Vital statistics:
Taking the real pulse of foreign direct investment

by
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Let’s start with a quiz. Which country is the second biggest direct investor in China? Who are the largest investors in India and Russia? You probably won’t believe it, but the answers are (a) British Virgin Islands, (b) Mauritius and (c) Cyprus. It’s not a sordid tale of hot money but rather a more mundane story of companies investing abroad through a holding company or affiliate located in a third country. They might be driven by the presence of a double taxation or bilateral investment treaty, or it might simply reflect corporate strategy to invest through an existing affiliate rather than by sending cash from the parent company.

Whatever the reason, it’s all perfectly legal. But as a consequence, we sometimes know very little about who owns what. Those Cypriot investors in Russia are almost certainly owned by an investor in another country, sometimes even a Russian investor. As a result, national statistics on flows of foreign direct investment (FDI) tell us less and less about what we want to know. Who is investing in our country and where are our own companies investing? To know the truth about a country’s FDI you need a comprehensive standard for measurement, which is why the OECD produced its standard: the Benchmark Definition of Foreign Direct Investment, 4th Edition (BMD4).

BMD4 makes two key recommendations which address the problems posed by the complex ownership structures of MNEs. The first is to compile FDI statistics separately for resident special purpose entities (SPEs). But what are SPEs? The OECD defines them as “entities with no or few employees, little or no physical presence in the host economy and whose assets and liabilities represent investments in or from other countries and whose core business consists of group financing or holding activities”. You may have seen images of them in TV reports about tax avoidance, when the camera shows a wall in a grubby building lined with mail boxes representing gigantic multinational firms. SPEs are often used to channel investments through several countries before reaching their final destinations. By separately compiling FDI statistics for SPEs, you can derive FDI into real businesses, giving countries a much better measure of the FDI into their country that is having a real impact on their economy. The second is to compile inward investment positions according to the ultimate investing country
(UIC) to identify the country of the investor that ultimately controls the investments in their country.

This boils down to less double counting and more meaningful FDI statistics.

By recommending that countries compile FDI statistics separately for resident SPEs, BMD4 eliminates a layer of complication due to the ownership structures of MNEs.

Our data show the percentage of the inward stock of FDI – that is the accumulated value of investment by foreigners in the economy – accounted for by resident SPEs for 13 OECD economies. SPEs are very significant in Luxembourg and the Netherlands, accounting for more than 80% of all inward investment. SPEs are also significant in Hungary, Austria, and Iceland, where they account for more than 40% of inward investment. SPEs play smaller, but still important, roles in investment for Spain, Portugal, Denmark, and Sweden. In contrast, SPEs are not significant in Korea, Chile, Poland, and Norway.

BMD4 also eliminates the lack of transparency regarding the country of the direct investor who ultimately controls the investment and, thus, bears the risks and reaps the rewards of it by recommending countries compile statistics by ultimate investing country (UIC) in addition to the standard presentation by immediate investing country.

The presentation by UIC can shed light on another important issue: round-tripping. Round-tripping is when funds that have been channelled abroad by resident investors are returned to the domestic economy in the form of direct investment. It is of interest to know how important round-tripping is to the total inward FDI in a country because it can be argued that round-tripping is not genuine FDI. The presentation by UIC identifies round-tripping by showing the amount of inward FDI controlled by investors in the reporting economy.

We can illustrate this by looking in more detail at France and Estonia and comparing the inward stock of FDI of the top ten ultimate investors to the amounts coming from the immediate investing country.
On the UIC basis, the United States is a much more important investor in France than it appears when presented by immediate partner country. Indeed, the inward stock of the United States increases from USD 79.6 billion to USD 142.1 billion. The inward investment stocks from Luxembourg and the Netherlands drop considerably, indicating that US companies may be using affiliates in these countries to handle business done in France. French investors are the 8th largest source of FDI into France. While this indicates there is some round-tripping, it accounts for less than 4% of the inward stock of FDI in France.

On the UIC basis, Estonia becomes its own second largest source of investment, indicating that round-tripping is more common than in France. Given that Sweden, Finland, the Netherlands, Russia, and Norway become less important as sources of investment when measured according to the ultimate investor, it appears that some of the round-tripping from Estonia is going through some or all of these countries. In contrast, the United States, Austria, Germany and Denmark are all more important sources of FDI in Estonia than the standard presentation indicates.

Does removing these layers of complexity matter? Yes. Every country has a strategy to attract investment and high quality statistics must be the empirical basis for any informed policy dialogue. Following the recommendations in BMD4 produces more meaningful FDI statistics that enable us to better understand who is really investing where internationally.

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Original article: Maria Borga, OECD Investment Division, “Vital statistics: Taking the real pulse of foreign direct investment”, TO COME.

