

CHAPTER 5

FINANCE FOR THE BALANCE OF PAYMENTS

by Paul Atkinson

This article examines the non-trade items of the balance of payments and considers the problems of external financing that lie ahead.

The Background

In the past, thinking about the balance of payments has been dominated by the current account, particularly the trade balance. The IPD flows and transfers were a stable positive item and the structural, as opposed to monetary, capital flows were normally of the order of £200-£300m debit per annum. The key variables were thus exports and imports of goods and services. The balance of goods and services, particularly the visible import component, has tended to deteriorate sharply during periods of expansion in the British economy, bringing on crises of confidence in sterling. The problem has been exacerbated by the existence of the sterling balances.

The official reserves, perhaps because there have been so few of them, have rarely been heavily drawn on since the Korean War, except in 1972. Payments difficulties during the 1950's and 1960's were largely handled by official loans or swaps from the IMF or various Central Monetary Institutions. These usually entailed a promise to adjust the situation fairly quickly by deflation. The surpluses that followed were used not to augment reserves, but to pay off the official loans, until in 1971 a massive current surplus and an anti-dollar hot money inflow allowed reserves to more than double.

In 1972, another expansion took place and the current balance deteriorated with unusual rapidity. The worst current deficit since 1951 had been £382m (in 1964), but in 1973 it reached £1198m, and in 1974 £3730m. Financing deficits of this size (unprecedented, even after adjusting for inflation), never mind the accompanying speculative attack, would in the past have been unthinkable, yet the deficits have been financed, there has been no crippling speculative attack on sterling, and over the two year period 1973-74 official reserves have actually increased. It is true that much of the 1974 deterioration is due to the oil price rise, but the U.K. current deficit is the world's largest. How do we explain the situation?

One major factor helping to finance the current deficit, as Table 1 shows, has been the U.K.'s abandonment of its historical role as a capital exporter and its emergence as a major capital importer.⁽¹⁾ U.K. private investment abroad has long since ceased to affect the

exchange market for sterling significantly, as the private sector invests abroad little beyond those profits that it retains abroad from already existing assets plus what it can finance by borrowing in overseas currencies. Meantime, foreign investment in the U.K. private sector has grown rapidly so that the U.K. was a long term private capital importer of £730m in 1973 and £1520m in 1974. The 1974 figure is affected by unusual disinvestment of oil assets in the Persian Gulf early in the year, but would be very high regardless. Thus despite the "inconceivable" current deficit in 1973, the basic deficit, i.e. the balance of current and structural capital flows, was only £810m. or not much more than in 1964, and considerably less in real terms. Similarly, the 1974 basic deficit, at £3106m, is considerably less than the current deficit. The basic deficit is a better measure of the financing that is required than is the current balance.

The financing of the basic deficits in 1973 and 1974 has been remarkably easy. In March 1973 an exchange guarantee scheme was introduced whereby the Treasury assumed the exchange risk on overseas currency borrowing by public sector bodies. In 1973 £1099m were borrowed by the public sector, much of it under this scheme, more than covering the basic deficit. In 1974 £1886m were borrowed in overseas currencies, leaving only £1220m to be financed. This has been more than covered by a buildup of sterling balances, as several oil producing countries have chosen to hold their exchange reserves in sterling. It should be noted that the buildup of sterling balances is considerably less than the actual OPEC inflow, as exchange reserves held by non-OPEC countries have been withdrawn, presumably to pay for oil.

The Prospects to 1978

Table 5.2 shows the likely movement of the autonomous non-trade items and the resulting basic balance on the assumption of a steady reduction of the trade deficit up to 1977. In order to abstract from inflation the forecasts have all been expressed in 1974 values using the export price deflator. This adjustment is simply a scale adjustment, affecting all flows equally in one year. The figures should not be taken to represent volumes.

The balance on goods and services is sensitive to various assumptions about factors discussed in Chapter 1 of this review. The autonomous non-trade items are largely independent of changes in these assumptions⁽¹⁾, and it is the sum of these items which is significant here. By adding this sum to the goods and services balance for any set of assumptions about policy, we get the basic balance, or financing requirements.

(1) The deterioration in the current balance over the last two years actually understates the deterioration in the balance of goods and services taken alone. This is because net IPD more than doubled during this period after a long period of slow growth. The current non-trade items, after averaging £232m during 1963-72, averaged £724m in 1973 and 1974.

(1) Trade credit depends on exports and imports, while IPD contains a financing debit which depends on past basic deficits.

Table 5.1 Balance of Payments, 1963-1974

	(£ million)											
	1963	1964	1965	1966	1967	1968	1969	1970	1971	1972	1973	1974
Goods and Services	-137	-602	-300	-101	-460	-381	176	388	781	-140	-1832	-4544
IPD and Transfers	261	220	251	185	147	101	273	319	312	254	634	814
Current Balance	124	-382	-49	84	-313	-280	449	707	1093	114	-1198	-3730
Structural												
Capital Flows	-239	-388	-228	-274	-226	-227	-279	-347	96	245	388	624
Basic Balance	-115	-770	-277	-190	-539	-507	170	360	1189	-131	-810	-3106

Table 5.2 Autonomous Items of Balance of Payments to 1978

	(£m, 1974 values)				
	1974	1975	1976	1977	1978
Goods and Services	-4544	-3396	-1751	-943	-990
IPD	1200	524	150	-201	-406
Govt. trans.	-302	-430	-505	-587	-639
Private trans.	-84	-112	-128	-145	-162
Current Balance	-3730	-3414	-2234	-1876	-2197
Long term capital	1320	929	941	1027	1117
Net trade credit	-616	-316	-374	-347	-249
Capital transfers	-80	-	-	-	-
Basic Balance	-3106	-2801	-1667	-1196	-1329
Memorandum Item					
Sum of autonomous					
Non trade items	1438	595	84	-253	-339

The sum of the autonomous items is expected to deteriorate sharply, until in 1978 it is almost £1800m worse than in 1974. As mentioned earlier, there were unusually favourable factors affecting these flows in 1974, but the financing charges on continued deficits and profit outflows due to North Sea operations are responsible for the bulk of the decline. The financing charges by 1978 will be £483m at 1974 values while the North Sea debit is estimated to be £1014m (see Chapter 4). The latter figure is highly uncertain but a large profit outflow is inevitable during the first few years of production.⁽¹⁾

(1) The Government in its election manifesto has committed itself to 51% participation in the North Sea. Negotiations toward this end are in their initial stage, and it is not clear what the results will be, particularly with regard to compensation arrangements, timing of the take-over, or the transition period. Accordingly the calculations are made here on the assumption that such participation does not occur within our time horizon, but that taxes are levied in accordance with announcements to date.

The other estimates, compared with IPD, involve relatively little change. Government transfers show a steady rise due to net contributions to the EEC, while trade credit becomes more favourable after the unusually high debit in 1974. Methods of forecasting all items are explained in the Appendix.

There appears to be limited scope for Government measures directly to improve the balance on the items considered here. Government transfers and capital outflows commonly involve international commitments, such as debt repayment and foreign aid, which tend to be inflexible. The possible exception is the EEC contributions, the future of which depends on whether Britain remains in the Community. Since, as noted earlier, private investment abroad involves very little flow across the exchanges, there is little scope for quick direct action. The main area where government action might influence the position is in its policies toward the North Sea. This problem is discussed in Chapter 4, but in order to keep the companies here and to maintain the

development rate any consequential saving by 1978 would be at the cost of higher payments later.

There seems to be no escaping the conclusion that, as in the past, if action is needed to strengthen the basic balance, it will have to be aimed primarily at goods and services.

Sources of Finance for the Basic Deficit

There are three fundamentally different ways of financing a basic deficit available, all of which have been used in the past. First, overseas currencies can be borrowed on a commercial basis. Secondly, the U.K. can accumulate more sterling liabilities. Finally, there is resort to official financing measures. We shall discuss these in order.

(a) Overseas Currency Borrowing

Since March 1973 the U.K. public sector has borrowed almost £3,000m, much of it under the Exchange Guarantee scheme, and mostly on the Euromarkets. There remain \$1000m (£430m) to be drawn on the Central Government loan announced last March by the Chancellor, which will presumably be drawn this year.⁽¹⁾ There are also two tranches of \$400m each, (£170m each), remaining of the Iranian loan, which will be drawn this year and next. There thus exist known facilities for borrowing £600m in 1975 and £170m in 1976 (current prices). The question of how much more is available here is anybody's guess, but it is unlikely that borrowing can be continued indefinitely at anything like this rate. By the end of the period, if it continued at current rates, much of the borrowing would be to service the interest payments on the debt. Bankers tend to be very dubious about lending for this purpose, particularly if there is no indication that repayment of principal is imminent.

It should be noted that the U.K. has not been the only major borrower on the Euromarkets during the last two years. Italy, France, and Japan have all been heavy borrowers, while the Japanese have also borrowed heavily from U.S. banks. It is of note that the markets reacted increasingly negatively, particularly in the cases of Italy and Japan. Japanese banks found throughout the summer that increasingly they had to pay substantial interest rate premiums in order to borrow. The last large loan arranged for Italy, in the spring, was very much touch and go, requiring an unusually large number of banks in the syndicate, and is unlikely to be repeated in the near future. Italy has more or less run out of commercial credit. While the U.K.'s position as a borrower is reinforced by the presence of oil, it is extremely unlikely that unlimited credit from the commercial banking system will be available. For the purposes of this exercise it is assumed that in addition to the known facilities for borrowing, roughly as much again can be raised in 1975 to be drawn in 1975-76, and no more afterwards. To the extent that more can be raised, less financing is required by other means.

(b) Sterling Liabilities

The alternative to denominating debt in overseas currencies is to denominate it in sterling. In practice this means inducing foreigners to increase their sterling balances, i.e. exchange reserves and banking and money market liabilities in sterling. Normally the "hot money" element of the balance of payments is expected to move to where it will earn the greatest return. In periods when exchange rate changes appear likely these funds tend to move with the current balance. Thus the threat of a withdrawal of sterling balances has always been assumed to accompany a weak current balance, as in November 1964 or 1967-68, while the large surpluses during the Jenkins' squeeze, occurring during a period of obviously imminent dollar devaluation, were accompanied by large inflows to the banking sector. This means that official borrowing and reserve transactions, when the basic balance is strongly out of equilibrium, are often exaggerated versions of the basic balance. In 1973 however, there was no net outflow of sterling balances for the year as a whole, and in 1974 augmentation of these balances has been sufficient to finance the liquidity deficit and even allow a buildup of reserves.

Holders of sterling balances can be classed into three major groups. In the balances held by other than central monetary authorities we have what might be called "hot money" (although many exchange reserves belong in this category also). These balances tend to move to where the return is highest. They rose marginally during the first nine months of 1974 to £2481m, but probably stand lower now. The problem of keeping these balances in London is the same as ever, requiring continued confidence in sterling and a high return. It is likely that funds of this sort will move as in the past, and that hot money inflows will not finance any significant part of future deficits. Inflows of this sort have been of consequence only during 1970-71, accompanying large basic surpluses, and due largely to anti-dollar sentiment.

The second important group of sterling holders consists of non-OPEC governments which hold exchange reserves in sterling. A relatively moderate level of reserves held in London by EEC countries and international organisations has been stable in 1974, while reserves held by other countries have been withdrawn at a £1000m annual rate. If these withdrawals continue at this rate they will be exhausted by the end of 1975. Increased use of sterling as a reserve currency by non-OPEC countries is obviously not going to provide any finance, but the inevitable reduction in the withdrawal of existing reserves will be of considerable assistance, as it will to some extent offset the likely drying up of commercial credit.

It is from the third class of sterling holder, the OPEC countries, that a significant inflow can be anticipated. In the first nine months of 1974 OPEC holdings of sterling reserves rose by nearly £1800m, and, as these countries have been holding roughly one eighth of their surplus revenues in sterling, the total for the year may be of the order of £3000m. The total increase in sterling balances this year is thus more than accounted for by the oil producers, who have financed that part of the basic deficit not covered by overseas currency borrowing and also the sterling withdrawals of other central banks.

The question of how large a basic deficit can be financed without resorting to official financing thus

(1) Only \$300m now remain, as \$700m were drawn in January.

Table 5.3 Changing Composition of Sterling Balances (£ million)

	Exchange Reserves in Sterling			External Banking & Money Market Liabilities in Sterling to Other Holders		
	End 1973	End Sept. 74	Change	End 1973	End Sept. 1974	Change
Oil Exporting Countries	959	2729	+1770	314	333	+19
EEC & International Orgs., excl. IMF	598	568	-30	468	513	+45
Other Countries	2132	1380	-752	1502	1635	+133
Total	3689	4677	+988	2284	2481	+197

Source : B.E.Q.B.

comes down to the willingness of a few OPEC countries to hold their funds in sterling⁽¹⁾. One factor favouring the U.K. has been its historical ties with some of the Persian Gulf producers who have traditionally held their reserves in sterling. This has probably not been a major factor, and would be an extremely slender reed to rely on for the future. These countries will act in their own self interest.

A second factor, perhaps more important, has been a desire on the part of these countries to diversify their holdings, rather than to hold only dollars. The obvious alternative currencies, e.g. the Swiss franc and Deutsche-mark, are deliberately made unattractive, as Switzerland and Germany resist inflows of foreign funds. Sterling may thus gain through its relative accessibility.

Third, and most important, has been the high rates of interest paid on sterling assets. In order to attract a continuing inflow Britain will have to offer at least a premium in nominal interest rates relative to the rest of the world. This has historically been the case anyway, and would be required in order to hold the non-official sterling balances⁽²⁾.

In sum then, it is at least possible that sizable basic deficits can be financed over the next few years on essentially the same terms as it has been this year, with the likely drying up of commercial credit being more or less offset by declining outflows of sterling held by non-oil producers. Such a course would provide a handful of

Finance Ministers with enormous financial leverage over the U.K.

(c) Official Financing

The third option for dealing with deficits is to resort to official action. Table 5.4 shows the official assets available to the U.K. totalling roughly £6800m. These assets exist, however, as contingency reserves in case sterling comes under unusually heavy pressure. Any resort to these assets would be damaging to confidence, and should be avoided.

Table 5.4

Official Assets – End 1974

Official Reserves (£1=\$2.3495)	£2890m
Effect of valuing gold at \$170 per oz. rather than \$42.22	£1140m
IMF Conditional Drawing Rights (2800 SDR's)	£1460m
Federal Reserve Swap Facility (\$3000m)	£1280m
Total	£6770m

This leaves the possibility of official borrowing. What is available here is likely to be in the context of the emerging schemes to recycle surplus oil revenues. This is unlikely to be a large long term source of finance for large basic deficits.

At the moment the likely result of international negotiation appears to be an IMF facility of some \$6000m p.a., a similar but smaller EEC scheme, and an OECD safety net scheme of the same order of magnitude. The IMF deposits will come from the oil producers, while the OECD scheme will be funded by contributions from the industrial countries with the U.K. share likely to be 5–10%. These schemes are not particularly large in comparison to the OPEC surpluses, although pressure to expand the facilities in the future is likely to prove irresistible.

(1) The key point here is that the oil producers are probably the only significant source of finance for large deficits over the next five years. For simplicity of exposition it is assumed that the question at issue is their willingness to continue adding to sterling balances. It is possible that their investment policy will lead them to reduce the buildup of liquid holdings in favour of medium term loans or government to government loans, in which case the problem would become one of attracting an equivalent share of these loans, which would be essentially like the loan from Iran. The Iranian loan has been treated here as a commercial loan because of its term (5 years), its denomination (U.S. Dollars), and because it is covered by the exchange scheme. It could equally well have been included with the other OPEC holdings.

(2) During inflationary periods such as the present, nominal interest rates tend to be less than the inflation rate. In these circumstances it is possible that even while offering an interest premium, the real burden will be negative. The real interest rate in the U.K. may simply be less negative than anywhere else.

The U.K., since it has the largest deficit, will presumably have a strong claim to some of this money should it be needed, but there are three points to be kept in mind.

First, OPEC deposits will have to come at the expense of deposits elsewhere. It is unlikely, for political reasons, that loans to LDC's will be reduced, or that government to government transactions will be reduced. The IMF deposits will probably be at the expense of other liquid holdings which at the moment are largely in dollars or sterling. It is at least possible that sterling holdings will be reduced (relative to what they would be in the absence of the IMF scheme), in which case the net benefit to the U.K. may be small or negative. Secondly, a true recycling scheme would take account of the existing destinations of OPEC money. Although this does not seem likely to be a major consideration, to the extent that it is the U.K. will seem considerably less "deserving" than most other countries. Thirdly, the OECD scheme is quite likely to have strings attached in the form of requirements to reduce inflation and imports via fiscal-monetary means, to reduce energy consumption, or not to impose trade restrictions. It is furthermore envisaged to be a last resort, after commercial avenues, the IMF scheme, and official loans backed by gold have been tried and exhausted. It may well be in lieu of, rather than supplementary to, the network of official swaps and borrowing that has seen the U.K. through previous balance of payments crises, most recently the 1964-68 period.

Official recycling and mutual support schemes, then, will be helpful in that they provide some security in case a sharp change in OPEC willingness to hold sterling takes place, and should prevent such an occurrence from being an overnight disaster. But it is unlikely that these will provide a significant amount of money for any length of time, unless offset by decreased OPEC holdings of sterling, nor is it likely that such finance would be available on terms that didn't require substantial adjustment of the basic deficit fairly rapidly.

The Impact of Inflation

A difficulty will occur should a chronic and substantial differential rate of inflation develop between the U.K. and the rest of the world. If U.K. and world inflation rates are comparable, the oil producers may be happy to allow the U.K. to spend beyond its means in exchange for a higher return on sterling holdings. The oil producers, by their own action, would maintain stability in the exchange market for sterling. If a differential inflation develops, however, the U.K. government may choose to devalue sterling in order to maintain the competitiveness of its exports, so OPEC may find its assets depreciating in foreign currency terms regardless. In theory it ought to be possible to compensate for this by offering a sufficiently large interest rate differential, so that the return on sterling, measured in foreign currency, is greater than on alternative assets. In practice things may not be this simple. While nominal interest rates are known with precision, future differential inflation and exchange rate changes are not. In a situation where differential inflation is between 5 and 10% p.a., and the interest rate differential more than enough to compensate, while comparable devaluations occur in fits and starts at unpredictable intervals, un-

certainty would pervade the situation. In this circumstance, where no one knew what sterling was really worth, it is possible that a forward market in sterling would either cease to function or to yield a discount well beyond the differential inflation rate.

A very high nominal interest rate is furthermore unlikely to be in the U.K.'s interest domestically. In such a situation it is quite likely that special provisions will have to be made for foreign holders of sterling, perhaps by reviving the sterling guarantee or some equivalent measure.

Finally, there is always the possibility that the producers will decide that they are throwing good money after bad, and cut their losses. It is possible to envisage a situation in which they leave their existing assets in sterling in exchange for a high return and guarantees, but don't increase the balances.

Even with a sizeable inflation differential it is possible that by offering the appropriate real return to all foreigners the inflow assumed above can be maintained. But it would be a mistake to assume that the oil producers had no choice but to continue to increase their sterling holdings (or, for that matter, that other holders cannot withdraw their balances).

Repayments of Loans in Overseas Currencies

So far the discussion has been in terms of a 1978 time horizon. It is well to look briefly beyond then. By the end of 1975 cumulative borrowing in overseas currencies will exceed \$8000m, and will perhaps be closer to \$9000m. Details of the repayment schedule of borrowing to date are not available, but Table 5.5 gives the repayment schedule of those loans drawn between 1.1.72 and 1.4.74, plus the Central Government loan, of which \$1500m has been drawn. Also included is the first tranche of the Iranian loan (\$400m) drawn last fall and due for repayment around 1979. The terms for the remaining two tranches are to be negotiated separately. Another \$1000m is unaccounted for here, but the bulk will probably fall due during the period 1979-84. The

Table 5.5

	\$ million
1978	537
1979	1184
1980	841
1981	1309
1982	1043
1983	1002
1984	743
1985	18
1986	20
1987	22
1988	25
Total	6744

N.B. Figures are derived from an answer to a written Question in Hansard [1.4.74] which gave the repayment schedule due on loans drawn under Treasury Exchange Cover Scheme 1.1.72-1.4.74. Additionally the 1979 figure includes \$400m on the Iranian loan and the 1981-84 figures include \$625m p.a. on the Central Government Loan.

Table 5.6 Financable Deficits to 1978

	(£ million – 1974 values)				
	1974	1975	1976	1977	1978
Official Financing	-133	250	250	250	250
Liquid Borrowing	1353	2000	2000	2500	2500
Public Sector Borrowing in Overseas Currencies	1886	800	400	—	-150
Basic Balance Financable	-3106	-3050	-2650	-2750	-2600
Capital Flows	624	600	600	700	850
Current Balance Financable	-3730	-3650	-3250	-3450	-3450
Transfers	-386	-550	-650	-750	-800
IPD	1200	500	150	-200	-400
Goods and Services Balance Financable	-4544	-3600	-2750	-2500	-2250

more that future deficits are financed by overseas currency borrowing, the heavier we can expect the burden to be in the late 1970's and early 1980's, although we can expect the real value of one dollar to be less than now. Detailed discussion of the prospects for 1978-82 are not possible here, but there will be obligations to be met that don't exist in the meantime.

Conclusions

Consider, finally, the largest deficits that we can plausibly imagine financing over the next four years. These estimates are presented in Table 5.6. Official assets are assumed unusable but it is assumed that a small net amount (£250m p.a.) will be available through recycling schemes with no strings attached.

Sterling inflows from OPEC averaging £2500m p.a. in real terms are assumed to be offset by withdrawals of £500m p.a. by other holders in 1975-76 which then cease as most exchange reserves are exhausted. It is further assumed that £1250m in overseas currency loans

can be raised this year, i.e. the £600m already raised and another £650m, but that half the new borrowings are drawn in 1975 and half in 1976. These figures are expressed in 1974 values, and the goods and services balance is the residual in the Table.

The implication of these estimates is that the basic deficit cannot be allowed to worsen in 1975, compared with 1974 and must after that show at the very least a moderate improvement. Improving capital flows will allow a steady current deficit throughout the period at a level only marginally better than this year's. The balance on goods and services, however, must steadily improve until in 1978 it is half the 1974 level, due to the expected deterioration of IPD. It should be noted, comparing Table 5.6 with Table 5.2, that should the assumptions underlying the Table 5.2 forecast be met, the goods and services balance, and thus financing requirements, will be marginally within the required range in 1975, and comfortably within it thereafter.