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Geographical breakdowns of UK International Investment Position statistics

By

Simon Humphries
Office for National Statistics, UK

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Summary

This paper presents a geographical breakdown of the United Kingdom's international investment position statement for 2001 and 2002 and suggests some analytical uses for the data. It describes the data sources used and assesses their reliability, outlining the international improvements made to portfolio investment data collection in particular. Finally it presents the UK data, offering some analytical comment, concluding that the real analytical benefits of such data will grow as the time series develop.

Introduction

Conceptually, the balance of payments, including the international investment position (IIP), form part of the broader system of the United Kingdom (UK) national accounts. In the UK, the balance of payments and IIP are compiled at the same time as the national accounts and are equivalent to the rest of world sector within the UK sector accounts.

Traditionally user interest has focused on a country's overall balance of payments statement with the rest of the world, with the main focus on the headline current balance. Recently, however, user interest has expanded toward analysis of more detailed diasaggregations of the current balance and IIP. In particular, there is a growing body of users who are increasingly interested in geographical breakdowns of the balance of payments IIP aggregates. This paper describes how the availability of geographical information has expanded in the UK in recent years to meet the increased user demand for such data, and discusses the analytical value of the data. The paper focuses on the compilation and analysis of geographical breakdowns of UK international investment - in particular the IIP.

What is the International Investment Position?

The international investment position brings together the estimates of the levels of UK external assets (foreign assets owned by UK residents) and UK external liabilities (UK assets owned by foreign residents) at the end of each calendar year. Changes in balance sheet levels will reflect not only transactions in the corresponding assets and liabilities but also changes in valuation and certain other changes.

Changes in valuation will occur in the following circumstances:

(i) where assets and liabilities are denominated in foreign currencies, their sterling value may change because of changes in foreign exchange rates;

(ii) where assets and liabilities are regularly bought and sold (e.g. British government stocks, UK and foreign company securities), the current market value may be different from the value at which they were acquired;

(iii) where the holders of assets and liabilities change their values in preparing their accounts to reflect what is thought to represent the current position (e.g. bad debts may be written off and direct investment assets may be written up or down in the books of the investing company).

Analysis of the IIP as part of the overall assessment of the financial stability of the economy is well established in the UK. Following the financial crises in East Asia, Russia and Latin America in the late 1990's, analyses of a country's IIP has attracted increased attention. Although advanced industrial economies, with highly developed financial markets such as the UK, may not face the same risks as developing economies, they do deserve further analysis. Until now the analysis has focused on the overall size of the external assets and liabilities, type of investment and the sectoral breakdown of the assets and liabilities. In addition, for the banking sector, information on the nationality and currency of the liabilities is also available. A full geographical breakdown of UK assets and liabilities has not been available before now, but is seen as of particular use in assessing the risks associated with external positions.

What is it about external positions that might cause their impact to differ from that of purely domestic exposures? The Bank of England in their most recent assessment of financial stability[1], highlight a number of potential impacts. Perhaps most importantly, external positions expose domestic institutions to non-resident risks. Although non-resident exposures allow domestic investors to diversify their asset portfolios and their sources of finance, they become exposed to a broader array of potential macroeconomic shocks. In addition, non-resident financing may be less reliable than dependence on the domestic financial services industry, especially if assets and liabilities are not perfectly hedged for currency changes. 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 large net foreign currency liability, can have stark implications for debt sustainability.

Clearly, to assess the risk, policy makers require information on the overall size of the external assets and liabilities, but also a disaggregation by country, currency and maturity to be able to identify concentrations of exposure and assess the risk of individual positions. For the UK, total assets and liabilities are available by type of investment, with only limited currency breakdowns available. The information presented here on the geographical breakdowns of the UK assets and liabilities by type of investment is therefore an important addition to the information available to assess the risk posed by the UK's exposure to non-resident risks.

Geographical breakdown of the UK's International Investment Position

The UK has compiled a detailed geographical breakdown of the current account and its components for several years. A detailed annual breakdown, broadly in line with level 3 of *Eurostat's vade mecum*[2] is published around 9 months after the reporting year in the *Balance of Payments Pink Book*[3]. A more limited quarterly breakdown with the UK's main partner countries - the USA, the European Union, Japan and Canada - is also published within 3 months of the end of the reporting period in *United Kingdom Economic Accounts (UKEA)*[4].

In response to user demand, the UK started to compile a geographical breakdown of the international investment position dataset from 2001. An article describing the data sources, methodology employed and results for 2001 and 2002 was published in the June 2004 edition of *Economic Trends*[5].

Reliability

Data compiled on a regional basis for stocks of financial assets and liabilities should be geographically allocated on the basis of the issuer principle. That is, financial claims of the UK are allocated to the country of residence of the non-resident debtor (or issuer), and liabilities are allocated to the country of residence of the non-resident creditor (or holder). Geographical breakdowns of portfolio investment are particularly difficult to allocate correctly to the country of residence of the owner or issuer of the security, as the transactions are often made through financial intermediaries.

A further difficulty for the UK stems from the recording of direct investment stock data at book value, rather than the market valuation recorded for other forms of investment. In principle, all assets and liabilities should be measured at market prices. For direct investment, however, market values are often not available, so book values are reported instead. These will often underestimate the true market of direct investment assets and liabilities.

Data sources

Geographical breakdowns of levels of foreign *direct investment* abroad (UK assets) and foreign direct investment in the UK (UK liabilities) are derived from the annual inquiries to outward and inward investors in the UK. The analysis of foreign direct investment in the UK, or inward investment, is based on the country of the immediate foreign parent company, except for banks where the information relates to the country of residence of the ultimate owner. For non-banks therefore, where foreign investment in the UK is channelled through holding companies in a third country, the underlying level of investment from this country is overstated and the level from originating countries is understated. Data for the Netherlands are probably overstated due to the practice of routing investment via Dutch-resident "Special Purpose Entities". The country analysis of foreign direct investment abroad, or outward investment, is based on the country of residence of the foreign affiliate published in the annual *Foreign Direct Investment Business Monitor - MA4*[6] (ONS 2004).

Information on the geographical breakdown of UK holdings of *portfolio investment* assets is based on the UK contribution to the IMF's Co-ordinated Portfolio Investment Survey (CPIS) exercise (see Box for more detail). Banking data are obtained from existing Bank of England quarterly surveys that include a geographical analysis of portfolio investment assets. For non-banks, a geographical breakdown of portfolio investment assets was added to existing quarterly and annual surveys to meet the requirements of the CPIS from 2001.

Information on the geographical breakdown of UK portfolio investment liabilities has been based on other countries' participation in the CPIS exercise. The IMF act as a central clearing house for the compilation of aggregate data from countries that have participated in the CPIS and disseminate the information to BoP compilers. In this way, the UK receives information about all participating countries on their holdings of UK issued securities. This

Coordinated Portfolio Investment Survey (CPIS) - background

The CPIS was launched by the International Monetary Fund (IMF) in response to the recommendations contained in the "Report on the Measurement of International Capital Flows"[1], published in 1992. The report highlighted the increasing importance of portfolio investment across international borders, reflecting the liberalisation of financial markets, financial innovation, and the changing behaviour of investors. The increased liberalisation brought measurement difficulties, which have been reflected in the imbalances between global financial assets and liabilities. If perfectly measured, assets and liabilities should be equal, but recorded liabilities have consistently exceeded recorded assets.

The CPIS was established by the IMF in order to address this problem by improving statistics of holdings of portfolio investment assets in the form of equity, long-term debt and short-term debt. The objectives are:

- To collect comprehensive information, with geographical detail on the country of residence of the issuer, on the stock of cross-border equities, long-term bonds and notes and short-term debt instruments. This information can be then be used to help validate the international investment position statistics (IIP) and check recorded portfolio investment financial flows and associated investment income recorded in the balance of payments.
- To exchange bilateral data via the IMF Statistics Department in order to improve estimates of non-resident holdings of portfolio investment liabilities, together with associated financial flows and investment income estimates. Although the initial sale is recorded, portfolio investment liabilities are often not allocated to the country of residence of the acquirer. This is because subsequent transactions are often not known by the original issuer.

By compiling more accurate statistics on each country's portfolio investment assets, it was hoped that the global imbalance would be reduced.

The first CPIS was conducted in 1998, in respect of positions held at end 1997. 29 countries participated, including the UK, with results published by the IMF in December 1999. Following the 1997 exercise a Task Force reviewed the results and recommended that the survey be repeated on an annual basis with participation expanded to include all important investing countries and a number of offshore financial centres.

63 investing countries participated in the 2001 exercise and around 70 in 2002.

counterpart information has been used to derive the geographical breakdown of UK liabilities, with some assumptions made to account for non-participants in the CPIS exercise.

Geographical breakdowns of *other investment* are based on banking data supplied to the Bank of England and from information on UK private sector loans and deposits reported by foreign banks in the Bank for International Settlements reporting area.

Analysis

Table 1 presents a summary of the geographical breakdown of total UK external assets and liabilities and the net international investment position as at end-2001 and end-2002. At end-2002, of total reported assets of £3133.4 billion, nearly half reflected UK investments in the EU and a further 20 per cent investments in the USA. While the total UK investment in the EU rose between 2001 and 2002, the level of UK investments in the USA fell over £100 billion to £628.3 billion. The rise in the value of EU assets and fall in the value of US assets can partly be attributed to exchange rate changes in 2002. While a currency breakdown of financial assets and liabilities is not available, the majority of US and EU assets can assumed to be denominated in their domestic currency - the dollar and (broadly) the euro. Between the end of 2001 and end-2002, the pound sterling rose over 10 per cent against the dollar, but fell 2.5 per cent against the euro. Therefore, disregarding any changes in the pattern of investment, these changes will lead to a fall in the value of dollar denominated assets and a rise in the level of euro-denominated assets when they are converted to sterling values.

Around 12 per cent of UK assets consisted of investments in Asia, with Japanese investments accounting for well over half of the total. Investments in Australasia, Africa and International Organisations together, accounted for less than 3 per cent of total UK assets.

UK liabilities are also highly concentrated in the EU and USA. Of total reported liabilities of £3185.8 billion at the end of 2002, around 40 per cent reflected EU investments in the UK, up from around a third in 2001. US investments in the UK declined to £719 billion, although still were the major foreign investor into the UK. Asian countries investments in the UK totalled £448 billion or around 14 per cent of total liabilities. Australasia, Africa and International Organisations investment together accounted for less than 3 per cent of total liabilities.

Table 1: Summary of geographical breakdown of assets and liabilities

£billion

	2001			2002		
	Assets	Liabilities	Net	Assets	Liabilities	Net
Euro Area	1358.9	1033.9	325.0	1395.9	1185.5	210.4
of which						
Belgium and Luxembourg	183.6	144.7	38.9	187.9	163.1	24.8
France	208.0	160.3	47.7	216.0	184.7	31.3
Germany	294.0	263.5	30.5	300.5	302.6	-2.2
Ireland	100.1	108.6	-8.6	124.7	137.4	-12.8
Italy	138.3	68.3	70.0	130.9	76.2	54.7
Netherlands	305.6	210.2	95.4	308.3	225.6	82.7
EU15	1441.7	1120.8	320.9	1480.0	1273.5	206.5
Switzerland	159.5	241.3	-81.8	154.7	247.8	-93.1
Total Europe	1729.6	1610.8	118.8	1770.2	1779.2	-9.0
United States of America	736.0	819.1	-83.0	628.3	718.7	-90.4
America	929.7	1000.7	-71.0	828.9	870.0	-41.2
Japan	224.9	217.7	7.3	227.3	206.6	20.7
Asia	405.7	531.4	-125.7	385.1	447.7	-62.6
Australasia & Oceania	54.4	29.1	25.3	50.7	28.2	22.5
Africa	22.6	48.4	-25.8	24.4	44.8	-20.3
International Organisations	10.0	15.5	-5.5	15.6	15.9	-0.2
Reserve Assets/Unallocated	54.2			58.3		
World Total	**3206.2**	**3236.0**	**-29.8**	**3133.4**	**3185.8**	**-52.4**

On balance, the UK had a net asset position with the EU, and Australasia, but net liability positions with Europe, the Americas, Asia and Africa.

A limited geographical breakdown by type of investment is also presented, to support the more detailed geographical analysis of total assets and liabilities. Table 2 shows that the value of UK's portfolio investment assets has generally declined between 2001 and 2002, primarily due to the fall in world stock markets. The value of direct investment in the US has declined between 2001 and 2002, mainly reflecting valuation changes following falls in the value of the dollar, rather than any significant disinvestments.

Table 2 - assets

ASSETS

£bn	2001				2002			
	Direct	Portfolio	Other	Total	Direct	Portfolio	Other	Total
Euro-area	326	361	672	1359	313	345	738	1396
of which								
Belgium & Lux	73	22	88	184	70	25	93	188
France	26	76	107	208	32	59	125	216
Germany	15	86	193	294	14	79	207	301
Ireland	24	13	63	100	29	26	70	125
Italy	4	67	66	138	4	66	61	131
Netherlands	171	50	84	306	153	50	105	308
Total EU	340	398	704	1442	327	382	771	1480
Switzerland	15	22	122	160	18	20	116	155
Total Europe	383	441	905	1730	372	428	970	1770
USA	150	244	342	736	120	211	298	628
Canada	11	15	25	51	8	12	30	50
Total America	184	310	435	930	151	270	408	829
Japan	3	74	148	225	3	51	173	227
Total Asia	32	130	243	406	29	89	267	385
Australasia	16	21	18	54	12	21	17	51
Africa	9	4	10	23	11	4	9	24

NOTE: totals may not be sum of components due to rounding

Table 3 - liabilities

LIABILITIES

	£bn	2001			2002			
	Direct	Portfolio	Other	Total	Direct	Portfolio	Other	Total
Euro-area	155	278	600	1034	163	324	698	1186
of which								
Belgium & Lux	5	50	90	145	7	54	102	163
France	37	47	76	160	37	53	95	185
Germany	36	50	177	264	43	49	210	303
Ireland	4	60	45	109	5	84	49	137
Italy	7	23	38	68	6	22	48	76
Netherlands	64	28	118	210	61	32	133	226
Total EU	163	314	644	1121	170	361	742	1274
Switzerland	10	17	214	241	10	17	220	248
Total Europe	180	384	1047	1611	185	435	1159	1779
USA	148	346	324	819	136	297	286	719
Canada	9	15	16	40	9	13	13	34
Total America	163	375	462	1001	150	321	400	870
Japan	16	76	126	218	17	66	124	207
Total Asia	25	160	346	531	25	106	317	448
Australasia	12	7	10	29	8	7	14	28
Africa	1	16	31	48	1	14	30	45

NOTE: totals may not be sum of components due to rounding

Table 3 highlights the higher levels of euro-area investment in the UK across all forms of investment between 2001 and 2002. In contrast, the level of US direct, portfolio and other investment in the UK all declined. Similarly, Asian holdings of UK issued securities fell from £160 billion at end 2001 to £106 billion in 2002.

By analysing the geographical breakdown of assets and liabilities alongside the geographical breakdown of the income that is earned and paid on those investments, it is possible to impute regional rates of return. So, taking the EU as an example, the UK earned £57.2 billion from its £1480 billion stock of investment in 2002 - equivalent to an annual rate of return of 3.86%. In 2002, the UK earned a 3.99% rate of return on its external assets and paid out a 3.23% rate of return on its external liabilities. By broad geographical area, the rates of return on assets and liabilities are shown in table 4.

Table 4 - Rates of return analysis

	External assets		External liabilities	
	2001	2002	2001	2002
European Union	4.49 %	3.86%	4.42%	3.21%
Europe	4.43 %	3.83 %	4.33%	3.1%
USA	4.34%	4.44%	3.62%	3.38%
Asia	4.28%	3.71%	4.07%	3.59%
World	4.41%	3.99%	4.04%	3.23%

The UK earns a higher rate of return both globally and with its main partners, than it pays out on its liabilities. This explains why the UK has recorded an investment income surplus in both 2001 and 2002, from an overall net liability position on its International Investment Position statement.

Conclusions

Geographical breakdowns of the international investment position provide a wealth of information for analysts. The main use of such data to date has been to aid assessments of financial stability, although it is expected that different uses will become apparent as users become familiar with the data. Currently the main limitations are that only two years information is available, and then not until at least 15 months after the year-end. This clearly limits the usefulness of any time series analysis, although it is hoped to accelerate data validation and production as the time series builds.

NOTES

[1] http://www.bankofengland.co.uk/qb/ukextl03.pdf
[2] http://www.statistics.gov.uk/downloads/theme_economy/Pink_Book_2003.pdf

[3] http://www.statistics.gov.uk/downloads/theme_economy/Pink_Book_2003.pdf
[4] UK Economic accounts [insert link]
[5] Economic Trends [insert link to article]
[6] Foreign Direct Investment Business Monitor MA4 [insert link to latest]