



## **Methodological notes to recording data on flows and stocks of special purpose entities (SPEs)<sup>1</sup> in the balance of payments from 1 January 2006**

Under an amendment to the Corporate Taxes Act in November 2002 effective from 1 January 2003, enterprises with off-shore status cannot be established in Hungary and the existing off-shore firms must be transformed into normal businesses by 1 January 2006 the latest. In the case of these transformed businesses, however, the Bank continues to apply the earlier recording approach, irrespective of the change in legal status, provided that the core activities of firms have remained broadly unchanged.

According to the international statistical recommendations, an off-shore firm is resident in the country in which it is registered, similarly to any other enterprise. Accordingly, data on flows and stocks of these enterprises must be recorded on a gross basis, as these overall figures allow for international comparisons of statistics and for bilateral comparisons. However, the data on enterprises playing a role in the intermediation of substantial financial resources within groups of company distort the statistics underlying the real economic and financial processes of the national economy. The reason for this is that these firms set up business in a given country in order to exploit taxation advantages; they play an intermediary role within a given group of company due to channelling funds (the direction and size of which are controlled by their parents), rather than being a target for direct investment (net flows on various financial instruments are close to zero taking a longer period). The problems related to recording special purpose entities conducting business abroad in the balance of payments are as follows:

### *Current account*

By definition, enterprises operating abroad have only marginal, if any, links to domestic economic processes. In most cases they play a passive intermediary role in transactions, with their earnings from transactions with residents being negligible. In principle, their activities do not influence the current account balance calculated on an accruals basis, only the gross figures. Nevertheless, recording their activities raises difficulties in a number of respects:

- Corporate sector profits/losses remain estimates based on domestic income processes until September of the year following the reference year. As there is little relationship between the financial results of these companies and domestic economic processes, they are not included in the earnings estimates. However, a significant portion of revenues originating from abroad (e.g. their interest income and expenses) are immediately recorded in the current account, and therefore the balance becomes distorted.
- Important economic information can be obtained by disaggregating the current account into the real economic as well as the transfer and income accounts, and by decomposing the income account into interest, dividend and reinvested earnings. The activities of SPEs also cause distortions to these indicators.

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<sup>1</sup> Enterprises pursuing passive functions abroad and engaged in channelling funds.

### *Financial account*

One major characteristic of SPEs is that they channel relatively large funds. Consequently, recording their transactions particularly strongly increases the gross figures of the financial accounts. The roles that debt generating and non-debt instruments play in the current account balance are of special importance in terms of financing it. Decision makers, investors and rating agencies treat this information as highly important in regard to the vulnerability of the forint and the sustainability of external equilibrium. Consequently, the problem arises when the assets and liabilities of an SPE are not in the same instrument category. Recording SPE data causes problems in a number of respects:

- Enterprises pursuing activities abroad may cause distortions to the percentage shares accounted for by debt generating and non-debt financing.
- The size of direct investment inflows is an important issue with regard to assessing developments in external balance and the business cycle.

From January 2006, based on economic considerations, the Bank continues to distinguish between data on flows and stocks of SPEs and to compile the balance of payments and the external balance sheet excluding SPEs. Nevertheless, the Bank compiles the balance of payments and the external balance sheet including SPEs, in accordance with the international statistical recommendations. (However, no estimates of SPEs' reinvested earnings and dividends are provided – reported data will only be included in the annual statistics.)

In defining the range of special purpose entities, the MNB cooperates with the CSO. Of the indicators available, only those are used to compile the registry which capture the major characteristic feature of these firms, namely, that basically they pursue their activities abroad and their linkages to the domestic economy are marginal:

- In their balance sheets, the weight of real assets is negligible relative to that of financial assets, with the latter consisting mainly of shares, long-term loans and securities.
- Their sales are made up primarily of export revenue.
- Numbers of staff are very low (90%–95% of firms employ staffs of maximum 2).
- Their material costs are negligible.
- The name of a firm refers to the 'off-shore type' of activity.

In Hungary there are 768 active enterprises which can be grouped into special purpose entities. The flows and stocks of these enterprises vis-à-vis non-residents are very large. As recording SPE data would cause a significant distortion to the contents of the various economic categories, the Bank publishes Hungary's balance of payments excluding SPE data in the press release. However, the Bank's website and reports to international institutions contain Hungary's balance of payments and external balance sheet including SPE data, in accordance with international methodological standards.