File- Monetary Policy Issues-Exchange Rate Intervention – Part C

Reference MG-MAMC/D/0002/001

File begins 11/09/1987

File ends 23/12/1987

Pages 20-40

psl/12A

MAMC: D3 20

FROM: A C S ALLAN
DATE: 17 September 1987

MR C W KELLY

cc Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Cassell
Mr Peretz
Mr Grice
Ms Goodman
Mr Cropper

PROFITABILITY OF INTERVENTION

The Chancellor was grateful for your minute of 16 September. He would be grateful if you could rework the figures on a different methodology, using true reserve movements, and calculating the profit/loss on the basis of matching transactions only (ie taking into account only the dollars bought to recoup those sold, and ignoring any "surplus" dollars we have acquired).

2. I should be grateful if you could let us have these calculations by close of play on Tuesday, 22 September.

ACSA

A C S ALLAN

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SS/87

21

MAMC: D3

FROM: D L C PERETZ

DATE: 22 SEPTEMBER 1987

MR KELLY

cc Mr Grice
Ms Goodman

PROFITABILITY OF INTERVENTION

Have we ever considered taking advice from our Accountancy Advice Group on methods of accounting for the profit and loss on the reserves; and on intervention? It would be surprising if there were not accounting conventions used in the private sector for measuring the performance on analogous operations

DLP

D L C PERETZ

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3888/041

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MAMC: D3

FROM: C W KELLY
DATE: 22 September 1987

CHANCELLOR

cc: Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler o/r
Mr Cassell
Mr Peretz
Mr Grice
Ms Goodman
Mr Nelson
Mr Cropper

PROFITABILITY OF INTERVENTION

You asked me to rework the figures in my minute of 16 September using true reserve movements (ie spot and forward combined) and calculating the profit/loss on the basis of matching transactions only, ignoring any "surplus" dollars.

2. In order to do this, we clearly need to have some rule about determining which purchases can be deemed to match which sales, otherwise we can produce almost any result we want by careful choice of periods.

3. One way round this problem is to calculate the figures only over periods during which intervention has summed to zero. The table attached does this for three such periods:

i. September 1985 (ie Plaza) to mid-April 1986.

ii. Mid-April 1986 to the end of the first week in March 1987.

iii. July, August and the first part of this month.

4. Using the same methodology as before produces a dealing profit of £57 million for the first of these periods and £42 million for the second, or a combined profit of £99 million for the whole period September 1985 to early March 1987.

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5. In the most recent period we made a loss of £14 million.

6. The run of total intervention figures in the months missing from this table were as follows:

		Intervention $ million	Average exchange rate $/£
1987	March (last 3 weeks)	2890	1.59
	April	4465	1.63
	May	7381	1.66½
	June	- 3356	1.63

7. If the sales of dollars in June are notionally matched against purchases made in March and the first part of April we would have made a "profit" on those too. If, however, they are notionally matched against purchases in May, we would have made a "loss" of -£26 million.

CWK

C W KELLY

PROFITABILITY OF INTERVENTION

Date	(1) True change in reserves (spot and forward) \$ million	(2) Cumulative totals \$ million	(3) Monthly average exchange rates (\$/£)	(4) End month exchange rate (\$/£)	(5) Cumulative sterling capital employed in intervention (Col(1)/Col(3)) then cumulated £ million	(6) Sterling value of cumulative intervention ((Col(1)/Col(4)) then cumulated £ million	(7) Cumulative dealing "profits" (Col(6)-Col(5)) £ million
1985							
September	- 22	- 22	1.365	1.407	+ 16	+ 16	-
October	- 324	- 346	1.422	1.445	+ 244	+ 240	- 4
November	- 202	- 548	1.440	1.409	+ 380	+ 383	+ 3
December	- 588	- 1136	1.446	1.446	+ 787	+ 790	+ 3
1986							
January	+ 79	- 1057	1.423	1.409	+ 731	+ 733	+ 2
February	+ 332	- 725	1.430	1.450	+ 449	+ 504	+ 55
March	+ 398	- 327	1.467	1.478	+ 178	+ 235	+ 57
April(to 16th)	+ 327	0	1.471	1.553	- 44	+ 13	+ 57
April(from 16th)	+ 231	+ 231	1.532	1.553	- 151	- 149	+ 2
May	+ 76	+ 307	1.521	1.472	- 201	- 201	-
June	+ 343	+ 650	1.509	1.534	- 428	- 425	+ 3
July	- 96	- 554	1.508	1.492	- 364	- 361	+ 3
August	- 286	+ 268	1.487	1.488	- 172	- 169	+ 3
September	- 688	- 420	1.472	1.488	+ 295	+ 293	- 2
October	- 1325	- 1745	1.428	1.408	+ 1223	+ 1234	+ 11
November	+ 147	- 1598	1.425	1.437	+ 1100	+ 1132	+ 22
December	+ 196	- 1402	1.438	1.484	+ 974	+ 1000	+ 36
1987							
January	+ 141	- 1261	1.507	1.514	+ 880	+ 907	+ 27
February	+ 380	881	1.527	1.616	+ 631	+ 661	+ 30
March(6th)	+ 881	0	1.571	1.604	+ 70	+ 112	+ 42
July	+ 810	+ 810	1.610	1.593	- 503	- 508	- 5
August	- 857	- 47	1.598	1.630	+ 33	+ 18	- 15
September(3rd)	+ 47	0	1.649	1.658	+ 4	- 10	- 14

3887B/008

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MAMC: D3

FROM: C W KELLY

DATE: 5 October 1987

CHANCELLOR

cc: Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Cassell
Mr Peretz
Mr Grice
Ms Goodman
Mr Nelson
Mr Cropper

PROFITABILITY OF INTERVENTION

I very much regret that I have uncovered an error in the figures attached to my minute of 22 September.

2. The correct figures are attached.

3. Unfortunately they show a rather different picture.

4. The first post-Plaza period of intervention remains profitable (+$44 million). But during the second period between 16 April 1986 and 6 March 1987 it now appears that we made a loss, of $70 million, which more than offset the profit during the first period.

5. I apologise for having mislead you. The error does not affect the earlier figures in my minute of 16 September.

C W KELLY

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PROFITABILITY OF INTERVENTION

Date	(1) True change in reserves (spot and forward) $ million	(2) Cumulative totals $ million	(3) Monthly average exchange rates ($/£)	(4) End month exchange rate ($/£)	(5) Cumulative sterling capital employed in intervention (Col(1)/Col(3)) then cumulated £ million	(6) Sterling value of cumulative intervention (Col(2)/Col(4)) £ million	(7) Cumulative dealing "profits" (Col(6)-Col(5)) £ million
1985							
September	- 22	- 22	1.365	1.407	+ 16	+ 16	-
October	- 324	- 346	1.422	1.445	+ 244	+ 240	- 4
November	- 202	- 548	1.440	1.409	+ 380	+ 389	+ 9
December	- 588	- 1136	1.446	1.446	+ 787	+ 786	- 1
1986							
January	+ 79	- 1057	1.423	1.409	+ 731	+ 750	+ 19
February	+ 332	- 725	1.430	1.450	+ 449	+ 500	+ 51
March	+ 398	- 327	1.467	1.478	+ 178	+ 221	+ 43
April(to 16th)	+ 327	0	1.471	1.553	- 44	0	+ 44
April(from 16th)	+ 231	+ 231	1.532	1.553	- 151	- 149	+ 2
May	+ 76	+ 307	1.521	1.472	- 201	- 209	- 8
June	+ 343	+ 650	1.509	1.534	- 428	- 424	+ 4
July	- 96	- 554	1.508	1.492	- 364	- 371	- 7
August	- 286	+ 268	1.487	1.488	- 172	- 191	- 19
September	- 688	- 420	1.472	1.488	+ 295	+ 282	- 13
October	- 1325	- 1745	1.428	1.408	+ 1223	+ 1239	+ 16
November	+ 147	- 1598	1.425	1.437	+ 1100	+ 1112	+ 12
December	+ 196	- 1402	1.438	1.484	+ 974	+ 945	- 29
1987							
January	+ 141	- 1261	1.507	1.514	+ 880	+ 833	- 47
February	+ 380	- 881	1.527	1.546	+ 631	+ 570	- 61
March(6th)	+ 881	0	1.571	1.604	+ 70	0	- 70
July	+ 810	+ 810	1.610	1.593	- 503	- 508	- 5
August	- 857	- 47	1.598	1.630	+ 33	+ 29	- 4
September(3rd)	+ 47	0	1.649	1.658	+ 4	0	- 4

4. On top of this we are about to complete forward sales of the equivalent of $1.3 billion to the MOD to cover the rest of this year's requirement. The bulk of these ($0.9 billion equivalent) are in DM. But the Bank are covering them by buying DM against dollars. When that operation is complete, and if nothing else happens, the position will look as follows:

Net assets $ billion equivalent

$	DM etc	Yen	$ Can	Total
3.4	4.7	1.0	0.1	9.2

5. This would represent a very substantial shift out of dollars into deutschemark since the beginning of July. What has happened to the dollar since then does in my view justify moving further in this direction than you agreed in July. But I would find it difficult to argue in present circumstances that the shift should go any further.

6. Partly redressing the balance will be the foreign currency receipts we can expect from the BP sale at the end of the month. These will be mainly in dollars and yen, and not at all in DM

CWK

C W KELLY

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MAMC : D3

FROM: C W KELLY

DATE: 6 October 1987

SIR G LITTLER

cc: Mr Cassell o/r
Mr Peretz
Mr ~~Grice~~
Ms Goodman

RESERVE HOLDINGS IN DEUTSCHEMARK

There was some discussion at Sir Peter Middleton's monetary meeting last week of the extent to which the proceeds of recent intervention were being held in DM. You may like to be aware of the figures.

2. The distribution of the net reserves at the time of your last six-monthly meeting and the position now are as follows:

Net assets $ billion equivalent

	$	DM etc	Yen	$ Can	Total
End-June	5.3	2.2	0.7	- 0.1	8.1
Now	4.7	4.7	1.0	0.1	10.5
Difference	- 0.6	+ 2.5	+ 0.3	+ 0.2	+ 2.4

3. In other words more than the whole of the $2.4 billion net addition to the reserves since you last took stock at the end of June has been added to the DM book. This has come about as the result of a combination of the switches agreed at your July meeting, (-$1.2 billion out of dollars, of which $0.8 billion was to go into DM with the remainder split between yen and Canadian dollars), the $/DM intervention in August and the most recent bout of sterling intervention which was partly against dollars and partly against DM.

23/202

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MAMC: D3

From : D L C Peretz
Date : 6 October 1987

CHANCELLOR

cc Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Cassell o/r
Mr C W Kelly
Mr Grice
Ms Goodman
Mr Cropper

INTERVENTION

You asked whether we should be taking advantage of current circumstances to cream off more foreign currency in the market, to add to the reserves. I gave my immediate reaction to Mr Allan earlier today, and promised a note. What follows reflects some discussion with Eddie George.

2. As you know, sterling has been bobbing along since Thursday last week at just under DM 3.0, with no help* from the Bank of England. This follows some substantial intervention over the preceding few days, including two bouts of very open intervention done through brokers in London, and one episode of fairly open intervention carried out through the Federal Reserve Bank in New York. The bank dealers are sure the market has got the message that they will defend 3 DM. Despite occasional stories to the contrary there has been no serious upward pressure in the market in recent days. Whenever the DM rate looks as if it is going up, and the bank dealers have been poised to come in, professional sellers have come in first.

3. Against this background, I have no doubt that we could do some substantial creaming off if we wanted to. I am less sure, though, what the aim would be. There seem to me to be three possible aims :

i) to try to depress the exchange rate.

ii) to add to the reserves.

* until this evening : see P.S.

cc 6/87

iii) to inject liquidity into the domestic market.

Impact on domestic liquidity

4. I list the third, only to dismiss it. Given our current assessment of monetary conditions the last thing we want to do, just at present, is to add to domestic liquidity. If we have to intervene, then in due course we would aim to siphon the liquidity off again, by funding. But it would be hard, given the current state of the gilt market, to do that immediately, even if we wanted to. Eddie George goes further and says he is worried that it could prove difficult to fund further intervention before the end of the financial year. I do not believe we would have any difficulty with that, given what appears to be happening to the PSBR. But I agree that we would have some difficulty funding any intervention in the immediate future; and that if we can, therefore, it would be better to avoid adding to liquidity in the short-term by intervention unless there is some other good reason for carrying it out.

Depressing the rate

5. Turning to the first possible motive, I think we would all be a good deal happier if we had more room to manoeuvre by getting a bit of space between the exchange rate and the 3 DM cap. But in the current market it seems quite likely that even very substantial intervention would do little to reduce the rate : unless we took it to such lengths, and with such determination, that we risked having too much effect. We would not want to give the market the idea that we were deliberately seeking a lower exchange rate, for example because of worries about the current account.

Adding to the reserves

6. That leaves the second possible purpose : to add to the reserves.

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7. The reserves are now in a pretty healthy state. The published reserves, at nearly $35 billion, are more than two times their level two years ago. And in the first three quarters of 1987 (up to end-September) we had added getting on for $14 billion to the spot and forward reserves by intervention. As things look at present, we could have a further addition of $600 or $700 million this month, as a result of intervention undertaken to date for value during October, and after allowing for expected off-market transactions. On top of that we could by the end of October get an addition of perhaps around $1 billion (this figure is very uncertain) from the dollar and yen proceeds of US and Japanese subscription to the BP issue.

8. Finally, there is the question of whether any purchases are likely to be profitable. Purchases of DM should prove profitable in due course. We have been actively seeking to lengthen the DM book rather than the $ book. But inevitably a fair proportion of any creaming off initially is in dollars, and here it is perhaps less obvious that we are likely to make a profit, even in the longer-run.

9. Against this background it looks a little hard to argue a very pressing case for adding to the reserves, as an objective in its own right.

<u>**Conclusion**</u>

10. The conclusion of our latest monetary assessment (Mr Grice's minute of 2 October) was that there was no case for reducing interest rates; that if anything there was a case for tightening policy; but that for a number of reasons we should for the time being leave interest rates unchanged and, if upward pressure on the exchange rate persisted, be prepared to intervene in the foreign exchange market as necessary to resist it. This conclusion suggests continuing as at present with only the minimum intervention$ we need to keep below DM 3.0, avoiding adding more than we have to, albeit temporarily, to domestic liquidity.

11. As to the question of what tactics to pursue in keeping below DM 3.0, for the time being I would not want to question the course the Bank is currently pursuing. It would clearly be more comfortable if the rate were further away from DM 3.0. I am not sure, though, that there is much we can (safely) do about that at present (see paragraph 5 above). It may well be, of course, that sterling will decline a little of its own accord, once the market gets tired of testing the top of the range, or (depending on what they are) after, say, the next set of trade figures.

12. If you wanted to, it might be worth having a meeting with the Bank about all this when you are back from the Party Conference. But, equally, there might be something to be said for leaving a meeting until we have had a chance to take stock of the situation more generally with the perspective of the Autumn Forecast, when it is available.

DLP

D L C PERETZ

PS :

As you will see from this evening's report the Bank in fact had to sell $48m of sterling towards the close in London today. This followed some further reports that we were about to uncap. Again this was done openly, through brokers, to have maximum effect; and, again, we hope will get through the message that the DM 3.00 limit is here to stay.

MAMC: D3

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FROM: R B SAUNDERS

DATE: 9 October 1987

SIR G LITTLER

cc Sir T Burns
Mr Cassell
Mr Peretz
Mr Grice
Mr C W Kelly
Ms Goodman

RESERVE HOLDINGS IN DM

Sir Peter Middleton has seen your minute of 7 October. He agrees with you that the position is perfectly defensible before the PAC.

[signature]

pp R B SAUNDERS

557/87

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Inland Revenue

Policy Division
Somerset House

From: P J A DRISCOLL
Tel: 438-6287

MG 1 file

D J Mallett Esq
Bank of England
Threadneedle Street
LONDON EC2

D2

13 October 1987

Dear David,

EXCHANGE RATE FLUCTUATIONS

I attach a first shot at a submission on this subject and should greatly value your comments and those of Treasury colleagues mentioned below, particularly on the questions of cost and exchange rate policy (see at paragraphs 17-24). Richard Timmins (Extension 6685) has replaced Mark Robson here as the Economist on our internal working group and he will be happy to discuss any alternative data sources you may be able to suggest.

As you will see the paper is still at a very preliminary stage but it is being trawled around here for technical comments. Please feel free therefore to comment on any aspect - including drafting. I shall try to reduce both the length and complexity of the paper and of the appendices and if possible I should like to get the whole thing up to the Financial Secretary by Friday 23 October.

I am copying this to Caroline Sinclair, George Michie, Helen Goodman and Douglas Haigh at the Treasury and to Richard Timmins and Frank Fitzpatrick here.

Yours sincerely

Peter.

P J A DRISCOLL

Mr Peret*
Mr Kelly
Mr Cropper.

I will co-ordinate comments with F.P.
H Goodman.
15/x.

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DRAFT

FIN...CIAL SECRETARY

FINANCE BILL 1988 : STARTER NO 210
EXCHANGE RATE FLUCTUATIONS

1. This is the further report promised in my note of 16 July (copy attached - top copy only). We have done further work and have held discussions with representatives of the "Group of 9". Our conclusions are set out at paragraphs 36-40 but very briefly these are :

- the Group of 9's proposals as they stand do not represent a satisfactory basis for legislation (paragraph 7);

- although we think the Group of 9 (at least privately) would support a comprehensive reform of the law on the lines set out in Appendix C (paragraph 8).

- However, on our best estimate (which the Group of 9 do not seriously dispute) the revenue effects of introducing a system of automatic relief for exchange losses could be of the order of £500m to £1bn in any one year (paragraph 18);

- these effects are subject to a high degree of volatility as exchange rates fluctuate and are extremely difficult to predict (paragraph 20).

- A comprehensive scheme would be vulnerable to large scale manipulation and abuse (paragraph 24).

- You may feel that this sort of uncertainty is too high a price to pay for this reform (paragraph 24).

- A more limited measure could be devised with more manageable costs (paragraph 25);

- there is a risk that such a limited reform would be attacked as "tinkering" (paragraph 26),

- and <u>any reform</u> would involve long and complex legislation which might not be ready in time for Finance Bill 1988 (paragraph 27).

- The Group of 9 suggest further public consultation with a view to legislation in 1989 (paragraph 28).

- You will want to consider whether to;

  a. do nothing;

  b. consult more widely ahead of possible legislation in 1989; or

  c. legislate on a limited scale in 1988 (paragraph 35).

- You will need to consider how and when your decision should be announced (paragraph 39).

2. Although the underlying problems are highly technical the issues may be simply stated. Can a workable solution be devised? And, if so, can the potential Exchequer cost be contained? Would the benefits of a major reform justify additional volatility and uncertainty in the Budget arithmetic? How should the next stage (whatever it is) be handled? We think you will want to hold a further meeting (? to include Bank representatives). You may want to hear directly the views of eg John Chown and Alan Willingale before forming a final view. These issues are dealt with in our paper and in any event we stand ready if you would like further advice.

<u>Background</u>

3. The treatment of exchange rate fluctuations in UK tax law is highly problematic. Matters were not helped by the House of

Lords decision in Marine Midland in 1984. People looked for clarification but were disappointed - the law is in some respects less certain than it was before. Our statement of practice of 17 February 1987 sets out how we propose to deal under current law with the affairs of traders. Marine Midland does not affect other taxpayers.

4. When the statement of practice was published you invited representations for a change in the law, acknowledging that the current law was complex and (by implication) less than satisfactory. You said:

> We have certainly not ruled out the possibility of major legislative reform but, before committing itself, the Government would need to be satisfied that a scheme could be devised which could be applied effectively in practice and reflect a broad measure of agreement without entailing an unacceptable cost to the Exchequer.

Representations

5. We have received [ ] representations from individual companies and bodies (see appendix A) but the only really significant contributions are that from the "Group of 9" (see my note of 16 July 1987 and Alan Willingale's letter of 27 July 1987 Appendix B) and a personal letter from the representative of a major UK multi-national company expressing strong reservations about the Group of 9 proposals.

6. The Group of 9 proposals were widely publicised and we have recently met representatives of that group - Messrs Chown, Tipping, White and Willingale - informally to discuss their paper and how they see the way ahead.

7. The spokesmen for the Group of 9 concede that their paper is "thin" - reflecting the fragility of the consensus it purports to represent. John Chown does not accept Alan Willingale's description of the paper as the "lowest common denominator" but frankly points out that a number of sensitive issues are either

not discussed there or are handled ambiguously with options provided to suit the taxpayer at virtually every turn. The Group of 9 do not seriously expect Treasury Ministers to adopt their proposals as they stand. The real idea is to place the onus on the Government to put forward its own proposals on this issue (although some may hope the idea of legislation will just "go away"leaving them to go on as they do now).

8. In the course of (a very amicable) discussion the spokesmen privately agreed that if legislation were to be introduced to tackle the fundamental problem (as they see it) of the non-deductibility of exchange losses realised on the repayment of long-term (capital) borrowings it ought probably realistically to be on the lines of the comprehensive scheme described at Appendix C to this note. This scheme would provide a logical framework for dealing with exchange differences and could, technically, be made to work within the existing UK corporate tax regime (although there will remain formidable problems of cost - see paragraphs 18-24 below).

A possible comprehensive solution

9. Very broadly, this scheme would distinguish between traders and others. For traders it would involve bringing gains and losses on all foreign exchange transactions into the computation of trading profits or losses. It would

- require foreign currency denominated assets and liabilities to be translated for tax purposes at each balance sheet date at the rate of exchange prevailing at that date;

- but allow groups of companies to make a once-for-all election to recognise exchange gains and losses only when actual transactions eg repayments of loans, took place.

For non-traders it would recognise exchange gains and losses when actual transactions took place, allowing losses as charges on

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income and taxing gains as income of the year the repayment etc took place.

10. Appendix D is a chart summarising and comparing

a. the position under existing law,

b. the Group of 9 proposals, and

c. a comprehensive scheme.

11. As noted at paragraph 3 above, the existing law is uncertain, and in several respects it produces perverse results. These include

- some, but not all, exchange differences are recognised for tax;

- there is uncertainty about the validity in law of the "translation" [1] basis adopted for accounts purposes and generally followed for tax purposes;

- some gains are in effect counted twice for tax purposes (once in computing trading profits and again for CGT purposes);

- whether a difference counts for tax may depend on the form a transaction takes ("debts on the security" are not chargeable assets for CGT purposes).

12. As John Chown has pointed out, for the unwary the present law conceals a tax trap if, for example a company wants to enter into a currency swap. While no problem arises during the life of

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[1] Under the 'translation' basis gains and losses arise when foreign currency balances are re-expressed in sterling. No actual transaction takes place so to some extent the difference is a 'paper' profit or loss. 'Translation' is distinguished from 'conversion' where currencies are actually bought and sold.

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the swap, repayment of the foreign currency borrowing at the end can give rise to a potential chargeable gain.

13. On the other hand, not all these anomalies and uncertainties work against the taxpayer. We have seen cases (and heard of others) where a taxpayer company has so arranged things as to play ducks and drakes with the system. For example, a company may organise matters so that its hard currency liabilities are current items (giving rise to a deduction if the pound falls) while currency loans to associates are debts not on a security (where any gain is a "nothing"). Conversely, it will ensure that its soft currency borrowings, on which it is likely to make foreign exchange gains,are on capital account (giving rise to a nothing). The major problem with the Group of 9 proposal is that even when it does tackle these problems it tends to leave a loophole by which the taxpayer can in effect enjoy the best of both worlds, usually by exercising an option for the treatment that suits him best.

14. It is very difficult to gauge the impact of the present rules - how far they work for or against the Exchequer. For one thing, in economic terms fewer and fewer taxpayers are now "unhedged" and exposed to the risk of exchange losses. The development and marketing of forwards, futures and options has seen to that. For another, where the rules do appear to work unevenly it is not always clear how far this is pure chance and how far the result of deliberate (wise or unwise) choices on the part of company treasurers.

15. A comprehensive, symmetrical scheme would at the very least provide certainty - particularly over "timing" ie ('translation' or 'conversion'). And it would in many respects bring the tax system into line with economic reality. For example, it <u>is</u> indefensible to count gains twice, and it does <u>not</u> make sense to allow "matching" [2] for traders while taxing non-traders on the

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[2]Following <u>Marine Midland</u> a foreign currency liability may for
(Footnote Continued)