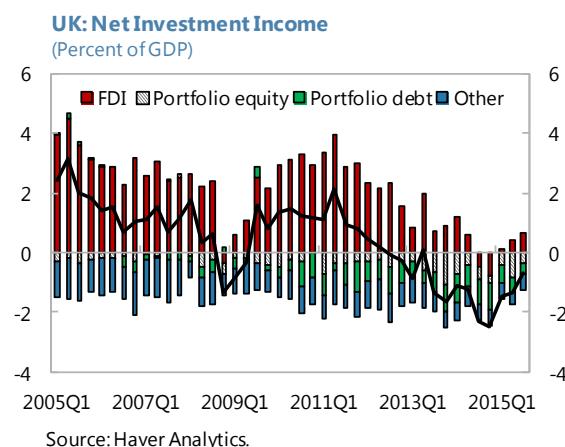
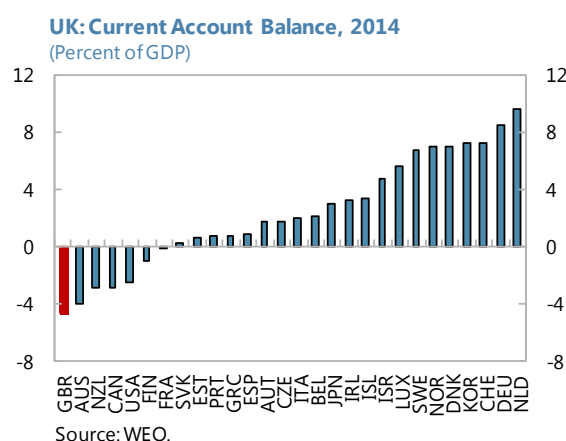
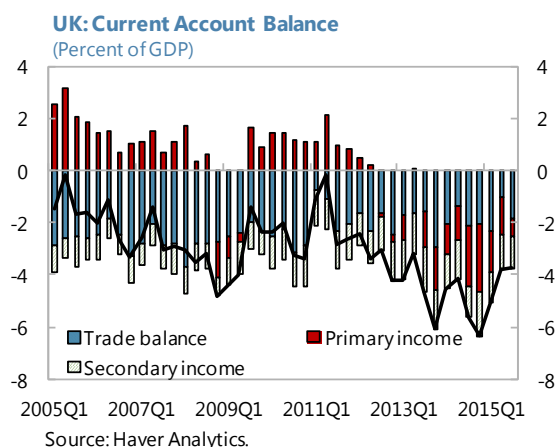


# HOW MUCH OF A CONCERN IS THE UK'S CURRENT ACCOUNT DEFICIT? AN ASSESSMENT OF THE UK'S EXTERNAL POSITION<sup>1</sup>

The UK's current account (CA) deficit stood at 5.1 percent of GDP in 2014, the largest in 50 years and the largest among advanced economies in 2014 as a percent of GDP.<sup>2</sup> This chapter looks at the reasons behind the widening CA balance, how it may evolve going forward, how it affects net investment positions, and to what degree one should be concerned about it.

## A. Why has the current account balance declined and to what extent will it improve?

**1. The income balance accounts for the recent deterioration.** From 2011 to 2014, the CA deficit deteriorated from 1.7 percent of GDP to 5.1 percent of GDP. However, this decline was not due to the trade deficit, which worsened by only 0.3 percentage point (1.6 percent of GDP to 1.9 percent of GDP). Rather, the wider current account is explained by sharply lower net investment income, particularly from FDI.



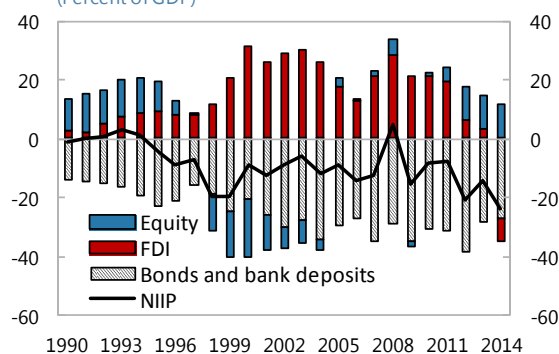
<sup>1</sup> Prepared by Anna Bordon (EUR).

<sup>2</sup> BOP and IIP data are based on statistics released by the ONS on December 23, 2015. New and preliminary results of the annual FDI survey suggest that the current account deficit could be revised down to 4 and 4.5 percent of GDP in 2013 and 2014, respectively.

**2. One reason for the drop in investment income is a shift in the UK's net investment position.** Net FDI has declined in recent years, while net portfolio equity has risen. This shift in the composition of net international investment matters because income flows from FDI tend to be higher than income flows from equity or debt.

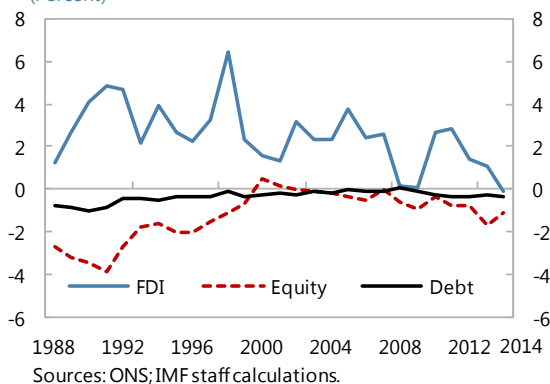
- Specifically, the average yield differential for FDI—computed from 1988 to 2014 as the ratio of income to the previous year's position of FDI assets and that of FDI liabilities and taking their difference—has been 2½ percent. The average yield differentials for equity and debt have been negative.

**UK: Decomposition of the IIP**  
(Percent of GDP)



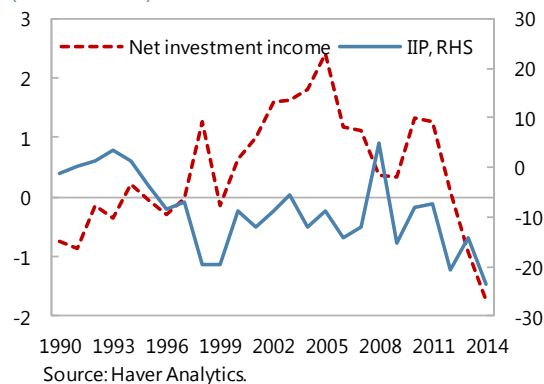
Source: Haver Analytics.

**UK: Yield Differential for Net FDI, Equity, and Debt**  
(Percent)



Sources: ONS; IMF staff calculations.

**UK: IIP and Net Investment Income**  
(Percent of GDP)



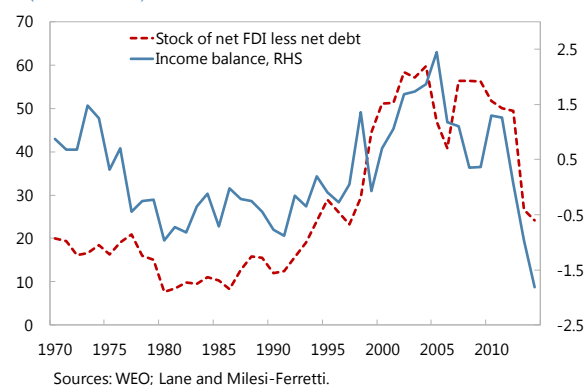
Source: Haver Analytics.

- Since UK residents' direct investment abroad earns more than nonresidents' investment in the UK,<sup>3</sup> a positive net FDI position will result in a strong investment income balance. Indeed, this so-called "exorbitant privilege" helped the UK's CA balance in previous years. Consequently, the investment income balance stayed positive from 2000 to 2012—contributing an average of 1.1 percent of GDP to the CA balance—even while the international investment position (IIP), except for 2008, was negative.

<sup>3</sup> Several reasons have been put forward to explain this result: (1) foreign investment consists of new firms that have lower returns due to inexperience or high initial expenses; (2) investment excludes intangible capital; (3) tax issues; and (4) compensation for risk of investing in countries with low sovereign credit rating. See Curcuro and Thomas (2012).

- This is also reflected in the positive relationship between the income balance and the difference between the net FDI and net debt positions. An increase in the income balance in the late 90s coincided with rising net FDI less net debt, and the recent deterioration is consistent with declining net FDI less net debt.

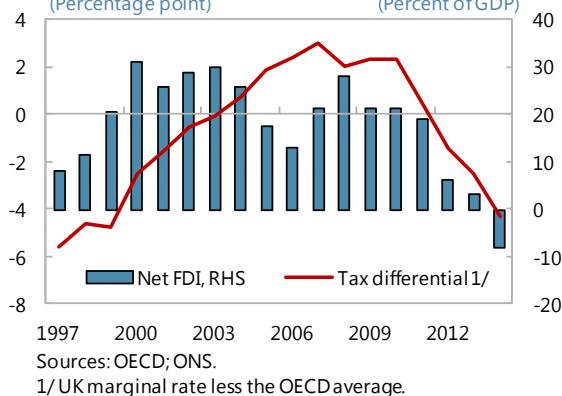
**UK: Income balance and Stock of Net Foreign Assets**  
(Percent of GDP)



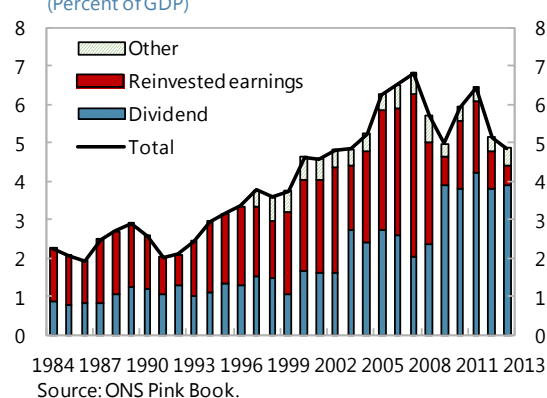
### 3. Changes in the UK's corporate tax system and asset sales may partly explain the shift in the UK's net investment position. The

UK's marginal tax rate has declined from 30 percent in 2007 (OECD average: 27 percent) to 21 percent in 2015 (OECD average: 25 percent), making the UK a more attractive place to invest.<sup>4</sup> In addition, the UK also moved from a worldwide to territorial system of corporate taxation in 2007.<sup>5</sup> This change may have led UK investors abroad to repatriate earnings that used to be reinvested abroad. Since reinvested earnings are accounted for in the balance of payments as outward FDI (as well as income inflow), the shift to repatriation would have reduced the stock of FDI abroad. In addition, in 2014, Vodafone cut its size in half by disposing its Verizon stake, amounting to more than 3 percent of GDP.

**UK: Relative Corporate Tax Rates and FDI**  
(Percentage point) (Percent of GDP)



**UK: FDI Income of UK Residents**  
(Percent of GDP)



<sup>4</sup> Lane (2015), on the other hand, suggests that UK-based multinational firms have transferred their head offices to lower tax jurisdictions, causing the FDI assets of these firms abroad to drop out of the IIP. Resident shareholders' foreign assets rise but in the form of portfolio equity.

<sup>5</sup> Worldwide taxation is a system under which corporations are taxable on income from all over the world. Territorial taxation is a system where income is taxed only at the host country and corporations do not incur any liability in their home country. See Matheson and others (2013).

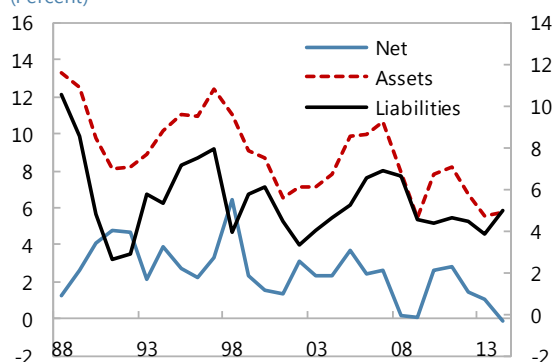
**4. Another reason for the worsening investment income balance is a decline in the returns of FDI.** Nominal yields of FDI averaged 8.0 percent for assets and 5.9 percent for liabilities during 2001–10, resulting in a differential of 2.1 percent. In 2014, the differential was down to -0.1 percent.

**5. Global cyclical factors could explain part of the decline in net returns.**

- *Stronger growth in the UK than abroad.* Growth in the UK has exceeded that of major partner countries in recent years, supporting higher returns on foreigners' investments in the UK than on UK investments in other countries. A geographic breakdown of assets and earnings reveals that returns from several destination regions have been declining. Returns are lowest in Europe, the location of more than 50 percent of investment abroad and a region where economic growth has been weak in recent years. However, tax optimization strategies by multinational companies could obscure the ultimate destinations of these investments.<sup>6</sup>

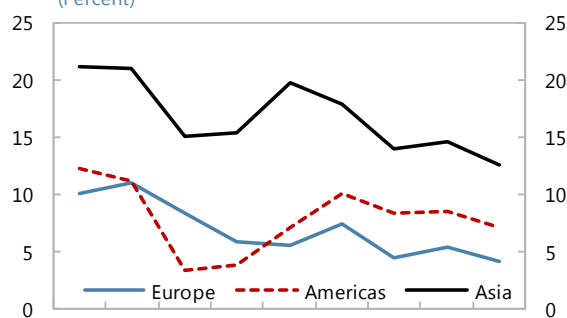
- *Sectoral cycles.* A sectoral breakdown of net FDI earnings by the UK's Office for National Statistics (2015) reveals that the largest change in net earnings came from industries engaged in production, particularly mining and quarrying. This

**UK: Nominal Yields of FDI**  
(Percent)



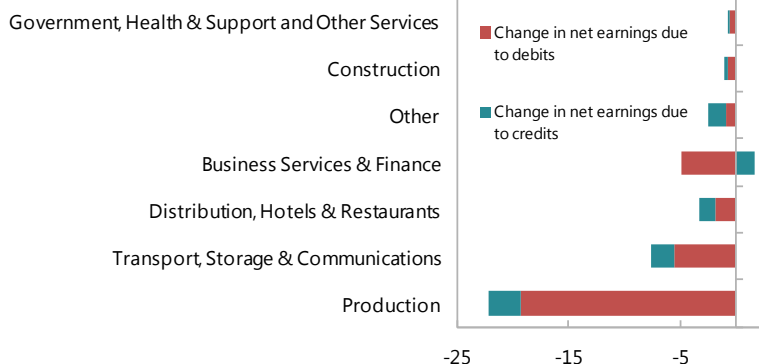
Sources: ONS; IMF staff calculations

**UK: Returns of FDI Assets, by Destination**  
(Percent)



2006 2007 2008 2009 2010 2011 2012 2013 2014  
Sources: Annual Foreign Direct Investment Survey, ONS; IMF staff calculations.

**UK: Change in Net FDI Earnings, 2011-2014**  
(Billion Pounds)



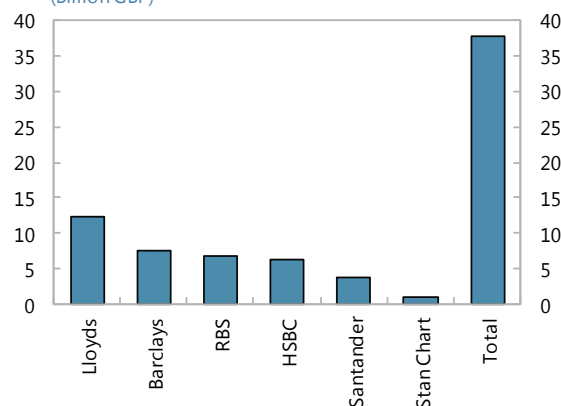
Sources: Annual Foreign Direct Investment Survey, Office for National Statistics (2015).

<sup>6</sup> Experimental statistics by the ONS (Hamroush and others, 2015) reveal that Luxembourg and the Netherlands, two important FDI partners, are not the ultimate destination of 42 percent of UK assets in these countries.

suggests that lower commodity prices may have also contributed to lackluster income from FDI—although this would only explain the deterioration in 2014, particularly in the second half of the year when commodity prices (especially oil) started declining significantly.

**6. Conduct fines paid by UK banks to foreign regulators may have contributed to the worsening income balance, but this effect appears modest.** These charges encompass allegations of foreign exchange manipulation, LIBOR manipulation, mis-selling of mortgage-backed securities before the crisis, mis-selling of interest-rate hedging products, and money laundering. Conduct costs are estimated to be around £38 billion from 2010–2014 (see chart). However, around £26 billion were compensation of customers for mis-selling payment protection insurance. As these were paid largely to residents, the overall conduct fines paid to nonresidents likely amount to at most £12 billion over 5 years—an average of £2.4 billion per year, or only 0.1 percent of 2014 GDP. Going forward, these fines are expected to fall.

UK: Conduct Fines, 2010-14  
(Billion GBP)



Source: CCP Research.

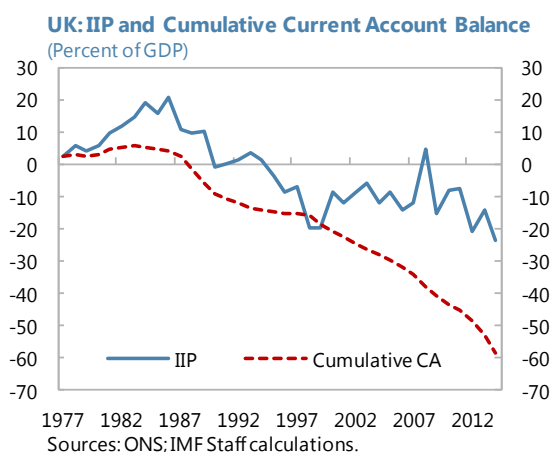
**7. The income balance is expected to rise as the world economy improves, but it is unlikely to go back to previous levels.**

- Returns are expected to recover, but the net stock of FDI—which is likely driven by more permanent shifts—is expected to remain low.
- Assuming the same levels of FDI assets and liabilities as in 2014 (67.5 percent of GDP and 75.7 percent of GDP, respectively), a recovery of net yields back to pre-crisis levels of 2.1 percent would raise the income balance by 0.9 percentage point of GDP. This would lift the balance from -1.2 percent of GDP in the first three quarters of 2015 to -0.3 percent of GDP.
- This is a somewhat stylized example—in reality, net yields may not fully revert, and the stocks may partially revert. But as an approximation, such a result—a partial recovery of net income flows on the order of 1 percentage point of GDP—seems plausible.<sup>7</sup>

<sup>7</sup> This conclusion is also supported by regression analysis of UK income inflows and outflows. The author can be contacted for further details.

## B. How has the current account balance affected the IIP, and how is the IIP likely to evolve?

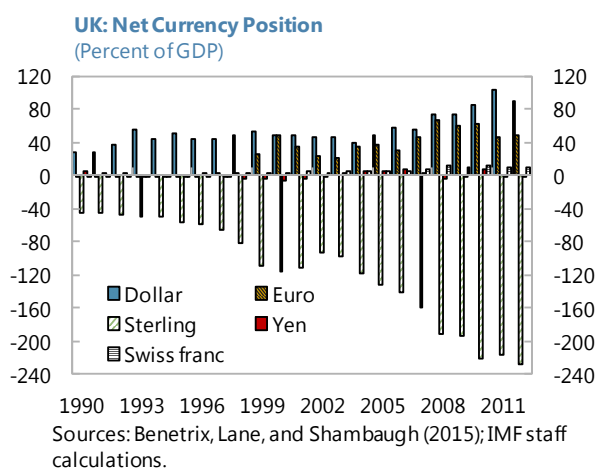
8. **Breaking from the past, the recent worsening of the CA balance is reflected in the IIP.** Since 1999, the IIP and cumulative CA have diverged. While the CA continued to run deficits, the IIP remained steady during the 2000s due to positive valuation effects. Starting in 2012, however, the IIP started deteriorating, reaching its lowest point of -25 percent of GDP at end-2014, even as it remains higher than the cumulative current account.<sup>8</sup>



9. **Weak growth in host countries might partly explain flagging valuation effects.** Weak partner country growth could have reduced capital gains on investments. Indeed, the decline in valuation effects coincides with large write-offs in the telecom sector in 2012 following heavy losses in southern Europe.<sup>9</sup>

10. **Currency movements could also have played a modest role in explaining valuation effects.**

- Estimates of the net currency positions of several countries from 1990 to 2012 by Benetrix, Lane, and Shambaugh (2015) reveal that the UK's external assets have a higher foreign-currency component than do the UK's external liabilities. Consequently, sterling appreciation reduces the IIP via valuation effects.
- In 2012, the IIP's net exposure to currency movements amounted to 90 percent of GDP for the U.S. dollar—implying that a 10 percent appreciation of sterling relative to the U.S. dollar, holding all other bilateral rates with sterling constant, would generate a 9 percentage point reduction of the IIP—and 48 percent of GDP for the euro.

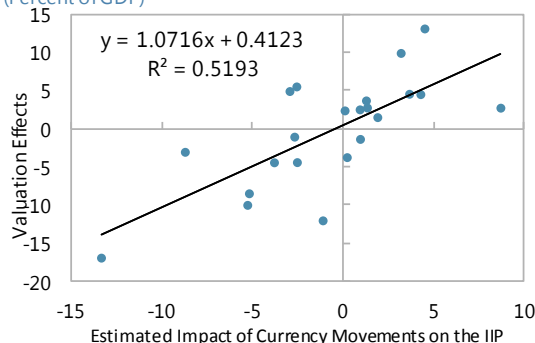


<sup>8</sup> [Bank of England estimates](#) suggest that the IIP would be stronger if FDI were measured at market prices, though it is difficult to measure this precisely.

<sup>9</sup> See "Vodafone in £6 billion Europe writedown" <http://www.ft.com/intl/cms/s/0/44ca6e8a-2d69-11e2-9988-00144feabdc0.html#axzz3pJsasF5Q>

- A scatter plot of actual IIP valuation changes against estimated valuation effects resulting from actual exchange rate movements of sterling relative to the USD, euro, yen, and Swiss franc suggests that currency movements do help explain the size of valuation effects from 1990 to 2012 (text chart).
- Thus, sterling appreciation against the dollar by around 3½ percent from 2012–14 could partly explain lower valuation effects during this period, more than offsetting the 4¾ percent depreciation against the euro, given that the exposure to the U.S. dollar is nearly twice as large as that to the euro. However, the net effect would still be modest.

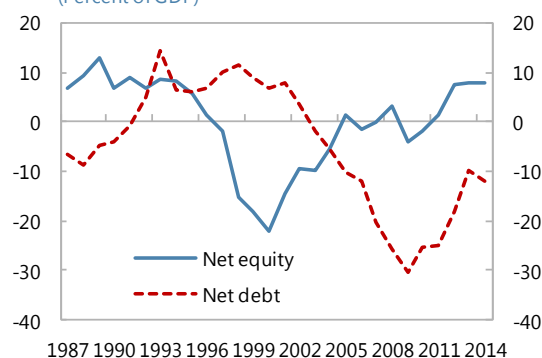
**UK: Currency Movements and Valuation Effects, 1990-2012**  
(Percent of GDP)



Sources: Benetrix, Lane, and Shambaugh (2015); IMF staff calculations.

**11. The likely evolution of the IIP over the medium term is uncertain.** Downward pressure from a negative CA balance is projected to continue, but diminish as the current account gradually improves. In addition, as cyclical factors wane, more profitable investments are expected to boost valuation effects. The composition of the IIP also remains favorable to strong asset price valuation effects: net portfolio equity positions—where the potential for capital gains is higher than for debt—have remained positive, and net portfolio debt positions—largely fixed income—have remained negative.

**UK: Portfolio Investment**  
(Percent of GDP)



Source: ONS.

## C. Implications for the external assessment

**12. Adjusting for cyclical factors in the income balance, the IMF's External Balance Assessment (EBA) models estimate that sterling is moderately overvalued in 2015.<sup>10</sup>** The 2015 CA balance is projected at -4.1 percent of GDP. If cyclical factors are removed, the EBA model estimates that the trade balance would improve by 0.3 percent of GDP. Based on the analysis above, staff estimates that the income balance will also improve by another 1 percent of GDP as cyclical conditions outside the UK improve. The underlying CA balance is therefore estimated at -2.8 percent of GDP. The EBA-estimated CA norm for the UK of -0.3 percent of GDP thus suggests a CA gap of

<sup>10</sup> See Phillips and others (2013) for a discussion of the models on external assessment.

2.5 percent of GDP. Applying an elasticity of -0.23 (for the relationship between the current account and exchange rate) yields exchange rate overvaluation of 11 percent. The EBA REER index and levels regression estimate sterling overvaluation of 12 and 10 percent, respectively. Taking an average of these approaches and allowing for uncertainty suggests sterling overvaluation in 2015 of about 5–15 percent.

**13. Among the identified policy gaps, the fiscal gap explains a large part of the overvaluation.** Indeed, breaking down the CA balance by sectors reveals that the government accounts for most of the deficit. This lends supports to current efforts to continue the fiscal adjustment. However, the private sector is also increasingly contributing to the deficit, with households' saving-investment balance turning negative in 2013.

#### D. To what degree is the current account gap a cause for concern?

**14. The floating exchange rate regime should help ease any adjustment.** Even if the income balance improves as cyclical factors diminish, some adjustment in the trade balance is likely to be necessary to close the CA gap. Event studies have shown that current account adjustments are often accompanied by slower GDP growth and increasing unemployment (Freund and Warnock, 2007), as reduced capital inflows depress domestic investment and consumption. However, adverse effects on growth tend to be less pronounced when the exchange rate is allowed to adjust.

**15. The currency composition of the IIP amplifies the benefits of sterling depreciation.** Given estimates that the UK has more liabilities than assets denominated in sterling and more assets than liabilities denominated in foreign currency, a depreciation would not only improve the trade balance through expenditure switching and reduction but also boost the income balance and IIP through valuation effects.

**16. The credibility of the inflation targeting framework also minimizes the cost of adjustment on growth.** Anchored inflation expectations should help the BoE look through the impact of a large depreciation on inflation. This would reduce the need to raise policy rates that would slow growth.

**17. Finally, while the CA deficit has grown, financing has become more stable.** FDI has been increasingly funding the deficit. This has not always been the case. The deficit was financed largely

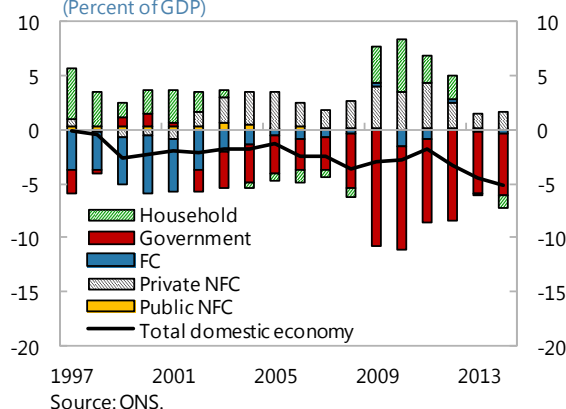
#### UK: Estimated Exchange Rate Overvaluation under Different EBA Approaches

Approach	Overvaluation (percent)
Adjusted Current Account Regression 1/	11
REER models	11
REER Index Regression	12
REER Level Regression	10
Average	11

Source: IMF staff calculation.

1/ Adjusted for cyclical factors. Uses an elasticity of -0.23.

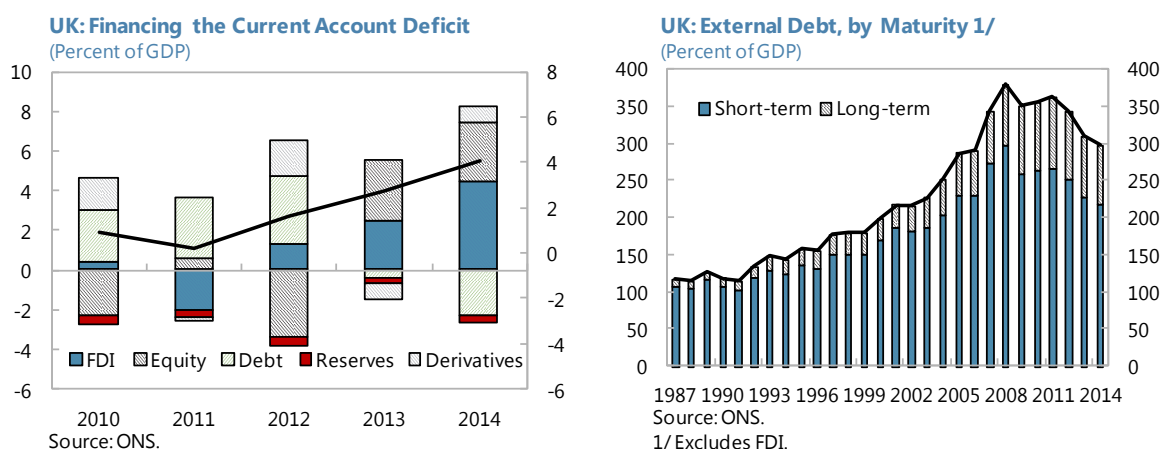
#### UK: Saving-Investment Balance, by Sectors (Percent of GDP)





by net debt prior to 2013, which is merely the flipside of the high income balance and capital gains that the UK enjoyed prior to 2012. Being long on (riskier but higher-yield) FDI but short on (safer but lower-yield) portfolio debt resulted in larger income flows, but also a higher risk of capital outflows. This situation reversed beginning in 2012: income flows have declined but financial inflows have stabilized.

**18. Nonetheless, despite rising FDI and declining debt inflows, the current stock of external liabilities remains largely short term.** Noting that short-term liabilities (mainly bank deposits) now are much larger than prior to the 1976 crisis, Broadbent (2014) has stressed the importance of institutional and policy credibility that are now in place.



## E. Conclusion

**19. The UK's CA deficit is explained by temporary as well as more permanent factors.** The CA deficit widened as a result of a deteriorating income balance. The income balance has declined as a result of lower returns from foreign direct investment in weak host country economies and a reduction of net FDI assets. While the former is expected to unwind as partner economies strengthen, the latter appears to be driven by more structural shifts in the economy, such as the reduction in corporate tax rates in the UK.

**20. A number of factors mitigate risks from the CA deficit, but its large size nonetheless warrants monitoring.** As mentioned above, some of the factors driving the CA deficit are expected to unwind. In addition, the currency composition of the balance sheet, the relatively high credibility of the monetary policy and exchange rate framework, and the increased stability of recent financing reduce risks from large and sudden adjustments. Nonetheless, the deficit is large by historical standards, and staff evaluates sterling to be moderately overvalued, even after removing cyclical factors that are temporarily reducing the income and trade balances. Hence, policies that facilitate current account adjustment, such the current mix of a tight fiscal and loose monetary stance, will be helpful.

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