BOPCOM-03/27

Sixteenth Meeting of the
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Analysis of Income in UK BOP

Prepared by the UK Office for National Statistics

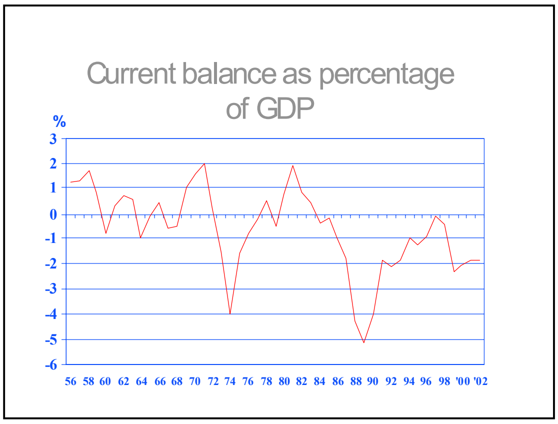
Analysis of Income in UK Balance of Payments

Introduction

1. The paper outlines some of the analyses of investment income that we present to our major users at the conference held on the publication day of each quarterly First Release. We make a fuller presentation, with more discussion, at a BoP User Group meeting held about a week later. The charts and figures in this paper are based on the statistics for Q2 2003 released on 30 September 2003. Compensation of employees is minimal in UK (around 1% of total income credits and debits) so the paper concentrates on investment income. Any comments and suggestions for additional analyses would be most welcome.

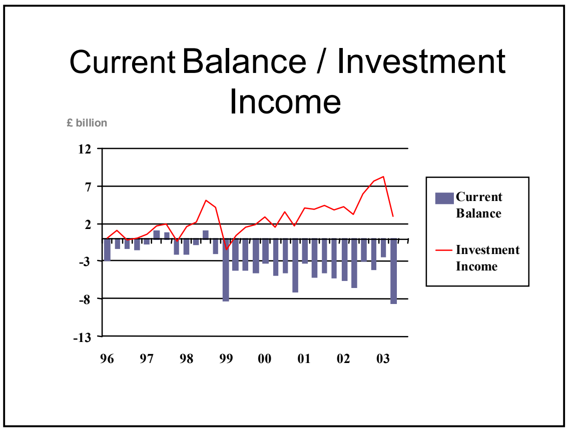
Context

2. This chart puts the size of the latest current account deficit into historical context by plotting it as a percentage of quarterly GDP. This is a commonly used measure of UK current account, rather than simply quoting current price value. The current deficit may seem large in cash terms, but is not so high historically in comparison to the GDP of the economy.



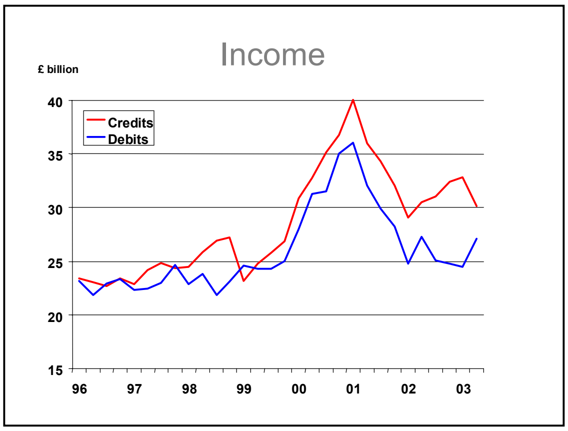
Contribution of Investment Income to Current Account

3. The widening current account deficit in the latest quarter (Q2 2003) is largely due to a sharp fall in the income surplus. Previously the narrowing current account deficit was largely due to an increasing income surplus. So in the last year at least, changes in the income account have driven movements in the headline current account balance. In the longer run, changes in the trade balance have been the main driver of movements in the current account balance.

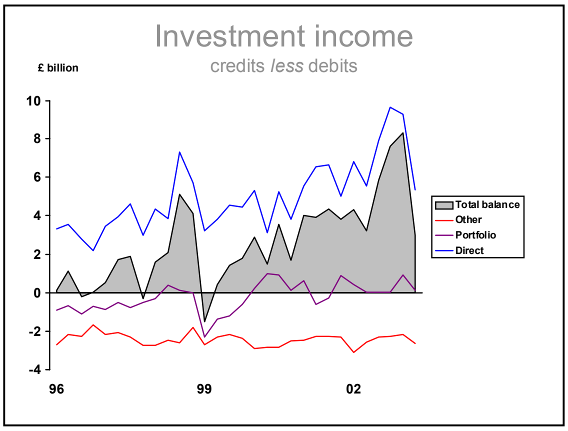


Breakdowns of Investment Income

4. This chart shows total income credits and debits separately. Income flows peaked in 2001 at the end of a period of substantial cross border investment. Income has since dropped, largely due to cuts in interest rates resulting in lower interest earned on debt securities and on deposit and lending activity. Income earned from UK investments abroad dropped sharply during the second quarter of 2003 compared to the first quarter, while income paid on non-resident investments in the UK has increased.

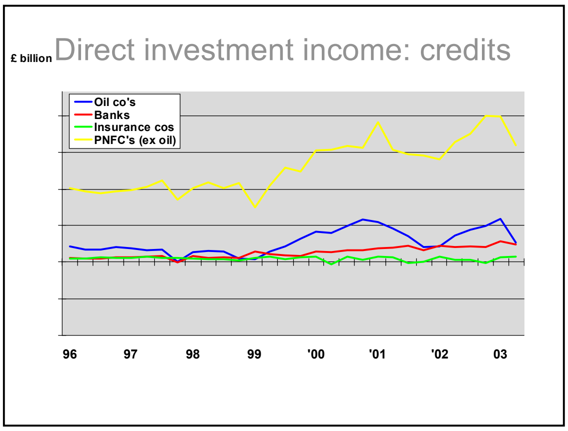


5. The profiles of net income earned on direct, portfolio and other investment are very different. The UK has historically earned more on its direct investments abroad than paid out on foreign direct investment in the UK. The large fall in the direct investment income balance in the latest quarter is largely due to a fall in income from UK outward direct investment. We will now look more closely at this.

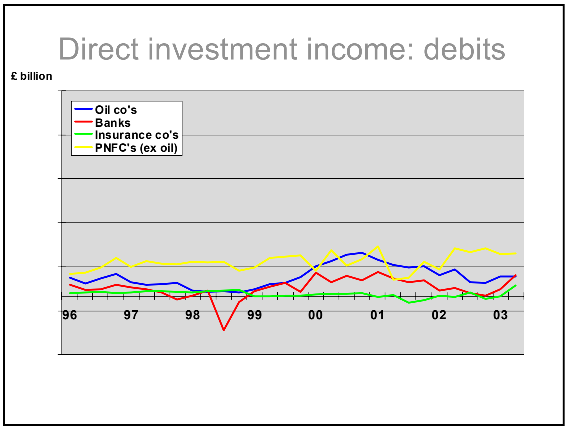


Direct Investment Income

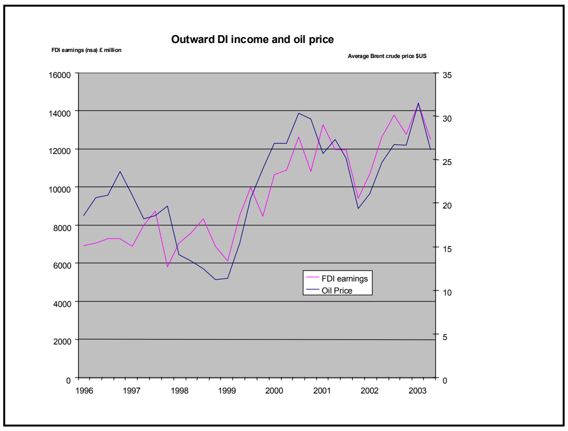
6. This chart looks at a sectoral breakdown of direct investment credits. In the latest quarter the fall in overall income credits has been due to a sharp decline in UK oil and other non-financial companies and, to a lesser extent, UK owned banks earnings from abroad.



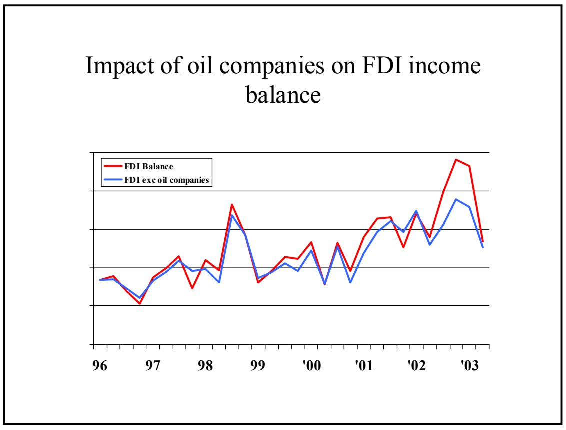
7. The debits chart uses the same scale as the credits chart. There has been a rise in direct investment income debits in the latest quarter, with a rise in foreign-owned banks and insurance companies' earnings in the UK. There is a marked difference between credits and debits in the banking sector. UK owned banks earnings from abroad have fallen, while foreign owned banks in the UK have picked up. The reason is thought to be primarily that foreign owned banks tend to locate in the UK to be close to the London markets and they earn income primarily from market trading rather than retail banking activity. Their profits will increase as market conditions improve. UK banks which invest abroad generally operate in the retail banking sector.



8. This chart shows the correlation between FDI earnings from abroad and movements in the oil price. The close correlation emphasises the importance of the UK oil sector to FDI earnings from abroad. The sharp rise in the oil price since Q4 2001 has been mirrored by a similar pick up in total FDI earnings from abroad. Similarly, the post-Iraq fall in oil price has seen a fall in FDI earnings from abroad.

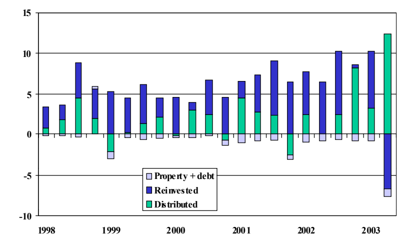


9. The impact of the oil sector can be shown by showing the FDI income balance including and excluding oil companies. Clearly, inward and outward investing oil companies have a very important impact on net FDI. In 2003, changes in oil prices have magnified this impact.



10. This chart shows the component breakdown of net FDI earnings. Reinvested earnings are derived as the difference between total profits and distributed dividends data collected in quarterly inquiries. In recent quarters, the UK has seen a number of companies paying exceptional dividends, which has led to negative reinvested earnings (ie dividends exceed profits). The Joint Eurostat/ECB FDI Task Force recommends that exceptional dividends should be treated as financial account transactions rather than current account. This would eliminate the presentational difficulty.

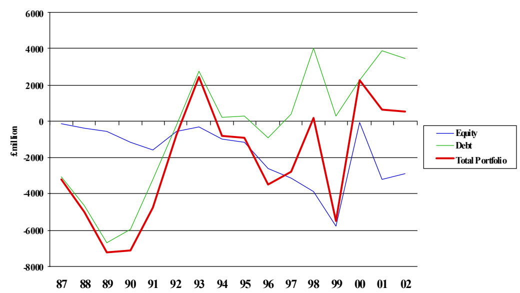
Net FDI earnings by component



Portfolio Investment Income

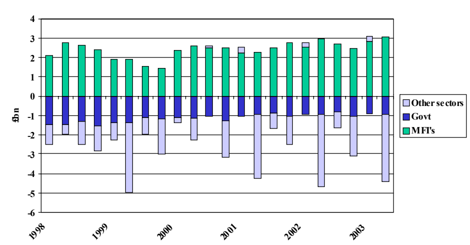
11. The UK has generally recorded a deficit on portfolio investment, with a net surplus on debt securities more than offset by a net deficit on equities. In recent periods a small surplus has been recorded, primarily due to higher UK banks and other financial intermediaries earnings on foreign-issued debt.

Portfolio Investment Income balance

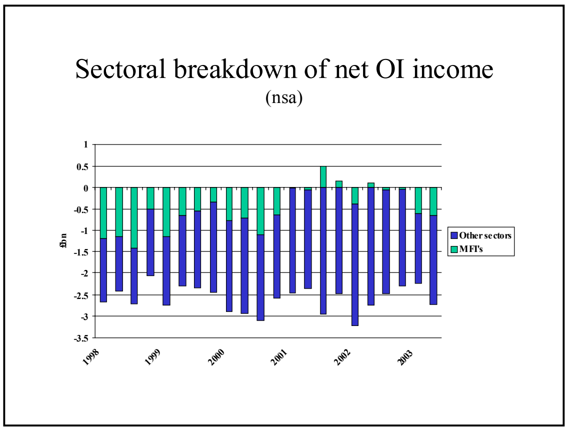


12. UK banks earn a substantial surplus on income received on their holdings over income paid out on their issues. UK banks primarily hold and issue debt (as opposed to equity securities). The Government Portfolio Investment deficit is due to foreign earnings on issues of British government stocks, treasury bills and other debt securities. The seasonality in other sectors' income is largely due to the pattern of payments on UK issued equity securities.

Sectoral breakdown of net PI income (nsa)

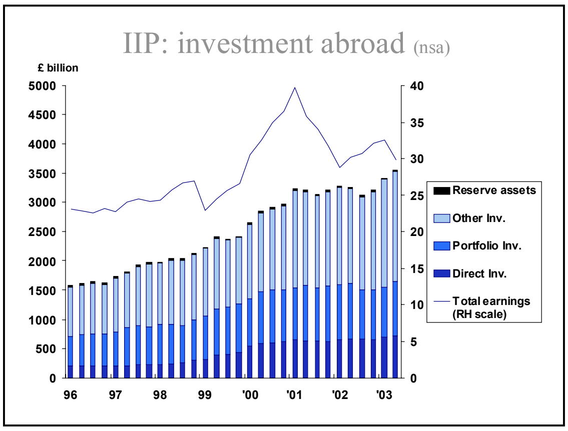


Other Investment Income

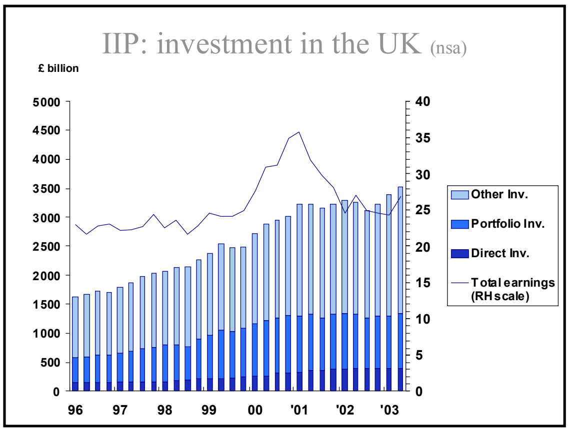


13. The UK deficit on other investment results from a net liability position on loans and deposits.

International Investment Position



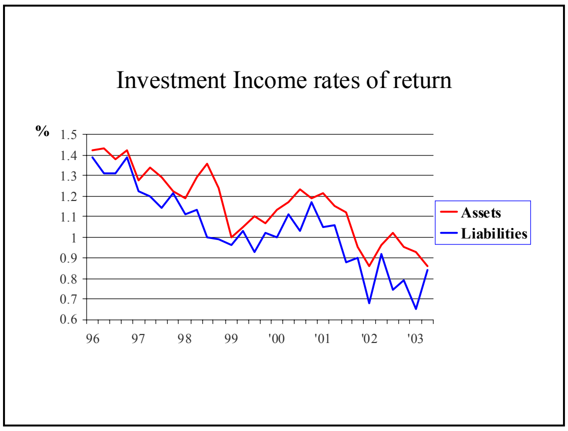
14. This chart shows the quarterly breakdown of UK assets abroad and the income accruing from those investments. The strong increase in UK assets through 1999 and 2000 partly reflects the substantial merger and acquisition activity during this period. Levels of investment were broadly unchanged in 2001to the end of 2002, but 2003 has again seen a sharp increase in the level of UK assets. This time changes in bank deposits and upward re-valuations due to rises in equity prices and a falling pound have been the prime movers.



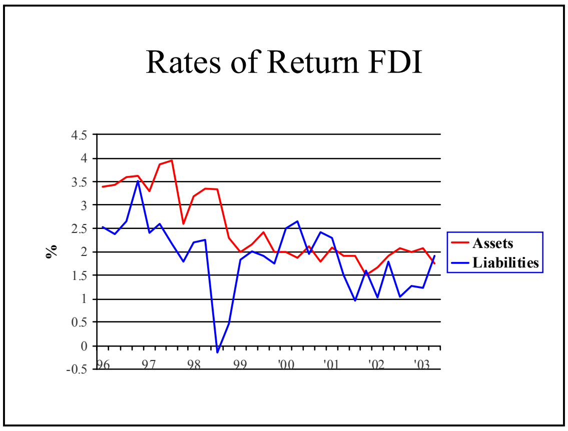
15. This chart shows level of investment in the UK and the income accruing.
The path of both income and balance sheets show a similar pattern as for income credits and assets.

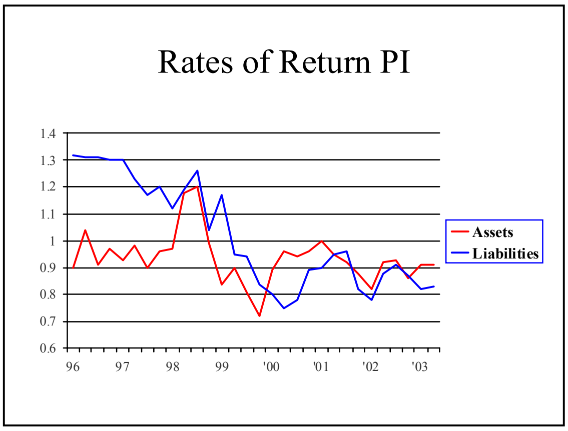
Rates of Return

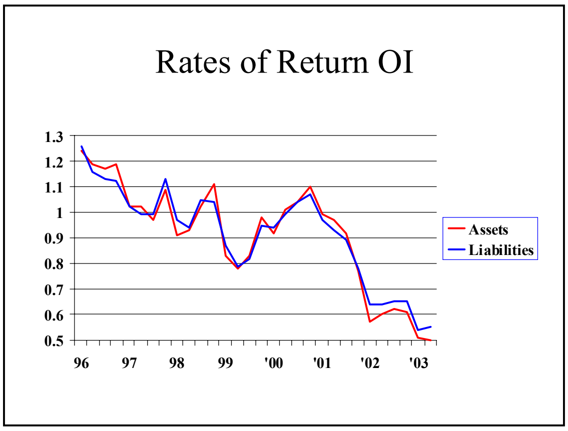
16. The following sequence of charts shows quarterly rates of return for each form of investment. Historically the UK has earned a higher rate of return on its assets than it has paid out on its liabilities (perhaps reflecting the riskier nature of its investments abroad compared to non-resident investment in to the UK). The gap has closed in the latest quarter, primarily due to a rise in inward direct investment earnings. Charts showing rates of return are a crucial part of the validation of the data during the compilation process, as well as giving analytical benefit to users.



17. Higher rates of return are earned on FDI than other forms of investment, largely because stock data are valued at book value rather than market value.



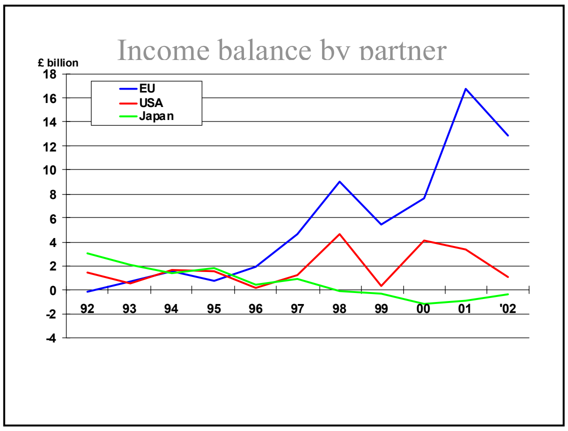




18. Other investments represent the safest forms of investment and therefore they earn the lowest rates of return. The path closely follows movements in market interest rates.

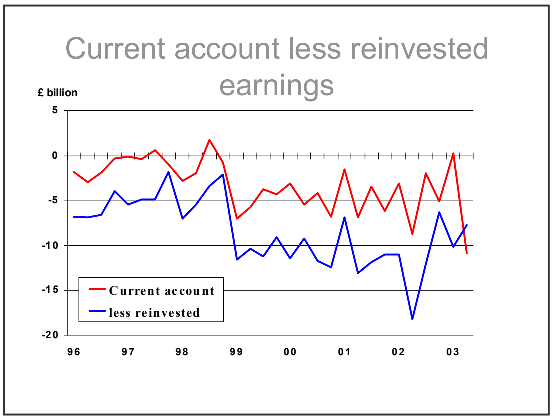
Income by Partner Country

19. Geographical current account data are produced both quarterly and annually. More detailed country breakdowns are available annually. This chart shows the relative UK income balances with EU, US and Japan.



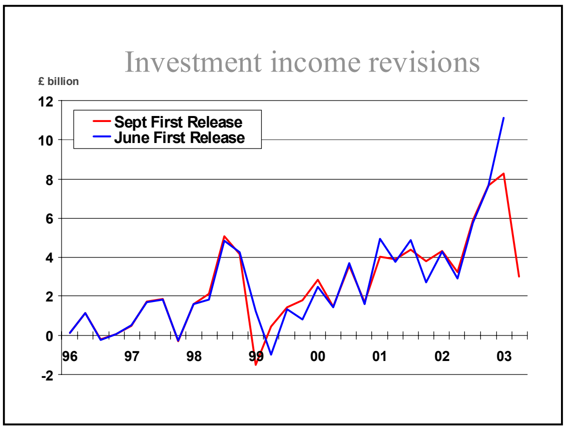
Income less Reinvested Earnings

20. UK generally runs a substantial surplus on reinvested earnings. That is, the current account deficit would generally be substantially wider if reinvested earnings were excluded. UK economists have questioned the validity of including direct investment reinvested earnings in the current account. It has been argued that it is anomalous to include reinvested earnings for direct investment, but not for portfolio investment. Data in the latest quarter show negative net reinvested earnings due to dividend payments exceeding profits for outward investment.



Revisions

21. This chart shows the revisions to the investment income balance between BoP data published in June and September. The most significant revisions are to the first quarter of 2003, which was revised down from a surplus of £5.9 billion when first published in June to a surplus of £3.0 billion in September. The main change was to earnings from direct investment abroad, primarily due to a large multinational changing its own estimates of earnings from abroad.



Users queries

22. A number of queries are raised repeatedly at our meetings with users. They are looking for the concerns to be addressed by the updated BPM. The broad areas are outlined below:

i. direct investment valuation: this is usually at book value whereas portfolio investment is valued at market prices. A market valuation of FDI would very likely change the UK net deficit on IIP. Asymmetrical reporting is a concern, as well as the implicit inconsistency in the data when an FDI acquisition is funded by the issuance of portfolio equity.

ii. the concept, interpretation and analysis of reinvested earnings: users often do not consider reinvested earnings as effective income - for example the earnings cannot offset a trade deficit in practice. Some users feel that the current account is artificially improved. They also point out the inconsistent treatment between FDI and PI - such earnings are ignored in the latter. The interpretation of quarterly reinvested earnings is unclear, and negative reinvested earnings is a difficult concept. Positive reinvested earnings do not represent funds which can be used by an economy, but negative reinvested earnings are funds coming into an economy.

iii. data underpinning the statistics: users ask about the amount of data collected in comparison to broad aggregates imputed and detailed breakdowns (eg by country) using proxy information. They are interested in initiatives to improve the quality of the figures and the trade-off between quality, timeliness and compliance/resources costs. In particular they are interested in learning more about how these trade-offs are set for various data series (are they quantified, or do they just happen), and how priorities are allocated across all the data series.

iv. revisions: users understand that revisions will happen, but they need explanations, advance warnings where possible, and a clear policy on revisions. The validity of quarterly data compared to annual benchmark data is often questioned.