cc Mr. Hoskyns
~~Mr. Vereker~~

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~~Prime Minister~~ ①

Yes - Content for Alan to pursue these discussions? Or would you like the Chancellor to present the options at X to you?

MLS 2/4

PRIME MINISTER

CONVERSION 1982

1. Just 50 years ago, Neville Chamberlain carried out the largest and most successful conversion operation in financial history. It was also, incidentally, a great political coup. The circumstances were not too dissimilar from those of 1982. Britain was emerging from a deep recession. Then, however, there had been a substantial deflation and the price level was still falling. The real interest rates on debt with a 5% coupon were very high - probably 9%. Chamberlain's coup was to convert to irredeemable low coupon stock and "relieve the Exchequer of a great burden".

2. Of course, 1982 is very different in one respect. We have a continuing but rapidly falling inflation. However we do have a large quantity of longish gilts with yields around 14%. Our basic funding instrument is still the long-dated conventional gilt.

3. The real interest rate on these conventional gilts depends on the rate of inflation, say over the next five years. But the expected rate of inflation depends critically on whether or not we are returned to power at the next general election. If we do come back, then I would conjecture that the average inflation rate is likely to be in the region of 5 or 6% over that period. I suspect that that prognosis is probably lower than the views of most people. But perceptions are changing quite rapidly in a downward direction. Alternatively, if we lose the election, then there is a chance of either an SDP or Labour Government or some coalition. Then I suspect the inflation rate would jump markedly and perhaps be of the order of 10 or 12% (or even more with a left wing Labour Party in power).

4. The important point, however, is that, if we win, the real rate of return on financial assets like gilt edged securities purchased today, will be over the next five years round about 8 or 9%. This compares with a yield of 2½-3% on indexed gilts. (On the other hand, if there is an inflation rate of 12% then of course the holder of conventional gilts will suffer compared with the man who holds indexed gilts.)

/5. For obvious

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5. For obvious reasons I believe it is important that our present policies be framed on the assumption that we win the general election. Then there is a prima facie case for a substantial conversion operation. If we do not convert to reduce these real yields, then there will be a considerable diversion of resources into the coffers of the gross funds which are predominant in holding long-dated conventional gilts. I do not think this is desirable in terms of the distribution of resources, and it is, of course, financially embarrassing.

6. Granted that we should consider conversion, there is a large number of options and programmes which are open to us. Although I have spoken so far only about indexed gilts as an alternative to conventionals, ~~there are many~~ other instruments such as the variable rate bond, the call option, drop-locks and no doubt many others yet to be devised. Similarly, there is a large number of ways of implementing this programme. One might simply stop issuing conventional stock and push indexed gilts or variable rates. Alternatively, one might offer optional redemption arrangements on existing stock. Similarly, the appropriate timing and sequencing has to be chosen with care. But all these are details which can be debated and thrashed out at a later stage.

X

7. However, I am quite convinced that we should not ignore the possibilities of reducing real interest rates over the next Parliament from around 8% to around (say) 3.5-4% on a substantial fraction of government debt. Consequently I have already alerted Peter Middleton, Eddie George and John Fforde to my thoughts on conversion operations. They see the strength of the case. The Bank, however, are ~~understand-ably~~ predictably reluctant to take steps which they would regard as dramatic.

8. As you will readily surmise, the gains from a conversion operation would come from a situation where the price of conventional stocks is low and the yields are high. In view of the likelihood of a fall in American interest rates during this year, it may well be that the opportunity will be lost if we delay too long. In markets the fleeting moment must be grasped lest it be for ever lost.

9. I will keep you informed of the progress of these discussions.

AW

2 April 1982 ALAN WALTERS