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Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

2 October 1989

P R C Gray Esq
Private Secretary to
Prime Minister
10 Downing Street
LONDON
SW1

BALANCING ITEMS

... I attach a note on balancing items in other country's overseas accounts and on what we are doing to reduce ours.

JOHN GIEVE

BALANCING ITEMS IN THE MAJOR ECONOMIES

Balancing items are found in the overseas accounts of all (major) countries. They occur when measured capital flows do not exactly match measured current account flows with the sign reversed.

The figures

2. Table 1 shows figures for balancing items for recent years for the major economies. (These are in $bn and as a share of GNP: they are the same as those used in the Bank's paper.) GNP is not necessarily the most appropriate standardising factor. An alternative would be the gross current and capital account flows across the exchanges. Errors in the accounts are in some instances likely to be proportional to the size of flows.

Table 1: BALANCING ITEMS IN MAJOR ECONOMIES, $bn (% of GNP)*

	US	Japan	Germany	UK
1977	-2.0 (-0.1)	0.7 (0.1)	-3.4 (-0.7)	7.1 (2.8)
1978	12.5 (0.6)	0.3 (0.0)	-3.8 (-0.6)	3.7 (1.2)
1979	25.4 (1.0)	2.3 (0.2)	-1.3 (-0.2)	2.3 (0.6)
1980	25.3 (0.9)	-3.1 (0.3)	1.2 (0.1)	2.0 (0.4)
1981	18.7 (0.0)	0.5 (0.0)	1.6 (0.2)	1.2 (0.2)
1982	34.4 (1.1)	4.7 (0.4)	-0.2 (0.0)	-3.9 (-0.8)
1983	9.2 (0.3)	2.1 (0.2)	0.9 (0.1)	0.9 (0.2)
1984	23.9 (0.6)	3.7 (0.3)	0.7 (0.1)	7.9 (1.8)
1985	15.3 (0.4)	4.0 (0.3)	-1.1 (-0.2)	8.2 (1.8)
1986	11.3 (0.3)	2.5 (0.1)	-1.4 (-0.2)	16.2 (2.9)
1987	1.9 (0.0)	-3.9 (0.2)	-5.2 (-0.5)	18.6 (2.7)
1988	-10.6 (0.2)		1.3 (0.1)	21.9 (2.6)

* Data derived from country national accounts. GDP used for UK's which involves a slight upward bias as GNP is larger than GDP.

3. Table 2 gives more details (in £) on the large positive balancing items that have recently been recorded in the UK. These reflect unidentified credits or overstated debits on either current or capital account or both. The size of the UK balancing item is now unprecedented among major economies in recent years as a percentage of GNP. The US had a run of higher nominal balancing items in the early 1980s.

Table 2: THE UK BALANCING ITEM (£ billion, NOT seasonally adjusted)

	1986	1987	1988	1988 Q1	Q2	Q3	Q4	1989 Q1	Q2
Current account balance	0.1	-3.7	-14.6	-3.4	-3.2	-3.5	-4.5	-4.6	-5.7
Net capital transactions	-11.1	-7.7	2.3	2.9	-0.5	0.6	-0.6	3.4	-0.9
Balancing item	11.0	11.3	12.3	0.5	3.7	2.9	5.2	1.2	6.6

The discrepancy in the world's balance of payments statistics

4. Balancing items have more often been positive than negative. A similar problem is that there are insufficient recorded current account credits in the world as a whole, because the current account of all countries do not sum to zero, but to a deficit. The IMF estimated this world discrepancy at 0.32% of world GNP in the period 1959-68, 0.12% in 1969-78 and 0.43% in 1979-88. It narrowed markedly between 1984 and 1987, but provisional figures in the IMF's September World Economic Outlook suggest an increase in 1988 to 0.59%.

5. The IMF suggest that most of the discrepancy can probably be attributed to developing countries, but in 1983 for example about $14 (out of $75) billion was attributed to OECD economies. A detailed IMF study found errors largely on the invisibles side, with investment income and shipping/transportation as the main causes. Visible balances were thought to be only slightly under-recorded.

Why differences in balancing items occur

6. Differing methods of data collection and institutional factors probably account for the variation between countries' balancing items.

(i) Measurement methods differ. The French, the Italians, the Germans and the Japanese all use some form of exchange control or direct reporting to banks. In contrast, countries like the United States and the United Kingdom use a greater variety of unrelated sources, notably surveys of transactors.

(ii) Deregulation has contributed to the greater relative scale of international capital flows and at the same time made measurement more difficult. The UK has moved much further down this path, and much more quickly than other G7 countries. The balancing item jumped in 1984: the run up to the "Big Bang" saw rapid growth of trade in financial instruments and (probably) international movements of capital in advance of the internationalisation of capital markets that Big Bang involved. Deregulation may also mean that transactions bypass UK institutions, and, therefore, the existing surveys. International institutional investment is almost certainly more regulated in Japan and Germany (and indirectly in the US, for example via moral suasion on pension funds to invest in US Treasury Bills).

What other countries do about balancing items

7. We can find no documentary evidence of attempts to remove or reduce the balancing item by adjusting the measured figures prior to publication. However, the CSO has been in touch with those who compile balance of payments figures in the US. The latter said they do not make regular adjustments, and pointed out that their annual balancing items conceal much larger quarterly ones.

8. Some countries have made considerable efforts to improve their data. Examples include:

(i) In Germany the Bundesbank has improved the quality of its capital flows statistics, with the improvements split roughly evenly between the current and capital accounts. The capital account corrections mostly reflect unrecorded outflows to banks in Luxembourg and the UK, possibly as German investors try to evade tax. The UK could well have a similar problem with the Channel Islands;

(ii) The US has recently increased significantly its coverage of services and investment income to take account of such items as improved measurements of telecommunications services. This has added around $20 bn to exports and $10 bn to imports per year. Worries about the balancing item led to further new surveys in 1988. (Additional resources are of course required to mount such surveys together with some increase in form filling.)

The UK balancing item and measures to reduce it

9. A balancing item averaging £11.5bn p.a in 1986-1988 could be taken to imply a misleading current account estimate. Although it is likely that a substantial part of the balancing item reflects unidentified net capital inflows, it is also possible there are still errors and omissions in the current account. For instance much of the data on financial services and investment are either estimated or based on irregular survey material. However, to the extent that unidentified net capital inflows do increase UK overseas liabilities, there will be some underrecording of investment income outflows on the current account.

10. The balancing item in the UK balance of payments has been recognised as a major problem for some time and a Treasury/CSO working group was established in 1987. The Pickford Scrutiny report on economic statistics also emphasised the problem (a copy of the relevant paragraphs is attached:- the balancing item in the balance of payments was considered alongside the large balancing items in the accounts for sectors of the domestic economy). The CSO and the Bank of England which collects most of the capital account data are making an effort to improve the quality of the data. The recent thrust of the CSO work programme is aimed at the capital account, especially portfolio flows which are thought to be particularly badly measured. The new inquiries include:

- extended coverage of securities dealers' overseas activity;
- constructing a database of bond issues;
- a new share register survey.

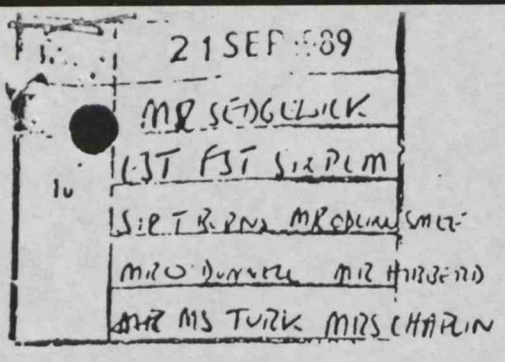
Initial results from the first of these have not yet resulted in any reduction in the balancing item. The latest quarterly figures for 1989Q2 show the highest balancing item on record at £6.6 billion.

11. Much of the new work takes the form of improvements to existing sources. One view is that these efforts will at best prevent the balancing item rising further. It is far more likely that there are large areas of activity which the present approach to data collection cannot hope to keep pace with or may fail to capture at all. This must surely be a problem in the financial services sector where

recording has probably not yet caught up with the moves towards deregulation epitomised by 'Big Bang', and where firms continue to innovate in anticipation of the opportunities which 1992 will bring.

12. Clearly one possibility is to follow the US line and mount new surveys. Although there is much to recommend this approach, there are always likely to be some problems with the data in a deregulated economy.

EA2 Division
HM Treasury



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10 DOWNING STREET

LONDON SW1A 2AA

20 September 1989

From the Private Secretary

Dear John,

BALANCING ITEMS

I told you earlier in the week that Sir Hector Laing had drawn to the Prime Minister's attention a report indicating that the balancing item in the UK's external financing accounts was far greater than for other G7 countries.

I have now identified this document as the enclosed report to the Court of the Bank of England, which the Deputy Governor's office have kindly let me have. The relevant tables are those in the statistical annex. I should be grateful if you could arrange for a note to be prepared for the Prime Minister which summarises what is known about the treatment of the balancing item in other countries accounts; for example, do any of them adopt methods of allocating out part of the original balancing item to other lines in the accounts? It would be helpful if the note could also indicate what work is in hand to seek to reduce the size of the balancing item in the UK's accounts.

I should be grateful if this material could be provided by next Wednesday, 27 September, so that it is available in advance of the Prime Minister's next bilateral meeting with the Chancellor.

Yours,

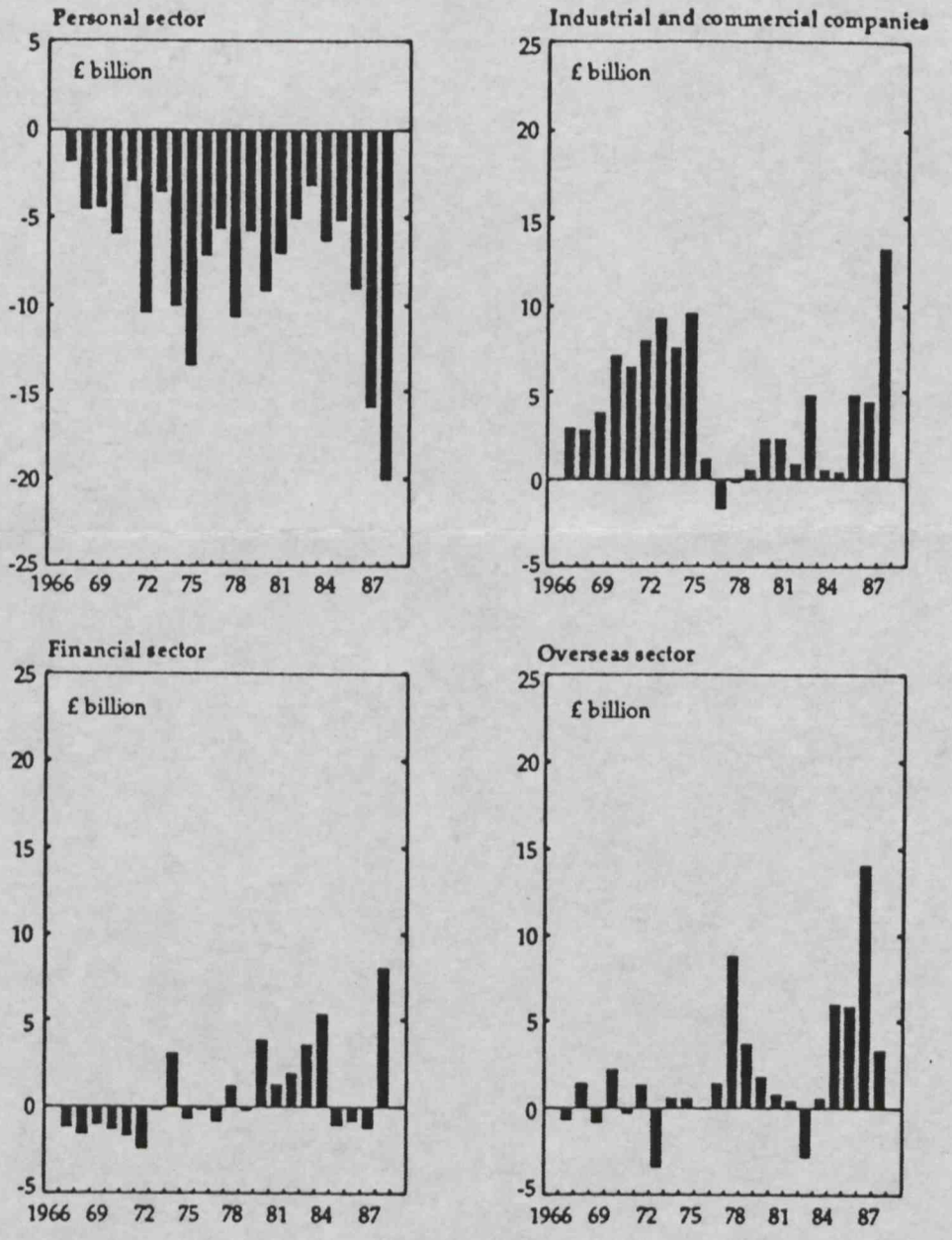
PG

(PAUL GRAY)

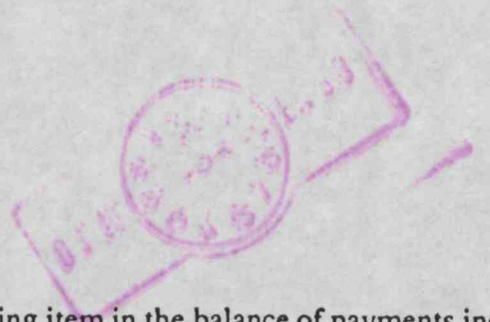
John Gieve, Esq

Extracts from The Scrutiny (Pickford) Report

Chart 2 Sector balancing items at 1985 prices

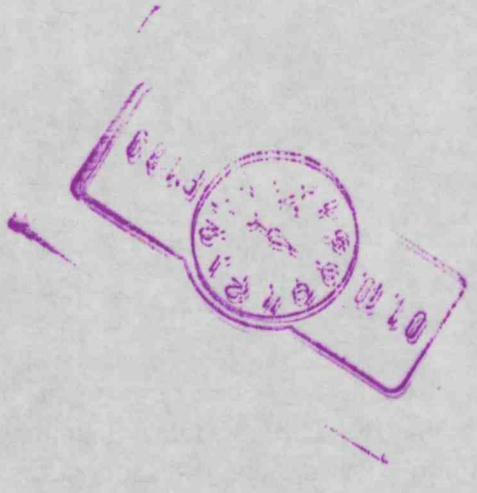


Balancing items are now so large in relation to some key economic indicators that they make it very difficult to interpret the figures. In 1987 the personal sector's balancing item was equivalent to 8% of its disposal income while the measured saving ratio was 5½%. As a result some commentators have concluded that the saving ratio is substantially under-recorded. The overseas sector's balancing item in 1987 was £3½billion compared with a balance of payments current account deficit of £2½billion; if the balancing item arose entirely because exports were under-recorded, the current account would instead have been in surplus.



L5. A positive balancing item in the balance of payments indicates a tendency to understate net inflows to the UK. The CSO told us that they suspected the main problem related to net capital inflows; they believed that the data for the capital account, in particular private sector financial transactions, were more suspect than those for the current account. The current account would be affected by mismeasurement of capital account transactions to the extent that interest, profit and dividend payments are often estimated from the same data sources as capital flows. If capital inflows were understated then there would be a corresponding, but considerably smaller, understatement of current account debits.

L8. The above exercises should help to resolve some of the current problems with the balance of payments statistics. However an underlying concern is that the statistical systems used to compile the figures are diverse, and do not keep pace with the changes in the financial world. In recent years the transactions of new financial institutions and instruments have not been recorded adequately in official statistics. As a first step towards identifying problem areas more quickly we believe the Bank of England should advise the CSO regularly on developments in financial markets, and their implications for financial statistics.



Report sent to HMT

FILE KK. Gieve

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(PAUL GRAY)

John Gieve, Esq.,
HM Treasury.

WORLD PAYMENTS REPORT

AUGUST 1989

WORLD ECONOMY GROUP

INTERNATIONAL DIVISION

0087p

WORLD PAYMENTS REPORT - JULY 1989

Contents

WORLD PAYMENTS REPORT - AUGUST 1989: HIGHLIGHTS

* World trade grew by 9% in 1988, the strongest performance this decade.

* The US current account deficit was reduced to 2 1/2% of GNP ($127 bn) in 1988 from 3 1/4% in 1987, aided by very rapid growth in exports. Falling net investment income hampered the adjustment process.

* The Japanese surplus fell to 2 3/4% of GNP ($87 bn) from 3 1/2% in 1987 as imports of goods and services expanded strongly.

* The German surplus remained at 4% of GNP.

* The UK current deficit rose sharply to 3 1/4% of GNP from 3/4% in 1987.

* The US current deficit was almost entirely financed by private capital inflows, in contrast to 1987 when official flows were predominant. Net direct investment flows to the US rose to $40 bn in 1988 from broad balance in 1987.

* Net portfolio outflows from Germany increased massively in 1988, partly in anticipation of the introduction of the withholding tax in January 1989 (and which has been abolished subsequently). The flows were partly financed by large official sales of dollars to support the deutschemark.

* Net bank borrowing played a reduced role in intermediating international capital flows, with the notable exception of inflows to the UK.

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WORLD PAYMENTS REPORT - 1989

Summary

1 The attached report is the latest in an annual series analysing the major trends in international trade and associated financing patterns.

2 Unexpectedly strong demand growth in the industrial economies last year was associated with a very rapid expansion in the volume of world trade, which grew according to IMF estimates at 9%, the strongest performance this decade. The stimulus to trade from demand growth in the industrial countries gave a boost to the developing countries and was in addition supported by some trade liberalising measures, particularly in the Far East. As demand and output growth in the major economies slows down in response to the monetary tightening over the last fifteen months, world trade growth is likely to ease.

3 Further progress was made last year in reducing the US current account deficit and the Japanese current surplus, particularly when measured as a proportion of GNP. The German surplus, however, remained at 4% of GNP. The US current deficit improved from 3 1/4% of GNP in 1987 to 2 1/2% in 1988 ($144 bn to $127 bn) as export volumes of goods rose by an extraordinary 22%, helped by strong demand growth overseas and by previous competitiveness gains. The improvement in the current account was more than fully accounted for by the improvement in visible trade, with the deficit improving by well over $30 bn, but as US net external liabilities continue to rise, debt servicing costs continue to mount. This factor led to a deterioration in the invisibles account of some $15 bn between 1987 and 1988. The trend deterioration in the invisibles account as external debt builds up adds to the difficulty of reducing the current account deficit. The Japanese and German invisibles accounts also deteriorated last year, as rapidly rising spending on foreign services, particularly tourism, more than outweighed the growing net investment income receipts from rising net external assets. In the Japanese case, this was a major factor underlying the fall in the current account surplus from 3 1/2% in 1987 to 2 3/4% in 1988 of GNP (from $87 bn to $80 bn) although the trade surplus also fell as the volume of imports of goods rose by almost 17%. In Germany,

however, the growing deficit on invisibles was more than outweighed by a rising surplus on trade as export volumes continued to perform strongly and the volume of imports rose more slowly than in any other member of the G7. The rapid deterioration in the UK current account in 1988 was the major development outside the three largest economies.

4 Prospects for further improvements in reducing the US deficit and the Japanese surplus (and of some improvement) in the German surplus (which increased to around 5% of GNP in the first half of this year) depend on the pattern of domestic demand growth relative to overseas and movements in competitiveness and trade prices. Charts 3 and 4 in the Report show movements over the 1980s in these measures and indicate that relative demand growth has been moving favourably for adjustment over the last two years in the US and Japan, but not in Germany. These trends have continued into this year. The benefit from the large improvement in US competitiveness between 1985 and 1987 may now be beginning to fade, whilst the rise in the dollar this year is unhelpful for further current account adjustment over the medium term. Movements in trade prices have also partially offset the effects on competitiveness of the dollar fall from 1985, as US exporters have tended to widen profit margins whilst Japanese and German producers have reduced theirs to maintain market share.

5 It is possible that the rapid growth of direct investment into the US in 1988 and continuing into this year (a net inflow of $40 bn last year from broad balance in 1987) will facilitate current account adjustment over the longer term, as the relocation of production from overseas into the US displaces imports and promotes exports. In the short term, however, this direct investment inflow might actually increase the US current deficit, as relocating firms import components and capital equipment from their overseas parents or trading affiliates.

6 Direct investment apart, the key development in financing flows last year was the marked turnaround in the financing of the US current deficit from largely official finance in 1987 associated with intervention to support the dollar, to almost entirely private finance in 1988 and into this year; indeed 'overfinance' in the most recent period as central banks have intervened to hold down the dollar. Factors underlying this radical change in sentiment over the last eighteen months or so include, the widening interest differentials in favour of dollar assets (true for Japanese investors but not for investors from many other countries, and a factor pushing in the opposite direction more recently); greater confidence that major central banks will underpin any perceived fall in the dollar following the experience of 1987 and achieve the goal of promoting greater stability in exchange

rates; greater faith in the management of the US economy, particularly in the operation of monetary policy; special factors such as the withholding tax in Germany which led to strong capital outflows, and more recently heightened political uncertainty in various regions which have improved the attractiveness of the dollar as a 'safe haven'.

7 Other interesting features of last year, include the general decline in the importance of international banks in intermediating capital flows, with the notable exception of inflows into the UK. This general development may be partly related to the impact of the new Basle capital requirements, but also reflects reduced hedging behaviour by Japanese investors in particular as they became more confident about exchange market stability. The introduction of the withholding tax was a major factor associated with the massive increase in German portfolio investment overseas in 1988, whilst a reassessment of prospects for the Tokyo stock market led to a large non-resident inflow of capital, a factor underlying the reduction in net Japanese portfolio outflows.

WORLD PAYMENTS REPORT - AUGUST 1989

Section 1: WORLD TRADE

1 The strength of economic activity in the industrial countries has been accompanied by a rapid expansion in world trade. According to the IMF, world trade volumes rose 8.9% in 1988 (6.5% in 1987), the highest rate recorded in this decade (Table 1). Three main reasons for this continued growth in world trade are evident.

Source:IMF WEO and OECD

Table 1: World Trade(Annual changes,in %)	1981	1982	1983	1984	1985	1986	1987	1988
Volume	1.2	-1.8	2.7	8.6	2.9	4.5	6.5	8.9
Volume of Trade								
Export Volumes								
Industrial countries	3.8	-2.0	3.0	9.8	4.7	2.6	5.5	8.8
Developing countries	-5.5	-6.6	1.6	7.0	0.7	8.8	11.2	10.9
Import Volumes								
Industrial countries	-1.6	-0.6	4.5	12.3	4.7	8.6	7.2	9.5
Developing countries	8.0	-3.4	-2.8	2.6	-0.6	-4.4	5.7	10.2
OECD Manufactured export prices local currency	8.3	7.6	2.7	4.8	2.7	-3.7	-1.2	1.8
OECD Domestic producer prices manufactures	8.6	5.9	4.0	4.8	2.8	-1.6	0.8	2.5
OECD Unit Labour costs manufacturing	7.4	5.4	0.7	0.5	2.3	3.1	0.7	-0.5
OECD GDP deflator export weighted	8.6	7.5	5.5	4.8	4.2	3.9	3.1	3.5

(1) Rapid growth in demand in the industrial countries, associated with buoyant investment growth, led to a marked increase in imports.

(2) Strong domestic demand, earlier competitiveness changes, and the relaxation of some trade barriers in Japan contributed to a marked increase in import volume growth last year, although there was a slowdown through the year. Rapid demand growth, trade liberalisation, and a loss of competitiveness in Taiwan and Korea (reflecting currency appreciation and rising wage inflation) helped to maintain import volume growth in the Asian newly industrialising economies - the NIEs (Taiwan, Korea, Singapore and Hong Kong) at almost 30%. Rising non-oil commodity prices resulted in terms of trade gains for many other LDCs. This factor, together with stronger growth in export volumes, led to a slight relaxation in the financing constraint facing indebted LDCs and allowed their import volumes to rise faster in 1988 than at any time this decade.

(3) Export prices of manufactured goods have risen less rapidly than domestic prices for the industrial countries as a whole between 1986 and 1988 and this may have stimulated trade. Manufactured export prices in local currency terms for the OECD rose 1 3/4% in 1988 while domestic producer prices rose by 2 1/2% and the GDP deflator by 3 1/2% (see Table 1). However, according to the OECD, this trend was reversed in the second half of the year.

Section 2: CURRENT ACCOUNT DEVELOPMENTS IN THE WORLD ECONOMY

2 This section charts the main developments in world current account positions during 1988 and the extent to which international adjustment has taken place.

3 Large movements in exchange rates during the 1980's have led to a significant redistribution of world export market shares and current account balances have diverged significantly. Chart 1 indicates the extent of this divergence. The US current balance deteriorated from a relatively small deficit in 1982 to a deficit of $127 bn in 1988 (although an improvement from $144 in 1987)* while the Japanese and German surpluses have risen from $7 bn and $5 bn in 1982 to $80 bn and $49 bn respectively. The UK's current account balance switched from a surplus of $8 bn in 1982 and broad balance through the mid 1980's to a deficit of $27 bn in 1988 while the aggregate position of the other OECD economies (Canada, Italy, France and smaller OECD) has deteriorated by over $20 bn in the last two years from a position of broad balance between 1983 and 1986. The current account of the NIEs has improved from a position of broad balance in the early 1980's to a surplus of around $30 bn more recently, whilst the current account deficit of the LDCs (non-OPEC,

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* Revised figures. Chart 1 has been based on figures before revision which gave a deficit around $10 bn larger in recent years.

Chart 1

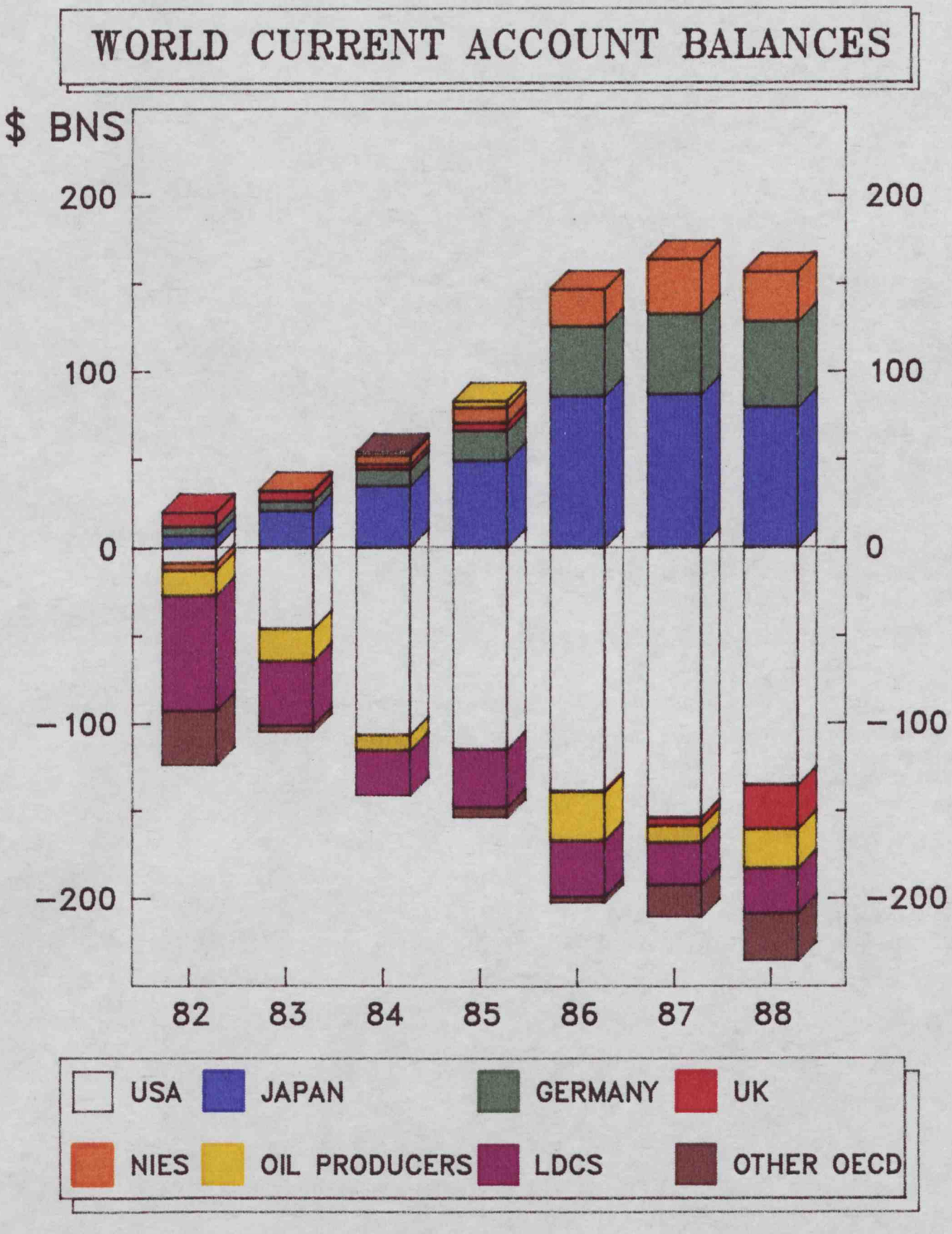

WORLD CURRENT ACCOUNT BALANCES
$ BNS
200
100
0
-100
-200
82
83
84
85
86
87
88
USA
JAPAN
GERMANY
UK
NIES
OIL PRODUCERS
LDCS
OTHER OECD

TABLE 2: MEASURES OF INTERNATIONAL ADJUSTMENT

CURRENT BALANCES
$ billions

	1986	1987	1988
US	-133.2	-143.7	-126.5
JAPAN	85.8	87.0	79.6
GERMANY	39.2	45.2	48.5
CANADA	-7.6	-8.0	-9.2
FRANCE	3.1	-4.1	-3.8
ITALY	2.6	-1.5	-5.2
UK	0.2	-4.8	-26.6
OTHER OECD (EO)	-4.0	-9.3	-11.6
OIL EXPORTERS (WEF)	-28.1	-9.5	-22.3
ASIAN NIES (WEF)	21.2	31.5	28.5
LDCS (WEF)	-31.7	-24.0	-25.6
OTHERS* (WEF)	8.7	8.4	8.3

INVISIBLES, NET
$ billions

	1986	1987	1988
US	11.9	15.8	0.7
JAPAN	-7.0	-9.4	-15.4
GERMANY	-13.3	-20.7	-24.3
CANADA	-14.6	-16.6	-17.2
FRANCE	5.0	4.8	5.3
ITALY	-1.9	-1.4	-4.4
UK	13.0	12.1	9.9
OTHER OECD (WEF)	5.2	7.7	3.3
OIL EXPORTERS (WEF)	-38.9	-42.8	-41.6
ASIAN NIES (WEF)	2.1	0.8	0.3
LDCS (WEF)	-13.5	-9.2	-7.4
OTHERS* (WEF)	-2.7	-9.0	-3.2

EXPORT VOLUME GROWTH (GOODS)
Annual changes, in percent.

	1986	1987	1988
US	5.2	15.0	21.9
JAPAN	-0.6	0.4	4.4
GERMANY	1.3	2.8	7.4
CANADA	3.5	7.3	10.0
FRANCE	-0.2	2.3	8.7
ITALY	3.8	3.0	5.7
UK	3.4	5.5	0.3
OTHER OECD (EO)	2.1	5.5	6.6
OIL EXPORTERS (WEF)	6.8	2.2	6.1
ASIAN NIES (WEF)	15.1	21.0	15.2
LDCS (EO)	11.2	2.4	6.1
OTHERS* (EO)	2.0	4.9	3.7

* CENTRALLY PLANNED ECONOMIES

IMPORT VOLUME GROWTH (GOODS)
Annual changes, in percent.

	1986	1987	1988
US	12.1	6.5	7.0
JAPAN	9.7	9.1	16.7
GERMANY	6.1	5.4	6.7
CANADA	7.5	9.1	14.6
FRANCE (WEO)	7.0	6.7	9.0
ITALY	7.6	10.8	6.9
UK	6.5	7.1	13.4
OTHER OECD (EO)	6.5	6.6	9.4
OIL EXPORTERS (WEF)	-9.7	7.6	-0.8
ASIAN NIES (WEF)	11.4	27.4	28.4
LDCS (EO)	5.1	-0.8	6.3
OTHERS* (EO)	-16.0	-4.1	7.7

CURRENT BALANCE AS A
PERCENTAGE OF GNP
Source:WEO

	1986	1987	1988
US	-3.2	-3.2	-2.6
JAPAN	4.3	3.6	2.8
GERMANY	4.4	4.0	4.0
CANADA	-2.1	-1.7	-1.7
FRANCE	0.4	-0.5	-0.4
ITALY	0.4	-0.2	-0.6
UK	-	-0.7	-3.2

TRADE BALANCES
$ billions

	1986	1987	1988
US	-145.1	-159.5	-127.2
JAPAN	92.8	96.4	95.0
GERMANY	52.5	65.9	72.8
CANADA	7.0	8.6	8.0
FRANCE	-1.9	-8.9	-9.1
ITALY	4.5	-0.07	-0.8
UK	-12.8	-16.9	-36.5
OTHER OECD (EO)	-9.2	-17.0	-14.9
OIL EXPORTERS (WEF)	10.8	33.3	19.3
ASIAN NIES (WEF)	19.1	30.7	28.7
LDCS (EO)	-16.9	-6.5	-3.1
OTHERS* (EO)	11.4	17.4	11.5

non-NIEs) was reduced rapidly after 1982 as the onset of debt servicing difficulties led to a sharp reduction in finance. The aggregate deficit was $26 bn in 1988 compared to $66 bn in 1982. The current account position of the major oil producers has moved largely in line with the oil price, improving earlier in the decade to record a small surplus in 1985 but then deteriorating again as prices fell back. World current account surpluses are concentrated in Japan, Germany and the NIEs (particularly Korea and Taiwan) with the deficits concentrated in the US, the UK and other country blocs.

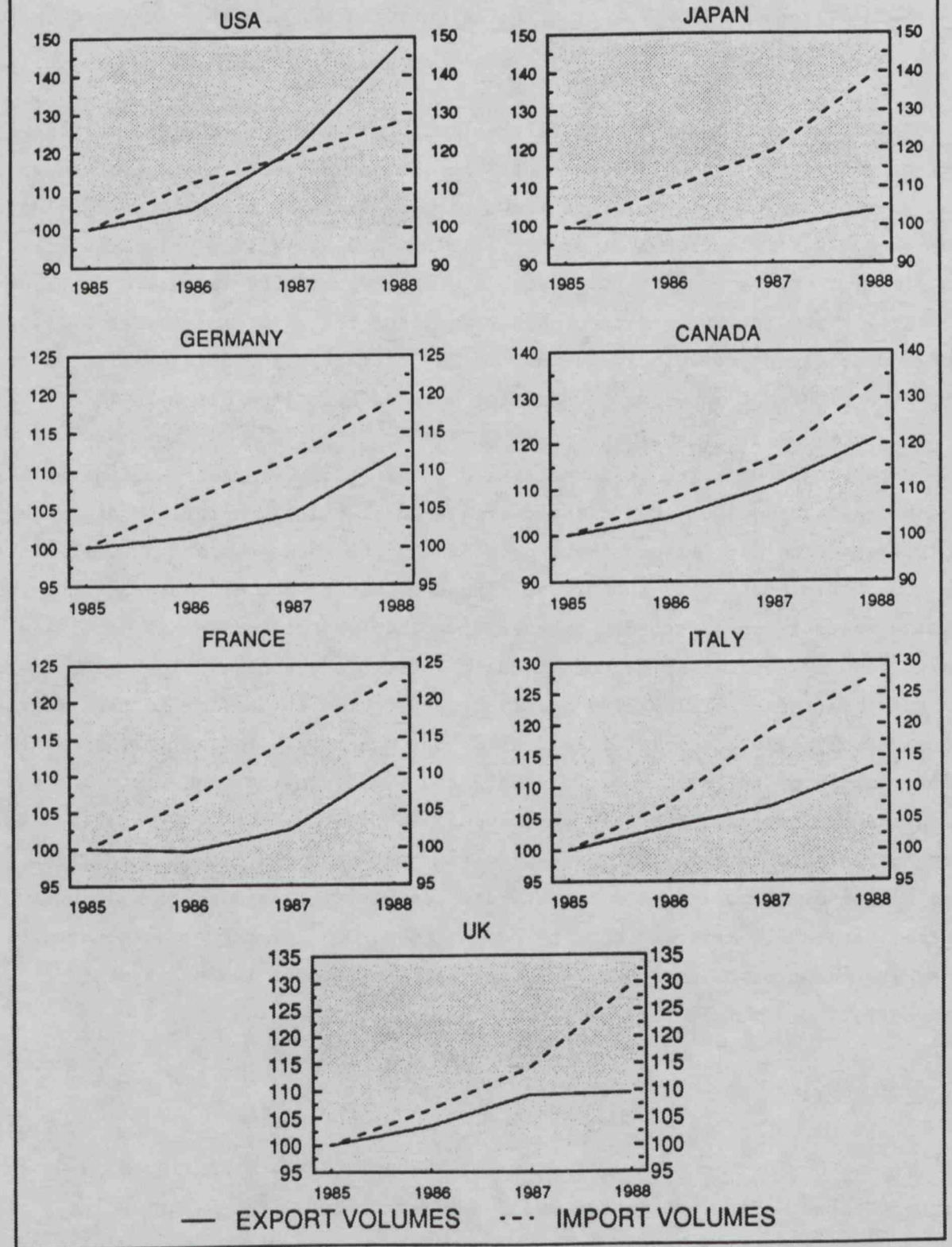
4 Most indicators suggest that further adjustment of the Japanese surplus and US deficit occurred during 1988 but that these movements were concentrated earlier in the year as the effects on trade flows of post-Plaza dollar depreciation unfolded. The US deficit fell from 3.2% of GNP in 1987 to 2.6% in 1988 while the comparable figures for the Japanese surplus were a decline from 3.6% to 2.8%. In Germany, however, there is little sign of adjustment and the surplus remained at 4.0% of GNP. More recent data indicate that the adjustment process is continuing in the US and Japan, but not in Germany where the surplus has risen markedly so far this year.

5 Care should be taken in interpreting international current account movements; Chart 1 indicates that identified deficits substantially outstrip identified surpluses. The gap between the two, known as the world current account discrepancy, is thought to be largely associated with the measurement of international investment income which is underrecorded on average. This underrecording is partially outweighed by an overestimate of trade positions on average. The world discrepancy narrowed markedly between 1984 and 1987, attributed by the IMF in part to the strength of world trade in dollars which in turn partly reflected the marked depreciation of the dollar between 1985 and 1987. In 1988 the world current account discrepancy increased markedly on provisional figures. This may be related to the strengthening of the dollar (weakening the rise in world trade in dollars), and to the increases in worldwide interest rates and profits leading to higher investment income payments. As these tend to be underrecorded the IMF suggest that the mismeasurement might increase at a time when investment income payments are rising strongly.

Major Economies

6 The US current account deficit was $127 bn in 1988, down from $144 bn in 1987. Trade volumes moved favourably (see Chart 2 and Table 2). Export volumes of goods rose 22% in 1988 (15% in 1987) and accounted for approximately one-third of the increase in world trade; while imports maintained a more moderate growth rate of 7%

CHART 2: MAJOR SEVEN EXPORT AND IMPORT VOLUMES



(6 1/2% in 1987 and 12% in 1986). The nominal current surplus in Japan fell to $80 bn in 1988 from $87 bn in 1987. In volume terms and as a proportion of GNP, adjustment was more pronounced. Import volumes rose 17% (9% in 1987) whilst export volumes rose by 4 1/2% in 1988 (1/2% in 1987). On the other hand, the German current account surplus continued to grow in dollar terms. It rose to $49 bn in 1988 ($45 bn in 1987) as strong external demand stimulated exports while a steady rise in domestic demand left the growth of imports little changed. In volume terms, exports of goods were up 7 1/2% in 1988 (2 3/4% in 1987) while imports rose by 6 3/4% (5 1/2% in 1987).

7 Trends in investment income are hindering balance of payments adjustment. Net investment income inflows into the US fell to only $3 bn in 1988 from $20 bn in 1987 as US net external debt continued to increase. Indeed, the surplus of less than $1 bn on the invisibles account was the smallest since 1972. This partly offset the improvement in the trade deficit and the trend deterioration in the invisibles account means that through time the US will require an even larger export surplus to finance both its import bill and growing debt service payments. Conversely, investment income continued to rise in Japan and Germany as a counterpart to their improved external asset positions associated with the run of large current surpluses. However, in contrast to the US, invisibles in total helped to support adjustment in both countries as the growth in service payments, particularly on tourism, exceeded the increase in investment income.

8 The current account positions of all the other major economies deteriorated in 1988, as domestic demand continued to grow strongly which attracted imports, particularly of capital equipment. The largest deterioration occurred in the UK current deficit which rose to almost $27 bn in 1988 (3 1/4% of GDP) from $5 bn in 1987. This was accounted for by an increase in import volumes of over 13% as domestic demand rose rapidly whilst export volumes rose only 1/4%. The Canadian current deficit increased to over $9 bn in 1988 from $8 bn in the previous year (remaining at 1 3/4% of GDP) as Canadian domestic demand continued to rise strongly and as competitiveness deteriorated (Chart 3). The Italian current deficit increased to over $5 bn (from well under $2 bn in 1987) whilst the French deficit stayed around $4 bn. In both countries the deficit in 1988 was around 1/2% of GDP. Chart 2 indicates that import volumes have been rising faster than export volumes in all the major OECD economies (except the US) in the last two years.

Developments in the Smaller OECD Economies

9 The current account position in the smaller OECD economies in aggregate worsened in dollar terms in 1988. The aggregate deficit rose slightly to almost $12 bn from

just over $9 bn in 1987. Rapid domestic demand growth gave rise in some cases to increased inflationary pressures and a deteriorating external balance, for example in the Iberian economies and some in Scandinavia. However, the aggregate trade balance in nominal terms recorded a slight improvement in 1988, as a strengthening in the terms of trade offset the deterioration in volumes, with the main contributory factor to the worsening current deficit a decline in receipts from net invisibles as investment income payments rose, particularly in Australia and Spain. Within the total, the surplus of the Netherlands almost doubled to 2 1/4% of GNP, while Switzerland's surplus declined from 4 1/4% in 1987 to 3 1/2% in 1988. In terms of GDP, the largest deficits were for Australia (4 1/2%), Iceland (4 1/4%) and Norway (4%), whilst the New Zealand deficit fell from 5% of GDP in 1987 to under 2% in 1988.

Current Account Developments in the NIEs

10 In 1988, the current account surplus of the NIEs stood at $29 bn, slightly lower in dollar terms than in 1987 (and a bigger reduction in terms of GNP). Korea and Taiwan continue to account for almost all of the surplus. In aggregate, export volumes rose 15% in 1988 (21% in 1987) but imports rose 28% (27% in 1987). Some loss in competitiveness associated with appreciating exchange rates and rising wages, strong domestic demand coupled with capacity constraints in Singapore and Hong Kong, and exceptional gold imports into Taiwan which reduced the current surplus by $3 bn, were the main factors behind this.

Developments in the Major Oil Producers

11 The aggregate current balance of the major oil producers has been in deficit throughout the 1980's (except for a small surplus in 1985) but worsened significantly in 1988 as the oil price fell sharply. The current deficit was $22 bn in 1988 ($10 bn in 1987) owing to a sharp drop in the trade surplus to $19 bn in 1988 from $33 bn in 1987. Lower oil prices entirely accounted for this deterioration as export volumes rose 6% in 1988 (up from 2% in 1987) whilst import volumes declined slightly.

Developments in the other LDCs

12 During the 1980s, the severe financing constraint facing the other LDCs following the onset of debt servicing difficulties in many countries forced an improvement in their aggregate current account position. Nevertheless the aggregate deficit in 1988 was slightly wider than 1987 as the trade balance deteriorated and

as higher average interest rates in creditor countries increased interest payments. Export market growth was a substantial 15% (10% in 1987) for the non-oil Asian economies (excluding the NIEs) as they benefited from the dynamism of the Pacific rim area and 9% (5% in 1987) in the other non-oil developing countries. For the Asian economies (excluding the NIEs) both exports and import volumes rose about 15% in aggregate in 1988, whilst the terms of trade strengthened slightly. In contrast, Sub-Saharan African economies benefited less from the strength of demand in the industrial countries because of their narrow export base. Export earnings were adversely affected by weaknesses in the market for oil and tropical beverages. In Latin America export volume growth of around 10% coupled with an improvement in the terms of trade, allowed import volume growth of almost 10% (the highest rate since 1980). Nevertheless, despite the better external environment, domestic economic difficulties worsened in some countries, and were reflected in rising inflation.

Section 3: THE PERSISTENCE OF CURRENT ACCOUNT IMBALANCES IN THE THREE MAJOR ECONOMIES

13 Not only have current account imbalances widened over the decade, but the distribution of deficits and surpluses have become concentrated in a few economies, with the US, Japan and Germany accounting for the largest shares. In addition, most forecasts point to a continuation in these large current imbalances. Many reasons have been given for this uneven development in the world economy, which are analysed under two broad headings below.

(i) The role of the exchange rate.
(ii) The evolution of domestic demand and the fiscal/monetary policy mix.

(i) The role of the exchange rate

14 Floating exchange rates in simple theoretical terms allow an alternative to deflation and reflation in bringing about adjustment in external positions. In countries with balance of payments deficits, a depreciation has the effect of increasing the relative price of foreign goods compared to domestic goods and thus inducing the public to buy less from abroad and more home-produced goods, and providing an incentive to produce exports. In simple theory under normal conditions, devaluation of the currency will tend to eliminate payments deficits. In reality, the effect of exchange rates on competitiveness is not as simple and direct. For example changes in nominal exchange rates may give rise to changes in wages and prices which

act to offset the effects of the original exchange rate movement. The final change in the real exchange rate (after adjusting for differential changes in prices and costs) may be substantially less than the initial change in the nominal rate. For example, Chart 3 (using relative normalised unit labour costs as a measure of the real exchange rate) indicates that despite a 50% appreciation in the nominal effective exchange rate of the yen since 1985, the Japanese real effective exchange rate has risen by only 30%. In contrast, competitiveness in the UK and Canada has deteriorated more than the nominal exchange rate suggests as unit labour costs have risen more rapidly than in competitor countries. In addition, changes in the relative costs of foreign and domestic goods may be counteracted to some extent by possible adjustments in firms' profit margins. Chart 3 indicates that the terms of trade in the major economies have not moved to the extent that exchange rates have, and in some cases have moved perversely. For example, in the US, although the effective exchange rate depreciated by about 35% between 1985 and 1988, the terms of trade have remained broadly stable. A BEQB article on profit margins* indicated that US exporters have continued to raise prices and profit margins, thus reducing the opportunities to increase international market share for US exports during this period, some of which had been lost during the strong and prolonged appreciation in the dollar's exchange rate in the early to mid-80s. Conversely, in Japan the terms of trade actually declined in 1987 despite a persistent appreciation in the yen effective exchange rate, suggests that Japanese exporters were engaging in margin restraint to reduce the erosion in export markets. This behaviour was also evident in Germany.

15 The reserve currency status of the dollar may also have diminished its potential role in reducing the US current account deficit. Many LDC currencies are pegged to the US dollar, and as the dollar depreciated in 1986 and 1987 these countries may have experienced some gains to competitiveness in third markets which would have reduced their deficits and provided less scope for US exporters to regain market share. The surpluses of the NIEs were boosted for the same reasons. In addition, in its role as an international reserve currency, the dollar may be subject to changes in sentiment associated with revised assessments of political stability which may at times become subject to bandwagon effects as participants in the foreign exchange market feel obliged to follow short term trends. Associated changes may not necessarily be compatible with underlying domestic economic fundamentals and may be a source of volatility.

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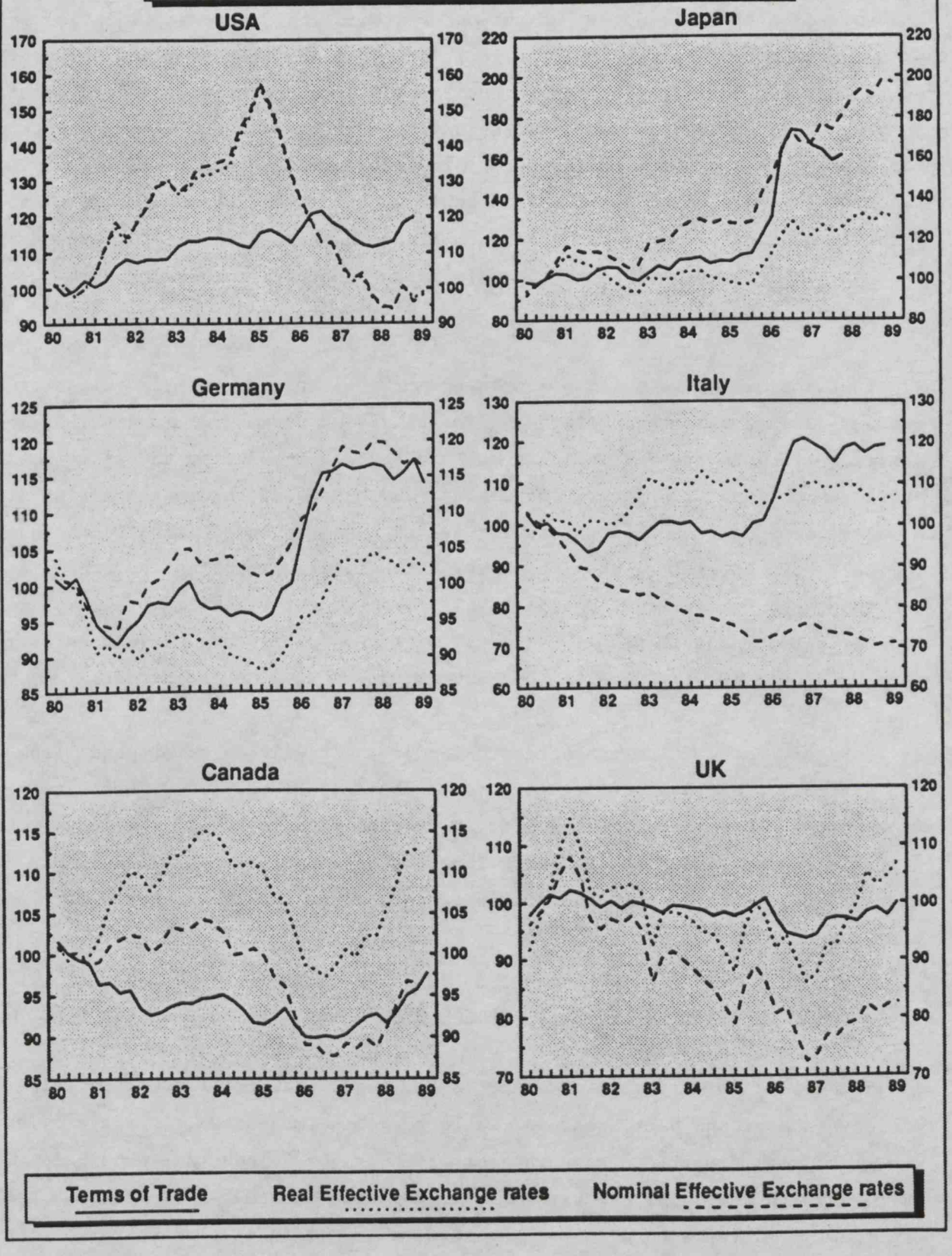
* "Trends in profit margins" by R L Wales and W J Niffikeer BEQB May 1989.

Chart 3: Terms of Trade and Effective Exchange Rates
1980=100



16 More recently, exchange rates themselves have moved in the opposite direction to those consistent with balance of payments equilibrium. The currencies of the major deficit economies have been strengthening while those of surplus economies have weakened. This may be partly rationalised by approaches to exchange rate determination which focus more on capital account rather than current account factors. The volume of transactions in foreign exchange markets is much larger than the volume of trade in goods, which together with the fact that financial market prices move more quickly than relatively sticky traded goods prices, means that it is quite possible that equilibrium in the foreign exchange market induced by changes in interest rate policy or even expectations of such changes may at times work counter to equilibrium in the goods market. For example, following heavy and relatively successful co-ordinated intervention in 1987, the market has been more confident recently of central banks' abilities to stabilise rates. The 'promise' of stability made the dollar attractive despite this being unhelpful for longer term current account adjustment.

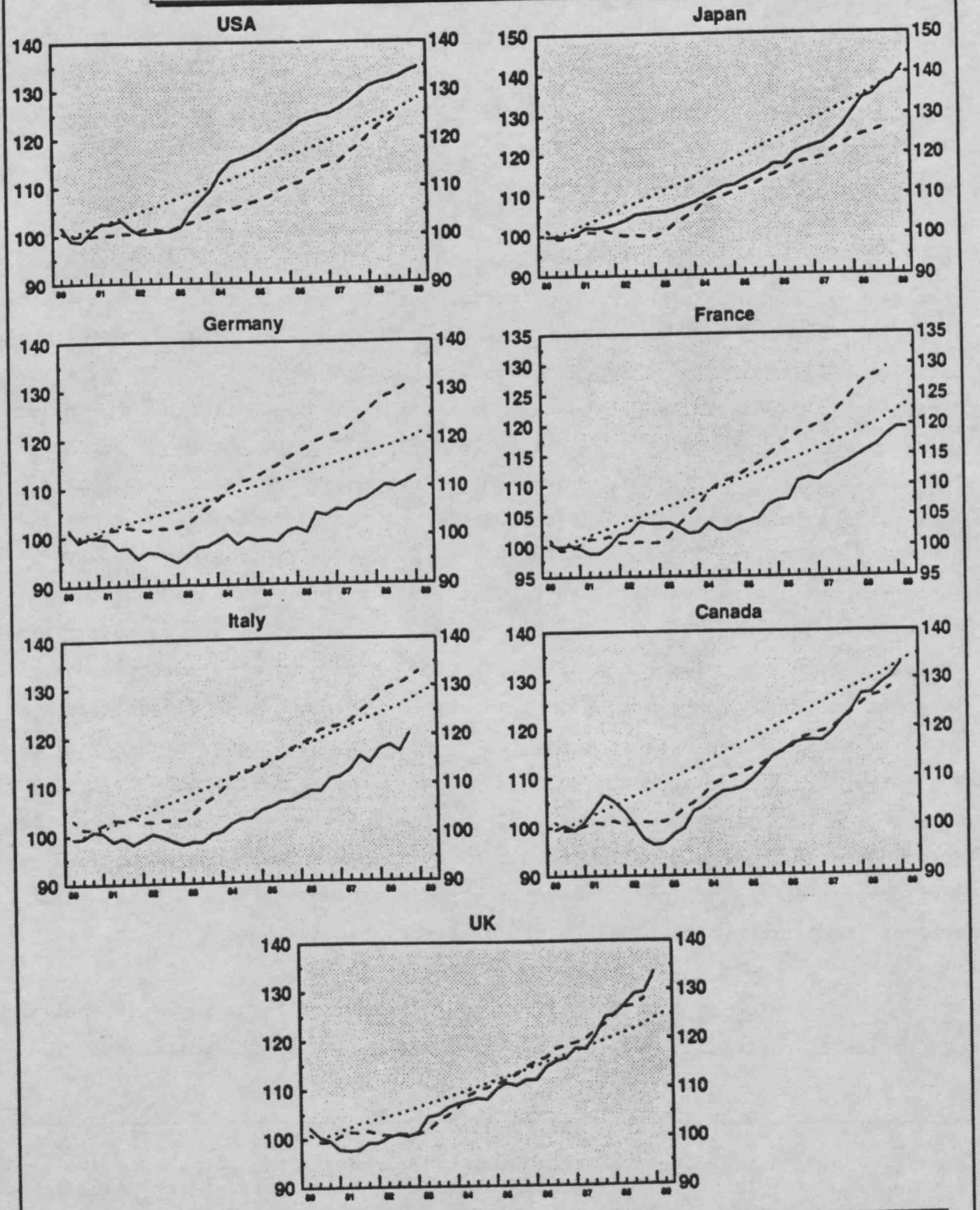
17 There is of course nothing sacrosanct or even (particularly) desirable about current account balance. Moreover, liberalisation of capital markets has made it easier to finance current deficits than in the past, reducing the likelihood of any short run balance of payments constraint. It has meant that national investment is now less dependent on national saving as the major source of finance and overseas capital (both short-term and long-term) has become an important source of funds. Providing the funds are used effectively for productive investment, this process of liberalisation adds to global welfare. Over the longer-term, investors from capital surplus countries will receive the returns yielded by the investment.

18 However, there is no guarantee that adjustment will be smooth and large surpluses and deficits clearly give rise to some potential vulnerability. Short-term capital flows could prove to be volatile, in which case the absence of foreign exchange controls may at times lead to wider interest rate differentials than would otherwise be the case. Deregulation in capital markets contains some elements of a double-edged weapon.

(ii) <u>The evolution of domestic demand and savings/investment balances</u>

19 The evolution of domestic demand in the major industrial countries also underlies the development and persistence of large payments imbalances. Chart 4 illustrates the growth of real domestic demand in each of the major 7 industrial countries, as compared with the aggregate rate of real domestic demand growth in the other six economies weighted according to GNP. Growth in demand is also compared with the IMF

Chart 4: G7 Domestic Demand and Potential Output 1980=100



measure of domestic potential output growth*. The chart indicates that domestic demand in Japan exceeded domestic demand growth overseas during the decade with a substantial widening in the last two years, when demand has also risen more rapidly than non inflationary supply. In some contrast German domestic demand has grown much less rapidly than in the other G6 and there has been no narrowing recently. This helps to explain the continued rise in the trade surplus. There is also a large gap between domestic demand and non inflationary supply (compared to the position in 1980) which has been filled to an extent by exports. In the US, the demand gap (relative to that overseas) has narrowed recently whilst the opposite has been the case in the UK (until the end of 1988 at least). Recent signs of a slowdown of domestic demand in both countries will help to narrow the gap.

20 A counterpart to the rise in domestic demand in the deficit economies has been a simultaneous decline in the savings ratio, particularly in the personal sector. According to the OECD, the decline in household saving can be attributed to the positive effects of disinflation and buoyancy in the stock and property markets on net wealth positions while reductions in uncertainty may also have induced individuals to reduce precautionary saving. Demographic factors may also be contributing to the changes in savings behaviour. In the major economies the ageing population problem is most serious in Germany and Japan, and may be a factor underlying the relative stability of national savings in those two countries. The liberalisation of international capital markets has facilitated a shift in savings behaviour by making domestic savings more internationally mobile. Consequently the pursuit of the highest risk-adjusted, after-tax rates of return has led to greater flows of capital overseas to countries with higher marginal efficiency of investment (as indicated by relative interest rates) - the deficit economies. In Japan, Germany, the Netherlands, Taiwan and Korea, the current account surplus reflects the fact that the investment ratio has fallen by more than the aggregate saving ratio and vice versa for the USA where the fiscal deficit further adds to the claim on savings. These cross-national developments in the savings/investment gap lie behind the persistence of the current account imbalances which have emerged over the last few years.

21 Another related explanation for the persistence of large payments imbalances can be attributed to an inappropriate mix of monetary and fiscal policy, particularly in

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* It should be noted that all the lines on the chart are normalised on 1980. Consequently the level of demand relative to that overseas and relative to potential supply should be interpreted with care - the gaps refer to relative changes compared with the position in 1980.

the US. In the US, the size of the budget deficit has reduced national savings and put further upward pressure on interest rates. As monetary policy has been tightened to combat rising inflationary tensions, increases in interest rates have induced capital inflows and have been at times associated with a rise in the dollar, which although helpful from a counterinflationary perspective may be harmful for current account adjustment. A tighter fiscal stance would ease the burden on monetary policy and help to achieve the twin goals of reducing inflation and the current account deficit.

Section 4: CAPITAL ACCOUNT DEVELOPMENTS

(i) Financing current deficits

Table 3:
G7 Total changes in Reserves
(- = increase)

	1986	1987	1988
US	0.3	9.1	-3.6
JAPAN	-15.7	-39.2	-16.2
GERMANY	-1.3	-17.8	18.5
FRANCE	-1.2	9.8	0.6
ITALY	-1.4	-5.1	-9.1
CANADA	-0.5	-3.4	-7.7
UK	-4.2	-19.7	-4.9
TOTAL	-24.0	-66.3	-22.4

22 In 1987 the pattern of external financing flows was strongly influenced by large scale official purchases of US assets reflecting exchange market intervention to support the dollar. In 1988 however, private financing flows were the main counterpart to the US current account deficit although some official intervention was evident earlier in the year in support of the dollar and later in the year in the opposite direction, with Germany intervening heavily to support the deutschemark. Financing current account deficits became easier in 1988 partly because markets became more confident that the aim of the major countries to promote greater stability in exchange rates would succeed. This view was encouraged by timely rounds of official intervention and by some progress in reducing the US current deficit. As market participants became more confident that a floor for the dollar would be supported by the major central banks, they tended to pay greater attention to short run nominal interest differentials which attracted private capital flows into the US, and also into other deficit countries. Nevertheless the dollar was well above estimates of the floor for most of the year (and at times pushing against a ceiling) which should have

implied that any perceived limit to the potential short run downside risk should not have affected behaviour very much.

23 The issue of the sustainability of financing a current account deficit depends partly on the extent to which the counterpart to the current account deficit lies in long-term or short-term capital flows. Long-term flows such as direct investment and to a lesser extent bond purchases may be more permanent than short-term "hot money" flows through the banking system because they are less liquid than short-term instruments and arguably less susceptible to changes in market sentiment. Clearly though this point should not be overstressed, particularly in the context of international bond markets where liquidity and short term trading opportunities are important considerations.

24 During 1988, the US current account deficit was financed largely by direct and portfolio investment inflows. Direct investment switched from a very modest net inflow of $3 bn in 1987 to a substantial net inflow of $41 bn associated especially with large foreign takeover and merger activity. In addition, foreign direct investment in the US continued to be strong in the first quarter of 1989. Net portfolio investment in the US was slightly higher in 1988 than 1987 with additions to liabilities to the private sector surpassing increases in liabilities to the foreign official sector (some of which may have reflected portfolio reallocation from intervention in 1987 which was not captured in US capital account statistics). Investment by foreign corporations and residents in the US was concentrated in US Treasury securities which recorded net inflows of $20 bn in 1988 compared to a net outflow of $8 bn in 1987. It is also noteworthy that the preliminary estimate of foreign investment in US Treasury securities in the first quarter of 1989 was $9 bn (greater than the figure for the whole of 1987). The main explanations for this increase in US bond purchases relate to greater pessimism about the equity market post-crash, favourable interest rate differentials particularly for Japanese investors (particularly after adjusting for their revised perception of the downside exchange rate risk), and possibly greater relative optimism about the containment of US inflation than for other industrial countries compared to earlier expectations. Net banking inflows slowed to $14 bn in 1988 ($51 bn in 1987) and non-bank inflows recorded a small increase during 1988. In total, net inflows into the US capital account exceeded the current account deficit in 1988 and reserves rose by $4 bn, the first annual increase recorded in 3 years. This tendency has continued in 1989 as the dollar has strengthened.

25 As in the US, the current account deficit in the UK was financed by the foreign private sector but in contrast to the US, the finance was entirely in the form of

short-term deposits through the banking system while net direct and portfolio investment recorded large net outflows. These structural capital outflows further increased the requirement for short-term finance and hence may make the UK payments deficit rather more vulnerable than the US deficit to short-term shocks, although the danger is somewhat attenuated by the relatively strong UK external asset and reserves position. The growth in net international liabilities of UK banks rose from $4 bn in 1987 to $26 bn in 1988 with a further large inflow in the first quarter of 1989. Non-bank flows, which are largely transactions by residents with banks abroad, switched from net outflows in 1987 of $2 bn to inflows of $6 bn in 1988. Total identified inflows fall far short of matching the current account deficit; the large statistical discrepancy in the UK balance of payments is believed to reflect mostly unrecorded inflows probably of a short-term nature.

26 The deficits of the other major OECD economies were financed by a mixture of short and long-term inflows. Long-term non-banking inflows in Italy were $8 bn ($3 bn in 1987), while net bank borrowing doubled to $9 bn. In addition, both direct and portfolio investment recorded net inflows in 1988 perhaps in part associated with the removal of some exchange controls during the year. The strength of inflows meant that despite a current deficit in 1988 which was over $5 bn, reserves rose strongly. In contrast the French current deficit was financed largely by short-term private capital inflows and by portfolio flows while direct investment recorded large net outflows of $6 bn in 1988 ($4 bn in 1987). Net Canadian direct investment overseas was outweighed by overseas purchases of Canadian securities which together with other short-term inflows more than financed the current deficit. Reserves rose strongly as the Bank of Canada intervened to limit the appreciation of the Canadian dollar.

27 Current deficits in the major oil producers were financed in 1988 mainly by borrowing in the case of the non-Arab countries (eg Venezuela and Nigeria) and by drawing down reserves and delaying payments in the Arab countries.

28 Despite the relatively favourable external outlook for many developing countries in 1988, new borrowing continued to be extremely scarce, and was dominated by the package to clear Brazilian arrears (of $12.6 bn) and by Chinese and Indian borrowing to finance current account deficits. Direct investment inflows increased, partly reflecting various debt/equity conversion schemes, but remains relatively small in value. The dearth of new finance from banks underlies the new proposals for middle income debtors put forward by US Treasury Secretary Brady. His proposals advocate a case-by-case approach to debt and debt service reduction together with the option of new lending as a means of providing financial support to individual debtor countries.

The first financing package along these lines has recently been agreed between Mexico and its Bank Advisory Committee.

(ii) Deployment of world current account surpluses

29 The Japanese current surplus continued to be deployed in long-term private capital outflows and rising official reserves. In comparison with 1987, the Japanese capital account demonstrated three important features in 1988. Firstly, net direct investment overseas rose sharply (to $35 bn from $18 bn in 1987). Factors underlying this strong rise include a desire by Japanese exporters to avoid tariff and other protectionist barriers, while capacity and production cost constraints at home have increased the attraction of overseas production. In addition, the appreciation of the yen since 1985 has made the acquisition of physical assets overseas considerably cheaper. Net portfolio investment abroad declined from $97 bn in 1987 to $65 bn in 1988. This reflects both a slowdown in Japanese purchases of foreign securities and a big reversal in non-resident transactions in Japanese securities which turned into a net inflow of $20 bn in 1988 from an outflow of $6 bn in 1987. The rapid recovery of the Japanese stock market post-crash and the actual and expected appreciation of the yen appear to be the main motivating factors. Finally, capital inflows via the banking system were much below the 1987 peaks with short-term borrowings down to $62 bn in 1988 ($96 bn in 1987). The BIS Annual Report argues that the background of higher short-term interest rates abroad and greater stability in excnange markets in 1988 probably reduced incentives for resident investors to hedge as large a share of their foreign investment as in 1987 tnrough snort-term borrowing in foreign currency. New capital adequacy requirements may also have dampened growth of intermediation through banks.

30 Despite a further rise in the German current surplus, foreign exchange reserves fell by $19 bn in 1988. This reflected substantial intervention by the monetary authorities to support the deutschemark in the foreign exchange market given sharp downward pressure arising from strong demand for foreign currency assets. Net German residents' purchases of foreign securities was $37 bn in 1988 compared with net sales of $5 bn in 1987. Investors were attracted by significant interest rate differentials in some countries announcement and by the desire to avoid paying the withholding tax introduced in January 1989 (subsequently abolished following an announcement in April with effect from July) on domestic interest income. Latest monthly data suggest however that capital may be returning. In the second quarter there was a slight net portfolio inflow, compared with a massive net outflow of over $15 bn in Q1.

31 The current account surpluses of the Asian NIEs are also associated with large capital outflows although the situation is different for Taiwan and Korea. The relaxation of foreign exchange controls in Taiwan and the temporary collapse of the very volatile Taiwanese stock market led to massive outflows of mainly illegally deposited funds from overseas to Hong Kong and Singapore. There has also been a large rise in direct investment abroad particularly in other SE Asian economies for example Thailand and also in China. Labour shortages at home, pollution legislation and wage pressures underpin this movement. Foreign exchange reserves fell by $3 bn in 1988 (although a large part was switched into gold). In Korea long-term capital exports (investments and repayments of debt) have continued in 1988 as a counterpart to its growing current account surplus. Indeed, Korea is expected to become a net creditor country by the end of 1989. Certain relaxations in foreign exchange controls and some appreciation of the won have assisted the Korean economy to become more integrated with the world economy while future plans for liberalisation of the securities markets will contribute further to this process.

32 In conclusion, the extent to which surplus economies can aid international adjustment depends on whether their excess savings are being used to support productive investment in the deficit economies. In the longer term, investment by the surplus economies in deficit economies is likely to raise capacity and relieve demand pressures which may reduce imports and promote exports by the deficit economy (providing the funds are used productively and not, for example, supporting government consumption) although in the short-term foreign-owned firms may worsen the deficit by importing equipment and components from their parent companies and trading partners at home. A recent paper published by the Royal Institute of International Affairs* estimates that in the US, foreign-owned firms were responsible for one third of US imports and a quarter of US exports in 1986. Japanese multinational firms send both more exports to and receive more imports from their affiliates abroad then do US multinationals as a percentage of total exports and imports. It is still too early to tell whether international shifts in production will ultimately lead to adjustment in world current account imbalances.

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* "Inward Investment and Foreign-Owned Firms in the G5" RIIA Discussion Papers #12

WORLD PAYMENTS REPORT

AUGUST 1989

STATISTICAL ANNEX

EXTERNAL FINANCING TABLES

TABLE A1:
UNITED STATES: EXTERNAL FINANCING

(billions of dollars; seasonally adjusted)

	1986	1987	1988	1988 Q1	1988 Q2	1988 Q3	1988 Q4	1989 Q1
Identified current account	-133.2	-143.7	-126.5	-27.6	-33.9	-36.9	-28.2	-26.1
Financed by:								
Direct investment, net	7.8	2.7	40.9	3.0	12.9	7.0	18.0	10.6
Portfolio investment, net	103.7	74.0	81.7	31.4	22.5	6.1	21.8	20.1
Assets	-4.3	-5.3	-7.8	-4.5	1.3	-1.6	-3.0	-2.6
Liabilities	107.9	79.3	89.6	35.9	21.2	7.7	24.8	22.6
Foreign official	33.2	44.8	43.0	27.5	6.1	-3.2	12.6	5.3
Foreign private	74.8	34.5	46.6	8.4	15.2	10.9	12.2	17.3
Bank borrowing, net	21.0	50.8	14.0	-3.6	18.6	-1.2	0.3	-10.7
Assets	-60.0	-42.1	-54.5	15.3	-12.6	-26.2	-30.9	-22.6
Liabilities	81.0	92.9	68.5	-18.9	31.2	25.0	31.2	11.9
Foreign official	1.2	3.9	-0.3	-1.8	0.8	1.7	-1.0	1.5
Foreign private	79.8	89.0	68.8	-17.1	30.5	23.3	32.2	10.4
Gvt borrowing, net (1)	0.1	-1.5	1.7	-2.0	-1.3	1.8	3.3	0.5
Non-banks', net	-10.9	6.6	2.4	0.7	-6.9	2.1	6.5	0.5
Official financing balance (--increase in reserves)	0.3	9.1	-3.6	1.5	0.0	-7.4	2.3	-4.0
Balancing item (2)	11.3	1.9	-10.6	-3.4	-12.0	28.6	-23.9	9.2

(1) Securitised Treasury borrowing included under portfolio investment
(2) Reflects unidentified net flows, which may be either current or capital account items

Memo item

Nominal effective exchange rate 1985=100	80.2	70.3	65.9	64.9	64.5	68.7	65.6	67.2

TABLE A2:
JAPAN: EXTERNAL FINANCING

(billions of dollars; not seasonally adjusted)

	1986	1987	1988	1988 Q1	1988 Q2	1988 Q3	1988 Q4	1989 Q1
Identified current account	85.8	87.0	79.6	18.4	18.6	19.1	23.6	15.8
Financed by:								
Direct investment, net	-14.3	-18.4	-34.7	-7.7	-8.0	-8.6	-10.4	-9.0
Portfolio investment, net	-105.1	-97.1	-64.7	-6.4	-25.4	-19.3	-13.6	6.9
Bank borrowing, net	55.1	79.8	46.8	-6.2	23.1	21.4	8.4	-14.4
of which: long-term	-9.3	-16.3	-15.3	-4.1	-2.6	-5.1	-3.6	-5.4
short-term	64.4	96.2	62.1	-2.1	25.7	26.5	12.0	-9.0
Non-banks', net	-8.2	-8.3	-13.6	-2.1	-3.0	-3.9	-4.5	-1.4
of which: trade credits	-3.3	-0.8	-7.8	-0.9	-1.3	-1.9	-3.7	-1.0
other	-4.9	-7.5	-5.8	-1.2	-1.6	-2.1	-0.9	-0.4
Official financing balance (-=increase in reserves)	-15.7	-39.2	-16.2	-3.4	-2.8	-3.5	-6.5	-1.7
Balancing item (1)	2.5	-3.9	2.8	7.4	-2.4	-5.2	3.0	3.8

(1) Reflects unidentified net flows, which may be either current or capital account items

Memo items

Y per US$ (period average)	168.5	144.6	128.2	128.0	125.6	133.7	125.3	128.5
Nominal effective exchange rate 1985=100	124.4	133.2	147.4	144.6	148.0	145.5	151.4	150.3

TABLE A3:

GERMANY: EXTERNAL FINANCING

(billions of dollars; not seasonally adjusted)

	1986	1987	1988	1988 Q1	1988 Q2	1988 Q3	1988 Q4	1989 Q1	1989 Q2
Identified current account	39.2	45.2	48.5	9.7	14.4	8.7	15.8	15.8	13.7
Financed by:									
Direct investment, net	-8.5	-7.1	-8.8	-1.7	-3.9	-2.0	-1.3	-1.3	-2.4
Portfolio investment, net	24.3	4.6	-37.1	-9.0	-10.8	-8.2	-9.2	-15.3	1.5
Bank borrowing, net	-22.2	-4.2	-4.6	7.5	-3.0	-6.1	-2.3	12.8	-5.5
of which: long-term	5.0	-0.8	6.9	-0.8	0.3	4.2	2.9	2.4	2.5
short-term	-27.2	-3.4	-11.5	8.3	-3.3	-10.3	-5.2	10.4	-8.0
Government borrowing, net	-5.2	-9.0	-8.0	-3.6	-1.8	-2.6	-0.1	-2.5	-1.6
Non-banks', net	-25.2	-7.2	-10.4	-7.5	0.0	-0.8	-2.3	-11.4	-5.3
Official financing balance (--=increase in reserves)	-1.3	-17.8	18.5	1.8	5.2	11.0	0.1	4.8	4.3
Balancing item (2)	-1.1	-4.4	1.8	2.8	0.0	-0.1	-0.7	-3.0	-4.9

(1) Totals in US$ calculated using the relevant period average exchange rate. For this reason, quarterly totals may not sum to annual totals.

(2) Reflects unidentified net flows, which may be either current or capital account items

Memo items

DM per US$ (period average)	2.17	1.80	1.76	1.68	1.71	1.87	1.78	1.85	1.93
Nominal effective exchange rate 1985=100	108.8	115.4	114.6	116.2	114.9	113.2	114.0	112.7	n\a

TABLE A4:
FRANCE: EXTERNAL FINANCING

(billions of dollars; not seasonally adjusted)

	1986	1987	1988	1988 Q1	Q2	Q3	Q4
Identified current account	3.1	-4.1	-3.8	-0.5	-0.3	-0.4	-2.6
Financed by:							
Direct investment, net	-2.6	-4.2	-6.0	-1.2	-1.1	-0.6	-3.1
Portfolio investment	1.9	4.5	7.7	-0.6	6.4	-0.7	2.7
Long-term capital net	-6.9	1.5	2.1	0.9	0.0	0.5	0.6
of which:							
Official sector, net	-6.4	-4.7	-4.1	-0.7	-1.1	-1.2	-1.1
Bank's net	0.8	5.0	1.3	0.9	0.2	-0.4	0.6
Non-Bank private, net	-1.2	1.3	4.9	0.7	0.9	2.2	1.0
Short-term capital net	4.0	-5.3	3.8	3.7	-6.0	2.8	3.3
of which:							
Official sector, net	-0.5	1.9	4.3	0.7	-0.9	1.5	3.1
Bank's net	2.4	-9.5	1.4	3.5	-3.6	2.6	-1.1
Non-Bank private, net	2.1	2.4	-1.9	-0.5	-1.5	-1.3	1.3
Other flows	1.1	-3.0	-4.9	0.7	-0.6	-2.3	-2.7
Official financing balance (-=increase in reserves)	-1.2	9.8	0.6	-5.2	-0.4	1.5	4.6
Balancing item (2)	0.7	0.6	0.6	2.2	1.9	-0.9	-2.7

(1) Totals in US$ calculated using the relevant period average exchange rate. For this reason quarterly totals may not sum to annual totals.
(2) Reflects unidentified net flows, which may be either current or capital account items

Memo items							
FF per US$ (period average)	6.93	6.01	5.96	5.67	5.78	6.32	6.06
Nominal effective exchange rate 1985=100	102.8	103.0	100.9	102.4	101.4	100.0	99.6

TABLE A5:
UNITED KINGDOM: EXTERNAL FINANCING
(billions of dollars; not seasonally adjusted)

				1988				1989
	1986	1987	1988	Q1	Q2	Q3	Q4	Q1
Identified current account	0.2	-4.8	-26.6	-6.1	-6.1	-6.2	-8.2	-8.0
Financed by:								
Direct investment, net	-9.5	-17.5	-13.0	0.7	-6.1	-3.6	-4.0	-3.5
Portfolio investment, net	-25.8	18.3	-12.0	-4.4	-6.6	3.6	-4.9	-12.5
Bank borrowing, net	14.5	4.1	26.0	5.3	9.9	0.7	10.5	14.2
of which : assets	-78.9	-82.6	-34.3	2.8	-16.1	-28.3	8.3	-26.4
liabilities	93.5	86.7	60.3	2.6	26.0	29.0	2.2	40.6
Government borrowing,net	-0.5	1.3	0.0	-1.1	0.0	-0.6	1.8	-0.6
Non-banks', net	5.1	-2.1	5.8	3.7	1.4	1.7	-1.1	3.0
Official financing balance (--increase in reserves)	-4.2	-19.7	-4.9	-1.2	-1.2	-1.7	-0.9	0.9
Balancing item	20.1	20.3	24.7	3.1	8.8	6.1	6.8	6.5
Memo Items								
£ per US$ (period average)	0.68	0.61	0.56	0.56	0.54	0.59	0.56	0.57
Nominal effective exchange rate 1985=100	91.6	90.1	95.5	93.4	96.8	95.2	96.7	97.1

TABLE A6:
ITALY: EXTERNAL FINANCING

(billions of dollars; not seasonally adjusted)

	1986	1987	1988	1988 Q1	Q2	Q3	Q4
Identified current account	2.6	-1.5	-5.2	-5.2	1.0	0.2	-1.5
Financed by:							
Non-banks', net	-2.8	5.0	6.7	3.6	-1.3	4.7	-0.4
of which: long-term	-2.7	3.2	7.8	3.1	-0.9	4.8	0.6
short-term	-0.1	1.9	-1.2	0.5	-0.4	-0.2	-1.1
Bank borrowing, net	3.4	4.2	8.6	2.1	3.2	-0.6	4.2
Official financing balance (-=increase in reserves)	-1.4	-5.1	-9.1	-2.5	-0.5	-2.8	-3.3
Balancing item (2)	-1.7	-2.6	-0.9	2.0	-2.3	-1.5	1.0

(1) Totals in US$ calculated using the relevant period average exchange rate. For this reason, quarterly totals may not sum to annual totals.
(2) Reflects unidentified net flows, which may be either current or capital account items

Memo items

IFS Data

Direct investment
Portfolio investment

LIT per $ (period average)	1490.8	1296.1	1301.6	1235.3	1268.1	1385.9	1317.3
Nominal effective exchange rate 1985=100	101.4	101.2	97.8	99.5	97.8	96.5	97.3

TABLE A7:
CANADA: EXTERNAL FINANCING

(billions of dollars; not seasonally adjusted)

	1986	1987	1988	1988 Q1	1988 Q2	1988 Q3	1988 Q4	198 Q1
Identified current account	-7.6	-8.0	-9.2	-3.8	-1.1	-0.4	-3.8	-5.1
Financed by:								
Direct investment, net	-2.1	-1.2	-2.5	0.1	-1.5	-0.4	-0.7	-0.8
Portfolio investment, net	16.1	8.8	10.3	2.2	2.9	3.8	1.4	5.1
Bank borrowing, net	-4.0	1.7	2.1	1.0	-2.7	4.1	-0.3	-3.2
Government borrowing, net	1.3	0.7	5.2	2.3	2.7	-0.5	0.6	1.6
Non-banks', net	-0.8	3.6	2.0	0.1	2.9	-4.7	3.7	1.7
Official financing balance (--increase in reserves)	-0.5	-3.4	-7.7	-4.4	-3.7	1.5	-1.0	-0.2
Balancing item (2)	-2.4	-2.2	-0.4	2.3	0.5	-3.3	0.1	0.9

(1) Totals in US$ calculated using the relevant period average exchange rate. For this reason, quarterly totals may not sum to annual totals.
(2) Reflects unidentified net flows, which may be either current or capital account items.

Memo items								
C$ per US$ (period average)	1.39	1.33	1.23	1.27	1.23	1.22	1.21	1.19
Nominal effective exchange rate 1985=100	91.7	92.4	98.1	94.6	97.5	100.4	100.0	102.0

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BANK OF ENGLAND
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THE DEPUTY GOVERNOR

18 September 1989

P R Gray Esq
Prime Minister's Office
No 10 Downing Street
London SW1A 2AA

RA

Dear Mr Gray

As requested, I attach a copy of the paper which Sir Hector Laing drew to the attention of the Prime Minister. It is the Bank's World Payments Report, based on published information. The data on balancing items in different countries' balance of payments statistics are to be found in the annex to the paper.

Clive Briault

C B Briault
Private Secretary to the Deputy Governor