B/F next time in A Walters is here

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AT 21/5

10 June

PRIME MINISTER

Funding Strategy

Alan Walters has suggested that the Treasury undertake a review of strategy and tactics for funding - see his minute attached. I have spoken to both Peter Middleton and John Redwood (who now represents No.10 at the Treasury/Bank funding meetings). They both feel that what Alan is recommending is already going on. The Treasury are looking at a number of issues relating to funding - in what circumstances, if any, it is appropriate to sell long dated gilts; whether there should be an effort to convert outstanding long gilts into indexed gilts; what are the implications for the way in which gilts are marketed ~~and~~ of the changes now taking place in the stock market. When auctions of gilts were considered, a major objection was always that there were not sufficient, adequately capitalized, market makers to cope with the swings in price which auctions would produce, but this lack is now being made good as the jobbers join forces with larger institutions.

Alan's minute also gives the impression that the method of selling gilts has survived unchanged from the 1960s and 1970s. This does not give credit for the substantial changes in instruments and methods of sale which have taken place since 1979 and which have improved our funding effort:

He will know this because of our insistence to him about it

- part payment of gilts
- minimum price tenders as opposed to fixed price offers
- IGs, sold by auction
- tranchettes as opposed to full sized taps

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- convertibles
- greater willingness to adjust the price of tap stocks
- a facility to borrow stock from the National Debt Commissioners to meet demand for stock not held by the Bank
- greater emphasis on short dated stocks
- greater emphasis on National Savings and asset sales as alternatives to gilts

In these circumstances I do not think we need to minute the Treasury to put Alan's suggestions to them. John Redwood and I will follow progress on the Treasury work and report from time to time.

AT

Andrew Turnbull

18 May 1984

cc Mr Wiggett

PRIME MINISTER

FUNDING STRATEGY

I expect that real interest rates will continue to be, in historical terms, high for the next two or three years. We can do little about that. The world capital market will be dominated by the extraordinary United States demand for credit. I see little sign of that waning over the next two or three years.

Our basic funding strategy and tactics were developed over the late Sixties and Seventies. This was a period when we had negative real interest rates. Thus the Bank developed the "Duke of York" technique. It put interest rates up sharply and suddenly, and thereafter allowed a gentle fall in interest rates over the next year. This gave a sure-fire capital gain to the bond holder who bought when the price was low, provided he got out before the next interest rate rise.

It was argued that a sure-fire capital gain was the only way we could sell gilts. The active traders made capital gains and the long term holders, or those who were not so fleet of foot, lost out. The prospective capital gain, however, always kept the active traders punting.

Now, and indeed over the last two years, the situation has changed dramatically. Today the real rate of return on gilts is about 5%, before tax. No longer is it negative, nor is it likely to be negative over the next few years and, as I've argued above, it is likely to be much higher than the historical normal rate of about 2½% or 3½%.

We have, therefore no need to consider "Duke of York" tactics. They are clearly inappropriate when the holder of gilts is getting 5% real. In principle this enables the Government to withdraw further from an active policy in the short term credit markets.

I suggested to the Treasury that they should consider the need for a new strategy and tactics for funding. It is a large issue which spills over into virtually all aspects of financial policy.

I would like to participate at some stage. However, in view of our discussion yesterday about the interest rate policy, I thought I ought to tell you of my general thoughts and of my suggestions to the Treasury. It is likely that the Chancellor will talk to you about this during one of your normal meetings.

I will talk to Alan
next time he is over.
Please allocate enough
time
MT

ALAN WALTERS
9 May 1984