PO-CH/NL/0193 PT A

Alex Lawson

PART A

SECRET

(Circulate under cover and notify REGISTRY of movement)

PO -CH /NL/0193

PART A

Gilts

Begins: 4/1/88

Ends: 30/3/88 (CONTINUED)

DD: 25 years

8/9/95

CHANCELLOR'S 1988 PAPERS ON FUNDING AND GILTS

PO -CH /NL/0193 PART A

SECRET

From : D L C Peretz
Date : 4 January 1988

CHANCELLOR

Ch/ content?

OK, MPW 4/1

cc EST o/r
Sir P Middleton
Sir G Littler
Sir T Burns
Mr Scholar
Miss O'Mara
Mr Grice
Mrs Ryding o/r
Mr Cropper

MEDIUM GILT AUCTION

The Economic Secretary approved the timing of the third experimental gilt auction - which is to be for a medium-dated stock-at the funding meeting on 3 December, and the Bank of England subsequently announced that it would be in "mid-January". I attach a copy of the relevant paragraphs of the minutes of the funding meeting.

2. You will see that we then agreed on Thursday 14 January as the best date, which would in fact have meant an announcement of the details on 6 January.

3. On reflection the Bank of England have concluded that Wednesday 13 January would be a better date : partly because Wednesday is the "normal" day of the week for auctions; and partly because there are no UK statistics at all on 13 January, whereas figures for November earnings and December unemployment are published on 14 January. 13 January is also better distanced from the important US November trade figures, published on 15 January. This timing, however, means making an announcement at 3.30 tomorrow afternoon, which in turn means I have to trouble you to agree the details (in the Economic Secretary's absence) tonight. I am sorry for the short notice : if necessary we could revert to the original 14 January timing, though I agree with the Bank that 13 January would be preferable.

Proposed stock

4. The stock is to be a "medium", which means between 7 and 15 year maturity. We are agreed with the Bank that :-

a) we should choose a new tranche of an existing stock, rather than a new stock. This is to test further the proposition that the market finds it easier to deal in stocks issued in larger volume than has been typical up to now.

b) the stock should be deliverable into the new medium gilt future contract - which means it has to be in the 7-10 year maturity range.

c) we need a coupon that will give a price just a little below par.

d) on balance, it would be better to choose a FOTRA stock, to help give us a better chance of a successful auction.

5. The Bank's preferred option is for a new tranche of $8^3/_4$% Treasury 1997 - in fact a "C" tranche, since there has already been a "B" tranche of this stock. This has a $9^3/_4$ year maturity, which is shorter than the other two options the Bank suggested ($9^3/_4$% Exchequer 98, and 8½% Treasury 2000), and we would also prefer it, therefore, on maturity grounds.

Amount and payments

6. The first auction was for £1 billion (a short); and the second for £800 million (a long). The Bank are proposing £1 billion for the medium auction. But despite what was said at the funding meeting they now want to go for a partly paid stock (like the previous two auctions) - £50 to be paid on 24 February, and the balance immediately. This would leave us about a further £1 billion of gilts to sell in January to reach the £3 billion target we set for December/January, whereas a fully paid stock would get us to within £½ billion of the target. Even so, I agree with the Bank that we should go for a partly paid stock. It will give a better chance of making the auction a success. And given the way the 1987-88 PSBR seems to be developing, and the pause we are now experiencing on intervention, I think we can be reasonably

relaxed about the possible risk of undershooting the December/January gilt sales target. (The funding will of course be still tied up for the current financial year, but in February rather than January).

Recommendation

7. So I agree with the Bank that we should choose a further tranche of $8^3/_4$% Treasury 1997; and an amount of £1 billion, with £50 paid on 24 February. As I say, if you are content with this proposal the Bank would very much like to announce the details tomorrow, for an auction on 13 January.

DLCP

D L C PERETZ

Timing of the medium gilt auction

6. The Economic Secretary agreed with the advice in the Bank paper that the auction should not take place immediately before the trade figures. He thought that 14 January would be an appropriate date. Though figures on the real economy would be published around then, it was difficult to see that they would have much impact on the gilt-edged market. Mr Plenderleith agreed that these statistics would have less influence on the market but argued that they were still of some importance. After some discussion, it was agreed that the auction should take place on 14 January. Precise details would have to be announced a week earlier (7 January) which should be clear of the end of the BP support scheme.

7. The Economic Secretary asked for a recommendation as to the size and type of auction. Mr George said that at present he envisaged a £1 billion fully paid sale and said that he had still to reflect on the appropriate maturity. It was essential for the sale that medium term gilt futures should be in place by 14 January. Stock deliverable in the medium term future contract would probably be in the 7-10 year range, so though the Bank would have preferred a twelve year maturity for the auction, it might be better to choose a ten year maturity.

8. The Economic Secretary agreed that there should be an initial announcement in December, giving notice that the auction would be held in mid January.

mjd 3/52m

SECRET

PMP

FROM: MOIRA WALLACE

DATE: 5 January 1988

MR PERETZ

cc EST o/r
Sir P Middleton
Sir G Littler
Sir T Burns
Mr Scholar
Miss O'Mara
Mr Grice
Mrs Ryding o/r
Mr Cropper

MEDIUM GILT AUCTION

The Chancellor has seen your minute of 4 January and is content both with the timing and the stock proposed.

MPW.

MOIRA WALLACE

CONFIDENTIAL

From : D L C Peretz
Date : 5 January 1988

CHANCELLOR

cc EST o/r
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Scholar
Miss O'Mara
Mr R I G Allen
Mr Grice
Mrs Ryding
Ms Bronk

Cnth...

GILT REPO

In recent years at this time of the year the Bank have regularly offered gilt-edged sale and repurchase arrangements to the banks, as a way of topping up money market assistance over the period of heaviest revenue inflows (and therefore peak money market shortages). In general we have tried to avoid the Bank's holdings of commercial bills rising above £13 or £14 billion, on the grounds that once the figure goes above that it tends to strain the market's ability to create new commercial bills, and as a result produces interest rate differentials between the bill and interbank market giving opportunities for round tripping.

2. The Bank's judgement, this year, is that the overall size of money market assistance has now fallen to a level where we might be able to get away this year without any gilt repo operations at all.

3. Money market assistance is currently expected to rise from a level of £7.2 billion at the end of December to about £11 $^3/_4$ billion at the end of January, reaching a peak of around £12¼ billion in the third week in January.

4. There is, however, another argument for carrying out a repo operation now, and for announcing it quickly. A curious feature of the money markets, that has developed since Christmas, is something like a ½% gap between interbank rates and rates in the bill market. In the bill market three month rates, for example,

are around 8½% - in line with the Bank of England's dealing rates - whereas in the interbank market three month rates have been only just under 9% for the last few days. It is difficult to explain why this differential has persisted, and not been arbitraged away. It obviously <u>could</u> give rise to round tripping, though the Bank (as usual) report no signs of this. More important, it is distinctly uncomfortable with the £/DM rate moving up within reach of DM 3 again to have interbank rates ½% above the Bank's dealing rates.

5. In these circumstances it seems at least worth a try to see whether announcing a repo would help bring interbank rates down a little towards bill rates. A 1% repo (that is an offer to take an amount of gilts on sale and repurchase terms up to 1% of banks' eligible liabilities) - which is what the Bank of England have in mind - would shift around £1¼ billion out of the bill market and into the banking system. And since it is the three month rate we are most concerned about, the Bank would like to announce a repo for a near-three month period (in fact running from 13 January to 28 March). This would not be at all unusual, bridging the whole of the revenue gathering season.

6. The idea is to keep the whole operation very low profile :

- the reason given would be the normal one, a way of giving extra money market assistance at time of seasonal money market shortages. (There is no cause for the market to suspect any other motive if we do not give one).

- the interest rate, as normal would be set in line with interbank rates (LIMEAN) on the day of the operation. (We have in the past, very exceptionally, announced the interest rate in advance - but that would be too high profile on this occasion).

The hope is that shifting an amount of money of this order from the bill market to the banking system might, in itself, have an effect on the differential between interbank and bill market interest rates. (If it fails we will at least have the compensation of getting a better rate of interest than we are getting on bills).

7. I think, particularly given the current position on the exchange rate, this is worth a try. It is normal to announce gilt repos a week in advance, and if you agree, the Bank of England would like to announce it at 9.30 tomorrow morning (the traditional time). I doubt whether it would give rise to any comment, but if it did IDT should refer any enquiries to the Bank.

J. Englefield (PS)

p.p. **D L C PERETZ**

ps2/11M

CONFIDENTIAL

pmp

FROM: MISS M P WALLACE
DATE: 6 January 1988

MR PERETZ

cc Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Scholar
Miss O'Mara
Mr R I G Allen
Mr Grice
Mrs Ryding
Ms Bronk

GILT REPO

The Chancellor has seen your minute of 5 January, and is content for the repo operation you describe to be announced today.

MPW.

MOIRA WALLACE

From : D L C Peretz
Date : 7 January 1988

CHANCELLOR

cc Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr H P Evans
Miss O'Mara
Mr Grice o/r
Mr R I G Allen
Mr Cropper

Thanks.
XNOTE.
2. Given latest estimates of 1987-88 PSBR outturn, what is likely underfunding of intervention now looking like for 1987-88, assuming no further net intervention?
N

REDUCTION IN BUNDESBANK REDISCOUNT QUOTAS

You may have noticed the announcement today by the Bundesbank of a 6 billion DM cut, from 1 February, in its rediscount quotas. The Bundesbank has gone to great lengths to describe this as a "purely technical measure" that "does not affect the Bundesbank's monetary policy stance" (see attached press release).

2. In a sense this description is quite correct. What the Bundesbank is doing is "sterilising" some of its recent intervention by taking liquidity out of the system, thereby ensuring that there continue to be sizeable market shortages that it can relieve through the regular repo operations - which is how the Bundesbank sets its main operational interest rate, at present $3\frac{1}{4}$%.

3. In recent days German call money rates have come down - from around $3\frac{1}{2}$% a few days ago to under $3\frac{1}{4}$% today - no doubt reflecting the effects on liquidity of intervention. Today's move will allow the Bundesbank to keep its repo dealing rates at $3\frac{1}{4}$%, and thus to prevent market rates falling any further : in fact following the signal call money rates may well harden a little. Since money put out under rediscount quotas is lent at the very low discount rate of $2\frac{1}{2}$%, and will have to be replaced by banks at market rates, there will also be a more direct, modest, upward effect on the cost of bank funds.

4. Thus, there seems little doubt that the effect of the operation will be DM market interest rates higher than they would

otherwise have been : but not necessarily higher than the average of recent weeks. There is, therefore, some contrast with the action taken by the Dutch authorities today, and the French a couple of days ago, to reduce their interest rates by ¼%.

DLCP

D L C PERETZ

ph/229

UNCLASSIFIED

pmp

FROM: MISS M P WALLACE

DATE: 11 JANUARY 1988

MR PERETZ

cc Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr H P Evans
Miss O'Mara
Mr Grice o/r
Mr R I G Allen
Mr Cropper

REDUCTION IN BUNDESBANK REDISCOUNT QUOTAS

The Chancellor has noted and was grateful for your minute of 7 January. Given the latest indications of 1987-88 PSBR outturn, the Chancellor has asked what the likely under-funding of intervention now looks like for 1987-88, assuming no further net intervention.

MPW.

MOIRA WALLACE

SECRET

PWP-

From : D L C Peretz
Date : 13 January 1988

PS/ECONOMIC SECRETARY

cc PPS
Sir P Middleton
Sir G Littler
Mr Scholar
Miss O'Mara
Mrs Ryding
Mr Cropper

MEDIUM GILT AUCTION

As I explained to the Economic Secretary earlier this morning, the Bank of England's initial impression that this auction would be less than covered turned out in the end to be, just, untrue. Total bids of £1065 million were received for the £1 billion auction.

2. The distribution of bids was as follows :-

£92 and above	:	988
£91.55	:	5
£91.50	:	40
around £91	:	32

3. These bids compare with a price in the "when issued" market immediately prior to the auction equivalent to £93 - and the market level for similar stocks immediately prior to the auction equivalent to a price of around £92$^{3}/_{4}$.

4. I discussed this with the Economic Secretary, and we agreed there was no case - indeed no argument - for triggering the force majeure clause which enables the Bank to allocate auctions less than in full in exceptional circumstances. This means that the lowest accepted price will be £91.50, and bids at that price will be allotted at around 10%. Bids above £91.50 will be allotted in full. In fact as can be seen from the table this means that less than £10 million will be allotted at a price below £92 (the Bank need to hold a little back to cover "non-competitive" bids). But one or two bidders will get stock at a particularly good

price, and this may be useful in encouraging bids at future auctions.

5. In order not to mislead the market the Bank of England are making a rather fuller statement about the auction than is usual in their first announcement, at 11.30, including some of the details that would normally not be announced until the second announcement in the day (normally around 12.30). The important point is to get across the message that £91.50, the lowest accepted price, is not typical of accepted bids, and that the average accepted price is well over £92.

6. The announcement at 11.30 therefore mentions as well as the lowest accepted price : that the average accepted price is expected to be in the region of £92.45; that the auction was covered 1.07 times; that the majority of bids were made at prices at £92 and above; and that the amount bid at the lowest accepted price was small. It also says that the highest accepted price is £93.10.

7. The announcement later in the morning will give firm figures.

8. It is a pity that this auction was not better covered; but I think we might hope that the fact that one or two bidders have got stock at very fine prices will encourage more bidders at future auctions.

DLCP

D L C PERETZ

From : D L C Peretz
Date : 13 January 1988

CHANCELLOR

Thanks. I agree. I wd hope we can do a full fund this year (1987/88). N.

cc Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Scholar
Miss O'Mara
Mr Grice
Mr C Mowl
Mrs Ryding
Ms V Bronk

1987-88 FUNDING POSITION

You asked (Miss Wallace's minute of 11 January) how much of an underfund we are projecting in the current year.

2. The papers you saw for Chevening reported that the PSBR outturn this year might be a surplus of £2-3 billion. I attach two tables, one showing the position if the outturn is a £2 billion surplus, and the other a £3 billion surplus. Both assume no further net intervention over the rest of the year.

3. There are of course several other major uncertainties, for example about banking sector purchases/sales of gilts over the rest of the year, local authority debt sales, and the national savings outturn. The tables incorporate our most up to date estimates of each.

4. With a £2 billion PSBR surplus, we would achieve a full fund over the financial year by selling £$4\frac{1}{4}$ billion gilts over the three months January-March. You will see from the bottom line of the first table that this is a monthly striking rate a little above that achieved over the financial year so far. This leaves £$2\,^{3}/_{4}$ billion to go after today's auction and allowing for the second payment of last month's tender.

5. With a PSBR surplus of £3 billion we need to sell a further £$1\,^{3}/_{4}$ billion of gilts over the rest of the year in order to achieve a full fund (see second table). This

would be a striking rate over the rest of the year somewhat below that we have achieved over the year so far.

6. On either basis, as things look at present it ought to be posible to achieve a full fund this financial year if we wish to do so. So for now at least I would not want to recommend using the option we left open, with your Mansion House speech, of carrying some of this year's funding over to next financial year unless we find ourselves drawn into further substantial intervention in the course of the next 2½ months.

DLP

D L C PERETZ

SECRET

FUNDING : FINANCIAL YEAR POSITION 1987/88

12/1/88

£ million

	FORECAST	OUTTURN @	RESIDUAL	
	Financial Year 87/88	April - Dec 1987	January - March 88	
PSBR AND FUNDING TARGET				
1 PSBR excl asset sales	3000	3786	-786	
2 Asset sales (sales-)	-5000	-5080	80	
3 PSBR @	-2000	-1294	-706	
FINANCED BY:				
4 OPS debt sales to nbps (sales-) @	2000	2043	-43	
5 National Savings (sales-)	-1750	-1350	-400	* -133
6 CTDs (sales-)	400	-367	767	
7 Treasury bills etc (sales-)	0	-265	265	
8 Intervention (reserves inc+)	10161	10486	-325	
9 Public sector externals excl intervention and gilts (inc-)	-500	-479	-21	
10 NET GILT SALES TO NBPS & OVERSEAS NEEDED FOR FULL FUND (sales+)	8311	8774		
11 Adjustment for 1986/87 underfund	400			
12 OVER(-)/UNDER(+)FUNDING	-400	2400	-2800	
GILT SALES:				
13 Net purchases by nbps and overseas (purchases+)	8711	6374	2337	
14 Net purchases by monetary and other public sector (purchases+)	-1000	-1073	73	
15 Maturities	6950	5083	1867	
16 GROSS OFFICIAL SALES	14661	10384	4277	
17 Monthly average gross gilt sales	1222	1154	1426	

@ December figures are based on 'First Guess' and refer to Modified PSBR
* average per month

Relationship between lines:
3 = 1 + 2
10 = 3+4+5+6+7+8+9
12 = 10 + 11 - 13
16 = 13 + 14 + 15

SECRET

FUNDING : FINANCIAL YEAR POSITION 1987/88 12/1/88

£ million

	FORECAST	OUTTURN @	RESIDUAL	
	Financial Year 87/88	April - Dec 1987	January - March 88	
PSBR AND FUNDING TARGET				
1 PSBR excl asset sales	2000	3786	-1786	
2 Asset sales (sales-)	-5000	-5080	80	
3 PSBR @	-3000	-1294	-1706	
FINANCED BY:				
4 OPS debt sales to nbps (sales-) @	2000	2043	-43	
5 National Savings (sales-)	-1750	-1350	-400	* -133
6 CTDs (sales-)	400	-367	767	
7 Treasury bills etc (sales-)	0	-265	265	
8 Intervention (reserves inc+)	10161	10486	-325	
9 Public sector externals excl intervention and gilts (inc-)	-500	-479	-21	
10 NET GILT SALES TO NBPS & OVERSEAS NEEDED FOR FULL FUND (sales+)	7311	8774		
11 Adjustment for 1986/87 underfund	400			
12 OVER(-)/UNDER(+)FUNDING	-400	2400	-2800	
GILT SALES:				
13 Net purchases by nbps and overseas (purchases+)	7711	6374	1337	
14 Net purchases by monetary and other public sector (purchases+)	-1000	-1073	73	
15 Maturities	6950	5083	1867	
16 GROSS OFFICIAL SALES	13661	10384	3277	
17 Monthly average gross gilt sales	1138	1154	1092	

@ December figures are based on 'First Guess' and refer to Modified PSBR
* average per month

Relationship between lines:

3 = 1 + 2
10 = 3+4+5+6+7+8+9
12 = 10 + 11 - 13
16 = 13 + 14 + 15

53/2/LPD/3748/003

pmp

SECRET

FROM: P D P BARNES
DATE: 14 January 1988

MR PERETZ

cc PS/Chancellor
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Scholar
Miss O'Mara
Mr Grice
Miss C Mowl
Mrs Ryding
Ms V Bronk

1987-88 FUNDING POSITION

The Economic Secretary has seen your minute to the Chancellor of 13 January. The Economic Secretary has commented that this is good news, although the auction may make the task harder.

PB

P D P BARNES
Private Secretary

mjd 3/68m

SECRET

pnp

CHANCELLOR OF THE EXCHEQUER

FROM: MOIRA WALLACE

DATE: 14 January 1988

D L C PERETZ

cc Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Scholar
Miss O'Mara
Mr Grice
Mr C Mowl
Mrs Ryding
Ms V Bronk

1987-88 FUNDING POSITION

The Chancellor has seen and was grateful for your minute of 13 January. He agrees with your conclusions; he too would hope we can do a full fund this financial year.

mpw.

MOIRA WALLACE

PMP.

From : D L C Peretz
Date : 14 January 1988

pmg

ECONOMIC SECRETARY

cc Chancellor
Sir P Middleton
Sir G Littler
Mr Scholar
Miss O'Mara
Mr Grice
Mrs Ryding
Mr Cropper

GILTS : TRANCHETTES

Following yesterday's strong rise in the gilts market (shorts up ½ a point, longs more than a point) the Bank would like to be ready to announce a small package of tranchettes this afternoon <u>if</u> the market were to move ahead sharply following the US trade figures (I suppose either very bad or better than expected figures could have this effect). They have around £200m of IGs on their books, but no conventional stock. They can of course borrow conventional stock from NILO to supply to the market. The aim in announcing a package of tranchettes would be largely a market management one.

2. Under the auction rules we are in baulk from creating new mediums at the moment; and the Bank have plenty of IGs on their books. So the "package" has to be composed of either just a short; or a short and a long. The Bank think, ~~as~~ usual, that to announce only a short would not serve the market management purpose. But they have gone some way to meet our preference from shorts in the following proposal :

i) up to £300m of 8% Treasury 1992 (a FOTRA)

ii) up to £150m of 9½% Conversion 2005

with the ratio of 2 : 1 to the kept if the amounts are reduced. (they would also announce £150m of 9½ Conversion 2004 to be created for NILO).

3. The long ,at 17 years, is in fact the closest we can get to a medium in an existing stock with the right coupon, other than 9½% Conversion 2004 - which was tranchetted just before Christmas.

4. This is against the background where the Bank fully understand our strong preference for the next full stock being a short. And I think the package is consistent with your understanding with Mr George, recorded in Mr Barnes' minute of 21 December. So I recommend giving the Bank the contingent authority they seek. Of course they will only go ahead if the gilt market reacts positively to the US trade figures.

DLCP

D L C PERETZ

P.S. The Bank realise that a decision on whether or not to go ahead would have to be taken before we know the outcome of the meeting this afternoon on interest rates. In present circumstances I doubt whether a base rate move would have much impact on the gilt market - even the direction of the effect is uncertain.

Greenwell Montagu Gilt-Edged
10 Lower Thames Street
London EC3R 6AE
Telephone 01-260 9900
Telex 27783
Fax 01-220 7113

MIDLAND MONTAGU

Pup

c Sir P Middleton

Mr Allan,
Robert Thomas rang me earlier in the week to ask if we had any objection to Simon Briscoe being a joint author of an article on public sector finances. I told him we had no objection (Sir P Middleton agreed). I attach the article as it is to be published. They suggest an £11 b fiscal adjustment.
TB.

RLT/SB

15 January 1988

Sir Terence Burns
HM Treasury
Parliament Street
London SW1P 3AG

Dear Terry,

As promised, I enclose a copy of this week's Gilt-Edged Market Background. Rough copies have been sent to the Press this afternoon. It is in the process of being printed and will go out to our clients overnight.

I gather from market rumours that we are not the only brokers writing on this subject. Our traders tell me that both Grievesons and Goldman Sachs may be taking a somewhat similar line.

If you need to speak to me over the weekend, I can be contacted at my home 01-508 3021.

Yours

Robert.

R L Thomas

Gruesome but, sooner or later, inevitable.

Ch
Richard Allen tells me this will make a splash in tomorrow's press. He's poured as much cold water as he reasonably can.
AA

Greenwell Montagu Gilt-Edged is a market maker in gilt-edged and other sterling fixed interest stocks, and in money market instruments. It is part of Midland Montagu, the investment banking and securities arm of Midland Bank Group.

Registered in England as an unlimited company
Registration no. 1915770
Registered office
10 Lower Thames Street
London EC3R 6AE

Greenwell Montagu Research

GILT-EDGED MARKET BACKGROUND

No.167 Editors : *Robert Thomas/Kevin Boakes* **18th January 1988**

MIDLAND MONTAGU

Greenwell Montagu Gilt-Edged
10 Lower Thames Street
London EC3R 6AE
Telephone 01 260 9900
Telex 27783
Fax 01-220 7113

Midland Montagu Inc.
520 Madison Avenue
New York
NY 10022
Telephone 0101 212 715 5770
Telex 888401
Fax 0101 212 715 5975

Greenwell Montagu Gilt-Edged
Registered in England as an Unlimited Company no 1915770
Registered address:
10 Lower Thames Street
London EC3R 6AE

Members of The Stock Exchange

Director Bond Research
Robert Thomas Tel 01 260 9897
Chief UK Economist
Kevin Boakes Tel 01 260 9909
Economic Consultant
Ray Richardson
Financial Economist
Simon Briscoe

Too Much to Give Away

Three months ago we forecast that the PSBR would show a small surplus this year. **We have now revised our forecast and believe that the surplus will be at least £1½bn in 1987-88, significantly larger than the present consensus.** If our forecast is correct, the PSBR outturn will be some £5½bn less than the level forecast by the Treasury last March in the Budget, and £2½bn below the level in November's Autumn Statement.

The prospect for 1988-89 is even more startling. In our view, the PSBR surplus next year **is likely to be more than £7bn.** This forecast allows for full indexation in the Budget on March 15th but is before any tax cuts or expenditure increases that the Chancellor might announce. If we are correct, **the Chancellor would be able to make tax cuts of more than £11bn and still meet his target, declared last March, of the PSBR being no greater than 1% of GDP.** This would, for example, allow him to cut the top rate of income tax to 40% and get the basic rate down all the way to 20%.

We do not expect the Chancellor to announce tax cuts of anything close to this amount, however. First, the Treasury is unlikely to publish a fiscal adjustment next year as large as our forecast. It has consistently underestimated tax revenues over the last 5 years. It is likely to do so again and publish a PSBR forecast based on less optimistic revenue assumptions. Secondly, the Chancellor will be making his Budget judgment at a time when the latest data are underlining the strength of the UK economy. A pragmatic monetarist like Mr Lawson would not wish to give so large an injection at so uncertain a time. Thirdly, to announce tax cuts of anything like £11bn at a time when there is so much agitation about public expenditure would be unnecessarily provocative.

We therefore expect the Chancellor to announce tax cuts of £3-5bn and to forecast a small PSBR surplus for 1988-89. If our own forecast is broadly correct, the outturn will be significantly better, so that this time next year the Chancellor would again have the luxury of being pleasantly surprised at the state of the nation's finances.

PSBR Surplus in 1987-88

We are forecasting that the PSBR for December, the figures for which are released tomorrow, was in surplus by £½bn. This implies a surplus in the first nine months of the financial year of £1.6bn. In the rest of the financial year we expect a further larg[e] repayment in January to be offset b[y] substantial borrowing in March, following th[e] traditional seasonal pattern. **Our forecast fo[r] the year as a whole is for a surplus of at leas[t] £1½bn.**

Table I shows how our assessment fo[r] 1987-88 differs from the Budget projection[.] The largest contribution is from buoyan[t] Corporation Tax. Around 40% of **Corporatio[n] Tax** is received in January but, based on th[e] year to date, we expect the total for 1987-8[8] to be up to 25% higher than last year, roughl[y] twice as buoyant as was assumed in th[e] Budget.

Table I : Comparison of PSBR plans & forecast outturn in 1987-88

	£bn
PSBR:Budget*	3.9
:GMGE:For:	-1.5
Difference between Budget & GMGE forecast	5.4
of which:	
Income tax and NICs	1.0
Corporation tax	1.4
Stamp duty	0.2
PRT	0.5
Customs and Excise	0.6
PCBR & LABR	1.0
Privatisation proceeds	0.5
Other	0.2

*reduced to £1.0bn in Autumn Statement

Income taxes and **stamp duty** receipts taken together are expected to be over £1bn higher than was estimated in the Budget. Allowing for the changes in the price of oil and the sterling/dollar exchange rate in the second half of 1987, tax receipts from **oil** are expected to be £½bn above the Budget projection. We forecast that Customs and Excise duties will grow by 7¾% in 1987-88 compared to the Budget forecast of 6¼%, reflecting faster GDP growth than forecast. This will add over £½bn to receipts, largely **VAT** as consumers continue to spend more on vatable goods.

Privatisation proceeds for 1987-88 totalled £4.9bn by end November. We are forecasting that the government received £250m from BT preference shares in December and will receive a further £250m in

March from the BG loan stock. In total the privatisation receipts will overshoot the target by £1bn. These proceeds are taken as receipts to the Consolidated Fund but count as negative expenditure within the public expenditure planning total and general government expenditure aggregates. As a consequence these aggregates are forecast to undershoot plans. In the absence of up to date information we assume the bulk of expenditure to be once again on track. Evidence that exists, such as announced claims on the Reserve, suggests that some additional undershoot is possible.

We believe that **local authorities** and **public corporations** will undershoot their borrowing requirements by a little over £1bn. The Treasury has not published a forecast for either the LABR or PCBR, so this assessment, based on our assumption of the allocation of the expenditure Reserve, is largely subjective.

OUTLOOK FOR 1988-89

Table II sets out the prospects for 1988-89, as projected in the Budget and the Autumn Statement, and compares them with our forecasts. The Budget last March forecast a PSBR of £1bn after a fiscal adjustment of £3bn. We, on the other hand, are looking at a surplus of £8bn before fiscal adjustment and indexation. Last March, the Chancellor also said that the PSBR should average 1% of GDP, £4bn in 1987 prices. Its actual level in any one year, however, would depend on the circumstances at the time. **Adding this £4bn to our forecast PSBR surplus, and allowing for indexation, means that the Chancellor has up to £11bn to play with.**

Table II - Fiscal Prospects on Current Policies

	1988-89		
	1987 Budget	Autumn Statement	GMGE+ forecast
£billion			
Government expenditure	180	183	183
Government receipts	178	-	190
General government borrowing requirement	2	-	-7
Other borrowing	-1	-	-1
PSBR	1*	-	-8

*included £3bn fiscal adjustment
+ before Budget measures

Expenditure in 1988-89

Recent experience suggests that expenditure plans outlined in the Autu Statement can be achieved. The plans, wh will be published in full in next wee expenditure White Paper, added £2.6bn to public expenditure planning total for 1988- and £3.3bn to General Governme Expenditure. The plans included a £3½ contingency Reserve for unalloca expenditure which, by recent yea experience, will be sufficient to satisfy year demands. Since its inception in the ea 1980's the Reserve for the year immediat ahead has come under pressure only exceptional circumstances, such as during t miners' strike and the Falkland's War.

The proceeds from privatisation a included as negative items in the expendit aggregates. Most of next year's target of £5 is already guaranteed since it compri second and third calls on earlier issu Receipts due from the sale of BAA, BG and will total about £4¾bn. The option to take t £400m BG loan stock would fully meet t target without allowing for any receipts fr minor sales. The cost to the government the BP buyback is estimated at £40m ne year, and does not threaten achievement the target.

Revenues in 1988-89

Receipts are harder to forec accurately than expenditure. Even t Treasury appears to have difficulty. Errors c often be large. The £4bn overshoot we a forecasting on government receipts in 1987- is roughly in line with the error for 1986- receipts made in the 1986 Budget. Table shows the errors, which are consistently or way, in the last five Budgets, a demonstrates the caution in the Treasur presentation.

An appreciation of the systema underestimation is essential when trying **understand why the Budget forecast for 198 89 revenues now appears so low. The 19** Budget revenue projection for 1988-89, second year out, grew by no more than ot second year projections have done in ear Budgets. It did not allow for the cumulat effect of over-caution or the effect buoyancy in 1987-88 which was not forecast the Treasury. These are worth £6bn and £4 respectively. In addition, buoyancy for 198 89 itself must be added. Allowing a cautious £2bn for buoyancy in 1988-89 would imply a likely level of receipts in 1988-89 of £190bn.

Confirmation of our projection com from an analysis of taxes by broad catego

Our revenue forecast implies growth of 10% if receipts are to be £190bn in 1988-89. Four components together comprise close to 90% of government receipts. Local authority rates, national insurance contributions and Inland Revenue taxes have all grown by around 10% or more in the current year. Customs and Excise taxes - a quarter of the total - have grown by only 7%. There seems little reason to suppose that the growth in receipts will average significantly less than 10% next year. In addition we expect the increase in the tax paying propensity of the economy to continue.

A major constraint on tax revenue growth will be economic growth. We are not as pessimistic as some regarding the prospects for UK growth in 1988. There is evidence from some industries that producers' stocks are low and that order books are full until mid-year. Doubts about 1989 might exist but 1988 does not seem likely to be a year of low growth in terms of the long term average. Earnings look set to stay close to current levels, outstripping inflation, for some months ensuring continued growth in income tax and NICs receipts.

Corporation tax receipts in 1988-89 are based largely on profits in 1987 and should therefore stay high. One threat to Corporation Tax receipts is the extent to which banks are to be allowed to offset for tax purposes their provisions for loans to developing countries against other income. The loss could be up to £1bn in 1988-89 with respect to the provisions made in 1987.

There are of course other uncertainties. Receipts from oil have the potential to fluctuate considerably from year to year according to production, exchange rates and price movements. However, their importance to the British Exchequer is less than a few years ago.

Conclusions

In our view, the Chancellor has an embarrassment of riches. The reality is that he will be able to make very large tax cuts or expenditure increases and still pursue a course of fiscal prudence. He must, however, still want to keep total public expenditure very tightly under control. The inflow of revenue would make it exceptionally difficult to resist demands from colleagues or outsiders that expenditure should be allowed to rise. It is unlikely therefore that the Chancellor's Budget projections will fully reflect reality.

Further, it is going to be difficult in March to judge the profile of the economy during 1988-89. The latest data will all be indicating rapid economic growth whereas forecasts will point to a deterioration in the current account deficit and slowing economic growth. The Chancellor will therefore not wish to be making large fiscal injections at that time.

Overall, the Chancellor will surely feel more comfortable in announcing sizable but not striking tax cuts and a PSBR close to balance. We might, therefore, see a fiscal adjustment of £3-5bn and a small PSBR surplus forecast for 1988-89. Consequently, 1988-89 will be one of those years when the PSBR to GDP ratio will fall below the long run target. **In comparison to the projection in last year's Budget and allowing for the £3bn additional expenditure announced in the Autumn Statement, this would mean a fiscal adjustment of up to £5bn more and a PSBR of £4bn less. In our judgement, if the Chancellor were to go along this path he would again find himself in twelve months time in the happy position of being pleasantly surprised by the PSBR outturn.**

The message for gilts is straightforward. An outturn close to our forecast for the PSBR with the consequent effect on funding, would be an important factor contributing to the underlying strength of the market, especially at a time when the institutions are expected to channel more of their funds into the gilt-edged market. It is true that the market is likely to pay considerable attention to the Chancellor's published PSBR forecast and that this could be slightly less favourable than the outturn for 1987-88. It will nevertheless be significantly below the Chancellor's target of 1% of GDP. **On balance the news from the public finance front is very good for gilts.**

Table III : Error on Budget forecasts of tax receipts

Underforecast+ (£billion)	1983-84	1984-85	1985-86	1986-87	1987-88*
Non-oil	0.5	0.7	3.4	5.5	3.5
Total	1.6	2.4	1.4	4.2	4.0

+Difference between outturn and budget forecast.
*GMGE estimate.

53/2/LPD/3747/062

pmp.

SECRET

ECONOMIC SECRETARY TO THE TREASURY

FROM: P D P BARNES
DATE: 15 January 1988

MR PERETZ

cc PS/Chancellor
Sir P Middleton
Sir G Littler
Mr Scholar
Miss O'Mara
Mr Grice
Mrs Ryding
Mr Cropper

GILTS : TRANCHETTES

The Economic Secretary was grateful for yoru submission dated 14 January.

2. The Economic Secretary is content to give the Bank contingent authority to bring the tranchettes mentioned in paragraph 2 of your minute.

PB

P D P BARNES
Private Secretary

53/2/LPD/3748/016

SECRET

pp

FROM: P D P BARNES
DATE: 18 January 1988

MR PERETZ

cc PS/Chancellor
Sir P Middleton
Sir G Littler
Mr Scholar
Miss O'Mara
Mr Grice
Mrs Ryding
Mr Cropper

GILTS : TRANCHETTES

We spoke.

2. As I told your office, the Economic Secretary is content to extend for this afternoon his contingent authority for the Bank to bring the tranchettes mentioned in paragraph 2 of your minute of 14 January.

PB

P D P BARNES
Private Secretary

SECRET

pmp.

GUINNESS FLIGHT
GLOBAL ASSET MANAGEMENT LIMITED

PO BOX 442 32 ST MARY AT HILL LONDON EC3P 3AJ TELEPHONE 01-623 9333
CABLES GUIMACO TELEX 884035 GUIMACO G TELEFAX 01-283 4811

PRIVATE AND CONFIDENTIAL

HEF/BS/1138E

FINANCIAL SECRETARY
26 JAN 1988

20 January 1988

MR. W.H. MASON IR
PPS, CST, PMG, EST
MR. Scholar
MR. Peretz Miss. Sinclair
MR. Tyrie MR. Cropper
MR. Houghton IR
MR. TAYLOR-Thompson
PS/IR.

The Rt. Hon. Norman Lamont
Financial Secretary to the Treasurer
Treasury Chambers
Parliament Street
LONDON SW1

Dear Norman

Thank you very much for your letter of the 11th January. I was not previously clear whether you wanted my thoughts on gilts and residence/domicile. I enclose brief papers on both - although I am not doing proper justice to either subject in terms of checking relevant tax references!

Before closing, there are two other observations which I thought you might find of wider economic interest:

1. Despite justified concern at the apparent high continuing level of UK earnings growth (at least historically) it is my own view that we are already in a situation where pay increases are about what companies believe they can reasonably afford, rather than trade union and worker pressures. In other words if, as I anticipate, profit margins will come under pressure over the next year, I would expect the level of wage increases to come down with this process. I believe the continuation of a high level of wage increases has been very much about the sharp rise in productivity and profitability where businesses have felt they could and should pay relatively generous increases - particularly given that labour costs in the UK are substantially below those in Germany, France etc.

2. The popular wisdom is that floating exchange rates have an inflationary impact - in part through imported inflation in a particular country during periods of currency depreciation and in part as uncertainty is supposed to reduce physical investment.

I now tend to the view that the type of exchange rate cycles we have seen over the last decade have, if anything, had disinflationary effects. First of all it is noticeable in the case of the USA and the UK and even Germany in the early 1980s, that a substantial weakening of the exchange rate did not result in any major imported inflationary cycle.

I believe there are in addition, other disinflationary effects of the exchange rate seesaw. During times when a particular country's currency is overvalued, massive efforts go on in industry to cut costs and increase efficiency. All of the main economies have now been through this process over the last eight years.

In addition, during periods of undervalued currency, there seems to me to be a substantial addition to capacity in such economies. At the present this is relevant to the total dollar area as well as the USA e.g. large new aluminium capacity in Venzuela. It appears to me that this latter factor is tending to keep up over capacity worldwide - built up particularly during the 1970s - in raw material processing and industrial production. The efficiency effects of an over valued exchange rate - together with relatively free trade etc. - have contributed to making the world substantially more competitive generally and thus reducing the ability of producers to put up prices.

To conclude, my theories only make sense if the currency seesaw operates on a relatively long basis e.g. five years. I accept that a much shorter cycle of exchange rate volativity could be inflationary.

With kindest regards

Yours ever

Howard

HOWARD E. FLIGHT

Attach.

THE TAXATION OF GILTS

Gilt Funds v Individual Investment

The point here is simply that if a UK resident invests directly in gilts his gains are essentially free of capital gains tax. If he invests in either an onshore or offshore gilt fund, there is a capital gains tax liability on the realisation of the gain.

This seems to us to be illogical and to wholly discourage retail gilt funds. Particularly in the present environment, we believe there is a large potential retail appetite and that putting gilt investment funds on the same basis as direct personal investment in gilts, could contribute to lowering the cost of the Government borrowing.

There is, however, an accounting point here. While gilts have gone over to the same basis as other bond markets where the principal price and number of days interest bought and sold are shown separately, a gilt fund can still keep its accounts if it wishes on the old basis. If gilt funds were required to account on a straightforward basis, in line with other bond markets, strictly separating interest bought and sold within the overall income account, I cannot see that the Inland Revenue could object to then putting gilt funds on the same basis as direct personal gilt investments.

DOMICILE AND RESIDENCE

1. The objection to the way in which domicile and residence law presently works out must surely be that while the UK is arguably the most tax attractive of western countries for wealthy foreigners to reside in - having no UK income tax or capital gains liability on income or capital gains which are not remitted into the United Kingdom - our tax laws encourage - nay compel - successful British entrepreneurs to become tax exiles, particularly when they have reached the stage of selling out their companies, to avoid capital gains tax and if possible to set themselves up to avoid inheritance tax.

At simplest, we get a lot of rich Arabs with some degree of spending power in exchange for losing a lot of successful entrepreneurs who still have much to contribute the UK economy! I find it a caracature visiting Monte Carlo and finding so many able British businessmen all totally bored; wishing they were running a business in the UK and having nothing better to talk about than their latest investment decision or the cleverness or stupidity of their Investment Manager!

2. From the starting point, therefore, that present law in this area has undesirable effects I believe that the objectives in any reforms should be to continue to make the UK relatively attractive for wealthy foreigners to live in - their spending power is useful for the economy - but more particularly to stem the entrepreneur drain.

A major area of reform must point to the reduction or abolition of tax on long term capital gains; a further reduction of inheritance tax and a sharp reduction in the higher rates of income tax - ie. so that the successful entrepreneur is reasonably taxed in the United Kingdom and less motivated to become a tax exile. I query, however, whether or not we should also seek to make it less tax attractive for UK entrepreneurs to become non resident. The only ultimate weapon here would be to switch to the US practice of taxing on the basis of citizenship. As with the US a significant concession of fixing an income level below which no UK tax applies would be capable of accommodating most of the UK ex patriot community - e.g. an income of £100,000 per annum?

If this approach were followed, there would obviously then be left to potential UK tax avoiders, the option of changing citizenship - e.g. a Cayman passport. My belief is that most people would think hard about giving up citizenship but, if necessary, to discourage this, there could be a tax on British citizens surrendering their citizenship.

3. If the concept of domicile was essentially abolished for UK citizens and replaced with that of citizenship, the law would then obviously need to be changed with regard to the tax rules pertaining to foreign residents.

Here I think there is an insoluble problem. Most EEC countries have tax laws based on residence only with various concessions to foreign residents or in the case of France and Italy, in practice ignoring foreign residents' income and assets overseas. Here I see no alternative but to a set of rules raising the level of UK taxation applying to foreign residents in the UK depending upon the length of time they have been resident but even after say 20 years, still being at concessionary rates.

4. In summary, if the highly undesirable effects of present residence and domicile taxation principles are to be ended, I doubt this can be achieved without abolishing the concept of domicile.

Administratively, I readily perceive that the concepts of residence and domicile are effective and conceptionally sound - what is wrong with them is simply their effects!

If there are overpowering reasons for wishing to keep the concepts of both domicile and residence, my only thoughts are to regulate definitions here more precisely e.g. loss of UK domicile requires an individual to have been consistently resident abroad say 20 years. I would still see a need to impose UK taxation on non resident UK individuals with UK domicile, to discourage people from going abroad, albeit that this would obviously be difficult to administer.

5. To conclude, looking to the future I believe there will inevitably be a need to fight to keep down tax rates which I trust the present administration will end up reducing very substantially. The ease with which penal rates of UK taxation could be avoided in the past by becoming a tax exile seem to me to have been a major cause for the natural business leaders of the community not resisting excessive taxation more robustly! I also believe, in principle, that this is a difficult territory which is worth tackling in principle. Obviously, the ability of highly wealthy entrepreneurs to escape all or much of their potential UK tax liabilities means that those who stay in the UK "working hard" have to pay more tax which is in principle wrong. My Utopian dream is of a UK tax regime where the overall impact of income tax, capital gains tax and inheritance tax, is no longer confiscatory and is sufficiently modest that successful entrepreneurs will not particularly object to being forced to pay their fair dues whether they stay at home or go abroad!

5. As you probably know, the concepts of residence and domicile were invented by Pitt and Addison in the late 18th Century and on the first introduction of income tax. They have survived remarkably but I believe they are appropriate to low income tax rates of say "10d in the £" with no other significant personal direct taxes, unlike the post war tax regime, where avoidance by becoming a tax exile is only too attractive.

3886B/29

pnp.

SECRET

FROM: MISS M O'MARA
DATE: 22 January 1988

ECONOMIC SECRETARY

cc Chancellor
Sir P Middleton
Sir G Littler
Mr Scholar
Mr Peretz
Mr Grice o/r
Mrs Ryding
Mr Cropper

Passed to PS/EST

INDEX-LINKED GILTS: TRANCHETTES

By last night the Bank had sold out of the remainder of the tranchettes they issued on 18 January and had also sold a substantial number of IGs. They would therefore like to announce a further small package of IGs this afternoon.

2. The IGs market has picked up a little, after a fairly substantial fall in the first part of this month and is a fraction firmer this morning than at last night's close. The Bank are therefore seeking authority to issue the following small package of index-linked stock:

i. £50 million of 2½% Treasury 2003

ii. £50 million of 2½% Treasury 2013

iii. £50 million of 2½% Treasury 2020.

These are the areas of the market in which the Bank detect the most interest.

3. The Bank acknowledge the market is rather subdued, probably in expectation of an announcement this afternoon. They have therefore deliberately proposed a small package. They point out that the market remains below the levels at which it stood when they last brought a package of IGs on 21 December and that we can always bring more next week, if the demand is there.

4. This seems a sensible proposal to us. We are quite well ahead on our funding for 1987-88 but proposals by the Bank to bring IGs are always welcome. We recommend that you give them the authority they seek.

MOM

MISS M O'MARA

53/2/LPD/3749/024

SECRET

pmp.

FROM: P D P BARNES
DATE: 22 January 1988

MISS O'MARA

cc PS/Chancellor
Sir P Middleton
Sir G Littler
Mr Scholar
Mr Peretz
Mr Grice
Mrs Ryding
Mr Cropper

INDEX-LINKED GILTS : TRANCHETTES

The Economic Secretary was grateful for your submission of 22 January.

2. The Economic Secretary is content to give contingent authority for the package mentioned in paragraph 2 of your submission.

PB

P D P BARNES
Private Secretary

SECRET

SECRET

CHANCELLOR OF THE EXCHEQUER

PWP

MR GEORGE

~~MR PLENDERLEITH~~

MR PERETZ

cc Mr A C S Allan

1. Ian Plenderleith rang, & asked me to pass on this message.

2. The gilt market has picked up ~~since~~ by some $\frac{3}{8}$ since you last spoke to him, e.g. the long gilt future is at $117\frac{1}{2}$, cf. $117\frac{1}{8}$. There is quite good two-way business. The FTSE is also up 40 points.

3. Mr Plenderleith is therefore proposing to go ahead with 200 shorts and 100 longs, at 3.30, unless he hears from you.

OK

AH

PAM15

CONFIDENTIAL

MJ

FROM: MOIRA WALLACE

DATE: 26 JANUARY 1988

MR RICH

cc Mr Peretz

NATIONAL LOTTERY

The Chancellor has seen and was most grateful for your minute of 25 January.

MPW

MOIRA WALLACE

53/2/LPD/3749/015

SECRET

pmp

FROM: P D P BARNES
DATE: 29 January 1988

MR PERETZ

cc PS/Chancellor
PS/Sir P Middlcton
Sir G Littler
Mr Scholar
Miss O'Mara
Mrs Ryding
Mr Cropper

GILTS : TRANCHETTES

The Economic Secretary discussed with you this morning the gilts proposals as set out in paragraph 3 of your submission of 29 January.

2. The Economic Secretary told you that he was content for the Bank to be given contingent authority to bring these Tranchettes.

PB

P D P BARNES
Private Secretary

SECRET

pmp

From : D L C Peretz
Date : 29 January 1988

ECONOMIC SECRETARY

Ch/ EST has approved.

MPW 29/1

cc Chancellor
Sir P Middleton
Sir G Littler
Mr Scholar
Miss O'Mara
Mrs Ryding
Mr Cropper

GILTS: TRANCHETTES

Although the gilt market opened down a little this morning (around a quarter of the point at the short end) it has since picked up, and the Bank would like to be ready to announce a small packet of tranchettes this afternoon if it is then going ahead at all strongly.

2. This would be largely for "market management" reasons. The Bank accept, absolutely, that the funding target we have laid down for February - £1 billion, of which £500 million is already tied up with the auction call - is a constraint. So anything they sell early in the month means there will be less opportunity to [redacted] bring stock for "market management reasons" later on in the month, unless they had done some buying in in the meantime. Stock announced today would come on sale next week, and therefore counts towards the February figure.

3. The proposal is: -

(i) Up to £200 million of Treasury 9% 1994, a short and a FOTRA.

(ii) £100 million of 2½% index linked 2011.

(iii) £50 million of 2½% index linked 2024, a FOTRA.

If they announce these they would also announce £150 million of stock for NILO.

4. The composition of the package, shorts and IGs, is precisely what we want.

5. The only difficulty, at this time of year, is fine tuning the amount of funding (and buying in) so as to achieve as near as we can to a full fund. On the understanding set out in the second paragraph above, I recommend we give the Bank contingent authority to announce this package this afternoon, if the market then is moving ahead more strongly.

DLCP

D L C PERETZ

53/2/LPD/3750/034

SECRET pnp. pnf

FROM: G R WESTHEAD
DATE: 1 February 1988

MR PERETZ

cc PS/Chancellor
PS/Sir P Middleton
Sir G Littler
Mr Scholar
Miss O'Mara
Mrs Ryding
Mr Cropper

GILTS : TRANCHETTES

This is merely to note for the record that the Economic Secretary's contingent approval was given today to the following gilts package:

(i) up to £200 million of Treasury 9% 1994 - a short and a FOTRA

(ii) £100 million of 2½% index-linked 2011

(iii) £100 million of 2½% index-linked 2024 - a FOTRA

2. In the event due to the depressed state of the gilts market, it was decided not to proceed with the above package.

Guy Westhead.

GUY WESTHEAD
Assistant Private Secretary

01 FEB 1988

120

BARCLAYS de ZOETE WEDD

GILTS LIMITED

ECONOMIC SECRETARY
REC'D 01 FEB 1988
ACTION MR PERETZ
COPIES TO PS/CHANCELLOR
SIR P MIDDLETON
MR SCHOLAR
MRS LOMAX
MISS O'MARA

P. Lilley, Esq., M.P.,
Economic Secretary,
H.M. Treasury,
Parliament Square,
LONDON, SW1P 3AG

28th Janaury, 1988

Dear Peter,

I should be delighted if you could join us for lunch at BZW when I would like you to meet some of my colleagues, including Kenneth Sinclair, who is the Chairman of BZW Gilts. The dates I can offer are listed below but, of course, if none of these would be convenient for you I should be happy to find some alternatives.

Thursday, 31st March
" 21st April
" 28th "

I do hope you will be able to accept my invitation and look forward to meeting you again.

Yours sincerely,

Stephen

S.J.R. Rumsey

EBBGATE HOUSE 2 SWAN LANE LONDON EC4R 3TS TELEPHONE 01-623 2323

TELEX: 8950859 FAX: DEX 01-623 6075 REGISTERED IN ENGLAND
REGISTERED NUMBER 1957771 REGISTERED OFFICE: AS ABOVE

53/2/LPD/3750/054

mg

SECRET

FROM: G R WESTHEAD
DATE: 3 February 1988

MR PERETZ

cc PS/Chancellor
PS/Sir P Middleton
Sir G Littler
Mr Scholar
Miss O'Mara
Mrs Rydinq
Mr Cropper

GILTS : TRANCHETTES

This is to note for the record that the Economic Secretary's contingent approval was given today for the Bank of England to bring the following gilts package this afternoon, if market conditions permit:

(i) £100 million of 2½% index-linked 2011

(ii) £100 million of 2½% index-linked 2024 - a FOTRA

Guy Westhead.

GUY WESATHEAD
Assistant Private Secretary

91G.SCB.4316.16

papers PSE

pmp

FROM: CATHY RYDING

DATE: 3 February 1988

1. MR PERETZ RL 3/2
2. ECONOMIC SECRETARY

cc: PS/Chancellor
Sir P Middleton
Mr Scholar
Mrs Lomax
Miss O'Mara

INVITATION FROM BZW GILTS

Stephen Rumsey from BZW Gilts wrote on 28 January inviting you to lunch and your office asked for advice.

2. Wedd Durlacher Mordaunt were one of the two large jobbing firms pre Big Bang and BZW are a major gilt edged market maker in terms of market share. We are keen to keep in touch with the GEMMs and see no reasons at all why you should not accept this invitation. Indeed, it could be a useful opportunity to explain the new M4 funding rule. FIM are also happy for you to accept this invitation, although you should be aware that BZW are still smarting from their failure to obtain a seat on the Tokyo Stock Exchange (but we can give you briefing on this).

3. On the dates themselves, all fall after the budget, and are all outside the sensitive period between the first guess and publication of the provisionals. The provisionals will actually be published on 21 April (the second of the three dates offered). The March trade figures are due out on 29 April (the day after the third date offered) but this should not present any particular problems.

4. If you accept the invitation, we will provide more detailed briefing nearer the time.

Cathy Ryding

CATH RYDING

ps2/10M

CONFIDENTIAL

pmp

FROM: MISS M P WALLACE

DATE: 10 February 1988

PS/FINANCIAL SECRETARY

cc PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Anson
Mr Kemp
Mr Scholar
Mr Turnbull
Mr Saunders
Miss O'Mara
Mr Rich
Mr Cropper
Mr Tyrie
Mr Call

LOTTERIES

The Chancellor has seen Mr Rich's minute of 8 February, and Mr Tyrie's minute of 9 February. He agrees with Mr Tyrie that the letter ought to warn the Home Secretary that the idea of a health lottery is bound to be considered as part of the health review.

MPW.

MOIRA WALLACE

CONFIDENTIAL

CC: . PPS, CST, PMG, EST
Sir. P. Middleton
Sir. T. Burns
Mr. Anson
Mr. Kemp
Mr. Scholar

pmp

Treasury Chambers, Parliament Street, SW1P 3AG

Mr. Turnbull
Mr. Saunders
Miss. O'Mara
Mr. Rich
Mr. Cropper

The Rt Hon Douglas Hurd CBE MP
Secretary of State for the Home Department
Home Office
50 Queen Anne's Gate
LONDON
SW1H 9AT

11th February 1988

Mr. Tyrie.
Mr. Call.

Dear Douglas

LOTTERIES

Thank you for sending me a copy of your letter of 22 December to Richard Luce. I am sorry that I have not been able to respond earlier.

I very much welcome your proposal that we should raise the monetary limits set out in the 1976 Lotteries and Amusements Act. It seems to me that this would be a significant measure of deregulation and well worth doing on its own merits.

As you point out, it would also offer a way of testing the market for lotteries with larger prizes. I suggest that our officials get in touch to discuss the details as soon as possible.

On the separate question of a national lottery, I should think this is bound to be considered as part of the current NHS Review. But I do not think we should let that stand in the way of the deregulatory measure you are proposing now.

I am copying this letter to Malcolm Rifkind, John Wakeham, Richard Luce, Colin Moynihan and Tony Newton.

Yours

Norman

NORMAN LAMONT

CONFIDENTIAL

BF 12/2

FROM: P D P BARNES
DATE: 11 February 1988

ECONOMIC SECRETARY TO THE TREASURY

PS/FINANCIAL SECRETARY

pmp

cc PS/Chancellor
PS/Chief Secretary
Sir P Middleton
Mr Anson
Sir T Burns
Mr Kemp
Miss O'Mara
Mr Scholar
Mr Culpin
Mr Gilmore
Mr Peretz
Mr Turnbull
Mr Gieve
Mr Saunders
Miss Sinclair
Mr Call
Mr Cropper
Mr Tyrie

LOTTERIES

The Economic Secretary has seen Mr Rich's submission to the Financial Secretary of 8 February.

2. The Economic Secretary believes that we can only ensure that the deregulation of limits on prizes and turnovers of lotteries will result in more money being raised if we insist on a minimum charitable take, for example 42½ per cent.

PB

P D P BARNES
Private Secretary

SECRET

prg

MG EVENING REPORT

FOREIGN EXCHANGE MARKETS

Thursday 18 February 1988

Previous close		Today opening 8.30am	Today close 4.00pm	%change $/currency since Plaza	since Paris	since 16 October 1987
74.3	£ERI	74.2	74.3	-9.4	7.5	1.0
1.7502	$/£	1.7490	1.751	27.4	14.6	5.2
2.9853	DM/£	2.9803	2.9837	-23.5	6.9	-0.4
1.4452	ECU/£	1.4431	1.4432			
95.4	$ERI	-	95.3	-31.7	-8.4	-4.9
1.7057	DM/$	1.7040	1.704	66.7	7.2	5.7
130.35	Yen/$	130.00	129.72	83.9	18.4	10.1

Mar $16.05 Apr $16.17 May $16.20 Spot Brent Mar $15.60 Apr $15.82 May $15.82

UK RESERVE TRANSACTIONS ($million)

	(a) Today	This month so far	Total since 1 Apr 87	(b) Estimated end-month position *
Market intervention	-14	-9	28215	-15
Off-market transactions	-9	4	-7324	-13
TOTAL	-23	-5	20891	-28
Net borrowing				-220
Valuation changes				0
TOTAL CHANGE IN RESERVES				-248

(a) Spot and forward transactions on a done date basis.

(b) Spot transactions only on a value date basis, as in published figures.

* On conventional assumption of no further market intervention.

OTHER COUNTRIES MARKET INTERVENTION ($million equivalent)

Belgium	-100DM	Germany	-	Italy	-6$
Denmark	-	Holland	-	Japan	-
France	-	Ireland	-	US	-

MARKET COMMENT

Yet another lacklustre day in the markets! The dollar eased overnight in New York and the Far East on some profit taking but with no other factors to influence trading.It started in London firmly,but following a news report that Ministry of Finance/BOJ officials expected the dollar to fall further in the medium term because of imbalances in world payments,the dollar eased to a low of DM1.7007.Since the close it has firmed above DM1.71 on comments by Reagan at a press conference that he will rescue the marine taken hostage in Lebanon. The Belgians score was done to hold down any pressure in the EMS with political uncertainties in Belgium and Italy.The EMS band closed 1 13/16 (+1/16 on the day). Sterling on the sidelines with some talk of an early base rate rise.Money figures had no effect.

Rates at 5.45PM: $1.7465 DM2.9839 DM/$1.7085 Y/$130.10

Ian Polin

HONG KONG	**Previous**	**Today**	**Change**
Hong Kong dollar	CLOSED FOR		
Hang Seng Index	CHINESE NEW YEAR		
3 month interbank rate	"		

NAME: I.C.Polin
TEL N

SECRET

MONEY MARKETS Thursday 18th February

INTEREST RATES

	£ Interbank Today	£ Interbank Change	Eurodollar Today	Eurodollar Change
7 days	8 15/32	5/32	6 3/4	0
1 mth	8 3/4	1/16	6 13/16	1/16
3 mth	9 5/16	1/32	6 7/8	0
12 mth	9 13/16	1/16	7 5/16	0

BILLS

	Today	Change
3 Month Treasury Bills	8 13/16 - bid only	0

BANK MONEY MARKET OPERATIONS

	Purchases/Sales £ m	Rates	Discount Rate on Eligible Bank Bills
Band 1 (0-14 days)	21	8 7/8	8 9/16 - 1/2
Band 2 (15-31 days)			8 5/8 - 9/16
Band 3 (32-63 days)	2	8 7/8	8 7/8 - 13/16
Band 4 (64-91 days)	57	8 7/8	8 31/32 - 29/32
TOTAL BILLS	80		
Repurchase			
Lending	110		
TOTAL OPERATIONS	190	against shortage £ 250 m	

US RATES

	3 month CDs		10 yr Tsy Bond		20 yr Tsy Bond	
Today/Change	6.68	-0.07	8.31	0.01	8.56	0.02

STOCK MARKET

	FT Ind-Ord		FTSE		Gilt index	
Today/Change	1390	-8	1736	-12	88.97	0.21

MARKET COMMENT

GILTS opened easier, shorts down 1/16, mediums 1/8, longs 1/4. The market was quiet before the various figures announced at 11.30am, at which it eased until lunchtime. Prices picked up in the afternoon, closing at the day's best. There were some reports of continental buying, possibly out of French government bonds. Shorts ended up 1/4, mediums 1/4, longs 3/8 to 1/2.

INDEX LINKED were little better, rising 1/4.

EQUITIES fell away in the afternoon following the announcement of a £5.5bn rise in bank lending, and a rise in average earnings of 8.5%.

Steph Bowden

NAME: S Bowden
TEL NO: 270 4616

SECRET

GILT-EDGED MARKET — Thursday 18th February

Transactions basis, cash values (£m); sales + purchases -

ISSUE DEPARTMENT: MARKET TRANSACTIONS

	Today	February
Gross sales shorts	9.3	23.1
Gross sales mediums	57.2	84.8
Gross sales longs and undated	16.8	55.1
Gross sales index-linked		206.7
Part paid calls		0.5
Buying in non-next maturities		-129.2
CRND: Market transactions	-2.0	-41.1
TOTAL 'GROSS' SALES	81.3	199.9
Buying in of next maturities		
Redemptions	-0.3	-34.2
TOTAL TRANSACTIONS WITH MARKET	81.0	165.7

Future calls	500
Sales required to meet February target of £ 1000 m	301

PRICES/YIELDS OF GILT-EDGED STOCKS

	Yesterday's close	Change from yesterday's close	
	Par yield (per cent)	Price (£/32)	Yield (%)
Shorts	9.404	2	-0.02
Mediums	9.595	7	-0.04
Longs	9.449	13	-0.05

REPRESENTATIVE STOCKS

	Price (£/32)			Yield (per cent)	
	Today		Change	Today	Change
8% Treasury 1992	95	10	3	9.38	-0.02
8 3/4% Treasury 1997 'C'	45	11	9	9.50	-0.04
11 3/4% Treasury 2003/07	117	26	14	9.68	-0.04
2% Index-Linked 2006	107	24	8	3.96	-0.01
3% Treasury Loan, 1992	83	23	1	7.48	-0.01
8% Treasury Convertible 1990	99	23	7	8.12	-0.10

GILT FUTURES

		Open	Close	Volume
Long Contract	March	119.04	119.27	37656
Medium Contract	March	95.09	95.19	1247

NAME: S Bowden
TEL NO: 270 4616

pmp

AMENDMENT SHEET

SECRET

GILT-EDGED MARKET — Monday 22nd February 1988

Transactions basis, cash values (£m); sales + purchases -

ISSUE DEPARTMENT: MARKET TRANSACTIONS

	Today	February
Gross sales shorts	204.0	229.2
Gross sales mediums	96.8	247.3
Gross sales longs and undated		55.1
Gross sales index-linked	24.7	273.2
Part paid calls		0.5
Buying in non-next maturities	-10.4	-149.7
CRND: Market transactions	-1.6	-51.1
TOTAL 'GROSS' SALES	313.5	604.5
Buying in of next maturities		8.3
Redemptions	-0.3	-34.8
TOTAL TRANSACTIONS WITH MARKET	313.2	578.0

Future calls	500
Sales required to meet February target of £ 1000 m	-104

PRICES/YIELDS OF GILT-EDGED STOCKS

	Yesterday's close: Par yield (per cent)	Change from yesterday's close: Price (£/32)	Yield (%)
Shorts	9.269	-4	0.04
Mediums	9.442	-6	0.03
Longs	9.282	-9	0.04

REPRESENTATIVE STOCKS

	Price (£/32) Today		Change	Yield (per cent) Today	Change
8% Treasury 1992	95	16	-4	9.32	0.04
8 3/4% Treasury 1997 'C'	45	28	-4	9.41	0.02
11 3/4% Treasury 2003/07	118	18	-14	9.60	0.04
2% Index-Linked 2006	108	8	-6	3.93	0.01
3% Treasury Loan, 1992	83	26	0	7.46	0.00
8% Treasury Convertible 1990	100	4	-2	7.93	0.03

GILT FUTURES

		Open	Close	Volume
Long Contract	March	120.26	120.19	38035
Medium Contract	March	95.23	95.29	141

NAME: C A Davey
TEL NO: 270 4613

FUNDING

Ch

These are latest available funding figures: before Feb CGBR figure (c £0·4bn better than forecast) and before intervention totalling some £0·6 - 0·7bn in last few days.

Net gilt sales required for full fund will be negligible (& funding rule allows carry forward of funding intervention).

AA

SECRET AND PERSONAL

FUNDING : FINANCIAL YEAR POSITION 1987/88 Pry 19/2/88

£ million

	FORECAST	OUTTURN	RESIDUAL	
	Financial Year 87/88	April 87 - Jan 88	February - March 88	
PSBR AND FUNDING TARGET				
1 PSBR excl asset sales	1611	-1895	3506	
2 Asset sales (sales-)	-5011	-5070	59	
3 PSBR	-3400	-6965	3565	
FINANCED BY:				
4 OPS debt sales to nbps (sales-)	1491	1191	300	
5 National Savings (sales-)	-2120	-1630	-490	* -245
6 CTDs (sales-)	149	-126	275	
7 Treasury bills etc (sales-)	0	-52	52	
8 Intervention (reserves inc+)	10130	10130	0	
9 Public sector externals excl intervention and gilts (inc-)	416	416	0	
10 NET GILT SALES TO NBPS & OVERSEAS	6666	2964		
11 Adjustment for 1986/87 underfund	400			
12 OVER(-)/UNDER(+)FUNDING	-400	-4153	3753	
GILT SALES:				
13 Net purchases by nbps and overseas (purchases+)	7066	7117	-51	
14 Net purchases by monetary and other public sector (purchases+)	-467	-467	0	
15 Maturities	6950	5439	1511	
16 GROSS OFFICIAL SALES	13549	12089	1460	
17 Monthly average gross gilt sales	1129	1209	730	

* average per month

Relationship between lines:

3 = 1 + 2
10 = 3+4+5+6+7+8+9
12 = 10 + 11 - 13
16 = 13 + 14 + 15

SECRET

FU[redacted]NG : FINANCIAL YEAR POSITION 1987/88 - M4 RULE 19/2/88

£ million

	FORECAST Financial Year 87/88	OUTTURN April 87 - Jan 88	RESIDUAL February - March 88	
PSBR AND FUNDING TARGET				
1 PSBR excl asset sales	1611	-1895	3506	
2 Asset sales (sales-)	-5011	-5070	59	
3 PSBR	-3400	-6965	3565	
FINANCED BY:				
4 OPS debt sales to nbps (sales-)	509	209	300	
5 National Savings (sales-)	-2120	-1629	-491	* -246
6 CTDs (sales-)	-32	-132	100	
7 Treasury bills etc (sales-)	0	-82	82	
8 Intervention (reserves inc+)	10130	10130	0	
9 Public sector externals excl intervention and gilts (inc-)	416	416	0	
10 NET GILT SALES TO NBPS & OVERSEAS NEEDED FOR FULL FUND (sales+)	5503	1947		
11 Adjustment for 1986/87 underfund	400			
12 OVER(-)/UNDER(+)FUNDING	-400	-5231	4831	
GILT SALES:				
13 Net purchases by M4ps and overseas (purchases+)	5903	7178	-1275	
14 Net purchases by OPS, banks and building societies (purchases+)	-428	-528	100	
15 Maturities	6950	5439	1511	
16 GROSS OFFICIAL SALES	12425	12089	336	
17 Monthly average gross gilt sales	1035	1209	168	

* average per month

Relationship between lines:

3 = 1 + 2
10 = 3+4+5+6+7+8+9
12 = 10 + 11 - 13
16 = 13 + 14 + 15

mjd 3/143m

UNCLASSIFIED

pmp

FROM: MISS M P WALLACE
DATE: 22 February 1988

MS BRONK

cc Sir T Burns
Mr Peretz
Miss O'Mara
Mr Grice

STERILISATION OF INTERVENTION

The Chancellor has seen and was grateful for your minute of 17 February.

MPW

MOIRA WALLACE

S E C R E T

Commissioned from Tim Pike by 12.00.

From : Ms V Bronk
Date : 17 February 1988

PS/CHANCELLOR

cc Sir T Burns
Mr Peretz
Miss O'Mara
Mr Grice

STERILISATION OF INTERVENTION

You asked how much of this year's intervention had been sterilised to date, and how much we expect to have funded by the end of the financial year.

2. As is noted in today's minute about tomorrow's money figures, the current position is that the PSBR and the increase in the reserves between March 1987 and end-January 1988 have together been overfunded by £4.2 billion. Over the financial year as a whole, assuming no further intervention, we are now aiming for an exact full fund (including funding all the year's intervention and to offset the £400 million underfund in 1986-87). These figures are shown in the attached updated version of our regular funding table (lines 3, 8 and 12).

Vyvien Bronk

MS V BRONK

SECRET AND PERSONAL

FUNDING : FINANCIAL YEAR POSITION 1987/88

17/2/88

£ million

	FORECAST Financial Year 87/88	OUTTURN April 87 - Jan 88	RESIDUAL February - March 88	
PSBR AND FUNDING TARGET				
1 PSBR excl asset sales	2139	-1895	4034	
2 Asset sales (sales-)	-5011	-5070	59	
3 PSBR	-2872	-6965	4093	
FINANCED BY:				
4 OPS debt sales to nbps (sales-)	1491	1191	300	
5 National Savings (sales-)	-2120	-1630	-490	* -245
6 CTDs (sales-)	149	-126	275	
7 Treasury bills etc (sales-)	0	-52	52	
8 Intervention (reserves inc+)	10130	10130	0	
9 Public sector externals excl intervention and gilts (inc-)	416	416	0	
10 NET GILT SALES TO NBPS & OVERSEAS NEEDED FOR FULL FUND (sales+)	7194	2964		
11 Adjustment for 1986/87 underfund	400			
12 OVER(-)/UNDER(+)FUNDING	-400	-4153	3753	
GILT SALES:				
13 Net purchases by nbps and overseas (purchases+)	7594	7117	477	
14 Net purchases by monetary and other public sector (purchases+)	-217	-467	250	
15 Maturities	6950	5439	1511	
16 GROSS OFFICIAL SALES	14327	12089	2238	
17 Monthly average gross gilt sales	1194	1209	1119	

@ Modified PSBR only
* average per month
Relationship between lines:

3 = 1 + 2
10 = 3+4+5+6+7+8+9
12 = 10 + 11 - 13
16 = 13 + 14 + 15

91G.SCB.4317.5

COVERING SECRET

pmp BF 24/2

FROM: N I HOLGATE

DATE: 19 February 1988

ECONOMIC SECRETARY

cc: Chancellor
Sir P Middleton
Sir G Littler
Sir T Burns
Mr Scholar
Mr Peretz
Miss O'Mara
Mr Grice
Mr Rich
Mr Carr
Ms Bronk
Mr Cropper

Mr Patterson) DNS
Mr Wilson)
Mr Plenderleith - B/E
Prof Griffiths - No 10

FUNDING MEETING

There are four items on the agenda for the meeting on Wednesday 24 February:

(i) Funding arithmetic

(ii) National Savings

(iii) Gilt-edged funding

(iv) Gilt auctions.

2. I attach papers on the first three items, and a note on cost of funding. The paper on gilt auctions will be distributed on Monday, 22 February.

N I Holgate

N I HOLGATE

COVERING SECRET

FUNDING ARITHMETIC 1987-88

(Note by MG)

This note discusses the total funding requirement for the current financial year, on the current M3 funding rule, and assuming that intervention is fully funded within the financial year.

The PSBR forecast for 1987-88 is still being worked on, but for planning purposes, the table attached assumes a PSBR surplus of £3.4bn for 1987-88. The table also assumes that there will be no intervention in February or March.

National savings are now forecast to contribute about £2.1 billion over the year.

The redemption/buying in assumption excludes any element for purchases of 1989-90 maturities made to level the hump of stocks maturing that year.

On these assumptions, the arithmetic implies a gross gilt sales task of £13½bn for the year as a whole. This would require £1½bn sales to be achieved over the last 2 months of the year.

Gross gilt sales in February so far have totalled £0.2bn, but the second call of the medium auction stock (8¾% Treasury Stock 1997 'C') is due on 25 February and is worth £0.5bn. Assuming no further sales this will bring the total for February to £0.7bn. This suggests that to achieve a full fund, further gilt sales are required of £0.8 billion in February and March, over and above sales already made or tied up in calls.

The assumptions made, particularly those for the PSBR and for intervention, remain uncertain. Even at this stage in the financial year there is a margin of error either way on the PSBR of over £1 billion and other elements of the arithmetic are also uncertain.

SECRET AND PERSONAL

FUNDING : FINANCIAL YEAR POSITION 1987/88 19/2/88

£ million

	FORECAST Financial Year 87/88	OUTTURN April 87 - Jan 88	RESIDUAL February - March 88	
PSBR AND FUNDING TARGET				
1 PSBR excl asset sales	1611	-1895	3506	
2 Asset sales (sales-)	-5011	-5070	59	
3 PSBR	-3400	-6965	3565	
FINANCED BY:				
4 OPS debt sales to nbps (sales-)	1491	1191	300	
5 National Savings (sales-)	-2120	-1630	-490	* -245
6 CTDs (sales-)	149	-126	275	
7 Treasury bills etc (sales-)	0	-52	52	
8 Intervention (reserves inc+)	10130	10130	0	
9 Public sector externals excl intervention and gilts (inc-)	416	416	0	
10 NET GILT SALES TO NBPS & OVERSEAS NEEDED FOR FULL FUND (sales+)	6666	2964		
11 Adjustment for 1986/87 underfund	400			
12 OVER(-)/UNDER(+)FUNDING	-400	-4153	3753	
GILT SALES:				
13 Net purchases by nbps and overseas (purchases+)	7066	7117	-51	
14 Net purchases by monetary and other public sector (purchases+)	-467	-467	0	
15 Maturities	6950	5439	1511	
16 GROSS OFFICIAL SALES	13549	12089	1460	
17 Monthly average gross gilt sales	1129	1209	730	

* average per month

Relationship between lines:

3 = 1 + 2
10 = 3+4+5+6+7+8+9
12 = 10 + 11 - 13
16 = 13 + 14 + 15

NATIONAL SAVINGS
(NOTE BY MG1)

RESULTS FOR JANUARY 1988

1. Total contribution was £287 million - about £50 million more than forecast earlier. There are 2 main reasons. First, large increase in Income Bond sales. Terms have become very attractive following reductions in building society deposit rates in December. Second, savings certificate repayments continue to be much lower than was earlier thought likely. Sales of fixed interest and index linked savings certificates remain modest.

2. Total contribution in the first 10 months of 1987-88 is £1629 million. This leaves £371m (£185 million a month) to be raised in February and March if £2000 million is to be raised by National Savings this year.

Forecast for the rest of 1987-88

3. On the presumption that no major changes to terms will be made before the Budget, DNS forecast a final figure of £2.1 billion. Sales of Income Bonds have increased further. In the first two weeks of February sales are £105 million - well over £50 million a week, and the highest for nearly a year. If this trend continues, the total could exceed £2.1 billion.

Further details

4. These are set out in the attached standard table.

E:HMTFUND

CONFIDENTIAL

NATIONAL SAVINGS NET CASH FLOW AND FUNDING CONTRIBUTION (£million)

RECEIPTS LESS REPAYMENTS OF PRINCIPAL	1986-87 Full Year	1987-88 NOV	DEC	JAN	APR TO JAN	FEB to MAR 88	APR 88	Forecast next three months
FINSC	290	-123	-49	-50	-711	-100 *	-50 *	-150 *
ILNSC	-447	-5	2	-8	-137	-10	-5	-15
INVESTMENT A/C	156	27	25	77	182	50	30	80
INCOME BOND	1813	95	67	136	1133	330	140	470
DEPOSIT BOND	187	9	6	9	93	22	12	34
OTHER	52	12	5	35	148	56	24	80
TOTAL	2051	15	56	199	708	348	151	499
GROSS ACCRUED INTEREST	2278	159	190	168	1814	306	166	472
ACCRUED INTEREST REPAID	-964	-143	-82	-80	-893	-166	-83	-249
TOTAL NET FUNDING CONTRIBUTION	3365	31	164	287	1629	488	234	722

DEPARTMENT FOR NATIONAL SAVINGS
STATISTICS BRANCH 01-605-9316
12 FEBRUARY 1988

* This forecast takes no account of a possible reduction in General Extension rate from 1 March

SECRET

£ million

GILT-EDGED FUNDING IN MARCH
(Note by the Bank of England)

1 This note reviews the prospects for gilt-edged funding in the remainder of the financial year.

The funding arithmetic

2 The latest funding arithmetic is presented in tables 1 and 2 (not seasonally adjusted and seasonally adjusted, respectively). The figures for financial year 1987/88 have been revised since the last funding meeting to reflect the latest data. In particular:

i) the PSBR outturn for January suggests a surplus for the full year higher than the 2800 incorporated in last months' figuring - a surplus of 3400 has now been assumed;

iii) net redemptions of other public sector debt have recently been lower than forecast, and the total for the year has been revised down by 300;

iv) national savings inflows have outstripped expectations since the fall in competing interest rates late last year. The forecast now assumes receipts of 2120 in 1987/88, 170 more than incorporated last time;

iv) external and foreign currency finance of the public sector, which is expected to be zero in February and March, has been revised down by 240. The split between intervention and other public sector externals has been changed since last month's forecast reflecting January's early repayment of loans guaranteed under the ECS; and

(v) banks bought about 700 of gilts in January. The forecast assumes no further change from now on, giving a fall of 470 over the year as a whole, as against a fall of 1000 assumed last month.

The net result of these changes is to reduce the gross gilt sales target in 1987/88 by 300, to 13550. By end-January gross gilt sales totalled about 12100, leaving around 1450 to be sold in February and March together. This compares with 2060 expected to be needed in these two months at the time of the last funding meeting. By midday today about 750 of sales had been tied up so far this month, of which the call on the auction stock accounts for 500, leaving some 700 of sales to be made in the next five weeks.

4 The forecast, while central, is subject to a number of major uncertainties. Though close to the year end, the PSBR is perhaps one of the largest of these. The PSBR forecast taken at the funding meeting at this time last year was almost 1000 wide of the mark. The path of other public sector debt sales (net) has been lumpy this year, and though the forecast envisages a smaller run-off in February and March than in the same two months last year, local authorities actually increased their borrowing from the nbps in December and January: whether the forecast will be too high or too low is evenly balanced. CTD redemptions were lower than expected in January, especially given heavy corporation tax receipts, but have begun to pick up sharply in early February, leaving the eventual outturn uncertain. Fourthly, banks' gilt portfolios have been very volatile, with monthly shifts of more than 500 on five occasions so far during 1987/88. The experience of October, when banks bought a large amount of stock near maturity, suggests that we may see the banks purchase a sizeable chunk of the next high coupon maturity (which goes ex-dividend in early April), though the early signs in February are of gilt shedding by the banks. Finally, the forecast assumes that the reserves are unchanged to end March, and this could be falsified either way either by intervention or by decisions on what to publish.

Market Conditions and Funding tactics

Yields %	8 May 87 (trough)	19 Oct 87 (peak)	13 Jan 88 (medium auction)	27 Jan 88 (last funding meeting)	18 Feb 88
Shorts	8 5/16	10 9/16	9 5/16	9 1/4	9 1/2
Mediums	8 11/16	10 9/16	10 1/8	9 1/2	9 1/2
Longs	8 3/4	10 1/16	9 11/16	9 5/16	9 1/4
IGs (2006) (real yield at 5% inflation)	3 5/8	4 11/16	4 5/16	4 1/16	4

5 The rally which followed the peak in yields at the medium auction on 13 January continued during the rest of the month (see chart 1), into which we sold some 1720 during January. The rise in short term rates on 1 February and the weaker tone in the US bond market set the market back, and it has been moving sideways. Long yields are close to the level when the last funding meeting was held, though yields have risen at the short end (see chart 2). Recently, gilt turnover has slipped back - about 24,000 long gilt futures contracts per day have been traded on LIFFE this week, as against about 35,000 contracts per day in the previous fortnight. Domestic investors have been mesmerised by conflicting ecomomic and financial indicators, but on balance are nervous about the recent labour unrest and worries about overheating, which the rise in interest rates has done little to dampen. Overseas investors have spasmodically found gilt yields attractive. Overall, there is a sense of the market waiting for the Budget before deciding which way to move next.

6 With the economic background uncertain, it is unlikely that the market will be very active. But there is a growing perception of the strong technical position implied by the limited gross funding need in the next financial year. This factor may tend to produce a gradual easing of yields. Against this background we should have no problem in achieving the 700 of further gross sales we currently see to be needed by end March. Given the uncertainties of the funding arithmetic we will nevertheless need to keep the momentum going, bearing in mind that we can buy in some of the heavy future maturities if we look like overshooting.

By today our portfolio was effectively exhausted in all sectors. It is being replenished this evening by an issue of tranchettes - 200 of shorts, 100 of mediums and 100 of index-linked. Assuming we sell these we are left with only 300 of further gross gilt sales to be made this year. This might usefully be handled through a partly-paid stock with the further call in April or, if the market is more subdued, by further tranchettes on the lines of today's issues.

8 Our debt to NILO is 130

Bank of England
19 February 1988

0089J SECRET 18. 2.88

Table 1

FUNDING : FINANCIAL YEAR POSITION 1987/88 M3 basis £ millions

Not Seasonally adjusted

	Revised FORECAST FY 1987/88	OUTTURN Apr 87 - Jan 1988	RESIDUAL Feb - March 88	
PSBR AND FUNDING TARGET				
1 PSBR excl asset sales	1611	-1895	3506	
2 Asset sales (sales-)	-5011	-5070	59	
3 PSBR	-3400	-6965	3565	
Financed by:				
4 Other public sector debt sales to nbps net (sales-)	1491	1191	300	
5 National Savings (sales-)	-2120	-1630	-490	(-245)a
6 CTDS (sales-)	149	-126	275	
7 Treasury bills etc (sales-)	0	-52	52	
8 Intervention (reserves inc+)	10130	10130	0	
9 External finance of public sector excluding intervention and gilts (increase-)	416	416	0	
10 Target gilt sales to nbps and overseas for full fund (sales+)	6666	2964	3702	(1851)a
11 Over(-)/Under(+) funding brought forward	400			
12 Over (-)/Under (+) funding 1987/88	-400	-4153	3753	
GILT SALES				
13 Net purchases by nbps and overseas (purchases+)	7066	7117	-51	
14 Net purchases by monetary and other public sector (purchases+)	-467	-467	0	
15 Maturities	6950	5439	1511	
16 GROSS OFFICIAL SALES	13549	12089	1460	
17 Monthly average gross gilt sales	1129	1209	730	

a average per month for remainder of year

Relationship between lines:

3 = 1 + 2

10 = 3 + 4 + 5 + 6 + 7 + 8 + 9

12 = 10 - 13

16 = 13 + 14 + 15

Table 2

FUNDING : FINANCIAL YEAR POSITION 1987/88 M3 basis £ millions
Seasonally adjusted

	Revised FORECAST FY 1987/88	OUTTURN Apr 87 - Jan 1988	RESIDUAL Feb - March 88	
PSBR AND FUNDING TARGET				
1 PSBR excl asset sales	1611	57	1554	
2 Asset sales (sales-)	-5011	-5070	59	
3 PSBR	-3400	-5013	1613	
Financed by:				
4 Other public sector debt sales to nbps net (sales-)	1491	663	828	
5 National Savings (sales-)	-2120	- 1615	- 505	(-257)a
6 CTDS (sales-)	149	-302	451	
7 Treasury bills etc (sales-)	0	-125	125	
8 Intervention (reserves inc+)	10130	10130	0	
9 External finance of public sector excluding intervention and gilts (increase-)	416	404	12	
10 Target gilt sales to nbps and overseas for full fund (sales+)	6666	4142	2524	(1262)a
11 Over(-)/Under(+) funding brought forward	400			
12 Over (-)/Under (+) funding 1987/88	-400	-2975	2575	
GILT SALES				
13 Net purchases by nbps and overseas (purchases+)	7066	7117	-51	
14 Net purchases by monetary and other public sectors (purchases+)	-467	-467	0	
15 Maturities	6950	5439	1511	
16 GROSS OFFICIAL SALES	13549	12089	1460	
17 Monthly average gross gilt sales	1129	1209	730	

a average per month for remainder of year

Relationship between lines:

3 = 1 + 2
10 = 3 + 4 + 5 + 6 + 7 + 8 + 9
12 = 10 - 13
16 = 13 + 14 + 15

Chart 1

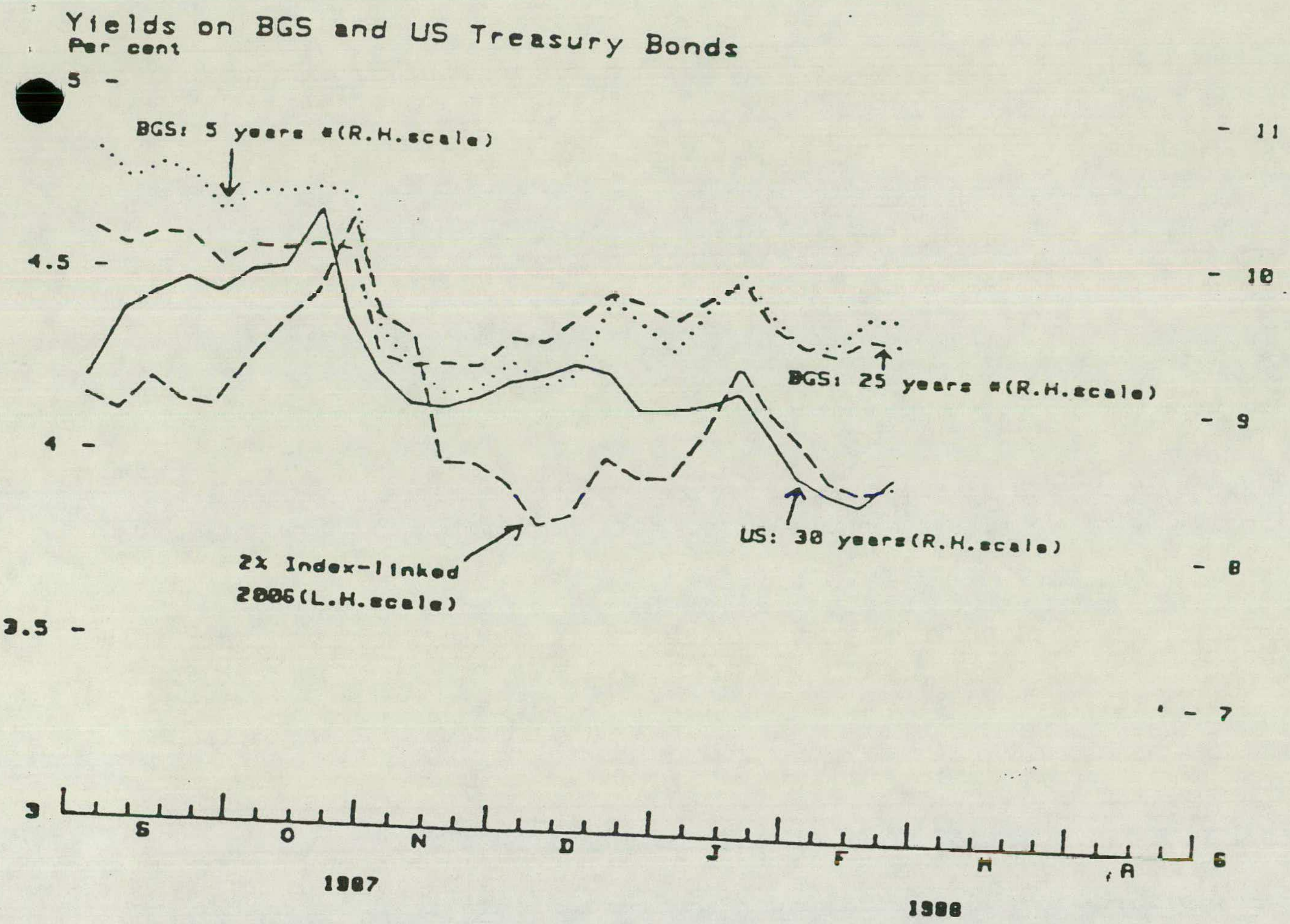
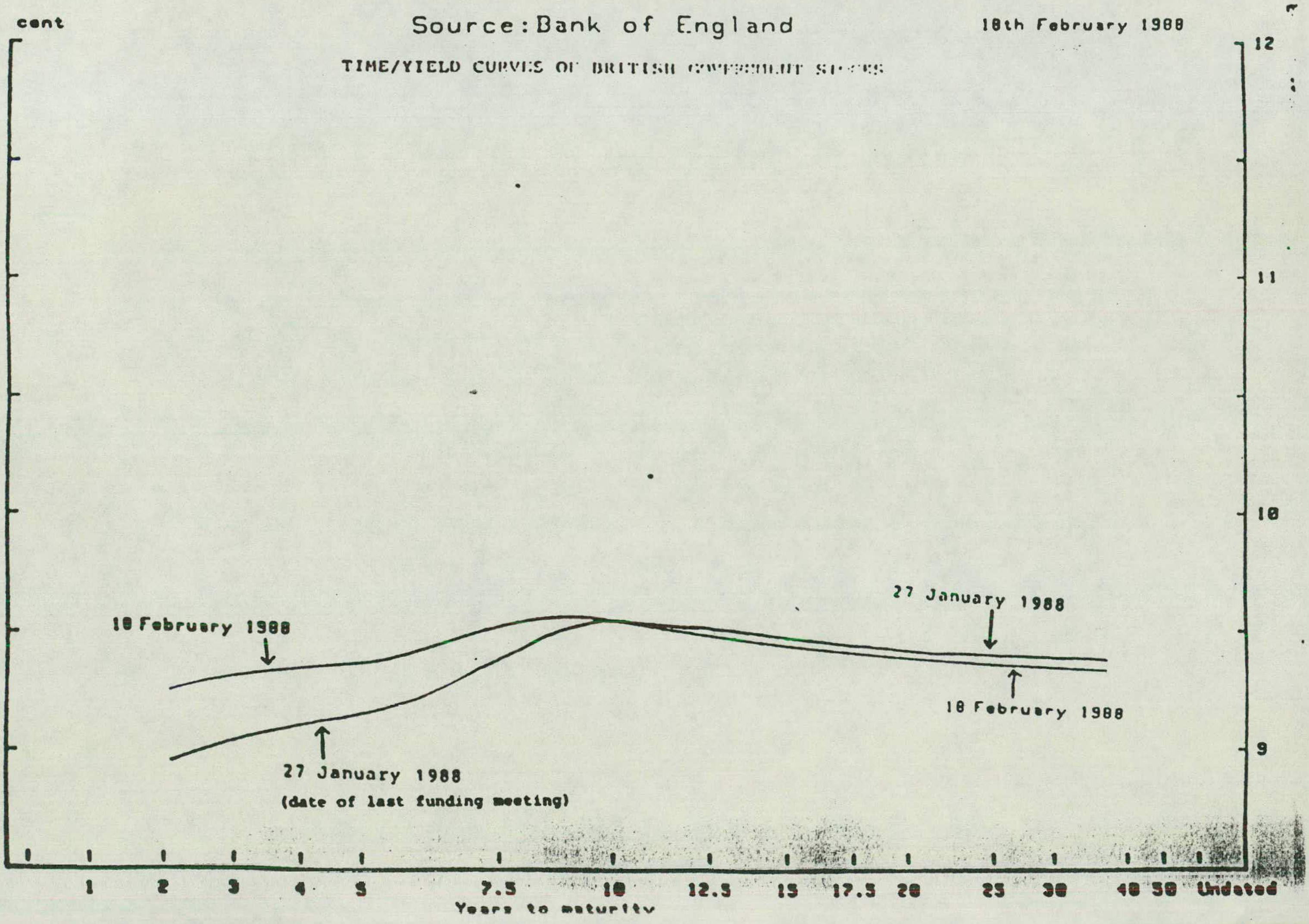


Chart 2



90/G.jfw.4569.009

SECRET

COST OF FUNDING : 19 FEBRUARY 1988

(Note by MG2)

Main Points

- Over the month since the last funding meeting, the hump in the yield curve has flattened a little (see Chart I). Short rates are higher but long rates lower than a month ago.
- Break-even yields have fallen a little (Table 2)

- The proportion of shorts has fallen back from 32 to 30 per cent compared to a Guideline indication of 57 per cent (Table 3)

- Nevertheless, with virtually no conventional sales over the period, the average life of the dated conventional gilts stock has fallen again to 9.3 years (Table 3)

- Savings Certificate rates still remain broadly in line with gilts yields. But Variable Rate National Savings products look expensive relative to other forms of government borrowing and equally relative to bank and building society accounts (Tables 4A and 4B).

TABLE [illegible] COMPARATIVE COSTS OF AN INITIAL BORROWING OF 100 BY ISSUING A GILT.

1988 prices, net of tax *

Inflation Scenarios **

	MTFS Case	Low Inflation Case	High Inflation Case	Weighted Projection	Winter Case
(a) Five Years					
5 year Conventional	122- 125	127- 131	102- 105	120- 123	115- 118
5 year Index-Linked	112- 113	112- 113	112- 113	112- 113	112- 113
(b) Ten Years					
5, then 5, year Convs	140- 147	155- 162	102- 109	137- 143	136- 143
10 year Conventional	161- 168	186- 194	103- 109	157- 163	153- 160
10 year Index-Linked	140- 142	140- 142	137- 139	140- 142	140- 142
(c) Twenty Years					
5, then 15, year Convs	196- 209	237- 250	119- 134	191- 205	200- 215
20 year Conventional	235- 250	317- 333	106- 117	228- 243	226- 241
20 year Index-Linked	215- 216	215- 216	209- 210	214- 216	215- 216

* Average marginal tax rates are not known with precision and likely ranges are used here instead so that the cost figures also emerge as ranges.

** (i) The MTFS, low and high inflation scenarios are weighted 5:1:1 for the Weighted Projection case.
(ii) The MTFS case assumes the MTFS inflation forecast (of around 3 per cent a year) to 1991 and 2.5 per cent a year thereafter in line with the central case of the long-term assumptions paper (which is used by departments for public expenditure planning purposes).
(iii) The Low Inflation case has inflation falling to 2 per cent by 1990 and price stability achieved and sustained after 1994.
(iv) The High Inflation case has inflation accelerating to 6.5 per cent by 1990 and thereafter gradually to 10 per cent by 1995. Inflation is then taken to remain at this level.
(v) The Winter case assumes the Winter internal forecast to 1992 (with inflation peaking at 5.3 per cent in 1988 H2 and falling to 2.9 per cent in 1992 Q1) and 2.5 per cent a year therafter (see ii)

*** File closed (3): BEIR.SDB
*** File closed (3): BEY.SDB

SECRET

TABLE 2: BREAK-EVEN YIELDS AND BREAK-EVEN INFLATION RATES

Per cent

A: Break-Even Yields

	MTFS	Low	High	Weighted Projection	Winter
(a) 10 Year **	6.7	4.9	13.1	7.4 (7.5)*	8.1
(b) 20 Years ***	6.9	5.1	13.4	7.6 (7.8)*	8.3

* MTFS ,low and high inflation scenarios are weighted 5:1:1

** Below the rate shown it would be cheaper to issue a 10 year conventional than a five followed by a five, year conventional.

*** Below the rate shown it would be cheaper to issue a 20 year conventional than a five, followed by a fifteen, year conventional.

\+ Bracketed figures refer to last funding meeting(January).

B: Break-Even Inflation Rates *

	Break-even Inflation Rate at 16 February 1988		Average Inflation Rate in Each Scenario: MTFS	Low	High	Weighted Projection	Winter
a. 5 years	4.2- 5.0	(4.1-4.9)+	2.7	1.8	6.7	3.1	4.0
b. 10 years	4.1- 4.8	(4.0-4.7)+	2.6	0.9	8.2	3.2	3.3
c. 20 years	3.8- 4.2	(3.6-4.1)+	2.5	0.4	9.1	3.2	2.9

* At the break-even inflation rate the cost of an index-linked gilt is the same as that of a conventional. Below it, the IG will be cheaper than a conventional, and above it more expensive.

TABLE 3: GROSS SALES OF GILTS TO DATE IN RELATION TO THE GUIDELINES

A. The Guidelines for Gross Issues of Conventionals

Yields on medium and Long Stocks (%)	Proportion of Gross Issues (%) Shorts	Mediums and Longs consider buying in
above 11	100+	
10½-11	95	5
10-10½	80	20
9½-10	65	35
9-9½	50	50
8½-9	35	65
8-8½	20	80
7½-8	5	95
below 7½	consider refinancing with longs/mediums	100+
Proportions implied by average yields in F.Y. to Feb 17.	57	43

B. Gross Sales

£ billion (Percentage of total in brackets)

Conventionals

	Shorts	Mediums	Longs	Total
1987-88*	3.3 (30)	4.0 (36)	3.7 (34)	11.0
[New Issues**	4.4 (37)	4.7 (39)	2.8 (24)	11.9
1987 Q2	0.9	1.5	1.7	4.1
Q3	1.1	0.4	1.0	2.6
Q4	1.0	1.5	0.8	3.3
Jan	0.3	0.0	0.3	0.5
Feb ***	0.0	0.0	0.0	-0.1
Calls	0.0	0.5	0.0	0.5

Index-linked

	Shorts	Mediums	Longs	Total
1987-88*	-0.0 (0)	0.1 (0)	0.8 (0)	0.8
[New Issues**	0.0 (0)	0.1 (12)	0.7 (88)	0.8
1987 Q2	-0.0	-0.0	-0.1	-0.2
Q3	-0.0	0.0	0.1	0.0
Q4	-0.0	0.1	0.4	0.5
Jan	0.0	-0.0	0.3	0.3
Feb***	0.0	0.0	0.2	0.2
Calls	0.0	0.0	0.0	0.0

Memo item:	1-7 Years	7-15 Years	Over 15 Years	Total
1987-88 Conv	4.1 (37)	3.2 (29)	3.7 (34)	11.0
IG	0.0 (0)	0.0 (0)	0.8 (100)	0.8

C. Average Life of Dated Gilts

	All	Conventionals only
End 1986-87	10.5	9.5
17 February 1988	10.3	9.3
(New issues**	10.9	10.0)

* Sales secured for 1987-88. **Announced 87-88 incl. CRND ***To 17 Feb.

SECRET

TABLE 4A: NATIONAL SAVINGS INSTRUMENTS : FIXED RATE PRODUCTS.

A. Costs of an Initial Borrowing of #100 over Five Years

1988 prices , net of tax

	MTFS Case	Low Inflation Case	High Inflation Case	Weighted Projection	Winter Case
Fixed Interest National Savings Certificate (FINSC)	123	128	101	120	118
Index-Linked National Savings Certificate (ILNSC)	121	121	120	121	121
Conventional 5 Year Gilt	122- 125	127- 131	102- 105	120- 123	115-118

B. Equalising National Savings Rates.

Per cent

Rate on FINSC to match Cost of Conventional Gilt	6.9- 7.5	6.8-7.4	7.2- 7.8	6.9- 7.5	7.0- 7.5
Current rate on FINSC	7.0	7.0	7.0	7.0	7.0
Rate on ILNSC to match Cost of Conventional Gilt *	4.2- 4.8	5.0-5.6	0.5- 1.1	3.8- 4.3	3.0- 3.5
Current rate on ILNSC *	4.0	4.0	4.0	4.0	4.0

* In addition to inflation-proofing.

CONFIDENTIAL

TABLE 4B : NATIONAL SAVINGS INSTRUMENTS : VARIABLE RATE PRODUCTS.

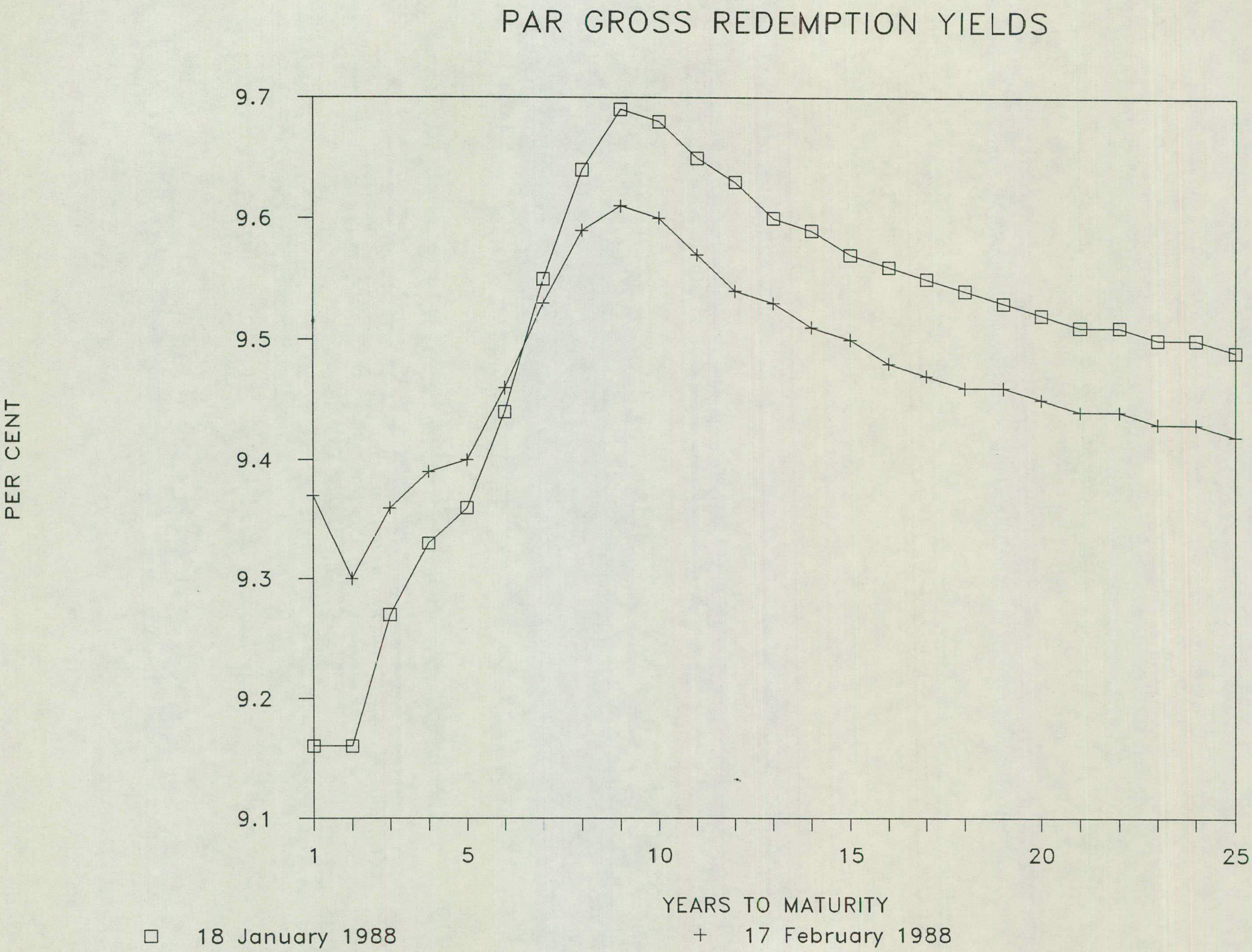
Compound Return	Per cent		
	Tax Rate (%)		
	0	27	60
Income Bond (1)	11.0	8.0	4.4
Deposit Bond	10.5	7.7	4.2
Investment Account	10.0	7.3	4.0
Premium Bond	7.0	7.0	7.0
Savings Certificate on GER terms	6.5	6.5	6.5
12 Month Cost of Government Borrowing (2)	9.2	6.7	3.7
CTDs	8.8	6.4	3.5
Bank Retail Deposit Rate (3)	6.2	6.2	3.4
Building Society Retail Deposit Rate (3)	7.0	7.0	3.8

(1) Assuming interest reinvested in Investment Account.

(2) Yield on a basket of gilts with maturities clustered around one year.

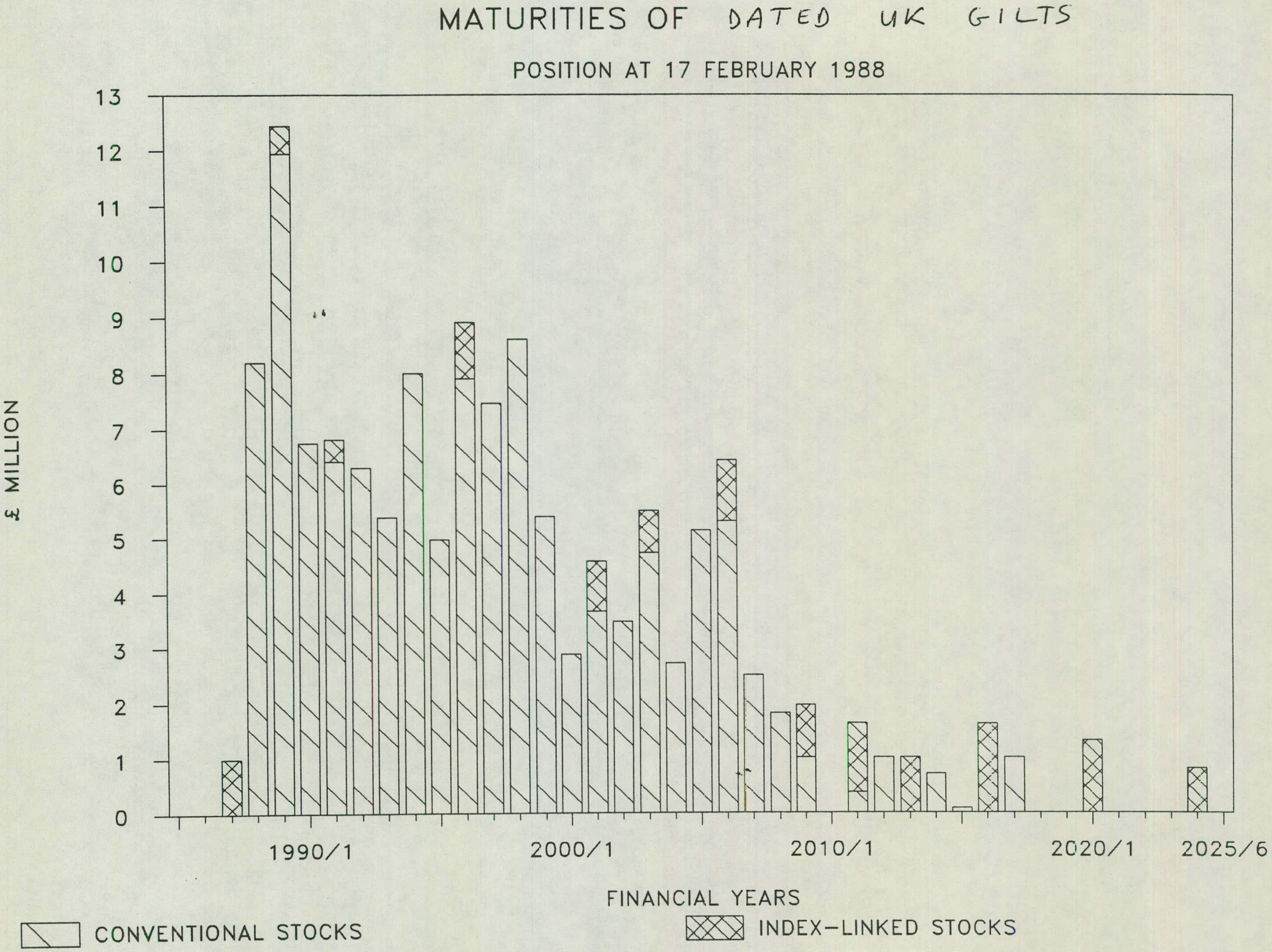
(3) Average of rates applying to the top bands of selected high interest accounts at 8 February 1988.

CHART I



PAR GROSS REDEMPTION YIELDS
PER CENT
9.7
9.6
9.5
9.4
9.3
9.2
9.1
1
5
10
15
20
25
YEARS TO MATURITY
□ 18 January 1988
+ 17 February 1988

CHART II


MATURITIES OF DATED UK GILTS
POSITION AT 17 FEBRUARY 1988
£ MILLION
0
1
2
3
4
5
6
7
8
9
10
11
12
13
1990/1
2000/1
2010/1
2020/1
2025/6
FINANCIAL YEARS
CONVENTIONAL STOCKS
INDEX-LINKED STOCKS

MARKET SENSITIVE - IN CONFIDENCE

From : D L C Peretz
Date : 19 February 1988

ECONOMIC SECRETARY

cc Chancellor
Sir P Middleton
Sir G Littler
Mr Scholar
Mrs Lomax
Miss O'Mara
Mrs Ryding
Mr Cropper

GEMMs : PRU BACHE

Pru Bache, who include what used to be Clive Discount - will be announcing, and telling their staff, this afternoon that they are withdrawing as a gilt-edged market maker. This will bring the total number of market makers down to 23. The news is clearly market sensitive until announced, which the Bank tell me will probably be around 4.30 this afternoon.

2. Pru Bache at present have around 2% of the market. Their decision to withdraw does not follow any great losses; as I understand it they have simply reached the conclusion that profits are hard to make, and that their capital would be put to better use elsewhere.

3. It would not surprise me were we to see one or two further withdrawals once the market wakes up to the much reduced demands we are likely to be placing on the gilt-edged market next year.

D L C PERETZ

From : D L C Peretz
Date : 19 February 1988

ECONOMIC SECRETARY

cc Chancellor
Sir P Middleton
Sir G Littler
Mr Scholar
Miss O'Mara
Mrs Ryding
Mr Cropper

GILTS : TRANCHETTES

The gilt market is in a reasonably good state at present. The future put on 3/4 of a point yesterday, despite the money figures, and remains at about the same level this morning. As you will have seen from yesterday's evening report the Bank sold some stock from their book yesterday, and now have very little left. They have also more or less sold out the last lot of IG tranchettes, with around £40 million of the IG 2013 left.

2. They would like to take the opportunity to announce a tiny package of tranchettes this afternoon, as follows :

i) £200 million 10% Treasury 1992 (not a FOTRA)

ii) £100 million of 9G% Treasury 1999 (a FOTRA)

iii) *if* the remainder of the IG 2013 is sold out in the course of the morning, £100 million of Indexed Linked 2½% 2013.

They would also announce £100 million of i) and £50 million of ii) for NILO.

3. The composition of the package, more short than medium and with the possibility of some IG, gives me no difficulty.

4. The other thing we need to watch is the overall funding position. The latest arithmetic (based on the latest PSBR estimate), which we will be circulating this evening, shows just

under £1½ billion of gilts to be sold over the whole of February and March to reach a full fund. Of this we have already tied up £500 million with the auction call, and a further £200 million of stock sold already this month. That leaves approximately £800 million to go, of which this package would account for £300 or £400 million, when sold.

5. The Bank can fine tune as necessary over the course of next month by buying stock in. So I think there is sufficient room within the funding arithmetic to allow this package to go ahead today, and I recommend that we do so.

D L C PERETZ

3/43/102

SECRET

ECONOMIC SECRETARY TO THE TREASURY

FROM: P D P BARNES

DATE: 19 February 1988

MR PERETZ

cc PS/Chancellor
Sir P Middleton
Sir G Littler
Mr Scholar
Miss O'Mara
Mrs Ryding
Mr Cropper

No harm if FY [illegible] ~~[illegible]~~ slightly overfunded anyway — [illegible]

GILTS: TRANCHETTES

The Economic Secretary was grateful for your submission of 19 February, which he discussed with you briefly this morning.

2. The Economic Secretary expressed some concern about the possibility of overfunding if we continued to issue tranchettes at the current rate. You said that the Bank would be able to counter this problem, if necessary, by buying in stock, which could well be profitable for the Government.

3. The Economic Secretary gave his authority for the tranchettes mentioned in your paragraph 2 to be brought this afternoon. You told me that the Bank had sold out of the IG 2013, so that they would be bringing the stock mentioned in your paragraph 2(iii).

Since as I recall, the funding rule relates to the position in the 1987/88 financial year, ~~[illegible]~~ the A.C. [illegible] reserves, which [illegible] understate the ~~[illegible]~~ intervention [illegible] rather [illegible]

PB

?

P D P BARNES
Private Secretary

mjd 3/147m

SECRET

pmp

FROM: MISS M P WALLACE

DATE: 22 February 1988

PS/ECONOMIC SECRETARY

cc Sir P Middleton
Sir G Littler
Mr Scholar
Mr Peretz
Miss O'Mara
Mrs Ryding
Mr Cropper

GILTS: TRANCHETTES

Chancellor has seen Mr Peretz's minute of 19 February, and your minute of the same date. He has commented that there will be no harm done if we end the financial year slightly over-funded - especially since his recollection is that the funding rule relates to the increase in the published reserves, which in 1987-88 understates the true extent of intervention.

MPW

MOIRA WALLACE

From : D L C Peretz
Date : 10 March 1988

ECONOMIC SECRETARY

cc Chancellor
Sir P Middleton
Sir T Burns
Mr Scholar
Miss O'Mara
Mr Grice
Mrs Ryding
Mr Cropper

NEW GILT

It was half agreed at last week's funding meeting that we would announce a new short conventional gilt tomorrow, to be available for sale after the Budget. I now have a firm proposal from the Bank.

2. They would like to announce tomorrow afternoon the following stock :-

i) 8½% coupon, 1994

ii) not a FOTRA

iii) amount : up to £1 billion (but possibly only £800 million, depending on the market), with £50 paid and the balance to be paid on 25 April.

At the same time they would announce £250 million of the same stock for NILO.

3. This would be for conventional minimum price tender on Wednesday next week. At current prices the stock would sell with a yield of around 9%, and at a price of around £97. But of course we might easily do better than that after the Budget.

4. Our latest look at the 1987-88 funding arithmetic, taking account of the latest central PSBR forecast and intervention undertaken so far this month (assuming we decide to publish all of it), suggests that we would need to sell £1½ billion of gilts this

month to achieve a full fund over the financial year. So far we have sold none. So this funding move would leave us, on present estimates, around £1 billion underfunded over the financial year.

5. This is perfectly consistent with our general position on the funding of intervention. Indeed, as I think is already agreed, current circumstances are very much those we had in mind when changing the funding rule to allow the funding of some intervention to be carried over from one financial year to the next. To seek aggressively to sell gilts in current circumstances could all too easily trigger further foreign inflows which we might need to counter with further intervention.

6. For this reason, I should be perfectly content if this turned out to be the final funding move this year, as it well might. I also agree that the stock should not be a FOTRA.

7. The other characteristics of the stock are acceptable. It is a short (less than 7 years) and will reduce the average maturity of outstanding debt. The partly paid feature will be reflected in the tender price, and will tie up a little funding for next year : although our funding needs for next year are quite small, they will be larger than they would otherwise have been to the extent that we carry over the funding of any of this year's intervention.

8. So I recommend we give the Bank authority to proceed as proposed.

D L C PERETZ

CONFIDENTIAL

JM
11/3.

FROM: J D PORTES

Date: 11 March 1988

1. MR McINTYRE

2. FINANCIAL SECRETARY

* A few suggested ~~changes~~ amendments to the draft letter.

Chancellor
Chief Secretary
Paymaster General
Economic Secretary
Sir Peter Middleton
Mr Anson
Mr Scholar
Mr Culpin
Mrs Lomax
Mr Peretz
Miss Peirson
Mr McIntyre
Mr Ilett
Miss Sinclair
Mr Macpherson
Mr Cropper

Mr Jenkins OPC
Mr Lewis IR
Mr Evershed IR
PS/IR

NICs ON GILTS

You asked for further advice, following your meeting yesterday.

Extent of avoidance

2. Revenue say that the practise of paying salary through gilts is largely confined to directors and senior staff. The number of cases is small but the sums involved very large for the individuals concerned. They estimate, very roughly, that the total amount so paid in 1986-87 might have been £20-30m, representing an exchequer loss of £2-3m. Information about 1987-88 will not be available until the end of the tax year, so this estimate does not reflect any recent growth in the use of such schemes.

Need for legislation

3. Parliamentary Counsel has now confirmed that the Finance Bill could not be used for the imposition of National Insurance

contributions (NICs) on gilts. We believe that it might well be possible to impose NICs on gilts and other fixed interest securities through social security regulations under existing legislation, but that in order to extend them any further primary legislation might be needed.

4. The questions of what form of legislation is needed and how far NIC liability should be extended are closely related. We will need to consult DHSS and their lawyers to get clear answers.

<u>Conclusions</u>

5. We therefore recommend that you write to Mr Moore, informing him of the proposal to close this loophole and asking that Treasury, Revenue and DHSS officials consider how this might best be done. The draft letter assumes that you will <u>not</u> wish to announce a decision in the Budget debate but very soon thereafter.

6. A draft letter is attached.

JDP

J D PORTES

CONFIDENTIAL

DRAFT LETTER TO: RT HON JOHN MOORE MP
SECRETARY OF STATE FOR SOCIAL SERVICES

NICS AND GILTS

As you know, National Insurance Contributions (NICs) are not payable on 'benefits in kind'. The original reason for the exemption was the difficulty in calculating the value of some goods. It has, however, become apparent that some employers of high paid employees are using this exemption in order to avoid NICs by paying part of salary in gilt-edged securities. These are at present classified as benefits in kind and hence are not liable to NICs. Abolition of the employers' Upper Earnings Limit in 1985 appears to have stimulated the setting up of avoidance schemes using the exemption.

Since gilts are readily convertible into cash, I believe this loophole is unjustifiable - the only reason such schemes pay in gilts rather than cash is to avoid NICs. I would therefore like to propose that we take early action to make payments in gilts liable to NICs as if they were cash. In order not to allow employers to escape the impact of the change by switching to other securities, such measures might have to cover these as well.

The legislation needed to make this change would be for your Department. I understand that it may be possible for the change to be made by regulations, though this is a point which our officials will need to consider. They will also have to look at the scope of the measure (i.e. exactly which other securities should also be removed from the NIC exemption) and the administrative implications.

I hope you will be able to agree that our officials should consider how best to implement this change as a matter of urgency. It would not be necessary to refer to this in the Budget Debate but, if we confirm that action should be taken when officials report back, I hope an announcement could be make very soon thereafter.

NORMAN LAMONT

SECRET

From : D L C Peretz
Date : 11 March 1988

NOTE FOR THE RECORD

cc PPS
PS/EST
Sir P Middleton
Sir T Burns
Mr Scholar
Miss O'Mara
Mr Grice
Mr Cropper

NEW GILT

As is normal practice, I agreed the final details and minimum tender price for this afternoon's new gilt with Ian Plenderleith at the Bank.

2. Since the market was not as strong as it might have been (quite possibly because it was expecting stock) the amount to be issued is £800 million rather than £1 billion. 8½%, 1994, with £50 paid and the balance to be paid on 25 April, as agreed.

3. We agreed a minimum tender price of £97. This gives a yield of 9.17%. This is roughly in line with the yield on comparable stocks (slightly above some, slightly below others), after allowing for differences in coupons and the fact that the new stock is not a FOTRA. It will not therefore be taken as any kind of signal to the market. The price the stock actually sells at on Wednesday will, of course, depend on how the markets react to the Budget.

!

Y. Engledow (PS)

p.p. D L C PERETZ

PWP

FROM: J M G TAYLOR
DATE: 14 March 1988

PS/FINANCIAL SECRETARY

cc PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Mr Anson
Mr Scholar
Mr Culpin
Mrs Lomax
Mr Peretz
Miss Peirson
Mr McIntyre
Mr Ilett
Miss Sinclair
Mr Macpherson
Mr Portes
Mr Cropper
Mr Jenkins - OPC
Mr Lewis - IR
Mr Evershed - IR
PS/IR

NICs ON GILTS

The Chancellor has seen Mr Portes' minute of 11 March.

2. He has the following amendments to the draft letter:

<u>Paragraph 1, line 8</u>: To read: "... to NICs. Abolition of the employers' Upper Earnings Limit in 1985 appears ..."

<u>Paragraph 3, line 5</u>: Amend to read: "... the scope of the measure (ie exactly which other securities should also be ..."

J M G TAYLOR

4374/033/lk

CC: PPS, CST, PMG, EST, Sir P. Middleton, Mr Anson, Mr Scholar, Mr Culpin, MB Lomax, Mr Peretz, Miss Peirson, Mr McIntyre, Mr Ilett, Miss Sinclair, Mr Macpherson
Mr Portes, Mr Cropper, Mr Jenkins - OPC, Mr Lewis
Mr Evershed - IR, PS/IR.

PWP

CONFIDENTIAL

Treasury Chambers, Parliament Street, SW1P 3AG

The Rt Hon John Moore MP
Secretary of State for Social Services
House of Commons
LONDON
SW1A 0AA

14 March 1988

Dear John,

NICS AND GILTS

As you know, National Insurance Contributions (NICs) are not payable on 'benefits in kind'. The original reason for the exemption was the difficulty in calculating the value of some goods. It has, however, become apparent that some employers of high paid employees are using this exemption in order to avoid NICs by paying part of salary in gilt-edged securities. These are at present classified as benefits in kind and hence are not liable to NICs. Abolition of the employers' Upper Earnings Limit in 1985 appears to have stimulated the setting up of avoidance schemes using the exemption.

Since gilts are readily convertible into cash, I believe this loophole is unjustified - the only reason such schemes pay in gilts rather than cash is to avoid NICs. I would therefore like to propose that we take early action to make payments in gilts liable to NICs as if they were cash. In order not to allow employers to escape the impact of the change to switching to other securities, such measures might have to cover these as well.

The legislation needed to make this change would be for your Department. I understand that it may be possible for the change to be made by regulations, though this is a point which our officials will need to consider. They will also have to look at the scope of the measure (ie exactly which other securities should also be removed from the NIC exemption) and the administrative implications.

I hope you will be able to agree that our officials should consider how best to implement this change as a matter of urgency. It would not be necessary to refer to this in the Budget Debate but, if we confirm that action should be taken when officials report back, I hope an announcement could be made very soon thereafter.

NORMAN LAMONT

53/2/MAD/3759/5

SECRET

ECONOMIC SECRETARY TO THE TREASURY

FROM: P D P BARNES
DATE: 15 March 1988

MR PERETZ

cc: PS/Chancellor
Sir P Middleton
Sir T Burns
Mr Scholar
Miss O'Mara
Mr Grice
Mrs Ryding
Mr Cropper

NEW GILTS

The Economic Secretary was grateful for your submission of 10 March, which he discussed with you

2. The Economic Secretary asked about the rationale for bringing a partly-paid stock, since from one point of view this would mean that less of our intervention was funded this year, whilst from another point of view we would be tying up funding for next year when our need for such funding would not be substantial.

3. You said that we would want to fund intervention in due course, but the disadvantage about trying to do too much at once was that it risked attracting further foreign money, thus exacerbating upward pressure on the pound. A partly paid stock had the advantage that foreign investors would not need to purchase now their sterling for the April call, and that if foreigners sold their purchases prior to 25 April, no upward pressure on sterling would result. You thought the partly paid feature fitted quite well with the policy of funding intervention, but not immediately. You also pointed out that we had not had a new fully paid full coupon stock since 1979, and that bringing only £400 million-worth of a new stock was likely to be badly received, since it would mean that there would be insufficient liquidity in the stock.

4. The Economic Secretary said that he was content for the Bank to bring the gilt mentioned in paragraph 2 of your submission.

PB

P D P BARNES
Private Secretary

SECRET

FROM: P D P BARNES
DATE: 15 March 1988

MR PERETZ

cc: PS/Chancellor
Sir P Middleton
Sir T Burns
Mr Scholar
Miss O'Mara
Mr Grice
Mrs Ryding
Mr Cropper

NEW GILTS

The Economic Secretary was grateful for your submission of 10 March, which he discussed with you this morning.

2. The Economic Secretary asked about the rationale for bringing a partly-paid stock, since from one point of view this would mean that less of our intervention was funded this year, whilst from another point of view we would be tying up funding for next year when our need for such funding would not be substantial.

3. You said that we would want to fund intervention in due course, but the disadvantage about trying to do too much at once was that it risked attracting further foreign money, thus exacerbating upward pressure on the pound. A partly paid stock had the advantage that foreign investors would not need to purchase now their sterling for the April call, so that if foreigners sold their purchases prior to 25 April, no upward pressure on sterling would result. You thought that the effect on foreign exchange inflows or long-term interest rates of an immediate call of only £400 million would be negligible, but that, if we did nothing, any rise in gilts prices after the Budget would be accentuated. But bringing only £400 million-worth of a new stock was likely to be badly received, since it would mean that there would be insufficient liquidity in the stock.

4. The Economic Secretary said that he was content for the Bank

to bring the gilt mentioned in paragraph 2 of your submission.

P D P BARNES
Private Secretary

SECRET

From : D L C Peretz
Date : 16 March 1988

NOTE FOR THE RECORD

cc PPS
PS/EST
Sir P Middleton
Sir G Littler
Mr Scholar
Miss O'Mara
Mrs Ryding

GILT TENDER

The Bank received bids this morning for £170m of the £800m of 8½% Treasury 1994. Most bids were at the minimum tender price. The Bank have announced that all tenders have been accepted in full at the minimum price. The rest of the stock has been placed in the Issue Department, for use as a tap.

DLP

D L C PERETZ

AR0018t

CONFIDENTIAL

DEPARTMENT OF HEALTH AND SOCIAL SECURITY
Richmond House, 79 Whitehall, London SW1A 2NS
Telephone 01-210 3000

24 MAR 1988

From the Secretary of State for Social Services

The Rt Hon Norman Lamont MP
Financial Secretary to the Treasury
HM Treasury
Parliamentary Street
LONDON
SW1P 3AG

26 March 1988

Dear Norman,

NICs AND GILTS

Thank you for your letter of 14 March.

I agree that we should take action to remove the NIC exemption on earnings paid in gilts and that we will probably need to cover other securities also. As you say, the necessary legislation - which would be secondary - would be for my Department. I have asked officials here to consider with yours the scope of the exemption removal, the administrative implications and other details, and to report back urgently.

Yours
John

JOHN MOORE

FINANCIAL SECRETARY	
REC.	24 MAR 1988
ACTION	MR. McINTYRE
COPIES TO	PPS, CST, PMG, EST, Sir P Middleton, Mr Anson, Mr Scholar, Mr Culpin, Mr Peretz, Miss Peirson, MRS. LOMAX, Mr Ilett, Miss Sinclair, Mr Macpherson, Mr Portes, Mr Cropper, Mr Jenkins OPC, Mr Lewis, Mr Evershed IR, PS/IR

91G.SCB.4317.5

COVERING SECRET

BE 28/3

FROM: CATHY RYDING

DATE: 25 March 1988

ECONOMIC SECRETARY

cc: Chancellor
Sir P Middleton
Sir G Littler
Sir T Burns
Mr Scholar
Mr Peretz
Miss O'Mara
Mr Grice
Mr Rich
Mr Carr
Ms Bronk
Mr Cropper

Mr Patterson) DNS
Mr Wilson)
Mr Plenderleith - B/E
Prof Griffiths - No 10

FUNDING MEETING

There are four items on the agenda for the meeting on Wednesday 24 February: !

(i) Funding arithmetic

(ii) National Savings

(iii) Gilt-Edged funding

(iv) Funding Strategy: 1988-89

2. I attach papers on items (i) and (ii) of the agenda, together with a note on cost of funding. The paper for item (iii) will be circulated on Monday. The papers for item (iv) are being circulated separately under cover of a minute from Mr Peretz to you.

Cathy Ryding

CATHY RYDING

COVERING SECRET

SECRET

FUNDING ARITHMETIC 1987-88
(NOTE BY MG)

1987-88

This note discusses the funding requirement for this financial year, on the current M3 funding rule. Table 1 attached shows the arithmetic. Even at this stage of the financial year the numbers are still very uncertain.

The PSBR is based on PSF's latest internal forecast, but adjusted to take account of the latest weekly information on Central Government borrowing. The PSBR surplus is slightly higher than the figure of £3bn surplus published in the FSBR. The figure for intervention is consistent with a underlying change in the reserves of $2½bn.

National savings are now forecast to contribute about £2bn over the year.

The redemption/buying in assumption excludes any element for purchases of 1989-90 maturities made to level the lump of stocks maturing that year.

On these assumptions, the arithmetic implies a gross gilt sales task of £14¼bn for the financial year as a whole and £1.1bn sales in March. Gilt sales so far in March have totalled £0.3bn, implying an underfund for the year as a whole of £0.8bn, assuming no further sales.

Table 2 attached shows, for information, figures on an M4 funding rule, which we will be using from next financial year. On this basis, gross sales of £0.2bn are required in March for a full fund. Taking account of sales so far in March, and assuming no further sales, implies an overfund on an M4 rule of £0.1bn.

1988-89

The funding arithmetic for 1988-89 is contained in Table 1 of paper 1 (the Funding Arithmetic in prospect for 1988-89) attached to David Peretz' minute to the Economic Secretary of 25 March.

TABLE 1

SECRET AND PERSONAL

FUNDING : FINANCIAL YEAR POSITION 1987/88 — 25/3/88

£ million

		FORECAST	OUTTURN	RESIDUAL	
		Financial Year 87/88	April 87 - Feb 88	March 88	
	PSBR AND FUNDING TARGET				
1	PSBR excl asset sales	1770	-2321	4091	
2	Asset sales (sales-)	-5070	-5078	8	
3	PSBR	-3300	-7399	4099	
	FINANCED BY:				
4	OPS debt sales to nbps (sales-)	894	1294	-400	
5	National Savings (sales-)	-2000	-1837	-163	* -163
6	CTDs (sales-)	66	41	25	
7	Treasury bills etc (sales-)	-73	-73	0	
8	Intervention (reserves inc+)	11530	10030	1500	
9	Public sector externals excl intervention and gilts (inc-)	464	464	0	
10	NET GILT SALES TO NBPS & OVERSEAS NEEDED FOR FULL FUND (sales+)	7581	2520		
11	Adjustment for 1986/87 underfund	318			
12	OVER(-)/UNDER(+)FUNDING	-318	-5693	5375	
	GILT SALES:				
13	Net purchases by nbps and overseas (purchases+)	7899	8213	-314	
14	Net purchases by monetary and other public sector (purchases+)	-432	-532	100	
15	Maturities	6800	5460	1340	
16	GROSS OFFICIAL SALES	14267	13141	1126	
	MARCH GROSS GILT SALES TO DATE			307	
	EXPECTED UNDERFUND 1987/88			819	
17	Monthly average gross gilt sales	1189	1195		

* average per month

Relationship between lines:

3 = 1 + 2
10 = 3+4+5+6+7+8+9
12 = 10 + 11 - 13
16 = 13 + 14 + 15

TABLE 2

SECRET AND PERSONAL

FUNDING : FINANCIAL YEAR POSITION 1987/88 - M4 RULE 25/3/88

£ million

	FORECAST	OUTTURN	RESIDUAL	
	Financial Year 87/88	April 87 - Feb 88	March 88	
PSBR AND FUNDING TARGET				
1 PSBR excl asset sales	1770	-2321	4091	
2 Asset sales (sales-)	-5070	-5078	8	
3 PSBR	-3300	-7399	4099	
FINANCED BY:				
4 OPS debt sales to M4ps (sales-)	204	454	-250	
5 National Savings (sales-)	-2000	-1836	-164	* -164
6 CTDs sales to M4ps (sales-)	83	108	-25	
7 Treasury bills etc (sales-)	-108	-108	0	
8 Intervention (reserves inc+)	11530	10030	1500	
9 Public sector externals excl intervention and gilts (inc-)	464	464	0	
10 NET GILT SALES TO NBPS & OVERSEAS NEEDED FOR FULL FUND (sales+)	6873	1713		
11 Adjustment for 1986/87 underfund	318			
12 OVER(-)/UNDER(+)FUNDING	-318	-6707	6389	
GILT SALES:				
13 Net purchases by M4ps and overseas (purchases+)	7191	8420	-1229	
14 Net purchases by OPS, banks and building societies (purchases+)	-639	-739	100	
15 Maturities	6800	5460	1340	
16 GROSS OFFICIAL SALES	13352	13141	211	
MARCH GROSS GILT SALES TO DATE			307	
IMPLIED "M4 OVERFUND (-)" 1987/88			-96	
17 Monthly average gross gilt sales	1113	1195	211	

* average per month

Relationship between lines:

3 = 1 + 2
10 = 3+4+5+6+7+8+9
12 = 10 + 11 - 13
16 = 13 + 14 + 15

NATIONAL SAVINGS

NOTE BY MG1 DIVISION

Results for 1987-88

1. The forecast total is £2.0 billion. An analysis is shown in the attached table. The main contributors are the three gross products. New sales of fixed interest and IL certificates have remained modest throughout the year - well below repayments (particularly of maturing fixed interest certificates) which have been very heavy. There has been a modest but worthwhile contribution from Yearly Plan.

April and May 1988

2. The forecasts in the attached table were prepared on the assumption that interest rates remained unchanged, and suggest net inflows of £190-200 a month. The General Extension Rate (GER) was reduced by ¾% a year from 1 March and the figures already allow for this. On 17 March, reductions of 1½% a year in the interest rates payable on the three gross products, and of ½% a year in the interest rate used to calculate the premium bond prize fund were announced. The main purpose of the reductions was to remove the over-competitiveness of the gross products since building societies started reducing their deposit rates last December. Lower sales and higher repayments than included in the forecast are likely as a result. But it is too early to estimate with any precision what effect these decisions will have on flows.

3. First very broad estimates are that in each of these two months net inflows into the three gross products might be reduced by £50 million.

4. On this tentative basis, we might now expect total net inflows of around £150 million in April and May.

25 March 1988

CONFIDENTIAL

FUNDING FORECAST MARCH 1988 TO MAY 1988

****

TABLE D1: ANALYSIS BY PRODUCT

£ million

	FEBRUARY NET INFLOW	FEBRUARY GROSS ACCRUED INT	FEBRUARY TOTAL	MARCH NET INFLOW	MARCH GROSS ACCRUED INT	MARCH TOTAL	TOTAL CONTRBTN 1987-88	APRIL NET INFLOW	APRIL GROSS ACCRUED INT	APRIL TOTAL	MAY NET INFLOW	MAY GROSS ACCRUED INT	MAY TOTAL	3 MONTHS TOTAL CONTRBTN	AMOUNTS INVESTED AT END OF MAY	
NSC FIXED INTEREST	-121	76	-45	-160	72	-88	-665	-125	72	-53	-120	72	-48	-189	12,993	(of which £7,300m matured certificate
NSC INDEX LINKED	-43	-1	-44	-50	3	-47	-170	-40	23	-17	-30	9	-21	-85	3,514	(of which £2800m matured certificate
INCOME BONDS	154	0	154	185	0	185	1473	140	0	140	145	0	145	470	7,255	
DEPOSIT BONDS	12	7	19	12	7	19	192	12	7	19	12	7	19	57	838	
INVESTMENT ACCOUNT	29	58	87	30	59	89	894	20	59	79	20	59	79	247	7,441	
ORDINARY ACCOUNT	-4	3	-1	-4	3	-1	6	-4	3	-1	-4	3	-1	-3	1,670	
YEARLY PLAN	9	4	13	9	2	11	143	9	2	11	9	2	11	33	430	
PREMIUM BONDS	18	0	18	15	0	15	163	15	0	15	15	0	15	45	2,109	
SAYE	-3	2	-1	-3	2	-1	-18	-3	2	-1	-3	2	-1	-3	467	
TOTAL DNS	51	149	200	34	148	182	2018	24	168	192	44	154	198	572	36,717	

DEPARTMENT FOR NATIONAL SAVINGS
STATISTICS BRANCH 01 605 9316
15 MARCH 1988

Total contribution to end March=£1636m+£200m+£82m=£2018m

COST OF FUNDING : 21 MARCH 1988

(Note by MG2)

Main Points

- The cost calculations shown in tables 1 and 4A and the break-even yields in table 2 have been computed using the new MTFS inflation and interest rate assumptions. Since these rates are slightly higher than last year's, break-even yields have risen accordingly. The rates in the low and high cases have however been reduced slightly, hence in the weighted case the break-even yields remain more or less unchanged (see table 2).

- Nominal yields have fallen relative to real yields and consequently BEIRs have been reduced a little (see table 2).

- The proportion of shorts has changed very little. The figure of 31% is still well below the 56% figure suggested by the guideline (see table 3).

- Current National Savings rates are fairly high relative to other forms of government borrowing and relative to bank and building society rates. However the forthcoming reduction in rates should bring them into line (table 4B).

TABLE : COMPARATIVE COSTS OF AN INITIAL BORROWING OF 100 BY ISSUING A GILT.

1988 prices, net of tax *

Inflation Scenarios **

	MTFS Case	Low Inflation Case	High Inflation Case	Weighted Projection	Winter Case
(a) Five Years					
5 year Conventional	116- 119	123- 126	103- 106	115- 118	113- 116
5 year Index-Linked	112- 113	112- 113	112- 113	112- 113	112- 113
(b) Ten Years					
5, then 5, year Convs	134- 140	145- 150	104- 110	131- 137	134- 141
10 year Conventional	151- 157	175- 182	108- 114	148- 155	150- 157
10 year Index-Linked	139- 141	139- 141	136- 138	139- 141	139- 141
(c) Twenty Years					
5, then 15, year Convs	195- 209	213- 224	115- 128	186- 200	197- 211
20 year Conventional	224- 238	294- 308	109- 120	217- 231	222- 236
20 year Index-Linked	213- 215	213- 215	208- 210	213- 215	213- 215

* Average marginal tax rates are not known with precision and likely ranges are used here instead so that the cost figures also emerge as ranges.

** (i) The MTFS, low and high inflation scenarios are weighted 5:1:1 for the Weighted Projection case.
(ii) The MTFS case assumes the MTFS inflation forecast (of around 3 per cent a year) to 1991 and 2.5 per cent a year thereafter in line with the central case of the long-term assumptions paper (which is used by departments for public expenditure planning purposes).
(iii) The Low Inflation case has inflation falling to 2 per cent by 1990 and price stability achieved and sustained after 1994.
(iv) The High Inflation case has inflation accelerating to 6.5 per cent by 1990 and thereafter gradually to 10 per cent by 1995. Inflation is then taken to remain at this level.
(v) The Winter case assumes the Winter internal forecast to 1992 (with inflation peaking at 5.3 per cent in 1988 H2 and falling to 2.9 per cent in 1992 Q1) and 2.5 per cent a year therafter (see ii)

SECRET

TABLE 2: BREAK-EVEN YIELDS AND BREAK-EVEN INFLATION RATES

Per cent

A: Break-Even Yields

	MTFS	Low	High	Weighted Projection	Winter
(a) 10 Year **	7.3	4.3	11.1	7.4 (7.4)*	8.1
(b) 20 Years ***	7.6	4.5	11.3	7.7 (7.7)*	8.3

* MTFS ,low and high inflation scenarios are weighted 5:1:1

** Below the rate shown it would be cheaper to issue a 10 year conventional than a five followed by a five, year conventional.

*** Below the rate shown it would be cheaper to issue a 20 year conventional than a five, followed by a fifteen, year conventional.

\+ Bracketed figures refer to last funding meeting (February).

B: Break-Even Inflation Rates *

	Break-even Inflation Rate at 21 March 1988		Average Inflation Rate in Each Scenario: MTFS	Low	High	Weighted Projection	Winter
a. 5 years	3.9- 4.6	(4.2-5.0)+	3.5	2.0	6.1	3.7	4.0
b. 10 years	4.0- 4.6	(4.0-4.7)+	3.2	1.2	7.3	3.5	3.3
c. 20 years	3.6- 4.1	(3.6-4.1)+	2.8	0.6	8.5	3.3	2.9

* At the break-even inflation rate the cost of an index-linked gilt is the same as that of a conventional. Below it, the IG will be cheaper than a conventional, and above it more expensive.

\+ Bracketed figures refer to last funding meeting (February).

SECRET

TABLE 3: GROSS SALES OF GILTS TO DATE IN RELATION TO THE GUIDELINES

A. The Guidelines for Gross Issues of Conventionals

Yields on medium and Long Stocks (%)	Proportion of Gross Issues (%) Shorts	Mediums and Longs
above 11	100+	consider buying in
10½-11	95	5
10-10½	80	20
9½-10	65	35
9-9½	50	50
8½-9	35	65
8-8½	20	80
7½-8	5	95
below 7½	consider refinancing with longs/mediums	100+
Proportions implied by average yields in F.Y. to Mar 21.	56	44

B. Gross Sales

£ billion (Percentage of total in brackets)

Conventionals

	Shorts		Mediums		Longs		Total
1987-88*	3.9	(31)	5.1	(40)	3.7	(29)	12.6
[New Issues**	4.7	(35)	5.9	(44)	2.9	(21)	13.5]
1987 Q2	0.9		1.5		1.7		4.1
Q3	1.1		0.4		1.0		2.6
Q4	1.0		1.5		0.8		3.3
Jan	0.8		0.4		0.3		1.4
Feb	0.1		0.7		0.0		0.8
Mar ***	0		0.3		0		0.3
Calls	0.0		0.1		0.0		0.1

Index-linked

	Shorts		Mediums		Longs		Total
1987-88*	-0.0	(0)	0.1	(10)	0.9	(90)	1.0 *
[New Issues**	0.0	(0)	0.1	(12)	0.7	(88)	0.8]
1987 Q2	-0.0		-0.0		-0.1		-0.2
Q3	-0.0		0.0		0.1		0.0
Q4	-0.0		0.1		0.4		0.5
Jan	0.0		-0.0		0.3		0.3
Feb	0.0		0.0		0.3		0.3
Mar ***	0		0		0		0
Calls	0.0		0.0		0.0		0.0

Memo item:	1-7 Years		7-15 Years		Over 15 Years		Total
1987-88 Conv	5.0	(40)	3.8	(30)	3.7	(29)	12.6
IG	0.0	(0)	0.1	(10)	0.9	(90)	1.0

C. Average Life of Dated Gilts

	All	Conventionals only
End 1986-87	10.5	9.5
21 March 1988	10.1	9.2
(New issues**	9.7	8.8)

* Sales secured for 1987-88. **Announced 87-88 incl. CRND ***To 21 Mar.

TABLE 4A: NATIONAL SAVINGS INSTRUMENTS : FIXED RATE PRODUCTS.

A. Costs of an Initial Borrowing of 100 over Five Years +

1988 prices , net of tax

	MTFS Case	Low Inflation Case	High Inflation Case	Weighted Projection	Winter Case
Fixed Interest National Savings Certificate (FINSC)	119	128	105	118	119
Index-Linked National Savings Certificate (ILNSC)	122	122	121	122	125
Conventional 5 Year Gilt	116- 119	123- 126	103- 106	115- 118	116- 119

B. Equalising National Savings Rates.

Per cent

Rate on FINSC to match Cost of Conventional Gilt	6.6- 7.1	6.4-6.9	6.8- 7.4	6.6- 7.1	6.6- 7.2
Current rate on FINSC	7.2	7.2	7.2	7.2	7.2
Rate on ILNSC to match Cost of Conventional Gilt *	3.1- 3.6	4.4-4.9	0.7- 1.3	2.9- 3.5	2.6- 3.1
Current rate on ILNSC *	4.2	4.2	4.2	4.2	4.2

\+ Including administrative costs.

* In addition to inflation-proofing.

CONFIDENTIAL

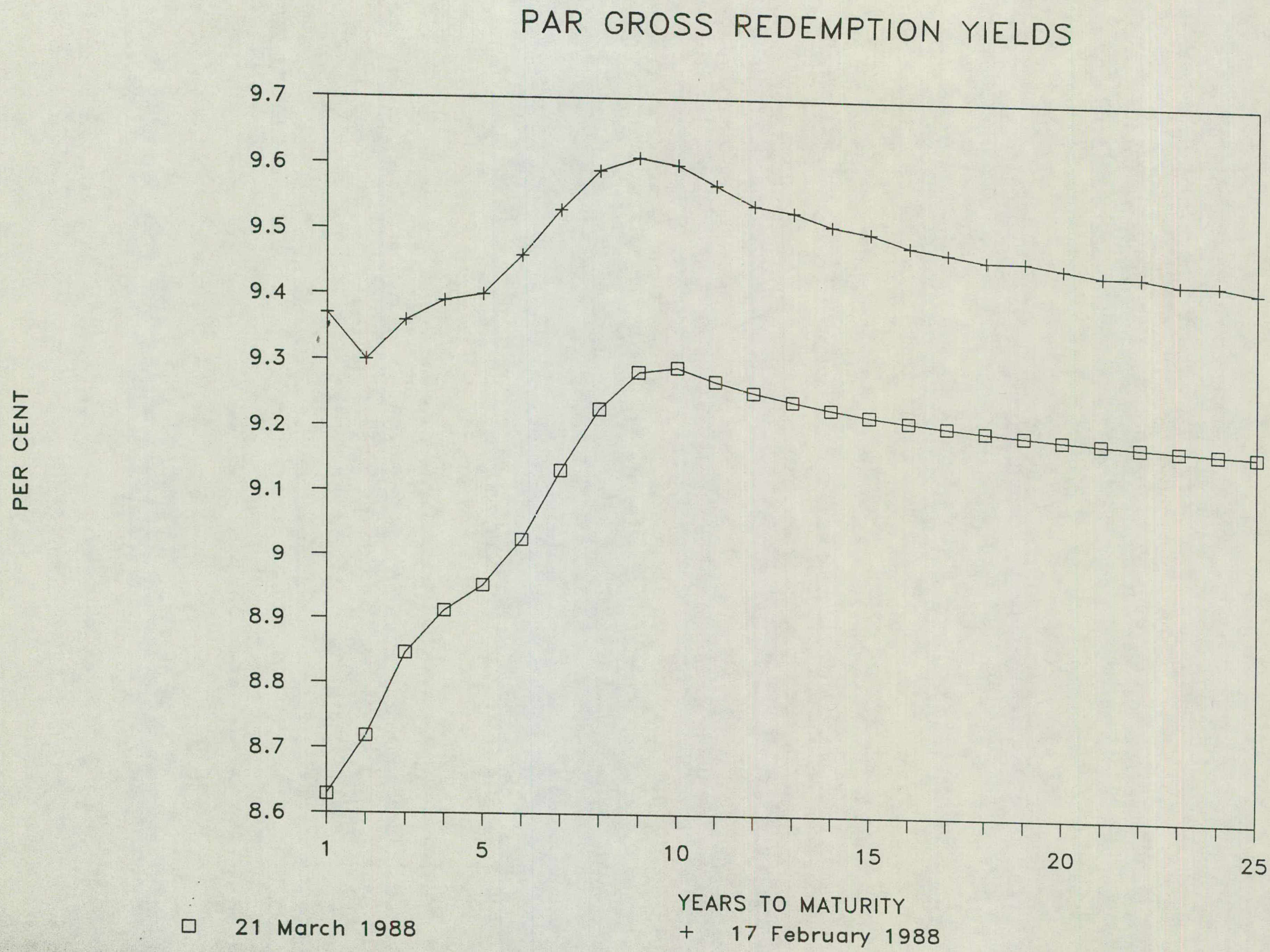
TABLE 4B : NATIONAL SAVINGS INSTRUMENTS : VARIABLE RATE PRODUCTS.

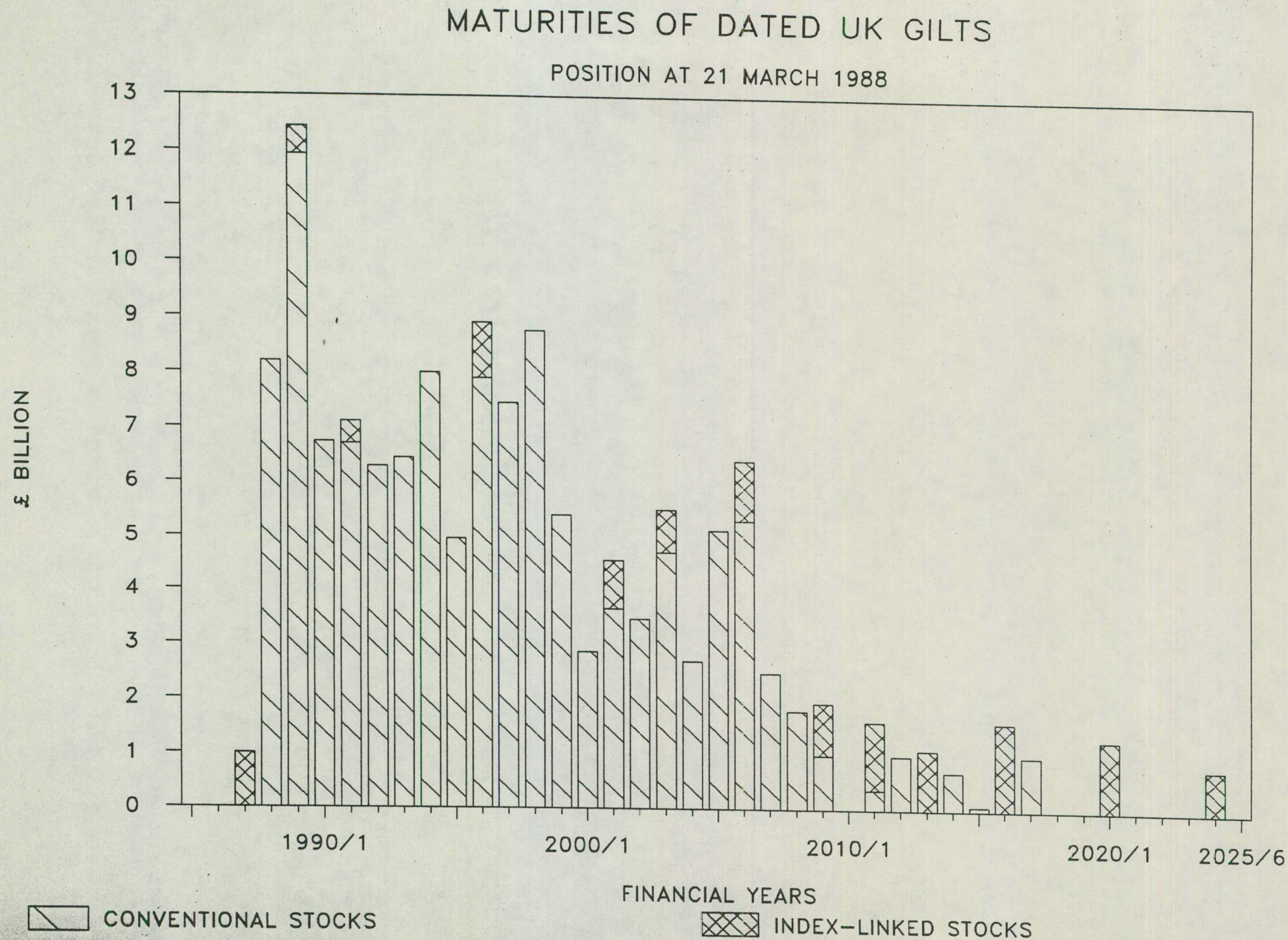
Compound Return	Per cent			
	Tax Rate (%)			
	0	27	60	Administrative costs
Income Bond (1)	11.0	8.0	4.4	0.2
Deposit Bond	10.5	7.7	4.2	0.3
Investment Account	10.0	7.3	4.0	0.4
Premium Bond	7.0	7.0	7.0	1.1
Savings Certificate on GER terms	6.5	6.5	6.5	0.2
12 Month Cost of Government Borrowing (2)	8.6	6.3	3.5	-
CTDs	8.0	5.8	3.2	-
Bank Retail Deposit Rate (3)	6.2	6.2	3.4	N/A
Building Society Retail Deposit Rate (3)	7.0	7.0	3.8	N/A

(1) Assuming interest reinvested in Investment Account.

(2) Yield on a basket of gilts with maturities clustered around one year.

(3) Average of rates applying to the top bands of selected high interest accounts at 21 March 1988.


PAR GROSS REDEMPTION YIELDS
9.7
9.6
9.5
9.4
9.3
9.2
9.1
9
8.9
8.8
8.7
8.6
PER CENT
1
5
10
15
20
25
YEARS TO MATURITY
21 March 1988
+ 17 February 1988


MATURITIES OF DATED UK GILTS
POSITION AT 21 MARCH 1988
£ BILLION
0
1
2
3
4
5
6
7
8
9
10
11
12
13
1990/1
2000/1
2010/1
2020/1
2025/6
FINANCIAL YEARS
CONVENTIONAL STOCKS
INDEX-LINKED STOCKS

COVERING SECRET

BF 29/3

38/3

FROM: CATHY RYDING

DATE: 28 March 1988

ECONOMIC SECRETARY

cc: Chancellor
Sir P Middleton
Sir G Littler
Sir T Burns
Mr Scholar
Mr Peretz
Miss O'Mara
Mr Grice
Mr Rich
Mr Conaty
Ms Bronk
Mr Cropper

Mr Patterson) DNS
Mr Wilson)
Mr Plenderleith - B/E
Prof Griffiths - No 10

FUNDING MEETING: WEDNESDAY 30 MARCH

I attach the Bank of England's paper on item (iii) - Gilt-Edged funding.

Cathy Ryding

CATHY RYDING

COVERING SECRET

GILT-EDGED FUNDING STRATEGY 1988/89
(Note by Bank of England)

1 This paper first estimates the funding task in 1988/89 and then deals with how this should be met. We differ from the Treasury's paper in our assessment of the funding need next year and in the framework of analysis used to decide the type of issues to make.

The funding requirement

2 The Treasury's post-budget forecast shows a gross gilt sales requirement of only £2 billion in (Table 1). In the last four years FSBR forecasts have tended to underestimate the funding need; we think that this year's forecast also underestimates the required total of gilt sales:

(i) The HMT forecast has a fall in the reserves of £3 billion. Though a fall of this magnitude is entirely possible, against the background of a buoyant economy it is unclear to what extent downward pressure on the exchange rate would be met by intervention rather than by a rise in interest rates. Also, the pressures on sterling may be other than those assumed, especially as international investors may continue to wish to diversify their portfolios away from the dollar. In the variant to the forecast shown in table 1 we have assumed no change in the reserves.

(ii) We agree with HMT's assessment that national savings' contribution to funding should be lower 1988/89 than in 1987/88, and have incorporated zero net sales in the variant.

(iii) We also agree that CTDs represent relatively poor quality funding, though we would not wish to see them run off entirely. The variant assumes that there is scope to reduce the total outstanding stock of CTDs (through ungenerous rate setting) by perhaps £3/4 billion next year.

(iv) Banks are likely to have shed around £1/2 billion of gilts this year and may wish to rebuild their holdings in 1988/89. With much of building societies' portfolio adjustment to the new capital adequacy requirements having taken place (the societies' gilt holdings have fluctuated around a broadly constant level this financial year) the gilt holdings of banks and building societies together seem likely to be flat in 1988/89.

With maturities of £8.2 billion due next year, this would give a gross gilt sales requirement of some £7 billion. If we make allowance, say £1 billion, in the forecast for errors which may reduce the funding need, we are left with a gilt sales target of £6 billion, a striking rate of around £0.5 billion per month - still of course well down on the 1987/8 rate of funding.

3 This seems to represent a more central estimate of the likely funding need. By starting out the year aiming for middle ground sales of £500 million per month we could also adjust more comfortably to a greater or lesser funding need without disrupting the market. Given the modest funding requirement we would not be concerned if we were to fall behind the average striking rate, and would be able to step up sales if we were undershooting. In the event that the funding requirement for the year were to be less than £6 billion we could take the opportunity to buy in stock in order to smooth the profile of maturities (see below).

The funding guidelines

4 Our misgivings about the proposed funding guidelines fall under three headings. First, they start from the premise of a £2 billion gilt funding requirement which, as discussed above, is not in our judgement central. Second, their treatment of uncertainty is inadequate. The guidelines are heavly based on a

view of the future which is in effect treated as a near certainty; it would be a risky strategy to place too much weight in gilt funding decisions on this one factor. Third, they give insufficient weight to demand and other practical considerations.

5 With regard to uncertainty, the problem is that with inflation already at moderate levels the risks are assymetrical. The cost implications of inflation turning out much higher than assumed are severe and would vastly outweigh the savings which would arise from a lower inflation outturn. The arbitrary 5:1:1 weighting of the MTFS, low inflation and high inflation scenarios by the Treasury does not adequately reflect these risks.

6 Knowing that we are faced with an uncertain future our preferred approach is to hedge our bets, and not to avoid major funding options altogether unless we are quite sure that these would be more costly. This approach cannot yield the lowest possible cost for any single outcome but provides much greater protection against very high cost outturns.

7 We of course accept the principle that we should aim to fund at shorter maturities when yields are high and at longer maturities when yields are low, but within a framework which seeks to spread the risks. Charts 2 and 3 show that in 1987/88 for non-auction stocks long issues were heaviest when yields were low and short issues were more often the norm when yields were high. Given the inevitable uncertainties about the future and the underlying stability of yields over the last few years (see chart 1) our yardstick for judging whether yields are low or high would be more closely related to the range of recent experience rather than to a single set of projections. We share the Treasury's concern to minimise costs but we are much more sceptical about our ability to out-guess the market and much less willing to take a large punt on such views.

8 This year's suggested guidelines have been cast in the form of targets for the average maturity of the stock of debt outstanding. We feel uncomfortable with consciously setting out

reduce the maturity (equivalent to increasing the liquidity) of the debt. This would appear to run counter to the main objective of funding, which is to provide non-inflationary debt finance to government, as acknowledged in the Treasury paper. Adopting the guidelines as they stand in an uncertain world would result in a shifting target for the maturity of the stock of debt. Given the gearing between the average maturity of the stock of debt and the average maturity of gross sales this would result in sharp and disruptive discontinuties in the profile of our gross gilt sales. It seems inevitable that we would end up paying more to issue debt as the price of increasing the volatility of the market. At yields much different from current levels the guidelines as they stand are impractical and internally inconsistent. They are impracticable because, as shown in tables 2 and 3, they imply very large sale refinancing or extreme maturities for gross gilt sales. They are inconsistent because operations of the type and scale implied would imply significant changes in the yield curve, falsifying the presumption of no change underlying the guidelines.

Cost of Funding

9 We would take issue with the arguments advanced in the HMT paper relating to the comparative costs and riskiness of indexed and conventional debt. By the nature of the instrument the cost of indexed debt is highly sensitive to the inflation outcome, whereas the cash flows associated with conventionals are known in advance. If inflation were to be high indexed debt could prove to be relatively very expensive. At the technical level, calculating breakeven inflation rates between indexed and conventional gilts of the same maturity overstates the advantage of IGs: a comparison of stocks of equal duration (that is stocks whose total weighted cash flows, not just redemption proceeds, are equal) shows a breakeven inflation rate about one percentage point lower.

10 This is not to say that we are against maximising our sales of indexed debt, quite the contrary. But we need to take full account of the risks involved and to pay heed to the narrow base

of the market. It will not encourage greater liquidity or a broadening in the client base for index-linked gilts if we aggressively force existing holders to suffer substantial losses.

11 We agree that the cost of funding is an important consideration in deciding which gilts to issue. But it is equally also important to remember that funding has dimensions other than finance costs, for example it affects general monetary conditions. Furthermore, we have a number of reservations about the Treasury's most recent cost of funding analysis. These can be ironed out in detail between officials at a later date, but it is worthwhile outlining them here. In contrast to last year, the Treasury now wish to ignore the effect of tax in assessing the cost of funding: we think this is a step in the wrong direction. The post-tax figures, though imperfect, give a better idea of the relative costs of raising deficit finance at the margin than do the pre-tax figures. In view of the heavy purchases in 1987/88 of gilts by foreigners (who shy away from longer-maturities and pay no tax), the relative cost of issuing shorts and longs turned out to be different from what was asssumed this time last year: the lower than expected tax clawback raised the relative cost of shorts. We also have a number of other reservations: for example, the cost of funding scenarios assume an unchanged yield curve whereas, as chart 1 above shows, long yields tend to be less variable than shorts.

Demand

12 Demand is largely ignored in the Treasury paper, though over time the strategy which minimises costs will be that which most closely matches the profile of demand. Different types of investors want investments with different characteristics. Because different sectors of the market are prepared to accept a lower return on their preferred instruments, the overall cost of funding to the government is improved by borrowing across a wider range of instruments. This has long been a principle underlying the funding program (Tables 4 and 5).

Table 4 shows that not only has the quantum of gilt sales in 1987/88 been very different from that incorporated in last year's budget forecast, but the pattern of demand has been quite different also. Most notably the take up by overseas has been much larger than forecast, totalling as much as in the two previous years combined. Purchases by the domestic non-bank private sector have also been greater than expected, though no particular divergences from forecast stand out. The monetary sector, which had increased its gilt holdings in each of the previous four years, unexpectedly sold gilts in 1987/88. The annual figures conceal more recent developments, with the pattern of demand having changed following the October equity market crash (table 5). Since then, LAPFs have repatriated investments from abroad and have held back from domestic equities. They have turned instead towards gilts, and in the second half of 1987/88 lapfs are estimated to have more than offset the run down in their gilt holdings over the previous six months.

14 Looking forward, we would expect the longer-term institutions to continue to be cautious in their attitude to equity markets at home and abroad, while worries about the US dollar may restrict bond investment there. It is very likely that their refreshed taste for gilts will continue to be felt this year. With modest gilt sales in prospect and almost £5 billion of stock moving from the long (15+ years) to medium (7-15 years) range during 1988/89 we might expect to see long yields fall significantly, with the yield curve tilting downwards. That this has not yet happened in part reflects worries about the strength of demand and future inflation and also suggests that the implications of the fiscal outlook have not yet been absorbed fully.

15 Overseas demand for gilts has strengthened over recent years and was particularly prominent in 1987/88. In view of continued US vulnerability and the strong UK fiscal position we would expect to see a continued foreign appetite for short-medium gilts, though the timing and strength of this demand would depend on, inter alia, exchange rate developments. In deciding whether or

not to tap into periods of foreign demand by issuing short-medium maturities we will need to bear in mind not only the relative costs of various debt maturities but also the likely impact on other objectives, including the exchange rate.

16 The reduced attractions of the equity market for the investor and the forecast reduction in gilt supply may encourage more corporate bond issues in the euro-sterling and other markets. Given corporate preferences for maturity of issues, we might wish to limit our issues around the five year area.

17 The move to an M4-based funding rule reduces the likelihood that sales of short gilts will count as funding, though we do not foresee any significant change in gilt holdings by banks and building societies in the year ahead. With the redemption of 3% Transport 1987/88 in July we might expect to see a fall in personal sector gilt holdings in net terms, because many of the smaller amounts redeemed are unlikely to be directed towards new gilt purchases.

18 In total, we would envisage that demand for gilts would be strong relative to the prospective supply and that the mismatch might be greatest at longer maturities. At least initially, we would want to hold back from long funding in the expectation that long yields will fall, but this is something we would need to keep under review.

Maturity Structure

19 Smoothing the hump of maturities in 1989/90 would not be consistent with the objective of concentrating funding on the shorter rather than the longer maturities whenever possible, since it would lengthen the maturity of the debt. We would be ready to pick up stock from 1989/90 when it is on offer, but would not propose to go out of our way to buy those maturities. We would instead propose to lessen the bunching of maturities in the years 1996/97 to 1998/99, averaging around £9 billion a year. Reducing the maturities in these years, spreading them both forward and

back, would leave more room in future to fund at shorter maturities should we wish to do so. We would not wish our buying in to disrupt the market and therefore would aim to buy into periods of weakness, which would also be desirable on cost grounds. Recognising that our buying in will be variable, according to market conditions, we see little value in setting numerical targets for it.

SECRET

Table 1

THE FUNDING ARITHMETIC
1987/88 - 1988/89 (£ bn)

	1987/88 Budget Projections (1)	1987/88 Current Projections (2)	1988-89 HMT (3)	1988-89 Variant (4)
1 FUNDING REQUIREMENT (+)				
PSBR (+)	3.9	-3.6	-3.2	-3.2
Reserve Change (+)	-	11.5	-3.0	-
Adjustment from previous year (+)	0.4	0.3	1.0	1.0
2 NON-GILT FUNDING (-)				
Other Public Sector (-)	0.4	1.4	0.6	0.6
National Savings (-)	-2.2	-2.0	-1.0	0.0
CTDs (-)	-0.1	0.1	0.3	0.8
External Finance (-) (excl Gilts)	-0.4	0.5	-0.4	-0.4
3 REQUIRED GILT SALES (+)	2.0	8.2	-5.7	-1.2
O/W Gilt Sales to				
Overseas (+)	0.6	5.7	-	+0.3
NBPS (+)	1.3	2.5	-5.7	-1.5
4 GILT SALES TO BANKS AND* BUILDING SOCIETIES (+)	0.4	-0.6	-0.5	0.0
5 1987/88 UNDERFUND (-)	-	-1.0	-	-
6 GILT MATURITIES (+)	6.7	7.0	8.2	8.2
7 GROSS GILT SALES	9.0	13.6	2.0	7.0

Line 3 = 1 + 2

Line 7 = 3 + 4 + 5 + 6

* In 1988/89

0224J

Table 2

Amount of gilt refinancing implied by draft HMT guidelines.

Yield (%)	Average life at end-March 1989 (years)	Amount to be bought in and refinanced (£ bn) (1) at 10 years shorter maturity	at 10 years longer maturity
6 1/2 to 7	10.3		18.4
7 to 7 1/2	9.9		13.5
7 1/2 to 8	9.5		8.6
8 to 8 1/2	9.1		3.7
8 1/2 to 9	8.7	1.2	
9 to 9 1/2	8.3	6.1	
9 1/2 to 10	7.9	11.1	
10 to 10 1/2	7.5	16.0	

(1) Assuming £6 bn of gross sales (in absence of refinancing) at average maturity of 8.8 years.

Table 3

Implications of guidelines for maturity of gross sales.

Yield (%)	Average life at end-March 1989 for stock of gilts (years)	Implied average life for gross gilt sales: at gross gilt sales of £1 bn (years)	at gross gilt sales of £3 bn (years)	at gross gilt sales of £6 bn (years)
6 1/2 to 7	10.3	185.7	68.7	39.5
7 to 7 1/2	9.9	138.5	56.1	31.3
7 1/2 to 8	9.5	91.3	36.8	23.1
8 to 8 1/2	9.1	44.2	20.8	14.9
8 1/2 to 9	8.7	- 2.9	4.8	6.8
9 to 9 1/2	8.3	- 50.1	-11.2	- 1.4
9 1/2 to 10	7.9	- 97.3	-27.2	- 9.6
10 to 10 1/2	7.5	-144.5	-43.2	-17.8

0231J/edh 24. 3.88

SECRET

Tab[redacted]4

Analysis by purchaser of official sales of gilt-edged

Financial years £ billion (Figures exclude repos)	1982/3	1983/4	1984/5	1985/6	1986/7	1987/88 Budget Forecast	1987/88 Estimate
Gross Official Sales	10.5	15.4	15.3	11.7	14.7	9.0	13.6
Redemptions and Purchases of Under One-Year Stocks	-5.2	-3.9	-4.2	-6.5	-8.8	-6.7	-7.0
Net Official Sales	5.3	11.5	11.1	5.2	5.9	1.9	6.6
Monetary Sector	-	0.5	0.4	0.1	1.4	0.4	-0.7
Overseas Sector	0.7	1.2	1.3	2.3	2.8	0.6	5.0
Other Public Sector	-	-	-	-	0.1	-	-
Non-Bank Private Sector	4.6	9.8	9.4	2.8	1.5	1.3	2.2
o/w Building Societies	0.8	1.8	0.7	-0.8	-2.6	-	-0.2
Life Assurance and Pension Funds	3.0	5.0	5.8	3.5	1.2	1.1	1.1
Other OFIs**	0.2	0.4	0.1	1.3	2.4	0.2	0.7
Persons**	0.4	2.2	3.0	-0.6	0.7	0.3	0.4
ICCs	0.2	0.4	-0.2	-0.5	-0.3	-0.3	0.1

** an estimated adjustment £(0.8 bn in 1985/6 and £0.2 bn in 1986/7) has been made to shift the rise in security dealers' holdings out of "persons" and into "other OFIs"

0232J/edh

24. 3.88

SECRET

Table 5

Gilt Sales 1987/8

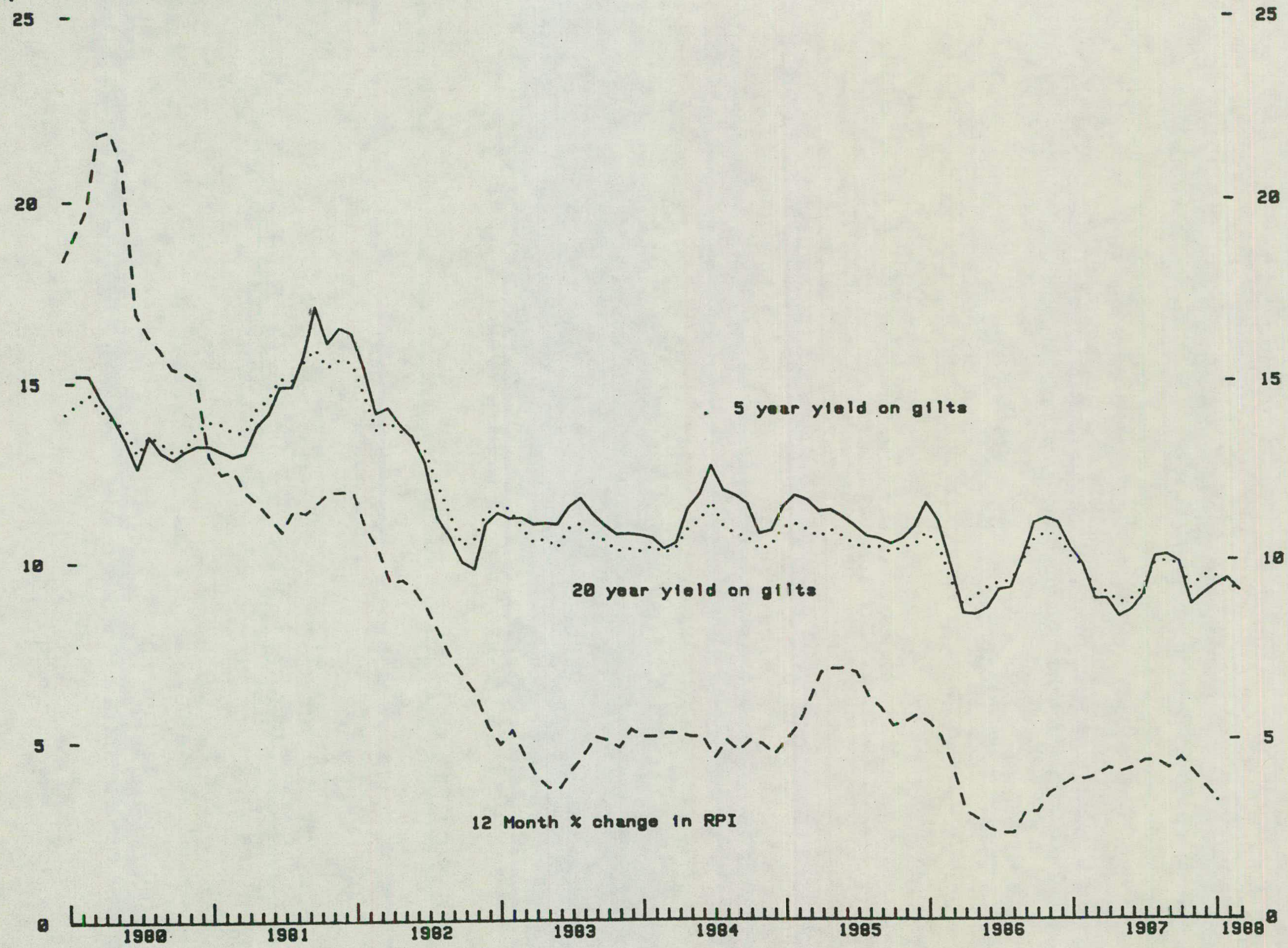
	Q2	Q3	Q4	Jan/Feb	March Forecast	FY
Gross Sales	4.0	2.6	3.8	2.8	0.3	13.6
Redemptions	-2.6	-1.2	-1.3	-0.4	-1.5	-7.0
Net Sales	1.4	1.4	2.5	2.4	-1.1	6.6
O/W Other Public	-	0.1	-	-	-	-
Monetary Sector	-1.4	0.2	-	0.6	-0.1	-0.7
Overseas	1.7	2.3	0.6	0.6	-0.2	5.0
nbps	1.1	-1.2	1.9	1.2	-0.8	2.2
O/W ICC	-0.1	0.1	[0.1]	[-]	[-]	[0.1]
Persons	1.7	-1.3	[1.3]*	[-0.3]*	[-1.0]	[0.4]
Building Societies	0.1	0.2	-0.5	-	-	-0.2
LAPF	-0.9	-0.4	0.7	[1.3]	[0.4]	[1.1]
Other OFIs	0.2	0.2	[0.3]	[0.2]	[-0.2]	[0.7]

[ ] estimates

* of which GEMMS (misregarded as personal sector) Q4 +0.9
Jan/Feb -0.7

CHART 1

Inflation and gilt yields



YIELD ON REPRESENTATIVE SHORT AND LONG STOCKS

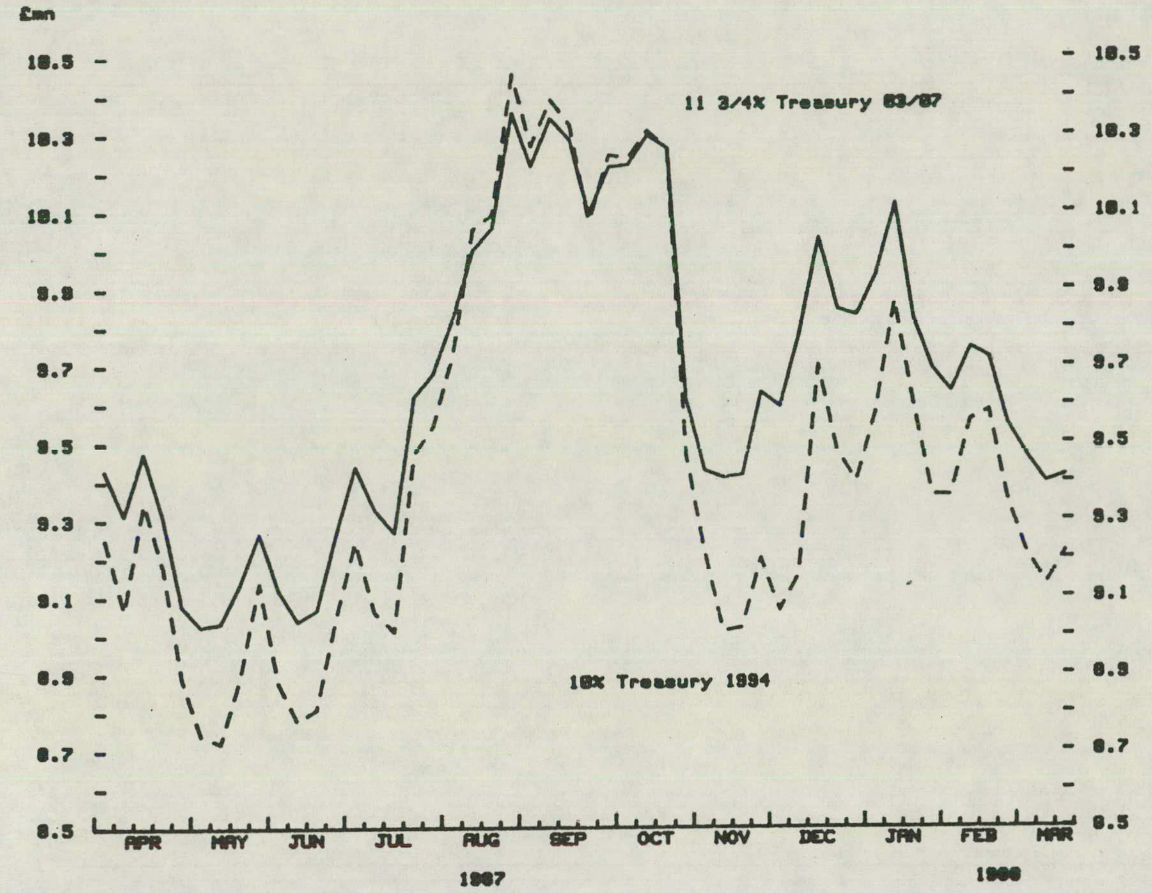
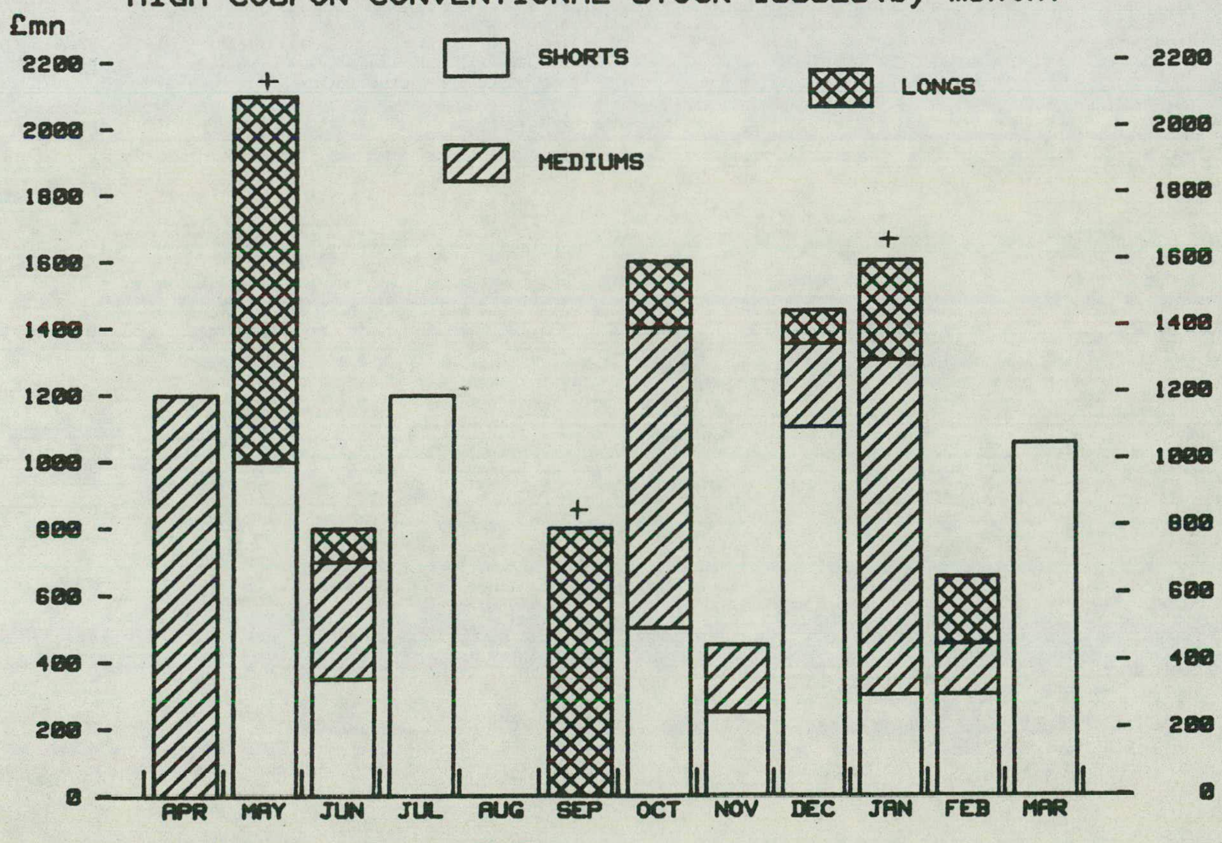


CHART 3

HIGH COUPON CONVENTIONAL STOCK ISSUES(by month)*



* Including issues to CRND
\+ Auction months

CHART 4 MATURITIES OF GILT-EDGED STOCK

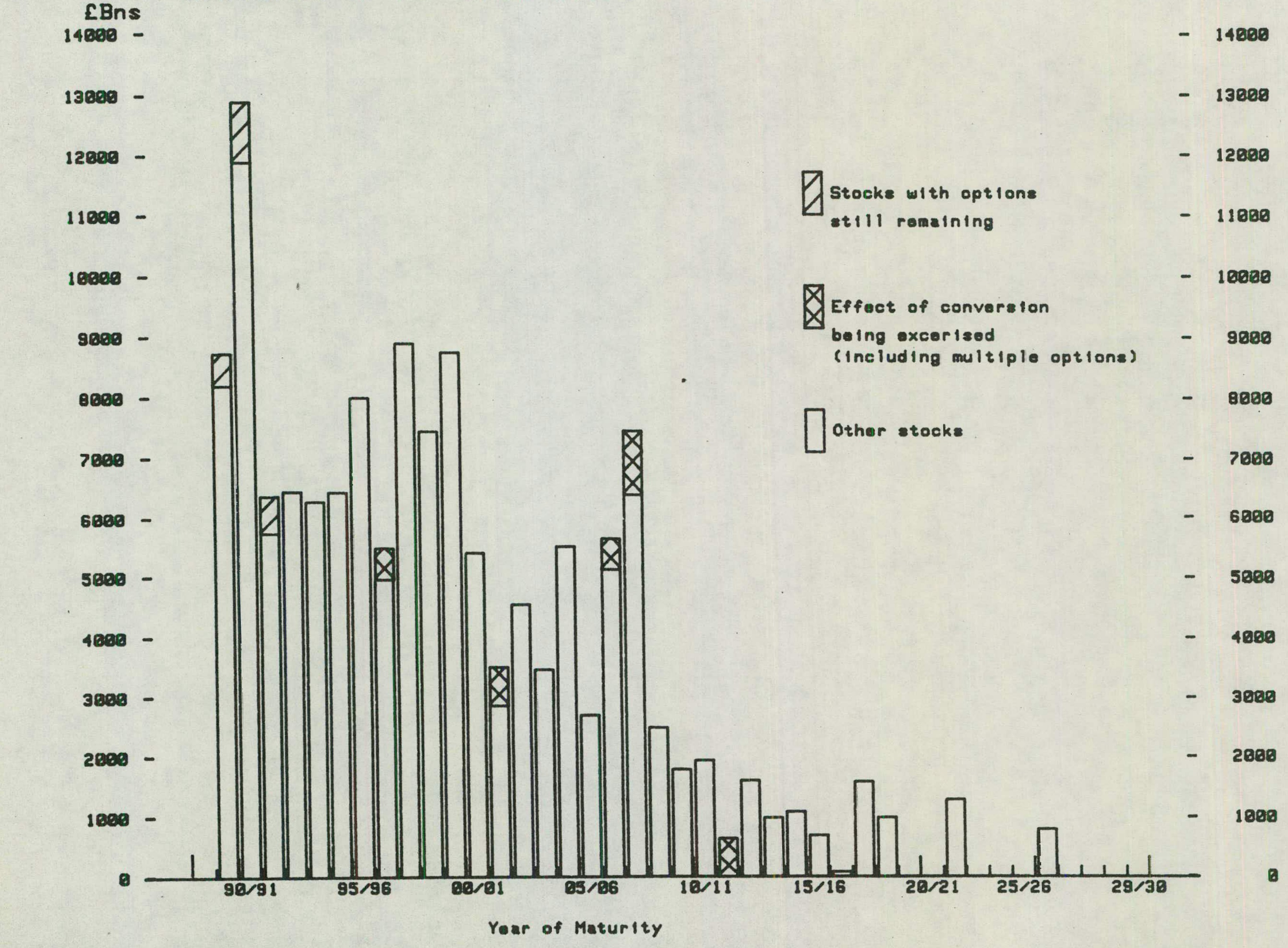
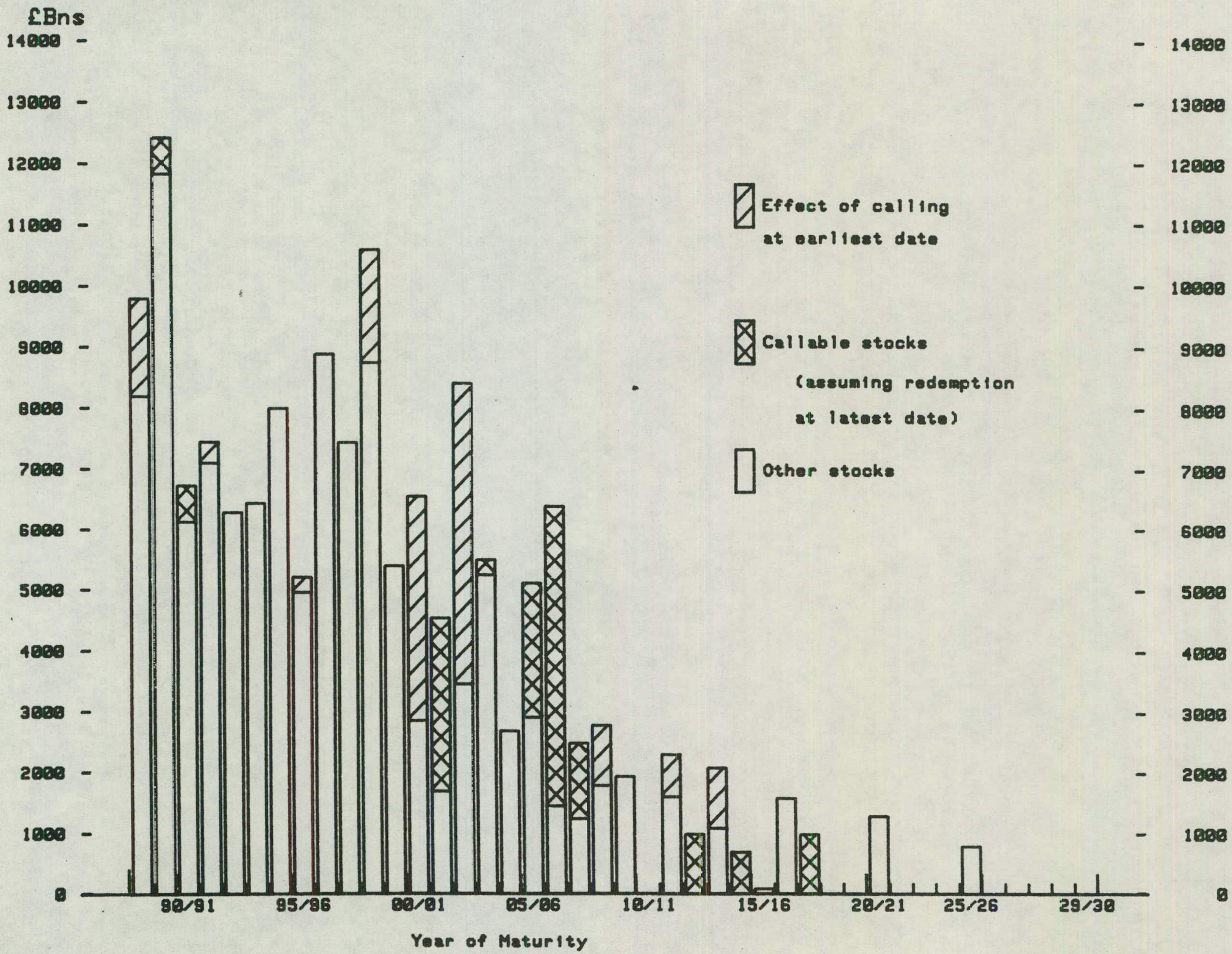


CHART 5 MATURITIES OF GILT-EDGED STOCK



0240J/edh 25. 3.88

SECRET

£ million

GILT-EGED FUNDING IN APRIL
(Note by Bank of England)

1 This note reviews the likely funding outturn for 1987/88 and the prospects for funding in April.

The Funding Arithmetic

2 The latest funding arithmetic is presented in tables 1 and 2 (not seasonally adjusted and seasonally adjusted, respectively). The figures for financial year 1987/88 have been revised since the last funding meeting to reflect the latest data. The main revisions are:

i) the PSBR surplus has been revised down from 3400 to 3300;

ii) net redemptions of other public sector debt have continued to be lower than forecast, and the total for the year has been revised down by 600;

iii) national savings inflows have been lower than expected, and the forecast now assumes receipts of 2000, rather than 2120;

iv) reflecting the estimated March outcome, intervention has been revised up by 1400;

v) maturities have been revised down by 150 to 6800, reflecting more information on the pattern of holdings of near maturities and likely late encashment of redemption proceeds; and

vi) a number of other individually smaller changes have reduced the estimated sales requirement by about 150.

3 The net result of these changes since last month's meeting is to increase the total of gilt sales that would be required by some 700, to 14267. Taking into account the 13140 of gross sales between April 1987 and February 1988 and the 300 of further sales so far this month implies an underfund of 820 in 1987/88 as a

whole, on the assumption that no more gross sales are made during the remainder of March. Uncertainties about some of the magnitudes involved, for example concerning the exact timing of cashflows around the end of the financial year, mean that the outturn could still vary.

4 On the M4-basis, it seems likely that we will be close to a full fund, and perhaps a little overfunded, as table 3 shows.

5 The outlook for 1988/89 is discussed in our note on funding strategy. We envisage a striking rate of around 500 a month.

Market Conditions and Funding tactics

Yields %	8 May 87 (trough)	19 Oct 87 (peak)	13 Jan 88 (medium auction)	1 Mar 88 (last funding meeting)	24 Mar 88
Shorts	8 5/16	10 9/16	9 5/16	9 3/16	9 1/16
Mediums	8 11/16	10 9/16	10 1/8	9 5/16	9 1/4
Longs	8 3/4	10 1/16	9 11/16	9	9
IGs (2006) (real yield at 5% inflation)	3 5/8	4 11/16	4 5/16	3 15/16	3 15/16

6 The gilt market has been concerned about the implications of the cut in interest rates and, despite the rise in the exchange rate, remains uncertain about the longer term outlook for inflation. Though yields at the short end have fallen with the cut in interest rates, long yields have remained almost exactly as they were early in March in spite of the strong technical outlook implied by the PSBR projections (see Chart).

7 Following the exhaustion of the short tap we have very little stock in our portfolio - about 20 of useable conventionals and about the some amount of IGs. Calls of some 380 due in April will virtually account for the 500 of gross sales we expect to

make each month during 1988/89. On funding grounds therefore there is little call for us to bring new stock. If the market were to move ahead at all strongly, however, our current holdings would be insufficient to allow us to manage the market. In these circumstances we would wish to bring a small quantity of tranchettes, with the composition depending mainly on market conditions.

8 Our debt to NILO is 140.

able 1

UNDING : FINANCIAL YEAR POSITION 1987/88 — M3 basis — £ millions

Seasonally adjusted

	Revised FORECAST FY 1987/88	OUTTURN Apr 87 - Feb 1988	RESIDUAL March 88
PSBR AND FUNDING TARGET			
1 PSBR excl asset sales	1770	-2321	4091
2 Asset sales (sales-)	-5070	-5078	8
3 PSBR	-3300	-7399	4099
Financed by:			
4 Other public sector debt sales to nbps net (sales-)	894	1294	-400
5 National Savings (sales-)	-2000	-1837	-163
6 CTDS (sales-)	66	41	25
7 Treasury bills etc (sales-)	-73	-73	0
8 Intervention (reserves inc+)	11530	10030	1500
9 External finance of public sector excluding intervention and gilts (increase-)	464	464	0
10 Target gilt sales to nbps and overseas for full fund (sales+)	7581	2520	5061
11 Over(-)/Under(+) funding brought forward	318		
12 Over (-)/Under (+) funding 1987/88	-318	-5693	5375
GILT SALES			
13 Net purchases by nbps and overseas (purchases+)	7899	8213	-314
14 Net purchases by monetary and other public sector (purchases+)	-432	-532	100
15 Maturities	6800	5460	1340
16 GROSS OFFICIAL SALES	14267	13141	1126
17 Monthly average gross gilt sales	1189	1195	1126

a average per month for remainder of year

Relationship between lines:

3 = 1 + 2
10 = 3 + 4 + 5 + 6 + 7 + 8 + 9
12 = 10 - 13
16 = 13 + 14 + 15

Table 2

FUNDING : FINANCIAL YEAR POSITION 1987/88 M3 basis £ millions

Seasonally adjusted

	Revised FORECAST FY 1987/88	OUTTURN Apr 87 - Feb 1988	RESIDUAL March 88
PSBR AND FUNDING TARGET			
1 PSBR excl asset sales	1770	407	1363
2 Asset sales (sales-)	-5070	-5078	8
3 PSBR	-3300	-4671	1371
Financed by:			
4 Other public sector debt sales to nbps net (sales-)	894	783	111
5 National Savings (sales-)	-2000	-1829	-171
6 CTDS (sales-)	66	-315	381
7 Treasury bills etc (sales-)	-73	-80	7
8 Intervention (reserves inc+)	11530	10030	1500
9 External finance of public sector excluding intervention and gilts (increase-)	464	455	9
10 Target gilt sales to nbps and overseas for full fund (sales+)	7581	4373	3208
11 Over(-)/Under(+) funding brought forward	318		
12 Over (-)/Under (+) funding 1987/88	-318	-3840	3522
GILT SALES			
13 Net purchases by nbps and overseas (purchases+)	7899	8213	-314
14 Net purchases by monetary and other public sectors (purchases+)	-432	-532	100
15 Maturities	6800	5460	1340
16 GROSS OFFICIAL SALES	14267	13141	1126
17 Monthly average gross gilt sales	1189	1195	1126

a average per month for remainder of year

Relationship between lines:

3 = 1 + 2
10 = 3 + 4 + 5 + 6 + 7 + 8 + 9
12 = 10 - 13
16 = 13 + 14 + 15

Table 3

SECRET

25/3/88

FUNDING : FINANCIAL YEAR POSITION 1987/88 - M4 RULE

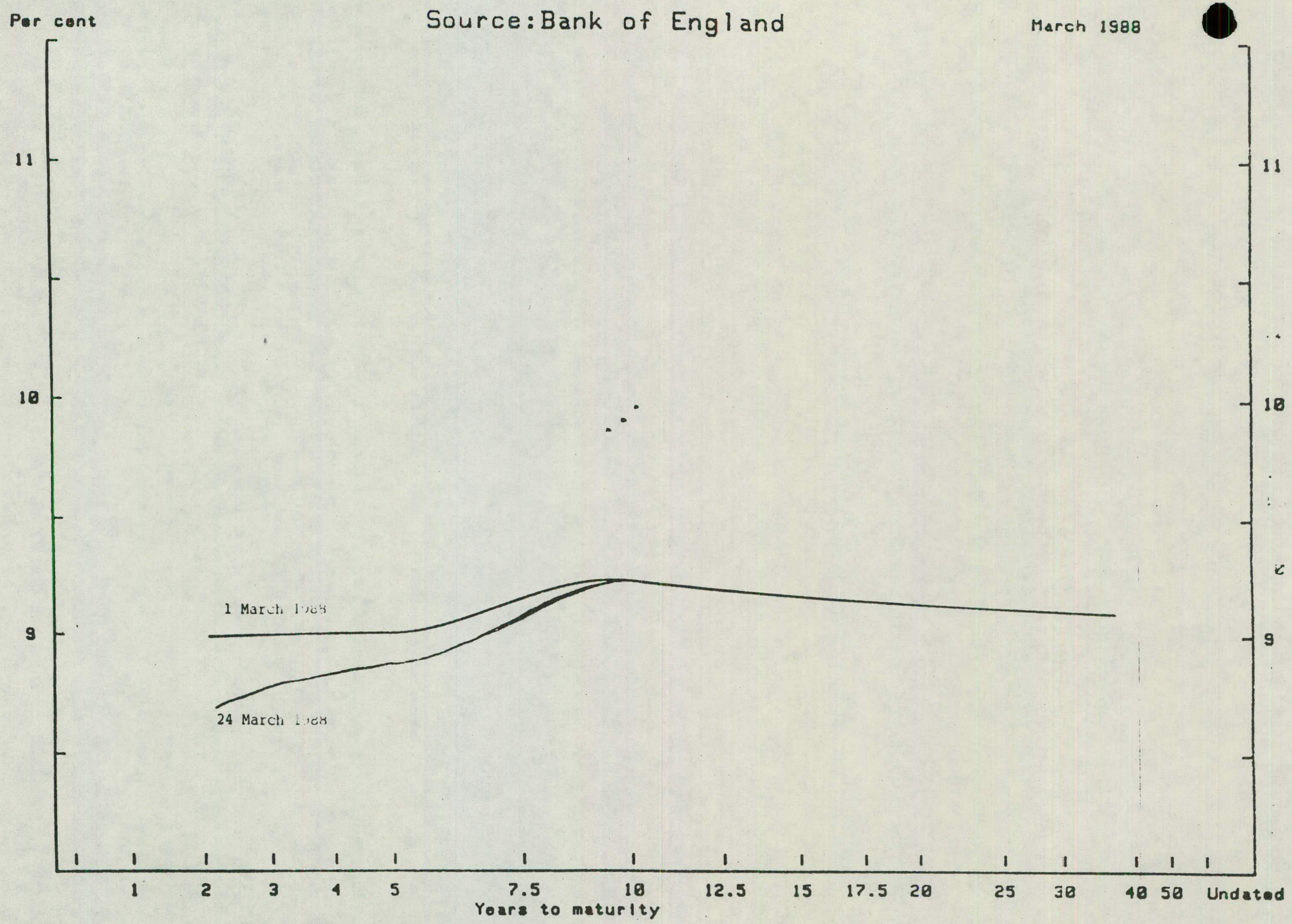
£ million

	FORECAST Financial Year 87/88	OUTTURN April 87 - Feb 88	RESIDUAL March 88	
PSBR AND FUNDING TARGET				
1 PSBR excl asset sales	1770	-2321	4091	
2 Asset sales (sales-)	-5070	-5078	8	
3 PSBR	-3300	-7399	4099	
FINANCED BY:				
4 OPS debt sales to M4ps (sales-)	204	454	-250	
5 National Savings (sales-)	-2000	-1836	-164	* -164
6 CTDs sales to M4ps (sales-)	83	108	-25	
7 Treasury bills etc (sales-)	-108	-108	0	
8 Intervention (reserves inc+)	11530	10030	1500	
9 Public sector externals excl intervention and gilts (inc-)	464	464	0	
10 NET GILT SALES TO NBPS & OVERSEAS NEEDED FOR FULL FUND (sales+)	6873	1713		
11 Adjustment for 1986/87 underfund	318			
12 OVER(-)/UNDER(+)FUNDING	-318	-6707	6389	
GILT SALES:				
13 Net purchases by M4ps and overseas (purchases+)	7191	8420	-1229	
14 Net purchases by OPS, banks and building societies (purchases+)	-639	-739	100	
15 Maturities	6800	5460	1340	
16 GROSS OFFICIAL SALES	13352	13141	211	
MARCH GROSS GILT SALES TO DATE			307	
IMPLIED "M4 OVERFUND (-)" 1987/88			-96	
17 Monthly average gross gilt sales	1113	1195	211	

* average per month

Relationship between lines:

3 = 1 + 2
10 = 3+4+5+6+7+8+9
12 = 10 + 11 - 13
16 = 13 + 14 + 15


Per cent
Source:Bank of England
March 1988
11
10
9
1 March 1988
24 March 1988
1
2
3
4
5
7.5
10
12.5
15
17.5
20
25
30
40
50
Undated
Years to maturity

Confidential

FROM: J P MCINTYRE
DATE: 30 MARCH 1988

FINANCIAL SECRETARY

cc Chancellor
Chief Secretary
Sir P Middleton
Mr Anson
Mr Phillips
Mr Scholar
Mrs Lomax
Miss Peirson
Mr Peretz
Mr Culpin
Miss Sinclair
Mr Ilett
Miss O'Mara
Mr Cropper
Mr Tyrie
Mr P Lewis - IR
Mr Jenkins -T.Sol

I hope we can reach agreement on this. I await FST's recommendations.

PS. Is there a yield estimate?

NICS ON GILTS ETC

I attach a paper which has been prepared with the help of DHSS, the Inland Revenue, the Bank and other Treasury divisions (FP, MG, FIM, and ETS).

2. The paper confirms that NICs can be imposed on gilts and other securities by secondary (DHSS) legislation. But the whole process, from the point of decision to implementation, could take upto 3 months. This is because of the need to prepare the amendments to the DHSS regulations, consultation with the Social Security Advisory Committee, and the negative resolution procedure in Parliament.

3. On coverage, the consensus among officials is that action should be taken not only against gilts but as a minimum against all marketable securities so that employers using gilts will not easily be able to turn to another means of NIC avoidance. The only exception would be shares provided under approved employee share schemes and certain employee share options (though the Revenue want to give further thought as to precisely what should

be done on employee schemes). The paper does, however, point out that even including all marketable securities would leave some gaps such as commodities and unquoted shares. (Marketability is, of course, difficult to define, since unquoted shares can be bought and sold).

4. Mr Moore's letter of 24 March confirms his agreement on removing the NIC exemption from earnings paid in gilts and that other securities would also probably need to be covered.

5. There is one other issue you should be aware of and which is not covered in the officials paper. This is the question of disclosure. If an announcement were made very soon after a decision was taken, say at the beginning of the Finance Bill debates, a disclosure problem would not arise. But this problem could arise if an announcement were delayed eg because we wanted to minimise the amount of time in which employers could take forestalling action in advance of implementation.

6. As you know, as soon as a decision has been taken by Ministers to do anything which would be likely to have a material effect on the price of gilts, we are meant to disclose it. However, the Treasury Solicitors Department has confirmed that, in this case, a disclosure requirement does not cause difficulties. One reason is that we judge that the effect of imposing NICs on gilts should not have a significant effect on gilt prices generally. Thus, employers purchasing gilts before the announcement, with a view to passing them on to employees as part of salary, would suffer no material loss on the market value of the gilt as a consequence of a decision to impose NICs. They would have to pay the 10.45 percent NIC charge on the gilts if they chose to pass them on after the measure has become effective, but this would mean only that the gilts would be treated in the same way as cash (except that the employers would have incurred a transaction cost). In any event, those employers who have bought gilts for this purpose just before the announcement would have up to three weeks to make the payments and avoid NICs, because of the delay in the regulations taking effect, explained above.

7. However, we have a continuing obligation not to mislead, and we would have to be careful about what was said on the scope of employers' NICs if there were a significant period between a decision being taken and an announcement.

Next Steps

8. DHSS officials favour Autumn implementation so as to give employers plenty of notice of the change. (DHSS are not much concerned about the risk of forestalling activity on the evidence from last year's NIC change affecting trusts). But if Ministers wanted an announcement at the time of the Finance Bill debates, with implementation in the Summer, we would need to agree quickly with DHSS the scope of the new measure. It is unlikely that the draft regulations could be ready and printed in time for the Finance Bill Second Reading (planned for 25 April), but we might be able to agree on enough of the detail by then for an announcement to be made.

9. You may wish to discuss.

JPM

J P MCINTYRE

NICS ON GILTS ETC

Extent of problem

1. Neither Inland Revenue nor DHSS have any reliable information on the extent to which employers are using gilts and other means of payment to avoid NICs on cash earnings. The Revenue estimates that, very roughly, £20-30 million may have been paid in gilts in 1986-87, resulting in an Exchequer loss of £2-3 million. DHSS are clear that there has been a significant increase in this kind of activity since abolition of the UEL on employers' NICs in 1985 and that gilts are by no means the only route. For example, they know that some firms allow employees to use company credit cards, with the firms paying the bills. Some companies pay employees' telephone bills direct to BT and their childrens' school fees direct to the schools so as to avoid NICs.

2. The wider question of applying NICs to benefits in kind generally has been considered on several occasions. To date Ministers have not found any of the options for dealing with the problem attractive. One difficulty identified in December 1985 was that any system which applied NICs to the gross cost to the employer of providing benefits would penalise expenses payments etc for which there is a matching relief for income tax. Another is that the annual basis of income tax allows time for a proper valuation of a benefit such as accommodation to be worked out with the tax office after the end of the tax year. For NICs there is no system of adjustment after the end of the pay period for which contributions are due: the employer would need to have an agreed figure every week or month. The problem of expenses deductions does not arise for the more limited proposal examined here of applying NICs to payment in gilts or other marketable securities and valuation should in many such cases be straightforward (but see paragraph 16 below).

The existing rules on securities

3. Instruments which can be immediately turned into cash at their face value by surrender to the issuing authority are not

regarded as payments in kind for NICs purposes and are thus not exempt from NICs. At present, therefore, only instruments such as premium bonds and National Savings Certificates are subject to NICs.

Securities to be subject to NICs

4. Imposing NICs on gilts alone might deter some avoiders. But most would probably switch to other securities or derivative instruments such as futures and options. As long as the transaction costs and administration costs for the employer are significantly below 10.45 per cent, there will be an incentive to avoid. Moreover, if the transactions were carried out quickly, even securities not usually thought of as capital certain could be used. For these reasons, the minimum action necessary would be to make all marketable securities subject to NICs.

5. This raises the question of defining the securities to which NICs would apply. The Inland Revenue definition for income tax purposes is of no help here: in principle virtually everything supplied by an employer provides for a "higher paid" by reason of his employment employee is taxable as a benefit unless it is specifically exempted (eg pens, heating in offices etc). This means that the Inland Revenue do not need to maintain an up to date list of taxable benefits, including new financial instruments devised by ingenious people in the City.

6. But if NICs are only going to be applied to a limited range of benefits ie marketable securities and derivative instruments, it will be necessary to define these. "Securities" and "derivative instruments" are listed in Schedule 1 to the Financial Services Act 1986. As well as gilts, "securities" include shares, debentures, bonds, local authority stock and units in unit trusts, while derivative instruments include options, futures warrants and ADRs. We would not distinguish between instruments traded in retail markets and those traded on wholesale markets, including Eurobonds. For some high salary earners, it would be just as feasible to pay in Eurobonds as gilts.

7. The list in Schedule 1 does not distinguish between those instruments that are readily marketable and those that are not, such as most unquoted shares and some derivative instruments or arrangements such as swaps. We can consider the feasibility of including a definition of "marketable" in the DHSS regulations, so as to exclude, for example, any instrument which could not be sold on an open market in the month following receipt by the employee. On the other hand we could employ a wider definition which in principal caught unquoted shares etc. In practice most of these could have no marketable value for NIC purposes, but it would help deter some arrangements for by-passing the NIC changes, eg by buying back unquoted shares shortly after the transfer.

8. There is a strong case for two exceptions to the FSA list:

i. Life insurance contracts

ii. Shares made available under employee share schemes.

9. Life contracts could not be realised in the short term without significant loss. And they are partly in the nature of services provided by employers as well as investments, so that their inclusion would raise the general issue of NICs on benefits in kind.

10. On (ii), the case for exempting acquisition of employee shares or share interests is that imposing NICs would conflict with the Government's wider - and employee - share ownership policies. But there are then choices to be made:-

a. between exempting shares and share options under approved employee share schemes only; or going further and extending the exemption to all such employee acquisitions by virtue of their employment;

and b. between exempting share acquisitions only (which in the case of share options means an exemption arising only at exercise), or going further and exempting the grant of share options.

11. Further consideration would need to be given to the practical effects of these different choices. Annex A considers an exemption for employee shares from a policy standpoint, and concludes tentatively that it would be consistent with other policy to limit the exemption to: shares provided under approved schemes where such acquisitions qualify for any of the tax reliefs associated with such schemes; and all grants of share options to employees and all exercises of share options (save where either attracts income tax because the option price was set at a discount to market value at the time of grant). But the position of certain unapproved schemes, where only technical problems prevent them achieving approved status, will need further work.

Scope for Further Avoidance

12. However we define "securities" and "derivative instruments" for this purpose, it will be almost impossible to eliminate avoidance by those who are clever and determined enough. The DHSS regulations may have to be amended further, from time to time, in order to catch up with the latest wheezes.

13. The present proposal addresses the question of preventing NIC avoidance through payments of securities and derivative instruments which have readily realisable value. But there are many other assets which have readily realisable value. Some would probably not be used as a substitute for pay since their market value is highly uncertain. But where there is a recognised market place, with regular trading, such physical assets may be attractive. The most obvious are traded physical commodities. Although the inclusion of securities and derivative instruments would cover commodity options and futures, it would not cover forward contracts for physical delivery. There is a grey area between futures and forwards, but the FS Act says that contracts not made on a recognised investment exchange (which is the case for physical contracts) shall be regarded as being for commercial purposes, and are therefore not futures, if delivery is to be made

within 7 days. So a 7 day forward (ie a "spot") contract would not be liable to NICs.

14. There is an argument for including all commodities now. However, this would raise greater problems of definition and provoke the question as to why we were not including all benefits-in-kind now. If Ministers wish to take early action, and given DHSS' ability to make further amendments to their regulations if evasion appears significant, there is a good case for confining the present action to securities and related derivative instruments.

Valuation

15. Securities and derivative instruments would in general be valued at the greater of cost to the employer or market value at the point of transfer to the employee. This would align NIC treatment with the tax treatment of benefits in kind for directors and for employees earning at least £8,500.

16. But if NICs were applied to securities in approved employee share schemes where shares do not qualify for tax relief, and in unapproved schemes (other than where an option is granted at market value), then the valuation would need to take account of any contribution towards the shares made by the employee.

17. These rules should suffice to give a firm basis of valuation in most cases where a payment in simply translated into gilts or some other commonly traded security. But the Revenue's experience suggests that the valuation of securities is not always straightforward. There might also be questions whether allowance should be made for dealing costs.

Employees NICs

18. The main target of anti-avoidance action would be employers using gilts etc to avoid employers NICs on payments to employees who earn more than the Upper Earnings Limit (£15,860 in 1988-89). However, both employers and employees NICs could still be avoided in respect of employees earning less than the UEL, through salaries being paid partly (or even wholly) in gilts. Moreover,

making the change for employers NICs only would probably require primary legislation. For these reasons, there is a strong case for imposing both employers and employees NICs on securities and derivative instruments.

<u>Administration</u>

19. NICs on gilts etc would be collected by the Inland Revenue as part of their usual collection from employers of Class 1 contributions. That is, the relevant NICs would be due, along with PAYE tax and other Class 1 contributions, on the 19th of the month following the payment. (<u>Tax</u> on gilts is not generally covered by PAYE and is paid after the end of the tax year.)

20. Employers would have to record the amount of gilts etc paid to their employees in their annual returns to the Revenue; this already has to be done for tax purposes. So there should be only a small additional burden on employers, arising from the need to record gilts etc on a weekly or monthly basis for NICs purposes. And <u>this</u> will only arise to the extent that employers continue, despite the new NIC charge, to make payments in gilts etc rather than cash. Additional administration costs for the Revenue and DHSS would be minimal.

21. Policing of the new liability should be fairly straightforward since the value of gilts or other securities at the point of transfer to the employee would merely need to be included in gross pay for NIC assessment purposes. It should be possible to cover this in the normal checking processes carried out by DHSS inspectors. The maximum penalty for evasion would be at point 3 on the Home Office scale of offences, presently set at £400.

22. The main source of additional work for employers and DHSS is likely to arise from applying NICs to unapproved employee share schemes which may well continue despite imposition of NICs. If valuation problems arise, these will need to be sorted out on a case by case basis - possibly after the event with NICs being collected by DHSS administrative action outside the normal NIC system.

Legislation

23. NICs could be imposed on gilts and other securities by changing social security regulations using the negative resolution procedure. The existing provision (regulation 19(1)(d) of the (Contributions) Regulations 1979, made under the Social Security Act 1975) is that:

> "...there shall be excluded from the computation of a person's earnings in respect of any employed earner's employment any payment in so far as it is ...any payment in kind or by way of the provision of board or lodging or of services or other facilities..."

24. DHSS lawyers believe there would be no difficulty in amending this provision to exclude gilts and other securities from the exemption, particularly if these were specified by reference to Schedule 1 of the FSA. (There is, however, a case for self-standing DHSS regulations which would not vary automatically with changes in Schedule 1. This is a point which can be considered further.) Other means of payment could be brought into the net at a later stage, if that were thought necessary. DHSS say that the minimum time taken to prepare the amending Regulations once Ministers had agreed would be about six weeks.

Timetable

25. Ideally, we would want the shortest possible period between announcement of a decision and implementation, in order to minimise forestalling activity by employers. But NIC changes cannot be implemented instantly in the same way as tax changes. There are two constraints:

i. If an instrument is subject to the negative procedure, it should generally be laid, and copies provided to the Joint Committee on Statutory Instruments (or if appropriate, the House of Commons Select Committee on Statutory Instruments) at least 21 days before it is due to come into force. Where there is a compelling reason for an instrument to take effect at shorter notice, an explanation must be provided to the Clerk, or in the Memorandum to the Committee if one is supplied.

ii. DHSS need to consult the Social Security Advisory Committee (SSAC). This can take up to 3 months. But, in this case, DHSS may be able to persuade SSAC that they do not need to consider the regulations. This could reduce the delay to about two weeks. But the SSAC consultation needs to be done <u>before</u> the laying of the order, in case they do decide they need to consider it.

26. These constraints would mean a minimum 5 week gap between announcement and implementation, and possibly longer if the SSAC wanted more than 2 weeks to consider the proposals. However, DHSS are doubtful whether there would, in fact, be much forestalling activity. They say they had little evidence of forestalling last year, when the Trust Fund loophole was closed (and this was announced 8 months before implementation).

27. On this basis, it may be possible to announce a decision at the time of the Finance Bill debates (Second Reading is planned for 25 April), though the detailed regulations would almost certainly not be ready at that stage. The SSAC and negative resolution procedures would follow in May/June, with implementation in June/July.

28. A slower timetable, which would give employers more time to prepare (especially those with computerised payrolls) would involve a Spring/Summer announcement and October implementation. DHSS officials favour this.

29. DHSS would need sufficient time to prepare instructions for their local offices and the necessary guidance to employers. This could be done concurrently with preparation and printing of the necessary Statutory Instrument and need not delay implementation in either of the timescales envisaged above.

<u>Monitoring/Policy Evaluation</u>

30. Further growth in substitution of payments in gilts etc for

cash could cause increased workload for tax districts and delays in receipt of tax (because those forms of payment are not subject to PAYE). The Revenue already plan an exercise later this year to determine the extent of this forming payment and its growth. This exercise will provide some feed back on the impact of any decision to impose NICs.

Conclusions

31. NICs can be imposed on gilts, other securities and derivative instruments by secondary legislation, though there would be a minimum five weeks gap between announcement and implementation unless we decided we could justify a shorter notice period to Parliament than the usual 3 weeks. If Treasury and DHSS Ministers agreed quickly on the scope of the new measure, it may be possible to make an announcement at the time of the Finance Bill debates, though the detailed regulations would probably not be ready until a little later.

32. To restrict switching into other instruments by employers, NICs could be imposed on all marketable securities and derivative instruments as listed in Schedule 1 of the FSA 1986, with the exception of life assurance contracts and shares made available under approved employee share schemes and certain share options, on the basis proposed in paragraph 8 of Annex A.

33. This would mean applying NICs to shares made available to employees:-

a. Under approved schemes where the shares did not qualify for tax relief (eg through early sale)

b. Under unapproved share schemes.

c. Under approved share option schemes where the option was granted at below market value.

But the Revenue wish to give this further thought to this, particularly whether some unapproved schemes should be exempt.

34. The DTI will have to be consulted about the use of the FSA.

35. There is a strong case for imposing both employer and employee NICs and for valuing the securities in the same way as for tax i.e the greater of cost to the employer or the market value at the point of transfer to employees.

HM Treasury/DHSS/Inland Revenue
March 1988

ANNEX A

EXEMPTION FOR EMPLOYEE ACQUISITIONS OF SHARES AND SHARE OPTIONS

Approved Schemes

The tax reliefs associated with approved employee share schemes are aimed at encouraging employee motivation and interest in the prosperity of the business in which they work by providing employees with shares or share options. The legislation deliberately aims to prolong these effects by requiring shares or share options to be retained for specified periods. As such the shares or share options granted are not 'cash equivalents'. It would conflict with the Government's policies in this area to subject the provision of such share interests to NICs.

2. Such a blanket exemption would ignore the possibility, however, that some employers might use such schemes to avoid a NIC charge on shares or share options which, in the event, would be taken or exercised early and so not qualify for any of the tax reliefs associated with such schemes. An exemption for approved schemes would therefore be made conditional on the share interests provided qualifying the recipients for those tax reliefs.

Unapproved Schemes

3. There is, however, an infinite variety of ways or circumstances in which employers may provide employees with shares or rights over shares under unapproved arrangements. These shares when provided free or at a discount are usually liable to income tax on the benefit in the employees hands, the employers concerned having often freely chosen not to use approved schemes and to accept the conditions required of such schemes. In a large number of these cases, therefore, it is very doubtful whether the Government's employee share ownership policies are served (eg as to duration of employees share or share option retention, as to "similar terms" distribution to "all employees", etc). The shares may be 'near cash' equivalents.

4. There are problems however for some companies such as unquoted subsidiaries of unquoted parents which cannot get approved status even if employees have to retain shares for 5 years. In these cases we could consider allowing a NIC exemptions where only the companies' status prevented approval. Although few companies with unapproved arrangements are likely to impose a retention requirement of this kind at present, some might be prepared to do so as the price of NIC exemptions.

5. Any decision to impose NICs on the benefits of most 'unapproved' employee acquisitions of shares or rights over shares should, however, recognise the distinction between, first, acquisition of shares and, second, the acquisition of share options and the subsequent acquisition of shares through their exercise. In the first case, as indicated in paragraph 3 above, the new NIC charge should probably apply in most cases. In the second, however, no tax charge normally arises on the grant of an option, and it would seem inappropriate that a new NIC charge should be applied either. At least where the option price approximates to the shares' market value, no benefit arises at grant.

6. As to exercises of 'unapproved' share options, a choice has to be made between providing for a NIC exemption to apply on the gain then realised or not. Usually the gain will have been uncertain at the time the option was granted, and to require a NIC charge on the total value of the shares acquired on exercise (or preferably on the gain) could be a severe deterrent for employers to the granting of such options in the first place. While the Government may not have acted to support "unapproved" options for employees, it has not sought positively to discourage them. They are simply taxed as emoluments. The optimum approach may therefore be to exempt from the new NIC charge any share option grants or exercises, save where the price of the shares fixed in the option represented a discount on the market value of the shares at the time of grant.

7. Such an approach would not seem to be at odds with certain proposals contained in this year's Finance Bill, aimed at

assisting some kinds of unapproved employee share acquisition arrangements. The anti-avoidance Section 79 FA 1972 provisions are to be replaced, and a relief provided for employee priority in public offers of shares. The first, however, is to take the opportunity of lower tax rates to substitute a less stringent provision. The second provides statutory cover for desisting from taxation in circumstances where raising a charge would in practice be difficult (and where, often, other approved means are also used to encourage employee take-up of shares).

8. We tentatively conclude, therefore, that an exemption from a new NIC charge on securities provided to employees should be made:-

a. for shares and rights over shares provided under approved employee share schemes (but only where the tax reliefs associated with such schemes apply - evasion of the new NIC charge could be encouraged were this stipulation not made, though it might require some complex provision), and

b. for share options granted to and exercised by employees, in cases where the price for the shares fixed in the option was not less than their market value at the time of grant.

9. We would want to consider further the position of shares and rights over shares provided under unapproved arrangements where they cannot qualify for approval because of the company's status (eg an unquoted subsidiary of an unquoted company) but would otherwise qualify for approval.

NOTE OF A MEETING HELD IN ROOM 47/2 AT 3.15pm, WEDNESDAY 30 MARCH

Those present:

Economic Secretary
Mr Scholar
Mr Peretz
Mr Grice
Miss O'Mara
Mr Rich
Mrs Ryding
Mr Barnes
Mr Tyrie
Mr Patterson)
Mr Wilson) DNS
Mr Ward)

Mr George)
Mr Plenderleith) Bank of England
Mr Althaus)

Funding Arithmetic

Mrs Ryding explained that since the funding tables had been circulated for the meeting, later information on the reserves and PWLB lending to local authorities suggested that the under-fund would be lower than indicated in the table by £200 million.

National Savings

Mr Patterson reported that the 1 March cut in the GER had resulted in quite heavy withdrawals from certificates. He was keen to cut rates again on 1 May, but would prefer a cut of half per cent rather than three-quarters of a percent. He agreed that the aim was to lower the rate substantially, but thought this could best be achieved by moving in small steps. DNS would like to advertise the opportunities for reinvestment in certificates, against the background of a further cut in the GER. Mr Peretz said he preferred a cut of three-quarters of a per cent, partly on the grounds that if large outflows were to result, it was better to know earlier in the financial year. The Economic Secretary agreed that a three-quarters of a per cent cut should be announced soon after Easter to be implemented on 1 May.

1988-89 Funding Strategy

Funding Arithmetic

Mr George said the only real difference between the Bank and Treasury numbers was what constituted a neutral assumption for intervention. This was a very uncertain area. As a practical matter, the difference in terms of the monthly funding objective was not vast, and over the next four months or so it would not be too difficult if we were to move too far ahead or to fall a little behind. Mr Peretz added that another large uncertainty was the PSBR which could be in larger surplus than forecast. Also, the proposed new National Savings product might be so successful that it reduced the number of gilts we wanted to sell. But whatever the exact numbers, the message was that gilt sales this year would be substantially below those of previous years.

Mr Patterson explained the difficulties involved in achieving low National Savings figures. Unlike gilts, National Savings could be held for an indefinite period. Interest accrued at a rate of £2 billion a year and this had to be taken into account in the figuring. Also, the emphasis must be on good quality funding; the proposed new product would represent better funding than the Deposit Bond it would probably replace.

On variable rate products, Mr Patterson said that he agreed with the recommendation in Mr Peretz's paper that rates should be kept if anything a shade below the competition, but he was anxious that our position should not be made public through the use of any automatic formula. Mr Peretz said that he was keen that we should be much readier and quicker to move rates, and he thought if we did so it would minimise signalling problems.

On the proposed new taxable fixed rate product, Mr Peretz explained that this had arisen from an exercise to improve the quality of funding. There were problems with existing saving certificates because they were tax free. We had tried to devise a product retaining some of the features of saving certificates, but also some distinguishing features from gilts. In particular, the new certificate would not be marketable. Mr George said that he was happy to look at the proposal with an open mind, but was concerned that marketable products typically sold more cheaply than non-marketable products and the costing would have to be carefully considered. If the Revenue were content for interest to be paid gross on this product, then

It might be difficult to justify not paying interest gross on gilts. Mr Patterson explained that a limit of £100,000 was proposed on the new product and Mr Peretz pointed out that interest was paid gross on gilts held on the NSSR. It was agreed that the proposed fixed rate product should be investigated further, in consultation with the Revenue. Mr Scholar raised the presentational difficulty posed by independent taxation. Mr Patterson commented that this was one reason for withdrawing the Deposit Bond; if there was a need to be more restrictive, the maximum purchase could be reduced to £50,000.

CTDs

Mr George commented that there had been a proposal at one point to investigate ways of making more rapid changes in interest rates on CTDs during the day if there were rapid movements in interbank rates. He would like to explore this option further, but agreed that if rates 1 percent below LIBID were acceptable to CTD users, then that scheme could be shelved. It was agreed that rates should be gradually reduced to one percent below LIBID to assess the reaction.

Guidelines

Mr Peretz explained that this year we had tried to establish guidelines for National Savings. Mr Patterson said that he was broadly happy with these, though as he had explained earlier he was reluctant to make public how rates were set on gross variable products.

Continuing, Mr Peretz explained that the low gross gilt sales target for this year gave an opportunity to smooth future maturities. However, the paper proposed that we should go beyond this to do more extensive restructuring. With gilt sales so low, it did not make sense to frame the guidelines simply in terms of new issues. So instead, the guidelines were expressed as average desired life of the stock outstanding. If we were to put 100 percent weight on our expectations compared with the market's, this would imply buying in all longs and refinancing by sales of shorts. This was not sensible for a variety of reasons. But the tarriff of desired average maturities represented an aspiration we were aiming to achieve over a period of time, and he hoped that each month it would be possible to set a specific target for progress in the desired direction.

Mr George said that he was sympathetic to the notion of minimising the cost of funding and of taking some account of our view compared with the market's. However, He differed on the matter of degree. He thought there were considerable difficulties with the proposal at the level of detail. He thought that the guidelines were unworkable in terms of the scale of buying-in that would be necessary as yields changed. The aim should be to fund long when yields were low and to fund short when yields were high. The guidelines as expressed did not allow for the proper exercise of judgement. He objected to the rigidity of the guidelines, not the general principle. Mr Althaus added that buying in of substantial quantities of debt was not easy. It would quickly become apparent to the market, with widespread consequences. Mr Plenderleith added that a policy of restructuring was bound to affect the slope of the yield curve. When the market was weak, the Bank would naturally try to pick up stock in the desired maturities. But it was a very different matter to say that they should do a certain amount each month, irrespective of market conditions. This would produce substantial volatility and disruption in the market.

It was agreed that officials should discuss separately further detailed points on the guidelines, and also the issues raised by the Bank in their paper. Mr Peretz would report back to the next funding meeting.

Target in April

£400 million of sales were already tied up for next month and if the £400 million of tranchettes announced that day were sold, that would bring the total to £800 million for the month. If market opportunities arose, the Bank should try to buy in anything up to £½ billion of longer maturities at yields of over $9^1/_8$%.

Auctions

Mr George explained that he would like to announce two auctions of up to £1 billion each (but with the expectation that they would be nearer £¾ billion): one for a short and one for a medium or long. The first auction would take place in July/August and the second January/February. At this stage he did not want to announce which would be the short and which the medium/long, but in return was prepared to give the market at least one month's notice of the precise date and type of stock and seven days notice of the precise details when "when issued" trading would begin. There was some discussion of whether the way should be left open to have two "short" aunctions instead, but it was agreed that if appropriate

The second auction could be for a "short" medium. It was agreed that a draft statement would be cleared with Economic Secretary after his return to the office, to be issued in the week beginning 11 April.

Cathy Ryding

CATHY RYDING

circulation: Those present

PPS

Sir P Middleton
Sir T Burns
Sir G Littler
Professor Griffiths - No 10.

PAPER 4

CERTIFICATES OF TAX DEPOSIT

This note sets out the conclusions of the last review of the CTD scheme in November 1986; reports on experience since then and discusses possible adaptations of the scheme.

The Last Review

Mr Barnes' note of 17 November 1986 records the following decisions.

a. There should be no sharp change in the stock of CTDs in fragile pre-election markets.

b. Nor should there be any change to the CTD prospectus although there were attractions in setting a minimum holding period for CTDs used to pay certain types of tax, in dealing with large amounts through the Bank's dealing room and in changing the rates paid on large amounts more quickly.

c. Experimental reductions should be made in the interest rates to below the level of LIBID + 1/8 per cent, to observe the effect on the stock of CTDs and on funding.

3. It was agreed that CTDs served a useful function for taxpayers and for emergency funding. The extent and reliability of their use in routine funding and in smoothing out seasonal variations in money market assistance was less clear. The Treasury and the Bank disagreed over their cost-effectiveness.

4. Subsequently, the review of funding policy in 1987 suggested that in principle a maturity-based funding rule would have a number of advantages over a sectoral-based rule. But it was decided as an initial change to move to an M4-based rule, while this more radical option was investigated further. This change was announced at the time of the 1988 Budget.

Experience since November 1986

5. The stock of CTDs stood at £4365 million in November 1986. As Chart 1 shows, it fell to £3074 million in June 1987 and rose only to £3484 million in October. Since then it has fallen back, to £2915 million in March 1988. This contrasts with the pattern in 1986, where the fall in and around January to meet tax demands was fully made up by deposits later in the year so that CTDs returned to much the same upward path that they had followed in 1985.

6. Chart 2 helps to explain this. Whereas the differential with LIBID was often positive in 1986, it was very rarely so in 1987.

7. Chart 3 shows the relationship between CTD sales and the differential with LIBID for the period between 1 April and 30 October 1987. (This covers most of the experimental period when rates were set below LIBID, excluding the months at the start of 1987 when sales were deliberately deterred.) On 16 days out of 148, rates offered equalled or exceeded LIBID. (Because a day's notice is required for any change to CTD rates, sharp falls in LIBID can sometimes reverse the normally unfavourable interest rate differential.) These 16 days account for 47 per cent of sales over the period (and more

than account for the increase in the stock between April and October). This inflow probably represents round-tripping by corporate treasurers, which will have resulted in especially expensive funding and an expansion in the monetary aggregates.

Discussion

8. The relative cost and quality of funding provided by CTDs are the crucial questions. CTDs provide low quality funding:

a. They are held for less than a year.

b. The CTD rates for holdings of less than three months' duration has often been over a point lower than other rates. But withdrawals after three months to pay a tax liability incur a very small interest penalty (of about ¼ to ½ per cent) compared with holding the CTD for longer.

c. Companies may hold several certificates and can therefore juggle the holdings to retain some flexibility on withdrawals.

d. As Chart 4 shows, withdrawals are made in each quarter of the financial year.

e. But the largest and most unpredictable withdrawals occur in January, just when calculations for a full fund demand most precision.

CTDs are therefore a short term and unreliable funding instrument.

9. Neither do CTDs provide the Government with especially cheap funding. Chart 5A shows the differential between CTD rates at 3 to 6 months and the discount on the weekly Treasury Bill (TB) tender [1]. (The 1 to 3 month CTD rate has at times been kept deliberately uncompetitive and is therefore, not an appropriate comparator). Chart 5B shows the differential between CTD rates and redemption yields for two gilts with a year or less to maturity, which might serve as a crude alternative proxy for the cost of funds to the Government. The chart shows that although CTD rates were normally less than LIBID, they were higher than the discount on TBs and the yield on gilts with a year or less to maturity.

10. From the point of view of CTD holders, CTDs do appear to be reasonably competitive with other short term investments. Their rates have compared well with sterling certificates of deposit over the period April to October 1987 (Chart 6A). And on the whole, CTD rates are slightly higher than three month prime bank bills (Chart 6B).

Conclusion

11. Given the low quality and relatively high cost of CTDs, there are three alternative courses for action.

a. Wind the scheme up altogether.

b. Raise the quality of funding to match the cost.

c. Reduce the cost of funding to match the quality.

---

(1) Charts 5A, 6A and 6B are published rates, source Financial Statistics but are adjusted from compound to 'flat' rates so that they are comparable with CTDs.

12. The CTD scheme cannot be wound up altogether until the pay-and file scheme is adopted for tax payments. It is hard to see how to raise the quality of what is inevitably a short term instrument, so the second course also looks difficult.

13. It is recommended instead that CTD rates are further reduced below LIBID so that their cost fully reflects both the poor quality of funding which they represent, the alternative returns to CTD holders and other more competitive short-term funding options open to Government. A further fall in the stock of CTDs may result in 1988-89, (of perhaps £1 billion - around 1/3 of the existing stock) which should cause little difficulty for the funding position.

14. Even this may not resolve the problem identified in Paragraph 7, when market rates fall rapidly to a point where round-tripping by corporate treasurers into CTDs becomes an attractive proposition. This is tantamount to the Government financing itself by bank borrowing, with corporate treasurers acting as intermediaries. The problem arises because of the day's delay in setting CTD rates. If we can agree normally to keep a gap of around 1% below LIBID there would be little risk of this. But too low rates might cause complaints from CTD users. If we concluded the gap should be less than this it is recommended that we now consider amending the prospectus along the lines suggested at the last review, to require large deposits to be handled through the Bank's dealing room allowing the rates paid on large amounts to be changed more quickly.

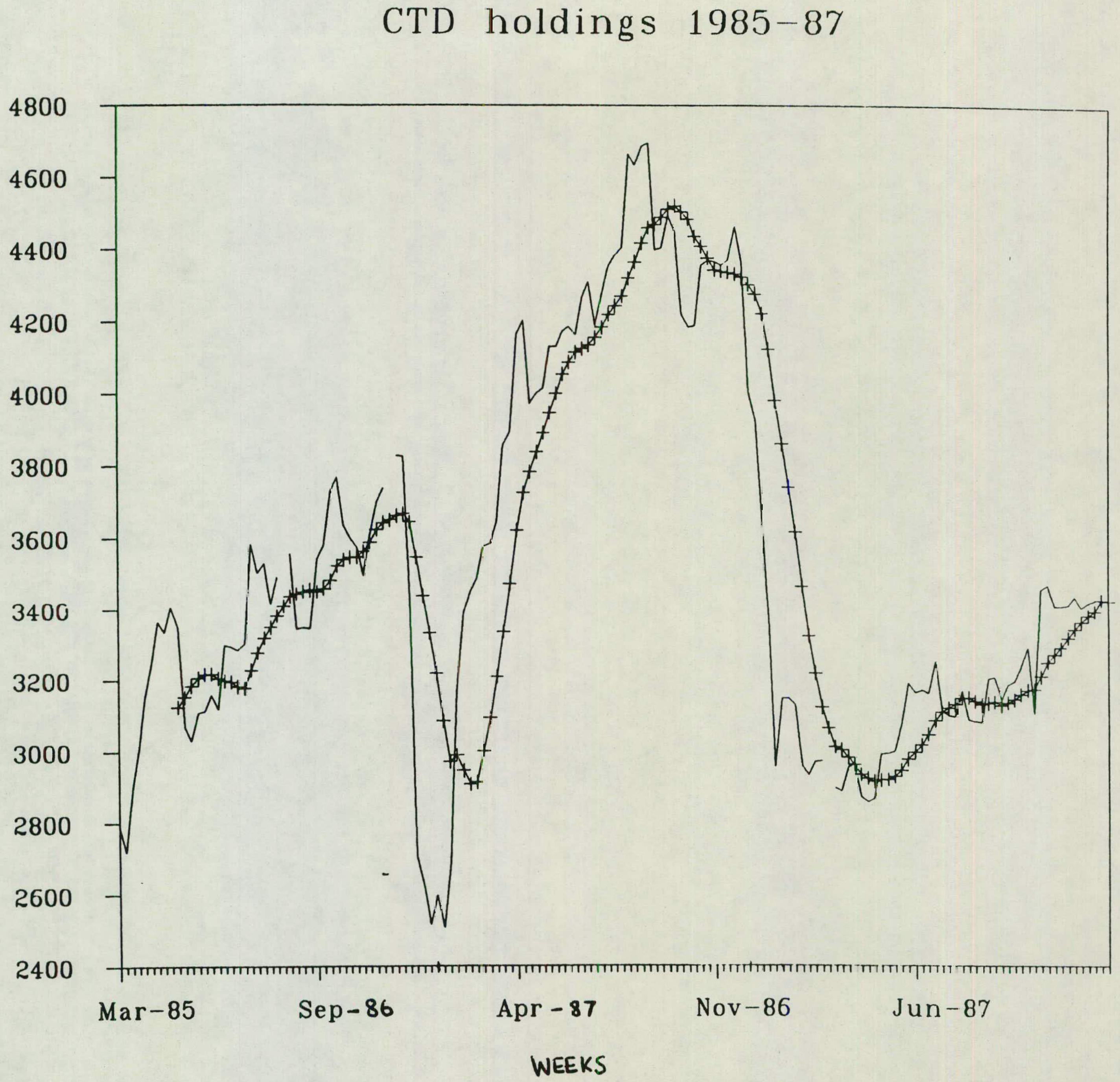

CTD holdings 1985-87
4800
4600
4400
4200
4000
3800
3600
3400
3200
3000
2800
2600
2400
Mar-85
Sep-86
Apr-87
Nov-86
Jun-87
WEEKS

CHART 1

CTD differential 1985–87

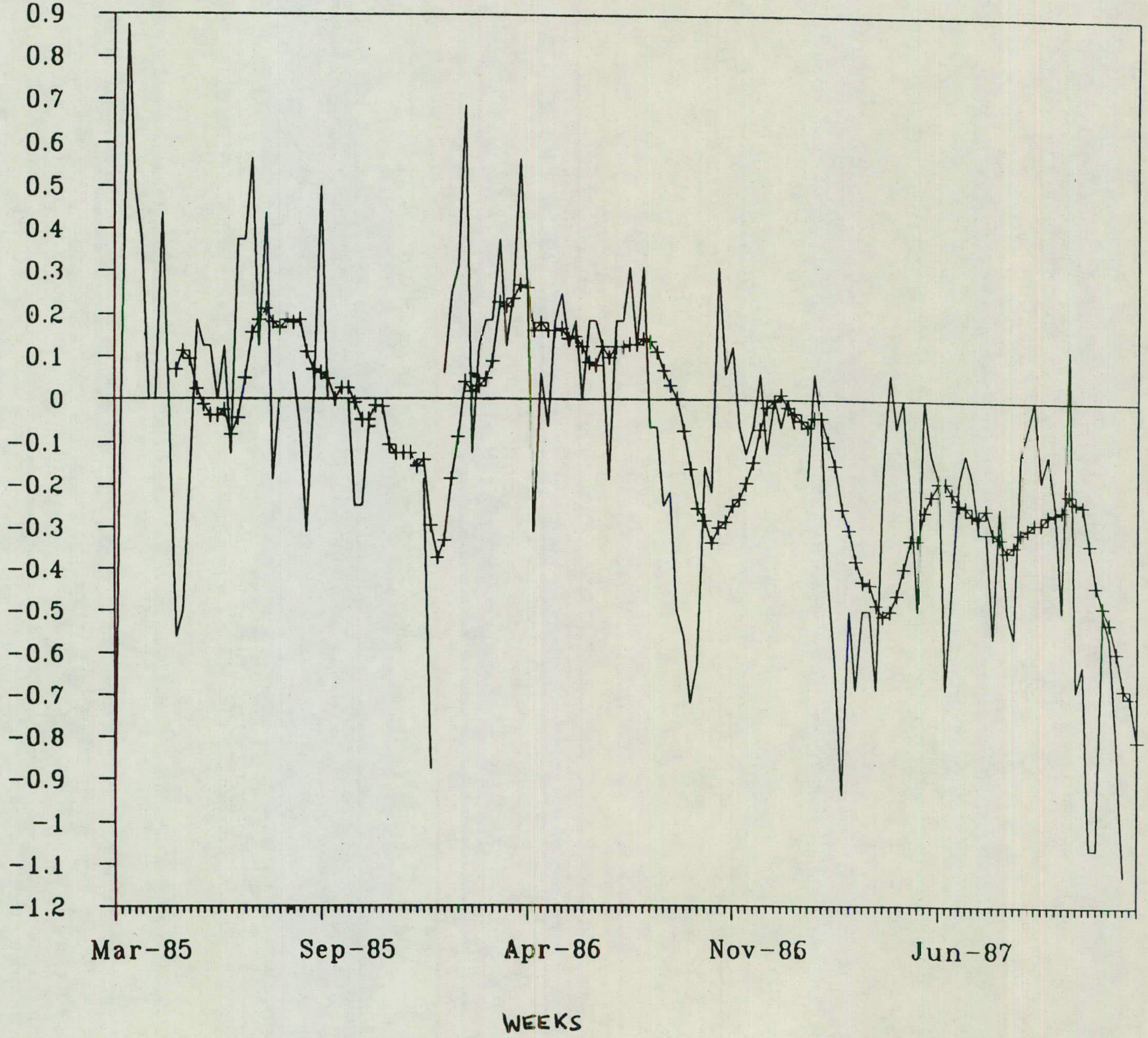


CHART 2

CTD daily sales

vs 12 month differential, logged

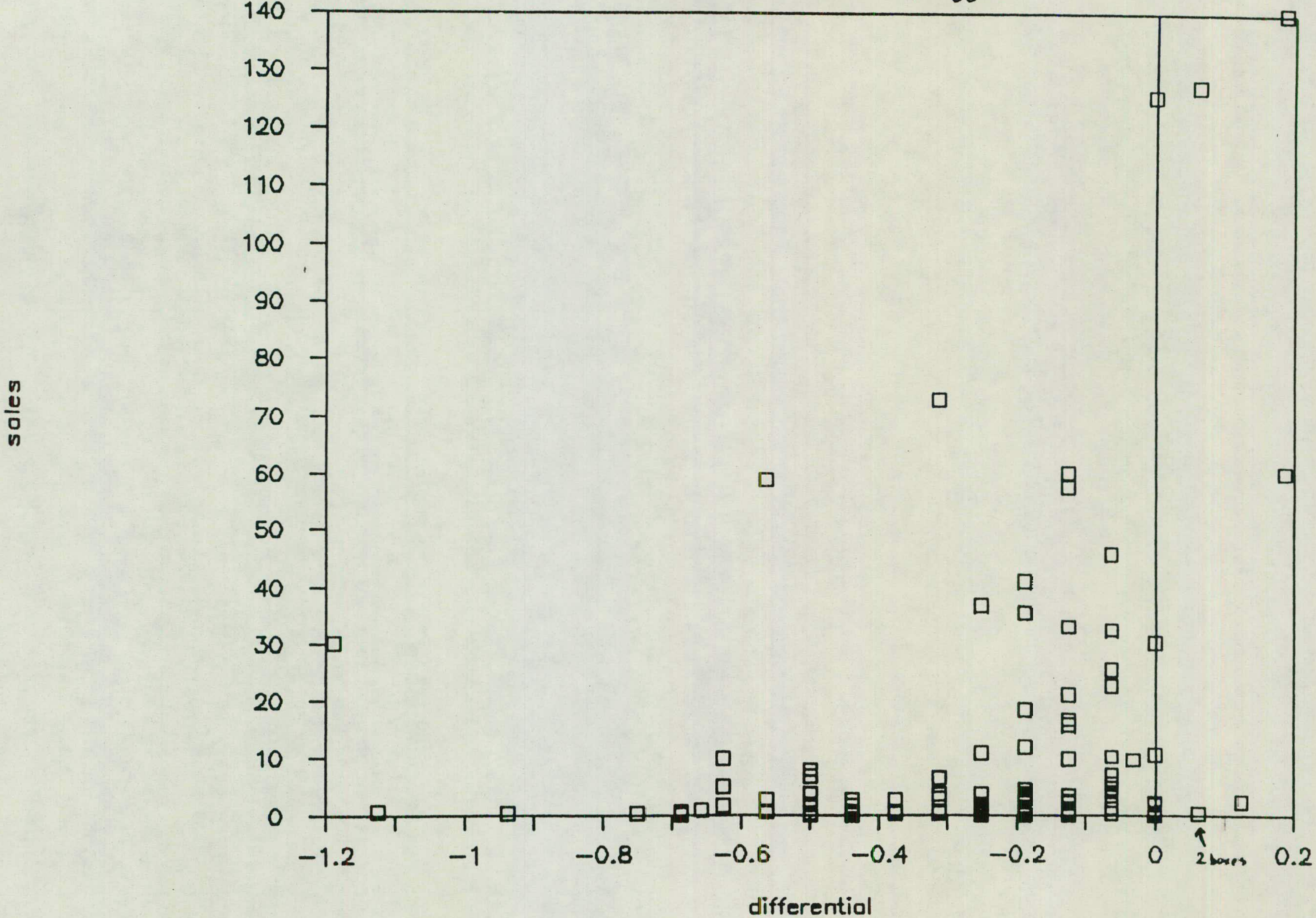


CHART 3

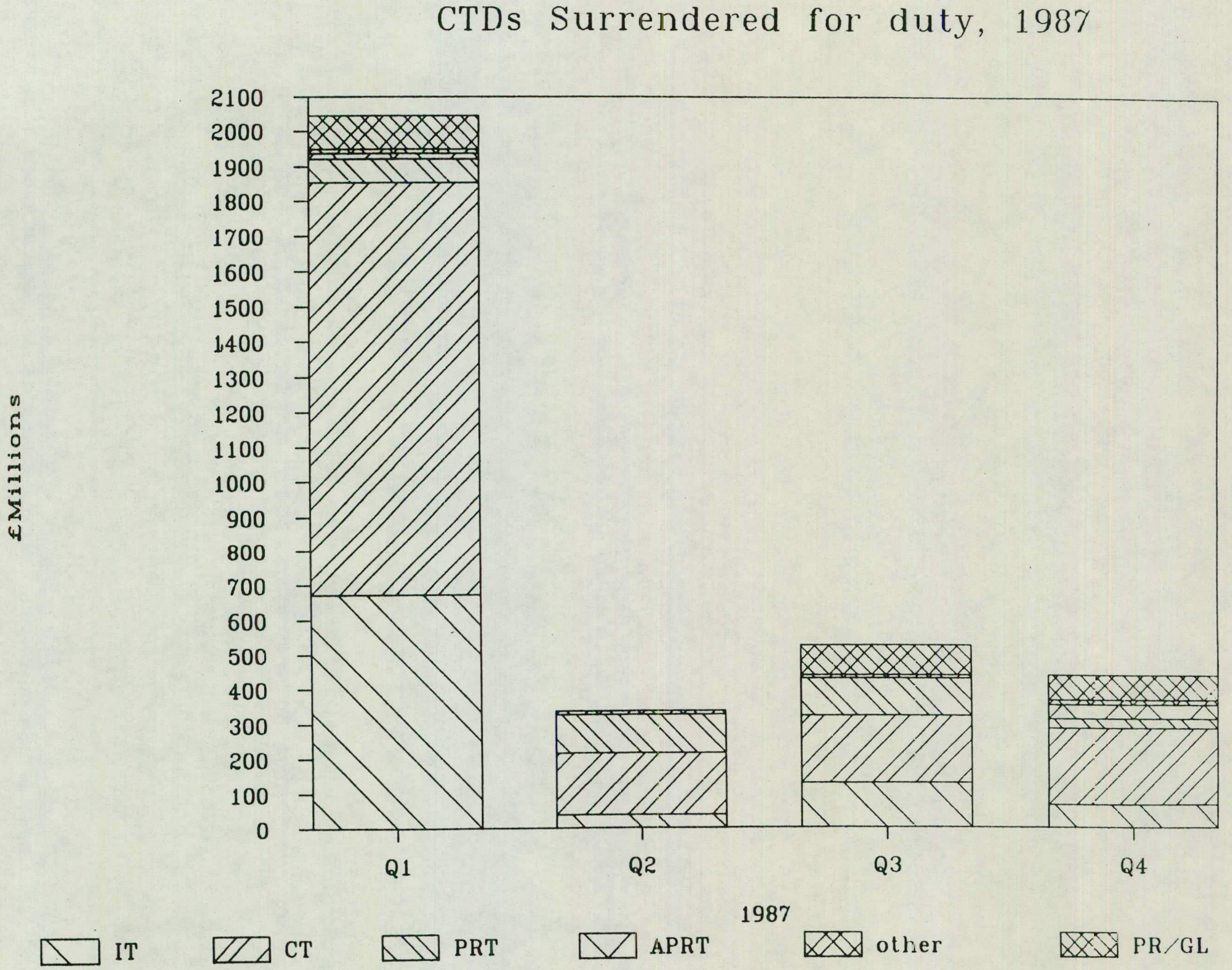

CTDs Surrendered for duty, 1987
£Millions
2100
2000
1900
1800
1700
1600
1500
1400
1300
1200
1100
1000
900
800
700
600
500
400
300
200
100
0
Q1
Q2
Q3
Q4
1987
IT
CT
PRT
APRT
other
PR/GL

CHART 4

CTD rates minus Treasury bill rates

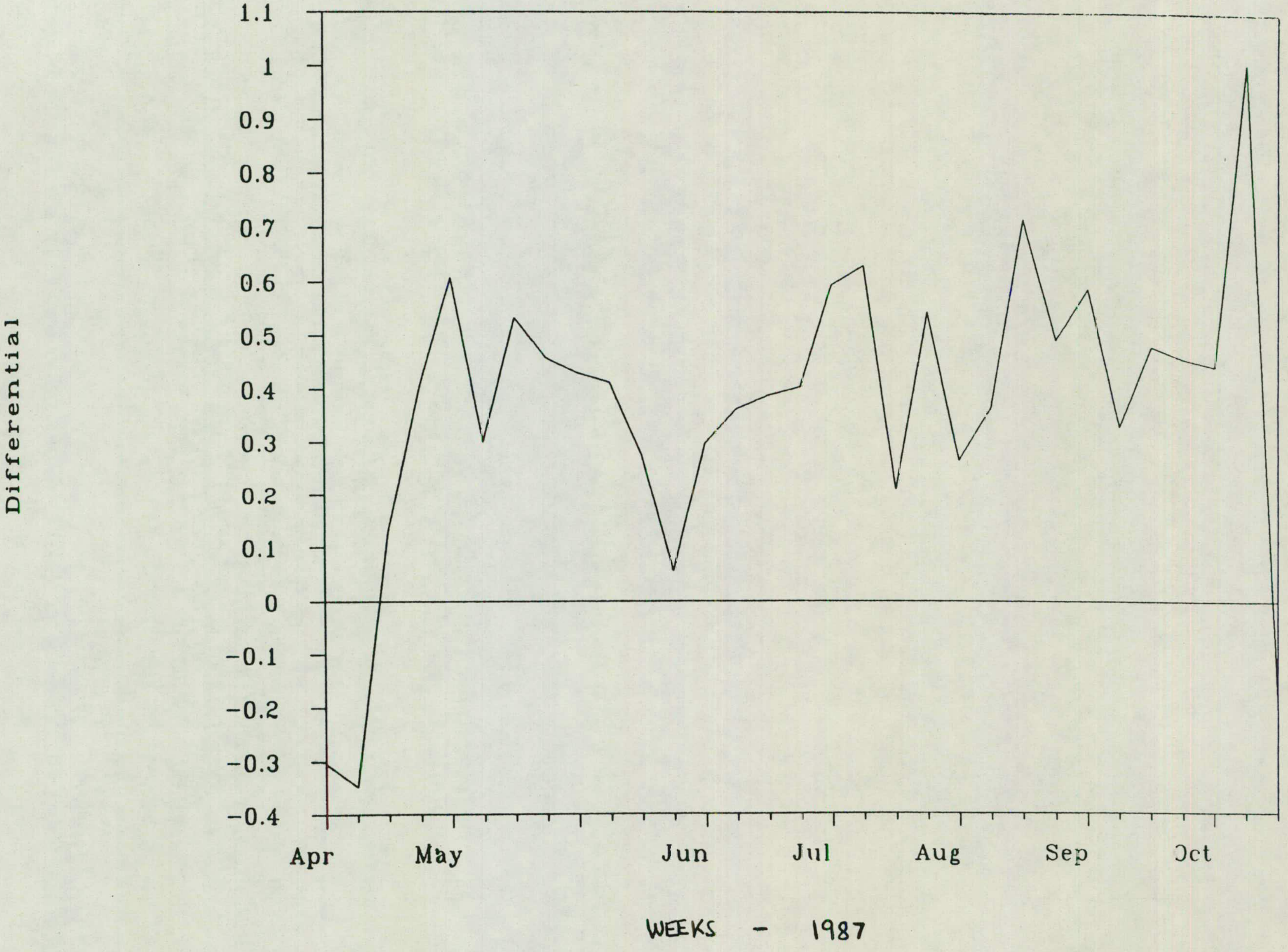


CHART 5A

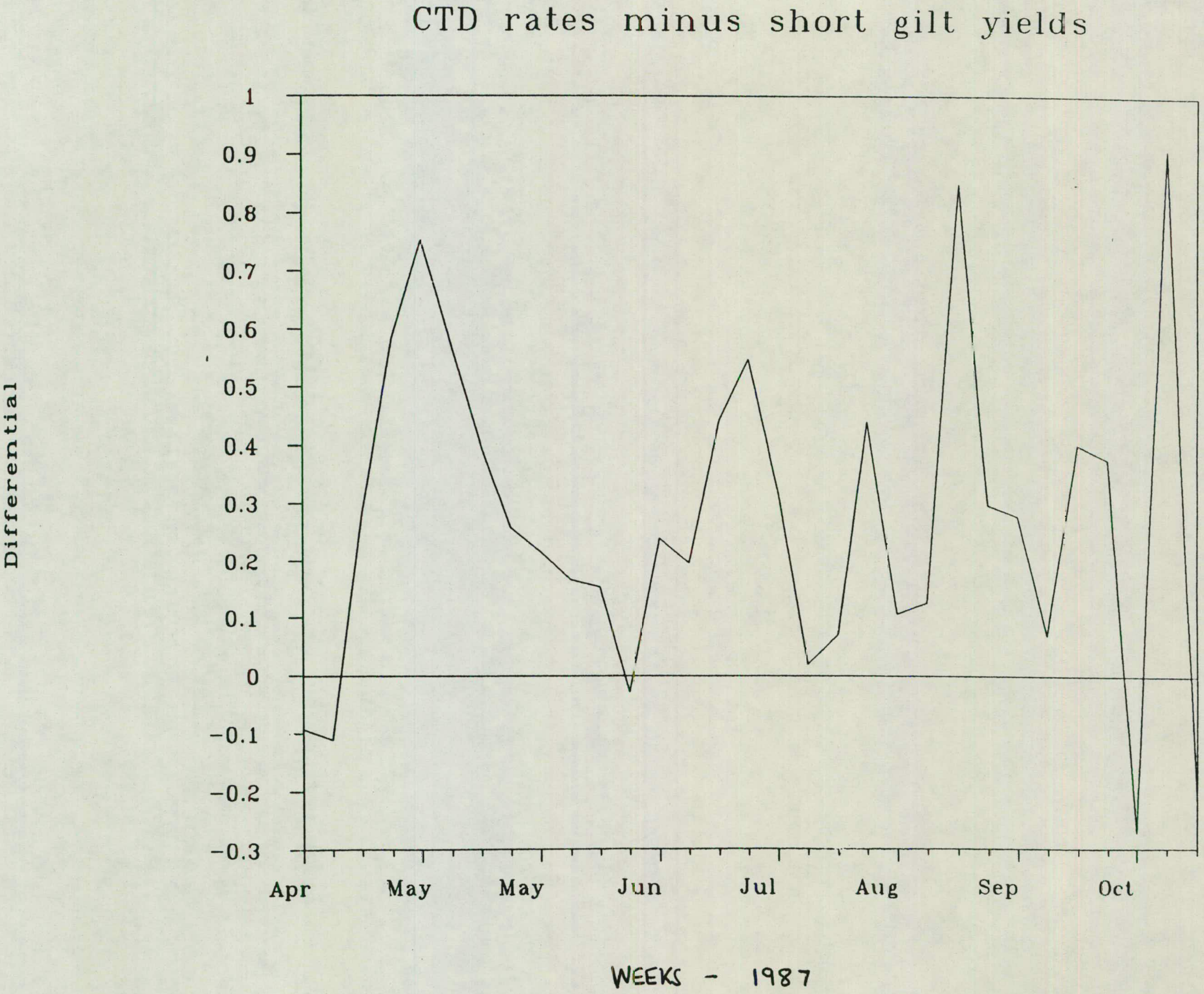

CTD rates minus short gilt yields
Differential
1
0.9
0.8
0.7
0.6
0.5
0.4
0.3
0.2
0.1
0
-0.1
-0.2
-0.3
Apr
May
May
Jun
Jul
Aug
Sep
Oct
WEEKS - 1987

CHART 5B

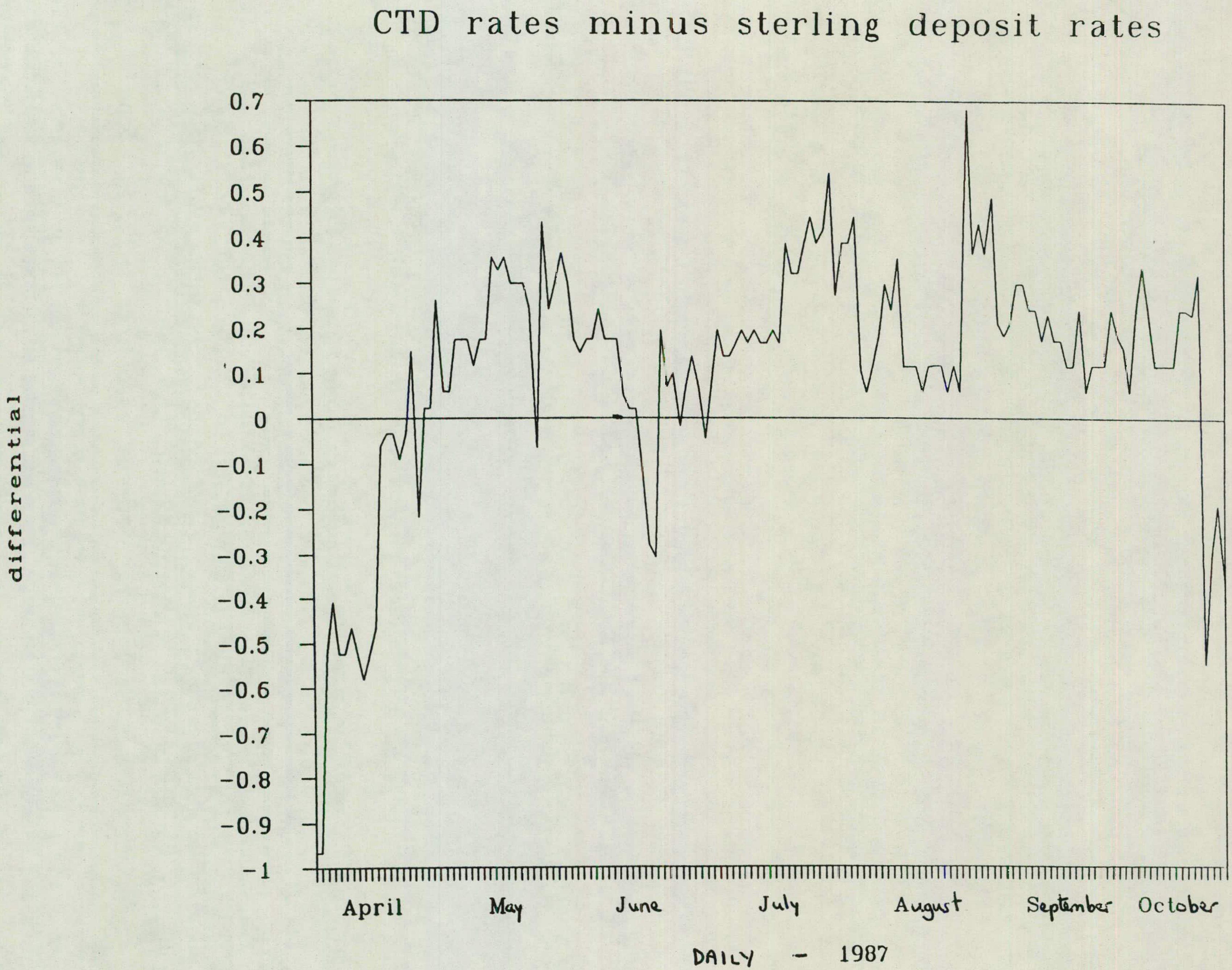

CTD rates minus sterling deposit rates
differential
0.7
0.6
0.5
0.4
0.3
0.2
0.1
0
-0.1
-0.2
-0.3
-0.4
-0.5
-0.6
-0.7
-0.8
-0.9
-1
April
May
June
July
August
September
October
DAILY - 1987

CHART 6A

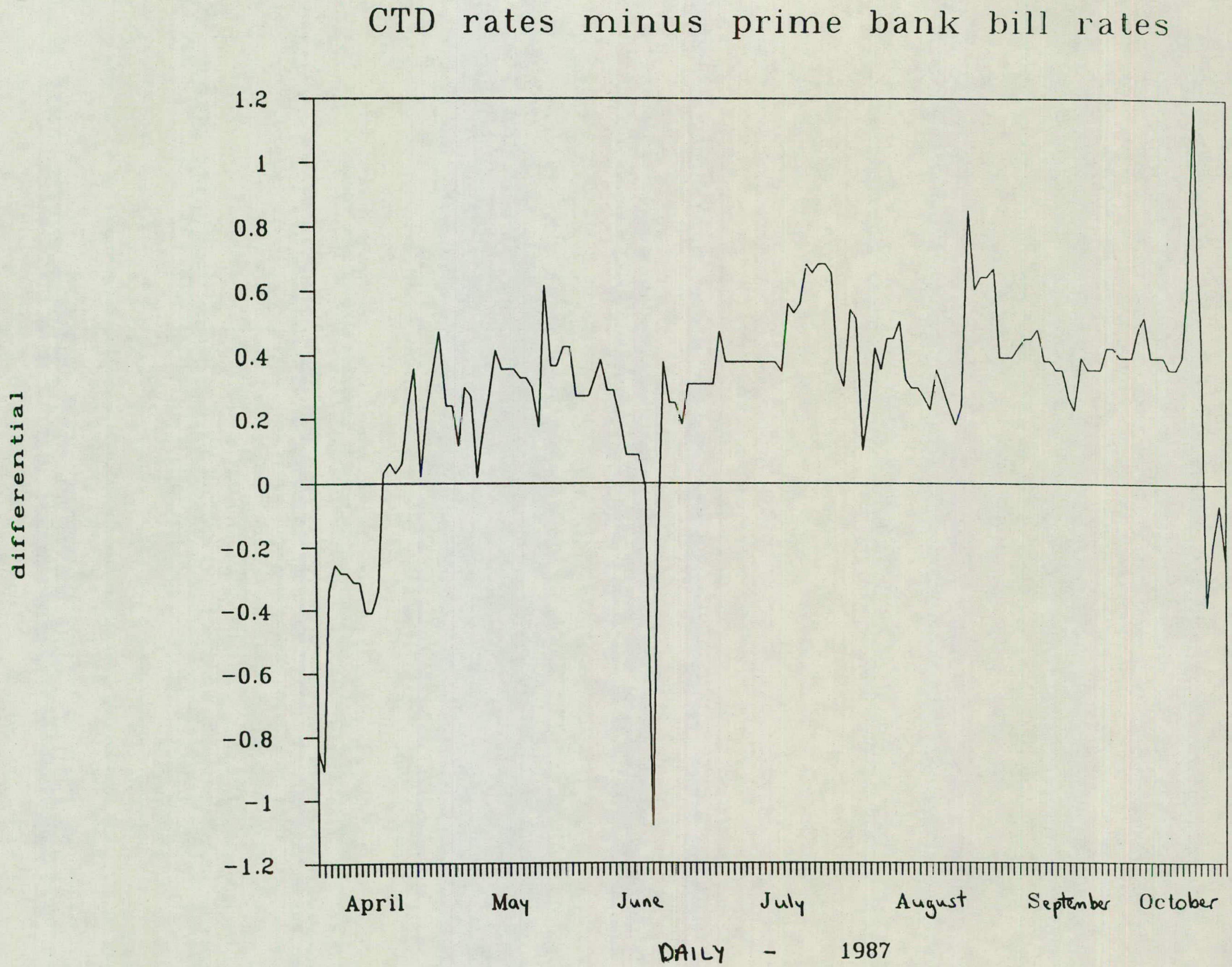

CTD rates minus prime bank bill rates
1.2
1
0.8
0.6
0.4
0.2
0
-0.2
-0.4
-0.6
-0.8
-1
-1.2
differential
April
May
June
July
August
September
October
DAILY - 1987

CHART 6B

THE EFFECTS OF NEGLIGBLE GROSS SALES ON THE GILTS MARKET

If it materialises, the gilt sales requirement projected in the accompanying paper would have significant consequences for the gilts market. 1988-89 would see negligible sales after a period of some years when the authorities have made gross sales of about £1 billion on average a month. There would be important implications for both the market makers and for the habitual firm holders of gilts. These are discussed in turn.

2. <u>Effects on the Markets and the Market Makers</u>: The continued viability of the gilts market is clearly an important consideration for public policy and will remain so for many years to come. Even if the Government continuously balances its Budget, there would be a constant need to re-finance the £130 billion of dated gilts outstanding, as they are successively redeemed. Moreover, minimising the cost of servicing the public debt also entails a liquid gilts market. Buyers and sellers need to be able to find respective counterparties quickly and easily at reasonable or "effective" prices. Other things being equal, investors will be unwilling to hold gilts - or demand a higher reward for doing so - if they perceive difficulty in trading them at effective prices. This applies particularly to investors who hold gilts for liquidity purposes (such as banks and building societies) but also longer term investors such as pension funds and insurance companies for whom comparative performance is important.

3. Gilt Edged Market Makers, or GEMMs, play a crucial role in enhancing the liquidity of the market by offering effective two way prices in all stocks. Inter Dealer Brokers, or IDBs, further help the process by enabling GEMMs to deal with one another anonymously. There are already, in many people's view, too many GEMMs for the size and turnover of the gilt market. New issues form a significant part of a GEMMs activity and a reduction in new gilt sales to zero must have a detrimental effect on the financial viability of GEMMs. Some GEMMs will almost certainly pull out of the gilts market, although how many and how fast is difficult to predict. There will probably be an adverse effect on the

difficult to predict. There will probably be an adverse effect on the profitability of the remainder. Some reduction in numbers would not be a disaster but the authorities have an interest in ensuring that sufficient GEMMs remain, devoting sufficient resources to this activity, to ensure an efficient and liquid gilts market for future sales. So far as IDBs are concerned, one has already pulled out of the gilts market. As with GEMMs, there are more IDBs than are thought to be sustainable in the long run but again the authorities have an interest in ensuring that any reduction is controlled.

4. Overall, the market mechanism can probably survive a period of negligible funding even if some thinning of the present market population takes place. New issues activites are not the only source of business for market makers. But the absence of such business would obviously increase the pressures towards a reduced market making capacity. To that extent, there could be advantage if other forms of business became available. In part, this may happen automatically if, for example, companies continue to issue fixed interest debt in sizeable volume. If we did decide to undertake some debt restructuring this would, in addition, be likely to have a beneficial effect on market making capacity.

5. Effects on End-holders: Whereas gross sales are the important consideration for the market makers, it is net sales which are more relevant to the ultimate investors. When a holder has an existing gilt in his portfolio which is redeemed, he needs to purchase a new one just to maintain his holding unchanged. The expected changes in net gilt sales in 1988-89 compared to the current year is no less striking - in fact slightly more so - than in the case of gross sales. On the figures in Paper 1, shows, at -£6¼ billion, net sales in 1988-89 would represent a reduction of £13¼ billion from the net sales which are likely to be achieved this year.

6. Even with net gilt sales averaging around £8 billion a year, as has been the case in the 1980s to date, the proportion of private sector wealth hed in the form of gilts has been declining. Financial

assets generally have been growing at a faster pace than the net gilts stock. This can be seen by reference to the portfolio proportions of the life assurance companies and pension funds, the main institutional holders of gilts.

Table 1: Portfolio Share of Life Assurance and Pension Funds

End Year, Per Cent

	Public Debt	UK Company Secturities Ordinary Shares	UK Company Secturities Other**	Overseas Assets	Other*
1977	24.4	36.9	5.3	3.5	29.9
1982	25.0	37.2	2.3	9.8	25.7
1985	20.1	45.3	2.2	12.9	19.5
1986	17.4	47.8	2.2	14.5	18.1
1987***	17.1	49.7	2.6	11.5	19.0

* Principally land, property, loans, mortgages and cash
** Mainly debentures and loan stock
*** Projected

7. Table 1 shows that with net issues of £4.6 billion in calendar 1987, there was a further slight decline in the public debt proportion of portfolios. The pressures are likely to intensify next year and (probably) for a while thereafter. These pressures could be resolved in several ways:

(a) there could be lower inflows into institutional portfolios. Personal sector savings have certainly been falling recently. But there are prolonged lags before these effects are felt in life assurance and pension funds contributions. It seems unlikely that there will be a significant reduction in inflows in the next few years;

(b) the pressures would also be relieved if there were a further decline in equity prices. Falling prices would automatically tend to raise the gilts proportions of the portfolios. Given a large enough fall in equity prices, the gilts proportion could remain high enough for fund managers to be content with it. The fact that there were no gilts to buy would not then matter since, equally, there would be no demand;

(c) if neither (a) nor (b) occurs, then fund managers will have to decide which other asset category to expand to offset the diminishing proportion of their portfolios held in gilts. One possibility is that there could be increased holdings of corporate fixed interest debt. There was a substantial increase in corporate debt issues in 1987: some £3.7 billion were raised. Table 3 shows that increased holdings of corporate debt did in fact offset the reduction in public debt proportions in 1987. Alternatively, overseas borrowers could return in volume to the sterling market and there have been some signs of this happening. It is more doubtful, however, whether company or overseas issues could expand sufficiently to offset the substantial reduction in net gilts projected for the next financial years. This would certainly be the case if, as we expect, yields fall only modestly, if at all. On the other hand, if the gilts famine produces a sharp reduction in yields as investors bid aggressively for those available, the chances of a countervailing increase in corporate and foreign issues would be increased;

(d) in the past, fund managers might have been inclined to increase their UK equity holdings as the gilts proportion fell. In current circumstances this seems less likely. Despite the equity market correction in the autumn, by the end of 1987, funds still held an historically high proportion of the portfolios in UK equities - nearly a half. Chastened by the experience of the autumn, it is hard to see managers further building up equity holdings aggressively. Perhaps a more likely outcome is that funds will increase their overseas assets. Overseas bonds in particular may be a reasonably good substitute for gilts. Whether transactions of this kind would affect the exchange rate or not depends upon whether funds chose to cover their consequent foreign currency exposure. To the extent that they did so, there would be no effect on the exchange rate.

SECRET

PG

From : D L C Peretz
Date : 30 March 1988

ECONOMIC SECRETARY

cc Chancellor
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Scholar
Miss O'Mara
Mrs Ryding
Mr Cropper

a
This was done.
AA

NEW GILT TRANCHETTES

The gilt market is quite strong today : particularly IGs and other stocks benefitting from reinvestment demand from 1988 IG redemption monies.

2. The Bank would therefore like to announce the following two tranchettes this afternoon, to come on sale tomorrow (any sales tomorrow would count as funding for April, ie next financial year, not March) :

i) £250 million of index-linked Treasury 2% 1992.

ii) £150 million of 8% Treasury 1991.

At the same time the Bank would want to issue £150 million of 9% 2000 and £150 million of 8½% 2007 for NILO.

3. The IG is unlikely to be attractive to foreign investors. And the 8% 1991 is <u>not</u> FOTRA, and also chosen so as not to be attractive to foreign investors.

4. Both are the kind of stocks we want to issue at current yields (if necessary buying in long conventionals to keep the funding total down to what is required). If they are both sold in April it will bring the month's funding total to around £800 million (around £400 million is already tied up from the call from the last gilt tender). This would be rather above the average monthly striking rate needed for next year, as we see it

at present. But there will be some carry over of intervention from 1987-88 to fund, and there is something to be said for funding that sooner rather than later. So I recommend we go ahead this afternoon with this package.

DLP

D L C PERETZ

53/2/LPD/3761/039

SECRET

Alex - other pp? ... up

FROM: P D P BARNES
DATE: 30 March 1988

PMP

MR PERETZ

cc PS/Chancellor
Sir P Middleton
Sir T Burns
Sir C Littler
Mr Scholar
Miss O'Mara
Mrs Ryding
Mr Tyrie

NEW GILT TRANCHETTES

You discussed the substance of your submission of 30 March with the Economic Secretary this morning.

2. The Economic Secretary told you that he was content for the Bank to announce the new tranchettes mentioned in the second paragraph of your submission.

PB

P D P BARNES
Private Secretary