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ADAPTING FDI STATISTICS TO TODAY'S WORLD

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Session 2.5.: The revised Benchmark Definition (BMD): Adapting FDI data to the new realities of the global economy

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ADAPTING FDI STATISTICS TO TODAY'S WORLD

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INTRODUCTION

1. While economic globalisation tends to increase the need for information on cross-border investment by multinational groups, and therefore make Foreign Direct Investment statistics ever more useful, experience has shown that it also results in increasingly sophisticated behaviours within multinational groups. By contrast to this increasing complexity, statisticians are faced with mounting pressure to reduce the reporting burden and simplify statistical reporting. The updating process of the OECD Benchmark Definition on FDI statistics, the international standard for the compilation of these statistics², intended to draw a reasonable balance between this need for higher sophistication of statistical concepts and the constraints faced by compilers to collect data.

2. This note summarises main market developments which affect the readability and usefulness of FDI statistics. Section 1 provides an overview of the main uses of FDI statistics, and highlights that they require a large variety of data. Section 2 assesses challenges raised for FDI statistics by developments in financial markets and in the behaviour of multinational companies. Section 3 suggests some fields which may be explored to further adapt FDI statistics to economic developments. It is followed by concluding remarks on the main challenges ahead for FDI statisticians.

¹ The views expressed in this note are those of the author, and do not necessarily reflect those of the European Central Bank.

² Together with the IMF Balance of Payments and International Investment Position Manual.

SECTION 1 – THE VARIETY OF USES OF FDI STATISTICS TENDS TO REQUIRE A PERMANENT EXPANSION OF DATA SETS

3. As described in chapter 2 of the revised OECD Benchmark Definition of FDI, FDI statistics are used for a number of different purposes. Three key uses may be highlighted:

- *Use of inward FDI as an indicator of attractiveness of a country for setting up (or investing in) local companies*

There are many examples of this use³. Many of these studies focus on the link between direct investment and policies run in a given country.

- *Use of FDI as a catalyst to sustainable economic growth*

Many studies have highlighted the positive effects of FDI related to (i) its (usual) stability and (ii) the know-how transfers which often accompany such investments⁴. However, additional information is frequently regarded as useful for this assessment. In particular, a number of such studies noted the different effect for economic growth of new investment (e.g. creation of a company in a country by non-residents), often named “Greenfield investment”, as opposed to the purchase of existing companies by foreign investors.

- *FDI as an indicator of globalisation*

The OECD Handbook on Economic Globalisation Indicators includes useful FDI indicators on the involvement of OECD countries in the economic globalisation process.

4. Frequent requests for specific data are submitted to statisticians. For instance, interest has been expressed to study the involvement of Small and Medium Size enterprises in direct investment, or FDI developments in specific sectors, e.g. the financial sector.

5. Furthermore, FDI are used by a number of economists for additional purposes, which these statistics can only partly fulfil:

3 For instance, “Foreign direct investment in Southeastern Europe: how (and how much) can policies help? IMF Working Paper WP/05/110, June 2005, or “Competitiveness and Economic Policies Related to Foreign Direct Investment, Working Paper 3. Hungarian Ministry of Finance, Budapest, September 2003, or “Lithuania: foreign direct investment – impact and policy analysis”, OECD Working Paper on international investment No 2000/3.

4 See for example “Transparency, Specialization and FDI”, Working Paper 1161, Centre for Economic Studies, University of Munich, Germany, March 2004.

- *Indicators of the internationalisation of firms:*

A note by the European Commission (Directorate General for Economic and Financial Affairs), published within the Quarterly Report on the euro area for the fourth quarter 2004⁵, illustrated this use very clearly, as well as its limitations, by noting that “FDI is an imperfect but so far the best available indicator in terms of coverage, timeliness and international comparability of the data. A difference between both emerges for instance when an international company expands activity but finances this with capital in the source country because this transaction is not counted as FDI. Another trend in the internationalisation of production that is not covered in FDI statistics is the spread of cross-border franchising contracts and other forms of intra-firms agreements”.

- *Indicators of outsourcing, defined as the creation of industrial structures abroad which replace existing structures in the national economy*

While FDI statistics allow to assess part of the creation of industrial structures abroad (i.e. the part financed from the local economy), these aggregated statistics do not include information on the motivations underlying such investment abroad, including on whether/to which extent investment abroad may substitute investment in the national economy. Furthermore, in a globalised economy, the creation of a factory abroad may be financed directly in the host country of the factory, or from other financing entities of a multinational group, thus making it difficult to trace such operations purely on the basis of FDI statistics.

⁵ European Commission, Directorate General for Economic and Financial Affairs, “Quarterly report on the euro area (IV 2004)” - see “focus: FDI in EMU”, Q4-2004.

SECTION 2 – WHY DEVELOPMENTS IN FINANCIAL MARKETS AND IN THE BEHAVIOUR OF MULTINATIONAL COMPANIES MAY DISTORT THE INFORMATION CONTENT OF FDI STATISTICS

6. While some basic analytical needs may be regarded by some economists as largely independent from market practices, it may not be taken for granted that these needs can still be answered in the same way as in previous decades. Just as it has become irrelevant to identify the country of production of certain goods (which may include parts built in various countries, assembled together in another territory), globalisation has made it much more difficult to measure some aspects of FDI.

7. In the context of the high mobility of capital allowed by modern technologies and most national legislations, the following trends have developed:

- Increasingly complex group structures and a difficulty to identify unambiguous boundaries of multinational groups;
- Increasing disconnection between the origin of funds and the residence/nationality of decision makers, related with the recourse to specialised entities devoted to group financing;
- Widespread development of “capital in transit”, largely for tax reasons;
- Limitations to the country allocations in FDI statistics.

Increasingly complex group structures and a difficulty to identify unambiguous boundaries of multinational groups

8. Multinational groups frequently have very complex structures, related to e.g. the participation of minority investors and the set up of legal entities in most jurisdictions, and often in most sectors, in which the group is involved.

9. Entities controlled directly or indirectly by the same enterprise can unambiguously be allocated to the same group. However, entities may be so strongly influenced that they may be considered as part of a given group even in the absence of effective control. The attached example illustrates⁶ that the company Cegetel, only 40% owned by Vivendi, is described to the public as being part of the Vivendi Group, even though it is not controlled by Vivendi.

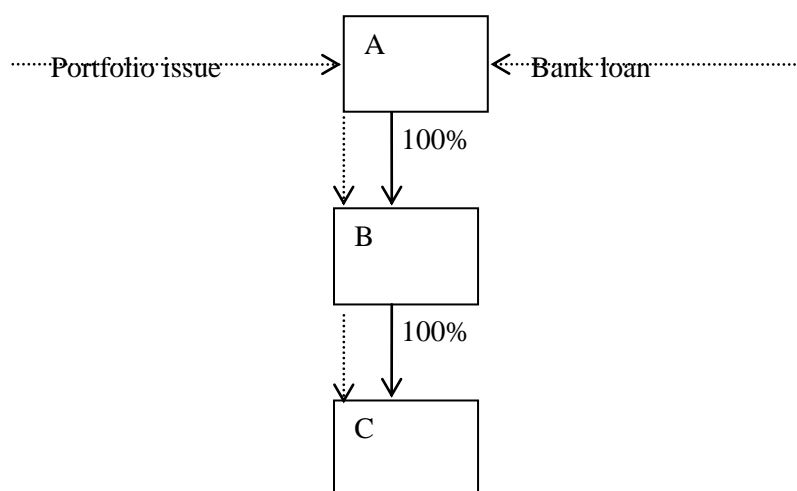
⁶ See e.g. the structure of the Vivendi Group: <http://www.vivendi.com/corp/en/group/subsidiaries.php>.

10. FDI statistics refer to links of at least 10% of voting shares⁷. For statisticians, the inclusion of entities with links between 10% and 50% implies a much higher complexity in the conceptual framework. For instance, it means that these entities may be part of several different groups.

Increasing disconnection between the origin of funds and the residence/nationality of decision makers, related with the recourse to specialised entities devoted to group financing;

11. In “classical” structures of multinational groups, the mother company centralises both the decision making and the financing of the group. Such a situation may be summarised in the following chart:

Example 1



Legend:



Dashed arrow: non-equity financing [e.g. loans]

Plain arrow: equity (FDI) holding

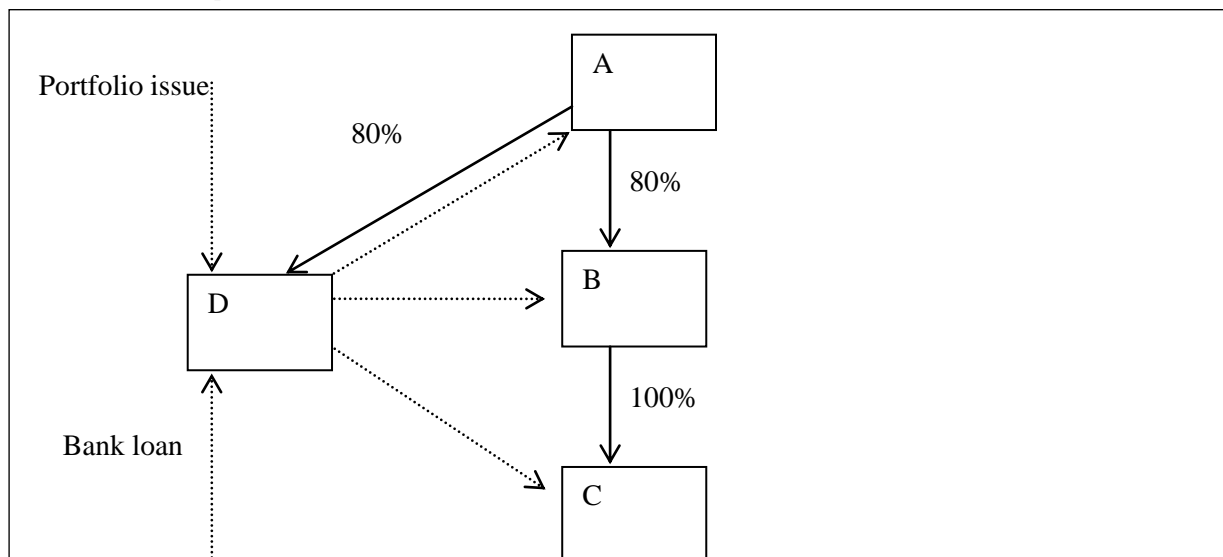
It is assumed that all entities shown are in different territories.

12. In this example 1, company A has direct investment in companies B and C. This FDI is likely to be more stable than other financing (e.g. more resilient in times of strains on financial markets) and to be accompanied with transfers of know-how from A to B and C. Although FDI is not a measure of know-how transfer, the more FDI is received in a country from another country, the more it is likely that the receiving country will also receive know-how transfers.

⁷ This approach materialises the definition of multinational enterprise group provided in the revised Benchmark, i.e. “all the enterprises located in different economies and under the control or influence of the same owner wherever located”.

13. The widespread recourse to cash pooling and other treasury entities has led to a separation between the functions of (i) decision maker (which may, or may not, be associated with potential know-how transfer) and (ii) capital provider.

Example 2



14. In example 2, company A may only hold equity capital in B and C for limited amounts, and D may provide day to day financing, and even receive temporary excess liquidity from A, B or C and lend them to the other companies of the group.

15. The widespread development of structures such as that in example 2 makes it more difficult to provide unambiguous information "who is the direct investor" and above all "how much the direct investor has invested". Some users tend to restrict their analysis to equity capital, but of course this excludes a large part of intra group financing which does have the characteristics of FDI (e.g. in terms of stability).

Widespread development of "capital in transit", largely for tax reasons

16. Beyond the development of specialised structures aimed at centralising certain tasks within a group (e.g. financing tasks, treasury management, but also in other cases accounting, marketing, research...), a proliferation of legal entities without any activity has been observed in the last decades. This development seems to be mainly attributable to tax and regulatory advantages obtained via these structures.

17. This proliferation has led to unexpected developments in FDI statistics. For example, some small territories have become the world highest recipients of FDI in some years. The country breakdowns of FDI statistics show a high concentration of transactions and positions vis-à-vis a few partners, acting as "hubs" (in legal terms) for FDI.

18. Beyond the recourse to "empty" legal structures, groups also frequently have recourse to existing and active companies to channel (in accounting and tax terms) funds, thus making the identification of this "capital in transit" even more difficult.

Example: a company located in the US, investing 1 million euros in China via an entity based in Netherlands Antilla:

US =====> NA =====> CN

Conceptual limitations to the country identifications in FDI statistics

19. The identification in FDI statistics of "counterpart countries" is usually of high interest to data users. Large FDI inflows in a European country may not have the same implications if they come from a large variety of countries, or mainly from a single one, located in Europe, in America or in Asia.

20. There are still a number of multinational groups for which at least the residence of the parent company is relatively straightforward to identify. However, more and more groups have no clear "nationality". Statisticians have to rely in a number of cases on the legal residence of the holding legally controlling the other entities of the group, but borderline cases in which decision makers are spread in several countries are increasingly frequent.

SECTION 3 – STEPS TAKEN BY THE REVISED OECD BENCHMARK TO ADAPT TO THESE DEVELOPMENTS, AND POSSIBLE PROSPECTS FOR THE LONGER TERM

21. The steps taken by the revised OECD Benchmark may be summarised as follows:

- The “Framework for Direct Investment Relationship”, defining which entities are in direct investment relationship, has been much clarified. Two proxies of this demanding approach have been described, in order to provide more practical guidance to compilers.
- Capital in transit is aimed to be identified by (i) the separate identification of resident “Special Purpose Entities” (to be defined at national level) and (ii) supplemental data “looking through” non-resident SPEs.
- Data on positions vis-à-vis ultimate owners are recommended to be compiled.
- Transactions between “fellow enterprises” will be netted out in order to avoid double counting of funds simply circulating within a group, e.g. via cash pooling or treasury centres.

22. These steps are certainly important contributions to improve the information to users on the FDI transactions and positions that are of real interest to most users.

23. The following further steps might be considered for future adaptations of FDI statistics to the changes in the observed reality:

- *Dilemma on the threshold for the definition of FDI*

24. As described above, a significant influence in a company may be obtained via a low percentage of voting rights, depending on how dispersed other shareholders may be. However, an increase to a threshold of 50% of voting rights would reduce the complexity in the reporting, such as reciprocal investment exchanged between two companies, or entities belonging to several groups. It would also solve the main obstacle to consistency with AMNE Statistics (Statistics on the Activity of Multi-National Enterprises), which refer only to controlled entities within multinational groups.

25. Of course, such a step would have significant drawbacks, in particular the exclusion from the scope of FDI a number of investment flows which have the characteristics of FDI, i.e. reflect intra-group financing, and imply some know-how transfers. In addition, it would imply a heavy break in the time series so far.

- *Further steps in the identification of capital in transit*

26. It might make sense to distinguish at least two categories of capital in transit, depending on whether the funds have no incidence at all on an economy (apart from a tax perspective) or whether they reflect real funding activities such as those of cash pooling or treasury centres. In particular, the latter category may lead to set up very significant economic activities, similar to those of banks, and may therefore not have to be "looked through" in the same way as those of empty shells.

27. Conversely, funds going through active entities but only recorded for tax reasons would ideally be identified, regardless of the entity which channels them. This would plead for an identification of whether funds are transformed, e.g. in terms of maturity or risk, by an entity. However, funds being fungible, it may not be possible to collect data linking the characteristics of assets and liabilities. The treatment of Special Purpose Entities (SPEs) is included in the OECD Working Group on International Investment Statistics (WG IIS) research agenda, keeping in mind that the current approach based on national definitions of SPEs may affect the comparability between national data.

- *Further steps to identify "ultimate investors"*

28. The revised OECD Benchmark definition of FDI requests supplemental data on ultimate investing countries, but does not recommend the compilation of data on ultimate host countries. This work is also included in the research agenda of the WG IIS.

29. A data set on ultimate host countries would allow having a better understanding of the links between economies, and their interdependencies. However, given groups' complex structures, compiling such data for individual transactions clearly raises strong conceptual and practical difficulties, so that progress is expected to focus only on positions.

- *Refinements to the construction of net aggregates*

The so-called "directional principle" avoids recording FDI transactions or positions in a number of cases reflecting the circulation of funds within a multinational group. It involves the netting of transactions or positions exchanged between a parent company and its daughter, or between fellow enterprises. While this principle makes much sense, this approach implies that negative values for e.g. inward direct investment may potentially⁸ be recorded within inward FDI and outward FDI.

30. In this context, some refinements to the "directional principle" might be useful. Again, this issue will be further studied in the context of the WG IIS research agenda.

⁸ It has been argued that in practice this difficulty would materialize only in very rare cases. Investigations are planned by the WG IIS in this respect.

CONCLUSION

31. The following main conclusions may be drawn from this analysis:

- the adaptation to globalisation is very challenging for statisticians, and in particular FDI statisticians. Much progress has been achieved within the revised OECD Benchmark definition of FDI, but further efforts are required and may materialise in a few years through the completion of the research agenda;
- FDI statistics increasingly need to be interconnected with AMNE statistics, given the frequent connections between the expansion of groups and the corresponding financing transactions;
- the variety of user needs has been increasingly answered by the publication of firm level data (e.g. in the United States or Germany). This development is certainly positive for users, although it can not replace the compilation of aggregated information usable for policy making purposes;
- in terms of data collection, national collection systems intend to identify the national components of multinational groups, often without benefiting from the overview of the parent of the group, which usually has full information on the group entities in each country. Some data exchange, in particular with the country where the “head of the group” is resident, might allow to reduce the reporting burden at national level, and/or improve data quality by enhanced cross-checking of information;
- the large number of “supplemental” data sets included in the revised OECD Benchmark Definition of FDI illustrates the growing discrepancy between extensive user needs and limited resources of statistical compilers, as well as the need to restrict to the minimum the reporting burden for companies.