

Treatment of Gold in Balance of Payments Statistics

1. Characteristics of Gold Transactions by Japanese Residents

In order to understand the characteristics of transactions in gold and to find out proper treatment in balance of payments statistics, the Bank of Japan conducted a study on activities of cross-border transactions in gold performed by Japanese residents. Following are the main findings of the study:

- (1) The magnitude of transactions in gold traded without any cross-border physical shipment is much larger than that of international gold shipments with Japan's trading partners (see table 1 below). Transactions in gold without cross-border physical shipment involve gold that is deposited in metal accounts with a financial corporation in London; transfer of ownership is conducted by the settlement in those accounts.

Table 1. Transactions in Non-monetary Gold in Japan's Balance of Payments Statistics

(100 million yen)

	Non-monetary gold shipped across Japanese border			Non-monetary gold without physical shipment ¹ (figures for internal use)		
	Balance	Export	Import	Balance	Export	Import
1997	-656	265	922	-1,635	34,337	35,972
1998	-664	245	909	-1,240	33,287	34,527
1999	-644	416	1,060	-169	36,148	36,317
2000	-147	465	612	173	27,901	27,727
2001	-37	398	435	320	31,559	31,239
2002	-452	471	923	-155	41,376	41,531
2003	391	1,007	616	310	73,731	73,421

Note: Figures for non-monetary gold without physical shipment have not been published.

- (2) Japanese trading firms rather than financial corporations handle most transactions in gold that don't involve physical shipment. Three major trading firms concentrate more than 90 percent of transactions of gold without physical shipment (see table 2 below).

¹ Gold bullion (including 90 % or more fine gold) purchased and sold by residents without physical shipment.

Historical reasons explain that these trading firms have played an important role in transactions in gold in Japan. After the World War II, the Japanese government banned exports/imports of gold so that national saving could be used to develop emerging industries. After the deregulation of gold transactions in the 1980's, non-bank traders started dealing with international gold traders. Meanwhile, in 1982, banks were allowed to sell gold in retail markets, but were not allowed to get into wholesale gold markets. This measure was aimed to protect small non-bank gold traders. Large trading firms took advantage of this fragmentation of the gold market and expanded their transactions in gold into wholesale markets using their large capital funds.

Table 2. Market Share of Major Trading Firms for Non-monetary Gold without Physical Shipment in Japan

(100 million yen)				
	Export		Import	
		Three major Japanese trading firms		Three major Japanese trading firms
Amount transacted	6,574.05	6,067.62	6,633.04	6,090.74
Market share (%)	----	92.3	----	91.8

Note: Figures for September 2004. Figures for three major Japanese trading firms have not been published.

- (3) Most transactions of trading firms are forwards on gold. They are taking advantage of arbitrage opportunities on the OTC forward market in London, and on those between the OTC forward market in London and the future market in Tokyo Commodity Exchange. It follows that positions on forwards on gold are supposed to be offset at the time of the delivery date; however, the transfer of ownership of gold in metal accounts does not usually occur unless there are exceptional circumstances.
- (4) Wholesalers of gold that import gold for industrial purposes do not engage in forwards in gold. They usually import gold using consignment contracts with Swiss banks and sell it to manufacturing firms in Japan when they deem it necessary. Since there are different ends to the use of gold and gold is fungible merchandise, gold wholesalers do not distinguish gold held for its storage value and gold held for other purposes, e.g., used in the industry.

2. Current Treatment of Gold in Japan's Balance of Payments Statistics

Currently, settlements of forward transactions of gold are treated as merchanting transactions in Japan's balance of payments statistics. This is irrespective of whether they are settled by cash transfer or ownership transfer of gold in metal accounts. There are several reasons that explain why we adopted this treatment.

First, it was understood that classification under merchanting was the relevant item for transactions that involve change in ownership without physical shipment; the *Balance of Payments of Compilation Guide* (paragraph 138) explicitly refers to selling and buying of nonmonetary gold as being a merchanting transaction. This element is further confirmed by the *Balance of Payments Textbook*, that speculative gains or losses realized from transactions in commodity arbitrage are also recorded under merchanting (paragraph 361).

In this connection, reclassifying nonmonetary gold without physical shipment from trade in goods to trade in services was considered appropriate, as this could reduce the volatility of the figures of trade in goods. Before implementing the recommendation of *BPM5*, all settlements of gold without physical shipment were recorded as trade in goods on a net basis since 1983. Balance of payments figures of gross credits and debits were volatile and excessively inflated with successive purchases and sales, and recording transactions on a net basis could mitigate this problem.

Second, there was still ambiguity in international guidelines on the treatment of forwards on commodities. We regarded forwards on gold as fixed-price contracts, which should be excluded from financial derivatives as discussed in *Financial Derivatives A Supplement to the Fifth Edition (1993) of the Balance of Payments Manual*.

Third, because data sources had several limitations, it was considered difficult to distinguish between settlements by cash transfer and settlements by ownership transfer of gold in metal accounts. As a consequence, we decided to view net amounts of reported figures as margins for merchanting transactions.

These reasons explain why initially transactions on gold were reported under merchanting transactions. However, we believe now that this approach needs to be revisited.

3. Revision of the Treatment of Gold in Japan's Balance of Payments Statistics

Given that forwards on gold are dealt by Japanese trading firms for arbitrage purposes, such forwards are considered to be offsetable and fall within the boundary of financial assets. According to the *Financial Derivatives Additions to the Fifth Edition (1993) of the Balance of Payments Manual*, offsetability means that it is often possible to eliminate the risk associated with a derivative by creating a new but “reverse” contract having characteristics that countervail the risk of the first derivative.

Settlements on gold should be treated as transactions in financial derivatives, rather than merchanting transactions. Thus, as positions are settled by cash transfers, the outstanding positions should be simply debited or credited under financial derivatives. When positions are settled by ownership transfer of gold in metal accounts, the ownership transfer of gold should be recorded at the current gold price, while the difference between the forward and current prices is debited or credited under financial derivatives.

A remaining and very important issue is how to treat the transfer of ownership of gold to settle forwards when deliveries occur under exceptional circumstances. We believe that it is not relevant to go back to pre-*BPM5* treatment and record it as trade in goods on a gross basis, since transfer is executed simply in metal accounts and is not consistent with the concept of trade in goods. A solution would be to treat the transfer of ownership of gold using metal accounts as financial transactions. This is exactly the reason why we support the creation of a financial gold item, distinct from non-monetary gold and gold as a reserve item.

4. Distinction between Gold and Other Precious Metals

One may argue that forwards on other precious metals, such as platinum and silver, as well as other commodities can be traded the same way as forwards on gold in balance of payments statistics and international investment positions. How could forwards on gold be treated differently from forwards on other precious metals and commodities?

The *International Reserves and Foreign Currency Liquidity Guidelines for a Data Template* states that forwards on gold should be included in the item of other reserve assets. Based on the *Guidelines*, it seems appropriate to include only forwards and options on gold that the monetary authorities used for the management of reserve assets.

We have the following arguments in favor of making a clear case between forwards on gold and forwards on other commodities.

First, forwards on other precious metals and commodities are not necessarily offsettable due to the lack of market liquidity. Therefore, such forwards fall outside the boundary of financial assets. Most forwards on other precious metals and commodities can be regarded as fixed price contracts for goods, because such forwards are not standardized so that the market risks therein can be traded in financial markets in its own weight.

Second, most forwards on gold are aimed for financial investment (including arbitrage), while most forwards on other precious metals and commodities are directly linked to procurement of those materials. Investment in other precious metals and commodities are performed in future markets, rather than OTC forward markets, with some exceptions (e.g., forwards on other precious metals in London Metal Exchange). As a result, the price of gold is affected by macro-economic circumstances, whereas prices of other precious metals are primarily affected by demand in industries.

Third, gold itself has characteristics of financial assets. For example, gold has been used as means to store value due to its fungibility and high liquidity in its market.

5. Conclusion

We recommend that a new item of financial gold be clearly established in the financial account. The definition of financial gold should be gold deposited with financial corporations, such as metal accounts London, without physical shipment (especially across borders). Such category broadly corresponds to gold used for investment/speculation by financial corporations and trading firms. If financial gold is newly created, it will be possible to record forward transactions of gold not under services (or goods) but under financial accounts.