nonresident transactions, and, thus the information on any transactions between two residents is not available. In some countries the compilers wishing to follow debtor/creditor approach as close as possible experience difficulties in identification of two parties of the transaction if the deal is closed through stock exchange, for example. This means that no matter which data source is used by countries: ITRS, direct reporting, custodian information or combination of all, - a significant number of portfolio investment transactions can't be unambiguously attributed to the BOP. Under such circumstances use of the other changes in financial assets and liabilities account is a rational proposal. Nevertheless, quite a few questions arise:
  1. What types of external assets are meant in paragraph 3.7?

2. Should reclassification flows in the other changes in volume account be classified by type?
3. Won't the growing role of the other changes account undermine the importance of the BOP?
4. How can this innovation be reflected in the BOP standard presentation and in the sectoral analytic presentation?

### **Types of external assets covered in paragraph 3.7**

4. At a glance all external assets seem to be concerned. This impression even deepens on reading paragraph 6.104 that interprets general principles of accounting of reserve assets: "When a central bank acquires, or disposes of, a liquid foreign currency claim on a nonresident from a domestic bank, either through an exchange of foreign or domestic 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, but not in the balance of payments given that the transaction is between two residents".
5. If a liquid foreign currency claim on a nonresident acquired by a central bank from a domestic bank is a security or another tradable instrument, then the conclusion of paragraph 6.104 is clear, as nonresidents are not involved in this flow of securities. At the same time we know that "each transaction consists of two flows, and gives rise to two accounting entries for each party" (paragraph 3.11). The flow associated with the security is shown in the other changes account, but the flow of funds between buyer and seller of the security is recorded in the BOP, given these are not domestic currency funds, because the foreign exchange funds are finally held by residents with nonresident banks.

**Table 1: International Investment Position**

	Beginning of period IIP	Transactions	Other changes in volume	End of period IIP
Portfolio investment of banks	100		-100	0
Other investment of banks	0	100		100
Reserve assets	100			100
Securities	0		100	100
Deposits	100	-100		0

6. Can a central bank acquire from a domestic bank a claim on a nonresident in a form of a deposit? It is said in paragraph 6.104 that a domestic bank can have different types of foreign currency deposits with its central bank or there can be other types of domestic transactions between them (interventions, for example). It's reasonable to assume that the central bank can place the acquired funds with a nonresident in a form of a liquid foreign currency claim. In this case the reserve assets of the central bank go up as a result of its interaction with a nonresident. The banks simultaneously

close some of their deposits with nonresidents, that is conduct of the transactions with the latter.

7. Though the wording of this paragraph is puzzling, the experience allows to conclude, that only domestic transactions in tradable external assets with nonresident debtor not involved should be recorded in the other changes in volume account. The settlements of these instruments in foreign currency are BOP entries. In principle, settlements in domestic currency can be recorded in the BOP as well. Apparently, the exchange of two tradable instruments, irrespective to the residence of their debtors, between two resident units can be treated as a pure case when there are no BOP flows.

#### **Need for breakdown of reclassification flows by type**

8. In Chapter 9 “Other Changes in the Financial Assets and Liabilities Account” the issue of separate presentation of different types of other flows including reclassifications is brought up. According to BPM5 the predominant types of reclassification beyond the reserve assets were changes in functional category, mainly from portfolio to direct investment or vice versa. These reclassifications were more or less identifiable in the IIP, because for portfolio and direct investment one could see similar figures with the opposite signs.
9. In BPM6 domestic transactions between different sectors as well as changes in contractual terms are added to reclassifications. As a result, the items for securities in the IIP cover quite a few types of reclassification entries. Only additional breakdown could help preserve understanding of what influenced the volume of the financial instrument.

#### **The growing role of the other changes account**

10. The BOP is a generally recognized instrument of macroeconomic analysis and forecasting. From this point of view it's more advanced than the IIP. The decisions, though reasonable, to exclude some additional transactions from the BOP make the latter insufficient for comprehensive analysis. In the example mentioned above the BOP shows the decline in the reserve assets, whereas the stock of the reserves doesn't change. For tradable foreign instruments the BPM6 BOP needs to be supplemented by the IIP. But the IIP is not disseminated as frequently as the BOP is.

#### **The recording in the BOP standard presentation and in the sectoral analytic presentation**

11. The recording of resident-to-resident transactions in foreign securities in the BOP is similar to the accounting of transactions between residents in foreign currency, as both are tradable assets. Paragraph 5.38 of BPM6 says “Transactions that take place between residents settled in foreign currency in circulation are domestic transaction.”

12. It may be the case in some countries that the foreign currency is one of the most important financial assets of the households and that's why the item is worth separate disclosing. And, at the same time the policy-makers in these countries can prefer the BOP sectoral presentation to the standard one. In this case the switch to BPM6 recommendation can appear rather painful.
13. In Russia the BOP compilers have been estimating the households' accumulation of foreign currency through estimating their transactions. All transactions with nonresidents as well as residents in other sectors are recorded in the BOP. Example: During the crisis the aspiration of the households to converse their domestic assets in foreign currency was the immediate cause of the sharp decline in the international reserves.

**Table 2: Difference between the standard presentation and the sectoral analytic presentation**

	BPM6		BPM5	
	Credits	Debits	Credits	Debits
<b>Standard Components</b>				
Deposits	100	100	100	100
Foreign Currency		100		100
<i>Banks</i>		100	100	100
<i>Other Sectors</i>		0		100
Reserve Assets	100		100	
<b>Sectoral Presentation</b>				
Banks' Assets		100		0
<i>Deposits</i>	100	100	100	100
<i>Foreign Currency</i>		100	100	100
Other Sectors' Assets		0		100
<i>Foreign Currency</i>				100
Reserve Assets	100		100	

14. An important point is that the BPM5 and BPM6 standard presentations coincide with each other at the aggregate level of financial instruments and, therefore, functional categories, whereas sectoral presentations are different at all levels.
15. Under BPM5 approach the beneficiaries of the deals recorded are better identifiable: in the BOP the credit entry for reserve assets is balanced by the debits for foreign currency of households in spite of the fact that the latter bought cash from the domestic banks. The role of banks, that purchase foreign banknotes abroad, import and sell them to the households, is shown as just intermediary, their debits and credits for foreign currency item net each other. It's clear that the banks' holdings of foreign currency haven't changed.
16. In accordance with BPM5, the BOP sectoral presentation seems more transparent and, because of that, more friendly for users. The BOP seems all-sufficient, and it does explain the bulk of the changes in positions of different sectors. In general it can be difficult to explain to the users where some important BOP transactions have disappeared.

*Questions for the Committee:*

1. *What types of external assets are meant in paragraph 3.7?*
2. *Should reclassification flows in the other changes in volume account be classified by type?*
3. *Won't the growing role of the other changes account undermine the importance of the BOP?*
4. *How can this innovation be reflected in the BOP standard presentation and in the sectoral analytic presentation?*