2.5.80

Financial Secretary

cc Chancellor of the Exchequer
Chief Secretary
Minister of State (L)
Minister of State (C)
Sir Douglas Wass
Mr Ryrie
Mr Burns
Sir Anthony Rawlinson
Sir Kenneth Couzens
Mr Barratt
Mr Byatt
Mr Bridgeman
Mr Britton
Mr Lavelle
Mr Riley
Mr Williams
PS/Governor)
Mr Fforde) B/Eng
Mr Leonis)
Sir Lawrence Airey) IR
Mr Gracey)
Mr Hibbert CSO

Copies to the Deputy Governor
Mr Dow
Mr George
Mr Flemming
Mr Goodhart
Mr Holland
Mr Walker.

6/5.

Please speak. We need to arrange for a meeting to consider this issue — with adequate time

2/5

INDEXED GILTS

1. I attach a paper surveying the main questions relevant to the issue of an indexed gilt. This discharges the remit following your meeting on 19 February. It is also intended to meet the Chancellor's request for a paper round which to structure an early seminar.

2. In order to go into the subject thoroughly, we have prepared separate papers on key points; these are an important part of the analysis. Though I realise that it involves a lot of reading, I hope that subsequent discussion can be based on both the main issues note and the supporting papers.

3. The home and overseas sides of the Treasury and the Bank have been involved in the work, as have the Inland Revenue and the Central Statistical Office. The papers have been put to the Governors in the Bank and discussed in the PCC. You will no doubt wish to give the Chancellor your advice before his seminar and perhaps have a preliminary discussion with us. So it might help if I very briefly point up the fundamental issues referred to in the final paragraph of the main issues note.

a. <u>Expectations</u>

4. The judgement about the effect of issuing an indexed gilt on

expectations and the underpinning it might provide for the medium term strategy is an important element in the decision. We should present it as a sign of the Government's confidence in its own policies; others will seek to suggest that it shows that the Government is uncertain about its ability to control the money supply if inflation continues at a high level, and is taking out a bit of insurance.

5. The potential saving to the government from issuing indexed gilts would be very considerable if inflation comes down as the Government intend. But it is important that the decision should not be seen simply in terms of a contest with the market about the rate of inflation at various dates in the future. There would be benefits to be had from indexation whatever the inflation rate, because of the reduction in risk to the government and to investors alike.

b. Overseas Questions

6. The attempt to find a way of excluding or inhibiting non-residents' purchases has taken up a lot of our time. There are still some legal issues to be settled. But it seems very doubtful whether we shall succeed in excluding foreigners sufficiently to prevent this being a problem. So a crucial element in the decision will be whether risk of a higher exchange rate resulting from the unique attractions of indexed debt seems acceptable in present circumstances.

7. This is an issue which causes some of those who would otherwise be in favour to pause. We are looking into it further. But preliminary work in the Treasury suggests that though there could be difficult problems of market management if there is great overseas demand, the effect on the exchange rate may not be as big as one might assume from simply looking at the scale of inflows which could be involved. Inflows into gilts have no direct effect on the money supply. If intervention tactics remain unchanged, the tendency for the exchange rate to rise would be offset by a fall in domestic interest rates. Confidence effects could of course increase the upward pressure on the exchange rate - but, again, this would probably be offset by lower interest rates.

c. Tax Policy

8. The problems here are not ones of practicability but of

making explicit issues which have been conveniently obscure concerning the taxation of gains which are no more than a compensation for inflation. Ministers will wish to be sure that any move towards indexation in this field is consistent with the Government's general philosophy and intentions in related fields.

d. Company Sector

9. The problems for the company sector concern the long term effect on the capital market and the short term problems which we are already experiencing in monetary control because the capital market is dead. These are very important issues. On the other hand, provided monetary policy is no tighter than it was before, companies have something to gain in lower interest rates, and there are some who believe that the way ahead for companies would be to issue indexed debt if the tax obstacles could be overcome.

10. Finally, I should perhaps say that we have not attempted to boil this down to a recommendation before the seminar. But the PCC discussion revealed that the Chancellor can expect a range of views about the merits of an indexed gilt when the discussion takes place.

E. A. Clarke

pp P E MIDDLETON
2 May 1980

Enc

INDEXATION OF GILTS: MAIN ISSUES AND ASSESSMENT

Introduction

At his meeting on 19 February, the Financial Secretary commissioned further work on the characteristics and effects of the issue of index linked gilts (IGs) by Central Government. The implications of issuing such a security are extensive. Separate papers on the key aspects have therefore been prepared.

2. The papers have been discussed in a group chaired by Mr Middleton in which the Treasury, the Bank of England, the Inland Revenue and CSO have taken part. They are:-

A The characteristics of IGs, their method of issue and details of the prospectus (paper by the Bank, together with draft prospectus).

B The potential effects on financial flows in the domestic economy, and on money supply and interest rates (paper by HF/FEU Groups, Treasury).

C The likely reactions of, and implications for, other borrowers (paper by HF Group, Treasury).

D The possible effects on debt interest costs, and the Government's cash flow (paper by the Bank).

E The statistical treatment in the national accounts, and effects on public expenditure, the PSBR and the PSFD (paper by CSO).

F The possible international implications, both for inflows and for international relations (paper by OF Sector, Treasury).

G The scope in relation to our EC obligations for excluding purchases by non-residents (paper by EF Group, Treasury).

H The tax treatment of indexed securities, whether issued by Central Government or others (paper by Inland Revenue).

3. This note does not summarise the above papers. Rather, it seeks to bring out those issues which have emerged as being critical to a decision whether to issue IGs. A prospectus has been drafted, on the assumption that we would wish to exclude non-resident purchases. This raises a number of difficulties, of practice, in law and in relation to our EC obligations. But there are otherwise no purely technical obstacles to an issue. There are, however, a number of other aspects which would need further consideration before an IG was issued, although they are unlikely to prove critical to the decision whether or not to proceed. They include, for example, the specification in the prospectus of what should happen if the RPI were to be discontinued or radically altered at some point in the future, and the terms on which public sector bodies should in future borrow from the NLF.

The Advantages of IGs

4. There are two main arguments in favour of introducing IGs. The first is that the substantial risks incurred with conventional gilts by both purchasers and the Exchequer as a result of uncertainty about future rates of inflation would be eliminated. This means that purchasers might be prepared to accept a lower rate of interest in return for the increased insurance against inflation that an indexed gilt would offer, thus reducing the cost of servicing Government debt.* Moreover, the possibility of substantial real losses to either the Exchequer or the purchaser in the event of inflation turning out differently from expectations would be eliminated. If in the years to come inflation were to decline more rapidly than the market currently expects, issuing indexed gilts would enable the Government to avoid the substantial real interest costs implicit in long term borrowing at current interest rates.

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*IGs offer a guaranteed real rate of return - which could be negative if the market price was bid up sufficiently - only if held to maturity. Their price in the market could fluctuate substantially, and this could mitigate their attractiveness and hence the potential benefit to borrowing costs.

5. In the short run, the monetary policy benefit and hence the scope for lower interest rates from which all borrowers would benefit could be much greater if IGs improved inflationary expectations. This effect, which could go the other way, would depend on the markets' assessment of whether the Government was issuing IGs because it expected inflation to fall (and hence wished to reduce its future debt burden) or because it expected it to rise (and hence was concerned about its ability to sell conventional gilts). Of key importance in this context would be the markets' assessment of the role of IGs in relation to the medium term financial strategy.

6. The second argument in favour of issuing IGs is that there may be some benefit for monetary control and market management. Because purchasers of IGs would shift out of money as well as other assets, given monetary targets could be met in the medium term with somewhat lower interest rates on conventional debt. IGs could lesson market management problems, as a result of their price resilience in the face of deteriorating inflationary expectations; although this would not be the case when, say, Government action was expected to increase real interest rates. On the assumption that the IG was of the indexed principal variety (see paragraph 9 below) there would be a lower net cash outflow from the Exchequer, which could be of some presentational benefit. The PSBR* would be reduced, and there would, once there was a substantial volume of IGs outstanding, be less scope for institutions to build up their liquidity in the short term so temporarily swelling £M3 at a time of funding pauses.

7. The extent of these advantages, and the difficulties for other areas of policy to which IGs give rise, are discussed in the attached paper. The following section, however, discusses the form of the IG being considered.

The Nature of the IG to be Issued

8. There are a number of questions that need to be decided concerning the nature and terms of an IG.

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*Public expenditure, however, would not be lower.

(i) <u>The Form of Inflation Compensation</u>

9. The work has concentrated throughout on an IG of the indexed principal variety; i.e. with outstanding principal and interest payments (paid every six months) constant in real terms. The alternative of an "inflation compensation" gilt, whereby the interest paid would equal the guaranteed real coupon plus the current rate of inflation (with the principal remaining constant in nominal terms), is judged to be less attractive; taxpayers would face a substantial tax liability on interest payments and the real rate of return it offered would be more uncertain even if held to maturity (since it could only be achieved if the interest payments could be invested at the same real rate). From the authorities' point of view there would be no cash flow advantage over conventional stocks.

10. We have assumed that the IG should have a low coupon, rather than none at all, because it is judged that it would be more attractive to the market, and so give the Exchequer a lower real cost, after allowing for the difference in issue price between the two. This is essentially because investors are more used to stocks which give a yield during their life, and not only on redemption. A coupon of 2% is suggested, at least for the first issue, being broadly in line with general views about real rates of return on gilts.

(ii) <u>Liability to CGT</u>

11. If IGs were (like conventional gilts) exempt from CGT if held for more than a year, taxpayers, particularly higher rate taxpayers, would find IGs especially attractive by comparison with conventional securities. There would be a consequent loss of revenue to the Exchequer. This could in principle be offset in the price at which the stock was sold. However, a large volume of IGs could only be sold if gross funds (i.e. those funds, such as pension funds, who are exempt from tax on their income) also found them attractive. This means that the market clearing price would be that at which a gross fund purchased the stock, and it could be well below the price at which it would be necessary to sell the stock to offset the foregone revenue from taxpayers who would mostly be left as intra marginal holders.* The relative position of taxpayers and others

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*In principle the Government could cream off some of the higher price that taxpayers were willing to pay if the stock was auctioned and bids accepted at the price they were made, rather than at the minimum price. But this would make it difficult for even sophisticated investors to know at what price they bid, make the stock less attractive and inhibit subsequent development of the market.

would be restored somewhat by bringing the gains on IGs within the scope of CGT. This would, however, have implications for tax policy which are discussed below.

(iii) <u>Restrictions to Residents</u>

12. It is likely that there would be considerable overseas interest in IGs. No developed country offers an equivalent instrument, and OPEC countires, with a massive surplus to invest this year, would probably be particularly attracted. This would put upward pressure on the exchange rate, with complications for exchange rate and monetary management, and have implications for our relations with our OECD partners. It therefore seems desirable to prevent, if practicable, non-resident purchases, and the prospectus has been drafted to this end. But there are a number of difficulties, both in relation to our EC obligations and the powers to exclude or confiscate non-resident purchases, and these are considered further below.

(iv) <u>Issue Technique</u>

13. It is proposed, at least initially, to issue IGs by tender, with no minimum price specified, and leaving the authorities with the option to allot to the public less than the amount issued. In this way it would be possible both to handle oversubscriptions and reject bids at unacceptable low prices even if these did not clear the volume on offer. Allotments would be made at a uniform price.* Once a market had been made, future issues could be sold by more usual methods.

(v) <u>The amount of Issue</u>

14. Total issues of £3-4 billion of IGs are envisaged in the first year, with an initial tranche of, say, £1 billion. It would be important to announce our broad intentions as to the total volume of the sales to avoid driving up the price of the first tranche to an artificially high level. A smaller volume of issues could be sold at a higher price, but that would tend to crowd out pension funds and would give little clear indication of the extent or sectoral distribution of demand for IGs, and thus the monetary

*(See footnote to paragraph 11)

control benefits that they might offer. Moreover, a smaller issue would not avoid any of the possible disruption to financial markets, nor the problems concerning tax policy, non-resident purchases, etc.

The Impact of IGs

15. There are a number of wider questions relevant to deciding whether to issue IGs. These are separately discussed in the following section of the paper; this section represents an overview of how the various issues inter-relate.

16. There are three distinct sectors who would have an interest in IGs:

(a) those financial institutions, particularly pension funds, who receive interest gross of tax;

(b) tax paying persons, in particular higher rate taxpayers;

(c) and non-residents who are in effect also exempt from UK tax.

Any assessment of the cost to the Government, the benefits to monetary control and the implications for financial markets depends on the strength of the demand from each of these sectors. The sectoral distribution of purchases would depend in turn on the terms of the stock, and the tax provisions. If IGs were issued in future years, the continuing impact on different sectors could be somewhat different than the impact in the first year (leaving aside the short run impact on expectations).

17. In the first year at least, there would be a substantial demand for IGs from persons, particularly from higher rate taxpayers. But, as explained in paragraph 11, if the price were set by non taxpayers, there would be a loss for the Exchequer as a result of a substantial take up by persons who would benefit relatively from the CGT exemption. Hence the need to consider

CGT. IGs are also likely to be very attractive to non-residents on whom, as a result of international tax arrangements, CGT cannot be charged. Charging CGT on domestic taxpayers might not greatly affect the market clearing price, particularly in later years, but to the extent it reduced it, IGs would be even more attractive to non-residents. The prospectus (paper A) has therefore been drafted on the assumption that restricting non-residents is desirable and practicable.

18. IGs could have substantial repercussions for other areas of the economy. These are explored in paper C. The impact on the company sector could be particularly important. Companies would be affected by likely falls in equity prices, which would add to the present unattractiveness of risk capital. They would also face a possible higher exchange rate, and tax regulations that (unless they were changed) would mean, for some companies, a loss of tax relief if they sought to compete for long term funds by issuing indexed securities of the indexed principal variety. Morever, these adverse effects would persist in future years. Against this, however, they would benefit from the reduction that would be expected (see paragraph 6 above) in interest rates on conventional fixed interest debt and bank borrowing.

19. Even if companies did not follow suit and issue indexed securities, some borrowers, particularly perhaps local authorities, would. But, leaving aside questions of the legal powers, it is certainly arguable whether we could expect local authority or other borrowers to police effectively restrictions that we required them to impose. Therefore, although it would be desirable if we could to require such borrowers to apply the same restrictions, e.g. on non-resident holdings, as Central Government, their issues could effectively undermine any such restrictions.

<u>Wider Issues</u>

20. The implications of IGs for a number of policy issues must be assessed before a decision is made. These are implicit in the preceding paragraphs; in this section they are briefly discussed separately.

(i) Further Spread of Indexation in Financial Markets

21. Paper C discusses the implications of IGs for other borrowers, some of which are summarised in paragraphs 17 and 18 above. It would be difficult, politically and legally, to prevent other sectors from issuing indexed debt. It is not possible to be precise about the ways in which index-linking would spread in the capital markets, or the effect it would have on particular borrowers (although the implications for the company sector are addressed further below).

22. It is, however, doubtful whether the authorities have the necessary powers under present legislation to require other borrowers to impose restrictions similar to those imposed by Central Government. This problem is being discussed with our legal advisors, but if restrictions were to be imposed, new primary legislation might be required, both to give Central Government the necessary control of other issuers and to give those issuers, along with Central Government, the powers to impose the restrictions. This would still leave the problem of whether other borrowers could, in practice, effectively impose the restrictions, e.g. to exclude non-residents. Thus there is a risk that the spread of indexation to other borrowers would undermine the policy intentions of any special restriction imposed by Central Government.

23. A separate difficulty arises concerning the terms of those national savings instruments, the SAYE scheme and the granny bonds, that are currently indexed. IGs would undermine the justification for maintaining the limited nature of those instruments. But DNS could not cope with a wider spread of the schemes with current resources. There might be similar obstacles to issuing a new indexed national savings instrument for small savings. Any national savings scheme could also be expensive (since it would be difficult to sell national savings with a negative real rate of return, even if IGs commanded a premium that implied a negative real rate of return). The alternative of not extending the benefits of indexation to small savers would be presentationally difficult.

(ii) Further Spread of Indexation in the Economy as a Whole

24. The "Wass Group" study on "de-indexation" concluded that Ministers would be advised to move away from formal indexation where it existed in the economy, to a system of less formal indexation or none at all. However, it considered that the issue of IGs would be consistent with de-indexation elsewhere. The degree of protection enjoyed by a holder of an IG would vary with fluctuations in market conditions, and this would be in line with the extent of protection enjoyed by, e.g. social security beneficiaries under the recommended approaches in those areas. There was, moreover, already considerable informal indexation in a wide variety of financial relationships. Thus the issue of IGs would not undermine policy in this area.

25. It is nevertheless likely that the spread of indexation in financial markets would have some effects in other markets. But whether it led to increased pressure for formal indexation would depend, as would the implications of indexation, on how a shift to indexation affected expectations in the economy generally. This is further discussed under the following sub-head.

(iii) Monetary Control, Expectations and Interest Rates

26. Paper B analyses the benefits to monetary control that arise from the fact that IGs would represent an attractive addition to the range of assets available. The paper suggeststhat the first years effects on monetary growth might only be small (about ½% on £M3 at fixed interest and exchange rates although nearer 1½% if the exchange rate is allowed to float upwards); IGs are not a good substitute for money. The main case in the paper assumes that IGs are freely available and exempt from CGT, but the paper also analyses the case where indexed gilts are purchased only by institutions; this approximates to a situation in which issues are subject to CGT and confined to residents. However, the benefits to monetary control are estimated to be of the same order.

27. The analyses in paper B abstract from the effects on confidence. But the technical effects discussed there could

easily be swampted in the short run by the impact of IGs on inflationary expectations. In the Medium Term Financial Strategy, the Government has formalised its commitment to a progressive reduction in monetary growth as a prerequisite to a sustained fall in the rate of inflation. IGs could be presented as an integral component of this strategy; in view of the probability of a sharp reduction in the rate of inflation, IGs would reduce the future burden of debt interest costs as well as improving monetary control. If IGs did have this favourable impact on confidence, there is the possibility that, in the short run, they would allow interest rates to be substantially lower than otherwise (in the long run, expecations are likely to depend more heavily on success in meeting monetary targets and reducing inflation). Even if IGs increased the yields on equities and other securities relative to gilts, all borrowers could benefit from a fall in the general level of interest rates.

28. The confidence effect could go the other way. IGs could be taken as indicating that the Government was more willing, in spite of the MTFS, to tolerate higher inflation. Alternatively they could be taken as a sign that, given a tight monetary target, we expected difficulty in funding the PSBR on conventional terms. In the medium term, when expectations are dominated by other factors, IGs should mean somewhat lower interest rates generally, provided monetary targets are met. But the judgement of the likely effects on expectations in financial markets in the short term will clearly be important to the assessment. The need to avoid an adverse reaction strongly suggests that the first issue should be made at a time of improving expectations, e.g. when monetary growth was clearly under control.

(iv) <u>Benefit to the Exchequer</u>

29. In assessing the impact on confidence, account also needs to be taken of the effects of changes in the recorded size of PSBR, the public sector financial deficit and public expenditure. Paper E discusses CSO's proposed statistical treatment of indexed principal gilts in the national accounts. The effect would be to reduce the CGBR and hence the PSBR, by comparison with issuing

conventional gilts, the reduction reflecting the lower nominal interest payments on IGs, at least in the early years of an issue. However, public expenditure (on both the White Paper and national accounts definitions) and the PSFD would not be reduced since the increases in the nominal amounts of the stock outstanding as a result of revaluation would be recorded as imputed transactions, in the form of accrued interest (in coming to a total for the CGBR, which measures actual cash flows, there would be an accruals adjustment in the financial accounts).

30. These changes would be largely cosmetic. Institutional managers might nevertheless fail fully to take into account the revaluation of the IGs in their portfolio when deciding where to invest their annual cash flow, and there could be some small increase in total demand for gilts as a result.

31. Paper D illustrates the possible impact on Central Government's cash flow and real debt servicing costs under alternative inflation and tax assumptions. The assumptions are highly stylised; the cost of issuing both conventional debt and IGs are probably overstated, although it is not clear by how much. But the comparative results are of interest. Thus the sharper the fall in inflation the greater the benefit of IGs. The paper also shows how the real cost of the issue might vary with the sectoral distribution, and thus tax status, of the purchasers. An appendix to the paper seeks to establish the inflation path at which the costs of issuing indexed and conventional debt are equal. The break even point (i.e. the inflation path below which there would be an advantage to future debt interest costs from issuing IGs) will similarly indicate that rate of inflation which would equalise the expected return on the different assets to the investor. The calculations have been prepared on different assumptions, particularly about the price at which IGs are sold. The figures should therefore not be taken as indicative of the actual rate of inflation below which it would be worthwhile for the Government to issue IGs. Rather, they indicate a variety of such rates of inflation that would be implied by sales of IGs on the terms assumed.

(v) <u>External Effects</u>

32. Large overseas inflows into indexed gilts would, as explained in paper F, be disruptive for exchange rate and monetary management. But it would be difficult to prevent non-resident purchases of IGs - see paper A. The draft prospectus attempts to exclude non-residents by requiring all holders to sign a declaration about their residence whenever the stock changes hands. This would not entirely prevent overseas purchases; but direct purchases through a vehicle that was resident in the UK for tax purposes would be treated on all fours with resident purchases. This would not necessarily mean that they would be charged CGT; since if purchased via an authorised unit they would be eligible for the same exemptions as are residents (as proposed in the 1980 Finance Bill). But the tax penalty might offer a deterrent to some purchasers. There would, however, be effectively no deterrent if CGT were not charged on resident purchases. Over time the possible loopholes would be discovered and exploited, requiring more, but in time perhaps equally ineffective, exclusion provisions.

33. It is in any event unlikely that it would prove possible to rest the power of the Registrar to confiscate stock, or to ask for proof of residency, on the terms of the prospectus alone. Advice on this is being sought, but further primary legislation could be required (an appendix to paper A discusses the scope for using the Exchange Control Act for this purpose). However, we would not be able, without leave of the Commission, to exclude Community purchases under our obligations. Even if restrictions were authorised by the Commission, and this is far from certain, there would be no guarantee that the authorisation would hold for the life of the stock. (This is further discussed in paper G). In short, restricting non-resident purchases, although economically desirable, might prove very difficult to carry out. It would certainly be administratively cumbersome, might require restrictions of a kind that would sit strangely on the shoulders of a Government that has abolished exchange controls, and might in any case have only limited effectiveness as new loopholes were found and exploited. Furthermore, as mentioned in paragraph 22

above, we could not expect such restrictions to be operated by other issuers, even if we and they had the necessary powers.

34. Whether or not we tried to exclude overseas purchases, our OECD partners might well see the issue of IGs as breaking ranks in the face of perennial demands from OPEC and developing countries for indexed assets in which to invest. Indeed it would be likely to whet OPEC's appetite for more. Countries such as Germany and Switzerland, who have recently been making considerable efforts to attract OPEC investors to finance their oil deficit, might accuse us of being distinctly unhelpful, and in effect of pushing them also into issuing indexed securities.

35. The desirability, on the one hand, of restricting non-resident purchases and, on the other hand, the severe difficulties of doing so, have led us to consider two other approaches. The first would be to issue IGs that would only partially be indexed, for example with just 70% of the RPI change being taken into the value of the principal. Since non-residents are effectively exempt from CGT this might seem a way of "taxing" their purchases. However, a provision of this kind would not operate as an effective withholding tax, because its effect would be reflected in the price at which the stock was purchased by the lenders who would, in effect, be able to extract the benefits of full indexation. Moreover, partial indexation would do nothing to improve the position of domestic gross funds relative to non-residents. It would therefore not inhibit non-resident purchases.

36. The alternative would be to restrict the issue of IGs to institutional funds. The securities would be non-marketable, but sold by tender to the eligible holders. This would seem to have the advantage of both excluding non-residents and avoiding tax losses associated with purchases by domestic taxpayers. But there are difficulties with this option, as the Financial Secretary indicated at his meeting last February. It might prove possible for non-residents to avoid the restriction by establishing their own funds in the UK; this would be particularly easy if life assurance as well as pension funds were eligible. An issue confined to institutional funds would be difficult to defend to

the self-employed and small savers. But to offer an indexed linked security to those groups would be extremely difficult administratively (see paragraph 23), and could also carry important implications for the flow of funds to building societies. (The analysis in paper B does not explore the implications for building societies of the issue of an indexed security for small savers). This option, although more promising than partial indexation, has not therefore been studied in any detail.

(vi) <u>Effects on Tax Policy</u>

37. The choice of whether or not to charge CGT also presents difficulties, which are discussed in paper H. By not doing so, a substantial volume of revenue would be at risk, at least initially, which would not be reflected in the sale price. To this must be added revenue lost if a similar exemption were extended to non-Government issues. Moreover, an exemption from CGT would focus increased attention on the fact that taxation currently applies to compensation for inflation that is paid in the form of nominal interest. It would certainly be seen as carrying implications for the Government's future attitude to gains resulting from inflation. But to charge CGT would mean that the Government was, for the first time, explicitly taxing inflationary gains and this would heighten criticism of the present operation of CGT. In addition, some of the advantages of certainty would be lost to the lender (unless he was within the £3,000 annual gains exemption); and this might affect purchases from taxpayers to an unlooked-for extent.

(vii) <u>Effects on Company Sector Policy</u>

38. As already mentioned, the impact on the company sector of IGs could be particularly difficult. They would face a fall in equity prices and the overall cost of finance to companies could well rise unless the general level of interest rates were significantly lower. The increase in the cost of risk capital relative to other forms of finance would have structural implications both for companies' balance sheets and the allocation of resources in the economy as a whole. Moreover, the downward pressure on equity prices, although a continuing effect of IGs, would come

at a time when companies are expected to be under financial pressure. To the extent IGs also depressed property prices there would be less scope for relieving this pressure by e.g., sale and leaseback deals.

39. Companies would also have difficulty competing for longer term funds. Under present tax provisions the revaluation of the nominal capital of indexed issues (of the indexed principal variety) would not be deductible. A number of proposals have been made for mitigating this tax impact. Some, which would be consistent with the accountants' proposals for inflation accounting, would remove or reduce the present tax advantage for interest on conventional debt; others, for allowing the revaluation premium to be deducted, would run counter to current thinking on inflation accounting and, to the extent that they would require the premium to be taxed in the hands of the lender, would perhaps be no more attractive than the present rules. An alternative for companies would be to issue indexed securities of the inflation compensation variety. But as indicated in paragraph 9 these would be less attractive to the market, and thus more expensive to the borrower.

40. The difficult position currently faced by companies and the unattractiveness of debenture issues would mean that, whatever the longer term financing shift, the issue of IGs would force them to continue to rely more heavily in the short term on bank finance. This could prolong the current pressures on banks' liquidity and hence short term interest rates.

<u>Conclusion</u>

41. There is no single way through the complex of issues described above. The further work that has been done has clarified the issues, but it points up a number of areas of uncertainty and difficulty. Ministers' attitudes will no doubt be conditioned particularly by the following issues discussed above:

(a) the effect on expectations in relation to the medium term financial strategy.

(b) the difficulties posed by the attraction of such assets to non-residents.

(c) the implications for tax policy.

(d) the implications of the spread of indexation with the domestic economy.

(e) possible difficulties for the company sector, particularly in the period immediately ahead.