The external balance sheet of the United Kingdom: recent developments

This article examines changes to the net external asset position of the United Kingdom during 1991 (using figures published in the 1992 CSO Pink Book). It focuses on the impact of valuation changes to existing assets and to investment flows recorded in the capital account of the balance of payments; and suggests that the composition of the external balance sheet is an important influence on the extent to which the yield on external stocks is measured by flows of interest, profits and dividends.

Overview

The current account balance of payments deficit in 1991 was financed by identified net capital inflows of £5.2 billion. It might be expected that net external assets would have fallen correspondingly, but they did not. Instead net external assets, which were marginally negative at the end of 1990, rose by £16.5 billion to £16.1 billion (see Table A). This swing into surplus arose from a large positive revaluation, largely reflecting asset price and exchange rate movements, to the identified stock of net external assets. Revaluations are volatile, however, and preliminary estimates suggest that negative revaluations have contributed to a fall in identified net external assets of £9.9 billion (to £6.2 billion) in the first half of 1992.

Net receipts of interest, profits and dividends (IPD) fell to £0.3 billion in 1991, down from £2.1 billion in 1990. Over a period of years, IPD flows tend to be much more heavily influenced by changes in the level of net external assets than by changes in the rate of return or the composition of the balance sheet. But in 1991, the slight fall in the *average* value of UK net external assets accounted for perhaps only £0.5 billion of the decline in net IPD inflows. The remainder of the decline reflected changes in the aggregate measured rate of return. In the first half of 1992, net IPD inflows recovered to £0.8 billion.

IPD flows do not measure the full yield earned by external capital stocks because they do not include retained profits and expected capital gain. Moreover, given the particular composition of the United Kingdom's external balance sheet, it is likely that the overall yield from assets is less fully measured than for liabilities.

As in previous years, there have been substantial revisions to external capital flow and stock data. Identified net external assets for 1990 were revised downwards by £30 billion compared with the figure published in the 1991 CSO Pink Book.

Table A
UK external assets and liabilities(a)

£ billions

	Stock end-1990	Identified capital flows	Net valuation effect (b)	Total change in stock	**Stock end-1991**
Non-bank portfolio investment:					
Assets	**141.5**	22.4	25.6	48.0	**189.4**
Liabilities(c)	**86.9**	7.7	8.9	16.7	**103.5**
Direct investment: (d)					
Assets	**113.2**	11.0	0.1	11.0	**124.2**
Liabilities	**116.6**	12.0	-1.7	10.4	**127.0**
UK banks'(e) net liabilities in:					
Foreign currency	**9.0**	5.4	-0.8	4.6	**13.6**
Sterling	**42.7**	-3.0	-0.1	-3.1	**39.6**
Public sector:					
Reserves (assets)	**22.7**	2.7	1.0	3.6	**26.3**
British government stocks (liabilities)	**11.0**	6.2	-0.1	6.1	**17.1**
Other net public sector assets	**-1.3**	1.0	0.1	1.1	**-0.2**
Other net assets	**-10.2**	-14.0	1.4	-12.6	**-22.7**
Total net assets	**-0.4**	**-5.2**	**21.7**	**16.5**	**16.1**

(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 a part of banks' net foreign currency liabilities.
(d) Estimated take-up of UK banks' bonds appears indistinguishably from foreign investment in other UK company subsidiaries 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 financial institutions.

Movements in the external balance sheet

A current account deficit has to be financed by net capital inflows. These inflows, which lead to a reduction in external assets and/or an increase in external liabilities, would usually be expected to result in a decline in net external assets. In the United Kingdom, a cumulative current account deficit of £65.7 billion between 1987 and 1991 was accompanied by a fall in net identified external assets of £83.3 billion (see Table B).

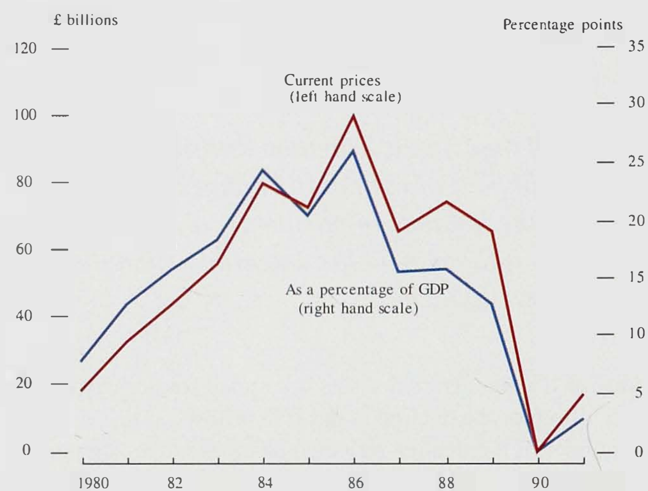
Table B
Cumulative change in net external assets

£ billions, cumulative changes

	End-1980–end-1986	End-1986–end-1991
Cumulative change in net external assets	81.3	-83.3
of which:		
Capital flows	*29.8*	*-49.3*
Revaluations	*51.5*	*-34.0*

But net external assets are also affected by changes in the value of existing external assets and liabilities. These changes can be large, particularly within a given year. In 1991, the effect of net identified capital inflows of £5.2 billion on the stock of net external assets was more than offset by a positive revaluation of some £21.7 billion. As a

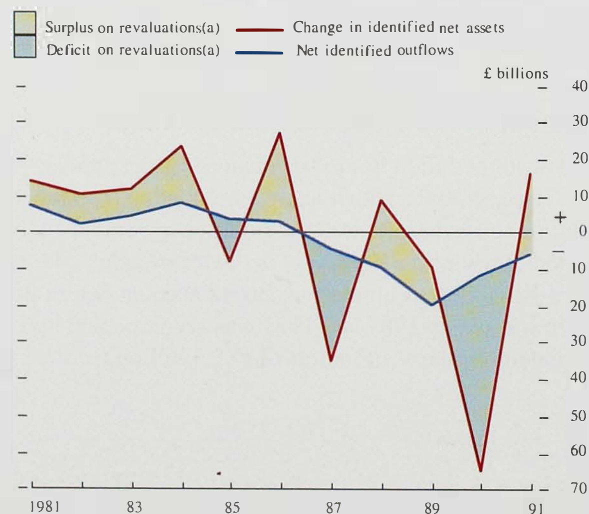
Chart 1
Net identified external assets in current prices and as a percentage of annual GDP



result, net identified external assets rose by £16.5 billion to £16.1 billion, or from -0.1% to 2.8% of GDP (see Chart 1).

Chart 2 shows how revaluations have been the dominant factor behind the recent volatility of annual changes in UK net external assets. Their cumulative impact over the last decade has, nevertheless, been of less importance, since revaluations in different years have tended to offset each other (see Table B).

Chart 2
Contributions to changes in net external assets



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

Capital flows

Net identified capital inflows fell to £5.2 billion in 1991 (from £11.1 billion in 1990), in line with the reduction in the current account deficit. Gross outflows of non-bank portfolio and direct investment rose to £33.4 billion (compared with £18.9 billion in 1990), largely because of a sharp rise in non-bank portfolio outflows (see Table C). This increase in net outflows was mostly offset by 'other' net inflows, mainly associated with the actions of securities dealers. Gross inward direct investment fell.

Table C
UK capital flows(a)

£ billions

	1987	1988	1989	1990	1991	1992 H1
Non-bank portfolio investment:						
Transactions in net assets	4.9	-10.1	-29.0	-9.9	-22.4	-10.1
Transactions in net liabilities (b)	15.4	13.6	15.8	8.9	7.7	3.9
Direct investment (c):						
Transactions in net assets	-19.6	-21.7	-21.4	-9.0	-11.0	-4.7
Transactions in net liabilities	9.4	12.0	18.6	18.6	12.0	5.4
UK banks' (d) net liabilities in:						
Foreign currency (b) (c)	-2.1	5.0	2.9	-5.7	5.4	-9.3
Sterling	4.4	9.3	9.7	8.8	-3.0	-1.9
Net transactions in the public sector	-7.1	-1.5	5.0	-4.4	2.5	4.0
Other net flows	-1.0	2.7	17.7	3.8	14.0	7.9
Total net identified capital flows	**4.3**	**9.4**	**19.3**	**11.1**	**5.2**	**-4.8**

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

As in 1989, other financial institutions (OFIs) were largely responsible for the increase in non-bank net portfolio outflows in 1991. These were accompanied by substantial 'other' net inflows which were dominated by transfers of funds by securities dealers. Since OFIs' portfolio investment includes portfolio investment by securities dealers, this would suggest that 'other' net inflows were used to finance portfolio outflows by securities dealers. These 'other' flows may, however, be unwound in the future.

In 1991 gross direct investment inflows fell for the first time since 1986. One explanation for the earlier increase in gross direct investment inflows was that the United Kingdom attracted a large proportion of overseas investment ahead of the completion of the single European market. The more recent fall may therefore indicate a slowdown in such inward direct investment. Inward direct investment may also have been affected by weak activity in the world economy generally (and in particular in the United States, whose companies have been major investors in the United Kingdom).

As in 1990, direct investment gross outflows were far smaller than in previous years, largely reflecting changes in inter-company accounts and a fall in net acquisitions of share and loan capital. This may be as a result of continuing unfavourable trading conditions abroad or financial difficulties in the United Kingdom.

Also as in 1990, net banking inflows remained small in comparison with previous years. Overseas purchases of public sector securities (mainly gilts) amounted to £6.2 billion. Capital transactions accounted for a £2.7 billion rise in the United Kingdom's official reserves.

Preliminary capital flow data for the first half of 1992 suggest that net non-bank portfolio investment has remained outward, and may have been financed by international transfers of funds by securities dealers. There were also substantial net identified outflows from the banking sector. This accounts for the shift toward net identified capital *out*flows which occurred in the first half of 1992. The data

are, nevertheless, highly provisional and are inconsistent with a current account deficit recorded over the same period.

Effects of revaluations

Revaluations to identified net external assets totalled £21.7 billion in 1991. 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.[1] Stock revaluations can be sizable, even if the value of net external assets is small, since gross external assets and liabilities are large.

The results of an attempt to determine the relative importance of exchange rates, bond prices and share prices on revaluations are shown in Table D. These can only be approximate because of the lack of accurate information about the exact location, the currency of denomination and the type of investment instrument involved. They should therefore be interpreted as indicative of broad movements only.

A positive revaluation to gross non-bank portfolio assets of £25.6 billion was by far the largest single contributor to the overall rise in net external assets during 1991. This was partially offset by an upward revaluation to gross non-bank portfolio liabilities of £8.9 billion. The upward revaluation of both non-bank portfolio gross liabilities and gross assets largely reflected increases in share prices. The positive net revaluation stemmed largely from the fact that gross assets were higher than gross liabilities. But share prices also rose more strongly overseas than in the United Kingdom and US bond prices increased substantially. Exchange rate movements were also responsible for a small part of the upward revaluation to gross non-bank portfolio assets.

The effects on the balance sheet as a whole of both increases in local currency denominated share prices and exchange rate movements were substantial. Positive revaluations arising from exchange rate movements were due largely to sterling weakening slightly against the dollar (by 3.2%) over the year as a whole, with a large proportion of UK gross direct and portfolio investment assets denominated in US dollars.

Table D
Change in identified net external assets

£ billions

	Average(a) 1981-87	1988	1989	1990	1991	1992 H1
A Current balance (deficit -)	2.2	-16.2	-21.7	-17.0	-6.3	- 5.7 (b)
B Identified capital flows (inflows -)(c)	3.6	-9.4	-19.3	-11.1	-5.2	4.8
C Revaluations	3.0	18.2	10.1	-53.9	21.7	-14.7
of which:						
Share prices		*13*	*2*	*-9*	*16*	*-7*
Bond prices		—	*2*	*2*	*-2*	—
Exchange rates		*2*	*13*	*-35*	*9*	*-6*
Other(d)		*3*	*-7*	*-11*	*-2*	*-2*
D Change in identified net assets (increase +)	6.7	8.9	-9.1	-65.0	16.5	-9.9
E Net asset level (end-year)	64.9	73.7	64.6	-0.4	16.1	6.2 (e)
F Balancing item(f) (inflows/credits +)	1.4	6.8	2.5	5.9	1.1	11.7

(a) End-year net asset level refers to end-1986.
(b) Seasonally *un*adjusted.
(c) Note the difference between this sign convention and that of the balance of payment statistics.
(d) Including revaluations to direct investment stocks relating to write-offs, profitable disposals of assets etc as well as residual error.
(e) This is a preliminary estimate of the net stock position at the end of the second quarter of 1992.
(f) F = B - A.

Preliminary estimates for the first half of 1992 show a negative revaluation to net external assets of £14.7 billion. This was triggered mostly by exchange rate movements, which partly reflected an appreciation of sterling by 1.9% against the US dollar. A rise in domestic share prices relative to the rest of the world during the first half of 1992 also had a negative impact on the sterling value of net external portfolio assets. Conversely, the recent depreciation of sterling will have increased substantially the sterling value of net external assets in the third quarter.

Interest, profits and dividends

Net IPD inflows fell from £2.1 billion in 1990 to £0.3 billion in 1991 (see Table E). This fall was spread across all sectors in the external balance sheet except the public sector.

Table E
Interest, profits and dividends

£ billions

	Annual average 1980–1987	1988	1989	1990	1991	1992 H1
Earnings on assets						
Portfolio(a)	1.9	3.2	4.3	4.7	5.7	3.3
Direct	7.0	13.9	16.7	15.9	13.5	7.0
Other non-bank private sector	1.5	1.8	2.8	3.8	4.1	1.8
Public sector (b)	0.9	1.5	1.9	1.8	1.8	0.8
UK banks' spread earnings on external lending	1.9	1.6	0.9	0.6	0.7	0.1
Total	**13.1**	**21.9**	**26.6**	**26.7**	**25.7**	**13.0**
Payments on liabilities						
Portfolio(a)	0.6	2.6	4.1	5.5	6.2	3.0
Direct	5.7	8.7	9.2	7.0	5.8	3.4
Other non-bank private sector	1.5	2.1	3.5	4.6	5.6	2.8
Public sector(c)	1.4	2.3	2.5	2.2	1.9	1.1
Banks' cost of net liabilities	1.3	1.8	3.6	5.3	5.8	1.9
Total	**10.5**	**17.5**	**23.1**	**24.6**	**25.4**	**12.2**
Net IPD earnings	**2.6**	**4.4**	**3.5**	**2.1**	**0.3**	**0.8**
Net IPD excluding spread earnings	0.7	2.8	2.6	1.5	-0.4	0.7

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

IPD flows equal *average* (as opposed to end-year) identified net external assets multiplied by their aggregate rate of return. In 1991 changes in the average net external balance sheet,[2] which contracted by a small amount, accounted for only £0.5 billion of the fall in IPD flows. The remaining £1.3 billion reflected a decline in the aggregate rate of return.

The aggregate rate of return is affected by changes in the relative rates of return earned on different assets and paid on different liabilities and by changes in the composition of the

(1) Revaluations to direct investment stocks stem from occasional revaluations of individual companies' balance sheets and profitable disposals of assets etc.
(2) Calculated from end-quarter net external asset figures.

gross external balance sheet. Three influences were particularly important in 1991. First, the yield earned from gross direct investment assets fell relative to that paid on gross direct liabilities. Second, the increase in UK gross external assets was more concentrated in low yielding portfolio assets than was the increase in UK gross liabilities. Third, the yield earned from gross non-bank portfolio assets rose relative to that paid on gross non-bank portfolio liabilities. The first two acted to reduce net IPD inflows in 1991.

In 1991, net IPD inflows from non-bank direct investment fell by £1.2 billion to £7.7 billion (see Table E). This was the only sector with net IPD inflows, and continues to underpin net IPD inflows into the United Kingdom.[1] The fall resulted from an increase in the yield earned on non-bank direct investment gross liabilities relative to non-bank direct investment gross assets. This probably reflected a decline in the profitability of firms and subsidiaries located overseas (and in particular in the United States) relative to those located in the United Kingdom. The profitability of these firms and subsidiaries, in turn, varies according to economic conditions in the country and industry in which they operate.

Net outflows of earnings from non-bank portfolio investment fell by £0.3 billion, from £0.8 billion in 1990 to £0.5 billion in 1991. This did not reflect an increase in average net portfolio assets in 1991 compared with 1990. In fact, the yield earned by gross portfolio assets is so much lower than that earned by gross portfolio liabilities (see Table F) that the effect of balance sheet changes on portfolio investment net IPD inflows was negative, since both the asset and liability side of the balance sheet increased. The reduction in net outflows was owing to an increase in the rate of return earned on gross non-bank portfolio assets relative to that paid on gross non-bank portfolio liabilities (see Table F).

Table F
Estimated IPD[(a)] and full[(b)] rates of return on identified assets and liabilities

Percentage points

Assets

	Total		Non-bank portfolio		Non-bank direct		Banks: Foreign currency		Banks: Sterling	
	IPD	Full	IPD	Full	IPD	Full	IPD	Full	IPD	Full
1988	7.5	10.4	3.3	24.5	14.4	12.7	7.2	8.5	9.6	10.0
1989	8.2	18.7	3.7	30.3	14.5	11.9	8.3	18.1	13.2	14.3
1990	8.8	-6.5	4.0	-33.0	13.6	-8.9	9.1	-5.3	14.3	13.7
1991	7.9	10.8	4.4	24.2	10.4	12.0	8.8	6.9	14.5	11.0

Liabilities

	Total		Non-bank portfolio		Non-bank direct		Banks: Foreign currency		Banks: Sterling	
	IPD	Full	IPD	Full	IPD	Full	IPD	Full	IPD	Full
1988	7.6	8.1	4.5	8.6	12.7	9.0	7.0	7.8	8.5	8.6
1989	8.4	18.4	5.0	21.8	10.2	14.5	8.2	19.3	12.0	10.3
1990	8.7	-0.8	6.1	-5.8	6.2	-3.3	9.0	-3.8	13.7	16.2
1991	8.0	8.8	5.8	14.1	4.7	3.4	8.8	8.5	12.7	10.9

(a) IPD earnings as a percentage of the stock.
(b) IPD earnings plus stock revaluations as a percentage of the stock.

Net IPD outflows from the banking sector increased by £0.4 billion to £5.1 billion in 1991. Conceptually, net IPD flows from the banking sector can be split into the cost of servicing net liabilities and interest rate spread earnings derived from the provision of intermediation services.

The interest rates paid on both sterling and foreign currency liabilities increased in 1991, accounting for much of the increase in the cost of servicing net liabilities from £5.3 billion in 1990 to £5.8 billion in 1991.

UK banks' spread earnings arise because IPD rates of return earned from banking sector gross assets are higher than those paid on gross liabilities (see Table F). These spread earnings accounted for £0.7 billion of net IPD earnings in 1991 out of a total of £0.3 billion, compared with £0.6 billion in 1990. In previous years, spread earnings have been an important constituent of net IPD flows, averaging £1.9 billion between 1980 and 1988 (see Table E). But interest rate margins have fallen in recent years, as international competition in the banking sector has increased. In 1991 interest rate margins rose slightly (but from an exceptionally low level) following increased concerns over creditworthiness.

Spread earnings have many similarities with services, for which a direct charge is made in the form of a fee or commission, since they arise from the provision of a service by the banking industry. And as such, they should not strictly be thought of as earnings from net assets held abroad. Excluding spread earnings, total IPD flows were net *out*ward by £0.4 billion in 1991.

In the first half of 1992, net IPD inflows totalled £0.9 billion, of which spread earnings accounted for £0.1 billion. This improvement has resulted largely from a shift from net outflows to net inflows of portfolio investment IPD and a sharp drop in the cost of banks' net liabilities.

Capital gains and 'full' rates of return

As shown in Table F, the UK net external balance sheet consists of low yielding gross assets and high yielding gross liabilities. This has led to a low rate of return being earned from the net external assets of the United Kingdom. The low rate of return is compensated for, however, by an expected capital gain. In an efficient market, the rate of return plus the expected capital gain would be the same for all assets and liabilities (after allowing for, among other things, risk and costs of intermediation). Although this expected 'full' rate of return cannot be observed directly, since *expected* capital gain and costs of intermediation are

(1) This may seem inconsistent with net non-bank direct investment liabilities of £2.8 billion at end-1991. But identified direct investment balance sheet figures may give a misleading picture of the true position of the net balance sheet because direct investment is measured at book value, rather than market value, and is only revalued following write-offs, occasional revaluations to individual companies' balance sheets and/or profitable disposals. This has probably led to an underrecording of the values of direct investment assets and liabilities. This underrecording need not be the same on both sides of the balance sheet.

not measured, *actual* full rates of return can be estimated by adding revaluations as a percentage of outstanding stock to the yield (or IPD rate of return). This is done in Table F.

As Table F shows, the difference between full and IPD rates of return has tended to be greater for total assets than for total liabilities. This suggests that the yield from gross external liabilities tends to be measured more fully, as IPD debits, than is the yield from gross external assets, as IPD credits.

Portfolio investment assets include those with a low rate of return, offset by an expected capital gain. The lower IPD rate of return earned on portfolio gross assets compared with gross liabilities, over a sustained period, suggests that the expected rate of capital gain is higher for gross portfolio assets than liabilities. This may be because high yielding bonds (which tend not to have an expected capital gain) form a larger proportion of gross portfolio liabilities than of gross portfolio assets.(1) In contrast, external assets and liabilities in the banking sector earn a high yield, but have no, or little, expected capital gain.(2)

Revisions to data and measurement problems

Errors and omissions may arise in both the current and capital accounts of the balance of payments statistics. Following the ending of exchange controls and financial liberalisation, errors and omissions in the capital account have risen, in terms of both capital account transactions and levels of outstanding stock.(3) Efforts to improve the quality of the balance of payments data have led to large revisions to the balance of payments statistics compared with the CSO 1991 Pink Book.(4)

UK identified net external assets at end-1990 were revised downwards by a substantial £30 billion. Most of this revision can be accounted for by a downward revision to net non-bank direct investment stock, which totalled £27.7 billion. This reflected the incorporation of a more comprehensive register of UK affiliates of overseas companies, which increased UK gross liabilities by £8 billion, downward revisions to UK gross assets owing to new values obtained from triennial surveys of direct investors' detailed balance sheets and the discovery of larger write-downs of goodwill than previously thought.

Net IPD flows for 1990 were revised downwards by £1.9 billion from £4.0 billion. This followed the introduction of a new system of deriving dividends and interest estimates in a more consistent way throughout the national accounts, which has altered the estimates of some overseas income flows. However, it mainly reflects later data from annual surveys (replacing provisional quarterly estimates) and improved data sources.

Revisions to capital transactions data have been substantial as new methodologies have been introduced, especially for securities dealers. Considerable parts of the large and fluctuating balances with counterparties have for the first time been attributed overseas. Net capital inflows from securities dealers in 1989 and 1990 have been revised upwards by £10.9 billion, although this has been largely offset by upward revisions to net capital outflows in other sectors (particularly net portfolio investment outflows which were revised upwards by £7.6 billion). Revisions to the balance of payments statistics have reduced the average size of the balancing item (the measure of net errors and omissions in both the current and capital accounts). But these redistributed rather than reduced the cumulative balancing item, which remained largely unchanged at £26.2 billion. A positive balancing item implies an underrecording of net capital inflows or current account net credits. The increased use of separate data sources to estimate net external assets means, however, that a positive cumulative balancing item is now less likely to reflect a possible underrecording of net outstanding external assets.

(1) An alternative explanation is that portfolio stocks are mismeasured. For example, if IPD were measured correctly and gross portfolio liabilities underrecorded, this would lead to the rate of return calculated on gross portfolio liabilities being higher than the true figure.
(2) There may be an expected capital gain or loss for banking sector assets held in foreign currency owing to expected exchange rate movements. The difference in yield earned on assets in different currencies should have been reflected in expected capital gain (in the form of exchange rate movements).
(3) The current account is thought to be more accurate, although it is itself prone to some error through imprecise estimates of invisibles, particularly IPD.
(4) Many of these result from the Chancellor of the Exchequer's Initiatives on Economic Statistics introduced in 1989.