SECRET

24.8.82

recd from APS 3/9/82

1. Meeting held with [illegible] and EASG.

2. I will talk to the Chancellor in general terms about the difference in approach, and if a further issue of stock is required, in detailed terms as & when required operationally - eg tomorrow for Friday or Tues or Wed next week

THE GOVERNORS

Copies to Mr Fforde
Mr Plenderleith

re-copied

FUNDING POLICY

I attach a note which sets out in some detail the problem we have with HMT on the question of funding volume. (There is also a continuing problem on the question of maturities, which is mentioned only in passing: HMT is also taking an unreasonably restrictive view on this aspect in the light of what was agreed at the 30 July meeting, which did not entirely exclude next-century stock. This is a lesser immediate problem and I should prefer to get the question of volumes resolved first.)

GR 25/8

It is possible that if, after its recent strong rise, the market now becomes subdued the problem will disappear through a substantial underfund from forecast in September. It is perhaps more likely, however, as short rates come down here and possibly in the US, that a buoyant market will re-emerge. It is against that contingency that the matter needs to be cleared up.

If you were content, and given the absence of both Middleton and Monck at HMT, the appropriate course might be for the Deputy Governor to send the note to Wass tomorrow as a basis for discussion between the Governor and Chancellor on Thursday.

24 August 1982
Dictated but not seen by Mr George

L961

FUNDING POLICY

1 Since the 30 July meeting on funding policy between the Governor and Chancellor an important difference of emphasis has emerged between Bank and Treasury over the interpretation of what was agreed.

2 At that meeting the Chancellor agreed with the general aim set out in Middleton's minute of 29 July, which he summarised as to "endeavour to maintain downward movement in interest rates as rapidly, and as far, as was consistent with keeping the target aggregates on course. ... Funding policy should be made consistent with that overriding objective". Specifically he thought that the funding "objectives set out in the latest forecast* and referred to in Middleton's note of 29 July were reasonable". Agreeing, the Governor said: "We should aim to fund in such a way that we avoided any awkward developments in the broad aggregates which could make the interest rate policy harder to pursue". (Quotations from Davies' record dated 3 August.)

3 Broadly speaking, in the very strong market conditions we have experienced for most of the time since end-July, and particularly during the past 10 days, the Treasury has interpreted the policy to mean that we should not risk <u>exceeding</u> month by month the gross official gilt sales figure in the short-term monetary forecast, while the Bank has taken the view that we should, as far as possible, not risk <u>falling short</u> of the forecast of gross sales, and, more importantly in relation to the broad aggregates, of the net sales to NBPS.

4 The respective risks of these conflicting approaches are considered below. The extent of the difference between them is discussed more fully in the Annex on funding arithmetic, but, on plausible but probably extreme assumptions, it could <u>for banking September</u> be the difference between, on the one hand, an <u>undershoot</u> from the forecast of £300 million on gross sales and of around, say, £600 million (=½%+of £M3) on net sales to the NBPS if the Treasury approach is followed, and on the other an <u>overshoot</u> on the forecast

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*Gross sales and net sales to the NBPS of £1,200 million and £500 million respectively in banking August, and £900 million and £725 million respectively in banking September.

of perhaps £400 million on gross sales and about £400 million on net sales to the NBPS if the Bank approach is followed.

The respective risks

5 The Treasury emphasis, as we understand it, starts from the view if an amount of stock is made available to the Bank for sale in a particular month in excess of the amount of gross sales forecast for the month, and if there is market demand for the stock, then the stock will be sold and the gross sales forecast will be exceeded. This view is partly true: it is operationally difficult to refuse at some price to sell to the market stock that we are known to have: declining to deal will simply be taken as a signal that we are looking for a higher price, encouraging yields to fall if the surrounding market circumstances make this credible, quite possibly to unsustainable levels.

6 The Treasury view accepts that if we only have available for sale in any particular month an amount of stock more or less precisely equal to the gross sales forecast, and if we are not able to sell the kind of stock available to us in that month, we will undershoot the forecast. Thus, for banking September our stock "ration" includes £400 million IGs - which we are seeking to sell to take account of the views expressed at the 30 July meeting and elsewhere, on the type of stock the Government wishes to offer - and if, at present relative yields and against the background of falling inflation, there is no immediate market demand for IGs the Treasury interpretation of policy would cause a £300-400 million undershoot on the month. This they would then argue would justify a corresponding increase in the following month's ration.

7 The aim of this approach is twofold: first, to insure against the possibility of an accumulating overfund of the borrowing requirement over "the year" as a whole, to limit pressures in the money market and the extent of any associated NLF balances that may need to be built up at the Bank under the recent legislation; secondly, to restrict gilt-edged funding to the minimum necessary in order to leave as much room as possible for lower yields and corporate debt issues, which in turn could reduce bank borrowing and thereby facilitate broad money control.

8 In the Bank's view this approach is almost certain at some point to lead to a significant shortfall in gross official sales because market demand will not necessarily match the mix of stock (IG and conventionals, shorter and longer maturities etc) which is included within the "ration" for any particular month. And it is likely to lead to a more substantial shortfall in net sales to the NBPS in circumstances such as present where we suspect from qualitative evidence, but cannot demonstrate quantitatively, that gilt purchases by banks and overseas are a good deal larger than is assumed in the forecast on which the "ration" is based. It reduces the flexibility with which, given the market opportunity, we can adjust the funding volume to the emerging situation.

9 The risk is that as a result of such shortfall the broad aggregates will blip, damaging expectations of further declines in interest rates. In that climate particularly - and especially if yields had fallen more than they would otherwise have done, as a result of the shortfall in gilt sales - it may take several weeks while yields readjust upwards to reaccelerate the funding programme.

10 More generally the Treasury approach assumes that a shortfall in one month can be made up by increasing the amount of stock available for sale in the next; it does not provide the flexibility for advantage to be taken of favourable market circumstances to keep ahead of the funding objective in a particular month as a cushion against a subsequent pause in market demand. Operationally, there can be no assurance whatever that, if funding opportunities are passed up, we will be able to fund when that is required by the forecast or that a shortfall in one month will be capable of being made up in a reasonably short period. In this sense there is an asymmetry: the funding tap cannot necessarily be turned on to order, but it <u>can</u> always be turned off if the bath in fact (rather than forecast) begins to overflow.

11 In this context the Bank's approach is to have sufficient, and sufficiently varied, stock available for sale to give the best chance of achieving the forecast funding levels month-by-month, accepting - indeed welcoming - the possibility that this will for the time being keep us ahead of the funding objective for the target period as a whole.

12 This difference of emphasis does not imply different objectives from those set out in paragraph 7 above. With £3,350 million of stock maturing in the first calendar quarter of next year (the revenue quarter) there is more than enough scope to ensure that any cumulative overfund of the borrowing requirement is run off, if that is still then judged to be appropriate, to deliver the objective of a full fund over the period as a whole. Nor would we accept that - except possibly in the very short run - keeping ahead of the game need involve higher yields and less scope for corporate stock issues than the alternative approach: that will depend significantly upon the impact of the alternative approaches on expectations and not solely upon the short-run supply of gilt-edged stock as is amply evidenced by the fall in yields which has occurred this year. Certainly the direct effect of keeping ahead with the funding programme will facilitate broad money control in the short term, and that in the Bank view is more likely to help yields to be sustainably lower.

The issue for decision

13 The practical effect of the difference of emphasis between the Bank and Treasury, while not critical thus far, has already caused us to scale down proposals for prospective stock issues (as well as limiting the proposed range of maturities). More substantial problems could arise if the market is buoyant over the next three or four weeks over decisions about how much stock we should sell from the £635 million portfolio acquired this week from the NSB Investment Fund and about a possible new partly-paid issue. It is for this reason that we need guidance.

14 If the emphasis is to be given to not exceeding the month-by-month forecast of gross sales, the Bank cannot be held responsible for any resulting undershoot of forecast funding levels, particularly in net sales to the NBPS, and hence for any sudden acceleration in the broad aggregates. Nor, as an operational matter, can we be expected to be able to compensate in short order, and without a yield disturbance, for any such undershoot.

15 If the emphasis is to be given, as in the past, to not falling short of the forecast funding levels and to keeping £M3 on track - at least until the degree of conflict between the objectives of a full fund over the year and broad aggregate control becomes clear -

the Bank must have the flexibility in funding volume (and variety of stock) month by month to keep ahead of the game.

24 August 1982

FUNDING ARITHMETIC

1 The forecast funding arithmetic for banking August to banking October, together with as much as is known of the actual funding position to date is shown below -

£ millions

	Banking August		Banking September		Banking October	
	Forecast	Actual	Forecast	First 4 days	Forecast	Call on 10½% 1987
Gross sales	+1200	+1310	+ 900	+ 400	+ 840	+ 450
Next maturity	- 600	- 760	- 100	-	- 440	- 440
Net sales to all-comers	+ 600	+ 550	+ 800	+ 400	+ 400	+ 10
Monetary sector	- 75	- 10	- 50	N/A	+ 25	N/A
Overseas	- 25	-	- 25	N/A	- 25	N/A
Net sales to NBPS	+ 500	+ 540	+ 725	N/A	+ 400	N/A

Between 1 to 2. on Sept ? +1½

2 The effective stock portfolio as at the beginning of this week* consisted of £250 million of IG 2001 for public subscription on Thursday, and £150 million of IG 1988. If, as is possible but by no means certain, there is demand for these IGs, and we sell them out completely in the three remaining weeks of banking September we would need only £100 million of other stock to meet the gross sales forecast for the month. The Treasury suggestion has been that, assuming we buy back £50 million of stock owed to NILO during the month, we should be permitted £250 million of other stock (in the form of tranchettes or of a partly-paid tap stock), envisaging a maximum possible overshoot of the gross sales forecast of £100 million if all the available stock were to be sold, or an undershoot of £300 million if - in the extreme case - we sold no IGs.

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*We subsequently, and unexpectedly, acquired some £635 million of usable conventional stock from the NSB Investment Fund. This does not affect the substance of the argument - the question becoming how far we should sell this stock rather than how far we should create new stock.

3 Even if, on this basis, we were to achieve the gross sales figure for September it is likely (from what we know of the attitude of certain discount houses, from so far only partial analysis of the accepted applications of last Thursday's issue of 10½% 1987, and from market chat) that the banking system and overseas residents bought substantial amounts of stock in last week's euphoric market. While we cannot quantify this, it would not be unprecedented in conditions such as we have recently had for such purchases to run into hundreds of millions of pounds. With gross sales, as above, in the range of £600 million - £1,000 million net sales to the NBPS could then range from, say, £100 million - £500 million.

4 The Bank view would be that we should equip ourselves to meet the gross sales objective - if the market demand were there - even if we were not able to sell significant amounts of IGs. This would involve having some £500 million of other stock available for sale in the rest of banking September. If in the event we did succeed in selling all the IGs as well as this £500 million of other stock the overshoot of the gross sales forecast could be as much as some £400 million and we would have given ourselves a better chance of avoiding an undershoot. With gross sales in the range of £900 million to £1,300 million and assuming, as in the previous paragraph, purchases of £400 million by the banking system and overseas, net sales to the NBPS could range from £400 million to £800 million. If purchases by the banking system and overseas were as small as in the forecast (£75 million) net sales to the NBPS would range from £725 million to £1,125 million.

5 An illustrative range of possible outcomes of the two approaches therefore would be as follows -

	Gross sales	Net sales to NBPS Taking 400 purchases by banks/overseas	Taking 75 purchases by banks/overseas
	Variations from forecast		
HMT	+100 to -300	-225 to -625	+100 to -300
Bank	+400 to =	+ 75 to -325	+400 to = [illegible]

6 The present arithmetic for October suggests that we will need only some £400 million of additional gross sales, but assumes no net purchases by banks and overseas taken together. We will only be able to gauge whether that is a reasonable assumption when October arrives.

SECRET

GILT-EDGED TRANSACTIONS IN BANKING SEPTEMBER £ millions

The table below shows the funding position for banking September to date, compared with the forecast. We made very heavy net sales in the euphoric atmosphere of the first three days of the month (ie the last three days of last week). This week we have cushioned the reaction by buying conventional stocks partly against sales of IGs with the aim of consolidating the present level of yields and thereby encouraging the debenture market.

	Forecast	Actual, up to mid-day 26 August		
Gross official sales	900	350	of which:	
			10½% Exchequer 1987	310
			2% I-L 1988	230
			2½% I-L 2001	50
			Net purchases of other stock from market	240
Purchases of next maturities (-)	-100	-		
Net official sales to all-comers	800	350		
Net purchases (-) by				
monetary sector	- 50	N/A		
overseas sector	- 25	N/A		
Net purchases by non-bank private sector	725	N/A		
Sterling M3	660 (0.7%)			

For sale – £800 m. of conventionals
– £200 I L 2011.

No rationing on what we sell.
If we do sell half of £800 – look to sell partly paid [illegible]
[illegible] of fully [illegible]