

# The external balance sheet of the United Kingdom: recent developments

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*The United Kingdom’s external balance sheet currently records assets and liabilities of more than £3.5 trillion. Both sides of the external balance sheet grew sharply during 2003, continuing the marked expansion that has been recorded since the early 1990s. This article examines recent trends within the balance sheet components with reference to the associated financial flows and income. There is a particular focus on data reported by monetary financial institutions. The article discusses some of the problems involved in compiling an external balance sheet, examining two key issues through the estimation of a breakdown of revaluations to outstanding stocks and a discussion of foreign direct investment data. We also report on current domestic and international initiatives aimed at further improving the quality of external statistics.*

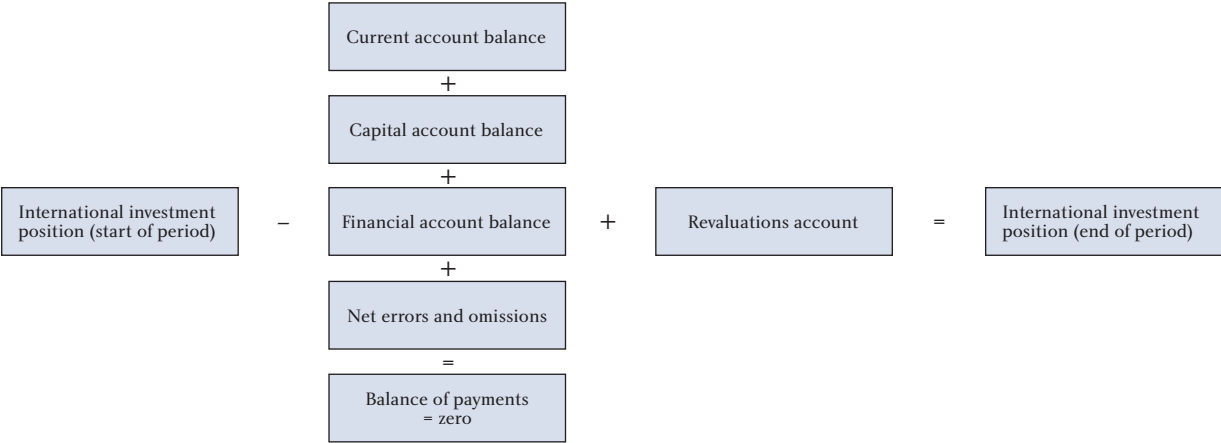
## Introduction

The external balance sheet is a summary of a country’s financial relationship with the rest of the world. For the United Kingdom, it combines the stock of UK residents’ financial investments in the rest of the world (assets) and the stock of financial investments into the United Kingdom from abroad (liabilities). Figure 1 places the external balance sheet in the integrated balance of payments accounts and shows its conceptual relationship to the balance of payments flow measures.<sup>(1)</sup>

The external balance sheet is now usually referred to as the international investment position (IIP).

Reading horizontally, the change in the net asset/liability position between two points in time must, by definition, be equal to the net flow of assets and liabilities recorded in the financial account, plus or minus net changes in the valuation of the stocks, recorded in the revaluations account.<sup>(2)</sup> Reading vertically outlines the balance of payments identity; the current account should be equal and opposite to the

Figure 1



(1) The financial account records transactions in financial assets and liabilities, with the main classifications being the same as those used in the IIP (see page 486 of this article). The capital account consists of capital transfers and the net acquisition or disposal of non-produced, non-financial assets (such as land, patents and copyrights). Capital transfers include transfers of ownership of fixed assets and the cancellation of liabilities by creditors, without any counterparts received in return. Most transfer payments involve central government: examples include payments to and receipts from institutions of the European Union, and debt forgiveness. For more details see *The Pink Book 2004*, pages 170–71.

(2) In this simplified representation the revaluations account will capture changes in net worth due to both nominal holding gains/losses and other changes in volume (for example write-offs). International manuals suggest the construction of a revaluations account sourced from data suppliers, but at present the United Kingdom is not able to do this. The revaluations decomposition presented in this article is based on a Bank of England best endeavours method. See *Balance of Payments Manual — 5th edition (BPM5)* published by the International Monetary Fund (IMF), Chapter 3, pages 14–19.

sum of the financial account and the capital account. In practice an errors and omissions term is necessary to ensure that this is so. We discuss some of the problems involved in the collection of balance of payments and IIP data in the box on page 491.

Table A sets out the United Kingdom's balance of payments flows since 1998. The financial account is presented in accordance with the usual balance of payments convention, so a positive figure represents a net financial inflow.

**Table A**  
**Balance of payments**

£ millions

	1998	1999	2000	2001	2002	2003	2004 H1
Current account	-3,972	-24,416	-24,094	-22,391	-18,222	-20,430	-11,909
Capital account	516	773	1,527	1,206	868	1,243	1,241
Financial account	2,219	20,944	24,944	23,816	8,849	17,455	4,880
Errors and omissions	1,237	2,699	-2,377	-2,631	8,505	1,732	5,788

Source: ONS.

Table B sets out the changes in the net IIP since 1998. When considered in this context the sign on the financial account flows is reversed. A net financial account inflow represents a net increase in external liabilities.

**Table B**  
**Net international investment position**

£ millions

	Net IIP (at start period)	Financial account flows	Revaluations	Net IIP (at end period)
1998	-73,833	-2,219	-57,168	-133,220
1999	-133,220	-20,944	83,520	-70,644
2000	-70,644	-24,944	59,475	-36,113
2001	-36,113	-23,816	-13,500	-73,429
2002	-73,429	-8,849	-29,085	-111,363
2003	-111,363	-17,455	76,384	-52,434
2004 H1	-52,434	-4,880	-48,351	-105,665

Source: ONS.

The Office for National Statistics (ONS) publishes a limited set of IIP figures each quarter in the *Balance of Payments First Release* with a full breakdown published annually in the *Pink Book*.<sup>(1)</sup> The IIP is broken down into the following instruments:

- **Direct investment** is defined as a cross-border financial transaction in which a resident in one economy acquires a lasting interest in an

enterprise resident in another economy. A direct investment relationship exists if the investor has an equity interest in an enterprise of 10% or more of the ordinary shares or voting stock. Direct investment levels are also affected by all subsequent financial transactions (equity or debt) and any earnings of the direct investment enterprise that are retained rather than repatriated to the investor.<sup>(2)</sup>

- **Portfolio investments** are defined as investments in equity and debt securities apart from those included in direct investment and reserve assets. Debt securities comprise bonds and notes and money market instruments.
- Though the term **other investment** suggests a residual category, it is in fact the largest component of the UK external balance sheet. Other investment consists of external transactions other than direct and portfolio investments. The largest component of other investment is loans and deposits, including repos and reverse repos.
- **Reserve assets** refer to foreign financial assets controlled by monetary authorities, for example foreign exchange, monetary gold and special drawing rights.
- **Financial derivatives**<sup>(3)</sup> covers any financial instrument the price of which is based upon the value of an underlying asset. The main contract types include futures and forwards, options and swaps.

## Recent trends in the UK external balance sheet

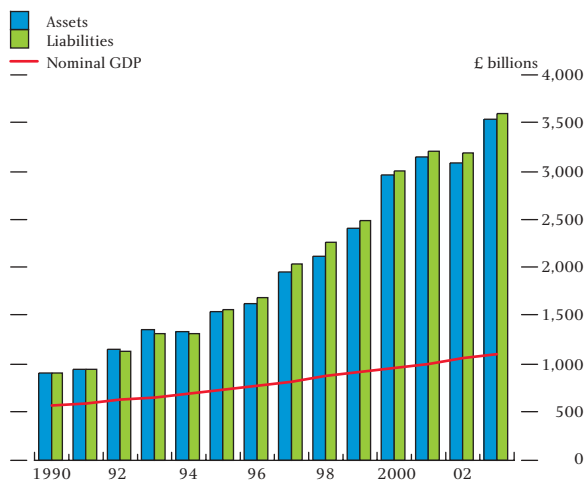
Chart 1 shows the extent to which the United Kingdom's gross external assets and liabilities have grown since 1990. In this 13-year period, both assets and liabilities have increased by more than £2.6 trillion, at an average annual rate of more than 11%. This easily outstripped the 5.4% average annual growth rate of nominal UK GDP over the same period. At end-2003, external assets stood at £3.55 trillion and external liabilities stood at £3.60 trillion.

(1) 'United Kingdom Balance of Payments', published annually by the ONS, Chapter 8.

(2) BPM5, Chapter 8, paragraph 177.

(3) UK IIP data do not at present include stock figures for financial derivative instruments. Table FD in the *Pink Book* gives a partial sectoral breakdown of derivatives assets/liabilities for end-1998 to end-2003 inclusive. The ONS has stated that '[they] are not included in the main aggregates of the United Kingdom's IIP as the data are experimental'. Limited data on transactions in financial derivatives are included in the financial account of the balance of payments.

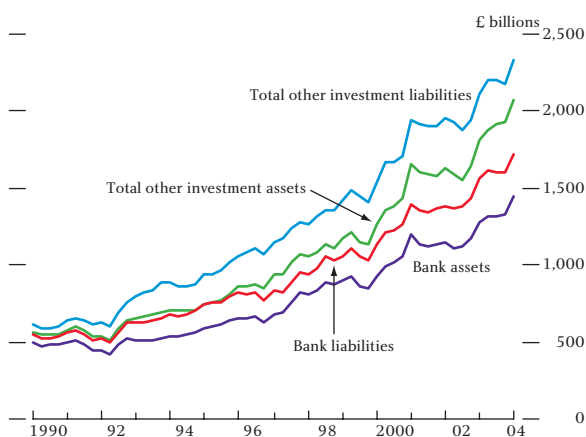
**Chart 1**  
**UK gross external assets and liabilities**



Source: ONS.

More than half of the £2.6 trillion expansion of the United Kingdom's external assets and liabilities has been in other investment, which probably reflects the success of the United Kingdom as an international financial centre, particularly for cross-border banking. Chart 2 shows how influential the banking sector is within other investment, accounting for almost 70% of other investment assets and almost 75% of other investment liabilities at end-2003. Data collected by the Bank of England disaggregate this into assets and liabilities of UK-owned and non resident-owned banks. At end-2003, non resident-owned banks held just under 80% of the UK banking sector's external other investment assets, with the figure at just over 75% for liabilities. We present geographic and currency detail of banking sector other investment data in the box on page 488.

**Chart 2**  
**Other investment assets and liabilities**



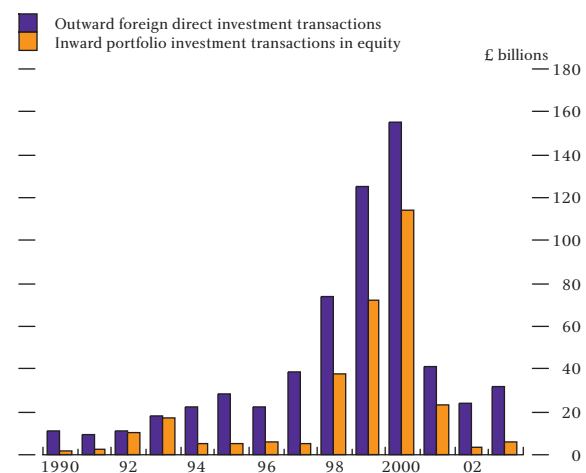
Source: ONS.

The other major factor driving growth in the United Kingdom's external assets and liabilities over this period was the sharp surge in cross-border mergers and

acquisitions beginning in 1998 and peaking in 2000. This activity typically affects the external balance sheet in two places. The acquisition of an overseas company will be recorded as direct investment abroad, which increases external assets. When the purchase is financed wholly or partly with equity, initially at least, the acquisition will also increase non-residents' portfolio investment in UK equities, which raises external liabilities.

Chart 3 shows that the most significant financial transactions resulting from this activity increased foreign direct investment assets and portfolio equity liabilities. A similar pattern, but on a smaller scale, was seen through direct investment into the United Kingdom (boosting direct investment liabilities and portfolio equity assets).

**Chart 3**  
**UK direct investment abroad and non-residents' portfolio investment in the United Kingdom**



Source: ONS.

International mergers and acquisitions activity will result in a permanent increase in non-residents' holdings of UK equities only to the extent that non-residents are willing to retain their increased exposure to the UK economy and corporate sector. Chart 3 shows that non-residents have continued to invest into UK equity (via positive flows every year).

Chart 4 shows how the respective net positions of each of the IIP components have developed over the same period. The United Kingdom ran a small net asset position in direct investment and equity portfolio investment until past the mid-point in the previous decade. From 1998 to 2000 the increase in the net direct investment asset position and the swing from a net equity portfolio investment asset position to a net liability position are evident.

## Geographic and currency detail of banking sector other investment data

Geographic detail for the complete IIP is presently only available for end-2002. The full details are presented in the ONS publication *Economic Trends*, June 2004.

Data collected in the statistics division of the Bank of England allow us to study the geographic and currency detail of the banking sector contribution to other investment up to the end of 2004 Q2.

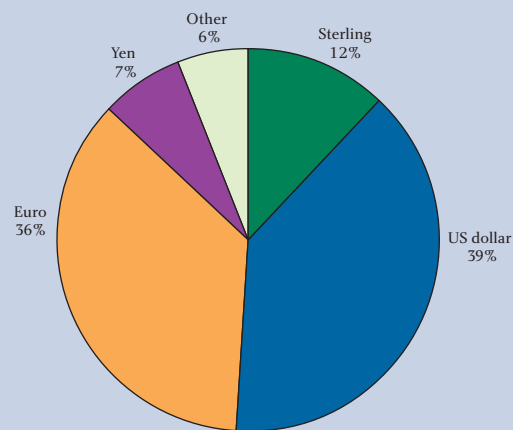
The currency breakdowns of banks' assets and liabilities at the end of 2004 Q2 (Charts A and B respectively) show that the US dollar remains the most important currency within the United Kingdom's gross positions, although the euro accounts for only a slightly smaller proportion. The

breakdowns also confirm that the currency composition of cross-border banking is broadly neutral, as mentioned in the revaluations section on pages 489–90.

The net positions, displayed in Chart C, show that sterling and the US dollar drive the net liability position.

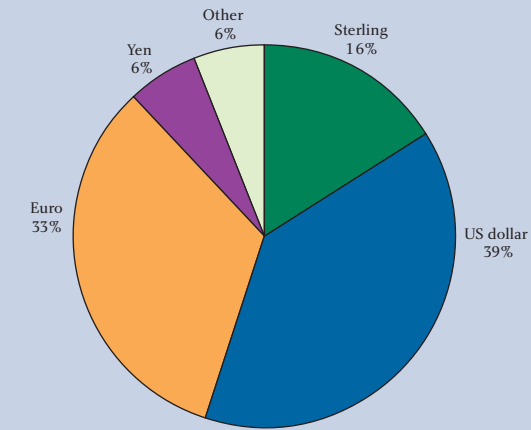
Chart D shows the country breakdown of the net banking sector other investment position. The country with whom the United Kingdom holds the largest net liability position is Switzerland, followed by Jersey, Germany and the Cayman Islands. The United Kingdom holds a net asset position with the United States, Japan and France.

**Chart A**  
Currency breakdown of banks' assets – end-2004 Q2



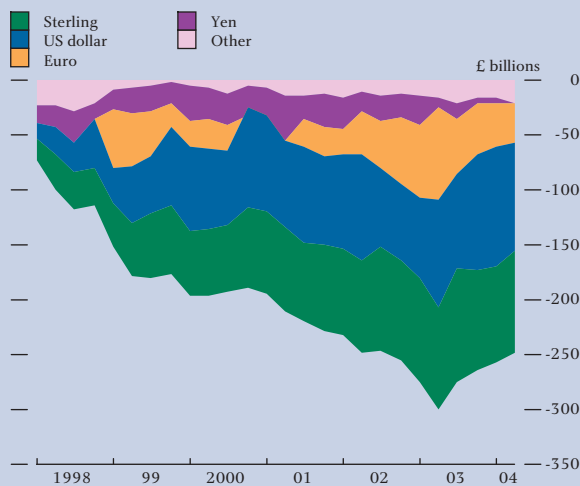
Source: Bank of England.

**Chart B**  
Currency breakdown of banks' liabilities – end-2004 Q2



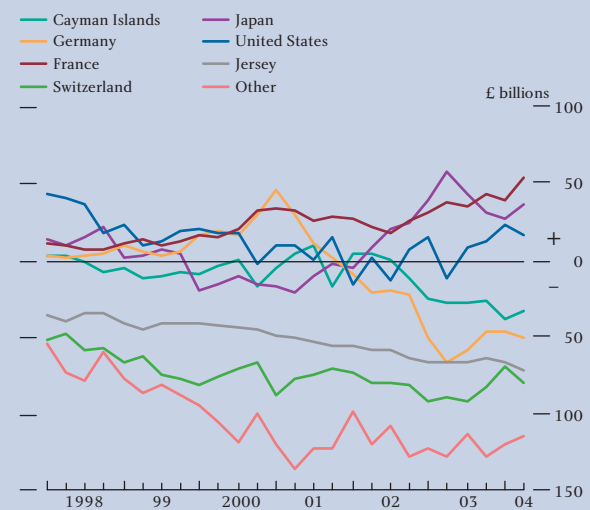
Source: Bank of England.

**Chart C**  
Net position split by currency



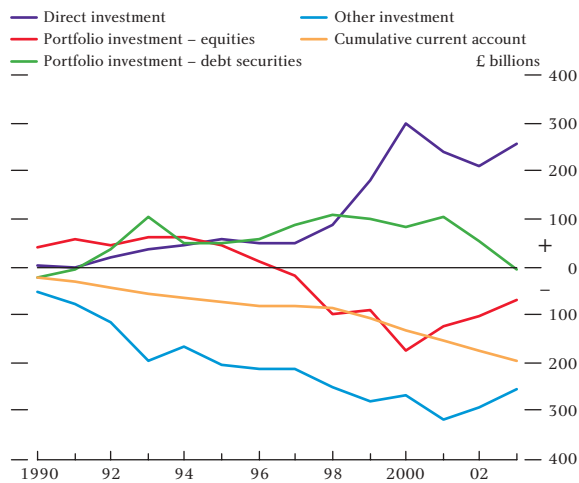
Source: Bank of England.

**Chart D**  
Net banking sector other investment position



Source: Bank of England.

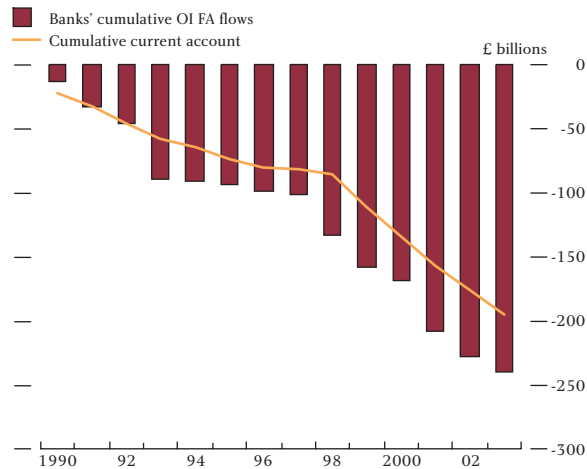
**Chart 4**  
**UK net external positions by component**



Source: ONS.

Alongside the growth in the United Kingdom's gross other investment assets and liabilities since 1990 there has been a trend increase in the other investment net liability position, although this has been partly reversed over the past two years. For much of this period, the development in the other investment net liability position has broadly tracked the cumulative current account deficit (Chart 4), suggesting that UK residents without access to capital markets have been borrowing from abroad, through the domestic banking sector, to fund their net external expenditure.<sup>(1)</sup> Chart 5 plots cumulative banking sector other investment financial account flows<sup>(2)</sup> against the cumulative current account. It shows that this pattern of overseas borrowing through banks has continued over the past two years. The

**Chart 5**  
**Banking sector cumulative other investment (OI) financial account (FA) flows and cumulative current account deficit**



Source: ONS.

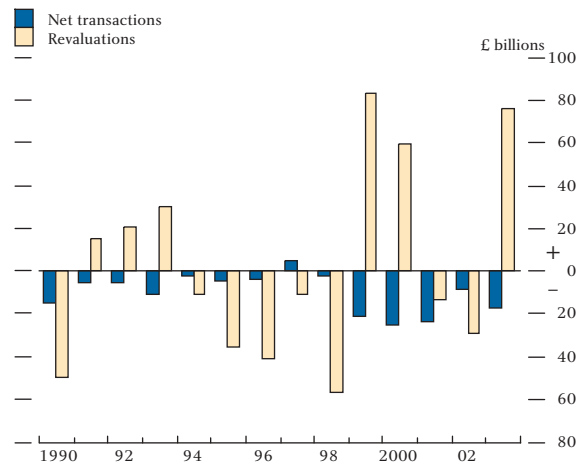
narrowing of the total other investment net liability position is explained by the reduction in the other investment liability position of securities dealers, and the increase in the other investment asset position of other UK residents.

**Revaluations**

Movements in the external balance sheet can result not only from financial transactions but also from the revaluation of outstanding stocks. For example an increased net external liability position does not necessarily require inward net financial flows, but may be caused by negative revaluations to stocks.

Chart 6 shows how important revaluations have been to the evolution of the United Kingdom's external balance sheet in recent years. They were larger than recorded financial transactions in all but one year since 1990. In 2003, large positive revaluations of almost £80 billion more than offset the inward financial flows (see footnote 2 below) of £17.5 billion and narrowed the net liability position. This contrasts with 2001 and 2002, when the financial account inflows were accompanied by negative net revaluations, which added further to the widening in the net liability position.

**Chart 6**  
**Changes in UK net external balance sheet**



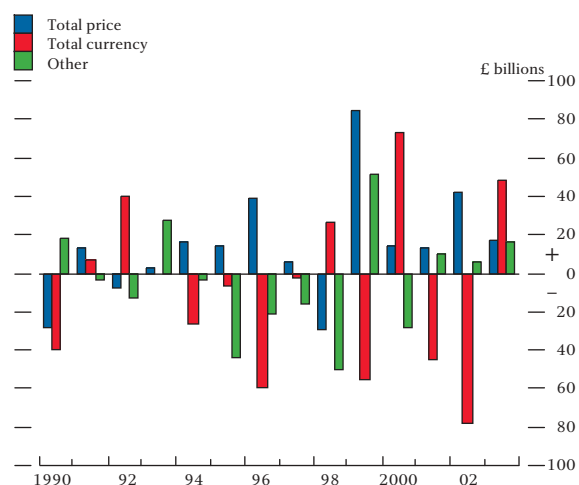
Sources: Bank calculations and ONS.

Two factors contributing to revaluations of assets and liabilities are changes in value due to movements in marketable instrument prices (in the currency of denomination) and changes in value due to the translation of foreign currency denominated assets and liabilities into sterling at prevailing exchange rates. The

(1) See Speight, G and Parkinson, S (2003), 'Large UK-owned banks' funding patterns: recent changes and implications', *Financial Stability Review*, December, pages 135-42.  
 (2) Financial account inflows represented by a negative figure, contrary to usual Balance of Payments convention.

Bank attempts to estimate the respective effects of these two factors using limited instrument and geographic detail of the balance sheet together with market indices and exchange rates. There is also a residual category which captures the effect of other changes in volume, for example write-offs.<sup>(1)</sup> It also picks up errors and omissions in the collection of the balance of payments data (see the box on page 491 for a discussion of errors and omissions), and in the Bank's decomposition method. Chart 7 sets out the Bank's estimate of this decomposition of net revaluations since 1990.

**Chart 7**  
Revaluation effects decomposition



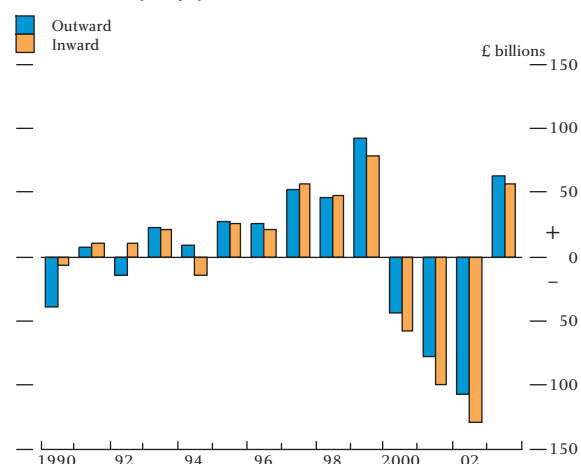
Sources: Bank calculations and ONS.

Currency effects have tended to be the most important factor in the revaluation of the United Kingdom's IIP over the past decade or so. This highlights the different currency composition of the United Kingdom's assets and liabilities. Investment into the United Kingdom tends to be denominated in sterling while UK investment abroad tends to be in foreign currencies (the major exception to this is cross-border banking business, which is broadly currency neutral). Consequently (and with other factors held unchanged), a general fall in the external value of sterling will lead to a rise in the sterling value of foreign currency denominated assets, hence a positive revaluation to the IIP. This is demonstrated by the positive net revaluation in 1992 following sterling's departure from the Exchange Rate Mechanism.

Revaluations due to price effects have been driven largely by equity price movements in recent years. The

net revaluation effect of price changes has tended to be relatively small because the world's major equity markets have broadly moved in line with each other. This can be seen in Chart 8, which shows estimated revaluations to portfolio equity investment assets and liabilities due to equity price movements. Both inward and outward revaluations due to price changes were positive in 2003, reflecting the return to positive capital growth in the world's major equity markets. Revaluations due to movements in bond prices are also estimated and were relatively small in 2003. Negative revaluations to both assets and liabilities were caused by falls in bond prices. The revaluation to liabilities was larger than that to assets, leading to a net positive effect for the UK IIP.

**Chart 8**  
Portfolio equity price revaluations



Sources: Bank calculations and ONS.

## International comparisons

In this section, we compare the external balance sheet data of the United Kingdom with those of some of its major international counterparts. Geographical detail of balance of payments data can highlight, through bilateral asymmetries, the different compilation methods used in different countries. Therefore, care should be taken when making comparisons. One of the main areas in which this is evident is the measurement of foreign direct investment stocks and income. We focus on some of the issues arising in this area in the box on foreign direct investment measurement issues on pages 492–93. Progress continues to be made internationally to harmonise concepts and collection methods. The primary focus for this is the planned update to the fifth Balance of Payments Manual.<sup>(2)</sup>

(1) See footnote 2 on page 485.

(2) The Intersecretariat Working Group on National Accounts (ISWGNA) is overseeing the process of updating the System of National Accounts, 1993; the revision of associated manuals — including the Balance of Payments Manual — is being co-ordinated by the IMF. Details of the process are available on the United Nations Statistics Division website at <http://unstats.un.org/unsd/nationalaccount/snarev1.htm>.

## Errors and omissions

The compilation of the balance of payments for an economy such as the United Kingdom involves drawing together data from a wide range of institutions and economic agents, which inevitably results in a degree of imprecision.<sup>(1)</sup>

Within the balance of payments flows identity this is allowed for by the incorporation of an 'errors and omissions' term. This acts as a natural indicator of internal consistency for the balance of payments.

Chart A plots the errors and omissions term since 1990 and shows that in 12 years out of 14 it has been positive. Errors and omissions are believed to stem mainly from the financial account, in which case a positive error term would imply that either assets have been overestimated or that liabilities have been underrecorded.

For the relationship between the financial account and the IIP, we have no such natural indicator. Within our revaluations estimates, we have an 'other revaluations' term which is constructed to pick up discrepancies between flows and stocks not explained by price and currency effects. In the majority of years since we began to estimate the decomposition (in 1987), this 'other revaluations' term has been negative.

**Chart A**  
Net errors and omissions



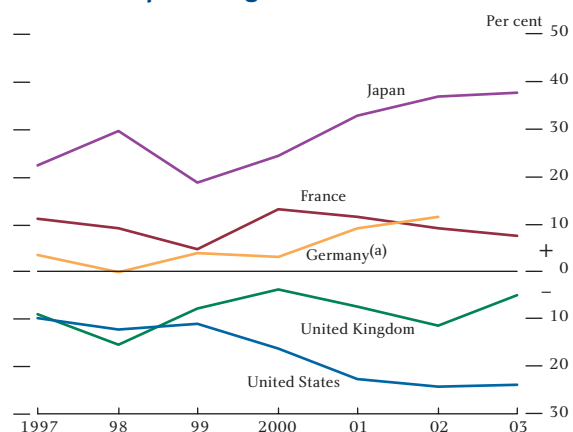
Source: ONS.

A possibility that would account for both these discrepancies would be the underrecording of the flow of non-residents' acquisitions of UK liabilities. Portfolio investment is a likely area in which this may occur. CPIS data<sup>(2)</sup> on stocks of portfolio investment liabilities present a similar picture to ONS published data. This suggests that the bulk of the error is explained by a failure to record liability flows in the financial account.

(1) The Bank of England compiles data from the monetary financial institutions sector using a near-census. The Office for National Statistics uses a combination of administrative data and large-scale surveys to compile data from the other sectors of the economy, although the data on the household sector are limited.

(2) The co-ordinated portfolio investment survey (CPIS), an International Monetary Fund initiative completed by 68 countries in 2002, allows countries to build a picture of their gross external portfolio investment liabilities from counterpart countries' portfolio investment assets data. For more details see the box in Westwood, R and Young, J (2002), 'The external balance sheet of the United Kingdom: recent developments', *Bank of England Quarterly Bulletin*, Winter, pages 440–50.

**Chart 9**  
Net IIP as a percentage of nominal GDP



Source: *International Financial Statistics*.

(a) Data for 2005 not available at time of publication.

Chart 9 compares the net international investment positions, as a percentage of nominal GDP, for the United States, Japan, Germany, France and the United

Kingdom. Japan's net assets and the United States' net liabilities have both grown over recent years. Germany's net asset position has begun to grow again after moving into a net liability position in 1998. France and the United Kingdom have maintained their respective net asset and net liability positions.

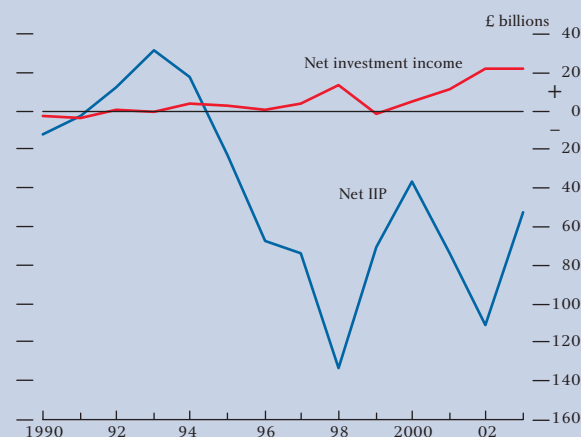
Germany ran a current account and public sector deficit during the 1990s following reunification. As a result of the offsetting financial account net inflows, Germany's net external assets declined, before stabilising around the turn of the century. From 2002, the German current account has turned from a deficit to a surplus, mainly driven by a large increase in exports of goods. The resultant net financial account outflow has led to an increase in the net asset position evident in Chart 9.

The United States' increasing net external liability position (Chart 9) reflects the financial flows required to

## Foreign direct investment measurement issues

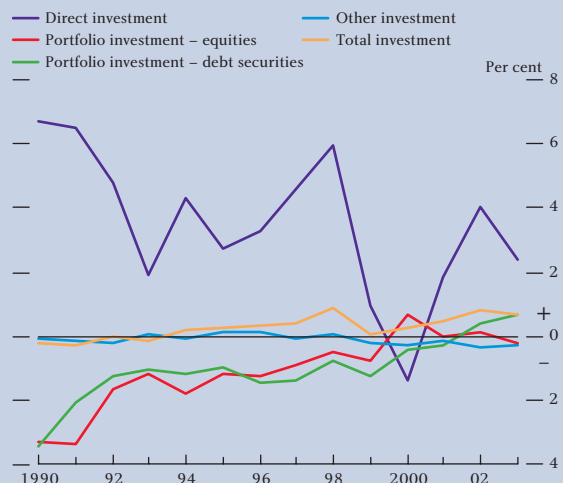
Chart A shows how, throughout the early part of the 1990s, net investment income was broadly stable whereas the net IIP moved from a net asset to a net liability position. Over the past few years the United Kingdom has recorded an increasing net investment income surplus despite running a net IIP liability position. Chart B, which plots net rates of return on investment,<sup>(1)</sup> suggests that income earned on direct investment might be the main factor.

**Chart A**  
Net IIP and investment income



Source: ONS.

**Chart B**  
Net rates of return on individual components



Source: ONS.

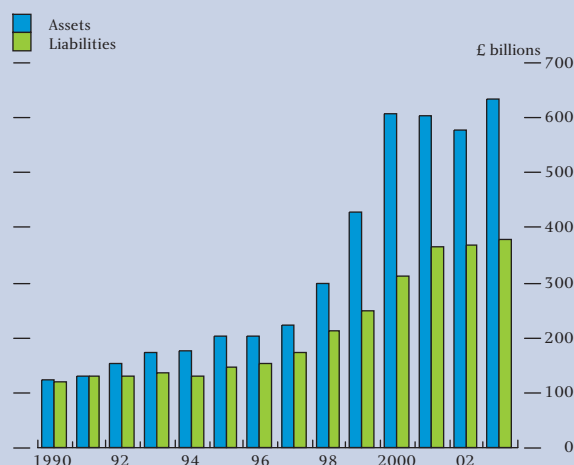
International standards recommend that direct investment assets and liabilities are measured at current market prices.<sup>(2)</sup> However, due to data availability, many countries, including the United Kingdom, depart from this when compiling direct investment stocks. Book values are often used to determine the value of the stock of direct investments.

With asset prices generally rising over time, it is almost certain that these book values underestimate the corresponding market values.

Direct investment income is the return that non-resident investors receive on their investment, ie the profits of the respective branch or subsidiary. The Balance of Payments Manual (BPM5) states that this should exclude capital gains or losses which arise from the revaluation of assets.<sup>(3)</sup> Typically the data available for the statistical reporting of direct investment income are the bottom-line profits figures. While for most sectors of the economy this complies with international definitions, for monetary financial institutions this will often include holding gains and losses arising from their portfolio investments.<sup>(4)</sup> With asset prices generally rising over time, this will usually imply a trend overestimation of direct investment income.

Therefore, due to the underestimation of stocks and the overestimation of income, rates of return on both direct investment assets and liabilities will be inflated. During the period since 1997 UK net direct investment assets have risen sharply, as shown in Chart C. The overestimation of income on these net direct investment assets relative to the imputed income on the portfolio investment liabilities created as a counterpart (Chart 4) is likely to have contributed to the positive net total investment income (Chart A).

**Chart C**  
UK direct investment assets and liabilities



Source: ONS.

The Bank of England and the ONS are involved in efforts to improve the collection of foreign direct

(1) These are simple yields — ie the income figures do not include holding gains or losses.

(2) BPM5, paragraphs 376 and 377.

(3) BPM5, paragraph 285.

(4) For all sectors of the economy the treatment of reinvested earnings further complicates comparisons between income on direct investment and other instruments. See BPM5, paragraph 31.



investment data both domestically and internationally. Relevant initiatives and developments currently include:

- A Eurostat/ECB taskforce recently completed a study into the reporting of direct investment.<sup>(5)</sup> A result of this is that from 2006 euro-area countries will be required to collect direct investment stocks according to a common definition, and will report market values for listed companies.
- The move to International Accounting Standards<sup>(6)</sup> and in particular the emphasis on recording economically meaningful valuations in financial reporting may result in better coverage of direct investment assets and liabilities at market or fair value.
- The IMF has proposed conducting an international co-ordinated direct investment

survey (CDIS).<sup>(7)</sup> Such a survey would (i) increase the coverage of direct investment statistics; (ii) improve the comparability of direct investment statistics between countries; and (iii) provide data on the geographical breakdown of direct investment. Gross direct investment assets would be compiled by participating countries with a geographical breakdown. Participants could then derive their direct investment liabilities from counterpart countries' assets data. A taskforce comprising the IMF, World Bank, OECD, ECB, Eurostat and UNCTAD is currently reviewing the feasibility of a CDIS.

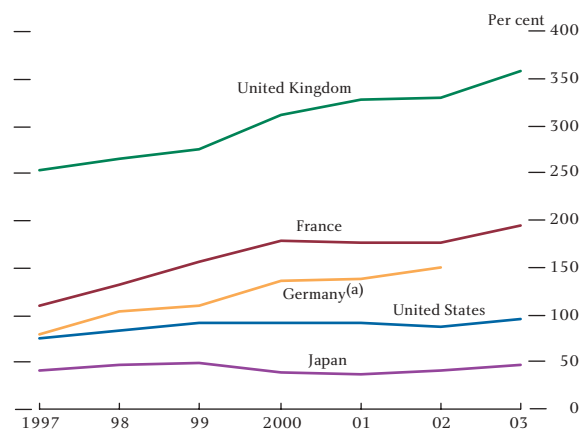
- It is anticipated that, in the medium term, direct investment income for UK monetary financial institutions will be presented on the internationally preferred basis, ie holding gains and losses will be excluded.

(5) Available at [www.ecb.int/pub/pdf/other/foreigndirectinvestment200403en.pdf](http://www.ecb.int/pub/pdf/other/foreigndirectinvestment200403en.pdf).

(6) See [www.iasb.org/index.asp](http://www.iasb.org/index.asp).

(7) See [www.imf.org/external/pubs/ft/bop/news/pdf/0804.pdf](http://www.imf.org/external/pubs/ft/bop/news/pdf/0804.pdf).

**Chart 10**  
Gross external liabilities as a percentage of nominal GDP

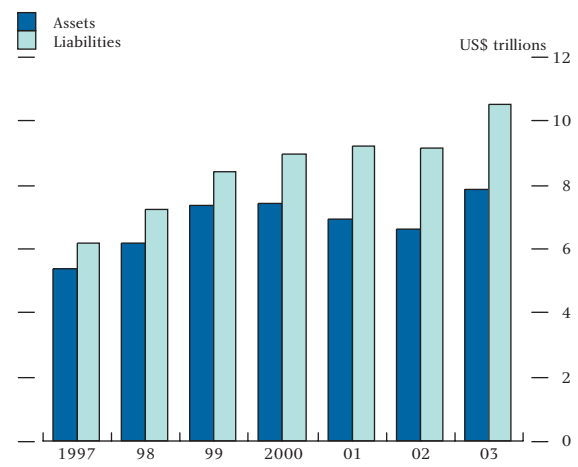


Source: *International Financial Statistics*.

(a) Data for 2005 not available at time of publication.

fund the current account deficit over recent years. However, Chart 10 shows that gross external liabilities as a percentage of GDP were little changed over this period. Chart 11 shows that, when considered in money terms, the increase in the net liability position between end-1999 and end-2002 is explained by a combination of a US\$777 billion reduction in gross external assets and a US\$730 billion increase in gross external liabilities. In 2003, the reduction in gross external assets recorded in the preceding three years was more than reversed — by a US\$1,251 billion increase. Gross external liabilities rose even more sharply, by US\$1,348 billion.

**Chart 11**  
US gross external assets and liabilities



Source: *International Financial Statistics*.

Chart 10 shows that the United Kingdom's gross external liabilities (a similar picture emerges for gross external assets) remain significantly higher than those of the other major economies considered, when expressed as a percentage of nominal GDP. This reflects in the main the combination of the presence of the City of London in the UK economy (the predominant international financial centre in its time zone) and the relatively open nature of the UK economy, in particular to inward and outward portfolio investment.

### Future initiatives

The statistical community recognises that there are problems in the quality, comparability and availability of

external statistics. While mindful of the need to limit the burden on survey respondents, there are a number of domestic and international initiatives aimed at further improving the quality of external statistics.

Over the next two to three years, both the Bank and the ONS will be providing input into the planned revisions to the IMF's Balance of Payments Manual and the United Nations' System of National Accounts.<sup>(1)</sup> Research has already begun on a number of major conceptual issues. Staff from both organisations are represented on groups of experts set up to consider various topics.

A new reporting form for gold will be introduced at the beginning of 2005. The United Kingdom's Balance of Payments statistics currently include only limited estimates of transactions in non-monetary gold — additional data collection from participants in the London gold market will improve this.

Work has begun on the assessment of the potential implications for financial statistics of new institutional netting arrangements, and of the possible need to look for additional sources of information.

The Special Data Dissemination Standards (SDDS)<sup>(2)</sup> were established by the International Monetary Fund as a guide to the provision of economic and financial data to the public, in the hope of enhancing the availability of timely and comprehensive statistics. In 2003, these were extended to cover external debt statistics.

A new European Commission Balance of Payments regulation comes into force in 2006. This will require the United Kingdom to provide more information on the geographical breakdowns of direct investment flows and stocks. As part of the re-engineering of the foreign direct investment surveys used to collect this information, the ONS will also assess the feasibility of collecting stock data at market prices.

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(1) See footnote 2 on page 490.

(2) Available at <http://dsbb.imf.org/Applications/web/dsbbhome>.