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Econ Pol M

Prime Minister

MCS 2/2

Treasury Chambers, Parliament Street, SW1P 3AG
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2 February

M. Scholar, Esq.,
Private Secretary,
10, Downing Street

Dear Michael.

OVERSEAS INVESTMENT AND CAPITAL FLOWS: NEDC(82)9

At this morning's meeting with the Chancellor the Prime Minister asked for a further explanatory note on why it is that a current account surplus brings with it an increase in our net overseas assets (a net capital outflow); and why the abolition of exchange controls reduced the exchange rate even though, after the event, it will not directly have increased the total net capital outflow. This note ... is now attached.

Yours ever
Peter

P.S. JENKINS

Michael Told Peretz OK.

Following our word yesterday, the Chancellor has approved a

~~Your Ref~~ version of this paper for the February EPR - revised to take account of the PM's comments and also to give it a more definite message. He did not want to trouble the PM. But you might like to have a copy as it has gone to the printers. (Message as agreed with J Kerr!)

David Peretz

**with compliments**

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## OVERSEAS INVESTMENT AND CAPITAL FLOWS

There was a discussion of inward and outward investment and capital flows at the meeting of the National Economic Development Council on 3 February. This article is based on the paper submitted to that meeting by the Chancellor of the Exchequer and sets out some of the facts and arguments.

2. It is clear in retrospect that abolition of exchange controls in 1979 not only removed a large unnecessary administrative burden on industry; but also that it was very timely. There was bound to be a sharp increase in outflows of investment by people and companies resident in the UK, as UK investors sought to build up the overseas element of their portfolios to a desired level ~~by residents as UK investors made the adjustment~~ following 40 years of controls. But in the event this came at a time, in 1980 and early 1981, when oil factors would otherwise have carried the exchange rate to even higher levels. Because the exchange rate was thus lower than it would otherwise have been, exports, production, employment and investment have all been helped by the abolition of exchange controls. At the same time, as set out more fully in an article in the January Economic Progress Report, ~~we have~~ Britain has been building up a stock of profitable overseas assets ~~that~~ which will provide a flow of overseas income for the future after the value of North Sea production has begun to decline; and which, in the meantime, will help to balance the outflow of interest and profit from the substantial overseas investments in the North Sea.

Relationship between capital flows and the current account

3. Concern is sometimes expressed about the size of capital outflows in recent years. While the abolition of exchange controls will have affected the composition of these flows and the exchange rate, it will not, directly, have affected their total size. The size of the total net capital outflow is not a cause for concern; on the contrary. Just as when countries run current account deficits they have to draw on their reserves or borrow, so when they are in surplus they necessarily build up their net overseas assets or reduce their overseas debts, in one ~~form~~ ways or another. The net capital outflow for 1981 shown in table 1 below reflects the substantial current account surplus the UK has been running - perhaps £6 billion in 1981 alone - helped by North Sea oil, and

means that as a nation we are increasing our net overseas wealth and paying off debts. Table 3 shows the figures in more detail.

Table 1

£ billion

| | Investment and other capital transactions | Official financing transactions | Current account balance | Balancing item |
|---|---|---|---|---|
| 1970-4 (annual average) | +0.7 | -0.2 | -0.4 | -0.1 |
| 1975 | +0.1 | +1.5 | -1.5 | 0.0 |
| 1976 | -3.1 | +3.6 | -0.9 | +0.3 |
| 1977 | +4.2 | -7.4 | 0.0 | +3.2 |
| 1978 | -4.2 | +1.1 | 0.9 | +2.2 |
| 1979 | +2.2 | -1.7 | -0.9 | +0.4 |
| 1980 | -1.4 | -1.2 | +3.1 | -0.5 |
| 1981 (first 3 quarters only) | -6.2 | +0.7 | na | na |

Note: minus sign means capital outflow, current account deficit.

~~Relationship between capital and current accounts~~

~~3.~~ 4 This is ~~a~~ point that is not always fully appreciated. ~~is that the nature of these flows requires~~ the first three columns in Table 1 should ~~to~~ add to zero; and the fact that they do not do so, and that a "balancing item" is needed, simply indicates that not all transactions have been correctly identified and measured. If as a country we export more than we import, then we necessarily acquire claims on foreigners - either in the form of credit extended to them, or by buying ~~capital~~ assets – or by reducing our overseas debts. ~~from them either abroad (overseas investment or a reduction in overseas debt) or in the UK~~. A net capital outflow and increase in the nation's overseas wealth is thus the automatic counter-part to a current account surplus. This increase in ~~Such an outflow increases~~ the UK's holdings of net external assets which ~~and either~~ will reduce~~s~~ future current account payments on servicing overseas debts, or add~~s~~ to the future flow of interest, profits and dividends from abroad.

~~2.~~ 5 If exchange controls inhibit certain forms of capital outflow such as overseas portfolio investment, then the exchange rate will be forced up to the point where it induces different kinds of outflow (eg withdrawal of non-resident funds), or a lower level of exports and reduced current account surplus. When official intervention was used to limit the rise in the exchange rate, then the outflow took the form of an addition to the ~~assets~~ portfolio of overseas securities held in the o/f foreign currency reserves rather than private sector overseas investment. Abolishing exchange controls has not therefore affected the total net capital outflow, except to the extent that a higher exchange rate ~~would have meant~~ might in due course have lead to a smaller current account surplus, but the composition of the capital account outflow will have been changed.

## Direct investment abroad

6 Direct investment abroad means investment by UK companies in the operations of their overseas branches, subsidiaries and associates. One effect of exchange controls was to require most of such investment to be financed by foreign currency borrowing (or retained foreign earnings). This rule was not designed to discourage investment, but to protect the exchange rate and the official foreign currency reserves. An early effect of exchange control abolition was that many companies were able to repay foreign currency loans previously raised to finance overseas investment. But, as expected, there has probably been little impact on the level of overseas direct investment itself, (with the figures for 1980 and 1981 showing only a fairly modest rise from the 1978-79 level) (See ~~Annex~~ Table 3, column 2).

~~8~~7 ~~There are reasons to suppose that~~ This continuing flow of direct investment overseas brings benefits to industry and UK employment in addition to the expected flow of future profits and dividends from abroad. Most ~~of our major trading partners~~ other developed countries have reached a similar conclusion. Much of such investment will complement rather than substitute for UK production. In some cases it helps promote UK exports by establishing sales and distribution networks and providing personnel links with UK firms and also by bringing orders for UK machinery and components. In some cases countries require exporters seeking export orders to invest in their country, particularly if large projects are at stake. And in other cases the alternative to investment by UK firms in overseas manufacturing capacity, where there is a profitable opportunity, will be similar investment by one of our overseas competitors, with a consequential loss of export markets to the UK.

## Other capital outflows

~~4~~8. Most other capital outflows on the part of UK residents were tightly controlled before 1979, although non-resident flows were not controlled and large changes in leads and lags on trade payments were possible. Overseas portfolio investment had to be financed either by foreign currency borrowing or through the investment currency market, and it was illegal for UK residents to hold foreign currency bank notes or deposits (or to engage in forward exchange market transactions) without permission. These controls, which had been in existence since the start of the last war, were used to help defend the fixed exchange rate for sterling in the period up to the early 1970's.

8. The removal of exchange controls allowed residents (including financial institutions) to increase the proportion of net foreign currency assets in their portfolios. In principle there might be both temporary and continuing effects on the flow of new investment abroad: a temporary (or stock-shift) effect as investors make up for a low level of investment in the past; and a continuing (or flow) effect thereafter as a larger porportion of new saving is invested overseas. The continuing flow effect is likely to be much smaller than the initial stock-shift effect. For this reason, the early impact of abolishing controls on overseas investment flows is unlikely to be a good guide to the flows that will continue into the longer term.

9. In the event perhaps the most obvious effect on the balance of payments of relaxing exchange controls has been the large outflow of portfolio investment (see Annex, column 1). This appears to have taken some time to build up, perhaps as institutions adjusted to the new freedom, but was running at the rate of over £4 billions a year during the second half of 1980 and the first half of 1981. Although there remains a great deal of uncertainty about the scale of future portfolio outflows, these figures are probably mainly the result of a once-and-for-all adjustment, following 40 years of control. Net UK bank lending overseas (Annex , columns 4 and 5) has also increased, although the increased sterling lending overseas has been partly matched by a related growth in overseas sterling deposits in the UK, as the euro-sterling and domestic sterling markets have become more integrated. This reflects continued development of London's business as an international banking and financial centre.

Effect of outflows on the domestic economy

(a) The exchange rate

10. These developments meant that the exchange rate was lower than it would otherwise have been in 1980 and in 1981. For much of the period, of course, other upwards pressures on the rate more than offset this effect: but without it, the rate would have risen higher than it did. The UK current account has been in massive surplus over the last two years, helped by the build up of North Sea oil production. There had to be a corresponding capital outflow as the counterpart to such a surplus. Removing controls on private capital outflows facilitated this adjustment, reducing the upward pressure on the exchange rate.

10. In the event perhaps the most obvious effect on the balance of payments of relaxing exchange controls has been the large outflow of portfolio investment (see Table 3, column 1). This appears to have taken some time to build up, perhaps as institutions adjusted to the new freedom, but was running at the rate of over £4 billions a year during the second half of 1980 and the first half of 1981. These large figures reflected a once-and-for-all adjustment, following 40 years of control, as financial institutions sought to reach a desired spread of investments round the world. There will be a natural ~~national~~ limit to this adjustment process, which is of course to the benefit of the pensioners and others who invest through these institutions. Table 2 below shows the proportions of new investment flows by the major investing institutions - insurance companies and pension funds - going abroad, into UK company securities and into British government securities during 1979, 1980, and the first three quarters ~~half~~ of 1981. In practice the increase in proportion of funds going abroad even during the 1980-1981 period of once and for all adjustment in portfolios ~~balance seems to have~~ has had little impact on ~~either~~ the ~~level or~~ proportion of funds going into British shares ~~UK equities.~~

Table 2 →

11. Net UK bank lending overseas (Table 3, columns 4 and 5) has also increased, although the increased sterling lending overseas has been partly matched by a related growth in overseas sterling deposits in the UK, as the euro-sterling and domestic sterling markets have become more integrated. This reflects continued development of London's business as an international banking and financial centre.

## Effect of outflows on the domestic economy

### (a) The exchange rate

12. Although as noted above the total net capital outflow will not have been directly affected by the abolition of exchange controls, it will have had a different composition. The outflow of resident funds, pent up for 40 years, will have taken place at

Table 2

% of new net investment going to:-

| | Overseas investment | UK company shares | British Government securities |
|---|---|---|---|
| **Insurance companies (long term funds)** | | | |
| 1979 | 2.0 | 14.9 | 55.1 |
| 1980 | 11.3 | 14.9 | 39.5 |
| 1981 (first 3 quarters) | 14.5 | 13.8 | 40.2 |
| **Superannuation funds** | | | |
| 1979 | 8.2 | 26.8 | 41.0 |
| 1980 | 21.6 | 32.1 | 32.2 |
| 1981 (first 3 quarters) | 23.5 | 26.9 | 31.8 |

a lower exchange rate than would have been required to induce a corresponding withdrawal of non-resident funds had exchange controls not been abolished. So, the exchange rate was lower than it would otherwise have been in 1980 and in 1981. For much of the period, of course, other upwards pressures on the rate more than offset this effect: but without it, the rate would have risen higher than it did. The UK current account has been in massive surplus over the last two years, helped by the build up of North Sea oil production. There had to be a corresponding capital outflow as the counterpart to such a surplus. Removing controls on private capital outflows facilitated this adjustment, reducing the upward pressure on the exchange rate.

13. Although the ending of exchange controls has thus had the effect of smoothing the impact of current account influences on the exchange rate, it is sometimes argued that it may have made the rate more sensitive to financial influences such as international interest rate differentials, and hence more volatile. The evidence is inconclusive. There has been an

increase in volatility in most major currencies in the period since mid-1979 compared with the immediately preceding period. This is no doubt associated with the worldwide growth in internationall mobile funds after the 1979 oil price rises. As to the impact in the UK of abolishing exchange controls, it is important to remember that even when tight exchange controls were in place, small changes in the timing of payments for imports and exports and changes in non-residents' investments in sterling could make the exchange rate extremely volatile, as they did during 1976 and 1977. Moreover the flows which were liberalised - notably portfolio outflows - seem in practice to have been stable, and also to have had a stabilising influence (since they have tended to be largest in the quarters when sterling has been strongest).

(b) Interest Rates

14. Exchange controls restricted access to overseas securities by UK residents and for this reason may have allowed UK interest rates to be marginally lower (and security prices higher), relative to those abroad, than they would otherwise have been. Removing the controls will have reduced the demand of UK residents for UK assets, but it is likely that the net effect on interest rates has been small, for two main reasons:

(i) Non residents have always been able to move their funds freely between UK and overseas assets; this will have tended to keep expected returns in the UK in line with those overseas, even when exchange controls were in force.

(ii) The UK monetary authorities need to sell a lesser quantity of public sector debt to maintain any given degree of domestic monetary stringency. Thus the supply of UK public sector debt is reduced as well as the demand for it.

(c) Domestic activity and investment

15. Although it is difficult to be certain, the net effect of removing exchange controls has probably been beneficial for domestic activity. The exchange rate will have been lower and the international competitiveness better than otherwise, tending to sustain the level of activity. On the other hand interest rates may have been a little higher, tending to work in the opposite direction. But for the internationally exposed sectors of the economy, including manufacturing industry, the effect with the major once and for all outflows following the abolition of controls has almost certainly been beneficial, coming at just the right time to help ~~helping these~~ industries to adjust to the impact of North Sea oil at a time of rising world oil prices by moderating the associated rise in the exchange rate.

16. The lower exchange rate will have helped increasing the profitability of industry, especially in the internationally exposed sectors; and thus will certainly have helped rather than hindered domestic investment.

Investment in the UK was not helped by 40 years of rigid exchange controls, and will not have been damaged by their abolition. Increased investment depends on increased profitability. In this respect.

Conclusion

15. Most direct investment overseas probably helps complement UK exports and investment. Such investment was little inhibited by exchange controls, nor, following their abolition, has its level ~~significantly~~ greatly increased.

16. Abolishing exchange controls will not have increased total net capital outflows, except to the extent that by reducing the exchange rate it may have increased the current account surplus. But it will have changed the composition of these flows; outward portfolio investment has increased in particular. The net effect of this on the economy is hard to assess. But the results have been:-

(a) A smaller rise in the sterling exchange rate in 1980-81 than we would otherwise have experienced, at a time when oil factors in particular were carrying the rate to high levels.

(b) Perhaps some marginal upwards impact on interest rates.

(c) As a net result of (a) and (b), levels of output, investment and employment which are probably higher than they would otherwise have been, particularly in internationally exposed sectors of industry.

17. At the same time, by increasing profitable investment abroad through the private sector, the nation is building up an important source of overseas earnings that will continue to produce benefits beyond the period of peak North Sea production.

H M Treasury
22 January 1982

Table 3 ~~ANNEX~~

## BALANCE OF PAYMENTS FLOWS

£ billion

| | (1) | (2) | (3) | (4) | (5) | (6) | (7) | (8) | (9) | (10) |
|---|---|---|---|---|---|---|---|---|---|---|
| | UK Private Investment Overseas | | | UK banks external sterling lending (net of repayments) | UK banks external foreign currency borrowing or lending | Overseas investment in UK private sector | Other | TOTAL investment and other capital transactions | Official financing including allocation of SDR's | Current account balance |
| | Portfolio | Direct | Oil & Misc. | | | | | | | |
| Average 1970-74 | 0.0 | -1.0 | -0.2 | 0.0 | +0.3 | +1.1 | +0.4 | +0.7 | -0.2 | -0.4 |
| 1975 | -0.1 | -1.1 | -0.1 | +0.1 | +0.3 | +1.5 | -0.4 | +0.1 | +1.5 | -1.7 |
| 1976 | +0.1 | -2.1 | -0.2 | -0.3 | -1.0 | +1.9 | -2.3 | -3.1 | +3.6 | -0.9 |
| 1977 | 0.0 | -1.9 | -0.5 | +0.1 | +0.4 | +3.0 | +3.1 | +4.2 | -7.4 | 0.0 |
| 1978 | -1.1 | -2.7 | -0.8 | -0.5 | -0.4 | +2.0 | -0.7 | -4.2 | +1.1 | +0.9 |
| 1979 | -0.9 | -2.8 | -2.9 | +0.2 | +1.6 | +3.4 | +3.5 | +2.2 | -1.7 | -0.9 |
| 1980 | -3.1 | -2.6 | -1.4 | -2.5 | +2.0 | +4.2 | +1.9 | -1.4 | -1.2 | +3.1 |
| 1981 Q1 | -1.3 | -1.0 | -0.4 | -1.2 | -0.6 | +0.6 | +0.7 | -3.3 | -0.2 | na |
| Q2 | -1.0 | -1.0 | -0.4 | -0.4 | -0.8 | +1.3 | +0.4 | -1.9 | +0.2 | |
| Q3 | -0.8 | -1.0 | -0.3 | -0.8 | +0.1 | +0.9 | +0.9 | -0.9 | +0.7 | |

NB. If all transactions are correctly and comprehensively recorded the current account balance necessarily equals total investment and other capital flows plus official financing.

5 FEB 1982

ANNEX C

OVERSEAS INVESTMENT AND CAPITAL FLOWS

SPEAKING NOTE FOR CHANCELLOR

To help the discussion today, I have circulated a paper that both sets out the facts about capital outflows in recent years, and assesses what the implications have been. The overall picture and the ways that the different flows interact are not, I think, as widely understood as they might be, so I welcome this opportunity for a discussion in NEDC.

2. By way of introduction let me stress the main points that the paper brings out.

3. First, the current account of the balance of payments has been in very substantial surplus (perhaps £6-7 billion in 1981 alone). Everyone understands that when we are running a deficit we have to rundown our reserves or borrow. Similarly when the current account is in surplus we necessarily build up our net overseas assets, by increasing the reserves, reducing past borrowing or by investing overseas. The net capital outflow is thus not a cause for concern: on the contrary, it reflects the current account surplus; and means that as a nation we are increasing our net overseas wealth.

4. Secondly, it follows that abolishing exchange controls will have made no difference, directly at least, to the net capital outflow. The main effect of allowing new forms of outflow will have been an exchange rate lower than it would otherwise

have been. At the same time any fall in UK securities prices [illegible] consequential upwards impact on interest rates is likely to have been small. Particularly for the internationally exposed sectors of industry the net effect will certainly have been helpful to employment, output and investment.

5. In retrospect it is clear that we got the timing of abolition almost precisely right. Certainly we did well not to delay. The main stock adjustment, as domestic investors sought to make up for 40 years of control, came at a time when oil factors in particular would otherwise have carried the exchange rate to even higher levels. I would commend the episode as a good example of the indirect as well as direct benefits to the economy of abolishing outdated bureaucracy and control.

6. Finally, it is worth recalling that North Sea production has now built up to near its maximum level. The overseas assets we are acquiring will provide a flow of overseas income in future after the value of North Sea production has begun to decline. [I do not pretend these assets are a substitute for the greater profitable investment we need at home. But I hope that by the end of today's discussion we might be able to agree that they are a useful complement].