

# 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 1992 (using figures published in the 1993 CSO Pink Book). It focuses on changes in the pattern of capital flows during the year and the impact of valuation changes to existing assets, and includes an international comparison of external balance sheets.

## Introduction

In 1992 identified net capital inflows into the United Kingdom were £8.3 billion. But, despite this inflow, the United Kingdom's net external assets at end-1992 had risen to £27.0 billion, up from the revised £6.3 billion at the end of 1991 (see Table A and Chart 1). The increase in net assets largely reflected revaluation gains resulting from the depreciation of sterling against other currencies in the latter part of 1992. Net interest, profits and dividends (IPD) receipts also rose, from £0.3 billion in 1991 to a record £5.8 billion in 1992.

**Table A**  
UK external assets and liabilities<sup>(a)</sup>

£ billions	Stock end-1991	Identified capital flows	Net valuation effect (b)	Total change in stock	Stock end-1992
<b>Non-bank portfolio investment:</b>					
Assets	185.6	19.9	26.3	46.2	231.9
Liabilities (c)	111.7	12.4	15.4	27.8	139.4
<b>Direct investment: (d)</b>					
Assets	124.5	10.1	22.6	32.7	157.3
Liabilities	120.5	10.3	0.7	11.0	131.5
<b>UK banks' (e) net liabilities in:</b>					
Foreign currency	15.3	1.0	2.9	3.9	19.2
Sterling	39.4	-9.0	1.0	-8.0	31.4
<b>Public sector:</b>					
Reserves (assets)	26.3	-1.4	3.0	1.6	27.9
British government stocks (liabilities)	17.3	2.3	0.2	2.5	19.8
Other net public sector assets	0.4	-2.4	-2.8	-5.2	-4.8
Other net assets	-26.5	-17.4	-0.1	-17.5	-44.0
<b>Total net assets</b>	<b>6.3</b>	<b>-8.3</b>	<b>29.0</b>	<b>20.7</b>	<b>27.0</b>

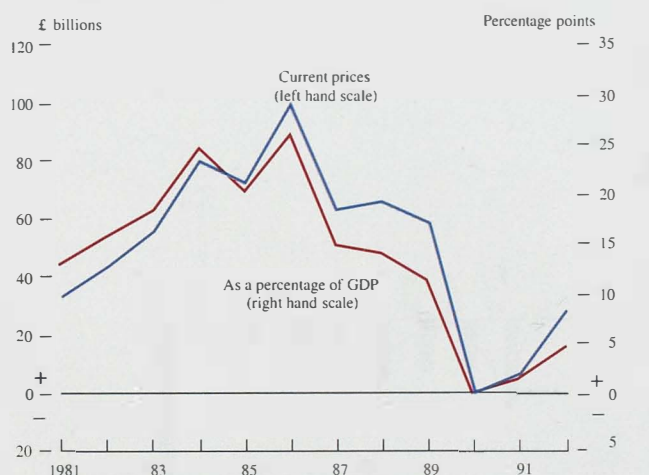
- (a) The sign convention is not the same as in the balance of payments: a transaction that increases an itemised stock is + and one that decreases it is -.  
 (b) Residual component.  
 (c) UK banks' external borrowing from overseas affiliates is treated in the published data as an offset to outward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

## Capital flows

As Table B shows, the recorded net identified capital inflows in 1992 of £8.3 billion were similar to those of 1991 but below those of the three previous years. This was in line with a narrowing of the current account deficit over the past two years.

The year began with sterling in the exchange rate mechanism (ERM), but in September sterling left the mechanism.

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



Recorded balance of payments data can provide only limited insights into the impact of these events on the intentions of investors because these data record flows which, in the event, equilibrated transactions at the exchange rates and asset prices established in the market. Nonetheless, the pattern of capital flows in the second half of 1992 was sharply different from the first. In the first half of 1992 there were net portfolio investment inflows into the United Kingdom and net short-term banking outflows. This pattern was historically unusual and was reversed in the last quarter

**Table B**  
UK capital flows<sup>(a)</sup>

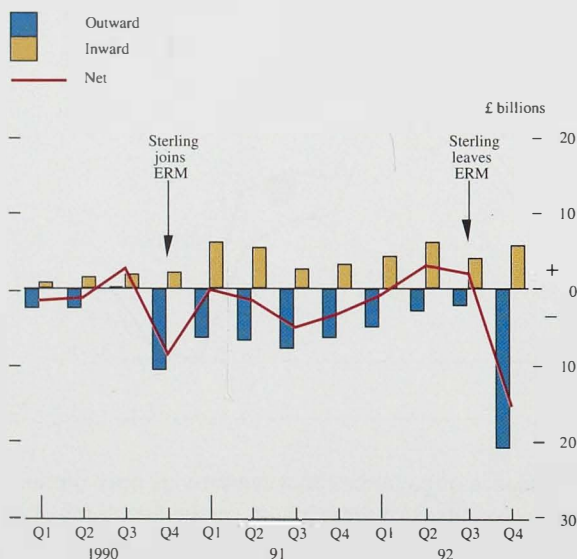
£ billions	1988	1989	1990	1991	1992	1993 H1
<b>Non-bank portfolio investment:</b>						
Transactions in net assets	-10.1	-29.9	-10.6	-20.7	-19.9	-25.6
Transactions in net liabilities (b)	14.8	17.0	11.4	10.6	12.4	12.2
<b>Direct investment: (c)</b>						
Transactions in net assets	-21.6	-21.4	-10.0	-9.4	-10.1	-8.7
Transactions in net liabilities	12.0	18.6	18.5	9.0	10.3	4.8
<b>UK banks' (d) net liabilities in:</b>						
Foreign currency (b)(c)	5.0	2.6	-5.8	5.3	1.0	2.7
Sterling	9.3	9.4	8.8	-3.7	-9.0	-0.8
<b>Net transactions in the public sector</b>						
Other net flows	-1.7	5.3	-4.7	2.1	6.2	3.6
<b>Total net identified capital flows</b>	<b>10.4</b>	<b>19.4</b>	<b>11.0</b>	<b>6.7</b>	<b>8.3</b>	<b>1.2</b>

- (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.

of the year when there were high net portfolio outflows and short-term banking inflows. In this latter period turnover, as measured by gross inward and outward capital flows, surged.

Strong inward investment and a slowdown in gross outward investment led to net inflows on portfolio investment of over £2 billion in the first half of 1992. Overseas investment in UK securities was large, by recent historical standards, as it had been since the United Kingdom joined the ERM (see Chart 2), and was particularly strong in government securities. Overseas residents were also significant buyers of equities (largest inflows since 1989); and in the sterling corporate bond markets there was a spate of issues in the first half which attracted overseas interest.

**Chart 2**  
Portfolio investment<sup>(a)</sup>



(a) Includes banks' investment. += increase in liabilities.

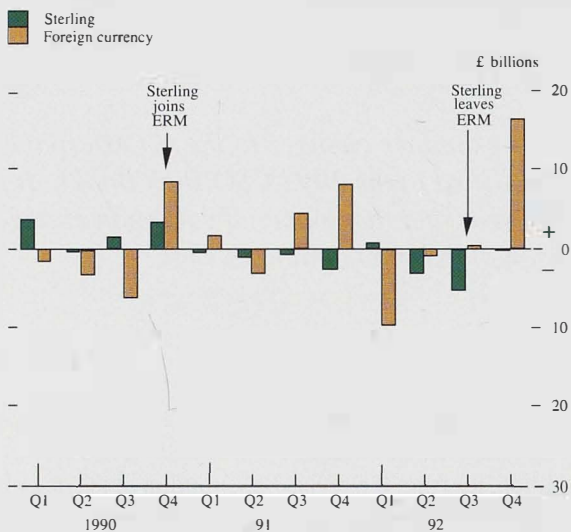
By contrast, Chart 2 shows that gross outward portfolio investment by UK residents declined during the first three quarters of 1992. This may have in part reflected the attraction of high-yielding sterling assets. Investment by other financial institutions (OFIs) shifted from overseas (but also UK) company securities into UK government stock as the UK government funded a growing public sector deficit. Banks also scaled back their investment in foreign securities, perhaps a counterpart to the contraction in their gross foreign currency borrowing (see below).

Also unusually, net portfolio inflows were accompanied by large net short-term banking outflows in the first half of the year (see Chart 3). Net and gross foreign currency lending to non-banks abroad increased modestly but was overshadowed by a rundown of business on both sides of the balance sheet by Japanese-owned banks, no doubt motivated by balance sheet ratio considerations.

While adding to portfolio assets in sterling, the overseas sector increased both its gross and net sterling borrowing

(1) Non-bank, non-general government.

**Chart 3**  
UK banks' net sterling and foreign currency lending<sup>(a)</sup> to overseas residents

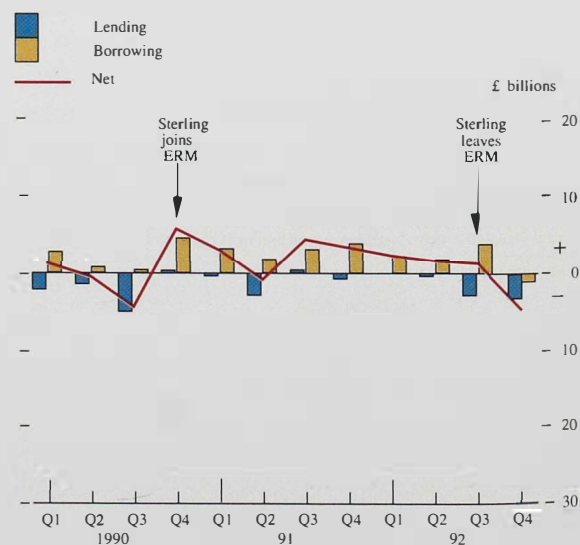


(a) Excludes banks' holdings of foreign currency bonds. += increase in liabilities.

from banks in the first half. This borrowing occurred primarily in June and took the form of advances, rather than shorter-term market loans. Around this period, and particularly after the Danish referendum, perceptions about the stability of the ERM began to alter and some overseas residents, particularly European, may have begun hedging their sterling assets.

Data on the activities of UK residents<sup>(1)</sup> with banks outside the United Kingdom are probably one of the weakest components of the accounts. Misleading conclusions could be drawn from quarterly data in isolation. Nevertheless, the trend while sterling was in the ERM is clear (see Chart 4). UK residents accumulated gross liabilities, mainly in foreign currencies. At end-Q3 1990, the quarter before the United Kingdom joined the ERM, UK residents had net assets

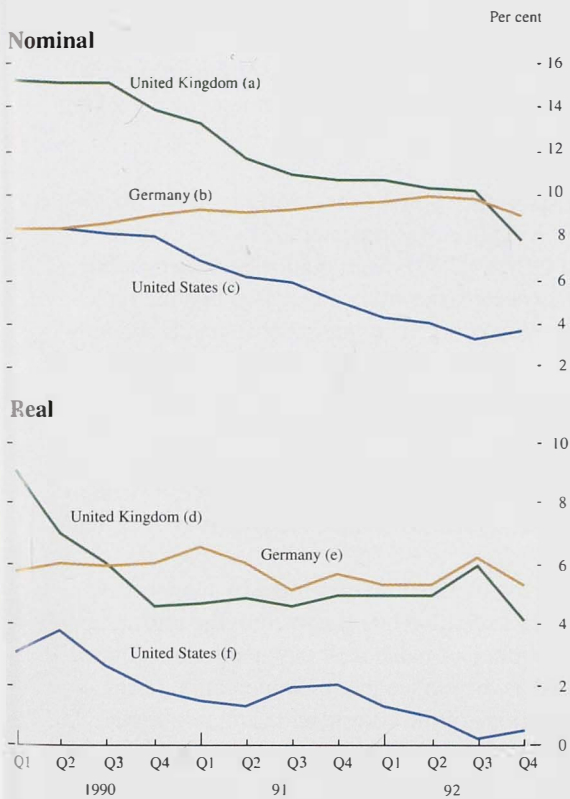
**Chart 4**  
Borrowing and lending by UK<sup>(a)</sup> residents with overseas banks



(a) Non-bank non-general government. += increase in liabilities.



**Chart 5**  
Three-month interest rates



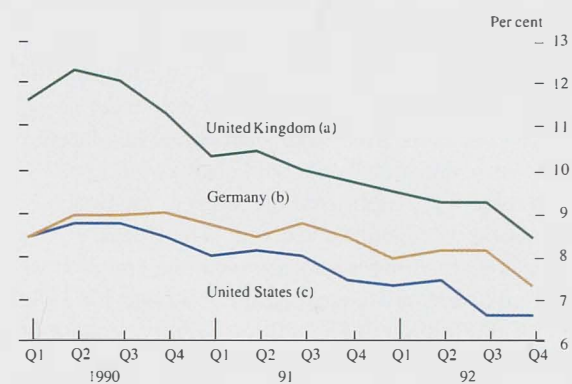
- (a) Three-month interbank.  
 (b) Deutsche Mark three-month FIBOR.  
 (c) Three-month eurodollar deposits in London.  
 (d) Three-month interbank deflated by annual retail prices excluding mortgage interest payments.  
 (e) Deutsche Mark three-month FIBOR deflated by annual retail prices.  
 (f) Three-month eurodollar deposits in London deflated by annual retail prices.

equivalent to £10.9 billion with overseas banks; at the end of the quarter before sterling left the ERM, they had net liabilities of £6.4 billion. This behaviour would be consistent with the view that they had downgraded the exchange rate risk of having foreign currency liabilities.

Gross capital flows are influenced by investors' expectations about rates of return. In their study of international capital movements and foreign exchange markets (April 1993), the G10 deputies found that a feature of the financial markets for some time before the autumn of 1992 was a growing confidence in the process of convergence of economic and financial performance among EC countries, and diminishing concern about possible realignments in the ERM. This gave rise to what was termed 'convergence trading': capital inflows into the assets of higher-yielding currencies, such as sterling, perhaps financed by borrowing in lower-yielding currencies and with only a limited regard to potential currency risk. These findings provide one possible explanation for the unusual pattern of UK capital flows data in the first half of the year.<sup>(1)</sup>

In mid-September sterling left the ERM. In the third quarter, turnover (in terms of gross inflows and outflows of

**Chart 6**  
Ten-year government bond yields



- (a) Ten-year par yield on UK government stock.  
 (b) Ten-year par yield on German federal government bonds.  
 (c) Ten-year par yield on US federal government bonds.

capital) surged, particularly in the short-term banking markets. Overseas investors borrowed a record gross £11.2 billion in sterling from UK banks.<sup>(2)</sup> Overseas residents also sold UK government stock—the first net sale over a quarter since the United Kingdom joined the ERM. The official sector ran down its net foreign currency assets.

#### Capital flows data since sterling left the ERM

By the start of the fourth quarter, the market's perception of the outlook for the exchange rate and interest rates had altered sharply. Unlike the first half of the year, changes in asset prices—sterling and Deutsche Mark prices began to diverge rather than converge—were accompanied by a sharp increase in gross capital flows. The more familiar pattern of net portfolio capital outflows and net short-term banking inflows was re-established. The net inward investment on the portfolio account over the first three quarters of the year was transformed during the fourth quarter into a large net outflow for the year.

In the fourth quarter, net foreign currency borrowing by UK banks was significant. The net outflow of £10.3 billion over the first three quarters became a net inflow of £6.5 billion over the year as a whole. Net borrowing (£13.3 billion) from overseas by UK residents other than banks (but including security dealers) helped to finance huge gross purchases of overseas securities (£14.7 billion).

The surge in investment came at a time of heavy international bond issuance by western European governments, as they funded widening budget deficits, replenished foreign exchange reserves or repaid short-term borrowing. The availability of high-quality sovereign liabilities, together with expectations of declining short-term interest rates, opened up attractive investment opportunities. Virtually all OFI investment in overseas government securities in 1992 occurred in the fourth quarter. Banks, faced by weak loan demand, were also large purchasers of these bonds.

(1) Some activity may have occurred in derivative instruments. Unfortunately, statistical information on derivative instruments is far from comprehensive. Work is progressing both internationally, through the BIS, and in the United Kingdom to improve coverage.

(2) Market participants could borrow sterling and sell it for foreign currency. This would leave them with an open position. Once sterling had depreciated, the sterling liability would be worth less in foreign currency terms.

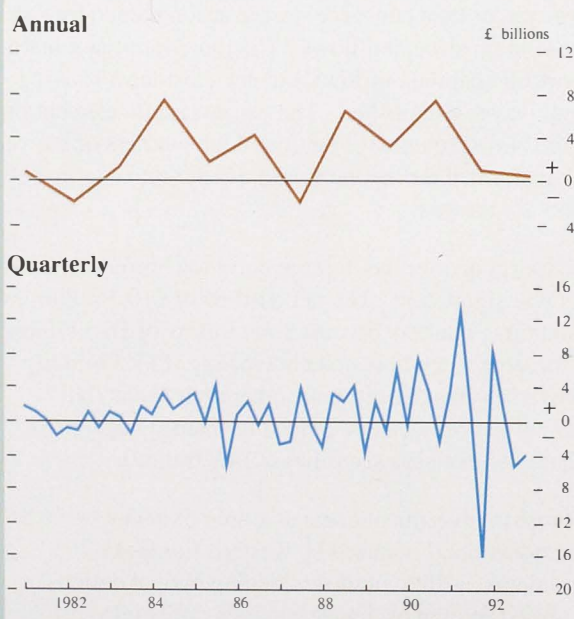


## Measurement problems

Errors and omissions may arise in both the current or capital account. For both 1991 and 1992 the net statistical discrepancy in the balance of payments was under £1 billion. The latest Pink Book data reveal few large revisions since the annual data published a year ago, although there were significant revisions to the first estimate of the 1992 current account. The United Kingdom's net external asset position at the end of 1991 was revised downwards, between the 1992 and 1993 Pink Books, by £9.8 billion to £6.3 billion, largely because of improvements to the estimates of inward portfolio investment in UK company bonds.

The reduction in the size of the United Kingdom's balancing item and the lack of substantial revisions to back data is perhaps evidence of an improvement in the quality of UK balance of payments statistics compared with the mid-1980s. Major efforts have been made to improve the quality of balance of payments data in recent years, many resulting from the Chancellor of the Exchequer's Initiatives on Economic Statistics introduced in 1990.<sup>(1)</sup> Nonetheless, it is probable that the gross errors and omissions remain significant, as the fluctuating pattern of net errors and omissions through the year indicate (see the chart).

### Balancing item: annual and quarterly



The United Kingdom is not unique in facing measurement difficulties. The liberalisation of financial markets over the past decade, with the resultant loss of key data sources (eg information from exchange controls), has created problems for balance of payments compilers. To address some of these difficulties the International Monetary Fund

set up a working party in 1985 to investigate the principal sources of discrepancy of the global current account,<sup>(2)</sup> and this was followed by the establishment of a working party on capital flows in 1989.

The findings of the capital flows working party, on which the United Kingdom was represented by the Central Statistical Office (CSO), were published in September 1992. As expected, the study concluded that the rapid pace of developments in international financial markets had not been matched by corresponding developments in balance of payments compilation methods. The report, which was accepted by the IMF executive board, urged countries to keep compilation systems under review and to provide compilers with necessary resources in order to help them maintain and enhance the quality of their data.

To continue the momentum generated by the working party the IMF executive board agreed to the setting up of a small committee of balance of payments statisticians. Its main task is to oversee the implementation of the recommendations of the current and capital account studies. So far the committee has concentrated its efforts in two areas: the use of BIS/IMF international banking statistics (IBS) in national balance of payments accounts, and portfolio investment.

On IBS, the report found that in comparing BIS/IMF international banking data with that from national balance of payments accounts there was strong evidence that cross-border transactions in both assets and liabilities of domestic non-banks were being seriously underestimated. It recommended that the BIS and the IMF consider refining their data to make the results more readily usable in balance of payments accounts. (The United Kingdom already uses these data.) At its second meeting in April 1993, the IMF committee decided to ask the BIS to consider whether improvements could be made to the presentation of their data.

The report had identified portfolio investment as a particular area of measurement difficulty. The liberalisation of capital markets, financial innovation and the changing behaviour of investors had undermined the traditional method of going to domestic intermediaries for statistical information on their clients' activities. The report recommended that national compilers conduct independent surveys of holdings of foreign securities as a necessary benchmark to check on the plausibility of transactions data. At its second meeting, the committee agreed that the IMF should begin work on co-ordinating a benchmark survey of portfolio investment among major countries.

(1) Among the improvements incorporated in the 1993 Pink Book data is a more complete coverage of UK affiliates of overseas companies in the direct investment account. There is also better information on UK bond and *EMTS* liabilities which has improved the estimate of inward portfolio investment.

(2) Mismeasurement of the interest, profits and dividends component of the account was considered to be a major cause of the global current account discrepancy.



Overseas residents, having built up sterling deposits and borrowing in each of the previous three quarters of the year, ran them both down in the fourth quarter. They modestly divested out of British government stock, despite the sharp rally in that market, but were large purchasers of the two foreign currency bonds issued by HMG.

Preliminary capital account data for the first half of 1993 suggest that gross capital flows remained well above those of a year earlier. This may imply that, since the events of autumn 1992, investors have far less convergent views on the future direction of exchange rates and interest rates and have reappraised their portfolios accordingly.

As in the fourth quarter, the preliminary data suggest that there were large gross portfolio outflows, financed in part by borrowing from overseas residents. Gross inward portfolio investment into sterling instruments appeared to recover, with record inflows of £13.8 billion in the second quarter.

### Direct investment

Although the determinants of direct investment flows are still debated, they are likely to be different (eg longer-term and more structural) than those of portfolio investment.<sup>(1)</sup> In the short term, the level of economic activity can also be important.

In 1992 there was a small net inward flow of direct investment into the United Kingdom. Nonetheless, as in 1991, gross direct investment flows remained lower than in the late 1980s. This probably reflected the general slowdown in economic activity worldwide; a reduction in direct investment flows was a feature of all G7 industrialised countries.<sup>(2)</sup>

Gross inflows of share and loan capital, although below the exceptional level of 1990, remained historically high, indeed close to double the rate of five years earlier. Between 1990 and 1992 there was a net inflow of share and loan capital into the United Kingdom following a net outflow over the previous decade. One factor supporting inward investment appears to have been the development of the European Community's single market.

The development of trade zones, such as the EC and the proposed North American Free Trade Association, could divert trade between third countries and those within the trade zone and increase trade among countries within the zone. There is some evidence of increasing regional insularity in world trade, particularly in the EC and North America.<sup>(3)</sup> Even if only the perception exists among third countries that trade will be diverted, it encourages

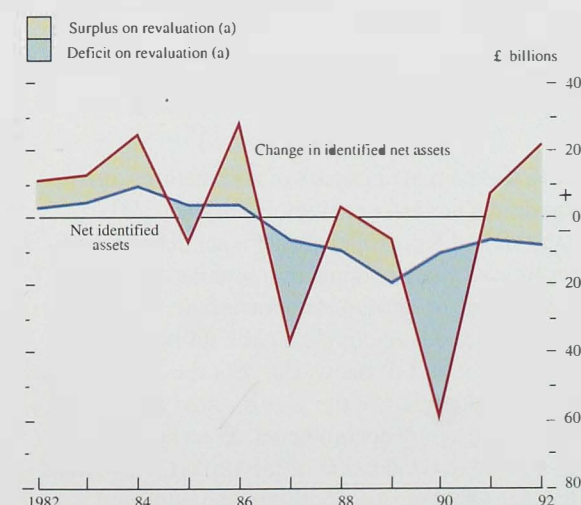
enterprises in those countries to establish direct investment ventures within each trade zone. The United Kingdom appears to have been regarded as an attractive location by third countries. This may explain the resilience of inward flows of share and loan capital.

Gross outflows of share and loan capital were much lower than in the late 1980s and, as in both 1990 and 1991, there were inflows on the intercompany account. As UK companies faced a recession at home and attempted to reduce their overall debt levels, outward investment was not attractive. Unremitted profits of UK companies abroad accounted for two thirds of gross outward investment. Provisional data for the first half of 1993 suggest a recovery in outward direct investment, largely because of a number of large acquisitions by UK companies.

### Effects of revaluations and an international comparison of external balance sheets

There were revaluations of £29 billion to identified net external assets in 1992—the largest positive revaluation for some years, and the main reason for the sharp jump in external assets.

**Chart 7**  
Contributions to changes in net external assets



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

Revaluations occur as a result of movements in exchange rates, changes in equity and bond prices, write-offs and revaluations to direct investment.<sup>(4)</sup> Taking account of changes in exchange rates and asset prices in the official statistics is difficult and so, with the gross stocks of UK assets and liabilities over £1.1 trillion, there is a degree of uncertainty in the estimate of the net asset position.

(1) See for instance the chapter 'Foreign Direct Investment' by J Saul Lizondo in *Determinants and Systemic Consequences of International Capital Flows*, IMF March 1991.

(2) The *UN World Investment Report 1993* suggests that the recent reversal of the upward trend seen in the 1980s is temporary: continuing liberalisation in policies towards foreign investment (notably in telecommunications, transportation and the utilities) together with increasing privatisation will promote further growth in gross direct investment flows.

(3) For a discussion of the possible ramifications of trade and currency zones see 'Policy implications of trade and currency zones: a summary of the Bank's 1991 Symposium', *Reserve Bank of Kansas Economic Review*, November/December 1991. See also 'Regional trading blocs, mobile capital and exchange rate co-ordination', by Bayoumi and Sterne, *Bank of England Working paper No 12*, for an examination of the evolution of regional trade patterns.

(4) Revaluations to direct investment stocks stem from occasional revaluations of individual companies' balance sheets and profitable disposals of assets etc.



An estimate of the revaluation factors and how they relate to identified capital flows is set out in Table C. Estimates of the revaluation factors are only approximate because of the lack of accurate information about the exact location, the currency of denomination and type of investment involved. This is evident from the 'other' factor which contributes to the revaluation estimate. This factor is calculated as a residual of the estimates of the effect of exchange rates and asset prices on identified capital flows. The estimates should be treated with particular caution in a year when exchange rates moved sharply.

**Table C**  
Change in identified net external assets

	£ billions					
	Average(a) 1981-88	1989	1990	1991	1992	1993 H1
A Current balance (deficit -)	-0.5	-22.5	-18.3	-7.7	-8.6	-6.3 (b)
B Identified capital flows (inflows -)(c)	1.6	-19.4	-11.0	-6.7	-8.3	-1.2
C Revaluations	4.3	14.0	-48.3	13.7	29.0	27.7
of which:						
Share prices		5	-7	15	-6	12
Bond prices		1	3	-2	—	-2
Exchange rates		24	-33	14	71	10
Other (d)		-16	-11	-13	-36	-8
D Change in identified net assets (increase +)	5.9	-5.4	-59.2	7.0	20.7	26.5
E Net asset level (end-year)	65.4	58.5	-0.7	6.3	27.0	53.4 (e)
F Balancing item(f) (inflows/credits +)	2.1	3.1	7.3	0.9	0.3	5.1

(a) End-year net asset level refers to end-1988.

(b) Seasonally unadjusted.

(c) Note the difference between this sign convention and that of the balance of payments 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 1993.

(f) F=B-A.

Nevertheless, the estimated impact of revaluations on the United Kingdom's net asset position is striking. At end-1990 the United Kingdom became a net debtor and in the subsequent two years continued to be a net capital importer, reflecting the current account deficit. At the end of June 1992, the United Kingdom had net liabilities of £3.5 billion with the rest of the world. But the depreciation of sterling in the latter half of the year boosted the sterling value of foreign currency denominated assets held abroad. This led to a positive revaluation of the United Kingdom's external balance sheet position between end-June and end-December of an estimated £43 billion, and a net external asset position of £27 billion by the end of the year.<sup>(1)</sup> Changes in asset prices had relatively little impact over the year. This was despite the fall in long-term UK interest rates, which boosted the capital value of sterling denominated bonds, and the rise in UK equity prices late in the year.

Preliminary estimates for the first half of 1993 suggest that revaluations further boosted the value of the United Kingdom's net external assets by £28 billion. Two main factors appear to be behind this positive revaluation. First, a rise in world equity prices relative to those in the United Kingdom. Second, movements in relative exchange rates which, given the currency composition of the United

Kingdom's assets and liabilities, boosted the sterling value of net external assets despite the sterling effective rate being broadly unchanged over the period.

Swings in exchange rates have in recent years had a significant impact on external balance sheet positions both for the United Kingdom and other industrialised countries because the currency composition of external assets and liabilities is unlikely to be identical. The boost to UK external assets at the end of 1992 was similar to the increases in the early 1980s. Between the end of 1981 and the end of 1984 the value of sterling fell against the US dollar by almost 40%, resulting in a large revaluation gain of over £30 billion. Conversely, between end-1989 and end-1990 sterling's appreciation (by almost 20% against the dollar) led to negative revaluations of £33 billion which, along with the need to finance a current account deficit, transformed the United Kingdom into a net debtor.

Table D shows the net external positions of Japan and Germany (large net creditors) and the United States (a large net debtor). The main influence on the net external balance sheets of these countries has been the current account. For instance, the switch of Germany's current account into deficit in 1991 (following nine years of surplus) was a key factor contributing to the reduction in Germany's net external asset position to \$300 billion (17% of GNP) at end-1992 from an end-year peak of \$357 billion in 1990.

**Table D**  
International comparisons of external net asset positions<sup>(a)</sup>

End-years	1981	1985	1989	1990	1991	1992
United States						
\$ billions	374.3	139.1	-288.5	-291.9	-364.9	-521.3
Percentage of GNP	12.2	3.4	-5.5	-5.3	-6.4	-8.7
Japan						
\$ billions	10.9	129.8	293.2	328.1	383.1	513.6
Percentage of GNP	0.9	9.5	10.1	11.0	11.3	13.9
Germany						
\$ billions	29.2	53.3	269.8	357.4	335.4	300.4
Percentage of GNP	4.3	8.5	22.6	23.7	21.0	16.8
United Kingdom						
\$ billions	62.2	104.6	93.9	-1.3	11.8	40.8
percentage of GNP	11.9	22.5	11.0	-0.1	1.2	4.5

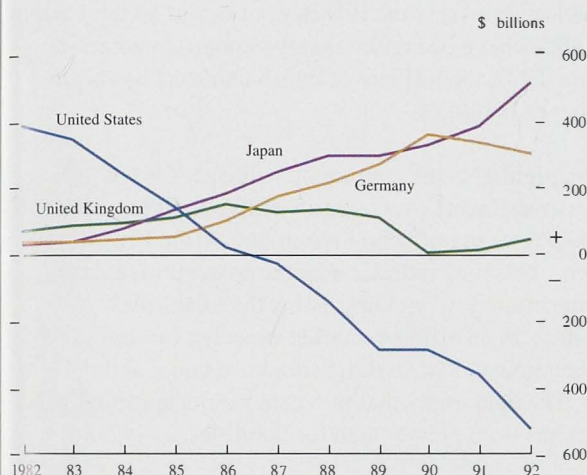
(a) The data underlying this table are taken from national sources and the IMF *International Financial Statistics Publication*. National sources may use disparate methodologies.

Nonetheless, revaluations have also been a factor. It is estimated that around 50% of German gross external assets and liabilities are denominated in currencies other than the Deutsche Mark; as a result, changes in the value of the German currency have had a significant impact on the value of external assets. The continued strengthening of the Deutsche Mark since the end of 1988, together with price fluctuations in securities markets, led to an estimated negative revaluation to Germany's external assets of DM 70 billion between the end of 1988 and the middle of 1992. The United States recorded its largest ever increase in net external liabilities in 1992, to reach \$521 billion. Around half of the \$156 billion increase reflected negative revaluation effects.

(1) Between 15 September and the end of December 1992, sterling's fall against the dollar amounted to almost 20%. The depreciation against the Deutsche Mark and the ecu were 14% and 6% respectively.



**Chart 8**  
International comparisons of external net asset positions<sup>(a)</sup>



(a) See footnote to Table D.

The swing in the value of the yen, particularly against the dollar, has at times resulted in substantial valuation changes to Japan's net asset position. In 1989, because of the sharp yen depreciation, a 15% increase in the yen value of Japanese external assets translated into a virtually unchanged position in dollar terms. By contrast, the 15% appreciation of the yen against the dollar between end-1992 and end-June 1993 will have depressed any increase in Japan's net external asset position in yen terms.

### Interest, profits and dividends (IPD)

Net IPD inflows rebounded in 1992 to a record £5.8 billion, after narrowing sharply to £0.3 billion the previous year. Despite the relative strength of earnings in the first half, IPD earnings in the second half of the year were close to double those in the first half.

As Table E shows, the banking sector's earnings explained much of the recovery in IPD earnings. Their net interest

**Table E**  
Interest, profits and dividends

£ billions

	Annual average 1981-1988	1989	1990	1991	1992	1993 H1
<b>Earnings on assets</b>						
Portfolio <sup>(a)</sup>	2.1	4.3	4.6	5.5	9.2	5.5
Direct	8.1	16.7	15.6	12.8	14.1	8.4
Other non-bank private sector	1.6	2.8	3.8	4.2	3.8	2.0
Public sector <sup>(b)</sup>	0.9	1.9	1.8	1.8	1.6	0.7
UK banks' spread earnings on external lending	1.8	1.1	0.7	0.7	1.7	0.4
<b>Total</b>	<b>14.6</b>	<b>26.8</b>	<b>26.5</b>	<b>25.0</b>	<b>30.4</b>	<b>16.9</b>
<b>Payments on liabilities</b>						
Portfolio <sup>(a)</sup>	0.8	4.4	5.6	6.6	6.6	3.5
Direct	6.2	9.2	7.0	4.5	5.5	4.9
Other non-bank private sector	1.6	3.5	4.6	5.7	7.0	4.2
Public sector <sup>(c)</sup>	1.6	2.5	2.2	2.0	2.1	1.2
Banks' cost of net liabilities	1.2	3.7	5.4	5.9	3.4	1.6
<b>Total</b>	<b>11.5</b>	<b>23.4</b>	<b>24.9</b>	<b>24.7</b>	<b>24.6</b>	<b>15.5</b>
<b>Net IPD earnings</b>	<b>3.1</b>	<b>3.4</b>	<b>1.6</b>	<b>0.3</b>	<b>5.8</b>	<b>1.5</b> (d)
Net IPD excluding spread earnings	1.3	2.3	1.0	-0.4	4.0	1.1

(a) Non-bank private sector.  
(b) Including official reserves.  
(c) Including gilts.  
(d) Not seasonally adjusted.

payments contracted by £3.5 billion. There were three main influences. First, the general level of interest rates fell which, given that UK banks are net debtors to overseas residents, reduced net payments. Second, the composition of the gross balance sheet changed. Net sterling claims and net foreign currency liabilities increased. As the average interest rate on sterling assets was around 3% to 4% above that paid on foreign currency liabilities, the change in composition reduced net payments. And third, the tension in the exchange markets in September almost certainly boosted UK banks' overseas earnings. One indication of this was that UK banks reported significant net receipts on their interest rate and currency swap transactions in the second half of the year. Overseas residents needing to acquire sterling may have 'borrowed' the currency from UK banks in the swaps market. As a result of the last two influences, banks' spread earnings widened to almost £1.7 billion in 1992. This followed a significant narrowing over the previous five years.

Net non-bank portfolio investment earnings became positive in 1992 after two years of net payments. This reflected a sharp (£3.7 billion) increase in gross portfolio investment earnings compared with the depressed 1991 income levels. All sectors recorded increased earnings in 1992; the largest rises were recorded by insurance companies and other financial institutions (principally securities dealers) who increased earnings by £0.8 billion and £1.4 billion respectively. These increases were partially offset by higher net payments on borrowing from overseas residents. Net IPD payments of the public sector increased modestly, reflecting the deterioration in their net asset position.

Net earnings on direct investment assets continued to underpin the IPD data. Both gross earnings and payments rose in 1992 leaving the net position unchanged. UK earnings benefited from the recovery in the US economy; around 40% of gross UK direct investment assets, by book value, are in the United States. The much reduced losses of the foreign banking community in the United Kingdom boosted payments from the depressed 1991 levels. Nonetheless, both gross earnings and payments were well below those recorded in 1990, reflecting the subdued economic activity in the United Kingdom and abroad.

Estimates for the first half of 1993 show a reduction in net IPD earnings. Banks' spread earnings, not surprisingly, narrowed as the special factors evident in 1992 unwound. Portfolio investment earnings remained particularly strong, but net earnings on direct investment contracted. Gross earnings on inward direct investment increased markedly, particularly in the banking sector, reflecting strong activity in the capital markets.

### Capital gains and full rates of return

Table F sets out estimates of both the IPD and 'full' rates of return. The latter include any capital gains which accrue to capital uncertain portfolio assets and liabilities. As the rates of return are calculated in sterling terms the depreciation of

**Table F**  
**Estimated IPD<sup>(a)</sup> and full<sup>(b)</sup> rates of return on identified assets and liabilities**

Percentage points

	Total		Portfolio		Direct		Banks Foreign currency		Sterling	
	IPD	Full	IPD	Full	IPD	Full	IPD	Full	IPD	Full
	1988	7.3	10.1	3.9	18.7	13.3	11.5	7.1	7.9	9.6
1989	7.7	17.4	3.3	18.7	13.4	11.9	8.1	17.4	12.6	13.7
1990	8.7	-6.4	4.3	-23.4	13.0	0.8	9.3	-4.8	13.8	14.3
1991	8.1	10.8	3.9	14.3	9.8	10.7	9.8	8.7	15.3	11.6
1992	5.9	19.2	4.4	16.3	8.7	23.0	6.1	21.7	10.2	8.2

	Total		Portfolio		Direct		Banks Foreign currency		Sterling	
	IPD	Full	IPD	Full	IPD	Full	IPD	Full	IPD	Full
	1988	7.3	8.6	5.5	8.1	11.3	14.1	6.9	7.7	8.0
1989	7.8	16.8	5.6	18.2	9.3	9.3	7.8	18.3	11.3	9.7
1990	8.6	-1.3	6.6	-5.2	6.2	-5.5	9.0	-4.4	12.9	12.7
1991	8.1	9.4	6.0	12.8	3.7	2.5	9.3	8.9	13.7	11.6
1992	5.6	16.7	4.8	15.0	4.2	4.7	5.4	20.9	9.0	6.9

(a) IPD earnings as a percentage of the stock.

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

sterling in 1992 boosted the full rate of return on UK assets denominated in foreign currencies. Conversely, in foreign currency terms overseas investors' full rate of return on their

sterling assets would have been considerably less than quoted in the table.

Over the last five years the IPD rates of return on total assets and liabilities have been remarkably similar. In contrast, except for 1990, the full rate of return on assets has been above that of liabilities.

The table highlights the continuing tendency for UK portfolio investments overseas to yield lower IPD rates of return than foreign portfolio investments in the United Kingdom. This may indicate a larger proportion of gross capital-uncertain low-yielding assets than liabilities. Nonetheless, in an efficient market expected full rates of return, denominated in sterling, should be equal at the margin. The data imply that in recent years the capital gain on assets has been greater than for liabilities.

The lower IPD yields on portfolio assets than on liabilities is also reflected in higher interest rates on sterling than foreign currency liabilities. These interest differentials are of importance and, to the extent that they result from risk premia effects, are a deadweight cost. The benefits of reduced interest differentials, in terms of reducing the cost of financing the current deficit, were evident in 1992.