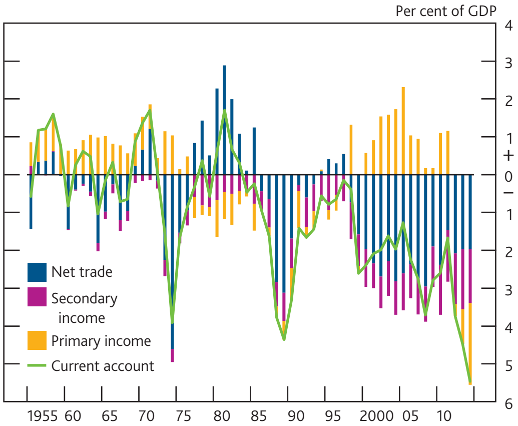
A UK current account

The UK current account deficit is large by historical and international standards. It could narrow through a stronger recovery in global growth, but there is also the risk of a more disruptive adjustment, through a sudden slowing of capital inflows, with adverse consequences for UK financial stability. The nature of the capital flows financing the deficit does not suggest a particular vulnerability in addition to its size, however, and the external balance sheet has become more resilient to shocks. The resilience of the UK banking system to an abrupt adjustment of the United Kingdom's external imbalance was assessed as part of the 2014 stress test. The FPC will continue to monitor the nature of capital flows that finance the deficit.

Chart A.17 The UK current account deficit has widened in recent years

Decomposition of the UK current account[a]

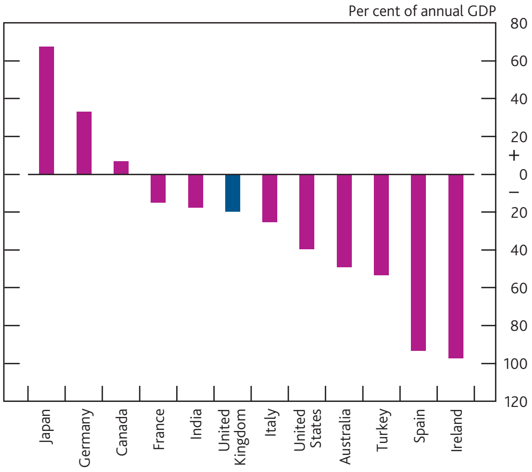


Sources: ONS and Bank calculations.

(a) Primary income mainly consists of compensation of employees and net investment income. Secondary income consists of transfers.

Chart A.18 The UK net international investment position is not unusually low by international standards

Net international investment positions at end-2014



Sources: Eurostat, IMF *World Economic Outlook*, ONS and Bank calculations.

The UK current account deficit is at record levels...

The UK current account deficit has widened since 2011 and averaged 5.5% of GDP in 2014, the highest annual deficit since official records began in 1955 (**Chart A.17**).[1] As explained in the May 2014 *Inflation Report*, this deterioration has not been caused by a wider trade deficit.[2] Rather, income earned by UK residents on their foreign direct investment (FDI) has fallen in recent years. Empirical evidence does not show a particularly clear relationship between the current account deficit and future financial crises. But IMF analysis does suggest a greater vulnerability when advanced economies have current account deficits of 6% of GDP or more.[3] This section assesses the threat posed by the United Kingdom's large current account deficit to UK financial stability, building on the box presented in the December 2014 *Report*.[4]

...but the net international investment position is not especially low by international standards.

The UK net international investment position (NIIP) measures the difference between the United Kingdom's external assets (UK residents' claims on foreign assets) and its external liabilities (overseas residents' claims on UK assets). The UK NIIP has fallen since 2011, as net capital gains have been too small to offset the sequence of UK current account deficits. At end-2014, it stood at around -20% of GDP.[5] That does not appear low by international standards (**Chart A.18**). Further, the current account deficit could narrow, and the UK NIIP improve, if economic growth in the

(1) The data cut-off for this section was 19 June, so it does not reflect the revisions contained in the Quarterly National Accounts release on 30 June.
(2) See the box on pages 22–23 of the May 2014 *Inflation Report*; www.bankofengland.co.uk/publications/Documents/inflationreport/2014/ir14may.pdf.
(3) IMF *World Economic Outlook*, October 2014, Chapter 4.
(4) See the box on pages 29–31 of the December 2014 *Financial Stability Report*; www.bankofengland.co.uk/publications/Documents/fsr/2014/fsrfull1412.pdf.
(5) This calculation uses official data on the NIIP, with FDI at book value. Measuring FDI at market value gives a NIIP of around 30% of GDP for 2014 Q4. For more information, see the box on pages 22–23 of the May 2014 *Inflation Report*.

euro area were to pick up, leading to higher returns on the United Kingdom's euro-area assets and boosting exports.

The United Kingdom relies on net capital inflows from abroad...

Nevertheless, the United Kingdom's large current account deficit remains a vulnerability. A current account deficit indicates that UK domestic expenditure is higher than its income, leaving a shortfall to be met by net borrowing from abroad. This can be achieved either by UK residents reducing their external assets (by lending less abroad or divesting foreign assets) or increasing their external liabilities. And any increase in external liabilities can only continue for as long as foreign investors are willing to acquire them. If overseas demand for these liabilities were to fall, perhaps because of a change in the risk environment, there could be a sudden slowing of capital inflows. This could lead to financial instability and cause domestic expenditure to fall sharply.

...so it needs to retain the confidence of foreign investors.

Ease in financing the current account deficit rests on the credibility of the United Kingdom's macroeconomic policy framework and continuing openness to trade and investment. The United Kingdom has maintained this confidence in recent years, but it is important that this continues.

The 2014 UK banking system stress test assessed the impact of a hypothetical scenario in which concerns over the sustainability of the United Kingdom's internal and external debt positions led to a reassessment of the prospects for the economy, a sharp depreciation of sterling and a rise in borrowing costs.[1] At the time, the FPC judged that the stress-test results and banks' capital plans, taken together, suggested that the banking system would have the capacity to maintain its core functions in such a stress scenario.

Recent capital flows do not appear to be creating large refinancing risks...

Countries that rely on an increase in short-term bank lending to finance a current account deficit are particularly vulnerable to a loss of confidence because of the ongoing need to refinance the loans. If the loans cannot be refinanced, the country may need to run a current account surplus, forcing domestic residents to cut expenditure to below income levels.

The composition of recent capital inflows to the United Kingdom should make it less vulnerable to a sudden loss of confidence. The United Kingdom has been reducing its foreign short-term bank loan liabilities, included within 'other investment' (**Table A.1**). In order to finance the deficit, however, the United Kingdom has had to incur new external liabilities. These new liabilities have been mostly longer term and include FDI, equity and longer-term debt (including gilts).

(1) www.bankofengland.co.uk/financialstability/Documents/fpc/results161214.pdf.

Table A.1 The composition of recent financing flows is not a major source of vulnerability

Financing flows behind the current account deficit, 2013–14

£ billions, 2013–14 annual averages

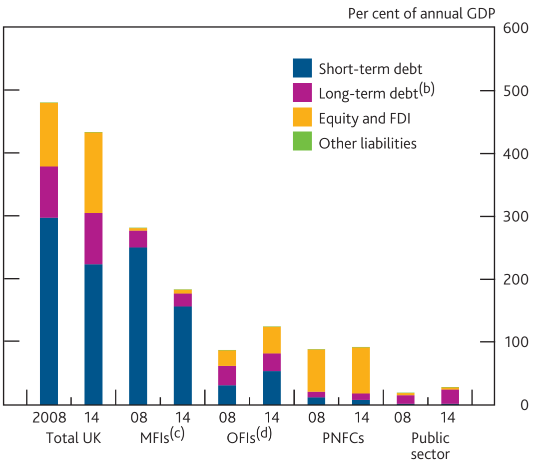
	Inward investment (net acquisition of foreign liabilities by UK residents)	Outward investment (net acquisition of foreign assets by UK residents)	Net inward financing flow[a]
Direct investment	22	-38	60
Portfolio investment	76	9	67
of which equity and investment fund shares	*31*	*-18*	*49*
of which debt securities	*45*	*27*	*18*
of which Government debt	*21*	*n.a.*	*n.a.*
of which other debt securities	*24*	*n.a.*	*n.a.*
Other investment (loans and deposits)	-90	-48	-42
Other (reserves and net derivatives)	*n.a.*	6	-6
Total	8	-71	79

Sources: ONS and Bank calculations.

(a) This is the change in UK foreign liabilities, less the change in UK foreign assets, for each category of flow. The total net inward financing flow is equal in magnitude to the current account deficit (plus net errors and omissions).

Chart A.19 The United Kingdom's external liabilities are smaller than in 2008

UK gross external liabilities by sector[a]

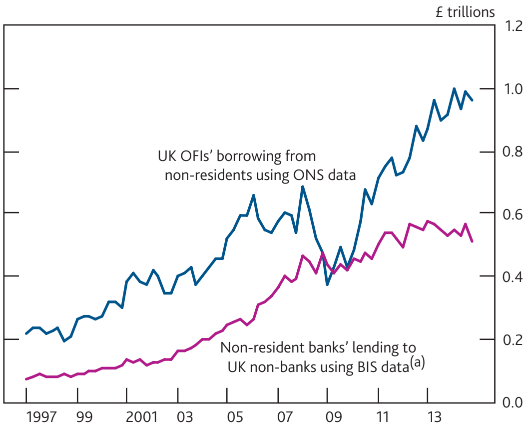


Sources: ONS and Bank calculations.

(a) Derivatives are not included.
(b) Original maturity of greater than twelve months.
(c) Monetary financial institutions (banks and building societies).
(d) Other financial institutions (financial corporations excluding MFIs and insurance companies and pension funds).

Chart A.20 Official data may overstate the recent growth of OFIs' external borrowing

OFIs' borrowing abroad compared with lending to UK non-banks reported by non-resident banks

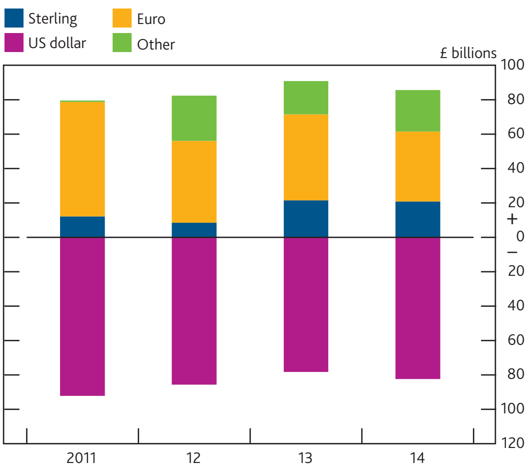


Sources: Bank of England, BIS, ONS and Bank calculations.

(a) Lending from non-resident banks to the whole UK economy, excluding UK-resident banks. It is not possible to construct a more granular breakdown of lending to the United Kingdom using BIS data.

Chart A.21 Broker-dealer currency mismatches are not growing significantly

Net currency positions (assets less liabilities) of the largest UK-resident broker-dealers[a][b][c]



Sources: Regulatory returns and Bank calculations.

(a) Broker-dealers include Citigroup Global Markets Limited, Credit Suisse International, Goldman Sachs International, Merrill Lynch International, Mitsubishi UFJ Securities International plc and Nomura International plc.
(b) Positions at end-year.
(c) Net derivatives are excluded.

While these financing flows could still be susceptible to a sudden slowing or repricing, they are less vulnerable to refinancing risk. Empirical studies show that net capital inflows are more likely to be a risk to financial stability if they are associated with rapid domestic credit growth.[1] But present levels of UK credit growth are modest (Section B.4).

...and the UK external balance sheet has become more resilient.

Studies also suggest greater risk to financial stability from capital inflows in countries with large external liabilities, particularly bank debt. UK external liabilities have fallen since 2008, as banks' balance sheets have shrunk (**Chart A.19**), though they remain high as a share of GDP by international standards.

The currency composition of a country's external balance sheet also matters. A sudden loss of confidence in a country can lead to a depreciation in the exchange rate. If that were to occur, institutions that have borrowed in foreign currency to finance assets denominated in domestic currency could incur losses. The United Kingdom, in aggregate, is in the opposite position: a greater share of external liabilities is denominated in sterling than external assets.[2] A depreciation of sterling should therefore boost the NIIP, with the exchange rate acting as a stabilising mechanism.

Nonetheless, while the aggregate position may be reassuring, fragilities can still exist in particular sectors or institutions. The December 2014 *Report* showed that, based on official data, the 'other financial institutions' (OFI) sector was a net borrower from the rest of the world, and could be increasing its net short-term foreign currency borrowing.[3] However, it also noted the poor quality of official data on OFIs and that further analysis was needed. Additional work since December 2014, using a variety of information sources, suggests a lesser degree of fragility in the OFI sector than the official data. For example, official data suggest that OFIs' external borrowing has more than doubled since 2009 (**Chart A.20**). But data collected from banks resident abroad, which should account for the majority of this, show that their recent lending to the UK non-bank sector has increased only modestly. And regulatory data collected from large broker-dealers, the component of the OFI sector with the largest stock of outstanding debt, show that while those institutions have net US dollar borrowing, their currency mismatches have not worsened materially (**Chart A.21**).

(1) See, for example, al-Saffar,Y, Ridlinger, W and Whitaker, S (2013), 'The role of external balance sheets in the financial crisis', *Bank of England FS Paper No. 24*; www.bankofengland.co.uk/financialstability/Documents/fpc/fspapers/fs_paper24.pdf.
(2) See Broadbent, B (2014), 'The UK current account'; www.bankofengland.co.uk/publications/Documents/speeches/2014/speech750.pdf.
(3) The OFI sector includes a range of non-bank financial firms, including broker-dealers, special purpose vehicles, hedge funds, finance companies and central counterparties.