

UNRECORDED MOVEMENTS IN THE U.K. BALANCE OF PAYMENTS

The "Balancing item"

The United Kingdom's balance of payments has recently become more difficult to interpret because a large discrepancy has emerged in the official estimates^(a) between the deficit on current and long-term capital account, and the net change in reserves, overseas sterling holdings and other items that by convention together make up the balance of "Monetary movements". After amounting to £66 million in 1958 and £10 million in 1959 this discrepancy, known as the "Balancing item", rose to £364 million in 1960 and was £222 million in provisional estimates for the first nine months of 1961. For each year the discrepancy was "positive", implying either that the balance on current and long-term capital account has been less unfavourable than shown or that the net monetary movement has been more unfavourable, or a combination of both (a more likely situation).

One of the main uses of the balance of payments estimates is to compare the outcome of one period with another. For such a purpose the statistical discrepancy would not cause much difficulty if it were reasonably constant. In practice, however, it varies widely and this note tries not only to show where errors and omissions may arise in the estimates but also, where possible, to point out which seem most likely to have contributed to an increase in recent periods. Conclusions will inevitably be conjectural because the evidence will already have been well sifted and all firm information taken into account in the process of compiling the estimates. Moreover, the size of the errors and omissions, particularly in recent periods, is liable to considerable revision as new or later information is received. It is possible that the next balance of payments White Paper, due to be published shortly, may alter the figures for recent years substantially, although

a sharp contrast between 1959 and 1960 seems likely to remain.

Nevertheless, in view of the size which errors and omissions have recently attained, it is important to try to assess the possible explanations because the way they are interpreted must affect the view taken of the development of the United Kingdom's balance of payments. To the extent that the positive balancing item were attributable to overstatement of payments or understatement of receipts on current account, the deficit on current account in 1960 would have been smaller than shown. In so far as it were attributable to long-term capital, implying that there had been a substantial overstatement of U.K. investment overseas and/or an understatement of foreign investment in the United Kingdom (which is more likely) the assessment of the outcome would be different and it might be considered less favourable. If, however, part of the balancing item resulted from an unrecorded increase in short-term liabilities, the outcome would have to be regarded as more unfavourable.

Definition of "Balancing item" The discrepancy known as the "Balancing item" is the difference between estimates of the two parts of the balance of payments picture which, in theory, should be equal and opposite. If all were known, there would be two self-balancing entries for each transaction, usually one in the current or long-term capital account for the purchase or sale in question, and the other in monetary movements covering the means of financing the transaction. In practice, items which go to make up the whole of the balance of payments are estimated or measured from many different sources. A few of them are precise but most are subject

^(a) The estimates are prepared by the Central Statistical Office with the collaboration of other Government Departments and the Bank of England.

to various imperfections. There is therefore bound to be some discrepancy between the identified balance on current and long-term capital account and the identified balance of monetary movements; and in the official balance of payments estimates this discrepancy is termed the "Balancing item". To some extent the word "item" gives it a more positive appearance than it deserves. It is not an item comparable with the others in the balance of payments such as imports, exports, invisibles and so on; it is simply the net total of all errors and omissions in the estimates.

Nevertheless, the balancing item is not entirely a collection of unknowns. The essential prerequisite for entering any item in the balance of payments is that some reasonably firm estimate of its size can be made. If this cannot be done, it automatically falls into the balancing item; but the compiler may be able to infer with some confidence that certain kinds of movement have taken place without, however, being able to measure them and enter them separately.

It would be reasonable to look forward to further progress in identifying and measuring some of the more elusive transactions, as statistical resources are improved or extended, thus reducing the balancing item. But this cannot be taken for granted. Indeed, an improvement in some items may lead to an increase, because the balancing item is the *net* result of a number of positive and negative items and if the improvement reduces a negative error of one of the components the final balancing item, if already positive, will be increased. Another problem is that there have always been new types of transaction growing in significance which have not been adequately covered by existing methods, and indeed may have been unrecognised for a time. However, with improved methods of deriving and co-ordinating information, there is more likelihood in the future of being able to identify these developments as they occur.

Sources of estimates The sources used in compiling the estimates were described in "United Kingdom Balance of Payments 1946-57" published by H.M. Stationery Office in March 1959, and some important changes were explained in an article in "Economic Trends" for March 1961.

1. *Visible trade* The entries for visible trade in the U.K. balance of payments form the largest individual category in the accounts. The figures are based on the U.K. Trade and Navigation Accounts, which provide an almost comprehensive record of goods entering or leaving the country, but certain adjustments need to be made to obtain estimates of imports and exports appropriate for balance of payments purposes. The chief adjustments are intended: (i) to deduct freight and insurance from the Trade Account valuation of imports; (ii) to include certain categories of goods, for example diamonds, not recorded in the Trade Accounts; (iii) to exclude returned goods (such as cancelled export contracts, or goods imported for processing or repair) from both imports and exports.

The first of these adjustments is liable to error, although as explained later (under 2. *Invisibles*) there will be a compensating error in the shipping estimate. No direct measure is available of the amount of freight included in Trade Account imports; an estimate for freight has to be built up by applying known freight rates to the quantities shown. The other two adjustments are based on information available to Government Departments that is thought to be fairly complete. As regards returned goods, adjustments to both imports and exports are made in the period when the goods are recorded as imports. If the goods were not exported or re-exported in the same period, there would be an error of timing.

Apart from these adjustments, the valuation of goods in the Trade Accounts is carried over with only minor changes into the balance of payments estimates. The valuation in the Trade Accounts is based on importers' and exporters' declarations of market values, which may be verified by Customs officials. A relatively small difference between the Trade Account valuation and the prices at which the goods actually changed hands could affect the balancing item appreciably. For example, a difference of 1% on the annual total of about £4,000 million of imports would of itself create a balancing item of £40 million. Such errors, so far as they exist, would be more likely to contribute regularly to the balancing item than to cause it to increase markedly between one year and another. But if as a general rule

import payments tended to be over-estimated in relation to export earnings, the balancing item would probably be swollen in a year like 1960, when imports increased much more than exports.

Many differences of timing exist undetected between the shipment of individual imports and exports and the related payments. Those which merely reflect the normal terms of settlement between traders (e.g., when goods are shipped on consignment) should largely cancel out and are unlikely to affect the balancing item, except in the very short term. Changes in the timing of trade settlements (the so-called "leads and lags") may be more important, but the effect again will be only temporary. These were discussed in an article "Leads and Lags in Overseas Trade" in the March 1961 issue of this Bulletin. The discrepancies that need to be considered in this note result from the use of some form of trade credit. The treatment of trade credit is described later (under 4. *Monetary movements*).

2. *Invisibles* Some categories of invisible transactions are particularly difficult to record satisfactorily and although attempts are constantly made to improve the estimates, this section of the balance of payments still remains subject to a considerable margin of error. Even so, no new developments in this field seem to have occurred in recent years capable of explaining more than a small part of the rise in the balancing item.

Government transactions recorded among the invisibles are taken from departmental records and any errors and omissions should only arise through minor differences of timing.

The estimates of shipping transactions, so far as they relate to U.K. shipping, are based on information collected by the General Council of British Shipping. This covers charter payments to foreigners and ships' disbursements abroad, as well as the overseas earnings of British ships. The figures are based on periodic full surveys of the industry (the latest in 1958) supplemented by annual sample enquiries (the latest available is that for 1960). Although there is more scope for error here, it seems likely that important changes in

the pattern of U.K. shipping transactions would be revealed by the sample enquiries. The sample is large and the results are examined by those in close touch with the industry.

As regards foreign shipping, freight payments for carrying U.K. imports are derived as a residual, by subtracting the earnings of U.K. ships when carrying imports (as estimated by the General Council) from the estimates mentioned earlier of the total freight included in the Trade Account valuation of imports. It seems unlikely that the General Council's estimate has suddenly become misleading. Any other error in this calculation will cancel out and cannot contribute to the balancing item; for example, if too much freight has been deducted from Trade Account imports c.i.f., the estimate of imports f.o.b. will be too low and the estimates of freight payments to foreign shipping too high by the same amount. The estimates of earnings from foreign ships' disbursements in this country, based on enquiries of those in the United Kingdom providing the stores and services, are less precise but should be a reliable guide to trends.

Debits and credits for interest, profits and dividends are derived from a mixed collection of sources. Income on direct investment (excluding oil and insurance) by U.K. companies overseas and by overseas companies in the United Kingdom has been covered since 1958 by annual enquiries carried out by the Board of Trade, more recently supplemented by quarterly sample enquiries. Payments on overseas portfolio investment in the United Kingdom are based mainly on exchange control records when they are made to countries outside the sterling area and on overseas sources when made inside it. Receipts on U.K. portfolio investment overseas are based on Inland Revenue sources. Interest on inter-government loans is taken from official records. The interest on overseas sterling holdings is estimated from what is known about the size of overseas holdings of the assets included (deposits, Treasury Bills and other British government securities, etc.) and the interest payments appropriate to each. Estimates of oil companies' earnings are based on information provided by the companies. Although errors and omissions might well arise in all these calculations there is no obvious reason why they should suddenly have become larger in

1960. All marked changes in trend at that time should have been picked up in the statistics available.

The estimates for other invisibles are in general less reliable. For example, the estimates of travel expenditure depend on the results of sample enquiries into the amounts per head taken abroad by U.K. travellers or spent in this country by travellers from abroad. The amounts derived from the samples are applied to the estimated numbers of travellers in both directions. The margin of error here is appreciable and may have become greater in 1960, partly because since the removal at the end of 1959 of the restriction on U.K. travel expenditure abroad, some U.K. travellers may be taking more abroad to cover contingencies and bringing back unspent a greater proportion than before. The sources for other categories of invisibles are too diverse to be described in this note. There is little to suggest that any of the estimates has suddenly become particularly liable to greater error and even less reason to suppose that all errors and omissions newly emerging should work towards substantially increasing the balancing item.

3. *Long-term capital account* Official transactions are taken from departmental records which provide a comprehensive account of government lending and borrowing. Various types of private long-term capital transaction are recorded with varying degrees of accuracy. Changes in direct investment (excluding oil and insurance) by U.K. companies overseas and by overseas companies in the United Kingdom are covered, as is the income on such investment, by regular enquiries by the Board of Trade. Similarly the oil companies provide periodic returns giving changes in their direct investments and all large transactions by insurance companies are thought to be covered.

Changes in portfolio investments are covered less fully in the estimates. Figures of U.K. portfolio investment abroad are based on the Bank of England's survey. The survey is known to give incomplete coverage, but it is possible to adjust totals for certain sterling area countries by reference to overseas sources. In recent years there has been a considerable U.K. disinvestment in certain African countries, for example South Africa and Rhodesia, some of which, if it were by sale of securities which

had no London registrars, might not be included in the estimates. Any omissions will have contributed to the positive balancing item. Changes in portfolio investment in countries outside the sterling area are less likely to be omitted, because dealings by U.K. residents in non-sterling securities are virtually confined to switching, the proceeds of the sale of a non-sterling security being used to purchase another non-sterling security.

The estimates of portfolio investment in the United Kingdom by overseas residents are mainly derived from exchange control information and overseas sources. They may be seriously incomplete, although until 1960 it was considered unlikely that residents of countries outside the sterling area were on balance appreciably increasing their holdings of U.K. securities. A special enquiry conducted with the help of a group of large companies in the United Kingdom showed that in fact a substantial amount of portfolio investment in these companies by overseas residents took place during the second half of 1960. Although allowance for this investment was made in the estimates, considerable scope for error remains; unrecorded changes in overseas holdings of gilt-edged securities may have occurred, for example. A new enquiry into changes in overseas holdings of U.K. securities in 1961 is now being carried out and its results will be taken into account in the balance of payments estimates for the full year 1961. If overseas holdings prove to have increased, the positive balancing item for 1961 will be reduced.

4. *Monetary movements* The figures of changes in assets and liabilities that are the chief constituents of this section are on the whole more precise than the estimates used in other parts of the balance of payments accounts. Nevertheless gaps in coverage exist which cannot be overlooked in a search for an explanation of the balancing item.

Changes in the gold and convertible currency reserves and in official holdings of non-convertible currencies are known precisely from official records, and need not be considered further. The overseas sterling holdings series is based on regular returns to the Bank of England by the banking system, although coverage is not complete.

Other information obtained from the banking system (including authorised dealers in gold and foreign exchange) covers changes in dealers' holdings of gold and foreign currencies and changes in the outstanding total of banks' acceptances. Coverage is fairly complete. The movements are brought into the net total of "Miscellaneous capital".

Other doubts about coverage, in the light of the emergence of a large positive balancing item, arise from the fact that sterling can be deposited with institutions other than banks. If the deposit is made direct from overseas it will not be recorded by the banking system as an overseas liability, although funds coming from countries outside the sterling area are to some extent covered by exchange control information. Funds may be placed for example with local authorities and hire purchase finance companies. Overseas loans to local authorities have been included since the end of 1960 in returns provided by local authorities. Only fragmentary information is at present available about overseas deposits with hire purchase finance companies. What is known under both headings is included in "Miscellaneous capital".

The published total of "Miscellaneous capital" also includes some entries for credit granted or received on merchandise, for example on ships and aircraft. Some other credit on imports and exports is included elsewhere in the balance of payments accounts, although the amounts cannot be identified separately. Thus, credit given through the banking system is included, whether as an asset or a liability, in the banks' returns of overseas sterling holdings and of acceptances outstanding. Credit given by companies to their branches or associated companies is included among other changes in direct investment in the long-term capital account. But much of the credit given direct by one trader to another is not included at all. In this category would fall leading and lagging by traders. Although some of the unidentified credit, for example on capital goods, is for periods of years, the omission of trade credit is in general more likely to lead to a fluctuating than to a persistently large balancing item. U.K. imports of capital goods increased sharply in 1960 and 1961, which could have led to a significant increase in import credit outstand-

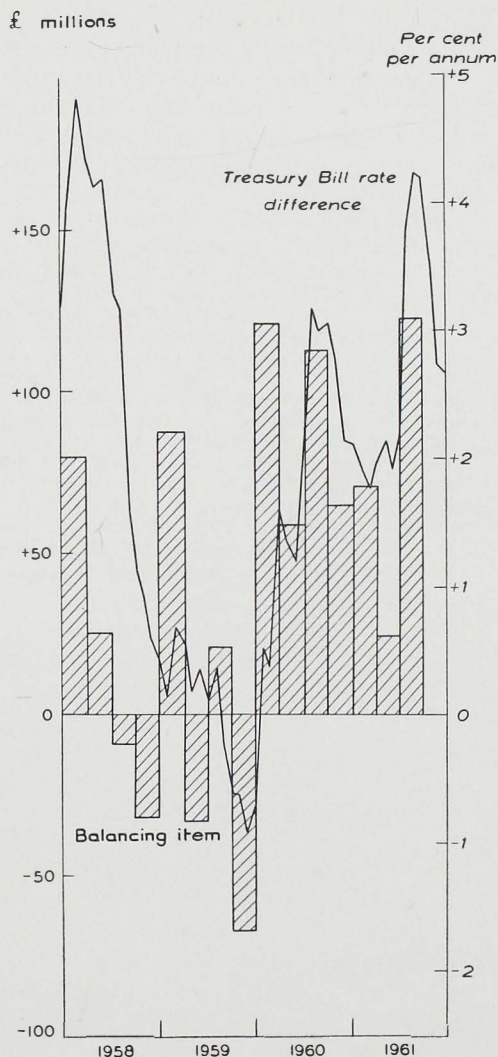
ing. At the same time, exports of capital goods, and no doubt the credit given, were rising. This, taken on its own, suggests that the net contribution to the balancing item over the two years may have been quite small.

Interest rates

As the preceding analysis has shown, unrecorded changes in U.K. external assets and liabilities may have occurred both in the kinds of investment conventionally included in the long-term capital account and in those included in monetary movements. In trying to assess how far these unrecorded changes have contributed to the balancing item, comparative interest rates in the United Kingdom and other countries should be considered, for they will be one important influence. It is evident that the interest rates that are relevant will vary considerably according to the kind of investment concerned, and such international comparisons are far from straightforward. Nevertheless, in this context it is worth looking at the difference between the yields on U.K. and U.S. Treasury Bills, which are a guide to the level of short-term money rates in the two chief financial centres. The accompanying chart shows this difference in yields and the quarterly balancing item since 1958. No allowance is made in this comparison for the cost of forward exchange cover, for this may not always be taken even for movements of short-term funds between the two centres and would not apply to longer-term movements or to capital movements between the United Kingdom and other countries in the sterling area. It will be seen that the two series often move in the same direction which provides some ground for believing that fluctuations in the balancing item may be to some extent due to the omission of capital movements that are influenced by interest rates. Such a belief does not necessarily imply that changes in the balancing item are directly caused by changes in interest rates. The correspondence that exists between the two series might well arise because both are linked similarly with one or more factors not examined here.

The view that fluctuations in the U.K. balancing item may be to some extent associated with capital movements receives some support from the behaviour of the balancing

**U.K. BALANCING ITEM AND DIFFERENCE
BETWEEN U.K. AND U.S. TREASURY
BILL RATES^(a)**



item in the U.S. balance of payments estimates. It was +£136 million in 1958, +£189 million in 1959 and then swung to -£231 million in 1960 and -£66 million in the first nine months of 1961. The coincidence of large and opposite balancing items in the U.K. and U.S. balance of payments estimates during 1960 and 1961 might well be partly due to unrecorded capital movements. Changes in the indebtedness of U.K. and U.S. residents to each

other could be partly responsible. But more important than changes in the bilateral position would be switches between London and New York in the employment outside the banking system of funds owned by residents of countries other than the United Kingdom and the United States.

Summary The earlier review of sources has shown that errors and omissions can arise at many points in the balance of payments estimates. Explanations of the balancing item that look plausible at one time may appear less so later on as circumstances change or as new information becomes available. From the early 1950's there was a persistent positive balancing item and it was suspected that this might to a considerable extent reflect unidentified net receipts on current account. The later emergence in 1960 of a much larger positive balancing item seems to call for a further explanation, although the possibility cannot be ruled out that these unidentified net receipts on current account have for one reason or another grown larger in recent years. There is reason to believe that the growth of the balancing item may to some extent be due to an unrecorded increase in U.K. liabilities (both long-term and short-term) or decline in U.K. assets.

These inferences, uncertain though they are, have a bearing on the interpretation of the course of the U.K. balance of payments. Thus a belief that in the past there has been a persistent tendency to understate earnings or overstate expenditure in the current account would justify making some allowance for this when looking ahead. A positive balancing item that is thought to reflect a failure to record an increase in U.K. liabilities or a decline in U.K. assets may need to be interpreted differently. First, it would reduce the United Kingdom's net investment income from overseas in the future, though this effect may not be perceptible in the short term. The implications for capital account will depend on the nature of the asset that changes hands and particularly on whether it is thought that such transactions will recur or be reversed in future. The unrecorded sale of U.K. holdings of over-

^(a) The left hand scale relates to the U.K. balancing item, whether positive + or negative -. The right hand scale relates to the difference in yields on three months' Treasury Bills (without allowance for the forward margin for U.S. dollars), whether in favour of London + or in favour of New York -.

seas securities, for instance those of African countries, may not continue on the same scale but any sales already made carry no risk for the U.K. balance of payments unless it is thought, for example, that the proceeds of such sales are likely in due course to be reinvested elsewhere in the sterling area. The unrecorded flow of overseas funds into various kinds of investment in the United Kingdom may change its volume or cease; it might even to some extent be reversed, although overseas funds that have been used to purchase U.K. gilt-edged or industrial securities may not be so liable to be withdrawn as for example those invested in Treasury Bills or deposited with hire purchase finance companies. Finally, credit given by one trader to another is a liability that by its nature is bound to be liquidated sooner or later, and credit relating to consumer goods nearly always within six months of shipment. An increase in the balancing item arising because U.K. traders as a whole are in net receipt of trade credit in

forms unrecorded in the estimates will be reversed if a net repayment of such credit takes place.

This article has inevitably contributed little quantitatively towards solving the problem of the "Balancing item". At the end it is perhaps some consolation to recall that the problem troubled commentators at least as early as the 18th century, as the following quotation shows:

"The several Sums supposed to be paid, are only set down to give the Reader in a short View some Idea of the general Trade we drive, and the great Sums those Nations draw from us, but not for him to depend on as certain Balances; there may be more due to some Countries, to other Countries there may be less, or the General Balance may be more, or it may be less; nor do I think it is possible by the Custom-house Accounts, or any other Calculations, to come to a Certainty; but by former Calculations the Sums set down here were supposed to be near the Balances those Countries had upon us, and we have Reason to believe they are not less now."
—*The Trade and Navigation of Great-Britain Considered* by Joshua Gee, 1st Edition, 1729.