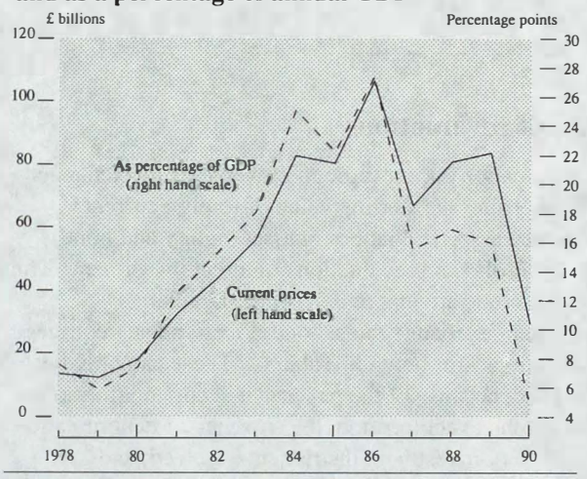
The external balance sheet of the United Kingdom: recent developments

This article continues an annual series, and examines changes to identified external assets and liabilities recorded during 1990 (using figures published in the 1991 CSO Pink Book). In particular, the article examines the impact of changes in exchange rates and asset prices on the external balance sheet and the possibility of estimating a more stable 'underlying' external balance sheet.

Overview

The United Kingdom's stock of identified net external assets fell by £54.1 billion in 1990 to stand at £29.6 billion. As a proportion of GDP, this represents a fall from 16% to 5% between 1989 and 1990, and compares with a peak level of net external assets of £103.6 billion in 1986, or 27% of GDP (see Chart 1). While part of this fall can be attributed to the current account deficit in 1990, revaluations to capital stocks have, as in previous years, dominated. Preliminary estimates suggest that net external assets have risen since end-1990, to stand at around £48 billion by mid-1991, despite the continuing current account deficit.

Chart 1
Net identified external assets in current prices and as a percentage of annual GDP



Of the £54.1 billion fall during 1990, net identified capital inflows accounted for only £12.1 billion, with a negative stock revaluation of £42 billion accounting for the remainder. Table A provides a detailed breakdown of the changes in UK external assets and liabilities, and capital flows are shown in detail in Table B.

While total net identified capital flows were broadly unchanged between 1989 and 1990, the pattern of capital flows altered. In previous years, net portfolio and non-bank direct investment capital flows had been strongly outward, with net banking flows being inward. In 1990 this pattern was, in part, reversed with reduced net banking inflows and net (non-bank) direct investment inflows. The preliminary figures for the first half of 1991 suggest that this shift has continued.

Table A
UK external assets and liabilities[a]
£ billions

	Stock end-1989	Identified capital flows	Net valuation effect[b]	Total change in stock	Stock end-1990
Non-bank portfolio investment					
Assets	**179.0**	6.7	-39.9	-33.2	**145.8**
Liabilities[c]	**90.7**	9.6	-10.9	-1.3	**89.4**
Direct investment[d]:					
Assets	**134.5**	11.7	-15.3	-3.6	**130.9**
Liabilities	**93.3**	19.0	-5.7	13.3	**106.6**
UK banks'[e] net liabilities in:					
Foreign currency[c][d]	**13.0**	-2.7	1.3	-1.4	**11.6**
Sterling	**31.6**	8.2	2.4	10.6	**42.2**
Public sector: Reserves (assets) *less* official foreign currency borrowing	**20.7**	0.1	-2.3	-2.4	**18.3**
British government stocks (liabilities)	**16.5**	-4.6	0.2	-4.4	**12.1**
Other net public sector assets	**3.2**	0.5	-0.4	0.1	**3.3**
Other net assets	**-8.6**	-1.5	3.2	1.7	**-6.9**
Total net assets	**83.7**	**-12.1**	**-42.0**	**-54.1**	**29.6**

(a) The sign convention is not the same as in the balance of payments: a transaction that increases an itemised stock is + and one that decreases it is -.
(b) Residual component.
(c) UK banks' external borrowing from overseas affiliates is treated in the published data as an offset to outward direct investment, but is treated here as part of banks' net foreign currency liabilities.
(d) Estimated take-up of UK banks' bonds 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.

The changing pattern in (non-bank) direct investment flows reflected a substantial reduction in gross direct investment outflows in 1990 compared with 1989, almost entirely owing to changes in inter-company accounts. This may have been due to firms divesting from their overseas subsidiaries, either in response to financial difficulties in the United Kingdom or as a result of less favourable trading conditions abroad. Over a longer horizon, however, the emerging pattern of net

Table B
UK capital flows[a]
£ billions

	1987	1988	1989	1990	1991 H1
Non-bank portfolio investment:					
Transactions in net assets	6.9	-7.4	-24.8	-6.7	-7.4
Transactions in net liabilities(b)	15.3	13.0	15.6	9.6	6.6
Direct investment(c):					
Transactions in net assets	-19.2	-20.9	-21.5	-11.7	-7.9
Transactions in net liabilities	8.5	10.2	17.1	19.0	8.7
UK banks'(d) net liabilities in:					
Foreign currency(b)(c)	-2.8	3.8	3.8	-2.7	-1.9
Sterling	5.0	9.5	8.2	8.2	-1.1
Net transactions in the public sector	-7.0	-1.5	4.3	-5.2	1.3
Other net flows	-0.7	2.9	10.1	1.5	—
Total net identified capital flows	**5.8**	**9.6**	**12.9**	**12.1**	**-1.7**

(a) Using balance of payments sign convention: 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.

inward direct investment is not simply a consequence of the divestment of overseas subsidiaries: a pattern of increasing gross direct investment inflows has been apparent since 1986. One explanation for this is that the United Kingdom is attracting a large amount of direct investment ahead of the completion of the single European market.

The fall in overall net banking inflows almost entirely reflected an increase in foreign currency lending abroad by UK banks. This was possibly the counterpart of higher domestic saving and lower net foreign saving following the relatively depressed state of the domestic economy but may also have been in response to increased interest rate margins abroad. The sizable fall in outward portfolio investment was largely due to a decline in investment by other UK financial institutions[1] in overseas ordinary shares from its exceptionally high 1989 level.

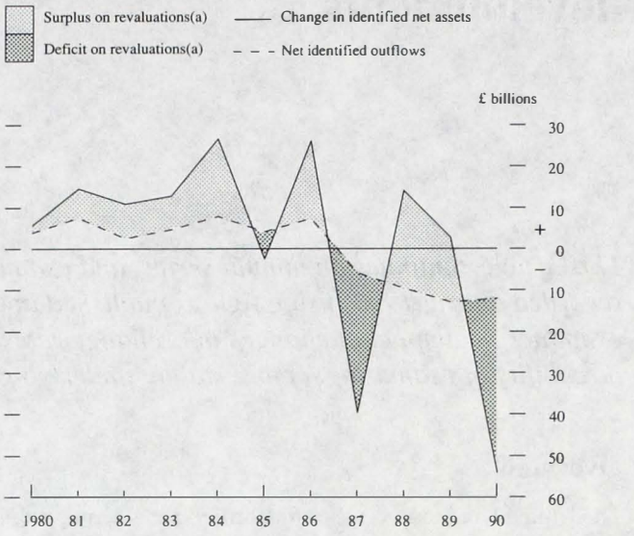
Table C and Chart 2 show the overriding importance of stock revaluations in explaining the recent *annual* changes

Table C
Change in identified net external assets[a]
£ billions

	Average(b) 1981-86	1987	1988	1989	1990	1991H1
A Net asset level (end-year)	103.6	66.9	81.0	83.7	29.6	48.0 (c)
B Change in identified net assets (increase +)	14.3	-36.7	14.1	2.7	-54.1	18.4
Due to:						
(i) identified capital flows (inflows-)(d)	5.6	-5.8	-9.6	-12.9	-12.1	1.7
(ii) revaluations	8.7	-30.9	23.7	15.6	-42.0	16.7
of which:						
Share prices		*2*	*15*	*3*	*-17*	*3*
Bond prices		*-5*	*—*	*2*	*-2*	*-2*
Exchange rates		*-26*	*1*	*21*	*-29*	*21*
Other(e)		*-2*	*8*	*-10*	*6*	*-5*
C Current balance (deficit-)	3.3	-4.2	-15.5	-20.4	-14.4	-4.3 (f)
D Balancing item (inflows/credits+)	2.2	-1.7	5.9	7.5	2.3	6.1

(a) D = B(i) - C.
(b) End-year net asset level refers to end-1986.
(c) This is a preliminary estimate of the net stock position at the end of the second quarter of 1991.
(d) Note the difference between this sign convention and that of the balance of payments statistics.
(e) Including revaluations to direct investment stocks relating to write-offs, profitable disposals of assets etc. as well as residual error.
(f) Seasonally *un*adjusted.

Chart 2
Contributions to changes in net identified external assets



(a) Residual component - difference between change in record net stock and net identified outflows.

in UK net external assets. However, because of their volatility since 1987, the *cumulative* impact of these revaluations has been smaller than that of flows over the last four years (see Table D).

Table D
Cumulative change in net external assets
£ billions, cumulative changes

	End-1980—end-1986	End-1986—end-1990
Cumulative change in net external assets	85.5	-74.0
of which:		
Capital flows	*33.6*	*-40.4*
Revaluations	*51.9*	*-33.6*

Effects of revaluations

Stock revaluations occur through movements in exchange rates (which alter the sterling value of foreign currency denominated assets), changes in asset (equity and bond) prices, write-offs and revaluations to direct investment. The results of a crude attempt to determine the relative importance of exchange rates, bond prices and share prices on revaluations are shown in Table C. These can only be approximate, because of the paucity of accurate information concerning the exact location, the currency of denomination and the type of investment instrument involved, and therefore should be interpreted as indicative of broad movements only.

The fall in non-bank portfolio investment assets was by far the largest single contributor to the change in net external asset stock during 1990, with capital outflows of £6.7 billion being overwhelmed by a negative stock revaluation of £40 billion, though this was partially offset by a negative valuation effect on non-bank portfolio liabilities.

(1) These 'other financial institutions' comprise non-bank, non-building-society financial institutions, including insurance companies, pension funds, unit trust companies and securities dealers.

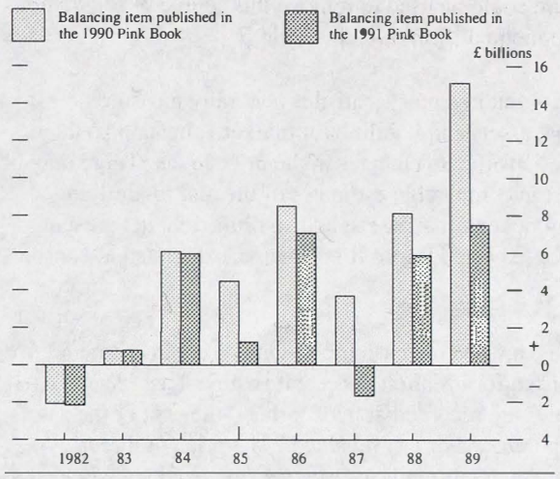
Revisions to the balance of payments statistics

The balance of payments statistics include a balancing item. This reflects the net effect of errors and omissions. While errors and omissions may arise in both the current and capital accounts, many are thought to originate in the capital account, since there is greater potential for misrecording capital flows than for flows of goods and services (though the current account is prone to some error through the poor quality of IPD data).(1) Since the stocks of external assets and liabilities are to a large extent inferred from the data for cumulative capital flows and revaluations, such errors and omissions will also create inaccuracies within the external balance sheet data.

The article on the United Kingdom's external balance sheet in the November 1990 *Bulletin* (pages 487–99) noted the tendency for the balancing item to be positive, implying a net under-recording of capital account inflows or current account exports. The article also outlined some possible problems associated with the balance of payments statistics and referred to attempts to improve their quality under the Chancellor's initiative. As a result of these efforts, the balance of payments statistics now incorporate both new data sources and improved methods of deriving estimates. Substantial revisions have taken place since the 1990 article, to as far back as 1982, and have led to some large reductions in the unidentified component of the external account (see the chart).

Almost all the revisions since last year to past balancing items have reflected the inclusion of previously unrecorded net capital inflows. Since stock levels are inferred from capital flows, this has led to an accompanying downward revision to the level of net identified external assets for end-1989 by £28.8 billion to £83.7 billion, with (smaller) revisions to net external assets going back to 1983. The bulk of this revision stems from three factors: a downward revision of £11.7 billion to the gross direct investment asset stock held by the non-financial private sector; an upward revision of £5.3 billion to gross direct investment liabilities in non-financial institutions; and an upward revision of £9.3 billion to gross portfolio investment liabilities in ordinary shares. The revision to portfolio investment liabilities is due largely to information from a UK share ownership survey, while revisions to direct investment stocks stem from annual enquiries undertaken by the CSO.

Estimates of the balancing item



(1) This has been particularly so following the ending of exchange controls and the deregulation of financial institutions, as this has led to increasing reliance on surveys (with no statutory base) and to an increase in direct transactions which by-pass the records of intermediaries.

Taking the external balance sheet as a whole, the effect of changes in exchange rates was considerable in 1990. This was largely due to the weakness of the dollar (which depreciated by 20% against sterling) and the large proportion of the United Kingdom's asset stock that is located in the United States (42% of direct investment asset stocks in 1989). This was compounded by negative effects from share prices (owing particularly to falls in Japanese share prices) and from bond prices.

Preliminary estimates show that, during the first half of 1991, net external assets rose to £48 billion. This can be accounted for mostly by the recovery of the dollar (which rose by 16% against sterling) over this period, combined with a small positive effect from increased share prices (both in the United Kingdom and abroad, with the net effect being positive) and preliminary estimates of net identified capital outflows.

'Underlying' net external assets

The stock of net identified external assets is primarily of interest because it is an estimate of the net present value of *future* interest, profit and dividend (IPD) streams between the United Kingdom and overseas residents. The recorded sterling value of net external assets may, however, be an inadequate or even misleading measure for this purpose. This is owing not only to the unavoidable uncertainties about the quality of external asset and liability data, but also to the sensitivity of the sterling value of net external assets to revaluations which are transitory or which do not affect the real value of future IPD income streams. An 'underlying' or smoothed level of net external assets may be a more reliable guide.

Exchange rates have fluctuated considerably in recent years, altering markedly the sterling value of net identified external

Table E
Underlying measures of net identified capital stock
£ billions

	1986	1987	1988	1989	1990
Year-end unadjusted net external assets	103.6	67.0	81.0	85.5	29.6
Adjusted to smooth exchange rate movements: Moving average (2-year)	91	78	93	66	40
Adjusted for inflation(a) Excluding direct investment	90	74	89	68	46
Including direct investment	88	70	78	52	29

(a) At 1985 prices.

assets from year to year.(1) A smoothed exchange rate measure could be used to remove this source of fluctuation. Such a method is reported in Table E.

The external inventory statistics generally measure net external assets and liabilities at market value and so they will be sensitive to changes in the price level. There may be interest in comparable estimates of the real 'underlying' level of net external assets, and so of the real net present value of expected future IPD streams, calculated at constant prices.

There is, however, a case for leaving direct investment unadjusted for inflation. Direct investment assets and liabilities are recorded at book value—the cost of the assets when purchased or last revalued. The price of direct investment assets tends to rise over time, and so may lead to undervaluations of direct investment stocks on both the asset and the liability side of the balance sheet. Leaving direct investment unadjusted for inflation may offset this undervaluation of gross direct investment stocks, but is unlikely to do so exactly. A separate adjustment to direct investment to allow for changes in direct investment asset prices would be preferable.(2)

Table E shows some approximate estimates of the value of the 'underlying' identified external asset stock at market prices using some of the methods outlined above. Gross external assets are revalued as if the exchange rate were the two-year moving average rate,(3) and inflation adjustments, using the GDP deflator, are shown both inclusive and exclusive of adjustment to direct investment stocks.

The adjustments used to obtain a measure of the 'underlying' position are by no means perfect. Some important caveats should be borne in mind. The degree of uncertainty surrounding the 'underlying' value of net direct investment assets is considerable, as can be seen from the effect that adjusting recorded direct investment for inflation has on the final net asset stock figures in Table E. The possibility of transitory movements in share and bond prices, which is clearly an additional contributor to fluctuations in net external asset figures, has not been addressed. Further, the estimates are subject to the same approximations (concerning currency composition of assets etc) as the estimates for the breakdown of the contributions of revaluations to net external assets, reported in Table C. Therefore, the figures reported in Table E should be treated carefully and with no one measure used in isolation.

While the results in Table E should be interpreted cautiously, they do suggest that underlying net external assets were overstated at the peaks of the unadjusted figure (1987 and 1989), but may have been understated in 1990. Moreover, despite the obvious crudeness and deficiencies of these adjustments, the figures illustrate how much less volatile an 'underlying' measure of the net external asset stock would be compared with the unadjusted measure.

The importance of 'underlying' net external assets

One of the effects of financial liberalisation has been to permit the efficient re-allocation of global savings among capital surplus and capital shortage countries. The emergence of, for example, a capital shortage and a corresponding fall in the net identified external asset stock may simply represent the financing by the private sector of expenditure in excess of its current income, in the full knowledge that eventually this must be paid back (with interest). Meanwhile, inward direct investment may increase productive potential and have a favourable impact on future movements in the current account. Indeed, Japanese inward investment in the United Kingdom in areas such as the car industry is already likely to have had beneficial growth and employment implications. The compositions, and not simply the levels, of net identified external asset stock and capital flows may therefore be of interest in helping to determine the reason for the emergence of a capital shortage or surplus.

Expenditure decisions made by economic agents are influenced by, among other determinants, their net wealth and changes in it. Net external assets constitute a (small) component of this wealth, and so changes in net external assets may have an influence on future spending decisions through such a wealth effect.

In so far as they influence the degree of exposure of UK and foreign owners of external assets to exchange rate and other country-based risks,(4) changes in UK net external assets may influence 'risk premia' for assets held in sterling or located in the United Kingdom. UK owners of foreign currency denominated assets suffer capital losses if sterling strengthens in relation to the currency in which their assets are denominated. In the same way, foreign owners of sterling denominated liabilities face a capital loss if sterling weakens against the currencies they use for their

(1) One effect of the United Kingdom joining the ERM is to reduce such exchange rate fluctuations with respect to other ERM countries. As a result, exchange rate revaluations will be largely limited to movements against the dollar and yen, and so, while such revaluations could still be large, they may tend to be smaller than experienced in the recent past, provided the proportion of ERM currency denominated external assets is at least maintained.

(2) Some methods for this were referred to in the November 1990 *Bulletin*, page 490.

(3) The choice of two years is purely arbitrary.

(4) The relationship between net external assets and net exposure to exchange rate risk is not simple, since some external assets and liabilities, particularly within the banking sector, can be foreign currency matched.

expenditure. A fall in the level of net external assets may therefore serve to increase risk premia for assets denominated in sterling or located in the United Kingdom. This would require interest rates, and other rates of return, to be higher than they would otherwise have been to sustain a given exchange rate. However, while this 'portfolio balance effect' has gained substantial attention in the academic literature, the importance of this effect for the United Kingdom[1]—indeed its very existence—is still a source of considerable debate.

Conclusions

The value of UK net external assets in sterling terms fell considerably in 1990. This was owing largely to revaluations, mostly resulting from a strengthening of the sterling exchange rate. While net external asset stock figures can be useful as an indicator of future IPD flows, taking such figures at face value is potentially misleading.

The sensitivity of external balance sheet data to transitory revaluations, as well as to future revisions, suggests that these external capital account figures should be treated with caution. Estimates, albeit crude ones, suggest that the 'underlying' level of net external assets fell by a smaller amount than implied by the unadjusted figures.

Care should also be taken in interpreting the economic significance of any measure of 'underlying' net external assets. While its significance as an indicator of future IPD flows and as a component of UK wealth is theoretically straightforward, changes in it may simply represent an alteration in the private sector's relative preference for consumption or investment today over consumption or investment tomorrow. The reason for such a change in preferences may be of significance. To this end, attention should be paid to the composition, as well as the aggregate level of, and changes in, external capital stock.

(1) Particularly when within an exchange rate discipline such as the ERM.