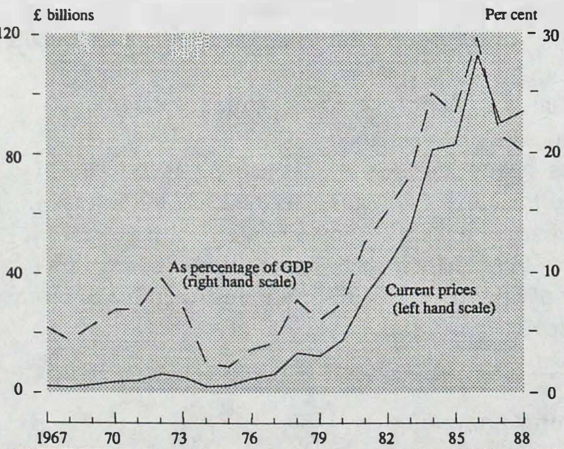
The external balance sheet of the United Kingdom: recent developments

This article, which continues an annual series, analyses the net external asset position of the United Kingdom as recorded at the end of 1988 and looks at indications for the first half of 1989. It examines the capital transactions and revaluations of assets and liabilities on the external balance sheet, and considers, in particular, the changes in the pattern of capital flows over the 1980s along with the associated flows of interest, profits and dividends. The United Kingdom's identified net asset position is compared with those of other major economies, and problems with the measurement of balance of payments flows are also discussed.

Introduction and overview

The United Kingdom's identified net external asset position stood at £94 billion at the end of 1988, a rise of nearly £4 billion on the (revised) end-1987 level. Despite this increase, net assets have not yet fully recovered from the fall in 1987, and still stand below the record end-1986 level of £112.8 billion (Chart 1).

Chart 1
Level of net external assets, in current prices and as a percentage of GDP



As in previous years, revaluation factors have been the principal element in the year's change in identified net external assets (Table A). In 1988 there was a total recorded net capital inflow of £2.3 billion (reducing net assets) which was more than offset by net revaluations of £6.2 billion due mainly to the increase in world stock market prices between end-1987 and end-1988. Chart 2 illustrates the annual contribution of capital flows and revaluations to the identified net asset position: revaluation factors have historically been the more volatile of the two effects, and it can be seen that 1988 is the first year since 1976 that net capital *inflows* have been recorded.

As well as being influenced by capital flows, the United Kingdom's identified external net asset position varies

Table A
Change in identified net external assets[(a)(b)]

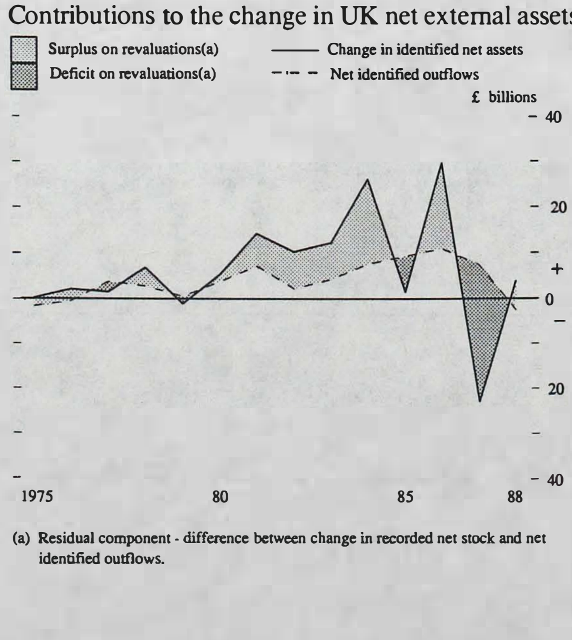
£ billions

	1986	1987	1988
A Change in identified net external assets (increase+)	29.9	-22.7	3.9
of which:			
(i) revaluations	18.8	-30.4	6.2
(ii) identified capital flows (outflows+)	11.1	7.7	-2.3
B Current balance (deficit -)	0.1	-3.7	-14.6
C Balancing item (inflows/credits+)	11.0	11.3	12.3

(a) Note different sign convention between section A and the rest of the table.
(b) C=A(ii)-B.

with fluctuations in asset prices: hence the end-year figure reported is not necessarily representative of the net asset position over the year as a whole. In 1988, the net asset position would have peaked around mid-year, probably at around £100 billion, because of the strength of the dollar (a large proportion of the United Kingdom's assets are dollar denominated) combined with a recovery in world stock market prices following the October 1987 declines. By the end of 1988, however, the dollar had fallen back from its mid-year peak and world share prices had steadied, leaving net assets lower at £94 billion.

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.

Table B
UK external assets and liabilities[(a)]

£ billions

	Stock end-1987	Identified capital flows	Net valuation effect(b)	Total change in stock	Stock end-1988
Direct investment:					
Assets(c)	**94.1**	14.5	-2.4	12.1	**106.2**
Liabilities	**56.1**	7.3	2.8	10.1	**66.2**
Non-bank portfolio investment:					
Assets	**92.9**	8.6	14.8	23.4	**116.3**
Liabilities(d)	**28.9**	3.2	2.2	5.4	**34.3**
UK banks'(e) net liabilities in:					
Foreign currency(c)(d)	**9.7**	3.8	—	3.8	**13.5**
Sterling	**13.9**	9.3	-0.2	9.1	**23.0**
Public sector:					
Reserves(assets)less official foreign currency borrowing	**20.3**	2.5	-0.3	2.2	**22.5**
British government stocks (liabilities)	**18.1**	0.9	-0.4	0.5	**18.6**
Other net public sector assets	**5.8**	0.7	-1.1	-0.4	**5.4**
Other net assets	**3.7**	-4.4	-0.1	-4.5	**-0.8**
Total net assets	**90.1**	-2.3	6.2	3.9	**94.0**

(a) The sign convention is not the same as in the balance of payments: thus a transaction that increases an itemised stock is + and one that decreases it is - .
(b) Residual component.
(c) 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.
(d) Excluding estimated 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. Banks' holdings of foreign currency bonds are treated as foreign currency lending.
(e) UK monetary sector plus certain other UK financial institutions.

In the first half of 1989, the strengthening of the dollar (by nearly 15% against sterling) will have acted to boost the United Kingdom's identified net asset position, as will the positive revaluation effects from rises in world share prices and, to a lesser extent, rises in world bond prices.

Table C
UK capital flows, 1976-88[(a)]

£ billions

	Annual averages 1975-80	Annual averages 1981-86	1987	1988	1989 H1
Direct investment:					
Net transactions in assets(b)	-3.4	-6.4	-18.2	-14.5	-8.7
Net transactions in liabilities	2.5	3.0	8.1	7.3	9.2
Non-bank portfolio investment:					
Net transactions in assets	-0.9	-6.7	2.4	-8.6	-12.6
Net transactions in liabilities(c)	0.2	1.7	6.5	3.2	1.2
UK banks'(d) net liabilities in:					
Foreign currency(b) (c)	0.4	-0.5	-1.9	3.6	1.9
Sterling	0.4	0.9	4.1	9.3	4.5
Public sector:					
Reserves *less* official foreign currency borrowing	-0.6	0.1	-12.7	-2.5	2.0
British government stocks	0.6	1.3	4.3	0.9	-1.2
Other public sector flows (net)	-0.4	-0.5	0.7	-0.7	-0.6
Other net flows	-0.5	—	-1.0	4.4	6.8
Total net identified capital flows	**-1.6**	**-7.1**	**-7.7**	**2.3**	**2.5**

(a) Using balance of payments sign convention: increase in assets -/liabilities +.
(b) See footnote (c) to Table B.
(c) See footnote (d) to Table B.
(d) See footnote (e) to Table B.

These revaluation effects, only partially offset by recorded net capital inflows in the first half-year as a whole, are likely to have restored the United Kingdom's identified net external asset position to over £100 billion around the middle of this year.

Net interest, profits and dividend (IPD) earnings on these assets were £5.6 billion in 1988, an increase of £0.6 billion on the previous year. The rise is essentially attributable to increases in the return on the existing stock, since exchange rate movements and the net capital inflows over the year will have tended to depress the IPD balance.

The path of external payments flows over recent years is obscured to some degree by the presence of the large balancing item, and it is not possible to say exactly where the misrecording lies. Over recent years the balancing item, while large, has been relatively stable, and as such there can be greater confidence in the direction in which identified balance of payments flows have moved than in their absolute size. It can therefore be said with some confidence that the current balance has worsened, net banking inflows have risen, and net direct and portfolio investment flows have generally continued on a (broadly rising) outward path over the 1980s. The next sections take the figures for individual elements of the capital account at face value and analyse their course over recent years.

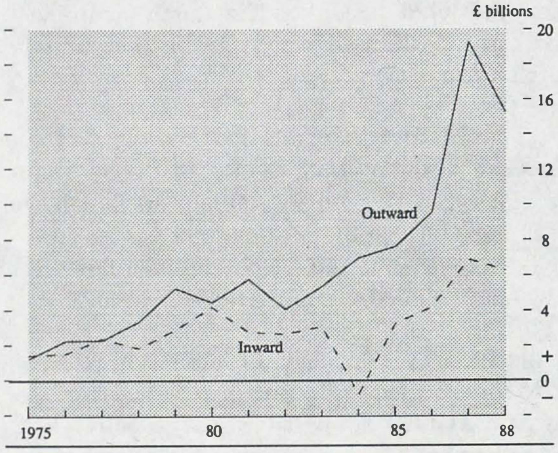
Direct investment

Sustained net direct investment outflows from the United Kingdom have clearly increased the financing requirement of the balance of payments. The last few years have seen a worldwide increase in direct investment flows. In 1987 the sum of gross direct investment outflows from G7 countries totalled nearly $120 billion and 1988 saw an outflow of similar magnitude ($114 billion).[(1)] These figures were sharply higher than the 1986 flows of $78 billion, and were more than three times the annual average flows of 1980–85, which fluctuated around $33 billion. (It should be noted that the dollar's effective rate was around 30% lower in 1987–88 than in 1985, which increases the value of transactions in dollar terms.)

The United Kingdom's direct investment flows have reflected this worldwide increase in activity, being strong in both directions during the late 1980s—the figures for 1988 and indications for 1989 suggest a level of investment only slightly lower than the record flows in 1987 (Chart 3). Over the 1980s outward flows from the United Kingdom have been around twice inward ones. The years 1986 to 1988 have seen a total of £45 billion outward flows, compared with a total of only £20 billion in the previous three years. Expressing these figures as a percentage of GDP shows that the United Kingdom has had by far the largest relative direct investment flows of the G7 economies.[(1)] Since 1980, outward direct investment from the United Kingdom has averaged 2.5%

(1) Figures are constructed from various local sources, which may not be directly comparable.

Chart 3
Outward and inward non-bank direct investment



of GDP, while inward flows have averaged 1.2%. The corresponding figures for the (unweighted average of) other G7 countries were 0.6% and 0.3%.

While the historically high levels of direct investment around 1986–87 were associated with buoyant world stock markets, the less certain market conditions following the October 1987 stock market crash have not ended the high levels of direct investment. Greater internationalisation of trade and the associated trend of cross-border acquisitions and mergers have been key influences here, while the United Kingdom's position as both an investor and a home for investment has been strengthened by generally high levels of profitability and the lowest rate of corporation tax among major economies.

The United States is the major home for, and one of the major sources of, the United Kingdom's direct investment, with transactions encouraged by the relative absence of administrative and regulatory impediments and the similarities of the markets in terms, for example, of language and culture. The falls in the dollar in the late 1980s served to make dollar-denominated assets relatively cheap, thus possibly further encouraging UK investment in the United States. The proportion of investment to and from other EC countries has risen markedly: in 1980–84 the EC accounted for an average of only 1% of outward[1] and 11% of inward flows, compared with 20% and 40% in 1985–87. The approach of the single European market in 1992 is likely to sustain and possibly boost these intra-European flows.

Acquisitions and mergers are an important component of international direct investment, although, because of varying methods of financing such activities, the values of deals *cannot* be equated with balance of payments flows. Cross-border acquisitions and mergers rose quite sharply in 1988 and remained strong in the first half of this year (Table D). On the outward side, the United States continued to dominate in value terms, but the number of

Table D
UK cross-border acquisitions and mergers
Value £ millions; *numbers of deals in italics*

	By UK companies (outward flows)				From overseas companies (inward flows)			
	1986	1987	1988	1989 H1	1986	1987	1988	1989 H1
United States								
Value £ millions	7,127	9,283	13,741	8,228	263	225	894	770
Number of deals	*176*	*197*	*290*	*137*	*16*	*19*	*23*	*13*
EC								
Value £ millions	643	1,199	1,809	1124	1,098	979	1,266	1,322
Number of deals	*62*	*124*	*193*	*142*	*14*	*12*	*32*	*25*
Rest of the world								
Value £ millions	1,169	1,305	1,525	702	1,513	1,498	3,474	435
Number of deals	*79*	*113*	*125*	*62*	*22*	*27*	*39*	*23*

Source: *British Business*, 15 September 1989; DTI.

deals with EC companies trebled between 1986 and 1988. The average value of such deals, however, has been relatively low at under £10 million, less than a quarter of the average value of deals with the United States. On the inward side, the United Kingdom has generally experienced a smaller number of higher value deals from the EC. Both inward and outward direct investment might be expected to increase as the EC moves towards being a single market, as the United Kingdom will be a target for other European firms and vice versa. Investment into the United Kingdom will also be boosted by investment from firms outside Europe wanting to strengthen or establish a European base, encouraged by the United Kingdom's generally open markets and relatively favourable regulatory environment.

In stock terms, the United States is the largest holder of direct investment in the United Kingdom—over £25 billion at end-1987,[2] while the equivalent figure for the EC was £14 billion. Japan apparently still has a very low stock of direct investment in the United Kingdom, under £2 billion at end-1987, of which over half took place in the most recent three years. This pattern is mirrored in the United Kingdom's stock of outward direct investments—with the largest share (over £30 billion) invested in the United States while under £1 billion is invested in Japan.

Other capital flows

Identified portfolio investment in 1988 (and so far in 1989) resumed its historical tendency to net outflows, following large-scale repatriations in the immediate aftermath of the October 1987 stock market crash. This disinvestment has now been fully reversed, although with the overall size of portfolios growing, the share of overseas securities will still be significantly below pre-crash levels. All the main categories of other financial institutions (OFIs)—pension funds, insurance companies, investment and unit trusts—made net overseas investments in 1988, being particularly active in the equity markets. Pension

(1) If disinvestment from the Netherlands over the period is excluded, most of which was due to holding companies' response to tax regulations, the proportion of UK investment to the EC over 1980–84 would have averaged around 12%.

(2) Further details of valuation of direct investment stocks are given in *British Business*, 29.9.89, 'Book value of UK direct investment overseas at end-1987'.

funds were the most active foreign investors of the main institutions in terms of gross flows, committing nearly £2.5 billion to overseas securities in 1988.

Several features can be distinguished within the inward portfolio flows, although these figures are probably one of the less reliable parts of the capital account statistics. Calls on various partly paid privatisation issues may have boosted the inflows into UK equities, with calls on, among others, British Gas, BP and British Steel. The generally low take-up of gilts in 1988 (less than a fifth of the 1987 figure) is probably associated with the scarcity of new issues coupled with net redemptions and the inverted slope of the UK yield curve, making short-term assets (such as sterling deposits) more attractive. Shortage of new gilts issues may also have caused some substitution into private sector bonds, the inflows into which may not be well covered in the statistics.

In 1988 banks' business overseas was dominated by huge net inflows in both sterling and foreign currency, the former largely reflecting the profile of UK interest differentials. The sterling interest rate differential against other major economies rose throughout 1988—the average differential was approximately 2½, 6 and 6½ percentage points against the US dollar, the deutschemark and the yen respectively, rising by an average of over 2 percentage points between the first quarter of 1988 and the second quarter of 1989.

The sustainability of the current deficit is often thought to be related to the extent to which it is being financed by shorter-term funds. While, however, short-term funds may be thought of as potentially volatile, there are a number of reasons why the recent recorded increase in such inflows may not reflect a fundamental shift in vulnerability. First, the definition of short/long term is essentially arbitrary. For example, it is probably not feasible to classify portfolio flows as either short or long term—they may be anything from speculative positions to part of a strategic long-term investment portfolio. Furthermore, whatever distinction were to be made, the absolute size of the component flows must be treated with caution given the size of the balancing item. It is also the case that the large size of the gross stocks of many aspects of the balance sheet means that apparently substantial fluctuations in annual transactions can have a relatively small impact on the overall levels.

Effects of revaluations

The United Kingdom's identified net asset stock rose £3.9 billion over 1988, despite there being net identified capital inflows of £2.3 billion. The implied £6.2 billion of revaluations can be decomposed into specific effects, although such analysis will inevitably be approximate owing to imprecise knowledge of the distribution of assets/liabilities between each currency, country and instrument and the lack of information on the detailed time-profiles of the investment flows. Bank estimates of the relative contributions to the total stock of revaluation

Table E
Contributions[a] to revaluations of net external assets

£ billions

	1987	1988	1989 H1
Equity prices	1	15	2
Bond prices	-5	-1	2
Exchange rates	-25	-4	12
Other	—	-3	-2
Total	**-29**	**7**	**14**

(a) Bank estimates.

from exchange rate and security market movements (which need to be interpreted in the light of this caveat) are given in Table E, while Table F gives examples of the underlying variables.

The major positive contribution to the revaluation of net assets in 1988 was the appreciation of world equity prices. The stock of overseas equity held by the non-bank private sector was around £90 billion, some £60 billion higher than the stock of UK equity held by the overseas sector, and world equity prices in 1988 rose approximately five times as much as UK equity prices (in local currency terms): the combined effects of which added £15 billion to the value of UK net assets. This relatively slow growth of UK stock markets was partially reversed in the first half of 1989, with UK equity prices rising by 13 percentage points more than those overseas. The estimated net effect, however, was a £2 billion rise in net assets—a consequence of the comparative sizes of equity holdings noted above.

Table F
Sample of revaluation variables

Percentage changes

	End-1986–end-1987	End-1987–end-1988	End-1988–end-June 89
$/£ exchange rate	+27	-4	-14
£ effective exchange rate	+9	+4	-7
UK 20-year gilt price	+8	+1	-2
US 30-year bond price	-16	-1	+12
UK share price	+5	+5	+21
World share price(a)	-1	+26	+8

(a) Excluding the United Kingdom. Local currency terms.

Movements in exchange rates reduced the end-1988 net external asset stock by around £4 billion compared with end-1987. This was the balance between a 4% depreciation of sterling against the dollar over the year—which served to boost the dollar-denominated portion of the net foreign currency stock—and a 6% appreciation against non-dollar currencies, with the latter effect dominating. The 7% depreciation of the (effective) exchange rate in the first half of 1989 will have caused an upward revaluation totalling approximately £12 billion. Such a pronounced effect is a consequence of the especially sharp (14%) depreciation against the dollar, in which around 40% of the United Kingdom's net foreign currency asset stock is denominated.

A slight fall in world bond prices over 1988 caused a negative revaluation effect of nearly £1 billion over the year, although the impact of sharp rises in US bond prices in the second quarter of 1989 will probably have more than reversed this.

Balancing item

A positive balancing item implies (some combination of) unrecorded current account net credits and unrecorded net capital inflows. The balancing item in 1988 was a record £12.3 billion and its cumulated sum (following revisions/improvements to back data) since 1975 is over £54 billion—£35 billion of which has accrued since 1985.

The errors could lie in either the current or the capital account; in both cases there are grounds for suspecting greater accuracy in certain individual areas, in part because of the type of reporting systems in place. Since this article is primarily concerned with the net asset position and the associated flows, only the relative reliability of elements of the capital account figures is examined here. Several known areas of weakness can be cited in the statistical reporting systems for capital flows which would lead to relatively low reliability of the figures. The abolition of exchange controls and, later, the deregulation of the London financial markets in 1986 ('Big Bang') have made the recording of flows more problematic and have been followed by increased international capital movements. The entry of large numbers of institutions into the London markets, along with the development in recent years of several new financial instruments, for the most part in bearer form, have made ownership more difficult to trace. Statistical reporting systems, some of which were lost with the abolition of exchange controls, have inevitably lagged behind these innovations, and this could contribute in large measure to the problem of recording capital flows. Particular inadequacies exist in the capturing of portfolio investment (particularly inflows to the United Kingdom), the recording of trade credit (which tends to make the balancing item more positive if the current deficit worsens), securities dealers' activities and certain types of short-term capital flows which by-pass the banking system, eg short-term euronotes.

Several improvements to the reporting system are, however, in train, particularly as regards portfolio investment. With the exception of outward investment by the major types of investment institutions, which is directly reported by those institutions, the statistical system for portfolio investment currently relies on returns completed by a panel of banks and securities dealers in respect of their own-account transactions in securities, and of transactions handled by them for clients. The Bank has carried out the regular triennial census of the potential reporting population in the second half of 1988—which will enable the panel of regular reporters to be updated. This panel was last determined in 1986 and developments since then (such as Big Bang) may mean that the updating of the panel may result in larger changes than usual.

A new reporting system for securities dealers, akin to that for other OFIs and based on regular balance sheet information, is also now in place. This will provide a fuller picture of the activities of securities dealers. The results of these various exercises have not yet been fully incorporated into the figures but are expected to be so in the course of 1990. They are intended to improve coverage and hence, it is hoped, reliability. (It is, however, unlikely that the resultant revisions would significantly alter the broad shape of the capital account, with longer-term net outflows and shorter-term inflows.)

Notwithstanding the above improvements, the presence of a persistently large unidirectional balancing item inevitably raises questions about the accuracy of other aspects of the balance of payments accounts: and the true net asset position could differ substantially from the identified figure.

The existence of unrecorded inflows in the external accounts has a number of possible implications. To the extent that the balancing item is composed of missing capital inflows, the United Kingdom's actual gross liabilities will be higher, and hence the actual net asset position will be lower, than the recorded figure. To calculate the actual net asset position, the unrecorded inflows should first be included in the gross liability stock. These (unrecorded) net liabilities may (depending on their precise nature)[1] imply unrecorded associated IPD debits, which would worsen the current balance and hence imply further unrecorded capital inflows. At a third stage, the unrecorded inflows should be subject to revaluation, which would be likely to reduce the United Kingdom's net asset position further.

To take an extreme example for simplicity, if the balancing item were entirely composed of unrecorded capital inflows, simply adjusting the liability stock for these missing inflows alone could reduce the United Kingdom's net asset position by approximately £54 billion (taking 1975 as a starting point). The net position would then be further reduced by revaluation effects and, assuming the missing inflows were of a type associated with unrecorded IPD debits, by the flows corresponding to these debits. According to which part of the capital account the unrecorded capital flows were attributed to, the payment of these additional IPD debits may either leave the current account position unchanged or worsen it. This calculation assumes that the balancing item is composed entirely of unidentified capital inflows. Were it the case, however, that the balancing item reflected, in its entirety, unrecorded current account credits, the recorded net asset position would be unchanged.

In the above example, the effects all combine to reduce identified net external assets. It should be noted, however, that the recording system for direct investment may bias

(1) For some capital account items the associated IPD is directly measured or independently estimated; for some items it is imputed from a directly measured stock position, while for a third category it is imputed from a stock position which is itself imputed from recorded flows. Only in this last category does the supposition of unrecorded inflows directly give rise to associated IPD debits.

the figures in the opposite direction, as direct investment tends to be recorded at book value.[1] The actual market value of the United Kingdom's (large) net stock of overseas direct investment is therefore likely to be substantially higher, hence the net asset position will be correspondingly higher. These two effects, of unrecorded inflows acting to reduce identified net assets and the underrecording of direct investment, will be offsetting to some degree.

International comparisons

Expressed in dollars, the United Kingdom's identified net asset position (excluding gold holdings) has remained fairly flat over the last three years, following a steady rise throughout the early 1980s (Table G). The slight

Table G
International comparisons of external net asset positions(a)(b)(c)

End year	Average 1980-83	1984	1985	1986	1987	1988
United States						
$ billions	107	-8	-123	-279	-389	-544
Per cent of GNP	4	—	-3	-7	-9	-11
Per cent of exports (d)	39	-3	-44	-90	-110	-126
Japan						
$ billions	20	74	129	179	240	291
Per cent of GNP	2	6	8	9	8	10
Per cent of exports (d)	11	37	50	65	66	76
Germany						
$ billions	26	36	46	87	158	199
Per cent of GNP	4	6	6	9	12	17
Per cent of exports (d)	12	19	17	26	39	52
United Kingdom						
$ billions	55	88	114	160	161	162
Per cent of GNP	12	23	22	28	20	19
Per cent of exports (d)	44	83	77	109	80	83

(a) Net external assets are only one component of net national wealth, the relative size of which varies from country to country. In the United Kingdom, net external assets (including gold) have averaged less than 5% of net national wealth over the 1980s.
(b) Excluding gold holdings.
(c) The data underlying this table are taken from national sources which may use disparate methodologies.
(d) Gross exports of goods and services.

depreciation of the dollar between end-1987 and end-1988 and movements in world stock prices combined to leave the United Kingdom's net assets, excluding gold, little changed in dollar terms at $162 billion at end-1988, while in the previous year the appreciation of sterling against the dollar by over 25% in the year to end-1987 effectively disguised the fall in total sterling value of net external assets. UK net assets at end-1988 remained at around 20% of GNP, while rising to 83% of gross exports.

While the figures in Table G are subject to the qualification that they have been compiled from national sources which may not have been constructed on an entirely consistent basis, the divergent trends between the G3 countries are clear. The net external asset position of the United States deteriorated further in 1988, by over £150 billion. The gross liabilities of the United States have risen much faster than its assets in recent years, leading to the switch in the mid-1980s from net external creditor to net external debtor, a development which mirrored the movement in the current account deficit. It is also notable that in 1988 the United States for the first time had a net stock of direct investment liabilities. Both Japan and Germany, with substantial current account surpluses, have continued to accumulate net assets abroad, following the pattern seen throughout most of the 1980s.

Interest, profits and dividends

Of the income earned on the net external assets of the United Kingdom, net interest, profits and dividends (IPD) in 1988 was £5.6 billion, £0.6 billion higher than in 1987. Within total IPD, net monetary sector interest income (Tables H and J), at *minus* £0.5 billion, was virtually unchanged from the previous year as an increase in spread earnings on assets (ie profits earned from the interest differential between lending to and borrowing from the overseas sector) offset the higher cost of net liabilities (ie the cost of borrowing from overseas

Table H
Interest, profits and dividends
£ billions

	1987	1988	1989H1
Earnings on assets			
Portfolio(a)	3.1	3.4	1.9
Direct	11.3	12.9	7.1
Other non-bank private sector	1.7	1.7	1.2
Public sector(b)	0.9	1.5	1.0
UK banks' spread earnings on external lending	1.3	2.0	0.9
Payments on liabilities			
Portfolio(a)	1.3	1.8	1.4
Direct	6.6	7.4	4.3
Other non-bank private sector	1.7	1.9	1.3
Public sector(b)	2.1	2.3	1.2
Banks' cost of net liabilities	1.7	2.5	2.2
IPD balance	**5.0**	**5.6**	**1.6**
Balance excluding spread earnings	3.7	3.6	0.7

(a) Non-bank private sector.
(b) Including official reserves.

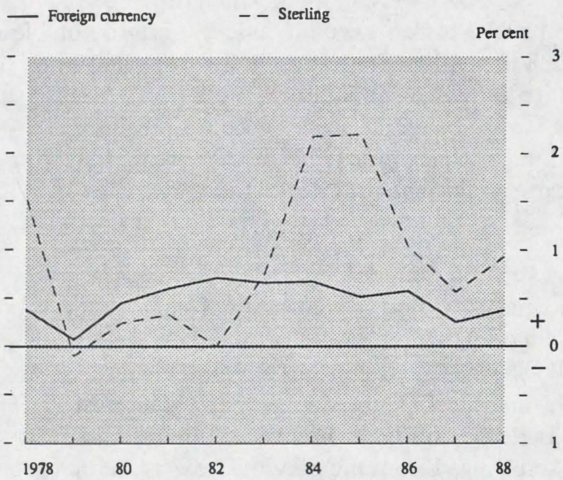
Table J
UK banks'(a) estimated spread earnings in 1988
£ billions, *percentages in italics*

	Foreign currency	Sterling	Total
Net interest income(b)	0.8	-1.3	-0.5
less			
Estimated cost of net liabilities (c)	-0.9	-1.6	-2.5
Cost of funds(d)	*6.9*	*8.7*	*7.1*
equals			
Implicit spread earnings	1.6	0.4	2.0
Implied margin(e)	*0.4*	*0.9*	*0.4*

(a) UK monetary sector plus certain other financial institutions.
(b) Including income from holdings of foreign bonds and export credits; excluding direct investment earnings.
(c) Cost of net liabilities = rate of return on liabilities multiplied by the average stock of net liabilities.
(d) Equals calculated average cost of all liabilities.
(e) Equals implicit spread earnings as a proportion of the (average) asset stock.

(1) See footnote 2 on page 538.

Chart 4
Calculated margins on UK banks' international lending



undertaken on behalf of the non-monetary private sector). The foreign currency and sterling components of this net interest income have, however, diverged. Earnings on foreign currency business rose, principally owing to a widening of the interest rate spread (Chart 4), while sterling earnings fell, despite the rise in spread earnings, as the record £9.3 billion net sterling inflows increased the cost of net liabilities. The effect of rising UK interest rates in 1988 is not manifested in the *average* annual rates of return, although the quarterly trend in the cost of net sterling liabilities has been upward, particularly in 1989 so far.

Table K
UK banks'[(a)] income from external transactions

£ billions

	Annual averages 1976-80	1981-85	1986	1987	1988	1989H1
Net IPD earnings:(b)						
Foreign currency	-0.1	1.1	1.6	0.5	0.8	—
Sterling	-0.1	-0.4	-0.8	-0.9	-1.3	-1.3
Sub-total	-0.2	0.5	0.8	-0.4	-0.5	-1.2
Direct investment earnings	—	-0.3	-0.1	0.1	-0.2	-0.1
Fee income	0.4	0.8	1.2	1.3	1.3	0.8
Total net income	**0.1**	**1.1**	**1.9**	**1.0**	**0.6**	**-0.6**

(a) See footnote (a) to Table J.
(b) See footnote (b) to Table J.

The monetary sector's aggregate contribution to the current account is shown in Table K. This comprises the IPD balance from traditional banking intermediation plus net income flows from overseas affiliates (including interest received from inter-company loans) plus banks' fee income, with the latter entering the services, not the IPD, account. Fee income has remained broadly flat over the past few years, at around £1.3 billion, while gross direct investment earnings, at £0.5 billion, were more than offset by the £0.7 billion earned by overseas investors in UK banks.

Net earnings from overseas direct investment, which continue to be the largest component of IPD, rose by nearly £1 billion to £5.5 billion in 1988, reflecting the high relative profitability of the United Kingdom's stock of direct investment overseas and a sharp fall in oil debits following the spate of North Sea disruptions. Remitted dividends were high on both the credit and debit sides of the account, with UK companies paying out nearly twice as much to the overseas sector compared with 1987. Gross direct investment credits have been markedly higher in 1987 and 1988 than previously, following the increase in annual outward investment flows. So far in 1989, net direct investment earnings have continued at a similar level to 1988. Non-oil credits and debits have remained broadly stable, while oil credits and debits have risen more or less commensurately, probably aided by higher oil prices. North Sea debits remain subdued, although refining profits to overseas investors were especially strong in the second quarter.

Net portfolio earnings (as defined in Table H) fell by £0.2 billion in 1988 as high returns on UK company securities led to a rise in debits, although the net asset stock increased by £18.1 billion over the year. The latter effect is a capital gain which does not appear in recorded IPD (see below). The rise in debits was partly a lagged reaction to strong flows into UK equities in 1987, but also a product of high dividend payouts by UK companies and high yields on UK corporate bonds. Bonds accounted for 44% of portfolio debits in 1988, but only 22% of the stock, reflecting the fact that the IPD rate of return on UK corporate bonds is about three times that on UK equity. The IPD rate of return on total portfolio debits in 1988 was, at 5.7%, nearly twice as high as the 3.3% earned by UK residents on their portfolio investment overseas.

This comparison looks quite different if 'full' rates of return are considered; that is, if account is taken of the implicit capital gain component of investment. Then, as

Table L
Estimated IPD and full rates of return on identified assets and liabilities

Per cent

Assets

	Total		Portfolio		Direct		Banks: Foreign currency		Banks: Sterling	
	IPD	Full	IPD	Full	IPD	Full	IPD	Full	IPD	Full
1986	7.2	12.6	3.5	26.0	9.4	9.8	7.5	10.8	10.8	10.7
1987	6.7	-8.4	3.1	-11.6	12.1	-6.1	6.5	-9.6	10.0	13.1
1988	7.5	9.7	3.3	17.5	12.8	10.5	7.4	8.4	10.3	10.9

Liabilities

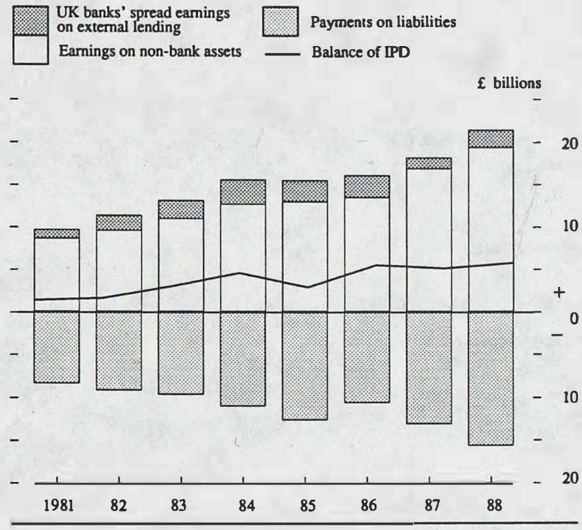
	Total		Portfolio		Direct		Banks: Foreign currency		Banks: Sterling	
	IPD	Full	IPD	Full	IPD	Full	IPD	Full	IPD	Full
1986	7.5	10.6	3.6	18.3	11.4	12.3	7.0	10.1	9.7	9.6
1987	7.0	-5.7	4.7	-1.3	12.7	12.2	6.2	-9.9	9.2	9.0
1988	7.7	9.2	5.6	12.6	12.1	16.5	7.0	8.1	9.2	9.3

shown in Table L, the rise in world stock markets over 1988 resulted in a total return to the UK portfolio investor of 17.5%, compared with the 12.6% earned by overseas portfolio investors in the United Kingdom. Furthermore, interconnections between world stock markets imply that years in which there are capital gains on assets also tend to be those in which there are rises in liabilities. So while the full returns do vary with capital gain effects, the effect on the net figure will tend to be somewhat muted. A corresponding adjustment to total direct investment shows that unfavourable exchange rate movements (that is, capital losses on the stocks) reduced the full return on assets to 10.5%—the simple IPD return was 12.8%—while capital gains on the liabilities (mainly property revaluations) boosted returns from 12.1% to 16.5%.

Furthermore, compositional shifts in the external balance sheet are reflected in gross asset/liability rates of return on total assets and total liabilities. As expected, the shift towards high-yielding, capital-certain banking sector liabilities has raised the IPD return on gross liabilities, but at the same time, the return on gross assets has risen by even more, reducing the margin on gross liabilities over gross assets from 0.3% to 0.2%. The full rates on the gross stocks (ie when stock market and exchange rate revaluations are taken into account) were 9.7% for assets and 9.2% for liabilities.

Total IPD can alternatively be divided into two stylised components—earnings accruing to the banks from the interest rate spread between lending to non-residents and borrowing from non-residents, and other net IPD earned on bank and non-bank net assets. Banks' spread earnings rose £0.7 billion in 1988, whereas the balance of the other categories of IPD was slightly down on the 1987 level (Chart 5). Another notable feature of the IPD earnings profile was the 60% rise (to £1.4 billion) in income from the official reserves, which reflected the combined effect of a rise in the stock (the average level in sterling terms in 1988 was over 20% higher than in 1987) and higher world interest rates.

Chart 5
Interest, profits and dividends



Changes in actual IPD flows between two periods can be split into effects due to exchange rate changes (ie a rescaling of the previous period's IPD), to capital inflows and to changing rates of return of variable rate instruments (acting on the previous period's stock). Such an exercise is subject to the same qualifications as analysing revaluations (see previous section), but in broad terms, the £0.6 billion rise in IPD in 1988 over 1987 was due to a large positive rate of return effect, partly offset by negative exchange rate and capital flow influences. As regards the exchange rate, sterling was higher on average both against the dollar and against a basket of non-dollar currencies in 1988 than in 1987 and this is likely to have depressed net IPD by about £0.2 billion. The recorded net capital inflow over the year exerted downward pressure on recorded IPD of about £0.1 billion.

Table M
UK external asssets and liabilites[a]

£ millions

End-years	1983	1984	1985	1986	1987	1988
External assets						
Private sector						
UK banks' assets						
Overseas investment:						
Direct	1,277	751	1,658	3,579	3,622	2,969
Portfolio	10,572	22,265	28,125	34,422	28,913	31,228
External claims:						
Sterling	16,474	20,863	23,041	28,965	34,605	39,421
Foreign currencies	307,536	385,185	346,706	409,343	390,809	408,645
Non-bank assets						
Private investment abroad:						
Direct	56,372	78,146	74,098	84,460	86,589	98,493
Portfolio	49,762	62,321	74,013	110,234	92,863	116,313
Deposits held abroad plus advance progress payments on imports by UK business	16,989	24,946	22,887	26,498	27,003	30,680
Other lending and short-term assets	7,835	10,323	8,628	6,597	5,283	4,419
Foreign notes and coin held by UK residents	68	81	85	100	118	131
Total private sector	**466,885**	**604,881**	**579,241**	**704,198**	**669,805**	**732,299**
Public sector						
Public corporations' assets						
Overseas investments:						
Direct	174	184	151	158	160	0
Other long-term assets	474	563	615	660	666	715
Other short-term assets and credit on imports	299	487	61	108	2	3
Total identified external assets of public corporations	947	1,234	827	926	828	718
General government						
Inter-government loans by the United Kingdom	1,214	1,149	1,096	1,027	944	877
Subscriptions to international financial organisations(other than IMF)	2,266	2,474	2,682	2,909	3,119	3,375
Other long-term assets	70	70	70	70	70	70
Export credit and bills	3,199	4,356	4,580	4,942	4,526	4,959
Total general government lending	6,749	8,049	8,428	8,948	8,659	9,281
Official reserves	12,805	13,219	13,201	17,424	27,008	28,711
Total external assets of general government	19,554	21,268	21,629	26,372	35,667	37,992
Total public sector	**20,501**	**22,502**	**22,456**	**27,298**	**36,495**	**38,710**
Total identified assets	**487,386**	**627,383**	**601,697**	**731,496**	**706,300**	**771,009**
External liabilities						
Private sector						
Overseas investment in the UK private sector:						
Direct	37,232	40,092	43,015	48,255	56,116	66,159
Portfolio	9,729	13,361	18,974	27,202	32,242	37,830
Total identified overseas investment in the private sector	46,961	53,453	61,989	75,457	88,358	103,989
UK banks' deposits in:						
Sterling	23,357	29,647	33,909	39,491	47,924	61,561
Foreign currencies	327,338	423,956	382,088	453,913	426,286	450,124
Advance and progress payments on exports	81	81	70	100	134	136
Direct borrowing abroad by UK non-banks, plus suppliers' trade credits on imports	14,654	16,457	16,738	21,215	20,842	25,098
Other (mainly short-term) liabilities	2,451	3,449	3,489	4,408	5,061	7,202
Total identified banking and other commercial liabilities	367,881	473,590	436,294	519,127	500,247	544,121
Total identified external liabilities of the private sector	**414,842**	**527,043**	**498,283**	**594,584**	**588,605**	**648,110**
Public sector						
Public corporations' liabilities						
Overseas borrowing by public corporations:						
Under the exchange cover scheme	2,640	3,013	2,725	2,917	2,407	2,148
Other	815	812	553	491	272	205
Overseas holdings of public corporations' securities	1,077	942	712	706	411	369
Total liabilities of public corporations	4,532	4,767	3,990	4,114	3,090	2,722
Liabilities of general government						
Net drawings on the IMF	—	—	—	—	—	—
Inter-government loans to the United Kingdom	1,957	2,323	1,758	1,631	1,226	1,227
Overseas borrowing by local authorities:						
Under the exchange cover scheme	360	481	530	708	751	715
Other	67	67	55	52	39	33
Short-term liabilities	384	274	284	487	644	934
British government stocks held by:						
Central monetary institutions	3,138	3,173	4,690	5,199	6,465	6,666
Other overseas residents	4,748	5,531	6,882	8,544	11,653	11,972
British government foreign currency bonds	547	272	562	1,689	836	969
Overseas holdings of local authority securities	210	200	200	210	200	200
Overseas holdings of Treasury bills and non-interest-bearing notes	1,206	1,330	1,345	1,304	2,681	3,369
Total general government	12,617	13,651	16,306	19,824	24,495	26,085
Total external liabilities of the public sector	**17,149**	**18,418**	**20,296**	**23,938**	**27,585**	**28,807**
Total identified external liabilities	**431,991**	**545,461**	**518,579**	**618,522**	**616,190**	**676,917**

(a) Notes and definitons on the series which comprise UK external assets and liabilities can be found in *United Kingdom Balance of Payments, 1989 Edition* (the Pink Book) published by the Central Statistical Office.