

File E8

FROM: SUSAN OWEN (EA2)
DATE: 12 DECEMBER 1989
Ext : 5385

1. MR ~~OWEN~~ ^{DWO}
2. CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Economic Secretary
Paymaster General
Sir P Middleton
Sir T Burns
Mr Wicks
Mr Scholar
Mr Peretz
Mr Sedgwick o.r
Mr Ilett
Miss O'Mara
Mr O'Donnell
Mr Ritchie
Mr Patterson
Mr Turner
Mr Parkes
Mr Lind
Mrs Chaplin
Mr Tyrie
Mr Lightfoot

BALANCE OF PAYMENTS FIGURES: THIRD QUARTER 1989

These will be published at 11.30am on Thursday 14 December. They include first estimates of the invisibles balance and capital account transactions for the third quarter of 1989 and revised quarterly estimates back to 1986. We should receive the final CSO Press Notice tomorrow. Draft briefing for IDT will follow early tomorrow.

Summary

2. The main points are:-

- (i) The invisibles surplus for 1989Q3 is estimated at £204 million, which combined with a visible trade deficit of £6717 million, gives a current account deficit of £6513 million.

- (ii) This is disappointing compared with the projected invisibles surplus for Q3 of £900 million and projected Q3 current account deficit of £5817 million which were given with the September and October trade figures notices.
- (iii) Revisions to invisibles in earlier periods result in slightly larger current account deficits in 1987 (up £150 million) and 1988 (up £55 million). A bigger deficit in 1989Q2 is offset by a smaller deficit in 1989Q1 giving an almost unchanged position for the first half of the year.
- (iv) The invisibles surplus continues to deteriorate. It averaged about £1.5 billion a quarter in 1988 and 1989Q1 but fell by half a billion to £0.8 billion in 1989Q2 and by about the same amount again in Q3 to £0.2 billion. This is the lowest quarterly figure since 1980Q2 (and before that, 1972).
- (v) The current account deficit in 1989Q3 is £6.7 billion on a not seasonally adjusted basis. On a similar basis, the capital account records net inflows of £5.1 billion, so a balancing item of £1.6 billion is required. This represents unidentified net inflows/unrecorded net exports. It is a reasonably small quarterly figure, but even so, the balancing item for 1989 as a whole is running at an annual rate of £15 billion.
- (vi) The figures include upward revisions in recent years to the estimates of overseas take up of bonds issued by UK companies, and improved estimates of transactions in short term securities. This has resulted in the identification of additional net capital inflows of £1.5 billion on average in years 1986-1988 and downward revisions of a similar magnitude to the balancing item.
- (vii) The CSO's revised projection for the monthly invisibles balance will be published with the November trade figures on 29 December. They have yet to finalise the projection,

but it is clearly likely to be below the £300 million published with the October figures.

Table 1: Balance of Payments Summary

	£ billion									
	1986	1987	1988	1988				1989		
				Q1	Q2	Q3	Q4	Q1	Q2	Q3
Visibles balance	-9.4	-10.9	-20.2	-4.1	-4.5	-5.7	-6.5	-6.0	-5.9	-6.7
Services	6.3	5.7	4.2	1.0	1.2	1.1	0.9	1.0	1.4	1.1
IPD*	5.2	4.8	5.5	1.0	1.5	1.5	1.5	1.2	0.4	0.5
<u>Transfers</u>	<u>-2.1</u>	<u>-3.4</u>	<u>-3.5</u>	<u>-1.0</u>	<u>-0.9</u>	<u>-0.2</u>	<u>-1.4</u>	<u>-0.8</u>	<u>-0.9</u>	<u>-1.4</u>
Invisibles	9.3	7.1	6.2	1.1	1.7	2.4	1.0	1.4	0.8	0.2
Current account	0.0	-3.8	-14.7	-3.1	-2.8	-3.3	-5.5	-4.6	-5.1	-6.5

* Interest, profits and dividends
Deterioration in Invisibles

3. Table 1 shows that whilst invisibles deteriorated by around £½ billion between 1989Q1 and 1989Q2 and again in 1989Q3, the composition of the fall was different in each case.

Table 2: Changes in invisibles balance, £ billion

	<u>1989Q1 to 1989Q2</u>	<u>1989Q2 to 1989Q3</u>
Services	+0.4	-0.3
IPD	-0.8	+0.2
<u>Transfers</u>	<u>-0.1</u>	<u>-0.5</u>
Invisibles	<u>-0.5</u>	<u>-0.6</u>

In the third quarter services have fallen back a little but still show a trend improvement since the low point in 1988Q4. IPD showed a big deterioration in Q2 and in Q1, but actually improved in Q3. Transfers deteriorated the most in Q3, but these are mostly out of our control being made up of net EC payments.

4. In the Autumn Statement forecast we anticipated the deterioration on transfers, and the services surplus has turned out only slightly below expectations. However, the Q3 IPD recovery is weaker than forecast.

Services

5. Although the services balance in 1989Q3 fell to £1.1 billion, the Q2 figure was high, and there seems to be an underlying improvement since 1988Q4. The surplus on services has declined every year since 1985, reaching £4.2 billion in 1988. In the first three quarters of 1989, the surplus is £3.4 billion, and it is unlikely that the year as a whole will not show an improvement on 1988. Within services it is somewhat disappointing that the travel balance remained flat in 1989Q3 after an improvement in Q2. The travel deficit had worsened continuously since 1985 and was the main source of deterioration in the services balance. Circumstantial evidence such as tour operators' provisional bookings suggests that the travel balance will improve sharply in 1990.

IPD

6. Figures for this sector tend to be erratic and are derived in a variety of ways. There is actual data on bank interest payments for example, but the figures for portfolio dividend payments have to be estimated by applying a likely rate of return to estimates of the value of asset stocks.

7. The quarterly balance averaged about £1½ billion through most of 1988 but fell by £1.1 billion over the first half of 1989 to reach a low point of £0.4 billion in Q2. This deterioration was arrested in 1989Q3 with a slightly better IPD balance at £0.5 billion.

8. Table 3 shows that interest payments on bank lending and borrowing have both increased over the last year. This is because net money inflows have risen and because interest rates have risen.

Table 3: Recent interest payments on bank lending and borrowing
 (Sterling and foreign currency), £ billion

	1988 Q3	Q4	1989 Q1	Q2	Q3
Credits (earnings)	8.7	8.8	10.1	10.7	11.1
Debits (payments)	<u>-9.3</u>	<u>-9.5</u>	<u>-11.2</u>	<u>-12.2</u>	<u>-12.6</u>
Balance	-0.6	-0.7	-1.1	-1.5	-1.5

The net effect was a deteriorating balance in 1989Q1 and Q2. However, in 1989Q3 the net effect was unchanged from the previous quarter.

9. Given that a significant proportion of capital inflows are into sterling bank deposits, it is inevitable that high UK interest rates will increase IPD payments overseas. By contrast, a relatively high proportion of UK gross overseas assets are portfolio assets - in particular overseas equities. These earn a relatively low dividend yield, although the total return to the UK investor is higher because there will be a capital gain. But capital gains do not score as a credit (IPD or otherwise) in balance of payments figures.

Transfers

10. The deficit on transfers deteriorated in 1989Q3 by £0.5 billion to -£1.4 billion. This was made up of a fall in receipts from various EC funds following particularly large receipts from the agricultural fund in Q1 and the social fund in Q2. There was also a small increase in bilateral aid payments. Net EC contributions are expected to be substantially lower in 1990, which should reduce the deficit on transfers.

Identified capital transactions

Table 4: Capital Account, £ billion, not seasonally adjusted

Net flows*	1986	1987	1988	(1989) (Q1-3)	1989		
					Q1	Q2	Q3
Direct	-6.5	-10.5	-7.6	(-2.7)	-0.8	1.0	-2.8
Portfolio	-13.7	14.6	-3.9	(-20.8)	-6.8	-6.8	-7.2
Banks net lending abroad							
£	-0.4	3.9	9.0	(9.1)	4.7	-0.1	4.5
Foreign currency	10.5	-1.4	5.6	(7.6)	3.3	-0.9	5.2
Other	3.1	-0.8	2.9	(9.5)	2.6	1.8	5.1
<u>Official reserves</u>	<u>-2.9</u>	<u>-12.0</u>	<u>-2.8</u>	<u>(3.0)</u>	<u>0.5</u>	<u>2.1</u>	<u>0.4</u>
Total	-9.9	-6.2	4.2	(5.7)	3.5	-2.9	5.1

* - sign means net outflows

11. There are three main points to note:

- (i) Direct investment abroad was little changed in the third quarter but overseas investment in the UK fell, producing net outward investment.
- (ii) The continued strength of outward portfolio investment. This will in part reflect further rebuilding of overseas portfolios following the repatriation of assets which occurred after the 1987 stock market crash.
- (iii) The resumed strength of inward net banking flows, in particular sterling (already mentioned in connection with high IPD interest payments). Some commentators will be arguing that this is "hot money" chasing high UK interest rates which reflect the need to "finance" the current account deficit.

New data and balancing item

12. As part of their efforts to reduce the size of the balancing item, the CSO and Bank have identified some additional capital inflows for recent years. In particular these latest estimates include upward revisions to the estimates of overseas take up of UK issued bonds in recent years. Discussions with securities dealers have also resulted in improved estimates of investment in short term instruments.

13. In the first draft of the Q3 balance of payments press notice the CSO had allowed for underrecording of overseas purchases of new corporate bond issues and the corresponding interest payments (IPD). These revisions have been offset to some extent in the final estimates to be published because additional new information on the redemption of such bonds has been included. Consequently the revisions to capital flows and reductions in the balancing item are not as large as we had previously expected. (The effect on IPD is reduced further because the CSO have made some offsetting revisions to the estimated rate of return on these bonds. The net revisions to IPD in recent years are therefore small.)

Table 5: Balancing Item

£ billion, NOT seasonally adjusted

	1986	1987	1988	1989		
				Q1	Q2	Q3
Current account balance	0	3.8	-14.7	-4.4	-5.9	-6.7
Net capital transactions	-9.9	-6.2	4.2	3.5	-2.9	5.1
Balancing item	9.9	10.0	10.5	0.9	8.8	1.6
(Balancing item, previous estimate)	11.0	11.3	12.3	1.2	6.6	

The effect of the new data is nevertheless an improved, ie reduced balancing item in recent years. However, this balancing items remain large at around £10 billion a year. In 1989 the value of unidentified transactions represented by the balancing item are relatively low in Q1 and Q3, but still very large in Q2. Thus the

revisions, though in the right direction, do not significantly improve the overall coherence of the overseas sector accounts.

Assessment

14. The invisibles figures to be published for Q3 are certainly disappointing. But invisibles estimates, particularly for recent quarters, are notoriously unreliable and subject to revision. Whilst investment income IPD has deteriorated from a year ago, it improved slightly in Q3 and there is no reason to expect it to fall further, indeed it is more likely to rise. The deterioration in the exchange rate should increase the value of the UK's overseas assets thereby increasing IPD credits in Q4.

15. The underlying trend in services is upward. The "damage" can be accounted for mainly by transfers which will improve markedly in 1990.

Susan Owen

SUSAN OWEN