

The overseas earnings of U.K. financial institutions

A growing recognition of the importance to the United Kingdom of the overseas earnings of its service industries has stimulated attempts to measure their contribution.¹ In the balance of payments accounts exports and imports of services – commonly referred to as ‘invisibles’ – are by international convention classified according to the nature of the transaction rather than the industry or type of institution which carries it out; thus it is not generally possible to identify the contribution made by an individual industry to the surplus that the United Kingdom habitually earns on its invisible transactions. Nor is it possible to measure the extent to which service industries facilitate the import and export of goods. Nevertheless it is worth trying to make industrial classifications of transactions on invisibles account, not only to illustrate the contribution that a particular industry may be making – and thereby perhaps to spur its efforts – but also to facilitate economic analysis as a basis of policy.

With these aims in mind, estimates have been made from time to time of the overseas earnings of the group of industries and institutions whose activities are historically associated with the City of London.² However, there are considerable conceptual problems involved in making such estimates. Not only is there the general problem (discussed later) of attributing overseas earnings, or payments, to a particular industry, but there is the additional difficulty of defining ‘the City’ in terms which are meaningful in a balance of payments context. Clearly the City cannot be taken as simply the ‘square mile’, as this would lead to a meaningless division of, for example, banking and insurance into business transacted within the City’s geographical limits and that transacted elsewhere. Equally, it cannot be taken to embrace all U.K. financial activities of whatever kind, because this would draw in firms whose business may not be connected in any way with the City. Ideally, the definition would take account of those activities, essentially financial in character, which are conducted within the City’s geographical boundaries or which are determined by the institutions and companies having their controlling offices within the City. But it is much easier to recognise the nature of the City’s activities than to frame an exclusive statistical definition of them.

If, however, the geographical concept of the City is replaced by a wider one covering the national total of activities traditionally associated with the City, only the problems of attribution remain – formidable though they are. Moreover, the economic justification for such an analysis is stronger. This article concerns itself therefore with such a grouping; in fact the basic grouping chosen is used in the official balance of payments estimates, where the overseas earnings from services provided by financial and similar institutions are recorded in the invisibles account under the heading “financial and allied services”.³ The activities of these institutions (insurance, banking, merchanting, brokerage and so

¹ The most recent example was the report *Britain's Invisible Earnings* by the Committee on Invisible Exports.

² *Britain's Invisible Earnings*, Chapter XIII.

³ See *United Kingdom Balance of Payments 1968* published by H.M.S.O.

on) are very largely, although not exclusively, associated with the City; and their overseas earnings are of special interest to the Bank.

However, it is necessary to go beyond the balance of payments item "financial and allied services" in three respects. In the first place – as was indicated earlier – the institutions may have receipts from overseas which are recorded under several other headings in the conventional balance of payments; these must be taken into account. Second, if a misleading impression is to be avoided, overseas earnings of any industry or institution must be recorded net of any associated payments made overseas. A supplementary note in the latest official balance of payments estimates¹ does in fact bring together the net receipts on current account for various financial and allied institutions, thus meeting the first two requirements set out above. The present article takes a third step: a number of other institutions, also associated with the City, which do not provide financial or allied services as defined in the balance of payments accounts, but which nevertheless earn substantial amounts from overseas by way of interest and dividends, are brought into the discussion. These are investment and unit trusts, and pension funds.

A true industrial classification of the balance of payments estimates should take account not only of 'direct' earnings² but of 'indirect' net earnings as well. Where the foreign currency proceeds received by one industry arise in part from the activities of another, this part of the proceeds may in principle be attributed as indirect earnings to the industry which facilitated the transaction, even though it did not necessarily receive the earnings direct from an overseas resident. (Going further still, a comprehensive account of the effect on the balance of payments of the activities of a particular industry should perhaps also consider what the results might be if the resources used by that industry were employed for different purposes – however, this is well beyond the scope of the present article.)

Generally, however, it is not yet possible to measure the institutions' indirect earnings from overseas – and in most cases it is doubtful whether it will ever be possible. Financial institutions provide services that are often closely associated with other services – it is probably true that the concentration of a wide range of financial activities in the City of London results in greater earnings for each industry than it could hope to gain alone – and they also provide services in connection with the import and export of goods, payment for which is not recorded in the invisibles account. Export merchants acting on behalf of U.K. manufacturers facilitate exports that might otherwise fail to find a market; and the banks finance many imports at a lower cost in foreign currency than if credits were obtained abroad – though it is also fair to point out that they may thereby facilitate some imports which might not otherwise have been made.

Because of the difficulties of estimating indirect receipts and payments this article is confined almost entirely to the direct earnings of the U.K. industries concerned. The article moreover is concerned with current rather than capital

¹ *United Kingdom Balance of Payments 1968*, page 49.

² The expression 'direct earnings' in the context of this article covers both the earnings from resources employed by U.K. companies in the United Kingdom and profits or income received from overseas assets. It should not be confused with the narrower term 'direct investment income' used in the balance of payments, which is confined to profits from investments in branches or subsidiaries overseas.

transactions. It is not a complete account, therefore, of the effect on the balance of payments of each industry's overseas business. Nor does the article generally concern itself with the earnings of foreign institutions. Extensive use is made of the official balance of payments statistics, but where it has proved impossible to adapt these to an industrial classification other sources have been employed. Many of the figures are very approximate and indeed for some items it is not yet possible to provide figures at all. For the present, the figures do little more than give some indication of the size of the overseas transactions directly attributable to each of the industries concerned.

Banking

The total of direct net earnings of banks, together with those of finance houses and similar institutions, averaged around £25 million a year over the years 1965 to 1967.

£ millions	1965	1966	1967
Services	16	20	23
Other earnings	98	97	96
Payments	-82	-99	-97
	32	18	22

The first item includes receipts from abroad on bill business, foreign exchange dealing, registrar and new issue business, and so on. The second item covers the greater part of the banks' overseas earnings, and includes the interest earned from the provision of credit to non-residents (mainly by way of loans, advances and discounts)¹ and earnings from branches abroad. The third item includes the interest paid on deposits taken from abroad (which fluctuates quite markedly from year to year), and also the profits earned by branches and subsidiaries in the United Kingdom which accrue to head offices or parent banks abroad. Although, as was explained above, the earnings of foreign institutions are outside the scope of this article, it is necessary to enter the profits earned by these foreign-owned branches and subsidiaries as a debit, simply because their overseas earnings are included indistinguishably in the statistics from which the first two items in the table are derived. However, this in turn produces an anomaly, in that the profits of these foreign-owned banks include those earned on their business in the United Kingdom – which by definition are not included in the first two items of the table. As a result, the direct overseas earnings of the U.K. banking industry are understated.

As was also explained earlier, indirect earnings are not included, and this leads to the overseas activities of the banking industry being presented in a particularly misleading light. Deposits by overseas residents with banks in the United Kingdom greatly exceed the banks' lending to overseas residents, so that the banks are net payers of interest abroad. But against this direct cost – which is taken into account in the figures set out in the table – there is a substantial indirect benefit to the United Kingdom, in that some

¹ Including sterling credits for the financing of trade between non-sterling countries – the exchange control authority for which has now been withdrawn (see page 347).

of the deposits are employed in lending to U.K. residents. Furthermore, when the banks switch foreign currency deposits into sterling instead of relending the currency abroad, there is an immediate increase in the official reserves and, depending on what kind of foreign asset is acquired for the reserves, a possible receipt of interest – or a saving of interest payments if the currency is used to repay official debt.

The impossibility of measuring indirect earnings has hampered many who have tried to estimate the overall effect on the balance of payments of the banks' earnings. Some have tried to repair the omission in their calculations by allowing the banks a compensating benefit – notably by deducting only part of their direct interest payments abroad from their gross direct income from abroad,¹ and by implication attributing the rest of the interest payable on deposits to the U.K. residents whose borrowing is thereby financed. But there is an insoluble problem in deciding what proportion of the banks' overseas deposits to treat in this way. The difficulty with this and similar adjustments is that they introduce arbitrary distortions into the estimates of direct earnings without truly repairing the omission of indirect benefits.

One kind of indirect earning can be estimated, namely interest charged by the banks on bills lodged with them by U.K. exporters against Export Credits Guarantee Department bank guarantees.² Though it is arguable that the banks can take at least partial credit for this type of business – even though it is the exporter who receives the earning direct from abroad – estimates of such interest are not recorded as banking earnings for the purpose of this article.³

Insurance

The overseas transactions of U.K. insurance companies and brokers, and of Lloyd's, comprise the premium income (less the cost of claims) on policies written in the United Kingdom on behalf of overseas residents and net earnings on re-insurance business; the profits of branches and subsidiary or associate companies abroad; and income from overseas portfolio investment. The total earnings are estimated at £80 million in 1965, rising to £135 million in 1967.⁴

Merchanting

Overseas earnings from 'merchanting' are rather diverse, but comprise, in the main, the profits from the overseas business of the various commodity markets (and the commodities section of the Baltic Exchange) and the profits on trade between third countries earned by other merchants. Merchanting profit is officially estimated to have been some £25 million a year in recent years. Merchants also receive income from abroad in the form of profits on re-exports from the United Kingdom; these profits are estimated at some £5-10 million a year.⁵

Commission on some U.K. exports is also earned by merchants, but this is more likely to come from the U.K. exporter (who passes on the cost to the foreign importer) than as a direct receipt from abroad.

¹ For example, in *Britain's Invisible Earnings*, Chapter XIII.

² For a detailed explanation of these bills see *United Kingdom Balance of Payments 1968*, page 51.

³ Estimates made by the Central Statistical Office for the three years 1965-67 are £7 million, £9 million and £14 million respectively.

⁴ The estimates of Lloyd's earnings included in these totals are three- or two-year averages; for a detailed explanation see *United Kingdom Balance of Payments 1968*, pages 49-50.

⁵ In the balance of payments accounts such profits are part of the value of re-exports and are not separately recorded under 'invisibles'.

There are also invisible earnings from imports, namely commissions paid to U.K. agents by foreign exporters for whom they act, and merchants' profits which serve to reduce the amount otherwise earned by foreign exporters. The total is officially estimated at £100 million for 1967, but it is impossible to distinguish between the earnings of merchants mainly engaged in trade between third countries – whose services qualify for inclusion in this article – and the earnings of those whose business is restricted to importing, which do not qualify.

Other financial and allied institutions

The figures given below are estimates of income in 1967 from a miscellany of activities.

£ millions	
Investment trusts	30
Unit trusts	2
Pension funds	5
Brokerage and other	33
	70

The income earned by investment and unit trusts and pension funds on their overseas investments is contained – but is not identifiable – in the balance of payments item “interest, profits and dividends”. It is not possible to adapt the official estimates for the present purpose, and the figures above are compiled instead by applying what appears to be an appropriate interest or dividend yield (net of certain taxes) to holdings of overseas securities at end-1967. In all cases, the institutions make payments abroad – dividend or income distributions, or pensions – but these are believed to be relatively small. Building societies are not included here merely because their overseas receipts and payments are believed to be very small.

The earnings of the remaining institutions listed under “brokerage and other” come from providing services to overseas residents. The major part is earned by the Baltic Exchange from chartering ships and aircraft, and from commissions received for arranging the sale overseas of second-hand ships on behalf of overseas owners; the estimates are approximate. (Brokers also earn commissions when second-hand ships are sold overseas on behalf of U.K. residents, but these cannot yet be measured satisfactorily.)

Also part of this grouping are the earnings of Lloyd's Register of Shipping – from surveying ships and industrial structures – and the earnings of the London stock exchange, such as brokers' earnings from deals on behalf of overseas residents and from handling new issue business. Other items include allowances for the earnings of dealers in gold and silver bullion, provincial stock exchanges, and shipbrokers who are not members of the Baltic Exchange.

Summary

If the estimates used in this article are aggregated – and there is some value in this even though the components are not comprehensive – the direct net earnings from abroad of financial and similar institutions appear to have averaged

out at some £235 million a year over the three years 1965-67, as follows:

£ millions	
Banking	25
Insurance	110
Merchanting	35
Other	65
	235

However, attention is again drawn to the tentative nature of many of the estimates and to the fact that no assessment can be made of these institutions' indirect earnings. In time, and with further information, it may be possible to widen the scope of this enquiry and to identify the contributions of other types of financial institutions for which separate estimates are not yet available. It may also be possible to publish figures which are sufficiently detailed and well founded to support conclusions about the trend of the institutions' direct earnings. It is likely, however, that conceptual and other difficulties will continue to prevent estimates being made of indirect earnings or of the aggregate effect (direct and indirect) of the institutions' transactions on the balance of payments.