

# Daiwa's View

## Considering supply/demand of the British pound

- UK has been incurring constant current account deficit
- Performance of British pound depends on inflow of investment funds
- British pound will be influenced by whether UK can retain position as financial center

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### UK has been incurring constant current account deficit

### Considering supply/demand of the British pound

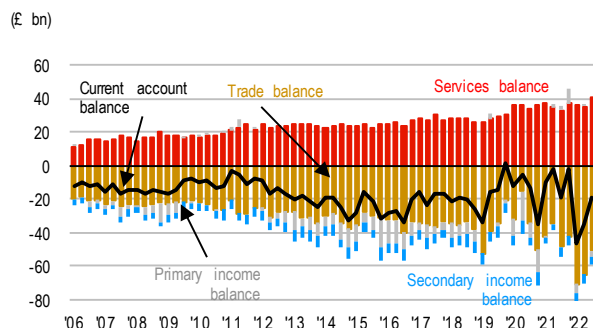
The UK has been incurring a constant current account deficit, with the deficit in Jul-Sep 2022 standing at £20.5bn (Chart 1). This is mainly due to the fact that the manufacturing sector accounts for a small part of the overall economy—slightly less than 20%. The trade deficit has also widened together with the rise in commodity prices since mid-2021, leading to the deterioration of the current account balance. However, with the UK being a major financial center, the services account has been in surplus, supported by the financial services sector.

### Performance of British pound depends on inflow of investment funds

With the current account balance being in deficit, the performance of the British pound depends on whether there is an inflow of investment funds from other nations. Considering the basic supply and demand of the British pound from the perspective of the current account balance and investments (security investments, direct investments, other investments, Chart 2), it is true that the flow of investment makes up a large portion of the total (Chart 3 on next page). Security investments and other investments account for a large and volatile portion of overall investments, suggesting that short-term movements of the British pound depend on these figures.

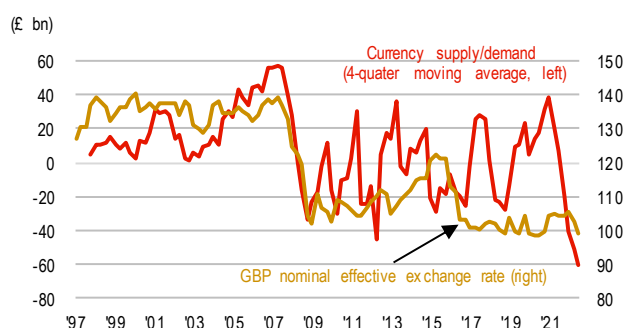
There appears to be a tendency for the scale of security investments to be correlated with global stock prices. In other words, when stock prices move favorably, there is an outflow of security investments from the UK. However, with other types of investments that are inversely correlated with stock prices, there is an inflow to the UK when stock prices are favorable. This appears to indicate that speculative money is flowing into the UK in line with the rise in stock prices because the UK is a center for financial services. In fact, the cumulative total of other investments is strongly correlated with the currency futures position at the IMM (Chart 4 on next page).

Chart 1: UK Current Account Balance



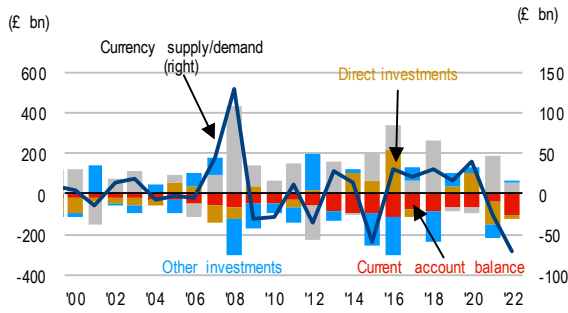
Source: Office for National Statistics of UK; compiled by Daiwa Securities.

Chart 2: British Pound, Currency Supply/demand



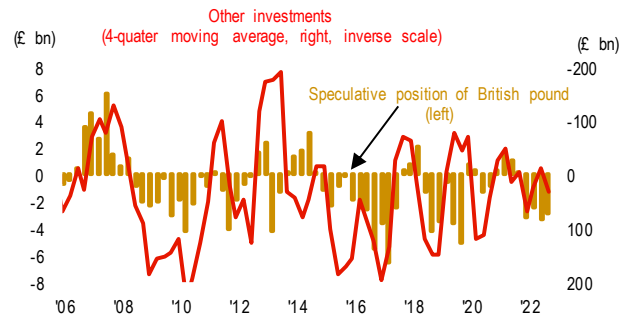
Source: BIS, Office for National Statistics of UK; compiled by Daiwa Securities.

**Chart 3: Currency Supply/demand in British Pound Market**



Source: Office for National Statistics of UK; compiled by Daiwa Securities.  
Note: Total figures through Jul-Sep quarter used as data in 2022

**Chart 4: Other Investments, Speculative Position of British Pound**



Source: CFTC, Office for National Statistics of UK; compiled by Daiwa Securities.

**Performance of British point is correlated with stock prices**

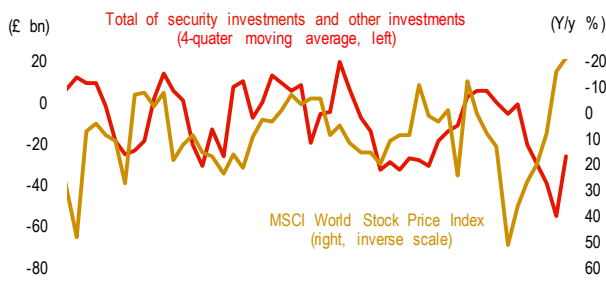
Since 2010, the absolute amount of other investments has tended to be larger than that of security investments. Therefore, the total of security investments and other investments has been inversely correlated with stock prices. When stock prices are favorable, there is a tendency for funds to flow into the UK (Chart 5). This relationship between security investments, other investments, and stock prices is also seen in other nations that serve as financial centers. This appears to be one factor behind the strong correlation between stock prices and the performance of the British pound. Some felt that the UK would lose its position as a major financial center due to Brexit. However, the UK has continued to retain its important position, and there has been no change to the structure in which security investments and other investments have a major impact on the British pound in terms of supply and demand.

In the turmoil surrounding the UK financial market since September 2022, inward security investments into the UK have leaned significantly towards selling, and global stock prices have declined. Therefore, we can conclude that the substantial drop in the British pound was caused by the fact that the inflow of other investments was small. From September to November, non-British investors sold a large number of UK Gilts (Chart 6). In contrast, a significant number of UK Gilts were repurchased in December, which is thought to have led to the rise in the British pound through mid-December.

**UK's position as financial center remains stable**

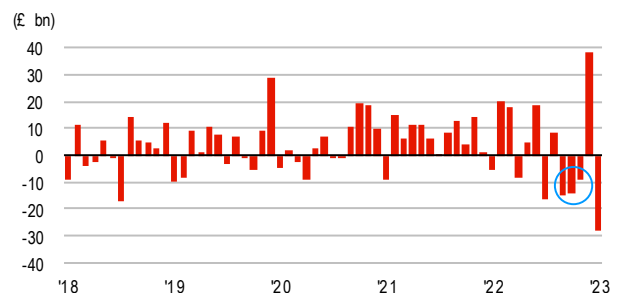
As mentioned above, the supply/demand structure of the British pound is based on the fact that the UK plays an important role as a financial center. It would be hard to imagine the UK losing that position right away. While the UK makes up a declining share of forex transactions and OTC rate derivative transactions, it still accounts for around 40% (Chart 7 on next page). Its share of these transactions is unlikely to be taken away by other nations right away. We have seen many cases in which the functions of financial institutions have been transferred outside the UK in order to deal with institutions losing the EU single passport. However, the number of financial institutions in the UK has been increasing at the same time. Therefore, we can say that not all companies have responded to Brexit in the same way.

**Chart 5: Stock Price, Total of Security Investments and Other Investments**



Source: BOE; compiled by Daiwa Securities.

**Chart 6: Trading of UK Gilts by Non-British Investors**



Source: BOE; compiled by Daiwa Securities.

The same could also be said from the standpoint of the flow of direct investments. Since the UK decided to leave the EU in 2016, there has been a general correlation between the amount of outward and inward direct investment (Chart 8), without a situation developing in which only the amount of overseas investment was increasing. The share of the financial sector with positions making direct investments in the UK remained largely unchanged at around 30% between 2016, when the UK decided to leave the EU, and 2021. Therefore, the financial sector has retained its importance within the UK.

### British pound will be influenced by whether UK can retain position as financial center

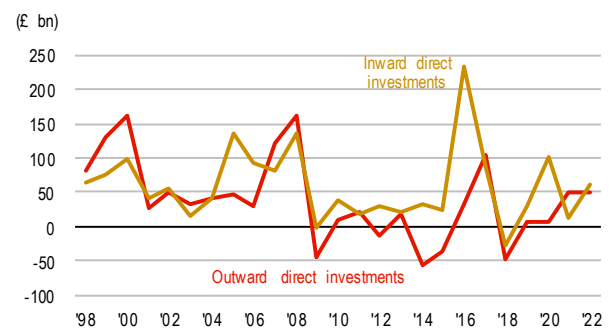
However, we do not know whether the UK will continue to retain its position as a financial center over the long term. If the UK were to lose its position as a major financial center, the UK's services account surplus, which is supported by the financial sector, would gradually decline, and the current account deficit would widen further. Therefore, the supply and demand of the British pound would be expected to continually worsen. Fluctuations in the short-term British pound market depend on the BOE's monetary policy and financial market trends. However, in the long-term, the key will be whether the UK can retain its position as a financial center.

Chart 7: UK's Share in Financial Markets

	Cross-border bank loans	FX trading	Interest rate OTC derivatives trading	Asset management
CY 2013	17%	41%	50%	8%
2014	18%	-	-	7%
2015	17%	-	-	7%
2016	16%	37%	39%	7%
2017	17%	-	-	6%
2018	17%	-	-	6%
2019	16%	43%	46%	5%
2020	15%	-	-	-
2021	16%	-	-	-
2022	15%	38%	46%	-

Source: TheCityUK; compiled by Daiwa Securities.

Chart 8: Outward/inward Direct Investments



Source: Office for National Statistics of UK; compiled by Daiwa Securities.  
Note: Excluding reinvestment of return.

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