FDI statistics excluding special purpose entities, capital-in-transit and financial restructuring – Hungarian practice

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“Assessing international capital flows after the crisis”

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Summary

Globalisation may have significant distortive effects on the national statistical data and in order to avoid distortions, even data collections, processing, publications- and interpretation - of national FDI-statistical publications need to be supplemented. The MNB in its practice has identified and has been published FDI statistics supplemented with the following elements:

- separate BOP compilation for Special purpose entities (SPE)
- separate publications of capital in transit transactions and
- asset portfolio restructuring transactions

The new editions of international guidelines, especially the OECD Benchmark Definition on FDI 4th edition (BMD4) gives new measures of foreign direct investment. These special effects have appeared in practice preceding the implementation of international guidelines in Hungary, so we had to find some way to handle these distortions before the international consensus and practices became well-known. In order to improve the quality of BoP and FDI statistics and to reduce the distortive elements of FDI statistics hereby the findings and good practices applied in Hungary are presented in this paper.

1. Background

Hungary is an open economy in Central Europe. Its territory is 93 thousand square kilometre /359 thousand square miles with 10 million inhabitants. The annual GDP is about 100 billion euros fairly stable in the last 7 years. Hungary is a member of the IMF and World Bank as of 1982, OECD since 1996 and the European Union since 2004. By our integration into the international distribution of labour, foreign trade and foreign direct investment plays an increasingly important role in Hungary’s economic activity. Foreign direct investment (FDI) is a key driver of international economic integration. The weight of FDI stock compared to GDP varies by countries. The significance of FDI activity in Hungary by OECD countries is shown in Chart 4 and 5 in Annex I.

The source of FDI data are Hungarian BOP statistics. BOP statistics data with the same methodology (BPM6 which is consistent with BMD4) is available since 1995.

Chart1 shows that between 1995 and 2006 inward FDI had dynamically expanded (reaching 50 billion euros by 2005) and significantly exceeded outward FDI (almost non-existent). After 2006 the level of inward and outward stock remained stable, the slight further expansion is due to the later detailed new distortive effects, the stability of net FDI shows that no further expansion can be seen in the last decade. The development of net FDI for SPEs (near zero) shows well, that in net terms they have no investment added to the Hungarian economy.

In line with BPM6, Special purpose entities have been separated in BOP statistics already from 2006, well before the implementation of the new OECD and IMF guidelines in the member states of the European Union (2014).

This presentation describes details of our recent and present practice, including recent developments in separating the new distortive effects in publications of FDI flows.
2. Characteristics of FDI statistics

2.1. 1999-2005: Off-shore companies

Between 1999 and 2005 activities not directly effecting economic activities in Hungary were experienced with off-shore companies. Pass through flows were recorded on a net basis.

At the end of nineties special huge transactions had appeared in the magnitude of billions of euros - arriving and leaving the country in a short period of time not affecting the Hungarian economy. Off-shore companies were defined by an administrative concept; we had registry information based on administrative data source. At that time treating off-shore companies was a compilation issue; their statistical treatment was based on considerations of their types of activities. One was the pass-through activity: these off-shore enterprises were only passively rechannelling huge funds (although conversion of financial instruments: mainly FDI equity [inflow] vs. debt instruments (loan) [outflow].

For that type of entities we applied the net recording of their transactions as FDI equity in Hungary. At that time positions were calculated as cumulated net flows.
The other type of off-shore entities were trading with property rights. We applied no difference in recording their transactions compared to „normal” enterprises. There were no separate set of data published on off-shore companies.

As of 1 January 2003 to the Corporate Taxes Law was amended - enterprises with off-shore status no longer could be established in Hungary. The existing off-shore firms had to be transformed into normal businesses by 1 January 2006 at the latest. Some off-shore companies had left Hungary. However there were some newly established companies with pass-through activity but not registered as off-shore companies. We had to find definition for identifying pass-through entities.

In the meantime the revision of the international standards (BPM6 and BD4) had started and showed that Hungary is not alone: other countries face similar problems. These pass through enterprises are called in the international guidance special purpose entities.

2.2. From 2006: Special Purpose Entities in Hungary

What are the characteristics of special purpose entities?

Foreign direct investment (FDI) is a key element in the rapidly evolving international economic integration. Due to the widening globalisation, multinational enterprises (MNEs) become the key players of cross border investments. In order to optimise their profitability they establish complex structures of enterprises including special purpose entities. Examples: financing subsidiaries, conduits, holding companies, shell-companies. Different types of SPEs have been created worldwide. Thus there is no internationally agreed definition of SPE, but there are common features elaborated in OECD. (OECD BMD4, p 188):

An enterprise is usually considered as an SPE if it meets the following criteria:

i) The enterprise is a legal entity,
   a) Formally registered with a national authority; and
   b) subject to fiscal and other legal obligations of the economy in which it is resident.
   
   ii) The enterprise is ultimately controlled by a non-resident parent, directly or indirectly.

   iii) The enterprise has no or few employees, little or no production in the host economy and little or no physical presence.

   iv) Almost all the assets and liabilities of the enterprise represent investments in or from other countries.

   v) The core business of the enterprise consist of group financing or holding activities, that is – viewed from the perspective of the compiler in a given country – the channelling of funds from non-residents to other non-residents. However, in its daily activities, managing and directing local operations plays only a minor role.

The SPEs in Hungary are resident enterprises basically performing their activities abroad, and their connection with the domestic economy is minimal. They are primarily involved in the intra-group intermediation of financial resources, but in fact, their parent companies decide the direction and the amount of the funds flowing through them. They are not targets of direct investment; they participate in the allocation of funds within the enterprise group through different countries. Their net investment registered through various financial instruments is close to zero over longer periods of time. However, large amounts are moved through them, and thus their transactions
inflate particularly the assets and liabilities of the financial account, which distorts the statistics describing the real economic and financial processes of the national economy.

The major issue is, how to reconcile the two competing principles:

1. SPEs are resident entities, they should be covered by BoP and IIP statistics regardless of their specificities, however
2. recording their transactions and positions in the core accounts highly distorts and limits the analytical power of BoP and IIP for economic analysis

For proper decision making and analysis we had been segregating transactions and positions of SPEs (segregating pass-through capital). Since 2006 there is no difference in statistical treatment of SPEs, it is a publication and interpretation issue and not a compilation one. In line with the international requirements, from January 2006 the MNB has also been preparing the balance of payments and the related international investment positions which include SPEs on a gross basis, to enable the analysis of international data by mirror statistics. At the same time, the balance of payments and international investment position of Hungary can also be analysed from an economic aspect based on data excluding SPEs. In its statistical publications and reports, the MNB analyses data excluding SPEs.

Activities and characteristics of SPEs are changing in time

We have experienced that the characteristics of SPEs can change not only by countries but in time in the same country, in Hungary.

- The early pattern was „incoming FDI equity flow/ and direct loan extension”.
- after 2005 this pattern changed to establishment of non-resident branch financed loan of a related company
- Indirectly (through a resident affiliate) having equity stake in a non-resident enterprise
- An enterprise previously providing services sets up a non-resident branch and continues its business through the branch

The changing activity and characteristics of enterprises might result in a need for statistical reclassification from/into SPEs.

SPEs are defined jointly by the Hungarian Statistical Office (HCSO) and the MNB. (The maintenance of SPE registry is a joint effort, too). The source of information is the BOP data collection survey system, the corporate tax declarations and data collection surveys for goods and services in the HCSO.

Before the implementation of BPM6 Hungary has continuously experienced the distortive effects of data including SPEs published in the international institutions. Therefore we have made initiatives in order to achieve, that

- all affected countries report their relevant statistics excluding and including SPEs, and
- all international organizations publish both national data
- draw attention to the confusing distortion of data including SPEs, that they are not appropriate for analyzing country data, interpretation of economic trends, debt indicators, etc.
- support the initiatives for a common register of SPEs
- separate SPEs’ data within the Financial Account Statistics in a specific sector breakdown.
Despite our efforts after the implementation of BPM6/BMD4/ESA2010 in more international organizations’ database BOP data are available only including SPEs. However we are aware that only a few countries are seriously affected with these issues. (See Chart 2) The major affected countries are Luxemburg, the Netherlands and Hungary, and partly Austria and Iceland (within the OECD). They are all engaged in the importance of publishing FDI data excluding SPEs.

Chart2. Share of FDI into SPEs and non-SPEs at end-2014

Source: OECD International Direct Investment Statistics database

2.3. New distortive effects in 2010’s (capital in transit and restructuring of asset portfolio)

Within a multinational corporation, mixed groups can be formed from SPE and non-SPE affiliates in a country. Furthermore, there are companies that perform real economic operations and therefore cannot be classified as SPEs, however at the same time, they also take part in intermediary activities and their foreign parents pass through them large amounts from one foreign subsidiary to the other. Segregating capital transiting through operational affiliates of multinational enterprises are in the Research Agenda of the OECD Working group of International Investment Statistics, there are no internationally available guidelines for their treatment. In Hungary, we call these transactions capital in transit, passing through resident subsidiaries also engaged in real economic operation. The difficulty is that beside enterprise approach, transactions have to be investigated. We have identified two types of activities that resulting huge transactions without any effect on the domestic economy: one is capital in transit, the other is restructuring of asset portfolios, when transactions are related to a financial restructuring of some affiliate of MNEs. Besides capital in transit, restructuring of asset portfolios has similar effects on FDI flows (sharp increase and decrease in flows), these impacts on statistical data are very similar to that of SPEs.

(i) National practice in Hungary for separating capital in transit
At the end of 2011 huge capital in transit transactions have appeared within the scope of non-SPE companies in which the inflow and outflow took place within the same quarter. As mentioned above, there is no general international methodological guidance on how to treat these special transactions. However the magnitude of these transactions made it necessary to separate them, since these transactions distorted our statistics excluding SPEs very significantly. In the second half of 2011, the MNB launched a project exploring the phenomenon of capital in transit, with the purpose of identifying and separately presenting them. Capital in transit transactions were identified during the monthly compilation of balance of payments. Typically, these large transactions are completed within one month.

This micro-level approach, checking every company individually, is possible in Hungary because the relevant scope of companies only includes 10-20 enterprises and there are less than 10 such transactions quarterly. At the same time, the size of the transactions is sometimes one magnitude larger than the value of regular transactions, which needs to be explained to users. As a result of this work, since September 2012 capitals in transit transactions have been presented in a separate table on the website of the MNB, retrospectively to 2008. Furthermore, in order to make the direct investment data more interpretable, FDI flows excluding capital in transit are published separately.

We refer to capital in transit, when a resident, non-SPE company belonging to a multinational company group is also active in passing through capital within the enterprise group, in addition to its normal activities (production, service). This activity increases the total value of both capital inflows and outflows in the statistics. Similarly to the activities of SPEs, this flow of capital has no effect on the economy of the given country. As the activities of SPEs, capital in transit transactions are usually FDI, but can take the form of portfolio investment or other investment.

Capital in transit is usually related to special function(s) of Hungarian affiliates of multinational enterprises. It is important that the foreign owner decides if the special activity is performed through the affiliate in Hungary or third countries. In defining pass through transactions the activity and the content shall be considered rather than the form of transaction. To recognize a capital in transit or asset portfolio restructuring transaction it helps that the volume of inflow and outflow is typically same or similar within a specific (short) period.

We consider the following pairs of transactions as capital in transit transaction:

<table>
<thead>
<tr>
<th>Inflows</th>
<th>Outflows</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity investment by non-residents (which may be direct investment, portfolio investment)</td>
<td>Equity investment abroad</td>
</tr>
<tr>
<td>Equity investment by non-residents</td>
<td>Lending by Hungarians to non-resident members of the company group</td>
</tr>
<tr>
<td>Loan received from parent/other non-resident members of the company group</td>
<td>Equity investment abroad</td>
</tr>
<tr>
<td>Loan received from parent/other non-resident members of the company group</td>
<td>Lending to a non-resident subsidiary/member of the company group</td>
</tr>
</tbody>
</table>

We do not consider pairs of transactions generated by portfolio reclassification and offsetting arrangements of claims/liabilities as capital in transit, since these are reclassifications of the asset or liability side portfolio of the resident enterprise:
| conversion of a loan debt/claim to capital injection or repayment of a loan debt | claim from capital injection |
| settlement of accounts receivable | accounts payable |
| The flow of dividends from a non-resident subsidiary | to the parent |

In Hungary capital in transit transactions are identified on the basis of company reporting during the compilation of the monthly or quarterly balance of payments data.

(ii)  Restructuring of the asset portfolio

If a multinational corporation realigns its asset portfolio in a cross-border fashion: liquidating one subsidiary, establishing a new subsidiary, contributing the assets of one subsidiary into another, etc., then extremely high capital withdrawal and equity investment transactions must be recorded in the balance of payments without any real capital withdrawal or equity investment taking place into the country. Therefore, together with capital in transit, we also classify these transactions as transactions to be separated. In order to easier interpret the direct investment transactions data, we publish the data on foreign direct investment transactions excluding capital in transit and asset portfolio restructuring. (See the link.)

(iii)  Adjusted direct investment flows

In Hungary, the effect of capital in transit and asset portfolio restructuring was especially significant in 2012. However, its magnitude varies annually. Especially for the users, interpreting FDI statistics data makes it especially important to adjust the data for capital in transit and asset portfolio restructuring. The magnitudes of these differences are shown on Table 1 and Chart 3. All including SPEs, excluding SPEs, adjusted FDI data are available in the MNB website (See the link). Country and activity break down are also available for the adjusted data.

Chart3. FDI flows data

| Euro million |
The first two lines are the internationally available FDI flow data in the IMF and Eurostat database. Data excluding SPEs are available in the OECD and UNCTAD database. Adjusted FDI data are available only on the MNB website.

(iv) **Filtering out the distortive effects from the stock data - future challenge**

International definition of stocks of capital in transit is not available, yet (income effect, revaluations, etc.). However, Switzerland and Austria apply macro estimation to identify the passing through part of FDI. They split inward and outward FDI, if the ultimate investor resident or non-resident. Inward FDI with resident ultimate investor is considered as round tripping (a type of capital in transit), and the outward FDI with non-resident ultimate investor is considered as the activity of multinationals, and so, as capital in transit. It is an easy practice to make a robust estimation (if the FDI stock according to the ultimate investor is available.)

Our case by case method in identifying the distortive effects from the transactions is hardly could be applied for stocks. Our data processing system is a closed system based on reported data. Adjusted enterprise data at present is supplemental information, not part of the processing system, however the country and activity breakdown of stocks are distorted significantly with the stocks of the enterprises including capital in transit.
3. **Conclusive remarks**

- Globalisation may have significant distortive effects on the national statistical data collection, processing, publication - thus interpretation - of national FDI-statistical publications.

- The weight of FDI compared to GDP significantly varies among countries and in time. In those countries where the role and effects of FDI is high, more detailed FDI statistics are needed inward and outward FDI alike.

- In order to improve the quality of these statistics and to reducing the distortive elements of FDI statistics we have developed a special practice in Hungary. Besides separating Special Purpose Enterprises as required in BMD4/BPM6, we found informative/necessary for our users to publish detailed data on capital in transit and asset portfolio restructuring transactions as well as on adjusted direct investment flows.
Annex I.

The weight of FDI compared to GDP varies by countries. The country breakdown of inward FDI to GDP is shown in Chart 4 and the weight of outward FDI to GDP is shown in Chart 5 for OECD countries. The data of Hungary, European Union and OECD-total are highlighted to show the significance of FDI activity in Hungary. (FDI data are excluding SPEs)

Chart 4

Inward FDI stocks as % of GDP at the end 2014

Chart 5

Outward FDI stocks as % of GDP at the end 2014

Source: [https://data.oecd.org/fdi/fdi-stocks.htm](https://data.oecd.org/fdi/fdi-stocks.htm)