The external balance sheet of the United Kingdom: recent developments

This article, which continues an annual series,[1] examines changes in external assets and liabilities recorded in 1986, and indications for the first half of 1987. Limited international comparisons are drawn. The article also considers the earnings on these assets and liabilities, comparing estimates of the full return, which includes capital gains, with the recorded flow of interest, profits and dividends; and factors affecting the banks' overall contribution to the current account are described.

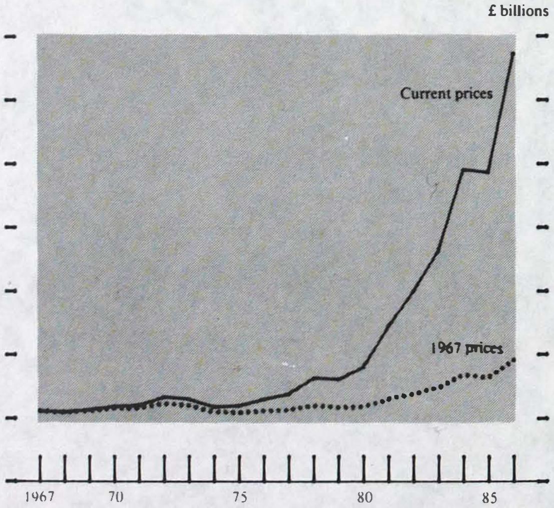
Developments to end-1986 and indications for 1987

As illustrated in Chart 1, the United Kingdom's net external assets increased markedly in 1986, from £77 billion to £114 billion.[2] Table H (at the end of this article) shows detailed figures of the composition of the balance sheet for the past five years, while Table A summarises the end-1986 position, allocating changes during 1986 between identified capital flows and a residual 'valuation' category. The pattern of capital flows in recent years, and for the first half of 1987, is further illustrated in Table B.

Recorded balance of payments flows during 1986 were, in summary:

	£ billions
Current account	− 1
Net identified transactions in assets and liabilities	−11
Balancing item	+12

Chart 1
Level of net external assets, in current prices and 1967 prices(a)



(a) On the basis of the GDP deflator.

Table A
UK external assets and liabilities(a)

£ billions

	Stock end-1985	Identified capital flows	Net valuation effect(b)	Total change in stock	Stock end-1986
Non-bank portfolio investment:					
Assets	**72.6**	15.3	23.4	38.7	**111.3**
Liabilities(c)	**17.8**	4.9	1.8	6.7	**24.5**
Direct investment:(d)					
Assets	**78.6**	11.8	4.2	16.0	**94.6**
Liabilities	**43.3**	5.4	− 0.1	5.3	**48.6**
UK banks'(e) net liabilities in:					
Foreign currency	**8.1**	4.1	− 0.3	3.8	**11.9**
Sterling	**11.2**	− 0.3	0.1	− 0.2	**11.0**
Public sector:					
Reserves (assets) less official foreign currency borrowing	**5.8**	1.4	1.3	2.7	**8.5**
British government stocks (liabilities)	**11.5**	2.1	0.1	2.2	**13.7**
Other net public sector assets	**7.8**	0.4	− 0.1	0.3	**8.1**
Other net assets	**4.4**	− 2.0	− 0.8	− 2.8	**1.6**
Total net assets	**77.3**	10.7	26.4	37.1	**114.4**

(a) The sign convention is *not* the same as in the balance of payments: thus a transaction which increases an itemised stock is + and one that decreases it is −.
(b) Residual component.
(c) Excluding estimated foreign take-up of UK banks' floating-rate note issues, which appears indistinguishably from foreign investment in other UK company securities in the published data but is treated here as part of banks' net foreign currency liabilities.
(d) Excluding UK banks' external borrowing from overseas affiliates, which is treated as an offset to outward direct investment in the published data but is treated here as part of banks' net foreign currency liabilities.
(e) UK monetary sector plus certain other financial institutions. Banks' holdings of foreign bonds are treated as foreign currency lending.

The rise of £37 billion in recorded net external assets could be attributed (as it is in Table A) to the net transactions outflow on capital account of £11 billion together with net revaluation gains amounting to £26 billion on the outstanding stock of net assets. Revaluation gains will have resulted both from sterling's decline during the year against most major currencies other than the US dollar and, more especially, from the buoyant performance of world stock markets, bearing in mind that UK holdings of overseas equities greatly exceed overseas holdings of UK equities. Chart 2 indicates, on this basis, the substantial contribution of revaluations to developments last year. There was, however, a very large positive balancing item. This may represent both

(1) Published in the September *Bulletin* in 1985 and 1986 and in the June issue in earlier years.
(2) This article is based on estimates published in *United Kingdom Balance of Payments, 1987 Edition* (the Pink Book): Central Statistical Office, August 1987, where the basis of valuation is also described. The net figure for end-1985 has been revised downwards from that quoted in last year's article (£80 billion).

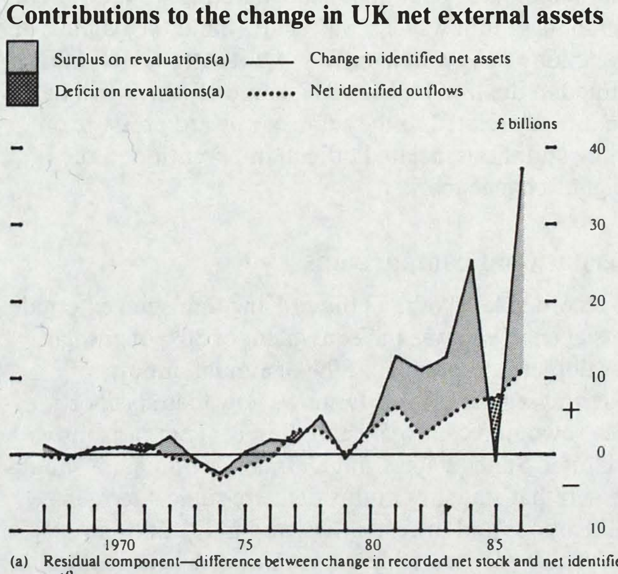
Table B
UK capital flows, 1975–86[a]
£ billions

	Annual averages 1975–79	Annual averages 1980–84	1985	1986	1987 H1
Non-bank portfolio investment:					
Net transactions in assets	-0.4	-3.3	-7.7	-15.3	-3.0
Net transactions in liabilities(b)	0.2	0.5	3.9	4.9	3.4
Direct investment:(c)					
Net transactions in assets	-3.1	-6.0	-9.3	-11.8	-6.6
Net transactions in liabilities(b)	2.1	2.7	4.4	5.4	1.7
UK banks' net liabilities in:(d)					
Foreign currency	0.4	0.7	-2.0	4.1	-9.3
Sterling	0.5	0.6	2.8	- 0.3	2.6
Public sector:					
Reserves less official foreign currency borrowing	-0.6	0.6	1.1	- 1.4	-6.2
British government stocks	0.4	0.9	2.9	2.1	2.4
Other public sector flows (net)	-0.5	-0.2	-0.5	- 0.4	0.3
Other net flows	—	-0.8	-0.6	2.0	0.5
Total net identified capital flows	**-0.8**	**-4.6**	**-7.2**	**-10.7**	**4.4**

(a) Increase in assets – /liabilities +.
(b) See footnote (c) to Table A.
(c) See footnote (d) to Table A.
(d) See footnote (e) to Table A. Through most of 1975–79 banks had net sterling claims.

unrecorded net capital inflows and unrecorded net current account credits, but it is generally presumed that the former have greater weight. In particular, the statistical reporting system is known to capture very inadequately many international financial transactions of companies with counterparties other than banks; certain such transactions have probably been growing in importance recently. To the extent that net capital inflows therefore passed unrecorded, the true total net outflow in 1986 will have been smaller.

Chart 2
Contributions to the change in UK net external assets



(a) Residual component—difference between change in recorded net stock and net identified outflows.

Moreover, measurement of the net asset position itself may have been distorted by some of the same factors responsible for the balancing item: in other words, where flows are known to be imperfectly recorded, so also may be the related stocks, most obviously in cases where the stock statistics are created by cumulating and revaluing flows. With a cumulative positive balancing item of some £27 billion over the ten years 1977–86, it is likely that the published statistics overstate, if anything, the underlying net external asset stock, but one cannot be precise. The figure of £114 billion remains the best estimate available on the basis of identified items.

During the first six months of 1987 there was, on the basis of current information, an identified net capital inflow of some £4 billion; sterling strengthened by about 9% against the dollar but by less against other major currencies, so that the rise in effective terms was 4½%; and most stock markets advanced further, with the UK one of the firmest. These developments contain offsetting influences on the external position. On balance they would seem to be indicative of little change or a slight decline in the net asset position up to mid-year, but the situation is clouded by, *inter alia,* a negative balancing item of some £4 billion, which may imply some unrecorded capital outflows.

The growth of net foreign assets during the 1980s has appeared in the private rather than the public sector's balance sheet. Indeed, the public sector's net foreign assets were, at £4 billion, somewhat lower at the end of last year than in 1979, although the substantial accretion of official reserves in the early months of this year, resulting in an end-September level of $35 billion as against $22 billion last December, will, despite the stronger sterling exchange rate, have altered the picture somewhat by now.

Portfolio investment

Most of the implied valuation contribution to the increase in net external assets last year arose in respect of portfolio investments overseas (Table A). The United Kingdom has more than three times as much invested abroad in ordinary shares as the overseas sector has invested in UK equities. Thus, other things being equal, a worldwide rise in stock prices will generate an increase in the United Kingdom's net asset position. Moreover, in 1986 the main overseas stock markets advanced more rapidly than London (Table C), and this effect was compounded by sterling's depreciation. In addition, foreign bond markets performed generally better than those of the United Kingdom: for example, prices of US dollar long bonds, which could account for around three quarters of all outstanding holdings of foreign bonds by UK investors,

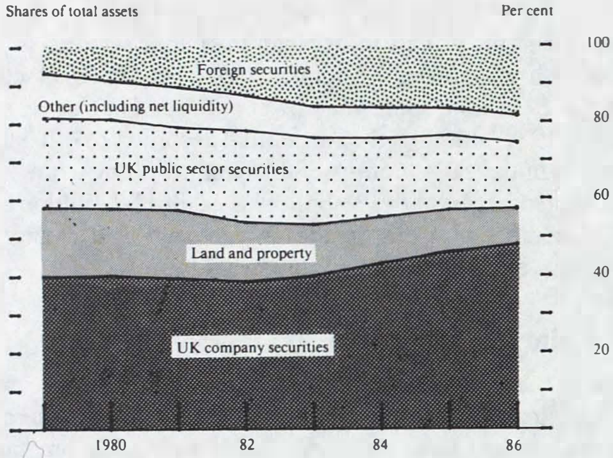
Table C
International comparisons of investment returns
Percentage increases

	1985		1986		1987 to end-September	
	Local currency	Sterling equivalent	Local currency	Sterling equivalent	Local currency	Sterling equivalent
Equity prices						
United States	23	- 1	24	27	28	14
Japan	14	12	52	75	40	40
Germany	54	55	22	47	- 4	- 8
France	29	-30	57	76	10	9
United Kingdom	20	20	17	17	44	44
Government long bonds						
United States	30	6	16	19	-23	-47
Japan	17	15	26	49	- 4	- 4
Germany	18	19	8	33	- 8	-12
United Kingdom	15	15	- 3	- 3	3	3

rose by 16% (19% in sterling terms) as against a small decline in UK long gilts. All of these factors will have led to UK assets abroad being revalued by more than UK liabilities to overseas.

Valuation effects were largely responsible for the overseas share in the portfolios of main UK institutional investors (ie insurance companies, pension funds, unit trusts and investment trusts) rising sharply, from around 16%, the level for the previous three years, to an estimated 18½% (Chart 3). This increase may also reflect the growing importance of unit trusts—which typically seek to hold a higher proportion of overseas securities than do other institutions—in the flow of new investment. Most of the increase in the outflow of new portfolio investment in 1986 was, however, accounted for not by the main

Chart 3
Composition of main OFIs' portfolios[(a)]



(a) Pension funds, insurance companies, investment and unit trusts.

traditional institutions but by securities dealers. It is possible, though by no means certain, that they sought to hold larger stocks of, for example, dollar floating-rate notes in order to support new techniques of interest rate management; or they may have been left with larger amounts of newly issued paper than they wished, as long bond rates bottomed out. In terms of the overall balance of payments it is likely that much of securities dealers' purchases were offset by inflows to finance them. Some of these inflows may have been through UK banks (whose foreign currency positions suggest as much), who on-lent to the dealers, but a possibly significant portion may have been borrowing not so far identified—for example from overseas affiliates—thus contributing to the positive balancing item. The latter possibility is corroborated by the coincidence in the first half of this year of a negative balancing item and significant disinvestment from foreign securities by dealers.

Higher UK share prices contributed to the increased value of the stock of inward portfolio investment in 1986, but the identified flow of new investment was a more important factor; this may have been related in part to increased new issue activity. It should be noted, however, that recorded inflows may understate the true flow of foreign investment, in that non-residents making purchases through UK-registered nominees may not always be properly identified as being from overseas.

Direct investment

The flow of direct investment also increased in both directions last year, doubtless associated in part with the high level of takeover activity both at home and abroad. At the end of the year the stock of outward direct investment was valued at roughly twice the inward stock. Outflows remained strong in the first half of this year, but inflows eased somewhat. The buoyancy of outward direct investment may owe something to the general growth of the UK economy in the recent past, which may be seen as providing a firm domestic base for expansion overseas. A positive association of this sort is suggested by recent Bank research.[(1)]

Banks' external transactions

Net external foreign currency transactions by UK banks resulted in a sizable inflow in 1986. Most of this was on-lent to the UK non-bank private sector (including, in particular, securities dealers), which also sharply increased its direct borrowing from banks abroad. Borrowing by the non-bank private sector gathered pace in the first half of this year even though securities dealers were then repaying. Some of this borrowing may have represented hedging against the weakness of the US dollar or speculation on its further decline. The pattern of sterling inflows to the UK banking sector was somewhat different. In 1986 these inflows fell away sharply and the balance of transactions was a small outflow. Quite strong net inflows resumed in the first half of 1987, some of which will have been directly related to the surge of upward pressure on sterling and the associated official intervention in the foreign exchange market.

International comparisons

The recorded level of the United Kingdom's net external assets at end-1986 was the equivalent of 30% of annual gross domestic product, or 89% of annual imports of goods and services. Table D shows how these proportions have grown in recent years and presents comparisons with the United States, Japan and Germany, although it should be noted that statistics in this field are subject to many qualifications and uncertainties, and may not be strictly comparable between countries. A point to bear in mind is that the net external position represents only a small fraction of total national wealth, most of which exists, so far as economic statistics measure it, in the form of tangible assets such as plant, machinery and buildings: the United Kingdom's net national wealth at end-1986 is estimated to have stood at £1,810 billion.[(2)] It is possible to adduce various arguments, on grounds of, for example,

(1) Pentecost E J. 'A model of UK non-oil ICCs' direct investment': Bank of England *Discussion paper* No 30, to be published shortly.
(2) See Table 11.1 in *United Kingdom National Accounts, 1987 Edition* (the CSO Blue Book).

Table D
International comparisons of external net asset positions[a]

End-years	1982	1983	1984	1985	1986
United States					
$ billions	126	77	- 7	-119	-275
Per cent of GDP	4	2	—	- 3	- 7
Per cent of imports(b)	36	21	- 1	-26	- 55
Japan					
$ billions	24	37	74	129	179
Per cent of GDP	2	3	6	10	9
Per cent of imports(b)	14	23	42	76	105
Germany					
$ billions	30	30	36	61	114
Per cent of GDP	5	5	6	10	11
Per cent of imports(b)	15	15	19	31	39
United Kingdom					
$ billions	62	75	89	112	186
Per cent of GDP	13	16	21	25	30
Per cent of imports(b)	32	42	48	58	89

(a) Excluding gold.
(b) Gross imports of goods and services.

economic development or demography, why particular countries might justifiably run current account surpluses (or deficits) for certain periods in their history, and so establish net external asset (or liability) positions. The United Kingdom's net asset position has arisen in part as a consequence of North Sea oil; it was clearly prudent that part of the wealth that originally lay beneath the sea should have been conserved rather than spent and it is not surprising that, in the short term at any rate, the wealth should have been transformed into external assets rather than into additions to the domestic capital stock, which would be expected to need more time to adjust effectively.[1]

Earnings related to the external position

The United Kingdom's net overseas investment income is estimated to have recovered sharply last year to £4.7 billion from £3.0 billion in 1985. It is possible to analyse the surplus on interest, profits and dividends in terms of two stylised components: banks' earnings from the spread they charge on loans to non-residents funded by borrowing from non-residents, which can be regarded as tantamount to receipts from banking services supplied to non-residents; and the balance of interest, profits and dividends earned or paid on the remainder of assets or liabilities respectively.

The calculation of the spreads on banks' lending to non-residents (and hence the earnings generated) was explained in some detail in last year's article. Spread earnings were maintained in 1986 at a similar level to the (revised) figure for the previous year (£2.6 billion—Table E) owing to a number of offsetting changes. Although average margins fell slightly, volume growth was sufficient to sustain the level of earnings. Margins on sterling business fell sharply from their 1985 peak (Chart 4) while those on foreign currency business, which is the dominant component, were little changed for the year as a whole, but started to fall towards the end of the year and have continued to do so this year. As a result, spread earnings

Table E
UK banks'[a] estimated spread earnings in 1986

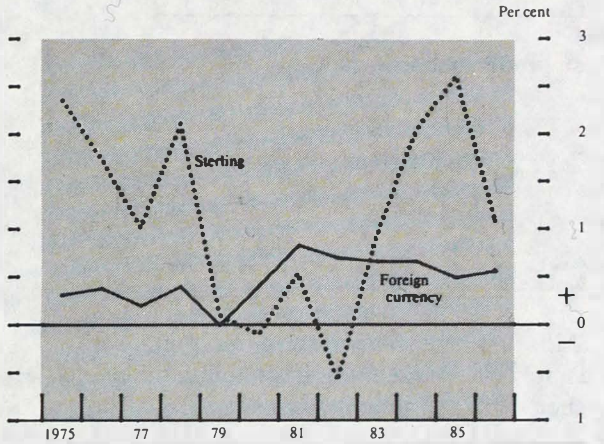
£ billions, *percentages in italics*

	Foreign currency	Sterling	Total
Net interest income(b)	1.6	- 0.8	0.8
less			
Estimated cost of net liabilities	-0.7	- 1.1	-1.8
Cost of funds(c)	*7.0*	*9.7*	*7.2*
equals			
Implicit spread earnings	**2.3**	**0.3**	**2.6**
Implied margin	*0.6*	*1.1*	*0.6*

(a) UK monetary sector plus certain other financial institutions.
(b) Including income from holdings of foreign bonds and export credit; excluding payments on loans from overseas affiliates.
(c) Equals calculated average cost of all liabilities.

are estimated to have fallen in the first half of this year. Recent moratoria on interest payments by certain troubled developing country debtors, and reschedulings at revised interest rates will have affected margins; increased competition and a shift in the balance of business from net lender to net borrower from non-banks abroad may also have been a factor.

Chart 4
Calculated margins on UK banks' international lending



Spread earnings alone do not provide a complete picture of the contribution of banks to the current account. Among other elements are interest payments on their *net* liabilities to overseas (ie funds that are on-lent domestically rather than re-routed abroad) and earnings in the form of fee income, which enter the services account (rather than IPD) and have become important in recent years on account of securities business. Table F shows the full picture for banks and the main other financial institutions together. The figures are confined to balance of payments flows and, as such, are more of accounting than of economic significance. In particular, bank borrowing from overseas to lend to domestic customers gives rise to a negative IPD flow in respect of banks, but they are plainly acting only as intermediaries, though nevertheless making a positive contribution to UK economic activity which would be lost if the customer borrowed directly from a bank abroad.

(1) For a fuller discussion of the North Sea endowment see the article in the December 1986 *Bulletin*, page 510.

Table F
UK banks'(a) income from external transactions
£ billions

	Annual averages 1975–79	Annual averages 1980–84	1985	1986
Net IPD earnings:(b)				
Foreign currency	−0.2	1.0	1.1	1.6
Sterling	—	−0.4	−0.5	−0.8
Sub-total	−0.2	0.6	0.6	0.8
Direct investment earnings	−0.1	−0.2	−0.5	—
Fee income	0.3	0.7	1.1	1.2
Total net income	**0.1**	**1.1**	**1.2**	**2.0**

(a) UK monetary sector plus certain other financial institutions.
(b) Including income from holdings of foreign bonds and export credit; excluding payments on loans from overseas affiliates and direct investment earnings.

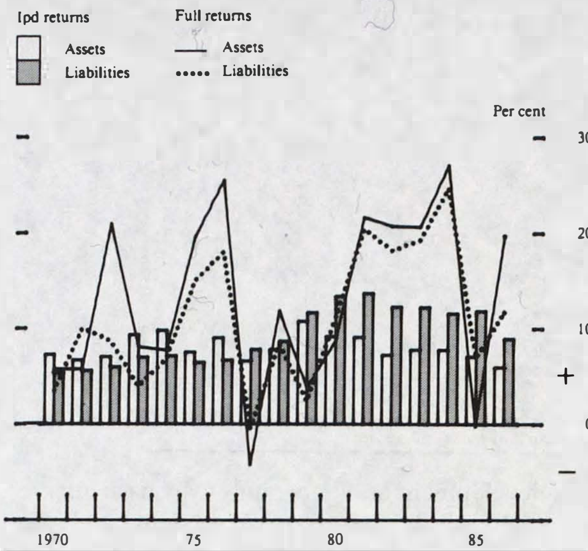
If the spread earnings described above are excluded, earnings received on external assets were unchanged in 1986, despite the growth in the stock of investments abroad resulting from both revaluations and capital outflows. Meanwhile foreigners' earnings on UK external liabilities fell (Table G). These developments underline the fact that movements in IPD earnings are not necessarily closely related to changes in the relevant balance sheet totals. In particular, asset prices may rise in the expectation of a higher return only at some future date. Shifts in interest rates are also important, with a considerably larger amount of UK liabilities than of assets being short-term instruments earning interest. The generally lower level of interest rates in 1986 helps explain the decline in IPD debits. Some of this decline may also be attributable to the lower oil price, which will have reduced the profits of foreign companies operating in the North Sea sector (but separate figures for oil IPD are no longer published).

Table G
Interest, profits and dividends
£ billions

	1985	1986
UK banks' spread earnings on external lending	2.6	2.6
Earnings on assets(a)	12.9	12.9
Payments (−) on liabilities(a)	−12.5	−10.8
IPD balance	3.0	4.7

(a) Figures for UK banks, other than their spread earnings, are entered on a net basis only, as payments on their net liabilities.

Chart 5
Estimated IPD and full rates of return on total identified assets and liabilities



The bars on Chart 5 show movements in the implicit IPD rates of return for total external assets and liabilities. The lines on the chart represent the 'full' returns once valuation gains (or losses) on the relevant stocks have been taken into account. Because of, in particular, fluctuations in equity prices and exchange rates, full returns can be quite volatile from year to year. Taking a run of years, in the period 1977–81 the average full rate of return on external assets and on liabilities were both about 8% per annum, while the rate of inflation (as measured by the GDP deflator) averaged about 14%. By contrast, in the five years 1982–86 the full rate of return on assets averaged some 18% compared with 16% on liabilities, and over this period the average rate of inflation was 6%. This latest period was clearly a satisfactory one for the United Kingdom, with assets earning somewhat more than liabilities and a significant positive real rate of return being achieved.

Table H
UK external assets and liabilities[a]

£ millions

End-years	1982	1983	1984	1985	1986
External assets					
Private sector					
UK banks' assets					
Overseas investment:					
Direct	1,985	1,912	941	2,954	5,720
Portfolio	6,701	10,572	22,265	28,125	34,422
External claims:					
Sterling	14,074	16,451	20,822	23,013	28,897
Foreign currencies	264,216	307,536	385,185	346,715	409,352
Non-bank assets					
Private investment abroad:					
Direct	49,794	56,004	77,470	71,412	84,578
Portfolio	33,499	49,028	61,735	72,575	111,278
Deposits held abroad plus advance and progress payments on imports by UK businesses	15,716	14,053	21,324	19,176	22,361
Other lending and short-term assets	4,820	7,554	9,884	8,624	6,578
Foreign notes and coin held by UK residents	55	68	80	84	96
Total private sector	**390,860**	**463,178**	**599,706**	**572,678**	**703,282**
Public sector					
Public corporations' assets					
Overseas investments:					
Direct	499	452	534	466	524
Other long-term assets	435	474	563	615	661
Other short-term assets and credit on imports	201	299	487	61	108
Total identified external assets of public corporations	1,135	1,225	1,584	1,142	1,293
General government					
Inter-government loans by the United Kingdom	1,226	1,214	1,149	1,097	1,053
Subscriptions to international financial organisations (other than IMF)	2,002	2,266	2,473	2,682	2,909
Other long-term assets	71	70	70	70	70
Export credit and bills	2,934	3,222	4,397	4,610	5,010
Total general government lending	6,233	6,772	8,089	8,459	9,042
Official reserves	12,939	12,805	13,219	13,201	17,424
Total external assets of general government	19,172	19,577	21,308	21,660	26,466
Total public sector	**20,307**	**20,802**	**22,892**	**22,802**	**27,759**
Total identified assets	**411,167**	**483,980**	**622,598**	**595,480**	**731,041**
External liabilities					
Private sector					
Overseas investment in the UK private sector:					
Direct	32,301	37,232	39,884	43,322	48,637
Portfolio	6,800	9,600	13,418	19,456	26,611
Total identified overseas investment in the private sector	39,101	46,832	53,302	62,778	75,248
UK banks' deposit liabilities in:					
Sterling	18,859	23,357	29,647	33,904	39,491
Foreign currencies	279,510	327,338	423,956	382,088	453,947
Advance and progress payments on exports	2,867	81	82	71	101
Direct borrowing abroad by UK non-banks, plus suppliers' trade credits on imports	12,948	14,065	15,758	16,007	20,152
Other (mainly short-term) liabilities	1,560	2,437	3,356	3,221	3,835
Total identified banking and other commercial liabilities	315,744	367,278	472,799	435,291	517,526
Total identified external liabilities of the private sector	**354,845**	**414,110**	**526,101**	**498,069**	**592,774**
Public sector					
Public corporations' liabilities					
Overseas borrowing by public corporations:					
Under the exchange cover scheme	2,432	2,640	3,013	2,725	2,917
Other	802	815	812	553	492
Overseas holdings of public corporations' securities	963	1,077	942	712	706
Total liabilities of public corporations	4,197	4,532	4,767	3,990	4,115
Liabilities of general government					
Net drawings on the IMF	35	—	—	—	—
Inter-government loans to the United Kingdom	1,846	1,957	2,323	1,758	1,631
Overseas borrowing by local authorities:					
Under the exchange cover scheme	262	360	481	530	708
Other	88	67	67	55	52
Short-term liabilities	880	403	294	299	490
British government stocks held by:					
Central monetary institutions	3,028	3,138	3,173	4,690	5,199
Other overseas residents	4,162	4,748	5,531	6,786	8,471
British government foreign currency bonds	491	547	272	562	1,689
Overseas holdings of local authority securities	223	210	200	200	210
Overseas holdings of Treasury bills and non-interest-bearing notes	1,186	1,206	1,330	1,345	1,304
Total general government	12,201	12,636	13,671	16,225	19,754
Total external liabilities of the public sector	**16,398**	**17,168**	**18,438**	**20,215**	**23,869**
Total identified external liabilities	**371,243**	**431,278**	**544,539**	**518,284**	**616,643**

(a) Notes and definitions on the series which comprise UK external assets and liabilities can be found in *United Kingdom Balance of Payments 1987 Edition* (the Pink Book) published by the Central Statistical Office.