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Treatment of Freight and Insurance Associated to Merchanting and the Geographical Allocation of Net Merchanting

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The revised classification of merchanting transactions in BPM6 *- which requires such transactions to be recorded in the goods account whilst it was previously a service - brings about a discussion on the correct treatment of associated freight and insurance services as well as the counterpart country to be recognized for the net export of goods under merchanting. For freight and insurance associated to merchanting, the note clarifies the recommended treatment which can be inferred unambiguously in our view from* BPM6 *provisions. For the geographical allocation of net merchanting two alternatives are outlined. The paper argues that* BPM6 *provisions hint at compiling the net item as the sum of all positive and negative credit entries against each counterpart country of the underlying goods transactions.*

I. Introduction

1. According to the IMF's *Balance of Payments and International Investment Position Manual (BPM6)*, merchanting is defined "as the purchase of goods by a resident (of the compiling economy) from a nonresident combined with the subsequent resale of the same goods to another nonresident without the goods being present in the compiling economy" (BPM6 paragraph 10.41).

2. Although *BPM6* retains the overall concept of merchanting from the fifth edition of the IMF's Balance of Payments Manual (*BPM5*, paragraph 262), the revised classification of merchanting under goods transactions instead of services raises some questions that require further clarification. Two issues are discussed in the following sections of the paper: first, the treatment of freight and insurance in connection with the transportation of the goods imported/exported under merchanting and second, the country allocation of the item "net exports of goods under merchanting".

II. Treatment of freight and insurance for goods under merchanting

3. With the introduction of *BPM6* merchanting transactions are to be classified under goods (and no longer under services as in *BPM5*), with purchases and resales shown on a gross basis as negative and positive exports, respectively, and net amounts included in the goods exports aggregate. Therefore, from the viewpoint of a balance of payments (BOP) compiler of country A where a merchant is resident, it could be argued that freight and insurance costs associated with the transportation of these goods between country B of the seller to country C of the purchaser should be treated for the recorded gross flows (purchases/sales under merchanting) in the same way as all other freight and insurance costs incurred with "regular" imports and exports, i.e. fob at the border of the exporting country.

4. Such a conclusion, however, would ignore that the point of uniform valuation at the customs frontier of the exporting country, as stipulated in paragraph 10.30 of *BPM6*, only

applies to the valuation of general merchandise. And goods transactions between residents and non-residents which fall under the definition of merchanting are explicitly excluded from general merchandise, as stated in paragraph 10.13 *BPM6*. Transportation and insurance costs associated with merchanting transactions are therefore included or excluded in the value of transaction prices as agreed by the merchant with its counterparties (see paragraph 10.44 of *BPM6*), depending on the agreed delivery terms.

5. For example, if a merchant A agrees with the seller B and the buyer C an ex works price, the transaction values (from the viewpoint of the merchant A) exclude any of the transport and insurance costs and also net merchanting will not include these charges. In contrast, if A concurs with both parties to be responsible for the transport and insurance, the transaction value for the purchase under merchanting will exclude these costs but the value for the sale under merchanting and the value for net merchanting will include them. If, in the latter case a non-resident is contracted by A to transport the goods from B to C or to provide freight insurance these costs are recorded separately as a service import in the BOP of the country of residence of the merchant A. Any other delivery term agreed between the parties will result in BOP entries following the same reasoning.

6. This treatment also coincides with the definition of freight transportation and freight insurance. According to paragraphs 10.78 and 10.116 *BPM6* such services are only recorded in the balance of payments in connection with a countries' exports and imports (which implies that the goods cross the border of the compiling country) or in cases where the goods do not change ownership. Obviously, the latter case applies to transports and insurance costs borne by the merchant A. After the purchase from B he becomes the owner of the goods and takes the responsibility for the delivery to C. If A uses third parties who are resident in a foreign economy to transport and insure the goods, economy of A recognizes in its balance of payments a transportation and insurance service import like it would be the case for similar costs when sending goods for storage or processing.

7. Further, this recording of transport and insurance costs is also in line with the recommendation given in paragraph 14.74 of the *System of National Accounts 2008 (SNA 2008*) regarding transport of merchanted goods which refers to the general rules of the treatment of transport margins (paragraph 14.53 *SNA 2008* and following).

III. Geographical allocation of net merchanting

8. Neither *BPM6* nor the *BPM6 Compilation Guide (Guide)* currently provide explicit guidance related to the geographical allocation of the item net merchanting. As long as a country only publishes its BOP at the level of "world total" the question has indeed no relevance. However, more and more countries today publish BOP-figures with a more or less detailed country breakdown and the issue has high relevance for BOP compilers, especially in view of recording global production arrangements or for compiling international input/output tables.

Two alternatives for the geographical allocation of net export of goods under merchanting

9. The following remarks mainly trace a discussion which has taken place in the European Union throughout 2012/2013 in the course of preparing the implementation of *BPM6* for the year 2014. The discussion at the time concluded that the issue can be seen from two perspectives; one is the conceptual angle and the other a more practical angle.

10. In general, two ways of recording the geographical breakdown of net merchanting can be considered[1].

1. The net "export of goods under merchanting" is purely the sum of all (positive and negative) credit entries against each country. Merchanting would be therefore treated in the same way like any other transaction under general merchandise (further on called alternative 1).
2. The net "export of goods under merchanting" of each transaction is allocated to the country of the buyer of the goods (further on called alternative 2).

11. Before some of the conceptual issues are discussed it should be mentioned that none of the alternatives will affect the bilateral asymmetries in the goods account of the exporting and importing countries. Asymmetries are an inherent problem in the case of merchanting.

12. From the absence of clear indications about the geographical allocation of the item "net export of goods under merchanting" in both *BPM6* and the *Guide*, one could deduce that no special treatment for the net merchanting item is intended, i.e. that the net should be purely the sum of the underlying gross flows (alternative 1).

13. This interpretation is substantiated by the example given in Table A5.3 of the Guide on the country attribution of the gross flows in context with the purchase and the sale of goods under merchanting.

[1] In the context of EU discussions Austria suggested a third option for the geographical breakdown of merchanting. Following this proposal, merchanting could be treated in a similar way as "buying/selling margins", since merchants provide services to both buyers and sellers. The geographical breakdown of net merchanting could therefore be done by adding up the "merchanting-turnover" (imports plus exports) and then distributing pro-rata the global net values to all countries of imports and exports. The alternative was not further elaborated in the EU and can be seen as a variant of alternative 2 where the total net is distributed to the export countries.

Table A5.3 Comparison of Merchandise Trade and Trade in Goods for Merchanting						
	IMTS (movement of goods)			Balance of payments—trade in goods (change of ownership)		
	Partner economy			Partner economy		
	A	B	C	A	B	C
Economy A records	...	...	...	...	Negative export	Export
Economy B records	...	...	Export	Export	...	...
Economy C records	...	Import	...	Import	...	...

14. In the example, the merchant resides in country A, the seller in B and the final buyer in C. It can be seen from the table, that the gross flows under merchanting are recorded as any other transaction under general merchandise, i.e. the country where the merchant resides records the purchase (=negative export) with partner B and the subsequent sale as an export to country C. As mentioned before, no indication for the treatment of the net item is provided.

15. Likely, the authors of *BPM6* did not see a need to further elaborate on this issue because it is obvious that for consistency reasons the net should be treated like the gross flows, i.e. as the sum of all goods which changed ownership between residents and non-residents (of the rest of the world or a single partner country). In the above example this would mean, that the net reflects the negative export (e.g. of -100) against B and a positive export (e.g. of + 120) against C. The value of total net merchanting against the world would then be +20. Admittedly, for a single partner country, the aggregated net item under this option is difficult to interpret economically and in an extreme case might even result in negative exports in the bilateral balance on trade in goods if a negative net merchanting aggregate is not absorbed at the level of general merchandise[2].

16. Under alternative 2, the BOP of country A would record under net merchanting +20 against country C which would correspond neither with the recorded gross flow for country B nor for country C, i.e. users would not be able to calculate the net at the country level from the gross flows as it is the case under alternative 1.

Geographical allocation of similar economic transactions

17. Opting for alternative 1 is further in concordance with recording of other items of the goods account which have an economic impact quite similar to merchanting.

a. Goods sold by merchants to residents (*BPM 6*, paragraph 10.48)

18. Under paragraph 10.48 *BPM6* describes transactions where a resident merchant is purchasing goods from a non-resident and sells them to another resident,

[2] See also BPM6, Paragraph 10.44 (c)

who then resells these goods to a non-resident. Economically, the impact of such transactions is obviously the same as for merchanting with the only difference, that a second resident merchant is involved.

19. *BPM6* stipulates for these cases that the purchase is to be shown as an import (from the country where the former owner resides) and the resale to the non-resident as an export (to the country where the new owner resides) under general merchandise. In line with this rule, the balancing item, too, must represent the sum of all debit and credit transactions against each country. It seems to be stringent to allocate "net exports of goods under merchanting" similarly.

20. The fact that changes in inventories are also included in the net item (*BPM6*, paragraph 10.44) also supports the same treatment. Such changes happen for instance when goods are purchased but not resold in the same accounting period. Here, no difference between the sales over the purchase price can be calculated and the negative net can only be attributed if alternative 1 is applied.

b. Re-exports (*BPM 6*, paragraph 10.37-10.39)

21. *"Re-exports are foreign goods (goods produced in other economies and previously imported) that are exported with no substantial transformation from the state in which they were when previously imported" (BPM6*, paragraph 10.37). Again, this definition exhibits potential similarity to merchanting when three parties are involved (country of original exporter; country of importer, and country of destination of re-exported goods), though in terms of recording re-exports are gross flows only (shown separately from exports). A further difference is that the goods must pass the reporting economy while for "net exports of goods under merchanting" the goods must be located abroad. The country allocation in this case corresponds for the re-exports (as well as the former imports) to the example under a. and can be seen as an additional argument for choosing alternative 1 for "net exports of goods under merchanting".

c. Non-monetary gold (*BPM6*, paragraph 10.50-10.54)

22. According to paragraph 10.50 *BPM6* non-monetary gold covers all sales and purchases regardless whether the non-monetary gold is shipped or not. Given this definition the BOP item "non-monetary gold" includes both, merchanting transactions (no physical movement across the border of the compiling economy) and transactions followed by a physical movement. Again, "merchanting" purchases/sales are recorded here like normal imports/exports with the net attributed in the way it is described for alternative 1.

23. To summarize, all remarks in *BPM6* regarding transactions that show similar economic characteristics to goods under merchanting do not back the option of

allocating “net merchanting” in the same way as the former *BPM5* services component “merchanting“ (as proposed by alternative 2). Also, the heading of the new item points into this same direction. Not “merchanting” is shown, but the (net) value of goods acquired and resold abroad.

IV. Conclusion

24. The discussion under section II highlighted, that *BPM6* gives clear guidance in regard to the treatment of freight transportation and insurance. Paragraph 10.44 states that the goods under merchanting are valued at transaction prices agreed between the parties and not on a fob/fob basis as for regular imports and exports. As a consequence, the paper concludes that recording of these costs depends on the agreed delivery terms. If the merchant of the goods is responsible for transportation and insurance, the transaction value for the purchase under merchanting will exclude these costs but the value for the sale under merchanting and the value for net merchanting will include them. If in the latter case a non-resident is contracted by the merchant to transport the goods from B to C or to provide freight insurance, these costs are to be recorded as a service import in the BOP of the country where the merchant resides.

25. In section III we argue, that *BPM6* and the *Guide* provide indications that “net exports of goods under merchanting” should not be allocated differently than other items of the goods account. This is underpinned by several examples of similar types of transactions mentioned in *BPM6*, leading to conclude that -from a conceptual point of view – countries should generally allocate “net merchanting” geographically by adding up all credit and debit entries of goods under merchanting for each partner country (alternative 1).

Questions to the Committee:

1. *Does the Committee share the opinion regarding the conceptual treatment of freight transport and insurance costs associated to merchanting transactions?*
2. *Which alternative, allocating net merchanting according to alternative 1 or alternative 2, would be recommend by the Committee considering the arguments as outlined in section III of the paper?*
3. *Do Committee members agree that the concluding step would be to publish a clarification beyond dispute that addresses the treatment of freight and insurance associated with merchanting and geographical allocation of net merchanting?*