S41/1

copy to indexation dossier ✓

Copy held in Indexation Dossier

NOTE OF A MEETING HELD IN THE CHANCELLOR OF THE EXCHEQUER'S ROOM, HM TREASURY ON THURSDAY, 17 JULY AT 9.30 A.M.

Present:

Chancellor of the Exchequer
Chief Secretary
Financial Secretary
Sir Douglas Wass
Mr. Burns
Sir Kenneth Couzens
Sir Anthony Rawlinson
Mr. Ryrie
Mr. Middleton
Mr. Byatt
Mr. Bridgeman
Mr. Britton
Mr. Lavelle
Mr. Riley
Mr. M.L. Williams
Mr. Ridley

Governor of the Bank of England
Deputy Governor
Mr. A.D. Loehnis) Bank of England
Mr. E.A.J. George) Bank of England
Mr. C.A.E. Goodhart) Bank of England
Mr. J.S. Flemming) Bank of England
Mr. A.H. Dalton) Inland Revenue
Mr. J. Gracey) Inland Revenue
Mr. J. Hibbert - CSO

INDEX-LINKED GILTS

The discussion focussed on the papers submitted by Mr. Middleton to the Financial Secretary on 2 May; on the note of the Financial Secretary's meeting on 21 May; on the Financial Secretary's minute to the Chancellor of 30 June; and on Sir Kenneth Couzens' minute to the Chancellor of 15 July.

2. The Chancellor, opening the discussion, regretted the shortage of time available for this first discussion. His first instinct was that the burden of proof rested on those who wanted to issue index-linked gilts. The Financial Secretary, responding to the Chancellor's invitation, suggested that the arguments in Sir Kenneth Couzens' note did not overturn the conclusions of the Wass report about Indexation. That report had indicated that indexed gilts could be useful and helpful at the right time; and we had no answer to the question why we continued to issue very high coupon stocks in increasingly enormous amounts. While sales

DG 22/7 23

of conventional gilts were going well, and inflation was expected to decline, there was no reason why the issue of IGs should be seen as a panic move. The Financial Secretary accepted Mrs. Lomax's conclusion that the issue of IGs would not have any very substantial impact on the exchange rate. Even if there were some relatively small upward impact on the exchange rate, the Financial Secretary noted that it was not Government policy to reduce the exchange rate, and that any likely appreciation would be of little significance in relation to the other advantages of IGs.

3. Mr. Byatt saw the advantage of IGs as deriving from the contribution they would make to improving monetary control. Better control would mean that interest rates could be lower for a given money supply, and this would help industry. The Financial Secretary suggested that IGs would bring closer the rebirth of the industrial debenture market, although he agreed that the issue of IGs would make it harder for companies to borrow through the issue of new equity.

4. Sir Douglas Wass thought the disadvantages of IGs outweighed the advantages. £4 billion a year of IGs would be too large an amount, although we might contemplate some additional issues of "granny bonds" (but even this would have the disadvantage of making life more difficult for the building societies). The advantages of easier monetary control were doubtful and unquantifiable; but the damage to the equity market was clear. Nor was Sir Douglas Wass sure that interest rates would be lower with IGs; they were a closer substitute for equities and debt than for money, and the possibility could not be excluded that they would tend to drive up the rate of interest on fixed interest stocks.

5. In further discussion it was suggested that interest rates could be expected to fall, although not by much, particularly if the issue of IGs stimulated capital inflows. The only

circumstances in which interest rates might be pushed up would be if the adverse expectational effects arising from the issue outweighed the direct market effects of a contraction in the supply of fixed interest stocks. Mr. Bridgeman thought that interest rates on balance would fall by a small amount, but that the advantage to companies would be far outweighed by the damage to the equity market. Any effect on the exchange rate seemed likely to hurt industry, and there was little prospect of the reduction in interest rates arising from the issue of IGs being large enough to re-open the market for new company debentures.

6. The Chancellor asked whether the objections to the issue of IGs would be as compelling if they were restricted to small amounts on an avowedly experimental basis. It was noted that the difficulty with such an experiment was that it would not be possible to establish a genuine market; there would be very great competition for the limited amount of IGs available, and the authorities would be none the wiser about the longer run desirability or otherwise of IGs.

7. The Deputy Governor said he was pre-disposed to favour IGs; they offered some prospect of an improvement in monetary control, they could help market expectations, and they should reduce the costs of funding the PSBR. He was rather cautious about the prospects for continuing very substantial sales of conventional debt, and was particularly attracted by the extension of "granny bonds". If IGs were to be issued, plainly this should be done when the authorities did not particularly need to rely on them. Mr. McMahon doubted whether the cost saving from IGs on any assumptions was likely to turn out to be very large; the decision whether or not to go ahead would turn to a large extent on judgements about their effect on expectations. The difficulty was that if the expectational effects were "good", there was a risk of very substantial inflows particularly from OPEC, and this could push the exchange rate up quite a long way. If, subsequently, the expectations turned out to have been right, and inflation fell

rapidly, then the effect on the exchange rate might be still greater. Mr. McMahon suggested that more consideration should be given to the possibility of achieving some of the desired improvement in monetary control through the issue of non-marketable securities which would not attract inflows.

8. Mr. Middleton urged that a clear view be reached about IGs before further discussion of non-marketables; the study had been directed at IGs, and not at other debt instruments. Even if we were to extend granny bonds, it would still be necessary for the authorities to sell a very large volume of gilts. Mr. Byatt questioned how important any adverse impact on the equity market was likely to be; and if the exchange rate were to be pushed up, the disadvantages to industry should be neutralised by the parallel reduction in interest rates. Mr. Byatt further expected a more general benefit to the economy through the improvement in monetary control which would facilitate economic management and so yield gains which he was confident would offset any technical disadvantages. A question remained, however, about the scale on which IGs were to be introduced. Sir Kenneth Couzens noted that financial markets would expect to be told clearly whether IGs were in future to be a major element in Government funding - the authorities would have to make clear whether or not IGs would be issued on a substantial and continuing scale.

9. Mr. Dalton drew attention to the implications of indexation for the future of the capital gains tax. If IGs were issued, it would be much harder to resist indexation of the CGT base, and this could place at risk very substantial revenues. Sir Anthony Rawlinson emphasised the adverse psychological link with wage indexation; even though it might be possible to distinguish conceptually between indexation of debt and indexation of wages (as the Wass report had done), the authorities would be portrayed as giving the full benefits of indexation to rentiers while denying them to the working man. Sir Anthony Rawlinson was also concerned that the Government would seem to be relying on

the markets' adverse expectations to persuade them to buy IGs - the implication would be that the Government were worried about their ability to finance the PSBR in future, and this would tend to make inflationary expectations worse.

10. Mr. Burns on balance favoured the issue of IGs. He attached importance to the improvement in monetary control and to the efficiency gains from greater certainty; the cost advantages were unlikely to be large, and although there were difficulties over the exchange rate in present circumstances, these might well become less in future. Mr. Goodhart agreed that a different kind of asset could help monetary control; but he pointed out that marketable IGs could prove just as difficult to sell as conventional gilts, if market expectations grew of a need for an upward movement in both nominal and real interest rates. He suggested that instruments like granny bonds were a better bet, since interest rates on them would be under the control of the authorities. As things were the Government should be able to secure funds from life insurance and pension funds in almost any event, and in adverse circumstances greater efforts could be made to increase the flow of funds direct from the personal sector.

11. It was noted that non-marketable instruments aimed at pension funds could be presented as a reasonable response by the Government to criticism of index-linking of pensions in the public sector. Such instruments were, however, likely to prove more expensive than marketable instruments issued by auction, since in the case of the latter negative real interest rates would be a possibility while for the non-marketables the Government would almost inevitably have to offer at least maintenance on the real value, and possibly a positive real interest rate. The point was made that the benefits in terms of better monetary control could equally well be pursued by the issue of conventional gilts by auction - it was not necessary to issue IGs. It was further noted that marketable IGs would be

subject to a good deal of capital uncertainty during their lives as real interest rates fluctuated.

12. The Governor said he had started out wanting to issue IGs to strengthen monetary control; the difficult prospect for the PSBR during the current year emphasised the importance of this. However, he agreed that IGs should only be issued when the immediate prospects were favourable, and in fact the monetary statistics might well be adverse for some months because of the problem of reintermediation, as well as that of high public sector borrowing. Despite his predispositions, he had concluded that the balance of advantage was firmly against the issue of IGs; he saw the level of the exchange rate as the most difficult issue of current policy, and one which was doing major and, if it were to continue, unendurable damage to UK industry. In these circumstances, whatever might happen to the exchange rate in future, he was certain that we should not take the risk of putting sharp upward pressure on the rate now - he was not persuaded by simulations suggesting that the exchange rate effects might be small. There was no doubt that overseas (and particularly OPEC) investors wanted to diversify their assets, national currencies had become much more unstable, with first the dollar and then even the DM coming to look less solid. This being so, people could well want to put, say, 5 per cent of their assets in IGs, and this would be very likely to have a substantial effect on sterling. The Governor was also worried at the prospect that the UK would be isolated in offering indexed debt; we should face very considerable criticism from other OECD countries for giving the oil producers what they wanted. Nor was other countries' experience in the past of indexed debt of various kinds very favourable; the French loans tied to the price of gold had turned out to be a complete disaster, and they now represented nearly half the total outstanding French government debt, as compared with less than 10 per cent in 1973. As to the domestic implications of IGs, the Governor thought the company sector would on the whole be harmed, since IGs were a closer substitute for equities than for debentures. He thought there was not a great deal in the

arguments about cost, and his own judgement was that conventional debt would turn out in the event to have been cheaper. Where monetary control was concerned he favoured trying to secure additional funds directly from the personal sector rather than through the issue of marketable securities.

13. The Chancellor, summing up the discussion, recognised the importance of the issue; as the Financial Secretary said, the issue of IGs would be a step comparable in importance with the abolition of exchange control. He would arrange for the discussion of IGs to be resumed at a early date; if any action were to be taken, it would need to be done soon. He asked Mr. Middleton to suggest what other possible innovations in Government debt instruments and marketing methods might usefully be studied in a longer time scale, if the decision were taken not to proceed now with the issue of marketable IGs.

JW

(A.J. WIGGINS)
22 July 1980

Distribution
Those present

Chancellor of the Exchequer

cc Chief Secretary
Financial Secretary
Sir Douglas Wass
Mr Ryrie
Mr Burns
Sir Kenneth Couzens
Sir Anthony Rawlinson
Mr Byatt
Mr Barratt
Mr Hancock
Mr Bridgeman
Mr Britton
Mr Riley
Mr Collinson
Mrs Gilmore
Mr Ward
Mr Williams
Mr Ridley
Mr Cropper
Mr Cardona
Mr Gracey IR
Mr Hibbert - CSO
Mr Fforde)
Mr George) B/Eng
Mr Goodhart)

Deputy Governor -
Maybe there will be a meeting, maybe not. The first paragraph is, I feel, slightly dissimulant.

8/7

INDEX-LINKED GILTS

recd 17.7.80

1. I wonder if I could urge you to have the proposed seminar on indexed gilts in the near future. Following the Financial Secretary's recent minute, we should welcome the opportunity to discuss the issues further with you and the Governor. This would be a good time to go over the arguments because conditions are currently very like those in which we suggested that a security of this sort could be successfully marketed.

2. The relevent papers are:

a. The submission and notes attached to my minute of 2 May. The main issues and assessment paper brings the arguments together.

b. The Financial Secretary's minute of 30 June and the note of the meeting which the Financial Secretary held with Treasury and Bank officials on 27 May.

P E MIDDLETON
8 July 1980

B B B B B

JSFf 8/7 DG 9/7

CONFIDENTIAL 10. 7.80

Suggestions pse ?

NOTE FOR RECORD

Copies to The Governor
The Deputy Governor
Mr Fforde
Mr Dow
Mr Loehnis
Mr Coleby
Mr Flemming
Mr George
Mr Goodhart
Mr Holland
Mr Walker

GR 12/7

1) The Deputy Governor
2) Govs Office

The Governor mentioned this to you at Weekly Policy Committee this afternoon

The Chancellor is to hold a seminar on Index-Linked Gilts at 9.30 am on Thursday 17 July. I am told that this is the only convenient time for the Chancellor next week - and after then the leave season will not make it possible to assemble a full meeting (Middleton in particular will be away). The meeting, which will consider Lawson's minute of 30 June and previous papers, will be attended by Biffen, Lawson, Wass, Ryrie, Burns, Couzens, Rawlinson, Middleton, Bridgeman, Britton and others. I have told the Chancellor's Office that I will advise them later who will attend from the Bank.

14/7

The Deputy Governor suggested: G, DG, ~~JCRD~~ and/or JSF,* EAJG, ADL, CAEG

I will consult JCRD on *. - JSF to go

15.7.80.

Governor's Office HO-G
10 July 1980

J S Beverly (4121)

DG 15/742

10. 7.80

THE DEPUTY GOVERNOR

Copies to Mr Fforde
Mr Dow
Mr George
Mr Goodhart
Mr Dicks-Mireaux

GR

INDEXED GILTS

At your meeting yesterday I was aked to prepare notes on two issues: the problems involved in restricting holdings to authorised pension funds; and the further consideration of the exchange rate effects of a continuing inflow across the exchanges to purchase continuing issues of IGs.

1 Restricted IGs

I have not been able to find in the files much discussion, as opposed to references, to the problems of restricting indexed gilts to eg authorised pension funds, by making a suitable non-marketable issue.

Three problems occur to me. The first and less difficult is the problem of reconciling their non-marketability with the desire, at least initially, to let the market fix their price. How would an authorised holder sell? There would not be a secondary market. Would the Bank have a fixed bid price? One solution as long as only one (presumably very long) stock were issued, would be to invite bids including "negative bids" and to combine the "auction" of new stock with a managed secondary market. It is, anyway, unlikely that any fund would become a seller before sufficient experience had been gained for the Bank to make a two-way market.

The more difficult issue relates to the equity of a line drawn at authorised pension funds. There are two potentially aggrieved groups here. Life insurance companies (and the widows and orphans who are the beneficiaries of their policies) and the self employed who provide for their retirement outside pension funds. In particular, it is not certain whether Inland Revenue rules and procedures relating

DG 11/7

to Retirement Annuity Premia would be sufficiently watertight to allow them to be invested in IGs. My own belief is that they probably are or could be made so. If not it may be necessary to try to make a special extension of the indexed SAYE scheme for the self-employed (on which some work has been done in the Bank).

The final problem relates to other public sector borrowers. Local authorities could probably not be relied upon to impose similar restrictions. The price of preventing them from making an indexed issue might be central government indexed on-lending. CAEG's minute of the FST's meeting on 21 May refers to a short note on this which I understand is still in preparation by HMT.

2 Exchange rate effects

The Treasury paper of 1. 5.80 on the exchange rate effects of a £4 bn. issue of IG's in one year entirely taken up by foreigners concludes that on the assumption that the effect on expectations is neutral (ie the expected future exchange rate is unchanged) "the exchange rate might rise by around 2% over the year. On the same basis short term interest rates would fall by around 2%....These effects would build up over time if IGs were issued at the same rate in subsequent years, but even then the effect on the exchange rate would probably be only about 3% after four years: the interest rate effect would also build up over time possibly quite substantially".

I find this picture of inverse paths for exchange and interest rates implausible. In the one-shot case the 2% movement of sterling <u>over</u> the year may be plausible but should be associated with a <u>step</u> fall in interest rates at the beginning of the year.

The Bank exercise (7. 5.80) implies that the expectation of continuing sales of IGs would involve a rise in the future expected value of sterling which would eliminate the speculative switches out of domestically held money balances (at a given interest rate) which contributed to the fall in interest rates. If the interest rate fell only one point rather than two, how much further would sterling rise? At one absurd extreme a 100% rise in sterling would convert a given change from being 2% to being 1%.

Unfortunately the earlier work was done by Miles who has now left the Bank. Townend is looking into the effect of changing the assumption about the future exchange rate but it will take a few days. I have spoken to Riley at HMT who wrote their note. He agrees that things are very uncertain but is not inclined to make much of it.

10 July 1980

Dictated but not seen by
J S Flemming, HO-3

BANK OF ENGLAND

Meeting held
GPS
[initials] 16/7

We need to hold a meeting on this, as the Deputy Governor has suggested to me, as early as possible before the CX's meeting / seminar on Thursday. [initials] 14/7

11. 7.80

THE GOVERNOR

Copies to Mr Fforde o/r*
Mr Dow*
Mr Loehnis
Mr Flemming*
Mr George*
Mr Goodhart*
Mr Holland
Mr Walker
Mr Dicks-Mireaux*
Mr Quinn
GPS

INDEXED GILTS

1 On 9. 7.80 I held a meeting with those indicated by a star amongst the copies to consider further the Bank's position on indexed gilts, in particular in the light of the FST's minute to the Chancellor (30. 6.80) and the, now confirmed, intention in the Treasury of holding a seminar with Ministers on Thursday next (17. 7.80).

2 A general canvass of views indicated widespread agreement that the FST had not really recognised the force of the "overseas inflow" difficulty, both in terms of the prospective pressure on the exchange rate and the likely reaction in other industrial countries. On the question of timing, the FST's paper was again thought not to address seriously the problem of "Unripe Time". The market could, as EAJG pointed out, derive either one of two possible messages from our making an issue: that the authorities were planning for a significant reduction in the rate of inflation and were introducing the new instrument so as to minimise the cost of funding, or that, on the contrary, expectations were for a continuing high level of inflation and the innovation was a way of helping to bolster the funding programme. Very likely, in present circumstances, the market would be split half-and-half in its views. On a theoretical level, CAEG noted the welfare benefit from the "insurance" aspect of indexed debt, but said he remained concerned about the practical difficulties. JSFf was unsure of the wisdom of aiming to provide a constant real income for bondholders at a time when it was by no means clear that this could be matched by the economy as a whole. While I did not seek to establish any formal conclusion, the balance in the meeting seemed to me clearly against a marketable indexed gilt, certainly at this time, largely because of practical problems (especially the potential external effect) plus the fact that we looked able to sell conventional debt satisfactorily in the months ahead.

3 There was, however, some discussion on various more restricted instruments, principally an extension of the "granny bonds" scheme and the option of a special instrument for pension funds. Some concern was expressed that the Bank should not get into the position of, on the one hand, lamenting an undue shift of savings into the institutions, and on the other, advocating a new form of debt designed especially for them. It was agreed that we should assemble briefing on the question of restricted instruments in advance of the proposed seminar on indexed gilts and that it would be worth analysing further the exchange rate effects, examining especially the Bank and Treasury forecasting model arithmetic. (JSF has now kindly provided a note on these questions, which I attach.)

CWM

11 July 1980

Index Collection

Tel: 01-233

[ADDR]ESSED TO THE GOVERNOR

with compliments

GS 16/7

Sir Kenneth Couzens KCB
Second Permanent Secretary
Overseas Finance

H M TREASURY

CONFIDENTIAL

15 7 80

For Information:

Chief Secretary
Financial Secretary
Sir Douglas Wass
Mr Burns
Sir Anthony Rawlinson
Mr Byatt
Mr Barratt
Mr Middleton
Mr Bridgeman
Mr Britton
Mr Riley
Mr M Williams
Mr Ridley
Mr Cropper
Mr Gracey IR
Mr Hibbert CSO
Governor

CHANCELLOR

INDEXED LINKED GILTS

1. In the hope of saving time at your meeting on Thursday I wonder if I might record one or two comments on index linked gilts, both from the OF and the more general standpoint.

2. OF Aspects. I know that the Treasury and Bank models show limited effects on the exchange rate from inflows into indexed gilts (though even the 2% rise thought to be produced by £4 billion of inflows is not negligible). But the real point is surely that the Government ought not to be seen at the moment to adopt a technique which, by a side-blow, puts the exchange rate up. There is a good deal of acceptance at present that there is not very much the Government can do about the high exchange rate and its effects on competitiveness. This would be regarded as an "own goal" and could attract criticism on that score quite disproportionate to the real effect (which might be a lot or a little - I am sceptical about our guesses).

3. I would not dismiss either the irritation we might cause to other industrial oil importing countries if we gave the oil exporters an indexed asset, so to speak gratuitously. If there were a clear-cut and important national benefit to us, I would not worry about that. But if the case is at best a balanced one, then this irritation is worth taking into account. It would be linked in the minds of others with the thought that because we are self-sufficient in oil, we just don't care about the bargaining situation of others in relation to the oil exporters.

3. Other Aspects. I do not think that the announcement of a policy of issuing debt indexed to the RPI on a large scale would fit very well with your efforts to persuade wage-earners that they

ought to accept pay increases <u>below</u> the RPI increase. The reasons why the two things are very different may be obvious enough to the sophisticated, but those seeking a debating point against you might use this. I do not think it would help.

4. The possible financial advantages are difficult to assess and seem to turn heavily on relative tax treatment. At the end of the day they perhaps come down to whether the Government would be right to expect a considerably faster deceleration of inflation than the market; but also to the discount rate - since any difference considerable enough to produce a real profit over conventional gilts must lie a little way off.

5. Finally, I think it is fair to say that indexation generally has not been terribly rewarding for Finance Ministers. French debt indexed to gold etc has proved a disaster. Pay indexation is something Finance Ministers struggle with in Holland, Belgium, Denmark, Italy: and thresholds here were no picnic. Indexation of income tax allowances has been legislated and suspended in Canada and Australia. Brazil is no longer regarded as the demonstration case for indexation. The unexpected unfortunately happens.

6. I accept that this is very general and that there are real differences about the proposal we are now considering, and its circumstances. But I think the points above suggest that one needs to be very confident of the case before adopting it.

K E COUZENS
15 July 1980

Index? Collection

16. 7.80

THE GOVERNOR

has seen. Meeting held at HMT with Chancellor + others. GB 7/7.

Copies to The Deputy Governor
Mr Dow
Mr Loehnis
Mr George
Mr Goodhart
Mr Quinn

INDEXATION: TREASURY SEMINAR, 17 JULY

You asked for a quick and very brief aide memoire summary of the main points of the discussion in your room this afternoon.

1 There was general concern on the external side under three headings:

(i) There would undoubtedly be upward pressure on the exchange rate. Simple static simulations of a one-shot issue suggested the effect would be small but there was a serious risk that they were misleading.

(ii) An issue would be seen as offensive to other members of OECD more dependent on imported oil.

(iii) The experience of other countries was not encouraging.

2 There was general concern about the repercussions elsewhere in the economy

(i) on wages /although a group under Sir Douglas Wass, whose report we have not seen, is said to have played down these dangers/;

(ii) on company finance; IGs being closer substitutes for equity than are ordinary Gilts and companies being nearer to making rights issues than issuing debentures; possibly also as an extension of the fiscal privileges for public sector borrowing.

3 The effect on inflation expectations could go either way. If the Government was thought to be motivated by the cost argument the effect would be helpful. If the reason was thought to be the control argument (which appealed more to those present) the effect could be damaging.

If to meet 1 above indexed borrowing were through National Savings any promotional campaign would have to highlight the dangers of inflation.

4 The cost argument was not seen as being decisive when the current level of taxable nominal yields was compared to the present inflation rate. If the danger of inflows was regarded as small one would be relying on institutions who were said to be looking for 2% real. While this might be a pre-negotiating stance it might be bolstered by actuarial valuation conventions.

5 If the institutions wanted 2% real, and it might be more if they sought additional compensation for the non-marketability required to keep out foreigners, it could be cheaper to issue more Granny Bonds or Indexed SAYE. This appealed to several people on control grounds. The repercussions on Building Societies were noted.

16 July 1980
J S Flemming, HO-3