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 163-183

Swizerland

Background

15. Switzerland was (and remains) an even more open economy than Germany. By contrast to Germany, fiscal policy was not used actively for demand management. The monetary target followed, first adopted in 1975, was M1.

1977-78

16. Table 3 presents some of the main economic indicators for Switzerland in the late 1970s. It shows large current account surpluses, an exceptionally high reserves/imports ratio and low inflation/unemployment, in 1976-77. GDP growth resumed in 1977. Against this background upward pressure on the Swiss franc mounted from mid-1977. The authorities responded with a combination of sterilisied intervention, and 'special measures'. These measures which included the equivalent of negative interest rates on foreign deposits in Swiss francs, were designed to resist the internationalisation of the Swiss franc on the grounds that it would undermine monetary control and/or exaggerate exchange rate movements. The outturn for M1 turned out only marginally higher than that targetted.

TABLE 3: SWISS ECONOMIC INDICATORS

	1975	1976	1977	1978	1979
GDP*	-7.3	-1.4	2.4	0.4	2.5
Unemployment+	0.3	0.7	0.4	0.4	0.3
Current account ($bns)	2.8	3.8	4.1	4.8	2.8
Reserves/Imports (months)	7.6	8.1	7.6	7.6	7.2
Consumer Prices*	6.7	1.7	1.3	1.1	3.6
Real Short-Term Interest Rates	-3.6	-1.5	1.8	-2.9	-0.5

*Year to year percentage changes
+As a percentage of total labour force.

17. In 1978 GDP growth slowed but inflows into Swiss francs continued, reflecting the weakness of the dollar. The portfolio diversification by dollar holders into Swiss francs had a disproportionately large effect on the Swiss franc due to the small size of Swiss financial markets. Sterilisied intervention was impotent in restraining the rise of the Swiss franc and it strengthened against not only the dollar, but also, crucially (since Germany represented its largets market and main competitor in third markets) the DM. Reflecting this the competitiveness of Swiss exporters was sharply eroded - relative normalised unit labour costs eg increased by 15½ per cent in 1978 as a whole - and new foreign orders dried up.

The Authorities' dilemma

18. Sterilisied intervention and direct controls had both failed to restrain the rise of the Swiss franc, leaving the authorities with a choice between:

(i) unsterilised intervention to prevent any further rise of the Swiss franc;

and (ii) acceptance of a further rise.

GDP growth was already slowing sharply from 1977 while inflation was only just above 1 per cent. The authorities decided that the inflationary risks associated with abandonment of the M1 target were not great and decided to employ their large reserve buffer in dampening pressure on the currency. This was seen as the right course given their judgement that the source of the pressure was portfolio diversification by dollar holders which could safely be met by supplying them with Swiss francs.

19. The M1 target for 1978 was thus abandoned in 1978 (and not reinstated in 1979) and a Swiss franc/DM target established. It was made clear that this target would be pursued using unsterilised intervention, notwithstanding any repercussions for M1 growth (which far outstripped the initial target). Extra administrative measures were simulataneously taken to ward off capital inflows.

Results

20. Following the actions taken in October and the dollar support operation of November, the Swiss franc declined from 1978 Q4. $7bn reserves were used up in the year as a whole. The single-minded switch to an exchange rate policy clearly helped change expectations about the Swiss franc, and by the spring 1979 the authorities were able to begin to reassert their control over M1.

21. Inflation, as in Germany, subsequently picked up to peak at 6.5 per cent in 1981, reflecting the effect of OPEC II as well as the a monetary loosening of 1978. GDP growth, which had slumped to 0.4 per cent in 1978, recovered to 2.5 per cent in 1979.

Assessment

22. The Swiss authorities' actions in late 1978 rested on the belief that the pursuit of price stability could not best be achieved by a relentless single-minded pursuit of a monetary target irrespective of developments in the rest of the world (such as shifts in portfolio diversification). They therefore exercised discretion in temporarily abandoning the target; since the market viewed them as credible in their anti-inflationary resolve expectations were indeed altered, and little serious longer term inflationary damage was done.

J L CARR

91G.SCB.219.17

MAMC: D2

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FROM: H C GOODMAN
DATE: 22 December 1987

1. MISS O'MARA
2. PS/CHANCELLOR

cc: Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Scholar
Mr Peretz
Mr Grice
Mr Pike
Mrs Ryding

ARTICLE IN WALL STREET JOURNAL: DOLLARS SEASONAL TRADING PATTERN

The Chancellor saw an article in the WSJ saying that the dollar declines in late December and asked whether there is a seasonal pattern for sterling, (your minute of 15 December).

2. Earlier this year Mr Pike investigated this question and the connected one of seasonality in interest rates. I am attaching the note he did then.

3. This shows:-

(a) so far as interest rates are concerned, there is evidence of significant seasonality throughout the period of the last twelve years. As one might expect, the pattern is of higher interest rates in the late Autumn through to February the following year. In the summer months, interest rates tend to be below the yearly average. Looking at sub-periods, there is relatively little variation in this basic pattern;

(b) The exchange rate presents rather a different story. The test statistics again indicate stable and marked seasonality over various sub-periods, but there is no stable pattern over the period as a whole. There appears to be a clear break in behaviour after 1982. Between 1975 and 1982 the exchange rate had a seasonal pattern

quite strongly correlated with that of interest rates. Since then, however, the pattern has been near the mirror image. The exchange rate has been seasonally weak in December, January, February and March and then strong over the summer months.

4. It is not entirely easy to know what to make of these patterns. In an efficient market, there should be no seasonality in either variable since existence of seasonality leaves room for arbitrageurs to make profits. On the other hand, so far as the exchange rate is concerned at least, the conditions for arbitrage profits may not wholly be present. A market operator needs to know not only that there is stable seasonality over short groups of years, but that also there will not be sharp swings in the pattern at short notice, as apparently occurred between 1982 and 1983. Basing his actions on pre-1982 behaviour, he would have lost money from 1983 onwards until he had convinced himself that the pattern had changed.

H C GOODMAN

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FROM: T PIKE
DATE: 16 MARCH 1987

MR GRICE

SEASONALITY OF INTEREST AND EXCHANGE RATES

You asked me to investigate the claim in the Times article ("Why base rates rise and fall with the seasons" by David Smith, 11 March) that interest rates exhibit seasonality.

2. I have run monthly figures for three-month interbank rates,and for the $/£ and £ effective exchange rates, through the X-11 program for the following periods:

1975M1 - 1987M1

1975M1 - 1978M12

1979M1 - 1982M12

1983M1 - 1987M1

1979M1 - 1987M1

Over a number of these periods there was evidence of significant seasonality summarised in the table below. Further details are shown in the annex.

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MONTHLY SEASONAL FACTORS FOR INTEREST AND EXCHANGE RATES

(Seasonal Factors are expressed as a percentage of the average value of the series)

	J	F	M	A	M	J	J	A	S	O	N	D	F Test*
Interest Rates: (3 month I/B)													
1975-87	3.2	1.4	-2.5	-3.2	-1.8	-0.5	0.7	-2.2	-1.9	-2.3	3.4	3.8	2.35 (1.8)
1979-87	3.7	3.6	1.6	-1.2	-1.9	-2.1	0.4	-1.3	-0.8	-2.0	-2.7	1.9	2.44 (1.9)
Sterling Effective Exchange Rate:													
1975-78	2.0	2.2	1.2	-0.2	-0.6	-1.0	-0.8	-0.4	-0.2	-1.0	-0.9	-0.1	9.70 (2.1)
1979-82	1.6	1.6	0.5	0.7	-0.3	-0.4	-0.7	-0.3	-0.8	-1.4	0.2	-0.4	2.80 (2.1)
1983-87	-3.7	-4.3	-2.4	1.4	2.5	2.9	2.8	2.4	1.4	-0.6	-0.6	-2.0	16.69 (2.1)
$/£ Exchange Rate													
1975-78	2.4	2.4	1.5	-0.6	-1.5	-1.8	-0.7	0	-0.6	-0.8	-0.6	0.4	7.73 (2.1)
1979-82	2.7	0.9	-0.4	-1.0	-0.2	-1.6	-1.2	0	-0.3	-0.2	0.2	1.1	2.51 (2.1)
1983-87	-3.1	-3.4	-2.6	0.5	2.1	2.1	2.1	2.2	1.2	0.1	0.1	-1.4	7.85 (2.1)

NOTES

* The F Test measures significance of the seasonality in the series, at the 5 per cent level. Critical values of the statistic are shown in brackets. Significant values exceed the critical value.

The Seasonal Factors are subtracted from the actual series to derive the seasonally adjusted series.

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3. The summary table shows that there is a consistent monthly seasonal pattern in interest rates - the F Statistic is above the 5 per cent critical value and near to the 1 per cent level. Using data from 1979-87, annex table 1 shows that the seasonal factor rarely exceeds ½ percentage point per month and is on average about ¼ percentage point, compared to the average interest rate of 12½ per cent.

4. The seasonal pattern is much as described in the Times article, with seasonal factors pushing up rates in January and February, but reducing rates slightly between April and June and again over the autumn. Rates then tend to rise again in December.

5. With respect to the exchange rate, there is no evidence of a consistent monthly seasonal pattern in either the dollar rate or the effective rate over the longer periods, but breaking down the series into their four year sub-samples does reveal some evidence of seasonality. This is particularly true of the sterling effective rate from 1983-87, where the F Statistic is strongly significant.

6. From 1975-82 both the dollar and effective rates are pushed up by seasonal factors during the first quarter - on average by about 3 cents and 1¼ points per month respectively - and are depressed by seasonal factors for most of the remainder of the year - on average by about 1 cent and ½ a point per month respectively (see annex tables 3 and 4).

7. From 1983-87, the seasonal pattern is largely reversed: sterling is sharply depressed by seasonal factors during the first quarter - on average by over 4 cents and 2¾ EER points per month (see annex table 5) - and is lifted by seasonal factors thereafter, except that the effective rate is depressed again in the fourth quarter.

8. In conclusion, the January sterling crises of recent years that have depressed exchange rates during the first quarter are clearly picked up in the seasonal factors, as is the usual post-Budget recovery. The interest rate seasonality is consistent with the exchange rate seasonality from 1983-87, given that the authorities defend sterling by raising interest rates. Prior to 1983, although the exchange rate seasonality is reversed there doesn't seem to be any reaction in the seasonal pattern of interest rates. Whilst there are factors that could explain sterling's reversed seasonal pattern prior to 1983 (oil prices, for example) it is not obvious why this is not reflected in a reversal of interest rate seasonality as well.

T. Pike

T PIKE

Why base rates rise and fall with the seasons

There has been a certain familiarity about this week's interest rate developments. If it is March, base rates must be coming down.

The reduction in base rates from 11 to 10.5 per cent will almost certainly be followed by another cut next week. No one can accuse the Treasury and the Bank of England of taking risks by allowing the banks to trim their rates.

It is a far cry from the situation just a few months ago, when the Chancellor of the Exchequer held off from raising rates until after the Conservative Party conference and then faced a nervous run-up to Christmas as the markets bayed for further interest-rate rises.

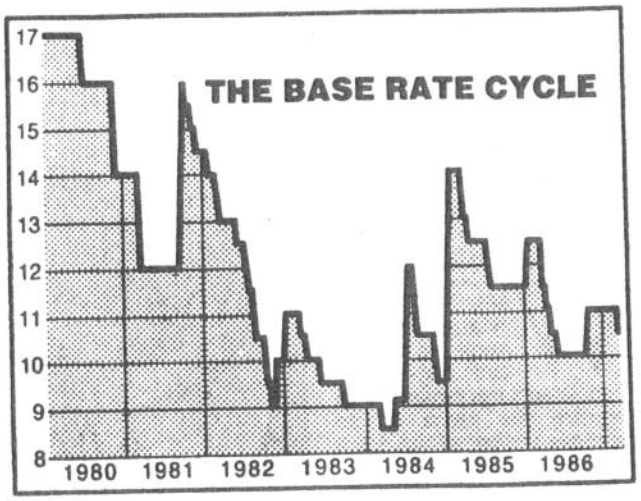
Why has the situation changed so dramatically? Has the monetary situation improved that much in a short time? Or is it that interest rates display a seasonal pattern?

Since the early 1980s, base rates have moved within something like an annual cycle. The cycle is far from precise but it suggests interest rate changes do not occur at random.

Interest rates tend to be high around the turn of the year, falling through the spring months – hence the profusion of Budget-time base rate cuts – and flat to slightly firmer over the summer months.

In some years, this slight firmness during the summer has been rather more pronounced, as in the case of July 1984, when interest rates were raised sharply to defend sterling. Indeed, before the 1980s, July tended to be a month when sterling was particularly prone to weakness, as evidenced by a succession of emergency July packages to protect the pound.

Rates tend to be soft in the autumn, particularly during the party conference season. This is followed by a tendency to rise as winter starts.



There are several reasons why interest rates may be expected to move with the seasons. The first has to do with market operators.

If people expect certain changes to occur at certain times, then those expectations can become self-fulfilling. Thus, foreign exchange dealers prepare themselves for an assault on sterling in January, and the money markets to test the Bank of England on its willingness to allow rate rises.

Chancellors, it is correctly believed in the markets, like to see their Budgets receive the accolade of an interest rate cut. Again, once this is built into expectations, it can happen almost automatically. The same is true of rate cuts in the party conference season.

But expectations alone may not be enough to force changes in rates. And expectations can be wrong. This January, for example, there was no sterling-inspired raising of interest rates.

During the year, the Bank of England has to accommodate varying pressures in the money markets. These pressures are at their most intense during the corporate tax-paying season from the middle of December until February.

During this period, large shortages develop in the money markets, shortages which, as a matter of course, the Bank takes out through its money market operations.

There is no reason why large money market shortages should be translated into higher base rates.

However, if big daily shortages in the money markets occur in tandem with other pressures for interest rate changes – for example those coming through the exchange rate – then avoiding base rate changes is more difficult for the authorities. The bigger the run of daily shortages, the harder it is for the authorities to prevent the money markets forcing a base rate change.

Against this, there is the traditional reason why January-February should be associated with sterling strength and, therefore, an easier tone for interest rates.

British companies with overseas subsidiaries repatriate funds at this time to pay their tax bills and this flow of funds across the exchanges ought to provide sterling with a boost.

But such flows, in recent years, may have been offset by the movement abroad of profits by foreign companies operating in the North Sea and, more generally, by the importance of very short-term capital flows in determining exchange rates.

North Sea oil should have transformed the seasonality of both sterling and interest rates more than it has. The second quarter of the year has frequently been a period of oil price weakness, reflecting the annual low point in demand.

But this has not been carried through to pressure on the exchange rate and interest rates. In fact, the second quarter has typically been a period of sterling strength and interest rate falls.

One reason for the interest rate declines has to do with the cash flow of financial institutions. The peak months for dividend receipts by the institutions are January, May and November. Selling gilt-edged stock should be relatively easy for the authorities in these months but, in the intervening months, gilt sales may have to be teased out by providing the market with regular small interest rate cuts.

This phenomenon, usually known as the Grand Old Duke of York syndrome, suggests more official control over interest rates than is, in fact, possible. But it provides a rationale, certainly, for spring-time base rate cuts.

The Treasury's own work on seasonal movements in the exchange rate and, for that matter, interest rates, suggests that any seasonality falls short of being statistically significant. The Bank of England has been unwilling to accept the principle of seasonal movements in exchange rates or interest rates.

The problem for the monetary authority in accepting the view that part of any movement in, say, sterling, simply reflected seasonal behaviour, is that it would imply allowing the pound to fall in January, for example, in the certain knowledge that any weakness would disappear by March.

It is the case that in recent years, with the notable exception of 1985, base rates have mainly ended the first quarter at a lower level than they started it. It is also the case that after the March flurry of base rate cuts, progress in the second quarter is usually slow, and a fall of more than 1 per cent over the quarter would be unusual, notwithstanding election timing.

One thing is certain, whatever the changes in base rates through the year: seasonally adjusted, interest rates are too high.

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D L C Peretz Esq
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Your reference

Our reference

Date 23 December 1987

Dear David,

EXCHANGE RATE FLUCTUATIONS

Thank you for your letter of 4 November 1987 commenting on Peter Driscoll's draft submission. As I expect you know, Peter has left us and I have inherited this interesting topic.

Following further internal debate here, we have effectively abandoned Peter's draft and started again. I am therefore attaching a completely new paper for your comments please.

May I ask for a response by Friday 8 January 1988? We would, if at all possible, like to submit the paper by mid-January.

Like the earlier version, this paper critically examines the "Group of 9" proposals. But, above all, it attempts to address the basic issue of whether a root and branch reform is either necessary or desirable at all.

The details of any reform, and its scope, are therefore left for later consideration if Ministers decide in principle that they want to pursue the matter. Consequently, particular concerns such as your point about the costs incurred by companies in hedging against exchange risk have deliberately been left until a later stage. However, we have of course noted what you say and we will address the matter, amongst the many other issues to be discussed, in a later submission and, I expect, in any Consultative Document which results. Furthermore, as you point out, there may be a case for action on the costs of exchange cover, and perhaps some other specific issues, even if there is no comprehensive reform.

I am copying this to Caroline Sinclair and Helen Goodman and, also, to David Mallett at the Bank.

Yours sincerely,
Mike.

M A KEITH

PS I understand that our Technical Division has now written to Helen Goodman setting out a basis upon which British Nuclear Fuels plc will be able to obtain tax relief for costs incurred under the exchange cover scheme with a corresponding tax charge on any receipts.

1. MR McGIVERN
2. FINANCIAL SECRETARY

EXCHANGE DIFFERENCES

1. This is the further report promised in Mr Driscoll's note of 16 July (copy attached as Annex 1 - top copy only). Its purpose is to examine the proposals put forward by the Group of Nine ("G9") for changing the law as it applies to exchange differences; and to suggest what the next step should be. Our broad conclusions are:-

a. the G9 proposals do not tackle anything like the full range of problems and their restricted proposals are unacceptable as they stand;

b. there <u>is</u> a case for changing the law - but well advised companies can often get the right result by manipulating the present rules, although they may be put to some inconvenience in order to do so;

c. the cost of changing the law, as in b., is unknown
and unpredictable. The <u>potential</u> cost is high, but the <u>actual</u> cost may not be very much .....

d. ..... it follows from b. and c. that the economic benefits flowing from a change in the law may not be very great. There is certainly no evidence that the present rules are inhibiting overseas trade or investment;

e. the G9 do not expect legislation in next year's Finance Bill. They want the Government to issue a consultative document, perhaps with a view to legislation in 1989. We agree that a consultative

document should be the next step.

BACKGROUND

2. Before looking at what the G9 want, it is well to see what happens under existing law. Exchange differences which arise out of the normal course of a trade (for example, differences caused by the change in exchange rates between the time goods are invoiced and the time payment is received) are already recognised as a part of the trading profits. There is no problem with these. The areas where the problems arise are, very broadly:-

- for trading companies:

  Exchange differences on capital liabilities - loans which add to the capital of the company, such as long-term borrowings - and on certain monetary assets, such as advances to subsidiaries, are not recognised for tax purposes unless they can be "matched" with an opposite and equal amount (which is recognised for tax) under the rules set out in the Statement of Practice issued on 17 February 1987.

- for other companies:

  Exchange differences on liabilities are not recognised for tax purposes, but exchange differences on assets, which are chargeable assets for capital gains tax purposes, are recognised.

The UK is the only OECD country where exchange differences are "nothings" on this scale. This is because other countries do not have a schedular system - so that they recognise profits, rather than profits from separate sources; or do not distinguish between "capital" and "current"; or have introduced special rules to bring exchange differences within the scope of their tax rules

(the USA and Australia are examples of countries which have legislated recently - see Annex 3 attached).

3. When the Statement of Practice was published you invited representations for a change in the law, acknowledging that the present 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."

4. The only really significant representations are those from the G9 (see Mr Driscoll's note of 16 July 1987 and Alan Willingale's letter of 27 July 1987 at Annex 2 - top copy only. We would not really expect to receive separate representations from companies - most of which will be members of one or other of the representative bodies making up the G9. However, we have received a personal letter from the representative of a major multi-national company expressing strong reservations about one aspect of the G9 proposals.

5. The G9 proposals were widely publicised and we have recently met representatives of that Group - Messrs Chown, Tipping, White and Willingale - to discuss their paper informally. They conceded 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 or are handled ambiguously with options provided to suit the taxpayer at virtually every turn. The G9 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.

WHAT THE G9 WANT

6. What the G9 want is:-

- relief for (and taxation of) all exchange differences on borrowings (they do not mention monetary assets, such as loans and currency deposits, which can also give rise to exchange differences) which are not already recognised under the present rules summarised above. Broadly, exchange differences of trading companies would be recognised as part of trading income
whether or not the liabilities giving rise to them are connected with the trade; exchange differences of other
companies would be recognised in some way (unspecified - they say: "the answer is not altogether clear at present") in arriving at either income or profits.

- companies would, however, be allowed the option to "earmark" exchange differences on borrowings against gains on assets which are financed by the borrowings; the exchange difference would then be treated in the same way as the asset. So that if a company finances the purchase of an asset in the US with a dollar loan, the exchange difference on that loan would not be recognised until the asset is disposed of, and would then be taxed or allowed in the same way, ie usually as a capital gain or loss.

- on timing, exchange differences would be recognised on a "realisation basis" (when the loan is repaid) rather than on a translation or "accruals" basis (under which exchange differences would be recognised each year, as the sterling value of the liability increases or

decreases*). But there would be unspecified exceptions to this rule to protect both the Revenue and the taxpayer.

7. This is not a detailed scheme. Nevertheless, there is just enough detail in it to draw some conclusions about how it would work. In the following paragraphs, we look at the more common situations in which exchange differences arise - in each case on a capital borrowing - and try to visualise:-

- what happens under the present rules;
- what the "right" answer should be, with particular reference to accounting practice;
- whether the company can get that right answer under the existing rules (if it can, there is an argument - at least - for doing nothing);
- whether the G9 proposals are acceptable.

The situations are:-

- unhedged borrowing
- swaps
- trading companies which conduct their business in foreign currency
- companies which invest abroad.

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*ie the liability is re-valued each year according to the sterling value at the balance sheet date of the currency borrowed; and the resulting gain or loss is taxed or allowed.

Unhedged borrowing

8. In unhedged capital borrowing, the company borrows in a foreign currency, converts the currency into sterling and uses the proceeds in its business. When the loan becomes due for repayment, it will purchase the currency for sterling - and the sterling cost of that currency will be more or less than the original sterling proceeds of the loan. It will thus have an exchange gain or loss; in the company's accounts that exchange difference will be recognised on a translation basis over the period of the loan; and that gain or loss will be a real one. Should the company get relief for it? The UK tax system draws a distinction between current and capital items. Expenditure in respect of current items is allowable; expenditure in respect of capital items is not. But this age-old principle has been breached in a number of respects, not least in connection with capital borrowing (so that interest on capital borrowing is now allowable; as are the incidental costs of raising capital debt finance). Moreover, exchange movements tend to reflect differences in interest rates (indeed the forward rate is determined entirely by such differences). There is at least an argument that if interest is allowed for tax purposes, exchange differences should similarly be allowed. For the purposes of this note, therefore, it is taken as our starting point that it is right in principle for exchange differences to be recognised for tax purposes; although the timing of the relief - whether it should be given on translation or when the loan is repaid or some other occasion - is a particularly thorny issue which will need to be addressed: we will not trouble you with it here.

9. The G9 scheme would recognise these exchange differences. Present law does not. A company can, however, achieve this "right" answer for itself under the present rules by turning capital borrowing into current borrowing - either by setting up an offshore subsidiary which borrows long and on-lends short; or by having the UK holding company, or another company set up for the purpose (for which the exchange differences will be "nothings" providing

that the on-lending is structured in the right way) perform the same function. Some of these arrangements may fall foul of present law - but for many well-advised companies which trade internationally, there may be no real problem in this area.

10. Most companies resort to these devices when they have borrowed to finance or hedge overseas assets rather than when they have borrowed in foreign currency in order to convert it into sterling. Indeed, it is doubtful whether companies any longer go in for unhedged foreign currency borrowing on a significant scale. In the past, it may have seemed attractive to have borrowed - say - Swiss francs at interest rates which were only half the rates charged on sterling borrowings. But companies which did this got their fingers burned when they came to repay the loans and found that sterling had depreciated against the foreign currency. They have now probably learned the lesson. But if companies still expose themselves to exchange risks by borrowing foreign currency in this way, it is at least arguable that it is no function of the tax code to provide them with the safety net of tax relief for their exchange losses.

11. Generally, companies do not usually expose themselves to an exchange risk for no reason; and where there is a reason it may be one which involves an element of tax planning or avoidance. An example is a subsidiary of - say - a US parent. If the subsidiary issues shares to the parent in amounts which are needed to capitalise it adequately, those shares will normally be denominated in sterling and the parent will bear the full risk, including the exchange risk, which attaches to equity investment. However, all too often subsidiaries are not adequately capitalised in this way: instead, the subsidiary borrows from its parent and the loans are denominated in the parent's currency. It is then the subsidiary which bears the exchange risk. Relief for exchange losses on the loan would make that exchange risk easier to bear and would make

this sort of capitalisation ("thin capitalisation") more attractive than it already is. In reply to an arranged PQ on 1 December, you indicated that thin capitalisation in the context of the financing of UK subsidiaries by foreign companies was giving rise to growing concern. In order to assess the wider economic and commercial implications of taking counteraction, comments were invited on the recent OECD study of the matter. The "possible solutions" canvassed in Annex A of Mr Bryce's note of 27 October suggested that "excess interest" be assimilated to distributions, thus recognising the commercial reality of this form of financing. It would look very odd - to say the least - if relief for interest on the loan were to be denied, and at the same time relief given for exchange differences on the loan itself. It follows that if exchange differences on unhedged borrowing are to be recognised for tax purposes, there will have to be limitations. Put shortly, the answer is not as easy as the G9 suggest.

12. Most companies which are motivated by solely commercial considerations borrow in foreign currency for entirely different reasons. In one way or another the borrowings are hedged or act as a hedge. The more common situations are set out below.

Currency swaps*

13. The next stage along from unhedged borrowing is the loan in foreign currency which is swapped into another currency - typically sterling. One reason why a company borrows in - say - Swiss francs and swaps into sterling, rather than borrowing sterling in the first place, is that it
may enjoy finer interest rates by doing so. There is no exchange risk because under the terms of the swap the sterling

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*an example of a currency swap is set out in Annex 4.

will be swapped back into Swiss francs at the original exchange rate when the loan is due for repayment. Because there is no exchange risk, there is no exchange difference in the accounts or, if there is, two entries (a loss on the repayment of the loan; a corresponding gain on the Swiss francs under the swap arrangements) which cancel out.

14. The tax treatment should follow suit, but does not. Under the present rules the loss on the loan would not be recognised while the corresponding gain on the currency would generally be taxed as a capital gain but reduced by the indexation allowance. This may often get roughly the right result - but is unpredictable enough for well-advised companies to avoid swaps and thus deny themselves the opportunity of cheaper borrowing; or to get around the problem by setting up an offshore subsidiary to enter into swaps on its behalf. Under the G9 proposals the loss on the loan would be allowed - but there could be a mismatch both as to timing (synchronisation of relief for the loss and tax on the gain) and amount (relief for nominal losses on the borrowing; tax on real gains on the currency).

15. Clearly the present rules are imperfect, but the G9 proposals are not much better.

Trading companies which conduct their business in foreign currency

16. Swaps are typically entered into by companies whose business is mainly conducted in sterling but which borrow abroad because they can get better terms abroad. The essential point is that the borrowings are fully hedged and the exchange risk is eliminated as a result. At the other extreme is the company whose business is conducted in the foreign currency where again borrowings are fully hedged in order to avoid the exchange risk. An example would be a UK bank which borrows in dollars and advances the proceeds of the loans to its customers - again in dollars. So long as the borrowing and on-lending are equal in amount, or perfectly "matched", there will again be no exchange difference in the accounts (or possibly two exchange

differences which cancel out) just as in the swaps example. This was, of course, the situation in the Marine Midland case; and the upshot of the Courts' decision is that the tax treatment follows the commercial reality. The G9 proposals could be made to secure the same result (in their present form, the exchange difference on the borrowing could be counted twice). Either way, there is no real problem here.

17. But companies are never perfectly matched in this way. They will have a surplus either of currency borrowings or of currency assets. Suppose that there is an excess of capital currency borrowings. Under present law the exchange
difference on that excess would not be recognised for tax purposes. Under the G9 proposals, it would be. Which treatment is right? If the company draws up its accounts in dollars, the accounts will show no exchange difference - clearly, the amount of its profits available for distribution
(in dollars) will be entirely unaffected by fluctuations in the exchange rate. In that case, the right answer may be to translate the dollar profit into sterling with no relief for the non-existent exchange loss on the capital borrowing.
This is what the Americans do; they call this the "functional currency" approach. If, on the other hand, the accounts are prepared in sterling, the accounts <u>will</u> show an exchange difference; the sterling profits available for distribution <u>will</u> be increased or reduced by that exchange difference and it may therefore seem right that the exchange difference should be taxed or allowed.

18. So even in this extreme case the "right" answer may be said to depend on the way the accounts are drawn up. The risk is, of course, that if "functional currency" treatment is made optional, companies will opt for it when it suits them (for example, where their business is done primarily in hard currencies - where the functional currency approach will mean that any exchange gain on the excess of assets over liabilities will not be taxed). If, on the other

hand, it is made mandatory in some cases but not in others, the dividing line will have to be drawn in statutory language; and that will not be easy.

19. Can the "right" answer be obtained under present law? Probably yes. The "functional currency" approach has already been applied to overseas branches of UK companies, and there is no reason why it should not be applied selectively to UK companies which draw up their accounts in foreign currency; or have groups of assets and liabilities denominated in foreign currency. These existing rules are perhaps flexible enough to allow a "functional currency" approach, but it is an area where we are still feeling our way - which is another way of saying that, from the taxpayer's viewpoint, the application of the present rules is not free from uncertainty.

Companies which invest abroad

20. A company which invests abroad - typically by acquiring shares in an overseas company which then becomes its subsidiary - will normally finance or hedge that investment by borrowing in the currency in which the shares are denominated. Any increase or fall in the value of the investment or more importantly the income produced by it, as a consequence of exchange rate fluctuations, will then be offset by an opposing fall or increase in the cost of repaying the loan, and of servicing it. Again, the intention is to minimise the exchange risk.

21. Under the existing rules, the exchange difference on the loan will not be recognised for tax purposes, even though the gain or loss on the disposal of the corresponding investment (including the exchange element, although this will not be separately identified) will be a capital gain or loss and will be taxed or allowed accordingly, after taking account of indexation. Under the G9 proposals, the exchange difference on the loan will be recognised for tax normally on a realisation basis (ie when the loan is repaid); but the company would be allowed to opt for a quite different treatment under which the