
Financial stability and the United Kingdom's external balance sheet

By Mhairi Burnett of the Bank's Monetary and Financial Statistics Division and Mark Manning of the Bank's Domestic Finance Division.

This article, one in an annual series, examines the United Kingdom's financial transactions with the rest of the world, paying particular attention to the implications for financial stability. In recent years, the United Kingdom's stocks of external assets and liabilities have increased considerably, and each now exceeds £3.5 trillion. This is three times UK GDP and around a third of the United Kingdom's total financial assets. The monetary financial institutions (MFI) sector accounts for approximately half of the external balance sheet, reflecting both the international orientation of UK-owned banks and the cross-border activities of foreign-owned UK-resident banks. The article begins with a conceptual discussion of how external positions might affect financial stability, before turning to recent developments. The principal focus is on the MFI and private non-financial corporate (PNFC) sectors, in which the largest external positions exist. The discussion draws upon data from a variety of sources, including the Pink Book, sectoral financial balance sheets, the Bank of England and the IMF.

Why are external positions important?

The financial crises in the emerging economies in the late 1990s demonstrated that cross-border capital flows can have financial stability consequences. The benefits of such flows to both borrower and lender are well documented: improved resource allocation; the facility to smooth consumption over time; and increased opportunities to manage and diversify risks. However, the crises in East Asia, Russia and Latin America, although undoubtedly originating in shocks to the domestic economy, were exacerbated by a sharp reversal of capital inflows. A great deal of attention has focused on this topic in recent years. In one report, released in the Spring of 2000, the Capital Flows Working Group of the Financial Stability Forum drew attention to the destabilising effects of 'abrupt portfolio adjustments'. The report highlighted the potential loss of liquidity should non-resident lenders withdraw their funds or decline to refinance, with the consequences particularly stark for countries with large amounts of short-term external debt and small, but open, financial markets.

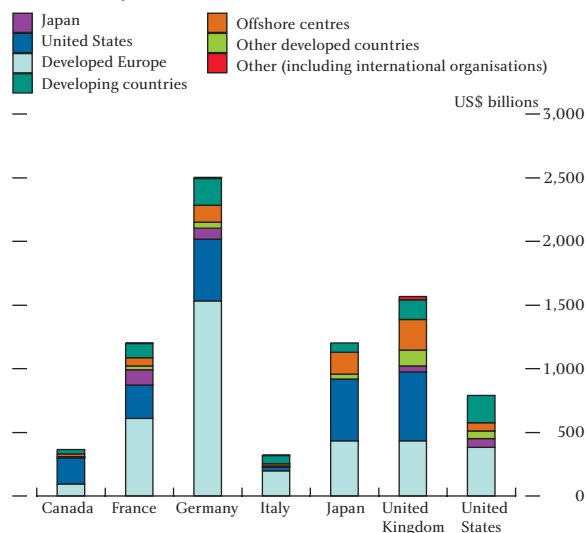
Advanced industrial economies, such as the United Kingdom, with deep, open and highly developed financial markets, and manageable external debt positions, do not exhibit the same vulnerabilities in this regard. But the United Kingdom's external assets and

liabilities each amounted to more than £3.5 trillion in 2003 Q2, up by approximately two thirds since 1998. At more than three times GDP, and a third of total financial assets, these positions are significant. Resident entities, notably monetary financial institutions (MFIs) and private non-financial corporations (PNFCs), have increasingly relied on external finance from non-resident investors, while also building up their stocks of external financial assets via foreign direct investment and portfolio diversification. Macroeconomic shocks occurring outside the United Kingdom can be transmitted rapidly to the domestic economy through the portfolio choices of both UK-resident asset holders and foreign lenders and investors, as well as through changes in the value of non-resident assets and fluctuations in the exchange rate. The effects of such shocks can thus be greater than would be implied by trade links alone.

These developments have also increased the potential for the international transmission of failures in national payments and settlements systems. And with London's status as a major international financial centre, and its position as host to more than 270 foreign-owned banks, the increasing interconnectedness of financial markets is particularly important to the United Kingdom. Indeed, the MFI sector in the United Kingdom is responsible for approximately half of the United Kingdom's total

external assets and liabilities. This international orientation is not due to foreign-owned UK-resident banks alone. As Chart 1 shows, the size of UK-owned banks' consolidated foreign claims is second only to those of Germany.

Chart 1
Consolidated foreign claims by nationality of bank ownership—end-June 2003



Source: Bank for International Settlements.

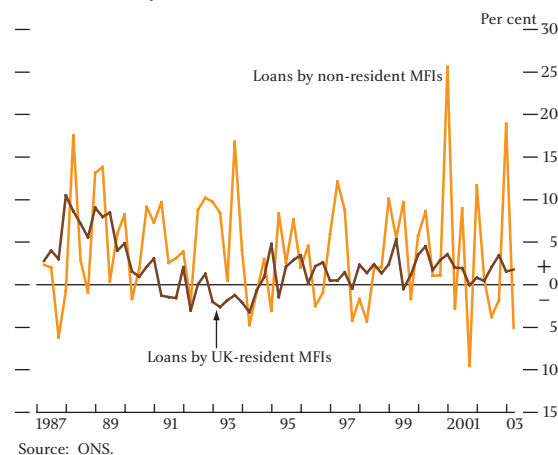
Assessing the risks associated with external positions

What is it about external positions⁽¹⁾ that might cause their impact to differ from that of purely domestic exposures?

First, there is the question of domestic entities' reliance on non-resident sources of finance. Despite increased globalisation of the financial services industry, it remains the case that committed long-term relationships are more likely to become established between banks and borrowers of the same nationality. For example, even for the United Kingdom's largest and most internationally oriented banks, claims on domestic residents constitute on average 60% of total on-balance-sheet assets. To the extent that non-resident lending is not a 'core' part of a lender's business, the potential systemic externalities associated with a decision to withdraw funding are less likely to be taken into account. This may lead to greater volatility in the

provision of finance from non-resident lenders. Indeed, Chart 2 shows that lending to the UK PNFC sector by non-resident MFIs has been considerably more volatile than that by resident MFIs.⁽²⁾

Chart 2
Quarterly growth in the stock of lending to UK PNFCs by domestic and external MFIs



Source: ONS.

This is related to the second key issue, which is that external positions naturally carry with them direct non-resident exposure. The implications of this for financial stability are not easy to assess. On the one hand, larger non-resident exposures allow domestic residents to diversify both their asset portfolios and their sources of finance. However, in so doing, domestic residents become exposed to a broader array of potential macroeconomic and other shocks, which may affect both asset values and access to finance. Furthermore, many non-resident positions will carry with them a higher institutional risk: in the extreme, the risk of currency controls or expropriation of assets.

A further issue often associated with external positions is currency risk.⁽³⁾ Insofar as foreign currency positions are not perfectly hedged, currency changes will alter the value of external assets and liabilities, and associated cash flows. For example, depreciation of the domestic currency will increase both the sterling value of a domestic resident's foreign-currency obligations and the debt service associated with such obligations. A marked depreciation of the currency, combined with a sufficiently large net foreign currency liability, can have

(1) External positions are defined in this article, and by the Office for National Statistics, as assets and liabilities *vis-à-vis* non-UK-resident counterparties.

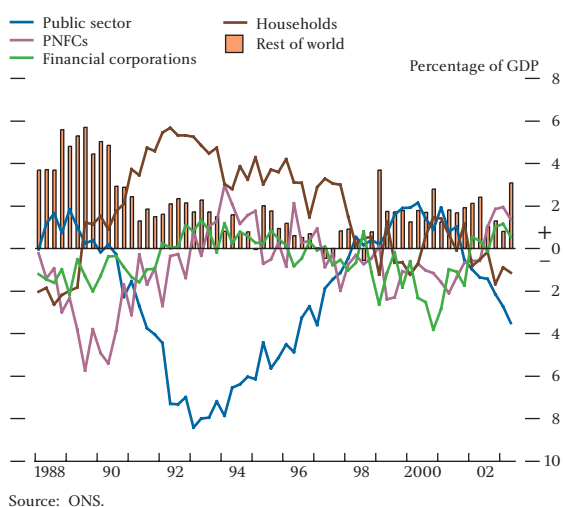
(2) The standard deviation of quarterly growth in the stock of lending by non-resident MFIs is 6.7% over the period March 1987 to June 2003, compared with 3.0% for resident MFIs. Nevertheless, as will be shown later in this article, non-resident lending to UK PNFCs has been on an upward trend in recent years, and hence the mean quarterly change is also higher.

(3) To the extent that domestic MFIs intermediate the foreign currency positions of domestic non-bank entities, not all foreign currency positions will be cross-border. Indeed, in the United Kingdom, around 15% of resident MFIs' foreign currency exposures are with resident non-bank entities.

stark implications for debt sustainability, increasing the value to borrowers of the option to default and undermining refinancing opportunities.

It should be emphasised that the external financial balance is necessarily the sum of internal sectoral balances. Very often net borrowing from non-residents may be explained in terms of the rational accumulation of positions by agents in a particular sector—eg investment by the private non-financial corporate sector, financed by an inflow of funds from abroad. Evidence of a growing external liability over a long period of time, however, will often raise questions about sustainability and potential instability in the face of shocks. Chart 3 illustrates financial balances to June 2003 for sectors of the UK economy (lines), as well as non-resident balances *vis-à-vis* the United Kingdom (bars). The balances shown are flows as percentages of GDP, reflecting net borrowing or lending by each sector in each quarter. It is clear from the chart that the United Kingdom has been a net borrower from abroad in almost every quarter covered by the chart. In recent periods, the household and public sectors have accumulated large net financial deficits. Although these sectors do not have large direct external positions, they have contributed to net external borrowing via their transactions with the UK financial sector. The issues associated with recent trends in the internal sectoral balances are discussed in the Bank's *Financial Stability Review*, December 2003.

Chart 3
UK sectoral financial balances, as a percentage of GDP



To what extent can balance of payments data assist in surveillance?

The *Pink Book*⁽¹⁾ is the principal source of data on the United Kingdom's external financial transactions. This publication provides a breakdown of both stocks and flows⁽²⁾ of external assets and liabilities by instrument and sector, identifying the most significant external positions. Analysis of these data can also assist in assessing the net external wealth of the economy and the present value of future income owed to external lenders and investors.

International investment position

The *Pink Book* decomposes the external balance sheet, or international investment position (IIP), into three principal categories: direct investment, portfolio investment (comprising cross-border positions in debt and equity securities) and other investment (essentially, cross-border loans and deposits in the banking system). Data on financial derivatives are also presented (but not included in the main IIP tables). Stock positions and financial account flows in each of these categories are also available by sector: ie monetary financial institutions, central government, local authorities, public corporations and 'other'.⁽³⁾ The factors behind the accumulation of positions in each sector are likely to be very different and hence the aggregate position will generally, in itself, be uninformative. Furthermore, the disaggregation of these data is generally insufficient to allow strong conclusions to be drawn on financial stability questions. Ideally, one would wish to observe a full disaggregation by country, currency and maturity, so as to be able to identify concentrations of exposure and assess the risk of individual positions. While the instrument breakdown does distinguish between long and short-term loans and securities, allowing some judgment to be made on issues such as refinancing risk and the stability of particular sources of finance, no such disaggregation is available for country and currency exposures. However, the ONS published a geographical breakdown of total IIP assets and liabilities for 2001 data this year⁽⁴⁾ and intends to include a functional breakdown of direct, portfolio and other investment next year.

- (1) 'United Kingdom Balance of Payments', published annually by the Office for National Statistics.
- (2) Stocks appear in the external balance sheet (or international investment position), while flows are recorded in the financial account. The latter flows mirror the sum of current and capital account flows and net errors and omissions.
- (3) For certain items, 'other' is disaggregated further, allowing PNFs and various non-bank financial companies to be separately identified. Households and non-profit institutions serving households (NPISH) are also separately identified on the asset side of the balance sheet and financial account.
- (4) 'Geographical breakdown of the UK International Investment Position', *ONS Economic Trends*, July 2003.

Currency risk

The *Pink Book* provides some data on the extent to which cross-border exposures are denominated in sterling and foreign currency. Other positions may be inferred, either by the nature of the exposure or by observation of the contribution of revaluations to changes in the outstanding stock position.⁽¹⁾ But, even where the split between sterling and foreign currency is recorded, an explicit breakdown by currency is generally unavailable. And data on hedging are incomplete.

Positions may be hedged in one of three ways. First, offsetting positions may be held elsewhere. Given that the United Kingdom is defined by residence in the balance of payments data, one cannot observe potentially offsetting currency positions held by associated non-resident entities. Indeed, this is a more general problem in the analysis of financial stability risks, for which consolidated data are more appropriate than data based upon residency. Second, positions may be hedged explicitly using financial derivatives.⁽²⁾ Finally, foreign-currency exposures may be hedged via the normal course of a company's business. For example, to the extent that debt service and debt repayment on a foreign-currency liability are met by cash flows generated in that currency, the position may be considered hedged. The *Pink Book* data cannot assist in this context; much greater disaggregation would be required to do so.

Methodological issues

Recent articles in this series have highlighted a number of methodological issues which hinder interpretation of the data. First, the United Kingdom's net external asset position is generally subject to heavy revision, making analysis of longer-term trends and recent developments more difficult. Since 1990, the average revision between the first and second estimates of net assets has been £26 billion (although we should bear in mind that total assets and liabilities are over £3.5 trillion).

There is also some inconsistency in the way in which certain positions are valued. In particular, while portfolio assets and liabilities are marked to market, foreign direct investment is valued at book cost (see the box on page 467). If a UK company makes an overseas acquisition via an exchange of equity, the cost of the acquisition is reflected in an increase in direct-investment assets, while the equity of the new UK parent retained by the acquired company's shareholders appears as a portfolio investment liability. Although the former position remains at book value, the latter position is marked to market, potentially leading to a divergence of assets and liabilities over time.

We will consider below some additional data sources, which when combined with the *Pink Book* data provide a more detailed picture of external exposures and their possible implications for financial stability.

Additional sources of data

Two additional sources offer a further geographical breakdown of country exposures and a disaggregation of currency positions, at least for certain sectors and instruments. First, in the case of the MFI sector, Bank of England data on the external business of UK-resident banks provide a currency and geographical breakdown of exposures. Second, the IMF's Coordinated Portfolio Investment Survey (CPIS) provides a geographical breakdown of all portfolio investment exposures. The survey was first carried out in 1998, for 1997 data, and then repeated in 2002, for 2001 data. In total, 67 countries reported a full geographical breakdown of their portfolio investment assets at end-2001. The IMF then aggregated the data by country to yield a table of claims on each country. In the most recent study, the United Kingdom had a net portfolio investment asset position of \$24 billion, with \$1.304 trillion of outward portfolio investment and \$1.280 trillion of inward portfolio investment.⁽³⁾ The United Kingdom was second only to the United States in terms of the level of portfolio investment. The CPIS will be carried out annually in future and the data will become increasingly useful as a time series is built up.

(1) This will, however, not always be straightforward. For example, one might assume that an investment in foreign equity is denominated in foreign currency, and that foreign investment in a UK company's equity is a sterling liability. However, to the extent that foreign-listed securities are denominated in the currency of the country of listing, this will not necessarily be true.

(2) Although the IIP data do not yet include stock figures for financial derivative instruments, there is a project under way at the ONS to review data quality and integrate data on financial derivatives into the balance sheet. Initial coverage may be extended beyond banks and securities dealers to other categories of non-bank institution. Table FD in the *Pink Book* shows the estimated market value of total derivative assets and liabilities held by banks and securities dealers.

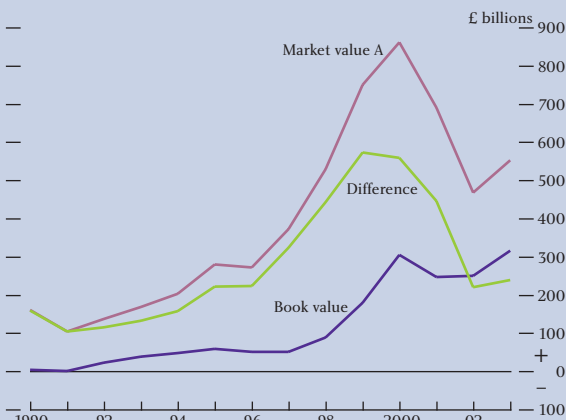
(3) The CPIS value for portfolio investment assets (converted to sterling at the end-2001 exchange rate) closely matches that in the 2001 *Pink Book*, while that for liabilities is slightly lower due to differences in coverage. This is discussed in 'IMF Coordinated Portfolio Investment Survey', *ONS Economic Trends*, May 2003.

Estimating market values for foreign direct investment

Foreign direct investment, as noted above, is valued at book values in the external balance sheet. This box updates the estimates of foreign direct investment (FDI) published in previous articles in this series. These estimates are based on a study by Pratten,⁽¹⁾ in which the author established market to book value ratios for outward and inward direct investment at end-1991.⁽²⁾ Time series have been generated backwards and forwards using changes in domestic and international equity market values and exchange rates to proxy for movements in the value of FDI.

Chart A extends Pratten's study to 2003 Q2. As equity markets rose throughout the 1990s the difference between the estimated market value and book value increased to a maximum of £570 billion at

Chart A
Estimated values of UK net foreign direct investment: method A

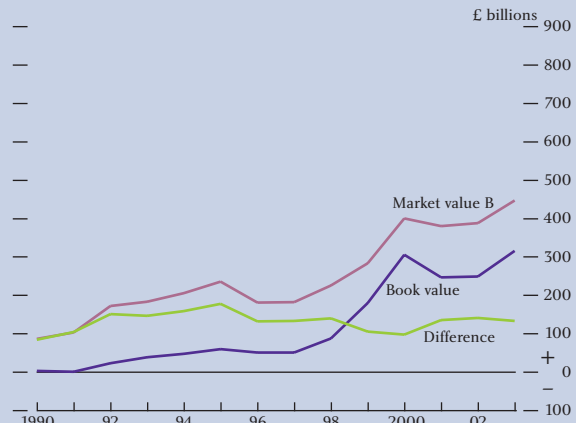


Sources: ONS and Bank calculations.

end-1999. The difference then decreased as the market value estimate fell due to world stock market declines. The most recent observations show that the estimated market value has started to increase again with the recovery in domestic and international markets.

Another method of estimating the market value of FDI (shown in Chart B) is to use a combination of GDP growth and exchange rates (based on Pratten's initial market to book value ratios). This assumes that the value of a business in which an investment has been made should grow at the same rate as the GDP of the country in which it is based. Using this method, net FDI has grown at a slower pace than that implied by the first method, but remains higher than book value.

Chart B
Estimated values of UK net foreign direct investment: method B



Sources: ONS and Bank calculations.

- (1) Pratten, C (1994), *The valuation of outward and inward direct investment: a report for the CSO*, Department of Applied Economics, University of Cambridge. The Central Statistical Office (CSO) was the predecessor to the ONS.
- (2) Pratten found that in 1991 the market value of outward direct investment was twice the book value and the market value of inward direct investment was 1.25 times the book value.

It is also instructive to consider *Pink Book* data alongside other ONS sources; in particular, internal sectoral financial accounts and balance sheets. This not only allows external positions to be considered in the context of each sector's total financial assets and liabilities, but also provides additional detail for those sectors, such as PNFs, for which separately identified external positions are not available for all items. It should be borne in mind, however, that analysis at the sectoral level will still mask heterogeneity at the level of the individual entity.

Finally, for international comparisons, BIS data and other IMF surveys are very useful. We draw upon IMF data on external debt in the box on page 468.

Recent trends in the UK external balance sheet

The United Kingdom returned to a net external asset position of 2% of GDP in 2003 Q2 (Chart 4), having had net external liabilities of more than 15% of GDP in 1999 Q1. Nevertheless, the United Kingdom remained a net borrower from abroad (in flow terms) in each of the four quarters ending 2003 Q2, and hence the recent

External debt statistics

This year the IMF published 'External debt statistics: guide for compilers and users', an updated version of its 1988 publication 'External debt: definitions, statistical coverage and methodology' (commonly known as the *Grey Book*). The Guide has been updated following the adoption of the System for National Accounts 1993 and the Balance of Payments Manual (BPM5). It also takes into account the dramatic increase in private sector international financial flows in the 1990s and the increased use of derivatives to manage risk.

Member countries of the IMF's Special Data Dissemination Standard (SDDS) were required to publish a new external debt table by end-September 2003. The new table covers gross external debt outstanding, split by economic sector, maturity and instrument. Additionally, two encouraged but not prescribed tables (which the United Kingdom will not be publishing) show prospective debt-service obligations and a domestic/foreign currency split of external debt.

The United Kingdom published its external debt table in United Kingdom Economic Accounts (UKEA), released alongside the *Pink Book*. This, reproduced in Table 1 alongside a sample of other developed and developing countries, shows that the United Kingdom had gross external debt of £2.95 trillion at end-June 2003. This confirms that debt instruments make up a high proportion of the United Kingdom's total external liabilities.⁽¹⁾ Approximately 60% of the United Kingdom's external debt consists of banks' short-term debt, with over 90% of banks' external debt being owed to

non-resident banks. This reflects London's status as an international financial centre and helps to explain why the United Kingdom's external debt appears large as a percentage of GDP compared with the other developed economies in Table 1. By contrast, just 50% of German banks' total external debt is short term.

Table 1
External debt

£ billions, end-June 2003

	United Kingdom	Germany	United States	Japan	Argentina	Ecuador
General government	58	393	796	128	49	7
Central bank	9	7	187	5	9	0
Banks	1,849	993	896	396	7	0
Other	767	164	1,613	220	19	3
Direct investment	268	268	360	16	-	-
Total	2,950	1,824	3,852	764	85	10
<i>of which:</i>						
Short term	2,319	607	1,558	533	19	1
Long term	631	1,218	2,294	231	66	8
As a percentage of GDP	271	123	59	32	133 (a)	80 (a)

Source: IMF.

(a) These percentages are based upon the most recent values of GDP, due to the fact that these countries have not yet published GDP data for 2003 Q2.

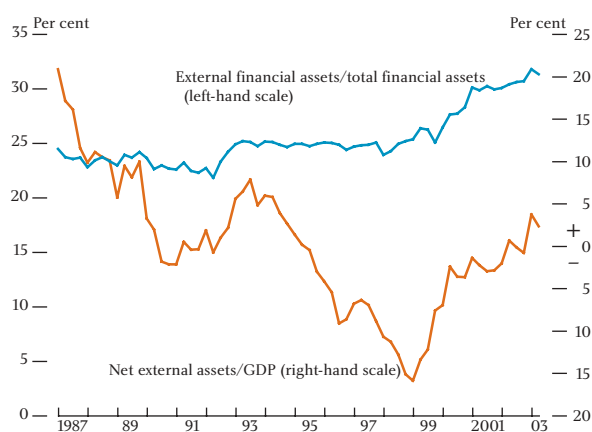
The United States and Japan have external debt valued at around two thirds and one third of annual GDP respectively. US banks account for 23% of their country's total external debt (with 85% short term), while in Japan banks account for 52% (with 87% short term). In the United States, the monetary authority accounts for 5% of total external debt, which compares with less than 1% in each of the three other developed countries in Table 1.

For the two developing countries in the table, external debt is much smaller in absolute terms, but larger as a percentage of GDP than that of two of the four developed countries. Furthermore, the public sector accounts for a greater proportion of their external debt than for the developed countries.

(1) The definition of debt in these calculations differs from that adopted in the *Pink Book*, due to the way in which the netting of assets and liabilities is carried out. Nevertheless, the comparison of £2.95 trillion in external debt with £3.5 trillion in total external liabilities provides an indication of the size of the debt component of the United Kingdom's external obligations.

improvement in the international investment position reflects positive implied revaluations, rather than a change in the direction of flows.⁽¹⁾ Although the net position is relatively small, the stocks of both assets and liabilities are substantial, each being more than £3.5 trillion (see Table A). This is more than three times the value of UK GDP, a much higher multiple than that for other developed countries.⁽²⁾ Stocks of both assets and liabilities have continued to increase in recent quarters, each by approximately 10% since the end of 2002, taking external positions to more than 31% of total UK financial assets. This compares with 25% less than four years ago.

Chart 4
UK net external assets as a percentage of GDP and external financial assets as a percentage of total financial assets

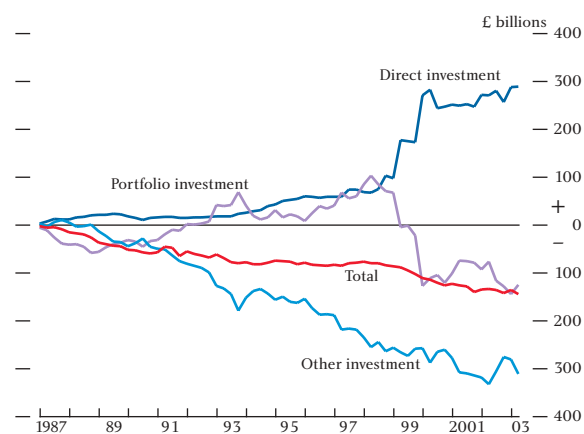


Source: ONS.

Chart 5 presents the cumulative effect on UK net assets arising from financial flows in each of the principal instrument categories of the external balance sheet. The

chart shows that, in recent years, the accumulation of net direct investment assets has been offset by a steady accumulation of net 'other investment' liabilities, and more recently net portfolio investment liabilities.

Chart 5
Cumulative change in the UK net asset position due to financial flows



Sources: ONS and Bank calculations.

Implied revaluations, by contrast, have increased net external assets by some £224 billion since March 1999 (Chart 6). The most significant effect has come from portfolio investment revaluations, which tend to be driven by the relative performance of UK and world equity markets (in sterling terms). Revaluation effects on direct investment and other investment are primarily dependent upon exchange rate, as opposed to other asset price, effects. Chart 7 shows the recent paths of factors driving revaluations. It is clear that the sharp positive revaluation of portfolio investments will have been driven by the large excess return on foreign equities during 1999 and 2000. In the year to

Table A
The UK external balance sheet

£ billions. Values at year-end unless otherwise stated.

	1999		2000		2001		2002		2003 Q2	
	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities
Direct investment	428	250	607	310	625	381	645	398	717	403
Portfolio investment										
Debt	420	510	429	604	410	530	334	410	389	438
Equity	418	319	477	394	533	425	532	483	541	508
Other investment	1,150	1,410	1,435	1,705	1,613	1,901	1,677	1,931	1,879	2,176
Reserve assets	22		29		26		25		24	
Total	2,419	2,490	2,977	3,013	3,206	3,236	3,212	3,221	3,550	3,524
<i>Memorandum items:</i>										
Total financial assets/liabilities	9,677	9,747	10,549	10,585	10,734	10,763	10,486	10,496	11,357	11,333
External positions as a percentage of total financial assets/liabilities	25.0	25.5	28.2	28.5	29.9	30.1	30.6	30.7	31.3	31.1

Source: ONS.

(1) In accordance with the method adopted in previous articles in this series, any change in the gross position that cannot be attributed to a financial flow is considered to be an implied revaluation.

(2) See Senior, S and Westwood, R (2000), 'The external balance sheet of the United Kingdom: implications for financial stability?', *Bank of England Quarterly Bulletin*, November, pages 351–64.

June 2003, the 4% decline in the sterling effective exchange rate has been the principal driver, leading to a positive revaluation of direct investments and other assets denominated in foreign currency. Indeed, given that overall the United Kingdom's external assets are largely denominated in foreign currency, while a significant proportion of its liabilities is denominated in sterling, a depreciation of the domestic currency naturally leads to an improvement in the net asset position.

Chart 6
Cumulative change in the UK net asset position due to implied revaluations

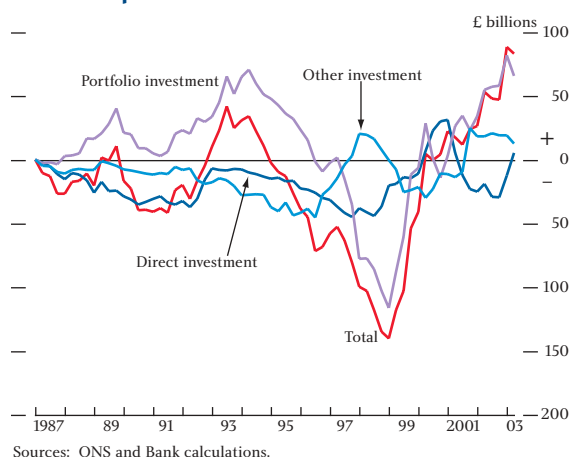
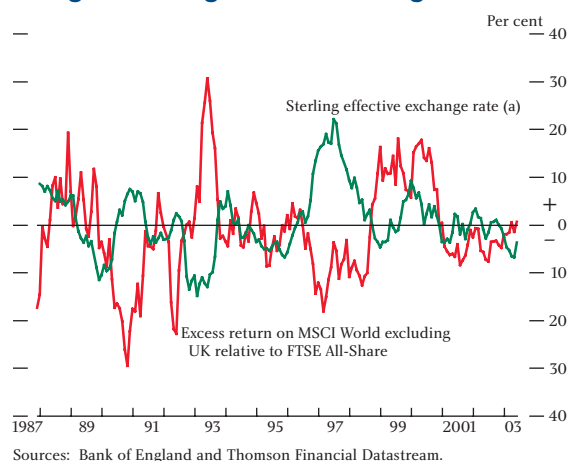


Chart 7
Excess annual return on MSCI World excluding the United Kingdom relative to FTSE All-Share and annual change in sterling effective exchange rate

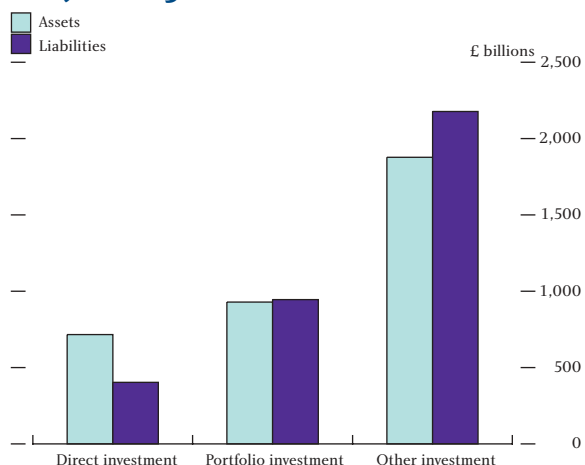


(a) Monthly average of Bank of England calculated effective exchange rate.

A closer look at the international investment position in Table A and Chart 8 reveals that the largest stock positions are held in 'other investment'. Indeed, in June 2003, gross other investment liabilities amounted to more than £2 trillion—almost two thirds of total liabilities—which largely reflects the size and international orientation of the UK financial sector. The

net liability in other investments is more modest, at around £300 billion, or 28% of GDP. The net asset position in direct investment is of a similar order of magnitude, but as noted above, this is estimated at book values.

Chart 8
UK external assets and liabilities, by instrument—end-June 2003



Some 84% of the United Kingdom's direct investment assets, and 69% of its portfolio investment liabilities, are held by PNFCs, while 75% of other investment liabilities are held by MFIs. As the largest positions occur in these sectors, we consider them in greater depth in the following subsections.

Private non-financial corporations

The external positions of UK PNFCs have increased substantially in recent years, with the accumulation of direct investment assets and equity investment liabilities through large-scale equity-financed merger and acquisition activity in the late 1990s, and an increase in external debt. This section generates a stylised PNFC balance sheet, using a combination of *Pink Book* data (and quarterly updates thereof) and the internal sectoral balance sheet, in order to illuminate the key exposures of this sector. It is the first time that has been done in this annual series of articles. Table B reveals a net external liability of more than £300 billion at mid-2003.

As the PNFC sector's net asset position in direct investment grew in the late 1990s, so did the sector's net portfolio investment liability. This has steadied more recently. Chart 9 shows clearly that the largest moves in both direct investment and portfolio investment occurred at the height of the merger and acquisition boom in 1999–2000, and the flattening of both series

Table B
A stylised balance sheet for the PNFC sector
(unconsolidated)^(a)

£ billions, end-June 2003

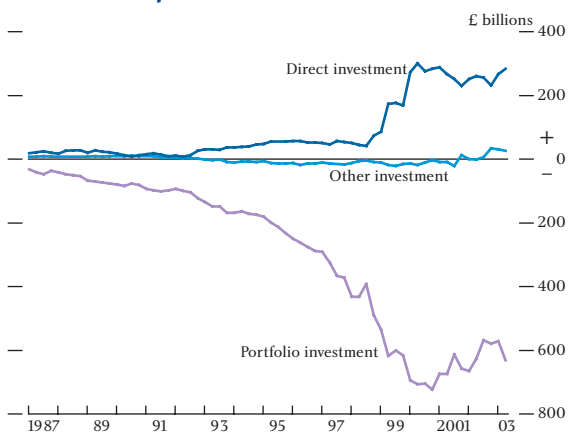
	Assets			Liabilities		
	Resident	Non-resident	Total	Resident	Non-resident	Total
Portfolio investment	81	16	97	628	651	1,279
Money market instruments	23	7	30	1	28	29
Bonds	6	2	8	47	187	234
Equities	52	7	59	580	436	1,016
Direct investment	-	597	597	-	323	323
Bonds	-	24	24	-	-	-
Equities	-	573	573	-	323	323
Other investment	194	185	379	363	162	525
Currency and deposits	186	185	371	-	-	-
Loans	8	-	8	363	162	525
Balancing item (b)	1,054	-	1,054	-	-	-
Total	1,329	798	2,127	991	1,136	2,127

Sources: ONS and Bank calculations.

(a) This table combines data from the PNFC sector financial balance sheet in ONS *Financial Statistics*, Table 12.1D and the *Pink Book*. Where the PNFC sector is not separately identified in the *Pink Book*, data have been allocated to the PNFC sector either by reference to the sectoral financial balance sheet, or by assumption. The most significant assumption is that all 'other sectors' portfolio investment liabilities may be allocated to the PNFC sector.

(b) This will comprise intra-group loans, current assets and liabilities and the value of the sector's non-financial assets.

Chart 9
Net external positions of UK PNFCs



Source: ONS.

since then largely reflects the tail-off in such activity. Analysis of the geographical composition of portfolio investment, using the IMF's Coordinated Portfolio Investment Survey (CPIS), reveals that 50% of total overseas holdings of UK equity in 2001 were in the United States. EU residents held a further 31% of the total. This, again, is consistent with the pattern of overseas direct investment in recent years, which has included large acquisitions by UK companies in the United States and continental Europe in 1999–2000, financed by the exchange of shares. To the extent that foreign shareholders retain an equity investment in the new parent, the double entry for a cross-border acquisition by a UK company is an increase in direct investment assets, coupled with an increase in portfolio investment liabilities. A further significant factor in the

increase in foreign ownership of UK equities is the greater tendency of UK multinationals to obtain listings on stock exchanges in the United States and continental Europe. Some 52 UK companies now have a listing on the New York Stock Exchange, 22 of which have sought a listing only since the end of 1997.

Debt securities constitute a third of PNFCs' total portfolio investment liabilities. Indeed, recourse to overseas debt finance has also been increasing in recent years, and external debt is now almost half of total PNFC net debt (see the box on page 472).

Monetary financial institutions

The largest external stock positions are in the MFI sector, although the net external liability was a more modest £150 billion at mid-2003. The cross-border activity of foreign-owned UK-resident banks is central to the development of this sector's external assets and liabilities. This section combines data from a variety of sources to construct a stylised balance sheet for the MFI sector, and then to examine the distribution of country and currency exposures. This analysis reveals that, although the sector has been increasingly borrowing from non-residents, currency positions are broadly matched and the lion's share of non-resident exposures is with other developed countries.

The stylised sectoral balance sheet in Table C reveals that the net liability position reflects an excess of inward over outward deposits, which is not fully offset by loans to non-residents and a net asset position in portfolio investments. Chart 10 shows that the net external

Table C
A stylised balance sheet for the MFI sector
(unconsolidated)^(a)

£ billions, end-June 2003

	Assets			Liabilities		
	Resident	Non-resident	Total	Resident	Non-resident	Total
Portfolio investment	240	402	642	287	239	526
Money market instruments	128	46	174	172	128	300
Bonds	66	344	410	65	109	174
Equities	46	12	58	50	2	52
Direct investment	-	28	28	-	28	28
Equities	-	28	28	-	28	28
Other investment	2,169	1,313	3,482	1,863	1,622	3,485
Currency and deposits	685	927	1,612	1,861	1,622	3,483
Loans	1,484	386	1,870	2	-	2
Balancing item (b)	-	-	-	113	-	113
Total	2,409	1,743	4,152	2,263	1,889	4,152

Sources: ONS and Bank calculations.

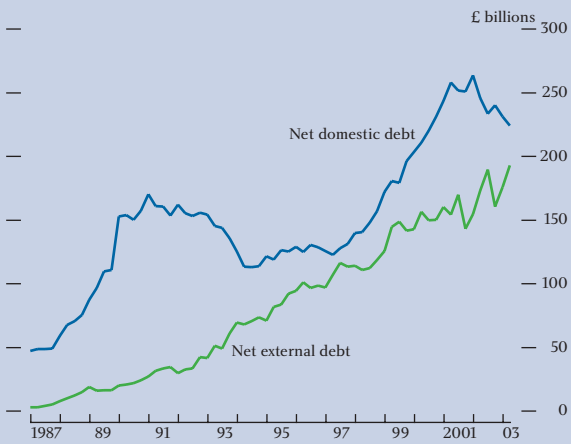
(a) This table combines data from the MFI sector financial balance sheet in ONS *Financial Statistics*, Table 12.1F and the *Pink Book*.

(b) This will comprise current assets and liabilities and the difference between the total values of financial assets and financial liabilities.

Recent trends in PNFCs' external debt

The external debt liabilities of the United Kingdom's private non-financial corporate sector have increased significantly. Chart A shows that, while borrowing from domestic residents stalled during the recession years of the early 1990s, and has dipped again recently, net borrowing from non-residents has been increasing throughout the past decade. Notwithstanding some recent volatility, the trend in borrowing from non-residents remains upwards and net external debt currently accounts for just under half of total net debt.

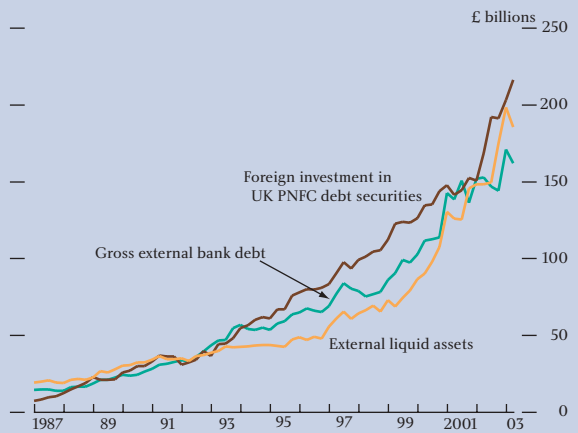
Chart A
PNFCs' net domestic and external debt



Source: ONS.

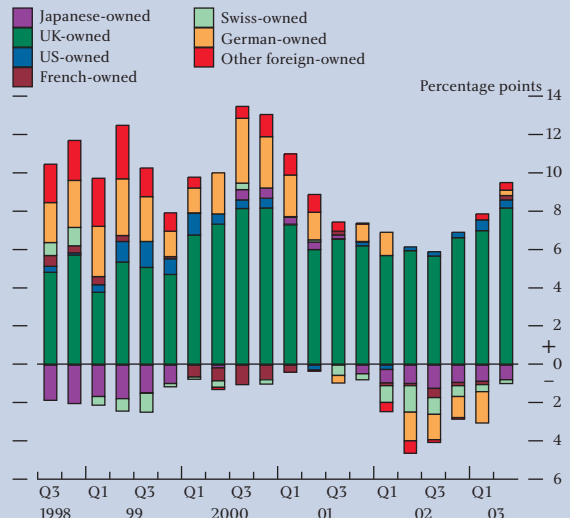
Until very recently, gross PNFC borrowing from non-resident banks had stalled for approximately two years. Given a sharp rise in external liquid assets during this period, UK PNFCs now have a net asset position with non-resident banks. Such growth as has been observed in net external debt has thus been due to an increase in foreign investment in UK PNFC debt securities (Chart B). At least for some countries, non-resident bank lending to the UK corporate sector may have been curtailed in response to adverse developments in their own domestic economies. Indeed, in the recent past, a similar trend has also been observed in lending to UK PNFCs by foreign-owned UK-resident banks. Chart C presents the contributions to the annual growth in UK-resident bank lending by banks of different nationalities, revealing that German, Japanese and Swiss banks, in particular, cut back their lending to UK PNFCs during 2002. Bond investors, on the other hand, may have increased exposure to the UK

Chart B
Trends in external bank debt and overseas investment in UK PNFC debt securities



Source: ONS.

Chart C
Contributions to annual growth in the stock of UK-resident bank lending to UK PNFCs, by nationality of bank

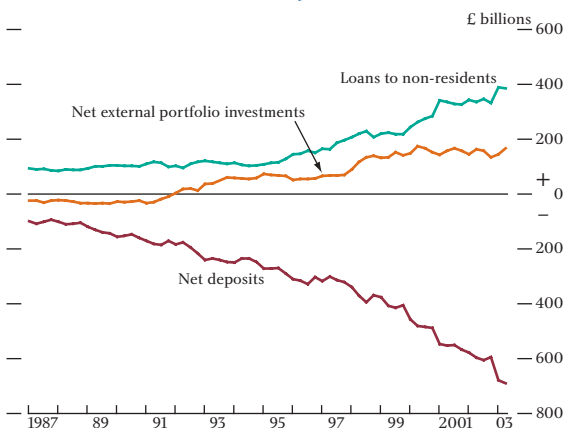


Source: Bank of England.

corporate sector in diversifying away from home markets.

Volatility in these series suggests that the PNFC sector may not always be able to rely on cross-border corporate finance. To the extent that non-resident lenders are constrained by the incidence of shocks in their domestic economies, the provision of finance from these sources might be considered less predictable (see Chart 2). Hence, increased dependence on such finance could constitute a future risk.

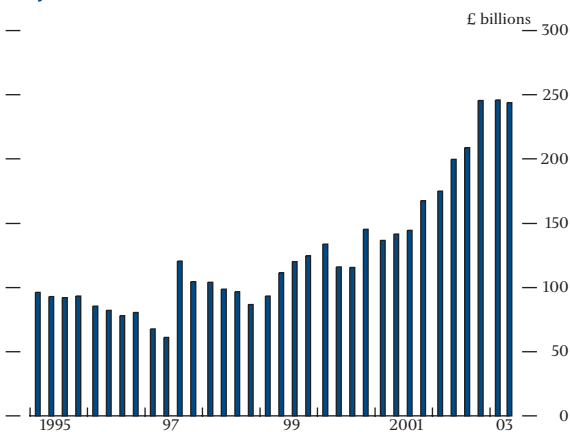
Chart 10
MFI sector's net external positions



Source: ONS.

deposit liability has been accumulating over time, helping the UK MFI sector to fund a growing excess of loans relative to deposits in the UK non-bank sector (Chart 11).⁽¹⁾ Indeed, this excess of loans relative to deposits has accelerated in recent quarters, rising by some 22% in the four quarters from June 2002. It is thus via the net external deposit liability that the MFI sector has been intermediating a current account deficit that originated in the non-bank sector.

Chart 11
Excess of UK-resident bank loans relative to deposits in the UK non-bank sector

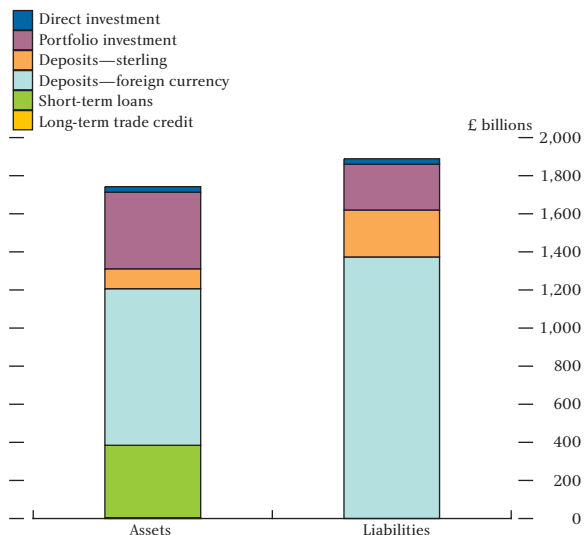


Source: Bank of England.

Chart 12 summarises some of the key data on the MFI sector's external positions. The most significant liability is in foreign-currency deposits, which is largely a reflection of the external banking activities of foreign-owned UK-resident financial institutions.

Indeed, the latter account for some 79% of these deposits. This net liability position in foreign-currency deposits currently exceeds £500 billion, although, with around £345 billion of UK-resident banks' cross-border loans also denominated in foreign currency, there is some offset to this position.

Chart 12
Breakdown of MFI sector's external exposures—end-June 2003



Source: ONS.

Bank of England data allow non-resident exposures to be viewed within the context of the entire UK MFI balance sheet, and also provide a geographical and currency breakdown of bank exposures.⁽²⁾ The data reveal that the bulk of the securities held by MFIs are denominated in foreign currency, while non-deposit liabilities tend to be denominated in sterling. If one then takes into account foreign-currency positions held *vis-à-vis* other UK residents, the net foreign-currency position of the MFI sector, as at mid-2003, was a small liability of less than £12 billion.⁽³⁾

Analysis of the composition of foreign-currency assets and liabilities allows one to determine the concentration of exposures. Charts 13 and 14 detail the currency composition of non-resident liabilities and claims. Exposures are concentrated in US dollars, which account for around 40% of both liabilities and claims. Euro exposures make up a further 32% of liabilities and 40% of claims, with 14% and 10% respectively denominated

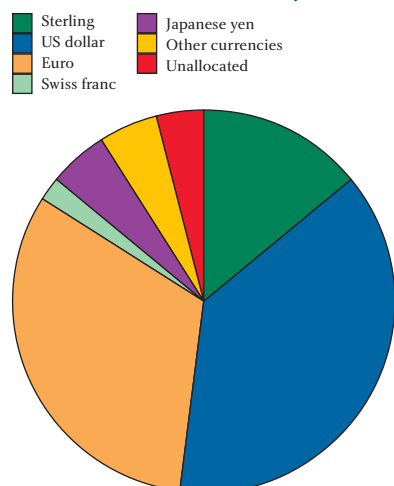
(1) This issue is discussed in Speight, G and Parkinson, S (2003), 'Large UK-owned banks' funding patterns: recent changes and implications', *Bank of England Financial Stability Review*, December.

(2) Although it is not possible to determine whether offsetting financial derivative positions or offsetting non-resident positions (eg UK-resident foreign-owned banks' non-resident positions) exist.

(3) It should be noted, however, that this conclusion is subject to interpretative difficulties associated with the residency-based definition of the UK MFI sector. In particular, positions held by the non-resident operations of UK-resident banks are not taken into account. Nor is it possible to establish whether offsetting financial derivatives positions exist.

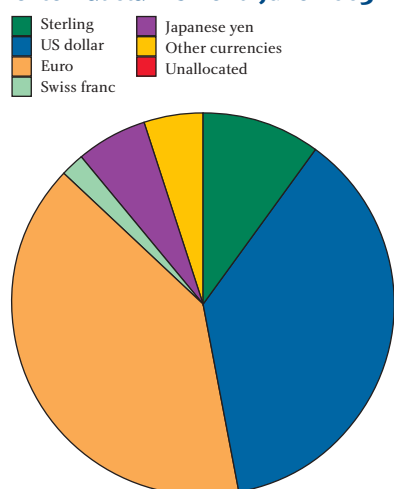
in sterling. Thus, even within the foreign-currency component of exposures, the MFI sector appears to be broadly currency-matched.

Chart 13
Currency breakdown of UK resident banks' external liabilities—end-June 2003



Source: Bank of England.

Chart 14
Currency breakdown of UK resident banks' external claims—end-June 2003



Source: Bank of England.

It is reasonable to believe that the domestic systemic implications of an externally generated shock would be more significant if the bank in question were UK-owned, as opposed to a foreign-owned UK-resident bank, reflecting the fact that the former remains of far greater importance to the UK payments system.⁽¹⁾ In this regard, one might wish to examine the geographical breakdown of UK-owned banks' consolidated worldwide claims,

including local claims by local subsidiaries. This is done in Table D below, using data from the Bank of England. With regard to institutional risks, one might take comfort from the predominance of lending to the developed world; just 10% of consolidated foreign claims are on developing countries.⁽²⁾

Table D
Geographical distribution of UK-owned banks' consolidated foreign claims

£ billions, end-June 2003

	Consolidated claims	Percentage
Developed Europe	262.8	28
United States	326.7	34
Japan	30.1	3
Other developed countries	47.1	5
Offshore centres	146.0	15
Developing countries	92.6	10
Other (including international organisations)	45.2	5
	950.5	

Source: Bank of England.

Overall assessment of financial stability risks

Financial transactions with the rest of the world yield undoubted benefits. Cross-border flows facilitate the smoothing of consumption over time; they allow lenders and investors to diversify their portfolios and reduce their dependence on the domestic economy; and they allow borrowers to access diverse sources of finance. However, this article has argued that external positions can also introduce additional sources of financial instability. Drawing on diverse data sources, including the Bank of England, the IMF and the Bank for International Settlements, as well as the ONS's *Pink Book* and sectoral balances, the volatility of cross-border flows, currency risk and country risk have all been considered.

It has been shown that the United Kingdom has recently moved into a net external asset position. However, this is entirely due to revaluation effects, for the United Kingdom remains a net external borrower (in flow terms). Furthermore, the aggregate position disguises some important sectoral trends, most notably in the PNFC and MFI sectors. Further examination reveals an increasing reliance on non-resident funding in both sectors. Indeed, external debt accounts for almost half of the total in the PNFC sector, and the accumulation of non-resident deposits has been helping UK-resident MFIs to fund an increasing excess of lending to the UK non-bank sector relative to deposits.

(1) Indeed, Bank of England data reveal that some two thirds of all loans outstanding to UK residents are by UK-owned, UK-resident banks.

(2) Almost half of the United Kingdom's developing-country claims are on the Asian region, with the remainder spread across Africa and Latin America, and to a lesser extent developing Europe. Lending slowed between 2000 and 2002, falling sharply in Latin America at the time of the Argentine financial crisis. More recently flows have resumed, rising almost 19% overall in the year to June 2003, mainly due to acquisitions.

Nevertheless, the increasing globalisation of the financial sector and investors' growing demands for international diversification suggest that the current external stock position of these sectors is sustainable. One concern might be that these imbalances carry with them a significant currency risk. In this regard, some comfort may be taken from the fact that much of the PNFC sector's liabilities are likely to be denominated in sterling, while the MFI sector's external positions seem to be broadly currency-matched if one takes into account foreign-currency exposures with both UK residents and non-residents.

Finally, in terms of country risk, an analysis of the geographical distribution of both portfolio investments and MFIs' external claims reveals that the largest positions are with the United States and developed Europe. Particularly in the MFI sector, these positions are sizable. The greatest source of country risk with regard to these positions would be intensifying macroeconomic weakness, and a concomitant erosion of credit quality. Developing-country exposures, although increasing after a lull in recent years, constitute a relatively small proportion of overall international positions.