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PROFESSOR BAIN ON INDEX-LINKED GILTS

Background

1. At a time when there are simultaneously (i) perceived problems with funding and debt management, (ii) concern about the level of the PSBR, and (iii) sharply revived fears about future inflationary developments, there is almost bound to be a revival of interest in the idea that the authorities should issue index-linked gilts, as a means of partially dealing with the problems that the fore-mentioned circumstances bring about. It is, perhaps, not therefore surprising that yesterday both at lunch with F.T. journalists and at an evening reception for L.S.E. academic economists, the main suggestion that was put forward for future governmental action was that index-linked bonds should be issued by the authorities. Against this background Professor Bain's paper is well-timed, and is characteristically lucidly and cogently argued.

Relative or Absolute Protection

2. The central point of Professor Bain's paper, with which I am in entire agreement, is that it is not possible for a country in the UK's present position to provide investors with a guarantee of protection of the real value of their financial holdings. With low productivity and potential shocks from outside, e.g. oil, it might be inevitable that most sectors of the UK will, perhaps for some years, have to suffer a decline in their real standard of living. Against that background it would be quite wrong, in my opinion, to offer the rentier a real value guarantee. Indeed some real value guarantees within the public sector should, under present circumstances, be seriously reconsidered. The implication of this is that it would be inappropriate to relate any index-linked security to some measure of the price level; see Professor Bain's paragraphs 9 and 18 particularly, which are both valid and most important.

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11

3. Once that has been recognised, the role of an index-linked security must be seen as a more modest one in protecting savers, pensioners and potential weaker members of the economy against a fall in their relative standard of living (see Bain, paragraph 10). This means that the appropriate link for any index-linked bond must be some earnings index.

4. While I am sure that this is absolutely correct, and indeed that index-linking on to a price index could be potentially disastrous, the shift to index-linking on to an earnings index could lead to a number of difficulties. First, the concept is probably in itself less familiar, and perhaps less attractive, than the standard indexation on to a price series. Second, since the form of indexation makes it absolutely clear that the exercise is about relative standards of living, it might be argued that this procedure would only exacerbate the British habit of excessive concern about relativities and what the other person is getting paid. Third, Bain suggests that an appropriate index of earnings now exists (paragraph 14). I have some doubts, though others know much more about this series than I do. What, for example, would happen if a strike lowered the earnings series in the month when the revision to the value of the earnings-linked bond was to be recalculated. Fourth, linking on to an earning series would raise difficult questions about the appropriate coupon. As Bain notes (paragraph 13), real average earnings have risen by about 2½% per annum on average. That is in itself not a bad real return by the financial standards of recent decades. Moreover, could one expect that rentiers should get a guaranteed return higher than real earners? Accordingly, if the value of the bond was to be linked to the earnings series, it would suggest that a zero coupon would be appropriate, but would the effect of that, e.g. on institutions' cash flow, be acceptable? Alternatively, might one consider a bond whose capital value would be revised in line with the earnings series less x%, where x might be, say, 2%, but where a coupon rate of interest of x% would also be paid regularly.

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Taxation

5. Bain notes quite rightly (paragraphs 15 and 19) that the introduction of such a bond would raise the question of the reform of taxation in inflationary environment even more acutely, and welcomes the pressure for such reform that this should bring. Again I would comment that the fact that this bond would highlight questions of relative standards of living would spur concern with tax equity under inflation. For example,

consider the situation of a rentier who held such an index-linked bond whose value was linked to the earnings series but had a zero coupon index as compared with the average wage earner. As the wage earner's real income rose, he would be paying income tax on that, presumably at increasingly high rates as he entered the higher tranches (NB this assumes indexation of tax bands). On the other hand, the rentier, under present circumstances, would only be paying capital gains tax on realisation. It is surely likely that the step that Bain advocates would put considerable further pressure behind the move towards a comprehensive tax treatment of real incomes, including within that capital gains. The question then remains that, if the Government and the Revenue were not prepared to countenance this latter fiscal step, would it then be sensible, or not, to undertake a major change which must put further pressure on them to take the fiscal steps which they were apparently unwilling to do.

Issue Methods

6. The main point on which I would disagree with Bain on the substance of the argument is in his short discussion of issue methods in paragraph 16. He argues that the appropriate market price could initially be tested by "fairly small issues by tender". Then "once a price basis had been established a large scale conversion offer for outstanding medium and long-dated securities could be made". But such an initial small tender would be made on a false basis and would have a false price if the market was led to believe that only a very small volume of such issues would in future be made. If the market was to be told that the authorities were considering a large conversion issue, as would of course be necessary to get any great benefit in reducing interest costs and the PSBR, then there would seem to be little advantage in not proceeding from the outset with a view towards a major conversion issue.

7. In my own view any move towards the issue of index-linked bonds, to be worth while, would have to be on an absolutely massive scale involving a conversion issue as significant to the development of the economy as that which occurred in 1935. I think that the authorities would have to envisage that from the outset and that it would, therefore, be wrong not to let the market know this; in which case the correct procedure would probably be to take all the main institutions into one's confidence from the beginning and organise a massive conversion issue with pension funds, life assurance companies and banks all taking part

dealing both for themselves and, in the case of banks, acting to promote the issue to their clients. Indeed my first thought in such an issue would be to go over the files about exactly what was done with the conversion issue in 1935 (Dr. Susan Howson now in the Bank is probably about as expert on this matter as anyone else in the country).

Equity Market

8. An objection to index-linked bonds that has certainly had some weight in the Bank has been that it would further crowd out industry by inducing savings institutions to substitute holdings of index-linked bonds in place of equities. Bain tries to meet this point head on in paragraph 22. I do not feel entirely confident about the strength of his argument here, and would be grateful for any comments from ART and MEH on this particular point.

Response to Bain

9. The arguments about the advantages, or otherwise, of indexation are not likely to disappear. We must surely recognise that the arguments in favour of such a step are, indeed, weighty, whether or not they are regarded as sufficiently strong to make the authorities wish to make this major step. In these circumstances, the Bank would presumably wish to support a thorough discussion of the issues both within official circles and more widely. Would that mean, in this instance, sending Professor Bain's letter and paper on to the Chancellor, with whatever covering note might be thought to be helpful. Furthermore, in the light of the general interest in this subject, should we suggest to Professor Bain that he publishes this paper in some public forum. For myself, I think that both steps would be desirable. I think that Bain's paper is an extremely well-argued piece and would generally add to public enlightenment on this difficult and pressing subject.

CAEG
21st November 1979.

C.A.E. Goodhart