27.1.81

The Governor ~~&c.~~ The Deputy Governor – has own copy
Mr. Fforde – has own copy
Mr. Loehnis
Mr. Coleby
Mr. George – has own copy
Mr. Goodhart
Mr. Fleming
Mr. Walker
GPS

NOTE OF A MEETING HELD IN THE CHANCELLOR OF THE EXCHEQUER'S ROOM, HM TREASURY AT 4.30 P.M. ON FRIDAY, 23 JANUARY, 1981.

Present:

Chancellor of the Exchequer (in the chair)
Chief Secretary
Financial Secretary
Sir Douglas Wass
Mr. Burns
Mr. Ryrie
Mr. Middleton
Mr. Turnbull
Mr. H.J. Davies
Mr. Ridley

Governor of the Bank of England
Deputy Governor
Mr. J.S. Fforde
Mr. E.A.J. George

recd 28 JAN 1981 5.30

RESTRICTED INDEXED GILTS

The meeting was held to prepare for the meeting the Chancellor and the Governor were to have with the Prime Minister on 28 January.

2. The Financial Secretary said he saw a strong case for the introduction of Restricted Indexed Gilts (RIGs) on the basis of their intrinsic advantages; but they could also play an important part in improving monetary control. There would be a good argument for RIGs even if monetary control was already perfect; but in present difficult circumstances they had particular attraction.

3. The Governor suggested that the meeting should consider in detail the various arguments offered for RIGs before seeking to draw any general conclusions. He questioned the role they could play in monetary control: did those who favoured them expect them to make it possible for the Government to borrow more money, or to borrow the same amount of money but more cheaply? In further discussion it was suggested that recent difficulties in the gilts market had been rather exaggerated; gross sales of £3¼ billion had been achieved since 18 November, with net receipts at £2 billion – this had fully maintained the momentum of the Government's

funding programme, despite some hiatus in banking December. Nor was it clear that pension funds would want to increase substantially the proportion of their assets held in Government debt - the Government was already securing the lion's share of their cash flow through the issue of conventional gilts. To the extent that pension funds, who were probably "intra-marginal" holders of conventional gilts at present, bought RIGs instead of the latter, there might not be much benefit to the Government in reducing the return which had to be offered on conventional gilts to attract the marginal investors. To the extent that pension funds bought RIGs in place of equities, the cost to companies of equity finance would tend to increase. However, the main area in which the Government should be looking to secure additional funding was the discretionary savings of the personal sector, much of which went at present into building societies and bank accounts; securing additional funds through national savings was therefore the first priority.

4. As to pension fund investors, it was suggested that at any given time some are likely to have relatively more bearish and some more bullish expectations; if they were in effect offered a choice between RIGs and conventional gilts (CGs), the bulls would choose the latter and the bears the former. Because instruments more attuned to the expectations of each group would be on offer, in principle there should be some net reduction in the Government's long-run funding costs. It was generally agreed that the "structural" effect of introducing RIGs on interest rates should in principle be of this kind; but in view of the modest extent to which pension funds would be likely to divert an increased proportion of their cash flow into Government debt, the interest rate effect was unlikely to be large. Nevertheless provided the introduction of the new instrument did not itself damage expectations, it was accepted that RIGs should in principle reduce the Government's real debt servicing costs, in effect as one group of investors paid a premium for the greater certainty RIGs would offer as compared with CGs.

5. It was noted that there would be particular advantage in the introduction of RIGs at a time when the authorities had good reason to believe inflation would fall faster than the market believed at that time. A particular difficulty in present circumstances was that investors might interpret the introduction of RIGs as indicating that the Government feared a further rapid increase in the PSBR which they would otherwise be unable to fund. It would be important, therefore, to be able to provide adequate assurances not only that inflation would be coming down but also that the PSBR was under effective control at the time RIGs were first introduced. A parallel was suggested between the market's response to the recent enlargement of the issues of Granny Bonds (GBs), which had certainly not damaged inflationary expectations but had at the same time attracted less in the way of new funds than had initially been envisaged. The point was made, however, in further discussion that RIGs, since they were marketable and only aimed at institutional investors, were entirely different from GBs and that the market's reception of the latter was unlikely to be much guide to its attitude to the former.

6. The Governor asked about the relationship between the possible introduction of RIGs, and the recommendations of the Scott Committee. The Chancellor said the Committee had argued that inflation was a bad thing against which people should be protected; the public sector already had index-linked pensions, which were in principle desirable, but the private sector had so far been unable to match this. The Committee had therefore favoured the issue of RIGs so as to facilitate a greater degree of indexation in the private sector. At the same time they had raised questions whether the employees of the public sector were paying enough for their pension entitlements, and whether the private sector were paying enough to support even the degree of indexation they already had. The Governor noted that if the Government were to abolish index-linked pensions, the arguments for the private sector to match the public sector on index-linking would disappear, and the case for RIGs would be much reduced.

7. The Governor reported that the Bank had recently made clear to companies who had expressed interest that the authorities no longer had any objection to their borrowing through the issue of index-linked securities. However, despite the enthusiasm of some merchant banks there was no sign now that any industrial company would be willing to take the risk; and institutional investors had made clear not only that they would refuse to buy indexed debt from companies but also that they would themselves sell the equity stake they held in any companies which issued such debt.

8. As to the likely reception of an issue of RIGs, the Governor said the pension funds were themselves divided; although some of them were in favour, others thought the move would be disastrous to the national interest although very convenient to them. The Deputy Governor thought the US, French and German governments would regret such an initiative on the part of the UK.

9. The Deputy Governor thought that the technical arguments were in favour of issuing RIGs. But he questioned how large the real advantages would be; the main problem lay in the personal sector's preference for holding discretionary savings in a liquid form, and it was doubtful how much further elasticity there was in institutional demand for Government debt, given the large proportion of their cash flow already going into gilts. He was concerned that RIGs would be a very radical innovation - much more so than GBs - and wondered whether the risks could be justified by reference to the rather modest improvements for which the Government might hope in monetary control and debt servicing costs. The Governor said that he was personally opposed to any avoidable extension of the principle of indexation; money should itself be a satisfactory standard of value. The Government had had considerable success in seeking to restore that standard, and he doubted whether the UK alone among OECD countries should now substitute a variable standard of value for money. The Financial Secretary pointed out, however, that different forms of indexation had different effects - while indexation of wages would

certainly harm the stability of money, the issue of RIGs would reduce the incentive to inflate and thereby repudiate part of previous debts. The UK had had only the wrong forms of indexation, and thus the worst of both worlds.

10. The Chancellor, concluding the discussion, said he saw RIGs not as a device enabling the Government to fund a higher PSBR, but rather as helping the Government to finance a given PSBR more smoothly and a little cheaper. Although the problem about the creation of a false market if only small amounts of indexed debt were issued would be reduced as a result of restricting the issue to pension funds, he thought that if the Government were to take the plunge, they would need to commit themselves to covering a substantial part of their funding requirements through RIGs - he had in mind about 20 per cent, or £4 billion, which would represent a very substantial part of pension funds' cash flow. He noted that there was still a loose end on the eligibility of life assurance companies, and that tax changes would be required enabling the company sector to raise funds through the issue of index-linked debt. There would also be a large number of practical questions to be settled if the Government decided to go ahead.

JW

A.J. WIGGINS
27 January 1981

Distribution:

Those present
Mr. Britton
Mr. Monck