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26/11

Subject

cc memo

NOTE FOR THE RECORD

The Prime Minister held a meeting with the Chancellor of the Exchequer, the Financial Secretary and Sir Douglas Wass at 0900 hours today to discuss the proposal for the introduction of a restricted indexed gilt (RIG).

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 RIG. The Financial Secretary believed we should introduce an RIG straightaway. He himself felt there was a good intellectual case for such a move, but he still had some anxieties about how the markets would react - particularly at a time when we were trying to de-index expenditure. He felt there was a stronger case for concentrating on marketing methods; and if he could be confident that he could get an undertaking from the Governor to pursue improvements in this area, he would be disinclined to introduce an RIG.

Sir Douglas Wass said that an RIG could have the following benefits: it could result in a small real reduction in the cost of borrowing because of the lower risk being borne by the lender and it would involve a lower nominal cost, prior to redemption, because of the low coupon. The Financial Secretary added that there was a third benefit - namely that, assuming inflation turned out to be lower than what the market expected, there would be substantial real savings. Per contra, to continue excessive reliance on conventional funding would, in this situation, make such funding very expensive. Sir Douglas commented that this third benefit was very uncertain; and if inflation turned out to be worse than the market expected, the RIG would be very expensive. He added that, in his own view, the introduction of an RIG could be expected to reduce interest rates generally slightly; but this would be offset by unfavourable effects on equities and the ability of companies to resume rights' issues - this was because private sector companies could not afford to offer indexed debentures themselves.

The Prime Minister said that she was in favour of introducing the RIG (though she did not want it to be known by these initials). In so far as it would help with the funding problem and reduce interest rates, it should be beneficial. She understood that it would be necessary for it to be auctioned, and that the Governor would be prepared to introduce it on this basis if so instructed. It would be right, in her view, to press him to move towards an auction system for conventional stocks at the same time.

Sir Douglas Wass said that a general system of auctioning would involve major institutional changes. In particular, the jobbers would not have the resources to cope with the increased price volatility that would follow from an auction system. A new system of underwriting would have to be devised instead. The Financial Secretary added that such a change would involve a major market upheaval; it would interrupt the funding programme and at least in the short term make funding more expensive.

In conclusion, the Prime Minister said that she and the Chancellor should press the Governor, when they saw him tomorrow, to introduce an RIG by auction; they should also press him on the question of moving to auctions more generally, although she understood that the chances of success on this front for the time being were not great. The question of the timing of the announcement of the RIG should be considered by the Treasury in the course of today; there was the option of either announcing it forthwith, which would help the February banking figures, or announcing it in the Budget which might be more attractive politically.

The Prime Minister also said that she would like the Treasury to provide her with a note on how they saw the prospects for funding in banking February.

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27 January 1981