

Report of the Meeting of the

Expert **Group** Meeting on External Sector Transactions for
the Revision of the System of National Accounts

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	<u>Contents</u>	<u>Page</u>
I.	Introduction	1
II.	The Statistical Discrepancy in World Current Account Balances	2
III.	The Residents of an Economy	3
	1. Basic concept of residence and supplementary rules	
	a. Point of reference	
	b. The definition of residents	
	c. Territory	
	2. Individuals	
	a. Students	
	b. Ships' crews	
	c. Technical assistants	
	d. Employees of international organizations	
	e. Other workers	
	f. Illegal aliens and refugees	
	3. Enterprises	
	a. Operators of mobile equipment	8
	b. Offshore enterprises	8
	c. Owners of land and structures	8
	d. Ships flying "flags of convenience"	8
	e. Jointly owned and organized enterprises operating outside national territories	9
	f. Enterprises engaged in installation of equipment	9
	g. Agents	9
IV.	International Organizations	9
V.	Conversion	10
	1. Time of conversion	10
	a. The principle for converting flow data	12
	b. The practice for converting flow data	12
	c. The principle for converting stock data	12
	2. Exchange rate differentials	12
	3. Multiple exchange rate regimes	13
VI.	The Change-of-Ownership Principle and Time of Recording	14
	1. The principle	14
	2. Transactions between parts of the same legal entity	14
	3. Financial leases and similar arrangements	14
	4. The time of recording for income	15
	5. Reinvested earnings on direct investment	15
	6. Transactions between affiliated enterprises	16
	7. Goods. for sale on consignment	17
	8. The f.o.b. value of imports	17
	9. The write-off of bad debts	18
	10. Free goods and services for travelers	13
	11. Goods for processing	18
	12. Goods for repair	19

<u>Contents</u>		<u>Page</u>
VII.	Classification of Transactions	20
1.	Consolidation of goods and services components	20
2.	Classification of service, income, and unrequited transfers	21
a.	Factor income	22
b.	Standard list for services items	22
c.	Current and capital transfers	23
d.	Other specific recommendations	23
3.	Classification of capital account transactions	24
a.	Monetary and commodity gold	24
b.	Supplementary information on the total change in reserves	25
c.	Liabilities constituting foreign authorities' reserves	25
d.	Exceptional financing	25
e.	Sectorization	26
f.	Long-term versus short-term capital	26
VIII.	Financial Assets and Liabilities	27
1.	Harmonization	27
2.	Repurchase agreements	27
3.	Deposits	27
4.	Trade credits	27
5.	Other financial instruments	28
6.	Gross recording	29
7.	The International Securities Identification Numbering System	29
8.	Arrears and debt reorganization	29
IX.	Specific Transactions	30
1.	Insurance	30
2.	Banking	31
Appendix 1.	List of Participants	32
Appendix 2.	Discussion Papers	35
Appendix 3.	Background Papers	37
Appendix 4.	A Proposal for the Introduction of f.o.b. Valuation of Imports in the SNA	38
Appendix 5.	Presentation of Merchandise Flows	44
Appendix 6.	Alternative Treatment Monetization and Demonetization of Gold in the SNA	45
Appendix 7.	The Treatment of Insurance Transactions in the SNA and BPM	47

I. Introduction

The meeting, which was held at IMF headquarters, was opened by Mr. Werner Dannemann, Director of the Fund's Bureau of Statistics, who welcomed the participants to the meeting. (A list of the participants is shown in Appendix 1.) In his remarks, Mr. Dannemann emphasized the Fund's support for the SNA review process and its particular relationship to statistical areas of special interest to the Fund, namely the balance of payments, financial, and government finance statistics. Mr. Dannemann felt that those relationships are important because they facilitate the work of statistical procedures and that of analysts and policy makers, who have to interpret the various bodies of statistics. Gaps and differences in concepts and definitions should be reduced to a minimum and be permitted to exist only to the extent necessary for the policy formulation of national authorities and international organizations in the context of specific analytical needs and, if such differences exist, they should be made reconcilable through bridges and cross-classifications.

The meeting appointed Mrs. Carol Carson as chairman. A short discussion ensued on the agenda. It was agreed that the papers brought to the meeting by participants should be added to the list of background documents (see Appendix 2), and that the list of discussion papers (see Appendix 3) should remain unchanged.

The Group was aware that several issues that were scheduled to come up in its discussions were relevant not only to the external sector but also to the domestic sectors. In a number of these cases, the Group believed that it would be inappropriate to make a recommendation for a treatment without giving attention to the implications for the domestic sectors. In these cases, the Group tried to identify the major needs and concerns relevant to the external sector and referred the issues to a subsequent Expert Group, usually the Expert Group on Production Accounts and Input-Output Tables or the Expert Group on Financial Flows and Balance Sheets. The Group urged, however, that a paper outlining the implications for the external sector of proposals to be considered by other Groups be prepared as part of the documentation for the meetings of those Groups and that members of this Group, who will not be at those meetings, be asked to provide written comments.

The Group recognized the extreme importance of harmonization between the SNA and the BPM. For that reason, the Group tried to reach unanimous decisions on all aspects of methodology. When the report says that "the Group agreed" it means that there was unanimous agreement. When the report says that "most of the members of the Group agreed" it normally means that the Group agreed as a whole, but that there were participants who had reservations.

II. The Statistical Discrepancy in World Current Account Balances

As background to the work of the Expert Group, the Final Report of the Working Party on the Statistical Discrepancy in World Current Account Balances (Ext. 2) was introduced. In this introduction, it was noted that:

- a. the global current account discrepancy, while down from its 1982 peak of over \$100 billion, was still a cause for concern;
- b. the Working Party had concentrated its activities on the investment income account, which had shown a persistent growth in its discrepancy since 1979;
- c. some initial work was also done on two other large discrepancies in the current account - those in the shipment and unrequited transfers accounts -, which have, however, remained reasonably stable in the last few years;
- d. the study also reviewed capital flows, the relationship of financial assets and liabilities to investment income flows, and the impact on such flows of offshore financial centers and financial innovation;
- e. the study confirmed that countries have better statistics on their liabilities than on their assets and, consequently, better data on their investment income payments than on their receipts; the rising investment income discrepancy, therefore, can be explained by the increasing gap between liabilities and assets, and sharply higher interest rates in the period;
- f. most recommendations of the Working Party were of a practical nature, rather than addressed to the refinement of definitions, e.g., using International Banking Statistics stock data to obtain position numbers on which income flows could be estimated by applying representative interest rates;
- g. the data problems created by offshore financial centers were not new but had existed in the international financial markets of London, Paris, etc., but that it was recognized that some aspects of financial innovation would make it more difficult to obtain balance of payments data;
- h. the Bureau of Statistics was currently preparing a plan of action for its implementation of the Report's recommendations;
- i. implementation by countries should not involve the need for new resources but would rather mean using existing resources more effectively;
- j. the geographic distribution of the statistical discrepancy was not sufficiently concentrated to cause analytical problems; and

k. it was inappropriate to try to expand greatly the standard components in the balance of payments framework; additional details should be collected by occasional surveys.

III. The Residents of an Economy

1. Basic concept of residence and supplementary rules

The discussion paper on this topic was The Residents of an Economy (Ext. 3), which was accompanied by the first part of a summary paper on comments and points for discussion (Ext. 5, updated). In the introduction of the paper, it was suggested that the general principle with regard to residency suggested by the paper related to governmental jurisdiction, rather than to center of economic interest. This reflected a government's interest in determining policies for the residents of the territory it governs. The paper discussed the problem of temporary shifts of residence and suggested that a one-year rule normally be applied to determine residence, i.e., if it is expected that an entity will be in a given economy for one year or more, that entity will be considered a resident of that economy. The paper then examined residency issues in the main economic sectors of general government, individuals, private nonprofit bodies serving individuals, and enterprises.

a. Point of reference

With very little discussion, the Group agreed that the definition of residence should refer to natural and legal entities, rather than to the real or financial assets of those entities.

b. The definition of residents

Discussion on the basic concept of residence focussed on whether the concept to be applied should be jurisdictional, as proposed in the paper, or should be the center of an entity's economic interest. The paper argued that the jurisdictional approach concentrated on the policy needs of a government and the application of its authority to entities within the territory it governed. This approach, it was suggested, was more realistic than the center of economic interest, which was a vague concept. Nevertheless, some notion of permanency of residence was required, so that the one-year rule for determining residency would continue to be the rule of thumb.

Many participants, however, preferred to retain the concept of center of economic interest, using the one-year rule as a proxy, or guideline, for it. Some exceptions to the one-year rule, however, would be required.

It was suggested that the main residency criterion for an individual might be the activity which the individual pursues, e.g., whether the individual is a consumer or a producer. That criterion would accommodate tourists, who travel abroad but remain residents of their country of origin, and also workers. It was mentioned, however, that that criterion does not

address the question of retirees who establish themselves abroad. Another possible criterion was to take note of the reach of the taxation authority of governments.

One exception to the center-of-economic-interest rule that was suggested referred to diplomatic, military, and certain other government officials stationed abroad. For these individuals, the jurisdictional approach, which dictated considering these individuals as residents of their employing country, was preferred. In expressing that preference, no reference was made, however, to these individuals' dependents. On the other hand, locally-engaged employees of these individuals were considered to be residents of the country where they lived.

When applying the one-year rule it was also generally recognized by the Group that an exception should be made for students, as their center of economic interest would not have changed to the country where they were being educated. One expert pointed out, however, that students may not return to their countries of origin, may receive allowances from their own government, and may make remittances to their home countries.

Concluding its discussion on the definition of residents, the Group agreed that the residents of an economy should be identified as the entities that may be expected to consume goods and services, participate in production, or engage in other economic activities in the territory of an economy on other than a temporary basis. In general, these are entities whose "center of economic interest" is in the given economy.

There are exceptions to the use of the center of economic interest to distinguish nonresidents and residents. One of these is based on the jurisdictional criterion: official diplomatic and consular representatives, members of the armed forces, and other government personnel working in offices of their government in a foreign country where they live are not considered residents of that foreign country.

The phrase "on other than a temporary basis" is generally implemented by reference to the "one-year rule." There are, however, exceptions to that rule; for example, an exception is made for students, as it is considered that their center of economic interest remains in their country of origin.

As described below, this principle and the implementation of the "one-year rule" are to be supplemented by reference to specific recommendations for individuals and enterprises made on the basis of their activities.

c. Territory

In discussing the definition of territory it was acknowledged that the territorial coverage of some data is motivated by political decisions, which the statistician must accommodate. In fact, there are many examples

of countries that use a territorial coverage for the national accounts that differs from that used for the balance of payments.

Nevertheless, the Group agreed that, in principle, the territorial coverage for the balance of payments and the national accounts should be the same. In practice, however, given the practical problems faced in various countries in deciding on their territorial coverage, it is not feasible for a set of international guidelines to set out what the territorial coverage in either set of accounts should be. It would, however, be desirable to have official reconciliations of any differences in the territorial coverage of the two sets of accounts so that users would have access to that information.

2. **Individuals**

Following the decisions on the concept of center of economic interest and the application of the one-year rule, the residency of certain individuals, whose status might be in doubt, was discussed.

Discussion focussed principally on the treatment of students, technical assistance personnel, and workers under long-term contracts. The discussion on students is summarized in paragraph 11, above. For technical assistance personnel, there were major concerns about the appropriate treatment. Several balance of payments experts favored treating these personnel in the same way as other government employees stationed abroad, i.e., as residents of the country employing them, as, in the view of these experts, the center of economic interest of these personnel had not been transferred to the country to which they were giving technical assistance, even in the exceptional cases where technical assistance personnel stayed in a host country longer than two or three years. It was also pointed out that for countries where such personnel are an important economic factor, the inclusion of their income in the domestic economy could distort some aggregates.

It was also mentioned that all major donor countries and most host countries, except for a number of francophone African countries, treat such personnel as residents of the donor country. No host country treating these personnel as their residents follows through consistently in this treatment, for example, by including balance of payments entries for migrants' transfers when the technical assistance personnel arrive for, or leave after, an assignment.

Other experts, however, considered that the important factor to consider is that these people are largely integrated into the work units of the host economy and that their production should therefore be considered as domestic.

Due to the sharply divergent conceptual views, a suggestion was made to see if a resolution of the problem could be arrived at by an examination of the practical issues involved in the two treatments, especially the data requirements for their implementation. Many experts also suggested

that all technical assistance personnel should be treated the same, i.e., those from international organizations should be treated the same as those provided under bilateral agreements.

With regard to workers under long-term contracts, particularly those living in enclaves, a few experts suggested that their center of economic interest should remain with their country of origin, rather than transfer to the country where they are employed. This is the balance of payments treatment followed by a number of small countries providing such workers, where the contribution of these factors of production to GNP is substantial. It was also pointed out that in many cases the workers do not receive their full compensation in the employing country, but, instead, in the workers' accounts in their country of origin.

Most experts were, however, reluctant to accept that workers under a long-term contract should be treated as an exception to the one-year rule, i.e., they should be treated as residents of the country where they are working.

In discussing the one-year rule, it was mentioned that the present cut-off for the determination of residency is one-year or more, that is, to be considered a resident of an economy an individual must have the intention of spending one year or more in that economy. However in the capital account the distinction between short-term and long-term is slightly different, in that long-term is defined as a financial claim with a original term to maturity of more than a year. While there is no conceptual reason why the two rules should be identical, it was suggested that from a practical point of view it would be preferable if they were the same.

Following these discussions, the recommendations for the treatment of specific types of individuals were:

a. Students

Most members of the Group agreed that students' residence does not change, regardless of their length of stay in a country, but remains that of their home country.

b. Ships' crews

The Group agreed that the residence of constantly moving individuals, such as members of ships' crews, is the economy of the last-established residence.

c. Technical assistants

The Group was fairly evenly split on the residency of individuals working under long-term contracts providing technical assistance. The Group recommended that a paper be prepared that would explore the conceptual and practical implications of treating these individuals as

residents of the host and, alternatively, the donor country. The paper should be forwarded to the members of the Expert Group on External Sector Transactions, who should indicate their preferred treatment in writing. The paper, along with a summary of the preferences, should be forwarded to the Core Coordinating Group.

d. Employees of international organizations

The Group agreed to recommend that employees of international organizations be considered residents of the country in which the local or regional office is located.

e. Other workers

Most members of the Group agreed to the general principle that a person expected to be employed in a host country for [more than one year]/[one year or more] is so closely associated with the units of production that are in that host country that the person should be regarded as a resident of that country. (On pragmatic, rather than analytical grounds, the Group agreed, that the time period referred to in the previous sentence should be brought in line with the time period selected for the distinction between long-term and short-term capital.) This principle, it was generally agreed, would apply to individuals working under long-term contracts, even if these individuals were living in an enclave.

f. Illegal aliens and refugees

The Group agreed that illegal aliens and refugees be considered residents of the host country. These individuals should be included in the population statistics of that country.

3. Enterprises

On the whole the Group was able to reach broadly acceptable positions on the issues in Ext. 5, Updated, on the residency of enterprises. The discussion focussed principally on the treatment of nonfinancial intangible assets and installation services.

With regard to the acquisition of nonfinancial intangible assets, such as patents or copyrights, the consensus of the Group was that it was not necessary to create a notional resident enterprise to record the acquisition of these assets. It was pointed out, however, that, unless a notional resident enterprise was created, the capital account of the balance of payments would change its character to comprise more than just financial assets if the acquisition was to be entered in the capital account.

For installation services, the discussion centered around whether a notional unit, which would be the generator of the installation activity, should be imputed in the country acquiring the services. If so, the the question would arise whether a notional unit should be imputed

under all circumstances or only if the activity would take longer than a year. Most experts were opposed to creating a notional enterprise, even if the installation activity were to take more than one year.

The conclusions with regard to the issues pertaining to the residency of enterprises were:

a. Operators of mobile equipment

The Group could not offer any alternative to the current approach of using various attributes--such as the flag of registration of the equipment, the economy of incorporation of the company directing its operations, the residence of the owners of that company, and, for an unincorporated enterprise, the residence of the entity responsible for its operations--in identifying the residence of operators of mobile equipment. The Group looked forward to what the further pursuit of the study of the Working Party on the Statistical Discrepancy in World Current Account Balances might yield in the way of guidelines that would result in consistent statistics on the transactions of these operators in countries' balance of payments accounts.

b. Offshore enterprises

The Group agreed that the residence of offshore enterprises be considered the economy in which they are located. The Group agreed that both the gross and the net flows in and out of these enterprises are desirable for analytical purposes, but recognized that it is very difficult to get a complete accounting of these flows.

c. Owners of land and structures

The Group agreed that the existing practice for the treatment of land--i.e., attributing ownership of the land to a resident enterprise, notional if necessary, with a nonresident as the owner of that enterprise--be maintained.

The Group agreed that immovable assets, such as structures, be treated as land is treated. Most members of the Group agreed, however, that it is not necessary to create a notional enterprise as the owner of nonfinancial intangible assets, such as patents, i.e., such assets would not be treated as land is treated.

d. Ships flying "flags of convenience"

Most members of the Group agreed that fees to register ships or other mobile equipment in a so-called open-registry country for the purpose of obtaining the right to fly the flag of that country be treated as unrequited transfers.

e. Jointly owned and organized enterprises operating outside national territories

The Group agreed that the present treatment, in the balance of payments and the national accounts, of transactions of jointly owned and organized enterprises operating outside national territories, i.e., the attribution of their transactions to enterprises in the economies of each of their owners in proportion to the owners' shares in the financial capital of the joint enterprises, be continued. The Group recognized, however, that the practical problems of implementing this recommendation may be great and that some judgmental solutions, such as considering the residence of the joint enterprise to be that of the member with the largest share, may be necessary.

f. Enterprises engaged in installation of equipment

The Group agreed that enterprises engaged in installation of equipment abroad should be considered residents of their economy of origin.

g. Agents

The Group agreed that transactions involving agents be attributed to the economy of the principal for whom the agent works and that the service of the agent to the principal be attributed to the economy of the agent.

IV. International Organizations

The discussion paper on the topic was The Treatment of International Organizations (Ext. 4), which was accompanied by the second part of Ext. 5, Updated, the summary paper on comments and points for discussion. The new, more detailed definition of an international organization, proposed in the discussion paper, addressed the jurisdictional status of an organization. According to this definition, an international organization would derive its authority directly from the authority of its members, i.e., from independent states. An international organization would have a sovereign status, because it would not be under the jurisdiction of any single government.

In the ensuing discussion reference was made to the Fund's recent survey of its members to determine the current treatment of international organizations in member countries' balance of payments. This survey provided a list of international organizations, as perceived by national compilers, as well as their treatment. On the whole, most countries were recording transactions with international organizations, including those physically located in their country, as being with a separate economy.

The problem of coping with a large number of international organizations was also mentioned. As the Fund intends to collect balance of payments data from international organizations to round out global totals, it was seen advantageous to keep the number of such organizations to a minimum.

Another point that was raised related to the product of international organizations. On the whole it was felt that the services produced are primarily nonmarket services, but it was recognized that in many instances financial intermediation services are important. While an international organization can be viewed as an economy similar to any other economy, a major reason for compiling data is not to analyze the activities of international organizations themselves but rather to provide global counterparts to countries' transactions with these organizations.

Certain problems were also mentioned relating to regional central banks, such as the Central Bank for West African States. These banks have a central headquarters organization as well as national offices, which act as the central bank in the country where they are located. The question is whether the headquarters should be treated as an international institution or whether its activities and financial position should be distributed among its member countries.

Concluding its discussion on this topic, the Group agreed that the definition of an international organization should be based on three considerations. First, that it must have authority derived directly from the authority of its members, which may be independent states or international organizations. Second, that it must have a sovereign status, i.e., the laws and regulations of the country or countries in which it is located do not apply to the international organization. Third, that the services it produces are primarily nonmarket services.

The Group recommended that a list of such international organizations, which are considered to be operating outside any national territory, be drawn up in time for discussion by the Expert Group on Financial Flows and Balance Sheets (the Group on Financial Flows) and provided for use by national compilers and international organizations working in the field.

V. Conversion

The discussion papers for this topic were: The Conversion of Balance of Payments Transactions as a Source of Valuation Changes: Problems, Principles, and Practical Solutions (Ext.8); Currency Conversion in a Multiple Exchange Rate System (Ext.9); and The Treatment of Exchange Rate Differentials in the National Accounts (Ext. 10). Comments and points for discussion on Ext. 8 and Ext. 9 were contained in Ext. 11.

1. Time of Conversion

Ext. 8 reviewed the principles of conversion of transactions values from a transaction currency into a unit of account. In that connection, Ext. 11 compared the effects of using the exchange rates at the contract date and at the date when ownership of the assets changes, or a proxy for this point in time, such as the time of the delivery of the assets.

The rationale for using the exchange rate prevailing at the contract date, which is the treatment preferred in the paper, is that that rate reflects the price of the transaction currency that the party with a currency risk in the transaction has to take into account when entering into the contract. If the exchange rate prevailing at the contract date were used for all facets of a transaction involving a borrowing with a subsequent repayment, the borrowing and the repayment would be reflected at the same value, both in the transaction currency and in the unit of account. If, on the other hand, the conversions were made at rates prevailing at the transaction dates, the values of the borrowing and subsequent repayment would be different in the unit of account, reflecting the change in the exchange rate between the two transaction dates.

In the ensuing discussion nearly all participants expressed their support for the conversion of transactions at the exchange rates prevailing at the transaction dates rather than at the contract date. It was argued that a change in the exchange rate is a price change which is similar to the difference between the price prevailing at the contract date and the price at which the contract is executed. In the example, discussed in the previous paragraph, any difference in values, for the borrowing and the repayment, expressed in the unit of account would be handled in the national accounts in the Reconciliation Account. It was suggested that using the exchange rate prevailing at the contract date would create problems for global data when expressed in the unit of account used for international comparisons. Specifically, if a country had applied that rate reconversion into the unit of account used for international comparisons, such as the SDR, at a period average exchange rate, would yield a result that would differ from that obtained by converting the values in the transaction currency to that unit of account at contract-date rates.

With regard to the exchange rate that should be used for conversions into a unit of account, the ideal would be to use the exchange rate prevailing at the time of change of ownership. In most cases, however, it was thought that the exchange rate prevailing at the time of delivery of the assets would have to be accepted as a proxy for the one prevailing at the time of the change-of-ownership. The average exchange rate of the day of the change of ownership or delivery would be desirable. However, if that were not possible, the rate to be used should be the average for the shortest time span that includes the time of change of ownership.

The discussion on the conversion of stock data showed no disagreement with the principle, suggested in Ext. 8, that conversion should be at the exchange rate prevailing at the balance sheet date. In using balance sheet data to derive transactions data, however, the attention of statisticians should be drawn to that component of the total change in stock data that represents unrealized valuation changes. To derive the flow data, this element has to be excluded from the total change.

The conclusions were:

a. The principle for converting flow data

Most members of the Group agreed that the exchange rate to be used for the conversion of flow data from a transactions unit to the unit of account is the rate prevailing when ownership of the assets changes (rather than the rate prevailing at the time of contract). Most members of the Group agreed that use of this rate would bring external transactions into alignment with the principle of recording activity when it actually takes place.

For example, if delivery of the assets provided under a contract by transactor A (for example, provision of goods) has taken place at point t^1 and delivery of the assets provided under that contract by transactor B (for example, the payment for the goods) has taken place at points t^2 and t^3 , then the transaction values of these deliveries should be converted at exchange rates prevailing at points t^1 , t^2 , and t^3 , respectively.

b. The practice for converting flow data

The Group agreed that, if it is not possible to convert flow data from the transactions unit to the unit of account at the rate prevailing when the change of ownership is recorded, the rate to be used should be an average of rates over the shortest period possible.

c. The principle for converting stock data

The Group agreed that the exchange rate to be used for the conversion of balance sheet data is the rate prevailing at the balance sheet date. It should be noted, however, that when balance sheets compiled in this way are used to estimate flow data, the data have to be adjusted to eliminate changes in valuation.

2. Exchange rate differentials

During the presentation of the UNSO paper, entitled The Treatment of Exchange Rate Differentials in the National Accounts (Ext. 10), it was stressed that exchange rates are important not only in compiling data for the external sector of the national accounts, but also as a link between components of the national accounts framework of individual countries and for making comparisons between major economic aggregates of countries. Ext. 10, to some extent, covers the same ground as Ext. 8 and Ext. 9. The one topic that is covered only in Ext. 10 relates to the spread between the buying and selling rates for foreign exchange. Discussion focussed on whether this spread represented a service, provided by the financial institution involved, or whether it was a realized capital gain.

Concluding the discussion, the Group agreed that the average of the buying and selling rates should be the rate for converting transactions

from a foreign currency into the domestic currency. Any spread between the buying and selling rates and that average (the mid-point of buying and selling rates) should be construed as a service charge.

3. Multiple exchange rate regimes

The main discussion paper for this topic was Currency Conversion in a Multiple Exchange Rate System (Ext.9), which was supplemented by a part of Ext. 10, while comments and points for discussion were contained in Ext. 11.

In Ext. 9, the point was made that multiple exchange rate systems give rise to implicit taxes and subsidies between different sectors of an economy and in determining the unitary rate of exchange these taxes and subsidies have to be taken into account. While Ext. 9 implies that adjustments to the actual rates should be made at the transaction level, Ext. 10 envisages transactions being converted at actual exchange rates with the intersector transfers being handled at a global level.

Most experts, while agreeing with the principle of a unitary rate, thought that there were considerable practical difficulties in its application. One way to arrive at a unitary rate might be to try to weight transactions according to actual rates used and derive a weighted average from these data, which could be considered an accounting exchange rate. Another suggestion was to use the exchange rate at which market demand was satisfied as being the best representative rate available, which should be applied to all transactions.

Other experts favored using the actual exchange rates applied to specific transactions to determine their values in the unit of account. For example, if one wanted to study the effects of the terms of trade on trade patterns it would seem appropriate to use actual exchange rates rather than a unitary rate.

In conclusion, the Group agreed that a unitary rate would be analytically appropriate for some purposes and that the use of actual rates would be appropriate for other purposes. It was noted, however, that it would be difficult to identify a unitary rate; use of both a weighted average and specific transaction rates were discussed. Because the implications of these alternatives for the full set of national accounts were not clear, the Group recommended that the matter be examined in depth by the Expert Group on Production Accounts and Input-Output Tables (the Group on Production Accounts). It was also noted that similar problems occur when the exchange rate of a country is artificially fixed by its government.

VI. The Change-of-Ownership Principle

This topic was covered by two discussion papers, Change of Ownership and Time of Recording in the National Accounts (Ext. 6) and section IV.2 of Harmonization of the Classification of International Transactions in the System of National Accounts (SNA) and the Balance of Payments Manual (BPM) (EXT. 13). Summaries of comments and points for discussion were contained in EXT.7, Revised and Section II of EXT 18. Updated.

1. The principle

In compiling data it is important to identify assets and liabilities, and their ownership. In both the current SNA and BPM, a transaction is deemed to have taken place when there is a change in the ownership of an asset. This, however, begs the question of how to record illegal transactions, which, from a economic point of view, are quite relevant. A complicating factor may be that a transaction is illegal in one country but not in the other. This suggests that a somewhat different concept is required; a concept that takes into account control over the assets in question.

The Group agreed that the change-of-ownership principle should be the primary guide for recording transactions. However, it should not be used to the neglect of other aspects that may be more appropriate in particular situations, as exemplified below. The Group also agreed that, although time-of-contract recording is not appropriate for the balance of payments or the national accounts, information on that basis would also be useful.

2. Transactions between parts of the same legal entity

Transactions between parts of the same legal entity, for example, between a branch and its foreign head office, do not reflect a change in the ownership of the assets involved. Nevertheless, the balance of payments should register such transactions as if a change of ownership had occurred. As a rule, there would be a set of accounts created to reflect the branch/head office relationship. Such records might be construed as reflecting a change in the control of assets within the same legal entity, which could be used for recording financial items, but which would probably be too cumbersome to use as a substitute for customs data to record merchandise flows. The Group therefore agreed that there is not much potential for the adjustment of customs data on the basis of transactors' records in order to reflect change of control (as a proxy for change of ownership) between parts of the same legal entity.

3. Financial leases and similar arrangements

In financial lease arrangements there is no change of ownership of the goods being leased. Nevertheless, due to the terms of the lease, a change of ownership is to be imputed, with the lease arrangements being regarded as the financing of a purchase.

The Group agreed that guidelines for both the balance of payments and the national accounts should refer to the same cut-off point in determining what percent of the cost of a good, together with the carrying charges, must be recovered by an arrangement to qualify it as a financial lease. The Group, furthermore, agreed that the cut-off point should be less than 100 percent (unlike one OECD recommendation) and should be considered in light of any current developments in financial accounting. The commencement of the lease is to be recognized as the proxy for the change in ownership of the equipment under the financial lease. The Group also agreed that arrangements similar to financial leases be examined along with financial leases in preparing guidelines.

4. The time of recording for income

Three different possibilities for the recording of income are discussed in EXT. 6--accrual, due-for-payment, and cash bases. Accrual refers to the recording of income related to financial instruments on a continuous basis, e.g., for bonds which pay interest only once a year their interest payments would be pro-rated on a quarterly basis if the balance of payments is compiled quarterly. On a due-for-payment basis the annual payment would be included in the quarter in which the payment is due, even if it is not paid, while on a cash basis, the payment would only be included when it is actually paid.

The paper recommended the adoption of accrual accounting for interest income, so that the recording of income would be commensurate with the provision of capital. In particular, it was pointed out that recording on a due-for-payment basis, the current BPM recommendation, led to recordings of a distorting nature in the case of zero-coupon bonds.

Many experts were, however, reluctant to adopt accrual recording for all interest transactions, particularly as they recognized that in many cases the data either would not be available or would be difficult to obtain. The present treatment should, therefore, be maintained with an exception made for zero-coupon bonds. It was also mentioned that supplementary information on cash payments was needed for certain types of analysis related to arrears. Methods for recording income are also being considered by the International Compilers' Working Group on External Debt Statistics.

The Group agreed that the due-for-payment, as opposed to the full-accrual, recording of income should be maintained. (The Group agreed that an exception to the due-for-payment recording be made for zero-coupon bonds.) There are situations, however, such as debt arrears, when supplementary information would be needed.

5. Reinvested earnings on direct investment

The recommendation of the current BPM, supported by the national balance of payments experts, is that reinvested earnings on direct investment

be included in the balance of payments. If it is analytically useful to record direct investment transactions separately in the balance of payments, then the picture would be incomplete without these undistributed profits. Their inclusion ensures that incorporated subsidiaries are treated in the same way as branches in those cases where branch profits cannot be arbitrarily divided into distributed and undistributed parts. In addition, a better link is provided between the flow and stock data, while rates of return become more meaningful.

The national accounts experts were reluctant to fully endorse this position, as the implications for the treatment in the full set of national accounts were not clear. They felt that the matter should, therefore, be referred to the Group on Financial Flows for its consideration.

In the course of the discussion it was mentioned that there are many countries that do not have these data. Information from their partner countries could, however, be used by these countries as a starting point in constructing these estimates. Reference was also made to the work of the OECD in refining the definition of direct investment and related flows, such as earnings, both distributed and undistributed.

Concluding its discussion, most members of the Group agreed that both the external and the domestic sector account of the national accounts, like the balance of payments, should include international flows of reinvested earnings attributable to direct investors. Direct investment and reinvested earnings on direct investment would be as defined in the OECD "Detailed Benchmark Definition of Foreign Direct Investment." The Group, furthermore, strongly recommended that a full accounting for reinvested earnings should be prepared for consideration of other groups in the SNA review process, specifically the Group on Financial Flows, and that, in that accounting particular attention should be drawn to the implications for saving and national disposable income.

Neither for the balance of payments nor for the external sector of the national accounts is there any reason to extend this treatment to portfolio investment.

6. Transactions between affiliated enterprises

In Ext. 13, it is suggested that the SNA does not include cross-border flows of merchandise between affiliated enterprises in export and import statistics. Such flows should, however, be included in the merchandise account according to the BPM. In commenting on Ext. 13, some correspondents had queried the interpretation of the SNA given in the paper.

The Group agreed that transactions between direct investment enterprises and their parents or other related enterprises be recorded as if a change in ownership had occurred in order to make the treatment of those transactions parallel to that of transactions between unrelated enterprises. The exceptions to this procedure are the same as those for unrelated enterprises.

7. Goods for sale on consignment

If the principle of change of ownership is followed, goods on consignment should be included in the merchandise account when they are sold, i.e., when their ownership changes. Such goods would, however, be included in customs data when they cross the customs border. Some experts doubted that adequate adjustments could be made at the commodity level to correctly adjust the data. It was pointed out, however, that some exporters of primary commodities, who sell on consignment, such as Australia, do have the capacity to make the necessary adjustments at the commodity level.

The Group agreed that the change-of-ownership principle should be adhered to for goods for sale on consignment. Consequently, for significant transactions, it may be necessary to make valuation and timing adjustments to the trade statistics when these are used as the basis for compiling the merchandise data. However, there may be practical problems to making those adjustments.

8. The f.o.b. value of imports

There presently is a difference in the valuation of imports in the SNA and the BPM. In the SNA imports are valued c.i.f., that is the cost of insurance and freight is included whether these services are provided by residents or nonresidents, while in the BPM imports are valued f.o.b., with the cost of insurance and freight services provided by nonresidents being included in the shipment account. To harmonize the treatment it was suggested, in EXT. 13, that the BPM valuation be followed in both systems.

From the discussion it appeared that the national accounts experts were not averse to the BPM solution in principle, but were concerned about the practical problems of getting commodity detail on an f.o.b. basis. A solution to this problem was, however, proposed (see Appendix 4), which involved introducing a global adjustment to the import data. It was noted that such adjustments presently are often carried in the detail of balance of payments presentations, where the total of imports on a c.i.f. basis is given together with the adjustments to come to an f.o.b. figure.

The Group agreed to the proposal that the total of imported goods would be recorded in the external accounts on an f.o.b. basis. Thus, imports and exports of goods and services would both be recorded on an f.o.b. basis, eliminating the discrepancy between the national accounts and the balance of payments. For the detailed analysis of goods and services, as a rule, it is not possible to get an f.o.b. value for each category of imported goods, so that a global adjustment would have to be made in the supply and disposition figures, as in the input-output tables, in order to adjust the c.i.f. total to the f.o.b. total for imports.

9. The write-off of bad debts

Write-offs of bad debts are treated differently in the current SNA and the BPM. In the SNA, an entry is made for the notional repayment of the amount written off, with a counterpart entry made in unrequited transfers. In the BPM, however, write-offs are treated as valuation adjustments, so that no entries are recorded.

The experts favored the BPM treatment, but noted that in cases that involve the voluntary cancellation of debt through an agreement between the two parties involved, the SNA treatment would apply. This treatment also accords with the BPM treatment for this type of transaction.

The Group agreed that the write-off of a bad debt be treated as a valuation change, which should be excluded from the data on external transactions. In contrast, when the voluntary cancellation of a debt is a contractual arrangement between the parties concerned it is to be construed as an unrequited transfer.

10. Free goods and services for travelers

While noting that the data would be very difficult to obtain in practice, the Group agreed that the value of free goods and services provided to travelers be included as part of travel. A contra-entry to the flow of free goods and services would have to be made in current transfers.

11. Goods for processing

Goods that are sent for processing without a change of ownership from one country to another and that thereafter leave the second country are treated in the SNA in a way that differs from the way in which they are treated in the BPM. In the national accounts, the value of these goods is recorded in the merchandise account at their original and processed values, while in the balance of payments no entries are made in the merchandise account, with the value added due to processing being recorded as a service item.

The need to harmonize the treatment was recognized, with discussion focussing on how to do this. The national accounts experts seemed to feel that, particularly where the value added due to processing was a substantial proportion of the final value, the data should be recorded gross in the production account and in the merchandise account. There was, however, some support for the suggestion that where the processing might only consist of packaging, instead of transforming the goods, only the value added should be recorded, as the recording of the transactions on a gross basis might distort the analysis of the trade data. It was also noted that processing is not a very precise term, but may span a whole range of activities from labeling, to packaging, assembling, or completely transforming the original goods in question. (According to paragraph 221 of the BPM, the first two activities would clearly not be

considered to be processing). It would be useful to have a clear definition of processing and, in this connection, it was suggested that reference should be made to the latest recommendations of the United Nations on trade statistics.

The practical difficulties of obtaining the data were also mentioned. If, for example, goods for processing without a change of ownership are included in the trade statistics indistinguishably from other data, there would be no possibility for making any adjustments. In this case, there would be no choice but to have gross recording.

Another factor concerned the stock of goods for processing in an economy at the end of a reporting period. It was recognized that if the flows for these goods are incorporated in the merchandise account, to the extent that amounts are left in the processing economy at the end of a reporting period a contra-entry in the capital account has to be created.

To try to accommodate the points made above, two suggested tabulations were presented to the Group. On the whole, the Group favored a presentation that separated export and import flows into processed goods, goods for processing, and other goods (see Appendix 5). A possible variation would be to deduct imported goods for processing from exports of processed goods and to deduct exported goods for processing from imports of processed goods.

Concluding its discussion on this topic, the Group agreed that both in the balance of payments and in the national accounts, goods exported/imported for processing and re-import/re-export should be recorded gross by the processing economy as well as by the economy that sent the goods for processing. This procedure should be followed if there is a substantial physical change in the goods reflecting a change in their characteristics. The Group further agreed that in the presentation of the balance of payments data goods that do not involve a change of ownership should be separately identified. In addition, an entry in the capital account may be needed in respect of these goods when exported/imported for processing in one accounting period and re-imported/re-exported in another period. The Group also agreed that there is a need for a clear definition in the revised SNA as to what constitutes processing activity. In this context, reference should be made to existing international guidelines on external trade statistics.

12. Goods for repair

As a corollary to its discussion on goods for processing, the Group also considered the case of goods for repair. In the balance of payments, such transactions are treated in a similar fashion to goods for processing in that, as there is no change of ownership, no entries are recorded in the merchandise account. The national accounts experts, however, felt that a distinction should be drawn between repair activity that involved a substantial amount of manufacturing or reconstruction work, which would

normally be performed on investment goods, and other repair activity, which might just involve the replacement of defective parts in a machine. In neither case should the value of the goods before the repair be shown in the balance of payments; however, the value of repairs on investment goods should be entered in the merchandise account, while other repair activity should be recorded as a service item.

With regard to repair activity, the Group accepted that a distinction should be made between repairs performed on investment goods and repairs performed on other goods. The value of repairs on investment goods should be shown as part of the merchandise item; other repairs should be classified as a service item in both the balance of payments and the national accounts. With respect to the recording of goods for repair, the Group expressed the need for a review of existing international guidelines for the compilation of external trade statistics.

VII. Classification of Transactions

The discussion papers on this topic were: Harmonization of the Classification of International Transactions in the System of National Accounts (SNA) and the Balance of Payments Manual (BPM) (EXT. 13); The Classification of International Transactions in Services, Income, and Unrequited Current Transfers (EXT. 14); and The Classification of Capital Account Transactions (EXT. 15); together with related comments and points for discussion contained in EXT. 18, Updated.

1. Consolidation of goods and services components

It was stated that the work covered in the paper, which had been undertaken jointly by the Fund and the U.N.S.O., focused on the explicit and implicit links between the external sector account of the SNA and the BPM, and studied the availability of data in selected countries to narrow gaps between the systems. Detailed bridge tables, going from the balance of payments to the national accounts and vice versa, are shown in Appendix III of Ext. 13. Essentially, in the first table each standard component of the balance of payments is divided into subcomponents, with each subcomponent identified as to its location in the SNA. In the second table, the process is reversed with each subcomponent of the national accounts being identified as to its location in the balance of payments.

The links shown in these tables are very complex, although in many cases the differences between the two systems are marginal and often unintentional. Examples of major differences are the treatment of factor and non-factor services, which in the balance of payments, contrary to the national accounts, are sometimes grouped together, and unilateral transfers, which are not segregated between current and capital transfers in the balance of payments.

From the studies of selected country practices, it became apparent that many of the details needed to effect a reconciliation were not available, so that consideration was given to establishing the links at

a more aggregate level. This simplified link is shown in Appendix VI of EXT. 13 which bridges the balance of payments with Table 26 of the SNA, which is shown in Appendix I of the paper.

An example of a link at a more aggregate level of detail would be one established at the level of total merchandise exports and imports, rather than at the level of individual commodities.

The Group agreed that, in order to simplify the reconciliation of the balance of payments and the national accounts, the national accounts details for exports and imports of goods and services should be the details that are needed for internal consistency. (For the present SNA, these details are shown as part of Appendix Table 6 in EXT. 13.) The development of a more detailed breakdown should be done in such a framework.

2. Classification of services, income, and unrequited transfers

In the discussion of EXT. 14, reference was made to the views of a small, representative group of national balance of payments compilers who, in the capacity of consultants, assisted the staff of the Fund in drafting the fourth edition of the BPM. Originally, it had been the view of these consultants that there should be no more than 50 standard components. In the end, however, they agreed to distinguish more than twice that number of standard components. Nevertheless, by now it has become clear that there is a need for an expansion of the current list of standard components, particularly with respect to transactions in services.

The EEC's representatives agreed that they were interested in more detail, but pointed out that there was a general interest in more data on services, not just in the balance of payments, but throughout the spectrum of economic statistics. In the balance of payments there should, at least, be a clear distinction between services, income, and transfers.

It was noted that in OECD member countries, over 60 percent of the labor force is engaged in the production of services, which generates a demand for more data on these activities. This demand is augmented by the data requirements of GATT negotiations on services. Currently, there is no counterpart for services to the Standard International Trade Classification (SITC).

Some practical difficulties to collecting data on services were also mentioned, such as the need to obtain data from what one could identify as service producing enterprises, which provide services as a by-product of the main operation. Another problem would be valuing cross-licensing arrangements for which no payment is made, while, in the income accounts, even if a decision can be made as to whether a particular return represents income or capital gain, the allocation of the flow by residency may still be difficult.

a. Factor income

A main concern of the Group was the identification of factor incomes in the current account of the balance of payments. Currently, factor incomes show up in the current account in five places--as direct investment income; as other investment income; as a subcomponent of government transactions, reflecting the compensation of employees; as the labor income, n.i.e., component of other goods, services, and income, reflecting the compensation of border workers and seasonal workers; and as the property income, n.i.e., component of other goods, services, and income, reflecting the income on nonfinancial intangible assets. Appendix 2 of EXT. 14, which provides a proposed presentation of the current account, including all the detail required for the identification of factor income, was generally favorably received by the Group. Some experts queried whether all of the data would be available, and if not, whether it would be appropriate to request what would be difficult to provide. In this context, reference was made to the need to be clear as to what is required from a conceptual point of view. Practical difficulties about obtaining data could be addressed in a companion handbook to the next BPM.

The Group agreed that the balance of payments and the external sector of the national accounts should identify factor income items. In some cases, mainly with respect to compensation of employees, the identification may be difficult. Because of the importance of the concept, factor income should be recognized in setting up the hierarchy of the tables.

b. Standard list for service items

Opinion on the need to expand the list of service items contained in the BPM was divided. It was recognized that the list is currently quite short and that developments since the fourth edition of the BPM have increased the desirability of incorporating new details. However, it was also pointed out that keeping service details to a minimum is consistent with the merchandise account for which no commodity detail is requested. The counter argument that was made suggested that the commodity detail on merchandise trade is available elsewhere, while details on international service transactions are normally only available in the balance of payments. Any development of the classification of services should be done in conjunction with other areas of the national accounts, such as input-output.

The Group agreed that a standard list of services items should be used as the basis for a harmonized presentation. These items would include the traditional items shown under services--transport, travel, etc.--and also those items that are becoming increasingly important as international transactions, such as financial services and communications. The details to be shown should agree with the Central Product Classification (CPC), preferably at a high level of that hierarchy. The Group agreed that those concerned with the CPC classification pay particular attention to the needs of the balance of payments and external sector accounts, so that harmonization between these accounts and other accounts, including input-output, be attainable.

c. Current and capital transfers

There is presently no distinction between current and capital unrequited transfers in the balance of payments. All unrequited transfers are included in the current account, so that the capital account reflects changes in financial assets and liabilities (net lending in the SNA). One reason why there is no distinction between the two types of transfers is the difficulty in determining the nature of a transfer. Appendix 2 of EXT. 14 does, however, show current transfers separately. It was suggested that criteria that could be adopted for distinguishing between current and capital transfers are contained in the European System of Accounts (ESA). The remaining problem is whether to include capital transfers with the capital account or to incorporate them elsewhere in the balance of payments. (A concomitant problem is the treatment of purchases and sales of nonfinancial intangible assets. If these are not included in the current account, the current account will not be conceptually consistent with net lending).

The Group agreed that the distinction between current and capital transfers is essential to the national accounts. The Group, furthermore, agreed that harmonization between the balance of payments and the external sector account of the national accounts is desirable and that harmonization would be in the direction of recognizing capital transfers in the balance of payments. The Group saw some difficulty in implementing the concept of capital transfers for the balance of payments and recommended that the principles be clarified in a paper that is to include references to empirical cases. The placement of capital transfers in the balance of payments would be worked out on the basis of the review of capital transfers.

d. Other specific recommendations

In the context of the discussion on the classification of services, income, and unrequited transfers, the Group dealt with several other specific issues and agreed to the following: (a) Travel in the balance of payments is to be defined to exclude passport fees, visa fees, and airport taxes; they are to be treated as current transfers. The Group, furthermore, agreed that rent on land paid by travelers is not a reconciliation issue; it is covered within "travel" in the BPM and within "direct purchases abroad by resident households/direct purchases in the domestic market by nonresident households" in the SNA; (b) The content of the present category "official goods, services, and income" should be broken down to show factor income and services (where, in practice, services may include some goods that it would be desirable to show separately); and (c) Labor income in the BPM should be defined to be equivalent to the concept of compensation of employees as defined in the SNA. Practical solutions to distinguishing the flows of goods, services, factor income, and transfers will be needed.

3. Classification of capital account transactions

The principal discussion paper for the topic was EXT. 15. There were four principal considerations contained in the paper. First, were the analytical and operational needs of the Fund; second, was the harmonization of the balance of payments and the financial accounts in the national accounts; third, was the desirability of having a classification scheme that facilitated comparisons between flow and stock data, and between the current and capital accounts in the balance of payments; and fourth, was the desirability of having compatible systems for the three areas of statistics for which the Fund has a prime responsibility, namely, the balance of payments, money and banking, and government accounts. Discussion focussed on the following points:

a. Monetary and commodity gold

The present SNA treatment of gold monetization/demonetization is the same as that in the third edition of the BPM, i.e., these transactions are reflected through entries in the merchandise trade account. The fourth edition of the BPM changed this treatment, so that gold monetization/demonetization in the balance of payments is essentially recorded as a reconciliation item. This treatment parallels that for the allocation/cancellation of SDRs. Following a presentation of such a treatment in the SNA (see Appendix 6), the national accounts experts concurred to show the monetization/demonetization entries in the reconciliation accounts.

Another point for discussion was the treatment of nonmonetary gold. Some experts felt that there were two classes of nonmonetary gold--gold held as a commodity, e.g., for industrial use, and gold held as a financial asset. Questions arose as to how to distinguish between these two types of gold and as to whether the gold held as a financial asset would be a foreign asset or a domestic asset.

Concluding the discussion on this topic, most members of the Group agreed that the BPM distinction between monetary gold and commodity gold be the basis for the harmonized treatment of gold: "Monetary gold is gold owned by the authorities (or others subject to their effective control ...) that is held as a financial asset. Other gold (nonmonetary gold) owned by any entity, including the authorities that also own monetary gold, is treated ... like any other commodity." The Group recognized that the Group on Financial Flows may also have a view about the application of this distinction, and it would be useful for that Group to take this issue up in its meeting as well. The Group, furthermore, agreed to treat the reclassification of commodity to monetary gold and vice-versa (monetization/demonetization of gold) in line with what is described in the BPM. As now described in the BPM, such a change is to be shown in the balance of payments, together with a counterpart for monetization (credit) or demonetization (debit) that matches the respective entry for the increase (debit) or decrease (credit) in holdings of the financial asset. In the SNA, the entry offsetting the entry for the change in holdings of the financial asset is to be made in the reconciliation accounts.

b. Supplementary information on the total change in reserves

In the BPM presentation of reserves, transactions are derived from data on total changes in reserves and counterparts to valuation changes, while the SNA, in its flow accounts, incorporates transactions data directly. Many balance of payments experts, while recognizing the usefulness of the additional data on stock and valuation changes, suggested that such data should be contained in a supplementary table, rather than in the body of the main table, which might also contain equally useful information on other stock changes. It was noted from the national accounts point of view that valuation changes belong not in the flow accounts but in the reconciliation accounts.

A related issue concerned the inclusion in reserves of assets held by deposit money banks that are under the effective control of the monetary authorities. This is the treatment in the BPM, and, to harmonize the SNA, a breakdown of the assets of deposit money banks would be required. Some participants noted that it might be difficult to come up with precise guidelines and that it might even be counterproductive to do so, as countries would find ways of circumventing them. The Group saw, however, the need to harmonize the SNA treatment with that of the RPM, and referred to the Group on Financial Flows the detailed resolution of the harmonization.

The Group agreed that with regard to the presentation of supplementary information on the total change in reserves the presentational issue for the balance of payments be left to be worked out by those who have special interest in that information. The Group urged that due consideration be given to making clear the relationship between the lines for transactions in the balance of payments presentation and the corresponding lines in the national accounts. With regard to the question of whether assets held by deposit money banks should be excluded or included in reserves, the Group agreed to bring to the attention of the Group on Financial Flows the need to include as reserve assets the assets that, although not owned by the monetary authorities, are under the effective control of those authorities, and to recommend that that Group work out a way to accommodate that need.

c. Liabilities constituting foreign authorities' reserves

Most members of the Group agreed that information on liabilities constituting foreign authorities' reserves is useful. In the view of most members of the Group, the balance of payments should continue to show breakdowns that identify these liabilities where appropriate. It was noted, however, that the practical difficulties of providing these breakdowns are substantial.

d. Exceptional financing

The elements of exceptional financing are not shown as separate standard components in the balance of payments but as details of standard components, which are regrouped from the detailed presentation to form an

exceptional financing group in the aggregated presentation. Some experts felt that the present presentation did not, in all cases, make it clear what was covered by exceptional financing.

Most members of the Group agreed that information on exceptional financing (financing other than reserves and liabilities constituting foreign authorities' reserves) be reported as supplementary information, rather than as standard components.

e. Sectorization

Proposals for functional and sector breakdowns, as shown in Appendix I of EXT. 15, are changed from the breakdowns contained in the fourth edition of the BPM. The functional breakdowns have been reduced to three: direct investment, reserves, and other capital. The existing category of portfolio investment has been subsumed within the category of other capital. Other capital is still divided into long-term and short-term, but the sectorization has been expanded to five: general government, monetary authorities, deposit money banks, nonmonetary financial institutions, and other sectors; the changes were the break-out of monetary authorities from general government, and nonmonetary institutions from other sectors. Some marginal instrument data has also been introduced for trade and other suppliers' credits. Liabilities constituting foreign authorities' reserves could be shown, where appropriate, as a functional item. However, the items comprising exceptional financing would not be shown separately in the detailed presentation, but would be included in an analytic presentation.

It was noted that the balance of payments is fundamentally different from the SNA in its categorization of capital account flows, as the latter is based strictly on a-sector approach correlated to an instrument breakdown. Nevertheless, satisfactory links between the two should be possible through a building block approach.

The Group acknowledged that extensive work on sectorization will need to be done by the Group on Financial Flows and, therefore, agreed to forward to that Group the sectorization proposals in The Classification of Capital Account Transactions for their use in identifying building blocks that are necessary in order to construct presentations useful for balance of payments analysis. In addition, the Group suggested that the Group on Financial Flows should consider the possibility of providing a sector breakdown of direct investment.

f. Long-term versus short-term capital

The Group agreed that there should be a single definition of long-term and short-term with respect to financial assets and liabilities, and it referred the matter to the Group on Financial Flows for them to work out. (Reference was made to international liberalization codes on capital flows which the Group on Financial Flows might consider when drawing up a definition.) The Group noted that recent developments, affecting not

only international but also domestic transactions, bring into question the usefulness of a long-term versus short-term distinction and urged that the distinction be reviewed critically.

VIII. Financial Assets and Liabilities

Discussion papers for this topic were mainly The Classification of Financial Assets and Liabilities (EXT. 16); New Financial Instruments and the Balance of Payments (EXT. 17); Some Issues in the Balance of Payments Presentation of Arrears and Debt Reorganization (EXT. 19); and Classification of Transactions in Zero-Coupon Bonds, Junk Bonds, and Indexed Bonds in the Balance of Payments (EXT. 20) together with summaries of comments and points for discussion contained in papers EXT. 18, Updated and EXT. 22.

1. Harmonization of classification

With regard to the classification of financial instruments, contained in EXT. 16, the Group did not see any problem in harmonizing what is useful for the balance of payments with what would be useful for the other parts of the economic accounts.

2. Repurchase agreements

One possible difference in treatment between the BPM and the SNA raised in EXT. 16 related to repurchase agreements. The proposed SNA instrument classification views a repurchase agreement as the creation of a new instrument, whereas the BPM treats a repurchase agreement as a direct transfer of ownership of the underlying assets.

The Group noted the need to harmonize the treatment of repurchase agreements as proposed in EXT. 16 and referred the problem to the Group on Financial Flows for them to work out a treatment that would be applicable to both domestically and internationally traded assets.

3. Deposits

The Group noted the need to change the definition of deposits, as proposed in EXT. 16, and to have, as a minimum, a distinction between residents and nonresidents. The Group referred the problem of working out the definition to the Group on Financial Flows.

4. Trade credits

One instrument breakdown proposed for the capital account, in EXT. 15, which would be carried through to stock data of financial assets and liabilities, was that for trade and other suppliers' credits. It was noted that many analysts consider these types of claims to be interesting in the analysis of the balance of payments, although some experts mentioned the difficulty of segregating such information from short-term accounts payable and receivable. In discussions on the fourth edition of the BPM,

these latter considerations were determined to be sufficiently important to exclude trade credits as a standard component in the balance of payments.

The Group agreed to refer to the Group on Financial Flows the need for working out a definition of trade and other suppliers' credit. One consideration might well be that, in national practice, trade credit appears to cover credit on open book accounts as well as credit financed through trade bills.

5. Other financial instruments

Discussion focused on the general issues raised in EXT. 17 and EXT. 20, rather than on the specifics of each type of financial instrument described in the papers. A major concern was the separation of flows between capital, returns on capital in the form of interest (including similar forms of income), and service fees associated with financial transactions and capital gains and losses. The distinction between capital gains and losses and interest (including similar forms of income) is particularly important in the case of bond transactions, both when they are issued at a price other than their face value, in subsequent trading, as well as at redemption. The time of recording income transactions for zero-coupon bonds is also an open question, depending on whether one records income on an accrual or due for payment basis. With regard to option transactions, the question was raised as to whether the premium paid by the buyer to the seller should be regarded as a service fee or as a capital flow, which would recognize the existence of the buyer's financial asset, similar to a nonfinancial intangible asset. The issues raised in the securitizing of debt (the practice by which non-bank financing, some through the intermediation of banks, is supplanting traditional bank financing) seems to be more a practical problem of obtaining data from the asset holders than a conceptual one of deciding how the transaction should be treated.

Because the balance of payments issues cannot be resolved in isolation from the domestic sectors, it was suggested that these issues should be discussed in the expert groups looking at these issues.

With regard to other financial instruments, the Group noted several general issues: the separation of principal, interest, service fees, and capital gains/losses; the specification of a time of recording of these transactions; and the identification of the kinds of instrument and the maturity (which is complicated by the securitization of debt). These issues present some problems for the harmonization of the balance of payments and the external and domestic accounts; of particular note is the problem of identifying the resident status of the transactors, the associated flows, and assets/liabilities. However, the harmonization issues would probably be easier to identify and to resolve after some of the problems had been addressed in the context of the domestic sectors. It is recommended that consideration of what constitutes income, services, and capital gains/losses be handled initially in the Group on Production Accounts, which then can forward advice to the Group on Financial Flows.

The results of the deliberations of both Groups would be available to the IMF for use in revising the BPM. In their work, the Groups will probably find it useful to draw upon the papers on New Financial Instruments and the Balance of Payments and Classification of Transactions in Zero-Coupon Bonds, Junk Bonds, and Indexed Bonds in the Balance of Payments.

6. Gross recording

The classification of capital account transactions, in EXT. 15, for direct investment transactions follows the treatment in the current BPM, i.e., capital flows relating to direct investment abroad of the reporting economy are reported on a net basis (asset flows minus liability flows). Similarly, flows relating to foreign direct investment in the reporting economy are also reported on a net basis (liability flows minus asset flows). It was noted that this is the only instance in the capital account where flows relating to assets and liabilities are not segregated, and, therefore, inconsistent with the SNA.

The Group noted that, while in the SNA transactions in assets and liabilities are shown separately, in the BPM, with regard to direct investment, the flows relating to assets of direct investment abroad are shown net of related liabilities and the flows relating to liabilities of direct investment from abroad are shown net of related assets. The effort to harmonize recommendations (including those in the OECD Detailed Benchmark Definition of Foreign Direct Investment) for both direct investment income and capital flows should be in the direction of showing more gross flows, because these flows are analytically useful.

7. The International Securities Identification Numbering System

This system, which is described in background document EXT/B.17, was brought to the Group's attention and was recommended as being a useful tool in the classification and identification of securities.

The Group acknowledged the potential usefulness of the work on identifying securities represented by the "International Securities Identification Numbering System." The Group recommended that this material be forwarded to the Group on Financial Flows.

8. Arrears and debt reorganization

The details on transactions for arrears and debt reorganization, described in EXT. 19, are needed to link the data with external debt statistics being worked on by the International Compilers' Working Group on External Debt Statistics, and also to provide the data for calculating exceptional financing. These data should not, however, be new standard components of the balance of payments, but should rather be supplementary details to existing standard components.

One issue raised in the paper was the possible asymmetry in the treatment of interest arrears, which may have been capitalized by the debtor but not by the creditor. Another issue was the treatment of debt forgiveness. In the light of the recommendation to segregate current and capital transfers, once a decision has been taken on what constitutes current and capital transfers, debt forgiveness will have to be classified in accordance with that decision.

The Group emphasized the importance of the problem of arrears and debt reorganization in both the domestic and international settings. The Group noted the necessity of having detailed information of the kind suggested in the paper Some Issues in the Balance of Payments Presentation of Arrears and Debt Reorganization. It was also noted that the paper was written prior to the Group's recommendation that capital and current transfers be distinguished in the balance of payments. This issue and the associated paper were referred to the Group on Financial Flows and the International Compilers' Working Group on External Debt Statistics.

IX. Specific Transactions

Two types of transactions associated with services related to financial activities were also referred to other groups for their consideration. These were insurance, for which a background note entitled The Treatment of Insurance Transactions in the SNA and BPM had been provided (see Appendix 7), and banking, for which a discussion paper, The Treatment of Output in the Banking Industry (EXT. 21) had been provided.

1. Insurance

The problem with insurance is that premiums and claims are entered on a net basis in the service account in the balance of payments. This may produce peculiar fluctuations in the series on services for casualty insurance, depending on the claims experience. (It was suggested that one way in which the problem could be addressed would be to consider claim payments for major disasters as a contractual transfer, rather than as a negative service charge).

A further complication is that the gross premium for casualty insurance comprises two elements--a service fee, which is the gross output of the insurance sector, and a net premium covering the insurance risk. For life insurance, the gross premium has a third element, representing an addition to actuarial reserves.

It was suggested that it might be possible to adopt a simplified solution for life insurance, where the flows are usually small. Another point mentioned was the impact of net insurance data (premiums less claims) on the c.i.f./f.o.b. adjustment for merchandise trade. Probably when going from a c.i.f. basis of imports to an f.o.b. basis, one should, in addition to adjusting for freight costs, deduct gross insurance premiums and add back the value of losses.

The Group saw the possibility of harmonization with regard to casualty insurance by approximating the service charge as a percentage of the gross premium. However, the Group agreed that it would be inappropriate to recommend that treatment until a full evaluation of the treatment of the complex of insurance transactions, including those related to life insurance and pension funds, would be in place. The Group, therefore, forwarded the matter to the Group on Production Accounts, the Group on Financial Flows, and the Group on the Household Sector Accounts and Income Distribution Statistics for an examination of the relevant issues, including the issues pertaining to the treatment of insurance on imports in the input-output table.

2. Banking

The question was posed whether, if it is recognized that a part of the output of the banking industry represents final demand, an adjustment to interest payments should be made in order to differentiate between factor income flows and nonfactor services. This is, of course, a much wider issue than that determining the correct entries for the balance of payments and will, therefore, have to be examined by other expert groups; however, the issue does seem to be particularly important for countries with important external banking activities.

The Group noted the substantial impact of the treatment of banking services on the external sector of the national accounts and on the balance of payments and strongly advised that the Group on Production Accounts and the Group on Financial Flows give due consideration to that impact in working out a revised treatment. These Groups may find the IMF paper The Treatment of Output in the Banking Industry useful in this work. The balance of payments experts noted their willingness, in principle, to accept, if necessary, imputations and adjustments to interest flows as part of a harmonized treatment.