The external balance sheet of the United Kingdom: recent developments

This article[1] summarises the changes to the net external asset position of the United Kingdom during 1996[2] and the first half of 1997. It continues an annual series of articles in the Quarterly Bulletin *begun in 1985.*

The article describes the principal influences on the external asset position of the United Kingdom, arising from capital transactions and the changes in the value of existing assets and liabilities. It describes UK overseas investment earnings and compares the UK net external asset position with that of other major economies. The box on pages 372–73 presents the results of the most recent Bank of England survey of the geographical distribution of direct investment holdings by banks operating in the United Kingdom and of direct investment in UK banks.

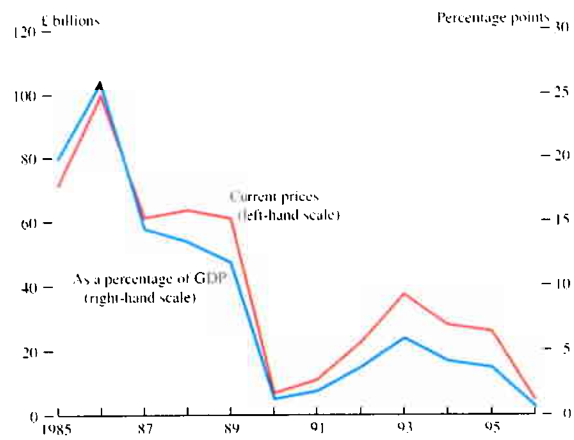
Overview

The United Kingdom's estimated overseas assets, net of foreign-held liabilities, fell to £5 billion at the end of 1996 from a revised £26 billion at the end of 1995 (see Chart 1). Gross external assets rose by nearly £78 billion to £1,666 billion, but the United Kingdom's liabilities to overseas residents rose more, by just under £99 billion, raising the total outstanding to £1,661 billion. To put the size of these holdings in context, the United Kingdom's gross domestic product in 1996 was a little under £750 billion. Preliminary data for the first half of 1997 show that the net external asset position rose by £20 billion, to £25 billion, almost entirely reversing the fall recorded in 1996.

The data discussed in this article are based on the latest published balance of payments data, but are subject to revision as the results of more detailed inquiries by the Office for National Statistics and its data suppliers become available. (For example, the net external asset position at the end of 1995 was revised down by almost a half between the publication of the 1996 and 1997 *Pink Books*.) Revisions to the net external position are usually small when compared with gross external assets and liabilities, but relatively small revisions to these gross levels have a significant effect on the net figure.

Problems in measuring the balance of payments accounts are acknowledged by the Office for National Statistics in the methodological notes to the *Pink Book*. It is generally presumed that official records of government departments are of good quality; data received through statutory enquiries are of reasonable quality; and data based on voluntary enquiries or estimates are of comparatively poor quality.

Chart 1
Net identified external assets



Source: ONS.

The recorded decrease in the net asset position during 1996 was more than accounted for by changes in the sterling value of existing holdings. Table A[3] shows that estimated valuation changes, resulting from price and exchange rate movements, reduced UK net external assets by £23 billion during the year. Movements in the foreign currency value of sterling appeared to have had particularly marked effects on UK banks' assets and liabilities.

More than half of the £1,666 billion UK external assets at the end of 1996 were owned by UK banks (see Table A). UK residents' direct investments and non-bank portfolio investments together accounted for nearly 35% of the total. The remainder comprised non-bank holdings of deposits with banks outside the United Kingdom, non-bank lending to overseas borrowers, and the external assets of general government (for example, the United Kingdom's foreign

(1) Prepared by Andrew Clayton of the Bank's Monetary and Financial Statistics Division.
(2) Using figures published in the *United Kingdom Balance of Payments (the Pink Book)*, Office for National Statistics, 1997.
(3) The net valuation effect in Table A is calculated by a residual: the part of the total change in stock that is not identified as a capital flow is presumed to be the result of revaluations. In Table C, an estimate of the composition of the revaluation effects is calculated. This is based on the movement of sterling against the US dollar, Deutsche Mark, Japanese yen and Swiss franc. In respect of portfolio assets and liabilities, movements in the FT-SE world index of leading shares, the FT-SE 100 share index and the S&P index of leading US equities are accounted for. Revaluation effects resulting from sterling, US dollar, Deutsche Mark, Japanese yen and Swiss franc bond yield movements are also included.

Table A
UK external assets and liabilities(a)(b)

£ billions

	Stock end 1995	Identified capital flows	Net valuation effect (c)	Total change in stock	Stock end 1996	Percentage of total stock
Non-bank portfolio investment:						
Assets	322.7	36.8	-2.2	34.6	357.3	*21*
Liabilities	238.4	19.6	8.8	28.4	266.8	*16*
Direct investment: (d)						
Assets	197.5	27.9	-15.4	12.6	210.1	*13*
Liabilities	131.5	20.8	1.8	22.5	154.0	*9*
UK banks' (e)(f)						
Foreign currency: Assets	811.6	76.4	-101.1	-24.8	786.8	*47*
Foreign currency: Liabilities	810.2	80.3	-106.0	-25.7	784.5	*47*
Sterling: assets	67.9	8.5	-0.1	8.3	76.2	*4*
Sterling: liabilities	98.1	-2.5	0.7	-1.8	96.3	*6*
Public sector:						
Reserves (assets)	31.8	-0.5	-3.9	-4.4	27.3	*2*
British government stock (liabilities)	45.7	7.6	-1.3	6.2	51.9	*3*
Other public sector:						
Assets	13.9	0.7	0.0	0.6	14.5	*1*
Liabilities	21.7	-2.4	-1.8	-4.2	17.5	*1*
Other assets	142.7	69.6	-18.7	50.9	193.5	*12*
Other liabilities	216.7	93.8	-20.4	73.4	290.1	*18*
Total gross assets	1588.0	219.3	-141.6	77.7	1665.8	*100*
Total gross liabilities	1562.2	217.1	-118.2	98.9	1661.0	*100*
Total net assets	**25.9**	**2.2**	**-23.3**	**-21.1**	**4.7**	

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) Columns and rows may not sum because of rounding.
(c) Residual component.
(d) UK banks' external borrowing from overseas affiliates is treated in the published data as an offset to outward direct investment, but is treated here as part of the banks' net foreign currency liabilities.
(e) Estimated take-up of UK banks' bonds is not distinguished 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.
(f) UK banking sector plus certain other financial institutions.

exchange reserves). UK banks also accounted for more than half of the total of the United Kingdom's liabilities to foreign holders but the composition of other liabilities differed from that of assets. Inward direct investment and investment in non-bank securities made up 25% of total liabilities; both were lower than the corresponding outward investments. Other liabilities, largely resulting from external borrowing by UK non-banks, amounted to nearly one fifth of total liabilities. The differing compositions of external assets and liabilities, and corresponding different rates of return, help to explain the net earnings of nearly £10 billion made in 1996 by UK residents from overseas (see 'Investment income' below).

UK external portfolio assets rose by £45 billion during 1996 to £517 billion, £166 billion more than outstanding portfolio liabilities. UK residents' holdings of direct investments overseas also increased, by £12 billion, to £210 billion,[1] exceeding the stock of inward direct investment by £56 billion. The United Kingdom continued to be a net borrower of funds from the rest of the world, and the net liabilities on outstanding sterling and foreign currency borrowing increased by £19 billion, to £257 billion. The net liabilities of general government fell to £28 billion.

Other significant points arising from the 1996 data include:

- increased net investment income for the United Kingdom;
- the impact of movements in security prices and exchange rates; and
- record foreign currency overseas borrowing and lending by UK banks.

Revaluation effects on the external balance sheet of the United Kingdom

The foreign currency value of sterling rose during 1996. The effective exchange rate index climbed from a level of 83.1 at the end of 1995 to 96.1 a year later;[2] the appreciation was particularly marked during the last quarter of 1996. Sterling rose against nearly all major international currencies during 1996, though the extent of these movements varied. Against the US dollar, sterling fell a little in the first quarter of the year, but closed the year 10% higher than it opened. Sterling gained 17% against the French franc and rose by 19% against the Deutsche Mark. Against the Japanese yen, sterling appreciated by almost a quarter from the end-1995 rate.[3] These changes will have reduced the sterling value of the United Kingdom's foreign currency denominated assets relative to its liabilities.

The value of UK companies' securities also rose during 1996. The FT-SE 100 index increased by more than 10% during the year, closing at 4,115.7. The prices of company securities in international equity markets generally rose during 1996. The S&P 500 measure of US equity prices rose by 20% in dollar terms during the year. The French and German markets, like those in the United States, rose by around 20% in national currency terms. In contrast, the Nikkei 225 index of Japanese equity prices fell slightly during the year. Bond prices followed a different pattern: prices of US dollar and sterling bonds fell, whereas prices of bonds denominated in other major currencies rose.

The FT-SE 100 share index rose by a further 10% in the first six months of 1997, closing at 4,604.6 at the end of June. The US and French equity markets all rose in the first half of 1997 by similar amounts to their 1996 increases, and the FAZ index of the 100 leading German equities gained nearly a third in the same period, following the 20% increase in 1996. The Nikkei 225 index of leading Japanese equities,

(1) Direct investment capital flows data are reasonably accurate. But estimates of balance sheet levels are less sound, because direct investments are usually recorded at book value, using historical costs, rather than market values. This makes it difficult to compare and contrast directly with other investments. It has been estimated that the market values of the stocks of inward and outward direct investment may both be double the recorded levels. See Pratten, C. *Overseas investments, capital gains and the balance of payments*, published by the Institute of Economic Affairs, February 1992. The report was based on end-1989 direct investment levels and a number of assumptions. A further report by Pratten estimated that the net direct investment stock in 1993 was underestimated by about £60 billion: see Pratten, C. (1994) *The valuation of outward and inward direct investment*, Department of Applied Economics, University of Cambridge, unpublished report to the (then) Central Statistical Office.
(2) *See Monetary and Financial Statistics*, Bank of England, July 1997, Table 27. figures quoted are based on average 1990 rates = 100.
(3) Changes in exchange rates are calculated as:

$$\frac{(\text{rate at close of business on last working day of 1996} - \text{rate at close of business on last working day of 1995})}{\text{rate at close of business on last working day of 1996}} \times 100$$

which fell slightly in 1996, rose by 6.4% in the first half of 1997. In the international bond markets, the prices of most bonds rose further during the first half of 1997; sterling bond prices also began to rise, but US dollar bond prices continued to fall. These movements in overseas securities prices had a significant effect on UK residents' portfolio assets, increasing their value by £41 billion.

The change in value of existing external assets and liabilities was greater than the fall in the net asset position (see Table B and Chart 2). The estimated value of the United Kingdom's net external assets decreased by £23 billion in 1996 as a result of revaluations. Exchange rates and security price movements both had a significant effect, causing downward revaluations of £12 billion and £16 billion respectively.

Table B
Change in identified net external assets

£ billions

		Average (a) 1982–92	1991	1992	1993	1994	1995	1996	1997 H1
A	Current balance (deficit = -)	-7	-8	-10	-10	-2	-4	0	1 (b)
B	Identified capital flows (inflows = -) (c)	-5	-7	-5	-12	3	-2	2	7
C	Revaluations	4	11	16	27	-13	0	-23	13
	of which:								
	Exchange rates		*10*	*63*	*1*	*0*	*10*	*-12*	*-9*
	Portfolio investment		*3*	*28*	*0*	*1*	*7*	*-7*	*-6*
	Direct investment		*6*	*27*	*0*	*2*	*0*	*-8*	*-3*
	Other net assets		*1*	*8*	*1*	*-2*	*3*	*3*	*0*
	Securities price effect		*11*	*-16*	*26*	*1*	*-2*	*-16*	*41*
	Others (d)		*-9*	*-32*	*1*	*-14*	*-9*	*4*	*-19*
D	Change in identified net assets (increase = +)	-1	4	12	15	-9	-2	-21	20
E	Net asset level (end-year)	22	11	22	37	28	26	5	25 (e)
F	Balancing item (f) (inflows/credits = +)	2	1	5	-2	5	2	3	6

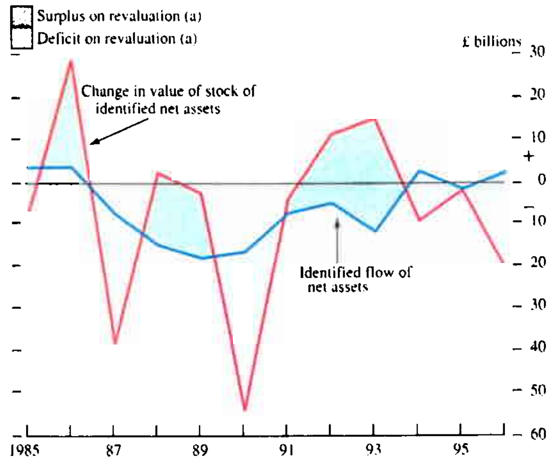
Sources: ONS and Bank of England.

(a) End-year net asset level refers to end 1992.
(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 1997.
(f) F = B – A: columns may not sum because of rounding.

Assets and liabilities can be revalued for a number of reasons: movements in the foreign currency value of sterling; changes in the prices of securities; revaluations of direct investments; and write-offs. But it is difficult to quantify each effect precisely, because information about the types of investment involved, their geographic location and currency of denomination is limited. Data in Table B should therefore be regarded as only broadly indicative.

The general rise in overseas equity and bond prices in 1996, relative to UK prices, suggests that UK residents made greater capital gains on their external assets than the gains made by non-residents on their holdings of UK securities. But the sterling value of UK residents' capital gains will have been affected by the fall in the sterling value of foreign currencies during 1996 (see Table B). This is particularly apparent in respect of UK banks' foreign currency assets and liabilities: exchange rate changes reduced the value of each by more than £100 billion (see Table A).

Chart 2
Contribution to changes in net external assets



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

Capital flows

The United Kingdom's current account was £0.4 billion in deficit in 1996, though there was an identified capital outflow during the year of just over £2 billion. A current account deficit is usually accompanied by net capital inflows, so that either non-residents increase their holdings of UK assets or UK residents' holdings of foreign assets decrease. But the United Kingdom has regularly had a current account deficit while recording either net capital outflows or net inflows that are smaller than the current account deficit. As a result of this inconsistency, a balancing item has to be written into the balance of payments accounts (see Table C) to reflect unmeasured flows. It is not known whether the balancing item reflects under-recorded net capital inflows or mis-recorded current account credits or debits.

Direct investment

A direct investment may be broadly defined as a cross-border financial transaction in which an economic agent resident in one economy acquires a lasting interest in an enterprise resident in another economy.[1] This investment may subsequently be increased or decreased; these capital flows are also direct investment transactions, either positive or negative respectively. Similarly, any earnings from the direct investment enterprise that are

(1) See the IMF *Balance of payments manual*, (Fifth edition), 1993, paragraph 359. In the past, the United Kingdom has applied a minimum shareholding of 20% as the benchmark for a direct investment relationship. But the OECD and the IMF now recommend a 10% threshold, to which the United Kingdom is moving. The Bank of England has recently conducted a review of the statistics collected from the UK banking sector. This review is being implemented in stages, and when it is fully completed (at the end of 1998), UK banks will be asked to report as outward direct investments any holding of 10% or more in a non-resident company. Inward direct investments will also be reported based 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).

Table C
UK balance of payments: transactions data[a]

£ billions
Increase in UK assets (-)/increase in UK liabilities (+)

	1990	1991	1992	1993	1994	1995	1996
Current account							
Trade in goods	-18.8	-10.3	-13.1	-13.5	-11.1	-11.6	-12.6
Other current account	0.1	2.3	3.0	3.2	9.5	7.9	12.2
of which:							
Services	*3.7*	*3.6*	*5.0*	*5.5*	*4.8*	*6.9*	*7.1*
Investment income	*1.3*	*0.2*	*3.1*	*2.6*	*9.7*	*7.9*	*9.7*
Transfers	*-4.9*	*-1.4*	*-5.1*	*-4.9*	*-5.0*	*-6.9*	*-4.6*
Current balance	**-18.7**	**-8.0**	**-10.1**	**-10.3**	**-1.7**	**-3.7**	**-0.4**
Financial account	16.5	7.4	5.0	11.8	-3.4	1.7	-2.2
of which:							
Direct and portfolio flows	*2.6*	*-12.1*	*-4.4*	*-46.0*	*35.5*	*-32.3*	*-40.8*
Banking and other flows (b)	*14.0*	*19.6*	*9.4*	*57.9*	*-38.9*	*33.9*	*38.6*
Balancing item	2.2	0.5	5.1	-1.5	5.0	2.0	2.6

Source: ONS.

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

retained rather than repatriated to the investor also increase direct investment.

At the end of 1996, UK residents' total direct investment overseas reached £210 billion, an increase of £29 billion. Unremitted profits (earnings of established direct investment enterprises overseas that are reinvested in the overseas affiliate by the UK parent) accounted for most outward direct investment transactions in 1996, at £18 billion; outflows of capital to new or existing direct investment enterprises amounted to £10 billion.[1]

In contrast, non-residents significantly increased their direct investments into the United Kingdom, with net purchases of £21 billion, 45% more than in 1995. New investment in the United Kingdom and capital inflows to existing affiliates accounted for £13 billion of inward direct investment flows, with a further £3 billion invested in UK oil companies after net sales of £0.1 billion in 1995. Earnings retained in the United Kingdom by direct investment affiliates contributed £5 billion to the increased inward investment by non-residents. The stock of outstanding inward direct investment was £154 billion at the end of 1996.

The volume of international mergers and acquisitions has grown substantially during the last two years. In the United Kingdom, there were several high-profile acquisitions during 1995, and the increased activity continued throughout 1996 and into 1997. The largest individual inward transactions during 1996 included the purchase of Mercantile and General Reinsurance Ltd by Swiss Reinsurance Company; Trafalgar House by the Norwegian company Kvaerner AS; and News International PLC by News Corporation of Australia. Total inward investment from mergers and acquisitions amounted to £10 billion, with disposals of nearly £2 billion. In spite of an increase in the volume of transactions, the balance of £8 billion was £3 billion lower than in 1995. Outward mergers and acquisitions by UK companies of £12 billion in 1996 were offset by significant disposals of £6 billion. The balance was only £0.3 billion higher than in the previous year. Net inward investment resulting from acquisitions and mergers was therefore almost £2 billion.

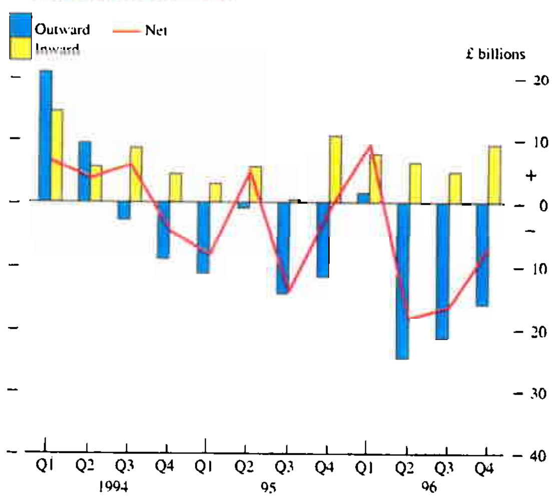
During the first half of 1997, a number of direct investment deals have taken place. Several of the privatised electricity companies have been bought by overseas companies, with those in Yorkshire, the East Midlands and London being purchased by US electricity and energy corporations. A number of UK companies have announced multi-billion dollar outward direct investment deals.

Portfolio investment

Portfolio investments are defined as investments in equity and debt securities, in the form of bonds and notes, as well as money-market instruments and financial derivatives.[2] Where any of these instruments satisfy the definition of direct investment, they cannot be portfolio investments.

UK residents continued to make substantial purchases of foreign securities during 1996, amounting to £61 billion, compared with £38 billion in the previous year.[3] In spite of the negative estimated effect of revaluations, the stock of UK portfolio assets increased. Increased purchases were largely of foreign bonds, which amounted to £51 billion, an increase of nearly 70% since 1995. Purchases of ordinary shares also rose, to £10 billion in 1996, £2 billion higher than the previous year. Chart 3 illustrates the net effect of inward and outward portfolio transactions during the last three years, showing the particularly high volume of transactions recorded in 1996.

Chart 3
Portfolio investment[a]



(a) Includes banks' investment. Positive figures represent increased liabilities.

(1) See the box on pages 372–73 for a geographical analysis of UK banks' direct investments overseas and non-residents' direct investments in UK banks.
(2) See the IMF *Balance of payments manual*, (Fifth edition), 1993, paragraph 385. Financial derivatives are treated as portfolio investments in the manual, because they are considered as separate (mainly financial) transactions, rather than integral parts of underlying transactions to which they may be linked as hedges.
(3) Data on outward portfolio flows for financial and non-financial institutions should be of reasonable quality, but data for the personal sector are weak. Data on inward investment in government and other public sector securities are good, but data on inward investment in UK companies' bonds have to be derived and are therefore subject to some margin of error.

A geographic analysis of UK banks' direct investments[1]

Every three years, banks operating in the United Kingdom are asked to submit to the Bank of England details of their holdings of direct investments overseas and any investment received by them from non-resident affiliates. This information is reported on a geographic basis, specifying the country of origin or receipt of the direct investment. This box analyses the results of the latest triennal census, which was conducted at the end of 1996.[2]

Direct investments can be either inward or outward. Inward investment in the United Kingdom is when an overseas company sets up or acquires a new branch, subsidiary or associate here. Outward investment is when a UK company sets up or acquires a branch, subsidiary or associate overseas.

A brief history of banks' direct investments

Overall, UK residents have net direct investment assets: direct investments overseas are greater than those in the United Kingdom. This has not been the case for banks since the late 1980s. Total overseas investment in UK banks stood at £20.2 billion at the end of 1996, much higher than overseas investment by UK banks of £9.3 billion.

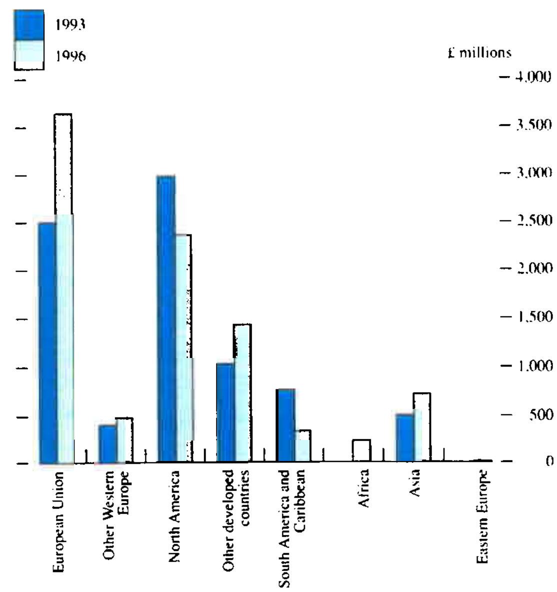
Motivations for direct investment have changed, particularly for banks. Historically, UK banks had substantial outward direct investment in the British Empire to serve trade finance. The United Kingdom became an attractive place for dollar lending by US banks in the 1960s and 1970s, because it was cheaper than lending from the United States. As these eurodollar markets expanded, inward direct investments in the United Kingdom increased, because US banks set up or acquired affiliates through which to lend dollars and other overseas banks invested here in order to borrow. During the 1980s many smaller US banks began to find the cost of their London operations prohibitive, and decreased their inward investments. At the same time, larger UK banks sought to increase their international presence and develop global operations, thus increasing UK banks' outward direct investments. Their success was limited and there has since been considerable retrenchment.

In the early 1990s, moves towards establishing closer EU integration led to a significant increase in the number of UK banking affiliates with overseas head offices and parents. The stock of inward investment in banks in the United Kingdom rose by nearly 50% between 1990–93, to £17.8 billion. These affiliates enable the overseas banks to benefit from access to different financial markets, counterparties and the location of the United Kingdom relative to other major financial centres. EU banking legislation, giving extra-EU banks access to EU markets through a single affiliate, has encouraged greater inward investment in the European Union, particularly the United Kingdom. More recently, a number of European investors, seeking to centre their activities on London, have bought UK investment banks.

Outward investment by UK banks

The total stock of all UK residents' overseas direct investments was £215 billion at the end of 1996, nearly treble the level a decade earlier and £46 billion higher than at the end of 1993. Within this, the stock of UK banks' outward direct investments increased by only £0.9 billion (see Chart A).[3]

Chart A
Outstanding stock of UK banks' overseas direct investment[(a)]



(a) Source: Bank of England.

UK banks' direct investment holdings in the European Union amounted to £3.6 billion at the end of 1996, up by £1.2 billion since the end of 1993. Investments in the Netherlands, Denmark and Portugal fell during these

(1) See page 370 for a definition of direct investment and a note of problems relating to measurement issues.
(2) The Bank of England has recently conducted a review of the statistics collected from banks operating in the United Kingdom. Implementation of the review began at the end of September 1997 and is taking place in stages. When implementation is completed, at the end of 1998, censuses of banks' levels of direct investment will be annual, instead of every three years.
(3) The geographic areas listed in the charts accord with the *Balance of Payments Vade Mecum*, published by the Statistical Office of the European Communities (EUROSTAT) and last updated in March 1996. This lists all the countries of the world and allocates them to a geographic area for the purposes of EU Member States' balance of payments accounting. For the purposes of the charts and to make comparisons easier, data for the European Union for both 1993 and 1996 include the 15 countries that were Member States at the end of 1996. (There were only twelve Member States at the end of 1993: Austria, Finland and Sweden joined the European Union on 1 January 1995.)

three years, but this was more than offset by increased investment in other EU countries, particularly France and Germany (both more than £1.1 billion at the end of 1996). Investment in 'other Western Europe' also increased during this period, to £0.5 billion, an increase of just under 20%. This was mainly because of more investment by UK banks in Switzerland.

Greater investment in Australia, New Zealand and Japan increased the level of investment in 'other developed countries' by £0.4 billion to £1.4 billion. No direct investment in South Africa was recorded at the end of 1993; a modest stock was shown at the end of 1996. UK banks also held more direct investment assets in Asia at the end of 1996; the level of investment in the Middle East fell slightly, but this was more than offset by increased investment in the Far East, bringing the total level of direct investment in Asia to £0.7 billion.

Though UK banks' investment in all these geographic areas rose between 1993–96, this was partly offset by disinvestment in North America (£0.6 billion) and in South America and the Caribbean (£0.4 billion). Disinvestment in North America was mainly in the United States, though investment in Canada also fell. The disinvestment in North America was the largest, but the disinvestment in South America and the Caribbean was proportionately greater.

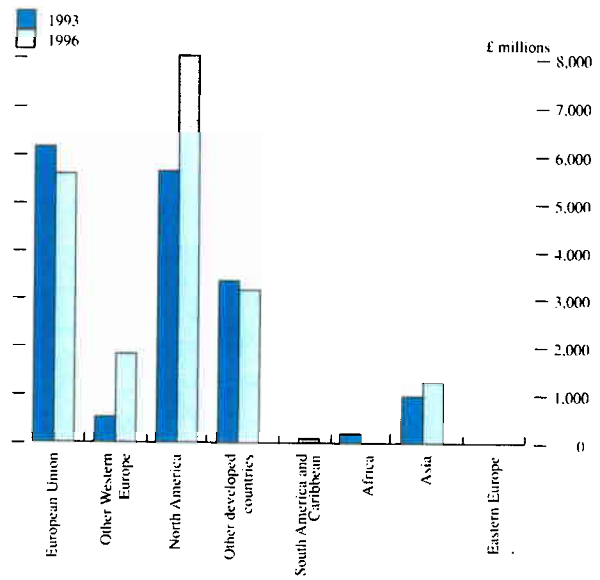
Inward investment in banks in the United Kingdom

The 1997 *Pink Book*(4) shows that the total stock of direct investment in the United Kingdom trebled in the ten years to the end of 1996, to £154 billion. UK labour market reforms and comparatively low corporate taxation and regulatory burdens have encouraged inward investment. Cultural factors such as language, workforce skills, the quality of infrastructure and spending on research are also thought to be influential. Establishing direct investments also enables the investor to minimise exchange rate risks by locating close to the final market, so that the costs of providing the product or service are in the same currency as the revenue derived from it.

The number of foreign banks in the United Kingdom more than doubled between 1986–96. Most have EU parents or head offices, (over 200).(5) But direct investment in UK banks from the EU countries fell from £6.1 billion in 1993 to £5.6 billion in 1996. Inward direct investment from the Benelux countries, particularly the Netherlands, fell by more than £1 billion, but this was partly offset by increased investment from other countries, particularly Germany and France. Inward investment from Germany almost doubled between 1993–96 to £2.1 billion, and investment from France increased by a half, to £750 million.

Inward direct investment in the UK banking sector from Japan has also decreased in value since the last triennial census. Total investment in UK banks from Japan amounted to £1.6 billion, a fall of nearly £0.2 billion. During these three years, there has been some retrenchment of Japanese bank investments, which is reflected in these data. A similar decrease in investment from Australia, to £1.3 billion, was recorded in the same period. The fall in investment from these two countries explains the decrease in inward investment from 'other developed countries' shown in the chart. This area also includes South Africa, from which investment in UK banks doubled to £0.3 billion between 1993–96.

Chart B
Outstanding stock of direct investment in banks in the United Kingdom(a)(b)



(a) Source: Bank of England.
(b) Data on inward investment from South America and the Caribbean at the end of 1993, Africa at the end of 1996 and Eastern Europe at the end of both years are confidential. So that no individual institution's data are identifiable, the Bank of England ensures that all published figures contain data reported by at least three different institutions; data that have been suppressed do not satisfy this requirement.

Inward investment from North America, principally from the United States, increased most in value during this three-year period, ending 1996 at £8 billion, 42% higher than at the end of 1993. Though this was the greatest increase in value, a proportionally greater rise was recorded in inward investment from 'other Western Europe'. Investment received from these countries was nearly two and a half times higher at the end of 1996, at £1.8 billion, than at the end of 1993.

Investments from Asian countries rose by nearly a third, to £1.2 billion. This rise came mainly from the Middle East, which accounted for 85% of total investment from Asia at the end of 1996. Direct investment in UK banks by South American and Caribbean countries increased between 1993–96 to a modest £0.1 billion; investment from Africa and Eastern Europe fell.

(4) *United Kingdom Balance of Payments (the Pink Book)*, Office for National Statistics, 1997.
(5) Includes EU institutions authorised to take deposits in the United Kingdom; this excludes representative offices of foreign banks.

Bonds in the United Kingdom (along with those in the United States) were among the few major bonds whose prices fell during 1996. Purchases by UK banks of £24 billion of overseas securities were virtually unchanged from the 1995 figure. But other financial institutions more than doubled their purchases in 1996 to £37 billion. Unit trusts and property unit trusts were the most significant institutional investors in 1996, increasing their holdings of overseas securities by more than £10 billion. This rise was entirely concentrated in investment in the ordinary share capital of companies overseas, which exceeded £11 billion, but this was offset by some sales of preference shares and overseas governments' securities. The holdings of self-administered pension funds, insurance funds, investment, unit and property trusts at the end of 1996 were little changed from those at the end of 1995. Provisional data show that 18% of these investors' total portfolio holdings were invested in overseas securities at the end of 1996.

Non-residents' total holdings of UK portfolio liabilities were £351 billion at the end of 1996. Net purchases of UK companies' bonds and equities rose slightly, but net investment of nearly £8 billion in British government stocks contributed to the flows of portfolio investment into the United Kingdom of £28 billion, more than £8 billion higher than in 1995. This increased investment in government stocks contrasted with net sales of £1 billion in 1995, though net sales of other general government securities approached £2 billion in 1996.

Purchases in the first half of 1997 of £45 billion of overseas securities had a significant impact on the level of UK assets: revaluing these and the existing outstanding stock of portfolio assets increased the level by more than £70 billion. Table B suggests that revaluations have been particularly affected by changes in securities prices during the first half of 1997.

Other capital flows

UK banks' external transactions, other than direct and portfolio investments, resulted in a net inflow of more than £11 billion in 1996, 20% higher than in 1995. But this net inflow disguises the fact that gross external claims and liabilities (other than direct and portfolio investments) both more than doubled in 1996, to £63 billion and £75 billion respectively. Considered in this context, the £2 billion increase in 1996 in the net inflow of banking funds is comparatively small.

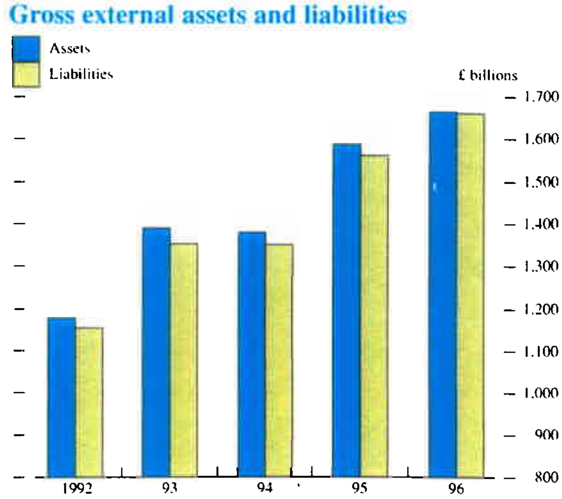
The United Kingdom is one of the world's leading centres for finance. The strong international financial presence in the United Kingdom may mean that flows are driven (at least in part) by relative interest and exchange rates, which would also help to explain why the series are so erratic. According to the Bank for International Settlements, 17% of the $8,000 billion total cross-border international lending in 1996 by banks originated in the United Kingdom.

There were record transactions in foreign currency lending to and borrowing from overseas by UK banks in 1996. UK-owned banks accounted for most of the currency borrowing, which totalled £78 billion, possibly influenced by the high foreign currency value of sterling. The same factor may be responsible for banks with ultimate parents overseas, particularly in America, Germany and Japan, being on balance net borrowers from the United Kingdom, reporting net outflows of funds. UK banks' claims on German residents have risen particularly in recent years. Germany's reunification in 1990 has required funding for the redevelopment of eastern Germany, and as a result, lending by UK banks to Germany has risen from 4% of total external bank lending in 1990 to 11% in 1996. Of the major industrial countries, only Japan has decreased its borrowing from the rest of the world during the 1990s. Banks' lending and borrowing transactions in the first half of 1997 were more than three times higher than in the same period of 1996 and resulted in a net increase of £11 billion in external lending.

Revisions

The identified net external asset position of the United Kingdom at the end of 1995 was revised downwards by £24 billion between the 1996 and 1997 *Pink Books*. Though this is a substantial change in terms of the net external asset position, it results from proportionately small adjustments to the estimates for gross assets and liabilities (of £1,588 billion and £1,562 billion, respectively) at the end of 1995 (see Chart 4). This should be borne in mind when interpreting the detailed developments described in this article.

Chart 4
Gross external assets and liabilities



Source: ONS.

Investment income

UK earnings from overseas assets increased by £5 billion to £96 billion in 1996, and payments abroad in respect of external liabilities increased by £3 billion to £86 billion (see Table D). These increases were both substantially smaller than those in 1995, but the improved balance of investment income, to just under £10 billion, reversed the fall recorded in the previous year.

Table D
Investment income

£ billions

	Annual average 1982–92	1993	1994	1995	1996	1997 H1
Earnings on assets						
Portfolio (a)	5.9	16.1	15.8	19.1	20.7	12.0
Direct	10.7	16.9	21.2	23.8	27.8	13.6
Other non-bank private sector	3.5	6.6	6.4	7.1	6.8	3.1
Public sector (b)	1.2	1.6	1.6	1.7	1.6	0.8
UK banks' spread earnings on external lending	37.0	33.2	32.8	39.6	39.1	17.6
Total (c)	**58.3**	**74.3**	**77.8**	**91.3**	**96.1**	**47.2**
Payments on liabilities						
Portfolio (a)	4.5	11.0	13.0	15.7	16.9	9.4
Direct	6.4	10.5	9.3	12.4	14.9	7.1
Other non-bank private sector	3.8	11.2	11.5	11.8	11.5	6.3
Public sector (d)	0.5	0.4	0.3	0.3	0.3	0.1
Banks' cost of net liabilities	40.1	38.7	34.0	43.3	42.9	19.6
Total (c)	**55.4**	**71.8**	**68.1**	**83.4**	**86.4**	**42.5** (e)
Net investment income earnings (c)	**2.9**	**2.6**	**9.7**	**7.9**	**9.7**	**4.7**

Sources: ONS and Bank of England.

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

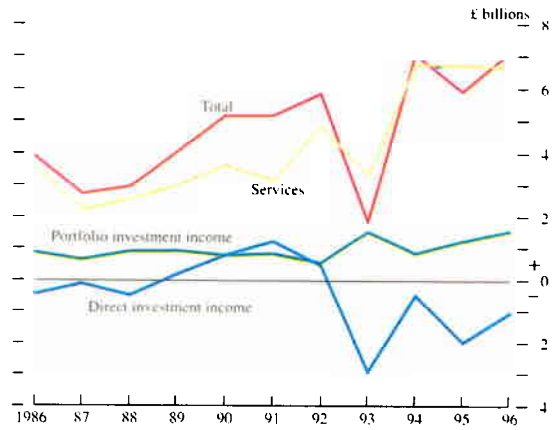
UK residents' earnings on portfolio assets rose to £21 billion in 1996, from £19 billion in 1995. Total income on overseas direct investments also increased during 1996, by £4 billion, to £28 billion. These increases occurred despite the appreciation of sterling.

The increase in total earnings on direct investments in 1996 was largely the result of a fall in the net outflow of earnings from the UK banking sector. The repatriation of income by UK subsidiaries to their overseas parents results in an outflow of earnings, but so too do payments by UK parents to meet any losses of their overseas subsidiaries. There was a particularly high net outflow in 1995, because of payments to cover the losses incurred by Barings in Singapore. In 1996, there was a net outflow of £1 billion on UK banks' direct investment earnings. This was about a half of the figure for 1995. Significant inward direct investment by non-residents in recent years has also increased the amount of income paid to non-residents and will continue to do so (see 'Capital flows' above). The quality of the estimates for banking sector direct investment was improved this year by inclusion of the results of the latest in a series of triennial benchmark surveys.[1]

Chart 5 shows that banks' net earnings from services in 1996 were £7 billion, £1 billion higher than in 1995 and similar to those in 1994. The increase in 1996 was largely a result of the fall in the net outflow of earnings from UK banks, but improved portfolio investment income also contributed. Banks' earnings on external lending increased strongly in 1995 but fell back slightly in 1996, to £39 billion, as shown in Table D. Payments on external borrowing fell similarly, to £43 billion.

On balance, therefore, UK banks paid nearly £4 billion (net) overseas as a result of their lending and borrowing

Chart 5
Net overseas earnings of UK banks



Source: British Invisibles *City Table*, 1996.

transactions. Data published by British Invisibles[2] show that this can be considered as comprising a positive margin of £5 billion earned by banks on their lending to and borrowing from overseas, less the cost of borrowing on behalf of other UK financial and non-financial institutions (£3 billion), less other costs of funding (£6 billion). The cost of borrowing on behalf of other UK residents is thought to be recouped by UK banks from the UK clients for whom the transactions are conducted. In addition, banks earned £2 billion from fees and commissions received for services performed for non-resident customers. Data for the first half of 1997 suggest that investment income this year is likely to be similar to that in 1996, with the earnings on assets and liabilities around half of the amounts recorded for 1996.

Capital gains and full rates of return

Table E gives details of the investment income and full rates of return on specific assets and liabilities in recent years. It shows that the estimated rate of return (interest and dividends only) on UK residents' outstanding external assets at the end of 1996 was unchanged from the end of the previous year, at 5.8%. But the estimated full rate of return, which also takes account of capital gains or losses arising from revaluations, fell substantially during 1996 from 11.4% to -2.7%, reflecting the downward effect of revaluations. The investment income is calculated by expressing earnings as a percentage of the stock of the investment. The full rate of return includes any capital gains or losses resulting from revaluations as well as the investment income, again calculated as a percentage of the stock.

This negative full rate of return contrasts with 1995 when the full rate of return increased significantly from the previous year, largely because of securities price movements. Securities prices continued to rise during 1996, but the value of UK residents' portfolio assets fell because of the appreciation of sterling (see Table E). Portfolio investment income was much the same as in 1995, but the full rate of return fell from 11% to 0.9%. The effect of exchange rate movements on overseas direct investments in

(1) See the box on pages 372–73 on the results of the Bank of England's latest triennial survey of direct investment.
(2) See *The City Table*, British Invisibles, 1997, Table D.

Table E
Estimated investment income (II)[a] and full rates of return[b] on identified assets and liabilities

Percentage points

Assets

	Total		Portfolio		Direct		Banks: Foreign currency		Banks: Sterling	
	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	9.4	3.7	15.4	10.0	11.7	5.8	5.9	7.1	7.4
1994	5.6	2.3	3.9	-0.7	12.3	1.4	5.4	9.2	6.1	7.4
1995	5.8	11.4	4.0	11.0	11.7	13.0	5.7	18.1	6.9	8.6
1996	5.8	-2.7	4.0	0.9	13.0	5.2	5.8	-2.0	6.5	6.6

Liabilities

	Total		Portfolio		Direct		Banks: Foreign currency		Banks: Sterling	
	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	7.2	4.3	14.4	8.2	4.1	5.5	5.1	6.1	7.0
1994	5.0	2.5	4.8	-2.6	7.6	-2.6	4.6	4.5	4.4	0.2
1995	5.3	10.9	5.0	14.3	9.4	0.8	5.1	13.5	5.6	6.0
1996	5.2	11.2	4.8	14.6	9.7	24.3	5.2	2.1	5.6	2.5

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.

1996 was also marked: investment income on these holdings increased, but the full rate of return fell back from 13% to 5.2%.

The value of UK banks' foreign currency assets was considerably affected by the appreciation of sterling during 1996. Investment income on these assets was virtually the same in 1996 as in the previous year, but the full rate of return was negative, at -2%, a fall of more than 20 percentage points. In comparison, the full rate of return on banks' sterling assets overseas in 1996 was little different from in 1995.

In contrast, the full rate of return on total liabilities to non-residents increased slightly; investment incomes on all external liabilities were similar to those in 1995. The full rates of return on UK portfolio and direct investment liabilities were also little changed, but those on banks' liabilities were significantly lower. The full rate of return on banks' sterling liabilities more than halved, and the external rate of return on banks' foreign currency liabilities fell from 13.5% in 1995, to 2.1% in 1996.

International comparison of net external assets

Table F and Chart 6 compare the net external assets of several major economies and show that the trends in the United States, Germany and Japan in recent years continued in 1996. The gap between Japan and the United States widened in 1996 as a result of increases to both Japan's net external assets and the United States' net external liabilities. The steady decline in Germany's net external assets, which began following reunification in 1990, continued in 1996. The recent upward trend in French net external assets reversed in 1996.

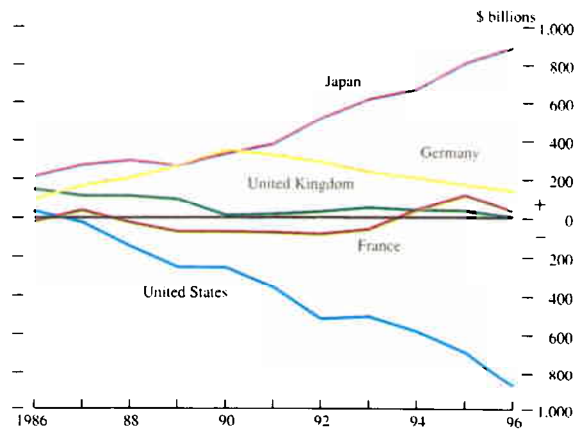
Table F
International comparisons of external net asset positions[a]

$ billions; *percentages of GNP in italics*

End years	1981	1985	1990	1994	1995	1996
United States	374.3	132.8	-251.1	-580.1	-687.7	-870.5
	13.9	*3.3*	*-4.5*	*-8.4*	*-9.5*	*-11.5*
Japan	10.9	164.5	327.5	669.9	809.9	890.6
	1.0	*10.3*	*10.2*	*14.1*	*17.3*	*20.4*
Germany	29.2	52.8	349.5	208.1	171.5	143.0
	4.0	*7.1*	*21.3*	*9.7*	*7.1*	*6.3*
France	56.4	6.1	-71.2	40.9	116.1	35.6
	8.6	*1.0*	*-5.7*	*3.0*	*7.4*	*2.4*
United Kingdom	62.3	102.5	13.3	43.7	40.1	8.1
	12.8	*19.8*	*1.3*	*4.1*	*3.7*	*0.6*

(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.

Chart 6
International comparisons of external net asset positions[a]



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

Increases in net external assets are generally linked to current account surpluses. Continuing the trend of the last decade, Japan had a current account surplus again in 1996, and further increased its net external asset position. In the same period, the United States has had a persistent current account deficit; this rose in 1996 to more than 2% of US GDP and now exceeds the combined surpluses of the Japanese and EU economies.