

CHAPTER 5

THE EXTERNAL FINANCIAL POSITION

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The recent past

A broad picture of the balance of payments during the recent past is presented in Table 5.1. The current balance has characteristically been more favourable to the UK than the balance of goods and services, due mainly to property income on overseas assets. Structural capital flows have characteristically resulted in a net outflow, leaving a 'basic' balance (the best measure of the financing problem), which is in worse shape than the current balance.

If the sum of non-trade components of the basic balance were perfectly stable, movements in the trade balance would be accurately reflected as changes in financing requirements for the 'basic' balance. Indeed, until 1970 the trade and basic balances moved closely together, never differing by more than £168m. But since the late 1960s two factors have disturbed this relationship. First, UK receipts of property income rose by £1100m in 1973, while payments rose by only £300m., so that the difference between the trade and current balances moved sharply in favour of the UK. Although inflation has since reduced its real value, this difference has remained high in money terms. Even in 1975, after very large borrowing at high interest rates during 1973-4, net property income was running at £1400m. annually, well above its 1972 level (£580m.), even in real terms.

Secondly, the UK private sector, from the late 1960s to 1974, became a substantial importer of capital; increasingly stringent exchange control has ensured that it normally invests abroad little beyond what it retains in profits on existing assets (this too is subject to exchange control) plus what it can borrow in overseas currencies. Foreign investments in the UK, on the other hand, have increased rapidly. The result is that in some years the sum of structural capital flows is actually positive, as net private investment inflows offset the chronically negative effects of official capital outflows and trade credit.

Taking the two effects together, we find that the financing problem, which during the 1960s was normally £100m. or so worse than the trade deficit,

recently became considerably less than the trade deficit (by £800m. in 1973 and £1500m. in 1974). Then in late 1974 and during the first half of 1975 the situation on capital account reversed itself radically, creating a financing problem apparently in excess of the trade deficit. A tentative guess is that this is explained in part by the way in which the world's oil trade is financed, and in part by the arbitrariness inherent in treating certain capital flows as 'structural' and others as purely 'monetary'.

Until mid-1974, nearly 25% of payments to oil producing countries were in sterling. Consequently, when the price of oil rose in 1973-4, sterling balances held by the oil industry rose sharply. This resulted in a very large once-and-for-all investment by foreign oil companies in the UK, most of which occurred during the first quarter of 1974, and explains much of the very high inward 'oil' investment in that year. From late 1974 the proportion of oil revenues payable in sterling has declined to about 11%, and the oil industry has reduced its sterling holdings accordingly. The effect of this was an outflow in the last quarter of 1974 and the first half of 1975 (under 'Oil and miscellaneous') amounting to £936m. The apparent decision of oil-producing countries to reverse the build-up of their sterling holdings thus presented a financing problem for Britain in the first half of last year. However during the third quarter net 'Oil and miscellaneous' capital transactions reverted to a more normal inflow of £376m.

The basic balance, since 1963, has been chronically in deficit apart from 1969-71, when the budget squeeze imposed by Mr Jenkins created a marked shift in the trade balance. During the mid-1960s the deficit on the basic balance was financed largely through official channels such as the IMF, and on concessionary terms. More recent deficits have been financed (prior to end-1975) without recourse to official monetary sources and on commercial terms.

Part of the 1974 deficit was financed by the willingness of oil-producing countries to hold increased

Table 5.1 Balance of payments in the recent past (£ million)

	1963	1964	1965	1966	1967
Goods and services	- 130	- 575	- 278	- 85	- 448
Interest, profit, dividends and transfers	261	220	251	185	147
Current balance	131	- 335	- 27	100	- 301
Structural capital flows	- 229	- 338	- 228	- 274	- 226
Basic balance	- 108	- 743	- 255	- 174	- 527

Note: Structural capital flows include capital transfers; official long-term capital flows; overseas investment in the UK public sector excluding net issues and bank borrowing abroad; overseas investment in the UK private sector; UK private investment overseas; overseas currency borrowing by UK banks to finance UK private investment overseas; net trade credit; and an

Table 5.2 Foreign currency debt of UK public sector outstanding on commercial terms (\$ million)

Raised during:	1969-71	1973	1974	1975	Total
Source:					
Eurobonds	240.7	460.4	70	—	771.1
Eurobanks	298.5	2216.9	3046	1000	6561.4
Middle East	—	60	1150	395	1605
EEC	—	34.2	239.4	533.9	807.5
Total	539.2	2771.5	4505.4	1928.9	9745

Source: Author's estimates

exchange reserves in sterling. From the beginning of 1974 to the end of March 1975 their reserves in sterling rose by £2500m., offsetting considerable reductions by other holders and leaving a net increase of £1632m. Increased holdings of sterling provided little help during 1973, however, and since March 1975 oil-producing countries have been reducing their holdings appreciably (£500m. by September 1975).

The bulk of the remaining deficit has been financed by borrowing in foreign currencies by the public sector. Public sector bodies were encouraged to borrow funds in foreign currencies during 1969-71, but most of the present loans have been raised since 1973, when an exchange cover scheme was re-introduced under which the Treasury insures public sector bodies against losses due to depreciation of sterling. A breakdown of this debt (which now stands very near \$10,000m.) by date of borrowing and origin is presented in Table 5.2.

Since the details of these loans, including their source, are officially confidential, the table has been constructed from a mix of official and unofficial sources. The estimates are probably quite good, but some parts are uncertain and have been allocated by guesswork. All figures are given in dollars at February 1976 exchange rates.

Eurobonds as a source of finance have been relatively minor, as the market itself is fairly small. The major source of finance has been the Euro-banking system, which during the last three years provided more than \$6000m. of revolving medium-term credits. The second largest source of funds has been oil-producing countries, which have provided \$1600m. Of this

\$400m. represents the first drawing on the facility arranged with Iran.

Since the middle of 1974, finance from these sources appears to have been difficult to arrange on acceptable terms. Apart from the money raised in the Middle East during 1975, nothing new was arranged and some drawings were delayed. Part of the problem is that the oil surpluses fell during 1975 due to rising imports by OPEC countries and reduced demand for oil. The Eurobanking system, which was lending heavily on terms very favourable to borrowers from 1972 until spring 1974, seized up after the Herstatt failure in June 1974 and for a period may even have contracted. Lending has now resumed, but on terms far more favourable to lenders, and large balance-of-payments motivated loans have been avoided. The Eurobond market has moved more or less in line with the Euro-banking system. The markets seem not to have regarded the UK government as entirely creditworthy.

Since mid-1974 the major sources of new funds have been the European Steel and Coal Community and the European Investment Bank. This money has been lent for specific projects, mostly to nationalised industries (although funds have also been made available to the private sector).

Public sector borrowing in 1975 was not sufficient to finance the basic deficit. Reserves fell by \$1360m., so that borrowing and reserves together provided \$3300m., or nearly £1500m. of finance. The remaining £1300m. cannot be fully identified (owing to the large 'balancing item'), but was at least in part provided by a net short-term banking inflow.

1968	1969	1970	1971	1972	1973	1974	1975
- 376	189	388	755	- 187	- 1780	- 4608	- 2744
101	273	347	293	315	945	940	1037
- 275	462	735	1048	128	- 835	- 3668	- 1707
- 226	- 279	- 234	181	- 213	- 149	635	- 1144
- 501	183	501	1229	- 95	- 984	- 3033	- 2851

estimate of £79m. in 1974 and £197m. in 1975 for overseas currency borrowing through UK banks by UK companies to finance North Sea development.

The prospects for financing future deficits

A year ago the author suggested¹ that it was at least possible that substantial basic deficits might be financed by continued increases in exchange reserves by oil-producing countries, but that 'a difficulty will occur should a chronic and substantial differential rate of inflation develop between the UK and the rest of the world'. This is just what happened in 1975 when inflation in the UK was running some 15% per annum higher than in Germany or the United States, suggesting that sterling's exchange rate would have to fall considerably in order to maintain the competitiveness of UK exports. As the UK was offering a differential interest rate of only 3-4% compared to dollars and 6-7% compared to D-marks, the build-up of exchange reserves by oil producers started to reverse. In the event the exchange rate did in fact fall rapidly, with the weighted exchange rate now standing 11.5% below that at the end of March 1975, while the exchange rate against the dollar has fallen by 16%. So long as a large differential inflation exists sterling inflows cannot be attracted without totally unacceptable interest rates, and it will be difficult to retain existing sterling balances.

Recourse to other sources of foreign currency finance presents for the most part a similar difficulty. It is likely that project finance will continue to be available from the EIB and ECSC on the same terms and in roughly the same amounts as in 1975, and there remain two tranches of \$400m. due from Iran, one to be drawn on 30 June and 30 September of this year, the other due some time in 1977. Any large sum beyond this will require the UK to convince the financial world that it is in some sense 'creditworthy', which probably means, first and foremost, demonstrating that public finances and inflation can be brought under control.

The general outlook as regards market sentiment is in the short term cautiously optimistic. The incomes policy appears to have been well received and inflation has sharply decelerated to a 13-14% annual rate during the last six months. The Gas Corporation recently made a Eurobond issue which was well received and the prices of outstanding public sector dollar securities suggest a considerable improvement in credit rating over the last six months. Should wage restraint continue and should inflation continue to abate, considerable sums may be available from the banks on acceptable terms.

It was partly in response to the difficulties of 1975 and partly for technical reasons that the Treasury arranged to draw SDR1000m. under the IMF oil facility (this was drawn in January) and SDR700m. under its conditional credit facility (£975m. total). These drawings require the UK to pursue efforts to conserve oil consumption and to eschew increased import restrictions without consulting the Fund. It is at the moment unclear whether further funds may be available through the oil facility (the IMF was unable to attract its quota of deposits in 1975).

Recently credit tranches at the Fund were increased temporarily by 45% and in principle the UK is entitled to increase the SDR700m. to SDR1015m. But this 45% increase in the amount countries can draw was

intended as a way of increasing immediate financial help for less developed countries. As the proposed increase in the UK's IMF quota is very small (4.5%), the IMF is likely to take a dim view of attempts by the UK to make use of the temporary increase in credit tranches.

It should be noted that by drawings on the IMF credit tranche the UK has begun to use facilities which are usually a 'last resort'. Other 'last resorts' include the official reserves, which now stand at \$6785m. (£3359m.), and \$3000m. (£1485m.) available through the Federal Reserve swap network. Beyond these the oil-inspired facilities provided by the EEC and OECD might be a further source of finance. However, the EEC has had difficulty raising deposits and plans to borrow from the Eurocurrency markets to raise a loan for Italy, while the OECD scheme is still bogged down in various national parliaments. Like the IMF schemes, the EEC and OECD facilities involve varying degrees of conditionality, depending on the amount drawn.

From the late 1970s the financing problem will be aggravated by the maturity of the foreign currency loans raised in the last few years. Table 5.3 presents tentative estimates of the repayment schedule. It is evident that by 1979 the UK will be faced with what will essentially be a large floating debt in foreign currencies.

Table 5.3 Estimated repayment schedule of public sector foreign currency debt (\$million)

	Commercial loans	IMF loans	Total
1976	46		46
1977	76		76
1978	676		676
1979	1578	507	2085
1980	1605	507	2112
1981	1820	507	2327
1982	1380	234	1614
1983	1191	234	1425
1984	932		932
1985	146		146
1986	148		148
1987	22		22
1988	25		25
1989 and beyond	100		100
Total	9745	1989	11,734

Source: Author's estimates.

Targets for the balance of payments up to 1980

The UK now has a foreign currency debt of some £6 billion, together with a potential liability for £7 billion sterling balances held by foreign investors. Against this total of £13 billion debts can be set exchange reserves of £3.5 billion, other 'last resort' sources of credit (IMF, Federal Reserve and EEC) amounting to perhaps £3 billion, and possible new borrowing on commercial terms, which at least in the next year or two is not likely to exceed £1 billion a year. In addition Britain probably retains some

¹Economic Policy Review, February 1975, chapter 5.

capacity to attract short-term banking inflows by offering a sizeable interest differential.

All this barely adds up to solvency. If the balance of payments remains in deficit, the availability of commercial debt is unlikely to rise and deficits on the basic balance will have to be met mainly from the reserves or 'last resort' sources of credit. Moreover the existing foreign currency debt will progressively mature. As it becomes shorter-term in nature the UK will either have to refinance it or prepare to meet the repayment schedule.

From now on Britain therefore cannot afford any sustained large deficits on the basic balance and must aim to restore it to credit within a few years to demonstrate that in the long term some repayment of debt will be possible. Given the continuing need to provide trade credit for exports, structural capital flows will provide little, if any, assistance. This all implies that current account deficits must be contained to within a low cumulative figure (say, £5 billion) in the next three or four years and that by 1980 the current account will probably have to be brought into balance or surplus.

The exceptional circumstances of the 'oil deficit' and oil finance available in 1974 are most unlikely to recur. They do not provide any valid precedent for believing that Britain could finance a £3-4 billion-a-year deficit in the future. The only conceivable qualification to this analysis would be if Britain could establish a reputation as a 'low-inflation' country with a particularly stable currency. In that unlikely event, sterling might play an increasing role as a reserve currency, providing regular inflows of funds for deficits on the basic balance.