

The external balance sheet of the United Kingdom: recent developments

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This article examines changes to the net external asset position of the United Kingdom during 1994 (using figures published in the 1995 CSO Pink Book); it continues a series begun in September 1985 and last updated in the November 1994 Bulletin. It focuses on capital flows, the impact of valuation changes to existing assets and the earnings on these assets. It also includes an international comparison of external balance sheets.

Introduction

The United Kingdom had identified net external assets of £17.7 billion at the end of 1994, compared with a revised estimate of £13.2 billion at the end of 1993 (see Table A).⁽¹⁾ As in the previous four years, the increase in net assets was achieved despite a recorded current account deficit (albeit the smallest since 1986); it was the result of changes in asset prices. The increase in net assets was accompanied by recorded net capital outflows which, taken together with the recorded current account deficit, imply significant unrecorded inflows; these measurement problems are reflected in the balancing item in the accounts.

Table A

UK external assets and liabilities^(a)

£ billions

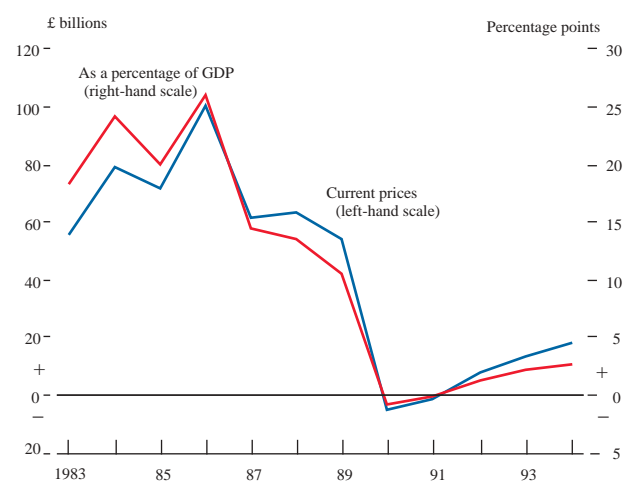
	Stock end-1993	Identified capital flows	Net valuation effect (b)	Total change in stock	Stock end-1994
Non-bank portfolio investment:					
Assets	323.1	-32.7	-5.7	-38.4	284.7
Liabilities	193.8	22.4	-12.0	10.4	204.2
Direct investment: (c)					
Assets	166.1	16.9	-4.8	12.1	178.2
Liabilities	132.9	6.7	0.1	6.8	139.7
UK banks' (d)(e) net liabilities in:					
Foreign currency	13.6	-18.9	9.2	-9.7	3.9
Sterling	23.5	5.2	-1.2	4.0	27.5
Public sector:					
Reserves (assets)	29.0	1.0	0.6	1.6	30.7
British government stocks (liabilities)	48.7	3.0	-7.5	-4.5	44.2
Other net public sector assets	-3.3	-2.7	-0.1	-2.8	-6.1
Other net assets	-89.2	39.4	-0.5	38.9	-50.3
Total net assets	13.2	3.6	0.9	4.5	17.7

- (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 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 banking sector plus certain other financial institutions.

(1) Direct investments are recorded at book rather than market value. It has been estimated that the net direct investment stock was underestimated by £60 billion in 1993. See Pratten, C. (1994), 'The valuation of outward and inward direct investment', Department of Applied Economics (DAE), University of Cambridge, unpublished report to the Central Statistical Office available on request from the DAE.

There were large changes in securities prices in 1994. Following rises in short-term US interest rates, bond yields increased and equity prices fell leading to capital losses on portfolio investments. The portfolio stocks and flows data suggest that UK external holdings of portfolio assets recorded capital losses; however, these were more than offset by the implied capital losses sustained on UK external portfolio liabilities. These movements resulted in a positive securities price effect on UK net portfolio assets. The

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

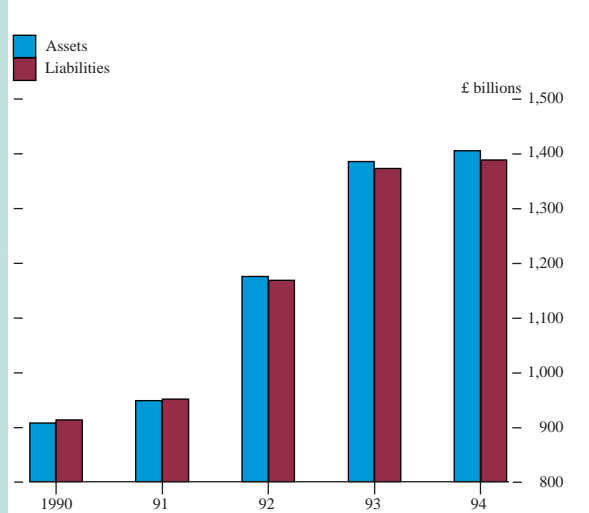


estimate of the size of this effect should, however, be regarded with caution, since the levels data are prone to revisions; the net asset position at the end of 1993 was, for example, revised down by £7.1 billion in the 1995 Pink Book. Although revisions are normally small in relation to the total of gross assets and liabilities (£1,405 billion and £1,388 billion respectively at the end of 1994), the effect on the net assets figure is significant (see the box on measurement issues on page 354).

Measurement issues

The 1995 CSO Pink Book contained revisions to the data published a year earlier. The revision to the reported 1993 current account was less than £1 billion; the relatively small adjustment maintained the trend observed for the current account since the then Chancellor of the Exchequer's initiative on economic statistics in 1990. The 1993 net external asset position was, however, revised downwards by £7.1 billion to £13.2 billion. This followed a substantial downward revision to the 1992 position in the 1994 Pink Book: the significant revisions to net assets are the result of relatively small amendments to the totals of gross external assets and liabilities. For example, the 54% revision to the 1993 net asset position was the result of an amendment of 0.63% to gross assets and a 1.17% change in gross liabilities.

Gross external assets and liabilities



Unusually, the 1994 balance of payments data displayed both a net capital outflow and a current account deficit. These apparently contradictory figures were reconciled by a balancing item of £5.2 billion—the largest since 1988. The United Kingdom is not unique in having such a statistical discrepancy; and at both a European and global level, efforts are being made to improve the quality of these data.

In Europe, for example, both Eurostat and the European Monetary Institute have established groups of balance of payments experts. One objective of these task forces is to produce meaningful aggregates for the European Union, based on the recommendations of the fifth edition of the IMF balance of payments manual. Among other things, the manual recommends the reconciliation of portfolio stocks and flows data, to allow statistical agencies to cross-check stocks and flows data. Since many of the banks most involved in

investment in foreign securities report both their transactions and holdings to the Bank of England, earlier this year the Bank completed an exercise to:

- reconcile stocks and flows data;
- produce actual and expected rates of return; and
- estimate full rates of return by adding capital gains to the income rate of return.

From this work, the Bank has created a system to estimate individual banks' portfolio stock positions at the end of quarters and compare the estimates with the actual outturn. The method chosen revalues the previous end-quarter stock positions using current end-quarter stock prices and adds revalued transactions data for the current quarter to produce an estimate of the stock position. This estimated position is compared with the outturn. Expected rates of return on both income and capital gains are generated. This system of cross-checking improves the accuracy of reporting and provides statisticians with a greater understanding of market developments.

The estimated end-quarter stock position is constructed by applying a yield and exchange rate revaluation to the previous quarter's data, so reflecting price and currency movements. But whereas the currency composition of a bank's end-quarter holdings is known, the maturity of those holdings is not. It is assumed (from the available evidence): that the average maturity of bonds held is five years;⁽¹⁾ that banks primarily hold fixed rather than floating-rate securities; and that in general they hold high-quality debt (not least because the Basle capital adequacy requirements encourage this).

To calculate the income rate of return, average portfolio income data are applied to an average of the previous two quarters' holdings. This provides a way of avoiding seasonal distortions, eg the usual six-monthly cycle of interest payments. An expected income rate of return is also calculated in order to allow the data reported by banks to be checked. It is constructed by weighting generic five-year bond yields according to the currency composition of banks' portfolios. To generate the full rate of return, the capital return is added to the income rate of return.

The exercise to reconcile transactions and levels should help to improve the quality of UK balance of payments. And, in addition, it has increased statistics-gatherers' understanding of the market and their ability to recognise and correct misreporting before data are published.

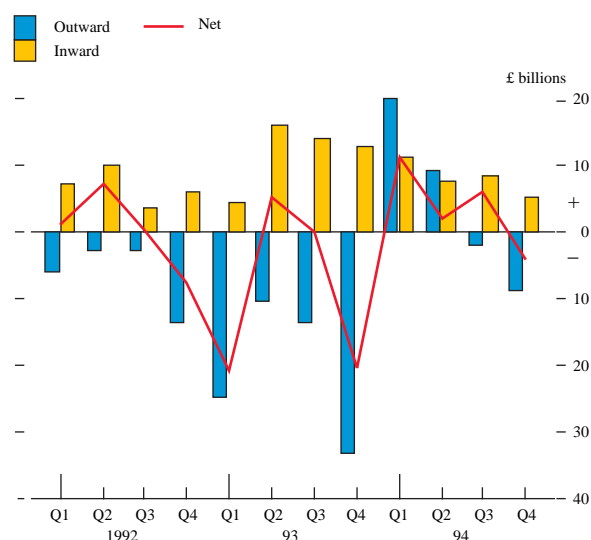
(1) Banks' holdings of foreign bonds tend to be of ten years or less. Although there are 30-year bonds and longer maturities in issue, they represent a relatively small segment of the market as a whole.

Capital flows

Portfolio investment

UK capital account transactions in 1994 were once again dominated by activity in the securities markets. Holdings of overseas securities were significantly reduced in the first half of the year, following the large increase in 1993 (see Chart 2). The disposal of overseas portfolio assets in the first half of the year led to net sales (of £18.6 billion) for the year as a whole.⁽¹⁾ The flow of inward portfolio investment was also lower than in 1993, but at £31.8 billion it remained significantly above the figures reported in prior years.

Chart 2
Portfolio investment^(a)



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

Following the increase in US interest rates on 4 February 1994, the holdings of overseas securities built up in 1993 were rapidly reduced. This sell-off was accompanied by a reduction in short-term liabilities to the overseas sector (see Table B). During 1993, UK residents—notably securities dealers—had increased their borrowing from overseas to finance holdings of securities; these liabilities were reduced in 1994. Banks and securities dealers both reduced their holdings of overseas securities in the first half of the year; securities dealers had, however, built up larger holdings in 1993 and their sales were correspondingly greater. Banks reported net sales of £2.9 billion in the period while other financial institutions (OFIs) sold £28.3 billion. In the second half of the year, banks purchased £17 billion worth of overseas securities, more than reversing their earlier sales. OFIs, however, remained net sellers of overseas securities, reducing their positions by a further £5.2 billion.

In the reduced net purchases of UK securities by overseas investors, there was a striking distinction between corporate and government issues. Net purchases of UK company securities fell by £4.4 billion to £26.1 billion, while net

Table B
UK balance of payments: transactions data

£ billions	1990	1991	1992	1993	1994
Increase in UK assets (-)/ increase in UK liabilities (+)					
Current balance	-19.3	-8.5	-9.5	-11.0	-1.7
Long-term capital:					
Public sector (a)	-0.7	7.0	7.8	16.2	5.4
Private sector (b)	3.2	-18.8	-11.3	-61.5	34.9
	2.5	-11.8	-3.5	-45.3	40.3
Balance	-16.8	-20.3	-13.0	-56.3	38.6
Short-term capital (c)	8.5	13.4	12.8	31.2	-40.6
Banks' transactions (d)	7.2	9.6	-5.6	28.3	-2.3
Balance before reserves and errors	-1.1	2.7	-5.8	3.2	-4.3
Reserves	-0.1	-2.7	1.4	-0.7	-1.0
Errors and omissions	-1.2	—	-4.4	2.5	-5.2

Columns may not sum to totals because of rounding.

- (a) Includes overseas purchases of gilts and long-term government borrowing.
 (b) Includes direct and portfolio investment excluding overseas investment in gilts.
 (c) Includes all other non-bank and government capital flows other than long term as defined above.
 (d) Banks' net deposits, ie excludes banks' portfolio and direct investment.

purchases of British government stocks fell by £12.2 billion to £3 billion. The substantial fall for government stocks was the result of reduced net buying by overseas residents other than overseas monetary authorities; this group of investors made small net sales during the first half of the year. There was reduced external demand for government securities elsewhere—including in Germany, Japan and the United States—in the second quarter of the year.⁽²⁾

The fall in overseas residents' net acquisitions of UK company securities reflected reduced buying of equities. Throughout the period, overseas investors remained net purchasers of both equities and bonds; however, net acquisitions of bonds increased to £21 billion in 1994 from £13.5 billion in 1993, whereas net equity acquisitions fell from £17 billion to £5.1 billion in 1994.

Direct investment

Direct investment overseas by UK residents continued at a similar rate as in 1993—that is significantly above the rates seen in the early 1990s. In 1994, these high capital outflows largely reflected profit retention by overseas affiliates. As the profitability of overseas affiliates of UK companies has increased, so have their retained profits.⁽³⁾ And of the direct investment outflows in 1994, 85% (£14.4 billion) represented retained profits.

Inward direct investment by overseas residents, by contrast, was at the lowest since 1986. This reflected almost a halving in the unremitted (ie reinvested) profits of non-oil companies, and the lowest level of acquisitions of share and loan capital since 1988. The box on page 358–59 examines the trends, determinants and implications of direct investment in more detail.

(1) See the article in the May 1995 *Quarterly Bulletin*, pages 154–59, which discussed bond yield changes in 1993 and 1994.

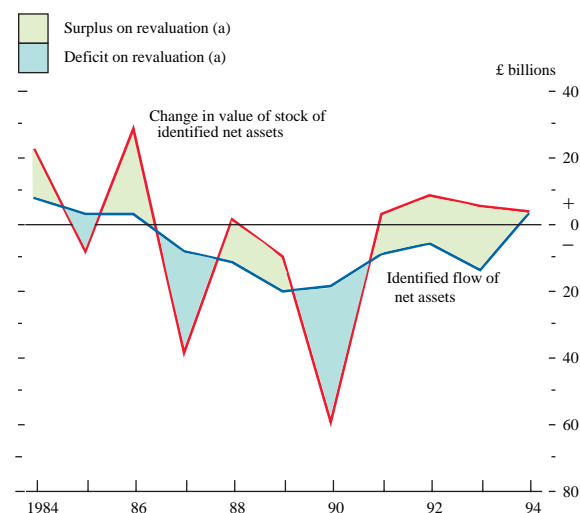
(2) More details can be found in the box on international securities transactions in 1994 in the February 1995 *Quarterly Bulletin*, pages 30–31.

(3) In balance of payments accounting, profits earned overseas are reported as income to the United Kingdom in the current account; the retained profits are then shown as an outflow in the capital account.

Effects of revaluation and an international comparison of external balance sheets

Of the recorded £4.5 billion increase in UK net assets in 1994, an estimated £0.9 billion was the result of revaluations—the smallest recorded revaluation effect in recent years. Because of positive revaluations in each of the past four years, the United Kingdom's net asset position has increased despite recorded current account deficits. By definition, a current account deficit must be accompanied by net capital inflows—as liabilities to overseas are increased, overseas assets are reduced, or some combination of the two. Other things being equal, this will reduce the external net asset position. During 1994, however, according to the official statistics, there was both a current account deficit and a net outflow on the capital account. This apparent inconsistency is explained by the existence of a balancing item of £5.2 billion reflecting errors and omissions elsewhere in the accounts.

Chart 3
Contributions to changes in net external assets



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

Revaluations of gross assets and liabilities occur as a result of exchange rate movements, securities price changes, write-offs and revaluations of direct investments. It is difficult to revalue assets and liabilities accurately using official data, largely because of a lack of detail in some sectors about the exact location, currency of denomination and the type of investment involved. Table C provides estimates of the impact of revaluation effects and relates them to recorded capital flows. The estimate for the exchange rate effect is disaggregated into components for portfolio investment, direct investment and other net assets (that is lending to overseas residents, and the effects on the official reserves and on central government assets). The 'other' element in revaluations is the residual amount, ie that not due to exchange rate or securities price effects: it may therefore reflect, among other factors, inaccuracies in estimating the sources of revaluations. Given the estimation problems, Table C should be viewed only as broadly indicative.

Table C
Change in identified net external assets

	Average (a)					
	1982–90	1991	1992	1993	1994	1995 H1
A Current balance (deficit -)	-5.8	-8.5	-9.5	-11.0	-1.7	-4.4 (b)
B Identified capital flows (inflows -) (c)	-3.6	-8.5	-5.1	-13.5	3.6	2.3
C Revaluations	-0.6	12.1	14.4	19.4	0.9	-4.0
of which:						
Exchange rates		7.5	63.2	3.9	0.3	14.3
Portfolio investment		3.2	27.8	0.2	0.5	8.1
Direct investment		6.2	27.3	2.9	1.8	11.8
Other net assets		-1.9	8.1	0.8	-2.0	-5.6
Securities price effect		11.0	-13.2	22.9	11.6	-4.5
Other (d)		-6.4	-35.6	-7.4	-11.0	-13.7
D Change in identified net assets (increase +)	-4.3	3.6	9.3	5.9	4.5	-1.7
E Net asset level (end-year)	-5.6	-2.0	7.3	13.2	17.7	15.9 (e)
F Balancing item (f) (inflows/credits +)	2.2	—	4.4	-2.5	5.2	6.7

(a) End-year net asset level refers to end-1990.

(b) Not seasonally adjusted.

(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 1995.

(f) F = B-A.

As in the previous two years, UK net portfolio assets were subject to significant revaluation effects in 1994. The overall positive securities price effect occurred despite overseas assets being subject to large negative price revaluations; the effect of these appears to have been outweighed by the impact of the fall in the price of UK securities on overseas residents' portfolios. This probably reflected the decline in UK securities prices relative to other securities markets in 1994. The overall exchange rate effect was also positive for the UK external balance sheet. The revaluation was consistent with a slight depreciation of the sterling effective exchange rate, and maintained the trend observed since 1991.

Preliminary estimates for the first half of this year indicate a downward revaluation of UK net assets, despite a significant positive exchange rate effect which reflected the depreciation of sterling against most major currencies during the period. The size of the revaluation should, however, be viewed with caution, since the half-year assets and liabilities data are prone to revision.

International comparisons of net external assets

Table D offers an international comparison of net external assets. Broadly speaking, in France, Germany, Japan, the United Kingdom and the United States, there was a continuation of the trend seen in recent years. Since 1985, when the net external assets of the United States and Japan were virtually identical in dollar terms, Japanese net external assets have increased while those of the United States have fallen. These movements are largely the result of the regular current account surplus of Japan and deficit of the United States. With a current account surplus and a strong Deutsche Mark, before 1990 German net assets followed a similar trend to Japanese. But following German unification in 1990, the current account moved into deficit, and this was accompanied by a fall in net external assets, despite the Deutsche Mark's slight depreciation against the US dollar

Table D
International comparisons of external net asset positions^(a)

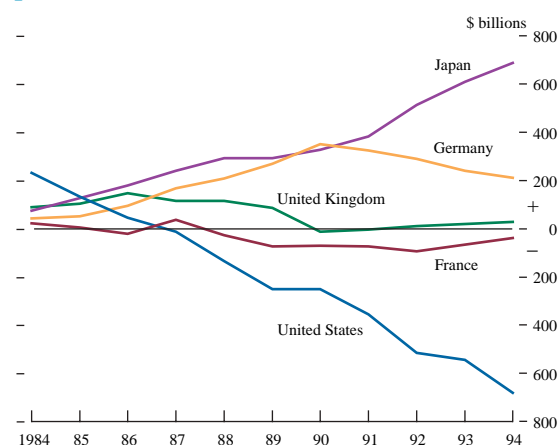
End-years	1981	1985	1991	1992	1993	1994
United States						
\$ billions	374.3	139.1	-355.1	-515.7	-545.3	-680.8
Percentage of GNP	12.3	3.4	-6.2	-8.6	-8.6	-10.1
Japan						
\$ billions	10.9	129.8	383.1	513.6	610.8	689.0
Percentage of GNP	1.0	10.0	10.6	13.7	14.5	14.5
Germany						
\$ billions	29.2	52.8	325.2	289.7	240.9	212.0
Percentage of GNP	4.0	9.0	18.5	16.6	14.6	11.2
France						
\$ billions	56.4	6.1	-74.4	-95.0	-66.8	-38.3
Percentage of GNP	8.6	1.0	-5.7	-7.5	-5.6	-2.8
United Kingdom						
\$ billions	62.2	102.6	-3.7	11.0	19.6	27.7
Percentage of GNP	11.9	22.4	-0.4	1.2	2.1	2.6

(a) The data underlying this table are taken from national sources, the IMF *International Financial Statistics Publication* (GNP figures) and *OECD Financial Statistics Part 2*. National sources may use differing methodologies.

between 1990 and 1993. France's net asset position improved during 1994, despite a small appreciation of the franc against the US dollar; this was countered by a current account surplus. International balance of payments data can be subject to large revisions and problems of comparison; however, these are unlikely to distort this broad picture significantly.

In general, increases in net external assets have been positively correlated with current account surpluses. The exception, however, has been the United Kingdom which, despite running current account deficits, has managed to

Chart 4
International comparisons of external net asset positions^(a)



(a) See footnote to Table D.

increase its estimated net external assets in recent years. This has been achieved—as Table C illustrates—primarily through significant exchange rate movements, but it has also reflected favourable net portfolio price movements. In 1993, the value of UK portfolio liabilities rose by less than UK overseas portfolio assets; in 1994, the value of UK portfolio liabilities fell by more than UK overseas portfolio assets.

Investment income

UK net investment income rose to a record high of £10.5 billion in 1994. This helped push the current account into surplus in the third quarter and contributed to the lowest annual current account deficit since 1986. As Table E

Table E
Investment income (II)

	£ billions					
	Annual average 1982–90	1991	1992	1993	1994	1995 H1
Earnings on assets						
Portfolio (a)	2.8	5.5	8.2	9.5	8.6	4.2
Direct	10.2	12.8	13.4	16.4	21.9	10.6
Other non-bank private sector	2.0	4.3	4.0	4.8	4.2	2.0
Public sector (b)	1.1	1.8	1.6	1.4	1.4	1.0
UK banks' spread earnings on external lending	1.6	0.3	1.8	2.1	6.7	2.1
Total	17.7	24.6	28.9	34.2	42.9	20.0
Payments on liabilities						
Portfolio (a)	1.8	6.5	6.8	7.3	7.9	4.9
Direct	6.8	4.5	5.3	10.4	9.5	5.8
Other non-bank private sector	2.2	5.7	6.8	8.9	9.0	4.2
Public sector (c)	1.9	2.6	3.2	3.4	4.1	2.2
Banks' cost of net liabilities	1.9	5.9	3.1	2.3	1.8	1.1
Total	14.6	25.2	25.2	32.4	32.3	18.2
Net II earnings	3.1	-0.6	3.7	1.9	10.5	1.8 (d)
Net II excluding spread earnings	1.5	-0.9	1.9	-0.2	5.6	-0.3

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

shows, the increase was the result of a substantial rise in earnings on assets and a small fall in the income paid on liabilities. In 1993, the decline in investment income was largely the result of a fall in net direct investment earnings; the increase in 1994 was largely attributable to a recovery in this area. Net direct investment income more than doubled, to £12.4 billion, in 1994.

Net earnings from direct investment by the banking and OFIs sectors significantly improved in 1994. The profits of overseas banks resident in the United Kingdom, affected by difficult trading conditions, fell from £2.9 billion in 1993 to £1.3 billion in 1994; these earnings are a debit in the UK current account so, other things being equal, a fall in them improves the UK net investment income position. Similarly, overseas OFIs operating in the United Kingdom experienced a £2.2 billion fall in earnings. The banking sector's net direct investment earnings were further boosted by an increase in the profits of UK banks' overseas affiliates—a credit to the UK current account. In 1993, these offices reported profits of £313 million; in 1994, their profits were some £700 million higher. The rise stemmed mainly from higher profits in European and US affiliates, following subdued earnings in 1993.

Net earnings from non-bank portfolio investments fell from £2.2 billion in 1993 to £0.7 billion in 1994. From the rates of return, shown in Table F and discussed further below, this seems to have been largely the result of non-banks, notably securities dealers, running down their overseas securities

Foreign direct investment

Recent trends in foreign direct investment illustrate the extent of changes to the pattern of global production. In advanced economies, foreign-owned firms now account for a large share of 'domestic' output, employment, investment and trade. This has important implications for global economic relations.

Measurement issues

International comparisons of direct investment are subject to considerable measurement problems. Not all countries adhere to IMF and OECD recommendations on measuring direct investment. Japanese figures, for example, exclude unremitted profits and take no account of disinvestment flows or loans from affiliates to parents. There is a further problem in identifying the *destination* of investment flows, because funds are often channelled through holding companies in third countries—this is particularly evident in the data for the Netherlands and Switzerland.

Despite these difficulties, detailed data are available on UK and global stocks and flows of direct investment. The Central Statistical Office's (CSO's) annual enquiry into overseas direct investment provides detailed data on the source, destination and industrial composition of UK direct investment. And comparative data can be generated using a combination of the IMF balance of payments data, OECD estimates and official national sources.⁽¹⁾

Global trends

In the 1980s, there was a surge in global foreign direct investment. UN estimates suggest that between 1983 and 1990 global flows rose at an average annual rate of 30%—over three times the rate of world export growth and four times as fast as world GDP growth. Direct investment flows reached a peak of around \$230 billion in 1990; the largest flows were between the United Kingdom, Japan and the United States. Outward investment fell in the following two years because of recession. But the flows have since recovered strongly; they reached around \$200 billion in 1993.

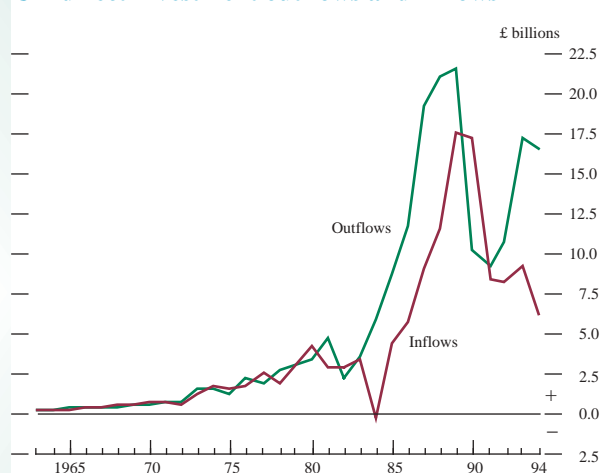
Developed countries account for the majority of outward flows (around 90% of the global total in

1991–93). And in recent years, there has been a sharp increase in inflows to the developing world, concentrated mainly in 10–15 countries in Asia and Latin America: most notably, in 1993 China became the second largest recipient of foreign direct investment inflows after the United States.

UK trends

The United Kingdom was the world's largest *outward* direct investor between 1986 and 1988, with a share of over 20% of total world flows. The main destination for UK investment was the United States, where UK companies were a major participant in cross-border merger and acquisition

UK direct investment outflows and inflows



activity. A decline in this activity and recession led to a sharp fall in UK outward investment in 1990–91. But outflows have now started to recover, and reached £16.4 billion in 1994, though remaining below their 1989 peak (see the chart).

The United Kingdom was also a major destination for *inward* investment in the late 1980s: inflows peaked at £17.4 billion in 1989 (about 16% of world and 38% of EU inflows); the main source was the United States. But in recent years, other EU states and, to a lesser extent, other developed countries have increased their share of inward investment. Despite Japan's importance as a source in the late 1980s, in 1993 its share of the total *stock* of UK direct investment was only 4.5%. Inward investment in the United Kingdom fell sharply in the recession and has yet to recover: inflows were only £6.7 billion in 1994, around 40% of their 1989 level.

(1) The UNCTAD, Division on Transnational Corporations and Investment holds a database on foreign direct investment, details of which are reported in the 1994 *World Investment Report*.

UK foreign direct investment flows by region

£ billions

		1988	1989	1990	1991	1992	1993
Western Europe	Outflows	5.8	5.6	5.8	4.0	4.9	6.6
	Inflows	7.3	7.9	8.1	4.9	4.1	2.1
North America	Outflows	11.0	12.2	0.9	2.6	1.2	7.0
	Inflows	1.5	7.0	4.8	2.1	3.7	4.4
Japan	Outflows	0.1	0.2	0.2	—	—	-0.1
	Inflows	1.1	1.2	2.1	—	—	0.4
Rest of the world	Outflows	4.0	3.4	3.1	2.8	4.0	3.6
	Inflows	1.7	1.2	2.2	1.3	1.0	2.3
Total	Outflows	20.9	21.5	10.1	9.3	10.1	17.0
	Inflows	11.6	17.4	17.2	8.4	8.8	9.2

Service industries have received a rising share of investment flows over the last decade, accounting for 40% of UK inward investment and 45% of outward investment in 1993 (compared with 36% and 38% respectively in 1980). This trend reflects both the growing importance of the sector in domestic and world output, and the extent of service-sector liberalisation (including privatisation programmes).

Determinants

A firm's *ability* to undertake foreign direct investment is dependent on the availability of finance, and consequently on aggregate profitability; but the factors affecting the *need* to undertake direct investment are less obvious. However, direct investment is generally much more difficult to reverse than portfolio investment. As a consequence, the determinants of its growth, location and industrial composition are likely to be longer-term and more structural than the risk-return influences on portfolio flows.⁽²⁾

There may be long-term advantages to a firm in replacing market transactions with internal transactions through vertical integration. Downstream integration with a foreign supplier may remove uncertainty involved in obtaining supplies, allow production to be moved to lower cost areas or offer tax advantages through transfer pricing. Upstream integration may improve a firm's responsiveness to local market conditions, or allow it to obtain or preserve a presence in regional market places.

Economic theory suggests that for a firm to be willing to establish an overseas subsidiary, there must be cost advantages relative to acquiring a domestic incumbent firm sufficient to compensate for the costs of adapting production to local conditions. These advantages may be superior

technological or managerial abilities, better marketing skills or a brand identity.

The United Kingdom's importance as a provider of direct investment is partly a product of its historical ties (with the United States and the Commonwealth), which have produced a large existing stock from which it can reinvest retained earnings. Outward investment in the United States may also have been motivated by a desire to acquire ready-made management structures or marketing and technological expertise.

Its attractiveness to inward investors may be attributable to the access that it provides to the developing European economy, a favourable corporate tax regime, and the extensive liberalisation of financial and other service industries in recent years. Japanese investment in the United Kingdom seems to have been particularly motivated by a perceived managerial and technological advantage. Finally, there may be fewer impediments to take-overs in the United Kingdom than in other EU countries: share ownership is widely dispersed, there are few dominant inter-company and bank shareholdings, and comprehensive shareholder registers exist.

Implications

Outward investment activity has provided companies with an additional source of earnings and the United Kingdom with a source of investment income which has boosted the *invisible* trade balance. Investment income was a major contributor to the improvement in the current account in 1994, and provided a quarter of the increase in ICCs' total income. In addition, outward investment has also allowed access to overseas markets which would otherwise be difficult to supply.

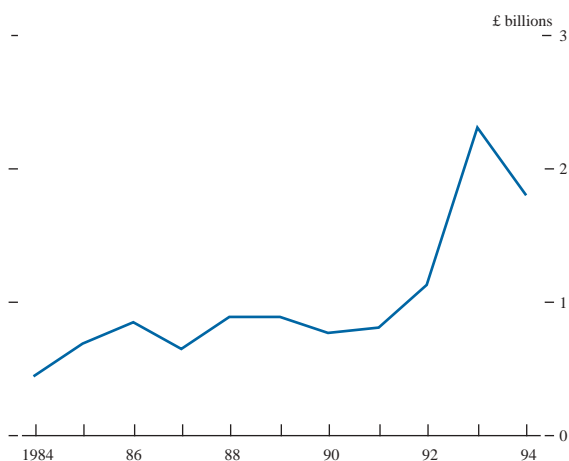
Inward investment may have benefited the *visible* trade balance by leading both to import substitution and an increase in re-exporting activities by foreign-owned firms. It has also accounted for a higher proportion of total domestic investment than in most developed countries (about 14% between 1986 and 1990, compared with an OECD average of 4%), suggesting that it may have slightly increased overall domestic investment in this period. Its wider benefits include increased domestic productivity and technology transfer.

(2) Theoretical explanations for foreign direct investment are discussed in Lizondo, J S, *Determinants and Systemic Consequences of International Capital Flows*, IMF March 1991.

portfolios during 1994. Despite large repayments of borrowing by the non-bank private sector, payments on overseas liabilities increased slightly. The combination of an increase in interest payments and a fall in overall liabilities reflected the lag on interest payments to overseas.

In contrast to securities dealers, banks increased their holdings of overseas securities by £11.1 billion (10%) during 1994. Their 48% increase in holdings of overseas securities during 1993 had resulted in a substantial increase in net earnings; but in 1994, despite the increase in assets, banks'

Chart 5
Banks: portfolio investment income net of funding costs^(a)



(a) British Invisibles 'City Table' 1995.

net income from portfolio investments fell by 21% (see Chart 5). The decline in net income occurred not because of a fall in interest and dividend receipts, but because of an increase in banks' funding costs.⁽¹⁾

Banks' spread earnings on external lending are estimated to have grown substantially in 1994. Banks continued to report net interest and dividend receipts and, as in 1993, net receipts on interest rate swaps. Net receipts on interest rate swaps with the overseas sector increased almost tenfold to £2.4 billion in 1994. Banks ascribed this increase mainly to positions in which they had taken on fixed-rate liabilities and floating-rate assets: when interest rates increased, UK banks' receipts exceeded their payments.

Estimates for 1995 H1 put net investment income at £1.8 billion—substantially lower than in 1994 H1. The main factors underlying the fall were higher payments on portfolio and direct investment liabilities compared with the first half of 1994. As a result of these, there were net payments on securities in 1995 H1, reversing the trend of net receipts recorded in recent years.

Capital gains and full rates of return

Table F sets out the investment income and full rates of return on specific assets in recent years. The investment income rate of return is calculated by taking earnings as a percentage of the stock of investment. The full rate of return includes investment income plus any capital gains, again expressed as a percentage of the stock. In 1994, the full rate of return on UK overseas assets fell once again. Having almost halved in 1993, there was a similar reduction in 1994. But whereas the decline in 1993 reflected a return to more normal rates following unusually high returns recorded in 1992,⁽²⁾ in 1994 the fall appears largely to have been the result of capital losses recorded on UK residents' holdings of overseas securities. In a similar way, the fall in the price of UK securities resulted in the full return on UK portfolio liabilities falling by 15.8 percentage points to -2.9% in 1994, which contributed to a fall of four percentage points on the total rate of return on liabilities.

Table F
Estimated investment income^(a) and full rates of return^(b) on identified assets and liabilities

Percentage points

	Total		Portfolio		Direct		Banks Foreign currency		Sterling	
	II	Full	II	Full	II	Full	II	Full	II	Full
	1990	8.7	-5.4	4.1	-20.1	13.0	2.0	9.3	-4.5	13.8
1991	8.1	10.4	3.8	14.1	10.2	7.3	9.8	8.8	15.2	11.6
1992	5.9	18.2	4.1	15.8	9.0	17.2	6.0	21.4	11.1	6.6
1993	5.3	9.2	3.6	14.3	9.6	13.0	5.7	5.9	7.4	8.3
1994	5.6	4.2	3.9	1.7	12.0	9.7	5.2	9.1	7.8	9.5

	Total		Portfolio		Direct		Banks Foreign currency		Sterling	
	II	Full	II	Full	II	Full	II	Full	II	Full
	1990	8.6	-1.0	6.9	-3.7	6.2	-4.8	9.0	-4.1	12.9
1991	8.1	9.1	6.4	13.6	3.8	2.0	9.3	8.6	13.6	11.5
1992	5.6	16.8	5.2	16.1	4.3	-0.3	5.6	21.5	9.2	7.2
1993	5.2	7.4	4.2	12.9	7.9	8.1	5.4	4.9	6.1	6.9
1994	4.9	3.4	4.6	-2.9	6.8	6.9	4.6	4.4	4.4	4.1

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

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

The investment income returns of portfolio assets continued to be lower than those on liabilities. It should be noted, however, that for the past two years the full rate of return has been slightly higher for assets than liabilities: the capital gain on assets has been higher than that on liabilities. This may indicate a larger proportion of capital-uncertain assets than liabilities.

The income rate of return on direct investments was significantly higher for assets than for liabilities in 1994; this probably reflected the pick-up in banks' and industrial and commercial companies' direct investment earnings overseas.

(1) Banks' portfolio investment income net of funding are published in the British Invisibles City Table. Banks' portfolio investment funding costs are not directly reported and have to be imputed. The method used was outlined in the press release issued with the July 1995 British Invisibles City Table. Essentially, the stock of investment to be funded is allocated between banks' own foreign currency capital, securitised borrowing from overseas and a residual amount. Capital is regarded as interest-free; interest on securitised borrowing is estimated by the Bank; and the rate of interest applied to the residual amounts is assumed to be equal to the implied rate of interest on banks' total foreign currency borrowing and deposit liabilities to overseas residents.

(2) Details of the 1992 returns can be found in the article on the UK external balance sheet in the November 1994 *Quarterly Bulletin*, page 361.