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***Item 6: Goods for Processing***

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### **1<sup>st</sup> meeting of the Expert Group on International Merchandise Trade Statistics**

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#### **Object: Goods for processing, change of economic ownership, "income view" instead of "engineer's view" and relative developments in the future manual IMTS, Rev.3**

The current manual IMTS, Rev.2 quotes many times the purpose to provide the needs of many users, among them are particularly the compilers of National Accounts and Balance of Payments. In its last paragraph, it says:

*"163. In the long run, provided that countries find it practical, modification of the customs procedures and development of non-customs data collection methods might create a basis for the recording of change of ownership of internationally traded goods. When and if such a stage is reached, the present recommendations might be reviewed with a view to achieving more harmonization with the 1993 SNA and BPM5 concepts."*

Such a stage is not yet reached, but developed countries use more and more non-customs data and consequently "change of ownership" rules<sup>1</sup>, and SNA 1993 Rev.1 and BPM6 have modified recently their conventions, in order to be more consistent with their basic concepts (i.e. change of "economic" ownership between residents and non-residents as basis for imports or exports of goods). Goods sent abroad for processing will be there treated as international trade of services. In parallel, the new international classifications of activities and products have reinforced the "income view" (relying on an "economic ownership") upon the "engineer's view" (relying on physical flows) in the treatment of industrial outsourcing (~ goods for processing). In order to promote an integration of all economic statistics, the challenge for the future manual IMTS, Rev.3 is to make one step forward in the direction of "change of economic ownership", at least for the case of "goods sent abroad for processing".

#### **I The substance of recent modifications in SNA 1993 Rev.1 and international classifications of activities and products: "economic ownership" of goods and manufacturing services**

##### **1) The original SNA 1993 was "hybrid" in the definition of the external trade of goods: concept "change of ownership" but definitions close to "customs statistics"**

Conceptually, the SNA 1993 was relying on the "change of ownership" between residents and non-residents, as should be the Balance of Payments:

*§ 14.55 : "[...] When the ownership of a good is exchanged between a resident and non-resident, there is a strong presumption that the good will cross the frontiers of the countries concerned either shortly before, or soon after, the change of ownership takes place, but not all exports and imports do so. Conversely, many goods cross frontiers without any change in ownership taking place, so that they are not to be counted as exports or imports."*

<sup>1</sup> See the results of the 2006 NCDP questionnaire.

Consistently, the “customs statistics” were not the compulsory source of National Accounts:

*§ 14.56 : “[...] It should not be assumed, therefore, that documentation submitted at a frontier invariably constitutes the principal source of data on exports or imports.”*

But, conceptually, it requested a valuation Fob, which is more relevant for customs statistics than for Balance of Payments (and which can be undetermined if the good does not cross a frontier or does not originate physically from the “exporting” country):

*§ 14.36: “Exports and imports of goods should be recorded at the market value of the goods at the point of uniform valuation, (the customs frontier of the economy from which they are exported), i.e., the goods are valued free on board (f.o.b.) at that frontier. [...]”*

And, above all, the SNA 1993 admitted 4 practical “Exceptions to the change of ownership principle” (§ 14.57-14.64), which were meeting the “natural” observations of customs statistics:

*§ 14.58: “The first exception concerns goods which are the subject of a financial lease. [...]”*

*§ 14.59: “The second exception to the change in ownership principally concerns goods shipped by an enterprise to a branch or subsidiary which it owns in a foreign country or to a foreign affiliate which belongs to the same group of enterprises as the exporter.[...]”*

*§ 14.60: “The third exception is one in which a change of ownership may occur but is ignored in the accounts. The exception relates to merchants or commodity dealers who buy commodities or other goods from non-residents and then sell them again to non-residents within the same accounting period without the commodities actually entering the economy in which the merchants are resident. The difference between the receipts and the sales of such dealers is treated as measuring the value of the services they provide and recorded under exports or imports of services. [...]”*

*§ 14.61: “The fourth and final exception to the change in ownership principle relates to goods which are sent for processing abroad. In general, the principle adopted in the System is that goods sent abroad temporarily without change of ownership between resident and non-resident units are not to be counted as exports or imports. [...] In these circumstances the goods originally sent abroad lose their identity by being transformed or incorporated into other goods. Similarly, the goods received back are essentially new goods produced abroad. [...]”*

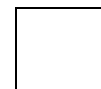
To be frank, the SNA 1993 was not much straightforward for this last item:

*§ 14.64: “[...] It is suggested, therefore, that goods should be treated as being processed when the goods from abroad have to be classified in a different group (3 digit level) of the Central Product Classification (CPC) from the goods sent abroad out of which they have been processed. On the other hand, when the goods returned fall in the same group of the CPC as the goods sent abroad, they should not be included in exports and imports of goods, the processing being treated as a service activity.”*

Due to the difficulty of matching the “sent” and “returned” goods, and consistently with the recommendation of BPM5, most countries have not used this criterion of group in CPC and have systematically treated goods “for processing” in external trade of goods. On the opposite, goods “for repairs” were treated in external trade of services.

In SNA 1993 Rev.1, the issues n° 40 and 41 have considered the third (“merchanting”) and the fourth (“goods sent abroad for processing”) exceptions, and have suppressed them<sup>2</sup>. As the first two exceptions concern differences between “ownership” and “economic ownership”, **SNA 1993 Rev.1 can be considered as relying imports and exports of goods on “change of economic ownership of goods”**. In the text of SNA 1993 Rev.1, “ownership” is now always preceded by “economic”.

<sup>2</sup> With the restriction for « goods sent abroad for processing » that only “back and forth” flows are considered, according to a note of UNSD disseminated in the ITS-TIS meeting of September 2007 in OECD, but this restriction is perhaps not necessary, neither desirable, as it is uneasy to distinguish “back and forth” from “triangle-shaped” exchanges.

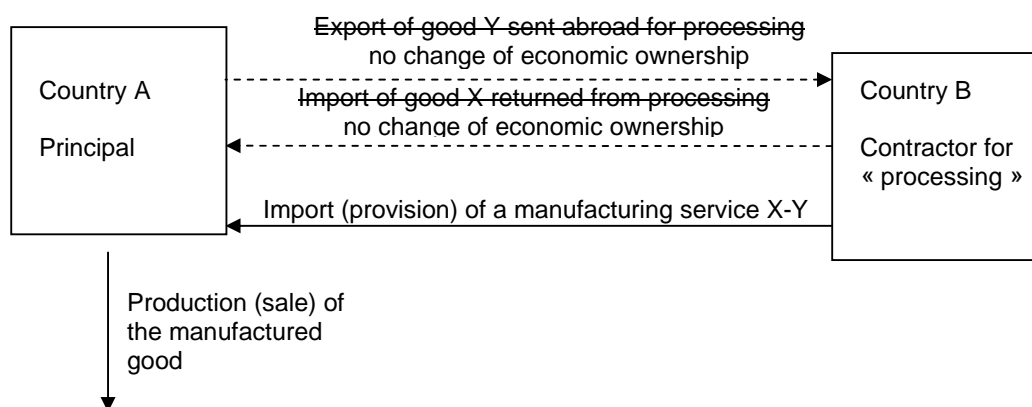


## 2) New rules of classification for outsourcing: an “income view” of production of goods, and a description of manufacturing services

One argument of paragraph 14.61 of the SNA 1993 was reflecting an “engineer’s view” on the nature of production: “*Similarly, the goods received back are essentially new goods produced abroad*”. This view is no longer consistent with the “income view” which prevails in the definitions of activities and products in case of manufacturing outsourcing, according to the decision of the Technical Sub Group of the Expert Group on International Economic and Social Classifications, UNSD, in April 2007: “*Treatment of Outsourcing in the International Standard Industrial Classification (ISIC), Rev.4*”.

*“A principal that owns the material inputs and thereby has economic ownership of the outputs, but has the production done by others, is classified to section C (Manufacturing), specifically to the classification category that corresponds to the complete (outsourced) manufacturing activity.”*

The principal is then considered as the producer of the good, the contractor as a producer of a service. The consequence is more explicit on the part D of this note dedicated to products in CPC, Ver.2, here translated in the basic case of goods sent abroad for processing:



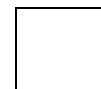
With these new rules, the **owner of the “good sent abroad for processing” is also the owner and the (domestic) producer of the returned good**. The contractor could hardly “export” a good he has not “produced” neither owned; he only produces and then exports a “manufacturing service”, on a net basis. Conversely, the principal cannot “import” a good that he has always owned and that he is reputed having produced himself. He only consumes and then imports a “manufacturing service”.

## **II The consequences on the “International Merchandise Trade Statistics” concepts and definitions**

### **1) Conceptually, “processing” and “repairs” should be treated in the same way**

From an “income view” now shared by national accounts, BPM6 and international classifications of activities and products, goods sent abroad for “processing” or for “repairs” are in the same situation: the goods have never changed of (economic) ownership, neither been produced by residents of another country than the consumers (in case of “back and forth” flows), the only objects of trade are “industrial services”, either division 87 of CPC: “*Maintenance, repair and installation (except construction) services*”, either division 88: “*Manufacturing services on physical inputs owned by others*”.

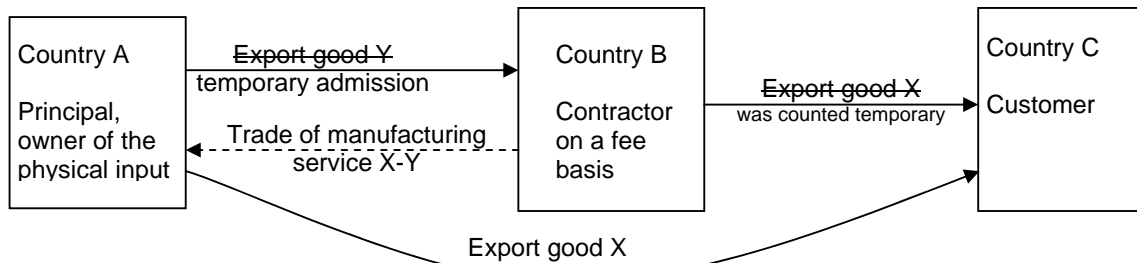
Consistently, the specific guidelines of IMTS, Rev.3 should be revised by an alignment of “goods for processing” on “goods for repair” (not “*to be included in the detailed IMTS*” but “*to be excluded and recorded separately for national accounts and Balance of Payments purposes*”). The recommendation on their valuation (paragraph 123) should be similar too (for instance both on a gross basis before and after processing respectively, distinguishing inward and outward processing: 4 kinds of flows; apart from an order of magnitude, the most important information is the identifier of the domestic enterprises involved, which another statistical service will certainly survey).



The report on 2006 NCDP questionnaires and compliance with IMTS, Rev.2 says that “countries are normally unable to capture goods for processing if they are not so declared.” It is also true for “goods for repair”. Although they are recommended to be excluded, we can note on the same document that only a half of the countries have done so. Were the others unable to do so?

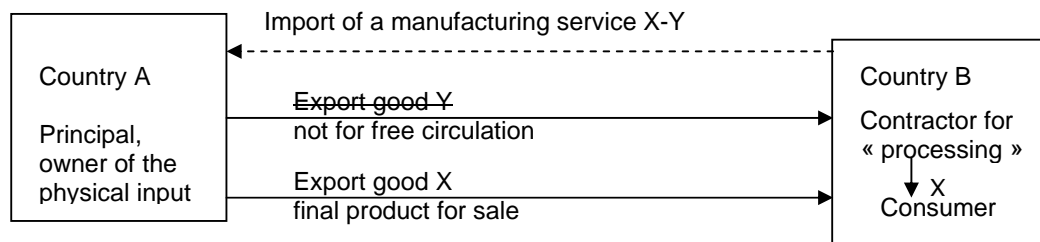
When the good for processing / repair is imported / exported, it is primarily declared for temporary admission. These two purposes should be recorded in a variable “nature of transaction”, which exists on the Single Administrative Document, even if in practice customs use a third digit in the kind of regime. If the good is returned to the same country after processing / repair, under the procedure “reexportation” / “reimportation”, the knowledge of the previous regime avoids to count it and no flow is recorded, neither in imports, neither in exports (but separately for the purposes of national accounts and Balance of Payments, with a consistent “nature of transaction” = “after processing / repair”). If the good is exported after processing to a tierce country, it is also to be declared under a reexportation procedure, excluded from exports of the compiling country as it was not counted in imports in the previous regime, and recorded separately for the purposes of national accounts and Balance of Payments with the same “nature of transaction” (“after processing / repair”). If the good is finally brought to free circulation in the country it has been processed, it is then to be “regularized” in imports with its final gross value and the new classification of the commodity (which has been transformed), the nature of transaction must be “acquisition/sale” and the flow is also to be recorded for the purposes of NA and BoP (ideally all flows “before” and “after” are to be recorded in order to avoid fallacious big balances transmitted to the other statistical services, but we can see that the “nature of transaction” will not be enough, as a good can be sent “after processing or repair” and “for sale”). If the originating exporting country knows that the good will never return after processing, it should be declared as a definitive exportation of the anticipated final product, with the mention of the last known destination equal to the presumed country of consumption. If the final country of consumption knows that it was only processed / repaired in the country of consignment, it should record in the country of origin this of the owner or, if it is itself the country of the owner, it should then declare the physical input material purchased abroad for its initial value and its country of production (if there is no physical input material purchased abroad, we are in the classic case of “back and forth” flows: no import to declare).

**Some particular cases which are not back and forth**



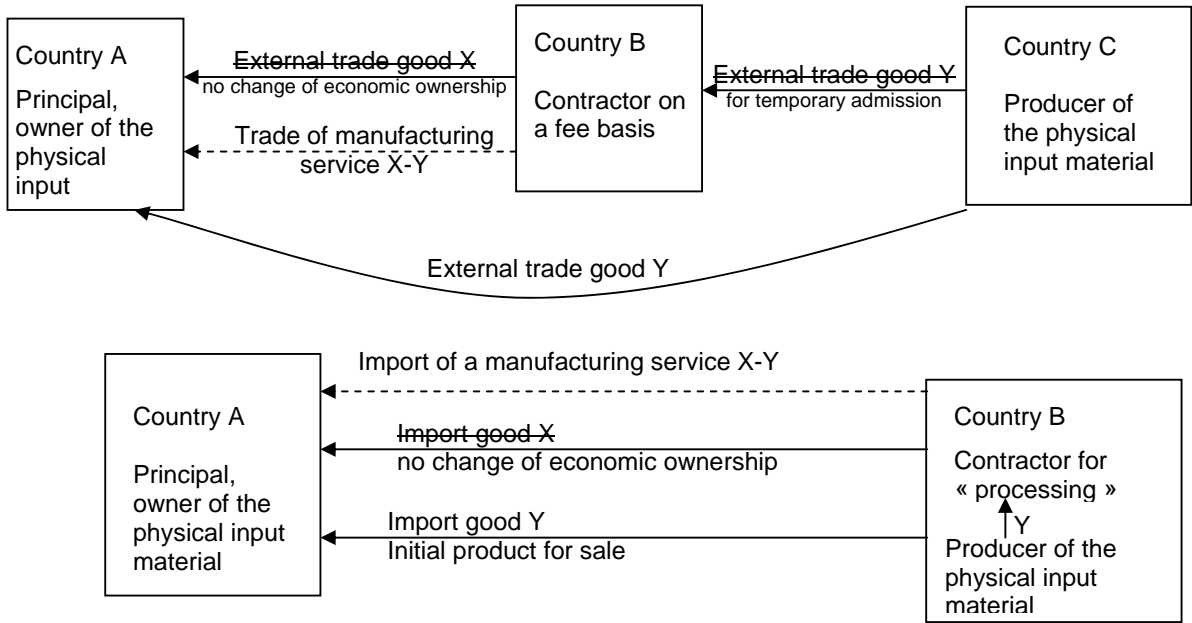
Export : IMTS, NA and BoP

Import : NA and BoP



The most important particularity of “processing” with regard to “repair” is that the classification of the commodity is not the same “before” and “after” processing, and that the “change of economic principle” would lead to declare another commodity than the one that moves physically. But it would be more consistent with the taxation system.



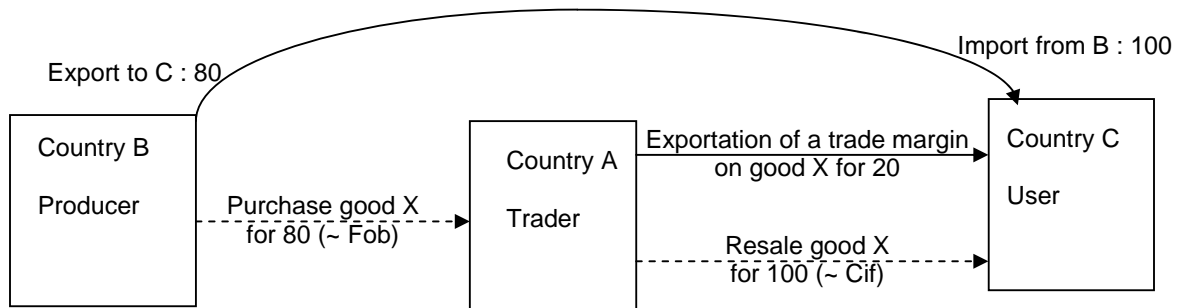


There exist other cases where the goods never enter the frontier of the principal, owner of the physical input material. It will necessarily be out of the scope of IMTS. For the purpose of national accounts and Balance of Payments, if it is not reputed to be recorded in the accounts of a non-resident affiliate, it could be collected under the surveys on “merchanting”, but reported as “production” and not as “trade margin”.

**2) The rules of the convention of Kyoto for the “country of origin” correspond no longer to the “country of production”, which should be the more convenient partner country for national accounts and Balance of Payments**

As we can see on the above reasoning, the consistent “country of origin” for balanced mirror flows should be the “country of production” of the product in the sense of national accounts and international classifications of activities and products.

It is also the case for merchanting:



purchase : monetary flow

Export : recommended flow in national accounts and balance of payments

The three national commodity flows of good X should be described as:

	Production	Import	Trade margin	=	Consumption	Export
Country A:			20			20 (to C)
Country B	80					80 (to C)
Country C		100 (from B)			100	



Even if the trader has acquired a temporary “economic ownership” of the good, the partner countries recommended by national accounts and balance of Payments are the country of production and the country of consumption respectively and the flows with Fob valuation could be balanced as national accounts at basic prices.

**It suggests that the rules defined by the Kyoto Convention for the country of origin, which were reflecting an “engineer’s view”, are no longer convenient for IMT Statistics if they are to be integrated with NA, BoP and international classifications:**

*17. "Where two or more countries have taken part in the production of the goods, the origin of the goods shall be determined according to the substantial transformation criterion" (Kyoto Convention, annex D.1, p 11).*

*"The term 'substantial transformation criterion' means the criterion according to which origin is determined by regarding as the country of origin the country in which the last substantial manufacturing or processing, deemed sufficient to give the commodity its essential character, has been carried out" (Kyoto Convention, annex D.1, p. 9).*

*18. According to the Kyoto Convention, "In practice the substantial transformation criterion can be expressed:*

*"- by a rule requiring a change of tariff heading in a specified nomenclature with lists of exceptions, and/or*

*"- by a list of manufacturing or processing operations which confer, or do not confer, upon the goods the origin of the country in which those operations were carried out, and/or*

*"- by the ad valorem percentage rule, where either the percentage value of the materials utilized or the percentage of the value added reaches a specified level" (Kyoto Convention, annex D.1, p. 12).*

The new rules would have to take account of the ownership of the physical input material, as in ISIC, Rev.4 and CPC, Ver.2 and would exclude “processing” strictly speaking (as well as percentage of the value added).

Of course, the engineer’s view is still relevant for the GATT policy, as it would be too easy for the trader to become “producer” by purchasing the physical input material and to avoid therefore all the system of tariffs or quotas! Perhaps we have to define a “country of production” beside the “country of origin”. The “country of production” would be recommended for the compiling of IMTS, NA and BoP.

### **3) Some guidance on the FOB and CIF values in case of triangle-shaped exchanges**

The case of “back and forth” processing is not very interesting for the refinement of FOB and CIF conventions, as these flows would be excluded from the detailed IMTS.

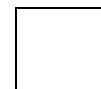
In case of merchanting or triangle-shaped exchanges, the valuation Fob of the export should not include the non-resident trade margin, while the valuation Cif of the import should include it all. It is the only solution to produce balanced mirror flows on a Fob valuation.

### **4) The notion of “change of economic ownership through the frontiers” could be introduced in the manual IMTS, Rev.3, but it is not necessary in order to interpret the “change of stock of material resources of a country”**

It is not necessary to modify the theoretical “coverage” of International Merchandise Trade Statistics in the manual IMTS, Rev.2:

*14. Coverage. As a general guideline, it is recommended that international merchandise trade statistics record all goods which add to or subtract from the stock of material resources of a country by entering (imports) or leaving (exports) its economic territory. Goods simply being transported through a country (goods in transit) or temporarily admitted or withdrawn (except for goods for inward or outward processing; see para. 28 below) do not add to or subtract from the stock of material resources of a country and are not included in the international merchandise trade statistics. [...]*

Goods sent abroad for processing do not add or subtract from the stock of material of the country where they are processed, as the economic ownership is not transferred and their vocation is to be quickly withdrawn towards the same or another country. If the good is finally brought to free circulation (consumption) in the country of the processing, it is at this time



only, with the consequent regularization, that the good can be considered adding to the stock of material resources.

We do not suggest to include merchanting in basic IMTS, as such informations are not usually collected with customs data, which remain the most important source for IMTS (with some administrative declarations organized in the same framework). Goods traded under merchanting do not add to the stock of "material resources" but to the stock of "monetary resources" only, for the country of the trader.

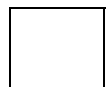
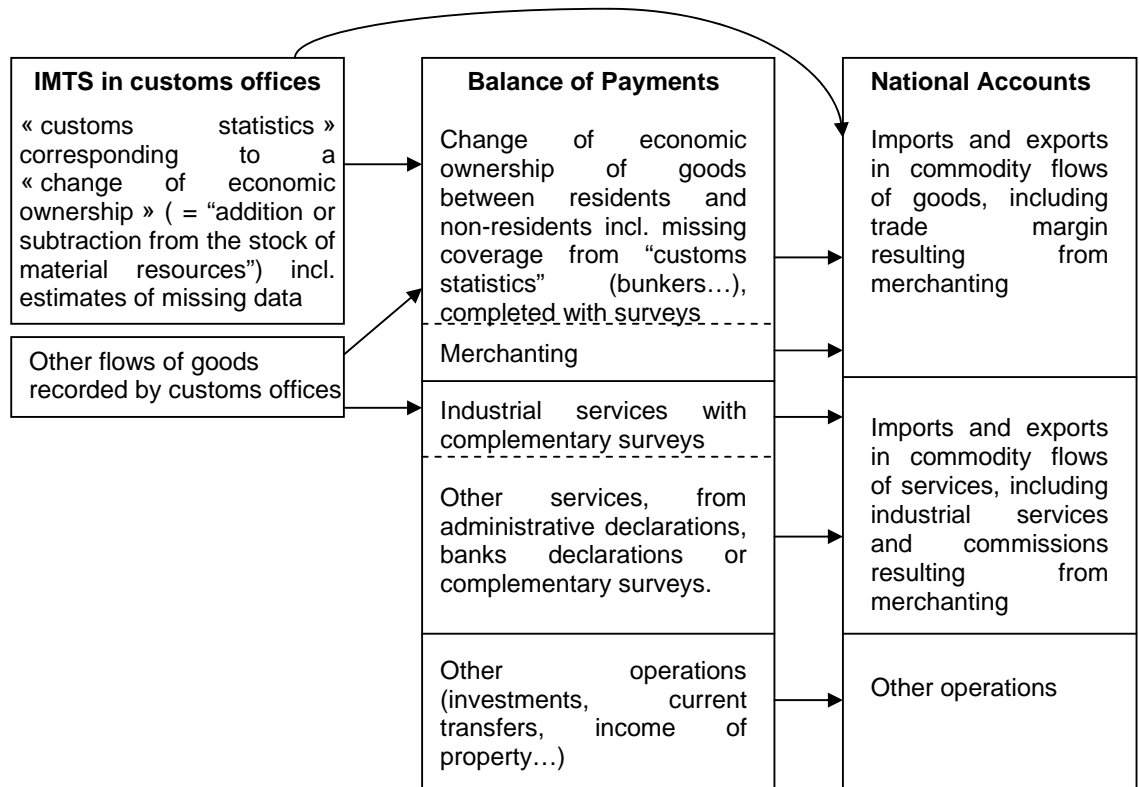
It could be worthy to add in this theoretical definition of IMTS coverage that it coincides with the "change of economic ownership" each time goods cross the frontier of the compiling country, with the help of regularizations when goods declared for temporary admission are finally brought to free circulation (for a definitive consumption).

To be fully consistent with the change of economic principle, returned goods, reimportations and reexportations could be better treated in regularizations and "negative" exportations and importations, but the issue is perhaps not so crucial.

**5) It is necessary to clarify the picture for the responsibility of statistics on "goods sent abroad for processing" and "merchanting" (and some more items)**

When it is written in comments of the SNA 1993 Rev.1 that "goods sent abroad for processing" have been transferred from "goods" to "services" and that "merchanting" has been conversely transferred from "services" to "goods", it is a view of commodity flows in national accounts, but not an automatic and symmetric transfer of responsibility between IMTS and Balance of Payments. For many statisticians, the picture of "goods" and "services" is now misted, and some omissions could be resulting from this situation. "Merchanting" could be considered as excluded from the core tasks of the statistical service of the Balance of Payments (which focusses on "international trade of services", and BPM6 says now that merchanting deals with "goods"), but merchanting does not fit either with the "customs statistics" that are the basis of IMTS. If IMTS wants to include merchanting in its scope, it will certainly involve or promote a transfer of responsibility of "full IMTS" from "customs offices" to National Statistical Institutes. We can observe this evolution in the report on 2006 NCDP questionnaires, but IMTS is still often produced by customs offices, which will have difficulties to adapt themselves to this extended scope.

"Traditional" articulation, with merchanting out of IMTS:





“Alternative” articulation, if merchanting is in IMTS:

