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Merchanting

MERCHANTING

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Executive Summary

The *Balance of Payments Manual, fifth edition (BPM5)* defines merchanting as the purchase of a good by a resident (of the compiling economy) from a nonresident and the subsequent resale of the good to another nonresident; during the process, the good does not enter or leave the compiling economy. The difference between the value of goods when acquired and the value when sold is recorded as the value of merchanting services provided (paragraph 262). If the merchant does not resell the commodities in the same accounting period, an import of goods is recorded in the first period, and a negative import entry is recorded in the later period. For other goods transactions when goods are internationally traded without transformation, wholesale and retail margins are included in the price of the goods because the goods are recorded when crossing the border of the economic territory. In addition, wholesale trading on behalf of others on a fee basis is recorded in the other trade-related services, part of the standard component “merchanting and other trade-related services.”

The same treatment of merchanting is adopted in the *1993 System of National Accounts (1993 SNA)* paragraph 14.60.

There are two key arguments in favor of changing the status quo. First, the definition of merchanting as it presently stands captures activity that is part of the production process in manufacturing in a global economy. Second, the present approach is contrary to the change of ownership principle that underlies both the *1993 SNA* and the *BPM5*.

In those instances where both of these key arguments apply such as transactions resulting from global manufacturing, the paper considers that there is an overwhelming case for recording trade in goods on a gross basis and to exclude such transactions from merchanting. In instances where only the second argument arises such as for wholesaling and retailing in goods and commodity dealings, the paper offers the possibilities of recording on a gross or net basis in goods. The paper also sets out the options for retaining the status quo.

¹ The views expressed in this paper are those of the author and should not be attributed to the International Monetary Fund, its Executive Board, or its management.

Among BOPCOM members, the views are divided. A small majority supports recording merchanting as goods, most on a gross basis. On the other hand, a significant number of BOPCOM members prefer the status quo, partly because of practical difficulties accompanied with recording the relevant transactions as goods on a gross basis, and concerns over the impact on the trade in goods data.

There is no impact on GDP, as the issues relate to gross or net recording in trade in goods or services.

This paper asks the Advisory Expert Group (AEG) the following questions:

- *Do the AEG members agree to record as goods: (1) transactions in goods resulting from global manufacturing on a gross basis; and, (2) global wholesaling/retailing when trading in goods, except on a fee basis, and commodity dealing?*
- *If (2) is acceptable, do the AEG members prefer net or gross recording in goods for global wholesaling/retailing and commodity dealing?*
- *Alternatively, should global wholesaling/retailing and commodity dealing be recorded on a net basis in services, as at present, with global manufacturing recorded on a gross basis in goods?*
- *Or do AEG members prefer the status quo for all three activities, so continuing to record these activities contrary to the change in ownership principle?*

Introduction

1. The treatment of merchanting has been discussed several times at the meetings of the Balance of Payments Technical Experts Group (BOPTTEG), the 18th meeting of Committee on Balance of Payments Statistics (BOPCOM), and the July 2005 Advisory Experts Group on National Accounts (AEG) meeting under the context of updating the *BPM5* and *1993 SNA*.
2. The paper is the outcome of the BOPCOM and AEG recommendation that a working group be created to carry forward the outcomes of the discussions in these groups and to come forward with revised proposals for the treatment of merchanting in the updated *BPM5* and revised *1993 SNA*.

Main reasons to change

3. No clear definitions, based on the economic nature, are provided for “merchanting” and “merchant” in the *BPM5* and *1993 SNA* and other current international standards. For example, *BPM5* simply defines merchanting as the purchase of a good by a resident (of the compiling economy) from a nonresident and the subsequent resale of the good to another nonresident; during the process, the good does not enter or leave the compiling economy. The difference between the value of goods when acquired and the value when sold is recorded as the value of merchanting services provided (paragraph 262). In addition, commodity arbitrage (*Balance of Payments Textbook* paragraph 361) are included. The description of *1993 SNA* on this issue (paragraph 14.60) is, in its substance, identical to that of *BPM5*².
4. As a result, various kinds of activities are included without any distinction into the current definition of merchanting. They include, (1) transactions resulting from global manufacturing^{3 4}, (2) global wholesaling services (and some retailing services), and (3), commodity arbitrage (dealing). In addition, holding gains and losses are also included as part of services.
5. The economic nature of the transactors differs and can be distinguished as follows.

² Regarding current international standards for the treatment of merchanting, also see *Balance of Payments Compilation Guide* (paragraphs 138-139), *Balance of Payments Textbook* paragraphs.189-194, 361-362) and *Manual on Statistics of International Trade in Services* (paragraph 3.123, Box 6).

³ Many transactions between enterprises *within* a multinational company may fall within the definition of merchanting. In reality, the merchanting service is a return for marketing, research and development, financing, process management, etc. provided by an enterprise that does not physically handle the goods. For instance, the *Manual on Statistics of International Trade in Services*, when discussing merchanting in Box 6, speaks of commodity arbitrage and wholesale trading but not transactions arising from global manufacturing.

⁴ Regarding examples of transactions included in each category, please see the attachment.

- **Global manufacturing** (see case 1 in the attachment): such activities aim to make profits from production of goods and the international transactions of goods take place as a process of such production activities;
 - **Global wholesaling/retailing** (see case 2): such activities aim to provide their customers (original sellers and purchasers of the relevant goods) with wholesale/retail services and, as a result, obtain margin (or fee, commission); and,
 - **Commodity dealing** (see case 3): such activities aim to obtain profits from the difference between purchased price and resale price of the relevant goods.⁵
6. Also, merchanting is an exception to the “change of ownership principle.”⁶ Exceptions to fundamental principles are usually restricted strictly to transactions that have an exceptional nature.⁷
7. Other concerns/shortcomings of the current treatment can be summarized as follows:
- Holding gains and losses for the relevant goods may distort the measurement of merchanting services.⁸

⁵ “Commodity arbitrage (dealing)” can be categorized in (i) hedging, and (ii) speculation. In actual commodity markets, these activities are usually conducted using derivatives (especially, futures and options) rather than actual commodities. This is because holding physical inventories of commodities is far more expensive than transacting derivatives and some commodities can be subject to physical deterioration if stored for long periods. Physical commodities are traded in some cases but the principal role of the commodity markets would seem to be more concerned with price setting and risk trading rather than physical supply. Therefore, the turnover in title of physical commodities is much smaller than total market turnover; according to a consultation with a London Metal Exchange trader, most, perhaps 95%, of transactions are settled in cash, rather than the physical commodity. Of course, trading in derivatives falls into the financial account, rather than the current account. The valuation of physical commodities transactions under derivative contracts should be recorded at the market, not contract, price.

⁶ Transaction of goods, in which the purchaser/reseller (merchant) do not get ownership of the relevant goods, but receives fees instead, should be regarded as brokerage services rather than trade in goods.

⁷ At present, “goods sent abroad for processing” is an example of an exception to the change of ownership principle. At its meeting in July 2005, the AEG decided to eliminate this exception, so further supporting the view that the change of ownership approach should be respected unless there are very strong counter arguments.

⁸ *Balance of Payments Textbook* states, “Speculative gains or losses realized from transactions in commodity arbitrage are also recorded under this item” (merchanting, paragraph 361). This is implied from the *BPM5* definition and explicitly presented in the *MSITS*. This, however, does not fit the *1993 SNA*’s concept of services.

- Holding gains/losses are valuation changes of merchants' assets (inventories), so, should not be included in the *1993 SNA* concept of services. However, in *BPM5*, merchanting services do include holding gains and losses because production and holding gains of goods are not international processes and do not appear in the balance of payments framework.
- The current guidance on merchanting results in a structural asymmetry.
 - While exports of merchanting services are recorded, no imports of this service are recorded. Importing countries value the imported goods at the price paid, which includes the value of the "services". The supply of a service without a use breaks the core economic accounting principle of symmetry. Thus, this causes asymmetry for merchanting services (*Balance of Payments Textbook*, paragraph 192; *MSITS*, Box 6).
 - The asymmetry stems from the pragmatic assumption that the importer would seldom, if ever, have information on the merchanting profit or loss realized by the intermediary in exporting country (*Balance of Payments Textbook*, paragraph 192).
- In terms of accounting, the recommendations in the *BPM5* and *1993 SNA* are appropriate when purchases and resale of the relevant goods straddle different accounting periods, and so merchanting services are not completed in the accounting period of purchase. As the ownership of the relevant goods changes from foreign providers to the merchants (residents), it is appropriate to record imports of the goods. Then, when the relevant goods are resold to nonresidents, merchanting services are to be recorded in the accounting period of resale because the services are completed in the period and negative imports of the relevant goods be recorded in order to reverse the entry in the previous period.
 - However, negative imports may provide misleading data on goods and are very difficult to implement in practice.
 - Data on trade in goods could be distorted under current treatments when large amount of merchanting transactions straddle different accounting periods.
 - There is a danger of mismeasurements under this *BPM5* procedure, and more generally problems in implementation.
- The treatment is inconsistent with inventories data and balance sheets both for the merchant and for supplier.
 - Since an actual change of legal and economic ownership occurs but is imputed as not occurring, the treatment results in data on assets that are inconsistent with the enterprise accounts and with balance sheets that show the actual positions of the merchant.

- As they are not recorded as owned by the merchant in its balance sheet, the inventories may be without any owner.
- The treatment is also inconsistent with financial account transactions. The trader pays a gross amount for the goods to one country, then receives gross payment from another, and these gross transactions are recorded in the financial account.
- The valuation principles are not consistent with other current account items or supply and use tables.
 - All other goods transactions in the balance of payments are shown including any retail and wholesale margins arising up to the international boundary, not with these margins separated.
 - Supply and use tables are valued at either basic prices (i.e., goods transactions and margins are shown separately) or purchasers' prices (i.e., goods transactions valued at basic prices plus corresponding margins). The existing treatment is not consistent with either. The treatment also undermines the relationship between distribution industries and the corresponding goods transactions as the latter are omitted.
- The classification of wholesaling services varies, according to whether the goods pass through the wholesaler's economy or not.
 - For example, consider the case of traders in Hong Kong SAR and Japan arranging sales of Chinese products shipped through Hong Kong, but neither trader handles the goods. The Hong Kong wholesaler is currently shown as dealing in goods, valued in gross terms, while the Japanese merchant is shown as producing a service, valued in net terms. The inconsistency also arises in cases where the Hong Kong trader has some goods shipped through Hong Kong and others shipped through Shanghai.

Recommendations

8. The treatment of a transaction in the balance of payments and national accounts statistics should reflect its economic nature and also should be in line with basic principles accepted in the system, such as change of ownership principle, unless there are very strong counter arguments. Regarding merchanting, consideration should also be paid to any possible impact on the analytical value of goods data that may arise from the gross recording of dealers' and traders' transactions.

(1) Classify transactions based on the economic nature of the underlying transactions.

A distinction can be as in paragraph 4, i.e., (i) transactions resulting from global manufacturing, (ii) global wholesaling and retailing, and (iii) commodity dealing (arbitrage). Such a distinction distinguishes activities by their economic nature (see paragraph 5).

(2) Type (i), global manufacturing to be classified as trade in goods, to be recorded on a change of ownership basis on a gross basis. If ownership does not change hands but processing activities occurred in the importing country, then service, not goods transactions would be recorded, given the recent AEG decision on goods for processing.

The goods that fall into this category could be recorded under a new sub-category “goods under global manufacturing” and be excluded from merchanting.

This approach has the following merits:

- It avoids exceptional treatment in relation to ‘change of ownership’ principle. As a result, it gives a view that is compatible with data on inventories, holding gains, and balance sheets.
- The recording of the relevant goods becomes symmetrical on the global basis.
- No negative exports are recorded for (i).
- Distortions in the measurement of services caused by holding gains and losses on the relevant goods are eliminated.
- Practical difficulties or misleading volatilities are also eliminated for (i) when merchanting transactions straddle different recording periods.
- The recommended approach can be implemented by requiring respondent in the ‘merchanting country’ to provide gross, not net, data, recorded as goods, not services.
- In the case of processing activity, not involving a change of ownership, the fee would be recorded in the books of the owner and the processor.

There will be some potential drawbacks:

- The inclusion of these transactions in goods will increase the difference between balance of payments trade in goods and merchandise trade statistics and arguably weaken the use of balance of payments trade in goods as an indicator of economic activity in the country.
- Also, to the extent that double counting might arise in selling/purchasing countries by recording trade in goods through customs and merchanting services through surveys, the gross recording of merchanting under goods would exacerbate the problem.
- Practical measures, such as exchange of data among the relevant countries, for assuring consistency among the countries will need to be considered, especially between a country where a merchant resides and countries where sellers/purchasers of the relevant goods reside. If not, bilateral asymmetries could increase. Also, possible double counting need to be considered. E.g., see paragraph 35-42 of Shimon Arieli and Soli Peleg (2005).
- Also, from a practical viewpoint, any change would need to be explained to users well before its implementation given that there are strong user interests in trade data; clear guidelines for

ensuring consistency of bilateral data of trade in goods would be needed; and there could be significant resource costs in changing to the new methodology in some instances.

(3) **Types (ii) and (iii), global wholesaling/retailing and commodity dealing, also to be recorded, on a change of ownership basis, as goods, under a title “goods under merchanting.”** They could be recorded (a) on a net basis, or (b) on a gross basis.⁹ If ownership of the goods did not change hands, but a fee was paid, then a service would be recorded.

These activities constitute merchanting activities.

- The merits are the same as above, although negative exports of goods could be recorded if recorded on a net based recording.^{10 11}
- Recording this category on a net basis takes account of a possible impact on the analytical value of goods data that may come from gross recording. However, negative imports of goods would still be recorded when merchanting transactions straddle different accounting periods of dealers’ and traders’ transactions.
- Negative exports of goods and negative imports of goods when the transactions straddle different accounting periods can be avoided by recording on a gross basis.
- In case (3) (a), the relevant gross data would be provided as a memorandum or supplementary item.

⁹ The combination of (2) and (3) (b) results in recording all merchanting transactions as goods on a gross basis. The impact of this approach on the balance of payments goods data would vary from country to country, but could be significant. For instance, figures presented to the OECD-EUROSTAT meeting of experts in trade in services statistics in 2004 for Japan suggested an impact of between a 15 and 20 % increase in both exports and imports data (see footnote 5 of Eika Yamaguchi, “The treatment of merchanting in balance of payments statistics.” This paper can be obtained from OECD website at http://www.oecd.org/document/40/0,2340,en_2649_34243_31430440_1_1_1_1,00.html)

¹⁰ Under the net recording, the method of recording net transactions would need to be determined. One possibility is to record the net, even if it is negative, as an export (the same treatment as the current merchanting approach). Another possibility is record as an export when the net-export is positive and record an import when the-net export is negative. These issues would be addressed during drafting of the manuals.

¹¹ Regarding (iii), commodity dealing, it might be possible to net all transactions between residents and non-residents, rather than tracking transactions of each individual good, to avoid inflating gross exports and imports. This treatment would be easier to implement since respondents would only need to distinguish transactions with residents from those with non-residents, i.e., no need to trace the subsequent history of purchased stock. Again this issue could be addressed in the drafting phase.

- In practice, compilers may have difficulty in distinguishing between (i) and (ii), and so clear definitions will be required as to the intent of the distinction.

(4) Alternatively, global wholesaling/retailing and commodity dealing could be recorded as trade in services on a net basis, with global manufacturing to be classified as gross trade in goods.

- Regarding the treatment of wholesaling/retailing, this alternative would be the status quo.
- The merits of this approach are seen in terms of the recording of an intermediation activity. The economic nature of the activity undertaken by the merchant could be seen to resemble that of an agent, working on a fee-basis, for a final buyer, and hence the provision of a service.

(5) Retain the status quo, with all activities classified as trade in services on a net basis contrary to the change of ownership principle.

- The merits of this approach are seen in terms of the global manufacturer providing a service through the control/management of the global manufacturing process; the purchaser/reseller does not physically engage in the production of the goods.

Question/Points for discussion

- *Do the AEG members agree to record trade in goods under global manufacturing on a change of ownership basis in trade in goods on a gross basis (paragraph 8, point 2)?*
- *Do the AEG members agree to record wholesaling/retailing and commodity dealing in trade in goods under “goods under merchanting” (paragraph 8, point 3).*
 - *If so, should this be on a net basis, (paragraph 8, point 3(a)), or*
 - *on a gross basis (paragraph 8, point 3(b))?*
- *Or do the AEG members prefer to record global wholesaling/retailing and commodity dealing in services, under merchanting, on a net basis, with global manufacturing to be classified as gross trade in goods (paragraph 8, point 4)?¹²*
- *Or do the AEG members prefer status quo, contrary to the change in ownership principle (paragraph 8, point 5)?*

¹² Under this option, as regards classification within services, the presumption would be the status quo, but other possibilities could be discussed in the appropriate fora once a decision is made on whether to classify these activities under goods or services.

Reference

Merchanting BOPTeg Issues Paper # 16, #16A

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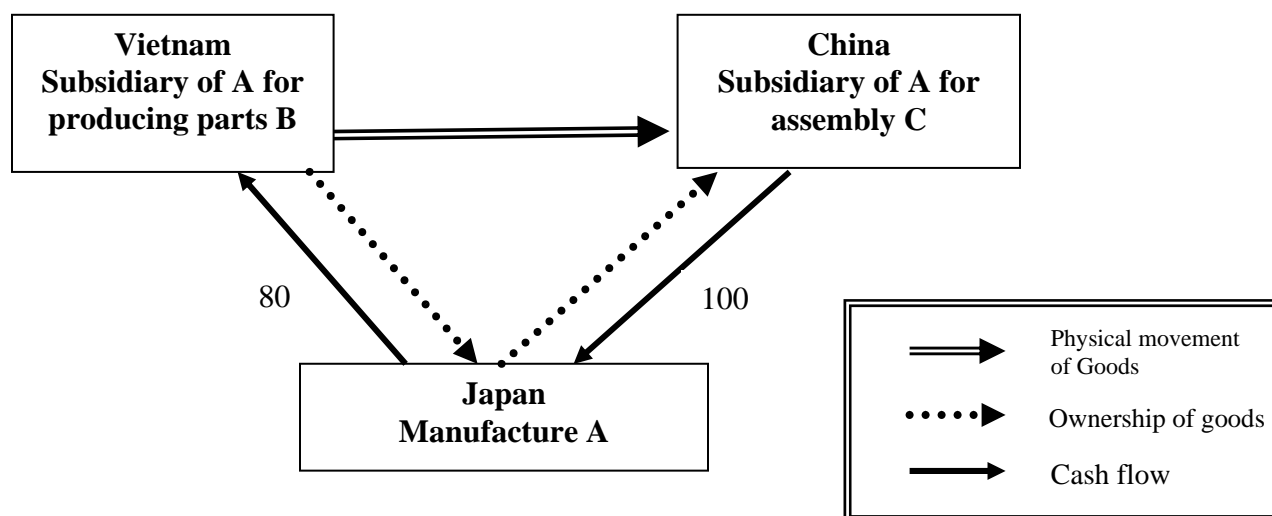
Eika Yamaguchi : The treatment of Merchanting in balance of payments statistics (2004)

Examples of the Different Categories of Merchanting Transactions*

The following examples illustrate the basic picture of transactions included in each category shown in the paragraph 8 of the text.

Case 1: Transactions accompanied by global manufacturing

A Japanese manufacturer purchases parts from its subsidiary in Vietnam (B) and resells the parts to another subsidiary in China (C) for assembling final product. The parts are shipped directly from Vietnam to China. On the other hand, the ownership of the parts changes from B to A, then A to C.



Current recording

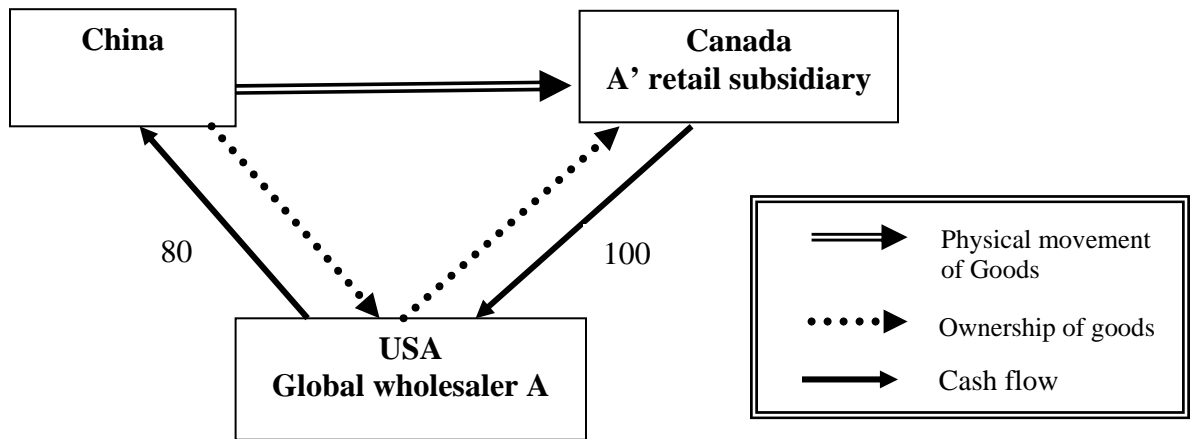
Proposed recording (based on paragraph 9 (2))

		Credit	Debit			Credit	Debit
Japan	merchanting	20		Japan	goods (under global manufacturing)	100	80
Vietnam	goods	80		Vietnam	goods	80	
China	goods		100	China	goods		100
Global balance	merchanting	20		Global balance	goods	180	180
	goods	80	100				

* Financial account transactions are ignored in all three examples.

Case 2: Global Wholesaling

A USA wholesaler purchases goods from China for resale to its subsidiary for retail sale in Canada.



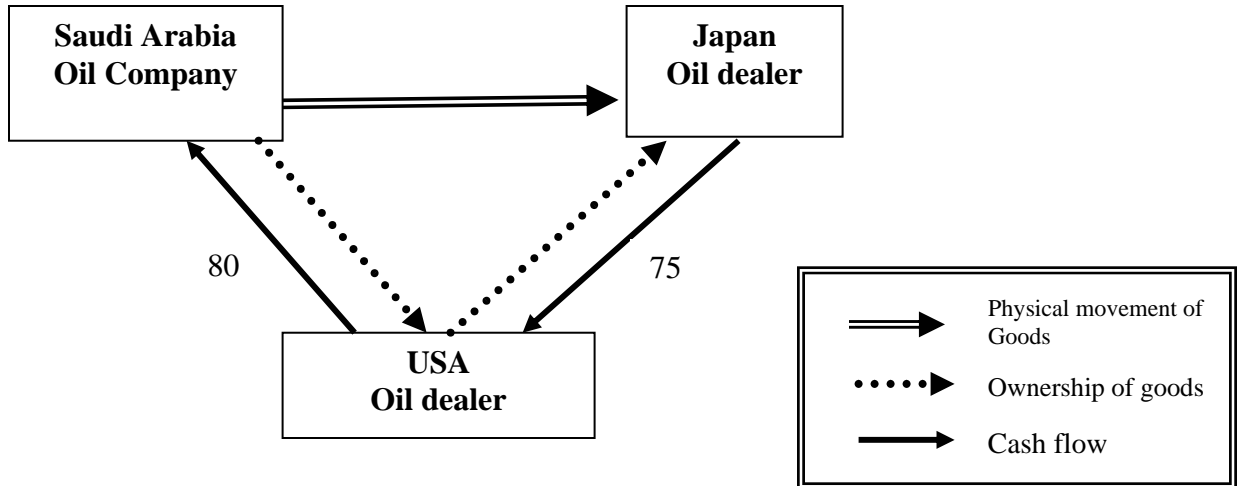
Current recording

Proposed recording (based on paragraph 9 (3)a)

		Credit	Debit			Credit	Debit
USA	merchanting	20		USA	goods (under merchanting)	20	
China	goods	80		China	goods	80	
Canada	goods		100	Canada	goods		100
Global balance	merchanting	20		Global balance	goods	100	100
	goods	80	100				

Case 3: Commodity Dealing¹³

A USA oil dealer purchases oil from Saudi Arabian oil company purchased oil at 80. Given the decrease in the oil prices (from 80 to 75), the USA dealer resells the oil to Japanese oil trader, accepting the holding loss of 5.



Current recording

Proposed recording (based on paragraph 9 (3)a)

		Credit	Debit			Credit	Debit
USA	merchanting	- 5		USA	goods (under merchanting)	- 5	
Saudi Arabia	goods	80		Saudi Arabia	goods	80	
Japan	goods		75	Japan	goods		75
Global balance	merchanting	- 5		Global balance	goods	75	75
	goods	80	75				

¹³ The above case treats holding losses; the recording principles are the same for a holding gain.