BANCO CENTRAL DO BRASIL

External Sector Statistics – Adoption of the Sixth Edition of the Balance of Payments and International Investment Position Manual (BPM6)

Methodological note nr.3 – Direct investment and primary income (earnings)

April 2015

1. Introduction

According to Statement and Methodological Note nr.1 both released on November 2014, the Central Bank of Brazil (CBB) started releasing statistics on the Balance of Payments (BOP) and International Investment Position (IIP) according to the Sixth Edition of the International Monetary Fund (IMF)'s[1] Balance of Payments and International Investment Position Manual (BPM6).

This methodological note deals with the conceptual changes of the new standard referring to direct investment, especially the replacement of the directional principle (BPM5) by the criterion of assets and liabilities (BPM6). Furthermore, new sources of information will allow resuming the compilation of the reinvested earnings account, wihich corresponds to the increase in the flows of direct investments.

2. Direct investment under BPM6 and the criterion of assets and liabilities

Direct investment, portfolio investment, financial derivatives and other investments are the four functional categories of the BOP financial account. BPM6 defines direct investment in the paragraph 6.8:

[1] BPM6 is available at the IMF website: http://www.imf.org/external/pubs/ft/bop/2007/bopman6.htm.

> "*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*. (…)"

With the aim of ensure consistency among several countries and compilers, the manual defines that "control or significant degree of influence" exists when the nonresident investor holds 10% or more of the voting power in the resident enterprise[2].

Direct investment comprises two subaccounts: Equity and investment fund shares (Equity capital) and Debt instruments (Intercompany lending), which includes all debt instruments between companies in a direct investment relationship belonging to the same economic group[3]. Although the most common modality refers to lending between related enterprises, debt securities and trade credit and advances are also included in this subaccount of foreign investment.

BPM6 defines the treatment of fellow enterprises (paragraph 6.17) and proposes that such information be presented as a supplementary item. Previously, only references to lending operations from direct investors to subsidiaries and from subsidiaries to direct investors were available. BPM6 emphasizes lending operations between enterprises under the same controller, even if one company does not hold capital in the other (fellow enterprises), and explicitly recommends the inclusion of these operations as direct investment – intercompany lending.

The most significant modification introduced by the adoption of the BPM6, however, refers to the replacement of the **directional principle by the criterion of assets and liabilities**, which are applied only to the modality of intercompany lending, and not to Equity capital.

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[2] The previous standard (BPM5), considered 10% or more of the social capital rather than the voting power.

[3] Further details on direct investment relationship are available at http://www.imf.org/external/pubs/ft/bop/2007/bopman6.htm), p. 101 and 106, and the 4th edition of the OECD Benchmark Definition of Direct Investment (BDM4), available in several languages at http://www.oecd.org/daf/inv/mne/fdibenchmarkdefinition.htm.

BPM5 followed the **directional principle,** which requires the identification of the investing enterprise in the case of intercompany lending. Reverse investment, when the subsidiary (invested enterprise) lends to the direct investor was subject to a specific treatment. For example, if a nonresident subsidiary or affiliated enterprise lent to its direct investor resident in Brazil, this Brazilian liability was classified as “asset reduction” in the account of Brazilian direct investments abroad (BDIA). In practice, lending operations between companies of the same economic group of Brazilian capital had always been recorded in the BDIA account, even if the lender was the nonresident enterprise. The treatment is symmetrical in the case in which an affiliated or subsidiary enterprise resident in Brazil lent to its direct investor abroad: the operation is recorded as “asset that reduces liability”.

According to the **criterion of assets and liabilities**, adopted by the BPM6, in a direct investment relationship (direct investor and subsidiary is the most common case), lending by an enterprise resident in Brazil to an enterprise resident abroad is recorded in the account Direct Investment – Assets, i.e., Brazilian direct investment abroad. Similarly, whenever the same economic group is taken into account, transactions in which an enterprise resident abroad lends to an enterprise resident in Brazil are compiled in the account Direct Investment – Liabilities, i.e., foreign direct investment in Brazil.

Therefore, according to the **criterion of assets and liabilities,** the identification of the direct investor, subsidiary or fellow company is no longer determinant in the relationship between creditor and debtor companies belonging to the same economic group. Under BPM6, the classification of the BOP transaction is done on the basis of the identification of the country of residence of the creditor and debtor.

Paragraph 6.42 of the BPM6 states the option for the criterion of assets and liabilities and comments the directional principle, which remains as a supplementary[4] item under the new methodological standard:

> *"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."* (Emphasis added)

[4] In the case of the Brazilian BOP, the indication of the directional principle of direct investment (BPM5) as a supplementary item means that the CBB will continue releasing these statistics as memorandum to the new concepts of direct investment.

The following scheme illustrates the methodological modification as a change of positions between the components of the account direct investment – intercompany lending.

BPM5 - Directional principle

BDIA
- Equity capital
- Intercompany lending
  - Brazilian direct investor to affiliated abroad
  - Affiliated abroad to Brazilian direct investor

FDI
- Equity capital
- Intercompany lending
  - Affiliated in Brazil to direct investor abroac
  - Direct investor abroad to affiliated in Brazi

BPM6 - Assets and liabilities

Brazilian direct investment abroad (assets)
- Equity capital
- Intercompany lending
  - Brazilian direct investor to affiliated abroad
  - Affiliated in Brazil to direct investor abroad

Foreign direct investment in Brazil (liabilities)
- Equity capital
- Intercompany lending
  - Affiliated abroad to Brazilian direct investor
  - Direct investor abroad to affiliated in Brazil

On the basis of statistics on direct investments released in the Brazilian BOP, according to the directional principle (BPM5), it may be observed that the impact consequent upon the adoption of the criterion of assets and liabilities (BPM6) will be significant. With regard to the scheme above, the item "Affiliated abroad to Brazilian direct investor" - component of the BDIA under the directional principle (BPM5) - will be reclassified as foreign direct investment in the country (liabilities). In 2014, net inflows of this modality totaled US$24.2 billion.

A significant share of this value refers to resources received by affiliated companies of Brazilian groups abroad, generally through issuance of securities, whose proceeds were brought into the country as intercompany lending[5].

Symmetrically, the item "Affiliated in Brazil to direct investor abroad", a component of foreign direct investment under the directional principle (BPM5),

[5] In the March 2015 Inflation Report, in the box "*Emissões de Subsidiárias de Matrizes Brasileiras no Mercado Internacional*" (Issuances of Subsidiaries of Brazilian Direct Investors on the International Market) (http://www.bcb.gov.br/htms/relinf/port/2015/03/ri201503b5p.pdf) 78.6% of this type of issuances abroad is estimated to be recorded in the account BDIA – intercompany lending. It should be stressed that these resources represent funding by foreign investors, which do not belong to the same economic group of the issuing subsidiary, who acquired these papers directly on the international market.

will also be reclassified as Brazilian direct investment abroad (assets). In 2014, net flows of this modality totaled US$461 million.

An annex to this methodological note reproduces, as an example, a box of the Bank for International Settlements (BIS) that analyzes this methodological change on direct investments by utilizing the Brazilian case.

The record of direct investments according to the asset/liability concept allows:

i) full consistency with the methodology applied to other functional categories (portfolio investments and other investments) and macroeconomic statistics, like the foreign debt, for instance;
ii) improvement of information sources used in the compilation of national accounts;
iii) facilitate the analysis under the prism of balances;
iv) simplify the interpretation of statistics.

3. Direct investment and reinvested earnings

Among the items that compose the primary income account, the BPM6 distinguishes, in paragraph 11.8, dividends from reinvested earnings. The breakdown of total net earnings into these two categories is an investor's economic decision. Paragraph 11.34 defines reinvested earnings and the corresponding entry in the BOP financial account, adding that this item is naturally included in the stocks of direct investment:

> *"11.34 Retained earnings of an enterprise shows the net earnings from production and primary and secondary income transactions before attributing reinvested earnings. It is equal to net operating surplus plus primary income, current transfers receivable, and change in pension entitlements, and minus primary income (excluding reinvested earnings payable to the enterprise's direct investors and owners of investment funds) and current transfers payable. Retained earnings of investment funds and the part of the retained earnings of direct investment enterprises that belongs to direct investors are treated as being distributed to the owners who then are deemed to reinvest back.* ***The imputation of income to the owners*** *of investment funds* ***and direct***

> ***investors is shown in the primary income account as "reinvested earnings" and the corresponding flow is recorded in the financial account as "reinvestment of earnings"*** *(see paragraphs 8.15–8.16 for the recording of financial account entries).* ***Reinvestment of earnings is an imputed financial transaction****. In the position data, reinvestment of earnings is not shown separately but included implicitly in the total value of equity."* (Emphasis added).

In the Brazilian case, the compilation of reinvested earnings was interrupted in 1999 due to limited sources of information. It should be highlighted that the main source for the compilation of the Brazilian BOP is the exchange system that captures the exchange of foreign currency by domestic currency consequent upon transactions from/to abroad. This is not the case of reinvested earnings, since it is an economic and accounting flow that does not impact the exchange market.

Currently, information sources are available for earnings reinvested by Brazilian direct investors in their subsidiaries abroad - the survey of Brazilian Capital Abroad (CBE), and for earnings reinvested by foreign direct investors in their subsidiaries in Brazil - the Census of Foreign Capitals in Brazil (Census).

The accounting of reinvested earnings abroad will impact both revenues on reinvested earnings in the current account and the direct investment assets (Brazilian assets), under the modality of equity capital. Similarly, reinvested earnings by foreign groups in Brazil will impact expenditures on reinvested earnings in the current account and direct investment liabilities (Brazilian liabilities), under the modality of equity capital. Therefore, the impacts of reinvested earnings on the current account will be, by definition, automatically financed in the financial account.

The signs of these entries referring to reinvested earnings change in the case of losses, or even if distributed dividends are higher than net income in that period. As a result, revenues and expenditures are inverted, with the corresponding decrease in the flows of direct investment - equity capital, according to paragraph 11.46 of BPM6:

> *"11.46 Reinvested earnings can be negative when a direct investment enterprise has a loss on its operations or the dividends declared in a*

> *period are larger than net income in that period. If direct investment abroad generates negative earnings, the entry should be shown as a negative income receivable by the direct investor. Similarly, the economy of the direct investment enterprise should record the losses as negative income payable.”*

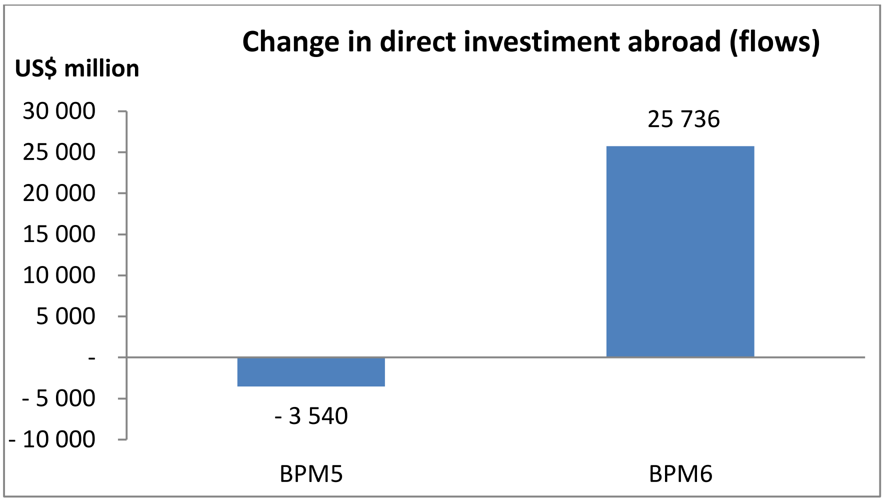
The expansion of information on total earnings (remitted and reinvested) by companies in a direct investment relationship will also allow calculating the implicit profitability when the stock of direct investment is compared with total income flows.

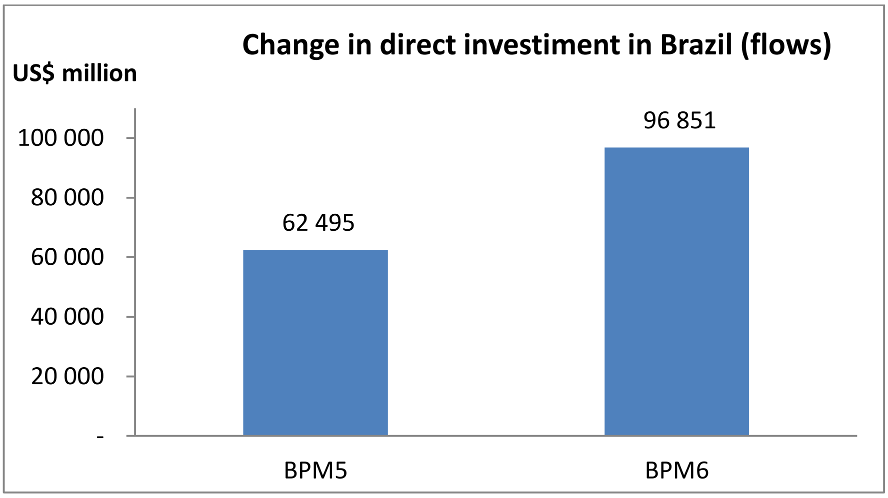
The magnitude of reinvested earnings depends on several factors, with emphasis on the amount of total earnings and the level of activity in the country where the company is resident; the exchange rate, which reduces or increases the original value of earnings when expressed in the currency that will be received by direct investors; and the strategy and current scenario of the multinational economic group.

Finally, it should be noted that the current positioning of Brazil on international rankings as recipient and sender of direct investments can change. The account reinvested earnings has never been absent from international statistical standards and these flows, which may be representative in terms of direct investment, have been compiled by several countries. In this context, the Brazilian flows of both outward and inward direct investments are underestimated in view of the interrupted compilation of the reinvested earnings component since 1999.

4. Preliminary results

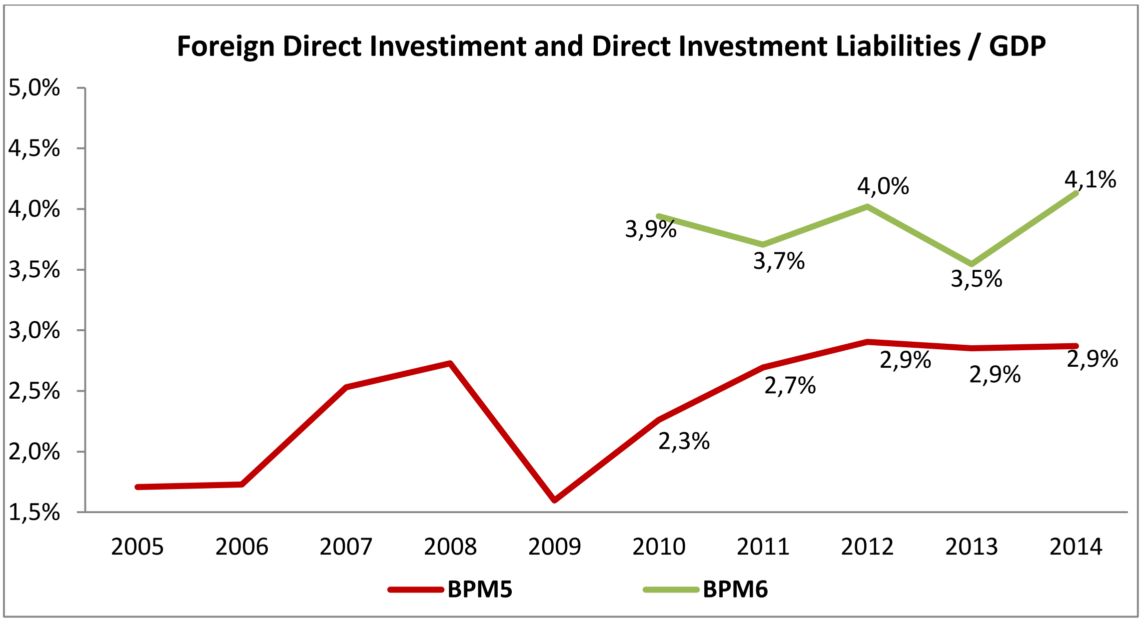
The following graph illustrates the impacts consequent upon this transition from BPM5 to BPM6 on the flows of direct investment in 2014, in Brazil and abroad. This change mostly reflects the incorporation of reinvested earnings and the adoption of the asset/liability principle instead of the directional principle.





For 2010, 2011, 2012 and 2013, the same relevant factors were estimated for elaborating preliminary statistics on direct investment liabilities. The following graph compares Foreign Direct Investment (FDI), measured according to BPM5, to Direct Investment Liabilities, estimated with the adoption of BPM6.

It should be noted that, in March 2015, the Brazilian Institute of Geography and Statistics also revised the GDP series with the adoption of new methodological standard for the national accounts (SNA 2008). Flows of direct investment compiled according to BPM6 and BPM5 are shown as a proportion of revised and not revised GDP series, in the order.



The BOP of 2014 has been released in the full format, while the results concerning direct investment liabilities in 2010, 2011, 2012 and 2013, above, refer to preliminary estimates. These figures have been calculated by taking into account key changes in concepts and information sources as described above. The complete BOP series should be released up to February 2016.

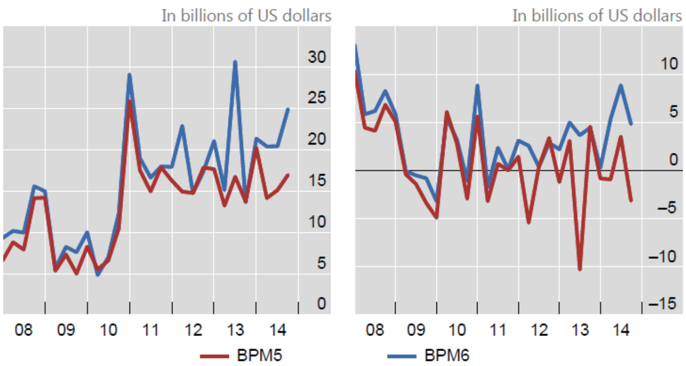
Annex

Interpreting FDI flows under the new balance of payments template

The rapid pace of financial globalisation over the past few decades has changed many aspects of international capital flows. To improve the understanding of these capital movements, in 2009 the IMF and its members agreed on a new template for collecting international financial transactions data: the sixth edition of the IMF's *Balance of Payments and International Investment Position Manual* (BPM6). From January 2015, the IMF will only accept data submissions under BPM6. In the transition period, some countries will still be publishing their BoP data under the previous template (BPM5, introduced in 1993) and the IMF will simply convert those "old" data to the new standard. **Using Brazil as an example, this box illustrates how the conversion between BPM5 and BPM6 affects the interpretation of FDI flows**.

Data published under the two formats reflect somewhat **different treatments of within-company loans**, resulting in differences in reported gross FDI inflows and outflows (Graph B, left-hand and centre panels), even though net FDI flows remain unchanged. This is because, under BPM5, FDI transactions between affiliates are recorded on a residence versus non-residence basis, whereas **BPM6 differentiates between the net acquisition of assets and the net incurrence of liabilities**. Simply put, under BPM5, both direct investor lending to affiliates (which increases claims) and borrowing from affiliates (which increases liabilities) are counted as gross outflows, albeit with opposite signs. Under **BPM6, by contrast, the two activities will fall into different categories**. While direct investor lending to affiliates will continue to count as capital outflow, borrowing from affiliates will be counted as net incurrence of liabilities (capital inflow). Using the notation in Graph B (right-hand panel), net acquisition of debt claims under BPM6 (item 6.1.2) will be the sum of items 5.1.2 and 5.2.2 under BPM5.

Brazilian FDI flows — Graph B



Direct investment flows

BPM 5	BPM 6
Gross outflows	
5.1 Direct investment abroad	**6.1 Net acquisition of assets**
5.1.1 Equity	6.1.1 Equity claims
5.1.2 Claims on affiliates	6.1.2 Debt claims
5.1.3 Liabilities to affiliates	
Gross inflows	
5.2 Direct investment in reporting country	**6.2 Net incurrence of liabilities**
5.2.1 Equity	6.2.1 Equity liabilities
5.2.2 Claims on direct investors	6.2.2 Debt liabilities
5.2.3 Liabilities to direct investors	

Sources: Central Bank of Brazil; IMF; BIS calculations.

AVDJIEV, S.; CHUI, M. E SHIN, H. Non-financial corporations from emerging market economies and capital flows. **BIS Quarterly Review**, December 2014, p. 75. Available at http://www.bis.org/publ/qtrpdf/r_qt1412h.pdf.