



PRIME MINISTER

GILT EDGED MARKET

I am writing in Geoffrey Howe's absence today to let you know of the two stocks which it is proposed to announce tomorrow, especially since I understand that you have expressed concern about the long term costs of borrowing by gilt edged stocks which will not mature until about the turn of the century.

As you will know, the Bank sold the complete long tap yesterday. This will have significantly reduced the growth of the money supply in banking June (which ends next Wednesday): although this falls before the new 10 month target period, it will be useful in avoiding uncomfortably high 3 month and 6 month moving average figures for monetary growth being quoted in the markets in coming months.

We have now to deal with the problem of funding the borrowing requirement in the first few months of the new target period. We need to have a high level of gilt sales in this period, if market conditions permit, while the borrowing requirement is still high before the Budget takes effect, and before the changes in MLR and clearing bank base rates have their effect on bank lending - this tends to come through only after a few months.

The Chancellor, advised by the Governor, has decided that there should be both a long dated stock and a short dated one. There are two main reasons for including a long dated stock as well as a short. The first is that the need is to secure sales outside the banking system, who in normal circumstances can be substantial buyers of short stocks. This requires a significant proportion of sales to

the long term investment institutions, the Life Offices and Pension Funds. In recent years the long term institutions have invested about twice the normal proportion of their new funds in gilts: this proportion will fall back as we reduce the PSBR but for some time to come we will need to sell to them substantially more than the normal proportion of their new funds, if we are both to control the money supply and leave room for an adequate level of bank lending to industry. The long term funds are primarily interested in securities which match their long term liabilities on life policies and pensions. We are therefore more likely to secure substantial sales of gilts to them without having to raise yields excessively if we provide gilts which are of a maturity which is attractive to them, namely in the 15-25 or 30 year band. Successive issues can be at different points in that band.

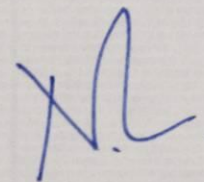
The other reason for bringing in a new stock is that we do not want yields to fall back again in the coming weeks. If they did, they would almost certainly rise again later as the market became worried about the inflationary prospect during the critical months of this autumn, causing a hiatus in gilt sales while they did so.

I am well aware that some commentators have argued that issuing stocks with this kind of maturity involves accepting very high borrowing costs in the years ahead if inflation does come down, and therefore either means that the Government expects inflation to continue in double figures, or that the Government is irresponsible in placing such a high interest burden on its successors. But this comment ignores the effect of the high inflation in the next two or three years on the real value of both the interest payments in subsequent years and the final repayment. The Treasury recently did some calculations of the real interest costs of long term borrowing, on alternative illustrative assumptions about the future rate of inflation. These showed that, on assumptions that involved inflation falling to 6% pa within 3 years, and remaining at that level thereafter, the real cost of borrowing now at a 13% yield for

10 years would be 3% and for 20 years would be 4%. Given that economists estimate that the real cost of long borrowing has averaged over the decades about 3%, neither is a very high figure historically. The Bank and Treasury consider that if the authorities were to shift the emphasis of their borrowing from stocks of about 20 years maturity to that of about 10 years, the relative prices and yields would shift to remove that advantage for 10 year stocks and we would at the same time have greater difficulty in securing the desired level of sales.

The intention is therefore to issue two stocks, a long and a short. Both would be part-paid, and with a tender provision on their price. Receipts from the short would come in banking July, and from the long in banking July and August. The short stock would be a new issue of £800 million (plus £250 million reserved for the National Debt Office) maturing in 1984, with an $11\frac{1}{2}\%$ coupon. The long stock would be a further tranche of £1,000 million $12\frac{1}{4}\%$ Exchequer 1999.

I hope that you will have been reassured by my explanation of the reasons for bringing in a long stock, and will be content that the Bank and Treasury should proceed this Friday on the basis proposed.



NIGEL LAWSON
14 June 1979

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