



10 DOWNING STREET

From the Private Secretary

29 January 1981

rec'd 30 JAN 1981 11.2

Dear Mr

As you know, the Prime Minister met the Chancellor and the Governor yesterday afternoon to discuss the proposal to introduce an indexed gilt.

The Chancellor said that the basic objective was to achieve a more effective marketing of debt. There were two possible approaches - improving the method of marketing, for example by introducing auctions; and improving the instruments, for example by introducing an indexed gilt. His preference would have been to have concentrated at this stage on improving the methods of marketing; but he understood that the Governor felt unable to make any general move in that direction. That being the case, although he continued to have some residual anxieties about the move to indexation, he believed, on balance, that an indexed gilt should now be introduced.

The Governor said that the Bank could change their methods of selling debt. But this would involve considerable market disruption and would thus interrupt the funding programme; and in their view, the proposed changes in method would raise the cost of borrowing. The present methods had worked remarkably well over the last few years. Enormous amounts of debt had been sold and this had been accomplished relatively smoothly and there had been only a very few funding pauses. If the Bank were to go over to an auction system for conventional stocks and this were to be accompanied by forced selling as some had proposed, gilts prices would become more volatile and less attractive to hold and the market would be irrevocably damaged. Therefore, it was not so much a question of the Bank being able to change their methods: they felt it would be undesirable.

The Governor went on to say that the proposal for an indexed gilt raised some very difficult questions. On the one hand, from a marketing point of view any increase in the variety of stock available was desirable. He understood that the Scott Report on public sector pensions was in favour of an indexed gilt; and it was possible that it would reduce the overall cost of borrowing. If there was to be such an issue, now was the time to introduce it - when inflation was coming down. On the other hand, there was

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the broad politico-economic question of whether it was wise to extend indexation in this way when the Government's whole philosophy was to re-establish nominal money as a store of value. He assumed that Ministers had considered this point carefully. Furthermore, there was likely to be criticism from some quarters that the Government had lost confidence in its ability to fund the seemingly out-of-control Government borrowing requirement. There would also be criticism from corporate borrowers who would never be able to compete with the Government and issue their own indexed debentures. But if Ministers were clear that they would like an indexed gilt, the Bank were prepared to issue one; and as would be necessary, to do so by auction - though possibly with a reserve price. They were considering what should be the amount of the issue; it would probably be in the region of £2 billion.

The Prime Minister said that she was aware of the arguments against. But she and the Chancellor had concluded that it would be right to announce an indexed gilt - mainly because it would provide some reduction in the cost of borrowing (especially in nominal terms in the early years); and because it would help to fund the borrowing requirement.

Finally, the question of timing was discussed. The Chancellor said that he was not entirely clear how soon an announcement could be made: there was still an outstanding Inland Revenue point to be resolved. On the whole, he felt it would be best to announce it in the Budget, but he did not wish to exclude the possibility of doing so earlier. He would consider this further with the Governor and report back to the Prime Minister.

The Governor emphasised that it was absolutely crucial that the decision to introduce an indexed gilt should not leak: if it did this would immediately cause the market to dry up pending the announcement.

The Prime Minister said that she would be inclined to wait until the Budget, but she would await the Chancellor's further advice.

In view of the Governor's point about the risks of a leak, you will no doubt ensure that knowledge of this decision is kept to as few people as possible.

I am sending a copy of this letter to Tim Allen in the Governor's Office.

Tim Allen

A.J. Wiggins, Esq.,
H.M. Treasury.

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10 DOWNING STREET

From the Private Secretary

29 January 1981

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As I told you, when the Chancellor of the Exchequer and the Governor called on the Prime Minister yesterday afternoon to discuss the indexed gilt proposal, they also discussed the possibility of a reduction in MLR in the near future. I did not take a detailed note of this part of the discussion; however, you may like to be aware of some of the points that came up.

It was pointed out that the first estimate of the January banking figures would not be available until next Wednesday. But on present information, it looked as if the figures would be relatively good - with M3 growth perhaps about 1%. If the estimate available next Wednesday turned out to be favourable, then a 1% reduction could perhaps be justified on the following day. If, on the other hand, the estimate was less good, and if nonetheless it were considered desirable to reduce MLR, then this would probably have to wait until after the banking figures were announced the following week - i.e. until the following Thursday.

The following arguments were adduced in favour of an early reduction. First, it would improve the funding prospect in the short run and therefore help the February banking figures which were due for announcement on Budget Day. Second, it would provide a useful psychological boost to industry at a time when there was evidence that some manufacturers were beginning to "give up" on their exports. Third, it would help reduce the exchange rate, or at least reduce some of the current upward pressure. Fourth, the real level of interest rates was now substantially positive, and a reduction could be justified and was desirable in its own right.

On the other hand, there were some important arguments against. First, unless the funding programme was going particularly well, a reduction prior to the Budget would look premature. Second, it could make the Chancellor's Budgetary task more difficult insofar as it might increase the pressure on him to restore the credibility of the monetary strategy. Third, there was a risk that a reduction before the Budget would be misunderstood, because this would be in advance of a restatement of the monetary strategy and in particular new targets and the fiscal measures needed to meet them.

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It was agreed that the pros and cons of an early MLR reduction, and its precise timing, would have to be considered further. If it was decided to move, it would be essential to present it in such a way that it was seen as consistent with the Government's future thinking on the monetary strategy; and some indication of the latter might have to be given. In this context it was suggested that the following points might be made: first, that the real extent of monetary pressure had been greater than the M3 figures suggested; second, that this was reflected in the lower figures for some of the other monetary aggregates; third, that the Government would be paying greater attention in future to these other aggregates; and fourth, although this would be a significant change - that the MLR reduction was being done partly to reduce the upward pressure on the exchange rate.

I am sending a copy of this letter to Tim Allen (Governor of the Bank of England's Office).

J. P. LANKESTER

John Wiggins, Esq.,
H. M. Treasury.

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