BANK OF ENGLAND

Andrew Tyrie
Chairman
Treasury Select Committee
14 Tothill St
London
SW1H 9NB

Mark Carney
Governor

5 February 2016

Dear Andrew,

I am writing in response to a question from Chris Philp MP at the 26th January Treasury Select Committee hearing about the Bank's December *Financial Stability Report*. Mr Philp asked us to comment on a recent paper by Prof. Philip Lane on the possible role of low tax jurisdictions in driving the widening in the UK's current account deficit between 2011 and 2014. We undertook to share analysis that Bank of England staff have carried out on this subject.

Recent movements in the UK current account have been monitored closely by both the Financial Policy Committee (FPC) and the Monetary Policy Committee (MPC). We have carried out extensive analysis of what has caused the widening in the deficit, and Bank staff continue to engage with the wider academic debate on the risks associated with current account imbalances. Both policy committees continue to remain vigilant, and the FPC have highlighted the potential risks to financial stability from the current account deficit in recent *Financial Stability Reports*.

The Bank also hosted a Monetary Policy Roundtable discussion with a large number of external economists on 3rd July 2014 which included a session on the UK's current account deficit.[1] Prof Lane was a guest speaker on that occasion and the paper referred to by Mr Philp draws on some of the analysis that Prof Lane presented at that event.

The widening in the current account deficit since 2011 can be accounted for almost entirely by weaker net income from foreign direct investment (FDI). Mr. Philp and Prof. Lane are right to draw attention to the potential role of companies relocating to low-tax jurisdictions in affecting the interpretation of FDI statistics. The measurement of FDI flows and earnings is a complicated subject and is made more so by the size and complexity of the structures of many multinational companies. For example, official UK statistics show that companies with parents in the Netherlands or Luxembourg account for 25% of the entire stock of inward FDI investment to the UK It is implausible that this reflects the economic reality of the UK's ultimate FDI liabilities to overseas residents. Prof. Lane's contribution to the debate is therefore both important and welcome.

I have spoken to Prof Lane about his recent work and its relevance for the UK's external position at the present time. In his article he argues that national and international agencies need to invest heavily in the collection and analysis of cross-border financial data in order to gain a better understanding of international financial linkages. We fully agree that policymakers would benefit from more comprehensive data, and that this would help economists to understand better the potential influence of financial engineering. In his paper, Prof Lane does not quantify the contribution of the particular mechanism that he is highlighting, only noting that it "may have contributed to the decline" in the FDI income balance. An

[1] For more information, see http://www.bankofengland.co.uk/publications/Documents/quarterlybulletin/2014/qb14q308.pdf.

annex to this letter explains the mechanism in more detail and analysis carried out by Bank staff on the subject. Based on the information we have, our analysis suggests that the contribution is unlikely to be material enough to explain much of the deterioration in the current account. That deterioration was around 3 ½ pp of GDP between 2011 and 2014, which was very large by historical standards. Our analysis partly draws on data and analysis that have been released by the UK Office for National Statistics (ONS) since Prof Lane's article was published[2].

A simple observation is that in recent years there has not been a noticeable trend of large UK companies changing the domicile of their head office. It would be surprising if there were a phenomenon of offshoring companies large enough to have such a significant impact on the balance of payments that would go generally unnoticed. A more substantive point, explained in the annex to this letter is that other flows in the balance of payments – such as net portfolio income – are not consistent with the mechanism described by Prof. Lane having a material effect.

There are also a number of other plausible explanations for the decline in FDI income since 2011, which Bank staff think are more likely to be quantitatively large enough to explain the 3.5pp fall in the current account. The euro area, which accounts for more than a third of UK outward FDI, has faced significant challenges over the period in question. Annual profits of UK firms from FDI in euro-area countries fell by around £20bn between 2011 and 2014 as the rate of return on those assets fell by around 3pp. Recently published ONS data also attribute around half of the fall in outward FDI income to companies in the energy and manufacturing sectors. Bank staff analysis suggests that challenging trading conditions for UK firms with global businesses in oil and pharmaceuticals may have had a quantitatively significant effect on FDI income receipts.

We will continue to monitor closely the issues raised in Prof Lane's article. Bank staff are in regular contact with staff at ONS who compile FDI statistics and the two organisations work closely together to understand and analyse them. ONS staff are aware of Prof. Lane's article and are carrying out work to investigate the possible role of financial engineering in driving recent movements in FDI income. Bank staff will continue to engage constructively with the ONS's efforts, which are greatly appreciated.

The FPC and MPC continue to monitor actively the current account deficit and the capital flows that finance it, particularly if those appear to be leading to growing vulnerabilities in the financial system or risks to UK growth prospects. Both Committees are also aware of the challenges involved in measuring FDI income flows precisely, particularly in an open economy like the United Kingdom with very large gross stocks of foreign assets and liabilities. We will continue to communicate the views of both Committees through future issues of the *Financial Stability Report* and *Inflation Report*.

I trust that this letter provides a useful account of the analysis Bank staff have carried out in this area. Given the important and ongoing nature of our work, I look forward to a continuing constructive dialogue on the topic with the Treasury Select Committee.

Yours sincerely

---

[2] See Office for National Statistics (2015, 2016): (i) Pink Book 2015; (ii) Foreign Direct Investment involving UK companies, 2014; and (iii) Hamroush, Hendry and Hardie (2016).

Annex: Further detail on Prof Lane's article and analysis carried out by Bank staff

Philip Lane's article in the National Institute Economic Review

Prof. Lane's article in the November 2015 issue of the National Institute Economic Review argues that financial engineering associated with the use of low-tax jurisdictions may have contributed to the widening in the UK's current account deficit since 2011.

Prof. Lane points out that Balance of Payments (BoP) data treat overseas profits differently, depending on whether an overseas asset is held as FDI or portfolio equity. If an asset is held as FDI, all profit made by the overseas subsidiary is treated as "income" in the BoP, regardless of whether it is actually paid out as dividends. On the other hand, if it is held as a portfolio claim, only dividend payments are recognised in the current account. Investors may also benefit from capital gains on those equities, which may reflect expectations of future payouts from retained earnings. However, while capital gains are reflected in estimates of the stocks of overseas assets, and hence the net international investment position, they do not contribute to the current account.

This asymmetry can lead to changes in the current account when a firm moves its headquarters to another country, even if there is little change to the underlying economic relationships. Prof Lane's paper uses a simple example where a company, Firm X, is fully owned by UK investors and is originally headquartered in the UK. It has domestic assets of 100, foreign assets of 100 and no foreign liabilities. It therefore contributes +100 to the UK's net international investment position. Suppose Firm X then moves its headquarters to a foreign location for tax reasons. There is a fall in the UK's FDI assets of 100 and an increase in its FDI liabilities of 100. However, the UK's portfolio equity assets increase by 200 (the total value of the firm), as UK residents still own all the shares in the company.

This transaction therefore has no effect on the UK's net international investment position (NIIP). However, there are circumstances in which it could affect the current account. Suppose all parts of the firm always return a profit, but the firm retains a significant share of earnings as well as paying out dividends. When the firm is headquarted in the UK, all of the profits of its overseas subsidiary accrue to the UK as FDI profits, whether or not they are repatriated. However, after the restructuring, the only positive contributions the firm makes to the UK income balance are through dividend income. Any retained earnings in the overseas subsidiary, which might be associated with capital gains as investors anticipate dividends being paid out in the future, would not be included in the UK income balance.

Summary of Bank staff analysis on the topic

We share Prof. Lane's concerns about the availability of detailed granular data on cross-border financial linkages, which makes the quantitative analysis of such issues very difficult. However, analysis by Bank staff suggests that the mechanism is unlikely to explain much of the 3 ½ pp decline in the current account balance between 2011 and 2014, which was a very large fall by historical standards.

One implication of Prof. Lane's hypothesis is that falls in net FDI income should be partly offset by rises in net portfolio equity income, as UK investors increasingly acquire new claims on foreign headquarters. However, net portfolio equity income has been broadly flat at about -0.5% of GDP since 2011 and the growth in the stock of outward portfolio equity over that period has not been unusually large by historical standards.

It is true that the UK's overseas FDI liabilities have increased since 2011, as Prof. Lane's theory would predict. However, that growth does not look out of line with long-run trends. Nor has that growth been especially concentrated in low-tax jurisdictions. For example, comparing the stock of FDI liabilities in 2014 with those in 2011, Ireland, Switzerland, Netherlands, Luxembourg and UK offshore islands account for less than half of the increase.

The use of low-tax jurisdictions by multinational companies has affected the interpretation of FDI statistics for many years, and there is no particular reason to think this has become more of a problem recently. Bank staff have been in discussions with colleagues at the ONS who track changes in company registrations regularly in order to produce statistics on UK mergers and acquisitions. The deterioration in the FDI income balance has actually coincided with a period where the incentive for UK firms to move their headquarters overseas is likely to have declined. The headline rate of UK corporation tax fell from 28% in 2010 to 21% in 2015, a bigger fall than in any other advanced economy. The UK has also moved from a worldwide to a territorial system of taxation, reducing the extent to which dividends repatriated from abroad are subject to tax.

There are also a number of other plausible explanations for the decline in FDI income since 2011, which Bank staff think are more likely to be quantitatively large enough to explain the 3.5pp fall in the current account. The euro area, which accounts for more than a third of UK outward FDI, has faced significant challenges over the period in question. Annual profits of UK firms from FDI in euro-area countries fell by around £20bn between 2011 and 2014. Recently published ONS data also attribute around half of the fall in outward FDI income to companies in the energy and manufacturing sectors. Bank staff analysis suggests that challenging trading conditions for UK firms with global businesses in oil and pharmaceuticals may have had a quantitatively significant effect on FDI income receipts.