SNA/M1.05/14

UPDATE OF THE 1993 SNA - ISSUE No. 41
ISSUES PAPER FOR THE JULY 2005 AEG MEETING

MERCHANTING[1]

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

Executive Summary

Balance of Payments Manual, fifth edition (BPM5) defines merchanting as the purchase of a good by a resident (of the compiling economy) from a nonresident and the subsequent resale of the good to another nonresident; during the process, the good does not enter or leave the compiling economy. The difference between the value of goods when acquired and the value when sold is recorded as the value of merchanting services provided (paragraph 262). If the merchant does not resell the commodities in the same accounting period, an import of goods is recorded in the first period, and a negative import entry is recorded in the later period. For other goods transactions, wholesale and retail margins are included in the price of the goods.

This same treatment is adopted in *1993 SNA* para. 14.60.

This issues paper proposes to record merchanting transactions as trade in goods, and indicates the shortcomings of the current treatment. Numerical examples are provided to show the difference between the present and proposed treatment.

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[1] The original version of this paper was considered at the November-December 2004 meeting of the Balance of Payments Technical Expert Group (BOPTEG), which was set up to consider issues and advise the IMF Committee on Balance of Payments Statistics (the Committee). BOPTEG's recommendations to the Committee are available from the IMF website. The paper will be considered by the Committee at its meeting of June 27-July 1, 2005. The conclusions of the Committee will be supplied to the AEG in time for the July 18-22, 2005 meeting.

I. Current international standards for the treatment of the issue

Balance of Payments Manual, 5th Edition (BPM5)[2]

Merchanting is defined as the purchase of a good by a resident (of the compiling economy) from a nonresident and the subsequent resale of the good to another nonresident; during the process, the good does not enter or leave the compiling economy. The difference between the value of goods when acquired and the value when sold is recorded as the value of merchanting services provided (para. 262). In addition, certain processing arrangements (para. 199) and commodity arbitrage (*Balance of Payments Textbook* para. 361) are included.

If the commodities are not resold by the merchant in the same accounting period, an import of goods is recorded in the first period, and a negative import entry is recorded in the later period. In the case that a merchanting transaction straddles different recording periods, changes from one recording period to another in the stocks of goods located abroad and valued at acquisition cost constitute part of goods of the economy of the owner (para 213, 262).

In either situation, any difference between the value of the goods when acquired and relinquished is entered as merchanting under other business services (para 213).

Balance of payments compilation guide (para 138-139) and ***Balance of Payments Textbook*** (para 189-194, 361-362) provide specific treatments of merchanting in BOP.

Manual on Statistics of International Trade in Services (MSITS)

The *MSITS*'s definition of and recommendation on treatments for merchanting are consistent with those of *BPM5* (3.123).

Box 6 of the *MSITS* provides detailed explanations on merchanting. The box also shows that; (1) the recording of merchanting transactions is asymmetrical, i.e., merchanting services are recorded only in the economy in which the merchant is resident[3], and (2) if the goods are resold for less than the original cost of purchase, then a negative export of merchanting services would be recorded.

Only a small number of countries report merchanting.

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[2] *BPM5* purports to reflect that wholesalers/retailers services are treated as margins in the *1993 SNA* production account. The *BPM4* treated merchanting the same as the *BPM5* (the *BPM4* references are para 219, 228, 237).

[3] Merchanting services are included in trade in goods in the economy of the original seller and the ultimate purchaser of goods.

II. Concerns/Shortcomings of the current treatment

(1) Holding gains and losses for the relevant goods may distort the measurement of merchanting services[4] (as shown in Case 2in V.).

- Holding gains/losses are valuation changes of merchants' assets (inventories), so, should not be included in the *1993 SNA* concept of services. However, in *BPM5*, merchanting services do include holding gains and losses because production and holding gains of goods are not international processes and do not appear in the balance of payments framework.

(2) The current guidance on merchanting results in structural asymmetry (as shown in Case 1 in V.).

- Merchanting services are recorded only by the exporting countries. This causes asymmetry for merchanting services (*Balance of Payments Textbook*, para 192; *MSITS*, Box6).

- The asymmetry stems from the pragmatic assumption that the importer would seldom, if ever, have information on the merchanting profit or loss realized by the intermediary in exporting country (*Balance of Payments Textbook*, para 192).

(3) The recommendation on merchanting trading that straddles different accounting periods may provide misleading data on goods (as shown in Case 3 in V.). The recommendation is also very difficult to implement in practice.

- Conceptually, the recommendations in the *BPM5* are appropriate when purchases and resale of the relevant goods straddle different accounting periods, and so merchanting services are not completed in the accounting period of purchase. As the ownership of the relevant goods changes from foreign providers to the merchants (residents), it is appropriate to record imports of the goods. Then, when the relevant goods are resold to nonresidents, merchanting services are to be recorded in the accounting period of resale because the services are completed in the period. Negative imports of the relevant goods are to be recorded for the accounting period of purchase in order to reverse the entry in the previous period.

- Data on trade in goods could be distorted under current treatments when large amount of merchanting transactions straddle different accounting periods.

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

- There is a danger of mismeasurements under this *BPM5* procedure, and more generally problems in implementation.

(4) The treatment is inconsistent with inventories data and balance sheets both for the merchant and supplier.

- Since an actual change of legal and economic ownership occurs but is imputed as not occurring, the treatment results in data on assets that are inconsistent with the enterprise accounts and with balance sheets that show the actual positions of the merchant.

- As they are not recorded as owned by the merchant in its balance sheet, the inventories may be without any owner.

(5) The valuation principles are not consistent with other current account items or supply and use tables.

- All other goods transactions in the balance of payments are shown including any retail and wholesale margins arising up to the international boundary, not with these margins separated.

- Supply and use tables are valued at either basic prices (i.e., goods transactions and margins are shown separately) or purchasers' prices (i.e., goods transactions valued at basic prices plus corresponding margins). The existing treatment is not consistent with either. The treatment also undermines the relationship between distribution industries and the corresponding goods transactions as the latter are omitted.

III. Possible Alternative treatments[5]

(1) Recording merchanting as trade in goods

The alternative is to record transactions in goods alone.

To support analysis, a new subcategory ‘goods under merchanting’ could be introduced under the goods in the economy of the merchant, where of analytical interest. The goods related to merchanting should be recorded separately from other goods under this subcategory.

This alternative has the following merits;

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[5] The alternatives coincide with whether the BOP goods and services account is trying to cover transactions in goods and services (as in the SNA’s Goods and Services Account) or production (as in the SNA’s production account).

- It avoids exceptional treatments in relation to ‘change of ownership’ principle. As a result, it gives a view that is compatible with data on inventories, holding gains, and balance sheets.
- Merchant sales would be treated consistently with other wholesale sales in the balance of payments. In the other cases, the wholesale margin is included with the price of the good, and it would not be separated.
- The recording of goods under merchanting becomes symmetrical.
- No negative exports of merchanting services are recorded.
- Distortions in the measurement of services caused by holding gains and losses on the relevant goods are eliminated.
- Practical difficulties or misleading volatilities are also eliminated when merchanting transactions straddle different recording periods

On the other hand, statistical continuity would not be kept between the current treatment and the revised standards.

(2) Recording merchanting as trade in services

The *BPM5* approach could be maintained, but for merchanting that straddle different accounting periods, a new subcategory ‘goods under merchanting’ under the trade in goods category could be introduced.

IV. Question/Points for discussion

(1) Should the legal change of ownership in goods subject to merchanting be recorded as imports and exports of goods in merchandise?

(2) Alternatively, should the legal change of ownership be ignored in this case and the difference in value between the selling price and buying price be treated as a service provider by the merchant to the purchaser of his goods?

(3) If (2), should the disposal of the goods in a subsequent period be recorded as negative imports at the original value (as now) or as exports at the original value (leaving an export of services)?

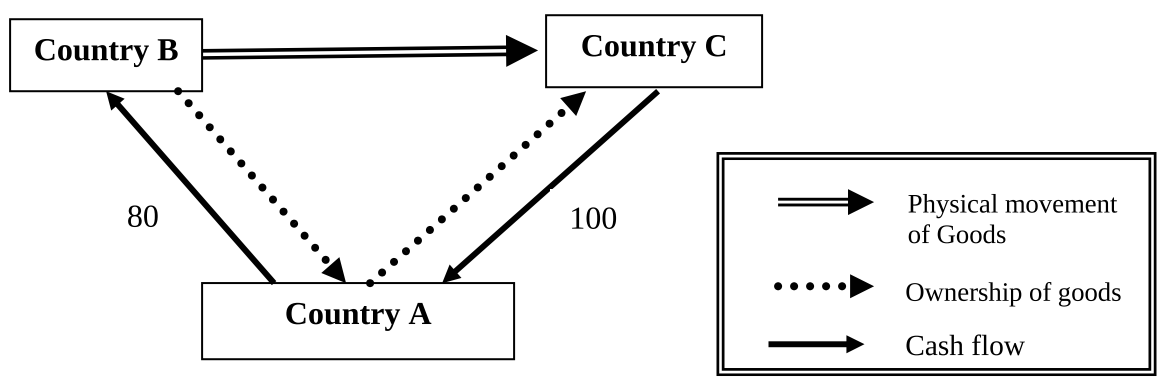
(4) Should a new subcategory of goods under merchanting be introduced under the trade in goods category?

V.Some Numerical Examples of the Present and Proposed Treatments of Merchanting

Case 1: Basic case

The following example illustrates the basic principles of the present and proposed treatments. All transactions occur within a recording period, with the goods physically moving from Country B to Country C directly, and not entering into Country A. It is assumed that all transactions are settled by currency and deposits.

Value of goods purchased by a resident of country A' from a resident of B'	80
Value of goods A' resells to a resident of C'	100



Present treatment

	Credit	Debit
Country A		
Services: Merchanting	20	
Currency & deposits		20
Country B		
Goods	80	
Currency & deposits		80
Country C		
Goods		100
Currency & deposits	100	
Global balance[6]		
Goods	80	100
Merchanting	20	
Currency & deposits	100	100

Proposed treatment

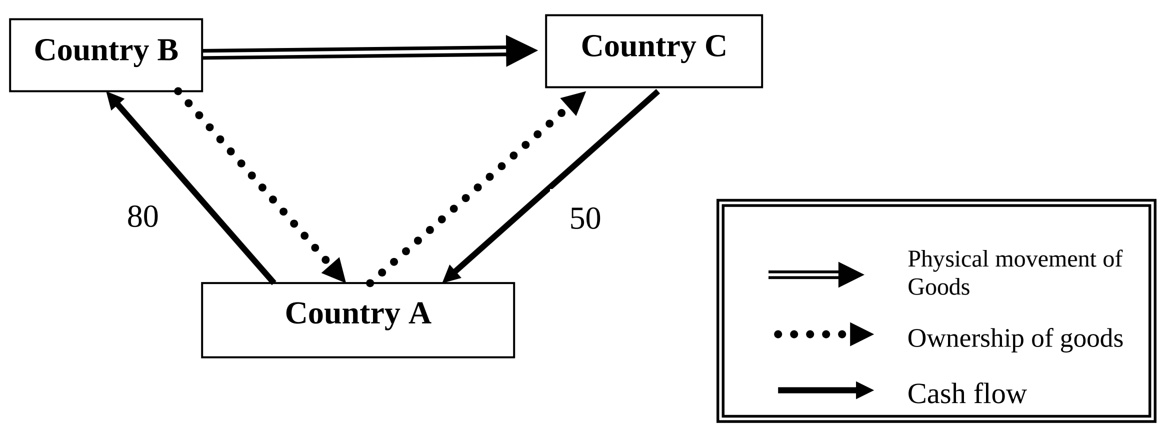
	Credit	Debit
Country A		
Goods under merchanting	100	80
Currency & deposits		20
Country B		
Goods	80	
Currency & deposits		80
Country C		
Goods		100
Currency & deposits	100	
Global balance		
Goods	180	180
Goods under merchanting	100	80
Currency & deposits	100	100

[6] Merchanting is recorded only in the country A (the exporter of merchanting services). This causes global imbalances in goods and services as no debit entry in merchanting is recorded.

Case 2: Holding gains/losses occur[7]

The following example illustrates the principles of the present and proposed treatments if holding gains and losses occur. Before A' resells the goods to B', the price decreases by up to 30. All transactions occur within a recording period, with the goods physically moving from Country B to Country C directly, and not entering into Country A. It is assumed that all transactions are settled by currency and deposits.

Value of goods purchased by a resident of country A' from a resident of B'	80
Value of goods A' resells to a resident of C'	50



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

Present treatment

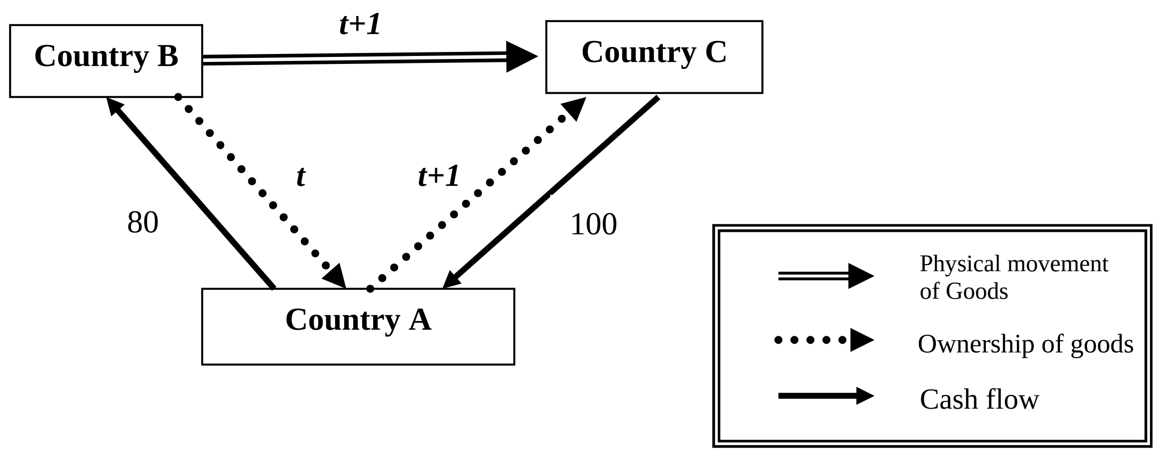
	Credit	Debit
Country A		
Services: Merchanting	-30	
Currency & deposits	30	
Country B		
Goods	80	
Currency & deposits		80
Country C		
Goods		50
Currency & deposits	50	
Global balance		
Goods	80	50
Services: Merchanting	-30	
Currency & deposits	80	80

Proposed treatment

	Credit	Debit
Country A		
Goods under merchanting	50	80
Currency & deposits	30	
Country B		
Goods	80	
Currency & deposits		80
Country C		
Goods		50
Currency & deposits	50	
Global balance		
Goods	130	130
Goods under merchanting	50	80
Currency & deposits	80	80

Case 3: Transactions that straddle recording periods

The following example illustrates the principles of the present and proposed treatments if transactions straddle the recording period. The value of the transactions is the same as in the basic case. However, resident of A purchases from the resident of B in time **t** and resells the goods to a resident of C in time ***(t+1)***. Goods physically move from Country B to Country C directly, and not entering into Country A. It is assumed that all transactions are settled by currency and deposits.



Present treatment

a) period t	**Credit**	**Debit**	**b) period (t +1)**	**Credit**	**Debit**
Country A			**Country A**		
Goods		80	Goods		-80
			Services: Merchanting	20	
Currency & deposits	80		Currency & deposits		100
Country B			**Country B**		
Goods*	80				
Currency & deposits		80			
			Country C		
			Goods		100
			Currency & deposits	100	
Global balance			**Global balance**		
Goods	80	80	Goods		20
			Services: Merchanting	20	
Currency & deposits	80	80	Currency & deposits	100	100

Proposed treatment

a) period t	Credit	Debit	b) period (t +1)	Credit	Debit
Country A			**Country A**		
Goods under merchanting		80	Goods under merchanting	100	
Currency & deposits	80		Currency & deposits		100
Country B			**Country B**		
Goods*	80				
Currency & deposits		80			
Country C			**Country C**		
			Goods, debit		100
			Currency & deposits	100	
Global balance			**Global balance**		
Goods	80	80	Goods	100	100
Goods under merchanting		80	Goods under merchanting	100	
Currency & deposits	80	80	Currency & deposits	100	100

* It is assumed that country B records the transactions of the relevant goods based on "change of ownership", rather than physical movement of the goods. In practice, many countries record trade in goods based on trade statistics, under which data are compiled based on goods physically cross the customs. If the country B records exports based solely on customs data, the country might record the export of the related goods in period (t+1), when the goods actually cross the customs. In such a case, errors and omissions would be recorded under country B's balance of payments in both period for balancing currency & deposits (t) and goods credit (t+1). Alternatively, the timing problem could show up in trade credit, if the countries derive trade credit from the difference between goods transactions from customs and those from banking system data

Reference

Merchanting BOPTEG Issues Paper # 16
Balance of Payments Manual, Fourth Edition (1977)
Balance of Payments Manual, Fifth Edition (1993)
Balance of Payments Compilation Guide (1995)
Balance of Payments Textbook (1996)
Manual on Statistics of International Trade in Services (2002)
1993 System of National Accounts