CONFIDENTIAL

30.6.80

1) The Deputy Gov^r
2) [illegible]

We need now, in view of this, to be ready to state our definitive position – no doubt we can tackle the last stage of the mind-clearing and decision process after my return.

G.R.

Copies: The Governor
Mr Dow
Mr Loehnis
Mr Walker
Mr Coleby.

The Governor

2/7.

CHANCELLOR

cc Chief Secretary
Sir D Wass
Mr Ryrie
Mr Burns
Sir K Couzens
Sir A Rawlinson
Mr Middleton
Mr Byatt
Mr Barratt
Mr Hancock
Mr Bridgeman
Mr Britton
Mr Riley
Mr Collinson
Mrs Gilmore
Mr C Ward
Mr M L Williams
Mr Ridley
Mr Cropper
Mr Cardona

Mr Gracey - IR
Mr Hibbert - CSO

Mr Fforde
Mr George
Mr Goodhart } B/E

The Deputy Governor

We need now, in view of this, to be ready to state our definitive position – no doubt we can tackle the last stage of the mind clearing and decision process soon after my return.

CR 6/7.

HMT seminar arranged for Thursday 17th July

INDEX-LINKED GILTS

You have already received a note of the meeting I held on 21 May to assess the progress made by Treasury and Bank officials since my original meeting on 19 February to discuss the launching of an index-linked gilt-edged security. The next stage is for you to hold a meeting to decide whether or not to recommend to the Prime Minister that we go ahead.

2. In my opinion we should. To fund the PSBR as we are doing, with 20-year stocks yielding $13\frac{1}{2}$ per cent and more to redemption, makes sense only on the assumption that the medium term financial strategy is a complete failure. If it succeeds, and if single-figure inflation is to become the norm, the real debt interest (public expenditure) burden of carrying on as we are will be very severe indeed. This is fully appreciated by the market, of course, which means that in addition to the straightforward real cost argument, there is an equally powerful case in terms of expectations: to

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continue as we are implies a lack of confidence in our own policies, whereas a switch to index-linked gilts would - in the right circumstances - be seen as a demonstration of self-confidence on the part of the Government which would have a favourable effect on inflationary expectations.

3. The right circumstances may be defined as a time when (a), the money supply is under control, (b) the authorities are successfully selling conventional gilts, and (c) a fall in the rate of inflation is widely expected. If these three conditions were not satisfied, issuing an index-linked gilt might be interpreted as a sign of desperation and/or a decision to live with inflation rather than fight it, in which case the effect on expectations would be adverse.

4. The potential cost saving inherent in the indexed gilt is in practice a double one. There is (a) the saving if inflation comes down more than is implicit in the existing yields on conventional long-dated gilts, and (b) the saving deriving from the fact that, even if inflation comes down no more (or no sooner) than the market at present expects, indexed debt can be sold more cheaply because it effectively eliminates the risk of a worse outcome. Thus simulations done by the Bank of England indicate that, assuming a reasonable tax situation, there is likely to be a significant cost-saving from selling indexed gilts so long as inflation falls at all.

5. The work done by officials - which has been very thorough indeed, and to which I pay tribute - indicates two further benefits from an indexed gilt. First, monetary control would on balance be slightly eased, making it possible to achieve a given monetary target with lower interest rates overall. Second, the PSBR (on the basis of existing statistical conventions) would be significantly reduced - by some £500 million on the assumptions in paragraph 9 below. Although the monetary consequences of this would be very slight, and to that extent the PSBR reduction would be cosmetic and should not be claimed to be other than what it was, there would be a presentational gain.

6. Two possible disadvantages have also been identified. The first is the risk of an adverse effect on the equity market. While there will of course be no 'crowding out' as such, since the switch from one

method of funding to another in no sense increases the total quantum of institutional funds arrogated by the authorities, an indexed gilt would clearly compete more closely with equities than do conventional gilts. To the extent that this is a problem for the corporate sector, it can - and in my opinion should - be mitigated by making indexed gilts liable to Capital Gains Tax. Consideration should also be given to following the recommendation of the Wilson Committee and removing the fiscal impediment to indexed-linked borrowing by companies.

7. The second potential disadvantage is that an indexed gilt might be excessively attractive to overseas investors, thus pushing up the exchange rate. However, the work done by Treasury economists suggests that this effect will be relatively slight, largely because of the offsetting reduction in interest rates. While there might still be complaints from our EEC and OECD partners that we had in some way broken ranks, and that the OPEC countries would henceforth expect an inflation-proofed home for their oil surpluses everywhere, I do not think we should be deterred from pursuing what is clearly in our own national economic interest on this account. The French, in any case have long offered gold bonds, which are a form of defence against the depreciating value of paper money.

8. Treasury and Bank officials have concluded that there is no foolproof method of preventing overseas purchases of a full-blooded indexed gilt, if this is thought to be of overwhelming importance. This could only in practice be achieved by the half-way house of issuing a non-marketable security which only approved pension funds would be eligible to hold. A device of this kind would incidentally also overcome the CGT liability dilemma, since pension funds are in any event exempt from CGT. It might also make it easier to deny local authorities the right to issue indexed debt, which would probably be desirable, at least initially. But this would be very much a second best course.

9. The proposal, then, is that HMG should issue an index-linked security, whose principal would be linked to the RPI, and which would carry a coupon of, say, 2 per cent. It would be a long-dated stock, issued by tender. In order to mount a realistic experiment,

and to prevent a false scarcity value being created, it should be announced in advance that some £4 billion of the stock would be issued in the first year.

10. You will recall that the Wass Report on deindexation concluded (paras 48-57) that the indexation of government borrowing (which of course already exists to a limited extent in the field of National Savings) was <u>sui generis</u>, and that there was a strong prima facie case for issuing indexed gilts. While it is fair to say that official opinion is divided, in my opinion the subsequent work done reinforces that conclusion. You may also find it worth reading the section on indexed gilts in the Wilson report (attached), even though the Committee refrained from making a firm recommendation.

NL

NIGEL LAWSON
30 June 1980

Index-linked industrial debentures

860. Index-linked industrial debentures would provide industry with the possibility of raising long-term capital without the undesirable features of high front loading and with certainty as to the real cost of their funds. In spite of these apparent advantages, a CBI survey in 1978 showed that at that time only about 3 per cent of their members were in favour of them This lack of enthusiasm may, however, have been partly caused by lack of understanding of what was involved, and partly by realisation of the present tax disadvantages. If taxes were levied on profits calculated after a proper allowance for inflation, industrialists' objections to index-linking could diminish. A tax change of this kind is a necessary precondition for a substantial index-linked industrial bond market to develop.

861. Even with this change there would remain the potential problem of an open-ended liability in nominal terms falling due at an inconvenient time. This risk could be reduced if borrowers retained some flexibility over terms, for example stipulating a five-year period during which they might opt at their discretion to make repayment. Alternatively, lenders and borrowers might both prefer to have capital repaid by regular instalments, or to set up a sinking fund rather than leaving the entire liability until the end of the loan period. Arrangements of this kind would be facilitated if index-linked gilts were also generally available, since it would then be possible to establish a sinking fund consisting of assets of which the characteristics matched the liability. Provided he retained the capacity to raise additional funds in a more conventional way, a company treasurer who became concerned about an existing indexed liability would be able to hedge all or part of it.

862. A possible alternative to index-linked debentures might be indexed preference shares. The main attraction to borrowers would be that their nominal commitment would not be so completely open-ended, since they would be in a position to postpone paying increased dividends or repaying capital in adverse circumstances. For the same reason such a security would be generally less attractive to most lenders, and would probably only be attractive to most companies if the dividends were treated as interest for tax purposes. There might, however, be a limited demand for them even without such a change. There is at present a fairly steady supply of conventional preference stocks from companies in special tax situations and from time to time institutions seek financial assets bearing franked fixed-dividend income to suit their own particular tax and other circumstances.

863. Arrangements comparable in concept to the ECGD cost escalation scheme might offer another means of limiting the nominal commitment. It would be possible for the government to set up an organisation which, in return for a premium, would be prepared to provide a hedging facility for borrowers against part or all of the risk that the relevant index would rise by more than some agreed figure before the maturity date. In the event that this figure was exceeded the organisation would repay the balance of the loan in excess of the company's own maximum commitment. Such an arrangement could, however, leave the organisation in a very exposed position, and the premiums could be expected to be correspondingly high.