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Not all foreign direct investment is foreign: the extent of round-tripping

by
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Usually, foreign direct investment (FDI) is considered a form of investment that provides host countries a variety of benefits, including finance, knowledge and technology transfers, and access to the foreign investors' distribution networks. However, if foreign investments actually represent funds that have been channelled abroad by resident investors and returned to the domestic economy in the form of FDI, then host economies will not receive the additional benefits associated with FDI. This phenomenon is called "round-tripping." A recent *FDI Perspective* discussed an individual transaction for Russia that involved round-tripping.[1]

There are several reasons a domestic investor may engage in round-tripping:

- Economies sometimes offer tax or other incentives to foreign investors to locate in their economy. If local investors do not receive this same preferential treatment, then they may engage in round-tripping to receive these benefits.
- Some economies have controls on capital movements or exchange rates that may lead domestic investors to round-trip to have more flexibility in managing their capital.
- Some economies may not have well-developed capital markets; so domestic investors first invest overseas to access better financial services and then return the funds to the home economy.
- If an economy has investment treaties that give greater protections to foreign investors, domestic investors may round-trip to ensure their investments receive these greater protections.
- Some investors may want to conceal their identity.

It is important to know how much of an economy's FDI is due to round-tripping because round-tripping is not genuine FDI and may indicate a problem in the country's investment policy regime. In addition, round-tripping can reduce tax receipts and regulatory oversight in the home country. On the other hand, a foreign affiliate may invest in a business in its ultimate investor's country for legitimate business reasons; while identified as round-tripping, such an investment does not indicate a problem.

Comprehensive information on the amount of round-tripping has been unavailable until recently. To provide more meaningful FDI measures, the OECD developed the fourth edition of its *Benchmark Definition of Foreign Direct Investment* (BMD4). BMD4 recommends that countries compile statistics on inward FDI by the ultimate investing country (UIC). This presentation allows countries to look through the complex ownership structures of multinational enterprises (MNEs) to see the country of the direct investor that ultimately controls an investment and, thus, bears the risks and reaps the rewards of the investment. The presentation by UIC identifies the amount of round-tripping in an economy by identifying that portion of inward investment that is controlled by a resident of the host economy. In contrast, the standard presentation of FDI statistics is by the immediate source of funding. Another important feature of BMD4 is the separate identification of FDI to and from resident special purpose entities (SPEs), i.e., entities with little physical presence in a host economy but that provide financial services to MNEs.

There can be substantial differences in the distribution of inward positions by country when presented by UIC rather than by the immediate partner country. Currently, six countries publish statistics by UIC: Austria, Estonia, Finland, France, Poland, and the United States.[2] For these countries, their own investors were among the top ten "foreign" investors in their countries. This indicates that round-tripping is quite a widespread phenomenon. In most of these countries, round-tripping accounted for less than 5% of inward investment, indicating that it may not be a significant issue for them. However, it could be a larger problem for other countries. For example, exploratory estimates for Russia indicated that more than half of Russia's outward FDI position at the end of 2010 consisted of funds that were eventually returned through round-tripping.[3]

In addition to identifying round-tripping, the statistics by UIC give a much better idea of the ultimate source of the investment, addressing one of the major shortcomings of FDI statistics. In countries that have produced the statistics the shares of inward FDI from countries with a lot of capital-in-transit, such as Luxembourg and the Netherlands, fall, while the shares of countries where investors commonly use SPEs, such as the United States, rise. For example, the statistics by UIC for Poland show that investors from the United States are beneficial owners of the second largest share of FDI in Poland and not the fourth largest as in the published statistics.

Given the importance of knowing who is investing in a country and to ensure that investment policies are not creating distortions that lead to round-tripping, all countries should produce FDI statistics by UIC. Due to the considerable burden of implementing new international standards for balance-of-payments accounts introduced in 2008, only a few countries publish FDI statistics by UIC. The number is expected to increase in coming years and can be encouraged by promoting the broader use of BMD4 and providing assistance with compiling these new statistics.

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[1] Delphine Nougayrède, "Untangling the effects of special purpose entities on FDI," *Columbia FDI Perspectives*, No. 171, April 11, 2016.

[2] *See*, http://dotstat.oecd.org, described at http://www.oecd.org/daf/inv/FDI-statistics-by-ultimate-investing-country.pdf.

[3] Central Bank of the Russian Federation, "Identifying round-tripping of funds: a note by Russia," presented at the October 3-5, 2011 meeting of the OECD's Working Group on International Investment Statistics.

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