The effects of exchange control abolition on capital flows

Almost two years have passed since the abolition of all remaining exchange controls in October 1979.[1] *This article assesses some of the effects of that decision on capital flows in the balance of payments. For a number of reasons, no precise estimates can be made.*

Introduction

Any assessment of the effects of exchange control abolition on capital flows is inevitably a rather limited one: with the lifting of exchange controls, a number of statistical sources were automatically discontinued, causing the loss of some data series and a deterioration in the quality of others, although the opportunity has subsequently been taken to introduce alternative sources in certain areas.[2]

More importantly, an assessment of the impact of abolition requires some estimate of what would have taken place had exchange controls remained in force. In addition to its direct effects—themselves hard enough to assess—abolition may have had considerable indirect results, changing, for example, the way sterling is perceived by residents and non-residents. If the demand for sterling has changed, the exchange rate will have developed differently in the absence of controls, affecting those flows, on current and capital account, sensitive to both actual and expected movements in it. Because of these difficulties, this article looks only at the capital flows most obviously affected by abolition, and refers almost exclusively to the response of UK residents.

During most of its life, exchange control was primarily intended to protect the foreign exchange reserves.[3] Investors were in general required to obtain prior permission for most categories of foreign currency investment, and were denied access to the 'official' exchange market for certain types of investment, which had to be financed by other means; the holding of other foreign currency assets, such as bank deposits, was restricted to those needed for trade; and the lending of sterling to non-residents, including trade credit, was also restricted.

Four categories of capital flows are identified here as being influenced by exchange control abolition: portfolio investment abroad; the refinancing in sterling of direct and, to a lesser extent, portfolio investment originally financed by foreign currency borrowing; private sector foreign currency deposits with UK and overseas banks; and sterling lending abroad by UK banks, including sterling deposits held by banks in the eurosterling market with UK banks.

Outward portfolio investment

When exchange controls were removed,[4] some increase in outward portfolio investment was expected for a number of reasons. In considering these, it may be helpful to distinguish a 'stock-adjustment' effect which, though once-for-all, may be spread over a considerable time as residents gradually adjust their holdings of overseas assets to desired levels; and a continuing 'flow' effect, which occurs even after this adjustment is complete, as residents seek to maintain their preferred portfolio allocation in the face of changes in wealth.[5]

Within the stock adjustment, three influences may be distinguished. First, the loss of the investment currency premium constituted a reduction in the wealth of investors who had previously been holding overseas securities whose sterling value had included the premium, and a disruption to their previous portfolio balance. At the end of 1978 the value of 'premium-worthy' securities was estimated at £5.3 billion, including the premium of 43% at that date, or £3.7 billion excluding it (see Table A).[6] While this loss was negligible compared with the total gross financial wealth of the non-bank private sector (estimated at £160 billion at end-1978), it was to be expected that attempts by investors to restore the pre-abolition share of overseas assets in portfolios would give rise to capital outflows. The period of adjustment is of course extremely uncertain, and must depend much on actual and expected movements in exchange rates and in domestic and overseas security prices.

Second, the abolition of the premium directly reduced the sterling price of foreign securities, and for this reason it was to be expected that investors would more than make good the fall in the share of overseas assets in their portfolios, as long as their foreign currency yields and risks remained unchanged. In addition, the removal of administrative

(1) Except for those needed to continue economic sanctions against Rhodesia until December 1979.

(2) Within the capital account, the two most important series lost were outward portfolio investment and direct borrowing abroad by companies. In addition, data on direct investment may no longer be as accurate as hitherto; it is no longer possible to identify within overseas currency net lending by UK banks that part used to finance investment overseas; and it can no longer be assumed that international issues of UK company securities are wholly taken up by non-residents.

(3) The details of exchange control were set out in *A guide to United Kingdom exchange control*, Bank of England, February 1977, and the relaxations were outlined in the September and December 1979 *Bulletins*.

(4) Some relaxations in the controls on outward portfolio investment were made in June and July 1979 before final abolition in October.

(5) A similar distinction may be drawn for other types of investment.

(6) Even if not all of this premium was regarded by investors as a permanent part of the market value of their investments it is clear that the disappearance of the premium caused some loss in wealth. The investment currency market was described in the September 1976 *Bulletin*, page 314.

Table A
UK portfolio investment in overseas securities— end-1978

£ billions

	Total(a)	Foreign currency securities			Sterling securities
		Premium-worthy		Non-premium-worthy	
		Including premium	Excluding premium		
Pension funds	1.5	..	..	0.3	..
Insurance companies	2.0	..	..	0.8	..
Unit and investment trusts	2.8	..	..	0.8	..
Other UK residents(b)	4.3	..	..	2.1	..
Total	**10.6**	**5.3**	**3.7**	**4.0(c)**	**1.3**

.. no analysis by holder is available for these securities.

(a) Includes premium-worthy securities as premium-inclusive. Excluding the premium, the total is estimated at 9.0 (see June 1981 *Bulletin*, page 204). The effective premium was 43% at end-1978. The estimate of the level of premium-worthy securities, in particular, is subject to a margin of error.

(b) Including Lloyd's (insurance).

(c) Of which about 1.7 financed by identified foreign currency borrowing.

Table B
Outward portfolio investment

Investment abroad − /disinvestment +
£ millions; quarterly averages

	1979		1980		1981	
	H1	H2	H1	H2	Q1(c)	Q2
Pension funds	− 45	− 147	− 237	− 355	− 353	..
Insurance companies	− 40	− 93	− 139	− 207	− 263	..
Unit and investment trusts	− 12	− 36	− 99	− 133	− 164	..
Cost adjustment(a)	+ 22	+ 30	+ 35	+ 50	+ 40	..
Other UK residents(b)	− 71	− 63	+ 16	− 410	− 550	..
Total	**− 146**	**− 309**	**− 424**	**− 1,055**	**− 1,290**	**− 1,180**

.. no analysis by holder is yet available.

(a) An adjustment to exclude the effect of costs (commissions, stamp duty and local taxes) of security transactions.

(b) Derived by residual up to and including the first half of 1980; thereafter, as shown by the new reporting system. Both series include estimates of transactions by Lloyd's (insurance).

barriers, and the resultant psychological impact, were expected to lead to an increase beyond the pre-abolition level in the desired share of overseas assets in portfolios. Such effects are likely to have been most important for the stock of overseas securities previously financed by investment currency, and to have had a smaller impact on that part financed by foreign currency borrowing or through any of the other exemptions.[1]

Third, some refinancing in sterling of investment originally financed with foreign currency borrowing was expected. Nevertheless, identified outstanding foreign currency borrowing for this purpose was only some £1.6 billion at the end of 1978, so that this effect was thought likely to be small.

Most portfolio investment by the personal sector is made indirectly through the financial institutions, which, it seemed, were likely to adjust their portfolios gradually by placing abroad a rather larger share of their cash flow. The stock adjustment could therefore take a considerable time to complete, but, once achieved, a continuing larger capital outflow, though smaller than in the stock-adjustment period, would be required to maintain this new portfolio balance as wealth increased.[2] Adjustment by residents other than through financial intermediaries was also expected to be prolonged.

Some of the effects expected have clearly taken place, as Tables B and C show. The institutions steadily increased their purchases of overseas assets throughout last year and into 1981.[3] This is not so clearly true for 'other UK residents' but the figures here (and therefore the aggregate figures for outward portfolio investment) are not from consistent sources throughout and must be treated with caution; the increase in portfolio outflows in the second half of last year may, therefore, have been less abrupt than shown in Table B.[4]

Table C shows separately average quarterly acquisitions by the financial institutions during the periods immediately before and after the lifting of exchange controls. For the pension funds, only some 7% of cash flow was placed overseas during the first three quarters of 1979, but since then the share has averaged 20%, and in the latest two quarters has reached 25%. This has been largely at the expense of investment in British government securities (BGS). The insurance companies also substantially increased the proportion of their cash flow placed overseas, although rather less rapidly than the pension funds, perhaps reflecting their different needs for growth because of the different proportions of their fixed and indexed liabilities and the greater freedom allowed to them earlier. By the first quarter of 1981, overseas acquisitions took 17% of insurance companies' cash flow, against 4% prior to abolition, with a relative shift away from BGS and company

Table C
Acquisition by financial institutions of overseas and selected UK assets

£ millions; quarterly averages
Percentages in parentheses

	Total acquisitions	*of which:*			
		UK liquid assets	British government securities	UK company securities	Overseas assets
Pension funds					
1979 Q1–Q3	1,160	78 (*7*)	486(*42*)	324(*28*)	77 (*7*)
1979 Q4–1981 Q1	1,377	− 8(—)	436(*32*)	398(*29*)	279(*20*)
Insurance companies					
1979 Q1–Q3	1,349	36(*3*)	739(*59*)	200(*15*)	48 (*4*)
1979 Q4–1981 Q1	1,458	− 13(—)	761(*52*)	190(*13*)	178(*12*)
Unit trusts					
1979 Q1–Q3	12	− 28	3	9	10
1979 Q4–1981 Q1	37	− 29	6	− 4	31
Investment trusts					
1979 Q1–Q3	− 2	− 3	24	− 21	9
1979 Q4–1981 Q1	—	− 8	− 7	− 67	81

(1) Insurance companies, for example, were allowed to purchase foreign currency securities to cover foreign currency risks.

(2) The size of the capital outflow would be smaller or bigger to the extent that changes in relative market prices or currencies were operating to facilitate or frustrate this objective.

(3) It may be that outflows in 1979 before abolition were depressed by anticipation of abolition.

(4) In order to fill the gap left by the disappearance of exchange control information, a new voluntary reporting system was introduced with effect from mid-1980. In the meantime, however, data were provided temporarily by a continuation of exchange control returns, at a reduced rate and on a voluntary basis, and there may therefore have been considerable understatement of portfolio outflows in late 1979 and the first half of 1980.

Table D
Shares of overseas assets in portfolios[a]
Percentages

End-year	1978	1979	1980(b)
Investment trusts	33.5	31.6	38
Unit trusts	16.4	19.5	23
Pension funds	5.4	6.0	8
Insurance companies	4.7	4.2	5

(a) Market values.
(b) Very tentative.

securities, and some reduction in liquidity. In net terms, unit trusts have acquired virtually nothing but overseas assets since late-1979, and investment trusts have substantially disinvested from the UK equity market in order to build up the stake of overseas securities in their portfolios.

Table D suggests that, on the basis of very tentative estimates, the institutions had by the end of 1980 not only recouped the loss on their portfolios caused by the disappearance of the investment currency premium, but had also in each case substantially increased the share of overseas assets, despite the appreciation of sterling over this period.

This share will have increased further during the first half of 1981 as a result both of the continuing large transactions outflow and the sharp increase in the value of the dollar.[1] As this stock adjustment comes to an end, outflows of portfolio investment should simply reflect the growth in domestic wealth, modified only by changes in relative yields and risks on domestic and overseas securities.

Clearly, outward portfolio investment has increased substantially since the abolition of exchange controls, though that is unlikely to be the sole reason.

Not all identified outward portfolio investment will have been in foreign currency securities. Some part (unidentifiable) will have been accounted for by resident purchases of sterling bond issues by non-residents in the London ('bulldog') market, now reopened.[2] Since July 1980 there have been eight issues, raising some £405 million in total.

In addition to these bigger outflows, there has been some change, as expected, in the financing of assets acquired before October 1979. Though the evidence is limited by the loss of statistical sources after 1979 due to abolition, the balance of payments data show net repayments of overseas borrowing for portfolio investment by companies of some £50 million in the final quarter of 1979, against an average quarterly rate of net borrowing since early 1978 of some £20 million. They also show repayments of foreign currency borrowing from UK banks, some of which will have been to finance portfolio investment.[3] Repayments ahead of schedule will have led to an immediate additional balance of payments outflow—a clear response to abolition—but this also means that outflows will later be reduced.

Outward direct investment

It is no less difficult to assess the impact of abolition on direct investment and its financing; and the statistical difficulties may be even more severe than for portfolio investment.

Table E
Outward direct investment and earnings
£ millions; quarterly averages

	1978 Q1–1979 Q2	1979 Q3–1979 Q4	1980 Q1–1981 Q2
Direct investment earnings	+611	+748	+662
Earnings retained overseas (increase–)	−325	−473	−341
New outward investment (increase–):			
New acquisitions	−314	−207	−347
Short-term	− 68	+ 37	− 35
Total outward direct investment (increase–)	−707	−643	−724
Finance of new investment:			
Identified foreign currency borrowing	+260	−378	..
Unidentified finance	+122	+548	+383

.. not available.

Table E divides the information about outward direct investment and its financing into three periods: before mid-1979, when the first relaxations were announced; during the second half of 1979 as these measures took effect; and finally since the beginning of 1980.

As exchange control was not designed to restrict profitable (direct) investment, which could generally be financed with foreign currency, it is perhaps not surprising that since abolition there has been little sign of any increase in direct investment overseas. The proportion of earnings retained abroad[4] increased substantially (from 53% to 63%) when controls were lifted but has since returned to its average pre-abolition level. In the last decade, this proportion has in any case varied markedly—from 56% in 1971 to 72% in 1972.[5] New acquisitions of overseas share and loan capital appear to have been lower in the second half of 1979, despite the removal of exchange controls, but if exceptional purchases of overseas companies in the earlier and later periods are excluded no new pattern is discernible.

The financing of overseas direct investment appears to have changed sharply (see lower part of Table E).[6] It is estimated that repayments of some £380 million were made

(1) Approximately half of overseas assets are thought to be held in North America.
(2) Within the balance of payments there may be offsets to the outward portfolio investment arising from resident participation in such issues to the extent that borrowers hold more sterling with UK banks than otherwise.
(3) A guide to that part representing institutional investment is given in the domestic banking sector data, which show net repayments of foreign currency loans from UK banks by 'other financial institutions' of some £560 million in the three quarters from mid-1979, compared with an average rate of borrowing of £165 million in the previous six quarters.
(4) The net taxed earnings of overseas subsidiaries retained abroad to finance investment, which were subject to the exchange control rule that two thirds of such earnings had to be repatriated to the United Kingdom.
(5) The 'two-thirds' rule does not appear to hold in the balance of payments statistics because exchange control applied only to companies where voting control lay within the United Kingdom, whereas the balance of payments data include figures for earnings of overseas companies where the UK interest is a minority.
(6) As with portfolio investment, the source of information on foreign currency borrowing was lost with abolition.

each quarter in the second half of 1979, in contrast to borrowing at a quarterly rate of £260 million between the beginning of 1978 and the middle of 1979.[1]

Apart from this 'immediate' adjustment, overseas direct investment is now likely to be financed relatively more in sterling, giving rise to continuing capital account outflows, though no firm indication is possible as to their size.

Private sector foreign currency deposits

The strong growth in private sector foreign currency deposits has also been in part a clear response to the lifting of exchange controls, although it may also owe much to movements in relative interest rates and in the exchange rate. These deposits have been mainly accumulated with banks in the United Kingdom (see Table F), though some have been with banks abroad. The latter are classified as balance of payments transactions but the former are not, as no non-resident is involved. Nevertheless, if UK banks on-lend the foreign currency overseas, there will be a balance of payments outflow.[2] The increase in foreign currency deposits held by UK residents with UK banks totalled the equivalent of £5.0 billion between end-September 1979 and end-June 1981;[3] most of this increase was attributable to industrial and commercial companies and financial institutions. In contrast, foreign currency borrowing by the private sector from banks in the United Kingdom has risen rather more slowly, by £2.9 billion;[4] and UK banks have increased their net external foreign currency lending by some £3.8 billion.[5]

Table F
Private sector foreign currency deposits, and sectoral net foreign currency positions

£ millions

	End-Sept. 1979	Average quarterly transactions			End-June 1981
		1979 Q4–1980 Q2	1980 Q3–1980 Q4	1981 Q1–1981 Q2	
Positions at banks in the United Kingdom					
Private sector					
Foreign currency deposits	4,737	417	358	926	9,690
Foreign currency borrowing	8,297	498	– 66	197	11,189
Switched position (– = out of sterling)	3,560	81	–424	– 729	1,499
Public sector switched position	2,393	– 118	–283	– 335	869
Overseas sector switched position	–4,798	328	392	1,355	– 994
Banks' switched position	– 1,155	–291	315	– 291	– 1,374
Positions at banks abroad(a)					
Private sector					
Foreign currency deposits	..	113	118	86(b)	2,789(c)
Foreign currency borrowing(d)	2,719	185	55	243(b)	3,480(c)

.. not available. (See footnote (a) below.)

(a) Based on statistics from banks in the overseas countries listed in footnote (a) to Table 13 in the statistical annex of this *Bulletin*. 'Deposits' include US dollar commercial paper and bankers' acceptances (about £250 million at end-September 1979 and £350 million at end-March 1981). The figures for borrowing include an estimated adjustment to exclude UK public sector borrowing and are therefore less reliable than the figures for deposits. Expansion of coverage increased deposits by about £600 million and borrowing by about £30 million in 1980; this break in series is excluded from the transactions data shown here, and means that, for deposits in particular, it is difficult to estimate a stock outstanding at end-September 1979 consistent with the transactions data shown.

(b) Transactions during Q1 only.

(c) Value at end-March.

(d) Includes borrowing through US dollar commercial paper.

Private sector foreign currency deposits with, and borrowing from, banks abroad each rose at about the same rate from end-September 1979 to end-March 1981—deposits by about £0.7 billion on a transactions basis (slightly less, taking into account valuation changes) and borrowing by some £0.9 billion.[6] There appears to have been no net capital outflow in this respect. But there has been a further drain on the balance of payments as UK residents' holdings abroad of sterling deposits (in the eurosterling market) have approximately doubled to about £1 billion.

Sterling lending overseas and overseas sterling deposits

Sterling lending overseas by UK banks, particularly to banks, and sterling deposits held by overseas banks with UK banks have both increased considerably since October 1979. When exchange controls were in force, lending had broadly to be associated with UK trade.[7] The flow was in general modest—some £6 million a month on average during 1979—and most outstanding lending was related to export credit.[8] By the first half of last year, sterling lending abroad had risen to some £110 million a month.

Since the ending of the supplementary special deposits scheme in mid-June last year, the average monthly increase in such loans has risen further, to £300 million. Much of this was to banks abroad, particularly unrelated banks rather than the overseas offices of domestic banks; by end-June 1981 loans to banks abroad accounted for over one third of UK banks' overseas sterling lending.

This additional sterling finance to banks abroad has been reflected, although to a smaller degree, in their increased holdings of sterling deposits with UK banks. Each is a manifestation of the growth of the eurosterling market and its closer integration now with the domestic inter-bank

(1) Even under exchange control, foreign currency borrowing could be repaid provided there had been matching benefits to the balance of payments.

(2) In balance of payments terms UK banks' net external assets in foreign currency will have increased. Since November 1979 the private sector's net foreign currency position with UK banks and the UK banks' net external lending in foreign currency have been significantly correlated with a coefficient of 0.72: that is, on average nearly three quarters of additional foreign currency deposits placed with UK banks by UK residents have been lent abroad.

(3) Of this, £3.9 billion was due to transactions and £1.1 billion to valuation changes.

(4) This includes the repayments referred to earlier. £1.8 billion was due to transactions and £1.1 billion to valuation changes.

(5) This figure may also have been influenced by other transactions, including some by the public sector, and in addition the banks themselves may have taken some advantage of their freedom from exchange controls to adjust their own currency positions.

(6) The data on UK residents' banking transactions abroad are based mainly on figures collated by the Bank for International Settlements from banks in the countries listed in footnote (a) to Table 13 in the statistical annex.

(7) From November 1976 onwards.

(8) The remainder was accounted for by sterling loans to banks' overseas offices and non-export-credit-related advances, each some 10% of the outstanding total, and lending to unrelated banks, only 5%.

sterling market; and though the gross flows are large, the net impact on the balance of payments and the exchange rate is probably rather modest.

Conclusion

No reliable quantitative estimates of the effects of the removal of exchange control can be made for the reasons discussed earlier. Nevertheless it is clear that there has been a considerable direct effect on certain capital flows in the balance of payments. Portfolio investment overseas has risen substantially since October 1979. The financing of both direct and portfolio investment has changed markedly, with early and substantial repayments of foreign currency borrowing; and a higher proportion of portfolio and direct investment is probably being financed in sterling on a more continuous basis. This shift towards sterling in the financing of investment flows could not have occurred had exchange controls remained in force. Although outward direct investment, which controls were not intended to restrict, has shown little sign of any increase since their removal, it is most unlikely that the rise in portfolio investment would have taken place without this shift. Finally, the recent increase in private holdings of foreign currency deposits with UK banks, much of which seems to have been on-lent abroad, has, in large part, only been possible as a result of the lifting of controls. There has also been a large increase in UK banks' sterling lending overseas following the growth and closer integration of the domestic and eurosterling inter-bank markets, but the net effect in this case on the balance of payments has been relatively small.

There must also have been indirect effects which this article has not sought to evaluate. First, the effectiveness of exchange controls in the past is likely to mean that in the absence of controls domestic interest rates are now somewhat higher,[1] albeit to an uncertain degree. Second, there is the related question of the behaviour of the exchange rate. It seems unlikely that the increase in overseas demand for sterling assets has been as great as the demand by UK residents for overseas assets in response to the lifting of exchange controls. Balance in the external account must, therefore, have been achieved by some downward, though unquantifiable, pressure on the exchange rate. This in turn will have affected flows throughout the balance of payments on both current and capital accounts.

(1) An effect independent of the way interest rates in the rest of the world have evolved since the lifting of exchange controls.