

Invisible earnings of the UK commodities and financial futures markets

The UK commodities and financial futures markets have long been recognised as significant contributors to UK invisible earnings. Their contribution has not, however, been measured reliably for more than ten years. Against a background of large, positive balancing items in the balance of payments over the last few years, indicating the existence of unidentified net inflows in either current or capital accounts, a programme of work is in hand to improve the quality of balance of payments statistics. One part of this has been to carry out an enquiry to measure the extent of invisible earnings by these markets. This article describes the enquiry's findings.

The extent of invisible earnings by the commodities markets was last measured by a detailed survey covering the period June 1974 to May 1976. The nature and results of this survey were the subject of an article in the March 1977 issue of the *Bulletin* (pages 34–8). The results were used as the basis for the relevant entry in the current account of the UK balance of payments and, in the absence of comparable information for more recent years, subsequent entries have been based likewise on these results.

The Bank carried out a further survey of firms active in the London commodities futures markets between December 1985 and April 1986. The principal purpose of this survey was not to measure invisible earnings for balance of payments purposes, although the survey form included questions on this subject, but to yield current information on the distinctive features and international positions of the UK commodity futures markets and of the firms operating in them. The results of this survey were reported in an article in the June 1986 issue of the *Bulletin* (pages 216–24), which provides a wide-ranging description of those markets and of the nature of the business undertaken by the firms surveyed. The questions on invisible earnings did not, in the event, succeed in furnishing sufficient information on which to re-base the entries in the current account of the balance of payments. One reason for this was that the survey was targeted specifically at active traders in futures on the London markets rather than at the wider population surveyed in the 1970s, which provided fuller coverage of invisible earnings including those from physicals as well as futures trading.

The purpose of the recent enquiry, which covered 1988, was solely to obtain, at as low a cost as possible to the institutions completing the return, a simple but up-to-date estimate of the invisible earnings generated by the UK commodities and financial futures markets. The enquiry was less detailed than the 1974–76 survey and less specific as to the time period covered. Whereas the earlier survey took the form of monthly returns over a two-year period, firms were, in this instance, requested more simply to

complete a single return covering a whole year, preferably January to December 1988, but, failing that, any twelve-month period ended between June 1988 and May 1989 convenient to the accounting records of the individual firm. The survey of 1974–76 also required earnings to be broken down systematically by commodity or commodity type, whereas the enquiry form for 1988 sought this information as a supplementary item; firms were requested, if possible, to show a breakdown of any category of reported earnings by commodity or by market in any configuration which their accounting records conveniently yielded. One consequence of this simpler approach is severely to limit the analytical potential of the enquiry results. They cannot, for example, readily be related to the conditions prevailing in particular markets at particular times.

The enquiry was addressed to the membership of the principal UK commodities forward/futures markets covering the commodities with which the 1974–76 survey was concerned, namely, the Baltic Futures Markets, the International Petroleum Exchange, London Fox, and the London Metal Exchange. In addition, it was addressed to the membership of the London Bullion Market (silver was covered in the 1974–76 survey, but gold bullion was not) and of the London International Financial Futures Exchange, which came into being in 1982. The enquiry covered all UK members of these markets, whether clearing members or not, other than banks and oil companies, whose invisible earnings are measured by other means. It is appreciated that a still wider population of firms generate invisible earnings of the types covered, particularly in relation to trade in physical commodities, but the criterion of membership of corresponding forward/futures markets in the United Kingdom succeeds in identifying a significant number of UK traders in physical commodities. Enquiry forms were sent to some 330 firms, of which about three quarters responded. The Bank is grateful to these firms for their co-operation and to representatives of the various markets covered and of the International Commodities Clearing House for their advice in the planning stage of the enquiry.

Invisible earnings were defined for the purposes of the enquiry to include only those components particular to the commodities and financial futures markets which are not estimated by other means in the balance of payments accounts. Examples of components which are estimated by other means include the profits of overseas branches or subsidiaries and dividends or interest on portfolio investment in overseas securities. Further examples are referred to below. Four distinct types of invisible earnings were identified on the survey form.

The first of these types of invisible earnings consisted of commissions, fees and brokerage receivable from overseas residents (net of those payable to overseas residents, for example to brokers on overseas markets). Such earnings stem typically from activities as agents for clients either in physical commodities or on commodities or financial futures markets. Payments or receipts in respect of shipping, ship brokerage or insurance were specifically excluded, because they are estimated from other sources.

The second type of earnings was the net profit or loss made from trading as a principal in physical commodities with overseas counterparties. The intention here was to survey the profit or loss from third-country merchanting, excluding any profit or loss made on commodities imported into or exported from the United Kingdom and thereby included in the UK statistics of visible trade.

The third type of earnings related to transactions between UK and overseas residents on futures markets and in options on futures. Firms were asked to report net amounts receivable in this respect from their overseas clients (typically resulting from dealings on UK futures markets) and from overseas markets or overseas brokers (resulting from dealings on overseas futures markets either for the firm's own account or for account of clients).

The fourth type of earnings consisted of interest receivable from (net of interest payable to) overseas residents (typically clients or overseas brokers) other than banks. Bank interest is estimated by other means.

In many instances it would appear that firms' information systems were not equipped to make the critical distinction between UK and overseas residents, as, since the removal of exchange controls, there has been no operational reason for such a distinction to be drawn. Reported figures had therefore to be arrived at manually by these firms and frequently this process involved some degree of estimation.

Summary of results

The table summarises the results of the enquiry for three of the four identified categories of earnings. Reported earnings in the first two categories have been grossed up to allow for firms which did not respond to the survey. The fourth category brought to light only a negligible net figure. Figures reported in the third category amounted to

Net invisible earnings of UK commodities and financial futures markets in 1988

£ millions

(+ indicates a net inflow into the United Kingdom)

	Invisible earnings
(1) Net commissions, fees and brokerage	90
(2) Net profit/loss from trading in physical commodities	104
(3) Net transactions on futures markets and in options on futures:	
(i) net amount receivable from overseas clients	..
(ii) net amounts receivable from overseas markets or brokers	..
(4) Net interest receivable	—
Total	194

reported figures have not been included in the table.

£14 million (£16 million net receivable from overseas clients and £2 million net payable to overseas markets or brokers) but these have not been included in the balance of payments accounts for the reasons described below.

Differences in coverage and methodology between this and the survey of 1974–76 limit the validity of detailed comparisons. One difference which does, however, merit remark is the significantly greater contribution apparent in the recent enquiry of net commissions to total net invisible earnings. Of the total of earnings reported in the 1974–76 survey in the categories as closely comparable as are available to the first two categories of the recent enquiry, some 80% was represented by earnings from trading in physicals and 20% by commission earnings. This contrasts with 54% and 46% respectively in the recent enquiry.

The exclusion of banks and of oil companies from the enquiry, because their invisible earnings are measured by different means, is a significantly distorting factor. Banks make up a high proportion of the membership of the London International Financial Futures Exchange and the effect of excluding oil companies has been to remove from the scope of the enquiry those members of the International Petroleum Exchange whose earnings from trading in energy physicals may well be the most significant.

Earnings from trading in physical commodities

There are two particular limitations to the information provided by this enquiry on firms' earnings from trading in physical commodities. The first is the selection of an enquiry population on the criterion of membership of a forward/futures market. While a substantial number of traders in physical commodities are included on this criterion, coverage is not complete. The second is the exclusion of oil companies, referred to above.

Firms were offered two alternative methods by which to report their earnings from trading in physical commodities with overseas counterparties. The first method was to state the net amounts receivable from or payable to overseas residents in respect of this trade over

the survey period. Relatively few firms opted to provide information in this way. The more popular method was to state overall profit or loss from trade in physical commodities over the period and the estimated percentage (by value) of turnover which took place with overseas counterparties. The greater part of the total figure for earnings in this category is therefore calculated by this estimated method. In most cases the percentages representing business with overseas counterparties exceeded 50%.

Irrespective of the method by which firms chose to report, they were asked to adjust their figures to avoid distortion from changes in the value of stocks held at the beginning and end of the survey period.

Earnings relating to transactions on futures markets and in options on futures⁽¹⁾

Transactions on futures markets relate to futures contracts (for delivery up to many months ahead) and to options to buy or to sell such contracts. These may be entered into for a variety of reasons, such as to cover price risks on operations in physical commodities and to make a trading profit. Practice varies between markets, but, for the most part, holders of contracts make or receive payments of margin during the life of a contract, reflecting a proportion of the price movement against the holder or in the holder's favour respectively. The contracts are normally terminated before maturity, at which point the holder settles the balance of the profit or loss (known as 'differences') which has arisen as a result of price movements. It is movements on 'difference account' (including margin payments) relating to transactions between UK and overseas residents which this section of the enquiry aimed to cover.

Firms found this section much the most difficult to complete. Information systems were often not arranged to produce data of this type. Some found measurement or reasonable estimation here insuperably difficult, although they were able to complete other sections of the form.

The distribution of figures reported by firms able to complete this section was very uneven, very large figures (both positive and negative) being reported by a relatively small number of firms, and a greater degree of confusion and difficulty was apparent here than in the case of trade in physical commodities over making the adjustments to avoid distortion from changes in the value of contracts held at the beginning and end of the period.

As a result of the lower levels of response to this section of the enquiry form, the uneven distribution of figures and difficulties over making the necessary adjustments, it was concluded that the results of this section of the enquiry could not reasonably be used to construct a reliable indication of this category of invisible earnings.

Earnings relating to transactions on futures markets and in options on futures are a particularly volatile component of invisible earnings; this was recognised in the March 1977 *Bulletin* article. Large flows in either direction can occur during a given period, but, over time, net flows might be expected to be much smaller. There is, therefore, a particular danger in using a questionable estimate drawn from an occasional enquiry. Bearing in mind that the net figure itself does not suggest this is a major source of invisible earnings, a more reliable picture is probably afforded by assuming such earnings are nil, although it is recognised that such an assumption is likely to result in a small downward bias to the current account balance.

Contribution to the balance of payments

The results of the survey serve to confirm that the markets covered in this enquiry continue to contribute significantly to the United Kingdom's invisible earnings. With the exception of those earnings which relate to transactions on futures markets (and in options, on futures) and which have been omitted, the results of the survey have formed the basis both for the entry for 1988 in the current account of the balance of payments and for revisions to the entries for earlier periods.

The figure of £194 million for 1988 and the revised figures for the years 1980-87 were first included in *The Invisible Earnings of the City* published by the Central Statistical Office on 1 August 1989 and will be repeated later this month in *United Kingdom Balance of Payments—1989 Edition* (the Pink Book), also published by the CSO. The level of earnings established by the enquiry has produced downward revisions to figures previously published for 1980-87, replacing forward projections of total earnings derived from the 1974-76 survey. In the revised figures for these years, earnings from transactions on futures markets have now been omitted. The revised series, therefore, now consists of net commissions, fees and brokerage and of net profit/loss from trading in physical commodities only, interpolated on the basis of the trend in turnover in UK futures markets and in UK commodity prices respectively.

This enquiry represents a new benchmark and, as such, allows improvements to be made to the quality of estimates in intervening years, which had previously been projected from a distant base. The Bank will be exploring ways in which reliance on projections can be reduced for the future for this item, as part of the continuing programme of work to improve balance of payments statistics. In the particular instance of this enquiry, the revisions, because of their direction, have not proved helpful in identifying missing flows affecting the balance of payments balancing item, though it is to be hoped and expected that the programme of work as a whole will improve the consistency of the accounts.

(1) It is possible that, if any of the firms responding to the enquiry engaged in transactions in options on equities, such transactions have also been included here.