8.25

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Prime Minister (1)

The Chancellor considered a slightly more aggressive set of rates but decided against them in order not to give the building societies a pretext for going still higher – many are already set ~~at~~ mortgage rates over 12½ per cent.

Agree Chancellor's proposals?

AT 19/7

Yes md

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

19 July 1984

Andrew Turnbull Esq
10 Downing Street
LONDON SW1

Dear Andrew

NATIONAL SAVINGS

As Adrian Ellis's letter of 18 June outlined, National Savings results so far are well below the trend necessary to hit the funding target of £3 billion for 1984-85. But we judged it prudent not to take the initiative in improving the terms on National Savings until the building societies had moved their rates.

The Chancellor has decided that we ought now to move. The building societies announced last Friday an increase of 1½ per cent in their ordinary share rate, along with the increase in the "advised" mortgage rate to 12½ per cent. Since then, it has become clear that the societies' premium rates are likely to rise by rather more than 1½ per cent net. In setting the new National Savings rates, we need to take account both of the higher building society rates and also of the 3 percentage point increase in the banks' deposit rates, coming on top of the ½ per cent increase at the beginning of May.

The new rates would start to come into effect over the next week or so, and the proposed increases are broadly in line with those already made by the banks and the building societies. The rates the Chancellor has in mind are:

	%
National Savings Certificate	9.0
Income and Deposit Bonds	12.75
INVAC	12.0

In order to make clear that the recent rise in market rates will, we hope, be short lived, it will be stressed that the current certificate is being suspended and that the new certificate is temporary and may be taken off without notice. The Chancellor does not believe that the move will be seen by the building societies as unduly aggressive.

Subject to the Prime Minister's views, the Chancellor's intention is that the new terms should be announced tomorrow (Friday).

Yours ever
David

D L C PERETZ
Principal Private Secretary

cc NO
File

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FROM: L WATTS
13 July 1984

1. MR LANKESTER ✓ I endorse these proposals - see my note at the end. JL

2. ECONOMIC SECRETARY

cc PPS/Chancellor
Sir P Middleton
Mr Cassell
Mr Sedgwick
Mr M Hall
Mrs Lomax
Mr Culpin
Mr Standen
Mr Hood
Mr Ridley
Mr Gilbert) DNS
Mr Patterson)

NEW TERMS FOR NATIONAL SAVINGS

This submission seeks your agreement to new terms for most National Savings instruments, following today's announcement by the Building Societies Association.

Background

2. The advised mortgage rate is being increased from 10.25% to 12.5%. The advised ordinary share rate is being set at 7.75% (from 6.25%). Premium rates are likely to be adjusted similarly, to between $8\frac{3}{4}\%$ and $9\frac{1}{4}\%$.

3. National Savings inflows (which were fair in April) have been disappointing in May and June, as have those for the building societies. The National Savings contribution to funding at end-June is put at £575 million, instead of £750m required to stay on course for the target of £3 billion. The forecasts for National Savings pointed to a worsening trend on unchanged competitiveness with building societies; National Savings might take perhaps £1 billion by end-September, two-thirds of the amount required to be on course for the target then, despite the package of minor measures announced in Mid-June to which there has been a mildly promising response.

4. In 1984-85 the PSBR is front-end loaded and so too should the National Savings contribution to funding it. But at the moment the National Savings contribution is well below even the required

uniform monthly inflow rate over the year. An improvement in competitiveness is obviously necessary. Table 1 attached gives a forecast of actual National Savings inflows over the next three months, that is, without adjusting for any seasonal influences which may be affecting inflows over the summer. It is very difficult to estimate pure seasonal effects on National Savings inflows, as this involves removing the effects of policy changes which may also tend to have a seasonal pattern. It is likely that seasonal inflows are low over the holiday season but we think that the effect of this is insufficient to affect our judgement that the National Savings products need to be made significantly more competitive to reach the £3 bn target. Furthermore the front end loading of the PSBR suggests that National Savings inflows should be high over the next few months, contrary to the normal seasonal pattern.

5. National Savings products are not all performing equally badly; indeed, the 27th Savings Certificate is doing moderately well. But the gross interest products (Invac, Income Bond and Deposit Bond), which will assume a new importance next year when composite rate tax is applied to the banks, are suffering. This probably reflects:-

(a) building society increased competitiveness on money at short, or no, notice for relatively large deposits;

(b) continutation of lost National Savings competitiveness from last summer when we increased our terms (except for the Savings Certificates) by significantly less than the building societies, and maintained that position this Spring when interest rates were last changed.

And in the more recent past, the banks have been fighting back in responding to building societies' competition by increasing their rates for 7 day deposit and premium rate money.

6. The building societies remain National Savings' principal competitor and in deciding on the movement in National Savings rates the advised rates announced today should be the main yardstick. As indicated earlier, maintaining the relative competitiveness of National Savings, as evidenced by recent results, would probably

mean National Savings falling a long way short of its funding target. We take the view that the increase in building society rates should therefore be more than matched. Another consideration is that the banks have increased their competitiveness vis-a-vis the societies; bank deposit rates have recently been increased by 3%, while those of the societies by only 2.1% (in grossed up terms). In our view this is another reason for exceeding the increase in rates announced by the societies. The question is how far above the building societies' increase should the National Savings increases be?

7. We see two main options:-

(a) to recover a significant element of lost competitiveness; broadly speaking, to increase all the main products by <u>0.5% net</u> more than the building societies' move, rounding the gross products up to the nearest 0.25%: or

(b) a more modest adjustment shaving 0.25% off the rates in the more positive approach.

The resultant rates from both options are set out in Table 2. Under either option the 27th National Savings Certificate would be replaced.

8. The following arguments favour course (a):-

(i) greater certainty of inflow and target achievement; our calculations suggest that this package should certainly enable us to meet the target;

(ii) a bigger contribution as early as possible, helpful for PSBR purposes;

(iii) thus some easing of pressure on gilts, when the market sees National Savings taking it share of the funding burden.

9. Course (a) could be seen as rather aggressive, and may be interpreted by the market as a sign of high (13%) rates and anxiety. But against that, this is what is needed to get the funding and there is much else going on so that this may pass unnotived. Given current uncertainty we suggest there is little harm in exceeding

the £3bn target if that should occur. We may be glad of the extra receipts; and with the bias on the variable rate gross products we have scope to act quickly if necessary. Course (b) lessens the disadvantages but our calculations suggest that course (b) might leave us undershooting the target and leaves us open to the risk of having to increase National Saving rates again, which could be very difficult to do.

10. Our firm preference would be to opt for course (a).

11. As to the individual products, assuming you endorse course(a), the following would be the new terms:-

(i) National Savings Certificate: Once the new 28th Issue is announced with its higher yield, the current 27th Issue is virtually moribund. There will be no last minute surge of sales (as can occur when there is a prospect of an Issue being replaced by a lower coupon Certificate). The new Certificate, on either proposed rate, would offer the biggest coupon since 1982, and there will be a sizeable differential (1.75%-2.0%) over the 27th's yield. Some switching is inevitable, particularly from the 27th Issue with its sales of £300m; some 30% of which is maximum holding probably in the hands of higher rate taxpayers who will normally want to hold on. For the earlier issues, the rate of growth of interest should act to hold in savers who in many cases will have in sight annual yields of 9% or more which would be lost on switching. In the absence of an attractive certificate those who want to switch would go outside National Savings. The 27th Issue will be left on sale until just before the 28th is launched on Monday 6 August. The overall yield of the 28th Issue would be 9.25%, compared with the 7.25% over 5 years on the 27th Issue. We suggest a maximum holding of £5,000. The rake on the 28th Issue will follow the usual slope. New Common Extension Terms will also follow and the rate for CET will be fixed at 8.76%, about one-half per cent below the rate on the new Certificate.

(ii) Invac: The interest rate would rise from 9.25% to 12.25% . Invac funds are fairly liquid (money at one month's notice) but the large Invac stock of about £5 billion must be defended, and Invac has been faring very badly recently. The new rate would apply from 30 July.

(iii) Income Bond: The net monthly inflow has been halved since the rate was reduced on 3 May. The funds raised through the Bond represent good quality funding and the hope is to restore the Income Bond to the star performer it was prior to May. The present rate of 10% would be increased to 13.0%. Six weeks' notice of a change of rate is required with the new rate applying from 30 August.

(iv) Deposit Bond: The same rate as for the Income Bond will apply to this instrument, and the new rate effective on the same date. Inflows may be improved, without any extra staffing cost, if the minimum deposit/balance is reduced from £500 to £250. This would also set up the Bond to attract money diverted from the banks on the approach to the implementation of composite rate tax.

(v) Yearly Plan: The same relativity with the conventional National Savings Certificate originally set should be maintained. The new rate would then be 9.3%, effective from the date of announcing the package. DNS attach importance, in the light of the very recent launch of this instrument, to making the change immediate.

12. Premium Savings Bonds

It is now 4 years since the prize fund interest rate was last set and over 3 years since the number of monthly prizes and the odds were fixed. The opportunity should be taken to announce in the context of the proposed National Savings package an increase in the rate of interest in the prize fund (currently 7%). If you decide in favour of our recommendation, we suggest a new rate of 7.75%. Three months' notice is required for a change in the prize fund, so the changes would take effect from 1 November. The intention is only to announce the interest rate change in the package and to publish the details later after Ministers have seen them. DNS will contain any manpower implications from this change from within the manpower limits fixed in PES 1984. Although the change should be good in terms of DNS image, it has to be recognised that we do not look to this particular proposal for a large contribution to funding.

13. Timing

The National Savings response to the building societies' increases should be announced as soon as possible in order to avoid conjecture about the Government's reaction. The timetable requires your decision over the weekend and early clearance with No 10. If DNS can have Ministers' decisions no later than early on Tuesday 17 July, the timetable of changes suggested above will be met. (The same operational dates would apply in the case of the more modest package.) The aim is to have a public announcement of the package in the afternoon of Tuesday 17 July. I therefore attach a draft letter to No 10 advising the Prime Minister of the proposed package. The draft can serve whichever package you prefer.

14. Conclusion

We recommend that a new National Savings package be announced on 17 July. While we recognise the sensitivities attached to the more positive package, that is the one which we recommend. On our best figuring that package should certainly achieve the £3 billion target. The more modest package might achieve the target, but equally may undershoot by a small margin. In addition to the changed interest rates which we suggest, we should also be grateful for your agreement to make the change to the Premium Savings Bond interest rate, and to the minor change on the Deposit Bond minimum purchase.

15. This submission has been agreed with DNS.

L WATTS

National Savings rates clearly need to go up by more than building society rates if we are to get back on track to meeting the £3 billion target. The question is how much.

DNS have done an analysis of the past monthly performance of the various NS products, taking into account the differentials that have existed between NS and building society rates. Based on this analysis, and taking into account the point that there may be some seasonality in NS flows, there is a reasonable prospect that with the less aggressive package (ie 7(b) above) we would meet the £3 billion target. Nonetheless, I would still recommend the more aggressive package (ie 7(a)) for the following reasons:

(i) bank 7-day deposit rates have gone up by 3 per cent - considerably more than building society rates; and high interest money-market accounts are spreading rapidly. This greater competition from the banks cannot be ignored. The 3 per cent increase proposed for the gross products would match the banks' deposit rate increases.

(ii) Assuming interest rates now stabilise, and if National Savings inflows failed to pick up adequately, it would be very difficult to raise NS rates again. To do so would be damaging to interest rate expectations. On the other hand, if it turns out in a few months time that we have over-done it, we could always reduce NS rates.

(iii) In view of our current difficulties and uncertain funding prospects - including uncertainties relating to BT - there is a good case for achieving much better NS inflows in the short-run and erring on the side of exceeding the £3 billion target for the year. We can consider how sacrosanct the target is if and when it looks as if we are likely to exceed it.

The main risks are that the package will be unwelcome to the building societies and banks, and that it will be taken as validating or perhaps more than validating - the rise in market rates. But I doubt whether the extra $\frac{1}{4}$ per cent on each of the products compared with the less aggressive package makes much difference in either respect. And the markets should be impressed that we are taking firm action to improve NS performance. There is also, of course, the cost argument, especially in respect of the certificate when we are potentially locked in for 5 years. But in current circumstances I think cost arguments are over-ridden by the need for more quantity.

DNS endorse these proposals. I have also discussed them with the Bank. They are strongly in favour of the more aggressive package, except that they would like the INVAC rate to be higher still at 12½ per cent. Their main argument is that even at 12½ per cent, INVAC will be slightly less attractive than the grossed up rate for 1 month building society deposits of 12.85 per cent (see table 2). Our view is that 12¼ per cent for INVAC is sufficient because -

(i) much of the INVAC money belongs to non-taxpayers; to that extent, the above comparison with building society rates is invalid.

(ii) INVAC has done well in the past without exactly matching the grossed up building society rate. What we are proposing already involves a significant narrowing of the differential - from 1.4 per cent to 0.6 per cent.

(iii) we do not want to narrow the differential between the income and deposit bonds and INVAC. If we do so, potential income/deposit bond money will find its way into INVAC, which is in PSL2 and worse quality funding.

TL

T P LANKESTER

Table 1

NATIONAL SAVINGS NET INFLOW 1984-85 (£ million)

CALENDAR MONTHS

	OUT-TURN				FORECAST				TOTAL
	APRIL	MAY	JUNE		JULY	AUG	SEPT		APR-SEPT
NSC FIXED INTEREST	101	111	85		83	83	80		543
NSC INDEX LINKED	-23	-32	23		-14	-17	-13		-76
INCOME BONDS	85	66	54		55	60	55		375
DEPOSIT BONDS	17	14	10		12	14	14		81
NSB INVAC	50	5	3		2	7	7		74
NSB ORD	1	-1	-3		-1	-1	-1		-6
YEARLY PLAN	N/A	N/A	N/A		NIL	4	7		11
PREMIUM BONDS	9	9	7		6	6	6		43
SAYE	-1	NIL	1		NIL	NIL	NIL		NIL
BSB	-1	-5	-11		-1	-19	-1		-38
TOTAL	238	167	169		142	137	154		1007

TABLE 2

COMPARATIVE INTEREST RATES

Grossed up for basic rate taxpayer or pre-tax (tax-free or net of basic rate tax)

National Savings	Current Rates	Possible Increases: Pro-rata to building societies	Course A	Course B
Income Bond	10.0) with effect) from	12.25	13.0	12.75
Deposit Bond	10.0) 3 May 1984	12.25	13.0	12.75
Invac	9.25 w.e.f. 2 April 1984	11.5	12.25	12.0
Conventional NSC	10.4)27th Issue)wef	12.5	13.2	12.9
(tax-free)	(7.25)5 April 1984	(8.75)	(9.25)	(9.0)
Building Societies (majors)	**Current Rates**	**New Rates***		
Ordinary share	8.9)	11.1		
(net)	(6.25))	(7.75)		
7 day money	10.4)	12.5)		
(net)	(7.25)) with	(8.75))		
1 month money	10.7) effect from	12.85) estimated		
(net)	(up to 7½)) April 1984	(9.0))		
3 month money	11.4)	13.2)		
(net)	(up to 8))	9.25)		
Bank 7 day deposit	5.75%-6.0% wef 9 May	6.5%-6.75% wef 6 July	8.75%-9.0% wef from 12 July	

Conventional gilts

	(at close [illegible]2/7/84)	
Short	12.773	5 years
Medium	12.426	10 years
Long	11.778	20 years

*The advised share rate announced on 13 July is 7.75%. Consequential new premium rates will be decided by individual societies later. The above premium rates are estimated.

CW

AFTER-TAX REAL INTEREST RATES PAID ON SELECTED FUNDING INSTRUMENTS Table 3

% per annum

	Income bond + (13.0%)	Invac + (12.25%)	28th issue NSC * (9.25%)	Index-linked certificate*	1988 high-coupon gilt*	1987 low-coupon gilt*	1988 indexed gilt*
3 percent inflation							
Zero marginal tax rate	10.0	9.25	6.25	3.5	9.6	6.6	6.2
30% marginal tax rate	6.1	5.6	6.25	3.5	5.6	5.6	5.5
60% marginal tax rate	2.2	1.9	6.25	3.5	2.0	4.6	4.8
5 per cent inflation							
Zero marginal tax rate	8.0	7.25	4.25	3.4	7.6	4.6	5.9
30% marginal tax rate	4.1	3.6	4.25	3.4	3.6	3.6	5.2
60% marginal tax rate	0.2	-0.1	4.25	3.4	0.0	2.6	4.5
7 per cent inflation							
Zero marginal tax rate	6.0	5.25	2.25	3.3	5.6	2.6	5.6
30% marginal tax rate	2.1	1.6	2.25	3.3	1.6	1.6	4.9
60% marginal tax rate	-1.8	-2.1	2.25	3.3	-2.0	0.6	4.7

+ variable rate

* held to maturity

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DRAFT LETTER

Andrew Turnbull Esq
Prime Minister's Office
10 Downing Street
London W1

NATIONAL SAVINGS

As Adrian Ellis [my] letter of 18 June outlined, National Savings results are badly down on the trend necessary to strike the funding target of £3 billion for 1984-85. We had previously judged it prudent not to take the initiative on improved terms pending the building societies' reaction to interest rate changes which have been occurring in the recent past.

2. The Chancellor has agreed that the time is now ripe, with the building societies announcement on 13 July of an increase of 1.5% in the ordinary share rate, to improve National Savings terms. It is also necessary to take into account the quite sharp increase in banks' deposit rates which have been made much more competitive. He intends therefore to have new National Savings rates announced on 17 July.

3. The new rates, which will start to come into effect from about the beginning of August, exceed, by about half per cent net, the increases announced by the Building Societies Association. This is for a number of reasons:

(a) to be more certain of earlier funding which we need for the front end loaded PSBR, and to get back on to trend to achieve the £3 billion target set for National Savings;

(b) bank deposit rates have increased by 3 per centage points over the last week

(c) to ease any City fears about National Savings not playing its full part in funding in 1984-85.

The Chancellor does not believe the package will be seen as overtly aggressive by the building societies because we are merely restoring some of the competitiveness lost over the last year. Our presentation will centre on the poor National Savings results so far this year and the need to make good the undershoot which we have so far suffered.

4. I should be grateful if you would confirm as early as possible that the Chancellor's proposals have the Prime Minister's endorsement. As I say, the intention is to announce the new terms on 17 July.

16 JUL [illegible]