

The external balance sheet of the United Kingdom: recent developments

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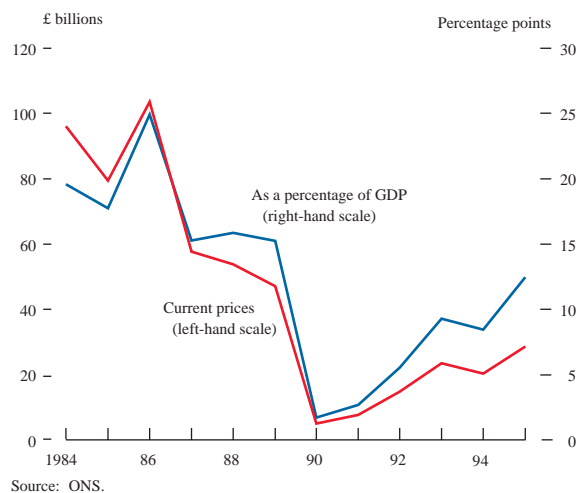
Continuing the annual series which began in 1985, this article summarises the changes to the net external asset position of the United Kingdom during 1995.⁽¹⁾

The article describes the principal influences on the external asset position of the United Kingdom arising from capital flows and from the impact of valuation changes to existing assets and liabilities. It includes an international comparison of external asset positions and also reviews developments in the United Kingdom's net investment earnings from abroad. In addition, the boxes on pages 420 and 422 describe the preparation for an internationally co-ordinated survey of cross-border holdings of portfolio assets, and recent evidence of the scale of UK-based repo business in foreign securities.

Overview

The United Kingdom had net external assets of £49.9 billion at the end of 1995 (see Chart 1). This represents the difference between external assets of £1,617 billion and external liabilities of £1,567 billion. To set these data in context, GDP in 1995 was £700 billion.

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



The net asset position at the end of 1995 was £16 billion higher than at the end of 1994 (see Table A).⁽²⁾ This increase was a result of valuation changes due both to price and exchange rate movements. The latest data indicate that the net asset position rose by a further £11.5 billion in the first half of this year.

Table A

UK external assets and liabilities^(a)

£ billions

	Stock end-1994	Identified capital flows	Net valuation effect (b)	Total change in stock	Stock end-1995
Non-bank portfolio investment:					
Assets	278.7	16.5	37.0	53.6	332.2
Liabilities	192.9	15.6	21.7	37.3	230.2
Direct investment: (c)					
Assets	174.5	25.3	8.8	34.1	208.6
Liabilities	129.6	20.5	0.3	20.8	150.4
UK banks' (d)(e) net liabilities in:					
Foreign currency	4.0	-15.4	9.9	-5.5	-1.5
Sterling	27.0	3.7	-0.2	3.4	30.4
Public sector:					
Reserves (assets)	30.7	-0.2	1.3	1.1	31.8
British government stocks (liabilities)	44.2	-0.5	2.6	2.1	46.3
Other net public sector assets	-5.7	-1.2	-0.9	-2.1	-7.8
Other net assets	-46.7	-17.0	4.5	-12.5	-59.2
Total net assets	33.9	-0.4	16.5	16.0	49.9

Sources: ONS and Bank of England.

- (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.
- (f) Columns and rows may not sum due to rounding.

UK residents held foreign portfolio assets of £481.9 billion and direct investment assets of £213.8 billion at the end of 1995. Both holdings were higher than at the end of 1994 and exceeded the equivalent foreign holdings of UK assets by £173 billion and £63.4 billion respectively. However,

(1) Using figures published in the *United Kingdom Balance of Payments*, (the *Pink Book*), Office for National Statistics, 1996.

(2) Direct investments are recorded at book rather than market value. Cliff Pratten of Cambridge University has estimated that the net direct investment stock was underestimated by about £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 (then) Central Statistical Office, available on request from the DAE.

UK residents were net borrowers of funds from the rest of the world with the deficit on outstanding sterling and foreign currency borrowing rising to £223.7 billion. The net asset position of general government was little changed over the year at £37.1 billion.

Other points to note from the 1995 data include:

- the positive effect on the United Kingdom's balance sheet due to increases in prices of foreign securities;
- record direct investment in UK companies; and
- increased net investment income for the United Kingdom, although the earnings of UK banks fell.

Revaluation effects on the external balance sheet of the United Kingdom

The United Kingdom recorded a balance of payments current account deficit in 1995. This should normally reflect net capital inflows such that either foreign holdings of UK assets increase or UK holdings of foreign assets decline. But, in 1995, recorded net capital inflows were much smaller than implied by the current account position, just £0.5 billion. The £2.4 billion balancing item (see Table B) highlights the measurement problems but does not indicate whether these arise more from an underrecording of net capital inflows or from any misrecording of current account credits or debits.

Table B
UK balance of payments: transactions data^(a)

£ billions	1990	1991	1992	1993	1994	1995
Increase in UK assets (-)/increase in UK liabilities (+)						
Current account						
Trade in goods	-18.8	-10.3	-13.1	-13.5	-10.8	-11.6
Other current account	0.1	2.4	3.0	2.7	8.4	8.7
of which:						
Services	3.7	3.6	5.0	5.5	4.7	6.1
Investment income	1.3	0.2	3.1	2.2	8.7	9.6
Transfers	-4.9	-1.4	-5.1	-5.0	-5.0	-7.0
Current balance	-18.7	-8.0	-10.1	-10.8	-2.4	-2.9
Financial account	18.8	8.0	10.2	10.8	2.4	2.9
of which:						
Direct and portfolio flows	2.6	-12.1	-4.4	-46.1	39.0	-28.5
Banking and other flows (b)	14.0	19.6	9.4	59.2	-41.7	29.0
Balancing item	2.2	0.5	5.2	-2.3	5.1	2.4

Source: ONS.

- (a) Columns may not sum to totals due to rounding.
 (b) Includes UK residents' net lending/borrowing and external assets/liabilities of general government (other than portfolio and direct investment).

Notwithstanding these uncertainties, a net capital inflow contrasts with the £16 billion increase in the United Kingdom's net external assets in 1995, and implies that the growth in the net asset position was more than accounted for by changes in the value of existing assets and liabilities (see Table C and Chart 2). The value of UK residents' holdings of overseas investments and other assets is estimated to have grown by £228 billion in 1995 with £104 billion of this increase due to revaluation effects. The

value of foreign holdings of UK assets also increased during the year, but by only £212 billion. A smaller estimate for revaluations—just £88 billion—accounts for the difference.

Table C
Change in identified net external assets

£ billions	Average (a) 1982–91	1992	1993	1994	1995	1996 H1 (b)
A Current balance (deficit -)	-5.9	-10.1	-10.8	-2.4	-2.9	-2.6
B Identified capital flows (inflows -) (c)	-4.1	-5.0	-13.1	2.7	-0.4	6.7
C Revaluations	2.0	16.3	28.1	-6.1	16.5	4.8
of which:						
Exchange rates		63.4	3.9	0.4	9.4	-12.6
Portfolio investment		28.0	0.1	0.5	7.2	-7.2
Direct investment		27.3	2.9	1.8	6.5	-8.3
Other net assets		8.1	0.9	-2.0	-4.3	2.9
Securities price effect		-15.6	25.5	2.6	7.7	12.9
Other (d)		-31.6	-1.4	-9.1	-0.7	4.5
D Change in identified net assets (increase +)	-2.2	11.4	15.0	-3.4	16.0	11.5
E Net asset level (end-year)	10.9	22.3	37.3	33.9	49.9	61.4 (e)
F Balancing item (f) (inflows/credits +)	1.8	5.2	-2.3	5.1	2.4	9.3

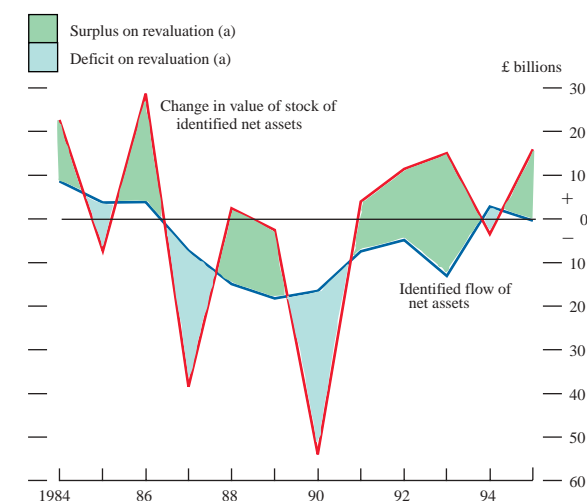
Sources: ONS and Bank of England.

- (a) End-year net asset level refers to end-1991.
 (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 1996.
 (f) F = B - A.

Revaluations of assets and liabilities can result from changes in the foreign currency value of sterling, from changes in the prices of securities, from revaluations of direct investments, and from write-offs. The lack of detailed information about the geographical location, currency of denomination and type of investment involved makes it difficult to quantify these separate effects with any precision. So the estimates presented in Table C should only be regarded as broadly indicative.

Increases in securities prices had a marked effect on the United Kingdom's external balance sheet in 1995. This

Chart 2
Contribution to changes in net external assets



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

The co-ordinated portfolio investment benchmark survey

An IMF working party reported in 1992 on the measurement of international capital flows,⁽¹⁾ recommending that consideration be given to a periodic benchmark survey of portfolio assets and liabilities. The report was approved by the IMF Executive Board which agreed that the Fund would assist in co-ordinating and following up such a survey. An IMF balance of payments committee was formed following the report and it has taken forward the benchmark survey proposal, setting end-1997 as the reporting date. In 1995, the United Kingdom consented in principle to participate in the survey, insofar as it is consistent with the government's commitment to limit the statistical reporting burden on businesses. This box reports on the United Kingdom's assistance with the survey's aims.

The IMF publishes global balance of payments statistics annually. In 1994, there was a discrepancy on the financial account of some \$102 billion, much of which derived from portfolio investment. The imbalance on the current account has declined in recent years but still amounted to \$79 billion in 1994, again associated particularly with income from portfolio investment. These continuing inconsistencies motivated the recommendation of a benchmark survey. It will involve the collection of comprehensive information on the participating countries' stocks of cross-border assets in the form of equities and bonds as at the end of 1997.

To encourage countries to participate in the survey, the IMF has sought to limit the associated costs. The survey will therefore focus only on outward stocks of portfolio assets, as this is where the gaps in the data are most pronounced. When the survey has been completed, the IMF will assist with the bilateral exchange of the data collected. So, statistics on external liabilities, as well as associated financial flows and investment income data, will be improved indirectly by exchange of the survey results, because countries will receive data from their counterparts on non-resident investment in their own domestic securities.

The reconciliation of international portfolio stocks and flows data is problematic because of the different bases on which many countries compile their balance of payments statistics. In order to be a valuable exercise, providing reliable information on international holdings of securities, the survey must be internationally co-ordinated or based on a common collection method. A common collection method was not favoured because the compliance cost would prevent countries with different collection methods from participating. The IMF

therefore established a task force to prepare for an internationally co-ordinated survey.

The task force decided that although a common collection method was not practicable, the survey had to have certain minimum core requirements to which all participating countries must adhere. The survey will require a full geographic breakdown of outward stocks of portfolio assets according to the country of issuer, subdivided into bonds and notes, and equities. In obtaining these data, countries may tailor their collection methods to their own particular national systems, again limiting compliance costs. So national compilers may adapt or extend the survey to meet their specific data needs, encouraging increased participation.

To ensure the co-ordination of the survey, the IMF has sought to produce common concepts, definitions and classifications for participants to use. Both the Bank of England and the Office for National Statistics (the ONS) have been closely involved in the IMF's work to develop a guide for this purpose; a finalised version has now been produced.

The IMF has drawn on work done under the auspices of the European Monetary Institute (EMI) to harmonise the treatment of portfolio investments by participating countries. The Bank of England was asked by a task force of the EMI to establish a Financial Terminology Database (FTD) for the use of national balance of payments compilers. Using information gleaned from capital markets, coupled with balance of payments methodology, such a database has been set up and is updated periodically. It details different types of portfolio security, distinguishing between bonds, notes, money-market instruments, equities and financial derivatives. The FTD is not intended to be a comprehensive guide to balance of payments accounting but provides information to enable national compilers to decide how to treat particular securities within their national accounts.

The survey task force included representatives of the Organisation for Economic Co-operation and Development, the Bank for International Settlements and the EMI. It is hoped that the survey will enable international institutions to harmonise more closely their collection and development of statistics. Countries which have agreed to participate in the survey will benefit from improved statistics on external assets and, through data exchange, an opportunity to establish who are the non-resident holders of their domestic securities. And the IMF hopes that the survey will reduce the imbalance between external assets and liabilities globally.

(1) 'Final report of the IMF working party on the measurement of international capital flows' (The 'Godeaux Report'), IMF, September 1992.

reflects the high level of equities held by UK residents, particularly resulting from investments by UK pension funds. Equity prices in Germany, the United States and the United Kingdom rose during the year, as did those in Japan, although in this latter case with more volatility. In addition, bond yields in most major economies decreased in 1995. As a result, the capital gains on UK holdings of assets outstripped the capital gains on foreign holdings of securities in the United Kingdom.

Preliminary data for the first half of 1996 show that the net external asset position of the United Kingdom has increased by a further £11.5 billion since the end of 1995. Securities prices continued to raise the value of the United Kingdom's external assets but this was largely offset by changes in the foreign currency value of sterling. The interpretation of the increased net external asset position is currently obscured by a balancing item of £9.3 billion, reflecting significant unrecorded flows.

Capital flows

Portfolio investment

Following net sales of foreign securities in 1994, UK residents made net purchases in 1995 (see Chart 3). International interest rates at all maturities generally fell during 1995. Relative to this pattern, bond yields in the United Kingdom were more stable, with yields on longer-term bonds little changed over the year. The declining yields on overseas securities imply that there were capital gains to be made. UK investors made net purchases of £40.3 billion of overseas securities in 1995, more than offsetting net sales of £18.0 billion in 1994. Both banks and other financial institutions (OFIs) made net purchases of

portfolio assets during the year of £23.8 billion and £17.1 billion respectively.

Transactions by non-residents in UK securities resulted in net disinvestment of £1.6 billion in the first quarter of 1995. The rest of 1995 saw a return to the more usual pattern of net investment, although the flow of inward portfolio investment for the year as a whole—£16.9 billion—was only half that recorded for 1994 and the lowest since 1990.

Within this total, there was a marked distinction between investments in corporate and government issues. Non-residents made net purchases of UK company securities, although the £17.2 billion invested in 1995 fell short of the £26.9 billion in 1994. By contrast, there were net sales of £0.5 billion of British government stocks in 1995, compared with net purchases of £3.1 billion the previous year.

The fall in non-residents' purchases of UK company securities was almost entirely accounted for by a £9.0 billion reduction in acquisitions of corporate bonds with a small £0.6 billion decrease in investments in ordinary shares. This occurred despite the steady increase during 1995 in the FT-SE 100 index, which closed the year at a record level.

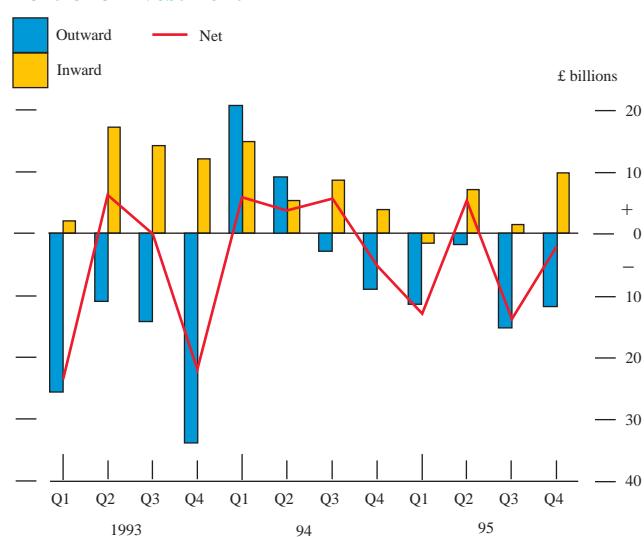
Direct investment

Direct investment is broadly defined as cross-border financial transactions by an economic agent resident in one economy to acquire a lasting interest in an enterprise resident in another economy.⁽¹⁾ In 1995, outward direct investment by UK residents increased by 40% to £25.5 billion, exceeding inward direct investment by £5.1 billion. The comparable net balance in 1994 was £11.5 billion. Inward direct investment was the highest recorded to date: a net inflow of £20.5 billion.

There was considerable cross-border merger and acquisition activity in 1995. Purchases of UK non-oil companies accounted for some 60% of the total inward direct investment. The most significant individual transactions were the purchases of Fisons plc by Rhone Poulenc Rorer Inc for £1.7 billion, Boots pharmaceutical businesses by BASF for £850 million and Gardner Merchant by the French company Sodhexo for £730 million.

UK merchant banks were a particular focus of attention for cross-border take overs and mergers in 1995. The purchase of Barings by the Dutch group ING was accompanied by an inward investment to cover the losses incurred in Singapore. The purchases of SG Warburg & Co by Swiss Bank Corporation and of Kleinwort Benson by Dresdner Bank

Chart 3
Portfolio investment^(a)



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

(1) See the IMF *Balance of payments manual*, (fifth edition), 1993, paragraph 359. Hitherto, the United Kingdom has applied a minimum shareholding of 20% as the benchmark for a direct investment relationship. However, internationally, the OECD and the IMF now recommend a 10% threshold to which the United Kingdom is moving. The Bank of England is currently conducting a review of the statistics collected from the UK banking sector. When this review is implemented, UK banks will be asked to report any holding of 10% or more in a non-resident company as an outward direct investment. Inward direct investments will also be reported on a threshold of 10%. This accords with the OECD's *Detailed benchmark definition of foreign direct investment* (third edition) and the IMF's *Balance of payments manual* (fifth edition).

Measurement issues: cross-border repos

This box focuses on Bank of England estimations of the size and importance of the cross-border repo market in foreign securities. A sale and repurchase agreement, or repo, is a sale of stock with a simultaneous agreement to repurchase that stock, or equivalent, for a specified price on a fixed date. These agreements enable parties to raise or lend short-term cash: the stock effectively secures the cash loaned.

In December 1995, the Bank implemented changes to the statistical reporting requirements for UK banks. These changes enabled the separate identification of liabilities and claims arising from repos and similar business.⁽¹⁾ They were primarily motivated by the need to monitor the repo market in British government stocks.⁽²⁾ So, repos in foreign securities with non-residents are not identified separately and a method of estimating these data has been devised. This box explains how these estimations have been made and it discusses the conceptual issues and possible alternative treatments of repos in balance of payments accounting.

Conceptual issues

The introduction of an open gilt repo market in London provided the catalyst to consider how such business should be recorded in the United Kingdom's national accounts. National accounts compilers had come to account for repo-type business in one of two ways. First, the agreement may be treated as two distinct transactions: the initial agreement to sell stock is treated as an outright sale and is followed at some fixed date in the future by the outright purchase of that stock, or

equivalent. Alternatively, repos may be thought of as analogous to transactions in which stock is used to secure a loan. The United Kingdom used to follow the former convention but has now adopted the collateralised loan approach. This approach has also been recommended by international organisations including the International Monetary Fund and the European Monetary Institute.

The adoption of compatible standards both within Europe and internationally has been complicated by the perceived differences between repos and other comparable forms of contract, such as buy/sell back agreements. Buy/sell backs also involve reaching an agreement to borrow cash in return for securities and for the reverse transaction to take place on a fixed date in the future. But the differences are that for the duration of a repo, the holder of the security must pass any coupons or dividends received to the original holder of the security, a so-called 'manufactured dividend'. Buy/sell back agreements do not automatically provide for manufactured dividends, the benefit of the coupon being passed back to the original 'seller' by adjusting the price at which the second leg of the deal is closed out, including reinvested earnings. Nor do buy/sell backs automatically provide for marking to market, collateral substitution or margining.

Analysis of the repo market in the United Kingdom

The Bank of England now obtains detailed information on the market in repos of British government stocks and

(1) Including, indistinguishably, repos, buy/sell-backs and bonds loaned against cash.

(2) See the box on 'The open gilt repo market' on page 131 of the May 1995 *Quarterly Bulletin*.

also contributed significantly to inward direct investment in 1995.

There was a general retrenchment of Japanese direct investment internationally and inward investment in the United Kingdom by the Japanese fell in 1995.

Other capital flows

The syndicated credit market was one of the most active sectors of the international financial markets, with 27% more facilities arranged than in 1994.⁽¹⁾ This increase was in part the result of significant mergers and acquisitions financing activity but there was also more refinancing of outstanding loans at lower costs. This was because there was a greater volume of funds available for loan in the international banking market and intense competition among lenders encouraged very low margins for borrowers. US and UK corporate entities were by far the most active borrowers.

International comparison of net external assets

Table D offers an international comparison of net external assets and shows that the trends in France, Germany, Japan and the United States in recent years continued in 1995.

The United Kingdom continues to be the exception to the general observation that increases in net external assets are generally linked to current account surpluses. With the exception of 1994, the United Kingdom has consistently increased its net external asset position, expressed in US dollars, in recent years despite having a current account deficit.

The explanation lies partly in the composition of the United Kingdom's external asset portfolio. This has a higher proportion of equities than those of other major economies. Consequently, the rise in equity prices in 1995 significantly

(1) Using data published by the Bank of International Settlements (BIS), Basle, in *International banking and financial market developments*, May 1996.

less detailed data relating to repo-type business in other securities. These data are only in their infancy, but initial indications are that the market has been increasing steadily since its introduction.⁽³⁾

As part of its preparatory work for the Co-ordinated Portfolio Investment Benchmark Survey,⁽⁴⁾ the United Kingdom has followed the recommendations in the IMF's Guide to completing the survey. The Guide suggests, *inter alia*, that national compilers obtain some idea of the importance of the repurchase market in their economy and investigate the extent to which residents conduct repo transactions with non-residents in non-resident securities. Given that the changes made by the Bank of England to the statistical returns were intended primarily to monitor the market in British government stocks, repos of other bonds are not further disaggregated. Consequently, a method of estimating repo transactions with non-residents in non-resident securities has been devised.

An estimate of the total value of turnover in the quarter is obtained by multiplying the levels reported on the balance sheet by the number of times that the portfolio is turned over in the period.⁽⁵⁾ Using the foreign currency element of the reported gilt repo claims and liabilities produces a proxy for total claims on and liabilities to non-residents in foreign securities. Multiplying these levels by estimates of quarterly turnover produces estimates of the total value of trades with non-residents in overseas securities in the quarter.

Estimates made using the first data received as at the end of December 1995 suggested that the size of the market

in foreign currency denominated repos and reverse repos with non-residents was between £560 billion and £740 billion. More recent data show that the market has expanded significantly: similar calculations performed on data as at the end of July 1996 resulted in estimates of between £860 billion and £1,100 billion.

In assessing the extent to which UK residents conduct repo transactions with non-residents in non-resident securities, the Bank of England has also estimated the geographical spread of this market. A sample of UK banks reports a breakdown of principal classes of assets and liabilities into 16 major currencies with a residual category for other foreign currencies. These data have been used to proxy the country of issuer in the absence of a directly collected geographical analysis. From these estimates, the major currencies involved appear to be the US dollar, the Deutsche Mark, the French franc, the Spanish peseta and the Italian lira.

In the absence of hard data on the type of securities, (other than gilts) involved in cross-border repo business, the Bank sought information from significant market participants. Their anecdotal evidence suggested that most trading in repos takes place in securities issued in national currencies so, for example, repos with a counterparty in the United States will be in dollar-denominated stocks, repos with Germany are predominately in Deutsche Marks and so on. Given the testimony of banks that transactions are almost exclusively in non-resident government securities, it seems reasonable to infer that the non-sterling, non-gilt data probably do relate overwhelmingly to non-resident government securities.

(3) The Bank's Gilt-Edged & Money Markets Division has conducted a survey of the gilts market; see 'Plans for the open gilt repo market', Bank of England, March 1995, and subsequent updates. See also, 'Gilts and the gilts market: review 1995-6'.

(4) See the box on 'The co-ordinated portfolio investment survey' on page 420.

(5) Using information obtained from major market participants and from aggregate data reported for supervisory purposes.

Table D
Comparison of external net asset positions internationally^(a)

End-years	1981	1985	1990	1993	1994	1995
United States						
\$ billions	374.3	139.1	-251.1	-503.5	-580.1	-814.0
Percentage of GNP	12.3	3.4	-4.6	-7.7	-8.4	-11.3
Japan						
\$ billions	10.9	129.8	327.5	615.3	669.9	741.7
Percentage of GNP	1.0	10.0	10.2	15.1	14.6	16.7
Germany						
\$ billions	29.2	52.8	349.5	237.4	209.5	182.0
Percentage of GNP	4.0	9.0	21.3	13.0	9.8	7.6
France						
\$ billions	56.4	6.1	-71.2	-60.2	40.9	116.1
Percentage of GNP	8.6	1.0	-5.7	-5.1	3.0	7.4
United Kingdom						
\$ billions	62.2	102.6	13.3	55.2	52.9	77.3
Percentage of GNP	11.9	22.4	1.3	5.9	5.0	7.1

(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.

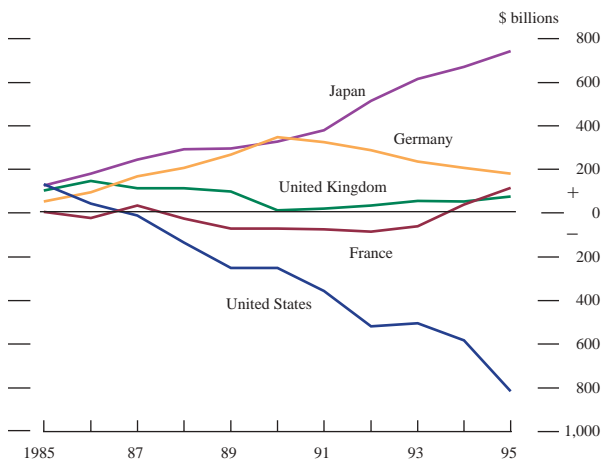
increased the United Kingdom's external assets. For those countries where portfolio investments include a higher

proportion of bonds, the effect of rising securities prices was less marked. For countries with net external portfolio liabilities, such as the United States and Germany, the increased bond and equity prices were also one factor that further reduced their net asset positions (see Chart 4).

Table D shows the large net external debt of the United States. Its net external liabilities continued to increase in 1995, as in each of the last ten years. Japan had a similar net asset position to the United States in 1985, but has increased its net asset position in every year since. These movements are reflected in the persistent current account surplus of Japan and deficit of the United States.

The US dollar's general decline in 1995 H1 was associated with an appreciation of the Deutsche Mark. For the year as a whole, there was a continuation of the decline in Germany's net external assets. Expressed in US dollars, the German net asset position has declined every year since 1990 when the current account moved into deficit following the country's reunification.

Chart 4
Comparison of external net asset positions internationally^(a)

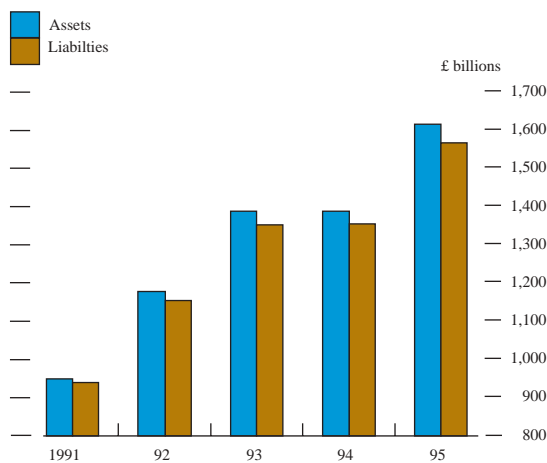


(a) The data underlying this table are taken from national sources, the IMF and OECD.

Revisions

The identified net asset position of the United Kingdom at the end of 1994 has been revised upwards by £16.2 billion between the publication of the 1995 and 1996 *Pink Books*. While revisions of this scale are large when set against the net asset position, they are modest in relation to the gross holdings of cross-border assets and liabilities (£1,617 billion and £1,567 billion respectively at the end of 1995; see Chart 5). This latest revision primarily affected the

Chart 5
Gross external assets and liabilities



Source: ONS.

recorded assets and liabilities positions of the UK private sector and was equally spread between portfolio and direct investments.

Investment income

The United Kingdom's income from its overseas assets increased by 15% in 1995 to £47.1 billion (see Table E). Payments to non-residents on their holdings of UK assets also grew strongly, but from a lower base, so that net investment income rose to £9.6 billion from an already high £8.7 billion in 1994.

Table E
Investment income (II)

£ billions

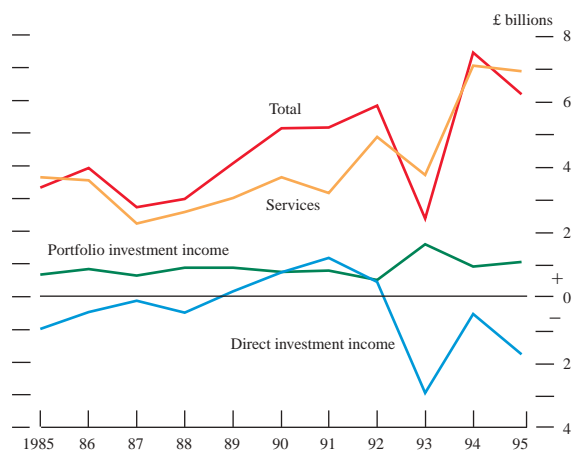
	Annual average 1982-91	1992	1993	1994	1995	1996 H1
Earnings on assets						
Portfolio (a)	3.1	7.7	9.9	8.7	9.5	5.3
Direct	10.4	13.4	16.9	20.9	24.8	14.0
Other non-bank private sector	2.3	4.0	4.8	4.4	4.9	2.6
Public sector (b)	1.2	1.6	1.4	1.6	1.6	1.0
UK banks' spread earnings on external lending	1.6	1.7	2.0	5.5	6.2	1.8
Total (c)	18.5	28.3	35.0	41.1	47.1	24.8
Payments on liabilities						
Portfolio (a)	2.3	6.9	7.9	9.2	10.8	5.6
Direct	6.6	5.3	10.5	9.5	12.0	6.7
Other non-bank private sector	2.6	6.8	8.9	9.1	8.5	4.2
Public sector (d)	1.9	3.2	3.3	4.0	4.4	2.2
Banks' cost of net liabilities	2.4	3.0	2.3	0.7	1.8	0.7
Total (c)	15.8	25.1	32.8	32.4	37.5	19.5
Net II earnings (c)	2.8	3.1	2.2	8.7	9.6	5.3 (e)
Net II excluding spread earnings	1.2	1.4	0.2	3.2	3.4	3.4

Sources: ONS and Bank of England.

- (a) Non-bank private sector.
- (b) Including official reserves.
- (c) May not sum due to rounding.
- (d) Including gilts.
- (e) Not seasonally adjusted.

Higher net investment income for the OFIs sector more than offset lower net earnings within the UK banking sector. The fall in the net earnings of UK banks largely resulted from a net outflow of earnings on direct investments and from increased net funding costs on international borrowing (see Chart 6). Within the OFIs sector, the net investment earnings of securities dealers also fell in 1995 but these were more than offset by an increase in the investment income of the insurance sector, where net earnings rose by £2.0 billion to £6.0 billion.

Chart 6
Banks: portfolio investment income costs^(a)



(a) Source: British Invisibles 'City Table' 1995.

All of the main investment income components increased. Income from direct investments abroad was particularly buoyant in 1995 and accounted for nearly two thirds of the growth in total investment income. But while the United Kingdom recorded an increased net credit on its direct investment income and payments, the growth in portfolio investment income was insufficient to prevent a widening of the deficit in these flows during the year,

notwithstanding the United Kingdom's larger holdings of these assets.

Early indications suggest that the deficit on portfolio investment income has been narrowing this year. In the first half of 1996, portfolio income was £5.3 billion. While this is still a little below the estimate for portfolio payments, it represents a sizable turnaround since the first half of 1995. Direct investment income was also higher in 1996 H1, contributing to an estimated net investment income total of £5.3 billion, substantially higher than for the corresponding period in 1995.

Capital gains and full rates of return

Table F expresses 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/losses, again expressed as a percentage of the stock. The full rate of return on UK overseas assets fell in both 1993 and 1994, having been unusually high in 1992. Rising securities prices in 1995 resulted in higher returns on total assets, but particularly on portfolio investments, where the full rate of return had been negative in 1994. The effect of changes in UK securities prices on foreign-owned investments in the United Kingdom was even more marked, with the full rate of return exceeding that on UK portfolio

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

Percentage points

	Total		Portfolio		Direct		Banks		Sterling	
							Foreign currency			
	II (c)	Full (d)	II	Full	II	Full	II	Full	II	Full
1991	8.1	10.1	3.8	13.0	10.2	7.4	9.8	8.8	15.2	11.6
1992	5.8	18.2	3.9	15.4	9.0	17.3	6.1	21.5	9.8	8.0
1993	5.3	9.3	3.7	15.2	10.0	12.2	5.8	5.9	7.1	7.3
1994	5.6	3.1	3.9	-0.8	11.6	7.2	5.4	9.2	6.1	7.4
1995	5.8	12.2	4.0	12.3	11.6	15.7	5.7	18.1	6.9	8.6

	Total		Portfolio		Direct		Banks		Sterling	
							Foreign currency			
	II	Full	II	Full	II	Full	II	Full	II	Full
1991	8.2	9.0	6.4	12.7	3.8	2.5	9.3	8.6	13.6	11.5
1992	5.7	16.9	5.6	17.8	4.3	-1.5	5.6	21.5	9.2	7.2
1993	5.3	7.1	4.5	14.3	8.2	4.1	5.5	5.1	6.1	6.9
1994	5.1	3.0	5.2	-3.0	7.3	3.4	4.6	4.5	4.4	0.4
1995	5.3	10.9	5.2	13.3	8.0	8.2	5.1	13.5	5.6	6.1

Source: ONS.

- (a) Investment income earnings as a percentage of the stock.
(b) Investment income earnings plus stock revaluations as a percentage of the stock.
(c) Investment income
(d) Full rates of return

investments abroad. Nonetheless, the full rate of return on all UK external assets remained above that on liabilities, reflecting the larger overall effect of revaluations on the assets side of the United Kingdom's external balance sheet.