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Differences in Treatment of Direct Investment in the Balance of Payments Statistics and the International Investment Position

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Summary

Direct investment refers to a long-term capital transaction across borders that consequently gives the direct investor an effective voice in the management of the direct investment enterprise. According to the *Balance of Payments Manual*, fifth edition (hereafter, the BPM5), an international standard for compiling the Balance of Payments (BOP) statistics, direct investment is basically defined as an international capital transaction made by a direct investor that has ownership of 10 percent or more in the direct investment enterprise. Major countries including Japan compile and release figures for transaction flows in direct investment in the BOP (flow statistics) and the stock at year-end of direct investment, a major component of the International Investment Position (IIP; stock statistics), as noted in the BPM5.

Direct investment statistics are often regarded as a significant reference in formulating economic policies or evaluating policy effects, due to their large impact on a nation's economy. Direct investment statistics have gained more attention in Japan, following Prime Minister Koizumi's proposal in his fiscal 2003 policy speech to double the stock of direct investment to Japan within the next five years, in order to revitalize the economy.[2]

Some statistical users, however, may feel confusion when analyzing direct investment statistics because there is disparity between accumulated flow and stock. This disparity comes from differences in valuation methods, significant differences in compilation methods, and data coverage caused by constraints in data sources, etc.

Various factors cause the disparity between accumulated flow and stock, and can be classified into the following two groups: (1) disparity caused inevitably in the process of compilation of flow and stock statistics as noted in the BPM5, and (2) that stemming from compilation methods specific to Japan (Chart 1).

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[1] We would like to express thanks to our colleagues at the Bank of Japan's (hereafter, the Bank) International Department and Research and Statistics Department for their helpful comments. Views expressed in this paper are, however, solely those of the authors and not those of the Bank, the International Department, or the Research and Statistics Department. The original Japanese-language version of this report was released on August 21, 2003.

[2] "Fiscal 2003 Economic Outlook and Basic Stance for Economic and Fiscal Management."

Chart 1: Factors Causing Disparity between Accumulated Flow and Stock in Direct Investment

Factors	Details
A. Factors stemming from compiling methodologies on flow and stock statistics, which are noted in the BPM5	1. Exchange rate changes (mainly in foreign direct investment abroad <outward direct investment or Japan's assets>). 2. Changes in direct investment assets and liabilities without actual transaction flows. 3. Difference in valuation methods (mainly in the stock of equity capital).[1]
B. Factors stemming from compilation methods specific to Japan	1. Exclusion of capital reserves from the stock of foreign direct investment in Japan (inward direct investment or Japan's liabilities).[2] 2. Addition of flow data to compile stock statistics at year-end. 3. Difference in the threshold of reporting for data source. 4. Difference in the timing of recording reinvested earnings.

Notes: 1. Many countries compile flow statistics on a market value basis, and stock statistics on a book value basis.

2. The stock of foreign direct investment in Japan including capital reserves will be released as of end-2005.

For statistical users, it is desirable to have no significant disparity between accumulated flow and stock. Statistics compilers should therefore further consider harmonization of flow and stock statistics. The following two points should be considered first in reviewing the compilation methods specific to Japan.

(1) Reviewing the method of adding flow data from April to December on fiscal year-end (end of March) stock (B.2. in Chart 1).

(2) Supplementing data for stock statistics that are below the threshold of the present reporting system (B.3 in Chart 1).

On the other hand, in the international project for updating the BPM5, the compiling methodologies for flow and stock statistics are under review. The majority view on this issue is that data for stock statistics should be recorded on a market value basis. Of concern is the valuation of nonlisted stocks, for which there are two possible methods. The first of these is to use the ratio of "market value to book value," calculated using the prices of individual listed stocks or stock price indices, while the second is to use the book value instead. It is considered desirable in this paper to use the book value basis for nonlisted stocks rather than individual estimates to improve international comparability. The reason for this is that experimental studies are unsatisfactory in terms of properly reflecting liquidity risk premiums (reduction in value due to low marketability and insufficient disclosure) to the estimated market values.

In the field of statistics, concerned parties, particularly the International Monetary Fund (IMF), are becoming more conscious of "data quality." The IMF has formulated the "Data Quality Assessment Framework (DQAF)," which provides assessment frameworks for the BOP and IIP. "Data quality" implies not only accuracy and reliability but also concepts such as

methodological soundness, as well as serviceability and accessibility for statistical users. Efforts should be made, concurrent with the explanation of the actual transaction practice in Japan, to actively participate in and contribute to discussions concerning updating the BPM5 so that more appropriate recording principles will be adopted. Meanwhile, compilation methods in Japan should be continuously reviewed in order to improve the quality of statistics, while giving due consideration to the reporting burden.

I. Introduction

Direct investment usually refers to a long-term capital transaction across borders that consequently gives the direct investor an effective voice in management of the direct investment enterprise. Familiar examples are the establishment of an overseas subsidiary by a Japanese firm, the establishment of a Japanese subsidiary by a foreign firm, or cross-border business mergers and acquisitions. Direct investment, however, is defined more specifically in the IMF's BPM5,[3] which provides an international standard for compiling the BOP.[4] In the BPM5, direct investment is a subcategory of financial account and is defined as international capital transactions between enterprises where, in principle, the direct investor has ownership of 10 percent or more in the direct investment enterprise.[5]

As noted in the BPM5, components of direct investment are equity capital, reinvested earnings, and other capital (Paragraph 369). Equity capital comprises equity in branches and shares in subsidiaries and associates.[6] Reinvested earnings consist of the direct investor's share

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[3] The BPM was revised to the current fifth edition in 1993. Japan began compiling statistics based on the BPM5 from January 1996 figures onward, following deliberation by the Council on Foreign Exchange and Other Transactions, an advisory group to the Ministry of Finance (MOF).

[4] The Foreign Exchange and Foreign Trade Law (hereafter, the Foreign Exchange Law) stipulates that the MOF shall compile and report to the Cabinet the IIP, as well as BOP statistics (Paragraph 1, Article 55-9). In practice, however, the Bank accepts reports and compiles statistics, entrusted by the MOF based on the Foreign Exchange Law (Paragraph 1, Article 69).

[5] The BPM5 defines direct investment as "… the category of international investment that reflects the objective of obtaining a lasting interest (such as participating in management from a long-term perspective <authors' note>) by a resident entity in one economy in an enterprise resident in another economy," (Paragraph 359). It also adopts the 10 percent criterion relative to the lasting interest being held by "… an incorporated or unincorporated enterprise in which a direct investor … owns 10 percent or more of the ordinary shares or voting power (for an incorporated enterprise) or the equivalent (for an unincorporated enterprise)" (Paragraph 362).

However, there are exceptions to the aforementioned 10 percent criterion. Paragraph 372 of the BPM5 notes that "deposits and other claims and liabilities related to usual banking transactions of depository institutions and claims and liabilities of other financial intermediaries are classified, as appropriate, under *portfolio investment* or *other investment*." In addition, Paragraph 382 notes that "private, nonbusiness real estate investment … is, in principle, included in *direct investment*."

[6] According to Paragraph 362 of the BPM5, subsidiaries are entities in which a direct investor owns more than 50 percent of the ordinary shares or voting power, and associates are those in which a direct investor

(in proportion to direct equity participation) of earnings not distributed as dividends by subsidiaries or associates, and earnings of branches not remitted to the direct investor. In the BOP statistics, undistributed (reinvested) earnings are imputed to be paid out to the direct investors as dividends and then reinvested by them to subsidiaries or associates, thus recorded both in income and in direct investment, with opposite sign. Other capital covers capital transactions across borders between direct investors and subsidiaries and associates involving other than equity capital and reinvested earnings, such as borrowings/lendings of funds and purchases/sales of debt securities.

The BPM5 also includes the concept of "stock" in the statistical framework of the BOP. Specifically, the BPM5 recommends compilation of the IIP at year-end, which shows an accumulation of international capital transactions (financial account). Direct investment is also one of the major items included in the IIP.

Direct investments are based on each firm's international business strategy. However, they draw economic and political attention because of their large impact, both positive and negative, on a nation's economy (Chart 8). In his fiscal 2003 policy speech (January 2003), for example, Prime Minister Koizumi proposed a plan to double the stock of foreign direct investment in Japan within the next five years as a means of revitalizing Japan's economy.[7] As a consequence, the significance of direct investment statistics has increased relative to formulating economic policies or evaluating policy effects.

Some statistical users, however, may feel confusion when analyzing direct investment statistics because there is disparity between accumulated flow and stock. That said, due to the differences in valuation methods for the BOP and the IIP, a certain level of disparity is inevitable. In addition, compilation methods and data coverage are considerably different between the two statistics due to data source constraints, etc.

Based on these facts, this paper attempts to facilitate understanding of the factors causing statistical disparity between the flow and stock. To this end, the compilation methods of both statistics will be presented first, followed by an explanation of causes of disparity from both conceptual and practical aspects (in particular, the compilation methods in Japan) with a focus on stock statistics. This paper also describes efforts to improve data quality, such as planned future reviews in Japan and various developments related to the current international discussions on updating the BPM5.

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owns 10 percent or more but less than 50 percent of the interests.

[7] "Fiscal 2003 Economic Outlook and Basic Stance for Economic and Fiscal Management."

See Appendix for recent measures to promote foreign direct investment in Japan, and evaluation methods for these measures.

II. Compilation Methods for Direct Investment Flow and Stock Statistics in Japan

As a premise to explanation of the disparity between the two statistics, compilation methods for direct investment flow and stock statistics in Japan are examined (Chart 9).

A. Direct Investment Flow Statistics

The same compilation methods are employed for the asset and liability sides in flow statistics; however, the methods are significantly different by component, i.e., equity capital, other capital, and reinvested earnings.

Equity capital and other capital are compiled by summing up figures in reports ("report on payments/receipts"),[8] which are submitted by (1) Japanese firms that have made/withdrawn foreign direct investments and (2) Japanese firms that have accepted/paid back foreign direct investments.

Reinvested earnings, on the other hand, are imputed and do not reflect actual transactions; therefore, the "report on payments/receipts" cannot be a data source. Instead, they are compiled using figures in the "report on the internal reserves of overseas direct investment enterprises" and the "report on the internal reserves of direct investment enterprises in Japan."[9] These reports are submitted by (1) Japanese parent companies that have made a certain amount of investment (capital + capital reserves) in overseas subsidiaries and (2) foreign firms' Japanese subsidiaries that have accepted a certain amount of investment (capital only) from overseas direct investors. Reporters should submit the amount of the foreign subsidiaries' or their outstanding major assets and liabilities, including internal reserves as of the accounting year-end.

As mentioned earlier, reinvested earnings consist of the direct investor's share (in proportion to direct equity participation) of earnings not distributed as dividends by subsidiaries or associates, and earnings of branches not remitted to the direct investor. In Japan, transaction flows of reinvested earnings are compiled based on the aforementioned reports; specifically, by summing up the direct investors' interest, which is calculated as their portion to the changes in the internal reserves of direct investment enterprises as of the accounting year-end. Reinvested earnings are then allocated equally over twelve months (<changes in the internal reserves at the accounting year-end X the percentage of ownership of direct investors> / 12), instead of recording them on the last month of the accounting year, which in Japan is usually March (Chart 2). This method is used because internal reserves have been accumulated throughout the accounting year.

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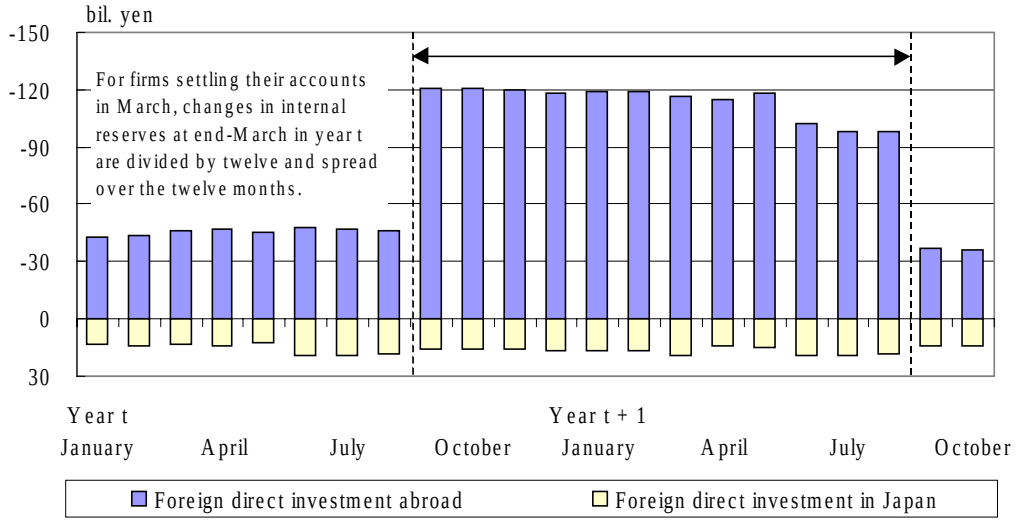
[8] In accordance with Paragraph 1, Article 55 of the Foreign Exchange Law, residents who paid/received more than 30 million yen (before March 2003, the threshold of reporting was 5 million yen) or more to/from nonresidents are required to submit the "report on payments/receipts" (reporting forms number 1 to 4) as specified by the first article of the ministerial ordinance on reporting of foreign exchange transactions (hereafter, the ministerial ordinance), with the exception of those who are exempted from reporting.

[9] Reporting forms number 50 to 52 as specified by articles 29 and 30 of the ministerial ordinance. The threshold for both reports is 1 billion yen.

Chart 2: Allocation of Reinvested Earnings[1]



Note: 1. Negative figures show outflow of capital.

Reinvested earnings should be recorded in the accounting year in which they were actually generated. In practice, the previous year's figures for income and direct investment in the BOP are revised in the following accounting year, as the reports are submitted after the accounting year-end in consideration. In Japan, however, figures are recorded after a certain period of time has been devoted to the statistical compilation process due to practical constraints.[10]

B. Direct Investment Stock Statistics

Direct investment stock statistics are compiled by summing up major asset and liability items in the "report on the internal reserves of overseas direct investment enterprises" and the "report on the internal reserves of direct investment enterprises in Japan." Some adjustments, as indicated in charts 3 and 4, are conducted in order to obtain year-end figures because most of the reported figures are as of end-March, which is the accounting year-end for most firms in Japan.

Year-end figures for equity capital and other capital are compiled as follows (Chart 3). The end of the accounting year for all firms is assumed to be end-March, and flow data from April to December calculated on the "report on payments/receipts" are added to the reported figures. The reported figures are those as of the actual accounting year-end for the year concerned for firms settling their accounts other than in December, and those as of the previous year-end for firms settling their accounts in December.[11]

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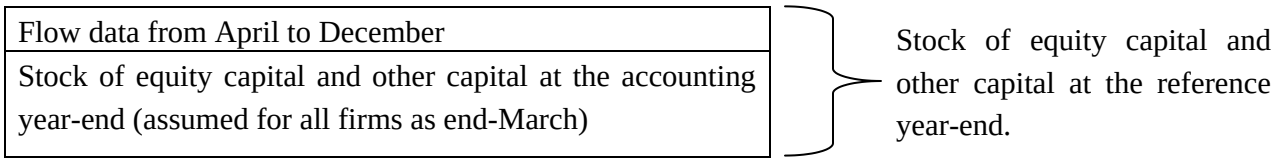
[10] The reporters are required to submit relevant reports within four months after the accounting year-end for foreign direct investment abroad and within three months for foreign direct investment in Japan. Reported figures are then checked and processed over the following two months. As a result, reinvested earnings figures become available for the BOP six months after the accounting year-end (in the case of firms settling their accounts in March, the data would be reflected from September).

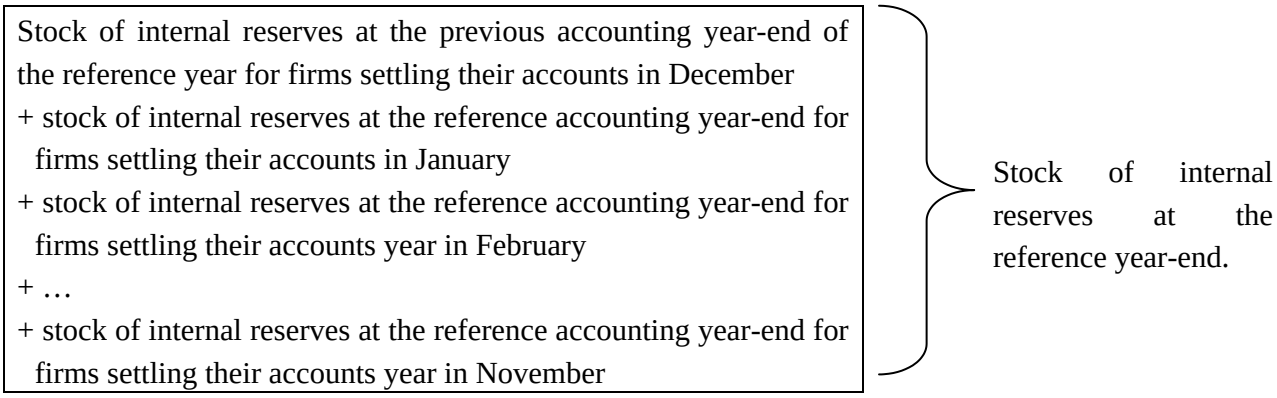
[11] We compile data for firms settling their accounts in December based on reports for the previous year-end

Chart 3: Calculation of Stock of Equity Capital and Other Capital at Reference Year-End



Year-end figures for reinvested earnings are compiled by summing up the internal reserves in the "report on the internal reserves of overseas direct investment enterprises" and the "report on the internal reserves of direct investment enterprises in Japan." The stock figures are those as of the reference accounting year-end for the year concerned for firms settling their accounts other than in December and those as of the previous year-end of the reference year for firms settling their accounts in December (Chart 4).

Chart 4: Calculation of Stock for Reinvested Earnings at Reference Year-End



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of the reference year for the following reasons: (1) to avoid delay in making reports to the Cabinet and (2) to avoid double entries of data for the firms. Reporting deadlines for the figures on direct investment stock are March (direct investment enterprises in Japan) and April (direct investors in Japan) of the following year, respectively. It is impossible to report to the Cabinet by end-May, which is required in Article 18-9 of the governmental ordinance. Moreover, direct investment stock is compiled by adding flow data from April to December of the reference year to the stock at the reference accounting year-end, assuming that the accounting year for all reporting firms ends in March. Thus, compilation based on reports at the reference year-end would therefore result in double-counting on transactions from April to December for firms settling their accounts in December.

Year-end figures for direct investment stock are therefore given with the following formula.

(1) Firms settling their accounts other than in December.

Stock at the reference year-end = stock of equity capital + stock of reinvested earnings + stock of other capital

= (stock of equity capital at the reference accounting year-end + transaction flows for equity capital from April to December of the reference year) + (stock of reinvested earnings at the reference accounting year-end) + (stock of other capital at the reference accounting year-end + transaction flows for other capital from April to December of the reference year).

(2) Firms settling their accounts in December.

Stock at the reference year-end = stock of equity capital + stock of reinvested earnings + stock of other capital

= (stock of equity capital at the previous accounting year-end of the reference year + transaction flows for equity capital from April to December of the reference year) + (stock of reinvested earnings at the previous accounting year-end of the reference year) + (stock of other capital at the previous accounting year-end of the reference year + transaction flows for other capital from April to December of the reference year).

III. Factors behind the Disparity in Direct Investment Flow and Stock Statistics

A comparison of accumulated flow and stock, for data from 1995 onward,[12] shows a certain disparity in both foreign direct investment abroad and foreign direct investment in Japan (Chart 10). For example, an accumulation of flow statistics from 1995 to 2002 and stock statistics as of end-2002 differs by 11.6 trillion yen for foreign direct investment abroad, and by 0.8 trillion yen for foreign direct investment in Japan. Such disparity, although varying in degree, is also observed in other countries' statistics (Chart 11).

Although various factors contribute to this disparity, they could be classified roughly into the following two groups.

(1) Factors stemming from compilation methodologies for flow and stock statistics

These factors stem from methodologies in the BPM5. Some disparity therefore arises in statistics for all of the countries that adopted the BPM5, which is mainly attributable to valuation methods.

[12] Japan's IIP data based on the BPM5 is compiled from year-end 1995.

(2) Factors stemming from compilation methods specific to Japan

These factors are specific to Japan and mainly owe to constraints in the data sources that are relatively prominent for stock statistics.

Several factors are included in each of the two groups, and are as follows (Chart 12).

(1) Factors stemming from compilation methodologies for flow and stock statistics

Apart from transactions between residents and nonresidents, which are covered by the BOP, various factors stemming from recording principles cause fluctuations in elements of the IIP. This is referred to in the BPM5 as follows: the "change in stocks during any defined period can be attributable to transactions (flows); to valuation changes reflecting changes in exchange rates, prices, etc.; or to other adjustments…. By contrast, balance of payments accounts reflect only transactions" (Paragraph 14).

Changes in the IIP from the previous year-end are released in Japan with breakdowns by transactions factor,[13] exchange rate changes factor,[14] and other factors (including price fluctuations; Chart 13), and this means that disparity between flow and stock statistics is equivalent to changes owing to exchange rate changes and other factors.

(a) Exchange rate changes

According to the BPM5, "the conversion of these values into a reference unit of account (usually the national currency of the compiler) is a requisite for the construction of consistent and analytically meaningful statements" (Paragraph 128). The BOP and the IIP are therefore compiled on a yen basis in Japan. Specifically, in the IIP, all foreign-currency denominated assets and liabilities are converted into yen at the reference year-end, causing changes in the stock regardless of transaction flows. In Japan, effects of exchange rate changes are larger on foreign direct investment abroad than on foreign direct investment in Japan, as the majority of foreign direct investment abroad is denominated in foreign currency (mainly in U.S. dollars), while that of foreign direct investment in Japan is denominated in yen (Charts 13 and 14).

(b) Changes in direct investment assets and liabilities without actual transaction flows

"Other adjustments"[15] are referred to in Paragraph 466 of the BPM5 as factors other than transaction flows, exchange rate changes, and price changes affecting the stock of assets and liabilities. The following are the major examples of "other adjustments" actually made to Japan's direct investment stock.

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[13] The value recorded for transactions throughout the year in flow statistics.

[14] Calculated as "stock of foreign-currency denominated assets or liabilities at the reference year-end × (exchange rate at the reference year-end – exchange rate at the previous year-end of the reference year)."

[15] "Other factors" in Japan's IIP includes "other adjustments" mentioned in the BPM5, as well as price changes, statistical errors, and others. Thus, the coverage is larger than "other adjustments" as defined by the BPM5.

(i) Devaluation of subsidiaries' stocks

An increasing number of Japanese parent companies are reducing the book value of their overseas subsidiaries' stocks due to their poor performance.[16] For example, in 2002, major Japanese telecommunications firms reduced the book value of their overseas subsidiaries' stocks in light of a worldwide plunge in telecommunications stocks. These cases accounted for around 40 percent (about 2.0 trillion yen) of changes in the stock of "other factors" (about 5.2 trillion yen) for foreign direct investment abroad at year-end. The stock of foreign direct investment abroad is presumed to be the main reason for the change because Japanese parent companies are required to report the book value of their foreign subsidiaries' stocks in foreign direct investment abroad, and the reduction may be reflected immediately in the reports. With respect to foreign direct investment in Japan, Japanese subsidiaries are only required to report the face value of capital, and revaluation of their stocks by foreign parent companies is therefore not reflected in the reporting figures.

(ii) Liquidation of subsidiaries or reduction in their capital and renunciation of loan claims against subsidiaries without actual collection of funds

In the past few years, there have been cases of Japanese parent companies liquidating deficit ridden subsidiaries, or reducing their capital (writing off accumulated losses of subsidiaries, using funds set aside as capital reserves), or renouncing loan claims against them. These cases are not accompanied by actual collection of funds and are therefore not reflected in flow statistics.[17] They are, however, recorded as a decrease in stock statistics, which accounted for about 20 percent (1.0 trillion yen) of the changes resulting from "other factors" in the stock of foreign direct investment abroad at end-2002.

(iii) Transfer entry to/from portfolio investment following changes in the percentage of ownership

Transfer entry to/from portfolio investment from/to direct investment sometimes occurs to reflect the gradual increase/decrease in the percentage of ownership. For example, if the share of capital held by a Japanese firm in a foreign firm increases with additional investment to 10 percent at current year-end from 9 percent at the previous year-end, only the value of shares corresponding to the 1 percent increase

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[16] In accordance with the accounting rules, firms should apply impairment procedures for shares of subsidiaries or affiliates whose market value has fallen by about 50 percent or more from their book value, except in cases where prices are likely to recover. Specifically, market value should replace the book value in the balance sheet, and the difference should be recognized for the current term as a valuation loss on shares of affiliated firms under extraordinary losses in the income statement.

[17] Liquidation or capital reduction of subsidiaries, as well as collections of loan claims against subsidiaries that are accompanied by collections of funds, are recorded as withdrawal from investment in flow statistics.

would be recorded as foreign direct investment abroad in flow statistics. Meanwhile, in stock statistics, all 10 percent of shares would be recorded as the stock in foreign direct investment abroad (the value of shares previously categorized as portfolio investment would be transferred). As a result, there would be disparity between flow and stock statistics equivalent to the 9 percent increase in the aforementioned example that would not be reflected in flow statistics.

(iv) Non cross-border transfer of foreign direct investment assets and liabilities

Some acquisitions or disposal of outstanding stocks may result in non cross-border transfer of direct investment assets and liabilities. For example, a foreign firm that has no capital relationship with a Japanese firm at the previous year-end may purchase outstanding stocks of that firm from several nonresident investors, each of whom hold less than a 10 percent share in the firm (a nonresident-to-nonresident transaction). As a result, suppose that the foreign firm holds a total share of 10 percent in the Japanese firm at the current year-end. This transaction would not be reflected in flow statistics because it is a nonresident-to-nonresident transaction, but would be reflected in stock statistics as direct investment. Thus, disparity will occur between the two statistics, as stock statistics would be larger than the flow statistics by a portion equivalent to the 10 percent increase.

(c) Difference in valuation methods for flow and stock statistics

In terms of valuation methods, the BPM5 notes that "this *Manual* generally uses, as the basis of transaction valuations, actual market prices agreed upon by transactors…. Conceptually, all stocks of assets and liabilities are valued at market prices prevailing at the time to which the international investment position relates" (Paragraph 23). Thus, the BPM5 recommends application of the market price principle not only for flow but also for stock statistics.

However, application of the market price principle is difficult for direct investment in stock statistics while relatively easy for flow statistics. This is because it is difficult to assess the market value of nonlisted stocks at year-end, and book value is therefore the only available data for stock statistics in many cases. For flow statistics, transaction values between direct investors and direct investment enterprises can be obtained rather easily. The BPM5 shows some tolerance in this respect and notes that "it is recognized that, in practice, book values from the balance sheets of direct investment enterprises (or investors) often are used to determine the value of the stock of *direct investment*. This practice reflects the fact that enterprise balance sheet values … represent the only source of valuation of assets and liabilities readily available in most countries" (Paragraph 377).[18]

[18] In essence, the BPM5 is not abandoning the market price principle. In Paragraph 467, the BPM5 notes that "if based on historical cost or on an interim but not current revaluation, such balance sheet values would not conform to the principle." It also notes in the same paragraph that "it would be desirable to have such data collected and made available on a current-market-value basis to eliminate the gap between

In practice, Japan—as well as many other countries—compiles stock statistics of direct investment on a book value basis due to practical constraints.[19] Among other G7 countries, the United Kingdom, Germany, and Canada compile and release figures using only book value, with the United States and France using both book value and market value and Italy using only market value (Chart 15). The United States compiles and releases two types of market value basis direct investment statistics (see Chapter IV, Section B).

Many countries, including Japan, therefore compile flow statistics on a market value basis and stock statistics on a book value basis. This practice causes disparity between the value of transactions recorded in flow statistics and the changes in stock statistics, especially in terms of equity capital.

For example, a Japanese parent company may sell outstanding stocks of its jointly established overseas subsidiary to its local partner at prices exceeding their face value, in line with the restructuring of overseas operations. In flow statistics, the value of transaction, including premium of management rights (market value), is recorded as withdrawal from direct investment. In stock statistics, foreign direct investment abroad (book value), reflecting investment held by the Japanese parent company in the previous year-end, is excluded from the stock at the current year-end. As a result, flow and stock statistics are disparate in terms of the amount of difference between direct investment withdrawal (market value) and the decrease in the stock of direct investment (book value).

Recently, there are an increasing number of cases in which foreign firms establish holding subsidiaries in Japan and sell shares of their existing Japanese subsidiaries to the newly established holding subsidiaries as a part of a realignment of their group operation in Japan. In 2002, there were cases in which foreign parent companies sold shares of their Japanese subsidiaries to their newly established Japanese holding subsidiaries at market value far exceeding their book value, while extending loans to those holding subsidiaries for the purchases. In flow statistics, these transactions were recorded on a market value basis and as balanced inflow and outflow of foreign direct investment in Japan. Specifically, the sales of shares were recorded as outflow of equity capital at market value, while loans, equivalent in amount to the shares sold, were recorded as inflow of other capital. In stock statistics, however, the aforementioned transactions are recorded as imbalanced transactions; stock of equity capital sold under direct investment is recorded at book value, while the loan was recorded at market value (almost equivalent in amount to market value of the shares sold) as an increase in other capital. As a result, the stock of foreign direct investment in Japan at end-2002 increased by the difference between market and book values of the shares transferred. This factor mainly accounts for the difference (about 1.5 trillion yen) between foreign direct investment in Japan in flow statistics

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principle and practice."

[19] See later sections on Japan's attempt to estimate market value of direct investment stock at year-end.

(about 1.2 trillion yen in 2002) and the year-on-year change of foreign direct investment in Japan in stock statistics (about 2.7 trillion yen as of end-2002).

(2) Factors stemming from compilation methods specific to Japan

The methods for compiling statistics specific to Japan are also causing disparity between flow and stock statistics. Major factors classified in this category are as follows.

(a) Exclusion of capital reserves from the stock of foreign direct investment in Japan

In flow statistics, equity capital consists of capital and capital reserves in both foreign direct investment abroad and foreign direct investment in Japan. In stock statistics, equity capital consists of capital and capital reserves for foreign direct investment abroad but consists only of capital in foreign direct investment in Japan. In foreign direct investment in Japan, only the ownership of Japanese subsidiaries' capital held by foreign firms is recorded. This is because no data on capital reserves is currently available from the "report on the internal reserves of direct investment enterprises in Japan." As a result, it is considered that a certain downward bias exists in the stock of foreign direct investment in Japan.[20]

In this connection, a certain measure has been taken to collect data on capital reserves (see Chapter IV, Section A.1).

(b) Addition of flow data to compile stock statistics at year-end

As explained earlier, figures of a part of flow statistics (from April to December) are added to the stock of major assets and liabilities accounts at the reference accounting year-end——for firms settling their accounts in December at the previous accounting year-end of the reference year——to compile stock of direct investment at the reference year-end. As a result, transactions from April to the settlement month are double counted for firms settling their accounts in a month from April to November. Also, disparity will occur between flow and stock statistics in a case where a foreign parent company sells to a resident a part of the stocks of its Japanese subsidiary with unrealized capital gains in any of the months from April to December (in year t). In the year of transaction, as changes in transaction flow, the stock at the reference year-end (at the end of year t) would decrease by the amount of capital withdrawal on a market value basis that reflects realized capital gains. In the following year, however, the stock would decrease only by book value, resulting in a year-on-year increase in the stock statistics compared with that of the reference year-end (Chart 5). As a result, disparity would arise between the two statistics.

[20] According to Article 284-2 of the Commercial Law, 50 percent or less of the total value of stocks issued is not necessarily appropriated as capital but allowed to be as capital reserves. As a result, the stock of foreign direct investment in Japan compiled on the current basis tends to be smaller than the actual amount by the capital reserves.

Chart 5: Recording Sales of Stocks with Unrealized Capital Gains in Stock Statistics

Premise:

Subsidiary's stocks sold during one of the months from April to December in year t.

Stocks' book value sold is 10, with unrealized capital stock gains of 40.

Transaction flows not made in year t+1.

Stock of investment in a foreign subsidiary at the end of year t	
Stock reported at end-March in year t	100
Flow data from April to December in year t	-50
Stock at the end of year t	50

Stock of investment in a foreign subsidiary at the end of year t+1	
Stock reported at end-March in year t+1	90
Flow data from April to December in year t+1	0
Stock at the end of year t+1	90

In the above example, the stock at the end of year t+1 increased by 40 from a year earlier even though no transaction took place in that year. This is because negative transaction flows added (equivalent to the unrealized capital stock gains of 40) in year t are not counted when compiling the stock of year t+1.

(c) Difference in the threshold of reporting for data sources

The coverage of flow and stock statistics is disparate due to a difference in the threshold of reporting for data sources. The threshold is 30 thousand yen in the "report on payments/receipts," the data source for compiling equity capital and other capital for flow statistics. On the other hand, the threshold is 1 billion yen for both foreign direct investment abroad and foreign direct investment in Japan reports employed as the data source for compiling stock statistics.[21] The difference is large and also indicates that the coverage of stock statistics is smaller than flow statistics. Moreover, it is assumed that the difference would have been a cause of bias on regional figures because small-scale direct investment, especially to Asia, is not fully covered in the stock statistics.

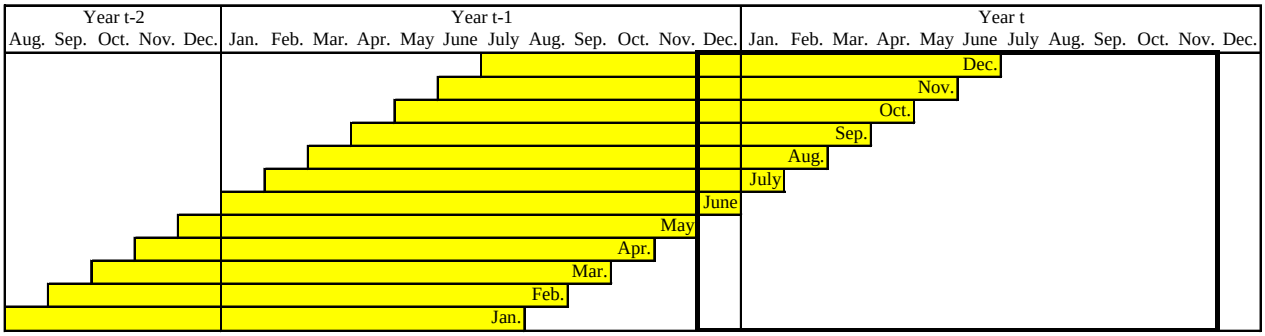
Direct investment in equity capital of 1 billion yen or more per case accounted for about 80 to 90 percent of flow transactions in 2002 to the United States, United Kingdom, France, Germany, and Canada. On the other hand, investment of the same size only accounted for about 30 to 70 percent to Asia (30 percent for China).

[21] To reduce the reporting burden, the minimum reporting threshold was raised to 1 billion yen from 100 million yen when the Foreign Exchange Law was revised in 1998. For foreign direct investment abroad, reporting is required if the stock of investment (capital + capital reserves) is 1 billion yen or more; for foreign direct investment in Japan, if the stock of capital is 1 billion yen or more.

(d) Difference in the timing of recording reinvested earnings

As mentioned earlier, in flow statistics, reinvested earnings are recorded with a six to eighteen month lag after the accounting year-end, and the timing of compiling reinvested earnings in flow and stock statistics differs greatly, as shown in Chart 6.

Chart 6: Timing of Recording Reinvested Earnings in Flow and Stock Statistics[1]



Notes: 1. Reinvested earnings compiled in stock statistics for year t are internal reserves of firms settling their accounts in one of the months within the area defined in bold. On the other hand, reinvested earnings recorded in flow statistics for year t are indicated by the shaded areas.

2. The month on the very right of each shaded bar indicates the timing of reflection for flow statistics in year t. For example, reinvested earnings in December of year t are calculated as an accumulation of "changes in internal reserves for the period × the percentage of ownership of direct investors / 12" for all firms settling their accounts from July of year t-1 to June of year t.

The current recording method causes disparity between flow and stock statistics; however, stock statistics compiled using this method enable reflection of a more adequate business performance for the subsidiaries.

IV. Efforts to Improve the Quality of Direct Investment Statistics

As explained earlier, disparity between direct investment flow and stock statistics is largely inevitable and stems from exchange rate changes and other factors. Evidence that developments in the two statistics are mostly consistent with one another is not only easy to understand but also in line with the state of the economy. Therefore, compilers of statistics should review the current statistical compilation methods from the viewpoint of the statistical users to bring about further improvement and thereby achieve harmony between flow and stock statistics. In addition, adoption of the market price principle for stock statistics should be further discussed internationally in revising the BPM5.[22]

[22] Ten years have passed since the BPM5 was introduced in 1993. Concerned parties have started various projects to introduce the revised manual, replacing the BPM5, to reflect changes in international transactions that took place during these past years. Specifically, the IMF and other international organizations, as well as statistical compilers for individual countries, have been discussing various issues to be reflected in the revised manual, which is to be finalized by end-2008.

In the following sections, our views will first be presented on the direction of the review of compilation methods specific to Japan causing disparity between flow and stock statistics, as explained in the previous sections. International discussions will then be briefly introduced regarding direct investment stock statistics for revising the BPM5.

A. Reviewing the Methods for Compiling Statistics in Japan

(1) Including capital reserves in the stock of foreign direct investment in Japan

From the viewpoint of achieving statistical consistency, capital reserves should be included in the stock of foreign direct investment in Japan. There is no rational reason to exclude capital reserves from the stock of foreign direct investment in Japan. The current treatment is also inconsistent with the fact that capital reserves are included in flow statistics and in the stock of foreign direct investment abroad.

Based on the aforementioned awareness of this issue, a measure has already been taken to revise the ministerial ordinance to include figures for capital reserves in the "report on the internal reserves of direct investment enterprises in Japan," currently used as the data source for foreign direct investment in Japan.[23] The revised ministerial ordinance will come into effect in January 2005 in line with the introduction of the electronic reporting system stipulated by the Foreign Exchange Law.[24] Capital reserves will therefore be included in the stock of foreign direct investment in Japan from end-2005 figures.

To grasp the degree of downward bias in the current statistics, the ratio of "capital + capital reserves" to "capital" based on the estimation of some sample enterprises is about 2.031 times.[25] Using this as a representative figure, equity capital would increase considerably, and the stock of foreign direct investment in Japan on the basis of including capital reserves as of end-2002 would be 12.3 trillion yen, which is about 30 percent larger than the amount calculated on the current basis (about 9.4 trillion yen; see the following formula).

Stock of foreign direct investment in Japan[1]

= stock of equity capital + stock of reinvested earnings + stock of other capital

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[23] Ministerial ordinance number 43 issued in July 2002: "ministerial ordinance on the amendment of an ordinance on reporting of exchange rate and other transactions."

[24] This is a part of digitizing the Foreign Exchange Law related procedures stipulated by "MOF's plan for digitizing application and notification procedures" (September 2000), based on the Basic Law on Formation of an Advanced Information and Telecommunications Network, which aim to improve convenience to users and enhance the simplicity and efficiency of administrative management.

[25] About 10 percent of the reporters of foreign direct investment in Japan, which accounts for about 50 percent of the capital of all reporting enterprises, were sampled. Samples were chosen in order of size in capital from firms settling their accounts either in March or December, which accounted for about 90 percent of all reporters. The ratio of "capital + capital reserves" to "capital" was calculated for each firm using information such as their released financial statements.

= (stock of investment from foreign parent companies at the reference accounting year-end <figures for the previous accounting year-end of the reference year for firms settling their accounts in December> ; capital of Japanese subsidiaries X percentage of foreign parent companies' ownership + transaction flows for equity capital from April to December of the reference year + stock of investment in Japanese branches – stock of claims by Japanese subsidiaries on direct investors held) + stock of reinvested earnings + stock of other capital.

Note: 1. Part of the stock of equity capital (shaded area above) was revalued in estimating the stock of foreign direct investment in Japan on the basis of including capital reserves.

(2) Reviewing the addition of flow data to compile year-end stock statistics

In Japan, flow data are used to compile year-end stock statistics because the accounting year for many firms ends in March. This was done to avoid firms' additional reporting burden of examining major assets and liabilities accounts at year-end, and to allow them to report at the end of their own accounting year.

Listed companies, however, are expected to begin quarterly disclosure of financial information from fiscal 2004. If this disclosure becomes widely practiced, collection of quarterly financial data instead of annual data, as currently practiced, will become a feasible option. Also, if a sufficient number of firms submit quarterly reports, flow statistics would no longer be necessary in compiling stock statistics, and the disparity between flow and stock statistics would consequently narrow. In the process of this review, it is important to take reporters' burden into account.

Quarterly reporting may also significantly shorten the time lag in registering reinvested earnings in flow statistics,[26] as changes in internal reserves would be grasped more quickly and frequently.

(3) Supplementing data on stock statistics that are below the threshold of current reporting

There are three possible measures to supplement data that are below the threshold of current reporting: (1) lowering the threshold of reporting, (2) adding flow data for transactions that are more than 30 million yen but not more than 1 billion yen, and (3) estimating figures using sources other than reports stipulated by the Foreign Exchange Law. Employment of the first measure should be considered carefully, keeping in mind the fact that the threshold of reporting was raised in 1998 to reduce reporters' burden. The second measure has merit in that it would not put additional burden on the reporters, although it may cause a statistical distortion, as shown in Chart 7.

[26] Reinvested earnings are currently recorded in flow statistics with a maximum time lag of 18 months. If reports are submitted on a quarterly basis, this time lag may be considerably shortened, even without

Chart 7: Statistical Distortion Caused by Adding Flow Statistics[1]

Premise:

The stock of investment at the previous year-end is 1.8 billion yen.

Withdrawal from investment in the current year concerned is 0.9 billion yen.

Actual transaction (bil. yen)	
Stock at the previous year-end	1.8
Transaction flows in the current year	-0.9
Stock at the current year-end	0.9

Statistical developments in stock statistics (bil. yen)	
Amount deducted because no longer subject to reporting	-1.8
Amount of flow statistics added	-0.9
Total	-2.7

The flow of -0.9 billion yen was recorded in the stock of direct investment; the year-on-year change calculated above is -2.7 billion yen. The disparity between the actual and calculated changes is -1.8 billion yen, and differs by -0.9 billion yen when compared to the amount before adding the flow figures for stock statistics.

Note: 1. This statistical distortion is very likely to surface in the calculation of the stock of foreign direct investment to Asia.

The third option of estimating figures by utilizing sources other than Foreign Exchange Law reports could merit consideration. Specifically, introduction of a benchmark survey, a complete survey that is carried out every few years, may be an option for stock statistics (as it has been in the United States) to increase accuracy by also considering reporters' burden. However, contents should be carefully examined when introducing such a survey to allow for application of the results for other public surveys and minimization of the reporting burden.

B. Outline of International Discussions on Market Value of the Stock of Direct Investment

As mentioned earlier, the market price principle is the basic valuation criterion recommended in the BPM5 (Paragraph 23). The BPM5 acknowledges the fact that book value is widely used to compile stock statistics in practice due to data constraints, but notes that "if based on historical cost or on an interim but not current revaluation, such balance sheet values would not conform to the principle" (Paragraph 467).

The BPM5, however, does not specify what measures should be taken to compile the stock of direct investment in cases where the enterprise's balance sheet is the only data source that may be used readily, and where market value data is not available. The manner in which the

changing the current deadline.

market price principle should be applied to the stock of direct investment is therefore one of the important issues relevant to discussions for revising the BPM5.

There are two possible approaches in compiling direct investment stock statistics on a market value basis: the market price method and the current price method. In the United States, two market value estimates using both methods, as well as book value estimates, are compiled and released.

The market price method uses stock prices in the market at the time of recognition. Market value of unlisted stocks is estimated by multiplying book value by the "market value to book value" ratio, using prices of listed individual stocks or the stock price indices for reference. In Japan, this method is used to estimate the stock of direct investment for end-1999 figures and beyond, subsequently presented in an analytical research paper on the IIP released by the Bank (Chart 16).[27] In this method, (1) the reporting burden and cost of compiling statistics are relatively small because the market value of capital is estimated from the stock prices and (2) the market value of intangible assets on a firm's balance sheet (e.g., patents, trademarks, management right, and goodwill) is reflected in the statistics. On the other hand, it should be noted that the market price method is influenced by fluctuations of stock prices caused by changes in the outlook for the economy or for individual industries.

In the current price method, tangible assets in the balance sheet (e.g., inventories, land, and plant and equipment) of foreign or Japanese subsidiaries are revalued on the assumption that they are repurchased at year-end.[28] Figures estimated based on this method are the sum of current tangible asset prices, and not greatly affected by fluctuations of stock prices. However, this casts a heavy burden on reporters and creates a large compiling cost for statistical compilers because it requires detailed information on each tangible asset.

Although both methods have advantages and disadvantages, details of the market price method are the focus of discussions in revising the BPM5, mainly in European nations.[29] For

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[27] Stock of equity capital was estimated using figures such as dividends received and dividend yields by region for foreign direct investment abroad, and the ratio of market value to book value for foreign direct investment in Japan. For details of the estimation methods, see *Japan's International Investment Position at Year-End 2002* available on the Bank's Internet Web site (http://www.boj.or.jp/en/index.htm) and the August 2003 issue of the *Bank of Japan Quarterly Bulletin.*

Stock of direct investment on a market value basis tends to be (1) considerably larger than that on a book value basis and (2) vulnerable to fluctuations in stock markets worldwide.

[28] Inventories, land, and plant and equipment are revalued using the current replacement cost, general price index, perpetual inventory model, and others. Financial assets are not revalued on the assumption that book value would be equivalent to market value at year-end.

[29] This is because (1) the current price method puts a heavy burden on reporters and requires large compilation costs, while (2) the market price method has a smaller effect of individual countries' reporting systems and has relatively fewer estimation errors, or a smaller disparity by the statistical compilers, due to the use of prices of listed individual stocks or stock price indexes.

example, the Task Force on Foreign Direct Investment, a joint ECB/Commission of Eurostat[30] is currently discussing the application of the market price method of unlisted stocks: whether or not to use "the ratio of 'market value to book value' estimated from stock prices" or "replace it by book value."

We consider it desirable to replace the estimated market value of unlisted firms with book value. This is because further experimental studies are still necessary to determine to what extent "liquidity risk premium (reduction in value due to lack of marketability or insufficient disclosure)" should be reflected in the estimated market value. International comparability of the statistics would consequently increase because each country could use the same data source. The use of market value for listed stocks and book value for unlisted stocks would be more true to the market price principle in the BPM5, taking into account the reporting burden, compilation cost, and statistical accuracy. Thus, it could be considered a rational evaluation principle to be adopted in the revised BPM5. Under this evaluation principle, the disparity between flow and stock statistics could be expected to significantly narrow.

V. Conclusion

In the field of statistics, the IMF and other concerned parties have started to pay greater attention to "data quality." For example, the IMF has established the "Data Quality Assessment Framework (DQAF)" to judge statistical quality. This includes specific frameworks designed for the BOP and the IIP. "Data quality" refers to not only accuracy and reliability but also concepts such as methodological soundness, as well as serviceability and accessibility for statistical users.

As stated at the beginning of this report, a certain disparity exists between flow and stock statistics of direct investment due to compilation principles and compilation methods specific to Japan. The statistical compilers in Japan should actively participate in and contribute to the discussions relevant to updating the BPM5, and explain the actual state of transactions in Japan so that an appropriate recording principle is adopted in the upcoming manual. At the same time, statistical compilers should continuously review the compilation methods in Japan in order to improve the quality of statistics, while giving due consideration to the reporting burden.

[30] Eurostat's BOP working group and the ECB's BOP and foreign currency reserves working group are jointly conducting surveys on direct investment statistics to coordinate compilation methods among countries and thereby increase international comparability.

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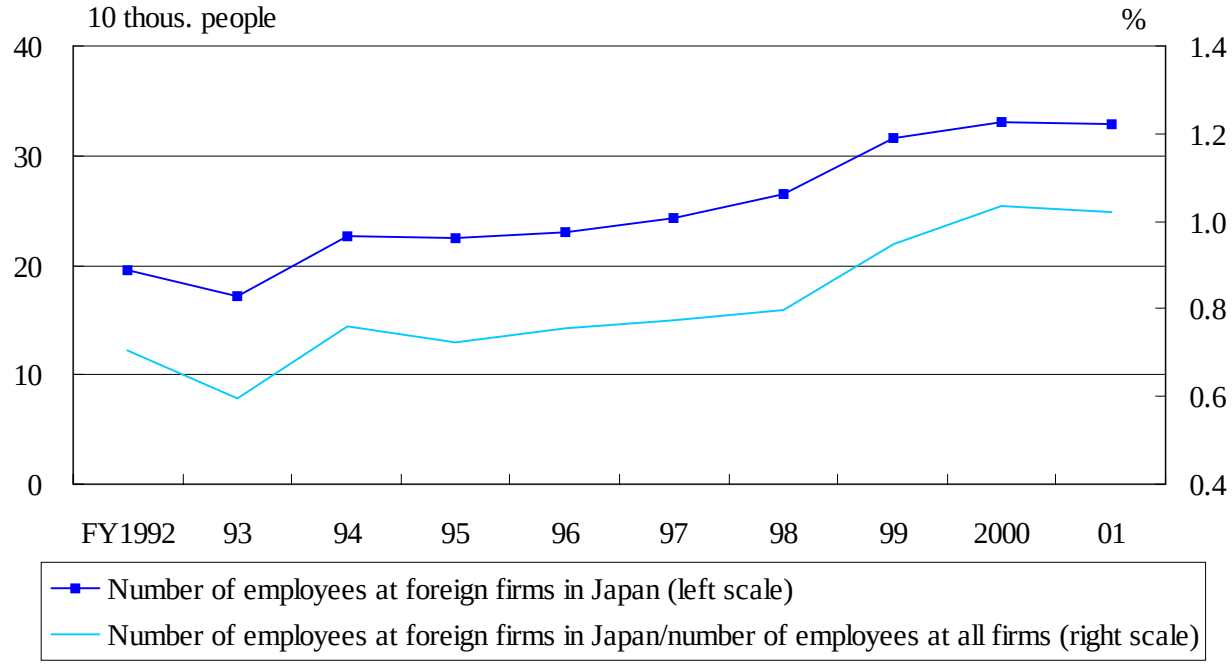
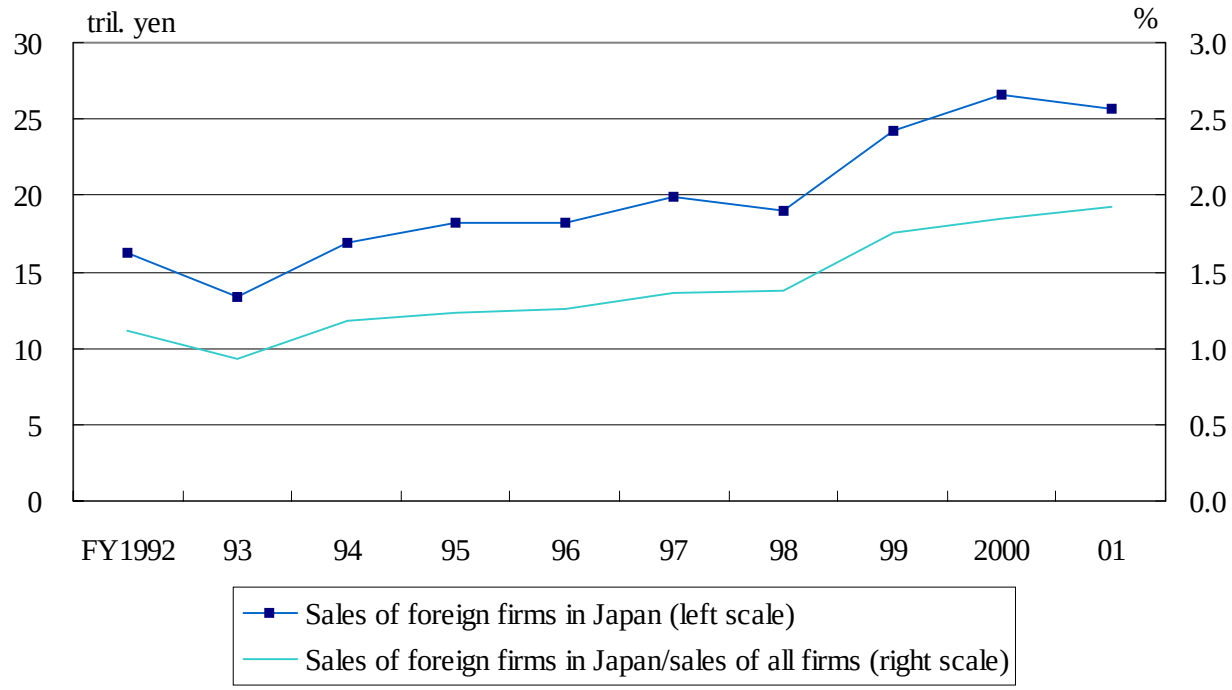
Chart 8: Foreign Firms in Japan[1]

[1] Number of Employees

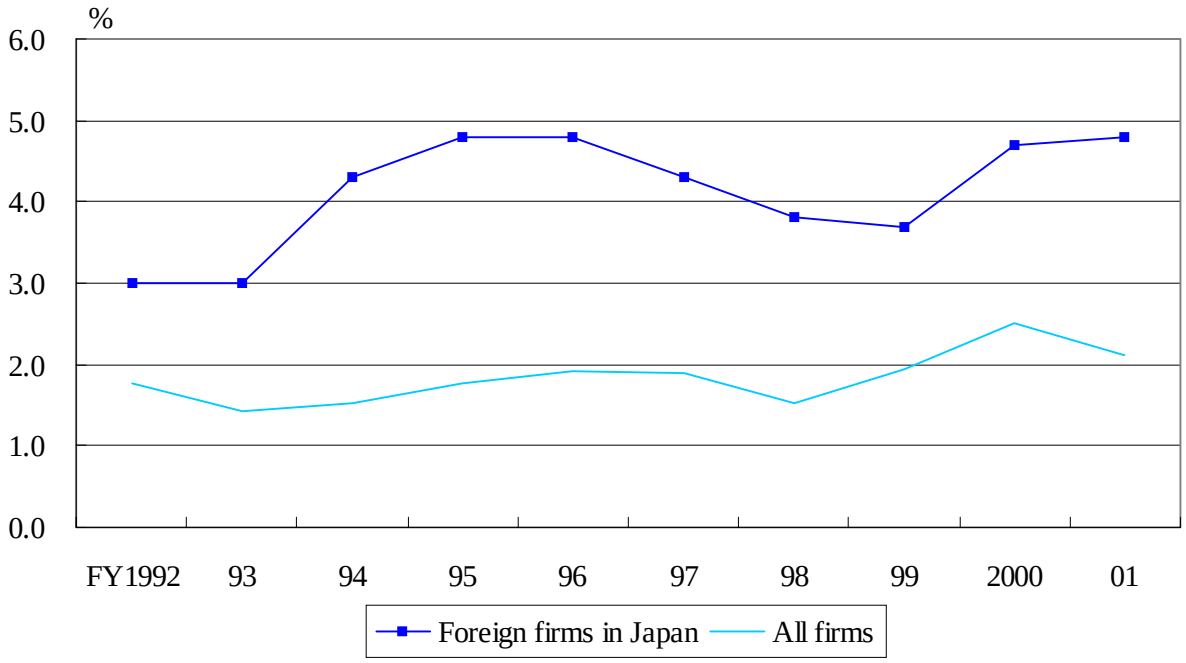


[2] Sales

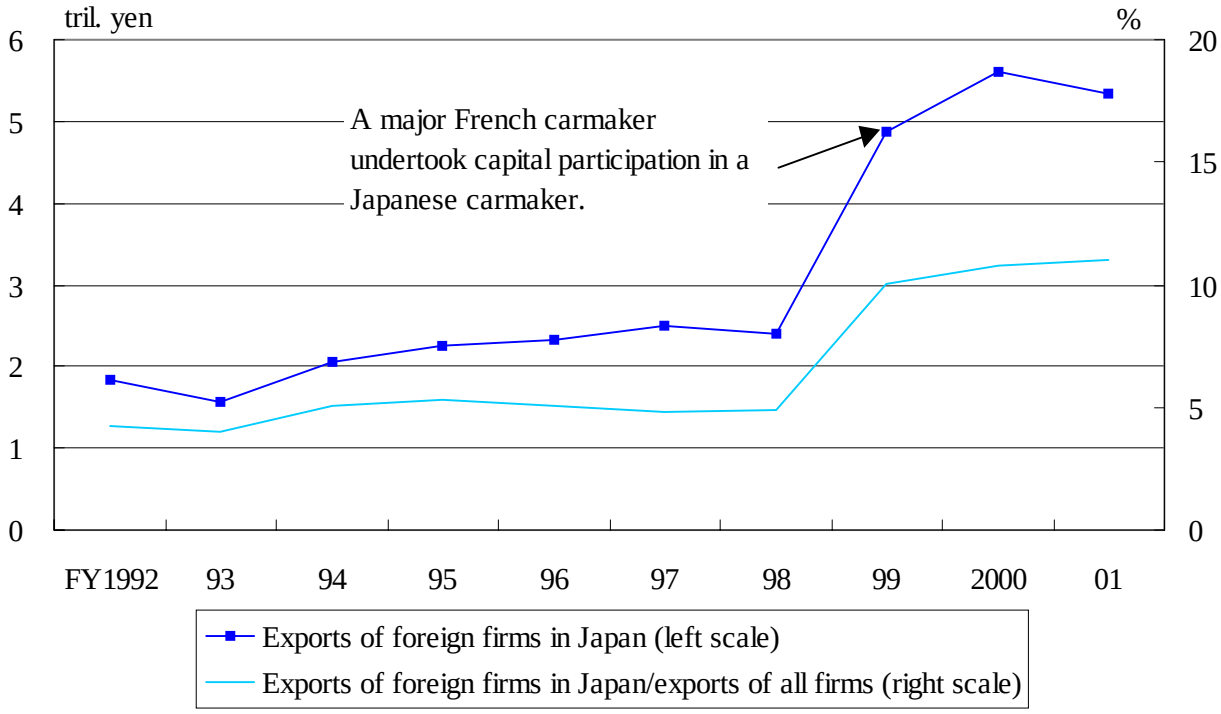


Note: 1. Firms with foreign capital accounting for more than one-third of total equity.

[3] Ratio of Current Profits to Sales



[4] Exports



Sources: Foreign firms: Ministry of Economy, Trade and Industry (METI), "Survey of Trends in Business Activities of Foreign Affiliates."
All firms: MOF, "Financial Statements of Corporations by Industry."

Chart 9: Items Comprising Direct Investment and Their Data Sources [1]

	Flow statistics		Stock statistics	
	Assets (Foreign direct investment abroad)	Liabilities (Foreign direct investment in Japan)	Assets (Foreign direct investment abroad)	Liabilities (Foreign direct investment in Japan)
A. Equity Capital	Value of transactions in purchases/sales of stocks of overseas subsidiaries (capital participation of 10 percent or more), and of the capital of overseas branches.	Value of transactions in purchases/sales of stocks of foreign subsidiaries in Japan (capital participation of 10 percent or more), and of the capital of branches in Japan.	Stock at year-end of stocks in overseas subsidiaries, and of the capital of overseas branches.	Stock at year-end of stocks in foreign subsidiaries in Japan, and of the capital of branches in Japan.
	(a)	(a)	(a) and mainly (b)	(a) and mainly (c)
B. Reinvested Earnings	Changes in the amount of undistributed profits of overseas subsidiaries belonging to parent firms in Japan, and of profits not remitted from overseas branches.	Changes in the amount of undistributed profits of foreign subsidiaries in Japan belonging to parent firms overseas, and profits not remitted from branches in Japan.	Stock at year-end of undistributed profits of overseas subsidiaries belonging to parent firms in Japan, and profits not remitted from overseas branches.	Stock at year-end of undistributed profits of foreign subsidiaries in Japan belonging to parent firms overseas, and profits not remitted from branches in Japan.
	(b)	(c)	(b)	(c)
C. Other Capital[2]	Value of cross-border transactions with parent firms and subsidiaries that do not correspond to (a) or (b), and in purchases/sales of real estate overseas by residents.	Value of cross-border transactions with parent firms and subsidiaries that do not correspond to (a) or (b), and in purchases/sales of real estate in Japan by nonresidents.	Stock of foreign direct investment abroad at year-end that does not correspond to (a) or (b), and of real estate overseas held by residents.	Stock of foreign direct investment in Japan at year-end that does not correspond to (a) or (b), and of real estate in Japan held by nonresidents.
	(a)	(a)	(a) and mainly (b)	(a) and mainly (c)

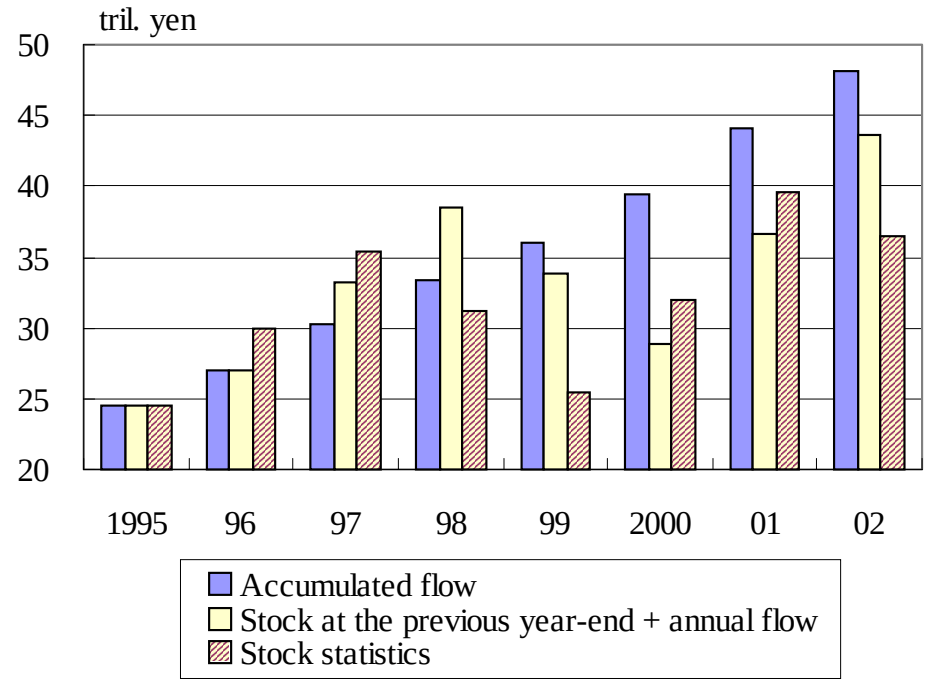
(a): Report on payments/receipts.
(b): Report on the internal reserves of overseas direct investment enterprises.
(c): Report on the internal reserves of direct investment enterprises in Japan.

Notes: 1.The reporting forms are available in Japanese on the Bank's Internet Web site (http://www.boj.or.jp/about/tame/tameindex.htm).

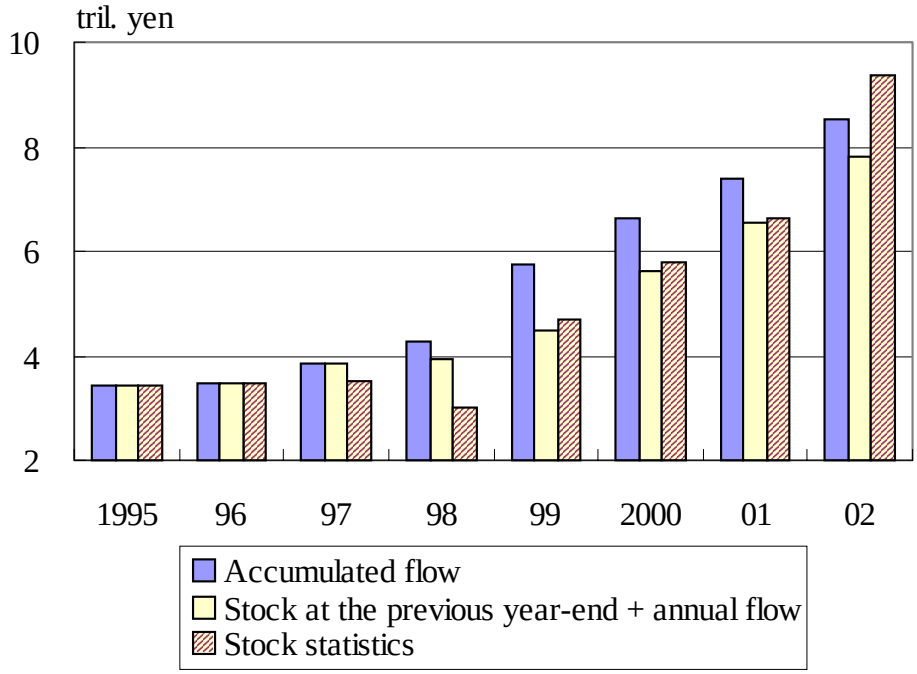
2. Excludes borrowings/lendings of funds and purchases/sales of debt securities between financial institutions. Paragraph 372 of the BPM5 notes that "intercompany transactions between affiliated banks (depository institutions) and affiliated financial intermediaries (e.g., securities dealers)——including SPEs with the sole purpose of serving as financial intermediaries——recorded under direct investment capital transactions are limited to those transactions associated with permanent debt (loan capital representing a permanent interest) and equity (share capital) investment or, in the case of branches, fixed assets. Deposits and other claims and liabilities related to usual banking transactions of depository institutions and claims and liabilities of other financial intermediaries are classified, as appropriate, under *portfolio investment* or *other investment*." Excluding financial intermediary transactions from direct investments aims to record cross-border-intercompany capital transactions to more accurately acquire a lasting interest.

Chart 10: Comparison of Flow and Stock Statistics in Japan[1]

[1] Foreign direct investment abroad



[2] Foreign direct investment in Japan



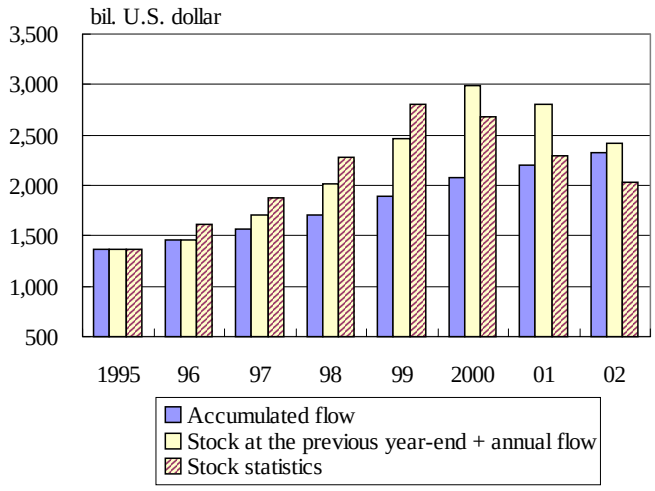
Notes: 1. "Accumulated flow" indicates total of the stock at end-1995 and accumulated annual flows. "Stock at the previous year-end + annual flow" indicates total of the stock as of the previous year-end of the reference year and the value of transactions in the reference year.

Source: BOJ, "Balance of Payments Monthly."

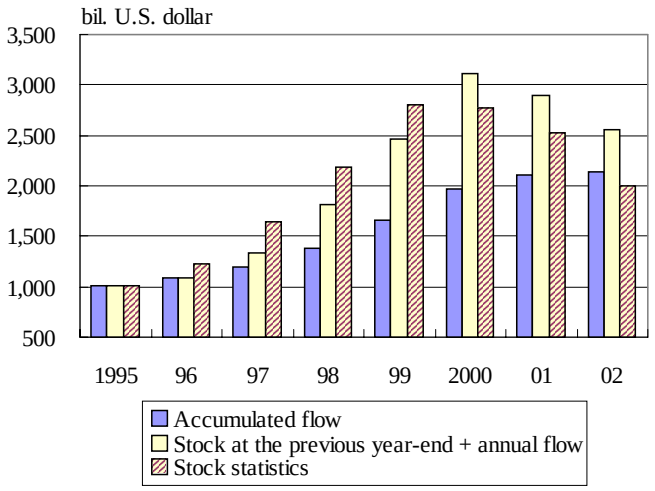
Chart 11: Comparison of Flow and Stock Statistics at Year-End in G-7 Countries[1]

[1] United States[2]

Foreign direct investment abroad

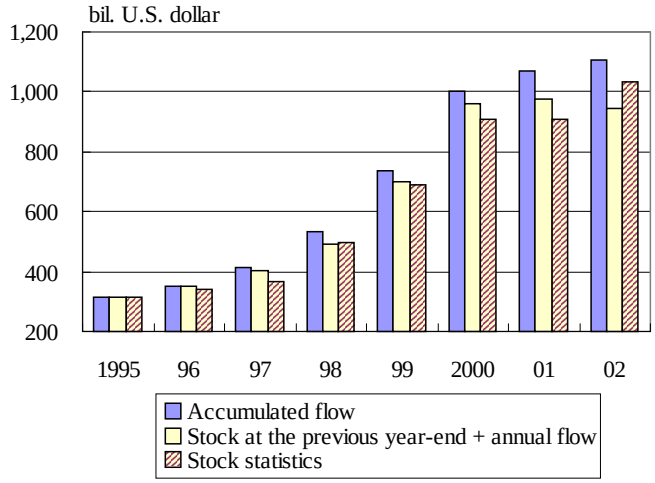


Foreign direct investment in the U.S.

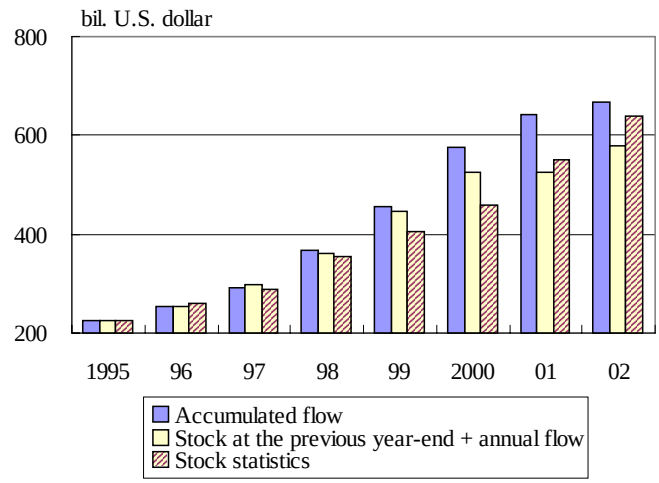


[2] United Kingdom

Foreign direct investment abroad

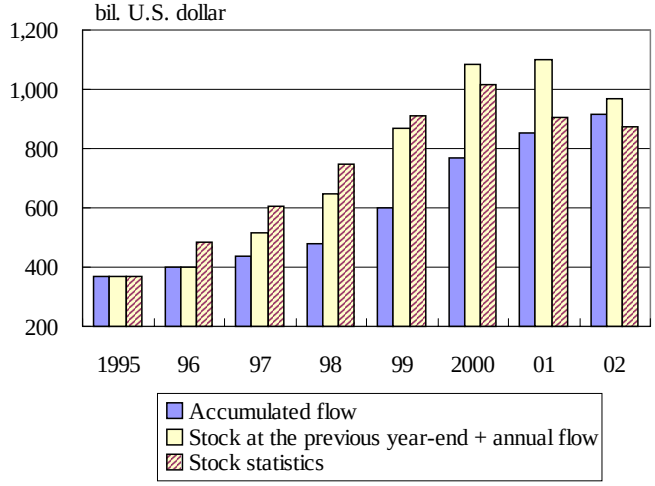


Foreign direct investment in the U.K.

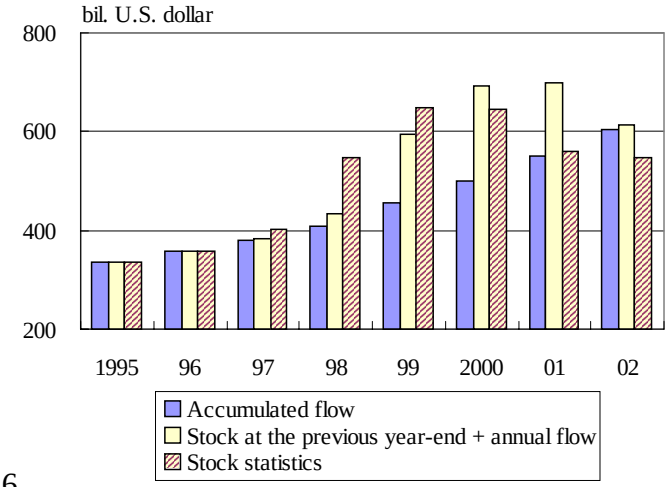


[3] France[2]

Foreign direct investment abroad

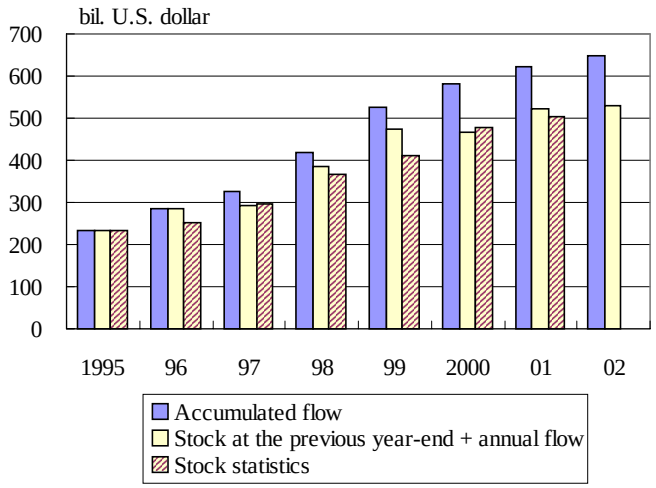


Foreign direct investment in France

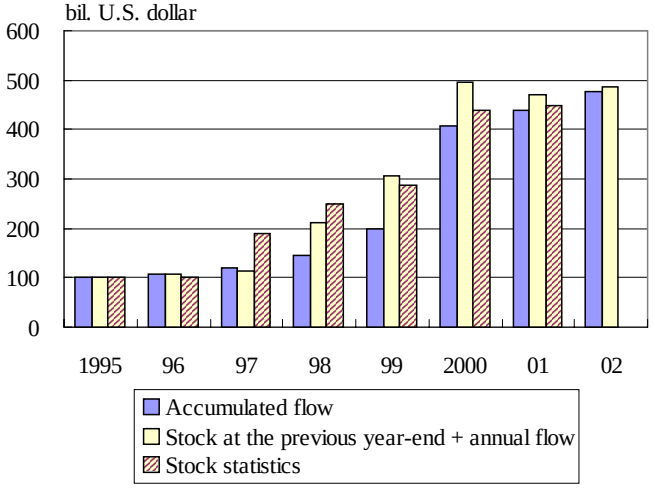


[4] Germany[3]

Foreign direct investment abroad

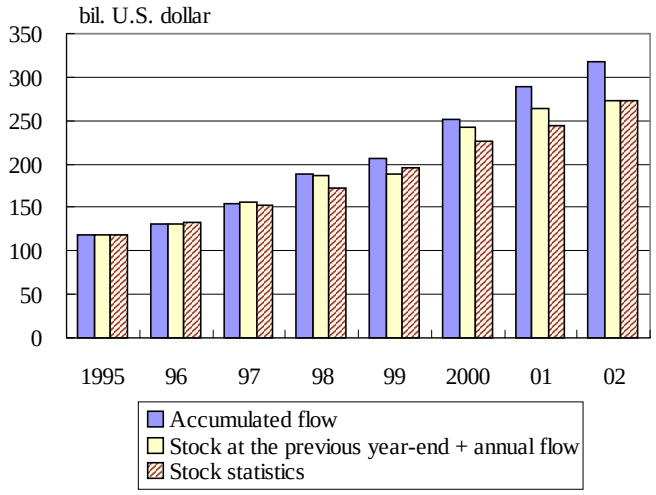


Foreign direct investment in Germany

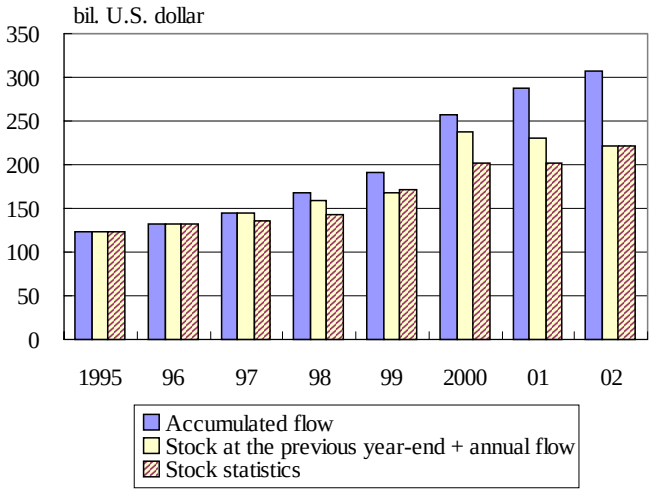


[5] Canada

Foreign direct investment abroad

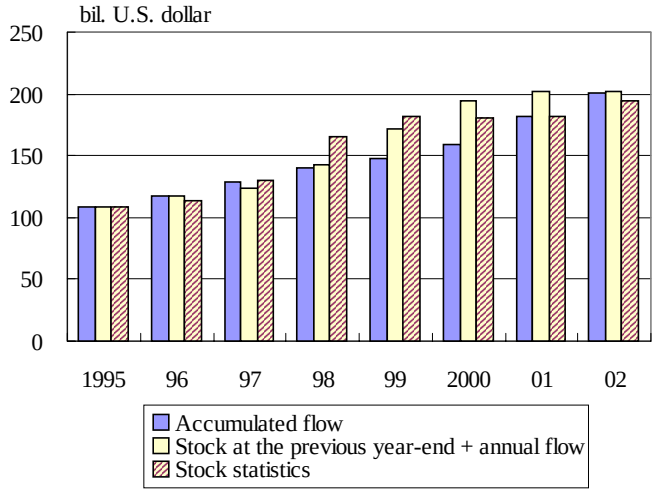


Foreign direct investment in Canada

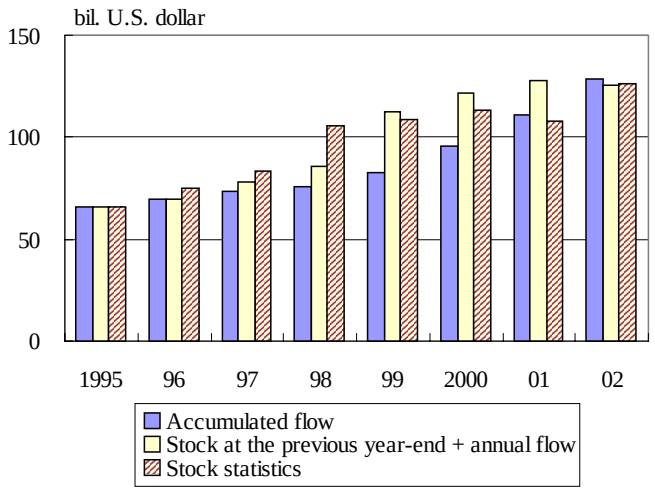


[6] Italy[2]

Foreign direct investment abroad



Foreign direct investment in Italy



Notes: 1. “Accumulated flow” indicates total of the stock at end-1995 and accumulated annual flows. “Stock at the previous year-end + annual flow” indicates total of the stock as of the previous year-end of the reference year and the value of transactions in the reference year (all figures are as of mid-August 2003).

2. Valuation is based on the market price method.

3. Figures for stock statistics at year-end 2002 were not available.

Sources: United States: IMF, “International Financial Statistics;” figures for stock statistics at year-end 2002 are from U.S. Bureau of Economic Analysis, “Survey of Current Business.”

United Kingdom: IMF, “International Financial Statistics.”

France: IMF, “International Financial Statistics;” figures for stock statistics at year-end 2002 are from National Institute for Statistics and Economic Studies.

Germany: IMF, “International Financial Statistics.”

Canada: IMF, “International Financial Statistics;” figures for stock statistics at year-end 2002 are from Statistics Canada.

Italy: IMF, “International Financial Statistics;” figures for stock statistics at year-end 2002 are from National Institute of Statistic.

Chart 12: Factors behind the Disparity between Flow and Stock Statistics of Direct Investment

Factors	Details
A. Factors stemming from compiling methodologies on flow and stock statistics, which are noted in the BPM5	1. Exchange rate changes (mainly in foreign direct investment abroad) Stems from the practice of both flow and stock statistics being recorded in the currency of the country compiling the statistics. Stock statistics are compiled using the exchange rate at year-end. Thus, changes in the stock are affected by the exchange rate changes from the previous year-end, whether or not there have been actual transaction flows. 2. Changes in direct investment assets and liabilities without actual transaction flows a. Devaluation of subsidiaries' stocks. b. Liquidation of subsidiaries or reduction in their capital and renunciation of loan claims against subsidiaries without actual collections of funds. c. Transfer entry to/from portfolio investment following changes in the percentage of ownership. ——In case the capital participation is 10 percent or more, investment is recorded as direct investment. On the other hand, when it is less than 10 percent, investment is recorded as portfolio investment. d. Non cross-border transfer of foreign direct investment assets and liabilities ——Changes in percentage of ownership may occur following a (non)resident-to-(non)resident transaction. 3. Difference in valuation methods for flow and stock statistics (mainly in the stock of equity capital) Flow statistics are recorded on a market price basis, while stock statistics are in practice recorded on a book value basis. In principle, the BPM5 recommends adoption of market value but considers the usage of book value as an alternative when necessary (Paragraph 377). Efforts made to adopt market value vary by country, but book value is employed for stock statistics in most countries.
B. Factors stemming from compilation methods specific to Japan	1. Exclusion of capital reserves from the stock of foreign direct investment in Japan. 2. Addition of flow data to compile stock statistics at year-end. Figures used for compiling stock statistics are reported at the end of the accounting period. Therefore, in compiling stock statistics for equity capital and other capital at the current year-end, all firms are assumed to settle their accounts in March, and flow statistics from April to December are added to the stock statistics data. As a result, some problems such as double-counting and omission occur. 3. Difference in the threshold of reporting for data sources. 4. Difference in the timing of recording reinvested earnings.

Chart 13: Breakdown of Year-on-Year Changes in the Stock of Direct Investment in Japan at Year-End[1]

[1] Foreign direct investment abroad

bil. yen; %

	Year-on-year changes (a)				|b/a|
		Transactions factor	Exchange rate changes factor	Other factors (b)	
1996	5,479	2,548	2,930	0	0.0
97	5,335	3,145	1,324	867	16.3
98	- 4,118	3,162	- 3,392	- 3,887	94.4
99	- 5,791	2,591	- 3,188	- 5,194	89.7
2000	6,568	3,401	2,151	1,016	15.5
01	7,562	4,659	3,692	- 789	10.4
02	- 3,077	4,048	- 1,951	- 5,174	1.7 times

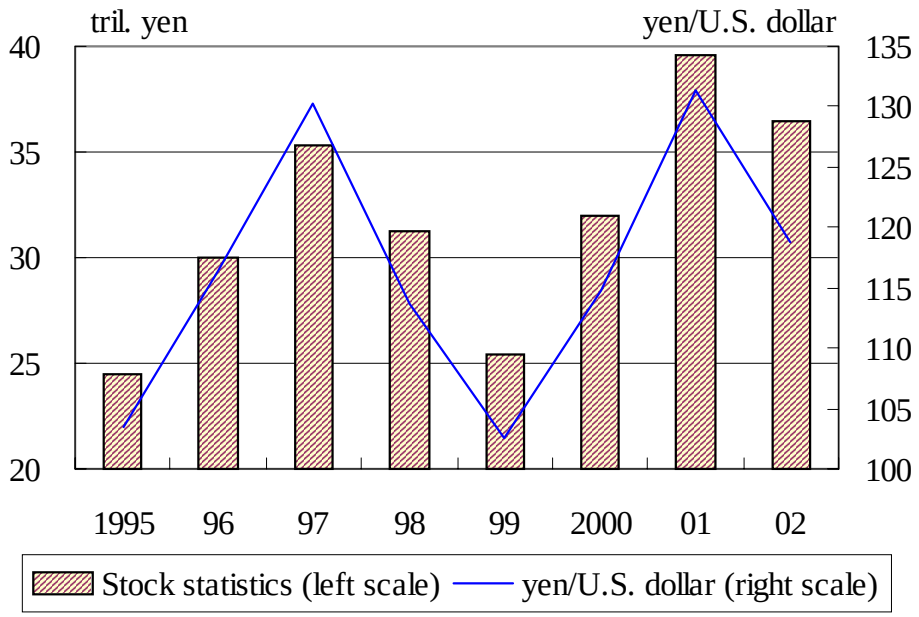
[2] Foreign direct investment in Japan

bil. yen; %

	Year-on-year changes (a)				|b/a|
		Transactions factor	Exchange rate changes factor	Other factors (b)	
1996	25	25	---	0	0.0
97	46	390	---	- 344	7.5 times
98	- 506	418	---	- 924	1.8 times
99	1,700	1,451	---	248	14.6
2000	1,069	897	---	172	16.1
01	850	759	---	91	10.7
02	2,737	1,159	---	1,579	57.7

Note: 1. Negative figures indicate year-on-year declines.

Chart 14: Stock of Foreign Direct Investment Abroad and the Exchange Rate at Year-End



Note: 1. Closing rate at the Tokyo Foreign Exchange Market.
Source: Bloomberg.

Chart 15: Compilation Methods for Stock Statistics of Direct Investment of G-7 Countries

	United States	United Kingdom	France	Germany	Canada	Italy	(Reference) Japan
Release timing[1]	About six months later	About three months later	About six months later	About nine months later	About three months later	About five months later	About five months later
Major data sources	· Quarterly survey · Benchmark survey conducted every five years	· Quarterly survey · Annual survey	· International Transactions Reporting System (ITRS)[2] · Annual survey	· Annual survey	· Annual survey	· ITRS[2] · Annual survey	· ITRS[2] · Fiscal year survey
Valuation methods	· Book value · Market value (by market price and current price methods)	· Book value	· Book value · Market value (by market price method)	· Book value	· Book value	· Market value (by market price method)	· Book value · Market value (by market price method)
Detailed information	· By region (book value) · By industry (book value)	· By region (book value) · By industry (book value)	· By region (book value) · By industry (book value)	· By region (book value) · By industry (book value)	· By region (book value) · By industry (book value)	· By region (book value) · By industry (book value)	· By region (book value)

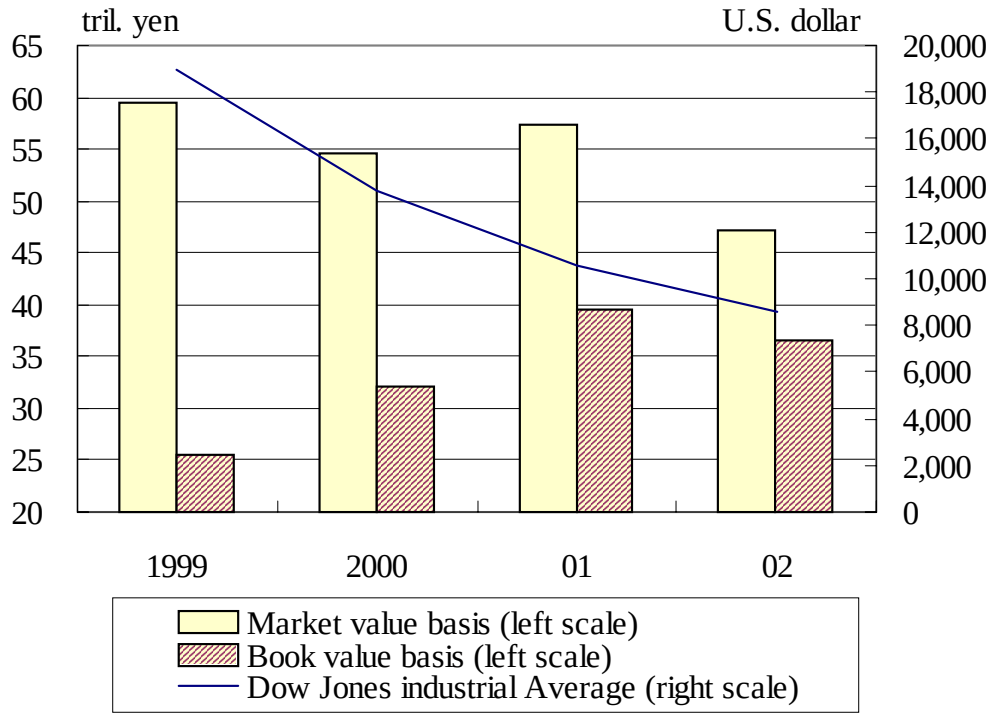
Notes: 1. Timing of the year-end preliminary figures release on a worldwide basis. Final figures on a worldwide basis or figures by region and industry may be released later.

2. ITRS is a system in which banks and residents are required to submit data on payments or receipts on individual transactions, including data on netted-out transactions not requiring actual funds transfer via financial institutions.

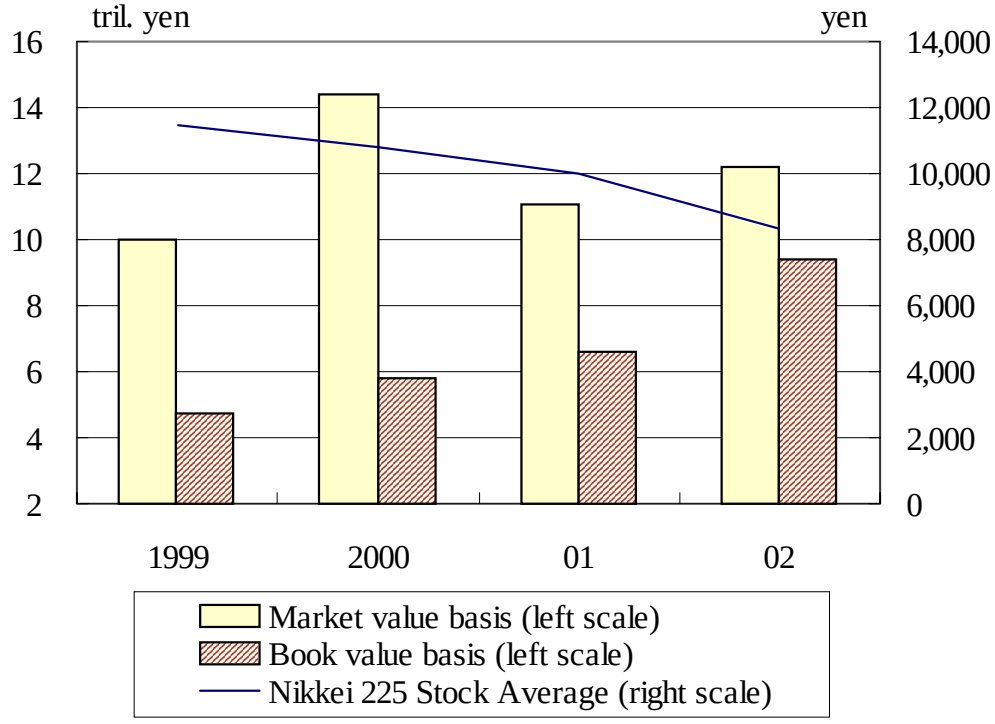
Source: IMF's Internet Web site, "Dissemination Standards Bulletin Board, Special Data Dissemination Standard, Subscribing Countries."

Chart 16: Stock of Direct Investment and Stock Prices at Year-End[1]

[1] Foreign direct investment abroad



[2] Foreign direct investment in Japan



Note: 1. Figures on a market value basis are available from 1999.

Source: Bloomberg.

Appendix: Recent Direct Investment Promotion Measures in Japan and Their Evaluation

The promotion of foreign direct investment in Japan is being emphasized as a measure to revitalize the stagnating economy, and specific measures are being examined by the Expert Committee of the Japan Investment Council (JIC), chaired by Prime Minister Koizumi.[1] The outlines of these measures are as shown in Chart 1 for Appendix. Surveys have been conducted by ministries and related organizations concerning the matters underlined in the chart, the results of which have been made public and may be used to evaluate the effectiveness of each measure in future.

A. Improving the Investment Environment[2]

The degree of future improvement in the investment environment in Japan for foreign firms may be analyzed using results from the "Survey on Attitudes of Foreign Companies toward Direct Investment in Japan." This survey was conducted by the Japan External Trade Organization (JETRO) and reveals the degree of changes in the business environment as well as the effective measures already taken or expected to be taken to promote direct investment. Chart 2 for Appendix shows Japan's current investment environment as seen by foreign firms, using results of the aforementioned survey.

In the survey for 2003, foreign firms were asked about "measures that had, or are expected to have, effects in improving the M&A environment." The most popular answer chosen was "lowering effective corporate taxes" (45.4 percent), followed by "abolishing consolidated additional taxes" (15.1 percent), and "integration of office windows for investment applications, notifications, and consultations (the provision of one-stop services)" (13.1 percent).

The survey for 2002 inquired into foreign firms' views on measures expected to improve

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[1] The JIC was established in July 1994 as part of market-opening measures. It released "Statement of the Japan Investment Council—Toward the Promotion of Foreign Direct Investment in Japan" in June 1995, "On the Preparation of M&A Environment in Japan—Aiming for the Promotion of Investment in Japan through M&A" in April 1996, "Statement of the Japan Investment Council—Toward an Age of Diversified Ideas through Foreign Direct Investment in Japan" in April 1999 (based on "Seven Recommendations for Foreign Direct Investment in Japan" by the JIC Expert Committee), and "Resolution of the Japan Investment Council—Promotion of Foreign Direct Investment into Japan" in March 2003.

[2] The following surveys are relevant references: "Survey on Attitudes of Foreign Companies toward Direct Investment in Japan" and "The Survey on Actual Conditions Regarding Access to Japan-Inward Foreign Direct Investment" conducted by JETRO, and "Survey of Trends in Business Activities of Foreign Affiliates" conducted by METI. The first of these is a voluntary survey on Japan's investment environment and business performances conducted on foreign firms. Foreign firms are defined here as those with foreign capital of one third or more of their total equity. The third is a chartered survey on Japan's investment environment conducted on foreign firms. Foreign firms in this survey are defined as those with foreign capital of more than one third of their total equity.

Japan's investment environment in future. The most popular answer chosen was "further cut in corporate tax" (69.0 percent), followed by "streamlining of administrative procedures" (44.5 percent), and "deregulation of administrative approval" (39.0 percent). Some firms also pointed out the need to "introduce international accounting standards, such as impairment procedures" and "introduce cross-border exchange of stocks."

The "Survey of Trends in Business Activities of Foreign Affiliates" conducted by the Ministry of Economy, Trade and Industry (METI) and "The Survey on Actual Conditions Regarding Access to Japan" conducted by JETRO could also provide useful data in evaluating the effectiveness of measures to promote foreign direct investment in Japan.

The survey for fiscal 2000 by METI asked firms about areas in the Japanese business environment requiring improvement. The most popular answer was "high business cost" (81.1 percent) followed by "high tax rate" (50.2 percent). According to "The Survey on Actual Conditions Regarding Access to Japan," the business cost including initial investment cost in Japan is relatively higher than in other major countries. In the United Kingdom, the size of initial investment cost (from preparation to start-up) is 24 percent that of Japan. In Germany, the United States, and France, the size relative to Japan's is 20, 14, and 9 percent, respectively (Chart 3 for Appendix).

B. Increasing International Competitiveness[3]

According to the *IMD World Competitiveness Yearbook* for 2003, Japan ranked fifth in "infrastructure," but only came in 21st place for "business efficiency," 17th place for "government efficiency," and 14th place for "economic performance." As in the previous year, Japan ranked 11th in total competitiveness.[4]

The Foreign Direct Investment (FDI) Confidence Index, compiled by A.T. Kearney, may also be used as a reference in evaluating the effectiveness of policy measures implemented. Rankings based on this index show changes in Japan's position from 1998 to 2002 as follows:

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[3] The following are relevant references: the *IMD World Competitiveness Yearbook* released by the International Institute for Management Development (IMD) and the "FDI Confidence Index" compiled by A.T. Kearney. In the *IMD World Competitiveness Yearbook*, a publication of a Swiss business school, 59 countries and regions are categorized into two groups by population (more than 20 million <30 major countries and regions>, and others). These countries and regions are analyzed based on 320 criteria in four areas: (1) economic situation, (2) government efficiency, (3) business efficiency, and (4) infrastructure. Countries are ranked according to the results. The FDI Confidence Index is an index compiled by A.T. Kearney, a U.S. consulting firm, based on surveys of executives of global corporations in 60 countries on the attractiveness of direct investment over the next three years.

[4] Highly ranked countries were as follows, in order of ranking; (1) the United States, (2) Australia, (3) Canada, (4) Malaysia, (5) Germany, (6) Taiwan, (7) United Kingdom, (8) France, (9) Spain, (10) Thailand, (11) Japan, and (12) China.

23rd, 21st, 16th, 20th, and 12th.[5] However, it is noted that (1) a deepening of Japan's recession, (2) progress of financial and banking reform, and (3) industrial restructuring and others, may significantly affect Japan's relative competitiveness in terms of a foreign country's decision on destination of investment.

[5] Japan's ranking rose in 2002 reflecting factors such as (1) the decline in prices of commercial land and property, (2) positive effects on the economy from World Cup Soccer (co-hosted with South Korea), and (3) progress in deregulation in telecommunications and wholesale/retail industries.

Chart 1 for Appendix: Main Measures of the Program for the Promotion of Foreign Direct Investment into Japan[1]

Main measures	Timing of implementation
Improve business environment	
In the course of work on modernization of the Corporate Law, examine a possible realization of "the easing of rules on compensation for merger etc." as a permanent measure, which would enable cross-border exchange of stocks (see Section A) to expedite the process of merger and acquisitions by foreign firms.	A draft legislative bill will be submitted to the Diet within fiscal 2004.
When liquidating stocks and loans owned by the Industrial Revitalization Corporation (IRC) and the Resolution and Collection Corporation (RCC), select the buyers through publicized procedures in a transparent, fair, and economically sound manner to encourage foreign firms to participate in the process of corporate revitalization.	Will start in fiscal 2003.
Create tax incentives in IT and research and development to reduce the tax burden of companies (see Section A).	Will start in fiscal 2003.
Strive to improve transparency and reliability of corporate information by means such as observing actions corresponding to the international accounting standards to strengthen corporate governance (see Section A).	Will start in fiscal 2003.[2]
Review administrative processes	
Place electronic filing procedures online for investment applications required by provisions of the Foreign Exchange Law.	Will start by fiscal 2005.
Clarify, simplify, and expedite administrative procedures (see Section A) by, for example, promoting the use of a "no action-letter" system to clarify interpretation of legislation.	Will start in fiscal 2003.
Translate various types of information on investment procedures such as those related to corporate establishment, M&As, and others into English, and establish a single contact point in the JETRO (see Section A) for access to such information.	Will start from fiscal 2003.
Create favorable employment and living environments	
Improve basic ability in English and communication ability based on cross-cultural understanding of the Japanese people.	Will continue to be implemented.
Improve local and national structures and systems	
Strengthen assistance to efforts by local governments to attract foreign direct investment.	Will start in fiscal 2003.
For building an internationally competitive structure for the attraction of foreign direct investment, the ministries and agencies concerned will study the structures and policies in other countries, and reach the conclusions on further implementation in Japan (see Section B).	Will examine and publicize conclusion within fiscal 2003.
Disseminate information within Japan and abroad	
Strengthen dissemination of information to the foreign press, embassies, and consulates and publicize investment success stories with cooperation from successful foreign-capitalized ventures in Japan.	Will start in fiscal 2003.
Seek the understanding of the wide range of Japanese people through the media and other measures on the role and importance of inward FDI in the revitalization of the Japanese economy.	Will start in fiscal 2003.

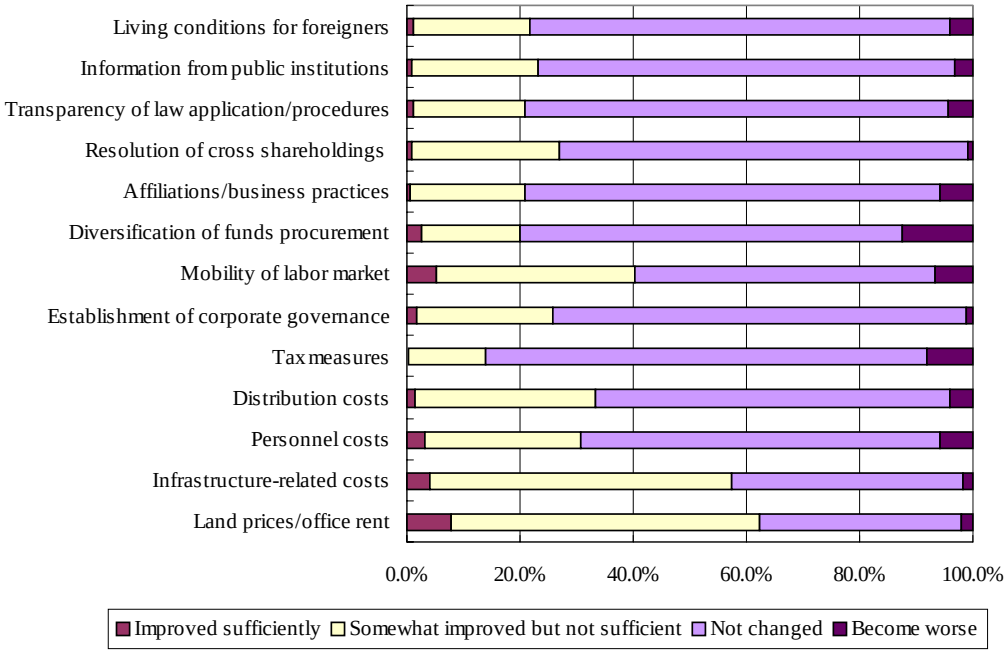
Notes: 1. The chart, based on various surveys, shows the main measures requiring improvement from the viewpoint of foreign firms investing in Japan.

2. Specific rules of international accounting standards will be introduced one by one, after going through deliberation and agreement by the Accounting Standards Board of Japan (ASBJ).

Source: Cabinet Office, "The Japan Investment Council Report."

Chart 2 for Appendix: Changes in the Business Environment in Japan for Foreign Firms in the Past Two to Three Years

[1] Survey Results[1]



[2] Diffusion Index[2]

	D.I.
Living conditions for foreigners	+15.5
Information from public institutions	+17.8
Transparency of law application/procedures	+15.1
Resolution of cross shareholdings	+21.6
Affiliations/business practices	+13.8
Diversification of funds procurement	+6.7
Mobility of labor market	+31.2
Establishment of corporate governance	+21.4
Tax measures	+5.3
Distribution costs	+26.9
Personnel costs	+23.2
Infrastructure-related costs	+51.6
Land prices/office rent	+56.5

Notes: 1. Survey results show respondent firms' view on changes in various business environments in Japan for the past few years. Firms were asked to choose from "sufficiently improved," "somewhat improved but not sufficient," "not changed," or "become worse."

2. Diffusion index is the difference of those answering "improved sufficiently" and "somewhat improved but not sufficient" minus those answering "become worse."

Source: JETRO, "Survey on Attitudes of Foreign Companies toward Direct Investment in Japan" (June 2003).

Chart 3 for Appendix: Comparison of Initial Investment Cost[1]

(Japan = 100)

		Japan	United States	United Kingdom	Germany	France
Manufacturing plant	Price of space in industrial park	100	13	12	17	2
Office	Lease guarantee	100	8	81	7	10
Setting up a company	Registration costs	100	7	139	76	2
Hiring costs	Factory manager	100	67	82	78	79
	Administrative manager	100	11	19	44	44
	Engineers	100	20	34	81	81
	Headquarters staff, factory workers	100	18	3	5	8
Cost for paying living expenses of resident officers	Rent guarantee	100	12	20	25	29
	Admission fee, tuition	100	85	62	46	59
Visa	Visa fee	100	158	283	67	333
	Ratio	100	14	24	20	9

Notes: 1. Shaded cells indicate the most expensive in each row.

Source: JETRO, “The Survey on Actual Conditions Regarding Access to Japan-Inward Foreign Direct Investment” (June 2000).