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24 July 1981

T Lankester Esq
Private Secretary
Prime Minister's Office
No.10 Downing Street
LONDON SW1

a Mr Walters

Dear Tim,

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FUNDING

We shall be sending over the papers for the Prime Minister's Monetary Control Seminar. But you may like to have separately a report on the work of the Treasury/Bank Committee on funding which the Prime Minister asked about in her minute to the Chancellor of 4 June. The Committee (of which Alan Walters was a member) reported to the Chancellor in February.

The report showed that the record on funding over recent years has been better than is frequently supposed. The Bank has shown that it has some flexibility over a period of months to vary the pace of funding in response to changing monetary prospects. But we cannot rely on variations in the quantity of debt sales alone either to deliver precise control of £M3 on a monthly or even quarterly basis or to offset major variations from forecasts in its counterparts, the PSBR, bank lending and externals. Beyond a certain point the cost, already high, would rise sharply in terms of interest rates and of the public expenditure burden of servicing the debt. Nor can we forecast accurately what proportion of gross debt sales will be to the non-bank public as opposed to the banking or overseas sectors.

However, although there are limitations on what it is sensible to expect from debt sales, the Committee attach great importance to increasing the flexibility available. Considerable progress has been made on this:

i) The Bank has increased the flexibility of its operations, for example its pricing policy on non-tap stocks.

/ii) One of these new

ii) One of these new instruments is "tranchettes", small quantities of existing stocks which are not treated as an official tap stock.

iii) Indexed gilts sold in a new way - by auction. This is new territory and the first IG was sold at what now looks to have been an unrealistically low yield. This led to some surprises with the second IG and we were criticised for conceding an excessive real yield. But it now seems generally recognised that without it we could not have sustained our funding programme by selling £1bn of stock with short rates and US rates rising and with the exchange rate weak. The yield of up to 3 per cent real has to be compared with current nominal yields on long dated conventional stock of about 15½ per cent.

iv) Issues of convertible gilts can also help in difficult circumstances. We had a successful one in January and may have another later in the year.

v) The National Savings initiative has been a success. We more than achieved the target for 1980-81 and have already got two-thirds of the original 1981-82 target of £3bn in the bag, though conditions in the rest of the financial year for National Savings, as for gilts, are likely to be more difficult than they were immediately after the Budget. We shall be announcing before the Recess that everyone will be able to buy indexed certificates from September onwards, thus raising our target for 1981-82 to £3½bn. (A significant part of the extra £500m will be at the expense of the Building Societies and this may produce an earlier move on mortgage interest rates than would otherwise be necessary. But the Societies would in any case blame increased competition from National Savings for any move they decide to make.)

This useful progress has been made within the present framework and has been generally welcomed. Outside that framework there remains the possibility of a wholesale move to a system of auctions and the Committee considered this. But such a change would involve major uncertainties and probably some disadvantages (greater cost and perhaps a smaller market). It could not in any event be made overnight because it would require a major restructuring of our securities market. We do not recommend such a move. But this does not mean that the present institutional

/structure is sacrosanct.

structure is sacrosanct. The Chancellor has asked the Treasury and the Bank to keep a close eye of developments that are already happening in response to the reference of the Stock Exchange to the Restrictive Practices Court or as a result of market forces.

Meanwhile a useful internal institutional change has been made. The Financial Secretary now holds periodic meetings with the Bank, the Government Broker and the Department for National Savings as well as Treasury officials to consider the broad issues of funding policy over the coming months in addition to taking operational decisions on individual debt instruments.

Yours

John

A J WIGGINS
Principal Private Secretary