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**Strategy for Implementing Recommendations
on Goods for Processing and Merchanting in BPM6
- The Case for Hong Kong**

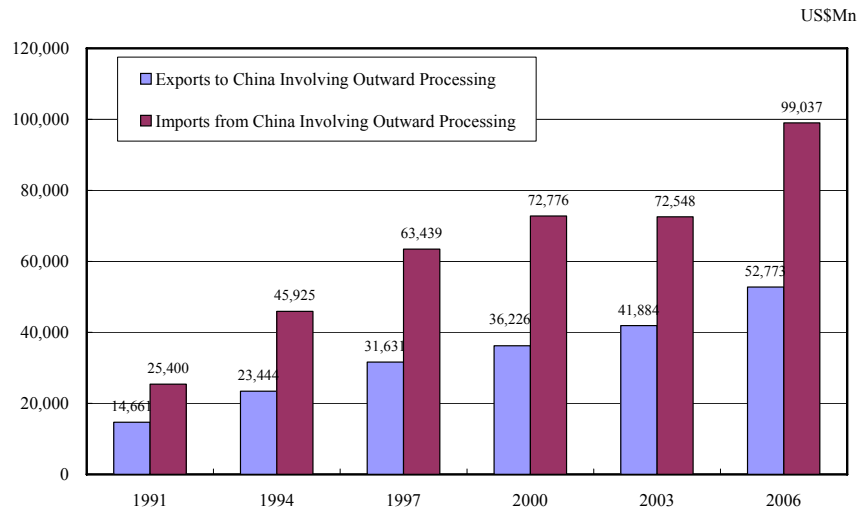
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Strategy for Implementing Recommendations on Goods for Processing and Merchancing in BPM6 - The Case for Hong Kong

Hong Kong is one of the world's largest trading entity and a premier trading hub in the Asia Pacific region. The past decades saw a continuous integration between the Hong Kong economy and the economy of Mainland China. Factories operated by Hong Kong entrepreneurs in the Mainland produce a wide range of commodities which are exported to many parts of the world.

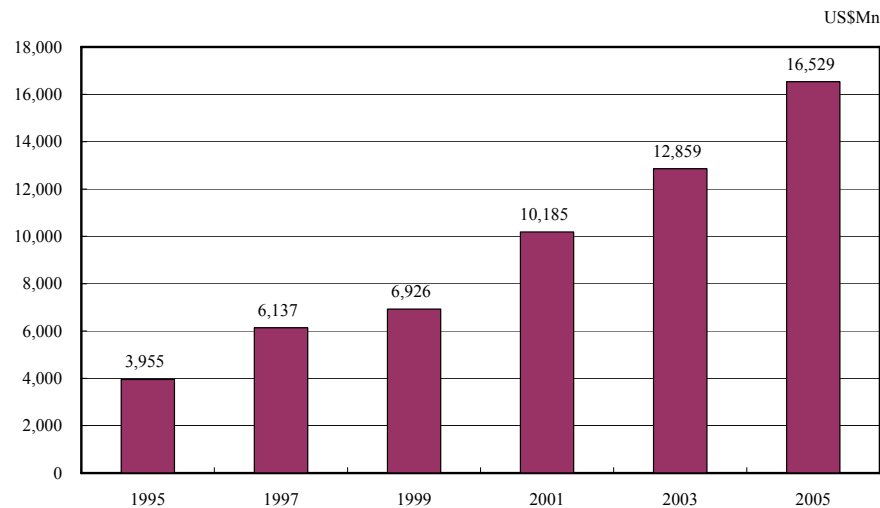
2. Over the past years, trading activities relating to ‘goods for processing’ and ‘merchancing’ play a vital role in the external trade front of Hong Kong. In 2006, about 30% of imported goods into Hong Kong, and 17% of goods exported from Hong Kong were related to goods for outward processing in the Mainland, whereas about 26% of exports of services of Hong Kong were related to ‘merchancing’ activities. The historical trend of outward processing trade of Hong Kong with Mainland China¹, and exports of merchancing services from Hong Kong, is presented in Charts 1 and 2 respectively.

Chart 1 Outward Processing Trade of Hong Kong with China



¹ Throughout the past twenty years, the Mainland of China remains to be the hinterland for outward processing activities of producers in Hong Kong. As Mainland China develops into a major manufacturing and processing centre in the region, its production cost remains relatively low. Take for example the production of computer monitors. Producers in Hong Kong would import major components from say, Japan, arrange to send the components to the Mainland for assembling, and then export the final products to the US. Producers in Hong Kong mainly perform the management, marketing and other manufacturing related functions. As an illustration, for every sales of US\$100 of these computer monitors, roughly about US\$50 would be the value of components imported from Japan, US\$17 the processing fees received by plants in the Mainland, and US\$33 the margins earned by producers and traders of Hong Kong.

Chart 2 Exports of Merchanting Services from Hong Kong



3. At present, data required for the compilation of goods account of Hong Kong's BoP statistics primarily come from external merchandise trade statistics compiled on the basis of trade declarations submitted by importers and exporters. The external merchandise trade statistics record all movements of goods at the time they cross the border of Hong Kong, but not at the time of change of ownership. "Goods for processing" are thus included in the merchandise trade statistics, and are recorded at the time they are exported to the processing economy or returned to the original economy for local use or re-export. This implies that a change in ownership is always imputed for "goods for processing" whenever they move into or out of Hong Kong, and are recorded on gross terms under the goods account.

4. Under the present framework, "merchanting" is also treated as an exception to the "change of ownership" principle. BPM5 defines "merchanting" as the purchase of goods by a resident (of the compiling economy) from a non-resident and the subsequent resale of the goods to another non-resident without the goods ever entering or leaving 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. BPM5 recommends recording such net amount of transactions under services rather than goods, though the commodity has changed ownership.

5. The new international statistical standards on 'goods for processing' and 'merchanting' which will be promulgated in BPM6 would have a substantial impact on the presentation, compilation and interpretation of external trade statistics of Hong Kong. The implementation of the new statistical standards would be one of the major initiatives and challenges of the Census and Statistics Department of the Hong Kong SAR in the coming years.

6. The major focus of this paper is to present preliminary ideas regarding future

plan of the Hong Kong SAR in implementing the new statistical standards under BPM6. Specific issues relating to data collection and dissemination of statistics are also briefly addressed in this paper. It should however be noted that the ideas as presented in the paper in the present form are only preliminary at this stage. It is expected that a thorough consultation process involving various parties concerned would be initiated shortly to provide inputs to enhance the implementation plan within resource limits.

New International Statistical Standards

7. A brief outline of the new international statistical standards in respect of “goods for processing” and “merchanting” which are to be recommended under the BPM6 is given below.

Goods for Processing

8. Under BPM5 and 93 SNA, the value of ‘goods for processing’ is recorded in both exports and imports of goods as genuine external trade in gross terms although no change of ownership is involved for those goods concerned. This is not consistent with one of the basic principles of balance of payments that a transaction should involve a change of ownership. Under BPM6 and 93 SNA Rev1, the value of ‘goods for processing’ would no longer be recorded in the goods account. Under the new standards, the payment of processing fees by the outward processing economy would be recorded as imports of services.

Merchanting

9. Under BPM5 and 93 SNA, the trade margin derived from ‘merchanting’ is recorded as exports of services in net terms by the economy where the trader resides. No external flow of goods is recorded in that economy notwithstanding that there is a change of ownership for those goods concerned. This is also not consistent with the ‘change of ownership’ principle. Under BPM6 and 93 SNA Rev1, ‘merchanting’ activities would be recorded in the goods account in net terms. The acquisition of goods abroad for ‘merchanting’ would be recorded as imports (shown as negative exports) of goods by the economy where the trader resides while the subsequent resale of goods as exports of goods from that economy

Impact of Implementing the New International Statistical Standards

10. In order to roughly assess the impact of implementing the new international statistical standards on relevant statistics of Hong Kong, an adjustment was made to the statistics for the year 2006 based on a crude estimation method. The adjusted figures help to illustrate the likely order of magnitude of the impact of the change.

Table 1 Impact of Implementing the New International Statistical Standards on ‘Goods for Processing’ and ‘Merchanting’

US\$Bn

External Trade of Hong Kong	Value for Year 2006	Adjusted for ‘Goods for Processing’ Only ²	Adjusted for ‘Merchanting’ Only	Adjusted for Both ‘Goods for Processing’ and ‘Merchanting’ ³
Imports of Goods	332	233 (-30%)	332	233 (-30%)
Exports of Goods	318	265 (-17%)	336 (+6%)	283 (-11%)
<i>Balance of Trade in Goods</i>	-14	+32	+5	+51
Imports of Services	37	83 (+127%)	37	83 (+127%)
Exports of Services	73	73	54 (-25%)	54 (-25%)
<i>Balance of Trade in Services</i>	+36	-10	+18	-29
<i>Balance of Trade in Goods and Services</i>	+22	+22	+22	+22

11. It can be seen from Table 1 that implementation of the new international statistical standards would have a sizeable impact on the external trade statistics of Hong Kong. In particular, the balance of trade in goods in 2006 would be revised from a deficit of US\$14Bn to a surplus of US\$51Bn, and the balance of trade in services from a surplus of US\$36Bn to a deficit of US\$29Bn. In addition, given the significance of ‘goods for Processing’ and ‘merchanting’ to the Hong Kong economy, the significant downward revision in the figures in respect of exports of goods and exports of services would change the relative ranking of Hong Kong in world exports of goods and services.

12. A comparison of the rankings of Hong Kong and major trading economies in terms of exports of goods and exports of services for 2006 are presented in Tables 2 and 3 respectively.

² Based on the assumption that the processing activities not related to the Mainland is not significant in size.

³ Summing up the adjustment for ‘goods for processing’ and the adjustment for ‘merchanting’ to obtain a combined adjustment. For example, the adjustment on exports of goods for both ‘goods for processing’ and ‘merchanting’, US\$(283-318)Bn, is equal to the sum of adjustment for ‘goods for processing’, US\$(265-318)Bn, and the adjustment for ‘merchanting’, US\$(336-318)Bn. Any remaining discrepancy is due to rounding.

Table 2 Top 15 Economies in Exports of Goods for Year 2006

(US\$Bn)		
Economy	Exports of Goods	Exports of Goods (Adjusted Figures) ⁴
Germany	1,131 (1)	1,131 (1)
United States	1,027 (2)	1,027 (2)
China	969 (3)	969 (3)
Japan	616 (4)	616 (4)
France	483 (5)	483 (5)
United Kingdom	450 (6)	450 (6)
Italy	417 (7)	417 (7)
Canada	402 (8)	402 (8)
Netherlands	391 (9)	391 (9)
Korea, Republic of	332 (10)	332 (10)
Hong Kong	318 (11)	283 (13)
Russian Federation	304 (12)	304 (11)
Belgium	284 (13)	284 (12)
Singapore	275 (14)	275 (14)
Mexico	250 (15)	250 (15)

Table 3 Top 15 Economies in Exports of Services for Year 2006

(US\$Bn)		
Economy	Exports of Services	Exports of Services (Adjusted Figures) ⁴
United States	409 (1)	409 (1)
United Kingdom	230 (2)	230 (2)
Germany	174 (3)	174 (3)
France	118 (4)	118 (4)
Japan	117 (5)	117 (5)
Spain	106 (6)	106 (6)
Italy	99 (7)	99 (7)
China	92 (8)	92 (8)
Netherlands	85 (9)	85 (9)
India	75 (10)	75 (10)
Hong Kong	73 (11)	54 (15)
Ireland	68 (12)	68 (11)
Belgium	60 (13)	60 (12)
Canada	59 (14)	59 (13)
Singapore	59 (15)	59 (14)

Figures in brackets are rankings among economies in the world.

Sources: International Financial Statistics of the IMF and statistics published in websites of relevant national statistics offices

13. As trade statistics are an important source of information used in bilateral trade negotiations among economies, a significant revision in trade figures would likely cause confusion to data users and policy makers. The likely impact of this revision on trade negotiations has to be carefully assessed. Issues concerned have to be identified and addressed before implementing the new international statistical standards.

⁴ Figures for Hong Kong are adjusted for 'goods for processing' and 'merchandising' based on BPM6 standard, whereas figures for other economies are assumed unchanged.

Important Issues in Implementing the New International Statistical Standards

(A) Additional Data Requirement

14. In order to implement the new statistical standards on ‘goods for processing’, the following additional information will have to be collected for Hong Kong:

- a) Exports and re-imports of goods for outward processing with breakdown by commodity group and by country; and
- b) Value of processing fee payment.

15. There are three different options for collecting these additional information, namely:

- a) Expanding the trade declaration documents to be reported by traders to Hong Kong Customs;
- b) Conducting an enhanced survey on outward processing trade activities; or
- c) Applying new data models and imputations.

16. In comparison with ‘goods for processing’, the implementation of the new standards on ‘merchandising’ is relatively less complicated. The additional information required can be obtained by enhancing the existing survey on trade in services. In the existing survey, data on the sales of goods and cost of goods sold for ‘merchandising’ are collected to compile the gross margin, i.e. value of merchandising services provided, which is the difference between the two components. However, the existing survey can only provide annual data and cannot simply be taken as the source data for compiling quarterly BoP statistics. Moreover, the existing survey must also be enhanced to provide data breakdown of “merchandising” by commodity group and by country.

Pros and Cons of Different Options for Collecting Additional Information for ‘Goods for Processing’

17. The pros and cons of each of the three options are elaborated below.

Expanding the Trade Declaration Documents

18. Any person in Hong Kong who imports or exports any article other than an exempted article is required to lodge with the Commissioner of Customs and Excise an accurate and complete import or export declaration within 14 days after the importation or exportation of the article under the Import and Export (Registration) Regulations. Currently, the volume of trade declarations reported by traders each quarter is more than 4.5 million. In order to provide the new data for ‘goods for processing’, additional items of information will need to be reported on each trade

declaration.

19. The benefit of this option is that it can provide all additional statistical information required under the new standards. Reliable and timely statistics of exports and imports of ‘goods for processing’ can be compiled. Moreover, detailed breakdown on commodity group, country of origin and destination can also be compiled. Nevertheless, this method requires a huge amount of resources in processing new data items collected from a large number of declarations each quarter. Besides, it imposes additional reporting burden on traders. In general, past experiences showed that traders and legislators would have a great concern on any expansion of the data requirements on the trade declaration documents since this would make the declaration procedures more costly and time-consuming. Hence, considerable resistance to the expansion of trade declaration is expected from the stakeholders who may see this as a move against further trade facilitation.

Conducting an Enhanced Survey on Outward Processing Trade Activities

20. The existing survey covers only the outward processing activities in the Mainland of China where there exists some contractual arrangement for subsequent re-importation of processed goods back into Hong Kong. Processing trade in areas other than the Mainland of China is not covered in the present survey since it is considered that this is relatively insignificant. Statistics on outward processing trade are available only with a time lag of around 3 months after the reference period. The sample size of the existing survey is about 7,200 trade declarations per quarter. In the existing survey, reporting burden imposed on traders is kept to a minimum. Only information on processing activities is collected from traders selected in the survey whereas information on value of goods involved are extracted directly from the selected trade declarations. In order to fulfil the new international statistical standards, several major enhancements to the survey are required. These include the following:

- a) Expanding the survey to cover ‘Goods for Processing’ in places other than the Mainland of China, e.g. Vietnam;
- b) Expanding the survey to cover processing activities in the Mainland where there is no contractual arrangement for subsequent re-importation of processed goods back into Hong Kong;
- c) Reducing the time lag of statistics on processing trade to support the timely release of GDP and BoP statistics; and
- d) Increasing the sample size substantially to support detailed data breakdown required.

21. The benefit of this option is that it can provide all the additional data required for compiling statistics on trade aggregates under the new standards. Moreover, less resistance is expected from traders because additional reporting burden will not be imposed on all of them but only on those selected in the survey. Nevertheless, this approach can only reasonably support a limited breakdown of

statistics by commodity group and by country, and the extent to which the time lag of statistics can be further reduced is rather limited even if substantial enhancement is made to the existing survey.

Applying New Data Models and Imputations

22. Based on existing information, new data models and imputation procedures can be constructed to provide additional data at the aggregate level. An obvious benefit of this option is that no additional reporting burden will be imposed on traders. However, this approach cannot provide reasonably accurate breakdown of processing trade by commodity group and by country, due to the lack of more detailed information for the breakdowns.

23. The data models will be designed to produce estimates on the proportion of goods related to processing trade within the overall trading activities, taking into account historical trends and relevant proxy indicators. Regression of relevant historical trends on a set of explanatory variables and proxy indicators, with appropriate time lag structures, will provide workable data models for producing timely data at the aggregate level. One of the examples of an explanatory variable to be included in such model for testing may be imports of raw materials into Hong Kong from various sourcing markets, since these raw materials would need to be imported into Hong Kong before they are delivered to the Mainland of China for outward processing.

24. These data models, with appropriate input assumptions, will also produce estimates on processing fee for inclusion into trade in services statistics. Benchmark ratios of processing fee to the value of goods involved by commodity group and by country can be collected from benchmark surveys once every few years to supplement the model estimates.

A Pragmatic Modular Approach for Implementation

25. Since each of the three options has its own pros and cons, it is quite clear that a pragmatic approach to implement the new standards is to flexibly combine the three options at different stages of implementation, and for different levels of statistical detail. First, new data models will be constructed to produce preliminary estimates of trade aggregates under the new standards for supporting timely compilation of major macroeconomic aggregates, such as GDP and BoP statistics. These aggregate statistics must be released with short time lags, and it is not practical to incorporate current information on processing trade collected from the enhanced survey into the preliminary aggregates when they are released for the first time.

26. Second, the existing survey on outward processing trade activities will be enhanced to collect additional information for compiling external trade statistics under the new standards with broad breakdown by commodity group and by country. Such information will be available only with longer time lag but it can be used to revise the

preliminary estimates of the trade aggregates produced by the data models, and to support more in-depth analysis. The enhanced survey will also provide the information necessary for regularly updating the parameters of the data models used for estimating the preliminary trade aggregates.

27. As a longer term development, it is our target to produce external trade statistics under the new standards with comprehensive breakdown by commodity group and by country. Among the various possible options, the possibility of collecting detailed information through expanding the trade declaration documents will also be explored. It is obvious that the most fundamental problem is obtaining source data of reasonable accuracy. In view of significant resistance from traders and the high cost involved, a strong policy support of the initiative from Hong Kong SAR Government is essential. In order to solicit the support and co-operation of traders and the business community, a long-term strategy has to be developed involving various parties concerned

28. A study will be conducted to examine the cost-effectiveness and technical details of various options, and to draw up a detailed implementation plan. The study will also cover two major tasks:

- a) Consulting key stakeholders in Hong Kong SAR Government and in the private sector to assess their views on each of the options; and
- b) Conducting research and consultation on international best practices in data collection, compilation and dissemination of statistics on 'goods for processing' and 'merchanting'.

(B) Presentation and Interpretation of New Statistics

29. Under the new statistical standards, the value of external trade in goods shown under national accounts will be significantly different from that shown under merchandise trade statistics since the latter statistics are not compiled based on the change-of-ownership principle. To reduce confusion to data users, the following alternative dissemination practices will be carefully considered:

(a) Releasing Two Different Figures on Trade in Goods with Appropriate Bridge Tables to Explain the Gaps

30. The benefit of this option is that it supports the specific needs of different data users and allows them to choose the figure of trade in goods, either from national accounts or from merchandise trade statistics, that best meets their need. The bridge tables which explain the gaps between the two set of figures on trade in goods would help to reduce the confusion to data users.

(b) Releasing Only One Single Figure for Trade in Goods and Services in National Accounts

31. The benefit of this option is that it avoids the publication of two different set of statistics on trade in goods, one under national accounts and one under merchandise trade. Given that the distinction between goods and services is increasingly blurred, an increasing number of users may accept that they have to perform analysis by pooling trade in goods and services together. However, there are always some data users who need to have breakdowns in goods and services, and their statistical needs must also be met. Hence, this option will not be adopted without first obtaining strong support and consent from major data users.

32. Views of major data users on these alternative dissemination practices will be sought. In particular, the following activities will be organized for different target groups of data users:

- a) Organise talks for the media to explain the rationale behind the new international statistical standards;
- b) Organise discussion sessions with analysts and academics to capture their responses and comments; and
- c) Arrange visits to major data users in both public and private sectors to consult their views.

33. It will also be helpful to provide illustrative examples on the appropriate applications of the two set of figures on trade in goods. For example, the figures of trade in goods under national accounts should be adopted for macroeconomic analysis, such as forecasting overall economic growth, whereas the figures of trade in goods under merchandise trade statistics should be adopted for analysis relating to physical handling of goods flow, such as forecasting demand on port facilities. Educational pamphlets elaborating on these applications will be prepared and distributed to data users.

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