Monetary movements in the U.K. balance of payments

The standard presentation of the balance of payments of the United Kingdom[1] has evolved since the war. Broadly speaking, it divides the accounts into two parts; first, the "balance of current and long-term capital transactions" – usually referred to as the surplus or deficit – and second, the "balance of monetary movements", which aims to show how the surplus or deficit has been financed. The two balances, if correctly recorded, would be equal; in practice they differ, and the difference is expressed as the "balancing item". This article is concerned with some aspects of the balance of monetary movements. It should be read in conjunction with other articles on the balance of payments that have appeared in earlier *Bulletins*.[2]

The balance of monetary movements is struck after grouping together a number of items which reflect flows, between the United Kingdom and the rest of the world, of different kinds of 'money', and of 'credit' – each term being used here in the broadest sense. In sum, it attempts to measure what may be termed the change in the country's net external liquidity position. For the United Kingdom, the change in short-term assets relative to that in short-term liabilities is of prime importance;[3] and the measurement of changes in net liquidity is, perhaps, the most generally useful way, among several possible alternatives, of presenting the monetary section of the accounts.

The items making up the balance of monetary movements are briefly defined at the end of this article; they are as follows:

a Miscellaneous capital.
b Change in liabilities and claims in non-sterling currencies.
c Change in liabilities and claims in overseas sterling area currencies.
d Change in external liabilities and claims in sterling.
e Change in official holdings of non-convertible currencies.
f Change in the account with the I.M.F.
g Transfer from H.M. Government's dollar portfolio to the reserves.
h Change in the gold and convertible currency reserves.

Sources and accuracy of the figures

Because most of the information needed for the calculation of monetary movements is derived from the records kept by the banking system, its collection has always fallen to the Bank of England. The Bank pass on the banking statistics to the Central Statistical Office, which is responsible for compiling the official U.K. balance of payments accounts. Nevertheless, for operational purposes, the Bank need to keep a close watch on the movements of funds into and out of the country.

About 200 banks and financial institutions in the United Kingdom furnish the Bank each month with information

1 As shown in *United Kingdom Balance of Payments 1967* (the 'Pink Book') and *Economic Trends*, published by Her Majesty's Stationery Office.

2 Articles entitled "Unrecorded movements in the U.K. balance of payments: the 'balancing item' ", and "The balance of payments: methods of presentation" have appeared in the March 1962 and December 1964 *Bulletins*, respectively.

3 The United Kingdom's short-term assets are exceeded by its short-term liabilities; the ratio of short-term assets to short-term liabilities is improved if both rise equally, and is made worse if both fall. In its international 'balance sheet', however, the United Kingdom has external assets (short and long-term) that substantially exceed its total external liabilities. See "An inventory of U.K. external assets and liabilities: end-1966" in the September 1967 *Bulletin*.

about their short-term external assets and liabilities in sterling and in foreign currencies;[1] detail is provided for some 85 countries. These statistics, combined with information obtained from the Bank's books about their own overseas assets and liabilities and the Exchange Equalisation Account's holdings of gold and convertible currencies, are the basis of seven of the eight monetary items. (Only "miscellaneous capital" is not derived from banking statistics.)

Because the books of the banking system are the prime source of most monetary movements there is good reason to believe that the figures in this section of the balance of payments accounts are more precise than most of the other items – which are mainly an aggregate of transactions entered into during a period, recorded or estimated with varying degrees of reliability. The banking items in monetary movements are derived from reports of amounts outstanding at the beginning and end of a period; and because the coverage of assets and liabilities is believed to be more or less complete, the question of estimation does not arise. Information supplied to the Bank for other purposes provides reassurance on this point.[2]

The individual monetary items represent the international financing flows arising both from current and long-term capital transactions and from other flows within the monetary account itself. An important example of offsetting flows within the monetary account is the movement of short-term investment funds between the United Kingdom and the rest of the world, which may produce changes in the United Kingdom's net external liabilities in sterling or in foreign currencies, and corresponding changes in the gold and convertible currency assets of the E.E.A. The reporting system is not designed, however, to show the extent to which changes in individual monetary items are directly related to other flows within the monetary account, and how far they reflect transactions elsewhere in the balance of payments.

In seeking links between monetary items and items in the current and long-term capital accounts, it must be borne in mind that, just as some transactions are offsetting within the monetary account, so others are offsetting within the rest of the accounts and do not impinge on monetary movements at all. Transactions in the current and long-term capital accounts are not restricted to cash flows; they are a record of transactions entered into, or of flows of resources, which may or may not involve a corresponding financing flow. A good example of a class of transactions that do not involve a financing flow is the substantial element of U.K. direct investment abroad that is financed by the retention of profits earned abroad. The debit entry included in the long-term capital account (the investment made out of retained profits) is matched by a credit entry of equal amount in the current account within "interest, profits and dividends" (the profits earned).

As noted earlier, the balance of current and long-term capital transactions should, if all entries were accurate, equal the balance of monetary movements, and should therefore itself be a measure of the total net financing flow. Such precision, however, is unobtainable; moreover, some entries

1 See "New series of external liabilities and claims in sterling" and "U.K. banks' external liabilities and claims in foreign currencies" in the June 1963 and June 1964 *Bulletins*, respectively.

2 Though there is always the possibility that some bank accounts of overseas residents may not be identified as such, there is no reason to think that these are significant in total.

recorded in the current and long-term capital account often do not synchronise with their related monetary flows – including the giving or receipt of trade credit. For these reasons the two measures of the financing flow obtained, on the one hand, from the balance of payments surplus/deficit and, on the other, from the balance of monetary movements, always differ; this difference is referred to as the "balancing item" or "errors and omissions".

The balancing item is thought to comprise a regular net credit, or positive element, of about £50-75 million a year, which probably reflects either a persistent underestimation of credits or an overestimation of debits, or both, in the current and long-term capital accounts. This is coupled with an irregular element, swinging between positive and negative, which, in the main, probably reflects unidentified flows of short-term funds and changes in the interval between the recording of transactions and payment for them. Many of these irregular flows would, if it were possible to identify them, qualify for inclusion in "miscellaneous capital".

"Miscellaneous capital" brings together a large number of identified movements in overseas accounts of U.K. residents (other than banks), and short-term lending and borrowing between U.K. and overseas residents. It includes, in particular, changes in outstanding trade credit which are not entered elsewhere in the balance of payments accounts. The figures for this item are derived from returns which financial institutions make to the Bank, and which government departments, public corporations and private companies make to the C.S.O. The information is incomplete; for example, little is known about changes in holdings of overseas sterling area currencies other than those held through U.K. banks. And the estimates for trade credit are probably not comprehensive, despite official efforts in recent years to improve them.[1]

Changes in the gold and convertible currency reserves

The efficient conduct of financial policy depends on ready access to reliable and up-to-date monetary statistics. Figures of key importance are the overseas liabilities and assets in foreign currencies and in sterling of the U.K. commerical banking system.[2] Along with early information about important elements of the current and long-term capital accounts, such as the figures of U.K. visible trade, changes in the banks' net external liabilities are indispensable to a preliminary interpretation of the movements in the official gold and foreign currency reserves.

The relationship between movements in the reserves and the many transactions entered in the balance of payments accounts is complex. In a few cases, changes in the reserves can be directly related to specific transactions – usually those of customers of the Bank, such as the Government and other central banks. Within the monetary account itself there are good examples of identifiable transactions in item *f* (official transactions with the I.M.F.) and item *g* (transfers from H.M. Government's dollar portfolio). But other changes in the reserves result from the dealings of the E.E.A. with commercial banks in the United Kingdom, and these, in turn, reflect a multitude of transactions entered

1 See Annex 3 of *United Kingdom Balance of Payments 1967*.

2 The statistics reported by the banks are included in the figures shown in Tables 20 and 21 of the annex.

into by the banks themselves, or by their customers.

In a world where most currencies are convertible, it is of little importance to the net liquidity position of the United Kingdom whether sterling or foreign currency is used as the means of settling balance of payments transactions. And what, in fact, finally determines movements in the reserves is the balance of all transactions on current and long-term capital account, taken in conjunction with the willingness, or otherwise, of overseas residents to hold part of their short-term external assets in sterling.

As mentioned earlier, the individual items that go to make up monetary movements include transactions which are offsetting within the same section of the accounts. Such transactions are largely inflows or outflows of volatile funds seeking short-term investment outlets. The flows cannot be identified with great precision, but tend to show up as changes in net external liabilities in non-sterling currencies[1] and in sterling. Movements of such funds will generally bring about an equivalent change in the official reserves – an inflow producing a rise, and an outflow a fall.

However, because monetary items *b* and *d* also reflect in part the financing of transactions on current and long-term capital account, it is impossible to determine to what extent they have led to movements in the reserves. At times both the balance of current and long-term capital and the net movement of short-term funds may be contributing to a fall (or an increase) in the reserves, whilst at other times they may be working in opposite directions. Because short-term funds normally move in response to interest rate differentials, there are occasions, as in 1960, when an inflow may completely overlie a developing deficit in the balance of payments. This kind of situation will not persist for very long, however – and, indeed, is likely to be quickly reversed – because movements of short-term funds are also swayed powerfully by confidence, which, in turn, is strongly influenced by the state of the balance of current and long-term capital transactions. For these reasons movements in the reserves can only be indicative of the balance of payments and short-term monetary movements taken together.

In recent years the development of central bank cooperation has made it possible to mitigate the impact on the reserves of large-scale movements of short-term funds – and indeed, for a time, to weather balance of payments deficits. But official action to counter the flows of short-term funds does not affect the balance of monetary movements as a whole; it simply rearranges the United Kingdom's liabilities between the overseas private and official sectors, and this is reflected in the components that make up monetary items *b* and *d.*

It is impracticable to compile the full balance of payments accounts of the United Kingdom at less than quarterly intervals. However, a good deal of information bearing on financing flows becomes available to the authorities soon after the figures of the reserves – though it is not in a form suitable for publication, being incomplete, more difficult to interpret than the published statistics, and not wholly consistent with them. A close study of this material, backed by information from foreign exchange markets and from

1 The change in net external liabilities in non-sterling currencies gives some indication of the extent to which U.K. banks, having taken in foreign currency deposits from non-residents, switch them into sterling, and lend them, in turn, to U.K. local authorities and others – see "U.K. banks' external liabilities and claims in foreign currencies" in the June 1964 *Bulletin.*

overseas monetary authorities, makes possible a provisional analysis of reserve movements for use by the authorities.

Problems of definition

So far in this article the monetary items have been regarded – as, indeed, they are defined – as short-term in their nature and as having primarily the character of 'money'. It can be argued that some of the items – particularly "miscellaneous capital" and the changes in net liabilities in non-sterling currencies and in sterling – contain elements that are not in this category at all. And, because of lack of information, there are elements included in certain items of the long-term capital account which might better qualify for inclusion within monetary movements. How far these qualifications seriously impair a realistic presentation of the balance of payments accounts is debatable.

Commercial credit is distributed between monetary items and the long-term capital account. Some changes in outstanding credit are, by definition, included in monetary items *b* and *d*, because the banks are asked to report on commercial bills and promissory notes deposited with them by their customers. And some, as mentioned earlier, is entered under "miscellaneous capital". Some of the credit transactions presently recorded within the monetary account might more appropriately be entered in the long-term capital account. For example, monetary items *b* and *d* include banking credit of a long-term nature, such as claims in the form of sterling promissory notes issued by non-residents, with repayment terms of between two and ten years; these fall well outside the usual definition of short-term credit – that having an original term of twelve months or less. Moreover, some of the trade credit that is entered under "miscellaneous capital" is not short-term. However, it is doubtful whether it would be possible to identify (and remove from the monetary account) long-term credit other than that covered by guarantees of the Export Credits Guarantee Department, without placing undue statistical burdens on reporting institutions.[1]

On the other hand, some commercial credit is not in the monetary account at all, but is recorded in the long-term capital account, under inward and outward direct investment. By convention, the figures of direct investment in the long-term capital account are in part a measurement of changes in intercompany and branch indebtedness. At the end of 1965 net indebtedness of overseas subsidiaries alone to their U.K. parent companies, measured over intercompany accounts, was of the order of £580 million;[2] gross indebtedness would have been substantially larger than this. Changes in such indebtedness reflect, in no small way, trade and other forms of short-term credit rather than the provision of fixed or working capital. It could be argued that the element of short-term credit within intercompany and branch indebtedness – though not having a high degree of liquidity – ought to be within the monetary account.

A case might also be made for removing from the monetary account some, if not all, of the changes in banking and official holdings of long-term British government stocks. These holdings are regarded as liquid, because they are

1 That is, banking credit, export credit not covered by guarantees, and credit for imports.
2 *Board of Trade Journal*, 30th June 1967, page vii.

readily marketable, and can, if necessary, be realised to finance the balance of payments deficits of the countries that hold them. Indeed, there have been some large movements in individual holdings over the years and this broadly justifies their treatment as short-term U.K. liabilities. On the other hand, it could be argued that some holdings, particularly those of overseas commercial banks, have an investment rather than a reserve or monetary function; and that holdings by central monetary institutions and by overseas commercial banks in total have remained remarkably stable. At the end of 1962, when records were first available, the combined holdings stood at £1,225 million; in December 1967 the total was £1,190 million. Over this period, they fluctuated within a range of about £100 million only. On these grounds there would seem some justification for entering such movements in the long-term capital account – along with changes in other holdings of gilt-edged.

These are but three examples of the complications of compiling a monetary account; the difficulties are in part methodological, and in part result from inadequate statistics. They have repercussions also outside the balance of payments accounts, for the criteria that determine whether transactions are entered there as short-term or long-term are used also to determine the division between outstanding short-term and long-term assets and liabilities in the United Kingdom's international 'balance sheet'.[1]

Improvements both in the presentation of the balance of payments accounts and in the figures are continually under review. Yet even if comprehensive information were available for all sections of the accounts, there would still be room for debate about the proper allocation of certain items between the long-term capital account and the balance of monetary movements.

1 September 1967 *Bulletin*, page 261.

Brief definitions of the items making up the balance of monetary movements

a **Miscellaneous capital**

Changes in official and private short-term assets and liabilities, which are not covered elsewhere in the accounts. Trade credit is included here if not granted or received through U.K. banks (when it is included in items *b* or *d* below) or over the accounts of related U.K. and overseas companies (when it is included in direct investment in the long-term capital account).

b **Change in liabilities and claims in non-sterling currencies**

Changes in official liabilities in non-sterling currencies in the form of deposits by overseas central banks, and changes in U.K. banks' external liabilities and claims in currencies of countries outside the sterling area; the latter mainly reflect the banks' participation in the euro-currency market and are a rough indication of the extent to which they switch foreign currency assets into sterling.

c **Change in liabilities and claims in overseas sterling area currencies**

Changes in U.K. banks' external liabilities and claims in currencies of other countries in the sterling area.

d **Change in external liabilities and claims in sterling**

Changes in external sterling liabilities (other than to the I.M.F.) and claims reported by the U.K. banking system (including the Bank of England), the Crown Agents, hire purchase finance companies and certain other financial institutions, together with temporary loans by overseas residents to U.K. local authorities.

e **Change in official holdings of non-convertible currencies**

Changes in the sterling equivalent of the E.E.A.'s holdings of non-convertible currencies; *i.e.* the very small element of foreign currency holdings excluded from the gold and convertible currency reserves.

f **Change in the account with the I.M.F.**

Changes in sterling liabilities to the I.M.F. arising from U.K. drawings on and repayments to the I.M.F. in foreign currencies; other countries' drawings and repayments in sterling; I.M.F. administrative and operational transactions in sterling; changes in the United Kingdom's gold subscription; and in I.M.F. gold deposits in the United Kingdom.

g **Transfer from H.M. Government's dollar portfolio to the reserves**

Transfers to the gold and convertible currency reserves of the proceeds of the portfolio of dollar securities vested in the Government during the war. (Before the transfers occurred, the composition of the portfolio had been changed from holdings mainly in equities to holdings of liquid assets).

h **Change in the gold and convertible currency reserves**

Changes in the sterling equivalent of the gold and convertible currencies held in the E.E.A.